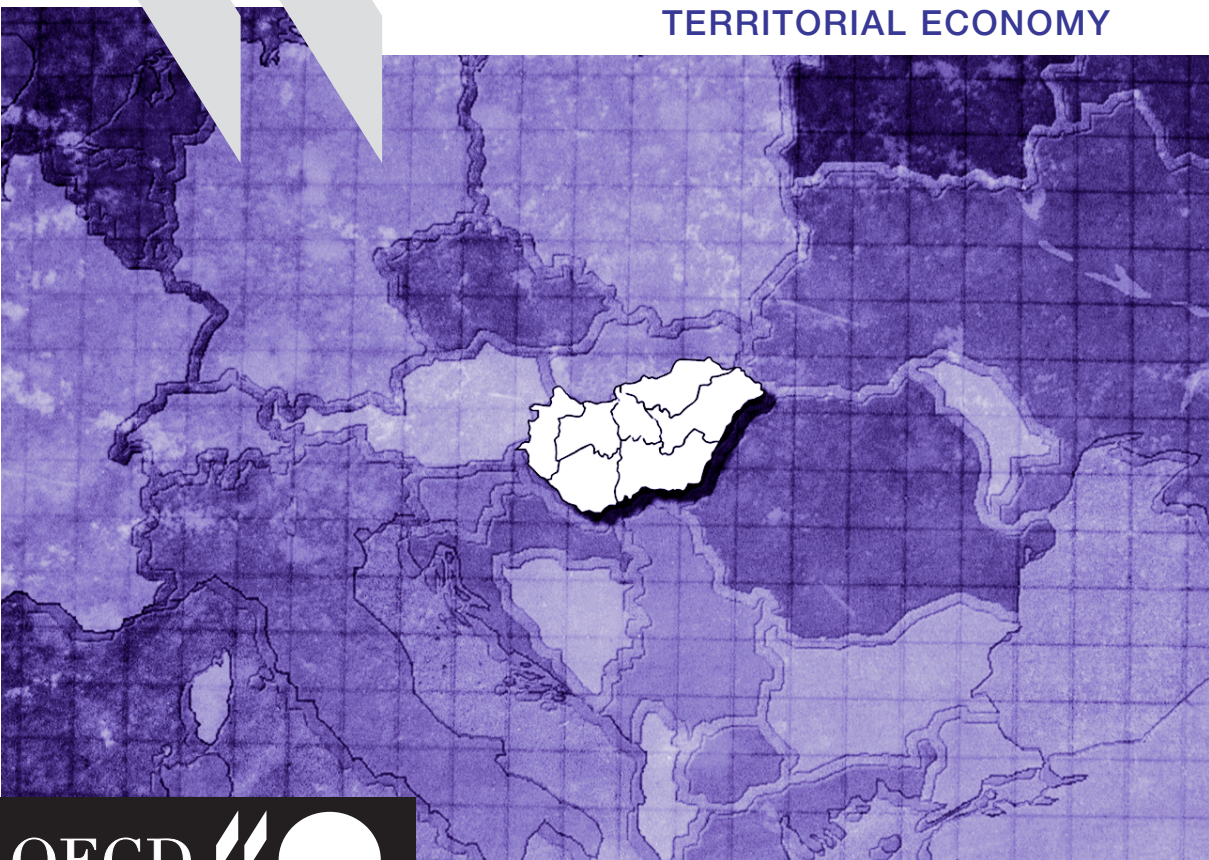


OECD Territorial Reviews

Hungary

TERRITORIAL ECONOMY



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Foreword

The globalisation of trade and economic activity is increasingly testing the ability of regional economies to adapt and exploit, or maintain their competitive edge. There is a tendency for performance gaps to widen between regions, and the cost of maintaining cohesion is increasing. On the other hand, rapid technological change, extended markets and a greater demand for knowledge are offering new opportunities for local and regional development. Yet this calls for further investment from enterprises, reorganisation of labour and production, upgrading skills and improvements in the local environment.

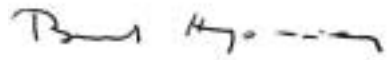
Amid this change and turbulence, regions are following very different paths. Some regions are doing well in the current phase of the growth cycle and are driving growth. Others are less successful in capturing trade and additional economic activities. Many territories with poor links to the sources of prosperity, afflicted by environmental problems, migration (notably of young people), and lagging behind in infrastructure and private investment, are finding it difficult to keep up with the general trend. At the same time, central governments are no longer the sole providers of territorial policy. The vertical distribution of power between the different tiers of government, as well as the decentralisation of fiscal resources, need to be reassessed in order to better respond to the expectations of the public and improve policy efficiency. All these trends are leading public authorities to rethink their policies and strategies.

The Territorial Development Policy Committee (TDPC) was created at the beginning of 1999 to provide governments with a forum for discussing the above issues. Within this framework, the TDPC has adopted a programme of work that focuses essentially on reviewing Member countries' territorial policies and on evaluating their impact at the regional level. The objectives of the reviews are to: *a)* identify the nature and scale of territorial challenges using a common analytical framework; *b)* assist governments in assessing and improving their territorial policies; *c)* assess the distribution of competencies and resources among the different levels of government; and *d)* identify and disseminate information on best practices regarding governance.

The TDPC Secretariat produces two types of reviews:

- *Territorial Reviews at the national level.* Requested by national authorities, they analyse trends in regional performances and institutional settings, and focus on policies to reduce territorial disparities and to assist regions in developing comparative advantages. They also concentrate on the governance framework, on the impact of national non-territorial policies on subnational entities and on specific aspects of fiscal federalism. The final report analyses conflicting issues and proposes territorial policy recommendations.
- *Territorial Reviews at the regional level.* Requested by subnational authorities (local or regional) with the agreement of national ones, they concentrate on strategies for developing the respective entity. In particular, they identify the role of key demographic, socio-economic, environmental, technological and institutional factors in explaining the performance of regions. They also provide a comparative analysis with regions of the same type using the typology elaborated by the Secretariat.

This Review is based on the Secretariat's study of the Territorial Development Policy of Hungary and on its examination by the Territorial Development Policy Committee on 14 December 2000. Further to this examination, the study was amended to integrate TDPC comments. The Committee subsequently gave approval of the Review for publication.



Bernard Hugonnier,
Director,
Territorial Development Service

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Assessment and Recommendations

*Recent
macroeconomic
performance
has been
satisfactory...*

The Hungarian economy has returned to a path of steady growth in recent years. Macroeconomic performance has been favourable: the GDP growth rate has held at between four and five per cent for four consecutive years, inflation has declined considerably to below 10 per cent with unemployment currently under seven per cent. Exports, expanded external markets, and increased competitiveness have fuelled the recovery, resulting in continuously progressing employment. This has made it possible to offset part of the job losses generated during the first years of the transition. While the current level of employment is 14 per cent below the level of the pre-transition period, the economy has been largely purged of redundant labour. Substantial reforms put in place by the Bokros package, a very wide liberalisation of foreign direct investment (FDI), and a new law on bankruptcy have helped to build a more competitive environment. Foreign firms have carried out microeconomic restructuring in the wake of a nearly-complete process of privatisation and an overhaul of the institutional and legal infrastructure. The concerns raised by the slow reduction of the budget deficit and the risk of overheating are often stressed, but other macroeconomic results have been satisfactory.

*... but disparities
throughout the
country have
widened...*

Hungary is regaining its former position within Europe as it undergoes a profound transformation. These changes are not being felt equally in all regions of the territory however. Performances diverged and disparities were amplified when the period of growth was established. Fuelled by important waves of FDI, western Hungary, as well as the capital and its surrounding area, have been the fastest to restructure and to take advantage

of cumulative effects, whereas counties in the northeast still suffer from the difficult restructuring of heavy industries and mono-sectoral activities, and the Great Plain and the southeast are experiencing a decline in agriculture. While northeastern regions were among the most developed during the communist period, growth has now shifted to the west. This east-west divide, the trend towards metropolisation encouraging suburbanisation around Budapest, the rural exodus and the accompanying process of urbanisation are increasing territorial fragmentation. These trends are widening income disparities between the countryside and the main cities.

... and will probably continue to do so if territorial policies are not strengthened.

There is a risk that this skewed distribution of activities will persist and even increase. The more advanced regions are in a better position to seize the development opportunities during a period of growth and to develop cutting-edge activities. FDI will probably continue to be attracted mostly to the western area and Budapest, particularly since the second generation of foreign investors is now focussing on value-added products and skilled manpower, while competing Central and Eastern European (CEE) countries increasingly attract low wage-based foreign investments. The strong concentration of a knowledge-based infrastructure in the capital, and of business R&D activities in the northwest where subcontracting networks of performing small companies have emerged, will offer newcomers strong advantages. Finally, an advantageous infrastructure, dynamic entrepreneurship and good connection with western markets is likely to fuel the endogenous development in these areas. Given that GDP depends strongly on external markets and centralised industries, the existing regional gap may widen. This situation calls for the renewal of territorial policies.

Regional policy is not new in Hungary...

The Hungarian government has traditionally used regional policy to address disparities and foster local development but its success has been mixed. The country has considerable experience in targeting public initiatives to improve structural problems and manage crises in more backward regions. In the early stages of the transition, a Regional Development Fund was created in Hungary, whereas other CEE countries such as Poland or the Czech Republic did not devote any significant public funding to this.

Policy assistance was biased towards financing infrastructure while economic objectives such as encouraging job creation investment and regional coverage became more important after 1995. Although the funds were initially low, they tripled between 1994 and 1997 during a period of slow growth. However, given the limited experience in assessing projects and the thinness of the support, the results of providing subsidies to firms and normative assistance disappointed expectations.

... but the more recent EU PHARE programme has significantly influenced policymaking while emphasising the importance of territorial development.

As early as the beginning of the transition, the EU significantly influenced policymaking in Hungary, notably through PHARE, the major EU programme that provides technical and financial support in key economic areas of CEE countries. Nearly seven per cent of the total PHARE budget dedicated to Hungary during the 1990-1999 period was directed to regional development, in particular to human resources, institution building, SME development and innovation, regional tourism and business-related infrastructure. One of PHARE's principal contributions has been to favour deconcentrated management, particularly for cross-border activities (PHARE CBC), the pilot programmes and the creation of Local Development Agencies. Another important PHARE contribution includes the new credit guarantee instruments for rural business, assistance to infrastructure funding and the introduction of modern management methods. The programme was also instrumental in urging the government to undertake institutional reforms at territorial level. PHARE procedures have drawn technical criticism, however, and many evaluation studies report mixed feelings for PHARE's having ignored (until recently) the strengthening of administrative capacities, and the supply of expertise and training. PHARE's impact on banking behaviour, co-operation among SMEs, and the involvement of municipalities has been disappointing on occasion.

Still, a coherent policy framework is needed.

If the institutional experience with regional policy assisted the implementation of PHARE, the EU programme has also introduced problems and distortions. A wealth of initiatives were undertaken under its umbrella but the limited results reflect the inability of the policy framework designed to fully articulate European assistance with domestic policy.

The structure of governance has been modified, but the division of tasks among the administrative layers is not sufficiently clear...

Changing the structure of governance is an attempt to strengthen this policy framework. Contrary to many CEE countries, Hungary has maintained a successful balance between the pace of economic transformation and the speed with which new institutions, new regulatory regimes, and new rules of the game have been introduced. More than a hundred acts have been passed each year and twice as many decrees have been adopted. The Act on Regional Development and Physical Planning, adopted by Parliament in 1996 and amended in 1999, created a new regional level in the territorial administration. A National Regional Development Council (NRDC) (NUTS 1), Regional Development Councils (RDCs) (NUTS 2) and County Development Councils (CDCs) (NUTS 3) draw representatives from central government, counties and the social partners. Both sub-national institutions co-ordinate functions particularly for implementing sectoral policy at the territorial level. They also have significant decision-making power for planning and selecting projects. The 1996 Act is an attempt to co-ordinate regional policy at different territorial levels. However it does not clearly define the power or the share of programming and planning responsibilities at each level or determine an appropriate level of sectoral co-ordination (*e.g.*, for health, education). Moreover, the 1999 amendment reduced local representation in CDCs and reinforced the RDCs' power and the participation of the central government. Furthermore, the CDCs as delegated institutions hold a strong position compared to the elected county assemblies. Many advantages will accrue from reconsidering the dual system of county representation and policy implementation. The CDCs could act as specialised development agencies reporting to the elected bodies of the counties rather than to the national government. This could also open the way for a better division of tasks between counties (which could be assigned intermediate general-purpose functions mainly in education and health care) and regions (which could manage structural funds and implement large spatial and infrastructure projects).

... and collaboration among the different tiers should be improved.

The creation of a multi-stage territorial organisation with four tiers of government (central, regional, county and municipal) is an important step towards decentralisation. However, the complexity of the new organisation makes vertical and horizontal collaboration necessary to achieve cost

effectiveness in the supply of public services. Moreover, given the size of municipalities and the scarcity of their resources, it is crucial that they join forces and reach a critical mass to provide public goods. The 1990 Act on Local Governments makes it possible for municipalities to form associations on a voluntary basis, but the incentives for this purpose provided by the government are not sufficient. Some OECD countries have rewarded municipal associations and provided incentives for specific types of co-operation and this could be usefully introduced into Hungarian legislation. Such rewards could also foster vertical collaboration.

The share of local taxes has been slightly increased, but further decentralisation would require a fiscal reform to facilitate local initiatives and help to reduce disparities.

The Hungarian sub-national financial system includes high state transfers and weak local taxes. Municipal budgets represent 41 per cent of central public expenditures while local taxes amount to only 12 per cent of central tax revenues. Although the share of own taxes has slightly increased, real own resources still amount to less than 40 per cent of all local revenue. In fact, fiscal decentralisation did not keep pace with the decentralisation of the 1990s. To compensate for these discrepancies, large intergovernmental grants are steered by the central government. After a difficult period of declining revenues, inflation and lower transfers from the central government, local governments have succeeded in generating surpluses, thanks to revenues from privatisation, strictly controlled spending and contracting out services. Local governments now have more leeway in financing local initiatives, but they still lack their own resources and this tends to limit their efforts. Furthermore, intergovernmental grants hardly reduce revenue disparities and do little to achieve national goals such as minimum standards for public services and the elimination of territorial spillovers. A reform that increases the predictability and accuracy of the fiscal system could put local governments in a better position to significantly enhance their financial planning capacities and to address their own long-term development. Increasing the share of the personal income tax going to local government, and promoting a value-based property tax could balance differences among the municipalities and equalise losses in business tax income. The reform should also lead to streamlining intergovernmental grants. In the long run, improving the present equalisation system should be considered.

While regional allocations for economic development, including EU assistance, increasingly target the less developed areas focusing on crucial growth factors, more attention is also given to institution building and EU accession preparation.

Until now, government policy directed towards reducing territorial disparities has relied mainly on increasing transfers to the less developed regions and using the grant system to amplify the redistribution. From the beginning of the 1990s, regional allocations were concentrated in the northeastern and eastern parts of the country. Two counties – Szabolcs-Szatmar-Bereg and Borsod-Abauj-Zemplen – still receive the bulk of the assistance. While EU funds were previously distributed relatively evenly between regions and sectors, PHARE 2000 now mainly targets eastern regions. The budget has been doubled and two additional EU government co-financed pre-adhesion programmes for large transport and environmental infrastructure (ISPA) and for agriculture and rural development (SAPARD) are being implemented. On the whole, assistance is increasingly accession-driven either from the EU side or from national sources (*e.g.*, through programmes launched in all seven regions). It emphasises institution building, reinforcing administrative capacities and enhancing expertise in programme management. These supplemental funds alleviate the tensions of distributing limited budget resources while the discipline of EU Structural Fund compliance helps policy efficiency.

In this context, the government should maintain and develop a long-term strategy...

The need to integrate the *acquis communautaire* and (pre-adhesion) funds, is now one of the policy makers' main tasks. Aligning priorities on EU guidelines is becoming a dominant goal, but domestic policies should continue to serve national objectives. EU cohesion policies are not meant to be substitutes for domestic strategy, and structural funds are just additional programmes. The government should therefore maintain local development programmes, and even ineligible ones that are linked with long-term strategy, and avoid delaying projects until accession. In addition, the allocations devoted to direct regional development purposes (regional and rural development allocations) seem modest, given the ambitious objectives of the National Regional Development Concept. It is therefore important that the government devote sufficient budgetary means to regional development to ensure balanced domestic purpose and co-financing. In particular, special attention should be devoted to the RDCs that in practice receive

significantly less funding than CDCs and to Regional Development Agencies (RDA) which require appropriate staffing levels that they currently lack. However, given the need to tighten fiscal policy, additional spending on territorial development would need to be financed by cuts elsewhere in the budget.

... and consider institutional arrangements to reinforce horizontal and vertical co-ordination.

As the number of programmes and the profile of regional policy grow, the involvement of ministries in policy making with development targets at sub-national level is critical. Many ministries finance local and regional investment to one degree or another, through special chapters in the budget. The number of allocations they channel is, in general, significantly higher than that of the Ministry of Agriculture and Regional Development (MARD), which remains the main central government actor for regional issues. The task of overall co-ordination of structural policies has been assigned to the Ministry of Economy, while a ministry without portfolio retains some responsibility with regard to the PHARE programme. Further efforts should be made to reduce the fragmentation of functions and streamline the institutional framework.

The spatial impacts of economic policies should be assessed.

Regional policies that were adopted at the beginning of the transition sought to reduce disparities and promote equalisation via direct subsidies, while economic policies pursued the traditional goal of promoting privatisation and product competition, furthering regulatory reform and enhancing competitiveness. This division of tasks no longer holds. In Hungary and in other OECD countries, the territorial dimension of economic policies is more apparent than before. Territorial policies that target regional, urban, and rural development focus increasingly on identifying the development potential of each territory and promoting the full exploitation of comparative advantage by providing services and infrastructures. The Szechenyi Plan, the recent initiative from the Hungarian Ministry of Economy that emphasises the need for a balanced territorial distribution of activity, is a first step. Until now, the spatial impacts of economic policy initiatives have not been analysed in depth and much remains to be done for more coherent and mutually reinforcing policy initiatives.

FDI must spread to less advanced territories, particularly in the east.

Foreign direct investment (FDI) remains the main tool of economic development strategies. So far, Budapest, and Central and West Transdanubia have attracted large influxes of foreign investment and internalised most of their economic benefits. Specific policy instruments and regional incentives (grants, tax exemption, industrial parks, custom free zones) notwithstanding, foreign investors, whether already implanted in Hungary or not, have only recently been attracted, in rather modest numbers, to the south or to the east. As several OECD country experiences show, it is possible to attract an important share of FDI to less wealthy regions. This requires comprehensive central policies as well as the involvement of regional development agencies, a high degree of professionalism and networking capabilities. National authorities would need to set up incentive ceilings and specific mechanisms to limit regional overbidding.

Home growth development, especially small and medium-size enterprises, deserves more attention...

Other alternatives to FDI development strategies are required, including strengthening local firms and regional market-based industries. SMEs often form the backbone of less advanced regions, especially in rural areas. In fact, there are many small, vital firms in Hungary. While they play a decisive role in trade, construction, light industries and services, they are not very productive, the quality of their products and services is low, marketing is insufficient and management is often weak. It is generally easy to launch a venture, but the environment is not very conducive to developing small businesses because of the administrative burden, relatively high taxes and a changing fiscal regime, a high social insurance rate and difficult access to bank loans and guarantee suppliers. In 1999, the government approved a decree on steps to be taken while a bill on small and medium-sized enterprises was passed in Parliament. The new budget appropriations for SMEs include budget lines from the Ministry of Economy that focus on direct business assistance, and from the MARD (Regional Development Allocation) that emphasise indirect business support (funding investment, business infrastructure, incubators and innovation centres). It is too early to assess these initiatives, but it is important to stress that the focus on SMEs has resulted in a proliferation of programmes that often have no clear relationship. The environment for SMEs must be stabilised and their access to the banking

system is crucial for this. Previous PHARE loan schemes generally failed to attract bank interest in the SME sector. Given the lack of intermediate institutions, sectoral formulae such as a Regional Guarantee Consortium should be considered.

... and the domestic sector should be linked with foreign-owned enterprises to strengthen territorial development.

There is some fear that the economy will comprise two different spheres: a duality with, on the one side, a well-performing foreign sector, usually composed of large firms, and, on the other, a mass of small firms that find it increasingly difficult to cope within a competitive and more global environment. As SME policies will not deliver results in the short term, increasing ties between the two sectors may help to upgrade the competitiveness of small firms involved in networks with foreign enterprises and sediment technical competence at local level. At the same time, foreign firms will be more locally anchored and therefore less prone to disinvestment. Industrial FDI is more common in those sectors that manufacture parts than in assembling industries, and their exports often have a high content of imports. There are nonetheless some signs of greater competitiveness from Hungarian subcontractors since the share of domestic supply in the output of foreign-owned enterprises located in custom free zones rose in 1998. If FDI operations are switching from a low-wage mass-production paradigm to a more high-skilled innovation-based one, as some new greenfield investments suggest, there will be greater requirements for subcontracting networks and domestic supplies. Whether current economic trends favour these changes is questionable. While the decline in research and technology investment seems to have stopped, foreign firms are largely responsible for overhauling the R&D system and innovation structures. Diffusion of technology to small firms is slow and there are few enterprises engaged in new products. The government is aware of these gaps and is taking steps to correct these imbalances. It has launched the Supplier Target Programme, which has resulted in a subcontractor Charter already signed by 50 foreign-owned enterprises with 1 500 firms participating in the programme. Under the Preliminary National Development Plan (PNDP), a competitive grants scheme will be accorded for establishing

networks and joint SME production while the Szechenyi Plan of the Ministry of Economy will launch a subcontracting programme. Other initiatives include support to business-related infrastructure and skills in SMEs and a regional catch-up programme for innovation and research from the Ministry of Education. These programmes should be co-ordinated at the delivery level and RDAs should be involved. More generally, the different services provided to SMEs (training, counselling, technological assistance and experiments, networking advice) should be streamlined and clustered at the regional level so that one-stop-shops and specialisation can be introduced among Local Employment Agencies, County Development Agencies and Regional Development Agencies. A regional technological platform integrating the different supply from universities, colleges, public laboratories could be created to diffuse information, offer assistance and propose technological packages for SMEs.

Improving transport and telecommunications infrastructures remains crucial for economic growth.

Adequate infrastructure and spatial externalities as a basis for territorial development are essential for attracting FDI, ensuring that SMEs are competitive and achieving a more balanced, sustainable regional distribution of activities. New transportation links and universal telecommunications access reduce the cost of doing business in peripheral regions, making the inherently lower land and labour costs more attractive to firms.

Highways and a network of main roads should be more evenly distributed and integrated nationwide. Railway and secondary roads need to be improved.

In Hungary, the efforts to improve accessibility have significantly helped to alleviate territorial bottlenecks and improve regional wealth, but much remains to be done. The plan to expand highways and main roads has been given new momentum recently, but the plan to modernise the network remains biased in favour of the West and of Budapest. Its configuration remains radial and few significant binding elements have been added. The railway network is more evenly spread but scarce resources mean that it is insufficiently maintained and repaired. Postponing the restructuring of the National Railway Company (MAV) has already been costly to the Ministry of Finance and the new development plans proposed should foresee the rationalisation of transport services and a separation of tracks and rolling stocks. It may be necessary to envisage the closing of less profitable lines in co-ordination with road modernisation

or regional or county level intermodality investment projects. This points to the need to pay greater attention to the secondary road networks including city by-pass and border crossing. Given that the central government bears three-quarters of the financial burden even with European funding (through the ISPA programme), investment programming needs to be carefully designed and the regional impact requires full assessment. Focusing too much on the TransEuropean Network corridors may broaden rather than narrow accessibility differences between central and peripheral regions.

Infrastructure planning needs to be enhanced to stop the decline of urban public transport...

In Hungary, the volume of public passenger traffic has lessened significantly because the quality of services has dropped and charges have risen to compensate for cuts in the central government subsidy. Apart from providing a reasonable subsidy given the important externalities of public transport, municipalities should improve infrastructure planning and increasingly consider the demand for multi-modal transport especially in suburban areas. The central government also has a role to play in promoting coherent land use planning, modernising city road networks and investing in traffic attenuation facilities. In Budapest and the major cities, it could help promote the co-ordination of services between railway, buses and interurban services.

... and a more open telecommunications market needs to be established to more rapidly bridge the gap with other OECD countries.

Telecommunications have experienced some degree of catching up. Hungary is now on a par with the OECD average for digitised networks and mobile services. However, telecommunications facilities are unevenly distributed across the territory, the density of telephone lines in villages is often low, and long distance calling and calls to the countryside can be of poor quality and subject to disconnection. Telecommunications are therefore a major obstacle to regional development, even outranking transport or border-crossing problems. Privatising the National Company (MATÁV) has been a significant leap forward, but competition remains limited, which means upward pressures on cost and price. The Hungarian unit price for Internet connection is still the highest among OECD countries. A more open market should be established to improve access to advanced telecommunications services and the universal services obligation should be enforced.

Despite progress, there are still considerable environmental problems, especially in the cities and the east, which call for greater involvement from sub-national authorities.

The sustainability of transport investment and public infrastructure in general have been major issues in Hungary since the early days of the transition process. At regional level, environmental cleanliness is now increasingly considered to be a comparative advantage and a potentially attractive element of the business climate for people and private investment. Although some progress has been made on pollutant emissions, Hungary still lags behind in waste management and water treatment capacity. The complete integration of the *acquis communautaire* requires time and effort. While western border regions will soon match the level of environmental protection of advanced OECD countries, progress in a number of other areas is disappointing. New sources of air pollution have emerged around major cities. There is not enough control of discharges into rivers (especially into the Danube). While financing environmental protection investment, harmonising priorities with those of the EU, and getting EU support (ISPA) are important tasks for the central government, sub-national authorities are generally best placed to offer local solutions to sustainable development problems. In Hungary, however, counties or regions still have few responsibilities. Since they have to prepare regional plans, their involvement in impact assessment studies, awareness campaigns, and citizen consultation should be better ensured.

Securing a more functional housing market can significantly improve the quality of life and the mobility of the labour force.

The quality and limited availability of housing infrastructure have hindered interregional mobility and job-generating investment. The housing market remains particularly rigid due to, among other factors, the previous policy of low give-away prices and the transfer of part of the stock to cash-deprived local governments. In addition, scarce resources and the absence of a central subsidy to municipalities have made renovation particularly difficult, especially in large cities. An underdeveloped credit market (particularly the mortgage system) prevents any large turnover of housing and makes new construction affordable only for the highest income strata. The central government is now more concerned with the problem of high real estate prices in major cities and the existence of an important non-solvent demand for housing. From 2001, greater commitment has been reflected in the Szechenyi Plan's priority for housing – while the National Budget provides

resources for rental housing and renovation. While the plan targets first-home buying and market expansion, it also aims at enhancing the liveability of regions and cities profile and at meeting the needs of the disadvantaged, especially the elderly. The plan will need to be carefully implemented in order to reduce existing disparities, which requires applying an equalisation formula to the allocation of subsidies to be derived from the new state fund.

Bridging the social gap with more advanced OECD countries will require more targeted policy responses.

According to official estimates, the percentage of the population living below the subsistence level rose from 10 per cent in the 80s to 25 per cent in the mid-90s. In addition, Hungary has a negative demographic situation because of a low rate of natural increase and a high mortality rate. The under-emphasis on social issues in territorial policy-making is all the more surprising given that poor social performance is widespread and touches even the most advanced regions. During the first stage of the transition, poverty spread in many areas after unemployment surged because of agricultural streamlining and the dramatic restructuring of the manufacturing industry. The budget and scope of policy responses have been limited thus far. Welfare provisions to the poor include social assistance, family allowances (childcare) and income supplement paid to the long-term unemployed. In 1999, a workfare element was introduced in the unemployment assistance system, which is a positive step to encourage work initiatives, but the new system is strongly biased in favour of public works, increasing the dependency of lagging regions on the public sector. So far, policies have done little to correct territorial imbalances in the number of hospital beds, doctors and the amount of resources allocated to health infrastructures between the different regions. With regard to family benefits, the focus is now increasingly put on the most needy, although it is still perceived as favouring the middle-classes. Overall, more efforts should be made to improve access to welfare benefits for the poorest.

Active labour market policies in lagging regions focus too much on public works.

Unemployment has been identified as the main cause of poverty and the government has taken some policy initiatives in order to meet this challenge. Many of these policy initiatives (*e.g.*, wage subsidies) are non-territorial by nature. However, the labour market fund is now focussed more on interventions in targeted regions. Furthermore, active labour market policies (ALMP) are being implemented by

the Country Labour Centres (CLC) to initiate welfare to work processes. Nine Regional Labour Development and Training Centres have also been set up to tackle structural unemployment issues but the network is not sufficiently articulated with the business environment. In addition, a major share of the CLC funds goes to public work programmes. On the whole, the policy efforts remain modest. Expenditure in less favoured regions is well below the OECD average, while several regions, including North Hungary and the Great Plain are still plagued with significant and persistent high unemployment rates.

More decentralised intervention will increase the efficiency of social policy initiatives.

Deconcentration and even the decentralisation of some social policies could help deal with the problem of poverty and exclusion more effectively. So far, local authorities have spent about 57 per cent of the social expenditure budget on social benefits, principally employment benefits, housing aid and other transitional aid, and the figure is growing. The capacity of local governments to intervene depends largely on local tax revenues, and deficits concerning basic equipment are very common in settlements with populations of above 20 000 or in small villages. In this context, social grants are targeted at local governments in fiscal crises. Intergovernmental grants and central programmes such as the Social Land Programme and emergency aid do lend some equalisation, but special attention should be given to covering basic procurement of equipment in villages. A preventive policy for health risks could be better promoted at local level while more flexible arrangements and active public participation should be encouraged. Such arrangements between local transport, housing and health policies are critical for determining an appropriate response to ageing and social problems and can be better co-ordinated and managed in a decentralised way. At the same time, strong vertical decentralisation does not seem to provide appropriate responses for managing large health equipment and hospitals when greater responsibility given to local governments is not accompanied by corresponding financial resources. Overall, clarifying the roles among administrative layers is required to avoid duplication and excess capacity.

Co-ordination of infrastructure and programmes in education should be improved.

Results of decentralisation in education are mixed. Local governments have been given significant autonomy and wide responsibilities, but decentralisation has led to fragmented curricula and has sometimes produced problems of cost-effectiveness. Some schools suffer from scarce resources and poor teaching staff while others are over-staffed. The merger of some schools seems necessary to use available resources more efficiently while access to basic education should be ensured in backward regions. The proportion of students leaving the education system without a diploma remains high and tertiary education participation rates are low in some areas. It is important to improve regional co-ordination of infrastructure and programme content as well as to elaborate a national strategy to tackle the most disadvantaged groups. It is also crucial that education and regional development policy be more integrated to improve school-to-work transitions.

The social problems of the Roma population require specific attention.

The Roma population is another important social issue. This disadvantaged minority is characterised by a particularly low rate of educational enrolment, low average income and high vulnerability to poverty. Therefore, it deserves special attention. The Roma represent, depending on the source, between five and 10 per cent of the population and far more in the northeastern and southern regions, and their number is expected to double by 2025. They have a higher than average rate of unemployment and most of their income is derived from social benefits. To improve their inclusion in the labour market and in society at large, successive Hungarian governments have targeted policy packages that emphasise education, training, preserving cultural values, enhancing employability, experimental housing and agrarian programmes. The success of these measures is critical if the government wants to alleviate the social budget burden. It is important to have the Roma participate in their own affairs and minority self-government has been recently established to implement cultural activities, create enterprises, and to allow them to voice their views and veto some local government decisions. The Law on Minorities should nevertheless be amended to enforce more efficient anti-discrimination legislation in employment and education and to ensure the consultative power and participation in major policy initiatives of

minority self-governments and their representation in Parliament. Initiatives associating Roma and non-Roma citizens should be strongly encouraged and information about Roma culture and values widely diffused.

In sum, a balanced approach to decentralisation and rural and urban development will greatly improve the sustainability of the current growth path of the Hungarian economy.

Hungary has made outstanding progress implementing institutional changes, privatising assets, creating macroeconomic policies and improving the quality of public services and infrastructure. The sustainability of the new growth trajectory is not yet established and requires policy corrections. Without these, spatial fragmentation, disparities in wealth and employment between the east and the west, the capital and the periphery, and between urban and rural areas will increase. The challenge is twofold. First, the central authorities need to partner increasingly with sub-national entities and to establish relevant institutional arrangements. This co-operation is already taking place through territorial development programmes provided for municipalities and agencies, but it should be intensified in order to meet regional economic demand. Assistance from the EU and additional infusions of resources from the European Commission clearly favour the country's progress, particularly in accelerating institutional building and laying the groundwork for increasing subsidiarity in the governance of territorial policy. Furthering the process of decentralisation will, however, require rebalancing resources in favour of the lower levels. Second, given the present trends towards polarising activities and growing intra-regional disparities, the central government must shape territorial policies in particular through regional aid schemes for SMEs, strengthening regional infrastructure and encouraging entrepreneurship. While much attention should be paid to rural development, modernisation of agriculture and diversifying services including tourism, urban policy should not be ignored. Budapest is the only city with international functions. Its role as gateway to the world needs to be reinforced and the institutional framework for the capital and the other large cities should be stabilised. It is especially critical to encourage better agglomeration management through inter-municipal co-operation. Such shifts in policy emphasis should facilitate the transition to EU adhesion and increase the acceptance of structural change.

Chapter 1

Transition and Territorial Disparities

In the early 20th century, Hungary's level of development resembled that of Austria, Finland, Italy and Spain. By 1989, however, before the depression of the transition period, Hungary was already lagging behind these countries, along with Greece and Portugal that had the lowest GDP per capita in Europe. Since then, it has undergone a transformation. It has become a market-driven economy, is once again a democracy and is preparing for accession to the European Union. Today, Hungary ranks as one of the top economic performers among Central and Eastern European countries in transition and is slowly catching up with countries in the southern EU zone. Growth has exceeded four per cent in each of the past three years, inflation has been cut by a third and unemployment is below European levels. This strong economic performance is expected to continue over several years. However, the benefits and costs of the transition process have not been distributed evenly. Income levels, unemployment and poverty rates differ widely across the country and large parts of the population currently suffer from social exclusion. Investment has been concentrated in just a few areas, leaving certain sectors and regions behind. The significant widening of spatial disparities, the lack of cohesion and infrastructure connections between different parts of the territory, and the need to consolidate the gains from stabilisation represent many good reasons for adopting a new approach bringing together macroeconomic and territorial policies.

Macroeconomic situation

During the last three years, the average growth rate of 4.7 per cent in Hungary was among the fastest in the OECD. The last OECD *Economic Survey* projected that this sustained expansion of GDP driven by exceptional growth in exports and a strong demand-side environment would continue at a rapid, balanced rate. Unemployment had fallen to 6.3 per cent – well below the European average and close to the OECD-wide mean – by the first quarter of 2000 while employment increased by a record three per cent during 1999. The inflation rate was reduced by one-third between 1995 and 1999, the general government deficit was reduced by one-half, and the gross debt declined from 90 to 62 per cent of GDP during the same period thanks to the substantial reforms implemented

during the past decade, such as the 1995 Bokros Stabilisation Plan which aimed at improving internal and external imbalances.

During the transition period, Hungary put in place most elements of the legal and institutional framework for a market economy: domestic prices and wages, and foreign trade and investment were liberalised; privatisation was almost completed (approximately 80% of value added is now produced in the private sector¹); a solid corporate governance structure was created with the help of a strict Bankruptcy Act; and the regulatory reform made impressive progress (see OECD, 2000*g*). In addition, more than 90 per cent of European Community directives have been adopted and should be integrated into the legal system over the coming years. The new environment has helped to improve the business climate and enterprise performance as attested to by the dramatic rise in foreign direct investment (FDI) and Hungarian exports, which increased by approximately 90 per cent between 1996 and 1999. Today, Hungary has a strong, competitive economy that survived the crisis in the Far East and Russia without any serious problems.

However, not all parts of the territory have benefited from this strong economic performance, and social exclusion is a matter of great concern for large parts of the population. During the first third of the 1990s, Hungary experienced an economic recession due to the external and supply shocks of the transition: the loss of eastern markets, price liberalisation and the shift to world prices resulted in a collapse of investment and a 20 per cent drop in personal income and consumption. The crisis affected the territories unevenly, with unemployment increasing sharply, particularly in certain regions and among some categories of workers. Even more worrisome was the increase in the share of the population living below subsistence level from 10 per cent in the 1980s to 25 per cent by the mid-1990s.

Although recent macroeconomic trends have been positive, there is some concern that the economy may be approaching the limit of potential growth. Thus, the disinflation process paused in 1999 and 2000, partly because of external factors, and, although in decline, the general government deficit remains high. Moreover, as strong capital inflows resumed in 2000, the narrow-fluctuation band of the existing exchange rate regime forced the central bank to allow interest rates to fall pro-cyclically even as the economy approached its level of potential output, redoubling the need for a more restrictive fiscal policy. In this context, current plans to raise government spending by as much as 1.5 per cent of GDP risk overheating the economy and increasing a current account deficit that would need to be offset by spending elsewhere to preserve an internal and external balance. This means that the government needs to examine its spending priorities carefully. Indeed, past efforts at fiscal restraint have concentrated on limiting wage growth and delaying investments – mechanisms that are not sustainable in the long run and which tend to hinder development efforts. Indeed, these trends highlight the structural problems of the deficit, since spending is biased towards public consumption, and transfers to enterprises and households, to the detriment of investment in areas such as infra-

structure. Public investment was cut heavily in 1999 but rebounded in 2000. If new spending is to take place and disinflation to resume, they will have to be accompanied by offsetting cutbacks to existing programmes.

Given the wide range of social, fiscal and industrial policies that have a territorial component and the need to lower or maintain overall spending at current levels, the government should continue to reorient programme spending in an effort to offset territorial imbalances and promote growth in persistently lagging areas. Indeed, more balanced territorial growth could relieve some of the fiscal burden by reducing social costs and increasing domestic supply as lagging regions increase output. In this respect and as indicated in the *OECD Economic Surveys: Hungary* (OECD, 2000c), there appears to be ample opportunity for increasing the extent to which household transfers are targeted at those most in need – which, given the uneven distribution of such people, would serve to reduce regional disparity. Moreover, freed resources could then be applied to territorial development issues.

Economic trends and empirical evidence of spatial disparities

Spatial disparities are not new in Hungary. After World War II, industrialisation based on heavy industry, had already created a strongly industrialised northeast development axis, and an agriculture-based southwest development axis. However, the economic crisis since the early 1980s together with the economic, political and social changes of the transition significantly modified the territorial pattern and increased disparities. Central Hungary, including the capital of Budapest, the only metropolitan region (see Box 1 and Figure 1), consolidated its dominance over other regions. The gap between urban and rural areas also increased. New differentials have been created and reinforced with an east-west gap and localised crisis areas. In general, the creation of a market economy favoured the already developed regions, especially Budapest and its surrounding area, but adversely affected regions dominated by traditional structures in sectors such as heavy industry or agriculture, which became the transformation losers (Figure 2). This was the case for the majority of labour-intensive industrial plants based in the rural areas of the northeast and southwest.

Output and income

Gross domestic product (GDP) is an obvious indicator of regional disparities. The bulk of the output registered by the Hungarian economy since the beginning of the transition was produced by Central Hungary (41.6%). Figure 3 indicates the regional disparities of GDP per capita in relation to the national average. The high performance of Central Hungary, however, does not concern all regions: Pest County exclusive of Budapest is not as prosperous as West or Central Transdanubia whose performances are above or close to the national average.² The other four regions (northeastern and southern regions) are approximately at the same

Box 1. The new territorial organisation

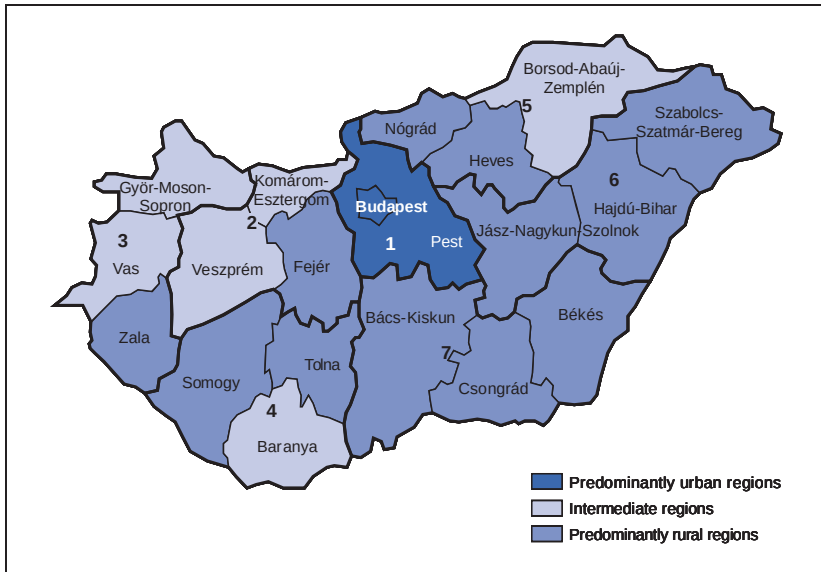
Statistical regions were introduced in the mid-1990s in the search for a more appropriate unit of analysis and intervention, given the important economic changes that had taken place in the economy. This choice was encouraged, among other things, by the need to adhere to European Union procedures for structural funds. The division of the country into “statistical and planning regions”, approved by Parliament in 1996, complies with the five-level nomenclature of territorial units (NUTS) of the European Union: the state (NUTS 1), the regions (NUTS 2), the counties (NUTS 3), the “statistical” small areas (micro-regions) (NUTS 4) and the settlement level (local governments) (NUTS 5). This system guarantees that the requirements of the information system of the European Union are fulfilled and that data are both comparable and adequate for access to the various assistance funds.

The OECD Territorial Development Service distinguishes between three types of regions on the basis of population density: Predominately Rural (more than 50%), Intermediate (between 15 and 50%) and Predominantly Urban (less than 15%).* The system of territorial breakdown distinguishes between two sub-national levels: local communities, which generally represent the smallest administrative or statistical unit of the country, and regions, which in most countries are the second official sub-national administrative level (departments in France, provinces in Italy, counties in the United Kingdom and Hungary). To establish the OECD typology, rural local communities are defined as having a population density below 150 inhabitant/km² (500 for Japan). As far as Hungary is concerned, 12 of 20 counties are predominantly rural, six are intermediate, and two, which form the statistical region of Central Hungary, are predominantly urban (Figure 1).

* In any analytical study conducted at sub-national levels, the choice of territorial unit is critical. The OECD's current territorial database encompasses demographic, economic and social data at two sub-national administrative levels: large regions (TL2 = some 300 such regions for the 29 OECD Member countries) and small regions (TL3 = approximately 2 300 regions). Despite all the imperfections of this breakdown for international comparability, it seems best suited to analytical and empirical work, for most of the available, updated and comparable data are found at this level. Moreover, these levels are officially established and relatively stable in all OECD Member countries, which many of them use as a framework for implementing regional policies.

level, around 70-80 per cent of the average. Covering the entire territory of the country, the standard deviation of GDP per capita moved between 25 and 30 per cent during the period 1994-1998 (Figure 4).³ During this period, the gap widened by five per cent and the figures indicate a steady growth. Excluding Budapest, the rate is still over 19 per cent, which suggests that there is more to the problem than the important capital *versus* non-metropolitan areas issue. Even in this relationship, the gap increased by five to six per cent during 1997-1998.

Figure 1. Typology of Hungarian regions

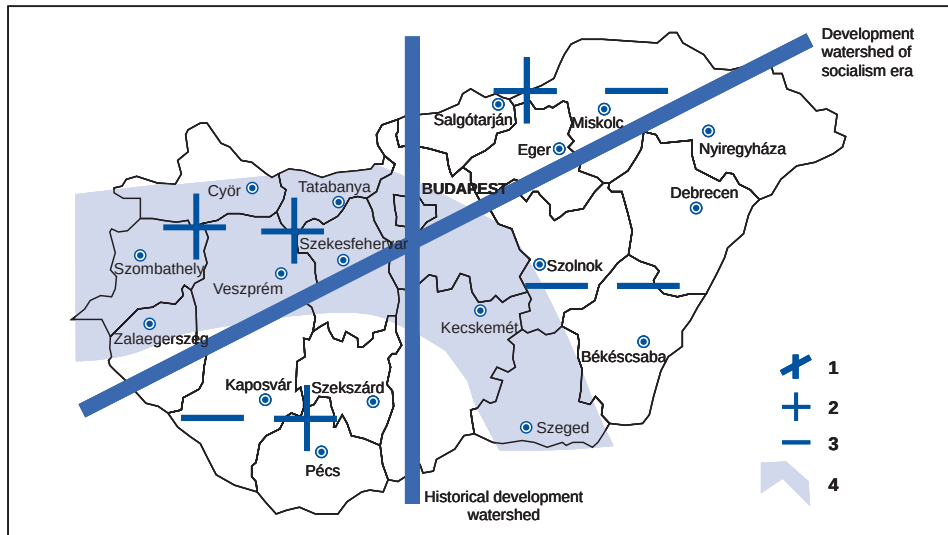


1. Central Hungary (Pest, Budapest).
2. Central Transdanubia (Fejér, Veszprém, Komárom-Esztergom).
3. West Transdanubia (Vas, Győr-Moson-Sopron, Zala).
4. South Transdanubia (Somogy, Tolna, Baranya).
5. North Hungary (Nógrád, Heves, Borsod-Abaúj-Zemplén).
6. North Great Plain (Szabolcs-Szatmár-Bereg, Hajdú-Bihar, Jász-Nagykun-Szolnok).
7. South Great Plain (Békés, Csongrád, Bács-Kiskun).

Source: OECD/TDS-TSI, 2000.

Income data confirm the existence of large spatial differentials (Figures 5 and 6). The regional income differential in 1998 shows a gap of 11 per cent. The central and western regions are better off than those situated on the Great Plain or in the northeast. An average household on the North Great Plain has around three-quarters of the income of a household in Budapest. However, if the comparison is based on counties, the standard deviation almost doubles to reach 18.2 per cent. If the comparison is based on the micro-regions, the standard deviation is nearly 30 per cent as in GDP and unemployment disparities.⁴ This latest unit of analysis is very similar to a functional region and local labour market areas (Box 2) that would be more appropriate to the study of territorial socio-economic trends. Figure 6 shows the taxable income base per capita of the counties. Four of the 19 counties – two of Central, two of West Transdanubia – and the capital are higher than the national average. The bulk of the southern counties are in the middle range, while the income levels of the northeastern counties vary between 63-79 per cent of the average. Counties with the highest share in agriculture produce the lowest income base.

