NEED A SCALPEL NOT AN AXE
TOWARDS A SUSTAINABLE WELFARE SYSTEM IN HUNGARY

EXECUTIVE SUMMARY

The past few years have seen various reform proposals developed by governmental, political, or professional bodies to improve the efficiency of the Hungarian welfare system. Although their reception has not been unequivocal, few commentators have questioned that major reforms are needed in order to ease social tensions and to start economic recovery.

The Budapest Institute shares this conviction and our recommendations even overlap with some of the previous proposals. The novelty of our recommendations lies in the depth and with of the approach: in that we estimate the expected impact and political cost of the proposed measures, and consider the coherence of and interactions between the measures. Further, we also point out structural weaknesses in the current institutional framework, which has been largely neglected by previous reform plans, even though the failure (or short-lived success) of several cost-cutting reforms may be traced back to these weaknesses.

We do not take sides in the current debate over the size of the state, as we believe that the relevant dimension is efficiency, not size. Welfare expenditures as a share of GDP in Hungary are roughly on par with British levels, and slightly below the Swedish – we believe that the main constraint of growth is not this, but the low level of employment. And the level of employment depends not only on the level of public spending, but also on its structure and on the taxes and social security contributions levied to finance it.

Our proposals for welfare reform are based on three assumptions. For one, we assume that the economic slow-down – which began well before the global crisis – is in part caused by the low equilibrium of the labour market, where social provisions reduce labour-supply, while high tax rates, the high minimum wage and an unstable business environment reduce labour-demand. For another, the uncertainty caused by the current crisis increases the relative price of capital and thus reduces the possibilities of capital-intensive growth and adjustment. Hence, a significant drop in labour costs could speed up the pace of adjustment. Lastly, we believe that a significant increase of the employment rate is key to achieving sustainable long term growth.

Our proposals improve efficiency in three ways: through stimulating labour-supply, improving the targeting of welfare provisions and strengthening the rules and constraints on public spending. We shall not discuss the demand-side of the labour market, but should stress here that the proposed measures can only be effective if they are supported by a strong commitment to long term stability and incentives to increase the demand for unskilled labour.

The proposals are grouped according to three main objectives: (1) strengthen labour supply incentives, (2) improve the targeting of social provisions and (3) develop the institutional framework.

Improve labour supply incentives

The employment rate of the population aged 15-64 is still below the average of the EU25, and also below its pre-transition level. Employment is especially low among the low educated, youth, older workers and mothers with small children, while it almost reaches the EU average among prime-age and educated workers.

Most of the unemployed population between 20 and 59 have less than upper secondary education: 590 thousand people have only primary education, 470 thousand have vocational education. Two thirds of the working age inactive population are on welfare, typically on pension, paid maternity leave or unemployment benefit. Most welfare recipients are not actively looking for a job. The average effective retirement age varies around 58-60 years, or 55-56 years with disability pensioners included.

The aim of our proposals is to reduce the inflow into unconditional benefits and at the same time provide effective rehabilitation and job search assistance to the unemployed – rather than to cut benefit amounts. The proposed measures are:

1. reduce inflow to early pensions and other transfer schemes for the inactive
2. extend and enforce job search criteria to most transfers to the working age
3. shift funds from mainstream active labour market programmes to client centred schemes
4. increase day care facilities for children and shorten paid maternity leave.

Improve targeting of social provisions

In 2007, total welfare spending amounted to 9.3 % of the GDP. Although the benefit system significantly reduces income inequality and poverty, the targeting of provisions is far from optimal: both overpayment and underpayment are relatively common. The system is also rather fragmented: beside the ten largest schemes, there are more than 350 types of benefits and allowances, which increases administration costs. Claiming procedures and benefit regulations in general tend to be complicated and incentives for providing efficient services are weak.

The essence of our proposals is to achieve a more transparent system with clearer objectives and better targeting. The proposed measures would reduce both underpayment and overpayment, and cut the administrative burden both for the government and for the claimants. In particular, we propose to:

5. reduce administration costs by cutting number of benefit types
6. improve targeting of child benefits
7. reduce public transport subsidies for certain groups
8. abolish gas price subsidy and introduce a better targeted maintenance allowance
9. abolish 13th month' pension with phasing out for the poorest
10. reduce loan subsidies for home-ownership.

Develop institutions to ensure sustainability

The political cycle has a strong impact on fiscal policy: spending shoots up in election years, which is followed by a decrease in the next one or two years. The recurring deficit can not be traced back to a few ill-advised measures, rather, it is typically a result of general imprudence in designing spending and revenues. Typically, the impact of cost cutting reforms implemented in some area is sooner or later eliminated by ad hoc initiatives following some short term political objective.

The proposed measures aim to raise the political and institutional cost of irresponsible public spending by strengthening watch-dog institutions. In particular, we propose to:

11. set up council of senior economists to support prime minister
12. establish a single, integrated, freely accessible public procurement database
13. raise legal and political constraints to ad-hoc interventions into the pension system
14. strengthen the Budget Council
15. introduce programme-based budgeting with outcome-oriented planning and implementation.

The next step

Large scale interventions should be based on thorough preparation and must fit into a coherent strategy. In absence of a clear plan, there is a risk that uncoordinated initiatives may counteract each other and stake holders will be much less willing to believe that they are not the only ones bearing the costs of the reform.

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