Südosteuropa 63 (2015), no. 2, pp. 249-271

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The Hungarian Economy. On the Wrong Trajectory

Abstract. Hungary's economy has lost the past decade. Since the country acceded to the European Union, it has not been able to converge towards the EU average in per capita GDP, whereas the majority of the countries in the Central and East European region have come much closer to it. The general government and the current account balance improved markedly, but in every other field (consumption, investment, competitiveness, attraction of capital, etc.) Hungary's performance has lagged behind the majority of the countries in the CEE region. This is due both to the former socialist-liberal and the present national-conservative governments. The irresponsible fiscal and unsuccessful reform policy of the former government contributed to the increase of the state debt. The latter government constrained democracy as well as the functioning of a market economy. Nationalisations, market reorganisations, and the deployment of a tax system as a means of punishment have undermined the rule of law and the security of property. As a result, a low growth potential and the widening of inequalities are economic characteristics of Hungary.

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Introduction

For the past decade and a half, analysts of the Hungarian economy, abroad and at home, have been examining the state of affairs with growing surprise. For a long time, they thought that unintended factors coincided, unfavourable trends were temporary in nature, policy decision-makers had bad luck, or some individual wrong decisions led to negative consequences. However, in 2014, at the tenth anniversary of Hungary's membership to the EU it is worth drawing a more comprehensive balance.

In Hungary both economic policy and the economy have lost a decade. An historic opportunity for real convergence was missed. If the economic performances of the eleven Central and East European countries (Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia) are compared, the conclusion can be drawn that in the past decade Hungary did not manage to converge to the EU average with respect to the major factors of economic development and well-being. Hungary fell from

the top to the bottom in the group of the CEE economies and is now closer to the Southeast European countries.[1]

Painful Facts

In Hungary, as in Slovenia and the Czech Republic, the per capita GDP in purchasing power standards (PPS) has grown only very slightly compared with the EU average since the accession to the EU. In contrast to this, Estonia, Lithuania, Latvia, Romania, Bulgaria, Slovakia, and Poland have managed to catch up to the EU average very rapidly, in some cases by 15 to 25 percentage points. This catching-up process of those seven countries was dynamic, both prior to and since the global financial and economic crises. The development of the three countries with the highest per capita GDP at the time of accession, the mentioned Slovenia, Czech Republic and Hungary, has stalled. Taken as a whole, the Central East European region caught up to the EU average (2003: 54 percent; 2013: 68 percent), and differences in per capita GDP within the region decreased in the past decade, too. The convergence continued after the financial and economic crises as well, albeit at a slower pace (Chart 1).

Hungary is lagging behind in almost all indicators, except for the general government balance and external equilibria. As a result of basic economic policy failures, in 2006 Hungary had to face both huge general government and current account deficits, long before the global economic and financial crises. From 2002 to 2006 the government deficit relative to GDP ranged between 6.4 and 9.3 percent, and the current account deficit permanently exceeded 5 percent of GDP. Consequently, both Hungary's public and external debt grew rapidly. In terms of fiscal equilibrium Hungary accomplished a substantial and successful turn from 2006, decreasing the deficit to 3.8 percent in 2008. Due to the impact of the global financial crisis, Hungary was forced to accomplish a second radical turnaround in these fields. The global financial crisis suddenly inhibited financing; after the bankruptcy of the Lehman Brothers investment bank, money markets refused to finance the renewal of the Hungarian government debt, even despite sharply rising yields. Therefore, Hungary had to apply for help to the International Monetary Fund (IMF) immediately, and within three weeks a stand-by credit agreement was negotiated. According to this agreement, Hungary received access to funding provided by the IMF, the World Bank and the EU, valued at around 20 billion Euro. The major part of this fund has helped to cover the current account deficit and to raise foreign currency reserves.

[1] On 17 October 2014, Eurostat published the first estimates of European aggregate economic data based on the new European System of National and Regional Accounts (ESA) 2010 methodology. This paper was prepared using the previous ESA95 statistics, which may account for small differences in outcome.

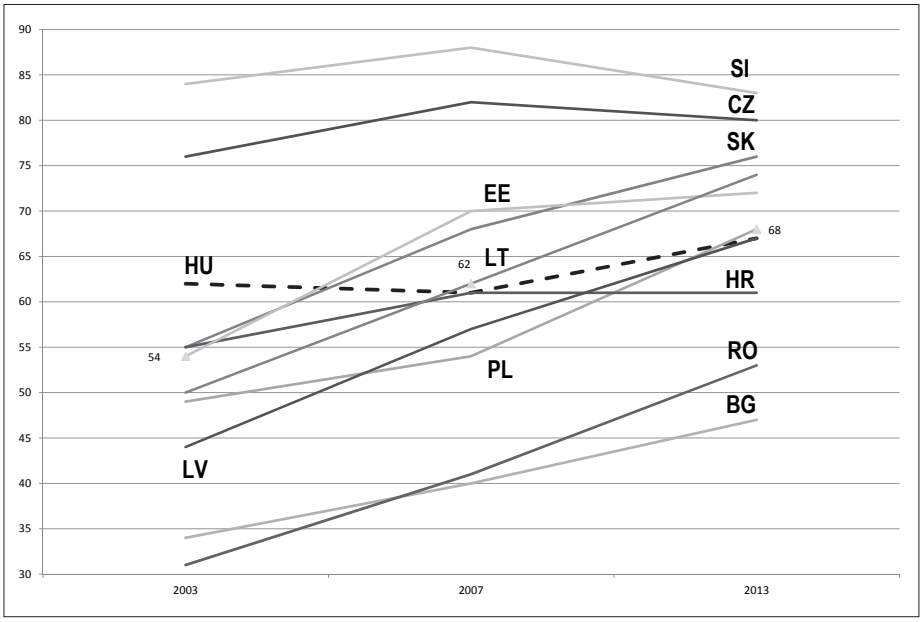

Chart 1: GDP per capita at purchasing power parity in percent of the EU average. Regional average (unweighted). Source: Eurostat.

Improvement occurred rather quickly, as the current account was balanced in 2009, and since that time a surplus has been recorded, equalling up to three percent of GDP in 2013. The surplus of the current and capital account (the latter including net inflow of EU transfers meant for investments) reached 6.7 percent of Hungary's GDP in 2013, an excellent performance even by EU standards. Despite the crises, the general government deficit did not increase. During 2008-2010, the deficit on average was at 4.1 percent of GDP, and from 2012 it sunk below 3 percent, even without deficit-reducing one-off temporary items.[2]

In the past decade Hungary has been through three austerity policy periods: the first under the government of Ferenc Gyurcsány in 2006-2007, the second during the financial crisis in 2008-2009, under the governments of Gyurcsány and later of Gordon Bajnai, and the third in 2011-2012, under the government led by Viktor Orbán. The latter was unavoidable, since on the one hand markets and international rating agencies downgraded Hungarian government securities to junk status, while on the other hand the EU institutions threatened the Hungarian government with freezing a part of the cohesion funds in the framework of the excessive deficit procedure. In order to prevent funds from

[2] The numbers are based on calculations drawn from data of the Hungarian National Bank (MNB), the Hungarian Central Statistical Office (KSH), and Eurostat.

being frozen, the Hungarian economic policy-makers did not have any other option but to resort to tough austerity measures. These measures included the elimination of thirteenth month pensions and salaries in the public sector, interest rate hikes and a sharp devaluation of the Forint (HUF), which stopped investments and pushed up inflation, while the dismissal of public employees decreased the public expenditures The austerity policy reduced real wages and income, endangering social peace. The international economic equilibrium improved sharply, mostly due to the good export performance of the multinational companies located in Hungary.

