# Social Exclusion in Central-Eastern Europe.

# **Concept, measurement and policy interventions.**

Working Paper

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**Fighting Social Exclusion**

# Social Exclusion in Central-Eastern Europe

## Concept, measurement and policy interventions

**Working Paper**

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**STEP Portugal, International Labour Office**

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# 1 Introduction

"Poverty is a highly political matter in most regions and nations, but in no region is it as highly politicised as in Central and Eastern Europe (CEE). This is largely due to its long and politically determined history. In a majority of those countries, during the communist regime the political authorities declared poverty dead; in some, poverty was considered temporary and exceptional. Consequently, poverty was not a subject of scientific investigation, and public discussions on poverty were banned for decades. In such countries as Romania, the USSR and Poland, the term 'poverty' was not officially used until the late 1980s. In Hungary, Czechoslovakia and Yugoslavia, poverty surveys were initiated in the 1960s, but the results remained confidential." (Dziewiecka-Bokun, 2000, p. 251)[1].

Poverty measurement in Eastern European countries before the economic transformation was primarily built on the notion of social minimum (Atkinson and Micklewright, 1992). The social minima in specific countries were based on a basket of goods. The unit of the analysis was the household, although all poverty estimates were always presented on a "per-capita" basis, implying the non-existence of economies of scale within the household. There was considerable variation across countries with respect to the items selected for the subsistence basket, and also with respect to the specified minimum daily calory intake (for a detailed and thourough discussion of methodologies, data sources and empirical evidence, see Atkinson et al., 1992, mentioned above).

The democratic changes of the 1990s witnessed a growing attention to the issue of poverty in the region. It resulted an extended scholarly work on describing the levels of poverty and income inequality. This included studies on both the objective and the subjective, in other words self-assessed, aspects of poverty, altough most studies focused on single countries (just to name a few comprehensive works: Ferge, Sik et al. 1996; Vecernik 1996; just to name a few comprehensive works: Milanovic 1998; Tóth 2005). The economic analysis of poverty in Eastern Europe includes various country-comparative studies as well (Atkinson and Micklewright, 1992; Förster and Tóth, 1997; Förster and d'Ercole, 2005). A smaller, but increasing strand of literature examines a broader concept called well-being, which includes the issues of mortality, children's school enrolment (Cornia, Fajth et al., 1996; Micklewright and Stewart, 2001), and life satisfaction (Lelkes, 2005, Sanfey Sanfey and Teksoz, 2005).

Social exclusion has received relatively little attention among *policy makers* in Central and Eastern Europe. In recent years, this seems to have somewhat changed as a result of pressure from the European Union, as the countries agreed to produce national reports on policies tackling social exclusion, the so-called National Action Plans for social inclusion. In many countries these reports tend be the most comprehensive government documents on the social situation and on social policies in general.

This paper aim to provide an analytical basis for formulating future strategies and policy interventions. For this, it describes (1) the conceptual issues related to social exclusion,

[1] The situation, however, may not have been different in a number of Western European countries either.

(2) its measurement, and (3) the scope of the problem in Central-Eastern Europe. The concluding section discusses social policy in Hungary.

## 2 Concept of social exclusion

*Income as a proxy for resources*

The use of income as a measure of individual welfare has many obvious advantages. Economists find it parsimonious, as it is a single measure. Income, e.g. units of euro, is comparable, or can be made comparable, across people. Policy-makers think it is a particularly relevant policy variable as they can influence it and the direction of causality (from a particular policy measure to final income) can be established. Income, in addition, expresses only a consumption opportunity, thus people's freedom is respected. In other words, the external evaluator does not impose value judgements on the items people choose to consume. Individual preferences, tastes are thus not examined, but taken as granted. The result is a focus on resources, rather than actual behaviour.

Income, however, may not be a good measure of consumption opportunities. Income may not be easily comparable across people. If we use personal incomes, we do not take into account the income that the individual may receive from other household members. If we use household income, we need to make simple assumptions on the sharing of resources within the household (which normally means equal sharing) on the efficiencies of scale operating as household size increases (choosing a particular equivalence scale). The definition of income is also a critical issue, and includes choices on whether gross or net (after tax) income is used, on what components of income are accounted for (other than earnings and cash benefits, should we include for example capital gains, income from own production, consumption of services in kind), or whether we account for income "not spent" (tax credits, imputed rents). (The recommendations of the "Canberra Group" have greatly contributed to the resolution of these issues. For more information, see: http://www.lisproject.org/links/canbaccess.htm.) Finally, the choice of time period is also crucial. Weekly incomes are likely to fluctuate more, as they are more exposed to shocks and seasonal effects. Yearly incomes appear to express long-term income position better, but may be more difficult to measure. The choice of time period is also relevant for designing policy interventions. The outcomes of income inequality or poverty calculations are thus sensitive to the choice of income unit, of the equivalence scale, of the definition of income, and of the time period. Therefore these choices need to be stated explicitly and their implications for the results need to be assessed.

Income seems to be an inadequate measure of resources, and it is often difficult to gather information on resources other than income. Wealth, in particular, has major measurement problems. It is difficult to assess individual's financial assets, savings, property value, or pension rights, just to name a few. Survey information on assets is mostly restricted to consumer durables owned by the household. These measurement issues may partly explain why income is often weakly correlated with measures of deprivation (Nolan and Whelan, 1996; Whelan, Layte et al., 2004).

Income based indicators may be inadequate for monitoring policy *outcomes*. Policies promoting social inclusion may be focusing on access to services, educational performance, labour market participation, rather than income per se.

On the other hand, there are many supporters of the view that income is a suitable cornerstone of welfare analysis. According to this, the crucial issues are (1) to improve the measurement of income and (2) to establish the causal links between particular policy measures and changes in incomes. A similar argument is often made for the use of consumption expenditure as a single measure for welfare comparisons. As Immervoll, Levy et al argue (2005), the impact of a particular policy measure can be significantly altered by other policy reforms, or the macroeconomic situation (e.g. changes in the level of economic activity). A possible way of tackling this problem is to use microsimulation modelling techniques, which enables to focus on one change at a time. The European tax-benefit model, Euromod[2], which covers all 15 member states, is the most comprehensive model of this type. Starting in 2005, as part of a major European Commission funded project, the possibility to introduce such microsimulation modelling technique to all new member states is being explored[3].

On the other hand, increasing attention is devoted to the use of non-income measures. Growing academic literature is devoted to multidimensional indicators of well-being[4], and policy-makers ever more include social exclusion in their agenda in addition to poverty. The next section aims to explore why it is so.

*Resources may not be adequate measure of quality of life*

Resources, however, are not the end in themselves. Resources are only means to achieve end-states, which may be called well-being, utility or welfare. Amartya Sen, the Nobel laureate in economics, has devoted much of his career to criticising traditional economic approaches and develop an alternative theory of so-called capabilities. Capabilities are not resources, but end-states, depicting various aspects of individuals' lives. Basic capabilities include the ability to avoid acute hunger, to avoid premature mortality, or the capability to take part in the life of the community (Sen, 1992, pp. 69, 109).

The use of capabilities seems to be especially relevant for the analysis of the countries of Central-Eastern Europe for various reasons. First of all, capabilities are valuable per se. It is the human condition and the choices people have which are the final test of the social consequences of transition. Secondly, income is an inadequate indicator of well-being during a major dislocation. Crucially change in economic system could produce a step change in the relationship between income and well-being. So before and after change, difference in income correlates with well-being, but not over transition itself. In addition, income may not be able to explain individual differences in well-being, such as health state or nutrition. Income may only partially reflect the effects of substantial economic

[2] For more information, see the working paper titled "Introduction into Euromod" (Immervol, O'Donoghue et al., 1999) and the University of Essex website: http://www.iser.essex.ac.uk/msu/emod/

[3] The project is coordinated by the European Centre for Social Welfare Policy and Research, Vienna. For more information, see www.euro.centre.org.

[4] See e.g. the Special Issue on Inequality and Multidimensional Well-being of the traditional "income" journal, The Review of Income and Wealth, June 2005 (Vol. 52, (2)).

changes, like the restructuring of the labour market, the redistribution of wealth and privatisation of state assets, the reorganisation of social services or changes in the relative prices of goods (e.g. due to cutbacks in price subsidies). Point-in-time income data inevitably show transient shocks as well, disregarding households' ability to pool over time and their ability to adjust their consumption patterns (Cornia, Fajth et al., 1996). Income analysis faces serious difficulties related to the intra-household allocation of resources. Individual level indicators of well-being avoid external judgements on this matter, and may be particularly useful in countries with intense cultural diversities. Income indicators may be deficient for describing resources themselves, due to measurement failures. Problems relating to hidden income, resulting for example from black market activities or own production, or tax evasion may substantially distort available data in certain countries.

Empirical evidence suggests that there is increasing divergence between incomes and well-being in developed nations. Despite the steady growth of income in the US in the past fifty years, with the GDP per capita tripling, life satisfaction has been virtually unchanged (Easterlin, 1974; Diener and Seligman, 2004), and social participation has declined (Putnam, 2000). In addition, there is also evidence that there is weak link between resources and outcomes on an individual level. Why is it so?

The level of resources and that of well-being may be only weakly correlated for various reasons. First, individuals' ability to convert resources into outcomes may greatly differ. A disabled person for example may need more resources to achieve the same standard of living (Zaidi and Burchardt, 2005). Resources may not be converted to outcomes due to external constraints. These constraints may include market inefficiencies (shortage), lack of access to services or goods, and external constraints of personal freedom. There is also the insider/outsider problem: migrants, for instance, need a higher level of income in traditional 'insider markets', e.g. to realise equal housing. Second, rising national incomes may not make people on average happier, because their aspirations rise or they compare their situation with that of others (who have rising income trajectories) (Clark and Oswald, 1996; Easterlin, 2001)[5]. On the other hand, evidence for Eastern Europe suggests that there is a strong association between the level of income and life satisfaction across countries and across individuals at one point in time. The level of GDP is correlated with life satisfaction in 19 transition countries (Sanfey and Utku, 2005). Comparing happiness over the decade of economic transition in eight countries, Sanfey and Utku conclude that average happiness[6] declined, then increased, similar to the pattern of changes in national income. Analysing Hungarian individual level data, Lelkes finds (2005) that although people with higher incomes tend to be more satisfied at one point in time, controlling for other personal characteristics, the relationship between income and life satisfaction has not changed significantly during the period of economic transition. This suggests that money did not to become a greater source of happiness in a more market-oriented economy.

[5] Note, however, that at one particular point in time rich people tend to be significantly happier than the poor within a country. This finding has been replicated in numerous countries and its validity has been tested (Frey and Stutzer, 2002).

[6] The measure of happiness is self-assessed life satisfaction in the World Values Survey. Respondents were asked to mark their answers on a scale from 1 (most dissatisfied) to 10 (most satisfied): "All things considered, how satisfied are you with your life as a whole these days?"

These concerns have been recognised in the literature on "quality of life", and recently in that of "social exclusion". It is difficult to give a single definition of these approaches, as there is a multitude of theoretical definitions and empirical applications. We can say in common, however, that these approaches have highlighted the importance of non-income measures and explored the use of multi-dimensional measures for describing well-being.

An important originator and proponent of such multidimensional approach was the United Nations (UN and ILO, 1954; Drewnowski and Scott, 1966). Empirical studies in this vein include for example the Swedish Level of Living Research[7] and the Comparative Scandinavian Welfare Study. The Swedish research is based on a one-country longitudinal survey especially designed to capture living conditions, and changes, between 1968 and 1981 (Erikson and Aberg, 1987; Erikson, 1993). The indicators incorporated both economic resources (income and wealth), and other components such as health, employment, education, housing, social integration and political resources. The Comparative Scandinavian Welfare Study also uses resources, but its primary focus is much broader. It incorporates measures of education, health, employment, social relations, political activities and opportunities to live in harmony with nature (Allardt, 1993). Subjective measures gained equal emphasis as objective ones in the design of the survey. The subjective indicators include dissatisfaction/satisfaction with living conditions, unhappiness/happiness about social relations and personal growth.

An influential application of Sen's capabilities theory is the Human Development Index (HDI) (with Amartya Sen's contribution as a consultant), published yearly in the Human Development Report by the UNDP starting from 1990, as the now widely quoted alternative to GDP for comparing human well-being between countries. The report interprets human development both as 'the process of widening people's choices and the level of their achieved well-being' (UNDP, 1990, p.10). The measurement of human development focuses on three essential elements of human life: longevity, knowledge and decent living standards. HDI is thus a composite index, calculated as the simple average of life expectancy at birth, illiteracy and school enrolment, and GDP per capita. The HDI rankings of countries may differ significantly from their ranking based upon GDP per capita.

The European Quality of Life Survey, conducted in 2003 by the European Foundation for the Improvement of Living and Working Conditions, offers a rich source of information on 28 countries, including the EU25 and three candidate countries (2004). Quality of life, in this approach, has the following features:

- It refers to individuals' life situations, thus it requires a micro perspective,

[7] 'Level of living' is a specific term used in the Swedish Level of Living Research. The designers of the research wanted to emphasise its difference from standard of living, because 'level of living' uses not only resources, but also states and achievements of individuals. Standard of living is however, far from being a well-defined concept, and various 'divergent and rival views' co-exist within it. In Sen's terminology, capabilities can be actually used for the assessment of living standards, thus there seems to be no contradiction between the standard of living and capabilities approach (Sen 1987).

- It is a multi-dimensional concept. “Multi-dimensionality not only requires the description of several life domains, but emphasises the interplay between domains as this contributes to quality of life.” (p. 1).
- It is measures by objective as well as subjective indicators. Subjective and attitudinal perceptions are essential in order to understand individual.

The Survey contains six core areas:

- employment,
- economic resources,
- family and households,
- community life and social participation,
- health and health care,
- knowledge, education and training.

The term “social exclusion” seems to has originated in France, referring to those who were administratively excluded from the social insurance system (Hills, Le Grand et al., 2002; Estivill, 2003). “Les exclus” were the uninsured unemployed, especially young adults, disabled people and lone parents in the 1970s. A recent UK definition suggests that “*an individual is socially excluded when he/she would like to but cannot participate in the generally accepted activities of the society in which he or she lives*” (Burchardt, Le Grand et al., 2002, 30, 32. o.). Accordingly, social exclusion is, for example, where an individual would like to have a job, invite guests or go to vote, but he or she cannot do so. This definition thus sensitive to the issue of “agency”: who is doing the excluding. Individuals would *not* be regarded excluded if they themselves do not want to participate. An example for this could be the voluntary withdrawal of a particular minority group from certain social activities. In practice, however, it may be difficult to distinguish voluntary and non-voluntary exclusion.

In addition to the social exclusion problem described above, the lack of social cohesion may also mean the segregation of the forms of life and institutions of the majority society and an elite group (Barry, 2002). This phenomenon is usually referred to in relation to the United States of America. The main characteristics of this problem are twofold: while the minority who uses private schools, private health care system or even security services has little interest in financing general public services, at the same time they constitute a strong interest group in politics. Ultimately, holds Barry, this situation leads to a change in the role of the state, which no longer reflects the majority’s preferences with respect to ‘social solidarity’. This argument highlights that the analysis of social exclusion should not exclusively focus on the position of those on the “bottom”.

This definition of social exclusion also emphasises the relative aspect of the concept. What the “generally accepted activities of the society” are depends on the particular society and the particular point in time. A consequence of economic development is that people need ever more resources for social participation. Internet access, for example, may not have been essential for access to services in the early 1990s, but it turns out to be increasingly so. The “digital divide” is a new aspect of social inequalities. This relative approach has been pioneered by Townsend’s classic study on poverty (1979), and has been recently adopted by the European Union when it defined its headline indicator of poverty. According to this indicator, those people are “at-risk-of-poverty” who have incomes below 60% of the national median income. This implies that in a richer society more resources are needed to stay out of poverty.

In sum, the concept of social exclusion may be summarised in the following way.

- Social exclusion refers to both the state of being excluded and the process of exclusion, thus
- it is dynamic, observes changes in individuals' states over time,
- it is multidimensional, explores various different aspects of individuals' lives,
- it is relative, relative to the time and place in question.

