THE OPINION OF THE FISCAL COUNCIL

on the major characteristics of the budgetary and economic processes of Hungary in the period of January-September, 2012

I.

Antecedents, legal basis and publicity of the preparation of the Opinion

According to § 23 d) of Act CXCIV 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. It can also give an opinion on any issues related to the use of public money.

Within the framework 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 and being aware of the following:

- in its **Resolution 7/2012/07/16**, on the basis of the available **preliminary** data, the Council reviewed the implementation of the central budget in the first half of 2012 and prepared an outlook for the whole of the year. It found that in case of certain expenditure items exceeding could be detected and, at the same time, in case of the revenues, significant incomes have been foregone. Most of them are related mostly to the trends of the macroeconomic course, and to the agreement signed with the Banking Association.
  According to the Opinion of the Council, the GDP proportionate budget deficit can be kept below 3 percent, in case they are not going to use the Country Protection Fund and the interest risk reserve and, the balance improving measures of the Széll Kálmán Plan 2.0 are realized entirely.

In its present Opinion the Council summarises the major characteristics of the processes of the central budget of Hungary in the first nine months of 2012, according to Act CLXXXVIII of 2011. The Council's aim is to offer a review on the expected trend of the 2012 central budget, on the basis of the data available so far; the expectations related to the microeconomic processes, as well as the new measures affecting the expected trend of the budget of the running year.

When preparing its Opinion, the Council used the evaluations and analyses made by the State Audit Office of Hungary and the Central Bank of Hungary, independent from the contents of the evaluation of the Hungarian Government to be published later and, on the basis of the available final data of the first nine months. In formulating its opinion, the Council also has taken into consideration the opinion of independent experts.

With regard to the above, the Council analysed the public finance processes of the first nine months and the expected annual trends, from the following aspects:

- do these processes support the preservation of public finance stability?
- to what extent do these processes make the preservation of public finance stability possible?
- whether the respective trends will be in harmony with the legal framework?

The present Opinion of the Council shall not concern the subsequent governmental corrections concerning the planning of the 2013 central budget. In harmony with the respective legal stipulations the Council, as a body, intends to deal with such amendments, initiatives, respectively take a stand, only when the concerned legal stipulations or initiatives of the Government specify it or make it reasonable.

The Council shall inform the proper quarters of both the National Assembly and the Government about the contents of its present Opinion respectively, also considering the substantiating documents prepared by the State Audit Office of Hungary and the Central Bank of Hungary; it shall publish its Opinion on the website of the National Assembly.

II

The Opinion of the Council

At its meeting held on 29th October 2012 the Council unanimously decided on its following Opinion:

1. The Council reviewed the trend of the budgetary processes in the first nine months of 2012. It found that there were no fundamental changes compared to its Opinion of 7/2012.07.16. that had been established on the basis of preliminary data. Despite measures aiming at cutting expenditures, respectively at increasing revenues, tensions remained in both fields as a consequence of the unfavourable trend of economic growth, in harmony with the earlier indication of the Council.
2. According to the Council's Opinion, by the execution of the measures stipulated in the Government Resolution 1428/2012. (X. 8.) aiming at the observation of the budgetary balance and by abstaining from the use of the Country Protection Fund, the GDP proportionate deficit of the central budget can be maintained and the basic processes of

the budget can ensure the lowering of the GDP proportionate public debt compared to the proportion of the previous year.

III

Justification

Based on the analysis of the year 2012 budgetary processes, overall we can say that risks primarily emerge on the revenues' side. Regarding the expenditures, the fact that due to the increase of pensions, prompted by having an inflation rate higher than originally planned, will very likely result in over-fruition and this will increase the risks. The expected overruns regarding the measure of subsidies of medicaments and the fact that the value of the debt accumulated by the institutions taken over from local governments in May 2012, respectively the planned form of debt settlement has been unknown due to lack of appropriate law, represent additional risks. Interest expenses have also been significantly higher than the prorated amount that has been offset by the higher interest revenues and the interest risk reserve. The balance improving effects of the measures of the Széll Kálmán Plan 2.0 expected by the end of 2012, the balance improving measures stipulated by the October 2012 EDP report, the increasing of the annual deficit target and the available reserves can serve as the coverage for the presently quantifiable risks. The precondition however would be that the Country Protection Fund shall not be used even after 30th September 2012.

1. The Changing of Macroeconomic Conditions

Ever since the macroeconomic forecast of the Government that served as the basis for the 2012 central budget, the prognoses have continuously worsened. Compared to the 1,5 % GDP growth cited by the submitted budget, the EDP report that was prepared in October 2012 already mentioned 1,2 % GDP decrease. The planned 4,2 % inflation rate mentioned by the forecasts is expected to reach the annual proportion of 5,8 %.

In harmony with the changing forecasts, the Government has reviewed the earlier prognoses. As a result they foresaw a 1,2 % decrease in the annual volume of the GDP and also have counted with the unfavourable effects of this amendment in the year 2013. Considering its earlier expressed opinion concerning economic growth, the Council deems this modification justified. This forecast is equal to the forecasts prepared by Consensus Economics (London) and the survey prepared by Reuters, and is close to the forecasts of OECD and the Central Bank of Hungary (MNB) however, it is more negative than the forecasts of the European Commission and of the IMF.

