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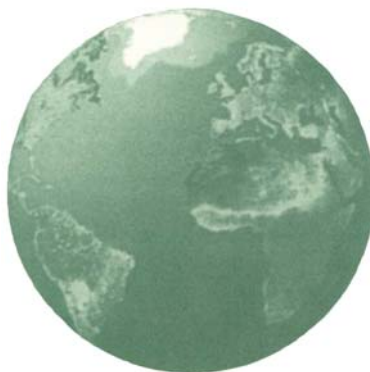
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FISCAL ADJUSTMENT IN HUNGARY
(1991-2003)



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INTRODUCTION*

This paper sets out to examine fiscal adjustment in Hungary and try to identify a period of successful fiscal adjustment in the last 13 years. The intention is also to identify the factors that hamper or favour successful fiscal adjustment. Fiscal adjustment is an important dimension of structural transformation, as it captures changes in the incentives offered by the state and its redistribution policy, which affect both capital and the labour market. There are also implications for short and medium-term economic growth. For EU member-states, fiscal adjustment was especially important in the 1990s in the run-up to meeting the Maastricht criteria for Economic and Monetary Union entry.

Double the effort seems to have been required of the transition countries. The state had to scale down the apparatus supposed to provide an extensive set of social policies for its citizens while building other reliable services, and to secure entry to the EU with an equally large bureaucracy that has to be motivated with appropriate incentives. Moreover, the transition economies have to address the social costs of transition through effective social policies built on the insurance principal.

To this end, the paper rests on findings of Von Hagen *et al.* (2001) in defining fiscal consolidation and on the work of Alesina and Perotti (1995 and 1997) in defining successful fiscal ad-

justment. The paper also makes use of comparisons between countries resulting from these papers, drawing on performance in the developed countries.

The paper uses an empirical approach to the problem of fiscal adjustment, insofar as the data analysed here are annual budget figures. The series are only for 13 years, which makes it difficult to apply econometric techniques. The paper sets out to analyse each episode of fiscal adjustment and then decide whether it was successful or not, according to definitions found in the literature.

In following the course of the budget deficits in Hungary over the last 13 years, an attempt is made first to find the episodes of decline in fiscal deficits. The next step is to analyse the factors behind this decline, by looking to the course of the main categories in budget revenues and expenditures. This helps to shed light on the sustainability of such fiscal consolidations. Secondly, the paper looks for follow-ups to these budget declines in a macroeconomic framework, mainly by analysing the behaviour of the GDP growth in years following the decrease in the budget deficit.

Nevertheless, the paper offers something new, for tracing the fiscal consolidation performance of just one country allows detection of the policies that were unsuccessful in securing a lasting fiscal adjustment.¹ This approach differs from the one taken in other papers on the transition countries (*e.g.* Purfield 2003 and Gleich 2003), which adopt a cross country view, and even if they take into account the entire period, their findings describe the averages for the region, not one country in particular.

On the other hand, the paper sets out for two reasons to discuss recent

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¹ LeLoup *et al.* (1998) analyses budgeting in Hungary since 1990 and Thuma *et al.* (1998) reviews more recent reforms in Hungarian public-finance management, in particular the establishment of the treasury system in 1996.

advice prompted by the IMF (2004) and OECD (2004) about the necessity and scope of fiscal adjustment in Hungary. (i) These are the only materials on fiscal adjustment that solely address Hungary's experience and give a concentrated view of its specific problems. (ii) Although the IMF encourages the view taken by the Hungarian government in its 2002 Pre-accession Economic Programme, it does not discuss the extent to which the two main changes decided by the authorities are feasible economically and politically. While the IMF presents an alternative scenario without measures to contain or consolidate the fiscal deficit, it does not appear that the government itself has a contingency plan.

All in all, the *first part* of the paper presents the theory of fiscal adjustment and describes episodes of fiscal adjustment in Hungary in the last 13 years. The *second part* presents the macroeconomic framework of these fiscal adjustment episodes and seeks factors that prevented success. The *third part* mentions briefly the political economy of fiscal adjustment in Hungary, as one of the factors that can largely influence its success. *Finally*, the author expresses some views on the measures for fiscal adjustment proposed by the authorities in 2002 and on their results in 2003.

