PUBLIC FINANCE
REPORT

2015
MAY

"Intending to ensure the benefit of the general public ... and the good condition of the country by useful remedies..."

(from a charter of King Charles Robert - February 1318)

PUBLIC FINANCE
REPORT

Analysis of the 2016. budget bill

With the aim to support the fulfilment of its fundamental duties stipulated in Act CXXXIX of 2013 on Magyar Nemzeti Bank, and particularly the task related to the definition and implementation of monetary policy, the Magyar Nemzeti Bank analyses the development of the budgetary deficit and debt, monitors the financing of the general government, analyses the impact of financing on the monetary processes, on the capital markets and on liquidity, and researches fiscal policy issues.

Pursuant to Act CXCIV of 2011 on the Economic Stability of Hungary, the Governor of the MNB is the member of the Fiscal Council (FC), and thus the professional expertise and accumulated information available in the MNB can indirectly support the work of the FC. The MNB prepares background analyses for the duties of the FC stipulated in the Stability Act, and makes them available for the FC. The general public can learn about the most important results of these expert analyses from the publication „Public Finance Report".

This report was prepared by the staff of the Directorate Fiscal Analysis with the contribution of the staff of the Directorate Economic Forecast and Analysis. The publication was approved by Dániel Palotai, Executive Director.

The analysis is based on information available for the period ending on 19 May 2015.

Contents

1 Summary

The subject of this analysis is the 2016 budget bill submitted to the Parliament on 13 May, which we assess in the light of the MNB's fiscal forecast. In addition to the bill, we also considered the submitted amendments of the tax laws and the information available until 19 May. As part of this analysis, the MNB prepared its own projection for the 2016 budget balance based on the available information, and this projection is compared with the appropriation in the bill.

According to the budget bill, the ESA budget deficit in 2016 may be 2.0 per cent of GDP. After reviewing the details of the bill, we believe that certain revenue items may fall short of the estimate, and thus the set deficit target can be approached only with the full cancellation of the Country Protection Fund; in that case, according to our forecast, a deficit of 2.2 per cent can be achieved in 2016.

Our fiscal projection for 2016 corresponds to our forecast published in the March *Inflation Report*. The impact of the tax cuts announced since March was offset by the fact that, pursuant to the bill, the amount of public wages, intermediate consumption of the budget, and own resources related to EU projects may be lower. In addition, our updated forecast with regard to net interest expenses also resulted in a lower deficit.

According to the bill, at constant exchange rate the debt ratio as a percentage of GDP may decrease by about 1 percentage point in 2016. According to the MNB's calculations, the nominal GDP growth rate, which is higher than that specified in the bill, may result in an even faster – about 2 percentage point – decrease in the debt ratio. In accordance with the rule stipulated in the Fundamental Law, the calculation is made by assuming a constant forint exchange rate throughout 2016. Accordingly, the debt rule of the Fundamental Law, which will be the focus of the Fiscal Council's future decision, is expected to be satisfied. However, the level of the debt ratio strongly depends on the forint exchange rate. If we use the EUR/HUF exchange rate of 315 from the end of 2014, the debt ratio would be 75.4 per cent and 73.4 per cent at the end of 2015 and 2016, respectively (at the end of 2014, gross government debt as a percentage of GDP was 76.9 per cent). If we use the EUR/HUF exchange rate of 304, assumed in the budget bill, the debt ratio may be 1 percentage point lower in both years.

At the same time, the bill does not comply with the current debt formula of the Stability Act, based on which the growth rate of the nominal debt must not exceed the difference between the planned inflation and half of the real growth rate. Based on the macroeconomic path included in the budget bill, the bill fails to satisfy this requirement, as it plans for nominal debt growth of 3.3 per cent as opposed to the 0.4 per cent permitted by the formula. After submission of the bill, the Government initiated amendment of the Stability Act with regard to the debt formula, and accordingly the rule will presumably be amended before the final vote on the budget bill.

The macroeconomic path underlying the budget is solid and is similar to the MNB's projection in the March *Inflation Report*, but there is some difference with regard to inflation. The bill estimates 2.5 per cent GDP growth and 1.6 per cent inflation for 2016. The MNB's projection in the March *Inflation Report* is 2.5 per cent economic growth and 2.6 per cent inflation. The lower inflation expectations in the budget act may partially be attributable to the fact that it also takes account of the new measures included in the bill.

The bill contains the following key risks, also including the measures from which substantial revenues are expected, but the details of the measures are not yet public:

- The most significant risk arises from the fact that the bill projects a revenue of HUF 115 billion in the line **revenues from other sales and utilisation**, but does not specify the source and background of this. In our forecast, we disregard this revenue in view of the fact that the source of the HUF 169 billion similar revenue planned for 2015 is also currently unknown.

- The **recurring debt balance of the health institutions** may increase next year's budget deficit by 0.1-0.2 per cent of GDP as a carry-over effect, unless full debt consolidation takes place this year.

- It is difficult to estimate **the amount available from EU funds.** In our forecast, we project an inflow of transfers more concentrated at the end of the EU 2014-2020 financial framework; accordingly our forecast for 2016 contains lower drawdown and therefore a smaller amount of own resources. If the government's plan with regard to the higher utilisation of EU funds materialises, it may generate a higher deficit than in our baseline scenario, but at the same time investment activity will be also higher.

Of the **key measures** and items of the **budget bill** the following items should be highlighted: the reduction of the personal income tax rate by 1 percentage point, the extension of the family tax allowance of families with two children, the reduction of the VAT on pork to 5 per cent, the decrease of the levy on banks, the continuation and extension of the career path models (teachers, law enforcement professionals, government officials), the launch of high-value public road development investments and the increase of the Country Protection Fund to HUF 100 billion.

The budget bill complies with the debt rule outlined in the Fundamental Law, the 3 per cent balance prescribed in the Act on Public Finance and the rules belonging to the „corrective arm" of the Stability and Growth Pact. At the same time, it fails to satisfy the currently effective debt rule in the Stability Act, and we see compliance with the rule of the Act on Public Finance with regard to the structural balance as being questionable, although measuring this is complicated by methodological difficulties.

1.1 FISCAL REQUIREMENTS STIPULATED IN HUNGARIAN LAWS

1. The bill **satisfies** the debt rule laid down in the Fundamental Law, as the debt-to-GDP ratio decreases in 2016 based on the estimates and also according to our forecast (debt that complies with the definition in the Stability Act and also debt under the EDP methodology).

2. The bill **does not comply with** the current debt formula of the Stability Act, based on which the growth rate of nominal debt may not exceed the difference between the planned inflation and half of the real growth rate. According to the rule, nominal debt could increase by 0.4 per cent in 2016, while the bill projects a 3.3 per cent increase.

3. The bill **complies** with the balance of 3 per cent prescribed in the General Government Act.

4. **It cannot be unambiguously assessed** whether the bill satisfies the structural balance prescribed in the Act on Public Finance. According to the Act, the structural balance net of the cyclical effects of the economy and one-off items must not exceed 1.7 per cent of GDP. The bill does not specify the structural deficit estimated for 2016, but in our opinion with the expected 2.2 per cent ESA deficit, compliance with the rule

is **questionable.** Compliance would require a massively negative output gap in 2016, but according to the MNB's actual and potential GDP estimates, this is unlikely.

1.2 RULES BELONGING TO THE CORRECTIVE ARM OF THE STABILITY AND GROWTH PACT

1. The bill **complies with** the 3 per cent Maastricht criterion with regard to the deficit.

2. The bill **complies with** the EU criterion with regard to the reduction of the debt ratio.

2 General government balance

The bill defines the general government balance on an ESA basis as 2.0 per cent of GDP for 2016, which is a 0.4 per cent improvement compared to the deficit expected for 2015. According to our forecast, the cash balance of the central budget may be slightly lower, while the balance of the local governments may be slightly higher than the appropriations. At the same time, according to the MNB estimate, the ESA reconciliation table containing the statistical corrections could be more unfavourable than that in the Budget Act, but this is mostly related to the accrual accounting of EU subsidies and net interest expenses, and as such it may be regarded basically as a technical item.[1]

Table 1
ESA balance of the government sector
(percentage of GDP)

	2015			2016		
	Statutory target	MNB forecast	Difference	Statutory target	MNB forecast	Difference
1. Balance of central subsector	−2.6	−2.7	−0.1	−2.1	−2.2	0.0
2. Balance of local subsector	−0.1	0.0	0.0	−0.1	0.0	0.0
3. GFS balance of general government (1+2)	**−2.7**	**−2.7**	**0.0**	**−2.2**	**−2.2**	**0.0**
4. ESA bridge	0.3	0.2	−0.1	0.2	−0.2	−0.5
5. ESA balance of general government (3+4)	**−2.4**	**−2.5**	**−0.2**	**−2.0**	**−2.5**	**−0.5**
6. ESA balance with the cancellation of the free reserves	**−2.4**	**−2.4**	**−0.1**	**−2.0**	**−2.2**	**−0.2**

According to our forecast, the general government deficit on an ESA- basis may be higher than the rate set in the budget by 0.2 per cent of GDP. According to our forecast, the primary revenues of the budget may fall short of the appropriations specified in the bill by 0.7 per cent of GDP. The major part of the difference is attributable to the fact that in our forecast we do not include the revenue estimated for the item of other sales and utilisation revenue related to state property. In addition, we also forecast lower revenues from the payments of enterprises, labour taxes and consumption taxes as compared to the appropriations included in the bill.

However, the revenues falling short of the appropriations and the higher pension expenses are offset by the fact that according to our forecast – without making the institutional system more efficient – the spending units will be able to use EU subsidies in 2016 to a slightly lesser extent than planned by the budget, and thus the savings on own resources may be as high as 0.2 per cent of GDP. A lower deficit may also materialise because our projection with regard to net interest expenses on an accrual basis is 0.1 per cent of GDP lower than the value stated in the bill. In addition, we assume full cancellation of the Country Protection Fund, which in its own right results in a better balance by 0.3 per cent of GDP (Table 2).

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[1] In the case of the settlements with the EU at the end of the programmes, with regard to the 5 per cent security retained by the EU until the closing of the programmes we projected a HUF 135 billion lower correction, on an accrual basis; however, this only offsets the difference appearing under the cash expenditures with different sign. In addition, our projection with regard to the interest balance correction on an accrual basis is HUF 30 billion lower than that specified in the bill, also including the swap settlements.

