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Was Viktor Orbán's Unorthodox Economic Policy the Right Answer to Hungary's Economic Misfortunes?

Abstract

This paper assesses whether the unorthodox policies implemented in Hungary since 2010 were, given a four-year perspective, the right answer to Hungarian economic problems.

The paper draws on findings from the author's August and November 2014 study trips to Hungary, during which Hungarian government officials and scholars from Budapest University of Technology and Economics were interviewed. These findings were supplemented by publications and data from Eurostat and World Bank databases.

Statistical data from May 2015 demonstrate that significant improvements took place in most (if not all) areas of the Hungarian economy since 2010. The country avoided bankruptcy and its 2014 GDP growth outpaced that of the Czech Republic and Poland. Viktor Orbán's economic reforms therefore seem to have been the appropriate response to the Hungary's economic misfortunes. The jury is, however, still out on whether those policies laid lasting fundaments for long-term growth.

Hungary is the first Central European country (since the anti-communist revolution triggered by Solidarność movement) that is experimenting with an independent economic policy. The results of Viktor Orbán's experiment, if ultimately judged positive, could have profound consequences for the other countries in Central Europe and beyond.

Keywords: Hungary, economic crisis, economic policy, post-communist economies, transition economies
JEL: F63, G01, N10, 025

Introduction

Viktor Orbán's Fidesz party won a landslide victory in the 2010 parliamentary elections gaining a two-thirds super majority. This ended the eight-year rule of the Hungarian Socialist Party and Alliance of Free Democrats' (MSZP-SZDSZ) coalition, during an exceptionally difficult time for Hungary's economy. In 2009, Hungarian GDP contracted by over 6%.

The new Hungarian government, empowered by a strong electoral majority, implemented ambitious socioeconomic reforms that were unprecedented not only in Hungary, but all of Central Europe since the transition from centrally planned economies started in 1989.

This paper assesses whether the unorthodox policies implemented in Hungary since 2010 were, given a four-year perspective, an appropriate answer to Hungary's economic problems.

The first section of the paper ("*Hungary's Economic Situation by 2010*") briefly presents the situation when Viktor Orbán was coming to power. That analysis is focused on the eight-year period, from 2002 to 2009, with 2002 marking the beginning of the MSZP-SZDSZ coalition government, and 2009 being the last full year before April 2010 elections. Given the economic policy focus of this paper, the analyzed time periods were selected to match the Hungarian electoral timetable.

The second section ("*Causes of Hungary's Economic Misfortunes as Viewed by Economists Close to Fidesz*") provides the Fidesz narrative, which is necessary to be able to verify the internal coherence of the economic policies implemented since 2010.

The third section ("*Key Economic Policies Implemented Post 2010*") is focused on the specific economic policies of Viktor Orbán's government. These policies are analyzed in the context of interpreting the root causes of Hungary's economic situation, as understood by economists close to Fidesz.

The fourth section ("*Critics of Viktor Orbán's Economic Reforms*") presents the view of Orbán's critics, both domestic and foreign, who viewed the Fidesz reforms as inappropriate for the Hungarian economy and, as such, expected them to negatively impact the Hungarian economy.

The penultimate, fifth section ("*The Results of Viktor Orbán's Economic Policy*") attempts to answer the question included in the title of the paper, i.e., whether Viktor Orbán's unorthodox economic policy has been a right answer to Hungary's economic misfortunes. The analysis is based on the statistical data available in early May 2015 and takes into account the performance of the economy since 2010.

The last section ("*Conclusions*") draws conclusions regarding the potential implications of the "Hungarian experiment" for the other Central European countries and its future influence on economic policy.

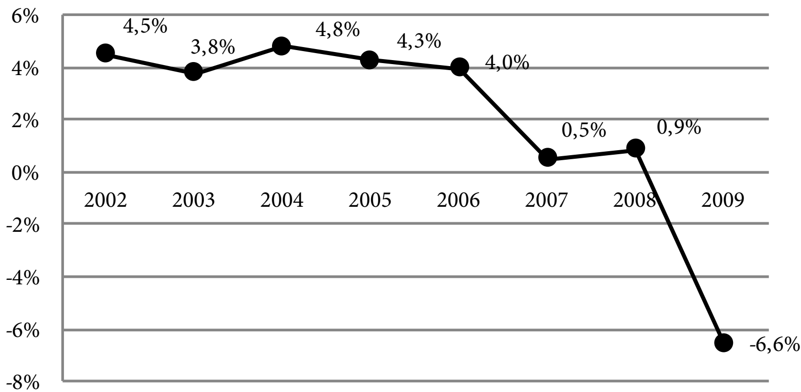
The research paper is based on available publications and findings from study trips to Hungary that took place in August and November 2014 – which were particularly central

to the information presented in sections two and three. During those visits, Hungarian government officials, analysts from Szazadveg Foundation (a Budapest based think-tank close to Fidesz), and scholars from Budapest University of Technology and Economics were interviewed.

Hungary's Economic Situation by 2010

During the years 2002 to 2006, the period coinciding with the rule of the MSZP-SZDSZ coalition after its victory in 2002 elections, Hungarian economy grew at a healthy rate of around 4% per annum. The years following the MSZP-SZDSZ coalition's second electoral victory, in 2006, present a very different picture (see Figure 1). In 2007, GDP growth collapsed to mere 0.5%, followed by 0.9% in 2008. In 2009 Hungarian GDP contracted by 6.6%.

FIGURE 1. **Hungarian real GDP dynamics**



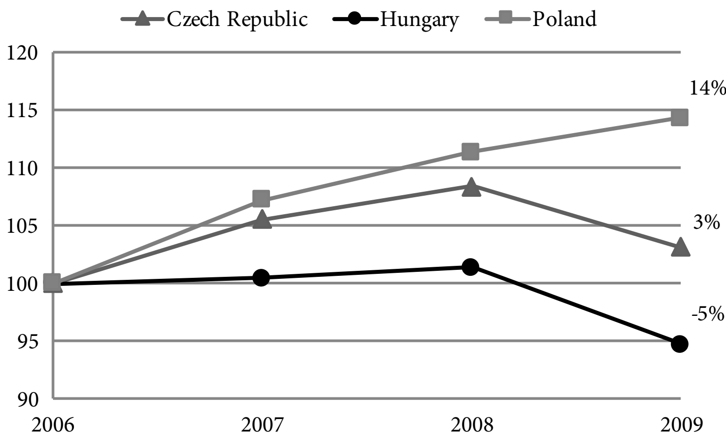
Source: Eurostat Database – 01, 2015.

At first sight, the shape of the GDP growth curve presented in Figure 1 does not seem unusual. The 2009 recession was an experience shared by multiple developing economies, post Lehman Brothers collapse. A comparison of Hungary's GDP statistics with those of Czech Republic and Poland does, however, reveal new information.

The chart in Figure 2 starts at year 2006 (the last year of significant growth of Hungarian economy) and traces GDP changes for the Czech Republic, Hungary, and Poland. Clearly, Hungary's economy has done much worse than its peers. During the years 2007 to 2009, the Hungarian GDP, in real terms, decreased by c. 5%, as compared to a c. 3% increase for Czech GDP and a c. 14% increase for Polish GDP over the same period. Particularly

interesting is the GDP growth divergence between Hungary and its peers that takes place in 2007. Czech and Polish GDPs continued to grow at an above 5% annual rate, while Hungarian growth stalled. The reasons for this Hungarian GDP growth collapse in 2007 must have been endogenous, not exogenous.

FIGURE 2. **Cumulated real GDP dynamics (GDP rebased to 100 in 2006)**



Source: Eurostat Database – 01, 2015.

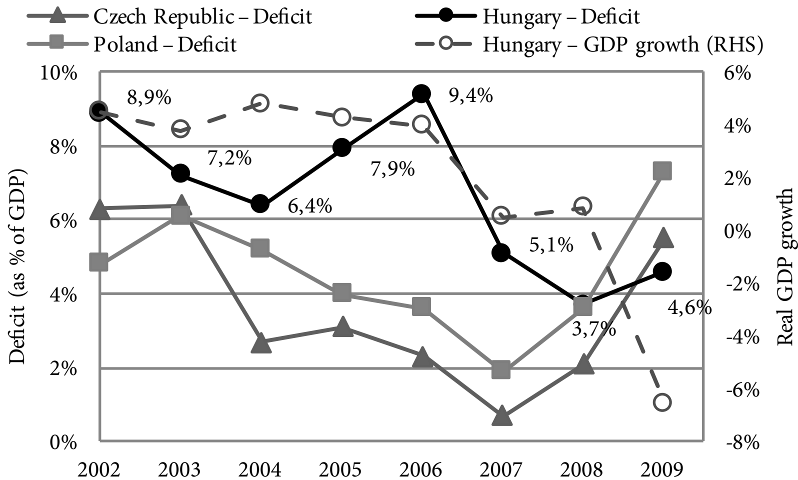
General government deficit (later referred to as deficit) statistics for these three countries shed some light on the potential reasons for this GDP growth divergence (Figure 3).

