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# **The Pillars of a New State Management Model in Hungary**

*The Renewal of Public Finances as a Precondition  
of a Lasting and Effective Cooperation Between the  
Hungarian State and the Economic Actors*



## *Summary*

Cohesive society, trust and social cooperation are among the social arrangements and meta-institutions required for building good institutions and a well-managed state. Before the global financial crisis, Hungary was characterized by unsustainable public finances, a flawed and irresponsible fiscal policy, and consequently, weak economic fundamentals. This represented a suboptimal state management, with the basics of cooperation between the state and the economic actors were seriously damaged. For this reason, by the beginning of the decade, the renewal of state management and, above all, public finances had become imperative. The first step was the adoption of the Fundamental Law (new constitution), including a chapter on public finances. The stabilization of Hungarian public finances is built on the Fundamental Law and the debt rule, and the

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monetary policy reforms (after 2013) and improvement in competitiveness (launched in recent years, but partly ahead of us) can also be associated with these regulations. The renewal of public finances after 2010 enables a lasting and effective cooperation between the Hungarian state and the economic actors. The new cooperative framework needs to be institutionalized and can be an appropriate basis for the creation of a well-managed state and an attitude change potentially leading to a state management actively leveraging positive incentives and seeking partnership with the relevant stakeholders.

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## INTRODUCTION

Large government deficit, increasing sovereign debt, the private sector running into debt, high taxes, high tax evasion, low employment, unsustainable growth with high inflation, outstanding external vulnerability, these characterised the Hungarian economic policy in the years preceding the crisis. By the beginning of the decade, the renewal of state institutions had gained key significance, however, it needed to be preceded by the reinforcement and consolidation of the state and the creation of firm macroeconomic underpinnings. The reason is that these institutional pillars are required for the development of a state operation capable of orienting the relevant social partners towards a cooperative behaviour and thus laying the foundations of a new method polity model, including a new management of public finances.

In this study, first the significance of the institutional matrix, and more specifically, of confidence and cooperation, and then the framework of a cooperative state management of public finances are presented. Then a summary outline is given of the actions taken in this decade to reinforce the Hungarian state and allow the permanent renewal of state operation. In addition to Hungary, the identification of the criteria of a successful and efficient state is in the focus of decision-makers and research communities all over the world, and the topicality of the issue is underlined by the fact that last year the Nobel Prize was awarded to an economist, namely Richard Thaler, who has given high priority to the study of correlations between state operation and individual and social (community) behaviour.<sup>1</sup>

## SOCIAL CONFIDENCE AND COOPERATION AS PART OF THE INSTITUTIONAL ENVIRONMENT

In the absence of good rules and good forms of behaviour, sustainable economic development is ruled out. Bad rules and forms of behaviour can cause serious damage: this is one of the fundamental propositions of the institutional approach, which is

increasingly accepted and widespread, and pervades also the proclamation of reforms in economics hanged out on the entrance of the London School of Economics last December.<sup>2</sup> An “institutional background” can be considered optimum if the various institutional levels are cascaded: formal rules fit to informal ones, and written statutes do not break with the community’s past, experiences and cultural endowments. During the elaboration of formal rules, the cultural and social background that characterises the particular community at the given moment (or period) must be taken into consideration in order to avoid unintended consequences.

The stable institutional foundations also allow for the completely different paces of institutional development in the case of formal and informal institutions (rules). Formal rules may be changed overnight, however, the informal restrictions giving the framework of individual and collective behaviour only allow a gradual evolution. Consequently, a regulation is good if it allows for the local conditions, and bad if it wants to press new forms of behaviour on the community going against them.

Thus it may be accepted that the economy cannot be separated from the background of political and social institutions, as the rules of the game that determine individual decisions are given by the political and social frames.<sup>3</sup> Thus instead of restrictions binding individuals hand and foot in their decision or obstacles paralysing economic development, social institutions should rather be viewed as facilities capable of raising the standard of welfare if managed appropriately. There is no need to assume that the institutional background is unalterable: ultimately, economic and social change is nothing else but the refinement of the institutional network, in other words, its adjustment to new challenges and situations. Historical experience underpins that a country’s competitiveness depends to a large extent on the adaptability of the institutional system and matrix. A community can only be successful if it gives the right responses at the right time to appropriately asked questions. One of the main findings of North’s research was exactly that in less developed states the conservation of the backlog can only be traced back to the fact that, for various reasons, these states have been incapable of improving their institutions and creating a stable and low-risk institutional environment. There is a disagreement in the literature about the driving force of institutional development and the factors that are responsible for “getting stuck”, but there are general conditions that can typically be considered as the bases of development. According to Rodrik (2000), one such meta-institution is democracy, which allows the entire political and social community to decide on the direction of development. Another example includes the level of confidence and cooperation characterising a given society. In the absence of confidence, transaction costs are high, and this renders the building up of an optimum institutional matrix impossible. A rising confidence level, however, gives the opportunity of building an institutional framework consistent with higher social welfare.

Williamson, another Nobel Prize winner of the institutional school, defined four levels of the institutional structure, built on one another, and having an impact on the performance of the economy and society in the broad sense of the word. The first level 1) comprises ethics, customs and norms, with the 2) fundamental rules of the institutional environment, 3) the management structures and 4) the daily decisions

and institutional solutions used for the allocation of resources settled as the next layers, respectively. Confidence between the state and the affected social groups corresponds to the second level, which may not be irrespective of the fundamental rules and relationships of the given community, and which is capable of determining the management structures and, through them, daily decision-making.

#### FUNDAMENTALS OF COOPERATIVE STATE OPERATION

Our basic proposition is that a state capable of building a cooperative relationship with its citizens, the business sector, banks and all other affected parties (collectively referred to as stakeholders) can be more successful than the one that is incapable of doing so.<sup>4</sup> As a result of this, and accepting that the higher level satisfaction of social needs inevitably entail a demand for an efficient partnership, in this study the question of bringing the state closer to this cooperative operation will be tackled. This study is built on two presumptions.

1) The effect of state actions depends greatly on environmental factors, with the level of confidence and cooperation between the state and the stakeholders having particular significance.

2) The “state of the country” (status), evolving on the basis of the existence or absence of cooperation between the state and the stakeholders largely determines if the state is capable of prompting the affected social groups to act cooperatively.

As a starting point, in this study it is presumed that the quality of state operation (economic policy) can be reasonably improved by making stakeholders<sup>5</sup>, especially the market and other state participants

- interested in the success of state actions;
- identify themselves with the objectives of state operation, the particular state action or programme;
- commit themselves to the achieving the state objectives.

In a certain sense, efficient state operation is the achievement of the above-described “status”, as it means cooperation between the state and stakeholders in the broad sense, and it is presumed that it is more efficient than the mode of operation built on the absence of cooperation. As the reinforcement of public confidence may result in a beneficial commonality of interests, the renewal of state operation should be conducive to cooperation and the reinforcement of public confidence at the level of basic principles, objectives, the target system and the targeted structure, as well as in practice, promoting change not only in specific action but also in the approach (frame of mind, attitude, value system) vis-a-vis the state.

