Adopted by Resolution 11/2013.09.23.
of the Fiscal Council KVT-113-1/2013

Opinion

of the Fiscal Council on the Draft Bill of the 2014 Central Budget of Hungary

I

Antecedents, legal basis and publicity of preparing the Opinion

Pursuant § 24 of the amended Act CXCIV of 2011 (henceforward: Stability Act), the Fiscal Council (hereinafter: the Council) shall deliver its opinion on the central budget Draft Bill. In its opinion the Council shall make notices concerning the Draft Bill and – in case it has fundamental objections regarding the authenticity or feasibility of the Draft Bill – the Council shall express its non-concurrence.

The document adopted by the Government as the Draft Bill on the 2014 Central Budget Bill of Hungary was forwarded to the Council as an attachment of the letter signed by Dr György Naszvady, Secretary of State for National Economy on 13th September 2013, under file number NGM/20631/2/2013.

The Council presents its opinion - recommendations and awareness raising remarks concerning the mitigation of the feasibility risks included – being aware of the followings:

- Upon reviewing the processes of the first half of 2013, in its resolution 7/2013.07.16. on the implementation and the expected trend of public debt, the Council identified transgressions in case of expenditures compared to the pro rata while, in case of certain revenues, it identified arrears, basically in relation to the external conditions and the uncertainties of the macro-economic course. In its opinion the Council deemed it justified to introduce the balance improving measures in May 2013 as well as the law amendments concerning the revenue side of the budget, getting valid from August 2013, together with the partial or total non-utilisation of the Country Protection Fund (reserve).

- While underlying the importance of the above measures, in its resolution 9/2013.09.07. on the draft amendment of Act CCIV of 2012 on the 2013 central budget of Hungary the Council drew the attention of the Government to the fact that reaching the planned budget deficit and the planned level of public debt required

increased emphasis on financial management discipline. As part of this disciplined financial management the Government had to fulfil the evaluation requirement of the feasibility of the public debt rule as stipulated by Indent (1) § 5 of the Stability Act.

When formulating its opinion, the Council did take into consideration the analyses prepared by the State Audit Office of Hungary and the Central Bank of Hungary. Apart from this, upon the request of the Chairman of the Council, the Council was relying on the analyses prepared by independent experts, analysing institutions (*GKI Economic Research Co*., *Századvég Economic Research Co.)* Following the publication of the Council's Opinion, these analyses are available, separately, on the website of the Council. The Council was also using the forecasts of reliable international organisations as well as other, well-known market analysts' opinions, evaluations. The Secretariat of the Council prepared a work document from the professional contents and the projections of the analysing institutes.

With unanimous resolution the Council authorised the Chairman of the Council to publish the Fiscal Council's Opinion pursuant the Draft Bill. The Chairman of the Council shall present the Opinion in the National Assembly (and before its committees) and shall demonstrate, to what extent had the submitted Draft Bill taken into consideration the Opinion of the Council.

II

The Opinion of the Council

At its meeting held on 23rd September 2013, relying on the documents submitted by the Government, the Council unanimously formulated the following Opinion:

1. As regards the authenticity and feasibility of the draft (henceforward: the Draft) of the 2014 central budget, the Council has no fundamental objections that would justify the indication of fundamental non-concurrence, concerning the document submitted for the purpose of asking for the opinion of the Council.

2. According to the evaluation of the Council the interim amendment introduced in 2013 has adequately mitigated the risk of substantial under-performance of the revenues – with the exception of VAT. Thus, counting with the economic recovery - the signs of what have already appeared in the second quarter of 2013 – the risks of the 2014 central budget on the base side are not significant. Once the establishing of the on-line connection of cash registers becomes complete and the realisation of the under-performing taxes expected in 2013 shall serve as the basis of the 2014 appropriations, the risks shall be further mitigated.

3. Taking into consideration the international economic recovery, the expansion of domestic demand – in the form of household consumption, the public investments financed from EU resources and the investments of the private sector using resources from the second phase of the Funding for Growth Scheme of MNB (Central Bank of Hungary) - the Council considers the 2 % economic growth prognosis of the Government viable. On the basis of analysing the processes of the economy and comparing those with the forecasts of international institutions, the Council believes that the 2 % GDP growth is at the top zone of the possible domain of economic growth. Some of the available forecasts have not taken into consideration yet the results of the expansion of the Funding for Growth Scheme and those of additional incentives with the purpose of stimulating the economy. This might not exclude the projection of an even more favourable economic growth.