In the years 2002–2004, the deficit of Hungary follows a general downward trend, albeit it remains relatively high when compared to the Czech Republic and Poland. Hungary's deficit as a percentage of GDP decreased from 8.9% to 6.4%. In 2005 and 2006, deficit reductions in the Czech Republic and Poland continued, but Hungary's deficit increased in both years, reaching 7.9% and 9.4% of GDP in 2005 and 2006, respectively. It appears that GDP growth in those two years was to a certain extent propped up by increased government spending.

The MSZP-SZDSZ coalition, having won second parliamentary election in 2006, undertook sharp deficit reduction measures in 2007, bringing it down to 5.1%. The move to drastically reduce the deficit coincided with a collapse in the GDP growth rate, and is a likely reason for GDP growth divergence between Hungary and its Central European peers.

The deficit in Hungary was further reduced in 2008, to 3.7%, roughly at par with Poland (3.6%). In 2009, Hungarian GDP contracted by over 6%, the deficit increased to 4.6%, which was significantly lower than that of both Czech Republic (5.5%) and Poland (7.3%) [Eurostat Database – 02, 2015].

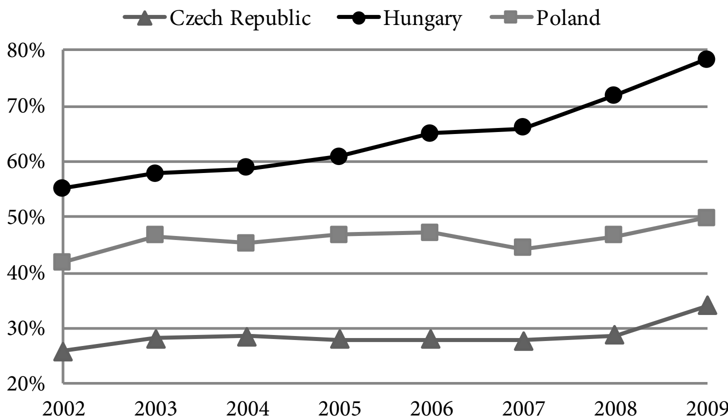
FIGURE 3. General government deficit as % of GDP



Source: Eurostat Database – 01, 2015; Eurostat Database – 02, 2015.

Relatively high deficits during the 2002 to 2006 period led to a gradual increase of general government gross debt (later referred to as debt) as a percentage of GDP (see Figure 4).

FIGURE 4. General government gross debt as % of GDP



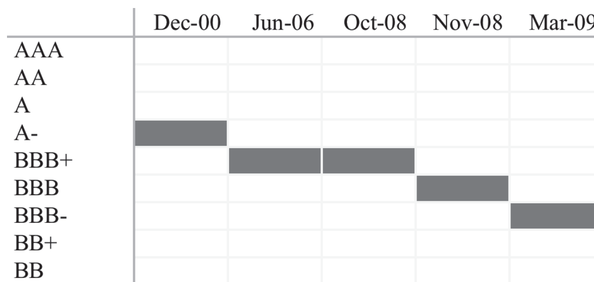
Source: Eurostat Database – 03, 2015.

By the end of 2002 Hungarian debt as percentage of GDP was already significantly higher than in the Czech Republic or Poland. The debt ratio was then 55.1% for Hungary

versus 43.5% for Poland and just 25.9% for the Czech Republic. Although the debt levels increased in all three Central European countries during the 2002 to 2009 period, Hungary's increase was highest (c. 42% increase in debt ratio for Hungary versus c. 32% for the Czech Republic and c. 20% for Poland) and started well ahead of the Lehman Brothers bankruptcy and subsequent global crisis.

Hungary's worsening economic performance, coupled with relatively high deficits and high and rising debt to GDP ratio was reflected in the evolution of Hungary's credit ratings (see Figure 5).

FIGURE 5. Hungary – S&P credit rating (Foreign currency long term debt)



Source: Bloomberg, 2015.

Standard&Poor's began downgrading Hungary's long-term foreign currency denominated debt in June 2006. Downgrades followed in October 2008, November 2008 and March 2009, bringing Hungary's credit rating to the lowest investment grade category. These significant downgrades taking place in times of global economic turmoil complicated Hungary's ability to raise new debt in international markets. A joint financing package for Hungary from the International Monetary Fund and the World Bank resulted, totaling USD 25 bn in October 2008 [IMF Website, 2008].

The Hungarian economy at the time of Fidesz's April 2010 victory was in dire straits. Hungarian GDP had contracted by 6.6% in the preceding year, the deficit had reached 4.6% of GDP, and the debt as a percentage of GDP reached a historic high of c. 78%. Fidesz achieved a 2/3'rds super majority in the 2010 elections, and a strong mandate to implement economic reforms. Before exploring the various economic policies introduced by Victor Orbán's government, it is important to understand how these economic difficulties were viewed by economists close to Fidesz.

Causes of Hungary's Economic Misfortunes as Viewed by Economists Close to Fidesz[2]

Economists close to Fidesz saw the source of the Hungary's economic problems before 2010, in the 20 years starting from 1989 – which is the year when transformation officially commenced. They believe that Hungary's transformation was rushed and marked by a number of serious economic policy mistakes. This view is well expressed in "*Background of structural imbalances in a post-communist transition economy,*" by Professors György and Veress from the Budapest University of Technology and Economics [György, Veress, 2014].

Liberalization of Foreign Trade

György and Veress [2014] point to rapid foreign trade liberalization as a key economic policy mistake. While acknowledging that trade liberalization in the Czech Republic and Poland was even more rapid, they highlight the higher tariffs that protected internal markets in both of those countries. In their view, the tariffs, coupled with a lack of real effective exchange rate (REER) appreciation, helped Polish and Czech domestic production. However, available World Bank data does not seem to support this claim, as all three countries have experienced REER appreciation since 1989, which in Poland was significantly stronger than in Hungary during the 1989–1999 period (although in 1990 REER in Poland depreciated by almost 22% and appreciated by almost 2% in Hungary [World Bank Database – 02, 2015]).

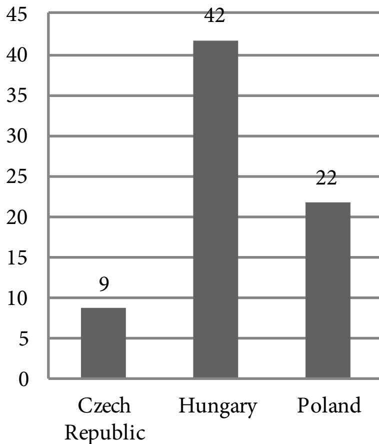
Rapid foreign trade liberalization led to a wave of corporate bankruptcies. Figure 6 compares Hungary, Czech Republic and Poland over the period 1992–1996 in this regard.

Plainly, the absolute number of corporate bankruptcies in Hungary was significantly higher than those of its peers. The comparison becomes even more striking when the respective sizes of each economy are considered (See Figure 7). Hungary experienced 898 corporate bankruptcies per each USD billion of its GDP vs. 129, and 139, for the Czech Republic and Poland, respectively.

Eric Reinert, a heterodox economist and a vocal critic of the way transformations in post-communist countries were conducted, highlights the negative impact of rapid liberalization in those countries on domestic corporations, arguing that: "[i]*n the former communist countries many firms went bankrupt even before they had an accounting system in place that made them understand their own costs. The shock therapy of the end of history will, given a bit more perspective, come across as sheer folly*" [Reinert, 2007, p. 252].

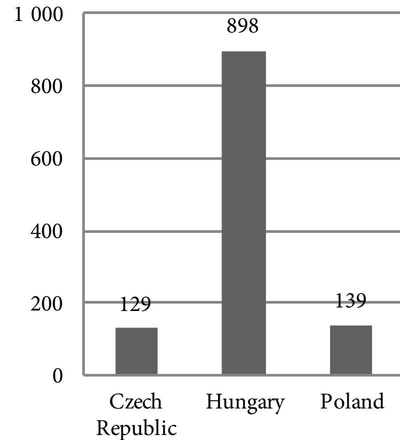
Corporate bankruptcies in Hungary inevitably contributed to a 30% reduction of employment in Hungary over the transformation period. Given the artificiality of full employment under the communist regime, some reduction of employment was unavoidable. However, the 30% reduction was much higher than in the Czech Republic and Poland, where 10% and 20% of jobs, respectively, were lost over the same period [György, Veress, 2014].

