PUBLIC FINANCE REPORT

2018
OCTOBER

“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)

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Analysis of the public finance developments in 2017–2018 and the 2019 Budget Act

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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 determination 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 a member of the Fiscal Council (FC), and thus the professional expertise and accumulated information available in the MNB can indirectly support the work of the FC. The MNB prepares background analyses for the duties of the FC stipulated in the Stability Act and provides them to the FC. The general public can learn about the most important results of these analyses from the publication entitled "Public Finance Report".

The analyses in this report were prepared under the general direction of Dániel Palotai, Executive Director for Economic Sciences and Priority Matters. This report was created by the staff of the Directorate for Fiscal and Competitiveness Analysis and the Directorate Economic Forecast and Analysis. It was approved for publication by Governor Dr György Matolcsy.

The analysis is based on information available for the period ending on 20 September 2018 as well as the EDP notification published by the HSCO on 2 October.

Contents

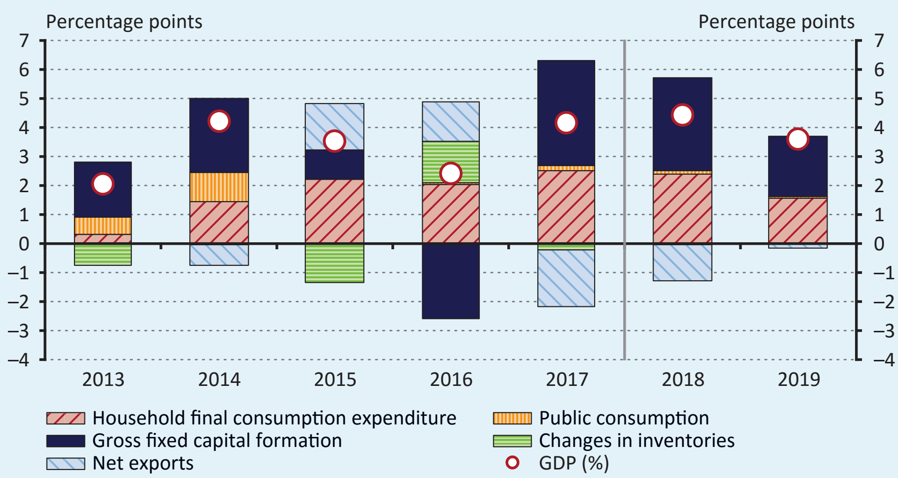
1 Summary

The purpose of this analysis is to present the developments in public finance in 2017 and the expected fiscal developments for 2018, on the basis of budget figures available for the first eight months and our forecast prepared for the September Inflation Report. The analysis also intends to provide an overview of the expected achievement of the targets in the 2019 budget adopted in July 2018. In view of the above, the actual compliance with the national and European Union rules related to the ESA-balance and debt for 2017 as well as the expected compliance for 2018 and 2019 are assessed.

The Hungarian economy follows a balanced and dynamic growth path in 2017–2019, i.e. the period under review, which strongly fosters fiscal stability, primarily through tax revenues. In 2017, economic growth rose to 4.1 per cent, and according to the MNB's September Inflation Report, this will be followed by 4.4 per cent this year and 3.5 per cent in 2019, mainly on the back of heavy domestic demand, which substantially promotes the expansion of tax revenues through increased consumption and wages.

Household consumption is a major driver of economic growth in all three years under review. This dynamic momentum is mostly generated by households' rising income, driven by massive wage outflows and employment growth. The rise in consumption is also propelled by the previously accumulated high level of financial net worth, the historically high consumer confidence as well as the second-round effects of the housing market boom (e.g. furniture purchases). In addition, households' consumption expenditure still falls short of the level warranted by the underlying income trends, therefore the recovery of the consumption deferred due to the crisis may further fuel demand, principally through the consumption of import-intensive durable goods.

Chart 1
Decomposition of the expenditure side of GDP

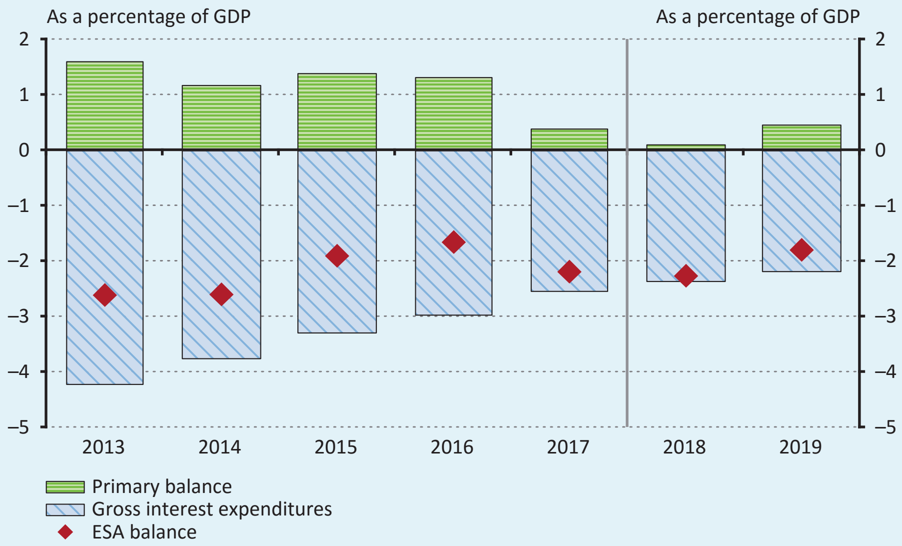


Source: HCSO and MNB.

Besides consumption, rising investments also considerably support growth in the period under review, and fixed capital formation is expected to produce double-digit growth, just like last year. The low interest environment and the growth in SME loans both support this trend, and increased public investment is also attributable to the growing absorption of funds from the EU's 2014–2020 programming period. The upswing in household investments is helped this year and the next by various government home construction schemes (temporary targeted VAT reduction and the family home creation allowance), which can be seen from the high number of building permits and the fact that home construction gradually gathers pace. However, due to the high import content of domestic absorption, net exports stymied growth, even in the context of improving foreign trade performance.

The labour demand generated by dynamic economic growth can also be observed in the expansion of employment and wage growth. The employment rate rose to above 60 per cent in 2018 Q2, which has been unprecedented since the political transition, while unemployment dipped to below 4 per cent. As a result of the increased demand for labour, the tight labour market entails permanently strong underlying wage trends. On account of this and the substantial increase of the minimum wage and the guaranteed minimum wage (the former grew by 15 per cent last year and 8 per cent this year, while the latter rose by 25 and 12 per cent in these two years), gross average earnings in the national economy soared by 12.9 per cent in 2017, and double-digit growth is expected in this year, too. The consumer price index climbed by 2.4 per cent last year, and according to the MNB' forecast in the September Inflation Report, inflation is expected to be 2.8 per cent this year and 3.1 per cent in 2019.

Chart 2
Balance of the government sector



Note: The data do not contain the imputed interest expenditures incurred since 2012 on account of the pension system reform. The point estimates assume the elimination or utilization of the National Defense Fund depending on which falls closer to the government deficit target.
Source: HCSO and MNB.

The favourable economic environment also contributes to the fact that the budget deficit on an ESA basis can steadily be around 2 per cent of GDP in all three years. According to the EDP notification, the ESA balance was 2.2 per cent of gross domestic product last year, and it is forecast to be around 2.2–2.3 per cent this year, dropping to 1.7–1.8 per cent in 2019 due to spending cuts. From the perspective of its direct impact on economic growth, fiscal policy was accommodating in 2017–2018, while the deficit reduction (and at the same time rising primary surplus) indicates a countercyclical budget for 2019.

The reduction of interest expenditures as a proportion of GDP observed since 2013 can continue in all three years under review, albeit at a diminishing pace on account of the repricing of debt in recent years, because the share of low-interest debt instruments within government debt is already high. Gross interest expenditures relative to GDP will sink to 2.2 per cent by 2019, with a 2 percentage point drop compared to 2013.

The cash-based deficit significantly exceeds the accrual-based deficit in the years under review, mainly on account of the absence of advance payments related to EU funds and the corresponding EU revenues. Half of the advances paid for the EU funds in 2017 have left the general government, therefore they were recorded as expenditure, however, the cash-based income related to advance-payment projects is only recognised after invoices are submitted and paid. By contrast, according to the ESA methodology, the deficit is increased only by the advance payments from the government sector, which is a broader category than the general government, and only to the extent of the national co-financing (this is because pursuant to statistical rules, the future expected reimbursements by the EU are recognised at the same time as the advance payments). According to actual figures from the first eight months of this year and our expectations, a high amount of advance payments can be expected in 2018, therefore the cash-based deficit will be higher than the accrual-based deficit this year, too. In addition to the accounting of EU funds, the difference between the cash-based and the accrual-based deficit is widened by the reform of the rules on the refunding of the value added tax. The refunding period used for reliable taxpayers was shortened from 75 to 45 days in January 2017, and to 30 days in this January. This reduces cash-based revenues in both years, without affecting accrual-based income.

The pre-financing of the European Union funds considerably increases the central budget's financing requirement, which, however, could be partly covered by the amendment of the rules on advance payments from the EU. The advance payment on EU funds and the delays in the receipt of the funds substantially adds to the financing requirement and entails more borrowing, which places a burden on the government securities market and slows down the reduction of government debt relative to GDP. However, the surplus financing requirement of the advances and the absence of EU revenues is moderated by the fact that the actors in the government sector need to transfer to their accounts held by the Hungarian State Treasury[1] the unused EU advances of over HUF 50 million disbursed earlier until 30 September 2018, and the rules on future advance payments from the EU will also be tightened.[2] Instead of issuing FX bonds – as in the past, so in the future – financing from retail government securities may provide adequate financing capacity without placing a burden on the forint bonds market, while also promoting a further decrease in the external vulnerability of Hungary.

The 2.2 per cent ESA deficit-to-GDP ratio in 2017 was lower by 0.2 percentage points than the target in the Budget Act. The deficit was lower than the target despite the fact that the Parliament decided to cut the corporate tax and social contribution tax rates at the end of 2016, after the budget was adopted. The greater-than-projected growth of the tax base basically offset the fiscal impact of the tax cuts. The actual use of EU funds has not reached the appropriation despite considerable advance payments, lowering the share of co-financing affecting the ESA deficit that also contributed to a lower deficit.

This year, depending on the utilisation of the Country Protection Fund, the government sector's deficit may be around 2.2–2.3 per cent of GDP, slightly below the deficit target of 2.4 per cent laid down in the Budget Act. According to our prognosis, the total tax revenue will exceed the appropriation by 0.6 per cent of GDP, due to the payments by enterprises, consumption taxes and the taxes on labour. On the expenditure side, surplus expenditure relative to the appropriation is derived from several implemented measures (advance wage increases in the healthcare sector, pension supplement in the form of Erzsébet vouchers, winter-related utility cost reduction) that were not included in the Budget Act, and also from the fact that the expenditure by budgetary institutions may come in higher this year than in the appropriation. However, these effects are all partly counterbalanced, since according to our forecast, certain expenditure items (public work programme, disability benefits) could be lower than the appropriation.

The 2019 Budget Act adopted in July stipulated that the ESA deficit should amount to 1.8 per cent of GDP, which can be achieved according to our forecast, although both the actual expenditure and the revenues can differ from the planned levels. We estimate that the total tax revenue will, primarily on account of the social contribution tax and the personal insurance contributions, fall short of the appropriation in the budget by 0.2 per cent of GDP. The difference is mostly explained by our assumption regarding wage growth, which is lower than in the Budget Act. However, this is counterbalanced by the fact that compared to the budget, our projection includes higher cash-based income from the EU as well as lower co-financing from the state linked to the payments from EU programmes.

Declining deficit reflects a countercyclical fiscal policy. Following a fiscal policy that stimulated the economy in 2017 and 2018, fiscal policy may cause contraction in demand as a result of the decreasing deficit in 2019, which on the whole will result in a countercyclical fiscal policy.

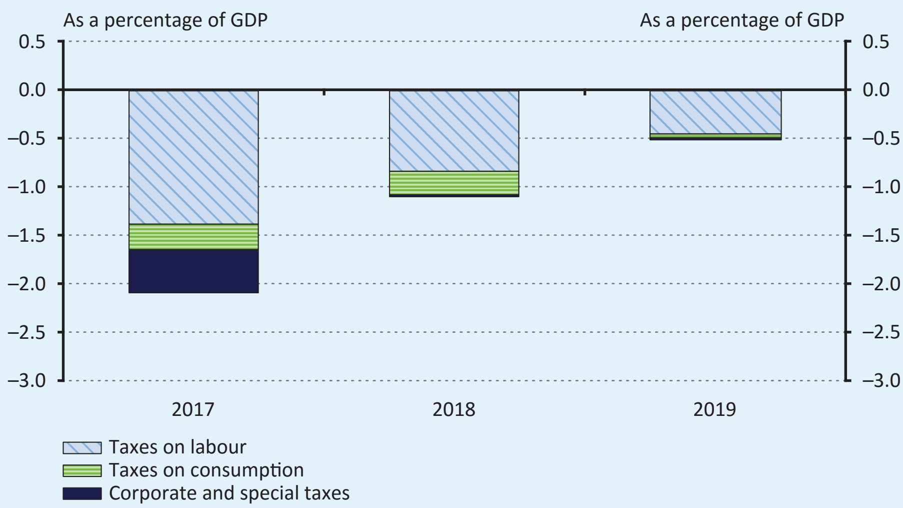
As a result of the multi-year tax cuts launched in 2017 in the context of the continued disciplined fiscal policy, tax centralisation relative to GDP dropped last year (from 39.1 per cent to 38.1 per cent), which is expected to continue in the years ahead. In themselves, the implemented and adopted measures in the years under review on an ongoing basis (i.e. assuming constant tax bases) reduced tax revenues by 2.1 per cent relative to GDP in 2017, lowering them by another 1.1 and 0.5 percentage points this year and the next. However, this effect is reduced by the increase in tax revenues derived from the dynamic rise of wages and earnings, the expansion of consumption and the reduction of the shadow economy.

[1] Article 76 of Act XL of 2018

[2] Government Decrees No. 397/2017 (XII.13.) and 160/2018 (IX.7.)

According to the tripartite wage agreement concluded in 2016, the social contribution tax diminishes in all three years under review. The tax rate sank by 5 percentage points from 27 per cent last year, this year it was cut by 2.5 percentage points and it is expected to be slashed by another 2 percentage points from the second half of 2019, which is estimated to reduce employer's contributions by 0.3–0.4 per cent of GDP annually. However, the effect of the tax relief is mitigated because of cuts to the system of fringe benefits and the transformation of the Job Protection Action Plan (target groups are changing, while the maximum amounts are rising), which is expected to lead to a fall in the number of beneficiaries. The tax burden on incomes is also eased by the gradual decline of the upper bracket of the healthcare contribution as well as the elimination of the healthcare contribution levied on interest income and income from letting property. With respect to personal income tax, the two-child family tax allowance increases each year, peaking in 2019, when the monthly amount per dependant will reach HUF 20,000 from the original HUF 10,000. In 2019, the almost complete tax exemption of pensioner workers considerably reduces the taxes on labour, while the tightening of fringe benefits is expected to generate surplus revenues.

Chart 3
Static budget impact of the tax measures implemented between 2017 and 2019 by year

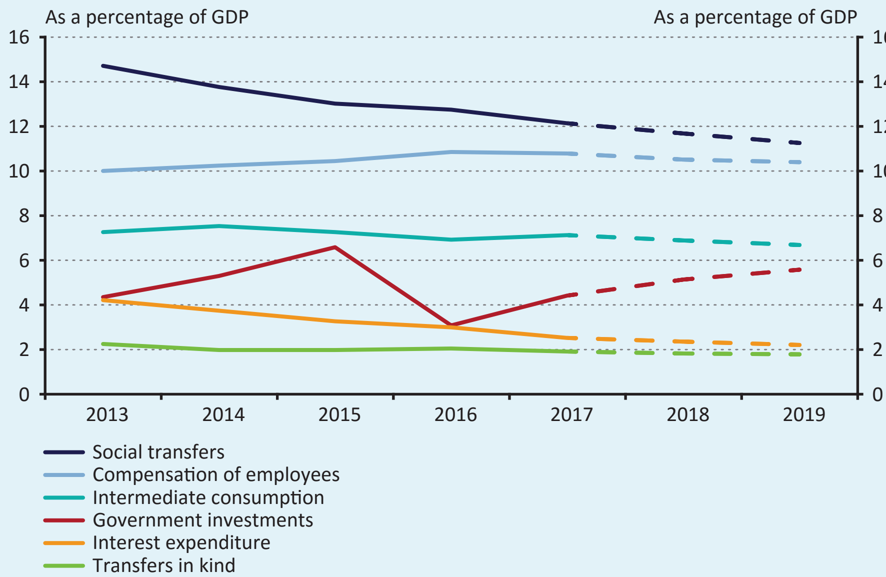


Source: MNB.

The amount of consumption taxes relative to GDP has diminished in the years under review, however, this is the result of measures with opposite effects. The targeted reduction of tax rates in certain product groups has continued in value added tax. Since 2017, the VAT on eggs, non-long-life milk, poultry, fish and pork offal has been cut, the VAT on restaurant dining and the Internet use was lowered in two steps, and next year the tax on long-life milk will decrease. By contrast, in line with EU regulations, the excise duty on tobacco products was raised last year in several steps, it was decided that there would be raises this year and the next, and that the public health product tax would be increased in 2019.

The taxes payable by businesses were substantially lowered in 2017. Most of the major changes in the rules on the payments by businesses were implemented in 2017. Corporate tax rates were cut to 9 per cent across the board from the earlier 10 and 19 per cent, the special tax on credit institutions was further lowered and the rules on the taxation of small enterprises also changed. In the case of KATA, the revenue limit up to which the preferential lump sum tax payment can be chosen was raised from HUF 6 million to HUF 12 million, while the KIVA tax rate declined by 1 percentage point. This easing also played a role in the fact that until June 2018, 307,000 taxpayers have chosen some form of small enterprise taxation (KATA: 279,000, KIVA: 28,000), and the increase in the number of taxpayers is expected to continue, which is also encouraged by the phase-out of the option of choosing the simplified business tax from 20 December 2018.

Chart 4
Government sector expenditures as a percentage of GDP

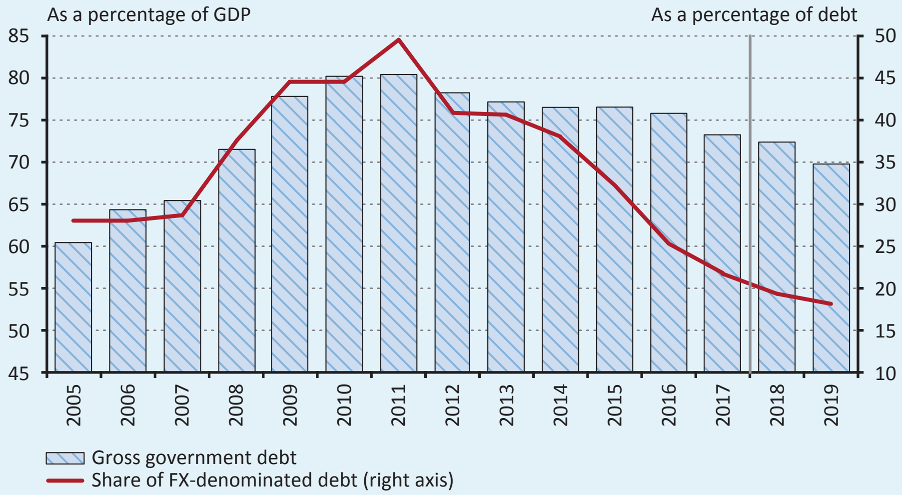


Source: HCSO, MNB forecast.

In parallel with the diminishing tax centralisation, state redistribution relative to GDP net of EU funds dropped by 0.6 percentage points to 45.4 per cent in 2017, and this is foreseen to continue in 2018 and 2019. Within this, the greatest fall can be observed in the case of social transfers, which is attributable to the nominal freezing of certain transfers (e.g. family allowance), the gradual raising of the retirement age as an earlier timetable indicates as well as the fact that the indexation of pensions falls short of nominal GDP growth. At the same time, the scope of targeted measures have increased with the expansion of the family tax allowance and payment of pension premium among other things. Due to the closing of the 2007-2013 EU programming period, public investments experienced a dramatic decline in 2016, however, the absorption of EU funds increases each year as more and more funds from the new programming period become available. According to our projections, from 2018, total public investments will be over 5 per cent once again. Compensation of employees will slightly fall in the period under review, attributable to the reduction of the wage expenditure on public work schemes and the labour taxes payable by the government (too). Relative to GDP, the government spends less and less each year on material expenditure and transfers in kind. However, interest expenses tumble, on account of the favourable interest rate environment and the shrinking government debt.

The period under review is characterised by a gradually declining debt ratio and a dynamically falling FX ratio. At the end of 2017, gross government debt as a percentage of GDP declined to 73.3 per cent from 75.9 per cent one year earlier (the highest year-end value was 80.5 per cent in 2011). In 2018, the ratio sank to 72.4 per cent, and it can be close to 70 per cent by the end of 2019. The FX share of the central debt shrank to below 22 per cent in 2017, and we estimate that it will sink to 18.2 per cent by the end of 2019.

Chart 5
Government debt forecast – calculated with an unchanged (end-of-2017) exchange rate over the forecast horizon



Source: Government Debt Management Agency, MNB.

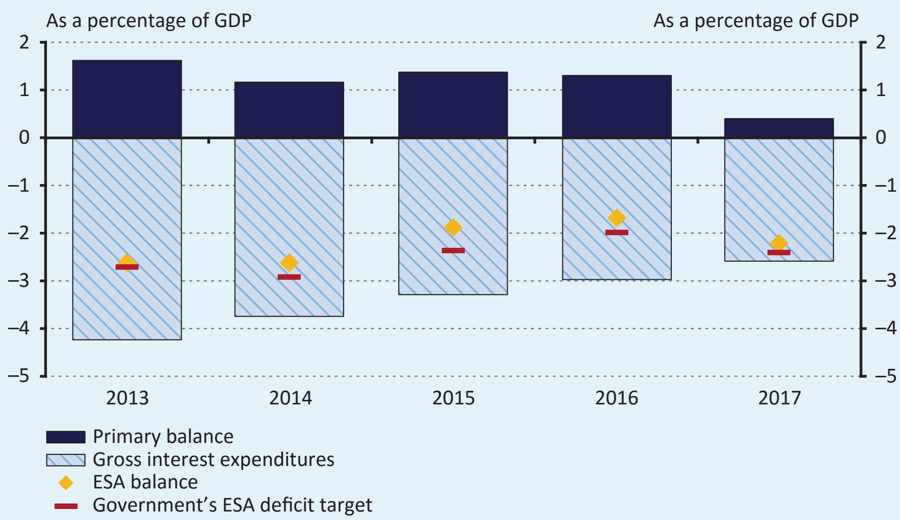
Besides economic growth, the dwindling debt-to-GDP ratio is influenced by the positive primary balance as well as low real interest rates, however, the advance payments on EU funds have hampered this process. In the years under review, high economic growth was observed and the primary budget balance (net of interest expenses) was positive, which points towards the reduction of the debt. Moreover, real interest payments mean less of a burden to the budget each year, due to the falling interest expenses and inflation, which has climbed to around the central bank's target. However, the advance payments on EU funds add to the debt in the period under review, but this effect will be reversed when the funds are received, therefore they may help reduce debt at a quicker pace in the future.

