How to make a creditable economic policy?

Tibor Erdős

Growth potential and economic policy

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Tibor Erdős's academic work – I believe – is characterised by two dominant features. The first is an unyielding consistency with which he becomes engrossed in the subject he is interested in, develops and progresses from general correlations to details, and at the same time, from the theoretical correlations to practical utilisation (in our case towards economic policy). Since I know him, he has always been occupied with the conditions of long-term economic growth, the growth problems of developed industrialised countries, i.e. the impetus and the driving force behind the growth process, the general modernisation taking place in the wake of innovations and technological development. These were the main topics of his heftier books already back in the 1970s and 1980s, namely, decades before the political transformation. His long study published in 2003 (also managed by the Akadémiai Kiadó) about the conditions of sustainable development is the continuation, several years later, of the same general direction.[1] This more recent work is also mapping out the factors influencing the long-term growth trend (keeping abreast with the latest developments of the theory on long-term growth, now on the grounds of the Schumpeter traditions of endogenous growth, and not being averse even to the sometimes complicated mathematical apparatus attached to the theory). The author's intention has been manifest even in this work, i.e. to address the growth dilemmas of the economy after the Central and Eastern European, then concretely after the Hungarian millennium, by going well beyond the description of the general criteria of sustainability with perhaps a few specific examples, but this time his study is based on the paradigm of innovation-based development.

Erdős's book on sustainable growth was followed by some of his articles published in professional journals[2]. These can already be considered as a sketch or preliminary study for his recent paper. His book published last year on the subject matter of economic policy, as a matter of course, continues to deal with the growth trend characterising a particular national economy (or perhaps a particular region). However, it no longer follows the highly abstract approach of long-term growth models (see the Solow-model), but couples the growth trend with the function of the state which inevitably strives to shape the development criteria, and consequently, with the state's economic policy means, and looking at its scope for action and impact mechanisms, thus coming one step closer to practice.

So the sphere of interest and the topic remain the same, whereas the manner of treating them has changed considerably. The starting question raised reads something like this now: "what is the apparent message of the theory of sustainable growth for the strategic decisions of economic policy currently on the agenda?" (In the case of Hungary, it is related to the reform debates, the stabilisation path described in the Convergence Programme, or to the by now uncertain target date of euro-accession.)

On top of an insistence on the fundamental theme, the author's other characteristic feature is that he is a professor who has spent a dominant period of his life teaching at university. Owing to this pedagogical role and mainly to Erdős's disposition, the new study addressing the relationship between growth potential and economic policy is didactic, meticulously structured with almost a geometrical accuracy. There can hardly be any undisciplined diversions observed from the main course of the material.

The book contains five chapters together with the summary, and each chapter examines totally identical aspects and criteria at different levels of analysis. *The first chapter* discusses the major factors which determine growth potential (growth trend), their structure and the non-reversible correlations of cause and effect. This part is still only a pure theoretical model. In this section, Tibor Erdős summarises his views already expressed in some of his former papers on the factors influencing long-term growth. According to his often underlined conviction, Erdős's point of departure is that the long-term growth rate (theoretical maximum) of productivity is defined by technological development. (It is worth highlighting that in an emerging country, such as Hungary, the "secondary" technology, secondary know-how transferred by more developed countries has an important, perhaps a key role in technological advance. In a given case, this can temporarily be a significantly stronger growth factor than the world's leading technology. It would probably be justified to overview it separately in the approach of growth patterns.) All other growth factors originate from this, i.e. technological advance.

The growth of investments is a factor arising as a consequence of and subordinated to the speed of technological development (i.e. if investment expansions are faster than justified by the technological advance, then the law of diminishing returns will without mercy prevail). A further criterion, the level of savings, arises from investments (namely, national savings including not only household savings but also the savings of the budget and the corporate sector). The merit of the study is that, as against the growth patterns concentrating generally on "real factors", it stresses that in given situations the role of the financing side is becoming critical from the aspect of the growth process.

The emphatic role (restricting character) of the financing side calls forth an independent treatment of external funds which represent an increasingly critical additional item. Furthermore, in the author's opinion, as a result of the change in the conditions of economic growth, the institution system and the environment (environmental load) appear among the other relevant factors determining growth potential. Finally, somewhat to my surprise, the market comes into view which – in the author's view – plays a major, however not exclusive, part in the realisation of the goods produced, in the allocation of resources and in the achievement of the proportionality conditions.

