

THE OECD ECONOMIC SURVEY OF HUNGARY 2007

**Introductory remarks by Andrew Dean,
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It is a pleasure to be here in Budapest together with one of the main authors, Phil Hemmings, to introduce the latest [OECD Economic Survey of Hungary](#), the tenth in what is now a long series since Hungary started to have closer relations with the OECD back in the 1990s.

Hungary has come a long way in this period, catching up substantially with living standards in other OECD countries, even if a large gap remains. Real per capita output growth has averaged 4½ per cent over the last ten years, a margin of growth over more advanced OECD economies which, if maintained, would imply significant convergence over time. Hungary clearly has the potential to continue to close that gap; this Survey picks up on a number of ways to ensure that the medium and longer-term prospects are raised and that sustainable growth can be secured.

However, that catch-up is currently stalled. According to our latest projections, which are shown in Chapter 1 of the *Survey* – growth this year and next is likely to be only around 2½-3 per cent – and it may be a couple of years before convergence resumes. But there are good reasons for this “pause” in the convergence process. The government is engaged in a tough, but very necessary process of budget consolidation. While this is depressing activity in the short term, it is vital that the public finances are put on a sound basis so that the economy can get onto a sustainable higher growth path over the medium and longer term. Budget deficits of up to 10 per cent of GDP do not give macroeconomic stability. A temporary period of slower growth is the cost to be paid for past fiscal laxness.

Budget consolidation is therefore the key challenge for the Hungarian economy and is the main feature of this year’s survey. We have focused on Hungary’s fiscal problems and the government’s reform programme which aims to bring the deficit below 3% of GDP in 2010. This is an important and sensible ambition but will be a tough challenge. Past governments have engaged in reform programmes but these have only been partly successful. While they have brought some progress in structural reform, none have yet succeeded in bringing a permanent reduction in the deficit.

The challenge is highlighted in Figure 1 in the [Policy Brief](#) (also shown as Figure 1.1 in Chapter 1 in the *Survey* which presents the key challenges for Hungary). This telling Figure shows the general government deficit as a share of GDP for the last 15 years. The black triangles mark election years and seem to indicate that the political business cycle is strong. All but one election year has been marked by a peak in the deficit. It is extremely important to break this pattern of pre-election spending.

The government’s ambitious consolidation programme, which aims at four consecutive years of consolidation to bring the deficit to below 3% of GDP by 2010, is represented by the dotted line in the chart. If it remains on course, the programme will bring the most prolonged period of deficit reduction in Hungary’s recent history and break with the strong electoral cycle in fiscal deficits.

Good progress in reducing the deficit has been made so far and we think that the deficit goal of 6.8% of GDP in 2007 will be reached and that the outcome will be reasonably close to the goal in 2008 of 4.3% of GDP. For 2009 and 2010 the situation is more uncertain, however. First, because there is uncertainty about whether some measures in the government’s programme will deliver the required fiscal savings; second,

because the run-up to the election could again see new measures that would weaken the prospects of reaching the deficit targets. Detailed recommendations concerning the strategy for fiscal consolidation, which could minimise the uncertainty and improve the prospects for success, are provided in Box 2.1 (page 50 in the *Survey*).

To get the much needed pay-off from the reform programme, the government needs to focus on three things:

- Discipline in budgetary processes
- Success in maintaining spending freezes
- And, last but not least, implementation of structural reforms to public spending

Let me say something about each of these in turn:

First, discipline in budget processes. Work needs to continue to strengthen budgetary mechanisms (an issue taken up on pages 54-55 in the *Survey*). The Minister of Finance has successfully pressured line ministries to provide more details on their medium-term spending plans (three years beyond the budget year). But there is no formal commitment to stick to these plans. The OECD recommends that a system of binding medium-term spending limits should be considered. Budgetary reform also needs to extend to sub-national governments – the subject of a special chapter in the *Survey*, Chapter 3, by one of my colleagues, Alessandro Goglio, and the third of the points that I will return to in a moment.

Second, success in maintaining spending freezes. Expenditure cuts for 2007 and 2008 reflect a mix of temporary and permanent measures. Spending freezes, such as the two-year freeze on public sector pay, are always difficult to maintain and there have already been some cracks in the wage freeze (the complicated re-scheduling of the payment of the 13th month salary that brings spending forward). It is important that the mix of spending measures switch over time from temporary to permanent so as to embed the budget consolidation achievements over the longer term. It is also important, in this context, that the government resist any spending pressures arising from revenue windfalls.

