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REGULATORY TRANSFORMATION IN HUNGARY, 1989–98

CASE STUDIES ON REFORM IMPLEMENTATION EXPERIENCE

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EXECUTIVE SUMMARY

Among the most difficult challenges facing governments is designing, implementing, and sustaining government-wide, multiyear economic and regulatory reforms. Better outcomes are likely if governments understand the institutional and political economy mechanisms of successful reforms elsewhere. This paper analyzes and draws lessons from Hungary's implementation of broad regulatory reforms in 1989–98 as part of its unprecedented structural metamorphosis. These efforts culminated at the end of 1997 with recognition by the European Union (EU) that Hungary had become a functioning market economy.

The focus of this case study is not on the content of the reforms, but on the events, strategies, and stakeholders that shaped structural reform efforts. The reforms had a broad scope consistent with international consensus on how to approach regulatory reform—that is, by improving the instruments, processes, and institutions of all forms of regulation through integrated strategies of deregulation, re-regulation, and enhanced capacity for higher-quality regulation that meet social needs and are consistent with open, competitive markets.

Hungary's transition was one of the most successful in Central and Eastern Europe. Reforms led to a flood of foreign direct investment. A robust private export sector has emerged. And solid economic growth and low unemployment are helping the country meet EU benchmarks. This performance is due to the efforts of successive administrations that, even before the 1989 change in regime, pursued structural and regulatory reforms as well as prudent macroeconomic policies.

Hungary began its transition with significant advantages over other Eastern European countries—namely, higher living standards and more market-oriented economic policies. Soon after the change in regime the country undertook a major adjustment that included bold market opening, price liberalization, and structural reforms, as well as stabilization measures. But by the mid-1990s macroeconomic performance had deteriorated, and unsustainable current account and fiscal deficits had reemerged. The country responded with a second round of deep, far-reaching reforms that included more aggressive regulatory reforms, including the famous "guillotine" processes.

Lessons from Hungarian reforms that are relevant to other countries are summarized below.

Success Factors

- Democratic change and respect for the rule of law provided political and social mechanisms that prevented a violent backlash, which could have caused a reversal in economic policy—and a crisis.

- The timing and sequencing of reforms—starting with market openness and later driven by the far more stringent requirements of EU accession—contributed to Hungary's successful transition. Opening markets played a vital role in anchoring structural and regulatory reforms. Modernization of the state apparatus came after structural reform.

- Commitment to reform by the highest levels of government was vital to changing the perceptions of foreign investors and lenders.

- Reforms were strengthened by careful adaptation of inherited and accepted institutions. International models were adjusted to Hungary's situation using existing legal and administrative frameworks.

- Economic reforms were more successful when driven by the center, but institutional reforms were more successful when supported by decentralized consensus, with ownership-building efforts led by ministries. One key to success was the flexibility of Hungarian reforms in adapting to different political economy incentives for reform.

- Government commissioners drove reforms but lacked the institutional and legal backing to implement and sustain them. Hungary's approach to interministerial reform gave commissioners direct access to the highest level of government and provided them with consultative bodies and specialized staff. Although this approach was successful in driving two guillotine processes, more permanent institutions were needed to institutionalize good regulation habits in the public administration.

- An active competition office was an influential driver of reform implementation, playing a vital role in advocating regulatory reforms and blocking distorting measures.

- Comprehensive, time-bound reviews of regulations expedited deregulation and re-regulation. The courageous guillotine system eliminated obsolete regulations in just a couple months. Still, policy aimed at sustainable changes in regulatory habits tends to take decades, not years, to produce results.

Shortcomings

- A focus on correcting old regulations missed an opportunity to reinforce the economic rationale for the emerging regulatory framework, which required longer-term institutional reforms.

- It was easier to control the stock than the flow of regulations, as shown by repeated failures to introduce regulatory impact analysis. Efforts to deregulate show that improving the stock without checking the flow of new regulations raises long-term costs and does not sustainably improve the business environment.

- Speed was important for some economic reforms, but more time is needed when reforming and building institutions. Some of the most important reforms involved transforming the legal and institutional setup required for markets to function. Such reforms require longer, more consensual approaches.

1. CONTEXT OF REFORMS

Between 1989 and 1998, Hungary moved to create a market-based economy by fundamentally reorienting the institutions and legal regimes built for socialist economic policies after World War II. During this period, Hungarian society also embraced the development of a more open, democratic political system. These dual goals—market economics and democracy—framed Hungary's balanced, pragmatic approach to reforms. From the start the new roles expected of the state in upholding procedural values, such as respect for the rule of law and consultation with stakeholders, were pursued simultaneously with aggressive reforms aimed at increasing economic growth.

These reforms did not happen in a vacuum: the command and control economy was on its way out before 1989. By the 1970s, an economic policy known as "goulash communism" (which relied heavily on money borrowed from foreign countries) had transformed Hungary into the most advanced country in the Soviet bloc in terms of living standards. But large foreign debt and rising inflation and unemployment led to public discontent with the government. As a result, a group of reformers took power in the mid-1980s.

These communist reformers made cautious but significant changes that laid the foundations for a market economy.[1] In particular, they began using financial and monetary instruments in place of fixed controls on production, wages, and prices. Other important reforms included modernizing the commercial code, enacting a competition law, developing the tax system, formalizing legislative and rulemaking processes, and passing laws on companies, capital markets, and foreign investments.

Nonetheless, by the end of the decade the soft transition model was encountering problems and contradictions. "Semi-markets" did not provide enough incentives and information to producers and consumers. Distorted economic

1 In 1982, the government announced that Hungarians were free to travel to the West. That same year, Hungary joined the International Monetary Fund and the World Bank.

decisions at lower levels—such as party decisions on state enterprise investments and human resource policies—were accumulating into macroeconomic problems. In addition, the government decided to control unemployment by taking on debt, which grew alarmingly during the 1980s. Inflation spiraled to double digits, and the melding of the party and government created enormous opportunities for rent seeking and corruption. By 1988 the macroeconomic situation had become very serious, and the government had little room to maneuver. In 1989, as external conditions changed, Hungary entered a new phase in its reforms.

2. CONTENT OF REFORMS

As noted, economic transformation had already begun before the political upheaval of 1989. But during the following decade, in negotiated and pragmatic ways—sometimes measured, sometimes bold—the legal and regulatory framework was almost completely transformed, changing the business environment entirely.

Goals

Although an overall blueprint for reform was never made explicit, policymakers pursued a clear goal of converging as quickly as possible with the Western European economic and social model, and ultimately joining the European Union. Policy and institutional reforms, including constitutional amendments, consistently focused on building a market economy and establishing democracy and the rule of law. Hungary was guided by historical traditions, since its new order was based on the structures of its pre-socialist civil law system, which was similar to those of Austria and Germany.

Economic and institutional reforms involved mutually reinforcing policies, including market openness, privatization, liberalization, deregulation, re-regulation, and institution building across all organs of the state.[2] The search for a better approach to reforms required a constant and difficult balancing between less intervention and better intervention (as well as intervention in new areas). But while reform efforts fluctuated, they never stopped. Administrations from different political parties were consistent in their commitment to achieving the European model and joining the European Union.

Reforms at a Glance

Major changes came in two main waves separated by a calmer period (during which there was some backtracking). The calmer period seemed to reflect social consensus on the need to consolidate and regroup, with almost no one advocating radical reforms during that time.

2 Hungary also experienced other transformational reforms not analyzed in this paper, including a major decentralization process started in the early 1990s, civil service reform, and a new power sharing mechanism between branches of the state.

The First Wave: The Great Adjustment, 1989–90

In 1987 the government began privatizing restaurants and commercial outlets. These reforms were spearheaded by a group of reformists who took over the Communist Party Politburo. In 1988 the party created the Reform Committee, which developed a reform program calling for Hungary to adopt a self-regulating market economy based on private ownership and reorientation toward the West. The government ensured representation across the political spectrum within the committee.

In early 1989, confronted by serious economic problems and major political changes throughout Eastern and Central Europe, the government accelerated reforms. As a result of historic meetings that summer, the National Assembly—under the guidance of Communist Party—made fundamental changes to the Constitution in October 1989. Regime change was complete. Within a few weeks the government launched the Great Adjustment with comprehensive policy reforms based on two pillars: structural change and legal and institutional renewal.