From this it follows that the operationalisation needs to focus on the various aspects of social participation, or "outcomes". Issues such as ethnicity, or living in a deprived area are not indicators of social exclusion as such, but rather risk factors of being excluded.

The European Union has long been concerned with the issue of poverty, but the term social exclusion has been adopted in the late 1980s and became a focus of the social agenda from the 1990s. A landmark of this development was the adoption of the eighteen common indicators for social inclusion in December 2001 in Laeken, generally referred to as the Laeken indicators. These indicators are used by member states in their National Action Plans on Social Inclusion to monitor social developments.

*The Laeken indicators*

The indicators used to monitor social inclusion, the so-called Laeken indicators, dominantly use the metric of income. Over half of the indicators (11 out of 21) are measures of poverty or income inequality (see Table 1). This means that the portfolio of Laeken indicators places much more emphasis on resources, than on outcome or performance. Other dimensions of well-being include employment, health and education. Housing indicators are being developed (Atkinson, Cantillon et al. 2005). The indicators suggested by the team are homelessness and an index of housing problems. Similarly, Atkinson et al suggest a deprivation index, which would include a set of items which can be regarded as basic necessities (e.g. inability to afford keeping the home adequately warm, paying for a week's annual holiday away from home, a meal with meat, chicken or fish every second day, etc.). The special feature of this index would be that the same weight would be given to each item across the member states and over time, thus it would be an "absolute" indicator. This deprivation index thus would provide useful complementary information to the "at-risk-of-poverty rate, which is a relative indicator, uses national poverty thresholds (defined as 60% of the national median income).

The current and possible future set of Laeken indicators does not include any measure of social isolation or subjective well-being (e.g. life satisfaction), albeit these are regarded as key aspects of quality of life in the academic literature. Both of these dimensions are included in the social indicators used by the OECD (2005). Similarly, they are part of the First European Quality of Life Survey 2003, as mentioned before. Subjective well-being measures (they) tend to gain increasing attention among policy-makers in various countries. In March 2005 the UK Government has committed to creating "a new indicator set, which is more outcome focused, with commitments to look at new indicators such as on wellbeing"[8]. The strategy document explicitly states that this may influence policies in order to have a more explicit well-being and outcome focus.

[8] http://www.sustainable-development.gov.uk/publications/uk-strategy/uk-strategy-2005.htm
Citation form the document: "In order to get a better understanding and focus on wellbeing, by the end of 2006 the Government will sponsor cross-disciplinary work to bring together existing research and international experience and to explore how policies might change with an explicit wellbeing focus. Depending on the strength of the evidence base, such work could be used to inform future policy development and spending decisions, as this sustainable development strategy is implemented. It could also provide the basis for developing a more comprehensive set of wellbeing indicators to support the Framework and our separate sustainable development strategies."

### Table 1. Laeken indicators and dimensions of well-being

| *Dimension* | *Laeken indicator* | | *OECD, EQOLS, or other indicator* |
|---|---|---|---|
| | *Primary indicator* | *Secondary indicator* | |
| Income | 1. At-risk-of-poverty rate<br>2. At-risk-of-poverty threshold<br>3. Income quintile ratio<br>4. Persistent at-risk-of-poverty rate<br>5. Relative median poverty risk gap | | |
| | | 13. Dispersion around the at risk-of-poverty threshold<br>14. At-risk-of-poverty rate anchored at a moment in time<br>15. At-risk-of-poverty rate before social cash transfers<br>16. Gini coefficient<br>17. Persistent at-risk-of-poverty rate (50% of median income)<br>18. Working poor (in-work poverty risk) | |
| Employment | 6. Regional cohesion (Coefficient of variation of employment rates at NUTS level 2)<br>7. Long-term unemployment rate | | |
| | | 19. Long-term unemployment share<br>20. Very long-term unemployment rate | |
| Education | 9. Early school leavers not in education or training<br>10. Low reading literacy performance of pupils | | |
| | | 21. Persons with low educational attainment | |
| Health | 11. Life expectancy at 0, 1, 60<br>12. Self-defined health status by income level | | |
| | | | Premature mortality or life expectancy |
| Housing | - | - | Index of housing problems<br>Homelessness |
| Social isolation | - | - | Lack of contact with other people in normal daily living<br>Group membership (formal and informal) |
| Subjective well-being | - | - | Self-reported life satisfaction<br>Self-reported happiness |

Sources: Atkinson et al (2005), European Foundation, Dublin (2004), OECD (2005)
Note: for a definition of the Laeken indicators, see e.g. Atkinson et al (2005), Tables 2.2a-b

*Data issues in CEE countries: comparability, longitudinal character and non-income components*

Easily accessible is the information provided by Eurostat in the NewCronos database. This contains various aggregate indicators of poverty and social exclusion, the so-called Laeken indicators. The methodology of the indicators is harmonized, thus comparable across countries. They provide a useful starting point for analysis, and will thus be also used in the following sections as well. In the case of Hungary, however, an alternative national data source appeared to be more appropriate, and therefore was used instead[9]. Although many of the Laeken indicators are also available by various breakdowns (e.g. age, gender, household type), they are essentially aggregate indicators. In-depth research requires individual level data, which is also comparable across nations.

The measurement of persistent poverty or deprivation requires datasets that contain information on the same individuals over a few years. In addition, for the purposes of a cross-country comparison, the dataset needs to be internationally comparable. For the fifteen "old" member states of the EU the only such source is the European Community Household Panel (ECHP), which covers the period between 1995 and 2001. This this will be replaced by an annual cross-sectional survey (Survey of Income and Living Conditions, SILC). Member states might collect longitudinal panel data, but they are not required to do so. In addition, SILC does not contain detailed survey questions on non-monetary indicators of deprivation, including the lack of ownership of consumer durables, access to commonly accepted necessities of live, or social relationships, which will inevitably limit the scope for analysing and comparing the socially excluded population across countries. The obvious advantage of the SILC surveys, however, is that they will incorporate the new member states of the European Union, including eight Central-Eastern European countries.

Alternative data sources contain only cross-sectional information, and cover only few Central and Eastern European countries. The Luxembourg Income Study includes harmonized and standardised household income surveys from currently 29 countries. As for the CEE region, it covers the Czech Republic, the Slovak Republic, Hungary and Poland since the early 1990s, and has been extended later with national data from Estonia, Romania, Slovenia. The LIS database enabled the empirical comparisons on the level of poverty in some of these countries (Förster and Tóth, 1997; 2001). LIS, however, has a number of shortfalls from the point of view of social exclusion research. It contains only cross-sectional information, thus it does not allow the dynamic assessment of individuals' situation over time. Currently, the most recent data is from 2000, and for some CEE countries only 1996, which seems somewhat outdated if we aim to assess the impact of social policies. Finally, LIS, as stated in its name, is primarily concerned with

[9] The Hungarian National Action Plan for Social Inclusion notes that "the reliability of income data is questionable. The data come from the National Statistical Insitutte (CSO) Household Budget Surveys, which tends to underestimate both the income and, in particular, the dispersion. The other available source, TARKI's Monitor Surveys, produces income data that appear more realistic, but with a small sample" (Government of Hungary, 2004, p. 10)

collecting comparable data on incomes, and thus proves to be inadequate on other aspects of social exclusion.

The European Social Survey (ESS) is a new cross-sectional multi-country survey. Among the 22 countries which participated in the first round in 2002/2003, four Eastern-European countries are also represented. The ongoing second run will include seven countries of the region: six EU member states and also Ukraine. The survey offers a variety of interesting aspects of social exclusion, including for example social isolation, neighbourhood problems and bad health, but the size of national samples (around 1000) does not enable the in-depth analysis of specific risk factors, such as ethnicity or regions. In sum, the ESS enables a multi-dimensional, but not dynamic approach.

The new European Union member states have been also surveyed as part of the First European Quality of Life Survey 2003, conducted by the European Foundation for the Improvement of Living and Working Conditions in Dublin, Ireland.

In sum, there is increasing data and empirical evidence for those CEE countries, which joined the EU, or who are awaiting accession. For other countries, however, the evidence is limited, especially in terms of internationally comparable data.

# 3 Social situation and the scope of the problem

*Low income*

Poverty in CEE countries is not significantly below that of the “old” EU member states, if we use a relative definition of poverty, the most widely used definition of poverty. 15% of European Union citizens are regarded to be poor according to the “at risk of poverty indicator”, the prime measure of poverty. This means that on average 15% of the EU population has incomes lower than 60% of the national median equivalised income. Poverty rates in the EU25 range between 8 and 21%, suggesting a factor of 3. As the countries with the lowest and highest levels of poverty are actually from the CEE region, this statement equals to saying that among new EU members in CEE, poverty ranges between 8% and 21%. Poverty is particularly low in the Czech Republic and Slovenia, similar to the level of that in the Nordic countries. At the other extreme is Slovakia, with the highest level of poverty, similar to that of Ireland and Greece. Poland, and to a lesser extent the Baltic states have poverty rates slightly above the avery EU25 poverty rate.

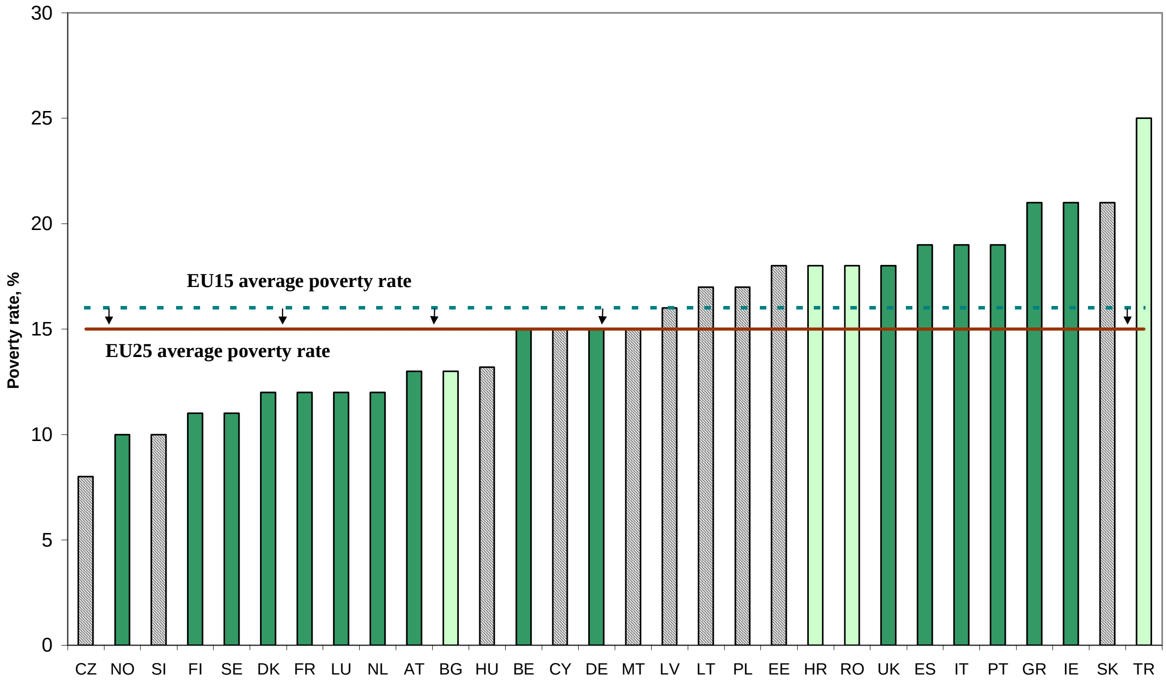
Counterintuitively, the average poverty rate (weighted by the population size) in 2001 was slightly *lower* in EU25 (15%) than in EU15 (16%). Average poverty rate in the eight New member states in CEE equalled 14%, somewhat below that of the EU15. Thus, enlargement did not increase the average poverty rate in the European Union, using national poverty thresholds and a relative definition of poverty.

***Measurement of poverty***

**Definition**
Poverty is defined here as having an equivalised income of under 60% of the national equivalised median income. This is the conventional definition which has come to be used in the EU, though it is equally relevant to take account of other possible definitions (such as the risk-of-poverty rates relative to poverty thresholds at 40%, 50% and 70% of the median, adopted as “secondary” Laeken indicators) and, in particular, the extent to which incomes fall below the poverty threshold (poverty gap).

**Adjustment for household size**
The basis of the analysis is household income adjusted for household size, rather than the income of individuals as such. This means that account is taken of the fact that individuals live in households where resources are shared between household members. This is particularly relevant for examination of the relative position of children, who do not usually have incomes of their own. Rather than using a simple measure of income per capita, the average income of those living in a household is calculated by weighting each according to the so-called ‘modified-OECD’ scale (attributing a weight of 1 to the first adult, 0.5 to the second and subsequent ones 0.3 to each child). In this way we account for economies of scale in spending within households (e.g. two people living together need less resources to achieve the same standard of living than if they lived separately because of the fixed costs of running a household).

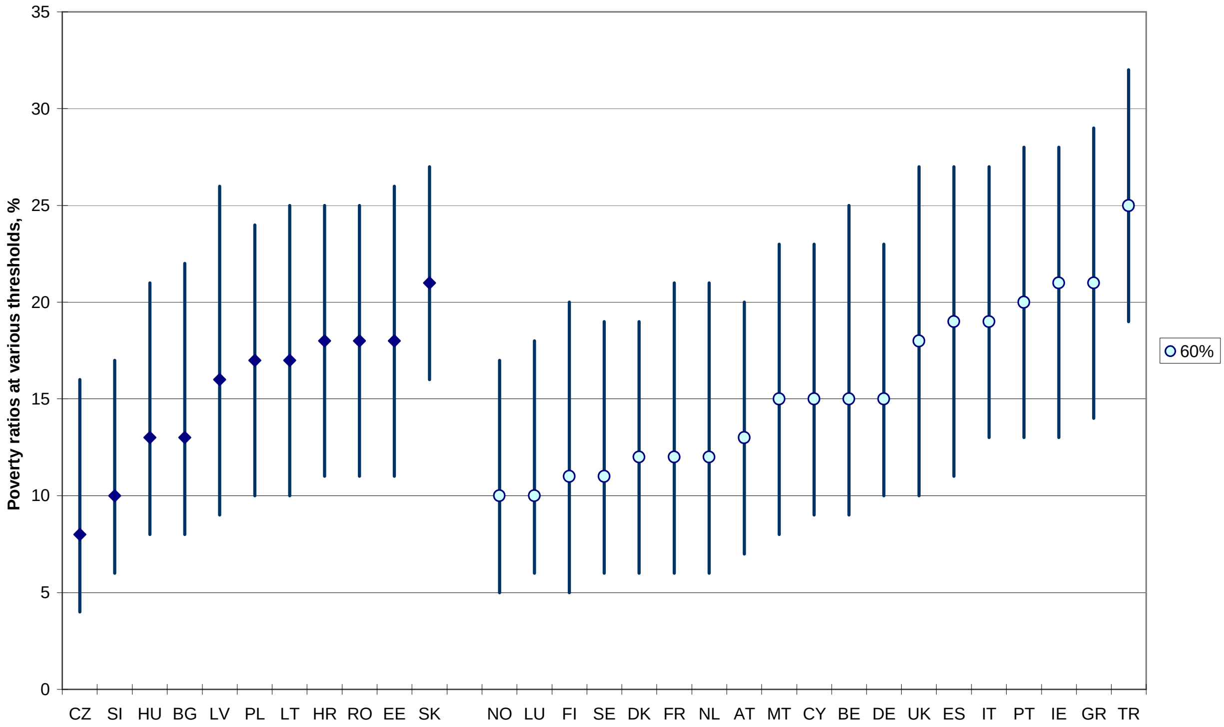
**Figure 1. Poverty rates in European countries**




Notes:
Reference year: 2003, except: SI, NO, NL, BG, AT, LT, PL, HR, PT, TR: 2002; RO: 2001; MT: 2000
Poverty rate: share of population with equivalised income of under 60% of the national median equivalised income
New member states and candidate countries are indicated with bars of different colour or pattern.
Source: Eurostat NewCronos Database (2005), Hungary: Tarki Monitor 2003

The estimates of poverty are sensitive to the threshold used. The most commonly used definition of poverty by the EU, also a primary Laeken indicator, is based on a poverty threshold which equals 60% of national median equivalised income. This poverty indicator suggests that 15% of the population of the European Union lives in poverty. As this poverty threshold is of a relatively arbitrary nature, we tested how sensitive the estimated poverty rates are to the threshold chosen (see Figure 2). When a high number of people have incomes just below or above the specific threshold, a modified threshold may alter the results significantly. If we used an alternative poverty line of 50% of national income, we would find that the proportion of poor is 9% on average in the EU. On the other hand, a poverty threshold of 70% would indicate an average rate of 24%.

