Opinion of the Fiscal Council

about the state of implementation of the 2018 central budget act of Hungary and the expected trend of sovereign debt

(based upon the processes of the first half of the year)

I

Antecedents, legal basis and publicity of the Opinion

According to Point c) Indent (1) of § 23 of Act CXCIV of 2011 on the Economic Stability of Hungary (henceforward: Stability Act) the Fiscal Council shall give an opinion on the state of the execution of the central budget act and the expected trend of the sovereign debt every six months.

Accordingly, the Council reviewed the processes of the execution of Act C. of 2017 on the 2018 central budget of Hungary (henceforward: the 2018 budget act, or budget act) in the first half of the year and the expected trend of the sovereign debt.

Following its standard working practices established earlier, in its Opinion the Council was building on the history related to the preparation of the 2018 budget bill as well and the antecedents related to Act L. of 2018 about the year 2019 central budget.

- In its Opinion of 3/2017.04.27. concerning the draft document of the 2018 central budget bill the FC established that the draft „was calculating with a high economic growth of 4, 3 percent that exceeded the available forecasts" and this expectation „was built on the expected dynamic growth of the gross average wages as well as the planned large scale utilisation of the EU resources". The Opinion also stated that „with some exceptions the planned expenditure and revenue appropriations were in harmony with the expected base year fruition of the appropriations as well as the prognosis of the Government for year 2018". The Council expounded that it was the surplus originating from the organisations classified under the local governmental subsystem and the governmental sector „that ensured keeping the ESA deficit of the whole of the governmental sector, in harmony with the stipulations of the EU as well as the rule of Point b) Indent (2) § 3/A of the Stability Act, i.e. below the 3 percent of the GDP". Apart from this in the above Opinion the Council called the attention to the risk of meeting „the EU criteria concerning structural deficit". „In order to safely implement the targeted fiscal deficit the FC deemed it necessary to keep the planned amount set aside for the Country Protection Fund" and agreed „that it should be used by observing the criteria of the draft document".
  Apart from the above, in its Opinion the Council established that „the planned nominal growth of sovereign debt was in harmony with the planned cash deficit of the central budget. The degree of this growth however was significantly lagging behind the planned

rate of the nominal growth of the GDP. As a consequence the GDP proportionate sovereign debt shall mitigate at such a rate that the decrease of the sovereign debt indicator according to the Stability Act shall meet the stipulations[1] of Indent (5) Article 36 of the Fundamental Law of Hungary and shall significantly exceed the measure set by Indent (2a) § 4 of the Stability Act" [2]. It also stated that „the expected decrease of the debt rate was also in harmony with the stipulations of the European Union concerning sovereign debt[3]".

- In its Opinion no. 5/2017.06.14. concerning the final vote on the 2018 central budget bill the FC expounded that the measure of the sovereign debt indicator projected for 31st December 2018, as described by Indent (3) § 3. of the uniform budget bill T/15381/1237. was well established, and calculated according to the stipulations of the Stability Act. Additionally, even by the increased risks resulting from the increase of certain revenue appropriations was in harmony with the processes that served as a basis of the bill, thus the stipulation of Indent (5) Article 36. of the Fundamental Law shall be met.

- In the Justification section of its Opinion 3/2018.06.07. on the draft of the 2019 central budget bill – including the expected implementation based on the first quarter's results of

[1] Indents (4) and (5) Article 36. of the Fundamental Law contains the sovereign debt rule as the most important element of the rule based budget. According to this the National Assembly shall not accept such central budget act as a result of what the sovereign debt would exceed half of the GDP. As long as the sovereign debt is exceeding half of the GDP the National Assembly shall accept only such central budget act that contains the decreasing of the GDP proportionate sovereign debt.

[2] Application of the sovereign debt rule according to the Indents (2)-(2a) § 4. of the Stability Act:
- in the course of **the preparation of the central budget act** the sovereign debt indicator shall have to be calculated both in case of the basic year and of the given year, as the quotient of the sovereign debt expected for the last day of the budget year and of the gross national product forecasted for the given year.
- at the calculation of the indicator the consolidated (eliminated from the obligations towards each other) debt of the central subsystems of public finance and other organisations – shall have to be correlated to the GDP.
- debts denominated in foreign currency shall have to be considered at an exchange rate regulated by the central budget act.
- sovereign debt increase that is the result of the retroactive rebate related timeframe of EU resources, the possible lack of liquidity of the EU budget or any other reasons as a consequence of what the EU support related to incurring expenditures shall not be calculated in the central budget shall not have to be taken into consideration.
According to the enacted regulation of the Stability Act in 2015 sovereign debt is allowed to increase to a degree that equals the half of the difference of the inflation and the real GDP growth rate forecasted by the budget act for the end of the subsequent year (debt formula). This regulation was amended due to its economic growth hampering effect. As a result, this formula shall be used only in case of having a targeted deficit higher than 3 percent and economic growth rate higher than 3 percent. In other cases the goal is to reach minimum 0, 1 percent degrease of the sovereign debt indicator.
The regulation laid down in Indent (3) Article 37. of the Fundamental Law concerning **the realisation of the budget:** as long as sovereign debt shall exceed half of the GDP, no such loan can be taken in the course of the implementation of the central budget and no such financial obligation should be undertaken as a consequence of what the proportion of the sovereign debt to the gross domestic product would increase when compared to the previous year.

