Miklós Losoncz
Research Director, GKI Economic Research Co., Budapest

Hungary's experience with fiscal stabilisation and budgetary consolidation in the 1990s and the 2000s. Lessons and conclusions

The objective of this paper is to analyse Hungary's fiscal stabilisation and budgetary consolidation policies accomplished in the 1990s and envisaged for the next years and to draw lessons from them for Hungary's accession to the EU and the EMU, respectively. In a historical perspective, there were several fiscal stabilisation efforts in the post World War II period in Hungary, but only those programs seem to be relevant at present which were accomplished after the transition to the market economy. Therefore, the first part of the report discusses the fiscal stabilisation efforts of the Hungarian government undertaken in 1995. The second chapter addresses issues related to the preparation of Hungary's access to the Economic and Monetary Union from the point of view of fiscal stabilisation and budgetary consolidation. Budgetary consolidation is an important part of the government's convergence program aimed at Hungary's accession to the EMU. This program was published in mid-May, 2004. There is an explicit relationship between the two programs economic policy decision makers tried to avoid the actual or perceived pitfalls of the 1995 fiscal stabilisation program. The final part of the paper summarises the most important conclusions which may be relevant for the other acceding and other member countries as well.

1. Fiscal stabilisation in 1995

Following the transition to the market economy, the first fiscal reforms organised into an austerity package named after the Finance Minister of that time Lajos Bokros started in March, 1995. It was growing external and internal imbalances that made the introduction of the austerity measures necessary. The current account deficit increased from $3.5 billion in 1993 to close to $4 billion in 1995, accounting for about 9 percent of the GDP. As a result of this, foreign debt jumped from $13 billion to $18 billion in the same time period amounting to 45 percent of the GDP in 1995. With negative real interest rates, the propensity of households to save declined in spite of expanding incomes, and the demand for money surged in the fairly overheated economy. The general government deficit reached 11 percent of the GDP in 1994, the government debt exceeded 80 percent of the GDP in 1993 and 1994. The burdens of debt service (interest payments and amortisation of loans) narrowed the room of manoeuvring of the private sector through crowding out. In addition, the Hungarian government failed to sign the stand-by agreement with the International Monetary Fund. This had a negative implication to foreign investors with the danger that Hungary would not be able to renew her foreign loans and could not meet her payment obligations in early 1995 (Várhegyi, Éva [2004]). The major external blow came from the Mexican crisis which destroyed investors' confidence not only in Latin America, but in the emerging markets in general, and in Central and Eastern Europe in particular as well.

Table 1.

Figures on Hungary's general government, current account and GDFP-growth

(In percent of GDP unless otherwise indicated)

	General government				Current account balance	GDP growth (percentage change yoy)
Year	**Total outlays**	**Revenues**	**Balance**	**Gross debt**		
1991	56,7	53,7	-3,0	80,1	1,2	-11,9
1992	60,3	53,2	-7,1	82,4	0,9	-3,0
1993	59,8	53,2	-6,6	95,8	-8,9	-0,6
1994	63,4	52,3	-11,0	87,1	-9,5	2,9
1995	56,9	49,3	-7,6	85,2	1,0	1,5
1996	53,9	48,1	-5,9	71,9	0,6	1,3
1997	51,8	44,6	-7,2	63,3	-1,4	4,6
1998	52,8	44,7	-8,0	61,1	-4,7	4,9
1999	50,0	44,4	-5,6	61,2	-5,1	4,2
2000	48,0	44,9	-3,0	55,4	-6,2	5,2
2001	48,5	43,8	-4,7	53,5	-3,4	3,8
2002	51,6	42,3	-9,2	57,1	-3,9	3,3
2003	50.4	44.5	5,9	59,1	-6,0	2,9
2004	48.8	44.2	4,6	59,4	-5,5	3,3
2005	47.5	43.4	4,1	57,9	-5,5	3,8
2006	46.5	42.9	3,6	56,8	n.a.	n.a.
2007	46.3	43.2	3,1	55,6	n.a.	n.a.
2008	46.7	44.0	2,7	53,7	n.a.	n.a.

