Hungary Announces Flat Tax and Bank Tax

After rattling markets last week with fears of a default, the Hungarian government announced a series of measures earlier this week including spending cuts, tax-policy changes, and a new tax on the financial sector aimed at satisfying international institutions and containing the nation's public deficit.

The reforms will reportedly include the introduction of a 16-percent flat tax on income, reduced salaries for public-sector workers, tax cuts for small businesses, a ban on foreign-currency denominated mortgages, and much more, according to the country's new "center-right" Prime Minister, Viktor Orban. The flat tax would constitute a reduction for most taxpayers, but it would also mean a tax increase for less affluent citizens.

"There will be people who will benefit from these changes from day one, others from day two, or in a few months or a year, but at the end of the day everyone will benefit from the new tax system," Prime Minister Orban said on June 8. The measure which won broadest support among law makers, according to news reports, was a plan to abolish taxes on home-made schnapps. "You may laugh, but people have been fighting for this right for 90 years," Orban said.

Another proposal that received wide-spread attention would impose a new "special tax" on banks, which the government hopes will bring in around $1 billion. Bankers, however, are resisting the measure, claiming it will erode their capital positions and could lead to losses if it is implemented. "I'm convinced that would be such a drastic tax on the Hungarian banking system, it would cause great harm," said Chairman Tamas Erdei of the Hungarian Banking Association, who noted that it could cause banks to reduce lending.

Under a deal reached with the European Union and the International Monetary Fund, the Hungarian government is supposed to keep its budget deficit at less than 3.8 percent of output. Analysts were satisfied, for the most part, that the new measures would help achieve that goal. Markets reacted positively as well, with the nation's currency rising against the Euro and interest rates on government bonds falling slightly after the announcements.

But not everybody was convinced that it would be acceptable. "We do not think it likely that such a plan will satisfy the EU, the rating agencies or financing institutions such as the IMF, as a credible fiscal consolidation package," said Commerzbank in a note cited by *Business Week*. "A plan of tax cuts is usually not an acceptable fiscal roadmap within an IMF program." Hungary is being forced to submit to the international institutions in part because it accepted bailout money when its economy was in even worse condition during the ongoing economic crisis.

But despite the claim that the measures would amount to a tax cut, other media outlets have called the proposals a tax increase. In reality, it will be a combination of both, with the net outcome still not clear. Ratings agencies have already offered tentatively positive statements about the plan, and the IMF has recently signaled its approval as well.

Separately, the EU is ordering the Hungarian government to demand more money from a mining company which allegedly did not pay high-enough fees. "The investigation has proven that MOL benefited [from] a financial advantage by paying lower mining fees than its competitors," said EU "Competition Commissioner" Joaquin Almunia in a statement. "This type of clearly discriminatory aid is not allowed under EU rules."

Hungary's new economic proposal consists of 29 specific measures aimed at reducing the government's deficit, though all of the details are not yet known. And while the nation enjoys a more robust export sector than other troubled countries like Greece, analysts predict that the plan will have far reaching consequences.

Photo: Hungarian Prime Minister Viktor Orban announces his government's new economic rescue package in the parliament building in Budapest on June 8, 2010.: AP Imafes