Nevertheless, the country paid a price. Due to the global crises, investments stalled everywhere, but in Hungary they fell comparatively more. According to Eurostat figures, even in 2013 the investment volume was much below the level of 2003. In the same time period, investments grew by 12 percent in the Czech Republic, by 23 percent in Slovakia, and by 70 percent in Poland. In the past ten years the inflow of foreign direct investments (FDI) has doubled in Hungary, but has tripled in the Czech Republic and Slovakia, quadrupled in Poland and has grown even faster in the Baltic states and in Romania. Even so, the Hungarian FDI per capita stock remained among the first three in the region, mainly due to the favourable inflow prior to the EU accession.

Hungary's consumption performance was also very weak. In 2013, Hungarian households consumed about five percent less in real terms than ten years earlier. In the new EU member states, consumption increased in every country during that period: by 11 percent in Slovenia, by 19 percent in the Czech Republic and by 20 to 40 percent in the Baltic states, Bulgaria, Romania, and Slovakia. Due to the fact that, with the introduction of the flat personal income tax rate (16 percent) in Hungary, additional income only increased for about 20 percent of the tax payers, namely those with the highest incomes and to families with at least three children. Social transfers declined significantly and social differentiation intensified sharply.[3] As the TARKI Research Institute survey showed, 47 percent of Hungarians live in a household in which at least one form of poverty or social exclusion exists.[4] By the Social Inclusion Monitor Europe, Hungary was 25th among 28 EU member states in the social justice index,: "Discrimination against specific minorities […] is particularly true with regards to the Roma, who are subject to significant restrictions and discriminations in Hungary, Romania,

[3] Csaba G. Tóth / Péter Virovácz, Nyertesek és vesztesek, *Pénzügyi Szemle* 58 (2013), no. 4., 385-400, available at <http://www.asz.hu/penzugyi-szemle-cikkek/2013/nyertesek-es-vesztesek-a-magyar-egykulcsos-adoreform-vizsgalata-mikroszimulacios-modszerrel/toth-virvacz-2013-4.pdf>. All internet sources were accessed on 15 April 2015.

[4] Péter Szivós / István György Tóth (eds.), Egyenlőtlenség és polarizálódás a magyar társadalomban, TÁRKI Monitor Jelentések 2012. Budapest 2013, available at <http://www.tarki.hu/hu/research/hm/monitor2012_teljes.pdf>.

Bulgaria and Slovakia, among other nations."[5] The share of children living in severe material deprivation increased by 11.9 percentage points between 2008 and 2012 in Hungary, exceeding 30 percent overall. The increase was the worst among 30 European countries in that period, and only Romania and Bulgaria performed worse.[6]

Hungary's position deteriorated not only in these relatively well quantifiable indicators, but also in several other softer, more uncertain, although extremely important development indicators. For example, in competitiveness rankings of the World Economic Forum (WEF), Hungary dropped from the 30th place in the early 2000s to 60th place in 2014. According to the WEF survey, the most problematic factors for doing business in Hungary are political instability, access to financing, corruption, tax regulations and rates as well as an inefficient government bureaucracy.[7] Considering the 272 regions of the EU, there are currently four Hungarian regions among the 20 least developed ones, together with six Romanian, five Bulgarian and five Polish regions.[8] The Doing Business Report of the World Bank for 2015 shows an unchanged ranking (54th place) for Hungary compared to 2014; meanwhile Poland improved by 13 positions (32nd place), Slovakia by 12 (37th place), Bulgaria by 20 (38th place), the Czech Republic by 31 (44th place), Romania by 25 (48th place), with only Slovenia worsening in the region by 18 positions, being on the 51st place, and thus still ahead of Hungary.[9]

Polemics

The weak performance demonstrated above is so unequivocal that no serious expert disputes it. There are basic differences only in defining who the culprit is for this development. The starting point of the first set of opinions, represented, among others, by the recent government, is that in Hungary privatisation was too rapid, prices were too cheap and in some cases totally wrong. In other

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[5] Daniel Schraad-Tischler / Christian Kroll, Social Justice in the EU. A Cross-National Comparison, Social Inclusion Monitor Europe (SIM) Index Report. Gütersloh 2014, 11, available at <http://www.sgi-network.org/docs/2014/basics/Social_Justice_in_the_EU_2014.pdf>.

[6] Luisa Natali et al., Trends in Child Well-Being in EU Countries during the Great Recession, UNICEF Office of Research Working Paper 2014-10, October 2014.

[7] The Global Competitiveness Report, 2015.

[8] Regional GDP in European Union, Eurostat, 2014, available at <http://ec.europa.eu/eurostat/statistics-explained/index.php/GDP_at_regional_level>.

[9] World Bank, Doing Business 2015, Going Beyond Efficiency, November 2014, available at <http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB15-Full-Report.pdf>; Idem, Doing Business 2014, Understanding Regulations for Small and Medium-Size Enterprises, 2013, available at <http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-reports/English/DB14-Full-Report.pdf>.

words, markets should not have been liberalised to the extent they had actually been. Few critics blame free competition as such, but rather the hasty exposure of unprepared domestic players to wealthy foreign competitors. Much more government regulation, even government ownership and direct government intervention would have been necessary in the economy, critics claim. This kind of reasoning is familiar to other countries as well. It attacks mostly those liberal, single market and fair competition oriented views which formed the foundation of the transition to the market economy 25 years ago in Central and Eastern Europe.

There can be no doubt that privatisation was burdened with much controversy. Naturally, it is very difficult to define the genuine value of a firm or business in general, all the more, when markets are about to collapse or are in a state of transition. It is quite sure that many state-owned assets were privatised at prices that were below their real value. Unsurprisingly, privatisation was encompassed with corruption. There was no real competition and a few pre-selected winners became rich. Foreign or multinational companies with extensive capital endowment were able to win almost every price competition. If they did not succeed in doing so, they were still able to bust the winners by deploying dumping prices.

