

Economic survey of Hungary, 2005

Summary

The composition of growth of the Hungarian economy has become healthier and real convergence looks set to be on a sustainable path. While most reforms to establish a flourishing market economy have been carried out and the current government is launching a new reform initiative of “100 Steps”, more needs to be done in two broad areas in order to maintain high growth:

- *Achieving a smooth entry into the euro area:* Frequently missed policy targets, tensions between the government and the Central Bank and stubbornly high twin deficits have established an unhealthy climate of financial volatility, which contrasts with and may even risk threatening the rather smooth process of real convergence.
- *Increasing trend growth by both raising the employment potential and trend productivity growth:* A large share of Hungarians with some work capacity is not working in part because of the way social benefits are designed. Low employment is aggravated by impediments to regional mobility of the labour force. Hungary needs to move further up the value added chain. This process for the time being rests very much on investments by foreign companies while innovative activities and commercial applications of own research remain limited.

Entrenching macroeconomic stability implies achieving fiscal targets for euro entry within a medium term framework. Putting government finances on a track that meets the criteria for euro entry is by far the most urgent challenge for Hungary. Meeting the targets of the budget for 2005 is essential to recover credibility. Budget practice could be improved by using conservative estimates for the current year’s deficit outcome in making budgets for

This Policy Brief presents the assessment and recommendations of the 2005 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.

What are the main policy challenges?

What refinements should be made to monetary policy?

How to make sustainable progress in fiscal consolidation?

What further reforms are needed in healthcare?

How to reduce the tax wedge?

What welfare reforms are needed?

What can be done to help labour mobility?

Innovation policy: how to follow-up on recent reforms?

How to build innovation capacity in education?

For further information

Where to contact us?

the upcoming year and making prudent assumptions on economic activity, revenue and spending items. Revenue windfalls should be used for debt reductions rather than incremental spending. The medium term fiscal framework should be strengthened.

Reforming health care is important for long term fiscal sustainability. Public sector spending on health care will rise in the future because of ageing and technological developments. Reforms should focus on reducing redundant hospital capacity, better gatekeeping and measures to limit excessive prescriptions of pharmaceuticals.

Monetary policy management could be refined. Inflation targets should be set for a fixed number of quarters ahead. Changes in Monetary Council membership should become smoother. More transparency and better communication of the achievement of fiscal targets by the Ministry of Finance would allow the Central Bank to reconsider the amount of detail and comment on fiscal projections in the Inflation Report.

The employment potential can be raised. Cuts to the tax wedge should be better designed so as to avoid high marginal tax rates above the minimum wage. The early retirement scheme which has no actuarial adjustment should be phased out and the remaining scheme should be made actuarially fair around the statutory retirement age. Inactivity traps in benefit programmes should be tackled by making the unemployment benefit programme relatively more attractive for short term unemployed while applying a "mutual obligation" approach to all benefit recipients with some work capacity. Particular attention should be devoted to further curbing inflows into disability pension.

Innovation policy has become a key priority for the government. The government is putting strong emphasis on targeted measures to support innovation. These programmes should be closely monitored and closed if found to be ineffective. Improvements in framework conditions for innovation, including in the general business environment, in public research funding, and in tertiary, vocational and compulsory education should receive more priority.

Hungary's expansion is becoming better balanced. Manufactured exports and investment have both picked up and GDP growth is expected to be about 3.5% this year and increase further to 4% in 2006. The rise in export and investment growth follows a period in which aggregate demand was largely driven by unsustainable increases in government spending and by private consumption that was fuelled by mini-

mum wage hikes and large increases in public-sector wages. With the impact of these measures coming to a close and supportive external developments, the composition of growth has become healthier. The capacity of the Hungarian economy to respond fairly rapidly to this change in macroeconomic signals is a tribute to current and previous reforms.

