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Restructuring taxes: helping equilibrium, killing growth

According to the forecast of GKI Economic Research Co. prepared in co-operation with Erste Bank, the restructuring of taxes in 2011 brings the general government deficit under 3 per cent of GDP, however, it is disadvantageous for economic growth in both the short and the long run. In 2011 GDP is expected to grow by 2.5 per cent, but household consumption will be up only by 1 per cent at most, whereas household savings increase further.

Since the inauguration of the new government considerable additional temporary taxes and charges exceeding 2.5 per cent of GDP have been announced. In the next three years the financial, energy and telecom sectors as well as retail trade companies will have to pay extra taxes. In the next 14 months beginning form November the compulsory private pension contribution of 2.8 million people will be taken away by the government. Tax allowance options for employees will shrink. At the same time, by introducing a flat rate and raising child benefits, the government aims to lift the income of some households via personal income taxation by a total amount corresponding to about 2 per cent of GDP. Beneficiaries include approximately 1 million employees, families with children and some 500 thousand people, who have high income in the white economy, of which especially the 150 thousand, who earn more than HUF 500 thousand per month, will do better.

The increase of tax revenues and the cuts on government spending together ensure that the general government deficit will be below 3 per cent of GDP. However, if the Constitutional Court or the EU cancels some laws, attaining the deficit target can be in danger. The ways of substituting the recent measures in the long run seem also questionable. Nonetheless, there is no danger yet as regards external disequilibria, because domestic consumption increases only moderately and the inflow of EU funds will be substantial. By the end of 2011, Hungary's total net foreign debt may decrease to EUR46 billion from EUR52 billion at the end of 2009.

Within investments, the development projects of export-oriented multinational companies will be determining, and there is no significant improvement expected in branches, upon which the extra levy is imposed and in SME sector, which has difficulties in obtaining credit. As the personal income tax changes favour mostly the high-income strata, rising real income will result in a smaller increase of consumption and in a higher growth of savings. This will be offset only partly by the improvement of the position of families with children, because there are only a few high-income families with many children, which can actually benefit from the more advantageous tax rates.

The decreasing trend of inflation will slow down because prices of energy and public utilities were kept under control prior to the local government elections, which causes an upward inflationary pressure, not to talk about the effects of the extra taxes. Rising purchasing power of households means less sharp constraints to raise prices. Provided that international markets welcome the 2011 budget as well as the revised convergence programme that demonstrates the long-term commitment of the government to equilibrium, confidence in the Hungarian economy and the forint is likely to set to return slowly. However, to have a successful convergence programme, the expenditure side of the budget needs to be reformed in a systemic way, which has to be announced and started - this way the temporary nature of recent tax increases could be demonstrated for the sake of credibility. Similarly to the first half of 2010, the annual average exchange rate of the forint to the euro will be around HUF270. The official rate of the National Bank of Hungary may be reduced only slightly, to about 5 per cent, taking also into account the likely interest rate increases in international markets during 2011.

Industry will have the highest growth rates in 2011, too, however, as growth in external markets slows down, its rate of growth decreases slightly and domestic demand is set to increase only in the second half of the year even in the best case. However, following many years of decline, growth is expected to start in construction and trade as well.

The forecast of GKI Economic Research Co.: the Hungarian economy in 2010-2011

	2008	2009	August 2010	2010 (forecast)	2011 (forecast)
1. Volume of GDP (previous year=100)	100.6	93.7	100.5*	101	102.5
2. Industrial production (constant prices. previous year=100)	98.9	82.3	110.0	108.5	107
3. Investment in the national economy (constant prices. previous year=100)	97.0	91.4	94.5*	97	104
4. Construction (constant prices. previous year=100)	94.9	95.7	89.2	92	104
5. Retail trade (volume index. previous year=100)	98.2	94.8	96.7	98	101
6. Exports (current prices in euro. previous year=100)	105.6	81.1	122.1	116	112
7. Imports (current prices in euro. previous year=100)	105.6	75.3	119.4	115	113
8. Trade balance (EUR billion)	-0.2	4.0	3.5	5..3	5
9. Balance of the current and capital account (EUR billion)	-6.5	1.4	1.7*	2.9	3
10. Average exchange rate of euro (forints)	251.2	280.6	275.1**	276	270
11. Deficit of the general government (cash flow basis. without local governments; billion forints)	909	918.6	1089**	890	790
12. Index of average gross earnings	107.5	100.5	102.5	102.5	103.5
13. Consumer price index (previous year=100)	106.1	104.2	105.2**	104.8	103.8
14. Consumer price index at the end of the period (corresponding month of the previous year=100)	103.5	105.6	103.7**	104.0	103.7
15. Rate of unemployment (at the end of the period. per cent)	8.0	10.5	10.9***	11.3	11

* First half of 2010
** Q1-Q3 2010
*** Q3 2010
Sources of actual data: HCSO, NBH, MoF