1) HISTORY OF FISCAL ADJUSTMENT

The fiscal adjustment that started in the OECD countries in the early 1990s was meant to reduce ratios of debt to GDP. For the Central and Eastern European (CEE) transition countries, however, the concern was to reduce the fiscal deficit resulting from the transition process. This was on average adjusting revenues downwards and spending upwards, as

extra social costs coincided with extra spending to increase efficiency.

The literature on fiscal adjustment has concentrated on four themes: the link between fiscal adjustment and budgetary expenditure and revenues, the success of fiscal adjustment and the composition of spending cuts, fiscal adjustment and its effect on economic growth (and external indebtedness), and the political economy of fiscal adjustment. The last two of these are dealt with in the next two sections.

There is a broad consensus in the literature (Alesina and Perotti 1995 and 1997, Buti and Sapir 1998, Buti *et al.* 1997, Perotti 1998, Von Hagen *et al.* 2001) that the composition of the adjustment matters, and that it is more important to restrain government spending than to increase revenues. According to Drummond *et al.* (2003), expenditure downsizing contributed on average about 50 per cent to fiscal adjustment while increasing revenues contributed only some 10 per cent.

Most EU member-states underwent substantial fiscal adjustment in the 1990s, in their efforts to meet the Maastricht fiscal criteria. According to EU Commission data, the EU economies reduced their fiscal balances by an average of 4.2 per cent of GDP over periods up to eight years. But experiences differed, some seeing steep tightening over short periods (Sweden, for instance, adjusted its overall budget balance by over 10 percentage points in four years) and others similar reductions over longer periods (Greece, for instance, cut its budget deficit by 12 percentage points in eight years).

Apart from the differences in scope and time span of the fiscal consolidations in EU member-states, there was also variation in the structure. Some countries opted from the outset to reduce government expenditures, while others tried a combination of increasing revenues first and then cutting expenditures (after

1994). Based on EU Commission data, Drummond *et al.* (2003) concludes that the first category covers the UK and the Nordic members. Sweden decreased its structural revenues by as much as 8.2 percentage points of GDP in three years, and Denmark by 2.1 percentage points of GDP in 1996–7. However, Denmark and the UK slightly increased their structural revenues over their respective periods of expenditure-based adjustments, while Finland and Sweden made significant efforts to decrease their revenues.

Table 1
Fiscal consolidation in EU member states

Member-state	Consolidation period	Actual budget balance (% of GDP)
Belgium	1992–6	-3.1
Denmark	1996–7	-3.7
German	1992–7	-0.3
Greece	1990–7	-11.9
Spain	1992–7	-1.3
France	1995–7	-2.6
Ireland	1991–3	0.1
Italy	1991–7	-8.1
Netherlands	1991–6	-2.8
Austria	1995–7	-2.0
Portugal	1994–6	-2.9
Finland	1993–7	-4.5
Sweden	1994–7	-10.4
United Kingdom	1994–7	-5.9

Source: IMF, Hungary Country Report 2003, Selected Issues, p. 43

Six member-states – France, Germany, Greece, Italy, the Netherlands and Spain – adopted a mixed strategy of first increasing budget revenues and then cutting expenditures. The most impressive efforts were made by Spain and Italy, which made the highest overall adjustment in this way. Nevertheless, the budgetary performance of all these countries worsened after 1998, particularly those of Germany and France, which continue to breach the Maastricht criteria, and of Greece and the Netherlands, which did not back their tax-reform policies with appropriate expenditure cuts.

A third group of states embraced a strategy of simply increasing revenues to cut budget deficits: Belgium, Ireland, Austria and Portugal. Belgium, the champion in debt to GDP ratio, increased structural revenues by 3.7 percentage points of GDP over four years. It is interesting that over 1998–2003, when all EU member-states faced a worsening of their budgetary balances, Portugal was the first, in 2001, to exceed the Maastricht budgetary target. Moreover, according to ECB (2004), Ireland suffered alongside other member states the most pronounced deterioration in its fiscal balance by an actual reversion of the budget adjustment implemented previously, due to the introduction of significant tax reforms accompanied by no measures to stabilize expenditure.

