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OECD Economic Surveys: Hungary

Assessment and recommendations

Fiscal consolidation dominates the policy agenda

After re-election of the centre-left coalition in April 2006, the government announced ambitious plans for fiscal consolidation, following admission that its deficit could be well over 10% of GDP without consolidation measures and indication that entry to the euro area in 2010 was impossible. The 2006 deficit, at 9.2% of GDP, indeed marked another peak in Hungary's strong electoral spending cycle. The government's goals imply breaking out of this. The aim is for a deficit below 3%, and on a sustainable basis for the future, by the next election in 2010. The consolidation programme comprises immediate revenue and spending measures, many of which are intended to be temporary, combined with wide ranging structural reform to public spending. The potential payoff is large. A permanently low deficit would put public debt on a downward path and return dividends to the economy *via* lower interest rates, reduced current account imbalances and fewer problems with exchange-rate volatility.

The government's austerity programme is temporarily slowing growth

Given the size of fiscal imbalances, there was no alternative to drastic revenue-raising measures in the first phase of the programme. These began in autumn 2006 with hikes in employee social contributions, value-added tax and business taxation. The resulting squeeze on households' disposable incomes and businesses is damping demand. Indeed, real GDP growth will dip well below its long-term average of around 4% to between 2 and 3% for this year and next. The increase in value-added tax, plus reduced gas-price subsidies, have generated a spike in inflation, creating uncertainty for rate setting in monetary policy.

Long-term payoff from the programme depends crucially on success in structural reforms and in resisting spending pressures

Two major challenges lie ahead. The first is ensuring adequate delivery on structural reform. A number of key measures have yet to pass through Parliament and some reforms are inherently difficult to implement, even if the necessary legislation is in place. The second challenge is ensuring that the various temporary measures stay on track. The two challenges are interrelated, as timely progress on structural reform will help prevent the derailment or unwanted extension of temporary measures. The biggest test of the consolidation programme will be from 2009 onwards, when structural reform is supposed to deliver more of the deficit reduction but when, also, pressures for new spending measures are likely to mount due to elections in 2010.

Further development of disciplining mechanisms in the central-government budgeting process is needed

Several mechanisms helping budgetary discipline have been strengthened in 2007. Notably, reserve funds are larger and rules on state guarantees and spending on infrastructure have been tightened. Also, a new rule has been brought in requiring the annual budget submission to show a primary surplus. These are positive steps, and developments along these lines must continue. *The primary-surplus rule should be augmented so that any windfalls are used for deficit and debt reduction. Other mechanisms ought to be considered as well. As previous Surveys have suggested, a system of binding medium-term spending limits may be one way forward. More assessment of budgetary plans by independent bodies should also be considered.*

The spending freezes in public-sector pay perpetuate a stop-go cycle that eventually needs to be broken

The freeze on public-sector pay is playing an important role in the initial phase of fiscal consolidation but is already proving difficult to sustain. Agreement with the public-sector unions early this year led to 13th month salary payments being partially brought forward and additional payment in 2008 conditional on extra budgetary savings. The freeze is anyway perpetuating a stop-go cycle in public sector pay that has damaged morale and recruitment. In the longer term, the cycle should be stopped, for example through the multi-year agreements.

Some areas of public-expenditure reform should be strengthened further

The largest immediate savings *via* structural reform are coming from large cuts in the number of hospital beds, reduced spending on pharmaceuticals and lower household gas-price subsidies. All these are welcome measures, and indeed, have been recommended in previous *Surveys*. But the full range of public-expenditure reforms runs much wider than this. For instance, a general campaign to cut administrative overheads is underway. Central government introduced cuts in ministries and formulated detailed plans for other centrally controlled bodies. It is important that this campaign extends to sub-national governments. Getting the counties and municipalities on board in the reform process is also important in other areas because these governments have responsibility and control of a large share of public services (see below).

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Reforms in healthcare are encouraging

Healthcare reforms also include setting up a tiered system in which access to some types of care requires insurance coverage. There is also welcome wider application of user fees, notably a fee for doctor consultations has been introduced. In addition, changes to the hospital system are underway to bring a more structured organisation of specialist, general and outpatient services. Progress in these areas has so far been encouraging. At the same time, the authorities are moving cautiously with plans to introduce a system of multiple insurance providers. The following additional measures ought to be considered to help boost the effectiveness of reform:

- The gate-keeping role of general practitioners should be strengthened to help prevent excessive referrals to specialist units in hospitals.
- Hospital managers should be given greater flexibility and responsibility for deficits and debts.

