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The Hungarian “Exception”: Lessons in Political Economy

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Outline

- **Background**
- **Broad fiscal trends**
- **Exception 1.0 (in 2001-09)**
- **Paradigm change?**
- **Exception 2.0 (since 2010)**
- **Consequences**
- **Lessons**

Background

Political setting: good news

- **Parliamentary democracy since 1990**
 - Constitutional reform (1990)
 - 5 full electoral cycles (3 socialist, 2 center-right)
 - Institutional progress, occasional backsliding
- **Defining events**
 - Council of Europe, GATT/WTO (early 1990s)
 - OECD membership (1996)
 - EU membership, Single Market, Schengen (from 2004)

.

Background

Political setting: bad news

- **Common denominator**
 - “Goulash populism”
 - Electoral cycle dominates economic performance
 - Zero-sum game
- **Overriding party strategies**
 - Permanent hold on power, clientelism
 - Fiscal sovereignty
 - Maximize scope for social entitlements
with high taxation or borrowing

Background

Mixed progress during the transition

- **Deep reforms in the tradable sector**
 - External liberalization (trade and finance)
 - Domestic liberalization (incl. financial system)
 - Privatization (incl. effective bankruptcy procedures)
- **Slow reforms in the non-tradable sector**
 - Public administration: bloated workforce
 - Social entitlements partially reformed
- **Monetary policy: broadly successful (XR peg; IT)**
- **Fiscal policy: continuous stress, dominant**
- **EU membership → moral hazard**

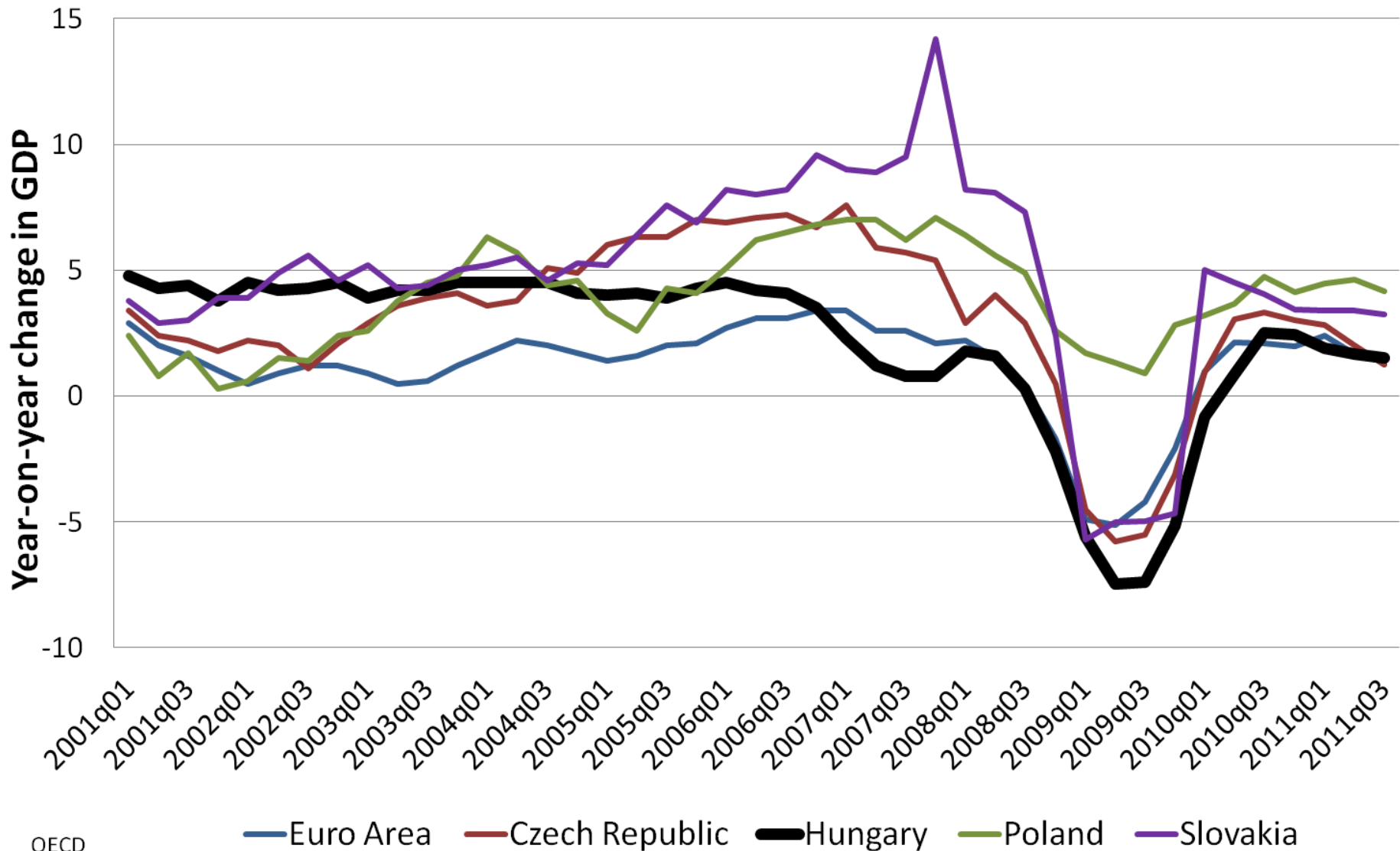
Background

Economic performance

- **Foreign direct investment: very strong at outset**
- **Swings in external performance**
- **Near crisis in 1995 and 2008 (need for IMF stand-bys)**
- **Disinflation into single digits, but some persistence**
- **Marked deceleration in economic growth**

