EQUILIBRIUM INSTITUTE

HOW CAN WE BECOME WEALTHIER?

THE EQUILIBRIUM INSTITUTE'S POLICY PROPOSALS FOR BOOSTING ECONOMIC GROWTH

POLICY PROPOSAL

2021. MARCH

2021-02

EXECUTIVE SUMMARY

- Hungary ranks among the poorest Member States of the European Union today. At the same time, the Hungarian economy has a lot of potential for growth. Our goal is to ensure that by pursuing sound economic policies and stimulating the Hungarian economy, our country can join the ranks of the wealthiest EU Member States by 2030.

- During the past decade and a half, the Hungarian economy has performed roughly 30% below the level its potential would have made possible. Unless we change course, the joint impact of the deterioration in the international environment, the decline of the working-age population, and technological progress will lead to Hungary falling even further behind instead of catching up to the more successful countries.

- Today, the Hungarian state is large and very active, but it performs poorly. The structure of our budget impedes economic growth, the tax burdens on wages and salaries are high in international comparison, while the tax system overall is not well-targeted and unstable. Corruption effectively acts as an additional tax on the economy, while public debt and inflation give rise to excessive risk premiums, thereby further slowing economic growth. State subsidies, in the meanwhile, introduce warped incentives into the market. All of these combine to reduce the flexibility of the Hungarian economy and compromise its ability to withstand crises.

- By 2030 we need to create a paperless, fully digitised service-centred state which offers a growth-friendly environment for the economy! Making VAT refunds available immediately would be commensurate with a large-scale and ‘cheap’ economic stimulus credit programme. In order to increase the security of property, the system of corporate bankruptcy and winding up needs to be comprehensively reformed.

- In order to increase transparency, acquisition and options contracts above a certain value threshold should only be considered legally effective if they are uploaded into a public National Registry of

Contracts! Furthermore, all state contracts and invoices paid by the state should be open to public review unless they involve issues of national security.

- The Hungarian economy needs to become cash-free! Private persons and corporations alike should use electronic payment methods! To this end, the share of cash – which makes it easier for the black economy to operate and also facilitates tax avoidance – has to be at least halved by 2030; but this needs to be achieved in a way that does not make life harder for the poorest. All cash withdrawals and deposits above a threshold value need to be subject to a higher tax. In instances when cash is used in the acquisition of real estate or other high-value goods, the buyer should be obliged to verify the origin of the cash to the tax authority! By 2030, the state should pay all pensions and social transfers exclusively by way of electronic deposits!

- We should be taxing 'bad' things – that is things that need to be scaled back – rather than the 'good' things, that is those activities which produce value! The tax wedge of the average salary needs to be reduced to the OECD average, namely 36%! Within the European Union, we need to support the levying of a carbon tax on imports, which should not be limited to the emissions generated by the products themselves but should also apply to the emissions generated in their production!

- Let's split the pension system into two pillars! The new pension scheme should include a solidarity-based pillar, which provides a universal and equal pension to every person above the retirement age. In parallel, there should also be a savings pillar, in which citizens hold their own individual accounts. With respect to the saving pillar, citizens should be able to adjust their age of retirement flexibly! This can help incentivise employment, which may help mitigate the drop in the share of the working-age population.

- Let's remove the expensive and market-distorting institution of non-refundable corporate subsidies! Let's promote the role of Hungarian-owned "international champions" in the economy! We need to lay the conditions that allow such majority Hungarian-owned, internationally competitive and innovative major corporations to emerge and thrive. The state can be most successful in helping this come about if it supports innovation and actual performance, while it provides conditions that incentivise competition overall rather than boosting specific economic players. The state can also play an important role in helping the successful international expansion of Hungarian-owned "international champions".

