Hungary under Orbán: Can Central Planning Revive Its Economy?

Simeon Djankov

Simeon Djankov, visiting fellow at the Peterson Institute for International Economics, was deputy prime minister and minister of finance of Bulgaria from 2009 to 2013. He is author of Inside the Euro Crisis: An Eyewitness Account (2014) and coeditor of The Great Rebirth: Lessons from the Victory of Capitalism over Communism (2014).

Since Viktor Orbán was elected prime minister of Hungary in 2010, the state has had a rising role in many sectors of the economy, either through nationalization, as in banking and energy, or through aggressive regulatory changes, as in insurance and retail. Economic policy in Hungary is moving towards centrally planned capitalism, similar to the economic development model pursued in Russia and Turkey. The apparent success and popularity of Hungary’s economic policy, in contrast to a lack of growth models in Europe, is moving some leaders in other former communist bloc countries to emulate Orbán, with the possible consequence of undermining the European Union’s structural reform efforts.

The dominant political figure in Hungary over the past 15 years, Prime Minister Viktor Orbán shares three features with Russian president Vladimir Putin. First, both frequently refer to their countries’ imperial histories and the uniqueness and exceptionality of their societies, invoking nationalist memories of past glories and fostering an attitude that leads to aggressive foreign policy. Second, both Orbán and Putin consider the increasing role of the state to be beneficial for their economies. And third, both consider the Western European economic and democratic model to be flawed. For these reasons, in recent years Orbán has carved out a regional leadership niche as a proponent of closer ties with Russia and a frequent fighter against the European Union’s fiscal and foreign policies.

The main economic policies in Hungary under Orbán are fivefold. First, reduce the fiscal deficit to below 3 percent of GDP through nationalizing the second pillar of the pension system and levying higher taxes on the banking, telecom, insurance, and retail sectors. Second, nationalize some strategic assets, primarily in the energy sector. Third, increase the role of the state in banking through nationalizing some banking sector assets and restructuring the state-owned development bank and postal services to deliver credit. Fourth, create monopolies in certain sectors, for example the production of tobacco and alcohol products. And fifth, reduce mortgage and small business lending rates through government subsidies.

Under Orbán, the public administration has been an arena for political battles, resulting in frequent and sweeping changes in top bureaucratic positions. However, the political cycle in Hungary has tolerated such swings before, with each incoming government clearing out the remnants of the past. In this regard, Orbán’s actions are merely an outgrowth of, and not a deviation from, the post-communist history of the last 25 years.

Both Orbán and Putin consider the Western European economic and democratic model to be flawed. Hungary has so far earned him popular support at home. This popularity is to a large extent because of the weakness in the European economy and the absence of successful economic models to follow in Europe after the collapse of the Irish banking sector in 2010. In the 1990s and early 2000s, Ireland was considered the model for small European economies like Hungary. The lack of focus on economic growth issues in Brussels in the past few years and the failure of the Lisbon Strategy, adopted in 2000 to bolster Europe’s international competitiveness by 2010, have led some countries to consider alternative growth models (Djankov 2014). As a result, some institutional investors, for
example the mutual fund Franklin Templeton, have bought several billion dollars’ worth of Hungarian government bonds, betting on the long-term success of Prime Minister Orbán’s economic policies.\footnote{Peter Eavis and Julie Creswell, “A Contrarian Bets Ireland and Hungary Will Rebound,” \textit{New York Times}, February 7, 2012.}

If the Hungarian economy continues to grow and the European Union fails to formulate a growth agenda, other politicians in the former communist bloc may follow Orbán. Some already have, for example Slovak prime minister Robert Fico. Currently in his second term, Fico has attempted to regulate food prices, has threatened gas companies with nationalization unless they reduce prices for households, and is steering foreign economic relations towards closer ties with Russia. Slovakia has followed Orbán’s lead in nationalizing the second pillar of their pension systems. As another example, Andrzej Duda recently won the Polish presidency on a platform borrowed from Orbán’s playbook. President-elect Duda promises to increase social benefits for families, reverse pension reforms, and raise taxes on banks. He also considers foreign ownership of banks to be detrimental to the Polish economy. Most importantly, Greek prime minister Alexis Tsipras has studied Hungary’s arguments with the European Union for clues on Greece’s own strategy of negotiations with the European Commission.