The other presumption in this study concerns the interaction of cooperative and non-cooperative forms of behaviour. In this framework, the two extreme polity models include the cooperative and the non-cooperative states. A state is considered to behave cooperatively if it sets up a framework and regulations that are optimal for the partners required to observe the rules. In contrast, a state’s non-cooperative approach includes mistrust of the stakeholders, and for this reason the typical regulatory

instrument of such a state is the excessive encumbrance of those expected to comply with the rules. The above descriptions are simplistic, due primarily to the fact that the adopted polity model may manifest in various ways in specific situations, and in the case of certain state actions, the scope of the relevant partners may, of course, differ.<sup>6</sup>

Depending on the stakeholders' response to state behaviour, in our pattern, four different status may be achieved:

1) cooperative state with cooperating stakeholders: this is the well managed state, with mutual cooperation between the government and the stakeholders (to give an example from the field of taxation: the government levies low taxes and taxpayers have high tax awareness and propensity to pay taxes);

2) cooperating state with non-cooperating stakeholders: stakeholders respond to the state's supportive behaviour in a non-cooperative manner, in other words, they practically exploit the elbowroom given by virtue of the government's behaviour (returning to the previous example: in this case taxes are low but tax evasion is high, and the size of the shadow economy is considerable);

3) non-cooperative state with cooperative stakeholders: this is the opposite of the previous state, when the society is cooperative (presumably arising from the state cooperation in a previous state), but the state is not (using the tax policy example, this means that there is a propensity and capacity to pay taxes, and the state responds by overtaxing and an excessive curtailing of incomes);

4) non-cooperative state and non-cooperative stakeholders: this is the state of distrust, when neither the state nor the stakeholders are characterised by a cooperative attitude (the government levies enormous taxes and the taxpayers' typical approach is to evade them).

In a social perspective, the optimum state of affairs is the well-managed state, as both the cooperating parties and, indirectly, the entire society benefit from cooperation, because it contributes to the improvement of public confidence and to the implementation of public welfare as the utmost social goal. It can be readily accepted that neither a "state using up its social basis", nor a "naive state" are sustainable (balanced), in contrast to the state of affairs when neither the state nor the stakeholders are cooperative, as the latter may also represent equilibrium, since no one is capable of improving by merely changing his/her/its own behaviour. Transition between the two equilibrium states is not self-evident: the main question is the stakeholders' response to the state's cooperative behaviour.

*Table 1: Cooperation matrix for the state and the stakeholders*

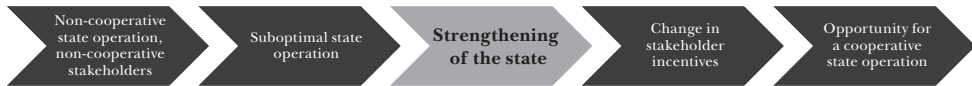
	<b>Cooperating partners</b>	<b>Non-cooperating partners</b>
<b>Cooperating state</b>	<i>"Well-managed, incentivising state"</i>	<i>"Naive and exploited state"</i>
<b>Non-cooperative state</b>	<i>"State using up its own social basis"</i>	<i>"Non-cooperative, punishing state"</i>

*Source: Edited by the author*

From the right bottom corner of the matrix, representing a suboptimum position, the left upper corner representing the Pareto optimum, can only be reached if state cooperation coincides with cooperation by the partners. This means that in order to achieve the condition of a cooperating state, the state needs to be sure that the response to its cooperative actions will be cooperation instead of a continuation of the previous non-cooperative.<sup>7</sup> As a precondition, this requires the reinforcement of the state, as permanent cooperation is only conceivable between equal parties, as a weak state cannot develop a cooperative environment, and only an efficient and powerful state is capable of getting the private sector to permanently cooperate.

It must also be taken into consideration that in the case of the structural reforms, which provide the basis for strengthening the state, costs exceed benefits over the short term, but in the long term, the beneficial effects outweigh costs.<sup>8</sup>

*Figure 1: Steps in the development of operation as a cooperative state*



*Source: Edited by the author*

Below is an analysis of the way the government actions taken since the early 2010s have facilitated the strengthening of the Hungarian state, in other word, the way they have laid the foundations for the Hungarian government's shift towards cooperative operation. The authors hope this study will be followed by analyses focusing on the second phase in building a well-managed state, presenting the areas where the expansion of the cooperative polity attitude is demonstrable.

## HUNGARY'S ECONOMY BEFORE THE CRISIS

The decade that started in 2000 saw macroeconomic developments in Hungary that turned the Hungarian economy from a spearhead to a tail-end Charlie in the region, and proved that imbalances leads the entire economy to an unsustainable trajectory.

1) The starting point of economic problems is the failed and irresponsible budget policy, as explained by Baksay and Palotai (2017). The budget deficit was salient even in a regional comparison, the state spent a lot on social transfers and little on productive goals (pension costs amounted to more than 20 percent of the budget spending). Year after year the Hungarian government spent 6 to 8 percent of its given annual economic performance more than its revenues. Naturally, the missing amount had to be financed primarily from external loans, and as a result, deficit stuck at a high level triggered a substantial rise in the sovereign debt. Hungary's sovereign debt amounted to 55 percent of GDP in 2002, this ratio had risen to 65 percent by 2007, and to 80% by 2010. In addition to the significant rise in the sovereign debt in

absolute terms, its structure also changed in an unfavourable direction (high FX and foreign debt).

2) The disequilibrium had its impact felt in all the other areas of the economy, of which the labour market is of paramount significance. Although in the decade preceding the crisis the activity rate started to increase, in a regional comparison it still remained low. In Hungary hardly more than 60 percent of the 15-60 age group were on the labour market, while the corresponding average of the EU15 exceeded 70 percent, and the Czech Republic had the same labour market activity. In all these, the state's responsibility can be clearly demonstrated, as the low employment rate was accompanied by high and unfavourably structured work-related taxes, and by a system of social transfers. In the case of a single employee paid an average wage or salary, in 2007 taxes exceeded 50 percent, two-thirds of them being employer and employee contributions. Only Belgium had a higher tax wedge among the OECD countries, the corresponding values were slightly above 40 percent in the Czech Republic and Poland, and below 40 percent in Slovakia.

3) The budget deficit led to increasing external indebtedness, while wage hike and the transfers to the population resulted in excessive consumptions and consequently, lower savings. Dues to the soaring deficit and declining savings, the current account deficit rose and led to increasing external indebtedness. Between 2002 and 2006 the state's financing requirement amounted to 7 to 8 percent of GDP, while household savings never exceeded 2 percent of GDP.