Source: OECD Economic Outlook, Vol. 2003/2, No. 74, December, Hungary's Ministry of Finance (Convergence program)

The major causes and roots of the austerity package were internal in nature, since external shocks did not exist at the beginning. The Mexican crisis as an external shock deepening the internal one took place later. The increase of economic imbalances was generated and nurtured primarily by the eclectic economic policy of the Hungarian government in 1992 and 1993 intending to achieve the contradictory objectives of promoting GDP growth and combating inflation simultaneously. Economic policy remained hesitant in 1994 and early 1995. Although the real appreciation of the Hungarian currency (the forint) prior to the Bokros package undoubtedly played a part in reducing the rate of inflation, it hampered export growth and pushed up imports, thereby lifting the current account deficit to unsustainable heights. The lowering of the interest rates by administrative means had an adverse impact on savings. The rate of inflation was kept at a low level by postponing energy price rises, with maintaining the subsidisation of household energy prices.

According to the evaluation of the situation made by the newly denominated Finance Minister Lajos Bokros in 1995 the major cause of imbalances was the budget, including the excessive size of the deficit as well as that of the outlays and the revenues of the general government in percent of the GDP and its structure together with the way government institutions worked and were financed (Antal, László [2000]). Therefore, the key to reducing external and internal imbalances was the implementation of comprehensive budgetary reforms.

The decisions aiming at fiscal consolidation included cuts in general government expenditures, the devaluation of the Hungarian national currency by 9 percent against the currency basket, the introduction of an exchange rate regime based on a pre-announced crawling peg devaluation aiming at establishing predictable conditions for exporters, cooling speculation and inflationary expectations, the imposition of a 8 percent surcharge on imports (excluding energy and machinery), the increase of excise taxes, the broadening of the base of social security contributions and the speeding up of privatisation by foreign investors.

The ex post analysis based on a set of financial and economic indicators shows that the Bokros package was basically successful, it helped reduce external and internal imbalances as well as the share of general government revenues and expenditures. The current account deficit dropped by 40 percent in six months. The confidence of international investors was restored in a relatively short period of time by several decisions including the speeding up of privatisation with the involvement of foreigners. Although the growth rate of the GDP dropped from 2.9 percent in 1994 to 1.5 percent in 1995 and 1.6 percent in 1996, the fiscal stabilisation contributed to rapid economic growth in the last third of the 1990s.

Nevertheless, regarding the details, the evaluation of the fiscal stabilisation program is more controversial. The measures undertaken were focused on the revenue side of the budget rather than expenditures. They concerned about 8 percent of general government revenues, and only 2 percent of total outlays, with a 1 percent drop in social expenditures accounting for 5 percent of total social transfers (Kádár, Béla [1995]). The remaining cuts hit the financing of the public sector.

As regards budgetary reforms, the philosophy of the Bokros package was that social benefits given on the basis of inherent rights without differential should be built down or abolished, and only those should be helped by the government who need it because of low incomes or for other reasons. E.g., the payment of family allowances to each family is not justified, only poor families should get access to this type of social benefits. However, the package contained relatively few measures aiming at budgetary reforms directly. (The most important exception was the establishment of the treasury for the implementation of payments in the public sector more efficiently and the further, but not yet complete liberalisation of foreign payments.) The long-term effects of those measures aiming at improving sustainability were erased by the decisions of the Constitutional Court which found the majority of the cuts in general government expenditures unconstitutional from the legal point of view and therefore nullified them. Another part of the measures relating to social expenditure were abolished later by the new government which took office in 1998.

Most of the planned and accomplished decisions aiming at reducing budgetary expenditures faced strong social resistance. In addition, no consultation took place with the trade unions and the professional organisations nurturing the suspicion of reform dictatorship In spite of their rather limited size, cuts in social and government expenditures transformed budgetary imbalances to social tensions since, first, the efficiency of public institutions deteriorated because of under-financing, second, the lion's share of the burdens were shifted to low income strata, thereby weakening social cohesion, but extreme social conflicts were avoided. The non-budgetary measures aiming at fiscal stabilisation fuelled inflation, with a subsequent reduction of pensions by 12 percent and wages by 5 percent in real terms.

Most of the fiscal measures introduced to restore internal and external equilibria, like the devaluation and the imposition of a surcharge on imports were of temporary nature, with short-term effects, they were not elements of a sustainable fiscal policy. Nevertheless, they had an impact on the budget, since as a result of the fiscal stabilisation, not only the relative share of the general government deficit decreased in Hungary's GDP, but that of expenditures and revenues as well.

