OECD ECONOMIC SURVEY OF HUNGARY 2004: RECOMMENDATIONS FOR FISCAL CONSOLIDATION

This is an excerpt of the OECD Economic Survey of Hungary, 2004, from the section on macroeconomic policy, chapter 2.

In broad terms, Hungary has a level of government spending that impinges on its long-term growth prospects. Following a scaling down of government in the years immediately following liberalisation, primary government spending has remained within a range of roughly 40 to 45 per cent of GDP (**Figure 2.1**), a relatively high level in comparison with other middle-income countries. Hungary's level of public spending raises three concerns for long-term growth. First, a high level of spending is likely to partially reflect excessive or inefficient delivery of public services, using up resources that could be better utilised elsewhere. Furthermore, even if efficiency is not poor in international comparison, a large public sector contributes more to overall inefficiency in the economy compared with a small one. In Hungary, given that the approximately 820 000 public-sector employees represent around 20 per cent of employment, improvements in productivity and, where appropriate, the release of resources to the private sector can clearly make a significant difference to total growth. Second, high levels of spending can also reflect inefficient and overly distorting systems of welfare transfers and subsidies. A key example in the case of Hungary is housing benefit, which distort location decisions and reduce labour mobility. Third, even if spending is efficient, it is difficult for a tax system that is required to collect large revenues not to be highly distorting and this reduces the efficiency of market operation (in particular the labour market) and compromises the international competitiveness of the economy.

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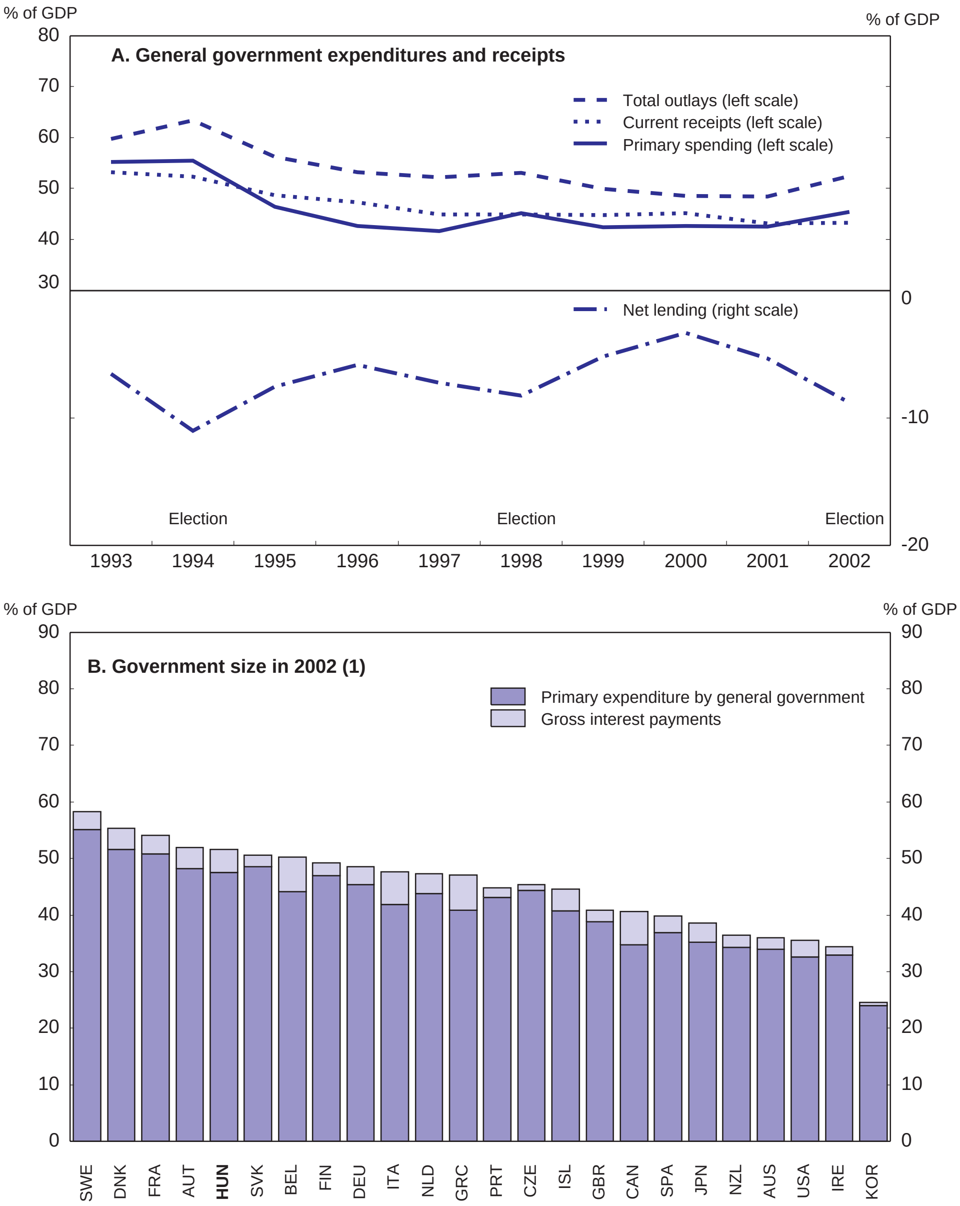
Figure 2.1. **Government spending**