FIGURE 6. **Corporate bankruptcies ('000 of companies)**



Source: György, Veress, 2014.

FIGURE 7. **Number of corporate bankruptcies (per 1bnUSD of GDP in 1996)**



Source: György, Veress, 2014; World Bank Database – 03, 2015 for GDP data.

External Funding Requirements

Rapid trade liberalization together with REER appreciation resulted in export collapse and significantly increased imports driven by the flow of consumption goods from the West. This translated into a foreign trade balance collapse and increased external financing requirements. The trade deficit was to be offset through increased foreign currency denominated debt and capital inflows from foreign investments. György and Veress [2014] indicate that Hungary's national debt increased by 20% of GDP between 1990 and 1995. Over time, high absolute indebtedness levels made further debt increases difficult and the foreign investments (especially foreign direct investments (FDI)) became an increasingly important source of foreign currency to fill in the funding gap.

Privatization and Dual Structure of Economy

Mass privatization in post-communist transition economies followed the prevailing belief that privatization was the only way to modernize inefficient post-communist economies. Ha-Joon Chang, another heterodox economist, has stated: "*state-owned enterprises (…) do not work. This judgment (…) acquired the status of a pseudo-religious credo during the 'transformation' of the former communist economies in the 1990s. For a while, it was as if the whole ex-communist world was hypnotized by the mantra, 'private good, public bad'*" [Chang, 2007, p. 104].

The economists close to Fidesz claim, however, that the driving forces behind Hungarian privatization were, in fact external financing needs. The scope of privatization conducted

in Hungary was wider than in any major post-communist country. By 2010, the asset ownership structure of the Hungarian economy more closely resembled Anglo-Saxon economies than the mixed-economies of continental Europe. An important characteristic of the privatization process in Hungary, and Central Europe in general, was the predominance of sales of companies to foreign investors. Banks, the national telecommunication company, and numerous state-owned industrial companies were sold to foreign corporations. Unlike the Czech Republic and Poland, Hungary also sold its national oil and public utilities companies (such as gas, power and water providers).

Together with the privatization, the Hungarian government also introduced a number of measures to attract FDI. The most common measure used in Hungary and other Central European countries like the Czech Republic and Poland were tax incentives. György and Veress [2014] claim that positive discrimination, as they call it, towards FDI created a dual economy. To substantiate their claim, György and Veress [2014] noted that the total tax burden of the foreign-owned companies hovers between 10 and 18 percent, as compared to the 53 to 58 per cent total tax burden of the domestic SME[3]. Economists close to Fidesz government viewed the preference for FDI as having a significant negative impact on the development of the domestically owned sector.

Hungary's trade deficit remained high until 2009. The resulting funding requirements were further exacerbated by significant transfers of profits by foreign-owned companies out of Hungary. With two thirds of privatization completed by 1998, FDI wasn't sufficient to fill in the balance of payments gap going forward, and Hungary's foreign denominated debt was again on the rise. According to György and Veress [2014], the gross national debt between 2002 and 2010 increased by 25.4 percentage points, and the share of foreign currency denominated debt increased from 25% to 48%. The Hungarian government was not alone in incurring substantial new debt. Hungarians, attracted by the availability of seemingly cheap credit denominated in foreign currency, were taking on new loans to finance consumption. György and Veress [2014] indicate that the combined debts of the Hungarian state and population increased by 55 percentage points in relation to GDP between 2002 and 2009.

The severe economic downturn experienced by the Hungarian economy in 2009, as previously presented, resulted from unsustainable debt and necessary government deficit reduction. Economists close to the Fidesz government perceive the weakness of Hungary's economy underlying this unsustainable debt level as a result of policy mistakes made during the rushed transformation from a centrally planned to market economy.

Rapid trade liberalization, unprecedented scale of privatization together with positive discrimination in favor of FDI, reliance on external resources for modernization of the economy and irresponsible incurrence of debt by the government, accompanied by individual consumption fueled by foreign denominated borrowings are the key economic policy mistakes that laid the foundations for Hungary's economic misfortunes by the time of the 2010 parliamentary elections.

Key Economic Policies Implemented Post 2010

The Fidesz government began implementing a wide array of economic reforms shortly after winning the 2010 elections. Some policy measures were designed, at least initially, as crisis management tools; others were designed as reforms to improve Hungary's long-term economic fundamentals.

Crisis Management

As outlined in the first section of this paper, Orbán's government inherited a highly indebted country with a debt to GDP ratio of over 78% and a history of significant budgetary deficits. Previous government attempts to reduce the deficit resulted in the Hungarian economy coming to a halt, with GDP growth ratios close to zero in 2007 and 2008. The situation was further aggravated by the global economic crisis, and Hungarian GDP contracted by over 6% in 2009. Orbán refused to follow the IMF's recommendations to keep cutting public spending, which meant he needed to find new sources of income to keep the deficit in line with the IMF 2008 bailout terms.[4]

Special Taxes

To increase inflows to the country's coffers, the Fidesz government introduced special taxes aimed at corporations in selected sectors of Hungarian economy, which were characterized as temporary measures to spread the burden of the economic downturn more fairly.

These special taxes were not profit based. Tax amounts were calculated either on the basis of company revenues or total net assets (for banks) and total net premiums (for insurers). In some cases, application of the special tax depended on the size of a company's operations.

TABLE 1. Special taxes implemented in Hungary in 2010

Sector Concerned	Revenues threshold for tax application	Tax rate	Base of tax
Telecommunication	HUF5bn	6.50%	Revenues
Retail	HUF100bn	2.50%	Revenues
Energy	None	1.05%	Revenues
Banking	None	0.45%	Total Net Assets
Insurance	None	5.20%	Total Net Premiums

Source: György, 2014.

Given the extent of Hungary's privatization, which was largely conducted through sales to foreign investors, foreign owned companies were most impacted by the new levy. Despite causing a major outcry in Western European capitals (undoubtedly prompted

by lobbyists for the companies concerned), the special taxes seem to have achieved their primary goal. They generated significant extra tax proceeds. For example, in 2013 the amount of special taxes collected equaled c. 2.3% of GDP [IMF, 2014]. These special taxes were subsequently declared to be a permanent feature of the Hungarian taxation system.

Once permanent, the new tax regime can be viewed as a revenue source and part of a wider economic policy of the Fidesz government. As noted above, in the telecommunication and retail sectors special taxes apply only to large corporations. The exclusion of smaller players, mostly domestically owned SMEs, from this new taxation can be interpreted as part of a policy to level the playing field for all entities present in Hungarian economy. Though special taxes may not, in fact, have led to fairer burden sharing (since in all likelihood the extra costs were passed onto the final customers), it probably improved the competitive landscape for Hungary's SME sector.

The special tax on energy companies, imposed regardless of company size, also contained policy features. Taxes could be materially reduced by reinvesting a certain minimum amount of the cash flow generated by a company in a given year [György, 2014]. This tax break can be seen as a smart way of influencing private corporate decision-making.

Introducing special taxes that disproportionately impacted companies with foreign ownership was an unorthodox policy for Hungary and, more generally, Central European post-communist economies. Special taxes can be viewed as a departure from the policy of enticing FDI through numerous incentives, including tax holidays. The overwhelming number of economists quoted by the international press when the new taxation scheme was introduced opined that this move by the Hungarian government would have dire consequences. Surprisingly, the flow of FDI did not dry up and, by 2012, FDI inflow in Hungary exceeded the pre-crisis levels [Piasecki, 2014].[5]

Notably, one aspect of the special taxes introduced in Hungary worth recalling is that they were not profit-based taxes. Tax is calculated on revenues generated in the country, regardless of the stated profitability of such activity. Taxes of this kind could be an alternative to profit based taxes in the sectors where, it is believed, stated profitability is notoriously low due to questionable transfer pricing policies, which is a common practice of multinational companies that governments (especially in developing countries) lack effective instruments to control [Todaro, Smith, 2011, p. 691].

Economic Policy

Apart from the anti-crisis measures presented above, the Fidesz government implemented a range of economic reforms to improve the performance of Hungary's economy in the long- run.

