

**OPINION OF THE FISCAL COUNCIL****on the execution of the 2012 central budget of Hungary****– major characteristics of the processes in the first half of 2012 –****I.****Antecedents, legal basis and publicity of preparing the Opinion**

According to § 23 d) of Act CXCV of 2011 on the Economic Stability of Hungary the Fiscal Council (henceforth: the Council) shall give an opinion every six months on issues related to the planning and the execution of the central budget, or any other issues related to the use of public money.

When summing up its evaluation of the processes in the first half of the year concerning the execution of Act CLXXXVIII of 2011 on the 2012 central budget of Hungary, with its Opinion the Council, on the one hand, is meeting its obligation as per its legal duty deriving from the above. On the other hand, the purpose of the Council's Opinion summarised in Chapter II is to offer a sizing up of the expected trend of the 2012 central budget, on the basis of the available data on the first half of the year, as well and the new measures concerning the running year's budget.

Within the frame of its legal mandate the Council considers itself concerned regarding the evaluation of the 2012 macroeconomic processes only from the aspect of examining if the central budget is fit for execution. The Council presents its opinion by maintaining its recommendations to mitigate the fruition risks, its earlier decisions, opinion and contributions – to be briefly referred to in dockets – as follows:

- According to the justification of the Council's opinion no. 4/2012.06.08. the calling of attention by its unanimous resolution of 12 December 2011 has been confirmed by the economic processes of 2012, the implementation of the central budget so far – the vulnerability of the economy, the economic output lagging behind the expected, the maintaining of blocking the reserves, and by the necessity of further budgetary corrections. Additionally, the GDP volume – following the 1, 7 % growth in 2011 - contrary to the earlier expectations and the factors considered when planning the 2012 central budget, will very likely decrease to a small extent;
- According to the justification of the Council's opinion no. 4/2012.06.08. although the economic output will be probably lower than the governmental prognosis that had served the basis for the 2012 planning process, in case of the full and timely execution of the new

measures listed in the Convergence Programme and the Széll Kálmán Plan 2:0, the so far taken and the necessary, additional corrections, as well as in case the blocked budgetary reserve will not be used; the targeted deficit of 2, 5 % in proportion to the GDP, is tenable in 2012. However, in this resolution the Council also called the attention to the fact that a portion of measures undertaken with the purpose of maintaining economic stability, impairs the possibilities of invigorating the economy and worsens the macroeconomic forecast for 2013.

- By its resolution no. 5/2012.06.28. the Council gave an opinion on the draft (T/7858) of Act CLXXXVIII of 2011 on the 2012 central budget of Hungary, respectively added a motion of amendment (T/7858/9) to the submitted document, and gave its preliminary consent to the 12 July 2012 final voting on the amendment no. 6/2012.07.10. In this opinion of the Council there were no such fundamental objections concerning the authenticity and the execution of the amendment that would have justified any indication of substantial disagreement. At the same time the Council called the attention to the risks of having trends significantly more unfavourable than those outlined by the governmental forecast that had been attached to the 2012 budget bill. Moreover, the Council emphasised that although the planned amendments were neutral from the aspect of cash-flow balance, they'd contribute to the increasing of the ESA aspect deficit. Thus, in case of adopting the amendment recommendation, the risk of overshooting the ESA approach target deficit undertaken by the government in 2012, will significantly increase.

When shaping its Opinion the Council used the evaluations and analyses made by the State Audit Office of Hungary and the Central Bank of Hungary, that had been simultaneously published and made available also at the website of the Council, irrespectively from the contents of the evaluation of the Government of Hungary that shall rely on final data and shall be published later.

The document of the State Audit Office of Hungary titled: "The Evaluation of the Budgetary Processes of Public Finance in the First Half of 2012" reviews the major macroeconomic determinations influencing the budgetary processes in the first half of the year. The SAO evaluated, analysed if the appropriations were achievable by taking into consideration the relevant changes of the regulations and of the cash-flow data of the first six months of 2012, as well as identified the risks from the aspect of the achievability of the targeted deficit.

