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How to achieve successful economic convergence?

A few words about the MNB's book entitled 'Competitiveness and Growth'

*At the time of the political transition, Hungary joined the ranks of democratic countries with high hopes of economic recovery and full convergence. It is plain to see today that it has failed to achieve this goal in the past 25 years. In recent years, the country has successfully stabilised the financing position of the economy and achieved adequate economic growth; however, additional reserves need to be mobilised in order for growth to ensure successful convergence over the long run. There is a need to rethink the possible ways of attaining sustainable growth and economic convergence in Hungary. Entitled '*Competitiveness and Growth*', the book written by experts of the Magyar Nemzeti Bank is intended to contribute this thinking process by exploring some key components of the economic policy of countries undergoing successful convergence, analysing the current economic status of Hungary from the aspect of long-term economic growth potential and offering recommendations about possible steps of improving this growth potential. These proposals cover a number of areas relevant to competitiveness, such as the labour market, the tax regime, the operation of the state, human capital, innovation capacities, the banking system and the utilisation of EU funds. Since most of the recommendations have fiscal effects, during their practical application the fiscal balance should be borne in mind at all times. The topicality of this article's publication is underpinned by the first* Competitiveness and Growth Forum *held on 24 June 2016 by the newly established Competitiveness Section*[1] *of the Hungarian Economic Association, of which some of the contributing authors are founding members.*[2]

At the time of the political transition, Hungary commenced its complete economic and social transformation harbouring the hope of having realistic opportunities and abilities to converge to the Western European living standards. From the perspective of 25 years it appears indisputable that Hungary's efforts to catch up with developed economies have failed. During this period, Hungary's economic growth fell far behind its regional competitors and its success in stepping on a sustainable convergence path proved to be short-lived. It failed to take advantage of the unique opportunity afforded by its accession to the European Union and its level of development has not surpassed that of moderately developed countries to date. Hungary is yet to extricate itself from the middle-income trap that ensnares so many of its moderately developed peers. After the economic crisis Hungary was forced to rethink its growth structure both with respect to structural factors and the financing side.

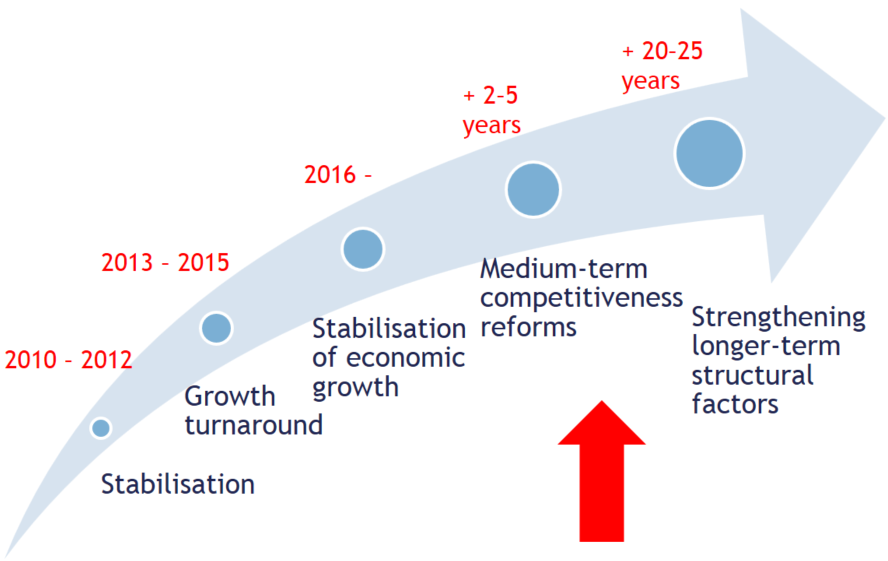
The purpose of the volume '*Competitiveness and Growth*' is to identify the cornerstones of the strategy required for achieving sustainable convergence founded on competitiveness. Under the MNB Act, the primary objective of the Magyar Nemzeti Bank is to achieve and maintain price stability; however, without prejudice to this objective, it also supports the economic policy of the Government. The forward-looking findings of the studies comprising the volume

[1] www.mkt.hu

[2] www.mnb.hu

may succeed in furthering this goal of the Central Bank. On one hand, the book presents the economic policy experiences of successfully converging countries; on the other hand, it provides a detailed snapshot of the current status of Hungary. In view of these results, a number of recommendations are offered which may stimulate Hungary's competitiveness and economic growth over the longer term in various areas.

