

Opinion
of the Fiscal Council
on the Draft Bill of the 2015 Central Budget of Hungary

I.

Antecedents, legal basis and publicity of preparing the Opinion

Pursuant § 24 of the amended Act CXCV 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 2015 Central Budget Bill of Hungary was forwarded to the Council as an attachment of the letter signed by Mr. Mihály Varga, Minister for National Economy on 20th October 2014, under file number NGM/17656/14/2014.

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

- In its Opinion No. 16/2013.12.30. established unanimously on the uniform bill No. 12.415/1041. the Council found that the GDP-proportionate public finance deficit – calculated by EU methodology – was attainable and the government debt rule feasible. In its justification the Council emphasised that the execution of the targets shall require strict budgetary management at all levels of public finance.
- On the basis of the macroeconomic processes and the pro rata implementation of the revenues and expenditures of the central budget in the first half of the year, in its Opinion No. 4/2014.07.14. on the expected trend of the execution of Hungary's 2014 central budget, the Council found that the

GDP-proportionate targeted deficit (calculated by EU methodology) was feasible. The FC gave a favourable assessment to the fact that the structural measures introduced by the government earlier (concerning the pension system, pharmaceutical related, etc. expenses) were met.

- At the same time, in this resolution the Council detected risk as regards the stipulation of the Fundamental Law of Hungary concerning the reduction of the GDP-proportionate public debt, as the mid-year purchasing of state shares shall increase the cash-flow deficit and via this, the public debt. Taking into consideration this, the FC indicated that such purchases should be compensated by refraining from using the Country Protection Fund, the cutting back of other current expenditures and the reduction of the treasury account holdings, in an appropriate measure.
- In the aforementioned resolution and regarding the amendment of the regulation concerning the pace of the reduction of public debt valid from 2015¹ the Council repeatedly called for the Government to focus its attention on examining the effect of this change on the economic growth and the central budget in later years.

The Council addressed the issue of the implemented or planned structural changes in the subsystems of public finance only in relation to the targeted deficit of the public finance and the realisation of the public debt rule.

Following its mechanism of giving an opinion established in the period after the adoption of the Stability Act and its rules of procedure, once again the FC attempted to ensure that the contents of its resolution (and justification) were formally presented in a way that would ensure easy comparison with Council's earlier, similar documents.

In harmony with the stipulations of the EU Law, the 2013 amendment of Act CXCV of 2011 on the Public Finance (henceforward: Áht.) clarified the requirements that the targeted deficit established by the budget act had to observe. In the course of designing its Opinion the Council emphatically evaluated if the budget bill of the

¹ The growth measure of government debt shall not exceed the half of the difference of the inflation and real growth.

2015 central budget was observing the specified requirements concerning the trends of government debt and deficit. As regards the fulfilment of the requirement of the structural balance² the Council could not evaluate this. When formulating its Opinion the Council was relying, first of all, on the analyses and findings prepared by the State Audit Office of Hungary and the Central Bank of Hungary. Apart from these, the FC was relying on the analyses of the research and analysing institutes invited by the Chairman of the Council – (these institutes can be found also on the website of the FC), forecasts of relevant international organisations and the opinions and evaluations prepared by other, well-known market analysts. Utilising the professional contents of the above sources the Secretariat of the Council elaborated a work document for the preparation of the Opinion of the Council on the Draft Bill of the 2015 budget act. In harmony with the rules of procedure of the FC this was followed by the reconciliation of experts' opinions. The draft document submitted to the Council was built on the above process.

II

The Opinion of the Council

At its meeting held on the 27th of October 2014, on the basis of the documents put at its disposal by the Government and as a result of having discussed its draft opinion as per the rules of procedure, the Council formulated the following Opinion with unanimous decision. At the same time the FC authorised the Chairman to publish the Opinion of the Council on the Draft Bill as well as to inform the National Assembly (and its committees) about the Opinion related to the submitted bill.

1. As regards the authenticity and feasibility of the Draft Bill (henceforward: the Bill) of the 2015 central budget the Council has no such fundamental objections that would justify the indication of non-concurrence of the presented document. At the same time the Council considers it necessary to introduce in

² Structural balance: the balance of the government sector cleaned of the cyclic effects of the economy and of individual items (Ident (1) item y) of Áht. §2).

detail in its Justification those significant departures of the 2015 bill that emerged when compared to the 2014 appropriation.