Our projection with regard to the deficit in 2016 has not changed compared to the forecast published in the March *Inflation Report*. The impact of the tax cuts announced since March was offset by the fact that, pursuant to the bill, the amount of public wages, material expenditures and own resources related to EU projects may be lower than previously expected.[2] In addition, our updated forecast with regard to net interest expenses also resulted in a lower deficit.

Table 2
Difference between the MNB forecast and the budget bill
(ESA-basis, as percentage of GDP)

	Difference from appropriation
I. Central government revenues	**−0.7**
Payments of business organisations	−0.1
Tax revenues related to labour	−0.1
Tax revenues related to consumption	−0.2
Revenues from state property and related expenses	−0.3
II. Central government expenditures	**0.2**
Net expenditures related to EU-funding	0.2
Pension related expenditures	−0.1
Interest expenditures	0.1
III. Other effects	**0.3**
Cancellation of the reserves	0.3
Total (I.+II.+III.)	**−0.2**

Note: The positive and negative signs indicate deficit-reducing and deficit-increasing effects, respectively, compared to the appropriations.

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[2] In respect of the increase in public wages, we worked with the technical assumption in the *Inflation Report* of March that public wages, calculated without the public work programmes, will increase by 4.2 per cent in 2016, in line with the private sector, and thus together with the effect of the career path models general government wages will increase by 6.5 per cent. However, the bill contains no general salary increase in the public sector, thus the average wage increase in the public sector falls short of our previous assumption by 0.6 percentage points.

3 Expected developments in government debt

According to our forecast, the general government debt-to-GDP ratio under the EDP methodology – using a constant EUR/HUF exchange rate of 314.9 from the end of 2014 – the debt ratio would be 75.4 per cent this year and fall to 73.4 per by the end of 2016. If we use the exchange rates specified in the budget bill, which are much lower than they were last year (EUR/HUF 304.7 in 2015 and EUR/HUF 303.7 in 2016), the dynamics of the debt ratio in 2016 (-2 percentage points) does not change, but in terms of its level the values are more favourable by 1 percentage point. The relatively high exchange rate sensitivity of the public debt is attributable to the foreign currency exposure of almost 40 per cent. Accordingly, each change of HUF 1 in the EUR/HUF exchange rate modifies the debt-to-GDP ratio by about 0.1 percentage point. According to our expectations, other changes in the debt arising from one-off items may contribute to the reduction of the debt ratio to a slight extent, by 0.1 per cent of GDP.

The dynamic increase in nominal GDP substantially contributes to the reduction in public debt in 2016. According to the March *Inflation Report,* GDP calculated at current prices may expand by 5.4 per cent in 2016.

| Table 3 Public debt calculated using the EDP methodology with constant exchange rates		
	HUF billion	**as a percentage of GDP**
1. EDP public debt at the end of 2015	25 467	75.4
2. GFS deficit of 2016*	696	2.0
3. Other effects	−30	−0.1
4. Expected EDP public debt in 2016 (1+2+3)	26 133	73.4
5. The change of the public debt-to-GDP ratio in 2016 (4-1)		−2.0
Note: *MNB projection, with cancellation of free reserves.		

4 Evaluation of the macroeconomic assumptions underlying the bill

With regard to economic growth, **the forecast of the submitted budget bill** essentially corresponds to the MNB's forecast in the March *Inflation Report* and also remains within the range of analysts' expectations. However, there are some deviations in terms of the structure of economic growth. The fiscal projection is more moderate with regard to household consumption expenses this year, while it envisages significant growth in 2016. This may be attributable to the continued increase in real wages resulting from the lower inflation path, and the positive impacts of the tax decreases and tax allowances (PIT rate cut, reduction of the VAT rate on pork and the higher family tax benefits). In the case of investments, the macro path of the budget projects more intense growth for 2015, and a slight decline for 2016, which may be attributable, *inter alia*, to the different assessment of the scheduling of the utilisation of EU transfers. Public consumption in 2016 is substantially lower compared to the MNB forecast. With regard to exports and imports, the budget projection assumes similar trends as in 2015, while it estimates a more moderate increase in net exports in 2016.

The **inflation projection** for this year corresponds to the projection in MNB's March *Inflation Report*, while next year it is substantially lower than that. The difference may be partly attributable to the fact that, based on the information included in the convergence programme, the macro path of the Ministry of National Economy (MNE) assesses the disinflationary impact of the real economic environment as being stronger (the output gap is more negative). On the other hand, the macro path also incorporates new tax cuts (reduction of the value-added tax on pork to 5 per cent). The GDP deflator included in the budget bill is lower than the MNB's expectations, in line with the lower projected inflation.

Chart 1
Comparison of the GDP and the consumer price index forecasts
(percentage change compared to the previous year)
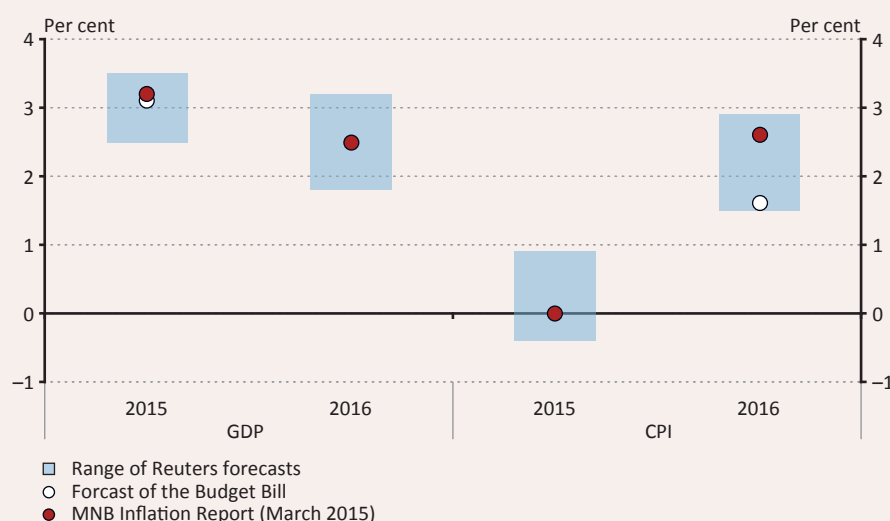
Range of Reuters forecasts
Forcast of the Budget Bill
MNB Inflation Report (March 2015)

Source: Budget bill, convergence programme of Hungary 2015-2018, Inflation Report (March 2015), Reuters (April 2015)

In line with the March *Inflation Report*, the budget forecast projects a further increase in **employment** and a decreasing unemployment rate. The higher growth in employment in 2015 compared to the MNB forecast may be justified by taking into consideration the contribution allowance extended to the employees of 25-55 years employed in agriculture. The expectations with regard to the wage increase in the private sector essentially correspond to the March *Inflation Report*.

Table 4
Comparison of the macroeconomic forecasts
(percentage change compared to the previous year)

		Budget Bill		MNB		Difference	
	2014	2015	2016	2015	2016	2015	2016
Real GDP growth	3.6	3.1	2.5	3.2	2.5	0.1	0.0
Consumption expenditure of households	1.7	2.9	3.6	3.2	2.7	0.3	−0.9
Public consumption	3.4	1.5	−3.0	0.8	−0.3	−0.7	2.7
Gross fixed capital formation	11.7	5.8	−0.9	5.2	−1.2	−0.6	−0.3
Exports of goods and services	8.7	7.5	7.4	7.3	7.6	−0.2	0.2
Imports of goods and services	10.0	7.7	7.1	7.4	6.8	−0.3	−0.3
GDP deflator	3.1	2.3	2.1	2.6	2.9	0.3	0.8
Consumer price index	−0.2	0.0	1.6	0.0	2.6	0.0	1.0

Source: Budget bill, convergence programme of Hungary 2015-2018, Inflation Report (March 2015)

5 Detailed evaluation of the budget bill

5.1 PRIMARY REVENUES

According to our forecast, the **primary revenues of the central sub-sector of the budget** may fall short of the appropriations in the bill by 0.7 per cent of GDP, i.e. HUF 237 billion in total (Table 5). The major part of the difference appears at the following two items:

- the Government expects revenue of HUF 115 billion in 2016 under the title of „other sales and utilisation revenues"; however, this appropriation is not supported in the bill by proper measures. Accordingly, for the time being we do not take into account this revenue in our forecast.

- our forecast with regard to the value-added tax is lower than the appropriation in the bill by HUF 78 billion, which is primarily attributable to the different assumptions with regard to the whitening effects of the new measures.

Our forecast with regard to the **payments by the enterprises** falls short of the appropriation by HUF 22 billion. Within this, our forecast with regard to revenues from corporate tax is lower than the appropriation by HUF 24 billion, which may be attributable to the different assessment of the impact of last year's tax advance top-up on the forecast on the one hand, and on the other hand the appropriation presumably does not incorporate the impact of the growth tax credit. Within the framework of the growth tax credit, companies that have managed to achieve an additional fivefold increase in their pre-tax profit are permitted to pay the additional corporate income tax arising from the growth in equal instalments over the next two tax years. The eligible entities may apply for the payment by instalment already at this year's tax advance top-up in December. According to our forecast, this measure may impact almost 18,000 companies and may result in a corporate income tax shortfall of HUF 19 billion and HUF 9 billion in this year's and next year's budget, respectively.

In addition, the Government's estimate with regard to the willingness to changeover to the small taxpayers' itemised lump sum tax (KATA) is higher than our assumption, as a result of which the bill expects the tax revenue under this tax type to be higher by HUF 15 billion (at the same time, the expected lower changeover to the KATA increases the revenues from other tax types, and thus on the whole it has a positive impact on the budget). According to the bill, mining royalties may decrease substantially in 2016, which we do not deem justified – in the absence of announced measures – and therefore our expectation exceeds the appropriation by HUF 12 billion.

The **levy on financial organisations** is impacted by several measures, as a result of which the revenues expected in 2016 will decrease substantially according to the appropriation and also to our forecast. In the case of credit institutions, the higher rate of the levy will be reduced from the present 0.53 per cent to 0.31 per cent. An additional change is that the tax base will have to be defined on the basis of the balance sheet total of 2014 rather than that of 2009. Just these two measures (primarily the rate cut and to a lesser extent the change in the tax base) reduce the revenues from the levy on financial organisations by HUF 62 billion in 2016.