1. Chart: Medium and long-term planning process



Source: Competitiveness and Growth

Economic growth and competitiveness are among the most widely analysed areas of economics that have a direct impact on the welfare of citizens and society. The sustained growth and convergence of a country may secure the funds required for the development of education, healthcare and infrastructure, reduce poverty and improve social welfare in general, whereas the lack of these elements might lead to severe instability.

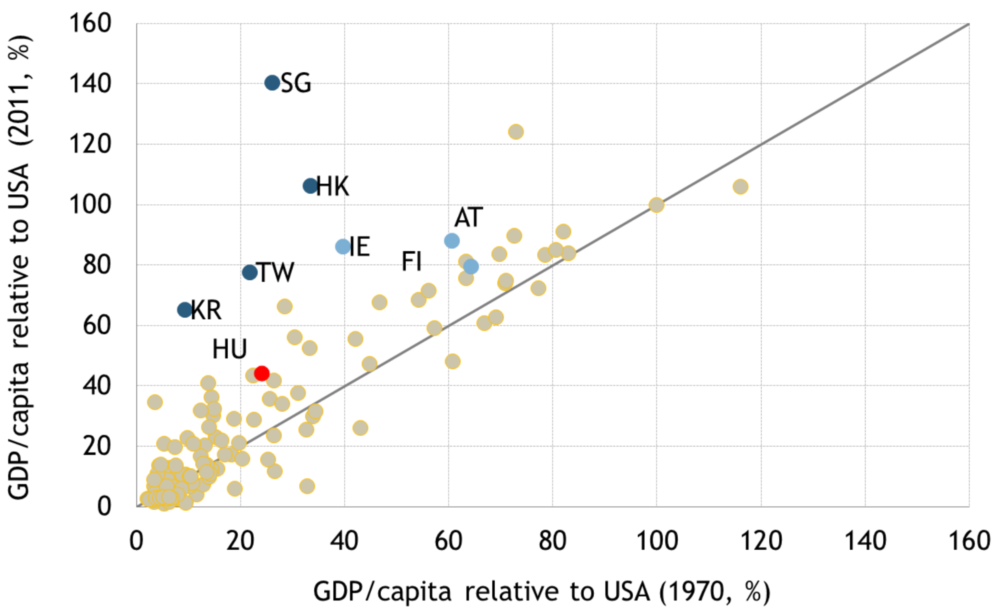
This issue has particular topicality today when, after the protracted period of the global crisis, numerous countries face the dilemma of how to return their economies to a more dynamic path in long-term growth. More than seven years after the outbreak of the global crisis, the economic outlook is still worse than it was before the crisis in most countries. Indeed, in numerous national economies, output levels have not even reached the levels seen nearly a decade ago. The recovery of developed countries, particularly in Europe, spurred high, often two-digit unemployment rates which in view of a low inflation and sluggish growth data, points to a protracted period of stagnation.

The issue under review has assumed further topicality in Hungary where a new, as yet unprecedented combination of economic growth and financial equilibrium has been achieved in recent years. At the same time, Hungary still faces the challenge of harnessing this opportunity for successful, long-term convergence. Thanks to fiscal retrenchment measures and the Plan Széll Kálmán, after 2010 the financing position of the economy was stabilised, reducing the vulnerability of the country significantly. Alongside balance indicators, since 2013 a noticeable improvement has been perceived in real economic indicators. However, additional reforms and the mobilisation of growth reserves are required for growth to ensure long-term, successful convergence. It is an important lesson of the latest global crisis that a successful growth stimulation programme should focus nearly as much on the short-term stabilisation of aggregate demand as on the implementation of structural reforms to improve the supply capacities of the economy.