Bad practices in transport financing have been halted

In a positive move, the 2007 budget has not assumed spending on motorways will go off-budget through a public-private partnership, unlike the previous two years. Indeed, the financial flows of both state-owned motorway constructions companies are now fully recorded in general-government accounts and a limit has been placed on the amount of debt they can accumulate. Also, there is a more rigorous approach to public-private partnerships, which will hopefully see an end to inadequate proposals aimed largely at getting spending off-budget and should be used as a vehicle for more private-sector participation. In rail transport, medium-term subsidy commitments have been made in an effort to insulate the state-owned rail company from a cycle of borrowing by the government. Also, large one-off capital injections are being made in 2007 and 2008 to help with a rationalisation programme, though there is a risk that the programme will not deliver all its promises.

More reform will be needed in education and pensions

In addition, several important reforms with longer-term payoffs are either being implemented or are in the pipeline, notably in education and pensions:

- In education, the various plans for rationalising services and altering financing arrangements look to be positive steps. In higher education, the widening application of tuition fees is welcome. *Further reform should be made to reduce the connection between fees and examination results. A system where fees are more uniformly applied that builds on the existing system of government loans ought to be considered.*
- Several reforms are underway to raise the effective age of retirement. Further tightening of eligibility for early-retirement pensions is scheduled. *Ultimately, the most popular early retirement scheme (the "advanced retirement pension") ought to be removed altogether because there is no reduction in the annual pension while the "reduced advanced retirement pension" should be checked for actuarial fairness.* In addition, reforms to the disability benefit system

look set to pick up speed, notably with the planned introduction of a new benefit that is conditional on participation in rehabilitation programmes and changes in institutional arrangements for medical assessment. To further raise the effective age of retirement, *the proposals for reform to the old-age pension system currently being developed should include increases in the statutory retirement age beyond 62 years.*

Sub-national government budgeting and financing needs to be improved

Municipal and county governments are responsible for a large share of public services so it is important that they have the motivation and the tools to make efficiency improvements and savings. Sub-national governments also initiate a large number of investment projects, and the much larger amounts of EU money now available for these activities means efficiency in the system for administering and co-ordinating development activities is critical.

Though sub-national governments are bound by tight rules to deliver balanced budgets, this does not guarantee either financing or spending efficiency. Indeed, budgeting in sub-national government lacks a longer-term perspective and there is plenty of room to increase accounting transparency and oversight. Furthermore, the whole system of financing is overly complex. The in-depth chapter on sub-national governments makes the following recommendations:

- *Budgeting.* Stronger multi-year budgeting frameworks are needed. Also, separate budget balance rules for current and capital items ought to be considered. Multi-year budgeting could also be a vehicle for removal of the deficit grant by allowing temporary deficits.
- *Transparency and oversight.* The mechanisms of account auditing ought to be widened to allow full oversight of sub-national government accounts. Oversight could also be strengthened by permitting audits by independent professionals. In addition, regulations should be introduced requiring local governments to re-submit sub-standard accounts and requiring that breaches of budget rules are accompanied by reports explaining the source of problems and plans for solving them. Finally, there should be greater transparency regarding off-budget items and increased monitoring of public procurement.
- *Benchmarking.* Much faster progress is required in the development of comparable cost, output and performance indicators.
- *Complexity.* The government must ensure it follows up on plans to reduce the number of formula based (*i.e.* normative) grants. However, the campaign to simplify the system ought to run much wider than this.
- *Specific tax issues.* A broadening of property taxation is under discussion as part of reform on the local revenue system. This reform should also include removal of the local business tax. Local “value maps” ought to be developed to help ensure the property tax is based on market prices. In addition, steps are needed to eliminate problems in the system for allocating personal income tax revenues to municipalities. In particular, the link between these revenues and funding for specific areas should be cut.

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Further measures are needed to motivate sub-national governments towards greater efficiency

Other channels need to be used to encourage spending efficiency in sub-national governments. A system with far fewer municipalities would be more efficient but constitutional and political barriers preclude such reform at the moment. In general, the governments of smaller communities are making a reasonable job of overcoming efficiency issues through joint provision arrangements and flexibility in the assignment of responsibilities between municipalities and counties. The following measures would improve the system further:

- Though widespread merger between municipalities faces insurmountable barriers, efforts to achieve a consensus ought to be pursued regarding replacement of the nineteen county governments with elected assemblies in the seven NUTS II Regions.
- The central-government's system of financial encouragement for joint provision using "micro-regions" is welcome. However, stronger mechanisms for public comment on the decisions taken by councils of mayors that run these services should be considered to bolster local-government support for joint provision. Also, welcome are the rules allowing municipalities to pass on responsibilities to counties. These would be more effective if municipalities were prevented from imposing rules on how the county runs the service.
- Some central-government provision regulations should be scaled back because they are overly prescriptive – hampering rather than encouraging efficiency improvements in public services by sub-national governments.
- Sub-national governments ought to be given more leeway in designing the work contracts of their employees and in setting wage levels. The type of reforms to the remuneration and management of civil-service employees envisaged at the central-government level should be adopted by sub-national governments.

