POLICYSOLUTIONS

# The budget deficits haunt the Hungarian government

*With their profligate ways, many governments have sown the seeds of potential penalties from Brussels on account of excessive budget deficits, but the Orbán-government is now most likely to reap the dire consequences. The European Commission threatens to withhold half a billion euros in Cohesion Funds from Hungary – this would be a first not only in Hungarian, but in European history – unless the budget deficit is brought under control, i.e. persistently 3% or less. While the government insists that it has done precisely that, the Commission is sceptical, arguing that Viktor Orbán's Cabinet has manoeuvred mostly based on one-off revenue items that do not guarantee long-term budget sustainability. The government still has the chance to avert an outcome whereby Hungary loses funds, and the question is whether it will grasp this opportunity. Another crucial question is whether in response to the current conundrum it will seek to portray the European Commission as a hostile force.*

The budget deficit has been one of the most sensitive public policy issues over the past decade, and though successive governments have paid in various ways for the failure to rein in spending and/or raise more revenue, the Orbán government is now in line to pay the highest price of all. A price in fact, that would be unprecedented not only in Hungarian, but even in European comparison. In the framework of an excessive deficit procedure, the European Commission has decided to withhold some 500 million euros in Cohesion Fund payments from Hungary, unless the Orbán government manages to present evidence of substantial budgetary improvement over 2012. This is a sanction that has never been imposed on any country.

The government's difficult situation is tied in with its efforts to secure an IMF loan, which would be needed to ensure that Hungarian public finances do not spiral towards a situation wherein a default becomes a realistic scenario. Orbán's stance is that the threat of essentially taking money away from Hungary is unfair and clearly disingenuous in light of the fact that there are countries in significantly worse state. In line with Orbán's argument, there is a strong suspicion on the political right in Hungary that the threatened sanctions are part of a politically inspired scheme to punish the Fidesz government for its independent course.

The EU's position is that Hungary is indeed the most suitable candidate for employing such sanctions, but not on account of the other political disputes between the European Commission and the Orbán government. Let's briefly review how the budgetary situation got to where it is and then review the arguments proffered by the Hungarian government and the European Commission, respectively.

### *A brief history of the Hungarian budget deficit*

After regime transition, the new Hungarian democracy and market economy was already burdened with a huge national debt. It was the government of Gyula Horn - the first socialist-liberal cabinet after transition - that began massively cutting the deficit and the debt. The first Orbán cabinet, which succeeded the MSZP-SZDSZ coalition in 1998, largely followed the same line of orthodox budget policy, keeping the deficit in check. It was mainly during its last year, in the run-up to the election, that the spending under Orbán shot up. One interpretation advanced is that especially in new democracies election year budgets tend to be bloated, and that medium-term fiscal balance could sustain such outliers if balanced by a thrifty post-election period.

2002 was unusual in the sense that the new government set out to realise its campaign promises and introduced vast new spending. The new government was in trouble from two fronts, as Fidesz charged that it had won the election through fraud, and the new PM, Péter Medgyessy, was revealed to have worked for the communist secret service under the old regime. Analysts argue that its decision to implement its campaign promises was taken to stabilise the coalition's position, which was perceived as shaky.

### *The spendthrift years continue*

When Medgyessy's successor, Ferenc Gyurcsány entered office in October 2004, the budget for 2005 was already done, and he made the fateful decision not to implement austerity measures. This was also the year when the excessive deficit procedure against Hungary began in Brussels. Gyurcsány's next opportunity to address the growing deficit and debt was the 2006 budget. Since this was an election year, however, the deficit ballooned instead, culminating in an election victory for the incumbent and the infamous Őszöd speech, in which the PM admitted that a radical change of course was needed.

The next years saw a significant but nevertheless insufficient effort to curtail the deficit. The international financial crisis of 2008/2009 exposed Hungary's extreme vulnerability due to its debt, and Gyurcsány's successor, Gordon Bajnai, had to cut spending radically to stave off a bankruptcy. By the time the second Orbán Cabinet came into office, the budget was in much better shape than in 2006, but still in need of further consolidation.

### *Fidesz's view of things*

Fidesz own position is that it inherited a mess from Bajnai in 2010 - Fidesz spokespersons repeatedly referred to "skeletons in the closet" - and that it undertook a significant effort to ensure that the deficit adhere to the Maastricht requirements, an effort that the Commission fails to appreciate. The 2010 budget, designed under Bajnai – though corrected by Fidesz – and mostly implemented by the new government, featured a 3.9% deficit, while Fidesz's first own budget was somewhere around the magic mark of 3%. This Ministry of National Economy projects that this year's deficit, too, will be under 3%.

As a trend, thus the Fidesz argument, there is definitely significant improvement going on, and generally the European Commission tends to appreciate such efforts. Moreover, Fidesz points out that the Hungarian deficit is currently one of the lowest in the EU, which makes the proceedings somewhat ironic. The most obvious explanation therefore is that this is part of a political vendetta against Hungary's successful political and economic course, which the European left and the forces of orthodoxy wish to thwart.

***The European Commission's view***

Brussels' official position is that the deficit procedure is unconnected to other issues and that, correspondingly, the threat of withholding money does not serve to pressure the Orbán government generally. This does not imply that from the Commission's point of view there are no other problems with the Hungarian government's policies, but only that those are not addressed in the framework of the excessive deficit question. In fact, the decision about the existence of an excessive deficit is far older in the case of Hungary - it stems from as early as 2004 - than for the other EU countries facing such a verdict.

More importantly, however, the European Commission is unhappy with what the government labels an improving trend. Despite warnings from the Commission, the Orbán government has based its relatively consolidated year in 2011 to a large degree on funds that are one-off or unsustainable revenues: particularly the nationalised private pension insurance savings and the bank and crisis taxes levied on large corporations. At the same time, the most significant recent source of budget problems, the flat tax, will persist. In the long-run, the trend is anything but improving in Hungary. According to the Commission, in light of the fact that Hungary has been in the penalty box for so long and that the Orbán government will have three years and two budgets under its belt by the time the withholding kicks in, this is fair.

***Another chance***

It is important to point out that as the starting date of the excessive deficit warning – 2004 – shows, the now threatened withdrawal of Cohesions Funds is the failure of the entire political elite, and not that of Fidesz alone. It is also crucial to consider that this is not the penalty yet, but only a final warning. By ensuring that the 3% deficit is met with sustainable policies, the government will not lose the funds. This will likely require some austerity measures, potentially even extensive ones. It may even necessitate the suspension or abolition of the government's most important economic policy measure, the flat tax.

Austerity, however, is also likely to be a precondition of the IMF loan, and just now Prime Minister Viktor Orbán himself admitted that Hungary needs the IMF because without it the country could not finance its financial needs two years hence. Though critics point out that the PM's assessment is still far too optimistic, the point is nevertheless that he appears to acknowledge that the IMF deal is necessary, and thus he may also be willing to perform the austerity measures that the Monetary Fund and the EU likely require.

Regardless of what the government will ultimately do, it may decide to heap blame on the Commission, for the pressure and/or the subsequent austerity. This will very likely result in growing euro-scepticism, however, which would in turn produce new problems for Hungary's membership in the EU.