The most important change in the **value-added tax** will be that instead of the present 27 per cent the VAT payable on pork will be only 5 per cent next year. According to our estimate this measure will result a revenue shortfall of HUF 29 billion, while total VAT revenue in 2016 will be HUF 3,274 billion. Our forecast lower than the budget estimate by HUF 78 billion, which is mainly attributable to the fact that in relation to the implementation of the Electronic Trade and Transport Control System (EKAER) – bearing in mind the principle of conservative forecasting – for the time being we do not project additional surplus revenue (the estimated impact of the

online cash registers is included in our forecast via the base effect), while the Government expects a surplus revenue of HUF 60 billion from the measure.

Our **excise duty** projection is slightly (by HUF 8 billion) lower than the value stated in the budget appropriation, which is presumably attributable to the different assessment of the durability of the present favourable procedures. At the same time, the revenue from the **financial transaction levy** may exceed the appropriation by HUF 24 billion. The revenue growth compared to this year is also supported by the latest payment statistics. According to the bill, revenue from the transaction levy may decrease in 2016 compared to this year, which is not supported by any measure.

Based on the published information, we regard the **personal income tax** estimate to be higher than justified, because it significantly, i.e. by HUF 36 billion, exceeds the value we forecast. This year, we estimate the growth in the wage bill to be roughly half percentage point lower than the growth stated in the convergence programme, and by about 1 percentage point more next year. Thus, the differences in the projected wage bill alone do not explain the difference in the expected personal income tax revenues for 2016. Our forecast with regard to the impact of the two key measures related to the personal income tax corresponds to the expectations in the convergence programme. According to our projection, the higher family allowance available for families with two children reduces tax revenue by HUF 14 billion, while we estimate the additionally lost personal income tax revenue as a result of the rate cut as HUF 107 billion (see chapter 8.1 for the impacts of the measures related to the personal income tax). The convergence programme envisages a personal income tax shortfall of about HUF 122 billion as a result of these two measures. Our forecast with regard to the rate of all tax allowances corresponds to the lower value of the government's estimation band in the bill.

We regard the **tax and contribution revenue appropriations of the social security funds** as justified; the appropriations exceed our forecast by merely HUF 9 billion. Despite the fact that we forecast a slower increase in the wage bill for this year and a faster increase next year than the government, we believe that revenues corresponding to the appropriations will be received in 2015 as well. According to our estimate, extension of the targeted social contribution tax allowance of the Job Protection Action Plan to agricultural employees of 25-55 years of age generates a tax shortfall of HUF 10 billion in 2016. We estimate the total amount of such allowance as HUF 147 billion, which exceeds the value stated in the bill by HUF 9 billion. According to our estimate, the new rules related to the reform of the vocational education scheme reduce next year's revenues from the vocational training contribution by HUF 11 billion. The conversion of the one-off health contribution obligation of certain actors in the tobacco industry in 2015 to a permanent obligation may generate additional revenue of HUF 13 billion, which is consistent with the estimate. According to the government's appropriation, the total family contribution allowance will amount to HUF 37 billion next year, which does not differ materially from the amount we expect.

In the absence of the measures substantiating the revenue, we do not expect any other sales and utilisation revenue under the **revenues related to state property.** Accordingly, the revenue in our baseline projection is lower than the appropriation in the bill by HUF 115 billion. However, the risk impact of the revenue shortfall on the budget balance is partly mitigated by the fact that the bill partially makes the expenditures of the Investment Fund conditional upon the realisation of this revenue; however, this does not cover the risks in full, because the expenditures of the Investment Fund arise continuously, while the expected date of the revenues is unknown, and it might only be realised in the second half of the year. The realisation of the appropriation and/or the partly cancellation of the Investment Fund is a positive risk compared to our estimate.

Table 5
Revenues of the central sub-sector – comparison of the forecasts
(HUF billion)

	2015		2016		
	Statutory target	MNB forecast	Statutory target	MNB forecast	Difference
Tax revenues and contributions of central government	**12 056**	**12 094**	**12 524**	**12 404**	**−120**
Payments by businesses	**1 306**	**1 270**	**1 277**	**1 256**	**−22**
Corporate income tax	341	341	401	377	−24
Special tax of financial institutions	144	144	89	87	−3
Sector-specific tax	0	0	0	0	0
Simplified entrepreneurial tax	84	82	75	75	0
Mining royalty	49	39	32	44	12
Gambling tax	40	36	41	38	−3
Income tax of energy companies	45	39	41	45	4
Lump sum tax on small enterpreneurs	56	52	70	55	−15
Small business tax	16	12	14	13	−1
E-road toll	149	136	141	139	−1
Utility tax	54	54	52	52	0
Other taxes and payments	327	335	322	331	10
Consumption taxes	**4 397**	**4 445**	**4 612**	**4 556**	**−56**
Value-added tax	3 172	3 185	3 352	3 274	−78
Excise duties	914	933	952	945	−8
Registration tax	20	19	21	21	0
Telecom tax	56	58	56	60	4
Financial transaction levy	206	220	201	225	24
Insurance tax	29	30	30	32	2
Payments by households	**1 807**	**1 823**	**1 829**	**1 791**	**−37**
Personal income tax	1 640	1 656	1 658	1 623	−36
Duties, other taxes	121	124	125	124	−1
Motor-vehicle tax	46	44	46	45	−1
Tax revenues and contributions of Extrabudgetary Funds	**283**	**288**	**287**	**292**	**5**
Tax revenues and contributions of Social Security Funds	**4 264**	**4 267**	**4 519**	**4 510**	**−9**
Social security contributions	3 983	3 987	4 230	4 216	−14
Other contributions and taxes	281	281	289	294	5
Other revenues	**417**	**255**	**361**	**244**	**−117**
Other revenues of central government	**317**	**149**	**245**	**130**	**−115**
Other revenues of Social Security Funds	**37**	**37**	**36**	**36**	**0**
Other revenues of Extrabudgetary Funds	**62**	**70**	**79**	**77**	**−2**
Interest revenues	**83**	**244**	**74**	**186**	**112**
Total revenues of central government	**12 555**	**12 592**	**12 959**	**12 834**	**−124**

5.2 PRIMARY EXPENDITURES

According to our projection, primary budget expenditures – considering in part consolidated figures – may fall short of the appropriations included in the budget bill by 0.7 per cent of GDP, i.e. HUF 266 billion in total (Table 4). A substantial part of the difference appears at the net expenses of the central budgetary institutions and chapters, and relates to the lower drawdown of EU funds and the smaller own resource requirements than assumed in the bill. In addition, in our forecast we expect the cancellation of the Country Protection Fund, which reduces the central reserves. At the same time, this is slightly offset by the fact that in the case of pensions and pension-type expenditures, as a result of the higher inflation projection, our forecast projects a higher expenditure level than the budget bill, and we also expect higher expenditures under health insurance benefits in kind (drug subsidies, allowances for therapeutic equipment) compared to the estimate.

Our estimate for for the cash balance of net expenditures of central budgetary institutions and chapters falls short of the balance calculated from the bill's appropriations by HUF 194 billion. The difference is attributable to the different projection with regard to the drawdown of EU funds. According to the MNB's forecast, the drawdown of EU funds, appearing in the cash flow, will fall short of the appropriation by HUF 233 billion, while we estimate about HUF 60 billion related to savings on own resources. The difference is primarily attributable to the fact that, as opposed to the government's projection, which calculate with the more or less steady use of the funds available in the 2014-2020 budget cycle, our forecast expects that the utilisation of the funds will be more concentrated at the end of the cycle. Furthermore, according to our estimates the advancing[3] of the last 5 per cent of the grants may be also much lower than that stated in the bill. For this latter item we project an expenditure that is lower by a net amount of HUF 135 billion, the whole of which reduces the gross cash expenditure. Due to the difference in the gross revenues and expenditures belonging to EU funds, our projection with regard to government investment is lower for 2016 than that included in the budget bill and, in line with that, in the convergence programme. In case of the own revenues and expenditures of institutional chapters, we took the statutory appropriations as a basis.

Taken together, it can be stated that our forecast for the net expenditures of budgetary institutions and chapters based on the ESA method is HUF 19 billion lower than the ESA expenditure stated in or deducible from the budget bill. The appropriation contains a public road improvement programme of about HUF 160 billion.

Of the **expenditures related to the state property**, it should be highlighted that the budget appropriates HUF 113 billion for the capital increase of Paks II Atomerőmű Fejlesztési Zrt.

Family allowances and social benefits may remain at the same nominal level next year, since the amount of the various benefits does not change, similarly to the previous years. An exception to this is the maternity pay (GYES): with the introduction of the child-care benefit (GYED) extra, now upon the birth of an additional child or the mother's taking up a job, eligibility for the GYES is no longer lost; accordingly the budget, as well as the MNB's projection project an increasing estimate compared to 2015.

In case of **labour market active and passive expenditure**, there is no significant difference between our forecast and the estimate. Next year, according to our expectations, the budget may spend HUF 335 billion on the Start labour programme – after this year's sum of HUF 267 billion – which is only a slight shortfall compared to the HUF 340 billion included in the appropriation. This is because the budget projects the extension of the Start labour programme compared to 2015, in the amount of about HUF 70 billion. In view of the fact that the number of participants in the public labour programme at the beginning of 2015 was less than expected,

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[3] The EU does not transfer the last 5 per cent of the grants from the EU programmes to the member state until the full audit of the given grants has been performed; meanwhile this amount has to be advanced by the budget of the member state. In 2014-2016, the Hungarian budget had to advance the projects concluding within the EU framework programme of 2007-2013 in the amount of HUF 400 million, for the closing programmes. Hungary receives this amount from the EU later, but meanwhile – according to the ESA budget methodology – it must be stated as a balance-improving imputed revenue among the corrections related to the bridge of the cash and the ESA-based balance.

we assumed in our forecast that next year the Labour Market Fund will not be able to use a small part of the increasing limit (about 3 per cent).

In the case of **medical and preventive care**, we use the appropriation included in the budget bill. The appropriation for 2016 exceeds our forecast for 2015 by HUF 34 billion, which represents an expenditure increase of 3.6 per cent. A major part of this increase is related to new measures. On the one hand, wage payment to healthcare workers may increase by HUF 16 billion in 2016 because 1) the wage increase performed in 2012-2013 in the healthcare sector will be integrated into the basic wage that underlies the calculation of variable pay; and 2) of the wage adjustment of the specialists finishing the intern programme. On the other hand, the reform of the primary healthcare, launched in 2015, continues: in 2015, in phase one, the financing of GP practices increases by HUF 10 billion, and additional resources in the same amount will be injected into primary care in 2016. In addition, the acceptance of the spare capacities in 2016 is expected to generate an increase of HUF 5 billion. Based on the foregoing, the material expenditures of the medical and preventive budget may essentially remain constant in nominal terms in 2016 compared to 2015, which may put pressure on expenditures.