For the CEE countries, Purfield (2003) analysed empirically fiscal stabilization occurring between 1992 and 2002. He showed first that there was significant fiscal adjustment in the transition countries, with consolidation of the budgetary deficit accelerating from an average of 1.25 per cent of GDP per annum for the decade to 3.5 per cent of GDP in 1999 and 2000. Moreover, Purfield shows that this downsizing of the deficit was achieved mainly through a decline in expenditure, by an average of 2 percentage points of GDP per annum. However, the budgetary framework was changed to mirror the changing role of the state in the economy, so that policies of downsizing the state or lack of state capacity to collect revenues led to falls equivalent to 0.75 percentage points of GDP per annum.

Table 2
Indicators of fiscal policy in the CEE
countries, 1992–2000

Annual change in (% of GDP)		
Overall deficit	Total expenditure	Total revenue
-1.2	-2.1	-0.7

Source: Purfield 2003, p. 5.

A second subject of interest is what categories of expenditure were the main contributors to the cuts in overall budget expenditure. Von Hagen *et al.* (2001) researched this for 65 successful budget consolidation episodes in a sample of 20 OECD countries over a period of almost 30 years.² One conclusion is that the composition of the expenditure adjustment matters, insofar as more emphasis on cutting current expenditure rather than investment outlays gives higher chances of lasting fiscal adjustment. The simple philosophy behind this is that increasing public spending increases labour costs and reduces profits, and therefore investment. The same authors hold that cuts in current expenditure, the most effective in terms of lasting fiscal adjustment are those made in transfers, subsidies and the wage bill. The same findings were reached by Alesina *et al.* (2001) on a panel of OECD countries, demonstrating a sizeable negative effect on business investment of public spending, in particular its public wage component. The rationale behind this is that an increase in government employment generates a negative wealth effect, as labour supply increases, but it does not do so enough to offset completely the higher government employment demand.

² One definition in Von Hagen *et al.* (2001) denotes as fiscal consolidation episodes in which the cyclically adjusted government balance rose by at least 1.25 per cent of cyclically adjusted GDP in two consecutive years. A consolidation effort is deemed successful if, two years after the initial adjustment, the government budget balance stands at no less than 75 per cent of the balance in the first year of the consolidation episode.

Hence, the fall in employment and marginal product of capital in the private sector is associated with an increase in real wages and a fall in investment. Purfield (2003) does not find evidence for the CEE transition countries on the effects of structure on expenditure-based adjustments, for want of data.

Comparison of the literature on fiscal adjustment in the OECD, EU and transition countries leads to three conclusions. (i) Adjustments of over 3 percentage points of GDP on average in EU member-states and CEE countries point to a similar effort at fiscal consolidation, but over a more limited period for most EU economies. (ii) Experience in both EU member-states and CEE countries shows most fiscal adjustment being gained through expenditure cuts. (iii) In developed economies, the primary expenditure contributing most to expenditure cutting was current expenditure, with the government wage bill as the preferred category.

In Hungary, the history of budgetary deficits since 1991³ shows *four episodes* of overall general-government budgetary deficit contraction, in only three of which was there a sustainable fall in the overall deficit. The *first* occurred in 1993, when the overall budget deficit fell from 6.6 per cent of GDP to 5.7. This trend was reversed the following year, when the 1994 deficit rebounded to 6.7 per cent of GDP. The overall deficit decrease in 1993 over 1992 was not prompted by the fall in primary expenditure, but by the fall in interest payments. In fact, primary expenditure rose in 1993, mainly due to expenditures on goods and services. But a positive fact was that subsidies and

³ For the early 1990s, it is difficult to analyse the cyclical evolution of the transition economies. The paper therefore analyses the evolution of the overall budget deficit. Moreover, the cyclically adjusted deficit is not very important for the present purposes. The interest is in seeing how changes in various categories of expenditure/revenue influenced the budget deficit.

current transfers began to fall, by a significant 1.8 percentage points of GDP between 1992 and 1993.