The increasing influence of Viktor Orbán’s policies has stark implications for the European Union, as its attempts at reforming public finances in the member countries will be undercut by the advent of unorthodox policies in Eastern Europe. So far, this trend has been pronounced in Southern Europe, with Northern and Eastern Europeans forming the fiscally-responsible, reform-minded coalition in the Union. A shift in this balance away from structural reforms will further retard Europe’s growth.

The economic policies undertaken during the second and third term of Orbán’s ascend to power have left Hungary exposed to increases in corruption and currency volatility. The nationalization of some productive assets and the concession of rights to sell certain consumer goods have brought about a bevy of corruption allegations—which in turn have scared off some private (mostly foreign) investors, reducing capital formation and hence prospects for higher economic growth. Currency volatility has increased as well, due to the higher dependence on public investment, both financed by the national budget and EU funds. This volatility reduces portfolio investment in Hungary, especially by Western European pension funds. However, Orbán has escaped the attention of the European Union, as corruption scandals in the governments of neighboring Poland and the Czech Republic have distracted the European Union from insisting on stronger transparency in public procurement and on stricter enforcement of competition policy in Hungary. Outside of such insistence, the European Union has limited means to influence Hungary. Reducing or freezing the flow of cohesion funds, as Orbán’s political opponents have sometimes suggested, has no legal grounds.

**INITIAL CONDITIONS AFTER COMMUNISM**

In 1990, at the beginning of the transition from a centrally planned economy, Hungary had the second highest income per capita in Eastern Europe, trailing only Slovenia. Twenty-five years later, Hungary trails the Czech Republic, Poland, Slovakia, Estonia, Latvia, and Lithuania, as well as Croatia. Something went wrong in the transition period.

Hungary’s initial conditions for a successful transformation were favorable. First, it had the most open and market-orientated economy among members of the communist bloc. Already in the 1980s, half of its foreign trade was with the West. Second, prices and domestic commerce were liberalized, with few monopolies retained by the central planning committee. And third, private business was allowed not only in small-scale agriculture—as it was in the former Czechoslovakia and Poland—but also in industry and services.

Some additional market reforms were implemented just before the collapse of central planning. In 1987, Hungary established a two-tier banking system with an autonomous central bank and competing (still state-owned) commercial banks. In 1988 the young economist Miklós Németh became prime minister and ushered in a new tax system, including personal income tax and value-added tax.

**THE EARLY TRANSITION EXPERIENCE**

In the early post-communist period, Hungary was considered the country that would have the most successful transformation in Eastern Europe. The initial steps in this direction looked promising. The first democratically elected government of József Antall (1990–93) introduced significant reforms that led to the restructuring of the Hungarian enterprise sector. The government set up a strong and transparent privatization
agency, which concentrated all ownership rights of the state in an efficient and corruption-free institution, making it easy for potential buyers to negotiate with the authorities in good faith. New laws on banking, insurance, state asset management, privatization, accounting and reporting, bankruptcy, and liquidation contributed to the fast and sweeping rejuvenation of the corporate sector. As a result, Hungary’s economy did not experience the significant collapse in production that other East European countries went through in the early 1990s (Bokros 2014).

The missing element in this first wave of reforms was sustainable fiscal policy. Thanks to chronic deficits in the last years of socialism and the first years of democracy, by the end of 1994 Hungary was on the verge of default. Pressed by international institutions, the government of Gyula Horn (1994–98) implemented a comprehensive stabilization program in March 1995. The program, designed by finance minister Lajos Bokros, included three major elements: a one-off 9 percent devaluation of the currency and the introduction of a crawling peg with gradually lower rates; an 8 percent surcharge on all imports except primary energy and investment goods, with a timetable for phasing it out; and a reduction in real wages to increase Hungary’s international competitiveness.

