



# Competition and Solidarity

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*An Essay on Economic Policy Turnaround and Structural Reforms  
Indispensable for the Convergence of Hungary with Europe: The 130 Points*

1. Despite a wide diversity in public opinion on important issues regarding the future of Hungary, there is unconditional consensus in striving for an early attainment of the Western European living standard. The great majority of citizens would also accept that for convergence to become reality, there is a need for rapid economic growth and the faster this growth is the shorter the time period will be within which the average Western European living standard can be reached. Hungarian economic growth should be substantially higher than that of Western Europe for a considerably long period of time.

2. In a small and open economy where income generated in the domestic economy is mostly realized through foreign trade, rapid economic growth can only be achieved by sustained rapid export growth. The reason for this is the small size and high diversity of the domestic market. Domestic demand can never grow quickly enough to keep up with the fast expanding supply of large domestic firms. At the same time, the selection and variety of domestic production can never exactly match the demand structure of domestic markets.

3. There is also pressure to import and increase efficiency in a small, open economy. Pressure to import obviously prevails in the market of consumer goods because we would not consider it real convergence if we could only buy Suzuki cars for our money no matter how high our salary may be.



(Moreover, at least one-third of the value of Suzuki cars produced in Hungary represents direct imports too.) But there is also pressure to import in the interenterprise market because world competition forces efficiency. If the market of everyday consumption is already open to world supply then holding ground in the competition for consumers will force the opening of all markets.

4. In a market economy the pressure to improve efficiency continuously stimulates productivity increases, quality improvements and cost cutting. In the short run, all three indicators can be improved by better organization of labor, more attentive work and more precise accounting, but in the long run only by increasing productive investments. In order to keep their positions in the domestic market for consumer goods, which is already subject to world market competition, domestic firms have to import the best equipment from world markets.

5. No economic policy aiming at real convergence can ignore this pressure to import and increase efficiency without severe backlash. If domestic economic growth, weakened by deteriorating world market conditions, is to be stimulated by artificially boosting domestic demand (ie fiscal overspending and/or wage hikes regularly exceeding productivity gains), this policy admittedly may be successful in the short run. Nevertheless, since domestic demand has a high import content, increasing this demand in an artificial manner will quickly result in a marked deterioration of the foreign trade balance, which makes it unsustainable in the long run. An economic policy that stimulates growth by artificially boosting domestic demand will soon collide with the hard constraints of external financial equilibrium in a small and open economy.

6. This relationship does not always hold so directly in general but it does prevail in a direct and unconditional way in transition economies.

7. There exist several developed economies in the West where some domestic fuel poured onto the fire of weak domestic demand can result in a beneficial flare-up even in the long run if and when the foreign trade balance is strongly positive for a considerable period of time. In countries where exports regularly exceed imports, the foreign trade surplus can be reduced without creating indebtedness. The example of Germany shows very well that stimulating domestic demand by cutting taxes could be a rational policy option, provided the budget balance deteriorates only temporarily. Today Germany keeps exporting its domestic savings to the world as a consequence of its huge export surplus; it is not necessarily a problem, therefore, if it now wants to consume and invest a growing proportion of its output at home in order to stimulate economic growth.

8. Hungary and the other small converging economies of Central and Eastern Europe, however, have negative trade balances. This is good and



sustainable if the import surplus is financed largely by foreign direct investment, because it does not increase foreign debt and this is exactly the main source of export led and sustainable growth based on a rapid increase in productivity. Boosting domestic demand in an artificial way would not push investments, but first and foremost increase consumption which, in turn, will increase foreign debt because growing importation of consumer goods are typically financed by foreign borrowing.

9. In the small, very open, converging economies of Central and Eastern Europe any policy based on artificially boosting domestic demand is characterized by twin deficits, that is, parallel and large deficits in both the fiscal and external sectors, and the parallel deterioration of fiscal and external balances typically with a 1-year time lag. In transition economies it is possible to increase growth temporarily by artificially boosting domestic demand but it can never be achieved while preserving external financial equilibrium at the same time.

10. In Hungary many people, not only on the street but also in parliament, would shrug their shoulders when told about financial equilibrium as a constraint. Why would it matter if the fiscal deficit or the deficit of the even less comprehensible current account increased? Let us spend even more even if it boosts further our 'accumulated deficit', that is to say, our debt. In addition to having a rational and maybe a less rational but very hard ultimate constraint to increasing our debt, we will see that even the so much desired economic growth cannot be accelerated at the expense of financial equilibrium.

## **EQUILIBRIUM AND GROWTH**

11. Let us consider four different concepts of debt that all have an important role in our economy, which is becoming more and more open and interconnected with world markets each day. We need to distinguish between private (enterprise and household sector) debt and state (central budget, social security, local governments) debt. Likewise, external debt should be clearly distinguished from domestic debt.

12. In a small, open and underdeveloped economy the most important engine of real convergence is the rapid growth of productive investments. These are realized in and by the enterprise sector. Investments are financed not only by internally generated funds, that is, accumulated profit, of enterprises and additional equity capital but also from funds borrowed from other sectors through bank loans and bond issues, that is to say, by debt. The more successful an enterprise, the more of its own funds will become



available and the more the enterprise can invest. More rapid growth will generate more future income and the enterprise will be able to borrow more from the banking sector and on capital markets.

13. Growing indebtedness of the enterprise sector is, therefore, beneficial because this is the primary motor of rapid economic growth. If financial resources are intermediated in an efficient way by the banks and capital markets then indebtedness of individual enterprises has a natural limit and massive bankruptcy of enterprises and a subsequent implosion of the whole economy can well be avoided.

14. In order for the enterprises to raise more and more outside funds, it is indispensable that these funds be available. There is a need for savings to exist in the economy generated by agents willing to lend these funds for investment by way of intermediation through the banking sector and capital markets. Outside the enterprises there are three such economic agents: households, the state and the external sector.

15. In the previous non-market system households typically saved a lot because many expensive consumer goods could be purchased only after a long period of (voluntary) savings. Many other consumer goods, however, were in short supply so that real and symbolic queues were formed with forced savings and a monetary overhang. In a market economy, people save for lifetime investments (pension, education of their children, health insurance, etc.), but it is also likely that they will borrow because an increasing number of expensive items – for example, houses, cars, etc. – can be purchased by retail loans.

16. In the present phase of convergence, households tend to save less in the transition economies because it is the first time in 50 years that people can buy houses and cars by using loans. This is obviously an option only for those who have sufficient disposable income to repay their loans. If their savings go down, then the aggregate savings of the entire household sector will also decline because low-income people cannot save. This is exactly what is happening now in Central Europe: while enterprises need more and more external funds for investments, household savings can finance less and less of these needs.

17. One might wonder whether the state could rally to the support of the enterprises. It would be conceivable only if the state saved, if its income exceeded its expenditure, that is, if the fiscal sector had a surplus. But the state typically spends more than its revenue. The very existence of a fiscal deficit, therefore, reduces further investment and growth in the enterprise sector.

