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What Shall We Do for a More Competitive Hungarian Economy?

Thoughts About the Monograph Competitiveness and Growth *of the Magyar Nemzeti Bank*[1]

Summary
Since 2010 Hungary has implemented a major turn in its fiscal policy which was followed by a fundamental change in its monetary policy resulting in a new era concerning the growth of the Hungarian economy. These changes form the basis of an economy being simultaneously characterised by balance and growth. Over the last six years the position of the Hungarian economy has been improving significantly especially concerning the quantitative aspects of competitiveness, the results of which have been recognized by financial and capital markets in addition to international organizations and the major credit-rating agencies. However, a faster and more sustainable convergence requires an improvement concerning the qualitative characteristics of the economic resources as well. For an outbreak from the moderately developed economic status it is essential to speed up the catch-up process with additional reforms focused on competitiveness. Along with the relevant international best practice and the theoretical background, the new volume of the book series of the Magyar Nemzeti Bank entitled "Competitiveness and Growth" presents also the necessary measures for that "competitiveness revolution".

Journal of Economic Literature (JEL) code: E58, E62, H20, J20, O40
Keywords: monetary policy, human capital, financial stability

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Introduction

What is the key factor to economic growth and performance? What differentiates successful economies from the ones that lag behind? What should be done to achieve economic and social development? – Considered as an independent science, economics has handled this dilemma since it was formed. It is quite telling that Adam Smith's, the father of economics, main work published in 1776 focused on what is behind the nations' economies, what explains if a nation has an abundance or shortage of necessities and convenience goods (Smith, 1776). For more than the last 200 years the question of competitiveness on a micro- and macro-economic level has remained in the centre of attention of both the mainstream and the alternative schools of economic thought.

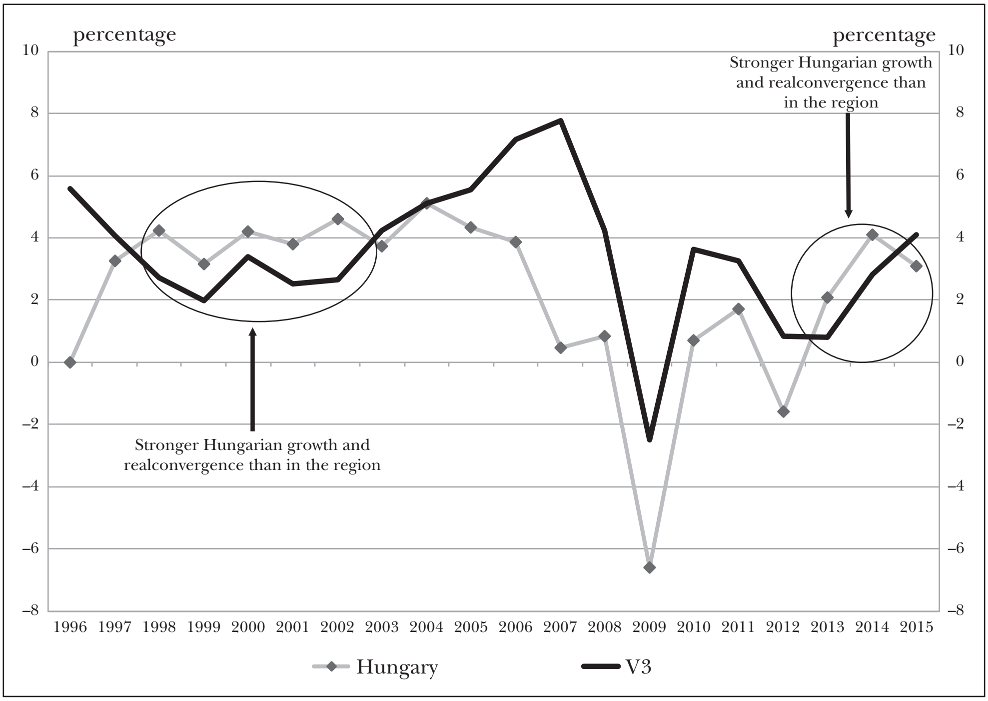
However, in the last decades the approach has become dominant but not predominant in the practice of economic policy that competition and the market themselves create development, and there is no need for state intervention to build up competitiveness consciously. The global financial and economic crisis that broke out in 2008 brought about changes in this respect as well, because it drew attention to the importance and responsibility of the state and to the fact that growth in itself is not sufficient: processes that do not converge with the equilibrium, and are not structurally founded, i.e. unsustainable, and leed to collapse sooner or later. Therefore a real solution may only be constituted by an economic policy offering firm grounds for the whole economy, and ensuring a place in the global competition: in other words it creates competitiveness. This experience was especially true and relevant in countries that were struck hard by the crisis – in Hungary as well among others, where several turnarounds in economic policy had to be implemented to restore stabilisation, economic balance, and to initiate the process of sustainable growth and an effective convergence that yields results.