2. According to the Council's opinion by 2014 the gaining momentum of economic growth enhanced the safety of the fulfilment of the revenues and, consequently the expenditures of the central budget. The Bill considered the expected compliance of the 2014 budget on the whole reasoned when identifying the basis of the 2015 central budget appropriations.
3. The Council establishes that the trends indicated by the Bill, namely that according to the Stability Act the 2014 debt indicator (76, 3 percent of the GDP) and the 2015 debt indicator (75, 4 percent of the GDP) are in harmony with the foreseen economic processes of year 2014 and the planned processes of year 2015 and meet the requirement stipulated by Indent (2) §13/A of the Public Finance Act (Áht.). The Council agrees with the envisagement of the Bill that stipulates a significant reducing of the debt indicator (0, 9 percent) as this means, on the one hand that the debt rule can succeed even if the GDP or government debt shall turn out less favourably than originally planned; on the other hand, it could serve as a starting point for the measured downgrading of government debt and the international financial vulnerability of the country. The Council recommends the Government to elaborate a mid-range programme (up to year 2022) for the measured decreasing of government debt in harmony with thus meeting the new EU requirements.
4. The Council establishes that the 2, 4 % GDP proportionate targeted deficit – calculated by EU methodology – is in harmony with the economic processes outlined by the Bill and the revenue and expenditure appropriations built on this. At the same time it is lower by 0, 6 percent that the 3 percent stipulated by Item c) Indent (2) of § 13/A of the Public Finance Act. This means that the requirement concerning the debt shall be met even if the GDP or the debt turns out to be slightly less favourable than planned.
5. As regards the implementation of the targeted deficit and the government debt rule the Council identified several risks. In the Council's opinion the macroeconomic course and, within that the 2, 5 percent economic growth rate,

shall be realistic only when the external conditions, the international boom shall not get worse significantly. Additionally, it shall be realistic if the influx of EU resources related to the 2007 – 2013 period shall be utilised according to the Bill. The fact that the planned, significant growth of revenues related to consumption is being realised only partially, also represents a risk. The revenues belonging to the Investment Fund do not appear to be adequately founded. Without getting familiar with the details of the measures serving the foundation of the cut-backs, the Council was unable to evaluate the grounds of the reduction of certain expenditure appropriations. The Council identified a contradiction in the fact that, according to the Bill, the debt of the local government sub-system shall grow by HUF 160 billion, while the planned deficit is merely HUF 15 billion.

6. The Council initiates that the Government shall quantify the risks identified by the Council and shall evaluate on this basis whether the reserves specified by the Bill – and especially the appropriation of the Country Protection Fund amounting to HUF 40 billion – will be adequate to handle the risks, the mitigation of the 2, 4 percent targeted deficit and that of the 0, 9 percent government debt indicator.

III

Justification

The Council formulated its Opinion by evaluating the followings and considering the respective results.

The Authenticity of the Bill

In the course of reviewing the Bill the Council did not detect any such objectionable rulings or tendencies that would justify the indication of general non-concurrence concerning the document submitted for giving and opinion. At the same time, due to the shortcomings of the submitted Bill the Council considered it appropriate to direct the attention of the Government to the necessity of giving a detailed presentation in the justification of the Draft Budget Bill concerning the significant shifts in 2015 compared to the 2014 appropriations.

The expected realisation of year 2014 (base year)

According to the Council's evaluation the growth that started in year 2013 shall keep on strengthening also in 2014. Standard international organisations and domestic analysing institutions kept adjusting their forecasts regarding the growth in 2014. Most of them foresee the expected growth of Hungarian GDP in the range of 3 to 3, 5 percent that surpasses the EU predictions (2, 3 percent) and the Summer forecast of the Hungarian Government (2, 7 percent). On the basis of analyses concerning the macroeconomic processes the Council found the expectations regarding the growth of the year 2014 economic output being well grounded. It also shares the opinion that the degree of the annual GDP expansion could be above 3 percent. In the Bill the Government calculated with 3, 2 percent.

Gross fixed assets accumulation drives the dynamic economic output. The ever strengthening investments of the private sector are playing a decisive role in this. The latter are being assisted also by the Growth Loan Programme of the Central Bank of Hungary (considering the increasing interest of businesses the Central Bank has recently decided to raise the available resources). Infrastructural developments (road, railway and public utility networks, etc.) were supporting the expansion of public investments. Since close to one and a half year investments have been continuously growing (in the first half of 2014 by more than 21 percent) and their industrial structures have been balanced. As a result the investment rate shows considerable growth; in the second quarter of 2014 the 19, 8 percent value was higher by 2 percent compared to the same period in the previous year and getting close to the level prior to the outbreak of the crisis.

