

Opinion of the Fiscal Council

on the state of the execution of the 2015 central budget of Hungary and the expected trend of the public debt (characteristics of the processes in the first half of 2015)

I

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

According to the stipulations of point c) indent (1) of § 23 of Act CXCV of 2011 on the Economic Stability of Hungary (henceforward: Stability Act) the Fiscal Council shall state its opinion on the state of the execution of the Central Budget Act and the expected trend of the public debt.

Accordingly, the Council shall summarise its evaluation of the characteristics of the processes of the first half of the running year, concerning Act C. of 2014 on the 2015 central budget of Hungary (henceforward: Budget Act) and the expected trend of the public debt.

In its Opinion the Council shall build on the following antecedents concerning the preparation of the budget and the amendment of the 2015 central budget:

- In its Opinion no. 5/2014/10.27. formulated on the 2015 draft budget bill, the FC assessed that „the 2, 4 percent GDP proportionate targeted deficit – calculated according to the EU methodology – was in harmony with the economic processes presented in the Draft Bill; with the revenue and expenditure appropriations that had been based on the above and was lower by 0, 6 percent than the defined 3 percent stipulated by point c), indent (2) of § 13/A of the Public Finance Act.” According to the judgement of the Council this meant that the „stipulation concerning the deficit shall be met even if the GDP or the deficit turns out to be slightly more unfavourably”. At the same time, in its Opinion the Council also identified several risks regarding the realisation of the targeted deficit and the public debt: thus the FC considered that the planned macroeconomic course was viable if the external conditions, the international prosperity were not worsening significantly. Additionally, if the influx of the EU sources for the period of 2014 – 2021 will be carried out as planned. Beyond this, the Council also called the attention to the shortcoming of the laying of the foundations for the revenues belonging to the Investment Fund and the risks concerning the large-scale increase of consumption related taxes.
- In its Opinion no. 7/2014.12.10. evaluating the harmony of the uniform budget bill T/1794/561. on the 2015 central budget of Hungary and the public debt rule – the Council stated that „by the end of 2015 the GDP proportionate public debt shall, very likely, be in harmony with the decreasing stipulation of indent (5), Article 36 of the Basic Law” and that the planned degree of public debt by 31st December 2015 shall be in harmony with the processes envisaged for 2015. Apart from the favourable macroeconomic and public finance conditions, in the Justification part of its Opinion the Council called the attention to the factors endangering the implementation (the moderate growth of the economic performance of the EU, the effects of the geopolitical tensions as a result of the EU sanctions against

Russia, etc.) that cannot be excluded. Accordingly, the FC deemed it necessary to maintain, also in the future, the strict budgetary management in order to observe the targeted deficit and to observe the stipulations of the public debt rule.

- The FC delivered its opinion on draft bill T/4477 that proposed the amendment of Act C of 2014 about the 2015 central budget of Hungary. In its Opinion no. 3/2015.04.14. the Council found that because of the measures presented by the draft bill (securing public share in the Hungarian subsidiary of Erste Bank, the development aid for municipalities that had not participated in the debt consolidation, engagement of the Ministry of Defence in the Kurdistan military project) the increase of expenditure appropriations, the securing of fund for the acceleration of central priority investments, etc. shall increase the deficit. However, the Council considered that – upon the evaluation of the macroeconomic and public finance processes in the first quarter of 2015 – the observance of the 2, 4 percent targeted deficit of the public finance remained viable, despite the higher expenditures. In its justification the FC also pointed out that the changing cash flow deficit and the taking over of the debt of BKV Zrt. shall, in itself, increase the government debt by 1, 2 percent of the GDP, yet „even by the effect of the above measures, the requirement of the decreasing GDP-proportionate government debt shall be observed.” Nevertheless, the Council pointed out that maintaining the financial management discipline was of great importance, in order to safely implement the stipulations of the targeted deficit and the government debt rule.
- As regards the evaluation of the expected implementation of the 2015 budget that served as the basis for the creation of the 2016 budget appropriations, according to the Council’s Opinion no. 4/2015.05.08. concerning the draft bill of the 2016 central budget bill of Hungary, the FC was of the opinion that „following the dynamism of the economic performance experienced in 2014, the output would be around 3 percent in 2015 and this might promote the implementation of the central budget revenues and the maintaining of the 2, 4 percent targeted deficit this year.”
- In the justification prepared for the Council’s Resolution no. 6/2015.06.19. concerning the final voting on the 2016 central budget of Hungary, the FC indicated that „in its evaluation of the first half of 2015 the body shall appraise the relations between the structural transformations and the public finance.”

