POLICY BRIEF

OECD

Economic survey of Hungary, 2004

Summary

For Hungary to maintain strong growth, macroeconomic policy has to aim for sound and sustainable public finances, low inflation and maintaining the competitiveness of its FDI-driven export sector. Fiscal consolidation has to focus on lasting structural reforms, which bring down the volume of government expenditure in a sustainable way. Revenue increases buy time for the 2004 budget, but this time has to be used to implement measures that will durably reduce spending in a medium-term framework. The difficult balancing act for monetary policy between achieving inflation targets and steering the exchange rate for entry into the euro zone could be made easier if fiscal targets are achieved. The move to base future budgets on the joint inflation target is a welcome step to improve co-ordination between the government and the Central Bank and should be continued. In wage setting, the indicative wage guidelines should be used to communicate disinflation in the run-up to EMU, and thereby limit the risk of unintended real wage increases. Wage moderation should also be assisted by measures which increase the supply responsiveness of labour. Any room created for tax cuts should be used to reduce Hungary's large tax wedge on labour, which interacts negatively with some social benefit programmes. Large regional disparities should be addressed by measures which increase labour mobility and broaden investment across regions through further improved infrastructure. Business conditions can be further improved by addressing the low level of competition in some network industries and more generally improving the conditions for market entry in the domestic sector. The considerable costs of programmes to reduce the emission of greenhouse gases and also more local air pollutants could be reduced with the wider application of economic instruments. Hungary will only be able

This Policy Brief presents the assessment and recommendations of the 2004 OECD Economic Survey of Hungary. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

OECD Observer

to reap the full benefits of European Union accession and EMU entry if it establishes a sound macroeconomic framework, boosts labour force participation and sustains high productivity growth. ■

How to continue with rapid real and nominal convergence?

The Hungarian economy has achieved strong growth, averaging 4 ¼ per cent annually since 1997. This good performance has relied on a dynamic export sector largely made up of foreign-invested firms, and a rapid integration into European production networks. Since 2001, very strong domestic demand has been underpinned by a surge in minimum wages and public sector pay as well as strong public-sector investment. However world-trade growth has slowed and gains in export-market share have diminished substantially so that, overall, GDP growth has weakened. The continued rapid real convergence of the Hungarian economy with that of the European Union will first and foremost require maintaining, and indeed strengthening, the competitiveness of the Hungarian economy in a broad sense of being an attractive location for developing business activities. This is key to assuring that highly productive export-driven firms continue to expand, that the linkages between these firms and Hungarian suppliers continue to deepen, and a high rate of enterprise creation and development is maintained to respond to the domestic market opportunities generated by rising incomes. However, continued strong growth cannot rely on high productivity growth alone but will also require a more intensive utilisation of labour resources. The Hungarian economy is characterised by a very low overall employment rate and a sharp regional divide between the booming central-western part of the country, where growth has been concentrated and labour shortages are emerging, and the poorer, less dynamic north, south and east. Increasing labour force participation, enhancing labour mobility and broadening the economic boom to currently less prospering regions thus constitutes another challenge for Hungary.

Alongside the challenge of maintaining the momentum of real convergence, Hungary faces the challenge of achieving rapid nominal convergence so as to meet the authorities' target of early entry into the European Monetary Union (EMU). Early entry is seen as desirable for further strengthening economic integration with the European Union, but also as a vehicle for importing macroeconomic stability while providing a medium-term boost to economic growth through lower real interest rates. However, this strategy does contain risks. Significant budget overruns have generated difficult conditions for monetary policy and have limited the room for reducing taxes. Thus, achieving both disinflation and budget consolidation to the required extent is challenging and major efforts from both monetary and fiscal policy will be essential to safeguarding external competitiveness in the process. The more a medium-term fiscal strategy manages to reduce expenditures and to free resources, the easier it will be to achieve disinflation targets implied by EMU entry, while reducing risks of turbulent developments in interest rates and the exchange rate. ■

Fiscal policy: what are the problems and prospects?