To manage the structural reforms, the government restored the powerful Reform Committee, supported by two subcommittees—one working on market openness and the other on general economic policies. A dozen advisers were appointed to assist the head of the committee and managed to circumvent the formal hierarchy. The National Price Office also played a prominent role in analyzing, designing, and implementing reforms.

The structural reforms were grouped into three comprehensive packages that amounted to economic shock therapy:

- Market openness, ending four decades of command and control economic regimes.
- Price and trade liberalization, including major deregulation of economic interventions, a revamped tax system, establishment of a stock exchange, and creation of a market-based banking system.
- Massive privatization of means of production (Box 1).

The second pillar of the Great Adjustment called for the "de-communization" of the legal framework, introduction of institutions needed to secure democracy and the rule of law, and launch of the complex transformation of the state and administrative apparatus. To achieve these goals, the government assigned two high-level commissioners to manage a comprehensive legal and regulatory improvement program based partly on the deregulation experiences of the United Kingdom, United States, and other countries in the 1980s. These efforts were split between the newly created Economic Deregulation Council and Public Administration Deregulation Council. The Office of the Council of Ministers provided administrative support to the former, and the Ministry of Interior to the latter. The Office of the Council of Ministers paid the costs of consultants for both.

In less than two years (spanning a change in administration), the two commissioners created a new legal and regulatory order based on the revised Constitution, which clarified and limited the use of subordinate regulations (those at the level of government decrees). In particular, a massive "guillotine" review eliminated outdated and unneeded regulations and deregulated the remaining legal framework as much as possible (Box 2). The core idea guiding this approach was that measures not explicitly justified after a six-month review were automatically abolished.

In managing reforms, the main difficulty involved building a well-functioning, sustainable legal framework. Deregulating economic regimes was easier than building the social, civil, and administrative institutions and frameworks needed for a rule-based economy. The adoption and adaptation of economic rules, procedures, and systems could be based on international precedents, consensus was easier to achieve, and legal implementation was simpler. By contrast, the establishment and functioning of new democratic institutions required political consensus for every major decision, and so took much longer.

BOX 1

Privatization in Hungary

In Hungary privatization was a steady process that started in 1987, slowed somewhat before and immediately after the 1994 elections, and picked up again in 1995. By then the government had liquidated more than half of the over 2,000 enterprises it owned previously. Privatization of apartments and small and medium-size enterprises occurred quickly, and sales of farms were largely complete by 1994. By contrast, privatization of industry proceeded unevenly, and little was done until 2002 to privatize the largest state enterprises and network companies.

Most privatization involved direct sales of assets through management buyouts and employee stock ownership plans. In addition, restoration in kind and restitution through transferable securities played a limited role. Negotiated mechanisms made the process slower to start than in other countries, where mass privatization and "big bang" strategies were in vogue. A particular difficulty involved "sales" of land to local governments where the central government negotiated the transfers using complex structures and procedures.

The direct sales method ending up favoring foreign investors. Still, the privatization program managed to transfer assets to genuine private interests rather than institutional owners. Selling to private owners was important for strengthening corporate governance, entrepreneurial incentives, and the middle class.

In 1997 private firms accounted for nearly 80 percent of GDP. By the end of the 1990s almost three-quarters of the country's assets were in private hands, with nearly 40 percent held by domestic investors and the rest by foreign investors. The central government held 16 percent of assets, local governments 9 percent, and other nonprivate institutions 2 percent.

Source: Voszka 1999; OECD 2000.

Altogether, more than 150 laws and regulations were eliminated or modified under the first guillotine review (using a special omnibus law, the Deregulation Act of 1990). A series of Ministerial Council decrees did the same for superfluous or harmful subordinate regulations. But this first systemic review did not address the economic soundness of laws and regulations. As a result, the deregulation process dismantled regulatory requirements and bureaucracies instead of modernizing economic regulations.

Still, other structural reforms greatly modified the economic and business environments. Liberalizing trade and inviting foreign investment were probably the most important policy changes in stimulating the development of a competitive market culture (Kovács and Szábo 1997).

A Slowdown, 1990–94

After the 1990 elections, József Antall's administration slowed the impetus for reform, and focused on implementing reforms and building institutions. The deceleration in economic reforms and privatization was linked to a social backlash. Structural reforms and privatization were creating hardships for citizens, workers, and firms. Cuts in subsidies led to higher prices for food, medicine, transportation, and energy. Reduced exports to the former Soviet bloc and shrinking industrial output contributed to a sharp drop in GDP. Privatization and restructuring also increased unemployment, which reached about 12 percent in 1993. In addition, a damaging taxi drivers' blockade destabilized the government. In response, in 1991 the government launched a program to stimulate the economy using an artificial squeeze on interest rates.

Despite the slowdown in reforms, this period brought important legal and regulatory changes because many existing measures had to be adapted to the new constitutional order and economic framework implemented during the previous phase. The period also provided an unexpected, beneficial chance to increase the bureaucracy's support for reforms. A broader sense of ownership developed, underpinning the sustainability of key institutional reforms, because

BOX 2

The Guillotine: Reforming Hungary's Regulatory Framework

During its two main waves of reforms Hungary experimented with a range of methods for reviewing the extensive regulations that had accumulated over four decades of socialist economics. These can be divided into systematic and special reviews.

Systematic reviews embraced a complete, itemized assessment of the entire stock of regulations. The first such review occurred in 1989–90 and focused on removing elements of the previous regime from laws, subordinate regulations (such as government decrees), quasi regulations (such as guidelines), and local measures. A second review, in 1994–95, had more ambitious goals—including improving the efficiency and effectiveness of the public administration.

Both reviews took a guillotine approach, which involves automatic repeal after a prescribed period of targeted measures that cannot be justified by a line ministry to a challenging body. In Hungary the challenging body was made up of commissioners responsible for deregulation (two for the first review, one for the second). The guillotine reviews proceeded as follows:

- The Ministry of Justice prepared an inventory of existing laws and regulations.
- Based on this inventory, line ministries presented commissioners with detailed schedules covering the preceding period. (The first review assessed laws and regulations in place before 30 June 1990; the second covered laws and regulations enacted after that date.) The ministries indicated which measures should be maintained and why, and which could be repealed or amended. If ministries proposed amendments, they had to provide draft legal text. Special justification was required to maintain any regulations enacted before October 1989.
- Commissioners and their teams evaluated regulations based on set criteria and could recommend rejecting ministry proposals or ask for further analysis.
- The Ministry of Justice prepared a "deregulation instrument"—to be issued by the government and presented to the Parliament—listing regulations to be abrogated.

The results of the two guillotine reviews were significant, particularly in terms of deregulation of subordinate regulations. But in some cases the deregulation was too sweeping, as it created a legal vacuum and practical problems for implementation.

Another type of systematic review, in 1997, involved listing all authorizations and licenses affecting 10 key sectors. The commissioners assessed each authorization in an effort to transform it into a notification, reduce authorities' response time, decentralize it to local governments, replace it with a self-regulation scheme enforced by business organizations, or supplant it with performance standards.

The government also used special sectoral and policy reviews, based on expert opinions and focusing on particular topics. The most important were:

- Reviews proposed by independent experts selected by the commissioners. The experts also proposed regulatory solutions.
- A national consultation on deregulation suggestions organized in 1995. A country-wide media campaign collected opinions of enforcers, entrepreneurs, and citizens, then presented them at a meeting attended by the prime minister and the press.
- Brainstorming sessions with senior lawyers, representatives of chambers of commerce and industry, and domestic and foreign businesspeople.
- A review of several hundred municipal rules and regulations.

of discussions in Parliament and because the design and implementation of reforms were assumed by line ministers who solicited cooperation from civil society and market players.

Moreover, the Antall administration succeeded in building consensus on key non-economic reforms and supervising active institution building that anchored democracy and the rule of law. These efforts were presented as a necessary re-regulation of a "gangster" capitalism that was supposedly emerging in the poorly regulated market. Especially important was the enactment of framework laws like the Bankruptcy Act (1991), Privatization Act (1991), Administrative Jurisdiction Act (1991), Civil Service Act (1992), and Parliamentary Ombudsman for Civic Rights Act (1993). The government also initiated an ambitious decentralization initiative that continued in following administrations (Local Self-Government Act of 1990).