What can be gleaned from international experiences?

While numerous countries were capable of achieving robust economic growth in the short run, only a few of them managed to maintain dynamic progress throughout several decades. The catching-up process cannot succeed in less developed countries without a thoughtful, consistent and proactive economic policy and a stable institutional background. The book provides an analysis of the experiences of South Korea, Ireland and Finland and the most successful state of the region, Austria, from a variety of perspectives.

2. Chart: Changes in the level of economic development between 1970 and 2011



Source: Penn World Table 8.1

One of the most important conclusions of the comparative analyses is that there is no one-size-fits-all solution for successful convergence. In other words, there is no single recipe for sustainable growth and economic convergence. Successfully converging countries comprise a fairly heterogeneous group with significant differences between natural conditions, institutional systems and political arrangements. During the decades of convergence, the countries concerned pursued economic policies suiting their own conditions, which may have differed from those applied in other countries in several regards. None of the countries can spare the effort of working out a convergence strategy tailored to its own individual conditions.

Despite of the differences, however, a number of common traits can be observed, shedding light on some of the key elements of a successful convergence. These elements include stability, sizeable investment in human and physical capital and continuous development through innovation, supported by the stable background provided by an active, pragmatic, efficient and well-functioning state that focuses on economic growth.

1) **Economic policy (including its fiscal, monetary policy and supervisory aspects) can make the most prominent contribution to competitiveness by ensuring long-term stability,** partly by smoothing out the effects of business cycle fluctuations and partly by ensuring that policy itself does not become a source of such cycles or crises. As evidenced by empirical results, the volatility of output greatly depends on the stability of the financial system and the financing model. Stability is both a condition for and – over the medium term – a source of sustainable growth.

2) **The quality and quantity of the human capital stock are the key elements of economic competitiveness.** In this era, successful economic convergence hinges on the extent to which economies are capable of creating value. At present, Hungarian enterprises – especially SMEs – reside in those segments of the production chain that generates the lowest value added. Well skilled and creative labour force is needed to facilitate their shift to more innovative segments with higher value added. The qualitative features of human capital can be enhanced by improving the performance of the education system and the healthcare delivery system. Successfully converging countries have typically spent a substantial amount on raising the standards of education. In addition to qualifications, the efficiency of labour is fundamentally influenced by the general health condition of the labour force. Developing a high-quality and efficient healthcare system, however, can pose considerable challenges even to developed countries.

3) **Sufficiently high capital formation, especially when coupled with an adequate structural composition, is indispensable for the success of convergence.** In certain areas, the state may play even a direct role in this regard. The quality of private investment, however, is primarily determined by corporate decisions. State regulation and incentives may still facilitate the targeted implementation of projects that raise the outputs of the economy even over a longer horizon.

4) **With respect to finances, the best case scenario is when projects are implemented mainly from internal funds without increasing external debt.** As demonstrated by the latest global economic crisis, excessive reliance on external – especially debt-type – financing increases the vulnerability of the economy and, over the long run, calls into question the sustainability of convergence. **An efficiently functioning financial sector plays a decisive role in satisfying the borrowing requirements arising from the convergence process and in the adequate allocation of available funds.**

5) **In the past few decades, competition has intensified in the increasingly broad markets where the survival of enterprises depended on their capability of continuous development and flexible adjustment.** In addition to a vast array of new opportunities, globalisation and the opening up for the global economy posed new challenges to

emerging countries. Driven by the free movement of capital and labour market mobility, new technologies gain ground increasingly fast, while individual countries engaged in increasingly specialised production activity. **The strong innovation and technology adaptation ability of economies is a crucial element in their successful participation in global competition.**

