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Towards Sustainable Growth?

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Introduction

According to a commonplace view of Hungarian official statements, as a result of stabilisation policy in the past years, the conditions of sustainable economic growth have been established in Hungary. Recession caused by stabilisation measures in 1995 (the so-called Bokros package) gave way to slightly accelerating growth from second half 1996 on: GDP grew by 2.1 per cent in first and by 4.3 per cent in second quarter of 1997. There is no external or internal factor, circumstance, political or economic reason within sight today inevitably jeopardising further expansion. The same trend seems quite likely to continue or even modestly accelerate at least up to the end of 1998 – this is how far ahead the development of the Hungarian economy may be predicted within relatively slight limits of error on the basis of the currently perceptible internal and external conditions and discernible economic policy trends.

At this point, however, we must stop to remind that other scenarios are likewise possible and, especially in the long run, economic development of a given time also depends on the then current economic policy, i.e. growth is not sustainable *per se*, as a result or in spite of certain policies and trends of the past, but only if the government of the given period pursues an economic policy that actually makes it sustainable. If future Hungarian politics is to succeed, it will have to differ in many respects from the economic policy of recent years and of the present as well.

The present paper uses the term *sustainable growth* as it is understood in official and unofficial international publications on the economies of Hungary and the other transition countries. It essentially covers ways and means of economic recovery on the medium term, without the recurrence of shocks, faltering or recession. *"Structural reforms"* aimed at increasing productivity and international competitiveness are usually referred to as being conducive to such growth, but this conceptual category is so broad, it embraces anything from the privatisation of state enterprises and the external and internal liberalisation of the economy through the transformation of the operating conditions of the corporate sector (Bankruptcy, Accountancy Commercial, Bank Acts etc.) to the transformation of the taxation system and taxation procedures and the revision of the role of the state in the economy, especially in the welfare and social fields.(Hungary: Structural Reforms..., 1995. p. 177.)[1]. However, the first and perhaps

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[1] It is a typical phenomenon that the media interpret massive plant closures as "reform". (Inevitable as they may be under certain circumstances, that clearly does not make them qualify as reform.)

sole *condition* of sustainable growth is financial equilibrium (sound finances): growth cannot be sustained if it is so fast or takes place in such an unfavourable structural context (e.g. import growth exceeding by far the growth of exports, wage bill surpassing growth of productivity, public expenditures not covered by revenues etc.) that the deterioration of the external and/or internal balances or incidentally inflation become intolerable.[2] In this interpretation, the requirement of satisfying conditions of financial soundness comes as a constraint on growth: economic growth will only be sustainable if its pace is *not faster* than permitted by the equilibrium criteria. More precisely, internal demand and especially private consumption must not exceed the level specified by the equilibrium requirements.

Formulated in such general terms, the above thesis is, of course, irrefutable. Debates concern specific interrelationships, extents and economic policy implications. Let us highlight two things here. Firstly, although equilibrium conditions must be satisfied, equilibrium (or a sufficiently low disequilibrium) is not a satisfactory condition of "sustainable" growth. Satisfying the equilibrium conditions will not result in "sustainable" growth, and a single stabilisation package will certainly not guarantee the sustainability of future growth. Despite any statements to the contrary, there exists no well-proven formula, no "policy mix" guaranteeing the sustainability of growth in the transition economies. Secondly, growth has a bottom limit as well, i.e. sustainable growth requires that economic activity, especially internal demand, should not be *below* a certain critical level. Under certain circumstances, slow consumption growth may itself be the major hindrance to recovery, to the commencement and persistence of growth.

The paper thus targets the specific problem of economic transition, i.e. how the former socialist countries could recover from severe recession of the years after the political change. The concept of "sustainable" growth as it is used here has nothing to do with the old debate, made topical again by the current lasting American uptrend, as to whether business cycles (recession periods) have or could come to an end in the developed economies(Weber, 1997), and even less with the concept of limits to growth introduced by the Club of Rome in the early seventies, i.e. the deliberate barring of

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2 What is intolerable in a given situation is not necessarily determined by "objective" circumstances only, but by political preferences and economic policy priorities as well. This is the reason why different standpoints often culminate in different interpretations of intolerableness. KOPINT-DATORG has, for quite some time, emphasised the correlation that, assuming that all other conditions are identical, inbalances are easier to manage in a growing economy (against the background of export growth and dynamic investment activities including foreign investments) than in a stagnating or declining one.

economic growth so that it should not be limited by the scarcity of non-renewable natural resources, the devastation of the human environment or overpopulation.

In what follows, I will first review the current position of Central and Eastern Europe in the process of economic transition and conclusions offered by staggering and/or unexpected crises having taken place in the countries of the region in recent months. After that, I will discuss some of the current problems of Hungarian economy, factors threatening the sustainability of growth, with special regard to those that may perpetuate slack consumption. Finally, I will outline some interconnections between welfare reform and sustainable growth.

Where Are We Now in Economic Transition?