I. WHAT IS THE PROBLEM?

- **Hungary ranks among the poorest EU Member States.** Based on our real per capita consumption we are in the seventh-lowest position within the EU. Although we are far better off than we were at the time of our EU expansion, **we are nowhere near the point where we can fully exploit our opportunities.**

- As compared to countries with a similar income level and considering our possibilities, **during the last decade and a half Hungary has performed roughly 30% below its potential in terms of economic growth.** In other words, there is plenty of unexploited potential in the Hungarian economy. As a result of the decline in the working-age population and of technological progress, our performance thus far will most likely result in us falling even further behind: That is why we need to revitalise the economy. The examples of successful countries prove that **our policy decisions and institutions do indeed matter, and that there are distinctly bad and good economic policies.**

- The economic success stories that we know to have three features in common: **1) a well-working market economy; 2) effective public services that facilitate the operation of an efficient market economy; 3) a sufficiently large-scale investment into human resources and innovation.** Successful countries typically have better institutions and better-trained populations. **The key to growth is that the country "rushes ahead" in certain areas as compared to its level of wealth, that is it sacrifices and invests in these areas disproportionately relative to its existing economic capacities –** there is a good chance that its economic growth will quickly catch up**.**

- In the following, we will highlight the main factors that stand in the way of economic growth, and then we will proceed to make recommendations that show how the economy could be revitalised. Our recommendations are informed by insights learned from the economic success stories of other countries. Our goal is to ensure that **over the next decade Hungary can successfully leave behind the ranks of the poorest EU Member States.**

II. AT THE STARTING LINE IN THE RACE FOR GROWTH – WHAT STANDS IN THE WAY OF INCREASING OUR WEALTH?

- The main factors holding back Hungarian economic growth are readily identifiable, and identifying them helps pinpoint where we need to intervene to stimulate and boost the Hungarian economy:

1. **The quality of the state:** Today, the Hungarian state is large and very active, but **compared to its size and the level of Hungary's development, it performs abysmally.** The size of the state is typically large in wealthier states, but generally the quality of the services it provides is high, too.

2. **The budget structure disincentivizes growth:** We spend too much on the operations of the state, micro-managing the economy and leisure activities, while at the same time we spend too little on education, health and other factors that could boost our competitiveness.

3. **The tax system also disincentivizes growth:** Our tax system is not well-targeted, it is unstable and characterised by an overly complex and inscrutable web of exemptions and loopholes. **Its impact is especially harmful when it comes to employment** since the tax burdens on salaries and wages are exceedingly high in international comparison. The average tax wedge of the mean wages in OECD countries is 36%, while in Hungary this figure is 44.6%.

4. **Corruption:** The level of corruption in Hungarian public procurement is higher than it tends to be in developed and successful economies. This is not only a moral problem – **it is also effectively a "special tax" with a negative impact on economic growth.** It is no coincidence that scholars have identified a close link between the perceived level of corruption in a country and the given nation's economic performance.

5. **A generally bad macro-economic and business climate:** Pro-cyclical economic policy, persistently high public debt and fiscal deficits, as well as macroeconomic and financial uncertainties all exert a negative impact on the business climate. These result **in massively increased risk spreads** for the private economy and for funding the state, and as a result they slow economic growth especially in periods when the availability and price of financing are most vital – in times of crisis, that is.

III. THE RECOMMENDATIONS OF THE EQUILIBRIUM INSTITUTE

1. HIGH QUALITY DIGITISED PUBLIC SERVICES

- **Let's digitise the operations of the state!** Let's exploit the opportunities provided by the information revolution: **It is easy these days to collate tax, employment, health, mobility, etc., and other data – unless they are gathering dust hidden deep inside some cabinet.** The digital state is revolutionary in terms of the benefits it yields, it provides public services that are can be evaluated more quickly and easily – if we avail ourselves of the opportunity. **The informational power that thus accrues to the state must be accompanied by increased oversight on the part of the citizenry:** Citizens should be able to follow in detail how the authorities use our personal data!

- **By 2030, public administrative procedures must be paperless!** By the end of the decade, the public administration, private persons and corporations must be able to manage their official procedures digitally!

