

**THE CURRENT SITUATION
ON THE LABOUR MARKET
AND LABOUR MARKET POLICY
IN HUNGARY**

KÁROLY FAZEKAS

1 INTRODUCTION*

Hungary has successfully passed, during the 90's, through the most painful period of economic transformation and today has developed into a vigorous market economy. The average growth of the GDP has been 4.25 per cent annually since 1997, steadily exceeding the EU average. This excellent performance of the economy was mainly due to the dynamism of the export oriented manufacturing sector which is dominated by foreign-owned companies. Hungary takes third place in the per capita ratio ranking of the net FDI inflows in the group of EU25 countries. In its 2003 Regular Report, the Commission concluded that the country *“is a functioning market economy and the continuation of its current reform path should enable Hungary to cope with competitive pressure and market forces of the Union”*.¹

1.1 Recent macro-economic tendencies

In 2001, mostly as a result of the downturn in the external economic environment and changes in economic policy the favourable position of the economy somewhat deteriorated. The export driven growth of the previous years was replaced by a development stimulated by internal demand. Strong fiscal expansion, such as the pre- and post-election wage increase in the public sector and state financed infrastructural developments prevented the economy from slowing down but the cost was high: the overall macro-economic balance of the Hungarian economy has deteriorated. In 2002, the investment of the national economy increased by 5.8 per cent largely due to projects financed by the state budget. The salaries of civil servants increased on average by 50 per cent from 1 September 2002 contributing to a 13.6 per cent real wage increase for the whole year. The growth of GDP decreased from 3.7 to 3.3 per cent in 2002 and to 2.5 per cent in the first eight months of 2003. Hungary's export growth has slowed considerably since 2001. The export growth was 9 per cent in 2001, 4 per cent in 2002 and almost stagnated in the first part of 2003. Inflow of Foreign Direct

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¹ CMR (2003) Comprehensive monitoring report on Hungary's preparation for membership. Released on 5th November 2003. http://europa.eu.int/comm/enlargement/report_2003/pdf/cmr_hu_final.pdf

Investment (FDI) decreased substantially in 2002 from 2.4 billion dollars in 2001 to 0.9 billion dollars in 2002 with a further deterioration of this trend in the first 6 months of 2003. The labour market reflected these negative tendencies. The employment ratio which showed steady increase since 1997 took a reverse direction. (see Figure 1) The economic and labour market performance of the most backward regions deteriorated to such an extent that regional differences have deepened further.

The recovery which was expected for the 2nd half of 2003 has been delayed and was moderate in 2003. Nevertheless, according to the latest forecasts made by GKI Economic Research Co., and by the National Bank of Hungary² the Hungarian economy probably reached the bottom of the slowdown in the summer of 2003 and growth slightly accelerated in the remaining part of the year. The expansion of the GDP was 2.9 per cent for the year as a whole. This figure is the smallest since 1996 but is still higher than the EU average by more than 2 percentage points and is more or less equal to the performance of other Central European countries. The rate of inflation increased. The inflow of foreign direct investment was substantially higher than in the previous year, mainly due to higher privatisation revenues. Nevertheless, it did not suffice to cover the current account deficit. Consequently, the net indebtedness of the country has been grown.

The service sector was responsible for the major part of growth but in the 2nd half of the year the GDP produced in industry started to gain more importance. Investments in the manufacturing industry – especially the purchase of new machinery – started to increase after the sharp decline of the previous year. The performance of the trade, real estate and non-business service sectors has been improved considerably. Employment was increasing in these three sectors, while it was decreasing in the business sector as a whole. Real earnings increased by 9.2 per cent in 2003.

The Central Statistical Office confirmed that the economy grew by 4.2 per cent (year-on-year) in the first quarter of 2004. The rise in industrial output averaged 10.4 per cent in this period. Even better news is that this revival of the economy was driven by investments and exports, indicating clearly the breaking away with the domestic demand stimulating policies of 2001–3 which led to a serious deterioration of macroeconomic balances and decline in the competitiveness of the Hungarian economy.

Inflation, fiscal and current account imbalances are, nevertheless, still the weakest points of the Hungarian macroeconomy. The rate of inflation which was 6.9 per cent in April increased further in May, reaching 7.6 per cent on a year to year basis. The rate registered for June was 7.5 per cent. The fast pace of price rise was mainly due to the increase of indirect taxes. The fiscal deficit amounted to HUF 1,045 billion (EUR 4 million) in the

2 GKI (2003): Forecast of GKI Economic Research Co. on Developments in the Hungarian Economy in 2003. <http://www.gki.hu/frame.php>; MNB (2003): Quarterly Report on Inflation. National Bank of Hungary. Budapest. November. 2003. 11. 25. <http://english.mnb.hu/modulei.asp?id=2&cid=2346>

first six months – almost 88 per cent of the full-year target. The government took restrictive measures (cuts in expenditure in the amount of HUF 120 billion (EUR 460 million) to reduce the budget deficit in February this year. The Government has submitted its Convergence Programme to the European Commission. The Programme envisages a reduction in deficit from 4.6 per cent as a proportion of GDP in 2004 to 4.1 per cent in 2005. In view of the disappointing budget situation, the Government postponed its plan of an early introduction of the Euro to 2009 or 2010. A reduction of the budget deficit of 0.5 percentage points annually is foreseen now, so the fulfillment of the Maastricht criterion of a maximum 3 per cent of GDP is only expected in 2007–2008.

Table 1: Key economic indicators

	2002 actual	2003 actual	January- May 2004	2004 forecast
1. Volume of GDP (%)	103.3	102.9	104.2	103.7
2. Industrial production (constant prices, %)	102.6	106.4	109.8	110.0
3. Investment in the national economy (constant prices, %)	105.8	103.1	118.9	107.0
4. Construction (constant prices, %)	120.1	100.7	111.2	105.0
5. Retail trade (constant prices, %)	108.6	108.8	106.8	103.0
6. Exports (current prices in euro, %)	107.4	104.1	113.1	110.0
7. Imports (current prices in euro, %)	106.4	105.8	113.7	110.0
8. Trade deficit (EUR, billion)	3.4	4.3	1.7	4.6
9. Current account deficit (according to new methodology; EUR, billion)	4.9	6.5	2.8	6.5
10. Average exchange rate of the euro (in HUF)	242.9	253.5	256.0	253.0
11. Deficit of the general government (on cash flow basis, without local governments; HUF, billion)	1,580	1,054	1,040	1,200
12. Index of average gross earnings	118.3	112.0	108.6	109.0
13. Consumer price index	105.3	104.7	107.1	106.7
14. Consumer price index at the end of the period (corresponding month of the previous year = 100)	104.8	105.7	107.5	106-106.5
15. Rate of unemployment (at the end of the period, %)	5.9	5.5	5.8	5.9