The common answer to this rather vague question, more akin to ideology and politics than to economics (cf. when shall we have finished laying the foundations of socialism ...), with respect to both Hungary and other countries constituting the vanguard of the transition economies is that the countries in question have entered the "second stage" or "relatively advanced stages" of transition. *(Transition Report, 1996*, p. 15. Beside the 1996 CEFTA countries, EBRD assigns Croatia and the Baltic states to this group.) That is, major institutional and legislative changes associated with the transition, the worst and most difficult periods are over; economic recession has come to an end and the deterioration of the standards of living stopped in several countries. In some countries, political leadership has recently gone so far as to proclaim that "transition is over".

True, the current circumstances of economic development in the former socialist countries are radically different from those in the beginning of the decade. Hungary was invited to the NATO with Poland and the Czech Republic, and after long delays and internal bargaining, the Brussels Commission proposed that the European Union commence accession negotiations with these countries and three others. With the exception of the countries of the Balkan and the former Soviet Union stricken by civil war or other kind of military conflict, the entire region has come to be considered internationally more and more as "normal", where no "drama", no extraordinary events occur, and the necessity of external "relief" has been taken off the agenda for good. In other words, as far as their nature and solution options are concerned, the undeniable disorders, problems and tensions of the countries of the region hardly differ from those of other countries the world over including many OECD countries as well having undergone no economic and political transformation.

This normalisation, however, is highly relative: the societies of the transition countries concerned have not recovered yet from economic recession, the decline of the standards of living and changes in life-style, unprecedented in post World War II European history with respect to their unexpectedness, dynamism and extent, having followed in the wake of the transition. With the exception of Poland, none of the transition economies had managed to reproduce their respective 1989 GDP levels in 1996 yet. As we shall see later on, neither can the possibility of the occurrence of new shocks be excluded.

Moreover, "normalisation" is not simply the outcome of a positive process, i.e. recovery from a crisis or at least its most acute phase, but covers negative changes as well associated with taking over and assimilating western norms. Although one does not usually enlarge on that, accession to the developed world, catching up, not only gives Hungary and the other countries of the region an enormous historical opportunity, but in many essential respects it also implies a *slipping-down* to the level of some of the leading western countries (large-scale unemployment, existential uncertainty, marked differentiation of incomes and wealth, extreme poverty as a society-wide problem, crime). Many of the relatively new, formerly unknown problems having appeared in Central Europe in the past 7 to 8 years have been the order of the day in many western countries for a long time. Well-known differences in the assessment of the social consequences of the transformation and of the role of the state are partially due to this. Analysts considering the phenomena listed above and others necessary and unalterable concomitants of any social system other than state socialism (granting at most that appropriate government policy may help cushion negative effects temporarily) see this type of "normalism" as the price to be accepted with the transition, willy-nilly (or to be refuted with it, for that matter). Those, on the other hand, who do not see the phenomena enumerated above as manifestations of historical necessity which, as such, have general validity, but as place- and time-specific endowments closely associated with the prevalent value system, dominant ideas concerning society, and political preferences ever, refute this formulation of the alternative on the ground that it is not self-evident that this price must be paid, and if it has to, under the given circumstances, that it will actually promote transition and social and economic progress, the *raison d' être* of the whole systemic transformation.

It is equally important that vital dilemmas having come to the foreground in the transition countries *after* the political change (e.g. trimming of the welfare systems) are at issue in the western world as well where no systemic transformation occurred – although they are treated with incomparably more foresight there than in Central Europe, selected as experimental field.[3]

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3 From another point of view: the oft-repeated statement that it was an illusion to expect some sort of a Marshall Plan after the political changes of 1989 change and it is (would be) equally futile to consider our prospective accession to the European Union, to be deserved by appropriate behaviour, a western relief action is quite correct. Joining will take place as and when the interests of the European Union and its member states warrant that. The illusory nature of such expectations not only stems from disappointment due to the overestimation of the favourable disposition and willingness of the West to assist us, but also from the fact that western countries, too, struggle with acute social and economic problems which, moreoever, have been escalating recently, that the governments concerned and the EU cannot disregard: they could not afford to be over-generous in their economic and trade relations and the treatment of the eastern enlargement even if they wanted to.

Facts clearly show that economic development and transformation is not as rectilinear a process as suggested by the formula referred to above. The hypothesis that the development of the economies (GDP) of the former socialist countries in the period of transition could be represented by a J curve, i.e. initial general slump, with differences in length and depth only, followed, after a certain period of time, by similarly general recovery (a period of growth), with country-specific differences in outset and strength, is proving untenable already. This conception predicts that the situation deteriorates until a certain point and improves thereafter, with improvement bringing about the easing and resolution of tension generated by the transition. In accordance with this formula, from 1992 on, when Polish economy, the first in this respect among the former socialist countries, passed the nadir and started to grow, the former socialist countries divided into two groups, with decline *still* continuing in one and the nadir being over and the economy showing an uptrend *already* the other. By 1994, Hungary, too, had joined the second group.

