SUMMARY

FEASIBILITY OF THE 2013 DEFICIT TARGET

According to our analysis, the ESA fiscal deficit may amount to 2.8 per cent of GDP in 2013, which may decrease to 2.4 per cent of GDP if all of the uncommitted budgetary reserves in the National Protection Fund are cancelled. Thus, the deficit may slightly exceed the 2.2 per cent target set in the Budget Bill. Our forecast indicates that both the deficit and the public debt ratio may show a declining trend and, assuming that the end-2012 figures are favourable, next year the Maastricht deficit criterion might be met for the third year in a row.

Including the uncommitted reserves, we forecast the fiscal deficit to exceed the Government's target by 0.6 percentage point. The higher deficit is attributable to a large extent to the difference between the macroeconomic forecast and the one underlying the Budget Bill as well as the diverging views on the fiscal developments of 2012, and to a smaller extent to the differences in the estimated effects of government measures.

Our analysis does not take into account the effects of any measures announced after the submission of the Budget Bill. Thus, our calculations do not include the effects of the HUF 300 billion growth stimulus and job creation package announced on 28 June 2012, aiming primarily to reduce the labour taxes and social security contributions. On the other hand, in our view the 2013 budget contains no real reserves, and therefore any additional expenditure not accompanied by balance improving measures will increase the fiscal deficit. The effects of the measures on the fiscal deficit can be estimated only after the details of the plans are known and their macroeconomic effects can be taken into account.

The Budget Bill projects considerably more favourable macroeconomic developments than our expectations. The Bill envisages real growth of 0.1 per cent for 2012 and 1.6 per cent for 2013, which is 0.9 and 0.8 percentage points higher, respectively, than the forecast included in MNB's Report on Inflation published in June. The difference is attributable mainly to the different assessment of the contribution of net exports to growth and the more optimistic view on investments in 2012, and mostly to the different forecasts of household consumption in 2013. In addition, the Budget Bill projects annual average inflation of 4.2 per cent in 2013, which is 0.7 percentage point higher than the current forecast of the MNB.

11: Difference between our forecast and the appropriations in the Budget Bill for 2013 (% of GDP)

	A. Deviation from budget appropriations (B+C)	B. Different estimate for the 2013 fiscal effect of measures	C. Effect of the 2012 base and the macroeconomic path of 2013
1. Primary revenues	-0.6	0.0	-0.6
2. Primary expenditures	0.1	0.1	0.0
3. Net interest expenditures	-0.1	0.0	-0.1
4. Total (1-2-3)	**-0.6**	**-0.2**	**-0.4**

As a result of the slower growth path and the different assessment of developments in 2012, we expect revenues to be some 0.6 percentage point of GDP lower than the figure in the Budget Bill, due to projected revenue shortfalls in PIT, social security contributions, VAT, corporate profit tax and the simplified business tax as well as other taxes (Table 1).

As regards primary expenditures, on the whole the difference between the statutory target and our expectations is minimal as a result of the different assessment of macroeconomic trends and fiscal developments in 2012. Due to our lower projection for the rate of utilisation of EU funds, the Government needs to finance a lower level of national co-financing. This effect is partly offset by the fact that, in our opinion, medical and preventive health-care expenditures are under-budgeted.

The divergence of opinions on the 2013 budgetary effects of government measures decided this year as well as of some earlier measures causes a difference of 0.2 per cent of GDP in the estimated balance (Table 2). In respect of the measures in the Structural Reform Programme 2.0, we expect a substantially lower net deficit reducing effect (0.15 percentage point of GDP) mainly in the case of the e-toll, explained partly by implementation risks (expected drop in traffic due to the tax burden) and partly by the operating costs of the system. Furthermore, we also expect lower-than-budgeted revenues from the environmental product fee. In respect of the financial transaction tax, we made the technical assumption that the revenue target will be met as the definitive regulation is not yet available, and thus we are not in a position to make exact estimation for the projected revenue. In our view, the measures announced in 2011-2012 fail to assure the proposed reduction in pharmaceutical expenditures, and thus we expect a balance deterioration of 0.1 per cent of GDP in aggregate in this area; furthermore, there are substantial downside risks as the sustainability of the additional payments by pharmaceutical producers is questionable. On the other hand, we estimate that the changes in the benefit system of persons with altered working capacity (disability benefits) may lead to savings amounting to 0.1 per cent of GDP as compared to the appropriation.