[3] The debt regulation of the European Union is regulated by the EU Treaty on the Functioning and the Resolution of the European Commission no. 1467/97/E of 7th June 1997. The debt rule of the European Union applies to Hungary for the first time since 2016.
According to this rule the proportion of sovereign debt to the gross national product (GDP) shall not exceed 60 percent. In case the sovereign debt exceeds this reference value then the departure shall have to be decreased annually and in average by one twentieth parts compared to the reference framework of the previous three years.

year 2018 – the Council established that" the international macroeconomic data received so far forecasted favourable economic activity" for years 2018 and 2019. Additionally, „the international organisations, domestic institutional and market analysers were also expecting the continuation of further, powerful growth and their forecasts indicate a growth rate around 4 percent." On the other hand the FC raised the awareness to the fact that „beside the generally supportive external conditions, circumstances bearing a certain element of danger might also appear […] and that might affect the economic output of the country in 2018".

In the Justification section of its above resolution the FC also underlined the „the economic development strategy of the Government supports the growth rate as well as the so far introduced and continuing tax and contribution decreases that are targeting the employment activity as well as the utilisation of the EU resources". The Council also considered it important that „the investment activity in most fields of the national economy has been outstanding". Additionally, based on the processes of the first quarter, in the Council's opinion „an economic growth close to the expectations of the Government was realistic for year 2018" and that the FC „considered that the 2, 4 percent targeted deficit – calculated by the EU methodology – was viable". At the same time the institution called the attention to the fact that the structural deficit[4] targeted by the Convergence Programme for year 2018 was higher […] than the 1, 5 percent medium range fiscal goal stipulated by Point a) Indent (2) § 3/A of the Stability Act".

According to its standard practices in in its 6 months' evaluation the Council was primarily relying on the written analyses prepared by the State Audit Office of Hungary and the Central Bank of Hungary about the processes of the first half of year 2018. Apart from the above documents it also reviewed the analyses prepared by the domestic research and analysing institutions commissioned by the Secretariat of the Council and the analyses of international organisations (EU, OECD, IMF), as well as the respective economic papers of other benchmarking market analysts. In the evaluation the FC also took into consideration the contents of the Convergence Programme of Hungary for 2018 – 2022.

According to the tasks stipulated by Point c) Indent (1) § 23. of the Stability Act, just like in its previous cycle, the Council examines the half-year processes of the implementation of the annual budget act and its characteristic features every year. Additionally, the FC also examined the expected trend of sovereign debt, formulated its respective opinion and published these opinions.

The FC shall inform the Speaker of the National Assembly about its Opinion as well as the Government and shall publish the Opinion on the website of the National Assembly. .

[4] The balance of the governmental sector adjusted from the cyclical effects of the economy and individual items (Point y) Indent (1) § 2. of the Public Finance Act.

II

The Opinion of the Council

In harmony with Indent c) § 23. of the Stability Act, at its meeting held on 18th September 2018 the Council reviewed the major processes of the execution of Act C of 2017 on the 2018 central budget act as well as its respective background and the expected trend of the sovereign debt. On that basis the FC formulated the following Opinion.

1) On the basis of the favourable macroeconomic processes of the first half of 2018 the Council is of the opinion that the economic growth rate for the whole year could be around 4, 3 percent, in harmony with the expectations of the Government. Apart from the external and internal conditions that, in general, are supporting the expansion the conditions bearing risks have also gained momentum and those might affect the economic output of the country in 2018 and thus the public finance.

2) As regards the trend of the public finance deficit in the first half of the year the Council finds that:

   a) It sees the annual 2, 4 percent, so-called ESA[5] targeted deficit – calculated by the EU methodology – viable as in the course of its calculation the advances paid for the EU supports don't have to be considered respectively, it is possible to add to them revenues, depending on whether it is an expenditure within public finance or outside public finance. To this end it is necessary to resort to robust control of the expenditures, especially in case of central fiscal organisations.

   b) The cash[6] deficit of the central subsystem in the first half of the year was HUF 1421 billion, which is HUF 509,3 billion higher compared to the previous year, and HUF 60 billion higher than it was forecasted. The Council sees risks related to the cash deficit goal for the year. The expenditures of the subsystem exceeded the pro rata temporis proportion and reached 52, 1 percent in the first half of 2018, while the revenues performed below the pro rata temporis share and represented 48, 3 percent, partly due to the approved but not paid EU programmes. On the revenue side the worse than the pro rata temporis share was mostly the result of the outstanding amount worth close to HUF 800 billion while on the expenditures side it was due to the implementation that was higher by 10 percent than the pro rata temporis appropriation as regards most of the expenditures of the fiscal organisations and chapter managed appropriations. The latter was also made possible by the utilisation of the residuals of the previous year however; this

[5] The ESA balance of public finance: when calculating the revenues and expenditures according the methodology of the European System of Accounts generally used in the EU it is not the financial flow that is considered but the time associated with the economic content of their emergence.