This formula ought to have been revised already in the light of Hungarian economic developments triggered by the Bokros austerity package, since, despite growth having begun in 1994, restrictions in second half 1995 and first half 1996 resulted in the contraction of the economy. Annual data, however, concealed that fact, and showed no GDP decline in either year.

The picture projected by the development of the former socialist countries by first half 1997, however, can obviously not be reconciled with the above two-phase pattern. Bulgaria is a relatively simple case in that steady economic contraction in the beginning of the decade and deep recession in 1996 stretching over to 1997 interrupted by two years of extremely slack growth at an average annual rate of 2 per cent only warrants the conclusion that the country had simply not recovered from the first phase. An explanation can be given to the Romanian case as well, i.e. GDP decline by 1 to 3 per cent in 1997 according to the forecasts in the wake of the stabilisation package of the new government after four consecutive years of steady and mostly very fast growth. It is usually said that there was no "real" transformation in Romania prior to 1996 – a rather elusive explanation that does not match the picture projected by the Romanian economic system earlier either.[4]

4 Neither does the EBRD publication cited already assign Bulgaria and Romania to the countries in „relatively advanced stages of transition". The countries in question are "at intermediate stages of transition", together with Albania, Macedonia and the majority of the CIS countries.

What really undermines the validity of the formula, however, is events having taken place in those countries that had been pointed out only six months or so ago as models of economic transformation and economic recovery to be followed by all transition economies worth their while. The 1997 spring Czech crisis is well-known to all, the same as the fact that Slovakia was compelled to introduce restrictive measures similar to the Czech ones, and less well-disposed analysts predict necessity of stabilisation measures in Poland as well by 1998 at the latest. At the time of writing these lines, one cannot exclude the possibility for economic correction to be implemented in the countries north of Hungary parallel with the preservation of economic growth, albeit at a slower pace. Nevertheless, what used to be *the* model example has, within a few months' time, turned into a sign of warning to the transition economies.

Of course, the above also show that there is definitely no reason to fear the recurrence of a general, drastic fall in production and incomes in East Central Europe on a par with that in the early nineties. Neither is it necessary, or possible for that matter, to change the economic and political system and trade/economic-policy orientation again. CMEA (and the Soviet market) cannot collapse anew. It is "simply" not easy to establish the conditions of sustainable growth. The introduction of capitalism according to the well-known formula – liberalisation, privatisation, stabilisation – is far from sufficient for that. And this is the real message of the Czech case as well.

Although the most common critique is that problems are mainly due to the Czech transition having been inconsistent and "frivolous", some caution is necessary. Czech economic policy was being reprimanded today mostly by those who had used to praise it without reserve, and for the very same reason, contrasting it with Hungary implementing a transition that they deemed much too slow and gradual. The Czech "prize pupil" image rested on shock therapy in 1991, the single, marked devaluation of the koruna, heavy decline in real wages, fast privatisation based on the mass distribution of state property and rapid external and internal liberalisation. The 1996 Report of the World Bank still described the Czech Republic as a country having realised "strong and credible" macroeconomic stabilisation (p.45). "The Czech Republic's mass privatisation program has been the most successful to date" (p.56.); as for social policy, they not only speak of changes, but also implement them, a rare exception among the transition countries (p.78.), and surveys covering private enterprises suggest that this policy "has achieved a high level of government

credibility" (p.94.). The former Czechoslovakia, the same as Albania, the Baltic states and Kyrgyzstan (!), followed the Polish "model of rapid and comprehensive liberalisation" (p.23.). (*World Development Report*, 1996).[5] Later on, however, it turned out that this exemplary child could or would not adjust and change structure as expected, privatisation was not "real" and the Klaus Government slacked "real" transition measures after 1991... Neither is it irrelevant that in the four former socialist countries having introduced strict stabilisation measures in the past months or implementing them now, i.e. Slovakia, Romania and Bulgaria in addition to the Czech Republic, this was not the first, but at least the second round of stabilisation packages already. Problems are of many kinds, but they definitely do not include the absence of a thick "Bokros package" earlier in these countries.

The recurrence of crises and shocks in the transition economies offer conclusions of many kinds. Some now assign economic growth and the concurrent improvement of the standards of living, considered a distinctive feature of the second phase of transition earlier, to the goals of the distant future, and claim that after a "real" transition involving reforms that are deep and comprehensive enough, it takes a long time for significant economic growth entailing a rise in consumption and real wages to evolve. Yet if such growth does occur, that inevitably intensifies economic tension and destabilises the economy: (the same thing happens, as a matter of course, if the reforms are not "deep enough", only it takes a longer time for that to become manifest, after a shorter or longer digression involving economic growth based on the increase of domestic demand, especially private consumption). Czech events actually serve as a warning not to ignore the financial equilibrium aspect of growth, without diverting attention from the fact that no lasting solution will be found to inbalances in the transition economies in the absence of economic growth. Restricting internal demand may be inevitable in an overheated economy, but the basic problem on the supply side, i.e. the poor performance and competitiveness of domestic production, will only be resolved in a growing economy.