Several structural reforms also took place: the introduction of tuition fees for higher education, the first in Eastern Europe; the reorientation of social transfers toward the needy by partial means testing; the introduction of a copayment for dental care; the abolishment of free accident insurance for sole entrepreneurs; limits to sick leave; the establishment of a treasury system in public finance; and the introduction of limits to municipal borrowing. In 1998 the government introduced pension reform and made private pension funds mandatory for people entering the labor market for the first time. This was a major step forward, as East European countries like Hungary face a demographic decline because of rapidly aging populations (Bokros 2013).

As a result of these measures, the Hungarian economy experienced a quick recovery and enjoyed a period of export-led growth between 1996 and 2001. In this period, growth averaged 3.5 percent, with exports rising by over 20 percent annually (figure 1). Much of the exports were driven by an inflow of foreign investment.

**FISCAL PROFLIGACY: 1998–2010**

The fiscal reform of 1996 and the pension reform in 1998 reduced the popularity of the socialist government, and the center-right party Fidesz won the 1998 parliamentary elections. Its leader Viktor Orbán became prime minister at age 35. Orbán’s political rise started as a student protester against the communist regime and the Soviet troops in Hungary. He was one of the founders of Fidesz, a radical student organization that was transformed into a center-right people’s party.
employees and a large one-time supplement to all pensions. Pension payouts that had not reached the level of the minimum wage were also increased to match it. Medgyessy’s approval rating soured, as did the budget deficit. Still, the government frequently increased social payments in later years, tripling public sector wages in the process. In 2005 alone, the new social commitments amounted to €940 million. The budget deficit reached 6.1 percent of GDP. Hungary thus became the only post-communist economy consistently lacking responsible fiscal policies. It is the only country in Eastern Europe that has never had a balanced annual budget.

In 2006 the Socialist party was reelected on a platform promising reform without austerity. This was easier promised than done, as Hungary’s budget deficit had grown to 10 percent of GDP. The continuous fiscal laxity portended disaster. And it came, with the global financial crisis. Declining exports and reduced domestic consumption and investments hit Hungary hard at the start of the financial crisis in 2008. Economic decline reached –6.4 percent of GDP, and revenues fell precipitously. The only way to avert economic disaster was to reach an agreement with the European Union on a rescue package. Initially the government demurred, worried about the impact on the next elections. But in October 2008, Hungary reached...
In October 2008, Hungary reached an agreement with the International Monetary Fund and the European Union for a $25 billion rescue package.

as we have. It can be explained. We have obviously been lying for the last one and a half to two years. It was perfectly clear that what we were saying was not true. … We lied morning, noon, and night.” This revelation started a wave of protests that continued until the prime minister resigned in 2009.

THE SECOND COMING OF ORBÁN: 2010–14

In the 2010 elections, Viktor Orbán’s party Fidesz won nearly 70 percent of the vote, a constitutional majority. Orbán came back with a mission to transform Hungarian society. Hungary never had a proper transition from communism, he argued in his election speeches. It kept its 1949 constitution, and its weak lustration law passed only after a number of top politicians were exposed as members of the secret police. The old communist regime and secret service dictated politics and permeated economic life, leading to a corrupt political system and the near bankruptcy of the Hungarian economy by 2009.

The only way to clear the morass was a fundamental transformation in policy and in the administration. But Orbán felt that Hungary, as unique and different from other European countries, should not copy the economic policies of the more developed countries of the European Union, which were losing competitiveness, but should instead seek its own way to foster growth. Orbán’s resolve won sympathies and fed off the rise in anti-EU attitudes after the 2008 financial rescue package.

Since its repeat rise to power, Fidesz has adopted positions on key historical events that have been staples of the Hungarian nationalists’ agenda and that raise anti-EU sentiment. In 2010, for example, the party passed legislation creating a day of national commemoration for the 1920 Treaty of Trianon—the peace agreement between most of the Allies and the Kingdom of Hungary that formally ended World War I and reshaped Hungary’s borders—a step that reinforced a sense of Europe’s guilt in Hungary’s view. Through the erection of statues and other commemorations, Fidesz has also resurrected the memory of Admiral Miklos Horthy, the interwar regent of the Kingdom of Hungary, also seen as a victim of European diplomacy. And Orbán immediately acted upon his election promise for a constitutional amendment to label the former communist party a criminal organization and list its crimes against the Hungarian people.

