Public finance consolidation in Hungary

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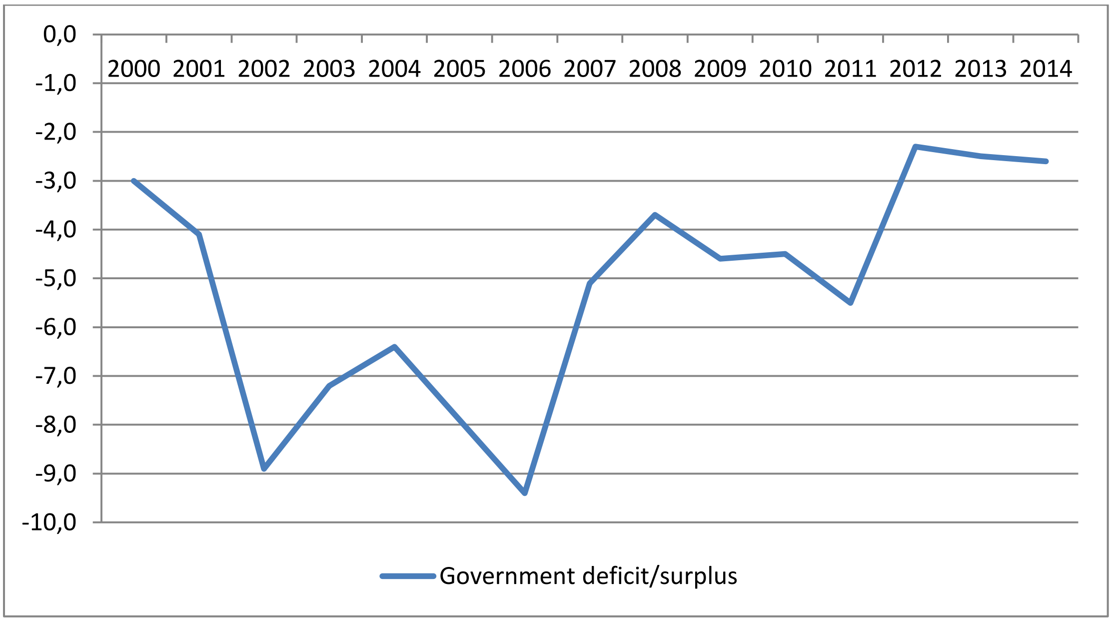
May 2015

The paper offers a brief overview of the public finance consolidation in Hungary over the period of 2008-2016. Public finance deficit was a constant problem in Hungary during the 2000s before the outbreak of the financial and economic crisis. As percentage of GDP general government deficit peaked at 9.4% in 2006 (*Figure 1*). Substantial fiscal consolidation in Hungary began in mid-2006, with the fiscal deficit falling from 9.4% to 5.1%in the subsequent year in 2007, therefore the government was able to stabilize debt-to-GDP ratio.

Figure 1 General government deficit/surplus in Hungary 2000-2014



Public finances in Hungary were among the worst ones in the EU before the outbreak of the 2007/08 crisis. The country was under excessive deficit procedure between 2004 and 2013, this period was characterised by steady increase of public debts. Consequently Hungary could not pursue an anti-cyclical economic policy in the crisis on the contrary; it had to introduce fiscal austerity in the middle of recession (Vida, 2012). Hungary requested a Stand-By Arrangement (SBA) from the IMF in October 2008, shortly after the culmination of the worldwide financial market crisis. The EU agreed and joined the IMF in providing Hungary additional financial support by using its Balance-of-Payments (BoP) Assistance Facility (total amount was to € 20 billion in which IMF: € 12.3 billion, EU: € 6.5 billion, World Bank: € 1.0 billion) (Seitz – Jost, 2012).

Hungary decreased public finance deficit from around 5 per cent of GDP in 2011 (similar level as in 2009 and 2010) to less than 3% in 2012 and onwards, so deficit can be maintained below the 3 per cent threshold.