In harmony with the established practice, when formulating its present Opinion, the FC was building on the written evaluations of the State Audit Office of Hungary and of the Central Bank of Hungary concerning the budgetary processes of the first half of 2015. Apart from this, the Council was relying on the updated economic forecasts prepared by key domestic analysing institutions (GKI Gazdaságkutató Zrt.- Economic Research Institute, Századvég Gazdaságkutató Zrt.- Economic Research Institute, MTA Közgazdaság- és Regionális Tudományi Kutatóközpont Közgazdaság-tudományi Intézet – Institute of Economics Centre for Economic and Regional Studies, Hungarian Academy of Sciences), by international organisations (EU, IMF, OECD) and evaluations prepared by other, standard market analysts. Apart from the above the Council also took into consideration the contents of the Convergence Programme of Hungary for the period of 2015-2018.

The Council shall inform about its Opinion the Speaker of the National Assembly and the Government. Its Opinion shall be published also at the FC website.

II

The Opinion of the Council

At its meeting held of 21st of September 2015 the Council reviewed the major processes of the execution of the 2015 budget act in the first half of the year as well as the background of those processes. On the basis of the above the Council formulated the following Opinion.

1. According to the Council's findings in the first half of 2015 the realisation of the revenue and expenditure appropriations of the central budget act has approached the pro rata proportions, with the exception of some factors (like, for example the failure of the EU supports).
2. According to the Council, following 2014 the rate of economic growth could be energetic also in 2015 – i.e. around 3 percent. The development of the global environment and the performance of the domestic economy both assist the realisation of the 2015 budgetary targets.
3. On the basis of the macroeconomic and budgetary processes in the first half of the year the Council found that the domestic and EU prescriptions as regards the budget deficit shall be met in 2015:
 - a) In the course of the past few years the structure of both the budgetary revenues and expenditures has undergone some changes that managed to stabilise the revenues and made the expenditures manageable. The gradual mitigation of the net expenditures related to the debt service has started. The large scale disbursement of EU resources on the other hand contributed to the economic growth. The Council found that the selective and gradual increase of those working in the budgetary sector was in harmony with the performance of the economy.
 - b) As regards the realisation of the tax and contribution revenues the FC does not see any risks, due to the favourable macroeconomic processes, the introduction of new tools following the trade (online connection of cash registers to the tax office and the use of the Electronic Public Road Trade Control System /EKÁER/) have improved the efficiency of the focused tax control.
 - c) In its earlier opinions the Council pointed out that the appropriation of „other revenues from selling and utilisation” (HUF 169 billion) within the revenues concerning public assets has not been adequately grounded. The planned selling of lands owned by the state can take place in the second half of the year. If the expenditures of investments to be financed from these revenues shall turn out in harmony with this and according to the stipulations of the law, the revenues being of lower level than originally planned, shall not present a risk. The financing of investments that were launched from the revenues of selling assets (frequencies) in the last year and continue this year though might present a problem.

- d) On the expenditure side there is no significant transgression of the pro rata value of the appropriations is characteristic. This fact indicates the existence of appropriate control over the planning and expenditure processes.
 - e) From the aspect of the trend of the cash flow deficit of the central budget the direct impact of the migrant crisis on the budget and, indirectly, via the economic processes represent a risk. According to the Council, due to the financing of the excess expenditures in relation to protecting the state borders it might be unavoidable to amend this year's budget.
 - f) What concerns the budgetary cash flow processes, the slow arrival of EU revenues pose a problem. According to the relevant regulations however, this shall not concern the trend of neither the EDP deficit or that of the government debt indicator, as stated by the Stability Act (it could negatively affect though the debt calculated by EU methodology).
4. The Council takes the view that as regards the budget deficit and, contrary to the additional risks affecting unfavourably the government debt (trend of exchange rates, the late EU financing), the government debt rule shall prevail nevertheless in 2015. According to the Stability Act, the latter risk factors have to be ignored when calculating the government debt indicator and the increase of the government debt, originating from the increasing budgetary liquidity, is only temporary.
5. The situation of the financing of the public finance is favourable. However, due to the worsening external conditions, the Council detected certain risks that might make debt financing more expensive. The lingering Greek crisis, the spill-over of the Russian-Ukrainian conflict, the trend of the Forint exchange rate and the late EU supports might create unfavourable conditions. The improvement of Hungary's credit rating at the same time would be a positive factor.

III

Justification

1. The trend of macroeconomic conditions

According to the spring forecast of the European Commission the mild, cyclic economic recovery would continue in the whole of the EU. As a result of the international economic downwind, several short range factor (volatile, yet low oil prices, global economic growth, the supporting economic policy of the EU, the depreciation of the Euro) the GDP growth in 2015 might be around 1, 8 percent on the EU level.

