



GKI Economic Research Co.

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# AN ECONOMIC RECOVERY PLAN FOR HUNGARY

A blueprint of the government's actions for the 2014-2018 period\*

(Main messages)

## 1. Assessment of the current situation

**The second Orban government brings serious hardship and disappointment to the Hungarian economy and society.** There were hopes in 2010 concerning growing welfare, massive creation of new jobs, boosting economy, the reduction of the tax burden, the creation of a more liveable and more business-friendly country, and modernizing public services. **None of these hopes have been fulfilled.**

**In 2012 the Hungarian economy is on a recessionary trajectory and it neglects perspectives as well.** The government apparently does not intend to change the institutional framework it created, its practice of exerting political power or its unsuccessful economic policy resulting in legal uncertainties and unpredictability. **The major objective of the government is to maintain the political power, whose scope has been extended substantially, and the position of beneficiary business groups.** The government debt remains financeable; however, the financing conditions are very unfavourable due to the government's attitude towards international institutions. As a result, households and businesses will have to take on an additional burden of HUF400bn per year from 2013 on. **No factors are discernible that may channel the economy by 2014 to a trajectory that is more dynamic than stagnation.** Hungary is lagging behind the EU in economic terms and is becoming isolated from the EU as far as its policy is concerned.

**In 2014 GDP will fall back to the level recorded about 8 years before, consumption to that of 11 years before, and investments to that of 14 years before.**

**In which years were these main economic indicators as low as they will be in 2014?**

|                     |      |
|---------------------|------|
| GDP in 2014         | 2006 |
| Consumption in 2014 | 2003 |
| Investments in 2014 | 2000 |

These indicators are more favourable in all other countries in the CEE region. The prolonged global economic crisis and especially the crises of the eurozone and the international financial system undoubtedly aggravated the slowdown of the Hungarian economy between 2010 and 2014. **However, the bad economic performance, which is much worse than that of the neighbouring countries, is mainly a consequence of serious governance failures, voluntarist and erratic economic policies, weakening legal certainty, and senseless “wars of independence” against foreign and domestic “enemies”.**

In 2014 the **general government deficit** might remain below or around 3 per cent of GDP; however, **financial indicators** might remain unfavourable. The outflow of **capital** and **skilled labour** will exceed

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their inflow. The decrease in **government debt** between 2010 and 2014 will not reach the amount gained by the nationalization of private pension funds accumulated by people as their future pension savings. **None of the major economic policy objectives of the government are fulfilled: employment in the business sector will be around at its 2010 level, total GDP growth over four years will not reach 2 per cent, consumption and investments will decrease.**

**In 2014 the main financial indicators of the standard of living will be even worse than they were in 2010.** In addition, during these four years **the rich are becoming much richer** and the **middle class** and especially the **poor are becoming poorer**. Though the scope of public tasks has changed a lot, the services offered have deteriorated. **As far as people's day-to-day life is concerned conflicts and tensions have increased, and social welfare has deteriorated.**

**The poisonous economic legacy of these years will be felt for a long time.** It is difficult and time-consuming to regain the **confidence** of domestic and foreign investors and businesses. Growth prospects are dim due to critically low **investment levels**. Savings are placed abroad and highly skilled people are leaving the country. These trends will be difficult to reverse. A **significant increase in investments** will be required to boost employment, **raise the number of jobs, and living standards.**

**In 2014 Hungary's economy, society and political system will be in critical condition, and voters knowing the situation will provide legitimacy for the subsequent four years of governance, including the task of economic recovery.**

## **2. Democracy, rule of law, fairness and perspectives**

**The first and most important task of the newly formed government in 2014 will be to return to the European values of democracy, freedom, transparency, and fair and professional governance.** The **restoration** of legal certainty and the **independence** of various **institutions** such as the Constitutional Court, the Budget Council, legislation and judiciary is of paramount importance for the development of the economy as well. **It would be wrong to follow a revenge policy to vent grievances. There is a need for real, meaningful dialogue, focusing on the future and solutions, with all democratic political forces, social partners and representatives of various stakeholders.** These are the **prerequisites** for the creation of a more favourable economic situation and social recovery.

