PUBLIC FINANCE REPORT

2017
AUGUST

"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 public finance developments in 2016–2017 and the 2018 Budget Act

2017

AUGUST

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To support the fulfilment of its fundamental duties set forth in Act CXXXIX of 2013 on the Magyar Nemzeti Bank, in particular the tasks related to the definition and implementation of monetary policy, the Magyar Nemzeti Bank analyses developments in the budget deficit and debt, monitors the financing of the general government, analyses the impact of financing on monetary developments, capital markets and 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 to the MNB can indirectly support the work of the FC. The MNB prepares background analyses for the tasks of the FC stipulated in the Stability Act and makes such available to the FC. The general public can learn about the most important results of these expert analysis from the publication entitled 'Public Finance Report'.

This analysis was prepared by the staff of the Directorate for Fiscal and Competitiveness Analysis. The publication was approved by Dániel Palotai, Executive Director. The analysis is based on information available for the period ending on 15 July 2017.

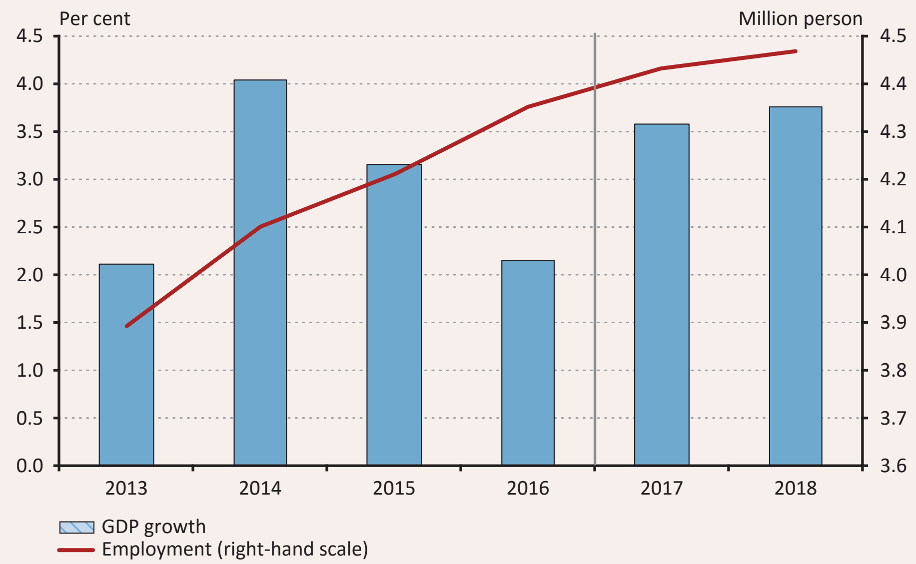
Contents

1 Summary

The purpose of this analysis is to present the developments in public finance in 2016 and the expected budget developments for 2017, on the basis of budget figures available for the first half of 2017 and our forecast prepared for the June Inflation Report. The analysis also intends to provide an overview of the expected realisation of the budget targets approved in June 2017 for 2018. In consideration of these factors, for 2016 we assess actual, and for 2017 and 2018, expected compliance with the national and EU rules related to the balance and debt.

The Hungarian economy is expected to grow at an accelerating rate in 2017-2018, which will also have a favourable impact on the fiscal balance, particularly through the tax revenues generated by the increase in employment and wages. Previously, in 2016, GDP growth slowed down, which is primarily attributable to the fact that the volume of EU funding substantially declined, the demand effect of the fiscal policy materially decreased, and industrial performance also slackened. In the next two years all three factors may point to accelerating growth, but the primary drivers of growth may be the households' consumption and the pick-up in investments. The favourable labour market processes, particularly the employment growth and the dynamic increase in wages, boost household consumption, which is also implied by the rise in consumer confidence and the recovery potential arising from the consumption postponed after the outbreak of the crisis.

Chart 1
Change in GDP and developments in total employment



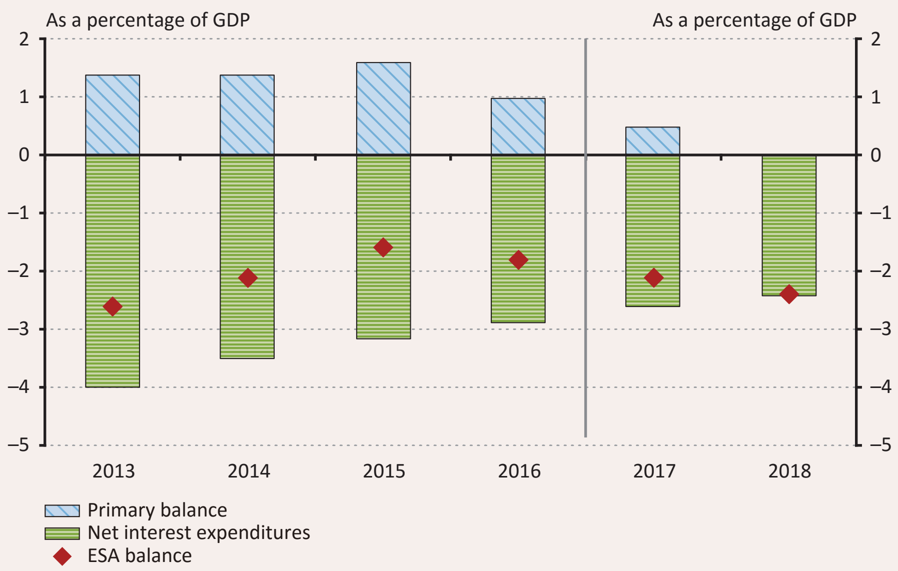
Source: HCSO, MNB.

In addition to consumption, according to the MNB's forecast, the expansion in investments also provides substantial support to growth in 2017-2018. After last year's decline in government investments, we expect a material change to take place, with the pick-up in the absorption of EU transfers playing an important role in it. Private sector investment develops favourably throughout the period under review, supported by the expansion of car manufacturing capacities and the related spillover effects, the dynamically increasing credit supply and the housing market boom, reinforced by state aids. In line with the rise in international business sentiments and the growth in external demand, we expect exports to increase; however, due to the significant import content linked with the dynamically increasing growth and investments, net exports will make a negative contribution to economic growth both this year and next year.

The labour demand generated by the economic activity materialises in the expansion of employment, as well as in the significant increase in wages. In the three years under review, employment and gross average wage will increase on average by 2 and 8.4 per cent, respectively. Wages have increased by 6.2 per cent already in 2016, and following this it receives major support from the significant increase in the minimum wage and guaranteed wage minimum (the first increasing by 15 per cent in 2017 and by 8 per cent in 2018, while the latter by 25 and 12 per cent, respectively). The rising wage costs are partially offset by the decrease in the social contribution tax and corporate income tax from 2017.

The favourable economic environment also contributes to the fact that the budget deficit on ESA basis may steadily be around 2 per cent of GDP in all three years. Last year the ESA deficit was 1.8 per cent of GDP, meaning that the deficit was below 2 per cent in two consecutive years, which was unprecedented in the previous 25 years. In 2017, according to the MNB's forecast, the deficit may be 1.8-2.1 per cent, while in 2018 – as a result of the additional tax cuts and expenditure hikes – the deficit may rise to 2.4 per cent. There is a trend decrease in the primary balance surplus between 2015 and 2018, which reflects the moderate, but gradually strengthening stimulating effect of the fiscal policy.

Chart 2
Fiscal balance and public interest expenditures



Note: The data do not contain the imputed interest expenditures and incomes incurred since 2012 on account of the pension system reform.
Source: Eurostat, MNB.

The decrease in the interest expenses as a percentage of GDP, lasting since 2013, may continue in all three years under review, as in the persistently low yield environment the government debt is repriced gradually; thus, the ratio of the low-interest debt instruments within the government debt increases year by year. In 2016 the interest expense amounting to 2.9 per cent of GDP represented an annual saving in interest expenditure of 1.4 percentage points as a percentage of GDP, compared to 2012.

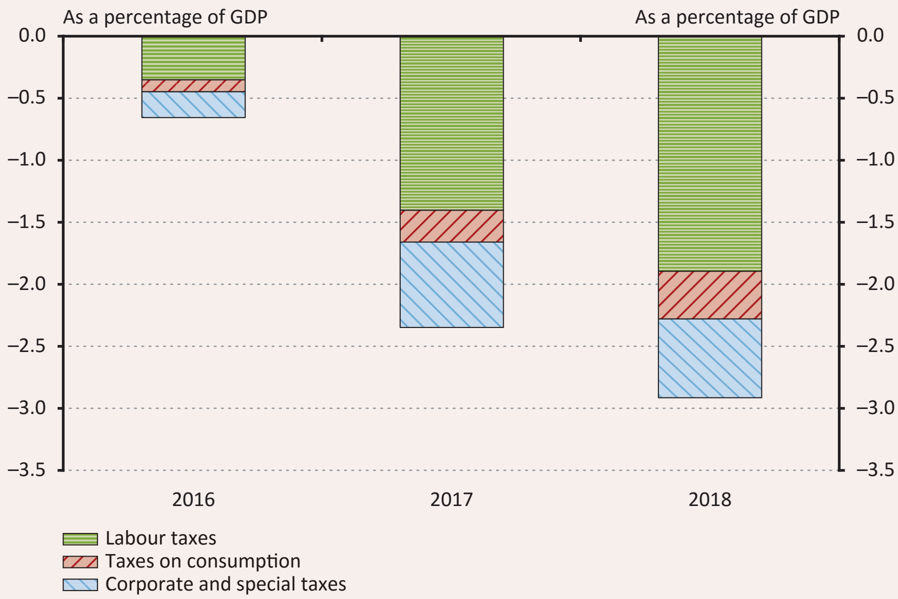
In 2016 the GDP-proportionate ESA deficit of 1.8 per cent was lower by 0.2 percentage points compared to the target deficit included in the originally approved Budget Act. Within that the deficit in the central sub-sector exceeded the plan by 0.3 percentage points, which is attributable to the fact that the growth in expenditures, compared to the appropriation, exceeded that in the revenues.. The growth in the expenditures can be partially linked with the amendment of the budget approved mid-year, and in part with the payments executed in December, but the growth in the public spending on healthcare and in the housing subsidies also pointed in this direction. The growth in revenues in excess of the plan is primarily attributable to the introduction of the Growth Tax Credit, but the surplus from the labour taxes was also substantial, generated by the recovery of the labour market and the rise in total economy wages. The balance of the local government sector became more favourable than the amount stated in the appropriation by 0.5 percentage points, which can be explained primarily by the fall in investment spending.

The amended 2017 Budget Act has set the general government's ESA deficit to 2.4 per cent of GDP, while according to the central bank's latest projection the deficit will be 1.8-2.1 per cent. The difference is mostly attributable to the fact that, contrary to the budget, the central bank's projection calculates with a lower absorption of the EU transfers for this year. In addition, based on last year's experiences, we believe that the balance of the local government sector will be more favourable by 0.2 per cent of GDP compared to the figure included in the Budget Act. On the other hand, according to our estimation, the tax revenues of the central budget will fall short of the amended appropriations, as those presumably assumed a more dynamic growth in investments financed from EU funds and a rise in the effects of the former measures aimed at reducing the shadow economy. As regards the labour taxes, the difference is primarily explained by the minor difference in the projections related to outflow of income. Since the revenues may fall short of the appropriations, while the EU expenditures may be high even under a lower actual absorption (as a result of the advance payments), the central budget may realise a higher than expected cash-based deficit (even though according to our projection, the ESA deficit calculated together with local governments will be lower than the target).

The Budget Act approved in June defined the 2018 ESA deficit in 2.4 per cent of GDP, which, according to our projection, may be feasible with the cancellation of the central free reserves. For the purpose of its projection, the MNB calculates with lower revenues from consumption and labour taxes, as well as from the payments by enterprises, compared to the appropriations, which is due to the different perception of this year's processes (base effect) and the macroeconomic path. On the other hand, we calculate with expenditures that are lower than the aggregated expenditure appropriation. On the one hand, the accrual-based (i.e. effective) absorption of the EU transfers may be lower according to our forecast and on the other hand the pension premium related to economic growth may also be smaller due to the difference in the macroeconomic projections.

The disciplined fiscal policy and the favourable macroeconomic environment permitted the budget to support economic growth by tax easing; thereby, stopping the rise in tax centralisation, experienced in former years. Among the tax changes, the reduction of labour taxes, and particularly the cutting of the personal income tax last year and of the social contribution tax in 2017 and 2018, were of key importance. The personal income tax rate was reduced in 2016 from 16 to 15 per cent, while that of the social contribution tax from 27 to 22 per cent in 2017 and to 20 per cent in 2018. The tax allowance for families with two children is also increasing annually by HUF 2,500 per month; thus, it will rise from HUF 10,000 to HUF 20,000 between 2016 and 2019. The VAT rate is reduced in a targeted manner for certain products (in 2017 the VAT on eggs, milk, poultry, internet service and meals in restaurants will be reduced, while in 2018, in addition to reducing the rate on the latter two, the VAT on fish will be also less), while the tax on excise goods (tobacco, fuel) will increase. The fact that in 2017 the corporate income tax rate was reduced uniformly to 9 per cent and in 2016 the upper rate of the special tax of financial institutions was reduced from 0.53 to 0.24 per cent, and in 2017 to 0.21 per cent, made a major contribution to the reduction of the burdens of enterprises. Although it has no effect on the tax revenues, the sales of state-owned arable land belong to the discretionary decisions on the revenue side, of which in 2016 the budget realised 0.3 per cent of GDP and this year further 0.4 per cent. In 2016 and 2018 tax easing equalled to 0.7 per cent of GDP, while this year it amounts to 1.7 per cent; thus, the joint cumulated, static impact of the tax cutting measures, entering into force in three years, reach 2.9 per cent of GDP.

Chart 3
Cumulated static budget impact of the tax measures implemented between 2016 and 2018

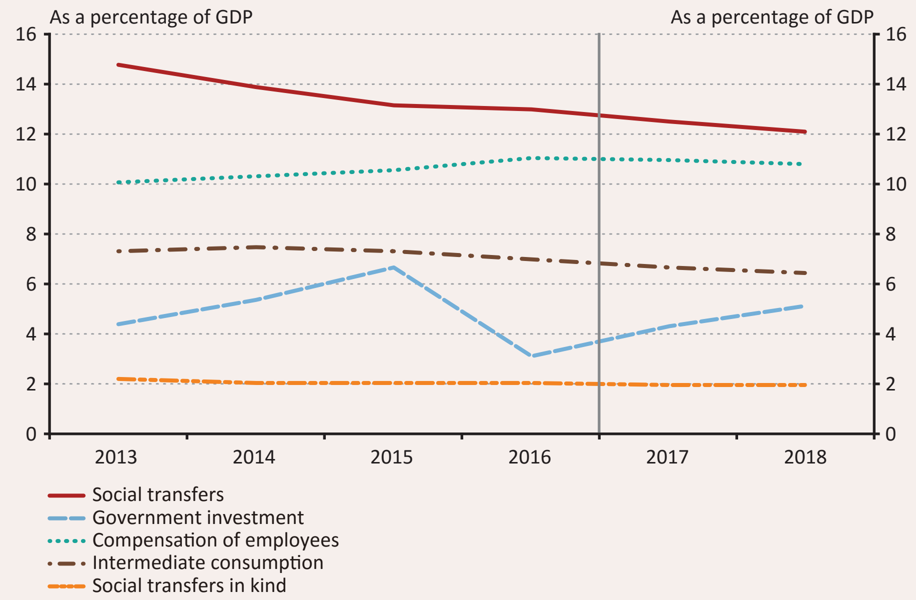


Source: MNB calculation.

On the expenditure side, the largest volatility is shown by investments, which moves closely with the absorption of EU transfers. The absorption of EU transfers peaked in 2015, which contributed to the public investment spending reaching 6.6 per cent of GDP. In 2016, due to the phase out of the financial assistance related to the 2007-2013 EU programming period, the volume of public investment halved compared to the previous year. However, from 2017, as a result of the gradual pick-up in the financial assistance paid within the framework of the new EU budget cycle, public investment activity may substantially increase; thus, the level of government investments may once again exceed 5 per cent of GDP in 2018 (Chart 4).

The GDP-proportionate value of several other expenditures will remain constant or decrease in the period under review. The GDP-proportionate decrease in the cash transfers is determined by the gradual increase in the retirement age, the pension increases indexed to inflation (which is exceeded by the nominal GDP growth) and the fixing of the nominal value of certain transfers. The GDP-proportionate level of personnel expenses will not change materially between 2016 and 2018, which can be explained by the fact that due to the extension of the career path models, the growth rate of all general government wage expenses corresponds to the growth in nominal GDP (Chart 4).

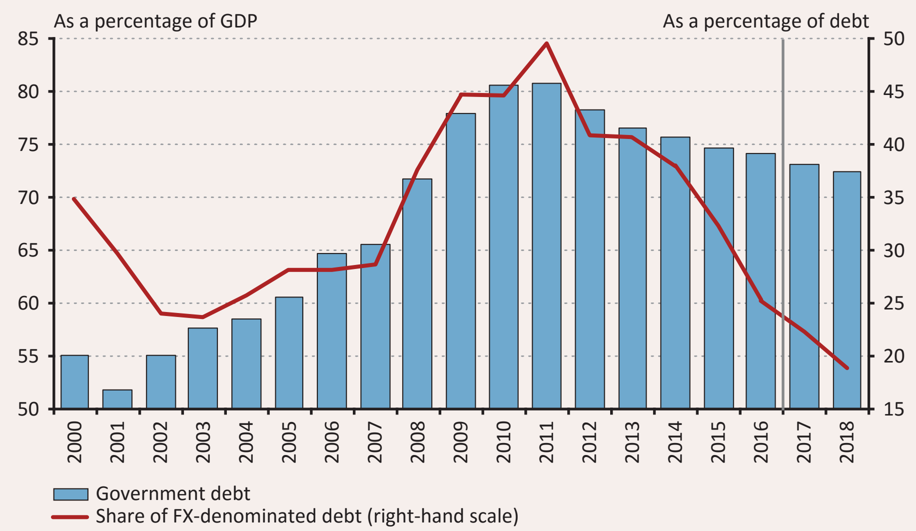
Chart 4
Government sector expenditures as a percentage of GDP



Source: HCSO, MNB.

As a result of the low deficit and the favourable macroeconomic developments, the decrease in GDP-proportionate government debt continues the trend since 2011. By the end-2016, the gross government debt as a per cent of GDP declined to 74.1 per cent from the level of 74.7 per cent of one year ago (the highest year-end value was 80.7 per cent in 2011) and by the end of 2018 it may fall close to 72 per cent. The decrease in the ratio is supported, apart from the dynamic economic growth, by the moderate general government borrowing requirement, in addition to which the substantial surplus of local governments may as well result in a larger decrease compared to the baseline scenario. During last year the volume of foreign currency financing was negligible; thus, the foreign currency ratio of the central debt was close to 25 per cent. The debt management agency still plans to refinance the expiring foreign currency debt from forint funds, as a result of which, according to our projection, the ratio of foreign currency will drop to 19 per cent by end-2018 (Chart 5).

Chart 5
Gross public debt forecast – calculated with an unchanged (end-2016) exchange rate over the forecast horizon



Source: MNB, Government Debt Management Agency, 2017-2018 MNB forecast.

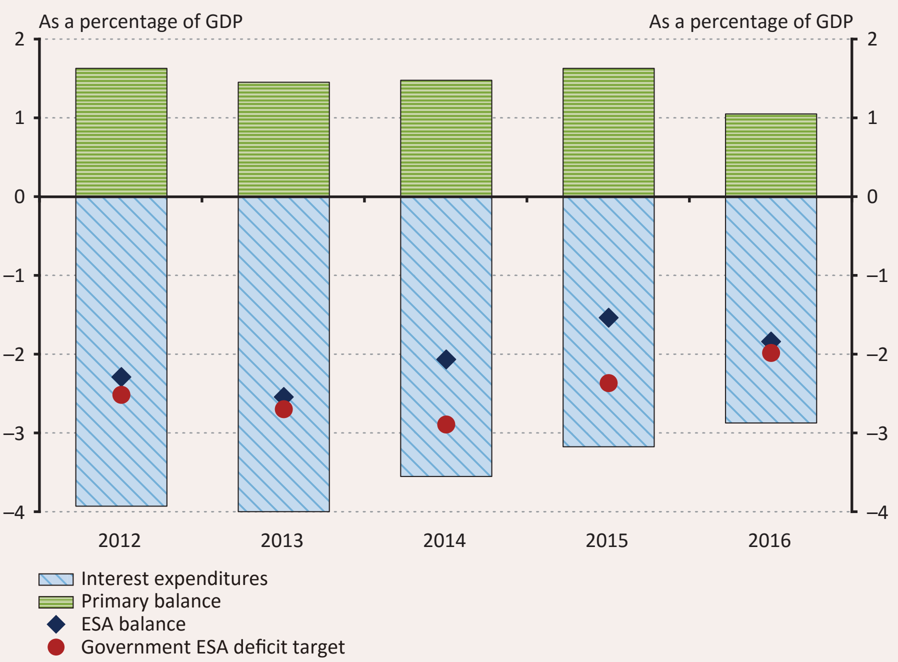
The Hungarian budget complied with the national and EU regulations applicable to the general government ESA balance and the debt ratio in 2016 and it is expected to comply with those in the coming years as well. The Hungarian budget management has to comply with four Hungarian and four EU fiscal rules between 2016 and 2018. According to the MNB's expectations, the Maastricht deficit target of 3 per cent, included both in the Hungarian and the EU rules, will be met every year. The annual decrease in the government debt is also in line with the debt rule of the Fundamental Law, the debt formula of the Stability Act and with the EU Maastricht debt rule. Compliance with the EU's deficit and debt rules is extremely important, as non-compliance may entail the launch of the excessive deficit procedure (EDP). The structural balance of the budget complied with the medium-term budgetary objective (MTO) and with the provisions of the related expenditure rules in 2016, while the 2017 and 2018 balance is unlikely to satisfy these criteria (however, these cannot entail an excessive deficit procedure).

2 Analysis of public finance developments in 2016

2.1 ESA BALANCE OF THE GOVERNMENT SECTOR IN 2016

The general government sector's 2016 ESA deficit, according to the preliminary statistical data, was 1.8 per cent of GDP. The primary surplus reached 1 per cent of GDP, while the net interest expenditures amounted to 2.9 per cent of GDP. On the whole, the trend that characterised the past years continued: the deficit of around 2 per cent developed under a primary surplus and the decrease in interest expenditures; this deficit is substantially lower than before the crisis and it is also below the 3 per cent criterion prescribed by EU budget rules.

Chart 6
Development of the key balance indicators in 2012-2016



Note: The data do not contain the imputed interest expenditures and incomes incurred since 2012 on account of the pension system reform.
Source: HCSO, Budget Acts of 2012-2016.

The 1.8 per cent general government ESA deficit developed under the 2.2 per cent deficit of the central sub-sector and the 0.4 per cent surplus of the local governments. The local government sector's budget management has been characterised by a surplus for several years, which is primarily attributable to the moderate expenditure level. The difference between the cash balance and the ESA balance, i.e. the ESA bridge, developed oppositely in the two sub-sectors, which is attributable to a common reason: namely, to the advance of roughly HUF 160 billion related to the EU transfers, granted by the central budget to the local governments. The advance payment increased the cash-based deficit of the central budget (as expenditure) and improved the surplus of local governments (as revenue). However, the ESA statistics ignore these advance transfers, as the transaction is accounted for only when the objective of the financial assistance (e.g. investment or procurement) effectively materialises. Accordingly, the statistics (ESA bridge) adjusts the cash balance for the advances; thus, it reduces the local governments' revenues by roughly HUF 160 billion. This transaction affects the central budget to the same degree, but in the opposite direction, by reducing the expenditures. The central balance was also affected by several other adjustments, as a result of which the ESA bridge amounted to + HUF 80 billion.

Table 1
Balance indicators in 2016

	Cash-based balance	ESA bridge	ESA balance
		HUF billion	
Central sub–sector	–849	80	–769
Local governments	285	–163	123
Total general government	–564	–83	–647
		percentage of GDP	
Central sub–sector	–2.4	0.2	–2.2
Local governments	0.8	–0.5	0.4
Total general government	–1.6	–0.2	–1.8

Note: Differences may occur due to rounding in the table.
Source: HCSO.

The 2016 ESA deficit fell short of the target set in the Budget Act by 0.2 per cent of GDP. Within that, the balance of the local government sector was t more favourable by 0.5 percentage points than planned, while at the level of the central sub-sector, the deficit exceeded the expectations by 0.3 percentage points. The latter is attributable to two processes of opposite effect, i.e. the substantial surplus both in revenues and expenditures. A good part of the surplus revenue is due to the developments in the corporate income tax in excess of the plan, primarily attributable to the introduction of the Growth Tax Credit. In addition, the recovery of the labour market and the rise in national economy wages, also generated substantial extra revenues. The total expenditure of the central sub-sector exceeded the appropriation to an even larger degree, which can be explained by the payments made partially on the basis of the budget amendment approved during the year and in part on the basis of the December government decrees (e.g. to churches, sports clubs and trans-border organisations). In addition, due to the hospital consolidations and the wage increases in the sector, there was a rise in healthcare financing, and as a result of the family home programme the volume of home construction subsidies also increased. On the other hand, the balance deteriorating effect of these processes was reduced by the fact that the government spent less on the financing of public programmes than planned, and the amount of social transfers paid, as well as the Member State contribution paid to the EU budget, decreased compared to the appropriations.