In addition, central framework institutions such as the Ombudsman and the Audit Office were reestablished or recreated. This period also saw the development and strengthening of pivotal bodies such as the Hungarian Competition Office, which replaced the National Price Office in 1991 and played a crucial role in the 1990s (Box 3). This office was a key advocate of reform, explicitly and implicitly. It focused on economic regulations—specifically, the legal framework for markets after privatization. Institutionalization of the office's advice during rulemaking procedures was crucial to blocking the most burdensome proposals from line ministries and agencies. The competition office also participated indirectly in the two guillotine reviews.

Despite having less reform momentum, the government also continued to advance economic reform. The intellectual engine of such reform emerged as a standing Economic Commission

BOX 3

The Role of the Hungarian Competition Office

Hungary's competition policies and institutions are in line with the practices of OECD countries. Indeed, competition policy—as measured by the status and independence of the competition agency—is stronger in Hungary than in many countries.

The Hungarian Competition Office is active, well-staffed, and widely respected in the government and the private sector. The head of this independent office has ministerial rank and direct access to policy discussions at the highest levels. (In most OECD countries the top official for competition policy does not have ministerial rank.) The office also has the power to challenge in court anticompetitive actions by other public agencies. Although the office has never used that power, the threat probably increases its clout in policymaking.

The competition office is in charge of traditional competition policy tasks, ensuring that:

- Horizontal agreements do not allow groups of firms to achieve attributes of monopoly, such as raising prices, limiting output, or preventing entry or innovation.
- Vertical agreements do not allow exclusive control over distribution or allow firms to dominate sectors or become monopolies.
- Mergers are not used, through acquisitions or other structural combinations, to exercise market power.

The office is required to be active in advocating competition through reviews of draft laws and regulations. Its advice should be sought on all draft proposals or legislation that could restrict competition, grant exclusive rights, or regulate prices or terms of sales. From an early stage, the office became active in reporting constraints on competition in existing regulations and participating in the government's policy development process, despite its independent status. The office was particularly influential during privatization.

Source: OECD 2000, ch. 3.

headed by the minister of finance. Commission members included ministers primarily responsible for economic matters and two observers: the heads of the National Bank of Hungary and the Hungarian Competition Office.

Aside from the social backlash, one reason reform efforts dissipated during this period was for lack of an institution with a clear mandate to drive them. Despite an array of market-based bodies like the competition office, no institution or senior official was responsible and accountable for promoting and coordinating reform efforts. An effort to develop such an official for regulatory reform was made in 1992, when the minister of justice was mandated to implement a modernization program for the public administration, including a simplification plan for administrative procedures. In addition, two advisory bodies that supported the government—the Blue Ribbon Commission and a consultative body of national and international experts intended to create an action plan for economic policy—failed to influence decisionmaking.

Aside from the conclusion in 1991 of market-opening reforms, most significant reforms during this period were sectoral rather than systemic. But even the sectoral reforms were often incomplete, due to weaknesses in national and municipal administrative capacity, unresolved political conflicts about policy goals, and competing institutional interests within the government. The result was incoherent regulatory policy. Legal and regulatory reforms were often changed or undercut by ad hoc political interventions. Reform proposals from the minister of finance were systematically opposed by other members of the Cabinet, who feared social unrest. Even when reforms were adopted, implementation often deviated from stated goals. Wide variation in the application of new laws and regulations increased business insecurity. And after the minister of finance was demoted, economic reforms nearly came to a halt.[3]

3 In September 1993 the International Monetary Fund suspended a standby loan for lack of progress on structural reforms.

Despite the government's stimulus package, the economy did not improve. Indeed, declining output and rising social transfer costs led to political and social pressures to further slow reforms. A vicious cycle emerged in which reforms were blamed for lack of economic progress, further slowing them and further undermining the transition.

The durability of the Antall administration gradually eroded, and the Cabinet became plagued by internal divisions and falling popularity. Antall's death in December 1993 symbolized the end of his administration. (Péter Boross carried out the rest of Antall's term, through July 1994.) In response to social pressures nurtured by corruption scandals, the political pendulum shifted again to the center-left party. The costs of government overspending and hesitant privatization had become clearly visible. And Hungary's external debt, among the highest in Europe, reached 250 percent of annual export earnings, while budget and current account deficits approached 10 percent of GDP. Antall's party lost the spring 1994 election.

The Second Wave, 1994–98

The new administration of Prime Minister Gyula Horn did not bring an immediate reversal in reform momentum. For the first few months the government maintained the previous approach, hewing to conservative lobbies. But international pressures and continuing macroeconomic deterioration forced a second wave of radical reforms (Csaba 1998).

In 1995 the government implemented an austerity program—known as the Bokros package—secretly prepared by Minister of Finance Lakos Bokros.[4] (The secrecy was mostly due to the need to prepare a surprise devaluation of the forint.) The package had macroeconomic and microeconomic components. Reforms focused on economic effectiveness and efficiency, which were able to once again take center stage because the basics of

4 The secrecy was mostly due to the need to prepare a surprise devaluation of the forint.

democracy and the rule of law were in place. The policy emphasized attracting strategic foreign direct investment in energy, telecommunications, transportation, and banking (OECD 2000).

The package coupled aggressive privatization of state enterprises with an export-promoting exchange rate regime to reduce debt, with the goals of cutting the current account deficit and shrinking public spending. To advance institutional and administrative reform, and as part of the austerity measures, the government reorganized executive bodies and agencies. Institutions were merged and privatization accelerated.

The government also made the reform process more coherent by recentralizing policymaking in a strengthened prime minister's office. Prime Minister Horn managed the austerity package himself, and assigned responsibility for regulatory reform to a single Commissioner for Public Administration, Imre Verebélyi, supported by a strong Deregulation Council. The commissioner's power grew as the prime minister charged him with making a 15 percent cut in the civil service. However, no specific coordination was established between the commissioner and the Ministry of Finance taskforce overseeing the Bokros package.

Commissioner Verebélyi's agenda included tackling the negative results of earlier reforms. As noted, initial zeal in deregulation created gaps in market rules that encouraged abuses. The business environment had to be regulated to distinguish between entrepreneurial and criminal activities. As part of his efforts to do this, the commissioner launched a second guillotine review (see Box 2). He also introduced an initiative to help local governments review and reform their decrees and resolutions, and with help from several think tanks prepared directives and methods for that purpose.

Verebélyi also initiated the first systematic effort to improve regulatory management and quality control—in particular, ex ante assessment of the potential impacts of regulations. But efforts at regulatory impact analysis did not prosper. They were too complex, a common failing of first-time regulatory impact analysis initiatives by well-meaning reformers. Too few incentives were built into the scheme, which was based on top-down mandatory requirements and highly theoretical guidance materials. The system could not overcome resistance and skepticism from entrenched legal departments in line ministries.

On the other hand, an important success of Commissioner Verebélyi was a drastic control, simplification, and reduction of licenses, authorizations, and permits. Modifications to the Administrative Procedure Law tightened rules requiring prompt decisions on submissions and applications. In addition, a useful program of one-stop shops was initiated.

These regulatory reforms were paralleled by major structural reforms in 1996–97, such as implementation of a fully funded pension system, reform of higher education, and creation of a national treasury. In 1997, the government asked Commissioner Verebélyi to start focusing on adopting EU legislation to support the path to a 1998 agreement to launch an EU accession process for Hungary.

The overall results of these reforms were positive, though the governing party ending up losing the 1998 elections. In particular, the Bokros package was an economic success. After Hungary's GDP dropped about 18 percent between 1990 and 1993 and grew only 1.0–1.5 percent a year through 1996, strong export performance propelled GDP growth to 4.4 percent in 1997. Other macroeconomic indicators were similarly improved. By the end of 1997 the consolidated public sector deficit had decreased to 4.6 percent of GDP, with public sector spending falling to less than 50 percent of GDP. The current account deficit was reduced to 2 percent of GDP, and government debt was paid down to 94 percent of annual export earnings. The return of macroeconomic stability enabled microeconomic reforms—regulatory reforms being the most important—to produce more benefits as the private sector began to grow strong again.

The 1998 elections brought back a central-right party led by Prime Minister Viktor Orban. Though many reforms continued—driven by the EU accession process—the government slowed their pace and launched some unhelpful populist economic initiatives. In particular, privatization slowed significantly and some nationalizations were carried out. A central focus of reform became accelerating and completing Hungary's decentralization. The government also raised wages and favored domestic over multinational companies.