The document was prepared for a webinar "Public Finance Consolidation" taking place on May 22, 2015 under the project "Hidden Triggers of Economic Growth in V4 plus Ukraine"[1] supported by the International Visegrad Fund. The project is led by INEKO , the Institute of World Economics of the Centre for Economic and Regional Studies of the Hungarian Academy of Sciences is a partner organisation with other partners from Poland, the Czech Republic and Ukraine.

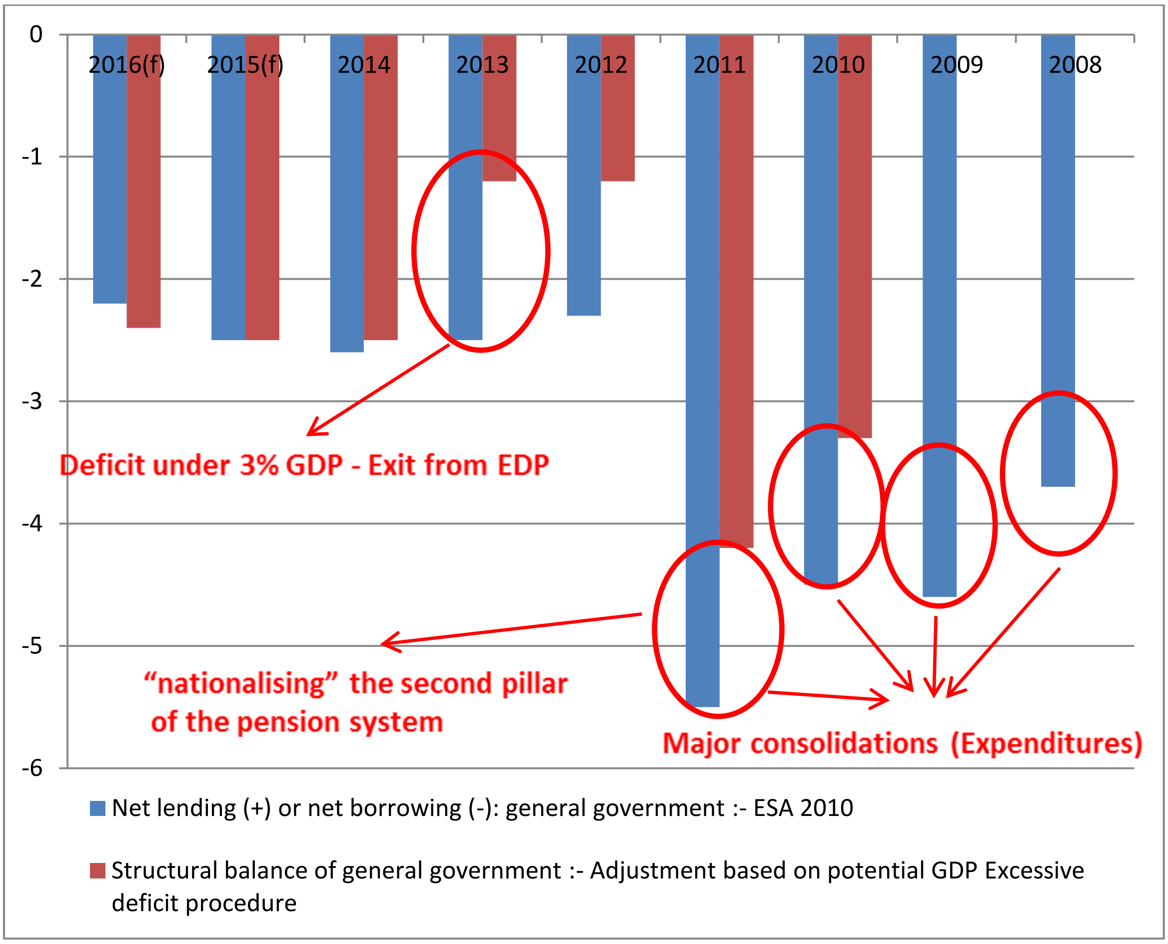
The Institute of World Economics of the Centre for Economic and Regional Studies of the Hungarian Academy of Sciences focuses on global economic trends and their effects on Hungary. It is the oldest and most experienced institute in this field in Hungary. As the successor to the Institute for World Economics founded in 1973, the Institute adopted its current name and structure on January 1st, 2012. See also http://vki.hu/home.html?setlang=english.