Throughout the year the output of the industry and building industry continues to grow (close to 9 percent, respectively 21 percent compared to the first eight months of the previous year). In the second quarter of 2014 the added value of the industry kept expanding further and the contribution of services were gaining speed as well, thus contributing to the growth of the GDP. Household consumption grew further and by the second quarter it reached 2, 4 percent. The driving force behind this phenomenon was the expanding employment and the growth of real wages. By the end of August 2014 the number of employees reached 4. 158 thousand that means a

growth by 177 thousand compared to the data of the previous year, thus the unemployment rate decreased to 7, 6 percent.

The rate of inflation is at its low. The average price level growth (in the first eight months of the year) is hardly perceptible and this remains well below the targeted inflation rate of the Government (2, 4 percent) primarily thanks to the reduction of utility costs in the whole year. Apart from its positive effects this has a negative influence on the revenue positions of the budget.

The Council maintains its half-year evaluation and alleges losses compared to the appropriations in case of specific payments by economic enterprises and VAT. The lower than calculated VAT is related to the low lever of inflation. The losses however shall be replaced (compensated) by the very likely higher than appropriated personal income tax, social contribution tax and contribution revenues. Not using the Country Protection Fund respectively, maintaining the mid-year blocks shall strengthen the safety of observing the targeted deficit.

Evaluation of the 2015 goals and conditions

Macroeconomic indicators expected for 2015

The durability of the economic growth built on the basis of year 2014 is surrounded by uncertainties. Among these uncertainties we can find the weakening effect of the sanctions related to the Ukrainian-Russian crisis that affects the economic performance of the EU and the demand of our major foreign trade partners, the slowing down of the growth of the world economy, the fragility of the EU attempts to overcome the crisis and other geopolitical events.

The Council examined the macroeconomic course described in the Draft Budget Bill – also taking into consideration the Convergence Programme of Hungary for the period of 2014 – 2017, as well as the available trade documents, those commissioned by the Council and the projection values. On the basis of the above documents the Council reached the conclusion that it considers the macroeconomic goals that served as the basis of the planning – and within that the forecasted 2, 5 percent growth – were feasible, in case the favourable conditions shall continue to exist.

In 2015 domestic growth is primarily led by the strengthening domestic consumption. According to the Bill the boom will be more favourable in the private sector, private investments keep picking up, the growing performance shall support quicker wage increases and this will have a positive effect on the public finance revenues. The high level of household indebtedness continues to constraint the dynamics of household expenditures. At the same time the Government resolution concerning the elimination of foreign currency loans (accounting between the banks and debtors, exchanging foreign currency debts to local currency) shall contribute to the growing level of household consumption. The Funding for Growth scheme of the Central Bank of Hungary is playing an important role in setting the economy on sustainable growth path.

The slowdown of the pace of economic growth is also related to the fact that compared to the favourable base year of 2014 now it is more difficult to produce a similar growth level. This is especially true in case of the growth of investments, where the significant expansion of utilised EU funds served as one of the stimulating factors. However, 2015 will not see a similar degree of growth. With regard to the fact that the EU resources that we can use up to 2015 are given, we are facing the (paradox) situation that the greater share of utilizing EU resources in 2014 shall improve the economic growth potential of 2014 but shall spoil that of year 2015.

Public Finance Deficit

The Bill laid down the targeted deficit of the governmental sector for 2015 in 2, 4 percent of the GDP – calculated by EU methodology. This means that in case of the realisation of the planned economic growth as regards to the deficit it contains a significant „implicit” reserve when compared to the upper limit of 3 percent, set by the Public Finance Act. At the same time, as a result of having analysed the macroeconomic processes and having reviewed the forecasts (evaluations) by the commissioned analysing institutes, the Council considers the feasibility of the 2, 4 percent targeted deficit safe if a higher amount of reserve shall be set aside to cover the risks outlined in the Council’s Opinion.

In connection with the analysis of the targeted deficit the Council did not find adequate explanation to the fact that, according to the Bill, the debt of the local government subsystem shall grow from HUF 40 billion to HUF 200 billion – primarily

due to financing of the starting up developments – while the current deficit of the subsystem, according to the Bill, shall be only HUF 15 billion. According to the Council's judgement, the growth of the debt to HUF 160 billion shall imply a bigger growth of the current deficit than mere HUF 15 billion, even by taking into consideration that local governments shall not use part of the loans immediately respectively, that there shall be local governments that shall have a positive budget balance in 2015. Apart from initiating the repeated review of this connection, the Council emphasises that in order to avoid a new wave of local governments' indebtedness, the Government should endorse borrowings for local governments only in case the repayment from local governmental resources is ensured.