18. In the market for savings we now have two economic agents with patterns of regular overspending: the enterprises and the state. If household



savings are insufficient to cover even the borrowing requirements of the enterprise sector, not to speak of the financing needs of the government, there is only one way out: the importation of foreign savings. The deficit of the current account shows exactly this relationship in the savings–investment balance.

19. As we argued in paragraph 8, the regular injection of foreign savings into the financial circulation of the domestic economy is not only beneficial but also sustainable if it is primarily in the form of direct investment rather than borrowing. But even enterprise borrowing can be beneficial and sustainable if funds are used efficiently for investments that would generate more exports. Is this what is happening in Hungary today ?

### **ECONOMIC POLICY DESTROYING FINANCIAL EQUILIBRIUM IS INEVITABLY AGAINST GROWTH**

20. As a consequence of a remarkable slowdown of the world economy, economic policy in Hungary changed course in 2000 and an artificial boost of domestic demand was substituted for declining exports. The intellectual basis for this policy change was the quite ambitious reasoning that the characteristics of the golden age of growth experienced between 1996 and 2000 contradicted all traditional textbook type thinking. In this period, the Hungarian economy was able to grow very fast with job creation, declining inflation and at the same time preserved both internal and external financial equilibrium.

21. The performance of the Hungarian economy in those 5 years was unprecedented indeed, but not because the stabilization policies enacted in 1995–1996 contradicted textbook theory. Rather this was an excellent example of good economic policy making. Let us look at the facts !

22. The two most important goals of the stabilization in 1995–1996 were to restore the international competitiveness of Hungarian labor and to avert the then threatening nightmare of fiscal collapse. Both aims were well served by a specific economy policy that was first opposed by many, including the IMF, because it was an unusual mix of traditional and innovative solutions. The one-time significant devaluation of the Hungarian currency, the introduction of a preannounced crawling peg exchange rate regime and a temporary import surcharge were traditional stabilization measures. At the same time the dramatic reduction of real wages through tripartite negotiations, a new social policy based on need instead of universal entitlements and several steps reinforcing fiscal accountability constituted remarkable innovations. The Hungarian stabilization of 1995–1996 is considered



exemplary by the international professional community today because it succeeded in restoring both external and internal financial equilibrium in a very short period of time without pushing the economy into recession. The fact that Hungarian society was willing to undertake considerable sacrifices makes these achievements even more remarkable.

23. The subsequent golden age growth for the Hungarian economy was made possible by the stabilization policy implemented in 1995–1996. Between 1996 and 2000, both internal (household sector) and external savings were readily available for the enterprise sector en masse. The fiscal deficit remained moderate, typically lower than the rate of growth itself; state debt, both foreign and domestic, declined at least in relative terms. The fiscal sector did not crowd out enterprise sector investments from the absorption of household and external savings. The engine of economic growth was an unprecedented export boom (double-digit growth for most of the period) generated by massive investments leading to huge productivity gains. This growth proved to be sustainable because it preserved financial equilibrium. What was done was perfectly in line with what modern economic theory would suggest.

24. If one does not see the real reasons and characteristics of this outstanding economic performance, one cannot understand the eventual mistakes of the next policy change, which was thought to be necessary when the conditions of the world economy became less favorable for Hungary after 2000. If it is not clear that the golden age growth was sustainable only because it preserved financial equilibrium, then it will not be clear why sustainable growth cannot be generated at the expense of deteriorating equilibrium.

25. The most important goal of the economic policy prevailing since the turn of the century has been to supplement slowing export growth with the rapid expansion of domestic demand. As demonstrated by the example of Germany (paragraph 7) this is not always an irrational option if the economy suffers from insufficient domestic demand while at the same time exports a huge amount of domestic savings through the surplus in the current account. But it is a well-known fact that Hungary at the millennium did not have any domestic saving surplus because no matter how fast exports had grown before, the total value of imports had always been much larger than the value of the exports. There was sufficient domestic demand in Hungary. The fact that the current account had always shown significant deficits clearly demonstrated that the economy was continuing to import external savings in order to satisfy the insatiable investment demand that had considerably exceeded the supply of domestic savings.



26. In an economy where aggregate domestic demand is not insufficient but, on the contrary, there is surplus demand generated by rapid asset accumulation via productive investments, any further boost of domestic demand can occur only in an artificial and political manner. The two most important ways of achieving this are fiscal overspending and the increase of real wages exceeding average productivity growth. As indicated in paragraphs 8 and 9 such policies would quickly destroy financial equilibrium, which might well be considered irrelevant by some politicians. But governments pursuing such a policy cannot be indifferent to the fact that an economic policy based on artificial boosting of domestic demand will not achieve sustained economic growth either even if this is the most important policy objective.

27. Demonstrating the validity of this relationship is quite simple. If domestic demand increases, consumption and imports will grow in the first place. Given the level of income, increasing consumption will reduce domestic savings even further. Fiscal overspending and growing household consumption will crowd out not only domestic but also external savings that could be used to finance productive investment in the enterprise sector. As fiscal borrowing grows, so do interest rates. As current account deficits widen, interest rates increase even more. Fiscal overspending will quickly absorb not only all domestic but also all external savings. The state will crowd out the enterprises from the money and capital markets. Investments will sharply decline and economic growth – considered slow beforehand – might even stop.

28. Is this an absurd theory ? Not really. During the last 3 years the Hungarian economy clearly proves that it can happen. Despite all efforts to boost the growth rate artificially, the economy has been declining for 3 years in a row. In 2002, when the fiscal deficit reached almost 10 percent of GDP, the state absorbed not only all domestic but all external savings, too. The enterprise sector had a net savings position instead of investing for the sake of growth. In 2002, the enterprise sector was crowded out completely by the fiscal sector. No savings were available for financing investment in the economy.

29. It is clear, therefore, that in a small open transition economy growth cannot be boosted in a sustainable way if conditions of financial equilibrium are totally ignored. It is important to note, however, that financial disequilibrium puts a brake on growth well before all savings available for investment have been exhausted. There is an even stricter requirement to be taken into account for economic policy makers in Hungary: it is not enough to be smart, it is also necessary to be perceived as such. In other words, only a consistent economic policy and good-quality



communication can convince our lenders that it is worth giving their savings to us.

30. The 2004 state budget became obsolete 2 weeks after its approval by parliament in December, 2003. The mini currency crisis in early December offered a forceful signal suggesting that things have been going in the wrong direction for some time. Having destroyed the fundamentals of export-led, investment-driven and financially sustainable economic growth, it is now imperative to prevent a final destruction of financial equilibrium. The government should avoid fiscal collapse at any rate. But it would be even better if it could restart export-led and sustainable growth.