In 2017–2019, Hungarian fiscal developments are in line with the Hungarian and European Union rules on the general government's ESA balance and debt, however, they have failed to satisfy the rules on the structural balance and expenditure in some years. The Hungarian budget management has to comply four Hungarian and four EU rules over the time horizon under review. The 3-per cent Maastricht deficit target included in both legal systems was met in 2017, and the MNB expects it to be met in the future, too. The contraction of the government debt ratio also conforms to the relevant rules, namely the debt rule in the Fundamental Law, the Hungarian debt formula and the stipulations of the Maastricht debt rule. The budgetary processes are in line with the rules that would entail an excessive deficit procedure (EDP) when violated. However, the rules on the medium-term budgetary objective are expected not to be satisfied: the structural balance is not consistent with attaining the medium-term objective, and budgetary spending exceeds the reference values expected by the EU. The EU institutions launched an SDP (significant deviation procedure) against Hungary on account of its violation of the rules. The SDP contains recommendations and their monitoring but does not entail financial sanctions.

2 Balance of the government sector in 2017

According to preliminary statistical data published on 2 October, the government sector's 2017 ESA deficit was 2.2 per cent of GDP. The primary surplus reached 0.4 per cent of the gross domestic product, while gross interest expenditures amounted to 2.6 per cent of GDP. Overall, 2017 saw a continuation of the trend of earlier years: the deficit was around 2 per cent in the context of a primary surplus and decreasing interest expenditures.

Chart 6
ESA balance (2013–2017) based on the October EDP notification
(% of GDP)



Note: The data do not contain the imputed interest expenditures and incomes incurred since 2012 on account of the pension system reform.
Source: Budget Acts of 2013–2017, HCSO.

The 2.2 per cent ESA deficit of the government sector is made up of the 2.3 per cent deficit of the central sub-sector and the 0.1 percent surplus of the local government sub-sector. The difference between the cash-based balance and the ESA balance was the opposite in the two sub-sectors in 2017, just like in the previous year. The central sub-sector (together with the companies classified into the general government) exhibited a substantial cash-based deficit, which was above the ESA deficit by 2.5 per cent of GDP. On the other hand, the accrual-based deficit in the local government sub-sector was lower than the cash-based version by 1.3 per cent of GDP. The statistical corrections in the opposite direction can be partly attributed to the same reason, namely the recognition of the advance payment of the subsidy of HUF 476 billion to local governments from the central budget. Advance payments within the government sector increase the cash-based deficit of the central budget (as an expenditure item), whereas in the ESA system the expenditure items do not include advance-payment transactions; they are recognised when the original goal of the advance (investment or other use) is actually realised. This approach is also true from the other side, so the advance-payment revenues are received by the local government sector in the cash-based approach, even though these are not actual income in the ESA system, since in such cases the transactions are merely financing operations because no real economy performance can be linked to these revenues so far. In view of the above, the government sector's balances in 2017 were as follows.

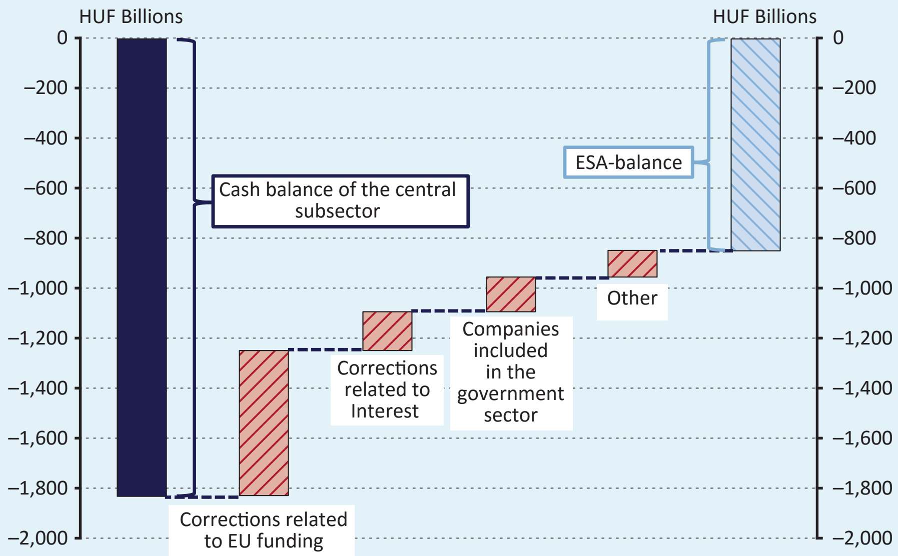
Table 1
Balance indicators in 2017

	Cash-based balance	ESA bridge	ESA balance
	HUF billion		
Central sub-sector	-1,833	957	-876
Local governments	519	-492	27
Total general government	**-1,314**	**465**	**-849**
	As a percentage of GDP		
Central sub-sector	-4.8	2.5	-2.3
Local governments	1.4	-1.3	0.1
Total general government	**-3.4**	**1.2**	**-2.2**

Source: HCSO.

The cash-based deficit of the central government was HUF 1,833 billion last year, HUF 629 billion higher than the originally adopted deficit target of HUF 1,204 billion. The elevated cash-based deficit was linked partly to the large amount of EU advances paid to local governments (which did not generate surplus deficit at the level of the consolidated general government), and partly to the lower-than-expected EU revenues realised on a cash basis. According to preliminary data, the cash-based balance of the general government (the central and the local government sub-sector combined) amounted to HUF 1,314 billion at the end of the year, higher than the cash-based deficit target of HUF 1,166 billion stipulated in the originally adopted Budget Act.

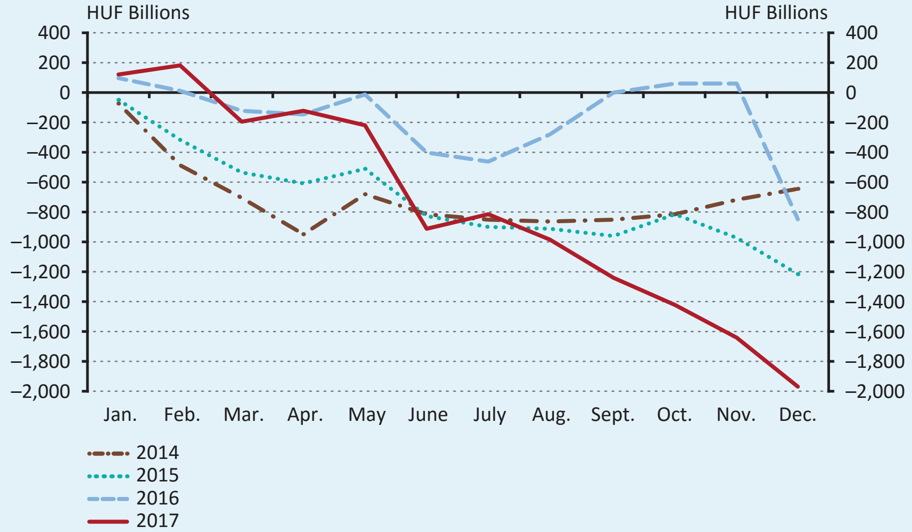
Chart 7
Decomposition of the differences between the ESA and cash-based balances in 2017



Source: HCSO.

The 2017 ESA deficit fell short of the target set out in the Budget Act by 0.2 per cent of GDP. Within that, the deficit level for both the local government sub-sector and the central sub-sector were 0.1 percentage point lower as compared to the target in the Act. On the revenue side, the revenues of the central sub-sector and the local government sub-sector, except for the revenues related to EU funds, increased more than the budgetary appropriations overall, owing to the greater-than-expected economic growth and the revenues from land sales carried over from the previous year. The effect of the reduction of the corporate tax and the social contribution tax was offset by the expansion of the tax base arising from more robust wage growth. The primary expenditure of the central sub-system exceeded the preliminary appropriation by roughly HUF 500 billion, mainly on account of the EU payments that came in higher than expected. Nevertheless, a major share of the EU payments were linked to advances, therefore they did not affect the ESA-based expenditure.

Chart 8
The development of the cash-based deficit of the central sub-sector within the year
(cumulative value starting at the beginning of the year)



Source: Hungarian State Treasury.

2.1 REALISATION OF THE MACROECONOMIC PROJECTIONS UNDERLYING THE BUDGET

The Hungarian economy exhibited real growth of 4.1 per cent last year, 1.0 percentage point higher than the growth assumed while planning the 2017 Budget Act. The forecast on domestic absorption was also significantly lower than the actual data from 2017, and the components of absorption also differed considerably from the structure assumed while drafting the Budget Act.

The growth rate of average gross earnings was close to 13 per cent, which was due to the tight labour market as well as the wage agreement , especially the increase of the minimum wage and guaranteed minimum wage. **Employment** in the national economy expanded by 1.6 per cent, in line with the government's forecast. The greater-than-expected wage outflows added much to budgetary revenues through the growing base of the taxes on labour, which mitigated the lost revenues on account of the social contribution tax cut.

The government assumed a 3.7 per cent rise in **households' consumption expenditure** for 2017, but expenses increased by 0.4 percentage points more. The greater-than-expected expansion of households' consumption expenditure was due to the larger-than-expected wage outflows. The ensuing growth in VAT revenues partly compensated the lost revenues due to targeted VAT cuts.

Table 2
Comparison of the projection in the 2017 Budget Act and the actual figures

	Government's forecast	Actual
Gdp	**3.1**	**4.1**
Exports	6.3	4.7
Imports	7.4	7.7
Gross fixed capital formation	9.1	18.2
Consumption expenditure of households	3.7	4.1
Public consumption	1.5	2.0
Consumer price index	**0.9**	**2.4**
Average gross earnings	**5.1**	**12.9**

Source: HCSO, Budget Act of 2017.

The **consumer price index** rose by 2.4 per cent rather than the 0.9 per cent planned last year, and within that core inflation excluding indirect taxes rose by 2.2 per cent. On account of global market developments, fuel prices increased, but the dominant household energy prices remained unchanged, and regulated prices in general did not contribute to the higher inflation overall. The inflation exceeding the government's drafts affected the budget through the VAT revenues rising on account of greater nominal consumption and the growing expenditure (pension) indexed for the changes of consumer prices.

The **gross fixed capital formation** of the national economy grew by 18.2 per cent rather than the 9.1 per cent projected, even though the absorption of EU funds fell short of the government's drafts. The stronger-than-expected dynamics was mainly due to the fact that in the base year of 2016, the national economy's investments nosedived by 15.5 per cent instead of the roughly 1 per cent projected for the year.

Box 1
The June 2017 amendment to the Budget Act

The only amendment of the 2017 Budget Act during the year occurred in June 2017, which was necessitated by the implementation of the tax measures from the end of 2016 and the tripartite wage agreement. The amendments of the statutory appropriations did not modify the cash-based 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' totals.

On the **revenue side**, the statutory appropriations were updated with the impacts of the measures 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 agreement, more robust wage growth). The budgetary impact of the greater-than-expected expansion of the tax cuts and tax bases were estimated by the amendment to be similar to each other, therefore the opposing effects practically neutralised each other: the modified appropriations in the Budget Act for tax, tax-type and contribution revenues decreased by HUF 38 billion in total. On account of the measures, the appropriation for corporate tax revenues declined by HUF 128 billion, while that for the social contribution tax dropped by HUF 294 billion, but, in line with macroeconomic developments, the appropriation for personal contribution revenues rose by HUF 124 billion and that for VAT revenues increased by HUF 116 billion. Other payment obligations of enterprises grew by HUF 83 billion overall, and the modification of the appropriations for the excise duty and duty payments meant a further revenue surplus of HUF 61 billion. Meanwhile, revenues related to state assets climbed by HUF 162 billion, because some of the sales of state-owned land continued from last year in the current year.

On the expenditure side, the amendment padded primary expenditure by HUF 253 billion in total, even without the greater amount of government subsidies to the social security system. 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 the appropriation for cash benefits (sick pay and childcare benefit) increased by HUF 26 billion due to the more robust demand in the national economy. Furthermore, the appropriations for provisions were raised (by HUF 66 billion, including a HUF 36 billion increase for the Country Protection Fund), and the expenditure appropriations for budgetary authorities also rose by approximately HUF 120 billion. The cash-based appropriation for interest payments was lower than the original figure by HUF 54 billion.

2.2 BUDGET REVENUES

The accrual-based revenues of the government sector amounted to 44.7 per cent of GDP in 2017, representing a 0.5 percentage point drop from 2016. The decrease was caused mainly by the 1 percentage point contraction of tax centralisation, while the EU transfers to the general government rose last year, after a major slump in 2016.

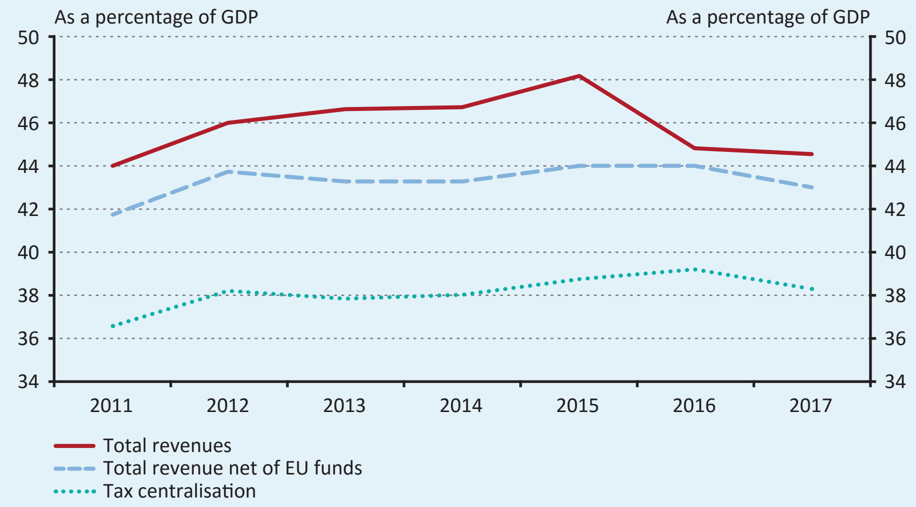
As a result of the tax cuts, tax centralisation fell to 38.1 per cent from 39.1 per cent in 2016. Several tax cuts were implemented in 2017, affecting the taxes on labour, capital and consumption. The social contribution tax was lowered from 27 per cent by 5 percentage points, the two-child family tax allowance was increased, corporate tax rates were cut to 9 per cent from the earlier 10 and 19 per cent, and the targeted tax cuts aimed at certain product groups were continued in value added taxation. According to our calculations, the static budget impact of the 2017 tax cuts amounted to 2.1 per cent of GDP. However, the rising tax revenues derived from the dynamic rise of wages and earnings, the expansion of consumption and the reduction of the shadow economy. Therefore tax centralisation diminished by 1 percentage point overall last year.

The primary revenues of the central sub-sector were lower than the amended appropriation by HUF 470 billion. The difference is almost completely linked to the lower-than-expected realisation of the revenues related to EU funds, primarily because fewer invoices were submitted to the European Commission during the year on account of the low level of invoiced payments and the slow absorption of the advances paid in previous years. Tax and contribution revenues were overall identical to the amended appropriations. More specifically, contribution revenues were above the amended appropriations, while the payments by enterprises and consumption tax revenues fell slightly short of the amended appropriations.

Recent years were characterised by a moderate increase in tax centralisation, in line with the government's measures aimed at reducing the shadow economy and expanding the tax bases. This trend was interrupted in 2017 when building on past achievements the need for improving the competitiveness of the Hungarian economy was given priority, and the parametric development of the tax system to achieve this goal through the reduction of the corporate sector's tax burden.

Within the diminishing tax centralisation, the amount of income taxes relative to GDP did not drop below the level of the previous year, therefore the combined tax burden on companies and households was 7.4 per cent of GDP in 2017. Nonetheless, in line with the dynamic rise in wages and earnings, households' tax payments relative to GDP increased by 0.3 percentage points as compared to 2016, while the corporate sector's tax burden was eased by 0.3 percentage points as a result of the tax cut and other tax relief measures affecting the sector. Consumption and production taxes sank by 0.1 percentage point relative to GDP, therefore the general government realised tax revenues from these taxes amounting to 18.0 per cent of GDP in 2017. The reduction of tax revenues relative to GDP is linked to the targeted VAT rate cuts and the falling excise duty on tobacco products relative to GDP, which could not be fully offset by the rising tax revenues from consumption expenditure and the reduction of the shadow economy. The robust contraction of tax centralisation was due to a 5-percentage point decrease in the social contribution tax, and the central government's contribution revenues fell by 0.8 percentage points relative to GDP.

Chart 9
The government sector's total accrual-based revenues and tax centralisation



Source: HCSO and MNB.

Payments by enterprises fell short of the original appropriation and the amended version by HUF 59 billion and HUF 14 billion, respectively. The reduction of the appropriation was necessitated by the corporate tax cut, however, the revenues expected from other tax types were increased.

Corporate tax payments came in HUF 18 billion higher than the amended appropriation. The reduction compared to the previous year (and the original appropriation) was caused by the lower corporate tax rate, which had an estimated effect of HUF 110 billion. Now Hungary boasts the lowest corporate tax rate in the European Union. The higher cash-based revenues relative to the amended appropriation are due to the fact that the corporate tax subsidy of major sports was partly transferred in early 2018. Similar to 2016, the higher corporate tax revenues compared to earlier years is attributable to the tax credit for growth, out of which HUF 268 billion was collected by the budget in 2017. The tax credit for growth enables the companies whose pre-tax profit increases significantly from one year to another to pay the additional tax arising as a result of the growth to the budget over 2 years, in 8 equal instalments.

The **special tax of financial institutions** was also amended in 2017, with the reduction of the upper bracket of the tax for credit institutions from 0.24 per cent to 0.21 per cent. As a result of the measure, the revenue from the special tax dropped by HUF 9 billion.

Revenues from the **lump sum tax of small entrepreneurs (KATA)** came in HUF 4 billion higher than the amended appropriation, and HUF 23 billion above the original appropriation. The limit above which sales revenue is subject to a 40 per cent tax was raised from HUF 6 million to HUF 12 million from 1 January 2017. Owing to this measure, the dynamic impact arising from the growing number of businesses opting for this tax type was included in the appropriation when the Budget Act was amended. In line with the reduction of the corporate tax and the social contribution tax, the **small enterprise tax (KIVA)** rate was decreased by 1 percentage point from 1 January 2017. In the case of the **simplified business tax (EVA)**, payments fell short of the appropriation by HUF 17 billion. The lost revenues are due to the changes to the rules on KATA and KIVA, which prompted some of the taxpayers previously choosing the simplified business tax to switch to paying taxes using the KATA or KIVA rules. As a result of the growing number of taxpayers, revenues from the small taxpayers' itemised lump sum tax were higher by HUF 28 billion than in the previous year, while revenues from KIVA were higher by HUF 9 billion.

The low level of **advertising tax** revenues (HUF -20 billion) and **other payments by enterprises** (HUF -9 billion) was partly offset by the surplus from **product charges** (HUF 6 billion). The poor advertising tax revenues are due to the amendment of the relevant law, which included stipulations on refunding the payments made between 2014 and May 2017 as advertising tax following the decision of the European Court of Justice on the one hand, and on raising the tax rate on the other hand. Instead of the earlier 0 and 5.3 per cent rates, now a 7.5 per cent flat-rate applies to all taxpayers. The revenue-boosting effect arising from raising the tax rate was able to offset the lost revenues derived from the refunds only slightly.

Table 3
Partially consolidated cash revenues of the central sub-sector in 2016 and 2017
(HUF billions)

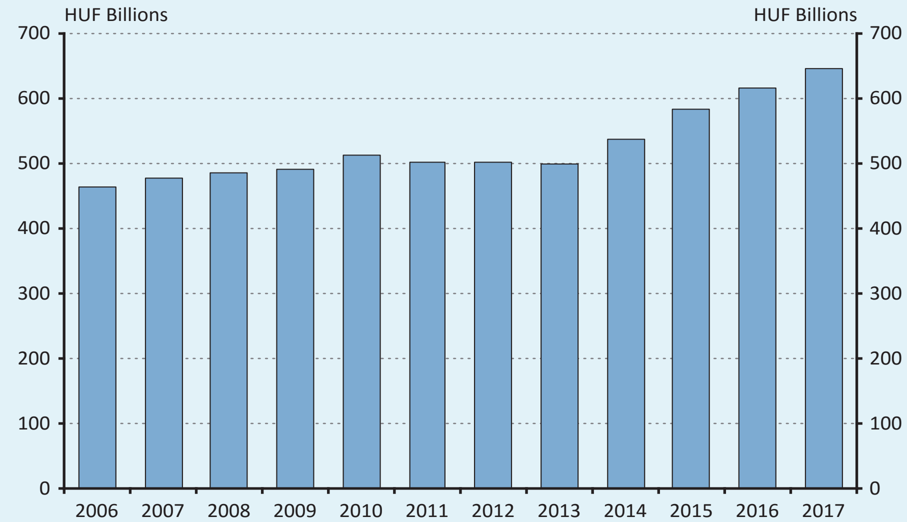
	2016	2017			
	Actual	Statutory appropriation (original)	Statutory appropriation (amended)	Actual (preliminary)	Difference (Actual – Original appropriation)
TAX AND CONTRIBUTION REVENUES OF THE CENTRAL SUB-SECTOR	**13,102**	**13,732**	**13,701**	**13,698**	**-34**
Payments by economic organisations	**1,593**	**1,622**	**1,578**	**1,564**	**-59**
Corporate income tax	683	735	607	625	-110
Special tax of financial institutions	73	67	67	64	-2
Simplified entrepreneurial tax	81	81	76	64	-17
Mining royalty	28	30	35	29	-1
Gambling tax	25	31	31	27	-3
Income tax on energy providers	46	56	56	53	-2
Lump sum of small entrepreneurs	70	76	95	98	23
Small enterprise tax	14	14	24	22	9
E-road toll	155	155	170	174	19
Utility tax	55	52	55	55	3
Other taxes and payments	363	329	364	353	24
Consumption taxes	**4,610**	**4,891**	**4,929**	**4,879**	**-12**
Value added tax	3,290	3,542	3,542	3,525	-17
Excise duties	1,012	1,035	1,069	1,022	-12
Registration tax	24	23	24	25	2
Telecom tax	53	54	54	54	-1
Financial transaction levy	199	206	206	217	12
Insurance tax	32	32	34	36	4
Payments by households	**1,922**	**2,000**	**2,139**	**2,147**	**147**
Personal income tax	1,718	1,793	1,909	1,920	127
Duties, other taxes	161	164	187	182	17
Motor vehicle tax	44	44	44	46	2
Tax and contribution revenues of extrabudgetary funds	**369**	**529**	**531**	**529**	**0**
Tax and contribution revenues of social security funds	**4,607**	**4,690**	**4,524**	**4,579**	**-111**
Social contribution tax and contributions	4,290	4,388	4,218	4,257	-131
Other contributions and taxes	317	301	306	322	20
REVENUES RELATED TO EU FUNDS	**1,073**	**1,588**	**1,644**	**1,128**	**-460**
OTHER REVENUES	**427**	**268**	**436**	**485**	**216**
Other revenues of the central budget	**289**	**140**	**308**	**336**	**196**
Other revenues of social security funds	**47**	**39**	**39**	**44**	**5**
Other revenues of extrabudgetary funds	**91**	**89**	**89**	**104**	**15**
TOTAL REVENUES	**14,603**	**15,589**	**15,781**	**15,310**	**-279**

Source: 2017 Budget Act, Hungarian State Treasury.