**Figure 2. Sensitivity of poverty rates to the threshold chosen: Poverty rates at 50%, and 60%, 70% of national median equivalised income**



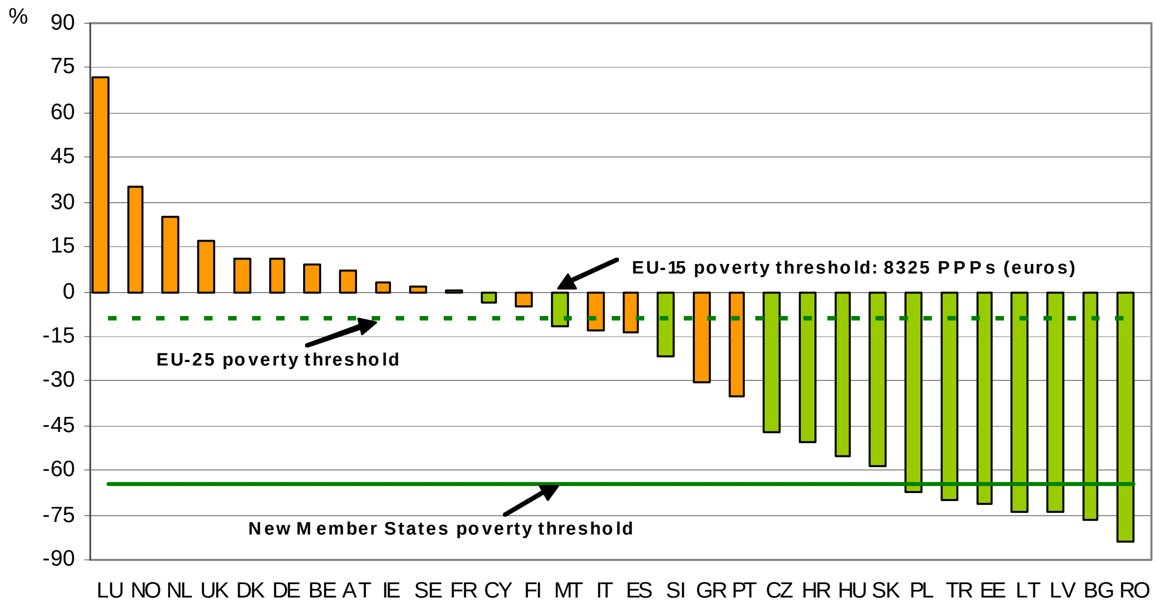

Source: Eurostat (2005), NewCronos database, Hungary: Tarki Monitor 2003
Notes: Reference year: 2003, except: HU, SI, NO, NL, BG, AT, LT, PL, HR, PT, TR: 2002; RO: 2001; MT: 2000

The poverty threshold greatly influences the degree of poverty, but affects the country ranking only a little. The countries on Figure 2 are ranked according to the commonly used 60% threshold. The circles indicate the level of poverty, using this definition, and the lines indicate the range of poverty, when alternative thresholds, 50 and 70% are used. The lowest endpoints of the lines indicate poverty rates at a threshold of 50%, while the highest point show poverty ratios at the threshold of 70%. The figure highlights differences in the income distribution across countries. Comparing for example Latvia and Lithuania, Latvia has *lower* poverty when the standard 60% threshold is used, but poverty turns out to be *higher* when a 10% higher threshold is used. This suggests that a relatively greater number of people have incomes around the standard 60% threshold in Latvia compared to Lithuania. In case of other countries, the divergence from the standard value, indicated by the length of the line, shows a sensitivity of the estimates. As we see, in countries such as Finland, the UK and Spain, a relatively large number of people have incomes close to the 60% threshold. In other countries, for example Slovenia, Austria, Germany and Slovakia, the poverty ratios are less sensitive to the threshold used, due to a relatively "flat" income distribution pattern. These results highlight that it is important to make the underlying estimates of the analysis explicit, as the results, especially the national poverty levels, are rather sensitive to these.

The use of relative national poverty thresholds, however, may not be fully adequate for cross-country comparisons. The monetary value of the national poverty thresholds greatly varies across countries, which also implies that a single EU threshold would result much greater poverty in the NMS. The rationale beyond the use of these is that it is the national governments' responsibility to design policies that influence income distribution. This implies that social justice is interpreted within a single society. In other words, the equity or fairness of a particular income distribution is evaluated among members of a particular country. The design of the European Union, its focus on social cohesion across countries, including the Funds spent on this purpose, implies, however, that social justice can be interpreted as a notion across the whole of the EU as well. In addition, it is also known in social attitude studies that people tend to compare their financial situation not solely to their fellow citizens, but also to citizens of other (normally richer) countries.

On the other hand, using a single *monetary* threshold across Europe would be misleading. In order to illustrate this, Förster et. al. (2003) calculated poverty rates in Hungary, the Czech Republic and Slovenia with a common EU18 threshold. Using 1999 data they conclude that poverty ratio would duplicate in Slovenia, would be over threefold in the Czech Republic, and would be close to six times as high in Hungary when an "EU18" threshold was used instead of a national poverty threshold (p. 29). According to this measure, 8 million out of the total 10 million would be regarded poor in Hungary. According to recent Eurostat figures, the overall poverty threshold in the new member states is over 60% lower than the average for the EU15. Poverty thresholds in Slovenia in purchasing power parity terms are close to those in Spain, Greece and Portugal. In all other the CEE NMS countries, the poverty threshold is much lower than in all EU 15 countries. The three Baltic States, Bulgaria and Romania have particularly low poverty thresholds, around 75% or more below the EU15 average. In terms of a universal poverty threshold equaling the EU average, therefore, relatively few people in most of the EU15 countries would be considered at risk of poverty, while in the new member states and candidate countries, as well as Greece and Portugal, most would.

**Figure 3. Poverty thresholds in specific countries compared to EU15 average, 2003 (% difference)**




Source: Eurostat (2005), CPI for Turkey: Turkish National Bank
Note: national threshold values have been adjusted with Consumer Price Index where only 2002 or 2001 data were available

These figures clearly illustrate the limitations of this approach. Given the current roles of the EU budget and that of the Union in general, it is rather unclear what the implication would be if, say, the overall majority of the population in a particular country would be regarded as poor in European standards. Therefore, the researchers of the European Centre, Vienna, argue that the current country-specific indicators of relative income need to be complemented with a European-wide measure of non-income deprivation, defined as a “carefully selected absolute minimum set of non-income items” (Förster, Fuchs et al., 2003, p.32)[10].

> *“We believe that the current and imminent future developments (less autonomy for national policies due to European integration and globalisation; free access to residence and labour markets within the EU; […]) build a strong argument for complementing traditional country-specific poverty estimates with estimates which treat the whole (enlarged) EU as one society” (pp. 22-23).*

The discussion of social exclusion in Central Eastern Europe cannot be restricted to comparing levels of incomes *at one point in time*, but also needs to analyse changes over time. These countries have undergone a major transformation, and people assess their current income situation compared to that in the past. It is well known that poverty and income inequality has greatly increased in these countries. The extent of this rise, however, is unclear, as there is scarce long term, comparable data (see discussion in previous section). Förster and d'Ercole (2005) analyse the change in the Gini coefficient

[10] Förster et al (2003) also argue that as an alternative, “upper benchmark”, a European-wide income threshold could be combined with country-specific non-monetary deprivation.

in Poland, Hungary and the Czech Republic between 1995 and 2000. In Hungary and the Czech Republic they find no significant change, while in Poland inequality has declined. This suggests that the greatest rise in inequality has actually happened at the early phase of transition.

Poverty and income inequality in Hungary has started to rise already in the 1980s. Toth, in a comprehensive review of the subject in his book (2004), shows that poverty has increased to twofold between 1987 and 1996, and then it has stabilised. Using a poverty threshold of 50% of the median equivalised income he finds that poverty has increased from 4% to 8% during the first decade of economic transition[11]. During the same period, the Gini coefficient has risen from 0.236 to 0.290. There has been a significant social polarisation: the relative share of both the well-off and the poor groups have increased, while the proportion of the middle income groups has decreased. In the late 1990s there has been no significant increase in the level of inequality in Hungary, according to Toth. He adds, however, that the level of incomes has increased during these years, and as a result, the nominal difference between the extremes has also grown.

*Non-income measures*

Unemployment is one of the key indicators of social exclusion. Thus, unemployment, the situation when an individual is searching for work and is ready to start working, is regarded to be undesirable compared to employment. Such judgements are more difficult referring to absence from the labour market. Inactivity may occur as a choice, for example for the purpose of child care, or it may be a necessity, e.g. an escape from unemployment in the forms of early retirement or disability pension. These latter forms of inactivity are problematic from various grounds. First of all, they seem to provide a dead-end, thus very limited probability for re-entry to the labour market, partly due to the financial incentives and the lack of reintegration schemes. This is both economically ineffective and socially undesirable. All this suggests that the ideal indicator of social inclusion would be:

- Being employed, having a fulfilling job or doing a socially valued activity outside the labour market

In the particular context of Eastern-Europe unemployment in itself seems to be an inadequate indicator of social exclusion, given the high number of "involuntary" inactive. As it is very difficult to separate non-voluntary and voluntary non-employment, in order words, to distinguish between choice and constraint[12], the analysis will focus on

- employment on the labour market.

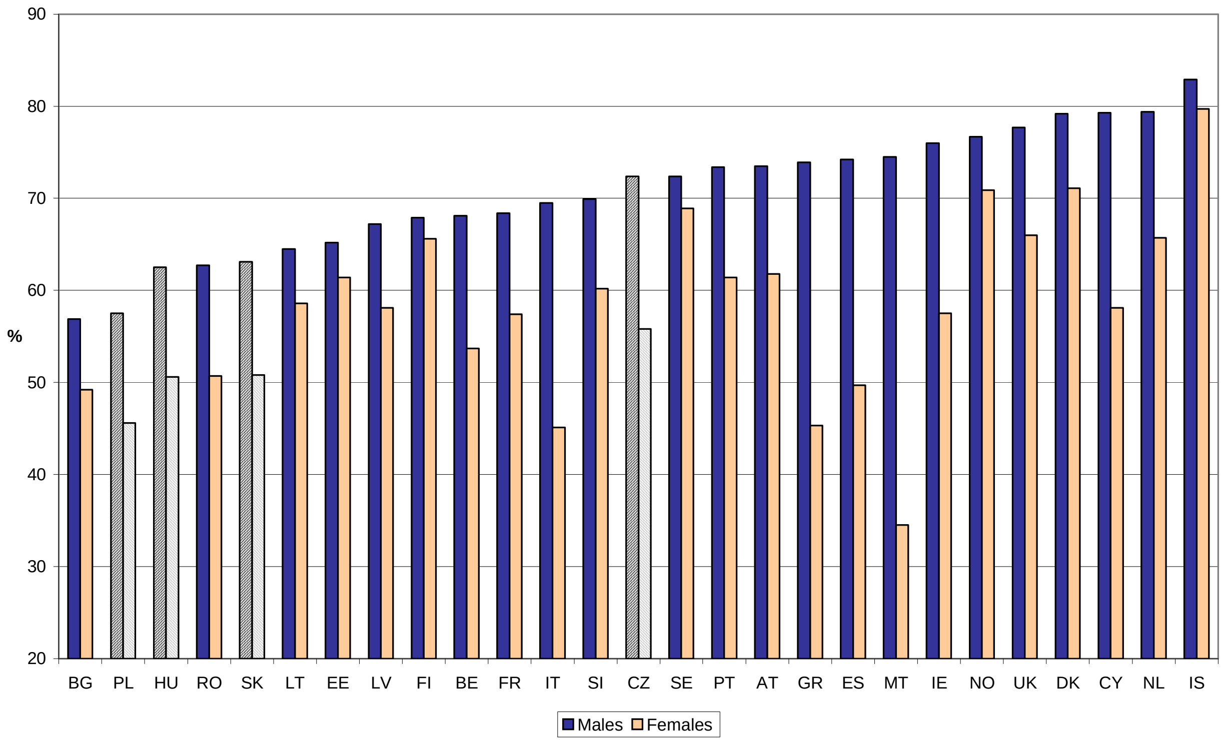
The level of employment among men is low in the majority of Eastern European countries: eight countries have male employment rates below 70%, the Lisbon target of the European Union for 2010, and are also below the intermediate Stockhold target of 67% for 2005. Among the Central-Eastern European countries in particular, Poland, Hungary and Slovakia suffer from the problem of low employment, with male employment rates ranging from 57% to 63% among the working age population. This means that even in the best performing Slovakia, only two out of three working age men

[11] Economic transformation preceded the first democratic election in 1990, and started already in the late 1980s, as shown by Table 2 later.

[12] For an interesting empirical attempt for this in the UK, see Burchardt and LeGrand (2002).

have jobs. The Czech Republic is not particularly affected by this problem: with 72% level of male employment, the situation is similar to those in Sweden, Austria and Portugal, all around the EU25 average.

**Figure 4. Employment rates of the working age population, 2005**




Notes: population aged 15 to 64
Source: Eurostat (2005), NewCronos database, based on LFS 2005 Q1

Employment rates of women are also low in CEE in European comparison. The reason is that while female employment had a rising trend on average in EU15 during the 1990s, in CEE countries it declined. In general, women were more affected by economic restructuring in these countries than men. As a result of this, these countries, once well-known for their high rates of female employment, have lost their relative advantage.

Decline in employment, and the appearance of unemployment seems to be an inherent part of the transition process and is widely discussed in the academic literature (Boeri, 1994; Kornai, 1994; Standing, 1997). One may argue that it did not actually appear from nowhere, rather it came out of the 'factory walls': the so-called 'unemployment on the job'[13] was replaced by 'unemployment without job'. In Hungary the decline in the level

[13] As shown in Figure 2.1 the labour market, alike the whole economy during the socialist era, was not based on market principles. Demand for labour was not determined by efficiency on a micro level, but with a fuzzy constellation of political and economic considerations in a planned economy. A typical characteristic of this socialist economic system was a 'soft budget constraint' combined with shortage. This resulted in a phenomenon where many factories employed more workers than they actually needed, accumulating

of employment approached 30%. The outstanding decline in Hungarian employment is predominantly due to the comparatively radical economy policy, containing a rigorous bankruptcy law at an early point of the transition, and also to the permissive social security benefit system, which allowed 'exit' from the labour market. Pension schemes, first of all early retirement and disability pensions, have offered a good option for leaving the labour market for many. These have resulted in a particular labour market situation, characterised by low levels of participation, particularly among the elderly.

The *employment* situation in Hungary has also some peculiar characteristics by international comparison. First, low level of participation is couple with relatively low level of unemployment. Unemployment in Hungary is 5.9%, which is lower than the OECD average (6.9%), but much below the unemployment rates of the Czech Republic (7.8%), Slovakia (17.5%), and Poland (19.6%) (Table SS2.3, OECD, 2005). On the other hand, however, joblessness in Hungary has a peculiar aspect: the high prevalence of long-term unemployment. The long term unemployed, people with unemployment spells of 6 months or more, make up 65% of the unemployed in total. In addition, 42% of the unemployed stay jobless for 12 months or more. Why is this indicator important? In recent discussions on social exclusion long-term unemployment has received particular attention as a possible measure (Atkinson, Cantillon et al., 2002). Long-term unemployment is distinct for various reasons. As empirical studies show the chance for labour market entry decreases by the length of the unemployment spell (e.g. Bernardi, Layte et al., 2000). Unemployment, especially longer spells of unemployment, were also shown to have a 'scarring effect' in the US and in Britain through lower future earnings in employment and the increased future incidence of unemployment (Arulampalam, Gregg et al., 2001). Also, there is a greater risk of poverty due to the fall in income and also because during the extended period of joblessness the individuals' ability to pool resources over time, for example to use savings, becomes limited. Long term unemployment poses a special risk of poverty in Hungary for a further reason as well. Currently, the maximum duration of unempoyment benefits is 9 months (see Table 2). After the expiry of this benefit, the jobless need to rely on means-tested social assistance.