The analysis prepared by the Central Bank of Hungary, titled: "Half-Year Evaluation of the Probable Trends of the 2012 Budgetary Processes for the Fiscal Council" offers a picture about the probable trends of the 2012 central budget on the basis of the data available for the first half of the year, the changes of the macroeconomic processes and the brand new measures concerning the budget of the running year. The analysis offers a pivot to the half-year examination of the realised debt rule and to the evaluation of the solidity of the 2013 budget bill. The analysis elaborated the relevant information regarding the period up to 30 June 2012. Apart from this, it also considered the 12 June 2012 amendments of the 2012 budget law.

In forming its opinion the Council also considered the opinions of independent experts and made use of the notions represented at the 16 June 2012 conference organized by the Hungarian Economic Association, upon the request of the Fiscal Council and related to the subject.

The Council shall inform about its Opinion the responsible office-holders of the National Assembly and of the Government, respectively shall publish its Opinion.

## **II.**

### **The Opinion of the Council**

At its continuous meetings held on July 13 and 16 of 2012 the Council unanimously decided on the following opinion:

1. The Council reviewed the trends of the budgetary processes in the first half of 2012. It established that in case of certain items of expenditures, there are transgressions and significant lagging behind also emerged in case of the revenues, most of what are related to the trend of the macro course and the agreement signed with the Hungarian Banking Association.
2. In the opinion of the Council the GDP proportionate deficit of the central budget can be kept under 3 % if the Country Protection Fund and the interest risk reserves will not be used and the balance improving measures of the Széll Kálmán Plan 2:0 will be implemented entirely.

## **III.**

### **Justification**

#### **1. Changing macroeconomic conditions**

In a recessing economic environment both the international and domestic forecasters predict the backsliding of the Hungarian economy in 2012. The various forecaster institutions estimate the size of the backslide between 0, 5 to 1, 5 %. The fact that the prognoses of the forecasters spread in a wide zone indicates that the external macroeconomic environment is unpredictable; the prediction regarding the measure of the expansion of Hungarian export typically foresees this measure between 3 to 6 %; that of the import between 1 to 5 %, while the forecast for the balance of payments is predicted to 1, 7 – 3, 7 % of the GDP. In respect of the inflation and unemployment the spread of the range of forecasts is smaller; concerning the former the measure is predicted between 5, 2 to 5, 7 %, the latter is expected between 10, 6 to 12, 0 %. As regards to the economic prognoses for 2012, both the Government and the forecasting institutions have continuously debased. The forecasts of the latter have been generally

more pessimistic than the expectations of the Government. OECD and IMF predict the slowing down of world economy in 2012 compared to the previous year. In Europe the economic policy built on restrictive measures put restraint on growth. The outlook of the German processing industry that represents a pulling force from the aspect of Hungarian export has worsened.

The real output of Hungarian economy in the first quarter shows a decline of 0,7 % in comparison to the similar period of the preceding year. The decline is related mostly to the weakening of the factors of foreign markets and the significant decline of investments. Personal consumption has lessened, due to the increasing inflation, the held back outflow of wages and the dropping resources coming from the early repayment of those indebted in foreign currency. Following the significant drop of the GDP in the first quarter, the second half of the year might actuate toward the direction of picking up of internal demand if, as a result of a successful agreement with international organisations, investors' trust will essentially gain strength.

## **2. Achievability of the deficit target**

The planned cash-flow deficit of the central budget for the whole year is HUF 593, 8 billion. At the end of the first half of the year the deficit was HUF 592, 3 billion that equals with 99, 7 % of the annual deficit. Complying with the governmental target of having 2, 5 % GDP proportionate deficit faces growing risks. Analysing institutions render the ESA value public finance deficit, calculated according to the method of the European Union – assuming the non-utilization of the Country Protection Fund and of the interest rate reserves – verisimilar at an average in 2, 7 % in proportion to the GDP. It is favourable that in its evaluation of May 2012 the European Commission – being aware of the so far done and planned measures –considered the targeted, GDP proportioned deficit of 2, 5 % achievable. Whether we succeed in keeping the economy in a state of near stagnation, i.e. whether the decline of the first quarter will shift to growth from the second half of the year, is of decisive importance from the aspect of achieving the targeted deficit of public finance. The deficit of local governments might lag behind the value of 0, 5 % of the GDP laid down by the budget law; at the same time, increasing EU developments might result in spending local governmental reserves and this would inflict unfavourable changes in respect of the deficit.