### **COMPETITIVENESS AND GROWTH**

31. Let us go back again to the stabilization program of 1995–1996. It is credible to say now that both its main objectives, avoiding fiscal collapse and restoring international competitiveness of Hungarian labor have been fully realized. Today, the nightmare of a fiscal crisis is not yet threatening if the present government takes clear steps to avoid it. But if export-led growth is to be restarted, the competitiveness of labor needs to improve markedly.

32. Many people dislike the expressions ‘competition’ and ‘competitiveness’ because they find them not only imprecise but also unworthy of explaining complex processes of societal life on the basis of heartless values of the market. I share the view that the wide diversity of societal life cannot be fully described by market concepts alone. I only state here that if we are to achieve convergence to Western living standards in the foreseeable future, a widely accepted goal of society, we need significantly faster growth for a long period of time than what is actually experienced in the West. This can be achieved only if our international competitiveness substantially improves.

33. International competitiveness is a difficult concept. It does not simply mean that labor has to be cheap. Rather, it establishes a relationship between the quality and price of labor. Labor can be very expensive if its quality is excellent and it is able to produce goods and services saleable at high prices. The relative cost of expensive labor producing expensive goods can well be lower than that of cheap labor producing cheap goods. Competitiveness depends on unit labor costs that, in turn, is determined by productivity.

34. There is an important political message attached to this definition. It occurs quite frequently in Central and Eastern Europe that trade unions demand rapid wage growth arguing that prices have already reached international levels but wages have not. This logic disregards the most important factor, the productivity of labor. If convergence is to be achieved in a sustainable way, wages should keep up with productivity, not prices.



35. This very strict relationship between wages and productivity can be violated by a voluntarist economic policy but never without negative consequences. The structure of the labor market makes it possible that wage hikes in areas with high productivity growth, where competitiveness is not in jeopardy, will inevitably spill over to areas with much slower productivity growth. This does not necessarily create a problem if it is possible to increase prices in those latter sectors. Personal services like catering, hotels, hairdressers, etc. do not face import competition on a large scale. Manufacturing, agriculture and other services are very different, however. Wages in these sectors are constrained by both export and import competition. In countries completely open to cross-border capital flows, the arrival and departure of domestic and foreign investors are a daily occurrence. Although there are thousands of factors to be taken into account when selecting sites for new investments, it cannot be denied that unit labor costs and even more so their expected future change will greatly influence investment decisions of entrepreneurs.

36. There is a particularly cruel corollary to this. The small and open economies of Central and Eastern Europe are faced with three huge challenges of historic proportions at the same time: (i) transition from non-market to market, (ii) convergence before and after EU-accession and last but not the least (iii) globalization. One might like or dislike these challenges but one thing is sure: they cannot be ignored. Ignorance would not only endanger the already achieved level of development but would clearly lead to decline. For Hungary, the only way to go is to restore international competitiveness of labor and keep it always at an adequate level.

## COMPETITIVENESS AND SOLIDARITY

37. There is also a fourth challenge, namely, the quality of future economic and societal development. While transition, convergence and globalization represent mainly exogenous factors; the latter constitutes an endogenous requirement. What type of development do we strive for? Do we want everybody to share the victory of transition, the success of convergence, the benefits of a globalizing world? Do we want everyone to get a fair share of the benefits of economic growth in a much more equitable manner? Do we prefer a society in which inequalities in income and wealth distribution will not widen further and differences in opportunities will clearly diminish? Do we aim at a society where solidarity goes hand in hand with competition?

38. The parallel prevalence of competition and solidarity as fundamental values and organizing principles of society is not self-explanatory. They are difficult to harmonize not only in our head but also in practice. Central and Eastern Europe represents an especially rich and fertile ground for their



apparent contradiction for a good part of income and wealth inequalities originates from shaky and shady competition limited largely to insiders and then partially mitigated either by forced solidarity, which does not reflect true sentiments in society or by false solidarity that, in reality, supports mainly the rich and affluent people.

39. There is no contradiction between competition and solidarity in principle. True solidarity can best develop through open and transparent competition in which everybody can participate because it constitutes the best ethical framework for an environment where affluent members of society would find it very much in their own interest to limit voluntarily inequalities stemming from competition itself. If our goal is to achieve convergence without growing inequalities in income and wealth and with significantly reduced differences in opportunities, then competitiveness can best be enhanced by those reforms that at the same time strengthen true solidarity. The best guarantee for rapid and sustainable growth is to pursue economic policies and structural reforms that result in improving competitiveness and rebuilding solidarity in society.

40. The economic policy conducted in Hungary in the last 3 years has been not only anti-growth but also anti-solidarity in nature. We have been conducting a welfare policy supporting mainly the well-to-do. Many institutional arrangements of this anti-social and anti-solidarity policy (eg family allowances based on universal entitlement, interest subsidies to housing loans, higher education without tuition fee, etc.) have become sacred cows. Influential groups of the political class do not dare and maybe do not want to touch them. Consequently, to appeal to social sensitivities would be in vain. It is more useful to show that there is no sustainable growth and convergence without a welfare policy targeting the needy and based on true solidarity.

## **SIZE AND STRUCTURE OF THE FISCAL SECTOR**

41. Income redistribution through fiscal channels can be analyzed in three segments. In addition to the deficit of the general government, the extent and structure of fiscal redistribution of income have a major impact on both the economy and society.

42. We have already shown that high fiscal deficits inhibit growth in transition economies because deficits typically absorb most of the available external and internal savings, which otherwise should and would be used for productive investment. Moreover, deficits contribute to the increase of state and foreign debt (paragraphs 17 and 27). Deficits resulting in growing state debt also work against societal solidarity. State debt increases the burden of



future generations without asking whether they want it or not. Although one can hope that future generations will be more affluent than present ones, this is usually not true for young people just entering the labor market. Even though high yield government paper is an attractive investment for the affluent elderly with significant private pension savings, younger generations, having no savings at all, would 'enjoy' only the higher tax burden in the future. Increasing state debt mortgages their future.

43. Not only is the budget deficit high in Hungary, the size of fiscal redistribution of income generated in the domestic economy is also high. General government centralizes more than half of GDP. The size of the Hungarian budget relative to GDP is not only higher than in the great majority of other underdeveloped transition economies (and clearly the highest among all EU-accession candidates) but it also significantly exceeds the ratios observed in most Western European countries. Hungarian income is burdened with 'Swedish' taxes while Hungarian productivity lags far behind Scandinavian levels.

44. Extremely excessive fiscal redistribution is absolutely anti-growth on both sides of the balance sheet of the budget. It is easy to see on the income side. High taxes clearly hold back economic activity. The anti-growth nature of high government spending is primarily explained by the fact that the state cannot know better what is efficient than the market. Offering fiscal subsidies are always tainted by political considerations, hence, redistribution of income by the state cannot be more efficient than market-based resource allocation.