Table 3
Hungary's macroeconomic indicators, 1991-2003: budget deficit, GDP growth and gross debt

	Overall budget deficit (% of GDP)	GDP growth (previous year =100)	Gross debt (% of GDP)
1991	-3.7		74.1
1992	-6.6		78.5
1993	-5.7	99.4	89.5
1994	-6.7	102.9	86.6
1995	0.6	101.5	85.2
1996	-2.6	101.3	71.9
1997	-2.3	104.6	63.3
1998	-6.5	104.9	61.5
1999	-3.7	104.2	60.5
2000	-3.0	105.2	55.8
2001	-4.7	103.8	53.5
2002	-9.4	103.5	57.1
2003	-6.0	102.9	59.1

Sources: GFS and IMF.

The *second* episode of fiscal consolidation, in 1995, seems to represent a big effort to reform the budgetary standing, as the annual overall budget ended up with a surplus of 0.6 percentage points of GDP. This turnaround is the more remarkable for following a year with a deficit of 6.7 percentage points of GDP. The remarkable change resulted primarily from a change in politics and policy. A new government elected in 1994 and a new finance minister, Lajos Bokros, decided to accelerate the economic transformation and thereby increase awareness of accountability in public spending. As a result, budgetary expenditures were cut significantly, from 45.4 per cent of GDP in 1994 to 42.1 per cent in 1995. Downward adjustment of revenues was achieved mainly by a decrease in the yield from direct taxation. The main achievement was a reduction in the cost of employment, through lower social-security contributions that

produced a fall in such revenues amounting to 1.2 percentage points of GDP. Equally important were lower rates of tax on turnover and profits, so that revenues from these decreased by 0.8 percentage points of GDP compared with the previous year. These two reforms alone accounted for two-thirds of the overall reduction in budgetary revenues.

Meanwhile primary expenditure contracted by 13.1 per cent of GDP. Current expenditure contributed to this mainly through a cut of 2 percentage points in expenditure on goods and services. Here it has to be mentioned that wages and salaries eased by only 0.6 percentage points of GDP over the previous year. However, it is important to underline that for the next three years, the downward trend in the weight of this expenditure category continued, which pointed to sustainable, successful fiscal adjustment.

The main contribution to fiscal contraction came from subsidies and transfers, which lost almost 4 percentage points between 1994 and 1995 and an average of two percentage points in each of the next two years. Thus the weight of subsidies and transfers decreased from 29.7 per cent of GDP in 2004 to 25.9 in 1995 and 21.5 in 1997.

Finally, capital expenditures were subject to a reduction of two percentage points of GDP from 1994 to 1995. However, after a slight subsequent reduction to 3.8 per cent of GDP in 1996, they stabilized to at around 4.1 per cent of GDP.

Another episode of overall budget-deficit decline came in 1999, when it was reduced to 3.7 per cent of GDP. It had jumped in 1998 to 6.5 per cent of GDP after a surplus of 2.3 per cent in 1997 due to an attempt to reform the pension system. Excluding this factor, the budget deficit in subsequent years increased by only one percentage point over 1996 and 1997, when a successful adjustment was achieved.

In terms of GFS data, fiscal adjustment continued in 2000. The decrease in the budget deficit of 0.2 percentage points of GDP was due most importantly to current expenditure, which lost 4.1 percentage points of GDP, mainly through a decrease in transfers and subsidies accounting for 4.5 percentage points of GDP. Despite this sharp fall in current revenues, total expenditures decreased by only 2.8 percentage points of GDP over the previous year. This was due to a 1.4 percentage-point increase in capital expenditure and a drop in current revenues of 1.2 percentage points of GDP since 1997, mainly through a loss in non-tax revenues of 0.7 percentage points of GDP.

However, it has to be pointed that after 1998 Hungary implemented anti-cyclical policies and changed its government statistics from GFS to an ESA95 basis, so that subsequent analysis is presented here in ESA terms.

