PUBLIC FINANCE REVIEW
October 2011

MAGYAR NEMZETI BANK

Analysis of the 2012 Budget Bill

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In order to support its core purposes defined in Act LVIII of 2001 on the Magyar Nemzeti Bank ('MNB Act'), and particularly to support the formulation and implementation of monetary policy, the Magyar Nemzeti Bank regularly analyses developments in the budget deficit and debt, monitors the financing of general government, analyses the impact of financing on monetary developments, financial market movements and liquidity, and conducts research on fiscal policy issues. Under the provisions of the MNB Act, the MNB is entitled to express its opinion on the budget proposal to the Government and the competent committee of Parliament.

Pursuant to Act LXXV of 2008 on Fiscal Responsibility, the Governor of MNB is a member of the Fiscal Council (FC) and in this capacity participates in the formulation of the FC's assessment on the draft budget bill to be submitted to Parliament. The Act provides that the work of the FC may be indirectly supported by the professional knowledge and accumulated information available within the MNB, rather than by an independent FC team.

In order to support the fulfilment of these tasks at the highest professional level, the MNB's expert team regularly analyses budgetary processes. The general public can learn of the main findings of the expert analyses from the *'Public Finance Review'*. The findings and conclusions of the analyses reflect the opinions of the experts involved in the preparation of the analysis and should not be interpreted as the views of the MNB or the Monetary Council.

This analysis has been prepared in cooperation with the Financial Analysis, Monetary Strategy and Economic Analysis, and Financial Stability Departments under the general direction of Director Áron Gereben. The publication has been approved by Governor András Simor.

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Summary

On the basis of the 2012 Budget Bill and the underlying detailed legal regulations as of 14 October 2011, next year's budget deficit will probably exceed the target set in the Budget Bill. In the absence of further measures, the ESA deficit may reach 3.1 per cent of GDP, but if a major part of the new uncommitted reserves in the Budget Bill, the National Protection Fund and the Interest Risk Reserve is abolished, the 2.5 per cent deficit target set by the Government for 2012 can be achieved. In this case, however, the budgetary reserves set aside to manage adverse effects during the year would be almost completely depleted.

Balance of the central government

In comparison with the anticipated 2011 deficit estimated by the MNB after eliminating extraordinary items (revenues from the private pension funds taken over, funds invested in the MOL stock acquisition and the negative effect of the one-time VAT refund due to the decision of the European Court of Justice), the HUF 577 billion deficit of the central government envisaged in the Budget Bill represents a very substantial improvement of the balance, amounting to over HUF 600 billion, i.e. 2.3 percentage points of GDP.

On the basis of the measures published so far, the improvement in the balance may amount to slightly more than one-half of what is envisaged by the Government, i.e. 1.4 per cent of GDP. According to our calculations, the improvement in the budget will primarily be generated on the revenue side. Exogenous revenues, mainly consisting of taxes and contributions, are expected to increase by nearly 0.9 per cent of GDP. Exogenous expenditures and discretionary items – the latter also consisting mostly of expenditures – will improve the balance by 0.5 per cent of GDP. Abolishment of the new uncommitted reserves classified as discretionary expenses would change the general picture, and in that scenario the improvement in the balance on the expenditure side could amount to 1-1.2 per cent of GDP.

In accordance with the above, the cash flow deficit of the central government may be roughly HUF 260 billion, i.e. 0.9 per cent of GDP, higher than the Budget Bill target (Table 1).

The difference is attributable to the following items:

1. The major part, i.e. an amount equal to nearly 0.7 per cent of GDP of our more pessimistic estimate for the deficit of the central government, is due to the fact that we offer independent forecasts for the budgetary effects of most government measures, which are in some cases lower than the deficit-decreasing effect planned by the Government. The most significant differences manifest themselves in relation to the following measures:

   • As far as the gambling tax is concerned, we are much more pessimistic than the Government in terms of the

Table 1
Difference between our forecast and the target in the 2012 Budget Bill
(% of GDP)

	Deviation from statutory target	Measures not included in our forecast because of the lack of details	Different estimate of the effects of measures	Net impact of other differences (macroeconomic forecast, base effect, methodological differences)
1. Primary revenues	−0.61	−0.04	−0.53	−0.04
2. Primary expenditures	0.19	0.05	0.14	0.00
3. Net interest expenditures	0.08	0.00	0.00	0.08
4. Balance (1–2–3)	**−0.88**	**−0.09**	**−0.67**	**−0.12**

feasibility of the taxation of online gambling, i.e. in total, we expect the revenue to be lower by 0.1 per cent of GDP.

- On the basis of the target for VAT revenue, it is probably assumed that extra income of approximately HUF 40 billion will be generated as a result of more efficient tax collection. According to our forecasting rules, this factor is not taken into account.

- Our estimates are HUF 14 billion and HUF 17 billion lower, respectively, than those of the Government in relation to revenue expected from the 1 percentage point increase of the employers' health insurance contribution rate and the increase of the contribution payable by businesses.

- On the expenditure side, while only 40 per cent of the Government's plan for curtailing the net amount of pharmaceutical subsidies is considered to be supported by measures, extra revenues from manufacturers are expected due to the larger-than-expected deficit. In our estimate, the deficit will be lower than the target by 0.1 per cent of GDP.

2. In total, the different perception of the expected amount of various revenues and expenditures in 2011, the difference between macroeconomic assumptions and other methodological differences result in a difference equal to 0.1 per cent of GDP.

   The latest macroeconomic forecast of the MNB takes into account the effects of the Government's measures included in the Budget Bill and the early repayment scheme for FX loans. On that basis, GDP growth of 0.6 per cent is forecasted for 2012, as compared to the 1.5 per cent envisaged in the Budget Bill, while the rate of inflation may rise to 4.9 per cent. We project that the planned increase in the minimum wage and the wage compensation will have a greater impact, resulting in a faster rate of wage growth. The forecast of the MNB is based on an exchange rate weaker than in the Budget Bill, i.e. one close to the current level.

   On the whole, however, the differing growth expectations have little effect on the 2012 deficit. On the one hand, the slower growth of consumption and investments and the lower profit of businesses will have an adverse effect on tax revenues, while on the other the greater part of these impacts will be counterbalanced by the potential increase in contribution revenues due to the faster wage growth generated by the minimum wage increase.

3. A small 0.1 per cent of GDP of our higher deficit forecast can be attributed to two announced measures which could not be taken into consideration in our forecast due to the lack of applicable legislation or the absence of detail required for substantiated calculations. These two items include the extra revenue expected from the expansion of the environmental tax base and the faster reduction of disability and rehabilitation benefits. These two measures represent a positive risk to our forecast, as they may improve the budgetary balance if they are realised.

Balance of the general government and the budgetary reserves

Our forecast for the ESA balance shows a deficit of 3.1 per cent of GDP. This is 0.6 percentage points higher than the deficit target of 2.5 per cent, despite the fact that our estimates for the deficit of the local government subsector and the amount of the accrual-based adjustment of interest are more positive than the expectations of the government, by 0.2 per cent and 0.1 per cent of GDP, respectively. The official deficit target meets the 3-per cent threshold set by the EU, but according to our forecast the deficit will probably slightly exceed that level.

According to our calculations, the medium-term balance, which measures the structural position of the budget, is expected to amount to about 2.2 to 2.5 per cent of GDP. This means that while the medium-term budgetary objective (MTO) set for Hungary by the European Union will not be achieved in 2012, the value of the indicator will improve following significant deterioration in 2011.

More types and higher amounts of reserve targets are provided for in the Budget Bill than in the previous year. Depletion of the HUF 100 billion reserve for extraordinary government measures, corresponding to the general reserves of previous budgets, was already assumed in our baseline forecast, similarly to the designated reserves of over HUF 150 billion, earmarked for wage compensations in connection with the change of the personal income tax system and the minimum wage increase. The reserves thus actually available for the management of the macroeconomic and feasibility risks related to the baseline scenario in the Budget Bill include two new uncommitted reserves in a narrow sense, i.e. the National Protection Fund of HUF 150 billion and the Interest Risk Reserve of HUF 50 billion.

Since these two reserves amount to 0.7 per cent of GDP, their almost complete deletion, i.e. up to 0.6 per cent of GDP, may be sufficient to improve our baseline ESA deficit forecast of 3.1 per cent to the 2.5 per cent objective of the government and allowing the medium-term balance to move very close to the MTO figure. The latter scenario, however, would leave the budget with minimum reserves of 0.1 per cent of GDP for countering any adverse effects during the year.

Main risks related to the Budget Bill

According to our calculations, the achievement of the net expenditure target of the Budget Bill for budgetary units and chapters would require savings of over HUF 60 billion, in addition to the full usage of the general reserve compared to the 2011 base which is already full of tensions. Therefore, the feasibility of the balance objective for budgetary units and chapters or, in a broader sense, for the capped discretionary items is uncertain, unless further sustainable expenditure-reducing measures are implemented.

Our baseline forecast is based on the fact that the budget will compensate the 2011 loss of the MNB of HUF 12 billion, an amount substantially lower than the previously assumed amount of HUF 95 billion. It is the result of the fact that, according to our calculations, the MNB may realise a gains from exchange rate revaluation related to the central bank's FX market intervention announced in connection with the early repayment of FX loans. The exact amount of the gains from exchange rate revaluation depends on the degree to which the central bank's operations are utilised. The MNB assumes that 20 per cent of FX loans will be paid off under the early repayment scheme. If the actual repayment rate is lower than that, the MNB may realise lower gains from exchange rate revaluation in 2011, which may increase the assumed loss compensation needs of the MNB in 2012.