In terms of the operation and financing of healthcare institutions, the gradually recurring supplier debts represent an additional risk: at the end of March 2015 these amounted to HUF 84 billion according to the data provided by the Hungarian State Treasury.[4] In the 2015 budget, HUF 60 billion was appropriated as provisions,outside the budget of the Health Insurance Fund, for the reduction of the outstanding debt; accordingly almost HUF 30 billion will have to be spent on the settlement of the outstanding debts in addition to the appropriated funds. At the same time, in view of the fact that the outstanding debts continued to increase in the recent months as well, additional measures (e.g. structural reforms, transformation of financing) may become necessary.

According to our forecast, within expenditures related to health insurance benefits in kind, the **net balance of the drug budget** and the **reimbursement of the therapeutic equipment** may exceed the estimate included in the budget bill by HUF 16 billion in total. The statutory appropriation for 2016 falls short of the expenditure level expected in 2015 for both items, but this is not supported by new measures. Our forecast calculated for the net expenditure of the drug budget – under a higher revenue and expenditure level than stated in the bill – exceeds the estimate by HUF 11 billion in 2016. In the case of the therapeutic equipment reimbursement, assuming a constant service level and taking into account the impact of the demographic ageing, we project an expenditure level that exceeds the appropriation by HUF 5 billion.

According to our forecast, **pensions and pension-type benefits** may exceed the appropriation by about HUF 20 billion in total. The difference may be primarily attributable to the different inflation forecasts: the budget bill includes a consumer price index of 1.6 per cent, while the MNB's latest March *Inflation Report* uses an inflation rate of 2.6 per cent for 2016. Accordingly, in our forecast of old-age pension expenditure, the disability and rehabilitation benefits exceeds the estimate by HUF 26 billion in total. However, the impact of this is partly offset by the fact that for the early retirement benefits we expect an expenditure level that is lower by HUF 7 billion, due to the different assessment of the effects of the measures. On the whole, our forecast for 2016 and the budget bill only project modest spending growth compared to the expenditures expected in 2015, and thus pension expenses in proportion to GDP may decrease next year as well, similarly to this year. In addition to fact that the indexation is lower than the nominal GDP rate, the decrease in proportion to GDP is attributable to the measures affecting the number of beneficiaries.

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[4] The figure related to the outstanding debt of the healthcare institutions includes the out-patient and in-patient healthcare institutions, the background institutions of the healthcare sector, as well as the universities with clinical centres.

Table 6
Expenditures of the central sub-sector – comparison of the forecasts
(HUF billion)

	2015		2016		
	Statutory target	MNB forecast	Statutory target	MNB forecast	Difference
Primary expenditures	**12 321**	**12 272**	**12 672**	**12 406**	**−266**
Subsidies to economic units, support to the media	**372**	**372**	**374**	**374**	**0**
Consumer price subsidy	**104**	**103**	**104**	**104**	**0**
Housing grants	**129**	**113**	**104**	**107**	**3**
Family benefits, social subsidies	**574**	**568**	**571**	**576**	**5**
Benefits under retirement age	**134**	**133**	**113**	**106**	**−7**
Net expenditures of central goverment agencies and chapters	**4 058**	**4 021**	**4 103**	**3 909**	**−194**
Net own expenditures	3 270	3 239	3 561	3 561	0
Net expenditures related to EU funds	788	782	542	348	−194
Support to local governments	**651**	**651**	**663**	**663**	**0**
Contribution to EU budget	**296**	**296**	**315**	**315**	**0**
Expenditures related to MNB	**0**	**0**	**0**	**0**	**0**
Central reserves	**286**	**286**	**361**	**261**	**−100**
Debt assumption	**0**	**0**	**0**	**0**	**0**
Other expenditures	**320**	**320**	**418**	**418**	**0**
Expenditures of Extrabudgetary Funds	**521**	**531**	**581**	**574**	**−7**
NEF - Passive allowances	50	49	52	50	−1
NEF - Active allowances	270	267	340	335	−5
Other expenditures	201	216	189	188	−1
Expenditures of Social Security Funds	**4 877**	**4 879**	**4 965**	**5 000**	**35**
PIF - Pensions	3 007	2 995	3 042	3 062	20
HIF - Disability and rehabilitation benefits	336	331	323	329	6
HIF - Cash benefits	229	231	249	241	−7
HIF - Medical and preventive care	949	949	982	982	0
HIF - Net expenditures related to drug subsidies	240	251	247	258	11
Other expenditures	116	122	122	127	5
Interest payments	**1 112**	**1 220**	**1 048**	**1 108**	**60**
Total expenditures of central government	**13 433**	**13 492**	**13 720**	**13 514**	**−206**

5.3 INTEREST BALANCE

The difference of HUF 52 billion between our forecast and the estimate of the budget bill with regard to **net cash interest expenditures** stems primarily from interest revenues. In recent years, upon preparing the budget the projection usually underestimated interest revenues, presumably due to prudential reasons. The difference may also be attributable in part to assuming a different output structure of issuance, as the interest revenue realised upon the issuance greatly depends on the precise financing plan, which is not known to us.

The difference between our net cash interest expense projection and the appropriation is partially reduced by the higher interest expenditures estimated by us, which may be primarily attributable to the different forint exchange rate assumptions.

Our **accrual-based net interest expenditures** forecast is HUF 21 billion lower than the value stated in the bill. This difference is smaller compared to the cash expenditures and this stems from the fact that compared to cash accounting, under the ESA method, interest revenues realised upon issuance does not occur in one sum, but rather is spread over time.

6 Key risks of the budget bill

Our forecast differs from the budget bill in several points, as our forecasts with regard to the macroeconomic path, the baseline processes of 2015, and the impacts of the measures may differ from the budget bill's assumptions. We do not regard these as risks, but rather we apply these differences in our own projection. In this sub-section we present the risks regarding our own baseline forecast.

Positive risks:

- In revenues related to state property, the budget projects a revenue of HUF 115 billion in the line **„other sale and utilisation revenues"**. We do not take this revenue into account in our baseline projection, as the manner in which this revenue may be realised is not known. However, the risk impact on the budget balance arising from failure to realise this revenue is partly mitigated by the fact that the bill makes the expenditures of the Investment Fund conditional on the realisation of this revenue. Realisation of the appropriation and/or cancellation of the expenditures of the Investment Fund is a positive risk, amounting to no more than 0.3 per cent of GDP, compared to our estimate.

- Another positive risk may be that due to the introduction of the EKAER, the **VAT revenues** may develop more favourable than in our projection, if that will have a major impact.

- The bill contains HUF 85 billion for the settlement of disputes that may arise upon the financial closing of the EU-funded projects related to the period of 2007-2013. In our forecast, we accept the assumption of MNE, which can be regarded as a conservative estimate.

Negative risks:

- The **recurring debt of healthcare institutions** may increase next year's budget deficit by 0.1-0.2 per cent of GDP as a carry-over effect, unless full debt consolidation takes place this year.

- There is no cap on appropriation for the **expenditures related to the Start labour programme** (public labour expenditures), and thus similarly to previous years, surplus expenditures as high as 0.1 per cent of GDP may occur if there is surplus labour supply.

- In the case of **EU funds**, if the drawdown stipulated in the bill – which is higher than our forecast – materialises, the higher own resource requirement may generate a larger fiscal deficit. The impact of this may be partially offset by the fact that, through its favourable effect on economic growth, tax revenues may also be higher.

7 Legal compliance of the bill

7.1 DEBT RULE OF THE FUNDAMENTAL LAW

According to the budget bill, the gross public debt-to-GDP ratio defined in line with the Stability Act is expected to decrease; accordingly the bill satisfies the debt rule requirement specified in the Fundamental Law. According to MNB's projection and assuming full blocking of the Country Protection Fund, on an accrual basis, the 2016 general government deficit is expected to be around 2.2 per cent of GDP, which – using the exchange rate specified in the bill – may decrease the debt ratio by 1.9 percentage points. The debt reduction expected by the MNB exceeds the dynamics specified in the bill by 1 percentage point. Of that 0.4 percentage point is attributable to the fact that the MNB expects a materially higher GDP at current prices in 2016 than the MNE, an additional 0.4 percentage point is attributable to the impact of the ESA bridge and 0.2 percentage point is explained by the impact of other factors. The difference in the GDP estimates at current prices is attributable to the GDP deflator, as the expected real growth is identical at both institutions (2.5 per cent).

The most determinng element of next year's debt change is the expected net financing need of the public sector. In accordance with the provisions of the Stability Act, we ignore both the exchange rate change and the change in government deposits (Treasury Account); the investment loan related to the expansion of the nuclear plant of Paks is also not part of our projection.

The debt ratio defined in accordance with the Stability Act slightly differs from that calculated under the EDP methodology, which is explained by the statistical approach. However, the change of the debt ratio in 2016 may be similar under both methodologies.

Table 7
Development of public debt
(in HUF billion and as percentage of GDP)

	Budget Bill	MNB	Budget Bill	MNB
	HUF billion		**as a percentage of GDP**	
1. Gross public debt according to the Stability Act at the end of 2015*	24 984	24 984	74.3	74.0
2. ESA deficit of 2016**	704	781	2.0	2.2
3. ESA-bridge	82	−86	0.2	−0.2
4. Other effects	34	−30	0.1	−0.1
5. Expected gross public debt according to the Stability Act in 2016 (1+2+3+4)	25 804	25 650	73.3	72.0
6. The change of the public debt-to-GDP ratio in 2016 (5-1)			−0.9	−1.9

Note: *The MNB and MNE project different nominal GDP in 2015. ** MNB forecast; free reserves are assumed to be cancelled.

7.2 THREE PER CENT DEFICIT RULE OF THE GENERAL GOVERNMENT ACT

Section 13/A (2) c) of the General Government Act stipulates that, on an accrual basis, the general government debt-to-GDP ratio must not exceed 3 per cent. According to our forecast, the general government deficit in 2016 – assuming the blocking of the Country Protection Fund – may be around 2.2 per cent of GDP; accordingly, the planning of the 2016 budget **satisfies** this legal requirement.