With respect to consumption taxes, in a cash-based approach, the general government collected roughly the same amount in 2017 as determined in the amended Budget Act, while overall the revenues fell short by HUF 50 billion. Net **VAT** revenues were HUF 3,525 billion, 99.5 per cent of the original appropriation in the Act. Relative to the VAT revenues in the base period, cash-based revenues increased by 7.1 per cent, even though the targeted VAT cuts (basic food, newly built residential properties, restaurant dining etc.) may have amounted to lost tax revenues of approximately HUF 120 billion to the budget. The government measure whereby the VAT refunding period used for reliable taxpayers was shortened from 75 to 45 days in 2017 did not affect the VAT revenues on an accrual basis, but it ate into cash-based revenues by around HUF 120 billion. Taking into consideration the above-mentioned factors, VAT revenue growth in 2017 can be considered dynamic, and it was driven by the macroeconomic developments determining the amount of tax revenues (inflation and consumption), which exceeded the government's expectations. Households' consumption expenditure increased by 1 percentage point more than in the macroeconomic projection in the Budget Act, while total domestic absorption grew by 2 percentage points more. Furthermore, in 2017 the consumer price index increased by 1.5 per cent more than the inflation expected by the government of 0.9 per cent. Overall, the budget received HUF 12 billion less **excise duty revenues** than in the original appropriation in the Budget Act. **Excise duty revenues** increased by merely 1.0 per cent relative to 2016, with 98.8 per cent of the original appropriation in the Budget Act being achieved. During the amendment of the Budget Act, the appropriation for excise duty revenues was raised by HUF 34 billion, therefore 95.7 per cent of the amended appropriation was achieved. The shortfall relative to the target was due to the deviation of the development of the excise duty on tobacco and alcoholic products from the appropriation. Both tax types saw nominal tax revenues drop as compared to 2016, while the excise duty on fuels rose by 4.9 per cent due to an increase in volume. **Financial transaction levy revenue** appropriations were overachieved by almost 6 per cent, HUF 12 billion. The growth rate of the revenues was over 9 per cent, therefore the revenue from this tax type was close to 0.6 per cent of GDP.

Compared to the previous year, consumption tax revenues climbed by around HUF 270 billion, a 5.8 per cent increase. More specifically, HUF 235 billion can be attributed to **value added tax**, however, according to accrual-based accounting, revenue growth was almost HUF 100 billion more than this. The reason behind the difference is that the VAT refunding period used for reliable taxpayers was shortened from 75 to 45 days from 1 January 2017. This change does not affect the accrual-based balance, but it significantly reduced the cash-based revenues. Furthermore, the targeted VAT reductions (eggs, milk, poultry, restaurant dining, Internet use) and other rule changes (expansion of the VAT exempt status) curbed the tax revenue growth in both accounting methods, with an estimated revenue loss of HUF 122 billion in total. The budget collected HUF 10 billion more **excise duty** revenues than one year earlier, which is basically attributable to the fact that the tax on tobacco products was lower than in the previous year, despite the January and July tax increases. This is due to the fact that since 1 April 2017, tobacco products may be released for free circulation only with a strip stamp containing no price instead of the former tax stamp that contained the price of the product, and the ensuing reduction of the stocks reduced excise duty revenues by tens of billions of forints in the two months prior to the introduction of the measure. In parallel with this, the dynamic rise of the excise duty on fuels that started in 2014 continued in 2017, driven by the increasing consumption of petrol and gas oil.

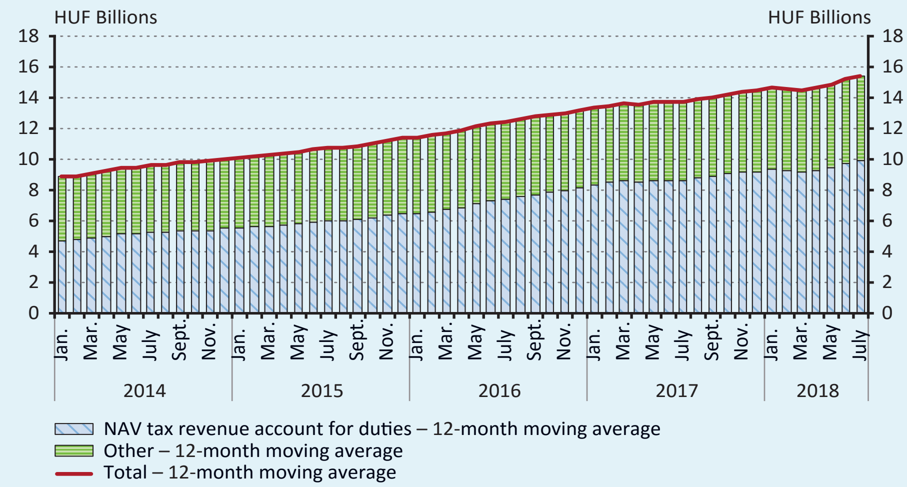
Chart 10
Excise duty revenues from fuel distribution



Source: Hungarian State Treasury

Households' tax and duty payments represented a revenue of HUF 2,147 billion in total for the central budget, therefore the original appropriation in the Budget Act was overachieved by 7.4 per cent, while the growth rate compared to 2016 was 11.7 per cent. **Personal income tax** revenues were above the amended Budget Act's appropriation by HUF 11 billion in 2017. As a result of the carry-over effects of the wage agreement concluded at the end of 2016, the appropriation for personal income tax revenues rose by HUF 116 billion during 2017. Last year's cash-based revenues of HUF 1,920 billion represented an almost 12 per cent increase over the previous year, which was caused by the dynamic expansion of the gross wage bill. In 2017, the number of employees increased by 1.6 per cent, while gross average earnings in the national economy grew by 12.9 per cent. The surge in earnings was also influenced by the tripartite wage agreement, according to which the minimum wage was boosted by 15 per cent and the guaranteed minimum wage was raised by 25 per cent. Last year, the tax allowance for families with two children rose to HUF 15,000 per month and dependant, which had been previously stipulated in law. The original appropriation for **duty revenues** increased by HUF 23 billion to HUF 178 billion with an amendment during the year, 97.5 per cent of which was achieved by the end of the year. Therefore the duty revenues due to the central budget expanded by 10 per cent compared to the base year. The amendment of the appropriation during the year was warranted by the rising duty revenues from the pick-up in home purchases.

Chart 11
Duty revenues
(12-month moving average; HUF billion)



Source: Hungarian State Treasury.

The **revenues linked to EU funds** were recognised in the budget as two balance sheet items. The EU receipts for the professional chapter-administered appropriations amounted to HUF 1,015 billion, which fell short of the appropriation in the budget amounting to HUF 1,545 billion by HUF 530 billion. The main reason for this was that due to the low level of invoiced payments and the slow utilisation of the advances paid in earlier years (i.e. the low actual utilisation), fewer-than-expected invoices were submitted to the European Commission during the year. The State Treasury recognised revenues of HUF 113 billion on the "Refund from the EU" revenue line, which comprised the revenues pertaining to the 2007–2013 programming period and the sugar levy. This was slightly above the amended appropriation in the budget, by HUF 15 billion, even though it was raised by HUF 56 billion when the Budget Act was amended.

Other primary budgetary revenues amounted to HUF 409 billion in 2017, HUF 68 billion more than in 2016. The increase was linked to revenues related to state assets, and the original appropriation in the Budget Act was overachieved by HUF 195 billion in the case of this revenue source. A major portion of the revenues from land sales was carried over from 2016 to 2017, adding HUF 152 billion to the revenues of the budget in 2017.

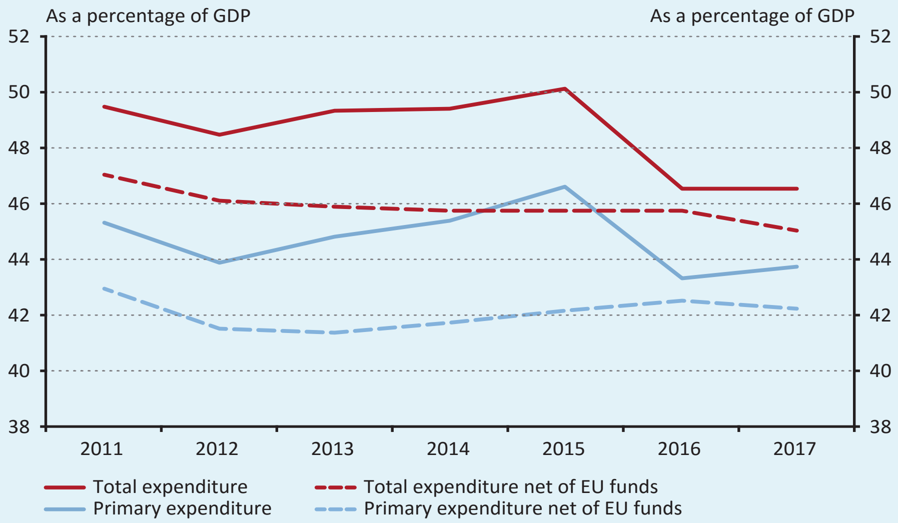
The total cash-based revenue of **extrabudgetary funds** was HUF 720 billion, HUF 105 billion more than in the base year. Surplus revenues of HUF 68 billion were collected relative to the appropriation in the Budget Act. The overachievement was due to the central subsidy of the surplus achieved during the year, since the funds' combined tax and contribution revenues fell short of the statutory appropriation by HUF 9 billion. The funds' combined tax and contribution revenues was HUF 438 billion in 2017, HUF 146 billion more than in 2016. The 50 per cent growth is attributable to the fact that last year, in contrast to 2016, the National Employment Fund also received revenues from the health insurance contribution.

Based on preliminary data, the revenues of **social security funds** amounted to HUF 5,326 billion, HUF 148 billion more than the original statutory appropriation. However, during the comparison to the original statutory appropriation, it has to be taken into account that the 2016 year-end wage agreement with the employers entailed a drop in contribution revenue through the reduction of the social contribution tax, and in order to compensate for this, the subsidies from the central budget increased by HUF 240 billion relative to the original statutory appropriation. The revenues adjusted for the additional subsidies were lower by HUF 92 billion than the original statutory appropriation for the total income of the funds. **Social contribution tax** payments were markedly influenced by the 2016 year-end wage agreement, because the tax rate sank by 5 percentage points to 22 per cent in 2017. However, this change was not included in the original budgetary appropriation of HUF 2,711 billion. The original statutory appropriation was lowered by almost HUF 300 billion by the amendment to the Budget Act, and the actual revenues of HUF 2,481 billion were roughly in line with this. The revenue losses caused by the tax relief included in the wage agreement could have been as high as HUF 500 billion without the second-round economic stimulus effects, however, the dynamic expansion of the wage bill was able to partly offset this revenue shortfall.

2.3 EXPENDITURE

The government sector's spending according to the ESA accounting method increased by 0.1 percentage points relative to GDP as compared to 2016, but if EU funds are stripped from the expenditure, primary expenditure was higher in 2017 than in the base year by 0.5 percentage points of GDP.

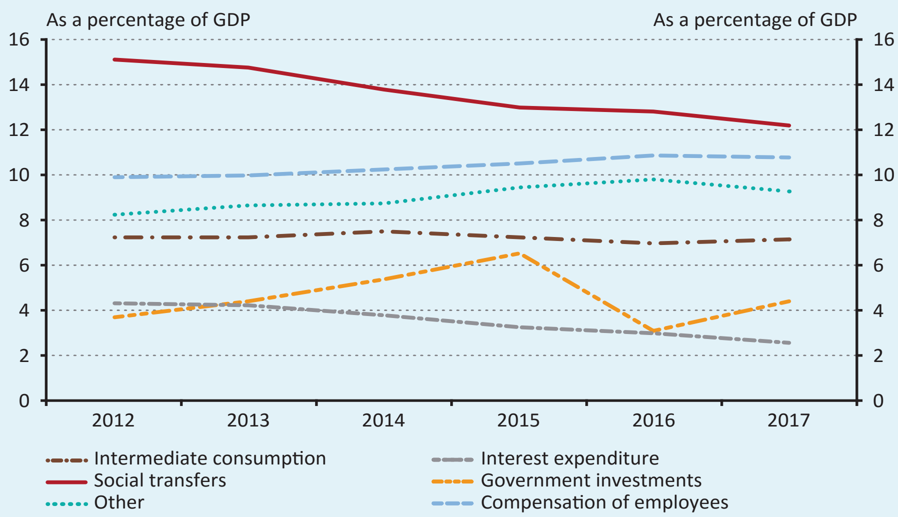
Chart 12
Total expenditure of the general government and changes in primary expenditure



Source: HCSO.

Current expenditure declined by 1.1 per cent of GDP, while capital expenditure rose by 1.2 percentage points of GDP, therefore the structure of expenditure changed in accordance with the target determined in the Convergence Programme (increasing the share of capital expenditure). Within current expenditure relative to GDP, the government's wage costs fell by 0.1 percentage point, the social benefits in cash dropped by 0.7 percentage points, whereas the government's consumption expenditure increased by 0.2 percentage points. Expenditure on social benefits in cash relative to GDP declines each year, since pension expenditure and other expenditure-side family allowances rise slower than the GDP growth rate. The drop in the government's wage expenditure relative to GDP was caused by the shrinking social contribution tax. In line with the reduction of financing costs, gross interest expenses fell by 0.4 percentage points of GDP, dipping to below 3 per cent of GDP. In four years, the general government's interest burden diminished by 1.2 percentage points of GDP, owing to the marked decline of debt and yields. Capital expenditure relative to GDP rose by 1.2 percentage points, specifically the increase in the direct investment expenditure of the government sector was over 1.4 percentage points of GDP, making the sector's investment ratio 4.5 per cent of GDP in 2017. The general government's direct investment expenditure expanded by over 40 per cent compared to the base year, mainly through expenditure from own resources, reaching the average investment-to-GDP ratio for 2011–2016. The low base also played a role in the high growth rate.

Chart 13
Structure of general government total expenditure



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

The expenditure of the central sub-sector exceeded the appropriations of the original Budget Act's by over HUF 500 billion, and the target was overachieved by HUF 335 billion relative to the amended statutory appropriations, out of which HUF 316 billion were realised in expenditure related to EU funds. The surplus expenditure related to EU funds occurred due to the higher-than-expected advance payments, therefore the overachievement of the appropriation was not recognised as ESA expenditure. Surplus expenditure as compared to the original plan appears mainly in expenditure items that used central reserves (e.g. curative and preventive expenditure, subsidies to local governments). Overall, the central control over the expenditure appropriations was maintained throughout the year.

All in all, no major overachievement of the appropriation could be observed in the case of **special and normative subsidies and the support of public broadcasts**, expenditure dropped by HUF 7 billion relative to the base period, while the expenditure was HUF 15 billion higher than the statutory appropriation due to the additional subsidy provided for public transport.

The expenditure on **home construction subsidies** were lower than the statutory appropriation by HUF 27 billion, as the utilisation of the benefits related to the family home creation allowance (CSOK) fell short of expectations. However, the amount of state subsidies paid was higher by HUF 36 billion than in previous years. A major portion of the growth, HUF 25 billion, was caused by the rise in CSOK subsidies, and the amount paid on building savings contracts also increased by HUF 7 billion.

The expenditure of the **National Family and Social Policy Fund** exhibited savings of 3.1 per cent relative to the base year. The expenditure related to early retirement benefits fell by HUF 21 billion in 2017 as compared to 2016. A major part of the decrease came from early retirement benefits, since no early retirement pension can be set since 2012, and the beneficiaries in this category are gradually transferred to the old-age pension group as they reach the old-age retirement age. In total, payments fell short of the statutory appropriation by HUF 5 billion, since the traditional family support payments (family allowance, maternity benefit etc.) were lower than the statutory appropriation by HUF 8 billion overall.

According to the preliminary data available before closing the accounts, **net expenditure of budgetary authorities, excluding EU receipts and payments** and together with the payments to the central budget, was HUF 4,875 billion in 2017, HUF 1,058 billion or 28 per cent more than in 2016. The dynamic rise of the expenditure is the result of the roughly 14 per cent increase in personal allowances, and the expansion of material expenditure by 10 per cent and of investment and renovation expenditure by 67 per cent. Furthermore, the growth rate of the capital transfer payments was also above 15 per cent. Net expenditure growth was also attributable to the fact that fewer EU advances were recorded as revenue by budgetary authorities in 2017 than in 2016, which explains a difference of around 10 per cent relative to the base period.

The expenditure of **budgetary authorities and professional chapter-administered appropriations** exceeded the statutory appropriation by HUF 1,572 billion. Since the achievement of the appropriations already includes the absorption of budgetary reserves, a more accurate picture can be gained about expenditure developments if they are compared to the previous year. The gross expenditure of budgetary authorities rose by 13.5 per cent compared to the previous year, while the growth of professional chapter-administered appropriation expenditure was as high as 25.5 per cent.

The rising expenditure in the case of the budgetary authorities was dominated by the 13.7 per cent increase of gross wage expenses relative to the previous year, the more than 60 per cent expansion in investment expenditure and the 9.9 per cent additional material expenditure. The dynamic rise in expenditure of professional chapter-administered appropriation occurred as a result of the above-mentioned investment expenditure and the close to 36 per cent increase in capital (transfer) expenditure and the approximately 19 per cent expansion of other operational expenditure.

Table 4
Partially consolidated cash expenditures of the central sub-sector in 2016 and 2017
(HUF billion)

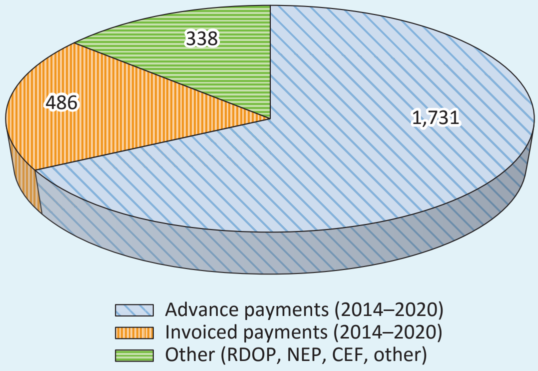
	2016	2017			
	Actual	Statutory appropriation (original)	Statutory appropriation (amended)	Actual (preliminary)	Difference (Actual – Original appropriation)
PRIMARY EXPENDITURE ITEMS	**14,442**	**15,842**	**16,092**	**16,295**	**454**
Special and normative subsidies and support to the public media	**404**	**381**	**382**	**396**	**15**
Social policy fare subsidy	**98**	**104**	**104**	**95**	**-9**
Housing grants	**148**	**211**	**211**	**185**	**-27**
Family allowances, social benefits	**559**	**562**	**562**	**557**	**-5**
Early retirement benefits	**113**	**96**	**96**	**95**	**-1**
Net own expenditures of central budgetary authorities and chapters	**3,878**	**4,781**	**4,897**	**4,875**	**94**
Support to local governments	**675**	**641**	**654**	**700**	**59**
Contribution to the EU budget	**295**	**317**	**286**	**260**	**-57**
Central reserves	**0**	**375**	**441**	**0**	**-375**
Other expenditures	**505**	**427**	**433**	**574**	**147**
Expenditures of extrabudgetary funds	**597**	**594**	**600**	**630**	**36**
NEF – Passive allowances	53	51	52	60	9
NEF – Active allowances	269	325	325	266	-59
Other expenditures	274	218	223	305	87
Expenditures of social security funds	**5,134**	**5,113**	**5,187**	**5,373**	**260**
PIF - Pensions	3,054	3,102	3,152	3,171	69
HIF - Disability and rehabilitation benefits	307	321	321	299	-22
HIF - Cash benefits	277	276	301	316	41
HIF - Medical and preventive care	1,090	1,040	1,040	1,196	156
HIF - Net expenditures of the drug budget	278	247	247	260	13
Other expenditures	128	127	127	130	2
Expenditures related to EU transfers	**2,035**	**2,239**	**2,239**	**2,555**	**316**
NET INTEREST EXPENDITURES	**970**	**912**	**856**	**987**	**75**
TOTAL EXPENDITURES	**15,412**	**16,754**	**16,947**	**17,282**	**528**

Source: 2017 Budget Act, Hungarian State Treasury.

The **EU expenditure of professional chapter-administered appropriations** reached HUF 2,555 billion in 2017, HUF 316 billion above the appropriation. This is because the payments of HUF 2,700 billion planned in the government decree[3] exceeded the statutory appropriation of HUF 2,239 billion. The higher amount of payments was achieved by accelerating and increasing advance payments, therefore – partly based on estimates – overall HUF 1,730 billion was paid in advances to beneficiaries in the year under review. Invoiced payments after performance amounted to around HUF 486 billion. Since a substantial portion of the payments were related to advances, no cash-based revenue from the European Commission could be linked to the majority of cash-based expenditure.

[3] Government Decree No. 1221/2017 (IV. 25.) on the Development Policy Objectives for 2017

Chart 14
Structure of the EU expenditures in 2017



Source: Ministry of Finance, Hungarian State Treasury, MNB calculation.

Expenditure on **subsidies to local governments** exceeded the original budgetary appropriation by 9.3 per cent, representing a growth of 3.7 per cent relative to the previous year. The surplus expenditure as compared to the appropriation was caused by the usual absorption of some of the provisions (e.g. wage compensation) and by the reallocations from other reserve funds.

Expenditure related to state assets rose by 40.2 per cent relative to the original budgetary appropriation. Similar to the earlier practice, the surplus expenditure was made based on individual government decisions, most of the additional funds were acquired from reallocation of appropriations and from the partial utilisation of central reserves. Expenditure growth was 14.4 per cent relative to the base period, representing a rise in capital expenditure.

The **contribution to the European Union budget** expenditure item exhibited savings of HUF 57 billion compared to the original budgetary appropriation, since Member States' fees paid based on GNI were used less than expected in previous years, therefore the current payment obligation was reduced by the European Commission with savings.

Net cash-based interest expenses exceeded the budgetary appropriation revised downwards during last year by HUF 131 billion. Gross interest expenditures exceeded the appropriation more than the surplus of the gross interest income. The fact that revenues and expenditures exceed the appropriations each year is the result of debt management transactions during the year. The greater-than-expected interest expenditures are linked to funding operations, specifically government securities redemptions, since the Debt Management Agency increased the total amount of redemptions during the year to support the reduction of government debt in the favourable liquidity position.

In nominal terms, the net cash-based interest expenditure hardly changed in 2017 compared to the previous year. This means that the expenditure-to-GDP ratio was substantially lowered, therefore the financing requirement relative to GDP arising from net interest expenses continued to fall in 2017.

Extrabudgetary fund expenditure exceeded the original and the amended statutory appropriation by HUF 36 billion and HUF 31 billion, respectively, while they increased by HUF 30 billion compared to the base year. Major differences from the appropriation could be observed in the case of the National Employment Fund and the Bethlen Gábor Fund, while in the case of the other funds the difference from the statutory appropriation (and the previous year) amounted to a couple of billion forints.[4]

[4] In addition, the Wesselényi Miklós Flood and Inundation Indemnification Fund and the Integration Fund of Cooperative Credit Institutions stopped functioning at the end of 2016.

The expenditure of the National Employment Fund fell short of the planned amount by HUF 35 billion, which was the result of a two opposing shifts. The expenditure related to the Start labour scheme came in HUF 59 billion lower than the appropriation, because the number of participants in public employment schemes was below the expected level due to the tight labour market. Moreover, passive and other expenditure together exceeded the appropriation by HUF 27 billion, which was slightly offset by the EU pre- and co-financing expenditure's shortfall of HUF 5 billion.