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5 EBRD assigns scores to the transition performance of former socialist countries. According to that, the Czech Republic was No 1 in 1994 and tied with Hungary in 1996. Moreover, since according to the rough estimate of EBRD, as far as GDP production is concerned, in mid-1996 the private sector's contribution to the GDP was 75% in the Czech Republic and only 70% in Hungary, the former could be considered absolute winner on the basis of its 1996 performance. (The significance of these figures is well illustrated by the fact that the other 75 per cent privatisator was Albania.) (*Transition Report, 1996.* p.11.)

According to another, less categorical, conclusion based on recent developments in the region, indicative of uncertainties and difficulties more than anything else, "despite important successes, progress towards stabilisation cannot be taken for granted, and backsliding *can take place anywhere at any time* (italics mine, A.K.). The social, political and economic transformation is simply far more difficult than originally expected." (Havlik, 1997, p.26.).

Difficulties of Growth in Hungary

In the second half of 1997, the macro performance of Hungarian economy is not unequivocally better than that of the others: external economic indicators are relatively favourable as compared to those of our northern neighbours (viz. the development of the current account or the exports, although most doubts raised by current economic policy concern processes of the external economy, namely the possible "run-away" of imports); as for the pace of economic growth and the rate of inflation, the performance of the other countries is better than that of Hungary, while unemployment figures, albeit more favourable than those of the other Central and East European countries (except for the Czech Republic and Romania), are nevertheless very high. It is the *trend* that differs from that observed in the other countries. In Hungary, figures indicate a general uptrend (economic growth has picked up speed, investments are in progress, the rate of inflation is diminishing and the current account is improving), while corresponding figures basically describe deterioration everywhere else or, as far as Poland is concerned, are highly likely to deteriorate in the near future according to the analysts. The traditional strength of Hungarian economy, i.e. its capacity to attract FDI, has prevailed, and the external debt of the country and especially that of the state declined in recent years. The improvement of the international view of the country from early 1996 on is indicated by the agreement concluded with the IMF, admission to the OECD, recently the invitation to the NATO and assignment to the first round of negotiations concerning membership in the EU. The perpetuance of this trend may be assisted by positive discrimination in favour of the countries admitted to the first round as compared to the other former socialist countries on the part of western governments, international organisations, banks and investors that will now invest their money first and foremost here. (Havlik, 1997).

However, economic growth in Hungary is not really marked yet. As opposed to the already mentioned dynamism of exports, internal demand has made little progress. Public consumption (in accordance with the intention of state economic policy) has declined and private consumption has so far grown hardly or not at all, the only change over the previous period being the termination of the major consumption decrease observed in 1995-1996.

Although the approach starting out from the assumption that the growth of incomes and consumption is a *danger* threatening to push the economy off the course

of improvement and to hinder the outfolding of sustainable growth is rather typical of Hungarian economic policy and economics thinking, we at KOPINT-DATORG see consumption growth as an *opportunity* which, if grasped, may help strengthen and secure economic revival and, under appropriate conditions, may actually lead to highly desired sustainable growth.

All available information indicates that there is no danger today of such a dynamic general growth of consumption whose import-stimulating and/or export-curbing impacts, hard to support at the macroeconomic level, would generate severe economic tension. Anyway, only a relatively small segment of the imports serves direct consumption purposes. Moreover, beside the imports, domestic production would probably also react to the expected growth of internal demand (private consumption) (the wider the range of consumer demand growth, i.e. the less it is restricted to the growth of the consumption of luxury and fashion goods imported from abroad, the higher the probability); the upswing of internal production in turn would trigger or accelerate investment/modernisation processes in larger areas of the economy than today which, in turn, would promote export orientation and import substitution, i.e. improve the financial conditions (external and internal balances) of growth in the long run.

It is important and timely to call attention to the above interrelationships between domestic demand, economic growth and (external and domestic) finances to counter-balance what is often a one-sided emphasis on the interrelationships of an opposite direction, and especially because *structural changes* having taken place/in progress in Hungary since the beginning of transition, especially, in the past one or two years – economic policy decisions and legislative action on the one hand and omission of certain governmental actions, passivity, the "withdrawal" of the state from the social and welfare systems and the specifics of privatisation on the other – may result, in case the current political and economic policy priorities will not be corrected, , in consumption in Hungary remaining permanently low. Given the fact that private consumption represents a decisive part in GDP demand, and the development of consumption exerts a strong influence on investment as well, it is not inconceivable that, owing to this ailment, contrary to the declared intentions and strivings of the government, economic growth will remain slow and imperceptible for the population for a long time to come.

