# ECONOMIC DEVELOPMENT IN HUNGARY: THE TRANSITION YEARS--1989 to 1998

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## Abstract

*This paper reviews Hungary's progress in transitioning from a centrally-planned, Communist state to a market economy in a democratic society over the decade of the 1990s. Hungary employed a gradualist approach in its transition, experiencing many wrong turns along the way. As of 1998, though, Hungary has, arguably, been the most successful former Soviet Bloc country. With its impending acceptance into NATO and the European Union, its transition will be nearly complete.*

## Introduction

In 1989, Hungary and neighboring countries in the Soviet Bloc, threw off the shackles of Communist Party dictatorship to pursue the difficult road to a market economy and a democratic government (Bartlett, 1997). This paper is a general assessment of how well Hungarians have done in their quest over the past decade.

Hungary itself is interesting for two reasons: (1) Not only did it have to reinvent its economy and government from scratch, but as a small country--land area the size of Indiana and a population as large as Ohio--it has to compete with much more powerful western nations. (2) In contrast to Poland which chose rapid shock transformation from one system to another, Hungary represents a successful more gradualist approach (World Bank, 1997).

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## Background

Hungarians undertook economic development in the 1990s on the legacy of a failed Communist economic/political system.

## Central Planning

Central planning guided economic development under Communist rule in Hungary (Kornai, 1992). Planners in Budapest, the capitol, allocated resources--including everything from sewer and water services through highways to industrial plants and buildings, not to mention education, health and social services--across the country. The Communist Party decided which regions and communities would benefit. Government decision-makers, functionaries, and technocrats, then implemented Party orders.

Two important ministries were economic planning--controlling all aspects of production, and construction--creating the built environment. County/regional governments managed economic development locally according to the plan, with city governments and local party organizations playing a subservient role. Defense, mining, agriculture, gas/oil/electric, and other ministries controlled industries related to their function.

Hungarian industries were large conglomerates, supporting not only worker needs for day care, schools, recreation areas, cafeterias, health care and so on, but also providing necessary infrastructure--including buildings, housing, roads, bridges, utilities and a host of other amenities--to support industry itself.

Occasionally, higher and lower Party organizations, ministries, and industries disagreed with policy, but not often. Generally, elites settled disagreements in private, with subordinates going along to get along. Security forces kept everyone in line.

Communist economics valued mass production, not individual consumption. Industrial production targeted capital goods (e.g., machinery, equipment, tools) and basic steel for use by other industries in production. Hungary used cheap Soviet raw materials and energy resources to produce goods traded back to Russia and other Soviet Bloc countries, as part of a comprehensive plan--Council for Mutual Economic Assistance--coordinating production across the Soviet empire.

Some industries produced for foreign markets either to obtain “hard currency” to pay off foreign debt from borrowing or importing, or to further Soviet foreign policy objectives--propping up Cuba’s, Angola’s, or Viet Nam’s economy, for example.

Communists did not lavish benefits on the population. Consumer goods, including food and clothing, were of poor quality and often in short supply, but usually inexpensive. Picture housing complexes of 50,000 inhabitants with no grocery store or restaurant within walking distance, no paved road or sidewalks, no department stores. Even so, Hungary probably enjoyed more foreign consumer goods than other Soviet Bloc countries.

Black markets flourished, and for many Hungarians were an important source of goods and services they could otherwise not obtain. People met at flea markets on weekends to barter goods. No one hired a construction company to build a house. Houses were built with materials pilfered from state-owned enterprises and by builders moonlighting from state employers. Bribery took care of building permits.

Much of the goods traded on the black market, ironically, were made in state-owned factories. Workers either stole products from factories for resale off the books, or used factory equipment to produce other goods not made at the factory.

Black markets co-existed along side the official market, because Communist Party members were also forced to obtain goods and services from the underground economy. Black marketeers charge high prices, because products are scarce and in demand. As such, black markets rationed goods, benefiting the rich and penalizing the poor.

Industries, not driven by market competition, but by often clueless planners, were highly inefficient. As long as they produced according to plan, no one cared. Industries were managed by Communist Party hacks, appointed for their loyalty to the Party, rather than their competency in management. Industries employed too many people, making very shoddy goods no one really wanted. Workers were poorly paid with little incentive to work, leading to low productivity, absenteeism, alcoholism, theft, and occasionally sabotage. A popular saying among workers sums things up: “They pretend to pay us, we pretend to work.” Industries were social entities: it was common to hear managers say to Westerners: “Our unemployment is inside the factory, yours is outside.”