Besides the above the Government has raised the 2,5 % deficit target stated by ESA'95 to 2,7 % that, in principle, equals to the expectations of the domestic and international forecasters. Due to the uncertainty of the macroeconomic processes expected for 2012 the fact that avoiding economic recession has not been successful, that the EU/IMF talks have not been concluded and thus the lowering of interest rates originally expected as a result of reaching an agreement on credit line have not materialised, all these factors represent risks from the aspect of meeting the targeted public finance deficit.

2. The Achievability of the 2012 Deficit Target

The deficit of the central subsystem of public finance in the first nine months of 2012 was HUF 545,8 billion that is equal to 94,7 % of the original deficit target. The surplus of the separated public funds in the first nine months of 2012 is close to the double of the annual forecast amounting to HUF 52,9 billion. The deficit of the Health Insurance Fund in the same period has reached 53, % of the amount forecast for the whole year, i.e. HUF 35,3 billion. The annual deficit of local governments might lag behind the amount set by the Budget Bill that was 0,5 % of the GDP.

Thanks to the macroeconomic processes that turned out to be more unfavourable than it had been set by the Budget Bill, when estimating the public finance deficit according to ESA '95 - and supposing that neither the Country Protection Fund, nor the interest risk reserves are going to be used – both the Council and the analysing organisations have indicated the size of the deficit to be 2,7 % of the GDP.

Whereas the expectations concerning economic growth and the trend of the budget balance have worsened, in October the Government decided to introduce a correction worth of HUF 133 billion. Parallel with this, in its EDP implementation report published on 5th October 2012, the Government raised this year's deficit target to 2,7 % of the GDP. Assuming the non-utilisation of the reserves and the full implementation of the declared measures, this deficit target appears to be attainable.

3. The Realisation of the Debt Rule

In the fiscal framework the debt rule stipulated by the Fundamental law is relevant concerning the central budget of 2012 and this rule prescribes decreasing GDP proportionate debt rate for each year.

The negative trend of the GDP expected in 2012 – the size of what the Government estimated to show a 1, 2 % shortfall in its EDP report published in October 2012 – has endangered the decrease of the GDP proportionate debt indicator, while other factors (for example, the surplus of the primary balance of the cash flow) have improved the debt indicator.

According to the stipulations of Indent (1) Paragraph 5 of the Act on the Economic Stability of Hungary if, on the basis of the half-yearly data, the diminishing of the public debt indicator is in danger, the Government shall submit an amendment bill to the National Assembly to modify the Budget Bill. Based on the half-yearly data though, the Government has not found that the diminishing of the public debt indicator was in any danger. Thereafter the Government has no obligation to initiate the amendment of the Act.

The National Assembly adopted the 2012 Budget Law prior to the entering into force of the Fundamental law and of the Act of the Economic Stability of Hungary (1st January 2012, respectively 28th December 2011); hence it does contain neither stipulations, nor indicators relative the implementation of the debt rule. As a result, the Government has no obligation to amend the law either.

According to Article 36, indent (6) of the Fundamental law, in case of the lasting and significant relapse of the national economy, diversion from the stipulated obligation of the implementation of the public debt rule is allowed. As per Paragraph 7 of the Act of the Economic Stability of Hungary, all cases when the real value of the annual gross national product relapses, in other words, the GDP volume decreases, constitute to lasting and significant relapse of the national economy.

In the Council's opinion the fiscal situation of the country remains vulnerable due to the fact that both the public debt and the external indebtedness are high when compared to the development of the country.

4. The Trend of the Revenues

The unfavourable move of the economic indicators – when compared to the presumed values stipulated by the Budget Bill – resulted in the significant mitigation of certain tax revenues. This was felt especially in the first half of the year but it can be detected in the cash-flow processes of the first nine months, as well. The effects of the decrease in tax revenues is manifested, first of all, in case of the expected tax revenues related to company profits but can be detected nearly in taxes of any kind. As a result of the Agreement signed with the Banking Association there is a significant loss of taxes too, the effect of what does not appear in the Budget Bill.

As a consequence of the above effects, in case of the more important taxes (like corporate income tax, simplified entrepreneurial tax, solidarity tax paid by financial organisations) the payments of economic organisations have successively lagged behind the prorate implementation of the appropriated revenues in the first nine months of the year.

A significant part of the annual corporate income tax comes in the central budget only in December hence, achieving this tax appropriation is insecure up to the last moment and underachievement is very likely in this respect. Apart from the above, a significant leeway is expected in case of the gambling tax, due to the changing regulation (first the raised tax payable after slot machines, followed by the practically total embargo on the operation of such machines).