Significant risks are attached to the balance of local governments. In the event that the adaptability of local governments is weaker or their sources of financing are less restricted than assumed, the deficit of the local government subsector may be higher than in the MNB forecast.

Legal compliance of the Budget Bill

The Budget Bill fails to comply with the applicable Act on budgetary responsibility formally and in terms of the figures. The balance of 2012 discretionary items is higher than the one set a year before, both according to the targets of the Budget Bill and our own estimate. The Budget Bill fails to specify the target for either the balance of discretionary targets for 2013 or the primary balance for 2014.

The Budget Bill complies with the debt rule laid down in the Constitution entering into force in 2012. According to our forecast, central government debt may decline from 71 per cent to 70 per cent in 2012, while total public debt may decrease from 78.5 to 77.5 per cent.

1 Introduction

Our analysis focuses on the feasibility of the expenditure and revenue appropriations and, as their sum, the budgetary balance objective specified in Bill T/4365 on Hungary's 2012 budget. In the paragraphs below, the principles and most important features of the forecast used for the assessment of the bill are first summarised. Our detailed analysis includes the assessment of the macroeconomic assumptions underlying the Budget Bill, the detailed assessment, on the level of the balance and by its main items, of the planned budget, including analysis of the underlying budgetary trends over the medium term as well as a description of the major risks attached to the Budget Bill. The final chapter of the analysis examines the compliance of the Budget Bill with the effective and upcoming rules concerning the budget. The analysis is based on relevant information from the period up to October 14th 2011. The background tables, the list of measures taken into account, the summary of the underlying methodological assumptions used for our forecast and the brief explanation of the public finance terms used in the analysis are found in the Appendices.

2 Forecasting principles

The bill on the 2012 budget is assessed primarily in comparison with our own budget forecast. Fiscal forecasting is undertaken on a rule basis. In that context, the best international practice has been followed in the Reports on Inflation since August 2003.[1] According to international recommendations, the fiscal measures adopted (or announced) should only be taken into account if they are **sufficiently detailed.**[2] The criterion of sufficient detail may have different interpretations for the various budget items, depending on the level of government control over the particular items. The following section will focus on the cash flow items of the central government and the local government and the accrual-based figures of the government sector in that respect.

The level of control is quite varied between the various cash flow items of the **central government.** One potential approach is to break down the items to interest balance and exogenous and discretionary items.

Exogenous items include the primary revenues and expenditures the realisation of which is clearly determined by the private economy and demographic trends, and the laws creating individual entitlements or obligations. Such items include, among others, tax revenues and pension expenditures. On the basis of our rule-based forecast, a measure is not considered to be sufficiently detailed in that context unless the envisaged parameters of the entitlement and obligation are available. In the absence of the above, the implications of these measures cannot be calculated. Similarly, the impact of measures envisaged in connection with the efficiency of tax collection cannot be taken into account, in other words no forecast is prepared on the changes in the rate of tax evasion.

Discretionary items including all other items constitute a more mixed group in terms of the extent of government control. As far as capped expenditure appropriations are concerned, their numerical amount is a sufficient condition of detail, as they cannot be exceeded. This cannot be automatically assumed for allowances which are also partly determined by certain demographic trends. On the revenue side, EU funds, institutional revenues and the disposal of real assets may differ from the target. The net expenditure of budgetary institutions and chapters is, however, only affected by this factor to the extent that co-financing is required for the part of EU financing used in the budget.

In addition to the exogenous and discretionary items, a rule-based forecast is also prepared for the **interest balance.** While in principle, the government has little control over the interest balance, the forint-currency composition and breakdown by maturity in the financing plan do affect the net interest expenditure. The official financing plan is therefore taken into account or, if it is not available, the assumption concerning the financing structure is based on the basic principles of the established interest management strategy.

While our forecast concerning the central government is purely rule-based, an expert forecast is prepared for the cash flow items determined by **local governments.** This is because the government does not exercise full control over local governments and therefore our forecast is based on the sources received from the central government, historical tendencies (the local election cycle) and financing opportunities.

Similarly, there is no government control over **accrual-based** developments or the institutions (e.g. not-for-profit institutions) considered to be part of the government sector for statistical purposes. The sum of these items, i.e. the difference of the cash-flow and the accrual-based balance, is the so-called ESA bridge adjusting the government deficit. With the exception of the interest adjustment

[1] For a more detailed description of our method, see pp. 76–77 of the 2003 August *Report on Inflation.*

[2] Of the fiscal measures announced, the OECD's rule of forecasting only takes into account the ones manifested in sufficiently defined programs (http://www.oecd.org/document/40/0,3746,en_2649_34573_1850792_1_1_1_1,00.html). On the basis of international experience, the ECB has stressed that fiscal forecasts should only take into consideration sufficiently detailed measures passed or likely to be passed by Parliament without changes (see Leal, Teresa, Javier J. Pérez, Mika Tujula and Jean-Pierre Vidal (2007), 'Fiscal Forecasting – Lessons from the Literature and Challenges', *ECB working paper,* no. 843, December).

recorded on an accrual basis, no specific projection is made for the ESA bridge. Instead, we take over the most recent official forecast (published in the Budget Bill or Eurostat notification).

This year, a number of economic policy measures were announced in various stages (Structural Reform Plan (Kálmán Széll Programme), the Convergence Programme and measures related to the 2012 Budget Bill), intended by the government to influence next year's budget. A significant part of these declared measures are taken into account in our rule-based forecast, in other words their expected budgetary implications are quantified, whereas a smaller group of measures cannot be taken into consideration due to a lack of sufficient detail.

The itemised list of government measures either taken into account or not quantified is included in Appendix 2, while our estimation method employed for the specific budgetary items is included in Appendix 3.

3 Assessment of the macroeconomic assumptions underlying the Budget Bill

3.1 MACROECONOMIC FORECAST OF THE MNB

Compared to our earlier assumptions, our macroeconomic forecast includes a worsening growth outlook and increasing inflation. As for 2012, we expect GDP and the consumer price index to increase by 0.6 and 4.9 per cent, respectively.

The considerable slowdown in economic growth results from both domestic and international factors. Exports, the main driver in the Hungarian economy, may decelerate due to the worsening global economic outlook. In addition to that, domestic demand may drop in 2012 due to a decline in lending and to the negative demand-side effect of the budget.

Inflation accelerates in 2012 primarily due to an increase in VAT and excise tax. While weak consumption demand has a disinflationary effect, the envisaged increase in the minimum wage will add to the inflationary pressure in terms of payroll costs.

The international economic environment has deteriorated substantially in 2011. Global economic growth has declined compared to 2010, and the latest forecasts (e.g. the IMF's World Economic Outlook, September 2011) predict further significant deceleration in 2012. This may lower growth in Hungarian exports in 2012. This decline may be partially offset by the new production capacities created by large projects in the automotive industry, which are expected to start operating in 2012. While the depreciation of the EUR/HUF exchange rate in recent months may temporarily improve the competitiveness of exporters, that advantage may be offset by increasing payroll costs due to the minimum wage increase in 2012.

The current trends in lending also point towards slower economic growth. Both international and domestic trends contribute to the current weakening of lending activity. The crisis in the euro area peripheral countries increases the financing costs for the parent companies of the banks operating in Hungary. In addition to that, the exchange rate fixing scheme for foreign-currency loans impairs the capital position of the banking system, which may lead to a decline in lending. These developments may result in stricter restrictions on corporate credit supply.

The increase in the minimum wage puts a significant burden on companies. Businesses may react in various ways to the significant decline in their profitability, even with the planned compensation considered. They may curb their labour demand, cut back on their investments and operating expenses or increase their sale prices.

Consequently, employment is not expected to increase in the private sector in 2012. The increase of the minimum wage will raise the cost of the employment of the very groups of workers whose labour supply may potentially increase as a result of previous measures of the government. In other respects, we expect a substantial decline in business investment, a trend reinforced by more restrictive rules on loss write-downs and stricter lending policies. Even adjustment by cost and investment management may be insufficient to prevent a deterioration in corporate profitability, which may encourage firms to raise their prices.

Total investments may decline in 2012. Similarly to the declining corporate investments, the investment activity of households and the government is not expected to grow either. The decline in households' investments is due to their weak income position and to restrictive lending policies.

Consumption demand may decline in 2012. Based on the Budget Act, the volume of public consumption will decrease at a substantial rate. Private consumption is restricted primarily by adverse labour market trends and increasing taxes. Since restrained labour demand may prevail in the private sector, employment may only increase as a result of the Start Labour Programme, primarily in the public sector. The increase in the minimum wage will result in a significant rise in gross average wages, even if nominal wages in higher income brackets remain constant. At the same time, the changes in personal income taxation will curb the increase in net wages, while the purchasing power households' income will be substantially reduced by rising inflation. The exchange rate fixing scheme for foreign-currency loans may also result in a temporary decline in consumption: although the net financial wealth of households increases over the long run, funds available for consumption may decrease over the short run. As a consequence of the above, household consumption may decline in 2012.

Altogether, GDP growth may be significantly slower compared to 2011. Net exports remain the only driving force behind growth, whereas the contribution of domestic demand is negative. Recent international analyses have, however, indicated that there are significant downward risks in relation to global economic growth in 2012.

On the whole, however, the worse growth expectations have little effect on the 2012 deficit. Slower growth in consumption and investments and lower corporate profits will have an adverse effect on tax revenues, but the greater part of these impacts will be counterbalanced by the potential increase in contribution revenues, due to faster wage rise generated by the minimum wage increase.

