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Oliver Kovacs

Fiscal Sustainability in the Lights of a
Political Economic Theory in Practice:
The Case of Hungary

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Olivér Kovács

Abstract

This contribution attempts to illustrate how a classical theory of political economics showed up in Hungary after its transformation between 1990 and 2009. Under the consideration of the changed circumstances, especially of the stronger external pressure from the markets triggered by the financial crisis in 2008, we emphasise that the coalition government might be forced to maintain its consolidation. As the example of Hungary shows, it is not statutory that the coalition government's belatedly coming consolidation will always be failed as it is predominantly observable in time of 'peace'. According to our general conjecture, in a little open economy running relatively high external indebtedness, a coalition government – even if it has major distributional conflicts – is more likely to be able to manage public finance with more notable fiscal discipline in case of strong and coercive external shocks. The long-lasting improvement of fiscal performance mostly depends on the future economic policy of the Hungarian governments rather than on the sheer existence of coalition.

JEL Classification: E62; E63; D72

Keywords: *fiscal sustainability, consolidation, new political economy, coalition government*

Introduction

Since the beginning of the 1980s the phenomenon of deteriorating fiscal performances was apparently observable in more and more countries of the world. In addition, there were merely a few examples of successful shifts towards fiscal sustainability in the 1990s. The fiscal outcomes of the European countries show considerable deviations. The new political economics intends *inter alia* to unravel these discrepancies out through the accentuation of political and institutional factors (such as coalition/one-party governments, electoral systems etc). While coalition governments have become the prevalent variant among European countries, there are still significant differences in fiscal performances even though they are not suggested by the political economics theory. Alesina and Drazen (1991) stated that coalition governments do not react to shocks in time, procrastinate with consolidations, subsequently this form of governance leads to weaker fiscal performance than the model of one-party governments presented by Alesina and Tabellini (1990). This is originated from distributional conflicts between coalition parties. Each party is about to alleviate the burden of its own voting base, thus the necessary consensus can easily be stymied.

The performance of the Hungarian fiscal policy was in conformity with the aforementioned theory of political economics from the regime change to the midst of the last decade. The achievements were merely temporary as a result of the belated intervention (*hysteresis*) practice of prevailing coalitions. After the economic underpinning of fiscal sustainability through the review of the institutional issues and the non-isolatable monetary policy, our paper aims to illustrate how this political economics theory worked in the behaviour of Hungarian fiscal policy. The hysteresis of coalition governments can be perceptible equally in the structure of revenues and expenditures, the institutionalisation, the consolidation of deficits and debts, and in the structural reforms alike.

On the other hand, we emphasize that the financial crisis exuding doubtfulness and distrust makes the external pressure for fiscal discipline much more amplified than it is in time of 'peace'. Subsequently, in a little and open economy with relatively high external indebtedness, a coalition government is more likely to be forced to better fiscal performance than in peacetime, as it can be registered in Hungary aftern 2006 up to the end of the analysed time period.

1. Economic grounding of fiscal sustainability

Fiscal sustainability assumes existing future-oriented relations among political, economic and societal dimensions. It means a fiscal behaviour which intends to create a strict and lasting management of public finances (Gokhale – Smatters, 2003; Auerbach et al. 2003; Presbitero – Arnone, 2006). Therefore maintaining a sustainable fiscal policy can be treated as a movement towards the *governance for sustainable development* (Swanson – Pintér, 2006).

In connection with the longer-term repercussion of the deficits, and of the resulting accumulating debts – including the inherited or further augmented parts – on the future generations, we claim with reasonable certainty that the interest payment is the quite important factor rather than the absolute volume of debts. The real emerging burden of public debts is the interest payment, which might have a strongly negative impact on the potential growth of an economy. According to debt-dynamic correlations, small negative changes in deficits and debts can induce much bigger increase in debt service (Dedák, 1998; Laubach, 2003; Ardagna et al. 2004). The rising debt service (interest payment on debts) requires more and more tax revenues.¹

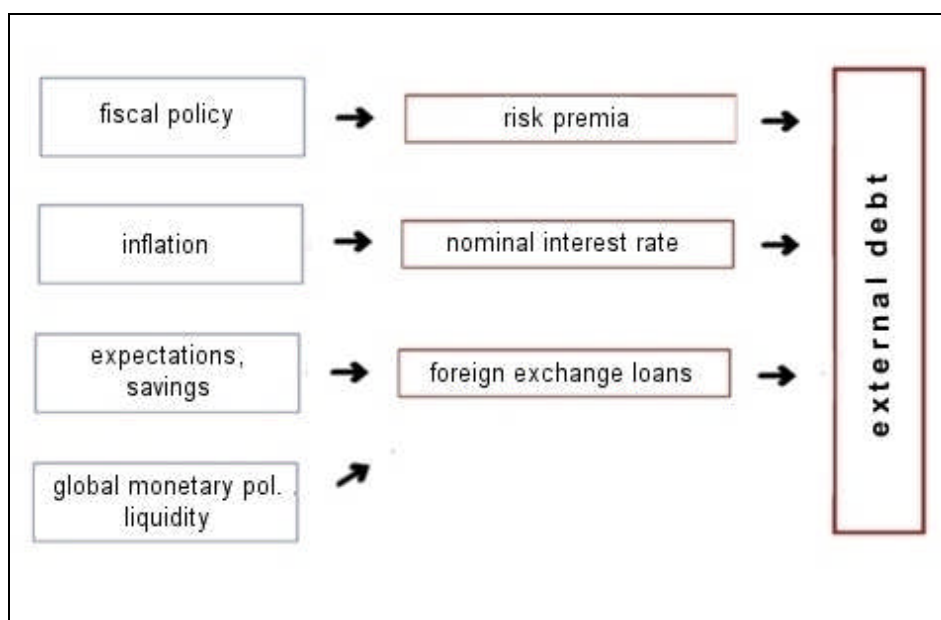
Since higher tax rates are responsible for the deterioration of competitiveness and for the increase of social welfare loss, higher taxes are obstacles of economic growth (Erdős, 2006). If public finances raise the level of dreams (expenditures) relative to the reality (revenues) without any significant fiscal adjustment, investment willingness is affected negatively (Blanchard – Perotti, 2002; Blanchard – Cottarelli, 2010). Insofar as we make a distinction between external and internal debt, we can assert that the interest payments on external debt will not be entirely reinvested in the sovereign debtor country. Therefore interest payment on external debt particularly influences potential economic growth (Domar, 1944; Cunningham, 1993).

The discipline and the moderation of risks require harmony between fiscal and monetary policies, and their mutual commitment to sustainability. The expansion of external debt is determined by the channels presented by *Chart 1*. The laxity of fiscal policy gives rise to the risk premia of the country. Peradventure the inflation rate managed by the monetary policy would increase; it would imperatively lead to a raising nominal interest rate. If future long term expectations are optimistic, coupled with a low level of propensity to save, so the foreign exchange exposure, the indebtedness denominated in foreign currency will

¹ Parallel with the increase of primary deficit by one percentage point – which captures the growth in public debt – the long-term interest rate can rise even by 10 percentage points (Ardagna et al. 2004). This also underpins the by no means irrelevant importance of the timing of governmental consolidation.

significantly rise (Kwon – Bae, 2010). This naturally needs that the glut of global liquidity be dominant, as a result of predominantly lax global monetary policy.

Chart 1. The main factors influencing external debt



Source: MNB, 2011.

The resultant of these processes is dual: on the one hand, the external debt runs up, i.e. we can count with a stock effect. On the other hand, growth based on external resources is not sustainable compared to growth based on internal savings (Akpan, 2009). The intensive accumulation of public debt (internal, external) undermines the prospects of real GDP growth. Additional risk will emerge in the case of unsustainable or lax fiscal policy, which provides incentives for risk aversion. As a corollary of this, the debt service is getting more and more expensive, which will have sooner or later enough coercive power to force the government to conduct a correction.

Hence, fiscal policy can be regarded as sustainable when maintaining its current condition without any change ensures solvency in the future.² The *sine qua non* of this is the strict definition of a fix debt/GDP ratio, and that the rate of economic growth should be at least as high as the real interest rate paid on debt. The eclipse of real interest payment could entail debt reduction due to the positive primary balance (Afonso – Hauptmeier, 2009). Albeit the permanent and substantial structural deficit could not be outgrown without any treatment, thus it is able to cause heavy damages in the life of the current generation. Moreover, it may also exacerbate the life of the next generation through crowding-out effect. Governments have

² With fully acceptance of the claim by Fisher (1933). The fiscal sustainability of a country also depends on the activity of other countries.

to set a target of such an optimal level of debt, which guarantees sustainability in a longer time horizon, and as such, also provides a highly safe way of repayments even in time of serious economic and social shocks (e.g. demographic challenges). In developing countries, this level of debt is around the average debt rate of advanced economies, but the past records of repayments ought to be treated as a determinative factor (Reinhart et al. 2003). Besides the future consequences of indebtedness, it also has immediate negative effects (slack economic growth, increasing inflation³, higher debt service, rising likelihood of potential debt crisis). Moreover, in case of unsustainability, there is no relevant chance for successfully manageable development strategy (Buiter, 2004)⁴.

A balanced public finance has the following beneficial impacts: (i) intergenerational awareness in a more emphatic way; (ii) improved quality of formal and informal institutions; (iii) more favourable latitude of fiscal policy and economic growth. The perspective of balanced public finance can only be imagined within the confines of a more rationalized economic framework, which strives to minimize the loss of future generations by fostering the fine-tuning of societal, economic and natural dimensions. If the *status quo* breaker long-term commitment to the fiscal discipline comes to light, it parallelly leads to an improvement in the quality of formal and informal institutional backgrounds. The commitment is accompanied with better quality of institutional formalization, and also affects the development of informal factors (habits, values, norms).⁵ The improvements in the quality of formal institutions, by developed monitoring and more transparent public finance, dampen the information costs of individuals/society which arise in connection with obtaining knowledge about the current fiscal landscape. It is an important aspect because these high costs have been making the sustainability of fiscal illusion happen for a long time documented by many (Buchanan et al. 1986). The latitude of fiscal policy also thrives from sustainability and the threat of the fiscal side will be minimized for macroeconomic stability and economic growth.⁶ In addition, fiscal sustainability offers an expanded room for manoeuvre for economic policy, specifically with regard to allocation policy aiming at the enhancement of the well-being of society.

³ Reinhart and Rogoff (2010) pointed out that inflation has sharply increased due to the intensified growth of debt/GDP ratio in the emerging countries.

⁴ If monetary policy does not insist on sustainability, the commitment of fiscal policy itself will not be credible (Dixit – Lambertini, 2003).

⁵ For further issues about compatibility and incompatibility between formal and informal institutions, see Helmke – Levitsky (2003).

⁶ The historical studies of emerging countries showed that the decline in economic growth is more significant if the debt/GDP rate is over 90%. This negative effect is more serious when the external debt rates exceed 60% of GDP (Reinhart – Rogoff, 2009, 2010).

2. Institutional opportunities of fiscal policy

Fiscal sustainability presumes on the formalization and better functional quality of the existing institutions. The analyses of new political economics suggest that the rules-based fiscal policy and the supplementary usage of an independent fiscal institutional framework live up to preliminary expectations (Kopits, 2007; Von Hagen et al. 2009). The classic papers of Friedman and Anna Schwartz (1971/2008) have already pointed out that the non rule-following behaviour of governments and central banks – in line with the thinking of Hayek (1945) – brings volatility into the system rather than quench the existing ones.

The rules-based fiscal policy defines the fiscal responsibility framework through country-specific procedural rules, transparency standards, supervisory and sanction mechanisms. Its purpose is to curtail the fiscal latitude (discretionary steps) of policymakers. To this end, it intends to build a mechanism into the budget planning and implementation stages which excludes one-off 'human interventionism'. With respect to the rules-based fiscal policy, it can emerge in the form of numerical, procedural, transparency-related and supervisory dimensions as it is well discernible in the practice of emerging and developed countries.⁷ Albeit, the institutionalization should consider the fact that the full elimination of discretionism could be very harmful, and it might trigger pro-cyclical behaviour in the fiscal policy (Fatás – Mihov, 2010). Therefore the design of an independent fiscal institution with credible monitoring function would be especially conducive to maintain the necessary fiscal flexibility beside the constrained discretion.

Studies pointed out that well-performing institutions also increase the likelihood of a successful consolidation even in the case of coalition governments (Larch - Turrini, 2008; Guichard et al. 2007; IMF, 2009). In principle, the institution buildings as trust builder- and maintainer channel could facilitate the *status quo* breaker fiscal consolidation. It might trigger a stimulating effect on economic growth even in the short run.

Even if each European fiscal consolidation can be regarded as a unique phenomenon, and therefore it is peculiarly difficult to get the standard and optimal rule of the expansionary fiscal consolidation (van Aarle – Garretsen, 2001; Prammer, 2004), we can claim with reasonable certainty that the core leitmotifs of successful consolidations are still decipherable. There is a massive identification problem due to the complexity of impacts. Firstly, fiscal institutions exert influence on fiscal outcomes. Secondly, the fiscal outcome has impacts on

⁷ 80 countries deployed fiscal rules at national or supranational level in 2009 (IMF, 2009).

fiscal institutions. Thirdly, the evolution of fiscal institutions also has effects on various factors which are influencing the fiscal outcomes.

Nevertheless, we can conclude the main findings of empirical analyses as follows. First of all, the government has to be genuinely committed to an expenditure-side consolidation, which focuses primarily on the public sector wages/salaries, transfers, and social contributions in accordance with the suggestions of empirical results. The durable and significant consolidation should be constituted under the consideration of the initial conditions. Further core factors of the potentially arising expansionary effects are the institutionalization of fiscal policy (i.e. the establishment of the rules-based fiscal framework), the structural reforms and the optimistic expectations of the private sector on future incomes, as well.