Yet, even if all these facts are correct, the weak performance of the past decade cannot be fully explained by them. Hungary was indeed the typical instance for quick and competitive privatisation based on market principles and involved foreigners. It must be considered that countries, where privatisation was implemented in a rather shallow and moderate way (e.g. voucher privatisation) with slow market liberalisation, such as the Czech Republic, did not catch up to the EU average either. Slovenia, where the banking sector and the major part of large companies in the past decade remained in state ownership fell back by some percentage points compared to the EU average. Two state-owned banks have been close to bankruptcy, and the Slovenian government will have to mobilise huge budgetary sources to save them. The position of several countries where privatisation was slower, is no more favourable than that of Hungary, on the contrary in fact.

Why, thus, could the three economically most developed East European countries at the time of EU accession, Slovenia, Czech Republic and Hungary, not converge further towards the EU average? At first, Slovenia and the Czech Republic safeguarded their leading position, outpacing Hungary. Slovenia paid a high price for the non-privatisation of banks and large companies, and the Czech Republic missed the advantages of an entry into the Eurozone immediately after its EU accession.

One common feature of the three countries was their "overripe" position at the time of the EU accession. All three had eliminated administrative barriers to

trade and capital movements, had attracted foreign direct investments, and had started to learn managerial skills much earlier than the other countries in the region. These advantages had been realised mostly before EU accession. Thus it is the poor economic performance of the past decade which created political and social tensions in all the three countries, but especially in Hungary.[10]

According to another argumentation, frequently cited by liberals, Hungary's difficult position can be explained by the fact that the change of social regime was implemented too early, with too much generosity and without genuine economic backing. There is undoubtedly a grain of truth in this reasoning. Hungarian society and politicians made basic and grave mistakes, which can be explained by impatience.

In the first decade following the transition to parliamentary democracy and market economy, the economic shock of the transition with the subsequent fall of GDP by close to 20 percent was neutralised. At the beginning of the 2000s, similar to other CEE countries, Hungary's GDP reached the level prior to the transition but the levels of incomes and consumption were still far below it. The society was keen on EU accession and hoped for a speedy convergence. Therefore, in the tense election campaign of 2002 the left-wing socialist party, with its prime minister candidate Péter Medgyessy, propagated a programme of "social regime change". It involved a significant rise of incomes for pensioners and public sector employees, but therefore worsened the public financing stance. This was a serious mistake, however not the only one. One quarter of the increment in the general government deficit was a consequence of this policy. In addition, the home construction boom which had been promoted initially by the previous government, led by Viktor Orbán with high budgetary subsidies, as well as the motorway construction projects planned in a Public Private Partnership (PPP) framework but then instead accomplished from budgetary sources played a role as well. On top of that, the EU institutions did not provide the Hungarian government with genuine budgetary room for manoeuvring for the development of the private pension fund system which otherwise would have been desirable in the long-run.

Social impatience was, above all, a symptom of a different and dangerous phenomenon; namely that of a sharpening political struggle. Since the end of the 1990s, the intertwining of political and economic power had been strengthening in Hungary. The economic part, the entrepreneurs realised that it would be easier to overcome competitors with the help of political support rather than in genuine market competition. Some politicians came to the conclusion, or were forced to do so, as it is rather difficult to define the difference, that they can

[10] New Progressive Economic Perspectives in the Central and Eastern European Member States of the EU, GKI Briefing Paper Series, Budapest, September 2013, available at <http://www.gki.hu/sites/default/files/users/Petz%20Raymund/GKI-1.pdf>.

access a great amount of wealth through their political positions. Greed hardly knows limits and wealth is colour blind, be it red (socialist), orange (Fidesz) or blue (liberal). Thus all political forces started a vigorous accumulation. This was further compelled by a political parties law which included budget financing well below costs and made it possible to poison political life through obvious tricks and lies.[11]

Now political power and political positions were among the most important possibilities to grow rich. Previously, an average manager's income in the business sector started to approach its counterparts in Western Europe. Salaries in the public sector, for example of a mayor in a small town or village, or in a district of Budapest, were much lower in comparison. But with the decentralisation of decision-making, the temptation to succumb to corruption was strengthened. From the early 2000s, an increasing number of investigations were launched against politicians, at that time mostly of socialist or liberal alignment. These substantially contributed to the dramatic failure of the socialist-liberal government in 2010. Afterwards, however, the conservative Fidesz government "nationalised" the corruption schemes:

> "In this special type of state capture the extensive and expansive state has been in symbiosis with some powerful business groups and oligarchs […]. Corruption, similar to the overall structures of the public sector, has an extremely centralized character in today's Hungary. It comprises the elimination of independent state institutions, the almost total abolishment of checks and balances, some violation of private ownership rights and also the rise of rent-seeking behavior and actions."[12]

The Shadow of Öszöd

At the end of the summer of 2004, the ruling two-party coalition (socialist-liberal) overthrew Prime Minister Péter Medgyessy. It was a great surprise that a relatively young and inexperienced but talented politician, Ferenc Gyurcsány, became the chairman of the Socialist Party and thereby prime minister. He was aware of the fact that the Hungarian economy needed structural reforms. He also thought that if he started the reforms in 2005, he would not be elected prime minister in 2006. Therefore, he decided to delay the introduction of the necessary and tough measures to after the spring 2006 elections.

Which steps should have then been taken? At that time the role of foreign direct investments was rather significant in Hungary, more important than in many other CEE countries. Market competition was more or less at work and

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[11] László Lengyel / György Surányi, A magyar hanyatlás, *Népszabadság*, 22 March 2014, available at <http://nol.hu/gazdasag/a-magyar-hanyatlas-1451545>.

[12] Transparency International, Lifting the Lid on Lobbying, National Report of Hungary, 2014, 5, available at <http://transparency.hu/uploads/docs/lobbi2014_web_eng.pdf>.

business entities pursued their activities. In contrast to this, the institutional system of government – its employees' professional skills and work ethic – was much below the required standard. According to the unanimous opinion of Hungarian experts, serious changes and reforms were needed in order to achieve progress.

Prime Minister Gyurcsány knew this, but did not dare to act. In the spring of 2006, with a dynamic personal campaign and the introduction of some popular measures, such as the reduction of the general VAT rate, while concealing the lift of the preferential rate, Gyurcsány and the socialists won the parliamentary elections with a close majority against Viktor Orbán's Fidesz party. Gyurcsány set out to implement structural reforms, but because of his unwariness and political inexperience he failed. His speech, delivered in a closed circle of the parliamentary fraction of the Socialist Party in Balatonöszöd, was leaked in the summer of 2006. Some of his statements, in which he basically admitted to have lied to the populace before the elections, turned public opinion against him. Within a few months' time the socialist-liberal coalition slid back to the second place in public opinion polls behind Fidesz, which knew how to make use of Gyurcsány's grave political mistakes. The opposition was also well aware of the necessity of reform and of the fact that certain exaggerations disseminated about the Gyurcsány speech in Balatonőszöd were unjustified, for example the wording: "… we lied morning, noon and evening …". In spite of being aware of this, Fidesz exploited the failure of the prime minister at full length and inhibited any kind of reforms or policy measures to the same effect. The opposition left the parliament, and street demonstrations were continuously organised. Fidesz' followers protested against any change in public services prompted by what they called "austerity" measures, they organised strikes and a referendum, but at the same time claimed fiscal responsibility. The socialists' election victory turned to a political defeat.