4) It represented a serious threat that up to the eruption of the crisis, household loans rose rapidly. The loan portfolio of the household sector to the available income approached 80 percent, while this ratio was 20 percent lower in the regional partner countries. A particular challenge included the fact that lending shifted towards foreign currency loans, and by 2008 households' open FX position had amounted to nearly 20 percent of GDP, as against 2000, when Hungarian families were still net savers up to 5 percent of GDP.

5) All this was combined with high inflation, considerably above the regional average, for the most part due to tax hikes. With the erosion of discipline, monetary policy was rigorous, resulting in high real interests. All this naturally contributed to a surge in FX lending.

The unsustainable fiscal and monetary developments seen in the years preceding the crisis caused stability and competitiveness problems, and as a result, Hungary was incapable of making use of the opportunities offered by the 2004 accession to the European Union: in a regional comparison, Hungary's growth data remained moderate, and duality in the economy, i.e. SME productivity remained considerably below that of large companies, became a fundamental barrier to closing the gap. The growth financed from increasing indebtedness and driven by consumption concealed structural problems, and the evolution of a debt spiral was facilitated by the fact that the Constitution in force before 2011 failed to include a chapter on public finances, in other words, no constitutional rule limited excessive sovereign indebtedness.



## STRENGTHENING HUNGARIAN PUBLIC FINANCES

When the economic crisis fed through to Hungary between 2007 and 2009, fiscal adjustment fell simultaneously. The combined effects of crisis and tightening resulted in a considerable recession, and the challenges could only be managed by applying unconventional economic policy instruments (Matolcsy and Palotai, 2016).

Parliament approved the Fundamental Law, the basis of renewal in public finances and in economic policy, in April 2011, and this started a new chapter, among others, in public finance management in Hungary, allowing the renewal of the entire system of public finances. For the purpose of this analysis, the following regulations of the Fundamental Law (which provide the basis for the debt rule) can be considered important.<sup>9</sup>

“(4) The National Assembly may not adopt an Act on the central budget as a result of which state debt would exceed half of the Gross Domestic Product.

(5) As long as state debt exceeds half of the Gross Domestic Product, the National Assembly may only adopt an Act on the central budget which provides for state debt reduction in proportion to the Gross Domestic Product.

(6) Any derogation from the provisions of Paragraphs (4) and (5) shall only be allowed during a special legal order and to the extent necessary to mitigate the consequences of the circumstances triggering the special legal order, or, in case of an enduring and significant national economic recession, to the extent necessary to restore the balance of the national economy.”

A debt rule raised to a constitutional level is a requirement affecting the entire economic policy, as the debt to GDP can only be reduced sustainably if all the economic policy lines set it as their objective. The success of the “Hungarian method” is well illustrated by the fact that in contrast to the sharp increase in the sovereign debt before 2010, after that year it started to fall: from above 80 percent, debt to GDP fell to around (below) 75 percent. Meanwhile the ratio of FX debt to the total debt dropped from above 50 percent to 25 percent, which means that the FX debt was halved.

Meanwhile, a genuine turnaround was achieved in the real economy as well. Labour market developments deserve a special mention. By 2014 the activity and the employment rates had risen by 6 percent on 2007, representing one of the fastest rises in the European Union. From the beginning of the crisis, activity increase had primarily been driven by welfare transfers and tax restructuring.

Below is an outline of the most important economic policy actions taken in Hungary during the renewal period after 2010, which allowed the above developments and state reinforcement.<sup>10</sup>

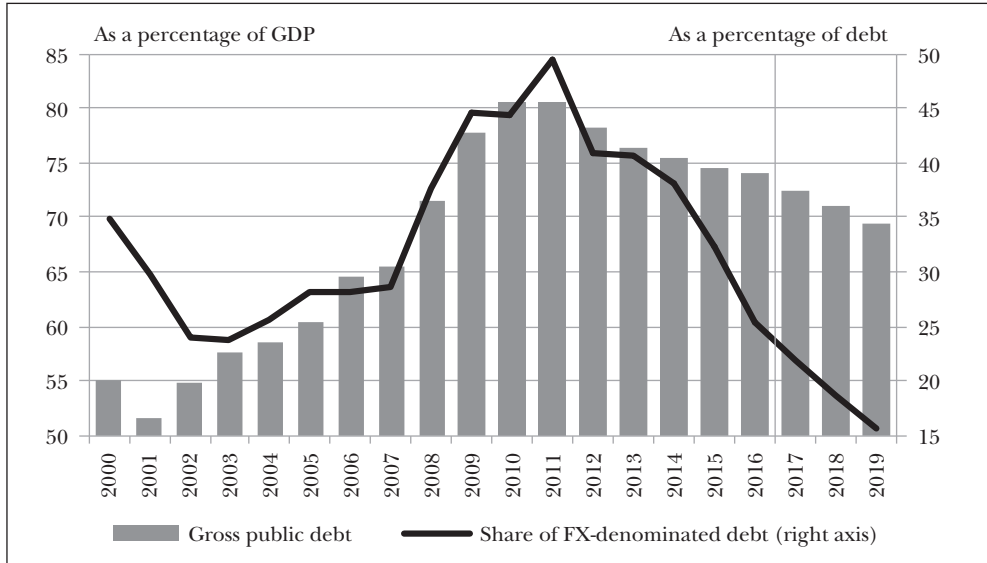
### *Stabilisation of Hungarian public finances*

#### Fiscal trends and turnaround

One of the clearest indications of deterioration in Hungarian public finances was the surge in the budget deficit followed by stabilisation at a high level. As a result,

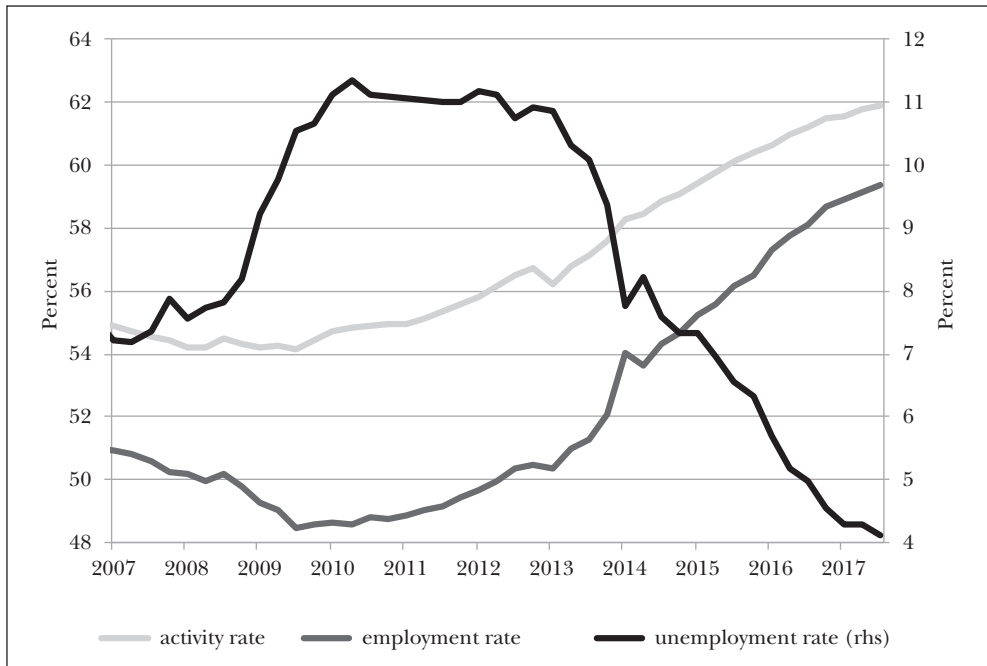


*Figure 2: Gross public debt forecast, calculated at an unchanged (end-of-2016) exchange rate over the forecast horizon*