Table 2
Projections for the 2016 ESA balance of the government sector

	Appropriation	Actual	Difference
		HUF billion	
Central sub-sector	–680	–769	–90
Local governments	–25	123	148
Total general government	–705	–647	58
		percentage of GDP	
Central sub-sector	–1.9	–2.2	–0.3
Local governments	–0.1	0.4	0.4
Total general government	–2.0	–1.8	0.2

Note: Differences may occur due to rounding in the table.
Source: Budget Act of 2016, HCSO.

Box 1

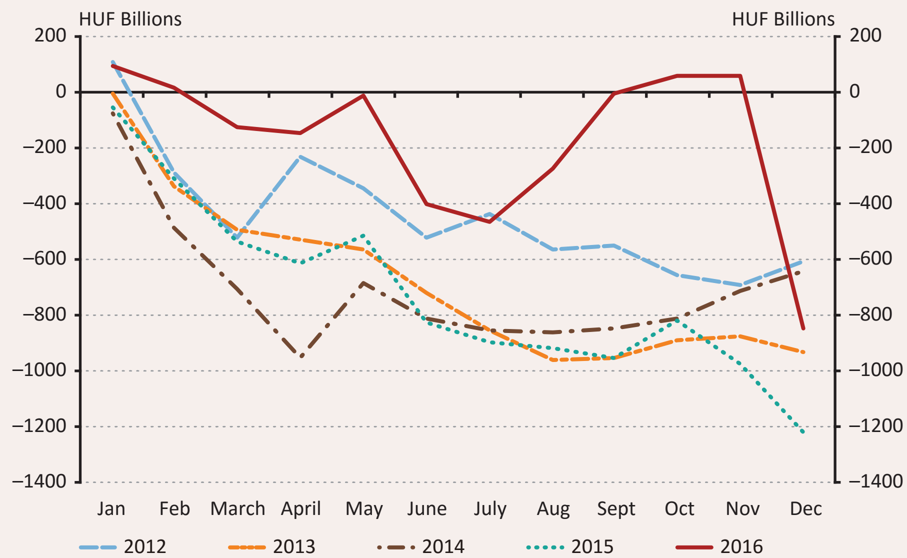
Amendment of the 2016 Budget Act approved in June 2017

In June 2016, the National Assembly amended the budget, in part responding to the underlying macroeconomic processes, and in part to harmonise the document with the measures taken since the approval of the Act. The change did not affect the cash balance of the central sub-sector; however, it raised both the revenue and expenditure appropriation by HUF 493 billion. Within the tax revenues, due to the Growth Tax Credit the corporate income tax appropriation rose by HUF 289 billion, the consumption tax appropriations by HUF 70 billion, while the appropriations for labour taxes and other payments by HUF 134 billion.

In parallel with this, the amendment supplemented education expenditures by HUF 110 billion, and raised the amount of the funds available for government investments by a total amount of HUF 150 billion, for public road improvements (HUF 69 billion), for the expenses related to public assets, and for the Modern Cities Programme (HUF 50 billion). Due to the substantial expansion of the Home Purchase Subsidy (HPS) scheme for families, house construction subsidies increased by HUF 50 billion and the central reserve was also raised by HUF 30 billion upon the amendment of the Budget Act.

While considering 2016 as a whole, the level of the budget deficit corresponded to that of previous year, the intra-year time profile of the balance substantially differed from that experienced in past years. In the past years the cash deficit of the central budget reached or approached the entire year's deficit, developed later, by the end of the first half-year and fluctuated around this level in the second half-year. By contrast, in 2016 the deficit in the first half-year was more moderate, and thereafter there was a surplus for several months; thus, the year-to-date balance between September and November showed a surplus. Finally, the deficit substantially rose in December, mostly due to the government decrees containing surplus expenditures.

Chart 7
Intra-year cumulated cash balance of the central subsector (2012–2016)



Source: Hungarian State Treasury.

It is worth emphasising that in the case of the individual budget items it is natural that the intra-year time profile varies, even when the legislative environment does not change from one year to the other. For example, while on the revenue side the intra-year distribution of taxes, and on the expenditure side that of the pensions and wage expenses is relatively stable, the intra-year time profile of revenues and expenditures relating to state assets, the investments and part of the material expenditures significantly vary between the years. Last year's processes are also mostly explained by the developments in these latter items.

The development of the budget balance in 2016, differing from that of the past years, is primarily attributable to the budget management of budgetary institutions. During the year, substantially lower expenses were incurred, while in the last month, based on the individual government decisions, more than HUF 400 billion was paid out, primarily to churches, sports clubs and trans-border organisations. This trend was strengthened by the soar in EU transfers disbursed in the last months of the year to the private sector and to local governments. All this is also reflected in the ESA balance, where after the surplus of the first three quarters, in the last quarter the general government's deficit compared to the quarterly GDP was 9.5 per cent.

2.2 REALISATION OF THE MACROECONOMIC PROJECTION UNDERLYING THE BUDGET

Based on the preliminary data, last year the Hungarian economy's real growth was 2.2 per cent, which falls short of the projection underlying the 2016 Budget Act by 0.3 per cent. On the whole, there was no major difference in **domestic consumption** compared to the expectations, while the individual components departed significantly from those.

The Budget Bill assumed that by 2016 investments would temporarily lose momentum due to the deceleration in EU funding; nevertheless, based on the recovery of the private sector, it projected a moderate, 0.9 percentage point decrease in the volume of **gross fixed capital formation**. By contrast, last year the whole-economy fixed investment fell by 12.6 per cent compared to its level registered a year ago, which substantially contributed to the difference between GDP growth anticipated in the budget and the actual one. Consequently, government investments shrank by 63 per cent compared to the extremely high base of the previous year, which is primarily attributable to the cyclical nature of developments implemented from EU funds. The financial assistance of the 2007-2013 EU budget cycle essentially could be used until 2015, and a substantial part of the drawdown concentrated on the last year, which led to a historically high community investment activity. By contrast, in 2016 the programmes could already be covered from the funds of the 2014-2020 budget cycle; however, the commencement and the run-up of those programmes required time; thus, in 2016 the volume of transfers absorbed and of the investments considerably declined.

The over-the-plan expansion in **household consumption** originated from the labour market boom and the moderate inflation. The Ministry of National Economy (MNE) anticipated a 3.6 per cent growth in household consumption, but as a result of the tight labour market the actual growth was higher than that, i.e. 4.9 per cent. The Budget Act projected a 2.4 per cent growth in **gross average wage**; however, the average monthly gross wage rose at a materially higher rate, i.e. at 6.1 per cent. The **number of people in employment** rose by 2.6 percentage points, which exceeds the projection of 2.1 per cent included in the convergence programme published in April 2015. The rise in labour demand is also shown by the fact that last year job vacancies rose at an average of 24 per cent.

The budget calculated with a 7.1 and 7.4 per cent growth in imports and exports, respectively, in 2016. However, the actual growth fell short of the government's expectations, as both imports and exports rose by 5.8 per cent.

In case of the **consumer price index,** the Budget Act calculated with an increase of 1.6 per cent, but last year the rise in the price level was lower, only 0.4 per cent. As a result of the world market processes, fuel prices further declined, while the price of the key household energy resources has not changed.

Table 3
Comparison of the macroeconomic projection in the 2016 Budget Act and the actual figures

	Budget Act	Actual
GDP	2.5	2.2 (2.0)
Exports	7.4	5.8
Imports	7.1	5.8 (5.7)
Domestic absorption	1.6	1.8 (1.5)
Gross fixed capital formation	–0.9	–12.6 (–15.5)
Consumption expenditure of households	3.6	4.9
Public consumption	–3.0	0.1
Consumer price index	1.6	0.4
Gross average wage	2.4	6.1

Note: The 2016 actual figures show the values after the expected revision according to the MNB's June Inflation Report. The figures in brackets are the data published by HCSO in its June 2017 data dissemination.

Source: Budget Act of 2016, HCSO, MNB.

2.3 BUDGET REVENUES

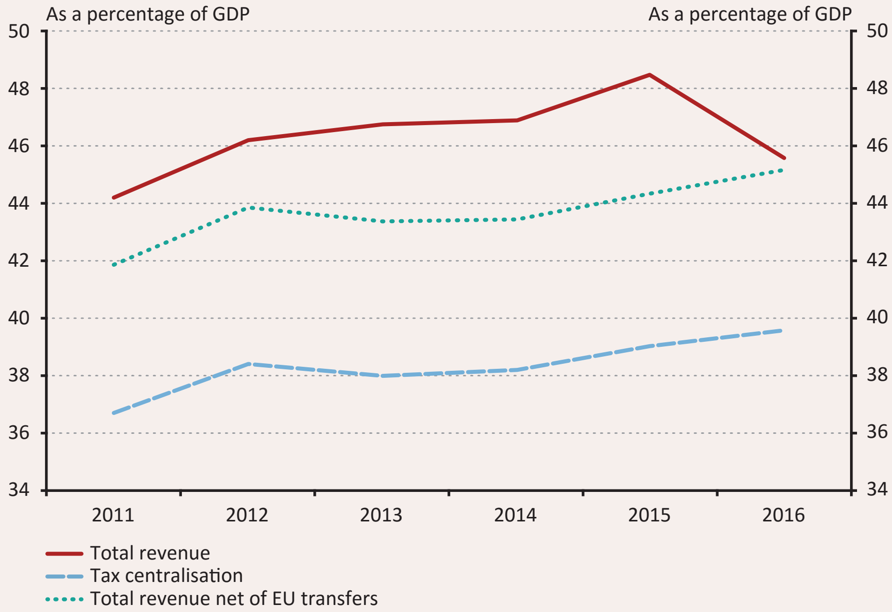
After several years of gradual increase, the revenue side of the general government substantially declined in 2016. According to the HCSO data, GDP-proportionate total revenue decreased by 2.9 percentage points to 45.6 per cent, which is essentially attributable to the decline in EU transfers. Total revenues net of the EU funds rose, in line with the trend of previous years, and last year it reached 45.2 per cent of GDP. Within that, GDP-proportionate tax centralisation rose by 0.6 per cent to 39.6 per cent, which is partly attributable to the tax payments under the Growth Tax Credit, and partly to the fact that the growth in the wage bill and the related labour taxes exceeded the increase in nominal GDP.[1]

The impact of the underlying economic processes may also be traced in the change of the tax revenue structure. Of the labour taxes, the amount of social insurance contributions as a per cent of GDP, and the income and property taxes, including the corporate income tax, (calculated without personal income tax) rose by 0.6 percentage points compared to previous year. In the case of the personal income tax, the decline of 0.1 percentage point is primarily attributable to the decrease in the tax rate and the increase in the tax allowance for families with two children.

After an increase of several years, the GDP-proportionate volume of value added tax received by the budget moderately decreased, which is presumably attributable to the fact that the effect of the measures introduced earlier to combat the shadow economy (introduction of online cash registers, Electronic Trade and Transport Control System) did not increase further. Apart from this, the nominal stagnation of VAT revenues was also contributed to by the decrease in government expenditures financed from EU funds, the impact of the targeted VAT cuts, and – through the base effect – the fact that in the last months of 2015 the budget realised substantial revenues compared to the previous years on the VAT payments related to the absorption of EU transfers.

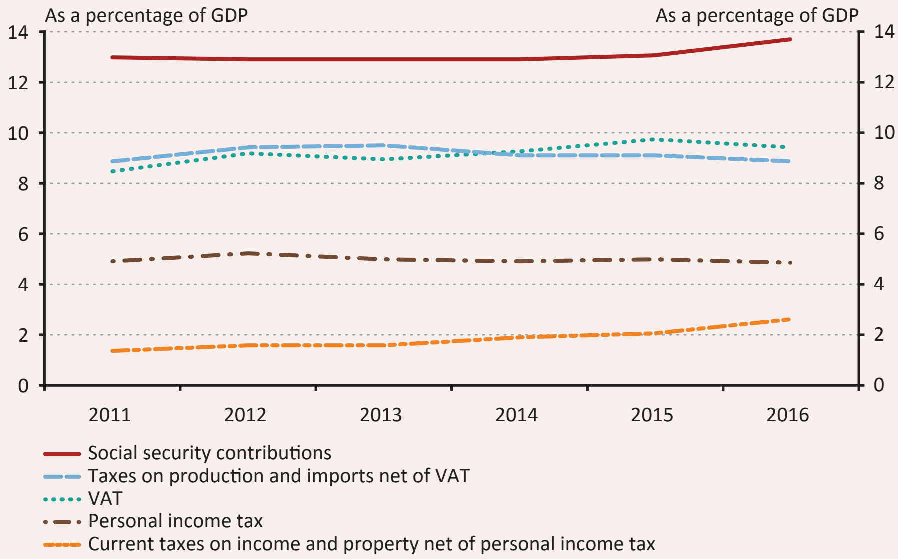
[1] It should be emphasised that these figures are already net of the transfers between the sub-sectors of the budget (this is why it is referred to as consolidated indicators); however, in addition to the EU transfers it applies to the taxes paid by the government as well that they appear on both the revenue and the expenditure side. After eliminating these items, the tax centralisation, and thereby the redistribution rate as well, would be lower.

Chart 8
Total revenue of the general government and tax centralisation



Source: Eurostat.

Chart 9
Development of revenues from different tax types



Source: HCSO, Hungarian State Treasury.

In 2016 the **cash revenues of the central sub-sector** exceeded the appropriation stated in the approved budget by HUF 645 billion, which is primarily the result of the favourable developments in tax and contribution revenues. In addition to the changes in the individual regulations applicable to corporate income tax, this is primarily the result of the growth in the wage bill generated by the higher than expected employment and wage increase. In view of the aforementioned processes, the appropriation was raised by HUF 493 billion in June 2016. Compared to 2015, revenues increased by HUF 573 billion, primarily due to the significant growth in wage-related revenues, corporate income tax and other revenues, while the amount of taxes on consumption did not increase materially compared to the previous year.

Payments by enterprises exceeded the appropriation stated in the Budget Act by HUF 326 billion in total, essentially due to the surplus in corporate income tax, attributable to the introduction of the Growth Tax Credit. The programme permits companies to pay the surplus tax in eight equal instalments to the budget in two years, if their pre-tax profit significantly increases year on year. In 2015 almost 60 companies opted for the Growth Tax Credit in the total amount of HUF 537 billion, of which the budget realised revenues of HUF 269 billion in 2016. The Government transferred the tax surplus to the appropriation during the June amendment of the Budget Act.

Compared to the 2016 statutory appropriation, the budget closed with a substantial surplus on the e-road toll and other taxes and contributions lines. In the latter case, the surplus was mostly generated by penalties and the surplus in the revenues from time-based road tolls and green taxes. Revenue from gambling tax declined by HUF 16 billion, partially because pursuant to the changing rules a larger part of the gambling tax is allocated to the extra-budgetary funds compared to 2015. Other payments by the enterprises fell short of the appropriation by HUF 9 billion.

Compared to 2015, payments by enterprises rose by HUF 96 billion. In the case of the corporate income tax, the increment of HUF 134 billion is primarily related to the Growth Tax Credit. Last year the statutory regulations relating to the special tax of financial institutions changed, reducing the upper rate of the tax for credit institutions from 0.53 per cent to 0.24 per cent. As a result of the measure, the revenue from the special tax dropped by HUF 76 billion. The increase in the number of taxpayers opting for the small taxpayers' itemised lump sum tax (KATA) continued in 2016 as well; the revenues from this tax type rose by HUF 15 billion compared to 2015.

In 2016, the general government realised from **consumption taxes in total** roughly the same amount that is stated in the Budget Act, since the shortfall in the value added tax was offset by the excise tax surplus. Last year, the VAT revenue fell short of the original appropriation by HUF 62 billion, which is presumably attributable to the fact that the volume of investments implemented from EU funds significantly fell short of the anticipated level and this reduced the volume of value added tax paid by the budgetary institutions. The deviation from the amended appropriation is even higher, as during the amendment of the budget the revenue expected on this line was raised by HUF 37 billion. Almost half of the excise tax surplus is attributable to the increase in the taxes paid on tobacco products, which may be due to the fact that the largest part of the base year growth was realised after the adoption of the Budget Act in June 2015. The fact that the permitted number of cigarettes per box was raised from 19 to 20 by the relevant laws from 20 May 2016, which prompted merchants to replenish stocks in the previous month and they adjusted only part of the increment later, also pointed in this direction. In addition, the dynamic growth in the tax paid on fuels and other products also contributed to the excise tax surplus. Based on the aforementioned processes, during the amendment of the Budget Act in June the appropriation raised by HUF 32 billion.

Compared to the previous year, total revenues from consumption taxes rose by HUF 12 billion, which is mostly due to the developments in VAT. Namely, while in nominal terms households' consumption, representing the largest item within the activities constituting the tax base, expanded by more than five per cent, the revenue from this tax type increased only by HUF 5 billion in 2016 compared to the previous year. This is partly due to the fact that in the final months of 2015 the budget realised significant revenues, compared to previous years, from VAT payments related to EU transfers, as invoices related to the transfers from the 2007-2013 programming period could be submitted by year-end. It also contributed to the stagnation of revenues that in 2016 the VAT rate on the construction and sales of new housing, and on pork sales was reduced from 27 to 5 per cent. In addition to these, the growth in VAT revenues was materially curbed by the fact that due to the already mentioned protraction of the investments financed from EU transfers, the value of public investments was halved in 2016 compared to the previous year. The growth in excise tax was generated, in addition to the expansion in fuel turnover and the already mentioned replenishment of tobacco stocks, by the small increase in the tax on tobacco products. The decrease in the financial transaction levy is due to the fact that the regulatory change based on which from 2015 the payment transactions of the accounts held by the Hungarian State Treasury are exempted from the levy, appeared in the monetary flow data with a delay.

In 2016 the revenue from **personal income tax** amounted to HUF 1,718 billion, i.e. it exceeded the original appropriation by roughly HUF 60 billion, which is explained by the dynamically increasing wage bill resulting from the tight labour market. From the beginning of last year, the personal income tax rate decreased from 16 to 15 per cent, the estimated impact of which was HUF 105 billion; in addition, the allowance available for families with two children rose from HUF 10,000 per dependant to HUF 12,500; thus, the original appropriation, despite the labour market boom, contained a lower revenue than the 2015 cash revenue. In line with the favourable underlying processes experienced during the year, the appropriation was revised upwards by HUF 36 billion; however, the annual revenue exceeded even this by more than HUF 20 billion. The personal income tax content of the Erzsébet voucher, granted to pensioners in December, also contributed to the substantial surplus in the revenue amount compared to the appropriation. The cash-based personal income tax revenues in 2016, despite the decrease in the tax rate, rose by 1.7 per cent year on year, due to the vigorous growth in employment and gross wages.

Table 4
Partially consolidated cash revenues of the central sub-sector in 2015 and 2016
(HUF billion)

	2015	2016			
	Actual	Statutory appropriation (original)	Statutory appropriation (amended)	Actual (preliminary)	Difference (Actual – Original appropriation)
TAX AND CONTRIBUTION REVENUES OF THE CENTRAL SUB-SECTOR	**12,612**	**12,514**	**13,007**	**13,102**	**588**
Payments by economic organisations	**1,506**	**1,267**	**1,557**	**1,593**	**326**
Corporate income tax	549	401	690	683	283
Special tax of financial institutions	150	79	79	73	–6
Simplified entrepreneurial tax	89	75	75	81	6
Mining royalty	35	32	32	28	–4
Gambling tax	33	41	41	25	–16
Income tax of energy companies	42	41	41	46	5
Lump sum tax of small entrepreneurs	54	70	70	70	0
Small enterprise tax	11	14	14	14	0
E-road toll	0	0	0	0	0
Utility tax	56	52	52	55	3
Other taxes and payments	487	462	462	518	56
Early retirement social security contribution	6	11	11	13	2
Consumption taxes	**4,598**	**4,612**	**4,681**	**4,610**	**–1**
Value added tax	3,286	3,352	3,389	3,290	–62
Excise duties	998	952	984	1,012	60
Registration tax	21	21	21	24	3
Telecom tax	55	56	56	53	–3
Financial transaction levy	208	201	201	199	–2
Insurance tax	30	30	30	32	2
Payments by households	**1,877**	**1,829**	**1,891**	**1,922**	**94**
Personal income tax	1,689	1,658	1,694	1,718	59
Duties, other taxes	144	125	152	161	36
Motor vehicle tax	44	46	46	44	–2
Tax and contribution revenues of extra-budgetary funds	**288**	**287**	**359**	**369**	**82**
Tax and contribution revenues of social security funds	**4,343**	**4,519**	**4,519**	**4,607**	**88**
Social contribution tax and contributions	4,056	4,230	4,230	4,290	60
Other contributions and taxes	287	289	289	318	28
OTHER REVENUES	**347**	**363**	**363**	**420**	**57**
Other revenues of the central budget	**220**	**247**	**247**	**282**	**35**
Other revenues of social security funds	**43**	**36**	**36**	**47**	**11**
Other revenues of extra-budgetary funds	**84**	**79**	**79**	**91**	**12**
TOTAL REVENUES	**12,958**	**12,877**	**13,370**	**13,522**	**645**

Note: The difference between the revenue totals shown in the table and those indicated in the Budget Act is due to the fact that, based on the data available, we excluded the effect of cash transfers within the central sub-sector, and recognised certain expenditure items in net terms, i.e. reduced by the related direct revenues. The table contains rounded figures.

Last year, **the tax and contribution revenues of the social security and extra-budgetary funds** exceeded the appropriation in the approved Budget Act by HUF 170 billion. A substantial part of the difference, i.e. roughly HUF 147 billion, is explained by the surplus in the social contribution tax and the contributions of the individual insured. From the second half of the year, part of the surplus revenue arising from the substantial growth in the wage bill was due to the National Employment Fund, since pursuant to the amendment of the 2016 Budget Act, from July 2016 the National Employment Fund received 5.2 per cent of the social contribution tax revenues, while in the first half of the year the full amount of the tax revenue was payable to the Health and Pension Insurance funds. Accordingly, the tax and contribution appropriation of the extra-budgetary funds rose by 71 billion mid-year. Other contributions and taxes among the social security funds exceeded the statutory appropriation by almost HUF 28 billion, mostly as a result of the higher than planned revenues from the health contribution, accident tax and public health green tax.

The social contribution tax and the individual insured contribution revenues of the social security and extra-budgetary funds in 2016 – irrespective of the change in the distribution within the funds – rose by 7.4 per cent in total compared to previous year's cash revenue. The growth of more than HUF 300 billion can be linked with the 6.1 per cent and 2.6 per cent rise in gross wages and employment, respectively. Other taxes and contributions exceeded those of 2015 by almost 11 per cent, primarily due to the substantially, higher revenues i.e. HUF 20 billion, from the health contribution.

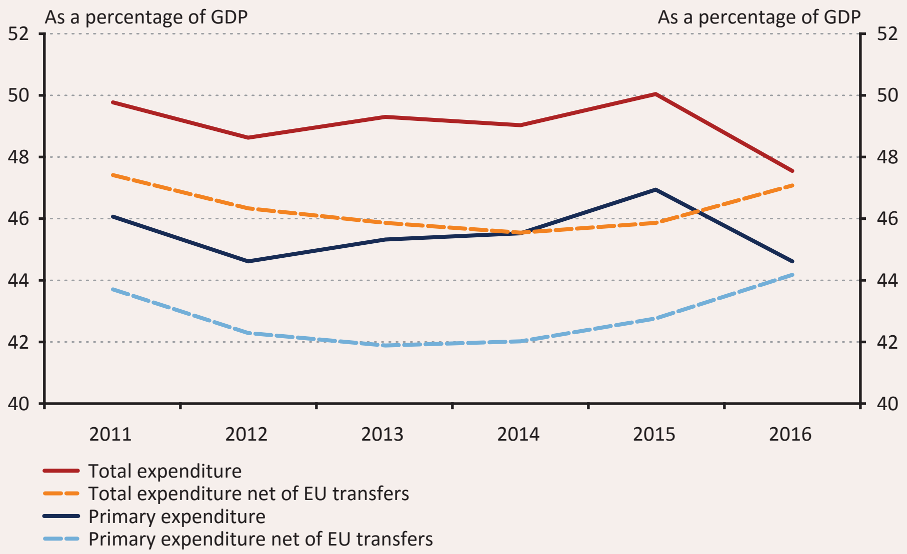
Other revenues of the central sub-sector exceeded the statutory appropriation by HUF 57 billion in total, despite the fact that instead of the planned revenue of HUF 133 billion within the framework of the "Land for Farmers Programme" the general government realised HUF 100 billion from the sales of arable lands in 2016. This was offset by an expenditure item relating to state assets, disbursed in 2015, which was not utilised then; thus, in the beginning of 2016 the unutilised amount of 29 billion was repaid to the account of the central budget. In addition, surplus revenue was realised from the extra payments of the local governments and the extra-budgetary funds, as well as from the sundry revenues. Furthermore, other revenues of the social security funds also exceeded the statutory appropriation by HUF 11 billion in total.

2.4 EXPENDITURES OF THE BUDGET

The development in the expenditure side of the budget carries the duality, which also characterised revenue totals in 2016. Namely, while the general government's GDP-proportionate expenditure decreased by 2.5 percentage points due to the decline in EU funds, the total calculated without the EU transfers rose by 1.2 per cent of GDP. While the decline in interest expenditure as a per cent of GDP, experienced in previous years, continued in 2016, the primary expenditures calculated without the EU funds rose by 1.4 percentage points to 44.2 per cent of GDP.

