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AUSTERITY POLICIES SPARK DISCONTENT IN HUNGARY

Key takeaways from the new austerity measures imposed by the Hungarian government

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Public discontent in Hungary has grown significantly in recent days, after the government introduced sweeping changes to the taxation of the Hungarian SME sector and partially reversed price caps on household energy prices by limiting discounts to below-average energy consumption. The measures have led to manifold increases in small business taxes and higher energy prices for a vast number of households.

Widely seen by the public as austerity measures, the policies provoked days of anti-government protests, marking the first major political challenge for Prime Minister Viktor Orbán's new Government and the ruling Fidesz-KDNP alliance. The public discontent with the austerity measures comes as Hungary faces up to a worsening economic climate, with the government hoping to reach an agreement with the EU to unlock much-needed post-pandemic recovery funding.

Below, Aretera takes a look at the recent austerity measures, their consequences for international businesses and Hungary's post-election landscape.

NEW AUSTERITY MEASURES TARGET CORE OF THE HUNGARIAN SME SECTOR

On 18th July, the government of Hungarian Prime Minister Viktor Orbán introduced sweeping changes to the country's taxation system, with severe consequences for the Hungarian SME sector. The new regulations, presented only a week ago but rapidly approved by the Hungarian parliament and enforced by Hungarian President Katalin Novák, drastically limit the number of SMEs entitled to use the so-called Itemized Tax for Small Businesses (commonly referred to as KATA) as their business tax option.

Largely due to its simplicity and low tax rate in comparison with other types of business taxes, KATA has become the most popular SME taxation scheme in Hungary: more than 450,000 small businesses use this tax option, in a country of under 10 million. Under the new rules, effective from 1st September, small businesses using the KATA scheme will be banned from doing business with legal entities and required to work only for private individuals.

Combined with other restrictions, this will prevent the vast majority of KATA-using SMEs to continue their business operations, with most of them forced to look for another entrepreneurial and taxation scheme in less than six weeks or cease operations. KATA-using SMEs wishing to continue operating can do so by switching to a (less favourable) flat tax rate system and now face a manifold increase in their business-related taxes and overall costs. The number of SMEs taxed under the KATA scheme is now likely to fall below 100,000.

THE PARTIAL END OF LOW HOUSEHOLD ENERGY PRICES

The announcement to change the KATA scheme in mid-July was rapidly followed by an even more far-reaching measure for the public: on 13th July, the government, as part of an "energy emergency plan", partially reversed its flagship public utility cuts program (*rezsicsökkentés*) by exempting above-average monthly household energy consumption from price caps on gas and electricity. As a result, energy prices are expected to skyrocket for numerous households. According to a further government decree issued on 21st July, above-average monthly electricity prices for households will double, with consumption to be paid at "residential market prices", while household gas consumption prices will see a more than sevenfold increase if consumed above the government-set average level.

Back in 2013, the second Orbán Government introduced the utility cuts program that reduced the centrally regulated price of electricity, gas and district heating for household consumers. Although seen as controversial, since the centrally regulated price has fluctuated not only above but also below market prices over the years, the program has become a cornerstone of the ruling Fidesz party's domestic policies. It has been widely seen as favourable for household consumers, particularly as energy prices, which started to rapidly increase in late 2021, continue to give reason for concern.

BACKLASH & PROTESTS

The two measures immediately provoked anti-government protests in Budapest and the Hungarian countryside, with protesters demanding the government reverse its recent decisions. While the government argued that the KATA scheme has become a tool for hidden employment and tax evasion and that Russia's war against Ukraine is severely impacting its utility cuts program, critics say

Fidesz has backtracked on its election promises and is targeting 'quick fix' additional revenues to balance the state budget. The demonstrations, however, have proved unsuccessful: Hungarian President Katalin Novák signed the amendment to the KATA act into law on 18th July, while the revised details of the utility cuts program will come into effect as early as next month.

POLITICAL IMPLICATIONS

Fidesz seems poised to lose popular support, even in its core voter groups. The "pro-KATA protests" mark the first major political challenge for the fifth Orbán Government[1], which on 3rd April secured a decisive victory in the parliamentary elections, having vowed to avoid direct austerity measures on households for a year. Although protests over the KATA changes are likely to fade, the partial reverse of the government's flagship utility cuts program will severely hit both the middle class and low-income households, particularly in the regions where Fidesz enjoys considerably higher support. The average consumption levels set by the government's new regulations remain under debate, with households likely to see manifold increases in their public utility bills as soon as August. Distrust towards the ruling bloc is further fuelled by the lack of public consultation on either issue and the limited amount of time left for SMEs and households to prepare for the changes. At the same time, the government has set much higher average consumption rates for families with at least three children (a traditionally Fidesz-supporting voter group), while the recently introduced residential market price for gas and electricity is still below market prices.