Source: MNB, 2017b

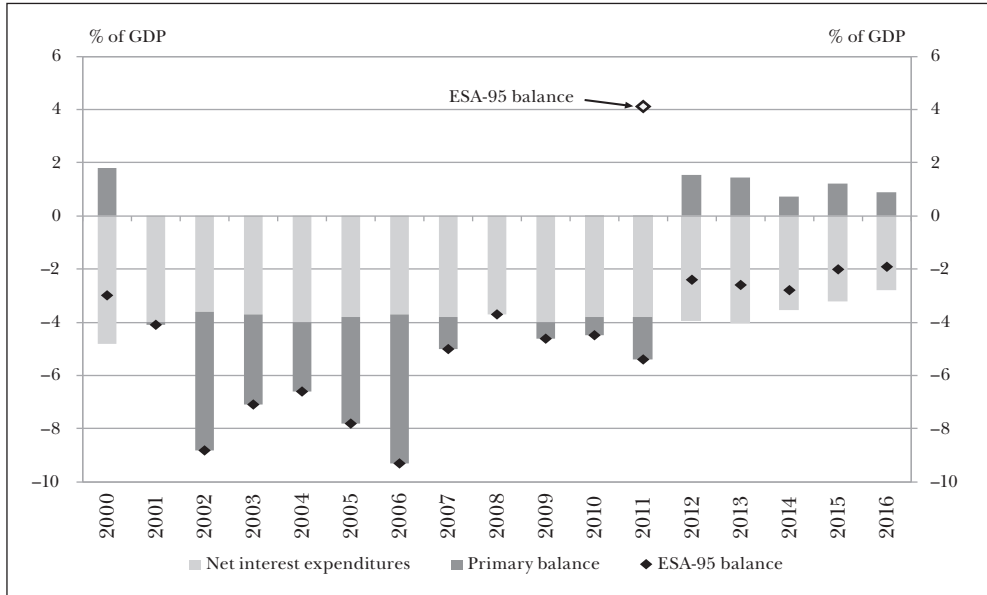
*Figure 3: Labour market developments (2007-2017)*



Source: MNB, 2017b

Hungary was under the European Union’s Excessive Deficit Procedure between 2004 and 2013. Fixing public finances started during 2010 and 2011, when the balance calculated according to the then valid methodology of the European Union suddenly rocketed to 4% of GDP. After 2012, the budget deficit remained below 3 percent of GDP according to every EU-compatible indicator. Deficit decrease was due to an improvement in the primary balance (net of the interest balance), and to falling net interest costs after 2013.

*Figure 4: Fiscal position (2000-2016)*



*Source: Matolcsy, 2017b*

The improvement in Hungary’s fiscal balance was outstanding even in an international comparison: after the crisis the Hungarian budget balance improved at the highest rate among the EU Member States. Between 2003 and 2007 the fiscal deficit was around 7 percent of GDP in Hungary. A similar deficit could only be seen in Greece. However, in 2014 and 2015, Hungary’s deficit fell to around 2 percent, representing a 5-percent improvement, as against Germany, showing the second highest improvement with its improvement below 3 percent.

The most important fiscal and other reforms affecting the budget included the Table 2.

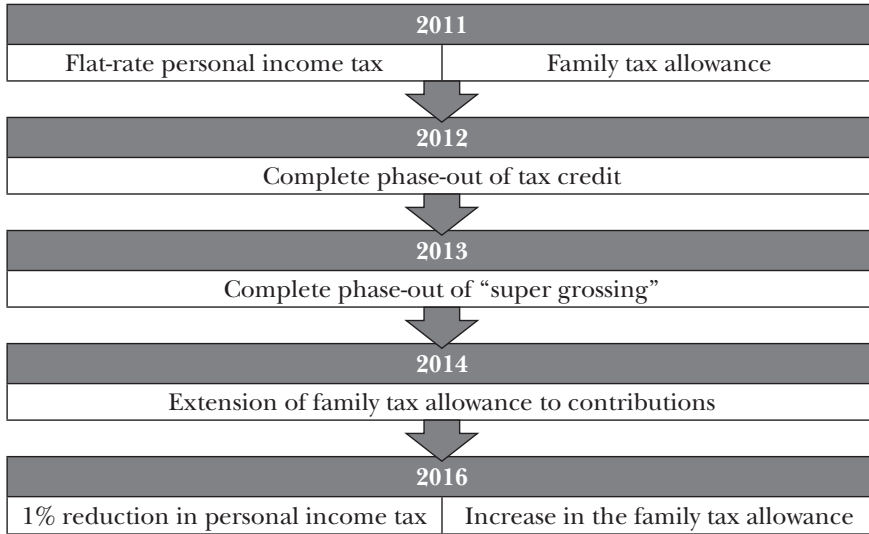
In the above list, special emphasis should be placed on the tax reform, which included, as an iconic step, the transformation of the personal income tax regime, cutting taxes by 2.5 percent of GDP on the whole.<sup>11</sup> After the 2011 adoption of a flat-rate personal income tax, the tax wedge fell from the nearly 60-percent measured in 2009 below 50 percent, and thus the Hungarian tax regime partly closed the gap to the international community (Varga, 2017a).

