László Akar

The economic policy turnaround and the new convergence programme

The Government that took office after the elections had to face an inescapable economic policy turnaround, which, by its very nature, had consequences in internal politics, too. At last, politics was required to frankly and profoundly consider the dramatic imbalance of the budget, which turned out to be even graver than the typical external expectations. This situation would have emerged after any election result, the only difference could have been witnessed in the presentation of the measures in internal politics, or maybe in the details of the chosen measures, however by that time the room for manoeuvre had narrowed down.

The economic policy shift was reflected in a general form in the Government's programme, but even more in the package of adjustment measures announced in June (and mostly specified in laws in July), and then in a more comprehensive and forward-looking manner in the new convergence programme, which was finalized by 1 September. The latter is true even if the analysis of longer-term reform steps in this document reflects uneven, not yet fully developed and rather general concepts in several fields due to the need for urgent programme development (apparently from the aspect of the current level of elaboration).

However all this clearly indicates that the Government opted for an economic turnaround, which has already been actually set off.

ECONOMIC POLICY LESSON – CRISIS OF THE EXTERNAL BALANCE OR THAT OF THE BUDGET?

Despite all possible analogies, the economic policy lesson that took shape by mid 2006 fundamentally differs from the situation characteristic for the turning point of 1994 and 1995. In contrast with the situation over a decade ago, neither the external balance, nor growth performance and inflation can be regarded as real problems. Yet, analogy does exist in the sense that due to the considerably disturbed balance of public finances massive and so called "front-loaded" adjustment (which yields significant results early on) became inevitable in both cases. (Interestingly enough, during the current adjustment cycle the primary balance of public finances should show exactly the same improvement as we could witness between 1994 and 1996.)

As far as the external balance is concerned, there circulate apparently different opinions. Apart from the methodology in force, the most comprehensive indicator of the external balance is the total of the current balance of payments and the balance of capital. The GDP proportionate value of this indicator dropped from 8.3% in 2004 to 6% by 2005 (according to the latest calculations), and is expected to be similar in 2006 (relative to the GDP calculated with the weak Hungarian currency). There is no doubt that the current level may also seem extremely high at first sight. At the same time however, according to the new methodology introduced a few years ago, the calculation of this deficit indicator also contains the not yet withdrawn profit of foreign owned companies (which is a natural feature of usual business operations), which means the automatic financing of part of the reported deficit. Reflecting this as well, in 2006 the use of non-debt generating resources is expected to exceed 60% in deficit financing. In addition, the foreign currency denominated debts of domestic companies and individuals will largely cover the funding of explicit indebtedness.

The realistic evaluation of the situation also requires noting that the external trade balance of goods and services (which are contained in the balance calculations of the GDP) is more or less in equilibrium, i.e. the deficit of the current balance of payments and balance of capital mostly arise from the natural demand for income realization from foreign direct investments, which have reached enormous proportions (obviously beneficially if the overall impacts are considered). On the other hand, the rapid growth of EU subsidies is expected to more and more favourably influence changes in this balance.

The relative acceptability of the external imbalance is suggested by the fact that the NBH has huge foreign currency reserves, and the interest margins of foreign exchange loans funding the state do not give rise to major concerns despite the deteriorating ratings.

All this shows that although the problem with the external balance is considerable, it shall not be considered as threatening for the time being. (Rather, it has the potential to turn into a serious problem, especially if the balance of public finances cannot be significantly improved).

As far as growth performance is concerned, the Hungarian economy can maintain the growth rate equalling the average growth of the EU-15 +2 percent. Obviously, the expected growth rate of around 4% does not reflect a crisis situation (especially if we take into account that more developed countries usually grow at a slower pace). Of course, an even more dynamic growth would be better, but the main problem of the current economic policy is not the lack of growth performance.

From among the balance indicators, inflation is undoubtedly low compared to the trend of the 1990s. If we look at core inflation, which reflects one-off impacts to a smaller extent, the inflation rate is still very favourable.

