GKI Economic Research Co.

We analyse and forecast. You decide.

THE ECONOMICS OF REDUCING OVERHEADS

It seems that following the restructuring of the legal and institutional framework of the state, the Hungarian government considered that the time has also come for the **"non-traditional" transformation of its EU-conform market economy**. Since the budget and the government debt are difficult to handle and the EU's excessive deficit procedure also represents major limiting factors, the traditional redistribution of incomes before the forthcoming elections is not a viable option, thus **"non-traditional" methods of redistribution** should be applied to achieve the same goal.

The first step has been the **forced reduction of households' overheads, which has become part of the government programme**. The choice of topic is arguably **clever**. Since the proportion of costs associated with energy in household expenditures is undoubtedly high, especially in those with incomes below the average, government measures aiming at tapping alleged excess profits of service providers meet the understanding of the general public. (This is all the more so since energy service provider companies are mostly in foreign ownership, similarly to the banking sector.) Holding the energy sector to ransom **would not create dramatic situations** in the short run as the effects of the measures in the sector typically are felt over a time-span of decades. The government may consider that the economic disadvantages forced by legal means and suffered by the business sector are a small price to pay for the benefits given to households. In fact, however, the economic implications of these measures can cause serious problems in the medium term as well.

The 10 per cent reduction of gas and electricity retail prices is **economically unfounded**. The world market price of gas may decline; however, at present it has no direct impact on the Hungarian purchase price. It will only affect future prices based on new agreements (effective from 2015). The situation is similar to this in district heating, water and wastewater treatment and waste collection as well. In our globalised world, the prices of energy sources are based on an external factor: the world market price of crude oil. National economies should accept and adapt to it. Countries depending on the imports of energy sources are especially compelled to adjust their consumer prices to the world market prices of energy sources. Natural gas plays a decisive role in Hungary's energy mix, and approximately 80 per cent of it is imported. In spite of the intentions of the government to turn this situation, this rate will hardly change until the end of this decade.

In spite of the views of the government and the general public, available statistical data published by the EU **do not justify that energy prices in Hungary are unrealistically high**. Domestic gas and electricity prices are in the middle of the range of prices of EU countries. Prices are slightly lower in Hungary than in the neighbouring Eastern European countries, and they are 10 per cent higher than in the developed countries. According to the preliminary data of the relevant domestic enterprises, in 2011 and 2012 the energy supply of households was unprofitable, whereas that of the competitive sector was profitable. Based on various official data, it seems to be obvious that the extremely large proportion that gas and electric costs represent in the expenditures of households is **mainly caused by the very low income of people (only one quarter or one third of the developed countries) and not by high prices or unrealistic profits**. The problem is that the denominator of the cost ratio is only one third of the average income of households in the EU, and this is what makes this ratio irritatingly high. (This is why the proportion of food is also very high in Hungarian consumption.) By the way, this excessively high rate is typical of Eastern European countries. **Therefore, the present proportions can hardly be**

reduced permanently by the forced reduction of retail prices. This is so because the import price of gas is an external factor for the Hungarian economy, and the range of costs that can be influenced domestically is very limited. The price of imported gas is currently around USD400/1000 cubic meter, and the recent dollar/forint exchange rate is HUF235, thus the price of gas entering Hungary is HUF94/cubic meter, or HUF120/cubic meter with the inclusion of 27 per cent VAT. According to HCSO data, the average retail price of gas was HUF136/cubic meter at the end of 2012. Consequently, the enforced 10 per cent price cut introduced as of 1 January 2013 eats up the total distribution expenditures of suppliers in domestic gas supply. Thus, the 10 per cent price reduction eliminates not only the profits, but it entails that the new price could not cover the costs of domestic suppliers.

According to our calculations, the 10 per cent price reduction represents about HUF100bn savings for households at the current consumption level (HUF20bn loss for the budget, and HUF80bn loss for the suppliers). In economic terms, overheads are used in conjunction with a variety of concepts, especially in connection with costing in the business world. According to various calculations, the average overhead costs of Hungarian households are around 40-50 per cent of incomes; however, this figure fluctuates widely. The majority of households do not have any freely disposable income. This reduction of overheads is quite unfair: **the poorest families using relatively small amounts of electricity and natural gas (half a million households have no gas supply through pipes) realize little or no benefits at all, whereas the highest income 20 per cent account for two thirds of the estimated HUF100bn of this "national present".**

The battle against overheads can hardly be won by official price reductions motivated by political reasons. Although the expenditures of households can be alleviated temporarily, someone has to pay energy costs at the macro-economic level. The unprofitable universal (public) services compel suppliers, on the one hand, **to increase their profits in the free market (corporate) segment** reducing the already weak competitiveness of the business sector, and, on the other hand, to minimize their expenditures by further reducing their already poor investment spending and downgrading the quality of supply and safety. This is a severe blow to their small- and medium-sized suppliers as well, hindering employment and economic growth. Not to mention the negative impacts on foreign investors.

GKI ECONOMIC RESEARCH CO.

1092 Budapest, Ráday u. 42-44.
Phone: +36 1 318 1284
E-mail: gki@gki.hu
For more information: Miklós Hegedűs