Source: OECD Economic Outlook Analytical Database; revised GFS accounts.

Final 2002 deficit: strong electoral spending

One reason for the continued high level of spending is that the authorities have had difficulty in reaching budget targets. Notably, there is a strong tendency for spending commitments to be ramped up in the run-up to elections (see **Figure 2.1**). This can have not only immediate fiscal and macroeconomic impacts. For instance, lagged impacts and pre-election commitments that are politically difficult to reverse mean that post-election governments can inherit a good part of the fall-out from electoral spending. With general elections in May and

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local elections in the autumn, 2002 was no exception in this regard. Indeed, at face value the deficit of 9.2 per cent (European Standard Accounts (ESA95) basis, (see **Table 2.1** and **Box 2.1**) overshot the approved budget target of 4.9 per cent by a large margin and increased the general government debt to 56.3 per cent. Alternative budget calculations to ESA95 accounts broadly confirm this picture. The government's cash account deficit for 2002 was 9.9 per cent and adjusted cash-account calculations by the OECD showed a deficit of 8.8 per cent. Part of the deficit (2.9 percentage points on an ESA95 basis), was due to debt transfers and other one-off operations.[1] Nevertheless, even discounting this, the deficit overshot the 2002 target by 1.8 percentage points and represented a fiscal loosening of some 3.4 percentage points on 2001.

A large share of the increase in current spending in 2002 was due to the continuation of a series of large wage hikes for government and public sector employees. These began in July 2001 with increases in pay for civil servants and public order officers and ended in 2003 with a second-round increase for civil servants and employees in the judiciary system (see **Table 2.2**). The vast majority of employees got a 50 per cent wage increase from these measures. In 2002, the partial implementation of this series of wage hikes, combined with a rise in public-sector employment of about 1½ per cent to 821 000, increased the government's wage bill by nearly 23 per cent (**Table 2.3**). Most observers recognise that prior to these increases many areas of government and the public sector were having difficulties in recruitment and retention. At the same time, large across-the-board wage increases are a blunt and inefficient instrument for dealing with labour market imbalances across the wide variety of occupations in government and the public sector at large. While some occupations may still have supply shortages even after the increase, in others there may have been over-compensation. This can feed through to the private sector in the form of unnecessary pressures on wages in certain occupations. Furthermore, large wage increases given to such a large percentage of the workforce act as a general signal for wage increase in the private sector. In order to avoid similar hikes in the future the authorities should put mechanisms in place that provide more regular, and tailored pay increases in the government and public sector. Aside from the increased wage bill, fiscal spending increases in 2002 were strong in social security benefits and similar transfer schemes, as were increases in fixed capital formation (**Table 2.3**). Spending on social security benefits and other transfers increased by 18 and 27 per cent, respectively between 2001 and 2002. Particularly notable were increases in family benefits.