Orbán is quite open about where he stands regarding liberalism and European democracy. “I don’t think that our European Union membership precludes us from building an illiberal new state based on national foundations,” he said in a July 2014 speech. “While breaking with the dogmas and ideologies that have been adopted by the West, we are trying to find the form of community organization, the new Hungarian state, which is capable of making our community competitive in the great global race for decades to come. Among the rising ‘stars’ of the new world order being built are Russia, Turkey, and China. None of which is liberal and some of which aren’t even democracies.”

This view that democracy and liberalism are not required to run a globally competitive economy has underscored five main features of the government’s policies during Orbán’s tenure. The first feature is the reduction in the fiscal deficit, based mostly on aggressive tax and structural policies for pensions. The primary deficit was eliminated by 2013 as a result of fiscal consolidation efforts. Debt reduction was achieved, mostly thanks to the sizeable capital transfer ($14 billion in assets, or 10 percent of GDP) that resulted when the state took over mandatory second-pillar private pension assets in 2011. In particular, savings in age-related costs account for about two-thirds of the consolidation effort. By 2013, the budget deficit was brought down to 2.5 percent of GDP—the lowest in the whole post-communist history of the country.

Tax policy was significantly revised to meet this target. First the marginal rate of the value-added tax was raised to 27 percent, the highest in the European Union. Fidesz also levied additional taxes on banking, insurance, retail trade, telecommunications, and electricity and gas distribution. Some new sector taxes were introduced and some existing ones were increased. For example, the tax on advertising in the media, in force since August 2014, was increased from 40 percent to 50 percent. A 4.5 percent turnover tax was introduced on tobacco manufac-

---

turers and distributors. Retailers are now charged a new “food chain fee” of up to 6 percent of annual turnover.

But the biggest revenue earner was the bank levy introduced in 2011. Hungary is not alone in charging a bank levy, but—at 0.6 percent of the banks’ total assets—it has one of the largest. The proposed levy was popular with ordinary Hungarians, who blamed banks for saddling them with foreign-currency denominated loans that became harder to repay as the forint weakened during the euro area crisis (Djankov 2014). And since the six biggest banks in the country, not counting the domestic OTP Bank, are subsidiaries of foreign banks, they became an easy target for politicians.

A second important feature of Fidesz’s economic policy during its second term was the nationalization of strategic assets, consistent with Orbán’s desire to strengthen the role of the state in the economy. In 2011, for example, the government reacquired a 20 percent stake in Hungarian oil conglomerate MOL from the private Russian company Surgutneftegaz at a price of €1.9 billion—or €700 million more than what Austria’s oil and gas company OMV paid Hungary for MOL in the original privatization sale in 2004.

“From a national strategic point of view, we have managed to place one of the most important corporations into safe hands,” Orbán commented on the purchase. “No country can be strong if its energy supply is exposed.”5 In 2012 and 2013, Hungary also bought back the domestic utilities owned by Germany’s utility firms E.ON and RWE.

The third feature of economic policy since Orbán’s return to power is the substantial nationalization of the banking sector. The stated purpose is to reduce the domestic economy’s dependence on foreign banks. During the euro area crisis, mother banks in Western Europe shored up their home bases at the expense of their East European subsidiaries, hence the conclusion that over-reliance on foreign banks hurts the Hungarian economy. Indeed, nonperforming loans in Hungary’s banking sector increased to 14 percent in 2013, about double the rate for the rest of Central Europe.

Orbán’s solution was to reestablish the state as a significant owner in the banking sector. A series of acquisitions between 2013 and 2015 transferred 13 percent of bank assets to government ownership.6

In parallel to this acquisition spree, the government developed an extensive bank branch network to reach smaller clients. The effort centered on the Hungarian Post with its 2,700 units nationwide. In September 2014, the Hungarian Post acquired a minority stake in FHB Bank to tap its lending expertise. The government also restructured the system of savings associations, with their nearly 1,600 branches, and opened new branches for the Hungarian Development Bank Group, Hungary’s only state-owned bank up until 2012. With these transformations, the share of bank assets in the government’s hands will likely rise to 20 percent by the end of 2015. Orbán also said in mid-2014 that Hungary should have the courage to reshuffle ownership of its banks to ensure that “at least” half of the sector is in Hungarian hands.7