In order to revitalize the economy, to safeguard jobs and to create new ones **confidence in the Hungarian economy and investments should be urgently restored and strengthened.** **Hungarian large investors, small and medium-sized enterprises** have to be convinced that it is worth to **start new projects** in Hungary. The main growth opportunity of the Hungarian economy continues to be the expansion of exports. This requires that **multinational companies**, accounting for the majority of exports, **implement new projects** enabling a rapid increase in production (and related domestic supply and employment) in Hungary. Increasing investments and exports and the resulting increase in domestic consumption may improve the development opportunities of businesses selling their goods and services in the domestic market.

Restoring business confidence, improving the investment climate, and terminating the war against banks may help to **re-establish the normal functioning of lending.** **Borrowers** and **banks** should negotiate in order to reach an agreement, if necessary, by extending maturity dates.

**Erroneous modifications in the functioning of the state should be corrected.** Taking into account the deepening social crisis, the welfare system must be amended as well. In order to boost employment, taxes on low-wage employees should be reduced.

As a frozen economy will not provide extra budgetary sources necessary for the initial measures, they can be acquired only by a **reallocation of existing sources**. A **more equitable share of public burdens** would require higher contributions from the relatively rich people, from those receiving above average wages or considerable income from capital, plus from those who tried to avoid taxes and from companies that paid lower corporate income taxes than others in general. A smaller portion of the money gained by tax cuts resulting from the flat tax system should be taken back. However, incomes from family tax allowances should not be affected, in order to maintain stability.

Starting the recovery process should include the following steps:

- **Adoption of a government program for 2014-2018 promising a return to the rule of law and the values of the EU, predictable and rational economic policies, maintenance of medium-term equilibrium objectives, and good governance.** Presenting an appropriate 2015 budget and medium-term economic program in autumn 2014.
- **Starting a review of the laws passed in the previous period** in accordance with the government program. This will include an **adjustment of the welfare system**. Those who were already retired should be treated as pensioners (retrospectively), except those whose disability pensions were discontinued due to a change in the condition causing disability. The unemployment benefit period should be extended to 5 months for new unemployed people.
- Hungary should **join the ERM-2 system**, thus accepting the requirements of a rational system of economic governance necessary for the future accession to the eurozone. The growing confidence would help financing not only the government debt cheaper but that of corporate and household debts as well.
- **Changing the system of public duties and charges** from the beginning of 2015 **by restricting the after 2009 introduced special targeted taxes and levies to an internationally tolerable limit and by reducing the public burdens of low-income employees**. Personal income taxation, including capital gains as well, will be progressive. Measures to reduce tax evasion and to whiten the economy will be introduced. A general level of corporate income tax will have to be paid on all profits exceeding a much lower limit. The government should return to the principles of social security, and a closer link should be established between the payment of taxes and services received (health care and pension). A system of cost free private bank accounts should be introduced to receive regular incomes.

### 3. Credible economic policy

In the first stage of the period leading to economic recovery (until 2016) **significant changes and corrections in the operation of the state should be prepared, and a host of government measures should be taken to boost economic growth, to create new jobs, and to alleviate the social crisis.**

**Conditions for good governance** should be created. A more rational and structured governmental structure should be established. The framework for the reconciliation of interests and meaningful on-going **social and professional dialogue** should be created. However, it should not be allowed that endless discussions hamper decision-making. Experts of various business and scientific fields should be involved in the preparation of large-scale changes. All stakeholders should be familiarized with the

well-developed ideas of changes and the necessary public support should be achieved for the execution of these proposals.

### ***3.1. A host of government measures should be taken to boost economic growth, to create new jobs, and to alleviate the social crisis***