Public finance balance

Public finance deficit skyrocketed even before the outbreak of the financial and economic crisis. As to public finances, the Hungarian performance has been among the worst ones in the EU before the crisis. In 2008 after successful consolidation the government was able to decrease general government deficit to 3.7%. Gross domestic product shrunk to nearly 7% in 2009 – well below the average recession rate of the EU27 (-4.3%), and deficit increased to 4.6 per cent in 2009. The cca 5 per cent deficit level remained until 2010. After several remarkable consolidation the deficit decreased to less than 3% in 2012 and deficit can be maintained below the 3 per cent threshold. The Hungarian government plans to gradually improve the headline deficit to 2.4% of GDP in 2015 and further to 1.6% in 2018.

[1] See http://www.ineko.sk/projekty/visegrad-fund.

Figure 2 Public finance balance in Hungary (% GDP)



Source: AMECO database

2008 and the following years were time of significant fiscal consolidation packages, after a period of large budget deficits and accumulation of public debt that lasted over a decade.

In 2008, the focus of applied measures was on the expenditure side, including pay cuts for public-sector employees, equivalent to 1% of GDP, the elimination of the 13th monthly pension for early retirees and a cap on the 13th monthly pension for other pensioners, equivalent to 0.2% of GDP. The indexation of selected social benefits was to be postponed or eliminated (0.2% of GDP), and other spending was to suffer a general reduction (0.5% of GDP) (Myant et al., 2013). In 2009 social spending cuts translated into cutbacks in universal provisions and social insurance (Matos, 2013).

In 2009 and 2010 expenditures were reduced by the equivalent of 1.6% and 3.6% of GDP, respectively, including cuts in pensions, by various means, and cuts in various social benefits. Public-sector pay was frozen for 2010 and 2011 and cut through abolition of the 13th-month salary from 2009. The dominant features of crisis management in Hungary were to remain a shift towards a less progressive tax system, cuts in redistributive state spending, most notably on the unemployed (Myant et al., 2013). In 2010 the government reduced the personal income tax effective to a flat rate system at 16 percent, which had an increase in labour participation as main objective (Guerson, 2013).

In late 2010, the government of Hungary decided to nationalize private pension funds, drifting away the Hungarian mixed pension system from private insurance, reinstalling the pay-as-you-go scheme (Matos, 2013). The nationalised pension capital (9 per cent rather than the original 11 per cent of GDP) has been targeted not only to reduce of the budget deficit (5 per cent of GDP), but for making room for a radical tax cut (cc. 4 per cent of GDP during three years). However Simonovits (2011) argues that the implicit government debt would be increased by the gains in future pension entitlements of those returning to the mono-pillar.

In 2011 the Hungarian government launched the Szell-Kalman Plan, a reform program that focused on fiscal consolidation and structural reform in order to implement ambitious fiscal reforms between 2012 and 2013, of which around three fourth were expenditure-based. The reforms targeted a broad set of areas including on health, education, social transfers, pensions, local administrations, and transport. During 2011-2012, there were savings in the expenditure areas of goods and services, public wages, and transfers to households totalling over 2 per cent of GDP (Guerson, 2013).