To cope with the challenges facing Hungary it is essential to improve economic thinking in Hungary, to integrate modern economic approaches that implement and exploit experiences stemming from the crisis and adjusts them to the domestic situation. Having established this as its objective the Magyar Nemzeti Bank (MNB) launched a series of books in 2015 by the publication of Economic Balance and Growth (Matolcsy, 2015), and it went on to publish the monograph Competitiveness and Growth in 2016 as the second piece of this series. The volume that aims to contribute to the public thinking on the subject of sustainable economic growth and competitiveness to promote the government's economic policy (Matolcsy, 2016) – fills a gap, primarily because it does not only facilitate the comprehension of the present challenges by examining theoretical studies and listing global experiences but it also sets 50 actual proposals for measures, which marks a break from the ivory tower attitude so typical of academics. The relevance of the proposals, the justification and timeliness of the volume is highlighted by the fact that the government and the central bank have implemented more than 40 per cent of the proposals.

The further improvement of competitiveness as the effective continuation of the reforms in Hungary after 2010

To fully understand the analyses and the proposals in particular set forth in the volume it is worth looking back to the recent events in the Hungarian economy and economic policy. At the beginning of the 2000s the competitive advantage of Hungary, a country considered number one in the region, had diminished to zero by the end of the 2000s as a result of the irresponsible economic policy and the wrongly structured economic model. Consequently a fundamentally weakened economy had to face the global financial and economic crisis; which economy had already been lagging behind the region by that time. Following the transformation crisis after the political transition Hungary had exhibited a relatively dynamic convergence until the beginning of the 2000s, and as a result the country held a strong position in the region (Figure 1). Subsequently, however, the Hungarian national economy – in spite of the favourable global real economic activity – fell behind the competitors in the region gradually, which is attributable to the applied unsustainable economic model that was fundamentally wrong in its structure and was based on external indebtedness.

Figure 1: Changes in the annual real economic growth in Hungary and the Visegrád region (V3) (GDP, year/year)



Source: Eurostat

The direct impact of the unsustainable model was that the growth in real economy supported artificially from external sources came to a halt in 2007, the employment rate was stuck at a low level, the current account and the budget balance showed high deficit permanently and the public debt rose significantly, which was coupled with the indebtedness of the private sector in foreign currency carrying an outstanding systemic risk (Matolcsy–Palotai, 2016). The serious macrostructural problems stemming from irresponsible and incoherent economic policy became even worse due to the global financial and capital market crisis in the autumn of 2008, and a national economy had to face this crisis which had already been weakened in its economic fundamentals and become unfit for competition.

The turnaround in fiscal and monetary policy after 2010 and 2013 respectively, provided a foundation for the economic growth coupled with balance by creating a healthy economic structure, which is one of the fundamental pillars of lasting convergence. After 2010 there was a sharp paradigm shift in the economy. It marked the start of a new economic policy in its approach and foundations that created an economic model – by gradually strengthening the domestic factors of production through structural reforms – which supports growth and also ensures external and internal macro-financial stability of the national economy. Following the realisation of the fiscal consolidation there was a major turnaround in the monetary policy from 2013. Consistent with its primary mandate, the central bank launched several innovative programmes to stimulate growth and to achieve a well-structured funding supported by the domestic investor base, beside its permanent base rate cut cycle.

As a result of the substantial structural changes the two main branches of the economic policy (fiscal and monetary policy) showed unprecedented coherence, which provided the basis for permanent economic convergence concurrently ensuring economic balance and growth. The results of this successful economic model have been visible for years. In the fourth year of real growth unemployment rate fell to historically low levels, the current account deficit has shown a surplus permanently, the government deficit-to-GDP ratio has remained well below 3 per cent and the public debt ratio has followed a downward path persistently, and foreign currency loans have been phased out of the households' balance sheet that constituted the basis for external vulnerability and hindered growth. Now the macroeconomic results achieved so far have not only been acknowledged by money and capital market participants but also by international organisations and credit rating agencies.