4. The Council has ascertained that the 2, 9 % targeted GDP proportionate deficit – calculated by EU methodology – and the 76, 8 % public debt indicator of 2013 – calculated according to the Stability Act that has been mitigated to 74, 6 % in 2014 - was in harmony with the requirements of the Stability Act. On the basis of the analysis of the Draft Bill it is the Council's opinion that the mitigation of the deficit is feasible. At the same time, the Council calls the attention to the fact that the intended targeted deficit is lagging behind only by 0, 1 per cent of the 3, 0 per cent requirement stipulated by the European Union and the Stability Act. Now, the planned improvement of the debt indicator is merely 0, 4 per cent. This means that a lower than expected economic growth rate, lower inflation or even a slightly bigger value of municipal debt and deficit, respectively the slightly bigger value of the debt of other organisations classified in the governmental sector might prevent the enforcement of the debt rule and the observance of the targeted deficit. The effect of the expansion of the Funding for Growth Scheme on the economic growth, and via this, on the budgetary revenues, represents a positive risk. In the Council's opinion the appropriate handling of the risk related to the observance of the debt rule is necessary also because the Fiscal Council has no view on public debt items beyond the trend of the central budget's debt, while the means of the government to facilitate the timely intervention, are also meagre.

5. From among the revenue appropriations of 2014 in the Council's opinion the estimation of the Draft Bill concerning the growth of consumption – first of all in case of VAT – and other consequences, supposedly originated from the "whitening" the economy, are over-optimistic. The Council also identified additional revenue and certain expenditure rows that represent negative risks; for example, in case of several corporate taxes and concession revenues. On the expenditure side the Council detected

tensions in case of higher education, human services and motorway management appropriations. It should be noted that the Government has planned the proportion of the utilisation of EU resources and the related own contribution expenditures very high. From the aspect of national economy the lower than the planned actual investment output is unfavourable however, in an indirect way, via the lower own contribution, it improves the budgetary balance.

6. The Council recommends the Government to repeatedly analyse the risks listed above and determine the measure of the reserves in the 2014 Draft Bill by taking this into consideration or make recommendations for other actions that are fit for managing the risks.

7. The Council deemed it necessary to examine the tensions resulting from the stipulations of the Stability Act that will come into force in 2015, in order to thus make it possible that the budgetary correction – that seems to be necessary to ensure the observance of the rule and that would act against economic growth – could be avoided.

III

Justification

The Council formulated its Opinion by evaluating the followings and by considering the evaluation results as the basis of this Opinion:

The Authenticity of the Draft Bill

In the course of reviewing the Draft Bill the Council has not detect any objectionable provisions, tendencies that would justify the indication of non-concurrence regarding the document that had been submitted for an opinion.

The expected fulfilment of year 2013 (base year)

In the Council's opinion, the justification of its earlier calling for awareness (resolution No. 13/2012.12.08. on the 2013 central budget of Hungary) was proven to be correct by the economic processes of 2013 (the lower rate of economic growth and inflation than calculated in the course of the budgetary planning) and the execution of the budget act so far (the

necessity of maintaining large amounts of reserve and the necessity of the interim budgetary corrections).

In its opinion, published in resolution 7/2013. 07. 16., on the state of the execution of the 2013 central budget of Hungary and the expected trend of the public debt, on the basis of the processes of the first half of the year, the Council pointed out the processes endangering the implementation of the planned balance and the mitigation of public debt.

The Council acknowledged that domestic economy got over the recession in the first quarter of 2013 – following the 1, 7 % decrease of the GDP in 2012. This finding was supported by the GDP growth measured in the second quarter. From the aspect of tax bases it is a favourable change that domestic consumption also has contributed, in a positive way, to the growth. On the basis of the available data, the Council is of the opinion that the increase of economic performance in 2013 can be expected in the range of 0, 5 to 1 %.

Maintaining its mid-term evaluation, the Council presumes significant losses in case of specific revenues (mostly in case of VAT), compared to the appropriation. The lower VAT revenues are related to the moderate nominal consumption on the one hand. On the other hand, it is related to the lower level of the expected "whitening" effect.

The evaluation of the 2014 macroeconomic forecast

The Council has also examined separately the extreme ranges and dispersions of experts' documents, projections at its disposal; the centres of gravity indicating in the same direction included. Considering all the above the Council reached the conclusion that the macroeconomic course described by the draft budget bill is feasible.

In 2014 domestic growth will be supported not only by the shifting of international boom in a more favourable direction but also, by the recovery of domestic demand. According to the Draft Bill, next year real income shall also increase; recovery in the private sector is expected to be more favourable, while in the public sector and the introduction of the educators' career model shall support the higher rise of salaries.