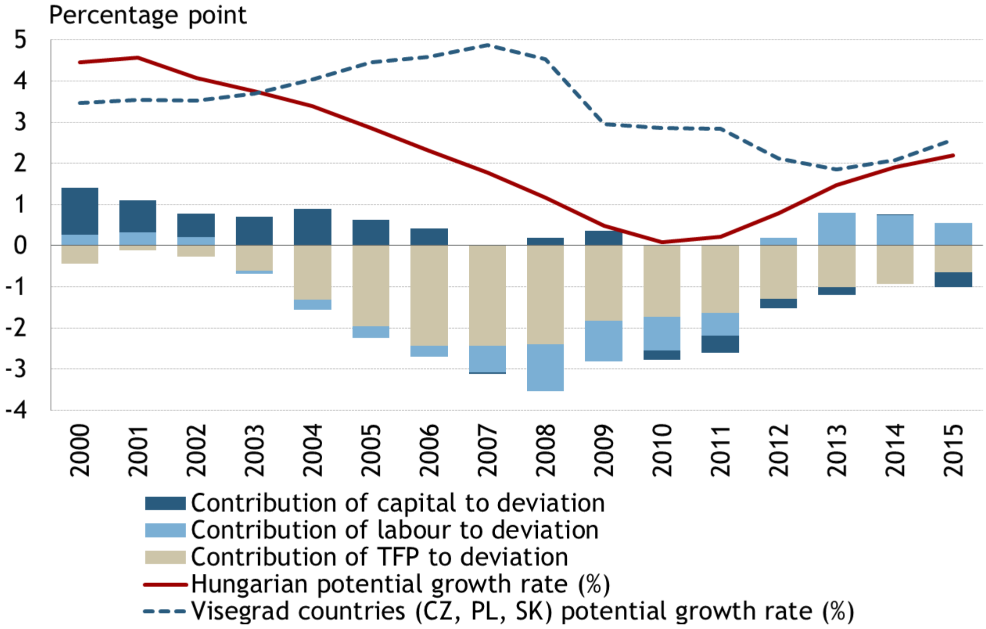
Hungarian snapshot

The economic crisis prompted numerous changes in the growth model adopted in Hungary. The newly established macroeconomic equilibrium and the creation of a new, sustainable growth model ushered in a new era in Hungary. The improvement in the current account was remarkable, even by international standards and facilitated a decline in (net) external debt. Hungary successfully maintained long-term fiscal discipline, while the country witnessed a robust shift in the tax regime from taxes on income toward consumption taxes.

The potential growth rate of Hungary has been accelerating steadily since 2010, although it is still somewhat below the average of the Visegrad countries. Hungary's lag stemming from the labour and capital factors has been reduced considerably in recent years; however, the country is still behind its peers in the area of productivity. The recommendations formulated in the second part of the book were intended to help remove the obstacles hindering the increase in productivity with a view to improve competitiveness. In the interest of preserving a more dynamic growth observed in recent years over the long run, the economic policy needs to face and respond to numerous additional challenges.

1) **Demographic developments may pose enormous challenges within decades.** Due to the labour market measures taken in recent years, the labour force participation rate increased significantly; however, since it is still low in international comparison, the focused expansion of labour supply should remain a priority.
2) **Mismatches have emerged in the labour market.** With technological advancement, the demand side of the labour market may also shift toward jobs requiring higher qualifications. The enhancement of the education and training system plays a prominent role in improving the skills of workers actively participating in the labour market. In pursuing this endeavour education – from basic skills through vocational training to higher education – should be treated comprehensively. Moreover, increasing the flexibility of the labour market and strengthening mobility may also stimulate education.
3) **The Hungarian economy is characterised by considerable duality.** The productivity of small and medium-sized enterprises falls far short from large corporations. The small average size, low capital adequacy and innovation capacity of Hungarian small and medium-sized enterprises coupled with their lack of modern management skills impede the strengthening of supplier networks and export capacities.