Leveling the Playing Field

The need to the level playing field and end the dual economy was a common theme of the discussions with economists close to the Fidesz government [Siba, 2014; György,

2014; Erdei, 2014]. Attempts to address this issue can be seen in a number of initiatives. To address an uneven tax burden between mostly foreign-owned large corporations and mostly domestically-owned SMEs, one of the first changes to the Hungarian tax code in 2010 was to introduce two different corporate income tax rates. Large corporations were taxed at the rate of 18% of pre-tax profits, while SMEs were taxed at 10%.[6]

The Growth Credit Scheme was another significant initiative aiming at improving the situation of SMEs. This was implemented by Hungary's Central Bank, and not the government, but can still be generally credited to the government (or Fidesz) since it was introduced at the direction of the bank's new governor, Dr György Matolcsy, who had previously served as Minister of the National Economy in Viktor Orbán's government [György, 2014]. Under the scheme, Hungarian Central Bank provided up to HUF2,000bn (c. EUR 6.6 bn) at zero cost to the banks on condition that the funds be loaned to Hungarian SMEs carrying an interest set at 2.5% per annum.[7]

The government has also demonstrated an intention to maximize the share of the EU funds from 2014–2020 perspective that will go to SME sector (the target was 60% of those funds) [György, 2014]. It is also the government's intention to amendment the public procurement law to enhance the ability of domestic SMEs to win public tenders [Erdei, 2014].

Increasing Domestic Ownership

Fidesz politicians believe in the need to rebalance the ownership structure of the Hungarian economy in favor of domestic capital, both state and private capital. They are pronounced critics of both the scope of the privatization and the way it was conducted. In 2010, Viktor Orbán's government started the process of renationalizing certain private companies, declaring its intention to take control of companies from sectors deemed strategic, like oil & gas and power generation, as well as companies in a monopolistic position, such as utilities.

The renationalization of utilities seems to follow Ha-Joon Chang's recommendation: "*Enterprises in industries that are natural monopolies, industries that involve large investment and high risk and enterprises that provide essential services should be kept as SOE's (State Owned Enterprises), unless the government has very high tax-raising and/or regulatory capabilities*" [Chang, 2007, p. 119]. Those conditions are rarely met in post-communist countries of Central Europe.[8]

The nationalization process in Hungary is progressing. Viktor Orbán's government bought back a significant stake in the Hungarian national oil company, MOL, and nationalized several players in the power and utilities sectors. The government made also acquisitions that did not meet the above-mentioned criteria, buying assets in the banking and industrial sectors. However, economists close to Fidesz government have indicated that the government intends to sell assets back to domestic private sector once it is ready to absorb them. An example of re-privatization is Takarekbank, which was purchased

from German DZ Bank AG in 2012 and subsequently sold in 2014 to Magyar Takarek, an entity controlled by Hungarian private domestic capital [Naczyk, 2014].

Increasing Competitiveness

A focus of the Fidesz government is the competitiveness of Hungary's economy, which it recognized could not (ultimately) be built on cheap labor because labor costs increase as a country achieves higher levels of development. This weakens labor costs as a key factor attracting foreign investment over time. Manufacturers (both domestic and international) can easily relocate production facilities to new locations offering lower labor costs. The Fidesz government identified electricity prices as significantly impacting future corporate relocation and investment decisions, and nationalized power generation to secure low electricity costs for businesses operating in Hungary. This clear objective is also said to have driven the controversial decision to grant Rosatom a contract to expand the Paks nuclear plant. A key cost component of the electricity produced by nuclear facility is the initial capital expenditure required to build it. Moreover, given the length of construction period, financing costs can equal 100% of capital expenditures (interest during construction). Given that Paks expansion is Rosatom's first foray into the European Union, the cost of the plant can be expected to be very competitive. Secondly, up to 80 percent of the construction costs will be financed with an EUR 10bn long-term loan provided by Russian state[9] [World Nuclear Association, 2014].

It will be interesting to see whether electricity prices will be lower and, if so, whether those lower prices will outweigh the political costs of partnering with the Russian government during the current geopolitical situation. Meanwhile, rapprochement with Russia may also be reflected in lower gas prices under the extension of long term gas supply contracts declared to be agreed during Vladimir Putin's visit to Budapest in February 2015.

The Fidesz government has also signed a number of strategic partnership agreements with Western corporations already present in Hungary or considering investing in the country [Naczyk, 2014]. The signatories to those agreements, including Audi, Daimler, Suzuki, General Electric, Coca-Cola, and GlaxoSmithKline, are primarily in the manufacturing sector and their investments in Hungary are expected to be export oriented. These strategic partnership agreements can be viewed as an attempt to attract the type of FDIs that are the most beneficial for economic development, as opposed to creating favorable conditions to any foreign investment. This is in line with the current trend in developing countries to "*promote targeted FDI so as to complement their broader industrialization strategies*" [Todaro, Smith, 2011, p. 694].

There are voices[10] in Hungary that see a direct relationship between the prospect of a stable supply of competitively priced electricity (to be provided by expanded nuclear facilities at Paks) and the Fidesz government's ability to sign strategic partnership agreements with German manufacturing corporations.

It was reported that since 2010 the likes of Audi, Mercedes and BMW either expanded their manufacturing operations in Hungary or took decision to relocate some of their production facilities to Hungary. Despite a general dissatisfaction in the EU about Hungary's selection of Rosatom for Paks expansion without a tender process, it is rumored that Siemens, Germany's engineering heavyweight, will also participate in this project [AFP, 2015].

Incentivizing Work

One weakness of Hungary's economy (as seen by the economists close to Fidesz) was low level of labor participation – defined as the ratio of the number of people in labor force, those employed or actively seeking employment, to the total population. The labor participation rates for those aged 15 to 64 years for Hungary, and for its peers, are presented in Table 2.

TABLE 2. **Labor participation rate in 2009 (15 to 64 years)**

Czech Republic	Hungary	Poland
70.0%	61.5%	64.7%

Source: World Bank Database – 01, 2015.

Hungary's labor participation rate at 61.5% in 2009 was significantly lower than that of the Czech Republic and Poland, with c. 70% and c. 65%, respectively.

The Fidesz government publically recognized this weakness and launched several economic reforms aimed at increasing the labor participation rate and creating what they call a "*workfare economy*".

First, the government tried to incentivize employment by changing the tax regime. A flat personal income tax of 16% was introduced (as compared to progressive taxes in the Czech Republic (15–22%) and Poland (18–32%). The flat tax resulted in lower tax proceeds that were partly compensated for by increasing the value added tax rate to 27%, with the balance of revenue shortfalls made up by special taxes. The shift from income-based to consumption based taxes increased domestic savings, which helped reduce the share of government debt held by foreigners [György, 2014].

These tax changes were a carrot; the stick was reduced social benefits, to make working more attractive than living on public transfers.

Incentives to be part of the labor force were accompanied by initiatives to create more jobs. One such initiative was to increase flexibility of the labor law, which the Fidesz government now describes as being the most flexible in the EU [Erdei, 2014].

The Fidesz government also decided to get directly involved in job creation activity through public works to create job opportunities for the long-term unemployed. Critics highlight the short-term impact of the initiative; proponents see it as a first step for the long-term unemployed (or those returning to the labor force), on their way to securing permanent employment.

Viktor Orbán's Economic Reforms as a Coherent Proposal

Very often the economic policies of Viktor Orbán's government are reduced to the special taxes and re-nationalizations of private, foreign-owned companies. The actual picture is more complex. A number of policies implemented since 2010 are similar to those recommended by heterodox economists, such as Erik Reinert and Ha-Joon Chang, although Fidesz advisors do not seem to be drawing directly from the works of the two economists.[11]

Critics of Viktor Orbán's Economic Reforms

The reforms introduced by Fidesz have attracted much criticism from the domestic political opposition and various international institutions, as well as a number of public figures and representatives of foreign governments. Those critical voices were picked up by the foreign press and made it to the headlines. Reforms that raised the most controversy were not those directly linked to economic policy (for example changes in the constitution). That said, a number of economic measures were also heavily criticized. This section outlines the key arguments in opposition to Viktor Orbán's unorthodox economic policies as voiced by the European Commission, the IMF and János Kornai, who is one of Hungary's most famous economists.

European Commission

Lack of Growth Potential

A common theme in recurrent publications of the European Commission, Macroeconomic Imbalances – Hungary, is the Hungarian economy's lack of growth potential [European Commission – MI, 2012; European Commission – MI, 2013; European Commission – MI, 2014]. According to these publications this results from a low investment rate, accompanied by the lack of productivity growth. The investment rate (the share of investments in GDP) did indeed experience a significant deterioration, dropping from c. 23–24% level in the years 2002–2009 to c. 20% from 2010 onwards[12] [Eurostat Database – 06, 2015].