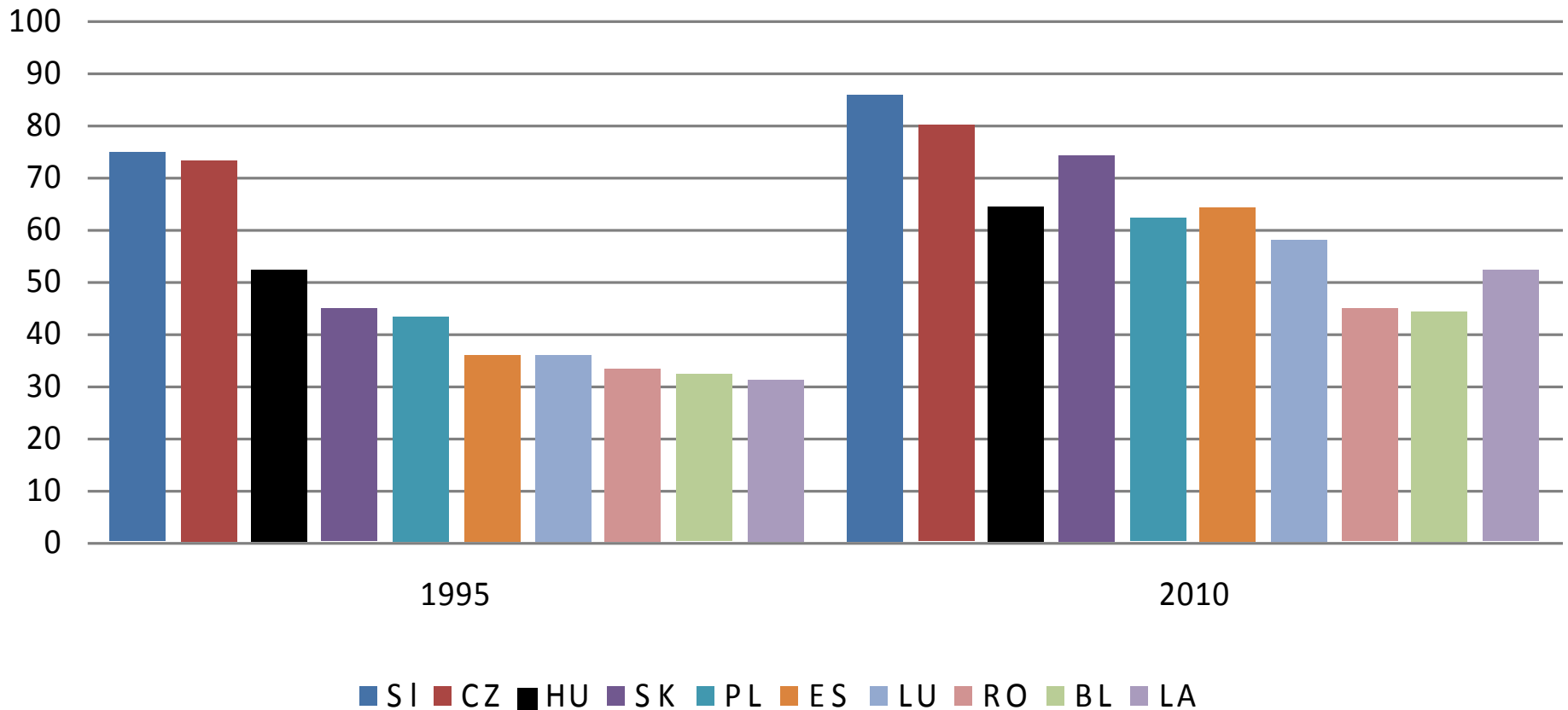
Background

GDP growth



Background

Real GDP per capita at ppp (100 = E U27 average)