3. Chart: Deviation of potential growth from the average of Visegrad countries according to the estimate of the European Commission



Source: European Commission

Recommendations for competitiveness reforms

With a view of improving competitiveness, the book proposes a number of reform recommendations that may help release some of the available resources and may constitute a part of a new structural reform programme aimed at competitiveness. The recommendations cover the labour market, the tax regime, the operation of the state, human capital, innovation capacities, the banking system and the utilisation of EU funds.

Numerous measures have been taken since the outbreak of the crisis regarding employment; as a result, employment increased sharply with a parallel decline in unemployment. Nevertheless, the Hungarian participation rate remains low by international standards. **Depending on sufficient fiscal leeway, employment may be boosted further by additional reductions of the tax burden on labour income.** The situation of low-income groups may be improved in a targeted manner by extending the assistance provided by the Job Protection Action Plan to employees' social contribution. As a result, the same amount of gross salary would imply to a higher net wage, which would increase labour supply in groups with loose links to the labour market. While the existing regulation provides an incentive to employers, the new proposition would incentivise employees to a greater extent. Moreover, the efficacy of existing rules should also be improved, for instance, by raising the cap on available targeted employer's social contribution allowances to at least up to the amount of the minimum wage. Transition from public work to the open labour market would be supported by enhanced training programmes on the one hand and by financial support to private sector employment on the other hand. A possible tool in this endeavour would be a scheme where, when an employer employs a public worker, the state would continue to pay the worker's original wage for a pre-defined period (for example one year), which would be supplemented by the employer up to the minimum wage. Moreover, Hungary lags behind the EU significantly in the application of atypical employment forms such as part-time work.

Convergence in this area may also be supported by the employment of certain persons or groups that are inactive from a labour market perspective.

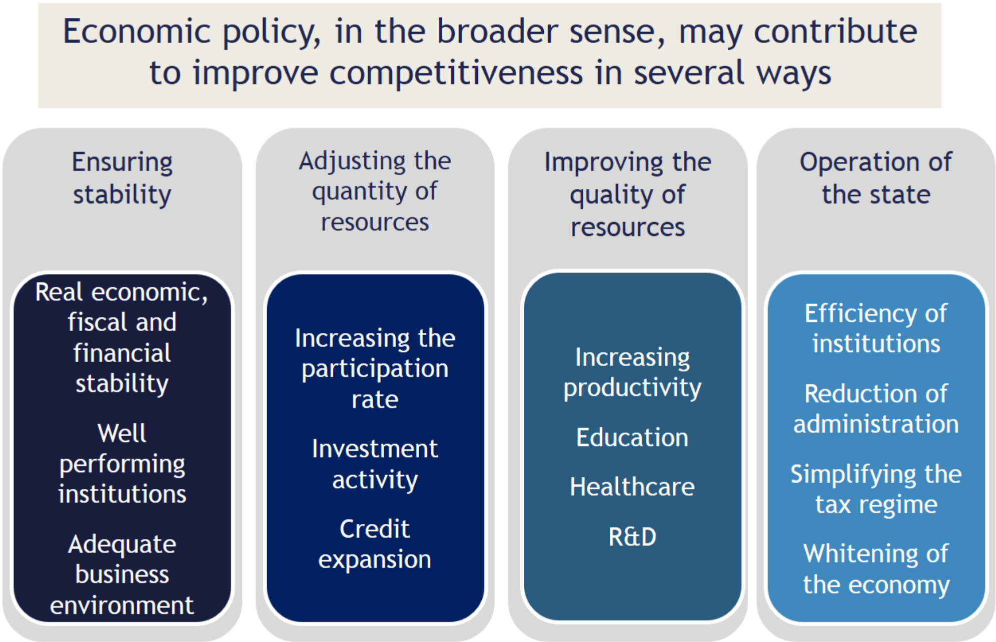
Besides increasing the revenue side of the budget, curbing the hidden economy may contribute to mitigating distortions in competition. To that end, it is recommended to raise the statutory minimum income within corporate taxes. Essentially, this means that a company would be given two options if its tax base falls below a pre-defined minimum level: it either pays corporate income tax on the statutory minimum income or it undertakes a more thorough investigation by the tax authority. Promoting electronic payment methods would also be expedient (as stated in the Budget Act for 2017 as an objective). Rationalising the tax burden on real property leases could also contribute to reducing tax evasion. Under the current regulation, up to an annual income of HUF 1 million this activity is subject to a 16 per cent personal income tax. Above this level, an additional 14 per cent of healthcare contribution is added to the total amount. This resulted in a controversial situation where the net income that can be realised in the case of HUF 1 million (HUF 840,000) can only be regained if the annual income is HUF 1.2 million.