[6] When calculating the cash-flow balance of public finance they are calculating with all the revenues and expenditures – with the exception of loans and debt repayment (on the other hand however they consider the interest revenues and expenditures originating from the management of sovereign debt).

represents a risk as it is increasing the cash deficit if the amount of residuals turns out to be less, at the end of year 2018.

c) According to the above the cash based targeted deficit of the central subsystem, stipulated by the budget act, would be viable at the end of the year only in case the arrival of the EU revenues would quicken in the second half of the year and, in case of the expenditures, especially in case of the budget chapters they would require even more strictly the coverage by revenues. Only in case of the latter stipulation sees the Council a chance for a „strict" financial management however, the FC sees only limited chances for the quickening influx of EU revenues. The Council does not think that the implementation of the targeted cash deficit is very likely.

3) As regards the sovereign debt trend the Council establishes the followings:

a) The FC considers the measures of the Government targeting the mitigation of the public finance indebtedness as a forwarding element. The advances on EU supports paid to beneficiaries of the state that have no treasury accounts (local governments, state owned companies) have to be managed on treasury accounts beginning with October this year – above the amount of HUF 50 billion. The establishing of the Central Residual Management Found this year might also assist keeping of the sovereign debt under control. Apart from the above additional measures promoting the control of sovereign debt are necessary.

b) The Council also deems it favourable that at the end of the first half of the year the structure of the sovereign debt amounting to HUF 28 3337, 7 billion improved further. The Forint denominated debt within sovereign debt approached 80 percent while the share of foreign currency denominated debt was 20 percent. By the decrease of the foreign currency denominated debt the vulnerability of the central budget further declined.

c) Thanks mostly to the strong acceleration of economic growth the rate of the GDP proportionate sovereign debt might decline in harmony with the stipulations of the Fundamental Law and the Stability Act and the year-end prognosis of the GDP proportionate sovereign debt calculated by the EU methodology, might also meet the so-called one-twentieth rule.

d) The minimum requirements stipulated by the law represent such implicit reserves that – in case of unfavourable conditions – they would allow a larger than planned sovereign debt. Despite this fact and apart from meeting the obligatory requirements it would be worth to consider reaching a higher decline of sovereign debt by using the favourable economic background. On the other hand we should be aware that the increase of the central budget debt in the first half of the year reached 114, 8 percent of the share forecasted for the whole year that is mostly the result of the unprecedented cash deficit of the past years.

e) Financing the increased sovereign debt might increase the burdens of the central budget and thus might stop the process of cutting back the interest rates.

III

Justification

1. The trend of the macroeconomic conditions

The Government built the 2018 central budget bill on a growth rate of 4, 3 percent. International organisations, domestic institutional and market analysts also are counting with a robust growth throughout the year. Their last forecasts are established on a rate around 4 percent (as a consequence of the robust/accelerated utilisation of the EU resources and the incoming foreign working capital they foresee a 4 percent growth while the OECD is counting with an even higher growth, i.e. by 4, 4 percent, and IMF – with respect to the acceleration of the world economic growth and its balanced nature expects the expansion of our annual economy around 3, 8 percent).

According to the Council's consideration, apart from the generally favourable external conditions, the Government's economic development strategy, the steady and dynamic growth of real wages, the related strengthening of household consumption as well as the tax and contribution decreasing policy, together with the utilisation of the EU resources are all supporting the economic growth.

However, the Council is of the opinion that apart from the generally supportive external conditions factors presenting hazards continue to be present (raising oil prices, the lingering Brexit talks, commercial „wars" and tensions attributable to the inconsistent management of massive immigration, etc.) and these factors can affect the economic performance of the country in 2018.

The rate of the expansion of our economic performance was 4, 5 percent in the first half of 2018 compared to the same period last year. The biggest contributors to this result were the market based services (2, 6 percent), the performance of the industry and the building industry (0, 5 – 0, 5 percent).

The dynamics of the export exceeded the GDP growth while that of the import was even bigger.

Final consumption also grew – within it, in harmony with the increasing household revenues; the household consumption was more robust while community consumption was more moderate.

Investments realised form EU and domestic resources kept expanding. The environment of low interest rates, the expansion of small and medium business loans and the more and more dynamic utilisation of the supports of the 2014 – 2020 EU budget cycle keep strengthening this process.

The building and apartment buying activities of the households, encouraged by the various governmental programmes are exerting a favourable effect on the housing market processes. In the first half of the year the number of newly built apartments kept growing. In this period altogether 6 517 apartments were build, which represents 30 percent more than in the same period of the previous year. The number of issued building permissions and the number of apartments built with simple notification remains high (18 thousand in the first half of the year), however; this is less by 8, 9 percent than the data of the same period of the last year.

As a consequence of the generally favourable external economic conditions and the measures of the Government supporting the economic expansion, the increasing activity and the absorption effect of the labour market employment kept growing further. This has a favourable effect on the increase of the wages and salaries and the revenues of the budget. According to the 2018 April – June data (three months rolling average) the average number of employees was 4 475 that means more by 55 thousand than in the same period of the previous year. The employment rate of the 15 to 64 age group increased to 69, 3 percent. At the primary labour market there are 100 thousand more people working and the number of those employed as public workers decreased by 39 thousand. The decrease of the number of unemployed also continued. It is less by 31 thousand and settled at 165 thousand compared to the same period of the previous year. The unemployment rate is less by 0, 7 percent and is now 3, 6 percent. In the first half of the year both the gross and net average wages grew by 11, 9 percent thus continuing the trend of the previous years. Increasing the minimum wage this year by 8 percent and the guaranteed minimum wage by 12 percent, together with the settling of wage/salary increases at certain fields of the fiscal sector have had significant effect on the growth. Due to the labour shortage in specific professions the competition for labourers increased and this indicates the continuation of the wage increasing trend.