Reasonable progress is being made in supply-side reforms to encourage higher labour utilisation

Hungary's low employment rate remains a key structural handicap to achieving higher living standards. The widening of tax wedges and damping of spending due to austerity measures means a temporary weakening of labour demand. Furthermore, public-sector layoffs are initially going to increase unemployment, though the release of these resources will help output growth in the longer term. The government is nevertheless continuing with positive supply side reforms which should improve the employment response when demand picks up again. As discussed above, useful reforms have been made in the key areas, namely early retirement, disability and old-age pensions. Unemployment insurance schemes have also been improved through more front-loading of benefit. All of these reforms are along the lines recommended in detailed analysis in previous *Surveys*.

Developments on other fronts are mixed. Welcome efforts are underway to simplify active labour market programmes. The impact of the additional "guaranteed wage minima" that are based on educational and vocational qualification required for the job must be very closely monitored. The system is whitening employment through reductions in undeclared cash top-ups and in-kind benefits but is likely to be pricing some jobs out of the market and driving others fully into the hidden economy. *Other, less costly, ways of reducing grey-sector activity should be sought*. Incentive problems *via* the tax schedule remain. *The allowances aimed at cutting the income-tax bills for low-wage workers should be reformed, or replaced by an alternative mechanism, to smooth the effective average and marginal tax schedules.*

Family policy needs to focus more on childcare services

Women in Hungary take much longer periods off work when they have children compared with most other OECD countries, largely due to a family policy that focuses on providing options for lengthy parental leave backed by cash benefits. While in terms of the employment rate, this is not as important as tackling the problems of early retirement and disability, there are nevertheless relevant policy issues. International evidence that this approach helps raise low fertility rates is thin and there are economic downsides to it. Long separation from the labour market damages women's earnings and career prospects, and from a macroeconomic perspective this reduces the employment rate and weakens human capital development. Policy should therefore focus more on helping parents combine work and family roles.

Central government has stepped up provision requirements on municipalities regarding childcare services and has increased grants. This will further help overcome under-provision that, for example, arises from externalities in human capital development and social cohesion. Future policies should focus on:

- *Continued attention to childcare provision requirements*. The impact of the changes in provision regulations should be closely monitored and, if necessary, bolstered by further measures. In terms of childcare service flexibility, policy goals laid out in the government's programme ought to be followed up on. In particular, plans to encourage longer operating hours look promising.
- *Reduction in the municipalities' contribution to costs*. Further increases in the central-government grant for services could be useful, as long as savings can be found elsewhere in the system – reductions in family cash benefits being one candidate. The restrictions on parental fees should also be lightened.
- *New funding arrangements*. A system in which vouchers are given to parents to spend on childcare services (possibly in lieu of cash benefit) could be one way of widening provision and allowing subsidies to more strongly reflect parental preferences.

And reform is required to the system of cash benefits and leave

Parental leave for each child can last for up to three years and often lasts much longer than this because leave can overlap when women have more than one child. The leaves are part of a complex system of additional cash benefits for when children are below kindergarten age. The Hungarian government considers this approach reflects societal preferences for family-based childcare. However, it is expensive to run and international evidence suggests it has adverse effects on women's careers. Given the size of budgetary transfers in the family support system, cost-effectiveness would seem to merit continuing attention.