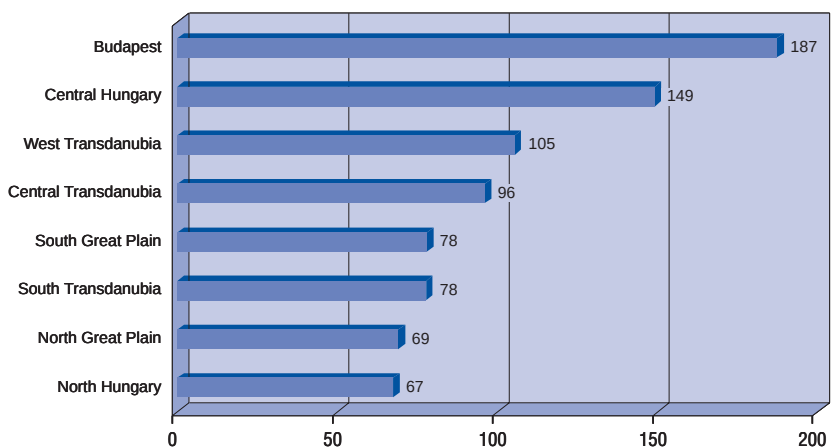
Figure 2. Winner and loser areas in Hungary



1. Development watershed.
 2. Winning areas.
 3. Losing areas.
 4. Development zone.
- Source: Faragó, L., 1999b.

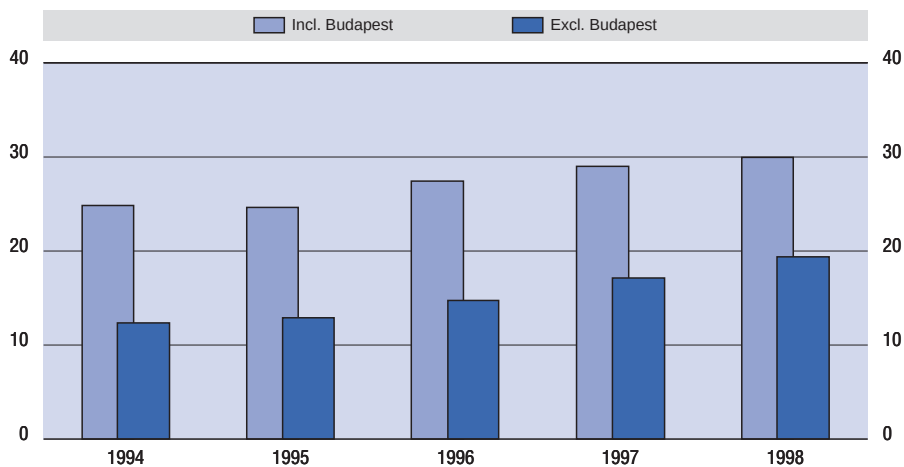
Figure 3. GDP per capita by regions, 1997

National average = 100



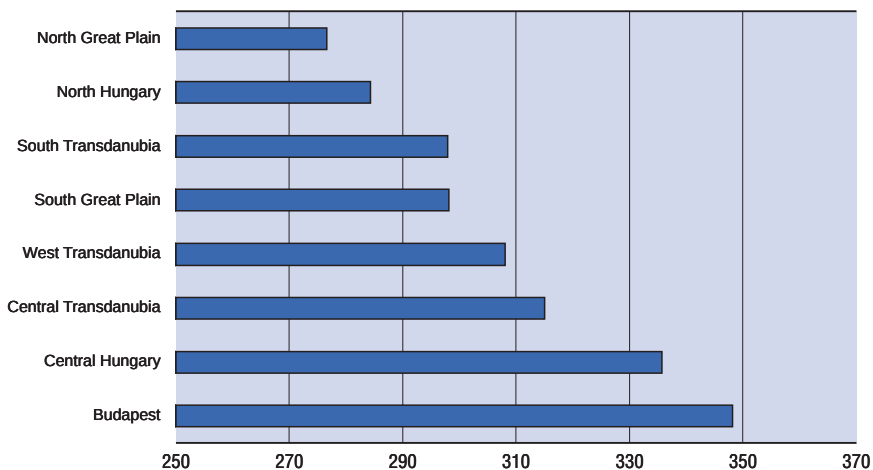
Source: Data from the Hungarian Central Statistical Office.

Figure 4. **GDP per capita at county level, 1994-98**
Standard deviation to national average



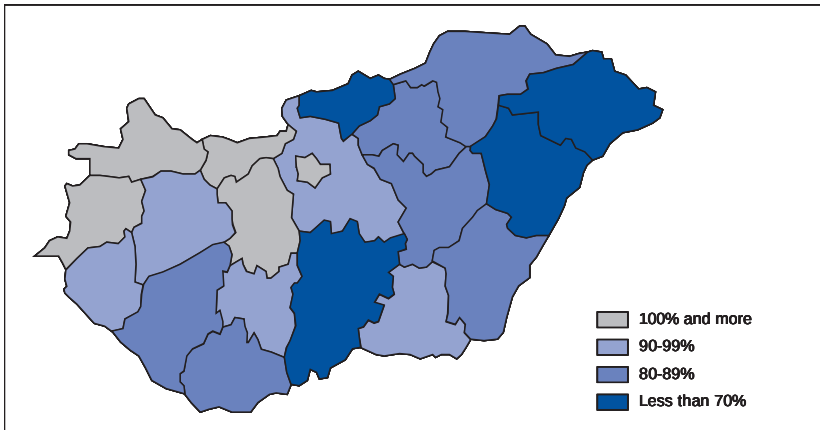
Source: Data from the Hungarian Central Statistical Office.

Figure 5. **Household average annual income by regions, 1998**
Thousands of HUF



Source: Data from the Hungarian Central Statistical Office.

Figure 6. **Taxable income per capita, 1997**
National average = 100



Source: Data from the Hungarian Central Statistical Office.

Employment and unemployment

Hungary is among the transition countries that suffered the worst consequences from the adjustment of the labour market. The loss of 27 per cent of all employment between 1990 and 1996 is striking compared with 18 per cent in Slovenia, 16 per cent in the Slovak Republic and 8.6 per cent in the Czech Republic and Poland. Unemployment spread rapidly from region to region, hitting its maximum national average of 12 per cent in 1993 and affecting every region (including the Centre). The gap between regions settled at around 30-35 per cent in 1998⁵. In general, apart from the gap between Budapest and non-metropolitan areas, there is a significant deviation between the western and eastern parts of Hungary. Figure 7 shows that unemployment rates were higher than average in the eastern counties and lower than average in the western counties with the exception of South Transdanubia. With the economic recovery, unemployment fell to 6.3 in early 2000. Disparities still persist as North Hungary, Northern Great Plain and South Transdanubian regions have higher unemployment rates – respectively 11.6, 10.2 and 8.3 per cent – than Central Hungary (5.2), West Transdanubia (4.5), Central Transdanubia (6.1) and South Great Plain (5.8).

Employment trends are similar, with some remarkable differences. In 1999, in West Transdanubia, 63 per cent of the population aged 15 to 64 was employed, while in North Hungary the figure was only 48.2 per cent. County disparities stand around 30 per cent (standard deviation). More than one-third of all

Box 2. The functional regions

One of the major difficulties in using census data for local analysis is that they usually refer to territorial units of an administrative nature, which are virtually without geographic or statistical significance and are therefore ill-suited to the study of socio-economic phenomena, or to formulating or managing policies intended to encourage or compare them. The solution is to adopt territorial entities representative of how the society organises itself by localising residential, productive and recreational units in relation to which economic activities and social relations develop.

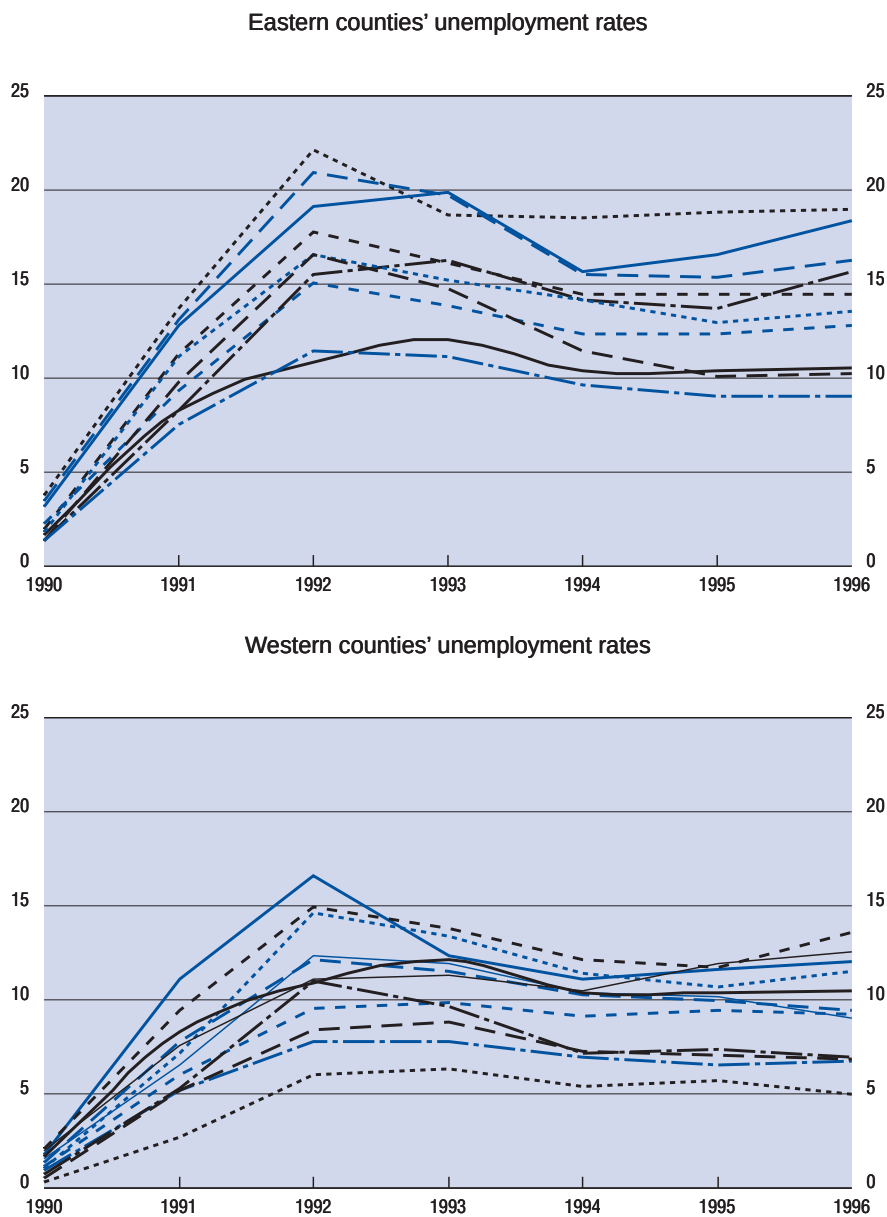
The importance of the territorial unit in any analytical study has led the OECD to undertake experimental work on the relevance of establishing the boundaries of functional regions on the basis of travel time to work. These regions correspond to Local Labour Market Areas (LLMAs) and provide an exhaustive breakdown of national territories. On the whole, the unofficial and unstable nature of these boundaries makes data collection and monitoring over time relatively difficult. But in most OECD Member countries, certain objectives and territorial strategies are being defined increasingly at these levels. The objective of these analyses is therefore to assess the possibility of using functional regions as a territorial unit of analysis and intervention for territorial policies.

Most OECD Member countries have now established official or semi-official boundaries for LLMAs. Even though the thresholds selected for commuters differ across countries and, in many cases, the criterion of travel to work is combined with other criteria (such as the distance of daily travel, inter-city co-operation, etc.), the boundaries of these functional regions are based on the same principle, which opens up new perspectives for international comparisons at sub-national levels.

In Italy, for example, a functional regionalisation of the country has been defined based on a geographical pattern of LLMAs. LLMAs are units of analysis that are statistically and geographically meaningful and comparable, because they are based on the same set of criteria all over the country. They are relatively self-contained, extended areas made up by a cluster of municipalities (cutting across provincial and regional boundaries) defined by processing daily journey-to-work data made available from the 1991 census. Self-containment refers to the fact that job supply and demand tend to be equal in respect to the area over which they extend, because the majority of the resident population works within it and employers recruit workers from the constituent municipalities. Therefore, they represent the daily living environment of the area's residents. One of the main characteristics of LLMAs is their high level of internal integration in terms of social, cultural and economic variables. Thanks to this feature, LLMAs are particularly well suited to the analysis of processes that are locally rooted, such as territorial disparities.

employees work in Budapest but less than one-fifth of the economically active population lives there. Győr-Moson-Sopron and Vas counties have the highest GDP in the west and employ a significantly larger share than their active population

Figure 7. Unemployment trends by counties



1. Note for both figures: National average = thick black line.
 Source: Data from the Hungarian Central Statistical Office.

would suggest. In all other areas, the share of employment is lower than the share of active population.⁶ Recent trends in the labour markets have been positive as employment registered a record three per cent increase. A positive trend is that from the beginning of 1999 to the first quarter of 2000, the growth rate of employment was fastest in the lagging regions, except for the Northern Great Plain. Yet, it is too early to confirm that a process of convergence is underway.

Some factors explaining the new pattern of territorial disparities

Spatial disparities appear particularly important in Hungary, whether they are measured in terms of income, output, or employment. Many factors can be identified as being responsible for this but any list would only be discouraging or frustrating, whereas the importance is to orient policy-making towards identifying a useful territorial strategy. Although they are not exhaustive, three issues appear crucial for explaining disparities in many OECD countries: the structural mix; entrepreneurship and foreign direct investment; and research and development.

Structural mix, localised crisis areas and poles of growth

Localised crisis areas emerged when the sectoral composition of the economy and industry were re-organised after the economic crisis of the 1980s and the transition of the 1990s. The heavy industry axis in the northeast-southwest central mountains, which had formed the most stable pier of the Hungarian economic structure for nearly four decades, completely collapsed. The competitiveness of these regions (mostly northeastern and South Transdanubia), dominated by a mono-sectoral industrial base and a rigid hierarchy, declined as labour-related taxes rose. Most suffered or still suffer from the restructuring. In mining, metallurgy and the textile industry, almost 200 000 jobs were suppressed between 1988 and 1994. Approximately 100 000 employees in these sectors are highly concentrated in a few locations: 92 per cent of the coal miners work in the Borsod-Abaúj-Zemplén, Komárom-Esztergom and Veszprém counties; significant coal and uranium mining took place in the hilly areas of South Transdanubia; 90 per cent of the jobs in iron and steel manufacturing are located in the Borsod-Abaúj-Zemplén, Fejér, Nógrád counties and the capital city, while half of all textile industry employees are concentrated in the Győr-Moson-Sopron, Vas and Csongrád counties, and in Budapest. Many of these regions definitively lost their main economic activity. The mining sector lost the biggest share of its employees (80% between 1984 and 1995), followed by mechanical engineering (67%), metallurgy (63%), shoes and leather manufacturing (56%) and the textile industry (54%). Between 1984 and 1995 the number of active earners in the primary sector fell by 621 000 (53%), while in the secondary sector it fell by 775 000 (39%).

Crisis areas in eastern Hungary including the counties of the Great Plain are related to agricultural production. During the transition, the integrated chain of

production purchasing broke up. State support ceased or decreased to a minimum, making agricultural credits scarce; the agricultural parity gap yawned. Changes in ownership, the loss of the eastern markets and the trade distortion of agricultural policy in certain western counties resulted in large-scale agricultural depression. Three-quarters of the agricultural organisations that went bankrupt were located in the lagging regions specialising in the primary sector. Table 1 indicates sectoral and branch shares in county and regional GDPs in 1997. Regions with the highest GDP share in agriculture are located on the Great Plain and in South Transdanubia.⁷ The economic performance of the counties is far from even. Southern Plain counties show much better output and employment figures than the northern ones. In North Hungary, particularly in Borsod-Abaúj-Zemplén County, agriculture became increasingly important because of land privatisation and the high numbers of industrial workers who had lost their jobs and were pushed into alternative employment, despite lower productivity and wages. This could have stabilised visible pockets of unemployment. Agricultural production and employment rates are constantly dropping since valuable natural assets and the technological tradition have not been able to strengthen the sector sufficiently to make it competitive.

Conversely, growth poles have emerged or consolidated in those regions that managed to adapt their economic structure to the new conditions of the market economy. The manufacturing industry and financial and business services have driven output growth since the mid-1990s. A new competitive industrial axis was relocated in central and western Hungary, with machinery as a key sector. In the tertiary sector, the most service-specialised regions include Budapest (76.8%), Baranya (62.7%) and Somogy (61.5%) counties. Recently, South Transdanubian regions increased their share of the service output. In financial services, Budapest and a few southern counties produce the highest share. Practically all new banks, insurance companies, international financial consultants, the entire turnover of the stock exchange market and the major part of international transactions are concentrated in the capital. The tourism sector, which registered slight improvement, is still thwarted by structural problems. In addition, it is geographically concentrated in Budapest and Balaton Lake despite such potential as thermal spring sources in many other areas.

Entrepreneurship and foreign direct investment

The many reforms launched in the 1980s to create a more market-oriented economic environment resulted in more enterprises in Hungary at the beginning of the 1990s than in other Central and Eastern European countries. During its transition, Hungary experienced extremely vivid entrepreneurship. According to Eurostat, enterprise density (50.7) is higher than the western European average (42.8).⁸ Small and medium-sized enterprises (SMEs) account for half of value added, only one-third of exports but two-thirds of employment (ISE, 1999).⁹ Thus, the Hungarian economic environment is dominated by micro enterprises and individual

Table 1. **Sectoral and branch shares of GDP, 1997**

% of GDP

Region and Metropolitan areas	Primary sector		Secondary sector		Tertiary sector		
	Total	<i>of which:</i> agriculture, farming and forestry	Total	<i>of which:</i> manu- facturing industry	Total	<i>of which:</i> financial services	<i>of which:</i> other services
Share of GDP calculated at 1997 basic price							
Budapest	3.4	0.5	19.9	15.7	76.8	29.1	19.6
Pest	9.3	5.4	35.9	28.7	54.8	15.4	15.3
<i>Central Hungary</i>	4.4	1.4	22.8	18.1	72.8	26.6	18.8
Fejér	10.9	6.1	50.0	46.0	39.0	12.2	12.8
Komárom-Esztergom	13.8	7.2	37.7	32.9	48.6	12.7	17.3
Veszprém	12.1	5.8	33.0	28.1	54.8	13.7	19.0
<i>Central Transdanubia</i>	12.0	6.3	42.1	37.6	45.9	12.8	15.7
Győr-Moson-Sopron	10.1	6.8	38.2	33.0	51.8	13.7	16.9
Vas	7.1	5.3	50.7	46.8	42.2	11.1	15.0
Zala	11.4	7.1	36.0	30.8	52.6	12.8	17.7
<i>West Transdanubia</i>	9.5	6.4	41.3	36.5	49.2	12.7	16.6
Baranya	17.3	9.1	20.0	15.9	62.7	17.5	22.8
Somogy	13.6	11.0	24.9	19.4	61.5	14.5	22.1
Tolna	32.8	13.0	19.7	15.0	47.5	12.6	17.7
<i>South Transdanubia</i>	20.4	10.7	21.4	16.8	58.2	15.3	21.2
Borsod-Abaúj-Zemplén	13.8	5.9	33.0	28.6	53.2	12.6	20.5
Heves	17.8	8.1	27.2	23.0	55.0	14.8	20.6
Nógrád	9.7	6.6	30.9	26.1	59.4	14.2	24.9
<i>North Hungary</i>	14.3	6.6	31.1	26.8	54.5	13.4	21.1
Hajdú-Bihar	15.6	11.8	26.7	22.3	57.7	14.0	22.2
Jász-Nagykun-Szolnok	14.1	10.5	33.2	29.4	52.7	14.1	19.8
Szabolcs-Szatmár-Bereg	14.0	10.9	26.9	21.5	59.1	12.1	23.2
<i>North Great Plain</i>	14.6	11.1	28.7	24.2	56.7	13.4	21.8
Bács-Kiskun	17.1	15.0	27.0	22.6	55.9	13.2	18.6
Békés	17.0	14.8	30.5	26.6	52.6	13.7	20.7
Csongrád	15.2	11.4	26.3	22.1	58.5	17.7	21.1
<i>South Great Plain</i>	16.4	13.6	27.7	23.5	55.9	15.0	20.0
Hungary total	10.1	5.9	28.5	23.9	61.4	19.1	19.1
Non-metropolitans area	13.7	8.7	33.0	28.2	53.3	13.9	18.8

Source: Hungarian Statistical Central Office (1999a): *Regional Statistical Yearbook*, 1998.

entrepreneurs just like the southern member states of the European Union. Regional policy thus has a very important role to play in order to provide SMEs with an environment that supports growth.

The spatial distribution of enterprises does not indicate large differentials although there are slight differences, especially between the northeast and north-

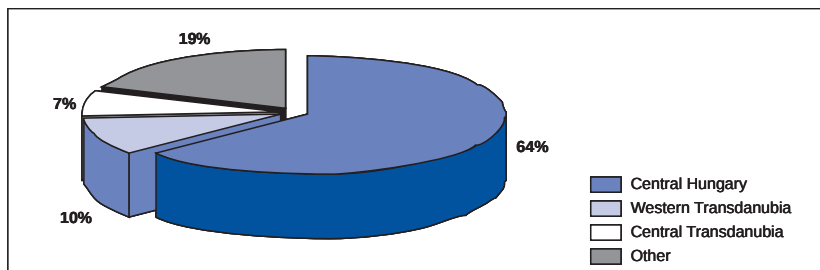
west. These disparities are less significant than for other indicators. Within regions, there is a high concentration in large and medium-sized towns. The only remarkable division is the large gap between the capital and non-metropolitan areas: enterprise density is nearly four times higher in Budapest (73%) than the countryside average (18.6%) which explains the high national correlation coefficient between GDP and enterprise density (0.65%) and the lack of correlation at non-metropolitan level. However, some correlation can be found between enterprise density and unemployment. Low unemployment with high enterprise density is typical for the capital, regional seats¹⁰ and highly touristic places such as Lake Balaton. Low unemployment with medium enterprise density or medium unemployment with high enterprise density characterises the capital seats of the more disadvantaged regions such as the northeastern counties or the micro-regions with medium-sized town centres in the more developed west. The other extreme situations are more typical in regions with localised crises (ex-heavy industrial areas) and agricultural peripheries (North and East Great Plain). The odd regions (low to medium figures in both categories) usually represent the less dynamic regions in the west and the central area (mainly with agricultural or old industrial bases). Some inner peripheries in the east also belong to the group of low enterprise density with high to medium unemployment.

A strong link exists between foreign ownership and enterprise efficiency (Halper and Korosi, 1998). In addition, productivity growth has been much higher in companies with foreign capital than in domestic firms and the same is true for employment growth, following initial layoffs. Even when total employment was decreasing, these companies raised their employment level (OECD, 2000b and Sass, 1996). As of 1997, enterprises with a share of foreign ownership accounted for approximately one-third of private sector employment, 70-80 per cent of industrial exports, and a large share of GDP. The government recognised the positive effects of FDI early on and introduced a complex incentive system to attract foreign investors. Total FDI in Hungary reached USD 20 billion at the end of 1999.

As for other indicators, FDI in Hungary is highly spatially concentrated. The central and the northwestern (West Transdanubian) regions accounted for almost three-quarters of all FDI in Hungary (Figure 8). Budapest alone captured 54 per cent of foreign capital invested. The areas along the Austrian borders continue to attract FDI but their share of the working capital imported into Hungary is tending to decrease and the foreign capital mostly benefits small organisations. Recently, North Hungary has also benefited from larger FDI inflow mainly through privatisation in steel and metalworking. Foreign investors still ignore South Transdanubia and to a lesser extent the Great Plain area where recent trends show a slight penetration of foreign capital in Debrecen, Nyíregyháza (Northern Great Plain) and Kecskemét, Békéscsaba, and Szarvas (South Great Plain).

There is a very strong correlation between the indicators of foreign capital per capita and GDP per capita among the regions. A correlation coefficient of 0.97

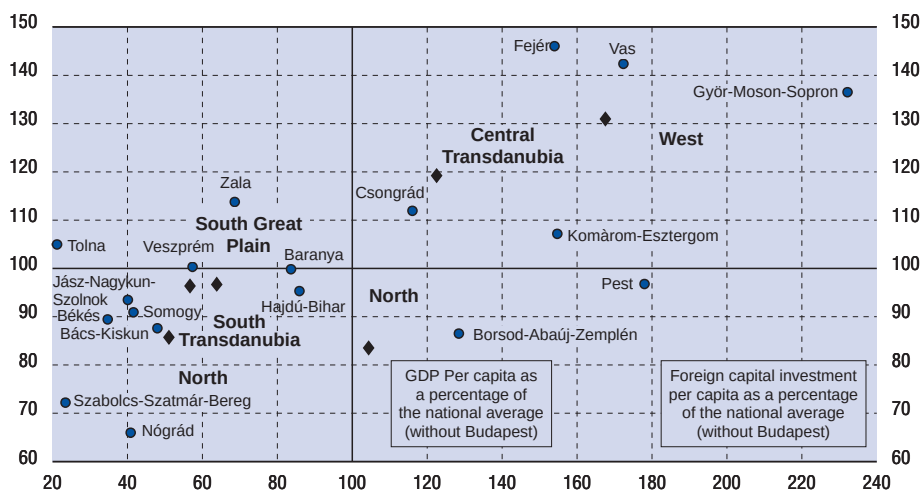
Figure 8. Geographical distribution of foreign capital stock, 1998



Source: Data from the Hungarian Central Statistical Office.

was detected in 1997 covering all counties, and of 0.69 when Budapest was excluded. Thus, FDI plays a key role in regional economic development. Figure 9 provides a more detailed picture of the relation between GDP and foreign capital per capita as a percentage of the non-metropolitan area average in 1997. Two counties in West Transdanubia (Vas and Győr-Moson-Sopron) and one county in Central Transdanubia (Fejér) are in the top right-hand corner, representing both high GDP and FDI. Zala and Veszprém (the remaining counties) obtained relatively high GDP but with under-average FDI. Borsod-Abaúj-Zemplén County is the

Figure 9. GDP and FDI per capita, 1997
% of national average (without Budapest)



Source: Hungarian Statistical Central Office (1999a): *Regional Statistical Yearbook, 1998*.

other unique example, which benefited from significant FDI from privatising large public companies in heavy industry, but did not manage a complete reconversion. The rest of the county is concentrated in the bottom left quarter, with under-average GDP and foreign investment share.

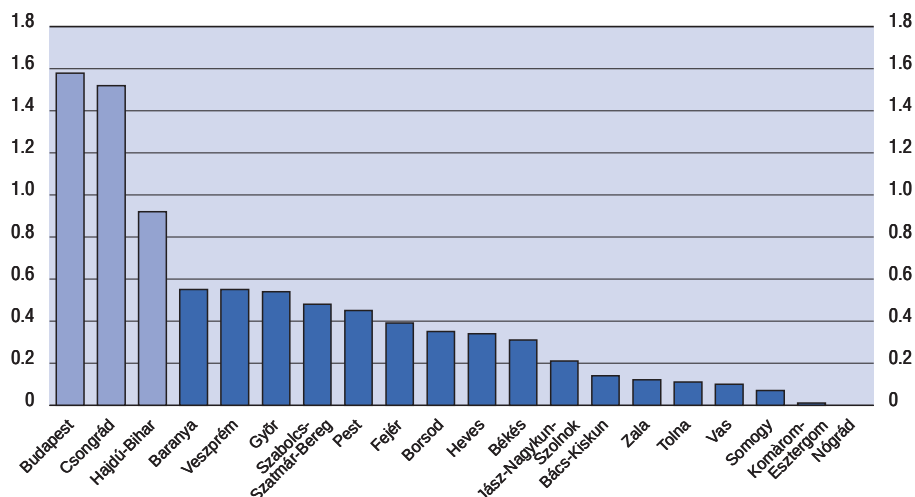
Territorial structure of research and development

Research and development (R&D) declined significantly during the transition period. The bulk of research and technological development is carried out in publicly-financed research institutes, which are highly concentrated in Budapest. Around 60 per cent of all employees in R&D institutions work in the capital and its surroundings (13 128 scientists and engineers). Only 18 of Hungary's 63 R&D institutes are located in non-metropolitan areas. Concerning corporate research and development units, 108 of 183 operate in Budapest. Many large regional centres such as Pécs, Szeged, Győr, Debrecen and Miskolc have run higher education institutions with research activities or other research institutions. These five cities account for another approximately 20-25 per cent of all employees in R&D. Public R&D expenditure is almost insignificant in small and medium-sized towns. Figure 10 presents R&D expenditures in each county as a percentage of GDP and shows the high concentration. Only three counties are over the average of 0.82 per cent, with Budapest and Csongrad producing particularly outstanding figures.¹¹ The rest of the country carries out very little R&D. Counties from the northeast, South Transdanubia and the Northern Great Plain lag at the very end. Not even the winning western counties produce significant figures. Komárom and Vas counties are among the five last.

Assessing innovation performance through the measurement of R&D expenditure and personnel implies that expenditure automatically leads to a new commercial product, but this is not always true. During the communist regime, Hungary typically had high expenditures and high numbers of employees in R&D but produced few marketable products. Alternative indicators such as business expenditure on R&D (BERD) are more appropriate. Measuring BERD slightly alters the picture of Hungarian regions in terms of R&D activities. The preponderance of the central region is even more striking in business-related research. Budapest and its surrounding county absorb around 80 per cent of expenditure and employ three-quarters of business R&D personnel in Hungary. The South Great Plain (the country's second-ranking scientific centre) primarily operates research institutes in the public sector, while West Transdanubia, which has considerable business research capacity, lacks university research centres. Research capacity in both sectors is rather weak in South Transdanubia and the northeast.

To complete the analysis of recent research efforts, statistics on patents are often referred to. Hungarian performances in this respect are particularly modest. In 1998, the Hungarian Patent Office received 44 913 patent applications, the bulk of which (98.6%) were submitted by foreign companies, against an almost

Figure 10. R&D expenditure as a percentage of GDP, 1997



Source: Data from Scientific Research and Experimental Development, 1997.

insignificant number submitted by Hungarian companies (only 727). Their spatial distribution is, therefore, irrelevant. This suggests serious problems with the innovation culture, dissemination of research and technology and social capital.

Main consequences of economic trends on social cohesion

In the 1990s, widespread unemployment followed the implementation of economic transition and stabilisation and led to countrywide poverty. Social disparities are evident throughout the population and the territories. Hungary now faces negative demographic trends, a deteriorating health situation, and a relatively high level of unemployment, particularly in remote rural areas, poor urban districts, and other backward regions.

Human development index and urban and rural poverty

The creation of a market economy brought new forms of social problems primarily because rising unemployment excluded unskilled employees from the labour market. The main consequence was the impoverishment of many households, especially when the head lost his job. Between 1989 and 1993, the percentage of the population under the national poverty line increased from 1.6 to 8.6 (World Bank, 2000a). The pattern of poverty shows greater social exclusion among rural populations, lowly-educated people and families with a head of household

above 60 and with three children or more. For the Roma minority, poverty rates are six to eight times higher than the rest of the population.

The UNDP Human Development Index (HDI) is a comprehensive indicator that can illustrate the weak human performance in Hungary. Its calculation is based on longevity (life expectancy at birth), educational attainment (two-thirds for adult literacy and one-third for first, second and third-level gross enrolment ratio) and standard of living (GDP per capita at Purchasing Power Parity [PPP] in dollars).¹² With an HDI of 0.795 in 1997, Hungary is considered to be an economy with average human development performance compared to other transition countries such as the Czech Republic, Slovenia and Poland, which are all considered to have a high human development performance with indexes above 0.800.¹³

Applying combined HDI to regions and counties for 1990 and 1996-1997 gives a territorial perspective of human development performance in Hungary (Table 2). Notwithstanding the complex methodological questions raised by disaggregating at county level the demographic and educational indices, data show a clear pattern of regional and county disparities in human potential. The gap between Central Hungary, Central Transdanubia and West Transdanubia, and the other regions is evident. Within Central Hungary, the human development gap between Budapest and Pest County is striking. Northern Hungary, South Transdanubia and the Northern Great Plain, which already had low HDI at the beginning of the period, registered important decreases. It is also worthwhile noting that all the counties with an HDI above the national average in 1990 managed to maintain or improve their positions during the period. These results tend to confirm the assumption of a growing gap between less developed and dynamic regions, in line with the winning and losing areas identified earlier.

The importance of the social gap can also be illustrated by the evolution of average household income. Overall, this indicator has increased slightly since the mid-1990s but has been accompanied by record inequality, a trend typical of central planning economies in transition. Table 3 shows the significant deterioration of the Gini coefficient per capita net income of households during the period 1987-1997 as well as the dramatic rise of the ratio between the top and bottom deciles.¹⁴ The transition has determined an inequality-led growth model, clearly favouring households in town counties, and above all the great agglomeration of Budapest. At the same time, there is a substantially greater dispersion of incomes in Budapest, where the growing differences between the top and bottom deciles for per capita income between 1987 and 1997 are much more important than in town counties and rural areas.

The spatial distribution of poverty in Hungary confirms the east-west gap pattern. Imbalances clearly exist between the capital and the metropolitan areas. Poverty rates are twice as high in the villages as in Budapest, and the same pattern of disparities is visible between the less advantaged regions of the north and east and those in the west. Rural poverty is due mainly to the rise of unemployment

Table 2. **Regional and county structure of HDI in Hungary, 1990 and 1996/97**

Region and county	1990	1996/1997	Percentage change
<i>Central Hungary</i>	0.673	0.693	2.9
Budapest	0.899	0.915	1.8
Pest	0.448	0.471	5.1
<i>Central Transdanubia</i>	0.619	0.668	7.9
Fejér	0.656	0.709	8.0
Komárom-Esztergom	0.517	0.562	8.7
Veszprém	0.685	0.733	7.0
<i>Western Transdanubia</i>	0.688	0.785	14.0
Győr-Moson-Sopron	0.818	0.883	7.9
Vas	0.652	0.788	20.8
Zala	0.593	0.684	15.3
<i>Southern Transdanubia</i>	0.413	0.369	-10.6
Baranya	0.452	0.451	-0.2
Somogy	0.324	0.280	-13.6
Tolna	0.462	0.376	-18.6
<i>Northern Hungary</i>	0.396	0.304	-23.2
Borsod-Abaúj-Zemplén	0.261	0.169	-35.2
Heves	0.508	0.524	3.1
Nógrád	0.419	0.218	-47.9
<i>Northern Great Plain</i>	0.266	0.258	-3.0
Hajdú-Bihar	0.359	0.406	13.1
Jász-Kiskun-Szolnok	0.411	0.330	-19.7
Szabolcs-Szatmár-Bereg	0.029	0.039	34.4
<i>Southern Great Plain</i>	0.468	0.491	4.9
Bács-Kiskun	0.295	0.322	9.2
Békés	0.519	0.543	4.6
Csongrád	0.592	0.610	3.0
Hungary	0.584	0.595	1.8

Note: The HDI values are arithmetical means of the requisite data for each county.

Source: UNDP (1999): *Human Development Report: Hungary*.

Table 3. **Inequality of per capita income of households, 1987-97**

Attributes of households	Gini coefficient			Bottom decile/top decile		
	1987	1995	1997	1987	1995	1997
Budapest residence	0.2516	0.3362	0.3564	4.9	10.0	11.7
Town counties	0.2340	0.2910	0.3142	4.5	7.2	8.9
Rural	0.2250	0.2570	0.2828	4.5	5.9	7.5
National	0.2358	0.2958	0.3206	4.6	7.5	9.2

Source: HIS 1987 and 1995 quoted and adapted from UNDP (1999): *Human Development Report Hungary*.

Table 4. **Poverty rates in Hungary by territorial units, 1997-98**

Territorial units	Per capita income Half of median		Equivalent units of income Half of median	
	1997	1998	1997	1998
Villages	11.8	16.4	11.1	14.7
Towns	8.4	12.4	6.5	10.6
Counties	7.3	11.5	6.4	9.6
Capital	6.1	7.2	5.2	7.3

Source: World Bank (1998-99): *Background Study for the Assessment of Poverty*.

following the global crisis in agriculture (Table 4). For urban counties, poverty is also significant when per capita income is considered. Unemployment is comparatively lower in towns, particularly in Central Hungary but the inner districts continue to deteriorate both socially and economically. The different typologies of poverty that exist between urban and rural areas call for differentiated territorial approaches, especially given that there is very little mobility from rural to urban areas.

Demography and health

The demographic situation in Hungary is critical. Since 1981, the mortality rate has exceeded the birth rate. With a decrease of five per cent between 1980 and 1998, Hungary is the only OECD country that has lost population (an annual loss of 30 000-40 000 was typical of the 1990s.) In parallel, the age distribution is deteriorating. In 1996, for the first time, the number of people over 60 exceeded the number of children under 14. Health, broadly measured by life expectancy at birth, is the variable responsible for bad HDI. Hungary lags behind other OECD countries, particularly for men in the 40-60 year-old group whose life expectancy has declined by nearly three years during the last 30 years. Hungary is also in a particularly bad position compared to other countries in transition (Table 5).

Table 5. **Life expectancy at birth in Hungary, Czech Republic, Slovenia and Poland**

Countries	Life expectancy at birth
Hungary	70.9
Czech Republic	73.9
Slovenia	74.4
Poland	72.5

Source: UNDP (1999): *Human Development Report: Hungary*.

The situation is especially troublesome in some parts of the territory, particularly in Central Hungary. The natural decrease of the population of Budapest is 1.8 times higher than the national average, mainly due to a low fertility rate. In addition, its ageing index (the number of old people per 100 children) is over 100, which is 40 per cent higher than the national average of 82, and is unique in Hungary. Cities have a more favourable age distribution than smaller settlements. High mortality rates differ across the territory because of a particularly worrisome health situation due to an inefficient healthcare system that is socially and spatially uneven.

The ageing of the population involves the same type of economic and societal challenges that already prevail in most OECD countries. The failure to keep pace with the western pattern of life expectancy at birth, and the shrinking of the working-age population reinforce the challenge posed by this trend. According to OECD estimates, the proportion of people 65 years old or older will more than double as the working-age population diminishes; demographic projections indicate a drop of as much as 25 per cent in the general population for the next 50 years (the second largest in OECD, in relative terms). These trends will continue to have important consequences on public expenditures and the sustainability of the welfare system.

Human capital endowments

Hungary has a very competitive endowment of human capital compared with some Southern European countries. The country spends generously on education among Central European countries. The education level of the population is high, even in an OECD-wide comparison. More than 95 per cent of those over 16 years of age have finished primary school and there is a 98 per cent enrolment rate in secondary education. The high quality of universities and colleges is well known and institutions in Budapest, Pécs, Debrecen and Miskolc are capable of developing poles of excellence in scientific and technical areas coherent with the national development strategy of switching FDI towards knowledge-based sectors. However, data from the National Assessment of Student Achievement show declining national performance at 8th grade in reading and mathematics scores between the mid-1980s and the late 1990s.

Data on educational attainment at regional and county levels do not show large spatial disparities either in the percentage of the population over 10 that has completed at least one year of schooling or in the mean number of completed years of schooling (UNDP, 1999). There is a minor difference favouring Budapest, but in less advanced regions, the overall situation is not so bad. However, education levels vary significantly within the country. The National Assessment of Student Achievement report mentions a growing performance gap between urban and rural areas. Moreover, although there are better equipped university centres in the eastern regions, people living in the western part of the country, particularly

in Central Hungary, generally have the highest qualifications. There are significant disparities with respect to the percentage of school failures and early school leavers. Dropout rates are particularly high in some settlements, particularly in those where there are high proportions of Roma (only 5% of Roma students finish compulsory education).

As far as the education level of workers is concerned, the situation in Central Hungary is different from that of the other regions, again primarily because of Budapest (Table 6). For example, the national average of employed people holding a university or college degree is 15.1 per cent, compared to 21.5 per cent in Central Hungary and 10.7 per cent in the North Great Plain.¹⁵

The education level of the unemployed differs significantly. Most unemployed people are uneducated and unskilled, few have completed secondary school and even fewer hold a university or college degree. A certain level of unemployment is present in all qualification categories, but unemployment may be a shorter, very temporary situation or may simply indicate the absence of current demand for a particular skill or qualification. In the case of the unskilled, especially in the most backward regions, it may mean that the chances of returning to the labour market are poor or even non-existent. Specific patterns emerge at the territorial level. In Central Hungary, unemployed white-collar workers and other tertiary skill levels are over-represented, while in less advanced regions, particularly in North Hungary, both skilled and non-skilled workers are over-represented relative to the national average. Table 7 shows that the education level of registered unemployed is significantly higher in Central Hungary than in less advanced regions.

Hungary is in a relatively good position concerning youth unemployment, though the participation rate is low. In 1999, the youth unemployment rate stood at 11.3 per cent compared to EU and OECD averages of 18.6 and 11.9 per cent respectively. The percentage of youth unemployment in total unemployment

Table 6. Education level of employed by regions, 1997
In percentage of total employed

Region	Not more than 8 grades of elementary	Vocational school	General grammar school	University, college	Total
Central Hungary	18.8	24.2	35.4	21.5	100.0
Central Transdanubia	24.3	33.1	29.6	13.8	100.0
West Transdanubia	22.8	32.0	32.6	12.6	100.0
South Transdanubia	21.5	35.8	29.8	12.9	100.0
North Hungary	20.0	34.4	32.1	13.5	100.0
North Great Plain	27.5	35.9	27.7	10.7	100.0
South Great Plain	27.3	33.4	28.0	11.3	100.0
Total	22.4	31.0	31.6	15.1	100.0

Source: Hungarian Statistical Central Office (1998): *Magyarország régiói (The Regions of Hungary)*, Bp., KSH.

Table 7. **Education level of registered unemployed by regions, 2000**
In percentage of total unemployed

Region	8 grades or less of primary school	Skill training, vocational and special vocational schools	Secondary and technical school	Grammar school	College and university degrees	Total
West Transdanubia	38.0	34.8	15.7	8.0	3.4	100.0
Central Transdanubia	39.4	36.6	14.0	7.4	2.7	100.0
South Transdanubia	44.2	36.0	11.1	6.6	2.0	100.0
Central Hungary	34.7	31.3	17.6	11.0	5.4	100.0
North Hungary	44.5	34.7	12.0	7.0	1.8	100.0
North Great Plain	44.7	35.5	10.0	7.9	1.8	100.0
South Great Plain	39.2	36.8	13.9	7.5	2.7	100.0
Hungary	41.6	35.1	12.8	7.9	2.6	100.0

Source: Data from the Ministry of Employment and Social Affairs.

varies from 14.4 in Central Hungary to 21.8 in the North Great Plain, suggesting either difficulties of transition to work or a low capacity to create jobs (Table 8). In West and Central Transdanubia, a strong capacity to reduce youth unemployment might have been expected thanks to FDI, suggesting room for active employment measures targeted at youth unemployment and transition to work. Vocational training for young people is a priority, given that around 40 per cent of young job seekers enter the labour market with no educational qualification.

Hungary faces an important problem of poverty primarily due to the rise of unemployment. Educational attainment is high countrywide but, in some settlements, dropout rates are often of concern. Education levels are high, but regional disparities exist. In the backward regions, education levels are lower especially among the unemployed. The same is true for youth unemployment, which is relatively low compared to the EU average but high in less developed areas.

Table 8. **Youth unemployment by regions, 2000**
% of total unemployed

Region	Per cent of youth unemployment in total unemployment
West Transdanubia	16.3
Central Transdanubia	18.7
South Transdanubia	19.6
Central Hungary	14.4
North Hungary	19.6
North Great Plain	21.8
South Great Plain	19.6
Hungary	19.2

Source: Data from the Ministry of Employment and Social Affairs.

Principal forms of spatial disparities

Disparities in income levels, unemployment, and poverty are high in Hungary. The exclusion of unskilled workers from the labour market and the impoverishment of many households have created social problems. Variegated industrial mix, concentrated placements of FDI, and highly uneven R&D capacities, all contribute to this lack of cohesion and tend to reinforce existing territorial dichotomies: East-West, centre-periphery, and urban-rural.

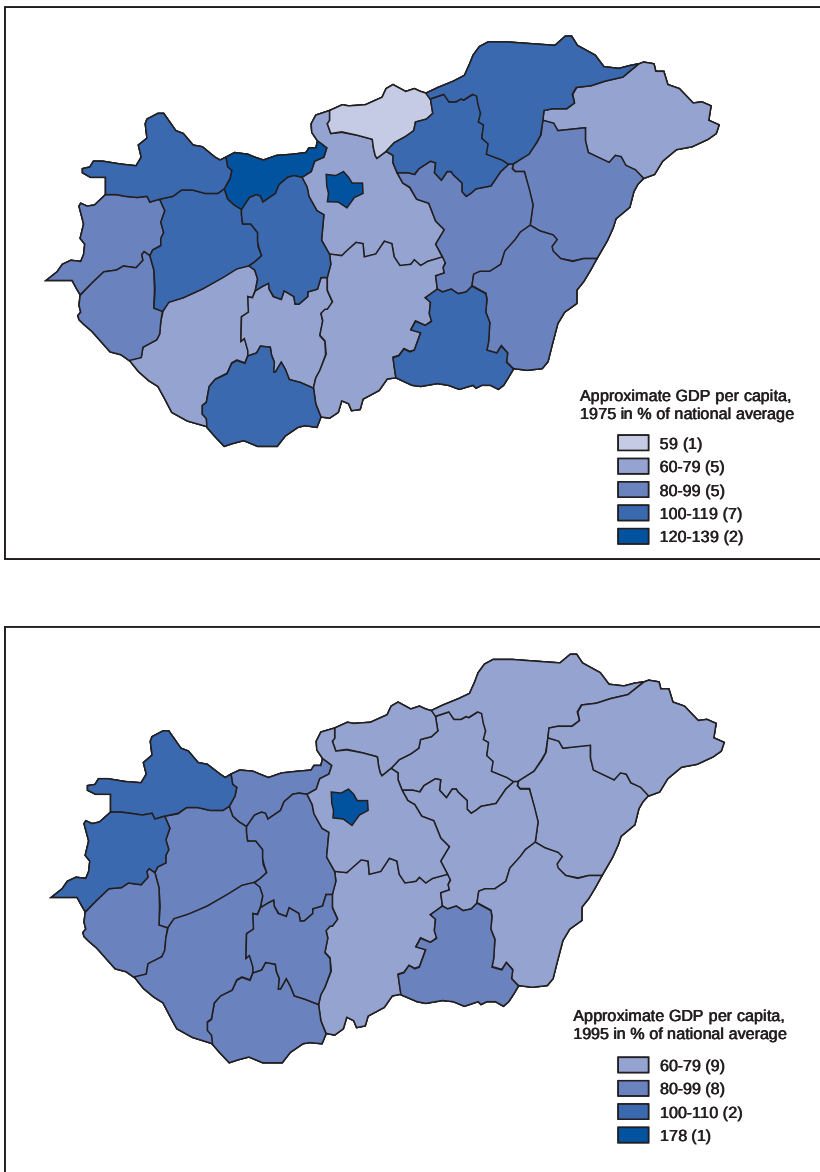
East-West

One of the striking patterns of spatial disparities that appeared clearly during the transition period, stems from the natural endowments of the east and west (Figure 11). The east depends more on agricultural production and food processing while the west benefits from natural mineral and energy resources and high-level industrialisation. Northeast Hungary is different because of its high, very mono-structured level of industrialisation. Besides their natural and infrastructure endowments, redirected foreign trade is widening the gap between the two areas. During the planned economy, the eastern territories of Hungary received special attention. In the north, the raw energy resources and the industrial base were important for the regime. The good agricultural facilities on the Great Plain were used for exports to the eastern market. These areas not only lost their large eastern markets when the CMEA (Council for Mutual Economic Assistance) disintegrated, but the collapse of co-operatives, uncertain ownership relations, and the lack of investment also contributed to the development of a serious agricultural crisis in the region. Most former affiliates were organised into independent units, while many industrial plants – mostly in the Great Plain regions – were liquidated. The heavy-industrial mono-structure of the northeast also led to large-scale depression. Western counties, by contrast, were able to boost their foreign trade relations with Western Europe, mainly Austria, Germany and Italy. The west, especially the northern and central counties, particularly benefited not only from its traditional links to western Europe, but also from its close links with the central region and its good infrastructure. This resulted in the second highest share of total foreign capital investments and the second highest GDP growth in Hungary. Economic development in the economy of more agriculturally-driven Southern Transdanubia, however, was slower given that it also had fewer contacts with the West and was affected by the Yugoslav crisis.

Centre-periphery

Budapest and its surrounding area have always dominated Hungary, but never so significantly as today. One in five Hungarians lives in Budapest, which possesses the country's smallest and most densely populated territory, and the most dense economic activities and social facilities. Its share of GDP in 1997

Figure 11. GDP per capita by counties, comparison 1975 and 1995



Source: VATI Hungarian Institute for Town and Regional Planning (1998): "National Regional Development Concept".

equalled 34.5 per cent of all Hungarian output. Although its share of industrial employees significantly decreased during the planned era (to less than 20%), its share of business employees now reaches almost 40 per cent. In addition, industries with the highest levels of R&D and innovation still reside in Budapest. Its dominance in the service sector and high-tech industry, and its outstanding infrastructure and telecommunications facilities are some of the reasons for the extreme weight of the capital in Hungary's spatial structure. Even in terms of social facilities such as healthcare services and education, Budapest is much better endowed than its population would suggest. The establishment of a market economy has clearly favoured regions with a developed industrial and service sector, good infrastructure, telecommunications base and skilled workers. The capital therefore obtained more than one-half of all FDI in the country and even more at the start of privatisation. The concentration of joint ventures and multinationals, the main driving force of economic growth in the country, further increased Budapest's lead. In addition, vivid entrepreneurship in the capital managed to compensate for jobs lost when the large state companies collapsed. The metropolisation of Budapest has, however, produced some less desirable effects such as congestion, pollution and other diseconomies familiar to the large agglomerations of the West.

Settlement structure, urban-rural division and peripheries

Economic prosperity seems to correlate strongly with the size of settlements, as the best performing territories include the capital city and the county and regional seats both in the most developed and least advantaged regions. In addition, the traditional urban-rural gap remains relevant in Hungary and widened on an aggregate level during the transition period (Box 3). The rise of unemployment in the villages resulted both from the collapse of village farming and from the large-scale downsizing of state-owned industrial companies. Comparing various economic and social indicators, regional and county centres produce much better figures than other smaller settlements, particularly for the less developed regions.