The general government deficit for 2002 overshot the initially approved deficit by a wide margin, coming in at 9.2 per cent of GDP on an accrual basis. To some extent this outcome reflects one-off factors worth about 3 per cent of GDP, in particular the incorporation into the budget of previously accumulated large quasi-fiscal debts relating to motorway construction. However, the large deficit was also due to overspending in almost all categories of expenditure in anticipation of local and general elections. The 2003 deficit, estimated in early 2004 to be 5.6 per cent of GDP, marks an improvement, especially in view of the difficult international environment But, in order to reach sustainable public financing and to comply with the Maastricht criteria for EMU entry in 2008, the general government deficit will have to be reduced to 3 per cent of GDP by 2006 through savings on the expenditure side. This further adjustment will be much more difficult as the easy measures have been taken. The 2004 budget envisages deficit reduction to 3.8 per cent of GDP (ESA95 basis). This is mainly brought about through increased revenue, rather than significant expenditure cuts. The relatively small expenditure cuts are due to accelerated investment in motorway construction, EU-accession related spending and the fact that achieving substantial saving in structural expenditure takes time. Given the already high tax-burden, its further increase next year is not helpful for growth. At the same time, there are useful moves in specific revenue and spending areas that could give rise to wider and substantial expenditure reductions. Following-up on measures taken in 2003, there is to be further narrowing of eligibility and reduced generosity in the housing-loan subsidy scheme. Also a cut of ten per cent in central government employment (around 7 000 employees) is scheduled for 2004. Though this is a small reduction in the approximately 821 000 public-sector employees, further cuts in employment may arise from tightening wage-related transfers from central budget to other areas of government. ■

How to make deficit reduction sustainable?

If Hungary is to comply in a sustainable way with euro-area membership criteria, budget consolidation from the expenditure side has to start now. Given development and implementation lags, the efficient continuation of budget consolidation in 2005 and beyond requires that work should begin now on the key elements of a medium-term fiscal strategy that:

- encompasses appropriate measures to broaden the tax base and lower rates where possible,
- strengthens budgetary procedures to assure that the longer-run implications of spending decisions are clearly identified and to promote value-for-money through output-oriented financing and performance benchmarks,
- and identifies structural measures to reign in the growth of spending across the full range of government programmes.

The scope for achieving deficit reduction through revenue enhancement seems exhausted. While efforts made over recent years to reduce tax evasion and strengthen tax administration and collection have yielded positive results and should be continued, the prospects for further reducing the grey economy and thereby enlarging the tax base would seem to require a substantial reduction of the tax-wedge on labour. While such a reduction is highly desirable on structural grounds, the trade off in revenue terms is almost surely negative, at least in the short term. At the same time, pressures to reduce business taxation will remain strong. Nonetheless there are a number of base-broadening measures the government should explore:

- The taxation of capital income varies widely across income types and in some cases is very lenient. Most notably, interest income, currently taxed at a zero rate, should become subject to some taxation once disinflation has progressed sufficiently.
- The system of income tax credits and allowances should also be reviewed. In particular the allowance on housing loans should be further cut back and family tax credits should focus more on increasing female labour force participation.
- There remains scope for broadening value added tax.
- Finally, local governments should be encouraged to make more use of the available opportunities for residential property taxation.

Overall, given the already high tax burden, the role of tax reform should be to improve efficiency and reduce the most damaging distortions in the system, while budget consolidation should be pursued primarily on the expenditure side.

A strategic, medium term framework to quicken expenditure reform is essential, and requires not only systematic review and prioritisation among central government programmes with a view to higher efficiency, but also an enhanced local government involvement and responsibility for achieving fiscal policy targets and adopting budget reforms. Specific issues to be examined include:

- Already in 2004, the planned cuts in public sector employment need to be linked to administrative reforms and targeted on lower-priority activities rather than being implemented across the board. The logic of the substantial pay increases awarded in the public sector in the last couple of years, 50 per cent for most employees, was to create the basis for a smaller, more productive public administration, which needs to be implemented.
- The 1998 pension reform foresaw a progressive reduction in spending on first-pillar benefits with a view to assuring the sustainability of the system. The logic of this reform should be restored, and the decision to introduce a thirteenth month to pensions should be reconsidered.
- While, overall, replacement rate levels in social transfer programmes are not very high in international terms, their coverage is very wide. In view of Hungary's low participation rate, careful re-design of these programs, as further discussed below, could both reduce spending pressures and improve work incentives ■

Monetary policy: how big are the challenges in the run-up to adopting the euro?