To rise from the moderately developed economic status it is essential to accelerate convergence; and to that end further reform measures need to be implemented that focus on the qualitative aspects of competitiveness. To maintain the results achieved since 2010 and to speed up permanent economic convergence it is imperative to improve our effectiveness and capacity of creating value. To that effect reform measures are required that further enhance competitiveness and favour qualitative over quantitative aspects in increasing resources. The acceleration of convergence in the global race of national economies is primarily warranted by the fact that Hungary regained its previous leading position within the region, as well as the need to escape from the middle income trap: something only few countries in the world have managed to do thus far.

The proposed measures aiming at the improvement of competitiveness, and their implementation up to now

The volume edited by Dániel Palotai and Barnabás Virág containing studies by numerous experts and analysts at the MNB specifies six areas of the multi-dimensional, tightly interrelated competitiveness criteria set while examining its domestic aspects: the competitiveness of employment, corporate sector, the state, human resources, the banking sector and the more effective utilisation of the EU funds. We present below the proposals for measures in the volume through the quantitative and qualitative dimensions of human and physical capital specifically mentioning the actual measures by the government and the central bank that have been implemented since the volume was published.

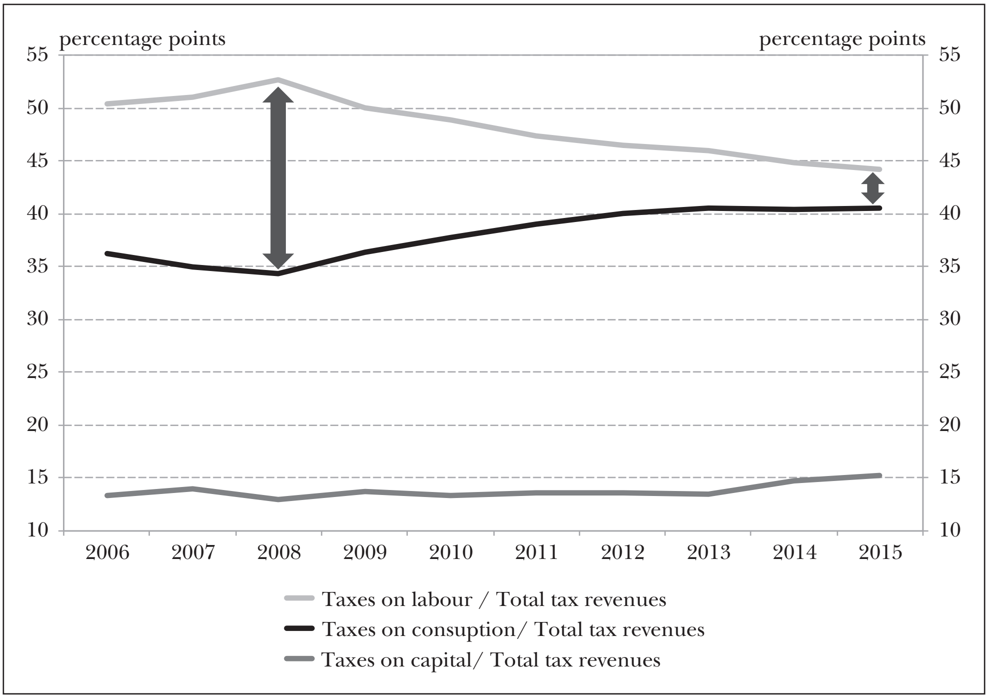
Increasing the volume of human capital

The volume pinpoints the unfavourable demographic processes as the potential obstacle of growth, and proposes measures aimed to mitigate and turn around these processes. One of the pillars of long-term growth potential is the continuous and active availability of the volume of human resources. The volume of human capital is determined by the demographic process typical of the national economy over the long-term. Similarly to the trends in Europe the gradual and permanent decline in the number of population and its aging have been observable in Hungary for decades, and this creates a production limit hindering economic growth seriously in the long term. To remedy this problem the volume proposes the implementation of numerous measures to increase birth rates, fertility rates. For example the expansion of the upper limit of the childcare benefit, the significant increase of the family tax base allowance for families who choose to have a second child, the increase of the one-off state (maternal) allowance after childbirth, quantitative improvement in nurseries and kindergartens, and the establishment of a family friendly workplace environment, promoting its publicity, and the improvement of day-childcare. The further, gradual increase of the family tax base allowance, the family housing allowance, as well as first marriage tax allowance and graduates' childcare benefit encourage young people to start a family and have children.