3. The role of the monetary policy – isolation or collaboration?

Both economic history and economic theory call our attention to the importance of the harmony between fiscal and monetary policies (Erdős, 2007; Király, 2009). Without a fiscal commitment monetary policy cannot be efficient; the economic history of the United States is a good example for this mechanism. We can observe several periods in the US when fiscal loosening has resulted in inflationary pressure therefore the dollar has been devaluated which has caused economic decline (Csaba, 2006). The opposite situation can be tragic for the economy, as well: strict fiscal policy needs tight monetary policy. The Japanese example proves that the liquidity trap is not just a theoretical category. It is a basic economic theoretical thesis that monetary policy alone cannot be a useful tool for reaching economic equilibrium. To reach this aim, the economy needs harmony between fiscal, income and monetary policies. On the one hand, fiscal sustainability requires price stability, on the other hand, the system of inflation targeting needs a balanced fiscal policy.

The outcome of expansive fiscal policy is much more visible, but monetary policy compared to fiscal policy affects the economy in a more indirect way. Monetary policy can be pervaded by political stressing causing imperfection functioning. Only independent monetary policy can guarantee the commitment to the primary aim.

The first years of the new millennium can be described as a period of high growth rate and low inflation (Bernanke, 2004), but from 2008 a global financial and economic crisis has evolved. This crisis has resulted in economic decline or slowdown in the developed and developing world alike.

Global fiscal stimulus – a kind of ‘Keynesian renaissance’ – has become decisive in today’s economic policy. In several countries governments have carried out nationalization and bank bail-out programmes while central banks have loosened monetary policy and cut interest rates in order to mitigate recession. Now liquidity management plays a more relevant role, we can observe this non-traditional monetary policy as a consequence of the current crisis (Liermann – Balling, 2010). At this stage it is clear that the central banks are limited to play the role of the lender of last resort. The nationalization of banks is not a permanent consequence of the current crisis, but crisis management has called our attention to the importance of setting intervention ceilings in order to reduce moral hazard. Therefore the lifespan of liquidity management as a non-traditional form of monetary policy can be only temporary (Caruna, 2010). Just the rising demand can support the increase of the money supply in a sustainable manner (Kaldor, 1982).

The crisis affects the debt spiral in two ways. On the one hand, the decreasing output and the consolidating actions increase the debt ratio. On the other hand, the fall in demand raises the danger of deflation which is also able to contribute to the escalation of interest payments on debt even if the central bank cuts the interest rate moreover when it applies zero interest rate policy (ZIRP) (Neményi, 2009). To counterbalance the well-known “snowball-effect”, i.e. the unfavourable links between growth and real interest rates, the government could use significant primary surpluses. In turn, this ideology is in diametrical opposition with a crisis management which is trying to foster domestic demand through stimulating packages. As far as the current crisis is discernible with the crisis of trust, having an assumption regarding the success of stimulation would be a risky undertaking.⁸ Indebtedness is inevitable in the short run. There is an increasing belief in the necessity of improving economic performance, strengthening fiscal discipline, independently functioning monetary policy, so that public debt could be on a sustainable path. This also requires the mutual commitment of monetary and fiscal policies (Corsetti et al. 2010). After the era of the ‘great moderation’, the revival of Keynesianism supposes the dominance of the great moderation right after the imperatively coming big fiscal retrenchment. With the big fluctuations triggered by the active Keynesian interventions, the government has to raise its awareness to refrain from surpassing deficits and public debt.

⁸ See Csaba (2010). Not to mention the still open question of when and to what extent stimulation is necessary. A demonstrable reason behind the deployment of stimulation is the weakness of the automatic stabilisers. European countries perform better compared to the U.S, but still there are considerable differences within Europe (Dolls et al. 2009).

4. The development of the Hungarian fiscal policy

Hungary from its regime change did not step authentically on the road of the long-lastingly balanced fiscal sustainability until the midst of 2000's. Our economic policy was pervaded by pro-cyclical fiscal policy. Consolidations were quite rhapsodic and every belatedly coming strengthening was followed by much bigger fiscal laxity. These performances to a certain extent might be attributable to the distributional conflicts of coalition governments. The indebtedness aggravates not just the outlooks of next generations but it also causes costs for the present (i.e. the decline in economic growth and the increasing risk of a potential debt crisis). Hungary could be a prime example for this especially in the 2000s.

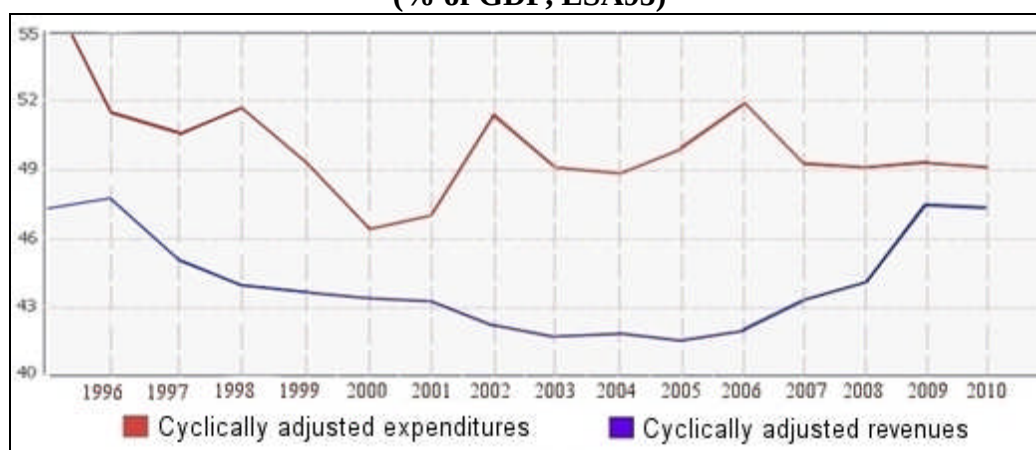
The already introduced standpoints of the New Political Economy can be applied to the Hungarian experience. Coalition governments did not implement the necessary adjustments on time and in appropriate volume. Consequently, they did not treat fiscal sustainability as a fundamental priority. While the stabilization in 1995 has become a textbook case among economists, it was also introduced after a 9-month delay. But, the end of the second decade in the Hungarian democracy can be regarded as an inflexion point, when the coalition governments appear to be more successful in achieving better fiscal performances than the economic literature suggests before. Behind the occurrence of this phenomenon are predominantly the changed characteristics of internal and external pressures. The resoundingly successful consolidations of old EU member states were mainly achieved through internal consensual commitments (Györffy, 2008). The external pressure arriving from the most cited institutions – i.e. the Stabilisation and Growth Pact – proved weaker than expected. The critically impaired health of the Hungarian public finance by 2006, and two years later the changed global conjuncture exuding distrustfulness together caused such an external pressure which seems to be enough even for coalition governments to break the *status quo bias*.

4.1 The structure of revenues and expenditures

As far as the development of revenue and expenditure structure is concerned, the efforts to increase revenues have only become significant by the end of the period 1990-2009 (*Chart 2*). The development of the total revenues of central government between the band of 25 per cent and 36 per cent can be characterized with downward tendency; furthermore the revenues did not attain the OECD average. The major problem of social security funds is the gradually dwindling level of social contributions and the simultaneously increasing demand for central

budget subsidies, especially after the pension reform in 1998. The decreasing trend of revenues was also observable in the case of local governments and separate state funds. The expenditure side seceded from the evolution of GDP. As a result of the 20 per cent downturn in GDP between 1990 and 1993, the expenditure/GDP ratio thrived further. Total public expenditure in percent of GDP grew until 1993, then it went through a 15 per cent shrinkage by 1996 (Benedek et al. 2006). After the consolidation, inducing Maastricht-close conditions by 2000, a permanent 'fiscal alcoholism' (Kopits, 2004; 2007) was vivified again by the time of elections. Nonetheless, there is some evidence that the Hungarian fiscal policy has been undergoing a 'sobering' process from the fall of 2006.

Chart 2. Cyclically adjusted expenditures and revenues in Hungary 1996-2010
(% of GDP, ESA95)



Source: European Commission, AMECO Database.

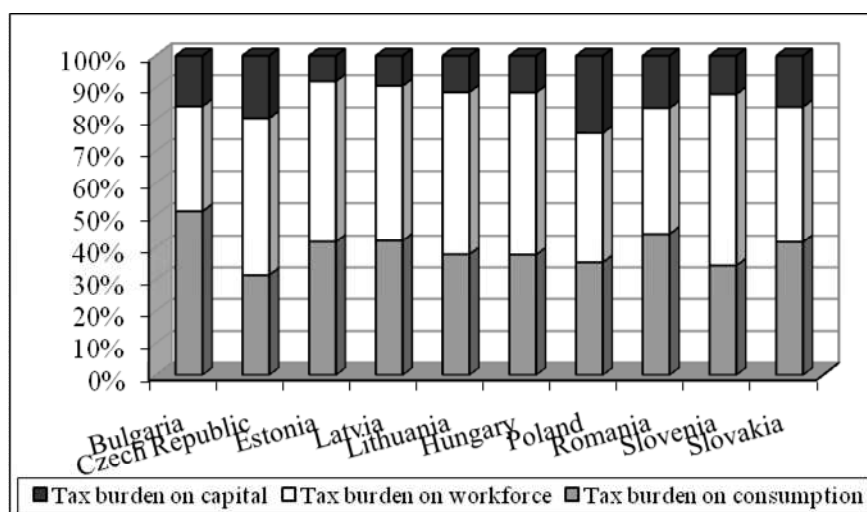
The Hungarian state centralization has been relatively high since the regime change. However, the average rate of tax revenues lags behind the EU27 average; at the same time, the structure of revenues is able to be harmful for the economy struggling with serious employment problems. Hungary has one of the lowest employment rates in the European Union, which is a huge challenge for the public finance.⁹ The comparison with nine other new member states also illustrates that consumption taxes are dominated by labour taxes (*Charts 3, 4*). The labour taxes bear the brunt of the total tax revenue, while the already mentioned consumption taxes are also important. Accordingly, the major reason behind the fiscal trap phenomenon is the obvious imperfection in the composition of the tax system, namely the dysfunctional incentives which assist in tax evasion and tax avoidance.¹⁰ The distribution of

⁹ Hungary has the second lowest employment rate (55.4 per cent of total active population) in the European Union after Malta. (KSH, 2010).

¹⁰ Which is worsened even further by the social institutions of the post-socialist and overspending Hungarian state (Szalai, 2007).

labour taxes between employees and employers is not evenly designed, the acceleration of the alignment, i.e. increasing tax burden on employees and reduction of the burden on employers, has become more and more perceivable after 2001 (*Chart 3*). As a result of the high level of the employers' wage contributions, the scissor has opened wide between the employment costs and the net wages. Let us add immediately that this is undesirable from the point of economic growth. Empirical studies have already confirmed the negative correlation between the high labour taxes and real GDP growth (Lee – Gordon, 2003), due to the increase of the immanently existing tax evasion bias (Agell et al. 1999).

Chart 3. Distribution of the tax burdens in new member states (in 2005)

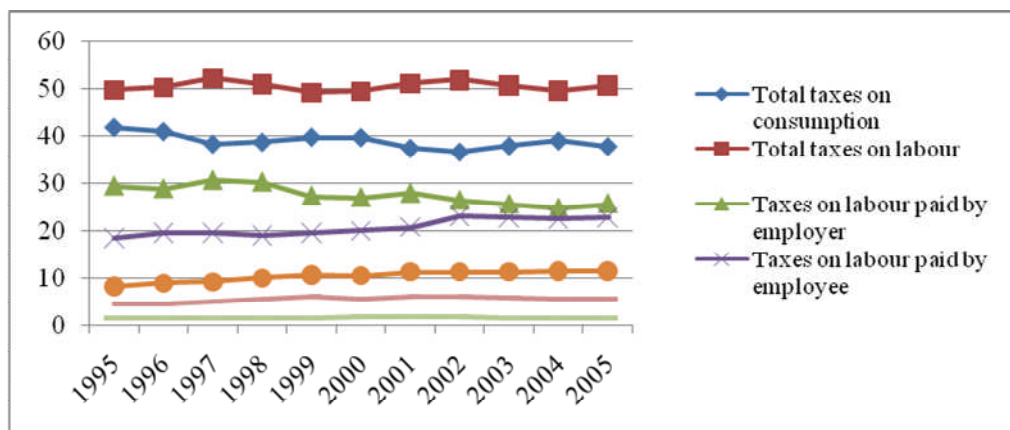


Source: Eurostat.

It can be held even in times of ongoing stabilization policy. The studies scrutinizing the fiscal consolidations have shed light on the issues related to fiscal sustainability regarding the composition of fiscal consolidation. Experience has shown that fiscal adjustments concentrating primarily on the revenue side led to temporary improvement relative to the expenditure side adjustments, which are more likely to have durable consolidation effects. Consequently, comprehensive and circumspect structural reforms in the tax system should be invoked to the enhancement of the mid- and long-term economic growth. Lifting taxes on productive sectors do not help this, conversely, there might be less negative consequences of the raising taxes in case of unproductive sectors. Thus, the well-documented (Erdős, 2008) negative effect might be eliminated on the economic growth.¹¹

¹¹ Hungary has the second largest tax wedge after Belgium among the OECD countries (OECD, 2007:14). While Belgium went through a taxation reform, its tax wedge has still a significant distortion effect on economic growth. See more: OECD (2009). In Hungary, the shrinkage of revenues has lost its high speed since 1998. This informing fact coincides with the findings of empirical analyses emphasizing that the tax awareness of medium

Chart 4. Tax revenues in Hungary (% of total taxation)



Source: Eurostat.