Since the autumn of 2006, Hungarian economic policy has been unambiguous, but hardly anything was efficiently implemented. The basic concept was attainable as it aimed at reducing the general government deficit, corresponding to nine percent of GDP, by introducing various temporary personal income and company taxes. In fact the government succeeded in limiting the deficit to five percent in 2007 and to 3.8 percent in 2008. At the same time, a more efficient and modern administrative system was intended to be implemented by a series of reforms concerning the local self-governing bodies, the educational and healthcare system, as well as other realms, in order to achieve substantial public savings in the medium term. As soon as these savings were realised, the temporary taxes were to be phased out.

However, when the Gyurcsány government's political credibility started to evaporate, the room for reform measures disappeared. Consequently, the

intended budgetary savings did not occur or were realised only to a limited extent. Consequently, the temporary taxes could thus not be abolished. In the eyes of public opinion, all this came across as improvised and tepid; and in fact it was just that. The long-term intentions were not made sufficiently clear, and the Hungarian society perceived the huge transformation fever as a reform dictatorship. The economic policy failed, as did prime minister Gyurcsány.[13]

The Global Financial Crisis

The Gyurcsány government suffered complete political defeat in the spring of 2008 at the so-called social referendum. The overwhelming majority of Hungarians rejected reforms such as the consultation fee of 300 Forint (1,20 Euro) charged by medical institutions, minor co-financing schemes planned to be introduced in healthcare, as well as tuition fees that would have equalled one fifth of those presently charged. The opposition party Fidesz substantially influenced public opinion through a populist campaign which rejected economic rationality. The mentioned referendum that the party's followers organised was more of a political protest than a rational articulation on the questions at hand.

The outbreak of the financial and economic crises in the autumn of 2008 accelerated the fall of the Gyurcsány government. The Hungarian economy featured the highest external and public debt in the region and was thus most vulnerable to external shocks. The government rightly applied for and quickly received access to IMF funds and thereby was able to maintain Hungary's financial stability in a rather difficult period of time. In spite of this, due to the political defeats suffered in the previous years, Gyurcsány' party did not manage to stay in office. The collapse in investor's confidence was the government's final stroke. Following a long casting procedure in the spring of 2009, which totally destroyed the reputation of the political left, a coalition of the Hungarian Socialist Party and the Alliance of Free Democrats elected Gordon Bajnai as new prime minister.

The Bajnai government did what could be done in such a situation. It initiated consolidation efforts and reforms which actually showed an initial positive impact on the Hungarian economy. The position of the government was strengthened again. It abolished some unsustainable social rights, such as the thirteenth month pension and the thirteenth month public sector salary. On the other hand, it reduced the progressivity of the tax system, so that in spite of the crises, enterprises could maintain a part of the achieved level of employment. Still, in 2009 Hungary's GDP plunged by nearly seven percent, investments by eleven percent, and consumption by 5.6 percent. In the same year, the exchange

[13] Cf. Attila Ágh / András Vértes / Zoltán Fleck, Tíz év az Európai Unióban, Felzárkózás vagy lecsúszás? Budapest 2014.

rate of the Forint to the Euro weakened by 10 percent. This sharply raised the debt of companies, households and the government in foreign exchange. In spite of the fact that economic figures disclosed at the beginning of 2010, prior to the parliamentary elections, reflected some signs of stabilisation by international standards and compared to the former months (the exchange rate of the Forint to the Euro strengthened by five to six percent in April 2010), voters turned away from the governing parties and voted for Fidesz. The party won two thirds of the parliamentary seats with 53 percent of the votes on the party lists, thus ending eight years of socialist-liberal governance.

New World, New Priorities

Fidesz achieved a huge victory in the parliamentary elections of spring 2010. In the words of Viktor Orbán, "the revolution has won in the polling booth". Many experts assumed that the election victory, resulting in a two thirds majority in parliament, would lead to a policy towards the restoration of social peace and a new developmental trajectory. The hope was for dialogue and the integration of professional knowledge in governance, in order to recover from the crisis as quickly as possible. Certain signs indeed indicated this direction, as the new prime minister announced "a system of national cooperation". However, the past four and a half years have since then unambiguously demonstrated that the objective of this motto was to divert public attention from more essential issues. The "system of national cooperation" was not given any genuine cooperative content. To the contrary, an extremely centralised governance emerged, based on the primary role of the Fidesz party leader and prime minister, Viktor Orbán. All political and economic decisions have been taken by a very small number of people. In fact, power is concentrated in the hands of three or four individuals who do not rely on the professional skills of the administration and exclude the majority of the political leadership, as well as their own political base, from the decision-making process. The rather small apparatus around the prime minister spends huge sums of money on opinion polls to test its ideas and the probable reception of public relation activities.

As a rule, two types of decisions have been taken. The first answers to the question "What should be done?", while the second concerns "How should this be sold?". In most cases there is no apparent relationship between the two decision types:

> "The Hungarian government, in office as of 2010, has turned policy-making into a terrain of unilateral decisions, where key political preferences are exclusively set and discretionarily implemented by the political elite. Independent policy initia-

> tives of civil society actors, policy experts, professionals or business actors are often not even debated."[14]

For example, in 2010 the government nationalized the private pension funds without any consultation and under the slogan "we will defend your pension"; in 2011, then, it used from these funds a lot of money for different fiscal expenditures.

In most cases, the ministers, and their respective ministries, are informed about decisions ex post, although they always receive instructions in time on what to tell the media.[15] Communication has become the most important field of governance. The governing political force has taken over the rule on public media by financial and administrative means, centralised it strongly and intimidated journalists and other experts. With the strict management of state advertising, the government has forced the majority of the media that has remained in private ownership, to serve its objectives.[16] The government has constructed a very efficient system in terms of managing its power that stifles critics and independent opinions. It has not refrained from the deployment of direct and indirect means, threatening the financial foundations of the lives of those targeted. This concerns government and non-government employees working in important positions, and in certain cases, companies as well. Independent institutions hardly exist any longer in Hungary.[17]

In such a system based on sheer power play, all real political issues are glossed over. Economic, cultural and educational policies as well as international activities are not effectively questioned or disputed. Only in some narrow realms critical thoughts, different opinions, and value judgements can be expressed, however these forums have a hard time muddling through, as their financial position is miserable and their scope and impact is largely limited to Budapest and the larger intellectual centres in the country. The opposition is very weak in effectively using the internet and digital media; at least civil society actors responsively attempt at keeping their initiatives up to date. For example, until 2014 the number of those who participated in the demonstrations was quite low.