7.3 REQUIREMENT PERTAINING TO THE STRUCTURAL BALANCE OF THE GENERAL GOVERNMENT

Section 13/A (2) b) of the General Government Act also stipulates that the balance of the public sector must be planned so that it is in line with the realisation of the medium-term fiscal target. This target level is the 1.7 per cent structural deficit (i.e. net of the cyclical effects of the economy and one-off items) stated in the convergence programme.

The bill does not present the structural deficit estimated for 2016, but in our view with the 2.2 per cent deficit on ESA basis, as forecast by the MNB, **compliance with the rule is questionable.** Compliance would require a massively negative output gap in 2016, but according to the actual and potential GDP forecasts of the MNB this is unlikely.

7.4 DEBT INCREMENT PERMITTED ON THE BASIS OF THE DEBT FORMULA SPECIFIED IN THE STABILITY ACT

The budget bill fails to satisfy the prevailing debt formula of the Stability Act. Through a numeric rule, the Stability Act precisely defines the permitted growth rate of public debt measured in forints. The formula is in effect since this year, and therefore the planning of the 2016 budget must also take into account compliance with this rule.

Section 4 (2) of the Economic Stability Act of Hungary prescribes that the growth of the nominal public debt may not exceed the difference between the inflation expected for the given year and half of the real growth rate. Based on its macroeconomic path, the bill does not comply with this requirement, as the 2 per cent deficit estimated in the bill results in 3.3 per cent growth in the nominal debt, while the debt formula permits a maximum rise of 0.4 per cent.

The MNB has long seen modification of the debt formula as being justified, as in the current situation of the economic cycle it requires excessive fiscal austerity. In addition, conceptual considerations may also justify the change, as the formula would often prescribe a procyclical economic policy and it does not properly manage the impact of other shocks, for example an external shock affecting inflation.

Table 8 Fiscal room for manoeuvre allowed by the current debt formula of the Stability Act *(as a percentage of GDP)*	
	Budget Bill
1. Inflation in 2016 (i)	1.6
2. Real growth rate in 2016 (g)	2.5
3. Index of the debt formula (i-g/2)	0.4
4. Gross public debt at the end of 2015	24 984
5. Allowable debt growth in 2016, in HUF billion (3 * 4)	**87**
6. Allowable debt growth in 2016, as a percentage of GDP	**0.2**

On 20 May, the Government submitted Bill No. T/4884 on the establishment of Hungary's central budget for 2016 to the Parliament, in which it initiates the amendment of the Stability Act with regard to the debt formula. Pursuant to the amendment, the earlier rule would be applicable only when both real GDP growth and inflation planned for the respective year exceed 3 per cent. In all other cases, a decrease of at least 0.1 percentage

point should be achieved in the debt ratio. This means that the new rule would prescribe the decrease of the general government gross debt ratio by 0.1 percentage point for 2016, which is satisfied by the budget bill.[5]

7.5 COMPLIANCE WITH THE CORRECTIVE ARM OF THE STABILITY AND GROWTH PACT

The rules belonging to the corrective arm of the European Union's Stability and Growth Pact contain two relevant fiscal requirements for Hungary with regard to 2016:

- The ESA balance must not exceed 3 per cent of GDP. In accordance with the foregoing, Hungary **complies** with this.

- The debt ratio should decrease at an appropriate rate (on average, annually, adjusted by one-twentieth of the part that exceeds 60 per cent). Based on the debt path included in the bill, Hungary **complies** with this in 2016.

Box 1

Debt rule of the European Union

The debt rule of the European Union applies to Hungary in its current form from 2016 for the first time. This is explained by the fact that in the first three years after the termination of the excessive deficit procedure (EDP), i.e. from 2013 until 2015, Hungary must comply with the temporary rule applicable to the structural balance instead of the public debt rule. Accordingly, we briefly describe the debt rule of the European Union.

The debt rule of the European Union is defined by the Treaty on the Functioning of the European Union and Decree 1467/97/EC of 7 July 1997 of the Council.

Pursuant to the Treaty, the ratio of the public debt to the gross domestic product (GDP) must not exceed 60 per cent. If the general government debt exceeds this reference value, the debt rule of the European Union prescribes that that difference from the reference value must decrease on average by one-twentieth of the previous three years' bench-mark per annum, based on the changes in those previous three years in respect of which data are available. The debt criterion requirement is also satisfied if, according to the Commission's budget forecasts, the difference will decrease at the prescribed rate in the three-year period that covers the two years following the last such year in respect of which data were available. Upon applying the adjustment of the reference value of the debt ratio, the impact of the cycle on the rate of the debt reduction must be taken into consideration.

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[5] The amendement of the act containing the new debt rule was submitted to the Parliament after the closing of our analysis; therefore in this analysis we do not deal in detail with the assessment of the rule.

8 Special topics

8.1 MEASURES RELATED TO PERSONAL INCOME TAX

Starting from 2016, the standard rate of personal income tax (PIT) will decrease from 16 to 15 per cent, while the total family tax allowance for families with two children (including the part that can be applied to contributions) will increase from the present HUF 10,000 per child per month to HUF 12,500. This latter increase will be followed by three additional increases of the same rate, accordingly, in 2019 the allowance available for families with two children will double compared to the present rate. According to our forecast, in 2016 PIT revenue will decrease by a total of HUF 121 billion as a result of these two measures. The extension of the family allowance alone generates a PIT shortfall of HUF 14 billion, while the rate cut will additionally decrease PIT revenue by HUF 111 billion. At the same time, the latter change reduces the extent of the family tax allowance utilisation by HUF 4 billion. Surplus VAT revenue of about HUF 15 billion may be generated as a result of increased consumption attributable to the tax cut. Thus, the net deficit-increasing impact on the 2016 budget may be around HUF 100 billion, i.e. 0.3 per cent of GDP.

The chart below illustrates the distribution impacts of the two measures by the number of children and income. For the purpose of the calculation, we considered PIT on the gross incomes belonging to the consolidated tax base and the family tax and contribution allowances (these categories covered 82 per cent of PIT revenue in 2013). The rate cut reduces the tax liability on the consolidated tax base by 1 percentage point, irrespective of the family and income conditions. The additional family tax allowance for two children alone corresponds to a rate cut of 2 percentage points for the average taxpayer with two children. However, the decreasing tax liability as a result of the rate cut reduces the utilisation of the family allowance. For the families raising at least three children this means that the average such taxpayer will perceive a tax cut of almost half percentage point. The impacts related to the family tax allowance are distributed more or less evenly depending on the gross annual income; therefore in each income quintile the average taxpayer will perceive an average tax cut of almost 1 percentage point.

Chart 2
**Change in the average tax rate on consolidated income**
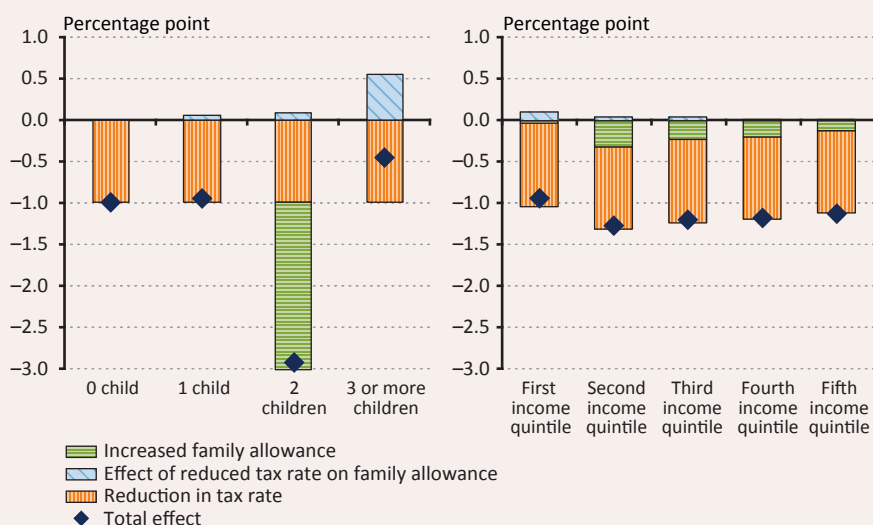
Source: MNB

We assessed the long-term macroeconomic and fiscal consequences of the two changes in the rules using a behaviour micro-simulation model developed at the MNB.[6] According to the model, as a result of the measure the number of employees will increase by 10,000-15,000 in the long run, and GDP will rise by 0.4 per cent. Over time this fiscal stimulus impact will almost halve the increase in the fiscal deficit to GDP generated by the measures in 2016.

8.2 WHITENING EFFECTS IN THE VALUE-ADDED TAX

Value-added tax revenues in 2014 substantially exceeded both the base of 2013 and analysts' expectations. In view of the fact that no other measures directly impacted VAT payment obligations, it is quite likely that the introduction of the online cash registers made a major contribution to this increase. The role of the measure is also reflected by the fact that, similarly to the rate of the implementation of the online cash registers, the revenue increase was also more pronounced in the second half of the year: on cash basis, in the first six months the budget realised 7 per cent higher net VAT revenues than a year ago, whereas in the second six months this figure reached 16 per cent. According to our calculations, the whitening effect of online cash registers in 2014 could be as high as HUF 150 billion.

The key objective of the measure was to curb tax evasion and whiten the economy by providing the tax authority with the opportunity, through the online cash registers, to obtain direct information on taxpayers' behaviour. The related decision of the government was passed in autumn 2012, and the first online cash registers were deployed in September 2013. By the end of the year, 15,000 online cash registers were in operation, and from then their number increased pro rata, exceeding 170,000 by the deadline of 31 August 2014.