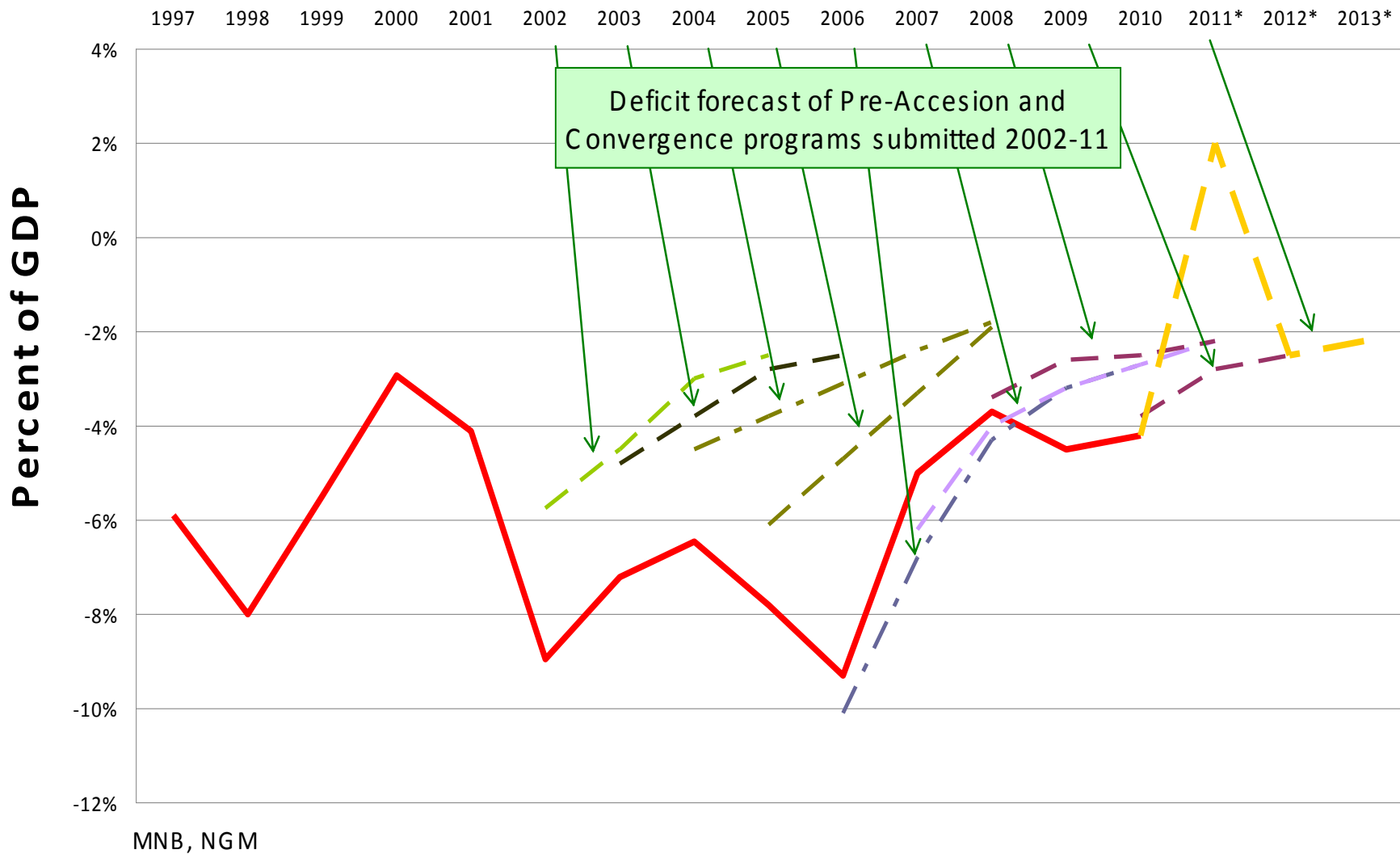
Broad fiscal trends

Distinguishing characteristics

- deficit bias
- time inconsistency
- pro-cyclicality
- debt sustainability problem
- lack of transparency
- non-cooperative with monetary policy

