

Hungary's risky economic strategy

Mariusz Bocian, Tomasz Dąborowski

On 23 December the Hungarian National Assembly adopted the budget law for 2011. Under this law the budget will be closed with one of the EU's lowest deficits – 2.94% of GDP. The budget law was prepared on the basis of a series of unconventional solutions in the area of economic policy. Some of the measures they include are the introduction of a low flat rate of personal income tax and corporate income tax for small and medium-sized enterprises and special sectoral taxes that will be in force until the end of 2012. Furthermore, in March 2011 an operation of transferring funds from the private to the state-owned pension system will be conducted.

These measures are part of the state's economic strategy that was implemented in April 2010 by the new government of Viktor Orban. This strategy is based on the premise that the reduction in taxes for people and small and medium-sized enterprises will boost Hungary's stagnant economy and that special sectoral taxes and the return to the state-owned pension system will considerably improve the country's fiscal situation. But this strategy is risky, because it harms large, mostly foreign companies, which drive economic growth.

The measures proposed under the strategy make it more difficult to reach a long-term balance in public finance.

The new budget: a revolution in taxes, no reforms on the spending side

In line with Hungary's commitments to the international financial institutions (IMF, World Bank, EU) the budget deficit for 2011 has been established at 2.94% of GDP, which is a slight improvement compared to the deficit of 2010 at 3.8% of GDP. Hungary will accomplish a low deficit mostly through increased contributions to the budget, which makes it stand out among other countries from Central Europe which have preferred a reduction in spending.

The budget was based on the premise of a 3% increase in GDP and a 3.5% inflation rate. The contributions to the budget were estimated at EUR 47.6 billion. Quite an important item in the budget (approximately EUR 1.2 billion) are contributions made due to new special sectoral taxes that apply to energy and telecommunications companies, the financial sector and retail chains. The sectoral taxes are calculated according to the net revenue (in case of banks – assets), which guarantees that companies will pay these taxes also when not making profit. These measures have been heavily criticised by large foreign companies. In December a letter signed by the representatives of 15 companies (Aegon, Allianz, ING Group, RWE, EnBW, E.ON, Deutsche Telekom and OMV) was submitted to the EU. In this letter the companies pointed out that the government was using chosen sectors of the

economy and foreign companies to fill the budget gap and was thus undermining confidence in the European internal market. The companies also complained that crisis taxes, although introduced in October, are retroactive and will have to be paid for the whole of 2010.

The introduction of the sectoral taxes will to a large extent enable the funding of a reduction in personal and corporate income taxes for small and medium-sized enterprises which comes into force from 2011. The progressive rates of the personal income tax have been replaced with a 16% flat rate. The rate of the corporate income tax for the companies whose annual turnover below EUR 1.8 million was also lowered from 19% to 10%. The reductions in personal and corporate income tax are quite important – contributions to the budget will fall respectively by 28% and 41% in comparison to 2010.

The structure of spending (EUR 50.1 billion) is very similar to that of the budget for 2010, except that expenditure for healthcare and education fell slightly whereas more money was allocated for public administration. The lack of change in spending is widely believed to be the largest weakness of this budget as for years Hungary has been postponing the reform of extended social welfare. The decision to significantly limit funding for the Fiscal Council – an independent body that gives opinions about what impact laws to be adopted will have on the state's finance and which criticised the laws put forward by the government of Orban – was also frowned upon.

An actual dismantling of a public-private pension system

Changes in the three-pillar pension system, in force since 1998, also play an important role in Fidesz's economic plans and the shaping of the budget. An amendment to the law on the pension system adopted in December 2010 lifts compulsory payments to the private pension pillar and it transfers its funds to the new state-owned Pension Reform Fund (PRF). Members of pension funds will be able to decide to stay in the private pillar until 31 January 2011 but in this case they will be excluded from the state-owned pension system even though the employer will have to pay premiums to the PRF. These modifications will in practice lead to the nationalisation of the majority of funds collected in private pension funds, which will allow the state to make profit by managing approximately EUR 10 billion (10.3% GDP), until now gathered under the private pillar of the pension system. The funds collected in the PRF are not considered contributions to the budget but in line with the amendment to the pension law half of them can be spent on the state's current needs. This opens up the possibility of using PRF funds for purposes not specified in the budget law. For example it is speculated that the government may buy back 22% of the shares in the Hungarian energy company MOL from the Russian Surgutneftegaz, which Orban's government is aiming for.

Conclusions

The adopted budget and other measures confirm that the new government is focusing on stimulating the economy and delays the reform of public finance that would include cuts in spending and heavily affect society. The government has however ensured itself a comfortable fiscal situation for the next two years but the moment the sectoral taxes are no longer in effect the government will have to find additional funds for financing the reduction

in taxes. Similarly, the return to a state pension system will enable the improvement in public finances only in the initial period. In the long term, due to unfavourable demographic trends, it will however prove a burden to the budget. It will also negatively impact the prospects of the development of the Hungarian capital market.

Optimistic assumptions about boosting internal demand and domestic production can be negatively verified by a fall in investments or a deteriorating global economic situation. The introduction of high taxes on the sectors of the economy that generate high revenues is likely to lead to decreased investments. This, along with the government's decisions about private pension funds, solidifies the image of Hungary as a country that is pursuing an economic policy quite unforeseeable and unfavourable to foreign capital.