The *last* episode of fiscal deficit contraction in Hungary was in 2003, when the overall budget deficit was reduced by 3.4 percentage points of GDP from 2002 and the deficit reached a record high of 9.2 per cent of GDP. The fiscal adjustment achieved in 2003 was an expenditure-type adjustment, as total revenues decreased by 1 percentage point of GDP, but on the expenditure side, the positive aspect was a decrease in total expenditure of 4.4 percentage points of GDP over the previous year. However, analysis of structure shows that the cut did not affect current expenditure severely, which fell by 0.6 percentage points of GDP. Analysis of the composition of the cut shows that expenditure on goods and services increased slightly with 0.6 percentage points of GDP, mainly due to a rise of 0.5 percentage points in wages expenditures. On the other hand, capital expenditures were down by 3.2 percentage points of GDP and this contributed most to the decrease in total expenditures.

What can be deduced from this description of the various episodes of overall deficit contraction is that there was *only one* period of sustainable deficit reduction (1995-1997). Nonetheless, it is important that over the entire analysed period Hungary managed to decrease the presence of the state in the economy as perceived through the level of primary expenditure with more than 10 percentage points of GDP (GFS accounting). However, compared with other countries in the panel of OECD member states, Hungary is still perceived as having a high level of government presence among the middle-income countries.

According to published findings, the post-1995 budget deficit adjustment was successful and sustainable, changing all expenditure parameters conducive to an overall sustainable spending reduction. Figures for the primary deficit over the 1994-6 period show it adjusting by over 1.25 percentage points of GDP. This is consistent with the findings of Purfield (2003) that the cyclically adjusted government balance increased by more than 1.25 per cent of cyclically adjusted GDP in two consecutive years (1995 and 1996). Moreover this was an expenditure-based adjustment, for total revenues over the 1994-6 period fell by 5.1 percentage points of GDP, while total expenditures fell by almost 10 percentage points. This is again consistent with the findings of Purfield (2003) that over 60 per cent of the improvement in the cyclically adjusted budget balance was due to primary expenditures. Finally, the literature suggests that a successful, sustainable, expenditure-based adjustment rests on reducing expenditure on goods and services (notably wages) and on transfers and subsidies, but without affecting capital expenditure. Here the success of the post-1995 adjustment was prolonged up to 2000 (except in 1998).

Thus, the expenditure with goods and services decreased continuously since 1995 until 2000 from 10.8 per cent of

GDP in 1994, to 8.3 per cent in 1995 and then steadily up to 7.1 per cent of GDP in 2000. Moreover, inside this group of expenditure, the spending on wages in the public sector decreased as a per cent of GDP almost one percentage point of GDP, from 4.5 in 1994 to 3.9 in 1995 and was stabilised around 3.5 per cent of GDP up to 2000. In the same time, capital expenditure were adjusted downwards in 1994 from 6.1 per cent of GDP to 4.1 per cent of GDP and were kept hovering around this level up to 2000 when they recovered to 5 per cent of GDP.

The episode in 2002–4 did not follow that consistent, sustainable and successful pattern of fiscal expenditure-based adjustment. For one thing, the government presence in the economy increased. Total expenditure rose by some 4 percentage points of GDP between 2001 and 2002 and then fell by 5 percentage points to the level of 2000, causing a 9.4 per cent deficit in 2002, then trimmed to 6 per cent. However, the new government taking office in 2002 inherited capital expenditures hitherto placed outside the budget framework. These made a big contribution to the budget deficit in 2002, as did recapitalization of the Hungarian Development Bank to cover its losses. According to OECD (2004), almost 3 percentage points of the 2002 deficit came from these.

The only rational course for the budget deficit in 2004 will be downwards – as confirmed by undershooting of the 4.5 per cent target in the first quarter to 3.4 per cent of GDP, due to better tax collection and successful economic growth. This in turn will most probably bring a fiscal deficit adjustment according to the standards of the literature. However, it remains to be seen if this is successful in bringing and sustaining an expenditure-based adjustment. Total revenues between 2001 and 2003 fell by 1.7 percentage points of

GDP and total expenditure by 0.5 percentage points of GDP.