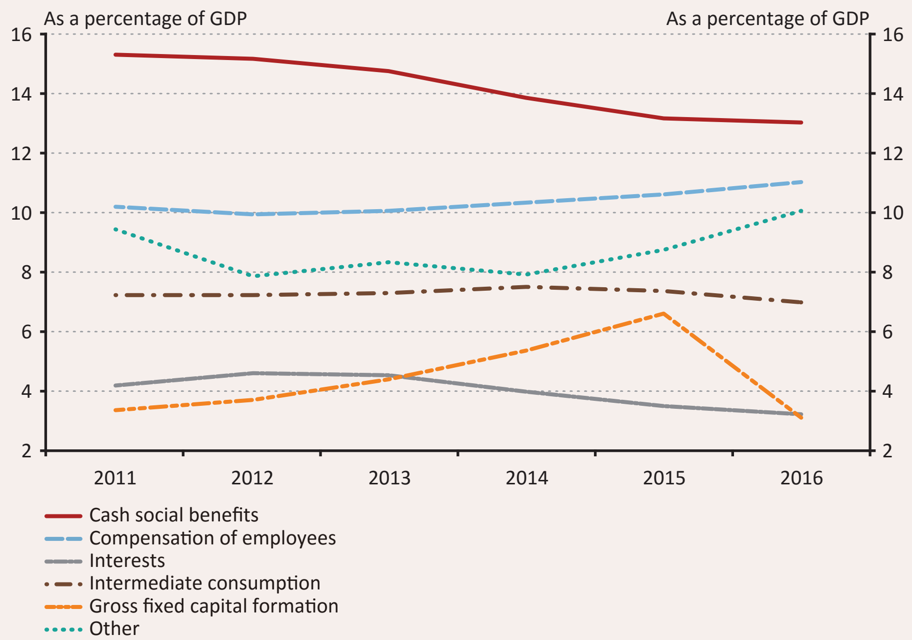
On the expenditure side, the largest change in 2016 was represented by the fact that GDP-proportionate volume of public investments shrank from last year's extremely high level 6.6 per cent to less than half thereof due to the temporarily decrease in absorption of EU transfers. On the other hand, the ratio of other expenditure as a per cent of GDP materially increased, which signals primarily the rise in the current and capital transfers to non-governmental organisations. In parallel with this, in line with the practice of previous years, the GDP-proportionate volume of cash social benefits decreased further, which is attributable, in addition to maintaining the nominal level of certain transfers, to the fall in GDP-proportionate pension expense resulting from the gradual raising of the retirement age and the inflation indexation of pensions. Last year, the employees' payments as a per cent of GDP increased further, due to the extension of the career path programmes, which commenced in 2013. As a result of the low interest environment, interest expenditures continued to decline in 2016.

Chart 10
Total expenditure of the general government and changes in primary expenditure



Source: Eurostat.

Chart 11
Structure of public sector spending



Source: HCSO.

In summary, the **total cash expenditure of the central sub-sector** exceeded the appropriation in the Budget Act by HUF 732 billion. The increment was caused by the higher than planned amount in the EU transfers (although a major part of these were advances paid to local governments; thus, they did not appear in the ESA statistics as expenditure) and by the surplus expenditures of the budgetary institutions and chapters based on the year-end decisions of the government. There was an unplanned mid-year wage increase in the health sector, accompanied by the consolidation of the outstanding debt of hospitals, triggering payments in excess of the appropriation. After the approval of the budget, the expanded Home Purchase Subsidy scheme for families also increased the expenditures. On the other hand, the financing of the public work programme substantially decreased (in line with the tight labour market). As a result of the foregoing, upon the amendment of the Budget Act the government increased the expenditure appropriation of the central sub-sector by HUF 493 billion.

The **special and normative subsidies** were realised in excess of the statutory appropriation by HUF 29 billion, linked with the mid-year takeover of the suburban railways of Budapest.

The expenditures on **home construction subsidies** exceeded the original appropriation by HUF 44 billion, because the major easing of the rules relating to the Home Purchase Subsidy (HPS) scheme for families was announced after the approval of the budget. This also explains the fact that the amount of state aids paid exceeded those of last year by HUF 39 billion and the rise of HUF 7 billion in the amount paid in respect of the building society programmes also raised the expenses. On the other hand, the annual growth in the housing subsidy expenditures of the government was decreased by the fact that due to the conversion of the foreign currency loans into forint no expenditures relating to the exchange rate cap regime were incurred, which back in 2015 represented an expenditure of HUF 10 billion for the budget. The mid-year amendment of the Budget Act in view of the expansion of HPS raised the housing subsidy appropriation from HUF 104 billion to HUF 154 billion, with the actual figure falling short thereof by HUF 6 billion.

The sum of the **family allowance expenditures and the early retirement benefits** was essentially realised in accordance with the appropriation. Compared to the previous year, a decrease of HUF 37 billion can be observed, as in the case of the early retirement benefits there is continuous decrease in the number of beneficiaries as a result of the tightening of the eligibility rules.

The net own expenses of the central budgetary institutions and chapters exceeded the original statutory appropriation by HUF 162 billion. Last year the high volume of EU advance payments was a new phenomenon compared to the previous years, which partially increased the revenues of the institutions and chapters. We estimate the degree of this to HUF 600 billion, within the total revenue of HUF 2,805 billion. However, revenues substantially exceeded the appropriations even without these. During the year the expenditures did not keep pace with the rise in revenues, but at year-end – as published in the 2017 Convergence Programme – a decision was adopted on a surplus expenditure of HUF 432 billion, as a result of which net expenditures (i.e. the difference of expenditures and revenues) exceeded the planned level, but still fell short of the appropriation raised mid-year by HUF 367 billion. The net cash expenditures relating to EU transfers exceeded the appropriation by roughly HUF 582 billion. Within this, gross expenditures were exceeded to a substantial degree, by about HUF 668 billion, and amounted to HUF 2,100 billion, while the revenues and reimbursements received from the EU exceeded the planned level only by HUF 82 billion, and closed at HUF 992 billion. However, it should be noted that about one-third of the revenues were received on the budget line belonging to revenues of the 2007-2013 EU budget cycle, while the revenues from the 2014-2020 cycle fell short of the government's expectation by more than HUF 250 billion.

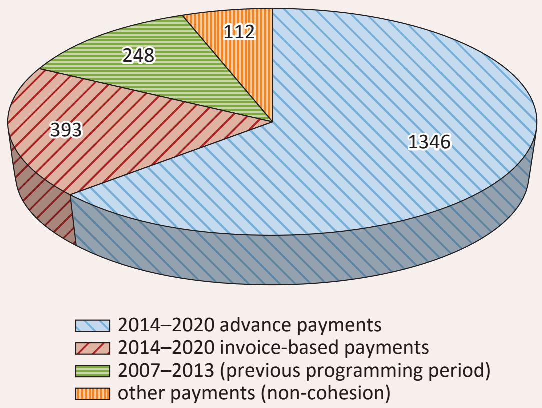
Table 5
Partially consolidated cash expenditures of the central sub-sector in 2015 and 2016
(HUF billion)

	2015	2016			
	Actual	Statutory appropriation (original)	Statutory appropriation (amended)	Actual (preliminary)	Difference (Actual – Original appropriation)
PRIMARY EXPENDITURE ITEMS	**13,222**	**12,664**	**13,157**	**13,401**	**737**
Special and normative subsidies and support to the public media	**375**	**374**	**380**	**404**	**29**
Social policy fare subsidy	**98**	**104**	**104**	**98**	**–6**
Housing grants	**109**	**104**	**154**	**148**	**44**
Family allowances, social benefits	**572**	**571**	**571**	**558**	**–13**
Early retirement benefits	**137**	**113**	**113**	**113**	**0**
Net expenditures of central budgetary institutions and chapters	**5,178**	**4,134**	**4,498**	**4,878**	**744**
Net own expenditures	3,665	3,608	3,975	3,770	162
Net expenditures related to EU funds	1,513	527	523	1,108	582
Support to local governments	**665**	**662**	**674**	**673**	**11**
Contribution to the EU budget	**306**	**315**	**315**	**295**	**–20**
Expenditures related to MNB settlements	**0**	**0**	**0**	**0**	**0**
Central reserves	**0**	**331**	**361**	**0**	**–331**
Debt assumption	**0**	**0**	**0**	**0**	**0**
Other expenditures	**387**	**410**	**440**	**502**	**93**
Expenditures of extra-budgetary funds	**499**	**581**	**581**	**597**	**16**
NEF – Passive allowances	50	52	47	53	2
NEF – Active allowances	254	340	340	269	–71
Other expenditures	195	189	194	274	85
Expenditures of social security funds	**4,896**	**4,965**	**4,965**	**5,135**	**170**
PIF – Pensions	2,988	3,042	3,042	3,055	13
HIF – Disability and rehabilitation benefits	318	323	323	307	–16
HIF – Cash benefits	245	249	249	277	28
HIF – Medical and preventive care	961	982	982	1,090	108
HIF – Net expenditures of the drug budget	261	247	247	278	31
Other expenditures	123	122	122	127	5
NET INTEREST EXPENDITURES	**973**	**974**	**974**	**970**	**–5**
TOTAL EXPENDITURES	**14,195**	**13,639**	**14,131**	**14,371**	**732**

Note: The difference between the expenditure totals shown in the table and those indicated in the Budget Act is due to the fact that, based on the data available, we excluded the effect of cash transfers within the central sub-sector, and recognised certain expenditure items in net terms, i.e. reduced by the related direct revenues. The table contains rounded figures.

The increase in the expenditures is due to the fact that the Government Decree raised the disbursement target of the EU transfers to HUF 2,048 billion, which was HUF 1,463 billion in the Budget Act.[2] The transfers were disbursed in the planned amount by the year-end; however, a substantial part of these were advances. The winners have several years to use the advances and settle accounts in respect of them; accordingly, the paths of the cash payment appearing in the budget and the effective absorption indicating the real economy implementation diverged from 2016. However, since most of the advances paid in 2016 were received by the general government (central budgetary institutions or local governments), the impact of the advance payments on the cash balance was negligible. Compared to 2015 the net cash expenditures relating to EU transfers declined by HUF 400 billion, as a consequence of the high base effect caused by the year closing the 2007-2013 cycle.

Chart 12
Structure of the EU expenditures of the professional chapter-managed appropriations in 2016
(in HUF billion)



Source: Hungarian State Treasury, Prime Minister's Office, MNB.

In 2016 the **support to local governments** exceeded the statutory appropriation by HUF 11 billion, but considering the wage compensation planned within the reserves, as well as the indicative targets belonging to the career path models, on the whole a saving was realised in the amount of HUF 7 billion. Compared to the previous year, support to local governments increased by HUF 6 billion. The decrease in the volume of local government tasks, for example the continued reallocation of the public education institutions, is one explanation for the low growth dynamics.

A saving of HUF 20 billion was realised on the **contribution to the EU budget** expenditure appropriation. This is mostly the result of the European Union's budget management in the 2015 budget year, as the saving realised on expenditure proportionately decreases the Member States' contribution obligation.

The National Assembly raised the original appropriation for **central reserves** by HUF 30 billion as part of the amendment of the Budget Act; thus, the total amount of the reserves was HUF 361 billion (without the chapter general reserves). In view of the favourable fiscal processes, the financial allocation of HUF 80 billion relating to the Country Protection Fund was spent in compliance with the statutory conditions. The total appropriation for the provisions and extraordinary government measures reserve was HUF 281 billion, which was exceeded by HUF 8 billion (at the provisions for the wage compensation and the industry career path models).[3]

[2] Government Decree 1214/2016 (IV.29) on the Development Policy Work Plan of 2016

[3] In the fiscal statistics, the spending of the reserves is reflected not in the reserve lines, but rather on the appropriations for which the expenditure was used (most of it is used on the budgetary institution and chapter items).

Other expenditures of the central budget reached HUF 502 billion in 2016, exceeding the original statutory appropriation of HUF 410 billion, as well as the amended appropriation, raised mid-year by HUF 31 billion. The exceeding of the appropriation is primarily attributable to the surplus in the expenditures related to the management of state assets, as well as to the implementation of the special government decrees passed at year-end. In addition, the difference can be attributed to the combined result of three factors: the expenditures relating to the surety bond claims fell short of the appropriation by HUF 15 billion, other debt management costs exceeded the appropriation by HUF 14 billion, while a total of HUF 23 billion surplus expenditure was generated at the other sundry expenditure items. Other expenditures exceeded the realisation in 2015 by almost HUF 120 billion; of the difference about HUF 90 billion was realised at the expenditure appropriation related to state assets.

The **expenditures of extra-budgetary funds** exceeded the original appropriation by HUF 16 billion. The passive allowances (e.g. employment and support allowance) developed in line with the statutory appropriation, while a saving of HUF 71 billion was realised under the active allowances. This is attributable to the fact that the number of participants in the public employment programme did not increase as a result of the tightness of the labour market. Other expenditures of the extra-budgetary funds exceeded the statutory appropriation by HUF 85 billion; within this the surplus expenditures of the Bethlen Gábor Fund, based on government decisions, should be highlighted, which exceeded HUF 50 billion in total, as well as the surplus payment of almost HUF 20 billion by the National Research, Development and Innovation Fund.

Last year the expenditures of the extra-budgetary funds rose by almost HUF 100 billion compared to the base year; within that the active and passive allowances relating to the labour market increased by roughly HUF 20 billion, while other expenditures rose substantially, by HUF 80 billion, half-and-half due to the increase in the expenditures of the Bethlen Gábor Fund and the National Research, Development and Innovation Fund.

In 2016 the expenditures of the **social security funds** exceeded the statutory appropriation by HUF 170 billion, a substantial part of which, HUF 151 billion, was generated on the Health Insurance Fund's items. The largest excess was realised in respect of the medical and preventive care: disbursement exceeded the original appropriation by HUF 108 billion. Half of this can be attributed to the cover of the wage increases in the healthcare sector, entering into force from September 2016 and the other half to the direct support reallocated from the special reserves to the healthcare institutions under the title of hospital consolidation. The net expenditures of the drug budget included a surplus expenditure of further HUF 31 billion. The cash benefits also exceeded the expectations, of which a surplus of HUF 12 billion was realised on sickness benefits and HUF 13 billion on the child-care benefit line. All these were somewhat offset by the underperformance of the disability and rehabilitation benefits, resulting in a saving of HUF 16 billion for health insurance. Pension benefits exceeded the planned level minimally, by HUF 13 billion, where the HUF 23 billion surplus expenditure in old-age pensions was partially offset by the realisation of the dependants' benefits below expectations.

Thus, in 2016 the expenditure side of the social security funds closed with HUF 5,135 billion, which exceeds the previous year's actual data by HUF 240 billion. The largest increase in expenditures was realised on pensions and the medical and preventive care. As regards the first item, the disbursements by the budget exceeded those of last year by HUF 67 billion, representing an increment of 2.2 per cent. In relation to the medical and preventive care expenditures increased by 13 per cent, which substantially exceeds the dynamics observed in previous years. The expense level of cash benefits rose by HUF 32 billion between 2015 and 2016, where the increment in the child-care benefit was the largest one, i.e. HUF 16 billion. However, expenditures in respect of disability and rehabilitation benefits fell by HUF 11 billion, which is in line with the declining expenditure level observed in recent years.

The net cash **interest expenditures** roughly corresponded to the value stated in the appropriation; however, the gross interest expenditures and interest revenues both exceeded the target amount. This is due to the fact that the debt management agency issues and redeems government securities at market price which exceeds the face value, under constant coupon and decreasing yield environment. In such case the issuance increases the interest income, the redemption increases the interest expenses, while the swap auction increases both. The material decrease in yields in 2016 pointed to the decrease in interest expenditures, which – in the favourable liquidity situation – could be offset by the redemption raised with a view to supporting the reduction of government debt. In 2016 the nominal level of the net cash interest expenditures has not changed materially compared to the previous year (which represents a GDP-proportionate decrease of 0.1 percentage point).

2.5 BUDGET MANAGEMENT OF LOCAL GOVERNMENTS

The cash balance of local governments closed with a surplus of HUF 285 billion, instead of the originally budgeted deficit of HUF 25 billion. Almost half of the difference is attributable to the fact that a substantial part of the EU transfers appeared (as advance) in the revenues of the local government sector, which has not been spent and hence it improved the cash balance. In view of these statistical adjustments, the preliminary balance on an accruals basis shows a surplus of HUF 123 billion, thus the underlying processes also materially departed from the expectations. This is partly due to the favourable development in revenues, and partly to the decrease in investment spending, which is presumably attributable to the fact that the closing of the previous EU budget cycle in 2015 temporarily exhausted the investment capacities and intentions.

The revenues of the sub-sector – without the funds from the EU transfers – increased by one percentage point in nominal terms compared to the previous year. Within that, there was a dynamic increase in the revenues from local taxes, while the revenues of institutions owned by the local governments and their weight within total revenues decreased. Total expenditure decreased by more than 21 per cent compared to 2015, which is primarily attributable to the major decline in investment and other capital expenditures. The EU funds used for investment purposes declined to a fraction of the absorption in 2015; thus, in 2016 substantial saving was generated on the co-financing as well. In addition, material expenses and other current subsidies also decreased and this effect was only partially offset by the moderate increase in personnel benefits.

2.6 STATISTICAL CORRECTIONS (ESA BRIDGE)

Reconciliation between the cash balance of the revenues and expenditures indicated above (GFS balance) and the ESA balance calculated in accordance with the EU methodology is ensured by supplementary statistical corrections (ESA bridge) applied to the cash accounting. The statistical corrections are necessary because some of the transactions are recorded, based on the EU accounting method, at the time of the execution (accrual accounting), contrary to the rules of Hungarian budget accounting practice, where they are recorded upon cash movement (cash accounting). Moreover, the EU regulations interpret the general government (government sector) more broadly than the Hungarian regulation, as they also allocate certain non-profit institutions, state-owned companies and certain monetary transactions to the government sector. Accordingly, the HCSO calculates the ESA balance obtained with the use of the EU methodology for the government sector; thus, this deficit ratio differs from the cash (GFS) balance also in terms of sectors.

When the 2016 Budget Bill was approved, the budget bill determined the balance of the accrual-based statistical corrections (ESA bridge) as 0.2 percentage points of GDP (HUF 82 billion), i.e. it contained an ESA balance being more favourable by this amount compared to the cash deficit. The actual figure, based on the preliminary data of the April 2017 EDP report, became – HUF 83 billion, i.e. –0.2 per cent of GDP. The difference is attributable to the partially opposite effect of several factors.

The largest difference is linked with the settlement of the EU transfers, which instead of the planned accrual-based adjustment of positive effect became substantially negative. The change is due to the different than expected development in the cash settlement of EU funds. The budget bill relied on the assumption that the drawdown of the EU transfers in 2015 is also settled financially in the same year. However, a substantial volume of receivables from the European Union was accumulated by the end of 2015; thus, the shift of the reimbursement of the EU funds to 2016 alone modified, that is worsened, the balance of the statistical corrections by HUF 339 billion (the budget realised HUF 339 billion such cash revenues in 2016 that in the accrual-based accounting belong to the previous year's settlement).

The accrual-based balance of the companies allocated to the government sector represented a change of the opposite direction; in this category, an almost tenfold balance improvement was realised instead of the planned HUF 15 billion. The accrual-based correction of the indirect taxes (VAT) and contribution was also much more favourable than planned; these two factors together increased the ESA bridge by roughly HUF 60 billion. The negative statistical correction in the April GDP report, amounting to 0.2 per cent of GDP, is the aggregate result of the more important differences listed above.

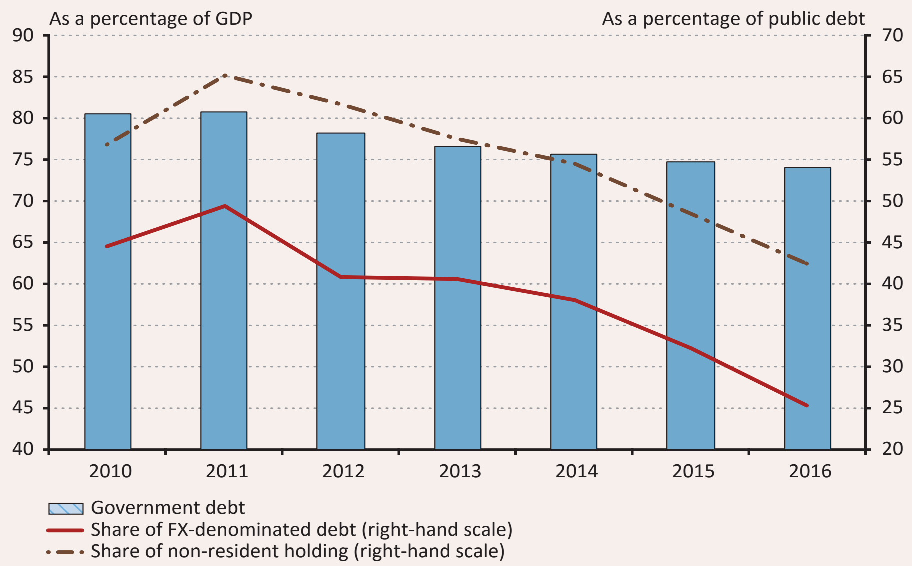
2.7 PUBLIC DEBT

According to the MNB's financial account data, last year the gross public debt as a per cent of GDP fell by 0.6 percentage points to 74.1 per cent. As with the previous years, the decline in the debt ratio was supported both by economic growth and low government deficit. One of the most important factors that influences the trend development in the gross debt ratio is the general government's net borrowing requirement, which last year amounted to 1.8 per cent of GDP (although the cash-based deficit became higher).

No factors aside from the baseline processes had any material impact on the value of the ratio. Due to the material decline in the foreign currency ratio and the smaller change in the HUF/EUR and USD/EUR exchange rates, last year the revaluation of the foreign currency debt had no material effect on the debt ratio, contrary to the previous years. On the whole, in 2016 the revaluations reduced the value of the debt ratio by 0.2 percentage points of GDP. In addition, last year EU transfers were disbursed in a substantial volume; however, a large part of these remained within the general government, hence its debt increasing effect was negligible.

The trend decline in the foreign currency ratio and in the proportion of foreign ownership within the GDP-proportionate debt observed since 2011 continued last year (Chart 13). The key driver of the structural change in government debt in the recent years was the growing demand for government securities by households and the domestic banking system. As a result, the proportion of the non-residents' holding within government debt decreased substantially, dropping from 65 per cent at the end of 2011 to 42 per cent by the end of 2016. In the meantime, the foreign currency ratio within central debt dropped to 25 percentage points, reaching one half of the 50-percentage point peak. During last year the decrease in the foreign currency ratio and the ratio of the non-residents' holding was contributed to by the fact that on 6 April 2016 Hungary repaid to the European Commission the last instalment of the roughly EUR 14.3 billion loan, drawn down within the framework of the 2008 IMF-EU loan agreement, in the amount of EUR 1.5 billion. The decrease in the ratio of non-residents' holding and foreign currency has a material role in the ongoing decline in external vulnerability and in the improvement of Hungary's credit rating.

Chart 13
Hungary's gross public debt relative to GDP since 2010



Source: MNB.

3 Expected general government developments in 2017

3.1 EXPECTED ESA BALANCE OF THE GOVERNMENT SECTOR IN 2017

According to our projection, in 2017 the accrual-based deficit of the government sector (ESA deficit) may be around 1.8-2.1 per cent of GDP, depending on the utilisation of the Country Protection Fund. Thus, according to our forecast, even upon the full absorption of the free reserves, amounting to 0.3 per cent of GDP, a deficit ratio of lower than 2.4 per cent, assumed at the time when the Budget Act was passed, may still develop. Our projection related to the cash-based deficit of the central sub-sector exceeds the amended statutory appropriation by 0.5 per cent of GDP; in addition, we expect a minor surplus in the statistical corrections relating to the general government sector and the accrual-based balance. Both differences point to a higher deficit, but these are offset by the cash surplus expected in the local government sub-sector.[4]

Table 6
Balance of the government sector in 2017

	Statutory appropriation		MNB forecast		Difference
	percentage of GDP	HUF billions	percentage of GDP	HUF billions	percentage of GDP
1. Balance of the central sub-sector	–3.1	–1,166	–3.6	–1,341	–0.5
2. Balance of local governments	–0.1	–20	1.1	422	1.2
3. Cash-based (GFS) balance of the general government (1+2)	**–3.2**	**–1,186**	**–2.5**	**–920**	**0.7**
4. GFS–ESA difference	0.8	292	0.4	161	–0.3
5. ESA balance of the government sector (3+4)	**–2.4**	**–895**	**–2.1**	**–759**	**0.3**
6. ESA balance with cancellation of central free reserves (in case of MNB forecast)	**–2.4**	**–895**	**–1.8**	**–663**	**0.6**

Note: Due to rounding, differences may occur in the table.

The Budget Act approved in December 2016 has set the 2016 cash balance of the central sub-sector of the general government to HUF -1,166 billion. Based on the amendment of the Budget Act in June 2017[5], the cash-based deficit target did not change, as the revenues and expenditures increased in the same amount after the amendments. The MNB's June Inflation Report projects a deficit that is higher than the cash deficit target specified in the Budget Act for the central sub-sector by HUF 175 billion, i.e. 0.5 percentage points of GDP.[6] The higher cash deficit may develop due to the shortfall in cash revenues relative to the amended statutory appropriation, but the surplus expenditure arising from the advancing of the EU transfers and the higher cash interest expenditure also contribute to it. The difference between our projection pertaining to the balance of the central sub-sector and the amended appropriation is as follows:

- Our projection for the *central budget balance* shows a deficit higher than the amended statutory appropriation by HUF 164 billion. If the reserve appropriated in the Country Protection Fund is not utilised in full, the cash-based deficit may be lower than this. The deficit that exceeds the appropriation is primarily caused by the expected

[4] In the EDP report submitted in April 2017, the government's projection also calculates already with a substantial cash surplus at the local governments for 2017.
[5] The amendment of the 2017 budget is included in Act LXXXVI of 2017; the amendment of the Act is described in the box.
[6] Assuming the full utilisation of the Country Protection Fund, in a manner that is directly comparable with the statutory appropriation.

shortfall in tax revenue compared to the raised appropriation, primarily in the case of the consumption tax revenues. This difference is explained by the difference in our projection relating to the absorption of EU funds and the central bank's lower projection relating to the expected economic growth rate. We estimate the primary expenditures to be lower than the appropriations' total, although in the individual lines we do calculate with the anticipated overrun of the uncapped appropriations. The substantial net expenditure surplus disbursement expected in the EU transfers line is offset by the fact that a large part of the disbursements also increases the revenues of the central sub-sector's budget chapters, as most of the payments are disbursed as advances.