Source: *Forecast of GKI Economic Research Co. on Developments in the Hungarian Economy in August 2004*. <http://www.gki.hu/index.php?id=19&lang=en>

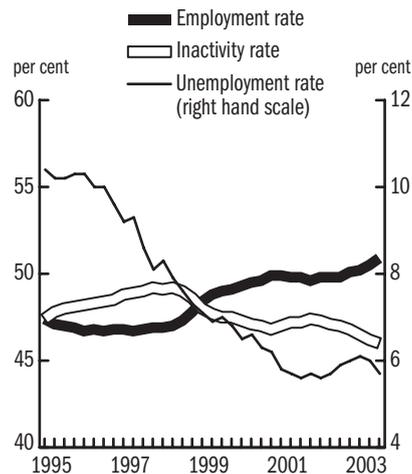
1.2 Recent tendencies on the labour market

From the mid-nineties until the second half of 2001 the performance of the Hungarian labour market was good. By the first quarter of 2001, the ILO unemployment rate fell to 5.6 per cent which was the lowest figure for the last 8 years and significantly less than the EU average (7.8 per cent).

Employment started to increase after 1997 for the first time in the decade since the transition. The decline of unemployment was striking in the most prosperous regions where not only full employment was reached but even a scarcity of (skilled) labour occurred in certain areas.

After the second quarter of 2001, however, some unsettling new tendencies emerged. The employment ratio started to decrease while the unemployment and the inactivity ratio once again started to grow with a pronounced negative effect for backward regions. The declining performance of the labour market can be explained both by external and internal factors: a general slump in the world economy and the deteriorating competitiveness of the Hungarian economy.

Figure 1: Changes in the rates of unemployment, inactivity and employment

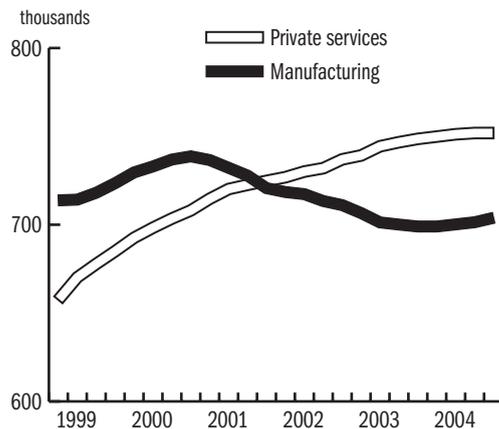


Source: CSO Labour Force Survey.

Hungary's manufacturing export growth slowed down considerably following the downturn of the world economy. This obviously had a negative effect on employment which was aggravated by rapid wage inflation within the country. In 2001 the gross average wage increased by 18 per cent and real wages by 6.4 per cent. In 2002, in the year of both the general and the local government elections the respective figures were 18.3 and 13.6 per cent. The explosion of wages was generated by government policy decisions: the minimum wage was increased by 57 per cent in 2001 and 25 per cent in 2002. In 2002 the wage of public sector employees was increased by 50 per cent. That year real wages grew more than three and a half times faster than the productivity of the economy. The second half of 2003 brought about improvements in the economy. Output and investments in manufacturing industries and services started to grow, unit labour costs went down somewhat and the level of employment slightly increased while un-

employment started to decrease. We can regard the developments on the labour market as a return to the longer term trend which was interrupted one and a half years ago.

Figure 2: Changes in full-time employment



Source: MNB Inflation Report, 2003.

1.3 Employment policy: preparation for accession

Progress in implementing the acquis in employment policy

According to the Commission's Comprehensive Monitoring Report on Hungary's preparation for EU membership (CMR)³ "Hungary has reached a high level of alignment with the acquis in most policy areas". The *acquis* in the field of social policy and employment includes minimum standards concerning labour laws, equal treatment of women and men, health and safety at work, social dialogue, public health, employment policy, European Social Fund (ESF), social inclusion, social protection and anti-discrimination. In certain areas, such as the European Social Fund and anti-discrimination, Hungary still has to make enhanced efforts to complete its preparations for accession. As far as the employment policy is concerned efforts are still needed to effectively implement priorities identified in the Joint Assessment of the Employment priorities. In particular, it is important to increase the employment rate, especially among older workers and women, the unskilled and the disadvantaged and to reduce regional imbalances.

Progress in implementing the Joint Assessment Papers on employment policies

After May 2004, acceding countries started to participate in the European co-ordination of employment policies and will present their first National

³ CMR (2003) Released on 5th November 2003. http://europa.eu.int/comm/enlargement/report_2003/pdf/cmr_hu_final.pdf

Action Plans in October 2004. As a preparation for this the Commission initiated the elaboration of Joint Assessment Papers (JAPs) on employment policy priorities in each country. The key priorities of the Hungarian JAP⁴ were “*boosting the job creation capacity in particular in services, increasing the employment rate, reviewing the tax and benefit systems to strengthen the incentives to create and take up jobs, adapting the education and training system to labour market needs, tackling the drop out problem, enhancing the effectiveness of adult training, addressing gender gaps and the strengthening of the Public Employment service and of the structures necessary for ESF preparation.*” On 6th. November 2003 the Commission’s presented a final report on JAPs in-depth reviews on progress in implementing policies.⁵ The communication updates the assessment presented in the first JAP Progress Report on common policy issues and in institutional setting and administrative capacities. The communication expressed certain concerns over the recent wage developments in the Czech Republic, Estonia and Hungary as they exceeded productivity trends. Concerning regular minimum wage increase in some countries “care must be taken not to price low-skilled workers out of the labour market. As far as the key priorities of the JAP are concerned the communication recognise Hungary’s efforts to develop a set of fairly comprehensive financial incentives for participation in training addressed at workers, the unemployed and the inactive while some concern was expressed over the very low levels in participation in education and training of low-skilled adults. The commission asked for a more rigorous implementation of already adopted integration strategies directed at the disadvantaged, ethnic minorities and the Roma in particular.

Preparation to utilise resources available from the Structural Fund

The Hungarian National Development Plan⁶ (NDP) serves as a basis of all Structural Fund Interventions in the field of human resource development for the period 2004–2006. The Hungarian Government has elaborated five Operational Programmes in the framework of the NDP from which three include measures financed from the European Social Fund. According to the CMR “the main elements of the administrative structures are in place – however, there is a need for stronger decision-making capacity as well as greater inter-ministerial co-ordination. A more strategic approach has to be ensured with respect to all measures proposed for ESF assistance. The management, administrative, monitoring and control capacities of the relevant Ministries, intermediate bodies and financial beneficiaries should be reinforced.”