Chart 3
**Annual change in VAT revenue and estimated tax base**
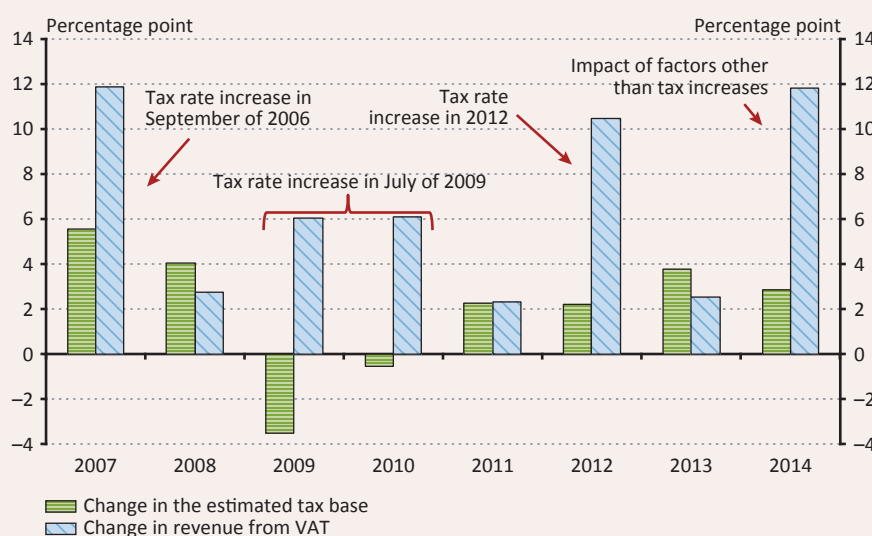
Source: MNB

Last year, VAT revenues (on an accrual basis) increased by HUF 318 billion to HUF 3,011 billion, representing a 12 per cent year-on-year increase. According to our estimate, the tax base related to the value-added tax increased by 3 per cent last year. Previously, there were several examples of differences between the change in the tax base and the tax revenue (see Chart 3), but these were always attributable to a significant increase in the VAT rate: for instance, in 2007, as a result of the carry-over effect of the VAT increase in September 2006, followed by similar developments after the rate increase in July 2009, as in 2012.

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[6] The developers of the model described the method for the first time here: Péter Benczúr–Gábor Kátay–Áron Kiss–Balázs Reizer–Mihály Szoboszlai (2011): Analysis of changes in the tax and transfer system with a behavioural micro-simulation model; MNB Bulletin, October 2011.

As a result of the growth difference between the estimated tax base and VAT revenue, the implicit tax rate (the quotient of the tax revenue and the estimated tax base) increased from 16.1 per cent to 17.5 per cent within one year. The Central Statistical Office (CSO) estimate related to the unregistered economy has been included in the estimated tax base through the consumption and investment data, and thus the increase in the implicit tax rate may suggest the whitening of the economy. However, it should be emphasised that the increase of the ratio may be attributable, apart from whitening, to several other factors (e.g. change in the consumption structure, estimation error, etc.); accordingly, these types of estimates are surrounded by a relatively large uncertainty.

Chart 4
Development of the quotient of VAT revenue and the estimated tax base
*(implicit tax rate)*
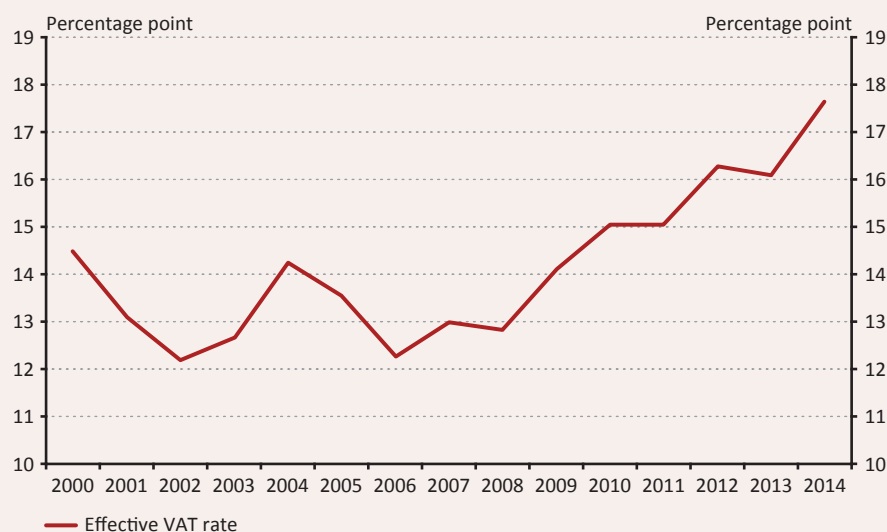
Source: MNB

8.3 MEASURES IMPACTING THE LEVY ON BANKS AND RATE OF THE BANK LEVY IN THE EUROPEAN UNION

In accordance with the agreement between the Hungarian Government and the EBRD, the levy on financial institutions will be reduced substantially in the coming years. According to the plans, in the case of credit institutions, the upper rate of the levy will decrease from the current 0.53 per cent to 0.31 per cent in 2016 and to 0.21 per cent in 2017. Starting from 2019, the levy on banks will be defined in accordance with the prevailing EU norms. An additional change is that the tax base will have to be defined on the basis of the balance sheet total of 2014 rather than that of 2009. Since, according to the bill, the amendment does not tie the decrease of the levy on banks to any condition, the change of the tax base in this way means that the relative tax burden will increase at those banks whose lending activity increased between 2009 and 2014 and will decrease at those who curbed their lending activity. However, this impact is partially offset by the fact that the levy payable by the credit institution must not exceed the amount of the levy payable in 2015. According to our forecast, as a result of the measures, the revenue from the levy on financial organisations will decrease by HUF 62 billion in 2016 and by further HUF 20 billion in 2017, which is primarily attributable to the rate cut, but to a smaller extent the change of the tax base also contributes to this decline.

Following the economic crisis of 2008, apart from Hungary, 13 EU countries introduced surtaxes on the financial sector, which differ from each other in the definition of the taxpayers, the tax base, the tax rate, as well as in

Chart 5
Special levy on financial organisations
(as a per cent of GDP)
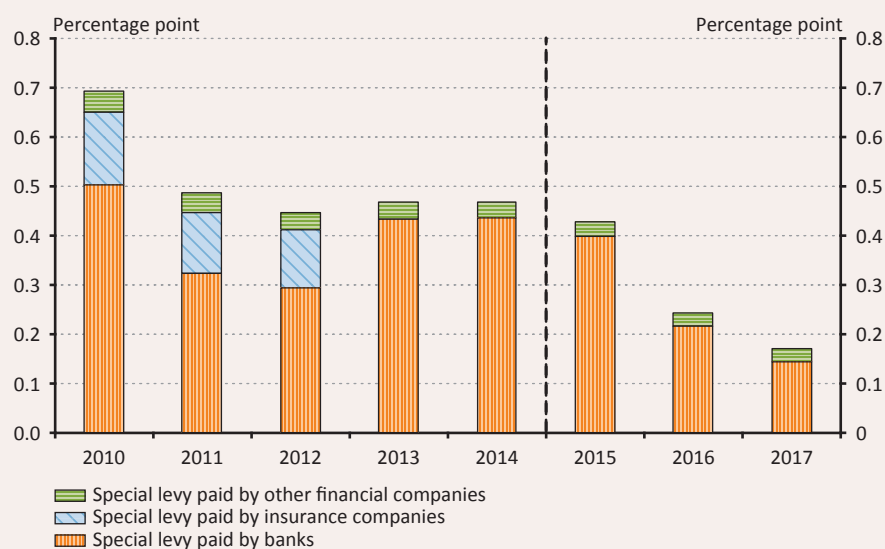
Source: CSO, MNB

the utilisation of the revenues.[7] As a result of the announced measures in the coming years, the levy on banks measured as a per cent of GDP may decrease in Hungary to the level typical in the European Union. The revenue that accounted for about 0.4 per cent of GDP in 2015 may decrease to 0.15 per cent in 2017.

Chart 6
Bank levies in some countries in the European Union in 2012
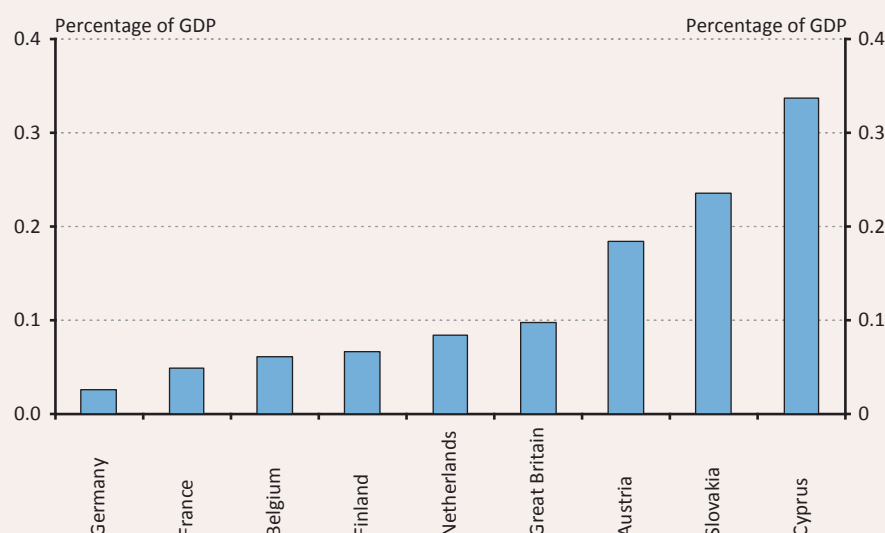
Source: European Commission, OECD

[7] Devereux, M.P., J. Vella, N. Johansen (2013): 'Can taxes tame the banks? Evidence from European bank levies' (No. 25). Oxford University Centre for Business Taxation.

8.4 EU FUNDS AND PUBLIC INVESTMENTS

The drawdown of the funds belonging to the EU budget cycle of 2007-2013 will end almost fully in 2015. The level of the funds passing through to 2016 could be minimal, while according to our forecast the payments related to the new cycle (2014-2020) may reach 2 per cent of GDP next year. The budget bill projects a higher inflow of funds, which is attributable to the different assessment of the run-up of projects related to the new cycle. Based on the forecast of the government, next year already the utilisation rate of the funds will reach the expected average level of the 2014-2020 cycle, subject to 100 per cent drawdown. As a result of the lower drawdown of funds in 2016 which we expect, the own resources related to the utilisation of the EU funds could be smaller compared to the bill, which results in a more favourable deficit.

Chart 7
Development of EU funds in the different programming periods

Source: Budget bill, CSO, MNB

The decline in public investments is the consequence of the temporary decrease in transfers, as a major part of such is implemented from EU funds. According to our assumptions, the high public investment ratio experienced in recent years will fall roughly to 3.6 per cent of GDP in 2016. As a result of the foregoing, the GDP-proportionate ratio of investments implemented from own funds in 2016 will be similar to that of previous years.

In addition to the full amount of the grants, the distribution of the funds related to the new cycle between the public and private sectors is also of the utmost importance. Based on the objectives of the operative programmes, we expect a perceivable decrease in the ratio of public transfers compared to the previous cycle. However, this process may start only in the second half of the cycle; in 2016 this ratio may still be similar to the value experienced in the period of 2007-2013.