The low investment rate, in turn, is said to be caused by two phenomena; the deleveraging of Hungary's banking sector and deterioration of the business environment. According to the European Commission, certain policies implemented by Viktor Orbán's government have contributed to these negative phenomena.

Deleveraging

Deleveraging is the natural result of the economic crisis and unsustainable levels of public and private debt. However, the European Commission points to the special taxes imposed on banking sector as an additional factor that has negatively impacted the amount of credit being made available to companies operating in Hungary.

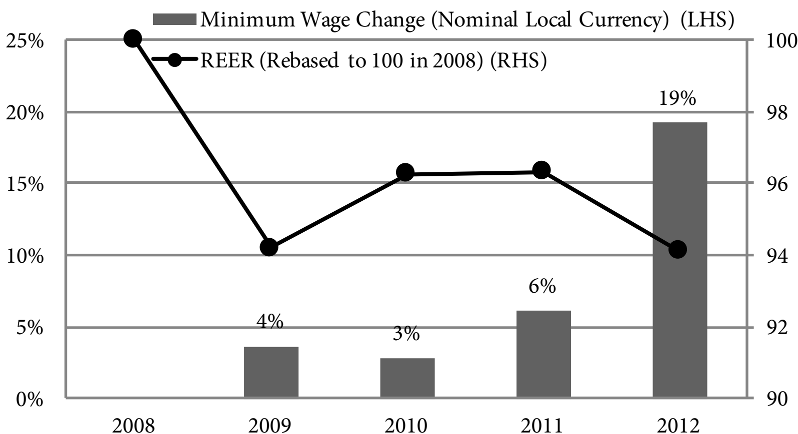
Business Environment

Most criticism of Viktor Orbán's economic policy relates to its impact on the business environment in Hungary. In a 2012 report, we read: "*The low level of economic confidence is also linked to a number of considerable (and often controversial) changes in the policy environment and legal and institutional system*" [European Commission – MI, 2012, p. 3]. The controversial changes referred to in the report are the introduction of special taxes, price controls in the utilities space, and certain restrictions on business in the retail sector[13]. The special taxes are viewed as distorting effective capital allocation and negatively impacting the level of both investment and lending [European Commission, 2013]. Suppression of the special taxes is also one of the 2012 Country Specific Recommendations issued to Hungary by the European Commission[14] [European Commission, 2013, p. 41]. The European Commission points to the deteriorating business environment as a key reason for a relatively low level of FDI inflows (recorded at 1.7% of GDP in 2010, significantly below 2002–2009 median of c. 4% [Eurostat Database – 07, 2015]). Lower FDI, in turn, translates into lower investment rate in Hungarian economy.

Competitiveness

The Hungarian economy's lack of growth potential is also attributed to deteriorating price competitiveness. Although the REER decrease that took place during the crisis (of c. 6% between 2008 and 2012) initially improved price competitiveness, a subsequent 2012 increase in the minimum wage (19% y-o-y in nominal terms) is expected to have eroded this gain in competitiveness [European Commission – MI, 2013] (see Figure 8).

FIGURE 8. Real effective exchange rate and minimum wage



Source: Eurostat Database – 09, 2015; World Bank Database – 02, 2015.

Outlook

As of April 2013, the view of the European Commission was that given its weak growth potential, the Hungarian economy will experience a second consecutive year of recession in 2013 followed by a moderate growth of 1.3% in 2014 [European Commission – MI, 2013]. In the next section we will see how far off from the reality those predictions proved to be.

International Monetary Fund

End of the Program

In case of the IMF, economic policy disagreements with Viktor Orbán's government led to expiry of the IMF Program before completion of scheduled reviews [IMF, 2011]. The disagreements revolved around "*the extent and sustainability of the proposed fiscal measures, notably on expenditure and corporate income tax cuts, as well as the size of a financial sector levy, regarded by staff as posing risks to growth and financial stability*" [IMF, 2011, p. 23]. Despite the end of the Program, the IMF staff continued to prepare and publish country reports for Hungary. The moderate criticism towards Viktor Orbán's economic policy reflected in 2011 report gives way to more assertive views in reports published in January 2012 and March 2013.

Domestic Policy Missteps

In March 2013, the IMF staff pointed to domestic policy missteps, along with structural factors, as reasons for the weak growth performance of Hungarian economy. This central argument mirrors that of the European Commission: "*increased state interference in the economy including through frequent and unpredictable policy changes (…) have hurt the investment climate, undercutting prospects for recovery*" [IMF, 2013, p. 4]. It is the IMF staff's view that "*Unconventional policies, high and uneven tax rates, and heavy regulatory burden have eroded investors' confidence and contributed to a sharp decline in investment, undermining growth and aggravating the ongoing balance sheet adjustments in the economy*" [IMF, 2013, p. 16].

Drop in FDI

A key concern of the IMF staff is a deterioration in the ratio of FDI inflows to GDP when compared to pre-crisis levels. The reasons for FDI inflow decreases, according to the IMF staff, are a deterioration of the non-price competitiveness of Hungarian economy, which is attributed to government policy. It is the view of the IMF staff that the drop in FDI undermines Hungary's growth prospects [IMF, 2014].

Outlook

As of the end of the first quarter of 2013, the IMF expressed relatively pessimistic view as to the growth potential of Hungarian economy. It expected real GDP to stay flat in 2013

with a mild recovery in 2014. It reiterated the poor investment climate and weak policies as being key reasons for bleak GDP growth prospects in the medium term [IMF, 2013].

János Kornai

János Kornai is an influential figure in the world of international economics whose views are widely followed. He proved to be a fierce critic of reforms implemented by Viktor Orbán's government [Kornai, 2012].

Centralization and Excessive Expansions of State

In Kornai's view, these reforms represent a reversal of the transition of Hungarian economy towards a capitalist market economy that was taking place since 1989. Kornai's criticism is focused on the process of centralization and increased role of the state in Hungarian economy. Being an economist close to the Austrian school [Lesson, 2008], he claims that "*it is mistake to think the various elements of state activity and the various elements of market activity can be combined in any desired proportion*" [Kornai, 2012, p. 584] i.e. the proportion of the state in the economy should be minimal. Kornai [2012] see no reasons for the state to be a shareholder; he describes the acquisition of 21% of shares in MOL by the Hungarian state as economically nonsensical.

State's Discriminating Policies Incompatible with Capitalist System

Kornai [2012] claims that discrimination between market players based on political grounds (such as exclusion of smaller mostly domestically owned retail entities from the special tax) is incompatible with the capitalist system. He also states that "*Brutally high 'crisis taxes' cannot qualify as praiseworthy 'unorthodox' methods of relieving citizens of higher direct taxes (…)*" [Kornai, 2012, p. 587]. Similarly to the European Commission's views, Kornai [2012] believes that special taxes, through reduction of corporate profits, will have a significant negative impact on investment.

Outlook

According to Kornai, the outlook for the Hungarian economy under Fidesz government is grim: "*(…) autocratic rule, unbridled centralization and excessive expansion of the state activity are incompatible with the healthy running of a modern capitalist market economy. Following this road it will be impossible to raise the Hungarian economy out of the trap, out of stagnation and onto a path of sustainable growth. And we will all be the sufferers by that, present and future generation*" [Kornai, 2012, p. 590].

Disappointingly, Kornai's article, ideologically charged as it is, limits its criticism of the reforms implemented by Fidesz to questions of principle i.e. their compatibility with the capitalist system. And, unlike the European Commission's reports, it does not provide much analysis of the concrete measures taken by Viktor Orbán's government.

Common Traits to Critics' Arguments

Though the criticisms by the European Commission, IMF and Kornai have different emphases, they share a common argument. Unorthodox policies implemented by Viktor Orbán's government have significantly, and negatively, impacted the business environment in Hungary. The deterioration in economic confidence has undercut Hungary's potential for future growth, predominantly through lower FDI inflows and low investment levels. In the years 2012 and 2013, the shared outlook for Hungary's economy, should Fidesz policies not to be reversed, was moderately pessimistic. The performance of the Hungarian economy since 2010, the subject of the next section, came as a surprise to most.