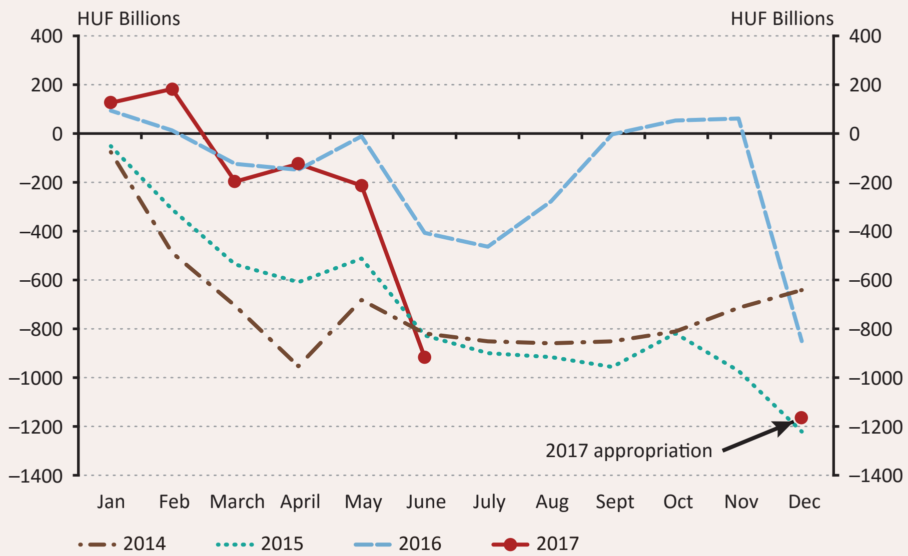
- *Our projection for the balance of extra-budgetary funds* calculates with a surplus that exceeds the statutory appropriation by HUF 70 billion. A dominant part of the difference appears at the public employment expenditures (Start Labour Programme). The utilisation of the Start Labour Programme was lower than anticipated already last year as well and this year we also expect the base effect to take hold due to the strong demand and low unemployment observed in the labour market.

- Our projection relating to the balance of the *social security funds* calculates with a deficit that exceeds the statutory appropriation by HUF 81 billion. The difference appears at the medical and preventive care, as the use of the special reserves planned for the wage increase in the health sector is recognised here – thus the deficit of the central budget is lower by the same amount.

The ESA balance of the general government showed a surplus in the first quarter this year as well. The balance of the entire general government was 2.0 per cent of the quarterly GDP, which exceeds the surplus recorded a year ago.

The cash-based deficit of the government budget – calculated without the local governments – in the first half-year was HUF 911 billion (Chart 14). In the first four months, the deficit developed similarly as last year, but then in May it exceeded it slightly and in June materially. A large part of the soar seen in the last months of the half-year can be linked to the payments relating to the EU programmes, the value of which exceeded HUF 500 billion, and the larger part thereof was disbursed in form of an advance. The change in the balance in the last two months – even without the EU payments – suggests that this year the time profile of the budget expenditures during the year may return to the seasonality observed in previous years. Accordingly, the realisation of the primary expenditure at the end of the first half-year is essentially in line with the appropriations in the Budget Act. The revenues of the central sub-sector slightly fall short of the pro rata level of the appropriation, but they were realised in line with the central bank's revenue projection.

Chart 14
Intra-year cumulative cash balance of the central sub-sector



Source: Budget Act of 2017, Hungarian State Treasury.

3.2 MACROECONOMIC PROJECTION UNDERLYING THE BUDGET

The National Assembly adopted the Act on the Amendment of the 2017 Budget Act in June 2017, in which it also changed the macroeconomic path related to this year. In our analysis, we examine the differences between the latest amendment of the Act and the MNB's macroeconomic projection published in its June Inflation Report. In the macroeconomic path of the budget, the projection for the **economic growth** in 2017 exceeds the projection included in the MNB's 2017 June Inflation Report by 0.5 per cent. The Ministry of National Economy anticipates a 1.7 per cent higher expansion in the households' consumption expenditure in 2017, which partially explains the higher GDP dynamics. According to the macroeconomic path in the budget, the gross fixed capital formation this year will provide substantial support for GDP growth, contributed to not only by the corporate and household investments, but also by public projects. Based on the Budget Act, the increase in the gross fixed capital formation will be around 10.2 per cent in 2017 (the MNB projects an even higher growth). As a result of the accelerating domestic consumption, the growth in imports is expected to surpass that in exports.

According to the expectations underlying the budget, the average wage and employment will increase at a particularly high rate (11 and 2.5 per cent, respectively), due to the economic activity. In its latest projection, the MNB expects similar, but somewhat lower growth in both areas. It follows from the foregoing that the most important tax bases (wage bill, consumption) will expand less dynamically according to the MNB's projection than the growth dynamics underlying the statutory appropriations and this also appears in the difference in the expectations relating to tax revenues.

Table 7
Comparison of the macroeconomic projection included in the 2017 Budget Act and in the MNB's June 2017 Inflation Report

	Original budget*	Amended budget**	MNB	Difference
GDP	**3.1**	**4.1**	**3.6**	**–0.5**
Consumption expenditure of households	3.7	6.1	4.4	–1.7
Public consumption	1.5	0.8	0.5	–0.3
Gross fixed capital formation	9.1	10.2	15.8	5.6
Exports	6.3	5.4	7.2	1.8
Imports	7.4	6.8	9.3	2.5
Inflation	**0.9**	**1.6**	**2.4**	**0.8**
Gross wage bill	**6.8**	**13.2**	**12.2**	**–1.0**
Gross average earning	5.1	11.0	10.0	–1.0
of which: private sector	5.0	10.2	10.0	–0.2
Number of employed	1.7	2.5	1.9	–0.6
of which: private sector	2.0	3.8	2.3	–1.5

*Note: In case of the labour market data, the different methodology (in the case of the MNB: full-time equivalent headcount) may also cause minor differences in the forecasts. * Based on the Act approved in June 2016 ** Based on the 2017 macroeconomic projection of the 2018 Budget Act approved in June 2017.*

Source: 2017 Budget Act, MNB's June 2017 Inflation Report.

Box 2
Amendment of the 2017 Budget Act

The National Assembly adopted the Act on the Amendment of the Budget Act on 26 June 2017. The amendments of the statutory appropriations did not modify the cash balance of the central sub-sector, since the revenue and expenditure totals of the individual sub-sectors of the government budget increased in aggregate with the same amount, i.e. by HUF 436 billion compared to the original statutory appropriations.

On the revenue side, the statutory appropriations were updated with the impacts of the measures affecting the revenue side, announced after the adoption of the original Budget Act (reduction of the social contribution tax rate, standardisation of the corporate income tax rate, increasing the limit for the small taxpayers' itemised lump sum tax – KATA) and of the change in the macroeconomic path (e.g. wage agreements). Within the framework of this, the Budget Act's modified tax, tax-type and contribute revenue appropriations decreased by HUF 38 billion in total. On the other hand, the revenues related to the state assets (sales of arable land) rose by HUF 162 billion, and the social security funds also received by HUF 240 billion higher transfers from the central sub-sector to substitute the lost tax revenues (this measure has no impact on the balance of the consolidated general government).

On the expenditure side, the new measures of the amendment of the Act raised the expenditure by HUF 200 billion in total, within which the raising of the reserves (HUF 66 billion) does not increase the actual deficit in the absence of subsequent government measures. New expenditures include, among others, the following important items:
– Renovation and modernisation of the national public road network (HUF 50 billion)
– Creating the appropriation for the Investment Preplanning Fund (HUF 25 billion)
– Renovation of the assets of the Ministry of Defence programme (HUF 10 billion)

Table 8
Measures affecting the revenue total
(HUF billion)

Revenue item	Change in the appropriation (HUF billion)
Total tax, tax-type and contribution revenues	**–38**
of that:	
corporate income tax	–128
lump sum tax of small entrepreneurs and small business tax	29
excise duties	34
personal income tax	116
duties	23
vocational training contribution	14
social security tax and other contributions	–180
centralised revenues (green tax, road toll)	45
other taxes and tax-type revenues	9
Total other revenues	**474**
of that:	
expenditures related to state property	162
fiscal subsidies	240
subsequent recovery of EU transfers	56
other small items consolidated	16
Total revenue of the central sub-sector	**436**

Source: Act LXXXVI of 2017.

Table 9
Measures affecting the expenditure total
(HUF billion)

Expenditure item	Change in the appropriation (HUF billion)
Amendment of expenditures in the central budget	**356**
of that total primary expenditures:	410
surplus spending of the budgetary institutions	119
subsidies to the general government sub-sectors	253
increase in central reserves	66
change in other expenditures	–29
of that decrease in interest expenditures:	–54
Change in the expenditures of extra-budgetary funds	**5**
Change in the expenditures of social security funds	**76**
pensions	50
sickness benefit and child-care benefit	26
Total expenditure of the central sub-sector	**436**
of that total primary expenditures:	490
of that adjustment of interest expenditures:	–54

Source: Act LXXXVI of 2017

In addition to the items listed before, due to the change in the macroeconomic path, the appropriation for pension expenditures rose by HUF 50 billion (higher inflation and payment of pension premium due to the higher growth path) and due to the higher national economy demand growth the appropriation for cash benefits (sick pay and childcare allowance) increased by HUF 26 billion. The appropriation of interest expenditures decreased by HUF 54 billion as a result of the amendment which was justified by the adjustment for the impact of the yield decrease, which had occurred in the meanwhile.

The raising of the central reserves is aimed at the more secure realisation of the budget balance target. Within that, the Country Protection Fund increases by almost HUF 36 billion, while the amount of the central free reserves rose by HUF 30 billion.

3.3 CASH REVENUES OF THE CENTRAL SUB-SECTOR

According to our forecast, the **primary revenues of the central sub-sector** may fall short of the modified appropriations of the Budget Act by 0.5 per cent of GDP, primarily in case of the value added tax and the excise duty.

According to our projection, the total payments by **economic organisations** may fall short of the appropriation by HUF 56 billion in total. Within that, the corporate income tax revenues may fall short of the Budget Act by HUF 11 billion, which is primarily attributable to the different projections related to economic growth. The statutory appropriation exceeds our projections for the revenues from the simplified entrepreneurial tax (EVA) by HUF 9 billion. The difference is caused by the different assessment of the willingness to switch from EVA to the small enterprise tax types (small taxpayers' itemised lump sum tax – KATA and small business tax – KIVA). Other payments by economic organisations may fall short of the appropriation in the Budget Act by HUF 15 billion, as the Budget Act does not calculate for 2017 with the reimbursement of the advertising tax paid by the taxpayers between 2014 and May 2017.

Compared to 2016, payments by enterprises to the budget may decline by HUF 69 billion. Within that, the revenues from corporate income tax may decrease by HUF 87 billion, as pursuant to the amendment adopted in December 2016, the former tax rates of 10 and 19 per cent were uniformly replaced from 1 January 2017 by the corporate income tax rate of 9 per cent (the impact of the measure alone is – HUF 150-160 billion). The simplified entrepreneurial tax may be lower by HUF 14 billion compared to 2016 due to the gradual decrease in the number of taxpayers opting for this tax type. The revenues from the special tax on financial organisations may be lower by HUF 8 billion, as the upper rate of the tax on credit institutions decreased from 0.24 per cent to 0.21 per cent in 2017 and the tax base will have to be defined on the basis of the adjusted balance sheet total calculated from the data of the annual accounts for the second tax year preceding the tax year rather than on the basis of the 2009 adjusted balance sheet total, i.e. in 2017 the tax base will be calculated on the basis of 2015.

Table 10
Partially consolidated cash revenues of the central sub-sector
(HUF billion)

	2017					
	Statutory appropriation (original)	Statutory appropriation (amended)	Realisation Jan-June	Per cent of appropriation	MNB forecast	Difference: MNB – amended appropriation
TAX AND CONTRIBUTION REVENUES OF THE CENTRAL SUB-SECTOR	**13,738**	**13,701**	**6,444**	**47%**	**13,501**	**–200**
Payments by economic organisations	**1,622**	**1,578**	**707**	**45%**	**1,522**	**–56**
Corporate income tax	735	607	280	46%	596	–11
Special tax of financial institutions	67	67	34	51%	65	–2
Simplified entrepreneurial tax	81	76	17	23%	67	–9
Mining royalty	30	35	15	43%	31	–4
Gambling tax	31	31	12	38%	27	–4
Income tax of energy companies	56	56	21	39%	49	–7
Lump sum tax of small entrepreneurs	76	95	46	49%	95	0
Small enterprise tax	14	24	10	44%	17	–6
E-road toll	155	170	85	50%	172	2
Utility tax	52	55	27	49%	55	0
Other taxes and payments	329	364	158	43%	349	–15
Advertising tax	12	12	2	16%	–11	–23
Consumption taxes	**4,891**	**4,929**	**2,181**	**44%**	**4,798**	**–131**
Value added tax	3,542	3,542	1,559	44%	3,442	–100
Excise duties	1,035	1,069	457	43%	1,040	–29
Registration tax	23	24	12	49%	24	0
Telecom tax	54	54	26	48%	53	–1
Financial transaction levy	206	206	108	53%	204	–2
Insurance tax	32	34	18	54%	35	1
Payments by households	2,000	2,139	1,036	48%	2,117	–22
Personal income tax	1,793	1,909	922	48%	1,884	–24
Duties, other taxes	164	187	90	48%	187	0
Motor vehicle tax	44	44	24	56%	46	2
Tax and contribution revenues of extra-budgetary funds	**535**	**531**	**248**	**47%**	**530**	**–1**
Tax and contribution revenues of social security funds	**4,690**	**4,524**	**2,273**	**50%**	**4,534**	**9**
Social contribution tax and contributions	4,388	4,218	2,104	50%	4,213	–6
Other contributions and taxes	301	306	168	55%	321	15
OTHER REVENUES	**262**	**436**	**355**	**82%**	**454**	**18**
Other revenues of the central budget	**140**	**308**	**256**	**83%**	**319**	**11**
Other revenues of social security funds	**39**	**39**	**19**	**49%**	**39**	**0**
Other revenues of extra-budgetary funds	**83**	**89**	**80**	**90%**	**96**	**7**
TOTAL REVENUES	**14,000**	**14,137**	**6,799**	**48%**	**13,955**	**–182**

Note: 1. The 2017 H1 actual data reflect the data provided by the Hungarian State Treasury. 2. The forecast of the MNB presents the fiscal projection included in the June 2017 Inflation Report. 3. The difference between the revenue totals shown in the table and those indicated in the Budget Act is due to the fact that, based on the data available, we excluded the effect of cash transfers within the central sub-sector, and recognised certain expenditure items in net terms, i.e. reduced by the related direct revenues. 4. The table contains rounded figures.

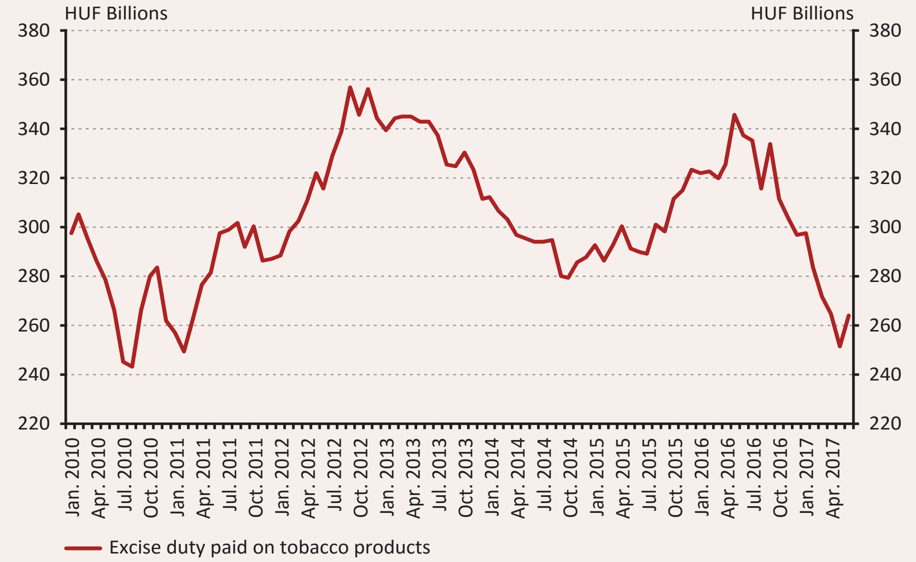
The revenues from the lump sum tax of small entrepreneurs (KATA) may increase by HUF 25 billion compared to last year, due to raising the income limit. The expectations relating to the willingness to switch assume a substantial increase in the number of taxpayers, as the limit was raised from HUF 6 million to HUF 12 million per annum, i.e. above which revenue is charged by a 40 per cent tax.

On a cash basis, in 2017 we project **value added tax** revenue of HUF 3,442 billion, which falls short of the amended budgetary appropriation by HUF 100 billion. Part of the difference is attributable to the fact that the appropriation calculates with higher public investments relating to the absorption of EU funds, and expects material growth in revenues as a result of the new measures aimed at reducing the shadow economy (online invoicing system) and the extension of the former measures of the same purpose (online cash registers, Electronic Trade and Transport Control System). It may slightly contribute to the difference between the forecasts that the budget's macroeconomic path calculates with a more dynamic growth in the volume of household consumption; however, the effect of this is mostly offset by the fact that the consumer price index expected by the budget falls short of the price index projected by the MNB.

In the first half-year the VAT revenue realised by the budget fell short of that of 2016 by HUF 2 billion total; however, this is merely the consequence of an accounting change. Namely, from 1 January the deadline for the refund was reduced from 75 to 45 days in the case of the taxpayers classified as "reliable taxpayers" and accordingly, this year refunds for 13 months will stand against 12 months' VAT receipt; thus, the net cash revenue will be lower. However, the net cash revenue-reducing effect of the measures is adjusted through the accrual-based corrections; thus, the legislative change will have no impact on the ESA balance of the budget. Gross payments, which capture the underlying processes better, rose dynamically, i.e. by 8.8 per cent in the first half-year of 2017 year on year.

Our **excise duty** projection for this year is HUF 1,040 billion, which falls short of the amended statutory appropriation by HUF 29 billion. The difference is presumably the result of the different perception of the developments in tobacco taxes. The revenue of the first six months is by HUF 11 billion lower than a year ago, which is attributable to one-off effects. On the one hand, last May the number of cigarettes permitted per box rose from 19 to 20, which prompted the merchants to replenish their stocks in the month preceding the effective date of the measure. On the other hand, this spring an opposite process took place, namely as of 1 April tobacco products may be released for free circulation only with tax stamp containing no price instead of the former tax stamp that contained the price of the product, which encourages merchants to reduce their stocks.

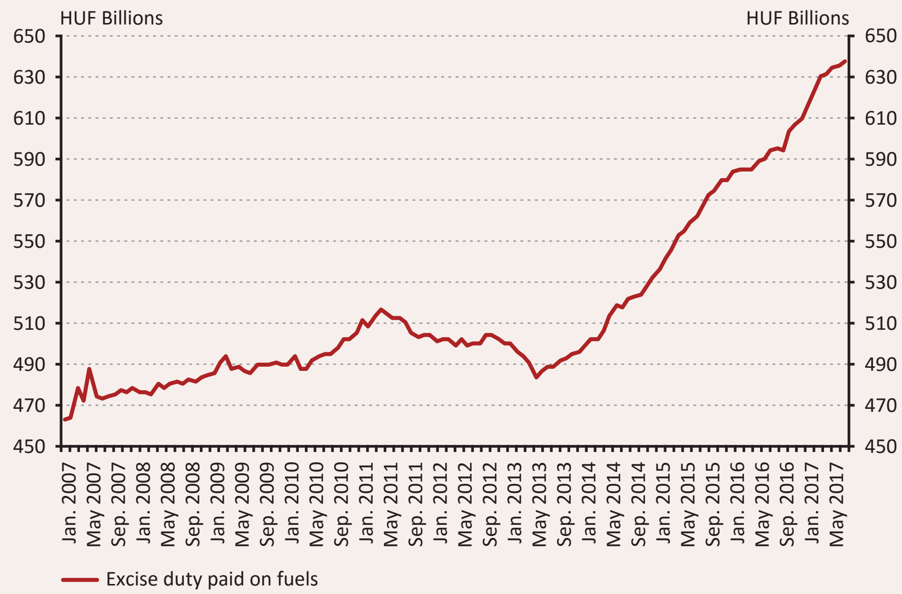
Chart 15
Excise duty revenue from tobacco products
(12-month cumulated value)



Source: Hungarian State Treasury.

Rising fuel sales, and particularly the dynamic growth in diesel sales, made a major contribution to the dynamic growth in excise duty revenues in the last two years.

Chart 16
Excise duty revenue from fuels
(12-month cumulated value)



Source: Hungarian State Treasury.

According to the MNB's forecast, revenues from **personal income tax** may fall short of the amended appropriation by HUF 24 billion in 2017. The difference may arise from the different perception of the macroeconomic paths. The minimum wage and guaranteed wage minimum stipulated in the wage agreement of 2016 materially increased the expectations with regard to the revenues from labour taxes; thus, the personal income tax appropriation of the Budget Act rose by almost HUF 120 billion during the mid-year amendment.

This year the family allowance for families with two children will increase further as defined in the law, i.e. last year's allowance of HUF 12,500 per dependant increases to HUF 15,000 this year. According to our projection, personal income tax revenues on a cash basis in 2017 may increase by roughly 10 per cent year on year. The revenue trends in the first half-year are in line with our projection.

As regards the revenues of the **extra-budgetary funds** our forecast essentially corresponds to the appropriation. As in the previous years, until the end of June only 30 per cent of the innovation contribution was realised, as the major part of the payments is received by the National Research, Development and Innovation Fund in December.

Our projection related to **the tax and contribution revenues of the social security and extra-budgetary funds** is essentially in line with the amended appropriation of the Budget Act, being the result of two processes of opposite effect. Our assumption with regard to the increase in the gross wage bill, falling short of the expectation in the amended macroeconomic path of the budget by 1 per cent, is offset by the fact that in relation to the decrease of the social contribution tax by 5 percentage points in 2017 our projection contains a somewhat lower income reducing effect than expected by the Ministry of National Economy. In the case of the individual contributions of the insured (pension, health insurance, labour market contribution), the appropriations exceed our projection, while in the case of the social contribution tax revenues they somewhat fall short thereof.

The cutting of the tax rate forms part of the wage agreement concluded at the end of last year, which – together with the dynamic increase in the wage bill – justified the amendment of the appropriation. As a result of the amendment, the appropriation of the revenues from individual contributions and the social contribution tax decreased by HUF 170 billion and HUF 18 billion in the case of the social security funds and the extra-budgetary funds, respectively. The latter was partially offset by the growth of roughly HUF 14 billion in the appropriation of the vocational training contribution. Despite the tax easing, based on our forecast, as a result of the material increase in gross wages and employment, the tax and contribution revenues of the social security and extra-budgetary funds will rise by roughly 1.8 per cent in 2017, which is also supported by the monthly actual data of the first half-year. We expect materially higher revenue than the appropriation of the Budget Act only in case of the health contribution.

Box 3

Tax measures announced since the adoption of the 2017 Budget Act

The National Assembly adopted the 2017 Budget Bill Act on 13 June 2016. However, after that the National Assembly decided on several tax measures that have material effect on the budget balance.

Pursuant to the amendment of the corporate income tax a uniform tax rate of 9 per cent will replace the former tax rates of 10 and 19 per cent from 2017. The measure reduces the budget revenues in one step by HUF 150-160 billion per annum. Of this HUF 130-150 billion reduces the tax burden of 800-900 enterprises that used to pay tax at the upper rate as well (19 per cent), while HUF 20-23 billion reduces the tax burden of 300,000 enterprises that used to pay tax at the lower rate (10 per cent).

Table 11
Estimated effect of the measures on the budget

Measure	Budget impact (HUF billion)
Reducing the lower and upper rate of the corporate income tax	–155
Reducing the social contribution tax	–390
Amendment of the Job Protection Action Plan (JPAP)	35
Benefits tied to minimum wage	–20
Wage measures impacting the public sector	–45
Amendment of the rules applicable to the lump sum tax of small entrepreneurs and the small business tax	–18

Source: MNB calculations

From 1 January, the social contribution tax rate was reduced by 5 percentage points from 27 to 22 per cent, while the allowances available under the Job Protection Action Plan decreased proportionately. On the budget side, the amendment affecting the employer's tax burden represents a total tax easing of HUF 390 billion this year, while the related modification of the Job Protection Action Plan results in a saving of HUF 35 billion. Simultaneously with cutting the rate of the social contribution tax, the rate of the health contribution was also reduced from 27 to 22 per cent.