The public finance deficit has hit (negative) records in Europe since 2005, and the nearly 10% GDP relative level expected in 2006 is already alarming. This means that if we use rounded figures, the Hungarian state spends HUF 120 from each revenue unit of HUF 100, which is obviously unsustainable. The public finance debt, which is growing because of the large current public finance deficit, is getting more and more dangerous, since it puts an increasing burden on the current budget due to rising interest expenses, too.

If we cannot radically change this situation already in the short run, the so far tolerant external assessment of Hungary's external imbalance may be reconsidered.

The EU convergence rules explicitly aim at preventing excessive deficits, they want to make the member states comply with the below 3% limit. Experience shows that member states may get away with smaller deviations, but the current Hungarian deficit is far greater than the commonly seen discrepancy. Going upstream against the EU rules may turn off the EU money taps in a few years, which would deprive Hungary from huge development opportunities.

If convergence becomes unrealistic, the danger of negative market reactions would grow, a major foreign currency crisis may emerge, or even a general balance crisis may unfold.

On this basis, today's main economic policy problem is the high public finance deficit, the curbing of which must be in the focus even at the expense of temporary growth sacrifices. It is now not an end in itself to adjust the consumption/accumulation ratio by the reduction of consumption, or the regrouping of incomes to companies for the same purpose, or the significant increase of the incomes of exporting companies, or making imports considerably more expensive.

However, with a view to improve the balance of public finances, it is a goal to cut the end-user expenses of public finances, to change the sharing ratios between public finances and the other income earners, which will obviously restrain consumptions and corporate investments, too. However this can be regarded as a bearable side-effect of the treatment (in particular in the light of the preceding events).

IN SUMMARY: the new economic policy, which focuses on the consolidation of public finances, influences the other economic policy goals, too, therefore it entails, among other things, the relative narrowing of internal consumption, growth setback, rising inflation and the improvement of the external balance.

In the current situation it is justified to improve the public finance balance by relying on tools different from those used in 1995, when the general external and internal imbalance had to be treated with drastic measures.

The need for significantly improving the public finance balance coincides with the comprehensive problems of the operation of the state, and the similarly justified need for the implementation of the state reform. This condition also considerably influences what methods should be reasonably used in the current adjustment strategy.

THE ROAD LEADING TO THE DISRUPTION OF THE BUDGET BALANCE

Evaluation of the shift in the budget policy is not possible without examining what public finance processes have led to the high public finance deficit. According to the official forecast, from the GDP relative public finance deficit of around 3% in 2000, by 2006 Hungary has managed to inflate this deficit to 11.5% without the measures or 10% if the one-off impacts are deducted.

There are not sufficient comparative public data available for the exact analysis of the balance sheets per economic classification, which could probably describe the processes the best. What is more, the planned figures for 206 cannot be used for the huge discrepancies either. Yet, the major underlying factors can bee seen from the comparison of the final account cash flow expenditures grouped according to the economic classification of 2000 and 2005.

If we take into account the expected value of the five-year cumulative consumer price index (133.2%), the growth figures of real expenditures can also be calculated for the purpose of analysis. According to these calculations, between 2000 and 2005:

- transfers and subsidies considerably ran up, within which the growth of household subsidies was the largest, including the growth of pension expenses, which was the biggest item. (In addition, gas price subsidies, which evolved from scratch, also played a role.) If we ignore the inflationary impact, the real growth in household subsidies equals HUF 1,027 billion;
- due to the wage increase of civil servants and public employees, and the unrealized

reforms, the total gross personnel costs of the system of public finances almost doubled. This means an additional gross expenditure of HUF 867 billion on top of the inflationary compensation. If we deduct the public dues payable on wages, which are automatically re-channelled to this group, the net real growth in expenditure is still estimated to be around HUF 350 billion;

- the real costs of public services also grew by almost 50%, reflecting the expansion of the institutional system. This represents a real growth of HUF 122 billion.

