Way for Hungary to come close to the German standard

Authors: Dániel Palotai, Executive Director and Chief Economist of the Magyar Nemzeti Bank and Ákos Szalai, Head of the Competitiveness and Structural Analysis Department of the Magyar Nemzeti Bank.

Germany is Hungary's most important trading partner, accounting for more than one quarter of Hungary's imports and exports; in addition, Germany is also the largest investor in Hungary. Dániel Palotai, Executive Director of the Magyar Nemzeti Bank, and Ákos Szalai, Head of Department, examine the most important elements of approaching the German standard, which bears outstanding importance for Hungary.

In the third part of the central bank's 5+1 series of articles on convergence, we present that in addition to the classic macroeconomic indicators, Hungary is on the path of convergence also in other areas of competitiveness, even when it is compared to one of the world's most competitive economic great powers, i.e. Germany. The fact that Hungary – and the Visegrád region – plays an increasing role in the German economy's outstanding world market performance is a clear evidence of convergence and the economic appreciation of Hungary. Companies operating in Hungary already face a lower tax burden than in Germany, accompanied by favourable labour market conditions, decreasing hidden economy and access to a high-class infocommunication network. These factors are essential for the successful management of future challenges, particularly those generated by the fourth industrial revolution.

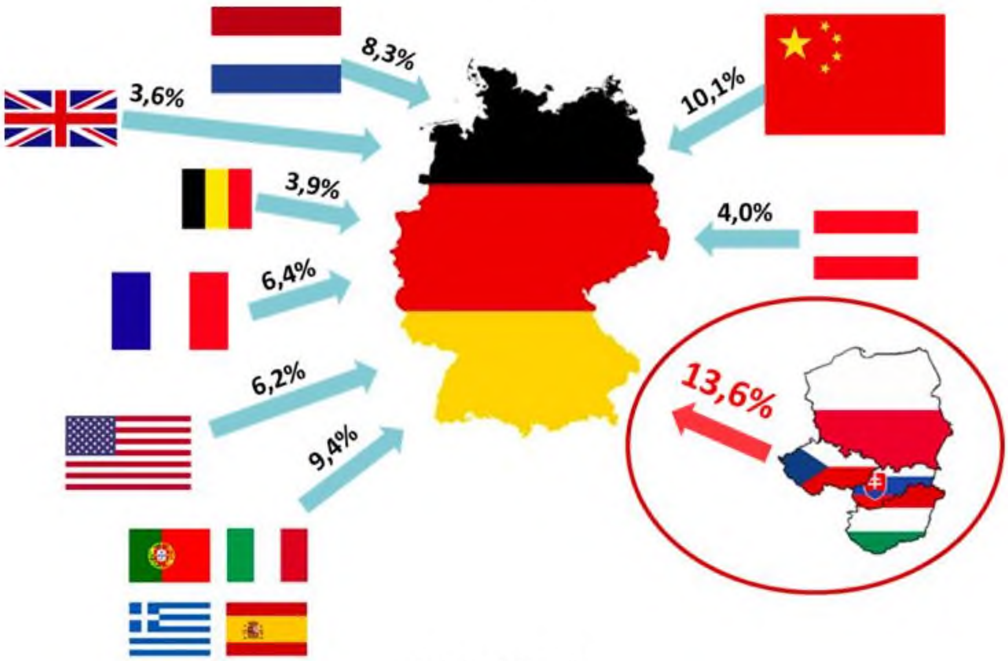
> Germany is one of the world's largest, most developed and most competitive economic great powers, and thus it is key for Hungary to have a close and successful relation with the German economy.

Although there is still plenty of room for improvement in Hungary's competitiveness, it is worth examining the areas where Hungary was able to demonstrate significant convergence after the economic policy reforms of 2010. Due to its leading position, Germany may be a good starting point for comparison in the area of competitiveness. In this paper, we illustrate Hungary's convergence through macroeconomic and competitiveness indices.

In the global economic shifts that followed the 2008 global crisis, the group of Visegrád countries became one of Germany's most important trading partners. During the years following the 2008 global crisis, the Visegrád region – and within that Hungary – has become an increasingly determinant driver of the European Union's growth, in parallel with which its importance in the external trade of Germany also showed a trend growth. At present, the volume of the region's exports accounts for almost 14 percent of Germany's goods imports, which exceeds the share of the most significant individual partner countries (China, the Netherlands, France or the United States), or the share of the group of Mediterranean countries. **The structural reorganisation of the world market and the headway of the new economic poles – such as China and Central Europe – are also reflected in the changes of Germany's most important trading partners.** Until the mid-2000s, the key import partners of

Germany included France, the United States and the Netherlands; however, by now the Central and Eastern European region and China took the lead. The reorganisation of world trade and the development of new power centres also contributed to the change in the perception of the functioning of the world market.