This decreasing trend continued until 2000 based on not only appropriate fiscal and monetary policies, but rapid GDP growth propelled by the international upturn as well. In 2001, the former government began to loosen fiscal and income policy in preparing for the general parliamentary elections in the following year. The loosening continued in 2002 and in the first half of 2003, since the new government did not tightened fiscal and wage and income policies. The loosening was related to political considerations. The former government wanted to collect more votes by boosting household incomes and government expenditure related to social purposes. The newly elected government followed suite by arguing that the promises made during the election campaign should be fulfilled. In addition, fiscal expansion took place amidst unfavourable international conditions, in a cyclical downturn in the world economy.

It should be noted, however, that a significant part of government expenditures did not appear in the budget between 1998 and early 2002, since they were financed by non-budgetary institutions, like the Hungarian Development Bank Ltd. The necessary corrections raised the general government deficit to 9.2 percent of the GDP in 2002. A certain part of this deficit was virtual, since it did not generate purchasing power in 2002. The actual deficit which burdened the budget of 2002 is estimated at 6.5-7 percent of GDP.

2. Fiscal stabilisation and budgetary consolidation in the convergence program of the Hungarian government

2.1. The background of fiscal stabilisation in international comparison

The new wave of fiscal stabilisation began in the second half of 2003 basically as a response to external pressures which were logical reactions to domestic fiscal expansion and its consequences. The deterioration of external and internal imbalances accompanied by economic policy failures weakened the confidence of foreign investors vis-à-vis Hungary which was reflected in adverse exchange rate developments and the withdrawal of capital form government securities. The general government deficit reached 5.9 percent of GDP in 2003, more than 1 percentage point higher than envisaged in the pre accession program of 2003. The current account deficit grew from 3.9 percent of GDP in 2002 to 6 percent in 2003 with net savings of households being close to zero. The exchange rate of the forint became volatile, the annual average exchange rate depreciated in 2003 compared to the preceding year. In order to restore external and internal equilibria, the government cut budgetary expenditures in mid-2003 and early 2004, and raised taxes in the 2004 budget. In addition, the government tightened wage and incomes policies from mid-2003 on. These measures are expected to reduce the deficit by 1 percentage point of the GDP. Without these corrections, the deficit target envisaged for 2004 cannot be achieved.

Because of the negative social perception of the measures of 1995, economic policy decision makers tend to avoid the introduction of budgetary reforms or fiscal measures that may have adverse social effects. In this sense, there is a direct relationship between the Bokros package of 1995 and the present situation. Because of its adverse public perception, also nurtured by certain political forces, the Bokros package is a negative example for the policy decision makers.

As it is well known, the acceding countries (AC-10) joined the European Union with the obligation of becoming members of the Economic and Monetary Union without the need of specifying any definite deadline. Until the formal accession to the euro area, they receive derogation from the rules of the EMU. However, they are supposed to elaborate their convergence programs aiming at achieving the criteria of financial stability as defined in the Maastricht Treaty whose accomplishment are thoroughly monitored by the European Commission. In the AC-10, public finances form the major bottleneck of achieving the convergence criteria, it is the budgetary criteria whose fulfilment appears to be most difficult.

Rather paradoxically, the AC-10 has to fulfil criteria, which are not met by several EU-15 members. Germany, France and Portugal broke the budgetary rule according to which the deficit must not exceed 3 percent of GDP. In November, 2003, Ecofin formed by the finance ministers of the EMU member states did not approve of the application of the excessive deficit procedure as proposed by the European Commission against Germany and France for the violation of the Stability and Growth Pact in terms of allowing budgetary deficits above 3 percent of their GDP. This decision of Ecofin implied the suspension of the Pact. In addition, according to the projections of the European Commission, half of the 12 euro-zone countries will post budget deficits above 3 percent of GDP in 2004 (European Commission [2004]). The violators include the region's three largest countries – Germany, France and Italy – as well as the Netherlands, Greece and Portugal. The European Commission sees only slight improvements for 2005. The rigid implementation of the rule, the tightening of the budget at the bottom of the poor conjuncture , at a time, when there was a surplus in the current account - purely from economic standpoint- really was not justified. The ongoing debates about the future of the Stability and Growth Pact create uncertainty about the objectives of the convergence programs. In other words, why should the acceding countries bring sacrifices for achieving objectives, which may change over the adjustment period.

