

**Opinion**  
**of the Fiscal Council**  
**on the Execution of the 2014 Central Budget of Hungary and the expected trend**  
**of Government Debt**  
**(Characteristics of the processes in the first half of the year)**

**I.**

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

According to Point 'c', Indent (1) of Paragraph 23 of the amended Act CXCV of 2011 on the Economic Stability of Hungary,(henceforward: Stability Act) the Fiscal Council (henceforward: the Council) shall give an Opinion every six months on the state of the execution of the central budget act and the trend of the government debt.

Fulfilling this obligation the Council shall summarise its evaluation on the characteristics of the processes related to the execution of Act CCXXX of 2013 on the 2014 central budget of Hungary and the trends of government debt.

In its Opinion the Council was building on the following antecedents, related to the preparation of the budget and the planned amendment of the accepted budget:

- in its Opinion 11/2013.09.23. concerning the bill on the 2014 central budget and related to the macroeconomic forecast of the Government, the Council found that taking into consideration the international economic recovery, the expanding domestic consumption i.e. household consumption, investments built on EU resources, the investments of the private sector receiving resources from the second phase of MNB's Funding for Growth programme, the macroeconomic forecast of the government regarding economic growth (2 percent) can be met. In its above Opinion– with regard to the sustainability of economic recovery – on the whole, the FC graded the revenue-related risks of the 2014 central budget low however, in case of the VAT revenues, the Council considered the calculated effects surrounding the growing consumption and the whitening of the economy exceeding the realities. As regards the expenditures, the FC identified risks – among others – in case of the EU resources (and own contributions);
- upon reviewing the updated forecasts, as well as the revenues and expenditures depending on the trend of the macroeconomic forecasts and the repeatedly completed calculations, in its Opinion 16/2013.12.13. on the uniform bill

T/12.415/1041. on the 2014 central budget of Hungary the Council assessed that the earlier identified risks (see FC resolution 11/2013.09.23.) remained, albeit to a lesser degree. With unanimous decision the Council decided that the targeted deficit can be met, i.e.

- the GDP-proportionate public finance deficit – calculated by the 2014 EU methodology – shall remain under the 3 percent stipulated by the respective EU rule. As the FC identified risks in case of certain appropriations – in harmony with the bill – it supported that, similarly to the practice of 2013 – the Country Protection Fund shall not be used by 30th September, 2014. The Council considered the government debt rule enforceable, supposing in its justification that „the conditions of the macroeconomic course as the basis of the central budget shall not change, i.e. the opinion on the country’s performance shall improve, the trust of investors shall strengthen and – thanks to a lower margins – the financing of the central budget shall become cheaper and no increase of the budgetary expenditures from indebtedness shall occur”. In its justification the Council also emphasised that thanks to the minimal improvement of the government debt indicator in 2014 and because the planned deficit shall fall short only by 0, 1 percent from the stipulations of the European Union, realising the goals „shall require strict budgetary management at all levels of public finance also in 2014”;
- the Council gave its opinion on the draft amendment of the 2014 budget act forwarded on 11th June 2014. The amendment primarily concerned the establishing of budgetary funds for purchasing shares in strategic firms. In connection with this, in its Opinion 2/2014.06.20. the FC formulated its standpoint regarding the accrual and cash-flow balance of the public finance (calculated by ESA methodology) and its opinion and recommendations regarding the meeting of the government debt rule. (In more detail see part III. Justification).

When formulating its opinion the FC took into consideration the analysis prepared by the State Audit Office of Hungary „On the budgetary processes of the first six months of 2014” and the findings of the Central Bank of Hungary that was relying on the data and documents of the Ministry for National Economy, the Treasury, the National Tax and Customs Administration of Hungary, the Government Debt Management Agency and the Hungarian Central Statistical Office. Apart from the above the Council was also relying on the economic forecasts prepared by competent analysing institutions, international organisations, experts and market analysers commissioned by the chairman of the Council, as well as on

documents prepared by the Secretariat of the Fiscal Council. Additionally, the Council took into consideration the contents of the Convergence Programme of Hungary 2014-2017.

The Council shall inform the Speaker of the National Assembly and the competent officials of the Government about its Opinion and shall publish it.

## **II.**

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

At its meeting held on 14th July 2014 the Council reviewed the major processes and the background of the execution of the 2014 central budget in the first half of the year. Following the review hereunder the Council formulated its Opinion.