1. ábra: Németország árubehozatalának forrás országai és azok súlya a német importon belül (2017)

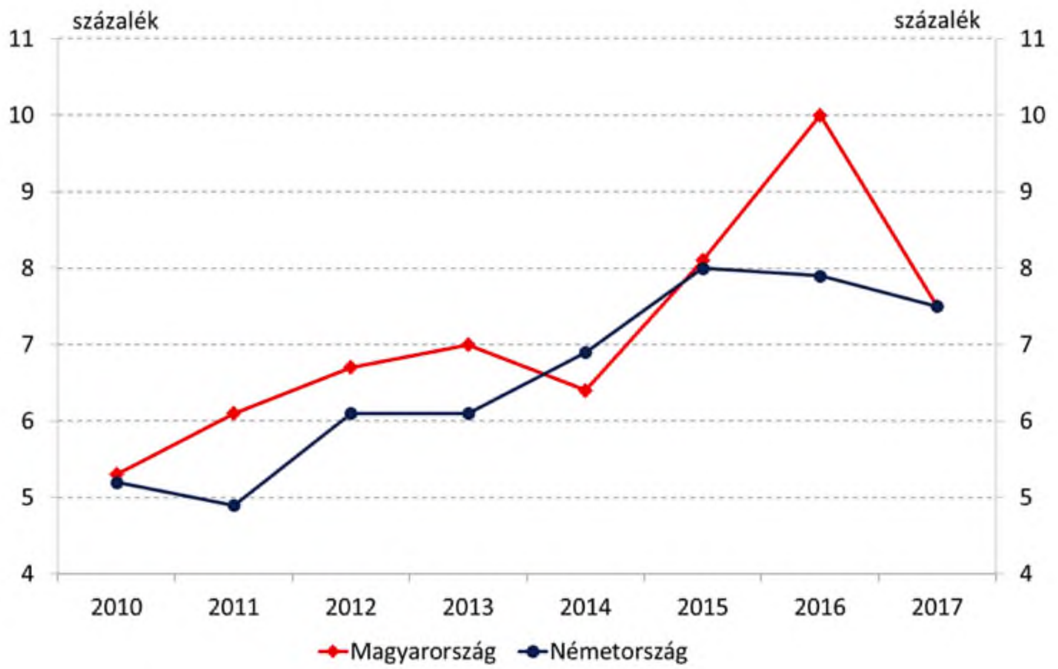


Forrás: UNCTAD

Germany is one of the largest exporters globally and Hungary also keeps abreast of its trade surplus. Based on its share in world trade (7.9 percent), Germany is the third largest economy after the United States (11.3 percent) and China (10.8 percent). Following the post-crisis decline, in recent years Germany’s trade balance-to-GDP ratio rose and at present it is around 8 percent of GDP.

The trade surplus contributes to the maintenance of external balance and dynamic economic growth. Hungary’s balance of trade, which also shows a substantial surplus, develops very similarly to that of Germany, which clearly evidences Hungary’s deep integration in the European and global value chains. The external trade of the two countries is strongly intertwined. Hungary’s most important trading partner is Germany; more than one quarter of Hungary’s imports and exports is transacted with Germany. In addition, Germany is also the most important investor in Hungary: German economic agents have the highest capital stock in Hungary for many years.