The aggravation of the urban-rural division is also well represented in the problems of peripheries. Two types of declining peripheries can be distinguished. External peripheries are located in the northern, southern and eastern border regions whereas internal peripheries are closer to the centre, or, cover areas in the valley of the Rába, the hilly country of Central Transdanubia, Mezőföld and the southern plain between the Danube and the Tisza. Border regions highly specialised in trade with neighbouring foreign regions suffered from the collapse of the CMEA and from the war in the Balkans. The internal peripheral problem indicates the rapid development of regional centres and county seats compared with the relative decline of rural areas at the peripheries of these regions and counties. Peripheries suffer from a lack of significant centres and one-sided, mainly agrarian-based economies. During the command era and particularly during the 1970s, villages and peripheries increasingly lagged behind. In addition, changes due to

Box 3. The settlement network of Hungary

Hungary is a small to medium-sized country on a European scale (similar to Portugal) that covers 93 029 km² and has a total population of 10 million inhabitants. Almost 30 per cent of the population live in Central Hungary, occupying approximately 7 per cent of the total territory. The settlement network is characterised by many small towns and villages, a few medium-sized county and regional seats, as well as the metropolis of Budapest with an average population per settlement of 3 322 in 1999. This figure is dropping, and Hungary is ahead of France, Greece, Portugal, Switzerland and Austria, but well behind the other EU countries. Settlements are unevenly distributed. In the hilly western and northern parts of the country, a dense network of smaller settlements has developed, compared to the much less dense network of larger settlements on the Great Plain.¹

The transition created favourable conditions for growing village autonomy. After nationalisation and collectivisation, farmers lost their property rights and the power to regulate economic activity in the villages. However, strong secondary economy activities prospered in agriculture. By now, most land has been returned to private ownership and the number of individual village entrepreneurs has increased. Political and some economic autonomy resulted in increasing differentials among villages and between urban and rural areas. The collapse of village farming can only be a partial explanation for this since only one-fifth of villagers are engaged in agriculture as their primary employment. The number of those employed primarily in agriculture has decreased by one-half in the past five years. At the same time, about 80 per cent of village households are involved in part-time agricultural activity for their own use. In the 1970s, substantial food-processing industry units were located in villages, partly within the framework of co-operatives and partly as plants belonging to large companies headquartered in the capital or regional centres. In 1987, one-quarter of all industrial workers were employed in village industry, more than the industrial employment of Budapest. The large-scale downsizing of state-owned industrial companies has also reduced village employment. Industrial companies based in Budapest maintained 1 400 plants in villages in 1986, but only 800 in 1991. Their closure largely contributed to the rise of village unemployment. Some northeastern villages experience a 40 per cent unemployment rate.

Judging by their populations, most towns are small. Nearly 40 per cent have fewer than 10 000 inhabitants, and every tenth town has fewer than 5 000 inhabitants although hardly any of these can be considered towns in the functional sense. A further 31 per cent of towns have populations between 10 000 and 20 000: 70.4 per cent of towns are small.² In 1960, only three cities in Hungary other than Budapest had more than 100 000 inhabitants: Miskolc, the most heavily populated, had nearly 150 000 inhabitants. Eight cities now have more than 100 000 inhabitants, with Debrecen (210 000 inhabitants) second to the primacy of Budapest. The small-to-medium-sized towns (10 000-50 000 inhabitants) are widely distributed. Although their share of the population is small, there is an especially high number of settlements with fewer than 1 000 inhabitants.

Box 3. The settlement network of Hungary (*cont.*)

On 1 January 1998, 218 settlements in Hungary (7% of all municipalities) were registered as towns. Of the total population, 63.5 per cent or 6 408 000 people lived in urban settlements. In European terms, Hungary is moderately urbanised. During the planned economy, urban status produced many advantages, including a favourable position in the national redistribution system, preferential location of urban institutions, and a larger, richer, more powerful administration. Therefore, achieving urban status was regulated by a strict but modest system of requirements. As a result, the number of towns with urban status was smaller than the number of settlements with urban functions. By around 1990, urban status and functions more or less coincided. Since then, several settlements have been granted urban status in the spirit of free democracy and independence and some towns now have either no or very poor urban functions.

1. Large areas of the Great Plain were deserted and then systematically repopulated under the Ottoman Empire and during the 18th century.
2. Statistical and government definitions of small towns is 20 000 inhabitants. In western European practice, the limit is usually 50 000.

the transition; mainly the disintegration of the ex-socialist trade bloc (especially for the external peripheries), the collapse of agricultural production and the closure of industrial plants, were further blows. These remote territories have limited potential for economic progress given the crisis in agriculture, their lack of capital, and above all their insufficient infrastructure facilities and unskilled labour.

Conclusion

In terms of territorial disparities, Hungary shares characteristics with other OECD countries. Like Italy and Germany, the disparities in Hungary between large geographical areas are significant where an East-West divide was clear after the transition. However, unlike Italy and Germany, disparities are also evident at smaller territorial levels. Central Hungary, Central Transdanubia and West Transdanubia are the best performing territories that are developing more quickly than the national average. South Transdanubia and even more, North Hungary and the North and South Great Plain, however, are burdened with problems and fall short of the average in almost all respects. The South Great Plain represents the middle in some respects, showing signs of revival and growth potential. For all regions, the differentials grow if the basis of comparison changes from macro to county to micro-regional level. Thus, the most appropriate unit of analysis of territorial disparities and intervention for policymakers is the functional region based

on local labour market areas. A functional regionalisation of Hungary would allow for a more coherent analysis of economic and social change from a territorial point of view.

The economic changes of the transition period have led to greater territorial disparities. Highly specialised regions with little flexibility in rigidly-organised heavy industry, mining or agriculture have been greatly affected while those with a more flexible structural base have recovered from the depression more rapidly and have produced higher-than-average growth and employment rates. The winning regions have managed to reorganise their industry so as to permanently upgrade products and processes and target competitive market niches. At the same time, their attractiveness has been reinforced by the new economic policy put in place during the transition based on tax allowances to joint ventures, foreign investments and new business. The best-off territories include those with a high share in manufacturing – especially machinery – and a large export potential resulting from high FDI. Foreign capital has been concentrated in the economic centres, protecting the renewal of the economic structure and still favouring Budapest and its surrounding areas.

The transition economic process increased poverty in the less developed regions and remote rural areas, and in some urban districts. Research generally concludes that the rise of unemployment is the primary cause of impoverishment. As there are different patterns of unemployment disparities, macro-economic and structural policies will not be sufficient to rectify the problem. The existence of pockets of unemployment within regions requires an integrated approach mainly based on local initiatives and external assistance.

From a macroeconomic perspective, the growth path is stable. Hungary's main challenge now is to ensure the sustainability of economic growth and design conditions for both maximising spill-over from growth poles, and to exploit untapped resources in weak regions in order to reach more balanced development in the long run. In this context, inflow of foreign capital coupled with local demand in densely populated territories may continue to boost the economic growth of advanced areas, helping them to remain in an endogenous virtuous circle. Conversely, stagnating and underdeveloped areas may require territorial policies to speed up the process of catching up.

NOTES

1. The process of divesting state-owned firms is largely complete. The state share of the capital stock of businesses is estimated at 20 per cent. The book value of the properties managed by the Hungarian Privatisation and State Holding Company was HUF 690 billion in mid-1999. Of this total, some HUF 400 billion is to remain permanently state-owned, while the remaining HUF 290 billion is supposed to be privatised in the near future.
2. According to the nomenclature of territorial units, the Central region is composed of Pest and Budapest counties.
3. Standard deviation of GDP per capita. Calculations are based on Hungarian Central Statistical Office's data.
4. Calculations are based on Hungarian Central Statistical Office (HSCO) data, 1998.
5. Standard deviation. When comparing data for micro-regions the gap exceeded 40 per cent in 1998.
6. The two extremes of Pest and Komárom counties result from the fact that a high share of their population commutes to Budapest to work.
7. Their share exceeds the national average of 10.5 per cent by around 50-60 per cent, excluding the extreme figure of 33.2 per cent in Tolna County.
8. Enterprise density is the number of enterprises per km².
9. The value added per person (€1 000/person) of SMEs in the EU is six times higher than in Hungary (see European Commission, 1999e).
10. "Regional seat", means cities of regional importance or coverage and does not refer to any administrative centres.
11. Csongrad has a strong tradition of academic research, which explains its high level of expenditure. Debrecen also runs a well-established university complex and a few related research institutes and has one of the lowest levels of GDP.
12. For any component of HDI, an individual index is calculated according to the following formula: (actual value – minimum value)/(maximum value – minimum value). The HDI is the simple average of the three indices (one for each component) and varies from 0 to 1.
13. In comparative terms, practically all OECD countries (except Hungary and Mexico) are considered high HD countries, led by Canada with a HDI of 0.904 in 1999. Hungary (0.795), Venezuela (0.792), Panama (0.791), Mexico (0.786), Estonia and Croatia (0.773) share similar HDI; the average HDI of low HDI countries is 0.416 and no CE countries belong to this group.

14. The Gini coefficient is one of the most popular indicators for measuring the inequality of income distributions. Its calculation is associated with the also well-known Lorenz curve. In very rough terms, considering a square of 1×1 , in which are registered the cumulative percentages of population and income, the Gini coefficient measures the ratio between the inequality area (limited by the maximum equality line, which is the diagonal of the square, and the Lorenz curve) and the area below the maximum equality line. It varies from zero (maximum equality) to one (maximum inequality).
15. It is interesting to note that the educational level of the employed population in North Hungary surpasses that of the most favourable Transdanubian regions and does not reflect the crisis situation in this area. This is a legacy of the previous era, when strong industrial development took place in these regions, and indicates that despite the prolonged depression, a part of the more highly educated workforce remained in the area.

Chapter 2

Spatial Policies

In most transition countries, the underlying assumption of catch-up policies is that appropriate investment in public infrastructure and related services will permit a decrease in transport and telecommunications costs that can compensate for the agglomeration effect in advanced regions and allow less developed ones and countries to fully exploit their main comparative advantage: the low cost of labour. These policies therefore usually focus on building physical infrastructure and assistance to basic utilities. In Hungary, transport infrastructures remain suboptimal in many areas, particularly in the eastern regions. Despite significant achievements, the telecommunications sector is strongly in need of improvement, the state of the environment raises concerns, and housing problems should be addressed to enhance labour mobility. The modernisation of the infrastructure network needs to be continued to respond to the dramatic development of the export sector and the rising demand for modern public services and infrastructure in big cities and under-equipped rural areas. This will require designing and implementing comprehensive spatial policies that consider the large disparities between and within counties and regions.

Reducing the gap in transport and communications infrastructures

Hungary needs to improve its transport system which is burdened by accumulated and often contradictory problems. Hungary's railroad network is dense, even compared to western Europe, but its technical standards are much lower. Motorways, by contrast, comply in general with international standards but their network is relatively sparse. In terms of length, the road network ranks lower than European countries with a medium level of development. Consequently, the railroad system must be modernised and the motorway network must be extended.

Road transport

Road infrastructure development has been a focus of attention for several reasons. First, the country has had to bear the burden of the past. Highway construction began in 1961 but was not developed much during the pre-transition period.

Important investment backlogs existed at the beginning of the last decade. Second, economic restructuring since 1989 resulted in a changing demand for transportation. Specialised SMEs increasingly replaced big firms in heavy industries, partnering with several customers in the country and the EU, and activities that previously took place within factory walls now occur at long distances (World Bank, 1999a). Third, since rail network has been insufficiently maintained and repaired, a growing part of freight traffic has to be moved by road transport.

The very limited and unbalanced expansion of the motorways reflects budgetary constraints and weak returns on investment. Between 1989 and 1999, around 170 km of motorways were constructed – around 70% during the last five years – and mainly on three lines (M3: 44 km, M1: 54 km, M5: 40 km).¹ Only one of the five motorways (M1) has been completed. In addition, the public road networks remain heavily centralised: all motorways start in Budapest. Not enough bridges span the Danube. Given the priority of connecting with the West, most central and eastern regions, especially South Transdanubia, the North and South Great Plain and to a lesser extent North Hungary, continue to suffer substantially from low road density and poor supply lines.

The current transport strategy includes rehabilitating the network and strengthening the pavement. Three ISPA projects (pre-accession fund for infrastructure) include strengthening pavement countrywide, the M0 motorway around Budapest, and the M43 connection from Szeged to Romania. National and European priorities more or less coincide. However, the M3 and its link to Miskolc are priorities for the central government, but no longer a ISPA project. In general, apart from the western side, the list of ISPA 2000 project proposals quoted in the PNDP from the Ministry without portfolio responsible for the co-ordination of PHARE Programmes seems to reinforce the radial nature of the network and does not contribute much to strengthening tangential or cross-border links. However, secondary networks are a prerequisite of effective trans-regional motorways, providing accessibility to trunk lines. Secondary networks also put regions on a more equal footing for development. For these reasons, the secondary networks should be emphasised more.

Recently, public policy for transportation has been the subject of a major reassessment of the role of the state. The market for transport operation and logistics was liberalised and many truck companies were privatised, although state-owned companies still account for 50 per cent of the market. In addition, funding and managing the highway system had to be redesigned, because of major deficiencies in the tolling system and inadequate maintenance. The highway system was therefore re-nationalised and a unified tolling system was created based on a vignette.² Motorway construction moved to the National Motorway Company, with the Hungarian Development Bank being the majority owner (98 per cent) while the Ministry of Transport has only one per cent of the shares. The funds for the debt service are provided by the state budget.

For the period 2000-2005, highway construction is a priority and substantial resources will be allocated to it. The Szechenyi Plan, elaborated by the Ministry of the Economy, allocates approximately HUF 250 billion for the 2001-2002 period, or more than one-third of the entire budget to building motorways, although funding decisions are made by parliament on the basis of annual budget.³ The government envisages that all motorways will be completed by 2005-2007, even if some parts will be replaced by express roads. Implementation is greatly influenced by political factors, especially at election time. Ecological concerns or the “Nimby” attitude can also play a role – people want more opportunity to travel but are not ready to face negative externalities of infrastructures.⁴ For example, there is some resistance about when and where the M0 ring road should be built – now or later, far from Budapest or not. The proliferation of long-term plans, including a 10-year plan for express road development, is also creating confusion. The Ministry of Transport and Water Management (MTWM) also has annual budgeting problems. Moreover the MTWM used to have a Road Fund furnished by fuel taxes that no longer exists. The MTWM works with counties but there is a plan to move inspection and maintenance operations to a regional basis to take advantage of EU Structural Funds. To sum up, much will depend on international funding and co-operation with the EU.

A 1999 government resolution was also adopted on building expressways, which allocates HUF 600 billion in the period 2000-2009 from a mixed financial arrangement involving the government, the private sector and the European Union (through the ISPA Programme). The Szechenyi Plan foresees the construction of secondary, connecting networks to significantly improve the regional diffusion of the inflow of capital.

Railway

Railroads provide a complementary means for meeting the demand for transport. However, lack of resources and low productivity has meant insufficient maintenance and repairs causing rail freight transport to lose one-third to one-half of its freight traffic, while road transport has remained relatively stable. Railway transportation does have several advantages and its competitiveness should be preserved: *i*) it provides an environmentally friendly mode of transport for freight and passengers; *ii*) it enables long distance transportation of bulk goods and unit loads; *iii*) it could relieve the bottlenecks that are starting to emerge especially in routes linking Hungary with the western border; and *iv*) from a territorial point of view, the network is more balanced than the road networks.

Restructuring the Railway Company (MAV) is a difficult but pressing task (World Bank, 1999a). MAV has cost an estimated one per cent of the GDP in the last six years. Railway unions are strong and oppose job losses. At the same time, the state cannot compensate for major financial losses and external financing is difficult because development plans usually fail to meet the conditions imposed

by international financial institutions such as higher fares and reduced overstaffing. Long-term losses need to be reduced. For this purpose, separation of railroads (state-owned only) and transportation services (managed by the Hungarian State rail) is foreseen. It is likely that modernisation efforts will concentrate on international trunk lines, in particular a Pan-European corridor, crossing the country and linking Hungary's main centres with its major trade partner. Closing less profitable railway lines will probably become increasingly attractive and there will be a higher risk of transport policy conflicting with territorial policy.

Other means of transport

Given Hungary's advantageous geographical position and its wealth of hydrologic basins, numerous regions are accessible through an inland waterways network, in principle. For example, Central Hungary and the northwestern part of the country are connected to the West through the Danube-Main Rhine system. However, waterways shipping has only a small share of the transport market. There are only 1 196 km of navigable waterways and another 530 km are suitable for small boat navigation. In fact, the shallow navigable water north of Budapest permanently affects the economics of water transportation. Other factors, such as port density are well below western European levels, and an ageing shipping fleet significantly increases the costs of operating vessels. Providing that the navigability of waterways is upgraded and that additional infrastructure is constructed, inland waterways could offer new opportunities for sustainable freight transport and reduce the pressure on most frequently used road links.

In terms of traffic expansion, air transport increased by 79 per cent during the period 1990-1998 but makes only a small contribution to long distance passenger traffic. There are no public domestic services. In 1997, Budapest-Ferihegy Airport, the only Hungarian international airport managed by a state-owned company and the air fleet had the second highest traffic in Central and Eastern European countries, after Prague. The airport operates from only two terminals, but further expansions and additions are underway. There are also plans to transform former Soviet air bases into domestic passenger terminals. A few domestic flights are provided during the summer, and only a few larger cities maintain airports for private aircraft. Thus, one objective will be to develop airports for regional connections, *e.g.*, Debrecen, Sarmellek, and to privatise these activities to accelerate its development and to satisfy EU requirements.

Telecommunications

Hungary had one of the least developed telecommunications networks in Central and Eastern Europe at the beginning of the transition. Its achievements in reforming and developing industry over the last decade are therefore impressive. The number of telephone lines per 100 inhabitants reached 33 per cent at the end

of 1998 (compared to 11% in 1991). Three-quarters of the traditional physical network and 90 per cent of mobile networks are digitised, a performance in line with the average of EU member states. By the end of 1999, there were four suppliers of mobile telephone networks and 1.6 million mobile telephones in operation (HCSO, 2000a). Internet subscriptions reached 137 000 for 45 suppliers at the end of 1999. Internet hosts per 1 000 increased from 1.2 in July 1995 to 14.2 in January 2000, a low performance in the OECD ranking because the unit price for Internet connection is expensive and even the most expensive among OECD countries (Table 9). Furthermore, the number of computers per 100 inhabitants is only seven against an average of 30 for the OECD.

The Hungarian network is expected to grow to about 3.7 million lines by the year 2000, almost tripling in 10 years. The national company has boosted the number of telecommunications connections to tackle the disparities in accessing services and IT notably in rural areas and major cities including Budapest. MATAV, the incumbent dominant operator, adopted wireless local loop technology. By mid-1995, MATAV had signed a contract for USD 100 million with Motorola to connect 200 000 new lines via wireless technology by the end of 1997. In April 2000, MATAV also introduced an unmetred internet access option called MATAV Mindenkinek for unlimited residential calls to the internet at off-peak times for a monthly fee (OECD, 2000f). But strong disparities persist.

Territorial provision of telecommunications equipment is particularly unequal. Calls to the countryside or within certain locales in Budapest can be of poor quality and subject to disconnection. The communications infrastructure in Central Hungary is 30 per cent higher than the national average but only reaches 77 per cent in the North Great Plain. The number of telephones per thousand people ranges from 498 in Budapest to 298 in the South Great Plain region; 280 in North Hungary; and 256 in the North Great Plain region (Table 10). Elsewhere, the average is above 300 per 1 000 people. Taking the county rather than the regional level, the inequality of provision appears more starkly. In Szabolcs-Szatmar County, there are 224 telephones per 1 000 people or less than half the Budapest average. In Nógrád County, there are 272 telephones per 1 000 people; in Borsod-Abaúj-Zemplén County, 270; Békés County, 266, Jász-Nagykun-Szolnok County, 273; and in Hajdú-Bihar County, there are 277 telephones per 1 000 people. Many telephones in these counties are located in urban rather than rural areas which means that the provision of telephones in villages is still lower.

The global nature of telecommunications and Hungary's integration into the world market requires taking careful account of developments in international telecommunications market trends and regulatory practice. In addition, the poor state of telecommunications in numerous Hungarian locations is often considered one of the main internal barriers to national and regional development. Strong competition policies and efficiency-promoting regulatory regimes are crucial for meeting consumer and industry demand at reasonable prices and for stimulating

Table 9. Internet hosts per 1 000 inhabitants

July	1995	1996	1997	1998	1999	January 2000	Change July 1999-Jan. 2000
Finland	22.5	55.3	67.1	104.0	122.7	148.1	25.4
United States	14.0	26.2	37.2	78.1	118.0	141.5	23.5
Iceland	25.6	40.5	52.6	77.1	108.2	137.0	28.8
Norway	16.1	29.4	50.1	77.0	92.8	120.3	27.6
Sweden	14.6	26.3	39.7	62.1	96.0	114.8	18.9
Canada	14.0	25.2	38.7	73.4	93.6	111.1	17.5
Denmark	9.0	18.8	32.0	51.1	73.4	92.7	19.3
New Zealand	12.3	21.7	42.5	49.6	59.2	88.1	28.9
Netherlands	9.9	16.3	25.5	42.0	56.9	84.8	27.8
Australia	12.2	23.3	40.6	45.5	60.2	77.3	17.1
Switzerland	10.6	17.9	25.6	41.3	59.6	76.1	16.5
United Kingdom	6.0	12.1	18.1	28.2	43.7	60.3	16.6
Austria	5.6	9.9	12.4	20.2	35.5	50.0	14.5
Belgium	2.8	5.3	10.0	19.1	36.8	49.2	12.4
Luxembourg	4.9	9.5	12.8	23.6	38.1	43.5	5.4
Ireland	3.3	7.1	10.8	16.6	28.8	36.4	7.7
Germany	4.8	7.9	12.4	18.4	25.6	34.0	8.4
France	2.5	4.4	6.6	11.4	22.7	29.8	7.2
Japan	1.4	4.2	8.0	11.8	18.1	25.8	7.6
Spain	1.5	2.6	4.6	9.9	16.2	22.8	6.5
Italy	1.1	2.6	4.6	8.0	12.6	18.9	6.3
Korea	0.7	1.5	3.5	5.4	8.5	18.8	10.3
Hungary	1.2	2.6	3.5	7.7	10.3	14.2	3.9
Portugal	1.0	2.0	2.2	5.4	8.1	12.8	4.7
Czech Republic	1.5	3.2	4.9	6.7	9.4	12.8	3.4
Greece	0.6	1.4	2.1	4.4	8.1	9.6	1.5
Poland	0.4	1.0	1.2	2.6	4.4	6.0	1.6
Turkey	0.1	0.3	0.6	1.0	2.6	5.4	2.8
Mexico	0.1	0.3	0.4	1.1	2.7	5.0	2.2
OECD average	5.9	11.2	16.8	31.4	47.1	59.3	12.2
Countries with unmetred local access charges	10.8	20.1	29.2	58.6	86.9	104.9	18.0
Countries with metered local access charges	2.9	5.8	9.2	14.6	22.2	30.8	8.6

Note: Based on a survey by Network Wizards for the Internet Software Consortium (ISC). Internet hosts under generic top-level domains (.com, .org and .net) have been reallocated according to the proportion of these domains registered by users in each country. Matthew Zook contributed the registration data for January 2000.

Source: Data from the ISC, OECD, Direction for Science, Technology and Industry.

the diffusion of information technologies. Since 1992, the role of the state has changed from that of service provider and business owner to regulator and telecommunications authority and tasks have been reorganised to accelerate development and profitability. MATAV was a public monopoly that has been privatised and its local telephone service coverage has been reduced from 54 to 36 (telephonic)

Table 10. **Regional distribution of telephone networks, 1998**

County, Capital, Region	Total main lines ¹	Number of main lines	
		in % of 1990 ²	per 1 000 inhabitants
Budapest	916 586	197.8	498
Pest	335 876	1 021.1	330
<i>Central Hungary</i>	1 252 462	252.6	438
Fejér	133 119	585.2	312
Komárom-Esztergom	96 543	468.1	311
Veszprém	121 883	445.4	325
<i>Central Transdanubia</i>	351 545	497.1	316
Győr-Moson-Sopron	143 735	380.4	339
Vas	85 181	376.5	318
Zala	93 369	500.4	316
<i>West Transdanubia</i>	322 285	407.6	326
Baranya	127 268	316.4	316
Somogy	103 346	409.3	311
Tolna	74 620	486.7	304
<i>South Transdanubia</i>	305 234	377.9	311
Borsod-Abaúj-Zemplén	198 540	304.7	270
Heves	99 629	417.1	307
Nógrád	59 238	466.4	272
<i>North Hungary</i>	357 407	351.4	280
Hajdú-Bihar	150 380	429.8	277
Jász-Nagykun-Szolnok	113 193	528.4	273
Szabolcs-Szatmár-Bereg	128 351	673.2	224
<i>North Great Plain</i>	391 924	519.5	256
Bács-Kiskun	158 933	435.5	297
Békés	105 083	446.1	266
Csongrád	138 882	350.9	331
<i>South Great Plain</i>	402 898	404.4	299
Total	3 383 755	337.4	335

1. Including telecommunications service main lines.

2. 1998 data are given without the telecommunications service main lines to ensure comparability.

Source: Hungarian Statistical Central Office (1999a): *Regional Statistical Yearbook*, 1998.

areas⁵ (see Rosston, 1999). It still holds the license for international and long distance voice telephone service. Limited competition has kept telecommunications costs and the costs for Internet unit connections high. Cellular service is the only exception. Hungary was the first Central European country to initiate mobile cellular service and to introduce competition in the sector. In sum, the government should consider the impact of its telecommunications strategies upon regional disparities. A more open market should be established to improve access to advanced telecommunications services and a system of universal (basic) services should be introduced to secure connections with remote areas. In particular, the

central government should speed up the introduction of competition in local, long distance and international services that are currently reserved.

Enhancing regional environmental quality and decentralising responsibilities

The environmental strategy currently being implemented was developed virtually from scratch at the beginning of the last decade mostly because the communist regime considered investment in this area to be unproductive. Since 1990, the responsibilities for environment and regional development were merged into a single ministry. Until 1997, about 1.5 per cent of GDP was devoted to environmental protection. Parliament adopted a six-year National Environmental Programme in 1997 with an annual budget of HUF 6.5 billion. Although the emission of pollutant per unit of GDP remains high by OECD standards, significant progress has been achieved and the rates of industrial and agricultural pollution, which are among the major sources of the problem, have decreased. Major efforts in environmental investments are being implemented in Central Hungary and Central Transdanubia (Table 11). Regions on the western border including Győr-Moson-Sopron, Vas and Zala, will soon match the environmental performance of nearby Austria (Vienna Institute/Economic Growth Institute-Budapest, 1999).

There are several worrisome trends nevertheless. Pollution that was previously restricted to narrow industrial districts, often in the vicinity of major urban centres, is now expanding (GHR, 1998). Closing factories and the structural adaptation of industry have helped to reduce air pollution, but the rapidly growing numbers of private cars in major cities such as Budapest and the development of activities such as tourism and logistics are creating new forms of pollution. Similarly, the quality of surface waters has improved but industrial effluents and underground waters are not sufficiently monitored. Nearly 80 per cent of unprocessed effluents discharged mostly into the Danube in the Budapest region and secondary rivers are heavily polluted, especially around cities (often with high concentrations of nitrogen). Waste management is becoming problematic given the continuous increase in economic activities and household consumption and the modest policy initiatives meant to tackle the issue. Here little progress has been made, particularly since the scarce attention given to the issue has been entirely dedicated to managing dangerous waste. Most EU legislation still needs to be transposed.

There are real challenges facing Hungarian environmental policy. The Ministry is now separate from the Regional Development Department that had been integrated into the Ministry of Agriculture. Its central administration, inspectorate department and regional offices are understaffed and some have lost personnel recently. Moreover, environmental responsibilities are being distributed among several ministries: the Ministry of Transport and Water Management for water issues, the Ministry of Interior for local waste management, the Ministry of Health

Table 11. **Investment in environmental protection, 1998**
Millions of HUF

County, Capital, Region	Total	of which:					
		Air	Wastewater	Waste	Soil and ground water	Noise and vibration	Landscape and nature
Budapest	11 166	3 354	5 097	1 029	174	209	164
Pest	11 406	423	8 598	781	1 459	64	39
<i>Central Hungary</i>	22 573	3 777	13 695	1 810	1 633	274	203
Fejér	5 023	1 112	2 831	175	657	51	59
Komárom-Esztergom	5 555	473	3 898	1 048	14	10	40
Veszprém	6 647	1 543	3 895	482	401	21	135
<i>Central Transdanubia</i>	17 225	3 127	10 624	1 705	1 073	82	234
Győr-Moson-Sopron	3 764	801	2 407	324	109	1	75
Vas	1 248	93	727	152	71	21	105
Zala	2 442	65	947	184	86	23	1 073
<i>West Transdanubia</i>	7 453	959	4 081	660	266	44	1 253
Baranya	2 128	650	336	395	690	39	14
Somogy	3 108	503	1 124	416	169	483	140
Tolna	1 229	37	541	524	58	26	21
<i>South Transdanubia</i>	6 465	1 190	2 002	1 334	916	547	175
Borsod-Abaúj-Zemplén	5 642	366	3 913	317	446	236	78
Hebes	7 066	4 110	859	1 418	96	54	525
Nógrád	1 222	179	871	59	95	—	—
<i>North Hungary</i>	13 931	4 655	5 643	1 794	636	290	603
Hajdú-Bihar	1 137	35	558	170	340	6	6
Jász-Nagykun-Szolnok	2 378	215	1 384	556	34	43	143
Szabolcs-Szatmár-Bereg	6 208	147	5 130	724	56	37	30
<i>North Great Plain</i>	9 723	398	7 072	1 451	431	86	178
Bács-Kiskun	1 320	32	935	177	46	28	77
Békés	2 424	64	2 004	153	90	—	48
Csongrád	3 365	236	2 405	585	54	26	30
<i>South Great Plain</i>	7 109	332	5 343	916	190	54	155
Total	84 479	14 439	48 462	9 669	5 144	1 377	2 802

Source: Hungarian Statistical Central Office (1999a): *Regional Statistical Yearbook*, 1998.

for air and drinking water quality or the Ministry of Agriculture and Regional Development for the management of soils and forests.

Within the framework of pre-adhesion, the need to comply with EU requirements already necessitates substantial supplementary spending and staff. Co-ordination needs to be improved, competencies better delineated and the speed of decision-making increased, in particular for infrastructure investment selection, as the return to substantial output growth is putting more pressure on the environment. The fact that national programmes such as the Szechenyi Plan

ignore the environmental dimension of policies shows that even if the government has set up an inter-ministerial committee for sustainable development, much work remains to be done to better integrate environmental concerns into economic policy.

Conflicting objectives and the multi-disciplinary nature of sustainable development make it difficult to develop such a policy within a single sectoral ministry. The result is often a widening gap between strategic approaches and policy implementation. For example, while the Ministry of Agriculture and Regional Development (MARD) has presented a national regional development concept emphasising environmental issues and also launched an agri-environmental programme, it can do little to reconcile the interests of farmers and hunters with those wishing to protect nature. For city infrastructure, although MTWM has applied to the ISPA for much-needed major sewage investment in the capital, the ministry is giving little incentive for developing public transportation. In general, rivers have been canalised, but dikes are becoming too expensive to maintain. Cross border co-operation programmes for water management exist with all neighbouring countries, but the Tisza River disaster has shown that they should be reinforced by multilateral accords.⁶

Subnational governments are well placed to supplement and often substitute for central bodies to offer locally-adjusted solutions to sustainable development problems. In OECD countries, most local and regional governments now have considerable responsibility for infrastructure projects and managing environmental resources. In Hungary, only local governments in particular cities have the institutional and financial power to tackle environmental issues. Counties or regions have very few responsibilities of this order, which is surprising since the dimension of ecosystems and scope of problems are more appropriate tasks for this level of government (*e.g.*, water catchment area). Agenda 21 programmes have been launched at local level with NGO support, but there are no mechanisms for county or regional co-ordination.⁷ Governments and experts are coming to believe that the regional dimension probably fits the environmental agenda better than the county level and that its role should be strengthened.⁸

Urban and rural aspects

Public transport

Progress has taken place in public transport but there are still persistent problems. Given the decreasing demand for passenger transport the volume of passenger traffic dropped significantly during 1990-1999, although it remained an important mode of transport.⁹ This decline reflected poorer quality of service and higher charges as the central government cut subsidies and transport companies raised fares to recoup their losses. At the same time, rising individual transport traffic has largely contributed to road congestion, air and noise pollution in major cities and decreasing traffic safety, especially since most of the car fleet is old and does not comply with environmental standards.

Budapest is the main area of concern. If the use of private cars in the capital continues to grow at the present rate, it will be more and more difficult for the city to remain attractive for living, tourism, and business. Developing the public transport system and especially its capacity to supply sufficiently attractive alternatives to commuters using private cars is crucial. For the time being, the Budapest Transport Company (BKV), which provides transport services throughout the metropolitan area, still needs to replace its worn-out vehicles, modernise its buses, underground stock, trolley-buses and trams and upgrade its management technologies. Given the necessity of increasing the cost recovery ratio and of meeting debt-servicing constraints, these objectives are difficult to realise in the short term. An additional infusion of capital (called a cost subsidy) comes from the Municipality of Budapest and provides short-term solutions but perhaps reduces the pressure to adapt. Since the beginning of the transition, these cost subsidies have nevertheless decreased in relative terms while state subsidy ceased in 1996. Privatising certain activities could help, as the whole organisation needs restructuring and more efficient management. Local and central governments should in any case enhance land use planning, modernise the city road network, and invest in traffic attenuation facilities. Another task would be to improve the co-ordination that MAV (railway), VOLANBUSZ (interurban coaches) and BKV services provide. The creation of a tariff association between these three operators in order to integrate fare and ticketing systems would be a significant step towards improving public transport in Budapest (see ECMT, 2000). Moreover, in suburban and outlying areas, infrastructure planning needs increasingly to satisfy the demand for multi-modal transport through different means such as parking facilities at railway and bus stations and transfers points, bicycle stands or storage facilities with connecting trails, or park and ride with easy access, supplemented by attractive service units. Combined park and ride tickets could also be promoted.

In smaller cities and villages, local based services also face competitiveness issues although different in scope and mainly linked with the size of small settlements and towns and the decline of population. Since 1990, local bus services have been sharply curtailed. The number of settlements with local public transport fell from 205 in 1990 to 110 in 1998. During this period, public transport in towns (without Budapest) served 1 045 500 000 passengers, down from 1 447 300 000.¹⁰ This decline is partly due to fare increases and real incomes dropping, but the main reason is the financial problems of local governments, which support transport from their budgets.¹¹ Independent companies in each county provided the national bus service even before the transition took place in the 1990s. Each company operating in a specific county is still a monopoly service provider.

Housing

Housing problems are often referred to as the main bottleneck to inter-regional and inter-county mobility of the working-age population, principally

between the less and more developed areas. As real estate prices become increasingly differentiated between regions, a potential migrant from an underdeveloped region cannot afford to purchase housing in a more developed area. A high inflation rate makes for an underdeveloped mortgage market. Regional differences have also increased because of the steady decline of the state's redistribution role. Local authorities and market forces are now responsible for regulating rents, interest and prices of housing-related services. However, either for renting a dwelling or buying a new apartment or a public rental unit, there is a non-solvent demand for housing which requires complementary public intervention, principally in an underdeveloped credit system. This might be aggravated in rural areas by hidden unemployment and a particularly low supply of dwellings. In 1996-1999, 96 000 new dwellings were built in Hungary while 24 000 were liquidated. Among the 30 500 new dwelling construction permits released in 1996, 41 per cent concerned the northeastern part of the country, one-third Central Hungary and 27 per cent Transdanubia (HCSO, 2000a).

Efforts to privatise housing in the second half of the 1990s raised very complex issues in an already complex context. Unlike other Socialist countries, Hungary had a relatively low and stable level of state rentals before transition. For a national average of 25 per cent of the total housing stock, only Budapest and other large cities had a public rental sector that exceeded 50 per cent of the stock (Hegedus *et al.*, 1996). In fact, privatisation was partially implemented before the transition, by selling public rental units to tenants as early as 1969, and it intensified around the middle of the 1980s. Nevertheless, very few units were sold to tenants before the privatisation law changed in the mid-1980s.

A legal framework for central and local housing policies began to be implemented in the 1990s with the transition, although in a very contradictory manner. State rental stock was first transferred to the local authorities that could legally set rents. Local authorities were allowed to have their own subsidy system, although with no equivalent funding from the central budget. All residential and commercial tenants were then granted the right to buy their units, although this was later limited to residential tenants. The complex evolution of this policy worked at cross-purposes. Local authorities had to make more decisions, including the right to set rents and fix housing allowances. After the Act on Rental Housing and Privatisation in 1993, tenants in public rented dwellings had significantly reinforced rights and benefited from a policy of give-away prices that created many expectations (Hegedus *et al.*, 1996). As a result, the housing stock subsequently deteriorated. The real value of rents is still decreasing and rehabilitation efforts have practically stopped.

There are now some misunderstandings about the best way to combine the correction of the real values of rents with a comprehensive housing allowance system in order to target non-solvent demand. There is little co-ordination of central and local housing policies and political conflicts are increasing. Local authorities

seem to hesitate in pushing for privatisation efforts and decreasing public stock or opting for a mix of real market price privatisation initiatives, rent increases, and social policy. Budapest illustrates the great disparities in the outcome of privatisation efforts: there are significant sales in business districts and few in deprived inner city districts. The cumulative number of privatised units as a percentage of state units differs also among cities: 35.2 per cent for Szeged, 56.6 per cent for Budapest and 70 per cent for Miskolc (C. Banks, S. O'Leary and C. Rabenhorst, 1996).

The lack of co-ordination between the authority in charge of housing policy and local governments responsible for implementing it still represents a shortcoming in consolidating the transition. For the stock that has been privatised, the key question is assessing how the improvement of management capacities has followed the developments of the condominium and owners' associations. In privatised buildings, owners' associations are now legally required. Nevertheless, they must be legally able to address market developments concerning rehabilitation and management services as a single entity rather than as multiple owners.¹²

Renovation is also a matter of concern. The housing stock is very deteriorated, given the difficulties of public ownership in the last years before the transition period. The Hungarian Statistical Office estimates that 1.9 million inhabitants live in dwellings of inferior quality, of which one-third are located in Budapest. When subsidies for maintaining the public rental stock were eliminated in 1990, local governments' budgetary situation was worsened because the give-away prices had significantly reduced sources of revenue. In addition, the maintenance of privatised condominiums is still unresolved. Except for those condominiums in upper income buildings, the great majority lack funding for renovation. No capitalisation was made in the past. The number of private management firms of owner-occupied condominiums is increasing but they have no investment capacity for renovation, so the problem remains. Renovation plans should review the different structural damage of the neglected stock. In some cases, independently of deeper internal renovations, buildings need specific physical interventions to stop deterioration, from water infiltration for example. Renovation issues are also relevant for unsold rental stock for which local governments are responsible. Here, the perverse effect is the tendency to cumulate give-away prices. Selling under real market values weakens the capacity of local governments to renovate their own stock, precipitating the need for new privatisation to complement revenues for maintenance.

Rehabilitation of privatised and public rental stock is especially problematic in larger urban areas, principally in the districts of the capital. Rehabilitating the existing stock should be coupled with decentralising new housing policy to help the market forces to play the role previously taken by public authorities and encourage developers that usually were big construction firms working with local councils and the National Savings Bank.¹³ The evolution of the financial bases of small construction companies that began to emerge in the first half of the 1990s will be a key factor in decentralising new construction and will allow housing promotion

to be more effectively used as a development policy targeting the regions without any economic initiative. Small and medium construction companies may also be involved in rehabilitation issues.

Hungary can follow the experience of certain western European countries for intervening on housing renovation and projects that involve institutional innovations such as the constitution of central-local or public-private consortia. It can also try to apply for the EU Urban Programme that has proved efficient in renovating deprived urban districts in cities such as Bari, Marseille, Malaga, or Vienna.

The 2001-2002 Széchenyi Plan raises some expectations concerning the political will necessary for resolving these problems. The formulation of programme objectives and the references to the resources that will be mobilised presents a new approach to housing problems. At the same time, the Széchenyi Plan points out that the increase in the rental flat sector is in strict coherence with regional and urban territory peculiarities, and it is foreseen that new housing policy instruments will foster real and progressing housing mobility. Finally, it introduces housing quality improvement as an instrument to reach higher levels of urban and regional environment quality and as part of a territorial marketing-based strategy.¹⁴ This is a pertinent framework to clarify the role of each administrative layer in housing policy.

The Széchenyi Plan requires a very careful implementation strategy regarding the potential effects that concentrating funding in western regions will imply for reinforcing regional disparities. Housing renovation and the supply of new dwellings in the capital agglomeration and the faster growth in western regions are necessary to take advantage of better employment prospects. On the other hand, actions in the most depressed areas will help attract investment and avoid emphasising existing territorial disparities. In rural areas, some imagination will be necessary considering the fact that older people and early retirees will seldom leave them. Financial support could be allocated for physical intervention in rural areas, adapted to household composition and based on such criteria as warming conditions and safety.

Basic utilities

There is a good degree of territorial variation among local governments concerning local utility coverage and the range of special services they deliver. A World Bank report (World Bank, 1999c) considered the case of six Hungarian cities and found large differences in urban infrastructure service coverage (Table 12). For example, three of the six cities had only one-third sewer service coverage whereas the three other cities cover three-quarters of sewer services. For gas supply and garbage collection, there are varying degrees of coverage. Differences also exist in the provision of special services. Cities like Nagykanizsa (West Transdanubia) and Szolnok (North Great Plain) provide a wide range of special services whereas other

Table 12. **Urban infrastructure service coverage, 1996**

In percentage

Regions	Sewer in house	Gas supply	Covered roads	Garbage
<i>1. South Great Plain</i>				
– Cson-grad County				
Oroshaza	32.4	76.5	60.4	74.0
Szentes	33.0	67.7	81.1	75.5
<i>2. North Great Plain</i>				
– Jasz-Nagykun County				
Szolnok	76.3	80.1	75.9	96.0
– Hadju-Bihar County				
Püspökladany	25.9	52.0	66.7	20.3
<i>3. Central Transdanubia</i>				
– Komaron-Esztergom County				
Tatabánya	81.8	11.5	91.7	100.0
– Zala County				
Nagykanizsa	76.5	100.0	87.0	99.2
National average	47.4	60.4	63.7	76.7

Source: World Bank, 2000b.

cities offer a more limited range. As far as contracting out of utilities such as water services, the results are somewhat mixed. By 1997, three large cities (Budapest, Szeged and Szolnok), which account for more than 10 per cent of all water services in the country, contracted out. In Szeged, for instance, the local government did not have the capacity to evaluate long-term service contracts and the legislation was relatively underdeveloped, which led to problems.¹⁵ However, Tatabánya, Szentes, Oroshaza, Puspokladany were successful in contracting out water services.

Fifteen per cent of the population still do not benefit from a regular service for urban solid waste collection (OECD, 2000a). Most collected waste is landfilled in small communal facilities, which for the most part do not conform to environmental regulations (100% collection in Budapest and 70% collection in other areas). Five million tons were collected in 1996 with a two per cent increase per year; 2.6 million tons of hazardous waste were produced in 1996 of which 0.7 million tons of red mud from alumina production; 34 million tons have accumulated on dumping grounds. There are 10 000 contaminated sites with very scarce information about them, comprising 175 abandoned Soviet military sites (toxic metals and hydrocarbons) and 200 sites need urgent action which would cost HUF 40 billion whereas the resources allocated are one billion for 1996 and 1997. Hospital waste weighing 6 500 tons was generated in 1995. Only 30 per cent of the 2 700 communal landfills conform to a certain extent to environmental standards, and only 10 per cent are operated properly. In order to enhance its performance, Hungary needs specific legislation and an action plan for waste collection and waste treatment.

The 1994 National Environmental and Nature Conservation Policy Concept envisages decommissioning illegal and improper waste dumps and replacing them with environmentally safe regional landfills through regional incinerators and landfills and a package of other measures to ensure revenues and effectiveness. A new comprehensive act on waste management that clearly establishes municipal responsibilities has been operational since the beginning of 2001. All settlements are to be provided with waste collection, transportation and processing by the beginning of 2003.

In most cases, municipal waste disposal is financed through municipal budget with subsidies from the Ministry of Interior (HUF 1.4 billion in 1996 and HUF 0.9 billion in 1997). Attempts are being made to introduce a local waste charge fee. Though ambitious, the National Environmental Programme 1997-2002 is not clear about funding. A survey of 1 800 municipalities to prepare the programme indicates this to be the most urgent issue for the coming years.

Other public services

Healthcare infrastructures are not distributed equally across the territory. The number of beds and doctors per 10 000 inhabitants highlights the advantage of Budapest where supplies of physicians and hospital beds are respectively 87 and 67 per cent higher than the national average (Table 13). The concentration of financial resources is even more pronounced as the healthcare institutions of the Central region receive 34 per cent more resources than the national average (Burns and Orosz, 2000).

The Public Education Act provides for universal basic services. Table 14 shows that primary and secondary schools are quite evenly distributed at regional and county levels. The number of schools seems to be proportionate to the total number of pupils and students. The number of pupils/students per teacher and

Table 13. **Regional breakdown of hospital beds and doctors**

	Beds	Beds per 10 000 people	Doctors per 10 000 people
Central Hungarian Region	28 435	99.5	66.5
Budapest	24 105	131.1	90.1
Central Transdanubia	8 205	73.8	30.7
West Transdanubia	8 415	85.2	37.3
South Transdanubia	7 805	79.5	42.4
Northern Hungarian Region	9 785	76.5	28.5
Northern Great Plain	11 325	74.0	34.1
Southern Great Plain	10 289	76.2	38.9
Total	84 232	83.5	45.4

Source: Hungarian Statistical Central Office (1999a): *Regional Statistical Yearbook*, 1998.

Table 14. Primary and secondary schools

Counties Regions	Primary schools				Secondary Schools				
	Primary schools	Pupils	Pupils per classroom	Pupils per teacher	Secondary schools	Students	Students per teacher	Students per classroom	Commuting students (%)
Budapest	414	143 294	20.1	10.9	258	93 530	11.0	27.5	20.7
Pest	305	96 926	20.5	12.4	71	19 604	11.0	25.3	54.1
<i>Central Hungary</i>	719	240 220	20.2	11.4	329	113 134	11.0	27.1	26.5
Fejér	149	42 429	20.2	12.6	42	14 294	13.6	28.5	40.8
Komárom-Esztergom	124	30 621	18.9	11.9	33	11 102	13.1	26.1	47.6
Veszprém	168	36 838	18.7	11.6	37	13 159	12.5	32.7	41.1
<i>Central Transdanubia</i>	441	109 888	19.3	12.1	1 120	38 555	13.1	29.0	42.9
Győr-Moson-Sopron	199	40 238	17.3	10.9	48	16 843	11.0	30.7	35.9
Vas	130	24 705	18.3	10.6	28	9 394	12.8	30.4	34.4
Zala	135	27 874	18.5	10.4	27	12 065	13.0	32.3	37.8
<i>West Transdanubia</i>	464	92 817	17.9	10.7	103	38 302	12.0	31.1	36.2
Baranya	180	37 927	18.9	11.1	39	14 461	12.3	31.3	29.2
Somogy	170	31 194	18.3	10.8	35	11 130	12.7	27.6	33.0
Tolna	114	24 696	18.3	10.9	25	8 563	12.0	30.8	38.6
<i>South Transdanubia</i>	464	93 817	18.5	10.9	99	34 154	12.4	29.9	32.8
Borsod-Abaúj-Zemplén	369	79 314	20.0	12.2	60	29 102	13.1	30.1	35.5
Heves	139	29 687	18.5	10.8	30	12 496	12.1	31.2	43.9
Nógrád	121	20 863	17.7	11.4	21	6 415	12.1	31.6	52.8
<i>North Hungary</i>	629	129 864	19.3	11.8	111	48 013	12.7	30.5	40.0
Hajdú-Bihar	166	58 104	22.2	11.9	49	19 971	12.0	33.9	21.8
Jász-Nagykún-Szolnok	138	42 337	20.5	12.5	43	15 858	12.7	29.2	35.9
Szabolcs-Szatmár-Bereg	252	65 306	20.0	11.8	47	18 722	13.6	32.0	34.6
<i>North Great Plain</i>	556	165 747	20.8	12.0	139	54 551	12.7	31.8	30.3
Bács-Kiskun	200	54 262	20.2	12.3	51	17 522	12.4	27.6	32.9
Békés	123	37 890	20.8	11.7	45	13 929	12.8	27.6	35.4
Csongrád	136	39 743	20.3	11.4	47	18 466	12.0	32.2	25.1
<i>South Great Plain</i>	459	131 895	20.4	11.8	143	49 917	12.3	29.2	30.7
Total	3 732	964 248	19.7	11.6	1 036	376 626	12.0	29.2	32.6

Source: Hungarian Statistical Central Office (1999a): *Regional Statistical Yearbook*, 1998.

the number of pupils/students per classroom show some slight disparities between regions and counties. Differences appear at a lower level. There are still 910 settlements without primary schools. This does not mean that each settlement must have its own school, but basic services should be accessible in the neighbourhood on reasonable and fair terms.