This economic system performed well at first. Workers, believing in Communism, were willing to make great sacrifices for the cause. Those unwilling to voluntarily sacrifice did so anyway through coercion. Foreign trade in weapons and natural resources brought in hard currency, in Hungary's case, to import consumer goods, in short supply.

As the system became more inefficient, planners robbed productive industries to prop up unproductive ones. When central bank funding was insufficient, firms began borrowing from one another, trading in kind, or delaying payments. Hungary's Communist government borrowed from other Eastern European countries and the Soviet Union--usually in credits, but also from Western banks--always in dollars. Debt soared. Central bankers responded by inflating currency to cover foreign debt. Eventually the system crashed.

## Fall of Communism

The Soviet Union, central to economies of its satellite nations, could not sustain the system and consequently was unable to enforce its will on Hungary and other Bloc countries. In 1989, Communism fell across Eastern Europe, with Hungarians playing a decisive role. East Germans tested Soviet weakness by visiting Hungary ostensibly as tourists, then fleeing across the Austrian border, without Hungarian border guards lifting a finger (EIU, 1997: p. 19). The Berlin Wall fell, allowing East Germans to move freely to West Berlin. In June 1989, Hungarians held a public funeral and re-burial for the leader of the 1956 Revolution, Imre Nagy, executed by the Russians after invading Hungary. Both acts openly defied Russian hegemony in the region.

## Economic Development Context

How does this tie into economic development? *First*, government totally controlled the economy; now a market economy is required. Prices and currency exchange must be liberalized, budget deficits must be reduced, taxation and legal systems must be established, social needs must be met, populations must be re-educated. Black market economies must be eliminated and rule of law established.

*Second*, Hungary, like other Eastern European countries, organized production by inefficient and outmoded state enterprises. New industries must be developed, and existing ones either retooled or shutdown. Industries must become competitive, especially with European trading partners. A marketbased banking system must be developed to drive the economy. Foreign investment is key in a country lacking capital.

*Third, communities existed to benefit industry under Communism. With many industries redundant, communities became redundant as well. Communities must redevelop: housing and retail stores are critical to appease the public, while industries reorganize in a market economy.*

*Fourth, Communists banned private property. For development to proceed, private ownership must be established and guaranteed, then state property must be transferred to private actors. Property, illegally seized, must be returned or compensated for.*

*Fifth, Communism persisted through credit provided by others.* Foreign debt must be repaid, as must bad debt of state enterprises in arrears and public funds--pensions and health care--essentially bankrupt.

*Sixth*, Communist governments are notoriously corrupt, tending to be *populated with opportunists. Those taking advantage under the Old Regime are likely to do so under reformed ones. Corruption must be minimized.*

*This paper addresses Hungary's progress in meeting these economic development challenges in sections below, a propitious undertaking at the end of the first decade of transition and reforms. Before discussing them*, it is useful to briefly look at Hungary's political/economic history that dictates the path of economic development.

## Hungary's Long Transition

To understand the course of Hungary's economic development, it is necessary to follow political events since the 1960s. In so doing, it becomes apparent that reform has been in the making for 40 years (EIU, 1997; Tokes, 1996).

***1956-1967***. In 1956, Hungary, lead by Imre Nagy, unilaterally left the Warsaw Pact, declaring its independence from Soviet domination. The Soviet Union invaded Hungary, executed Nagy, and installed a hard-line Stalinist, Janos Kadar, in power.

***1968-1988***. Amazingly, in 1968, Kadar, General Secretary of the Communist Party, introduced the New Economic Mechanism to guide the economy (Swain, 1992). Referred to as "Goulash Communism," Kadar partially abandoned the Soviet model of economic organization in favor of broad reforms, giving state enterprises considerable autonomy and allowing markets to determine economic decision-making rather than central planners. Following economic reform, agriculture and consumer goods production boomed, improving quality of life, but creating income inequality. Consumer goods imports and high oil prices forced Hungary into debt: political leaders chose to support the population's preference for foreign goods, rather than return to economic austerity. In 1982, Kadar legalized small private cooperative ventures. Throughout the 1980s, Kadar invested in Hungary's infrastructure, making it one of the more modern Eastern European countries. Economic reforms failed to work, having been propped up by increasingly larger foreign debt, budget deficits and state enterprises in arrears. The Communist Party non-violently deposed Kadar in May 1988.