It is possible to achieve labour market activity and the increase of employment within the whole population through such tax incentives as the reduction of taxes on labour. Although as a result of the reform measures after 2010 Hungarian labour market data improved significantly, they are not outstanding in a regional comparison, therefore the volume suggests further measures should be taken in the area. A measure that would stimulate both the demand and the supply side of the labour market is the reduction of taxes on labour. According to the literature and the recommendations by international organisations (European Commission, IMF, OECD, World Bank) in addition to taxes on capital taxes on labour have a truly harmful and distortive effect on the economy. For this reason it is widely agreed that the transformation of the tax structure is more effective if the balance of tax centralisation is shifted from the taxes on labour to the taxes on consumption that have a less distortive effect. Such a change in the structure lessens the distortive effects taxation has on the economy, it promotes formalising the economy, increases employment, real growth and improves competitiveness over the long term (OECD, 2010). After 2010 the fiscal policy has been following down this path (Figure 2). For example the introduction and the reduction of the flat rate, proportional personal income tax (PIT), – through an increase in net wages – promoted the labour supply on both the extensive and the intensive margins, and it lessened the willingness to underreport income both on the employer's and the employee's part. The MNB's volume supports further cuts of the personal income tax. Moreover, burdens imposed on labour will be reduced by the targeted exemptions of employer's social security contributions implemented earlier within the framework of the Job Protection Action Plan (JPAP) that supports 850–900 thousand employees. The volume also makes a proposition to increase these and to extend the exemptions to more employees. The government decision made in November 2016 fits in this path of tax policy that stimulates competitiveness. According to this, in 2017 employer's social security contributions will decrease significantly from 27 per cent to 22 per cent. Moreover, they will fall further by 2 or 2.5 percentage points in 2018, which may continue in 2019–2022 depending on wage growth. In addition the minimum wage and the guaranteed minimum wage will increase from HUF 111,000 to HUF 127,650 and from HUF 129,000 to HUF 161,250 in 2017 respectively (in 2018 another 8 and 12 per cent increase may be expected). Mutually reinforcing one another, these measures stimulate willingness to take jobs significantly, and may contribute to reduce labour shortage in several settlements and sectors.

In addition to the reduction of taxes on labour other alternative measures may also support the working age population in their willingness to take jobs actively on the primary market. According to the volume these measures include the improvement of the training aspect in the public employment programme and linking the programme to the private sector (providing temporal financial aid to the latter), as well as strengthening certain elements of the pension system that encourage pensioners to stay on the labour market, or stimulating atypical employment (telecommuting and part-time jobs). The fact that the SMEs that undertake to offer part-time employment receive subsidies is closely related to this. Another incentive is that public employment is counted towards the job-seeking period from June 2016 onwards, therefore they become eligible for JPAP allowance. Additionally to increase support to provide incentive to young people who are the least employed (those under the age of 25) to work the government initiated the creation of a multi-step system called National Youth Guarantee.

Figure 2: Changes in the Hungarian tax structure



Note: Eurostat data are available until 2012, data of 2013–2015 are based on calculations made by the MNB
Source: Eurostat, MNB (Matolcsy–Palotai, 2016)