In September 2003 the Minister of Employment and Labour signed the EQUAL community initiative programme for Hungary. EQUAL aims at addressing all forms of discrimination and inequalities in connection with

4 JAP (2001) Joint Assessment of the Employment Policy Priorities of Hungary. 16 November 2001, Budapest.

5 http://europa.eu.int/comm/employment_social/employment_analysis/communi2_en.htm

6 The Hungarian National Development Plan 2004–2006. http://www.nfh.hu/doc/nft/letolt3/NDP_Hungary.pdf

the labour market through developing, testing and disseminating innovative approaches and methods and through trans-national co-operation. The Hungarian Equal Programme has four priority themes: a) Facilitating access or return to the labour market for disadvantaged job-seekers; b) Promoting life-long learning and “inclusive” work practices that encourage the recruitment and retention of those suffering discrimination on the labour market; c) Reducing gender gaps and supporting job desegregation; d) Support the employability and inclusion of asylum seekers.

2 RECENT CHARACTERISTICS OF THE HUNGARIAN LABOUR MARKET

2.1 Employment, unemployment, inactivity

Labour market participation

Despite all of the governments efforts the participation ratio has been declining since the late 90's. In 2002 the Hungarian participation rate was 59.8 per cent while the corresponding figures of the OECD countries, EU member states and accession countries were 69.8, 69.2 and 66.7 per cent respectively. Among the determinants that cause the low participation rate four strongly interrelated factors seem to be crucial: a) weaknesses in labour demand for low-skilled/low-paid jobs, b) generous social transfer systems in terms of their coverage, c) the existence of serious regional backwardness on the labour market, d) the presence of a large scale informal economy.

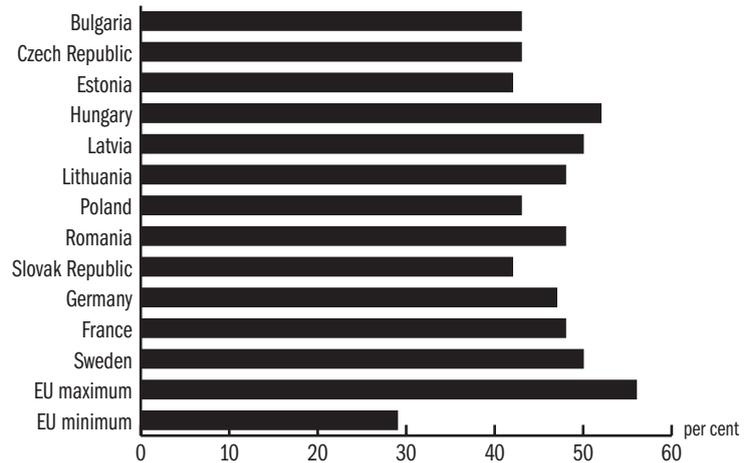
One of the important causes of low demand for the low-skilled/low-paid jobs and the large extension of the informal economy is the high tax wedge in Hungary. Despite a decrease in social security contribution rates since the early 90's, total taxes and contributions on labour remain the highest in Europe. A key element of the high tax wedge effect on low paid work is the employer's lump-sum contribution to healthcare funds. In 2003, this fixed contribution represented 9 per cent of the employer's contributions at the average wage but 17 per cent at the minimum wage.⁷ Lump-sum contribution also discourages the development of part-time employment. Part time employment represents 3.3 per cent of the total registered employment in Hungary against the 17.1 per cent of EU average in 2001.

Demand for low skilled/low paid jobs was largely reduced by the large increases in the statutory minimum wage since 2000. While in 2000, 10 per cent of business employment was at the minimum wage this share had risen to 18 per cent in 2002. The increase in labour costs hit the small domestically owned firms and local labour markets in the less developed regions especially hard. (Kertesi and Köllö 2003) Social transfers play an important role in the income of a large number of households. In 2000, about 30 per cent of the population received some kind of allowances from social

⁷ The lump-sum health contribution was reduced in 2003 as a first step towards complete elimination in 2006.

security. The problem is, that a large share of the working age population is covered by social benefits (such as disability benefits, official or quasi-official early retirement schemes) which, unlike unemployment benefits, do not encourage people to return to the labour market.

Figure 3: The Hungarian tax wedge in international comparison



Note: The tax wedge (for an average production worker) represents personal income tax plus employer's and employee's social contributions as a percentage of total labour cost (including employer's contribution).

Source: "Labour market and social policies in the Baltic States", OECD (2003), data 2000. Bulgaria, Romania: JAP.

The large extent of the informal economy means that calculations based on the labour force surveys tend to underestimate the actual work activity. According to the government's estimation as much as 40 per cent of employment is engaged in the informal sector. Uncertainty over the numbers and characteristics of informal jobs makes it difficult to develop well-targeted measures to switch them to the formal economy.

The low participation rate is influenced also by regional differences at the level of local labour markets. While job destruction during the transitional crises was evenly distributed across regions, job creation was concentrated in the most developed urban labour markets of the country. Alleviation of regional disparities was seriously hindered by obstacles of internal migration and commuting.

Employment

Unlike in most EU countries prime-age male population is also characterised by a relatively low employment rate. In 2002, 79.7 per cent of men aged 25–54 were employed, contrasting with EU countries where the rate was 86.7 per cent. Non-employed prime aged men are predominantly

low-skilled and live in the economically depressed areas. The division by gender of the employed population has been stagnant for years: around 45 per cent of the employed are women. The male employment rate exceeds the employment rates of women in all age groups. The average employment rate of prime working age (25–54) female population was 66.5 per cent in 2002. The subsequent figure for EU member states was 67.3 per cent in the same year.

During the last decade the sectoral structure of employment has changed considerably. In 2002 6.2 per cent of the employed worked in agriculture, 34 per cent in industry and 59.8 per cent in the service sector (the respective figures for the EU are: 4.4, 26.9, 68.8 per cent). The number of employees in the private sector has stagnated while that in public administration has increased. The low employment rate reflects mismatches in the levels and structure of skills. Unfortunately, the Hungarian educational performance is rather poor in international comparison. The prime age population has one of the lowest percentages of tertiary education attainment in the OECD countries. Although a sharp acceleration in enrolment has occurred in recent years, the conclusion is still valid: policies centred on education and training have to play a crucial role in improving the employability of all working age cohorts.

Unemployment

The unemployment rate reached its peak (12.5 per cent) in 1993 and has been decreasing continuously until 2001. Recently, the decrease in the unemployment rate has been partly due to the shortening of the period of eligibility for unemployment benefit, and the narrowing of the group of people eligible for such a benefit. In August–October 2003 the number of the unemployed population was 237,000, a decrease of 2.5 per cent compared to the same period in the previous year. The rate of unemployment (5.6 per cent) has slightly decreased during the last 12 months but the change is within the limits of the sample error. The Ministry of Employment Policy and Labour regards the latest developments on the labour market as a return to the longer term trend of improving labour market indicators interrupted one and a half years ago. 44.9 per cent of those unemployed searched for jobs for more than one year. The ratio of long term unemployed did not change over the last 12 months. The average length of job search was 16.3 months, almost the same as one year ago. The ratio of the 15–24 year old persons in the total number of unemployed was 22.5 per cent, while the unemployment rate of this age bracket was 13.0 per cent. This latter rate is almost the same as it was one year ago and is somewhat lower than the corresponding EU average (15.8 per cent) in September 2003.