The transition from a crawling-peg to an inflation-targeting regime was achieved smoothly and initially the new regime appeared to be working well. However, monetary policy has recently faced some difficult challenges, including speculative attacks on the currency. These events partly reflect a concern that monetary policy is overburdened, since that involves not only achieving inflation targets but also stabilising the exchange rate within a narrow band which is considered to be compatible with inflation objectives and contribute to a smooth entry to ERM II and the euro area. There is nevertheless a risk that market conditions will make these goals incompatible. Given this problem, the Central Bank's policy of pursuing a nuanced communication strategy that includes reference to an exchange rate objective seems appropriate but risks attracting speculative attack if a lot of detail on the willingness to defend the exchange rate target is made in public.

Particularly in late 2002 and in the beginning of 2003, there was discordant public debate between the Central Bank and the government, threatening the credibility of macroeconomic policy in the eyes of the markets. Since then, substantial efforts have been made for more visible, as well as substantive, consensus. It is important that the authorities maintain these efforts, particularly in light of the ambitious deficit and inflation targets for euro entry. Responding to some inflationary revenue increases in the 2004 budget, the Bank, in agreement with the government, has set an inflation target of 4 ±1 per cent for December 2005, half a percentage *above* that for the end of 2004 though still incorporating within the band the 3 per cent expected to be sufficient for euro entry. If fiscal policy goals are fully met, the jointly set inflation target may be reached without further monetary tightening. Nevertheless, if need be, a final push to the inflation rate required to fulfil the convergence criteria can be made in the final run-up to the 12-month assessment period. This strategy is not without risks. Adoption of the euro in early 2008 would require a positive convergence assessment which in the case of the inflation criterion would be based on a 12-month assessment period starting somewhere in 2006. It will thus be important to communicate in a credible way that the Bank would respond to a prolonged pause in disinflation with an appropriate tightening in monetary conditions. As noted, support from a fiscal strategy based on expenditure restraint will be necessary. Clearly, failure of fiscal policy to achieve the targets set for it would compromise both the credibility of the nominal convergence strategy and the coherence between inflation and exchange-rate objectives. ■

What policies are needed to improve wage setting?

Wage setting is crucially important for competitiveness and price stability. In recent years private sector real wage growth has been strong, though less so in 2003. The substantial fall in inflation from mid-2001 appeared to have had a delayed impact on the rate of nominal wage increases. Hikes in the minimum wage led to increases among the low-paid and likely had a ripple effect on wages above the minimum. In addition, a succession of large increases in public sector pay between 2001 and 2003 has had demonstration effects on private-sector pay increases and may have tightened supply for certain types of labour to the private sector. The challenge for wage determination in the years ahead is twofold: first, the wage increases that have been well above average productivity gains will have to be clawed back to some extent in order to restore a wage level which is compatible with international competitiveness, and second, nominal wage rises will have to appropriately incorporate the sharp disinflation that will be achieved, one way or another, on the way into the euro zone. Wage policy for 2004 reflects these aims and includes reverting to indicative wage guidelines in gross nominal (rather than net real) terms. This practice should be continued. ■

How to bring more people into regular employment?

The delayed reaction of nominal wages to falling price inflation suggests that inflation expectations have not yet fully incorporated actual developments. The lagged nominal wage response also points to tight labour markets in leading sectors and for certain skills in the central-western part of the country. This further underscores the need to implement policies that bring more of the non-employed into work. To some extent this is a regional issue, which has to be addressed by increasing labour mobility on the one hand and broadening job creation across the whole country on the other. More generally, formal employment is restricted by the high tax wedge on working, especially for the low-paid. Some social benefit programmes, like the disability scheme and family benefits, have become an effective route to leaving the labour force. Such an environment is also not conducive to human capital accumulation necessary to secure employability on the official labour market.