The rate of the growth of consumer prices was 2, 3 percent in the first half of the year. The price of medications, fuel, articles related to housing and household, alcohol, tobacco and food products have grown to the greatest extent. The deterioration of the exchange rate of the Forint also was playing an important role in the increase of the inflation rate.

The volume of retail trade expanded further in the first half of the year – by 6, 9 percent – compared to the similar period of the last year. (Within this the selling of food, of non-food products and fuel grew by 4, 4 percent, 9, 9 percent respectively by 7, 5 percent). The utilisation of accommodation is also indicating a growing demand: their revenues increased by 10 percent as a result of registered nights being higher by 5, 3 percent and the improving utilisation of rooms.

In the Council's opinion – in case of the subsistence of the favourable tendencies that had characterised the processes of the first half of the year and if the external tendencies shall not deteriorate – the economic growth might turn out close to the expectations of the Government and thus might ensure the reaching of the public finance goals.

2. The trend of the revenues

As regards the **total revenues of the central subsystem** of public finance the output of the first half of 2018 was HUF 9 046 that is 48, 3 percent of the annual appropriation (proportionally it is higher by 1 percent while in its amount is higher by HUF 605, 7 billion in comparison to the data of the same period last year).

Within the subsystem they realised HUF 5 973 billion **in the central budget** that represents 47, 6 percent of the planned amount.

In case of the payments of entities the amount of the first half of the year was HUF 566, 8 billion that is 41, 9 percent of the annual appropriation. A significant part of the failure compared to the annual plan was made up of the lagging behind of corporate tax (27, 1 percent), the simplified business tax (21 percent) and the other, centralised payments (51, 1 percent). From corporate tax altogether HUF 100, 2 billion was received in the first half of the year. The reason was the carry-over effect of the provisions concerning the advance supplement of year 2017 to January 2018. The payments for funding for growth tax credit have decreased as well. It is expected that the leeway of the corporate tax payments from the pro rata temporis amount will be settled at the execution of the advance upload obligation in December. The execution of payments was close to the respective annual appropriation – pro rata temporis – in case of the followings: energy suppliers' income tax (44, 2 percent), the special tax of financial organisations (48, 2 percent) and the public utility tax (48, 7 percent). The payments of the following exceeded the pro rata temporis proportion: energy tax (62, 4 percent), mining fee (52, 5 percent), business car tax (51, 6 percent), environmental charges (51, 4 percent), gambling tax (51, 1 percent) and other, centralised revenues (50, 1 percent). In case of the latter the favourable trend of the electronic and time based road tax and the fines were playing an important part. The six-month realisation of small corporate tax (69, 3 percent) and the revenues from the itemized tax of small taxpayers (52, 4 percent of the annual appropriation) turned out to be favourable as well.

From **consumption related taxes** a revenue of HUF 2 452 billion arrived in the budget that represents 46, 6 percent. This amount was exceeded – similarly to the same period last year – by the pro rata temporis payments of financial transaction fees (56, 0 percent), insurance tax (58, 6 percent) and the registration fee (53, 9 percent). The result of the value added tax revenues that in this revenue group represents great importance, was 46, 2 percent (HUF 1 773 billion) that exceeds both in value (by HUF 214, 2 billion) and in proportion (2 percent) the similar data of the previous year. The fact that the VAT revenues paid after tobacco products – both domestic and imported – increased had a favourable impact on the revenues and this was supported by a significant sales growth.

The expansion of domestic payments is fundamentally related to the commerce and manufacturing industry. As of 1st January 2018 in case of 'trusted taxpayers' the VAT refund deadline decreased from 45 days to 30 days and this does not endanger the realisation of the annual appropriation. The **excise duty** revenues of the budget was HUF 498 billion (45, 3 percent of the appropriation) that exceeded the similar data of the previous year by HUF 41 billion, i.e. by 0, 6 percent. The favourable trend of excise tax revenues is related to the expansion of the sales of tobacco and fuel.

Retail payments in the first half of the year resulted in revenues worth of HUF 1 174 billion (the realisation was exceeding the pro rata temporis measure and reached 50, 2 percent). Personal income tax was playing a decisive role in this (HUF 1 050 billion), that was 50, 1 percent of the appropriated amount. The continuous expansion of employment as well as the strong wage moderation was playing a significant part in the growth compared to the previous year that reached HUF 128, 3 billion. As regards the payment of the levy it turned out to reach 49, 3 percent that essentially was in harmony with the pro rata temporis share. The delivery of tax on motor vehicles – thanks to the expansion of sales – was favourable and exceeded the pro rata temporis share by reaching 57, 9 percent.

The revenues of **fiscal organisations and chapter managed appropriations** in the first half of the year reached HUF 1 234 billion that equals 91, 4 percent of the annual appropriation. From this amount 85 percent of the appropriation i.e. HUF 1 121 billion originated from fiscal organisations. In case of professional chapter managed appropriation the execution was four times higher than the appropriation. This follows from the accumulation within public finance – just like in the previous years. As regards the EU support of professional chapter managed appropriations the performance was HUF 230 million that is 7, 6 percent of the appropriation.