Improving the quality of human capital

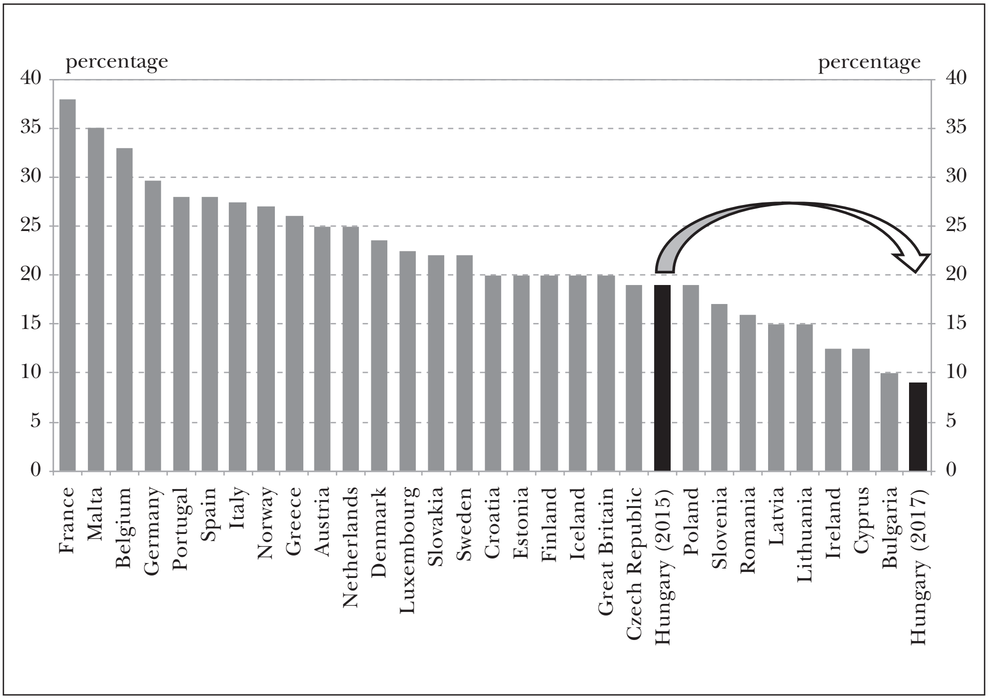
Another significant factor of the successful economic convergence is the high quality of the human resources actively participating on the labour market, which can be ensured by the appropriate quality of education and health care. The improvement of labour quality is able to increase competitiveness and the growth potential of the real economy over the long term through the capacity of innovation and thus labour productivity. This can be achieved primarily by the quality development of education and healthcare services. According to the volume, as state spending on education as a percentage of GDP in Hungary remains below the average of the OECD countries, it would be appropriate to increase the public and private funds spent on education. For example this objective is supported by the introduction of the teacher career path model and the dynamic wage and knowledge development for several years as a part of the programme. Over the long term this supports the improvement of the quality of public education; however to achieve this the structural development of the education is also required. Although the introduction of the dual vocational training system may be considered as significant step forward Hungary is behind with regards to the achievement of basic skills (counting, writing, reading, reading comprehension). The aim of the strengthening of competence- and skill-based curriculum adjusted to labour market needs and the introduction of the 9 grade education is to correct this. The improvement of language skills (in secondary education), and increasing the number of those holding university degrees especially in the field of science and technology, appears as another proposal, which may facilitate the adjustment to labour market needs.

It is concluded that the Hungarian healthcare system struggles with a lack of funding and resources, therefore it would be justified to provide additional resources, and the ideas in the volume see it partly achievable through the involvement of private funds. The volume points out that the health status of the Hungarian population is poor in international comparison: life expectancy at birth is significantly below the level our economic development would suggest. To tackle this effectively strengthening preventive healthcare in Hungary may prove to be a good solution through making regular check-ups more frequent and compulsory, encouragement of sport activity at the workplace and in school (e.g. by reducing the VAT on sports equipment), or raising the public health product tax further. In addition to these "mental health" is an important factor in competitiveness, and every measure that aims to improve the mental state of the public supports this. These measures include the implementation of the elements strengthening mental health into the education programme (e.g. self-awareness, stress management), as well as creating a national network for mental health or supporting telephone counselling services. The creation and implementation of the new National Youth Strategy also serves to strengthen preventive healthcare, which aims at the health promotion of school-age children and young people exploiting the instruments and methods of school social aid.

Increasing the volume of physical capital

Another key factor of creating competitiveness and persistently dynamic real economy convergence is the permanent and yet developed availability of physical capital. From the perspective of competitiveness and further progress the rate of capital accumulation of the corporate sector and its structure are important factors. Basically stability and profitability are required for corporate creditability, which can be supported through the tax system in a number of ways. According to the volume one instrument to achieve this can be the creation of a tax system that promotes productive private investments. In addition, corporate profitability and capital accumulation are supported by the reduction of corporate tax (as income tax) or the simplification of its payment (IMF, 2016), as well as through approaching the corporate income tax towards cash-based taxation. The latter has not been announced, but the former has: the so far progressive – with rates of 10 and 19 per cent – corporate income tax (CIT) is expected to become a flat rate and single-digit system in 2017 (9 per cent, which in turn will be the lowest corporate income tax rate in the European Union), and the conditions to access simplified and preferential small business taxation forms (kata, kiva) will be made easier in 2017, therefore they become accessible for more. In addition, the volume offers setting up a competitive guarantee organisation and the more effective utilisation of EU funds as a proposal, which may promote availability of loans to SMEs from both the demand and the supply side. This might increase employment and economic competitiveness over the short term. The reduction of regulated energy prices is also mentioned in the volume, which has only been introduced in the household sector so far.