While there have been encouraging, though slight, increases in labour force participation and employment rates in recent times, levels remain well below leading countries in this regard. While considerable reductions in the tax wedge have been made in recent years, further reductions are still needed. These should incorporate a focus on improving incentives for creating and taking up jobs with skill requirements appropriate for the inactive population. The tax-wedge reductions should also increase incentives to take up official employment so as to reduce grey-sector activity and widen the tax-base. The shift to exempt the minimum wage from income tax further bolsters incentives to join the labour force and measures should now focus on reducing the substantial employer contributions for low-paid workers in order to boost demand. In particular, the fixed component of the employers' contribution to health care adds excessively to labour costs at the low end of the job market and contributed to the poor development of part-time work. The authorities have decided to exempt this payment for certain groups, including certain categories of part-time workers and should aim to advance the complete phasing out of this fixed contribution from its envisaged date of 2006.

The increases in the statutory retirement age and significant tightening of access to early-retirement schemes were implemented effectively, reduced withdrawal from the labour market and have played an important role in encouraging recent improvement in the employment rate among older workers. And the full effect of the reform has yet to be realised as old schemes were grandfathered. However, as in other countries which have sought to restrict early retirement, Hungary has experienced a concomitant increase in the number of persons on disability benefits. Reforms to this system are needed and should introduce a more thorough assessment of the remaining capabilities of workers and promote their reintegration in the labour market through rehabilitation measures and in-work training.

Support for child care is largely in the form of cash benefits and family tax credits. Although participation of prime-age women in the labour market is roughly similar to the OECD average, further improvements in the relevant policy areas should be sought. In addition, state-supported child care services vary widely across local authorities but are in general limited. The possibility of three years parental leave may distance parents from the workforce, increasing the chances that they will not take the option of returning to their jobs and risking poor progress in professional terms if they do. With these issues in mind, the authorities should consider ways of re-balancing the package of child care support to provide less cash, but more child care services either directly, or by subsidising private-sector child-care for working families so as to make work a more attractive option.

Regional labour-market imbalances are accentuated by the "lock-in" effect on labour mobility generated by the combination of a small market for rental housing and high home ownership in all parts of the country. The enormous differences in house prices across regions reflect, at least in part, the impact of tax-breaks and non-transferable subsidies to home ownership which essentially impact on the property market in the west of the country. The recent reductions in the scope and generosity of the housing-loan subsidy scheme may help to reduce the bias in favour of home-ownership, and prevent a further regional widening of house price differences. Further downsizing of the scheme is needed and it should eventually be abolished. The tax-breaks on mortgage interest and capital repayments also favour buying rather than renting. At a minimum, the tax breaks should only be on interest payments and the authorities should seriously consider whether the welfare objectives of the breaks could not be better achieved in other ways. Expanding the dynamics of job creation throughout the country might be assisted by allowing local labour market conditions to be fully reflected in wages as well as by improving infrastructure so as to broaden the location of investment. ■

How to get good results from the big investment planned for transport?

The density and quality of long-distance road and rail transport influences firms' location decisions, contributing to the large regional differences in economic development. In addition, poor short-distance transport in many areas limits commuting possibilities. Thus, local labour markets are often small and this contributes to demand-supply imbalance and unemployment within regions. The substantial increase in resources allocated for road infrastructure in the 2004 budget submission is a welcome move to reduce regional disparities, as the main priority of road construction is to more closely link peripheral and less developed parts of the country to the more economically successful regions. In this environment of accelerated spending the authorities are urged to strive for greater efficiency in outcomes by increasing the role of cost-benefit studies in the decision making process. Steps in this direction have been taken recently to ensure that decisions are not excessively biased towards "glamorous" projects for new motorways over small-scale road-building and maintenance. In rail services, modernisation clearly needs major investment. This should be driven by further progress towards liberalisation, including the introduction of a fully independent network operator. ■

Are the right policies in place to encourage domestic and foreign investors?