Revenues concerning **state assets** (related to real estate, assets, dividends and other revenues) reached HUF 95 billion in the first half of the year that is 99, 3 percent of the appropriation).

Revenues (interest) related to debt service were realised to an extent that exceeded the annual appropriation (HUF 73, 4 billion) and the realisation was 105, 5 percent. The reason for the high realisation was the re-purchase of sovereign bonds that exceeded the original plans.

The revenues of the approved **EU programmes** amounted to HUF 162 billion, which is less than 10% of the forecasted value. This is mostly due to the significant delay relating to those programmes financing by the EU.

The combined revenue appropriation of the **separated state funds** (HUF 517 billion) was realised to 47, 4 percent (HUF 244, 9 billion) in the first half of the year. From among the separated state funds the revenues of the National Employment Fund, that represents the biggest share, were realised at 46, 7 percent; failure to reach the appropriation can be detected only under the title of over-recovery of the expenditures of pre-financing of EU programmes where the pro-rata temporis realisation was lower (39, 1 percent). The revenues of the National Employment Found (NEF) that represents the biggest share reached 46, 7 percent of the appropriation. Leeway occurred only under the title of reimbursement of the expenditures of pre-financed EU programmes when the realisation was below the pro rata temporis share (39, 1 percent). At the same time the revenues from the vocational training levy turned out to be higher than the pro rata temporis share (58 percent). The share of the NEF from the social contribution tax was terminated in 2018.

The revenue appropriation of the **social security funds** (HUF 5 680, 5 billion) was realised to 50, 1 percent in the first half of the year (within it the revenues of the Pension Insurance Fund reached 49, 7 percent, of the Health Insurance Fund reached 50, 6 percent). A decisive proportion of social security funds (in case of the Pension Insurance Fund 97, 1 percent, the Health Insurance Fund 58, 4 percent) originated from the social contribution tax and contributions. The revenue of the Pension Insurance Fund originating from the social contribution tax exceeded the result of the same period in the last year by HUF 160, 1 billion. As of 2018 the degree of the tax has changed: from 22 percent to 19, 5 percent however, the share of the Fund from this source has grown to 79, 5 percent. Additionally, the growth of gross wages and salaries increased the tax base (and the revenues). The revenue of the Health Insurance Fund originating from social contribution tax exceeded the revenue data of the same period in the previous year by HUF 46, 7 billion – thanks to the increasing gross wages and salaries. From among the revenue titles of the Funds a leeway compared to the pro rata temporis share can be detected only in case of default interest and fines (the under-performance here is 28 percent, respectively 30, 7 percent).

3. Expenditure implementation

In the first half of 2018 the **central subsystem of public finance realised** HUF 10 485 billion expenditures thus utilising 52, 1 percent of the appropriation. This is bigger by nearly 4 percent than in case of the revenues. Expenditures exceeded even the result of the same period last year by HUF 1 115 billion, i.e. nearly 12 percent. In case of the latter the growth manifested primarily in the expenditures of the fiscal organisations, the domestic and EU resourced expenditures of the professional chapter managed appropriations and the retirement benefits.

The **central budget** represents more than 71 percent of the subsystem where payments amounted to HUF 7 449 billion that is, to 53, 7 percent of the appropriation.

In case of the **individual, normative subsidies, those given to the public media and fare supports,** the utilisation was HUF 286 billion – 52, 8 percent of the annual appropriation – and serves mostly the operation of public transport.

As regards the **housing promotion activities** the realisation is merely HUF 80 billion (34 percent) that is lagging behind by HUF 4 billion, even of the expenditures of the same period last year. The explanation lies in the fact that the number of the applicants for such supports has changed and due to the accounting regulations the frequency of the payment has also been affected.

From the expenditure appropriation of **family allowances, income replacement and supplementary premiums as well as the benefits paid to below standard retirement age (National Family and Social Political Found)** they spent HUF 326 billion (50, 5 percent). In case of the family allowances and, within it, in case of the largest title, the child benefit, the payment was somewhat less than in the same period of the previous year. Namely, less people enter the support system than the number of those leaving it. They used somewhat less money for the income replacement and supplementary premiums as well, mostly because due to the favourable labour market processes the number of those applying for income replacement decreased.

Expenditures of the central fiscal organisations and chapter managed appropriations make up two thirds of the central budget expenditures. From among all items this was where the realisation was the highest in the first half of the year; the expenditure of HUF 5 273 billion represented 58 percent of the appropriation. They were using significantly more than the pro rata temporis amount/percentage (by 13, 7 percent) for the purposes of institutions, mostly for staff expenditures and the respective contributions. The paid amount for these was HUF 1 564 billion, that was even more by HUF 156 billion than the similar expenditures in the previous year.

The quicker increase of expenditures was made possible partly because of the higher than planned increase of the revenues and partly the utilisation of the significant residuals from year 2017. This however represents risks as in case the utilisation of the residuals incurred in the previous year exceeds the total of the residuals incurred in the given year, it shall increase the cash deficit.