- **Let's accelerate VAT refunds!** The tax authority should be able to decide within a matter of days whether they need to examine a given refund in more detail, and if they decide they don't, then they **must immediately reimburse the VAT paid at least in the case of taxpayers who are classified as reliable by the tax authority.** In terms of its impact, this would be equivalent to a huge and cheap (because it would be funded with money that the companies themselves have put up) economic stimulus credit programme.

- **Let's make winding up and bankruptcy procedures more efficient!** An average winding up procedure in Hungary takes two years these days, and creditors only recoup 44% of their funds. In Slovenia, by comparison, the same values are 0.8 years and 90%, respectively. Flawed bankruptcy procedures weaken the security of private property, which is why we need **faster and more transparent procedures** in which a wider array of investors has access to the auctions of the liquidated company's assets and which provides more options to continue the given corporation as a functional company.

2. MAKE THE ECONOMY MORE TRANSPARENT!

- **A cash-free economy!** Because the use of cash is difficult to track **and is inextricably linked to the black economy and tax avoidance.** Despite this, over two-thirds of payment transactions in Hungary today continue to be conducted in cash. This is an extraordinarily high ratio, especially in light of the fact that the **long-term trajectory of the developed world is trending towards a cashless economy.** With proper time for the transition, **we must make sure that by 2030 no more than a third of all payment transactions use cash – in other words, less than half of the current figure!**

- **Let's incentivise online banking!** We must make sure that the transition to a **cashless economy** does not harm those demographics who are more likely to use cash: those with lower incomes and the elderly. **Let's cut the cost of bank accounts and card use!** In addition to reducing the burdens on online transactions, the fees for **cash withdrawals and deposits must be increased, but only when their amount exceed a pre-defined threshold value!**

- **We must make sure that the conditions are in place to achieve that by 2030 the state can pay all pensions and social transfers digitally!** By this time, all sellers of goods and services should be obliged to provide their customers with the option to pay digitally!

- **In the event of real estate acquisitions or the purchase of other high-value goods, those who**

pay large sums of cash should be obliged to verify the source of the funds to the tax authority! In the event of their failure to do so, the seller, too, shall be subject to criminal liability and the public authorities have to refuse to register the transaction.

- **A mandatory *National Registry of Contracts*!** For all transactions involving transfers of ownership or options contracts in excess of a threshold value, the state shall only commit to upholding the underlying contracts if the contracting parties have notified the authorities that they have concluded such an agreement and have made the latter available for public review by uploading it into the **National Registry of Contracts (this shall also apply to private contracts)!**

- **All public contracts and invoices paid by public bodies shall be made available for public review unless they involve issues of national security!** In addition to bosting corporate transparency, this would also serve the comprehensive transparency of the state, radically reducing the risk of corruption. *(The Equilibrium Institute will address the issue of corruption in a separate policy paper).*

3. SMART FINANCES

- **Let's follow a strong-forint policy!** To reduce the costs of funding the public debt and to increase macro-economic stability we need to put an end to the depreciating trajectory in the value of the forint! What this means is that any **potential real appreciation must result from the nominal appreciation in the forint exchange rate, just as a real depreciation – if and when necessary – would result from the nominal depreciation in the exchange rate – and the two would fluctuate in track with the business cycle.** Although a weak forint will stimulate exports in the short run, in the long-run it will be factored into market expectations while it simultaneously weakens the international competitiveness of smaller Hungarian-owned enterprises and slows investments. **The appreciation of the forint during economic boom cycles would be an instrument for shoring up long-term reserves.** *(The Equilibrium Institute plans to devote a separate policy paper to the introduction of the euro.)*

- **Let's save during periods of economic growth to have something to spend during times of crisis!** Let's use what's known as *anti-cyclical fiscal policy*, which means that during boom periods budget spending is slashed – in fact, fiscal policy aims at a surplus during such times – so that in a time of crisis we can spend more on mitigating the negative impact of the crisis rather than being forced to implement austerity measures which exacerbate the recession!

4. GROWTH-FRIENDLY TAXES

- **Let's tax the "bad" things rather than the "good" things!** In other words, let's not burden any more than absolutely necessary the economic activities that contribute to value creation (be it employment or investments)! Instead, **we should impose higher taxes on activities that we want to scale back because of their harmful societal or environmental impact** (such as carbon-dioxide emissions or the use of cash).

