Hungary - Country Assistance Strategy

The macroeconomic framework

Hungary's transition from a planned economy to a more market-based environment is now a rather long story full of innovative advances and regrettable slowdowns. Generally, it might be viewed as more evidence of the inherent unsustainability of an ideologically mixed approach which is routinely aimed at the preservation of vast regulations and only piecemeal progress in the promotion of entrepreneurial activity. Due to the very early start of the reform process, Hungary was able to avoid dramatic economic disruptions familiar to other transition economies in 1989-1993 but found itself lagging behind several of them by mid-90s.

Thus, the policy changes instituted in 1995 were unavoidable and instrumental in bringing the economy firmly on the recovery path. Now we see the economic prospects of the country as being much more clear and optimistic. Nevertheless much still remains to be done, and the authorities must be encouraged to further strengthen their perseverance and to fully exercise the rare opportunities provided by public understanding and acceptance of the issues involved.

The 1995 turnaround has been fully appreciated by the markets, and Hungary now enjoys a very comfortable access to the international capital flows which is reflected in the ample opportunities to refinance its debt and in the sizable foreign direct investment. Nevertheless, the external debt servicing requirements are quite high and maintaining the external equilibrium will require a lot of efforts and steady attention. Taking into account the experience of East Asia, "the successful and continuing privatization of external debt" (p. 17) can entail some intrinsic dangers.

It was very much appropriate that the authorities focused their immediate attention primarily on fiscal issues, for fiscal health is a prerequisite of the successful structural reforms. I noticed, in this respect, many important measures such as the establishment of a full-fledged Treasury system, substantial decentralization of the public responsibilities along the principles of fiscal federalism, significant reduction of personnel on the public payroll, and the initiation of the health care reform. All of these steps are to be commended although some aspects may require further rectification.
I would suggest, for instance, to reconsider the existing mode of revenue-sharing, where the localities are virtually free-riders of the centralized fiscal efforts. It would, perhaps, be more consistent in eliminating the existing mismatch between spending responsibilities and power to levy taxes. Such enhanced fiscal decentralization would reduce the scope for centralized wage bargaining, too. This is an important aspect which should be not overlooked when one deals with the complicated issues of public payroll reduction.

To conclude my brief remarks on general macroeconomic policy, I would also suggest more early elimination of the indexation practices. These practices are known to be easy to commence but much more difficult to get rid of. They may entail more extensive politicization of the pension reform debate and bring about some weakening of the fiscal resolve needed for such a crucial accomplishment. I understand that indexation is now a built-in element of many specific policies in Hungary, including the exchange rate policy; in my view, this should warrant yet a more concentrated effort to put a stop to it.

**Bank’s strategy**

As far as particular aspects of the Bank approach -- as presented in the concise and informative CAS paper -- are concerned, I found them appropriately formulated. The proposed strategy duly takes into account the advanced stage of economic transformation in Hungary and identifies the areas where the Bank’s involvement may appear indispensable. The coming accession to the EU would probably render the Bank less competitive if compared with the facilities provided by the EU: therefore we must aim at greater selectivity in CAS.

I strongly welcome the combined efforts of the staff and the authorities which have led to the revitalization of our cooperation. The period of a noticeable worsening of the project implementation seems to be safely over.

I believe that there is an important lesson to be learned from what is explained in para 35 of the CAS paper, namely from the support we happened to lend to an institution clearly opposing the needed reforms. It might be not an isolated instance in a transition country that a public agency tries to pursue its own agenda not entirely corresponding to that of the Government, so we must be rather prudent and judicious in choosing our key partners. In general, it has to be recognized how difficult it is for Governments to implement several major reforms at the same time. Thus I would strongly support the conclusion that both the capacity of the Government to tackle ambitious reform agenda and the capacity of the civil society to accept sweeping changes need to be carefully gauged.

On the other hand, I would be somewhat skeptical about a value of the lesson claimed to be learned in Hungary according to the para 36. It is asserted there that “once political, economic and social consensus is obtained for major policy reform, implementation is strong and comprehensive.” To me, it sounds as a self-evident truth suspiciously close to tautology, and not a major discovery worth mentioning.
I am very supportive of the idea to expand our contacts with sub-sovereign clients, of course, on a very selective basis. All transition economies tend to reach such a stage in their reform when developments on the regional and local levels account for a major part of success or failure. Our bold, albeit prudent, involvement ought to set patterns of correct policies and result in strong incentives to emulate them elsewhere. To this end, it might be appropriate if our lending program which is aimed at assisting secondary cities is given more priority and more funds. I see, for instance, that the road project, unlike the municipal one, is marked as low in terms of strategic rewards expected; it might be advisable to consider some redistribution of resources between them.

It is possible -- and very much welcome -- that our knowledge and know-how would be valued at least at par to, if not higher than, our disbursement power. Therefore, I think we should continue our policy advice and analytical activities in the years to come.