Inactivity

43.8 per cent of the 15–64 year old population was not present on the labour market in 2002. (EU = 35.7 per cent) Withdrawal to inactivity is typical for the unskilled and older workers and especially for those living in depressed regions. Besides the skill and regional mismatches an important reason for the high inactivity ratio is the relatively low retirement age. Although the retirement age was substantially increased in recent years the higher age limits do not apply to those who are close to retirement. The dynamic expansion of secondary and tertiary education also contributed to the increase of inactivity.

2.2 Major disadvantages on the labour market

Low employment and high inactivity rates are determined by two sets of interrelated factors, a) extremely low employment probabilities of certain disadvantageous groups and b) cumulative regional backwardness on the labour market.

Disadvantageous groups on the labour markets

Roma population: The Roma are the biggest ethnic minority in Hungary. According to estimations there are 450–600 thousand Roma people (4–6 per cent of the population) in Hungary and this ratio will grow to 10–11 per cent in the next ten years. The employment rate of the Roma is roughly half, their unemployment rate is three to five times higher and the number of dependants per earner is three times higher than the corresponding figures of the non-Roma population. Family allowance and social benefits are the only source of living for many Roma families.

Table 2: Main source of income in the 15–74 year old Roma population

Status	Male	Female	Total
Child care allowance recipient	2.6	30.6	17.0
Pension recipient	16.4	16.1	16.2
Employee	17.8	11.7	14.6
Social benefit recipient	16.3	11.6	13.9
Casual work	7.4	2.0	4.6
Unemployment benefit recipient	5.8	1.7	3.7
Entrepreneur	2.9	1.4	2.1
Dependant	12.1	11.5	11.8
Student	11.0	10.4	10.7
Other	7.7	3.0	5.4
Total	100.0	100.0	100.0

Source: HAS, *National Roma Survey*, 2003. *Figyelő*. Labour market supplement. 4. Dec. 2003.

Disadvantaged young persons: The labour market situation of young people has been deteriorating. In 2002 in the age group 15–24, both the number and percentage of employed decreased. The year-on-year employment rate of the 15–19 age group decreased from 7.7 to 5.4 per cent, while the corresponding rate of the 20–24 age group fell from 51.1 to 49.3 per cent. A large proportion of young people enter the labour market either without any skill or with a skill or qualification that does not match the requirement of the employers. This is particularly true for those socially disadvantaged young persons who either come from Roma families or from state child care institutions.

Older workers: Early retirement or retirement on disability pension used to be the most important way of escaping unemployment for older people. Conditions of retirement were gradually tightened in recent years, therefore the number of people of working age pensioned for health or employment policy reasons has been decreasing. Nevertheless, as a result of previous mass early retirement schemes, only a small minority (26.4 per cent) of the over 55 population is on the labour market at present. (EU = 43.2 per cent) The Hungarian JER states that the increasing participation and employment of older people is crucial to the country's ability to finance pension and healthcare systems in the context of its fast ageing population.

**Table 3: Employed and unemployed persons
by highest educational attainment, 2002**

Highest educational level	Employed	Unemployed
<i>Men</i>		
ISCED 1+2 (<=8 grades)	14.6	36.7
ISCED 3+4 (Vocational school, Secondary school)	69.5	60.0
ISCED 5+6 (Higher education)	15.9	3.3
Total	100.0	100.0
<i>Women</i>		
ISCED 1+2 (<=8 grades)	18.5	33.2
ISCED 3+4 (Vocational school, Secondary school)	61.7	58.4
ISCED 5+6 (Higher education)	19.8	8.4
Total	100.0	100.0
<i>Total</i>		
ISCED 1+2 (<=8 grades)	16.4	35.2
ISCED 3+4 (Vocational school, Secondary school)	66.0	59.3
ISCED 5+6 (Higher education)	17.6	5.5
Total	100.0	100.0

* Recalculated figures based on 2001 Census.

Source: CSO Labour Force Survey.

There are two EU targets in this regard, both to be achieved by 2010: the Stockholm target of an employment rate of 50 per cent for older workers and the Barcelona target to delay by five years the average age at which

older workers stop working. The skill composition of the older people is very unfavourable, therefore, training, re-training and well targeted employment promotion are important tools to improve their position on the labour market.

People with disabilities: According to the latest survey conducted by the Central Statistical Office in 2002, less than 15 per cent of the population with long-term health problems were present on the labour market (13 per cent as employed and 1.5 per cent as unemployed). Among those employed less than 20 per cent were employed in special (sheltered or supported) jobs. One of the main reasons of the low employment probability of disabled people is the inadequate availability of integrated education and the lack of disabled friendly access to buildings.

People with low levels of qualification: The level of education is a decisive factor in labour market position and employment opportunities. The participation rate of those with low levels of education is well below the EU average and the level of unemployment is the highest within this group.

Regional disadvantages on the labour market

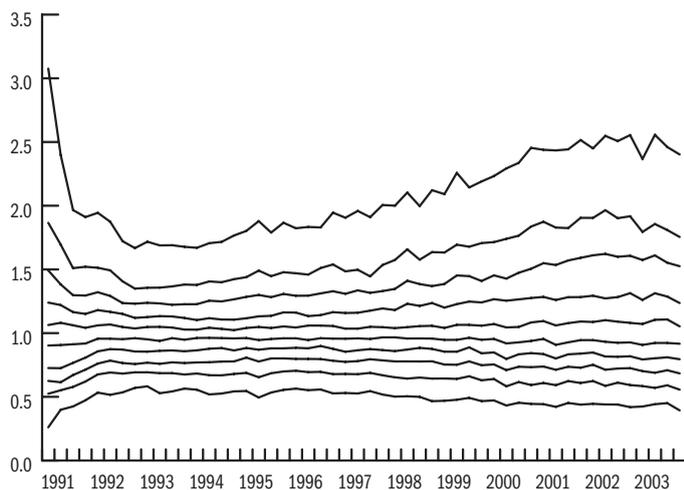
The decline in economic performance and employment during transition has been much more severe in disadvantaged rural regions of the East and Southwest than in the more urbanised Central and North-western territories. Nevertheless, regional employment or unemployment rate differences at the macro-region level are not particularly large by international comparison and have not tended to increase. The problem is that in the case of Hungary macro- or meso-region level analyses of labour market indicators give a distorted picture. Due to the relatively high travel costs of commuting and the underdeveloped transport infrastructure local labour markets are closed and fragmented. The size of local labour markets (LLMs) fits more into the category of “micro-regions”.