1. The Council found that the growth that had started in 2013 will keep gaining momentum also in 2014, partly thanks to the favourable processes going on in the global environment, and that of the domestic economy, the latter especially in comparison to the indicators appearing in the fundamental macroeconomic course of the 2014 budget.
2. Based on the macroeconomic processes and the pro-rata implementation of the revenues and expenditures of the budget in the first half of the year, the so-called EDP deficit set in the budget act, i.e. 2, 9 percent calculated by EU methodology, can be met. According to the Council's judgement – as a result of the favourable macroeconomic processes and the stabilisation of the tax system – altogether there are no signs of significant risks on the revenue side. As regards the expenditures' side, the earlier structural, governmental measures (like for example those, concerning the pension system or pharmaceutical expenses) are already yielding results. To maintain the targeted deficit the Government should exercise strong control over the expenditures also in the second half of the year so, that their growth on the whole shall not exceed the reserves of the Country Protection Fund. It remains an additional risk whether the planned surplus materialises in the local governmental subsystem. It would be justified to follow its trend regularly, every month.
3. As regards the reduction of the GDP-proportionate government debt stipulated by the Basic Law of Hungary, the Council sees a risk as significant new expenditure items of the budget – among them the purchase of shares by the state that had not been calculated in the original appropriations – were not accounted with when doing the calculations of the EDP deficit however, these add to the cash-flow deficit and via this

deficit, the government debt. It is necessary to create a fund for covering the realisation of these expenditure items that exceed the original appropriation, either by not using the Country Protection Fund or – depending on the processes of the second half of the year – restraining other current expenditures, reducing the Treasury accounts to the necessary extent or, perhaps, by increasing revenues as other possibilities of reducing government debt (like, for example the payment of the Pension Reform and Debt Reducing Fund) essentially have been exhausted.

4. On the basis of the public finance and macroeconomic processes of 2013 and the first half of 2014, the Council maintains its standpoint that examining the effects of the amendment of the paragraph of the Stability Act regarding the measure of the government debt decrease that shall come into force in 2015, have to be scrutinised and see, how they would affect the economic growth and budget of the future years.

### **III.**

#### **Justification**

##### **1. Trend of the macroeconomic condition**

According to the spring forecast of the European Commission, following the recovery from the recession, economic regeneration shall continue all over the EU. As a result the real GDP growth in 2014 on the EU level could be 1, 6 percent and this can possible gain further momentum and pick up speed in 2015 thanks to the starting expansion of investments, the gradual improvement of the employment data, the necessary and implemented amendments and structural reforms.

In harmony with the forecast of Hungary's Convergence Programme for the period of 2014 – 2017, the European Commission expects Hungarian economic growth for the whole of year 2014 to be 2, 3 percent. The majority of the analysers also expect the economic growth above 2 percent in 2014. Characteristically, their views differ as regards the sustainability of this growth.

According to the calculations of the Hungarian Central Statistical Office, the gross domestic product in the first quarter of 2014, grew by 3, 5 percent compared to the same period of the previous year (at that time the decrease was 0, 9 percent in comparison to the previous year). The growth was fundamentally the result of the stronger performance of the industry and the building industry. Beginning with July 2013 the industrial production output has been steadily growing and in April 2014 its measure exceeded the output of the previous year by

10, 1 percent. Within the improvement of the industrial performance, manufacturing industry represented a decisive proportion – within this transport equipment production and some related branches and food industry. Beginning with 2013, the performance of the building industry has been continuously improving and by April 2014 the output was 27, 2 percent higher than a year earlier. The export-import volume of products in the foreign trade sector grew by 8, 8 respectively 8, 2 percent in the first quarter of 2014, compared to the results of 2013, i.e. 4, 8 respectively 5 percent. This resulted in a greater foreign trade surplus.

Apart from the above there are other, favourable signs to be identified and these could strengthen the expectations regarding the growing economic performance.

Parallel with the improving economic performance the favourable trends of the labour market kept also improving, respectively have strengthened (this has affected favourably the tax revenues related to incomes). Employment has expanded; in March-April 2014 the average number of employees was 4.105 thousand, which represented 195 thousand persons more than a year earlier. The unemployment rate decreased to 8 percent from the 10 percent of the previous year. Significant increase of wages and salaries occurred in the private sector in the first half of the year that – by the low inflation brought along considerable growth as regards real wages and purchasing power. This also contributed to the continuation of the growth of retail trade that started in the second quarter of 2013; the turnover volume increased by 5, 1 percent in May compared to March 2013 – calculated with the changed methodology – and this affected favourably the tax revenues related to consumption.

Investments financed by the budget, respectively by EU funds have improved the investment performance and a strengthening can be detected also in the field of the private sector. However, the investment rate still remains low and the increasing of the rate is a necessary pre-condition of the sustainability of growth.