So analysis of the expenditure does not point to a sustainable expenditure-based adjustment, for the mentioned reasons that expenditure on goods and services increased by 1.8 percentage points of GDP between 2001 and 2003 and this increase was found even in 2003 over 2002. Furthermore, wages continue to increase as a proportion of GDP, even while the government struggles to decrease the overall deficit. The same applies to transfers, which grew by 2 percentage points of GDP in 2002 over 2001, were cut in 2003, but reached in 2003 a level higher than in 2001 by 0.5 percentage points of GDP. Finally, the adjustment in the last year was done almost exclusively on the back through capital expenditure. Excluding the hike in 2002, capital expenditures were cut in 2003 below the level achieved (an average of 4 per cent of GDP) up to 2002 and were forecast to return to this threshold in 2004.

To sum up, the only successful fiscal adjustment in Hungary was the expenditure-based one in 1994–6. The present fiscal contraction is not an expenditure-based adjustment and there are no aspects of it to justify classing it as a successful adjustment. The next two sections examine the impact of these fiscal-adjustment episodes on economic growth and to understand to what extent the political economy had any impact on the evolution of the fiscal adjustments.

2) THE MACROECONOMIC FRAMEWORK

There is a substantial literature reporting on studies of the effect of fiscal policy and adjustments on macroeco-

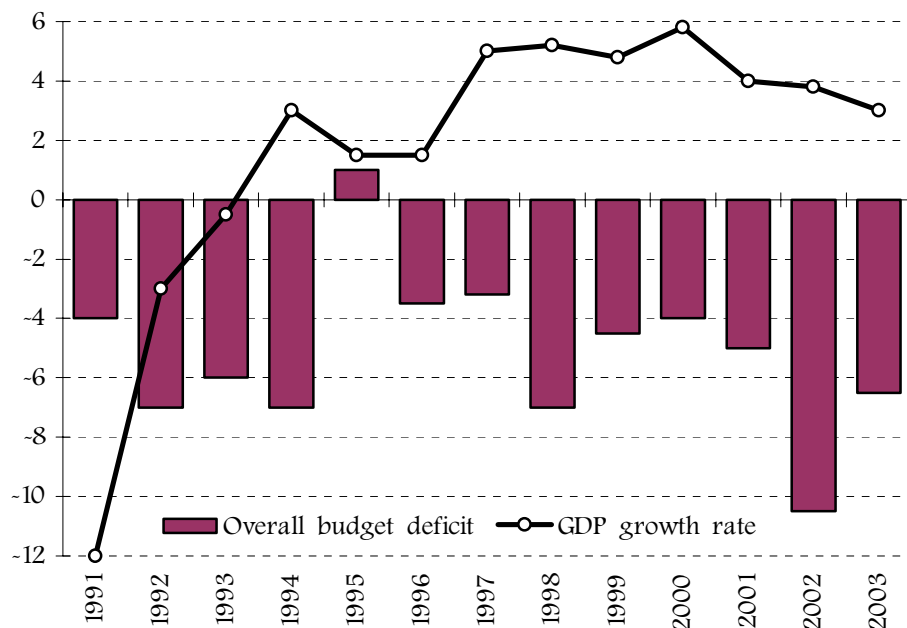
economic performance, particularly economic growth and attempts to model these. On a more intuitive level, large government, expressed in terms of total government expenditure, has an impact on economic development for at least three reasons. (i) Much public expenditure for delivering public services seems to waste resources, as it could have been employed more effectively elsewhere. According to OECD (2004), a large public sector accounting for about a fifth of total employment⁴ signifies scope for economic growth, as a large public sector accentuates the inefficiency in the economy as compared with a smaller one. (ii)

Figures for Hungary show that a large chunk of total expenditure goes into welfare transfers and subsidies, which points to distortion in the factor market by this policy, especially in the labour market. According to OECD (2004), one explanatory factor is housing benefit, which distorts labour mobility. (iii) Financing such high levels of expenditure calls for high taxation, which in turn distorts especially the labour market through increased labour costs, and so reduces international competitiveness.