- **Let's lower the tax wedge of the average salary to 36%!** The latter value is the average of the OECD Member States – in Hungary, by contrast, the tax burden of the average salary is 44.6%. **However, the detrimental impact of the high tax burden is not limited to corporations, it also stands in the way of increasing employment.**

- **Let's repeal the financial transaction duty!** Reducing the tax burden is especially important in those areas **where the target of the tax is an activity that is essential for the operation of the economy but does not actually generate new income that should be subject to taxation.** An example of the latter is the tax that we currently have to pay on electronic transfers between bank accounts, which is harmful to the operation of the economy in general, while the upper limit on the amount of the tax makes it especially punitive – relatively speaking – for small transactions (in other words it is a greater burden on those with lower incomes). This tax is also disruptive of financial innovation since it makes business models that rely on many small payments more expensive.

- **Let's scrap the tax on corporate profits in the case of reinvested incomes!** Reinvested incomes will generate profits in the future and hence – thanks to the higher capital stock in the economy – they spur economic growth and help generate higher wage levels. That is why profits (in the case of private individuals as well) should only be taxed when they end up with the owners as disposable income. The tax exemption of reinvested incomes **would also help small enterprises that grow quickly and are already turning a profit.** Given the political will to achieve this, **such a policy would be especially useful in stimulating domestic investments, so long as the exemption is limited to financial instruments denominated in forints.**

- **Let the polluters pay – let's introduce a carbon tax!** The activities that we need to scale back especially – also because of the climate goals that Hungary has committed itself to – are those that lead to carbon-dioxide emissions; these **need to be subject to a carbon tax that increases over time following a previously announced timeline.** In practice, this is the EU's responsibility, which means we have to call for this tax at the European level, too. The common European carbon tax must be designed in a way that does not limit it to the emissions generated by the imported products themselves but also applies to the carbon-dioxide emissions generated by their production (assuming that the country exporting these has not already levied such a tax). Based on our current emissions level, the **annual revenue from such a tax could be as high as a thousand billion forints (ca. 290 million euros),** and such an amount would allow us to phase out other taxes that have a negative impact on growth.

5. INNOVATIVE STATE

- **"Let's experiment"** with **innovative public policies!** In an era of lightning fast technological progress, flexible public and private sectors that constantly renew themselves provide a major competitive edge. Public policy decisions in Hungary are rendered without adequate groundwork and their impact is not systematically evaluated, either, which is why we do not know much about their effectiveness.

- **We need to** give **the state far more space to experiment with regulations, following the model of the "regulatory sandbox" implemented by the government in Singapore.** As part of such a policy, new regulations would be implemented with a limited scope and timeframe, but under real-life conditions, allowing us to experiment with the given regulations and to systemically evaluate their impact!

- **Let's create a two-pillar pension system!** The decline in the size of the working-age population has a detrimental impact on economic growth, which could be partially offset by restructuring the pension system. **The pension system should be divided into two pillars: a solidarity-based pillar and a savings-based pillar.** The goal would be to remove any counter-incentives to employment in the pension system, while at the same time providing every elderly person with a high enough income to spend their retirement age in dignity. **The solidarity-based pillar would operate as a tax-exempt and equal basic income that is paid – independently and regardless of any other income – once the recipient has reached the age of retirement**. **The savings-based pillar of the pension system, on the other hand, would be used to accumulate individual savings in a virtual account, with a percentage deducted from an individual's wages; the eventual pay-outs would be indexed based on the yields of Hungarian treasury bonds. A portion of the funds could be spent on education, for example on "Sabbatical"-type rest years,** which individuals could avail themselves of even before they reach the age of retirement.