Rural infrastructure

Rural infrastructure – especially roads, telephones and social services – is generally underdeveloped. Access to sewers is more difficult in rural areas. The

SAPARD Plan notes that roads in rural areas are poorly maintained and that many are unpaved. "A present deficiency of the road network is the lack of paved roads connecting villages (hence the 'dead end' villages). Thus, these villages lose the possibilities lying in transit traffic as far as public transport or deliveries are concerned. Moreover, long delivery times and the surplus of transportation expenses are basic barriers to the creation of local businesses" (MARD, 2000). Poor roads and unfavourable weather conditions make certain areas inaccessible at some times of the year. However, 30 000 kilometres of the 135 000 kilometre total road system are maintained by the central government.

Other areas of disadvantage for rural communities include telecommunications equipment, provision of sewers and wastewater treatment. Agriculture is a main water pollutant with a high nitrogen concentration. Only 724 of the 3 124 settlements in the country have sewer systems, and only 48 per cent of rural dwellings have access to sewers. Fifty-three per cent of all wastewater is discharged untreated into streams, and only 54 per cent of treated wastewater is properly treated. At the end of 1998, only 450 settlements had proper waste treatment facilities (MARD, 2000). This inequality may not only signal future difficulties in attracting development and investment, but also problems in retaining the current population.

Natural and cultural amenities

The importance of natural and cultural amenities to balanced territorial development takes on special relevance in the current context of potential increases in urban primacy. The value the urban population places on open rural landscapes; escape from noise, congestion and pollution; and sustaining activities that constitute an authentic Hungarian identity, will increase with income levels in the dynamic urban agglomeration of Budapest. Valorisation of rural amenities would increase economic opportunities in the countryside and would be likely to reduce the flow of migrants to towns and cities. But because the anticipated demand for these amenities is deferred, and because their provision is dependent on the actions of a very large number of individuals, one should not expect market forces to ensure an adequate supply.

The importance of the considerable endowment of natural, cultural, and built amenities has been acknowledged in recent legislation and development plans endorsed by various ministries. Hungary Act CXL and Act LIV of 1997 on the protection of monuments and on cultural heritage declare that the irreplaceable heritage of the country is embodied in objects and other forms of art that must be preserved to maintain historical awareness and a unique national identity. The SAPARD Plan of Hungary 2000-2006, elaborates on the conservation of natural heritage as a key tactic in an overall rural development strategy. The Széchenyi Plan for national development includes a detailed discussion of utilising the country's considerable resources in hot springs reserves to boost tourism potential (Box 4).

Box 4. Tourism: an alternative endogenous strategy for regional Hungary

The expansion of the tourism industry is often perceived to be one of the most effective tools of regional development as it takes advantage of urban and rural amenities, requires important influx of labour and generates significant local spillover effect. With the changes in consumer preferences related to per capita income growth, tourism has become the first economic sector in the world economy. In Hungary, it is already the second-largest industry. Since 1995, income from tourism has grown steadily. According to the Ministry of Economy, in 1999 tourists spent the equivalent of 1.1 per cent of the country's trade deficit and contributed to 10 per cent of GDP.

Before 1990, tourism in Hungary was a planned and centrally decided activity. However, since the beginning of the transition, the industry has undergone major changes. First, there has been substantial restructuring, mainly shifting from small to larger accommodation units as larger hotels meeting international standards have been built. Second, the number of tourists fell from 38 to 29 million during the decade due to fewer visitors from Central and Eastern Europe, partly compensated for by more visitors from western Europe. Tourism is important to the entire economy but is concentrated in just a few parts of the country. Traditionally, Budapest and Lake Balaton have dominated tourism in Hungary, followed distantly by the Matra Mountains. Since development potential exists in all regions, the PNDP for the period 2000-2002 implements several measures to strengthen local economic development. Indeed, each regional development council in co-operation with the regional tourism boards will select a list of up to three key tourist sites per region for major investments in infrastructure from 2001 onwards.

Aware of the growth potential of tourism, the government has taken several other measures to promote the sector. The Ministry of Economy has announced plans to support the construction of more three, four and five star hotels in county centres, including Szeged, S  kesfeh  rv  r, Gy  r, and Kaposv  r. The Ministry also has plans to provide financial assistance for the reconstruction of castles and their conversion into hotels. More generally, the government has devoted a full chapter in the Sz  chenyi Plan to the development of the tourism sector. The plan calls for regional and nation-wide marketing, and for the rapid expansion of tourism based on natural attractions and the national cultural heritage. It also calls for the establishment of supply networks and liaison programmes organised on a regional level. However, the plan does not make it clear how the proposed marketing programmes will be related to the existing marketing structure, and provides little information for translating goals and implementing them in programmes. Moreover, although the plan mentions supply networks and liaison programmes, it pays little attention to promoting best practice and sharing experience.

Besides calling for general support for the tourism industry, the Sz  chenyi Plan proposes the development of spa and health tourism. It suggests that tourism in this sub-sector could be supported from combined financing methods, involving funding from the national government, businesses, and municipalities.

Box 4. Tourism: an alternative endogenous strategy for regional Hungary (cont.)

According to the Ministry of Economy, government support amounting to one-third of the necessary total “enables the mobilisation of non-government business and municipal resources”. The plan estimates that an investment for a 200-room spa hotel would require HUF 3 to 4 billion (about USD 12 to 15 million), about one-third of which would come from the national government. However, such ventures are speculative and subject to many uncertainties. Even if the central government were to provide one-third of the costs, it is unclear how local governments would be able to raise money and commit it to such an endeavour.

The Széchenyi Plan also ignores the need to upgrade roads, water supply, telecommunications, and other infrastructure to improve access for guests and support services. In fact, all tourist schemes require a high level of support services embracing goods delivery, repair services, and other kinds of support. Failure to repair a faulty heating system or a similar basic utility can imperil the financial health of a tourist enterprise. Reliable telecommunications are also required, both to support guest needs and to expand outreach, take reservations, and so on. It may not be sufficient to fund new tourist hotels and other related investments. It may also be necessary to fund basic infrastructure, such as roads. The plan suggests that motorways and trunk roads can activate local areas within a ten to twenty kilometres reach from the road. This approach will condemn all perspectives for tourism in many rural areas, which still have important potential amenities to be exploited.

Tourism catering to the Hungarian market is also under-emphasised. Planning documents appear mainly concerned with promoting the growth of foreign tourism, whereas domestic tourism is also important. The average spending per Hungarian travelling abroad is greater than the average spending of foreign tourists: In 1990, it was USD 34.80 versus USD 21.70 for foreign visitors while both figures rose respectively to USD 97.80 and USD 74.50 in 1998. Domestic tourism could be particularly expanded in the backward regions. Moreover, the successful creation of new tourist regions for domestic tourists may eventually lead to greater numbers of foreign tourists.

National policy and regional and local initiatives can take advantage of the growing array of experiences in other OECD countries to make best use of valorising amenities to contribute to development objectives.

Co-ordinating the provision and possible use of amenities and their appropriate social valuation are the two critical public roles. Two conceptual dimensions differentiate amenities into four categories that are helpful for understanding these roles. An amenity can be characterised by whether its use value dominates (say, in the form of entry fees) or whether its non-use value dominates.

Non-use values can be further differentiated by existence value (values that citizens place on an amenity even if they never intend to use it), option value (the value of possible future use of an amenity) and bequest value. The other useful conceptual dimension differentiates amenities based on the characteristics of providers. Point source amenities are characterised by few producers whereas non-point source amenities require many producers. The detailed discussion of hot springs in the Széchenyi Plan provides a useful example of an amenity dominated by use values. The valorisation of this amenity also presents few co-ordination problems as it is most easily accessed through point source providers (*e.g.*, a spa resort).

More difficult to co-ordinate and valorise are non-point source amenities requiring many providers. But these are important to consider, particularly as regards the specific example of developing hot springs, owing to the important synergies they hold for point source amenities. Cultivating non-point source amenities such as an aesthetically engaging landscape, gastronomy, or maintaining economic and cultural activities comprising living traditions, can provide a milieu or authenticity to a place that is increasingly valued by potential tourists. Such non-point source amenities may be required for reaching a critical mass that makes the point source amenity a viable tourist attraction. This would be especially important to the spa resort strategy discussed in the Széchenyi Plan given the expressed interest in expanding the market segment beyond geriatric tourists to include more domestic tourism and other demographic segments of the international tourism market. Pursuing the non-point source strategy introduces problems of governance as their promotion and co-ordination is most effectively provided at the local level. An effective governance architecture will require greater retention of locally generated funds through taxes and fees so local governments are better able to allocate funds to amenity-based development projects.

A development strategy based on tourism, however, will not be suitable for all communities in the country. Farming activities, which are more ubiquitous, can still generate amenity values constituting a more equal mixture of use and non-use values. Use values derive from the higher prices commanded by agricultural products differentiated by a specific place of origin or mode of production. The Agri-Environment Programme (AEP), outlined in the SAPARD Plan of Hungary 2000-2006, addresses some of these issues in providing incentives for the development of organic farming. Other initiatives regarding eco-labelling and classification by place of origin should also be investigated.

The impetus for implementing the AEP derives partly from harmonisation with EU regulations. Protection of soil, surface and ground water, landscape and natural conservation are all stated objectives of this programme, making an appeal to farming that is environmentally friendly. These activities are more likely to reinforce the existence value of sustainable farming practices that work toward environmental preservation. That is, farming activities are seen to have social value to the extent that they contribute to these environmental objectives in addition to

any ability to ensure food security and provide livelihood for a segment of the rural population.

Conclusions and recommendations

Hungary has made major reforms in the infrastructure sector. Operators have been privatised in the entire sector excluding transport, and important investments have been made to modernise the telecommunications and road networks. While these investments have significantly improved the business climate in the country, there are still obstacles to the mobility of capital *e.g.*, rigidities in the housing market linked with underdeveloped housing services and credits and insufficient construction programmes which reduce local labour market flexibility and often impede or limit new investment projects. The quality of the environment can also discourage FDI. Much remains to be done in this sector especially to integrate the *acquis communautaire*. Air pollutant emissions have been reduced, but waste management and wastewater treatment performances are low and many regions are far from compliant with EU regulations.

Territorial disparities in infrastructure are often overlooked in Hungary. Rural infrastructure has been improved but often remains far behind urban levels especially in telecommunications equipment, waste management, sewer and housing, and road quality. Cities suffer more from local transport and air pollution problems. At the central level, MTWM policy should emphasise the territorial dimension and local government should be involved in infrastructure provision. Universal services policy also needs to be more elaborated and implemented. Detailed recommendations include the following:

- *Infrastructure and Planning Policy* should not be governed exclusively by EU accession preparation and by the extension of the EU TINA system (Transport Infrastructure Needs Assessment Programme) to Eastern European countries. It would be useful to establish a framework oriented towards long-term development in Hungary taking into consideration not only TEN (Trans European Networks) and the Helsinki corridors but also the geographic situation of the country within sub-regional spaces (Alps Adria, Eastern and Southeastern Europe, Danube belt).
- *Multimodal Transport*. Apart from roads, Hungary has a relatively developed infrastructure for public transportation for all means of transport. However, the infrastructure systems need important rehabilitation investments, which have only been partly realised so far, but this diversity is an advantage that should be better exploited. Multimodal logistic centres and technologies are under-emphasised and need to be granted appropriate priorities since they often provide more environment friendly solutions. More ambitious projects should be planned especially within the ISPA framework.

- *Environment.* The role of local and regional authorities in improving environmental infrastructure and monitoring should be more recognised and supported, and co-operation in the regions needs to be strengthened. Regional Development Agencies should undertake impact assessment studies and integrate the results into the preparation of regional plans. They should also be involved in environmental awareness campaigns with local authorities, in citizen-consulting procedures with regard to waste management, wastewater treatment and nature protection investment projects.
- *Housing.* It is important that local governments perceive housing policy as an additional instrument for attracting people and economic initiatives and develop more imaginative ways of creating a favourable business climate. A market for rental stock should be created that would be supervised by local governments and run by private developers. Rehabilitation efforts also need to be strengthened. For condominiums, this could be achieved through specific low-cost credit policies and incentives to collect savings for a renovation fund building up capital reserves. The rental sector needs a combination of fair increases in rents and selective social housing allowances.
- *Cross border co-operation.* Regions – especially eastern, northeastern and southeastern regions – should be granted sufficient competencies to effectively prepare and implement cross-border co-operation with partners in neighbouring countries. The national government could help in developing initiatives to transfer the experience of cross-border initiatives in western areas to the east.

NOTES

1. Five motorways cover 513 km. 1) M0-ring road around Budapest; 2) M1 Budapest-Győr-Austrian border (connection to Vienna); 3) M7 Budapest-Székesfehérvár-Balaton coast-Slovenian border; 4) M5 Budapest-Kecskemét-Szeged-Yugoslavian border; and 5) M3 Budapest-Hatvan-Miskolc-Nyíregyháza-Ukrainian border.
2. Car drivers can use motorways if they buy a vignette that they stick on their car wind-shield. This means that the most used motorways finance part of the maintenance of the less frequented ones.
3. Such figures should be considered indicative. The Szechenyi Plan will start this year and mobilize private sources. The total investment for 2001 and 2002 is expected to be around HUF630 billion
4. Not In My Backyard (NIMBY).
5. Magyarcom (owned by Deutsche Telekom and Ameritech) holds 56 per cent of MATAV shares while the Hungarian State has retained only 6.6 per cent of the shares. In the other 18 areas, tenders have been awarded to companies other than MATAV.
6. The river was polluted by cyanide in 2000.
7. Agenda 21 was adopted in 1992 by the United Nations Conference on Environment and Development. Its objective is to achieve sustainable development by implementing the principles of inter-generational and spatial equity, of multi-stakeholder participation, and the precautionary principle. Local Agendas 21 are meant to translate these general principles into local action plans and practice. For more details, see OECD, 2000a.
8. As emphasised by the Hungarian National Council of Environment (NCE). This council is an official advisor to the Government (consisting of representatives from academia, business and NGOs). The NCE reacts on governmental proposals and works closely with the media.
9. The public/private transport balance ratio in towns estimated at 80/20 during the 1980s is now close to 50/50.
10. Ministry of Transport and Water Management.
11. The profitability of local public transport is very low (about 0.1%) and the branch is considered as uneconomic for 16 out of 26 VOLAN companies. Local government subsidies to these companies have moderately increased from HUF342 million in 1998 to 354 million in 1999, but probably jumped to HUF500 million in 2000. Resources at hands are nevertheless not enough to cover the cost.
12. Under the Hungarian Condominium Law adopted in 1997 the owners' association was not considered a legal person. The amendment and modernisation of the condominium law is a complex task and requires parliamentary intervention.

13. The Small Enterprises Act and the Bidding for Public Construction Work Act allows the construction companies to develop construction projects themselves and the local governments to play an active role by developing and selling land to entrepreneurs.
14. Concerning the resources, the Széchenyi Plan insists on requiring broader methods of resource provision, establishing the following priorities: 1) Gradual transformation of budgetary resources for housing into active assets; 2) Establishment and maintenance of a budgetary competition fund with the co-operation of municipalities and regions and within the active assets; 3) Compilation of the various types of resources in constructions and models designed to ease selection; 4) Establishing the financing models of municipalities and regions; and 5) Presenting the security, comprehensibility and reliability of housing resources, which are tailored to meet individual requirements defined by one's disposition, life conditions and family model in a clear and intelligible manner.
15. Business Central Europe, "Szeged, Hungary".

Chapter 3

Economic Development Policies

After a decade of transition, Hungary's macroeconomic performance is positive, ahead of other CEE countries, and drawing closer to the OECD average. There is some concern about the inflation pressures, but most fundamentals are satisfactory. This reflects the capacity of Hungarian society to create wealth and to provide a tax basis, which is necessary to carry out a wide range of governmental policies. Other aspects of recent economic trends are less satisfactory. Output per employee is still at the bottom of the OECD ladder although higher than new OECD Members (except Korea) and GDP per capita remains below 50 per cent of the EU level on average (OECD, 2000*e*). More worrisome is the uneven spatial distribution of growth. The economy is strongly fragmented spatially, regional disparities have grown and the processes of regional polarisation have become evident. Public authorities have a major dilemma: should they focus on spatial equalisation using distributive policies or concentrate on promoting competitive territorial advantages, which could widen territorial disparities? The spatial concentration of FDI and new enterprises is striking, and the move towards the eastern and southern regions seems too limited to challenge the centre-periphery relation. At the same time, the development of the small and medium-sized enterprises sector, which represents 48 per cent of GDP, faces several bottlenecks including high taxes, capital shortage and social security burdens. Supporting home grown activities is a crucial complementary approach to attracting investors from abroad. This is particularly relevant for tourism, which represents the second largest industry in Hungary today. Besides its high potential for growth, tourism can promote sustainable development by developing natural amenities. Finally, Hungary faces the challenge of integrating the foreign and domestic sectors.

Spatial redistribution *versus* regional competitiveness:

The distribution of economic activities in Hungary is not unique in Europe but spatial imbalance is a social and political problem that deserves policy attention. The priority given to it, however, is a matter for debate. Some economists and development practitioners argue that further development and regional competitiveness enhancement is the main aim (efficiency argument). Certain authors,

e.g. Williamson, argue that below a certain level of development, spatial redistribution policies could be detrimental to national growth. From this perspective, central government policies should clearly favour the centres in the early stage of development by concentrating resources on a few poles of growth, and reverse this in the later stages of development¹ (see Williamson, 1965). This assumes that, under these circumstances, it is often preferable to focus support policies on more advanced regions because they diffuse expansion to neighbouring territories through input/output relations. Transferring funds directly to less developed regions could be less efficient given that they are not very able to absorb them and that their management abilities are poor. Public actions should clearly avoid weakening the most dynamic areas, without neglecting the less developed areas.

During the command era, heavy industry drove regional economic development, and spatial equalisation was ensured by the system of full employment based on artificially maintained salaries. The regional policies that have been adopted since the beginning of the transition appear much more oriented towards equalisation. The regional development actions, under the umbrella of the Ministry of Agriculture and Regional Development, are clearly focused on equity. However, until now, equity has been left strictly to regional development policies while general economic policies have primarily turned their attention to efficiency. The orientation seems to be changing. For instance, initiatives from the Ministry of Economics (the Szechenyi Plan) underline the need for a balanced territorial distribution. Some other Ministries (*e.g.* the Prime Minister's Office, Education and Transport) are also becoming increasingly aware of the territorial dimension of their policies, and the (political) interest in equity aspects appears to be growing. It remains to be seen, however, whether programmes and instruments will reflect this awareness. For instance, companies in the central and western parts of the country are much better placed to take advantage of incentives than those in the more backward areas. The commitment towards spatial distribution of development is not clear in other areas of intervention either. The announced programmes on housing, R&D and regional development would be open to all regions and will probably be of greater benefit to the more prosperous areas relative to the more peripheral areas. Strong co-operation between the different ministries and absorption capacity awareness are therefore required for the further elaboration of the National Development Plan, including the organisation and financing of various operational programmes.

Development based on exogenous investments

Foreign Direct Investment (FDI) has probably been the most successful means for Hungarian development in the recent period. At the beginning of 1999, FDI in Hungary reached US\$ 20 billion while annual inflows were around four to five per cent of GDP from the beginning of the decade until 1998. Although the share of FDI channelled to Hungary compared to the other CEE countries is lower than before

– 25% compared to more than 40% during 1990-1993 – FDI per capita remains by far the highest. Investments created with the help of FDI-fostered economic growth have been the major driving force behind the rise in productivity and competitiveness of the manufacturing industry. FDI stocks already account for 32 per cent of GDP and firms with foreign ownership now perform 70 per cent of Hungarian industrial exports. Germany has been the largest source country for FDI thus far with roughly 28 per cent of the total, followed by the Netherlands, the United States, and Austria.

It is generally agreed that FDI has played an outstanding role in the structural adaptation of the economy and in establishing new sectors such as electronics for professional and entertainment applications, telecommunications, vehicle assembly and car accessories. Additionally, a significant amount of capital has flowed into telecommunications services, the energy industry, trade and various service sectors. Foreign firms have neither been solely nor even principally attracted to Hungary by cheap labour unlike companies operating in Poland and the Czech Republic, which continue to be concentrated in labour and energy-intensive industries. Indeed, several firms have moved skill-intensive activities including some part of their R&D to Hungary (*e.g.* Audi, Nokia, Knorr-Bremse, General Electric, Ericsson and Sanofi – see OECD, 1999b).

These trends have different implications for territorial development. Foreign owners have preferred some regions or cities particularly for their greenfield investment or for acquisition of assets. Thus regional allocation of FDI exhibits a strong bias towards the capital region. Almost two-thirds of FDI is concentrated in Central Hungary including Budapest, followed at some distance by West Transdanubia (Table 15). Commonly, the proximity of western Hungary to the EU markets is seen as an advantage, which is somehow supported by the fact that German and Austrian investors in particular, prefer the western areas where many assembly plants are already located. American and Dutch companies seem to mainly locate in the Budapest area, which implies a larger dependence on the

Table 15. **FDI regional data, 1995-98**

Region	Average FDI 1995-98 billions HUF	Per cent	FDI 1998 billions HUF	Per cent
Central Hungary	1 032.00	62.4	1 317.00	61.8
Central Transdanubia	123.60	7.5	152.70	7.2
West Transdanubia	162.50	9.8	216.90	10.2
South Transdanubia	55.75	3.4	71.80	3.4
North Hungary	119.05	7.2	164.50	7.7
North Great Plain	76.65	4.6	101.70	4.8
South Great Plain	83.55	5.1	107.60	5.0
Total	1 654.00	100.0	2 131.80	100.0

Source: Hungarian Statistical Central Office (1999a): *Regional Statistical Yearbook*, 1998.

services sector and more generally on the urban economy including access to an international airport. Among major investors, the UK and France put less focus on Central Hungary. In 1998, for example, they channelled approximately one-quarter of their investments to North Hungary and the South Great Plain (Table 16).

It is difficult to predict national and regional FDI trends in the foreseeable future. At regional level, some empirical evidence shows a recent surge in the less developed eastern and northeastern regions such as Daewoo in Debrecen; General Electric in Hajdúböszörmény and Ózd; Bosch and Knorr-Bremse in Kecskemét; Zeiss in Matészalka; Benetton, Michelin and Flextronics in Nyíregyháza; or Unilever in Nyírbátor. While these investments benefited from centrally-provided incentives, active local investment policy and local incentives were also attractions. As far as the national level is concerned, experience from Ireland or more recently the UK suggests that increasing wages and costs will put pressure on FDI to look elsewhere in Central and Eastern Europe where costs can be significantly lower. This seems to be backed up by the latest figures on FDI inflow showing a more or less stable trend between 1995 and 1999 while rising in many competing countries (OECD, 1999a). This is partly caused by the privatisation programme, which is drawing to a close and can still be offset by portfolio investments. The key to avoiding this trap is to shift from a low to a high wage approach. For the moment, it is not clear whether the arrival of skill-intensive activities, including their R&D, points to a more incidental or more structural phenomenon. Sound policies and a supportive climate in regions will be crucial to help this trend materialize fully.

In order to attract FDI, territorial policy-makers must influence the regional and local investment climate, including the presence of other foreign enterprises (the prime mover is determinant for future potential investors), fiscal incentives and the accessibility to and availability of skilled manpower. Policies designed by several sectoral ministries are expected to play a more important role than those implemented by the ministry in charge of regional or territorial development. In Hungary, the Ministry of Economy has been instrumental in this

Table 16. **Share of largest FDI investors by region, 1998**

Regions	Germany	Netherlands	USA	Austria	UK	France
Central Hungary	56.5	68.7	64.4	65.5	42.4	51.1
Central Transdanubia	3.5	13.7	13.3	5.8	1.2	2.9
West Transdanubia	12.3	8.9	3.7	16.5	17.3	16.0
South Transdanubia	6.9	0.6	0.3	6.9	4.0	0.5
North Hungary	11.0	2.1	6.3	1.8	28.9	4.2
North Great Plain	7.5	2.5	3.2	1.4	1.5	1.7
South Great Plain	2.4	3.4	8.7	2.0	4.7	23.7
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Hungarian Statistical Central Office (2000c): *Foreign Direct Investment in Hungary*.

– the Szechenyi Plan highlights a number of economic development priorities. As mentioned above the most notable is the motorway construction programme aimed at improving international connections and links between regions. Another objective is to promote research and innovation, by consciously channelling FDI into environment-friendly and knowledge-intensive sectors that generate great added value, such as biotechnology, telecommunications and information technology. Such sectors should be supported by investment incentives.

With regard to policy instruments and direct support to business, the Hungarian government maintains a well-disposed fiscal climate including low corporate taxes, stable political commitment, and accompanying measures including investment promotion financed (among other sources) by the Allocation Fund. For example businesses may benefit by obtaining repayable or non-repayable grants of up to 20 per cent of the combined costs of investment in infrastructure and production facilities to a maximum of HUF 200 million. Although the business sector usually appreciates direct state support, it comes with a high bureaucratic burden. Moreover, its lack of transparency has often been highlighted. Special policy instruments are also available to improve the regional investment climate and complement the government machinery for stimulating investment, including a ten-year, 100 per cent allowance for companies that establish production facilities with a value of at least HUF 10 billion.² Since 1998, tax incentives also exist for companies in underdeveloped areas where unemployment stood at more than 15 per cent for one or two years prior to investment. In this case, the investor is exempted from paying corporate taxes for ten years if the investment exceeds HUF 3 billion and if it results in more than 100 employees being hired compared to the year preceding the start of the investment project. Any company that undertakes an infrastructure project in such regions in the year when the project is implemented can benefit from the same exemption. Furthermore, for companies in priority regions or in enterprise zones a tax allowance of six per cent of the investment value is available. Some international experiences have pointed to the relatively limited success of such incentives, however, while their open-end character is a potential risk for any state budget.

Industrial parks are another key feature of FDI-related policy. Foreign investors are reluctant to engage in building a range of utilities in a country that is new to them. Industrial parks, which provide businesses with a friendlier environment, can be an answer to their needs. From 1997 onwards, the title “industrial park” has been awarded in Hungary on a competitive basis. To date, 112 applicants have become industrial parks and are almost evenly distributed among the regions and counties. Eleven business zones located predominantly in underdeveloped areas along the borders also provide services and the requisite infrastructure demanded by investors. In 1999, approximately 970 enterprises operating in 88 industrial parks employed 81 000 workers and generated products with a total value of HUF 1 400 billion (15-16% of the industrial output). Not all of these parks are equitably suitable. To date, 37 industrial parks obtained support

through the infrastructure tenders jointly issued by the Economic Development and Regional Development Allocations (where only industrial parks were eligible bidders). This means that investments in infrastructures totalling HUF 8 billion will be implemented by 2001 with central support of HUF 3 billion.³

Custom free zones (CFZ) have been created and are deregulated country-wide (Antalóczy and Sass, 2000). CFZs are considered extra-territorial for duties, foreign exchange, and other legislation. The dutiable goods and means of production (excluding building and auxiliary material) are not subject to customs duties or value-added tax. A CFZ may be set up in any area inside Hungary after fulfilling the conditions required by the regulation, including producing mainly from imported inputs for exports, covering an area of at least 2 000 m² which is separated by the required fence from other areas, providing for the required customs control and paying the customs deposit.⁴ At the end of 1999, 115 CFZs established by 101 companies were operating in Hungary: a domestic or foreign company can operate more than one CFZ.⁵ Most CFZs are established by foreign investors (the share of foreign owned capital exceeds 90% of all the base capital of CFZ companies), and the majority of the CFZs were established through a greenfield investment.⁶ Not all FDI is operated as a CFZ, and not all CFZs are linked to FDI (a few are owned by Hungarian companies). However, most greenfield FDI in Hungary are established in a CFZ. Assembly companies that use local labour would benefit from importing high-value duty free equipment. International experience, however, has pointed to some weaknesses in the concept of custom free zones that do not necessarily attract companies with a long-term regional commitment.

Other FDI-related policies include county and city level provisions. Cash grants are rarely available at the municipal level, but cheap land, assistance in finding and training employees, provision of infrastructure and introductions to reliable local contractors are common. Certain cities have pursued a very active promotion policy. Szekesfehervar (and its surroundings), which is relatively close to Budapest, granted exemptions on local taxes until 1995 and attracted more than US\$1 billion in foreign investment. Today, the city ranks among the fastest-growing industrial zones world-wide (OECD, 2000b). Tatabánya County is another successful example – by the end of 1999, its industrial tradition and available skilled workforce, and its active local investment attraction policy had helped attract HUF50 billion (from, among others, Hitachi Cable, Grundfos, Backbee Mears, the French FCI, the Italian-Argentine SOINCO and Selina). However, Regional Development Agencies have not played a significant role so far, whether for diffusing information to potential investors or as mediators with the central government.

Development policies based on endogenous investments

FDI may be important in small countries like Hungary, which have limited resources and need to open up to the international economy. However over-dependence on foreign firm investment might be risky given the mobility of such

investment and its tendency to dry up during global downturns. The recent closure of the German company Mannesman in Sárbogárd, which decided to establish itself in China, led to the layoff of 1 600 workers. This is just one example of the volatility of such investments. Over-dependence on FDI might also lead governments to neglect regions and local areas of less interest to foreign investors. As a consequence, national authorities have become increasingly aware of the need to pay attention to endogenous (home grown) activities as sources of growth opportunities and job creation. Support to SMEs and young entrepreneurs is a main component of these strategies, all the more so since there are very few medium to large domestic enterprises in Hungary.

Small and medium-sized enterprises

In Hungary, SMEs account for two-thirds of employment, one-half of value added and less than one-third of exports. Despite the dynamics of entrepreneurship, the structure of Hungarian small firms has been rather stable for the last five years or so. The number of SMEs (about 1 million) and their share of GDP have been more or less constant since 1994. However, the contribution of small enterprises to export sales decreased from about 50 per cent in 1994 to 35 per cent in 1998, due to the increasing significance of FDI. Companies with a staff of 11 to 50 showed marked growth, indicating that this part of the economy is increasing its international competitiveness (ISE, 1999). The regional distribution of SMEs is rather uneven; Budapest excels with 125 active enterprises per 1 000 inhabitants, followed by western counties such as Csongrád, Győr-Moson-Sopron and Zala. Entrepreneurship is relatively low in the more eastern counties (38 to 54 enterprises per 1 000 inhabitants). Small businesses play a decisive role in trade and personal services (*e.g.* real estate), but are lagging behind those in western European market economies. In short, the Hungarian economy has a dual nature: a sector of large multinational firms that perform well, and less competitive, small domestic suppliers.

Nearly 90 per cent of SMEs are micro-companies (58%) and enterprises with no employees (31%) that deserve special attention. They mainly serve a local market using universal machines that can perform a wide range of tasks with little precision or tolerance. Entrepreneurial skills are acquired on the job, without any formal technical training and the relationship with other firms is basically structured on competition. These firms are relatively isolated and may remain unstable solutions for workers with limited employment opportunities and access to capital; whether they can grow into SMEs is doubtful as many barriers exist, including institutional and financial ones (Csaba, 1999). However, they could evolve by specialising in a few phases of the production process and joining networks of other small firms as subcontractors or producers of final products. Generally, entrepreneurs earn no real profit, nor do they accumulate a pension or any other allowance.

Surveys on SMEs usually list bottlenecks or permanent hindrances to enterprise growth. The last public report on SMEs in Hungary underlined the earlier finding that these factors change very little over time and place – almost irrespective of policies (ISBD, 1999⁷). Findings point to only a slight decrease in the severity of macro-economic bottlenecks such as high taxes, social security burdens, and unpredictable economic regulations and capital shortage. These findings also support the view that the macro-economic environment for SMEs has been improving over the last few years, especially thanks to the gradual deceleration of inflation. Conversely, other obstacles that are more territorial or local by nature such as unfair competition, procurement problems and labour shortage, may have been exacerbated. Limited access to capital is likely to remain a problem, especially in provinces where competition is limited by the dominant position of the National Savings Bank (OTP) and the Post Bank (ISBD, 1999). This is particularly acute in the agricultural sector, as small farms cannot raise the capital to upgrade their production facilities. Whether slaughtering or processing poultry and fish, most SMEs do not meet EU requirements and few operate under competitive conditions, often relying on outdated technology.

Hungarian policy focuses primarily on providing favourable regulatory conditions to promote the development of SMEs. In 1999, a bill on SMEs that alters the role and functions of the Enterprise Development Council was presented to parliament. From 2000 on, part of the programme has been funded by the Budget Allocation for SMEs. Given that small business usually forms the backbone of less developed regions and especially rural areas, SME policies have an implicitly strong territorial dimension. It is not surprising therefore that they are financed not only through the allocations for economic development objectives but also through the Regional Development Allocation. This framework gives priority to the development of the regional economy and infrastructure, promoting employment, innovation centres, incubator houses, industrial parks and integrated regional development programmes. While the latter budget line is managed by the Ministry of Agriculture and Regional Development and clearly favours indirect business support over direct business support, other budget allocations tend to be more focused on direct business support to individual or groups of enterprises. In addition, the Hungarian government and the EU PHARE Programme finance the Micro Credit Scheme, (the PHARE contribution will end in 2001). Eligible applicants are small enterprises with no more than 10 employees, and the enterprise promotion centres process the applications. The borrowed amounts may be higher in disadvantaged regions. Other credit schemes come from the Hungarian Foundation for Enterprise Promotion (MVA), the Hungarian Development Bank and the Hungarian Export-Import Bank.

The emphasis in Hungarian policy on developing SMEs is also reflected in the Ministry of Economy's priority on reducing the gap between SME and foreign sectors notably with regard to technical performances, product quality, management

efficiency and corporate governance. Although modest in budget, the recent SME support programme within the framework of the Szechenyi Plan focuses on assisting non-productive SME activities (training, networks, etc.), expanding financing opportunities and improving operational conditions (*e.g.*, regulatory framework, one-stop windows). The plan aims to promote regional clustering of enterprises to reduce transaction costs, according to the principle of the network economy, and to improve the links between multinational and domestic firms. Although it is too early to judge, current subsidy and credit schemes have proliferated with no clear relationship among them and therefore it appears that particular attention should be paid to delivery and effectiveness of existing instruments. Some instruments also appear to be more or less palliative. One important reason why SMEs have difficulty in getting access to credit lines lies in the banking system itself, which has no tradition of providing capital to SMEs. Even worse, banks that have been connected to subsidised loan schemes sometimes use them to remedy their own funding problems, while loan request assessment is slow and very bureaucratic (Csaba, 1999). Some slight improvements have nevertheless been reported: for the first time in 1999, credits to households and SMEs grew at a faster rate than loans to large businesses (OECD, 1999b).

Effective SME support also requires the managing staff to know the customer. Therefore, effective local and regional intermediaries need to be in place. Currently, the institutional landscape of SME support is not very clear. The role of the Chambers of Commerce is changing since mandatory membership ended in October 2000. It is expected that only the larger firms will remain associated and all others will need to pay for their services. The Hungarian Foundation for Enterprise Promotion (MVA) will also be restructured in order to give better assistance to large enterprises. Locally, banks do not play a crucial role yet. With 400 branches, the OTP Bank would be well placed but it has not fully taken on the challenge of SME finance thus far (OECD, 1999b). The delivery of SME policy in Hungary therefore lacks clarity and many companies do not know where to go. It remains to be seen whether the ongoing restructuring and government initiatives will provide the necessary clarity and institutional environment for SMEs.

Challenges linking the foreign and domestic sectors

Several issues point to the need to strengthen economic ties between foreign investors and Hungarian SMEs. First, as many analysts point out, industrial FDI is still more common in sectors manufacturing parts than in those involved in assembling. In addition, the import content of exports is often high (up to 90%), suggesting little value-added activity and the subsequent fear of a persistently dual Hungarian economy. Second, the creation of Custom Free Zones (CFZ) may have been a disincentive to integrating foreign firms entering the local or regional market (OECD, 2000b). After 1995, many foreign companies moved their activities to these CFZ where they pay no duties or value added tax and where they can function as islands. Third, when international conditions change or the advantages that

motivated FDI implantation end, the risk of disinvestment increases. Encouraging the development of local subcontracting practices might help when wanting to retain them.

While these problems are undeniable, several studies conclude that domestic suppliers are increasingly competitive. The share of domestic supply in the output of foreign firms located in CFZ rose in 1998, as did the number of Hungarian companies involved in these subcontracting networks (OECD, 2000c). Moreover, numerous foreign firms are now well established in Hungary and run by Hungarian management. The example of Delco Remy, a division of General Motors, is all the more interesting in that the company was established in Borsod County (northeast region), a disadvantaged area (Box 5). Other Hungarian firms have internationalised their activities and operate on the European market (*e.g.* Ikarus or Raba⁸). While negligible before mid-decade, the stock of Hungarian outward investment reached US\$ 1.7 billion at the beginning of 2000. Neighbouring countries such as Romania have recently become important destinations (OECD, 2000c).

Box 5. A foreign company with a local management team in the northeast

Delco Remy Hungary Remanufacturing Ltd. is an established company, a division of General Motors, which manufactures starters and motors for heavy-duty vehicles. After a management buy-out in the United States in 1994, a plant was bought in Borsod County (northeastern region) in 1995, which employs 550 people. Operations from 1995 onwards were successful, and Delco Remy is currently building a second factory in Hungary for passenger car starters. The location search involved a national and a regional choice. The country selection was based on the fact that Hungary is the most westernised country in the Central and Eastern European region, which has adopted a market-based economic policy and a stable political system with limited investment risks. In addition, the firm has good experience in the country. It has an operation in Borsod, and several arguments justify the location in this region, particularly in Miskolc. First, a very high unemployment rate, much lower labour costs, an industrial tradition and available skilled labour, provide favourable labour supply conditions. Second, the business environment is quite favourable: transport infrastructure will be improved as the motorway to Budapest is to be finished within two years; there is access to suppliers and subcontractors and available managerial functions and good universities. Both local and central governments have provided specific supports.

A key factor in the selection of Miskolc is that Delco Remy has a local Hungarian management team knowledgeable about local regulations, plant construction, and securing requisite utilities. Local management could therefore overcome the absence of all available industrial parks except a less attractive reconversion site. The Delco Remy case proves that familiarity with a local situation is vital, even for companies that exclusively serve international markets.

Several major policy initiatives have encouraged these trends. In 1998, an agreement was signed between the Hungarian government and a number of multinationals to increase subcontracting with local companies (especially in the automotive, electronic and chemical sector). At the same time, the Subcontracting Programme – often called the Supplier Target Programme – was launched under the Ministry of Economy. The Hungarian Foundation for Enterprise Promotion was responsible for supporting suppliers' enterprises in establishing business relations with large Hungarian enterprises and multinationals that conform to EU regulations. The Subcontractor's Charter, signed in March 1998, is a milestone: the signatories commit to *"increasing the involvement of SMEs in the international division of labour"*, *"to interest multinational and domestic companies in increasing their purchases in Hungary"* and *"to increase the proportion of Hungarian added value in the products of large companies"* (ME, 1998). By October 1999, about 50 companies had signed. The programme has now gained strength and a range of firms has used it. By August 1999, 1 438 enterprises, with a total of 110 000 workers on payroll, were taking part in the programme; 82 per cent is entirely domestic, private ownership. One optimistic achievement is that the imported contents of supplies to free zones decreased from 79 per cent in 1998 to 75 per cent in the first half of 1999, indicating that enterprises operating under free zones are starting to resort more to Hungarian suppliers.

However, it was also recognised that most Hungarian firms could only join the small group of domestic subcontractors of large multinationals (about 2 500 to 3 000 firms) if they seriously upgraded their product design, marketing and distribution performance. At stake here is the capacity of these firms to deliver high quality service and to supply innovative products. Modernising small business operations and investing in new technology is very important for several reasons:

- R&D expenditure has considerably declined – from 2.28% in 1988 to 0.7% of GDP in 1998 – as has the share of business enterprise as a financial source.
- Only one or two per cent of firms (10 000 to 20 000) are engaged in innovative activities and the number of patents has decreased significantly over the decade.
- Innovation diffusion is slow; modernisation in all regions and sectors depends on the transfer of technology and open-minded managers.
- Government research and education institutions have poor relations with business, and intermediation centres do not perform well.

The central government faces a daunting task in overhauling R&D and innovation structures. This process began at the end of the last decade, but was due mainly to the actions of foreign firms. Since the diffusion of knowledge and techniques largely takes place through supplier/buyer relationships, Hungarian subcontractors and foreign ownership enterprise-linked companies benefit increasingly from an innovative environment while domestic firms with no backward or

forward linkages, are less and less able to connect to the networks. National authorities are now taking steps to break this vicious circle. Recent initiatives emphasise:

- *Co-operation between firms.* The PNDP which sets out the main priorities for EU funding for 2000-2002, will devote €7 million to interventions in the three targeted regions (North and East). Competitive grant schemes will support the establishment of sub-supplier networks and the joint production and market actions of SMEs within the same sector, of clusters, or of firms with similar business interests. The Szechenyi Plan has launched a sub-contracting programme to strengthen the production, innovation and information ties of domestic SMEs with multinational corporations in Hungary. To this end, a national sub-contractor information network was established and will be expanded. The promotion of specific product clusters in regions is foreseen as well.
- *Business-related infrastructure and management culture and skills in SMEs.* PNDP support will go to training programmes (€2 million) and transition to working life (€4 million) in the same regions. Major projects in business-related infrastructure will receive a PHARE contribution of between €2 and €5 million, respecting the minimum project size for PHARE and the minimum ISPA threshold.
- *Research and innovation.* R&D is concentrated in the capital region (80% of business-related research and 60% of all R&D employees) whereas peripheral regions and the local domestic sector are particularly weak in innovation. A special catch-up development programme is carried out by the Ministry of Education to enhance science and technology infrastructures in less developed counties and to increase local demand-driven innovation programmes for SMEs. The Szechenyi Plan also supports the creation and development of regional networks of innovation and research institutions through non-refundable development grants.⁹

Despite the good intentions of these programmes, the organisation of their delivery and their relationship to each other remains unclear. The strategic goal of reinforcing the links between the foreign and domestic sectors can only be supported. Yet, there is only limited experience in initiating efficient programmes. One possible danger lies in the fact that government would need to greatly intervene in business operations through a range of direct business support measures. Before designing the new programmes, it would be wise to carefully evaluate the efficacy and efficiency of the existing initiatives, such as the Supplier Target Programme and the agreements (*e.g.*, in the automobile sector). Finally, the challenge lies not only in linking the foreign and domestic sectors, but also in linking the policy initiatives, especially those between the PNDP and the Szechenyi Plan.

Conclusions and recommendations

Now that macroeconomic management has reached some level of success in Hungary, regional and subnational problems are receiving more attention. This is reflected particularly in the wide array of programmes and schemes designed and implemented to strengthen regional development and to remedy the growing spatial fragmentation of the economy. The analysis has pointed to several implementation problems and touched upon several dilemmas faced by the public authorities, including the strategic objectives (efficiency versus equity), policy efficiency (endogenous and/or exogenous development) and policy efficacy (direct or indirect business supports). A few important insights can be gleaned from this analysis.

First, there are some perceptible shifts between direct and indirect business support. An extensive range of instruments for direct business support are currently in place, including state aid to foreign companies and grants, and credit schemes to SMEs. However, the transparency in the provision of direct state support has been limited: the conditions under which state support is provided and what market failures are being addressed are not always clear. Traditionally, the programmes supported by the Ministry of Agriculture and Regional Development have focused more on indirect business support programmes, partly due to state aid restrictions under PHARE. The Szechenyi Plan also appears to favour indirect business support. Special attention is given to motorways, industrial parks, access to suppliers and improvement of the quality of life by ameliorating the housing stock. However, there appears to be no overall attention given to the regional investment climate. The focus on specific location factors is fragmented and not always based on analysis. For instance, the Szechenyi Plan makes no mention of labour markets (shortages have already materialised in western parts of the country due to the large influx of foreign capital), access to business services, transportation infrastructure other than roads (*e.g.*, rail and water) and the importance of efficient government administration. The regional business environment should be monitored carefully and regularly in an integrated way. This could be a task for the Regional Development Councils and their agencies, as a cornerstone for future regional development plans and programmes.

Second, the admixture of endogenous and exogenous development policies is gradually being rationalised. Hungary has emerged as an important laboratory for policies that aim to reduce the gap between the foreign and local sectors. A number of interesting programmes and initiatives have been launched in this respect and it remains to be seen whether they will be effective. The temptation to interfere too much in the daily business operations of companies should be resisted. The ultimate challenge lies in designing and implementing an integrated multi-dimensional policy that effectively improves the business conditions for both foreign and domestic firms, while promoting more balanced territorial development.

The implementation of such a multi-dimensional policy is likely to be difficult in the current context because of limited capacity to implement policy at national, regional and local levels. As a legacy of the past, Hungarian administration has performed well for planning design, but most of the plans are neither budgeted nor implemented. It appears that the policy life cycle is not being followed properly and the links between problem recognition, policy formulation, implementation, evaluation and corrective action appear to be weak. Despite the long tradition of economic development policy, learning and improvement have been less than optimal because of the lack of co-operation and the short-term orientation of the system. In economic development, the horizontal co-operation between the Ministry of Economy, the Ministry of Agriculture and Regional Development and the Ministry without portfolio co-ordinating PHARE programmes is particularly limited. The emergence of two separate plans at national level is a logical but rather problematic outcome. Against this background, the following specific recommendations can now be made:

- *Provide the right conditions for SME finance.* Banks have little inclination to lend money to firms that often have no collateral. Although the interest rates have come down, they remain relatively high compared to those of EU countries. Venture capital can be useful for a certain type of firm and in certain regions, but only as an additional source of finance. More regular base-finance for SMEs is needed, and access needs to be secured across the territory. An existing local banking system, such as the OTP network (National Savings Bank), could be used to promote regular SME finance.
- *Develop integral strategies for regional economic development.* Prevent a piecemeal approach, take into account all aspects of the regional investment climate and design a balanced policy mix as part of regional development plans and programmes.
- *Make the Regional Development Councils responsible for monitoring actions for improving the regional investment climate.* These councils will be responsible for preparing important regional operational programmes that will receive significant funding after EU accession. They need a solid foundation. In the short term, the Regional Development Allocation is a good tool.
- *Cluster available regional development capacities at regional level.* To add value, professional regional development requires a critical mass and specialisation. This can only be achieved by bundling or clustering the scarcely available expertise at the regional development level. County Development Agencies, Regional Development Agencies, Local Employment Agencies and Chambers of Commerce cannot afford to work on their own. They need to bundle their strengths and come to a clear division of labour.

NOTES

1. This is mainly based on Hirschman's theory of unbalanced growth and on Williamson's analysis. According to the latter, the typical pattern of national development creates an inter-regional divergence at the early stages of development and an inter-regional convergence at the later stages.
2. It is available when a company's workforce is increased by more than 500 people as compared to the year preceding the start of the investment project
3. With HUF 1.7 billion from Economic Development Allocation and HUF 1.3 billion from the Regional Development Allocation. Ministry of Economy, www.gm.hu/english/sme/industpark.htm
4. *Ibid.*
5. E.g., Philips (producing computer monitors, telecommunication products) or the Lear Corporation (producing car seats, other car parts) operates more than one CFZ.
6. Well-known multinationals with affiliates in one or more CFZs in Hungary include General Motors, Philips, Ford, Audi, IBM, United Technologies, Sony, Benetton.
7. The survey hinted at the following bottlenecks: 1) high tax and social security burdens; 2) unpredictable economic regulations; 3) keen competition; 4) shortage of orders; 5) unfair competition; 6) capital shortage; 7) payment arrears of customers; 8) shortage of credits; 9) obsolescence of existing capacities; 10) procurement problems; 11) labour shortage.
8. Ikarus and Rába are two big Hungarian companies that produce respectively buses, and engine and heavy vehicle components. Rába is currently Europe's second largest axle producer and the world's fifth largest. It is also Hungary's largest exporter to the United States.
9. Eligible organisations include innovation-oriented industrial parks, incubators, logistics and innovation transfer centres. Applicants should co-finance the investment.