Table 2: Reforms After 2010

Tax reform	Expenditure cuts	Debt management	Other measures
Reduction of work-related taxes	Structural Reform Programme	Permanent reduction in government debt	Community service
Adoption of a flat-rate personal income tax	Review of the invalidity pensions	Reducing the share of FX loans	Phasing out of FX loans (conversion to HUF)
Family allowance	Tightening early retirement	Improving the basis of Hungarian investors	Reform of the private pension fund plan
Job protection action plan	Cutting the period of subsidies paid for the unemployed	Increasing the average term	
Increasing consumption and turnover taxes (excise and VAT)			
Levying taxes on extra profits			

Source: Matolcsy, 2017a

Figure 5: Transformation of the personal income tax regime

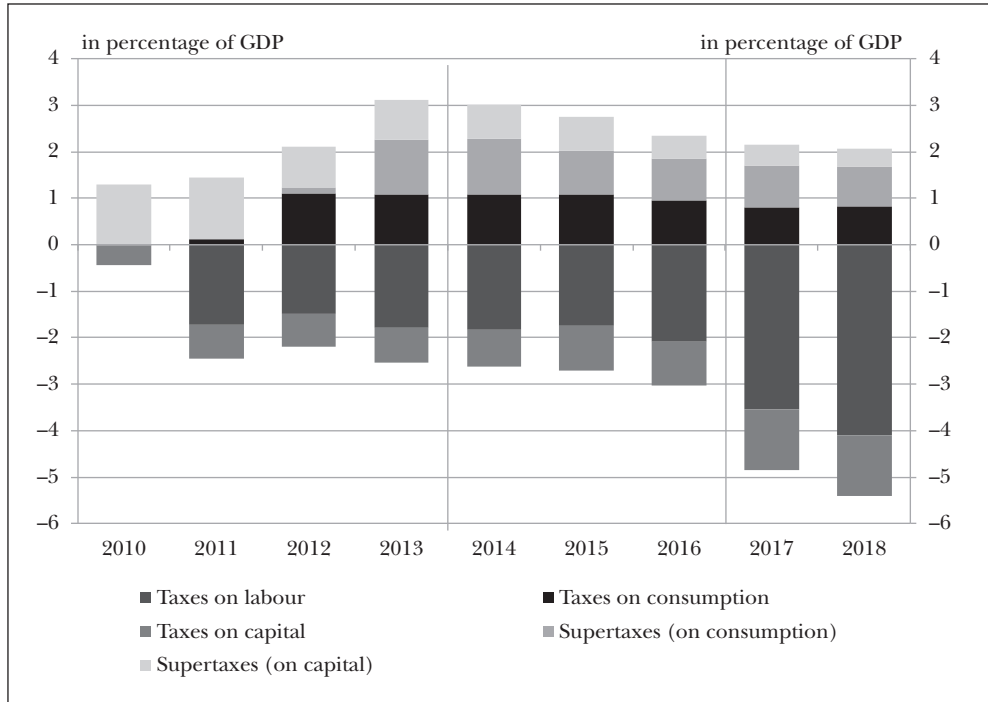


Source: Matolcsy, 2017a

Work-related taxes were replaced by consumption taxes, and the average personal income tax rate on the average wage was reduced from more than 20 percent in 2009 to 15 percent in 2016, placing Hungary below the average of the European Union. The Hungarian tax regime was placed on a new footing: work and capital-related taxes fell, while the revenues from consumption and special taxes increased (Palotai, 2017). The tax system became focused on consumption and performance. It pays to work hard and have a higher performance. Special taxes provided substantial support to the budget: These revenues amounted to 2 percent of GDP in 2013 and still nearly 1.5 in 2016. Between 2010 and 2012, the most significant special taxes included the

one levied on financial institutions (bank levy) and the income tax imposed on the power sector, while after 2013, the duty payable on financial transactions became the most important item.

*Figure 6: The cumulated static effect of the 2010 tax changes on the budget*



Source: Palotai, 2017

### Consolidation of local governments

Prevention of the regeneration of local government debt is a common national economic interest. While the financial balance of local governments deteriorated considerably between 2007 and 2010, financial risks increased.<sup>12</sup> As local governments assumed liabilities in excess of their actual financial capacities, central debt relief became unavoidable, as the bankruptcy of local governments in large masses would have caused unpredictable problems in the national budget. The government relieved local governments of their debts in three steps.

1) First, the debts of villages with a headcount below 5000, amounting to 1710, were assumed in the framework of tax consolidation.

2) In the second step of debt consolidation, the state assumed part of the debts of the local governments of communities with a headcount exceeding 5000, in the amount outstanding at the end of 2012, and their charges accrued up to the date of assumption.

3) The last phase of local government debt consolidation was performed in the spring of 2014, when the state also assumed the debts of municipalities with a population exceeding 5000. The total cost of the debt consolidation amounted to HUF 1300 billion.

It was also recorded that a local government may only have a share in a business if its responsibility does not exceed its financial contribution, and that a local government's business activity may not jeopardize the performance of its mandatory duties. As from 1 January 2012, several restrictions apply to local governments' debt generating transactions (borrowing, security issuance). These rules are set out in the Stability Act. Local governments may validly enter into debt-generating transactions, other than small-scale ones, only with the central government's preliminary approval. Another regulation that serves the stabilisation of finances in the local government sector is that since 2013, no operating loss may be planned in local government budgets. As from 1 January 2012, the healthcare institutions maintained by county institutions and the Local Government of Budapest and as from 1 May 2012, the hospitals maintained by community governments were transferred to state maintenance.

#### Reform of the social security system

At the end of 2010, Hungary was challenged by an increasing budget deficit generated by the mandatory private pension funds, while the budget deficit target set by the European Union had to be met. In response, the government terminated the "state umbrella" protecting private funds, and as a result, huge numbers of fund members returned to the public pension plan. This transformation was especially necessary because approximately one-fourth of the pension payable for private pension fund members flew to these funds, and as a result of the PAYG scheme, the current revenues providing a coverage for pension costs fell considerably, and the generated deficit had to be financed from the central budget. This mechanism automatically led to a rise in the sovereign debt in the phase preceding the fund members' retirement.<sup>13</sup> The sustainability of the public pension scheme remained a relevant issue after the reform, as demographic and employment-related factors must also be taken into consideration in this context, while the extremely high ratio of very low paid employees is another problem in Hungary. The solution may be in the encouragement to have children and in increasing employment, which have been promoted by numerous actions in recent years.

Healthcare, the other pillar of the social security system, influences a country's economic capacity primarily through the amount and quality of available manpower by affecting the active time spent in work and labour productivity. The concept worded in the Semmelweis Programme, inseparably related to the New Széchenyi Plan, focussed on raising funds and the government's increased responsibility in order to help healthcare recover after the crisis and to rebuild it.

– In the framework of the Semmelweis Programme a public institutional system for health organisation was built to manage the patients' path and perform functional integration in order to improve sector efficiency through resource allocation.

– Gradual increase in the real value of health-related public expenditures paved the way to the moderation or elimination of erroneous and damaging incentives of financing, and to the retention of qualified labour. Included in the economy development strategy, the Semmelweis Programme “does not consider healthcare as a sector immoderately exhausting public funds, but as a significant potential engine for the economy”.

– Wage increases in healthcare, the 70 percent rise in financing primary healthcare, the consolidation of hospital debts and the structural changes implemented to reduce debt over the long term all contribute to the sustainable operation of healthcare. The control of certified public data and procedures, and the renewal through giving preference to patients’ interests and patient security over the interests of the care system may have a key role in modernisation. Restoring the prestige of freelance physicians and medicine in general, and the integration of private resources into the system are also pivotal.