There is also room for improvement in increasing the competitiveness of the state's operation and in establishing a more efficient regulatory environment. Elimination of the tax advance supplementation may help reduce red tape for corporations while improving intra-year budgetary planning. In this case, corporations would not need to estimate and pay by 20 December the full tax amount expected for the taxable year. Taxes would only be paid after the filling of the final tax return in May, following the taxable year. The introduction of 'cash-based' taxation would entail a major corporate income tax reform, which would stimulate investment activity by enabling companies to deduct the costs of projects from their tax base in the same year as they were incurred. Under the current regulation the tax base cannot be reduced by the investment itself; it can only be reduced years after the actual investment by recognising amortisation. In addition to the tax regime, the efficiency and the quality of public services can also be enhanced. International statistics show that the Hungarian government spends much more on itself and employs far more people in public administration than most EU Member States. Therefore our recommendations include the improvement of the efficiency of wage setting, the promotion of e-governance and the adequate measuring of performance and satisfaction.

R&D expenditures, which are currently below 1.5 of GDP in Hungary (compared to the 2 per cent EU average) should be raised, partly through regulatory tools and partly through direct public expenditures. A possible tool in this regard could be the extension of the social contribution tax allowances available to researchers and developers to researchers with higher education employed in research sites inside the business sector.

According to international experiences, developing human capital is a key factor behind long-term convergence. The state plays a crucial role in this regard, especially in the areas of education and healthcare. In healthcare, the resources available to the delivery system should be increased, primarily by stepping up the efforts to raise private funds. As regards of the education system, possible changes include the expansion of resources, the promotion of language skills or increasing the share of students obtaining technical and scientific degrees in tertiary education.

4. Chart: The impact of economic policy on competitiveness



Source: Own editing based on the book 'Competitiveness and Growth'

The accessibility, amount and efficiency of resources available for the national economy through EU funds should be improved in the banking sector. With regard to grants provided by the European Union, it would be important for Hungary to spend far more, around half of all EU transfers (compared to the former 16 per cent) on the development of the economy; accordingly, we welcome the Government's decision to define this as an objective. A smoothly functioning system of financial intermediation is indispensable for improving the competitiveness of the economy and for facilitating convergence. Consequently, it is important to promote a competitive banking system as banks supply the credit required for investments and the operation of the economy. The Magyar Nemzeti Bank is prepared to provide all possible assistance in order to enable the banking sector to ensure sufficient corporate credit to boost growth, in particular to increase the SME portfolio by 5 to 10 per cent. The profitability of the banking sector poses yet another challenge. Improving the sector's current profitability situation is a prerequisite of sustainable growth in the medium term.

In adopting the measures proposed by the book, short-term equilibrium should also be considered in light of their fiscal effect. It is the task of the Government to assess which of the proposed measures it wishes to adopt depending on its possibilities and preferences. Since successful reforms may ensure room for manoeuvre for the introduction of further reforms, it is important to schedule the measures appropriately. International experiences have demonstrated that the success of the reforms is facilitated by broad social consensus. With that in mind, a forum or an institution should be established involving all stakeholders: the Government, the central bank, enterprises, the banking sector, and experts of the academic community and the civil society.

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