The Hungarian state centralization is high since the regime change.¹² This, in a certain extent, can be treated as an accompanying phenomenon of the specific feature of the Hungarian state and society. The welfare system of the imperatively overspending post-socialist state has not been passed through any notable modernization, on the contrary, it has been contributing to such circumstances, which are able to maintain the disorder also in favour of the state (Sajó, 2008). It is an outcome of human action, but not of human deliberation (Hayek, 1948). This system has tilted the Hungarian economy on a lower steady-state path with weaker potential growth performance. Therefore, the corrosion of social trust to the necessary structural reforms is not surprising, and made the prevailing *status quo* sustainable.

After the Hungarian regime change the first *status quo* breaker stabilization took place in 1995. As a result of this crisis-preventive action the lessening of the cyclically adjusted expenditures was considerable in 1995-1996. Notwithstanding that, these expenditures turned into increase again and the dwindling period began merely in 1998. The surprisingly coming inflation substantially reduced the level of expenditures in percentage of GDP, due to their nominal pegging.¹³ Subsequently, the cyclically adjusted primary balance stepped on a temporarily improving orbit (Chart 5).¹⁴

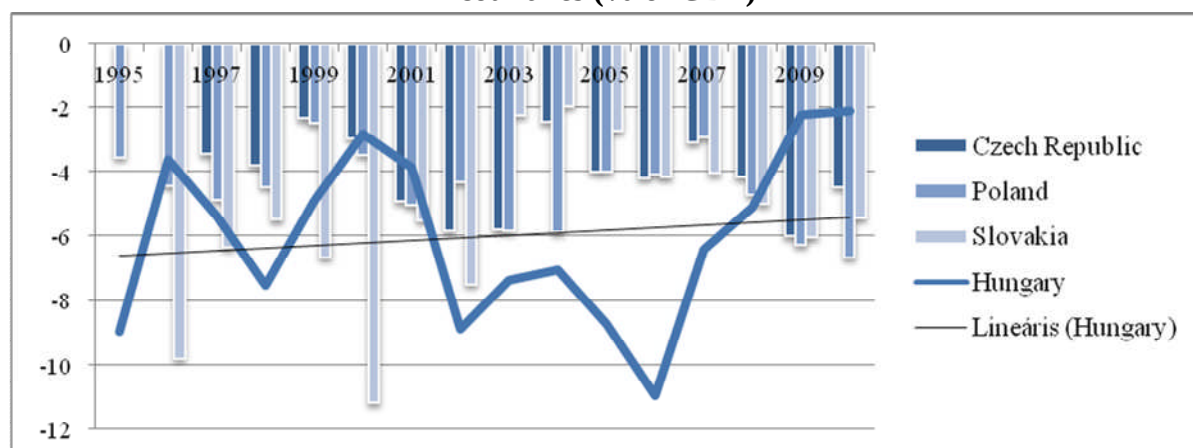
and large firms showed an incremental improvement at that time. Thus, the decreasing rate of revenues has dampened (Semjén – Tóth, 2001).

¹² The optimal degree of the state budget centralization depends on many different factors, but there is a consensual view in the international economic standard, which encounters 30-35 per cent of GDP (Stark, 2007), and 40-45 per cent of GDP (Straub – Tchakarov, 2007).

¹³ Other attenuating factors were: income proportional family allowances, cutting back the sick pay, public servant layoffs.

¹⁴ This balance is built from the difference between the nominal primary balance and the cyclical component. It filters out interest payments and one-off expenditures. This balance serves as a better picture about the governmental performance in the field of fiscal policy management.

Chart 5. Course of the cyclically adjusted primary balance (CAPB) in the Visegrad countries (% of GDP)



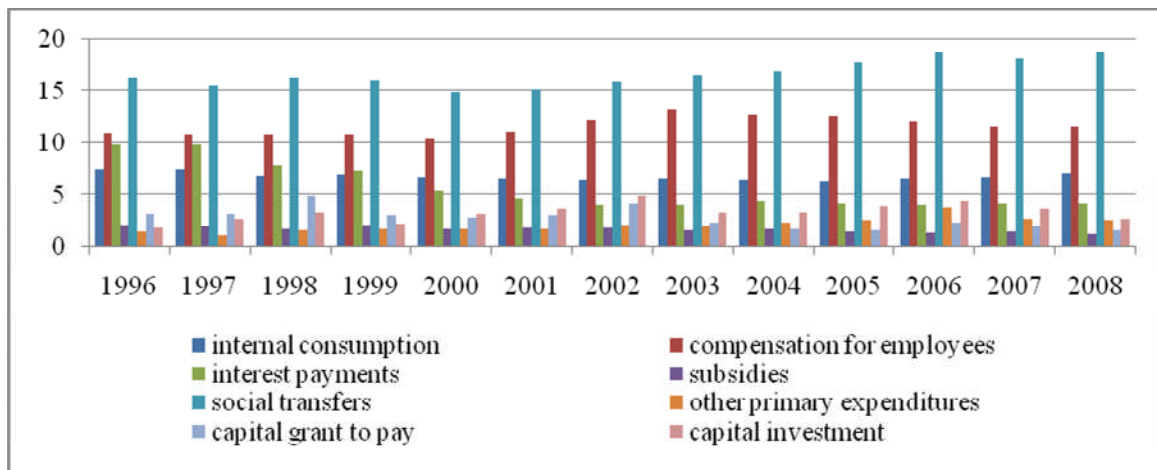
Source: European Commission, AMECO database.

The structure of expenditures has been informing us about the dominant role of social expenditures, which remained strong feature of public finance (*Chart 6*). After the 1995 consolidation the registrable relatively decreasing trend changed, and from the early 2000s – especially from 2002 – turned into a vehemently rising trend again. According to the international practice we can distinguish between productive expenditures (economic affairs, health, education) and unproductive expenditures (social transfers, pension). A bigger slice of productive expenditures is more favourable from the point of view of economic growth. Only in Hungary was the rate of unproductive expenditures higher in 2007 compared to other Visegrad countries, which is also a signal for the interpretation of different growth paths (P. Kiss – Szemere, 2009). However, Hungary has good openness and access to the international capital markets; we can find productive expenditures with neutral effects, as well.¹⁵ Specifically, where these expenditures preserve the structurally rigid and anachronistic systems. There is no need for the unproductive expenditures to be irrationally minimized, but the welfare systems ought to be in line with the fiscal discipline, and to be sustainable in the long run. Thus it could facilitate the long-term economic growth.¹⁶

¹⁵ Major and Szilágyi (2007) also emphasize the importance of the openness and the access to international capital markets.

¹⁶ According to the literature and the empirical findings it has a dampening effect primarily on the income inequalities, and on the cyclical income fluctuation (Schwabish et al. 2004, Baksay – P. Kiss 2008).

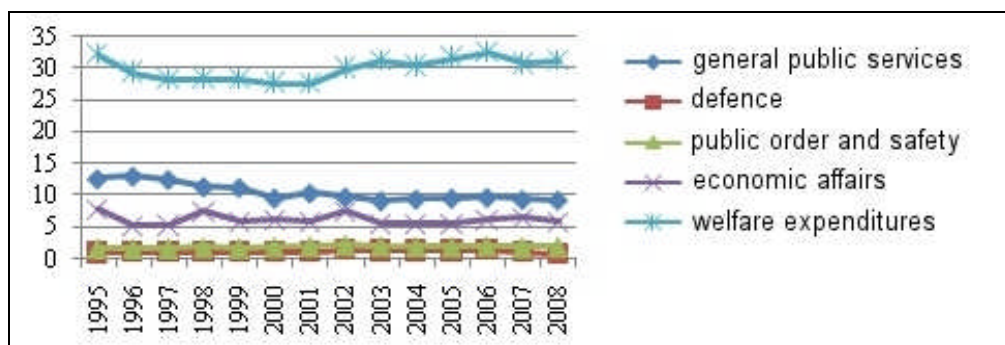
Chart 6. The structure of expenditures 1996-2008 (% of GDP)



Source: Eurostat, Central Statistical Office.

As the functional breakdown illustrates, Hungary has been eclipsing its capacity in supplying welfare expenditures. Although the expenditures on welfare and economic affairs in percentage of total expenditures showed the sharpest decrease until 1996, the welfare expenditures rose again from 2001 (*Chart 7*).

Chart 7. Expenditures by functions (% of total expenditures)



Note: Welfare expenditures contain: environmental protection, housing and community amenities, health, recreation and culture, education, and social protection.

Source: OECD Statistical Database.

Hungary had an election year in 1994. Nine months after the victory the government decided to start a fiscal consolidation in March 1995. In the course of stabilization the government intended to rein the domestic demand through income policy restrictions on the flow of wages. The government has frozen the salaries in budget institutions and public companies. This type of austerity measures is completely in conformity with empirical analyses on successful consolidations, which ascertained that the reduction in government sector wages is a crucial component (Alesina – Perotti, 1995; von Hagen et al. 2001; Briotti, 2004; Ahrend et al. 2006). The inflation rate rocketed to over 26 per cent due to the discretionary measures (devaluation, additional customs duty) of the stabilization package resulted in the rocketed

inflation of 29 per cent. Accordingly, the real wages were devalued by 10-12 per cent, thus the competitiveness went through an improving phase.

The domestic demand orientation turned into export orientation which became decisive in the area, and the rate of welfare expenditures went through a significant shrinkage in proportion of GDP. Before the consolidation the deficit was 5-7 per cent of GDP two years in a row, and this fact forced the government in 1995 to intervene through the introduction of a tuition fee in higher education, the application of needs-based principles in the social supply system.¹⁷ Furthermore, the maternity benefit (GYED) and the maternity leave (GYES) were bound to income limit; the retirement age was raised to 62 years and co-payment was introduced by some health services (e.g. dentistry, pulmonary screening).

The 1995 stabilization resulted in a remarkable, but merely provisional decrease in expenditures (see *Chart 7*). The increase in spending began again especially since 2000, and its speed became faster in 2002. The consolidation could not be durable. By now we have enough empirical evidence to claim with reasonable certainty that the temporary cut in the affluent welfare expenditures, without any notable structural changes, are counter-incentives of the successful long-run stabilization (Tagkalakis, 2009).

Despite a so-called 'cold-shower' fiscal consolidation after the elections in 1998, the mentioned increase was substantial. Therefore the 'cold-shower' adjustment can be treated as an unsuccessful attempt from the perspective of sustainability.¹⁸ The fiscal adjustment was expenditure-driven, the expenditures on public investments and on capital transfers were squeezed by austerity measures. The main achievement by the turn of the millennium was the 3.7 percentage points solid improvement of the cyclically adjusted primary balance (CAPB). Merely the 1999 year can be considered as a 'cold-shower'. While we cannot find any remarkable change in the side of cyclically adjusted revenues relative to the 1998 reference year, contrary to this the cyclically adjusted expenditures declined by 2.7 percentage point in both years. The impacts of the spending cut (e.g. public servant layoffs) were *inter alia* the restricted governmental consumption and the abating interest burden on debt.¹⁹ As for the revenue side, the tax brackets were halved and the government also mitigated the amount of the social security contribution paid by the employers.

¹⁷ The tuition fee (HUF 2000/month) had an objective to contribute to the intensified creation of better burden-awareness.

¹⁸ The consolidation-related international economic literature makes a distinction between 'cold-shower' and gradual adjustments. In the case of a 'cold-shower' adjustment, the cyclically adjusted primary balance goes through a significant positive development in only one year. The latter one means a slower, but longer-term improving tendency. See more: Larch – Turrini (2008)

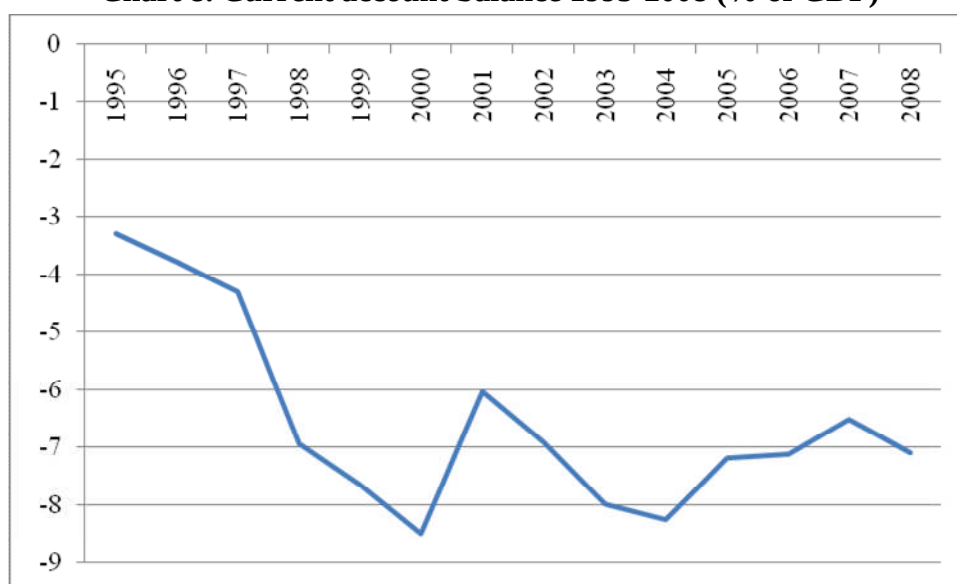
¹⁹ It was also emphasized by Alesina and Perotti (1997), Lambertini and Tavares (2005) in their consolidation-related very deep analyses on OECD countries concerning public wages and numbers of public servants.

As it was discernible on *Chart 7*, the gap between cyclically adjusted revenues and cyclically adjusted expenditures has been increasing since 2000. Behind the curtain of this tendency stands the 2.5 percentage points deterioration of the cyclically adjusted primary balance reflecting some discretionary measures (e.g. social expenditures and contributions in kind).