45. The structure of the Hungarian state budget is anti-growth and at the same time anti-solidarity in nature. High non-wage labor costs lead to holding back or concealing individual efforts. Price subsidies distort investment decisions, leading to waste and typically leading to support the affluent. Public goods and services with limited supply and high costs (health care and education), which are notionally free at the time and point of sale, are accessible more easily by high income and more influential groups of society. Tax holidays offered in a graduated tax regime will be enjoyed mostly by those who have taxable income and the more they have, the greater the subsidies they get.

46. The 2004 central budget in Hungary originally envisaged some reduction of the deficit but it was thought to be achieved primarily by boosting receipts even further (through increased value added tax rates) rather than by cutting back on expenditure. This is a huge problem. Reducing the deficit is beneficial to economic growth but increasing further the size of fiscal redistribution will largely neutralize its positive effects.

47. With respect to the structure of the budget there is no sign at all of strengthening its positive impact on growth or better reflecting the requirements of societal solidarity. Structural reforms reducing income



redistribution through fiscal channels, and changing fundamentally the direction of the remaining income redistribution are needed if the international competitiveness of the Hungarian economy is to be improved.

## **TAX SYSTEM LIMITING COMPETITION AND OPPOSING SOLIDARITY**

48. Let us start our analysis with the personal income tax system. At first glance high tax rates and especially the very high marginal rate appear to be the biggest problem. International comparison confirms this only partially. But it shows very clearly that the higher rates and even the highest one kick in very fast with the rise of income. As a result, even relatively low-income middle-class people soon find themselves paying the highest rate. Our personal income tax system limits economic activity and encourages both tax avoidance and tax evasion.

49. All graduated personal income tax systems try to mitigate the burden of the middle classes through a myriad of exemptions and deductions. Some of these may seem reasonable and justifiable (eg child rebate); others are clearly the results of political pressure from influential groups (eg generous costs deductibility for self-employed professionals). The faster the growth of nominal income and subsequent bracket creep, the stronger the pressure for the proliferation of exemptions and deductions. As a consequence, we may end up with an absolutely non-transparent and ineffective tax system in which actual burden sharing among various groups of society can no longer be determined at all. If it were still possible to track down the distribution of tax burden, the result would be shocking. The political fight for preferential tax treatment leads to a complete loss of solidarity.

50. An achievement that the present government is most proud of is the exemption of minimum wages from taxation. This is an excellent case in point. This exemption appears to be very 'poor friendly' because it looks like it helps low-income people. But if the tax system is seriously tainted with a fast growing number of exemptions and deductions as a response to its steep progressivity, then exempting the minimum wage makes no sense. A minimum wage earner who has so far benefited from rebates for his children will no longer be in a position to do so. Therefore, his position will not improve. But the situation of minimum wage earners with no children will. A minimum wage earner who, with the help of his large family, was able to obtain a housing loan and enjoy some tax rebate linked to its amortization will lose this subsidy too.

51. In a tax system richly tainted with rebates, exemption is a measure opposite to solidarity because it deprives exactly those people from using available rebates who need them most. Conversely, high-income people who in theory are supposed to pay higher and higher taxes will end up paying less



and less – at least in relative, if not in absolute, terms – because they are the ones who can take greater advantage of the fast proliferating rebates.

52. There are two ways to rectify this intrinsic distortion. One solution is to introduce a negative tax. If a minimum wage earner does not have taxable income he should get the socially justifiable support in the form of direct fiscal subsidies. In that case, the relative position of a minimum wage earner with children would not deteriorate *vis-à-vis* his childless colleague. This is important for the ‘horizontal solidarity’, that is, for promoting equal opportunity among people earning similar incomes.

53. The Hungarian tax system does not incorporate the concept of negative taxation. It is a big problem because with the fast proliferation of rebates and deductions, exempting low-income people from paying income tax could be socially efficient and well targeted only if there is a negative tax. (The anti-solidarity nature and inefficient targeting of social support were further exacerbated by the reintroduction of universal entitlement for family allowances by the previous government.)

54. The other solution is the complete elimination of all rebates and exemptions within the tax system and offering all social help outside taxation. As the great majority of rebates and holidays always support higher income groups, complete phasing out of rebates and holidays would be a huge step towards improving ‘vertical solidarity’, that is, providing more equal opportunities to people with different positions in the income and wealth pyramid. Moreover, the complete elimination of tax rebates and holidays would make it possible to reduce tax rates and shift tax brackets upwards.

55. Political aspirations centred around popularity contests become seriously flawed at this point. Many people demand the reduction of tax rates and the shifting of tax brackets. Very few would fight for the elimination of tax rebates and exemptions. But these two issues are closely interlinked in much the same way as tax exemptions and the negative tax. The more the tax rates are reduced and the more the brackets are shifted upwards, the more important it is to eliminate all tax rebates and holidays.

## THE SLOVAK EXAMPLE

56. Another – maybe somewhat extreme – option to consider is the flat tax. Slovakia has just introduced a 19 percent flat rate personal income tax. Slovakia, with its rapidly improving competitiveness, is now emerging as a formidable rival in our direct neighborhood. The Slovak example can and should serve as a valuable model from the viewpoint of improving competitiveness, which is key to achieving sustainable growth. But the question is whether it is a good model to be followed regarding solidarity.



57. The American model that served as a theoretical basis for the Slovak solution proposes the introduction of a single rate above a fully exempt basic income level that depends exclusively on the number of dependent children. In addition, the identification of the magnitude of the basic income exempt from taxation hinges upon the following three factors: how large a part of the lowest income group is to be fully exempted from paying income tax; how high the flat rate should be; and finally how much fiscal revenue is to be generated by this type of tax alone.

58. No matter how these parameters are set, one thing is certain: introducing a fully exempt basic income level makes the flat rate tax progressive without having to apply more than one single rate. This is a terrific advantage. If the single rate is not very high, it does not create disincentives to work. Although as a consequence of having a tax-exempt minimum income level the tax burden does grow progressively, the marginal rate always remains unchanged.

59. The flat rate tax system together with the application of a basic non-taxable income corresponds perfectly to the requirements of proportionate burden sharing in society because higher income groups will pay higher taxes not only in absolute but also in relative terms. It is very important to note, however, that this is true only if there are no rebates or exemptions whatsoever in the personal income tax system.

60. In this case there is one more great additional advantage: tax returns will become so simple that it could be performed on a single postcard. Imagine how much time and energy could be saved !

61. Reforming taxation is a very difficult task. There is no ideal tax system. The best system of taxation is what is most accepted by the largest part of society and it is proved by the (almost complete) disappearance of tax avoidance and evasion. We are very far from that situation, indeed. It is not hopeless, however, to start moving in this direction. We just need to understand the intrinsic logic of alternative tax systems. Then parliament should select that version which best promotes social harmony through competition and solidarity.

## **CONSISTENCY OF THE WHOLE TAX SYSTEM**

62. While it is the personal income tax that is perceived as a daily threat by ordinary citizens, other types of taxation cannot be ignored. Given constraints of time and space, I will not deal with custom duties, excise taxes, social security contributions or other taxes. Value-added and corporate taxation, however, deserve a few comments due to recent changes.