- **Let's scrap the expensive and market-distorting institution of investment subsidies to individual companies!** As a share of GDP, we spend nearly twice as much on subsidising private corporations (typically multinational corporations) based on unique government decisions than the other Visegrad states, the average of the EU6 or the Scandinavian countries. **But there is no economic benefit to show for it, even as it puts domestic small and medium-sized enterprises at a competitive disadvantage.** Rather than trying to counterbalance the costs of the difficult business environment by providing extra subsidies, we should instead aim to provide a favourable business environment for every company.

- **Let's strengthen the economic role of Hungarian-owned "international champions"!** Successful countries need nationally-owned multinational corporations which are competitive in the international markets. **However, for the time being Hungarian-owned corporations have simply not been able to grow large enough to achieve that** – it's as if they hit a glass ceiling at a certain point in their development. Even though we find 67 Hungarian companies in the list of the 500 largest Central and Eastern European corporations, only five of these have Hungarian majority owners, which is an extraordinarily low proportion compared to the relevant Polish and Czech figures, for example.

THE EQUILIBRIUM INSTITUTE'S PROPOSALS FOR BOOSTING ECONOMIC GROWTH

AREA	RECOMMENDATION
EFFECTIVE PUBLIC SERVICES	A paperless digital state by 2030! By that time, all paper use in public administration procedures must be phased out!
	Immediate VAT refunds for reliable taxpayers!
	Following the Slovenian example, we must make winding up and bankruptcy procedures quicker and more transparent!
MAKE ECONOMY MORE TRANSPARENT	Let's create a cash-free economy! By 2030, no more than a third of all payment transactions should be conducted in cash!
	While bank fees, taxes on bank accounts and online payments should be reduced, cash withdrawals and deposits above a pre-defined threshold value should be subject to a special levy.
	By 2030, the state should pay all pensions and social transfers digitally! The option to pay digitally should be available in all areas of commerce and services!
	All public and private contracts the value of which exceeds a pre-defined threshold value should be open to public review in a National Registry of Contracts!
	In the case of high-value sales and acquisitions, the source of the buyers' funds should be verified to the authorities!
SMART FINANCES	Let's pursue a strong-forint policy!
	Let's save during boom periods so we have something to spend in times of crisis!

THE EQUILIBRIUM INSTITUTE'S PROPOSALS FOR BOOSTING ECONOMIC GROWTH

AREA	RECOMMENDATION
GROWTH-FRIENDLY TAXATION	Let's lower the tax wedge of the average salary to 36% (the OECD average)!
	Let's get rid of the transaction tax on online transfers!
	Let's scrap the tax on corporate profits in the case of reinvested incomes!
	Let's tax activities that we want to scale back: Let's support the introduction of a carbon tax at the EU level!
INNOVATIVE STATE	Let's divide the pension system into two pillars! The first pillar should provide a universal basic income to any person above the age of retirement! The second should be paid into individual accounts with flexible rules concerning the timing of its pay-outs!
	Following the "policy sandbox" concept implemented by the government of Singapore, we need to improve regulations by experimenting with new policies in a setting that allows us to accurately track their effectiveness!
	Let's abolish the market-distorting institution of subsidies awarded based on unique government decisions in favour of specific players in the market!
	Let's promote the role of Hungarian-owned "international champions" – competitive multinational corporations that are majority Hungarian-owned! Rather than helping specific players, the state should aim to reward competitiveness and innovation!

ABOUT US

The Equilibrium Institute is a future-oriented Hungarian think tank. We are writing political, economic, and cultural visions and policy proposals for Hungary. We are establishing an intellectual background to underpin the success of Hungarians in the rapidly changing 21st century.

We are discussing topics that are underrepresented in public discussions. These topics include robotization, the transforming labour market, the air quality and the pollution of freshwater, national identity and the role of communities in a society, the future of education, the country's economic take-off, or the changing world order.

The Equilibrium Institute's research team and its advisory board consist of a wide variety of economists, sociologists, political analysts, climate experts, foreign policy experts, and researchers with extensive experiences in their academic fields being theoretical or applied sciences.

EQUILIBRIUM INSTITUTE

1024 Budapest, Ady Endre u. 24.

+36 1 249 5238

www.eib.hu

info@eib.hu

Coverphoto: Shutterstock