## **3. Prevalence of the debt rule**

In connection with the achieving of the debt rule that is part of the Basic Law of Hungary, the gross government debt might decrease by 0, 3 to 0, 5 % of the GDP, i.e. to a proportion of approximately 80 %; assuming that the deficit will remain under 3 % of the GDP, that the financing reserves will remain intact and that the rate of foreign currency exchange remains the same. Thus the 2012 central budget will be in harmony also in the future with the legal stipulations concerning the changing of the debt rate.

#### 4. Revenue risks

The unfavourable shifting of economic indicators resulted in the lessening of certain tax revenues and this had an effect mostly in the first quarter, but could be felt also in the cash-flow processes of the public finance in the first six months of the year. The tax decreasing effect can be detected, first of all, in case of tax revenues related to business profits.

The dropping of revenues resulting from the agreement signed with the Hungarian Banking Association has had a significant effect as well. As a resultant of the above two effects, in the first six months, the payments of economic organisations, in case of the more significant taxes (corporate income tax, simplified entrepreneurial tax, solidarity tax of financial organisations) have, by turn, lagged behind the time proportionate achievements prescribed by the appropriations. In case of the simplified entrepreneurial tax and the solidarity tax of financial organisations significant leeway can be expected also in respect of the whole year while the major part of the annual corporate income tax will come in to the budget only in December. Thus, the achievability of the corporate income tax appropriation remains uncertain until the last moment although, its under-achievement is more likely. Apart from the above, significant leeway can be expected also in case of gambling tax, due to the changing of the respective regulation (i.e. the raising of the taxes payable after gambling machines).

The lower than planned outflow of wages endangers the achievement of wage proportionate taxes and fees, as well. Despite this the achievement of social contribution taxes and fees are prorated, for the time being. The latter is due also to the fact that the seasonality of bonus payments changed at the beginning of the year, compared to the similar period of last year. In case of the personal income tax the slip from the prorated is already apparent, although, partly it is the result of the higher than planned number of claiming of tax refunds.

As a result of government measures, the tax structure witnessed a shifting of proportion beginning with 2010. Within 2 years the proportion of tax revenues originating from the payments of the population has fallen from 34 % to 25 %. Parallel with this decline the measure of taxes related to consumption have increased from 53 % to 61 %. In the meantime, the proportion of payments of economic enterprises, in essence, remained the same. In harmony with the tax policy goals the tax burden has shifted from income-type taxes to consumption-related taxes. In case of the latter – partly due to the higher inflation and partly to individual measures – no significant arrears have emerged in the tax revenues compared to the prorated revenues.

The excess revenues ensuing from those who had stepped back from the system of private pension fund systems, as well as the revenues related to the state assets, altogether making up 0,3 % of the GDP, contributed to the lessening of the tensions.

In case of revenue appropriations of a smaller amount, positive and negative departures from the prorate can be detected thus, these altogether do not endanger the realisation of the targeted deficit.

## **5. Expenditure risks**

The prorate direct expenditures of the central budget altogether have been met however, the interest rate subsidy introduced with the aim of helping out those who got indebted in foreign currency, respectively the taking over of the interest rate subsidy of those citizens who had been in delay in paying back their debt, might result in over-achievement.

In the first half of the year the divided provisions was HUF 98, 2 billion that made up 109, 1 % of the appropriation. This appropriation can be over-achieved without the obligation of amending the appropriation and, from the aspect of observing the planned deficit of the central sub-system of public finance represents a risk.

The gross sum of the chapter managed appropriations' expenditure of EU developments planned for the first half of 2012 was HUF 548, 5 billion, while the gross sum of revenues was HUF426, 5 billion.