***1989-1990***. Economic reformers gained control of the Communist Party following Kadar's ousting. Believing they would win national elections, Communist Party reformers allowed citizens to vote in a multi-party election for the first time since World War II. Communists lost to a coalition of parties, all representing even more extreme economic and political reform factions. The Hungarian Democratic Forum party, lead by Jozsef Antall, along with the Alliance of Young Democrats, a party with a libertarian free market orientation, and several other smaller parties, took power in March 1990.

***1990-1994***. Under Antall, Hungary created and instituted its basic laws--economic and political--in record time. Hungarian reformers accomplished this feat in months, what Russians have failed to do after a decade of reforms. Although the Antall government accomplished much, it ultimately collapsed, unable to politically enforce economic discipline necessary to privatize the economy, reduce growing budget deficits, and pay off burgeoning foreign debt. It spent a great deal of time fighting with Communist opposition parties. Antall died suddenly in office in December 1993, and that, along with a prolonged economic recession, lead to the re-election of the Communist Party, renamed the Hungarian Socialist Party, in May 1994.

***1994-1998***. An old time Communist Party hack, Gyula Horn, took over Hungary's leadership (PlanEcon, 1998; EIU, 1998). Surprisingly, Horn instituted a stabilization program--the Bokros package, after the finance minister at that time--that reduced social spending, lowered the budget deficit, devalued the forint, controlled incomes, and accelerated privatization (EIU, 1997). In short, Horn, the Communist, behaved more like Britain's Prime Minister Thatcher, in implementing reforms promised by the defeated Hungarian Democratic Forum under the previous regime. Economic reforms were just beginning to pay off in 1996-1997 after three years of austerity, when the electorate interceded once again. Voters were dissatisfied with sacrifice and apparent lack of progress in growing out of recession.

***1998***. In May 1998, new elections were held. The Hungarian Socialist Party was thrown out, and in its place, voters elected the Alliance of Young Democrats, lead by Viktor Orban, and a coalition of liberal parties, including the Hungarian Democratic Forum, to lead the country. Rather than continue reforms of the Horn regime, Orban's government intends to increase social spending, jeopardizing gains made in budget deficit and foreign debt reduction. Hungary is also becoming much more nationalistic, especially in support of oppressed Hungarian minorities in Romania, Slovakia, and former Yugoslav Republics.

## Economic Growth and Development

Hungary's economy appears on the right track, following recession and ineffective policies under Antall and subsequent stabilization under Horn (see Table 1). This could change as Orban's government reverses the course set by Horn. Real GDP has grown to 5% since 1996 and is expected to maintain that level. Inflation is declining annually, but remains too high. Current account deficits--money owed to trading partners--remain high. Foreign debt is high, but appears to be stabilizing. Exchange rates continue to climb. And unemployment has stabilized at 11%. As a result of the transition, more than one-fourth of the population lives at or below the official poverty line. Although the gap between rich and poor is wide, Hungary has greater income equality than other countries in transition (World Bank, 1997).

**Table 1.**
**Key Economic Indicators**

| Economic Indicators: | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|---|---|
| Real GDP growth (%) | -0.6 | 2.9 | 1.5 | 1.3 | 4.4 | 5.0 | 4.5 |
| GDP ($bn) at current prices | 2,408 | 4,365 | 5,494 | 6,845 | 8,341 | na | na |
| Consumer price inflation (%) | 22.5 | 18.8 | 28.2 | 23.6 | 18.3 | 15.7 | 13.5 |
| Current account ($bn) | -4.3 | -4.1 | -2.5 | -1.7 | -1.0 | -1.5 | -3.0 |
| Total foreign debt ($bn) | 24.2 | 28.0 | 31.7 | 27.7 | 23.8 | 23.7 | 24.9 |
| Exchange rate (forants/$) | 91.9 | 105.2 | 125.7 | 152.6 | 186.8 | 216.0 | 231.0 |
| Unemploy-ment rate | na | 11.4 | 11.3 | 10.6 | 11.0 | 10.6 | 10.8 |

## Progress on Economic Development Goals

In sections that follow, successes and shortcomings in attaining major economic development policy goals over the decade of transition are discussed. Data are drawn primarily from official Hungarian government statistics as reported by the U.S. Agency for International Development, PlanEcon, and EIU (Economist Intelligence Unit).