Expenditures related to EU programmes amounted to HUF 1 118 billion that represents a leeway of 3-4 percent as regards the pro rata temporis realisation however, they exceeded the result of the previous year by HUF 72 billion. Expenditures have risen mostly in relation to the cohesive operative programmes of the 2014 – 2020 cycle; in descending order at the Human Resources Development Programme, the Integrated Transport Development Programme and the Territorial and Urban Development Operative Programme.

They spent HUF 1 395 billion domestic resources for various tasks that was more by nearly 10 percent than the pro rata temporis proportion of the appropriated amount and more by HUF 492 billion than the expenditures of the same period last year. Within this approximately HUF 200 billion served the supporting of various public educational, non-state higher educational purposes and the normative support of social goals; HUF 100-100 billion each was spent on priority public road projects and the realisation of the

Modern Cities Programme. A significant amount was dedicated to the availability fee of motorways, the maintenance of public road system, investments of religious communities and other programmes, the management of migration, touristic, agrarian tasks as well as for the Healthy Budapest Programme.

The amount of HUF 353 billion transferred under the title of **local government support** was barely more than the pro rata temporis part of the appropriation. The amount that was higher by HUF 28 billion that that used in the same period of the previous year, was financing the extra expenditures of the various wage-policy measures concerning this sector as well as other, specific tasks – like the consequences of the transformation of the task financing of day-care centres.

The contribution to the EU budget amounted to HUF 257 billion that was close to the pro rata temporis proportion (50, 7 percent).

The expenditures related to state assets amounting to HUF 103 billion reached only 31, 9 percent and less by HUF 22 billion than the same expenditures a year earlier.

They spent HUF 483 billion for gross **interest expenditures** that was somewhat less than the pro rata temporis share. Mostly due to the decreasing yield environment, compared to the same expenditures in the first half of a year before, the decrease amounted to HUF 130 billion.

From the aspect of public finance balance from among the **central reserves,** the most important is the **Country Protection Found** that was set up to offset unforeseen risks. This appropriation is HUF 60 billion. In year 2018 the regulation remains unchanged, i.e. it can be used in two phases, up to HUF 30 billion each, thus the first part following the submission of the EDP report by 31st March 2018, the remaining part following the submission of the EDP report by 30th September 2018, in case the EDP deficit described in the EDP report does not exceed the 2, 4 percent of the GDP – the amount to be used included. In compliance with the above regulation in the first half of 2018 they transferred HUF 28, 1 billion in favour of four chapters.

The reserve for **extraordinary governmental measures** is also important. This is separated for financing tasks originating from governmental decisions and for replacing fiscal revenues that fail to materialise due to force majeure. From the original appropriation for year 2018 that amounted to HUF 110, 0 billion/year they transferred HUF 43, 7 billion in the first half of the year by Government Resolutions to 11 chapters. This is less by 0, 3 percent than the 40 percent reserve that – according the Public Finance Act – can be used in the first half of the year without the authorisation of the National Assembly.

In harmony with its name the role of the **Chapter Stability Reserve** is also important. HUF 33, 6 billion was set aside for this purpose and nothing was used from this amount in the first half of the year.

The **Central Found of the Budgeting of the Balance** is a new institution. The regulation on the execution of the Government Resolution 368/2011. (XII. 31.) concerning budget residuals has changed as of 1st January 2018. According to the new regulation the fiscal residuals free of commitments have to be paid to the Central Found of the Budgeting of the Balance. It is the Government that decides on the utilisation of the Central Found (sort of reserve) based on the proposition of the Ministry of Finance. However, compared to the previous years, this is not an „extra" opportunity to obtain resources as it was only the rule of procedure of the non-committed residuals (for the same or other purposes) that has changed. (In the previous years such amounts were transferred from the ministries, now they pay it first to the Central Found and the transfer is executed by them). From the appropriated amount of HUF 178, 0 billion they used HUF 45, 5 billion. According to the FC the new regulation offers a wider opportunity to enforce balance aspects.

The appropriation of **Provisions** to finance provided measures is HUF 90, 6 billion. From this, in the first half of 2018 they used HUF 12 billion for not prorated use of the wage compensation of public servants at the budgetary chapters, i.e. 60, 2 percent of the allocated amount. From the open at the top appropriation of Chapter Careers and wage measures they transferred HUF 66, 7 billion (101, 4 percent). This appropriation is to finance – among others – the resources required for the wage increases of public servants, law enforcement careers, state official careers and healthcare employees.

As regards the expenditures of the **separated public funds** that represent nearly more than 2 percent of the central subsystem (HUF 230 billion) the implementation lagged behind the pro rata temporis share by nearly 10 percent. This is mostly the consequence of the leeway of the largest item, the National Employment Found – and within it – that of the (active) expenditures of the Start Work Programme. The utilisation by Start Work Programme – similarly to the previous years – is small, as a consequence of the strong demand at the labour market and the low unemployment rate.

The **expenditures of the social security founds** amounted to HUF 2, 806 billion, i.e. approximately 27 percent of the total expenditures of the central subsystem. The utilisation in the first half of the year has not reached half of the annual appropriations at either founds.

The amount of HUF 1 656, 4 billion used from the **Pension Insurance Found** for pensions is an outstanding amount within the financial founds of social security. Thanks to the increases introduced at the beginning of the year it was more by HUF 92, 2 billion, i.e. by 5, 9 percent than the same data of the first half of 2017.