But while solving one issue, Orbán is creating another, potentially bigger problem. Increasing the role of the state in the banking sector raises the possibility of politically-directed lending. State-owned banks tend to favor lending to companies that are close to politicians. Such lending is not usually based on sound banking principles and breeds inefficiency as well as corruption. In some countries in Eastern Europe, it has led to the collapse of the banking system—for example in Lithuania in 1995–96, Bulgaria in 1996–97, and Croatia in 1998–99. Croatia and Slovenia have skirted disaster more recently.8

A fourth feature of Orbán’s economic policies is the establishment of monopolies in various sectors of the economy, distorting competition. One example is the new network of “national” tobacco shops. Following on an election promise, Fidesz submitted legislation establishing the state monopoly on the retail sale of tobacco in December 2011. The stated dual purpose of the law was to restrict minors’ access to cigarettes and to provide small family-run businesses with economic opportunities.

Most monopolies come with corruption opportunities, and these national tobacco shops are no exception. The media reported that more than a third of the tobacco concessions were awarded to people connected directly to Fidesz. In early 2013, a newspaper published a recording in which the

---


6. Stakes in two small banks—Széchenyi Bank and Gránit Bank—were acquired in late 2013. In 2014, the government bought MKB, Hungary’s fifth largest commercial bank, from Germany’s Bayerische Landesbank. In February 2015, the government acquired Budapest Bank, the eighth largest commercial bank, from GE Capital.


The appeal of these populist policies, combined with a stronger economy and the capture—through legal and even constitutional change—of many aspects of political and social life, led to another election victory. In April 2014, Orbán’s Fidesz government was reelected with a two-thirds majority in parliament. This third election victory gives the government a further political mandate to continue the alternative economic path established with the policies started in 2010–14. For example, the central bank launched a new $2 billion program—Funding for Growth Scheme Plus—that services small businesses through a partial takeover of the credit risk by the central bank. Its predecessor program is widely popular in Hungary and has been credited with boosting the popularity of the ruling party. Another debt assistance program, started in late 2014, targets distressed household borrowers. Where the borrowers are not able to pay their mortgages, the state buys the properties from commercial banks. Once the state takes over the mortgages, the terms are revised to extend their maturity and allow an initial grace period. The program has bought up about 25,000 apartments so far—mostly properties bought using Swiss franc or euro-denominated credit—and may ultimately cover about 150,000 apartments.

Another expanded program—on public works—aims to reduce unemployment among the less-educated. A precursor mayor of Szekszárd can be heard telling the Fidesz members of the city’s municipal council, while examining a list of local tobacco-concession bidders, that “one must be a committed right-winger” and “good, good, don’t let the socialists win!”

The fifth prominent policy of Orbán’s government is the Funding for Growth Scheme designed in 2012 to reduce the burden of corporate credits to smaller businesses. During the euro area crisis, because some viable businesses had difficulty paying debts, temporary state assistance was necessary for these companies to continue operations. In the first phase of the program in 2013, about $2.8 billion of credit was given out, of which 40 percent (or 1 percent of GDP) was given as new credit and the rest to refinance existing debt.

In 2014, prior to the parliamentary elections, the Funding for Growth Scheme was expanded by another $8 billion (or nearly 8 percent of GDP). The program was broadened to cover more types of borrowers, and lending limits were increased to medium businesses as well. It is credited with increasing the growth potential of the economy and contributing to the 3.6 percent increase in GDP in 2014—one of the highest annual rises in income since the start of transition (figure 3).

to this program, started in early 2014, gave temporary work to 200,000 workers. This year the program was expanded to include 250,000 workers, with the goal of reaching 350,000, or nearly 9 percent of the employed Hungarian population, by 2018—the year of the next parliamentary elections. With this program, Hungary is becoming the East European country with the largest share of the population working in the public sector.