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1. A number of one-off share acquisitions and debt adoptions are recorded in the government's cash account for 2002. Three corporations were purchased from the Hungarian Development Bank for a total of HUF 100.3 billion. The key debts taken over were (figures in HUF billion): NA Rt. (motorway construction), 190.95; AAK Rt. (motorway maintenance), 63.73; MAV (railways), 57.25 and BKV (Budapest public transport), 36.74. Including some small debt assumptions, the total value of debt adoptions recorded in the cash accounts was HUF 363.25 billion (2.1 per cent of GDP). In the *accrual* accounts the HUF 190.95 billion (1.1 per cent of GDP) concerning NA Rt. (as this involved the purchase of completed road) and share acquisitions had no effect on ESA-deficit. In contrast, HUF 30.4 billion of debt was assumed from Rendezvénycsarnok Rt. (construction of the Budapest Arena), as commitment had been made in 2002 but not realised before the end of the year. Another HUF 61.3 billion debt assumption from and HUF 1.7 billion claim cancellation against the Hungarian Railways, together HUF 63 billion, were included only in the accrual accounts. Thus the debt adoption in the accrual accounts for 2002 is 1.6 per cent of GDP. One-off measures covered also extra transfers to households (pensions and social payments HUF 59 billion) and farmers (HUF 60 billion) and Hungarian Development Bank to cover losses (HUF 60 billion), and various other extra expenditures, together 1.3 per cent of GDP.

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Table 2.1. **Budget plans and outcomes, 2002 to 2004**

General government accounts (unconsolidated)

Accrual basis (ESA95 account)

	2002 (approved)	2002 (Final)	2003 (approved)	2003 (MOF projection Oct.03)	2004 (submitted)
	HUF billion				
Primary revenues	8 125	9 486	9 812	10 076	11 100
Primary expenditures	8 266	10 418	9 976	10 271	11 165
Primary balance	-140	-933	-164	-195	-65
Primary balance in % of GDP	-0.9	-5	-0.9	-1.0	-0.3
Privatisation revenue				not applicable	
Interest revenues	56	52	50	43	38
Interest expenditures	719	687	725	754	756
Interest balance	-663	-635	-675	-711	-718
Gross revenues	8 182	9 537	9 862	10 119	11 137
Gross expenditures	8 985	11 105	10 701	11 025	11 920
Balance	-803	-1 568	-839	-906	-783
Balance in % of GDP	-4.9	-9.2	-4.5	-4.8	-3.8
GDP (HUF bn)	16 230	16 980	18 510	18 700	20 450

Cash basis (GFS account)

	2002 (approved)	2002 (Final)	2003 (approved)	2003 (MOF projection Oct.03)	2004 (submitted)
	HUF billion				
Primary revenues	8 099	9 061	9 754	10 014	10 942
Primary expenditures	7 940	10 124	9 944	10 205	11 143
Primary balance	159	-1 062	-190	-191	-201
Primary balance in % of GDP	1	-6	-1	-1	-1
Privatisation revenues	6	12	6	10	8
Interest revenues	56	115	74	91	79
Interest expenditures	721	739	722	799	760
Interest balance	-665	-623	-648	-709	-681
Gross revenues	8 156	9 188	9 834	10 114	11 029
Gross expenditures	8 661	10 862	10 666	1 004	1 904
Balance	-505	-1 674	-832	-890	-874
Balance in % of GDP	-3.1	-9.9	-4.5	-4.8	-4.3
GDP (HUF bn)	16 230	16 980	18 510	18 700	20 450

Source: Ministry of Finance.