The cyclically adjusted expenditures had a spectacular leap in the 2002 election-year, suchlike the cyclically adjusted primary balance worsened further by 5.5 per cent of GDP. As a corollary of the tax cut in late 2002 the revenues went through a visible moderation (the revenues were higher by 1-1.5 per cent in proportion of GDP in 2000-2001 than in the period 2002-2004). It was barely corrected by the indirect tax raising (VAT) in 2004 (European Commission, 2004).

The reason behind the increasing expenditures was partially the dominance of domestic demand and consumption-driven economic policy with its already introduced measures (salary increase in the public sector, public transfers such as pension increase). Albeit, vivifying the domestic demand is not consistent with the export-driven economic policy. Namely this policy – in time of ‘peaceful’ external conjuncture – in a little open economy leads to the overcompensation of exports by imports. Therefore, its unique repercussions are the deteriorating trade balance and the growing possibility of unsustainable economic growth (*Chart 8*).

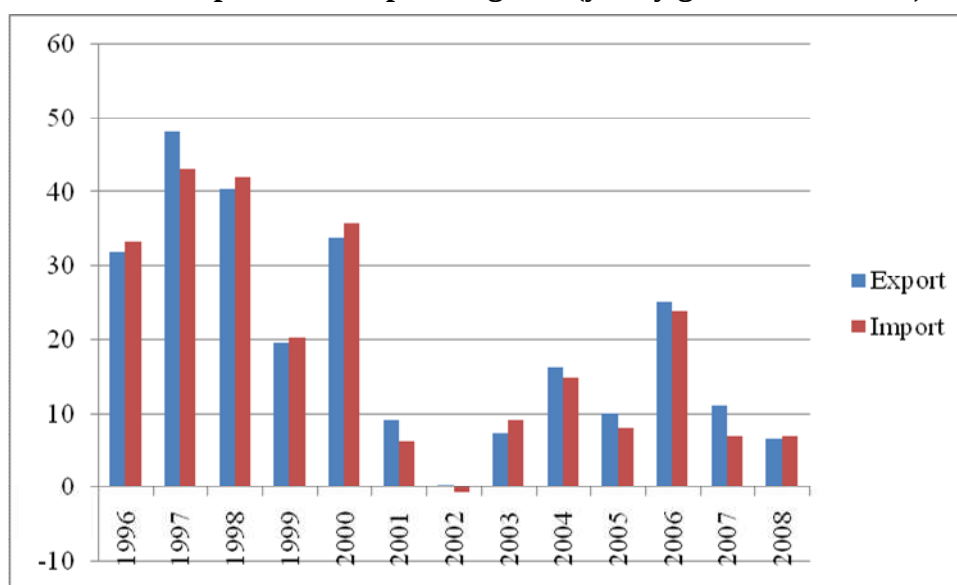
Chart 8. Current account balance 1995-2008 (% of GDP)



Source: Hungarian National Bank, Central Statistical Office database.

The major decline in the development of the current account 1998 over the period 1995–2008 was in 1997. The current account deficit increased continuously by the turn of the millennium, hence it decreased by 2001. But soon thereafter, the deficit began to deteriorate again due to the above mentioned domestic demand-driven economic policy. It is worth to note that the exports of goods and services were stronger after the 1995 stabilization relative to the imports, but the exports succumbed to torpidity after 1998 (*Chart 9*). There was a sharp falloff in the growing dynamics of exports of goods and services between 2000 and 2002. The most possible reason why the domestic demand-based economic policy did not lead to soaring imports by 2002 was the fact that the external conjuncture faced with a decline at the same time. Hungarian exports traditionally require a high volume of imports, and thus the external conjuncture is a crucial influential factor as it was clearly experientable during the decline in the conjuncture of the German economy, especially from 2000.²⁰

Chart 9. Export- and import of goods (yearly growth rate in %)



Source: Hungarian National Bank, Central Statistical Office.

If the government intends to reach the goals of the economic policy *via* unsecured spending – by stimulating the economy by domestic consumption – it unequivocally leads to unsustainable processes (Csaba, 2002; Kornai, 2003). The introduced measures and programmes, such as the Széchenyi Plan, infrastructural programmes and social housing subsidies, originally tried to counterbalance the negative effects of the declining external conjuncture. The measures containing priorities and future vision – some of them were based

²⁰ Germany's real GDP growth stood at 3.2 per cent of GDP in 2000, two years later it plunged into stagnation. Moreover, it shrank with 0.2 per cent of GDP in 2003 (Source: Eurostat).

on meticulous impact studies (e.g. the construction of motorways, see Fleischer et al. 2002) – entailed huge spending.²¹ These measures did not tend to focus on the issue of continuing the necessary structural reforms, and in this regard the pension system was no exception. The forthcoming 2002 elections softened the spending practice. The government raised the minimum wage by 57 per cent at the first and with 25 per cent at the second occasion in 2001. These problematical actions led to higher loss of employment, lower consumption (Kertesi – Köllő, 2003). There is a raucous debate on minimum-wage issues in the economic literature, but it is reasonable to assert that the minimum wage does not have the essential well-focusing ability in Hungary, therefore the increase of minimum wage covered lots of medium- and high-income households as well (Halpern et al. 2004; Szabó, 2007). The budget condition was worsened further by the increase in pensions (instead of the 6.5% preliminarily planned raise, the government raised the pensions by 16.3 per cent).

The incumbent government between 1998 and 2002 earmarked 7 per cent (MNB, 2001) inflation by 2001, thus the expectations oriented themselves to this anticipated value. But, the effective rate was 9.2 per cent, whereby the government could successfully realize some additional seigniorage revenues. The electoral year was characterized by deficit bias due to the introduced measures in 2002 (another raise in pension, increase in the interest-allowance of the Hungarian Student Loan Scheme²²).

As Chart 7 has already exemplified, welfare expenditures (especially spending on social security, education and health) in proportion of GDP rose substantially from 2002. This kind of spending behaviour was predominantly attributable to the surpassingly equitable Hungarian social system, which did not have the proper focusing ability.²³ The relatively high trade-off between work and social provisions is a cautionary signal in itself of the visible violation of the sustainable social system.

The new administration set on further intensified spending practice in 2002 through populist promises reflecting the aim of the voter maximalization. There were the following inaugurated measures during the first and second 100-day programmes: 50 per cent wage-rise in public sector without any layoffs; one-off supplementary pension payment in the amount HUF 19 000; increase in higher educational scholarships by 30 per cent; tax elimination on

²¹ The Széchenyi Plan was followed by the I. National Development Plan, of which co-financing related obligations entailed another burden on state budget.

²² See more: Berlinger (2009).

²³ The Hungarian welfare system has been performing relatively well in terms of poverty and inequality abatement. It is equitable, however, it operates with low efficiency and does not seem sustainable in long run. Benedek et al (2006) accentuated that the high-income households are getting an inproportionately big slice from the total amount of financial supports compared to the low-income households.

minimum wages; plus the so-called 13th month pension and the unchanged social housing contribution scheme also swelled the already existing expenditures from 2003. These overspendings and the declining external conjuncture deteriorated the twin deficit simultaneously. Twin deficit can easily be a massive obstacle to the sustainable growth; moreover its inflationary pressure can atrophy the country's competitiveness by the unrealistic outflow wages. Negative changes in expenditures, and *a fortiori* changes in euro-related economic policy also had perceivable inflationary effects, because the government decided to devalue the central parity of the Hungarian forint regarding the euro by 2.26 per cent in 2003. This step can be considered as an artificial correction of the planned revenues, which were obviously unrealistic, and of the realistic expenditures.

The permanent worsening in numbers had initially a very infinitesimal disciplinarian power for the coalition government to impose necessary adjustment measures. This was fully concordant with the conventional wisdom of the already mentioned theory of the new political economy. The government began its correction merely in 2003 by a 'cold-shower' consolidation, which was based primarily on the expenditure side. However, the adjustment shortly became softened regarding its original goals. The cyclically adjusted primary balance improved by approximately 1.5 percentage points. Principally, the 1.4 percentage points decrease in public investments explains the shrinkage of the cyclically adjusted expenditures. The measures mostly concentrated on the social housing contribution scheme and on unemployment benefits. Meanwhile, government consumption grew due to the wage increase in the public sector, and the government faced a large deficit-augmenting triggered chiefly by one-off measures. As for the revenue-related mechanism, the government had successfully limited the dwindling of the cyclically adjusted revenues through VAT increase. Although the consolidation continued in early 2004 (CAPB improved by 0.7 per cent of GDP), soon after it entirely eroded as *Table 1* shows it.

The evolution of the Hungarian state budget concerning the structure of revenues and expenditures, specifically from the regime change to the culmination of imbalances by 2006, conveys that political see-sawing, especially the all-time coalition governments kept hindering the achievement of the commitment to sustainable public finances. Instead of the comprehensive public finance and welfare system reforms, economic voluntarism became the dominant factor. The relatively tremendous deficit forced the coalition government to consolidation in 2006, it should be noted that it was apparently a belatedly coming enterprise. Since 2006, there were somewhat less resources allocated to general public services, economic affairs and welfare functions.

Table 1. Main budgetary measures between 2006 and 2008

	Measures on revenue side	Measures on expenditure side
2006	Reducing the upper VAT rate by 5 percentage points	Decrease in government investments by 1%
	Sinking of the upper tax rate of personal income tax from 38% to 36%	Creation of contingency reserve in the budget to be the deficit target feasible
	Raise in the lower income category with HUF 50tho	
	Elimination of certain tax allowances (0.1% of GDP)	Freeze the unused expenditures at the level of the 2005
	100% of the local business tax can be deductible from corporate tax base	
	Decreasing in corporate tax of micro enterprises to 10% (up to HUF 5 million yearly income)	
	Diminishing the health care lump sum (0.05% of GDP)	
	Compensate the decline of VAT revenues by increasing in registration and consumption taxes (0.2% of GDP)	
	Introduction of luxury tax (over HUF 100 million real estates) (irrelevant part of GDP)	
2007	Increase of the lower tax bracket by HUF 150tho (0.1% of GDP)	Decrease in government investments by 0.9%
	Introduction of the taxation on minimum expected income for corporations (0.2% of GDP)	Freezing the public sector's salaries at the level of 2006, reduction of administrative costs (0.6% of GDP)
	Separate tax (4%) on personal incomes (0.1% of GDP)	Increased subsidies (+0.2% of GDP) and capital injections (+0.4% of GDP) to the national railway company (MÁV) in the context of a restructuring plan
	Raise the employee's health care contribution with 1 percentage point (0.2% of GDP)	
	Introduction of health care co-payment system (0.1% of GDP)	
2008	Increase in the limit on investment related spending to be exempt from corporate taxation from 25% to 50% up to a maximum of HUF 0.5 bln (-0.05% of GDP)	Increase in EU funds co-financing expenditures (0.2% of GDP), overcompensated by the reduction in motorway investment projects (-0.3% of GDP)
	Extension of the preferential corporate tax rate for 10% in the case of the investor and job creator small and micro enterprises (0.08% of GDP)	Carrying out the long-term pension correction program (0.2% of GDP)
	Changes by the income tax credits (0.12% of GDP)	Retrenchment on the operational costs of public administration (0.3% of GDP)
	Broadening the base of social insurance contribution	Cuts in public education expenditure as a result of the new financing mechanism encouraging school mergers (-0.15% of GDP)

Forrás: Budget Bill, State Audit Office (2009).

The consolidation caused an inflexion point in the patterns of expenditure grouped in various functional classes. The consolidation period between 2006 and 2008 was rather revenue-side than expenditure-side (*Table 1*).²⁴

The government – during the consolidation, which began in the autumn of 2006 - had an indisposition for carrying out an adjustment with the sheer concentration on expenditure side, thus it can be particularly regarded as a revenue-side correction (VAT increase; introduction of co-payment in health care). The economic growth-related consequence of such a consolidation was totally in conjunction with the empirical findings, i.e. it did not facilitate either the GDP growth by 2007 or it was not able to maintain the growth dynamics. Beyond the displayed changes on the expenditure side, the government revised the price-support system and imposed some austerity measures on pension, health expenditures and local government expenditures.²⁵ These measures had a substantial effect on the various industries, as well.²⁶ Each of these arrangements accompanied with *inter alia* the significant decrease of the households' disposable income, the fall in investment activity and the worsening export-import gap. Ultimately, they contributed to the registrable economic meltdown in 2007 (the real GDP growth contracted by more than 2.8% and reached the 1.1% in the given year).

The whole gamut of 2009 measures, which were pervaded by the awareness of the global financial crisis erupted in 2008, could be interpreted as part of the Hungarian crisis management. The main lesson of this period of time is that the all-time government should have recognized the unsustainability of fiscal policy and the necessity of *status quo* breaker structural reforms in the past years in order to make realistic the avoidance of such an extremely difficult situation in which the country got into by the crisis. The latitude of the Hungarian fiscal policy did not make possible to run deficits temporarily in time of recession in order to stabilize the economy, thus the country was forced to imperatively continue its fiscal consolidation in the interest of gaining more credibility.

