Vikinomics vivisected

In a stunning policy reversal, the government was briefly contemplating last week the introduction of a solidarity tax, which in effect would mean the abandonment of its most treasured reform, the flat tax. Economic policy overall has failed to deliver on the government's projections, which were not all too ambitious to begin with. Most pressing, however, are the budgetary troubles, as sluggish growth yields less revenue than anticipated. The government is scrounging for money left and right, but every measure has proven insufficient to balance the shortfall from the flat tax and lagging VAT revenues. Still, the problems lie deeper than a mere failure to collect enough money and the question is if the government will recognise this.

Prime Minister Viktor Orbán has wagered his entire economic programme on the unorthodox supply side policies proffered by György Matolcsy. The risky wager looks increasingly like a deal gone bad. The government is continually plagued by the need to revise revenue and deficit projections.

From the outside, the efforts are occasionally reminiscent of plugging holes in a sinking ship. The government has already admitted that due to lagging growth revenues are slimmer than planned, which means that if the 3% deficit target is to be adhered to – the government continues to insists that it will – then further spending cuts must be enacted, or else revenues must be increased, read taxation.

And many experts say this year is comparatively benign – next year, without nationalised private pension funds to hold it over, the deficit could go through the roof unless the government takes drastic countermeasures.

How did we get here?

Prelude

The central tenet of Fidesz' economic plans, if you recall, was that all the crisis-stricken Hungarian economy needed was a major tax cut. Fidesz had been pushing this point relentlessly for a while now, well before it actually assumed the helm. Orbán's famous pronouncement on the issue was that "the greater the crisis, the larger the tax cut" that is necessary.

Pursuant to supply-side economic philosophy, the idea was that economic growth unleashed by the incentives that lower tax rates provide would compensate for lower revenue per currency unit earned. Concerned about the deficit, the IMF balked at the idea, and was shown the door in return for its refusal to endorse the government's plans. Its misgivings were apparently not unfounded.

Though it refused to renounce the flat tax rate regime it was seeking to introduce, the government was planning some measures to counterbalance the anticipated shortfall in income tax revenue (some 500 billion forints).

With a stroke that for all intents and purposes constituted a nationalisation of the mandatory private pension fund system, the government pumped staggering amounts of money into the public coffers (though not fully captured, the total wealth in these funds constituted over 10% of GDP). Surprisingly, even the acquisition of this vast amount of money appears like a mere stopgap measure in light of the government's inability to get a grip on the deficit.

Down austerity lane

On top, the government has for example slashed unemployment benefits; it seeks to realise savings by driving persons that retired early or illegitimately (by having themselves declared disabled) back into the labour market and by enforcing – retroactively! – the mandatory pension age for hitherto privileged groups that were legally allowed to retire early, such as those serving in the uniformed services; and it is levying new taxes, such as the infamous "hamburger tax", assessed on a range of often used unhealthy products.

Still, even though they foresaw the drop in income tax revenues, the budget calculations for this year were overly optimistic. With the economy lagging far behind expectations, the government's most crucial source of income, VAT, is diminished as well. PM Orbán has already announced that this year's budget needs to be revised to find another 100 billion in savings.

Worse is to come next year. Since growth was projected to pick up in the coming year but won't, or at least not to the degree anticipated, balancing the budget will require further painful measures. LMP's economic policy expert Gábor Scheiring expects that a combination of cuts and new revenues worth 560 billion will have to be found somewhere to adhere to the deficit targets. Though the projected figures vary, this view is by no means limited to the political opposition, but is espoused by experts as well.

About-face

The imposition of ever new austerity measures is already a striking departure from Fidesz' communication in opposition. The issue is not only that Fidesz bashed all and any attempts to curb spending between 2002-2010. It was not only against specific measures, but as opposition leader Orbán argued on grounds of economic policy that austerity measures were bad.

The cognitive dissonance dimension of this issue is handled by refusing to call austerity measures austerity measures. And, in fairness, the government's insistence that the above-mentioned actions are not austerity but, in essence, reform (not that they'd ever use that word, either), is to a certain extent justified.

The labour market is one of the few areas where the government has genuinely enacted sweeping changes, many of them with no immediate budgetary effect. While we'd argue that these realise excessive limitations of workers' rights, what cannot be claimed is that they fail to embody a new vision of how the labour market should look.

Thus far the concept, namely that workers forfeit rights so that employers will find it less risky to hire them, has generated little enthusiasm for creating new jobs. But is nevertheless one of the very few areas where the government has moved towards strategic change.

That said, it is no coincidence that these reforms will also end up saving the exchequer a fair amount of money (at a higher cost to social stability). Easing the burden on the budget – i.e. austerity – is definitely one consideration behind these measures.

Solidarity now

More significantly, a government MP was hinting that it might abandon its most sacred reform to save the budget. Interestingly, the stunning announcement came in the form of a radio interview by a KDNP backbencher, former newscaster István Pálffy, gave to left-wing Klubrádió, where he hinted that the rich might have to pay a "solidarity tax", read higher tax rate.

Those who follow the Fidesz-aligned press and saw there a surprising critique of the flat tax and its effects might have had an inkling that such a move was in the offing. Most observers, however, were caught off guard. Fidesz was so in love with the flat tax rate that it is considering enshrining it in the constitution, so that future governments won't have the option of changing back to a system of progressive taxation.

The government has continuously insisted that the flat tax is its most important policy measure and the basis for its economic programme. Its abandonment, even temporarily, would be an acknowledgment that the economic programme is not developing as planned. While the higher tax rate on high earners would be a welcome change – especially in light of the fact that the higher net incomes of top earners have done little to nothing to spur economic growth – it is insufficient if it is merely another avenue for collecting more money.

The question now is whether this will lead to strategic adjustments beyond the attempts to collect more money for the unhinged budget. Fidesz is famously disinclined to admit mistakes, and abandoning its economic course would be a harsh blow. But with the international environment increasingly dashing hopes that a global boom might help spiral the Hungarian economy out of its puny and insufficient growth, the day of reckoning might come sooner than even some critics of the government's economic programme anticipated.