2. ábra: GDP-arányos külkereskedelmi egyenleg

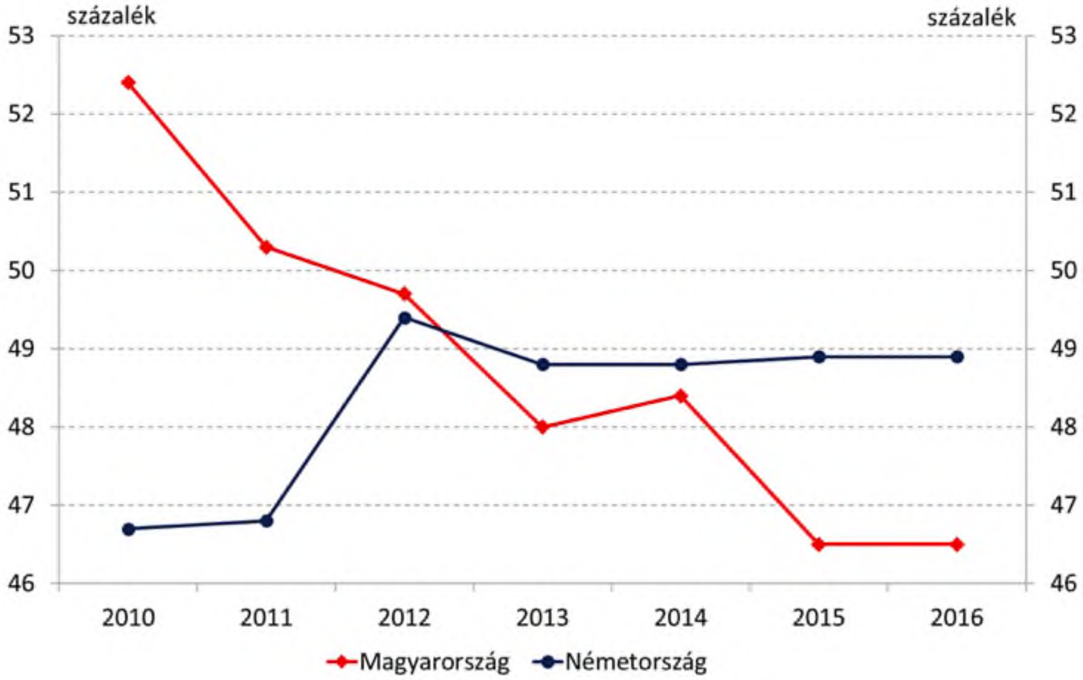


Forrás: Eurostat

The total tax burden of Hungarian companies is already lower than in Germany, which may provide them with a competitive advantage. As a result of the structural tax reforms performed after 2010, labour and capital taxes decreased significantly in Hungary, which supports growth in disposable income, capital accumulation capacity, willingness to invest and economic competitiveness. Owing to this, according to the joint Doing Business survey by PwC and the World Bank, the total tax burden of Hungarian companies declined by 6 percentage points below 47 percent between 2010 and 2016, while in Germany it rose by 2 percentage points to 49 percent.

That is, the tax burdens of companies are already lower in Hungary than in Germany; Angela Merkel, Chancellor of Germany, also expressed her appreciation of the incentive Hungarian tax regime. This is supported by the 2018 issue of the annual business survey by the German-Hungarian Chamber of Industry and Commerce, according to which two-thirds of the managers of German companies operating in Hungary and other non-resident investors were satisfied with the degree of the tax burden and the functioning of the tax regime. According to the business survey, there is also a trend improvement in the perception of the Hungarian business environment since 2012. These positive results are attributable to the reduction in the corporate income tax, which started in 2010, as well as to the radical simplification of the taxation of small enterprises and to the low tax liability of SMEs. Since 2017, the Hungarian corporate tax rate is 9 percent, the lowest in the European Union.