Figure 3: The marginal upper rates of corporate income tax



Source: OECD

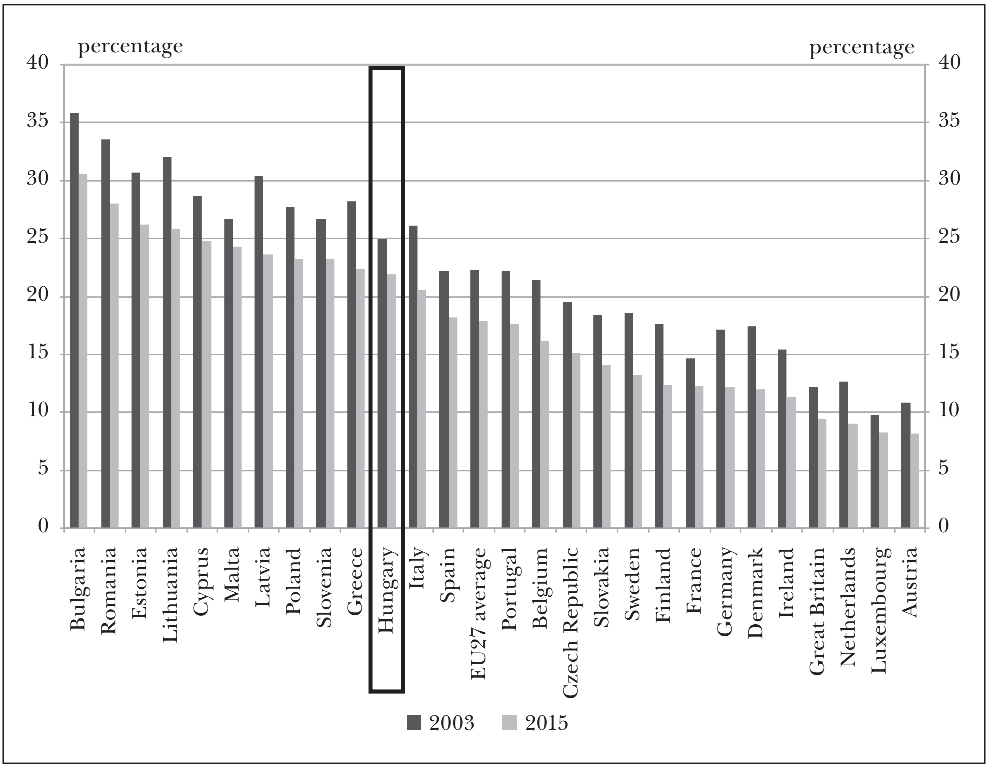
The improvement of the quality of the physical capital accumulated in the corporate sector

The quality of accumulated physical capital, and the effectiveness and productivity on corporate and macro-economic level can be improved significantly by increasing the expenditures of corporations on research and development (R&D). In this respect Hungary is doing relatively well compared to other competitors in the region; however, its performance is below the average in the European Union. Corporate trainings and spreading research cooperations between universities and corporations may provide an effective tool to improve this (EC, 2016). The volume also suggests increasing the number of researchers and developers in a way that would extend the benefit for researchers and developers available in social contribution tax to researchers with university degrees employed in research bases in the corporate sector. The authors point out that in addition to this the innovative capacity of the SME-sector would need to be increased, because the proportion of corporations with successful innovation activity in Hungary is far below the average in the European Union. To close the gap created by this competitive disadvantage the volume proposes setting up non-profit counselling centres as an effective instrument following the English example. A greater proportion of state support provided for R&D activities can be achieved through providing more significant government subsidy to the training of students majoring in the field of science and technology. Research and development can be supported by direct instruments and on the state side.