Hungary has made considerable efforts to establish a business friendly regulatory environment from the outset of the transition process and the high rate of FDI and enterprise creation is a positive reward in this regard. However there are outstanding issues, ranging from a need for better co-ordination between central and local tax authorities to strengthening competition and regulation in network industries and especially the part of the Hungarian economy serving the domestic market. There is also considerable scope for efficiency improvement by cutting back subsidy programmes for a wide range of activities. A fundamental issue concerns the accountability and *de facto* independence of regulators. In particular, legislation presented to parliament should be used as an opportunity to strengthen these in the area of financial supervision. While the legislation aims to strengthen accountability *vis-a-vis* the Ministry of Finance, it is accepted among OECD countries that financial supervisors should have the operational independence required to carry out supervision of financial institutions and markets autonomously.

In business taxation, the impact of the low corporate tax rate in making Hungary attractive for investment is weakened by the inappropriate base of the local business tax. More generally, there is a lack of stability to the tax system due to frequent changes, making compliance difficult and adding to administrative burdens. Local taxation on non-residential property also has an inappropriate base. Recent changes in business taxation are aimed to mitigate these problems, however further reform is necessary.

The banking sector dominates Hungary's financial system, with capital markets playing a less important role. Recent trends in the efficiency and profitability indicators of the banking sector bode well for future financial stability, although part of the buoyancy in the sector is related to subsidised loans, in particular the housing subsidy and, to a lesser extent, the various loan and credit subsidies for SMEs. The authorities should make a general evaluation of how much subsidy support is leaking into the financial sector and take a close look at the design of all relevant schemes. ■

Competition Policy: what are the strengths and weaknesses?

The examination of competition legislation and its enforcement in the special chapter of this *Survey* underscores that many features of this area of law and its application compare favourably with average OECD practice. Nevertheless, two areas of legislation are identified as requiring attention. First, individuals should be given the right to initiate actions in certain circumstances without having to go through the competition authority. This would avoid complications due to differences with European Union legislation and may also improve overall enforcement and reduce the workload of the competition authority. Second, introducing sanctions against individuals in hard-core cartel cases would likely improve the competition authority's effectiveness in this area provided that any new sanctions do not interfere with the current framework of enforcement. Procedural and organisational changes, supported where necessary by legislative changes should be explored with a view to freeing resources and improving the competition authority's ability to prioritise. In particular, the formation of a unit specialising in consumer fraud is recommended along with a number of reforms in procedures.

While broad indicators do not suggest Hungary suffers from endemic monopoly and cartel problems, there are clearly some problems in specific sectors. Entry restrictions and price setting in professional services are particularly stringent and competition law should be given greater powers through reductions in the scope of overriding legislation. In retailing, the prohibition of sales below costs and credit rules for certain food products aimed at protecting producers, traditional wholesalers and small retailers should be removed. Overall, estimated productivity gains from pro-competitive regulatory reform could be considerable and more efforts should be made to reduce entry barriers and enhance competition in areas which are serving the domestic market and are lagging in productivity.

Despite partial liberalisation further steps are necessary in developing competition in network industries. One problem is that the industry regulators do not have final authority in some key areas, a prime example being in the setting of retail household prices for gas and electricity where the government has the final word. These price controls should be phased out and prices allowed to reflect market rates. Welfare concerns about energy costs for low-income earners should be resolved by alternative means. A reduced role of government is also needed in the determination of access charges and in the independence of network operators. Dominance of markets by the incumbents needs to be tackled more vigorously in the gas and electricity sectors and long-term contracts in electricity markets need to be monitored. Postal services are being liberalised in accordance with the European Union Directives in this area. Within this context, the authorities need to confront more rigorously the problem of over-staffing and non-viable rural post offices. ■

How to reach environmental goals at lower costs?