The literature from OECD countries concentrates mainly on the effects of larger government, through taxation, on investment and hence on lower economic growth. Alesina *et al.* (2001)

showed that there is a ‘non-Keynesian’ effect of fiscal adjustment. Their main conclusion is that in OECD countries, an increase in public spending raises labour costs, which reduces profits and therefore investment. The magnitude of this effect is significant, as an increase of one percentage point of GDP in primary expenditure is conducive to a decrease in investment of 0.15 percentage points of GDP. Perotti (2002), on the other hand, shows that the effects of fiscal policy on GDP have become substantially weaker over time, so that positive government spending multipliers greater than 1 tend to be an exception.

Figure 1
Hungary’s GDP growth rate and overall budget deficit, 1991–2003



The picture in the transition countries is mixed, according to Purfield (2003). On the one hand, the macroeconomic indicators tend to improve significantly following episodes of successful fiscal adjustment. Indeed, results for the transition countries show that the inflation rate declined substantially and there were some improvements in the current-account balance as well. On the other hand, Purfield considers it difficult to attribute the rebound in growth to successful fiscal consolidations; there

⁴ Hungary’s public sector employs about 820,000.

is a significantly greater probability that it was produced by reorientation of expenditures from less-productive sectors, as Kornai (1994) suggested.

In Hungary, during the one recognized episode of successful expenditure-based fiscal adjustment, GDP growth speeded up considerably in the second year after the adjustment and high rates of about 4 per cent of GDP were maintained. However, compared with the year before the adjustment, the economic growth rate lost about 1 percentage point of its increase rate.

In 1995, slower economic growth was accompanied by faster inflation (28 per cent as compared to 18.8 in the previous year), while the current-account deficit improved from 5.6 per cent of GDP in 1994 to 2.54 per cent in 1995. The low current-account deficit was maintained in 1996, but increased to 4 per cent as growth recovered in subsequent years. It is also interesting that the slower economic growth in 1995 than in 1994 was mirrored by a decrease in real terms of household final consumption, with around 8 per cent. This finding is consistent with an adjustment of 2 percentage points of GDP in subsidies and transfers.

To sum up, fiscal adjustment in 1995 reversed the economic growth trend, but as this was not manifested until two years later, other factors must have had more influence on efficient allocation of resources at that time. In the present situation with fiscal adjustment, the preliminary macroeconomic data for 2003 reflect a mixed picture. Economic growth eased by 0.6 percentage points and data for the first quarter of 2004 show a stronger increase of 4.3 per cent. So the cuts in the fiscal deficit did not really influence economic growth, as they did not really affect the fundamentals of economic growth – the capital and labour markets – through the costs of these two factors. Yet data for 2004 show a target overshoot in the first

quarter. Meanwhile the inflation rate is on a decisive downward trend and the fiscal adjustment will probably help a rapid process of disinflation, unlike the decisions in 2001 and 2002, which stoked inflation by increasing household consumption.⁵ As expected, the current-account deficit is rising compared with 2002 due to increased household resources available for final consumption. So in a country like Hungary where margins for economic growth come from various sources, it is hard to gauge the contribution, if any, of fiscal adjustment.

3) THE POLITICAL ECONOMY OF FISCAL ADJUSTMENT

The success of fiscal consolidation in 1994–6 and subsequent improved economic performance in Hungary up to 2001 are to some extent explained by constant and determined pursuit of a programme of macroeconomic stabilization initiated as early as 1994 by the Ministry of Finance. This process included transformation of the budgeting process (preparation, legislation, and execution), for instance by introducing a treasury system. At first glance, this change in the institutional design of the budget process, due to a transformation of the structure of revenue and expenditure necessary in a changing economic and political environment, should have rendered the budgetary process insensitive to factors of political economy (*i.e.* institutions).

The literature suggests there is a strong relationship between the institutional design of budget processes and

⁵ There are three reasons for the overshoot of the budget-deficit target in Hungary in 2002: doubling of the minimum wage in 2000, a 50 per cent increase in wages in the public sector in 2001–3, and one-off operations (share acquisitions and debt adoptions).

aggregate fiscal performance. Several empirical studies have supported the view that budget institutions have an impact on fiscal outcomes (von Hagen 1992; Alesina *et al.* 1996). The underlying idea is that spending can be targeted to particular constituencies, whereas revenues are centralized and residually determined, so that politicians have an incentive to internalize the full benefit at only a fraction of the social costs of an increase in spending directed to their own specific constituency. Due to this negative externality, the individually rational strategies generate budgets that are sub-optimal from the perspective of the group. The literature suggests that both centralizing fiscal authority and cooperative bargaining are conducive to overcoming the inefficiency and so able to promote fiscal discipline (von Hagen 1996 and 1998).