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Box 2.1. **Budget accounting methods**

The Hungarian authorities use two sets of budget accounts. Following liberalization, a cash-based account using the IMF's *Government Finance Statistics* (GFS86) guidelines was developed. The GFS account is used in the legislated budget and its corresponding deficit presented to parliament. More recently, an accrual-based account using the European Commission's *European Standard Accounts* (ESA95) guidelines has been compiled. This is the account used for the official government deficit target (the so-called Maastricht deficit derived from ESA95 accounts). So, for example, the deficit in the 2004 budget plan presented to parliament by the Ministry of Finance in September 2003 was 4.3 per cent, while the target was 3.8 per cent on the Maastricht basis. In public statements the government is making increasing reference to ESA95 figures rather than GFS figures, although not all press coverage clarifies which account is being referred to.

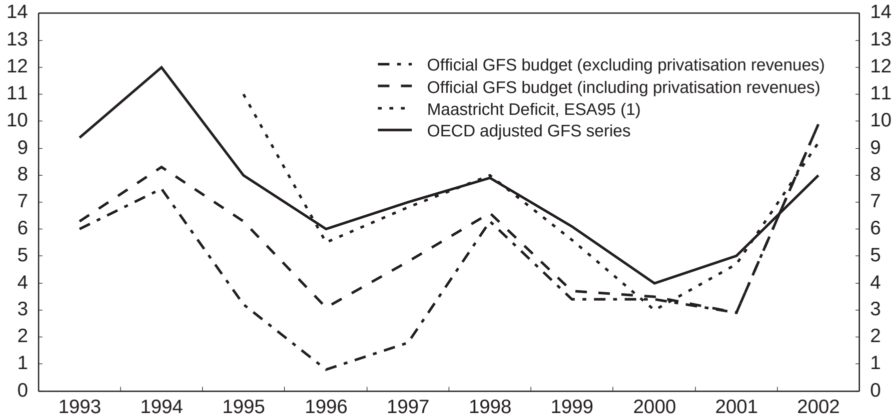
Particularly in earlier periods, the GFS account was not always suitable for economic analysis. The OECD dealt with this by making adjustments to the government's cash-based (GFS86) accounts to bring them more into line with the accrual-based *System of National Accounts* (SNA 93) principles, typically based on figures provided by the Central Bank. The main adjustments include: exclusion of privatisation revenues from the budget balance, inclusion of estimates of investment by off-budget companies, and explicit accounting of social security payments paid by government employers to the social security funds as part of employees' compensation (see *Annex I* of the 2002 *Survey* for more detail). As a result, particularly in earlier years when privatisation revenues were substantial, the gap between the GFS accounts and these OECD accounts has sometimes been considerable (see **Figure 2.2** and **Annex 3**).

From spring 2004, with Hungary's accession to the European Union, the official published OECD budget figures will be ESA95-based accounts provided by the Hungarian authorities to the OECD (and Eurostat). In principle, the ESA95 accounting system is fully consistent with SNA; differences arise largely because the relative homogeneity of European economies and statistical systems allows for a greater deal of precision in defining accounting units and activities.[2] Aside from the official OECD statistical publications, the ESA95 accounts are increasingly the principal benchmark for analysis in OECD research. At the same time, the GFS accounts or adjusted versions of them can provide a usefully different perspective to the ESA95 accounts. For instance, the accrual methods can sometimes give a misleading indication of the economic impact of budgets. The implications of the switch in VAT collection systems for the 2004 budget (see main text) illustrate this point well.

2. Eurostat's manual on ESA95 (Eurostat, 1996) accounting contains a brief assessment of the differences between SNA and ESA95 methods.