63. The value-added tax as a burden ultimately levied on consumption is functioning quite well and constitutes a rather neutral basis for the single European market. The problem in Hungary is the marginal rate, which is excessively high by international comparison. After joining the EU the current 25 percent marginal rate will be untenable. When all prices become immediately comparable in euro, Hungary will no longer be competitive with this high marginal rate. It is not easy to decide what to do. Lowering the marginal rate would reduce tax revenues. Leaving the rate where it is today may also lead to a marked reduction in fiscal revenues because a growing part of business activity and final consumption may leave the country. It would have been advisable to start reducing the marginal rate earlier this year because the need to avoid a sudden revenue loss limits the possible size of annual rate cuts anyway.

64. In Hungary, the corporate income tax was already lower than in most other countries even before its further reduction starting this year. Lowering the rate from 18 to 16 percent seems to be quite unnecessary. There is little hope that such a small measure will significantly improve our competitiveness. If anything, the full tax exemption for productive investments or, what is identical to this, the one-off full depreciation of the value of physical investments (in machinery) in the year of completion might have been considered instead. That could have provided a significant boost to productive investments and hence, to economic growth, which would be very beneficial even in the case of a substantial initial loss of budget revenues.

65. It is imperative to reduce the extent of income redistribution through the budget. It is not indifferent, either, which channel of revenue centralization is to be scaled back. It is even more important to cut back on fiscal expenditures because the budget deficit cannot be increased any further. Desirable tax reform should, therefore, take into account not only the intrinsic logic of the selected tax system, but it has to be coordinated with reforms resulting in a significant reduction of public spending too.

## **WITHDRAWAL OF SUBSIDIES FROM THE WELL-TO-DO**

66. These reforms are clearly the most difficult ones for a government policy centred around short-term popularity. The prophets of false solidarity will talk of the devil when reading this. There is no reason for us to abstain from this analysis because we know that the devil is already here and it is here to stay. The wolf in sheep's clothing has already been lying about solidarity for some time. It is high time to withdraw all superfluous fiscal subsidies that unnecessarily support the well-to-do.



67. Family allowances and all other forms of social support to children should be based again, and this time exclusively, on need. If a tax reform similar to what is described in paragraphs 56 through 60 is realized, the number of dependent children will be taken into account when calculating basic tax-exempt income. Nevertheless, it is justifiable to offer additional family allowances to those who do not even have sufficient basic tax-exempt income to take full advantage of these exemptions. For large and poor families, the strict application of means testing will result in supplementing their income to the full extent of the basic exemption. In exceptional cases, such as families with disabled children, supplementary direct fiscal support can go even beyond that.

68. The radical overhaul of personal income taxation will inevitably cancel the tax rebate attached to the amortization of housing loans. Furthermore, it is imperative to eliminate completely the subsidization of housing loan interests. This type of public expenditure is particularly anti-solidarity in nature because it supports, first and foremost, the financial institutions that provide the loans and, secondly, the well-to-do who are able to obtain huge loans thanks to this subsidy.

69. Terminating most of the remaining price subsidies would generate considerable savings for the budget. It is not true, for instance, that all elderly people are poor. Offering free urban transport to all people above the age of 65 is, therefore, unjustifiable. (Moreover, this is available only to retired people living in cities at the expense of the rural population and, hence, it violates the principle of horizontal solidarity too.) Transit companies may offer significant reductions voluntarily to the elderly, especially in non-rush hours because even a very small marginal revenue above marginal costs can help them to recover the huge fix costs they incur.

70. The same is true for subsidies for power, gas, water and sewer, or waste disposal. Price subsidies for public utilities, by design, support large and affluent consumers. Those in need should instead be supported by direct subsidies in the form of vouchers that can only be used for paying utility bills. The cost of these vouchers would only be partially borne by the budget. Fiscal subsidies can be nicely supplemented by recycling a small part of the profit of the utility companies and also by voluntary donations of those who are obliged to pay the full price.

71. Our system of income redistribution through the budget is very ineffective and wasteful even in areas that are not directly related to the price of domestic labor. There is wide scope for cutting back on public expenditure. Hungary spends more and more on agricultural subsidies without increasing efficient exports and reducing the mountains of produce that cannot be sold. The Hungarian Railways and the Hungarian Airlines are bottomless pits and



show no sign of improving the quality of their services and reducing their huge operating losses. It would be laughable if it were not so sad that in the absence of transparent public tenders, the costs of highway construction per kilometre is twice as high in the Hungarian plains than in the mountainous regions of neighboring Croatia.

72. The radical steps of tax and welfare reforms described above would significantly improve the international competitiveness of the Hungarian economy and solidarity in society by reducing the deficit and size of the budget and by improving its structure. Labor market reforms would have a similarly positive impact.

### **ANTI-REFORMS IN PUBLIC SERVICE**

73. The extraordinarily generous wage hikes for public employees is usually justified by the alleged remarkable improvement in their competitiveness in the labor market. It is argued that this measure reduced the danger of public employees leaving for the private sector and improved the quality of work of teachers and nurses. As a result, the quality of labor will rise in general. On these grounds, it is argued that the 50 percent wage hike realized within the framework of the first hundred days program of the incoming government in 2002 was absolutely rational and justifiable.

74. There would be a small grain of truth in this argument if at least one of the following conditions held. First, if there were few public employees compared to other countries. Second, if their salaries reflected rather strictly their individual performance. Third, if competition forced them to improve the quality of their work.

75. We know from experience that none of these conditions actually holds. Since 1998, the number of public employees has been constantly growing in Hungary while it has been reduced in almost all other transition economies. As a result, the share of public employees in total employment is the highest in Hungary among the 10 countries joining the EU in the first round of enlargement. It makes no sense talking about the danger of leaving public jobs in such a situation; on the contrary, overemployment in the public sector is crowding out the private sector labor market.

76. How is it possible when wages in public sector usually lag behind that of private employees? After the extremely generous wage hikes that contributed to the growing fiscal imbalances, the average salary of public employees in Hungary exceeds the wages of private sector employees by 30 percent: a distortion unprecedented on a world scale.

77. In Western Europe and in the US, higher private sector wages contain a risk premium that is justified by the much higher risk of eventual



redundancy. Public employees are usually compensated not only by higher job security but by perks like early retirement, transit support, clothing, free catering and cheap holidays.

78. In our country public employees earn not only higher wages but they also have some significant perks not available to private sector employees (eg housing loans with state guarantee). Moreover, public employees enjoy these perks under exceptionally favorable circumstances where job security is not only considerably higher in the public sector but wages are completely disconnected from individual performance by rigid wage scales reflecting only formal requirements.

### **DISTORTIONS IN THE LABOR MARKET**

79. This situation damages both competitiveness and solidarity. High salaries for public employees and overly generous wage increases disconnected from individual performance inevitably spill over to the private sector because the boundaries between the two segments in labor markets can easily be traversed. If enterprises in the private sector cannot absorb the higher wages induced by voluntarist economic policy, they will go bankrupt and unemployment will go up.