- a) New jobs can be created, especially by establishing **kindergartens** and **nurseries** at workplaces, by changing legal rules to facilitate **elderly care**, **child care** and **other personal services**, and by changing **work schedules in hospitals**. **Green economy**(e.g., biomass, geothermal energy, green building, recycling) offer further employment opportunities if proper incentives and business organization are applied and **organic farming** is expanding. Employment offices should be **converted to agencies** having an interest in the efficiency of the retraining programs they organize.
- b) Programs shall be started to find job opportunities for **graduates**, and for **educated and skilled young people** in general, and to **prevent the reproduction of unskilled** young people leaving the school system at a low educational level.
- c) It is appropriate to restore the **deductibility of costs of trainings** organized or ordered by the company itself **from the vocational training contribution**. The expansion of adult education is necessary also because it can help countering the exclusion spiral, that is, it can be a tool for social inclusion. **Adult education** should be made available especially for **disadvantaged social groups**.
- d) **Negotiations** with the representatives of domestic enterprises and multinational companies **concerning the recovery strategy** should begin in 2013. The aim is to **increase domestic developments and to attract new projects**. The fears from the risk of any future special taxation might be prevented by concluding special contracts and investment protection agreements.
- e) The **EU remains the most important** trading partner of Hungary. Other important targets are the Balkans and Ukraine. Russia and China are also important in terms of attracting capital.
- f) The **institutions supporting domestic project developments** (loan guarantees, start card, Hungarian Development Bank (MFB), Eximbank and MEHIB) should work more effectively. The portfolio of the MFB shall be cleaned of non-matching or parallel activities.
- g) A **more effective investment agency** should be created to help those intending to enter the domestic market. This could offer genuine one-stop administration. There is a need to establish an **agency to facilitate export** effectively.
- h) The **administrative burden on businesses**, especially on small businesses, **should be reduced**.
- i) The **spread of the internet**, including online banking, sales, tele-working and e-services, can be an important factor in boosting employment and economic growth.
- j) There are **important development tasks in the following sectors**: energy, the green economy, tourism, logistics, automotive industry, the pharmaceutical industry and in particular agriculture.

### ***3.2. The operation of the state as developed during the Orban government needs a radical reform***

Hungary should return to the rule of law and democratic norms, it is necessary to eliminate excessive centralization, and the operation of the state should be transparent and predictable. The public

ownership structure should be reviewed to see how state-owned enterprises were managed. Based on the results decision should be made about their on-going operation or sale.

a) **There is a need for comprehensive reforms in public transport and healthcare**

The requirements of local and inter-city **bus transport** should be met much **cheaper** and by using **more modern buses** of various sizes corresponding to actual needs. **Rail transport should typically be used only for long-distance travel, integrated by the bus service. A significant number of side-lines should be replaced by the much more flexible bus service, thus improving service levels.** The development of the public transport (and the system of minor roads) helps the access to distant health and education services of higher quality, improves the conditions of commuting and creates job opportunities.

There is a need for structural changes in **healthcare** enabling a higher level of care and better capacity utilization. The contribution payment schemes should also be changed. Basic health services should be financed in the framework of a closed fund, by fixed amount contributions paid by everybody equally (after the now not paying insured persons financed by the state), but that may be fully or partially subsidized for low-earning employed people.

b) **There is a need for significant corrections in the local government system, public and higher education, as well as in the pension system**

An **electronic administrative and utility system** should be created that is able to serve citizens and businesses where they operate. Over-centralized tasks (especially public education) should be returned to the **local government system**, primarily for sub-regional mandatory associations. The professional quality of **public education** should be improved by concentrating the smaller number of pupils to larger and better-equipped schools.

It is necessary to reduce the number of **higher education** establishments and improve their quality, and they should be more involved in international competition. The state financed quota will remain unchanged and it will be distributed among institutions in a correct way. The first academic year will be free, and then 10-20 per cent of students with the best academic achievement and 10 per cent of the socially most deprived will study free, whereas the others pay partial tuition. The system of full-tuition training will be preserved.

Preparatory work concerning the future changes of the **pension system** must be started again.

c) **There is a need for corrections in the social system, in public administration, the R&D system, in the management of public funds and in a number of other fields of state activities**

It is necessary to increase the **social support budget of local governments** that are able to take into account the actual circumstances of families in need of financial help. **Public administration** requires significant **deregulation**. E-government requires that all settlements have broadband access and at least one public WI-FI access be available in all communities.

The **budgetary management** system needs to be reformed and parliamentary decisions and public attention should be directed to multi-year budgetary programs, their intended goals and the identification and evaluation of their results. The originally intended power and team of experts of the Budget Council must be restored.

**Innovational contributions** should be allowed to be used locally as well. Steps should be taken to shift the research system towards strengthening applied research. Agreements between universities, research institutes, and domestic and foreign market actors supporting this goal should be encouraged. The Innovation Fund should support the development of appropriate patent protection. It is very important to channel venture capital and EU development funds into the innovation chain.