The European Commission is expecting the growth of the output of the Hungarian economy around 2, 8 percent for the whole of year 2015. This is close to the 3, 1 percent forecasted by the Convergence Programme of Hungary for the period of 2015 – 2018. Most of the analysing

organisations predicted an economic growth close to 3 percent or above for 2015. The difference of these forecasts lays in the judgement of the growth resources (the composition thereof) and their respective sustainability.

In the first half of 2015 the gross domestic product in Hungary grew by approximately 3, 0 percent compared to the same period of the previous year. According to the calculations of KSH (Hungarian Central Statistical Office) the expansion in the first quarter of the year was 3, 5 percent, while in the second quarter it was 2, 7 percent, compared to the same periods of the previous year. (The latter was partially the result of the base effect as the growth rate was excessively high – i.e. 4, 1 percent – in the second quarter of 2014.) The agricultural output in the first half of the year lagged behind that of the previous year as, at this phase of the year, the output is largely based on estimates.

From production side the GDP growth was the result of the increasing industrial production. From the aspect of utilisation this growth was fed by net export and the expanding consumption while investments have slowed it. Industrial production has been growing continuously in the course of the last two years. In the first six months of 2015 its degree surpassed the result of the same period in 2014, by 7, 3 percent. The engine of industrial growth remains the manufacturing of transport equipment with some other, related sectors. The turnover of commercial accommodations has also grown. According to the data from the first half of 2015 the accommodation of tourist has grown by close to 4, 9 percent while the gross revenues of commercial accommodations facilities has grown by 12, 0 percent, compared to the data of the previous year.

The investment performance of the country in the first half of the year surpassed the data of the same period in the previous year by 1, 7 percent, partly thanks also to the Loan for Growth Programme of the Central Bank of Hungary. In the first quarter we witnessed a downturn by 4, 5 percent, in the second quarter however we experienced a growth by 5, 7 percent. Investments by the private sector have recovered in the fields of transportation, storage, electricity and gas supplies. Throughout the whole of the period in question the investment output in the budgetary sector has declined. As a consequence of the above, the investment rate decreases again however, on an annual level it could remain over 20 percent.

The major driving force behind the growth was export. In the first half of 2015 the foreign trade turnover – export and import – grew by 8, 9 percent, respectively by 7, 5 percent, compared to the similar period of the previous year. The foreign trade balance surplus was higher by EUR 981 million, compared to the same data of the previous year.

Additional, favourable signs can be detected in the economy that supports the expectations concerning the growth rate. Parallel with the economic performance the favourable labour market processes continued. As a consequence, economic growth has been assisted significantly also by the expansion of consumption. Employment grew, in May-June 2015 the number of employees reached 4 224 thousand that was higher by 139 thousand (i.e. 3, 4 percent) compared to the similar data a year earlier. The employment rate of the 15-64 age group grew to 64, 1 percent in this period. Unemployment rate declined from 8, 1 percent in the second half of last year to 6, 9 percent.

In the first half of the year there was a 3, 6 percent of average salary increase (together with those employed by public works). By the low rate of inflation (in the first half of the year only 0, 3 percent) this resulted an increase also as regards real salaries and purchasing power (the carry over

effect of the agreements concerning the minimum wage, the guaranteed wage minimum, the trend of those employed by public works and the wage corrections of employees working in the social sector). As a consequence of the above, retail commerce turnover grew further. In the first half of the year it was higher by 6, 1 percent compared to the similar part of the previous year. (Within this the revenues from non-food products and retail fuel sales grew by 8, 6 percent, respectively 8, 8 percent). The decreasing oil and other raw material prices would – very likely – lead to a lower inflation rate than the prognosis of 1, 8 percent that served as the basis for the budget bill. As a consequence of the aggravated effect of the above it is expected that the appropriation of tax revenues on consumption (first of all the VAT, excise duty) will be over fulfilled.

2. The trend of revenues and expenditures

Altogether *the revenues of the central budget* were met close to the pro rata measure (46, 4 percent) in the first half of the year however, in case of certain items the realisation significantly differs from this percentage.

In case of the payment of economic operators the realisation is 46, 0 percent. A significant part of the arrear originated from the mining fee – 40, 2 percent (due to the low oil prices) and the corporation tax (realisation was 47, 5 percent). The realisation of the corporation tax revenue for the whole year does not represent any risks, due to its specific regulations (the obligation to fill up the advance stock at the end of the year), the higher level of current price GDP that affects the tax bases and thanks to the higher 2014 tax base taken into consideration at the time of the calculations regarding the appropriations, we can rather count on over-realisation. As ever, few opt for the KIVA (Small Business Tax) and as a result this contributes to the growth of corporation tax revenues.