The aggregate turnover of the expenditures in the first half of 2012 the revenue appropriations represented HUF 374, 0 billion (87, 7 %). As regards the expenditure in the first quarter the 32, 8 % departure – in comparison to the planned – has declined to 19, 4 % by the first half of the year. Nevertheless, the lagging behind of expenditures compared to the planned keeps being significant. This phenomenon can be explained by the lower than planned call for resources, the more unfavourable situation of the beneficiaries, the prolonged public procurement processes and the not appropriate preparation of projects. The speeding up of payments can be assisted by promoting the support of supplementing own resources regarding the EU development tenders of local governments and associations.

At the end of the first half of 2012 the amount of interest expenses related to the debt of the central budget reached HUF 692, 6 billion, that had significantly surpassed the prorate appropriation (65, 0 %). The net cash-flow interest expenses can exceed the 2012 annual appropriation by HUF 101 billion. Assuming a significant diminution of profits, in the budget they were planning a remarkably low level of interest expenses thus, the expected gross interest expenses can be higher than the appropriated amount by HUF 130 billion. This is counterbalanced by interest revenues amounting to HUF 67, 2 billion, that have been significantly higher than the prorated amount and made up 113, 3 % of the appropriated sum by end of June. In case of the favourable trend of interest revenues, the amount of real revenues in this respect may probably be bigger by HUF 28 billion than the plans of the Government. The signing of an agreement between the Government and the EU/IMF could also mitigate the risk of the over-

achieving the interest expenditures, thanks to the further strengthening of the rate of exchange and the decreasing of the CDS premium. The interest rate risk reserve, amounting to HUF 98 billion, may offer a backing for the net interest surplus, originating from the existing risks.

Due to the prorate, over-achievement of the appropriated pension expenditures, the Pension Fund closed the first half of the year by a deficit amounting to HUF 13, 7 billion. In case the inflation will be higher than the planned, the Government committed itself to rectify the pensions. Calculating with the presently known rate of inflation that has exceeded the planned rate of 4, 2 % by 1 percent, would mean an excess of expenditures, by HUF 25 billion.

Due to the 1 % over-achievement of the revenues in the first half of the year and the 0, 7 %, under-achievement of expenditures, the balance of the Health Insurance Fund shows a surplus of HUF 10, 4 billion. Expenditures of pharmaceutical subsidies have exceeded the prorate amount by 7, 9 % (i.e. HUF 22 billion). New measures have come into effect regarding pharmaceutical subsidies, however; their effect of decreasing expenditures could not be numerically expressed yet.

The National Assembly decreed upon the raising of the wages of health care providers in 2012 by HUF 30, 5 billion in June however, they had not raised the appropriation that should serve as a basis for the implementation of this measure. The original appropriation has not ensured the cover of the wage increases (there are no considerable savings within the expenditures), thus plus expenses arise.

The frame of expenditures has been further decreased – by approximately HUF 90 billion – due to the conditional blocking that had been announced in December 2011, and the additional decrease of expenditures mentioned in the Széll Kálmán Plan 2:0. The real necessities however have overwritten the appropriations' trend thus; as a result of the budgetary resolution adopted on 12 July 2012, expenditures of the concerned social and public education organisations have considerably grown. On the annual level, apart from the growing risk of the raising of revenues, the planned excess expenditures might result in a deficit increasing effect amounting to the 0, 2 % of the GDP. The slackening of holding back of expenditures has already been reflected by the May-June budget data.

## **6. Reserves**

The 2012 appropriation of the central budget reserves is HUF 360, 0 billion. By the end of June 2012 the Government decided on the use (rearrangement) of HUF 31, 1 billion to the debit of the reserves allocated for extraordinary government measures. On 30 June 2012, 64, 9 % of the annual reserve was available yet. The amount of the Country Protection Fund is HUF 170, 0 billion; according to the law no payment can be executed from this amount before 30 September 2012. Keeping the deficit under 3

% of the GDP requires that no payment should be made from the Country Protection Fund in the course of the remaining of the year.

Budapest, 16 July 2012

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