Time series of micro-regional data have indicated a disturbing long-term tendency. Expressing mean registered unemployment rates of each deciles of the 150 micro-regions in the percentage of the median at each period gives us a detailed picture of the time path of relative unemployment rate differential⁸ (Figure 4) High differences appeared during the turbulent period of the collapse of the old economy. In the second phase of transition, after a short period of decrease and stagnation, regional differences began to increase to the latest figures. The widening range has been mainly generated by the continuously deteriorating position of high unemployment regions where high inactivity ratios were combined with high unemployment, a high proportion of long-term unemployment, high dependency ratios and a serious accumulation of social backwardness. Figure 5 shows the Kernel density of relative employment rates of micro-regions in 1990 and 2001.

⁸ This measure is, by definition, independent from the actual levels of unemployment.

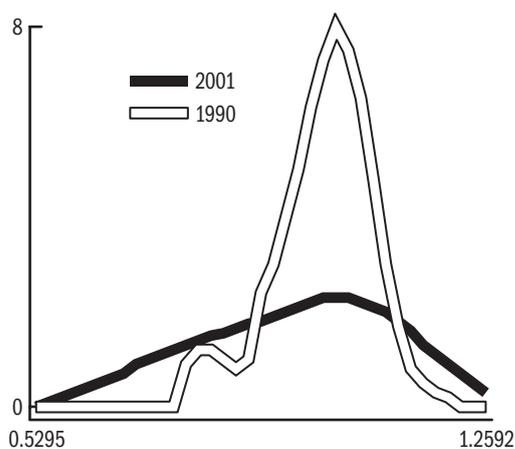
The two lines reflect high *polarisation* of micro-regions. Not only the range of the relative employment rates, but also the density of regions at the low and high end of the distribution have increased during the 1990's. This polarisation has led to an emergence of the sizeable groups of “extremely high” and “extremely low” employment regions.

Figure 4: Time path of micro-regional unemployment rate differences (1991/Q1 - 2002/Q3)



Source: National Employment Office. Unemployment Register Data Base.

Figure 5: Kernel density of relative employment rates (1990, 2001)

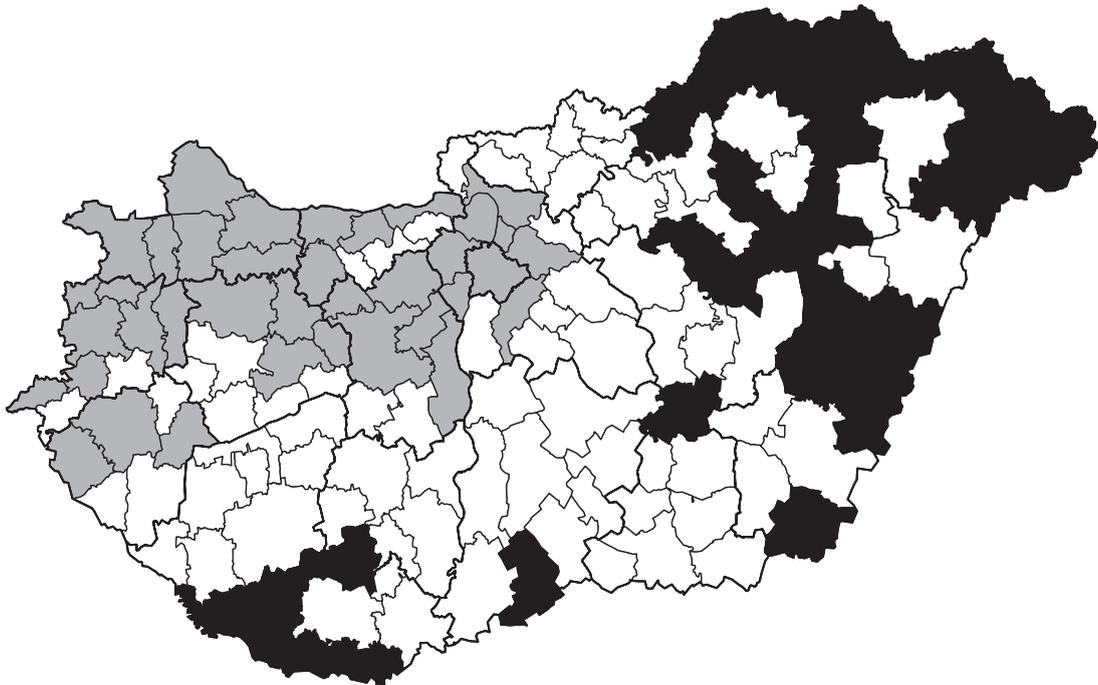


Source: HCSO Census 1990, 2001.

Grouping micro-regions into quartiles according to employment rates gives a simple but clearly defined picture of winners and losers of transition at

the level of LLMs. Social and economic indicators of the four quartiles indicate that employment rates are quite good proxies of the successes and failures of local economies and local societies. A high employment rate comes together with higher production, higher enterprise density, higher productivity of local firms and higher incomes, relative wealth and welfare of the local population. A low employment rate is accompanied by weak performance of the local economy, low enterprise density, low productivity of the local firms, and low income, relative poverty and lower life expectancy of the local population. (Fazekas 2003) Map 1 shows the geographical distribution of winners and losers (top and bottom quartiles of micro-regions). One can see a clear east-west, core-periphery division before and after the transition. The central agglomeration, and regions along the main east-west transport routes in the direction of Graz and Vienna have the highest employment rates while most of the low employment regions are located along the East-Slovakian, Ukrainian and Romanian and Croatian borders. Regional employment rate differences are determined by the region's proximity to the capital and to western portals.

Figure 6: Spatial distribution of micro-regions in the top and bottom quartiles of employment rates 2001



Grey: Top quarter; Black: Bottom quarter.
Source: IE-HAS Regional Data Base.

How to alleviate regional labour market differences? On the supply side of the labour market regional labour market differences could be alleviated: by *commuting*, by *internal migration* from high unemployment regions towards low unemployment areas and by *external migration and commuting* towards foreign countries. On the demand side of the labour market increasing job creation and reallocation of existing jobs towards high unemployment regions could be a means of mitigating regional differences.

Commuting: Enormous differences between the unemployment rates of urban and rural settlements indicate that daily commuting of the rural population to surrounding towns could be an equalising mechanism easing employment tensions. Köllö (1997) and Kertesi (2000b) estimated the impact of transport costs on the openness of local labour markets. They found that the equalisation of regional unemployment rate differences is strongly limited by the high costs of commuting and the resulting segregation of the local labour markets. Kertesi (2000b) examined commuting possibilities in the case of villages. He estimated how the costs of the availability of better urban labour markets affect the probability of becoming employed by those who could not find jobs in their places of residence. He found a strong effect of schooling on increasing the probability of work by commuting, mostly in the case of the male labour force. The more educated a person is, the higher his or her chances are to find employment that requires daily commuting. It is mostly educated people who could find jobs with wage levels high enough to cover commuting costs. Education raises the chances of employment by commuting considerably: travel costs induced job finding differentials are very large for unskilled workers, whereas similar travel costs have only trivial consequences for the job finding chances of people with higher education.