In the case of the Bethlen Gábor Fund, surplus expenditure of HUF 57 billion was incurred on account of government decrees. The average monthly expenditure of below HUF 3 billion was followed by an amount above HUF 50 billion in December, therefore last year the expenditure was HUF 16 billion higher than planned.

Pension expenditure exceeded the original statutory appropriation by HUF 70 billion, and it was higher even than the amended appropriation by HUF 20 billion. The macroeconomic projection of the 2017 Budget Act adopted in June 2016 included 0.9 per cent inflation and 3.1 per cent GDP growth for 2017. In early 2017, pensions were raised by 1.6 per cent instead of the 0.9 per cent stipulated in the Budget Act, since a government decree was issued back in 2016 to implement a higher pension increase at the beginning of the year. The effect of the divergence from the macroeconomic path expected while drafting the budget on pension expenditure was included in the June 2017 amendment, therefore the statutory appropriation for pensions grew by HUF 50 billion in total. More specifically, the appropriation for old-age pensions over the retirement age rose by HUF 26 billion on account of the stronger-than-expected inflation, and a pension premium provision of HUF 24 billion appeared in the budget as a new appropriation. In the first eight months of 2017, consumer prices rose more than the January pension increase, by 2.4 per cent year-on-year, therefore a supplementary 0.8 per cent pension increase was implemented in November. Since the amount of the increase was below 1 percentage point, the difference for the whole year was transferred to pensioners as a lump sum. The supplementary pension increase amounted to 9.6 per cent of the monthly benefit in November 2017 (0.8 per cent increase for 12 months, i.e. 0.8%*12=9.6%). Pension premiums were also paid in November, amounting to HUF 22.5 billion in the case of the benefits from the Pension Fund or HUF 30 billion when all the retirement benefits are taken into account.

Expenditure on **disability and rehabilitation benefits** came in HUF 22 billion below the statutory appropriation, falling short of the actual data from 2016 by HUF 8 billion. The decline in expenditure was due to the gradual decrease of the number of beneficiaries, because those who reach the retirement age are gradually transferred to the group of old-age pensioners, and the number of new beneficiaries is low on account of the tightened rules on eligibility.

Box 2
Retirement premium payment rules

Since the relevant rule entered into force in 2010, pension premiums were paid for the first time in 2017. Pursuant to the Pension Act,[5] the pension premium has to be paid if the extent of GDP growth expected for the current year calculated at constant prices is above 3.5 per cent and the general government's current-year balance target is expected to be met. The premium has to be paid in November of the given year to pensioners who were already beneficiaries in the previous year. In accordance with the Pension Act, the pension premium is payable to those who reached the old-age retirement age before the given year. However, the government issued a decree to extend the payment of the pension premium to those beneficiaries who have not reached the retirement age, for example to those women who receive pension after completing the 40-year eligibility period and those who receive retirement benefits.[6] A total of 2,750,000 people received the pension premium or a one-off benefit in November 2017, which was disbursed together with the monthly benefit in November.

The amount of the pension premium is determined by the extent of economic growth and the monthly benefit received by the pensioners. It is the multiple of two numbers:

[5] Act LXXXI of 1997 on Social Security Retirement Provision
[6] Government Decree No. 313/2017 (X.31.) on the 2017 Pension Premium and the One-off Benefit Payable on Certain Other Benefits

1) GDP growth less 3.5, but 4 at most,[7]

2) 25 per cent of the monthly pension benefit in November, but HUF 20,000 at most.

At the time of determining the retirement premium, the government expected a 4.1 per cent economic growth for 2017, therefore the premium had to be calculated by taking into account 0.6 times the 25 per cent of the pension benefit in November (up to HUF 20,000). According to the rule, HUF 12,000 of pension premium can be paid at most in the context of a 4.1 per cent GDP growth (0.6*HUF 20,000). Those pensioners whose monthly benefit was at least HUF 80,000 in 2017, received the maximum amount. In the case of lower pensions, the amount of the premium was calculated as 0.6 times the 25 per cent of the pension benefit. In the case of old-age pensions, HUF 12,000 was paid for the average pension of HUF 125,000.

The actual data on the **cash benefits paid by the Health Insurance Fund** exceeded the original HUF 276 billion appropriation by HUF 41 billion in 2017. This was due to the greater-than-expected base effect on the one hand, and on the other hand, the Budget Act did not include the expenditure hike arising from the cap on the social and family allowances increased on account of the rising minimum wage. **Cash benefits paid for the childcare benefit** were HUF 21.2 billion above the original statutory appropriation. The Health Insurance Fund spent HUF 152 billion on this in 2017, HUF 23 billion more than one year earlier. The dynamic rise in expenditure is the secondary effect of the 25 per cent increase of the minimum wage as part of the wage agreement, since the amount of the childcare benefit depends on the current amount of the minimum wage. The **sick pay expenditure's** greater-than-expected increase is attributable to the same reason, in line with the growth rate of earnings in the national economy. The original statutory appropriation was amended during the year on account of the minimum wage increase.

The original appropriation for **medical and preventive care** was HUF 1,040 billion, and the actual figure was HUF 156 billion higher. Roughly HUF 82 billion of the surplus expenditure represented the utilisation of the provision for the wage increase in the healthcare sector. Another approximately HUF 55 billion increase in expenditure was caused by raising the appropriation during the year, out of which HUF 44 billion was spent on reducing the debt of hospitals accumulated until the end of the year.

Net expenditure on **pharmaceutical subsidies** was HUF 13 billion higher than the appropriation, mainly due to the base effect, because this expenditure item was overachieved in 2016, too. The HUF 18 billion drop of net expenditure compared to the base year was down to the HUF 10 million decline in gross expenditure and the rising payments by pharmaceutical companies.

2.4 BUDGET MANAGEMENT OF LOCAL GOVERNMENTS

The cash-based (and ESA) balance of the **local government subsector** was set at HUF -20 billion in the Budget Act. According to the available preliminary data, the cash-based surplus of the local government subsector was HUF 519 billion in 2017, HUF 476 billion of which represented the revenues from the unused EU advances received from the central budget. When adjusting the cash-based surplus for the EU advance revenues, a HUF 43 billion cash-based surplus can be derived for 2017. The accrual-based statistical corrections related to the revenues and expenditure of the sub-sector reduced the cash-based balance by HUF 16 billion, therefore the sub-sector's ESA balance showed a surplus of HUF 27 billion according to the EDP report prepared at the beginning of October. The balance of the sub-sector in the EDP accounting method was above the government's preliminary target. The accrual-based accounting of investments diverged more than usual from the cash-based achievement of the revenues, towards the lower ESA expenditure.

The revenues of the sub-sector, without the funds from the EU transfers, increased by 8.0 percentage points in nominal terms compared to the previous year. Within that, the revenues from local taxes increased by 4.9 per cent, while the

[7] This means that the amount of the pension premium is capped at 7.5-per cent growth.

share of the own revenues of the institutions owned by the local governments within total revenues decreased. Total expenditure increased by more than 12 per cent compared to the base year, which is primarily attributable to the major growth in investment and other capital expenditures. Own, domestic capital expenditure expanded by 55 per cent, albeit from a low base. Material expenditure and personal allowances exhibited balanced growth, the former increased by 7.4 per cent, while the latter grew by 5.0 per cent, even though the public work programme's expenditure has already declined.

2.5 STATISTICAL CORRECTION (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. Statistical corrections are necessary because, based on the EU's accounting method, some of the transactions are recorded at the time of performance (accrual accounting), contrary to the rules of Hungarian budget accounting practice, where the transactions are recorded upon cash movement (cash accounting). Moreover, the EU regulations interpret the general government (the so-called government sector) more broadly than the Hungarian regulation, as they also include certain non-profit institutions, state-owned companies and financial transactions in the government sector. Accordingly, the HCSO calculates the ESA balance obtained with the European Union's methodology for the government sector, thus this deficit ratio differs from the cash-based (GFS) balance of the general government also in terms of sectors.

The 2017 budget act determined the balance of the accrual-based statistical corrections (ESA bridge) to be 0.8 percentage points of GDP (HUF 292 billion), i.e. it contained a correspondingly more favourable ESA balance compared to the cash-based deficit adopted in the Budget Act. According to the preliminary data from the EDP report from 2 October 2018, the ESA bridge was HUF 465 billion, 1.2 per cent of GDP. The difference is attributable to the partially opposite effect of several factors.

The greatest difference is linked to the recognition of EU transfers, whose balance became a balance-improving correction of roughly HUF 110 billion relative to the high cash-based deficit. The correction is attributable to the unexpected development of the cash-based achievement of EU funds, since a major amount of net cash-based receivables against the European Union were accumulated by the end of 2017.

The development of the accrual-based balance of the companies classified into the sector and guarantee funds pointed in a similar direction, where the HCSO used a correction of over HUF 132 billion. Among the included companies, NIF Zrt. and MÁV Start Zrt. had a high surplus, as they did not use the full amount of the funds received from the budget. Among the financial transactions recognised in the cash-based balance, the net surplus of stock purchases and sales was over HUF 41 billion, and the statistical correction used on account of lending and repayments improved the balance by HUF 126 billion. The difference between the interest paid and accumulated resulted in another balance-improving correction of HUF 155 billion. Greater corrections with a negative sign were linked to social security revenues and expenditure and the government sector's investments. In the case of the latter, the corrections amounted to over HUF 60 billion, which is different from the budgetary developments in earlier years, since those were characterised by statistical corrections for investments with a positive sign. The positive statistical correction in the preliminary EDP report from 2 October, close to 1.2 per cent of GDP, is the aggregate result of the major differences listed above.

2.6 GOVERNMENT DEBT

Last year, the gross government debt-to-GDP ratio fell markedly, by 2.6 percentage points, to 73.3 per cent. Similar to the previous years, the decline in the debt ratio was supported both by the low government deficit and economic growth. One of the most important factors that influences the trend development of the gross debt ratio is the general government's accrual-based deficit, which last year amounted to 2.2 per cent of GDP. More specifically, the primary balance contributed to lower debt, while interest expenses added to the ratio. The other basic factor influencing the change in the debt ratio is economic growth, which last year, just like in previous years, contributed to the decline in the ratio.

The advance payments on EU funds increased government debt. Last year, the budget provided EU funds equivalent to over HUF 2,500 billion to the beneficiaries. However, the revenues from the EU amounted to merely HUF 1,100 billion.

The financing requirement in excess of the underlying trends and necessary for making advance payments on the EU funds significantly boosts government debt on a temporary basis. The funds are expected to be transferred to the Hungarian budget in the future, and they can help reduce the government debt at a quicker pace in those years.

The dollar's depreciation against the euro pointed towards a fall in debt levels. The dollar weakened more than 10 per cent against the euro in 2017, which reduced government debt by 1.2 per cent of GDP. This is due to the fact that part of the public debt was issued in dollar bonds, which is typically swapped for euro debt by the Debt Management Agency, and thus gross debt is also influenced by the dollar's exchange rate movements relative to the euro indirectly, through the value of the market swaps. In 2015, a similar debt-increasing effect could be observed on account of a strengthening dollar, which was offset by last year's impact.

The downward trend of the share of FX within the debt-to-GDP ratio and the decline of foreign ownership observed since 2011 continued last year (Chart 15). The key driver of the structural change in government debt in 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' share within government debt decreased substantially, dropping from 65 per cent at the end of 2011 to 37 per cent by the end of 2017. Meanwhile, Hungary's FX debt also declined markedly. At the end of 2011, the FX ratio of the central government debt amounted to approximately 50 per cent, while this figure sank to below 22 per cent by the end of 2017. The diminishing FX and external debt contribute to the reduction of the Hungarian economy's vulnerability.

Chart 15
Developments in gross government debt, forint and FX debt within that and the proportion of foreign ownership

Source: MNB.

3 Expected general government developments in 2018

3.1 EXPECTED ESA BALANCE OF THE GOVERNMENT SECTOR IN 2018

According to our projection, in 2018 the accrual-based deficit of the government sector may be in the range of 2.2–2.3 per cent of GDP, depending on the utilisation of the Country Protection Fund. The cash-based deficit of the central sub-sector of the general government is expected to be much higher than the figures in the Budget Act, however, greater surpluses are projected among statistical corrections. Overall our forecast for the ESA deficit of the general government is somewhat lower than the 2.4-per cent accrual-based appropriation in the Budget Act.

Table 5
Balance of the general government in 2018

	Statutory appropriation	MNB forecast	Statutory appropriation	MNB forecast	Difference
	HUF billion		percentage of GDP		
1. Balance of the central sub-sector	-1,361	-1,899	-3.4	-4.6	-1.2
2. Balance of local governments	203	245	0.5	0.6	0.1
3. Cash-based (GFS) balance of the general government (1+2)	**-1,158**	**-1,655**	**-2.9**	**-4.0**	**-1.1**
4. GFS-ESA difference	175	710	0.4	1.7	1.3
5. ESA balance of the general government (3+4)	**-983**	**-945**	**-2.4**	**-2.3**	**0.1**
6. ESA balance with cancellation of central free reserves	**-923**	**-913**	**-2.3**	**-2.2**	**0.1**

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

The Budget Act determined the cash-based balance of the central sub-sector of the general government to be HUF -1,361 billion, whereas our forecast includes a cash-based deficit HUF 540 billion higher, equivalent to 1.2 per cent of GDP. According to our projection, the central sub-sector's deficit could be close to HUF 1,900 billion in 2018, and the difference is mostly attributable to the substantially lower revenue expectation related to European Union funds.

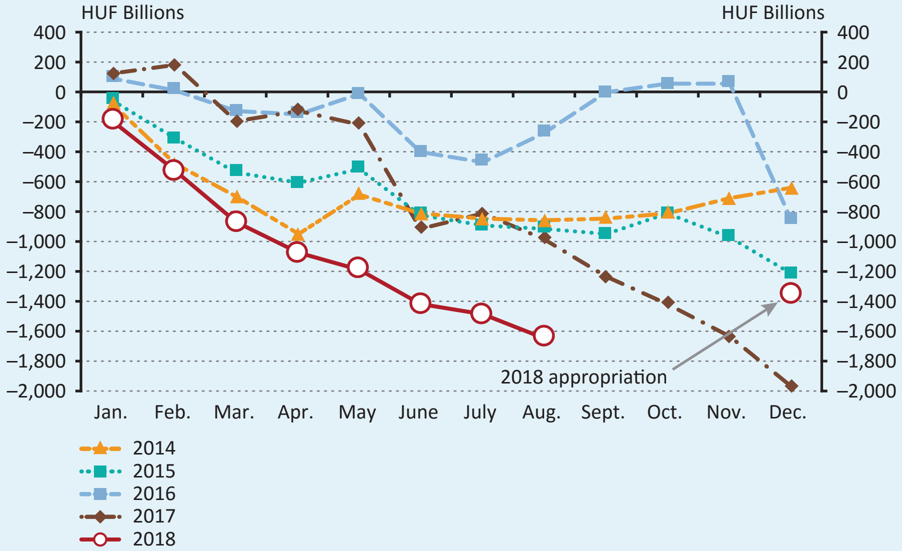
- The *central budget* deficit is expected to be HUF 634 billion higher than the appropriation in the Budget Act. Among revenues, payments by enterprises, consumption taxes and households' payments may all exceed the statutory appropriation. However, the cash-based revenue from EU programmes may fall well short of the budgetary target, by almost as much as HUF 1,000 billion, while expenditures related to EU funds may be below the appropriation to a lesser extent, roughly by HUF 200 billion. Furthermore, savings are expected regarding expenditures for this year in the case of several budgetary items.

- Our projection for the balance of *extra-budgetary funds* is more favourable than the expectation of the Budget Act by HUF 67 billion, and the funds' balance may be in a minor surplus of HUF 18 billion. Expenditures of the funds may be lower, especially on account of the expenditure related to the public work scheme, while the revenues are expected to be over the statutory appropriation, which is markedly influenced by the higher revenues of labour taxes and contributions.

- The financial management of *social security funds* was constructed to result in a zero net balance together with the necessary central subsidies, however, we expect their balance to show a surplus in 2018. The surplus is caused by the revenues related to wages and the higher revenues from smaller tax types.

The cumulative cash-based deficit of the central sub-sector for the first eight months was higher than in the same period in earlier years. The deficit amounted to HUF 1,646 billion until August, above the HUF 1,361 billion annual cash-based appropriation. The higher value of the eight-month cumulated cash-based deficit compared to last year is mostly attributable to the continuous pre-financing of EU funds, the low level of revenues from the EU, the higher expenditures of the budgetary institutions and the absence of last year's one-off revenues (tax credit for growth, land sales).

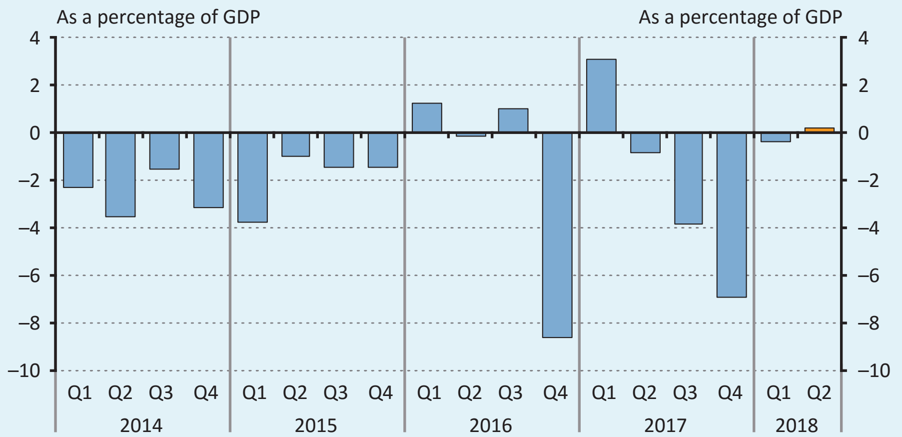
Chart 16
Intra-year cumulative cash-based balance of the central sub-sector



Source: Budget Act of 2018, Hungarian State Treasury.

The accrual-based deficit of the government sector was a mere 14 HUF billion in the first half of 2018. Based on the first two quarter ESA deficit of the general government published by the HCSO the development of the accrual-based deficit during the year differs from the trend seen in the past two years and may be similar to the patterns in earlier years (i.e. the interim distribution of the deficit might be smoother). Deficit in the first half of the year is significantly lower than the data published in the first quarter by the HSCO. The reason behind the emergence of a deficit higher than last year was the absence of one-off revenues (land sales, growth tax credit) and the dynamic growth of expenditures at the beginning of the year, which has slowed down in the past months. The major portion of the difference between the cash-based and the accrual-based deficit continues to be caused by the advance payments of EU funds.

Chart 17
Accrual-based budget balance



Source: HCSO and MNB.

Our forecast for the surplus of the local government sub-sector is in line with the expectations in the Budget Act. The high cash-based surplus of the sub-sector is mainly due to the advance revenues linked to EU funds, however, the ESA balance of local governments could also be in a slight surplus in 2018.

In 2018, the statistical corrections between cash-based and accrual-based accounting may be 1.3 per cent higher in GDP terms than in the Budget Act. The considerable growth is attributable to the unexpected development of the pre-financing of EU funds and the cash-based EU revenues as well as the higher-than-expected balance-improving correction of the companies classified into the general government. The government's expectation on the statistical correction in the Budget Act significantly differs from our own projection, however, the budget also assumed a greater cash-based–accrual-based difference of roughly HUF 400 billion in the autumn EDP notification, which is roughly equal to the statistical corrections forecast of the MNB.

3.2 MACROECONOMIC PROJECTION UNDERLYING THE BUDGET

The MNB's forecast on economic growth in 2018 is in line with the Budget Act's forecast. The annex to the 2018 Budget Act submitted to the Parliament included real growth of 4.3 per cent for this year, while according to the MNB's forecast published in its September Inflation Report, the economy may grow by 4.4 per cent this year. The robust growth is supported by the steady and dynamic rise of real wages, and corresponding increase in household consumption. There is a slight difference between the prognosis of the MNB and the Budget Act regarding the structure of growth. According to our own forecast, consumption may fall somewhat short of the expectation in the Budget Act, however, investment growth may be greater than foreseen in the budget. The MNB's projection includes stronger export growth for 2018, however, import growth may also be higher than the pace in the annex to the Budget Act.

Table 6
Comparison of the macroeconomic paths included in the 2018 Budget Act and the MNB's September 2018 Inflation Report

	2018		
	Budget Act	MNB	Difference
GDP	**4.3**	**4.4**	**0.1**
Consumption expenditure of households	5.4	4.9	-0.5
Public consumption	0.9	1.1	0.2
Gross fixed capital formation	12.9	14.9	2.0
Exports	6.5	6.9	0.4
Imports	8.2	9.2	1.0
Inflation	**3.0**	**2.8**	**-0.2**
Gross wage bill	**10.4**	**12.0**	**1.6**
Gross average earnings	8.8	10.5	1.7
of which: private sector	8.9	10.0	1.1
Number of employed	1.8	1.4	-0.4
of which: private sector	2.6	1.8 (2.3)	-0.3

*Note: * The Budget Act defines the private sector differently, therefore, the headcount projection comparable with the budget's macro path is shown in brackets, and the difference is also calculated from that.*
Source: Annex to the 2018 Budget Act, the MNB's September 2018 Inflation Report.

Labour market developments may be more favourable than the assumptions in the budget. The growth of the gross average earnings in the national economy may be 1.7 percentage points higher than in the Act, however, the rise in the number of employees could be slightly lower than assumed by the budget.

3.3 CASH REVENUES OF THE CENTRAL SUB-SECTOR

The **primary revenues of the central sub-sector** may fall short of the Budget Act's appropriations by HUF 636 billion, which is principally attributable to the low level of expected revenues related to European Union funds. The tax and contribution revenues of the central sub-sector are expected to be well over the target in the Budget Act, exceeding it by almost HUF 273 billion, due to the payments by enterprises, consumption taxes and the tax and contribution revenues related to wages.

According to our prognosis, the **payments by economic organisations** could exceed the appropriations by HUF 56 billion overall, however, the budget revenues from businesses may come in HUF 153 billion lower than in 2017. In the first eight months of the year, the developments in the payments by enterprises were in line with our projections. **Corporate income tax** revenues are expected to diminish by HUF 243 billion in 2018. The decline can be linked to the fact that the large-scale utilisation of the growth tax credit payable on the tax liability of 2015 ran out at the end of the last year. Mainly due to the revenue-decreasing effect of the tax credit arising from supporting major team sports introduced on 1 January 2018, revenues from the **special tax of financial institutions** may be HUF 15 billion lower.

In the case of the **simplified entrepreneurial tax (EVA)**, payments may fall short of the appropriation by HUF 14 billion. The revenue loss is due to the base effect and the attractive nature of other tax types for small enterprises (KATA and KIVA), therefore out of those companies that had previously opted for the simplified business tax, more than previously expected may switch to paying taxes under KATA rules. This appeal will be strengthened by a section of the new tax lawss, pursuant to which companies will not be able to pay their taxes under the simplified entrepreneurial tax rules after 20 December 2018. The EVA payments may be lower by HUF 8 billion compared to 2017 due to the gradual decrease in the number of taxpayers opting for this tax type.