Building on this base and ensuring that growth can remain healthy over the long-term will require further improvements to the macroeconomic and structural environment for business. If manufactured exports are to play an important role in growth then, as local wages catch up with the rest of Europe, producers will need to continue moving up the value-added chain through increasing capital intensity while workers need to upgrade their skills in order to remain employable. The service sector has to be the main source of new jobs to help absorb labour from declining manufacturing sectors and to bring more of Hungary's large pool of non-employed into the labour force. And, as in manufacturing, the service sector has to move up the value added chain through productivity improvements within firms and by compositional shifts towards high-value-adding activities. ■

What are the main policy challenges?

The broad policy challenges to improve macroeconomic conditions and the structural environment for business can be summarised as follows:

- *Entrenching macroeconomic stability and smoothing entry to the euro area:* The government aims to join the euro area in 2010. This will require further co-ordinated efforts to reduce inflation and the fiscal deficit by the Central Bank and the government. Going forward, the Central Bank should aim for slow but sustainable further reductions of inflation, avoiding unnecessary sacrifices in output growth or excessively high interest rates. In fiscal policy, further reductions in the deficit have to come about largely through spending cuts because the level of taxation is already harming competitiveness and labour utilisation as well as encouraging grey-sector activity. This implies that tough spending discipline will be needed to meet the Maastricht criteria. Above all, a more effective communication strategy and the visible achievement of targets will be essential to reducing the rather high degree of financial instability that Hungary has experienced.
- *Building sustainability in public spending:* Tough budget discipline needs to be backed up by structural

reforms to public spending that redefine service commitments and re-organise systems towards more efficient provision. This *Survey* assesses the best way forward in one of the key areas, namely health care. While substantial reforms have been made over the past decade, results so far are somewhat disappointing. Furthermore, the demand for health care is likely to rise significantly in coming decades due to a combination of ageing, rising incomes and new treatment options, underlining the need for additional reforms. The costs of failure to reform would be prohibitive and would undermine the sustainability of public finances.

- *Raising employment potential:* There is substantial room for increasing Hungary's employment potential. For instance, OECD calculations suggest that the employment rate could be far above current levels. In part the low employment rate arises from high tax wedges that are damping labour demand and encouraging grey-sector employment. But there are serious disincentives to work in current assistance schemes which have generated inactivity traps. In particular large inflows into disability benefit and early retirement schemes mean that many non-employed of working age with some remaining work capacity have little or no incentive to re-enter the official labour force.
- *Getting the right menu of business support and regulation:* Reflecting the focus on competitiveness, the government is conducting a campaign of general and targeted measures in corporate taxation and business support. One focus is to encourage greater levels of innovation, and this *Survey* takes an in-depth look at the recent steps taken. Policymakers face the same basic uncertainties in developing innovation policy as those found in other countries: while Hungary indeed has a relatively low level of innovative activity, policymakers have difficult decisions in deciding how far, and with what degree of targeting, policy incentives should go. ■

What refinements should be made to monetary policy?

In 2003-04 there were strong tensions in the macro-economic policy mix that adversely affected market confidence. Uncertainties about the future course of exchange rate policy provoked attacks on the forint in both directions, establishing an unhealthy environment of volatility to which the Central Bank had to respond with strong policy rate moves. Booming domestic demand and persistently missed fiscal targets generated

doubts about a rapid fall of inflation, which had surged after a series of administrative measures aimed at increasing budget revenues. High interest rates were maintained well into 2004, even as the forint appreciated to near the strong end of the target band. These developments provoked another round of public disagreement on the conduct of policy between the Central Bank and the government. However, a series of reductions in the base rate since the second half of 2004 has reduced tensions considerably, and further rate cuts are expected. Indeed, monetary policy was tight in 2004 and, because of lags in policy impacts, inflation at the end of 2005 is likely to be within the target band but well below the centre of it. Despite the easing of tensions, financial markets still regard progress in inflation and deficit reduction as fragile, adding nervousness to the foreign exchange market that is compounded by the large current account deficit.