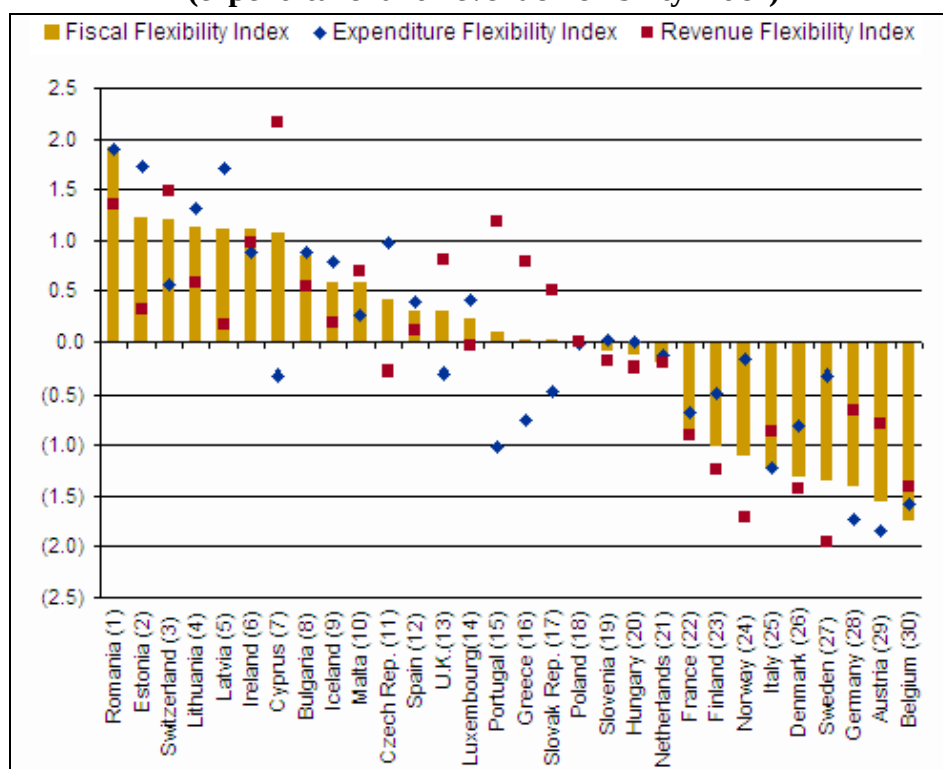
Consequently, there is much room for improvement in the field of Hungarian fiscal sustainability. The fiscal flexibility index shows inflexibility in 2008. Hungary has not got enough fiscal latitude to be able to manage flexibly the fiscal shocks (*Chart 10*).

²⁴ Most of the empirical literature seems to justify the success of expenditure-side consolidation both in terms of its duration and the possibility of its expansionary effect. See for more empirical analyses on the expansionary effect of consolidations: Giavazzi – Pagano (1990); (1995); Rzonca – Cizkowicz (2005), Benczes (2008). Although there are many influential factors (von Hagen et al. 2001; Aerle – Garretsen 2001).

²⁵ Meanwhile the 1.2 per cent deficit of the local governments (excluding privatisation revenues) outdid the level of 1994 by 2006 (Vígvári, 2009: 718).

²⁶ Construction fell by 14.1 per cent by 2007 (KSH, 2007). The pharmaceutical sector, which is also known as one of the most competitive industry (Antalóczy, 1997), has been seriously affected by the introduced separate tax resulting in a series of layoffs and cutting back on investments and R&D.

**Chart 10. Budgetary flexibility index and its components in Hungary 2008
(expenditure- and revenue flexibility index)**



Note: The indices are normalized. A negative number indicates below-average flexibility, a positive number indicates above-average flexibility. The expenditure flexibility index shows to what extent the government could impose discretionary measures through rapidly changeable expenditure items (the logic is the same in the case of revenue flexibility).

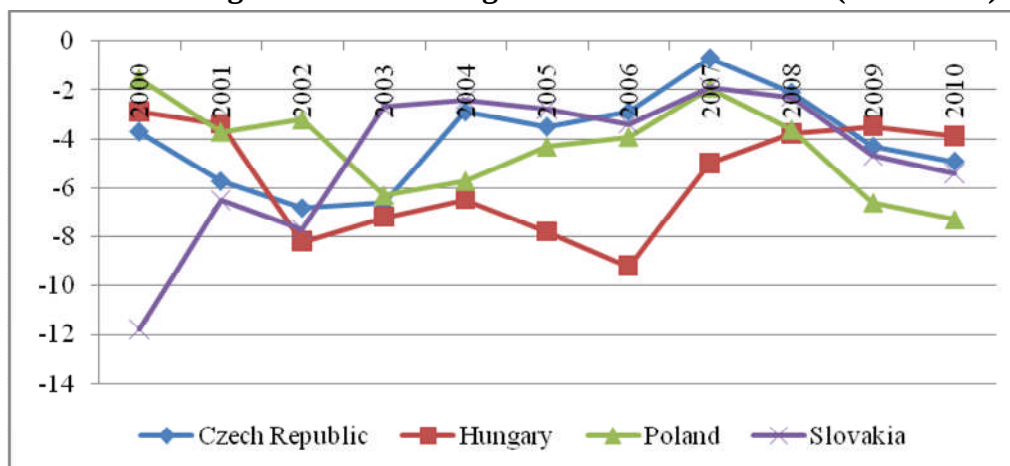
Source: S&P Credit Research (2008); RatingsDirect, The 2008 Fiscal Flexibility Index: Smaller Sovereign Remain Ahead of the Pack.

The improvement of flexibility needs the long-term mutual commitment of the fiscal and monetary policies to prudence and disciplined behaviour, which could promote the achievement of a manageable level of public debt and also could accelerate the recovery period.

4.2 The course of deficit and the sustainability of public debt

Hungarian government deficit has been exceeding the 3% Maastricht criterion since the regime change. Every dampening period was weak and transient, a more considerable improvement of the balance can be seen only since 2006. Also, the public debt/GDP ratio has been overrunning the 60 per cent Maastricht threshold since 1990 (excluding the early 2000s). The fiscal gap illustrates that Hungary has to carry out durable consolidation and structural reforms.

Chart 11. Budget balance in Visegrad countries 2000-2010 (% of GDP)

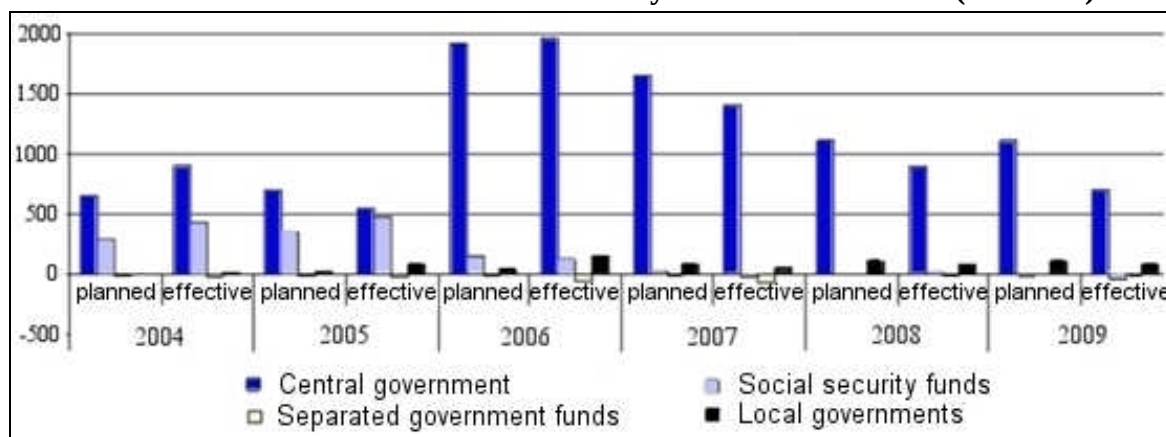


Note: for 2010 we used the estimation of the European Commission (2009).

Source: Eurostat.

As a result of the 2002 election year it rocketed and exceeded 8 per cent of GDP, in other words the fiscal consolidation failed in the light of sustainability. The unsustainable spending resulted in a quick growth of deficit until 2005, and the deficit doubled during 2006. As regards to the subsystems between 2004 and 2006, their deficits have been under 'pollyannaish' planning. The effective deficits were higher than the preliminarily planned targets year by year. Some amelioration has been achieved since 2006 both in terms of more credible planning and improving budget balance (*Chart 12*).

Chart 12. Planned and effective deficits by functions 2004-2009 (bln HUF)

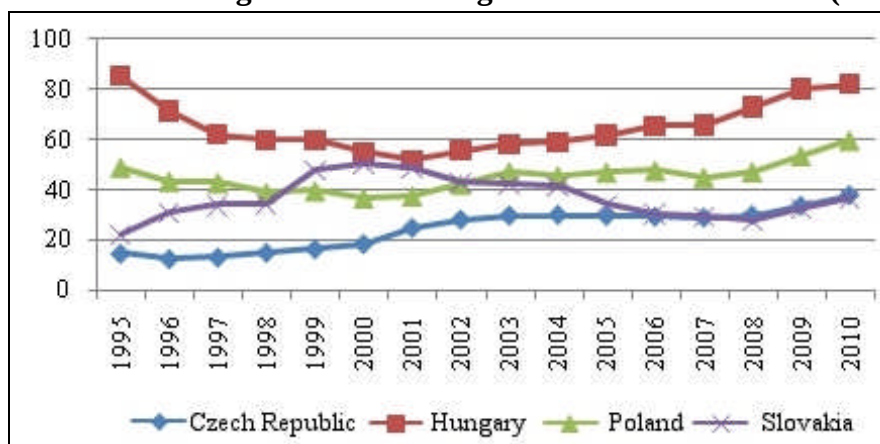


Sources: Budget bills.

The budget has become more balanced in 2007 owing to the already mentioned austerity measures introduced in the autumn of 2006. The austerity package had a regenerating effect on the deficit bias, but it has not relied predominantly on the expenditure side and on comprehensive structural reforms as the international empirical analyses suggest.

While the Hungarian public debt's path was converted into a descending trend after the first notable stabilization in 1995, the path changed to an upwards trend again from 2002 (*Chart 13*). The gross debt of the “premature welfare state” (Kornai, 1992) stood at 73.4 per cent of GDP in 1991. The debt has been rising further due to the exaggerated optimism (Árva, 1995) about foreign capital inflows, tourism, and sustainable current account, and the coalition government's ‘sit-on-the-fence’ also had a key role in the declining debt/GDP ratio. During the period 1995-2010 the Hungarian debt/GDP ratio has been tower above that of the other Visegrad countries.

Chart 13. Consolidated gross debt in Visegrad countries 1995-2010 (% of GDP)

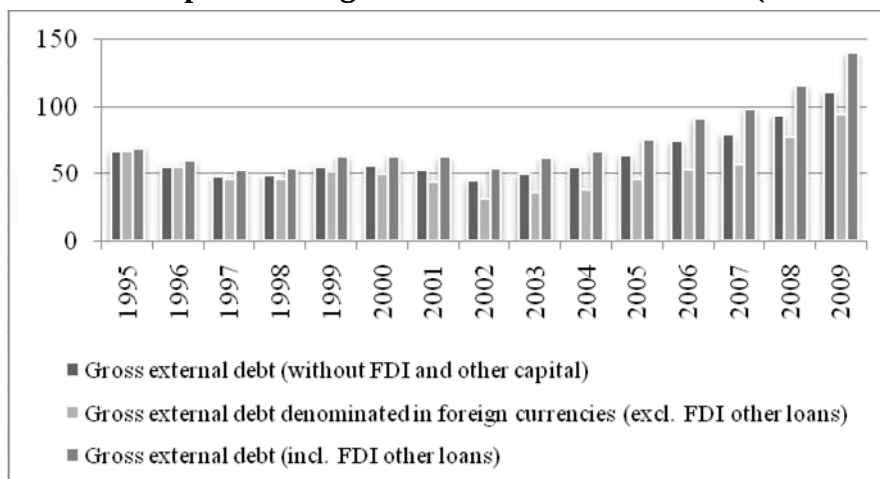


Note: The consolidated data do not contain the assets and liabilities of sub-sectors standing against each other. For 2010 we used an estimation of the European Commission (2009).

Source: Eurostat.

As far as the gross external debt is concerned, its reduction began after the 1995 stabilization, but this remarkable progress did not prove sustainable as the trend reached its turning point in 1998 (*Chart 14*).

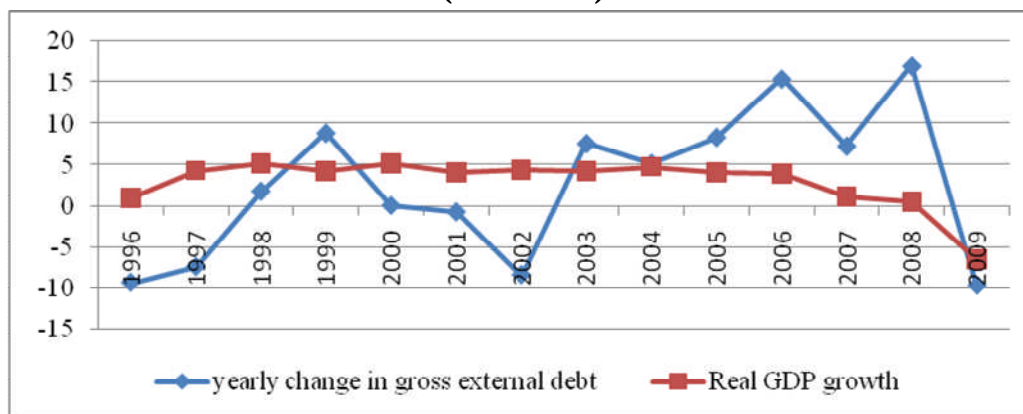
Chart 14. The path of the gross external debt 1995-2009 (% of GDP)



Source: Hungarian National Bank.

The most rapid growth, in the pre-crisis period, is observable especially between 2002 and 2007. The pivotal reason behind the scampering external debt was the relatively increasing rate of debt denominated in foreign currency (Holló, 2007). Due to the inflation targeting monetary policy, the interest rate was comparatively high reflecting in a certain extent the inconsistency between fiscal and monetary policies, thus the foreign currency credit could become cheaper.²⁷ It is important to delineate that the prudent debt management intends to limit the growth of external debt below the growth dynamics of real GDP. As long as it is feasible, the monetary policy can scroll obstacles towards the escalation of interest burden on debt. Nonetheless, the growth rate of real GDP could not compensate the yearly change of the gross external debt (*Chart 15*).