The realisation of taxes on consumption is 47, 6 percent. The realisation of the financial transaction fee is superior to this (52, 3 percent), the insurance tax (54, 4 percent) and the excise duty realisation is 48, 5 percent. The half year realisation of the value added tax is 46, 9 percent, significantly higher than the same data in the previous years. Thanks to the steeper improvement of household consumption (use of online cash registers, introduction of the EKÁER system / Electronic Public Road Trade Control System/ and employing other measures and control methods that improved the efficiency of tax collection, etc.) the VAT revenues can be met securely and exceeding the appropriated amount. It is the expansion of consumption (related to the decreasing oil prices) that is the driving force behind the increasing excise duty revenues. In case of financial transaction fees the growing cash flow might bring along excess performance.

As regards the private payments, the realisation of personal income tax in the first half of the year was 50, 3 percent. Thanks to the favourable trend of the labour market processes (expansion of employment) and the growth of the wage bill exceeding the expectations, it is expected that the realisation of the appropriation, on an annual level, will be higher. Payment of contributions were realised at 54, 9 percent in the first six months. This is fundamentally related to the take-off of the real estate market.

Revenues of the budgetary organisations and the chapter managed appropriations in the first half of the year made up 41 percent of the annual appropriation. The fact that the EU Commission has

partially suspended the payment of certain operative programmes and even the awarded supports have been arriving haltingly, was playing a role in the non-implementation, together with ordering an inspection regarding the introduction of food chain safety fee.

In the first half of 2015, revenues related to debt service (essentially interest income) surpassed the original appropriation according to the Budget Act (HUF 82, 6 billion) by HUF 113 billion. The surplus revenue was the result of the fact that thanks to the low yields, investors purchase government securities at bond auctions at a price higher than the nominal value and in the public finance statistics this appears as interest income. The fact that such type of revenues materialise to a great extent this was the result of the relatively widespread bond-swap auctions (true, interest expenditures have similarly increased too). However, the National Assembly has partially counted with these interest revenues beyond the planned amount when, mid-year, it raised this appropriation to HUF 124, 7 billion, by amending the Budget Act. to a small extent this type of revenue improves the ESA balance as the resulting balance improving effect has to be divided to the whole maturity period of the mentioned government securities that could be 3, 5, 10 or even 15 years.

As regards the annual performance of the revenues the fact that from the planned selling of assets worth of HUF 169 billion nothing was realised in the first half of the year, represents increasing risks. On the basis of the recent announcements the budget could get significant revenues from the selling of lands owned by the state. It is questionable, what portion of these land properties could be realised already in 2015. It is also questionable, what kind of a burden the carry-over expenditures of investments to be realised from the selling of assets (frequencies) would mean this year.

Expenditures of the central budget in the first half of the year surpassed slightly (by 0, 4 percent) the pro rata percentage.

Bigger arrears were detected in case of housing construction supports, guarantee invoking and in harmony with the foregone revenues from the selling of state properties, respectively in case of the expenditures of investments financed from the above. Additionally, it is worth mentioning the low level realisation (41 percent) in case of EU professional chapter managed appropriations. The primary reason for this is that no payments have arrived yet, related to the expenditure appropriations related to political operative cohesion programs from the period of 2014-2020.

As regards the individual and normative supports for businesses and the public media, the utilisation was excessive, reaching more than 60 percent of the appropriation. This is the consequence of the characteristically uneven mid-year payments (in 2014 the proportion was nearly the same).

In case of the expenditures of budgetary organisations the realisation was also significantly greater than the pro rata proportion (by 8 percent). Slightly more than one fifth of this was financed by excess revenues respectively, transfers of internal resources (for example, from reserves). But, in case of nearly 80 percent the source was the residual value of the previous year that is not a real cover. This will endanger the realisation of the targeted deficit of the budget if no similar amount of residue appropriation arises at the end of the year.

Expenditures related to debt service (mostly expenditures on interests) reached 62, 5 percent of the original appropriations. The over-performance of interest-related revenues and expenditures have partly common roots, i.e. the bond swap auctions (and redemptions). Due to the low yields the

exchange rates of the public securities' market have increased thus, the debt manager redeems the securities at a price above the nominal value and the difference between the current exchange rate and the nominal value shall be accounted in the cash flow statistics as expenditure on interest. This item does not concern the ESA balance.

Altogether it is expected that the interest revenues and expenditures will exceed the (amended) budget appropriation – partially because of the factors that result in their respective co-movements. The concrete measure depends on what degree of bond swaps will be justified – respectively allowed - by the money market in the remaining part of the year.