The government plans to offset the impact of the decline in EU capital funds by accelerating the larger volume public investment projects. The programme of accelerated investments is concentrated primarily on priority public road projects, which increases the self-financed investment expenditure not related to EU co-financing by about 0.7 per cent of GDP compared to the estimates of 2015. This measure is in line with our assumption used in the March *Inflation Report*, according to which the government, responding to the temporary larger scale decrease in EU funds, increases the investment expenditure at least up to the level of amortisation. In the March *Inflation Report*, we assumed investment-increasing government measures of 0.8 per cent of

GDP; this assumption essentially corresponds to the magnitude of the government's response. The budget bill implicitly contains an ESA expenditure for the government investment expenses of about 4.3 per cent of GDP, while the MNB's updated investment expenditure projection estimates the expected expenditure under ESA at 3.6 per cent of GDP. The difference in the expectations is attributable to the different projection of EU capital funds (and thereby the size of own resources, see Chart 7). The difference is primarily attributable to the fact that – as opposed to the government's plans, which project the more or less steady use of the funds available in the 2014-2020 budget cycle – our forecast expects that the utilisation of the funds will be more concentrated at the end of the cycle.

Chart 8
Government investments and capital transfers paid by EU to government
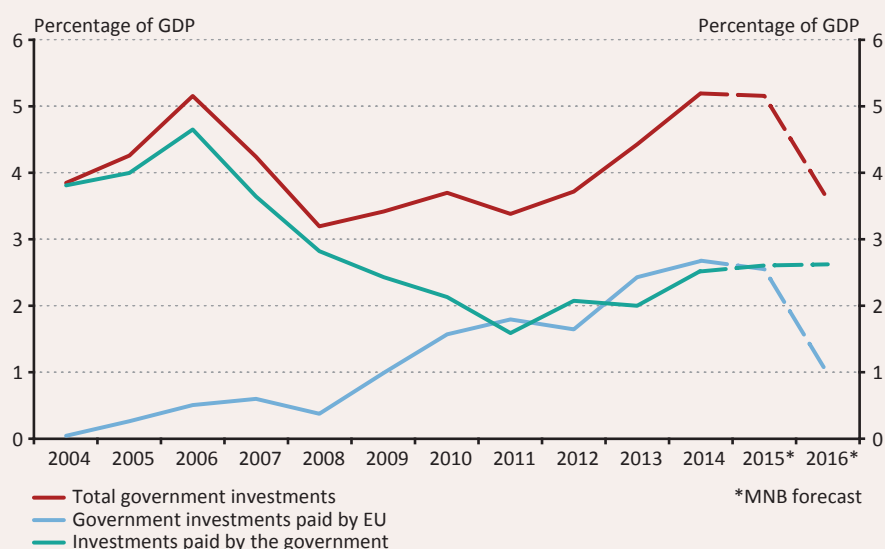

Source: Budget bill, CSO, MNB

8.5 LONG-TERM IMPACT OF FALLING YIELDS ON THE GENERAL GOVERNMENT'S INTEREST EXPENDITURES

The decline in government bond market yields generates substantial savings for the budget. Based on the statistical figures, net interest expenditures on an accrual basis in 2014, as a proportion of GDP, decreased by almost 0.5 per cent compared to the previous year. In addition to GDP growth, this was mostly attributable to the decrease of the nominal interest expenses. According to our forecast, the impact of the low yield environment may appear even more sharply in the next period: between 2014 and 2017 we project an annual decrease of 0.3 percentage point. By 2016, the interest balance of the general government on an accrual basis may decrease to 3 per cent of GDP. If the present low yields remain in place over the long run or, at the worst, they slightly increase, by 2020 the annual interest saving compared to 2012 may exceed 1.5 per cent of GDP.

Global and domestic factors have both had a positive impact on the decrease in yields. Due to fading fears of a global recession, risk appetite improved in international markets, resulting in a decrease in risk spreads. In the Central and Eastern European region, this was reinforced by the improving growth and stability prospects. The domestic monetary and fiscal measures, as well as Hungary's improving macroeconomic prospects, also had a positive impact on perceptions of the country's risk.

Compared to the peak at the beginning of 2012, yields had decreased on average by about 650 basis points by the end of April 2015. The improved risk appetite helped reduce the risk spread of Hungary, which resulted in a substantial decrease in yields for all maturities with the joint support of steadily disciplined domestic fiscal policy, the central bank's easing cycle, and the self-financing programme.

Chart 9
Net interest expenses of the general government on an accrual basis

Percentage of GDP
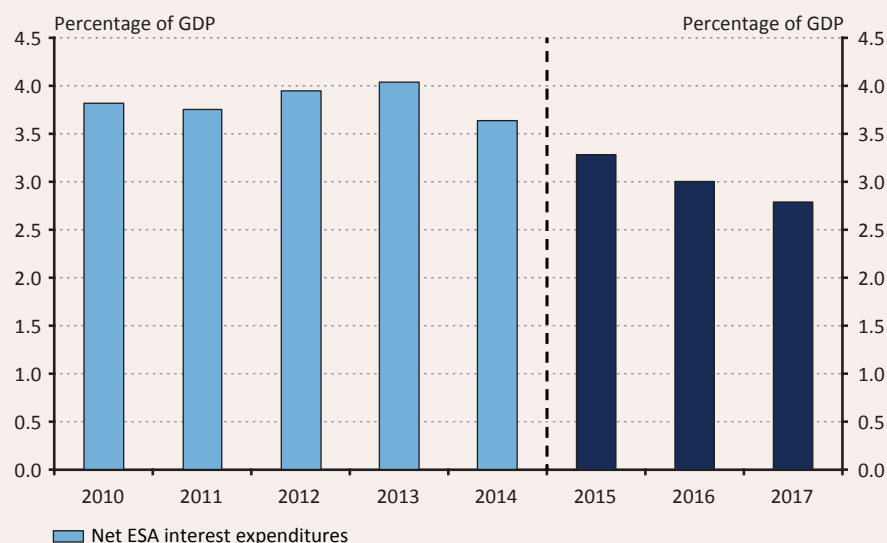
Note: Filtered by the imputed interest expenditures incurred as a result of the pension system reform.
Source: Eurostat, MNB

Chart 10
Development of yields and the base rate
(January 2011 - April 2015)
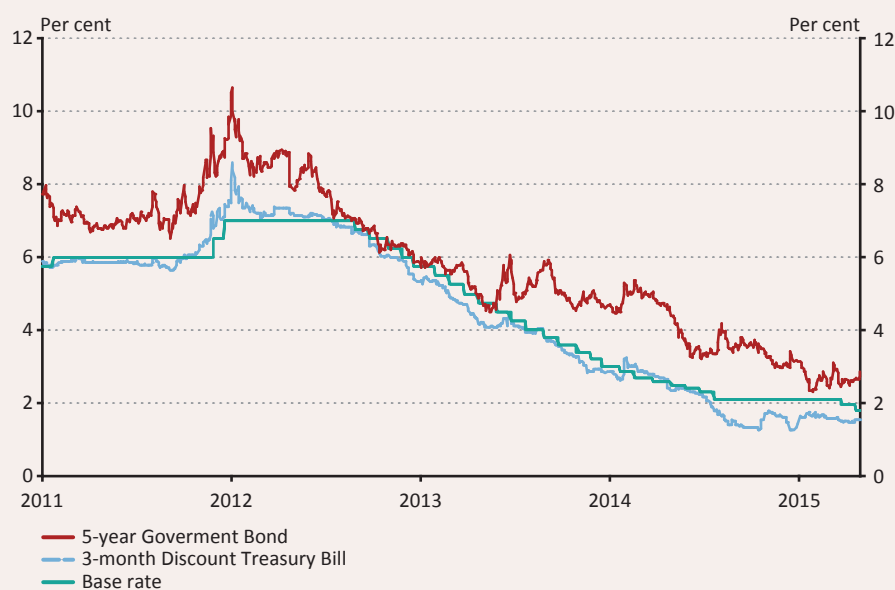
Source: Government Debt Management Agency (ÁKK), MNB

The fall in the government bond market yield reduces the general government's interest expenditures. However, the impact of the decreasing yields appears as a fall in the interest expenditures only with a time lag due to several reasons. The primary reason for the time lag is that the low yields are not repriced immediately. Starting from the present maturity structure, one-third of government securities will be repriced within one year, while

almost 90 per cent of the total debt will be repriced only after 9 years. However, the transactions of the debt management agency may accelerate repricing somewhat. On the other hand, in the case of accrual-based interest expenditures, the impact of the yield decrease appears more slowly due to the special features of the ESA methodology.

8.6 DEVELOPMENT OF THE GOVERNMENT SECTOR'S PERSONNEL EXPENDITURES AND THE HEADCOUNT OF PUBLIC WORK SCHEME

The GDP-proportionate personnel expenditures of the government sector – without public work scheme – dropped to close to 10 per cent from 11 per cent in 2009. The decreasing expenditure relative to GDP, lasting until 2012, was primarily attributable to the general wage freeze. However, as of 2013 the introduced and to be introduced career path models offset this impact and in 2016 they will increase the public sector's wage costs by 1 per cent of GDP. As a result of this, the public wage expenditures to GDP, net of public work scheme, may

Chart 11
Development of the wage costs of the government sector in 2009-2016
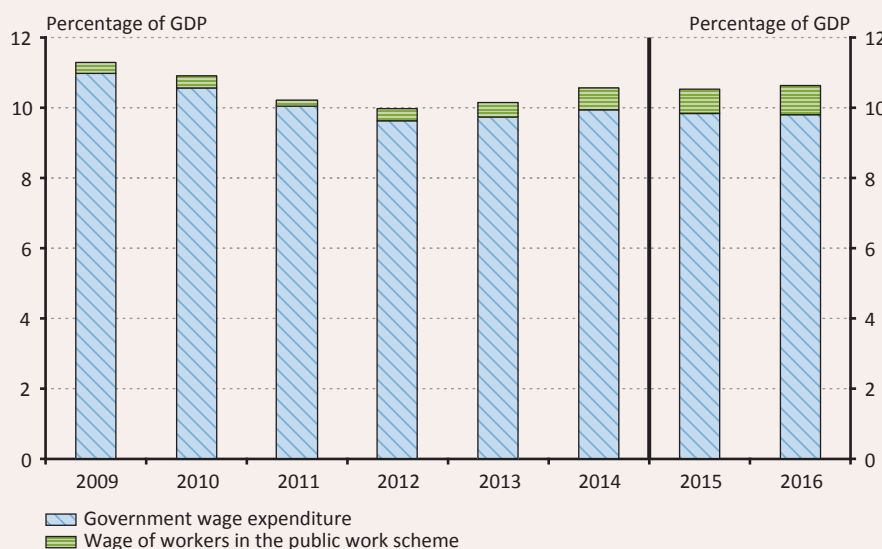
Source: CSO, MNB

still remain around 10 per cent between 2013 and 2016. Starting from 2012 there has been an increasing trend in the public work expenses and by 2016 they may reach 0.8 of GDP, which is a historic high level. According to our expectations, in 2016 the annual average headcount of public work scheme may exceed 250,000 persons, as a result of which the expenses for social benefits may continue to decrease proportional to GDP.