By the way, this is not a Hungarian idiosyncrasy. Slack economic growth in Western Europe over the past decades, lagging behind that recorded in other regions of

the OECD, has recently been attributed more and more to the permanently low level and in the long run strongly decelerating pace of growth of personal consumption (as compared to other OECD regions). (Average annual private consumption growth had decelerated from 3.6 per cent in the seventies to 1.8 per cent by the nineties.) See Rheinisch-Westfälisches Institut für Wirtschaftsforschung: (*Short-term Prospects...*, 1997), *(OECD Economic Outlook*, 1997). The probable explanation of this decline lies in the economic policy of the decades following the oil price explosion restricting social and welfare expenditures and increasing tax burdens, in the stabilisation of high-level unemployment and more recently fiscal stringency in order to meet the criteria set by the Maastricht Treaty.

Neither is the erosion of employment a Hungarian peculiarity (except that here it has turned acute within a very short period of time). The process has, *on the one hand,* narrowed the tax and social security contribution payment bases of the countries concerned (i.e. the scope of tax and contribution payers) and hence government revenues as well to an outstanding extent and, *on the other*, enhanced the expenditure liabilities of the state. It is therefore not at all surprising that, against the background of severe unemployment, ways and means of extending the tax base parallel with the reduction of the burdens of the tax payers, i.e. securing the necessary budgetary revenues without ruining the conditions of micro-level international competitiveness, has become one of the most difficult economic policy dilemmas.

Research in Hungary has shown that the nineties were not only characterised by a drop in employment by one third, and the perpetuation of large-scale unemployment, but also by the significant growth of the income gap between the well-to-do and the poorer strata, with a growing proportion of the population dropping behind, unable to keep up, and landing among the vulnerable. Sociological surveys suggest that the social and incomes structure having emerged this way in the beginning of the decade has apparently stabilised. Private consumption and consequently economic growth are greatly hindered by the burdens implied by stabilisation in 1995, governmental measures and privatisation practice over the past years, the welfare "reform" and the privatisation and commercialisation (i.e. service providers in what is actually a monopolistic position increasing prices unbridled with the assistance of the state or the municipality) of what used to be public services provided free of charge or at least relatively cheaply .

What we see today on one side is that now that real wages have finally started to increase after a protracted period of decline, growth is attaining relatively significant

proportions (with nominal wages growing faster) in those sectors and among those strata that used to be, to some extent at least, beneficiaries of the transition anyway, who were *favoured* by the reshuffling of incomes or at least have a higher-than-average interest asserting capacity. As for the other side, one of the essential elements and main reasons of inflation in Hungary today is the explicit or implicit indexing of a significant part of utilities (of course, not just that) against past inflation, mostly administratively, or on the basis of some former agreement concluded by the state and private service providers in a monopolistic position, and the constant increase of charges.[6] As a result of the exceptionally fast growth of the public services burdens, inflation is not only stubborn, but strikes the various social strata unevenly, causing exceptionally serious problems for those lower-income strata who consume a large proportion of these services, depriving them completely, for the time being, of the possibility to increase their consumption. Even if their wages (income) grow proportionately with the average inflation rate, the social strata in question have to pay so much more for basic *services* (electricity, gas, heating, water, sewage, refuse collection, public transport) *on the same scale* (or a lower one) as before that they will certainly lack the money to *increase their consumption of goods and other services.* The situation of one fourth or one fifth of the Hungarian population living in housing estates (panel compounds) is becoming untenable despite their decreasing use of services; for example, they simply cannot disconnect from central heating , the most expensive heating facility of all, used, paradoxically, in Hungary today by those whose living had become the most difficult after the change of regime and who, consequently, ought to be as thrifty as possible.

From a broader perspective, one of the hindrances to stepping on the oft-mentioned "course of sustainable growth" is exactly the withdrawal of the state (and the municipalities) from the financing of public services, and the special Hungarian way of privatisation, extending the process, a very fast one anyway (in the economic history sense), to areas where public (state, municipal) ownership would fit very well into the classical market economy conception, predominant in Western Europe up to the present day. This, too, has increased significantly the well-known social and economic risks and costs of privatisation (associated, so far, with the re-distribution of national wealth by lawful and unlawful means, i.e. "distribution and looting" as the Hungarian saying goes, even by the loudest proponents of privatisation).

[6] It is possible to index against inflation even if the service provider's expenditures do not increase proportionally with price increase.

Welfare Reform and "Sustainable" Growth

The other manifestation of privatisation a la Hongroise that has attracted international attention was the so-called "reform of the state household" (or, "reform of general government budget"). According to the official interpretation (beside certain financial techniques and budgetary/accounting novelties), the reform partly means the withdrawal of the state and reduction of state redistribution (budgetary revenues and outlays as a percentage of GDP) to the "western level", and partly the radical, "systematic", transformation of the large welfare systems (health care, pensions, other social provisions, education etc.) and the introduction of new systems. However, at least until the pension reform approved in summer 1997, it was proclaimed that transformation had not begun yet: whatever happened earlier (in terms of restrictions and the trimming of the social welfare systems) represented short-term emergency measures, with "reform of the state household", a new phase of the change of regime, or actually the "real" change of system itself, still laying ahead.