Political stability could become a major concern in the long run. While the current protests have fallen short of mass rallies, continuing public discontent could lead to further protests, with a politically heated autumn looking inevitable, fuelled primarily by the partial reverse of the utility cuts program. As the economic situation worsens, Fidesz could be forced to further reverse the utility cuts scheme or drop it entirely, which would lead to an even higher level of discontent. Although the government looks committed to protect what is left of the program, rapidly increasing living costs could potentially turn larger swathes of the public against Fidesz.

While Fidesz could lose public support, PM Orbán remains unchallenged. Any potential loss of popularity will most likely not be followed by the sudden re-emergence of the parliamentary opposition, which remains in disarray after their historic defeat on 3rd April. Given the lack of a credible opposition, Fidesz (which holds a two-thirds supermajority in the parliament and de facto controls most public institutions and all walks of economic life) could remain in government and even allow itself to lose large sections of its strong support. Public discontent with the opposition remains high over its electoral defeat, with even KATA protesters refusing to cooperate with "the old opposition parties." In the long run, however, if the new austerity measures provoke further anti-government protests, Hungary could see the emergence of new opposition movements.

ECONOMIC & BUSINESS IMPACT

The new tax rules will negatively impact large corporations working with subcontractors. While the revision of the KATA scheme primarily concerns Hungarian SMEs, several foreign investors in Hungary work with small business subcontractors, many of whom have been using the KATA scheme. Investors in the food and merchandise delivery industry, as well as in the mobility sectors, are among those most impacted, with multiple other service-providing industries now also required to ensure other

[1] See here for our overview of the fifth Orbán Government from 25 May

forms of cooperation with local contractors. In addition, increasing energy prices for households could also contribute to the rise in the energy costs of corporate consumers.

Calls to impose additional taxes on multinationals are likely to grow. In May, the Orbán Government announced special taxes on large companies in eight different industries[2], aiming to raise an annual HUF 800bn in the next two years for the state budget without imposing direct austerities on households. The newly imposed austerity measures have prompted both the protesters and a part of the moderate opposition parties to call for increased taxes on multinational investors instead of targeting citizens directly. While the government stated the special sectoral tax regime was a temporary solution in a time of crisis, its fear of losing popular support could see new taxes on MNCs or increases in the rate of existing measures. At the same time, PM Orbán remains committed to maintaining a favourable climate for investors, in part by opposing the OECD-proposed global corporate minimum tax rate. Most recently, this move has prompted the US government – the strongest advocate of the 15% global corporate minimum tax – to terminate its double taxation treaty with Hungary, effective from 2023.

Hungary's budgetary situation remains a concern. While the government argues that changing the KATA system and the utility cuts program are necessary mainly for non-budgetary reasons, both measures are widely seen as austerity policies aimed at balancing the state budget and, consequently, reassuring markets on the country's fiscal stability. Budgetary adjustments were expected well before Russia's invasion of Ukraine in late February, particularly with regards to PM Orbán's sweeping pre-election welfare program, which has put additional pressure on Hungary's state finances. As in the case of most CEE economies, inflation is an additional concern, with annual inflation likely to rise above 10%. At the same time, the most recent forecast of the European Commission expects Hungary's GDP to grow by 5.2% in 2022 (with a 11.8% inflation increase).

A settlement with Brussels could positively impact Hungary's outlook. Hungary is yet to secure billions of Euros in post-pandemic EU recovery funding[3], with the government hoping to reach an agreement with Brussels to unlock the recovery funds by autumn. Russia's war on Ukraine, the slower-than-expected growth of the world economy, rising inflation, the unfolding energy crisis and Hungary's troubled relations with the EU all increase budgetary risks. In response, the Orbán Government is committed to securing a deal and has recently announced a wide range of concessions on a series of issues, including anti-corruption efforts and the rule of law, two of the most pressing issues in the long-running dispute between Budapest and Brussels.

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If you would like to schedule a discussion of this paper, please contact:
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[2] See here for our overview of Hungary's new special sectoral tax regime from 30 May
[3] See here for our overview of the EU's post-pandemic recovery funding from 9 June