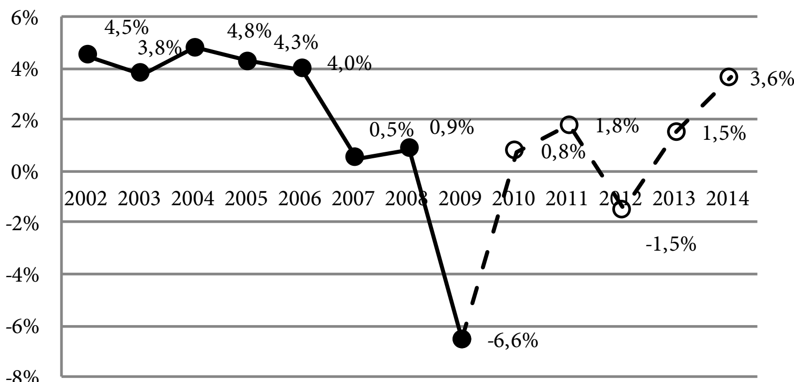
The Results of Viktor Orbán's Economic Policy

With the grim picture of 2009 in mind, we turn to how the Hungarian economy has done since. As indicated in the introduction, the analyzed time periods were selected to match the Hungarian electoral timetable. Naturally, a time lag is to be expected between implementation of certain initiatives (e.g., fiscal changes), and impacts on economic performance. When analyzing the results of Viktor Orbán's economic policy, we should focus on the period 2011–2014, with 2010 included for completeness since the parliamentary elections took place in the first half of 2010.

GDP Outperformance

The chart in Figure 9 presents Hungary's economic dynamics over the period 2002 to 2014.

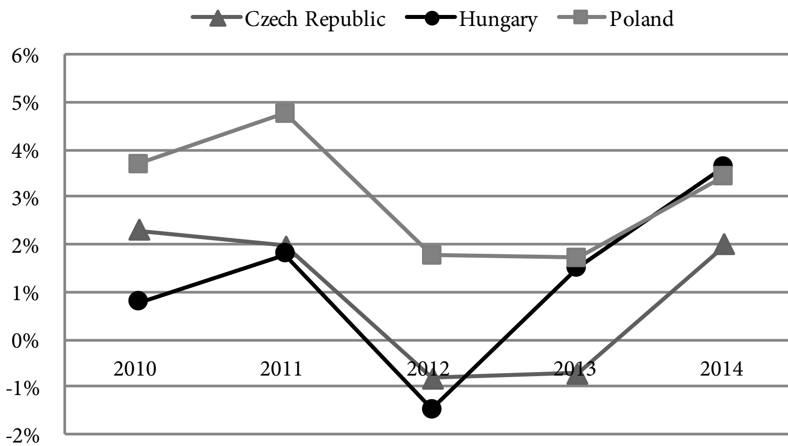
FIGURE 9. Hungarian real GDP dynamics



Source: Eurostat Database – 01, 2015.

The dashed line depicts the GDP growth under Viktor Orbán's government. The 2010 ended with growth of 0.8%. In 2011, the economy grew 1.8%, before slipping back into the recession in 2012. This coincided with intensified criticism of Fidesz's unorthodox economic policies. GDP started growing again in 2013 (at the rate of 1.5%), which continued in 2014 (3.6%). Figure 9 therefore presents a rather positive story of recovery. Figure 10 compares Hungary's performance in 2010 to 2014 with that of its peers.

FIGURE 10. Real GDP dynamics



Source: Eurostat Database – 01, 2015.

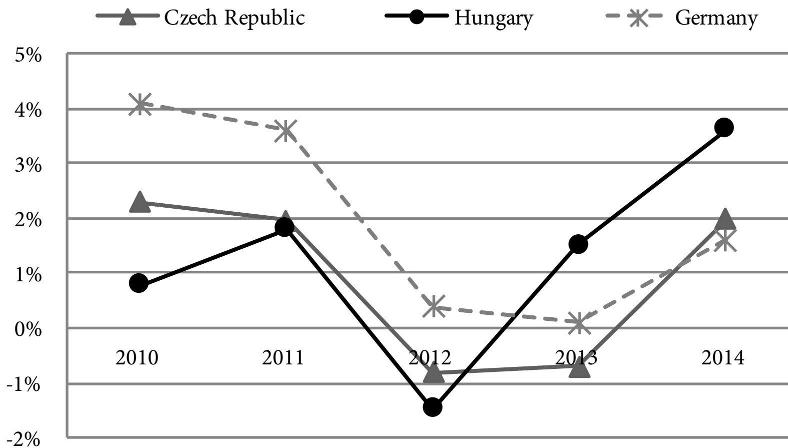
The Hungarian GDP growth pattern was similar to that of Czech GDP up to 2012. However, Hungarian economic performance in 2013 was significantly better than the Czech Republic's in the same period, and matched the GDP growth recorded in Poland. In 2014 Hungary outperformed both of these countries.

In case of a trade dependent economy (such as Hungary or the Czech Republic), economic performance is influenced by the performance of major trade partners. For both countries this partner is Germany; hence we substitute Germany for Poland in the real GDP growth chart (see Figure 11).

A clear relationship between Czech GDP and German GDP is confirmed by the correlation coefficient of 77%. This is not the case when comparing the pattern of changes in German GDP to that of Hungarian GDP, where the correlation coefficient is just 4%. This would suggest that other factors have a stronger influence on Hungarian GDP (at least during the period 2010–2014) than the performance of its most important trade partner. Without EU recovery it would be more challenging for Hungarian GDP to grow at the pace it actually did. However, Hungarian GDP outperformance cannot be credited

to simply external factors, especially when contrasted with the GDP growth recorded in a similarly trade dependent economy (i.e., the Czech Republic).

FIGURE 11. **Real GDP dynamics (including Germany)**



Source: Eurostat Database – 12, 2015.

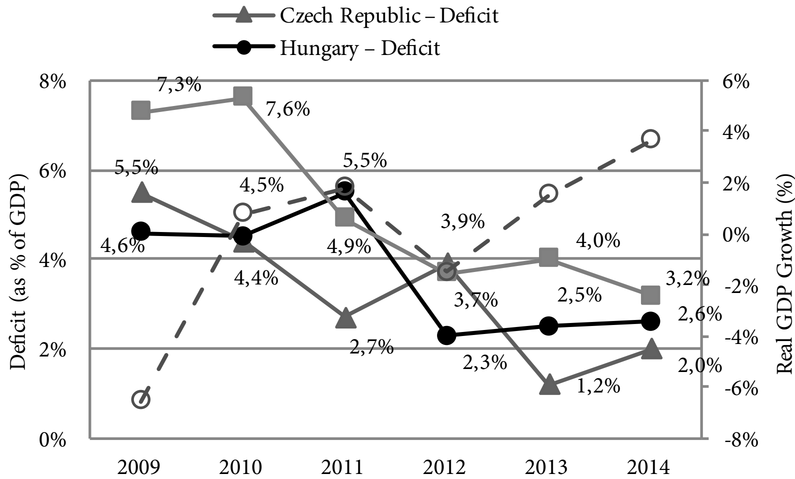
It is also worth mentioning, however, that despite its economic recovery, Hungary's GDP in 2014 (at EUR103.2bn in 2010 EUR) remained 0.6% lower than the pre-crisis 2008 GDP (at EUR 103.9bn) [Eurostat Database – 10, 2015]. Would it be then justified to state that Orbán's government only stabilized the Hungarian economy, and did not achieve economic growth? The answer is "no", since the 2006–2008 GDP level was fuelled by significant general debt increases that were unsustainable.

Stable Deficit and Debt Levels

Figure 12 indicates that the GDP growth since 2010 does not seem to be supported by increasing deficits, which were being gradually reduced from just below 5% of GDP (2009) to 2.6% (2014), with a one-time increase to 5.5% in 2011. Again, as in 2007, the significant drop in the 2012 growth rate was accompanied by a material reduction of the deficit (from 5.5% in 2011 to 2.3% in 2012). The GDP growth of 2013 and 2014 occurred despite the deficit staying at a similar level to that of 2012.

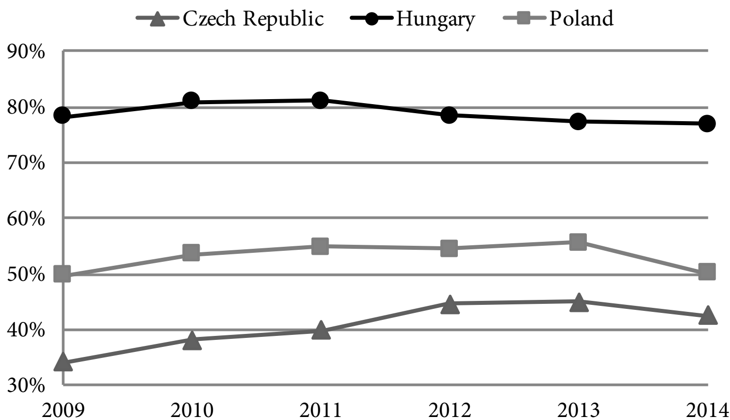
The moderate deficits in Hungary (being lower than those recorded in Poland) translated into a debt to GDP level of around 80%. Though stable, this debt level remains significantly higher than those of Hungary's peers (see Figure 13).