The revenues expected from the **lump sum tax of small entrepreneurs** (KATA) may be HUF 11 billion higher than the appropriation in the Budget Act. The increase is partly due to the base effect, as the revenues from this tax type exceeded the appropriation by HUF 4 billion in 2017. Other than the base effect, the increase can be attributed to the higher willingness to choose this type of tax than foreseen in the 2018 Budget Act. The revenues from the lump sum tax may grow by HUF 26 billion on account of the steady rise in the number of taxpayers opting for this tax type. Revenues from the **small enterprise tax** (KIVA) are expected to be HUF 13 billion higher than in the Budget Act's projections. The reason behind the difference is the increase in the number of taxpayers choosing the small enterprise tax. The number of businesses opting to use this tax type rose by 88 per cent between December 2017 and June 2018. As a result of the rise in the number of taxpayers, revenues from the small enterprise tax may be HUF 18 billion higher than in the previous year.

Other payments by enterprises may be above the appropriation by HUF 15 billion. The main reasons for the difference can be found among other centralised revenues. In 2017, revenues from product levies were over the appropriation for the year by HUF 6 billion, while those from water resource contributions, land protection contributions and other sources came in HUF 7 billion higher. The difference may persist in 2018, since the corresponding items in the current year's Budget Act were determined based on the low appropriations of 2017. Other payments by enterprises could be HUF 40 billion higher than in the previous year, more specifically the rehabilitation contribution revenues may grow by HUF 10 billion relative to 2017, since the minimum wage increased by another 8 per cent in 2018 due to the tripartite wage agreement at the end of 2016. Payments of the **e-road toll** may be higher than last year by HUF 13 billion, partly on account of the growing combined length of the network of toll roads. **Advertising tax** revenues could grow by HUF 20 billion, since a major portion of the one-off refunds arising from the 2017 amendment of the Advertising Tax Act was made last year.

Table 7
Partially consolidated cash revenues of the central sub-sector
(HUF billion)

	2018			
	Statutory appropriation	January–August realisation	MNB forecast	Difference: MNB – appropriation
TAX AND CONTRIBUTION REVENUES OF THE CENTRAL SUB-SECTOR	**14,287**	**9,285**	**14,560**	**273**
Payments by economic organisations	**1,354**	**760**	**1,411**	**56**
Corporate income tax	370	118	381	12
Special tax of financial institutions	50	26	49	-1
Simplified entrepreneurial tax	70	27	55	-14
Mining royalty	37	27	37	1
Gambling tax	26	18	31	5
Income tax of energy companies	52	22	58	6
Lump sum tax of small entrepreneurs	113	80	124	11
Small enterprise tax	27	29	40	13
E-road toll	178	120	187	9
Utility tax	55	28	55	0
Other taxes and payments	363	263	380	17
Advertising tax	14	3	12	-2
Consumption taxes	**5,266**	**3,388**	**5,343**	**77**
Value added tax	3,839	2,440	3,890	52
Excise duties	1,099	702	1,091	-9
Registration tax	24	18	25	1
Telecom tax	52	36	54	1
Financial transaction levy	205	154	230	25
Insurance tax	35	28	38	2
Tourism development contribution	11	11	16	4
Payments by households	**2,338**	**1,590**	**2,411**	**73**
Personal income tax	2,096	1,432	2,166	69
Duties, other taxes	198	131	198	0
Motor vehicle tax	44	27	48	4
Tax and contribution revenues of extra-budgetary funds	**356**	**227**	**377**	**21**
Tax and contribution revenues of social security funds	**4,973**	**3,320**	**5,019**	**45**
Social contribution tax and contributions	4,645	3,088	4,681	36
Other contributions and taxes	329	232	338	9
REVENUES RELATED TO EU FUNDS	**1,990**	**194**	**1,029**	**-961**
OTHER REVENUES	**277**	**277**	**329**	**52**
Other revenues of the central budget	**139**	**170**	**190**	**51**
Other revenues of social security funds	**38**	**37**	**33**	**-5**
Other revenues of extra-budgetary funds	**100**	**71**	**106**	**6**
TOTAL REVENUES	**16,554**	**9,756**	**15,918**	**-636**

Source: Budget Act of 2018, Hungarian State Treasury, MNB.

On a cash basis, we expect **value added tax** revenues of HUF 3,890 billion in 2018, which exceeds the budgetary appropriation by HUF 52 billion. The difference is mainly attributable to the fact that the favourable developments in recent months from the perspective of the budget balance were already taken into account while preparing our latest forecast.

In the first eight months, net VAT revenues rose by 7 per cent compared to the previous year, however, this figure may be misleading when assessing the macroeconomic fundamentals, because the amount of refunds within it increased by 18 per cent. The latter is attributable to a technical change, which considerably influences the annual cash-based revenue but does not influence the accrual-based balance. The refund period used for taxpayers who are deemed reliable was shortened from 75 to 45 days in last January, then it was cut further from 45 to 30 days in January 2018, and it has significantly transformed the development of interim VAT refunds. Therefore gross payments paint a more accurate picture about real economy developments and the expected accrual-based revenues than the net figure, and the former increased by 12 per cent between January and August year-on-year.

Our **excise duty** projection for this year is HUF 1,091 billion, which falls short of the appropriation by HUF 9 billion. The difference is presumably attributable to the base effect, as compared to the 2018 Budget Act submitted last year, excise duty revenues were HUF 12 billion lower in 2017. Our projection already included the increase of the excise duty of tobacco in September, which slightly increases this year’s revenues by a couple of billion forints.

The excise duty revenues in the first eight months of the year show a 9-per cent increase year-on-year, which is mainly attributable to the 22-per cent rise of the excise duty on tobacco products. The latter can be mostly explained by the base effect, because since April 2017 tobacco products may be released for free circulation only with a strip stamp containing no price instead of the former tax stamp that contained the price of the product, which encouraged merchants to reduce their stocks last year.

Our projection for **financial transaction levy** revenues is HUF 230 billion, HUF 25 billion higher than the appropriation in the Budget Act. The difference arises partly from the assessment of this year’s growth, and partly from the fact that the revenue from this tax type already exceeded the planned level by HUF 11 billion in 2017.

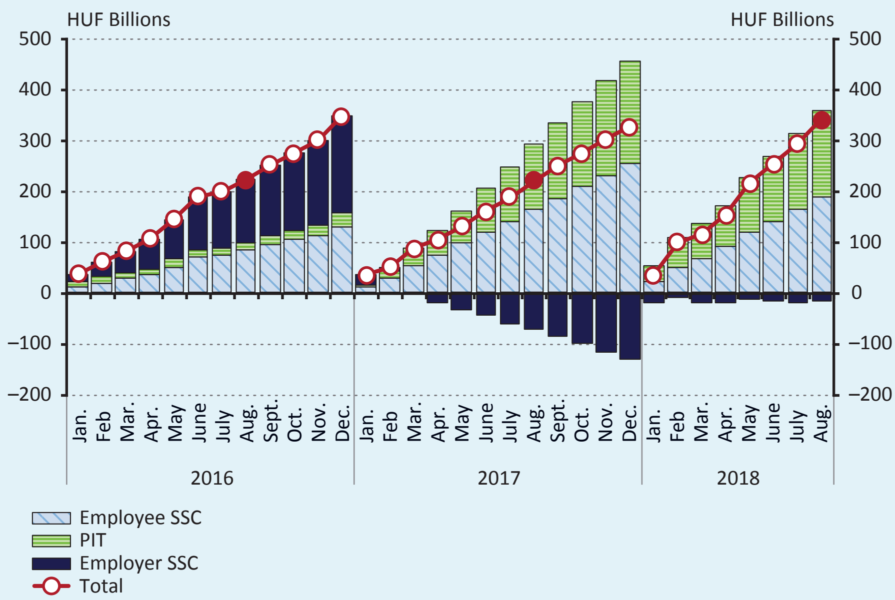
The appropriation of **duty revenues** for 2018 is HUF 189 billion, which is expected to be achieved based on the actual data from the first eight months and the experiences from earlier years. This year, duty revenues of HUF 124 billion were collected in the first eight months, representing 66 per cent of the appropriation for the year and a 10-per cent rise year-on-year. Almost two-thirds of duty revenues are still made up of the National Tax and Customs Administration’s revenues on its tax revenue account for duties that include the duties on property purchases.

Personal income tax revenues increased by 13.5 per cent year-on-year until August, which translates to HUF 170 billion additional revenues relative to the first eight months of last year. The substantial growth was influenced by the steady employment growth as well as the dynamic rise of gross average earnings. Employment expanded by 1.4 per cent until July compared to the first seven months of last year, while gross average wages exhibited a 12-per cent year-on-year hike until July. This year, personal income tax was affected by mostly administrative measures with a minor budgetary effect (elimination of tax equalisation, recognition of daily allowances, transfer of legal practice rights), however, the family allowance of those with two children increased in line with an earlier legal stipulation from last year’s HUF 15,000 to HUF 17,500. The cash-based revenue developments in the first eight months point towards a significant overachievement of the 2018 appropriation by approximately HUF 70 billion.

The combined **tax and contribution revenues of extra-budgetary and social security funds** came in HUF 170 billion higher in the first eight months than in the same period last year, and they could exceed this year’s annual budgetary appropriation by HUF 66 billion in total. According to our forecast, most of the tax-type revenues of the extra-budgetary funds are in line with the appropriation, and marked overachievement is expected only in the case of the vocational training contribution. Among the tax and contribution revenues of social security funds, the social contribution tax revenues may be lower than the budgetary appropriation by HUF 20 billion, while social security contributions of employees may be HUF 56 billion higher. In the first eight months, among other revenues of social security funds, the public health product tax and the accident tax grew by around HUF 4 billion year-on-year, and both tax types are expected to produce higher revenues than in the appropriation. Healthcare contribution revenues may fall short of the budgetary target by HUF 5 billion.

Following a 5-percentage point decline last year, the social contribution tax rate payable by employers has further decreased by another 2.5-percentage points to reach 19.5 per cent, however, this tax type had a minor negative contribution to the development of revenues, since the dynamic rise of gross wages and employment partly offset the effect of the tax cut. In parallel with this, the upper rate of the healthcare contribution also fell by 2.5 percentage points in 2018, and the obligation to pay the contribution on annual income of over HUF 1 million from letting property was abolished. Revenues from the social security contributions of employees rose by 13.3 per cent until August compared to the first eight months of last year.

Chart 18
The cumulative development of wage-related revenues year-on-year



Source: Hungarian State Treasury.

At the end of August 2018, **revenues from EU programmes** amounted to HUF 183 billion, mainly on account of invoice payments of HUF 100 billion received in June. Relative to the appropriation of HUF 1,911 billion, the cumulative value at the end of August seems to be very low, as it is below 10 per cent of the annual target. Pursuant to Government Decree No. 1367/2018 (VIII. 13.), the Managing Authorities need to submit invoices to the European Commission of at least EUR 3.1 billion until 31 December 2018. Pursuant to the plan on the drawdown of at least HUF 1,000 billion, at least 75 per cent of the invoices submitted need to be paid this year. On account of the low level of actual data, the slow progress on invoiced payments, the absorption of advances and the drawdown target specified in the Government Decree, this year's revenues are expected to fall well short of the appropriation, by HUF 960 billion. The item of **other EU revenues** contains HUF 11 billion until August, which is less than 15 per cent of the HUF 76 billion appropriation. The reasons behind the low level of EU revenues include the persistently high share of advances within cash-based payments. However, the revenues are expected to bloat in the rest of the year, similar to last year's pattern.

Other revenues of the central budget came close to 120 per cent of the annual appropriation. This high figure was caused by the sale of carbon dioxide quotas in the first half of the year as well as dividend revenues, which were higher than the appropriation. The annual revenue surplus is expected to be close to HUF 50 billion, HUF 17 billion of which is attributable to the payment of the year-end surplus of the Pension Fund into the central budget.

3.4 CASH EXPENDITURES OF THE CENTRAL SUB-SECTOR

Our prognosis on **primary expenditures** is lower than the appropriation in the Budget Act by HUF 110 billion. With respect to the other items of the central sub-sector, the appropriation is expected to be exceeded by more, while savings are forecasted in other areas. Spending by budgetary institutions, the subsidies to local governments, expenditures related to state assets and medical and preventive care may all be higher than the appropriation. However, major expenditure savings are expected in disability and rehabilitation benefits, the public work scheme and housing grants until the end of the year. The expenditures related to European Union funds is foreseen to fall short of the budgetary appropriation by over HUF 200 billion.

Payments related to **special and normative subsidies, as well as support to the public media** reached 70 per cent of the annual appropriation in the first eight months of the year, which is consistent with the previous two years' seasonality. With respect to the relevant expenditure items, the statutory appropriations are expected to be achieved by the end of the year, and past experience suggests that expenditure in the first and second half of the year is balanced.

According to our forecast, **housing grants** expenditures may be lower than the HUF 236 billion appropriation by HUF 30 billion. Based on the incoming data from the first eight months, 52 per cent of the appropriation for housing subsidies was realised, which points towards a saving on expenditures. The largest item within housing subsidies is the newly introduced housing grant scheme, the family home creation allowance (CSOK) programme, where the budget estimated annual expenditure of HUF 101 billion. However, the CSOK subsidies paid by the budget in the course of eight months amounted to merely half of the annual appropriation, while showing a year-on-year growth of 6 per cent. Another substantial expenditure items are the state subsidisedbuilding savings account, the anticipated annual expenditure of which, in line with the budgetary appropriation, is HUF 71 billion. Moreover, the expenditure on the tax refund programme may also fall short of the HUF 25 billion foreseen for this purpose, since the expenditure realised until the end of August only amounted to HUF 8 billion.

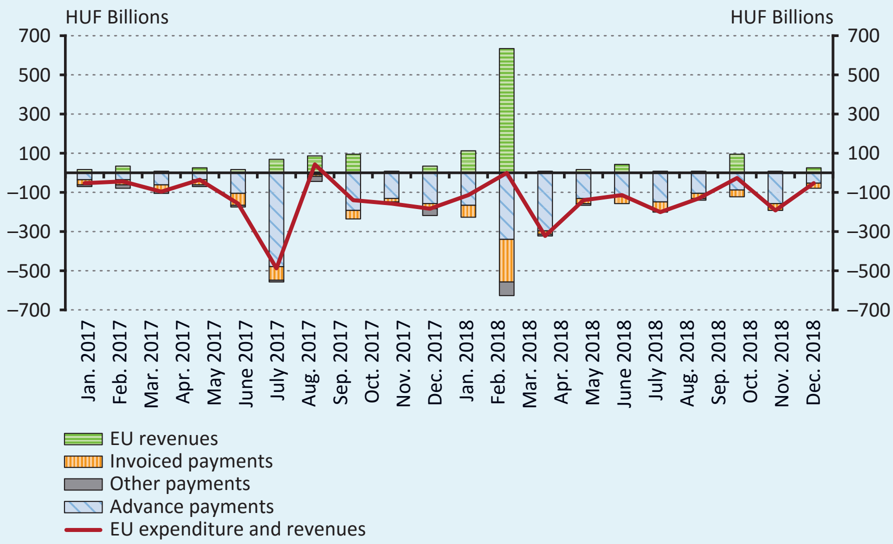
The expenditure appropriation of the **National Family and Social Policy Fund** is in line with our expectations in the case of the majority of the items. The Budget Act allocated HUF 645 billion for the Fund's expenditure. Roughly half of the expenses goes towards paying the family allowance, the HUF 313 billion appropriation of which slightly exceeds the amount of expenditure from the previous year and is in line with our expectations. The drop of roughly HUF 7 billion between the benefits paid in 2017 in the amount of HUF 651 billion and the appropriation for this year is explained by the decrease in the expenditures planned for early retirement benefits and public health services, attributable to the decrease in the number of beneficiaries, in line with the former tightening of the eligibility criteria.

The **net own expenditures of central budgetary institutions and chapters** were realised above the pro-rata level in the first eight months, coming close to 69 per cent of the statutory appropriation. Growth is robust compared to last year, mainly due to the low base (the overwhelming majority of the expenditure in 2016 and 2017 was concentrated in the second half or the very end of the year). A new government measure,[8] according to which budgetary authorities need to pay into the central budget their residual appropriations that are not tied to liabilities, seeks to prevent an excessive rise in expenditure and strengthen the government's control over spending. Such payments amounted to over HUF 185 billion at the end of August.

Our projection for the net own expenditures of central budgetary institutions and chapters exceeds the appropriation in the Budget Act by HUF 250 billion. However, taking into account the utilisation of central reserves recorded in these items, the difference is closer to HUF 50 billion. Compared to the appropriations, we expect extra spending on wage expenditure, certain uncapped expenditures of chapters (grants for social and public education human services), and we included the use of the residual appropriations tied to liabilities as well as the payment of incentive bonuses at the National Tax and Customs Administration. At the same time, the net own cash-based expenditure is 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 advance payments.

[8] Pursuant to Section 1 of Government Decree 426/2017 (XII. 19.).

Chart 19
Monthly revenues and expenditure related to EU programmes



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

The **expenditures related to EU programmes** amounted to HUF 1,389 billion in the first eight months, which is 57 per cent of the statutory appropriation for the year totalling HUF 2,418 billion. Expenditure related to EU funds is expected to be around HUF 2,200 billion by the end of the year, which may also be due to the curbing of advance payments reaffirmed by a Government Decree.[9] According to our estimates, roughly HUF 1,100 billion of the payments until the end of August were advances, i.e. the share of invoiced payments is still very low. As a result, cash-based revenues are linked to most of the payments only later, after the advances are used and the invoices are submitted and paid. The advances paid outside the central sub-sector but remaining within the government sector increase the cash-based deficit but do not affect the accrual-based balance. In the first eight months of the year, the payments from the IKOP (HUF 301 billion), EFOP (HUF 265 billion), TOP (HUF 228 billion) and GINOP (HUF 207 billion) programmes were the largest. Out of the **central reserves**, HUF 57 billion of free reserves of the approximately HUF 66 billion still available is allocated for special government measures and the Country Protection Fund, however, in the case of the reserve allocated for the sectoral career paths, the annual appropriation is expected to be exceeded, by roughly 0.1 percentage point of GDP. Nevertheless, the payments in the Central Residual Fund created with a Government Decree function as quasi-reserves in the context of a better-than-expected general government balance position. By the end of August, the amounts paid to the Residual Fund were over HUF 185 billion.

[9] Government Decree No. 160/2018 (IX.7.) on amending Government Decree No. 272/2014 (XI.5.)

Table 8
Partially consolidated cash expenditures of the central sub-sector
(HUF billion)

	2018			
	Statutory appropriation	January–August realisation	MNB forecast	Difference: MNB appropriation
PRIMARY EXPENDITURE ITEMS	**17,010**	**10,897**	**16,899**	**-110**
Special and normative subsidies and support to the public media	**444**	**321**	**444**	**0**
Social policy fare subsidy	**98**	**61**	**92**	**-6**
Housing grants	**236**	**122**	**203**	**-33**
Family allowances, social benefits	**555**	**404**	**553**	**-2**
Early retirement benefits	**90**	**62**	**90**	**0**
Net own expenditures of central budgetary institutions and chapters	**5,292**	**3,625**	**5,543**	**251**
Support to local governments	**705**	**482**	**770**	**65**
Contribution to the EU budget	**310**	**208**	**300**	**-10**
Central reserves	**261**	**0**	**65**	**-195**
Expenditures related to state property	**322**	**123**	**370**	**48**
Other expenditures	**118**	**81**	**124**	**6**
Expenditures of extra-budgetary funds	**553**	**305**	**522**	**-32**
NEF – Passive allowances	55	41	56	1
NEF – Start labour programme	225	126	178	-47
Other expenditures	273	139	287	14
Expenditures of social security funds	**5,608**	**3,715**	**5,624**	**15**
PIF - Pensions	3,343	2,208	3,343	-1
HIF - Disability and rehabilitation benefits	309	190	283	-26
HIF - Cash benefits	352	237	359	7
HIF - Medical and preventive care	1,204	811	1,234	30
HIF - Net expenditures of the drug budget	265	189	265	-1
Other expenditures	134	80	140	6
Expenditures related to EU transfers	**2,418**	**1,389**	**2,200**	**-218**
NET INTEREST EXPENDITURES	**905**	**505**	**918**	**13**
TOTAL EXPENDITURES	**17,914**	**11,402**	**17,817**	**-97**

Source: Budget Act of 2018, Hungarian State Treasury.

Within the expenditures of the **extra-budgetary funds,** an annual saving of HUF 40 billion is expected under the active spending of the National Employment Fund compared to the appropriation due to the lower utilisation of the public work scheme. **Spending on the Start labour programme** amounted to 56 per cent of the annual appropriation until the end of August. This is a marked drop in expenditure relative to the base period, as spending on public employment decreased by 25 per cent until the end of August relative to the same period last year. Due to seasonality changes, further minor reduction is expected in the number of participants in public work schemes in the rest of the year, therefore savings of roughly HUF 45 billion are expected as compared to the statutory appropriation for the Start Labour programme.

Pensions and pension-type benefits paid from the Pension Fund amounted to HUF 2,208 billion in the first eight months of 2018, which is in line with the level of spending expected on a pro-rata basis. Between January and August 2018, spending on pensions exceeded last year's figure by HUF 127 billion or 6 per cent year-on-year. A 3-per cent pension increase was implemented in January 2018 based on the inflation projected in the Budget Act. The MNB's September Inflation Report contains a 2.8-per cent inflation forecast for 2018, therefore no supplementary pension increase is expected for this November.

Besides the pension increase at the beginning of the year, the growth in expenditure relative to the previous year was attributable to the replacement effect and the rise in the number of beneficiaries. The benefits paid to new pensioners are typically higher than the average benefits of those leaving. In the first half of 2018, those born in the second half of 1954 could retire because the old-age retirement age for those born in that year is 63.5 years (Table 9). Due to the rise in the retirement age, no new old-age pension could be determined in the first half of 2017 for those born in 1954, which also contributes to the increase in the expenditure in the first half of the year relative to the previous year. However, no new group reaches the retirement age in the second half of 2018, because the retirement age is 64 years for those born in 1955, who can retire in 2019.

Table 9
Old-age retirement age in Hungary

Year of birth	Retirement age	Time of reaching retirement age
1951	62 years	2013
1952	62.5 years	2014 H2–2015 H1
1953	63 years	2016
1954	63.5 years	2017 H2–2018 H1
1955	64 years	2019
1956	64.5 years	2020 H2–2021 H1
1957	65 years	2022

Source: Act LXXXI of 1997 on Social Security Retirement Provision.

Pension benefits are foreseen to be in line with the appropriation in the Budget Act in 2018. The projected amount of pension spending is consistent with the statutory appropriation, although our forecast on the individual items differs. Our prognosis uses the 3-per cent inflation determined in the Budget Act. The MNB's 2.8-per cent projected inflation is lower than the figure in the Budget Act, however, the early January raise of the benefits was based on the 3-per cent value. Our projection for old-age pensions is higher than the statutory appropriation, while our forecast on pensions due to women after the 40-year eligibility period fall short of the appropriation based on the incoming actual data. The Budget Act contains an appropriation of HUF 260 billion for women's early retirement benefits, whereas our projection is significantly lower at HUF 236 billion. In the case of the pensions due to women after the 40-year eligibility period, a HUF 16 billion expenditure growth is expected for 2018 relative to the base year.