In my view, the so-called "reform of the state household " means the reduction of state redistribution, its re-structuring based, essentially, on the radical supervision (curbing) of state commitment in the human sector and in the social welfare systems, and the transfer of a growing proportion of health care, education, pension etc. services to the business sector and to private hands.

It follows from this approach that the this reform has been going on for a long time – it had actually begun prior to the political changes of 1989-90 and it has already made considerable progress in which the pension reform is but one stage. For, as far as the social/economics contents of the issue is concerned (reduced state commitment, replacement of gratis services with pay ones, raising the prices of cheaper services), there is no essential difference between "minor, emergency" measures motivated by practical/budgetary considerations and comprehensive social transformation projects supported by a "theoretical" foundation. The real difference is that the latter *may accelerate to a large extent* the growth of the burdens of the population, a rather marked process anyway.

From the point of view of the present paper, the crucial issue is the impact of welfare reform on the perspectives of Hungarian economy, its change-over to a course of "sustainable" growth. Well-known pro-reform arguments assume that "excessive" state commitment, extensive re-distribution are contrary to the objectives of economic

growth, catching-up and modernisation. *Firstly,* the re-allocation of revenues from the competitive sector to the state via state redistribution (heavy taxes and social security contributions) exert an unfavourable influence on productivity, and competitiveness in the *corporate sector* (this is one of the main reasons behind the spreading of the black economy) and, *secondly,* "excessive" reliance by citizens on state allowances, "free lunch", has a similar influence, one that reduces or withholds output and provokes a rentner's mentality and behaviour among *members of society.* Therefore,

- the level of public expenditures must be reduced (from 55 to 60 per cent of the GDP to 44 to 48 per cent of it or less) and their structural pattern be transformed (i.e. expenditures must be reduced to the detriment of welfare expenditures in the first place);
- in the area of social welfare services, the state must be driven into a "competitive" situation: once the private sector has emerged, "the laws of economic rationale" must be asserted with respect to the state as well;
- the relationship between state institutions and citizens must be reformed "radically" and state paternalism be replaced by citizens' self-care;
- income distribution must be modified in favour of the corporate/enterprise sector, to the detriment partly of the state (the central budget) and partly the population (the households);
- finally, state welfare provisions shall be "rationalised", i.e. a growing proportion of the services accessible on citizen's right earlier must be allocated on a needs basis. The oft-repeated thesis in this respect is that universal access is unjust and expensive, because it provides access to services to those who are not in need of it, while being insufficient for those in need of them; consequently, the proportion of general services provided free of charge should be reduced and those conditional on income or property certificates increased, so that those who can afford to do so should address private service providers.

True, in the early nineties, public welfare and social expenditures were excessive as compared to the (greatly reduced) performance of the Hungarian economy. This was partly due to the over-assertion of entitlement on citizen's right, as opposed to the insurance principle, while in some cases (e.g. early retirement) entitlement was treated, unnecessarily (or under some constraint such as the fast growth of unemployment), with excessive largesse. Moreover, the operating mechanism of the welfare system is not a very efficient one: waste and shortage co-exist and make everyone equally

discontent (with some complaining of the high prices, and others of the scarcity of services).

I will only highlight a few of the many conceptual issues raised by the Hungarian type welfare reform. One of the most important problems is that the reform conception postulates a uni-directional relationship between economic growth and the development level (more precisely: extent) of the welfare systems. That is, it assumes that growth is *hindered* by an "over"-extensive welfare system: there is not sufficient revenue left with the entrepreneur, a significant state revenue concentration takes place, with state revenues being spent on "improductive" purposes (to use an attribute familiar from way back). One-sided emphasis on this correlation, however, is once again not a Hungarian invention, but one that is quite fashionable today the world over. Trimming the welfare state is a topical issue today in the developed countries, although with little avail: severe restrictions, the contraction of the human sphere and life becoming ever harder do not produce the desired result, i.e. a decline in the share of the public social welfare expenditures (relative to the GDP). Western neo-liberals complain of the absence of "real" reform and lasting budgetary consolidation the same as their Hungarian "counterparts" do of the postponement of the " reform of the state household". It is a Hungarian peculiarity, however, that the proponents of reducing the welfare commitments of the state pretend that depression in Hungary in the early nineties was due to excessive welfare expenditures, instead of the relative share of public social/welfare expenditures having attained what was really an insupportable level in the long run *as a result of* the decline in GDP, and tend to forget that the expenditures in question decreased considerably in real terms in the meantime. They find it even more difficult to acknowledge that the *relatively* high level of social/welfare expenditures has actually helped society support the protracted period of recession, restrictions, the contraction of individual incomes and hence actually made transition easier.