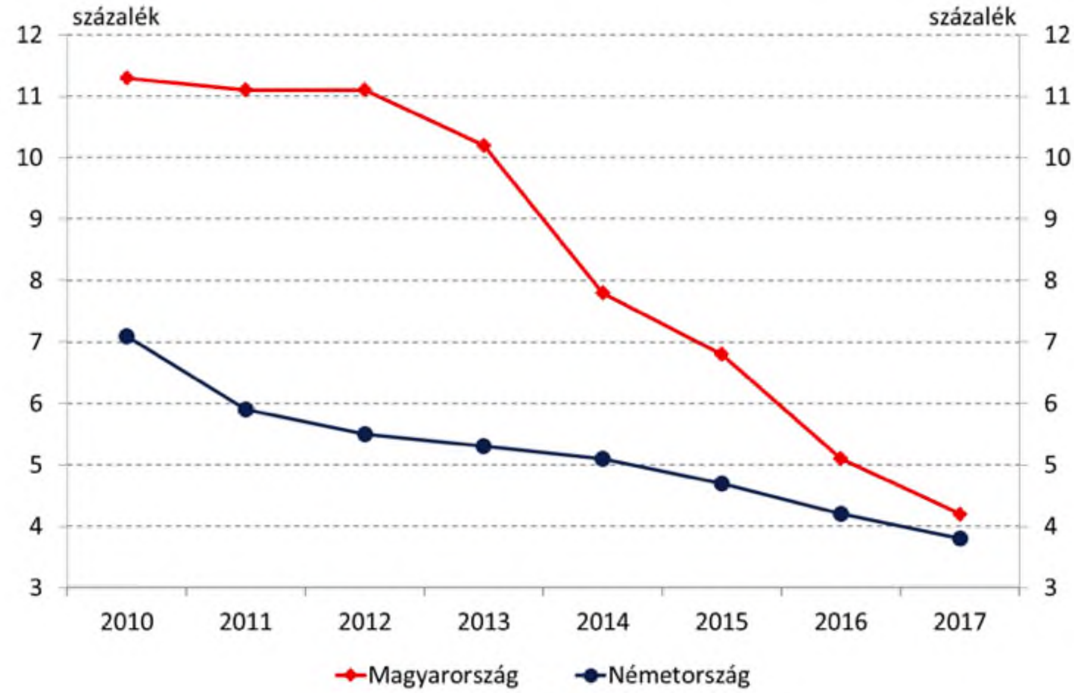
3. ábra: Teljes vállalati adóráta



Forrás: Világbank Doing Business – PwC

Hungarian economic activity is well reflected by the fact that at present the Hungarian and German unemployment rates are among the lowest ones in the European Union. Partly due to the high labour taxes, Hungary's labour market indices were among the poorest ones within the EU (low employment and high unemployment) before the economic policy reforms introduced after 2010, which strongly restrained the efficiency of the economy. As a result of the post-2010 measures aimed at stimulating the economy and raise employment, for example, the reduction in the labour taxes, rationalisation of the welfare transfers, the Hungarian unemployment rate showed one of the largest decline (more than 7 percentage points) in the EU between 2010 and 2017. The Hungarian index came close to the German value, which is below 4 percent, and by now it is among the lowest ones in an EU comparison. In parallel with low unemployment, total employment materially supports persistent convergence.

4. ábra: Munkanélküliségi ráta (15-64 éves korcsoport)

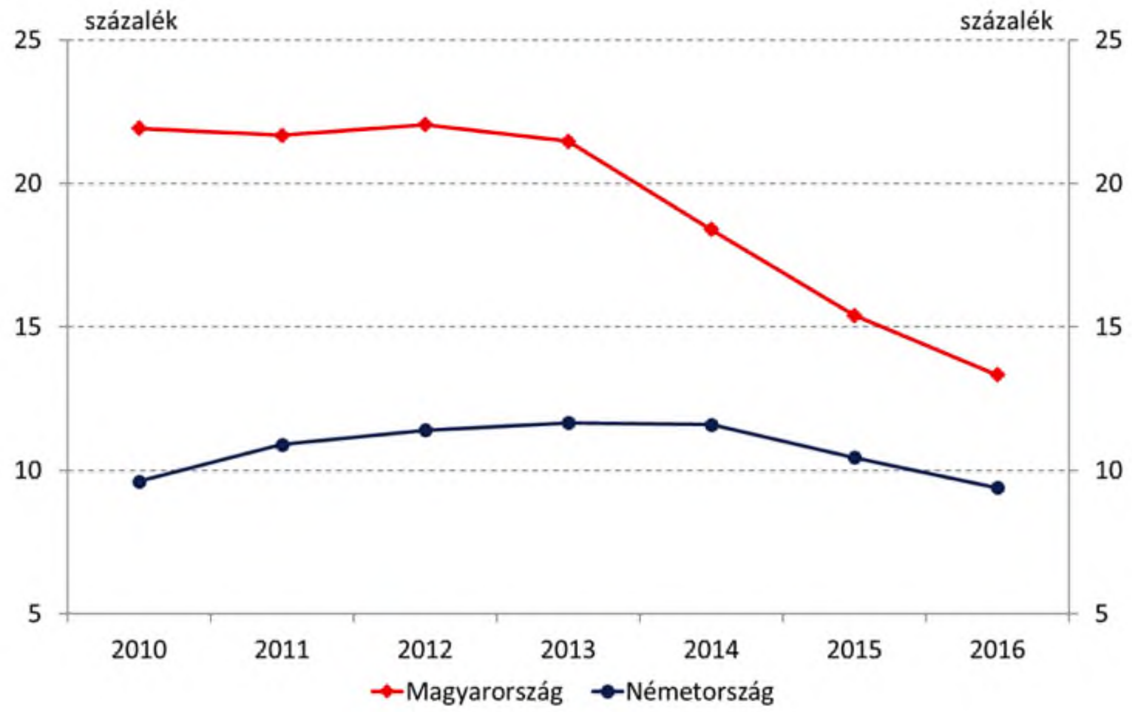


Forrás: Eurostat

The major decline in the VAT gap, observed in recent years, reflects the reduction of the shadow economy, which provides major support for fiscal stability and room for manoeuvre for additional competitiveness measures. The VAT gap is one of the most often used indices to estimate the hidden economy, which shows the difference between VAT actually collected and potentially collectable VAT revenue. In Hungary, the VAT gap was 21.9 percent in 2010, which exceeded that of Germany, a country in the vanguard of tax collection efficiency, by more than 12 percent.