With regard to the annual development of pension expenditure, it has to be pointed out that similar to 2017, **pension premiums may be paid in 2018, too**. The 2018 Budget Act estimates GDP growth of 4.3 per cent while the MNB's September Inflation Report projects real growth of 4.4 per cent. According to our expectations, the amount of the pension premium paid in November could be, somewhat higher than the HUF 32 billion foreseen in the budget.

Spending on **disability and rehabilitation benefits** amounted to HUF 190 billion in the first eight months of 2018, which is less than the pro-rata amount. Savings of HUF 26 billion are expected on an annual basis compared to the statutory appropriation. In the case of the disability and rehabilitation benefits, a gradual decrease of the number of beneficiaries can be observed, because those who reach the retirement age are gradually transferred to the group of old-age pensioners, and the number of new beneficiaries is low because the rules on eligibility have become substantially tighter in recent years.

The appropriation for **health insurance cash benefits** is HUF 352 billion for 2018, which is expected to be slightly exceeded, by 1.4 per cent, in view of the actual data from the first eight months. Expenditures of HUF 237 billion were recorded for this item in the first eight months of the year, which is 67 per cent of the annual appropriation and it represents an increase of HUF 30 billion year-on-year. This is partly due to the expenditure-increasing effect of the contribution cap that became higher on account of the minimum wage hike.

65.7 per cent of the appropriation for the **medical and preventive care** expenditure item was realised in the first eight months of the year. In the amendment during the year, the annual appropriation was raised by HUF 33 billion, and its main components include the advance wage increase of healthcare and social sector workers (ambulance workers and nurses) brought forward from November (HUF 21 billion), dentists' utility subsidy (HUF 3.3 billion), the combined specialised care (HUF 3 billion) and laboratory care (HUF 2.5 billion).

With respect to the **net expenditures of the drug budget**, expenditure is not expected to be exceeded in view of the actual data, because 65 per cent of the statutory appropriation was realised in the first eight months of the year. Net expenditure increased by 3.2 per cent year-on-year. With regard to gross expenditure, 69 per cent of the statutory appropriation was realised in the first eight months of the year, therefore on account of this and the seasonality, a minor, 2-per cent overachievement is expected by the end of this year, which is projected to be offset by the pharmaceutical budget's revenue side.

Based on the data for the first seven months of the year, the **outstanding debt of healthcare institutions** rose to HUF 41.5 billion, which is HUF 24 billion higher than at the end of last year (Chart 20). The re-accumulation of debt has necessitated debt consolidation several times in recent years, typically in the form of a one-off consolidation support at the end of the year, or through the reallocation of the residual amount of the appropriation for medical and preventive care, providing the funding for public healthcare institutions. Although due to the consolidation implemented at the end of 2016, the level of the outstanding debt is now on a lower path, it showed a rising trend from January 2017, which was consolidated again at the end of the year. With respect to the composition of this year's debt, debt with a maturity of under 30 days grew by 22 per cent as compared to the same period in 2017, while debt with a maturity of between 30 and 60 days increased by 31 per cent, and debt with a maturity of over 60 days rose by 57 per cent. Based on the above, the gradual re-accumulation of the debt may represent a risk, therefore the budgetary intervention could be necessary once again.

Chart 20
Debt of budgetary institutions and specifically healthcare institutions

Note: The time series of healthcare institutions includes institutions for both outpatient and hospital services, the background institutions of the healthcare sector, as well as universities with clinical centres. The time series contains an increasing number of institutions, hence its comparability is limited.

Source: Hungarian State Treasury

Net cash-based interest expenditures amounted to 56 per cent of the annual appropriation in the first eight months of 2018. The value falls well short of last year's figure, which is partly due to the fact that some of the interest payments were shifted from the first half of the year to the second, while the largest monthly expenditure was realised in June. The lower expenditure is also caused by the record low level of short-term yields at the and of 2017 and in the first quarter of this year, which mainly exerted its impact in the first months of 2018. Interest income was significantly above the annual appropriation until the end of August, which is mostly linked to debt management transactions. Our projection for the annual net cash-based interest expenditure exceeds the value stipulated in the appropriation by HUF 13 billion, i.e. it is practically identical to that. According to our prognosis, **net accrual-based interest expenditures** are also basically identical to the government's expectations of an 0.2-per cent decrease relative to the previous year.

3.5 BALANCE OF THE LOCAL GOVERNMENT SUB-SECTOR

In the September Inflation Report, our forecast was that the local government sub-sector could have a cash-based surplus of over HUF 240 billion by the end of 2018. The expected high cash-based surplus is linked to the advance revenues related to EU programmes, and we estimate that local governments may receive advances of HUF 260 billion from the central budget in 2018. The ESA balance calculated according to the EU's methodology could also show a surplus in 2018 (in 2017, the preliminary accrual-based year-end balance of local governments adjusted for EU advances stood at a surplus of HUF 27 billion).

The subsector's cash-based balance net of privatisation revenues had a surplus of HUF 256 billion at the end of the first half of the year, in contrast to the surplus of HUF 221 billion in the base period. If the differences between the EU funds and the budgetary subsidies received in the first half of the year relative to the base period are taken into account, the balance adjusted in this manner shows a deficit of HUF 264 billion, which is almost identical to the HUF 267 billion in the first half of 2017. In connection with the local business tax revenues, robust growth is expected in the second half of the year relative to the base period, and investment spending may also be more stable than in the base period. The ESA balance, which includes accrual-based statistical corrections, has improved since the base period, as the sub-sector's consolidated accrual-based deficit in 2018 Q1 was lower by HUF 10 billion than in the same period of the previous year. The expected balance is surrounded by unusually great uncertainties, because there are no past experiences about how the availability of substantial EU advances influences the financial management of local governments.

3.6 STATISTICAL CORRECTIONS (ESA BRIDGE)

The 2018 Budget Act was adopted assuming a **statistical correction** equivalent to HUF 175 billion. Our forecast, which is consistent with the September Inflation Report, includes a statistical correction of HUF 710 billion. The latter is more similar to the EDP report published by the HCSO in October, in which the government's projection for 2018 expected the sum of statistical corrections to exceed HUF 700 billion. The HUF 530 billion increase in the statistical corrections assumed during the adoption of the Budget Act is mainly the result of the unexpected realisation of the EU programmes, the accrual-based correction related to intermediate consumption and suppliers' advances and the greater-than-expected balance-improving effect of the companies classified into the genereal government. We mostly diverge from the government's forecast on the expected sum of the statistical corrections in the case of the EU accounting, due to the different assumptions regarding the structure of expenditures and the expected actual absorption of funds.

3.7 EXPECTED DEVELOPMENTS OF PUBLIC DEBT IN 2018

Together with the liabilities of Eximbank, the government debt ratio amounted to 74.5 per cent of GDP at the end of 2018 Q2, which was 1.2 percentage points lower than one year before.

According to our forecast, the debt-to-GDP ratio at constant 2017 end-year exchange rate will continue to decline this year to around 72.4 per cent, satisfying both Hungarian and EU fiscal rules. Our projection estimates a financing need of HUF 1,899 billion (the cash-based deficit of the central budget) and uses the exchange rate from the end of last year (EUR/HUF 310.1). The dynamic growth of nominal GDP (the denominator) of around 8.3 per cent points towards a reduction of the ratio this year. This growth is derived from the 4.4-per cent expansion of the real economy and the 3.7-per cent GDP deflator.

The advance payment of EU funds from the budget in 2018 curbs the pace of debt reduction. EU payments amounted to HUF 1,389 billion until the end of August, while EU revenues amounted to merely HUF 194 billion. The advance payment on the funds from the budget and the absence of received funds considerably increases the financing need and thus also government debt. This effect is slightly mitigated by the fact that a portion of the payments to the government sector stay on the Single Treasury Account.

The surplus financing need of the advances and the absence of EU revenues is moderated by the fact that on account of a law amendment in July, local governments and state-owned enterprises will transfer substantial amounts of EU advances received earlier to the Single Treasury Account. In essence, the amendment requires local governments and state-owned enterprises to transfer to their accounts held by the Hungarian State Treasury the unused EU advances of over HUF 50 million received earlier, until 30 September 2018. This measure helps expand the Single Treasury Account without the funds used for financing increasing government debt.

The financing need is also reduced by the fact that the government has tightened the rules on EU advance payments. In accordance with the changes, in the case of non-state or local government-backed beneficiaries, the amount of advance subsidies declines to 25 per cent at most from the earlier 50 per cent, and from 75 to 50 per cent in the case of research and development. With respect to the mandatory suppliers' advances, 30 per cent was set. In addition, in the case of state beneficiaries (local governments, state-owned enterprises), advance funds can only be provided for subsidies granted in excess of HUF 50 million if the beneficiaries hold a payment account with the Hungarian State Treasury to manage the EU funds.

The continued decline of FX debt could help further reduce the vulnerability of the economy. The FX ratio of the central debt fell from 50 per cent, recorded at the end of 2011, to 22 per cent by the end of 2017, and according to our forecast it will decline to around 19 per cent by the end of 2018 (however the share of FX debt within total government debt will be somewhat higher, 23 per cent). The reduction of FX debt could further lower the external vulnerability of the Hungarian economy and contribute to the improvement of Hungary's credit rating.

4 Expected general government developments in 2019

The Parliament adopted the Budget Act amended during the negotiations on 20 July 2018, and this is compared to the macroeconomic and fiscal forecast prepared for the MNB's Inflation Report published on 20 September 2018.

4.1 EXPECTED ESA BALANCE OF THE GOVERNMENT SECTOR IN 2019

According to the 2019 Budget Act, the ESA budget deficit could be 1.8 per cent of GDP in 2019. The set deficit target corresponds to the deficit stated in the Convergence Programme, and it is lower by 0.6 percentage points than the 2018 appropriation of 2.4 percentage points. According to our forecast, the specified deficit target can be achieved.

Table 10
Balance of the government sector in 2019

	2019				
	Statutory appropriation	MNB forecast	Statutory appropriation	MNB forecast	Difference
	HUF billion		*% of GDP*		
1. Balance of the central sub-sector	-998	-760	-2.3	-1.7	0.6
2. Balance of local governments	-199	-241	-0.5	-0.5	-0.1
3. Cash-based (GFS) balance of the general government (1+2)	**-1,197**	**-1,001**	**-2.7**	**-2.3**	**0.5**
4. GFS-ESA difference	400	211	0.9	0.5	-0.4
5. ESA balance of the government sector (3+4)	**-797**	**-790**	**-1.8**	**-1.8**	**0.0**
6. ESA balance with cancellation of free central reserves	**-737**	**-730**	**-1.7**	**-1.7**	**0.0**

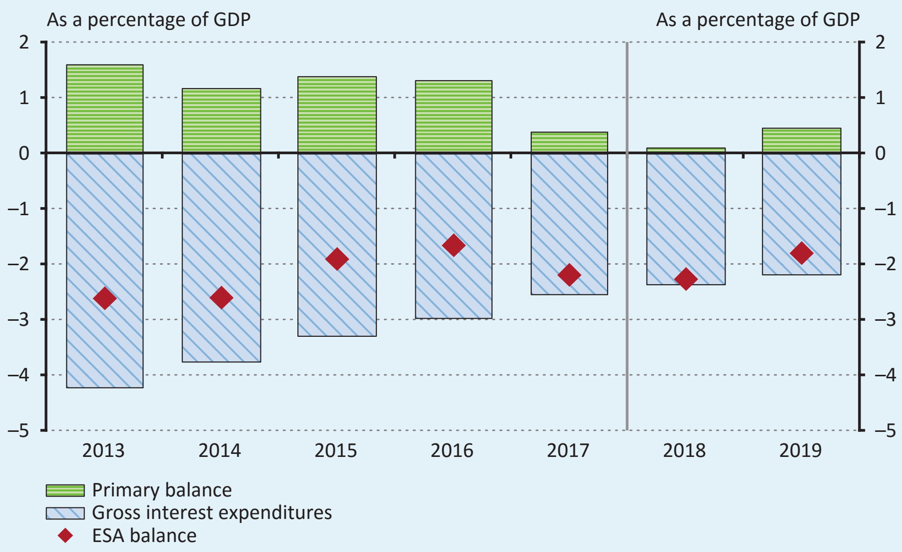
Note: Due to rounding, the totals of the table may show differences.

As a result of the declining deficit, fiscal policy accumulates countercyclical reserves. The 1.8-per cent deficit-to-GDP ratio for 2019 is 0.4–0.5 percentage points lower than the deficit forecast by the central bank for 2018. Fiscal policy may cause a contraction in demand as a result of the decreasing deficit, which on the whole will result in a countercyclical fiscal policy.

According to our forecast, the deficit target included in the Budget Act can be achieved. Based on our prognosis, the tax and contribution revenues of the budget may fall slightly short of the appropriations specified in the Act (Table 12). The difference is mostly attributable to the lower revenue expected from the social contribution tax and personal insurance contributions, which is primarily explained by the different macroeconomic paths. The Budget Act forecasts GDP growth of 4.1 per cent for 2019, contrary to the MNB's expectation of 3.5 per cent, included in the September Inflation Report. The tax bases are substantially influenced by the fact that the bill anticipates an increase in the wage bill, the rate of which exceeds the MNB's projection by roughly 1.8 percentage points. In addition, it is important to note in connection with value added tax that according to our forecast, the households' consumption expenditure will rise by 3.2 percent in 2019 while the budget assumes growth of 4.8 percent.

According to our projection, the effective absorption of the EU transfers and the co-financing ratio may be lower than planned in the Budget Act, and thus the net expenditure related to EU transfers may be lower by 0.4 percent of GDP. Furthermore, our prognosis on housing subsidy expenditure is lower than the statutory appropriation by 0.05 per cent of GDP.

Chart 21
Budget balance and the interest expenses of the government
(percentage of GDP)



Note: 1. The data do not contain the imputed interest expenditures incurred since 2012 on account of the pension system reform. 2. MNB projection for 2018–2019
Source: HCSO and MNB.

Box 3
Amendments between the submission and approval of the 2019 budget bill

The Public Finance Report published in July 2018 contains the analysis of the 2019 budget bill submitted to Parliament on 13 June. Although the bill adopted on 20 July 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.

The amendments did not affect the cash-based deficit of the central sub-sector, the general government's deficit calculated with the EU's methodology as well as the expected amount of government debt. Compared to the submitted bill, the amendments of the appropriations approved by the Parliament increased the revenue and expenditure totals of the central sub-sector of the general government by an identical amount, HUF 267.5 million.

In gross terms the amendments contained expenditure of HUF 30.3 billion in total. More specifically, the subsidies for nationality goals increased by HUF 4.6 billion, the development project of the Szeged Youth Centre received HUF 3.3 billion more, the subsidies to the Steindl Imre Programme and the School Programme were raised by HUF 2.5 billion each, and the developments helping the operation of the toll road systems and the appropriation for the development and popularisation of active relaxation were allocated HUF 2 billion more each.

The source of the surplus expenditure was the revenues and the reduction of certain expenditure items. Among the revenues, the amendments raised the appropriation for value added tax (by HUF 4.6 billion) and the excise duty (by HUF 4.6 billion). Moreover, the amendments cut specific expenditure items by HUF 21 billion in total, and shifts occurred that neutralised each other and ultimately reduced the change of the revenue and expenditure totals to a minimum (the realignment between the accident tax and insurance tax appropriations).

4.2 EVALUATION OF THE MACROECONOMIC PROJECTION UNDERLYING THE BUDGET

For the coming years, the Budget Act projects economic growth of over 4 per cent. The forecast for this year is in line with the expectations in the MNB's September Inflation Report, while the GDP growth in 2019 materially exceeds that (Table 8). The higher GDP growth compared to the MNB's forecast is primarily explained by the faster expansion of households' consumption, which is in line with the more favourable income trends resulting from the more dynamic real wages and employment. The macro path of the budget act projects materially stronger growth in employment and wages for 2019 than the September Inflation Report. The estimated wage growth moderately exceeds the MNB's projection in 2018, and it is well above it in 2019, which is explained by the assumed more dynamic wage setting by the private sector and hypothetically by the government sector.

The inflation projection in the budget for 2019 is lower than the MNB's forecast. If the inflation exceeds the planned one, an additional pension increase will become necessary in November (the assumed impact of this on the budget is already included in our forecast).

Table 11
Comparison of the macroeconomic forecasts
(percentage change compared to the previous year)

	2017	2018			2019		
	Actual	Budget	MNB	Difference	Budget	MNB	Difference
GDP	**4.0**	**4.3**	**4.4**	**0.1**	**4.1**	**3.5**	**-0.6**
Consumption expenditure of households	4.7	5.4	4.9	-0.5	4.8	3.2	-1.6
Public consumption	0.8	0.9	1.1	0.2	1.0	0.7	-0.3
Gross fixed capital formation	16.8	12.9	14.9	2.0	7.5	8.9	1.4
Exports	7.1	6.5	7.5	0.4	6.9	7.2	0.3
Imports	9.7	8.2	9.2	1.0	7.4	7.9	0.5
Inflation	**2.4**	**2.5**	**2.8**	**0.3**	**2.7**	**3.1**	**0.4**
Gross wage bill	**14.9**	**10.4**	**12.0**	**-1.6**	**10.3**	**8.5**	**-1.8**
Gross average earnings	12.9	8.8	10.5	1.7	8.8	7.9	-0.9
of which: private sector	11.6	8.9	10.0	1.1	9.3	8.2	-1.1
Number of employed	1.6	1.8	1.4	-0.4	1.5	0.6	-0.9
of which: private sector*	2.2 (2.9)	2.2	1.8 (2.3)	0.1	1.9	1.0 (1.1)	-0.8

*Note: * The Budget Act defines the private sector differently, therefore, the headcount projection comparable with the budget's macro path is shown in brackets, and the difference is also calculated from that.*
Source: 2019 Budget Act, MNB's September 2018 Inflation Report

4.3 CASH-BASED REVENUES OF THE CENTRAL SUB-SECTOR

On the whole, **the primary revenues of the central sub-sector** are expected to exceed the statutory appropriation by roughly HUF 59 billion in 2019. According to our projection, total tax revenue will fall short of the appropriation in the budget by roughly 0.2 per cent of GDP, which is primarily attributable to the lower expected revenues from the social contribution tax and the personal insurance contributions caused by the Act' forecast of a greater increase in the wage bill. On the other hand, this is offset by the fact that according to our forecast, the cash flow revenues related to EU transfers may exceed the appropriation in the bill.

Payments by enterprises may be over the Budget Act's appropriation by HUF 13 billion in 2019. In the case of the special tax of financial institutions, our forecast is lower than the appropriation by HUF 7 billion. The difference may be mostly attributable to the different assumptions about the major-team-sport tax allowances used. In the case of the small taxpayers' itemised lump sum tax (KATA), our projection falls short of the appropriation by HUF 3 billion, which is explained by the different assumptions regarding the willingness to switch to this tax type. The bill expects a revenue of

HUF 50 billion from the small business tax in 2019, which essentially corresponds to our forecast and exceeds the 2018 appropriation by HUF 23 billion. The significant growth is attributable to the fact that the number of taxpayers opting for this tax type almost doubled in 2018, and the 2018 appropriation did not include this. In addition, the growth in cash revenues is also supported by the fact that the impact of the rise in the number of taxpayers affects the cash revenues of the base year only partially in 2018, while the effect thereof on the 2019 revenue is fully realised. Other payments by enterprises may come in HUF 17 billion higher than the appropriation in the 2019 Budget Act. The difference is due to several factors. The 2019 Budget Act does not include the revenue-boosting effect of the increased price of the 10-day motorway toll stickers applicable from 1 October 2018 (approximately HUF 3 billion) and expectations differ on the revenues from the environmental product levies and other payments by enterprises in 2019.

On a cash basis, the budget expects revenues of HUF 4,290 billion from **value added tax** in 2019, which falls short of our projection by HUF 25 billion in total, less than one per cent. Our forecast includes the reduction of the VAT rate on long-life milk (ESL, UHT), which, according to our calculations, will decrease VAT revenues by HUF 22 billion next year. In 2019, the cash-based revenue from this tax type will increase by over 9 per cent compared to this year, however, this is partly a result of an administrative change. This is because the refund period used for taxpayers who are deemed reliable was shortened from 45 to 30 days from 1 January 2018, which does not affect the accrual-based balance, however, it reduces cash-based revenues by over HUF 100 billion in 2018. If this year's figure is adjusted for this, the VAT increase in 2019 amounts to 7 per cent.

Excise duty revenues are expected to be HUF 1,160 billion next year, which is HUF 19 billion higher than the appropriation in the budget. The planned two-step increases of the excise duty on tobacco products (in January and July) was taken into account during the preparation of our forecast. The increase of over 6 per cent compared to this year can be partly attributed to a balance-neutral technical change, because starting next year, the energy tax, which used to be among enterprises' payments, will be recognised in this item. If the expected revenues for 2019 are adjusted for this, growth is 4 per cent.

Table 12
Partially consolidated cash-based revenues of the central subsystem in 2018–2019
(HUF billion)

	2018			2019		
	Statutory appropriation	MNB forecast	Difference	Statutory appropriation	MNB forecast	Difference
TAX AND CONTRIBUTION REVENUES OF THE CENTRAL SUB-SECTOR	**14,287**	**14,560**	**273**	**15,651**	**15,573**	**-78**
Payments by economic organisations	**1,354**	**1,411**	**56**	**1,444**	**1,456**	**12**
Corporate income tax	370	381	12	400	400	1
Special tax of financial institutions	50	49	-1	53	46	-7
Simplified enrepreneurial tax	70	55	-14	45	45	0
Mining royalty	37	37	1	36	39	3
Gambling tax	26	31	5	31	34	3
Income tax on energy providers	52	58	6	59	61	2
Lump sum tax of small entrepreneurs	113	124	11	136	133	-3
Small enterprise tax	27	40	13	50	50	0
E-road toll	178	187	9	198	193	-4
Utility tax	55	55	0	55	55	0
Other taxes and payments	363	380	17	366	384	18
Advertising tax	14	12	-2	15	15	-1
Consumption taxes	**5,266**	**5,343**	**77**	**5,822**	**5,878**	**56**
Value added tax	3,839	3,890	52	4,290	4,316	25
Excise duties	1,099	1,091	-9	1,141	1,160	19
Registration tax	24	25	1	28	28	0
Telecommunication tax	52	54	1	52	54	1
Financial transaction levy	205	230	25	228	237	9
Insurance tax	35	38	2	67	68	0
Tourism development contribution	11	16	4	16	17	2
Payments by households	**2,338**	**2,411**	**73**	**2,608**	**2,560**	**-48**
Personal income tax	2,096	2,166	69	2,361	2,311	-50
Duties, other taxes	198	198	0	199	200	1
Motor vehicle tax	44	48	4	48	49	1
Tax and contribution revenues of extra-budgetary funds	**356**	**377**	**21**	**468**	**472**	**5**
Tax and contribution revenues of social security funds	**4,973**	**5,019**	**45**	**5,310**	**5,207**	**-103**
Social contribution tax and contributions	4,645	4,681	36	5,124	5,020	-104
Other contributions and taxes	329	338	9	186	187	1
REVENUES RELATED TO EU FUNDS	**1,990**	**1,029**	**-961**	**1,494**	**1,636**	**142**
OTHER REVENUES	**277**	**329**	**52**	**319**	**315**	**-4**
Other revenues of the central budget	**139**	**190**	**51**	**180**	**180**	**0**
Other revenues of social security funds	**38**	**33**	**-5**	**34**	**34**	**0**
Other revenues of extrabudgetary funds	**100**	**106**	**6**	**105**	**101**	**-4**
TOTAL REVENUES	**16,554**	**15,918**	**-636**	**17,464**	**17,524**	**59**

Note: The MNB's forecast for 2019 contains the fiscal projection prepared for the September 2018 Inflation Report.