One must call attention to the fact, neglected sometimes by writings depicting the necessity and beneficial nature of the welfare "reform", that there exists a different kind of correlation as well: an advanced social welfare system, although no doubt costing money and requiring the regrouping of resources from other areas to maintain it, is also an important precondition of economic growth and actually *promotes* that. Suffice it to refer here to such commonplace interconnections, beyond dispute, as the development level of education and science on the one hand, and economic performance on the other, that have become fashionable to overlook recently in

connection with the "state finances reform". As Hungarian economist László Szamuely writes, "a large (if not major) part of the public welfare services ... belongs to the category of the so-called public goods (such as health care, education), and it is an open question, in the economics sense, whether scientific research, the arts, public education, higher education, social care ("poverty affairs") and the education of children should not be ranged with the public goods. For, these all share the property of exerting favourable, positive, external impacts on society as a whole". (Szamuely, 1997, p.138.). Incidentally, recent World Bank research has also confirmed that a more equal asset distribution and greater equality in health care and education do stimulate economic growth. (Bruno – Squire, 1996, p.6.)

As mentioned already, the several-decade-long fight to restrain the welfare state was not conducive to the acceleration of economic growth in Western Europe. This is one more reason why Hungary, and the other transition countries, should not forget that the cut-back on social welfare expenditures, the curbing of the allowances may exert a negative influence on the conditions of growth. The withdrawal of the state, for that matter, would have exactly that effect, entailing as it does the general contraction of services (the majority of the Hungarian population cannot afford to buy now what used to be services provided free of charge), the deterioration of their infrastructure and their standards or, contrary to the declared objectives, a growth of budgetary expenditures (with resources being withdrawn from the state pension system due to the introduction of mandatory privately managed pension funds). The simultaneous reduction of the concentration of budgetary revenues in the framework of the welfare "reform", on the other hand, will not necessarily trigger a growth of investments by the enterprise or the competitive sector, for investments, as has been well-known for a long time, require not only mobile resources, but an expanding market as well, the expansion of the internal market included, where products poured out by the larger capacities can also be sold. However, the Hungarian welfare reform actually hinders that.

The embodies a rather one-sided approach in terms of the economic role of the state and the efficiency of the state sector as well. In accordance with the spirit of the day, it extends the principle that public and efficient are mutually exclusive attributes – it is only private property that can be efficient – to the welfare services as well. It deduces the necessity of the withdrawal of the state and the introduction, *with state assistance*, of private service providers and private capital to the social/welfare sector from that (see below). This approach compares a *real, existing* structure with its deficiencies and disorders familiar to all (i.e. the present, disintegrating, Hungarian

social welfare system) to an *ideal type*, a textbook example that does not exist in reality. That is, to use the terminology of philosophy, it mixes *sein* and *sollen.* The outcome of such a comparison is clear from the outset: it can only favour the latter. Even if the description and evaluation of the existing system is relatively precise, the suggestion that a public social welfare system cannot function differently from the way it does in Hungary today clearly reflects a biased attitude and only serves the purpose of limiting reflection on possible solutions by channelling it towards one alternative, namely change-over to private services. Yet in the course of the past 7 to 8 years, sufficient experience has accumulated in the so-called competitive sector as well to show that an economy based on private property does not function exactly as we imagined it in the fervour of transition or as we were told. This experience should definitely not be disregarded in connection with the transformation of the social welfare system whose operation is not governed solely by direct efficiency criteria. (And if we do focus on efficiency, it is worth recalling the fact that the most expensive and prodigal health care system of the world is the American one, in private hands for the most.)

Anyway, the slogans of increased efficiency, market-orientation, competition, self-care and withdrawal of the state are often abused. The creation of the mandatory funded pillar operated by private funds of the pension system, for example, a "novelty" in international comparison as well since the most developed countries still operate variants of the so-called pay-as-you-go system, definitely does not mean the withdrawal of the state, it only creates limited competition and no self-care at all. It is not that the introduction of the new pension system will open up a new, promising ground for enterprises, where the clever, the agile and the fortunate will grow rich on their merits while others, as is normal on a real market, will go bankrupt. Something completely different happens: the state will *move* from one economic sector to the other, it will *order* who is to receive the money of the employee-citizen (i.e. the pension contribution) and, moreover, it will also *ensure* itself that private funds should actually obtain that part of the contributions to which they are entitled. Hence the state will *manage* a long-term income and wealth redistribution in favour of part of the financial sector, to the detriment of state finances and the population. Consequently, pension funds are not self-providing organisations in the least.

Neither does self-care apply to citizens paying pension contribution to mandatory funds. Payment to individual accounts – mandatory ones – takes place just as in the current pay-as-you-go system. The employer deducts the amount from the wage (or

other payment) of the employee who never sees the amount put aside supposedly thanks to his/her own efforts at self-provision.