3.2 COMPARISON WITH THE MACROECONOMIC SCENARIO IN THE BUDGET BILL

Significant downward risks are observed compared to the path of the real economy in 2011-2012 presented in the budget. Economic growth may be slower than projected in the budget. In addition to that, the structure of growth may also be less favourable in terms of budgetary trends, as the contribution of domestic demand may be negative in 2012.

The difference between the forecasts of the Budget and the MNB may in part be traced back to differences in the perception of 2011 macroeconomic trends. The macroeconomic estimate of the government anticipates stronger economic growth in 2011 as well. In our opinion, the GDP figure for the second quarter indicates a deterioration in the growth outlook, particularly as far as investments are concerned. Accordingly, 2011 GDP growth may be 1.6 per cent, slightly weaker than the figure of 1.9 per cent specified in the budget estimate.

More significant downward risks are observed in the Budget in relation to the 2012 growth forecast. While the Budget projects 1.5 per cent growth, the central bank forecasts a

Table 2
Comparison of the macroeconomic forecast of the Budget Bill and the MNB forecast
(% change from the previous year)

		Budget		MNB		Difference	
	2010	2011	2012	2011	2012	2011	2012
	Actual	Forecast		Forecast		(MNB – budget)	
1. GDP growth (%)	1.2	1.9	1.5	1.6	0.6	–0.3	–0.9
2. GDP at current prices (HUF billion)	26,748	27,947	29,111	27,720	29,282	–0.8	0.6
3. GDP deflator %	2.9	2.6	2.6	2.0	5.0	–0.6	2.4
4. Changes in the consumer price index (annual average)	4.9	3.8	4.2	3.9	4.9	0.1	0.7
5. Growth rate of labour productivity	1.2	1.2	0.0	0.5	–1.0	–0.7	–1.0
6. Investment ratio (as a percentage of GDP)	19.3	18.6	19.0	17.0	16.6	–1.6	–2.4
7. Household consumption	–2.2	0.5	0.0	–0.2	–1.0	–0.7	–1.0
7/A of which: consumption expenditure of households	–2.1	0.7	0.2	0.4	–0.4	–0.3	–0.6
8. Collective consumption	–0.6	–2.5	–0.2	0.2	–4.5	2.7	–4.3
9. Gross fixed capital formation	–5.6	–2.0	3.2	–4.1	–0.1	–2.1	–3.3
10. Domestic absorption	–1.1	0.4	0.6	–0.5	–1.2	–0.9	–1.8
11. Exports of goods and services	14.1	8.8	8.4	9.3	7.4	0.5	–1.0
12. Imports of goods and services	12.0	7.7	8.1	7.8	6.5	0.1	–1.6

growth rate of 0.6 per cent. The risks primarily affect the forecast concerning domestic consumption: while the Budget projects 0.6 per cent growth, the MNB forecasts a 1.2 per cent decline.

As opposed to the 0.2 per cent growth projected by the Budget, household consumption may decrease in 2012. Weak labour market developments and the tax measures may significantly impair households' real disposable income. Over the short term, the exchange rate fixing scheme of foreign-currency loans may also limit the amount of disbursable funds.

Even stronger risks are observed in terms of gross fixed capital formation. According to the reasoning of the Budget Act, growth in employment will encourage businesses to increase their production capacities. In our opinion, however, the weak growth outlook, stricter lending policies and the weakening profitability of firms due to the minimum wage increase may result in further postponement of investments, and thus a decline in investment.

Export growth may also be lower than the budgetary expectation. While the weakening forint exchange rate may have improved the short-term competitiveness of Hungarian exporters in recent months, the increasing payroll costs due to the significant increase of the minimum wage coupled with fading external demand – resulting in a further slowdown of exports – may offset this improvement in competitiveness. At the same time, weaker domestic demand points to lower import volume. According to our forecast, the contribution of net exports to growth may therefore be actually higher than that outlined in the budgetary anchors.

The rate of inflation in 2012 may, however, exceed the 4.2 per cent rate anticipated by the budget: the MNB expects a 4.9 per cent inflation. The increase in indirect taxes will have a substantial inflationary effect at the beginning of 2012. While weak demand would encourage a more moderate level of inflation, firms may partly reflect their increasing costs due to the minimum wage increase in sales prices.

The amount of nominal GDP may be somewhat higher than the budgetary expectation. While growth of the GDP volume is beset with downward risks, we believe that GDP deflator may be substantially higher than the 2.6 per cent indicated in the budget. In our opinion, along with a nearly 5 per cent increase in consumer prices, the GDP price index will also accelerate significantly in 2012.

4 Assessment of the budgetary balances following from the Budget Bill

The Public Finance Review of the MNB published in July presented a detailed forecast on the prospective achievement of the 2011 budget. The following section contains a summary of our forecast for 2011, updated with incoming new information. This is followed by a presentation of our estimate for the expected cash flow (GFS) balance of the central government in 2012, compared to the statutory objective of the Budget Bill and by subsector. Considering the special importance of the indicator, the expected ESA deficit of the government sector is discussed in a separate section. The overall, balance-level assessment of the budget is concluded by the analysis of the structural position of the general government, based on the augmented deficit indicator developed by the MNB. The Box 1 contains a brief overview of the nature of the balance indicators discussed in this section.

Box 1
GFS, ESA and augmented cash flow balances

The calculation of the balance of the state budget is provided for in the Act on Public Finances, whereas its cash flow approach is close to that of the IMF's 1986 GFS system. In the event of the prevalence of the standard cash flow rules, this indicator is suitable to describe the position of the budget:

- It means, for example, that the timing of the current expenses and tax reimbursements coincides with the usual time-limits, i.e. no delays in payment occur.
- Similarly, the financing needs of state-owned companies are continuously covered by the subsidies, i.e. no quasi-fiscal indebtedness accrues.
- In addition to the above, capital revenues and capital expenditure arise in connection with real assets only, i.e. there is no need for capital transfers to subsequently compensate for the unpaid subsidies of state-owned companies, no other capital revenues (concessions, withdrawal from pension schemes) other than generated by the disposal of real assets accrue and all government-decided investments are recognised as capital expenditure at the time of their implementation (i.e. they are not outsourced under a PPP scheme).

Since the Hungarian fiscal practice noticeably differs from the above, the MNB's analytical 'augmented' deficit indicator, introduced fifteen years ago, serves to perform the adjustments to facilitate the approximation of the Hungarian fiscal accounting practice to the standard rules of cash flow accounting. This includes the adjustment of arrears, state-owned companies, PPP investments and capital revenues other than the disposal of real assets. In its approach, it is close to the standardised indicator suggested last year by the Expert Body on Budgetary Accounting with a view to facilitating the similar and timely accounting of economic events of a similar economic nature. In other words, it shows the cash flow revenues and expenditure that would accrue if the rules of standard cash flow accounting were consistently applied.

The ESA methodology employed in the European Union also adjusts statutory accounts. By employing an accrual-based approach, it eliminates the effects of late payments. It also widens the scope of the state budget; however, various loss-making state-owned companies are still left out from the government sector. Apart from that, only minor adjustments are made for PPP investments and capital items. A slightly different indicator was specified during the excessive deficit procedure (EDP), where interest expenditure is adjusted by the effect of swap and FRA transactions.

4.1 BUDGETARY BALANCES IN 2011

According to our updated forecast, the ESA balance of the government sector will achieve a surplus of 4.1 per cent of GDP in 2011, whereas the GFS balance of the general government may show a deficit of 5.5 per cent. According to the MNB forecast, the value of the officially communicated deficit indicator, the ESA deficit adjusted with certain one-off items, not included in the originally adopted budget, is 2.9 percent, which is equal to the government's deficit objective (Table 3).

The significant difference between the values of the GFS and the ESA balances is due primarily to the surplus revenue from the take-over of the private pension fund portfolio, whose part which is not included in the GFS statement of the budget of the central government improves the balance by 7.9 per cent of GDP. Apart from that, while the one-off expenditure related to the acquisition of MOL shares (1.8 per cent of GDP) increases the cash flow deficit, it does not affect the balance as it is considered a financing expenditure in terms of the ESA statement.

The forecast of the MNB for the cash flow deficit of the general government exceeds the statutory target by 0.8 per cent of GDP. The difference is due to the VAT refund commitment of HUF 250 billion as a result of the ruling of the Court of Justice of the European Union, which is not yet included in the statutory target. Without that extraordinary item, our forecast shows a cash flow deficit slightly lower than the target figure. Similarly, our estimate for the ESA balance is 0.1 percentage point better than the government's expectation published at the end of September in the EDP report in connection with the excessive deficit procedure of the European Union, which already took into account the negative impact of the VAT refund.

Our forecast for the ESA balance has improved by 1.3 percentage points compared to the surplus of 2.8 per cent of GDP published in our July analysis. This change is mainly related to one-off items. In a more detailed breakdown, the following major shifts have taken place since publication of the July forecast:

- The deficit of the central government has decreased by 1.2 percentage points due to the one-off items. The balance is improved by 2.1 percentage points due to the fact that, in accordance with the September EDP report, no extra expenditure is expected this year in connection with the debt consolidation of MÁV (Hungarian State Railways) and BKV (Budapest Public Transport Company) and the buyout of certain PPP contracts. The payment of negative VAT due to the Court's ruling, however, worsens the balance by 0.9 percentage points.

- The balance of the central government has deteriorated by 0.2 percentage points, permanently affecting the base. First, the achievement of tax and contribution revenues is expected to be nearly 0.3 percentage points lower due to the increasingly adverse macroeconomic trends. Second, the updating of our forecast for retirement allowances and certain financial transfers resulted in an improvement of the balance by about 0.1 percentage point.

- In the local government subsector, our deficit forecast has been reduced by more than 0.1 percentage point, mainly due to the cutting back of personnel expenses during the year.