#### Renewal of public finance audit

With the entry into force of the Fundamental Law, a new era started in both public finance discipline and control. A chapter on public finances, including several rigorous provisions about the management of public funds, was added to the Fundamental Law (see above).

1) Following the adoption of the Fundamental Law, Act LXVI of 2011 on the State Audit Office was the first cardinal law adopted by the National Assembly. The purpose of the new regulatory framework, effective as from 1 July 2011, is to improve the efficiency of the State Audit Office’s operation and action to protect the taxpayers’ money and the nation’s wealth. Pursuant to the new act, the State Audit Office has become one of the most significant elements in the system of economic checks and balances that ensure the democratic operation of the Hungarian state. The new statute introduced numerous important changes, as it extended the SAO’s audit powers, perceptibly increased the organisation’s independence and made the audit office’s work more transparent. The act grants extensive powers to the State Audit Office, in other words, the SAO is entitled, as a general rule, to check the use of any public fund or publicly owned asset.

2) The Fundamental Law raises the Fiscal Council among the organisations of a constitutional status, equal to the State Audit Office and the National Bank of Hungary (MNB). The Council’s powers stem from the Fundamental Law, as its duty is exactly to enforce the constitutional rule of debt, and not to allow it remain merely a written word. The Fundamental Law stipulates that in order to reduce the debt portfolio, the Fiscal Council has the right of veto, and with this the Hungarian legislators undertook voluntary restraint.

In addition, numerous other laws were re-codified. Most significantly, the act on public finances, which was renewed and placed on a new footing.

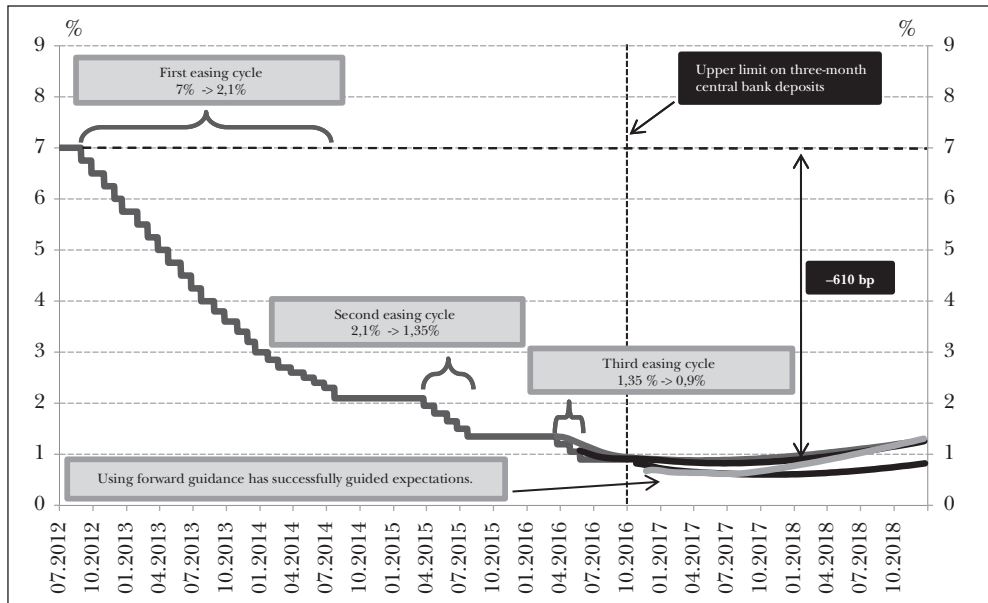
*Turnaround in Monetary Policy*

Through the renewal and wide application of the monetary policy instruments, in 2013 the National Bank of Hungary (MNB) joined the central banks that wished to mitigate the consequences of the crisis by a proactive monetary policy, with some actions taken in a new approach in addition to traditional ones (see Parragh, 2017). In compliance with its duty stipulated in the MNB Act, it launched several programmes in support of economy stabilisation and the government’s economy policy endeavours.<sup>14</sup> For the purpose of developing a well-managed state, the following are considered as the most important. The central bank’s actions are presented on the basis of Matolcsy and Palotai, 2016 and Kolozsi, 2017.

Interest rate-cutting cycles and monetary easing

Between 2012 and 2016, the Monetary Council lowered the initial 7 percent central bank base rate to 0.9 percent in three interest rate-cutting cycles, altogether 32 interest rate-cutting steps, and loan rates and money-market yields fell in parallel. Such a long easing cycle and such a low nominal interest rate had been unprecedented in Hungary since the change of regime. At the beginning of the interest cut cycle, inflation was around 6 percent, and from the end of 2013, the inflation started to reasonably decline. Once the 0.9 percent base rate had been reached, the MNB committed to maintain the base rate at a permanently low level.

*Figure 7: The central bank’s base rate and developments in interest rate expectations*



Source: Komlóssy and H. Váradi, 2017



Lowering the base rate and easing monetary conditions: 1) it reduced the interbank and securities market rates; 2) it supported economic growth and the medium-term achievement of the inflation target; 3) it reduced credit limits; 4) it prevented further drastic drops in consumption and investments. Due to the more relaxed monetary conditions, in 2017 HUF 600 billion HUF interest was saved by the government, amounting to a total of HUF 1600 billion since 2013.<sup>15</sup> Interest rate cuts increased economic growth by about 1.1 percentage points in the aggregate.<sup>16</sup>

#### The adoption of lending incentive programmes

As one of the first actions of the 2013 monetary policy turnaround, the MNB launched a targeted lending programme to stop decline in lending to small and medium-sized businesses, a sector of outstanding significance in employment, and allow lending processes normalise. In addition to the third, deregulatory phase of the Funding for Growth Scheme, at the end of 2015, under the name Market-Based Lending Scheme, the central bank also announced a programme in support of transition to market-based lending.

In the framework of the programme, lending and leasing transactions served new investments in the amount of approx. HUF 1700 billion, while the Funding for Growth Scheme contributed 2 percent to economic growth between 2013 and 2016, increasing the employee headcount by approximately 20.000. In order to facilitate transition to a market economy, in January 2016, the MNB launched the Market-Based Lending Scheme, which, in combination with the Funding for Growth Scheme, contributes greatly to keeping the extension of SME lending in the 5-10 band required for sustainable economic growth.