FIGURE 12. General government deficit as % of GDP



Source: Eurostat Database – 01, 2015; Eurostat Database – 02, 2015.

FIGURE 13. General government debt as % of GDP



Source: Eurostat Database – 03, 2015.

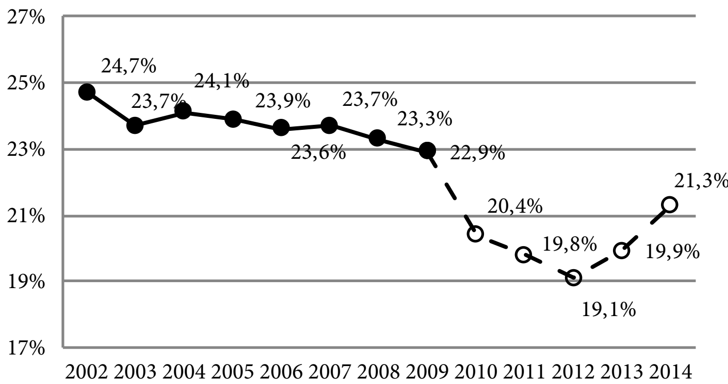
Hungary's debt to GDP ratio peaked in 2011 at 81%, followed by a moderate downward trend with the ratio reaching c. 77% in 2014. Over the same period, both the Czech Republic and Poland experienced debt to GDP ratio increases, although from much lower levels.[15]

Recovering Investment Levels

Share of Investment in GDP

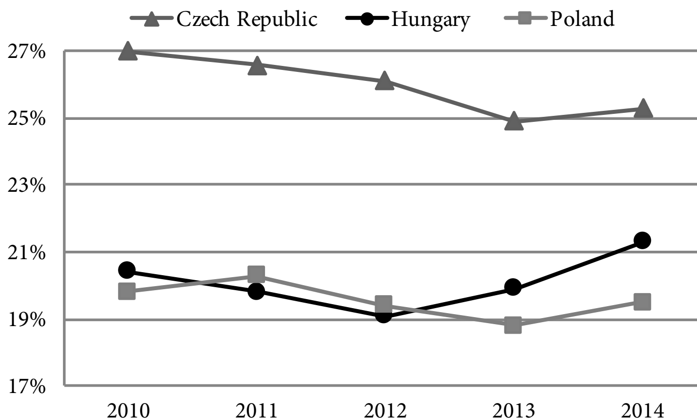
Both the IMF and European Commission cite low investment levels as a key reason for the weak growth potential of Hungary's economy. The share of investments in GDP remains significantly below the pre-crisis levels of c. 24% (see Figure 14). That said, the ratio bottomed out in 2012 at 19.1% and is slowly recovering, reaching 21.3% in 2014.

FIGURE 14. Investment to GDP ratio



Source: Eurostat Database – 06, 2015.

FIGURE 15. Investment to GDP ratio – Peer comparison



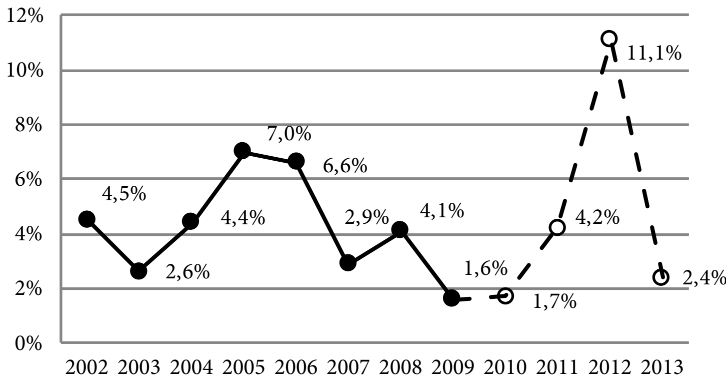
Source: Eurostat Database – 06, 2015.

Hungary's level of investment, as a fraction of GDP, was similar to that of Poland over 2010 to 2012 period (see Figure 15). The Czech Republic is a long-term outlier in this respect. The Hungarian investment ratio rebounded in 2013 and 2014, which is even more significant when compared to the performance of the Czech Republic and Poland. The investment to GDP ratio either remained flat (in the case of Poland) or declined (in the case of the Czech Republic). In absolute terms, the ratio was 2 percentage points higher in Hungary than in Poland by 2014.

Foreign Direct Investments

FDI inflow statistics present a mixed picture. FDI flowing to the Hungarian economy recovered from its crisis level, reaching 4.2% in 2011 and a historic high of 11.1% in 2012 (see Figure 16). This 2012 spike is due, in part, to the recapitalization of local bank subsidiaries by their foreign parent companies. Excluding this extraordinary flow, FDI inflows in 2012 would resemble those recorded in 2013. Moderate FDI inflows may reflect the reduced relative attractiveness of Hungarian economy (as indicated by the IMF), and the government policy of selecting new foreign investment. In their latest report, the IMF has recognized Hungary's effort and success in attracting foreign investments in manufacturing sector [IMF, 2015].

FIGURE 16. FDI to GDP ratio

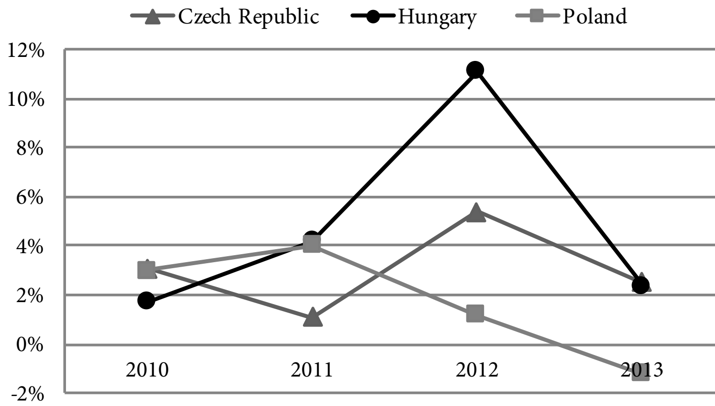


Source: Eurostat Database – 07, 2015.

As with the investment to GDP ratio, FDI inflows statistics for Hungary present a better picture when compared to those of its peers (see Figure 17).

Hungarian FDI inflows to GDP ratio in 2013 were at par with the Czech Republic's (2.5%) and significantly higher than Poland's, which turned negative (–1.2%). Unfortunately, FDI statistics for 2014 are not yet available in the Eurostat database.

FIGURE 17. FDI to GDP ratio – Peer comparison

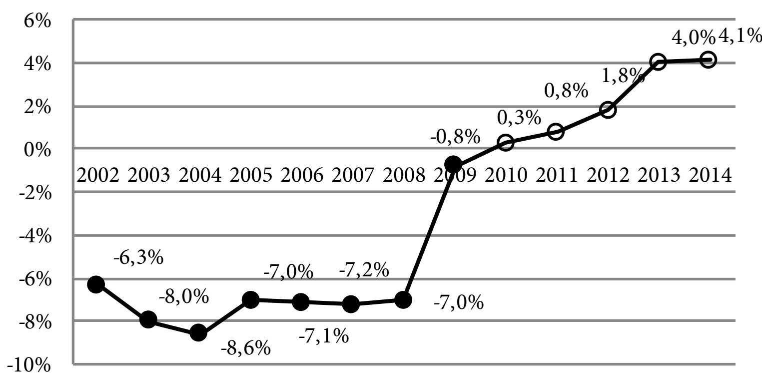


Source: Eurostat Database – 07, 2015.

Current Account Surplus

Both the IMF and European Commission downplayed the importance of the current account surplus experienced by Hungary. Since that surplus was explained by a drop in domestic demand due to the crisis, the current account balance was expected to return to negative territory once economic activity picked up. Despite a significant improvement in domestic demand in 2013 and 2014, current account surplus increased on rising exports, reaching c. 4% in 2013 and 2014 (see Figure 18). This surplus is not readily attributable to falling oil and gas prices, as the trade deficit in mineral fuels, lubricants and related materials increased during the 2009–2014 period [Eurostat Database – 11, 2015].