- Since the amount of real yields paid out to the members of private pension funds who returned to the public pension scheme was lower than the anticipated amount by 0.1 percentage point of GDP, the balance improved by that proportion of the taken-over portfolio.

Table 3
Summary data of the 2011 general government budget: statutory objective and MNB forecast

	2011			
	Statutory target	MNB forecast	Statutory target	MNB forecast
	HUF billion		as a percentage of GDP	
1. Balance of central government	−1,184	−1,406	−4.3	−5.1
2. Balance of local governments*	−110	−110	−0.4	−0.4
3. GFS balance of general government (1+2)	−1,294	−1,516	−4.7	−5.5
4. ESA balance of the government sector	n. a.	1,134	n. a.	4.1
5. A ESA balance specified in accordance with the government's target**	−815	−817	−2.9	−2.9

** The target figure for the municipal balance is taken from the supplement of the 2011 Budget Bill.*
*** The deficit calculated according to the government target represents the value of the actual ESA balance, adjusted with certain extraordinary items. In the adjusted ESA balance, we disregarded the amount of negative VAT due to the ruling of the Court and that part of funds taken over from private pension funds which was not incorporated in the budget. In this case, one-off items have thus not been taken into account according to their economic content.*

- A nearly 0.1 percentage point shift occurred in the value of GDP-based surplus as a result of the 2.6 per cent decline of the nominal level of GDP, which is partly due to the statistical adjustment affecting the period as a whole.

The officially communicated deficit target of 2.9 percent, adjusted with certain one-off items, appears to be viable. One important circumstance, however, is in that official deficit indicator, the portion of the taken-over private pension fund assets included in the approved budget (totalling HUF 529 billion) is still accounted for as revenue. Eliminating the full amount of the taken-over assets, the 2011 ESA deficit amounts to almost 4.9 per cent of GDP. Since next year the budget will no longer be able to rely on that one-off revenue, the deficit will in fact need to be pushed down to the 2.5 per cent level defined in the 2012 Budget Bill compared to that base.

4.2 2012 CASH FLOW BALANCE OF THE CENTRAL GOVERNMENT

Table 4 shows that our estimate for the 2012 deficit of the central government is HUF 257 billion (0.9 per cent of GDP) higher than the figure in the Budget Bill. The deficit of HUF 577 billion envisaged by the Budget Bill represents an improvement of the balance by HUF 638 billion (i.e. 2.4 percentage points on a GDP basis) compared to the 2011 target excluding extraordinary items.[3] However, compared to the slightly more favourable 2011 forecasting base of the MNB, our forecast contains an improvement of hardly more than half of that amount, i.e. approximately HUF 350 billion.

In respect of the difference between the deficit figures of the 2012 MNB forecast and the Budget Bill, HUF 234 billion appears in the primary balance. Roughly three quarters of that amount, i.e. 0.6 per cent of GDP, is linked to revenue items. The majority of this is due to our different perception of the viability of the tax measures and their quantifiable effects, while our macroeconomic forecast accounts for only a smaller part of the difference. In our opinion, the expected revenue structure is also different from the one described in the Budget Bill: according to our calculations, taxes and tax-type revenues may be substantially lower than the government's expectations, whereas we estimated slightly higher fulfilment in the case of contribution revenues. Due to the primary expenditure items, our forecast for the deficit of the central government exceeds the level envisaged in the Budget Bill by 0.2 per cent of GDP. This is primarily due to the different assessment of the probable effects of adopted or planned measures, whereas most of the differences attributable to macroeconomic and other effects cancel each other out. The differences between the various targets are explained in detail in the chapter discussing the main items of the budget.

In the breakdown within the central government, the following differences have arisen between the balances of the MNB forecast and the Budget Bill:

- In the case of the central budget, the deficit in our forecast is HUF 215 billion higher than the target figure. 90 per cent of that difference is attributable to our more pessimistic expectation concerning the achievement of the central tax revenues. On the expenditure side, the

Table 4
Cash flow balance of the central government
(HUF billion)

	2011		2012		
	Statutory target	MNB forecast	Statutory target	MNB forecast	Difference
1. Balance of central budget	−1,138	−1,455	−507	−722	−215
2. Balance of extrabudgetary funds	41	59	−35	−25	10
3. Balance of social security funds	−88	−11	−34	−86	−52
4. Balance of central government, total (1+2+3)	**−1,184**	**−1,406**	**−577**	**−833**	**−257**
of which:					
Net interest expenditure	−1,008	−972	−1,006	−1,029	−23
Primary balance	−177	−435	429	196	−234
Balance of central government without extraordinary one-off specific items for 2011	**−1,214**	**−1186**	**−577**	**−833**	**−257**

[3] Here and in the following, whenever a comparison is made with the 2011 balance excluding extraordinary items, the statutory target is taken into consideration without the expenditure on MOL shares and the revenues recorded from the taken-over assets of private pension funds. Similarly, the one-time negative impact of the VAT refund due to the ruling of the Court, which could not be included in the budget amended in July, is also eked out in the MNB forecast for 2011.

negative effect is mainly due to our higher forecast concerning net interest expenditure.

- In the case of Extrabudgetary Funds, we expect the deficit to be lower by HUF 10 billion, partly because we project slightly lower expenditure than the Budget Bill, due to the transformation of the system of job-seeking allowances.

- In our estimate, the deficit of the social security funds is HUF 52 billion higher than the figure in the Budget Bill, primarily in connection with expenditure items. We expect higher expenditure for the drugs budget and disability and other cash allowances.

4.3 ESA BALANCE OF THE GENERAL GOVERNMENT

The 2012 ESA deficit, calculated in accordance with our forecasting rules, may be around -3.1 per cent of GDP, 0.6 percentage points higher than the 2.5 per cent target set by the government (Table 5).

In our estimate, the 2012 cash flow deficit of the general government will exceed 3.1 per cent of GDP, which represents a 0.7 percentage point difference compared to the expectation of the government. In particular, the cash flow balance of the central government may show a deficit equal to -2.8 per cent of GDP.

We expect the deficit of local government in 2012 to amount to 0.3 per cent of GDP, as a gradual adaptation to the increasing adjustment pressure is expected in the subsector. Altogether, we expect a 0.1-percentage point improvement in the balance of the local government sector, compared to the expected 2011 GDP-based deficit, i.e. our forecast is by 0.2 percentage points better than the value in the Budget Bill.

In our forecast, we relied on the ESA bridge calculation of the Ministry for National Economy, adjusted with our accrual-based interest forecast. As a result of this modification, the accrual-based adjustment yielded a lower deficit.

It should be noted that the Budget Bill (BB) also contains additional reserves, i.e. the National Protection Fund and the Interest Risk Reserve, for the management of various risks, which we recorded as expenditure, in accordance with the Budget Bill. If the government deleted these extraordinary reserves, the ESA deficit would be reduced to a level corresponding to the 2.5 per cent objective of the government. Obviously, this depends on the potential occurrence of the negative risks identified beyond our baseline forecast. This issue will be discussed in more detail below.

4.4 ASSESSMENT OF THE STRUCTURAL POSITION OF THE BUDGET

4.4.1 Augmented cash flow balance

The augmented cash flow balance is an analytical indicator, which adjusts the official balance in order to ensure that events of the same economic content are displayed in the same manner, regardless of their form, thereby facilitating identification of basic budgetary trends from one year to another (See Box 1). A result of a number of factors, the adjustment may affect the balance in various ways from year to year. Table 6 shows that in 2010 the adjusted balance was more favourable than the official deficit, whereas in 2011 and 2012 the adjustments increase the deficit.

In 2010 and 2011, the difference between the official cash flow balance and the augmented indicator is mostly due to the different treatment of the transformation of the private pension fund system. While in 2011 the assets of former private pension fund members improved the official cash flow balance by 1.9 per cent of GDP, this capital revenue is not included in the augmented indicator

Table 5
Presentation of the ESA balance of the general government
(% of GDP)

	2010	2011	2012		
	Preliminary	MNB forecast	Statutory targets	MNB forecast	Difference
1. Balance of central government	−3.3	−5.1	−2.0	−2.8	−0.9
2. Balance of local governments	−0.9	−0.4	−0.5	−0.3	0.2
3. GFS balance of general government (1+2)	−4.2	−5.5	−2.5	−3.1	−0.7
4. GFS-ESA difference	−0.05	9.6	0.0	0.1	0.1
5. ESA balance of general government (3+4)	**−4.3**	**4.1**	**−2.5**	**−3.1**	**−0.6**

Table 6
Augmented cash flow balance
(% of GDP)

	2010	2011	2012
1. GFS balance of general government	−4.2	−5.5	−3.1
2. Corrections	0.6	−1.0	−0.5
3. Augmented balance of general government (1+2)	**−3.6**	**−6.5**	**−3.6**

since it was taken into consideration as contributions during earlier years. The return of former private fund members amounts to the same as if the members returning to the public pension scheme in 2011 had paid their contributions into the public scheme all along.[4] Additional negative adjustment was required due to the fact that the amount, equivalent to 0.8 per cent of GDP, paid as the real yield of the former private fund members, was taken into account as expenditure, although it did not appear in the official balance. On the other hand, the amount (1.8 per cent of GDP) spent on the acquisition of MOL shares is a financing expenditure according to the methodology of the augmented balance, i.e. it should be deducted from the amount of official expenditure. The aggregate net effect of the above was approximately -1.0 per cent of GDP in 2011.