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[14] Transparency International, Lifting the Lid on Lobbying, 5f.

[15] For example, when the proposal of a new tax on the use of the internet was announced in October 2014, the ministerial first estimations on the burden on telecommunication companies were ten times lower than the Prime Minister's actual decision, and nobody could explain the difference. As it turned out, Orbán had been on a private trip and nobody had the courage to speak out in his absence.

[16] The story of independent *Klubrádió* is the best-known exception: the radio station has survived and lives mostly from donations.

[17] Tamás Ungár, "Orbán nem az a vezető, akivel lehet értelmesen beszélni", interview with Tamás Mellár, former research director of the state-financed Századvég Economic Research Institute, *Népszabadság*, 31 October 2014, 2, available at <http://nol.hu/belfold/a-szazadveg-csak-egy-penzmosoda-1495681>.

Prior to the parliamentary elections of 2010, Fidesz did not disclose this party's economic policy intentions. It put forth a rather general programme that avoided certain elements of economic policy issues, such as the flat personal income tax and the austerity measures hitting households. At the same time, the word "national" replaced "international" or "European". In the spring of 2011, with the European debt crisis sharpening, the *Kálmán Széll Plan* was compiled, which did entail a genuine reform plan together with its expected impact on the general government. Half a year later the plan was no longer mentioned. The programme, which had included positive structural reform-type elements, sank into oblivion. Prior to the parliamentary elections in 2014 the ruling party again did not communicate any political programme. The slogans were, among others: "We prevent families to suffer from a price-increase for utilities", "We continue" and "We consolidate the banks".

The present Hungarian government was inaugurated without a draft programme being submitted to the parliament beforehand, which consequently was not in a position of discussing a written political programme. The Prime Minister delivered speeches, released ideas and fought a veritable "war of independence" against the EU, in terms of discourse more than in actual policy-making. A government programme approved by the parliament does not exist to this day.

To avoid misunderstanding, the problem is not the lack of a government programme alone. Although all previous Hungarian governments did issue such programmes, some of them were inconsistent, primitive, or unrealistic. More importantly, in the light of the actual policy measures taken, in many cases the original intentions are impossible to recognise. Huge deviations have existed between the letter and the deed. Finally, any member state of the European Union subscribes to the minimum requirement that its government submits a political programme to the general public well before the elections, and, after the elections are won, translates this into a publicly communicated action plan.

Economic Policy in the Dead End

After taking over power, Prime Minister Orbán and his Minister of National Economy, György Matolcsy, revealed a general government deficit corresponding to seven percent of GDP and attempted to have this accepted by the leaders of the European Union. Commission President José Manuel Barroso, in a meeting with the two Hungarian politicians, made it clear that the EU institutions would insist on the maintenance of the four percent general government deficit relative to GDP that had been promised by the preceding government of Gordon

Bajnai. Furthermore, Barroso considered it indispensable for Hungary to keep the deficit under three percent in subsequent years.[18]

The Hungarian government thus elaborated a convergence programme. This was based on the idea that the Hungarian economy would grow out of the general government debt through a sudden acceleration of GDP growth. At the same time, the government announced the introduction of a flat personal income tax in several steps as well as a significant rise in tax allowances for having children. Simultaneously it abolished the tax alleviations for low income earners. These measures led to a loss of GDP to about 1.5 percent. The ten percent of society with the highest incomes accounted for two thirds of the tax allowance, the rest accrued to the second ten percent and to those having three or more children. However, low-income families and individuals lost in this re-shuffling. High income families mostly saved their extra revenue. while low income families, instead, were constrained to cut their spending. As a consequence, the domestic demand declined.

In order to fill the emerging hole in the budget, the government first introduced a bank tax, which was initially meant to be temporary in nature. After realising that this would not be enough, the government extended the tax, then turned it into a permanent fixture of its economic policy, and finally extended it to another ten industries, such as telecommunications, retail trade, the energy sector, utilities, and pharmacies. The whole bundle went under the title of "crisis taxes". In Hungary, the general corporate income tax rate is low, being at ten percent for small firms and 19 percent for larger companies. Tax revenues derived from the mentioned "crisis taxes" totalled around 900 billion Forint, three percent of the GDP. They amount to 250 percent of the sum accruing from the normal corporate income tax. Due to the looming three percent deficit target relative to GDP, the general practice every year has been to raise revenues and to reduce expenditures. The government thus regularly preferred raising taxes, regardless of its negative impact on GDP growth.[19]

Since the Fidesz government had a two thirds majority in the parliament, the introduction of any new tax only had to reckon with constitutional limits. In autumn 2010, the Constitutional Court annihilated a law that was to impose a 98 percent tax rate on certain personal incomes. This tax was levied in order to reduce the payment of redundancy money and take away the income of those dismissed from public service. Yet, the parliament defied the decision of the Constitutional Court. It amended the constitution so that until Hungary's government debt rate is reduced to below 50 percent of GDP (at that time it amounted to 80 percent and currently is still close to this level), the Constitutional Court may not examine laws and decisions concerning taxes and duties, or is

[18] Zoltán Farkas, Hét szűk esztendő. A válságtól az önkénygazdaságig. Budapest 2014.
[19] Péter Ákos Bod, Nem szokványos gazdaságpolitikák – évtizedek óta. Budapest 2014.

limited in doing so to special circumstances. The Constitutional Court was thus excluded from the evaluation of correspondence between the tax and duty system on the one hand, and the constitution on the other. In fact, the government has used the method of amending the constitution and the new Basic Law (the de facto replacement of the constitution) close to a dozen times in order to limit the rights of the Constitutional Court. If the Constitutional Court would object to certain provisions, the parliament would include the very same principles and provisions in the amendments that were judged unconstitutional by the Constitutional Court.[20]

This process led to legal uncertainty, the questioning of private property, and economic unpredictability. One of the worst examples in the long-run has been the nationalisation of the private pension system. In autumn 2010, the government declared the suspension of the payments into the private pension funds for 13 months and the redirection of these sums to the government budget. As no effective protests followed from the pension fund members, the political parties, the Constitutional Court, or, for that matter, from the Court of Justice of the European Union, the government was encouraged to declare that who did not adhere to the statal public pension system would be deprived of the pension solidarity in the social security system. Later the government withdrew this provision, but by that time 95 percent of private pension fund members had already returned to the public system as they feared to lose their pensions ensured by the state social security. In this way, the state budget was enhanced by assets valued at nearly 3,000 billion Forint, corresponding to 10 percent of GDP, through nationalisation without any compensation. This amount was incorporated in the budget in 2011 to cover the additional deficit deriving from the introduction of the flat personal income tax rate and other deficit-raising measures. Since, according to the rules, this budget increase had to be recorded as one-off revenue, Hungary's general government budget could declare a substantial surplus. According to the new ESA2010 rules, however, the budget deficit still exceeded the three percent limit, being at 5.6 percent of GDP.[21]

It is nothing short of a scandal that all this could be accomplished in a member state of the EU. Of course, each member state has the right to shape its own pension system. Nevertheless, the aggressive nationalisation of the voluntary pension savings of 3 million private persons is certainly not in line with the basic principles of the European Union. This process will have a strong negative long-term impact on self-care and the potential accumulation of pensions, and

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[20] Cf. Imre Vörös' contribution to this special issue.