At present, it is the Baltic States and Slovenia, which meet the budgetary criterion of the Maastricht Treaty. Cyprus, Malta and the Visegrad countries (V-4: Poland, the Czech Republic, Slovakia and Hungary) lag significantly behind. The reduction of the general government deficit would require further decisive measures. The current fiscal deficits in the AC-10 seem to be mainly of structural nature. The size of the automatic stabilisers appears rather limited.

The meeting of the additional criterion of keeping the government debt under 60 percent of the GDP is much easier for the AC-10. Only Malta and Cyprus have failed to fulfil this requirement until recently. Nevertheless, the position of the new member countries is much better in this specific field than that of the EU-15. With enlargement and the need of the AC-10 to join the EMU, the old EU member countries have to face their internal problems of how to interpret or change the rules of the Economic and Monetary Union.

Table 2

Net lending (+) or net borrowing (-), general government
(In percentage of GDP)

	2001	2002	2003	2004	2005
Cyprus	-2,4	-4,6	-6,3	-4,6	-4,1
Czech Republic	-6,4	-6,4	-12,9	-5,9	-5,1
Estonia	0,3	1,8	2,6	0,7	0,0
Hungary	-4,4	-9,3	-5,9	-4,9	-4,3
Latvia	-1,6	-2,7	-1,8	-2,2	-2,0
Lithuania	-2,1	-1,4	-1,7	-2,8	-2,6
Malta	-6,4	-5,7	-9,7	-5,9	-4,5
Poland	-3,5	-3,6	-4,1	-6,0	-4,5
Slovakia	-6,0	-5,7	-3,6	-4,1	-3,9
Slovenia	-2,7	-1,9	-1,8	-1,7	-1,8
AC-10	-4,1	-4,9	-5,7	-5,0	-4,2
EU-15	-1,0	-2,0	-2,6	-2,6	-2,4
EU-25	-1,1	-2,1	-2,7	-2,7	-2,5

Source: European Commission: Economic Forecasts, Spring 2004, p. 131.

Table 3

Gross debt, general government
(As a percentage of GDP)

	2001	2002	2003	2004	2005
Cyprus	64,4	67,1	72,2	74,6	76,9
Czech Republic	25,2	28,9	37,6	40,6	42,4
Estonia	4,7	5,7	5,8	5,4	5,3
Hungary	53,5	57,1	59,0	58,7	58,0
Latvia	16,2	15,5	15,6	16,0	16,1
Lithuania	23,4	22,8	21,9	22,8	23,2
Malta	61,8	61,7	72,0	73,9	75,9
Poland	36,7	41,2	45,4	49,1	50,3
Slovakia	48,7	43,3	42,8	45,1	46,1
Slovenia	26,9	27,8	27,1	28,3	28,2
AC-10	38,5	39,4	42,2	44,4	45,2
EU-15	63,2	62,5	64,0	64,2	64,2
EU-25	62,1	61,5	63,1	63,4	63,4

Source: European Commission: Economic Forecasts, Spring 2004, p. 134.

2.2. Options for fiscal stabilisation and budgetary consolidation

As it is well-known from the economic literature, there may be a trade-off between nominal and real convergence, particularly in the short term. According to this way of thinking, the fulfilment of the convergence criteria of the Maastricht Treaty in general, those relating to balanced public finances in particular rather quickly may impede or delay the catching up process in terms of GDP per capita and may have a negative impact on employment. In other words, meeting the convergence criteria of the Maastricht Treaty requires short-term sacrifices in order to realise long-term advantages in terms of sustainable economic growth. The major argument against rapid nominal convergence is that the less developed acceding countries with lower per capita GDP have to invest heavily in physical infrastructure from public sources in order to speed up the catching up process. They also have to reform their public administration as well as their social security, pension and education systems with additional costs and the increase of their budgetary deficits in the short term.