As a combined result, we project revenues to be substantially lower than the figures in the Budget Bill. In the case of expenditure appropriations, we expect a slight overrun in aggregate; while in certain subsectors (such as healthcare) considerable tensions may emerge. The net expenditures of budgetary institutions, adjusted for the effects of the reallocation of tasks from local governments, will increase substantially in real terms compared to their projected 2012 level, indicating that the severely depressed expenditure level of recent years is not sustainable in the medium term.

There is also substantial disagreement in relation to interest expenditures: the Bill does not take into account the possible decline in the risk premium on public debt financial instruments due to conclusion of the agreement with the EU/IMF. In our calculations, we assume that the agreement is signed in the second half of 2012, which will gradually be reflected in funding costs. Assuming conclusion of the EU/IMF agreement and the resulting premium decline, net interest expenditures would be 0.1 percentage point lower than projected in the Budget Bill.

RISKS RELATING TO THE DEFICIT

We have identified a number of risk factors relating to the submitted Bill, pointing to a higher deficit in aggregate.

We consider the absence of real reserves in the Bill to be one of the risks. In our opinion, the National Protection Fund, halved from its 2012 level (that is, the amount of uncommitted reserves) is not in proportion to risks. Reserves fail to fully cover the fiscal effects of macroeconomic developments expected to be less favourable than envisaged in the Budget Bill or the risks relating to the implementation of measures. In our view, uncommitted reserves will have to be cancelled to meet the deficit target, but even in that case additional deficit reducing actions may become necessary on a smaller scale to achieve the deficit target of 2.2. per cent of GDP. Thus, there will be no reserves left in the budget to cover the potential deterioration of the economic outlook or the risk of other unexpected events.

The introduction of the new transaction tax also entails certain risks. The Bill incorporates transaction tax revenues corresponding to almost 1 per cent of GDP, while half of the special tax on financial institutions remains in place for 2013. Without knowing the final text of the law regulating the new tax, we have tentatively made the technical assumption that the transaction tax revenue reaches the budgeted HUF 283 billion level. On the other hand, if the motion for amendment of the bill regulating the financial transaction tax, submitted on 28 June 2012, is accepted in an unchanged form, the net deficit reducing effect of the new tax may remain below the budgeted level and it may prove mostly temporary.

Another risk that may drive the deficit higher is the potential failure to reach an agreement with the EU/IMF. In such a scenario, the higher risk premium would increase interest expenditures while the direct effects on macroeconomic developments would be conducive to reducing revenues. Furthermore, as another substantive risk amounting to 0.6 per cent of GDP, if the ECJ rules against the Hungarian State on the subject of the special tax imposed in 2010 on the telecommunication sector, the State will have to repay the revenues collected so far.

SUBSTANTIALITY AND CREDIBILITY OF THE BILL ON THE 2013 BUDGET

At the time of the conclusion of our analysis, some of the tax laws and other substantive laws underpinning the Budget Act were not completed or available. Consequently, as it stands, neither the balance in the Budget Bill nor the deficit in our forecast can be considered as fully substantiated by law.

The Budget Bill complies with the debt rule set forth in the Constitution as public debt will be reduced in 2013 both as indicated in the appropriations and as shown in our forecast. Our forecast shows that with an unchanged exchange rate assumption, public debt may decline by 0.3 percentage point to 78.1 per cent of GDP in 2013. Based on our macroeconomic path and taking into consideration the debt increasing effect of the Student Loan II arrangement, keeping the fiscal deficit below 2.9 per cent of GDP is sufficient to satisfy the debt rule. If the

Government also depletes its financial reserves, the debt rule set forth in the Constitution is satisfied even if the deficit is higher.