Between 2002 and 2004, the administration of Péter Medgyessy pushed again for free market reforms and relaunched some privatizations of banks. Many observers have suggested that Medgyessy was trying to match the gains of the 1994–98 reforms, for which he was one of the architects.

Impact of Reforms

Between 1989 and 1998, Hungary underwent a fundamental economic and social transformation. A pillar of this transformation was the definition of a new role for the state, which evolved from an interventionist, command and control approach toward a steering, motivating role consistent with a market-based democracy. The transformation provided important economic benefits, and since spring 2004 Hungary has been among the new EU members best prepared to integrate, compete, and flourish in the European Union.[5]

General Economic Performance

Until the 1989 regime change, 65 percent of Hungary's trade was with other Soviet bloc countries. By the end of 1997, Hungary had shifted much of its trade to the West, with EU countries accounting for more than 70 percent and OECD members for 80 percent. Germany became Hungary's largest trade partner. The United States was its 6th largest export market, while Hungary was the 72nd largest export market for the United States. Bilateral trade between the two countries increased 46 percent in 1997, reaching more than $1 billion.

A dramatic increase in foreign direct investment was key to Hungary's transition economy. Between 1990 and 1998 it was the largest recipient of such investment in Central Europe (relative to GDP; Figure 1). With about $18 billion in foreign direct investment since 1989, Hungary attracted more than a third of all such investment in Central and Eastern Europe, including the former Soviet Union. Foreign capital was attracted by the country's skilled and relatively cheap labor, tax incentives, location, and decent transportation and telecommunications.

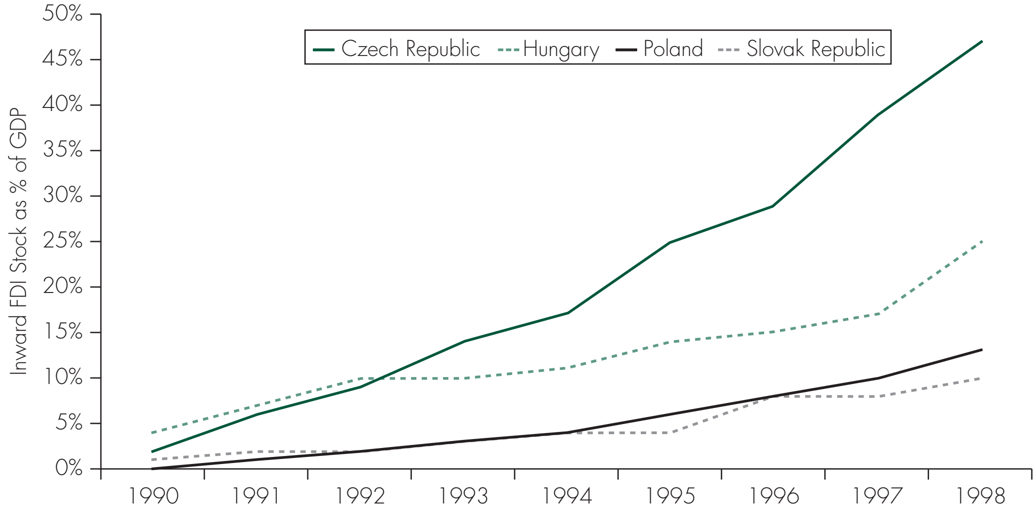
Reforms also improved the business climate for domestic firms. As a result of privatization, liberalization, and deregulation, the private sector generated 85 percent of GDP by the late 1990s—a larger share than in many OECD countries. Private investment grew by an annual average of 9 percent at the end of that decade, led by industrial investment. Domestic capital accumulation increased. And services as a share of GDP increased from 55 percent in 1990 to 63 percent in 1994 (Berend 2001).

In addition, reforms revitalized and promoted business-like behavior and entrepreneurialism. Hundreds of thousands of new enterprises emerged, most family-owned. Businesses became an important constituency favoring reform. Small and medium-size enterprises became the engine of economic growth and a major factor in economic restructuring. By the mid-1990s, growth in employment at such enterprises started to compensate for the heavy job losses caused by market openness, liberalization, and privatization. Employment levels stabilized in 1997 and increased slightly in 1998 (Bagó 2000). By 2000, employment had risen to 2,718,000, and firms with fewer than 50 employees accounted for half of GDP and three-quarters of employment.

5 According to Berend (2001), the transition will be over when the transforming countries achieve the economic level of the least developed EU members. The International Monetary Fund has projected that, if Hungary sustains annual growth of 4.5–6.0 percent (against an assumed 3 percent in low-income EU countries), it will take 20–25 years to reach that level.

FIGURE 1

Foreign Direct Investment in Four Central European Countries, 1990–98



Source: UNCTAD Database.

Specific Impacts

The two systematic (guillotine) reviews of laws and regulations led Hungary to construct an almost entirely new legal framework. By 1998 the country's regulations had reached a higher standard than those of neighboring countries—a trend that has continued since (Figure 2).

Regulatory reforms aimed at creating and securing the rule of law became a major political investment, as they became a precondition for Hungary's EU membership. Subsequent administrations strived to comply with the so-called Copenhagen criteria—institutional and rule of law standards set by the European Union that had favorable repercussions for economic and structural reforms.

Hungary was also quite successful in its deregulation efforts, particularly the use of the two guillotine processes. The reviews eliminated an impressive amount of legal deadweight and reduced discretion in the application of many regulations, and so minimized opportunities for abuse and corruption. Three deregulation legal measures led to the abrogation of several hundred laws. Successive reforms included the elimination of laws, central government decrees and resolutions, and ministerial regulations in 1995, elimination and reform of international agreements and directives of state secretaries in 1997, and elimination of more than 220 other laws in 1998.

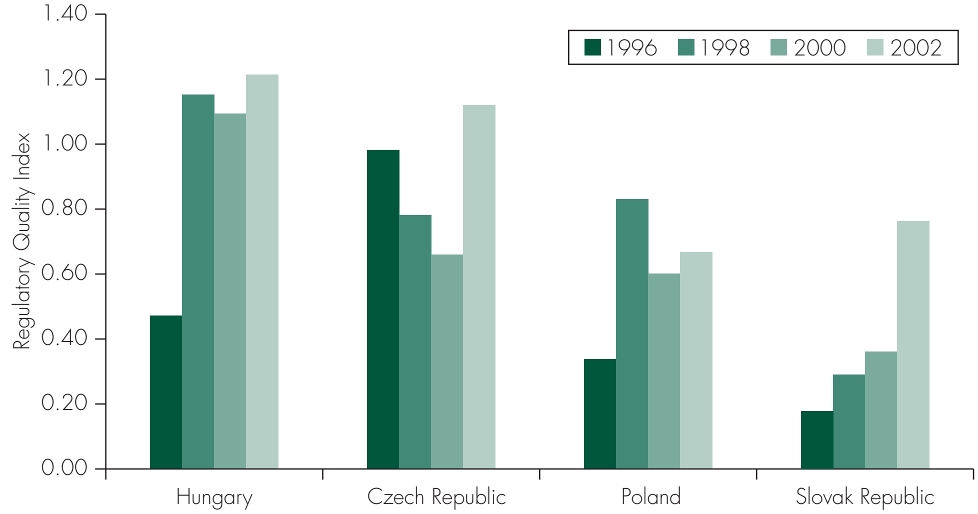
The simplification program launched during the Horn administration also eased administrative burdens. Although no evaluation has been made of the impact of licensing reforms, part of the impact was due to a 15 percent downsizing of the civil service in 1995. In addition, successive initiatives (formal and informal) enhanced the openness of government procedures. Public participation and consultation on rulemaking became common across the administration, and in 2000 became mandatory.

Still, these achievements cannot mask two major weaknesses that remain partly unresolved:

- Although the legal and regulatory reviews reduced many measures (and eliminated underpinning communist rules), they did not change the economic substance of remaining measures that were often far more important.

FIGURE 2

Regulatory Quality in Four Central European Countries, 1996–2002



Source: Kaufmann, Kraay, and Mastruzze 2003.

Some ministries eliminated trivial measures that were not used, but maintained other regulations that were more costly for businesses and society.