From this we can conclude that – despite the common belief – the run-up of public finance expenditures is not primarily the direct consequence of the wage hike in the public sector, although this also played an important role. The growth in expenditure was first of all caused by the quick rise in household subsidies. One factor of this is the gas price subsidy scheme, but the main cause is the dynamic growth of pension expenditures. Through the rule of indexation, pensioners were favourably affected by the wage hike of the public sector and the reductions of the personal income tax, which were beefed up with the introduction of the 13th month pension and the augmentation of survivors' pensions. (In the case of pensions no automatic state revenue is generated like from the public dues on wages in the case of wage increases in the public sector; the only favourable budget consequence can be seen in the case of VAT revenues.) In addition, the change in the composition of retiring people also drives pension expenditures up.

The growth in expenditures was also triggered by the increase in the real costs of public services, and obviously by the boom of motorway construction (which cannot be quantified by cash flow figures, yet were partially compensated by restraining other development expenditures).

However, the other factor explaining the disruption of the balance was the implementation of tax cuts that were obviously oversized for the given expenditure policies.

THE SIZE AND TIMING OF THE NEED FOR ADJUSTMENT

According to the latest official calculations, without any measures the GDP relative public finance deficit would have totalled 11.6% this year, which would mean a primary deficit of 7.8%. Of course, the measures include one-off items to reach the 2009 goal, including, beyond any doubt, the GRIPEN purchases, the cancellation of the Iraqi debt, flood protection related expenses, the usual extra deficit of the local governments in the election years, and the utilisation of reserves from the previous year, which together equal around 1.8% of the GDP. Taking all this into account, if Hungary wants to achieve the desirable target in 2009, the primary balance must be adjusted by nearly 7%. This entirely corresponds to the improvement of the primary balance that was achieved between 1994 and 1996 as a result of the Bokros package. The current situation is more favourable in that we have 3.5 years, economic growth is higher than it was then, and the very high level of motorway investments considered in the baseline calculations may drop (partly due to the lessening development needs, and partly because of the expansion of real PPP projects). It is true, however, that the co-financing of EU programmes may require increasing expenditures.

In the emerging situation the regaining of the confidence of the market and the EU (with regard to the global money market processes, too) required that a strategy demonstrating significant progress in the adjustment as early as in mid 2006 should be followed. Therefore, it obviously became necessary to choose methods than can yield quick results, too.

POSSIBLE METHODS OF BUDGETARY ADJUSTMENT

Experience shows that the strategic methods of adjusting the primary balance may theoretically be standardized (of course, we can argue about the classification of the methods, and the individual cases are not fully isolated, either). Decision-makers that face such a task need to consider the following possibilities.

a *The use of surplus revenues from economic growth (and in particular from the rise in consumption and wages) for balance improvement,* if the budgets would put a freeze on the real value of expenditures (or on the nominal value in the stricter versions, or combine the two approaches). A specific case of this is when somehow economic growth can be accelerated and the economy and employment (in particular the legal economy and employment) can also be expanded.

b *Enforcement of balance improvement by inflation (preferably by surprise inflation)* Higher inflation a priori generates surplus revenues that improve the balance, if the nominal value of the expenditure items do not need to be increased (this is temporarily not possible in the case of debt associated interest expenditures denominated in Forint). A particularly interesting balance scenario is when price rises occur through the increase of consumption type taxes or the attachment of "price tags" to budgetary subsides. (We can also mention here the policy where inflation is underplanned on purpose, and the expenditure levels are linked to this inflation, and then surplus revenue is realized due to higher inflation, which can be used for the improvement of the balance.)

c *Intervention into the distribution of incomes* in the system of sharing public dues, increasing taxes and contributions directly affecting incomes. This can happen by reducing exceptions and exemptions, by imposing taxes on tax avoiders and/or by increasing the general taxes and contributions on incomes.

d *Reduction of transfers and subsidies,* which may mean the curtailment of payments primarily to the population, part of which are protected by the Constitution, therefore cannot or can only slightly be curbed.

e *Reduction of the expenditures (personnel and real expenditures) of public services.*

f *Reduction of cumulative expenditures* funded by the system of public finances.