However, following the measures taken after 2012 to reduce the shadow economy, with the online cash registers and the introduction of the Electronic Trade and Transport Control System being the most important elements, the VAT gap declined substantially, to 13.3 percent. With this, Hungary came closer to Germany in this area, while the average of the V3 region exceeds 20 percent. The curbing of tax evasion – even without raising the VAT rates – greatly contributed to fiscal stability and, as a result of maintaining fiscal balance, to the further reduction in labour and capital taxes (e.g. social contribution tax, corporate income tax).

5. ábra: Az áfarés alakulása

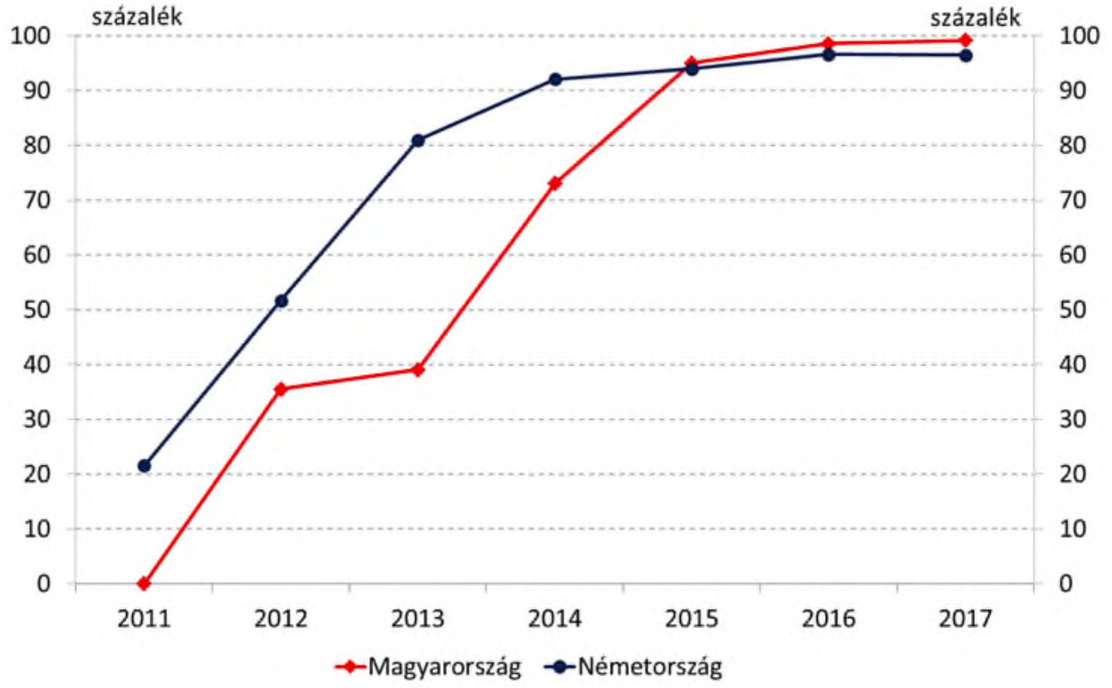


Forrás: Európai Bizottság

In Hungary 4G mobile internet coverage is full, which exceeds both the German value and the EU average. Today, internet access forms part of the basic infrastructure, since in the 21st century data is regarded as a key resource. The comprehensive 4G (and in the future 5G) mobile internet coverage of the countries is important, because the wide-ranging spread of the new solutions and accomplishments of the fourth industrial revolution is conditional upon the fast, wireless transmission of large volumes of data. Fast internet connection fosters the digitalisation of the economy, which contributes to the headway of high value added services.

Hungary achieved full 4G mobile internet coverage in a shorter time than Germany, recognised as the initiator and top player of the fourth industrial revolution. In Hungary, 4G coverage of the rural areas is 98 percent, putting Hungary within the first ten EU countries. This exceeds the German value and the EU average by roughly 10 percentage points. In Hungary, internet access, available to all citizens, is fostered by the reduction in the VAT rate on internet services and the introduction of the Digital Welfare Standard Package.

6. ábra: 4G mobilinternet lefedettség



Forrás: Európai Bizottság

19 November 2018

The article was published on novekedes.hu website.