Internal migration: On the basis of large and increasing unemployment rate disparities accompanied by substantial regional wage differentials across regions one could have expected that internal migration flows would increase in Hungary as well. Yet, the reality has contradicted this expectation. Using aggregate in and out migration data by settlements, Kertesi (2000b) and Cseres-Gergely (2003) has proved that migration behaviour reacts to economic incentives. Regions with high unemployment rates have suffered substantial migration losses while those with a low level of unemployment had migration gains. The magnitude of this effect, however, is quite modest and likely to remain so in the near future. Nevertheless there are several sets of factors (tight housing market, scarcity of rented flats, and serious regional mismatch of skill) that explain the low level of internal migration in Hungary and in other CEE countries.

External migration: There have been widespread concerns that the political and economic changes, and social and ethnic tensions would lead a

large scale out-migration from CEE countries towards the European Union. These concerns have not been realised to date. As far as Hungary is concerned we do not think that external migration will be a part of a solution that could ease the regional differences in the labour market. Labour flows from Hungary's backward regions to EU countries will be small even after the accession as has been made clear by empirical studies. The migration potential of the Hungarians is low compared to that in the other East European countries and did not change much over the 90's. Hungary's labour market has been, and will be, more affected by inward migration from neighbouring countries. According to the recent migration survey in Romania, there is a substantial migration potential of neighbouring countries towards Hungary, mostly among ethnic Hungarians and Roma minorities.

Local job creation: The location preferences of investors have dramatically changed since the pre-transition era. Available data on firm creation, small business start ups, physical capital formation, and foreign direct investments suggest increasing rather than decreasing regional differentials in the density of firms and capital endowments. Despite considerable regional wage cost differences investors have not been motivated to move to the depressed regions. Several studies confirmed that FDI was one of the key factors of the economic success of Hungary in recent years. Foreign capital can decisively promote the economic restructuring of local economies providing capital, modern technologies and work organisation practices. Foreign capital is also a means for integration into the global economy and could provide important spillovers of know how towards domestic firms in the region. As far as the labour market impact of FDI is concerned, in the case of Hungary foreign firms' employment was the expanding part of the corporate segment of the labour market while domestic firms' employment continuously decreased over the 90's. Analyses on the impact of FDI inflows on local labour markets share the view that regions with a higher ratio of foreign firms' employment perform more successfully. (*Schoors van der Tol* 2002; *Sgard, J.* 2001)

The micro regional distribution of the number of firms, jobs and the volume of capital shows high regional concentration. From this point of view there are no substantial differences between foreign and domestic firms. The question is: what are the most important factors of allocation preferences of foreign firms in Hungary, and how have these preferences changed over recent years? *Fazekas* (2002) showed that micro regions with a more educated labour force and a closer location to the western trade portals attracted more foreign capital and had higher foreign firms' employment than other regions. Urban centres with a high concentration of skilled labour and proximity to the western border are in the best position. Hungary's

only one large agglomeration – Budapest and its conurbation – together with a large skilled labour pool can offer a wide selection of externalities such as direct links to the political and financial decision makers, a rich cultural life and spillover effects due to high firm density and co-operation networks with a number of universities and scientific institutions.

3 LABOUR MARKET POLICIES

3.1 Financial resources and administrative capacity for employment and labour market policy

Financial resources of employment policy

The new Employment Guidelines of the Commission emphasised that ensuring adequate financial resources is a crucial factor for efficient delivery of employment policies. In Hungary the Labour Market Fund (LMF) is the main financial instrument through which both active and passive labour market measures and the Public Employment Services (PES) are financed. LMF is supported by the contribution of employers and employees and is under the control of a tripartite body, the Governing Board of the Labour Market Fund (GBLF). Parallel with the decrease of registered unemployment the share of the total expenditure on active and passive measures in the GDP decreased from 2.8 to 0.8 per cent between 1992–2001. The share of active measures within the total expenditures doubled in this period reaching 55 per cent in 2001. Last year the declining trend was reversed and active supports rose by 27 per cent, while those on passive labour market policy measures by 12 per cent. According to the budget of the LMF the financial sources for active and passive measures will increase by 10 per cent in 2003. These policy expenditures are moderate in Hungary compared with other CEE countries. Taking into account the size of the state budgets deficit and the extremely high Hungarian tax wedge, however, there is no room to raise either expenditures or employers/employees contributions any further. The effective usage of the available domestic sources and EU contributions seems to be the crucial factor of employment policy in the near future.

Public Employment Service

The Hungarian Public Employment Service (PES) set up in 1990 passed through a continuous reform and modernisation process during the last decade. Since the last election in 2002 the new Government has changed the whole institutional set-up. A new ministry, the Ministry of Employment and Labour (MEL) was established with the goal of co-ordinating and controlling the government's employment policy. According to the Government decree the main activities of the MEL should be based on four pillars:

employment policy, social dialogue, equal opportunity and life long learning. In October 2002 the MEL issued a regulation on the duty and competence of different institutions of the PES.⁹ Recent reforms aim at giving the PES a stronger role in implementing active labour market policies. After the accession the Employment Office should carry out new activities in the framework of the European Employment Services. The necessary legal conditions are in place, the next step is implementation.

According to a new proposal the government will introduce a Job Register to be based on the compulsory system of immediate registration of the initiation or the termination of employment both in the private and public sectors after 1 May 2004. The Job Register will be operated by a new administrative unit of the Employment Office. The legal foundation of the new system is under elaboration. The aim of the new register is to decrease the room for informal employment. It is estimated that 20 per cent of the 500,000 unemployed or inactive people are engaged in informal jobs. It will be possible to switch this status to registered employee status by the new system. If this proves to be successful, 100 billion HUF (385 million Euro) will be added to the GDP and 20 billion HUF (77 million Euro) to the revenue of the social security budget.

In November 2003 the Government decided on a 10 per cent cutback in the personnel of central and local government institutions. Taking into account the additional tasks of employment services in relation to the EU accession the average cutback was smaller in the PES organisation. There is no doubt that the PES needs a far more offensive strategy. It has to face the enormous task of answering requirements of the Commission's Employment Policy Guidelines and needs additional resources both in the numbers and the quality of the personnel. According to the latest update of the Commission's JAP Progress Report the administrative capacity of the PES has been improved but stronger efforts are still needed.