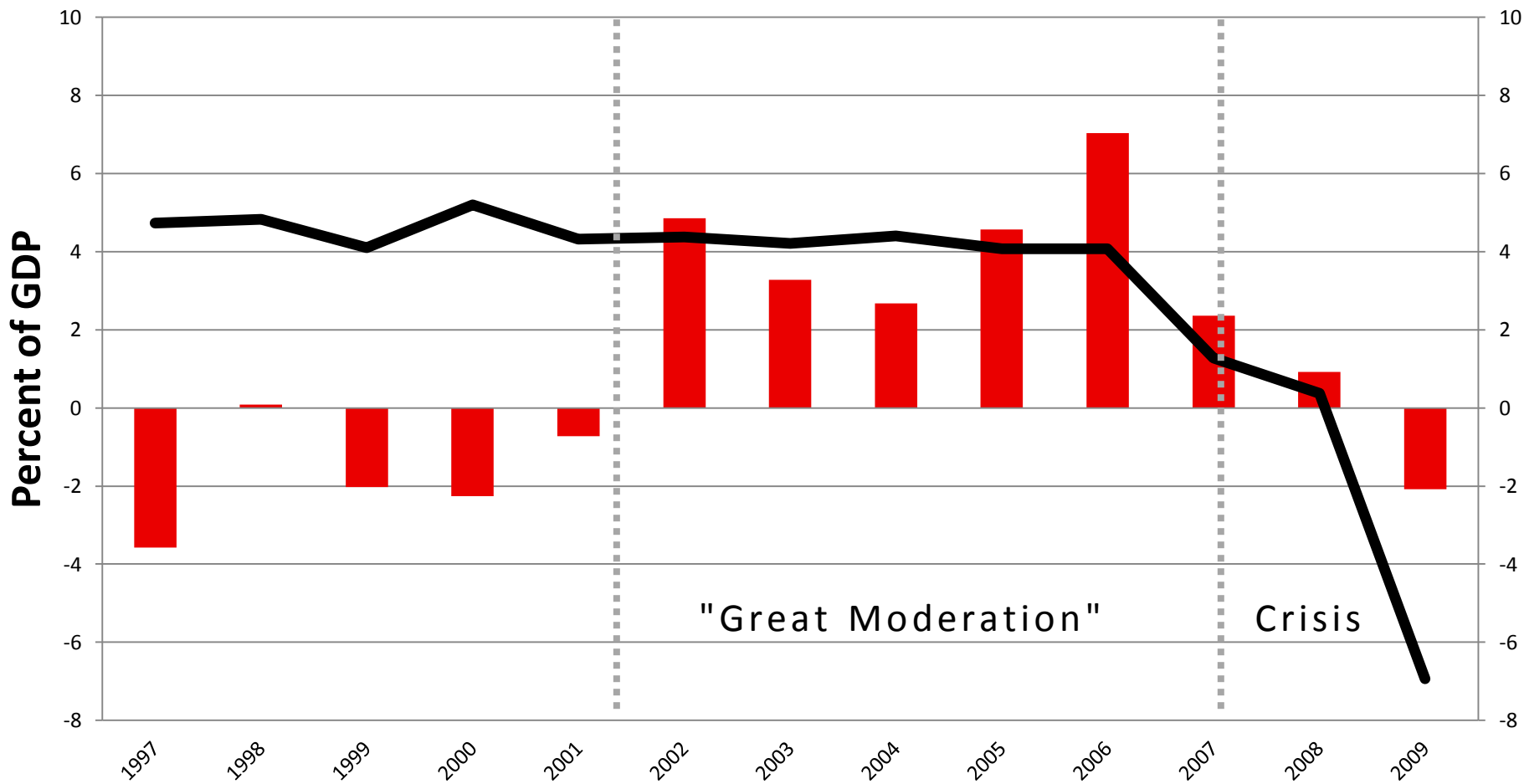
Broad fiscal trends

General Government Balance




Broad fiscal trends

Fiscal Stance: Hungary



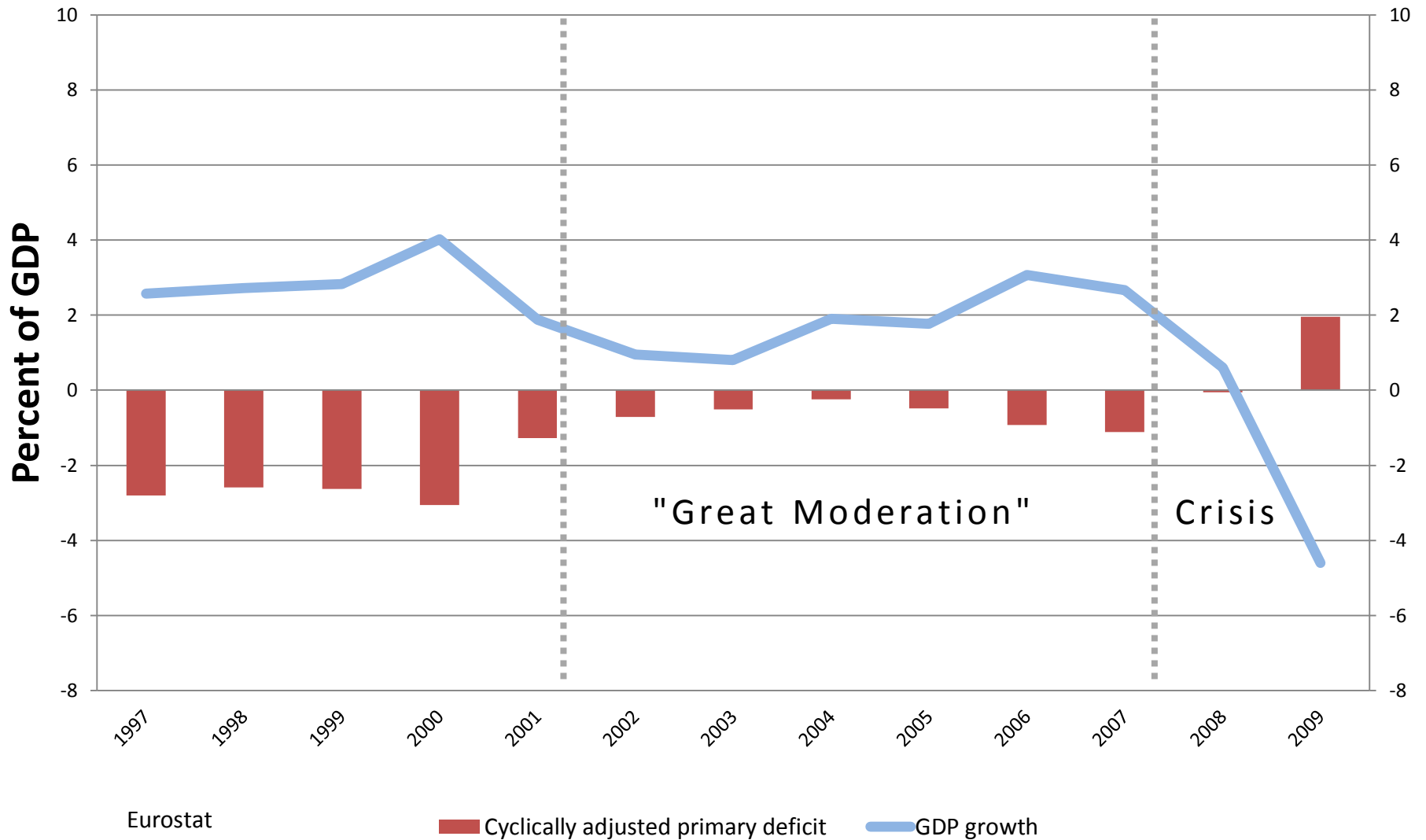
Eurostat

 Cyclically adjusted primary deficit

 GDP growth

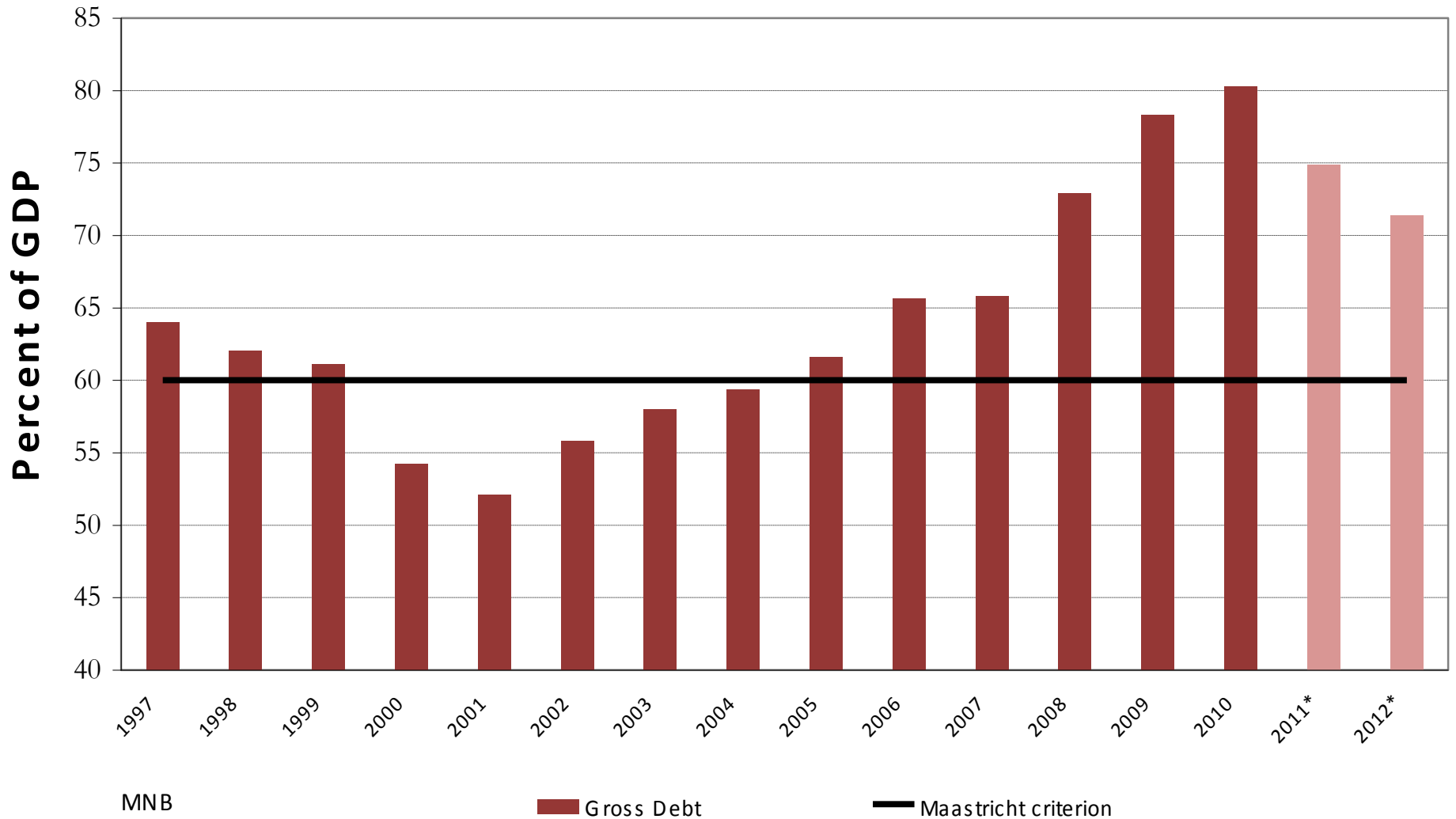
Broad fiscal trends

Fiscal Stance: Euro Area



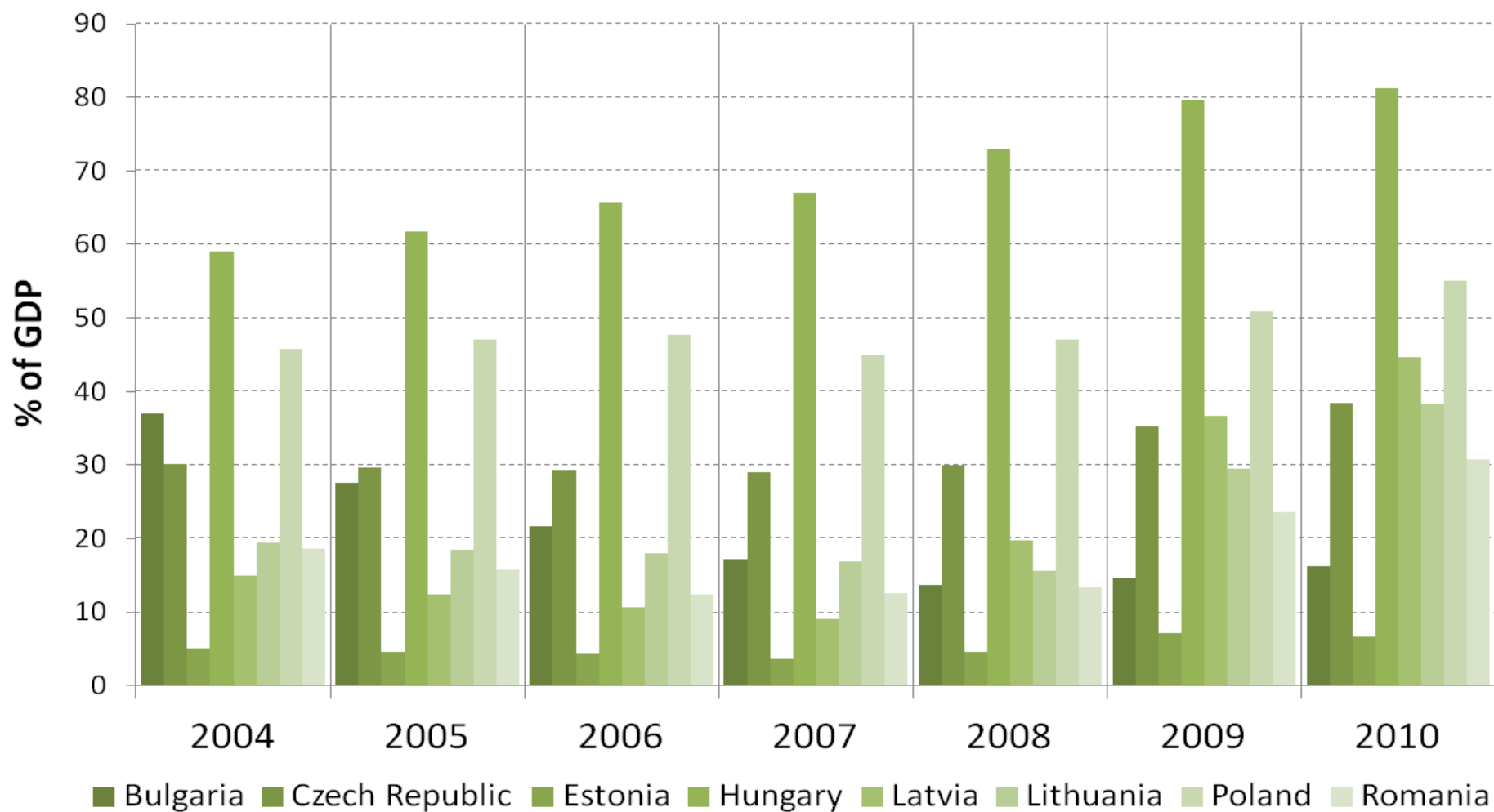
Broad fiscal trends

Public Debt



Broad fiscal trends

Public Debt



Exception 1.0 (2001- 09)

Center-left government

Expansionary stance during “Great Moderation”

- government wage hikes
- public pension hikes