80. This is exactly what is happening in sectors characterized by low and slowly growing productivity where the share of low wage workers is typically high. It is no coincidence that the remaining textile and shoe factories are quickly going broke these days. Foreign companies with low value-added and assembly-type activities are leaving Hungary.

81. One might be glad to see these low productivity and low value-added factories close down because it helps to increase the average productivity level in the economy as a whole. It also means that the average wage of those who actually work rises further. But it is only the average that grows and not individual wages, for this happens at the expense of having higher unemployment among low wage workers!

82. Workers laid off from factories with low levels of technology, productivity and value added are typically uneducated and semi-skilled. To retrain them for professions requiring serious knowledge that is more in demand in the labor market is no easy task, and is sometimes almost hopeless. The dismissal of semi-skilled workers is a huge problem because it increases structural unemployment, which is very difficult to tackle.

83. Public sector overemployment stimulated by spectacular wage hikes creates an artificial shortage of highly skilled labor at the high end of the labor market while it increases the sticky structural unemployment among



unskilled and semi-skilled workers at the bottom end. It is a wolf in sheep's clothing: irresponsible policy leading to the deterioration of the competitiveness of our economy and destroying the solidarity among workers.

84. There are other, even more blatant examples of government measures that disrupt the unity of and damage the solidarity among employees. One such measure is the minimum wage for graduates, and another is the establishment of a privileged class of senior civil servants.

85. From the viewpoint of pure economic theory the merits of a minimum wage are questionable in general, but in transition economies, where tax evasion is a national sport, it makes sense to apply a minimum wage level not wholly disconnected from what is justified by the market. But a minimum wage for graduates is not good for anyone, including the graduates themselves. First, a degree in itself may not improve the quality of labor of its holder. Second, it creates an illusion that graduates have a right to a job requiring a degree. Third, as a consequence, a specific minimum wage for graduates will increase unemployment among graduates, which is harmful not only for society but for the misled graduates too.

86. The establishment of a privileged class of senior civil servants is an adaptation of a primarily French aristocratic institution based on the worst Western European tradition. It was introduced by the previous government at the turn of the century. It was further distorted by the fact that positions for this new cadre of civil servants were not filled based on meritocracy but on personal political loyalty. The present government has tried to use more objective factors reflecting performance and experience, but it increased the number of senior civil servants even more instead of abolishing the whole system. The establishment of this spectacularly overprivileged caste of bureaucrats is severely constraining competition because it further weakens the flexibility of the labor market for public employees and it is decidedly against solidarity because it destroys brutally the unity and cohesion of the civil service.

### **MORE COMPETITION, MORE SOLIDARITY!**

87. What needs to be done? The solution is not the reduction of nominal wages of public employees. Obviously this is impossible to do, but, perhaps, it is unnecessary. There is a better way to restore the stability and unity of the labor market, increase its flexibility and boost solidarity considerably among employees (and with the unemployed) by deep, substantive structural reforms having a beneficial impact in the long run.

88. The most important step is to eliminate all bureaucratic pay scales. Following the example of the private sector, there is a need to establish



performance-related individual pay in public employment too. This may imply even higher wages for a good number of public employees provided that the budgetary unit where they work can cover it.

89. In the framework of an overarching reform of the fiscal sector it is indispensable to analyze the justification for each individual task performed in the public sector. The budgetary appropriation for wages in each individual fiscal establishment has to be determined accordingly. The precise and parsimonious identification of public functions will result in a marked reduction in their numbers, and there will be much scope for closing down or consolidating various budgetary institutions. A substantial reduction of the number of public employees will make it possible to preserve present remuneration levels and still achieve considerable fiscal savings.

90. If bureaucratic salary scales for both civil servants and other public employees are abolished and all tax deductions attached to public employee status are eliminated by a radical tax reform, public sector employees are unlikely to fight for preserving their legal status because it will become meaningless. If doctors, nurses, teachers and officials are remunerated primarily according to their own individual performance, then the presently prevailing block resistance to the state as an employer will be eased.

91. Needless to say, the minimum wage for graduates and the senior civil servant class should be abolished too. It is also necessary to withdraw all unfounded and irresponsible promises to cut working time. The realization of these promises led to a dramatic fall in the international competitiveness of much stronger economies such as Germany and France.

92. Last but not the least, we have to strive for a small, slim, effective, clean and efficient state that is there to serve us by offering useful services. This would include halving the number of members of parliament, streamlining central government administration, consolidating several ministries, eliminating most of the state secretariats belonging to the Office of the Prime Minister, etc. We need acceptance from the European Commission that Hungary be treated as one single region and as a consequence, all attempts to establish regional self-governments with public legal functions have to be refused. Since such huge reform will take a long time to be implemented, it is reasonable to start preparations for the consolidation of several thousands of local self-governments and the introduction of lowest level local governments corresponding to the size of our old 'járás' (a unit covering dozens of villages around a small city centre – a good example for this is offered by Sweden).

93. Because of space constraints I cannot discuss in detail the reform of subsovereign government. This would clearly deserve a separate essay. I will, however, discuss two reforms that affect our international competitiveness because they may significantly improve the quality of labor: education and



health care. In Hungary, these public goods are largely provided by institutions owned by subsovereign governments. Thus, all reforms needed to improve the quality and efficiency of education and health care are closely interrelated with subsovereign government reforms too.

## **WORLD CLASS MANUFACTURING, LOW-QUALITY PUBLIC GOODS**

94. There is another reason why I deal with the institutions of education and health care in a prominent way. As a consequence of the Central European tradition with excessive state interference and as a heritage of the non-market system we used to have before, these public goods have become sacred cows to such an extent that it is considered almost a sacrilege to call for the partial use of markets, competition, and direct contribution of consumers in the process of their provision even today.

95. But it is exactly the lack of market competition and the dominance of bureaucratic state distribution that has led to a dramatic and continuous fall in the quality of education and health care. While corporate restructuring, privatization and massive foreign direct investment have helped a good part of Hungarian manufacturing, banking, trade and services to reach world class levels, the quality of public goods provided by the state has deteriorated so much that it now directly threatens the competitiveness of the economy, constrains economic growth and future convergence.

96. Education and health care have so far avoided regime change based on the principle of competition. The Hungarian political class, irrespective of party affiliation, felt and announced almost unanimously that these public goods are too important for their provision and allocation to be left to the soulless market because the poor would not have access to them.

97. The real situation is exactly the opposite. On the one hand, it is an everyday experience that in the absence of market competition there is no pressure to perform better and increase efficiency. This leads to a general, but far from equitable decline in the quality with fiscal resources limited at all times. On the other hand, it is proven that quality would fall precisely for the poor and less educated people who do not have enough money, influence or connections. There is always competition for high-quality goods in short supply; in a non-market competition solidarity is always a loser.