The insurance tax is projected to generate HUF 68 billion after this year's HUF 38 billion, however, this does not mean a revenue increase overall. The change is caused by the fact that the accident tax that increased the revenues of social security funds will merge into the insurance tax in 2019 and 2020 in several steps, which raises the amount of consumption taxes collected by the central budget, however, this does not affect the general government balance.

According to our forecast, revenues from **personal income tax** may fall short of the appropriation included in the Budget Act by HUF 50 billion. The difference arises primarily from the difference in the macroeconomic assumptions underlying the growth in tax revenues, because the MNB's latest forecast about the gross wage bill and earnings falls short of that in the Act by almost 2 percentage points. The difference in the tax revenue forecasts may be also attributable to the Budget Act's higher headcount growth assumption related to pensioners' allowances (the pensioner employees using the allowance continue to pay personal income tax) and to the different expectations related to the reform of the fringe benefit scheme. The assumptions related to reduction of the shadow economy arising from the reform of the health contribution may also diverge: from 2019, the lower cap on tax payments on mixed income encourages taxpayers to report higher incomes, which may increase the personal income tax payments.

The Budget Act and the Tax Act adopted for next year includes the rise in the **family tax allowance** for families with two children, based on which the monthly amount of the allowance increases from HUF 17,500 to HUF 20,000 in 2019. Our forecast related to the family tax base and the first marriage tax allowance, the most important items among the personal income tax allowances, falls short of the Act's appropriation of more than HUF 300 billion. The new Tax Act affects the personal income tax in three major areas: from 2019 the National Tax and Customs Administration will prepare the draft tax return for sole proprietors as well, when letting property, utility costs will not count towards the income derived from letting, which simplifies administration and may contribute to the reduction of the shadow economy in that sector, and the system of fringe benefits will be overhauled. The tightening of the fringe benefit scheme may entail a material fall in personal income tax revenues, and the fact that in the case of the fringe benefits the multiplier applied to the tax base is also eliminated further reduces revenues (it remains in place in the case of certain defined benefits). Furthermore, the Tax Act contains several smaller measures that cut bureaucracy.

The **social insurance and extra-budgetary fund revenues** may be lower by HUF 98 billion in total than the appropriations in the Budget Act. Among the tax and contribution revenues of the extra-budgetary funds, the revenues from vocational training contribution and innovation contribution may exceed the appropriation, while the social contribution tax payments may slightly fall short of it. Within the revenues of the social security funds, the payments from the social contribution tax and personal insurance contributions may be materially lower than the values foreseen in the Budget Act. The Act's gross wage bill and earnings growth forecast exceeds our expectations consistent with the September Inflation Report by almost 2 percentage points, which explains a large part of the difference. Our projection related to the loss of tax and contribution revenues resulting from the various measures is in line with the budget estimates.

From next year, the **health contribution will be integrated into the social contribution tax**, and thus the incomes subject to health contribution will be taxed at a flat rate in the future. The lower of the two rates (14 per cent and the upper bracket of the prevailing social contribution tax) will be eliminated, and the higher one will remain in place, which may decrease in the future in line with the continued decrease in the social contribution tax rate based on the wage agreement in 2016. The HUF 450,000 upper limit of the health contribution changes to twice the minimum wage, which overall means a tax cut and encourages taxpayers to report higher incomes. In 2019, a comprehensive reform will be implemented in the fringe benefit scheme, which will reduce the social contribution tax revenues from next year. At the same time, the payment of the fringe benefits as wages may counterbalance this through the rise in the other taxes on labour. On the whole, the reform of the benefits of the Job Protection Action Plan reduces the amount of the tax allowances, in view of the fact that the number of beneficiaries may decrease in the short run, while the allowance per person is expected to rise as a result of the changed rules and the raising of the tax base limit from HUF 100,000 to the prevailing minimum wage.

According to our forecast, the other contribution and tax revenues of the social security funds may be almost identical to the appropriation in the Budget Act. One portion of the accident tax revenues (the payments by those with an MTPL policy with an effective date after the beginning of 2019) will go to the appropriation for the insurance tax, and our forecast for the remaining part slightly exceeds the figures in the Act. Public health product tax payments are expected to be in line with the appropriation. In the case of this tax type, the tax rate will be increased by about 20 per cent, and the range of alcoholic beverages subjected to this tax will be also expanded.

The **cash-based revenues related to EU funds** are budgeted to be HUF 1,483 billion, of which r*evenues from the EU programmes* amount to HUF 1,348 billion and the *subsequent reimbursement of the EU funds* amounts to HUF 135 billion. Thus the 2019 revenue appropriation's part related to the programmes of 2014–2020 is lower by roughly HUF 560 billion than the appropriation for 2018. The revenue appropriation, which is materially lower than the expenditure, continues to imply major advance payments, however, the Act does not mention its extent.

Considering the acceleration in the absorption of the advances paid in previous years and the rise in the invoiced payments, *revenues from EU programmes* may exceed the appropriation, which may reduce the cash-based deficit and the government debt. According to the MNB's prognosis, invoiced payments and the absorption of advances could be over HUF 2,000 billion in 2019, therefore *revenues from the EU programmes* are estimated to be over HUF 1,400 billion. Consequently, the total revenues related to EU funds may exceed the appropriation by HUF 142 billion and reach HUF 1,636 billion.

4.4 CASH-BASED EXPENDITURES OF THE CENTRAL SUB-SECTOR

According to our projection, the **cash-based expenditures of the central sub-sector** will fall short of the statutory appropriation by HUF 179 billion in 2019, explained mainly by the savings of HUF 156 billion on the spending related to EU funds. In addition, net expenditures of central budgetary institutions and chapters may be lower than the appropriation by HUF 32 billion, while those of housing grants may be lower by HUF 20 billion. Their deficit-reducing effect is offset by the fact that according to our forecast, net interest expenses will exceed the appropriation by HUF 24 billion.

In 2019, we expect savings on the **housing grants** expenditures, just like in 2018. Growth identical to the expected increase in 2018 is projected for 2019 (of roughly HUF 20 billion compared to 2017). Our forecast of HUF 222 billion, consistent with this, falls short of the 2019 appropriation by HUF 20 billion.

Out of the family allowances, among the key items of the **National Family and Social Policy Fund**, the 2019 appropriation for family allowance is consistent with our projection and it is expected to be around HUF 310 billion. Similar to the income substitute and supplementary social benefits and benefits provided on various grounds, the appropriations are taken over regarding the other items of family allowances.

Table 13
Partially consolidated cash expenditures of the central sub-sector in 2018–2019
(HUF billion)

	2018			2019		
	Statutory appropriation	MNB forecast	Difference	Statutory appropriation	MNB forecast	Difference
PRIMARY EXPENDITURE ITEMS	**17,010**	**16,899**	**-110**	**17,511**	**17,308**	**-203**
Special and normative subsidies and support to the public media	**444**	**444**	**0**	**448**	**448**	**0**
Social policy fare subsidy	**98**	**92**	**-6**	**91**	**92**	**1**
Housing grants	**236**	**203**	**-33**	**242**	**222**	**-20**
Family allowances, social benefits	**555**	**553**	**-2**	**551**	**553**	**2**
Early retirement benefits	**90**	**90**	**0**	**89**	**88**	**-1**
Net own expenditures of central budgetary institutions and chapters	**5,292**	**5,543**	**251**	**5,865**	**5,833**	**-32**
Support to local governments	**705**	**770**	**65**	**729**	**729**	**0**
Contribution to the EU budget	**310**	**300**	**-10**	**352**	**352**	**0**
Central reserves	**261**	**65**	**-195**	**361**	**361**	**0**
Expenditures related to state property	**322**	**370**	**48**	**338**	**338**	**0**
Other expenditures	**118**	**124**	**6**	**147**	**147**	**0**
Expenditures of extra-budgetary funds	**553**	**522**	**-32**	**531**	**508**	**-23**
NEF – Passive allowances	55	56	1	75	70	-5
NEF – Start labour programme	225	178	-47	180	162	-18
Other expenditures	273	287	14	276	276	0
Expenditures of social security funds	**5,608**	**5,624**	**15**	**5,812**	**5,838**	**26**
PIF - Pensions	3,343	3,343	-1	3,445	3,467	22
HIF - Disability and rehabilitation benefits	309	283	-26	287	278	-9
HIF - Cash benefits	352	359	7	394	391	-3
HIF - Medical and preventive care	1,204	1,234	30	1,274	1,274	0
HIF - Net expenditures of the drug budget	265	265	-1	281	283	2
Other expenditures	134	140	6	132	146	14
Expenditures related to EU transfers	**2,418**	**2,200**	**-218**	**1,956**	**1,800**	**-156**
NET INTEREST EXPENDITURES	**905**	**918**	**13**	**952**	**976**	**24**
TOTAL EXPENDITURES	**17,914**	**17,817**	**-97**	**18,463**	**18,284**	**-179**

Note: The MNB's forecast for 2019 contains the fiscal projection prepared for the September 2018 Inflation Report.

With respect to the expenditures of the **extra-budgetary funds**, our forecast related to the passive allowances of the **National Employment Fund** is almost the same as the appropriation, based on the labour market processes. We expect the jobseekers' allowance to be HUF 5 billion lower. At certain items of the funds we apply the appropriation, of which the most significant shift may be expected in the case of the Start labour programme. In 2019, the anticipated saving on expenditures at the Start labour programme is HUF 60 billion compared to the 2018 statutory appropriation and HUF 15 billion compared to the central bank's projection for 2018. The saving on expenditures is the consequence of the labour market's tightness and of the fact that, in our view, the government encourages jobseekers to find employment primarily in the private sector. Contrary to 2018 but like the years before that, the National Employment Fund's revenues will include the share from the social contribution tax, which will mean additional revenues of HUF 65–70 billion compared to 2018. This will be counterbalanced by the fact that from 2019 the NEF will contribute to the budget, HUF 75 billion according to the appropriation.

The **net own expenditure of the central budgetary institutions and chapters** may fall short of the statutory appropriation by HUF 32 billion. The difference is attributable partly to the divergent assumptions regarding the absorption of EU advances, where we expect savings, which are partly counterbalanced by the additional spending caused by the stronger-than-expected wage growth in 2018. Like in 2018, the central bank's projection assumes lower actual expenditure in the case of EU programmes than the Budget Act. In the case of the so-called uncapped appropriations (e.g. public education human services), in contrast to the underestimation of the appropriation typical of earlier years, the 2019 budget appropriations were adopted with a substantial increase in expenditure, therefore the risk of overruns in such expenditure items characteristic of earlier years is mitigated.

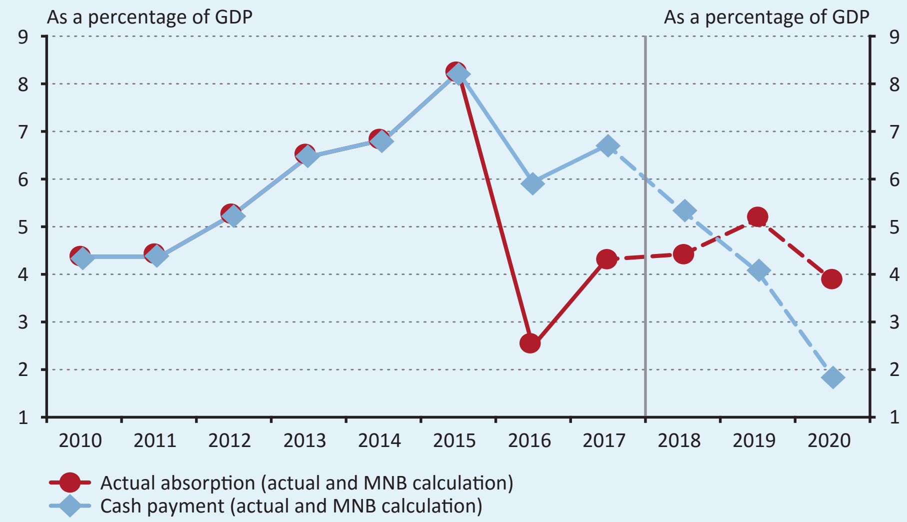
Expenditures of institutions and chapters will rise by 9 per cent in 2019 relative to the base period, more specifically, the growth rate of capital expenditure will be especially buoyant. Furthermore, the amount of available reserves will also rise by HUF 101 billion compared to the base year, and since a major portion of the reserves is spent among the expenditures of institutions and chapters, it can be argued that budgetary institutions' expected expenditure for 2019 will increase quicker than GDP, and at the same time the statutory appropriations will manage the expenditure-side risks.

The 2019 Budget Act foresees the **expenditures related to the EU programmes** to amount to HUF 1,956 billion, which falls short of the 2018 appropriation by HUF 460 billion. Of the total expenditure amount, the expenditure related to the cohesion policy, rural development and the fisheries operational programmes between 2014 and 2020 amount to HUF 1,734 billion. According to our forecast prepared for the September Inflation Report, payments could be HUF 160 billion below the appropriation, possibly due to the lower amount of advance payments. According to our expectations, of the disbursements in 2019, advance payments may amount to about HUF 600 billion, without direct cash revenue in the reporting year.

The cash-based deficit reflects the amount of domestic co-financing, as well as 10 percent of the funding that is not reimbursed by the European Commission in 2019, and thus it has to be pre-financed from the budget. As 10 per cent may be accounted for as accrual-based revenue, it does not affect the ESA balance, but substantially adds to the financing requirement and the public debt.

According to our expectations, owing to the rise in the invoiced payments and absorption of advances, the actual absorption, reflecting the real economy implementation of the projects related to EU funds, may exceed this year's level in 2019, followed by a decline in 2020 (Chart 22).

Chart 22
Developments in the actual absorption related to EU funds and in cash payments in 2010–2020



Source: Hungarian State Treasury, Ministry of Finance, MNB projection 2018–2020.

In our projection, **pension benefits** amount to HUF 3,467 billion, HUF 22 billion over the statutory appropriation (Table 14). First, our forecast on the old-age pension payable after reaching the retirement age is HUF 70 billion higher than the appropriation, and second, all in all we expect expenditure to be HUF 24 billion lower in the case of survivors' retirement benefits and women's early retirement benefits. Moreover, in contrast to the Budget Act, based on the macroeconomic path in the Inflation Report, we do not expect pension premium payments in 2019.

1) Our projection related to the **old-age pensions over the retirement age** exceeds the Budget Act's appropriation by HUF 70 billion, which is attributable to the different estimate of the inflation underlying the regular pension increase at the beginning of the year on the one hand, and the incoming actual data on the other hand. The macroeconomic projection of the Budget Act estimates a 2.7-per cent change in the consumer price index for 2019, while the MNB's latest projection, published in the September Inflation Report, estimates 3.1 per cent. Based on the projection of higher inflation, we assume that there will be a one-off supplementary pension increase in November. In the case of the old-age pensions, in 2019 new pension will be assessed in each month of the year (in 2017 and 2018 this took place only once every six months), since the retirement age for those born in 1955 is 64 years, which results in higher inflow in 2019 compared to the base year. Due to the replacement effect, our projection for 2019 assumes a 4.2-per cent growth in expenditures, exceeding the assumed inflation of 3.1 per cent. The incoming actual data from the first months of 2018 suggest that the amount of newly determined pensions may have been higher than expected, which is explained by dynamic net wage growth, and it also affects next year's spending.

2) In the case of the **pensions due to women after a 40-year eligibility period**, our projection is lower by HUF 17 billion than the statutory appropriation, which may be due to the different forecast for the number of beneficiaries. About the early retirement benefit of women, we continue to expect increasing utilisation, considering the fact that women increasingly complete the 40-year eligibility period necessary for retirement as the retirement age rises. At the same time, in 2019 the flow of the beneficiaries to the group of pensioners over the retirement age will also accelerate, since in 2019 the retirement age will be 64 years throughout the year (in the case of those born in 1955).

3) The statutory appropriation for **dependants' pension** exceeds our projection by HUF 7 billion. In the case of dependants' pensions, assuming a moderate decrease in the number of beneficiaries and an inflation of 3.1 per cent, we project only a moderate growth in expenditures. The moderate growth in expenditures may be attributable to the fact that an increasing number of beneficiaries earn entitlement to benefits on their own right.

4) The Budget Act expects **pension premium** payments of HUF 25 billion based on the GDP growth of 4.1 per cent included in the macroeconomic path. The MNB's macroeconomic forecast prepared for its September Inflation Report projects a GDP growth of 3.5 per cent for 2019, and thus we do not include pension premium payments in our forecast, since the pension premium is paid if real growth exceeds 3.5 per cent.

Table 14
Comparison of the statutory appropriation related to old-age pensions disbursed from the Pension Insurance Fund and our projection
(HUF billions)

	Statutory appropriation	MNB forecast	Difference
1. Old-age pensions over the retirement age	2,773	2,844	70
2. Early retirement benefit for women	259	242	-17
3. Retirement provision to dependants	388	381	-7
4. Provision for pension premium	25	0	-25
5. Total pension expenditures (1.+2.+3.+4.)	**3,444**	**3,467**	**22**

The appropriation for the **Health Insurance Fund cash benefits** amounts to HUF 394 billion, which exceeds our expenditure forecast for 2019 by HUF 3 billion. This is because our forecast prepared consistent with the September Inflation Report assumes lower gross wage bill and earnings than the 2019 Budget Act, therefore the childcare benefit, sickness leave benefit, infant-care allowance and other cash benefits will rise moderately.

The 2019 appropriation for **medical and preventive care** is HUF 1,274 billion, which exceeds the 2018 appropriation by HUF 40 billion. The related expenditure will rise in nominal terms, but the expenditure relative to GDP is similar than in 2018. According to our forecast, the appropriation includes a moderate upside risk due to the mid-year amendments of the appropriations, which characterised the previous years, and the increasing outstanding debt of hospitals.

Within expenditures related to health insurance benefits in kind, the appropriation related to **net expenditures of the drug budget** is HUF 281 billion, which falls short of our forecast by HUF 2 billion. Until 2018, this item was regularly underestimated in the budget, but in 2019 we do not anticipate any mid-year increase in the appropriation.

Our forecast for **net cash-based interest expenses** exceeds the appropriation in the Budget Act by HUF 24 billion. According to our projections and similar to data from earlier years, gross interest expenses and revenues could exceed the appropriation in 2019, too, which is probably mainly due to the fact that our forecast assumes a higher volume of debt management transactions during the year.

According to our projection, **net accrual-based interest expenditure** may slightly exceed the statutory appropriation, at around 2.2 per cent of GDP. The difference compared to the appropriation, close to 0.1 percent of GDP, may be caused by the yield increase realised since the preparation of the bill.

4.5 BALANCE OF LOCAL GOVERNMENTS

The **appropriation for the local government balance** may show a cash-based deficit of HUF 199 billion at the end of 2019, which is lower than our forecast by almost HUF 40 billion. In contrast to the cash-based surplus characteristic in earlier years, the sub-sector can have a deficit in 2019 because of the expected large-scale utilisation of the advances received earlier. However, the rise in the utilisation of EU advances affects the ESA balance only to the extent of the co-financing, therefore local governments' ESA balance could exceed the government's expectations by a couple of billion forints. Considerable uncertainty surrounds the local government subsector's 2019 balance because the pace of the absorption of the advances related to EU programmes and the pace of the implementation of the development goals defined in the Modern Cities Programme could diverge from the forecast.

4.6 STATISTICAL CORRECTIONS (ESA BRIDGE)

With respect to the sum of statistical corrections, the budget's expectation is twice that in the MNB's forecast. The 2019 Budget Act was adopted with balance-improving statistical corrections of HUF 400 billion, i.e. the government expects the **ESA bridge** to be around 0.9 per cent of GDP in the 2019. According to the government's forecasts, the usual statistical corrections improve the ESA bridge's surplus in all three major areas (accrual-based accounting, financial transactions and the group of organisations classified into the sector). The statistical corrections applied by us include balance-improving statistical corrections of HUF 210 billion in total, amounting to 0.5 per cent of GDP. The structure of the corrections slightly differs from that in the budget, primarily in the case of EU-related recognitions. It has to be noted that the amount of the statistical corrections linked to European Union funds depends on the extent of the 2018 absorption and their financial performance, therefore the ESA bridge is sensitive to the budgetary processes in the base period.

4.7 EXPECTED DEVELOPMENTS IN PUBLIC DEBT IN 2019

Using, as a rule, an unchanged end-2017 EUR/HUF exchange rate of 310.1, the **gross general government debt-to-GDP ratio according to the EDP methodology** is forecast to decline from 73,3 per cent recorded at the end of 2017 to 72.4 per cent in 2018, and then decrease further to around 70 per cent by the end of 2019. The substantial fall in the debt ratio may be supported, both in 2018 and 2019, by the low budget deficit and the dynamic economic growth.

The pre-financing of the EU transfers influences the developments in the debt ratio. In 2016–2018, the budget pre-finances part of the EU funds, which increases the cash-based deficit and thus also government debt. According to our forecast, the extent of this may be lower in 2019, and a major portion of the previously pre-financed funds may also be paid to the budget, which could accelerate the reduction of the debt ratio.

As a result of negative net FX 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. The foreign currency ratio of the central debt fell from 50 per cent, recorded at the end of 2011, to 22 per cent by the end of 2017, and according to our forecast it will decline to approximately 18 per cent by the end of 2019.

5 Compliance with the fiscal rules

There are a total of eight fiscal rules that pertain to the Hungarian general government between 2017 and 2019, with four Hungarian and four European Union requirements. There are two overlaps between the rules: the 3-per cent Maastricht deficit criterion and the rule on the medium-term budgetary objective (MTO). The other two Hungarian rules include the debt rule in the Fundamental Law and the debt formula specified in the Stability Act. The requirements that only appear in the European Union's fiscal framework are the expenditure benchmark and the Maastricht debt criterion.

The Hungarian budgetary processes were in line with the rules on the budget's ESA balance and debt in 2017, and they are expected to continue to do so in the future. The 3-per cent deficit threshold used in both legal frameworks is set to be achieved in all three years. The annual decline of gross public debt also complies with the Fundamental Law's debt rule, the debt formula's requirements and the Maastricht debt rule. However, the Hungarian budget's structural balance does not comply with the rules on the medium-term budgetary objective or the closely related EU expenditure benchmark over the time horizon under review. Failing to converge to the medium-term budgetary objective leads to a significant deviation procedure (SDP), which, however, does not entail financial sanctions for EU Member States outside the euro area.

Pursuant to the **debt rule specified in the Fundamental Law**, as long as government debt exceeds half of the gross domestic product, except in extraordinary situations, the Parliament may only adopt acts on the central budget that contain the reduction of the debt-to-GDP ratio, and no borrowing is permitted as a result of which the debt ratio increases compared to the previous year.[10] The government debt ratio is calculated according to the stipulations of the Stability Act that specify that during the calculation of the debt, the effects arising from the revaluation of FX debt and the time necessary for the subsequent refund of European Union funds should be disregarded.[11]

Hungary's debt ratio is over 50 per cent of GDP over the whole time horizon, therefore, in accordance with the rule, it has to be reduced in all years. According to the information provided by the Ministry of Finance to the Fiscal Council, the debt ratio defined by the Stability Act dropped by 0.8 percentage points to 73.2 per cent in 2017, which is consistent with the Fundamental Law's stipulations. Based on the MNB's projection, the debt ratio calculated with the EU's methodology at a constant exchange rate falls by 0.9 and 2.5 percentage points in 2018 and 2019 respectively, therefore the debt rule is expected to be satisfied, even when taking into account that based on the Stability Act, the Hungarian rules define debt slightly differently than the Maastricht methodology.