In the author's (subjective) judgement, the previously listed criteria have the greatest role in influencing growth potential in a (i.e. in any) national economy. All these relevant criteria are discussed at four levels in the book. The first, the theoretical level, has already been mentioned. The second level of analysis is the theoretical impacts (and impact mechanisms) of economic policy exerted upon the relevant factors influencing the growth potential. This part (*the second chapter* of the book) still treats the possibility of the deliberate (economic policy) influencing of the potential at a general level.

The third level of examination consists in the evaluation of Hungary's current features, likewise on the basis of the already adopted criteria. (This short – *third* – *chapter* reminds us most to the recently so fashionable SWOT-analysis.) Finally, the lengthiest and most thoroughly elaborated *fourth chapter* poses – in knowledge of the already discussed local features – the following question : what opportunities and means do the national economy have here and now to influence long-term growth capacity by applying the unchanged set of criteria adopted earlier. This chapter is the essence of the book – at least in my interpretation of the text – in which the author not only describes but also interprets, according to his own way of thinking and choice of values, the economic policy and/or reform debates of the day. (For this reason, I shall briefly return to this part further on.)…

The structure of the book as a whole – i.e. the first two chapters which still treat the issues non-country-specific, then the second two chapters which provide an evaluation directly relating to Hungary – leads to well-structured argumentation and a train of thought easy to follow – as already pointed out – always starting from the identical system of criteria. This effect is reinforced by the clear and closely reasoning style of academician Erdős.

Although a triviality, it perhaps deserves to be emphasised that Erdős does not intend to formulate a new reform programme or a new economic policy strategy. The menus have already been prepared, and they do not differ much. (See, first of all, *Lajos Bokros*'s collection of theses titled "Competition and Solidarity" published back in 2004 in the supplement of the weekly Élet és Irodalom (Life and Literature)[3]. Tibor Erdős regards Bokros's paper as a point of departure, or as he puts it, he can even identify himself with it. But as far as its message is concerned, it is very similar to Double Bind, the book written by *István Csillag – Péter Mihályi*[4], or to the Government's Convergence Programme. As regards Tibor Erdős, he clearly and inevitably commits himself to a drastic or, we may even say, forced expenditure cutting fiscal policy, to the radical reduction of the tax burden, to the soonest introduction of the single-rate tax, to the decrease of the social security contribution motivated by competitiveness and to the increase of the relative weight of taxes tied to consumption. (For the latter taxes do not have a direct impact on price- and cost-based competitiveness.) Similarly, first of all, the tax system and partly monetary and price policies and the interest margin regulated by the competition between banks can have a part in achieving the other important target, the increase of savings.

Academician Erdős is strongly in favour of even the forced implementation of the above outlined goals. However, he warns us, and rather emphatically at that, to exercise caution in one specific subject-area: we have to be especially prudent about introducing a general reduction of the tax rate or alternatively introducing a single-rate tax regime which also produces a radical tax reduction, something that is unfortunately in Hungary often referred to bombastically as a "tax revolution" which precedes in time the measures aimed at budgetary expenditure cuts. Erdős shares the view that we cannot build on mechanisms that refer to the fact that a tax cut "skilfully" selected at appropriate points and overstepping the stakeholders' (whether entrepreneurs or employees or perhaps consumers) threshold of response will within a very short time produce its own financial cover either by increasing the output or by improving the readiness to pay tax or possibly by reducing the grey and black economy. (This question is essential because the illusory success of the Slovakian tax miracle or the simplified enterprise tax once applied in Hungary relied exactly on such over-dimensioned impact mechanisms.)

On the other hand, Tibor Erdős's book is not about inventing an "optimal economic policy mixture". We – the author and the readers alike – know that there is no such thing as the "best" economic policy. A dominant part of decisions or suggestions is a matter of choosing values. What is more, the very decisions connected with the choice of values are the ones that distinguish economic policy. (Such question – in fact, a choice of value – is the lower tax level with social benefits granted exclusively to the needy, or higher tax level with a social support system extending to a wider range of people, and a decision of the same nature is the type of family support. But, to be honest, apart from the questions of scale and magnitude, almost all choices of greater significance fall within this latter category.) Even if not explicitly, but this question is present in academician Erdős's reasoning. Although long-term growth (capacity) is indeed a question of paramount importance (I daresay, perhaps the most important question), but economic policy has to reckon with such correlations as fairness and even the maintenance of short-term stability, which correlations represent a constraint, a real (inescapable) constraint, in terms of growth potential. The estimation of mutually limiting decision criteria is eventually also a choice of value. (I myself am in sympathy with the choice of values that appears in the author's writing in recent times. It is to be noticed, however, that, for instance, the Nobel laureate *J. Stiglitz* takes a totally different view on the function of economic policy, and he is by no means alone with his view.)[5]