The utilisation of the various reserves by 30th of June (40 percent in case of extraordinary governmental actions, in case of specific items of the provisions commensurable with the tasks and in case of the Country Protection Fund, zero percent) was in harmony with the legal stipulations.

3. The trend (feasibility) of the targeted deficit

Upon reviewing the budgetary processes of the first half of the year, the Council was of the opinion that the EDP deficit of the public finance in 2015 could be near to the 2, 4 percent considered at the time of planning the budget bill.

The annual budget act defined the 2015 cash flow deficit of the central budget subsystem in HUF 877, 1 billion. Act LXXIII of 2015 raised this amount to HUF 892, 1 billion. By taking into consideration the macroeconomic processes in the first six months, the realisation of the revenues and expenditures of the budget experienced in the same period and, on this basis, the expected annual trend, together with the presumption that the Government shall continue its careful budget management also in the future, the Council is on the opinion that – if necessary, by internal transferring of appropriations – the amended targeted deficit is feasible.

In the first half of the year the cash flow deficit of the central subsystem was HUF 823, 3 billion that represents 92, 3 percent of the annual deficit. The central budget finished the period with a deficit of HUF 868, 1 billion, while the social security funds had a surplus worth of HUF13, 0 billion and separated public sector funds had a surplus of HUF 30, 0 billion. The pro rata deficit is high however; this is the result of the usual, seasonal processes of the budget. (In 2014 the deficit in the first half of the year was 99 percent of the annual deficit, thus the realisation this year can be considered as favourable.

In case we filter the effect of the failure of the EU supports from the cash flow balance, the cumulative deficit would not reach HUF 300 billion in the first eight months of the year. As a consequence, according to the preliminary financial accounts published by MNB (Central Bank of Hungary) the net financing demand of the public finance in the first half of the year – where statistics corrected the failed EU supports – was significantly lower compared to the same periods of the previous years. In the second quarter, both the quarterly and the aggregated financing demand of the four quarters (i.e. the deficit calculated with the methodology of financial accounts) made up altogether 1 percent of the GDP.

Expenditures related to the migrant crisis represent a risk when we look at the realisation of the original appropriations of the budget. Provisions for the people entering our country affect directly

the budget on the one hand, due to the additional costs (border protection, defence, law enforcement, etc.) the cover for what has to be ensured. On the other hand, indirect effects spoiling the economic performance might also emerge.

4. Prevalence of the government debt rule

Complying with the stipulations of Indent (5), Article 36 of the Basic Law, the 2015 central budget act contains the decreasing of the GDP proportionate government debt by 0, 9 percent, in harmony with the Stability Act. The amendment of the budget act – explained above – shall mitigate the planned decrease by 0, 2 percent.

According to the budget act the planned debt of the public finance for 31st of December 2015 is HUF 25.100,4 billion (by the rates of exchange fixed in this act). By end of June, the debt of the central budget was near to the amount forecasted for the end of this year.

The basic courses regarding the trend of the debt are favourable: the budget deficit (disregarding the pre-financing of the EU supports) is lower than it was last year. Following some volatility, the exchange rate trend has not contributed significantly to the increase of the debt throughout the year. The causes of the growing debt were mostly individual reasons:

- the stock of the state Forint invoice (KESZ) grew by approximately HUF 400 billion in the course of the first six months of the year in the interest of ensuring the liquidity of budgetary processes;
- purchasing Budapest Bank contributed to the debt by close to HUF 200 billion;
- supports paid by the EU were lower by approximately HUF 300 billion than the amount paid by the budget in the first half of the year it had been awarded and accepted. This contributed to the increase of the cash flow deficit and the debt of the budget. We should note that, according to the actual regulations, the changes in the debt originating from the debt indicator calculated in harmony with the Stability Act, shall not count;
- due to the continuous strengthening of the US dollar the stock of foreign currency deposits has grown throughout the first six months by approximately HUF 400 billion.

Individual factors make the decrease of the debt rate more difficult. The target however, continues to be available in case the central budget deficit – by tight management and the realisation of the revenue side – shall not increase further throughout the remaining part of the year and the Forint shall not weaken. Additionally, if part of the realised issuing of government securities implemented in a favourable market situation in the first six months of the year will serve the refunding of government debt maturing in the second half of the year. Should the greater part of the failed EU supports from the first six months of the year arrive in the second half of 2015, it might contribute to a great extent to the mitigation of the government debt. (It was also characteristic in 2014 that the arrival of the EU supports was accelerated in the second half of the year however, the arrear this year is significantly higher as regards the first six months than it was a year before.)