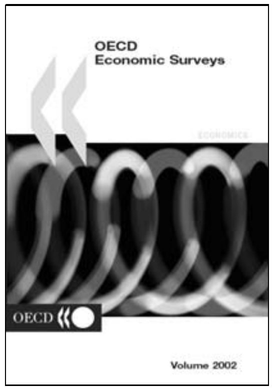
The Kyoto target is set to be attained, but the climate change strategy could be made more cost-effective. The current and future emissions trading price should be used as a benchmark for the evaluation of the cost-effectiveness of greenhouse gas mitigation measures. However, in doing so, costs and benefits that flow from meeting other policy objectives should also be taken into account. For instance, renewable energy programmes which are designed to reduce greenhouse gas emissions, can also improve air quality to a certain extent. More comprehensive analysis of the environmental impact of the various renewable energy projects should also be carried out. The alignment of energy prices for households to market rates, as already underway for businesses, would also provide a cost-effective mitigation measure. Although considerable improvement has been achieved in air quality, Hungary faces important challenges in reducing emissions to comply with its international commitments and those relating to forthcoming European Union membership. Hungary has recently transposed the EU Directive on large combustion plants into national legislation. Although the benefits of the associated emission reductions are likely to outweigh the costs, this command-and-control approach will not minimise the overall abatement costs. As regards mobile sources, economic instruments could be used to a greater extent to contain air pollutant emission; in particular, road-use pricing and vehicle taxation based on emissions should be seriously considered. ■

For further information:

For further information regarding this Policy Brief please contact: Philip Hemmings,
Tel.: (33-1) 45 24 76 69
(email: *Philip.hemmings@oecd.org*), or
Ann Vourc'h
Tel.: (33-1) 45 24 17 27
(email: *ann.vourch@oecd.org*). ■

For further reading

- **OECD Economic Surveys:** *Economic Surveys* review the economies of member countries and, from time to time, selected non-members. Approximately 18 Surveys are published each year. They are available individually or by subscription. For more information, consult the Periodicals section of the OECD online Bookshop at *www.oecd.org/bookshop*.



- **Additional Information:** More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's Web site at *www.oecd.org/eco*.
- **Economic Outlook No. 74,** December 2003. More information about this publication can be found on the OECD's Web site at *www.oecd.org/eco/Economic_Outlook*.

OECD publications can be securely purchased from the OECD Online Bookshop
www.oecd.org/bookshop

The OECD Policy Briefs are prepared by the Public Affairs Division,
Public Affairs and Communications Directorate.
They are published under the responsibility of the Secretary-General.

Where to contact us?

FRANCE
OECD Headquarters
2, rue André-Pascal
75775 PARIS Cedex 16
Tel.: (33) 01 45 24 81 81
Fax: (33) 01 45 24 19 50
E-mail: sales@oecd.org
Internet: *www.oecd.org*

GERMANY
OECD BERLIN Centre
Albrechtstrasse 9/10
D-10117 BERLIN
Tel.: (49-30) 2888353
Fax: (49-30) 28883545
E-mail:
berlin.contact@oecd.org
Internet:
www.oecd.org/deutschland

JAPAN
OECD TOKYO Centre
Nippon Press Center Bldg
2-2-1 Uchisaiwaicho,
Chiyoda-ku
TOKYO 100-0011
Tel.: (81-3) 5532 0021
Fax: (81-3) 5532 0036/0035
E-mail: center@oecdtokyo.org
Internet: *www.oecdtokyo.org*

MEXICO
OECD MEXICO Centre
Av. Presidente Mazaryk 526
Colonia: Polanco
C.P. 11560
MEXICO, D.F
Tel.: (00.52.55) 5281 3810
Fax: (00.52.55) 5280 0480
E-mail:
mexico.contact@oecd.org
Internet: *www.rtn.net.mx/ocde*

UNITED STATES
OECD WASHINGTON Center
2001 L Street N.W.,
Suite 650
WASHINGTON D.C. 20036-4922
Tel.: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail:
washington.contact@oecd.org
Internet: *www.oecdwash.org*
Toll free: (1-800) 456 6323

10 2004 02 1 P 4

The OECD Policy Briefs are available on the OECD's Internet site
www.oecd.org/publications/Pol_brief