Both the gross and net amounts of the adjustments are lower in 2012. An item adding to the deficit compared to the official balance is that the loss of the MNB for the year under review, to be reimbursed by the budget in 2013 pursuant to the applicable law, is recorded as a budgetary expenditure for 2012. In addition to that, the expected losses of MÁV and BKV also increase the augmented deficit, since these two state-owned companies are treated as part of the augmented budget sector, a fact also reflected in the official deficit at the times debts are assumed and capital injections are provided. The result of the adjustments shows that by immediately recognising such losses, the deficit of the augmented budget would approximate 3.6 per cent of GDP.

4.4.2 Medium-term balance

While in 2010 and 2012 the level of the augmented balance may be similar, in its assessment one must take into account the considerable change of the budgetary effect of the economic cycle during these two years. The fiscal impact of the cyclical fluctuation in the economy is eliminated in the so-called underlying balance, which shows how the augmented balance would look if the most important tax bases moved according to their actual trends without the cyclical fluctuations.

As far as its budgetary impact is concerned, the cyclical trough was reached in 2010. In that year, due to the low level of the most important tax bases (the national economy wage bill and consumption), tax revenue estimated to equal 2.6 per cent of GDP was lost. As a result of the approximation of the tax bases to their medium-term level, in 2012 the negative effect may be reduced to 1.4 per cent of GDP. Half of the change amounting to 1.2 per cent of GDP is due in the catching up of the nominal level of the tax bases and the other half is related to the reduction of the medium-term levels.

On the basis of our forecast, in 2012 the cyclically adjusted augmented deficit is about 2.2 per cent of GDP, since in our calculations 1.4 per cent of the 3.6 per cent augmented deficit is the result of the unfavourable cyclical position of the economy. Between 2010 and 2012, the increasing cyclically adjusted deficit deteriorates by approximately 1.2 per cent of GDP. Half of that is the result of the declining

Table 7
Medium-term balance indicators
(% of GDP)

	2010	2011	2012
1. Augmented balance of general government (1+2)	−3.6	−6.5	−3.6
2. Cyclical component	−2.6	−1.7	−1.4
3. Cyclically-adjusted augmented balance (1−2)	**−1.0**	**−4.8**	**−2.2**
4. Corrections for specific items	0.1	0.6	−0.3
5. Backward-looking indicator (3+4)	**−0.9**	**−4.2**	**−2.5**

[4] As far as its economic effect is concerned, it has always been treated as a contribution.

medium-term levels of tax bases, because as noted earlier this much of the cyclical loss of revenues is due to the trend (i.e. will occur over the medium term).

The other medium-term deficit indicator employed here, i.e. the underlying deficit adjusted with self-reversal, eliminates specific additional items in a way that it takes into account the mean value of the individual effects observed in the past over the horizon of the forecast. This reflects the assumption that the expected value of individual effects can be reckoned with in the future, e.g. as the budget impact of court rulings or natural disasters. Accordingly, the medium-term deficit indicated by that indicator is equivalent to 2.5 per cent of GDP.

For Hungary, the European Union set a 1.5-per cent medium-term deficit objective (MTO), the achievement of which is examined in accordance with the EU's own methodology (see Box 2). Since, in our opinion, our methodology is more suitable for identifying the medium-term position, the fulfilment of the MTO is measured against these indicators (Table 7, lines 3 and 5). In that context, the 2012 medium-term balance may amount to about 2.2 to 2.5 per cent of GDP, meaning that the MTO will not be achieved in 2012. If the risk reserves amounting to 0.7 per cent of GDP are cancelled, the medium-term balance may come very close to the MTO value, but in this case that would leave no cover for any risks resulting in a more substantial deficit.

Box 2
Possible medium-term balance indicators

There are three reasons why the medium-term balance is not reflected properly by the balance of a specific year.

1. As a result of the economic cycle, tax revenues are different from the level they would achieve if the tax bases corresponded to their medium-term trend. In addition to the size of the output gap, the effect of the cycle on the budget is also determined by the composition of the output gap, i.e. the actual wage/profit gaps and consumption/investment gaps. This is important because wages and consumption constitute the most relevant tax bases.

2. Medium-term indicators assume that fiscal measures applicable during the year under review are permanent ones. Measures of a temporary effect are an exception.

   a) Temporary nature of self-reversing measures is obvious and they are used for adjustment by the analytical augmented deficit indicator of the MNB. Among other things, this is required because, for example, the underfunding of the railway system improves the official balance over several years, then deteriorating it at the time the debts are assumed.

   b) The distinction between the temporary or permanent nature of other measures is much less explicit. It is not practical to single out a few specific items, since the larger the revenue/expenditure aggregates under review, the more obvious that they are being offset, even if with a delay at times. The so-called underlying deficit adjusted with policy reversal (see Hoffmann, M. and G. P. Kiss (2010), 'From those lying facts to the underlying deficit', *MNB Bulletin,* December) is used to take that delay into consideration.

3. In the case of certain special factors, the government is unable to control the timing of their inclusion in the cash flow budget. Such items include for example the effects of court decisions or natural disasters. Since their average effect on the balance can subsequently be established, their variation from year to year can be eliminated. An example of that is the Court's ruling concerning VAT refunds, which deteriorates the 2011 balance by 0.9 percent. Instead of that actual value, however, it is taken into consideration at a backward-looking moving average. This means that an average deteriorating effect will also be present in 2012, as there is a certain probability of similar events occurring during the forthcoming years.

The indicator of *cyclically adjusted augmented deficit* adjusts the effects referred to in paragraphs 1 and 2a. To these, the so-called *underlying deficit* adjusted with self-reversal adds the smoothing out of the effect of special factors. For both indicators, the sum of the medium-term balances is equal to the sum of the balances of the period under review, since on the medium term the effects of the adjustments cancel each other out.

In the European Union, the *structural deficit* is determined on the basis of the ESA balance. The method of cyclical adjustment employed here does not take into account the effect of the composition of the output gap, also differing from the MNB estimate in terms of the size of the output gap. Similarly, temporary effects and special factors are also defined differently as, in addition to the specific measures referred to in paragraph 2b., paragraph 2a. is adjusted in an asymmetrical way (as the assumption of debt). Therefore, their effects fail to cancel out each other on the medium term, i.e. the sum of the structural deficits does not correspond to the sum of the balances of the period under review.

5 Detailed assessment of the Budget Bill

In this chapter, the detailed numerical assessment of the Budget Bill is discussed in a breakdown according to the classifications of items defined in the Act on Public Finances. According to that, the budgetary appropriations are classified under three categories: 1. exogenous items, 2. discretionary items, and 3. interest revenues and expenditure.[5] Since the 2012 budget includes various types of reserves of substantially increased amounts, an overview of the budgetary reserves, which are discretionary items by virtue of their content, is provided at the end of this chapter.

On the basis of the three classes of items above, we came to the following conclusions vis-à-vis the figures in the Budget Bill (see Table 8):

- The MNB forecast for the appropriations more directly determined by macroeconomic and demographic trends, the balance of exogenous items, is HUF 227 billion more negative than the value in the Budget Bill. 80 per cent of the difference is attributable to tax revenues.

- In respect of discretionary items, the MNB prepared estimates for major uncapped targets only (the expenditure and revenue items for which estimations were prepared amounted to almost HUF 700 billion). As the resultant of contrasting effects, our forecast concerning the balance of internal items is less favourable than the Budget Bill target by just HUF 7 billion.

Table 8
Budget balance by classes of items
(HUF billion)

	2011		2012		
	Statutory target	MNB forecast	Statutory target	MNB forecast	Difference
1. Balance of exogenous items	5,381	5,111	6,249	6,022	−227
2. Balance of discretionary items	−5,557	−5,546	−5,820	−5,827	−7
3. Net interest expenditures	−1,008	−972	−1,006	−1,029	−23
4. Balance of central government (1+2+3)	**−1,184**	**−1,406**	**−577**	**−833**	**−257**

Table 9
Change of the cash flow balance of the central government compared to the adjusted 2011 base, by main categories
(% of GDP)

	2011 MNB forecast	2012 MNB forecast	Difference
1. Exogenous revenues, total	34.1	35.0	0.9
2. Exogenous expenditures, total	14.7	14.4	−0.3
3. Balance of exogenous items (1−2)	19.3	20.6	1.2
4. Balance of discretionary items	−20.1	−19.9	0.2
5. Net interest expenditures	−3.5	−3.5	−0.0
6. Balance of central government (3+4+5)	**−4.3**	**−2.8**	**1.4**

[5] For the exogenous items, Annex 10 of the 2011 Budget Act was taken into consideration, since the Budget Bill submitted does not include the corresponding Annex. Taking into account the relevant economic content, the list under Annex 10 has been completed with specific additional items on the basis of the methodology developed by the Fiscal Council. Such additional items include: (a) the reimbursement of the MNB's loss, for which no appropriation was earmarked in the budget during previous years yet whose amount is determined by macroeconomic trends and the industry-specific law; (b) the part of the gambling tax due to the National Cultural Fund with regard to the fact that the remaining part of the gambling tax has been treated by the Budget Act as an exogenous item; and (c) the new tax categories, i.e. the public health product tax and the accident surcharge.

- Our forecast for the cash flow net interest expenditure results in a budgetary deficit which is HUF 23 billion higher than the Budget Bill target.

In order to enable a more direct comparison with the Budget Bill, our detailed forecast is also included in a pattern following the official balance of the central government in Tables A1 and A2 of Appendix 1.