[21] European Commission, Directorate-General for Economic and Financial Affairs, Identifying Fiscal Sustainability Challenges in the Areas of Pension, Health Care and Long-term Care Policies, European Economy: Occasional Papers, October 2014, available at <http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/pdf/ocp201_en.pdf>.

will impose huge burdens on future governments. In contrast to the original concept, the state now has to fund 100 percent of the pensions rather than 75 percent. Not least, the set of measures destroyed the rule of law and damaged people's mentality concerning their future care. By recent rumors, the EU institutions did not take the actions of the Hungarian government seriously when they happened.

Motivated by its initial "successes" and based on the "cheap" money of the pension funds, the Hungarian government accomplished nationalisation in several other fields and reorganised markets artificially according to its political preferences:

> "In the field of economic policy it has implied a normative categorisation of businesses present in the Hungarian economy: a distinction between good, 'productive', and bad, 'speculative' companies along the dimensions of size, ownership and type of activity. Besides sectoral surtaxes it shifted policy contacts between public officials and private companies towards upper political levels […]. Our case studies of lobbying in the financial, retail trade and tobacco sectors provided various kinds of evidence on shadow lobbying practices in a business environment predominated by political considerations."[22]

The state repurchased a major part of Hungary's utility companies, and it is a fairly safe prediction that those remaining in private hands will follow suit. In the case of schools and hospitals, nationalisation basically implied that they were taken away from the local authorities to be managed by huge centralised institutions which have proven to work at very low efficiency. The government has also started to reorganise several market-based industries. Hungarian-owned banks have been preferred to foreign ones; savings cooperatives have been nationalised in a legally rather disputable manner. Cafeteria service providers have been put into huge difficulties by concentrating them into a single, non-competitive market entity. The government liquidated casinos and slot machines, but later handed over the concessions to government-friendly companies supported by huge state subsidies. It closed the old tobacco shops and issued only a few new concessions, to which special rules apply. Investment projects in retail shops larger than 300 square metres are subject to a selective licensing system (the so-called "plaza stop"), which permits the implementation of projects preferred by the authorities. In the tenders on state-owned agricultural land renting, a well-defined group of economic participants have been provided with the benefits, whereas local stockbreeders lost their land essential to their activity. A new law foresees that pharmacies have to be owned exclusively by pharmacists, enforcing ownership changes. The government also intervened in

[22] Transparency International, Lifting the Lid on Lobbying, 6.

the trade of medicines, in the assessment of cultural and art values, and in the distribution of copyright incomes, to name only a further few.[23]

The Hungarian economic policy is not only overtaxing the banking sector, which is paying more extra taxes than the total normal corporate tax revenue in Hungary. Moreover in 2014 the government issued a law that, practically declared all foreign currency mortgage contracts of banks with individual households that had been stipulated over the preceding six to twelve years, as invalid. This policy created a new burden of approximately 3 billion Euros for the banking sector, causing it to lose one third of its total equity.[24] As Transparency International puts it,

> "the Hungarian business environment is perceived to be more uncertain than in other countries of Central Europe, and international comparative surveys found that most of the critical factors of Hungarian competitiveness derived from the low level of credibility and stability of regulations, as well as the lack of transparency in government policymaking. At present, business environment uncertainties in Hungary are not mainly economic in nature; they are rather related to some specific features of democratic policy-making and shaped first and foremost by the governing political elite."[25]

Under these conditions, the de-leveraging in the banking sector has been continuing.[26] With the state insisting on placing the entire burden of the foreign currency mortgage problem of the Hungarian households on the banks, and losses approaching 2 billion Euros, the lending conditions are not favourable. The state regulations in Hungary's banking sector were seriously flawed 10 to 15 years ago, but the current state does not take on responsibility for the policies of its predecessors. The funding for a new growth programme, with a cheap interest rate of 2.5 percent, resulted in a single leap of corporate sector borrowing in the third quarter of 2013, but afterwards the preferential lending scheme has dropped to an even lower level than before.

Negotiations with the International Monetary Fund were launched several times but in the end the Hungarian government did not want to cooperate. Rather, it wanted to make itself independent from the IMF in the same way as it did from the EU. In May 2014, the IMF's policy recommendations for Hungary included the adoption of a growth-friendly fiscal adjustment strategy to reduce the public debt sustainably; a stop to the easing of the monetary policy; an improvement of the banks' operating environment; the implementation of a limited, targeted and time-bound Funding for Growth Scheme and the ad-

[23] EBRD Transition Report 2014.

[24] Péter Ákos Bod, Megelőzte korát?, *Világgazdaság*, 5 November 2014, 12.

[25] Transparency International, Lifting the Lid on Lobbying, 5.

[26] Mihály Kovács, Private Sector Deleveraging in Hungary. Economic Costs Amplified by Government Policies in the Banking Sector, ECFIN Country Focus European Commission 10 (2013), no. 5.

vancement of structural reforms aimed at enhancing the business climate; a limit to government interference to increase policy predictability; and the fostering of private sector investment and employment creation.[27]

As far as the EU's legal framework is concerned, the Orbán government has been on a confrontational course on many occasions. A great number of infringement procedures have been launched against the Hungarian government. In most cases, it did make concessions and implemented smaller or greater modifications that were deemed acceptable to the EU institutions. These conflicts led to a self-declared "war of independence" against the EU. The Hungarian government has declared that it is being treated by Brussels nearly in the same way as it was by Moscow in earlier times. Domestic policy considerations led the government to interpret the disputes in such a way that the irrational player was the EU, impeding the Hungarian efforts at political "independence" (Chart 2).

In 2012, the EU institutions threatened to suspend their commitments towards Hungary by freezing a considerable part of the cohesion fund allocated to Hungary. The main trigger for this reaction was, again, that the general government deficit relative to GDP exceeded the three percent threshold, thus breaking the rules of the excessive deficit procedure. An actual decision to freeze the funds would have been unprecedented in the history of the European Union. The Hungarian government realised that the three percent general government deficit rule had to be observed. However, in other economic fields the EU institutions do not have many tools to exert influence on Hungary's economic policy.