## **FAREWELL TO WORLD CLASS EDUCATION AS ONCE IT WAS**

98. Although it is proper to mention teachers with great respect in political speeches, there has been no government in Hungary since World War II with enough courage to address the fundamental problem of



education: “there are too many of us here, therefore, we are paid little”. This is a contradiction that leads to declining quality and reflects false solidarity. If there is any area in public service where there is chronic overemployment, it is clearly education.

99. The oversupply of teachers has been getting worse and worse since the political changes. It is happening despite stricter requirements in operating schools and sometimes a dramatic fall in school age cohorts, which forced more and more local governments to close or consolidate schools and dormitories. Although the central government has tried to mitigate the negative consequences of this trend by seemingly popular measures, such as reducing the number of obligatory weekly hours, which are now well below both EU and OECD averages, unemployment among teachers has been rising at an accelerated pace. At the same time, universities are releasing young teachers in growing numbers; the almost ten thousand young teachers graduating every year find less and less work in their profession. The teaching profession has become more attractive again due to the 50 percent wage hike and by the introduction of minimum wage for graduates, but there are no new jobs for teachers and the number of existing jobs is likely to decline even more rapidly in the future: waste and waste at all levels.

100. It is possible to make a virtue of necessity by now. The immediate abolition of teachers’ pay scales and the introduction of individual performance-related pay would lead to beneficial selection and improved quality. This is exactly what we need in order to increase the skill levels of labor and to preserve international competitiveness even with growing wages.

101. It is one of the most important tasks in general, but it is absolutely indispensable in the teachers’ profession in particular, to coordinate training in both quantity and quality with future demand of the labor market. It is almost unbelievable that nothing happens in this respect in Hungary. We look helplessly at the waste of taxpayers’ money in oversized training programs and the rapid depreciation of knowledge capital among young people. Although with public education being compulsory, it would be very easy to calculate the size and structure of future school age cohorts, present admission quotas at pedagogy faculties are not constrained by the future demand for teachers.

102. There are at least two parts of our education system, namely, vocational training and higher education, where supply does not match expected future demand at all. Since the start of political changes vocational training has declined dramatically. The number and quality of the few remaining secondary schools offering vocational training cannot even come close to the effective demand of manufacturing, which is fast converging to world class levels. The main obstacle to attracting new, sizeable greenfield investments to Hungary today is the lack of well-trained skilled workers.



103. The dramatic reduction of vocational training is closely linked to the wasteful and absolutely unnecessary overextension of higher education. The government at the turn of the millennium tried to accumulate political capital by doubling the number of young people admitted to universities. But it allocated neither additional resources nor defined efficiency requirements for this ambitious drive. So it is no surprise that the end result is a dramatic decline of quality. Today the system of higher education is involved in a mass production of degrees with declining value. This will lead to the reproduction of an even larger reserve army of unemployed graduates in the future.

104. The significant decline in the quality of higher education in Hungary is closely related to the fact that the government at the turn of the millennium proudly eliminated the tuition fee that could have been used as a mechanism for signaling effective demand and controlling quality, at least partially. Having to pay a tuition fee means that students (and their parents) are required to cover, at least in part, the costs of very expensive investment in their own human capital because obviously they will be the primary beneficiaries of its higher yield in the future.

105. In fact, the irrational expansion of higher education without additional resources finally forced the introduction of some kind of a tuition fee, but in a way diametrically opposite to minimal social sensitiveness. A limited quota was introduced for admission to free higher education, which is supposed to be fully financed by the central budget. But not only poor and disadvantaged young people are admitted under this quota. Masses of highly disadvantaged students, among them the great majority of Hungarians arriving from neighboring countries, are forced to pay full tuition fee covering all operating costs. These fees may reach several hundreds of thousands of Hungarian forints a year in certain universities. This is another wolf in sheep's clothing: the system of higher education, which should be the most important pillar of improving equal opportunity in the future, is clearly working against solidarity.

## **THE BASIC INGREDIENTS OF A TRUE EDUCATION REFORM**

106. In the framework of public administration reform indicated in paragraph 92., it would be desirable to merge the labor and education ministries. This would not be merely a change in the organizational structure of central government administration but would support three important societal objectives as well. First, education is truly a lifelong program; the continuous education and eventual retraining of adults is as important as public and higher education for the young. Second, supply of the whole education system is to be strictly harmonized with future demand in the



labor market. Third, it would reinforce the need to improve competitiveness of labor in all segments of the market and true solidarity among workers.

107. It is indispensable to overhaul completely the financing of educational institutions. In this regard, it is reasonable to distinguish between compulsory public education and non-compulsory higher education and post-secondary vocational training.

108. Demand for public education is generated by the law-obliging citizens to send their children to school. Consumer choice is clearly limited by the selection available in schooling districts. In this case, the best financing method is to have fixed costs of primary and secondary schools covered by the owners (local and regional governments, church, endowment, private capital) and the variable costs covered by the central budget on the basis of capitation.

109. Since every child attends primary and secondary school only once and attends only one school at a time, fiscal funding on the basis of capitation cannot be wasteful, while it leaves some room for competition as a consequence of free choice of school. It also corresponds best to the constitutional requirement that all youngsters be given equitable access to high-quality education irrespective of where they live and how much their parents earn. Using funds from the central budget on the basis of capitation would make it possible for schools in poor regions to hire good-quality teachers, provided the number of pupils they have reaches a minimum allowing them to raise enough funds to pay for good teachers.

110. The nature of higher education and post-secondary vocational training available after completing secondary education is very different. None are compulsory. Both are very close to the labor market. Both represent a direct investment into human capital the value of which will be fast discovered. Making a good choice in higher education can multiply the market value of labor, which pays off later in a handsome way.

111. The fact that higher education is very close to the labor market also means that the labor market needs only a limited number of graduates at all times. Although this number is likely to grow in the future, it is clear that at the present level of development less than half of the society really needs a degree. There is much waste in the system if the output of higher education far exceeds that.

112. The financing of higher educational institutions in Hungary today is based primarily on student capitation, which is similar to the system that is functioning rather well in public education. But it is a decidedly wasteful solution for higher education because full participation of respective school age cohorts in higher education is neither compulsory nor desirable. This arrangement leads to inflating admission quotas, ignoring future labor market demand, wasting taxpayers' money and to the deterioration of both the quality of higher education and the value of the degrees offered.



113. As the great majority of higher educational institutions in Hungary are in the hands of the central government and not in local government, church, endowment or private ownership, fiscal outlays should cover their fixed costs, not their operating ones. The size and composition of infrastructure thus created would determine the number of students and their distribution among faculties, which could then be well harmonized with labor market demand. Operating costs, including professors' salaries, should be covered by tuition fees, which can be different across faculties.