- Despite several efforts by the government and the commissioner in charge of emerging regulatory policy, the establishment of an empirical approach to developing new laws and rules repeatedly failed. Though in theory regulatory impact analysis was required, in practice it was not conducted in 1989–90 or 1990–94 (for the guillotine reviews).[6] Similarly, regulators used regulatory impact analysis only occasionally during 1994–97. In 1997–98, just seven draft laws were accompanied by quantitative justifications. Such analysis was conducted mostly on nonurgent measures not involving political resistance. Implementation of reform proposals, and specifically of regulator impact analysis, also suffered from a shortfall of analytical techniques and capacity in ministries.

Nevertheless, the constant push for economic and institutional improvements changed perceptions of Hungarian markets among foreign and domestic investors. Deregulation and market liberalization produced a more competitive economy and shaped a more entrepreneur-friendly environment. For instance, the 1995 Bokros package and its structural and institutional reforms galvanized national and international markets.

These promising efforts notwithstanding, Hungary had not finalized reforms by 1998. Indeed, it still faced many challenges and fell short of leading countries on the quality of its business environment. Remaining economic problems included the need to tackle regulatory and structural reforms in public infrastructure (transport, energy, telecommunications), the tax system, the health care system, employment, and local government financing. Still, by the end of 1998 Hungary had achieved its main goal of changing the economy and public governance in anticipation of the country's accession to the European Union. By then, regulatory reform became embedded into the massive effort of transposing the EU legislative corpus.

6 The 1987 Law on Legislation requires quite a developed justification report—in many ways close to a regulatory impact analysis.

3. REFORM PROCESS AND INSTITUTIONAL DESIGN

Several factors explain Hungary's success—and shortcomings—in reform. Government leadership and institutional adjustments were crucial, as were changes to the public administration, though the latter have been slower to advance. Legal reform was crucial to the development of a market economy, and stakeholders at all levels were consulted and involved in changes. But limited resources slowed some reforms, and inadequate monitoring and evaluation undermined the success of many.

Government Leadership and Strategy

Between 1989 and 1998 successive prime ministers generally backed reform. The focus of their support evolved as the reforms and society changed. At the beginning, the overall objective was to secure democracy and the rule of law, anchored to a market-based economy. Later the goal evolved into joining the European Union, which political leaders believed would first require joining the OECD (1995) and North Atlantic Treaty Organization (NATO; 1999). But the intensity, approach, and management of reforms varied according to the three administrations in charge during this period, which swung from left to right and back again.

Three strategic elements of the Hungarian approach to reforms are worth noting. First, the reforms were pragmatic. Since the regime change of 1989 the effect of reform on senior government officials has been measured and incremental—though accelerated by the movement of many officials into politics and business. Hungary's "negotiated revolution" allowed for institutional changes that accompanied radical economic reforms, but did not tolerate witch hunts. Many leading officials of the old regime enjoyed renewed tenures and late retirements (Csaba 2000). Some key actors remained at the center of the reforms, while others stayed in power long enough to support them.

Second, the government pushed for concerted, legally based reforms. Even during the two strong waves of reform and the launching of an austerity package (in March 1995), the rule of law was preserved. Parliament was always actively engaged, and democratic elements—such as thorough consultations with all social partners and opposition members—were considered fundamental. During this period a key institution was the Council for the Reconciliation of Interests (created in 1990), which built a social dialogue with businesses and trade unions.[7] A second council, the Social Council (1991) primarily dealt with the problems of disadvantaged social groups. It sought to identify opinions and problems, and reconcile them by providing information on various endeavors and helping to prepare ameliorating legislation (Bagó 2000).

Third, reform strategies alternated between top-down and bottom-up approaches. A sparking effort from the top of government was needed to launch deep-rooted changes and overcome resistance and apathy. In 1989 energetic early reformers designed and launched the Great Adjustment program. In less than two years Hungary had a reformed constitutional, legal, and regulatory framework. A top-down approach was also pursued in 1995–96, when the Horn administration designed and drove a second major round of structural, institutional, and legal reforms. Without strong pushes from the highest levels of government—the guillotine reviews, the Bokros package, and other "strong medicine"—reforms would have dissolved amid bureaucratic wrangling and opposition.

Between the two waves of reforms a more consensus-building, bottom-up approach was used. This shift in tactics was caused by the distaste that democratically elected governments had developed after 40 years of a command and control approach under communism. Based mostly on experience, Hungarian leaders knew that successful markets required a democratic, legally based system. During the 1980s the semi-market regime, run by a "soft political dictatorship" based on obscure and unaccountable orders from the top, had distorted and restricted markets. The resulting abuses and inefficiencies reflected the worst of both systems.

The bottom-up strategy pursued by the 1990–94 Antall administration was also a response to the unexpected backlash against reformers and unelected technocrats. The resistance that emerged during the painful taxi drivers strike of 1990 scared the Cabinet and reminded policymakers how social unrest could explode and cause political disruption (negative in 1956; positive in 1989). The bottom-up approach provided an opportunity to reach consensus and settle institution building arrangements, particularly on decentralization and civil service reform. Such arrangements typically required more time and dialogue than purely structural changes—at the cost of losing competitiveness relative to neighboring countries. Indeed, after a few years the bottom-up approach led to policy paralysis and constant bickering among ministries that were designing and implementing reforms.

Institutional Arrangements

In less than a decade Hungary underwent an almost complete overhaul of its institutional landscape. Analysis of the institution building experience can be split between the central and adjunct bodies that implemented the reforms.

Driving Institutions

Just as the reform strategy alternated between a top-down and bottom-up approach, so did the influence of central institutions. Management of Hungary's reforms fluctuated between strong central institutions that pushed the processes and a weaker center that acted as an information dispatcher and coordinator. Consequently, the role of the prime minister's office also varied.

The prime minister's office played a pivotal role during the two main reform waves. Miklós Németh's administration (1988–90) inherited the structures and traditions of the command and

7 In 1998 Parliament opened the council to new interests, transforming it into the Economic Council. In addition to the social partners, actors like the Hungarian National Bank, Bank Association, Stock Exchange Council, representatives of multinational investors, and economic chambers participate in the Economic Council.

control regime and was able to use them to drive the Great Adjustment. The Horn administration (1994–98) recognized the need for coherence and cohesion at the center to manage the response to a looming external crisis. During these two centralization phases the government was able to recover processes inherited from the Austro-Hungarian tradition. In contrast, the Antall administration (1990–94) tended to use the prime minister's office as an information dispatching body working primarily as the secretariat of the Cabinet—despite the fact that, constitutionally, the office was strengthened considerably in 1989.

In terms of institutional machinery, the main tools used during the two "pushing" phases were the creation of ad hoc and informal taskforces dominated by the Ministry of Finance but closely linked to the prime minister, and the establishment of formal government commissioners working from within the prime minister's office with a clear mandate. The first tool was used to design one-off reforms that were later implemented by line ministries or specific agencies (such as the privatization agency or competition office). The second was expected to operate longer and engage in laborious reforms like deregulation and the modernization of the public administration.

The two deregulation commissioners during the Németh administration and the single commissioner during the Horn administration had access to the prime minister through daily reporting. Their mandates and powers allowed them to make demands on line ministers. The commissioners were able to influence the traditionally decentralized ministries based on ministerial accountability to the Cabinet and Parliament, often reflecting the weight of government coalition partners. If there was serious divergence in opinion, the commissioners could express their views to the prime minister and request arbitration. Although the commissioners' legal and administrative positions were ambiguous inside the structure of the prime minister's office, their status was outside the formal hierarchy (that is, they were not legally mandated agencies). This status made them better able to advocate, design, and implement reforms.

Still, even when the government consolidated power in the hands of a "super minister" or commissioner, it required some accountability and openness. Committees were established where various ministry officials and outside experts discussed the proposals and evaluated the undertakings of the commissioners.

As often happens when mandates are centralized and personalized, coordination and cohesion tended to suffer during the waves of rapid reforms. Communication problems tended to surface despite the existence of interministerial forums and improving bureaucracy in the prime minister's office. Little communication and coordination occurred between economic and legal reformers, or between the commissioners. In contrast, the approach taken by the Antall administration—based on a weak prime minister's office and more collegial decisionmaking—tended to increase ownership and acceptance during institution building efforts. Responsibility for pushing deregulation and modernization was assigned to the Ministry of Justice, with unsatisfactory results (Box 4).