The debt formula set out in the Act on the Economic Stability of Hungary will enter into force in 2016; until then, as a transitory arrangement, the law requires the balance contained in the Convergence Programme submitted in April 2011 to be achieved. The balance target set in the 2011 Convergence Programme for 2013 is 2.2 per cent of GDP; our forecast shows that if the uncommitted central reserves are cancelled, the deficit to be expected is 0.2 per cent of GDP higher.

Our forecast indicates that the cyclically adjusted ESA deficit for 2013, assuming the cancellation of the uncommitted central reserves, may be around 1.7 per cent of GDP. This figure, however, is only a "snapshot" of the current structural position of the budget. The structural position is significantly influenced over time by past measures (such as pension rules, the Public Education Act) and external circumstances (for instance, EU funding, investment requirement). Our view on the medium term position has not substantially changed since the medium-term outlook published in May in the Public Finance Review series, that is, the deficit may remain below 3 per cent in the medium term and it may come close to 1.6 per cent of GDP by the end of the 15-year projection horizon.

22: Difference between our forecast and the appropriations in the Budget Bill for 2013 (% of GDP)

	A. Deviation from budget appropriations	B. Different estimate for the 2013 fiscal effect of measures	C. Effect of the 2012 base and the 2013 macroeconomic path	Note
1. Primary revenues	**-176**	**-4**	**-172**	
Corporate profit tax	-40		-40	Effect of the 2012 base and 2013 growth estimated to be lower than in the Bill
Simplified business tax	-22		-22	Base effect; as a result of tax changes we expect significantly lower revenues in 2012 than the estimate of the Ministry of National Economy
Mining royalty	16		16	Conservative approach in the Bill
Gambling tax	-7	-5	-2	Effect in 2013 of migration to a server-based system (slot machines) and base effect
Green taxes	-15	-15		Different assessment of the 2013 effects of the tax increasing measures in force from 2012.
Value added tax	-24		-24	Effect of household consumption estimated to be lower in 2013 than in the Bill.
Excise tax	10	16	-6	In contrast with the Bill, we assume an excise tax hike on tobacco; the e-toll reduces transit traffic and thus revenues from automotive fuel
Personal income tax	-39		-39	Mostly due to the gross wage bill of 2013 estimated to be lower than in the Bill; partly an effect of the 2012 base
Social contribution tax and contributions	-32		-32	Mostly due to the gross wage bill of 2013 estimated to be lower than in the Budget Bill
Other social insurance tax and contribution revenues	-13		-13	Primarily in the case of the healthcare contribution and the public health product tax, due to the base effect
Other revenues	-10		-10	
2. Primary expenditures	**29**	**42**	**-14**	
Net expenditures of budgetary chapters and institutions	13	43	-30	Taking into account the road maintenance expenditures of the motorway management company and the operating costs of the e-toll system (HUF +43 billion); smaller national co-finance of the lower drawdown of EU funding (HUF -30 billion)
Family benefits, social transfers	-6		-6	Difference in the estimates of the expected number of beneficiaries
Passive and other expenditures of the National Employment Fund	5		5	Difference in estimates of the number and age distribution of beneficiaries below the retirement age
Pension payments (Pension Fund Administration)	-13		-13	2012 base and different forecast for the number of pensioners retired based on the number of years worked
Benefits below retirement age (National Family and Social Policy Fund)	8		8	Different forecast for the 2012 base
Disability and rehabilitation benefits (HIF)	-29	-29		We project an approximately 10 percent drop in the number of beneficiaries
Medical and preventive care	22		22	Effect of the wage increase in 2012 is not incorporated in the appropriation
Net expenditures on pharmaceutical subsidies	29	29		Decline in pharmaceutical expenditures is not supported with measures
3. Net interest expenditures	**-30**		**-30**	We project a lower yield curve than the Bill
4. Total (1-2-3)	**-174**	**-46**	**-128**	
Note overall difference in the balance forecast	*-174*			