However, the dynamics of household expenditures could be slowed down by the reduction of debts and other measures of the government (for example, the decision concerning the derecognising of foreign currency loans) and could also have a significant effect of the consumer decisions of the households. On the other hand, the increasing and more and more successful drawings of resources with the approaching end of the present EU budget period,

and thus the increasing public investments, could give a positive impetus to growth. The Draft Bill did not count with the second phase of the Funding for Growth Scheme; the economic growth originating from this scheme and via it the surplus revenues represent a positive risk.

The deficit target, the feasibility of the planned revenues and expenditures

The Draft Bill determined the deficit target of the governmental sector in 2014 in 2, 9 per cent of the GDP, calculating with the EU methodology. The Council is of the opinion that the deficit target is viable, by significant risks. Hence, the Council deems it reasonable to re-think the appropriate level of the reserves.

In the Council's opinion, on the basis of the expected realisation in 2013, the course of the nominal GDP growth and the gross outflow of earnings in 2014, the major tax and contributions' revenues, with the exception of the VAT, were planned realistically. In case of the VAT revenues however, the Draft Bill evaluated the effects of the growing consumption and other, very likely attributed to the factors of "whitening" the economy, too optimistically. The real revenues might lag behind the appropriations even by up to 0, 5 % of the GDP.

In the Draft Bill (respectively, in its justification) the Council considered all the measures that it could identify. The fact that the exact rules of the population policy were not available when the Draft Bill was submitted, presented difficulties when preparing the judgement.

The Council found the income tax and contribution revenues feasible while also taking into consideration the raise of educator's salaries, the expected number of those opting for KIVA tax (Small Business Tax) and KATA tax (Itemised Tax of Small Businesses), the expansion of EHO (health care contribution) to incomes from capital and the decreasing interest rate incomes (due to the lower basic interest rate). Apart from the above, revenues might lag behind the appropriations, even if to a variable extent.

From among the risks encircling the revenue side the planned revenues from selling frequencies – together with VAT this could reach 0, 5 % of the GDP – seems to be hard to implement when considering the quantity of the cell phone frequencies used so far (those purchased at the time of the auction in 2011 also included), the fiscal burdens of the cell phone service providers and the uncertainties of consumer demand for the developments in the cell phone services are difficult to be met in practice.

The increase of the planned public finance expenditures is realistic. Compared to 2013 the biggest change is that the expenditures of the budgetary organisations and the chapter managed appropriations have grown significantly. The effect of the raising of educators' salaries was a factor in this (HUF 122 billion), but the planned significant growth of own financed and EU supported investments was an even more important factor. It is likely that next year the real investment performance will be lower than planned and this would not be favourable from the aspect of national economy however – indirectly – it would improve the budgetary balance thanks to the lower level of own contribution. In the field of sports, culture, ecclesiastical tasks, the police and transportation goals, they can count with additional and perceptible growth of supports.

Attaining the deficit target calculated by ESA methodology is highly endangered by the fact that, on the basis of general justification, the accrual based balance correction could be significantly more unfavourable than what the balance sheet shows. In the Council's opinion a smaller positive correction that would increase the ESA approach deficit, would be more well-grounded.

Both the revenue and expenditure related risks are significant. Quantification of the risks would be justified as well as introducing appropriate measures to balance out by them the mentioned risks. In the budget it is necessary to adjust both the Country Protection Fund and the chapter reserves to the quantified risks.

Incorporation of regulations concerning appropriations classified in the Investment Fund that would efficiently promote the feasibility of the deficit target should be considered.

The functioning and supervision of the debt rule

On the basis of its assumptions regarding the budget deficit and economic growth, the Council deems the observance of the public debt rule, as stipulated by the Basic Law of Hungary and the Stability Act, viable in 2014.

At the same time, the Council considers it necessary to examine what would be the effect of the Stability Act rule, valid from 2015, on the central budget and, via the budget, on the economic growth. According to the ruling of the Stability Act concerning the pace of decreasing public debt, beginning with 2015 (with respect to the central budget of 2016 for the first time) the balance of the budget should be determined in the act on the central budget in a way that on its basis, the growth of public debt compared to the previous year in the act on the central budget, should not exceed the difference between the inflation rate expected for the budget year and the half of the growth rate of the gross domestic product volume. According to the analyses and experts' opinions considered by the Council, the enforcement

of the Stability Act by low inflation rate and low economic growth would make it necessary to resort to significant budgetary corrections that would affect the growth course unfavourably. Hence the Council considers it necessary to review the debt rule.

Budapest, 23rd September 2013

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