This was the first time that the Bill referred to structural deficit. This indicator is the balance cleaned of the effects of the economic cycle and individual items and that is related to the mid-range orientation of the fiscal policy. The Council could not gain enough information from the Bill thus it could not evaluate the formulated 2015 goal in this respect. The Council considered it justified that the Government presented the related calculations as well.

Revenues and Expenditures

On the basis of the its analysis the Council is on the opinion that the major tax and contribution revenues were planned on a realistic basis, by considering the expected realisation of year 2014 as the starting point as regards the nominal GDP growth, the expansion of employment and consumption as well as the result of the endeavours to whiten the economy. In case of the revenues that shall very likely lag behind the 2014 appropriations (VAT, contribution tax or small business tax) the Bill regarded a lower implementation data as a basis. By taking into consideration the economic growth, the rate of inflation, the expansion of consumption as well as the changing gross wages and wage bill, the 2015 appropriations were planned on a realistic basis. On the basis of the Bill significant risks are likely to appear. The reason is the risk of the additional revenue planned as a result of the fight against black economy and tax evasion.

The downward pointing indicators surrounding inflation might mitigate specific revenues of the budget and this could counterbalance the expansion of consumption if it exceeds the planned measure.

The fact that due to the still in progress decisions the Government has not fully demonstrated yet the details of the measures mentioned in the general justification of the Bill and the impact calculations of the de-recognition of foreign currency loans affecting the tax payment obligations of financial institutions have not been available at the time of the presentation of the Bill, made the formulating of the Opinion difficult.

Due to the fact that there are only minor changes in the tax system in year 2015, the risk surrounding the realisation of tax revenue goals shall significantly decrease and thus shall strengthen the stability of the budget. Keeping the predictability of the tax system, the further improvement of the predictability of tax collection and preventing the generation of outstanding taxes shall have to get priority instead of the expansion of taxes.

The Bill puts high priority on „other sales and utilisation revenues” within the revenues related to public assets (HUF 169 billion) however, its exact contents are not clear. From the aspect of realisation and statistical accountability this represents significant uncertainty. In case of capital revenues there is always the danger that it shall not improve the ESA balance however, in lack of the details it is difficult to judge. It might present problems if in case of loss of revenues the expenditures of the Investment Fund that have been tied by the Draft Plan to these revenues cannot be terminated mid-year. In case of investments this has a high probability.

The fact that the justification of the Bill did not present the contents of the measures behind the significant changes of expenditure appropriations made the evaluations difficult. Thus the Council formulated its Opinion on the basis of the extrapolation of the tendencies of the past years and the already well-known measures. By taking this into consideration the reduction of the expenditures of the National Family and Social Policy Fund is in harmony with the launched processes (the decreasing number of those receiving entitlement prior to retirement age, the decreasing number of children entitled to family allowance due to the higher number of exiting age groups). On the basis of the housing supports paid in 2014 it is realistic that the budget envisages a lower amount for 2015.

At the same time uncertainties related to expenditures appear in case of public educational appropriations where – being familiar with the measures so far – it should

be expected that staff expenditures would increase at a greater proportion than planned.

The Enforcement of Government Debt Rule

According to the Bill by the end of 2014 the government debt indicator calculated according to the Stability Act shall decrease from the expected 76, 3 percent to 75, 4 percent, thus the debt rule shall be enforced.

The 0, 9 percent improvement of the indicator means that the debt rule shall be enforced even if the GDP or budget deficit turns out to be slightly less favourable than in the Bill – due to the risks identified by the Council. On the basis of the respective calculations and, by taking into consideration the economic processes and budgetary goals presented by the Bill, the Council believes that the realisation of the Debt Rule is not at risk.

At the same time it is the interest of Hungary and a new EU requirement³ to downscale government debt in a measured way and the planned reduction by 0, 9 percent in 2015 is in harmony with this endeavour. At the same time this could be the starting point of a mid-term government debt reducing programme as well. It would be practical to elaborate such a programme at least up to 2022, i.e. for the duration of the EU budgetary cycle in progress, paying attention also to the results of the economic development built on EU resources.

27th of October 2014

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³ The member states are liable to reduce their respective government debt annually (in an average of three years) at least by one twentieth of the portion of their government debt exceeding 60 percent of their GDP.