3.2 Active and passive labour market policies

Impact and counterbalance of the latest workfare reform package

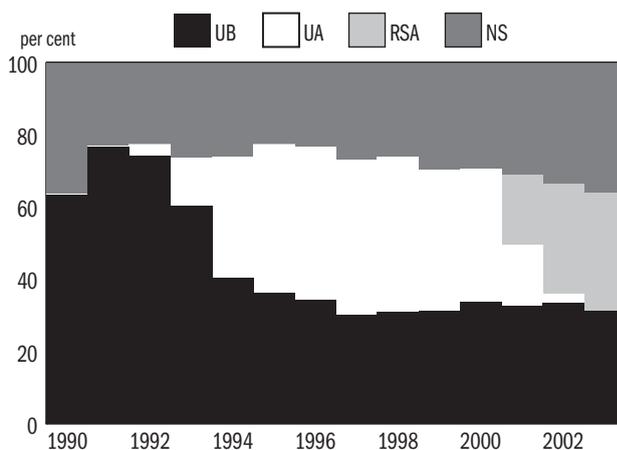
Subsequent modifications of the unemployment benefit system in 2000–2001 made it much less accessible and generous than it was in the past. In the “workfare reform package” the conditions for eligibility have been tightened and the maximum duration of the benefit was reduced from 12 to 9 months and the replacement rate was significantly lowered. The restrictions included the switch from the insurance based unemployment assistance (IUA) to a means-tested regular social assistance for the unemployed. (See Figure 7.) Local governments were put in charge of administering the Regular Social Assistance (RSA) which is given to people who

9 National Employment Office, 20 County Labour Centres, 134 Local Labour Offices and 20 Human Resource Development and Training Centres constitute the institutional framework of labour market administration in Hungary.

have exhausted the entitlements to IUA. A new responsibility of the local governments was to organise public work schemes for at least thirty days for applicants of the Regular Social Assistance. Responses and implications of the tightening of entitlement conditions and the financing and impact of public work schemes were thoroughly studied by a set of recent empirical studies (Fazekas 2002, Köllö 2002, Galasi – Nagy 2002). Results indicate little positive effects of the changes in terms of success in directing the long term unemployed and hard hit disadvantaged groups into the non-supported jobs of the labour market. The workfare reform has reduced the number of benefit claimants significantly but failed to raise non-subsidised private-sector employment (Csongor *at al* 2003).

In 2003 several measures were taken to counterbalance the negative effects of the former restrictions on the most disadvantaged groups of the population. One of the first promises of the new government was to elaborate a new incentive system for those who have exhausted their UB entitlement period and want to get jobs. In 2003 the Government announced several changes in the regulation of employment policy to stimulate life-long learning, employability of disadvantaged groups and better quality of work. A part of the new initiatives was aimed at the alleviation of the labour market situation of the older unemployed persons. The most important changes could be summarised as follows:

Figure 7: Composition of registered unemployed by form of assistance



UB: Unemployment benefit recipients; UA: Unemployment assistance recipients; RSA: Regular Social Assistance recipients; NS: do not receive cash assistance.

Source: *Employment Office. Unemployment Register.*

Life-long learning: After January 2003 participants of training programs under a certain level of income receive special cash benefits. Higher cash

benefits increase the motivation of the clients to participate in training. The aim of certain organizational changes was to improve the conditions of adult training.

Equal opportunity: To put into practice the principles of equal opportunity was among the priorities of the newly established Ministry of Employment Policy and Labour. On the organization side it involved the establishment a new Government Office and a new ministerial post to promote equal opportunities in Hungary.

Employability of disadvantaged people: In May 2003 the government introduced a new scheme called “job search incentive”. This benefit can be provided for those people without jobs who have passed their unemployment benefit entitlement period and co-operated with the employment office. The other scheme runs under the title “job finding incentive”. A modest sum will be provided for those who find employment before their job search incentive period ends. Both initiatives imply a positive discrimination in favour of older workers. Employed persons above the age of 45 are entitled to receive retraining assistance from the Employment Office even in those cases when the employer decides not to contribute to the costs of retraining. (Employers are bound by law to share the costs of the retraining of only the younger employees.) Those who are above the age of 45 are entitled to a wage subsidy after 3 months of being registered as unemployed, the sum of the wage subsidy is 70–100 per cent of the wage, the maximum entitlement period is 2 years. The respective figures for those under 45 are 6 months, 50–100 per cent and 1 year.

Local authorities are required to organise public works for the unemployed. Public works are co-financed by the local authorities and the Employment Office. For those above the age of 45 as much as 90 per cent of the total costs of the public work schemes could be financed by the Employment Office. In the case of public works in the field of health care, cultural services, education and environment protection the maximum length of the entitlement period is 1.5 years. The respective figures for those under 45 are 70 per cent and 1 year.

In the past the various measures of active labour market policy were strictly separated according to the Employment Act. One client was entitled to participate only in one program at the same time. From February 2002 the law has been made more flexible. When the target group is selected from the unemployed in the most disadvantaged position, it is possible to combine various employment policy measures within the framework of one labour market program. Compared to the individual schemes the complex programs can offer more generous benefits to those involved. Most of these programs are especially created for the Roma minority and for the older unemployed.

The shares of different active measures have markedly changed during the last year. In our opinion these changes were mostly due to the short term adjustment to the changing financial conditions, i.e. they reflect neither the adjustment to the long term priorities of employment policy nor the outcome of the evaluation of the effectiveness of different measures. Also, the aim of some of the changes was to guarantee EU conformity of employment subsidies. The fast increase of the statutory minimum wage in 2001 and 2002 decreased the employment probability in the low skilled/low wage segment of the labour market. Since unskilled/low paid workers were concentrated in high unemployment regions, the job-destruction effect of the minimum wage increase was the most obvious in backward regions. (Kertesi – Köllő 2003) In order to avoid further deterioration of the LM position of disadvantaged regions and workers, the Government decided that a substantial part of the Labour Market Fund should be re-arranged to finance a new scheme (*minimum wage increase compensation subsidy*) aimed at preventing the unemployment generating effects of the increase in the minimum wage. The Labour Market Fund provided support via tendering to the companies acting in “high labour-participation” and “low-wage-level” areas where the decrease of the contribution could counterbalance a part of cost-driving effects of the minimum wage increase. According to the estimation of MEL this support granted primarily to SMEs contributed to retaining the jobs of 355 thousand employees in 2002. The minimum wage increase compensation subsidy involved significant resources and limited the funds available for traditional active policies. In 2002 that part of the decentralised part of the Labour Market Fund which is the source of finance for active measures was reduced by 18 per cent. The number of those participating in training and of those affected by wage subsidies has decreased by a few percentage points, while the number of those helped by community works and travel cost subsidies has increased. All in all, it is the public works which have become the most preferred active policy measure of the county level labour centres in 2002. (Table 4.)