From 2017 the minimum wage rose by 15 per cent from gross HUF 111,000 to HUF 127,500, while the guarantee wage minimum increased by 25 per cent from gross HUF 129,000 to HUF 161,000. The wage increases substantially increase the tax bases, thereby generating a tax revenue surplus of roughly HUF 170 billion. On the other hand, the increase in the minimum wage and in the guaranteed wage minimum directly increases public sector wage outlays and various social benefits are also tied to the minimum wage. These together deteriorate the budget balance by about HUF 65 billion as a result of the measure.

From this January, the rules applicable to the lump sum tax of small entrepreneurs (KATA) have changed. The revenue limit above which the taxpayer is obliged to pay tax at 40 per cent rose from HUF 6 million to HUF 12 million. Essentially, this change means that this method of tax payment can be applied until reaching the aforementioned revenue. As a result of this, the number of taxpayers opting for the lump sum tax of small entrepreneurs is expected to increase, together with the revenue from this tax type. On the other hand, the total number of taxpayers falling under other tax types, primarily the simplified entrepreneurial tax, and their tax payment will decrease. Thus, the measure represents a loss of HUF 16 billion in the revenues of the budget, which may be mitigated by the resulting decrease in the shadow economy.

Of the amendments affecting the small business tax (KIVA) two should be highlighted. The tax rate from 1 January became 14 per cent of the tax base instead of the former 16 per cent, although the income limit for selecting the small business tax remains HUF 500 million, while the taxpayer status in this category terminates only one day before exceeding the limit of HUF 1 billion, which has to be reviewed quarterly. The impact of the measures is minimal, it may represent a revenue shortfall of maximum HUF 2 billion.

3.4 CASH EXPENDITURES OF THE CENTRAL SUB-SECTOR

Our projection for **primary expenditure items** calculates with an expenditure level lower by 0.2 per cent of GDP than the appropriations in the Budget Act. The main reason for this is that we expect lower use at the Start Labour Programme, as well as at the disability and rehabilitation benefits compared to the statutory appropriations. In addition, the net expenditures of the central budgetary institutions and chapters, calculated without the reserve appropriations, may also be somewhat lower than the statutory appropriations, including also the EU payments. The main reason for this is that a substantial part of the EU payments is fulfilled this year in the form of advances; thus, higher saving can be expected compared to the statutory appropriations through the saving of the co-financing belonging to the EU programmes. We anticipate an overrun of the appropriation only in the area of public transport service and the social insurance cash benefits, in the case of the latter one due to the increase in the minimum wage.

Payments relating to **special and normative subsidies, as well as support of the public media** reached 56 per cent of the annual appropriation in the first half of the year, with a similar time profile as the seasonality experienced last year. The higher expenditure level, on a pro rata basis, was linked with the special and normative subsidies (essentially with the public service contracts related to public transport); thus, it can be expected that, similarly to last year, by the year-end the statutory appropriation will be exceeded, according to our calculations by about HUF 22 billion.

As regards the **housing grants**, the budget planned HUF 211 billion, which roughly corresponds to our expectations, a substantial part of which is about the HUF 95 billion related to the housing investments implemented under the Home Purchase Subsidy (HPS) scheme for families. The budget appropriates about HUF 4 billion for the interest subsidised loans available under the HPS scheme and HUF 28 billion for the tax refund scheme. The Budget Act includes HUF 3 billion as the contribution to the saving by the National Home-building Societies. Another substantial expenditure item is the state subsidy provided for the building society savings, the anticipated amount of which is HUF 54 billion. Based on the incoming data of the first six months, 40 per cent of the appropriation was realised (similarly to the first half of last year), which signals a risk pointing to a saving on expenditures.

The expenditure appropriation of the **National Family and Social Policy Fund** is in line with our expectations at the majority of the items. The Budget Act appropriated HUF 658 billion for the expenditures of the Fund; about half of the expenditures is used for the payment of family allowances. The HUF 317 billion family allowance appropriation – similarly to the other items, with the exception of the early retirement benefits – slightly exceeds the year-on-year figure. The difference of roughly HUF 15 billion between the benefits paid in 2016 in the amount of HUF 671 billion and the appropriation for this year is explained almost in full by the decrease in the expenditures planned for early retirement benefits, attributable to the decrease in the number of beneficiaries, in line with the former tightening of the eligibility criteria.

Our projection for the **net own expenditures of central budgetary institutions and chapters** falls short of the appropriation in the Budget Act by HUF 248 billion. Compared to the appropriation, we projected extra expenditure in relation to certain uncapped expenditures of chapters (grants for social and public education human services) and calculated with the payment of incentive bonuses at the tax authority (NTCA). At the same time,

Table 12
Partially consolidated cash expenditures of the central sub-sector
(HUF billion)

	2017					
	Statutory appropriation (original)	Statutory appropriation (amended)	Realisation jan-june	Per cent of appropriation	MNB forecast	Difference: MNB – amended appropriation
Primary expenditure items	**14,253**	**14,448**	**7,158**	**50%**	**14,377**	**–71**
Special and normative subsidies and support to the public media	**381**	**382**	**214**	**56%**	**404**	**22**
Social policy fare subsidy	**104**	**104**	**49**	**47%**	**98**	**–6**
Housing grants	**211**	**211**	**85**	**40%**	**213**	**2**
Family allowances, social benefits	**562**	**562**	**285**	**51%**	**562**	**0**
Early retirement benefits	**96**	**96**	**47**	**49%**	**91**	**–5**
Net expenditures of central budgetary institutions and chapters	**5,432**	**5,492**	**2,986**	**54%**	**5,622**	**129**
Net own expenditures	4,781	4,897	2,100	43%	4,649	–248
Net expenditures related to eu funds	651	595	886	149%	972	377
Support to local governments	**641**	**654**	**325**	**50%**	**664**	**10**
Contribution to the eu budget	**317**	**286**	**132**	**46%**	**286**	**0**
Expenditures related to mnb settlements	**0**	**0**	**0**	**0%**	**0**	**0**
Central reserves	**375**	**441**	**0**	**0%**	**198**	**–243**
Debt assumption	**0**	**0**	**0**	**0%**	**0**	**0**
Expenditures related to state property	**316**	**318**	**139**	**44%**	**321**	**3**
Other expenditures	**112**	**114**	**64**	**56%**	**106**	**–9**
Expenditures of extra-budgetary funds	**594**	**600**	**239**	**40%**	**536**	**–64**
NEF – passive allowances	51	52	28	53%	49	–3
NEF – active allowances	325	325	133	41%	258	–67
Other expenditures	218	223	79	35%	229	6
Expenditures of social security funds	**5,112**	**5,187**	**2,594**	**50%**	**5,278**	**90**
PIF – pensions	3,102	3,152	1,564	50%	3,158	6
HIF – disability and rehabilitation benefits	321	321	148	46%	299	–22
HIF – cash benefits	276	301	153	51%	313	11
HIF – medical and preventive care	1,040	1,040	538	52%	1,121	82
HIF – net expenditures of the drug budget	247	247	127	51%	255	8
Other expenditures	127	127	64	50%	132	5
Net interest expenditures	**912**	**856**	**552**	**65%**	**919**	**63**
Total expenditures	**15,166**	**15,304**	**7,710**	**50%**	**15,296**	**–8**

Note: 1. The 2017 H1 actual data were prepared based on the data provided by the Hungarian State Treasury. 2. The forecast of the MNB presents the fiscal projection included in the June 2017 Inflation Report. 3. The difference between the expenditure totals shown in the table and those indicated in the Budget Act is due to the fact that, based on the data available, we excluded the effect of cash transfers within the central sub-sector, and recognised certain expenditure items in net terms, i.e. reduced by the related direct revenues. 4. The table contains rounded figures.

the net own expenditure is substantially reduced by the EU advances payable to the chapters, as well as by the lower-than-planned co-financing expenditures from own resources, due to the advances. It should be noted that the lower absorption of the EU transfers reduces the degree of the positive accrual-based corrections connected with the cash accounting, thus the savings in expenditures under ESA will be lower than that on cash basis.

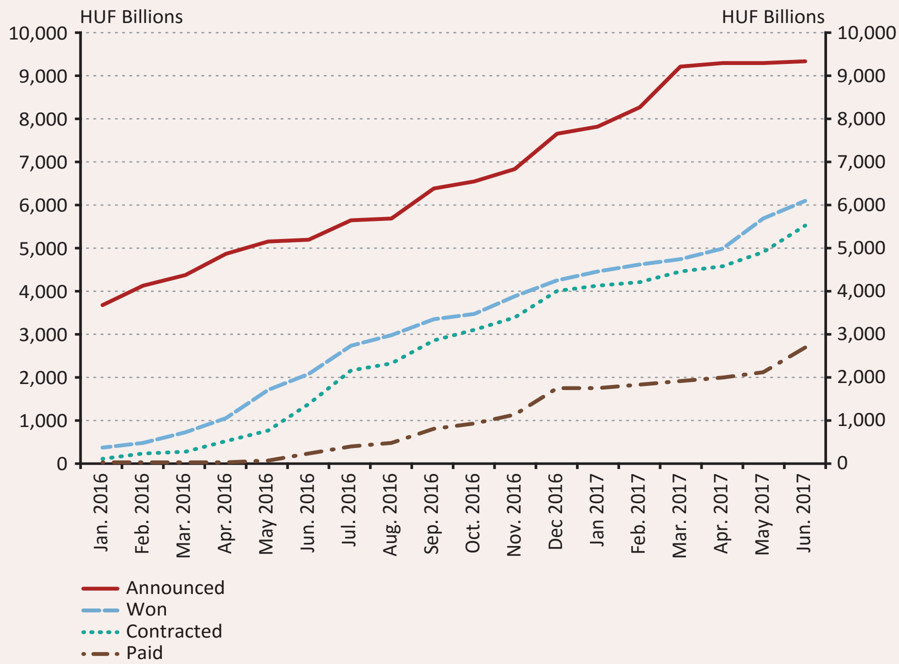
The appropriation for the **net cash expenditure linked with the EU programmes** is HUF 595 billion in 2017; however, according to our projection it may very well reach HUF 972 billion; thus, the statutory appropriation may be exceeded by an amount as high as HUF 377 billion. Within this, the appropriation for the cash expenditures is

HUF 2,239 billion in the Budget Act, while the amended budgetary appropriation for revenues amounts to HUF 1,644 billion. There is material difference on the revenue gross leg between our projection and the statutory appropriation, as according to our projection this year the revenue from the EU may amount to HUF 1,328 billion – including the subsequent reimbursement of the EU transfers differing from the appropriation. It also increases the deviation from the net expenditure appropriation that our expectation of HUF 2,300 billion related to cash expenditures slightly exceeds the appropriation. The lower revenue is due to the fact that according to our expectation the ratio of advances may be around 50 per cent of the total disbursement, and until the actual absorption of these no financial settlement of these expenditures can be expected from the EU.

In the **first half-year the cash expenditures relating to EU transfers** amounted to HUF 1,046 billion, while of the revenues from the EU only HUF 155 billion was recognised in the budget; thus, the net expenditure was HUF 891 billion at the end of the half-year. The extraordinarily high net expenditure value, compared to the same periods of the previous years, is the result of the payment of HUF 560 billion in June and the low revenues. The impact of the high net expenditure is offset by the fact that part of the disbursements were advance payments to the central institutions and to the local governments, hence those have no impact on the general government's cash balance (however, the advances paid to the local governments increase the cash-based deficit of the central budget). The advances transferred within the government sector (including local governments and public corporations allocated to this sector) do not qualify as expenditures even on an accruals basis, hence they have no impact on the ESA balance.

The announcement of the tenders relating to the new cycle was completed in accordance with the plans by March 2017; at half-year end the portfolio of announced tenders already exceeded HUF 9,300 billion. The volume of the won and contracted tenders rose by more than HUF 1,500 billion in the last six months; thus, there is a good chance of realising the government's objective to conclude contracts for 85 per cent of the entire allocation this year.

Chart 17
Developments in the tender announcements for the EU programmes
(HUF billion)



Source: Prime Minister's Office.

In the case of the EU expenditures, the first half-year's data (particular those of June) are in line with the expenditure appropriation and with our forecast. On the other hand, the faster than expected run-up of the programmes may represent a risk. Should the disbursements materially exceed the appropriation and the receipt of the EU transfer remain low due to the high ratio of advances, the cash-based deficit of the state budget or the borrowing requirement may consequently increase.

Within the expenditures of the **extra-budgetary funds** we calculate with an annual saving of HUF 67 billion in relation to the active spending of the National Employment Fund compared to the appropriation, due to the lower utilisation of the public work programme. The expenditures incurred in the first half of the year in the amount of roughly HUF 133 billion were consistent with this expectation. Last year, at the end of the first half-year the expenditure of the Start Labour Programme was 52 per cent of the annual realisation, while this year it was 41 per cent of the appropriation.

According to our forecast, the **expenditures of the social security funds** may exceed the statutory appropriation by HUF 90 billion. According to our projection, the budget may realise substantial savings on the disability and rehabilitation benefits by the end of the year, but extra expenditures in the total amount of HUF 101 billion are expected in relation to medical and preventive care, drug reimbursements and cash benefits. However, when assessing the relatively significant overrun of the appropriation, it should be borne in mind that the cover for the wage increase in the healthcare sector is included in the special reserve appropriation in the Budget Act, but the absorption thereof takes place under the medical and preventive care expenditure appropriation – considering the absorption of the special reserve, we assume the fulfilment of the original appropriation. The cash expenditure, adjusted for the special reserves, is expected to be exceeded by HUF 8 billion.

The **pensions and pension-type benefits** may be realised in line with the appropriation by the year-end, projected by the developments in the first half-year's data in line with the pro rata expenditure level. In the beginning of 2017 pensions were raised by 1.6 per cent instead of the 0.9 per cent, specified originally in the Budget Act – in the knowledge of this, the statutory appropriation was also raised by HUF 50 billion. However, the actual inflation data of May was even higher than that, and in addition, according to the projection in the MNB's June Inflation report, the annual consumer price change may be 2.4 per cent. Due to this it may be necessary to perform additional pension indexation at year-end, which may generate extra expenditures of HUF 25 billion in the budget. On the other hand, the payment of the pension bonus may fall short of the appropriation of HUF 24 billion. Contrary to the 4.1 per cent GDP growth rate specified in the budget, the MNB projects a grow rate of 3.6 per cent for 2017, hence the pension bonus tied to it may amount to merely HUF 4 billion. The realisation of the appropriation is not expected to be jeopardised by the additional disbursements due at year-end either. Finally, the disability and rehabilitation benefits may be below the statutory appropriation by the year-end. This is primarily attributable to the base effect, hence last year these expenditures fell short of the statutory appropriation by HUF 16 billion. The three factors – of partially opposite effect – listed above, together are essentially of neutral effect; thus, in respect of the pension payments we calculate with an outflow of income that corresponds to the statutory appropriation.

The **health insurance cash benefits** are expected to exceed the statutory appropriation, even after raising the original appropriation for the sick benefit and the child-care benefit by HUF 25 billion, due the effect of the minimum wage increase impacting the wage cap. Cash benefits amounted to HUF 153 billion in the first half-year, which corresponds to the appropriation on a pro rata basis, while based on the seasonality observed in the past years, the payments realised in the second half of the year are higher by 5-7 per cent, hence the overrun of the appropriation by HUF 11 billion may be projected for the year-end.

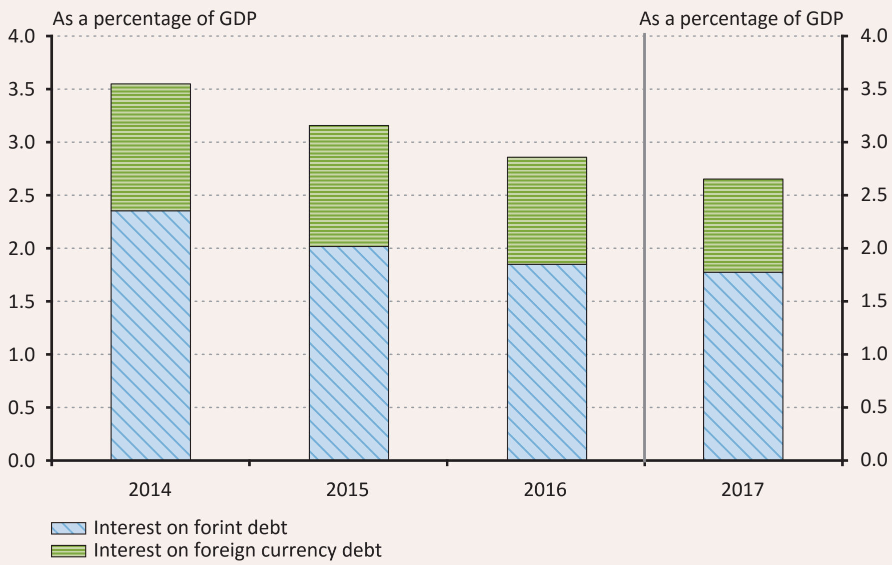
The **medical and preventive care expenditures** may exceed the original statutory appropriation, but this will have no effect on the consolidated budget balance. This is due to the fact that a part of the wage increases in the health sector allocable to this year was included in the special reserve appropriation; thus, in the beginning of the year HUF 82 billion was reallocated to the Health Insurance Fund from the special reserve appropriation available in the central budget. In the first half of the year the expenditures fell short of the pro rata expenditure level by 2 per cent, but no saving is presumed in the annual appropriation.

In our view, the **net expenditures of the drug budget** may exceed the appropriation specified in the budget by HUF 8-10 billion. The payments appropriated for 2017 fell short of last year's expenditure level, which ended with an overrun of HUF 24 billion, by HUF 37 billion.

The combined appropriation for **central reserves** is HUF 441 billion, of which HUF 96 billion belongs to the Country Protection Fund. According to our projection, the anticipated accrual-based deficit of 2017 may be below the deficit target this year as well, hence we expect that the Country Protection Fund will be utilised, as the spending of the Fund's reserves does not jeopardise the deficit target.[7] However, the utilisation of the Fund also requires a one-off government decision, hence there is a possibility that this reserve budget partially will not be used.[8] After the amendment of the Act, the full financial allocation for the central reserve appropriations exceeds that of the base year by HUF 80 billion. The special reserve financial allocation for wage compensations and wage measures has already been exceeded by the absorption by the eligible persons, presumably due to the increased demands resulting from the wage measures after the adoption of the Budget Act.

Our projection for the annual net cash interest expenditure exceeds the value stipulated in the amended appropriation **by HUF 63 billion**; however, on an accruals basis we projected expenditures lower by 0.1 per cent of GDP. As in previous years, the difference may be due to the fact that the yield decreases that took place since the adoption of the Act point to a decrease in the interest expenditures of the government. The net cash interest expenditures in the first half-year accounted for almost two-thirds of the annual appropriation, which suggests that the concentration of the annual interest expenditures increased further. For example, the interest expenditure at the end of June was close to one-quarter of the whole-year expenditure.

Chart 18
Budgetary interest expenditures
(MNB forecast for 2017)



Source: Government Debt Management Agency, MNB.

3.5 BALANCE OF THE LOCAL GOVERNMENT SUB-SECTOR

According to our forecast, the cash balance of the local government sub-sector may be more favourable than the statutory appropriation by HUF 442 billion. The substantial difference is determined by the EU advance payments; according to our projection, this year the sub-sector may receive EU advance from the central budget in the amount of HUF 350 billion. In addition to this, the favourable base of 2016 may also increase the balance surplus of the sub-sector, since the cash balance calculated without the EU advances last year exceeded HUF 120 billion. This expectation is also supported by the favourable first-quarter data, as the surplus in the local

[7] Our table presenting the partially consolidated expenditures of the central sub-sector reflects our cash-based expenditure expectations consistent with the full utilisation of the free reserves.

[8] According to the statutory regulation related to the utilisation of the Country Protection Fund, the government may use 50 per cent of the Fund's appropriation after the end-of-March EDP report. Up to 30 June, the government had decided on the reallocation of appropriations in the amount of HUF 30.0 billion, and thus the room for manoeuvre with the Country Protection Fund fell to 0.2 percentage points of GDP compared to the path assumed in the June Inflation Report.

governments' cash balance exceeded HUF 140 billion. The revenue processes developed similarly as in the first quarter of last year. On the expenditure side, the accumulation and capital expenditures substantially decreased in parallel with the decline in EU financing; however, as regards the entire year, we expect that the absorption of EU transfers will accelerate, supported by the use of part of the advances received last year.

3.6 STATISTICAL CORRECTIONS (ESA BRIDGE)

The 2017 Budget Act was approved assuming an accrual-based correction equivalent to HUF 292 billion. On the other hand, the MNB's projection, which is consistent with the June Inflation Report, includes an accrual-based correction of HUF 161 billion. A large part of the difference is attributed to the recognition of incomes related to the EU transfers. The effective absorption of the subsidies belonging to the EU programmes may fall short of the statutory appropriation; thus, the related corrections (cash receivables from the EU) will also be lower than assumed upon the planning of the budget. Moreover, the amount of the subsequent financial settlements carried forward from 2016 to 2017 may increase by almost HUF 55 billion, causing a negative correction in the same amount in the ESA bridge accounting.[9]

Corporate income tax is impacted by one correction, which was not taken into account by the Budget Act. This is attributable to the fact, that according to an amendment adopted in 2014[10], the taxpayers also had the opportunity to sponsor sports, performing arts or motion pictures from the paid tax advance in 2016, which is transferred to the specified beneficiary by the tax authority. In the cash-based budget, this was recognised last December as corporate income tax revenue and this January as a revenue decrease item. However, in ESA, the above transaction is not a revenue-reducing item but will be recognised as a subsidy expenditure according to the given item's content. However, since the subsidy in fact relates to last year, in 2017 a positive correction, corresponding to the assignment of January, must be recognised among the ESA bridge statistical corrections.

After the consolidation performed at the end of last year, the outstanding debt of hospitals is on the rise again, which is not an expenditure for the purpose of the cash accounting, but it is for the purpose of the accrual-based accounting, hence it has a negative impact on the ESA bridge (according to our estimation the annual amount will be HUF 30 billion).

3.7 EXPECTED DEVELOPMENTS IN PUBLIC DEBT IN 2017

According to the financial account data of the MNB, at the end of the first quarter of 2017, the gross public debt ratio stood at 74.3 per cent of GDP. The debt ratio slightly exceeded 74.1 per cent, recorded at the end of last year, but it is lower than the year-on-year value thereof by more than 2 percentage points. In the first quarter, the net debt issuance increased the government debt by HUF 576 billion, while the revaluation of the foreign currency debt reduced it by HUF 56 billion. The cash-based borrowing requirement was materially exceeded by the debt issuance, which resulted in a material increase in the general government's liquid deposits. Within the total public debt, the ratio of non-residents decreased from 42.4 per cent recorded at the end of 2016 to 40.7 per cent.

According to our forecast – which is consistent with the June Inflation Report – using the 2016 year-end exchange rate and assuming this to be constant, the gross public debt-to-GDP ratio may fall to 73.2 per cent by the end of 2017, which means that the debt rule of the Fundamental Law will be met in all probability this year as well. In addition to the dynamic economic growth, the sustained, trend decline in the debt ratio is also supported by the moderate net borrowing of the general government. As a result of the net foreign currency debt issuance, expected to be negative this year as well, the foreign currency ratio of public debt may fall below 22 per cent by the end of 2017, which may further reduce Hungary's external financial vulnerability.

[9] On the other hand, simultaneously with the payment of EU advances granted to the private sector, the general government's outstanding receivables from the European Union will rise, thereby increasing the amount of the accrual-based corrections of positive sign.
[10] Article 38 of Act LXXIV of 2014

4 Expected general government developments in 2018

In May 2017, the MNB published its analysis of the 2018 budget bill in its Public Finance Report series[11]. The National Assembly adopted the Budget Act, amended during the negotiation, on 15 June 2017, and in accordance with the usual practice, the MNB's macroeconomic forecast was also reviewed in June. Below we present the approved Budget Act and compare it with the budget forecast prepared for the Inflation Report of June 2017. In summary, it may be stated that the key findings of our May report are still valid.

4.1 EXPECTED ESA BALANCE OF THE GOVERNMENT SECTOR IN 2018

The budget bill defines the general government deficit for 2018 on ESA basis in 2.4 per cent of GDP, which corresponds to the appropriation for 2017. According to our forecast, the accrual-based budget deficit of 2.4 per cent applicable to 2018 can be achieved, if the Country Protection Fund is not utilised[12] (Table 13).

Table 13
Balance of the government sector in 2018
(as a percentage of GDP and in HUF billion)

	Statutory appropriation		MNB forecast		Difference
	percentage of GDP	HUF billions	percentage of GDP	HUF billions	percentage of GDP
1. Balance of the central sub-sector	–3.4	–1,361	–3.9	–1,546	–0.6
2. Balance of local governments	0.5	203	0.7	256	0.2
3. Cash-based (GFS) balance of the general government (1+2)	**–2.9**	**–1,158**	**–3.3**	**–1,290**	**–0.4**
4. GFS–ESA difference	0.4	175	0.7	288	0.3
5. ESA balance of the government sector (3+4)	**–2.4**	**–983**	**–2.6**	**–1002**	**–0.1**
6. ESA balance with cancellation of central free reserves (in case of MNB forecast)	**–2.4**	**–983**	**–2.4**	**–942**	**0.0**

Note: 1. The forecast of the MNB presents the fiscal projection included in the June 2017 Inflation Report. 2. Due to rounding, certain items of the table may show differences.

The GDP-proportion deficit target of 2.4 per cent set for 2018 exceeds the central bank's deficit projection for 2017 by 0.3-0.6 percentage points, which means that fiscal impulse to boost economic growth can be expected next year as well. Within that, according to our projection the primary balance surplus of the general government will decrease in 2018 by 0.5-0.8 percentage points compared to 2017. This is offset by the fact that the general government's net interest expenditures on accrual basis are expected to decrease further by 0.2 percentage points, which is attributable to the historically low domestic interest environment, resulting from the persistently low level of the central bank base rate (Chart 2).