The Hungarian government finally succeeded to bring the general government deficit below three percent of GDP by way of eight to ten modifications in the budgetary law per annum. The excessive deficit procedure against the Hungarian government was ended in 2013, and budgetary discipline was maintained.[28] This was favourable for Hungary's assessment by international money and capital markets. The cost of financing the government debt decreased significantly with a fall of interest rates. However, Croatia and Slovenia aside, Hungary finances its government debt at the highest cost, if measured in interest rate spreads over a ten year Euro yield. The Forint has weakened substantially in the past years against the Euro, and has created an extra burden on foreign currency mortgage holding households, companies as well as the state.

In spring 2011, the Hungarian government saw the reduction of government debt as a major objective; and justifiably so, given the debt had amounted to 82

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[27] International Monetary Fund (IMF), Hungary: Article IV. Consultation Staff Report, IMF Country Report no. 14/155., 2014, available at <https://www.imf.org/external/pubs/cat/longres.aspx?sk=41618.0>.

[28] European Commission, Macroeconomic Imbalances: Hungary 2013, European Economy, Occasional Papers 137, April 2013, available at <http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp137_en.pdf>.

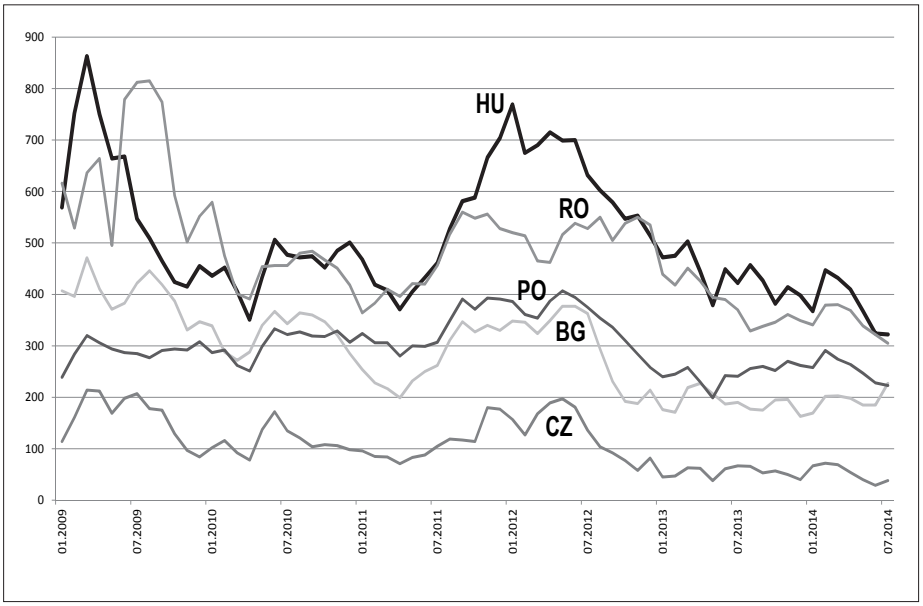

Chart 2: Interest rate spreads over a 10-year Euro yield (Basis points). Source: Eurostat.

percent of GDP in 2010. However, built on unrealistic assumptions, forecasts predicted a rapid reduction of debt (to 67 percent by 2014). Although, as shown with the nationalisation of the private pension funds, the government debt relative to GDP declined by nearly 10 percentage points, it presently still amounts to 80 percent, or, by the new ESA2010 methodology, to 77-78 percent of GDP. Thus, the government has not achieved its goal. If the window-dressing policy measures are disregarded and only the sustainable economic trends are taken into account, the government debt did not decrease but has in fact increased.

Compared with the wider CEE region, Hungary's government debt has been the highest (see Chart 3), although Slovenia and Croatia also feature worrisome figures. Nevertheless, Hungary's position is favourable compared to the EU average, which is above 90 percent.[29] However, substantial risk is implied in the fact that the share of foreign capital is quite high in financing Hungary's government debt.[30] Therefore, the government took measures to divert domestic savings from bank deposits to government securities. The first results of these efforts have become apparent. Taking into consideration that in 2013 40 percent of the government debt was denominated in foreign exchange and foreign investors

[29] According to Eurostat data.

[30] OECD, Economic Survey of Hungary 2014, Paris, January 2014, available at <http://www.oecd.org/economy/economic-survey-hungary.htm>.

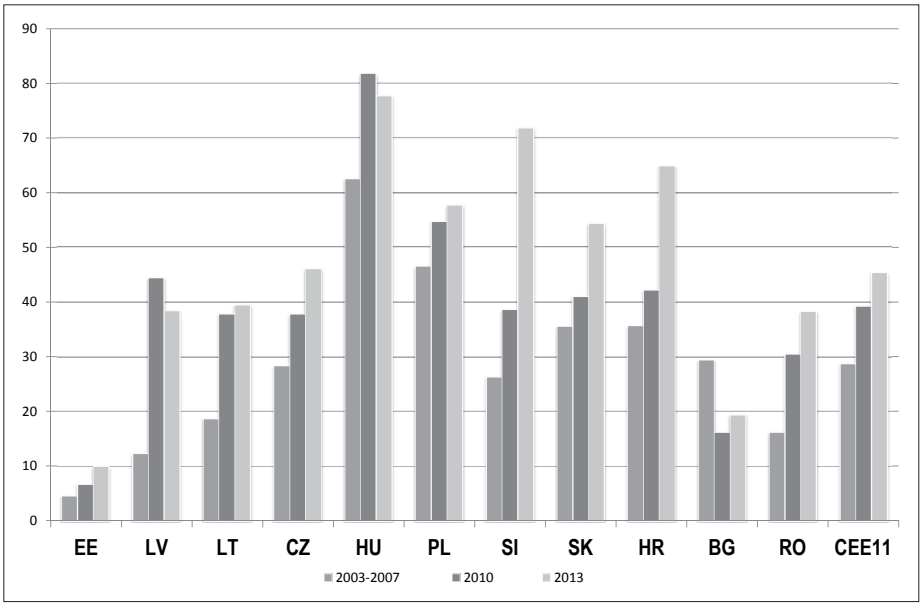

Chart 3: General government gross debt (ESA, in percent of GDP). Source: Eurostat.

accounted for more than 40 percent of the government debt denominated in Forint, the share of foreign financing totalled more than 60 percent. It would be rational to change, possibly reduce, these proportions, but radical changes are difficult to accomplish. Domestic savings do not suffice to significantly modify these proportions. Even if such modifications were achieved it would lead to a considerable shortage of domestic sources necessary for investments.