*Bad health* appears to be a major problem in countries of the region. Altough life expectancy has been increasing recently, and for men it is between 68 (Hungary) and 73 (Slovenia), it is still below that of Western Europe (WHO, 2005). In Hungary, this low figure is attributable to the exceptionally high mortality rate (13.1‰ compared to the EU average 9.5‰). As own calculations based on the European Social Survey suggest, over 10% of the population in CEE countries are hampered a lot in their daily activities by health problems. In Hungary, the figure reaches 18%. In contrast, this ratio is only around 2% in Ireland and Switzerland. The differences are less marked, altough to some extent still prevalent, when an alternative indicator, self-assessed health state is used. Hungary and Slovenia are the two countries out of the 21 examined in the survey where self-proclaimed health is the worst: around 10% of the people say that their health is "bad" or "very bad". National statistical data finds that over one-third of Hungarians have regular physical complaints and over one-fourth have mental health problems (CSO data, cited by the NAP, 2004, p. 8).

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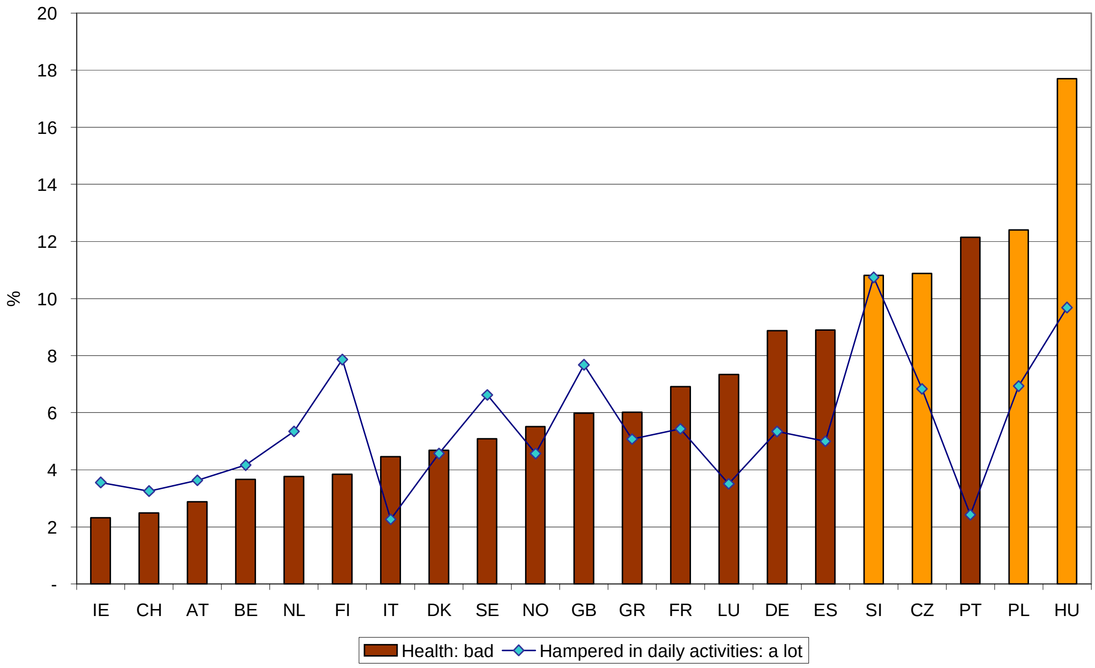
internal surplus for possible future needs. It resulted in 'hidden unemployment', or in Kornai's terminology 'unemployment on the job' (Kornai, 1992, p. 223).

## Figure 5. Health problems in European countries



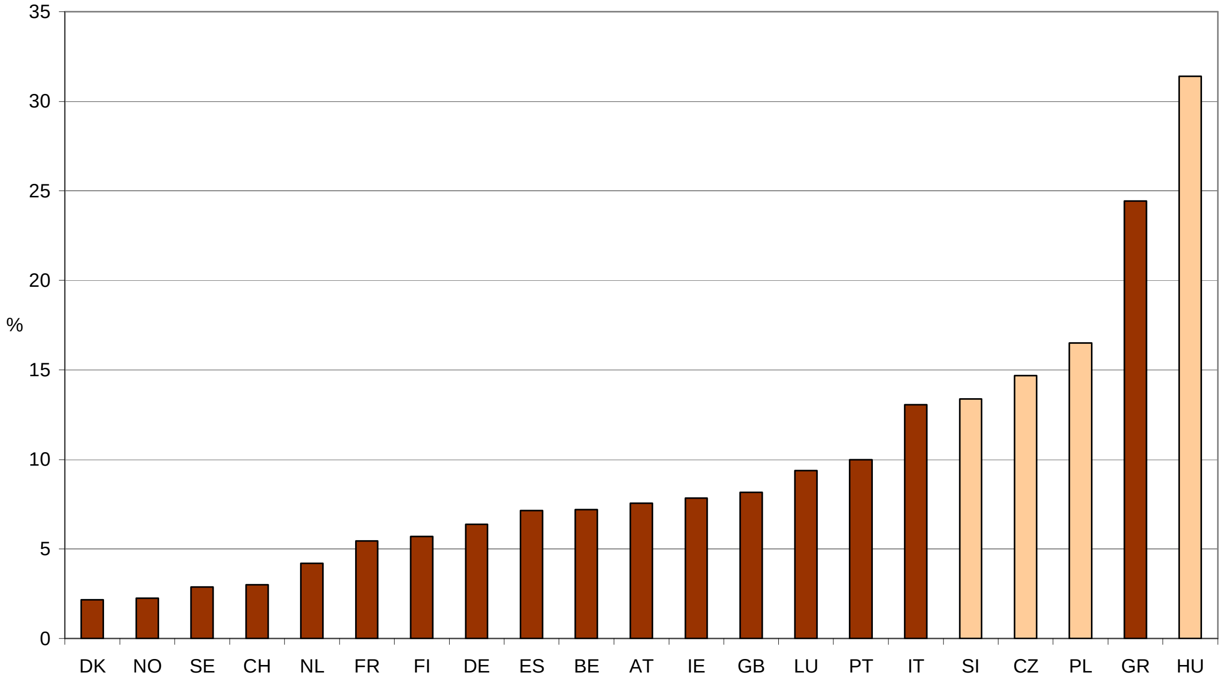

Notes:

'Are you hampered[14] in your daily activities in any way by any longstanding illness, or disability, infirmity or mental health problem?' (1) yes, a lot, (2) yes, to some extent, (3) no.
'How is your health (physical and mental health) in general? Would you say it is very good, good, fair, bad, or, very bad?' Responses of "bad" and "very bad" were recoded and presented as "bad" in the figure.
Weighted frequency as a percentage of the population of the country concerned
Source: European Social Survey 2002/2003, N= 37,654

A great number of people suffer from *social isolation*. The fact that civil society is still weak in these countries is well-known. Less is known about the grave situation in terms of personal contacts. In Hungary, around one third of people do not meet friends or relatives regularly (Figure 6). This is not attributable to the particular dataset used here. Similar results were shown by alternative data for the 1990s (Albert and Dávid, 1998; Lelkes, 2002). Social isolation is also a major problem in Slovenia, Czech Republic and Poland in European comparison, and around 15% of people suffer from it. This warrants that issue of social capital may be a major factor in social exclusion. This seems to have been acknowledged recently by the European Commission as well, who in their Observatory of the European Social Situation, included a network on social capital, over and above the more "conventional" networks on income inequality, health and demography. This network is going to provide comprehensive evidence on the patterns of social capital across the enlarged Europe and explore the explanatory factors of the differences across countries.

[14] "Hampered" = limited, restricted in your daily activities.

**Figure 6. Social isolation in European countries (% of people with infrequent social contacts)**



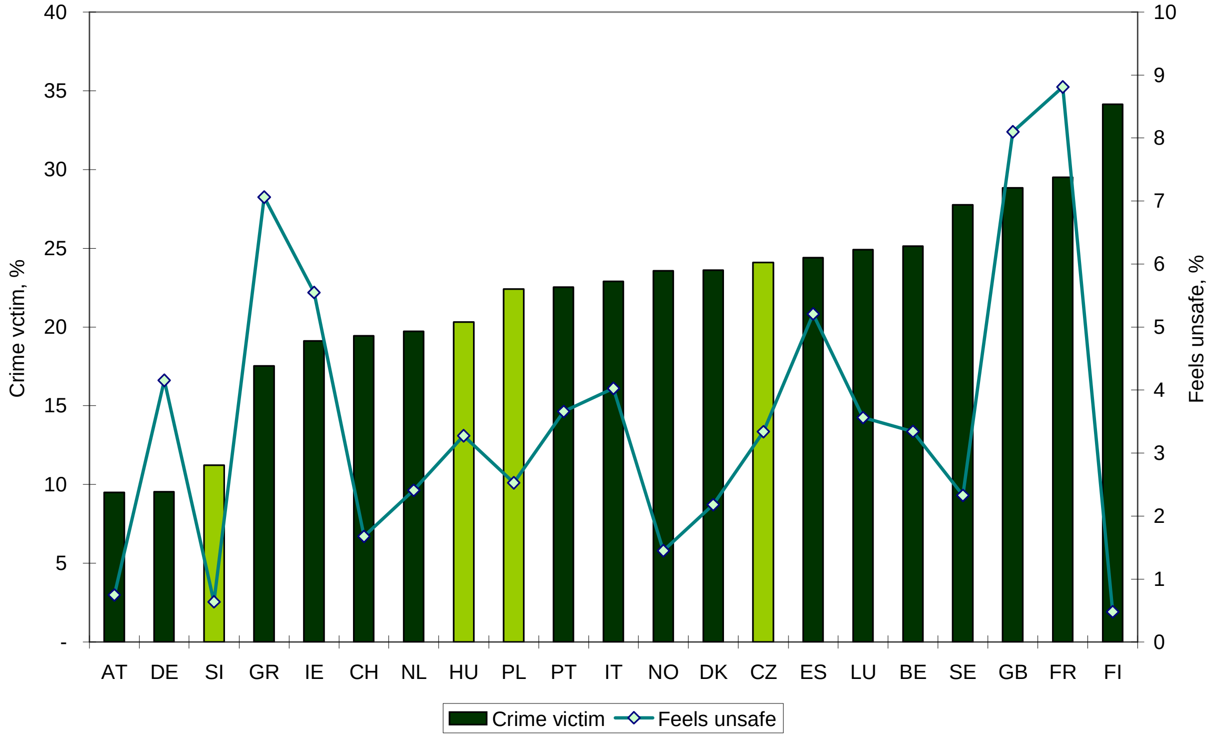

Notes:
Infrequent social contact=people who meet friends, relatives or colleagues less often than once a month
Weighted frequency as a percentage of the population of the country concerned
Source: European Social Survey 2002/2003, N= 37,654

*Crime rates* have multiplied during the 1990s. Reported and registered crime rates have doubled in CEE countries between 1989 and 2002, and in the Czech Republic it grew threefold[15]. As the authoritarian regimes dismantled, public security was deteriorating. People's well-being may be strongly affected by these negative changes. The comparison of the level of crimes, however, does not show that these countries are in a particularly bad situation. The proportion of Slovens who have been crime victims in the past five years and those who feel unsafe walking home after dark is particularly low, one of the lowest in Europe. Interestingly, the proportion of Hungarians, Poles and Czech who feel unsafe in their neighbourhood is relatively low, between 10-12%, much below the rates in Great-Britain or France, where over one third feels unsafe.

[15] See: UNICEF TransMONEE 2004 Database

**Figure 7. Crime and neighbourhood safety in European countries**

**(% of people who were crime victims, or who feel unsafe)**



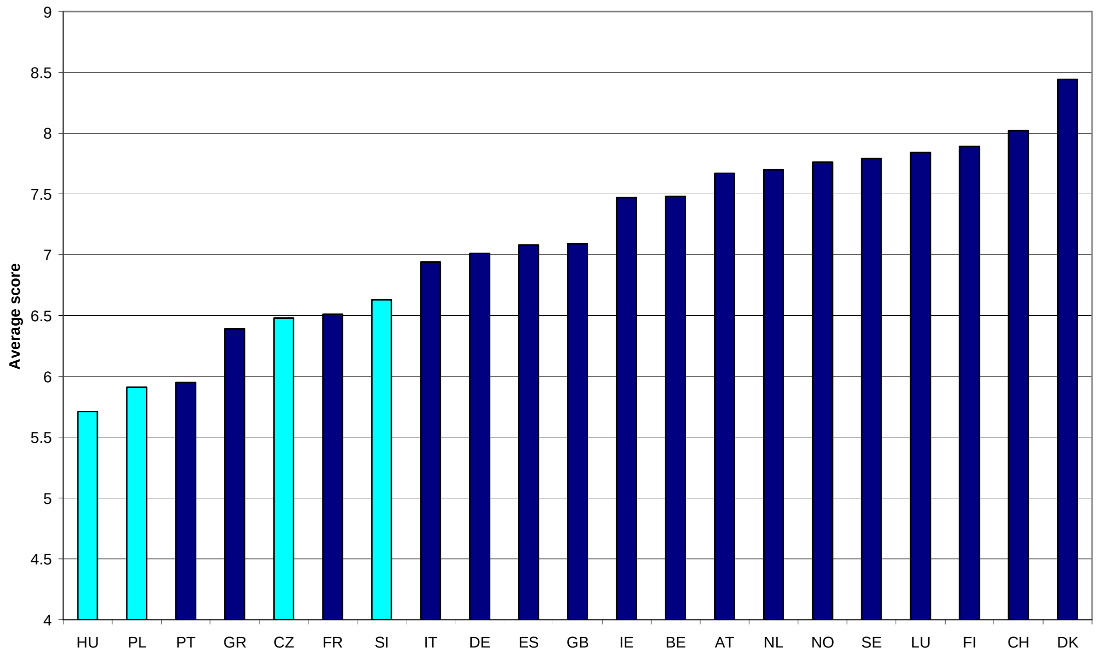

Notes:
Crime victim=has been crime victim in the past 5 years (crime is not specified)
Feels unsafe= does not feel (or would not feel) safe walking alone locally after dark
Weighted frequency as a percentage of the population of the country concerned
Source: European Social Survey 2002/2003, N= 37,654

*Measuring subjective well-being: life satisfaction*

Little is known about happiness or subjective well-being during Socialism. “The official ideology claimed that every, or almost every, member of the society was satisfied” (Andorka, 1999, 147). Recent surveys suggest, however, that there is a major difference in the level of subjective well-being across European countries (see Figure 8)[16]. We could even say that there is a new iron curtain, this time of unhappiness, that separates a happier part of Europe from a much less happy one. There is a clear division line between most Western European nations and other countries of Europe. Further, Central-Europe, especially Poland, Hungary and Slovenia, can be distinguished from Eastern Europe, and the former Soviet Union (CIS).

[16] This difference cannot be attributed simply to cultural differences of the notion of happiness. A similar ‘iron curtain’ seems to exist when using other measures, such as the Bradburn Affect-Balance Scale or satisfaction with life. While in most Western European countries, over two-thirds of the population say they are satisfied, in Central-Eastern Europe this number is generally less than half. A similar division seems to exist when people are asked about recent positive and negative affects in their lives[16] (own calculations based on the World Database of Happiness).