## Privatization

Hungary has successfully privatized 75% of its state-owned enterprises. Only the Czech Republic, Slovak Republic and Albania, among former Eastern European Soviet Bloc countries, have done as well.

Hungary chose its own unique path to privatization (Mihalyi, 1997). In 1988, under waning Communist control, spontaneous privatization was encouraged--workers or managers simply took over smaller state-owned firms. Initial results were that Communist Party members owned newly-privatized firms, while leaving substantial debts for others to pay. In 1989, the State Property Agency (AVRt) was created to oversee the privatization process. Rather than distributing vouchers to each citizen or turning over ownership of large enterprises directly to workers or managers--privatization schemes followed in one form or another by all other Eastern European and former Soviet Republics--the Antall and Horn governments privatized each state-owned firm, on a case-by-case basis. Hungary, unlike its counterparts, also allowed unrestricted foreign ownership. Firms were sold for cash to the highest bidder.

Initially, AVRt moved very slowly, drawing criticism from all sides. In 1990, only 20 large enterprises were sold, and by 1993, only six were fully-privatized and five had gone bankrupt. One reason for delays was that privatization officials had difficulty establishing the value of state enterprises, absence a market economy, and breaking up large conglomerates into meaningful economic units. In early years, 1991-1992, AVRt did have one great success: they forced large enterprises to divest themselves of small units, and nearly 7,000 new small businesses were created.

The Horn Administration in response to public dissatisfaction, in June 1995 combined AVRt with the State Holding Company (AVU)--the agency that holds equity in enterprises--into APV to accelerate privatization. Previously, AVRt and AVU had overlapping responsibilities they pursued in contradictory ways. The merger de-bureaucratized the privatization process, in part, through by-passing entrenched interests ("Privatization," 1997).

As of mid-1998, there are roughly 1.1 million economic organizations, of which 120,000 are incorporated companies, and 800,000 are entrepreneurs, all in the private sector. About 10,000 state-owned shops and small businesses have been privatized, with only a few remaining in public hands. Around 100 larger companies failed to sell as of 1998, making them eligible for management non-cash buyouts. By the end of 1995, 200 companies, employing 75,000 workers, had been privatized through Employee Stock Ownership Plans (ESOPs). Only two other countries--United States and Great Britain--allow ESOPs.

Proceeds from privatization are well over $7 billion, six-sevenths invested by foreigners. In spite of Hungarian privatization achievements, successive national administrations have not mustered courage to complete the process. Fifty state-owned enterprises, including the postal services (understandably) and railways, will remain fully state-owned. APV retains supervisory responsibility for state enterprises. In addition, APV is a minority shareholder--referred to as the “golden share”--in 109 large enterprises giving government considerable control over venture operations.

## Enterprise Governance and Restructuring

Under Communism, there was no need for bankruptcy laws: the central bank simply propped up dysfunctional state-enterprises with transfers from more efficient ones. In market economies, bankruptcy is necessary, if viable enterprises are to replace failed ones and their debt obligations resolved. Hungary has an effective bankruptcy process. Beginning in 1992, bankruptcies soared to over 14,000 as enterprises discovered they were not competitive. Nearly two-thirds were liquidations, the other third reorganizations. From 1993 to 1996, bankruptcies leveled out at about 6,000 to 7,000 annually, with reorganizations declining to a handful, thanks mostly to a 1993 revision in the Bankruptcy Law and an easing of recession.

But Hungary has made less progress in enterprise restructuring compared to gains in privatization. In this respect, all former Soviet Bloc countries have some way to go before government is exorcized from private enterprise. Only 29% of enterprise bank debt, in addition to 60% enterprise debt to the state, has been restructured for pay back among nearly 2,000 large firms.

In 1992, the Antall government designated 14 industries, employing 83,000, as “strategically important,” and therefore, requiring special treatment. The Antall regime invested nearly $2 billion (4% of GDP) in these industries, paying off debt and restructuring operations. As of 1998, seven are profitable, but two are struggling, and five are bankrupt. Not being able to make the leap to a free enterprise system, then, cost Hungarians $1 billion, now unrecoverable from 7 failing or failed enterprises.