#### Self-Financing Programme: the reduction of external vulnerability

Prior to the launching of the Self-Financing Programme, i.e. between 2014 and 2016, due to the increased amount of forints issued, the Hungarian government was able to repay approximately EUR 11 billion (HUF 3400 billion) from the HUF seigniorage income. Its role in bank financing also increased significantly: by 2016 foreign investors had been replaced by domestic banks as the most important owners in the market of HUF-denominated government securities. Between 2011 and 2015, foreign investors predominated in the HUF-denominated government securities market. However, at the end of the first six months of 2017, the ratio of Hungarian sectors exceeded 80 percent. Credit institutions' share rose from 30 to 37 percent, while the households' increased from about 5 to above 20 percent (in 2012, the government made increase in government securities in household ownership a strategic goal). The ratio of foreign currency in the sovereign debt fell from 42 percent in 2014 to 25 percent in 2016, which roughly corresponded to the value recorded in 2008, before the crisis.<sup>17</sup>

Phasing-out of household FX loans and their conversion to HUF

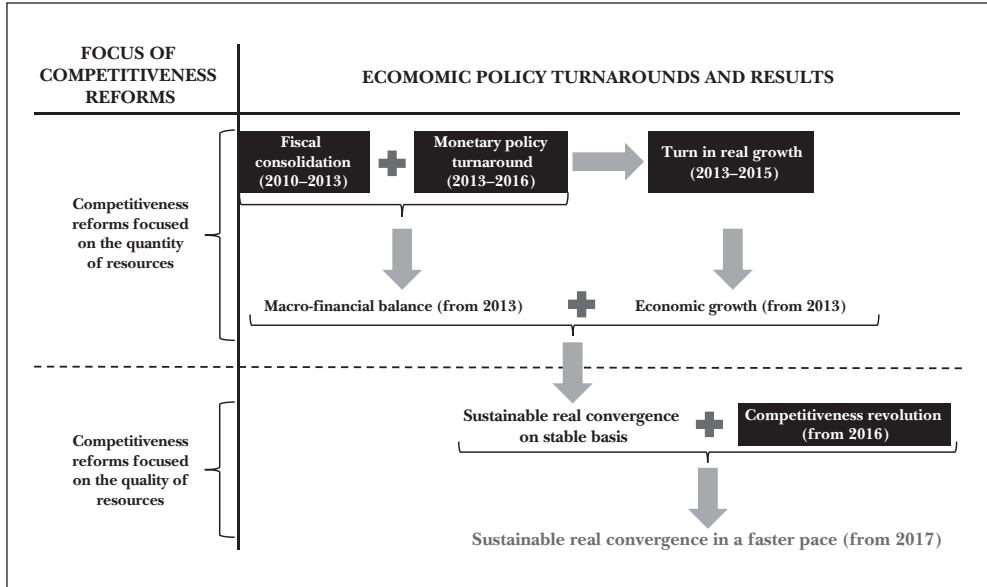
The indebtedness of the population in foreign currency had been one of the high-priority risks in the Hungarian economy since the early 2000s. The risks and system-level challenges justified the government's action against uncollateralised household FX loans (Nagy, 2010; Nagy and Prugberger, 2011), and in 2014-2015 also the conversion of FX and FX-denominated loans.<sup>18</sup> FX loans were phased out in two phases (first, household FX-based and FX mortgage loans, and then other household FX loans). Within this framework the MNB selling approx. EUR 9.7 billion to banks without the central bank's reserves falling below the expected international standards. As a result of conversion to HUF and the settlement of accounts, Hungary's financial stability improved considerably, as did risk control. This is why the phasing-out of household FX loans, especially coupled with the Self-Financing Programme, could be one of the actions credit rating agencies specified as a reason for upgrading the debt of Hungary.

*Turnaround in competitiveness*

A national economy is competitive if it optimises the use its available human, physical and natural resources in the interest of the highest possible but still sustainable level of welfare (MNB, 2017a, p. 11). Firm foundations, a stable macroeconomy and financing, a potent and stable institutional background, streamlined and efficient regulation, and high-standard education and healthcare are indispensable for a competitive economy, to serve as a basis for a smoothly operating and predictable environment encouraging investments and innovation, and closing the gap over the long term may start.

The budgetary and monetary policy turnarounds performed since 2010 have restored the macroeconomic equilibrium required for the improvement of competitiveness, and after 2013, they allowed the economy to grow at a pace exceeding the average of the European Union. The fiscal measurements and the central bank's actions facilitated economic development<sup>19</sup> and increased employment,<sup>20</sup> and in addition to the money and capital markets, the achievements of the growth-oriented economic policy are recognised by the international organisations and large credit rating agencies. However, a faster and permanent convergence requires an improvement in the qualitative attributes of resources. For an escape from the medium-developed economy status, the acceleration of convergence is indispensable, and requires reform actions performed with primary focus on the quality criteria of competitiveness. In order to preserve the achievements made since 2010 and accelerate permanent convergence, it is indispensable to make efforts at improving efficiency and increasing value creating capacity and productivity (turnaround in competitiveness). In order to regain Hungary's former regional leading position and to break free from the trap of medium development, the gap must be closed more rapidly than previously and the exploitation of the growth pattern needs to be carried on and improved.

*Figure 8: Reforms in competitiveness and turnarounds in economic policy*



Source: Szalai and Kolozsi, 2016

## EPILOGUE

As a combined effect of debt reduction, fiscal stabilization and the turnaround in monetary policy, in 2013 Hungary could start to close the gap. As a prerequisite of the polity model change the state had to be reinforced, and the framework for co-operation between the state and various social groups had to be developed. After accepting the institutional foundations brought once again into the limelight, parallel with increase in the demand for reforms, rise in social confidence and cooperation may allow the creation of a higher-standard state operation. As a first step in the creation of an appropriate institutional background, the state was reinforced and is now capable of receiving cooperative responses from the relevant social groups, especially market participants and citizens, to its own cooperative actions. This study describes the steps that highly facilitated the reinforcement of the Hungarian state, and through this, the transition to a cooperative polity model and the change in the entire state operation.

Arising from the achievements made in recent years, the Hungarian state has already got sufficient elbowroom to take actions that presume both a room to manoeuvre and sufficient weight to enforce a cooperative response from the stakeholders to the government's initiatives at cooperation. The following include, but are not on any account limited to, more significant examples of actions taken in the direction of a well-governed state:

- Tax cut policy, which, in combination with an improvement in tax compliance and the renewal of tax collection (NAV 2.0 concept), shows that the state is gaining

strength, and that it is a government strategy affecting large masses and representing cooperation between the state and taxpayers. Prior to the adoption of the flat-rate personal income tax, the tax base was the income increased by 27 percent VAT, and the rates were 17 and 32 percent. Currently, the tax base is not adjusted, i.e. the tax base is more than one quarter less, and the rate is uniformly 15 percent. In addition, tax credits have been terminated and the available family tax allowance has increased considerably. However, in comparison to the size of tax cuts, personal income tax decrease was considerably smaller: while in 2010, the amount collected as personal income tax was 6.4 percent of GDP, in 2017 it amounted to 5.2 percent, representing an increase in nearly HUF 200 billion in nominal terms. These values are modified by numerous factors, however, the trend shows that the tax payment morale may have improved (in the case of VAT that trend was even more obvious).