With the expansion of the public work scheme, the government aims to reduce to ratio of social benefits and replace it with labour income. According to the institutional statistics of the CSO, the number of full-time employees participating in the public work scheme increased by about 60 per cent in 2014 (participation in the training programmes was high); in 2015 the annual growth rate may be 15 per cent and in 2016 it may exceed 20 per cent, according to the budget bill. It should be noted that according to the experience in the previous years when the labour demand exceeded the target figures, the government authorised the overrun of the appropriation. We based our forecast on the assumption that the increase of the 2016 appropriation compared to the base year will be spent.

Table 9
Annual average headcount of public work scheme
(thousand persons)

	2013	2014	2015	2016
Full-time	111	180	207	251
Part-time	18	3	3	3
Total	**129**	**183**	**210**	**254**

*MNB forecast for 2015 and 2016

Table 10
Expenditures of the Start public work scheme*
(HUF billion)

	2013	2014	2015	2016
Intermediate and other expenditures	35	28	34	43
Labour cost (according to Hungarian Statistical Office statistics)	136	198	233	293
Total expenditure of the Start public work scheme	**171**	**226**	**266**	**336**

*MNB forecast for 2015 and 2016

9 Appendix

Table 11			
Major measures in the 2016 Budget			
Items	**Description**	**Ministry for National Economy calculations***	**MNB forecast**
Measures affecting budget revenues			
Personal income tax	Flat rate is cut to 15 per cent from 16 per cent and family tax benefit is raised for families with 2 children.	−122	−121
Special tax of financial institutions	Special tax of financial institutions is lowered.	−60	−62
Value-added tax	VAT on pork is reduced to 5 per cent from 27 per cent.	−25	−29
Reform of vocational contribution system	In the framework of the vocational training system reform, corporates will be able to deduct larger expenses from their vocational contribution levy.	−10	−11
Reduction of administrative charges	Some administrative charges will be reduced or cancelled.	−10	−10
Extension of Job Protection Action Plan	From July 2015, up to 100,000 HUF gross monthly earning, 14.5 per cent social contribution benefit may be requested for agricultural employees between age 25 and 55.	−8	−10
Public utility tax	The newly developed communication networks' length may be written down from the tax base for five years after it was put into operation.	n.a.	−2
Delayed corporate tax for growth (DCTG)	Those corporations that managed to increase their earnings before tax six times larger compared to the previous year can pay part of their tax liabilities in arrears.	n.a.	−9
Lengthening of the health care contributions of the tobacco companies	Planned one-off levy of the tobacco producers and traders will remain in 2016.	12	13
Other revenues related to state property	Other revenues from real estate sales and utilisation.	115	0
Measures affecting budget expenditures			
Career model for government officials	The career modell for goverment officials will start from second half of 2016.	23	23
Medical and preventive care	Reform of basic health care - second phase.	10	10
*From the 2016 Budget Bill, Convergence Programme of Hungary 2015-2018, or press releases of the Ministry for National Economy			

Table 12
Development of cash-flow revenues of the central government between 2014 and 2016
(as percentage of the GDP

	2014	2015	2016
	Actual	**MNB forecast**	**MNB forecast**
Tax revenues and contributions of central government	**36.7**	**35.8**	**34.8**
Payments by businesses	**4.1**	**3.8**	**3.5**
Corporate income tax	1.2	1.0	1.1
Special tax of financial institutions	0.5	0.4	0.2
Sector-specific tax	0.0	0.0	0.0
Simplified entrepreneurial tax	0.3	0.2	0.2
Mining royalty	0.2	0.1	0.1
Gambling tax	0.1	0.1	0.1
Income tax of energy companies	0.1	0.1	0.1
Lump sum tax on small enterpreneurs	0.1	0.2	0.2
Small business tax	0.0	0.0	0.0
E-road toll	0.4	0.4	0.4
Utility tax	0.2	0.2	0.1
Other taxes and payments	0.9	1.0	0.9
Consumption taxes	**13.6**	**13.2**	**12.8**
Value-added tax	9.5	9.4	9.2
Excise duties	2.9	2.8	2.7
Registration tax	0.1	0.1	0.1
Telecom tax	0.2	0.2	0.2
Financial transaction levy	0.9	0.7	0.6
Insurance tax	0.1	0.1	0.1
Payments by households	**5.5**	**5.4**	**5.0**
Personal income tax	5.0	4.9	4.6
Duties, other taxes	0.4	0.4	0.3
Motor-vehicle tax	0.1	0.1	0.1
Tax revenues and contributions of Extrabudgetary Funds	**0.9**	**0.9**	**0.8**
Tax revenues and contributions of Social Security Funds	**12.7**	**12.6**	**12.7**
Social security contributions	11.9	11.8	11.8
Other contributions and taxes	0.8	0.8	0.8
Other revenues	**1.5**	**0.8**	**0.7**
Revenues related to state property	0.8	0.2	0.3
Other revenues of central government	0.3	0.2	0.1
Other revenues ofSocial Security Funds	0.1	0.1	0.1
Other revenues ofExtrabudgetary Funds	0.2	0.2	0.2
Interest revenues	**1.0**	**0.7**	**0.5**
Total revenues of central government	**39.2**	**37.3**	**36.0**

Table 13

Development of cash-flow expenditures of the central government between 2014 and 2016

(as a percentage of GDP)

	2014	2015	2016
	Actual	**MNB forecast**	**MNB forecast**
Primary expenditures	**37.6**	**36.3**	**35.1**
Subsidies to economic units, support to the media	**1.1**	**1.1**	**1.1**
Consumer price subsidy	**0.3**	**0.3**	**0.3**
Housing grants	**0.4**	**0.3**	**0.3**
Family benefits, social subsidies	**1.6**	**1.7**	**1.6**
Benefits under retirement age	**0.5**	**0.4**	**0.3**
Net expenditures of central goverment agencies and chapters	**12.0**	**11.9**	**11.0**
Net own expenditures	10.3	9.6	10.0
Net expenditures related to EU funds	1.7	2.3	1.0
Support to local governments	**2.3**	**1.9**	**1.9**
Contribution to EU budget	**0.9**	**0.9**	**0.9**
Expenditures related to MNB	**0.0**	**0.0**	**0.0**
Central reserves	**0.0**	**0.8**	**1.0**
Debt assumption	**0.2**	**0.0**	**0.0**
Expenditures related to state property	**1.3**	**0.6**	**0.9**
Other expenditures	**0.5**	**0.3**	**0.3**
Expenditures of Extrabudgetary Funds	**1.4**	**1.6**	**1.6**
NEF – Passive allowances	0.2	0.1	0.1
NEF – Active allowances	0.7	0.8	0.9
Other expenditures	0.6	0.6	0.5
Expenditures of Social Security Funds	**15.0**	**14.4**	**14.0**
PIF – Pensions	9.1	8.9	8.6
HIF – Disability and rehabilitation benefits	1.1	1.0	0.9
HIF – Cash benefits	0.7	0.7	0.7
HIF – Medical and preventive care	3.0	2.8	2.8
HIF – Net expenditures related to drug subsidies	0.8	0.7	0.7
Other expenditures	0.4	0.4	0.4
Interest payments	**4.2**	**3.6**	**3.1**
Total expenditures of central government	**41.8**	**40.0**	**38.2**

Charles Robert

(1308 – 1342)

King Charles I. was one the most significant rulers of Hungary. He eliminated the anarchy that came about at the end of the Arpadian age, restored the prestige of royal power and its real influence as well as managed to put the economy back on its feet again. King Charles could well be called the new founding father of Hungary, since he could make Hungary a unified and great economic power even in the state of feudal division. A Hungarian king of French ancestry, the descendant of the Capeting dynasty and member of the Anjou family with great influence in Europe, Charles could only take the throne after considerable struggle.

Charles laid royal power onto new foundations and introduced profound reforms. The old and rebellious nobility was replaced by noblemen loyal to him and seized lands were divided up among them, but only as an office fief for the time they held a royal office. The king became even stronger after establishing a new military organisation with the royal banderium, shire banderium and cuman light cavalry.

He pursued a peaceful foreign policy establishing dynastic ties with neighbouring states, which enabled his son to become heir to the Polish crown. At the congress of Visegrád in 1335 (which is also the basis of our current neighbourhood policy) with the Polish and Czech king present, among others decision was made to create a new trade route,

Charles strengthened royal power in terms of finances as well by filling up the treasury. Since Hungary was the primary source of gold and silver in Europe, Charles put mining and trading under close royal control. Charles shared a significant part of royal revenues from mining lease paid for mining precious metals with the owner of the land to facilitate the discovery of new mines. He forbade the export of precious metals; gold and silver had to be given to newly established minting chambers at a price set by the king.

Instead of numerous various currencies, he started minting the silver denarius with a permanent value, then coining golden florins modelled on the golden coins of Florence with the silver farthing becoming its change. Charles abolished the practice of former rulers to inflate money by occasionally reducing the precious metal content of minted coins.

He increased royal revenues by imposing a new tax. Gate tax was levied for each land that had a gate wide enough to let through a cart laden with hay. Customs duty was introduced set at 1/30 of the value of goods exported to or imported from the west or north and 1/20 of southbound goods. Relying on sound economic foundations, in the second part of Charles' reign numerous gothic buildings were constructed, e.g. the royal palace in Visegrád and the Diósgyőr Castle. However, only traces of many of these buildings were left to posterity due to the Turkish devastation.

A Hungarian king with a truly outstanding life, Charles passed away after his 40-year-long reign, and left a strong and rich kingdom to his son. The political ambitions of the Hungarian Anjou dynasty were embodied in Louis the Great, Sigismund and Matthias Corvinus who restored the bygone glory of royal power, but the first stones in this path were laid by Charles I.