But the most marked characteristic to date of Orbán’s third term in power is the reorientation towards Russia as a strategic business partner. In September 2014, Orbán signed an agreement with Russian president Vladimir Putin to expand Hungary’s only nuclear plant, with Moscow providing a loan worth $13.9 billion, or 12 percent of Hungary’s GDP. “We can only make Russia interested in Hungary’s economic success if it receives a privileged partner status with a major contract,” Orbán stated on the occasion.10

The costs of this enormous investment are planned to be evenly distributed during the construction phase from 2018 to 2025 and would result in an annual primary budget deficit of 1.1 percent of GDP. “We are convinced that locking Russia out of Europe is not rational,” Orbán said. “Whoever thinks that Europe can be competitive, that the European economy can be competitive without economic cooperation with Russia, whoever thinks that energy security can exist in Europe without the energy that comes from Russia, is chasing ghosts.”11

Orbán has also been the most active European head of state in support of Gazprom’s South Stream project. Since the refusal of the Bulgarian government to continue with the project and Putin’s announcement of its cancellation in December 2014, Hungary has played the pivotal role to drum up support in Europe for an alternative project. In February 2015, Orbán hosted Putin in Budapest, his first state visit in the European Union after economic sanctions were imposed last year. Both Orbán and Putin backed a successor to the South Stream project by expanding a proposed Russian pipeline into Turkey to route the gas through Greece and the Balkans to Hungary. This may fulfill Orbán’s goal of Hungary becoming an energy hub in the heart of Europe.

The most marked characteristic to date of Orbán’s third term is the reorientation towards Russia as a strategic business partner.

CONCLUSIONS

Since the start of its transition from a centrally planned economy to capitalism, Hungary has fallen short of expectations to join Western Europe in terms of living standards and democracy. The country has been plagued by the most persistent budget deficit of any country in the post-communist world.

The dominant political figure in Hungary, Prime Minister Viktor Orbán, now in his third term, shares many features with Russian president Vladimir Putin. Both view the increasing role of the state as beneficial for their economies. And both consider the Western European economic model to be flawed.

Economic policy has veered towards a rising role of the state in many sectors of the economy, either through outright nationalization or through aggressive regulatory changes. The charted course is towards centrally planned capitalism, similar to the models of economic development pursued in Russia and Turkey. The three clearest manifestations of this new economic course are the partial nationalization of the banking sector, the monopolization of some sectors of the economy, and the reversal of the pension reforms of 1998.

The increasing role of the state has created greater opportunities for corruption. Dealing with this challenge may be one of Prime Minister Orbán’s biggest tests; previous scandals in Hungarian politics have shown how sensitive voters can be to allegations of corruption. Repairing Hungary’s relationship with the European Union, long regarded by Orbán’s administration as a public adversary, is another challenge. But the biggest challenge that Hungary faces is to establish a fiscally sustainable growth path, something that no Hungarian government has managed to do in the post-communist period.

In the past five years, the European Union has been preoccupied with the euro area crisis and the continued problems in Greece and more recently Ukraine. These crises have reduced the European Union’s opportunity to pay sufficient attention to Hungary. When the time comes, the major focus of discussion will be how to ensure sustainable economic growth for Hungary within the European economic space. Brussels is currently struggling to enunciate an economic model that can appeal to post-communist politicians like Viktor Orbán. Failure to provide a compelling growth model will result in an increasing draw towards interventionist state policies in other East European countries. The recent Polish presidential election has demonstrated how imminent this danger is.

REFERENCES


This publication has been subjected to a prepublication peer review intended to ensure analytical quality. The views expressed are those of the author. This publication is part of the overall program of the Peterson Institute for International Economics, as endorsed by its Board of Directors, but it does not necessarily reflect the views of individual members of the Board or of the Institute’s staff or management.

The Peterson Institute for International Economics is a private nonpartisan, nonprofit institution for rigorous, intellectually open, and indepth study and discussion of international economic policy. Its purpose is to identify and analyze important issues to make globalization beneficial and sustainable for the people of the United States and the world, and then to develop and communicate practical new approaches for dealing with them. Its work is funded by a highly diverse group of philanthropic foundations, private corporations, and interested individuals, as well as income on its capital fund. About 35 percent of the Institute’s resources in its latest fiscal year were provided by contributors from outside the United States. A list of all financial supporters for the preceding four years is posted at http://piie.com/supporters.cfm.