– Constructive cooperation between monetary and fiscal policies, representing a break with the previous practice of competitive and contrasting operation of the central bank and the government, and making efforts at the achievement of economic policy objectives via synergies, while maintaining the central bank's independence. There is a long list of economic policy areas jointly affected by fiscal and monetary policies, and the jointly managed economic policy challenges (for more details, see Matolcsy and Palotai, 2016), but perhaps the most conspicuous example for constructive cooperation was the phasing out (conversion into HUF) of household FX loans, which could not have been implemented without a coordinated action of the government and the central bank.

– The central bank's programmes based on the voluntary cooperation by banks, which are successful because of banks' constructive and cooperative response to the MNB's incentives. In the case of the Self-Financing Programme launched in 2014, the combined and complementary transformation of the MNB's instruments, the negative FX issuance by the Government Debt Management Agency (ÁKK) and the bank sector's demand for government securities promote the implementation of the self-financing concept, i.e. reduction of the country's exposure and thus vulnerability to the rest of the world. In this programme, the ratio of FX in the sovereign debt fell from 50 percent to 25 percent. In the course of the Market-Based Lending Scheme launched in 2016, the banks with access to the central bank's instruments undertake a lending commitment, which is, by definition, a kind of cooperation with the other participants of the banking system and with the central bank. Lending undertaken by the banks has allowed a shift in the SME developments from the previous drop to a 5-10 percent annual rise.

– The transformation of public finance audit, with the reinforced State Audit Office adopting and operating programmes which "channel" the behaviour of the users of public funds. Examples include the State Audit Office's Integrity Project, launched in 2011 for an annual measuring of the public sector's corruption risks and the level of their control. The State Audit Office's courses endeavouring to share good practice in public finances fit well to this advisory role: in addition to revealing errors, in the course of inspections, the auditors also meet forward-looking management solutions

and good practices they subsequently share with the stakeholders in the framework of the seminar series entitled “Good Examples Are Contagious. Best Practices in Using Public Funds”. Between 2011 and 2017, the State Audit Office organised 17 such seminars. Another kind of steering role is undertaken by the State Audit Office’s news portal that allows for the daily tracking of the work done at the office, thus setting an example for the entire public finance system in respect of transparency.

Due to the state’s position as a special economic participant and a regulator, it can substantially contribute to the improvement of the national economy’s competitiveness. The improvement of competitiveness requires the efficient application of coordinated and targeted action packages, which was subject to the renewal and strengthening of the Hungarian state, as an indispensable precondition, implemented ever since 2010.

Looking ahead, both the paradigm change that may lead to a state operation proactively applying positive incentives and making efforts at partnership, and the institutionalisation of the achievements made so far are of strategic significance. “Institutions matter”, Nobel Prize winning economist Douglass C. North’s theorem, which has become something like a catchphrase, can thus be affirmed in contrast to the neoclassical doctrine. The rules of the game set by the given political and social framework determine and shape the decisions made by social stakeholders, and especially markets and individuals, in other words, the stable and efficient institutional matrix presumes the building up of a state that encourages the entire society to cooperate. As in the case of the informal frameworks that determine individual and collective behaviour to a major extent, improvement may only be gradual, and so transition to a cooperative polity model needs time. Hungary’s current leverage is due exactly to the fact that the stabilising actions and economic policy turnarounds implemented in this decade provide an appropriate basis for a switch to a polity model built on trust.

## NOTES

- <sup>1</sup> Perhaps the most relevant part of Thaler’s heritage concerns government institutions set up for the purpose of steering and pushing individuals in the direction that represent a more optimum output at a community level (nudge units).
- <sup>2</sup> *33 Theses for an Economics Reformation*. <http://www.newweather.org/wp-content/uploads/2017/12/33-Theses-for-an-Economics-Reformation.pdf>.
- <sup>3</sup> What is an “institution”? This concept was first used by the renowned American lawyer and economist, Walton Hamilton, in 1919, and the American economist John R. Commons, a follower of institutionalism, was the first to point out the complexity of the concept of an “institution”. The term “institution” includes written laws and regulations, unwritten norms, culture and habits, in other words, all the “collective frameworks” that influence and channel an individual’s behaviour. The history of ideas consider Thorstein Veblen as the founder of institutional economics. The Norwegian-American economist was the first to widely emphasise that economic behaviour largely depends on the social institutions and the environment of the economic actors, and consequently, one and the same kind of solution is inapplicable to countries with completely different backgrounds and operation.
- <sup>4</sup> According to Domokos, 2016, the opportunity for the state to implement good governance is given in the framework of gradual reforms, through becoming a reliable and efficient partner, and by the adoption of a two-phase strategy.

- <sup>5</sup> About the stakeholder approach see Kecskés, 2011, p. 43.
- <sup>6</sup> In the frame of cooperation, persons and organisations act in concert to achieve common goals, on the one hand, and the practice of arriving at an agreement between stakeholders is also improved, on the other. Cooperation between the participants gives way to an increase in the economic and social benefit.
- <sup>7</sup> To put it simple, in a game theory approach, the question is practically: when the payment matrix becomes from a prisoner's dilemma to a stag hunt. Here we dispense with its detailed explanation.
- <sup>8</sup> Structural reforms cause changes in the deep layers of the economy and the society through altering the institutional framework, the legislative environment and the institutional rules. They change public thinking and the improvement of the state brings the improvement of public confidence in its train. See Matolcsy, 2015, p. 232.
- <sup>9</sup> See Articles 33-44 of the Fundamental Law (chapter on public finances).
- <sup>10</sup> Although these rules limited the powers of National Assembly, they were indispensable for the creation of the new framework of public finances. See Kecskés, 2015.
- <sup>11</sup> For further details and the consequences see Baksay and Csomós, 2015.
- <sup>12</sup> The businesses in the majority ownership of local governments also piled a significant amount of debt because up to 2011 the State Audit Office had not been authorised by law to audit businesses in local government ownership. Local governments, on the other hand, did not pay sufficient attention to controlling the indebtedness of their businesses.
- <sup>13</sup> There are also several other arguments in support of transformation (low actual costs, high costs borne by members, below-the-expected development in the Hungarian capital market, etc.).
- <sup>14</sup> For more details about the central bank's actions see Lehmann et al., 2017.
- <sup>15</sup> About this correlation, see Csomós and Kicsák, 2015.
- <sup>16</sup> At the end of 2017, market investors already welcomed the MNB's easing policy. See Eder, 2017.
- <sup>17</sup> See Kolozsi and Hoffmann, 2016; Nagy and Kolozsi, 2017
- <sup>18</sup> Conversion to HUF was performed in a period when both the legal background and the economic conditions were given (see Kolozsi et al., 2015).
- <sup>19</sup> Economic growth has exceeded 3 percent on average since 2013.
- <sup>20</sup> In mid-2010 the employee headcount was 3.7 million, which had increased to 4.4 million by 2016.

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