I believe that adjustment of the existing institutions to the requirements of a mature market economy is an overwhelming issue to be addressed by the authorities and ourselves. I assume that this approach will be fully present in the Higher Education Project which is expected to be approved in FY 98. I also assume that the specific timing of the Health Reform Project will allow for a full accommodation of policy lessons stemming from the implementation of the pension reform which I shall discuss in more detail in the final section of my statement.

I would venture to suggest a closer look into the proposed involvement of the Bank in the area of fighting poverty, or "promoting social cohesion" in the wording of the paper. According to the Box 1, poverty is already very shallow in Hungary, and by standards of the immense majority of our clients cannot be termed as poverty at all. It is mentioned that the assessment of poverty incidence is based on the 1993 data which reflect the low of the 1989-1993 recession and may be assumed to be out of date either already or very shortly. Moreover, it is noted by the staff that the unreported economic activity in Hungary may account for at least a third of formal GDP, and various schemes of tax evasion are still pervasive. Thus, formal poverty data tend to overestimate its magnitude. This is not to say that this problem is not in need of an affirmative correction; my point is that the social clusters of poverty are quite identifiable, and the Hungarian authorities might be already relatively well prepared to address this issue. I would agree, however, that it is ultimately up to the authorities themselves to establish their priorities.

PSAL

The paper on the PSAL clearly demonstrates that a thorough pension reform is a timely and urgent task which would crown the reform story in Hungary. It might be asserted that, once the pension reform is successfully completed, the country is no longer in a process of transition. Such a reform would deal with one of the most important among the long-term policies; its effects will be many and economy-wide. Thus, I strongly support the proposed loan.

The whole package seems to be thought over in detail, extensively discussed in the various quarters of the society, and supported by a wide margin. This is, indeed, the major precondition for such a profound reform carried out within democratic framework. The undertaking is based
on the solid experience of extremely strong fiscal adjustment, substantial primary surplus, and the reduction of public debt burden.

One must acknowledge a great deal of preparatory work performed by the authorities. I am truly impressed by their thoughtful, comprehensive, bold, and responsible strategy as revealed in the paper.

I particularly welcome the fact that the pension reform is being developed with a view of the health care reform as well. The two are intrinsically linked, for the health outlays for old and retired constitute one of the most complicated challenges for the public sector. Although the accompanying health care reform is so far not expected to be launched shortly, I would recommend its early preparation in order to harmonize it with the pension one.

Allow me to comment on a few specific aspects of the adopted design of the reform.

First, I am somewhat concerned about a still very high mandatory contribution rate envisaged under reform. Since the incidence of evasion is already on rise, it is doubtful that compliance-enhancing measures alone would be able to alter this aspect of business culture. The high contribution rates are related to the fact that the bulk of contributions will be channeled to the PAYG pillar. Such an approach does not permit the removal of a familiar moral hazard implied in the PAYG system, for participants tend to see their contribution as taxes and not as personal saving. Thus, I am afraid that the proposed contribution rate of 31 percent exceeds levels realistically acceptable for the most contributors. The unfortunate episodes of unexpectedly high Social Security deficits in 1996 and 1997 seem to forcefully prove this charge.

The only way to defuse this time-bomb is to more aggressively tackle the accumulated implicit pension debt. I do not think that a simple refusal to recognize this debt in full when it is transferred to the second pillar is a real instrument of having this debt partially canceled; it would prevent only its conversion from implicit debt to explicit one. What may be suggested is either a more steep increase in the retirement age coupled with trimming of benefits, or stronger fiscal action aimed at the retirement of this debt out of general revenue.

Second, I think we should be more than cautious with the actuarial calculations running through mid-XXI century. They rely on the extremely imprecise estimates of GDP (when the gray economy is assessed to be in a range of 30 percent of formal GDP, prospects of some activities moving from and into this area are very unclear, inflation is still two-digit, and across-the-board policy reforms are still underway, any estimates of GDP growth expressed in tenths of percentage point mean practically next to nothing), and on the basically unchanged patterns of demographic behavior. However, the latter is likely to be affected by the very reform of the pension and health care system. All in all, the approach of having specific numerical targets and indicators established for a period 15 years from now seems to be simplistic. It may be intended to produce a feeling of omniscient preparedness for reform, but may easily backfire when something goes slightly off track.
Third, it may be advisable to expedite further clarification of tax rules surrounding pension contributions and benefits. The simple principle of exemptions for contributions and accumulated income and taxation of benefits is much easier to understand and accommodate. It would be even better, of course, if such a move is accompanied by some reduction, if not outright elimination, of the PIT progression.

Fourth, I am not sure whether the design of pension funds for the second pillar is appropriate enough. The non-profit and self-governing format is surely a legitimate option; however, simply allowing the possibility of fully commercial undertakings like AFP in Chile, and some mixed varieties, would only enhance the menu available to future participants.

I mentioned these concerns only due to the fact that they can be addressed without significant alteration of the reform design and without compromising the project, which I regard as very much exemplary. I expect all other transition countries to monitor closely its implementation in order to draw valuable lessons.