Table 9 shows the change of the balance as a percentage of GDP, based on the MNB's forecast, by main categories in such a manner that the 2011 values were adjusted with extraordinary items not included in the base.[6] On that basis, the balance of the central government may improve by 1.4 per cent of GDP in 2012 compared to the base. About two-thirds of the improvement in the budget will probably be generated on the revenue side. Exogenous revenues, constituted mainly by taxes and contributions, are expected to increase by nearly 0.9 per cent of GDP. However, the change of exogenous expenditure and discretional items (which essentially represent expenditure items) will improve the balance by only 0.5 percentage points. (It should be noted here that Interest risk reserve and National Protection Fund are also accounted for as discretionary expenditures, the deletion of which may substantially modify the overall picture.)

5.1 EXOGENOUS ITEMS

After accounting for the measures that can be taken into consideration on the basis of our forecasting rules, the balance of exogenous items may be HUF 227 billion lower than the value included in the 2012 Budget Bill. This stems from the fact that the amount of revenues estimated is HUF 179 billion lower than the government's revenue target and the amount of expenditure is expected to exceed the target by HUF 48 billion.

5.1.1 Exogenous revenues

The fact that actual tax and contribution revenues are expected to fall substantially short of the target is due mainly to the different accounting of the relevant measures and, to a smaller extent, to the differences between the underlying macroeconomic forecasts. The different accounting of the measures is primarily the result of the fact that, in our estimates for the revenue-increasing measures announced, the balance-enhancing effect we projected is less than that incorporated in the Budget Bill target. In addition to that, a minor part of the measures have not been incorporated into our forecast or have only been partly incorporated due to the lack of information on their key parameters. In respect of the macroeconomic assumptions, the assessment of the effects related to the early repayment scheme and the effect mechanism of the minimum wage increase may be particularly different.

Payments by businesses

According to our forecast, revenues from the payments of businesses may be HUF 126 billion lower than the target. In the case of three minor taxes, i.e. the gambling tax, the company car tax and the environmental protection product fee, the effect of the revenue-increasing measures is estimated to be different from the target of the government, whereas in the case of the corporate tax, the significant difference in the forecasts is due to the different macroeconomic expectations.

We expect the revenues from corporate income tax to fall HUF 67 billion short of the target in 2012. The majority of this difference is probably due to the difference in the macroeconomic expectations and to the differing evaluation of the base effect. As far as the former is concerned, two important factors can be highlighted: first, as a direct effect related to the early repayment scheme, the loss of HUF 13 billion in tax revenues is expected for the financial intermediary sector and, second, the significant wage shock will considerably reduce corporate profits. On the basis of past experience, the effect of the restriction of loss write-offs may be HUF 9 billion lower than expected by the government.

As for the company car tax, the 40-per cent tax increase fails to substantiate the extra revenue indicated in the Budget Bill. Rather than the additional revenue of HUF 20 billion expected by the government, the MNB calculates an increase of approximately HUF 8 billion on the assumption that company car owners will respond flexibly to a significant increase of the tax.

As for the mining royalty, the HUF 6 billion additional revenue estimated by the MNB is attributable mainly to the conservative planning of the government, which has been typical of the earlier years, assuming that there are no significant differences between the expectations concerning the path of oil prices.

The gambling tax revenue may be HUF 30 billion lower than the target. This is practically due to the sole fact that we

[6] Of the extraordinary items, MOL and the private pension funds are discretionary items (for their adjustment see Table 12), whereas the effect of the VAT refund appears under the exogenous items.

Table 10
Major differences between our forecast concerning the exogenous items and the Budget Bill targets
(HUF billion)

	Deviation from statutory target	Measures are not included in our forecast because of the lack of details	Different estimate of the effects of measures	Net impact of other differences (macro-economic path, base effect, methodological differences)	Note
Revenues	**–179**	**–11**	**–154**	**–14**	
Corporate income tax	–67		–9	–58	The impact of limitations on loss write-offs is higher than what is set forth in the tax proposal. The remaining difference can be attributed to the base effect and a different macro-economic path (the early repayment of FX denominated debts, the profit-moderating impact of the wage shock, etc.).
Gambling tax	–30		–29	–1	A different estimate of tax revenues coming from on-line gambling.
Company car tax	–13		–12	–1	The government's estimate for the impact of the tax raise is higher.
Enviromental protection product fee	–22	–11	–11		As no details are available, we do not calculate with planned significat tax increase.
Value-added tax	–49		–40	–9	We do not calculate with any improvement in the efficiency of VAT collection.
Personal income tax	–12		–21	9	We have a different opinion of the impact of changes in the tax code.
Employer and employee contribution	6		–32	38	The Government's estimate for the impact of higher taxes and a wider tax base is higher; however, this is offset by the difference between the anticipated wage paths.
Accident surcharge	3		3		We estimate revenues stemming from the new tax lower than the goverment.
Public health product tax	–4		–4		Estimated impact of tax-base broadening and tax increases is smaller than the government's expectation.
Other	8			8	
Expenditures	**48**	**0**	**8**	**39**	
National Social Policy Fund – benefits under retirement age	9			9	We anticipate a higher inflation trajectory than the one indicated in the Budget Bill and a different number of those eligible for the benefits.
Expenditures related to settlements with MNB	12			12	The bill puts forth no appropriation for the refund of the loss incurred by the MNB.
Payments to the EU	22			22	Assuming a weaker HUF exchange rate.
Benefits in cash from Health Insurace Fund	5		13	–8	A rise in the minimum wage will automatically raise the maximum amount of benefits.
Unemployment benefits	–5		–5		Our estimate for the impact of the restructuring of the scheme of jobseekers allowance is higher.
Other	5			5	
Balance of exogenous items	**–227**	**–11**	**–163**	**–54**	

expect a revenue of only HUF 1 billion from the taxation of online gambling in 2012, as opposed to the HUF 30 billion expected by the government. On the basis of international experience, we believe that there is a very high level of tax evasion in the case of this type of taxes, which is difficult to control. As a result of the fivefold increase, on average, of the itemised gambling tax on slot machines, we expect an 80-per cent decrease in the number of legally operated gambling machines, i.e. no extra revenue has been projected. The revenue from the new percentage tax is expected to amount to about HUF 2 billion.

As far as special taxes are concerned (special tax of financial organisations, sector-specific taxes), no significant revenue increase is expected in 2012 compared to 2011. On the basis of this year's advance tax payment data, the businesses concerned have complied with their liabilities compared to the 2010 base, and we expect that the level of the willingness to pay will not decline in 2012 either.

The environmental protection product fee, constituting part of the other centralised revenues, may significantly increase on the basis of a new legislation entering into force next year. However, it still contains considerable uncertainties as the legislative environment is still deficient (e.g. the detailed rules of the product fee liability and the assumption and reimbursement of the product fee are provided for in a government decree). While it is assumed that the revenue of HUF 60 billion expected by the government includes the prospective tax increases, this factor has not been incorporated into our forecast due to the lack of sufficient detail.

Taxes on consumption

The difference between the MNB forecast and the budget target is HUF 49 billion, mainly in terms of the value-added tax due to the effect of the 2011 base and the different estimates concerning the efficiency of tax collection.

- The numerical effect of the measures announced with regard to excise taxes is close to the deduction in the Budget Bill. In addition to the above, the government probably objects an increasing level of tax evasion, which we disregarded and therefore our revenue forecast is slightly higher than the official target.

- In the case of the value-added tax, the estimated effect of the 2 percentage point increase of the rate is in line with the government's calculation (a gross static effect of HUF 150 billion). It follows from our forecasting rules, however, that we have not projected the HUF 40 billion additional revenue arising due to the improving efficiency of tax collection. This factor therefore appears among the positive risks. A further difference of HUF 9 billion is probably due to the modification of the VAT payment rules with regard to agricultural products (the scope of the measure not being defined yet).

Payments by households

There is a minimal difference of HUF 15 billion between the MNB forecast and the government's target.

- Of the measures affecting personal income tax, the discontinuation of the supplemented gross wage scheme up to a monthly income of HUF 202,000 per month, the complete phasing-out of tax credits and reclassifications from corporate income tax to personal income tax have been taken into consideration. In the case of the latter, HUF 6 billion extra revenue is incorporated in our baseline forecast, with symmetrical risks. However, on the basis of the change of the national economy wage bill, taking into consideration the effects of the envisaged minimum wage increase, the effect of the change of the tax schedule may result in a revenue increase of HUF 82 billion. Our 2012 expected revenue forecast thus falls HUF 12 billion short of the target.

- As far as the preferential allowances related to the personal income tax system are concerned, an unchanged structure has been assumed for 2012, since the specific details of the restructuring of allowances have not been developed.

- The measure concerning excise duties, included in the Budget Bill, has been incorporated into our baseline forecast, since the re-regulation of the asset acquisition duty for motor vehicles does not involve a significant implementation risk and the expected extra revenue is within the forecasting error margin.

Exogenous revenues of extrabudgetary and social security funds

Our forecast estimated for the exogenous revenues of the extrabudgetary and social security funds is higher by a total of HUF 11 billion than the budgetary target. This is chiefly attributable to the fact that our forecast relating to contribution revenues exceeds that of the government as a result of our estimate that assumes a faster growth of the wage bill in the economy. However, we estimate the revenue-increasing effect of the measures to be lower than that of the government.

- We expect HUF 6 billion more revenues than budgeted for revenues and other contributions collected by the social security funds. Our wage bill index forecast exceeds fiscal expectations that alone would result in HUF 38 billion more in revenue. As a contrary effect, we expect HUF 14 billion less revenue as a result of the 1 percentage point increase of the health insurance contribution and HUF 18 billion less revenue from the expansion of the contribution base than the government.

- We estimate HUF 30 billion in revenue from the introduction of the accident surcharge, that is, HUF 3 billion higher than the budgeted amount. We are of the view that the government applied a conservative estimate of expected revenues.