At the same time the implementation of the government debt rule is not threatened by the possible delay in transferring the EU support. Namely, the National Assembly amended the Stability Act as

of 19th June 2015¹. According to the new regulation² „when calculating the government debt indicator, the Act on the central budget does not require the consideration of the growth of government debt due to the time requirement of reimbursing the EU resources at a later date, the possible lack of liquidity of the EU budget or any other reasons, as a consequence of what the central budget had not accounted the EU support on the arising expenditures.”

The FC deems the transformation of the debt stock structure favourable. The proportion of the foreign currency debt has been pressed back to 37 percent, thus mitigating the financial vulnerability of the country because of the fluctuation of the Forint exchange rate.

5. Structural transformations and public finance relations

From time to time – usually when preparing its opinion on the draft budget bills - the Fiscal Council reviews the structural changes of the public finance revenues and expenditures; primarily from the aspect of, to what extent those bills would improve the public finance balance and the sustainability of financing public tasks. When evaluating the implementation of the 2015 budget the Council paid attention not only to the tendencies of the first half of the year but also those predominant in the medium run. When formulating its opinion the FC considered primarily the following relations.

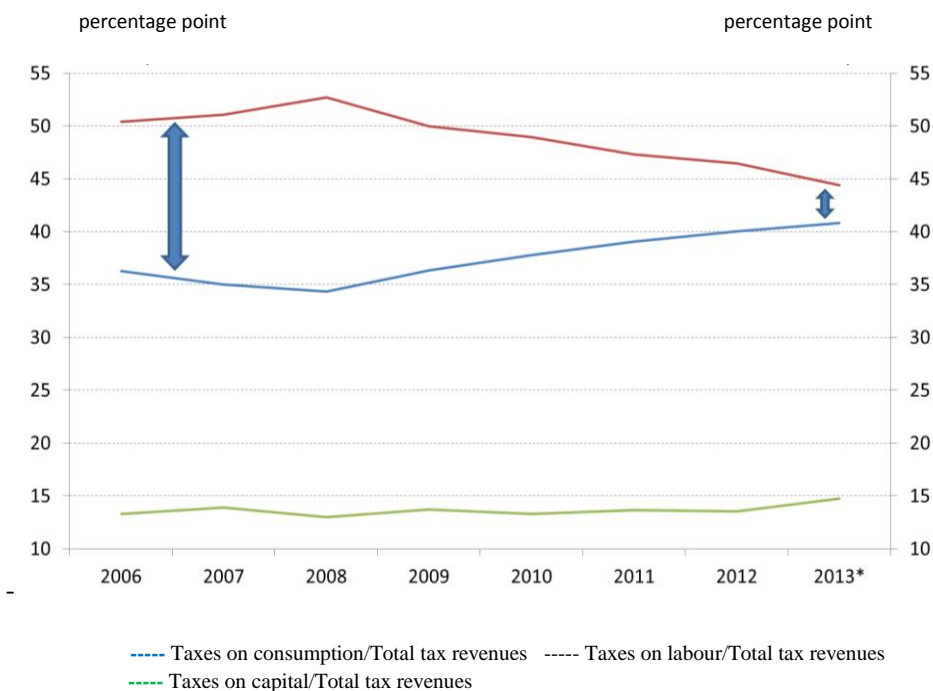
Developing the tax system

Following the 2008 economic crisis, in order to stabilise and consolidate the budget, it became a fundamental requirement to establish such a „tax rearrangement” that in the long run would promote the growth of the economy, the employment and the competitiveness of the country. In the course of the past 5 - 6 years a balance rearrangement of the structure of taxes took place: thanks to the measures introduced since 2010 the proportion of taxes on labour has decreased by 5, 6 percent up to 2012. This has been significantly counterbalanced by the increase of taxes on consumption.

¹§ 5. Act LXXII. of 2015.

² Indent (2) § 6 of the Stability Act

Tax Structure Changes in Hungary in the period of 2006 and 2013 (Source: Eurostat, MNB calculations)



Note: in case of taxes on labour we also took into consideration the membership fees of mandatory private pension funds.

In order to urge Hungarian labour market activity and labour supply, as well as pushing back the tax avoiding attitude of employees-employers, the tax reform transformed personal income tax from the very progressive taxation to the linear (one key) system. As a result of this step, the introduction of tax breaks for families, the termination of the so-called super-grossing principle and the benefits of the Job Protection Action Plan, the tax burden on job related revenues has lessened on the annual level by nearly HUF 450 billion. Due to the single key income tax system the so-called marginal tax wedge has declined to the level of the tax wedge of the countries in the region.