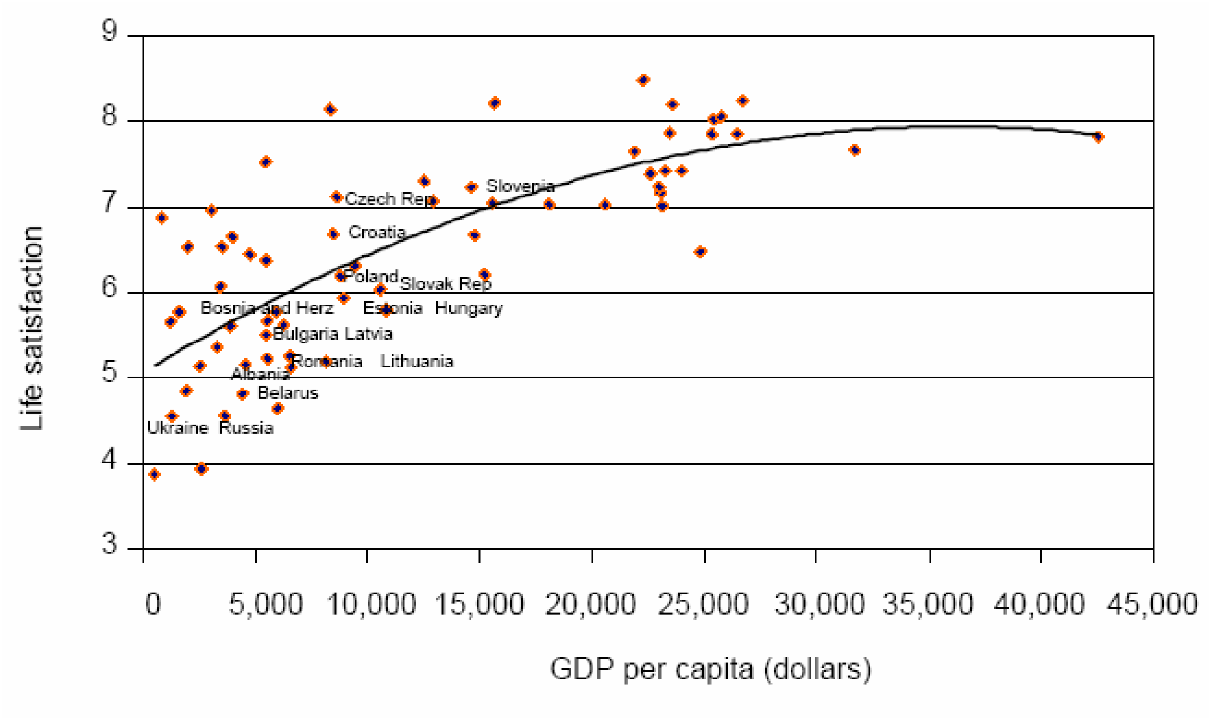
**Figure 8. Life satisfaction in European countries**




Notes:
N= 37,654
Life satisfaction measure: *'All things considered, how satisfied are you with your life as a whole these days?'*
Eleven-point scale: 0=extremely dissatisfied, and 10=extremely satisfied;
Source: European Social Survey, 2002/2003

The causes of this division may be related to differences in economic prosperity or may be attributable to negative consequences of the transition process. As Figure 9 suggests, there is a positive correlation between the level of national income and the average level of satisfaction. To put it simply, money tends to make people happy. This finding has been replicated over many other countries and regions before. The nature of the income-happiness relationship, however, is that of declining marginal returns: greater income tends to increase happiness the most among countries with low incomes. The graphs also highlights that the relationship between income and life satisfaction is far from being linear: there is considerable variation in the level of average satisfaction even among countries with similar level of national income.

**Figure 9. Life satisfaction and national income**

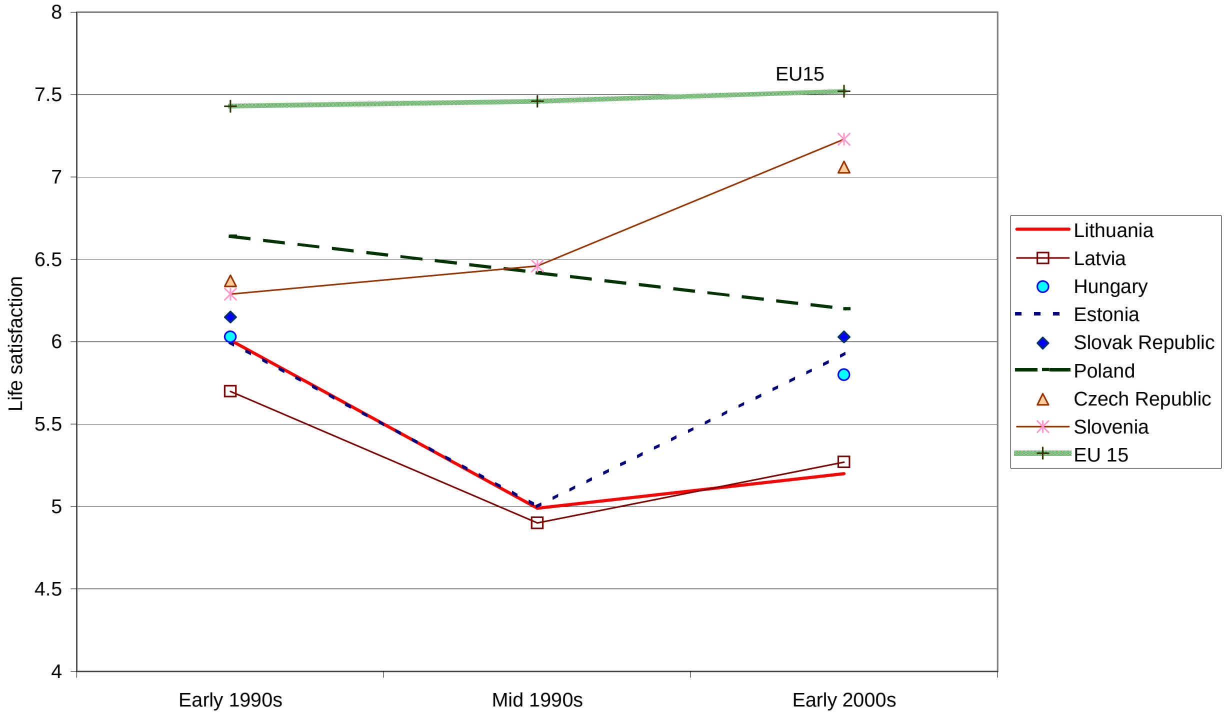



Source: (Sanfey and Teksoz, 2005, p. 6), calculations are based on the World Values Survey

Income, however, is far from being the sole and major determinant of national happiness. As Di Tella and MacCulloch shows, happiness responses of almost 400,000 people living in Western Europe and the US are positively correlated also with the generosity of the welfare state, and negatively correlated wit hthe average number of hours worked, measures of environmental degradation ($SO_x$ emissions), crime, openness to trade, inflation and unemployment (Di Tella and MaccCulloch, 2005).

People’s subjective well-being in the region was greatly affected during years of economic transition. We might expect two general patterns: one view, which attaches a high importance to human rights and personal freedoms would predict that satisfaction with life in general has increased during the years following the collapse of communism. A more materialistic view may predict that life satisfaction followed the pattern of economic restructuring: the significant initial decline is followed by a recovery. The evidence, however, does not overwhelmingly support either view. We can observe for all countries (for which data is available), except Slovenia, a decline in life satisfaction during the first half of the 1990s, the period of economic recession, growing unemployment and inequality. In Slovenia the transformational recession remained small and this effect appears to be counterbalanced by newly gained independence of the country in 1990 and the following political changes. Only in Slovenia and the Czech Republic, two countries with newly acquired souveregnity, did transition make people happier by the late 1990s than before. In most other countries, this has not been so. Why?

**Figure 10. Life satisfaction during the decade of economic transformation in some Eastern European countries**




Source: World Values Surveys 1990-93, 1995-97, 1999-2002
Life satisfaction measure: *'All things considered, how satisfied are you with your life as a whole these days?'* Ten-point scale: 1=extremely dissatisfied, and 10=extremely satisfied.

People in Central-Eastern Europe do not tend to report high well-being for various reasons. Research on the determinants on happiness shows that unemployment, low income, the fall of income in particular, and bad health tend to have a negative effect on well-being (Graham and Pettinato, 2002; Lelkes, 2005a; 2005b; Sanfey and Teksoz, 2005). As many people experience joblessness and poverty, many of whom had not had such experience before, average life satisfaction tends to decline. A further explanation is due to comparison effects: as some may get richer within the country, people who are "left behind" may feel frustrated. The reference groups may also change: more and more people might compare their situation to that of the "old" European Union member states. This view seems to be supported by the increased political focus on the "catching up" of incomes in these countries. Kornai, in a presentation, holds that it is to a great extent the short term memory of the people which is to be blamed.

> "*Decades ago, we were flooded with complaints from idividuals because certain consumer items were unavailable: one had to wait many years for a car or an apartment or a telephone line. Nowadays it seems that I, one the author of a book entitled Economics of Shortage (1980), will be left as the single individual in Eastern Europe, who still remembers the shortage economy and feels genuine joy that it is over.*" (Kornai, 2005).

*Income and non-income measures: the empirical relationship*

As mentioned before, there are two main motivations for using non-income measures of social exclusion:

1) they reveal important information about valuable aspects of people's lives
2) the correlation between income and non-income measures is at times weak, thus income is a poor predictor of other indicators.

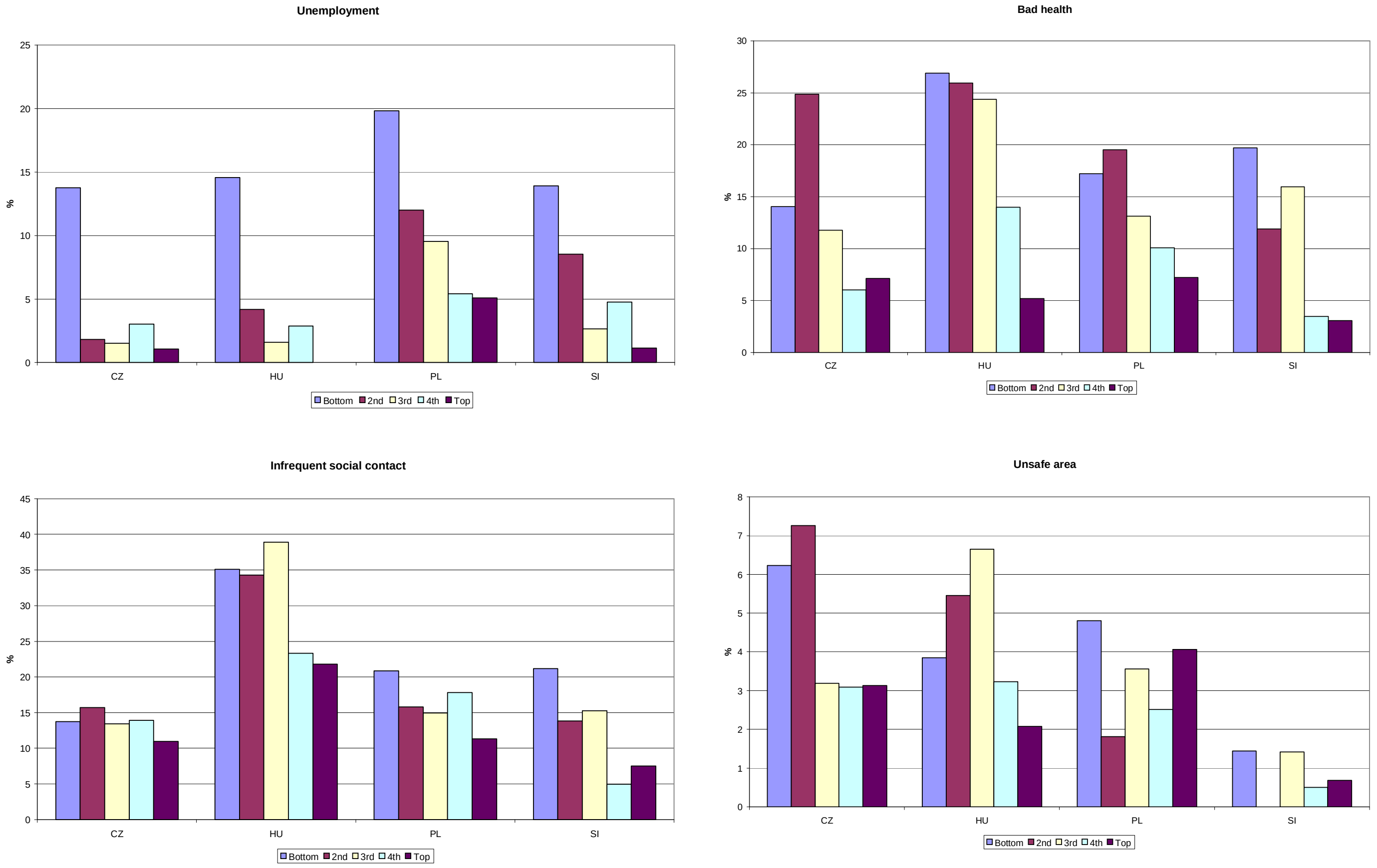
The motivation for presenting evidence on employment, health, social interactions, and neighbourhood safety came from 1). The following section will discuss briefly 2), the relationship of these measures with income. The main question of interest is whether it is primarily the poor who suffer the most in other respect as well. The calculations include the Czech Republic, Hugary, Poland and Slovenia, as these are the four CEE countries included in the European Social Survey 2002/2003. As the number of observations is at times very low, the observable differences may not be statistically significant for the total population.

As Figure 11 shows, the relationship between income and non-income measures of well-being is far from being linear, and the problems are often not concentrated amongst the poorest. The relationship between income and unemployment tends to be the strongest: in all four countries unemployment is most prevalent among the poorest income quintile. It is not surprising, given that unemployment is one of the main causes of poverty.

The poor, however, do not tend to have significantly worse health, less social contacts or worse neighbourhood conditions in general, as data for the four countries suggest. There is particularly little relationship between social isolation and income. Being poor may have an impact on the means of social participation, but it does not seem to prevent regular contact with friends or relatives as such. This measure, however, does not test the quality and size of the social network, just simply the fact whether it exists or not. With respect to health, it seems that the most prosperous fifth of the population tends to have the best health state. This top income group also tends to be of working age and have higher education level, which are both predictors of good health.

There is a moderate, but statistically significant relationship between income and life satisfaction. The poor tend to be the least satisfied group in a society, as findings from Western European countries and the United States uniformly suggest (for a recent survey see: Diener and Oishi, 2000). These results have been confirmed for Kyrgyztan, Russia, and also Hungary (Namazie and Sanfey, 2001; Lelkes, 2002; Senik, 2004; Lelkes, 2005b). Money seems to make people happy, controlling for personal differences in age, marital status, labour market status and others.