Supporting Institutions

Whether top-down or bottom-up, reforms cannot be sustained and expanded without a web of supporting institutions. Reforms driven by single ministries—even a powerful ministry of finance—are hard to sustain in case of backlash or a change in administration. More than other transition economies, Hungary engaged in institution building. From the start, the government focused on developing the institutions—such as the competition office, privatization agency, and various sector-specific regulators—needed to implement reforms.

The competition office has played an especially crucial role in Hungary's reforms, particularly during privatization (see Box 3). Sector-specific

BOX 4

The Role of the Ministry of Justice

Following Central European tradition, Hungary's Ministry of Justice was considered the master of all laws and regulations. Thus, the Ministry of Justice was in charge of deregulation and re-regulations except during the two major waves of reforms (which were handled by commissioners). In addition to maintaining administrative tradition in a quickly changing institutional landscape, the ministry's active involvement ensured that regulatory reform policy remained close to the "owners" of the legal information and supported by adequate legal expertise and institutional memory.

But delegating regulatory reform to the Ministry of Justice in 1990–94 (and since 1998) seems to have caused major problems in managing the reforms and improving regulation. As has been seen in other countries, it is difficult to merge the goals of improving the legal quality of drafts and infusing economic principles into the law. The latter was neglected by the Ministry of Justice, which lacks economic competence and is often overburdened with reforming its traditional areas of expertise (civil and criminal legislation and courts). As a result, reviews of the legal environment assigned little importance to substantive deregulation relative to the technical qualities of a draft.

Perhaps more damaging from a structural and hierarchical perspective, the Ministry of Justice's efforts and policies were easily challenged and ignored because it was perceived as small, politically weak, and not superior to other line ministries producing laws and regulations.

regulators, created to implement key reforms in network industries, include the Communication Authority (1993) and Hungarian Energy Office (1994). But these regulators, though playing an important role in enforcing regulations, have remained weak and dependent on politically sensitive ministers (OECD 2000).

Another important driver for the creation of institutions has been a constant preoccupation with restraining the executive branch's power in a democratic system of governance. Economic reforms were consistently balanced by major constitutional reforms and functional counterweights like the Constitutional Court, State Audit Office, Ombudsmen for Civil Rights, Ombudsmen for the Rights of National and Ethnic Minorities, and Ombudsman for Personal Data Protection. Moreover, Hungarian citizens and businesses can rely on a powerful judicial review of the legality of the public administration's decisionmaking—a feature unique in the region (SIGMA 1998, 2003).

A third important feature of Hungary's institution-building endeavors was the effort to add credibility to reforms and policy decisions by formalizing and increasing the transparency of administrative procedures. An insistence on formal procedures made the government and Parliament keep and improve key laws and institutions from the previous regime, expunging authoritarian and discretionary elements from them. This was the case for the Administrative Procedure Law, Law on Legislation, and rules and procedures framing the preparation of Council of Ministers decisions, which have provided a solid basis for an accountable administration and regulatory management.

Changes in the Civil Service and Public Administration

Hungary's civil service has traditionally been known for being well-educated, with technical credentials and strong legal expertise, rather than administrative or management skills (World Bank 1999). Consequently, reform leaders were forced to balance the need to preserve the high quality and formality of the system with the need to expand the narrow skills, legalistic culture, and tradition of control and command approaches to regulation.[8]

8 The dominance of lawyers in the policymaking structure might also hamper the need to instill greater empirical and market methods—such as ex ante and ex post evaluations—in policies and regulations (SIGMA 1999).

Early on, the government identified the civil service and, more broadly, the public administration as key areas for reform and modernization. Commissioners with clear mandates for such changes were established in 1989, a new law was passed in 1992, and programs of both broad and narrow scope were launched. About every two years the government adopted a resolution on the public administration modernization strategy and on needed next steps.

But results were modest and slow in coming. Successive reform initiatives were unable or unwilling to change and simplify approaches to government interventions. Though a major overhaul and a 15 percent downsizing of the civil service in 1995 made the bureaucracy more effective, by the early 2000s one in five workers were still employed by the government (World Bank 2004). Changes in the culture, quality, and efficiency of the public administration lagged legal reforms.

Reforms were often perceived as painful and so resisted, partly because of a conformist culture and corporatist reflexes. But structural aspects of the public administration also hindered change. Despite the recent introduction of performance-based measures, downsizing was accompanied by a relative and absolute drop in pay for public servants. Salaries declined relative to sharp increases in the private sector, creating a serious brain drain in the public sector for the most highly skilled and trained professionals. Moreover, rapid turnover has reduced institutional memory, and it has been difficult to recruit young professionals with the skills needed to meet the government's demands. (There are exceptions, including the competition authority and the ministries in charge of EU accession.)

Moreover, legal reforms in this area fell short of their goals. The 1992 Civil Service Law is hard to enforce, and the government has struggled to depoliticize the public administration. This was one of the pillars of the law, but political spoils remain entrenched in the system, with 60 percent of administrative state secretaries spending less than two years in office (World Bank 2004).

The bureaucracy remains a bastion of conservatism. Despite precise instructions and requirements, civil servants have rarely deregulated on their own, and have tried to limit the functions of deregulation commissioners to areas as narrow as possible. For instance, systematic opposition emerged from state secretaries and senior officials to any involvement by commissioners in overseeing the quality of draft measures. And often, after discrepancies have been solved at the political level and changes accepted verbally, line ministries have delayed implementation or made it difficult.

Although policies, bills, regulations, and proposals have continued to be of high quality in a legal sense, their economic rationality is limited—and impractical mechanisms are occasionally proposed for their implementation (World Bank 2004). During the communist era Hungary had too many subordinate regulations and too few laws. But since then the public administration has produced too many laws, resulting in overregulation in some areas (OECD 2000), albeit often linked to EU accession.

Limited resources and the rigidity of the bloated civil service have also impeded the government in supporting civil servants sympathetic to change but reluctant to introduce it for lack of resources needed to perform new tasks in addition to their existing workloads. Lack of resources and assistance has also complicated the introduction of new techniques, such as regulatory impact analysis, in ministries. In particular, additional resources were unavailable to protect against the natural fear of the difficulties associated with any reform.

Legal Reform

As a steppingstone to start reforms, the government and Parliament enacted a new Constitution in 1990. It promoted democracy and the rule of law and provided the basis for transforming the legal and regulatory framework—shifting the balance between laws and subordinate regulations. As a result the discretionary powers of the public administration were systematically reduced.

Tradition and long-held convictions also made legal reform a cornerstone for the development of a market economy. Despite the need to expedite changes and thus draft laws in weeks instead of months, Parliament systematically discussed and approved reforms. Hungary's strong tradition of open consultation also helped strengthen the rule of law. Formalism of procedures was not only recovered from the past, but also strengthened. For instance, during the first wave of reforms the commissioner meticulously developed procedures for deregulating the entire legal system—adapting deregulation techniques and frameworks used by other countries to Hungary's legal traditions. This background did not impede the development of legal innovations like the omnibus Deregulation Law of 1990, which allowed for the restoration of "dead" laws after the guillotine review. Hungary also developed new ways of reforming laws, particularly given the difficulty of obtaining a qualified majority in Parliament for important reforms. (The new Constitution created a special type of framework law that required a two-thirds majority for enactment and amendment.)

Reformers also worked to resuscitate and consolidate the solid legal infrastructure in place before the regime change. For instance, the 1987 Law on Legislation defined the goals and conditions for good regulation. In some cases important legal processes existed (such as the 1957 Administrative Procedure Law) but were unused.

In the mid-1990s legal reform got a new catalyst: the political goal of implementing the EU Acquis Communautaire. As a result, EU legislation strongly affected 40–60 percent of national economic legislation (Box 5). Adopting the Acquis Communautaire provided many benefits for Hungary. It gave coherence to the legal framework and drove a strong modernization in terms of substance. In particular, EU directives linked to the single market supported market principles and helped the administration modernize its

BOX 5

EU Acquis Communautaire

Candidates for EU membership must meet political and economic criteria and show their ability to assume related obligations. Political criteria focus on constitutional structures and human rights. Economic criteria relate to the existence of a working market economy and the capacity to withstand competition within the European Union. The obligations relate to the readiness to adopt, implement, and enforce the 29 chapters of the Acquis Communautaire.