The other fiscal rule applicable to public debt is the **debt formula** of the Stability Act, which stipulates that if inflation and real economic growth forecast for the given 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 should not exceed the difference between expected inflation and half of the growth rate. If either of them does not exceed 3 per cent, the rule requires a debt ratio reduction of merely 0.1 percentage point.[12] The debt ratio is calculated based on the Stability Act's methodology in this case, too.

Even though the 4-per cent economic growth rate in 2017 was over the 3 per cent determined in the rule, the given year's 2.4-per cent inflation was below that, therefore the debt formula only required the 0.1-percentage point debt reduction, which was achieved. Among the assumptions underlying this year's Budget Act, the 4.3-per cent real economic growth expected for 2018 is much higher than the threshold in the debt formula, the 3-per cent inflation stipulated in the Act for this year does not exceed it. The annex to the adopted 2019 Budget Act includes an economic growth rate of 4.1 per cent and inflation of 2.7 per cent, therefore the debt ratio has to be reduced by 0.1 percentage point both this year and the next, which is expected to be achieved.

[10] Fundamental Law of Hungary, Article 36(4)–(6), Article 37(2)–(3)
[11] Article 6(1)–(2b) of Act CXCIV of 2011 on the Economic Stability of Hungary
[12] Article 4(2)–(3) of Act CXCIV of 2011 on the Economic Stability of Hungary

The **Maastricht deficit requirement** that is part of both the Hungarian and the EU fiscal framework specifies that the accrual-based deficit of the general government may not exceed 3 per cent of GDP.[13] The Hungarian fiscal deficit was 2.2 per cent of GDP in 2017, this year's deficit is expected to be in the range of 2.2–2.3 per cent of GDP depending on the utilisation of reserves, and it could be between 1.7 and 1.8 per cent of GDP in 2019, therefore the fiscal rule on the general government's ESA deficit is foreseen to be satisfied in all years.

Pursuant to the rules on the **medium-term budgetary objective** that are also part of both legal systems, the general government's balance has to be determined in a way that it be in line with achieving the medium-term budgetary objective.[14] The objective is measured with the structural balance, which refers to the cyclically adjusted balance net of one-off and other temporary items. For Hungary, the medium-term budgetary objective has been set to -1.5 per cent of GDP since 2017. Based on this year's Convergence Programme,[15] Hungary's structural balance stood at -1.7 per cent of GDP in 2017, which will rise to -2.1 per cent of GDP this year, then it will decrease back to -1.7 per cent of GDP in 2019, therefore the general government's structural balance is not in line with the achievement of the medium-term budgetary objective over the time horizon under review. According to the adopted Budget Act and the Convergence Programme, Hungary's structural balance can comply with the MTO in 2020.

Based on the 2018 spring forecast by the European Commission, Hungary's structural deficit was 3.1 per cent of GDP in 2017, which will rise to 3.6 per cent this year before falling to 3.3 per cent in GDP terms in 2019.[16] Pursuant to the Stability and Growth Pact, the EU may require the Member States that do not converge towards the MTO to be on an adjustment path towards the MTO and a corresponding required correction, which is normally 0.5 per cent of GDP on average. The Commission believes that in view of the favourable economic times, significant positive output gap and the debt ratio of over 60 per cent, Hungary should improve its structural balance by 1 per cent of GDP. As a result of the failure to converge towards the MTO, the Commission initiated an SDP (significant deviation procedure) against Hungary. The SDP only entails concrete financial sanctions (lodging of an interest-bearing deposit) for euro area members.

The **European Union debt rule** states that the Member States' gross public debt ratio[17]must not exceed 60 per cent of GDP, or if it does, the debt ratio must be reduced to a satisfactory pace. The appropriate decrease in the debt is quantified by the one- twentieth rule, according to which the debt ratio should be reduced by one twentieth of the part that exceeds 60 per cent every year on an average over three years. Based on its own forecast, the European Commission calculates the extent of the change of the debt ratio using three different methodologies (forward-looking, backward-looking and cyclically adjusted), and if the one-twentieth drop is satisfied based on any of them, the rule is deemed to have been complied with.

Hungary's gross government debt ratio was over 60 per cent of GDP in all three years under review, but the extent of the expected reduction satisfies the requirements of the debt rule on average. The 2017 debt ratio amounted to 73.3 per cent of GDP, which was a 2.6-per cent decline compared to the previous year. According to the MNB's projection, the debt ratio may fall by 0.9 and 2.5 percentage points this year and the next respectively, while the European Commission expects a drop of 0.3 and 2.3 percentage points, therefore based on the forecast, the expected reduction of government debt will be implemented on average over the three years.[18]

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

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

[15] Hungary's Convergence Programme 2018–2022, Table 4

[16] Assessment of the 2018 Convergence Programme for Hungary, 23 May 2018, 4.2. Compliance with the required adjustment path towards the MTO, Table 5

[17] Gross, consolidated debt at nominal value, which, in contrast to definition of the debt ratio in the Stability Act, includes the additional debt arising from the subsequent return on EU funds and the impact of exchange rate movements.

[18] Assessment of the 2018 Convergence Programme for Hungary, 23 May 2018, 3.4. Debt developments, Table 2

6 Key topics

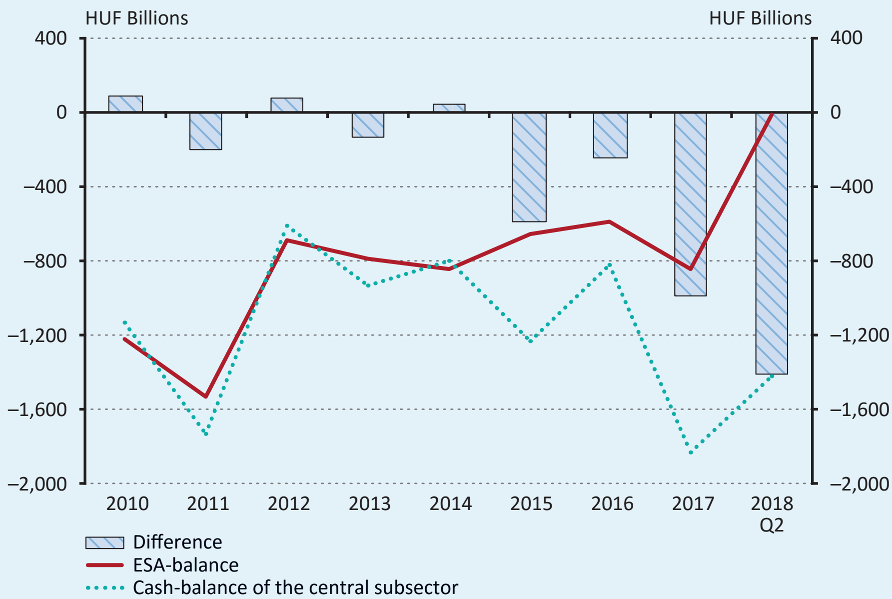
6.1 HIGH FINANCING REQUIREMENT DUE TO THE PRE-FINANCING OF EU FUNDS[19]

On account the pre-financing of European Union funds from the budget, the financing need of the budget has been persistently above the ESA deficit since 2016, and in the first half of 2018, the delays in the revenues of the funds also increased the financing need. The resulting higher borrowing burdens the government securities market and hampers the reduction of public debt in GDP terms, which may nevertheless amount to 0.9 percentage points in 2018. However, after this year, a dynamic debt reduction of over 2 percentage points of GDP is expected. Instead of issuing FX bonds – as in the past, so in the future – financing from retail government securities may provide adequate financing capacity without placing a burden on the forint bonds market, while also promoting a further decrease in the external vulnerability of Hungary.

The pre-financing of EU funds increases the budget's financing need

In recent years, there has been a considerable difference between the cash-based and the accrual-based deficit ratio: the budget's financing need was high due to the substantial cash-based deficit, despite the low ESA deficit. Whereas the accrual-based deficit varied between 1.6 and 2.2 per cent of GDP between 2015 and 2017, the cash-based deficit was higher than the ESA deficit by 2 per cent of GDP (HUF 600 billion) on average in the three years under review (Chart 23). Therefore the financing requirement that should be covered by issuing debt is consistently higher than the ESA deficit.

Chart 23
Difference between the fiscal balances



Source: Hungarian State Treasury, HCSO.

[19] Based on the article Gergely Baksay – Dávid Benkő – Gergely Kicsák: *Magas maradhat a finanszírozási igény az uniós források elmaradása miatt (The financing need may remain high due to the absence of EU funds).* http://www.mnb.hu/letoltes/baksay-benko-kicsak-magas-maradhat-a-finanszirozasi-igenymnb-honlapra.pdf

The main reason behind the difference between the two deficit indicators and the high financing need is the significant amount of pre-financing related to EU funds since 2016 as well as the corresponding slow receipt of the cash-based revenues from the EU. This is because in the last two years, the budget recorded a cash-based revenue of merely HUF 1,700 billion against the expenditure of HUF 4,400 billion related to the 2014–2020 EU programmes. The primary reason for the difference between the expenditure and revenues is the pre-financing that amounted to roughly HUF 3,000 billion in total during 2016 and 2017.

The ESA deficit is affected by the pre-financing of EU funds much less than the cash-based deficit (for 2017, see Chart 7). First, the portion of the advances paid within the general government does not increase the ESA deficit at all, and second, the expected EU budgetary revenue can be imputed against the advances outside the general government at the moment of payment, therefore the deficit is affected only by the co-financing of the funds. The difference between the ESA and the cash-based deficit is increased by other minor factors, such as the different interest expenditure calculations in the two methodologies.

The financing need may continue to remain high

The delay in the payment of EU funds and the receipt of revenues could increase the cash-based deficit in 2018 and 2019, which may cause a high financing need, just like in earlier years. The main reason behind the high cash-based deficit amounting to HUF 1,600 billion in the first eight months of the year is that this year EU revenues of merely HUF 190 billion were recorded in the budget against the EU expenditures of HUF 1,390 billion, which suggests that advance payments still have a high share. The substantial excess of financing need caused by the advances is slightly moderated by the fact that the agents in the government sector need to transfer to their accounts held by the Hungarian State Treasury[20] the unused EU advances of over HUF 50 million disbursed earlier, until 30 September 2018, and the rules on future advance payments from the EU will also be tightened.[21] Since the amount of funds received falls well short of the expectations, this continues to increase the financing need.

The high financing need caused by the pre-financing of EU funds and the absence of revenues in 2018 hampers the rapid reduction of government debt. Despite the fact that the ESA deficit remains below 2.4 per cent of GDP, a substantial financing requirement can be observed in 2018, too, which hinders the reduction of government debt. According to the MNB's projection in the September Inflation Report, the debt-to-GDP ratio could decline by 0.9 percentage points this year.

However, as the financing need diminishes, debt reduction could gather momentum. Based on the MNB's forecast, on account of the robust economic growth, the debt-to-GDP ratio could sink by over 2 percentage points going forward, dipping to below 68 per cent by the end of 2020.

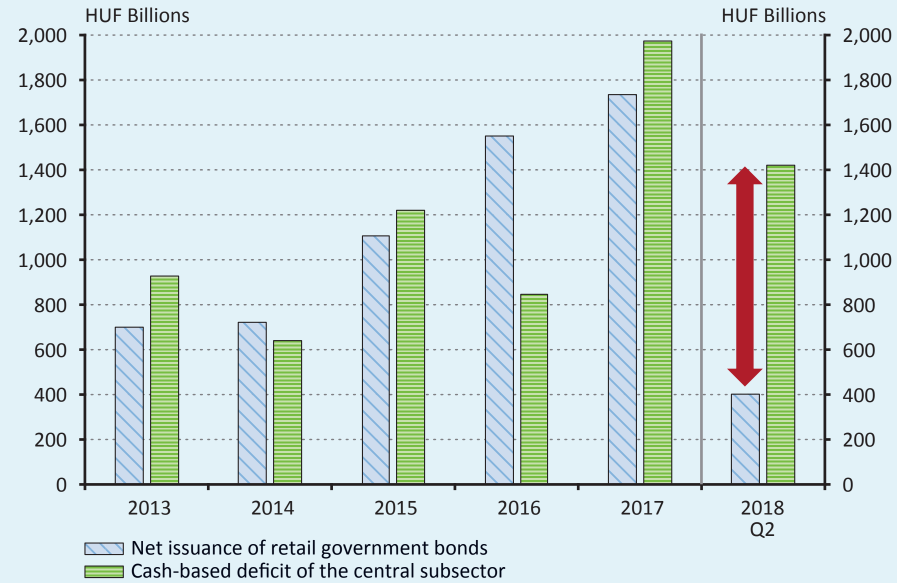
Retail government securities can still cover the high financing need

In 2016 and 2017, the net issuance of retail papers was crucial in financing the budget deficit, the share of which has diminished in the first half of this year. The net issuance of retail papers amounted to HUF 1,550 billion in 2016 and HUF 1,735 billion in 2017, in other words the issuance of securities was key in refinancing the budget deficit and the maturing debt. However, the yield on retail papers gradually lost its appeal, therefore their volume increased by merely HUF 400 billion in the first half of 2018. The Debt Management Agency had to cover the increased financing need from other sources. The Government Debt Management Agency raised the amount of forint bonds and discount treasury bills issued, which, however, caused supply-side pressure on the government securities market.

[20] Article 76 of Act XL of 2018

[21] Government Decrees No. 397/2017 (XII.13.) and 160/2018 (IX.7.)

Chart 24
Issuance of retail government securities and the cash-based deficit



Source: Government Debt Management Agency, Hungarian State Treasury.

Increasing the demand for retail papers can be used to acquire further funds, which could provide coverage for the high financing need in the future. Based on the muted growth in volume in the first half of this year and taking into account the favourable development of households' wealth and income position, there is still leeway for further expanding the issuance. This is primarily supported by the fact that on 1 August 2018, the Debt Management Agency raised the interest on shorter-term retail government securities by 50 basis points across the board. The interest-related cost of retail government securities are higher than the interest on market papers, however, this is basically returned to the budget through the corresponding surplus tax revenues and the thus sustainable lower market yields.[22]

Thanks to the available domestic funds, Hungary's external vulnerability could drop further. The FX share of the central government debt sank from 50 per cent at the end of 2011 to below 20 per cent at the end of August 2018, which was key in mitigating the economy's external vulnerability. The continued increase in domestic sales results in a further decline of FX debt and the contraction of foreign ownership in parallel with that, which leads to a more stable debt profile.

6.2 MAIN REASONS FOR THE ANNUAL CHANGE IN THE HUNGARIAN GROSS GOVERNMENT DEBT RATIO BETWEEN 2017 AND 2019

According to our forecast, the debt-to-GDP ratio will fall by 6.1 percentage points between 2017 and 2019. Below we present the factors influencing the change in the government debt ratio and the contribution of these factors. Overall, the underlying developments project a dynamically decreasing debt ratio, however, the degree of the decline is reduced by idiosyncratic factors (mostly the advances on EU funds). Based on our projection, the ratio may nevertheless fall significantly, by over 2 percentage points each year, assuming a constant EUR/HUF exchange rate of end-2017.

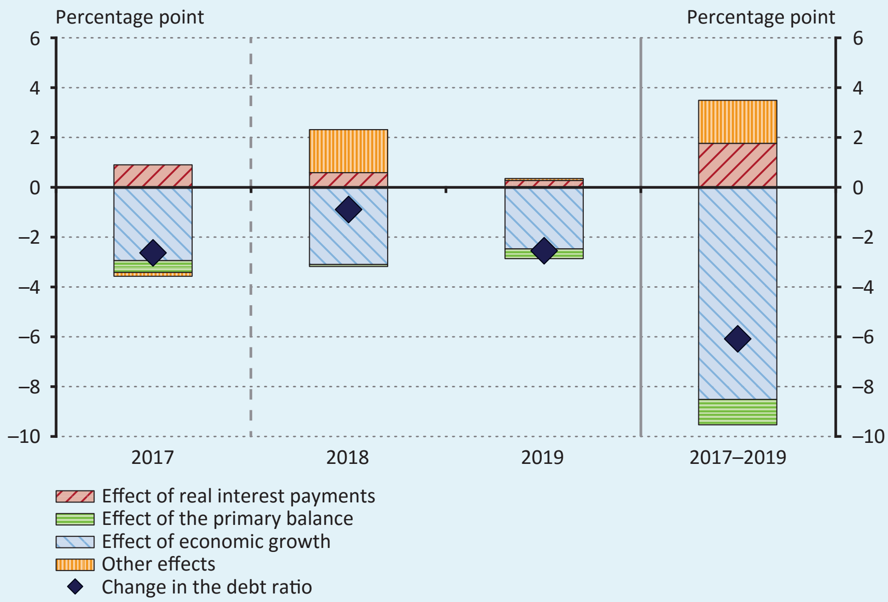
The decline in the gross government debt-to-GDP ratio is primarily supported by the high real growth and surplus in the primary general government balance. Between 2017 and 2019, we expect the Hungarian economy to grow at a robust pace of 4 per cent on average, which reduces the ratio by 9 percentage points through the denominator. Similar to last year, besides the dynamic economic growth, the primary budget balance (adjusted for interest expenditures) could show

[22] Gergely Kicsák: Lakossági állampapírok – Stabilabb finanszírozás, magasabb ár? (Retail government securities – More stable financing, higher price?) http://www.mnb.hu/kiadvanyok/szakmai-cikkek/befektetesek-megtakaritasok/kicsak-gergely-lakossagi-allampapirok-stabilabb-finanszirozas-magasabb-ar

a surplus in each year of the forecast horizon. The debt-reducing effect of the positive primary balance could amount to 1 per cent of GDP in the three years overall.

Due to the low interest rates and the inflation that converges towards the central bank's target, real interest payments are less and less of a burden. Thanks to the low interest rate environment prevailing on the forint government securities market for years now, the implicit forint interest rate of government debt declined to 3.2 per cent by 2018. In addition, the inflation rate will probably come close to the central bank target, by rising on average to 2.8 per cent next year, according to the forecast in the September Inflation Report. The two factors together result in a substantial decrease in the implicit forint real interest rate.

Chart 25
Decomposition of the annual change in the gross government debt-to-GDP ratio, with the real values being calculated with the inflation between 2017 and 2019



Source: MNB.

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. In 2017, EU funds payments amounted to HUF 2,550, while revenues amounted to HUF 1,116 billion. 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 EU pre-financing can add more than 1 per cent of GDP to the debt in 2018. The debt-increasing effect is mitigated by the fact that some of the advances are recorded on local governments' Single Treasury Account, therefore this will not raise the financing requirement either. The future reimbursement of EU funds will provide a substantial momentum for the quicker reduction of the debt ratio.

Last year, other liabilities within government debt fell on account of the depreciation of the dollar. The dollar weakened more than 10 per cent against the euro in 2017, which reduced government debt by 1.2 per cent of GDP. This is due to the fact that part of the public debt was issued in dollar bonds, which is typically swapped for euro debt by the Debt Management Agency, and thus gross debt is also influenced by the dollar's exchange rate movements relative to the euro indirectly, through the value of the market swaps. The depreciation of the dollar mostly offset the debt increase arising from the pre-financing of EU funds.

6.3 THE ROLE OF THE FISCAL COUNCIL IN THE ADOPTION OF THE BUDGET[23]

The Parliament adopted Hungary's 2019 budget in the summer, and the Fiscal Council played a crucial role in this. Hungarian laws stipulate two tasks for this body related to the adoption of the budget, however, according to the practice that emerged in line with the opportunities provided by the law, the FC supports the process even beyond its concrete obligations.

The most important task of the Fiscal Council is to assess before the final vote on the Budget Act whether it complies with the debt rule laid down in the Fundamental Law. Pursuant to the Fundamental Law, the debt-to-GDP ratio should decline in all years until reaching 50 per cent (with only special circumstances providing an excuse for not complying with this rule). The expected realisation of this is assessed by the Fiscal Council based on the final form of the budget bill, i.e. when all the proposed amendments adopted by the Parliament are included in it. If the Fiscal Council believes before the final vote that the reduction of the debt ratio is threatened, it provides a detailed explanation, based on which the government has to amend the budget to ensure the diminishment of the debt ratio. This is practically a veto for the Fiscal Council in the adoption process of the budget, which is a very strong power even by international standards.

The other main task of the Fiscal Council comes earlier in time, and it pertains to commenting on the draft budget bill. During this, it examines the bill's credibility and feasibility even before it is submitted to the Parliament. If the FC indicates that it does not agree with the draft, the government has to discuss the draft again, and it can only submit it to Parliament accordingly. This means a broad option for making comments regarding the macroeconomic path, the deficit, the debt, the revenue and expenditure appropriations and compliance with the fiscal rules. Moreover, the law allows the Fiscal Council to voice its opinion on any issues related to the drafting or implementation of the budget, and it also requires the FC to do so at least once a year based on bi-annual fiscal data.

The credibility of the FC's decisions is increased by the fact that it takes them based on its own macroeconomic expectations that may differ from the projection in the budget. During the analysis of the macroeconomic path, the Fiscal Council takes into account the projections of the background institutions (State Audit Office and Magyar Nemzeti Bank), just like the prognoses of international organisations and the further analyses commissioned by the FC from Hungarian research and analysis institutions.

It is important to underline that several quantifiable Hungarian and EU fiscal rules apply to the drafting of the Hungarian budget, but the laws only stipulate that the Fiscal Council should examine the debt rule of the Fundamental Law. This is where the FC has a veto. It can analyse the fulfilment of all other rules, but it is not legally required to do so, and this entails no legal consequences. Nevertheless, the FC has attempted to be as comprehensive in its approach as possible, touching on all rules in its opinions that can be analysed based on the available data.

Assessment of the 2019 Budget Act

In line with the statutory requirements, the Fiscal Council first discussed the 2019 budget bill on June 7 and then commented on it. It believed that the deficit of 1.8 per cent of GDP could be achieved and found that the expected reduction of the debt ratio was satisfactory. However, the FC argued that the bill expects economic growth over the consensus, which may affect the realisation of tax revenues. It identified risks surrounding the feasibility of certain revenue appropriations, but it also pointed out that if the rise in real wages does not reach the estimated extent, the social contribution tax's 2-percentage point reduction planned for 1 July 2019 could be delayed in line with the currently effective wage agreement. Moreover, the FC believes that the fiscally conservative planning of reserves and certain expenditure items (e.g. the absorption of EU funds) may also offset the revenue-side risks. It found in its analysis that

[23] The summary was prepared based on the article Gergely Baksay: A Költségvetési Tanács szerepe és a 2019. évi költségvetés (The role of the Fiscal Council and the 2019 budget). (http://www.mnb.hu/letoltes/frissitett-baksay-gergely-a-koltsegvetesi-tanacs-szerepe-es-a-2019-evi-koltsegvetes-mnbhonlapra.pdf)

according to the budget bill, the structural balance deviates from the medium-term budgetary objective, although it converged towards the latter.

The next task of the FC was to assess whether after the adoption of the proposed amendments to the bill satisfied the debt reduction requirement laid down in the Fundamental Law. On 17 July, the FC gave its preliminary approval for the final vote on the bill, after finding that the document was in line with the debt rule in the Fundamental Law.

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.

PUBLIC FINANCE REPORT

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AND THE 2019 BUDGET ACT

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