Importantly, foreign-controlled enterprises, currently accounting for 14% of GDP, forced reform in governance and restructuring. But they have not marshaled sufficient influence to convince government to allow many large ventures to sink or swim on their own.

## Markets and Trade

Hungary, as is the case with all other Eastern European countries, instituted trade and foreign exchange systems similar to advanced industrial economies. Hungarians gradually removed all quantitative and administrative import and export restrictions and significant export tariffs; allow only insignificant involvement in exports and imports by ministries and state enterprises; institute full currency convertibility; and hold membership in the World Trade Organization as of December 1994. Hungary also is a member of the Organization for Economic Cooperation and Development (OECD) and expects to join the European Union and NATO in the next few months. Hungary still protects some industries--energy and autos--by requiring a license to import.

Hungary, and most other Eastern European countries, lag behind in price liberalization and competition policy. Hungary still maintains some price controls. About 84% of consumer prices are free of administrative manipulation. Hungary tries to reduce abuse of market power and promote a competitive environment. Although government imposed fines of $9.7 million on enterprises, $9 million remains uncollected.

Hungary's balance of payments is in deficit, but remains steady and somewhat daunting ("Hungary's Trade Deficit...," 1998; "National Bank of Hungary...," 1998). In July 1998, its foreign trade deficit widened by $321 million, yielding a accumulated debt of $1.6 billion. Exports reached $12.7 billion, up 21.8% over last year; but imports climbed to $14.3 billion, up 20.3%. Unfortunately, Hungary has few indigenous energy resources--50% of energy is imported; when winters are severe or oil prices rise, deficits soar.

Hungary's major trading partners in exports and imports is Germany, followed by Russia. A country's share of trade is growing, now at more than half: imports are $9.1 billion, an increase of 22.3% over last year, and $9.1

billion in imports. Hungary will be hurt by the economic crisis in Russia, but only in the short term as it weans itself away from this unstable trading partner. Now, only 4% of Hungary's exports go to Russia, and 7% of its imports originate there.

About one-third of Hungary's labor force is unionized, making it difficult for government to control wages. Government tried to hold down wage increases through higher taxes, but labor unions forced them to abandon this policy. High taxes also encouraged black market activity (see below). Government works with industry and labor in a formal council to try to control wage increases, a process not too successful.

## Legal Systems

Economic development depends on an effective legal system, typically measured along three dimensions for transitional economies: enables borrowers to pledge property as collateral for credit, protects rights of shareholders against those of management and boards of directors, and allows debtors and creditors to reach a settlement rather than liquidating a company. These dimensions are contained in the overall effectiveness of commercial law and regulations (ERDB, 1997).

ERDB rated Hungary as highly effective in its commercial law system, a rating similar to the Czech Republic and Poland, but just short of advanced western countries generally. Borrowers are able to pledge property for collateral, with the only shortcoming being that there is not a centralized registry to keep track of pledges. Laws governing companies are defined and enforced for the most part. Liquidators in bankruptcy processes possess a wide variety of powers to reach settlement. The bankruptcy process is slow, however: court cases are heard from seven months to one year, with final judgements from one to two years.

In 1995, Hungary began a five-year program to bring 470 of its laws into full harmony with European Union standards in anticipation of its entry into the E.U. ("Country Presentation: Hungary," 1998, p. 1).

## Finance

The European Bank Reconstruction and Development (EBRD), an investment bank representing European Union (E.U.) countries, rates Hungary above all other former Soviet Bloc countries in its progress toward banking reform and interest rate liberalization (ERDB, 1997). Hungary has adopted international standards and regulations, fostered competition by domestic and foreign banks, incorporated effective supervision into the banking system, and developed effective lending practices for private enterprises.

EBRD's ratings show that Hungary, along with Poland, lead all other former Soviet Bloc countries in developing securities markets and non-bank financial institutions (ERDB, 1997). But both countries have yet to achieve systems comparable to advanced industrial nations. A substantial number of private enterprises issue stock, nearly 200 in 1997, with a capitalization of $12 million. Securities markets are regulated, although not fully to international standards. Secure clearance and settlement procedures are in place. Minority shareholders enjoy some protections. Investment funds, insurance companies and pension funds may invest, but are not yet themselves fully regulated. Liquidity and capitalization remain issues.