Reducing tax evasion may have a favorable effect on corporate innovation, which has a positive effect on potential growth through the improvement of productivity (Bobbio, 2016). Tax evasion distorts market competition and the effective allocation of capital, damages fiscal positions, and decreases the social, legal and financial security of employees. With regards to the estimated value of tax evasion as a percentage of GDP (22 per cent in 2015) Hungary is not far off from the competitor countries either, but it exceeds the average in the European Union a little (17 per cent) (Schneider, 2015).

There were several measures created with a view to eliminating the hidden economy in Hungary. As a result, the size of the black economy shrank by more than by 1.5 per cent of the GDP significant budget effect was the connection of online cash registers to the National

Figure 4: The estimated size of hidden economy in European Union member states in 2003 and in 2015

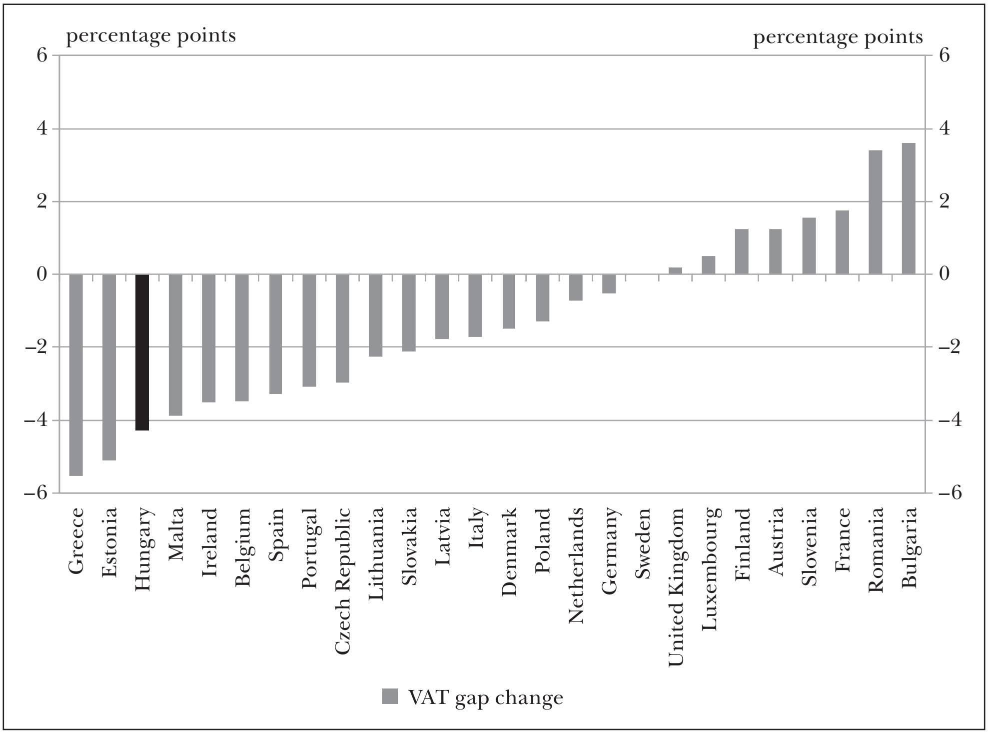


Source: Csomós–Kreisz Hudák, 2015

between 2010 and 2015 (Schneider, 2015). The best-known of these that had the most Tax and Customs Administration (NAV). The number of registers today is close to 200,000, and there will be another 25–30,000 the authority will monitor from 2017. In addition, the introduction of the Electronic Public Road Trade Control System (EKÁER), the targeted VAT-reductions and the application of the reverse charged VAT contributed to the increase of tax revenues from consumption in the past 2-3 years as a result of the reduction of tax rates in numerous cases. These processes and the increase of the estimated implicit VAT-rate by more than 2 percentage points between 2013 and 2015, as well as the steep reduction of the VAT tax gap in 2014 clearly mark the formalisation of the economy (Figure 4). In addition to expanding the group of online cash registers in 2017 the Electronic Public Road Trade Control System (EKÁER) has also been improved since the publication of the volume and the VAT on staple foods will be decreased from 2017 onwards.