- VAT rate cuts
- conflicts with central bank
- opaque fiscal and regulatory practices

Exception 1.0 (2001- 09)

Center-left government

Contractionary stance during crisis (IMF-EU standby)

- wage and pension freeze
- VAT rate increase
- some streamlining of social entitlements
- rules-based fiscal framework

Paradigm change?

Rules-based fiscal framework (FRL Nov. 2008)

- **policy rules: expenditure limit
debt limit**
- **procedural rules: pay-go rule
MT budgetary planning**
- **transparency norms**
- **independent fiscal institution: Fiscal Council**
- **consistency with EU stability and Growth Pact**

Paradigm change?

Expectations about Orbán government

- **Need to restore policy credibility**
- **No campaign promises, strong majority**
- **Good track record of first Orbán government**
- **EU supportive ahead of Hungarian presidency**
- **Financial markets welcoming**

Exception 2.0 (since 2010)

Center-right government

Unorthodox policy measures

- flat tax, without exempt threshold
- temporary taxes on selected activities
- record VAT rate (27%)
- nationalization of private pension funds
- tax exemption of employer-provided health insurance

Exception 2.0 (since 2010)

Center-right government

Demise of checks and balances

- limits on Constitutional Court on fiscal matters
- sharp cut in judges' retirement age
- political appointment as head of State Audit Office
- *de facto* abolition of Fiscal Council
- reduced independence of Central Bank

Consequences

Vulnerability to crises

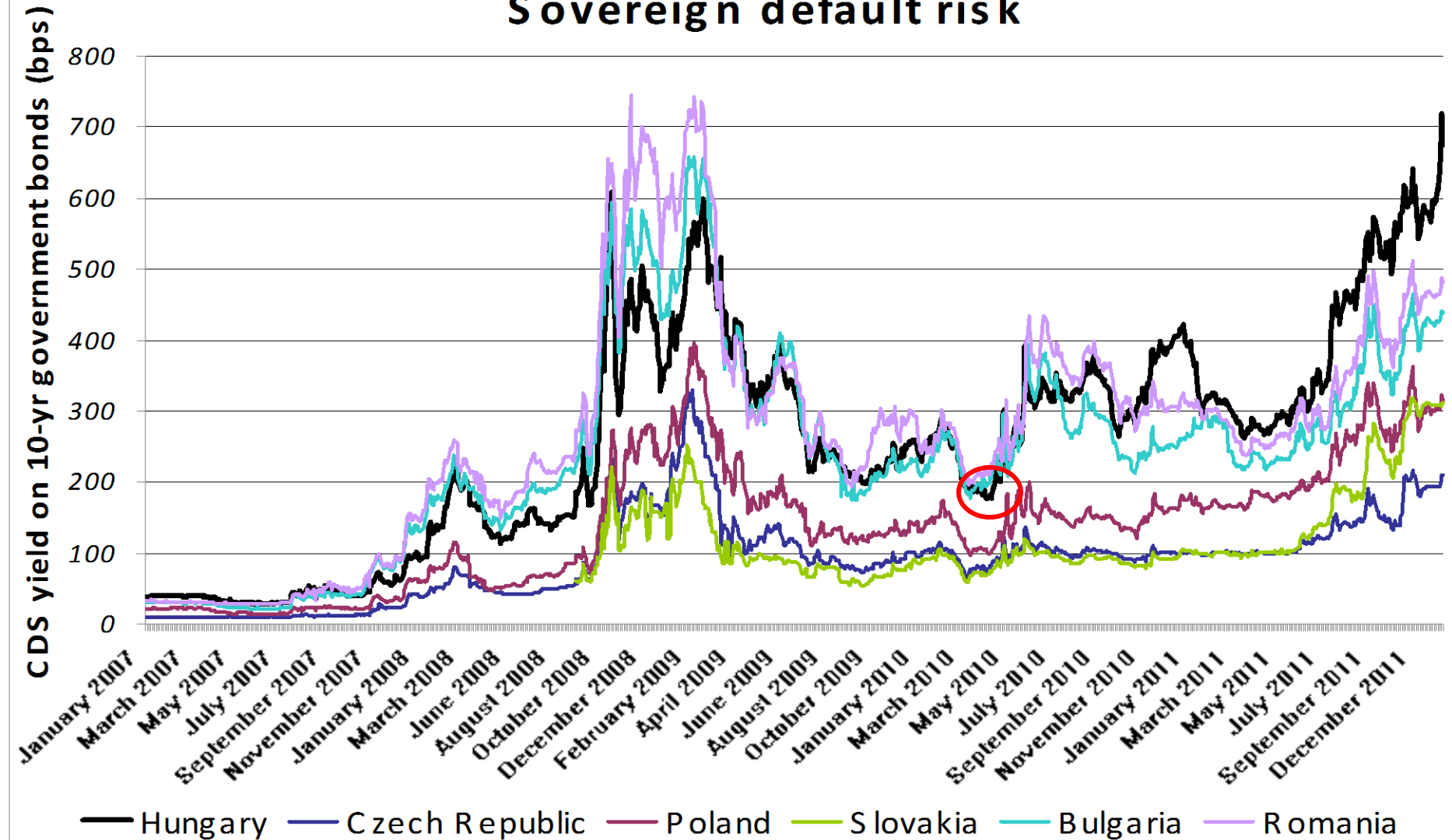
- Debt sustainability problem
- Spike in risk premium, junk bond status
- Costly interest bill, decline in investment, growth
- Potential loss of access to market financing