According to our forecast, the central sub-sector's cash-based deficit is higher, but the surplus of the local governments and the ESA corrections may be more favourable than the appropriations included in the

[11] http://www.mnb.hu/letoltes/koltsegvetesi-jelentes-2017-majus-a-2018-evi-koltsegvetesi-torvenyjavaslat-elemzese.pdf

[12] Pursuant to the Budget Act, the Country Protection Fund can be used, if with the recognition of the reserve amount to be used, the ESA deficit does not exceed 2.4 per cent of GDP.

Budget Act. According to our expectations, in 2018 the cash revenues of the central sub-sector will fall short of the appropriation by 0.9 per cent of GDP. Essentially, due to the different macroeconomic paths, we expect lower realisation in the case of revenues from value added tax, social contribution tax and personal income tax, as well as, in the case of excise duty. The shortfall in the revenues compared to the appropriation is offset by the fact that according to our projection, the effective absorption of the EU transfers may be lower than planned in the budget; thus, the savings of the EU co-financing may reach 0.3 per cent of GDP on accrual basis. In addition, our projection related to pension expenses falls short of the statutory appropriation by 0.2 per cent of GDP, which is partly attributable to the fact that contrary to the budget's GDP growth forecast of 4.3 per cent, the MNB's June Inflation Report calculates with a growth of 3.7 per cent for next year, which is accompanied by the payment of lower pension premium. In addition, in the case of the pensions payable to women after a 40-year eligibility period and the dependants' benefits, we calculate with a smaller increase in the number of beneficiaries (and presumably there is a difference in the estimated degree of the replacement effect as well). According to our expectations, as a result of the balances of the past years and the presumably large volume of EU transfers, the local government sector may realise an even higher surplus than anticipated in the Act. The different estimation of the ESA bridge, explaining the difference between the accrual-based and cash-based balances, is attributable to the structural differences in the disbursement of EU funds, as well as to the slightly different expectations related to the interest settlements.

Box 4

Main measures of the 2018 Budget Act

In 2018 the **targeted reduction of the value added tax rate** continues. In 2018 the VAT rate for internet services, restaurant catering and fish decreases to 5 per cent, and that of fresh milk to 18 per cent. According to our estimate, the downward effect on the tax burden of the measures related to value added tax may be HUF 49 billion.

The social contribution tax rate decreases by 2 percentage points to 20 per cent, and it may decline by further 0.5 percentage points if in the first nine months of 2017 the gross wage growth exceeds 11 per cent in the private sector. The **higher rate of the healthcare contribution decreases** to a similar degree, from 22 to 20 per cent. The effect of these tax cuts on the budget is close to HUF 220 billion. After the 2 per cent decrease in 2017, **the rate of small business tax is reduced further**, from 14 to 13 per cent; the impact of this on the budget is negligible. The **family allowance increases** to HUF 17,500 per child in the case of families with two children, which reduces the tax payable by roughly HUF 15 billion.

The budget appropriated in special reserves almost HUF 66 billion for the career path programmes and wage measures, while HUF 20 billion is spent from the special reserves on the wage compensation of public sector employees.

The purpose of the **Modern Cities Programme** is to foster the development and modernisation of provincial towns through infrastructural and economic stimulus investments. The appropriation has determined the cost of programme in 2018, as part of domestic capital formation budget for government investments, in the amount of HUF 150 billion, without public road developments. In addition to this, the budget spends more than HUF 250 billion in 2018 on priority **public road constructions**. Within the framework of the **Paks II project**, after the amendment, the 2018 Budget Act allocated a total amount of HUF 130 billion for the financing of the works, services and asset purchases necessary for the design, construction and deployment of the new blocks of the Paks Nuclear Plant.

Box 5

Amendments between the submission and approval of the 2018 budget bill

The Public Finance Report published in May 2017 contains the analysis of the 2018 budget bill submitted to Parliament on 2 May. Although the bill adopted on 15 June has been modified in several respects compared to the originally submitted proposal, the deficit target specified in the appropriation has not changed. This is due to the fact that the increase in the expenditures was offset by the raising of the tax revenue appropriations and the decrease of certain expenditures. Hereinafter, we present the key amendments of the submitted bill.

Compared to the submitted bill, the amendments of the appropriations approved by the National Assembly increased by an identical amount – HUF 11-11 billion – the revenue and expenditure totals of the central sub-sector of the general government. In gross terms – that is without eliminating the effect of the parallel payment flows affecting the central budget, the Pension Insurance Fund and the Health Insurance Fund – the amendments resulted in a revenue increase of HUF 89 billion, a revenue decrease of HUF 3 billion, an expenditure increase of HUF 123 billion and an expenditure decrease of HUF 37 billion.

Upon raising the expenditure estimates, the expenditures related to the investments of the **Paks II project** rose by HUF 20 billion, the **Indicative Targets for the Development of Tourism** increased by HUF 16 billion, and the budget appropriated HUF 15 billion for the set-up of the **Higher Education R&D Fund**.

The government spends by HUF 19 billion more for the improvement of the demographic situation, and particularly for **encouraging families to have children**. Within that, the largest item is the aid granted for the reduction of the housing debt liabilities of families with three or more children, for which HUF 10 billion has been appropriated. In addition, the budget supports families and the raising of children by a nursery development programme, the "Year of families" series of events in 2018, the extension of the baby bond programme, the extension of the child-care benefit period for degree-holders and by the set-up of a new family research institution, in the total amount of roughly HUF 9 billion. The establishment of the **Csoóri Sándor Fund**, and the instrument replacement programme offered to the schools of music, raises the expenditures by HUF 8 billion in total, to support the folk and classical music culture and education.

The expenses are covered from the increase in **revenue appropriations**, which is supported – on the basis of the motion for amendment – among others, by the favourable labour market figures received since the submission. Compared to the original appropriations, the revenues connected with the Pension Insurance and Health Insurance Fund improved the balance by HUF 53 billion, while the revenues from the healthcare contribution, personal income tax and corporate income tax increase it by more than HUF 14 billion. The introduction of the tourism development contribution generates surplus revenues in the amount of almost HUF 11 billion.

In the central bank's budget forecast the anticipated increase in the tax bases provides cover for the surplus expenditures. When analysing the budget bill, we found that by not spending the Country Protection Fund, the balance planned for 2018 can be achieved. For the fiscal projection included in the June 2017 Inflation Report – underlying this analysis as well – it was already possible to take account of the amendments of the budget bill and the central bank's new macroeconomic forecast. In the knowledge of the labour market data, the anticipated wage increase rose compared to the March Inflation Report, which materially increased the expected tax revenues. This change in the macroeconomic path has roughly the same effect as the approved surplus expenditures of the budget; thus, based on the bill we still deem the accrual-based budget deficit of 2.4 per cent feasible, if the Country Protection Fund is not used.

4.2 EVALUATION OF THE MACROECONOMIC PROJECTION UNDERLYING THE BUDGET

The budget – similarly to the central bank – expects the buoyant economic growth of 2017 to continue in 2018. The growth forecast for the economy in 2018, underlying the bill, is 4.3 per cent, which exceeds the projection included in the central bank's June Inflation Report and it is above the range of the economists' expectations. According to both projections, the driver of the economic growth is the domestic demand and particularly the consumption of households and fixed capital formation. In these areas, the budget expects higher growth than the central bank, while the MNB calculates with higher net exports (although due to the buoyant internal demand the trade surplus decreases in both forecasts). The anticipated development in tax revenues is largely influenced by the fact that the bill calculates with a larger increase in the gross wage bill, which originates from the expectations related to a larger increase in the number of employed.

There is also a difference in the expectations related to the change in the price level, as the budget calculates with an inflation of 3 per cent already in 2018, while according to the latest projection of the MNB the price index will reach the 3 per cent inflation target only from early 2019 in a sustainable manner.

Table 14
Comparison of the macroeconomic forecasts
(percentage change compared to the previous year)

	2017			2018		
	Budget	**MNB**	**Difference**	**Budget**	**MNB**	**Difference**
GDP	**4.1**	**3.6**	**–0.5**	**4.3**	**3.7**	**–0.6**
Consumption expenditure of households	6.1	4.4	–1.7	5.4	3.7	–1.7
Public consumption	0.8	0.5	–0.3	0.9	1.0	0.1
Gross fixed capital formation	10.2	15.8	5.6	12.9	11.1	–1.8
Exports	5.4	7.2	1.8	6.5	7.4	0.9
Imports	6.8	9.3	2.5	8.2	8.6	0.4
Inflation	**1.6**	**2.4**	**0.8**	**3.0**	**2.8**	**–0.2**
Gross wage bill	**13.2**	**12.2**	**–1.0**	**10.4**	**9.1**	**–1.3**
Gross average earning	11.0	10.0	–1.0	8.8	8.9	0.1
of which: private sector	10.2	10.0	–0.2	8.9	7.5	–1.4
Number of employed	2.5	1.9	–0.6	1.8	0.8	–1.0
of which: private sector	3.8	2.3	–1.5	2.6	1.6	–1.0

Source: Act C of 2017 on the 2018 Central Budget of Hungary, June 2017 Inflation Report of the MNB

4.3 CASH REVENUES OF THE CENTRAL SUB-SECTOR

On the whole, according to our expectations, in 2018 **the primary revenues of the central sub-sector** will fall short of the statutory appropriation by roughly HUF 350 billion in total. Our projection calculates with lower realisation than included in the statutory appropriation in the case of the value added tax, the social contribution tax, the personal income tax and the excise duty. The difference is primarily caused by the difference in the forecasts relating to the expansion in employment and consumption.

Table 15
Partially consolidated cash revenues of the central sub-sector
(HUF billion)

	2017			2018		
	Statutory appropriation	MNB forecast	Difference	Statutory appropriation	MNB forecast	Difference
TAX AND CONTRIBUTION REVENUES OF THE CENTRAL SUB-SECTOR	**13,701**	**13,501**	**–200**	**14,287**	**13,937**	**–350**
Payments by economic organisations	**1,578**	**1,522**	**–56**	**1,354**	**1,323**	**–32**
Corporate income tax	607	596	–11	370	354	–15
Special tax of financial institutions	67	65	–2	50	45	–5
Simplified entrepreneurial tax	76	67	–9	70	60	–9
Mining royalty	35	31	–4	37	31	–5
Gambling tax	31	27	–4	26	29	3
Income tax of energy companies	56	49	–7	52	52	0
Lump sum tax of small entrepreneurs	95	95	0	113	109	–4
Small enterprise tax	24	17	–6	27	19	–9
E-road toll	170	172	2	178	178	1
Utility tax	55	55	0	55	55	0
Other taxes and payments	364	349	–15	377	390	13
Advertising tax	12	–11	–23	14	19	5
Consumption taxes	**4,929**	**4,798**	**–131**	**5,266**	**5,072**	**–194**
Value added tax	3,542	3,442	–100	3,839	3,664	–175
Excise duties	1,069	1,040	–29	1,099	1,077	–22
Registration tax	24	24	0	24	24	0
Telecom tax	54	53	–1	52	53	1
Financial transaction levy	206	204	–2	205	204	–1
Insurance tax	34	35	1	35	37	2
Tourism development contribution	–	–	–	11	11	0
Payments by households	**2,139**	**2,117**	**–22**	**2,338**	**2,291**	**–46**
Personal income tax	1,909	1,884	–24	2,096	2,048	–48
Duties, other taxes	187	187	0	198	198	0
Motor vehicle tax	44	46	2	44	46	2
Tax and contribution revenues of extra-budgetary funds	**531**	**530**	**–1**	**356**	**358**	**3**
Tax and contribution revenues of social security funds	**4,524**	**4,534**	**9**	**4,973**	**4,893**	**–81**
Social contribution tax and contributions	4,218	4,213	–6	4,645	4,561	–84
Other contributions and taxes	306	321	15	329	332	3
OTHER REVENUES	**436**	**454**	**18**	**280**	**280**	**0**
Other revenues of the central budget	308	319	11	142	142	0
Other revenues of social security funds	39	39	0	38	38	0
Other revenues of extra-budgetary funds	89	96	7	100	100	0
TOTAL REVENUES	**14,137**	**13,955**	**–182**	**14,567**	**14,217**	**–350**

Note: 1. The appropriation for 2017 reflects the amended cash balance. 2. The forecast of the MNB presents the fiscal projection included in the June 2017 Inflation Report. 3. The difference between the revenue totals shown in the table and those indicated in the Budget Act is due to the fact that, based on the data available, we excluded the effect of cash transfers within the central sub-sector, and recognised certain expenditure items in net terms, i.e. reduced them by the related direct revenues. From 2018, contrary to the former practice, the EU transfer will be received in Chapter XLII – Direct revenues and expenditures of the budget, rather than in Chapter XIX – Developments financed by EU. However, to ease the comparability of the years, we indicated these revenues in accordance with the former practice in 2018 as well.

Our forecast with regard to the **payments by enterprises** falls short of the appropriation in the Budget Act by HUF 32 billion. Within that, the difference of HUF 15 billion at the corporate income tax is presumably attributable to the different perception of the resilience impact estimated in relation to the standardisation and reduction of the tax rate. Due to the different perception of the willingness to join the lump sum tax of small entrepreneurs or the small business tax scheme, the budget expects by HUF 4 billion and HUF 9 billion higher revenue at the lump sum tax of small entrepreneurs and at the small business tax, respectively, compared to the central bank's projection.

Compared to 2017 the anticipated tax revenue from the payments by enterprises decreases by HUF 197 billion, mostly due to the decrease in the revenues from **corporate income tax**. Namely, the large volume of Growth Tax Credit payment related to the tax liability of 2015 will end in 2017; thus, in 2018 the budget can no longer calculate with this revenue of roughly HUF 260 billion. (The Growth Tax Credit permits that if a company's pre-tax profit increases significantly from one year to another, the additional tax can be paid to the budget over 2 years, in 8 equal instalments.)

The volume of revenues expected from the **special tax of financial institutions** will decrease in 2018 by HUF 19 billion compared to 2017, as a result of the tax allowance introduced in relation to the support of spectacular team sports. Pursuant to the amendment of the Act on Special Tax, the taxpayers may also utilise the tax allowance related to the support of spectacular team sports, upon supporting amateur organisations and the education of juniors, in the special tax of financial institutions up to 50 per cent of the tax payable, subject to certain conditions.

Other payments by the enterprises may exceed those of 2017 by HUF 41 billion. The increment mainly originates from the fact that in 2017 the budget has refund obligation with regard to the advertising tax revenues received between 2014 and May 2017 (thus, the annual realisation is expected to be minus HUF 11 billion), while in 2018 the revenue from the advertising tax paid in accordance with the new rules is expected to be HUF 19 billion.

As regards to the **value added tax**, the 2018 budget includes an amount that exceeds our latest forecast by HUF 175 billion. More than half of the difference may be attributable to the base effect, as the submitted bill contains a revenue that exceeds the MNB's expectations by roughly HUF 100 billion this year as well. It also adds to the difference that the macroeconomic forecast relating to the budget expects a growth in the households' consumption at a higher rate. In addition, the Budget Act also calculates with higher growth in the case of investments and it presumably expects a material growth in revenues as a result of the measures aimed at the reduction of the shadow economy. Compared to this year, according to our latest projection, cash-based value added tax revenues will increase by HUF 222 billion in 2018.

The budget's **excise duty** appropriation for next year exceeds our projection by 22 billion, which is attributable to the different perception of the anticipated trends in the taxes paid on tobacco products and other excise goods. According to our projection, compared to this year the total excise duty revenue will increase by HUF 38 billion in 2018, which is mostly attributable to the higher turnover and to a smaller extent to the carry-over effect of the tax hike of 2017 applicable to tobacco products.

Our forecast related to **personal income tax** falls short of the estimate included in the approved 2018 Budget Act by HUF 48 billion. The difference stems from the different forecast of the macroeconomic paths: in our projection (in line with the Inflation Report) we calculate with a 9 per cent growth in the wage bill, serving as tax base, while the budget assumes a growth over 10 per cent. In 2018 the **family tax allowance** of families with two children will once again increase; this year's tax allowance of HUF 15,000 per dependant will increase to HUF 17,500 next year. Next year's Budget Act and the related Tax Act contain mostly administrative measures of moderate fiscal impact (cancellation of tax equalisation, technical legislative clarifications, per diem accounting), and from 2018 the conditions of property letting and the transfer of medical practice will become more favourable.

According to our forecast, in 2018 the **tax and contribution revenues of the social security funds** may fall short of the appropriation by roughly HUF 80 billion. The whole difference is linked with the revenues from the social contribution tax and the contributions of the insured arising from deviation in the forecasts related to next year's employment and gross wages. As regards to the tax and contribution revenues of the extra-budgetary funds and the other revenues of social security funds, our projection is in line with the appropriations in the approved Budget Act.

In 2018, the **social contribution tax** rate will decrease by 2 percentage points to 20 per cent, after this year's decrease of 5 percentage points. Despite the tax cut, according to our projection, the revenues from the social contribution tax and the employees' contributions may increase by 3.7 per cent compared to 2017. In parallel, the change in the tax rates also decreases the degree of the allowances available under the Job Protection Action Plan: the higher allowance for gross wage of HUF 100,000 decreases from 22 to 20 per cent, while the lower one for the same gross wage from 11 to 10 per cent. Our projection relating to the Job Protection Action Plan is in line with the expected loss of revenues of roughly HUF 100 billion, included in the Budget Act. Based on our forecast, the additional provisional decrease of 0.5 percentage points in the social contribution tax in 2018, conditional upon the 11 per cent increase in the average wage of the first three quarters of 2017 in the private sector, will not enter into force, as the anticipated increase in the wages may slightly fall short of this threshold.

4.4 CASH EXPENDITURES OF THE CENTRAL SUB-SECTOR

According to our projection, in 2018, **the cash expenditures of the central sub-sector** will fall short of the statutory appropriation by HUF 165 billion. According to our expectation, the net expenditures of the central budgetary institutions and chapters and those of the social security funds may be lower than the appropriation by HUF 90 billion and HUF 80 billion, respectively.

The budget planned HUF 236 billion in 2018 for the **housing grants**, a large part of which is the HUF 101 billion relating to the housing investments as part of the Home Purchase Subsidy (HPS) scheme for families. The budget calculates with about HUF 3 billion for the burden related to interest subsidised loans available under the HPS scheme and HUF 26 billion for the tax refund scheme. The Act allocates HUF 2 billion as contribution to the saving by the National Home-building Societies. Another substantial expenditure item is the state subsidy provided for the building society savings, the anticipated amount of which is HUF 71 billion. Our projection does not depart materially from the appropriation.

Our forecast essentially corresponds to the total expenditure appropriation of the **extra-budgetary funds**. Compared to 2017, major changes can be experienced in the cost structure of the National Employment Fund, as from 2018 the Fund no longer benefits from the social contribution tax, which represents a loss of revenue of about HUF 200 billion compared to 2017. This is partially offset by the savings of about HUF 100 billion, planned for the Start Labour Programme compared to 2017.

Table 16
Partially consolidated cash expenditures of the central sub-sector
(HUF billion)

	2017			2018		
	Statutory appropriation (amended)	MNB forecast	Difference	Statutory appropriation	MNB forecast	Difference
PRIMARY EXPENDITURE ITEMS	**14,448**	**14,377**	**–71**	**15,023**	**14,847**	**–176**
Special and normative subsidies and support to the public media	**382**	**404**	**22**	**444**	**444**	**0**
Social policy fare subsidy	**104**	**98**	**–6**	**98**	**97**	**–1**
Housing grants	**211**	**213**	**2**	**236**	**230**	**–6**
Family allowances, social benefits	**562**	**562**	**0**	**555**	**557**	**3**
Early retirement benefits	**96**	**91**	**–5**	**90**	**86**	**–4**
Net expenditures of central budgetary institutions and chapters	**5,492**	**5,622**	**129**	**5,723**	**5,633**	**–90**
Net own expenditures	4,897	4,649	–248	5,292	4,820	–473
Net expenditures related to EU funds	595	972	377	431	813	383
Support to local governments	**654**	**664**	**10**	**705**	**705**	**0**
Contribution to the EU budget	**286**	**286**	**0**	**310**	**310**	**0**
Central reserves	**441**	**198**	**–243**	**261**	**261**	**0**
Expenditures related to state property	**318**	**321**	**3**	**322**	**322**	**0**
Other expenditures	**114**	**106**	**–9**	**118**	**118**	**0**
Expenditures of extra-budgetary funds	**600**	**536**	**–64**	**553**	**554**	**1**
NEF – Passive allowances	52	49	–3	55	56	1
NEF – Active allowances	325	258	–67	225	225	0
Other expenditures	223	229	6	273	273	0
Expenditures of social security funds	**5,187**	**5,278**	**90**	**5,608**	**5,529**	**–79**
PIF – Pensions	3,152	3,158	6	3,343	3,272	–71
HIF – Disability and rehabilitation benefits	321	299	–22	309	293	–16
HIF – Cash benefits	301	313	11	352	342	–10
HIF – Medical and preventive care	1,040	1,121	82	1,204	1,204	0
HIF – Net expenditures of the drug budget	247	255	8	265	278	13
Other expenditures	127	132	5	134	140	6
NET INTEREST EXPENDITURES	**856**	**919**	**63**	**905**	**916**	**11**
TOTAL EXPENDITURES	**15,304**	**15,296**	**–8**	**15,927**	**15,763**	**–165**

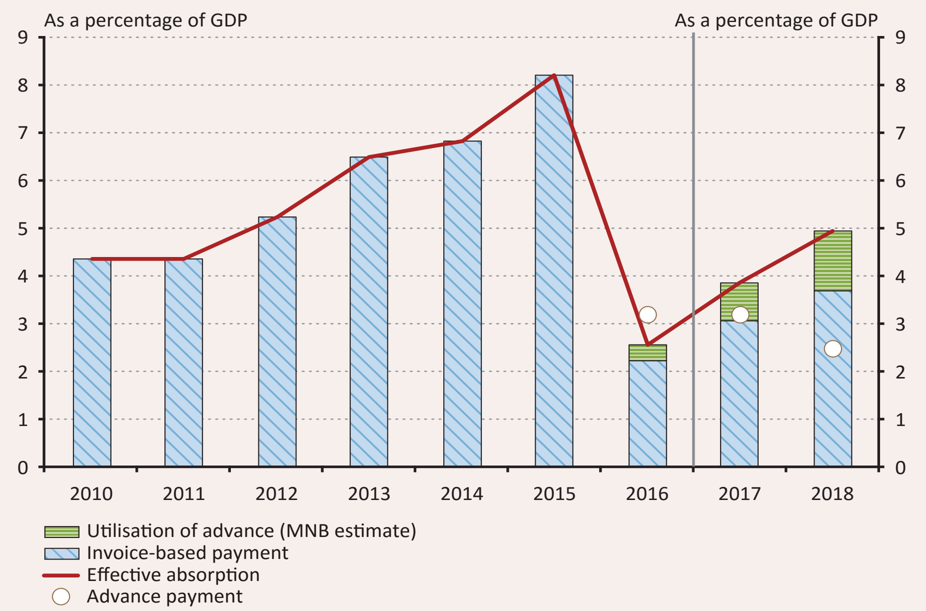
Note: 1. The appropriation for 2017 reflects the amended cash balance. 2. The forecast of the MNB presents the fiscal projection included in the June 2017 Inflation Report and assumes the full cancellation of the Country Protection Fund in 2018. 3. The difference between the expenditure totals shown in the table and those indicated in the Budget Act is due to the fact that, based on the data available, we excluded the effect of cash-transfers within the central sub-sector, and recognised certain expenditure items in net terms, i.e. reduced them by the related direct revenues. From 2018, contrary to the former practice, the EU transfer will be received in Chapter XLII – Direct revenues and expenditures of the budget, rather than in Chapter XIX – Developments financed by EU. However, to ease the comparability of the years, we indicated these revenues in accordance with the former practice in 2018 as well.

Compared to 2017 the Act contains a dynamic growth in the net expenditures – reduced by the own and the EU transfer revenues – of the **budgetary institution and chapter appropriations**; thus, according to our forecast the overrun of the appropriation will not be typical (apart from some exceptions). In addition to the tax cuts, it is primarily these budget lines where the realisation of next year's fiscal impulse can be expected (through the personnel expenditures, investments and capital transfers). Nevertheless, we expect lower effective absorption of the EU funds by the budgetary institutions and chapters in 2018, than the appropriation. The reason for the difference is that according to our forecast, the absorption of the EU advances transferred to the organisations in 2016-2017 will not be concentrated in 2018, but it will pass through to the years after as well. The amount of the EU transfers absorbed by the budgetary institutions and chapters may fall short of the appropriation by about HUF 400 billion.[13]

The 2018 Budget Act contains HUF 2,418 billion – supplemented with the domestic co-financing – on the line indicating the **expenditures of EU programmes[14]** (the appropriation for 2017 is HUF 2,239 billion). According to the Act, next year HUF 2,230 billion will be paid within the Széchenyi 2020 programme, while the remaining HUF 188 billion relates to other EU transfers. The corresponding cash revenues amount to HUF 1,987 billion in the approved Act, which appropriates a net expenditure of HUF 431 billion. This partly reflects the amount of domestic co-financing, as well as non-eligible items financed by the domestic budget. According to our expectations, next year the statutory appropriation for the disbursement of EU funds may be realised, but we calculate with lower, i.e. about HUF 1,600 billion, **cash revenues from the EU transfers**. The derogation from the revenue appropriation is due to the fact that our forecast calculates with substantial advance payment and at the same time with slower absorption of the advances paid earlier, which results in lower ESA and cash-based revenue.