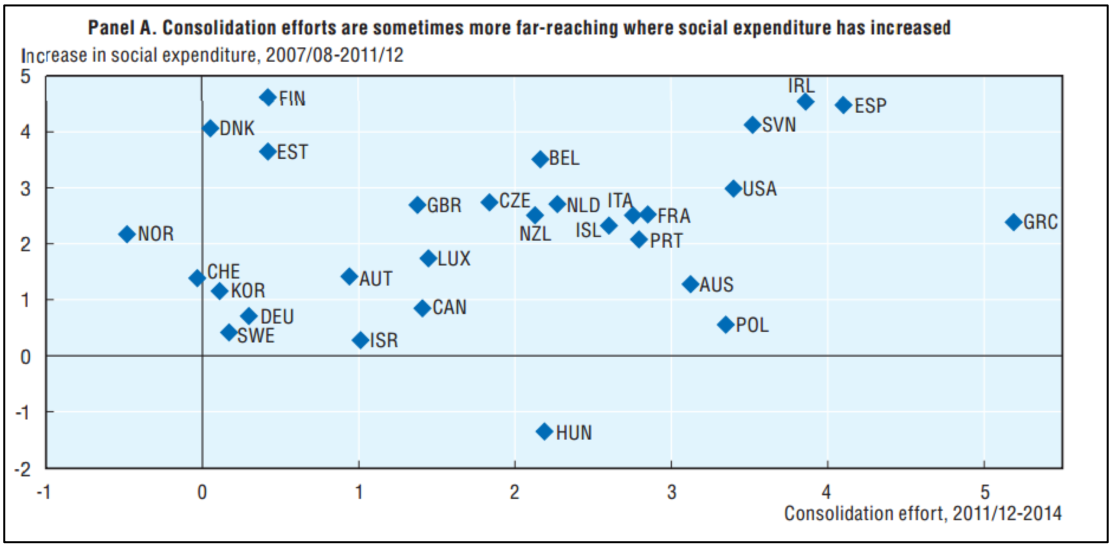
Year 2012 brought large vulnerabilities and limited space to absorb shocks, financial pressures rose sharply in the wake of growth and financial spillovers from the Eurozone crisis, which exacerbated existing strains on the domestic economy. However, despite these pressures, the authorities managed to maintain macroeconomic stability. From 2012 onwards the authorities have placed job creation as a key policy objective and have adopted measures to stimulate employment, including by tightening unemployment and welfare benefits, expanding the public works program, and reducing tax rates and social contributions for some segments of the labour force (IMF, 2013).

In 2013 authorities introduced two additional fiscal consolidation packages, one targeting the expenditure side and the other mainly raising and redesigning sector-specific taxes. Overall, the deficit remained and expected to remain below 3 per cent of GDP. Official plans suggested underlying fiscal expansion and a slight increase in the headline deficit amidst a recovery in activity and a broadly neutral fiscal stance in 2015-2016 (OECD, 2014).

In its 2015-2018 Convergence Programme, the Hungarian government plans to gradually improve the headline deficit to 2.4% of GDP in 2015 and further to 1.6% in 2018, and that the medium-term objective – a structural deficit of 1.7% of GDP − is reached by 2017. According to the Convergence Programme, the government plans to gradually reduce the debt-to-GDP ratio to 74.9% in 2015 and to 68.9% in 2018 (Magyarország Kormánya, 2015). The macroeconomic scenario underpinning these budgetary projections is broadly plausible until 2016 and becomes favourable thereafter. Measures to support the planned deficit targets from 2016 onwards have not been sufficiently specified, in particular beyond 2016. Based on the Commission's 2015 spring forecast, both the structural balance and net expenditure growth point to a risk of a significant deviation from the required adjustment path towards the medium-term objective in 2015 and 2016. Therefore, further measures will be needed in 2015 and 2016 (EC, 2015).

In general it can be concluded that fiscal space has been shrinking in most OECD countries, putting more pressure on social spending as governments reduce budget deficits. Regarding this process Hungary is the only exception where fiscal consolidation was accompanied with decreasing social spending (*Figure 3*).