It is essential from the point of view of our topic that the conception of the funded system posits a positive relationship, unequivocal in the economics sense, between savings accumulating on individual accounts, investments, productivity growth and the development of the GDP. Greater savings produce more investment, a faster rise in productivity and a bigger national product. This may be correct according to some theories and in some situations, but it is not necessarily so. As for the specific Hungarian case, the above line of reasoning is obviously false in several respects. Savings being forced ones, presumed employee interest in replenishing individual accounts – even if it could be demonstrated to exist[7] – would be of little importance if it would remain the primary interest of employers to evade social insurance contribution payment obligations. Savings accumulating on individual accounts create a deficit of an identical amount in state finances – state pension funds collect that much less social insurance revenue –, and the deficit must be financed, the same as state finances deficits due to any other cause.

From a macroeconomic point of view, this last circumstance may well prove to be the most important concern with respect to the approved pension reform in the long run. Also, the future fate of money accumulating in the pension funds continues to be relevant. As is well known, the majority will have to be invested into government securities. Later on probably enormous amounts will accumulate in non-government securities as well, but will those amounts ever result in internal real investment? And if they will, would that entail a growth of productivity? Amidst a liberalised international capital flow, domestic savings may equally be the sources of internal and external investments and, vice versa, domestic investments may originate from both internal and external savings. Consequently, one cannot give an unbiased answer to the question of what will happen to the money accumulating in the mandatory Hungarian pension funds in the next 30 to 40 years. Anyway, many researchers are of the opinion that the mere existence of the financial instruments in question does not guarantee good and secure investments which also increase productivity. (Schmähl, 1996, p. 413.)

The fact that enormous amounts are accumulating in pension funds the world over is often quoted as an important argument in favour of adding the *capital coverage*

[7] But it cannot. For the overwhelming majority of the Hungarian population today self-care in the first 10 to 20 years of their career means provision to ensure a living, found a family, buy a house (flat) and raise children, not gleaning, of an uncertain outcome, for the retirement years.

element to the system. However, in the developed countries, the funds in question collect money from voluntary, *not mandatory* contributions. More importantly, if a significant or even major part of savings in a given country accumulate in pension (or similar other) funds, that does not necessarily imply a high savings rate. Usually the United States is quoted as an example of the enormous share of pension funds in savings in general. However, the American savings rate is commonly known to be low. In Germany, where pension funds play a much more modest role, the savings rate is typically much higher.

As for the costs incurred by the state – by society – over a period of 30 to 40 years in the case of the pension reform, the official standpoint starts out from the assumption that it will be possible to keep the central budget deficit due to the pension reform below 1 per cent of the GDP throughout the entire period. This figure is possible to believe, although not small at all. However, this only implies that, *provided that all else functions smoothly* in the economy and in state finances, i.e. if there are no other problems and troubles making it difficult to finance the deficit of the budget and no other problems occur either, the pension reform itself will not set back growth significantly.

The above sounds like a rather weak argument in favour of a "reform" whose declared objective is no other but to accelerate economic growth. At the same time, it is also a rather bold assumption (it is very rare for everything to be in order in the economy), especially now that we do not even know whether the central budget has been able to cope with, for example, the consequences of bank consolidation, i.e. all the burdens that had made the 1995 stabilisation package necessary. Privatisation is not over, the welfare reform is still in progress, the same as the withdrawal of the state from public services in many areas. Meanwhile, official policy *on the one hand* tries to protect itself from "loosening", i.e. taking measures considerably deteriorating the external and internal financial balances of the country once again. *On the other*, as it is quite apparent in certain selected areas, in accordance with its proper preferences and under the pressure exerted by certain strong pressure groups, it *"loosens"* itself – an unnecessary and dangerous move. Dangerous, because economic restrictions imposed in the period since the political change and especially in the wake of the developments of the past two years have become so grave in numerous areas that "loosening" (i.e. the slow-down/suspension for a shorter or longer period of time of the withdrawal of the state from these areas or occasionally even providing more serious subsidies may prove the only alternative to complete breakdown – i.e. politically and socially

unacceptable disintegration, disorders – and, as such, the only rational political measure. What I have in mind, in accordance with previous arguments in the paper, could be public services in the broader sense for example, but one could also mention regional policy, employment policy, housing policy and so on. If this is the case, *any* reform raising the deficit relative to the GDP by even half a per cent may well prove a much heavier burden than we could imagine today, acting as a real hindrance to "sustainable" growth. A sober and moderate economic policy, on the other hand, contributing to managing the conflicts of such expected dilemmas and goals, may well be one of the most essential preconditions of lasting future growth.

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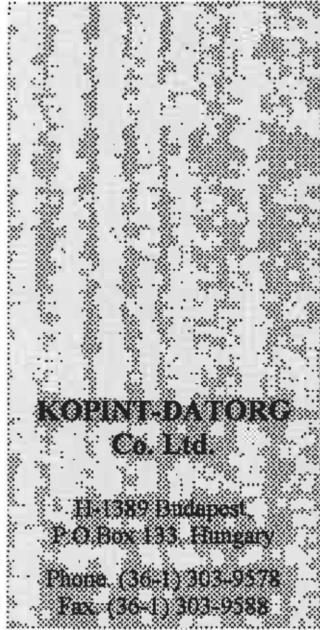

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