Chapter 4

Social Policies

Hungary is confronted with social problems that may impede social cohesion: the number of people living under the poverty line has increased substantially, the particularly high mortality rate exceeds the birth rate, the ageing of the population is a matter of concern, and the education level of the unemployed is relatively low. Yet, social issues do not seem to play the role in policymaking that they should. A Ministry of Social and Family Affairs responsible for the implementation and co-ordination of social policy was established only in 1998. The PNDP 2000-2002 within the framework of EU accession encompasses employment and human resources programmes that strongly emphasise growth. However, there is no provision to tackle imminent problems of poverty. Similarly, the Szechenyi Plan provides significant funds for housing programmes but the articulation with social issues is not explicit. PHARE 2000 includes some specific actions against social exclusion targeting underprivileged young people, unskilled Roma, and the disabled. As unemployment has been recognised as the main cause of poverty, it is crucial to assess whether labour market policies can help improve the employment situation. At the same time, some strata of the population cannot easily reintegrate the labour market and thus rely mainly on social allowances. Is the social safety net adequate to tackle the issue? More generally, do the social welfare policies provide a sound and viable system of social protection? The strong territorial dimension of social issues must be considered here, as some settlements are more in need than others. The role of the many administrative layers in providing social services is therefore very important. The Roma population poses another challenge. This minority accounts for five to six per cent of the total population and deserves particular attention as it is especially vulnerable to poverty and social exclusion. This issue could be addressed horizontally as Roma are often on the front line for all social problems. Aware of the depth of the social challenges faced, Hungarian public authorities have taken several measures that are worth being assessed.

Living conditions and quality of life

As the macroeconomic environment has improved, average household income has increased after reaching a low point in 1995, and private consumption

has risen steadily since 1995. Consequently, lifestyle has changed. More time is spent on leisure activities, including reading and watching TV, though people in villages spend much more time on earning activities.¹ However, this improvement has been accompanied by greater inequality. The market economy brought new forms of poverty especially among families where the head, often if unskilled, would lose his job. At territorial level, poverty has risen in small villages, especially in lagging areas, and in some urban districts. The UNDP Human Development Indicator (HDI), an indicator of social well-being that expresses living conditions, is relatively low in Hungary compared to other Eastern and Central European countries. Eastern regions and counties show human development indicators below the national average with some cases of stagnating indicators and others of declining performances.

Health problems are the main cause of this poor performance. The mortality rate is high, mainly among middle-aged men (30-59 years old) (United Nations, 1999). Hungary ranks first within OECD countries for male mortality from lung cancer, heart disease and cirrhosis of the liver (Burns and Orosz, 2000).² Other causes include over-work and unfulfilling work, poor diet, tobacco addiction and alcoholism, for which Hungary has the third highest consumption rates in the OECD. Suicide rates are also high, especially among men aged between 40-44 years of age. WHO ranked Hungary seventh in this category among the European countries between 1995-1998 (HCSO, 2000a).³ This indicator is higher in the North and South Great Plains.

Environment and infrastructure affect health. According to the National Medical and Public Health Office, about half of Hungary's population is exposed to serious or moderate air pollution. A positive correlation has indeed been found between ambient air quality and respiratory morbidity and mortality. The main areas of concern include Budapest and its surroundings, some cities in non-metropolitan regions, as well as industrial regions that are traditional hot spots (Sajó Valley, Central Transdanubia and Baranya) though large reductions in industrial activity have led to some improvement. About 80 per cent of the population drink water with a low iodine content (leading to a high frequency of goitre) and five per cent consume water of unacceptable quality. Arsenic and nitrate pollution has been reported in the Great Plain. The accident and death rates from road transport are relatively high.⁴ Transport is also responsible for safety problems on account of poorly maintained road surfaces, noise and vibration loads. Nearly 40 per cent of the population lives in areas where transport noise is intolerable (HCSO, 2000a).

Another area of concern has been rapidly increasing crime rates during the last decade, though the levels remain lower than the western European average. Eastern regions are more exposed to violent crimes and crimes against property, which can be explained by the economic crisis affecting this part of the territory (Scaba, 1999).

Social welfare policies

Growing poverty and the surge of unemployment after the economic crisis occurring during the first phase of the transition, led to a rise in social expenditures and in the number of benefit recipients. At the same time, retirement benefits, disability and sick pay expanded as the population aged and health deteriorated. Public expenditures on social benefits rose significantly to levels comparable to the most generous western European countries. With the implementation of the stabilisation programme, welfare expenditures have dropped gradually and significantly, eroding particularly the family allowance and unemployment benefits. Fiscal pressures have also led the government to adopt reforms of the pension and healthcare systems, which represent the major expenditure items. The mid-1990s brought a change in the previous policy of reducing subsidies and shrinking certain benefits in these areas. By 1999-2000 a reform of real subsidies involving significant amounts of extra resources triggered new processes, whose central element was the creation of a child- and family-oriented atmosphere. Considering the spatial disparities in living conditions, the structure of the welfare system automatically has territorial effects, and its local dimension deserves particular attention.

Role of local governments in providing social benefits

Since the beginning of the transition, the local dimension of the welfare system has increased. Local authorities are entitled to different levels of funding from the central government depending on the magnitude of the economically inactive population and on the ratio of the unemployed to taxpayers. Approximately four per cent of the local authority budget is spent on social benefits, principally on unemployment assistance, housing aid and other transitional aid that represents approximately 57 per cent of the social expenditures. Regular aid is established according to national (parliamentary) eligibility criteria. Emergency aid, by contrast, is established by local authorities and is demanded by unemployed people who receive no unemployment benefits, pensioners below the poverty line, children whose parents are in a temporarily bad economic situation, and homeless people.

The redistribution role played by social welfare authorities at local level varies significantly. From the most depressed districts of the capital to the small settlements with fundamental shortages of basic services – crisis regions or settlements strongly affected by ageing problems – a complex situation of social needs emerges. The capacity of local governments to intervene strongly depends on local tax revenues. Some outlying districts and older inner-city parts of Budapest are the principal areas of poverty intervention. At the same time, some settlements still lack basic equipment such as day-centres, and temporary and overnight shelters. Their provision strongly correlates with the debate on how to manage these problems efficiently in very small villages. The village administration

network is a possible alternative. It would provide the rural population with the services it requires by contributing directly to the social care of aged and infant populations. A nation-wide village administration network should be established, funded primarily by a state subsidy to cover procurement of essential equipment, and small settlements located in crisis regions should have priority. Moreover, the current social land programme through which local authorities receive central financial assistance should be pursued as it allows socially disadvantaged families and the long-term unemployed to be involved in agricultural activities through public funds, which guarantee the equipment, machinery, seed-corn, animals, etc. for agricultural production.

Social safety net provisions

Welfare provisions for the poor include social assistance (regular and occasional), family allowance (child-care allowance for low-income families) and income supplement paid to the long-term unemployed. A survey of income of households grouped in deciles shows that the share of social transfers in total household income, including pension benefits, has grown significantly, particularly for the poorest households (UNDP, 1999). In 1998, social income represented more than one-third of total income and 26.7 per cent of GDP. Inequality progressed significantly in practically all the income sources, including social transfers.

According to the UNDP, social assistance is crucial for the poorest households, representing more than half of the annual per capita income. On the other hand, it has been reported that a certain proportion of the most needy has no access to the benefits to which they are entitled, nor does the amount of social assistance always correspond to recipients' needs. Government has gradually introduced changes to the structure of social transfers. Access to family benefits was curtailed in 1998 and repealed in 1999, but has increased since then. Despite the fact that resources are better focused on more needy families, this social benefit tends to be perceived as still favouring the middle class. However, without family allowances, poverty would increase significantly among households with children. At the same time, a new subsidy system has been introduced, growing continuously in real value and targeted at families with children qualifying as poor. This form of provision, called the child protection subsidy (or supplementary family allowance as from 2001), adds some 80 per cent per month to the income of the families of the children concerned.

Other forms of social aid targeting the poorest include accommodation for the homeless. An institutional homeless care service exists, based on a system of day centres and rooms for temporary occupation. Although all settlements with a population of over 20 000 are required to build day centres, 34 of the 60 settlements in this category have not yet fulfilled this obligation. Even in Budapest, the number of day centres is below the required level. Considering the number of homeless people, building new sheltered accommodation institutions is urgent.

A comprehensive unemployment insurance system offering broad coverage funded by labour taxes was set up during the first phase of the transition, but expenditures have since been reduced. Early retirement and disability benefits were used greatly but the authorities introduced a series of measures to limit them.⁵ The government plans to introduce further restrictions to the overall unemployment benefit system. This should be accompanied by active labour market policies and appropriate social measures for those facing great difficulty in reintegrating the labour market, relying mainly on unemployment benefit as their source of income. The unemployment system, by its nature, benefits a greater proportion of the unemployed in well-developed areas. Indeed, the rate of those receiving unemployment benefits compared to all registered unemployed differs among regions: 38 per cent in the well-developed region of West Transdanubia *versus* below 24 per cent in the less-developed region of North Hungary. When the permanently unemployed represent a high proportion of the registered unemployed, as is the case in disadvantaged areas, the rate of those receiving unemployment benefits is relatively low since the benefit depends on the time spent out of work. Besides unemployment insurance, which aims at providing short-term transitional income, there is a means-tested unemployment assistance scheme that provides long-term assistance. At the end of 1999, an element of workfare was introduced in the latter system. Eligibility for benefits can be withdrawn if a participant refuses a public job that is being offered. Benefits are 10 per cent lower to finance the workfare component. Public works and the welfare components are administered by municipalities with central funds. While this new system is a positive step to improve work incentives, over emphasis on public works may increase the dependency of lagging regions on the public sector, where long-term unemployment is high.

A more targeted welfare programme should be developed for the poorest. It is essential to manage the poverty problem effectively in those settlements where social indicators are far below the national average. Existing family and child-care systems could be extended in crisis regions with cumulative problems. Formulating appropriate measures requires a comprehensive monitoring system to assess the consequences of the erosion of social benefits on the population and the territories. For example, social observatories implemented at regional or county level could be made responsible for permanently measuring the evolution of poverty and its causes.

The pension system

A major element of welfare support provided to the elderly is the mandatory pension, an insurance that includes pension allowance, invalidity pensions and survivor pensions. In the mid-1990s the disability pension was mostly used as a substitute for unemployment insurance. In order to ensure the viability of the public pension system, a new system was introduced in 1998.⁶ Prior to that, in 1997, the statutory retirement age was increased to 62 years while a new

two-pillar system replaced the previous compulsory Pay-As-You-Go (PAYG) system. This consisted of a modified PAYG system plus a fully funded private sub-system. It is mandatory for school leavers to participate in the mixed two-pillar system. Those who have paid contributions so far could choose to join the second pillar or remain associated with the old mandatory public pension scheme. Those that complete contributions, generally over 20 years until 2009, will receive 100 per cent of their pensions, which explains the persistence of the public system. A clear division has emerged between older workers who still participate in the public system and the younger workers recently arrived on the labour market who decide to join the system consisting of a modified version of the PAYG model combined with the compulsory, fully-funded scheme. In addition to that, anyone may choose to join the voluntary pension funds created in 1993 (third pillar), participation in these not being mandatory. Fund members in the active labour force in 1999 accounted for 0.8 and 0.15 per cent for ages 55-59 and 60-74 compared with 55.9 and 48 per cent for ages 25-29 and 30-39. This new division may have some territorial impacts. The second pillar of the system, a complete mandatory privately-funded scheme, is extended to people who entered the labour market after 1998 (principally younger workers). The extension of the second pillar will be stronger in regions with better prospects for employment creation.

Healthcare

The reform of the healthcare system has often been considered to represent one of the main challenges of the post-transition period. At the same time, the level of public expenditures is not very high and is disproportionate to Hungary's level of economic development. While poor health indicators are largely due to social and economic factors, excessive reliance on in-patient care, intensive care, a low ratio of nurses to doctors and high use of specialist services greatly reduce efficiency. Important structural changes, however, have been introduced during the last ten years, broadly moving from a centrally-planned public healthcare system financed through general budget revenues to a mix of social insurance payments, budgetary revenues and contributions from patients (Burns and Orosz, 2000 and OECD, 1999b).

While the Hungarian healthcare system provides near universal coverage, strong disparities exist within the population. Moreover, people often resort to under-the-table payments to obtain appropriate healthcare services. Territorial inequalities are also remarkable in terms of distribution of equipment, beds and medical staff, and to a lesser extent, consumption of medical services. The health status and supply of resources has been found to correlate with the socio-economic development situation of counties. The geographic distribution of spending shows a tendency for counties with the worst health status to have the lowest level of resources and *vice versa*.

A more territorial-based policy would therefore be more appropriate. Currently, local governments – mainly counties – are responsible for important areas

of healthcare, such as day-to-day operations of healthcare institutions, ownership and operation of hospitals and outpatient clinics, maintenance of doctor's offices and equipment and contracts with family doctors working in community health. Many reasons, however, call for a more decentralised healthcare policy. First, local government should play a more proactive role in health education. Preventive policies are indeed essential as many health-risk factors are related to alcohol and tobacco addiction, the high fat and sugar content of the traditional Hungarian diet, over-work and stress. The local level is also appropriate for trying experimental forms of policy co-ordination. The introduction of volunteer services and higher levels of solidarity within the communities will allow more flexible arrangements and a more active participation of citizens' organisations. The ageing problem, in particular, calls for policy arrangements and co-ordination of housing, local transport and health policies as well as new combinations of centralised-decentralised actions and inpatient and outpatient approaches. The OECD *Economic Surveys: Hungary* (OECD, 1999b) identified a lack of trust and co-operation among healthcare actors themselves and an excessive reliance on specialist and in-hospital care. Since then, the government has attempted to increase the role of the primary healthcare system and of outpatient services and family doctors. Certain programmes may be decentralised. The introduction of new programmes at regional level targeting the elderly, the Roma minority, and young smokers and drug users are a positive move in this direction.

A more efficient use of resources could be achieved by allocating funding incentives to local government to stimulate a more efficiency-based management of equipment. The process of decentralisation has given local government significant responsibility but has sometimes produced duplication and excess capacities that cannot be maintained by available financial resources. Important deficits resulted from the incapacity of local governments to exercise effective control of their hospitals and many were either bailed out or went bankrupt. According to OECD (1999b), hospital autonomy should also be increased to develop more efficient organisational settings and forms of ownership suitable to local conditions by making hospitals public utility companies. At the same time, political interference in investment decisions should be reduced. Currently, the 100 local governments that own a hospital do not receive capital funds each year. Generally, state budget support goes only to larger investments, following application.

Lastly, it is necessary to assess whether large-scale equipment or secondary and tertiary care services could be managed more efficiently at regional level by deconcentrating some national management services. In addition, intra-organisation conflicts and organisational problems at both national and sub-regional levels require clarification of the roles that should be played by decentralised public administration and local governments. As pointed out previously, the advantages of a more responsive and efficient healthcare system can only be reaped if the county has greater decision-making power and its own financial resources.

Education and employment policies

Some major trends concerning education should be mentioned. First, there has been a slight rise in expenditure on education in real terms, but its share compared to the GDP has indeed diminished. Second, the role of the non-state sector (private and church) in education is steadily increasing at all levels, particularly in the case of adult education. And last, but not least, the number of students is decreasing due to negative demographic trends. Overall, the Hungarian labour force is considered highly skilled, at least compared to the country's general development level. However, educational levels of the unemployed are relatively low, particularly in backward regions. There is a high rate of young job seekers entering the labour market without any educational qualifications. The school-to-work transition and adult training should both be priorities. This requires modernising the education system so that it is better adapted to the new knowledge-based economy. Similarly, active market labour policies should be implemented to respond to local needs.

Main pattern and challenges of regional unemployment

Hungary struggles with several dimensions of unemployment. First, as was mentioned previously, unemployment rates display clear-cut regional disparities. Unemployment rates in North Hungary, the North Great Plain, and the South Great Plain are significantly higher than the national average. Certain social groups have particular unemployment patterns. Youth joblessness represents one feature of this pattern, long-term unemployment and unemployment among an ethnic minority (Roma) another. The youth, long-term and Roma unemployment clearly overlap on a regional level and exacerbate existing regional problems caused by agricultural and industrial restructuring and demographic developments. Moreover, Hungary experienced a sharp decline in labour force participation, which at 59.9 per cent is one of the lowest in the OECD, with lower rates only in Italy and Turkey. At territorial level, there is overall a strong correlation between low labour market participation and high unemployment. This might be due to the composition of the regional population with a high portion of unskilled workers, women, young people, and older workers, who all tend to have low participation rates.

Several problems affect the labour market in targeted regions. First, a comparison of the regions concerned reveals striking out-migration of the qualified workforce in their local labour markets. Second, two regions – North Hungary and North Great Plain – have a relatively large Roma minority. Third, while North Hungary suffers from long-term unemployment caused by the structural adjustment processes due to the predominance of heavy industry, the North and South Great Plain regions are distinctly rural. Large intra-regional disparities represent a fourth common feature of these regions.

Regional unemployment disparities are sometimes perceived as an unavoidable consequence of structural adjustment or at least as a transitory and non-cumulative effect. Still, the huge and persistent regional differences in labour market performances reflect different characteristics of local and regional labour markets and could not be tackled by a national labour market regulatory policy alone. The structural reforms that are under way concerning the regulation of the labour market and the strategy of reorienting FDI must be complemented by territorial approaches that can implement active employment policy measures targeting spatial differences.⁷ This is the case, for example, of programmes seeking to ease the transition of youth to working life. The partners for this kind of programme obviously differ in dynamic regions to those in regions lacking investment and entrepreneurial capacity.

Education and training system

The Hungarian public education administration has a long tradition of decentralisation. Greater local autonomy and responsibilities have considerably enhanced the capacity of Hungarian public education to encourage competitiveness and local initiatives and to adapt to the changing economic and societal environment. However, decentralisation may have also produced perverse effects. The great autonomy of local governments has produced a lack of co-operation between the different administrative layers, thus creating problems of unequal opportunities, quality assurance, and efficient use of resources.

The current financial system of the education sector faces a serious problem of cost-effectiveness. A great number of schools suffer from scarce resources and poor teaching staff due to relatively low wages. The sector is almost exclusively funded by central and local government budgets. Local governments receive the bulk of central financial support as normative educational grants according to statistical indicators for pupils by grade, educational programme, and school type.⁸ This form of support represents approximately one-half of all local government expenditures; other financing comes from school “maintainer” contributions, other state grants and local revenues. Teachers’ salaries are set according to central legal regulations and local budgetary decisions. Consequently, local governments tend to maintain teacher employment with low wages sometimes by splitting classes, even at the cost of efficiency and educational quality.

Decentralisation has also produced fragmentation. Since 1990, local governments are responsible for kindergarten and basic school education. They can decide to create, maintain, reorganise, or close schools. The central government has only minimal responsibility for school infrastructure. In the first years of the transition, local governments inherited a wide range of social institutions to maintain with insufficient resources. Some of them tended to reduce the number of classes, close pre-schools and schools, or in most cases, rely on county governments to maintain schools (Zám, 2000). On the other hand, local decision-makers

often have strong political interests in maintaining schools or opening new ones without reasonable budgets. Currently, more than 2 400 of the 3 100 local governments maintain an educational institution, and more than 1 800 maintain an eighth-grade general school for the 10-14 year-old cohort. More than 55 per cent of these schools operate in settlements with fewer than 2 000 people (OECD, 2000d). In certain cases, a degree of centralisation and the merger of some small schools seem necessary to use available resources more efficiently and to help ensure the modernisation of the system. However, whether schools with few pupils should be closed is a delicate question. There are still 910 settlements in Hungary with no primary school. Children in small villages in backward regions should have access to basic education as per the Public Education Act. In its PNPD, the government intends to increase its contribution to school maintenance for backward regions by 80 per cent to overcome regional disparities (GHR, 1999).

Fragmentation also affects the curriculum. The Ministry of Education is responsible for defining the basic curriculum and other standards but local governments and schools have wide latitude to determine local curricula. This does not assure quality, and, with no co-ordination of content, creates problems of equity.⁹ A joint OECD/WBI report on the role of government in delivering education systems identified several key governance problems and suggested some areas for improvement (OECD, 2000d). Proposals include the need to clarify the role of the counties and the regions, to improve regional co-ordination of infrastructure and programme content planning and to elaborate a national strategy to target the most disadvantaged groups, including those in backward regions and settlements. The underlying idea is that educational and regional development should be more closely related.

Hungary has an important network of universities and colleges well-known for its quality, but poorly integrated, even in the same city or small region. Nevertheless, higher education remains too elitist: only 23 per cent of the population between 18-22 years of age is enrolled in institutions at higher education level. Despite the introduction of tuition exemptions on a quota basis for first degree studies in centrally-financed institutions, access to higher education remains a problem for many qualified students who cannot afford to attend. However, projected enrolments are expected to grow by up to 30 per cent. A comprehensive reform of the national system to favour mobility and visibility is required to respond to demands of the labour market. The system is said to be traditionally oriented towards humanities and must adapt to the changing business environment.

Despite slight changes that made vocational education training (VET) more output-oriented, the system lacks accountability mechanisms. Thus, the VET system must be modernised to improve the employability of the unemployed. This requires political willingness and financial means. An OECD report stresses the danger of financial challenges for adult education: *"given the deep socio-economic regional disparities, plus the dramatic expansion of the private delivery of adult and continuing*

education, the dangers of creating new inequalities of access to learning are all too obvious" (OECD, 1999g). As for basic education, VET has been decentralised. Local governments run 90 per cent of vocational training schools and receive most of the funding from central government, although this has diminished in relative terms. There is also a VET Fund, made up principally of compulsory contributions by employers, which cover up to 30 per cent of the VET schools' network expenditures.

The government should improve the education levels of school graduates, of young people in general and of the Roma minority in particular. It must also adapt adult education more to local qualification requirements of the local economic structure through special vocational training programmes. This requires using resources more effectively and co-ordinating programmes with the policy and long-term conceptions of economic development. Regional planning can be one of the most effective tools for creating the professional training structure that meets the demands of the economy. Nine Regional Labour Development and Training Centres, were recently placed under the aegis of the Ministry of Education. They constitute one of the most significant policies in this field to date. By offering a wide range of programmes with nearly half of the courses devoted to commerce, administration, finance, accounting, and computer science, these bodies are more responsive to the needs of the labour market and provide training courses for the unemployed including youth and long-term unemployed and/or training courses at the request of local enterprises.¹⁰

Active labour market policies

Labour market policy belongs to the Ministry of Economy (ME), the Ministry of Social and Family Affairs (MFSA), and the Ministry of Education. The ME has been made responsible for overall employment policy, including active and passive labour market measures, social dialogue, labour market legislation and the Public Employment Service (PES). It also administers the Labour Market Fund. The MFSA has three employment-related specific competencies, namely gender issues, rehabilitation of the disabled and labour safety inspection. The Ministry of Education is responsible for vocational training and education, supervises the regional labour development and training centres and manages the so-called VET Fund. The PES is responsible for administering unemployment benefits, job matching, and selecting candidates for labour market programmes. The PES includes three bodies which operate at local level: the 20 County Labour Centres (CLCs) which implement and co-ordinate all initiatives; the National Centre for Labour Research and Methodology; and the nine Regional Labour Development and Training Centres.

Programmes are funded by the Labour Market Fund. In 1999, Hungary spent 0.4 per cent of its GDP on active labour market measures. This is less than Sweden (1.84%), Germany (1.3%) and Finland (1.22%), but more than Mexico (0.08%), the Czech Republic (0.19%) and Japan (0.09%) (OECD, 2000e). Funding was

increased however by some 20 per cent in 2000, with a growing share spent on regional development. The Labour Market Fund (which is about HUF 100 billion per year) has several sub-funds including the Solidarity Fund, Employment Fund and the Rehabilitation Fund. The Employment Fund (about HUF 30 billion) also has three main subparts: one for public works, one for training, and one for creation of workplaces (Table 17). It is almost entirely decentralised (80-90%) to all CLCs according to a list of criteria. It aims at helping counties in difficulty to catch up and contribute to target regional development objectives.

Over the past years, programmes have considered the regional dimension much more. For instance, the government has set incentives for employers hiring workers from regions with high unemployment.¹¹ The programme contributes up to HUF 500 000 to recruitment event costs. The programme also stipulates that the CLCs can reimburse travel costs to workers who have been unemployed for at least six months (or three months for school graduates and disabled people) and to employers (who are legally required to bear travel costs) for a maximum of one year as an inter-settlement travel subsidy.¹² In 1999, HUF 142.5 million were pledged to 6 700 people. The Labour Market Fund also reimburses employers who provide collective transport to employees when public transportation is not

Table 17. **Expenditure of labour market programmes in underprivileged regions**
Millions HUF

Region	Total active market expenditure			
	1996	1997	1998	1999
Northern Hungary (Borsod, Heves, Nógrád)	3 697	4 798	5 426	6 179
Northern Great Plain (Hajdú, Szabolcs, Szolnok)	3 223	4 930	5 980	6 731
Southern Great Plain (Bács, Békés, Csongrád)	2 130	2 922	3 297	3 920
Hungary	15 082	22 834	26 163	28 450
Region	Public works expenditure			
	1996	1997	1998	1999
Northern Hungary (Borsod, Heves, Nógrád)	989	2 052	2 189	2 223
Northern Great Plain (Hajdú, Szabolcs, Szolnok)	862	1 677	2 089	2 366
Southern Great Plain (Bács, Békés, Csongrád)	776	1 303	1 207	1 335
Hungary	4 224	8 287	9 140	9 296
Region	Assistance to creation of workplaces expenditure			
	1996	1997	1998	1999
Northern Hungary (Borsod, Heves, Nógrád)	202	550	575	698
Northern Great Plain (Hajdú, Szabolcs, Szolnok)	55	384	408	830
Southern Great Plain (Bács, Békés, Csongrád)	172	161	186	280
Hungary	832	1 544	1 681	2 158

Source: Data from the Ministry of Economy.

available. In 1999, 3 600 people benefited from that programme which cost the Labour Market Fund HUF 132.6 million. In addition, funds to support job creation such as those earmarked for regional development targets or tax concessions allocated to investors in high unemployment regions have been set up.

Other specific regional measures include a requirement that employers contribute up to 85-90 per cent of travel costs to increase regional labour force mobility. This is not an appropriate policy as it makes distant workers more costly to hire than local ones. The travel subsidy policy mentioned previously is a better solution. Commuting is an important spatial labour supply adjustment mechanism that can be enhanced by incentives. Hungary shows rather average migration patterns with respect to OECD mobility patterns but has one of the lowest commuting rates.¹³ Only around 2.5 per cent of the employed commute and cross regional borders to go to work. Only Spain has lower rates. Trends in the OECD show that commuting increasingly replaces migration because of the development of transportation, communication and information technologies. But as long as transportation costs remain high, and there are serious constraints on the availability and reliability of the public network, labour mobility will not increase.¹⁴

The Szechenyi Plan heavily emphasises fostering the capacity of SMEs to create jobs. However, the self-employed can be seen as a form of disguised employment. Entrepreneurship and self-employment are promoted through financial assistance programmes for business start-ups, which include the continued payment of benefits, interest-free credit and training and consulting. In addition, there are plans to offer job opportunities in newly-created SMEs to qualified unemployed people who will be entitled to self-employment starting assistance when they receive unemployment benefits, and when the CLC has not been able to offer them a suitable job. They will then receive unemployment benefits, or get their costs partly reimbursed. The newly established Micro-Credit Fund will finance entrepreneurs that do not dispose of adequate means and guarantees to be eligible for commercial bank loans. The upper limit of this micro-credit has been increased from HUF 1.5 million to HUF 3 million. Together with this programme, a small company loan scheme was launched to provide loans of HUF 7 million, supported by interest subsidies to the budget allocation for SMEs. The Hungarian Development Bank has been financing SME investment. Job creation by SMEs has also been supported by the Employment Fund, which helped start-up businesses to increase their staff level.

Until now, there has been no comprehensive evaluation of active labour market programmes. An overview of the impact of these measures would be of great interest for redesigning policies on the territorial level. The government intends to conduct impact analyses in ten different counties. It is already possible however to make some remarks based on the experience of the CLC of Borsod-Abaúj-Zemplén County in the North Hungarian region (Box 6). The most striking remark is that the great majority of unemployed people registered in the centre

Box 6. Case study of Borsod-Abaúj-Zemplén County Labour Centre

A case study in BAZ County reveals pending issues and future problems. BAZ County belongs to North Hungary, one of the three targeted regions, with the nation's highest registered unemployment rate (17.2% in May 2000). The dispersion of registered unemployment rates within the county is enormous. Some local areas (Encs, Edelény, Szikszó and Gónc) experience unemployment rates of over 30 per cent, particularly in Gónc with 42.5 per cent. The difference between the unemployment rate in Hungary and in BAZ County is increasing. In December 1991, rates were respectively 8.5 and 13.9 per cent and in December 1995 they were 10.4 and 16.6 per cent. In May 2000, the rates were 6.6 and 20.2 per cent. Since 1997, youth unemployment has been on the decline, but BAZ County accounts for the highest absolute number of unemployed people between 17 and 20 years of age (2 562 people in May 2000). Sixty per cent of registered unemployed people in May 2000 were 26-45 years old, mainly men, who were considered skilled or semi-skilled (55% of the total) with low human capital potential (56% have elementary and vocational training school degrees). Most unemployed have been registered fewer than 360 days at the CLC (64% of all registered unemployed).

BAZ County has predominantly very small firms: in December 1999, of the 12 210 corporations registered in the county, 90 per cent had fewer than 10 employees. Among the active labour market measures carried out by the CLC, training, public service employment and wage subsidies account for 80 per cent of the total decentralised Employment Fund. Though decreasing in the last three years, public service employment still accounts for 30 per cent of total funding and 44.5 per cent of the number of participants. Job-creation investment, subsidies for entrepreneurs and self-employment subsidies account only for 2.3 per cent of all participants and 6.5 per cent of all funding.

The BAZ County example suggests that the labour market adjustments will remain subject to regional disparities in the near future. Other regions have increased labour productivity and decreased unemployment thanks to a faster adaptation of their economic structure and the prevalence of FDI. Firms under domestic ownership or public enterprises enjoyed a much weaker productivity increase. The difference between job creation and continued job destruction is particularly large in targeted regions like North Hungary that lag behind the fast-growing regions.

are temporarily placed in the labour market of public institutions. The biggest portion of funds spent for unemployed people goes into public service employment (30%) and more than 40 per cent of participants are employed by local public service. There is little capacity to search for other placements, either within civil society organisations or in the private sector. As yet, there has been no success in identifying efficient sustainable job strategies. The BAZ Labour County Centre's training capacity is also a valid topic, although there is positive feedback from international companies whose staff has been trained by the CLC. However,

meeting the needs of foreign companies located there or interested in moving to BAZ County should be a future objective.

Some more general comments can be made on the overall system. First, the active employment measures consist almost exclusively of public works programmes operated by local governments, a major limitation to achieving high and stable labour force participation rates. The EU experience of leading territorial pacts for employment not limited to public authorities but involving private (profit and non-profit) organisations should provide a good reference to encourage regional and local authorities to seek more creative forms of aid for young job seekers (Box 7). Second, the CLC funding system, which depends on the magnitude of the

Box 7. Territorial pacts for employment

Echoing a proposal of the President of the European Commission in its communication "Action for Employment in Europe: A Confidential Pact", the Heads of State or Government of the member states of the European Union, at their June 1996 summit in Florence, proposed to launch "territorial and local employment pacts" in certain regions and cities. Eighty-nine proposals were selected in October 1996 by national authorities and subsequently adopted by the Commission. They have been implemented since the beginning of 1997 with the aid of EU financing for an initial three-year period.

Territorial pacts are part of the partnerships supported by the European Commission to develop new and experimental approaches to employment creation. They unite different partners at local and regional levels of the public and private sector, to develop an integrated strategy to enhance employment. They aim to create new jobs through endogenous local development. Many ideas for implementing the pact were adopted from local initiatives with workable solutions to common local problems.

In Ireland, young people with no diploma can enroll in training to obtain professional experience adapted to the needs of regional enterprises. Since 1988, 61 non-profit Youthreach Centres have been created and have trained up to 2 450 young people each year. These centres work on a partnership basis that involves professional training operators, agencies for the promotion of enterprises and other actors from the business sector. Thus, by operating in a concerted fashion, they help implement a coherent approach to youth employment that maximises local resources and effort.

Pacts currently supported by the European Commission are found in each member state. The 89 pacts cover a population of 36 million, or 10 per cent of the European population. The unemployment rates range from four to 55 per cent in these areas, and average 13.7 per cent.

Source: European Commission, 1997c.

unemployment problem, is independent of the results. Incentives should therefore be made available to stimulate more pro-active intervention plans. CLC programmes should remain in line with county and regional development strategies and in strict co-ordination with county and regional development agencies. The CLCs need strategic orientations about development objectives and their target audience for establishing training priorities. Their training capacity should be transparent and used as a regional policy instrument aimed at promoting new ventures and attracting FDI and other investment.

The Roma minority: a special case

Main policies

The Roma (gypsy) minority is the largest minority in Hungary and poses one of the greatest social challenges. All data and reports on Hungary identify this population as the most vulnerable to poverty. The majority of Roma were previously employed in heavy industry or seasonal agriculture and construction, and have lost their jobs. In several areas including education, labour market, infrastructure or health, they have experienced social and economic exclusion (Box 8). However, as Hungarian law forbids the registration of unemployed people based on ethnicity, it is difficult to build a comprehensive view of the level of integration or exclusion of the Roma population. Several authoritative institutions estimate that the Roma minority accounts for five to six per cent of the total population and represents 600 000 citizens.¹⁵ Some minority organisations speak of 700 000 to 800 000 people and some even close to one million (Doncsev, 2000). Contrary to the general trend of a declining and ageing population, the Roma population is expected to double by the year 2025.

The Roma population live in 2 000 of the 3 200 Hungarian settlements but they are spatially concentrated: 120 000 live in the three northern counties; 60 000 in the Great Plain region; 90 000 in the Budapest area; 115 000 in South Transdanubia; 100 000 in the eastern parts of the country and only 15 000 in the western regions. More than two-thirds live in villages. The high spatial concentration in the less developed areas is enhanced by very low geographical mobility.

Successive governments have taken measures to respond to the problem (Box 9). The medium-term package established in 1999 (government decision 1047/1999) constitutes the first comprehensive programme with an approach that emphasises public education, vocational training, higher education and employment in order to avoid over-focussing on social assistance. At the same time, an Inter-Ministerial Committee on Roma Affairs has been created to insure programme co-ordination and implementation among the different ministries involved. This committee is also in charge of the elaboration of a long-term strategy that would set sectoral and general priorities. This long-term strategy, which extends over a period of some 20 years, aims at serving as a framework and guaranteeing the

Box 8. Some evidence of disparities affecting Roma

Education

The highest level of education attained by Roma in Hungary are:

- grade 0: 9 per cent;
- grades 1-7: 33 per cent;
- grade 8: 46 per cent;
- vocational school: 11 per cent;
- general secondary: 2 per cent;
- tertiary: 0 per cent.*

Labour market

In 1993, 54.8 per cent of non-Roma people were employed compared to 28.7 per cent of Roma. In 1993, the unemployment rate stood at 9 per cent for non-Roma compared to 28.8 per cent for Roma.

The proportion of the long-term unemployed among young Roma school leavers is more than 40 per cent higher than for young non-Roma starting a career. Young Roma just out of vocational training school are more than twice as likely to be unemployed for longer periods. Inactivity among Roma stands at 42.5 per cent against 36.2 per cent for non-Roma.

Housing and health

Roughly 14 per cent of Roma live in isolated, colony-like surroundings, with poor facilities and basic infrastructures. In rural areas, they are frequently isolated on the outskirts of a town or a village while in urban areas they are relegated to particularly overcrowded districts with poor or non-existent public services. Roma people have a higher incidence of chronic illnesses, higher infant mortality, and a life span 10 years shorter than the average, yet they have higher fertility rates.

* These figures are taken from Ringold (2000): Annex Table 8, p. 53. The original source is Puporka and Zadori (1999).

Source: Adapted from Doncsev, 2000 and OECD data.

continuation of the short-term and mid-term measures.¹⁶ Financing of the medium-term package comes from individual ministerial budgets. The budget for 2000 is HUF 4.86 billion, the bulk of it being provided by the Ministry of Education and the Ministry of Social and Family Affairs (Table 18). Since 1999, PHARE has supported a joint programme of the Ministry of Social Affairs and the Ministry of Education designed to promote the socially disadvantaged young Roma and other disadvantaged youth. In 2000, two more programmes received PHARE support:

Box 9. Governmental measures targeted at Roma population

Government decisions since 1995

- 1120/1995: Creation of the Co-ordination Council for Roma Affairs.
- 1121/1995: Establishment of the Public Foundation for Roma.
- 1125/1995: Measures for reducing social inequality of the Roma.
- 1093/1997: Medium-term package of measures for improving living conditions of the Roma, with the participation of National Roma self-government.
- 1107/1997: Measures intended to improve the situation of the Roma minority.
- 1047/1999: Medium-term package of measures to improve the living standards and social position of the Roma.
- 1048/1999: Inter-Ministerial Committee on Roma Affairs.

The 1999 medium-term package of measures and its objectives

Education: To develop the content of primary level education; to reduce drop-out rates of young Roma school leavers; to promote graduation opportunities; to increase the participation of Roma children in pre-school instruction; to use quality assurance of the education system, promoting non-segregating Roma minority educational programmes; scholarships for young Roma students.

Culture: To preserve cultural values; to reinforce the role of the National Roma Information and Cultural Centre; to support the formation of multi-functional Roma minority Community Houses; to support the publication of Roma newspapers.

Employment: Central employment training programmes for unemployed Roma; to support young people starting a career; to reinforce public works programmes.

Agrarian programmes: To expand the social land programme for Roma; to foster the number of Roma families that become household small producers and animal breeders.

Regional development: To ensure that County Development Councils and County Labour Centres launch programmes for enhancing the employability of Roma; to enhance measures supporting the creation of new jobs and improved living conditions.

Social, healthcare, and housing programmes: To replace colonies or colony-like housing environments; measures to diffuse health protection culture and knowledge among Roma; experimental housing programme targeted at Roma population.

Programmes against discrimination: To support publication of legislation outlawing discriminatory policies; carry out surveys on educational material diffusing anti-discrimination legislation; conduct research focusing on minorities and statements issued by Roma organisations.

another programme from the Ministry of Social Affairs and the Roma Social Integration Programme run by the Office of National and Ethnic Minorities.

Table 18. **State support for minorities**
Million HUF

	1997	1999
National self-governments for minorities	303.0	506.0
<i>of which: Roma</i>	96.0	138.0
Local self-governments for minorities	300.0	730.0
Minority civil organisations	70.0	87.8
Public Foundation for National and Ethnic Minorities in Hungary	395.0	530.0
Public Foundation for Hungarian Gypsies	170.0	280.0
Minority co-ordination and intervention budget	50.0	44.0
Ministry of Education, for minority tasks	275.0	250.0
Gandhi Foundation	325.0	210.0
Minority theatres	62.0	74.0
Ministry of National Cultural Heritage, support for minority cultural tasks	–	100.0

Source: Official Hungarian Gazette.

Some private initiatives deserve a mention. Foreign enterprises have sometimes adopted codes of conduct governing their overseas operations, such as favouring partners that do not discriminate in their hiring practices. An OSCE report identified US firm Levi-Strauss and Co., as one such enterprise that has adopted an affirmative action policy for recruiting Roma in Kiskunhalás. The terms of engagement used to identify local contractors stipulate that the business partners should follow business practices consistent with company policies (OSCE, 2000).

Other specific governmental action should include efforts to make the public aware of the living conditions of Roma. As a recent governmental report on Roma population puts it, “the great majority of society is not aware of the problems that Roma face and is not interested in improving their situation”. In line with legislation targeted to protect and support the national and ethnic minorities living in Hungary, there are signs that a more favourable trend is emerging in political decisions. Political willingness will not suffice, however, if a large part of the population remains resentful of this ethnic minority. Despite legal protection and constitutional guarantee of equal treatment, systematic discrimination practices exist, particularly in education and the labour market.¹⁷ Besides political and financial support to any Roma institutions or organisations aimed at improving their living conditions and integration, other initiatives associating Roma and non-Roma citizens should be encouraged. The impact of the 1999 medium-term package of measures will be fundamental, and requires persistence and financial commitment.

Minority self-governments

One way to increase the participation of Roma in the process of social integration is to improve their role in public affairs. The 1993 Act of Hungarian Parliament on the Rights of National and Ethnic Minorities, which gives minorities the

right to form ethnic self-government bodies, was a decisive political step. The minority self-government is a new legal entity, which operates in partnerships with the appropriate public authorities. In June 2000, 753 Roma self-government bodies were established, and formed county level associations.¹⁸ By now, an estimated 3 000 Roma have a role in public affairs at local level. The overwhelming majority of local minority self-governments have been established through direct elections (Kovats, 1998). Roma can voice their views on draft regulations concerning themselves, including county and municipal self-government decrees, through their national instance, the Roma self-government. The national self-governments also have their own regional offices in 19 counties.

The Minorities Law that aims at improving the control of minorities over cultural matters and education issues regulates the activities of minority self-governments. They are entitled to take charge of cultural activities, request information from official bodies, have the right to establish and run educational institutions and enterprises, can offer opinions and in some strict cases have the right to veto certain decisions of the local authority. A recent report on the assessment of self-minority governments says, *"self-government promotes Roma integration, resulting in better communication between Roma and non-Roma inhabitants of the same settlement, and the establishment of co-operation and the speeding up of Roma embourgeoisement as well"* (Doncsev, 2000). Impressive accomplishments have been made in some settlements since a minority self-government was established, improving educational prospects through innovative programmes, and sometimes working with non-Roma population, thereby fostering mutual understanding and respect.

Financial supports stem from several sources (Table 18). National self-governments receive central funding through the Ministry of Justice, while the subsidy to the local governments appears in the Ministry of Interior's budget. In 2000, national self-governments received HUF 546 million while HUF 803 million were allocated to local self-governments (against respectively HUF 306 million and HUF 300 million in 1997). These contributions go to all minority self-governments, including the Roma. For instance, as far as national self-government supports are concerned, only HUF 148.9 million out of the HUF 546 million go to the Roma national minority self-government although the Roma population represents around 60 per cent of the total minority population. Supplementary state contributions within the framework of normative financing are provided for those settlements that maintain institutions conducting minority instruction and education programmes.¹⁹ Public foundations also provide other financial contributions.²⁰

Although minority self-governments have had greater state support these last years, it is not sufficient to cover expenses and handle programmes. The funds received by the central government go through the channel of local governments but constitute a separate line. At the same time, it is possible for the local governments to provide additional financial support depending on their resources. In this context, co-operation between the two is essential. Many

discriminatory local government practices against Roma self-governments have been reported, such as giving more money to non-Roma minority self-governments. There is no legal mechanism to resolve conflicts with local governments. The minority law does not mandate that local governments provide support from their budgets to local minority self-governments. The financial guarantees of these institutions are also undermined by the absence of a mechanism ensuring equal opportunities countrywide. The location of the self-governments seems to play an important role as urban settlements receive many more grants than villages (from tens of millions of HUF in some Budapest districts to no support in small rural settlements). This is particularly problematic since most Roma self-governments are located in poor settlements that already face financial difficulties. Moreover, unlike non-Roma self-governments, Roma self-governments cannot rely on extra support from a mother country.

Minority-self governments also have insufficiently broad and unclearly defined competence and authority. In fact, self-governments do not have the authority to govern in conventional terms. They have much legislative power but difficulty implementing it. Indeed, they lack the power to compel local authorities to take account of their views, even when they are legally obliged to do so. A reconsideration of the Law on Minorities is thus necessary to give minority self-governments greater authority in determining policies of local governments. In addition, the law's emphasis on cultural and educational development does not address the fundamental problems of poverty, unemployment, and exclusion. A proposition to amend the minority act is being considered.²¹ The government also envisages an amendment to ensure minority representation in parliament.

Conclusion and recommendations

Hungary has successfully undergone an economic transition, leading to higher average household income, private consumption and quality of life. As a result of a long tradition of education policies, the education level of the population is high relative to other transition economies and the OECD average. This is important as FDI, the main vehicle of economic growth, is switching from low-skilled to a highly-skilled labour force as the emergence of the knowledge economy will call for a highly-trained labour force. This good performance will not be sufficient however to conceal other negative social indicators, increasing social disparities and spatial concentration of social ills. There are several fields where efforts and improvement should be concentrated.

Poverty is a primary concern. As unemployment is the main cause of poverty in Hungary, and as the education level of the unemployed is low, active labour market policies are essential. The high disparities among regional unemployment rates and the structural reform of the labour market underway at national level call for complementary territorial-based measures integrating spatial differences. To a certain extent, the regional dimension seems to have been

taken into account by ALMP programmes. Further steps need, however, to be taken to improve the system.

The high vulnerability of the Roma population deserves particular attention. Estimates suggest that raising Roma employment rates to the level of the rest of the Hungarian population would increase annual GDP growth by 0.2 per cent on average during the next 50 years. Similarly, increasing their employability will relieve social expenditures as most of their income now comes from social benefits. Successive governments have already taken specific measures to enhance integration of the Roma minority, among other things by creating minority self-government. However, considering the breadth of the problem, it is crucial to improve their status.

The definition of individual roles and partnerships among actors involved in providing social services is being given greater attention. In recent years, Hungary has undergone a phase of major change in the role and resources of public action particularly in the case of social policies where, starting from a tradition of centralisation, several actors, at different levels of government, are formally engaged in providing policies and delivering support. In order to take appropriate measures to ensure financial viability, cost-effectiveness, horizontal and vertical co-operation, an appropriate monitoring process should be established to ensure an ongoing process of evaluation, and to learn how to define standards and roles in an interactive way involving both central and local authorities.

More specific recommendations include the following:

- Pockets of social ills in certain regions call for a more territorial-based strategy. Regional crisis programmes held in regions that are badly affected by acute problems of economic restructuring, deficiencies in social infrastructures and a high unemployment rate, have produced quite mixed results in terms of unemployment and poverty alleviation. Social observatories could be implemented at regional or county level to improve knowledge, assessment and monitoring of the local situation.
- Poverty alleviation is a main concern. It is crucial that the most vulnerable strata of the population have access to minimum social benefits. More precisely, existing family and child-care benefits in crisis regions with cumulative problems should be extended.
- Improving public health and changing a negative demographic trend call for further engagement in the reforms of the healthcare system. A more needs-based allocation of financial resources between territories should be targeted. It is important to increase the responsibilities of local governments in health education, allocate funding incentives to stimulate a more-efficiency-based management of equipment and improve the transparency of investment procedures. The tasks of the different administrative layers in the healthcare system should be clarified,

and the potential role of the regions should be assessed in order to avoid duplication and excess capacity.

- Regions with below-average social indicators are most often those that suffer from poor basic services and infrastructures. Here, it is crucial to reinforce the financial intervention capacity of local government in settlements that suffer from fundamental shortages of basic services, while new sheltered accommodation institutions in the most needy settlements should be constructed. The experience of the village administration network in rural areas should be supported along with the existing social land programme.
- Recent measures in education policy, including quality assessment control, expanding secondary education and modernisation of the content of the VET have been taken and efforts should be pursued in this direction. Excessive decentralisation in education towards largely autonomous local governments has produced fragmented physical infrastructure and curricula. According to the 1993 Education Act amended in 1999, a “framework curricula” shall be introduced as of September 2001. The government should introduce a monitoring and incentive system to control and increase primary and secondary education at the local level. Financial viability must be promoted and education and transport policies co-ordinated in remote areas without schools. Financial supports to school maintenance in backward regions should also be increased.
- To improve employment policies, it is necessary to engage in a comprehensive evaluation of active labour market programmes and to assess whether the new sharing of responsibilities among ministries produces co-ordination problems, administrative burdens and inefficiency. Active labour market policies should be adapted to the specific needs of the local unemployed population and those of the local economy. CLC activities should be co-ordinated with the new regional development agencies. The CLCs must also enhance their capacity to insert job seekers in the private sector. Finally, to improve the flexibility and the mobility of the labour force, transport and labour market policies should be co-ordinated at the local level.
- To enhance the integration of Roma, public authorities have to ensure that the medium-term package of governmental measures find appropriate funding and are effectively implemented. Further steps should be taken against all forms of discrimination, while genuine equality of opportunity for the Roma in education and the labour market should be ensured. Consultative mechanisms should be created to ensure their participation in major policy initiatives and meaningful participation at all levels of governance. It is crucial to encourage the representation of minorities in parliament as well as the creation of a Roma political party.

It would also be interesting to assess the degree to which minority self-governments can contribute to improving social conditions of the minorities. These bodies can only be efficient if guarantee mechanisms are established to ensure their financial capacities. The Government should support the amendment to the Law on Minority Self-government to improve the implementation of their legal power.