Figure 2.2 **The general government deficit under different accounting methods**

Per cent of GDP



1. Data for 1995 to 1997 are provisional.
Source: OECD, Eurostat and Ministry of Finance.

Table 2.2. **Public-sector pay increases 2001-2003**

Date pay increase effective	Groups covered	Percentage increase
July 2001	Civil servants, Public order officers	35 to 55 per cent for both groups
January 2002	Public order officers Army officers	15 per cent 55 per cent
September 2002	Public servants	50 per cent
July 2003	Civil servants Employees in the judiciary system	15 per cent 25 per cent
November 2003	Employees in the judiciary system	25 per cent

Source: Ministry of Finance, Hungary

Table 2.3. **Consolidated general government revenue and expenditure, ESA95 account**

	1999	2000	2001	2002	*2002*
	Percentage change				*% of GDP*
Revenue	12.2	16.9	10.3	11.9	*43.4*
Indirect Taxes (VAT, customs, excise)	17.1	15.1	7.6	9.7	*15.6*
Direct taxes	18.7	19.6	19.1	13.1	*9.9*
On households	17.3	22.2	18.8	13.3	*7.6*
On business	22.1	11.5	20.2	12.7	*2.3*
Social security contributions	7.9	11.8	13.2	12.1	*12.7*
Sales of goods and services	-5.9	18.7	-4.0	7.1	*2.1*
Property income received	3.7	5.8	4.4	-28.3	*0.6*
Expenditure	7.1	10.8	14.4	22.7	*52.6*
Current expenditure	13.1	8.7	13.5	16.4	*43.2*
Government consumption expenditure	12.0	13.6	15.7	17.8	*18.6*
Final wage expenditure	11.7	12.8	19.9	22.7	*11.8*
Final non-wage expenditure	12.5	14.6	9.7	10.0	*6.7*
Social security benefits paid	14.1	8.1	17.2	18.4	*15.9*
Other current transfers paid	-13.2	232.0	-29.6	26.6	*1.2*
Subsidies	58.2	-12.5	43.2	29.7	*3.3*
Property income paid	3.8	-12.2	-1.9	-5.2	*4.1*
Capital expenditure	-26.8	29.4	17.5	58.3	*8.3*
Government fixed capital formation	-9.2	29.1	36.9	44.1	*5.6*
Net capital transfers	-45.8	30.0	-17.1	100.3	*2.6*
Memorandum items	Per cent of GDP				
Net interest	-6.5	-4.8	-4.2	-3.8	
Primary balance	0.9	1.8	-0.5	-5.5	
Overall balance	-5.6	-3.0	-4.7	-9.2	
GDP (HUF bn)	11 393	13 172	14 849	16 980	

Source: Ministry of Finance, see Annex 3 for further details.

The increase in investment in 2002 was driven notably by local government whose typically close-to-zero balance gave way to a deficit of 0.7 per cent of GDP. Aside from possible election-related motives, local authority investment was boosted by opportunities for European Union-funded subsidies *via* co-payment arrangements. This spending increase came as a surprise to the central budgeting authorities who have reasonably good monitoring of current expenditure by local governments over the course of the year but a less clear picture of investment activity. The additional local authority spending was concentrated in the final quarter of 2002 and it was not until some time into 2003 that the full scale of the local authority deficit became apparent. In the initial estimate of the 2002 general government deficit that was made in early 2003, the local authority deficit was reckoned to be HUF 44 billion. In the finalised accounts for 2002 (published in autumn 2003), the deficit was HUF 124 billion.

2003 deficit: a missed target but nevertheless a turnaround

The new government has undertaken significant efforts to reverse the fiscal easing of its predecessor while making the fiscal environment for business more favourable (see **Box 2.2**). In contrast to the previous year, the budget deficit for 2003 looks set to miss its budget target by a smaller margin, with a reduction in the primary deficit. In October 2003, estimates by the Ministry of Finance were for a general government deficit of 4.8 per cent both on an accrual and cash basis, 0.3 percentage points higher than the 2003 budget target. Deviations from budget plans on the revenue side were expected to balance out. On the one hand, the introduction of a simplified entrepreneurs' tax had yielded higher than expected revenues. Also, value added tax (VAT) revenues and some other wage-related revenues were higher than expected. On the other hand, the negative impact on revenue of rebates from 2002 tax-allowances was greater than expected. The main source of slippage from the approved budget was expenditures: total expenditure (GFS-based) was expected to exceed income by some HUF 235 billion, equivalent to 4.4 per cent of that approved in the 2003 budget. The chief components of this expected increase in spending were:

- Greater than expected spending in a number of areas including: *i)* housing subsidies (HUF 50 billion) *ii)* financing of non-state institutions providing social assistance and education services (HUF 40 billion) *iii)* subsidies on prescribed drugs (HUF 30 billion) *iv*) subsidies for firms employing disabled workers (HUF 10 billion).