Going forward, the inflation outlook now seems well on track to fulfil the Maastricht criteria in time for euro entry in 2010. Inflation in the year to March 2005 was 3.5%, not far off the level likely to be needed to meet the inflation criterion. Some fine-tuning of the Central Bank's inflation targeting regime in the run up to euro entry would help avoid missing policy goals:

- The current approach to setting inflation targets involves the setting of new end-of-year inflation targets once a year, implying that in monetary policy the time lag to target varies during the year. *This could be remedied if the target was set in terms of a fixed number of quarters ahead or if a rather longer-term target were set.*
- The authorities should ensure that the schedule of Monetary Council members' terms of office avoids the replacement of several council members at the same time to reduce the risk of actual, or perceived, swings in the outlook. Though it is too late to avoid this for the additional four members that recently increased the council from nine to thirteen members earlier this year, *future changes in monetary council membership should aim to avoid such situations arising.* ■

How to make sustainable progress in fiscal consolidation?

Ensuring fiscal sustainability must be a key priority. At the first glance, the budget deficit also looks well on track to meeting the 3% Maastricht limit required for euro entry. In 2004, the deficit was 4.5% of GDP,

down from 6.2% in 2003 and 8.5% in 2002. But, progress in sustainable fiscal consolidation has been less impressive than these deficit figures imply. The deficit reductions partly reflect one-off accounting items and changes in accounting practices. Stripping away these influences reveals that the adjusted deficit is just 1.1 percentage points lower since the government came into office in 2002, which is about half the deficit reduction initially planned by the government over this period. *Meeting the fiscal targets necessary to enter the euro area will thus require major efforts in the years to come.*

This year's budget relies heavily on one-off operations. The 2005 budget outlines plans for a 0.9 percentage-point deficit reduction to 3.6%. Most importantly, the deficit is being helped by a new public-private partnership deal for motorway construction that is taking an amount equivalent to 1.4 percentage points of GDP off budget, suggesting that the 2005 budget, together with the increase in private infrastructure spending, is in fact expansionary. *Any slippage from this target should be avoided.* Achieving targets beyond 2005 will have to take into account that from 2007 onwards adjustments relating to compulsory private pensions can no longer be included in the headline Maastricht deficit, though the net cost of the pension reform shall be also partially taken into account for the decision of the Council of the EU on the abrogation of the excessive deficit, if the deficit has declined substantially and continuously and has reached a level that comes close to the reference value.

Failure to reach targets and blurring of deficit outcomes is damaging credibility. To remedy this, a transformation in the attitude to fiscal policy is needed. In particular, the authorities should:

- *Use realistic estimates for the current year's deficit outcome in making budgets for the upcoming year, make prudent assumptions on real GDP growth and deflators, and improve projections of revenue and spending items. To make sure that these measures are effective, strict rules on the use of positive revenue and expenditure surprises should be applied.*
- *Communicate more transparently on the contents of the budget, particularly on the key factors behind shifts in revenue and expenditure, and communicate more openly on positive and negative developments over the course of the budget year.* This would also allow the Central Bank to reduce the level of comment and detail on its fiscal projections in quarterly inflation reports.

- *Resist the temptation to exploit accounting rules in order to make the progress in headline deficit figures look more impressive.*

In terms of concrete measures to improve spending discipline, welcome new rules have been introduced including expenditure freezes, tighter conditions on unspent appropriations and stronger ceilings on decentralised agencies. *These steps should be backed up by stronger medium-term fiscal commitment. In particular, there should be a more strongly binding commitment to the fiscal objectives laid out in the Convergence Programmes. In addition, within the budget process itself, a medium-term framework should be introduced and long-term fiscal projections regularly updated.* ■

What further reforms are needed in healthcare?

Health care is an area where spending discipline will become increasingly important. The demand for health care services is likely to rise significantly in coming decades in a population that already places high demands on the health system. While public spending on health care is not yet worryingly high, failure to speed up modernisation of the health system could lead to significant increases in spending or unacceptable falls in the range and quality of public health services. While the health system is based on a purchaser-provider model, and reforms over the past decade have generally moved in the right direction, progress has been slow. However the government is launching a series of measures as part of the Hundred Steps programme.