- We expect HUF 27 billion in revenue from the public health product tax, HUF 3 billion less than the budgetary target. The difference is caused by the varying accounting of tax base expanding and tax increase measures, presumably attributable to the differing assessment of consumer and manufacturer behavioural effects arising in reaction to the price-increasing effect of the tax increase.

- The exogenous revenues of the extrabudgetary funds (amount of labour market contribution, training contribution, innovation contribution and some part of gambling tax earmarked for the National Cultural Fund) are more than HUF 5 billion higher than budgeted. Of the above amount, we estimate a revenue surplus from labour market contributions, owing to our assumption also related to the trend of the wage bill index.

5.1.2 Development of exogenous expenditures

The difference between the MNB forecast and the budgetary target relating to exogenous expenditure items is partly attributable to the difference between macroeconomic parameters and partly to estimates and assumptions in relation to measures that vary from those of the government.

- According to our recent forecast, as a result of the expected loss of the MNB in 2011, a loss reimbursement obligation of HUF 12 billion arises for the central budget in 2012. The HUF 33 billion in capital reserve of the MNB partly offsets the expected loss in 2011, currently estimated at HUF 45 billion.[7]

- In relation to EU payments, the difference between the appropriation and our forecast is caused by the varying exchange rate assumptions. Due to the assumed HUF exchange rate that is weaker than that assumed by the government, our forecast may exceed the budgetary target by HUF 22 billion.

- The significant increase of the minimum wage will result in an automatic increase in cash health insurance benefits (maternity assistance, child care allowance, sick allowance) which, according to our estimates, result *ceteris paribus* in a HUF 13 billion total increase in expenditures. Presumably this accounts for our forecast being HUF 5 billion higher than the budgetary target, while our estimate is more optimistic regarding the underlying macroeconomic path.

- Our forecast of unemployment benefits is approximately HUF 5 billion lower than the budgeted figure, even if we take into account the direct effect of the minimum wage increase on the average amount of benefits. The difference probably stems from the fact that we account for larger savings resulting from the transformation of unemployment benefits than the government. Based on the MNB's macroeconomic path, our calculations suggest that the measure will reduce expenditures by roughly gross HUF 75 billion (HUF 44 billion without taxes and contributions) in 2012.

Pension expenditures

The Budget Bill presents pension expenditures in 2012 in three chapters, with modified content and terms. The *"retirement benefits"* sub-title of the Pension Insurance Fund chapter presents old age benefits payable to pensioners over the retirement age survivor pensions, discretionary welfare assistance payments and – as a new category – long service early retirement pensions. The *"disability benefits"* title of the Health Insurance Fund sets out disability and accident pensions payable to beneficiaries under the retirement age as well as rehabilitation benefits. Payments defined so far as old age pension below the retirement age are shown in 2012 under the sub-title of *"early retirement benefits"* of the National Welfare Fund. The bill (No. T/4663) on early retirement benefits provides partial guidelines on the restructuring and renaming of pension expenditures. Preliminary estimates of the effect of the changes is integrated in our forecast.

[7] The early repayment of the foreign exchange denominated mortgage-loans may significantly reduce the amount of interest rate loss continuously arising on an annual level, considering that the central bank realises an exchange gain on the related central bank foreign exchange provision transactions compared to the historical cost of the foreign exchange reserves. As an additional factor reducing central bank losses, the foreign exchange requirement of banks also reduces the stock of MNB bonds, which – *ceteris paribus* – points to lower interest expenditures (and losses).

Table 11
Changes in exogenous items
(HUF billion)

	2011		2012		
	Statutory target	MNB forecast	Statutory target	MNB forecast	Difference
Revenues	**9,540**	**9,199**	**10,422**	**10,243**	**−179**
Payments by businesses, total	**1,160**	**1,132**	**1,306**	**1,180**	**−126**
Corporate income tax	288	279	356	289	−67
Surtax of corporations	0	−17	0	0	0
Fees of financial institutions	11	9	8	8	0
Special tax of financial institutions	187	186	187	186	−1
Sector-specific taxes	161	158	155	160	5
Simplified entrepreneurial tax	180	172	179	173	−6
Green taxes	27	24.3	26	24.4	−2
Mining royalty	88	106	93	99	6
Gambling tax	51	47	82	53	−30
Income tax of energy companies	20	17	14	14	0
Company car tax	28	25	46	33	−13
Enviromental protection product fee	21	26	60	38	−22
Rehabilitation contribution	65	67	65	68	3
Other centralised revenues (penalties)	1	1	1	1	0
Other payments	32	32	33	33	0
Consumption taxes	**3,402**	**3,043**	**3,635**	**3,586**	**−49**
Value-added tax	2,489	2,142	2,698	2,648	−49
Excise duties	881	866	898	900	2
Registration tax	32	35	39	37	−2
Payments by households	**1,446**	**1,463**	**1,654**	**1,639**	**−15**
Personal income tax	1,363	1,385	1,551	1,539	−12
Fees and duties	82	75	103	99	−3
Other taxes	1	4	0	0	0
Revenues form the EU	**9**	**9**	**9**	**9**	**0**
Refunds on custom duties and contribution to sugar industry	9	9	9	9	0
Exogenous revenues of extrabudgetary and social security funds	**3,522**	**3,552**	**3,819**	**3,829**	**11**
LMF – Health insurance and labour market contribution	188	187	197	201	4
LMF – Vocational contribution	49	48	51	51	−0
LMF – Repayment of wage guarantee	1	1	1	1	0
RDF – Innovation contribution	23	24	23	25	2
NCF – Revenues from lottery	9	10	10	10	0
PIF – Employer's and insured persons' contribution	2,553	2,573	2,644	2,661	17
PIF – Other contributions (exogenous items)	28	22	20	20	0
HIF – Employer's and insured persons' contribution	597	590	721	705	−15
HIF – Other contributions (exogenous items)	39	40	39	42	3
HIF – Per capita health contribution	36	54	56	57	0
HIF – Accident surcharge	0	0	27	30	3
HIF – Public health product tax	0	4	30	27	−4
Expenditures	**4,159**	**4,088**	**4,173**	**4,221**	**48**
National Social Policy Fund	**474**	**474**	**785**	**793**	**8**
Family allowances, social benefits (exogenous)	474	474	472	471	−1
Benefits under retirement age	n. a.	n. a.	313	321	9
Expenditures related to settlements with the MNB	**0**	**0**	**0**	**12**	**12**
Payments to the EU	**258**	**258**	**264**	**286**	**22**
Exogenous expeditures of extrabudgetary and social security funds	**3,427**	**3,355**	**3,124**	**3,130**	**6**
LMF – Jobseekers' assistance and wage guarantee	142	125	73	68	−5
PIF – Pensions	3,054	3,029	2,555	2,557	2
HIF – Cash benefits	231	202	211	216	5
HIF – Disability benefits (exogenous items)	n. a.	n. a.	284	288	3
Balance of the items	**5,381**	**5,111**	**6,249**	**6,022**	**−227**

Our forecast of the various types of retirement benefits is HUF 14 billion higher than the budgeted amount with the difference attributable to the factors below:

• With regard to the total pension expenditures of the Pension Insurance Fund, our estimate is only moderately higher – by HUF 2 billion – although the overall difference is the result of two effect of opposite directions: while we expect the inflation of pensioners' consumption basket to justify a pension benefit indexation higher the one budgeted by the government, the resulting higher expenditures are mostly offset by our estimate concerning the changes in beneficiary numbers.

• With respect to disability benefits transferred to the Health Insurance Fund, our forecast exceeds the budget allocation by HUF 3 billion, attributable to different assumptions of benefit indexation and recipient numbers, the latter of which being less favourable than forecast by the government. (Partial disability allowances have been moved into the same expenditure category as disability benefits payable to people under retirement age. These benefits and the larger difference seen, in their case, between our estimate and the budget are discussed among the discretionary items.)

• The budgeted expenditures of early retirement benefits paid from the National Welfare Fund is approximately HUF 9 billion less than the MNB forecast. The difference is explained by indexation and recipient numbers. In the case of early retirement benefits of former members of the police and armed forces, we took into account the proposed legislation which, from 2012, would subject the benefits of recipients younger than 57 to personal income tax. We estimate the resulting savings at approximately HUF 11 billion.

5.2 DISCRETIONARY ITEMS

We accept the majority of the budgeted discretionary items of the Budget Bill. We provide independent forecasts of four open-ended items with autonomous dynamics: consumer price subsidies, health damage benefits, the drugs budget balance, EU funds and the related budgetary

Table 12
MNB forecast and budgetary target relating to discretionary items

	2011		2012		
	Statutory target	MNB forecast	Statutory target	MNB forecast	Difference
Discretionary revenues					
Other discretionary revenues of central budget	111	123	163	165	2
Revenues of extrabudgetary funds	60	69	54	54	0
Own revenues of social security funds	55	58	63	63	0
Discretionary expenditures					
Consumer price subsidy	109	109	93	93	0
Family allowances, social subsidies (discretionary items)	154	150	79	79	0
Housing grants	126	126	120	120	0
Net expenditures of budgetary institutions and chapters	2,255	2,333	2,216	2,177	–39
Transfers to business organisations	274	274	302	302	0
Transfers to local governments	1,173	1,197	1,141	1,141	0
Expenditures related to state property	96	115	110	110	0
Other discretionary expenditures	88	91	91	91	0
Expenditures of extrabudgetary funds	232	242	298	298	0
Net expenditures of the drug budget	300	314	217	250	33
HIF – health impairment benefits	0	0	58	71	13
Other discretionary expenditures of HIF (in-kind benefits)	862	858	904	904	0
Discretionary expenditures of PIF	19	19	18	18	0
Designated and general reserves	124	0	254	254	0
National Protection Fund and interest risk reserves	0	0	200	200	0
Discretionary balance without specific items	**–5,587**	**–5,576**	**–5,820**	**–5827**	**–7**
Corrections for extraordinary items	30	30	0	0	0
Discretionary balance in accordance with Act on public finances	**–5,557**	**–5,546**	**–5,820**	**–5,827**	**–7**

co-financing. As a result, our forecast provided on the balance of discretionary items is only moderately worse by HUF 7 billion than the budgetary target (Table 12).