**Figure 11. Various indicators of social exclusion and income: the ratio of people experiencing the specific situation within income quintiles, %**



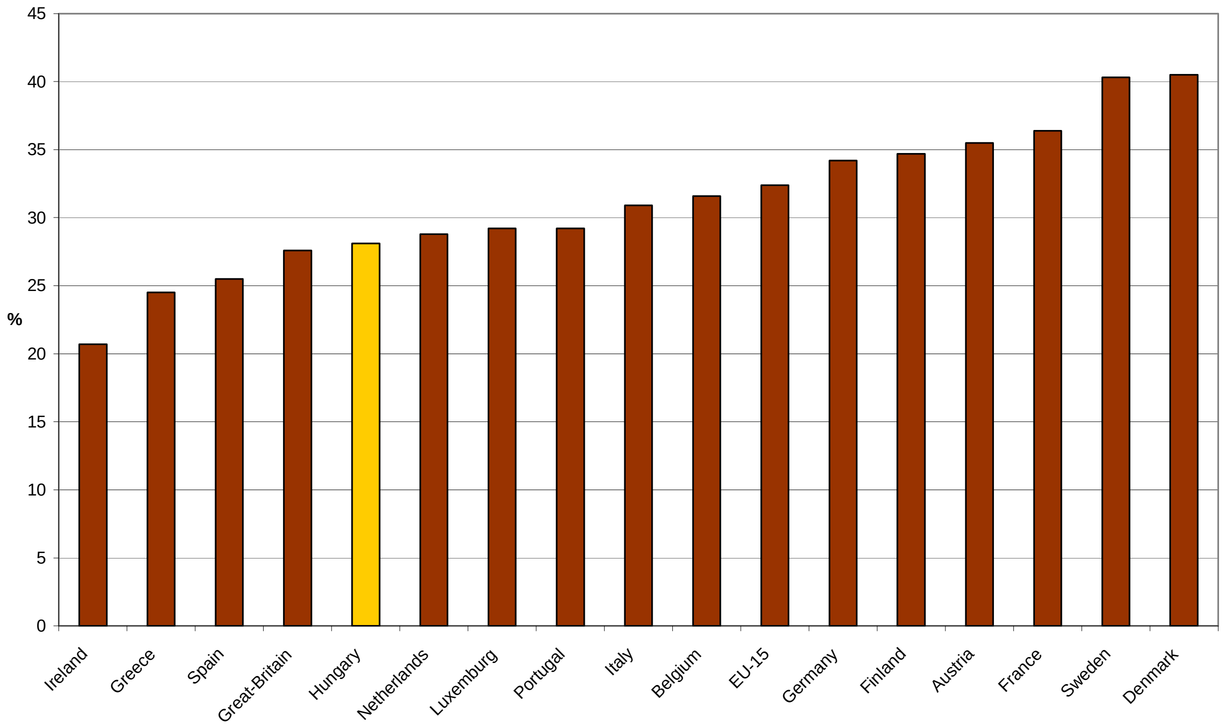

Notes:
Bad health: see Figure 5
Infrequent social contact= people who meet friends, relatives or colleagues less often than a month
Unsafe area= individuals who feel (or would feel) not safe walking alone locally after dark

Source: own calculations based on the European Social Survey, 2002/2003
N= 6,293

# 4 Social Policy in Hungary

The Hungarian government spends 28.1% of its Gross National Product on welfare functions, in other words, on social security, social welfare, education, health and housing (Figure 12). This is lower than the fifteen "old" member states on average, which spend 32.4% of their GDP on welfare. This suggests that the level of social spending (including both cash benefits and social services) in Hungary is close to that in Great Britain, the Netherlands and Portugal, and is far below that of Scandianavian countries, where this ratio reaches 40%.

**Figure 12. Expenditure on welfare functions in 2001, as a percentage of GDP**




Notes: COFOG (Classification of Functions of Government) classification
Welfare functions: social protection, education, health, and housing services provided or subsidised by the government
The data are "consolidated", in other words, excludes transfers between units of the government. The international data are accrual, while the Hungarian data are on a cash basis.
Source: International data: EUROSTAT, Hungarian data: Based on calculations of the Budget Department at the Ministry of Finance17.

Such simple indicator has obvious limits. First of all, it cannot express properly the fundamental principles of redistribution, as we do not know what is the structure of the

[17] An important sign of democratisation of Hungary is the increasing transparency of government policies. In the past, there was no officially published, internationally comparable data on social spending. Earlier efforts, including that of the author (Lelkes, 1997), tried to prepare such data manually from budget documents. In recent years, however, the Ministry of Finance regularly provides data for the annual publications of the IMF on social spending (Government Finance Statistics Yearbook), and also for the OECD on tax revenues (Revenue Statistics of OECD member countries).

welfare system, who receive these benefits, whether the redistribution is primarily based on universal or means-tested benefits. In addition, it leaves the other major means of redistribution, the tax system, unexplored, including tax benefits, which often tend to function as a type of benefit. Despite these obvious reservations, this chart, however, raises the question: has the generous welfare provision of the Socialist era evaporated during the transformation to Capitalism? Can such relatively low spending provide effective protection against poverty and social exclusion?

*Historical and institutional context*

Several Hungarian scholars tried to describe the welfare system of the 1990s as increasingly liberal, or as liberal with conservative-corporatist elements (Deacon, 1992; Ferge, 1992; Tóth, 1994), referring to the three-fold typology of welfare regimes by Esping-Andersen (1990). These views, however, seem rather loosely related to the original typology. Furthermore, this typology does not seem to be adequate to describe a welfare system in fundamental transition (Lelkes, 2000). It focuses for example on current spending levels and does not consider changes in rights, entitlement and future spending commitments. In this way, it would disregard a major pension privatisation programme if current spending remained still dominantly public. The normative content of one of the main criteria used by Esping-Andersen, that of 'de-commodification' is also problematic in the context of transition from socialism. In the author's terminology, de-commodification means that 'citizens can freely, and without potential loss of job, income, or general welfare, opt out of work when they themselves consider it necessary' (Esping-Andersen, 1990, p. 23). Beyond the arising incentive problems and possible 'unemployment trap', the use of this as a normative criterion for the assessment of a post-socialist welfare system seems inadequate. Instead of sweeping generalisations, a more fruitful way of characterising the welfare system seems to be the analysis of its specific segments[18].

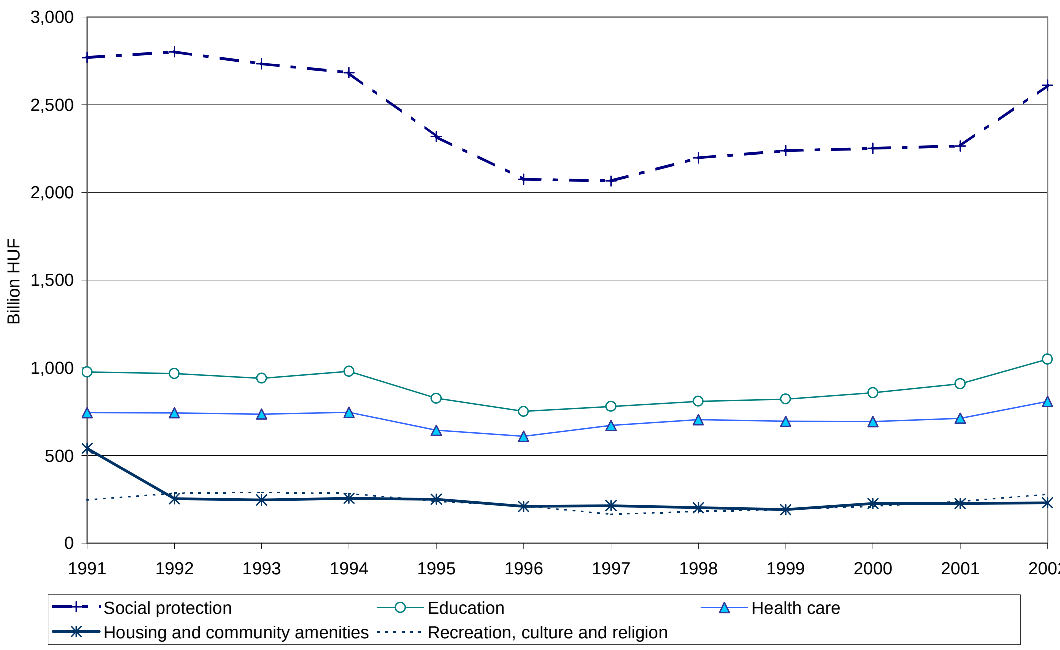
The welfare system has changed in two major ways during the 1990s. Firstly, there was a major general decline of social spending both in real terms and as a share of the GDP. Total spending on welfare functions fell by 26% in real terms between 1991 and 1997 (own calculations based on Ministry of Finance data, see Benedek, Lelkes et al., 2005)). Using a different measure, it has declined from 40% of the GDP to 29% (ibid.). This has been followed by only a moderate increase: total welfare spending equalled 30% of GDP in 2002. In sum, transition brought a significant decline in government welfare spending.

In order to provide a fuller picture of the overall welfare system, this spending data should be complemented with tax expenditures, in other words tax credits and allowances provided for social policy purposes. Unfortunately no such data are available for the whole period, which makes this element of the welfare system, which is also called 'fiscal welfare', invisible. Due to recent work in the Ministry of Finance on this subject, and the introduction of the so-called tax-benefit microsimulation modelling technique in the Hungarian government I will be able to discuss some aspects this issue later on.

[18] My own analysis has tried to test the 'liberal' hypothesis by discussing the role of the welfare state three specific aspects of income maintenance: family support, social assistance and pensions. I found that these different programs do not add up to constitute any specific type of welfare regime. 'Rather, the emerging, and still transitory welfare system appears "faceless"' (Lelkes, 2000, p. 92).

The second major change of the welfare system refers to its structure. During the decade of transformation, social protection expenditure proved to be more volatile than spending on social services. As Figure 13 suggests, spending on social protection (using constant prices) has fallen by about 25% in the mid 1990s, followed by a gradual increase. The real value of welfare expenditures on each of the above reviewed groups increased between 1997 and 2002 with the largest increases observed in social protection, education, and health care expenditures. A particularly large increase was observed in 2002, as a result of the major (50%!) increase in public servants' salaries. These calculations use constant prices, which is particularly important in the context of high, and varying level of inflation over the years. Inflation itself was one of the main "passive" policy measures in the country: as benefit levels were not adjusted to price changes, they decreased significantly in real terms.

**Figure 13. Welfare functions at constant (2002) prices, between 1991 and 2002, in HUF billion**




Source: Ministry of Finance, Hungary, ÁHÍR data base

In particular, social protection expenditure remained relatively stable in the early 1990s. As this period witnessed a major economic recession (falling GDP), spending on this item increased as a share of GDP. This meant that social protection spending, including pensions as the greatest spending item, largely preserved its value in real terms despite the decline of the GDP. The year 1995 marks a turning point, with gradually declining social security spending afterwards. The related issues, including the pension reform steps, will be discussed in detail in the coming section. In contrast, the early 1990s already brought a major fall in government spending on housing and community amenities, which dropped altogether from 4.1% of GDP in 1991 to 1.4% in 1998. In real terms, this meant a drop of 61% in the same period. Government spending on health and education also suffered significantly during this period, with losses of 10% and 20% in real terms, respectively.  Altogether, the extent of resizing the welfare system is probably unprecedented in the recent history of Western Europe. The Hungarian state, however, managed to implement such cut-back without major public outcry. What were the major policy tools which enabled such a drastic change? What were the main features of the social policy during transition? I will primarily focus on those aspects, which are most likely to affect people's quality of life.

*Changes in entitlements: pendulum politics*

In the early phase of transition the state tried to smooth the negative consequences of growing unemployment. The government decided to cover the additional costs of pre-retirement, which made possible to remove older workers from the labour market five years prior to normal retirement age, which was itself very low by international standards, 55 years for women and 60 years for men. Disability pensioner status was another exit route from the labour market, enabled by liberal law enforcement of eligibility criteria. The result was a 'great abnormal pensioner boom', in the terminology of Vanhuysse (2001). In his view, this was a rational and conscious government policy for pacifying people and buying patience during socially costly reform periods, rather than the result of the lack of action, e.g. due to the underestimation of costs (p. 860).

This government policy was substantially revised in 1996-98, when the state opted for delegating some of its responsibilities to citizens. The previously mentioned growth in the number of beneficiaries, due to early retirement, together with the decline of contributors, due to unemployment and inactivity, and due to the growth of the informal sector, brought major problems regarding the financial sustainability of the pension system. The 1992 pension reform settled institutional issues and set an indexation principle in the law (which did not exist before), but did not touch the basis of the system. Only the 1996 reform touched entitlements, and raised retirement age for men and women equally to 62 years. Due to increasing domestic fiscal pressure and the support of the World Bank, the government opted for a more fundamental change of the whole pension system (Simonovits, 1998). The new scheme was first regarded a variant of the Chilean reform, but later all such reference to Latin American reforms were avoided[19] (Müller, 2001). The new pension system is based on three pillars: a basic state pension, a compulsory private pension and an optional voluntary pension. The system is thus altogether a mixed type, still containing a predominant public pay-as-you-go scheme, i.e. a system where pension payments are funded by the current contributions of the working age population.

The change of government in 1998 brought a halt to the gradual implementation of the reform. The new government decided not to implement the gradual increase of contributions to the private pillar decided in the reform law, and thus reduced the future private element of the system. Also, they have abolished the compulsory entry to the new pension system for new labour market entrants, therefore preserving the fully pay-as-you-go scheme alongside the mixed scheme as part of the future pension system. This was probably a response to the unexpectedly high numbers of new entrants to the 'mixed',

[19] 'It turned out that Chile was particularly ill-suited as an example in public discourse, as the connotations of the 'Chilean model' extended to the dictatorial political rule under which the well-known pension reform was carried through' (Müller, 2001, p. 63).

new system. According to Augusztinovics (1999), this highlights the main problem of the pension reform as well, that a proper estimation of future costs and the open public debate on these issues were lacking.

In 2003, the (then) new government restored some of the original features of the new pension system, and made the entry to private pension system compulsory again for new labour market entrants. They also enabled those below the age of thirty to join the nex system (during a transitory period, ending in December 2003). From the individuals' point of view, the series of ad hoc measures, both in the old pay-as-you-go system (on indexation rules, for example), and on the implementation of the pension reform, undermine trust in both the public and the private pension system.

Another area of the welfare system, affected by substantial changes in the 1990s is family support. There is no clear trend for entitlement restriction here, since many of such limitations implemented mostly in 1995, proved to be temporary and universality was reinstalled in 1998. As a result, the universal family allowance seems to function as an extensive 'social wage' for mothers caring for their children. However, this benefit is 'extensive' only in terms of its coverage, rather than its level. One further element of family support is that of maternity benefits, offering an earnings related benefit until the age of 2 of the child, complemented by a flat rate benefit until the age of 3. In addition, mothers with three or more children are entitled for a flat rate benefit if they stay at home, in addition to the universal family allowance. In contrast to these, a major policy choice of the Conservative government, which came to power in 1998, was to increase the real value of tax support at the expense of these universal flat rate benefits. This tax credit benefited only working families, moreover penalised those with low earnings, because they could not receive its full amount. This reinforced a normative element in family support, a certain criteria of 'merit' attached to employment, and also to higher earnings, rather than simply contributing to the costs of children primarily on the basis of need.

In the meantime, there have been numerous new benefits introduced in response to new social needs, primarily as social assistance and as unemployment support (see Annex 2). Notably, though, there is a clear trend of withdrawal of the government in unemployment provision following the original generosity: the entitlement period and the replacement rates have been repeatedly reduced, for the first time already in 1992.

The gradual restrictions in the duration of benefits and low outflow rates, resulted in a major decline of the proportion of unemployed people receiving unemployment insurance. By 1997 only 30% of the registered unemployed was covered by such benefit (KSH, 1997). A particular feature of the Hungarian situation is that 'exhausting entitlement is the most common way of leaving the UI register' (Micklewright and Nagy, 1999, p. 317). The authors find that about a half of all exhausters received means-tested social assistance in 1995. Thus means-tested social assistance is a major benefit type for the unemployed, and more of them are actual beneficients (over 40% in 1997) than that of unemployment insurance (KSH, 1997, Table 4.3). Notably, a significant proportion, nearly 30%, of the registered unemployed received no benefits at all.

This situation is problematic on various grounds. Firstly, not receiving unemployment assistance results a major drop in income (Micklewright and Nagy, 1999). A smaller, but still significant decline awaits those who do receive such benefit after the exhaustion of UI. Secondly, the authors find that there is significant variation in the claiming and the award of benefits, for example by education level and by regions, unrelated to the income level of the claimant. This raises worries about the equity of the unemployment support system, although a positive sign is that Micklewright and Nagy found no evidence that benefit awards vary by the actual resources of the local governments.

The system of housing subsidies has also been radically cut back, primarily with the elimination of the highly subsidised housing loan system in the early 1990s. In sum, however, the transformation of the benefit system in terms of the eligibility criteria seems to imply partly expansion, and partly withdrawal of government responsibility.