- d) **On-going measures** should be taken in **taxation** in order to **whiten the economy** and to strengthen **fiscal discipline**.
- e) Comprehensive measures should be taken to **fight corruption**, to ban the initiatives of the clientele, to improve **transparency** in the management of public funds and to improve the controllability of power.
- f) Businesses and customers suffering from the **abuse of dominant position** and the acquisition of one-sided advantages can be protected by new government regulations, agreements, **antitrust** and **consumer protection** controls, and by providing protective services for weaker parties. Unjustified governmental restrictions on competition should be removed (e.g., in public procurements).
- g) The **organization of public works** should be continued; however, it is necessary to review them in terms of **value creation**. State-owned enterprises may also provide opportunities for such employment (e.g., by the rationalization of the transport system).
- h) **EU transfers** should be absorbed in the framework of a **focused national development strategy**. These **funds** may finance **reforms** in the operation of the state and the **implementation of major changes**, as well as **increasing employment and competitiveness**. The tendering system **should be simplified** considerably, making the award **automatic** if certain conditions are met. Certain programs may be implemented by state-owned enterprises as well, in cooperation with the local entrepreneurial community.

## 4. The world, the EU and Hungary

The global financial and economic crisis, which began in 2007, **may last for up to 10 years. A general social and political crisis is emerging in Europe.** A twofold trend can be discerned: in principle everybody emphasizes the importance of integration and joint actions; however, in practice specific decisions are often based on very different short-term national aspirations and election considerations of politicians. This recovery plan assumes that, in the end, the EU and the eurozone will emerge from the crisis.

**It cannot be expected that either the EU or Hungary will return to pre-crisis growth between 2014 and 2018. Providing that credibility, trust and European values can be restored in Hungary, a GDP increase of 1.5-2 per cent per year can be expected, reaching around 3 per cent by the end of the period.**

Hungary has been unable to find the best methods in the institutions of the EU to enforce its interests and often found itself in a disadvantaged position. **In a multi-speed EU it is in Hungary's long-term interest to be as close as possible to those core countries whose aims are deep integration and fast and competitive economic development.** The government should represent Hungary's national interests in accordance with this. It is probably **important** for Hungary to **participate** in the emerging

banking union of the EU, in the reviving monetary union supported by a fiscal union (i.e., the **political union taking shape**).

## 5. The scope and effects of fiscal policy

**A successful recovery policy may initiate investments, economic growth, increase employment and raise incomes of the state as well.** This could allow later (in the second half of the 2014-18 period) some room for manoeuvring in fiscal policy, i.e., **budget revenue surpluses could be allocated in accordance with priorities.**

These priorities might be the following:

- reducing employers' social security contributions in order to facilitate competitiveness and job creation,
- accelerating reforms and restructuring, creating favourable conditions for their acceptance,
- improving the quality of education,
- increasing healthcare spending, especially to implement the salary catch-up program,
- improving public safety,
- improving social services and increasing expenditures for enhancing equal opportunities.

## 6. Social well-being

**In the 2014-2018 period, society's material well-being can be expected to increase only modestly.** However, income differences may be mitigated by a more equitable payment of public duties and by various social measures. The development and the effectiveness of the government's activities can be measured not only by GDP, but also by other quality of life indicators.

In a period of modest economic growth **it is particularly important to utilize all opportunities that can improve social welfare in a broader sense (though these are difficult to quantify), outside the categories of income, consumption and employment.**

A **calm government attitude building on dialogue and common understanding** can help a lot in itself. It would be great if everyday life would be **free from politically motivated conflicts, and tolerance would prevail.** This in itself would make the life in Hungary more liveable.

**A number of small steps could be taken to improve living conditions and eliminate unnecessary stress situations. The government should fully explore and utilize these opportunities.**

**During the general deregulation of legislation the temporal and procedural burdens caused for citizens and businesses should also be considered,** not only the costs it involves.

The steps proposed in this paper have such beneficial effects as well. For example:

- As a result of the reform of public transport, people can reach their workplaces and public institutions **faster and in a more comfortable way.**
- The healthcare reform may **improve the level of healthcare,** patients will have **faster** access to treatment, and it would be **easier** to find a nursing home for sick family members.
- Enhancing the capacity of nurseries and kindergartens would make the life of families with small children **easier,** especially the lives and commuting of mothers.

- New legitimate businesses offering services for families may **alleviate** many problems.
- Measures strengthening consumer protection (e.g., establishing NGOs offering free help to those having complaints) could **facilitate** the fast and **favourable** solution of such conflicts.
- Offering wide-range e-government services, including the provision of free access points (and help) in every settlement could **save a lot of time** for citizens.