FEASIBILITY OF THE POSSIBLE STRATEGIES IN THE COURSE OF THE CURRENT ADJUSTMENT

In Hungary all of the above mentioned methods have been tried in the recurrent restrictive cycles, and the various options have been often used in combination. Any time a serious imbalance occurred, for decades the first reaction was the immediate augmentation of the tax content of the prices of alcohol, cigarettes and petrol. Budgets that experimented with restraining investment expenditures were also a common sight.

The most renowned adjustment package, the so called Bokros package relied mainly on the so called surprise inflation, the devaluation of the Forint, the introduction of the customs surcharge, and the curbing of public finance expenditures. This programme also included both expenditure cuts and massive tax hikes, however, the main method of the latter was the introduction of the above mentioned customs surcharge, which set off inflation (the personal income tax was also increased).

It is worth reviewing the feasibility of each potential strategy that may be followed in the adjustment of the public finance system, which has become necessary and has been started lately. It is equally worth examining how such strategies have appeared in the decisions that have been adopted so far.

a *The strategy that builds on the impacts of growth* is the most gentle, most easily acceptable option, especially if it only requires the freezing of the real value of expenditures. However, this strategy cannot be used in certain areas (pension indexation, due to the increasing EU co-financing costs), and its stronger form can obviously be used only for a few years. What is more, with this method results can only be achieved later on (not at all in 2006, and at the earliest within the framework of the 2007 budget). Due to the aforesaid and the size of the public finance deficit, there is no way to use this strategy initially or by itself, although it could be applied later on. And this intention is indeed reflected in the convergence programme. The intentions that basically mean the freezing of nominal spending can be revealed especially in all public sector operational expenditures, but also in other expenditure items.

It must be examined separately, how the public finance balance can be improved by accelerating economic growth and by expanding employment (in particular legal employment), as well as by the reduction of social security contributions to this end. In the short run, the reduction of the public dues on employment would certainly entail revenue losses only, and (to a smaller extent) this phenomenon would probably prevail in the longer run, too. The expansion of employment is restrained by the market (especially by external markets in Hungary's case), and the larger scale reduction of the grey economy can hardly be expected from the realistically presumable general improvement of the so called wage wedge (the share of public dues from all wage costs).

The advocates of balance improvement by tax cuts emphasize, among other things, the success of the reduction of corporate income tax by 50% at the beginning of 1995. However, the real value of tax revenues did not actually increase at that time either. The relatively strong tax-paying discipline was mainly caused by other impacts, including especially the dynamic growth of corporate profits from an unbelievably low level due to the massive reduction of real wages. We must add though that in those days the corporate income tax played a rather insignificant role in public finance revenue. In contrast, public dues on wages currently represent the main sources of revenues, and their reduction by 50% (or even 25%) could hardly be undertaken even in a more stable budget situation due to the risk of an enormous loss of revenues.

b *The inflation based adjustment strategy* can only moderately applied in the current situation, compared to 1995. In principle, it is easy to turn inflation up, but then it is difficult to bring it down. Having the objective of adopting the euro, Hungary can hardly undertake significant (say 10%) inflation acceleration, since then it would take a long time to reach price stability. Furthermore, with the current legal role of NBH, such an economic policy shift would be against the price stability objective of NBH, which could trigger astronomical interest rates due to the different target functions (temporarily increasing the budgetary burdens, too). Seemingly it is easier to choose an inflation based adjustment policy (the direct losers of the measures remain invisible versus in the case of tax rises and subsidy cuts), but its practical implementation would be rather difficult today, since the Government cannot decide about the exchange rate, and the room of manoeuvre of officially fixed prices (tax content increase) is also limited (and conflict-ridden).