The effectiveness of the most important active labour market programs has been assessed annually by follow up surveys since 1994. The latest survey monitored 93 thousand clients who completed active programs in the first half of 2002. The results of these surveys give plenty of information on the composition of the participants, the costs of the programs and the employment probabilities of those who completed the programs. Nevertheless, the data base and the methodology of the analysis are not suitable for the control of the effects of the changing composition of clients and of the different characteristics of local labour markets. Resources derived from the Labour Market Fund which are assigned for financing employment policy measures are divided between central and local authorities

with the corresponding levels of decision-making. It is of crucial importance that both the central and the county level decision-making bodies have more accurate information on the outcome and the effectiveness of the labour market programs.

Table 4: Inflow to different active employment policy programs in 2002

Active Employment Policy Programmes	Inflow in 2002		Previous year = 100%
	Persons	%	
Training	48,296	29.5	78.9
Wage support schemes	18,035	11.0	82.8
Public works	67,860	41.4	100.4
Job creation support schemes	285	0.2	38.8
Small business start-up schemes	2,989	1.8	82.6
Mobility schemes	6,764	4.1	109.2
Support for school leavers	8,780	5.4	90.5
Job keeping support schemes	2,894	1.8	-
Wage related tax support schemes	7,882	4.3	90.3
Self-employment support schemes	1,080	0.5	70.1
Intensive job search support schemes	54	0.0	-
Total	163,829	100.0	91.1

Source: *National Employment Office.*

4 OUTLOOK

The short-term outlook of the economy

The prognosis for the coming few months is influenced by a mix of positive and negative indicators. Preliminary data for the third quarter of 2003 suggest that the economy is in the upward phase of the business cycle with a 2.9 per cent growth of the GDP. The growth of the industrial output and the investments in this sector has been accelerating. The manufacturing production was clearly export-driven, yet overall imports have been rising faster than exports. The current account deficit is increasing due to both the worsening balance of trade and the net capital outflow. The latest report of the Hungarian Central Bank forecasts a 3.4 per cent growth of GDP in 2004 with a slow-down in domestic demand (*MNB 2004*).

The positive outlook for GDP growth, however, does not necessarily imply the expansion of employment or a further reduction in unemployment rates. Information available on labour demand and the fact of mass lay-offs are contradictory to other evidence of the boom in the private sector. According to the KOPINT-DATORG Business Survey, in the second quarter of 2003 nearly half of the manufacturing enterprises decreased, and less than one-fifth increased, the number of employees. Despite massive dismissals reported to the Employment Office the high ratio of companies making constant employment expansion indicates that a significant restructuring

taking place in the manufacturing sector. According to the short term labour market prognosis of the Employment Office the level of employment will barely increase in the second half of 2003. According to the latest report of the Central Bank on Inflation: "A pick-up in the global business cycle, the deterioration of competitiveness due to a stronger exchange rate and corporate decisions on production input ratios have a combined influence on manufacturing. Employment in manufacturing is expected to fall till the end of next year and slightly increase in 2005. The layoffs in manufacturing are compensated in the service sector where the business cycle allows employment to rise steadily. This year we expect a stagnating level of employment in the private sector as a whole. In 2004–2005 we project labour demand to pick up with a resulting modest increase in private sector employment." (MNB 2003).

In recent years the bulk of the employment increase was registered in the public sector. Taking into account the financial restrictions due to the high budget deficit experts anticipate further layoffs in the public sector and this trend will continue in 2004. The central budget for the next year makes it almost certain that the activity rate of the Hungarian population will stagnate while it may improve in 2005. The unemployment rate is projected to increase slightly and remain around 6 per cent throughout the next two years.

The disturbances on the financial markets at the second half of 2003 had a further negative effect on the expansion on the labour market. For reasons still to be clear the confidence of financial investors in the Hungarian currency was shaken and this led to the weakening of the HUF at the end of November. To regain the confidence of the investors the Hungarian National Bank took a drastic measure: it raised the interest rate by an unprecedented 3 per cent. A sound economic policy requires that restrictive monetary measures be harmonised with the fiscal policy. Thus, the curtailment of fiscal expenditures carried out in the first part of 2004 and expected for the next part of the year meaning *inter alia* less availability of jobs in the public sector.

Mid term expectations and employment policy answers

The number of the working age population will increase until, and will sharply decrease after, 2006. The expansion of educational attainment will continue but the structural discrepancies between the demand and supply will be accelerated. According to the latest projections (MEL 2004) the participation rate will be 61.7 per cent in 2006 – much less than the requirement of the EU Employment Strategy for 2005 (67 per cent). Unfortunately there are no reliable prognoses on medium and long term development of labour demand in Hungary. All of the projections stressed high

uncertainty concerning the future development of the economy and uncertainty over the labour market consequences resulting from the different paths of future developments. Nevertheless certain immediate effects could be estimated. Direct job creation effects of the accession are estimated to be around 8,000–10,000 jobs. Demand for a highly educated workforce will increase while in certain occupations (customs officials, carriers etc) a large element of jobs will be diminished. Unfortunately there are no detailed calculations on immediate short term job creation and job destruction effects of the accession. There is no doubt: the fast structural changes of employment by sectors and by branches will continue. The share of agriculture and industry will decrease while the expansion of employment in the service sector will continue. Despite decreasing labour demand in manufacturing, scarcity of (skilled) labour will accelerate and concentrate in the most developed regions. Structural changes within the manufacturing industry will continue. Employment in the textile and food industry will decrease considerably, employment in the chemical industry will slightly decrease and employment in the machine and steel industry will stagnate in the years to come.

Based on the information available the most important challenges of employment policy in the next five years could be summarised as follows:

- Insufficient demand for low-skilled labour, decreasing employment probabilities of school leavers and highly educated job seekers. Increasing structural regional discrepancies between demand and supply on the labour market, increasing scarcity of labour in certain segments of the labour market.
- Insufficient supply of highly motivated work force with special skills required by high-technology, competitive industries.
- Low employability of a large pool of long term unemployed, inactive population, disadvantaged groups concentrated in local labour markets in the less developed regions of the country.

In order to find satisfactory solutions for the recent challenges the Ministry of Employment Policy and Labour elaborated an Action Plan for 2004. The strategy was adopted by the government and was discussed by the Interest Conciliation Committee of Hungary in December 2003. The Action Plan schedules concrete steps in six fields: 1) Improving institutional and background and quality of labour market forecasts; 2) Improving job creation effects of economic development; 3) Enlargement of employment capacity of the formal economy; 4) Increase in the capacity and effectiveness of supported employment; 5) Development of employability, adaptability and training of disadvantaged persons; 6) Actions to answer the requirements of the European Employment Strategy. Most of the projects in the Action Plan are important parts of preparations for the National Employ-

ment Strategy to be elaborated and delivered to the Commission prior to October 2004. The first version of the Action Plan (*MEL 2004*) was prepared and introduced to the social partners and experts of the academic community in July 2004. Developments in the next months will answer the key question: Is the Hungarian Government capable of developing and fulfilling a comprehensive economic policy which should be a prerequisite for sustainable employment development in the coming years.

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