114. The introduction of a tuition fee, not symbolic but one covering most if not all operating costs, would have a positive impact in many respects. First, it could alleviate the chronic underfunding of higher educational institutions, which is one of the root causes of declining quality. Second, it would create competition among universities stimulating quality improvements. Third, it would limit demand for degrees, stop inflated admission and overextended training because students (and their parents) would be willing to pay only for good-quality education. This outcome could never be achieved with inflated numbers of professors and students and with limited infrastructure. Fourth, it would limit the waste in fiscal resources because institutions, failing to admit a minimum number of students, could not survive. This would not be a tragedy. We have to get used to the fact that the opening and closing of institutions in the sacred pantheon of education (and health care) is a natural way of life, a natural outcome of competition.

115. Fifth, a tuition fee would restore inter- and intra-generational solidarity in a beneficial and efficient manner by improving equal opportunity. All those who are not poor would be obliged to pay. Poor but talented students, comprising a maximum 20 percent of respective cohorts, would be offered full exemption by all universities.

116. The arrival of this nice, new world, centred around quality and solidarity, could in theory be blocked by the supposedly untouchable autonomy of higher educational institutions, which today have extensive autonomy in managing their finances without public accountability. Autonomy should be redefined to reflect competition prevalent in a market economy and the requirements of solidarity in a livable society. Autonomy should be interpreted as the freedom to set the academic curricula, and not as independence from the legitimate owner, or as a right to spend resources without control and accountability.

117. In market economies with developed higher education system, owners like the state, churches, endowments or private capitalists determine the size and profile of the university, the skills taught and specializations offered, the desirable admission quota, etc. The chief financial manager is



appointed and dismissed by a council where all owners and regular donors are represented. Then it is the senate of the university, a wholly different group, a self-governing body of professors representing academic autonomy, which has the right to determine curricula, the professional content of education, the election of the rector, the appointment of tenured professors, the hiring of new assistant teachers, etc.

118. The financial resources covering fixed costs and determined by owners and tuition fees covering operating costs will no doubt enforce an efficient and effective use of these always limited resources and stimulate permanent quality improvements. In such circumstances, it would be unnecessary to keep bureaucratic pay scales and public employee status because it would only hamper the recognition of professional excellence and the firing of professors with unacceptable performance. The parallel prevalence of competition and solidarity would stop overemployment and inadequate pay without larger fiscal outlays but with a substantially larger burden sharing by direct beneficiaries.

## **REFORMING HEALTH CARE**

119. Having dealt with the grave problems of health care in contemporary Hungary and the issues related to reform in other essays, now it seems sufficient to recapitulate only the main conclusions. Nevertheless, it is important to supplement our analysis with a short reminder because there has been no positive change whatsoever in the last two years.

120. The problems of health care are somewhat similar to those of education. It is also a public good that (in theory) is not paid for by the consumer at the time and point of sale because its costs are being borne by society as a whole on the basis of risk pooling and covered by taxes in general and health care contributions in particular. As a consequence, there is no link between the quality of services received and the financial burden borne by the individual. This lack of a direct link seriously undermines the willingness to pay these taxes and contributions and makes health care providers interested in fighting for more funds in fiscal redistribution rather than vying for the favor of their customers.

121. In addition, health care has other characteristics that limit equal access when it is offered as a public good. On the supply side the cost explosion of health care technology and, on the demand side, the seemingly unlimited demand for good-quality services further increase the tensions between physicians and patients. In the absence of competition, there is no pressure to improve quality and use resources in an effective and efficient way. There is a permanent shortage and waste in our health care system,



which leads to long waiting lines and widespread use of ‘gratuity payments’, that is, corruption. This situation is particularly disadvantageous for the poor and the needy, not infrequently with tragic consequences.

122. The way out is not the complete privatization and marketization of health care, but to calibrate a fine equilibrium between self-care and solidarity. The most important task is to create the conditions for competition for customers. This would require first and foremost the introduction of multipillar financing. A health care fund administered by the state can be forced to achieve economic results based on financial equilibrium only if there are private health insurance companies, and employees are obliged to enter into contracts with them. The state health care fund should finance only basic services, and even those only partially. A considerable part of services provided by in- and outpatient care facilities and a growing part of their costs would be financed by private insurers.

123. From the viewpoint of proportionate burden sharing, a multipillar system of health care finance contributions paid by employers would decrease, but would still be channeled through the state health care fund. Contributions paid by employees would increase because health care is truly a public good that has always been underfinanced in Hungary, and it would be reasonable to restore financial equilibrium of the state health care fund after fifty years. Moreover, similar to what has been achieved in the pension system, contributions paid by employees would go to competing private insurers, who would be obliged to sign individual contracts with their customers.

124. There are spectacular advantages to this arrangement. Neither employers, nor employees will be able to avoid paying health care fees. Without a private health care insurance contract, it would be impossible to get any meaningful service, and employees would find it very much in their own interest to pay their dues regularly. Once they pay, they will also be interested in controlling and forcing their employers to pay for them. Hence, these two intertwined pillars would create a dynamic equilibrium between self-interest and solidarity.

125. It is very important that private health insurers have a great degree of freedom when entering into contracts with health care providers. Having the interest of their clients in sight, while pursuing their own, private insurers would force competition upon health care providers. It is not really important who owns these latter institutions. Central, regional and local governments, churches, endowments and private individuals can all potentially own health care providers – let all flowers blossom. The point is that the new and competing private insurers will sign contracts only with providers who are able to offer quality services in an efficient manner.

126. As it will be impossible to survive exclusively on the basis of state financing, providers will strive to enter into a contractual relationship with



private insurers too. The state health care fund will have no choice but to follow the tough judgements of private insurers. This way the hitherto pampered monopolist, the so far wasteful state health care fund will also be obliged to improve its own efficiency.

127. Competition among insurers for paying clients and competition among providers for the money of insurers and ultimately for customers will lead to improved service quality. Hard budget constraints will be restored to health care providers who will be free to hire and fire doctors and, nurses, and offer them individual performance-related pay. Bureaucratic pay scales and public employees status will be completely unnecessary. Excellent professionals will earn many times more than today with heads high, legally and without any corruption. All excess and low-quality staff will leave.

128. This new system will correspond much better to the requirements of solidarity too. Insurance fees for unemployed, children and students participating in public education will be paid by the central budget while retired people will keep paying for themselves. As retired people will have already acquired the right to choose a private insurer previously as active workers, it would be inappropriate to withdraw this right from them in a period of their life cycle when they need the great majority of health care services.

## **INSTEAD OF EPILOGUE**

129. International research institutes regularly rank countries in various respects. Two of these are particularly relevant here, namely, competitiveness and lack of corruption. It is remarkable although not at all that surprising that in both lists Finland has been first for many years now. The historic achievements of Finland are less known than those of Ireland, but we can emulate them if we adopt a fundamentally different approach and take action to speed up the economic and social development in Hungary.

130. Let us remember the words of the late president Kennedy: 'Do not ask what your country can do for you but ask what you can do for your country'. With this in mind as a guiding principle for future action there will be a future.