*Tactics for withdrawal: letting benefit value fall, privatising, and making people pay*

Individuals had to face a more indirect way of government disengagement, which happened through the loss of real value of social benefits. Family allowances, for example, fell by over 50% in real terms between 1990 and 1998 (Ferge, 2001, p.121). The drop in the real value of per capita unemployment provision was about the same between 1992 and 1998 (p.118). The 'passive' government policy, which ignored the indexation of benefits to inflation proved to be rather efficient in preventing major social protest[20]. As a result of all these changes in the welfare system, total social expenditure fell from 46% of the GDP in 1991 to 30% in 1999 (IMF, 2001).

Social spending on housing was cut back significantly, too. The generous subsidies for housing construction and maintenance proved to be unsustainable when inflation rose to two-digit figures in the late 1980s. The time bomb of subsidised loans with fixed interest rates exploded. As a result, in 1990 the government greatly increased the interest rates and also offered a 40% reduction of the outstanding debt for those who opted for immediate repayment. A more important measure was, however, the transfer of social housing stock to local governments in 1990. In this year a major *privatisation* also started. Between 1990 and 1996 over half a million dwellings were sold, over two thirds of the existing social stock (Dániel, 1997; KSH, 1997). As a result, the proportion of public housing declined to around 7%[21]. First the most valuable homes were sold. Despite the major cumulative backlog of deferred maintenance, housing privatisation proved to be a 'national gift' (Dániel, 1997). According to Dániel, the main winners are the top groups in terms of housing value: those who lived in larger and better quality dwellings gained more and faced lower cost of renovation. The value of the privatisation 'gift', even after accounting for the costs of renovation, is estimated to be equal to about 11 years of average household income for the best quintile of housing.

[20] Similarly, and more strikingly, there was no public outcry at the huge real wage loss either. In contrast, certain, more apparent changes in the benefit system, however minor they were, mobilised large demonstrations of protest (for example the introduction of tuition fees in higher education).

[21] The statistical data include not only state property, but all other, except private property (KSH, 1997, Table 6.2). The proportion of these were altogether 7.6% in 1996, which is predominantly made up of state property (see also the discussion on occupational welfare later on).

The financing of the welfare system has increasingly become the individuals' responsibility. While tax revenue during socialism primarily came from enterprises, with the economic changes individuals' tax burden increased. In 1988 new taxes, such as Personal Income Tax and Value Added Tax were introduced, taxing incomes and consumption, respectively. In addition to this, individuals had to pay partly for their social security (in addition to their employers), including pension and health, and in addition to this, a contribution for a 'Solidarity Fund' for the unemployed. The new pension system is also increasingly based on individuals' contribution, or rather increases the link between benefits and contribution. The compulsory private pillar and the voluntary third pillar are both aimed to increase incentives to contribute, thus making people pay.

A striking feature of the welfare system, however, is the low level of tax awareness of people. As surveys show, Hungarians have major misconceptions of the 'tax price' of certain welfare services provided by the state: a high proportion of the population tends to significantly underestimate the actual costs (Csontos, Kornai et al., 1996; Kornai, 1997; Csontos, Kornai et al., 1998). This 'fiscal illusion' seems to result in excess demand for state provision and also in a nostalgia for 'socialist welfare'. When, however, they were actually informed about the cost of services, the majority of the people opted for a limited role of the state, a 'mixed system' of private and public provision.

**Table 2. Major changes in the Hungarian welfare system, 1985-2005**

| *Area* | *1985-1989* | *1990 (Election year) - 1991* | *1992-1993* |
|---|---|---|---|
| *Economy policy – relating to social welfare* | 1988: introducing personal income tax and value added tax<br>1989: foreign trade liberalisation | 1990: Abolition of price control by state bodies<br>1991: bankruptcy law (the first one, passed in 1986 has not been enforced) | |
| *Pensions* | 1989: Social Security Funds become independent of the central budget | 1991: introduction of early retirement | 1992: Social Security fund is replaced by two separate funds for Pension and Health – with elected governing bodies of representatives of employers and employees (and not the government)<br>'Partial pension' is introduced for those who do not have the necessary insurance period; indexing of pensions to net wages |
| *Family support* | 1985: introduction of the earnings related maternity allowance (gyed) (up until 2 yrs of age of the child)<br>1986: extending the eligibility for flat rate maternity benefit (gyes) (up until 3 yrs) | 1990: existing family allowance is made universal (replacing employment as eligibility criteria) | 1993: introduction of a lump sum maternity grant<br>1993: introduction of child raising grant (gyet) for mothers who stay at home caring for three or more children below the age of 10 (gyet) (flat rate, means-tested) |
| *Employment* | 1986: first, partial unemployment support scheme<br>1989: introduction of comprehensive unemployment support | 1991: *Employment Act:* creation of the 'Solidarity Fund' (extra-budgetary fund),<br>introduction of training grants for the unemployed, and that of<br>compulsory severance payment | 1992 and 1993: reduction in unemployment benefit levels and entitlement periods (to 12 months by 1993),<br>increases in the rate of contribution |
| *Social assistance* | | 1990: major local government reform: new financing system, new financial resources for social policy purposes | 1993: *Social Act:* local governments receive extensive discretionary rights in the provision of cash benefits<br>introduction of new benefits, e.g. the public health voucher system, which provides free medicine<br>Introduction of 'income supplement' for the long-term unemployed (with no time limit) |
| *Health care* | | 1990: health care financing is moved from central budget to the separate Social Security Fund | 1992: new financing, getting closer to an 'insurance' principle |
| *Other* | | Abolition of statutory state support for nurseries | |

| *Area* | *1994 (Election year) - 1995* | *1996-1997* | *1998 (Election year)* |
|---|---|---|---|
| Economy policy – relating to social welfare | 1995: Restrictive 'Bokros package' with a series of measures aiming to stabilise the economy and restrict government spending (some of the measures were later declared unconstitutional by the Constitutional Court and were abolished) | | |
| Pensions | 1994: Entitlement for early retirement is extended (from 3 to 4 yrs before retirement age)<br>Employment during early retirement is restricted.<br>1994: Voluntary pension funds introduced next to existing state pension system; major tax allowance on contributions | 1997: Pension age is increased to 62 years, both for men and women (from 60 and 55 yrs, respectively)<br>1997: Pension Reform Act: introduction of a new pension system based on three pillars | Modifying the implementation of the pension law in order to keep 'status quo' (maintain the share of contributions to the state pillar)<br>Abolition of the Pension Insurance Self-government |
| Family support | 1995: Family allowance: becomes means-tested for families with one or two children, for others it remains universal<br>Child care fee (gyed) is eliminated<br>Child care allowance (gyes) becomes means-tested | 1997: Child Protection Act: statutory income-tested child protection support | Family allowance becomes universal again (on the condition that children above 6 attend school regularly)<br>Child care allowance (gyes) becomes universal<br>Child raising grant (gyet) becomes universal |
| Employment | 'Income supplement' for the long-term unemployed is reduced to 2 years | More extensive active labour market measures<br>Employers are obliged to cover 1/3 of *sick pay*. | Equal Opportunities Act for people with disabilities |
| Social assistance | | | |
| Health care | 1995: New system of pharmaceutical subsidies – as a result, medicine prices increase by 53% in March<br>Decision on reducing hospital beds by 10,000. | Introduction of user fees in health care (examination fees) | Abolition of the Health Insurance Self-government |
| Other | State support for nurseries is reintroduced. | | |

| *Area* | *1999-2000* | *2001-2002 (election year)* | *2003-2005* |
|---|---|---|---|
| Economy policy – relating to social welfare | | 2002: earnings up to the minimum wage pay zero income tax | |
| Pensions | | | 2003: Compulsory entry to private pension system for new labour market entrants<br>Possibility for those below the age of 30 to join the new system (till the end of 2003)<br>2003: Gradual introduction of 13th month pension (full amount is paid only in 2006) |
| Family support | 1999: tax credit system introduced for parents, where amount varies by the number of children. Since then, it was raised considerably, especially for those with 3 or more children. | 2002: Child care fee (gyed) re-introduced<br>(earnings-related, up to 2 years after birth) | |
| Employment | 1999: unemployment benefit - duration reduced from 12 to 9 months<br>2000: 'Income supplement' for the long-term unemployed abolished | 2001: minimum wages raised by 57%.<br>2002: minimum wages raised by 25%. (An increase of almost 100% in two years time.)<br>2002: increase of salaries for public employees by about 50% (health care, education, etc.) | 2003: once the child reaches 1, childcare allowance may be transferred to a grandparent, enabling the parent's reentry to the labour market.<br>2005: recipients of the child-care allowance can take on part-time employment after the child turns 1 |
| Social assistance | | | 2004: *housing maintenance support* reformed. Capitation grant for local governments in order to guarantee support for people in need. The minimum amount greatly increased.<br>2004: debt management programme for home loans and unpaid utility bills for the most needy<br>2003-2004: free meals in kindergartens, and in crèches, for children receiving regular child protection benefit. (Affects 100,000 children) |
| Health care | 2000: Privatization of the practices of general practitioners | 2001: Hospital and outpatient centers privatization | |
| Other | | | |

Sources: (Tóth, 1994; Kornai, 1996; Ferge, 2001; Ferge and Tausz, 2002; Gál, Mogyorósy et al., 2003), communication with the Ministry of Finance, with the Ministry of Welfare

*Enterprises as providers of welfare*

What were the characteristics of occupational welfare during socialism? How has it transformed in the late 80s? What were the main components of this shift in welfare provision between the state and the enterprises?

The provision of enterprise benefits in Hungary during socialism had both political and economic goals. A political goal was for example to maintain central control, because in most cases only (Communist Party dominated) trade union members were actually eligible (Fajth and Lakatos, 1997, p. 168). Enterprise services also served as a means of influence on local politics, since the investment decisions using mostly state subsidies benefited the local communities as well. The primary economic goal of welfare provision was to use it as an incentive to workers and as a direct gain for the decision-makers themselves[22]. This incentive effect was especially relevant in a socialist economy, where there was no major wage competition between firms and, due to the rigidities of the labour market, there was often a lack of adequate labour supply. These in-kind benefits were less important means for providing shortage goods for the workers than in other Eastern-European countries, because the market of goods in Hungary was relatively more developed. Nevertheless, in-kind benefits were less strictly regulated than wages in Hungary (after the reforms in 1968), moreover they were tax free. The most central planners did was that they prescribed a compulsory minimum of 'welfare funds'.

In the late 1980s, the major economic reforms included the introduction of a new tax system and a massive deregulation. The requirement for compulsory 'welfare funds' was abolished. As Fajth and Lakatos remark 'since then the former party-state pressure on employers to provide in-kind services has been replaced by complete neglect of the issue' (Fajth and Lakatos, 1997, p. 171). As a result, benefits provided in-kind have been declining. As studies from the mid 90s show there was a major cutback in crèches, kindergartens, holiday homes for children, and workers' hostels, and a smaller fall in the number of holiday homes (Fajth and Lakatos, 1997; Rein and Friedman, 1997). In the meantime, however, other type of benefits, such as meal subsidies, clothing and subsidised housing loans have increased (Rein and Friedman, 1997, Table 7.6, p. 146). As the data from 1992 show, the main item of the 'enterprise welfare' is food, including subsidised canteens and food coupons (ibid.).

At the same time, however the government transferred some of its social security tasks to the enterprises. New responsibilities of enterprises included contribution to unemployment compensation, severance payments, introduced in 1991, and early retirement. Some benefits financed by the social security system have been transferred to employers. For example, employers became increasingly responsible for the financing of sick pay for their workers. As a result, there has been a restructuring in occupational welfare: the declining proportion of benefits-in-kind has been accompanied by a rise in cash benefits. Total occupational welfare has become increasingly important: its share greatly increased as a proportion of real wages between 1988 and 1994 (Fajth and Lakatos, 1997, p. 184). Although this is attributable to a fall in real wages, and these benefits have actually declined in real terms, this clearly shows their increasing role in the remuneration of employees. According to one calculation, total non-wage enterprise

[22] As Fajth and Lakatos note, the privileges of high-ranking political cadres were primarily linked to the Communist Party itself, not to the enterprises (Fajth and Lakatos, 1997, p.169).

benefits reached 23% of gross wages in 1992 (Table 8.1, p. 177)23. Since the distribution of occupational welfare tends to be rather unequal, benefiting those in high-income positions the most, it most likely aggravates income inequalities.

*Impact of income redistribution policies*

Altough the National Action Plan for Social Inclusion, prepared for the European Union, already contains a series of specific output targets for policy measures, meeting these targets will not be possible without a regular and systematic assessment of the impact of specific policy measures. In the following section I will discuss a novel instrument in policy assessment in Hungary, a tax-benefit microsimulation model[24].

> ***"Microsimulation is a technique used to assess the effects of various economic policy measures, relying on data on households or individuals.*** *For the micro-economic effects of economic incentives (e.g. taxes) are just as important as the macroeconomic factors relating to taxation. The goal of microsimulation is to show the impacts of the various policies on the whole of society. In impact assessments calculations are generally produced only for two or three 'typical' groups, for example for the poorest 10% of society, or families with two children. By contrast, microsimulation enables the production of impact assessments that cover all major demographic groups." (Benedek and Lelkes, 2005, p. 8)*

The inclusion of taxes in the analysis of income redistribution is essential in my view, as taxes play a major role in altering people's incomes, and thus in determining the level of poverty. The social policy discourse often tends to focus exclusively on cash benefits, and their role in redistribution, while ignoring taxes and tax allowances. One reason for this may be a pragmatic constraint: income surveys typically explore net incomes, and thus contain detailed information on benefits received, but not on taxes paid by people. The specific design of this instrument overcomes this problem.

The Hungarian microsimulation is based on nationally representative household surveys, which is then linked to administrative data on tax records. In this way, the model enables to analyse:

- The overall impact of both taxes and benefits on households' or individuals' incomes. This enables for example an overview of the whole of the family support system. As family support includes both tax credits and cash benefits, thus providing a picture on the aggregate effect of these two types of policy instruments on family incomes.
- The impact of changes in the tax-benefit system, answering questions such as "who are the winners and losers of a particular policy reform?"
- It can provide not only ex-post, but also ex-ante assessment of policy reforms, enabling informed policy choices by the decision makers.

As the system of social assistance is largely decentralized in Hungary, and the local governments (numbering no less than 3200) have discreationary power on both the

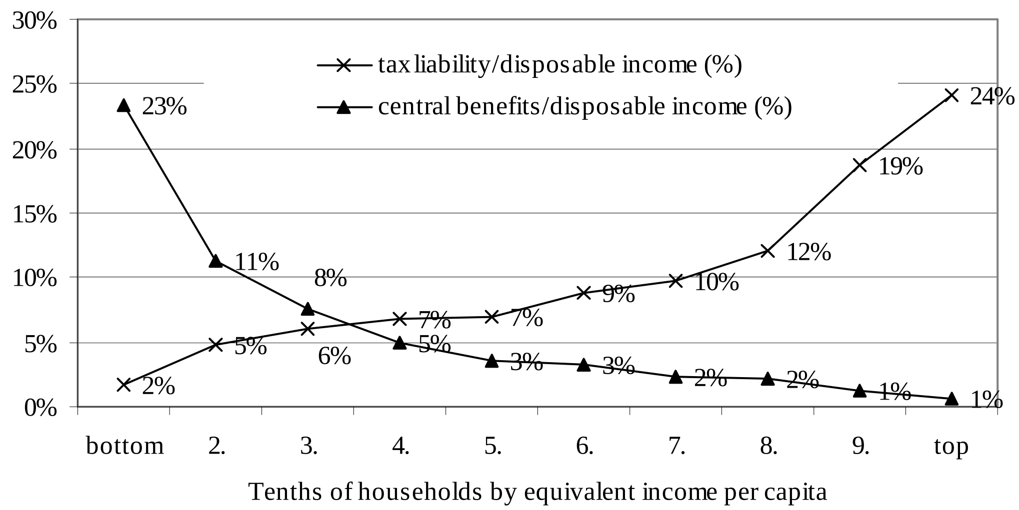
[23] This figure includes social security payments paid by the enterprises, often on a compulsory basis, replacing public provision. Such payments are for example sick pay, early retirement, disability insurance and severance pay.