**Chart 15. The path of gross external debt and real GDP growth
(% of GDP)**



Note: The changes of gross external debt are represented relative to the former year in %.

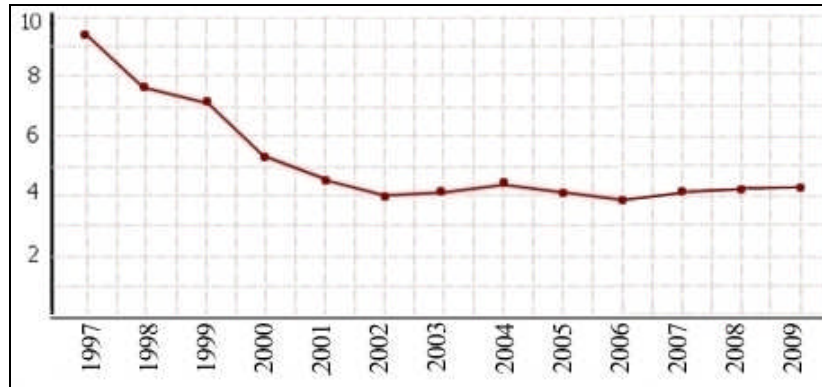
Source: OECD Economic Outlook No. 86, Hungarian National Bank.

It is important to note that the thriving external debt does not affect potential GDP growth if the interest burden does not grow simultaneously. The increase of the interest payment was still discernible after the 1995 stabilization package until 1997. This also led to the slowing down in the decreasing dynamics of public debt. Moreover, the revaluating foreign currency debt also had an indisputable negative effect on the debt/GDP ratio due to real and nominal devaluation. As a result of the yearly changes in the gross external debt, which outreached and exceeded the real GDP growth, the interest burden has become more moderate between 1998 and 1999.

²⁷ As Darvas and Szapáry (2008) pointed out, the share of the households' foreign currency denominated loans to the total amount of households' loans was 43 per cent between 2004 and 2006. In comparison, this share was 2 per cent in Slovakia during the same period. The belatedly revised social housing scheme also had a substantial effect on domestic demand, which triggered the expansion of foreign currency loans (Bélyácz – Kuti, 2009).

After this period, the real GDP growth could overcompensate the external debt, thus the path of the interest payment on debt became dwindling until 2002 (*Chart 16*). The interest burden was in a downward trend and shrunk by more than 5 percentage points until 2009; it is of particular importance as interest payment is a crucial component in the progress of deficit.²⁸

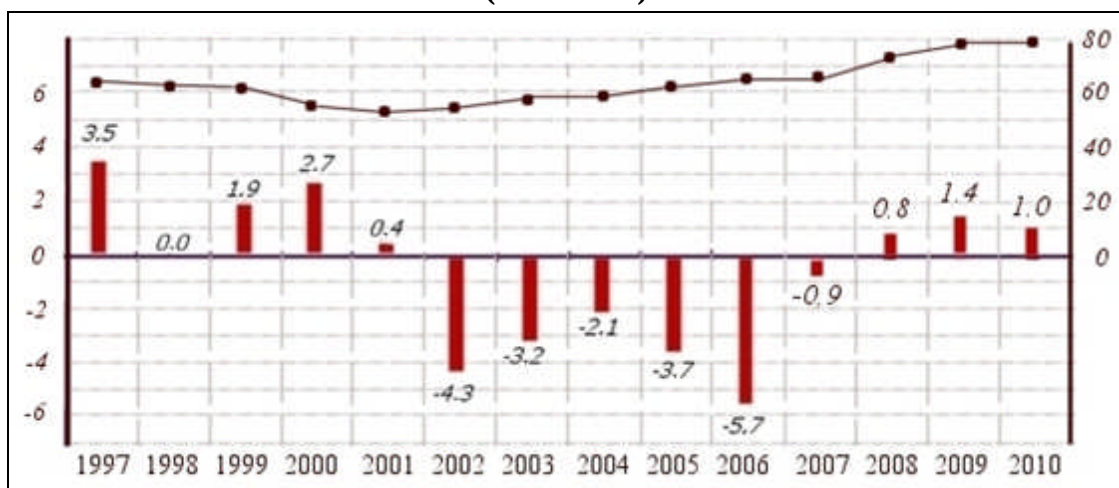
Chart 16. The development of interest payment in Hungary 1997-2009 (%)



Source: Hungarian National Bank, Hungarian Statistical Office Yearbooks.

An equally important factor influencing the development of public debt is the primary balance, which shows whether the government's fiscal policy accelerates the pace of debt dynamics in the given year or not (*Chart 17*).²⁹

Chart 17. Primary balance (left axis) and public debt (right axis) 1997-2010 (% of GDP)



Source: Eurostat, Ministry of Finance.

²⁸ See for example Mellár (1997).

²⁹ On the one hand, primary revenues do not contain incomes from loans, interest and privatization. On the other hand, primary expenditures do not encompass the interest payments on debt and the accounting with the Central Bank. Subsequently, the primary balance is therefore able to illustrate how much the deficit could be if the public property would not wane and the public debt would not be there.

Whereas the primary balance was dampening, the public debt was accumulating. While the debt/GDP ratio was going through significant moderation until 2001, the rhythm of its descending trend varied considerably during this period of time. The shrinkage was more than 25 per cent of GDP by 1998³⁰, although then this improvement became much more moderated. Nevertheless, when the primary balance became negative, the consolidation has completely failed in 2002. The fading away of fiscal consolidation as a basic hindrance of the further abatement of debt/GDP ratio led to a negative primary balance. The debt assumptions of the quasi-fiscal activities (e.g. MÁV, BKV³¹) were a prevailed technic in the Hungarian economic policy especially in election years (e.g. in 1998: Postabank; in 2002: State Motorway Management Company Ltd.). This also resulted in the aggravation of the primary balance. As Czeti – Hoffmann (2006) pointed out, the assumption problem has remained unsolved until nowadays.

The new administration resorted to a short-term consolidation in 2003, but it was not able to provide such mechanisms which could have positively influenced the public debt. Owing to the extremely high deficit in 2006, the debt/GDP ratio expanded significantly from 61 per cent of GDP in 2005 to 66 per cent by 2006 (European Commission, 2007). As a consequence of the belatedly coming fiscal correction in the second half of 2006, the deficit improved more than many would have expected. But it was not enough to cushion against a further increase of public debt.³²

From the point of view of unsustainability it is important to note that every effort targeting the reduction of debt service obligations and the absolute volume of public debt embraces the interest of future generations, as well. The primary fiscal gap indicator also underpins the fact that there is much room for improvement in the Hungarian fiscal performance³³ (Blanchard, 1990). This tool indicated the necessity of substantial adjustment, which was a must because of the surpassing level of public debt in 2009 (*Chart 18*).

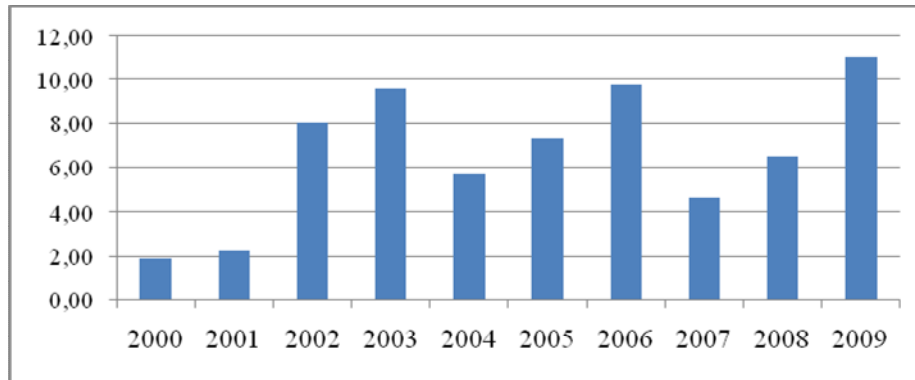
³⁰ Forgetting the fact that the incomes from privatisation also played a key role in the decreasing public debt between 1995 and 1997 would be not advisable. See more: Czeti and Hoffmann (2006).

³¹ The Government Debt Management Agency converted MÁV's loan, which was provided by MKB Bank, into foreign currency in 2002. The interest burden on it was HUF 640 million in 2004.

³² Recent progress in the Hungarian deficit shows that the efforts intending much more fiscal discipline can be regarded efficient, even if the debt has been rising further due to the crisis-ridden domestic and foreign economy.

³³ The primary fiscal gap captures the difference between the actual primary balance and the one necessary to keep public debt constant as a share of GDP. Its positive value equals the required size of the necessary fiscal adjustment.

Chart 18. Primary fiscal gap 2000-2009

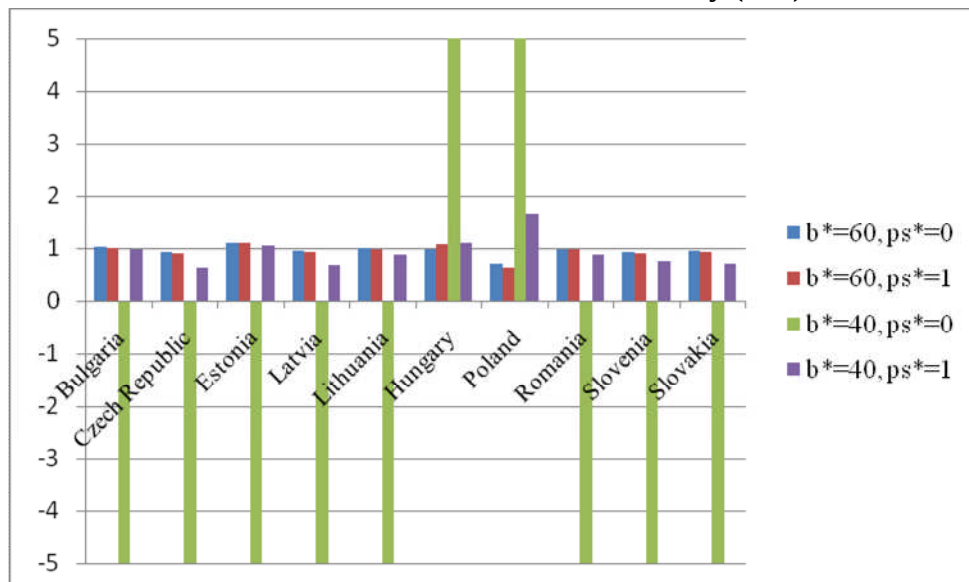


Source: Eurostat.

The most distinct correction took place in 2006 and 2007. Apart from the fact that the public debt has been growing; the deficit was sharply reduced by 2007. There was not any precedent of such consolidation in terms of the evolution of the primary fiscal gap in the period 2000-2006. Albeit the fiscal consolidation was able to improve deficit-path, there is still need for a continuously credible commitment to fiscal discipline, deliberately introduced structural reforms and trust-builder fiscal institutionalizations.

The Indicator of Fiscal Sustainability (IFS), as another relevant tool, also calls our attention to the deleterious absence of perspective outbalanced public finance. IFS could be calculated for various targets.

Chart 19. The Indicator of Fiscal Sustainability (IFS) in 2009



Note: b^* symbolizes the targeted debt/GDP ratio, ps^* is the targeted primary balance. If the absolute value of IFS is less than 1, the public finance is sustainable.

Source: Eurostat.

Chart 19 demonstrates whether the public finances of the selected Central and Eastern European countries are sustainable with 60 per cent or 40 per cent debt-targets and 0 per cent or 1 per cent primary surpluses. The index shows that Hungarian public finance, with a 60% debt-target and a 0% primary surplus, appears to converge to the sustainability. The lasting convergence mostly depends on the existence of governmental apathy regarding the *status quo* breaker structural reforms, which have been procrastinated for many years.

4.3 Major developments in the fiscal institutional framework

If we take a mere glimpse into the development of the fiscal institutionalization in Hungary we can claim with reasonable certainty that it conserved unsustainability rather than promoted sustainability. Institutions have been cementing the *status quo bias*. The institutional streamlining kept coming into consideration in time of economic and financial meltdown. It is essential that the retentiveness of institutions should not be able to weaken in the future.

Several EMU-accession related analyses have revealed that the external institutional pressure *per se* is insufficient. By contrast, the internally created and maintained consensual initiations are much more important (de Haan et al. 2004; von Hagen et al. 2006; Györfy, 2008). Since the democratic regimes *per se* encode some *deficit bias*, the fiscal institutionalization, as some sort of way of commitment to break the bias, may play an essential role. The vote- and the budget-maximizing by manipulating the voters (Downs, 1957; Niskanen, 1971) are used in reaching power or preserving the already possessed control (Nordhaus, 1975). This phenomenon can easily generate political fiscal cycles.³⁴ The most favourable return of the institutionalization is the strengthening transparency in public finance, which also attenuates the fiscal cycles. Nonetheless, transparency requires a precise and definit listing of public services, because the lack of proper listing perpetually resulted in failures of the public finance reform due to the persistence of *status quo bias*.³⁵ Even the adjustment periods were not able to provide significant changes in this field.³⁶

Another potential guarantee for transparency building could be the introduction of an independent fiscal institution, which is *inter alia* entitled to monitor the public finance by impact assessment. The patterns of deficit suggest that the State Audit Office of Hungary was

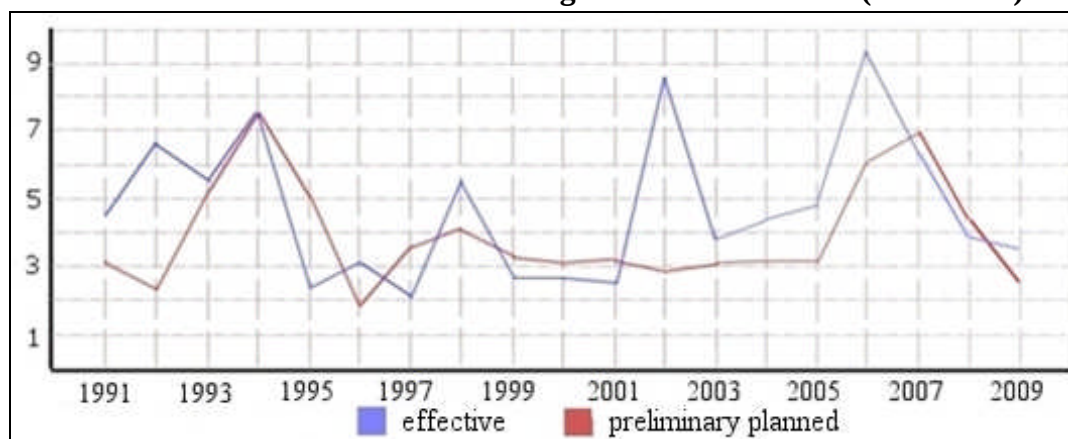
³⁴ Political fiscal cycles, caused by the manipulation of voters, often take place in new democracies. This was documented by Drazen and Brender (2003), and their paper pointed out that the voters will be able to resist manipulation by the fourth election cycle. By that time most of the voters have already gained the necessary knowledge about the fiscal behaviour of the past.