■ The initial question raised by the book dwelling upon the relationship of growth capacity and economic policy is roughly the following: what can be required from – or, if you like, what constraints can be imposed on – the decisions shaping economic policy from the aspect of improving growth potential. The way I interpret it, the strategic direction of economic policy is, on the one hand, completely independent of (yet not necessarily contradictory to!) the intentions of the parties involved in decision-making or in the preparation of decision-making, but on the other, it is after all formulated as a result of negotiations between economic groups or professional bodies which represent various interests. These negotiations should be conducted within the framework of such rules (constraints) – on *"rule based"* foundations as *György Kopits* puts it – that diminish at least the chances of gross mistakes. By translating it to the language of economic decision-making (to the practical language), in Tibor Erdős's view, the starting point is that economic policy opportunities (strategies) that presumably weaken growth potential should be excluded from the options. (To avoid any misunderstandings, or rather misconstruction, the author strongly emphasizes several times that, on the one hand, growth potential is not exclusively the consequence of government decisions. On the other, reinforcing the conditions of potential growth is not the only objective of economic policy – it is also aimed at fairness – but it is undoubtedly the most important criterion of the mass of still acceptable decisions.)

The second chapter of the book tries to rake together the non-country-specific criteria that should be taken into account seriously by economic policy if it does not want to exhaust its own future additional resources. The study mentions as a priority – presumably in order of importance – the encouragement of technological development and the increasing public incentive for research expenditures (including within them the state support of corporate research). Determined by the opportunities offered by technological advance and by the absorption capacity of the economy, the priorities also include that first of all the willingness to invest should be strengthened by tax policy means (profit tax, investment tax credit, etc.), and then as an indirect factor by the predictability of economic policy and its ability to guarantee stability. The next priority is the savings incentive. (In addition to the well-known instruments of tax policy, such as tax benefits and tax credits, general government savings – i.e. not only public expenditure cuts, in general, but the reduction of the state's consumption expenditures, in particular – can play a key role in savings incentives.)

It is followed by an economic policy geared at facilitating efficiency, a subject not quite tangible, a topic that contains very diverse factors, everything from the efficiency of allocation (not to be mistaken for the capital intensiveness of production), from capital efficiency to deadweight loss, from competitiveness to restructuring or to the change in the tax structure. (In this heterogonous group of factors, the impacts beyond efficiency improvement generated by technological development, the impacts of the micro-level rationality adopted in cost management and of performance motivation noticeable to some extent in the whole system manifest themselves. All of the above have an important yet secondary role in relation to technological development.) Industrial policy is at the end of the line which is the remainder coefficient, the noise, in the language of econometrics. In this division of roles, the market must ensure that the fundamental proportionality conditions – wages, productivity, etc. – are met. From the aspect of economic policy, it means the degree of liberalisation, the segmentation of the market and the opening up of new competitive markets within the domain of network-based services.

The main point in this train of thought is the logical chain which starts with innovation and attempts to show that everything else derives from there. Financeability is an inseparable part of this chain in contradiction to traditional growth patterns which concentrate on real factors (which can even be described without money).

The longest as well as the most weighty and informative chapter of the book contains the critical issues of present-day economic policy and, on top of the proposals that seem to be mature, it also tackles “ambitious” professional ideas and the already noticeable risks ahead of economic policy. The fourth chapter, which overviews the Hungarian economic policy dilemmas of our time, aims to prove (at most times successfully), among others, that the planned changes, most of which can presumably be carried out within a couple of years, or at least their determining elements are a coherent part of a logical system. (For that matter, the presentation of the current general government reforms – health, pension, education, public administration and government reforms – targeted at reducing expenditures are designed to demonstrate the above-mentioned coherence.)