The slow progress in modernising the health care system is reflected in key weaknesses in the efficiency of hospital care, failure to prevent uneconomic use of hospital services and excessive spending on prescription drugs. These problems need to be tackled along the following lines:

- *The allocational efficiency of resources across all providers in the purchaser-provider system needs to be improved. In particular, caps on reimbursements should be made more needs-based to take account of local differences in population characteristics. Hospitals have to be put under more pressure to cooperate or merge in order to improve cost effectiveness.*
- *Individual hospitals also have to be given more scope in managing resources and greater incentives to*

make efficiency improvements. Responsibility of owners and managers for deficits and debt needs to be increased and made more congruent with service obligations. This would give more control over investment expenditure and greater freedom in the management of human resources while also increasing accountability.

- “Gatekeeping” by general practitioners for access to specialists needs to be strengthened to help reduce avoidable use of hospital services. The use of hospital services also needs to be more effectively controlled by better checking of treatment decisions, particularly those where there are alternatives to treatment requiring long stays in hospital. Some financial and contractual changes have already been made and others are planned. Nevertheless, further policy work will be needed.
- General practitioners and specialists also need to be made more cost-conscious in drug prescription through reforms of prescription guidelines and improved monitoring of doctors’ behaviour. This should encourage greater use of low-cost drugs. The authorities also need to maintain their current contract with the pharmaceutical companies, so that pressures to remove caps on government subsidies can be resisted. ■

How to reduce the tax wedge?

Fiscal pressures inevitably make it difficult for the authorities to achieve substantial across-the-board cuts in the tax wedge on labour, and this will continue to be the case without significant further economies in public spending, though effective tax-base broadening measures could also finance tax rate cuts to some extent. In fact, the government has been finding some room for cutbacks on both the employers’ and employees’ components of the wedge. More are planned for the future. Though these are welcome, there is room for improvement in the envisaged policy measures.

- In particular the strategy on personal income tax reductions should be rethought. Reductions in tax bills for low-income earners are generated through tax allowances that imply zero tax at the minimum wage and reduced taxation for a large share of taxpayers earning above the minimum. This approach has the drawback of raising effective marginal tax rates sharply over a range above the minimum wage. In addition, the timing of the large recent tax cut to middle and upper income recipients arising from a shift from three to two tax brackets is questionable.

A more appropriate approach to cutting taxes for both low and high earners would be to scrap the special zero-tax and allowance, replace them with a universal tax allowance and go for smaller tax reductions through bracket increases. The whole package should be phased in according to the budgetary room made available by savings on the expenditure side.

- *The size of the bias towards families with children should be reconsidered.* Some improvement in the way child financial support is delivered is scheduled as part of the Hundred Steps programme. However, while there are understandable motivations (such as the low birth rate), the gap in post-tax incomes between households with and without children is exceptionally high in international comparison and there may be more efficient ways to reach family policy objectives. ■

What welfare reforms are needed?

The number of disability benefit recipients grew massively over the 1990s, and the system has clearly ended up providing welfare to a much wider group than intended. In recent years policies have focused on containing the inflow by tightening up assessment, and there have been welcome falls in inflow in the past couple of years. Medical guidelines have recently been streamlined as a first step towards a system that takes more account of remaining work abilities and which encourages rehabilitation. However, given the often weak outcomes internationally from rehabilitation, the authorities need to be cautious in introducing new measures that require significant additional resources. *Further tightening of the screening procedures for entering disability might be a more effective instrument.*

Though there has been welcome adjustment of sick-pay rules for those facing unemployment, the system remains open to abuse and further reform is needed. *The benefits for those facing unemployment while being sick should be brought in line with the unemployment benefit. In addition, granting of the discretionary 3-month prolongation of sick pay for those facing unemployment should be limited and further cuts to the standard period allowed for the unemployed to get sick pay extension should be considered.*