## **2. Trend of the targeted deficit (its feasibility)**

The budget act stipulated the cash-flow deficit of the central subsystem of the budget in HUF 984, 6 billion for 2014. The GDP-proportionate targeted deficit of the whole of the public finance turned out to be 2, 9 percent, calculated by the EDP methodology, by considering the planned surplus of the local governmental subsystem amounting to HUF 30 billion. On the basis of the macroeconomic processes and the pro-rata implementation of the revenues and expenditures of the budget the Fiscal Council considers it to be feasible.

The cash-flow deficit of the central subsystem was HUF 814 billion, i.e. 82, 6 percent of the targeted annual deficit. From the pro-rate aspect the deficit is high however; the reason lies in the usual seasonal processes of the budget. The departure of the deficit from the pro-rate degree is not bigger than the average of the similar departures of the past few years. As regards the monthly processes, April saw an unusually big deficit but this originated mostly in the expenditures paid in advance from May thus, the favourable balance in May counterbalanced the deficit of the previous month.

As regards the major revenue and expenditure processes, it can be said that the favourable turn can be thanked to the recovery of the labour market, the higher than predicted wage growth and due to the consequence of the fact that less individuals opted for the so-called small taxes (KATA, KIVA). Taxes related to consumption have risen dynamically as well, compared to the 2013 data however, the budget appropriation assumed an even greater rise. The reason for the lagging behind primarily was the lower than planned inflation rate.

The creation of the cover for the purchasing of shares by state owned companies contributed to the growth of the targeted cash-flow deficit. In its resolution referred to above, the FC gave its opinion on this consequence. According to the draft, increasing the expenditure appropriations of the central budget by HUF 152 billion shall be necessary, for nationalising Antenna Hungaria Zrt., Hungarian Gas Transit Zrt, and purchasing FŐGÁZ Zrt. - in the form of capital increase. The need to increase the financing of the above has mitigated to the minimum the expected improving of the government debt rate. In its above resolution the Council indicated that the transactions resulting the lucrative ownership shares in proportion to the investments, very likely shall not concern the accrual based balance although this risk cannot be altogether excluded.

According to the opinion of the FC further control of expenditures is necessary to meet the targeted annual EDP deficit. Apart from this continuous tracing of the balance of the local government subsystem remains important.

The Fiscal Council calls the attention of the Government also to the fact that due to the methodology changes of defining the EDP deficit the effect of swaps (foreign currency swaps) influencing the state interest rate accounting shall not appear in the balance in the future. This means that the deficit, expected by the European Union, has to be reached in 2014 by this – very likely favourable – correction. The justification of the submitted budget bill contains this change however, it shall be important to consider this also in the course of the execution of the budget.

### **3. Enforcement of the government debt rule**

The 2014 central budget act contains the 0, 5 percent reduction of the GDP-proportionate government debt indicator for 2014 – in harmony with the regulations of the stability act. The reduction of the debt rate corresponds to the respective stipulations of the Basic Law of Hungary.

The additional expenditures creating the cover for the purchasing of shares listed in the amendment of the 2014 budget act – the Fiscal Council gave its opinion on this amendment in its resolution 2/2014.06.20. – shall directly increase the cash-flow deficit together with the gross government debt. Because of planned excess expenditures the government debt rate shall, very likely, decrease only to a very small extent while this implies growing risks of the realisation. The favourable trend of specific „tax bases” (wage bill, consumption) shall support the feasibility of debt reduction from macroeconomic side while the lower than expected inflation rate exerts an opposite effect. Taking into consideration this effect, it will be necessary to curb the expenditures, refrain from using the Country Protection Fund, reducing the stock of the Hungarian Treasury Account (KESZ) or, possibly, increase the revenues.

Apart from the above, the FC supports the endeavours of the Government to transform the structure of the debt stock. Namely, by pushing back the proportion of debts in foreign currency, the financial vulnerability of the country can be mitigated.

### **4. Trend of the revenues**

On the revenue side of the central budget processes of mildly positive effect can be identified on the whole. The total of the tax and contribution revenues of the central subsystem in the first six months was in harmony with the annual appropriation of the 2014 law however, in a structure that was different than the forecasted one. A certain restructuring can be identified as regards the payments of economic organisations and the revenues of the social security funds. The lower degree utilisation of certain elements of the Job Protection Action Fund is the primary reason behind the failure of the original governmental expectations in this respect. Thanks to this, the pro-rate payments of the economic organisations failed to meet the legal appropriations. At the same time the revenues from contributions have significantly surpassed the forecasts.