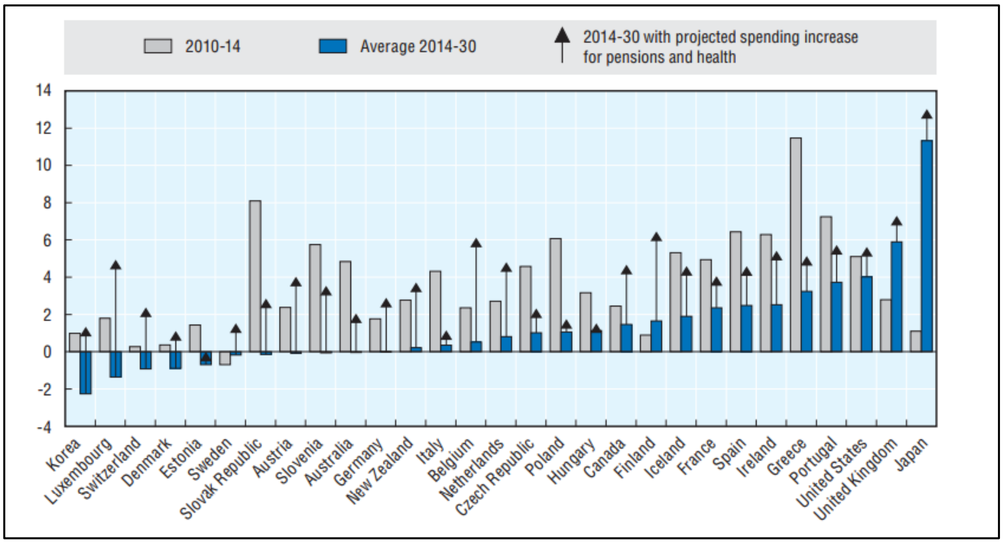
Figure 3 Relationship between consolidation efforts and change in social expenditure



Source: OECD (2014) pp. 41.

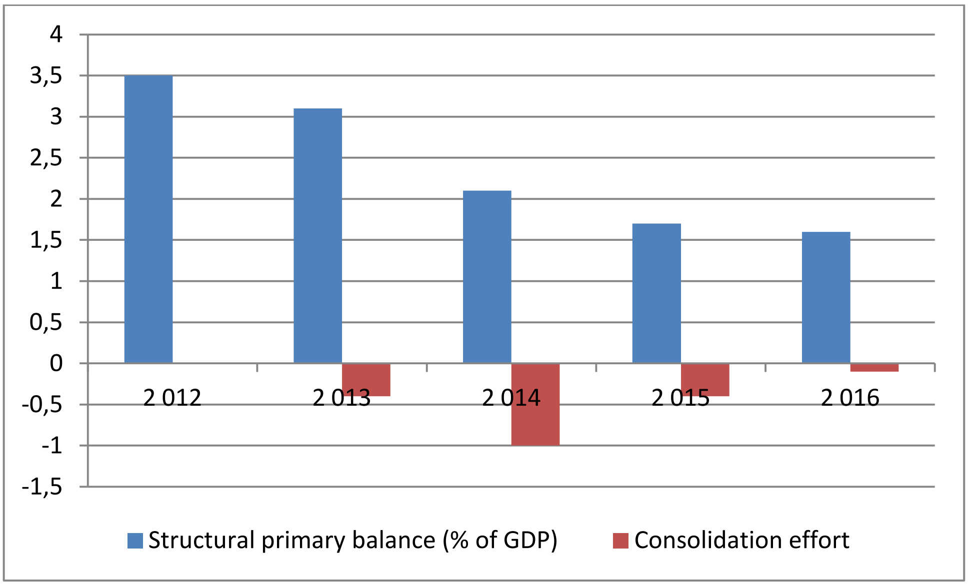
Analysing short and long term consolidation efforts, it can be concluded that Hungary already carried out significant consolidation efforts between 2010 and 2014, and the long term projections are considerably lower.