Ironically, success of Hungary's transition may have adversely affected the securities market in the short term (Milligan, 1998). Hungary, as is the case with many other countries, experienced economic downturns in summer 1998. Firms in difficulty raised capital on the Budapest Stock Exchange because of Hungary's reputations as a good investment region. This created panic selling causing the market to drop 17%. As of October 1998, it has recovered.

In 1989, government authorized newly-formed commercial banks to handle all banking activities, once solely the state's province (Buss and Vaughan, 1997: pp. 422-428). In 1992, Hungary accepted the Basle Accords, international agreements setting standards for bank operations. In 1994, government re-capitalized banks through equity investment and subordinated loans, in the process, injecting $34 billion or 8% of GDP into private banks. Banks in turn assigned bad debt into special departments to be sold or written off. By 1997, the banking industry had been mostly privatized with government owning about one-third of capital and controlling one-fifth of assets. Foreign investors replaced government, now controlling more than one-half of banking assets. In 1997, banks were permitted to trade in government securities. Hungary insures individual deposits up to $4,600. Today, there are more than 40 private banks and at least 250 savings and loans.

Hungary's banking system appears healthy. Non-performing loans, as a percentage of total outstanding loans, declined from 1993 at a high of 29% to a low of 13% in 1996, a figure lowest among other Eastern European countries.

Interest rates in Hungary are fully liberalized. Government control of interest rates were removed for enterprise borrowers in 1987 and for households in 1992. The central bank uses a full range of monetary policy interventions to influence interest rates. Hungary has a well-functioning interbank money market.

Typically, Hungarian governments cannot resist bailing out moribund enterprises ("Hungary Postabank Loss Reaches $500M," 1998). By September 1998, the state-owned Postabank, had accumulated $500 million in losses, more than twice its capitalization, representing two percent of the state budget. Government acquired Postabank in May 1998, after depositors withdrew $109 million and bailout attempts failed. As of this writing, government promises to keep the bank afloat.

## Black Market

Under Hungarian Communists, successive regimes invested in defense and heavy industry, not unlike their Soviet mentors. As a result, consumer goods were in short supply for the average Hungarian, as well as Party members. Artificial consumer goods shortages, precipitated by central planners, were alleviated by black marketeers willing to risk imprisonment to earn high returns in the underground economy. Old habits are hard to break: About one-third of the Hungarian economy, as measured in percentage GDP, is in the black market, persisting at this level since 1989. This rivals black market economies in the former Soviet Republics. With the exception of Bulgaria, other Eastern European countries have black market activity only one-third Hungary's.

No one knows why black markets persist in Hungary to a greater extent than in other Eastern European countries. One explanation is that Hungarians cannot tolerate high taxes imposed by governments they do not fully support.

Consequences for Hungary of such a large underground economy are two-fold, one positive, one negative. On the positive side, businesses without much start-up capital can develop and grow outside government's reach. By definition, they supply goods and services not available or over-priced in regulated markets. On the negative side, black market ventures deprive government of much needed tax revenues to reduce budget deficits and fund public services.

## Foreign Investment

Until 1998, when Poland surged ahead at $20 billion, Hungary had attracted more cumulative foreign direct investment--nearly $19 billion--than any other Eastern European country and far more than Russia. The United States--at 40%, Netherlands and Germany are the top investors, although there is a sizable presence from Cyprus, Israel and Austria.

Seven-tenths of foreign direct investment flows into greenfield sites, ostensibly for two reasons: (1) avoidance of the requirement to form joint ventures when acquiring an existing Hungarian firm, and (2) necessity to create new industries from scratch, many of the Communist ones being obsolete or environmentally problematic.

Almost half of foreign direct investment flows to Budapest. National government ministries, major banks and foreign embassies, all in Budapest, make it difficult for foreigners to stray into other parts of the country.

Manufacturing, transport and communications attracted more than 60% of investments. Finance also held a large share. USWest and Lucent Technologies in telecommunications ("Lucent Opens Plant in Hungary," 1998), Germany's Allianz in insurance, and Alcoa in aluminum have heavily invested. General Electric alone invested nearly $1 billion in a joint venture, Tungstram, over the decade (Linn, 1998). The automotive industry has benefitted greatly. Companies include: Volkswagen-Audi in car engines, Suzuki in a car assembly, GM Opel in transmissions and a car assembly ("Opel Retools Hungarian Plants," 1998). Ironically, Ikarus, a Hungarian firm producing buses for much of the Soviet Bloc, now is in economic difficulty.