[24] The project for building microsimulation model for the Hungarian government was initiated and commissioned by the Economic Research Unit of the Ministry of Finance in 2004 and built by TÁRKI, Social Research Informatics Centre, Budapest. In 2005, the development work has continued, this time also involving the Ministry for Youth, Families, Social Affairs and Equal Opportunities.

amounts and the actual entitlement, social assistance benefits cannot be fully simulated in the model. In particular, the model cannot assess changes in the entitlement criteria of social assistance, but it does include social assistance as an income component in household incomes (to the extent as these are reported in the household surveys used). This means that the microsimulation model can *assess changes in taxes and benefits provided by the central budget,* but not of those of local governments.

In the next section I present some of the first results of assessing the Hungarian income redistribution system. The main questions I seek to answer are the following: How does income redistibution affect people's incomes? In particular, what is the role of taxes and cash benefits?

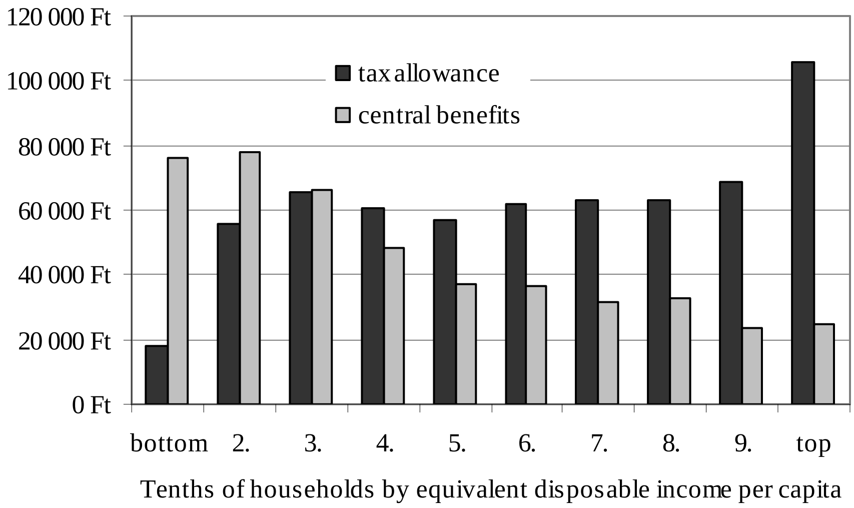
**Figure 14. The tax liability of households and the benefits received from central government, as a percentage of disposable income**




Source: Benedek, Lelkes, 2005
Note: disposable income: total household income adjusted for household size, including cash benefits and excluding direct taxes (e.g. PIT)

A useful indicator of the impact of state redistribution is to show the size of taxes and benefits compared to household incomes. For this, we calculated the share of tax liabilities and central benefits (the latter including family allowance, child care aid, maternity benefit and gas price subsidy) as a percentage of disposable income. As shown by Figure 14, households in the bottom three income deciles benefit from state redistribution: the amount of benefits received surpasses that of the (income) taxes paid. Note, that the actual amount of state benefits within household incomes in the bottom of the distribution is actually greater than presented here, as this calculation does not include means-tested social assistance benefits provided by local governments. This figure also suggests that the main instrument for increasing incomes in the bottom is by providing cash benefits, while the main instrument for decreasing incomes in the top is levying taxes. This does not sound surprising. It is rather interesting, however, that state intervention is has a largely similar *relative* impact on incomes at the two ends of the income distribution: about one fourth of incomes in the bottom tenth are constituted of cash benefits paid by the central budget, and equally about one fourth of incomes at the top are paid as income taxes into the budget.

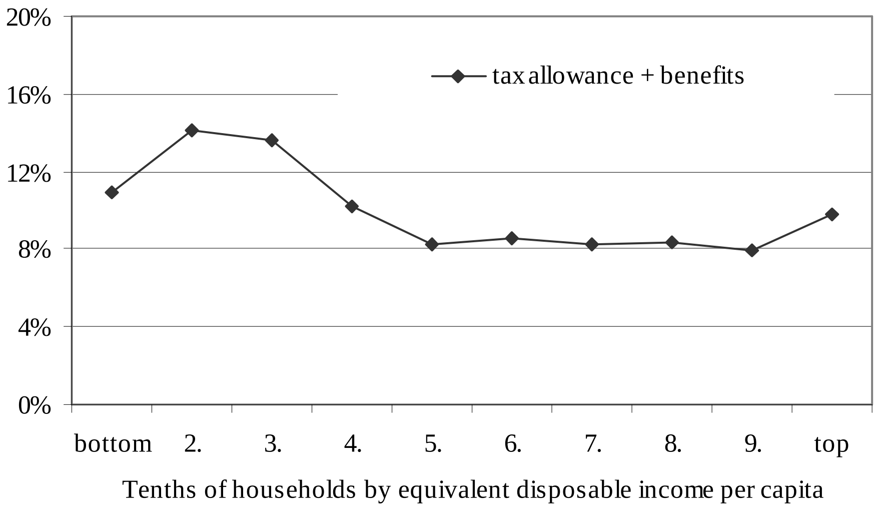
**Figure 15. Equivalent per capita tax allowance and central benefit, by income decile**




Source: Benedek, Lelkes, 2005

Tax allowances may be regarded as an alternative way of providing benefits to people, although they are often "less visible" in national budgets or in assessments of social policies. Interestingly, their amount is rather high, thus their general neglect is far from being justified by the data. The average forint amount of tax allowances surpasses that of central budget cash benefits in the majority of income groups. In other words, households which belong to the fourth or higher income decile tend to gain higher sums in the form of tax allowances than cash benefits. Only the bottom fifth of the income distribution tends to receive significantly greater amounts of cash benefits than tax allowances. A further interesting feature of Figure 15 is the low amount of tax allowances at the bottom income decile. This is due to the fact that these households do not have taxable incomes which are high enough to fully deduct tax allowances. The high amount of tax allowances going to well-off population groups highlights another feature of the system: tax allowances often tend to serve purposes other than income equalisation, such as providing incentives for pension savings, or for investment. In sum, these calculations highlight the importance of tax allowances as redistributive instruments, and call for more openness on their use and their impact.

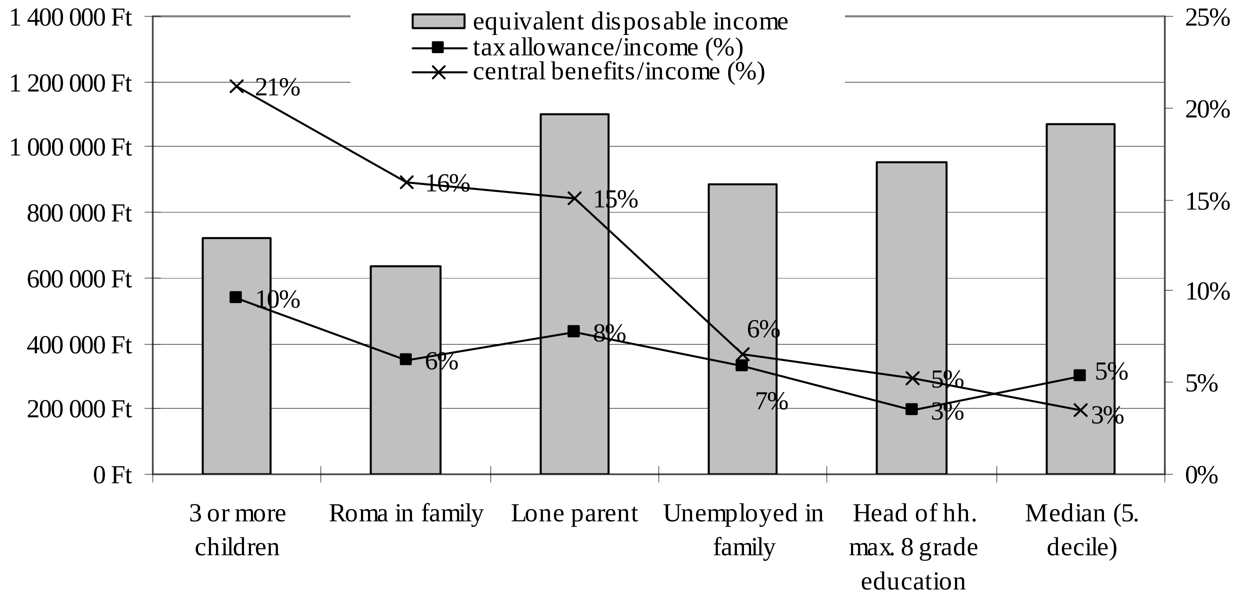
**Figure 16. Combined distribution of tax allowances and central benefits within the whole of society, by income decile**




Source: Benedek, Lelkes, 2005

From a macroeconomic or budget point of view, it is essential to see how these two instruments are distributed across the income scale. In this logic, I regard tax allowances or "unpaid taxes" equal to actual benefits paid. Given the total amount of tax allowances and central budget benefits, where are they exactly spent? As shown by Figure 16, the distribution of the amount of these is rather flat in the upper half of the income distribution, while lower income groups tend to benefit more. Two particular phenomena call for attention. First, the top income group receives a relatively higher share of these than many income groups below. The policy-makers need to see this clearly and assess whether it has been their intention, and whether this is in line with the fundamental principle of redistribution they signed up to. For an outside observer, this clearly warrants for caution. The second phenomenon is even more worrying from a social policy point of view. We can see that the bottom tenth group receives much less than the second or third income quintile. As mentioned before, it is due to the fact that their low income does not enable them to fully benefit from tax allowances. Why does it seem to be a problem? The bottom income group tends to be eligible for other, local sources of cash benefits. These benefits, however, are dominantly based on means-testing, while the benefits (and tax allowances) presented here are primarily universal. Means-tested benefits are prone to problems of inadequate take-up, in other words not all of those who are eligible do actually claim them, or possibly also exposed to stigma. Minimum income guarantee is thus left to the discrepancy of local governments, whose funds largely depend on the prosperity of the settlement where they are based.

**Figure 17. Ratio of central benefits and tax allowances to total income in some types of households particularly vulnerable to the risk of poverty**




Source: Benedek, Lelkes, 2005

Finally, I present evidence on the impact of state income policies on vulnerable social groups. These groups include large families (with three or more children), the Roma ethnicity, lone parents, the unemployed, and those with low education (with maximum 8 grades of primary education). These groups have been identified in the literature as groups exposed to high poverty risk (Ferge, Tausz et al., 2002; Tóth, 2005). For comparison, the situation of an "average" household (indicated by the fifth income decile) is also included. The bars of Figure 17 show that all of these vulnerable groups, with the exception of lone parents, have incomes lower than the median. Families with three of more children tend to receive both high benefits, equalling 21% of their incomes, and high tax allowances, making up 10% of their incomes. Families where at least one member is of Roma ethnicity receive 16% of their incomes as cash benefits from the central budget and 6% as tax allowances. Nearly one fourth of the incomes of lone parents tends to come from the central budget, dominantly in the form of cash benefits (15%). In all these three groups the amounts received as cash benefits greatly surpass those of tax allowances. It is much less the case for the unemployed and the low educated. For these groups, there is only small difference in the relative share of these two instruments in their disposable incomes. The relatively small amount of state transfers to the unemployed are due to the gradual erosion of unemployment support over time, as discussed earlier (Table 2).

This section explored the impact of state redistribution on household incomes, and on incomes of vulnerable social groups in particular. The analysis was based on a novel instrument in the Hungarian government, tax-benefit microsimulation. In my view, in addition to the obvious merits of this approach (the exploration of new evidence), it also provides a useful case study on "best practice" in government. In order to combat social exclusion efficiently, the government will need to expand the use of similar instruments, which enable the monitoring of social outcomes (defined e.g. in the National Action Plan for Social Inclusion), and establish clear causal links between policy interventions and outcomes, and enable the joint assessment of various policy measures together. Such practices will make the distinction between underlying values and policy instruments clearer. In this ideal world, policy makers will be able to focus on defining values and principles of state intervention, and then make informed choices on policy instruments.

# 5 Conclusions

The paper presented arguments for and against the use of income, or more widely, resources. A conclusion may be that income is a suitable element of welfare analysis, but it needs to be complemented by alternative, non-income measures. Ideally, these measures are "outcome" measures of well-being and they are also able to capture policy the impact of policy interventions. Major developments in methodology include the efforts of the Canberra Group (related to income), the acceptance and publication of the Laeken indicators by the European Union. There is increasing statistical evidence for the social situation in the Central-European countries. The harmonized aggregate indicators published by the Eurostat, and the new surveys of the European Quality of Life Survey and the European Social Survey provide comparable data across many countries, and include non-income measures as well. The major shortfall is the lack of longitudinal data for this region, which makes it impossible to assess to what extent social exclusion (or poverty) is a long-term phenomenon.

Poverty in Central-European countries ranges between 8% (Czech Republic) and 21% (Slovak Republic), using 60% of the national median equivalised income as a poverty threshold. The monetary value of these national thresholds, however, greatly varies across countries. In Hungary, for example, this value is less than half of the EU-15 average. A possible solution for providing meaningful cross-comparisons was suggested by Förster et al (2003), who argue for complementing the national poverty indicators with a European wide measure of "absolute minimum", based on non-monetary items.

Uemployment, bad health, social isolation, crime rates, neighbourhood safety, and life satisfaction were the particular non-income measures which were assessed in greater details. Central-European countries seem suffer particularly from grave health problems, and also from social isolation compared to other European countries. In addition, this region tends to have the lowest levels of self-reported life-satisfaction as well. Life satisfaction has fell greatly in the initial period of transition, which was followed by a gradual recovery in most countries since the mid 1990s. The relationship between income and these indicators appears to be moderate in case of unemployment and life satisfaction. On the other hand, the poor do not tend to have significantly worse health, less social contacts or worse neighbourhood conditions in general in these countries.

In the last section, the paper provided an illustrative case study on social policy developments in Hungary in the past decade.

It was shown that the role of the government has changed considerably. The level of total welfare spending has declined from 40% to 30% of GDP between 1991 and 2002. As a result, the level of total social spending is about the same as that in Great Britain and the Netherlands, and is somewhat below the level of average spending in EU15. This information on spending, however, would ideally need to be complemented with data on tax allowances, as these can be also regarded as part of the social welfare system. In addition to the size of the welfare system, its structure has also changed. During the decade of transformation, social protection expenditure proved to be more volatile than spending on social services. Spending on social protection (using constant prices) has fallen by about 25% in the mid 1990s, followed by a gradual increase. The real value of welfare expenditures increased between 1997 and 2002 with the largest increases observed in social protection, education, and health care expenditures

Some scholars described the welfare system of the early 1990s as increasingly liberal, referring to the welfare regime typology of Esping Andersen. In the paper, however, I have argued that this static typology does not seem to be adequate to characterise a system under major transformation.

The transformation has had an active form, when government modified benefit entitlements and benefits as such. The major policy reform of this decade is probably the pension reform, which included an increase in the retirement age and also a partial privatization of the current pay-as-you-go system. In addition, the undemployment support system has undergone gradual restrictions both in the duration and the replacement rates (thus the amount of the benefits). There have been ongoing changes in the family support system, which may be characterised as “pendulum politics”. The other, more passive way of government withdrawal was letting benefit value fall, privatising, and making people pay.

The role of enterprises as providers of welfare has also undergone major changes. Benefits provided in-kind, such as crèches, kindergartens, holiday homes, have significantly declined. On the other hand, cash payments by enterprises have increased, as former government responsibilities, including unemployment compensation, severance payments, sick pay, early retirement, were (partly or entirely) transferred to enterprises.

Finally, the paper discussed the assessment of income redistribution policies, using a novel instrument in Hungary, tax-benefit microsimulation model. The results show that only the bottom three income deciles are net winners of income redistribution by the central government. The other income groups are net contributors to the state budget. Interestingly, tax allowances, which are often “less visible” in national budgets or in assessments of social policies, constitute a more important source of income for the majority of income groups than cash benefits. For is not the case for certain “vulnerable” social groups, such as large families, lone parents or ethnic minorities. These groups tend to benefit primarily from cash benefits.

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