In harmony with the tax-policy intentions of the Government, the proportion of taxes on consumption and commerce however increased. One of the reasons for this increase was the raising of the normal VAT key and the excise tax rates in 2012. The other reason was the introduction of surplus tax liability for specific sectors first, to be followed by phasing out some of them, then introduction of taxes on other consumption, thus the telecommunication tax, financial transaction tax and insurance tax.

Meanwhile the burden of business organisations altogether remained the same. Within this, by the introduction of two new taxes, the small business tax and the fixed-rate tax of small taxpayer enterprises, as well as the decreasing of the corporation tax to 10 percent up to a tax base of HUF 500 million, the tax burden of the small and medium size business sector declined. In case of the special taxes the phasing out of the sector specific special taxes in 2013 resulted in a significant change.

The system/proportion of local taxes did not change as a result of the above changes however; the option of introducing town tax expanded the room to manoeuvre of the municipalities.

On the whole, the tax structure ensures the feasibility of the realisation of the (tax) revenue appropriations of the public finance. The tax structure has been stabilised by now as well thus, the payments of households and economic enterprises – in proportion to the GDP and compared to 2010 – have declined gradually by 2014 from 7, respectively 4, 4 percent to 5, 5 respectively 4, 1 percent. At the same time, taxes related to consumption grew from 12 percent to 13, 6 percent. As a result of the tax reform the proportion of revenues compared to the GDP fell back to a lower level than in the years prior to 2008 and following 2012 it remained on the same level. The degree of tax centralisation (i.e. what proportion of the gross domestic product is absorbed by the state in form of taxes) remains high when compared to countries of similar development level in the region.

The trend of the functional expenditures of public finance

The table below contains the so-called, consolidated expenditures of the public finance in retrospect of five years and projected for the period of 2015 – 2016, regarding the financial flows between both subsystems (central and municipal), calculated with the elimination of aggregations, in a functional³ composition.

³ The breakdown of the expenditures of the public finance according to functions is classified on the basis of the so-called COFOG system. Several international institutions employ the so-called COFOG standard (Classification of Functions of Government) when it comes to measuring government functions. This makes the expansion and composition of the government sectors of various countries comparable. Functional classification distinguishes four categories. (1) Administration, foreign affairs, defence, law enforcement and legal certainty and administration of justice belong to the group of *Operational State Functions*. (2) *Welfare Functions* encompass services organised or supported by the governments in the field of education, health care, social security, social and welfare and other services. (3) *Economic Functions* include economic activities organised and supported the government together with their development (for example energy supply, agriculture, transportation, telecommunication). (4) *Government Debt Management* category includes interest expenditures related to government debt financing (capital repayment is not part of public finance expenditures).

Consolidated Expenditure Structure of Public Finance in Functional Breakdown

(In cash accounting principle, percentage)

Source: Calculations by NGM (Ministry for National Economy) and the FC Secretariat

Designation	Fact					Budget	
	2010	2011	2012	2013	2014	2015	2016
OPERATIONAL STATE FUNCTIONS ALTOGETHER	15,3	19,3	15,2	17,0	18,1	16,8	18,3
General Community Services	9,8	13,9	9,6	11,6	13,1	11,9	12,5
Defence	1,8	1,7	1,7	1,7	1,3	1,3	1,6
Law Enforcement and Public Safety	3,7	3,7	3,9	3,7	3,7	3,6	4,2
WELFARE FUNCTIONS ALTOGETHER	61,5	57,6	58,8	56,5	54,7	56,1	56,7
Educational Activities and Services	11,6	10,8	10,3	10,2	10,3	10,0	10,1
Healthcare	9,1	8,8	8,6	8,6	8,4	8,5	8,6
Social Security and Welfare Services	34,6	32,3	33,9	31,9	29,9	31,2	31,6
Housing, Municipal and Community Activities and Services	3,3	2,9	3,2	3,0	2,8	2,9	2,7
Entertainment, cultural and religious activities and services	2,9	2,8	2,8	2,8	3,3	3,5	3,7
ECONOMIC FUNCTIONS ALTOGETHER	14,3	13,1	15,5	17,3	18,3	19,0	16,7
<u>Showing separately from this:</u> Agriculture, Forestry, Fish Farming and Game Farming	2,2	1,5	1,7	2,1	2,3	2,7	1,7
Transportation and Telecommunication Activities and Services	5,8	5,9	6,0	7,3	8,3	7,8	7,3
Environment Protection	1,5	1,6	2,0	2,3	2,3	2,0	1,5
GOVERNMENT DEBT MANAGEMENT	8,5	7,7	8,7	8,6	8,7	7,1	6,8
Items Not Classified in Functions	0,4	2,4	1,8	0,6	0,2	1,0	1,5
ALTOGETHER	100,0	100,0	100,0	100,0	100,0	100,0	100,0
Public Finance Expenditures Altogether in the Percentage of the GDP	49,9	50,0	48,6	49,8	50,1	49,1	46,3