Within the **Health Insurance Found** that used HUF 1, 147 billion the amount paid for curative and prevention cases and reached HUF 596 billion, i.e. more by HUF 58 billion than the same data of the base period, thus represented the largest expenditure appropriation. The growth was the result of the following factors: wage increases in the health care (raising of wages of specialised workers and doctors in November 2017, additionally – as regards the specialised workers the frontloading of the November 2018 increases to January – as well as the increased financing of general practitioners and dentists. (According to the latter the monthly amount of supporting the overhead expenditures of GP offices grew by HUF 130 thousand per month in the second half of 2017, to be followed in March 2018 with a same amount of increase. As a consequence the overhead support of HUF 130 thousand per month was introduced also for basic dental care.) Close to one third of the Found – HUF 320 billion – was used for cash benefits (for the rehabilitation of the disabled they used less than in the previous six months, while for childcare and sick pay the expenditures were higher than earlier).

4. Viability of the targeted deficit

The 2018 budget act determined the **cash deficit of the public finance subsystem** in HUF 1 360, 7 billion. The deficit in the first half of the year amounting to HUF 1 420, 5 billion consisted of the HUF 1 476,3 billion of the central budget respectively the surplus of the separated state funds, worth of HUF 15, 3 billion and that of the social security found worth of HUF 40, 5 billion. The subsystem's deficit turned out to be higher by HUF 509, 3 billion compared to the deficit of the first half of the previous year thus it reached 104, 4 percent of the annual appropriation (the same data was 46, 2 percent in the first half of 2017).

In order to be able to judge this result the Council considered it necessary to review the evaluations of the first six months of the previous years. It turned out that in the earlier period it happened only once that the cash deficit of the first half of a year exceeded the amount calculated for the whole year. At that time this was the result of the over-expenditure of the previous government. Now it was the result of the high amount of the advance payments of EU supports to thus accelerate the concerned investments.

The fact that the expenditures of the subsystem were realised at a rate exceeding the pro rata temporis amount, i.e. 52, 1 percent, while the revenues were realised below the pro rata temporis, to 48, 3 percent, were playing a part in the trend of the cash deficit in the first half of 2018.

The reason behind the departure of the cash deficit from the pro rata temporis value was mostly that there was a backlog as regards the revenues of the EU programme worth of HUF 800 billion. Apart from this the realisation of certain direct revenues in the first six months of the year (especially the corporate tax, the VAT and the excise tax revenues) were lagging behind the pro rata temporis. The improving factor concerning the cash deficit was that the revenues of the budget chapters were realised in a higher amount that the pro rata temporis appropriation.

As regards the expenditure side, the over-performance of the pro rata temporis were defined by the expenditures of the fiscal organisations and chapter managed appropriations that – compared to the 2018 appropriation – were realised to 58, 0 percent.

Within the above the unfavourable trend of the cash deficit in the first half of 2018 was influenced by the difference in the pace of realising the expenditures and revenues related to EU supports. The amount of the EU payments accounted among the chapter managed appropriations was HUF 1 118, 4 billion that equalled 46, 3 percent of the planned appropriation while revenues of the central budget, as regards the EU supports of chapter managed appropriations the revenue was merely HUF 0, 2 billion (7, 6 percent), the revenue of EU programmes was HUF 162, 0 billion (8, 6 percent). The realisation of the revenues of EU programmes was lower by HUF 793, 6 billion in the pro rata temporis amount of the first six months of the year. The significant difference between revenues and expenditures is mainly due to the delay of those EU funds being withheld for now.

Considering all the above the Council is of the opinion that the risks endangering the implementation of the cash based targeted deficit defined by the budget act regarding the central subsystem are significantly more serious than they were in the past years.

As regards the total of public finance – on the basis of the ESA deficit in the first quarter published by the Central Statistical Office and the net financing ability of the public finance as indicated for the second quarter by the Central Bank of Hungary – the calculated **accrual base deficit** in the first six months of the year was HUF 330 billion. This is merely one third of the yearly appropriation. The significant deviation of the cash deficit and accrual base deficit almost exclusively was the result of the advance payments for the EU supports that shall not be taken into consideration when calculating with accrual base accounting. Thus the annual 2, 4 percent targeted ESA deficit, according to the Council, is viable. To this end it is necessary to keep the expenditures under strict control, especially in case of fiscal organisations.

Similarly to the case of the 2018 draft budget bill, the Council called the attention to the fact that the 2, 5 percent structural deficit is higher than the stipulation of Point a) Indent (2) § 3/A. of the Stability Act that defines the deficit in its medium term budget target in 1, 5 percent. This is not expected to change in 2018 however; in 2019 the structural balance shall be improved considerably.

5. The succeeding of the sovereign debt rule/s

By the end of year 2017 the **gross sovereign debt** amounted to 73, 6 percent of the GDP while at the end of the first half of 2018 it amounted to 74, 5 percent. According to the Convergence Programme for 2018 – 2022 this rate should decrease by the end of 2018 to 73, 2 percent.