Many people effectively exit from the labour force and go on disability benefit, or to a lessening extent sickness pay, because these schemes offer more money than the unemployment benefit (which is capped at a fairly low level). *One way to retain some of the advan-*

tage of the current benefit amount, while dissuading application to other benefit schemes, would be for the unemployment benefit to start relatively generously but be reduced over time. Contact with the labour market offices also needs to be strengthened. Recent measures as part of the Hundred Steps programme have been undertaken. Requirements for job-search activity could also be boosted. While an activation scheme introduced in 2003, which requires especially intensive job-search, has thus far yielded disappointing results, the international evidence is that a strong “mutual obligations” approach including active job search requirements and efficient placement services, is an effective framework, and efforts should continue to improve its implementation in Hungary.

Early retirement options mean that most people become pensioners at least two-years earlier than the standard age of retirement, i.e. somewhere below 60 for men and (currently) below 57 for women. These relatively low retirement ages are, in part, justifiable because of shorter life expectancy but nevertheless there will be a need for increases as life expectancies rise. There are some welcome changes already underway or in the pipeline (including further increase in the standard retirement age for women to 62 years) but additional reforms could be considered. *In particular, the system would be improved if the Advanced Retirement Pension were phased out and if the pension adjustments in the Reduced Advanced Retirement Pension were reformulated.* ■

What can be done to help labour mobility?

In transport infrastructure there is strong and appropriate policy attention to motorway construction. There has, however, been rather weak progress in urban transport systems, and this is restricting commuting distances. Indeed it is questionable whether sufficient progress on urban transport can be made within the current structure of transport policy. *The authorities should consider alternative structures that improve the cohesion between responsibility, administration and financing.* Movement between regions is affected by high levels of home ownership and is also discouraged by regional differences in the purchasing power of the minimum wage and welfare payouts. However, the room for positive policy moves on these fronts seem limited: active policies to reduce home ownership would in themselves be distorting and the Hungarian authorities argue that making minimum wages and welfare payouts vary across regions to reflect local price differences would be too difficult to administer. *Never-*

theless, the authorities should explore whether there are impediments to the development of rental low-cost housing markets in high growth regions. ■

Innovation policy: how to follow-up on recent reforms?

The government's focus on increasing innovation has included setting up a new decision-making structure involving senior politicians which has a welcome focus on encouraging commercially sustainable innovation. In terms of specific measures, R&D grants are being funded through a new special levy on businesses and grant allocation for applied research is focusing more on research with strong commercial potential. There is also greater targeting on specific areas of scientific research. In addition, tax breaks for R&D spending have been increased and regulatory changes have made it easier for universities to create spin-off companies.

Healthy general business conditions are the precondition for Hungarian innovation to take off. This should be a key consideration in overall thinking on innovation policy. The country's sizeable small-and-medium enterprise sector means the creation of new products and processes on an informal basis is an important aspect of innovation in a broad sense. In addition, good framework conditions are also important for ensuring that the embodied know-how in imported capital equipment and foreign business techniques continue to pull Hungary up the value-added chain through imported innovation. In terms of framework conditions relating to ICT, a significant step to further strengthen competition among providers was taken just last year (the 2004 Telecommunication Act) but it is too early to tell how it is working. However, price data signalling relatively high telephony costs suggests that *the market, particularly the dominant player, needs to be closely monitored.*

Following the recent changes made in the financial incentives for R&D through tax relief and grants, the authorities should now focus on critical evaluation of the impact of measures. This process should bear in mind the following:

- R&D tax relief is already high in international comparison and coupled with the often sceptical conclusions from research on the impact of tax relief, suggests that these incentives may be too high and deadweight costs could be substantial.
- Given the increased spending on grants, it is important that the authorities follow up on plans to improve

monitoring of individual programmes. *The authorities should also consider the potential for spillover effects to other sectors in deciding which areas to target. Unsuccessful programmes should be closed.*