The lower than planned wage growth might also endanger the realisation of the appropriated revenues from wage related charges. Despite this, for the time being, the realisation of social contribution tax and affixes is prorate. However, this is due also to the fact that the seasonality of bonus payments has changed at the beginning of this year, compared to the previous years. In case of the personal income tax though, from the prorate leeway it is obvious that the leeway is the result of the weaker than expected taxing of revenues that cannot be related to private persons (for example: contributions in kind), the underestimating of the carry-over effects of the disappearing tax credits in 2012, the smaller than expected income growth and the larger than planned enforcement of tax credits.

As a consequence of the above the expected overall annual cash-flow tax and contribution revenues lag behind the percentage stipulated by the Budget Bill by approximately 1 % of the GDP. Within this, the largest drop will very likely occur in case of the payments of economic organisations (corporate income tax, gambling tax, solidarity tax of financial organisations); a lower drop is expected in case of the personal income tax and the social security contributions, while the sales types of taxes (value added tax/VAT, excise tax) will very likely be close to the prognosis.

The fact that, according to the EDP report, with those stepping over from the private pension fund, a surplus worth of HUF 59 billion may arise. As to the absence of revenues, the Government intends to compensate them by measures encompassing several sectors (by increasing the excise duty on tobacco products, by introducing reverse VAT procedure regarding transactions above a certain limit in specific fields of agriculture, by telecommunication tax and locks). As regards the revenue trends, the fact that the Central Statistical Office has modified the data concerning the first quarter was an important development. Mostly, it was the more precise accounting of accrual based EU revenues that prompted the data revision; the EU revenues worth of 0,2 % of the GDP appeared in the public finance in 2011 and not in the first quarter of 2012.

As a consequence of the governmental measures, beginning with 2010, an asymmetry has taken place in the debtor structure. The proportion of tax revenues from the payments of the population has decreased from 34 % to 25 %. Parallel with this, revenues from consumption related taxes have increased from 53 % to 61 %. Meanwhile, the proportion of taxes paid by economic organisations has essentially remained the same. In harmony with the goals of taxation policies, tax burdens have shifted from income type taxes to consumption type ones. In case of the latter – partly due to the higher inflation rate and partly, as a result of individual measures – no arrears incurred in the cash flow of tax revenues, when compared to the prorate revenues.

5. The Trend of Expenditures

On the whole, the expenditures of the central subsystem have been underachieved in the first nine months of the year when compared to the prorate forecast and may lag behind also on the annual level. The measures introduced in the course of the year, with the aim of improving the balance, have played a decisive role in this. With the inclusion of the non-utilisation of balance insuring reserves at the chapters, a restriction of expenditures worth more than HUF 200 billion may be realised this year, due to the locking of appropriations, respectively their decreasing. The more moderate utilisation of EU supports and the related lower level of co-payment needs would also contribute to the more laid back trend of the expenditures. Apart from the above, in case of supplying the National Fund for Family and Social Policy and the healthcare insurance fund with cash payment, the factual data concerning the first nine months of 2012 project the outstanding of payments compared to the appropriated.

Meanwhile however, more significant tensions in the expenditures can be detected, that are manifested also in the growing outstanding amounts of the budgetary organisations. Hence, in our opinion, the realisation of the newer locks announced in October, are shrouded by substantial risks.

The fact that the expenditures paid for pensions and healthcare provisions will, very likely, significantly exceed the appropriated amounts, might, partially, neutralise the effects of the cuts in spending. In case of retirement provisions the excess is due partly to the higher use of retirement provisions related to the years spent in service, partly to the higher than planned growth of the consumer price index (CPI). Despite the new measures that have come into force throughout the year, the supports for medicaments and therapeutic equipments have been significantly more dynamic than planned. From the aspect of the size of the exceeding expected by the end of the year, the effect of tightening the prescription of medicaments on consumers' behaviour represents uncertainty. The mid-year implementation of wage raises will result tensions in the expenditures within the healthcare sector.

On the basis of the cash-flow processes, smaller or bigger expenditure surpluses might appear by the end of the year also in certain appropriations of the central budget. Within this, in case of the individual and normative supports, among the communal service provision contracts related to intercity railway services, due to the disbursement of earlier occurred expenses this year, the fulfilment was higher in the first half of the year than the prorated amount and over-performance is likely also in the first nine months of the year. Warranty validation indicates also a more significant over-performance than the prorated proportion. However, in case of consumer price supplement payments, thanks to the restrictions implemented on preferences in April, have mitigated the earlier indicated expenditures' risks.

6. Reserves

The appropriated amount of the central budget reserves for 2012 is HUF 360 billion. To the debit of the reserve appropriations (HUF 100 billion), serving the purposes of extraordinary governmental measures, by the end of September 2012 the Government decided on using (rearranging) HUF 52 billion. Forty-eight percent of the annual frame has been available yet on 30th September 2012. The amount of the Country Protection Fund is HUF 170 billion, the use of what has been legally prohibited by 30th September 2012. Keeping the deficit under 3 % requires that the Country Protection Fund shall not be used in the remaining of the year. The amount of warranty provision appropriation is HUF 90 billion. Payments have already exceeded the amount appropriated for the whole year. By 30th September 2012. they used a total of HUF 99 billion, that represents 110 % of the appropriation.

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