Pursuant to the foregoing, on the net expenditures relating to EU transfer and the net own expenditures of budgetary institutions line, there are two deviations from the appropriation with opposite sign, which are related to and offset each other. The smaller net expenditures of the budgetary institutions are due to the fact that we estimate the degree of the absorption of the EU transfers disbursed to them in the past. The other side of the coin is that for this very reason the volume of EU transfers received is also smaller, as those are disbursed by the EU after the effective absorption of the transfers. Our forecast relating to EU expenditures and revenues is surrounded by major uncertainties.

Chart 19
Developments in the absorption of EU transfers in 2010-2018



Note: From 2010 to 2015, we represented all payments as invoice-based payment in the absence of detailed information.
Source: Hungarian State Treasury, Prime Minister's Office, MNB projection 2017-2018.

[13] These expenditures are related to the effective absorption of the EU transfers, irrespective of the date when the budgetary institution or chapter received it as an advance.

[14] Subsidies paid to budgetary institutions, local governments or private sector actors, related to EU programmes, including also the advances. Obviously, the transfer of the advances appears at the other party as revenue, which may improve the balance of the budgetary institutions or local governments. The absorption of the advance originates expenditures in the future, but it is accounted for not on this budget line, but among the expenditures of the given institution or local government.

Our projection for the **pension expenditures** falls short of the statutory appropriation by HUF 71 billion; this difference is the combined effect of three factors pointing to the same direction. Our expectation related to the *old-age pension* falls short of the statutory appropriation by HUF 36 billion. This is primarily due to the fact that contrary to the budget's GDP growth forecast of 4.3 per cent, the MNB expects a growth of 3.7 per cent for next year, as a result of which the pension premium declines by roughly HUF 20 billion.

Our forecast also falls short of the appropriation *in the pensions due to women after a 40-year eligibility period*: compared to the expenditure of HUF 260 billion included in the Act, our estimate is lower by HUF 20 billion, which may be attributable to the difference in the headcount forecasts. Our projection is based on a gradual increase in the number of women choosing early retirement; thus, compared to our expectation for 2017, it assumes expenditures higher by HUF 25 billion and a 6 per cent higher number of beneficiaries.

Our more moderate expectations in respect of the *provisions for dependants* represents a further difference of HUF 15 billion. Assuming a decrease in the number of beneficiaries and an inflation rate of 3 per cent, we expect a constant expenditure level, while the budget projects an increase of HUF 15 billion in expenditures compared to the anticipated 2017 expenditure level.

As regards to the **disability and rehabilitation benefits** we expect the payments to fall short of the appropriation by HUF 16 billion. The 2016 realisation fell behind the fiscal expectations, in light of which both the 2017 expected expenditure level and the 2018 appropriation may be deemed high. Our forecast, based on the fall in the expenditure level observed in recent years, assumes a decrease in the number of beneficiaries.

Our projection relating to the **cash benefits** of the National Health Insurance Fund is below the statutory appropriation by HUF 10 billion. A substantial part of the difference appears at the sick benefits, where we expect by HUF 5 billion lower realisation.

In case of the **medical and preventive care** the expenditure planned for 2018 exceeds the 2017 appropriation by HUF 164 billion, representing an increment of almost 16 per cent. This is primarily due to the fact that in 2017 the 2017 part of the wage increase in the health sector was included in the special reserve appropriation available in the central budget, of which HUF 82 billion was reallocated to the Health Insurance Fund in the beginning of the year.

According to our expectations, within expenditures related to benefits in kind, the **net balance of the drug budget** may exceed the estimate included in the budget by HUF 19 billion. Within this, we anticipate the drug reimbursements to be exceeded by HUF 16 billion. In 2016, on the expenditure side of the drug budget the appropriation had to be raised by HUF 41 billion at year-end and a similar requirement may arise in 2018 as well. Our forecast calculates with a gradual increase in expenses in order to maintain the service quality, also bearing in mind the impact of ageing on expenditures.

Our forecast related to the **net cash interest expenditure** essentially corresponds to the appropriation included in the Budget Act. Based on the appropriation and also on our projection, the decrease in interest expenditures continues year by year, which will continue in the coming years as well due to the gradual repricing of the debt to low yields. According to our forecast, based on the figures of previous year, the gross interest expenditures and interest revenues may exceed the appropriation in 2018 as well.

Our **net accrual-based interest expenditure** projection also corresponds to the value stated in the Budget Act, that is, the repricing of the debt to the low yield level may continue and the rate of this is assessed by both forecasts positively: GDP-proportionate ESA interest expenditure may decrease to 2.4 per cent, approaching the EU average.

4.5 BALANCE OF LOCAL GOVERNMENTS

The **appropriation for the balance of the local governments** includes a surplus of HUF 203 billion. During the planning stage, the government assumed that the revenues of the sub-sector would increase by 7 per cent in total compared to the 2017 budget figures, while the expenditures of the sub-sector decrease by 1 per cent compared to the 2017 budget figures. According to our expectations, within the expenditures the growth rate of personnel benefits will be moderate, and the capital expenditure of the sub-sector will decrease. The central bank's forecast assumes the development of a more favourable balance, by about HUF 50 billion, as we calculate with lower growth rate at the absorption of EU funding by the sub-sector than the budget figures.

4.6 STATISTICAL CORRECTIONS (ESA BRIDGE)

In the course of planning the Budget Act, the difference of the **cash-based and accrual-based balances** (ESA bridge) was budgeted at 0.4 per cent of GDP, i.e. the statistical corrections performed in line with the EU methodology to improve the cash balance approved in the Budget Act by 0.4 per cent of GDP. When preparing our forecast, we set out from statistical corrections prepared for the Budget Act, which we adjust for the central bank's interest projection and the different estimate relating to the transactions of the EU funds. As a result of the adjustments, according to our forecast, the total amount of the accrual-based adjustments may be more favourable than that assumed upon the compilation of the budget bill by HUF 113 billion (0.3 percentage points of GDP). Approximately HUF 25 billion of the difference is caused by the deviation in the accrual-based interest settlements, we calculated with a HUF 7 billion higher correction at the financial transactions and at the statistical corrections of the EU settlements our projection contains an adjustment that is more favourable by 70 billion. The higher statistical correction is the result of the fact that we estimate the advance paid by the budget to the private sector and the public corporations not allocated to the government sector to be higher. No cash-based revenue is linked with this in the budget in the current year, but it can be recognised as accrued revenue.

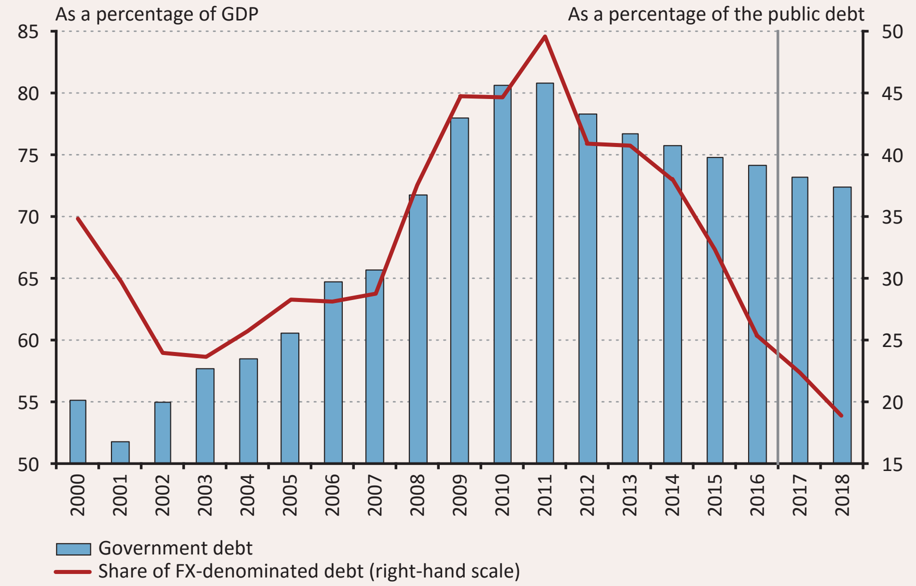
4.7 EXPECTED DEVELOPMENTS IN PUBLIC DEBT IN 2018

Using the end-2016 exchange rate of EUR/HUF 311.0, **the gross general government debt-to-GDP ratio according to the EDP methodology** is forecast to decline from 74.1 per cent at end-2016 to around 73.2 per cent in 2017 and then to decrease further to 72.3 per cent by end-2018. The substantial, i.e. almost 1 percentage point, annual decrease in the debt ratio is supported both by the low budget deficit and the dynamic economic growth. Due to the low yield environment and the fall in government debt ratio, interest expenditures decrease year by year, providing the budget with increasing room for manoeuvre.

The substantial surplus of local governments represents a positive risk for the developments in the Maastricht public debt. The balance of the local governments may record a surplus in 2018 as well, which is attributable, in addition to the favourable underlying processes, to the EU advances granted by the central budget. As in the previous year, based on the actual figures received to date, it can be observed that the local governments invested part of their free funds generated by their underlying processes in government securities. This government securities holding reduces the Maastricht debt, as during the calculation thereof this holding must be consolidated. In the baseline scenario we ignore this effect, as it is the competence of the local governments to decide how they manage their liquid monetary assets; thus, the amount of their end-2018 government securities holding is uncertain.

As a result of negative net foreign currency issuance, the share of foreign currency within government debt is expected to continue to decline, contributing to a decrease in the external vulnerability of the economy. According to our forecast, the foreign currency ratio of the central government's debt will decrease below 20 per cent by end-2018 from 25 per cent recorded at end-2016.

Chart 20
Developments in gross government debt



Note: The projection for 2017 and 2018 is identical to that prepared for the MNB's 2017 June Inflation Report, calculated at a constant exchange rate from the end of 2016.

Source: MNB, Government Debt Management Agency.

5 Compliance with the fiscal rules

Between 2016 and 2018 the Hungarian budget management is governed by eight fiscal rules, four of which are included in the Hungarian legislation and four in the European Union's fiscal framework. Two of the Hungarian rules are specific to the Hungarian legislation; these are the debt rule of the Fundamental Law and the debt formula of the Stability Act. In two cases, there is an overlap between the Hungarian and the EU rules, applicable to the Maastricht debt criterion and the medium-term budgetary objective. Further two rules are specific to the EU, these are the Maastricht debt rule and the expenditure rule.

The Hungarian budget complied with the national and EU fiscal regulations applicable to the general government ESA balance and the debt ratio in 2016 and it is expected to comply with those in the coming years as well. According to the MNB's expectations, the Maastricht deficit target of 3 per cent, included both in the Hungarian and the EU rules, will be met every year. The annual decrease in the government debt is also in line with the debt rule of the Fundamental Law, the debt formula of the Stability Act and with the EU Maastricht debt rule. Compliance with the EU's deficit and debt rules is extremely important, as non-compliance may entail the launch of the excessive deficit procedure (EDP). The structural balance of the budget complied with the medium-term budgetary objective (MTO) and with the provisions of the related expenditure rules in 2016, while the 2017 and 2018 balance is unlikely to satisfy these criteria (however, these cannot entail an excessive deficit procedure).

Pursuant to the **debt rule** specified in the Fundamental Law, until such time as the government debt exceeds half of the gross domestic product, the National Assembly may only adopt such Act on the central budget – save extraordinary situations – that contains the reduction of the government debt ratio to GDP, and no such borrowing is permitted as a result of which the debt ratio increases compared to the previous year. [15] The calculation of the ratio is defined by the Stability Act, according to which upon calculating the public debt, it is not necessary to take into consideration the revaluation effect arising from the exchange rate movements and the obligations arising from the time needed for the subsequent refund of the EU transfers. [16]

Based on the information provided by the Ministry of National Economy to the Fiscal Council, the nominal gross public debt adjusted on the basis of the Stability Act was HUF 24,950 billion on 31 December 2015, representing 73.4 per cent of GDP in the reporting year. The end-2016 debt rose to HUF 25,621 billion in nominal terms; however, GDP growth exceeded the debt growth, thus the GDP-proportionate debt ratio decreased to 73.2 per cent, and as such the realisation of the 2016 budget complied with the debt rule of the Fundamental Law.

According to the forecast of the Ministry of National Economy, submitted to the Fiscal Council, in 2017 the debt ratio may fall from 73.2 per cent of last year to 71.4 per cent by the end of this year, that is, the decline continues to comply with the requirements of the debt rule. Based on approved Budget Act, in 2018 the debt ratio will decline further to 69.5 per cent; thus, the rule is expected to be satisfied.

Looking ahead, according to the MNB's forecast the debt ratio will decrease both in 2017 and 2018, hence the debt rule will be met. The central bank prepares detailed forecast for the Maastricht debt, which slightly differs, in terms of methodology, from the debt defined in the Stability Act, but the annual change in the two indicators is very similar. According to our forecast, in 2017 the debt ratio may fall by 0.9 percentage points under a deficit of 1.8-2.1 per cent and a 3.6 per cent GDP growth. In 2018, with the cancellation of the Country Protection Fund, the deficit may become 2.4 per cent, which may once again lead to 0.9 per cent decrease in

[15] Article 36(4)–(5) of the Fundamental Law.

[16] Act CXCIV of 2011 on the Economic Stability of Hungary, Article 6 (1)-(2b).

debt under a 3.7 per cent GDP growth. Accordingly, the decline in the debt ratio is attainable even upon the materialisation of certain risks and under less favourable economic conditions.

The other rule applicable to the debt, i.e. the **debt formula** of the Stability Act, stipulates that if the rates of inflation and real economic growth forecast for the fiscal year both exceed 3 per cent, the balance of the budget should be planned in a way that the annual growth rate of nominal debt must not exceed the rate of the difference between the planned inflation and half of the growth rate. If at least one of the two ratios is lower than 3 per cent, the debt formula prescribes a decrease in the debt ratio of merely 0.1 percentage point.

In 2016 the real economy growth rate and the annual average inflation were both below 3 per cent; thus, the debt formula required the debt ratio to be decreased only by 0.1 percentage point, which was fulfilled according to the actual data. Although, according to the MNB's forecast, the economic growth rate will exceed 3 per cent in 2017 and 2018, the inflation will be lower than that; thus, in order to satisfy the debt formula the debt will have to be reduced by merely 0.1 percentage point in both years, which is expected to be satisfied in the manner described above.

The **deficit criterion**, also specified in Hungarian laws[17], prescribes that the general government ESA deficit must not exceed 3 per cent of GDP. In 2016 the general government deficit became 1.8 per cent of GDP, while in 2017, according to the MNB's forecast and depending on the use of the reserves, it may be around 1.8-2.1 per cent of GDP, and in 2018 around 2.4-2.6 per cent of GDP, that is, the budget satisfies the deficit rule in all three years. The official deficit target of 2.4-2.4 per cent as a per cent of GDP, set in the 2017-2018 Budget Acts is also in line with the criterion.

Pursuant to the requirement of the Stability Act, the structural balance of the budget must comply with the attainment of the **medium-term budgetary objective** (MTO).[18] The structural balance is the cyclically adjusted balance net of the one-off and temporary items.

In agreement with the European Commission, the medium-term budgetary objective for Hungary represents a structural balance of -1.7 per cent in 2016 and -1.5 per cent from 2017. Based on the latest, 2017 Convergence Programme, the structural deficit of the Hungarian budget stood at 1.6 per cent of GDP, hence it complies with the medium-term budgetary objective rule. According to the Budget Act, in 2017 and 2018 the structural balance may be -2.5 and -2.4 per cent of GDP, which does not satisfy the specified objective.

The Hungarian general government budget management is subject to four EU rules. According to the **Maastricht deficit target**, belonging to the corrective arm of the European Union's fiscal framework, the accrual-based ESA deficit of the general government may not exceed 3 per cent of GDP. Last year the budget deficit was 1.8 per cent of GDP, while according to the MNB's forecast, this year it may be around 1.8-2.1 per cent and next year around 2.4-2.6 per cent of GDP; hence, the budget satisfies the deficit criterion in all three years.

The **debt rule**, belonging to the corrective arm of the EU fiscal framework, prescribes that the Maastricht debt of the given Member State must not exceed 60 per cent of GDP, or if it does, the debt must be reduced at a satisfactory rate.[19] The rate of the reduction is defined by the "one-twentieth" rule: the EU calculates the degree of the change in the debt using three methodologies (forward-looking, retrospective, cyclical) and if based on at least one of those, the debt ratio has decreased by one twentieth of the part that exceeds 60 per cent on the average of 3 years, the rule is deemed fulfilled.

The gross Hungarian government debt exceeds 60 per cent of GDP in all three years; however, according to the MNB's forecast, the rate of decrease satisfies the EU debt rule in each year. According to the 2016 actual data,

[17] Section 3/A(2b) of Act CXCIV of 2011 on the Economic Stability of Hungary

[18] Section 3/A(2a) of Act CXCIV of 2011 on the Economic Stability of Hungary

[19] Gross, consolidated debt, calculated at face value, which contains – contrary to the definition included in the Stability Act – the debt increment arising from the subsequent recovery of the EU funds, as well as the impacts of the exchange rate movements.

the Maastricht debt ratio decreased by 0.7 percentage points to 74.1 per cent year on year. According to the MNB's forecast, this year and in 2018 may decrease, after further declines of 0.9 percentage points, close to 72 per cent of GDP, which satisfies the one-twentieth rule. According to the European Commission's forecast, Hungary's Maastricht government debt ratio may fall even faster, i.e. by 1.5 and 1.4 percentage points in 2017 and 2018, respectively, declining to 71.2 per cent of GDP by end-2018. [20]

The requirements of the preventive arm of the EU rules represent the rule applicable to the **medium-term budgetary objective**, or upon non-compliance with the MTO rule, the expenditure rule. In agreement with the European Commission, Hungary specified as medium-term budgetary objective a structural deficit of 1.7 per cent for 2016 and 1.5 per cent for the years after. If the balance does not reach the objective, as a general rule, next year it must be approximated by 0.5 per cent of GDP (the annual rate of the approximation prescribed in the corrective path may change, which is affected by various circumstances).

According to the calculations of the European Commission, the Hungarian structural balance showed a deficit of 1.9 per cent in 2016, which slightly exceeds the target; thus, it failed to meet the medium-term budgetary objective in full; however, the difference is smaller than the GDP-proportionate tolerance band of 0.25 percentage points; thus, in the Commission's opinion the 2016 structural balance complies with the attainment of MTO. [21] Based on the Commission's forecast, the Hungarian structural balance in 2017, as a per cent of GDP, may be -3.4 per cent, which does not comply with the MTO, and in all probability the balance improvement of 0.3 percentage points, specified in the corrective path set by the Commission, will not be satisfied either. In 2018 the general government structural deficit may be 3.7 per cent, which exceeds the medium-term budgetary objective, and the expected structural balance will also fall short of the GDP-proportionate improvement of 1 per cent, prescribed by the European Commission, based on the corrective path necessary for attaining the MTO.

The **expenditure rule** of the preventive arm enters into force when the budget path of a Member State does not comply with the requirement related to the medium-term budgetary objective. In this case, in order to attain the medium-term objective, the expenditure rule prescribes that the fiscal expenditures of the given Member State may not increase by more than the growth in potential output in the given year, unless it is the discretionary revenue measures provide cover for the surplus expenditures. In the opinion of the European Commission, the Hungarian fiscal expenditures rose at a faster rate in all three years than the rate prescribed by the rule, hence the budget does not comply with the expenditure rule in the years under review. [22]

The breach of the rules belonging to the preventive arm of the EU rules does not entail the launch of EDP. Although in 2017 and 2018 Hungary in all likelihood will satisfy neither the medium-term budgetary objective, nor the expenditure rule of the European Union, upon the breach of these criteria the European Commission may not launch an excessive deficit procedure; however, it may make proposals in the form of country-specific recommendations with a view to future compliance.

[20] European Commission: Assessment of the 2017 Convergence Programme for Hungary, Brussels, 23 May 2017, page 12
[21] European Commission: Assessment of the 2017 Convergence Programme for Hungary, Brussels, 23 May 2017, page 16
[22] European Commission: Assessment of the 2017 Convergence Programme for Hungary, Brussels, 23 May 2017, page 19

6 Special topics

6.1 MAIN REASONS FOR THE ANNUAL CHANGE IN THE HUNGARIAN GROSS GOVERNMENT DEBT RATIO BETWEEN 2016 AND 2018

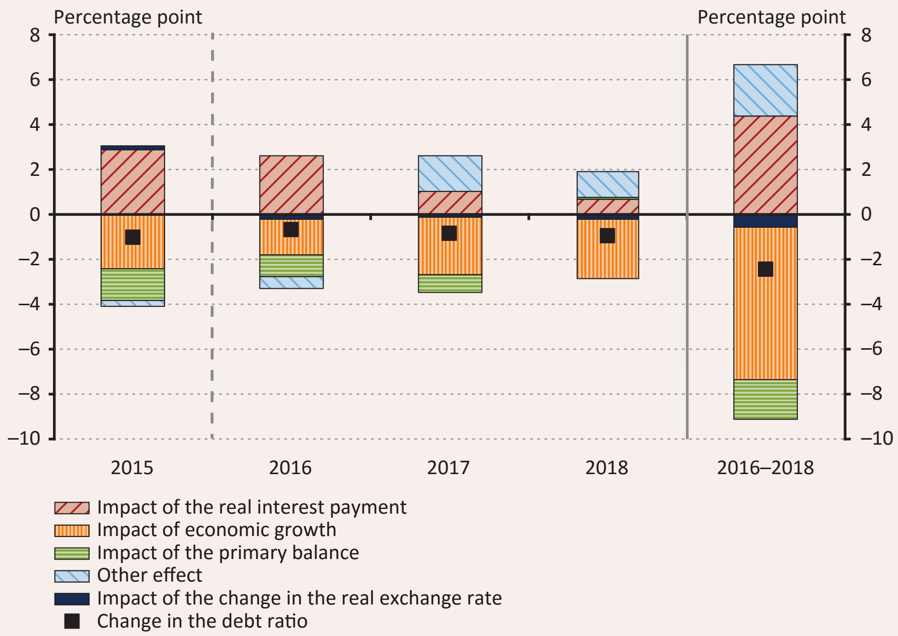
Between 2016 and 2018, according to our forecast the GDP-proportionate government debt ratio will fall by 2.4 percentage points. Below we present the factors influencing the change in the government debt ratio and the degree of such influence. On the whole, it can be stated that the underlying processes project a dynamically decreasing debt ratio; however, the degree of the decrease are materially reduced by idiosyncratic factors (mostly the advancing of the EU transfers). Based on our projection, the value of the ratio may fall materially, almost by 1 percentage point per annum, assuming a constant HUF/EUR exchange rate of end-2016.

The decline in the GDP-proportionate gross government debt is primarily supported by the high real growth and surplus in the primary general government balance. On the forecast horizon, we expect the Hungarian economy to grow at an accelerating rate, which materially reduces the value of the rate through the denominator. In addition to the dynamic economic growth, similarly to last year, the primary balance of the budget may record a surplus, which also contributes to the debt reduction. According to our projection, in 2018 the primary balance may be around zero, hence it has no material effect on public debt in that year.

As a result of the low level interest rates, due to the gradual repricing of the debt, the GDP-proportionate value of interest expenses decrease year by year. In the forint government securities market, the lower interest rates may persist in the coming years, as a result of which the ratio of the relatively high-interest debt components will gradually decrease. As a result of this, the nominal forint implied interest rate further declines on the forecast horizon. In addition, the inflation rate in all likelihood will come close to the central bank target, by rising on average to 2.4 per cent this year, and to 2.8 per cent next year, according to the forecast included in the June Inflation Report. The two factors together result in a substantial decrease in the implicit forint real interest in 2017 and 2018.

The advancing of the EU transfers by the budget, temporarily reduces the rate of decrease in the debt ratio, but in the future the return on the transfers will accelerate the debt reduction. The planned disbursement of the EU transfers is of large magnitude both in 2017 and 2018, which, according to our projection, may be mostly advance payments. The European Commission reimburses these transfers to the Hungarian budget, when the advances have been absorbed. The advancing has no impact on the accrual-based balance of the budget, but it increases the cash-based deficit and, as a result of this, the government debt ratio. The debt-increasing effect is mitigated by the fact that part of the advances is transferred to budgetary institutions, and thus it does not increase the cash-based deficit of the central budget, the future return on the EU advances will provide substantial support for the reduction of the debt ratio. On the whole, the advance payment influences only the time profile of the change in the debt, but not the trend thereof.

Chart 21
Decomposition of the annual change in the Hungarian gross government debt ratio between 2015 and 2018



Source: MNB.

6.2 ESTIMATION OF THE EFFECTS OF THE CUT IN THE SOCIAL CONTRIBUTION TAX RATE USING THE MICRO-SIMULATION MODEL

Below we present the estimated macroeconomic and budget balance effect of the reduction of the social contribution tax rate this year and next year, relying on the micro-simulation model framework based on the HCSO's data survey related to household budgets and living circumstances. The model calculates the measures' immediate (static) and long-term (dynamic) fiscal impacts, compared to the situation without the measures, through the series of iterations between the labour supply created by a micro-simulation based on the detailed household statistics and the general equilibrium reaction described by a macro model.

According to our estimation, through the long-term processes, the reduction of the social contribution tax rate in 2017 may increase employment by 0.6 per cent and GDP also by 0.6 per cent, as a result of which more than half of the tax easing may be recovered for the budget. The increasing personal income tax and employees' contribution payments, resulting from the measure's positive economic stimulus effect, and the consumption tax revenues, mitigate the measure's static fiscal impact.