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Reforms should be contemplated to reduce the duration of these provisions and savings from this channelled into childcare services. Specifically:

- *Reform could entail removal of the universal third-child benefit and significant reform of the benefits for when children are below kindergarten age. Whatever specific measures are considered, possibilities for extended leave ought to be cut back and savings in spending made to help fund childcare services. Some offset could be made through increases in the replacement rate (and perhaps raising of the cap) of the insurance benefit covering the six-month maternity leave. Increased paternity leave should also be considered.*
- *Three schemes could be removed without any significant implications for either the universal or targeted "safety net" dimensions of policy. The cash component of "child social support" is effectively redundant due to the new welfare top-up payments. Also, the maternity grant and the third-child tax allowance provide relatively small amounts of cash support that could be integrated into another benefit, such as the family allowance.*
- *Changes to the equivalence scale used in calculating the welfare top-up payments to deal with welfare trap problems should be considered. Additional measures could comprise extension of the period allowing retention of a share of the welfare top-up payments when someone gets a job, or the introduction of earned-income tax credits.*

Further work is needed in identifying and removing barriers to the creation of jobs with hours and flexibility that suit working parents. Further reforms that give more flexible choices to public-sector employees would provide a useful lead on this front. Also, when room becomes available to proceed with tax reforms, resumption of the phase-out of the lump-sum employers' healthcare contribution should be on the priority list.

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Glossary

ÁAK	State Motorway Management Company
APW	Average production worker
ARP	Advanced Retirement Pension
CAP	Common Agricultural Policy
CF	Cohesion Fund
CHP	Combined heat and power
EPL	Employment protection legislation
ESA95	European System of Accounts
ERM II	Exchange-rate mechanism II
FIDESZ-MPSZ	Young Democratic Alliance-Hungarian Civic Union
GYED	Childcare benefit
GYES	Childcare allowance
GVH	Hungarian Competition Authority
GYET	Childcare raising support
HUF	Hungarian forint
IEA	International Energy Agency
KDNP	Christian Democratic Peoples' Party
MÁV	Hungarian State Railways
MAVIR	Hungarian Transmission System Operator Company
MDF	Hungarian Democratic Forum
MNB	Magyar Nemzeti Bank (the Central Bank)
MSZP	Hungarian Socialist Party
MVH	Agricultural and Rural Development Office
MVM	Hungarian power companies
NA	National Motorway Company
NAO	National Authorising Office
NFÜ	National Development Agency (successor of the National Development Office, NFH)
NHIFA	National Health Insurance Fund Administration
NUTS	Nomenclature of territorial units for statistics
PAYG	Pay-as-you-go
PIT	Personal income tax
PPP	Public-private partnership
SAO	State Audit Office
SF	Structural Funds
SME	Small and medium-sized enterprise
SZDSZ	Alliance of Free Democrats
TGYAS	Pregnancy and confinement benefit
VAT	Value-added tax

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HUNGARY

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The economic situation and policies of Hungary were reviewed by the Committee on 12 April 2007. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 23 April 2007.

The Secretariat's draft report was prepared for the Committee by Philip Hemmings and Alessandro Goglio under the supervision of Andreas Wörgötter. The drafting team was assisted by Roland Natran (on secondment from the Hungarian Ministry of Finance).

The previous Survey of Hungary was issued in July 2005.

BASIC STATISTICS OF HUNGARY, 2006

LAND

Area (1 000 sq. km)	93	Major cities (1 000 inhabitants)	
Agriculture (%)	63	Budapest	1 698
Forest (%)	19	Debrecen	204

PEOPLE

Population (1 000)	10 076	Employment (1 000)	3 887
Inhabitants per sq. km	108	Agriculture (%)	5
Natural increase in population (1 000)	–32	Industry (%)	33
Net immigration (1 000)	15	Services (%)	62

GOVERNMENT

Public consumption (% of GDP)	23	Number of seats in Parliament	386
General government total revenue (% of GDP)	44	Share of seats held by governing coalition (%)	54
General government deficit (% of GDP)	9	Number of political parties	4
Public debt, 2005, Maastricht definition (% of GDP)	58	Last election	2006

PRODUCTION

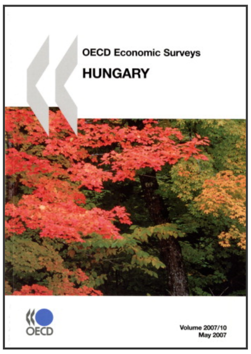
GDP, current prices (billion HUF)	23 562	Agriculture (% of value added)	4
GDP per capita (USD, current prices)	11 121	Industry (% of value added)	30
Gross fixed investment (% of GDP)	22	Services (% of value added)	65

FOREIGN TRADE

Exports of goods and services (% of GDP)	78	Imports of goods and services (% of GDP)	77
Main exports (% of total merchandise)		Main imports (% of total merchandise)	
Machinery and transport equipment	62	Machinery and transport equipment	50
Manufactured goods	28	Manufactured goods	33

CURRENCY

Forints per $	210.40	Forints per €	264.09



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