In a study on budget institutions and fiscal performance in CEE countries, Gleich (2003) demonstrates that budget institutions in all these countries have had a significant effect on the capability of governments to gain control over public finances during the transition. He concludes that the politically more sensitive budget preparation and authorization stages, in which most of the political bargaining and decision-making occurs, are more important in determining fiscal outcomes than the implementation stage.

These findings may explain the evolution of the budget deficit in Hungary in 2000–2002 and give a hint on whether the present effort at fiscal adjustment will succeed. The then government in 2000 decided on a 100 per cent increase in the minimum wage, which triggered inequalities in the wage grid across economy, mainly felt in the public sector. In the following pre-election year, the government went on to increase public-sector wages, promised substantial capital funds to local government, and raised transfers (mainly social-security benefits). The 2002 elections were won by the opposition social-

ists, who kept their promise to increase public-sector wages by 50 per cent. The effect of this in 2002 was an almost 23 per cent increase in the government wage bill.

Furthermore, new governments in Hungary tend to consolidate budgetary expenditure incurred in the election year by the outgoing government, which swells the budget deficit. The incoming government in 1998 consolidated the expenditures of the pension reform, taking the deficit up to 6.5 per cent of GDP. Discounting such consolidation, deficit levels remained closer to the average for the period.

The influence of politics on budget policy has been pronounced during the term of the present government, as lack of communication between it and the National Bank (under the minister of finance of the previous government) undermined confidence in economic targets in 2003. The market then forced the National Bank into devaluing the currency, as inflation rose, economic growth slowed and the budget deficit persisted. Rostowski (2003) links Hungary's sluggish performance compared with Poland⁶ to the political struggle between two blocs of parties with similar levels of electoral support.

However, the authorities place these events against the background of the transition process. First came macroeconomic stabilization and privatization, producing reallocation that financed subsequent institution building. These steps had social costs, and the final stage was to address consequent inequalities of personal income. According to this argument, Hungary has been stuck in the last stage since 1998. This provides the rationale behind a policy change from encouraging export-led growth to stimulating household consumption, especially

⁶ Rostowski shows that Hungary, during the accelerated economic growth of 1998–2001, ran a budget deficit consistently above 4 per cent of GDP, whereas Poland's was only 2 per cent.

through generous housing-credit subsidies under the last government and wage and revenue increases under both the last government and this.

Thus fiscal policy in Hungary is linked with the political cycle. Since the government is now in mid-term, it will be hard for it to refrain from spending. It will clearly not cut public-sector wages or transfers, so that the adjustable item remains capital expenditure. Some capital expenditure assigned to local government in the run-up to the last elections was short-term and ended in 2003, which helped to slash capital expenditure last year.

4) CONCLUSIONS

Hungary is committed to the 2002 Pre-accession Programme and is working with the IMF on a programme conducive to successful fiscal adjustment. The basic ideas behind this are to introduce three-year rolling expenditure ceilings, as a basis for medium-term budget planning and to move towards performance-based budgeting.

The ceilings make policy more predictable, to allow for efficient planning and offer backing for the achievement of medium-term objectives. However, the IMF warns that this commitment to ‘tie the hands’ of the government may lead to less flexibility and hence less desirable policies to cope with unexpected developments. Moreover, badly set ceilings (for instance, greater than necessary capital expenditure) may delay investment projects and so hinder economic development. On the other hand, the move towards performance-based budgeting should improve transparency and so promote efficient public-service delivery.

The two measures may therefore provide an answer to the problem of the political–fiscal cycle, but only to the extent to which constituencies in Hungary can decide what is the appropriate level of public spending and how to achieve it.

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