The **debt of the central budget** that is playing a decisive role from the aspect of sovereign debt is nearly 95 percent. The planned amount for 2008 is HUF 27 828, 5 billion. Compared to the 2017 base of HUF 26 456, 2 billion the appropriated growth is HUF 1 372, 2 billion. The debt increase experienced in the first six months of the year (HUF 1 587, 5 billion) represents 115, 7 percent of the annual appropriation. This originated from the cash deficit of the public finance central subsystem – and within this, of the central budget – that was unprecedented in the previous years (above we have seen its factors related to the advance payments for EU supports).

The **financing of the increased sovereign debt** might increase the burdens of the central budget. It can stop the favourable process that started in 2015 and meant the cutting of interest rates.

As regards the management of sovereign debt the FC considers that the endeavours of the Government are positive. Like the Public Finance regulation that came into power on 26th July 2018 (Indent (4) § 51.) according to what the advance payments for EU supports also shall have to be managed on a treasury account – above the amount of HUF 50 billion – even in case of state beneficiaries (local governments, state owned companies) that have no treasury accounts (the „shift" shall have to be completed by 30th December 2018). However, the Council sees it necessary to make additional, similar steps.

The Council has a positive view on the improvement of the **indebtedness structure** that amounted to HUF 28 333, 7 billion by the end of the first half of the year. The tendency of the previous years continued, i.e. the share of the Forint debt increased. The value of the **Forint denominated debt of the central budget** grew by end of June to 22, 441, 2 billion as a consequence of what its proportion within the total sovereign debt has grown from the 77, 4 percent on 31st December 2017 to 79, 1 percent.

Within this it was a significant momentum that as a result of repurchasing retail securities from the banks contributed to the realisation of the goal to have those securities in the hands of the citizens instead of the banks. **The foreign currency denominated debt of the central budget** decreased by HUF 153, 1 billion to HUF 5 629, 4 billion compared to the end of the past year. Thus the share of the foreign currency denominated debt mitigated from 21, 6 percent to 19, 9 percent within the total indebtedness. As a result of the declining exposure of the central budget to the rate of exchange changes grew even smaller.

Apart from the nominal indebtedness of the central subsystem the debt of the local governmental subsystem is expected to be higher as well but this amount is expected to be considerably lower than that of the central subsystem (below HUF 200 billion).

The large extent gross cash deficit foreseeably shall match the dynamic economic growth that shall exceed the planned ratio throughout the whole year. Thus **the gross debt rate might decrease in harmony with the domestic and EU requirements** by the end of 2018. According to the stipulation of the debt rule of the Fundamental Law the sovereign debt per GDP will decrease and the rule of the Stability Act (debt formula) might also be observed. Namely, the latter says that in case the growth rates of the inflation and of the real economy forecasted for the given budget year equally exceed 3 percent then the balance of the budget shall have to be planned so that the annual growth rate of the sovereign debt shall not exceed the rate of the half of the difference of the inflation and growth. However, if from the two at least one is lower than 3 percent the debt rule prescribes a minimum 0, 1 percent debt rate decrease. As in the course of the calculations of the 2018 budget act they were counting with an inflation rate below 3 percent the stipulation is to reach a 0, 1 percent debt rate reduction.

The latter carries an implicit reserve. Instead of resorting to this reserve the Council wishes to urge the Government to make use of the favourable economic situation of these years and make a progress in applying a brake on the growth of the nominal amount of the sovereign debt.

According to the FC the observance of the so-called **one twentieth rule** that belongs to the correction branch of the Stability and Growth Pact of the European Union is also viable. According to the Maastricht debt rule the debt of the governmental sector shall not be more than 60 percent of the GDP. In case the debt exceeds this limit the debt rate shall have to be decreased and it shall have to be approaching - at an appropriate pace - the 60 percent. According to the principle the decrease of the debt of a member state can be regarded as adequate if the part between the 60 percent and the actual debt is decreased by one twentieth part regarding the actual year and the two years preceding the actual year. The Commission is using three methods when checking the compliance with the one twentieth rule and it is enough if the compliance exists according to one of the three methods. From among the three methods in case of two they determine a threshold, a benchmark that the debts should achieve. In the first case they examine if the debt decreased in an average of one twentieth part in the subject year and the previous two years. This is the retrospective method. In case the finding is negative comes the second method, the foresight method: they examine if following the actual year the debt rate is expected to decrease in the required pace. In the course of the analyses the Commission takes into consideration its own estimation, forecast, apart from the factual data and independent from the forecasts of the member state. In case of the third method they are counting with a debt rate cleaned of the effects of the economic cycle for the past three years and this has to meet the first type (retrospective) benchmark. In case a member state does not meet the stipulation of the one twentieth rule according to the above methods, the Commission might initiate an EDP against the given member state.

At the end of 2017 the Maastricht debt rate amounted to 73, 6 percent. As to this year, in an extraordinary way the one twentieth rule does not stipulate debt rate decrease because of the dynamic mitigation of this data in the previous years. This means that in 2018 it is possible to observe the one twentieth rule even by a moderate debt rate increase. Namely the decrease of the debt rate in the previous two years has been significantly exceeded; the rate decreased from 76, 7 percent in 2015 to76 percent in 2016 and by 2017 the indicator was 73, 6 percent. The criteria value calculated for 2018 by the retrospective method is 73, 9 percent that is higher than the debt rate of the previous year. Thus the stipulation is being met in this year.

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