- Increased interest expenditure (HUF 60 billion).

- Increased pay-outs due to legal rulings regarding eligibility for a supplement to child care fees (HUF 30 billion) and compensation to victims of the Communist regime (HUF 5 billion)

The greater than expected spending on drugs subsidies and the financing of non-state institutions in 2003 were of particular concern to budgetary experts in the Ministry of Finance. The projected overshoot on subsidies for prescribed drugs is reckoned to be due to, greater than expected consumption and a shift towards more expensive products with a high rate of subsidy. Countering this, a switch to a "global subsidy system" in autumn 2003 (the first step to curb pharmaceutical subsidies since 1990) is assessed as being successful and should help rein in final-year spending. However it is yet to be seen if this new system can be continued into 2004.[3] The financing cost of non-state institutions, mainly for social assistance and education services, was at least twice the initial estimate. The overspend appears to be partly because appropriations are uncapped but also because, in this instance, a supplementary subsidy had been introduced that contributed to rapid growth in the number of beneficiaries.

3. In the global subsidy scheme, the producers sell to wholesalers at 80 per cent of an agreed non-subsidised price. The wholesalers sell on for 100 per cent of this price to the pharmacies. The pharmacies receive an agreed subsidised price. A planned monthly subsidy is distributed in two stages. An initial instalment is made to pharmacies which covers part of the gap between the cost of the products and the revenue from customers. A second instalment is made at later date which gives the pharmacies the remainder of the subsidy. Part of the remaining subsidy remains with the pharmacies, the rest is passed back to the wholesalers and producers.

Since October a less positive picture of the likely 2003 budget outcome emerged. In January 2004 the Ministry of Finance estimated that the deficit would be 5.6 per cent of GDP (accrual basis). The slippage from the autumn figures is largely due to weaker than expected central government revenues. Nevertheless, should the January estimates prove to be accurate, the 2003 final budget still looks set to signal a turnaround, contrasting sharply with the 9.2 per cent deficit outturn of the previous year and, more importantly, still representing an improvement even if account is taken of the one-off operations that boosted the 2002 deficit by 2.9 percentage points (see above).

Close to the full impact of the series of increases in government and public-sector salaries will be felt in the 2003 wage bill (see **Table 2.2**) as only a 15 per cent increase for civil-servants remained and was implemented part-way through 2003. There are temporary special arrangements to help local authorities meet the increased wage bill, including increases in tax-revenue allocations from personal income tax and car tax to local government. In addition, a special fund of HUF 7 billion was made available for local authorities where, even with these measures, budget problems remained due to the wage rises.

Box 2.2. **The main changes to taxation and transfer systems, 2003**

Taxation and social security contributions

Corporate taxation: the introduction of new tax-free provision for development and accelerated depreciation, reduced healthcare contributions.

Taxation of SME's and the self-employed: simplified taxation for small enterprises, tax-free threshold increased for self-employed in small settlements and farms.

Earned-income taxation and social security contributions: tax exception of earned income up to the minimum wage, tax-bracket increases, tax benefits on adult education, computer equipment and internet connection, increase in the private pension fund membership fee.

Other aspects of income tax: increase in the insurance tax credit, abolition of tax liability on exchange markets, preferential taxation for those in an approved "Employee Securities Benefit Program".

Value-added tax: rates on some items increased from the preferential rate or special exemption to the normal rate.

Transfers

Unemployment: Modification of Act IV of the 1991 legislation on job assistance and unemployment benefits as of 1st January 2003. Measures include: introduction of the "job search" allowance, possibility of transfers to part-time workers, support for distance working and options for introducing new support schemes to help Romas and those aged over 45 integrate into the labour market.