Third, and the most important in the longer term, is the implementation of structural reforms to public spending. Chapter 2 of the *Survey* reviews the government's structural reform programme. In broad terms, the programme looks sound and so far is running to schedule. The efforts to cut back on public spending on pharmaceuticals and to reduce the use of hospitalisation for treating patients are welcome steps in the right direction on healthcare. The reduction in spending on drugs is in particular yielding significant fiscal savings. The better targeting of household gas subsidies to low-income households is also a good move and the efforts to make savings in central-government administration are encouraging.

The government needs to maintain momentum on current reforms but also needs to look forward to other areas where public spending could be made more efficient. This *Survey* focuses on local government. Hungary's county and municipal governments are responsible for a large share of public services and so it is important they have the motivation and the tools to make efficiency improvements. The special chapter spells out two areas where the system could be improved:

- *First*, capturing economies of scale. Along with a number of other OECD countries, Hungary has a large number of small municipalities; with such a small size, there is a risk that many of these municipalities have relatively high running costs or have to compromise on the quality of services because of the small scale of operations. But there are political constraints which preclude widespread mergers.

- On balance we think the system addresses this problem reasonably well through the joint provision of services and is encouraged by central government through the system of micro regions. Such moves should be further encouraged wherever possible.
 - At the same time the “middle” level of government and administration has become rather complicated with the introduction of the regions alongside the counties. We think the present government’s proposal to replace elected government at the county level with elected assemblies at the regional level would have been a positive move.
- *Second*, reforming financing systems. In broad terms the system of financing local government seems overly complex and there are problems in transparency. We understand that the government is making some moves to cut back on the number of funding formulae but we think additional measures are needed. In particular, performance could be improved with more oversight of sub-national government accounts through independent audits, greater transparency of off-budget items and increased monitoring of public procurement. Benchmarking of services via output and performance indicators needs to become more widespread, while reform of local taxation should include widening of the property tax and removal of the local business tax. Detailed recommendations about both spending assignment issues and funding arrangements for local governments can be found in Box 3.1 (page 75 in the *Survey*).

Turning back to the broader economic picture, the government’s reforms are not confined to measures aimed at reducing the government deficit but also cover important issues in the labour market and in social policy.

- In particular, we welcome the reform of unemployment benefit and the upcoming reforms scheduled to early retirement, and we encourage the efforts to tackle the problems in disability pensions. These measures will help overcome Hungary’s long standing problem of low employment rates.
- At the same time, we are somewhat worried about the new system of “guaranteed wage minima” that are based on educational and vocational qualifications required for the job, which we fear could price some jobs out of the labour market.

The *Survey* also looks at family policy in a special chapter by my colleague here, Phil Hemmings, on improving the reconciliation between work and family life. As in other OECD countries, rising education levels and job and career prospects for women mean that policy needs to pay increased attention to ensuring that there are appropriate channels for combining work and family.

- The government has been making some welcome moves to encourage municipalities to increase the volume and flexibility of childcare services and we think that further steps along these lines should be considered.
- At the same time, we think that the system of long parental leave allowances and attendant cash benefits needs re-thinking. The leave allowances are among the longest in the OECD and we are worried that the resulting prolonged career breaks in employment are damaging women’s careers and dissuading employers both from taking on women in the first place and from investing in women through training and promotion.

Detailed recommendations on family policy can be found in Box 4.1 (page 102 in the *Survey*).

In concluding, let me return to the paramount theme in the *Survey* -- the need to rein back public finances. Although the fiscal and monetary policy mix is tight and has been instrumental in driving the current slowdown, this correction has been necessary and should have a pay-off in rebalancing the economy and improving performance in later years.

The government must stay the course. The budgetary consolidation plans are ambitious and courageous, but they are needed to break the political business cycle and allow Hungary to move back to a sustainable convergence path in the future. Many of the right things are being done and we hope the government will keep to the reform process. The *Survey* provides many suggestions which are summarised in the [Policy Brief](#) and in the recommendation boxes in each chapter. We hope that these recommendations will help and sustain the reform process.