- *Assessment of the Innovation Fund system should focus on whether the opportunity for businesses to reduce their innovation levy by increasing R&D activity has successfully widened private-sector innovation.*

One of the key steps to increase commercially oriented public-sector research has been the introduction of lighter regulations relating to university spin-off companies and the secondment of researchers to the private sector. However, more regulatory work needs to be done, particularly regarding the Hungarian Academy of Science (HAS). *One way of helping HAS reform would be to raise the importance of joint work with business in evaluating HAS's research activities and to strengthen the link between performance and budget allocation. Reforms may also require more performance related pay components for HAS's researchers, and the abandonment of unconditional tenure.* ■

How to build innovation capacity in education?

The introduction of shorter and more vocational degrees and several other measures, as part of a recent act on higher education, that strengthen responsiveness of tertiary education are welcome. However, more progress in reforms to tertiary-level teaching is needed to raise the long-term potential for innovation. Despite the recent reforms, there is still some criticism of supply responses in courses offered by the tertiary sector to changing labour market demands. For innovation these weaknesses risk that any take-off in research industries will get stifled by shortages of suitably qualified graduates. Further reform efforts should include:

- *The government should try again to introduce greater consultation between the tertiary sector and business on the content and mix of courses.*
- *More pressure is needed for the tertiary education system to shift more quickly out of areas of excess supply. In this regard the government should con-*

sider making greater use of incentives in tertiary-education funding to encourage changes in the allocation of teaching resources.

- *In vocational education, stronger supply responses to changing labour market demands are also needed. In particular, practical training, consultation and cooperation with the business sector should be strengthened.*

In compulsory education the authorities recently took welcome steps to improve quality, notably with the introduction of output measures of student and school performance as well as teaching of ICT and language skills. *However, the authorities should take stock of the current system of segregating secondary-school students into vocational and academic streams.* The system has a tendency to misallocate students and the division into vocational and academic streams is anyway less useful in the context of providing skills for modern labour markets. *In addition, the teaching profession needs a better alignment of teacher education, career incentives, professional development and school needs. Excessive job protection needs to be addressed as it is undermining motivation.* It is also limiting scope for redundancy plans to bring down the number of teachers to match falling student numbers and rejuvenate the profession through larger graduate intakes. *Pay structures also need reform;* though teachers, along with other public servants, have got large pay increases over the past couple of years, the salary structure overly rewards senior teachers and performance-related pay components remain low. Also, the recent pay increases are unlikely to have dissuaded a common practise of teachers holding second jobs, a situation that is likely to detract from skill development and focus in the teaching profession. ■

For further information

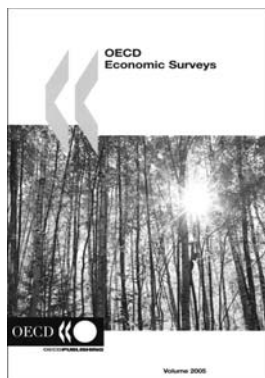
Further information on the Survey can be obtained from:

Philip Hemmings, Tel.: (33-1) 45 24 76 69
(e-mail: philip.hemmings@oecd.org)

Alessandro Goglio, Tel.: (33-1) 45 24 75 71
(e-mail: alessandro.goglio@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.oecdbookshop.org.



- **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. 77**, June 2005. 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.oecdbookshop.org

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 67
Fax: (33) 01 45 24 19 50
E-mail: sales@oecd.org
Internet: www.oecd.org

GERMANY

OECD BERLIN Centre
Schumannstrasse 10
D-10117 BERLIN
Tel.: (49-30) 288 8353
Fax: (49-30) 288 83545
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 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) 9138 6233
Fax: (00.52.55) 5280 0480
E-mail:
mexico.contact@oecd.org
Internet:
www.oecdemexico.org.mx

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

The OECD Policy Briefs are available on the OECD's Internet site

www.oecd.org/publications/Pol_brief