The Acquis Communautaire is the body of legislation of the European Community that has been accumulated and revised over the past 40 years, comprising more than 96,000 pages of legal text. It includes the:

- Founding Treaty of Rome, as revised by the Maastricht, Amsterdam, and Nice treaties.
- Regulations and directives passed by the Council of Ministers, most of which relate to the single market.
- Judgments of the European Court of Justice.
- Recent additions such as the Common Foreign and Security Policy and justice and home affairs cooperation, as well as the goals and realization of political, economic, and monetary union.

Countries wishing to join the European Union must implement the entire Acquis on accession, though there is some flexibility on timing. The European Council has ruled out partial adoption of the Acquis because it felt that this would create more problems than it would solve, and would water down the Acquis.

Since the 1993 Copenhagen Summit, and in addition to transposing the body of EU legislation into their national law, candidate countries must ensure that EU law is properly implemented and enforced. This may mean that administrative structures need to be created or modernized, legal systems reformed, and civil servants and members of the judiciary trained. The European Commission assesses progress on these fronts every year.

procedures. On the downside, in some cases the EU framework restricted experimentation and adoption of local solutions and methods. Moreover, critics have said that the Acquis Communautaire introduced some unneeded interventionist aspects and complex rules, reducing simplification efforts and increasing burdens on businesses.

Another important feature of Hungary's evolving legal and regulatory system is the growing role of the judicial system. The courts began to play a major role in resolving disputes between citizens and the government, between different levels of government, and between parliamentary and government authorities. For instance, the Constitutional Court became one of the busiest in the world, and judicial review of laws and regulations offered a check and balance mechanism on parliamentary and administrative powers.[9] This is a vivid indicator of the extent to which the rule of law has been restored in Hungary.

But these initiatives and assets for rule-based reform had to confront some major challenges—with mixed results. First, the speed of change in legislation created instability and diminishing predictability. For instance, inadequate legal implementation of the first guillotine review meant that serious legal gaps suddenly appeared. The imperative to create a new legal order also meant frequent creation of, changes to, and dissolution of the regulatory framework, to the great alarm of citizens and businesses. Parliament used reform as a cover to rapidly enact half-cooked measures, either for lack of preparation or in search of cosmetic reforms. This phenomenon, called "legislation dumping" in Hungary, was compounded by the alternation of coalition governments and dealing of raucous parliaments.

As a result new laws often had to be quickly amended or corrected. For instance, 58 percent of laws published in 1997 needed amendments and sometimes repeal, as did 288 government decrees and 122 ministerial decrees. Moreover, Hungary was not immune to the "legislative illusion" afflicting other countries, where laws are promulgated for all possible problems without sufficient attention to results and alternative instruments. These phenomena also reflected systemic failures to control the quality of proposals before they were issued.

In addition, decentralization required that Hungary increasingly be administered at local levels. Yet that created real and potential problems of regulatory duplication, overlap, and inefficiency. Municipalities were too small to reap economies of scale, and transitional problems of creating and maintaining an effective municipal civil service undermined the development of a competitive business environment.

Management and Involvement of Stakeholders

With all major reforms, transitional and short-term impacts are more visible than long-term benefits (or the unseen but growing costs of maintaining the status quo). In Hungary managing opposition to reforms was crucial for alternating governments in the search for consensus and bottom-up policies between the waves of top-down reforms. The need to delicately manage resistance also explains the gradualism of some reforms and the need for governments to accept that most of society prefers a smoother transition. In Hungary the gradual approach—intended to reduce the costs of transition—was easier because markets were relatively advanced from the start.

Most reform policies, including privatization, restitution, and enterprise restructuring, were based on the desire to create a strong middle class within a market economy as the basis for democracy. Reaching this goal required achieving widespread business ownership and entrepreneurship. The prime ministers in charge during the two reform waves—following the recommendations of deregulation commissioners—occasionally had to confront opposition. For

9 Though even in 2004 government and ministerial decrees remained off-limits from judicial review.

instance, in 1996 a high-ranking minister was pushed to resign because of his opposition to the restructuring of his ministry.

Management of reforms implied a tactical effort to involve and gain support from the opposition, involving it as much as possible. Members of the opposition were often invited to join advisory councils and committees. Social partners were involved as well. Widespread consultation with society at large required accepting watered-down regulatory goals and methods. For new regulation, social acceptance was more important than any other consideration.

Another important element of reform involved reaching out to the public and communicating the significance of the undertaking. During the first wave of reforms the commissioner of public administration organized various consultation and promotional activities, one of which involved soliciting proposals for deregulation and other reforms from citizens, civil servants, and businesspeople. The winners of this competition received monetary prizes. The commissioner and the Deregulation Council also organized deregulation conferences and technical workshops throughout the country.

Hungarian reformers were also open to new ideas from other sources. Close relationships between government officials and the spawning think tanks participating in debates on reform dramatically increased the inflow of good new ideas. The International Monetary Fund, World Bank, U.S. Agency for International Development, Organisation for Economic Co-operation and Development, U.K. Department for International Development, European Community, and other partners actively supported reforms. For instance, the World Bank provided financing for decentralization and civil service reform. In addition, Leal (a nongovernmental organization) and the Center for International Private Enterprise provided significant intellectual leverage for pension reform, drawing on experiences in Argentina and Chile.

At the same time, the cost of reform was never systematically addressed, except through a constant effort to accompany all structural efforts with the steady development of a comprehensive social safety net—though this includes the costs of addressing rigidities and other problems to reduce unemployment. Significant costs were also incurred in terms of increased poverty and inequality, reduced employment, deterioration of public services, and growth in corruption. These costs tended to fall heaviest on specific groups, such as pensioners, rural populations, the Roma, and middle-aged employees of state enterprises.

Such costs were mostly accepted, thanks to the emergence of a democratic system that allowed a change in government every four years. Overall social acceptance was rooted in the belief that long-term benefits (particularly EU accession) are worth sacrifices. In addition, the system provided two escape valves: the opportunities offered by a dynamic informal sector and the possibility of emigration. Finally, acceptance of the social and economic costs of reform was linked to active efforts by bilateral and international donors and by the tangible benefits—such as access to better, cheaper consumer goods—of early reforms to open markets (Ellman 2000).

Resource Issues

Finding resources for reforms was always a challenge due to the government's fragile financial situation. Indeed, the two waves of reform coincided with a need for increased budget control. But drivers of reform—such as the deregulation commissioners—were always properly supported. At the peak of his activity (1995–97), the administration reform commissioner had 20 professional staff at his disposal. Members of deregulation councils were paid a monthly fee.

But limited resources were allocated to line ministries, which had to rely on their own human resources and capacities to implement reforms and comply with new procedures. And as noted, insufficient resources were allocated to the civil service. Even when allocated, they were often poorly distributed and could not be used to encourage effective reforms (rewarding specific progress, for instance).

Similarly, economic regulators—such as the National Communications Authority—were generally starved of sufficient resources to be effective and confront incumbents. On the other hand, the competition office has had adequate resources to play a key role in reforms, contributing in many ways to their success (OECD 2000).

Monitoring and Evaluation of Reform Impacts

Monitoring and evaluating reforms was as difficult for Hungary as for most other transition economies. Reform policies seldom set targets, timetables, or surveillance mechanisms to assess progress and retreat. Reforms were pushed, implemented, sustained, ignored, or reversed through the strength of political will or resistance of interested groups, or because of external obligations (such as to EU accession or international donors).

Assessments of progress were complicated by a lack of economic analysis, ex post or ex ante, at the sectoral and macroeconomic levels. This problem was exacerbated by the scope and breadth of the reforms undertaken in a relatively short period. Studies to justify reforms and new policies tend to focus on their feasibility or budget impacts. A lack of administrative capacity and shortage of analytically oriented applied economists also contributed to weak evaluation, and was exacerbated by strong opposition from ministries to conducting evidence-based analysis of proposals and allowing an oversight body to challenge their assumptions. In many cases inadequate monitoring and evaluation resulted in inconsistencies and sometimes failures.

4. LESSONS OF REFORMS

Hungary's reform experience points to clear factors for success, exposes several shortcomings, and offers lessons for other countries.

Success Factors

- *The timing and sequencing of reforms—starting with market openness and later driven by the stringent requirements of EU accession—contributed to one of the most successful transitions in the region.*

In its first 10 years of reform, Hungary moved faster and made fewer mistakes than many other transition economies. Many observers have said that this was due to effective timing and sequencing (sometimes fortuitous) of key reforms. Early market opening reforms certainly played a vital role in anchoring structural reforms. This cornerstone of reform also provided a long-term advantage in terms of attracting foreign direct investment and lowering social and economic costs through cheaper imports. In addition, it aided privatization and the transfer of technology needed to sustain future growth.