At the same time, the preceding events put the partial application of this strategy on a "forced orbit". The half-finished VAT reform had to be completed, and gas price rises are inevitable due to the current world market prices. Meanwhile, the devaluation of the Forint, which was triggered by several causes (including causes influenced by the Government and the NBH) – albeit to a smaller extent – induces inflation. Therefore, inflation does have a role in adjustment, but it cannot be regarded as the number one player.

c *The strategy modifying the distribution of incomes* is supported first of all by the fact that it can be quickly implemented, and according to the analysis of the previous years, tax reduction is no longer an option, what is more, without any measures the net real wage rise in 2006 would have exceeded 5%, which is far from the level that could be justified by economic performance (if the growth performance and the deterioration of the terms of trade are taken into account). Obviously, it is easier to undertake the increase of burdens by curbing tax allowances and reducing tax avoidance. The raising of the general tax rates (especially those on live labour) is more problematic. The first stage of adjustment greatly relied on such measures. Several measures are designed to reduce tax avoidance (contribution payment on the basis of twice the minimum wage, etc.) while the increase of the individual contributions, the two types of solidarity tax and the tax on income from interest gains will modify the proportions of income distribution for a longer time.

d Within the framework of the *strategy based on the reduction of transfers,* one can hardly argue – from the economic point of view – about the need for the significant curtailment of household gas price subsidies (to pass on the considerable growth in import prices) and the transformation of the remaining subsidies into means tested social subsidies. The restraint of the growth in pharmaceutical subsidies is also long overdue. The interest subsidies associated with housing loans are based on set conditions, while new loans are drawn in foreign currencies (without subsidies). Pensions are protected by constitutional provisions, wherefore the only options include the modification of the rules of annual pension rises, and in theory, the reform of the 13th month's pension, and the restructuring of the system of disability pensions, which has been postponed for a long time.

It seems that restraining the transfers is difficult because of the social consequences. Certain partial reforms may yield some savings, but naturally, this cannot be the main strategy of adjustment. The already adopted governmental decisions include the transformation and narrowing of the gas price subsidy scheme, and the convergence programme earmarks the rationalization and transformation of the system of disability pensions into a separate system. The convergence programme also outlines the need for further corrections in the pension system, albeit only in rather general terms.

e *The strategy restraining the expenditures of public services provided by the state* can be made accepted relatively most easily, and it is expected to trigger resistance by the affected (but influential) minority "only". This strategy can be regarded justified based on the processes of the past years and also due to the need for the state reform. Furthermore, the need for following this strategy is also supported by the current status of public services as a whole, the low level of realization of economies of scale, the over-inflated organizational structure and the quality of operations. At the same time though, in this case the financial impact of the measures is delayed, and the preparation of the decisions is also time-consuming (especially in the local governmental sector). Therefore, this strategy can only be used as part of a strategy mix, but it will play an important role in the implementation of the adjustment according to the convergence programme.

The ideas pertaining to the rationalization of the central public administration are relatively clear-cut and mature in terms of direction in the convergence programme. Yet, most of the expenditures are linked to the local governmental sector, where the road could not yet been opened to the introduction of mandatory small regional cooperation and regional administration with laws requiring the support of two thirds of the members of Parliament. Hopefully, a consensus will be reached in this matter after the local governmental elections. If the consensus falls through (and also, until a consensus is reached), in principle the local governmental system can be significantly rationalized by the adequate modification of the financial funding rules and the relevant laws. However, it is not yet clear from the convergence programme, what methods will be used for this purpose.

f *The strategy aiming at restricting investments* seems to be only partially applicable given the ongoing road construction projects and the needs for EU co-financing. Yet, the channelling of development needs into EU programmes and the very high level of investments in 2006 (and the prevalence of the PPP scheme in new developments) do provide some possibilities in this area, too.

IN SUMMARY: it seems that due to the magnitude of the required adjustments and the need for significant results early on, the realistic way could only be a strategy mix, and this approach is reflected in the decisions and programmes adopted so far.

The Government expects quick results primarily from strategy *c)*, which affects income distribution, and strategy *b)*, which is a more moderate, inflation based strategy primarily building on a direct budgetary impact. This expectation is well-founded.

On the other hand, in later stages of the adjustment (according to the convergence programme, the adoption of which in the budget for 2007 is still to come) preference will be given to strategy *e)* (rationalization of public services) and strategy *a)* (building on growth and the freezing of expenditures), but strategy *f)* (restraining investment expenditures from own resources, re-channelling tasks into EU programmes) may also be applicable. Strategy *d)* (reduction of transfers) can probably contribute to balance improvement to a larger extent only in certain specific areas. (Apparently, this strategy will take over as a main strategy only after all other options have been exhausted.)