NOTES

1. According to a "Time Balance Survey" held between September 1999 and 2000, the Hungarian adult population spent between 10 to 13 hours per day sleeping, taking meals or partaking in other activities. Disparities, however, emerge among the type of settlements. People living in villages spend more time on earning activities while transport takes considerable time for those living in cities and towns. Reading and sports are essentially urban leisure. The share of time spent watching TV represents 56-59 per cent of free time. See HCSO, 2000a.
2. Deaths per 100 000.
3. Behind Lithuania, Belarus, Russia, Latvia, Kazakhstan and Estonia.
4. In 1997, 14 people per 100 000 of total population were killed in road accidents. Of the OECD countries, six countries registered worse performances and five others similar ones. See OECD (1999d).
5. The early retirement policy in Hungary is one piece of the complex puzzle that helps explain the loss of 1 million people from the labour market between 1990 and 1996. The decline of as many as 1.5 million employed combined with the increase in unemployment to about 500 000 means that about 1 million people seemed to be out of the labour market altogether. The "discouraged worker effect" that seems to determine this huge drop in labour market participation can be explained by the easy early retirement scheme implemented in the first years of transition, other kinds of income support and the old-age pension system. Before the 1996 amendment of the pension system, the mandatory retirement age was 55 for women and 60 for men. The IMF estimates an increase in working age pensioners of about 0.3 million in the period 1990-1996. The Hungarian Government is trying to reverse this policy, being more selective, and progressively eliminate the possibility of leaving the labour market early, abolishing some early retirement programmes financed by the Labour Market Fund. Besides these facilities, the low statutory retirement age has been gradually increasing since 1996. According to the Pension Law of 1996, men by 2001 and women by 2009 will have a statutory retirement age of 62 years. Nonetheless, the OECD estimates that about 800 000 working-age individuals will still be out of the labour force with a very low probability of returning. See OECD (1999b).
6. Hungary was among the first countries in Central and Eastern Europe to follow a multi-pillar pension system. The first pillar is a social security system based on a traditional pay-as-you-go model that evolved significantly during the transition, mainly by smoothly increasing the statutory retirement age and introducing a combined wage-price indexation. It may be called the public pillar. The second pillar is a fully funded, defined, contribution private pension fund scheme, called the mandatory private, funded by and extensive to people entering the labour market after June 1998, and based on non-profit mutual trust funds providing pension insurance to members in the

form of a life annuity and then based on employment. This modality involves approximately 2.1 million members. Finally, the third pillar is supplemented by voluntary mutual pension funds in which some 1.3 million citizens participate, indicating a growth of approximately 10 times the number of fund members existing in 1995. For a comprehensive description of the reform, see OECD (1999b and 2000c).

7. The main aspects of this reform are: authorisation for works councils to negotiate certain plant-level wage bargaining conditions; tendency for raising the minimum wage albeit with strong opposition from business representatives; reducing the maximum duration of unemployment insurance benefits from 12 to 9 months; some progress in reducing early retirement incentives; reducing employers' social security contributions by 7 per cent; some experimental programmes targeted at introducing more flexible work forms; an as yet unassessed set of active employment measures and the share of political responsibilities for employment policies among the Ministry of Economy, Ministry of Social and Family Affairs and Ministry of Education. For a complete assessment of this reform, see OECD, 2000c.
8. Central normative grants vary yearly, depending on fiscal conditions. Since 1996, the state grants cannot be less than 80 per cent of the real local educational expenditures of two years earlier. Local governments spend approximately 30 per cent of their annual budget on education, far more than they receive in state grants.
9. A new model of quality assurance adjusted to the conditions of local and institutional autonomy is developing, but many problems need to be resolved before the system can function effectively. Under the Act on Public Education, the different administrative levels have different assessment responsibilities. Assessment is hindered, however, by fragmented responsibilities and by a lack of proper tools and capabilities. No institutions exist to conduct regional surveys.
10. The Regional Labour Development and Training Centres are now under the aegis of the Ministry of Education.
11. Decree 39/1998 (III. 4.)
12. Decree 78/1993 (V. 12.)
13. As migration patterns indicate, Hungary is situated well within the OECD average. 1.47 per cent of the Hungarian population moved in 1995, which is more than in Belgium (1.27%), Germany (1.24%), Spain (0.6%), and the Czech Republic (0.55%). As for age groups, internal migration for 15 to 24 year-olds accounts almost for the same amount as in Canada, but exceeds that of France and the Czech Republic, for instance. For people 25 years old and older, migration is the same as in France and slightly lower than in the UK. See OECD (2000e).
14. Other Active Labour Market Policies (ALMP), which do not specifically target disadvantaged regions, can also contribute to regional development. For instance, measures which provide wage subsidies (between 50 and 100%) for the long-term unemployed, and especially for young people without a job since leaving school as well as disabled people, can foster labour force flexibility and mobility.
15. Demographic Institute of the Central Statistical Office.
16. The work is underway in the Office of National and Ethnic Minorities with the professional support of the Council of Europe.
17. The Parliamentary Commissioner for national and ethnic minorities disposes of the rights of ombudsman for all minorities living in Hungary and examines complaints related to alleged injustices perpetrated against the Roma. In the education system, Roma students suffer discrimination from segregation and inappropriate teaching

methods. The Labour Code contains sections forbidding discrimination in working conditions. A new regulation was established in 1997 to stop discrimination in employment by imposing heavy sanctions on employers found to discriminate against an employee. However, an action can be initiated only by legal disputes between parties concerning an already established job. In addition, the lack of legal regulations means that Roma has no public administrative directive at its disposal to take action against the publication of employment notices which violate the Constitution. There are no legal administrative sanctions against such actions.

18. There are 1 369 minority self-governments. Their geographical distribution at the county level is: Budapest districts (23), Bács-Kiskun (25), Baranya (63), Békés (19), Borsod-Abaúj-Zemplén (122), Csongrád (7), Fejér (16), Győr-Moson-Sopron (14), Hajdú-Bihar (34), Heves (55), Jász-Nagykun-Szolnok (33), Komárom-Esztergom (8), Nógrád (40), Pest (45), Somogy (54), Szabolcs-Szatmár-Bereg (87), Tolna (27), Vas (13), Veszprém (21) and Zala (32).
19. The budget law for 1999 provided a total of HUF4.6 billion for pre-school instruction, school education and support for the residential halls of pupils and students belonging to the national and ethnic minorities.
20. The following public foundations are important institutions of the budgetary minority financial support system: the Public Foundation for National and Ethnic Minorities in Hungary, the Public Foundation for Roma in Hungary, and the Ghandi Public Foundation.
21. The main point under consideration in the Act on the Rights of National and Ethnic Minorities are: *i*) incorporating the provisions concerning minority self-governments that have been so far included in the Act on Local Governments; *ii*) introducing a system of partial registration (a declaration on minority identity will be required from those who become candidates in the elections); *iii*) instituting minority self-governments at a regional (county) level; and *iv*) ensuring financial guarantees and conditions for taking over and running cultural and educational institutions with a view to implementing cultural autonomy.

Chapter 5

Institutional Reform, Regional Policy and Fiscal Decentralisation

Hungarian territorial governance has undergone tremendous reforms in the last ten years. The centralised structures of the socialist period gave way to a system of power and resource sharing between national and subnational governments. Local governments, consisting of counties and municipalities, have a number of responsibilities and resources to shape and promote their own development. However, institutional evolution has become somewhat uneven and rather complex after transition began in 1990. The local government reforms of 1990 provided Hungary with a large number of small and scattered municipalities with limited taxing power. Since the counties, as the historic intermediate level, lost most of their prerogatives to the municipalities, the local level soon became overburdened by its new responsibilities and had to resort to central government support. The result has been large vertical dependency.

With the Act on Regional Development and Physical Planning of 1996 and its amendment in 1999, the Hungarian government introduced a system of regional development whose most distinctive feature was the creation of a new regional level. The new macro-regions are supposed to implement regional policy and assume or co-ordinate responsibilities that lie beyond the scope of the local level. The European Union had a strong impact on shaping the new level since it considers an adequate territorial structure imperative for implementing its various pre-accession and structural funds. The new regional actor is generally viewed as a central government partner for regional policy implementation; some consider it a core for a full government level between central and municipal levels. However, since the regional development institutions run parallel to the existing framework, the new system has created some confusion. The distribution of responsibilities between new regional development bodies and existing government institutions is unclear, and disputes on project implementation are quite common. Institution building is a core issue for decentralising the Hungarian State. Streamlining the organisational and administrative structure, reducing the multitude of actors and strengthening the remaining institutions are key issues for reform. Furthermore, a healthy balance between EU requirements and national policy priorities has to be found to tune regional policy strategies appropriately.

Akin to the institutional reforms, fiscal decentralisation has been much improved but it is still an unfinished agenda. Local governments have responsibilities above those of other OECD countries, however these are hardly matched with the respective taxing powers. Hungary is one of the least decentralised OECD countries fiscally speaking, and compared even with other Central European countries in transition, its fiscal gap is very large. This gap is largely compensated by means of an elaborated system of grants and transfers. This system is nevertheless oversized and gives local governments little incentive to improve the efficacy and quality of public services. Local governments have limited tax-raising capacity, which creates problems of financial accountability and discipline and a certain culture of local dependency. The fiscal system today mitigates rather than strengthens coherence between national and local decision-making. With respect to fiscal federal reforms, there needs to be a better balance between national and subnational public finance. This requires that local tax imposition authority and intergovernmental financial relations be strengthened, with a clear set of objectives and mechanisms to put them through.

The framework of Hungarian territorial governance

Legal background

The legal framework of decentralisation in Hungary went through fundamental modifications at the beginning of the 1990s. The Act on Local Government was one of the first laws approved by the newly-elected parliament in 1990. It provided the legal basis for the shift of responsibilities and resources from the central state and the counties to the new municipalities and their elected councils. The Act on Local Taxes provided the financial framework for the municipalities. Both laws basically resulted from the European Charter on Local Governments whose signing and ratification were regarded as an important part of the accession process to the Council of Europe.

From the financial point of view, the Act on Local Governments and the Act on Local Taxes provided Hungary with a two-level government: the central state and the municipalities. The counties, that had performed some functions on behalf of the central government during the communist period were almost completely deprived of their own financial resources and today have no tax prerogatives. In 1990, what resulted was a strong national government and a dissected local government system comprising 3 200 independent municipalities, more than 50 per cent of which have less than 1 000 inhabitants.

Responsibilities

The Act on Local Governments defines a number of compulsory municipal missions. Since the constitution determines that local governments cannot be

obligated to perform missions without being given the necessary funds, Parliament must provide the financial terms necessary for the provision of these duties. Municipalities are otherwise free to undertake missions that are not prohibited by law. Beyond compulsory duties, local governments themselves decide which duties they shall perform, to what extent, and how.

Local governments may fully merge with other local representative bodies, or they may create associations of local governments. The Act on Municipal Associations provides incentives for inter-municipal co-operation; however, municipalities cannot be forced to co-operate or to merge. Local governments are free to contract out public utilities. This led to the privatisation of local public authorities and the contracting-out of several services such as water supply, sewage, drainage, wastewater treatment, and waste disposal. Hungary has managed to quickly enforce the EU regulations on public procurement acts. The framework set up should enable Hungarian local authorities to abide by European rules of competition. Non-public agencies thus tend to play an increasing role in education, social provision, and healthcare.

Local governments are divided into municipalities and counties. Both have the right to local self-government. The Act on Local Governments lists the task of the municipalities and the counties. Municipalities may then take over additional tasks from the county level and, if they lack resources, hand them back again. County functions are primarily funded by the central government and by some fees.

Resources

The Act on Local Governments entitles local authorities to their own resources and assets. Consonant with the aims of democratic transition, the rules of private property were applied to local governments. The Act on Local Governments determines their different income sources. Local governments have the right to determine the base and rates of local taxes in accordance with the framework established by the Act on Local Taxes. These include:

- *Local taxes.* The most important local tax is the business tax, a turnover tax on local business units that accounts for approximately 80 per cent of local tax revenue. Hungary is the only former socialist country to have introduced such a tax so far. Another local tax is a property tax based on the size of plots or buildings, and on the value of the property in some cases. There are some minor taxes like the tourist tax. The Act on Local Taxes usually defines the ceiling but not the floor of local taxes. This means that local authorities have the right but not the obligation to introduce certain taxes. This provides a framework for competition among local authorities. In fact, only half of the 3 200 municipalities have introduced a business tax, and only one-third have introduced a property tax. Local governments are free to establish fees for local utilities.

- *Shared taxes.* The most important shared tax is the personal income tax (PIT). Introduced in 1990, it was at that time entirely handed over to the local level. In 1991, the share going to the local level was reduced to 50 per cent, in 1993 to 30 per cent, and in 1999, increased to 40 per cent. However, the cessation level (the percentage of tax revenue remaining in its place of origin) is only 15 per cent, the remaining 25 per cent are redistributed between the municipalities on the basis of several horizontally equalising formulae akin to the grant system. The Budget Act defines the revenue split of the PIT, which can be adapted annually by a simple parliamentary majority.
- *Intergovernmental grants.* Intergovernmental grants fall into three well-defined groups:
 1. Non-earmarked normative contributions given to local governments. There are around 20 single normative grants, most of which are paid on a per capita basis. The formulae on the basis of which the grants are distributed are revised periodically, and the total amount of contributions is subject to the annual parliamentary budget debate. Technically, all grants are subsumed and then paid to the municipality as one single amount. This group accounts for approximately 80 per cent of intergovernmental transfers.
 2. Specific state grants that are also distributed through normative methods, but are restricted to a specific use. The main investment priorities are set every year by the Government which include the development of the sewage system, waste disposal, healthcare (hospitals) and education (schools). It accounts for approximately 10 per cent of intergovernmental transfers.
 3. State grants that are distributed by Parliament individually, for conditional use in large-scale infrastructure projects. This group also includes some grants that the county development councils can decide upon (the Targeted Decentralised Assistance). It accounts for approximately 10 per cent of intergovernmental transfers.
- *Borrowing.* The Act on Local Governments gives local governments the freedom to borrow from financial intermediaries and local capital markets. However, as a consequence of local bankruptcies in the aftermath of transition, restrictions on local borrowing were introduced in 1995. The law maximises the upper credit limit to 70 per cent of the local authorities' own revenues. Furthermore, like the German model, local authorities are bound to abide by the golden rule of public finances, which stipulates that borrowing should finance capital expenditures. This rule however is not always strictly followed.

The evolution of local public finance

Local governments' activities are primarily influenced by the amount of centrally and locally collected revenue and the proportional distribution of total government receipts between central and municipal budgets. In Hungary, the municipal budget receives 13 to 17 per cent of GDP, a relatively high proportion by international standards. The recent financial history of Hungarian municipalities can be broken into two periods.

- *Deficits from 1991 to 1996.* After the system changed in 1990, local public finances came under severe budget constraint. Like many transition economies, Hungarian GDP fell by 20 per cent in the years between 1990 and 1993. Over 1990-1998, general government expenditures declined by 31 per cent. Locally generated revenue, local taxes, privatisation programmes and the transfer of assets to local governments did not counterbalance the reduction in general government transfers. Furthermore, local government revenues did not keep pace with inflation. In 1994, there was a significant 8.8 per cent real decrease in revenues. Local expenditures did not keep up with inflation, but increased more rapidly than revenues. The worsening financial conditions resulted in negative savings for municipalities (Table 19).
- *Surpluses from 1996 to 1999.* In the second period, local governments managed to keep balanced budgets. The Act on Local Bankruptcies that was passed in 1995 and its adoption, limiting borrowing to finance capital expenditures, helped strengthen local budget constraints. In addition, local governments reduced their expenditures, increased their own revenues (mainly from the sales of assets), privatised and contracted out services. Most local governments used their privatisation revenues to finance local investments and to reduce their debts.

The macroeconomic constraints of the early 1990s postponed the renewal of local assets and led to the deterioration of several public services. Today, municipal investments are still well below replacement rates, which may threaten local development in the future.

Table 19. Change in municipal revenue and expenditure, 1992-96
Percentage change (deflated GDP)

Revenue/Expenditure	1992	1993	1994	1995	1996
Total revenue	-1.3	-2.5	-8.8	-4.9	-16.7
Current revenue	-5.8	-9.7	-7.4	-0.6	-17.2
Total expenditure	-1.1	-1.6	-0.7	-4.9	-16.7
Current expenditure	-4.0	-0.7	-2.2	-4.6	-16.3

Source: Ministry of the Interior, "Municipal Budget 1992-96".

Regional policy framework

With the Act on Local Governments in 1990, the central government started to reshape the whole system of territorial governance. Local municipalities became independent from central and county authorities. County authorities lost significant responsibilities and fiscal powers. Given that regional policies were ancillary and designed to serve centrally planned strategies during the communist period, changes were also introduced in order to accelerate regional development notably through infrastructure provision and crisis management in the heavy industry-based economies of the Northeast. In the beginning of the 1990s, the design of regional policy remained the privilege of the central level, and the new policy context continued to be weak at regional level and be relatively strongly biased towards sectoral approaches.

Recent policy trends

These contradictions and the lack of co-ordinating institutions within the executive and the legislative branches delayed the establishment of a coherent territorial policy approach and engendered some turbulence, which may have weakened the momentum. A Ministry of the Environment and Regional Policy was created in 1990 and given responsibility for the territorial development portfolio. In 1991, a Regional Development Allocation was introduced (called Regional Development Fund [RDF] from 1992 to 1996). In 1993, the Parliament specified in a resolution the principles of the regional development support system and the government published a list of areas that would be eligible for regional assistance. The 1996 Act XXI on Regional Development and Physical Planning, which established a new institutional system of territorial development in Hungary, was followed by a series of decrees on the use and the distribution of the regional development allocation for territorial equalisation among counties.¹ During the past years, some other development allocations were created in addition to the regional development allocation to enlarge the financial means of the new institutions including the Spatial Equalisation Support (1996), the Targeted Decentralised Assistance (1998) and the Rural Development Allocation (2000). After governmental elections in 1998, the regional development portfolio was attached to the MARD.

Uncertainties also resulted in defining the strategic aims and principles governing the policy initiatives at subnational level. For example, the 1996 Act was an attempt not only to establish the institutional infrastructure of territorial policy but also to refine its key objectives. As mentioned in the Act, all regions and counties were assigned priorities that include promoting a social market economy, creating appropriate conditions for self-sustained growth, and stimulating the spatial diffusion of innovation while encouraging balanced regional development. Reducing disparities between Budapest and the peripheral areas and between advanced regions and less developed ones were more relevant central government

goals. The act also strengthened the focus on disadvantaged regions by adjusting selection criteria and aligning them with the EU zoning methodology. The drafting of the National Regional Development Concept within the framework of Parliamentary Resolution 35/1998 (III.20), furthered the process by defining targets and guidelines with a special view to ensuring compatibility with EU structural funds policy during accession. The wide-ranging nature of the concept and the multiplicity of tasks leave many issues unaddressed, particularly the role assigned to regional competitiveness policy and how to surmount efficiency/equity conflicts.

New regional policy institutions

With the 1996 Act, which defines responsibilities across administrative levels, Hungary is probably one of the most advanced transition countries. This Act provides the country with more stable institutional foundations and territorial policy is now developed and implemented at four levels:

- At the top, a National Regional Development Council (NRDC) is responsible for developing regional policy. The council is composed of one person from each of the regional development councils, the mayor of Budapest, chairmen of the national chambers of commerce, the employer and employee's representative before the Interest Reconciliation Council, ministers from several ministries, one representative from the National Self-Government Federations and the chairman of the National Committee of Technical Development.² The council comments on principles of regional policies, regional development grants, and the classification of regions eligible for development assistance. It also co-ordinates sectoral aid for regional development. It has a 12-member secretariat called the National Regional Development Centre which supports its work.
- Below this are seven Regional Development Councils (RDCs), which include the chairmen of the County Development Councils (the third level), representatives of national ministries,³ one representative per county of the associations of municipalities, mayors of towns of county rank, the Chairman of the competent Regional Tourism Committee (in the case of Central Hungary, there are five additional members of the Council). The RDC's main tasks include the formulation and adoption of the regional development concept and programme, the co-ordination of territorial economic development, the preparation of financial plans and the decision regarding the implementation of the programmes. Initially not all RDCs had permanent staff or secretariats to assist them. After the 1999 amendment of Act XXI, the executive bodies of RDCs – the Regional Development Agencies (RDAs) – were strengthened. They were created as public service companies with permanent staff to help the councils in their work. RDA staffing ranges from five to sixteen. Although limited, their staff levels are slowly increasing.

- The county level includes the president of the general assembly of the county, the mayors of any towns of county status, the ministerial representatives of MARD, the head of the county's agricultural office, the chair of the local regional tourism committee, and three representatives from associations of municipalities. The County Development Councils (CDC) are in many ways analogous to a regional planning and information organisation, responsible for analysing the social and economic situation in the county and co-ordinating development plans at county level, and making decisions regarding the use and distribution of development funds.
- A fourth level in the hierarchy is that of micro-regions, and takes the form of groups of self-governing communities that plan and implement their co-ordinated development ideas.

While this new territorial organisation tries to accommodate the need of the different territorial levels and to fill the vacuum between the county and the central levels, certain weaknesses are obvious. First, the share of responsibilities remains unclear, thus leaving room for parallel functions and conflicts. Second, the 1999 amendment discontinued the participation of the chambers of commerce at regional level, making relationships and partnerships with the private sector more difficult. Third, CDCs and RDCs depend primarily on state resources for their budgets.

Decentralisation and regional policy in Hungary: an uneven evolution

Weaknesses of the new regional policy institutions

Regional policy analysts are pinpointing many regional policy problems, which some link to the new territorial organisation where others point to recurrent deficiencies in government machinery. First, the budgets of regional policy institutions are limited. MARD, the main actor on the side of the central government, has to match resources with objectives. Direct funding from this ministry comes from the Regional Development Allocation and the Rural Development Allocation, which have limited budgets (HUF 11 and 3.5 billion respectively in 2000), the latter not being decentralised to lower levels. Other sources include the Spatial Equalisation Support (HUF 11 billion in 2000) and the Targeted Decentralised Assistance (HUF 7 billions in 2000), numerous budget allocations of ministries earmarked for development purposes, grants to local governments as well as international assistance such as the PHARE programme (around HUF 24 billion per year) and EU specific support instruments including ISPA (around HUF 20-25 billion per year) and SAPARD (around HUF 10 billion per year).⁴ The pre-adhesion process discussed above gives the central government some room to manoeuvre but also necessitates co-financing investments and other types of spending to comply with the *acquis communautaires*.

Second, co-ordination among ministries involved in regional policy is a matter of concern. Until 1999, several ministries controlled 13 funds that financed different kinds of spatial and social assistance at subnational level (Table 20). Their budget capacity was often significantly higher than that of the MARD. For example, the road fund, the labour market fund, the central environmental fund, and the economic development fund, accounted for more than 50 per cent of central government development funding (HUF 275 billion in 1999). These separate state funds were recently abolished and the money has been transferred to a special chapter on ministries within the national budget. For instance, the road fund was passed to the Road Maintenance and Development Allocation, which is still administered by MTWM. Sectoral concerns, which did not necessarily coincide with regional development preoccupations, are the major factor in allocating these funds.

Multiple forms of assistance are available for regional development and are adding to the complexity of policy interventions. In addition to the 13 funds, there are addressed and earmarked supports (HUF 48 billion in 1999) as well as spatial equalisation support and targeted decentralised assistance (HUF 16 billion in 1999).⁵ While these supports provide assistance to local budgets, they bear indirectly on regional development. Their main objective is to improve communal infrastructure. County Development Councils are responsible for distributing

Table 20. **Separate state funds and sectoral budgetary allocations, 1999**

Base, provisions	Billion HUF
Roads	80.66
Water management	5.59
Labour-market, active employment policies	31.35
National cultural	7.77
Central environmental	29.15
Economy development	15.88
Tourism	6.08
Market intervention	1.11
Technical development	9.29
Regional development	5.79
Other regional development tasks ¹	8.07
Telecommunications development	5.38
Public works	2.00
Labour-market structure development	1.10
National Research Fund	2.65
Sub-total	211.87
Local government addressed and earmarked supports	48.00
Targeted oriented decentralised assistance (CEDA)	6.00
Spatial equalisation support (TEKI)	10.00
Total	275.87

1. PHARE CBC, Rural Development Institutional System.

Source: Official Hungarian Gazette, 1998.

these two grants (CEDA and TEKI – see Note 5) that aim at reducing regional differences among local municipalities in disadvantaged micro-regions and among counties. Financial assistance to regional development targets is therefore effected through numerous channels.

The amount of support can also vary according to complex parameters. For support to regional investment, assistance is provided according to a sophisticated matrix of eligibility by aid type and area. At the beginning of 2000, grants were allocated on a weighted basis to the counties that received a grant based on county population (20%), GDP per capita (30%), and the population of micro-regions within the county eligible for assistance (50%). However, proposals currently under discussion suggest that the weightings used in distributing funds and their distribution change. In order to give some decision-making power to RDCs, the Regional Development Allocation would be shared among national, regional and county development authorities, 35 per cent would go to Regional Development Councils, 30 per cent to county development councils, and the remainder to the central government regional development budget. Under this scheme, RDCs would gain authority.

Institutional weaknesses of the decentralised levels

Governance weaknesses are also perceived at the lower levels. Within county and national government administrations, there is a widespread feeling that there are too many local governments, whose powers are not sufficiently differentiated. Many people involved in higher levels of government appear to feel that local governments are economically inefficient and a barrier to administrative innovation. One of the reasons for creating the seven new macro-regions is to incite lower levels of government to co-operate, but another apparent reason is to side-step the existing political-administrative structure such as the counties by creating new institutions. In the short term, control over regional assistance funding such as the Regional Development Allocation is to be devolved to the seven macro-regions.

However, the Hungarian governance structure and the plans to introduce new fully-fledged political layers could cause more problems rather than solve the current ones. First, although the creation of new government layers could overcome some problems of fragmentation and intergovernmental co-operation, it may create new ones. A new layer of administration will add to the costs of administration and government. New layers of administration and government will not always be responsive to the electorate. If the new regions take on a legislative role and are served by elected councils, new electoral and administrative structures will have to be created, which will further increase the cost of government. Finally, if the new regions are to implement regional policies and programmes, this may create a top-down bias in the regional development process.

Second, staffing in macro-regions is appointed, not elected, making the new districts creatures of the central government. There is also some confusion about the long-term nature of the NUTS 2 level regions. In the longer term, some people have suggested that an elected council could supplement the current administrative staff. In the Széchenyi Plan, for example, it is recognized that “the planning statistical regions are administrative-political units which still lack internal economic coherence and regional identity. Consequently, the main aim of regional economic development is to promote the internal economic coherence of the regions in the course of implementing the programmes set out in the Plan”. On the other hand, the PNDP suggests that the role of the NUTS regions will be mainly as follows: Regional Development Councils will select projects for funding within their regions, and Regional Development Agencies, as RDC executive bodies, will oversee implementation and play a technical and administrative role. In the future, they may act as oversight and co-ordinating agencies similar to metropolitan or regional planning agencies.

Third, if the regions were introduced as political entities (this is not imminent given that a two-thirds majority in the national parliament is needed), there would be four political levels, which would be high by OECD standards.⁶ Furthermore, the new Hungarian macro-regions generally comprise only two or three county local governments, which means that the distance between the upper and lower government levels remains rather low. There are some indications that the creation of new government institutions in Hungary is sometimes used to side-step local government or to circumvent tensions within and between existing institutions.

Fourth, the present Hungarian territorial governance system is not a typical hierarchy where any lower level government is politically or administratively subordinated to the next level. At the sub-national level, all governments, whether county, town, or village, are local and have the same legal status and the same status with respect to the central government. This means that while counties embrace a larger physical area, their legal status is the same as the villages and towns within them. This lack of hierarchy has led to administrative confusion, in part because many villages and towns are jealous of their prerogatives and reluctant to co-operate with other governments, and in part because missing economies of scale makes it difficult for some local governments to provide certain kinds of services. The result has been a complicated bargaining process in which local governments have ceded some responsibilities, such as hospital management, and retained control over others, such as schools.

Fifth, the power of the counties sharply declined in the 1990s. With the 1990 Act on Local Government, the responsibilities and competencies of the counties were reduced in favour of the municipalities. Despite a history of more than 1 000 years, counties today have a rather weak institutional and bargaining position. Although they have elected bodies, their power is restricted since their funding is mainly secured by negotiations between the central and municipal levels.

Taken together, the different steps in the process of decentralisation do not yet provide Hungary with a strong intermediate level, despite the creation of many institutions in the last ten years. It is still unclear whether these institutions would be in a position to co-ordinate hitherto fragmented municipal decision-making and to assume significant national territorial development policies. Neither the counties nor the newly-created macro-regions currently can take over this function since they have no essential political or financial prerogatives to do so. The introduction of macro-regions or County Development Councils has increased the problems of delimiting responsibilities and resources without strengthening sub-central decision-making power. In fact, the large number of government institutions, aimed at overcoming some shortcomings of the decentralisation process, may even have prevented more appropriate forms of public service delivery such as horizontal or public-private partnerships. Meanwhile, it is not easy for efficient and functional decentralisation to gain a foothold.

Counties and/or regions?

The public administration reform and the new spatial development policy of Hungary led to the weakening of county authority and the rise of regions. The county has also lost significant power to the local administration system. This loss is not as obvious as that given up to the municipalities. But these distinctions blur the issue of the appropriate mediating role between the central and the municipal levels. The question rather is how the relationship between the county and regional level is evolving, and which intermediate level is appropriate in the medium and long run.

The present state of development planning in Hungary is characterised by a comparatively strong role of local government, by an as yet unclear role of the new regions, and by a rather traditional and partly contradictory handling of responsibilities at the national level. As was described earlier, new regions were created in Hungary during the second half of the 1990s. First, the government introduced the statistical designation of the seven macro-regions and encouraged the establishment of voluntary Regional Development Councils (RDC). As counties were free to choose their partners to unite into regions, the statistical regional system and the development regional system did not match. Furthermore, many counties belong to more than one region. Several RDCs were established, although most of them have not been operational for a long time, due mainly to lack of firm commitment to the creation of a regional level and strong resistance from the counties.

The European Union has been very influential in regionalising Hungary, both via technical and financial assistance; it strongly promoted or even triggered the creation of the regional level. The PHARE programme significantly contributed to the regionalisation process. Several pilot projects have been implemented in the less developed regions, which not only carried out individual development projects

but also contributed to the administration capacity of the regional organisations, most of all the Regional Development Councils and their agencies. In June 2000, the Hungarian regions jointly established a representation office in Brussels. However, as the accession gains momentum, the Commission has expressed its doubts about the administrative capacity of sub-national levels (countries, regions) and seems to favour a more centralised implementation system.

The introduction of the regional level has not clarified power-sharing in the Hungarian territorial governance and regional development system. One of the crucial issues of Hungary's current regional development approach concerns the still unclear future roles of the current counties, on the one hand, and the newly created regions on the other, as well as the role of the central state. While there is probably no reason to question the opportunity of maintaining and strengthening local government at county level, whether the size of the country justifies splitting up development planning and programming into a county and a regional level is questionable. Aspects of efficiency and the European Union requirement to dispose of operational development programmes at the NUTS 2 level might lead to the conclusion that a single level should be responsible for preparing and implementing development plans and programmes.

At local level, the practical ability to prepare and decide upon feasible development programmes based on priorities determined in corresponding regional development plans depends to a large extent on the existing financial system. The fact that counties and regions do not dispose of sufficient financial resources to take their own decisions independently of complementary funding decisions at the national level seriously handicaps any effective decentralisation.

From a more sectoral policy point of view, advantages or disadvantages of the region over the county cannot be clearly discerned. Regional decision-making can be justified on the grounds of large economies of scale or the need to internalise territorial spillovers between lower levels of government. Actually, although there are a number of public services such as higher education, healthcare, local public transport, or spatial planning for which an intermediate level would be appropriate, neither level offers clear-cut advantages over the other. One exception might be the implementation of environmental policy or the management of environmentally sensitive goods for which a regional level would be more appropriate. However, functional environmental regions such as water catchment areas or nature protection zones often do not correspond to the boundaries of political regions, again creating spillovers requiring subnational horizontal co-ordination.

In sum, the introduction of regions seems to be a reaction to the current weakness of the county level rather than a response to a specific need for a new political level. Although most policies can probably be performed or implemented at county level as well, the geopolitical context and the need to ensure EU policy compatibility should obviously be taken into account. It is important however that the introduction of the regions does not lead to confusion on the

delimitation of power between the two proximate levels. If both are to be maintained, the dual system of counties and regions needs to be clearly assigned tasks and policy responsibilities⁷. Given that the counties are politically well rooted, it is probably useful to strengthen their institutions and maintain their present responsibilities mainly for secondary education and healthcare whereas the regions would be basically responsible for implementing regional policy and the use of the European Structural Funds.

Size of governments and intermunicipal co-operation

With approximately 3 200 independent municipalities, the Hungarian municipal system is utterly fragmented, comparable to the French, Greek, Swiss or Austrian systems. The municipalities have an average population of 3 100 people and are smaller than in most OECD countries (Box 10). Hungarian local governments have to perform more functions than in most countries with similarly small municipalities. Duties and fragmentation prevent local governments from reaching a critical size that could enhance their tax raising capacities and would allow them to make use of economies of scale. In many cases, the counties or even the central government must assume tasks that larger or amalgamated municipalities could perform easily. In a certain sense therefore, over-centralisation can be the result of over-fragmentation.

Enlarging the size of municipalities through mergers would allow them to perform their duties more efficiently. However, it is considered politically impossible in Hungary to reduce significantly the number of independent local governments. Furthermore, the amalgamation of municipalities would not necessarily reduce the problems of economies of scale or inter-municipal spillovers since the cost of many public services does not depend on the size of a political entity but on physical and territorial features such as population density or settlement structure. The alternative to amalgamation is the promotion of voluntary associations, a path that is often closer to economic rationality and political feasibility (Box 11). This kind of integration is usually pursued on the basis of appropriate economies of scale for a given function and can be referred to as functional integration. Since the optimal size is different for different public functions, a set or pattern of overlapping municipal associations results, which may be referred to as functional regions.

The Hungarian legal framework has provided some incentives for the creation of voluntary associations. The 1990 Act on Local Government already encouraged the establishment of inter-communal partnerships (associations of municipalities). The Act on Municipal Associations passed in 1997 has laid down in detail the various types of associations that the local municipalities may form. According to the Government Decree on Addressed and Earmarked Supports, municipalities are entitled in the case of joint investments to a 10 per cent mark-up on intergovernmental grants. Furthermore, regional policy encourages municipal associations: the County Development Councils receive decentralised funds to finance development

Box 10. The advantages of a decentralised municipal pattern

Hungary has many local governments. In the words of one government spokesman, there are too many governments, too much competition among governments, too many mayors fighting for their own town, and too much dispersal of scarce resources among too many claimants.

However, several OECD Member countries have a pattern of local government like that in Hungary, which is considered normal. Many theorists argue that small-scale local governments constitute a democratic ideal. In the United Kingdom, Switzerland, and the United States, an ideal form of local democracy is one in which the entire adult population of a town can participate in decision-making in a town meeting. In Switzerland, there are around 3 000 independent municipalities with a population slightly lower than seven million. Town meetings are common in all municipalities with fewer than 10 000 inhabitants. In the United States, at the start of the 1990s, there were approximately 85 000 local governments, including 3 000 counties, 36 000 towns and municipalities, 14 500 school districts, and 31 500 special districts, or one district for slightly more than 3 000 people. (This number had fallen from about 155 000 in 1942, due to the consolidation of school districts, which fell from over 100 000.) As in Hungary, the main role of most of these districts is the operation of primary and (in the US) secondary and vocational schools. Other services include rubbish collection, street cleaning, street lighting, provision and maintenance of public services including public transportation in some cases, as well as the provision of police and fire services. Most revenues come from local taxes, particularly the property tax, but the state and federal government also provide money to local governments on a per capita basis. Some of this money is paid in the form of block grants, which can be used for general, often community development, and some is allocated on the basis of measures of social exclusion or economic disadvantage (USDCEs, 1997).

It is often argued that large numbers of local governments are inefficient in terms of cost (see for example Prud'homme, 1994). Their number increases the costs of administration, and makes economies of scale impossible. However, within Hungary, local government is still in a transitional stage, and taxation, subsidy, and local tasks are still evolving. Moreover, greater local voice, self-determination, and satisfaction may compensate for higher costs. Small local governments can also be more efficient if there is intergovernmental competition. Competition can drive down prices and lead to more productivity and better services. For competition to work, however, governments need to be made more responsible for raising their revenue and for managing their spending. Currently, the system of subsidies makes governments dependent on central government without strongly encouraging a search for efficiency or quality of services. Greater self-reliance also brings government closer to the people. For some groups, such as the Roma, this may be an excellent way to promote a local voice on local policies.

programmes in micro-regional areas. These incentives are limited compared to those the French authorities provide to intermunicipal associations (Box 12).

Box 11. Government as corporate enterprise

The Széchenyi Plan suggests that the region should act as a corporate enterprise, fostering the creation of economic networks and local economic co-operation (ME, 2000). In the United States, local government is viewed as an enterprise, and the citizens as shareholders. Taxes are, in effect, fees for services provided by local governments. State governments and local governments compete with each other to attract and retain new residents and businesses. This competition is taken for granted, and is said to be a prime determinant in the location process. Prospective residents (or businesses) look for a "market basket" of services with a given quality at a given price, and select a location on that basis (Tiebout, 1956 and Oates, 1993).

One unanticipated outcome of competition is that no single government dominates policy-making, and minorities and the majority have their say. Instead, competition and overlapping competencies have created what some call a system of functionally overlapping and competing jurisdictions characterised by shared tasks, shared jurisdictions (for example, several local authorities joining together to form a school district or a water treatment plant), shared fund-raising and taxation powers. Furthermore, a local authority may be grouped with one set of local governments to form a school district, but with another set to form a water treatment district. The authority pattern is based on bargaining and the optimal size of the respective public service. Although the federal or national government is above state governments legally, and state governments are above local governments, in practice, state and local government operate alongside national government. A feature of this system is that substantial areas of governmental operations involve national, state and local units and officials simultaneously.

Those areas in which governments, regardless of their level, have complete freedom of action or single-jurisdiction independence and full discretion are relatively few. No one jurisdiction dominates, and the power and influence available to any one jurisdiction or official is limited, producing a pattern in which bargaining is the rule. Instead, power is limited and dispersed, and there is a high level of interdependence, fostering simultaneous competition and co-operation.

Horizontal co-operation of municipalities through voluntary associations could gain more popularity in Hungary. There are about 200 municipal associations in micro-regions with regional development aims and another several hundred partnerships in the country for various objectives (*e.g.*, implementation of communal investment projects, joint municipal administration or management of schools). However, the counties do not co-operate at all in horizontal associations. There are several reasons for this still relatively low association rate. First, the municipalities reacted with a strong desire for independence after forced co-operation during the socialist period. Furthermore, it is still difficult for them to realise the advantages,

Box 12. Intermunicipal co-operation in France

French territorial administration is enormously fragmented. Its 36 000 municipalities clearly sets it apart from the rest of the EU. Intermunicipal collaboration began early as a result. Since 1890, 680 “public establishments for intermunicipal co-operation” have come about, covering 30 million inhabitants, about one-half of the French population. Forced amalgamation of municipalities was unsuccessfully attempted during the 1960s and 1970s. The current judicial framework comprises the 1992 Law on Territorial Administration and the 1999 Law on Intermunicipal Co-operation.

The 1992 law was aimed at promoting municipal associations in urban and rural areas basically through tax sharing. These intermunicipal associations received their own tax revenues derived from a single business tax. They were entrusted with five compulsory missions (economic development, transport, territorial development, housing, urban policies) and three of five optional ones (roads, wastewater treatment, garbage, sports and cultural infrastructure). Each association was provided with a share of the *Dotation Générale de Fonctionnement* (DGF), a task-financing block grant for operating expenditures. The rural associations were granted FF 120 per annum and inhabitant, the urban associations FF 470. However, since the shares of the DGF replaced grants that were previously allocated to individual municipalities, the results proved limited. Only five urban associations and 82 rural associations came about.

The 1999 law proved much more successful in promoting intermunicipal co-operation. It was enacted primarily to strengthen the horizontal equalisation between municipalities while reducing tax competition on the business tax. The three main provisions are to:

- create a new tier of government: the association of urban areas, with its single business tax;
- create tax sharing: associations between municipalities are henceforth entitled to share the business tax and other local taxes (property taxes, housing taxes);
- give fiscal incentives through the DGF: the “*communautés d’agglomération*” will receive a share of the DGF (FF 250 per year and per inhabitant instead of the previous FF 120) whereas the share granted to rural associations will increase from FF 120 to FF 175.

As a result of the law, seven additional urban associations have been created in 2001. As of 1 January 2000, 51 *communautés d’agglomérations* had been created by 763 municipalities. Since the law was passed, 120 rural associations have been formed.

benefits and gains of an equal partnership and co-operation with others despite the advantages and benefits of this co-operation. Second, the fiscal “federal” system only gives small incentives to local governments to collaborate horizontally; *e.g.*, the counties, being primarily financed through government grants (apart from fees), cannot save their own money by producing joint public services.

In general, the overwhelming part of central government subsidies – mainly the large bulk of normative grants – spent at local level includes hardly any incentives to form associations. Most national financing is allocated on an individual settlement basis, and joint applications have only recently been encouraged. Moreover, rather than providing money to local authorities on a pass-through basis, central government might consider devolving the collection of revenue to local governments, including some parts of VAT, road tax, and income tax. Currently, centralised collection of taxes and distribution of funds constitute a kind of subsidy to local government, in which the costs of collection and distribution are paid for by the national government.

There are also political obstacles to inter-municipal partnerships in Hungary. First, a mayor depends much more on the local assembly than the prime minister/government does on parliament, so partnerships become cumbersome. Achieving consensus in two bodies, the assembly (several assemblies in case of more than two municipalities) and the partnership is a time-consuming process. As a result, the bulk of the partnerships are project specific and *ad hoc* or temporary, which, need not be a shortcoming. Second, urban-rural contacts are rather restricted. During the socialist era village-town relationships were forced to be highly subordinated, so local village authorities often refused to co-operate with towns. Villages usually establish micro-regional development associations with no participation from bigger towns. This serious lack of urban-rural partnership further hinders efficient planning and development at the local, micro-regional level. Third, a negative point of inter-communal partnerships is the lack of public-private co-operation. Local governments form most of the partnerships, and only a few involve private enterprises or NGOs.

Conflicts between political counties and county development councils

With the emergence of regional policy and the apparent need for coherent regional policy measures, the central state created an institutional system apart from the existing territorial governance framework. Within this framework, County Development Councils (CDC) have been created in parallel to the already established political counties. Since both county organs cover and are responsible for the same area, conflicts on policy implementation may emerge.

The counties lost a wide range of tasks to the municipal level after the introduction of the 1990 Act on Local Government. The Act on Local Government only defines obligatory and voluntary tasks for county governments. Obligatory tasks cover the entire or large territory of the county or districts (mainly micro-regions) such as highly specialised social institutes, county libraries, large natural reserve areas, co-ordination of services (from sector to sector) carried out by local governments,⁸ co-ordination and discovery of tourist resources in the county, and all tasks above basic services⁹ that local governments decline.

Secondary and higher education institutions and hospitals are typical examples of county responsibility.¹⁰

The County Development Councils (CDC) evolved with the need to co-ordinate local development policies, to prepare countywide programmes and to implement development programmes. CDCs are delegate organisations whose membership counts a maximum of nine people. Today, CDCs not only provide a forum for discussing development plans and co-ordination of local development strategies or implementation of PHARE programmes, but have also obtained some fiscal power as state aid financing is further decentralised. Three state funds have a total budget of nearly HUF23 billion allocated in 2000 to all CDCs.¹¹ The bulk of the three funds (62%) cover productive infrastructure investments. Around one-third of the resources aim at business related infrastructure (industrial parks, incubation houses) and job-creating, maintaining investments. However, the implementation level was shifted during the last series of PHARE programmes from county to region. As the regional level gains attention, the CDC share in the decentralised parts of the Regional Development Allocation will be reduced in relative terms. The other two funds (SES, DTA – see Note 11) will remain at county level.

There is a twofold source of conflict between the political counties and the CDCs. First, both organisations often have to deal with similar public services such as physical infrastructure. Whether a water treatment plant is a traditional local government infrastructure endeavour or a development project is difficult to say, so the two county organisations disagree on who will be in charge. Second, the CDCs, which are constituted by appointed delegates, are empowered with fiscal and decision-making powers at the cost of a democratically-elected legislative body. The major development tasks (infrastructure and business) of the county are managed by the CDCs. Although the County Assembly “shall form an opinion about the long-term regional development concept of the county before the County Development Council makes its decision, and after the decision is made it shall approve the development objectives which concern local governments”, the main decision-making power lies in the hand of the CDC.¹² Concerning the project selection and money allocation the County Assembly can only express its interest via its president who has one single vote.

In sum, the parallel system of political and regional development bodies at the county level seems to increase rather than reduce the complexity of regional development policy. The closeness of “traditional” infrastructure projects implemented by political counties to the “development projects” to be implemented by the CDCs leads to territorial conflicts. Backlogs may be the consequence. The reduction of local representation in the CDCs has compromised the idea of local partnership and decentralisation. The mechanisms of power-sharing introduced at county level are not the same as those at the national level, the National Development Council being a pure consultative body to the government.

Fiscal federalism and territorial development: an advanced, but unfinished agenda

The fiscal gap

Hungarian fiscal federalism is characterised by a significant fiscal gap that clearly sets the country apart from other OECD countries. Hungarian local finances reveal a sharp discrepancy between the level of local expenditure – above the OECD average – and the level of local resources one of the lowest among OECD countries (Table 21). With only six per cent of total tax income accruing to the local level in 1995 (10% in 1999), Hungary is one of the least decentralised OECD countries fiscally, even compared to other countries in transition (OECD, 1999c). Whereas Hungarian local governments have a large degree of expenditure powers, their fiscal flexibility is comparatively small.

The sharp contrast between revenue and expenditure power is partly explained by the fact that Hungarian local governments carry a degree of responsibility beyond that of most European countries mainly for social services like education, health and social welfare that were extensively decentralised in Hungary in the 1990s; in most countries, these services make up the lions' share of the public budget (Council of Europe, 1997c). While the constitution protects local governments from the obligation to perform any function without being given the necessary funds, the new tasks entrusted to them since 1990 have not been matched with adequate financial means. In the last years, the ratio of local revenues to central government grants has increased only slightly (Figure 12).

Own local revenue as a per cent of total local revenue has increased in the last years. However, the central government still provided around 56 per cent of the local budget in 1999. Furthermore, since the local share of the Personal

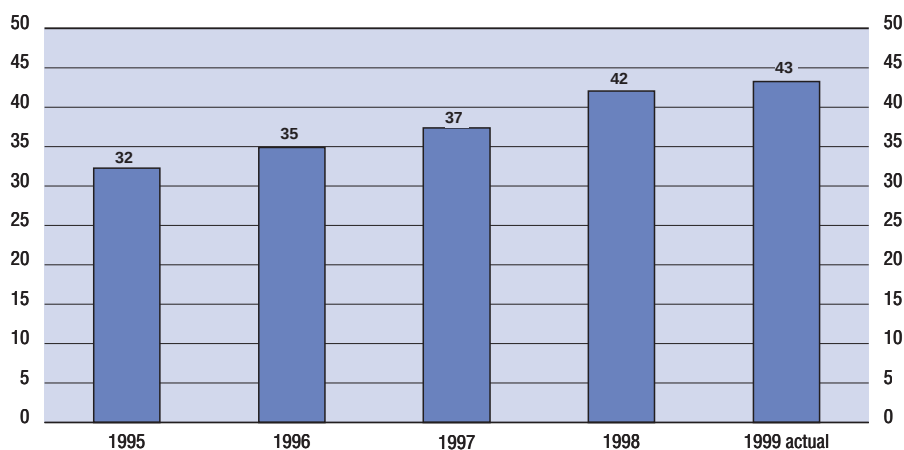
Table 21. **Subnational revenue and expenditure ratios, 1996**

Country type	Local revenues as percentage of total revenue	Local expenditures as percentage of central public expenditures
Overseas federations	72.0	98.3
German type federations	42.0	56.5
Unitary states	11.1	26.6
Nordic countries	44.6	59.3
Central European countries	17.8	23.9
Hungary	12.2	41.3

Note: Overseas federations: Australia, Canada, and USA. German type federation: Germany, Austria. Unitary states: Belgium, France, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, and United Kingdom. Nordic countries: Denmark, Finland, Norway, and Sweden. Central European countries: Bulgaria, Croatia, Czech Republic, Estonia, Latvia, Lithuania, Poland, and Romania.