Budgeting practices: reform still needed

The large budgetary slippage in 2002 and the smaller one in 2003 partly reflect weaknesses in budgetary procedures identified in the special chapter on public expenditure in the 2002 *Survey* (see **Box 2.3**). The key message of the recommendations called for a more medium-term outlook both in overall strategy and budgetary implementation. In terms of budgeting, the annually revised *Pre-accession Economic Program (PEP)* provides some degree of strategy and a medium-term focus.[4] And, in a welcome move, the authorities have explicitly incorporated the ESA95 deficit profile for 2004 to 2006 in the 2004 budget document, and stipulated multi-year budgeting for items relating to EU structural funds. However, the PEP budget profile tends to shift from one year to another, in a way that accommodates recent budgetary outcomes and so does not represent a very reliable benchmark. In light of the targets for 2005 and 2006, better anchoring to a more fixed medium-term target is needed.

Box 2.3. **Budgeting issues: key recommendations from the 2002 *Survey***

Central government budgeting

- Elaborate a government policy statement at the beginning of each legislature as a strategic policy framework.
- Tie annual budgets more strongly to a medium-term budgetary framework based on medium-term expenditure targets.
- Accompany the institutionally-oriented budget with a task-oriented budget (organised into functional chapters).
- Clarify macroeconomic assumptions of the multi-year and annual budget frameworks. Open alternative scenarios to public discussion and make the fiscal risks transparent.
- Estimate structural (cyclically-neutral) budget expenditure, revenue and deficit targets.

Local government budgeting

- Involve local governments in the multi-year strategic budget process recommended above. Have local governments produce their own medium term fiscal programmes and frameworks.
- Extend monthly budget monitoring to local governments.
- Revise the exemptions to local borrowing caps. Replace sectoral exemptions by exemptions based on project characteristics (for example, degree of actual risk sharing by private investors, or availability of audited cost-benefit analyses).
- Extend public procurement rules to all local investment spending (including spending by off-budget utility companies) above a critical threshold level.

4. The PEP reports have been produced annually and typically made public in August (see Government of the Republic of Hungary, 2003, for the last report).

Public expenditure: bolder structural reforms needed

While there is commendable intention in the 2004 budget submission, it is not backed up by significant plans for concrete structural reforms to public expenditure that bring more efficient public services and transfer systems. The lack of such reform not only increases the difficulty of achieving deficit targets, but also continues the impairment of growth potential due to high taxation and inefficient resource utilisation. Measures taken by the government towards fiscal consolidation remain largely within an input-focussed environment and do not signal an increased concern for efficiency. For instance, the planned staffing cuts for 2004 will certainly generate budget savings and release resources for the private-sector labour market. However, it would be more effective if comprehensive output measures, such as those outlined in the 2002 *Survey* (see **Box 2.4**), were available. Such measures would not only facilitate analysis but can also help overcome political and institutional resistance to proposed cuts.

Box 2.4. **Structural reforms to public expenditure: key recommendations from the 2002 *Survey***

General principles

- Set performance benchmarks for service supply efficiency. Trigger management and organisation changes when targets are not met.
- Replace (gradually, also using pilot projects) input-oriented financing with output-oriented financing.

Local-government

- Analyse the efficiency of the existing public service supply. In areas where excessive fragmentation between municipalities curbs competition and efficiency, consolidate supply structures *via* voluntary associations or by furthering the role of an intermediate level of government.
- In areas where local monopolies are natural, reduce their costs and increase the quality of their services by giving local taxpayers and central funding agencies more direct control over their activities (by making them more powerful "principals" for their services).

Infrastructure investment

- Prepare an integrated national infrastructure investment programme. Clarify interdependencies between infrastructures (notably between transportation modes) and between national and regional networks. Make comprehensive use of cost-benefit analyses.
- Explore avenues for private sector participation in long-term infrastructure planning and investment. Devise more economically efficient methods than in the past, by taking into account best-practice international experience. This should be applied notably to the development of new roads and regional airports.