FIGURE 18. Current account to GDP ratio



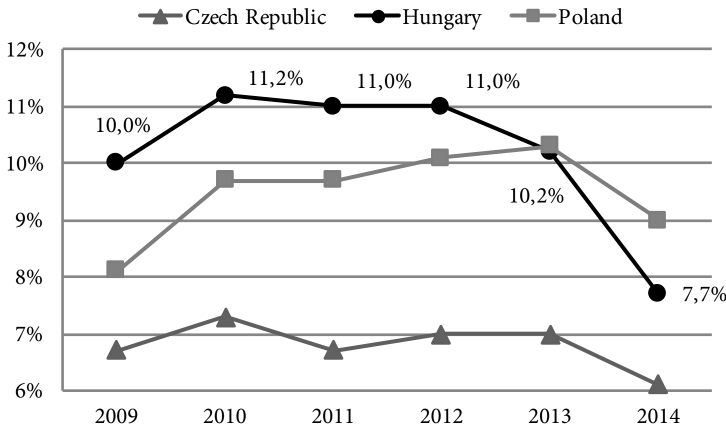
Source: Eurostat Database – 08, 2015.

During the period 2010 to 2014, Hungary's current account balance as a percentage of GDP was, on average, 4.6 percentage points higher than the Czech Republic and Poland. In 2014, Hungary's 4.1% surplus is to be compared with a 0.6% surplus for the Czech Republic and 1.4% deficit for Poland [Eurostat Database – 08, 2015].

Encouraging Unemployment Statistics

The Hungarian labor market also showed signs of improvement since 2010, especially when set against that of its peers. Unemployment decreased during the last two years and, in 2014, was at 7.7%, which is lower than the Polish unemployment rate (9%), though behind that of the Czech Republic (6.1%) (see Figure 19).

FIGURE 19. Unemployment



Source: Eurostat Database – 04, 2015.

The European Commission cited public works scheme as a reason for (in their view) a temporarily improved Hungarian unemployment rate [European Commission – MI, 2014]. The latest IMF report indicates that although this was true for 2013, the contribution of the business sector overtook that of budgetary institutions (including public works) in 2014 [IMF, 2015].

Also positive is that improvement in the unemployment rate was accompanied by increased labor force participation, which by 2013[16] reached 64.3%, which is the highest level recorded in 2002 to 2013 period [World Bank Database – 01, 2015]. Nonetheless, Hungary still trails its peers, as labor participation rates improved in both the Czech Republic (c. 73%) and Poland (c. 67%) [World Bank Database – 01, 2015].[17]

Orbánomics?

Although we have only up to 5 years of available data, we can draw some conclusions about the results of Orbán's unorthodox economic policies since 2010. At a minimum, Hungary avoided the downside scenarios predicted by critics, including the IMF and European Commission. The country staved off bankruptcy, and was able to repay the IMF facility and tap international bond markets.

The more detailed review of various economic performance indicators performed in this section suggests that significant improvements occurred in most (if not all) areas of the Hungarian economy, in either absolute terms or in comparison to Hungary's peers. This significant improvement in the Hungarian economy is recognized in the latest IMF report [IMF, 2015]. However, the IMF also stresses Hungary's continuing external vulnerabilities, which remain significant due to high net foreign liabilities, despite recent improvements on the IMF's three key macroeconomic indicators (current account balance, foreign currency reserves and fiscal balance) [IMF, 2015].

Unlike the IMF, European Commission is more skeptical when analyzing Hungary's recent economic performance. The Commission credits the higher absorption of EU funds with most of these positive developments in Hungarian economy, and expresses the unshaken belief that government policies implemented by Fidesz represent a significant drag on potential economic growth [European Commission, 2015].

Naturally, it is yet to be seen whether the fundaments of Hungarian growth will be permanent. Current statistics (through May 2015) are, however, promising.

The unorthodox policies implemented by Viktor Orbán are not often called Orbánomics by the international press. This expression, which resembles Japan's Abenomics (name after Japanese Prime Minister Shinzo Abe), carries positive connotations (if not of appreciation, then at least of respect). Given Hungary's economic performance since 2010 (and especially over the last two years) this expression may appear more often going forward.

Conclusions

The Hungarian economy was in crisis at the time of the 2010 elections. The immediate reason was the unsustainable level of government debt, amplified by the global economic crisis. Economists close to Fidesz see the crisis as a result of mistakes made during transition from a centrally planned to a market economy. The key economic policies implemented by Viktor Orbán's government, despite their populist flavor, present a coherent proposal, consistent with one's interpretation of the root causes of Hungary's economic misfortunes. Based on the statistical data available for 2010 to 2014 period, these reforms seem appropriate in response to Hungary's economic situation in 2010. The country avoided bankruptcy and resumed GDP growth. The year 2014 is the second consecutive year of

real GDP increase in Hungary, and marks the first time since the crisis when Hungary's economy outpaced that of the Czech Republic and Poland. Nonetheless, the jury is still out on whether the economic policies implemented by Viktor Orbán's government laid a lasting foundation for long-term growth.

The perceived shortcomings of transformation – as outlined by economists close to Fidesz -were a shared experience of all major Central European countries. A number of politicians and economists view Hungary under Fidesz as an experiment with policies that go against the recommendations of the IMF and World Bank, as well as the neo-liberal paradigm. Hungary's success can be a powerful tool in the hands of a new wave of reformers in countries that may want to follow Viktor Orbán's example. However, the power of this example has somewhat weakened by Fidesz's controversial involvement with Russia in pursuit of an independent policy. Nonetheless, Hungary is the first country in Central Europe (since the anti-communist revolution triggered by Solidarność movement) that is experimenting with an independent economic policy. The results of this experiment, if ultimately positive, could have profound consequences for the other countries in Central Europe and beyond.

Notes

[1] Marcin A. Piasecki: marcin.a.piasecki@hotmail.com

[2] The content of this section draws to a large extent from the findings of György and Veress (György & Veress, 2014), supplemented by information collected during interviews conducted by the author in 2014 [György, 2014; Barcza, 2014; Siba, 2014; Veress, 2014; Dombi, 2014; Erdei, 2014].

[3] Small and Medium Enterprise.

[4] 3.8% of GDP [IMF, 2009].

[5] The 2013 proved to be more difficult with FDI inflows in Hungary dropping significantly, however this wasn't an isolated case, the FDI inflows in Poland turned negative over the same period of time.

[6] To be exact the first HUF500 m of a given company's pretax profit are taxed at the rate of 10%, anything above that threshold at the rate of 18% [Deloitte, 2012].

[7] The banks are taking the credit risk of the SMEs.

[8] In Poland, the anecdotal evidence tends to support this assertion. Foreign corporations that acquired Polish power generation assets are generally known for trying to avoid committing any funds to capital expenditures in their Polish subsidiaries, with French EDF being the most notorious example.

[9] It is worth contrasting with the case of nuclear project currently being developed in the UK. According to the UK government and EDF, the construction of the nuclear, new built plant, to be economically viable requires not only a guarantee of a set electricity price covering a period of 35 years but also a government guarantee for the totality of external debt that is going to be raised to finance the costs of the project. Should Hungary decide to apply UK approach, the construction would need to be postponed for a number of years because of the current level of debt.

[10] The source wished to remain anonymous.

[11] Surprisingly most of author's interlocutors were not familiar with the works of those hetorodox economists.

[12] The European Commission reports indicate 17% as investment rate for Hungary in 2012, however this is not supported by the data that can be found in Eurostat database (Eurostat Database – 01).

[13] The argument on business restrictions presented in the European Commission report is based on anecdotal examples of limitations on construction of large commercial facilities and limitations of the number of pharmacies that can be owned by single owner (European Commission – MI, 2012). Those two examples can hardly support an economy-wide argument of business restrictions being introduced by Viktor Orbán's government.

[14] „*CSR 5: (…) ensure a stable regulatory and business-friendly environment for financial and non-financial enterprises, including foreign direct investors. (…) establish a stable, lawful and non-distortive framework for corporate taxation. Remove unjustifiable restrictions on the establishment of large-scale retail premises. (…)*" [European Commission, 2013, p. 41].

[15] The general debt statistics presented in this paper follow Eurostat ESA 2010 methodology and as such they are not impacted by one-off effects of pension plan reforms in both Hungary and Poland.

[16] 2014 data is not yet available.

[17] This being said even Czech Republic is significantly behind the countries like United Kingdom or Germany, where labor participation rate was recorded at c. 77.4% and 76,2% respectively in 2014 [World Bank Database-01, 2015].

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