In principle, a **scenario of rapid access** is feasible, Hungary could meet the deficit criteria by 2006 and join the EMU in 2008, but the risks of a program like this are very high. The cutting of the deficit by some 1.5 percentage points of the GDP annually would impose significant burdens on the economy and society. There are certain areas whose reform needs the co-operation of the political parties now in opposition, since any change can be accomplished only with two third majority voting. At present, the political conditions are not appropriate for the implementation of such reforms, it is not probable that political consensus could be reached over them. In addition, social resistance to reforms, too, is rather strong. There is a major political risk related to the general parliamentary elections in 2006. Before elections, governments are reluctant to cut budgetary expenditures. Therefore, in order to achieve the deficit target, it would be necessary to introduce a fiscal adjustment package following the elections in 2006.

Another weak point of this rapid access scenario is related to the finances of local governments and authorities. It is uncertain whether the deficit in the budget of local governments and authorities can be reduced. With the specific features of the finances of local governments, precise information on the final results could be gained only in early 2007. Even if the budget deficit targets are reached formally, it is not sure that the budgetary position with a deficit smaller than 3 percent of the GDP would be sustainable, and it would be approved of by the European Commission. (However, former government officials maintain the view that negations with officials of the International

Monetary Fund were much tougher than those with people in the European Commission.) According to the rules, it is not sufficient to fulfil the requirements formally, eventually by producing good statistics, since the European Commission insists on sustainable budgetary positions.

A different option is **the scenario of prolonged access** with Hungary's joining the EMU beyond 2010. However, a rather long adjustment period with gradual — and probably controversial — improvements in the general government deficit may also be harmful, at least under the present Hungarian circumstances in which foreign capital, invested primarily in government securities, covers and finances the major part of the deficit in the budget and the current account. If the transition period to the EMU is too long, the negative reactions of foreign investors in general and convergence players in particular to the dragging consolidation process may impose more severe adjustment requirements on Hungary in terms of pressing down external and internal imbalances than those included in a credible convergence program. In other words, international markets may enforce more radical adjustments in the budget and the current account than it would be necessary under a realistic and credible convergence program.

This scenario of prolonged adjustment and access to the EMU may occur in response to the decision of the European Commission, if it gives derogation from the 3 percent budget deficit requirement to the AC-10 as it has been hinted at by Commissioner Pedro Solbes recently. It is not known whether or not the old member states share this view. Nevertheless, this formula would most probably result in the postponement of Hungary's accession to the EMU with similar reactions of the financial markets as described above. The only difference is that financial markets might be more empathic in this case with somewhat milder responses.

According to empirical evidence, fiscal policy does not work in an isolated environment, it may receive **support from the other elements of policies promoting fiscal stabilisation**. Rapid economic growth, too, may broaden the room of manoeuvring of fiscal policy to dampen general government deficit expressed in percentage of the GDP. The individual convergence criteria of the Maastricht Treaty are closely interrelated with each other. Exchange rate stability and convergence in inflation rates and interest rates may have a significant impact on the outlays and the revenues of the general government. On the other hand, fiscal adjustment, too, is an important precondition of meeting the other criteria. According to past experience, fiscal restrictions may result in the improvement of the general government budget, but at the same time they may shift imbalances from the general government to other areas of social life with declining quality and level of various social services, etc. Based on this "systemic approach", the optimal way leading to the EMU should be elaborated.

The meeting of the budgetary requirements impose limits only on the size of the general government deficit expressed in percent of the GDP. The autonomy of the fiscal policy is preserved as regards the internal proportions of general government expenditures and revenues. As regards Hungary, the size of the general government deficit in percentage of the GDP is lower than that registered by the official statistics if the contributions to the private pension funds (instead of to the pay-as-you-go social security system) are included in public finances. They equal to some 1 percent of the GDP annually, and they should be deducted from the general government deficit, since they represent a revenue loss in the budget and they do not generate additional demand in the economy. However, with the decision approved of lately by Eurostat, this deduction is not allowed. The deficit adjusted for by the impact of the pension reform will be below 3 percent of the GPD from 2006 on.

The size of total tax revenues in percent of the GDP is not extremely high in Hungary by international standards, it slightly exceeds that of the EU average, but it is higher than the concomitant figure of the USA or some other countries with similar per capita GDP as Hungary. It should be noted, however, that with the inclusion of the black or the grey or the unobserved economy, the actual volume of Hungary's GDP is about 20 percent higher than that pointed out by official statistics (Akar, László [2004G, p. 80). The revenues produced in the unobserved economy are transferred to legitimate consumption or financing source of business investments. This implies that, on one hand, the share of tax revenues in GDP is more favourable by international standards, on the other one, tax burdens are allocated in the economy rather unevenly, since those involved in the unobserved economy do not pay taxes. The "whitening" of the unobserved economy may help push down the tax burdens.