From among the payments of economic organisations, in case of the KATA (Small Taxpayers' Itemised Lump Sum Tax) and KIVA (Small Business Tax) significant shortfalls can be identified on the basis of the data of the first half of the year, as much less taxpayers opted

for these taxpaying forms. The expected over-performance in case of the social contribution tax, the contributions and simplified entrepreneurial tax counterbalanced the above shortfall of revenues. In the first half of the year, as regards the other payments by economic organisations, the revenues fell short of the pro-rate expectations by 10 percent.

As regards taxes related to consumption, the effects of opposite direction can be identified. On the one hand the measure of the inflation significantly lags behind the presumed growth rate of 2, 4 percent. On the other hand the dynamics of aggregate wages of the national economy have significantly surpassed the planned rhythm and via the household revenues this could increase the purchased consumption expenditures of the households. Forty-six percent of the annual appropriation of VAT flew in in the first half of the year. There are considerable uncertainties as regards the size of the expected tax surplus from the shifting to the use of online cash registers. VAT revenues of the first six months were more favourable than a year before: the growth rate surpassed the expansion of retail commerce and consumption. Despite these results it is likely that the annual revenues will lag behind the appropriation by approximately HUF 100 billion. Overestimating the revenues from the whitening of the economy was a factor. The meeting of the appropriated excise taxes was close to 45 percent. The shortfall was the result of the set-back of tobacco products that could be felt upon examining the sale of the seals. Revenues from financial transaction duty surpassed the pro-rate level.

As regards the revenues from personal income tax, those corresponded with the pro-rate forecasts. Processes of the labour market, the growing employment rate also in the private sector, the significant raises of the wages despite the low inflation rate, have exerted a favourable effect on the trend of these revenues.

The contributions have significantly surpassed the appropriations, mostly in close relation to the raising of wages and employment. The lower than expected utilisation of the allowances of the Workplace Protection Action Plan has also contributed to this result.

## **5. The trend of expenditures**

The realisation surpassed the pro-rate expenditures of budgetary organisations and chapter managed net expenditures (reduced with the related revenues) mostly due to the advances concerning EU resources. As regards the advances, it is expected that the tendency of the first six months of the year shall reverse in the rest of the year and/or the offset of the advances will appear in the accrual base corrections among the EU accounting. On this basis the expenditures can be controlled.



Social transfers in cash (pension-like entitlements, social supports and other entitlements included) lag behind the pro-rate, primarily due to the more severe than supposed effect of the measures tightening the possibilities of under-age retirement. Additionally, the development of public work programmes result in savings regarding social expenditures. In case of housing support the 37 percent of the realisation is related to the fact that less people applied for the option of the so-called fixed exchange rate of foreign currency mortgages.

The pro-rate support of local governments was high (58, 2 percent), as a result of restructuring of central reserves.

In the separated state funds and within that, in case of the active expenditures the realisation of the pro-rate level was higher by 10 percent, thanks to the additional public work programmes (i.e. the expansion of those participating in such programmes). The average number of those employed in the framework of the public work system throughout the year could be approximately 200 thousand and the respective excess of expenditures would be about HUF 70 billion (within this amount a government resolution was born concerning HUF 40 billion). The net budgetary effect of this measure will be lower than this, thanks to the recoverable taxes and contributions and savings might occur also in the social entitlements of those of active age.

In case of further expenditures (primarily in case of expenditures related to public assets) significant additional expenditures have to be calculated with compared to the original appropriation, according to the draft amendment of the budget act that the FC had given its opinion about. The reason for the excess expenditures is that the government wants to buy up additional shares.

Interest rate expenditures are higher than the pro-rate appropriation however, this does not mean high risks as interest revenues have been outperformed and the same can be expected on annual level.

## **6. Supervision of the regulations of the government debt rule valid from 2015**

Under point 7 of its Opinion added to the 2014 central budget bill the Council already called the attention that „it deemed it justified to examine the tensions originating from the regulations of the Stability Act valid from 2015, in order to avoid a powerful adjustment of the budget that would act against economic growth but could be necessary to implement the respective regulation.” Namely, according to the stipulation of the Stability Act regarding the rhythm of decreasing government debt, beginning with 2015 (for the first time concerning

the 2016 budget) the balance of the budget in the act on the central budget shall be defined so that the growth of government debt compared to that of the previous year shall not exceed the difference of the half of the expected rate of inflation, stipulated by the central budget act, and the half of the growth rate of the volume of the gross domestic product.

By the presently re-starting economic growth and the low inflation rate, meeting this stipulation shall make it necessary to introduce a significant budget amendment that would affect very directly the Hungarian economy that has just started to recover from the crisis.

On the basis of the macroeconomic processes of 2013 and 2014 (growth, inflation) and the ensuing outlook, the FC is on the opinion that it would be justified to repeatedly call the attention of the Government to the evaluation of this situation.

Budapest, 14th July 2014

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