Figure 4 Short-term consolidation efforts (2010-14) and medium-term consolidation scenarios (2014-30)
Change in the primary budget balance, in percentage of GDP



Source: OECD (2014) pp. 42.

Figure 5 Structural primary balance (% of GDP) and consolidation effort for Hungary



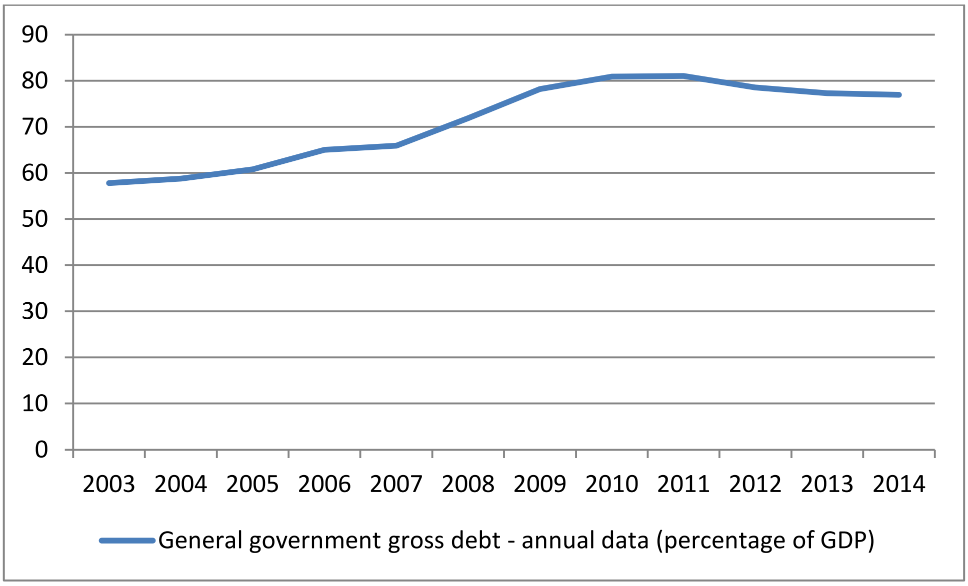
Source: Berti et al. (2013) pp. 13.

Public debt

Hungary is one of the worst-hit countries of the current financial crisis among the East Central European (ECE) countries. Financing external debt became a major constraint on policy in Hungary; in October 2008 the country received external financing from the IMF and EU under terms that implied budgetary restriction.

The high level of public debt in Hungary was an exception within the ECE, while in general the region was characterised by low debt levels in international terms. 2008 can be treated as a turning point in indebtedness processes of the region, debt levels started to rise considerably.

Figure 6 General government gross debt for Hungary



In 2003 general government gross debt level was slightly below 60 per cent of GDP, and afterwards it started to increase significantly. Debt level before the outbreak of the crisis was 71.9 per cent of GDP, and gross domestic product shrunk by 7 per cent in 2009. Since recovery in Hungary was considerably modest, debt level exceeded 80 per cent of the GDP in 2010 and could have been slightly reduced only after 2012.

Hungary is currently in the preventive arm of the Stability and Growth Pact and subject to the transitional debt rule for 2013-2015. According to the Convergence Programme, the government plans to gradually reduce the debt-to-GDP ratio to 74.9% in 2015 and to 68.9% in 2018. The macroeconomic scenario underpinning these budgetary projections is broadly plausible until 2016 and becomes favourable thereafter (EC, 2015).

Current challenges

Hungary appears not to face a risk of fiscal stress in the short term. Risks to fiscal sustainability are low also in the medium and long term perspective, conditional upon the full implementation of the planned ambitious fiscal consolidation and on maintaining the primary balance well beyond 2014 at the level expected to be reached in that year (EC, 2015). After several considerable consolidation efforts government debt is still above the 60% of GDP Treaty threshold and expected to remain above the threshold for long. The focus should, therefore, be on reducing government debt.

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