These factors are not considered in the evaluation of budgetary consolidation. It is justified to assume that the state of affairs is similar in the other acceding countries as well, although the size of the unobserved economy may be different.

An additional challenge is that in its present form, the Hungarian budget is not able to treat asymmetric shocks efficiently. The main reason for this is that automatic stabilisers are rather weak. Consequently, discretionary measures should play a great role in responding to asymmetric shocks.

The macroeconomic impact of the budgetary consolidation depends primarily on the ways and means as well as structural features of the reduction of the general government deficit. With declining yield curves, the decrease of interest payments could contribute to diminishing the deficit. The degree of the drop in the yield curves depend to a large extent on trends in the rate of inflation, the growth path selected as well as the confidence of foreign investors. The fall in interest payments does not have any adverse impact on economic growth. However, the general government deficit will be reduced in the near future by improvements in the primary balance (excluding interest payments).

The impact of the improvement of the primary balance on economic growth will depend partly on the magnitude of the change and partly on the effects of expenditure and revenue policies. The most favourable way of reducing the general government deficit is to combine cuts in expenditures with tax reductions. Tax reductions are assumed to generate additional growth in the economy. If this is not the case, and tax reductions will not be implemented, or even taxes will be raised, cuts in budgetary expenditures would lead to losses in economic growth through a decline of demand. Another way of pushing down the general government deficit is to introduce changes in the structure of expenditures. The replacement of certain items in expenditures by others, like those financing the running of businesses by those serving public investments, e.g., in infrastructure, too, generate growth through the expansion of demand. On the other hand, if expenditures financing infrastructural investments are shortened, the result could be loss in economic growth (GKI Economic Research Co. [2004]).

In the balanced or **optimal scenario**, the most appropriate year to meet the budgetary deficit criteria could be 2007 or 2008 with the accession to the EMU in 2009 or 2010. In this scenario, the problems associated with the elections to be held in 2006 could be eliminated, therefore this scenario is in line with political cycles. According to this scenario, general government deficit should be cut by 0.5 percent of GDP annually. The gradual drop in the general government deficit could create the conditions of tax reductions and the increase of investments. The consolidation losses could be minimised if the necessary reforms and rationalisations in general government expenditures could take place, even at least partially.

According to the government, Hungary should join the EMU in 2010. By that time the convergence criteria defined by the Maastricht Treaty can be met without significant economic losses. However, the possibility of an earlier accession cannot be excluded either if the appropriate conditions are established sooner.

The most important fiscal policy objective of the government’s convergence program is to reduce the size of both the deficit and the general government (Government of the Republic of Hungary [2004]). In 2004, the deficit is projected to be down by more than 1 percentage point of the GDP to 4.6 percent. The primary balance will improve by 1.5 percentage points, with a strong restriction of demand. The primary balance will further improve in the subsequent years, therefore a moderate demand restricting effect will remain in force in the medium term. By reducing aggregate demand, fiscal policy is expected to contribute to disinflation.

As a result of the income policy allowing to grow real wages and salaries in line with productivity growth, wages and salaries will grow moderately. By holding back the increase of the tax base, this would result in a reduction of the share of tax and tax type revenues of the general government in GDP as well. However, the changes introduced in the tax system in 2004 will mostly offset this impact, and the revenues/GDP ratio will drop only slightly compared to 2003. Thus, the improvement of the balance will be the result of the more than 1.5 percentage points fall in the expenditures/GDP ratio. The reduction of the redistribution ratio includes the impact of the government decisions taken early 2004, on expenditure cuts amounting to approximately 1 percent of GDP.

The ratio of tax and tax type revenues of the general government will decrease by 0.5 percentage points from 2005 annually, falling to 37 percent in 2008 from the present 39 percent figure. With EU transfers raising both budgetary revenues and expenditures, the revenue/GDP ratio will not change, but excluding them, the centralisation ratio will be down by more than 2 percentage points by 2008. The general government deficit will diminish with the reduction of the expenditure/GDP ratio. The restructuring of expenditures will allow for approximately 2 percentage points cut in the expenditures/GDP ratio by 2008 (more than 4 percentage points without the EU transfers).

