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Saving Hungary's Finances

Budapest's four-step plan for fiscal alcoholics.

By George Kopits

BUDAPEST—As the global financial turmoil metastasized from the advanced economies onto the emerging markets, Hungary was hit particularly hard. While many other emerging economies had built a war chest of foreign-exchange reserves or adopted a range of sound macroeconomic practices, Hungary's fiscal recklessness since 2001 had left it more vulnerable.

At the time of the 2006 election, the budget deficit peaked at nearly 10% of GDP, the worst fiscal performance in the European Union. Public debt now stands at 66% of GDP, or about €6,300 per capita, more than double the level at the beginning of the decade.

Only in the last couple of years did the left-center government embark on a budgetary correction program as agreed with the EU. But in the current circumstances, the market deemed this move was too little, too late. In early October, foreign investors became highly risk-averse, paralyzing Hungary's market for government bonds.

The country was heading to a full-fledged financial crisis. Swift monetary tightening—the central bank hiked the policy interest rate by 300 basis points on Oct. 22—and international financial assistance helped to avoid the worst. The IMF, in close coordination with the EU and the World Bank, provided Hungary with €20 billion in loans.

Under the arrangement, the government must accelerate its deficit-reduction plans. Budapest introduced a bank-support program to level the playing field with the euro area, whose financial institutions benefit from public guarantees. The budgetary adjustment, consisting of stop-gap measures (mainly a public-sector wage freeze), is helpful for gaining a temporary fiscal respite and for meeting the short-term financing needs of the economy.

Against this background, last month Hungary took a welcome—though hardly noticed—step toward restoring the medium- to long-run sustainability of its public finances. Drawing on similar legislation adopted in other countries and following a yearlong debate among major political parties, parliament enacted a well-designed fiscal responsibility law. The law incorporates the four key elements of a so-called rules-based fiscal framework.

First, the law requires the government to maintain a primary (excluding interest payments) surplus, and to limit in real terms any noninterest expenditure increase to half of GDP growth. These policy rules are intended to reverse the rise of public debt and government spending as a share of GDP.

Second, the law prescribes procedural rules that include the pay-go principle, which requires that every new spending proposal must be matched with an equivalent tax hike or expenditure cut elsewhere. Also, medium-term budgetary planning will help adjust for unexpected spending obligations or revenue shortfalls.

Third, the adoption of international best-practice accounting and reporting standards will improve transparency.

And fourth, an independent, three-mem-

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ber fiscal council, supported by a technical staff, will monitor government compliance with the rules.

The potential usefulness of the fiscal responsibility law for Hungary cannot be overstated. Beyond addressing the immediate concern about the present budgetary imbalance, it sets a clear, forward-looking context for tackling the restructuring of social security, taxation and local government finances—much needed in view of Hungary's worsening demographics and structural rigidities.

Spending responsibilities and revenue sources need to be clearly and fairly assigned among various government levels. Painful entitlement cuts, including pensions, will be necessary to bring the budget under control. This means that the welfare system will have to become better at targeting the needy.

Marginal tax rates must be reduced to encourage work and investment, while at the same time the government needs to broaden the effective tax base. The tax system should be pruned of all its loopholes and complexities.

The passage of the law is an important and promising step, but the proof of the pudding is in the eating. And the ultimate proof of any rules-based framework is its implementation over a full electoral cycle. In this regard, the main right-center opposition party's vote against the law puts in doubt the survival of the framework beyond the next election, which has to be held in the spring of 2010 the latest.

Hopefully, though, Hungary will be able to replicate the successful experience of such countries as Brazil, Bulgaria, Chile, Estonia, New Zealand, Peru and Sweden. Having adopted rules-based fiscal frameworks, these countries have all enjoyed relatively low risk premiums, high growth rates and moderate macroeconomic volatility.

Alternatively, abandoning or diluting the law, as done in Argentina, Ecuador or Venezuela, would obviously lead to a much worse outcome.

Hungary's new fiscal framework is worthy of study in countries that have a comparable track record of fiscal alcoholism, particularly as they face the current financial turmoil. Following a number of past (mostly failed) adjustment episodes, Turkey could benefit from such a framework.

In the euro area, Italy and Greece, currently experiencing a spike in default risk premiums, may want to consider adopting their own, similarly binding rules. Within the envelope of the Stability and Growth Pact, such rules would mitigate the heavy public debt burden that stifles productivity and competitiveness.

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