Challenges and Possible Solutions

In certain respects, the position Hungarian economic performance has recently improved.[31] First of all, with the early 2014 economic recovery in Europe, industrial production and exports are set to expand. This, and in particular the peak in inflow of EU transfers in 2013 and 2014, turned the formerly decreasing investment trajectory around. In 2013 and 2014 investments grew dynamically, unfortunately mainly in the public sector and less in the business sphere. The reason for this is that public investments are financed almost exclusively by EU funds and the EU money available for the budgetary period from 2007

[31] Central Europe Fit for the Future: Visegrad Group Ten Years after EU Accession, Report by the High Level Reflection Group, Bratislava and Warsaw, January 2014, available at <http://pdc.ceu.hu/archive/00007102/01/CEPI_central_europe_fit_for_the_future_2014.pdf>.

to 2013 can be used until the end of 2015. Therefore, the share of EU funds in Hungary's GDP temporarily reached five to six percent, but will decline to two to three percent by 2016. In other words, a temporary investment boom was under way. Another factor of dynamic growth is that due to global price trends and the artificial reduction of utility prices by the Hungarian government, with the rate of inflation being unusually low at close to zero. As a result, combined with a three to four percent nominal wage increase, real incomes will grow considerably and so will domestic consumption, in contrast to previous years. Generally, the rate of potential GDP growth does not accelerate simply on the basis of temporary investment and a domestic consumption boom based on anything but sustainability.

The artificial reduction of the price level in public utilities below costs, will prove to be of short notice. This policy may be appropriate to squeeze out foreign companies and to nationalise utilities, but the taxpayers will eventually pay the bill. Experience gathered over many years and from different contexts, shows that artificial intervention in prices leads, in the long run, to a pronounced deterioration of the quality of services, to the cheating of consumers, or to the increase of budgetary subsidies.

This short analysis, of why Hungary lost the past decade, why it has not been able to converge to the EU average, and why its economy is lagging behind the majority of its regional peers probably has shown that the country is on a wrong economic trajectory. The departure on the latter started with fiscal irresponsibility 13 to 14 years ago, but increasingly migrated into the political field. The intertwining of political and economic power, the proliferating corruption and the abuse of dominant positions, poisoned both the society and the economy. Market conditions, fair competition and economic success based on market output are overshadowed by other factors. The future economic success of Hungary depends on deep and long term political and economic reforms and recovery.

In order to create a sustainable basis, Hungary's rule of law should be strictly restored. Otherwise, foreign and domestic investors will only play a modest role in the future Hungarian economy. It may sound strange in the face of economic globalization trends, but large foreign investors, tend to ponder capital repatriation. After many years of booming, recently the net FDI inflow to Hungary has been negative: ignoring the bank recapitalisation (albeit involuntary, forced by government's regulations), the balance of FDI was 0.9 billion Euro in 2013 and 1.3 billion in the first half of 2014. The improvement of the business environment is an essential precondition for a more rapid and sustainable development. This could somewhat restore the predictability in business planning and result in more investment and innovation. According to the European Bank for Reconstruction and Development (EBRD) Transition Report 2014, the Hungar-

ian business sector is leading the region, but the permanent changes in the tax system have created serious insecurities for potential investors.

Hand in hand with the economic policy issues go issues concerning the labour market. Hungary needs to attract highly skilled personnel, and its overly centralised and over-regulated domestic public education needs to be opened up to the world. Public employment, if it is not mere window-dressing, is better than unemployment, but worse than private sector employment; and the latter should be promoted. Students' and workers' migration abroad is beneficial, as long as the assumption is grounded in that it is temporary and that acquired skills will be brought back to Hungary.

Two parallel goals of Hungary's present industrial policies are contradictory: the government contemporaneously promotes manufacturing through grants and low taxes, and promotes small and medium sized enterprises (SMEs) against foreign multinationals. The Hungarian SMEs are mostly involved in the service sector, which has been neglected and overtaxed. Entrepreneurs' strategy thus has been tax avoidance, which is burdening the state budget. The practice of the government to distinguish between "good" and "bad" multinationals, and to have much higher tax rates for foreign companies compared to Hungarian ones in branches where there are "bad" multinationals, is seriously violating the single market rules of the EU. Industrial policy should be based on private ownership and free market competition. The state has important obligations in promoting research and development, innovation activities and helping stable SMEs to grow. Over-regulation must be avoided.

New challenges are expected to appear concerning the public debt path as well. According to the excessive deficit provisions, the government debt has to be diminished by one twentieth of the sum exceeding 60 percent of GDP. Considering Hungary's 80 percent debt ratio, this translates to one percentage point annually. Huge burdens will accrue with the consequences of the nationalisations. On the one hand, one-off costs related to the acquisition of utilities and other companies account for 0.5-1 percent of GDP, and about the same costs will emerge during operation – assuming that prices will remain low. With the planned investment in the Paks-2 nuclear power plant, the government debt is expected to increase by another one percentage point per annum. Additional burdens are expected to come from investments in the national stadium (Puskás Ferenc Stadion) and other prestige projects with questionable returns. Therefore, new expenditures corresponding to three percent of GDP may annually appear in the budget. The EU's excessive deficit procedure will be re-launched if the conditions related to the reduction of government debt are not met. Without structural reforms or austerity measures this cannot be handled.

The potential GDP growth has recently been projected to be between one and two percent, thus very low. An economic policy needs to be elaborated which

lifts the annual average growth rate to at least two to three percent in a sustained way. In order to achieve this, the flexibility of the labour market needs to be enhanced by better education and training. Public services, that is health care, local administrations, public transport, among others, have to be modernised.

The degree of economic inequality in Hungary has become intolerable.[32] Economic policy should include a limited and well targeted income transfer for the advancement of poor families. It could concern for example children's subsidies, unemployment benefits, and a municipal aid system, while it is important to maintain a labour market structure that promotes incentives to work. The modernisation of public services could help to decrease inequality. A long term programme to reform the pension system, this time for the better, needs to be launched.

No substantial economic growth can be expected without a supportive banking system. If the government continues its war against the banks, the potential rate of GDP growth will be frozen at about one percent per annum. The efforts at "nationalisation" have proven to be a step in the wrong direction. Conditions need to be created for a banking system in which banks are interested in offering loans and are in the position to finance the best projects. Rational agreements between banks and debtors (both in Forint and foreign exchange) need to be promoted, and not least in such a way that the tax burdens of the banks decrease proportionately.

A new solution needs to be found for agriculture as well. One option could be a clear separation between the internationally competitive sector, mainly consisting of large and medium sized agricultural units, and the small farm sector, which is mostly based on self-sufficient production and sales to the local community. Cooperation between the two sectors is essential, however.

Concluding, one may wish for social peace, a fostered dialogue between the different political sides, an increased capacity to compromise and mutual understanding in order to lead Hungary out of its difficult economic position. The major task in the following years will be to create a common ground to bring back cohesion to a society that has been artificially broken.

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[32] Georgi Dragolov et al., Social Cohesion Radar, Measuring Common Ground an International Comparison of Social Cohesion. Gütersloh 2013, available at <http://www.gesellschaftlicher-zusammenhalt.de/fileadmin/Inhalte/Downloads_Sozialer%20Zusammenhalt/Radar_InternationalerVergleich_web_en.pdf>.