Confrontation with EU, IMF

- Indefinite postponement of euro membership
- Possible legal and financial sanctions
- Tough prior conditions for stand-by arrangement

Consequences

Sovereign default risk

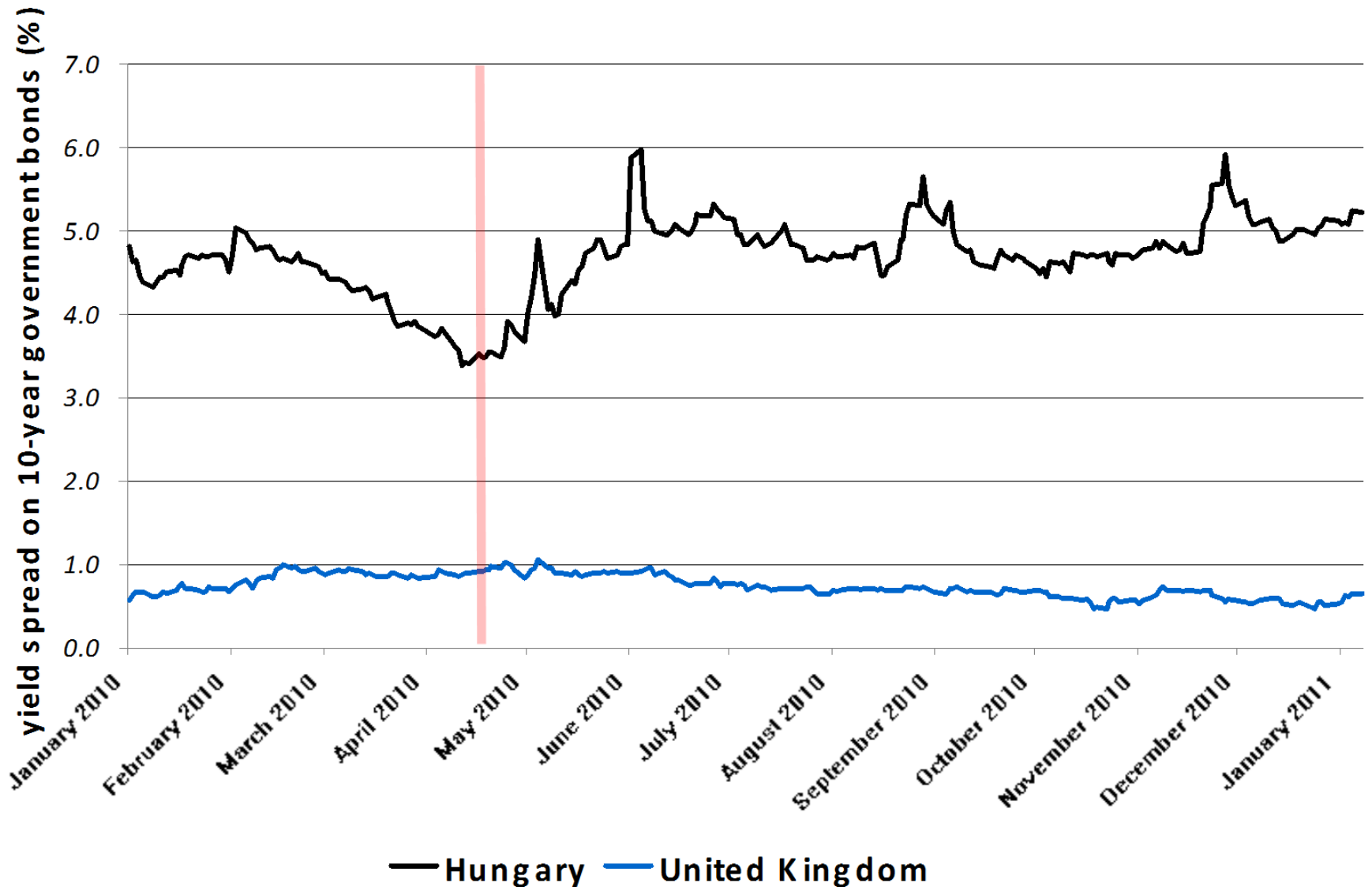


Consequences

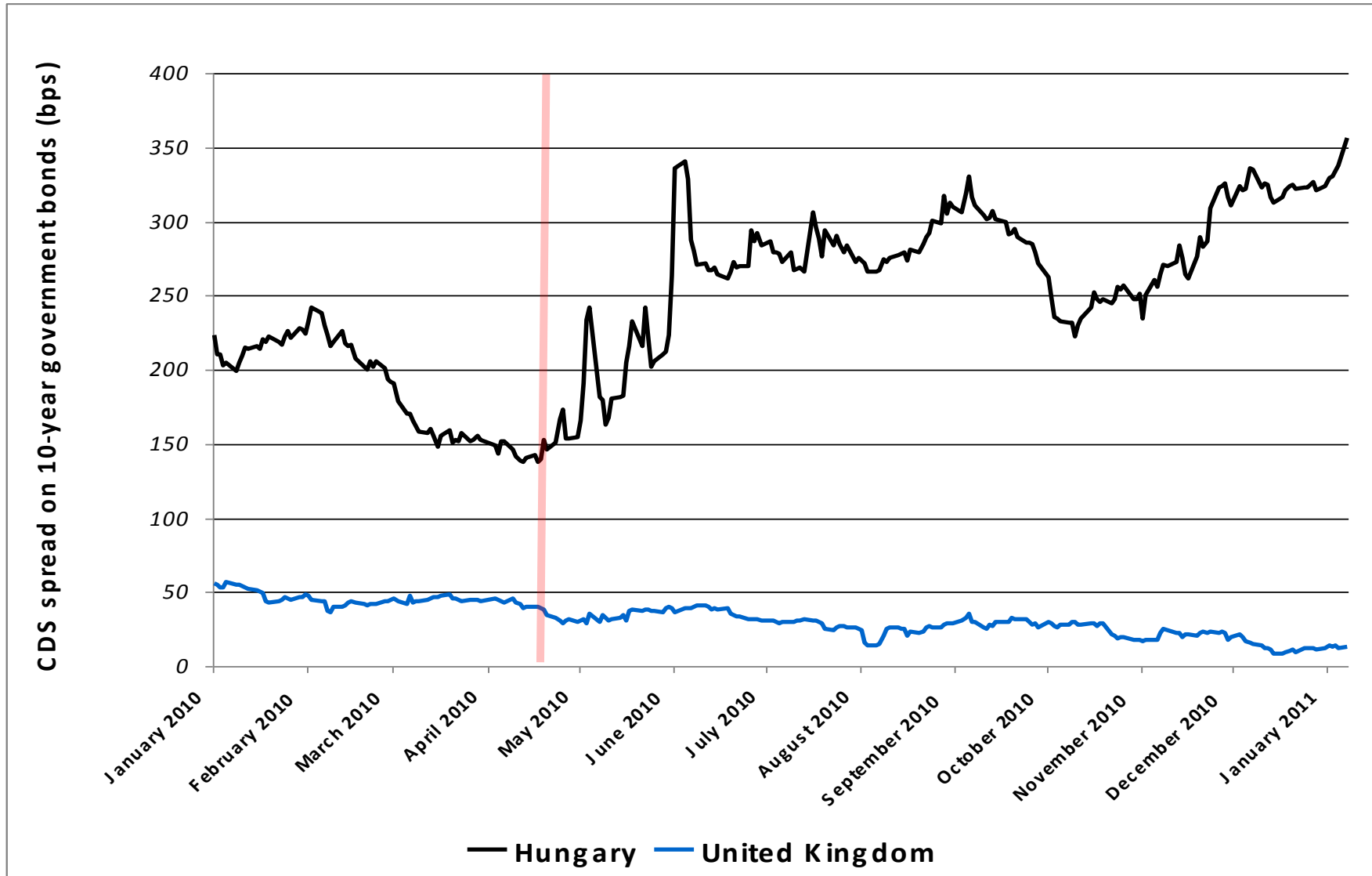
Comparison with the UK

- **Common features**
 - fiscal sustainability problem
 - low policy credibility
 - contemporaneous election of center-right governments
- **United Kingdom**
 - clear medium-term fiscal target
 - front-loaded adjustment program
 - establishment of Office for Budget Responsibility
- **Hungary**
 - mixed and opaque policy signals
 - adoption of distortionary stop-gap measures
 - abolition of Fiscal Council

Consequences: sovereign risk premium



Consequences: sovereign default risk premium



Negative Lessons

- **“Exception” leads to stagnant activity, long-term sustainability problem, and vulnerability to crisis (lacking a natural resource base)**
- **Fitful discretionary policies and weak institutions undermine confidence**
- **Populist strategy and moral hazard have only short-term benefits**
- **Government ignores financial markets at its peril**

Positive Lessons

- **Fiscal sovereignty can be achieved through a predictable well-designed rules-based policy framework (lacking a natural resource base)**
- **Policy credibility must be home-grown**
- **IMF or EU can only provide financial and technical assistance, and guidelines for good practices**
- **Government must use every opportunity to signal paradigm change, and follow up with action, that leads to virtuous cycle**

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