³⁵ See more: Pete (2001).

³⁶ Although there was a supervising survey on the institutional framework in 1993, its results were not applied in practice.

not able to perform this role efficiently and forcefully. Transparency also refers to the due and credible data publication (e.g. the planned and effective deficit data). The government should have avoided the exaggerating optimism and pessimism in the planning phase of deficits. Substantial disparity (*Chart 20*) between the planned and effective data could depress investors' confidence in economic policy, and also could buoy the well-documented fiscal illusion (Buchanan et al. 1986).

Chart 20. Planned and effective budget deficits 1991-2007 (% of GDP)



Source: Eurostat, budget bills, implementation reports of the budget.

It goes to seldom count that the all-time government would give enough attention to the institutionalization of fiscal rules, with the exception of the period after 2006. During the already mentioned 'cold-shower' fiscal consolidation the government tried to introduce some monitoring rules and a more tightened tax collection mechanism in 2003, albeit there was not any notable improvement. In comparison, the consolidation, introduced by late 2006, has already tried to plant the seeds of transparency and institutional rules.

Consequently, the budget reserve could rise by 0.3 percentage point and the Fiscal Responsibility Law came into force, as well. It seems that these changes sanctify the needs of medium term fiscal planning (with three-year budget planning, real debt rule, medium term spending ceiling, limited mid-term obligations, procedural rules with impact assessments). Furthermore, the Fiscal Council Republic of Hungary as an independent fiscal institution was set up.³⁷ The establishment such institution is not a newfangled enterprise; numerous countries have such institution throughout the world (Eichengreen et al. 1999; Wyplosz, 2002; Debrun et al. 2009).

³⁷ Let us add immediately, the institution was winded up by the government at the end of 2010.

In the light of the international practice, we can get to the conclusion that the ultimate objective is the achievement of an unambiguous, transparent, simple, flexible and well-focused institutional framework with accountability criteria.³⁸ Institutional quality affects not just fiscal, but also monetary policy through its credibility repercussion (Andreula et al. 2009), which is likely to dampen the risk premia. The domestic and international capital markets are aware of the fact that the institutional quality could guarantee the moderation of the perpetually condemned *deficit bias* (Hallerberg – Wolff, 2006). This implies the existence of some sort of harmonized relationship between fiscal and monetary policies in terms of their commitments. No one could expect fiscal sustainability without any consideration of its consequences and requirements on monetary policy.

4.5 Another belatedly coming consolidation – but this time is different

Contrary to the practice of the great majority of European countries, Hungary faced global financial meltdown resulted in a juncture in real economy just when its government was about to ‘sober up’ from the ‘fiscal alcoholism’ *via* significant and perceptible austerity measures.

Hungary’s fiscal policy became a vivid conductor by the autumn of 2006, and started to crescendo the improvement in fiscal discipline and to leave the inappropriate pro-cyclical behaviour behind.³⁹ The stabilization led to a much weaker economy by the time when the global financial crisis erupted in 2008 and its impact on the Hungarian economy was twofold. On the one hand, fiscal policy, which became anti-cyclical right after 2006, has been imperatively converted into pro-cyclical again. And although pro-cyclical fiscal policy is always regarded as an example of misguided fiscal management in time of peace, this change could cause a substantial improvement in terms of short-term deficit figures during the crisis. On the other hand, the country has successfully avoided the potential debt crisis due to the credit crunch. It goes without forgetting that fiscal sustainability mostly relies on the all-time governmental commitments.

Hungary needs to continue the consolidation due to its public finance position. Presumably, comprehensive and deep structural reforms might expose the economy to unmanageable risks during the crisis *via* its negative consequences on domestic demand.

³⁸ About fiscal rules see for example: Kopits and Symansky (1998).

³⁹ It should be noted that the credit package which accounts for EUR 20 bln provided by IMF, World Bank and European Investment Bank, depended on the commitment to the continuation of consolidation. The credit package *per se* can be treated as a cautionary sign about the empirically justified fact that the coalition government plays a ‘war of attrition’, thus it reacts with significant delay to the shocks.

Nonetheless, there is a chance for structural alteration in the tax system by offsetting every change. As matter stand, Hungary has to stabilize its unsustainable public finance in parallel with its stimulation efforts.

It is ascertainable that those countries are more likely to be able to use considerable fiscal stimulus with lower risks whose internal market is big enough, and which have not been on the verge of such a threatening public finance position like Hungary in 2006. The demonstrated internal imbalances of Hungary were accompanied with the deteriorating external balances owing to the inadequate conjunction of fiscal and monetary policies. Likewise, the structural weaknesses of Hungary also played a key role in this process. Thus, the dilemma whether Hungary has to continue the already started fiscal adjustment or has to stimulate the economy *via* intensifying the public expenditures during the crisis is just ostensible. Even if the government might rearrange the financial resources to energise the economy, further consolidation is inevitable due to the vulnerability stemming from the relatively high indebtedness and the dwindling foreign resources. Instead of the dampening of recession, avoiding the potential state bankruptcy enjoys priority. Namely, the pro-cyclical fiscal policy, which was continuously condemned between 1998 and 2006, has suddenly become indispensable because the government intended to preserve the solvency.

The 2009 measures laid on the common basis with the above mentioned (*Chart 21*). Beyond the already mentioned institutional changes a treasury system was designed and implemented, which stands sentinel to provide fiscal discipline with due diligence on the ministry level.⁴⁰ Sending strong signals to the markets about the credible commitment was particularly the key reason behind the reassessment of the 13th-month pension and wages, which were taboo themes formerly. According to the study of Gáspár and Kiss (2009), the elimination of the 13th-month pension did not induce a rise in the poverty level because most of the pensioners' households can be categorised as a medium-income group, but it could dampen the burden on the overcharged social system. It is widely acknowledged that the wage freezing has a beneficial impact on budget balance during the conjuncture, and it is also able to rigidly maintain the structure of consolidation.

In the aftermath of the measures the decreasing trend of the cyclically adjusted primary balance did not fade away. As for the numbers, the budget deficit was 3.5 per cent of the GDP in 2009, and the gross consolidated debt was 78.3 per cent of the GDP.

⁴⁰ According to the plans of the new government elected in 2010, it will be replaced by a supervisory system.

Chart 21. The main budgetary measures in 2009

	Measures on revenue side	Measures on expenditure side
2009	Introduction of the so called 'Robin Hood' tax (8%) on the profit of energetics sector (temporary: 2009-2010) (0.1% of GDP)	change in the pension indexation; the 13th month pension decreased to the level of average pension, the reduction was bigger by the early retirements (0.2% of GDP)
	Increasing in VAT by 5 percentage points	partial compensation in the 13th month salary of public sector, freeze in the nominal wages of public sector (0.25% of GDP)
		comprehensive reduction in operational expenditures of budgetary institutions, limit on the number of employees (0.2% of GDP)
		Cuts in chapter-administered and other government programmes (e.g. transport development and environmental protection, -0.25% of GDP)
		Modernisation and subsidy programme for district heating schemes (+0.1% of GDP, financed from the earmarked 'Robin Hood' tax)
		savings in social transfers due to the pension correction program, regular indexation of family allowances (0.15% of GDP)

Source: Budget bill.

Real GDP declined by 6.3 per cent, a record level since the transformational downturn in the early 1990s. The fiscal consolidation was not able to vigorously appease the wave of recession as a result of the global financial crisis, but the continuity of the fiscal correction should not be intermittent.

An interesting question arises at this point: should countries implement deep and comprehensive structural reforms simultaneously with fiscal consolidation during the still open-ended crisis or not. The consolidation deepened even further the recession, but the structural reforms would also have similar negative effects. It goes without saying that the structural reforms would not have a positive effect on economic growth, which can be anticipated especially in medium or long term. Beyond a peradventure, with structural reforms the negative impact on economic growth would have been even stronger in the case of the weakened Hungary (Erdős, 2010).

Additionally, there are lots of papers studying the empirically perceivable phenomenon of the – so-called non-Keynesian – expansionary effects in the short run, albeit the direct factors have not been exhaustively revealed yet. The distinct enhancement in the quality and accessibility of welfare services are more likely to take place in consequence of the reforms. And what is more, the opportunity for development of human capabilities would

broaden, which is a manifestation of the conclusion of the prevailing development economics (Sen, 1993). It should be accentuated that certain changes seem to be feasible in the tax and expenditure structure during the crisis, which could contribute to the building of fiscal discipline and the avoidance of state bankruptcy.⁴¹ Instead of establishing uniform personal income taxation, the government should concentrate on the tax abatement on employers (e.g. wage contributions),⁴² the elimination of tax allowances in parallel with reducing the tax rates.⁴³ The latitude of government to raise VAT is very limited because the present 25 per cent tax rate is the highest one throughout the EU. In case of any type of tax cut, economic policy has to be aware of the fact that the evolving income changes in consumption will extremely depend on tax-related expectations, especially, whether the tax payers count on a temporary or permanent tax cut (Jappelli – Pistaferri, 2010). It is consistent with the findings of Shapiro and Slemrod (2009) that shed light on the slight impact of the one-off tax changes on households' expenditures. If we take into account the high frequency of changes in the Hungarian tax system, we can assume that the society has a negative attitude towards the stability of planned tax modifications. This could fundamentally deform the optimistic expectations. Accordingly, the focus has to be on spending rationalization by restructuring the public administration to a much more performance based system during the recession. When the recession alleviates and the recovery period begins, the government should seize the opportunity to implement the inevitable structural reforms.⁴⁴

4.6 Sustainability scenarios on Hungarian public debt

As the Hungarian case has depicted, the permanent lack of the mutual commitment to sustainability between monetary and fiscal policy has been changed only by the imminence of insolvency in 2006. This lasting hysteresis exemplifies that the all-time coalition governments acted in conformity with the political economic theory through a long time.

It goes to platitude that there is no consensual agreement among the economists on what volume and dynamics of public debt would be optimal for a given country (Marcet - Scott, 2009). Notwithstanding, Hungary's public debt seems to be sustainable at (or below) the 60 per cent threshold level of GDP. This implies that the trend of public debt has to be

⁴¹ According to Szakolczai (2009) the changes should be counterbalancing both in revenue and expenditure side.

⁴² The relatively high income polarization is an unambiguous cord of the uniform taxation (Ferge, 2006).

⁴³ It is a major priority because of the low willingness of citizens to pay tax. As Elek et al. (2009) pointed out, this could lead to an increased inertia in the pension system due to the shadow economy which is likely to provide distorted employment forms.

⁴⁴ It is essential because the aging population problem is further aggravated by the improvement in life expectancy at birth (KSH, 2010).

descending.⁴⁵ This is required not only by the Maastricht Treaty, but also by the unsustainable welfare systems of Hungary with the unresolved problem of aging population.⁴⁶

If we take into account that the sustainability of debt/GDP ratio is primarily determined by the real interest rate, real GDP growth and the primary balance, it gives us an opportunity to prepare some theoretical scenarios on the sustainability of the Hungarian fiscal policy. We emphasize that the scenarios are based on projections of the macroeconomic indicators and on economic policy assumptions. In order to make projections on the development of the debt/GDP ratio we use the following simple real model:

$$b_t = b_{t-1} * \frac{(1+r_t)}{(1+g_t)} - pb_t$$

where b_t is the debt/GDP ratio at the end of period t , b_{t-1} is the same variable the year before, r_t represents the real interest rate in period t , g_t is the real GDP growth and pb_t is the targeted and reached primary balance in period t . While the real interest rate and real GDP growth can be considered as exogenous variables due to the government's limited power to affect them directly,⁴⁷ economic policy has the power to improve or deteriorate directly the primary balance. With the contribution of fiscal discipline and the mixture of rules and institutions, the government is likely to ensure a primary surplus, which is an indispensable precondition for debt reduction when the potential economic growth rate cannot overcompensate the real interest rate. The transparency and the more credible fiscal policy also have beneficial effects on the reduction of real interest rate.

Our paper does not strive to collect all the factors standing behind real economic growth. Nonetheless, it accentuates the essential role of the potential economic growth, which can be only indirectly and slightly influenced by economic policy, in the development of debt/GDP ratio. Accordingly, the level of the potential economic growth is a focal issue in the scenarios. Previous studies examining the Hungarian potential economic growth rate suggest that the rate could be around between 3.5 per cent and 4 per cent (Benk et al. 2005; Erdős, 2006). At the same time we must not skate over the recent findings conveying that the potential GDP growth has lessened since the beginning of 2000s as a result of the fiscal performances and the structural problems of the Hungarian public finance (Antal, 2009;

⁴⁵ This largely depends on the model specification used by the calculation (Aiyagari – McGrattan, 1998). Additionally, the empirical findings have pointed out that there are differences in the debt tolerance by investors among the countries (Reinhart et al. 2003; Reinhart – Rogoff, 2010; IMF, 2003).