The **tax measures taken into consideration** include the gradual reduction of the social contribution tax rate, together with the amendment of the rate of the allowances available under the Job Protection Action Plan (JPAP)[23] in two steps: first from 27 to 22 per cent, and then from 22 to 20 per cent. Table 14 contains the partial fiscal impacts of the tax changes as a per cent of GDP, where negative values indicate deficit increasing impacts, while positive values indicate balance improving effects.

[23] We differentiate allowances of two rates: the allowance applicable to the upper rate provide a social contribution tax allowance up to HUF 100,000 formerly at a rate of 27 per cent, from 2017 at 22 per cent and from 2018 at 20 per cent, for the given group, which includes employees below the age of 25, long-term unemployed, women returning from maternity leave (child-care allowance, child-care benefit) in the first two years of employment. The other form of the allowance, up to the same gross wage, formerly provided an exemption of 14.5 per cent, and from 2017 of up to 50 per cent of the prevailing rate, to those below the age of 25, the long-term unemployed and women returning from maternity leave from the second year, and to those over the age of 55, as well as unskilled and agricultural workers.

A substantial part of the decrease in fiscal revenues resulting from the tax easing will be recovered in the long run through the fiscal stimulus effects. The immediate balance deteriorating effect is offset by several factors, which we decompose into three channels. On the one hand, households use a large part of the surplus income resulting from the tax cut for consumption, in respect of which they pay value added tax and other consumption taxes (this may also be regarded as immediate effect). On the other hand, the reduction of the taxes increases the labour supply, since as a result of the higher net wage employment will be more appealing. The employees responding to the measure put the disposable income available after the tax change before part of their leisure time; thus, they will increase their volume of labour until such point as the choice between the income that may be earned by additional working hours and the usefulness of leisure time once again becomes neutral. Finally, the investment activity and labour demand may also increase, if their wage costs decrease. The larger economic activity arising from these increases tax and contribution revenues.

Table 17
Fiscal impact of the tax measures
(as a per cent of GDP)

	2017		2018	
	22% social contribution + JPAP		20% social contribution + JPAP	
	static	dynamic	static	dynamic
Macroeconomic effects	**as a percentage of GDP**		**as a percentage of GDP**	
Effective labour supply		0.7		0.3
Employment		0.6		0.2
Capital stock		0.3		0.2
GDP		0.6		0.3
Gross average wage adjusted for productivity		3.6		1.5
Disposable income		2.8		1.2
Fiscal impacts				
Personal income tax	0.0	0.2	0.0	0.1
Employees’ social contributions	0.0	0.3	0.0	0.1
Employer’s social contributions	–1.6	–1.2	–0.6	–0.5
Consumption taxes	0.0	0.2	0.0	0.1
Taxes on capital	0.0	0.0	0.0	0.0
Total	**–1.6**	**–0.6**	**–0.6**	**–0.2**

Note: At 2015 prices.

More than half of the reduction of the social contribution tax in 2017 may recover for the budget in the long run. According to our estimate, as a result of the tax cut the employers’ tax payments will decline in the short run at 1.6 per cent of GDP, while in the longer run the decline will be merely 0.6 per cent of GDP, as result of the fiscal stimulus effects. Initially, the allowance is received by the employers; however, in the long-run equilibrium the wage bargains will result in the sharing of the tax cut between employers and employees, which will enhance the investment and employment intentions of the first and the gross wage, and through that the consumption, of the latter.

According to our estimate, through the long-term processes, the reduction of the social contribution tax rate in 2017 may increase both the employment and the GDP by 0.6 per cent. As a result of these, the growth in the personal income tax and employees’ contribution payments improve the balance by 0.2 and 0.3 per cent of GDP, respectively, while through the consumption of part of the disposable surplus incomes the revenues from consumption taxes may rise by 0.2 per cent of GDP. The impacts of the measures of 2018 are proportionately similar to this.

It should be noted that as result of the limitations of the model, the simulation ignores the short-term frictional imperfection of job seeking and job finding, as well as the minimum wage.

6.3 FISCAL PROCESSES OF THE LOCAL GOVERNMENT SECTOR

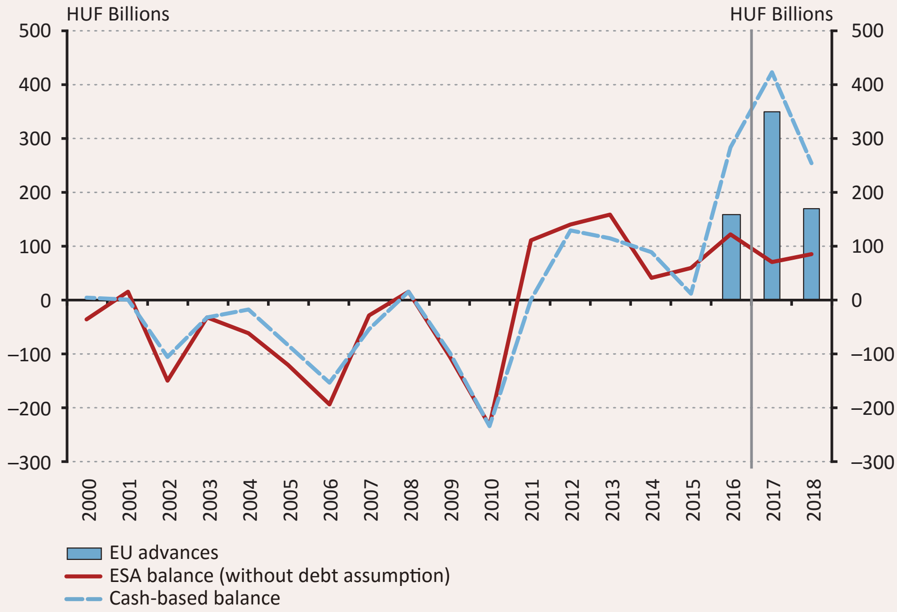
According to the April 2017 EDP report, the local government sector's accrual-based balance rose from HUF 60 billion of 2015 to HUF 122 billion in 2016. The change in the cash balance, relevant for the sub-sector's borrowing requirement, shows an even more distinct change: the sub-sector's cash balance surplus rose from HUF 13 billion recorded in 2015 to HUF 285 billion by 2016. The extremely large difference between the accrual-based and the cash-based balances is attributable to the different recognition of the EU transfers received by the local governments. While in the cash statistics this is stated as revenue, in the accrual approach this is ignored and it is recognised as revenue only when expenditure (e.g. investment) for the cover of which the local government applied for the transfer, is incurred. Due to the fact that the receipt of the subsidy (local government revenue) and the absorption thereof (local government expenditure) occurs at different times, the cash balance strongly fluctuates between the years. By contrast, the ESA balance is more stable, as it recognises the revenue and the expenditure at the same time.

The development of the local governments' extremely favourable accrual-based balance in 2016 was attributable to the decrease in expenditures along with keeping the revenues at a steady GDP-proportionate level. The decrease was primarily recorded in the investment spending and capital expenditures, but formerly a substantial part of these were financed from EU transfers, hence they had lesser effect on the balance. Material expenses, cash transfers for operating purposes and social policy and welfare benefits also decreased, due to the restructuring of the institutional system and the changes in the labour market situation. Of the expenditure reducing measures the decrease in consumption expenditures as a per cent of GDP may have a lasting effect (the recent centralisation of the public education institutions and the public administration duties represented cost-saving for several local governments). Capital expenditures are expected to increase in the coming years, but the EU funds may cover a good part of the expansion, while in the framework of the Modern Cities Programme local governments may have access to more resource form the central budget as well.

Based on our projection prepared for the June Inflation Report, the local governments' substantial surplus may persist in the coming years as well. According to our forecast, the cash-based revenue surplus of HUF 285 billion realised last year may rise to HUF 420 billion in 2017, and this surplus may exceed HUF 250 billion even in 2018, that is, the balance of the sub-sector may be by HUF 50 billion more favourable than assumed in the 2018 Budget Act. The cash balance surplus which exceeds that assumed in the budget is partly attributable to the larger amount of EU advance payments disbursed to the sub-sector, and partly we assume that the absorption of the accumulating EU advances will accelerate only gradually. This latter assumption is based on the fact that in 2016 a lower base developed for the absorption of the EU capital transfers and this is particularly valid for local governments.[24]

[24] According to our forecast, the absorption of the advances granted for EU programmes will further accelerate at the local governments in 2019, and the cash balance of the sub-sector may return to the low balance surplus level of 2015.

Chart 22
Balance of the local governments



Source: HCSO, Hungarian State Treasury, MNB.

The local governments may use the surplus stemming from the underlying processes for the purchase of government securities. The change in the financial wealth of the sub-sector is particularly important for the development in the consolidated government debt, due to its impact exerted on the financing structure of the public debt. The consolidated public debt does not include the debt held by the local governments, as these securities can be interpreted as the general government's receivables from itself. During last year, the ESA balance net of the EU advances showed a surplus of HUF 123 billion, which may have made a major contribution to the fact that the government securities holding of the sub-sector rose to HUF 140 billion by the end of last year. Due to the surplus of HUF 183 billion recorded in the first quarter of this year, the local governments' government securities holding increased further, exceeding HUF 300 billion by the end of March. About 90 per cent of the securities held by the institutions have maturity of less than 1 year.

6.4 ACCOUNTING FOR THE EU TRANSFERS IN THE BUDGET

The disbursement of EU funds – partially as advances – and the gradual absorption of those have a material effect on the fiscal processes between 2016 and 2018. It complicates the monitoring of the underlying processes that the budget simultaneously acts as the intermediary and user of the EU transfers, it recognises not only expenditures but also revenues, the cash-based and accrual-based data differ, and the ratio of advance payments is high. Of the aforementioned factors, it is the advance payment that represents a major difference compared to the practice of previous years.

Recognition in the cash-based balance

The budget is partially the final user of the EU transfers, but partially EU transfers only flow through the Budget. The transfers from the European Union's structural and cohesion funds are formally distributed through the central budget. The received transfers appear as revenues of the central budget, and thereafter also as expenditure, irrespective of the final beneficiary, which can be allocated to three groups in fiscal terms: (i) central budgetary institutions and chapters, (ii) local governments or (iii) non-governmental organisations (private sector and non-profit sector).

The principle of EU transfers is that the member state and the final beneficiary should also be involved in the costs. The EU basically pays 85 per cent of the costs of the beneficiary projects, with the remaining 15 per cent coming from the beneficiaries' own resources or budgetary resources. The latter increases the general government deficit, but in some years the difference can be considerably higher due to the timing of payments and reimbursements. At the level of the individual programmes the own contribution (for instance due to the state subsidy rules or the various non-eligible costs), exceeds 15 per cent, so the average is around 25 per cent. The European Commission annually transfers a small part of the financial support to member countries in advance (in the form of an annual advance), against which withholds a small part of the reimbursement of interim payments (10 per cent) and reimburses it only after 1 year when the program-level annual financial audit procedure is closed.

On the revenue side of the budget only the EU funds already transferred by the EU can be recognised. The European Commission transfers annually a small part of the funds in advance to the Member States, but it pays most of the funds only after the submission of the invoices related to the absorption. The funds are received on a separate account rather than directly to the budget, from which they are transferred to the budget's revenues as individual transactions. The invoice-based accounting method is that after the final beneficiary has submitted the invoice, the budget pays it then from previous transfers from the Union the budget records as revenue the EU part of the support. Subsequently, the supporting documents for eligible items will be sent to the EU, which will be reimbursed after the audits (in a separate account) and will provide funds for the next disbursements. However, even this procedure did not limit the resulting cash-based deficit in full, because it did happen occasionally that the EU reimbursed the budget for the subsidies with delay, which increased the cash-based deficit.

The advance payments disbursed to beneficiaries **substantially modified the effect on the cash balance.** From 2016 the practice of subsidy payments has changed. Although it did happen before as well that the budget transferred large parts of the subsidies as advance to the final beneficiaries, i.e. before the submission of the invoices or even before the commencement of the implementation of the project, this practice became common in 2016. However, it is a new phenomenon that while earlier these advances were directed outside the general government, now the general government institutions also benefit from this type of advances (we may refer to these as *primary disbursement)*. Compared to this, the implementation of the supported project and hence the effective absorption of the subsidy may drag on for years (for the sake of differentiation we refer to this in our analysis as *effective absorption*). However, the European Union continues to reimburse only the submitted invoices (apart from the small advances). Accordingly, no revenue is linked in the budget with the advance payments, as expenditures, hence they may substantially increase the cash-based deficit (as it was observed in the first half of 2017). [25]

The effect of the advance payments on the cash balance depends on the final beneficiary. The advance payment is to be recognised (correspondently with the payment against invoice) as the expenditure of the central budget, hence on its own it increases the cash-based deficit. However, the actual effect depends on the entity that the advance is to be paid to.

- If (i) the beneficiary belongs to the central sub-sector, it recognises the received subsidy as revenue, thus the expenditure and the revenue are incurred simultaneously; hence, the balance of the central sub-sector does not change.
- If (ii) the beneficiary is a local government, the balance of the whole general government does not change, but that of the central and local government sub-sectors separately does. Namely, the payment is an expenditure

[25] In theory, the EU-funded part of the advance payments can be accounted as cash-based revenue in the budget, in case of available liquidity on the allocated account for the funds received from the Commission. However, due to the significant decrease of the program-level advance payed by the Commission available at the beginning of the period compared to the 2007-2013 cycle, and the high share of advance payments for the beneficiaries, in practice the EU-funded part of the advance payments payed by the budget cannot be accounted as cash-based revenues, because of lack of liquidity on the detached account for operative programmes.

in the central budget, while it is a revenue in the local government's balance sheet, thus the balance of the first worsens and that of the latter improves.

- If (iii) the beneficiary is a non-governmental organisation, the budget is affected only by the expenditure, hence the balance worsens.

In the years under review the ratio of advance payments substantially increased. From 2016 a large part of the funds belonging to the 2014-2020 EU budget cycle is paid as advances. According to the relevant decision, the purpose of the advances is to enable the beneficiaries to commence the implementation of the programmes as soon as possible, without struggling with financing or liquidity problems.[26] The ratio of the advance for beneficiaries within the general government may be as high as 100 per cent of the full subsidy value, while it may be 50 per cent for beneficiaries of private sector. In 2016 the budget paid out HUF 2,100 billion EU funds, of which the ratio of advance may be estimated to 70 per cent. (**In the case of the 2014-2020 Operational Programmes** this ratio was even higher.) The advances granted to local governments made a major contribution to the sub-sector's cash surplus of HUF 285 billion (according to the EDP statistics, 158 billion of this may have come from the advances). The advances paid to the budgetary institutions did not affect the fiscal deficit in the manner described above, as the expenditure was also recognised as revenue at the beneficiary. In the first half 2017 the budget paid more than HUF 1,000 billion as EU transfer, a substantial part of which was once again advance, while it recognised revenues only in the amount of HUF 155 billion. The difference made a major contribution to the cash-based deficit of HUF 911 billion, which developed in the first half-year.

Accrual accounting of the EU transfers in the budget

The methodology of recognising the EU transfers in the budget in accordance with the ESA statistics materially differs from the cash accounting described above. The accrual accounting sets out from the assumption that the EU transfers, apart from the co-financing, must have no impact on the fiscal balance. Accordingly, the ESA methodology recognises the budget expenditure when the transfer leaves the general government (in the case of beneficiary outside the general government) or when the transfer is effectively absorbed (in the case of users belonging to the general government), that is, when the invoices are available (albeit in instalments). If no cash revenue is recognised for these expenditures, the system of national accounts *imputes* accrual-based revenue at the same time up to the amount of the EU transfer related to the project (i.e. typically up to 85 per cent). The recognition of the expenditure and the revenue always takes place simultaneously, hence only the co-financing (domestic) part of the project appears in the deficit.

The advance payments within the general government generate a time shift between the cash-based and accrual-based statistics. The advance payments within the general government is not recognised as expenditure in the accrual accounting. It recognises the expenditure only when the beneficiary commences the project and submits the relevant invoices. This may prolong the accrual-based recognition by years compared to the cash approach. In the case of the private sector, according to the methodology the advance payment is also recognised as accrual-based absorption; thus, the two types of accounting correspond in this case.

Accordingly, in respect of the advances there are two factors that may generate a difference between the cash-based and accrual-based data. If the private sector receives an advance in respect of which no cash revenues has been recognised, an ESA revenue must be imputed for it. By contrast, if a general government institution receives an advance in respect of which EU transfer cash revenue has been recognised, these transfers must be eliminated from the revenues in the accrual accounting.

[26] Government Decree 145/2016 (VI.13)

Appearance of the recognition of the EU transfers in our analysis

In our analysis, we separated the primary (advance) disbursement of the EU transfers from the effective absorption. It complicates the presentation of the related fiscal effects that in the central and local government sub-sectors, and in the cash-based and accrual-based indicators seemingly opposite processes can be observed. In our analysis, the EU transfers affect four fiscal items.

1. **Net expenditures of the central budgetary institutions and chapters related to EU transfers:** balance of the EU transfers that have flown through the budget. It is a net expenditure, because we stated the funds received from the EU and recognised in the budget against the total disbursed transfers (i.e. primary disbursements). The disbursed transfers also include the advance and depend on whether the final beneficiary will be the central budget, a local government or the private sector.

2. **Net own expenditures of central budgetary institutions and chapters:** in the larger part an item not affected by the EU transfers. The part independent of the EU transfers contains all expenditures appearing in the budget lines included in its title (personnel, material expenditures, investments, transfers), stated against the affected parties' own revenues and the non-EU subsidies granted by the central budget. In addition, the budgetary institutions and chapters account for a large part of the final beneficiaries of the EU transfers. If they receive a transfer from the funding discussed in the previous paragraph (albeit as an advance) it increases their revenue, while the absorption of the transfer increases their expenditure. Accordingly, the advance payments substantially influence their annual net expenditure, if the absorption takes place in the next years. As regards to the aggregate level of the central budget, their net expenditure can be stated against the previous items (net expenditures of the central budgetary institutions and chapters related to EU transfers), since the item that is an expenditure disbursed to institutions and chapters in the first, it is a revenue in the latter one). It will exert an effect on the central balance – up to the amount of the co-financing – when the effective absorption of the transfers commences.

3. **Balance of local governments:** as with the previous section, the EU transfers account for the smaller part of the local government's full budget, but their balance is substantially influenced by it in the years under review. They receive their EU transfers through the net expenditures of the central budgetary institutions and chapters related to EU transfers, which formerly usually reimbursed the costs ex post, while from 2016 it mostly disburses advances. At the level of the whole general government the two items can be stated against each other, and their offset their impacts on the balance, as the item that is an expenditure in the central budget (advance disbursed to the local governments) it is a revenue in the local government sector. It will exert an effect on the whole general government balance – up to the amount of the co-financing – when the effective absorption of the transfers commences.

4. **ESA bridge:** The difference between the general government's cash-based and ESA balance is referred to as the ESA bridge. This is where the difference between the recognition of the transfers in the budget in accordance with the ESA statistics and the cash accounting appears. The difference is essentially generated by the fact – as also described above – that the ESA methodology recognises the fiscal expenditure when the transfer is effectively absorbed, i.e. the invoices are available (albeit in tranches) and at the same time it *imputes* an accrual-based revenue up to the amount of the EU transfer. Compared to this, the cash-based expenditure and the receipt of the revenue from the EU may also pass through to subsequent years.

6.5 FISCAL IMPACTS OF THE 2016 WAGE AGREEMENT

At the end of 2016 a trilateral wage agreement was reached between the representatives of the government, the employees and the employers. The agreement includes, for several years in advance, the mandatory increase of the minimum wage and guaranteed wage minimum, as well as the unconditional and conditional reduction of the employers' burdens (social contribution tax, corporate income tax). In this analysis, we review the fiscal impacts of the labour market measures included in the agreement.

In 2017 the minimum wage and the guaranteed wage minimum increased by 15 and 25 per cent, respectively, to be followed by additional increases of 8 and 12 per cent in 2018 (Table 18). This growth, according to the MNB's estimate, impacts almost 30 per cent of the employees (in 2015 the basic pay of about 30 per cent of the full-time employees did not exceed the guaranteed wage minimum).[27] The administrative wage rise at such a rate materially increases the employers' burdens, which at the same time is mitigated by **the decrease in the social contribution tax by 5 percentage points this year and 2 percentage points next year**.[28] The reduction of the social contribution tax rate does not offset the impact of the wage increases at the companies where the ratio of employees earning the minimum wage or the guaranteed wage minimum is high, while at the companies where the majority of the employees earn above this level the wage burdens may materially decrease. On the whole, at national economy level, the enterprises' labour cost does not change materially.

Table 18
Developments in the minimum wage, guaranteed wage minimum and the social contribution tax

	2016	2017	2018
minimum wage (HUF)	**111,000**	**127,500**	**138,000**
change (per cent)		15	8
guaranteed wage minimum (HUF)	**129,000**	**161,000**	**180,500**
change (per cent)		25	12
social contribution tax (per cent)	**27**	**22**	**20**
change (percentage point)		–5	–2

The dynamic budget impact of **measures related to the wages represent a tax easing of 0.8 per cent of GDP in 2017, and 1 per cent of GDP in 2018** (Table 19). The reduction of the social contribution tax by 5 percentage points this year, alone reduces the budget revenues by roughly net HUF 390 billion. During our calculations, we estimated the impact of the measure on net basis, i.e. we eliminated the budget's expenses paid to "itself" (e.g. the tax and contribution burdens related to the wages of public employees) from the calculations. The revenue decreasing effect of the tax easing is mitigated by the transformation of the Job Protection Action Plan (JPAP). While earlier the allowances available under JPAP, up to a gross wage of HUF 100,000, provided an allowance of 27 or 14.5 per cent depending on the eligibility, from 2017 this rate decreased to 22 per cent or to half of the prevailing social contribution tax rate.

As a result of the wage increase, in the private sector the revenues from labour taxes increase by 0.3 and 0.6 per cent of GDP in 2017. In view of the fact that the administrative raising of the minimum wage and the guaranteed wage minimum affects the labour market rather widely and its impact may feed through to higher income categories as well, the resulting surplus will generate substantial revenue for the budget, which will partially offset the impacts of the social contribution tax cut. In addition, as a result of the increase in the gross wages, it will also appear at the payments originating from the employee's and employer's tax and contribution burdens. Accordingly, as a result of the wage increases, in 2017 the budget may receive surplus revenues of more than HUF 110 billion, compared to the baseline scenario, from personal income tax, contributions paid by the insured, vocational training contribution, labour market contribution and from the reduced social contribution tax. In the first five months of the year, at the enterprises employing at least 5 persons, the average gross and net wage of the employees rose substantially, by 10.6 per cent.

In relation to the wage agreement, the expenditures of the general government are increased by the expenses related to the wage of public employees and the social benefits tied to the minimum wage. The raising of the minimum wage and particularly of the guaranteed wage minimum directly increases the wage of part of

[27] Inflation Report, December 2016, Magyar Nemzeti Bank, page 19

[28] In 2018 the social contribution tax may decrease by further 0.5 percentage points to 19.5 per cent, if in the first three quarters of 2017 the gross average wage increase in the private sector reaches 11 per cent year on year. According to the MNB's latest forecast, prepared for the June Inflation Report, the dynamics of the wage increase may slightly fall short of this.

the public employees, which may result in extra expenditures of 0.1 per cent of GDP in 2017. According to the data available to date on 2017, the growth of the average wage of the employees of budgetary institutions between January and May, without the public employees, was 14.6 per cent (it should be noted that this figure also contains the impacts of the industry career path models). Another material expenditure increasing item relates to the social benefits, which increase in parallel with the raised minimum wage. The wage minimum typically determines the upper limit of these benefits (e.g. employment and support allowance, child-care benefit, sick benefit, disability and rehabilitation benefits).

Table 19
Net effect of the wage agreement on the budget as a per cent of GDP

	2017	2018
Impact of tax cut *(static, private sector)*	–1.1	–1.5
Amendment of JPAP *(static, private sector)*	0.1	0.1
Total impact of tax changes *(static, private sector)*	**–1.0**	**–1.4**
Impact of wage increases on contributions *(dynamic, private sector)*	0.2	0.4
Impact of wage increases on personal income tax *(dynamic, private sector)*	0.1	0.2
Impact of wage increase in the public sector *(dynamic, public sector)*	–0.1	–0.2
Total impact of higher wage bill *(dynamic, national economy)*	**0.2**	**0.5**
Benefits tied to minimum wage *(static, national economy)*	–0.1	–0.1
Total	**–0.8**	**–1.0**

The net cumulative tax reducing effect of the measures will reach 1 per cent of GDP in 2018. The reduction of the social contribution tax by further 2 percentage points reduces the budget revenues by roughly 1.5 per cent of GDP. The growth in the minimum wage and the guaranteed wage minimum next year will continue with 8 and 12 per cent, respectively, which will increase the general government revenues by more than HUF 240 billion compared to the baseline scenario, also considering the base effect of 2017. On the whole, the measures may represent a budgetary easing in 2018 of roughly HUF 380 billion in nominal terms.

In addition to the labour market measures, the corporate income tax rate was lowered **uniformly to 9 per cent.** Formerly, the corporate income tax rate was 10 per cent for tax base of up to HUF 500 million and 19 per cent above that. The material decline in the tax liability is felt primarily by the large enterprises, which – despite their small number – have material economic value added, investment capacity and sales revenue. The reduction of the previous upper tax rate affects 800-900 enterprises, the pre-tax profit of which exceeds HUF 500 million. The reduction of the corporate income tax rate in 2017 and 2018 may decrease the tax burdens of employers by roughly 0.4 per cent of GDP.

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.

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IN 2016-2017 AND THE 2018 BUDGET ACT

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