Perhaps in a more accidental way, successful sequencing can also be appreciated in terms of the differences in implementation efforts accorded to some reforms. Reform and modernization of the state apparatus came later than structural reform. Changes in institutions are much harder to implement than changes in tariffs or prices because people are bound by their culture, traditions, and formal and informal practices. Institutional changes can only be addressed over time and are seldom quick wins.

In a more pragmatic way, the Horn administration (1994–98) used the difficult financial situation and near debt crisis that it inherited to launch comprehensive reforms that paid off handsomely. Commitment to reforms by the highest levels of government was also vital to changing perceptions among foreign investors and creditors. As support waned and the government tried to advance politically costly reforms in the late 1990s, it began using EU accession as the central engine and justification for painful changes.

- *Reforms were strengthened by careful adaptation of inherited and accepted institutions.*

Successive administrations drew heavily on international expertise, but ensured that foreign models were adapted to the Hungarian situation, using existing legal and administrative frameworks to implement change. For instance, in its search for a way to consolidate the rule of law, the government resuscitated earlier framework laws such as the 1956 Administrative Procedure Law and maintained the 1987 Law on Legislation. And, recognizing the need for a central force that could drive and sustain the coherence of reforms, Hungary created an effective machinery in the prime minister's office that could support focused commissioners (see below).

- *Economic reforms were more successful when driven by the center, but institutional reforms were more successful when supported by decentralized consensus and ministry ownership.*

The speed and scope of reforms slowed between 1990 and 1994, with real and perceived costs. This deceleration coincided with the center of government (that is, the prime minister's office) delegating reforms to line ministries. As it turned out, the change in pace and approach helped build more cohesive and collective changes—for example, in terms of decentralization of changes to the judiciary. But the decentralized approach also caused many reforms to dissipate quickly. When reforms required leverage and incitement, the government often relied on focused taskforces and individual commissioners. But though a strong prime minister's office was probably required for a coherent approach to reforms, it was insufficient when key functions were absent (as was the case after 1998).

- *Government commissioners drove reforms, though they lacked the institutional and legal backing to implement and sustain them.*

The speed and scope of Hungary's reforms would have been much harder to achieve through decentralized processes. As in many parliamentarian systems, the country's collective governance relies on strong ministerial (sectoral) responsibility and accountability. But such a system faces problems when horizontal regulatory reform is launched. A driver of reform located above line ministries is needed to coordinate, monitor, and enforce changes. The Hungarian solution was to create commissioners with direct access to the highest level of the government, supported by consultative bodies and specialized staff. This framework drove two guillotine reviews. Still, the commissioners lacked the permanence—which could perhaps be provided through a legal and parliamentary mandate and a formal institution—to manage the incentives and bottom-up acceptance needed to effect long-term changes in rulemaking practices and procedures.

- *An active competition office drove reform implementation.*

An outstanding element of Hungary's success with structural reforms was early and fair accommodation of competition principles—achieved through a world-class competition law enforced by an independent competition office.[10] In particular, since the mid-1990s the competition office has played a key role in privatization and rulemaking. The competition authority has also advocated regulatory reforms and blocked many distortionary proposals.

- *Systematic, comprehensive, time-bound reviews of regulations accelerated deregulation and re-regulation.*

By the early 1990s Hungary had joined the small group of countries bold enough to launch massive reviews of their entire legal frameworks. Moreover, it used a guillotine review that in just a couple months helped eliminate scores of obsolete regulations. Five years later, in 1995, a second review was launched with less success, though it

10 For a small country like Hungary, an open market is also a source and safeguard for competition.

annulled more than 350 subordinate regulations. It also focused on deregulating and simplifying licenses and authorizations. Legal harmonization with EU law became a justification for a third review and engine for modernizing the regulatory framework, and continued until accession in 2004. Thanks to these efforts, Hungary renewed its legal regime to the benefit of businesses and citizens—in particular, reducing the potential for discretionary abuses by the administration (particularly in the licensing system).

Shortcomings

Much of Hungary's reform success in the 1990s was built on market openness, a progressive but determined privatization program, and a foreign direct investment strategy based on low wages and a flexible labor market. As a result, the Hungarian economy was able to eliminate and create jobs, putting the country on a convergence path with the average EU member. But the 1990–94 slowdown shows that slowing the pace and accepting too much complacency can rapidly undermine the competitiveness of domestic firms and the perceptions of foreign investors and donors. Now that wages are increasing rapidly and Hungarians aspire to European standards for social and environmental regulations, the country's appeal to foreign investors may deteriorate quickly—which could prompt a dash for a new, cruder regulatory package.

- *Systematic reviews of existing regulations missed the opportunity to reinforce the economic rationale for the rapidly developing regulatory framework.*

Despite a significant investment in reviewing regulations and outcomes, Hungary's systemic reviews were based on legal rather than economic principles. Though the scarce economic expertise inside the administration can explain this outcome, the reviews were missed opportunities for developing more effective and efficient regulations—despite the fact that Hungary relied on quite a few well-trained economists. The lack of success of other reviews conducted during the Antall administration can also be linked to the predominant role of the Ministry of Justice, which not only lacked expertise and resources but also the authority to drive a reform across the entire public administration.

- *It was easier to control the stock than the flow of regulations, as shown by repeated failures to introduce regulatory impact analysis.*

Hungary's efforts to deregulate show that improving the stock of regulations without checking the flow contributes to long-term costs and wasted efforts. Unsuccessful efforts to introduce regulatory impact analysis underscore the need for delicate embedding of the procedure in a system of positive and negative incentives. As with many revolutionary processes, it is easier to start small and scale up rapidly than to rely on a command and control strategy. Hungary's experience also shows that a single commissioner lacked the resources to break entrenched interests and traditions—especially when reformers have to deal with well-established, legalistic drafters, and a paucity of evidence-based capacities and skills. Moreover, a danger exists that the failure to introduce regulatory impact analysis may have blocked future efforts to ingrain evidence-based analysis in rulemaking. Such a situation may become apparent once EU accession is complete and rulemaking procedures prove incapable of filtering out low-quality regulation.

Lessons for Other Countries

- *Improvements in regulation policy tend to take decades, not years, to produce results.*

Hungary's experience shows that in the short run, levels of foreign direct investments are most likely linked to the broad definition of regulatory reform, including market openness, privatization, and sound macroeconomic management. Deregulation (especially of economic regulations) and high-quality regulation certainly play a role (in particular, by focusing on administrative regulation, which accounts for most problems with red tape). But because the effects of a new regulatory management system, based on evidence-based regulatory impact analysis, often take longer than a decade to become apparent, such reforms can mostly be used as investments for the long term—and, if carefully communicated and sustained, as political commitments to national and international investors.

- *Democratic change and respect for the rule of law provided political and social mechanisms to avoid a violent backlash that could have precipitated an economic U-turn and resulted in crisis.*

When complete transformation of a country is undertaken, dramatic social and economic costs are unavoidable. Losers are unavoidable, and Hungary's government had no way to directly compensate their losses. It was important that the country keep open economic safety valves such as the informal sector, the possibility of emigration, and, most important, better and cheaper consumer products and services thanks to increased imports and exports, liberal investment rules, and internal competition. But that was not always enough: the Horn administration rescued the economy but was rewarded with electoral defeat in 1998. Still, democratic change and respect for the rule of law provided the political and social mechanisms needed to avoid a violent backlash that could have caused an economic reversal. The overriding goal of EU accession also helped avoid a populist reaction.

- *Acceleration of some economic measures was important, but more time is needed when reforming and building institutions.*

The massive Great Adjustment (1989–90) was vital to sparking and anchoring the reforms that immediately followed. But those reforms can now be considered a down payment on an investment that requires continuous payments for many years. Some of the most important reforms transformed the legal and institutional frameworks required for effective markets. But institutional reforms require longer, more consensus-based approaches, including longstanding bodies with clear mandates (such as a dedicated high commissioner) or a special agency (like the competition office). Taking care to avoid complacency and immobility, a pause in reforms—as in 1990–94—can be used to build new consensus for them.

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IFC International Finance Corporation World Bank Group

MIGA World Bank Group Multilateral Investment Guarantee Agency

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