Contrary to the first two chapters of the book, the emphasis fundamentally changes in the section exploring the economic policy in the post-millenary period. Prominence is given to the rapid stabilisation of the economy, even at the price of substantial social (growth) sacrifices. It is also unavoidable to restore the recently broken credibility of economic policy, which will also require a growth sacrifice in the short run and, even if only for a few months, will bring about an inflationary wave. (The earlier low inflation rate is attributable to state subsidies, namely, to increased budget deficit, and if you like, to suppressed inflation. Their elimination, which has become indispensable by now, led to the growth sacrifice which society has to cope with and to a very short spell of inflationary wave without inducing the weakening of the forint. (Since the primary function of monetary policy is to dampen short-term fluctuations and vibrations and to reinforce the credibility and predictability of economic policy, it is hardly a coincidence that it represents a key issue of the strategy after the millennium, an issue treated as a secondary in the “theoretical” chapters (which are not hinged to national economies or time or any specific conditions). I venture to say: the order of importance shifts at this point. Restoring credibility and stabilising the economy in a forced manner is a precondition of all other strategic decisions, including the increase of the financial funds of innovation and the encouragement of corporate R & D investments.

This chapter addressing the current economic policy provides not only a general but also a thoroughly elaborated picture of the complicated, often contradictory, conditions and of the social, societal and political constraints that curb the decision-makers' scope of freedom and characterise the existing practice of decision-making. These sources of conflict accompany government decisions built on one another across even such a rare period that can be considered ideal and when a strong reform compulsion is apparent, and thus these government decisions might ricochet.

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Erdős gives a comprehensive and realistic picture of the economic policy dilemmas as well as the underlying theoretical considerations which do predominate in the background of seemingly chaotic details and, we trust, will eventually create harmony in the course of events. In this sense, his book stands pre-eminent among the innumerable papers published about topical programmes: his work is normative as opposed to János Kornai – often quoted by the author – who always endeavours to describe and explore the internal logic of the processes. At the same time, the requirements and norms Erdős lays down are not simple request shows, but they are based on economic regularities. And in the past decade and a half we were forced to learn the validity of these economic regularities at our own expense.

The author's work unquestionable proves his initial assumption. It is possible and worth shaping the direction of economic policy strategy on the basis of macroeconomic theories and, within certain limitations, this intention can be realised in practice. I would add howerer that although the growth theories (and their general considerations related to tax policy) may assume the role of a compass, but they can by no means serve as a tourist map that would provide the grounds for reform decisions. When preparing decisions of a specific period and developing the reform programmes, we must start from a system of axioms, i.e. from the ideas of the so-called new political economy, that is more extensive than the abstract theory of macro-economy and that is capable of integrating several points of view. Let us cite the copy editor of this book, *László Csaba:* “New political economy… means the approach in which the approach and the set of analysing tools based on mainstream paradigms are coupled with the analysis of institutions and Community decisions. It is not aimed at removing the foundations of the economy and replacing them with the paradigms of other disciplines. On the other hand, it is aimed at broadening the economic approach and supplementing it with political institutional factors."[6] Tibor Erdős's book – which can be a step forward to understanding the more profound features of the transformation process – now convinces me that we are heading somewhere in that direction.

László Antal

Notes

[1] Erdős, T. (2003) Sustainable economic growth, *Akadémiai Kiadó*

[2] Erdős, T. (2004) What Can be the Sustainable Growth Rate in Hungary? *Parts I and II, Economic Review, May and June 2004;* Erdős, Tibor: Growth Potential and the Hungarian Economy. *Development and Finance, Number 3*

[3] Bokros, L. (2004) Competition and Solidarity, published in *Élet és Irodalom*

[4] Csillag, I. – Mihályi, P. (2006) Double Bind. The Eighteen-Month Programme of Stabilisation and Reforms, *Globális Tudás Alapítvány*

[5] Stiglitz, J. (2005) The Roaring Nineties, *Napvilág*, Stiglitz, similarly to his previous, also hotly discussed book which addresses in details the problems of the Central European region (Globalization and its Discontents), Stiglitz argues violently against the standardised solution reflecting the general economic patterns favoured by international financial institutions (and, of course, the Washington Consensus). In his opinion, special attention must be paid to the cultural traditions of the given country. The especially important consideration of economic policy is to limit social shocks and to make the changes to be of human scale. He rejects radical solutions that require enormous social sacrifices in the short run even if they (theoretically) promote lasting growth in the long run. The former chief economist of the World Bank does not support solutions that originate from macroeconomic laws and can be applied non-country-specifically. (I myself am not in sympathy with Stiglitz's conception, but it has to be considered as a conception characterising a relatively broad circle of experts.)

[6] Csaba, L. (2006) The New Political Economy of merging Europe, *Akadémiai Kiadó, page 20.*