Source: OECD, IMF, Hungarian Ministry of Finance (Balance Sheet of Central and Local Governments).

Figure 12. **Local governments' own revenue**
As percentage of total revenue



Note: Own revenue: fees, local taxes, share of personal income tax.

Source: Hungarian Ministry of Finance (2000): "Balance sheets of local governments".

Income Tax is strongly influenced by the central government and partly used for equalisation purposes between municipalities, "real" own local revenue in 1999 amounted to less than 40 per cent of total local revenue (OECD, 1999c). The gap between responsibilities and resources is therefore barely closing. Fiscal decentralisation has not kept pace with the strong decentralisation endeavour of the Act on Local Government.

Intergovernmental transfers

The fiscal gap is increasingly filled with central government transfers. Since the introduction of the Act on Local Governments and the Act on Local Taxes, central government largely provided municipalities and counties with adequate financial means. Through a sophisticated set of normative and discretionary, earmarked and unconditional grants, national government supports current and capital expenditures of local governments. The latter are largely dependent on financial resources that are almost entirely outside their influence. Although most grants are governed by a set of normative rules and not subject to direct central government discretion, the transfer system is marked by a number of weaknesses that have a straightforward impact on local and regional development (Barati and Szalai, 1999).

First, its comparatively large size reduces accountability since decision-making on local expenditure and on local funding are separated, although local governments have to add own resources to a central grant. Local taxes make up

only a small part of total local revenue, and local fiscal decisions have only a modest impact on total local revenues. This reduces local governments' interest in making local development efforts such as attracting new firms, promoting a favourable local business environment or adapting public services to local needs. Finally, due to their exogenous character, intergovernmental grants reduce the influence of the population on local finances, which reduces local commitment. The grants system in the long run could create a certain culture of local dependency and undermine local fiscal discipline.

Second, the central government is highly arbitrary in its transfer system for conditional and unconditional grants. Although most grants are paid on the basis of normative criteria and may not be differentiated on a discretionary basis, the indicators themselves are subject to annual negotiation laid down in the Budget Act. Parliament may periodically add or withdraw some grants, change the amount of a normative grant and add or withdraw certain criteria – such as the size of municipalities – that determine their calculation. This decreases predictability, makes medium and long-term financial planning difficult, and promotes rent-seeking between the local and the national level. Municipalities or groups of municipalities are inclined to deal out individually beneficial normative grants at the expense of other groups and finally at the expense of all government levels.

Third, the grant system almost totally lacks any incentives to improve local public services. Most grants are paid on a per capita or cost basis instead of outcome or quality of the subsidised service. For example, grants for primary and secondary education are based on the number of students in classrooms, but do not appear to measure the number going on to higher education, or the quality of education as measured by performance on national tests. Neither local accountability measures nor national monitoring instruments are well developed (OECD, 2000d). Hospital treatment is financed under the principle of homogenous patient groups. Since most grants are not earmarked, local authorities have no obligation to use them for the respective public service. Central government authorities like the Ministry of Finance or the Ministry of the Interior do not verify the accurate use of transfers. Quality standards are set in the sectoral laws, but since the grants are not linked to quality achievement, they cannot contribute to their actual objective, namely securing countrywide development standards.

In general, the transfer system lacks a clear set of objectives and mechanisms to put it through. It is not clear whether the grants aim at reducing territorial disparities, at guaranteeing minimal standards, or at internalising territorial spill-overs between subnational units. Most grants are paid to support certain local public services, but since they are not linked to the quality standards set in sectoral laws and local governments are free to use them for whatever purpose they wish, central government has no control over standards achieved or internalisation efforts made. Since the transfer system, with few exceptions, does not take into

account differences in fiscal capacity in cost or in need, it probably makes only a small contribution to eliminating territorial disparities.¹³

Local tax-raising capacities

The high percentage of central government grants in local budgets is reflected in the low percentage of its own tax revenue. Only the PIT and the business tax provide significant local tax revenues, whereas property taxation, which constitutes an important part of local revenues in other countries, is insignificant in Hungary. The PIT is a shared tax under the unilateral control of parliament. Local governments cannot set their own tax rates on top of central rates (tax mark up or piggy backing). The structure of the Hungarian tax system is atypical compared to other OECD countries as it relies heavily on the local business tax. As will be shown, the present tax structure poses problems for the development of local governments.

Business tax. Its advantage is in being linked to the “beneficiaries pay” principle – the turnover of a firm being related to municipal public services. As the tax is not determined by central government, municipalities may use it as a tool for attracting or keeping local businesses, thereby competing among each other on the grounds of an efficient tax-benefit ratio of public services. The business tax may therefore give incentives for local economic development. The current business tax has a number of salient disadvantages, however. First, the tax base will be eroded in the long run. In general, local governments should avoid taxing mobile factors because tax competition may destroy the tax base.¹⁴ Hungarian local governments are already facing this downward spiral as tax competition puts the level of the average tax rate far below the maximum set up by the central government. Even today, around one-third of the Hungarian municipalities – mostly small ones – levy no business tax at all.

Furthermore, the business tax shows an exceptionally strong territorial concentration. According to the Hungarian Ministry of Finance, around 30 per cent of the countrywide business tax income is provided by four districts of Budapest alone. The business tax even more than other taxes reflects the uneven distribution of wealth in Hungary, which means that at present Budapest and its surrounding area reap the overwhelming part of business tax income. The business tax includes no horizontal redistribution. At present, there are strong political demands to harmonise business tax income, by introducing an element of equalisation. However the municipality of Budapest strongly opposes them.

Property tax. A local property tax has great advantages over the business tax, mainly because it is based on a non-mobile factor and because it is strongly linked to municipal public services. However, the current Hungarian property tax can hardly embrace these advantages. The tax is based mainly on physical indicators such as land surface or number of stories of a building whereas property value is hardly used to calculate the tax. The resulting property tax income is insignificant

and hardly comparable to other OECD countries (IMF, 1997). Despite several attempts at national level, there has been no reform resulting in a value-based (*ad valorem*) property tax. One reason is probably that it needs a complicated and repeated valuation process that is difficult even in countries with a property tax tradition and stable property prices, let alone in transition countries. Low tax-raising capacities also result from a non-existent reliable cadaster system. However, postponing property tax reform means depriving Hungarian municipalities of a major future tax source.

Access to the capital market for local governments

The unpredictability of the Hungarian grants system induces the private sector and the institutional investors to shy away from lending to local governments. Local capital markets are not sufficiently developed, except in the Budapest area. Up to now, local authorities in Hungary were not keen on borrowing from financial private institutions and preferred to finance investment through assets sales. These adverse incentives mean that local governments' investments have contracted from an average of three per cent to below two per cent of GDP at present. However, there is a great likelihood that the capacities of local governments to finance investment through revenues from assets will vanish in the years ahead,

Box 13. Local property taxation in Eastern European countries

Current local property tax yields in Hungary are low compared to other OECD countries. Local property taxes are an example of optimal taxation since the tax base is inelastic. Property taxes are difficult to evade, the tax base cannot move to another location, and there is a close link between the value of the real property and the infrastructure and services provided by the subnational government. So far, only Estonia, the Czech Republic and Poland have had satisfactory results by taxing real property. In Estonia, a market-value-based taxation of land has been introduced. It raises 1.5 per cent of total tax revenues; market value-based taxation of buildings is currently being prepared. After having completed a number of pilot studies in selected regions, including a district of Prague, the Czech Republic introduced a new value-based property tax in 1998. In Poland, pilot studies in the region of Krakow have shown that a well-developed property tax may contribute up to 25 per cent to local government revenues.

Therefore, the implementation of a value-based property tax system could be a much stronger source of local revenue in Hungary. Comparison with other OECD countries suggests that a target yield of about 0.8 per cent of GDP might be attainable. At such levels, property tax could raise up to seven per cent of local governments budgets. Making local property tax deductible from the national income taxation could alleviate the overall tax burden.

given the fact that the rate of local investment necessary to absorb EU Structural Funds is due to increase.

So far, only Budapest has had genuine access to capital markets and disintermediate finance. Municipal demand for medium-and long-term finance has been limited with borrowings concentrated mainly in a few large cities. Apart from Eurobond issues by the city of Budapest (DM 150 million 1998-2003), there has been no international bond issue by Hungarian municipalities or municipal companies. In Budapest, local officials seek the advice of American, German or Austrian investment banks, which play an important part in bond issues. Like in Nordic countries, the National Savings Bank is specialised in municipal debt. However, its share is declining, especially in Budapest.

Other local governments are too small to issue bonds and borrow on capital markets and are therefore bound to seek credit from commercial banks, public financial institutions like the National Savings Bank or the EBRD. Since 1994, the exclusive market dominance of the National Savings Bank (OTP Bank Rt.) declined slightly (from 100 to 92%). The immediate aftermath of the political changes in 1990-1991 was followed by a noticeable number of local bankruptcies mainly brought about by distorted over-investment where the central government had to step in as a last-resort lender. Thus a law was enacted in 1995 preventing local authorities from borrowing more than 70 per cent of their annual revenues (World Bank, 1999c).

The five-year maturity of loans contracted by local governments is a serious impediment given that long-dated debt-instruments are required for infrastructure finances. Some observers argue that the development of local capital markets is hampered by the EBRD. Experts view EBRD financing of local investment projects as possibly crowding out private borrowing.

Fiscal equalisation

Increased disparities between different parts of the country affect local finance since local tax revenue is straightforwardly linked to local economic performance. Disparities in fiscal capacity (tax raising capacity) have increased which in turn led to different levels of provision with public services.

So far the only element of equalisation is the local share of the PIT basically redistributed on a per capita basis. With respect to the distributional effect, a higher local share from PIT favours rich communities, while a higher proportion of central government grants favour the poorer ones. The drop in the cessation rate of the PIT in Hungary has prevented further aggravation of disparities in regional development. However, Hungarian tax sharing is an insular and not very sophisticated equalisation system because it takes into account the cessation rate of the PIT and the business tax potential only. Finally, since the PIT is the crucial equalisation measure, it may lead to financial re-centralisation:

it puts strong pressure on the cessation level for local governments, decreasing their share of and their power over the PIT, thereby reducing local financial responsibility.

Furthermore, there is no system to balance different *needs* or *costs* for the provision of local public services. The Hungarian transfer system rests mainly on a per unit cost basis, which is an average, and therefore the same across municipalities. Thus, these per unit grants do not take into consideration differences in net costs between jurisdictions. The only differentiation measure is some higher per capita grants for rural municipalities. This again is questionable, as it is often not clear whether small communities indeed have to bear higher cost per capita. Higher real cost per capita in urban areas for higher education or for cultural services is not taken into account.¹⁵ A lack of cost differentiation may, in the long run, aggravate differences in territorial development since local governments bearing higher cost may no longer be able to provide their citizenry with adequate services.

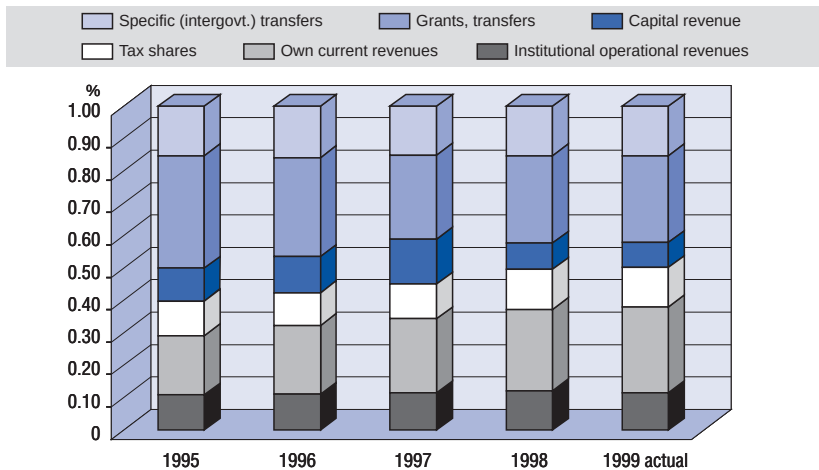
In sum, concerning equalisation, Hungarian local authorities have considerable financial support not only through the system of shared taxes but also through a variety of grants and subsidies. The orientation of this support varies considerably, however, and follows different principles for each individual measure. None of the current financial support systems aimed at equalising differences with respect to regional and local economic and resource background seem actually effective. Therefore one can ask to what extent the present system of vertical financial grants equalises territorial disparities.

Predictability of financial resources

The Hungarian fiscal federal system is plagued by the relatively unpredictable financial resources for local governments. The different elements forming the revenue basis for local governments are rather erratic (Figure 13).

The revenue resources that belong to a local government compared to shared taxes or transfers and grants have increased, as has already been shown above. Furthermore, the evolution of its own current revenue follows a more regular pattern than the evolution of shared taxes and transfers. The problem lies within central government resources that reveal important relative changes within short periods of time. Since local governments have full control over only a low percentage of revenues, the changes in the pattern of transferred resources strongly affect the composition of local revenues. The rather erratic structure of local revenues makes financial planning difficult and threatens the capacity of subnational governments to take care of their own long-term territorial development.

Figure 13. **Change in revenue resources for local governments, 1992-99**
Percentage shares



Source: Ministry of Finance, 2000.

Conclusions and recommendations

The need for institution building

Since the early stages of the transition, Hungarian regional policy has gained strength, although it is still constrained by limited resources and institutional problems. The EU has not only provided financial and technical assistance to introduce the necessary legislation and improve policy design in all spheres of the economy but has also contributed to changes in the territorial organisation of the country and to the 1996 law which has been instrumental in reforming regional policy-making. New actors for territorial policy are now emerging, and new regional institutions have been given responsibilities for policy implementation. The gradual introduction of a structural funds-like system has increased the participation of lower tiers of government significantly, notably through the partnership mechanisms, and has extended their consultative functions.

However, the new regional policy structure has led to a deconcentration of government administration rather than to a truly strengthened decentralisation, and has often complicated rather than purified the institutional system. Hungary still lacks a strong intermediate level that could take over powers from the central level and co-ordinate local level responsibilities. The regional development structure only partially matches the existing institutions. The new regional and county development councils may conflict with the existing counties over functions and responsibilities

because there is no clearly defined division of tasks. Furthermore, local governments are strongly dependent on central government. There is not enough horizontal collaboration among counties or municipalities.

The following constitute recommendations to remedy these problems.

- *Reduce institutional complexity and strengthen an intermediate level.* The complexity of Hungarian territorial governance should be reduced and institutional duplication avoided. Hungary should therefore strengthen an intermediate level. This intermediate level should be given extended competencies and sufficient taxation authority. Granting it more competencies and decision-making power especially with regard to the regional co-ordination of sectoral policies would help it to acquire more legitimacy, to strengthen its identity and to become more innovative. Institution building and increasing the quality of the administration should be concentrated at this intermediate level.
- *Foster horizontal collaboration.* A philosophy of flexible horizontal co-operation in associations, pacts and partnerships should be promoted to establish functional regions for different public services. Financial and other incentives should be created, *e.g.*, by raising the share of taxes that remain at local level. Counties should be encouraged to co-operate in selected policy fields. Central government should give financial incentives for horizontal collaboration, particularly by more strongly differentiating grants going to local governments or introducing financial rewards into the Law on Municipal Associations. Furthermore, it should establish and disseminate guidelines on how to run efficient horizontal and vertical partnerships.

The need for a fiscal constitution

Hungary has made tremendous progress both in terms of political and fiscal decentralisation. It has managed quite successfully to shift from an overly centralised structure to a decentralised state where local entities are enjoying increasing fiscal autonomy. Municipalities have their own resources whose share has grown continuously during the transition. However, the fiscal agenda is not finished yet. The Hungarian fiscal system still has many weaknesses. The scope of local governments to influence their own development is restricted.

- The gap between revenues and expenditures at local level is large. Local governments still largely depend on central government transfers to accomplish their own tasks. The transfer system is oversized and complicated. It gives rise to negotiation and rent-seeking activities between the central and local levels. Furthermore, it gives no incentives to local governments to increase the quality of subsidised public services.

- The structure of local tax revenue is inadequate. The main local tax, the business tax, is subject to tax erosion. The property tax is insignificant because it is not based on property values. The PIT, which is suitable for local governments, mainly accrues to the central government.
- Fiscal equalisation is not sophisticated and based mainly on tax sharing. There is neither vertical nor horizontal financial capacity equalisation, nor is there a system to equalise cost or need differentials.
- Local financial resources are not sufficiently predictable making it difficult for local government to make financial plans.

A reform of the Hungarian fiscal federal system should go hand in hand with the institutional reforms described above and result in a codified fiscal constitution. This constitution should provide the different levels of governments with reliable (revenue base remaining stable), predictable (revenues assigned according to long-term rules), adequate (tax base set at the right level) and appropriate fiscal resources (revenues according to responsibilities). This fiscal constitution would:

- *Increase the capacity of local governments to rely on their own resources.* The central government should increase and promote local governments' capacity to raise their own financial resources and reduce the gap between revenue and expenditure responsibilities. It should broaden the tax base and balance the tax structure of local governments. This can be done through the following reforms:
 1. The amount of the PIT that goes to local governments (municipalities and/or counties) should be augmented either by increasing the current share or by giving local governments the right to piggy back their tax rate on the central government rate (tax mark up or "piggy backing"). Future changes to the PIT split or that affect the right of local governments to set their own PIT rate should be subject to a parliamentary two-thirds majority vote.
 2. The property tax should become more important for local governments. The current land and building taxes should be transformed into a value-based (*ad valorem*) property tax. Central government should support local governments in setting up a cadaster system and evaluation process in order to embrace property values.
- *Streamline the system of intergovernmental grants and introduce incentive and monitoring mechanisms.* The size of intergovernmental transfers and the number of different grants should be reduced. Grants should be restricted to policy fields where intergovernmental co-operation or territorial spillovers are important (*e.g.*, environment) or where certain standards have to be guaranteed countrywide (*e.g.*, social welfare). Grants should, where appropriate, be paid on an unconditional basis. Those grants aimed at promoting such local public services as health or education should be paid on the

basis of the quality of the service. The national government should increase monitoring mechanisms for this type of grant.

- *Improving the equalisation system.* A system of financial equalisation should eventually be improved to replace the existing implicit equalisation through the PIT local share and the variety of grants to local governments. The new equalisation system should take into account disparities in financial capacity (tax raising capacity) and cost differentials (differences in cost to provide a given public service) more precisely. Grants for fiscal equalisation should be entirely unconditional. The equalisation system should provide all local governments with adequate financial resources without however mitigating local incentives to care for their own financial resources and for strict budgetary discipline.

It is useful to set up a permanent round table between local and regional governments and the central administration to discuss and negotiate the rules on local taxes, tax sharing, the system of transfers, monitoring of local finances and other issues of fiscal federalism. This round table could take the lead in establishing, implementing and adapting the elements of the fiscal constitution.

NOTES

1. Hungary was the first transition country to set up a legislative framework on regional development in order to strengthen its legitimacy and improve regional policy coherence and efficiency.
2. Ministries include: Interior, Environment, Transport and Water Management, Agriculture and Regional Development, Economy, Finance, Social and Family Affairs, Health, Education, National Cultural Heritage and the Ministry heading the Prime Minister's Office.
3. Ministries include apart from the Ministry of Youth and Sport the same ministries as those represented at the NRDC excluding Transport and Water Management.
4. Since 1992, €66 million have been spent on development programmes within the PHARE framework.
5. The Hungarian acronyms for these programmes are CEDA for targeted decentralised assistance, CCT for addressed and earmarked support, TEK1 for spatial equalisation support, VFC for rural development allocation, and TFC for regional development allocation.
6. Austria, the Czech Republic, Denmark, Finland, Netherlands, Portugal and Switzerland are comparable in size and population to Hungary and have three levels of government. Belgium has four levels due to the federal reforms of the 1990s. Source: OECD Territorial Information Base.
7. The Czech Republic abolished the counties with the introduction of the regional level in 2001. The number of government levels therefore remains constant.
8. According to the Act on Local Governments, local self-governments can be formed at settlement and county levels. Although the county self-government is also referred to as local self-government, the Act distinguished territorial local self-governments from the local self-government of settlements (municipalities). To avoid confusion, the term "local government" will be used for both municipalities and counties, whereas the more specific terms municipal and county level will be used where this distinction is necessary.
9. The Act on Local Governments defines a set of obligatory tasks for local governments that represent basic services such as local surgeries (GPs) and primary education or local fire services, etc.
10. The Act on Local Government only defines possible obligatory tasks that become obligatory if stated in acts such as the Authority Act (20/1990), or sectoral acts.
11. The Regional Development Allocation, the Spatial Equalisation Support (SES) and the Decentralised Targeted Assistance (DTA). A special government programme also provides HUF9 billion from sectoral budgetary allocations to five CDCs to reduce significant social and economic differences in the disadvantaged areas.
12. Act No. XXI/1996 (IV.5.) Article 11 Point 2a.

13. No data were available.
14. Internationally decreasing business tax rates seem to underline those theoretical considerations: in the last decade, the relative importance of local business taxes has decreased in most OECD countries. Most Swiss cantons reduced tax rates on local firms in the 1990s. Even at national level, the competition for new businesses has had its impact, *e.g.*, the German Kapitalsteuer was reduced some time ago, Austria abolished its business tax only a few years ago, and the French *taxe professionnelle* has been reformed and reduced lately.
15. In Switzerland, total public expenditure is rising almost monotonically with the size of municipalities. Only very small municipalities must bear higher expenditures again. See Administration Fédérale des Finances, 1997.

Chapter 6

Hungarian Regional Policy and EU Accession

Hungary's considerable experience with regional policy has been a factor that should not be neglected in the success of the transition, unlike many Central and Eastern European countries where regional policy legacy is often weak. This experience has been critical for accommodating EU programmes and triggering a self-reinforcing process of policy implementation and institution building. The Hungarian government started to combat disparities at the earlier stage of the transition by focussing efforts on deprived territories and problematic regions. With the vote by parliament of the Act on Regional Development and Physical Planning in 1996, regional policy received a new impulse. A reform was endorsed, driven by the need not only to instil some elements of decentralisation into policy implementation but also to create an appropriate regional level to meet European criteria. The EU indeed started to play an influential role as early as 1991 by signing important co-operative agreements, followed by the implementation of the partnership for enlargement. EU contribution was also significant at the policy-making level with the PHARE programme and subsequent pre-adhesion instruments.¹ The Commission has now defined milestones for the accession phase and promoted a useful discipline based on principles that need to be applied for structural funds type regional policy. Ensuring the EU compatibility of Hungarian policy is a necessary but not automatically sufficient condition for optimising regional policy intervention. This chapter analyses the trends in EU support and the impact of PHARE. It focuses on the main changes taking place in Hungarian policy-making within the adhesion framework.

PHARE framework and pre-accession context

PHARE was set up in 1989 and is the most important external support vehicle to assist policy implementation in Hungary (Box 14). While designed to facilitate the conversion of CEE countries to a market economy, it provides technical and financial aid in key economic areas and finances a wide range of development projects.²

Since the mid-1990s, the emphasis has moved from supporting privatisation, regional development, and infrastructure investments towards technical

Box 14. PHARE programmes

PHARE programmes are grouped as national programmes, horizontal programmes, cross-border co-operation programmes and community programmes. The first type of programme is streamlined to the special needs of each CEE country. The second group consists of 19 multi-beneficiary programmes including the Small and Medium-sized Enterprise Facility Programme, Democracy Programme, Consensus Programme, the Special Preparatory Programme for Structural Funds, etc. CBC programmes facilitate co-operation between the border regions of EU and candidate countries as well as between border regions of PHARE countries. Support is also granted for participating in various, already existing, European Community programmes (open to EU member states) such as Erasmus, Tempus, and Socrates.

assistance, training and education. Programmes have been increasingly accession driven. Given the need to rebalance support towards public reform, transposition of the *acquis* and local capacity development, PHARE has now been assigned two major priorities: 1) institution building and 2) investment support.

1. Around 30 per cent of PHARE funds is devoted to enhancing the capacity of all democratic institutions, public administrations and organisations for implementing and reinforcing Community legislation. One important aspect is the twinning exercise (exchanging knowledge and expertise between officials of member states and candidate countries).
2. The remaining 70 per cent finances investment projects to facilitate compliance with Community legislation and high EU requirements in fields such as energy, competition, transport safety, social and labour legislation, consumer protection, justice and home affairs, veterinary and phytosanitary norms, industrial products legislation, consumer protection and the *environment acquis*.³ Investment support falls into four major categories *i.e.*, investment in EU norms (adopting EU norms and standards), large-scale infrastructure (taken over by ISPA from the year 2000⁴), small and medium-sized enterprise support, and regional development.

Main aspects

A key feature of PHARE is the significance of resources allotted to the programme. It is by far the largest EU programme contributing to the transition in Central and Eastern Europe. Between 1990 and 1999, a total budget of nearly 11 billion ECU/€ was allocated for PHARE of which Hungary received around € 1.03 billion, or approximately nine per cent of the total (*i.e.*, an average 0.2 per

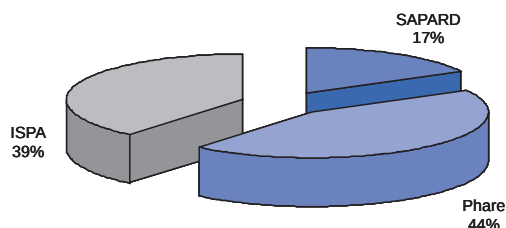
cent of Hungary's GDP per year). In the wake of the pre-accession process, the programme was recently strengthened with the adoption of Agenda 2000 that sets up firm accession criteria and allocates financial assistance of more than € 3 billion per annum to candidate countries for the period of 2000-2006.⁵ This amount is shared between three funds: the PHARE programme, ISPA (environment and transport infrastructure) and SAPARD (agricultural and rural development). These funds represent around 10 per cent of the EU Structural Funds expenditures in the member countries. PHARE has the largest share with about € 1.5 billion (€ 1 billion for ISPA and € 0.5 billion for SAPARD). The importance of the three funds in terms of their budget share varies from country to country. For Hungary, PHARE is about € 96 million⁶. ISPA can expect approximately € 80-90 million and SAPARD an average of 35-40 million a year (Figure 14) (MARD, 2000).

PHARE is a comprehensive programme with wide-ranging tasks. As shown in Figure 15, regional development has been a strong priority in particular since 1995. Other key sectors involve the reform of the public administration system to build up institutional capacity for membership; facilitating participation in current Community programmes; transport, energy and environmental investments; the modernisation of the agricultural sector, privatisation and cross-border co-operation between EU member states and candidate countries. However, co-financing problems hinder participation in Community programmes even if 10 per cent of PHARE can be used as national resources. The bulk of the financial resources is attributed to national programmes.

Regional development

With regard to Hungary's regional policy, EU assistance has contributed to consolidating the regional budget and to providing leverage money for many development projects. Until now, five regional development programmes have

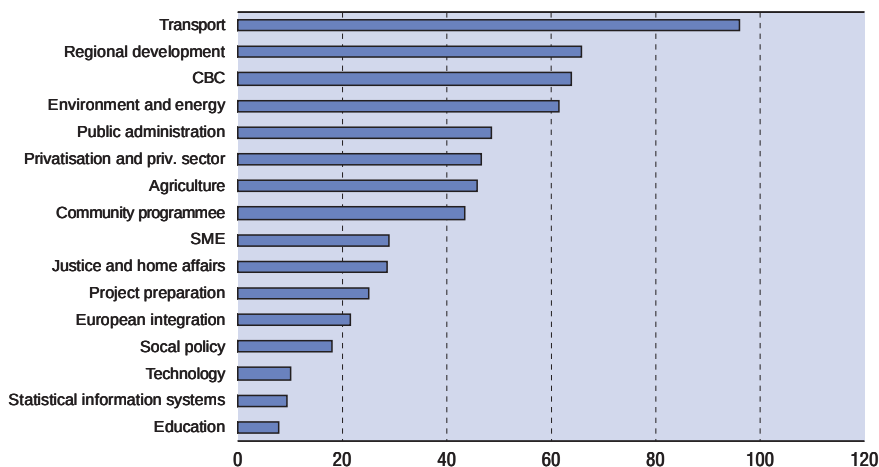
Figure 14. **Budget shares of the three pre-accession instruments in Hungary, 2000-2002**



Source: Data from the European Commission.

Figure 15. **PHARE programmes in Hungary, 1990-99**

Millions euro



Source: Data from the European Commission.

been approved for Hungary of which the 1998 pre-adhesion programme is still under implementation (GHR, 1999). In the framework of these five programmes, PHARE regional development obtained euro/ECU 66 million (Table 22). For the period of 2000-2002, a PNDP has been prepared to put the planning process in a multi-annual context, to comply with structural funds methodology and to provide a programming basis for PHARE, ISPA and SAPARD instruments⁷. The budget, including the national contribution, should more than double. As reflected in the PNDP priorities, PHARE support for economic and social cohesion will give the highest priority to local development and human resources, two areas that were not at the top of the agenda of previous programmes. Support will be focussed on the three least developed regions (North Hungary, North and South Great Plain).

Table 22. **PHARE regional development programmes**

PHARE regional development programmes	Year of approval	Budget Millions ECU/euro
Programme on regional policy and cohesion	1998	7
Regional development programme	1997	34
Regional development system programme	1996	10
Regional development and steel reconversion programme	1995	5
Regional development programme	1992	10

Source: Data from the European Commission.

However, these programmes are not directly aimed at reducing disparities and boosting economic development but at developing sub-national capacity for managing future development projects. Some development operations are still foreseen in particular for enterprise co-operation and preparing SMEs for the internal market, developing regional tourism, fostering innovation in SMEs, developing business-related infrastructure, employment projects such as promoting the transition from training to work. RDCs and RDAs will gain special attention in implementation and project planning. PHARE will also provide further funds for institution building to improve administration capacity at central and sub-national levels with a budget of € 4 million.

Significant progress was made during the last decade, with PHARE giving a major thrust for change in the regional economy and institutions. The first regional development programme that started in 1993 with an allocation of ECU 10 million significantly contributed to the preparation of the 1996 Act on Regional Development and Physical Planning and to modernising the Regional Development Fund. Regional policy and the development system of EU member states were analysed and adaptable methods were incorporated into the new regional policy. The programme also enhanced the creation and operation of County Development Councils in the two assisted counties of Borsod-Abaúj-Zemplen and Szabolcs-Szatmar-Bereg (through programme funding from Pilot Action Funds, tender system, control of utilisation, programme evaluation). In addition, a significant number of inter-communal partnerships (around 40) were set up. Following programmes with a total budget of € 56 million between 1996 and 1999 aimed at industrial restructuring (diversification of the economic structure via support for new businesses), rural development (*via* business-related infrastructure), human resource development (focusing on employment projects). Such programmes were particularly useful in paving the way for creating an enabling environment for business initiatives at local level.

The cross-border component

In 1995, in the wake of its Interregional Programme (INTERREG), the Commission extended the scope of PHARE by tackling the problem of border regions, an important territorial issue in Hungary as three-quarters of the counties have a border with another country. The Cross-border co-operation (CBC) PHARE programmes allocated € 42 million for co-operation between Austria and Hungary including regional planning, infrastructure investments, establishing industrial parks, trade co-operation, improving human resources and environmental protection. Similar programmes were introduced between Hungary-Romania, Hungary-Slovenia-Austria, Hungary-Austria-Slovakia, and Hungary-Slovakia. By the end of 1999, a total of € 64 million had been approved for CBC programmes. As shown in Table 23, the bulk of the programmes benefited the western counties of Hungary, the areas with the highest GDP per capita (after Budapest and Central Hungary) and the best

Table 23. **Beneficiary counties of PHARE CBC programmes**

CBC Programmes	Budget approved Millions ECU	Beneficiary counties
Hungary-Austria, 1995, 1996, 1997, 1999	42	Győr- Moson-Sopron, Vas, Zala
Hungary-Austria-Slovenia, 1995, 1996	3	Vas, Zala
Hungary- Austria, Slovakia, 1995, 1996	3	Győr- Moson-Sopron
Hungary-Romania, 1996, 1997, 1999	14	Csongrad, Hajdu-Bihar, Bekes, Szabolcs-Szatmar-Bereg
Hungary-Slovakia 1999	2	Győr -Moson-Sopron, Komarom-Eztergom, Pest, Nógrád, Heves, Borsod-Abauj-Zemplén
Total	64	

Source: Data from the European Commission.

employment figures. Some of the eastern and northern counties also participated in CBC programmes in co-operation with Romanian and Slovakian border territories. So far absorption problems seem to have stifled initiatives in the northeastern regions. With the recent progress of the EU-Croatian co-operation, there is hope for new CBC programmes in South Transdanubian counties.

CBC programmes provided support in five areas in addition to developing mid-term development programmes of the regions concerned, and contributed to the achievement of a myriad of often small but useful projects (Box 15).

Inter-regional co-operations can also be envisaged in a larger perspective. In 1997, a new INTERREG programme – Executive Measures for the Central, Adriatic, Danubian, southeastern Space – was launched. It included Austria, Germany, Italy, Greece, Hungary, Poland, the Czech Republic, Slovakia, Slovenia, Yugoslavia, Croatia, Bosnia-Herzegovina, FYROM, Albania, Moldavia and the Ukraine. Hungary is participating in the programme management structure and actively contributing to several transnational projects. Other co-operation initiatives include the Alps-Adria working Community (Austrian, Italian and Hungarian counties and regions) or the Carpathian Euroregion (bordering regions of Ukraine, Poland, Romania and Hungary). In addition, the National Regional Development Concept encourages the establishment of the Alföld-Banat-Vajdaság (with Yugoslavia) Euroregion and the Tisza-Maros Euroregion (with Romania).

ISPA, SAPARD and sectoral co-ordination

Transport and environmental programmes always accounted for an important share of the total budget (still close to 20% in PHARE 1999 country programme) reflecting 1) the under-equipment of the country in transport

Box 15. PHARE CBC achievements

Technical infrastructure. Several programmes have been completed including the construction of roads, bypasses, border crossings and local airports.

Environmental protection. Flood prevention spillways have been constructed, canal-works have been carried out and a hydro-meteorological information network has been set up. Waste depots and modernisation of waste treatment plans are also good examples.

Economic development. Derelict buildings have been renovated or new ones built such as the Sopron conference centre, the enterprise zone in Sopron, the innovation zone in Szombathely and the Lenti incubation house, or the construction of the Győr Chamber of Commerce service and training centre. A separate border crossing modernisation programme has been launched focusing on the Romanian, Slovakian and Ukrainian borders with a budget of ECU16 million.

Human resource development. Programmes such as the European Studies and Documentation Centre at Berzsényi Daniel Teacher's Training College have been implemented.

Microprojects. Mainly people-to-people type projects, have been implemented bringing people together, establishing networks and institutions and small-scale events to foster cross-border partnerships.

infrastructure and 2) the serious environmental problems it has to face and hence the need for policy intervention:

1. In the early 1990s, PHARE-related transport support was mainly devoted to emergency supplies of equipment and parts. Today and especially with the new pre-accession instrument ISPA, the overall objective is to align the candidate countries with Community infrastructure standards and to connect the major transport routes to the Trans-European network. Building such links is critical, given the close relationship between FDI and motorway construction and between FDI and regional economic development. Reaching an agreement on the priority axis, the speed and modes of construction is not easy, however.⁸ For example, constructing the M3 leading to the Ukraine through the Northeast, which is not even a candidate country for the EU, is not a priority transport route for the Union. As a result, the project will not receive ISPA assistance, as did M7 leading to the South along the Balaton coast.
- The central government and the Commission also have different views on environmental investment. While both believe that there is a need to focus on sewage treatment and waste disposal, the list of priorities is difficult to establish. The largest part of the investments was planned in

Budapest and a few major regional centres such as Debrecen, Szeged, Győr. Lake Balaton is a high priority for the Commission, but not for the Hungarian government. In addition some projects in Budapest, have been withdrawn from the proposed list mainly because of political conflict between the municipality and the central government. So far, however, many programmes have been completed under PHARE *e.g.*, municipal sanitary landfills, modernisation of the fire department (Szolnok, Miskolc, Győr, Budapest and Kiskunfelegyhaza), sewage treatment and sludge disposal (Szeged, Dunaujvaros, Szekesfehervar), water protection and pollution control and environmental investment in SMEs. A total of approximately ECU50 million has been allocated for environmental issues.

Although agriculture's share of GDP and employment has decreased since the beginning of the transition, the sector still plays a major role in several regions such as the Great Plain and South Transdanubia where it accounts for 15 per cent of GDP. It was not surprising therefore that agriculture and rural activities have been the focus of several PHARE programmes. For example within the 1997 regional development pilot project programme supported by PHARE, rural areas in Northeast Hungary and South Transdanubia received € 8 millions. At the same time, significant efforts were pursued by the central government as part of its 1998 Agricultural Programme. They include actions *i*) to strengthen the subnational organisations of the Ministry of Agriculture and Regional Development (MARD) *ii*) to foster rural development capacity via training, expertise and the establishment of a pilot office (€ 2 million) and *iii*) to support a co-operative network (€ 3 million). With SAPARD now replacing PHARE, the balance between agricultural and rural support is shifting, and rural support is gaining in importance (Box 16). Although 62 per cent of the funds will go to structural adjustments in agriculture and the implementation of the *acquis* for the Common Agricultural Policy of the Community, a more territorial approach is encouraged. It puts emphasis on renovation of villages, alternative activities (to agriculture) and rural infrastructures (36.5 per cent of the funds⁹). In addition, the Hungarian rural development plan budgets more resources for agriculture projects to start with and at a later period shifts the priority to rural development. Concerning the management of the programmes, the main policy-making responsibility lies in the hands of the MARD, which also supervises the SAPARD payment agency. Seven county offices are now poised to oversee the tendering of all SAPARD projects. SAPARD is a pioneer fund in terms of management. Following the recommendations of DG AGRI (EU General Directorate for Agriculture), the Community opted for a decentralised implementation system just like the EAGGF practice (EU Agricultural Fund). As a result, the Hungarian authorities will be fully responsible for allocating and managing the funds via a SAPARD Agency and a net of local offices. The Commission will proceed with conditional payments as long as the system runs sufficiently well.

Programme co-ordination was already an important problem at the time of the unique PHARE framework and is becoming a key issue. Many sectoral and

Box 16. The SAPARD Plan

Rural areas in Hungary have to face major structural adaptation problems linked with the restructuring of agricultural activities. As a consequence, employment has declined and many villages exhibit above-average rates of unemployment and lower levels of income compared to more urbanised areas.

In that context, the Special Accession Programme for Agriculture and Rural Development (SAPARD) intends to provide support to increase the efficiency of agricultural production, promote better conditions for food safety, hygiene and animal welfare, increase the proportion of higher quality and value-added products, release the burden on the environment, set up producers groups and enhance the capabilities of rural areas to retain population and create jobs. A new rural development assistance fund has been created endowed with HUF 7 billion for 2000, half of which will be devoted to the co-financing of SAPARD. It is expected from the plan that it will contribute to remedying the main disadvantages of rural settlements through infrastructure development, diversification and modernisation of agriculture and diffusion of knowledge and skills. According to government experts, the implementation of the SAPARD programme should result in the maintenance and creation of 25 000 jobs in the countryside.

regional (including CBC) programmes have overlapping targets and scopes. Attending to practice and looking for complementarity might help to avoid duplication and mismanagement. For example, flood control and protection cannot be financed from ISPA but is an important element in CBC programmes. Connections with appropriate SAPARD programmes need to be established to maximise their impact. If PHARE supports the restructuring of water management services and funds public awareness campaigns ISPA water infrastructure projects are likely to be strengthened and their social rate of return increased (European Commission, 1999c). Conflicting objectives (*e.g.*, promoting food standards within SAPARD and maintaining a high EU tariff) should also be given more attention. The focus should not only be the distribution of tasks between programmes but also the integration of the results of impact assessment studies. Policy measures are being taken in this direction. Indeed, co-ordinating international aid (including PHARE) has started very early with the introduction of the International Aid Co-ordination Inter-ministerial Committee. A new Aid Co-ordination Secretariat was established under the aegis of the Prime Minister's Office.

Subsidiarity

The PHARE programme has a centralised decision-making and implementation system. While programme management is outsourced, the Commission

must countersign every contract and Brussels must approve each payment. Therefore, PHARE allocations are only frameworks and the realisation of the payments depends on whether the Commission is satisfied with the work of the Hungarian management, with the progress of the programme and whether the contract and the tendering procedures follow EU regulations or not. The introduction of the pre-accession strategy, however, foresees a gradual decentralisation *i.e.*, the shifting of responsibility from Brussels to the national authorities. Steps toward strengthening national capacity have already taken place such as establishing the National Fund (creating a single fund), which is the Central Finance and Contract Unit's (CFCU) single responsibility for payments and contracts, better co-ordination between the various PHARE offices and ministries, setting up Monitoring Committees, and continuously improving financial control and audit. This implies an important extension of the central administration in several ministries including the Ministry of Agriculture and Regional Development, the Ministry of Environment and Ministry for Transport and Water Management. The Commission has constantly stated that the Hungarian administration system is not yet ready for managing structural funds, although serious improvements have been made to it (European Commission, 1998a). It still lacks suitable human resources due to low wages, insufficient training and lack of language capacity. For the EU, strengthening the central administration is a high priority.

The top down nature of PHARE is also clear at the operational level. So far on the national scene, the central government has kept responsibility for implementing a majority of projects. Some levels of decentralisation have nevertheless been introduced in many regional development and CBC programmes (Box 17).¹⁰ County Development Councils originated in the first PHARE programme. From the 1995 programme onwards, Regional Development Councils (RDCs) and Agencies (RDAs) have been set up to identify projects and manage tendering. Such RDCs and RDAs have been formed in the Northeast, the North Great Plain, the South Great Plain and South Transdanubia.

Administrative capacities and policy expertise at this level nevertheless still lag behind. The macro-regional level is operating with newly created institutions (many RDCs were established in 1999). These Regional Development Councils have a budget for financing development projects for the first time as of the year 2001, although more limited than the CDCs and at the cost of central and county budgets.

PHARE assessment

Given PHARE multiple targets, a general programme evaluation is particularly difficult and inherently imprecise. The Commission considers its economic and societal impact to be positive on the whole, especially with regard to strengthening institutions, the transfer of management know-how, and assistance to policy-making. Its contribution to the success of the privatisation process and

Box 17. PHARE contribution to more decentralised governance in Hungary

With the first PHARE Regional Development Programme, pilot action and decentralised strategic planning were conducted in two counties: Borsod-Abaúj-Zemplén and Szabolcs-Szatmar-Bereg. County Development Councils together with associated working organisations and development agencies were established on an experimental basis in accordance with the Act on Regional Development. RDAs played a key role within the more recently launched small area development pilot programme focussing on the South Great Plain and South Transdanubia. This programme is expected to assist regional institutions in establishing a model of project planning based on partnership and to enhance RDA expertise with regard to the EU institutional system. Cross-border co-operation has also been operating with decentralised regional PHARE offices. For example, the regional PHARE offices in Bekescsaba and Arad manage the CBC Hungary-Romania programmes. The former is responsible for the large and small projects on the Hungarian side while the latter is responsible for the small project on the Romanian side. The Austrian-Hungarian programmes are managed in Sopron. In addition, each border region established a co-operation committee to prepare the joint cross-border programming documents (development plans) and project identification. Monitoring sub-committees have also been created at regional level to review the progress of each programme in detail. These committees involve representatives of the national and sub-national levels. CBC programmes have significantly contributed to the development of the West Transdanubian region not only in physical terms (infrastructure investments) but also by enhancing the regional institution, its capacity to draw up long-term cross-border programmes and plans including the regional development concept. This region has been the most active and successful in regional development.

its active role in helping to create a local and regional environment that is friendlier to foreign direct investment are usually recognised. The 1999 *Regular Report from the Commission on the Hungary's Progress Towards Accession* notes in particular that PHARE was instrumental in securing the success of the Rural Credit Guarantee Fund that has permitted fund-starved rural SMEs better access to capital. The report also emphasises the active support of PHARE to the transport infrastructure sector, an investment consuming area where substantial funds are strongly needed. Finally, it underlines PHARE's success in introducing modern methods of restructuring and generating important job-saving investment in manufacturing industries.

Assessment studies on PHARE sub-programmes are often more mixed.¹¹ A common criticism refers to management problems and often-important delays in project implementation as well as the inflexible contracting procedures. Lack of preparative studies and master plans and insufficient support provided to the financial sector to develop its knowledge on infrastructure project management

are often emphasised. For PHARE-financed transport infrastructure, analyses show a strong bias towards investment (at the expense of institution building and especially of training) and lack of co-ordination between PHARE and other international financing institutions (on procedures) (European Commission, 1999d). Strategic PHARE-supported institutional projects were said to have little impact on policy formulation, while their effect on policy implementation was satisfactory (European Commission, 1999d). Within the core regional development schemes, the SME scheme has come most under focus. While recognised as the driving force behind the establishment of the Local Enterprise Agency (LEA) network, the programme is facing growing problems such as the lack of involvement of local governments and banks, which raises concern about the future capacities of these agencies as self-sustained institutions to assist SMEs especially in their subcontracting business (European Commission, 1999b). The PHARE Loan Scheme (PLS) in particular failed to attract the interest of bankers in the SME business. Applications to the Micro-Credit Scheme (MCS) were more important, since MCS represented the only local source of credit for new entrepreneurs. However, its sustainability seems compromised by LEAs and banks imposing high charges. The PHARE CBC is another programme that did not give full satisfaction. Weaknesses of institutions, management shortcomings and low absorption rates caused major delays in implementation. More focus on small projects, decentralised management and more active partnership could improve the governance of the programme considerably and enhance its efficiency.

EU compatibility

The new pre-adhesion approach alters significantly the conditions under which the Hungarian regional policy operates. It is generating considerable expectations, as is the possibility of tapping EU Structural Funds (SF) at the time of accession. So far, the pre-accession instruments expenditures represent approximately € 30 per inhabitant, three times the amount of 1999 transfers, which will be further expanded to a € 60 per inhabitant for aid during the first year of accession and will increase up to € 220 per inhabitant in later years (*i.e.*, current cohesion countries average). In order to receive these transfers, matching funds equivalent to about one-fourth of the EU transfer need, however, to be put in place. It is also necessary for the Hungarian policy framework to integrate the four principles which govern the EU structural approach *i.e.*, concentration, programming, partnership and additionality. Concentration means that available funds should focus on a limited number of objectives. Programming stands for programme assistance and decentralised management instead of top down supports. The partnership principle encourages the involvement of regional and local actors as well as social partners in formulating and implementing structural funds operations. Finally, additionality means that structural funds must add and not substitute for the public expenditure of member states in regional development. In this context, the extent to which Hungarian

regional policy complies with these principles characterises its state of preparedness. This compatibility analysis can also help to identify the major obstacles to convergence and anticipate the length of the accession period.

Concentration

With regard to zoning and regional targeting, Hungarian methodology is now close to EU methodology. The 1996 Act shifted the method of area designation from ranking settlements to assessing statistical territorial units to define four types of regions: underdeveloped areas,¹² industrial crisis areas, regions with high levels of unemployment, and rural territories (Bachtler and Downes, 1999). Such categorisation is very similar to the EU (former) objective areas 1 to 5b. In addition, around one-third of the population is covered by regional policy programmes in both the European Union and Hungary (where it constitutes a ceiling). Eligible areas are of course very concentrated in the western and central parts and more diffuse in the East and South of Hungary. Two counties – Szabolcs-Szatmar-Bereg and Borsod-Abaúj-Zemplen – received the bulk of regional assistance, nearly one-fourth of the regional funds distributed in the 1990-1998 period (Table 24). Jász-Nagykun-Szolnok and Nógrád also received high per capita spending. In Hungary, however, significantly more money is spent (in relative terms) on physical infrastructure than in western Europe. Conversely, a much higher share of EU projects in regional development targets investments creating new jobs, supporting enterprises and human resources development than in Hungary, particularly at local level where governments are overwhelmingly focused on operational tasks and (small) infrastructure investments.