⁴⁶ Without any demographic challenges in the future, the pension system will remain unsustainable due to its net implicit public liabilities which is around 230 per cent of GDP (Orbán – Palotai, 2006).

⁴⁷ See Upper and Worms (2003) on the macroeconomic consequences of the different patterns of long-term average real interest rates.

OECD, 2010). In addition, the relatively high volume of foreign resources was not able to boost the potential economic growth. Consequently, the domestic and foreign indebtedness of Hungary, and the culmination of imbalances resulted in a deterioration in the potential growth. All in all, it would be Panglossian to assume that the potential GDP growth is still the same, therefore we calculate with 2.5 per cent of GDP, of which achievement differs across the scenarios regarding the velocity.

As regards the real interest rate, we can suppose that its level was around 5 per cent in 2005 (Czeti – Hoffmann, 2006). The likelihood of a convergence below the mentioned level is increasing in the case of long-term average real interest rates, especially after the EMU-accession. Furthermore, the improving credibility induced by the fiscal discipline also could be another reason behind this presumption. Briefly, an economic policy facilitating the dampening of the long-term average real interest rate (such as the already mentioned institutionalization)⁴⁸ would be beneficial. It can be anticipated if the government makes effort to establish fiscal rules and independent fiscal institution simultaneously (Jánossy, 2008). The latter one could counterbalance the immanent inflexibility of fiscal rules by its flexible functioning. All these processes have taken place in Hungary more or less successfully, but belatedly. The further strengthening of the fiscal council's authority might accelerate the sinking of the average real interest rate below 3 per cent. This may also imply the sharp erosion of *deficit bias*, because the primary balance has to be positive if the real GDP growth cannot outdo the real interest rate.

According to the real model we outline optimistic, pessimistic and realistic scenarios. All these scenarios have a dynamic approach regarding the changes of the parameters in time.⁴⁹ Specifically, the optimistic and realistic scenarios encompass two different dates concerning the feasibility of the 60 per cent debt/GDP ratio (*Chart 22*).

The optimistic scenario envisages a potential average yearly GDP growth of 3.6 per cent with a relative faster access path. Beyond the short-term expansionary effect on economic growth of the durable consolidation and structural reforms, another strong feature of this scenario is the assumption of the establishment of such a fiscal responsibility framework, which targets and reaches 1 per cent primary surplus from 2010, and 3 per cent from 2014. According to this scenario, the average real interest rate will incrementally decrease to 2 per cent by 2012 from the 5 per cent initial level. The major lesson of this

⁴⁸ We should add to this the price stability, which is provided by the credible inflation targeting policy of the independent central bank.

⁴⁹ You can find Figure 1 in the Annex, which contains the parameter specifications of the scenarios.

scenario is that the debt/GDP ratio will be able to shrink to 60 per cent from 2016. Before 2016, the fulfilment of the Maastricht criterion seems to be achieved through the downward trend of the debt/GDP ratio.

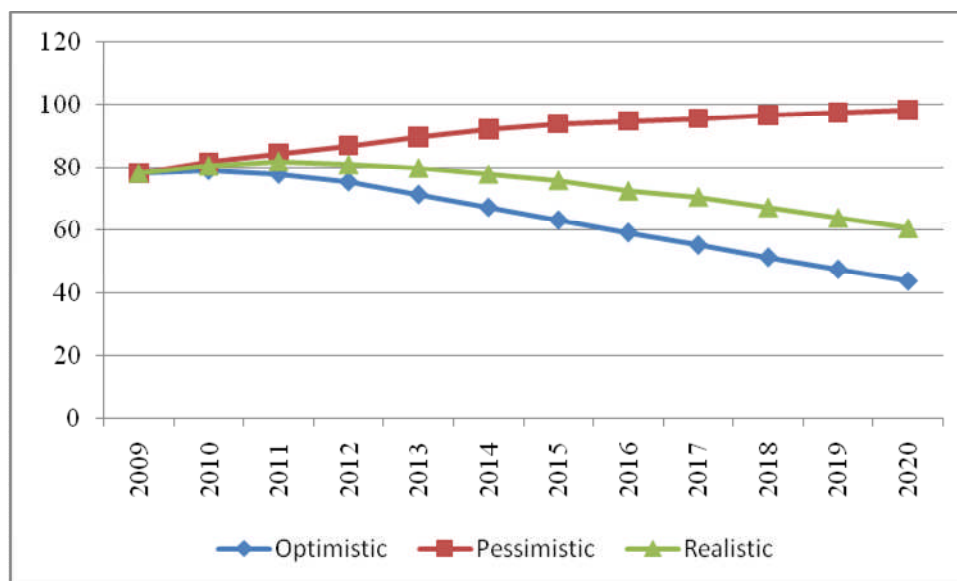
The pessimistic scenario envisages a slow recovery of the external conjuncture;⁵⁰ moreover it considers that the domestic fiscal and monetary policies will not make a strict commitment to fiscal sustainability. This could be interpreted as a triumph of the hysteresis-generating power of the coalition government's distributional conflicts. It is as much as saying that the economic policy is pervaded by the lack of *status quo* breaker commitments. We can anticipate as a corollary, that both the necessary institutional pressure and the improvement of primary balance will be insufficient. Thus, this scenario envisages 1 per cent, still anaemic, primary surpluses from merely 2015. In other words, the elimination of structural problems will not emerge after 2009, and the fiscal discipline will only be volatile. Consequently, the debt service must face with high real interest rates. This scenario also has an assumption regarding the potential GDP growth. It assumes that the potential economic growth will take its road to the 2 per cent annual growth from only 2014. All in all, the pessimistic scenario expects a permanent increase in the trajectory of debt/GDP ratio until 2020, however, the assumed 1 per cent primary surplus for 2015 will perceptibly dampen the dynamics of growth.

The realistic scenario predicts that the necessary intention and commitment will be there to stop the further relapse of the potential economic growth through carrying on the fiscal consolidation, implementing the supportive structural reforms and institutionalization including the strengthening of the already established institutions, as well. These *per se* are able to reduce the real interest rates. According to this scenario, the Hungarian potential economic growth is going through an incremental regeneration and it will reach 2.5 per cent by 2012, and from 2015 it will be 3 per cent. The realistic scenario reckons that the debt/GDP ratio will not be in proximity of 60 per cent before 2020. Nevertheless, the realization of this debt/GDP ratio requires 3 per cent primary surplus from 2015 to 2020. The realistic scenario embraces the recognition of the fact that sustainability is particularly sensitive to the development of the external conjuncture, especially to the growth conditions of the EU. Empirical studies have already underpinned that the potential economic growth of the EU member states has been slowing down since the beginning of the 1990s due to various

⁵⁰ Mellár (2001) points out that the European Union's economic growth has a significant effect on the domestic economic growth. There is an especially tight and documented correlation between the Hungarian economic growth performance and the dynamics of the German economy.

unfavourable processes, such as the weak adaptation ability to globalization, the anaemic and problematic productivity and the aging population, as well (Carone et al. 2006). On the back of this deterioration, the financial and economic crisis erupted in 2008 also smuggles risks regarding the sustainability of the current level of potential GDP growth. Subsequently, the 2.4 per cent potential GDP growth rate of the EU is likely to be halved in the next decades (Halmai, 2009).

Chart 22. Scenarios on the debt/GDP ratios until 2020 (% of GDP)



Note: Initial condition in 2009: debt/GDP ratio: 78.3 per cent; real interest rate: 5 per cent; real GDP growth: -6,5 per cent.

The reason why our optimistic scenario is not probable to turn into a real perspective is that the lasting consolidation and structural reforms, in Hungarian relation, would have an infinitesimal expansionary effect on the economic growth. Consequently, we had better calculate with medium- or long-term perspectives. In the case of the optimistic scenario, breaking the *status quo* would be equivalent with an immediately implemented and heavy fiscal adjustment. As we have seen previously, the government has not got the opportunity to intensify the ability of the Hungarian society to bear further burdens. On rational basis review, we cannot firmly believe in the optimistic scenario on the one hand, the pessimistic scenario has to be avoided on the other. Economic theory argues that the permanent worsening of the debt/GDP ratio has a tolerance threshold until which the country is able to finance itself. Above this tolerance threshold the country is more likely to become insolvent because of the waning financial resources to maintain its interest payments on debt and welfare services (Reinhart – Rogoff, 2010; Hausmann, 2003).

The realistic scenario envisages that the debt/GDP ratio will be under 60 per cent by 2020. It is more or less consistent with the findings of the stress test by IMD (2010), which estimates this to happen by 2022. Our realistic approach represents a more bearable consolidation path, which tries to make an effort to minimize the losses of an incidental emerging insolvency both for the present and the future generations. Therefore the potential economic growth will merely be 2.5 per cent. Benczes (2006) pointed out that the consolidation and structural reforms would negatively affect the domestic demand in the short run. We may not count on positive expectations, which could trigger the increase of the propensity to consume in the short run. This claim can be held, even if the consolidation would be based on the expenditure side as the international cases suggest regarding the successful consolidations.⁵¹ This also implies that even if the government motivates the investments, the savings, additionally it creates more favourable circumstances for the technology development, the innovation, the business climate and the development of human capital, the general effect of these altogether will not be enough to bring the potential economic growth over 3 per cent until 2020.⁵² Then again the growth should not be primarily based on domestic demand, because it would lead to a huge imbalance in the current account in the case of small open economies like Hungary.⁵³

This scenario calls our attention to the importance of trust-building, which could open the door for the structural reforms contributing to the viable consolidation. Hungary has to make efforts to shift towards this scenario in the following key areas: (i) transparency; (ii) decision-making mechanism; (iii) time consistency; (iv) accountability and responsibility. With prudent and painstakingly established impact assessments during the decision-making process could be able to improve the transparency, ultimately the *sustainability informer* role of the government. Another supportive effect would emerge due to the application of a

⁵¹ There are complex reasons behind that. Benczes (2006; 2008) highlighted *inter alia* the major role of the external conjuncture and liquidity in the short-term occurrence of expansionary fiscal consolidation. As a result of the financial crisis erupted in 2008, the banks became much more sensitive, and thus did not expand significantly their lending to support the private sector (Kregel, 2009). Consequently, the accessibility to financial intermediation has worsened. In addition, the Hungarian labour market has not got the necessary flexibility as it can be found in the case of successful economies. Moreover, there are lots of consensus-inhibitory factors such as the attitude of households and inhabitants due to the versatility of the „stop and go” economic policy. In the absence of positive experiences, this contributed to the negative future expectations. The fiscal adjustment and the structural reform are *experience goods* and *credence goods* as well. The all-time Hungarian coalition government has not got the creditable reference on this issue, thus the unconditional trust and the irreproachable belief in the future are merely phantasmagoria categories. About *credence goods* see: Dulleck et al. (2009).

⁵² The Hungarian Fiscal Council also predicts max. 2.5-3 per cent potential GDP growth.

⁵³ The economic theory have already well-documented that the twin deficit was among other things another major reason behind the currency crises over the period 1970-2004 (Efremidze – Tomohara, 2010).

participation-based decision-making process, which may foster the likelihood of a broader consensus. The coalition government has to aspire to the coherent decision making avoiding the huge discrepancies between the planned and effective data. Furthermore, if the government will be liable for its failures, this could enhance the social trust and capital in itself. These measures may be the main factors to eliminate the risks stemming from the deficits and debts and are able to be the institutional hurdles of public finance imbalances.

The above mentioned measures are the major fundamental factors of a successful expenditure-side consolidation, which concentrates on the number of public sector employees, wages and the rationalization of social transfers. These are very sensitive areas, and can weaken the resolution of the coalition government. But the international cases have confirmed that consolidations with similar leitmotifs can lead to short-term expansionary effects (Giudice et al. 2003; Benczes, 2008). As a consequence of this potential short-term growth effect, the government would have the opportunity to compensate the losers of the fiscal adjustment. Beside the fiscal institutionalization, this could be another trust-builder channel.

Conclusion

This contribution attempted to illustrate how an aforementioned theory of political economics worked in Hungary after its transformation between 1990 and 2009. Under the consideration of the changed circumstances, especially the stronger external pressure from markets triggered by the financial crisis in 2008, we emphasize that the coalition government might be forced to maintain its consolidation. As Hungary showed, it is not statutory that the coalition government's belatedly coming consolidation will always be diminished as it is predominantly observable in time of 'peace'. According to our general conjecture, in a small open economy running relatively high external indebtedness, the coalition government – even if it has major distributional conflicts – is more likely to be able to manage the public finance with more notable fiscal discipline due to strong and coercive external shocks. The long-lasting improvement of fiscal performance mostly depends on the future economic policy of the Hungarian governments.

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Annex

Figure 1: The parameter specifications of the scenarios

Optimistic						
	2009	2010	2011	2012	2013	2014-2020
<i>r</i>	5	4	3	2	2	2
<i>g</i>	-6.5	1.5	2	2.5	3	3.6
<i>pb</i>	0	1	2	2	2	3

Pessimistic								
	2009	2010	2011	2012	2013	2014	2015	2016-2020
<i>r</i>	5	5	5	5	5	5	5	4
<i>g</i>	-6.5	0.5	1.5	2	2	2	2	2
<i>pb</i>	0	0	0	0	0	0	1	1

Realistic						
	2009	2010	2011	2012-2013	2014-2015	2016-2020
<i>r</i>	5	4	3	2.5	2.5	2.5
<i>g</i>	-6.5	1	2	2.5	2.5	3
<i>pb</i>	0	0	1	1	2	3

Note: ***r*** is the real interest rate, ***g*** is the real GDP growth, ***pb*** is the targeted and reached primary balance.