In the period of 2010-2014 the main characteristics of the functional structural changes of the expenditures were the following:

Expenditures used for the operational functions of the state were between 15 and 19 percent in the previous years. In 2014 they represented more than 18 percent. Within this the biggest growth was experienced in the field of general public services that comprises „administration” as well. In the international practice they also include in this the expenditures of government debt management (interest and costs) that is otherwise listed in a separate function. According to this calculation in 2014 „administration” would take up more than 20 percent of public finance and this is a high

proportion indeed when compared to the average of the neighbouring and other EU countries. However, if we deduct the excessively high 8, 7 percent share of government debt management of this year then the measure of our „administrative” costs is closer to the international trend.

The operational expenditures of the state – together with the debt service – have limited the financing elbow room of the public finance services. As a consequence the expenditures used for financing welfare functions could follow a declining course. From the starting 62 percent, by 2014 their share has sunk to below 55 percent. The biggest decline was experienced in case of the social security and welfare services. Apart from the limited public finance resources the mitigation of the pension type expenditures was playing a significant role in this. The mitigation of the GDP proportionate level of pension expenditures was the result of the gradual maturation of two major actions in the budget: the raising of the retirement age and the tightening of the rules regarding invalidity pensions and pensions for people retiring earlier than the set age. On the other hand, as of 2011, measures bearing a character of changing paradigm took place as regards the distribution policy and these have influenced considerably the structure of budgetary expenses. By the gradual utilisation of „work instead of aid” principle the proportion of social expenditures has lessened as the supports of public works⁴ does not have to be accounted among welfare functions. But saving jobs is not encouraged primarily by supports rather, by tax and contribution reliefs awarded in the frame of Job Protection Action Plan. These do not appear as expenditures among the economic functions. Families get assistance by the expansion of the tax relief after children, instead of raising the family allowance however, this does not appear in the expenditures of welfare functions.

In the field of education health care organisation, changes aiming at the restraining of expenditures structural reforms were introduced. By introducing the Teacher Career Model the earlier savings were given back. In case of healthcare expenditure the launching of career models, the measures (mostly wage policy measures) launched in certain fields – for example in the interest of keeping resident doctors, young specialists in the country and to strengthen the „gatekeeper role” of family doctors, just like the shortening of the waiting lists of hospitals or the investments serving the debt settlement financed from additional resources for the first time in this year – have not resulted any structural changes.

We can evaluate the significant mitigation of the proportion of social security and welfare services from a social political aspect only by taking into consideration the above factors, as well as the other, marked changes of the expenditure structure, the effects and synergies of these changes. Also, this mitigation of the sources has been going on for years now and did continue also in 2014.

The high debt service burdens – interest expenses – decreased in the past few years, thanks to the favourable international and domestic environment and the significant decline of yields. From 2013 to 2014 the accrual based interest expenses of the public finance mitigated by 0, 4 percent of the GDP and in 2015 an additional decrease of 0, 4 percent can be projected. This means that within two years the decreasing interest expenses contributed to the improving balance of the budget, respectively other expenditures and tax reductions approximately by 0, 8 percent of the GDP.

In the recent period, the share of expenditures used for economic functions within the total expenditures increased (from 14, 3 percent in 2010 to 18, 3 percent in 2014). According to the

⁴ In 2014 HUF 225 billion (The appropriation in 2015 is HUF 340 billion)

intentions of the Government, in the future the economic fund can expand further – by concentrating a bigger portion of the EU supports in this field – so that government debt could continue to lessen, thus also the interest expenses, while the importance of expenditures used for welfare and human capital (education, healthcare) would grow permanently.

The overall sectoral reform effects appear only to a small extent yet as regards the composition of public finance expenditures. The above mentioned transformation of the social entitlement system is an exception. The actual results of the changes launched in public administration, education and healthcare, the centralisation of the management of institutions, the payment of employees and in organising entitlements will be ready for evaluation only when the whole system has been transformed.

In the course of the financial management of institutions (a group of institutions) having significant budgetary resources, indebtedness was detected. This justified their consolidation from the assets of the state budget. These focus our attention to the importance of continuing also in the future the disciplined financial management and beyond preventing new indebtedness, the continuing of structural reforms.

21st September 2015

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Chairman of the FC