The transparent, stable and effective operation of the state is the indispensable condition for the attractive and predictable business confidence required for investments (EBRD, 2016). That is the reason why it is vital that the state should operate a small administration and effective and transparent institutional system. The volume also points out that compared to the European Union the size of the Hungarian state is relatively big

Figure 5: Changes of the VAT gap in EU Member States from 2013 to 2014 (percentage points)



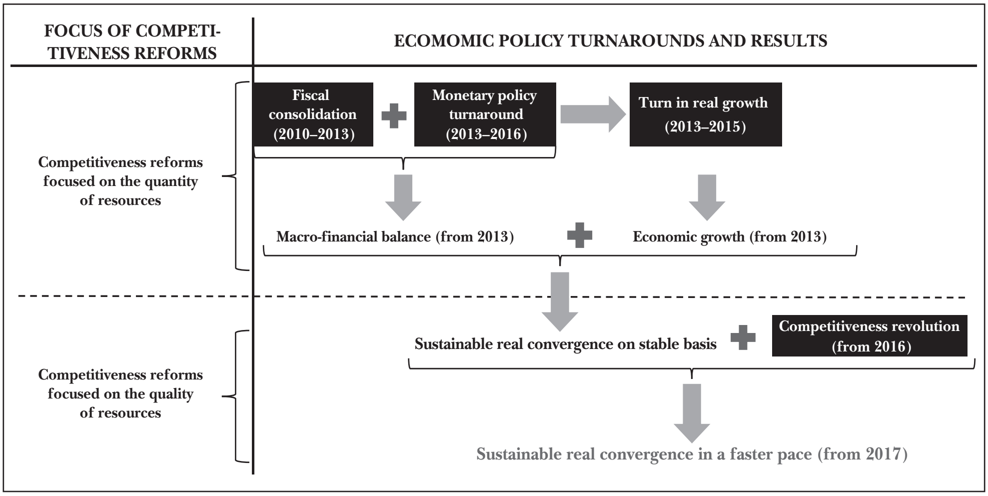
Source: Babos–Kicsák, 2016

and the state spends too much on itself. For this reason it proposes the revision of the number of state institutions, their labour costs and structure. For the latter the volume puts forward the screening of a wide range of background institutions to ministries and eliminating duplicate institutions as an actual measure. After the volume had been published the government announced significant redundancies in the number of public-sector employees; 44 background institutions were closed to cut bureaucracy. It is also worth mentioning that the volume includes the promotion of the culture of compliance as a measure to increase the effectiveness of the state institutional system. Progress may be expected in this area because the government announced the implementation of a new code of criminal procedure to strengthen the independence of courts and to speed up administration.

Summary

In the last six years there have been numerous structural reform measures to stabilise again the macro-financial balance of the Hungarian national economy as it was at the beginning of the 2000s, and to provide a solid basis for a permanent and successful convergence along with a turnaround in growth through the harmonisation of the branches of economic policy. Over the last six years Hungary has been improving significantly especially concerning the quantitative aspects of competitiveness in national economy resources, the results of which have been recognized by financial and capital markets in addition to international organizations and the three major credit-rating agencies. However, a faster and more sustainable convergence requires an improvement concerning the qualitative characteristics of the economic resources as well, and to that end further competitiveness reforms are needed.

Figure 6: Stylized flow chart of the Hungarian economic policy turnarounds and results after 2010



Source: Own compilation

Filling a gap the MNB's volume was published in recognition of this. It scrutinizes the subject of competitiveness and convergence from various perspectives and in a comprehensive manner, and provides an appropriate basis for the detailed analysis of the Hungarian economic environment an competitiveness. Nearly half of the proposals for measures to be taken in the volume is in the implementation phase, which demonstrates how well-grounded and relevant they are.

The collection of studies entitled Competitiveness and Growth edited by Dániel Palotai and Barnabás Virág may be recommended to both future and practising economists, experts working in the area of public finances and those interested in macroeconomy, as well as domestic non-professional readers who wish to obtain a full comprehension of the theoretical foundations of economic developments in Hungary. The volume is available both in Hungarian and in English, so experts from foreign countries and those interested who face problems similar to those in Hungary may find it a useful reading.

Dániel Palotai – Barnabás Virág (eds.): Versenyképesség és növekedés. [Competitiveness and Growth]. Válasz Könyvkiadó, Budapest, 2016, 832 pages.

Note

[1] The study was created partly by Dr Pál Péter Kolozsi within the Wekerle Sándor Közpénzügyi Tudományos Műhely (Sándor Wekerle Public Funds Scientific Workshop), National University of Public Service, Institute of Public Finances.

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