Some 70% of total capital investment in Hungary came from foreigners and 60% of all new companies were wholly foreign-owned. One-half of company ownership is by foreigners. More than one-half of exports are distributed by foreign-owned ventures.

In 1997 and 1998, foreign investors began to buy stocks in Hungarian companies at a greater rate than in the past. In 1996, foreign equity purchase totaled only $358 million. In 1997, investment soared to $1,003 million.

Hungary's success in attracting investment is attributed to its positive legal framework, successful privatization program, social peace, low wages, centralized location to western and eastern markets, low asset prices, and educated, skilled, dedicated workforce (U.S. Embassy, 1996).

## Fiscal Policy

Budget deficits remain a problem for Hungary, although it remains in better shape than other Soviet Bloc countries. In 1998, budget deficits amounted to 4.9% of GDP, a requirement of the International Monetary Fund. The latest budget proposal for 1999 reduces the deficit to 4% of GDP. Budget deficits have declined since 1994 from $3.1 billion to $850 million in 1996. Incredibly, in 1992, 40% of average income was received from the state (Langenkamp, 1998). Social Security spending accounts for much of Hungary's deficit. The Pension Insurance Fund and Health Insurance Fund both ran up deficits of $60 million and $46 million in the first quarter of 1998 alone. To these fiscal pressures, government faces costs of military readiness in preparation for NATO membership, infrastructure improvements and election costs. In 1998, government increased agricultural subsidies by 71%, government salaries by 18%, and Social Security benefits by 18%.

Hungarian regimes have reduced public subsidies to enterprises from a high--as a percent of GDP--of 7.0% in 1990 to a low of 3.8% in 1996. Only Romania among Eastern European countries has a higher subsidy level. But Hungary has a long way to go in relieving government of this burden.

## Foreign Debt

Hungary, unlike other Eastern European countries who received debt forgiveness or debt restructuring, reduced its foreign debt through economic growth and by using privatization revenues. Hungary, in recent years, owes about $24 billion to outsiders annually, or about one-half GDP. Hungary carries the largest debt per capita of any European country. Subtracting international reserves and foreign assets from gross debt leaves about $10 billion annually of which only one-half is owed by government.

Hungary has never defaulted on its loans, and occasionally has even paid them off earlier than required. As a result, Standard and Poor, an American credit rating agency, raised their investment rating level to BBB-, allowing Hungarian government to raise capital in international markets.

Hungary continues to borrow to improve its infrastructure and further social reforms. The World Bank, in April 1998, lent $250 million to support pension system reform. This followed a $150 million loan in March 1998 from the World Bank for higher education reform. Also in April 1998, Hungarians borrowed ECU 200 million from the EU's European Investment Bank (EIB) to construct a fourth line for the subway system in Budapest. And EIB and the EBRD lent ECU 40 million in February of an anticipated ECU 400 million to improve the railway system.

## Donor Assistance

Hungary has received the lion's share--with the possible exception of Russia--of bilateral and multilateral assistance in the form of grants, loans and technical assistance at more than $3 billion (see Table 2). From 1990 to 1996, EBRD and World Bank each contributed $1 billion, followed by the EU's PHARE program at $637 million in multilateral aid. The United States is the largest--$240 million--bilateral donor, followed by Germany, $71 million, Britain, $45 million, and Japan, $15 million.

**Table 2.**
**Donor Assistance from Major Providers, 1990-1996**

| Donor | Years | Amount | Purpose |
|---|---|---|---|
| USAID | 1990-6 | $240 m | Technical assistance, projects, Hungarian-American Investment Fund |
| EA./PH ARE | 1990-6 | $637 m | Technical assistance, projects |
| British Know How Fund | 1990-6 | $45 m | Economic restructuring |
| German Govern ment | 1990-6 | $71 m | Assistance to small/medium size enterprise |
| EBRD | 1991-6 | $1 b | Loans and infrastructure investment |
| World Bank | 1986-96 | $1 b | Loans and projects |
| Japanes e Govern ment | 1990-6 | $15 m | Environmental protection, agriculture, industry |

Source: US Agency for International Development, FY1998 Congressional Presentation, 1998, http://www.info.usaid.gov.