PUBLIC FINANCE ADJUSTMENT PATH FOR THE 2006-2009 PERIOD

According to the convergence programme, although public dues will increase by 4% of the GDP due to the measures adopted in the summer of 2006 (compared to the situation which would have emerged without the measures, and without considering the cancelled tax cuts scheduled to be implemented later on), but approximately 2 percentage points of this will automatically decentralize later on due to the characteristics of the economic policy path (low level of consumption and wage hikes). Therefore, the increase in public dues will ultimately contribute to the improvement of the balance only by around 2% of the GDP.

The convergence programme plans to reduce the operational expenditures of the public sector by 3.2%, i.e. from 18.4% to 15.2%. Assuming a nominal GDP growth of 23% this means that in three years the total nominal value of these expenditures can increase only by 1.5 to 2%, i.e. they must practically be stagnant.

In relation to investment projects and other government programmes implemented exclusively from domestic resources, the convergence programme counts with savings of nearly 2%.

In addition, the liquidation of the gas price subsidy scheme can be started and several other balance improving measures can be taken. Nonetheless, it is true that the non-recurrence of one-off expenditures technically appears as saving in the programme.

IN SUMMARY: with the planned measures we have all right to hope that the primary balance can be adjusted by 7%, in particular if we take into account the reserves arising from revenues as well as from the not fully quantified potential measurements.

Naturally, the rise in the interest level (temporarily over the level assumed in the programme) will influence the current status of the entire public finance balance. Yet, in the course of a longer-term adjustment the most important factor is the primary balance, since as convergence progresses, domestic interests will adapt to the system of euro interests. As far as the current public finance deficit is concerned, the ultimate impact of the temporarily less favourable interest balance becomes visible only through the additional interest burdens of the higher state debts. However, this is not an extremely huge amount, and should state debts reach this amount, it can be offset with privatization proceeds. (What is more, the annual target balances that are planned with some reserves are able to tolerate minor interest growths.)

CONCLUSIONS

The analysis shows that the decisions adopted so far and the convergence programme more or less follow a rational and expedient practice in relation to the strategic methods for the adjustment of public finances and in relation to the order of the application of the selected strategies. In the first stage of the adjustment controlled inflation rise and intervention into income distribution dominate, and then the rationalization of public services gains ground. At the same time, a few other strategies are also applied. The exact proportions of use may obviously change later on, since the revenue side has been forecast with a pessimistic approach. (The faster than assumed growth of wages in the business sector, the non-occurrence of the anticipated decline in consumption may clearly improve the budget balance.)

All this does not necessarily mean that the selected strategy mix has been and will be followed with the optimum tools during the enforcement of the individual strategies. The greatest risk is implied especially in the fact that the reform concepts have not reached full maturity. Therefore, from this point of view the convergence programme cannot be fully evaluated yet.

Since the Government expects that nearly half of real adjustments would come from the rationalization of public services, it is worth pointing out the related dilemmas. The curtailment of expenditures can in theory be implemented by almost retaining the existing structures, through the reduction of real wages while maintaining the current level of employment. This would not yield a permanent solution, and would sooner or later regenerate the public finance imbalance (the large-scale wage corrections of 2001 and 2002 also reflected the cumulative, ten-year backlog of the public sector.) At the same time, adjustment may also be carried out through the real rationalization of the public sector, the growing realization of economies of scale, by cutting back excess capacities (and employment), and by the reconsideration of processes. Keeping to such a path would yield permanent savings.

Therefore, the real issue is now a dual question. The first question is whether the plans outlined in the convergence programme are followed by consistent implementation, and the other is to what extent implementation can be both professionally and socially acceptable especially on the expenditure side, i.e. to put it more simply: are there across-the-board cuts and unstable improvement, or real reforms and permanent solutions?

The – hopefully positive – answers (or the majority of the answers) to these questions will be given by the budget for 2007 and the reform acts to be passed in 2007.

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