3. Conclusions

Empirical evidence shows that in the 1990s, Hungarian governments were fully aware of the necessity of introducing reforms in public finances. The propensity to implement fiscal stabilisation and budgetary consolidation has gained momentum under internal and external pressures. Internal pressure was generated by eclectic and inconsequent economic policies. External pressures were related partly to financial crises in other parts of the world being beyond the scope of influence of domestic economic policy. At present the major external pressure and disciplining force include the fulfilment of the convergence criteria as defined by the Treaty of Maastricht.

Fiscal stabilisation accomplished in the mid-1990s proved to be partially successful. It brought fruits in the short and at least in the medium term, but not in the long term. The main reason for this is that fiscal stabilisation policies failed to address the basic issues of sustainability properly. The measures accomplished contributed to the reduction of general government deficit by raising revenues through devaluation, the imposition of an import surcharge, etc., rather than structural reforms relating to both revenues (tax reforms) and expenditures (the reform of the welfare state).

The experience of the austerity program of 1995 shows that budgetary consolidation should be accomplished carefully, since restrictions in public finances may transform the general government deficit wholly or partly to social deficits and tensions. This holds true particularly for countries with a medium level of per capita GDP.

As regards the evaluation of the convergence program of the Hungarian government, the room of manoeuvring of economic policy is constrained by inflexible Community rules. Apart from the fact that the rules of the Stability and Growth Pact may change in the future, the high share of the unobserved economy in GDP distorts the relative size of expenditures, revenues and the deficit of the general government. Furthermore, the general government deficit would be lower, if contributions to the private pension funds were considered as part of public finances.

There is reason to come to the conclusion that both too rapid and too prolonged convergence in public finances may lead to losses in GDP growth. There must be an optimal path to the EMU which minimises losses in economic growth. The convergence program of the government presents quite credible figures on public finances (with the gradual reduction of expenditures, revenues and the deficit in percentage of GDP). One major exception is that the program reckons with the continuation of deficit reduction process in the election year of 2006.

The convergence program does not contain plans and ideas about the comprehensive reform of public finances. The detailed reform proposals will be elaborated and submitted this summer. The reform should concern three basic issues. The first issue is how to increase the efficiency of the administration, how to run and manage public institutions more efficiently. Second, the role of the general government surplus and deficit in influencing the business cycle should be defined. Third, structural reforms are needed, the role and the functioning of the large redistribution and other systems (social security, pensions, education, public administration) should be redefined and improved. According to international experience, structural reforms may increase the general government deficit in the short run, whereas their fruits appear later.

The convergence program says nothing about the principles of the reforms. First, the question concerning the distribution of burdens between the present generation and the future one should be defined. Second, the principles of the provision of welfare services and benefits should be clarified which is an issue of the choice of values. Lajos Bokros, former Minister of Finance published his views on this not long ago in a book entitled Competition and solidarity (Bokros, Lajos [2004]). There are other concepts ranging from the social market economy to the government ensuring equal opportunities.

According to empirical evidence, the fiscal austerity program of 1995 has raised political resistance against budgetary reforms. This is quite natural, since budgetary revenues are collected from a wide range of social strata, while only well specified social groups benefit from certain types of public expenditures. The expenditure side of the budget is shaped by political games, the final result depends on the bargaining power of the participants. It is understandable that cuts in expenditures generate social and political resistance. In addition, political cycles have a strong impact on general government expenditures. In spite of the efforts made so far, the necessary degree of consensus concerning Hungary's road to the EMU in general and the structural reforms in particular did not emerge among the political parties represented in Parliament on one hand and the major economic participants (employees, employers and the government) on the other one.

In order to create the institutional preconditions of sustainability, some experts suggest that an independent fiscal institution or authority similar to the status of the central bank should be established whose major task would be to keep an eye on financial stability (Benczes, István — Szentessy, Krisztián [2004]). This institution would fix the general government balance which would not be the subject to debate by parliament. However, the parliament would vote on the size and structure of general government revenues and expenditures. The fiscal institution would also articulate the interests of the future generations. As a summary it can be stated that the convergence program is a step forward to the EMU, but the preconditions of sustained public financing should still be brought about. This would certainly increase the credibility of the convergence program.

4. References

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