Donor assistance to Hungary at levels exceeding other former Soviet Bloc countries occurred first and foremost, because Hungary took the lead in making a transition from Communism to democratic capitalism, and was arguably the most successful. Alternatively, only Poland and then-

Czechoslovakia were serious contenders for aid, having progressed like Hungary. East Germany was absorbed into the Federal Republic of Germany so was not in contention. Former Yugoslavian Republics were in civil war, while Bulgaria, Romania and Albania were slow to make the transition.

Perhaps the largest single project undertaken in Hungary was the completion in 1995 of a turnpike from Budapest to Vienna at a cost of more than $200 million. The project is unusual in that private investors, lead by EBRD, funded the project and collect tolls in repayment.

## Compensation Coupons

Under the Nazi puppet regime during World War II and Communist regimes thereafter, Hungarians, not in favor with the state--Jews, especially, church groups, political dissidents, and political opposition--all had their property confiscated without compensation. With the fall of Communism, successor regimes have tried to redress these injustices through compensation schemes. Churches and schools, where possible, have been returned to original owners. In the case of individuals, who once owned houses or businesses, Hungarians devised a coupon scheme, where the wronged could use vouchers to purchase alternative properties or in some cases stocks in private ventures in compensation for losses. More than 1.2 million Hungarians benefited from the coupon scheme, in the process re-acquiring about $650 million in lost property.

This was not only the morally correct action for government to take, but also a courageous one. Much of the confiscated property was now in public use--church schools were now public schools, and churches were converted to museums or torn down for public buildings. From all appearances, Hungarians seemed to negotiate with one another civilly, without disrupting the re-development of their country.

## Corruption

Communism, as a system of government, is characterized by high levels of corruption. Opportunists under the failed system continue corrupt behaviors under the new. Hungary has some corruption, ranked 31 best in the world on a standard corruption index measuring kickbacks, extortion and bribery, but no where near the former Soviet Republics. But corruption so concerns Hungarians that they may have thrown out the Horn regime because of it. In the banking industry, until the national Bank forced change, bankers complained that the entire system was "... suffering from lack of internal controls and audits and damaged by corruption and loans made against kickbacks from borrowers" ("Banks with a Confident Air," 1998: p. 10). In 1996, AVT made large payments to a consultant without tendering the project for bid. Opposition parties bombed party headquarters and private residences, not to mention night clubs. Murder has been committed. Even so, Hungary has fewer problems with wide-spread corruption than most other countries.

## Future Prospects

Hungary arguably is the most successful of former Soviet Bloc countries in transitioning from Communism to a market economy in a democratic society. It has only a little way to go before it rejoins Europe as an equal.

There are threats to Hungary's economic success. Hungary has been unable to rid itself of its budget deficit, balance of payments deficit and foreign debt. Hungary continues to live beyond its means through credit and debt. Perhaps this is necessary to demonstrate to the public that their lives are better than under Communism, where public services were poor and consumer goods scarce. But the electorate, having thrown out three national governments, expects services and goods, but is unwilling to pay for them through high taxes. It is unlikely that Hungary can grow its way out of its fiscal problems.

National governments have shown reluctance to reduce public spending on social security--health care and pensions, and agricultural and industrial subsidies. National governments have been unwilling to relinguish control of former state enterprises even when they fail to produce. At the same time, although taxes are high, so are monies owed. Hungary cannot now negotiate debt forgiveness and still expect to borrow in the future.

Possibly, another austerity program with high taxes and reduced benefits is required. But the newly-elected Orban government has promised more benefits and lower taxes. Orban apparently is not willing to risk his political career in the short run to benefit his country in the long run (Eddy, 1998). Only time will tell whether a national leader has the courage to take actions necessary to extricate Hungary from its debt.

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## Biographical Sketch

Terry F. Buss is Professor and Chair of the Department of Public Management at Suffolk University in Boston. In 1992, he held a Fulbright Scholarship at the School of Public Administration, and another Fulbright in 1994 at the University of Economics, both in Budapest, Hungary. From 1991 to 1996, he directed technical assistance programs in Hungary and Russia under contract to the U.S. Information Agency. He has written 10 books and more than 200 professional articles.