Programming

Strategic programming in Hungary builds on a pyramid of plans and goals from local to regional to national levels. It needs more focus and articulation. The first regional plans (mid-term programming) were prepared as part of various PHARE Regional Development and CBC programmes. Countrywide preparation of such programmes and their integration into National Development Plans is still under operation. In general, Hungary continues to devote much effort to strategic planning at national level but government officials often claim that there are too many of them and that they are often little more than a set of ideas. Programming, on the other hand, involves not only the preparation of long and mid-term plans but also a strict order of procedures that compels the preparation and the implementation of the programmes. While PHARE has actively contributed to developing programming capacity *via* technical and financial assistance at the national level, more focus has been given during the last two years to building this capacity at regional level and this will be reinforced with PHARE 2000-2002. It is unfortunate, however, that the local level largely falls outside of this institutional building and planning effort. For inter-communal associations or county co-operation

Table 24. **Distribution of decentralised allocations by county, 1998-2000**

County	Distribution of decentralised allocations Millions HUF				Unemployment rate 1998
	Regional Development Allocation	Spatial Equalisation Support	Total	Total decentralised allocations per capita (HUF)	
Budapest	0	0	0	0	3.6
Baranya	890	1 588	2 478	5 676	4.0
Bács-Kiskun	1 442	2 585	4 027	6 997	9.4
Békés	1 007	1 805	2 812	6 579	12.3
Borsod-Abaúj-Zemplén	1 955	3 528	5 483	6 897	17.7
Csongrád	918	1 599	2 517	5 559	7.8
Fejér	497	801	3 815	2 949	7.6
Győr-Moson-Sopron	866	840	1 706	2 985	4.4
Hajdú-Bihar	1 255	2 243	3 498	5 982	13.7
Heves	594	1 065	1 659	4 782	11.6
Jász-Nagykun-Szolnok	1 130	2 021	3 151	7 071	12.4
Komárom-Esztergom	408	708	1 116	3 279	9.5
Nógrád	761	1 390	2 151	9 165	14.7
Pest	1 103	1 995	3 098	3 000	5.9
Somogy	716	1 290	2 006	5 580	11.2
Szabolcs-Szatmár-Bereg	1 758	3 216	4 974	8 025	14.9
Tolna	493	866	1 359	5 100	11.5
Vas	308	489	797	2 790	5.2
Veszprém	599	1 066	1 665	4 077	7.9
Zala	464	792	1 256	3 921	8.0
Total	17 164	29 887	47 051	5 249	

Source: Government Decree 28/1998 (II. 18). Official Hungarian Gazette, 1998-2000.

projects, some steps have already been taken towards pulling and programming various state resources (sectoral resources) but there is still much scope for improvement (Box 18).

Partnership

Instead of relying exclusively on administrative or political organs for the design and management of structural funds-supported programmes, the Commission partners with institutions including local and regional governments and social partners. EU Structural Funds programmes are managed by specific organisations (development councils, monitoring committees) composed of members from a wide range of political, administrative, public, semi-public or private institutions. In addition to these organisations, co-operation networks have been developed. This was incorporated early on into the new regional policy of Hungary. New actors such as CDCs and RDCs played an important role. So far, however, the planning and even more the financial allocation of power remains concentrated in the

Box 18. The IRP, an integrated regional programme

The IRP is the first example of a programme incorporating resources from budgets of ministries and state funds to finance common goals in disadvantaged regions. It provides financial resources for infrastructure and social investments. Each year the counties develop a plan and a medium-strategy for the IRP every three years. The money is then allocated at county level but is specifically addressed to plan programmes. Around 20 per cent of the Expenditures for Development envelope of the State Budget go to the IRP. The Ministry of Agriculture and Regional Development's portion usually contains money from the Regional Development Allocation. The IRP was established in 1995 for one county then extended to three counties and from 2000 finally to five: Bekes, Somogy, Szabolcs-Szatmar-Bereg, Nógrád and Borsod-Abaúj-Zemplén. The Borsod Programme was the first to be implemented. It was undertaken in co-operation with the CDC and the county agency. Other programmes are managed in the same way. Lessons learnt from the IRP will be particularly useful at regional level when structural funds are available.

hands of the central authorities. Despite centralisation, local initiatives are still vivid as reflected in the success of numerous inter-communal partnerships and the evolution of voluntary Regional Development Councils. In addition, the establishment of a regional representative office in Brussels in early 2000 indicates that the Hungarian regions are aware of the power of direct lobbying and information in structural funds allocations. Local entities through their activities in the Assembly of European Regions, the Carpathian Euroregion and the Alps-Adria Community are already integrated in European Union inter-regional co-operation. The elimination of the Chamber of Commerce as members of RDCs and the increase in the number of national representatives as stipulated in the 1999 amendment to the Regional Development Act are less positive signs. For fear of lack of administration capacity at sub-national level, the Commission does not seem to encourage decentralisation and partnerships to the extent that it did in the previous years.

Additionality

The additionality principle ensures that the Community does not spend on projects that would be financed otherwise from national resources to avoid dead-weight effects. Structural fund expenditure and projects should not replace national efforts but must follow the national line of development and not conflict with national priorities.

Assessing Hungary's potential for receiving structural funds in this context is difficult. The budget of all separate state funds aiming at countrywide development

slightly exceeds € 1 billion: about half of these funds is earmarked for road, environment or telecommunication infrastructure. However, not all projects financed from these funds are comparable to structural funds programmes, given the eligibility conditions imposed by the Commission.

It is known that during the 1994-1999 period, Greece and Portugal received structural funds resources of nearly eight per cent of their GDP. Taking this data as a basis, and especially the per capita level, Hungary would be eligible for 4.08 billion from EU Structural Funds (Estrin, Hughes and Todd, 1997). Given the gap between such amounts and co-financing resources available and given that other CEE countries exhibit similar or even greater disproportion, the Commission introduced a four per cent ceiling of the GDP for EU Structural Funds receipt in Agenda 2000 instead of the GDP per capita comparison. Finally, the Commission proposed € 1.33 billion for Hungary as EU Structural Funds allocations for the period 2002-2006 in case of accession in 2002.¹³ The current national spending might provide enough resources to co-finance EU Structural Funds programmes but to keep up the current spending (current programmes) and produce additional resources to co-finance structural funds operation will mean significantly increasing the regional development fund's present budgetary level.

The issue of co-financing also raises the problem of managing EU Funds in Hungary. Although in the early years of PHARE, the share of funds spent of the total allocated was relatively high, the overall share of the contracted amount of the total allocation reached 71 per cent for all programmes between 1990 and 1996 (Table 25) (KEI, 1997). The average time between programme approval (in Brussels) and completion is two to three years, excluding discussion time. At the end of 1996, only around 60 per cent of the support had been paid for the period

Table 25. Use of PHARE support, 1996

Year of approval	The amount of support Million ECU	Percentage of contracted support at the end of 1996	Percentage of paid support at the end of 1996
1990	89.8	105.8	105.3
1991	119.5	95.6	89.8
1992	97.5	96.4	90.4
1993	99.0	99.8	74.5
1994	84.5	64.9	41.4
1995	92.0	20.7	16.1
1996	101.0	9.4	9.4
Total	683.3	71.1	61.9
Other projects	4.2	84.0	81.7
Total	687.5	71.1	62.0

Source: Data from the Ministry of Foreign Affairs, Aid Co-ordination Office.

under review. 1999 data indicated some progress. Another problem concerns the present focus of pre-accession aid to three regions, which means that they will be the only ones to gain expertise in EU Fund management. Given that Hungary will become in its entirety an Objective I territory at the time of accession, the different regions will not be on equal footing to manage EU transfers. In this context, the decision by the government to fund development and administrative capacity building projects in those regions that are not targeted by PHARE 2000-2002 is particularly welcome. An equal amount to the PHARE support (per region) will be allocated to them to accelerate their preparation to accession.

Conclusions and recommendations

PHARE has been an important driving force in the formulation and consolidation of a market-based and partnership-based regional policy in Hungary. The set of EU supported programmes has benefited all regions (excluding Central Hungary and Central Transdanubia): developed regions through cross-border co-operation and disadvantaged regions through traditional regional development support mechanisms. EU initiatives have also contributed to changes in territorial organisation. Regional policy-making has been to a certain extent deconcentrated and new regional institutions have been given responsibilities for policy implementation. To what extent an appointed rather than representative system will enhance the efficiency of regional policy, ensure better accountability, and compensate for the handicap of the lack of legitimacy is difficult to establish at the moment. At this stage, it is generally recognised that the managerial capacity and skills of subnational authorities and agencies have been improved, especially in the case of the pilot projects and for CBC programmes.

Compatibility with EU Structural Funds regulations and procedures is now understandably one of the main tasks of Hungarian regional policy given the perspective of structural funds at the time of accession. Fast progress will probably accelerate accession. It should however be borne in mind that these regulations have been evolving and could change. What is crucial here is rather the present learning process and the capacity to develop flexible policy responses. Moreover, compliance with regulations does not suffice to ensure policy efficiency. Other factors such as the quality of partnerships, the ability to make the best use of available funds, selection of targets, project monitoring and professionalism are critical. The central government also needs to optimise project selection within the structural funds framework and avoid building a bureaucratic and time-consuming system in order to encourage the most efficient use of public funds. Drawing on the experience of cohesion countries would be particularly useful.

The following recommendations are designed to resolve these issues:

- *Improve institutional co-ordination.* Many ministries are involved in sectoral tasks and programmes with a territorial impact. To harmonise these

activities, inter-ministerial co-operation is critical and should be further strengthened. Co-ordination should also be reinforced vertically *e.g.*, between strategic and implementation agencies or departments. For this purpose, new institutional arrangements could be considered.

- *Maintain ordinary regional policy.* Given scarce central government resources, the EU influence on Hungarian regional policy tends to be increasingly overwhelming and all regional programmes are to various degrees framed within the (extraordinary) context of accession. Structural funds are only meant to fund additional programmes and not substitute domestic ones. As in other EU countries, a balance between conventional regional policy (based on indigenous resources) and co-financed programmes could usefully be established. Moreover, numerous projects are currently postponed until accession especially in less developed regions. Any disposition towards procrastination should be resisted.
- *Selection of EU eligible projects at the regional level.* Eligible projects need to be carefully assessed and compliance with regulations ensured to secure competitive bidding and to avoid all types of clientist practises. RDCs have a final say in the monitoring process and should devote sufficient time and money to guarantee the efficiency and integrity of the selection process. Special attention should be given to building up a reservoir of well-trained experts for projects assessment. RDAs will assist project promoters but will also serve as the secretariat for the future Regional Monitoring Committee. It is important to safeguard independence in selecting projects. Resolution of conflicts should not produce conflict of interest for the RDAs.
- *Give more attention to developing an evaluation culture.* Evaluation of PHARE programmes has not been systematic so far and has generally targeted a group of specific CEE countries rather than individual countries in depth. The PNDP foresees the creation of regional monitoring committees to assess the implementation process and its impact on the region, with RDAs serving as a secretariat and sectoral implementing agencies having overall responsibility for monitoring. To make the exercises useful, it is crucial that RDAs be appropriately staffed. A rigorous assessment methodology should also be applied to programmes, especially for future regional operational programmes and proposals for changes should be clearly identified. Regular programme adjustment should be planned taking these recommendations explicitly into account.

NOTES

1. PHARE stands for Poland-Hungary Aid for Reconstruction of the Economy programme.
2. The programme was subsequently extended to other CEEC and by 1997, 13 of them were eligible.
3. www.europa.eu.int/comm/enlargement/pas/Phare/pt/invsup.htm
4. ISPA and SAPARD are taking over responsibilities from PHARE for the infrastructure and agricultural sector.
5. Besides the three pre-accession funds, additional financial assistance is available from the European Investment Bank (€15 billion), European Bank for Reconstruction and Development (€3 billion and €1 billion from the World Bank) in the form of loans for infrastructural investments, enterprise promotion, privatisation.
6. Including PHARE Economic and Social Cohesion and CBC. PHARE budget is only calculated for the period 2000-2002. See GHR (1999).
7. *Preliminary National Development Plan, Hungary 2000-2002*, Ministry without portfolio responsible for the co-ordination of PHARE programme, Budapest, April 2000.
8. The Hungarian authorities want to advance more quickly with priority for motorway construction such as M3 and M7. For M3, it suggested a full motorway while the EU argued that the present volume of traffic could be adequately served by a main road or a semi-motorway (fewer and narrower lanes). These disputes resulted in the withdrawal of these projects.
9. Rural activities did not exceed 10 per cent of the MARD budget for agriculture (HUF116 billion in 1998).
10. Decentralisation henceforth means the involvement of local and regional actors in regional development.
11. See, for example, the series of reports produced at the end of the 1990s for the evaluation unit of the common Services for External Relations (SCR) of the European Commission.
12. Defined by a composite indicator measuring both economic and social performance.
13. The real amount will depend on the negotiation outcomes and the future budgetary reforms of the EU. Heavy debates are expected as neither the structural policy beneficiaries want less, nor do net contributors intend to put more into the "Community basket".

Chapter 7

Budapest: Governance in a Politically Fragmented Area

The municipality of Budapest stands out in the Hungarian economy, as it generates one-third of the national GDP. Its disproportionate weight is visible in all fields whether concerning FDI, R&D, exports, health status or education level. There is little doubt that it is likely to maintain its economic position. However, these observations do not reflect the strains and disparities in the metropolitan picture. Two large sets of problems are likely to impair Budapest's future social, spatial, and economic development. First, as for many large cities, suburbanisation increasingly extends jurisdictions beyond the city's traditional borders. The functional metropolitan area no longer corresponds to the administrative jurisdiction of the city of Budapest. The fiscal, social, and environmental issues that arise from suburbanisation are not tackled by a single entity but by many politically independent municipalities that hardly take territorial spillover into account. The lack of co-operation on a territorial basis leads to a mismatch between decision-makers, taxpayers, and beneficiaries of public services that is detrimental not only to the central city but also to the suburban population. Second, Budapest enjoys a unique institutional status that makes urban governance delicate. The municipality is divided into districts that have no hierarchical relationship. This affects both the intra-city relations between the districts and the municipality and central state-city relations. Since both urban administrations are on the same level, Budapest is entangled in an ongoing debate over responsibilities and revenue allocation between the districts and the municipality. In addition, due to the capital's dependence on central state grants, the central government exercises considerable power over the municipal and district governments. The administrative and political fragmentation makes financial planning somewhat difficult, binds financial and political resources, and thus might have a negative impact on Budapest's future economic and social performance.

Agglomeration growth and suburbanisation

Problems due to suburbanisation are common in large, fast growing metropolitan areas. Budapest faces similar problems and threats, many of which are related to its institutional setting and territorial governance structure. The specific

issues in the Budapest conurbation are in line with those of other large urban agglomerations situated in a decentralised or fragmented political environment.

Main geographical, economic and demographic patterns

Several indicators demonstrate Budapest's dominance in the Hungarian economy. Its income per capita exceeds the national average by about 87 per cent. Its proportion of operating businesses per 1 000 people is 60 per cent higher than the national average. It concentrates more than half of the companies with foreign capital and 56 per cent of all international equity stocks. It represents 70 per cent of national R&D expenditure and 60 per cent of all R&D employees, and it employs 50 per cent of the national teaching personnel in higher education. Its economic structure clearly focuses on services (76.8% share of the city's GDP), financial services accounting for almost 30 per cent of the total.

With 1.8 million inhabitants within the municipality, and two and one-half million inhabitants in the agglomeration, Budapest represents one of the largest capitals of Central Europe. The urban agglomeration consists of 79 communities and a territory of 2 549 km² of which 525 km² belong to the capital itself. Budapest concentrates 20 per cent of the Hungarian population and has a population density of 3 549 inhabitants per square km.

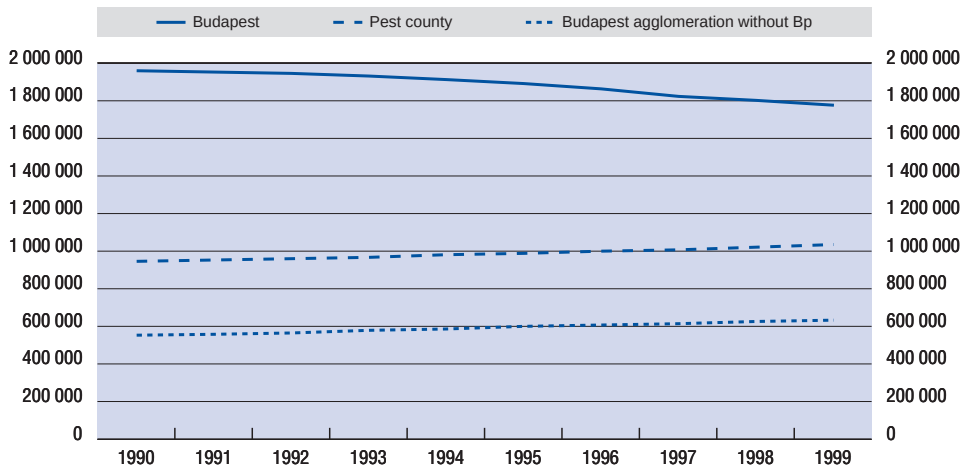
Pest County surrounds Budapest. The statistical agglomeration of Budapest, defined by the number of people commuting to the centre and therefore defining the boundaries of the functional region of Budapest, clearly goes beyond the municipal boundaries. It does not comprise all of Pest County however (Figure 16). The map shows a typical politico-geographical position of metropolitan areas whose functions have expanded to adjacent politically independent communities. While the tax base

Figure 16. **Budapest and its functional region within Pest County**



Source: Data from the Data from the National Regional Development and Spatial Planning Information System, 2000.

Figure 17. **Population change in Budapest, Pest County and Budapest urban agglomeration**



Source: Data from the National Regional Development and Spatial Planning Information System, 2000.

and administrative power remain limited to the municipality, residents of adjacent agglomerations enjoy services and functions provided by the metropolitan centre.

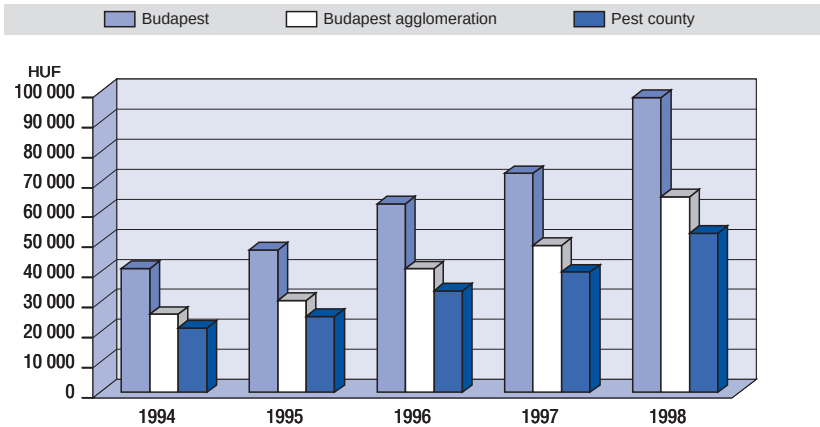
The area marked in grey represents the agglomeration of Budapest. Although, the population in the agglomeration of the capital grew faster than the national average during the last decade, it has been uneven and concentrated merely in bordering communities. The population in the capital itself is declining. Figure 17 shows the population development in Budapest, Pest County, and the Budapest agglomeration without Budapest. Between 1990 and 1999, Budapest lost 181 232 of its inhabitants, or 8.8 per cent of its population. At the same time, Pest County has grown by 90 104 people, or 6.4 per cent. The urban agglomeration without Budapest grew by nine per cent. Budapest is therefore losing people to its own agglomeration. The decrease can be explained by a relatively high mortality rate (especially in poor areas) and a low birth rate in the last ten years, and by increasing emigration to the suburbs outside the Budapest municipality. About 70 per cent of the growth can be attributed to outmigration – mainly of the middle and upper income classes – of the capital to the agglomeration.

Fiscal development

Income taxation

The demographic and economic evolution is reflected in the evolution of the personal income tax (PIT). Budapest's economic pole position is confirmed by its tax raising capacity (Figure 18). However, although the Budapest tax yield was

Figure 18. **Personal income tax in Hungary, 1994-98**
In HUF, adjusted for inflation (GDP deflator, 1993 = 100)



Source: Data from the National Regional Development and Spatial Planning Information System, 2000.

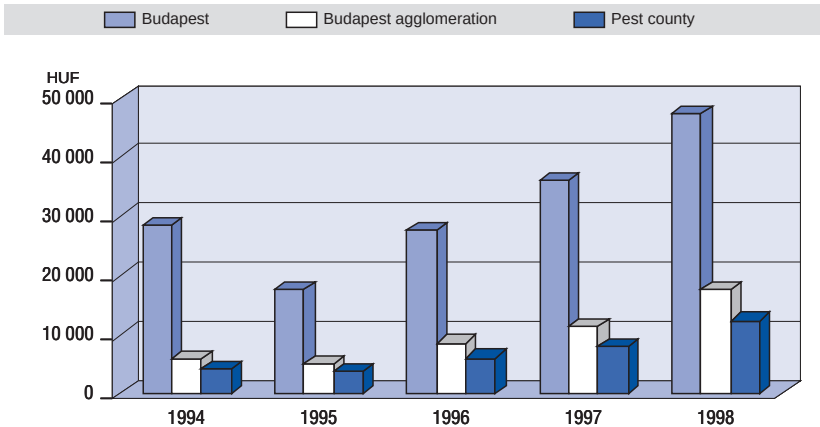
almost twice as high as in Pest County in 1998, its evolution was uneven. Whereas the Budapest PIT in real terms remained almost constant in the period 1993-1998, the PIT in the Budapest agglomeration and in Pest County rose by eight per cent and three per cent. Furthermore, Budapest was hit more by the crisis of 1994 than its surrounding areas. It seems that, due to outmigration, Budapest has begun losing financial resources to the suburban municipalities. The situation is aggravated by the fact that the city budget only gets a small portion of the tax yield since PIT revenues are shared with the central government. In 1998, income taxes accounted for 7.2 per cent of the city budget, or HUF 16.8 billion compared to a total tax yield of HUF 202.4 billion collected within Budapest.

Business and property taxation

In many large cities of the world, declining income taxes are being offset by rising property and business taxes. Spatially, firms are increasingly concentrated in the central business districts of large cities. A similar evolution has occurred in central Budapest where most large firms are currently located. The business tax yield in the Budapest area is therefore comparatively elevated. For instance, the four central districts of Budapest deliver around 30 per cent of the national business tax revenue.

This evolution of business tax per capita in the municipality of Budapest (municipality and districts taken together), the Budapest agglomeration and Pest County reflects these changes (Figure 19). In absolute terms, in 1998, Budapest

Figure 19. **Business tax revenue per capita, 1994-98**
In HUF, adjusted for inflation (GDP deflator, 1993 = 100)



Source: Data from the National Regional Development and Spatial Planning Information System, 2000.

disposed of an annual business tax revenue of HUF 97.6 billion (38.0 billion in 1993 prices). This corresponds to around HUF 21 000 (in 1993 prices) tax revenue per capita. In 1998, the urban agglomeration obtained HUF 4.9 billion, which is a per capita tax yield of HUF 7 900 only (1993 prices). All tax yields are subject to allocation between the districts and the municipalities. In 1998, the business tax income provided more than 12 per cent of the total Budapest municipal budget, and the single most important of its own financial resources.

Again, the evolution is uneven, and some strains may appear in the long run. The per capita Budapest business tax grew by 22 per cent between 1993 and 1998 in real terms, while the Budapest agglomeration and Pest County business tax yield rose by 58 and 116 per cent. During the financial crisis of 1995, Budapest's business tax revenue declined disproportionately in comparison to the agglomeration. As a result, the agglomeration's tax yield growth is stronger than in the capital, which could mean that the central city is losing businesses relative to the suburbs.

Trends in other OECD countries further indicate that the business tax loses its importance as a financial resource for local governments. Although the beneficiary pays principle (*i.e.*, firms using municipal infrastructure) justifies the levy of a business tax to a certain extent, the business tax contradicts theories of fiscal federalism, which state that mobile sources should be taxed at higher government levels. The business tax serves as a tool to attract or retain firms, as the tax rate and the tax base are determined at the municipal level. The levy of such a tax might lead to general competition between municipalities or local authorities

and contribute to reducing tax burdens on mobile firms rather than on other tax subjects. Trends in taxation seem to confirm these theories. Many countries have lowered or even abolished their business tax rates recently and shifted the tax burden to direct taxation *i.e.*, income tax. It seems that the business tax will probably lose its present importance in the fiscal municipal system.

Property tax is another substitute for local income or business taxes. Since it is based on immobile factors and roughly linked to the services a municipality renders to its citizens, the property tax seems to feature appropriate characteristics. However, property tax yields still contribute a rather small part to the local budget of Budapest. The Hungarian property tax system is based mainly on buildings and plots, without considering property values. The local revenue therefore mainly consists of the business tax: property tax only yields a few per cent. The long-term tax base of the city of Budapest therefore remains somewhat unstable.

Social and economic impact of suburbanisation

The change in settlement patterns in Budapest in the last ten years has modified both population and tax development. Whereas suburban populations have increased, the municipality of Budapest lost population in absolute terms, mainly through middle class moves to the suburbs in search of affordable housing and a pleasant environment. The merge with adjacent agglomerations, which represents a common feature of fast growing cities, seems to be delicate in Budapest. First, outmigration of relatively wealthy residents might cause spatial and social segregation. Already, in the central city a somewhat dichotomous social structure is evolving: on the one hand, a strata of very wealthy people occupies some of the attractive parts of Buda, on the other hand, the number of socially disfavoured people not benefiting from the economic development of the central districts is increasing. The social dichotomy leads to social disparities, which are congruent with spatial disparities. Whereas some districts are very wealthy, others struggle with high unemployment and high social welfare expenditures. In addition, hitherto densely populated residential areas in central Budapest face the danger of being transformed into office zones, changing the spatial structure of the capital as well.

Second, the outmigration of middle class residents is reflected by a comparatively stronger increase in business and income tax revenues of the suburban agglomeration. While this might weaken the capital's tax base in the future, an evident mismatch has already occurred between the financial contributions of the suburban communities to services offered and funded by the Budapest government, and their use. Residents of adjacent communities benefit from the capital's social, economic, transport, and cultural infrastructure.

So far, the 1996 Act on Regional Development and Physical Planning led, in 1997, to the establishment of the Council for the Development of the Budapest Agglomeration. The Council's powers were limited to management and

implementation. The national government, apart from the general support of associations of municipalities in micro-regions, has not yet established any specific incentives for the metropolitan area to build partnerships with their bordering communities. As a result, fiscal equivalence is not granted. Since no inter-jurisdictional government institutions exist in the metropolitan region, suburban communities are to a certain extent free-riders. A few examples may illustrate this central burden and the undesired side effects it may cause in the future (OECD, 1999*h*). This will be shown using transport, education, and culture examples, which together accounted for 55 per cent of the average public municipal investment between 1991 and 1999.

- *Public Transport.* The Budapest public transport company BKV (Budapesti Közlekedési Vállalat) operates a number of bus lines that cross municipal borders and serve suburban commuters. These lines carry huge deficits paid for by Budapest and its taxpayer. Negotiations between the city and the suburban municipalities have largely failed; the suburbs are not prepared to contribute to the funding of public transport. At present, only one suburban municipality contributes to BKV costs, since no regional transport co-operation has been able to be established. Spending among the different financial contributors to the regional transport (central government, the state-owned railway company MAV, the municipal BKV, and the agglomeration) is uncoordinated. As a result, funding necessary for an efficient, functional public transportation system is generally too low. Municipal transports may withdraw some services and offer a clearly suboptimal public transport system, and run the risk of losing its competitiveness compared to individual transportation. The agglomeration might lose services if the Budapest municipality seeks to reduce its deficits (Box 19).
- *Education and Culture.* County responsibilities include primary and secondary education. Budapest is financially treated as a county, and its high schools, therefore, receive their funding from the municipality and the central state. Since, however, a high percentage of non-Budapest students frequent the capital's high schools and vocational schools, the municipality carries out and finances responsibilities for other regions, particularly those around the Budapest area. There is no horizontal collaboration between counties for secondary school education and no financial contributions from those counties dispatching students to Budapest. The counties receive central government grants on a per capita, not on a per student basis. Since students pay no fee for secondary education, Budapest cannot capture the value of its educational system. Its attempts to receive additional compensation – from local as well as from central governments – are not always successful. The missing horizontal co-operation and the distorting grants might have a long-term

**Box 19. Public transport associations in functional areas:
an example from Switzerland**

The large metropolitan areas in Switzerland (Zürich, Basel, Geneva, Bern) extend beyond municipal and cantonal borders; the functional commuting zone does not correspond to the jurisdictional area. During the 1980s, the population increasingly demanded a coherent and user-friendly public transport network able to meet the needs of commuters and to reduce the environmental impact of the excessive use of private cars. Since no single political entity could be responsible for such a network, it had to be organised along functional lines and across political borders. Most Swiss urban transport associations created through the 1990s are the result of a sometimes-strenuous horizontal collaboration endeavour between municipalities, cantons and transport companies to transform a good idea into a workable and financially sustainable transport network.

The Tarifverbund Nordwestschweiz (Tarif Association of Northwestern Switzerland) in the Basel conurbation is the oldest and institutionally most complicated transport association. It was founded in 1987. Today it covers around 160 municipalities, four cantons, six bus and two railway companies and, through cross-border agreements, the two countries of Germany and France. The main features of the transport association are:

- Municipalities are free to join. The cantons pay member municipalities between 40 and 50 per cent of their share of the deficit, providing them with an incentive to join. Many municipalities do not participate, particularly those lying outside the functional area.
- The association sets fares and defines the transport offer. The service itself is contracted out by tender or through negotiations among public entities and transport companies. The single private bus or rail company, and federal railways, remain independent.
- The user has to buy a single ticket even if several companies or transport means are used. Fares are set according to zones.
- The municipalities share the overall deficit according to a weighted key of users and transport kilometres on their territory. The cantons and, for some services, the federation pay some minor subsidies.

The association emerged basically out of a common interest between the central city and its surrounding municipalities in providing commuters with a rapid, inexpensive public transport system. However, upper-level financial support, from cantons or even the federal government, proved to be an important glue for holding the association together. At present, some financial strain rests upon the association. Cantons and municipalities are thus asking for additional financial resources, and the federal government is currently examining additional investment support to urban transport.

negative effect on the educational system. The same could hold true for cultural activities *e.g.*, theatres subsidised by Budapest but used by people from the agglomeration.

In 2000, the Council was dissolved and replaced by the Regional Development Council (RDC) of Central Hungary, which includes the whole of Pest County. This might be the first step to increase intra-agglomeration collaboration and relieve the city of Budapest from sole responsibility for these tasks.

The fiscal drain caused by the outmigration of people and income and the central burden problem have not yet reached critical levels. The municipality is very large in European terms (525 km²) due to its merger with hitherto independent municipalities in 1950 so that some “suburbs” will eventually belong to the political municipality. The transportation network between the agglomeration and the central city is rather poor, still preventing long distance mass commuting, either by private or public means. The heavy system of normative grants, while not specifically designed for the cost or burden of large cities, has a certain inter-agglomeration burden or load equalisation effect. With increasing transport quality and possible fiscal decentralisation, which would again raise the municipal share of the PIT replacing the normative grants by the city’s own tax revenues, the intra-agglomeration fiscal discrepancies might worsen.

Intra-city administrative fragmentation

Municipal-district conflicts

Budapest is divided along the usual lines of the Hungarian territorial governance systems of counties and municipalities. After the fall of communism, a decentralised administrative model was chosen to replace the Soviet-type council system. With the passage of the Act on Local Governments in 1990 and its main reform in 1994, the municipality became an independent two-tier administered city whose position is akin to a county. Budapest was divided into 22 districts, each of which disposes of its own resources, carries out its responsibilities, and is governed by an elected body. In 1996, a 23rd district was added.

The act prescribes dual management, as powers are divided between the municipality of Budapest and the 23 districts. Therefore, the allocation of responsibilities and taxes between them is subject to political tensions due to a feature that is almost unique in OECD countries. The districts are treated as small municipalities, which means that there is no hierarchical decision-making relationship between the districts and the municipality of Budapest.

The city of Budapest, which comprises an elected independent assembly like the districts, has been made responsible for public services, such as historic preservation, water, gas and sewage services, road maintenance, public transport, etc. It also provides educational, cultural, health and social services when they affect more than one district. The municipality also prepares a Structure Plan and a Frame Regulation (FSZKT) on urban planning for the whole city. The districts have to prepare their plans within this framework. The districts also carry out services

covering their area only. They provide drinking water, primary level education, local road maintenance, social care, and the protection of ethnic minorities.

As regulated by the Act on Local Government, Budapest's revenues are shared between the municipality and the districts, which dispose altogether of three different incomes. They receive revenues directly and independently from each other (state grants, subsidies, etc.) and share a certain amount of their tax and other revenues. Both city and districts also obtain funds from their own sources. The shared amount essentially consists of three different revenue sources: equalisation grants (linked to the number of inhabitants), PIT (regulated in the annual Budget Act of the Republic of Hungary), and local taxes such as the business tax (BT). Table 26 indicates shared funds for 1999 of approximately 146 billion out of which around 70 billion was allocated to the municipal budget (see Figure 20 for fund-sharing since 1996).

The process of fund-sharing between the Budapest municipality and the districts has given rise to considerable debate. The annual allocation principle is based on a special rule set forth in the Local Government Act, which prescribes revenue shares according to the proportion of duties and powers exercised by the two different tiers and to the costs of these tasks and responsibilities. Revenue shares are subject to annual negotiations in the General Assembly of the Budapest municipality and the district assemblies. This leads to longstanding discussions and conflicts among districts and between districts and the municipality over the provision of services and their respective costs.

Figure 20 clearly shows that fund allocation schemes have been rendered every year since 1996. This applies also to other shared items such as the business tax, the most important source of revenue. As a result, this negotiation process

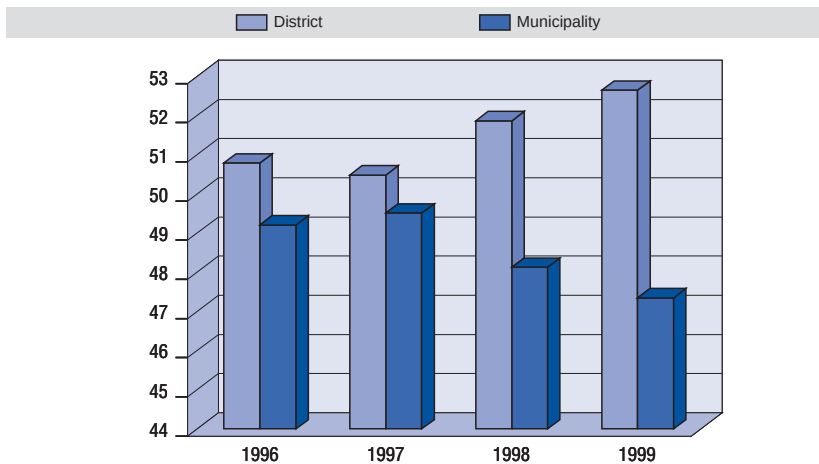
Table 26. **Fund-sharing between districts and municipality, 1999**

		Districts	Municipalities
Equalisation state grants shared	%	84.5	15.5
	total	4 350 991	800 308
Personal income tax transfers shared	%	60.9	39.1
	total	23 507 208	15 061 299
Business tax shared	%	39.91	60.1
	total	21 676 691	32 632 630
Additional funds ¹	%	54.3	45.7
	total	24 253 570	20 429 026
Vehicle tax	%	100.0	
	total	2 842 929	
Total funds reckoned with in fund sharing calculations	%	52.6	47.3
	total	76 631 389	68 923 263

1. Equalisation state grants linked to task and PIT indices. Values in HUF1 000.

Source: The Municipality of Budapest, 1999.

Figure 20. **Fund-sharing between districts and the municipality, 1996-99**
In percentage



Source: The Municipality of Budapest, 1999.

leads to unpredictable available funding and adversely affects the financial planning of both the districts and the municipality. While the municipal-district share is unpredictable, the PIT split between the local governments and the central state has also been changed since 1990. It decreased from 100 per cent in 1990, to 50 per cent in 1991, and to 30 per cent in 1993, until it was eventually increased to 35 per cent after central government negotiations in 1995, and to 40 per cent in 1998. The net PIT share of local governments, including Budapest, further decreased because the central government used PIT revenues to finance equalisation grants. The effective portion of PIT accounts for only 15 per cent in 1999 and was further reduced to 5 per cent in 2000.

Since 1997, received funding at the municipal level has tended to drop and the benefit of the districts has tended to rise. In addition, districts have been able to increase the amount of their own resources revenues in comparison to the municipality largely because, during the 1990s legislative reform, central state-owned public housing assets were transferred to the districts while the municipality received the seven state-owned public utilities (transport, water, sewage, garbage collection, gas, heating, public baths) which had significant negative net worth.

In sum, allocation of responsibilities somewhat interferes with negotiations on revenue sharing. Although the Act on Local Governments clearly defines the role of the municipalities and the districts, district-municipality tensions are high concerning everything from the allocation of responsibilities to load shedding. Both the negotiation process of responsibilities and revenue sharing and the horizontal nature of the decision-making mechanism cause a vicious circle. Dis-

Discussing the distribution of tasks and responsibilities is time-consuming, until the question finally shifts to revenue shares. As the revenue shares for taxes and grants depend strongly on the division of tasks and the costs attributed to them, the discussion again turns to responsibility allocation. This stalemate between the municipality and the districts results from the lack of clearly defined expenditure roles and responsibilities blocking political decision-making. It has retarded important infrastructure projects such as investments in schools or infrastructure such as industrial development zones to the south of the city for example (Ebel and Peter, 1996). The strong intra-metropolitan disagreements absorb political and financial resources and affect the city's ability to clearly express and push through municipal interests at regional or national level.

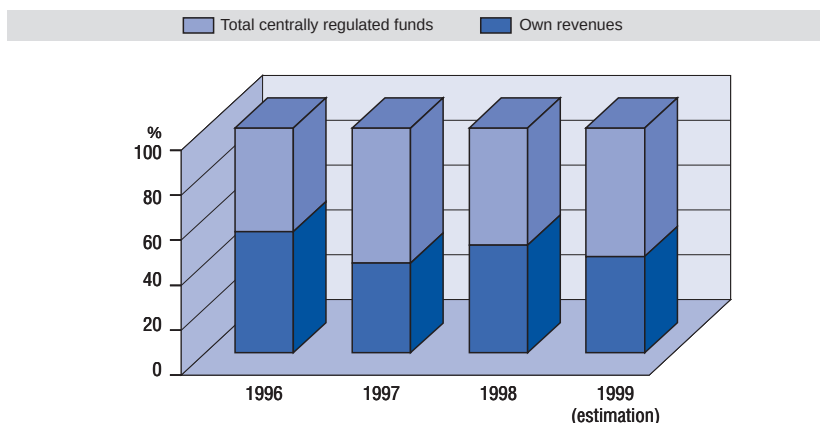
Nevertheless, despite the shortcomings of such a politically and administratively fragmented institutional setting, there are advantages to a decentralised city administration. In this respect, Budapest is almost unique in Europe. The districts give a large impetus to neighbourhood democracy, which better integrates people into the decision-making process and makes service provision more efficient. Some recent research indicates that the provision of public services can better be fulfilled by small entities because they set more incentives for citizens to participate in the political process and for government officials to be responsive to citizens' needs. That is, the partition into self-governing districts seems appropriate and advantageous. In addition, conflicts between government levels are somewhat common in a democracy. Centralised decision-making to a "super-municipal body" would probably conceal existing lines of conflicts and might lead to political under-representation of certain urban population groups.

Relations between the city and the central state

The financial relationship between the city (municipality and districts together) and the central government proves rather difficult. The central government, through the grant system, holds considerable power *vis-à-vis* lower government levels. Between 1994 and 1996, the central government reduced its share of normative grants to Budapest from 55 per cent to 20 per cent of the municipal budget. The share of the PIT dropped from 30 per cent to 10 per cent of the municipal budget. Since municipal and district tax-raising capacities remain limited, the city's own revenues did not keep up with this loss of intergovernmental transfers; central government somewhat squeezed the city budgets. Moreover, between 1996 and 1999, the ratio of all central government transfers to the total city budget changed significantly every year, although never in the same direction (Figure 21).

This unfavourable situation is exacerbated by the fact that the municipal and the central government belong to different political parties, a common occurrence in other metropolitan areas. The discretionary power of the central

Figure 21. **Central government grants to the municipality, 1996-99**
In percentage of total municipal revenues



Source: The Municipality of Budapest, 1999.

government to allocate financial resources works against the municipal authorities of Budapest.

The central government has no specific policy for urban areas as it does for rural areas. The economic success of urban areas and mainly Budapest is taken for granted; urban development or intra-metropolitan disparities are often regarded as a purely local problem. Urban policies of the central government are purely sectoral. Comprehensive policy approaches such as the National Regional Development Concept hardly take urban areas into account or treat them in a coherent way. Budapest is the only area to which the Regional Development Allocation grants no financial resources. It is often argued that a specific plan for Budapest would worsen disparities without considering that if the metropolitan area is neglected it will accumulate problems that depress its productivity. With regard to political programming, awareness of disparities in rural and urban areas is biased, which may eventually hamper the development of strong cities and towns. The Hungarian government will need to attend to the sustainable economic, social and environmental development of its only large metropolitan area.

Conclusions and recommendations

Budapest seems to have successfully managed the transition phase and is becoming a tertiary economy with a strong service sector typical of OECD metropolitan agglomerations. However, the capital's institutional setting creates two sets of problems that affect its capacity for sound and sustainable urban development. First, typical suburbanisation issues such as outmigration of residents to adjacent

municipalities and the resulting outflow of taxes poses additional financial burdens. Yet, the city has to cope with both rising expenditures such as increased transportation costs caused by more commuters, and with comparatively falling revenues that put pressure on its budget. New income sources such as a value-based property tax have not been identified yet on a larger scale. However, in the long run, only a tax on immobile sources will be able to compensate for other shrinking taxes and to assure revenues. By the same token, Budapest has to get involved in horizontal partnerships with adjacent or less proximate counties and towns to establish efficient co-operation and to reduce the load shedding so far practised by the agglomeration.

Second, the Hungarian capital fights a constant struggle with its districts over responsibilities and resource sharing. Those negotiations render long-term financial planning difficult because they alter the amount of funds received by the districts and the municipality and weaken the position of the capital city towards the central government. In addition, though Budapest receives more than 30 per cent of its budget from the state government, it lacks central financial and institutional

Recommendations at municipal level include the following

- *Rules rather than discretion in the district-municipal relationship.* The current discretionary negotiation mechanisms between the municipality and the districts should be replaced by rule-based procedures. Particular revenue should be shared according to a pre-determined, long-term split. Fixed shares should be introduced for the Personal Income Tax, the Business Tax and – if feasible – for central government subsidies. Changing the fixed percentage should be subject to a qualified majority in the assembly or to popular vote. The initial split can be made either according to historical averages or to the historical cost of services provided. Decisions on the revenue side will probably make it easier to find a consensus on the division of responsibilities.
- *Horizontal pacts and partnerships.* The Municipality of Budapest should set up, encourage, and become involved in horizontal partnerships with the surrounding agglomeration and other counties. Institutionally, the municipality should strengthen its ties with its agglomeration and try to set up specific collaboration forms with the suburban municipalities. It should demonstrate the advantages of such associations to suburban areas, and should find appropriate mechanisms that make them feasible for all participants, *i.e.*, extended co-determination and voting rights. An example concerns public transport. A commonly funded and managed association will not only improve the financial situation for the city but also improve the quality of transport services to the agglomeration and reduce the environmental impacts of transport. In general, Budapest could help propagating the philosophy and culture of horizontal collaboration as an alternative to both isolated and insufficient local decision-making or central government intervention.

Recommendations at central level include the following

- *Foster horizontal co-operation in metropolitan areas through incentives.* This can be done either through adapting the law on inter-municipal partnerships to metropolitan areas, or through a new piece of legislation. New legislation should also include horizontal co-operation between counties. Incentives can be given either through direct financial incentives or investment grants contingent on inter-municipal or inter-county collaboration. Minimal rules should be defined to make those partnerships efficient and accountable to the citizenry.
- *Reform the fiscal framework.* The central government should set up a framework for a value-based property tax, given that its introduction is among the priorities of the municipality. This will allow Budapest and the districts to have their own strong fiscal base that will also compensate for decreasing personal income or business taxes. Central government should define the framework for the tax base, however – since this is a local tax – and leave the decision on tax rates to the respective municipality and districts. More generally, municipal dependency on intergovernmental grants should be reduced as should, within the remaining grants, the percentage of specific and non-automated grants. Furthermore, the central government should adapt the intergovernmental transfer system, taking into account specific cost or burden borne by central cities (*e.g.*, adapting the grants for social welfare).
- *Strengthen an intermediate government level.* In the case of Budapest, this level should be able to facilitate intra-agglomeration negotiations on common policy programmes and implementation mechanism and reduce transaction costs. The Budapest municipality (in fact, a county) would be faced with territorial partners at the same level institutionally, and the numerous individual negotiations with single municipalities could gradually be replaced by a few essential partnerships.

support that would enable it to provide for certain country-wide public services and to establish a horizontal co-operation framework with its urban agglomeration.

Besides policy programmes like urban renewal, it is possible to formulate some recommendations on institutional and territorial governance issues at the municipal and the central levels aimed at providing them with sufficient, reliable and predictable resources of their own with which to realise their own development policies.

Policies for urban areas should be centred on increasing the ability of the city to manage its own tasks and to have access to its own resources. They should facilitate and promote intergovernmental co-operation mainly with the surrounding areas and should regularise, automate and make the relationship between the central government and the city of Budapest pragmatic.

Put more generally, the Hungarian government should develop a policy on urban areas like it did on rural areas. It should clarify and stabilise the institutional framework of regional development planning and regional development policy in urban areas. It should address the obvious complementarity of the relations between Budapest and the adjacent municipalities in the neighbouring county of Pest. This urban policy should concentrate on enabling metropolitan areas to drive economic growth and social cohesion. It should remove institutional and financial obstacles that prevent cities from making use of their specific advantages. It should strengthen the coherence of intra-metropolitan policy-making without destroying the benefits of the decentralisation process of the 1990s. It should concentrate on intra-metropolitan disparities and their institutional background. Finally, it should promote the metropolitan areas' capacity and resources to provide adequate public services for its citizens in the wider agglomeration.

GLOSSARY

AEP	The Agri-Environment Programme.
ALMP	Active Labour Market Policies.
BKV	(Budapesti Közlekedési Vállalat) – Budapest Transport Company.
CCT	Addressed and earmarked support programme.
CDC	County Development Councils.
CEDA	Target oriented decentralised assistance.
CEE/CEEC	Central and Eastern European countries.
CFCU	Central Finance and Contract Unit.
CLC	Country Labour Centres.
CMEA	Council for Mutual Economic Assistance.
CFZ	Custom Free Zones.
DGF	<i>Dotation Générale de Fonctionnement</i> .
EAGGF	EU Agricultural Fund.
EBRD	The European Bank for Reconstruction and Development.
ECMT	European Conference of Ministers of Transport.
EU	European Union.
FDI	Foreign Direct Investment.
FSZKT	A structure plan and a frame regulation on urban planning for Budapest.
HDI	The UNDP Human Development Index.
HUF	Hungarian Forints.
HSCO	Hungarian Central Statistical Office.
IMF	International Monetary Fund.
IRP	Integrated Regional Programme.
INTERREG	EU Interregional Programme.
ISE	Institute of Small Enterprises.
ISPA	Strategic instruments for a EU co-financed pre-adhesion programme for large transport and environmental infrastructure.
LEA	Local Enterprise Agency.
LLMA	Local Labour Market Areas.
MARD	Ministry of Agriculture and Regional Development.
MATAV	National Telecommunications Company.
MAV	National Railway Company.
MFSA	Ministry of Social and Family Affairs.
ME	Ministry of Economy.
MTWM	The Ministry of Transport and Water Management.
MVA	Hungarian Foundation for Enterprise Promotion.
NCE	Hungarian National Council of Environment.
NRDC	National Regional Development Council.

OSCE	Organisation for Security and Co-operation in Europe.
OTP	National Savings Bank.
PAYG	Pay-As-You-Go.
PES	Public Employment Service.
PHARE	Poland-Hungary Aid for Reconstruction of the Economy programme.
PHARE CBC	PHARE Cross Border Co-operation programme.
PHARE MCS	PHARE PHARE Micro-Credit Scheme.
PLS	PHARE Loan Scheme.
PNDP	The Preliminary National Development Plan.
PPP	Purchasing Power Parity.
RDA	Regional Development Agency.
RDC	Regional Development Council.
RDF	Regional Development Fund (1992 to 1996). The former name for the Regional Development Allocation.
SAPARD	EU co-financed pre-adhesion strategic programme for agriculture and rural development.
TDPC	OECD Territorial Development Policy Committee.
TEKI	Spatial equalisation support programme.
TFC	Regional development allocation.
UNDP	United Nations Development Programme.
VFC	Rural development allocation programme.
VOLANBUSZ	Interurban coaches.
VET Fund	Vocational Education Training.
WBI	World Bank Institute.

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