In our forecast of consumer price subsidies, we took into account the bill (No. T/4656) relating to the amendment of Act of 2003 on Consumer Price Subsidies. According to our estimates, the average 25 per cent price subsidy reduction proposed in relation to the local transport subsidy category may result in roughly HUF 16 billion savings, thus our forecast basically corresponds to the budgetary target.

With regard to health damage benefits financed by the Health Insurance Fund from 2012, according to our forecast, the expenditures of benefits provided to those with a reduced capacity to work will exceed the budgetary target of the Budget Bill by HUF 13 billion. While our own estimate only accounts for a continued decline in the number of individuals observed so far as a result of the omission of previously announced measures, the official budgetary target is presumably based on a substantial decrease in individuals on the basis of the Széll Kálmán Plan.

The government aims at realising HUF 97 billion savings in the drugs budget in comparison to the expected figure in 2011. According to our estimates, approximately 40 per cent of this amount is backed up with measures; as a result of increased manufacturer and distributor payments, new funding regulations and the pharmaceutical price bidding in August, a HUF 38 billion balance improvement is expected in 2012 compared to this year (the annual effect of savings is HUF 55 billion, but some of these have affected 2011 as well). As a result of the above measures, a HUF 59 billion larger deficit arises in comparison to the budgetary target. According to laws in force, in such a case the deficit of drugs budget is partially covered by the manufacturers and distributors and they may be obliged to pay an additional HUF 26 billion in 2012 in the framework of risk sharing payment. Thus, overall we expect the drugs budget balance to be one-third, or HUF 33 billion, less than the savings expected by the government.

In relation to the budgetary co-financing of European Union programmes, we estimate HUF 39 billion less in expenditures than the budgetary target. Normally, we apply the budgetary targets of budgetary authorities and chapters, but adjust these with our own forecast relating to the use of EU development funds. We expect the use of EU funds to follow the trend observed in previous years. Accordingly, revenues of budgetary authorities and chapters originating from EU funds are expected to amount to HUF 1,139 billion in 2012, HUF 389 billion less than targeted by the government. On the basis of the average amount of co-financing, we forecast HUF 39 billion savings in the expenditures of budgetary authorities and chapters.

5.3 INTEREST BALANCE

The interest expenditures appropriation in the Budget Bill, relating to forint denominated debt, are plausible, but foreign exchange interest expenditures are based on a forint exchange rate that is stronger than at present. As a result of different assumptions of the foreign exchange rate, our net interest expenditure is HUF 23 billion higher than that of the government that may be covered by the interest risk reserve.

The general exposition contains the accrual based net interest expenditure forecast of the government (HUF 1,049 billion) according to the EDP methodology that basically corresponds to the forecast of the MNB (HUF 1,045 billion).

5.4 RESERVES

The Budget Bill contains four different central reserve budgetary targets: the reserve for extraordinary government measures (HUF 100 billion), designated reserves (HUF 154 billion), the National Protection Fund (HUF 150 billion) and the Interest risk reserve (HUF 50 billion). Thus, the total amount of reserve budgetary targets coming under the authority of the government amounts to HUF 454 billion; in our view, however, of the above amount, only HUF 200 billion can be regarded as free reserves in a narrower sense (National Protection Fund and Interest risk reserve) and provide funds for the management of macroeconomic and feasibility risks related to the baseline scenario. Thus, these two reserves may contribute to the corrective adjustment of the deficit target by 0.7 percentage points of GDP.

In a wider sense, the reserve for extraordinary government measures may be classified among available free reserves, but these funds actually serve as a general reserve of the budget and provide room for manoeuvre for the government to manage interim extraordinary events. Past years have shown that such types of budgeted reserves are used during the year, and thus such reserve should not be considered as suitable for managing macroeconomic and feasibility risks. This particularly holds true in relation to 2012, as next year's budgeted net expenditures of budgetary authorities and chapters do not seem to be feasible without the use of this reserve (for details see chapter 6.1).

Designated reserves basically cover funds appropriated for compensation related to changes in the personal income tax scheme, and in relation thereto, the minimum wage. Thus, designated reserves will also be used concurrently with the implementation of the planned changes, that is, designated reserves should not be considered as free reserves from the outset.

Overall, we may conclude that upon the cancellation of most of the National Protection Fund and the Interest risk reserve may be sufficient for improving the GDP-proportionate ESA deficit next year (equalling 3.1 per cent according to our baseline forecast) to approximate the government's deficit target (–2.5 per cent of GDP). In this case, however, minimal budget reserves will remain to manage negative macroeconomic and other adverse effects arising during the year. We discuss the main risks relating to the fulfilment of the budget in chapter 6.

6 Main risks surrounding the Budget Bill

According to our calculations, in addition to utilising general reserves in full, the budgeted expenditures of **budget entities and chapters** will require additional downward adjustments of HUF 62 billion in comparison to the 2011 base, further aggravating the fiscal tensions already observed. For this reason, without further long-term expenditure-side adjustments, it is doubtful whether the balance target can be met either in terms of budgetary entities and chapters, or in terms of discretionary items.

In our baseline forecast, the 2011 loss of the MNB, reimbursable by the Budget in 2012, is estimated significantly lower than in our earlier forecast, at HUF 12 billion. This is based on the assumption that 20 per cent of FX-denominated loans will be prepaid, and thus the central bank will realise substantial exchange rate gains from the foreign exchange market intervention related to the prepayment of these loans and mortgages. In terms of budget balance, an asymmetric risk of a higher deficit arises if the rate of prepayment is lower than assumed, possibly resulting in exchange rate gains below our estimate. This may increase the loss of the central bank to be reimbursed by the budget in 2012 and may affect the 2012 deficit.

Risks related to the government **measures** may positively or negatively affect the budget balance. Positive risks are related to such measures which, in line with our forecasting principles, were disregarded but the realization of which cannot be ruled out.

Among other risks, there is a major negative risk related to the balance of **local governments.** If the adjustment capacity of local governments is weaker than assumed in our projections, or sources of funding become more accessible, the deficit of the local government subsector may become larger than indicated by our forecast.

6.1 RISKS RELATED TO DISCRETIONARY ITEMS

The 2012 budget bill reduced the budgeted expenditures of capped discretionary items, particularly in relation to the net expenditures of budgetary authorities and chapters. The government exerts firm procedural control over the financing of capped discretionary items; therefore, we normally accept the budgetary targets in the bill. The fulfilment of the budgetary targets, however, may pose underlying risks. Comparison of the budgetary targets for 2012 with the MNB forecast of 2011 may provide a reference for the assessment of risks on an aggregate level that also takes into account the trends of financial flows in the base period (Table 13).

In 2012, HUF 84 billion less funds are available, in nominal terms, for capped discretionary expenditures in comparison to the values expected for 2011. Fiscal pressures are expected to ease if the full amount (HUF 100 billion) of statutory general reserves are used as appropriated. On the other hand, the higher level of specific reserves does not reduce fiscal tensions as regards discretionary items, since the usage of these reserves is tied (compensation for minimum wage increase and phase-out of tax credits). We are not accounting for the amount of the National Protection Fund and Interest risk reserve that serve the management of macroeconomic and other external risks and thus, capped discretionary items only increase by HUF 16 billion in addition to the use of general reserves.

Compared to the MNB forecast for 2011, the direction and size of the changes in the Budget Bill vary (Table 13): some are attributable to the transfer or cancellation of function, while others to changes in budget allocations. The largest decrease is recorded in relation to the net expenditures of budget entities and chapters (HUF −162 billion). At the same time, expenditures allocated to public works and therapeutic-preventive care increased: the capped expenditures of Extrabudgetary and Social Security Funds are HUF 95 billion higher than in 2011. The increase related to these functions, however, does not reduce fiscal tensions among other allocations where reductions are planned.

Realising the 2012 net expenditures of budget entities authorities and chapters is doubtful, as the base year 2011 compared to which the government aims to save HUF 162 billion (without reserves) is also fraught with fiscal tensions. Even if the general reserve is fully spent on the expenditures of budget entities and chapters, a nominal decrease of HUF 62 billion arises in comparison to the base year.

Table 13
Capped discretionary items and general reserves
(HUF billion)

	2011 MNB forecast	2012 Statutory target	Difference
1. Capped expenditures of the extrabudgetary funds*	201	253	52
2. Capped net expenditures of the social security funds	900	942	43
3. Capped discretionary expenditures of the central budget**	3,685	3,507	−178
*Of which: net expenditures of budgetary institutions and chapters****	*2,119*	*1,956*	*−162*
4. Expenditures of capped discretionary items (1+2+3)	4,785	4,701	−84
5. General reserves****	0	100	100
6. Capped internal items including general reserves (4+5)	4,785	4,801	16
Of which: net expenditures of budgetary institutions and chapters including general reserves	*2,119*	*2,056*	*−62*

** Adjusted for EU revenues and own funds.*
*** Not including EU own funds and distributed provisions, adjusted in 2012 for centralised fine revenues as well.*
**** Not including EU own funds and distributed provisions for authorities and chapters, adjusted in 2012 for centralised fine revenues as well.*
***** Extraordinary government measures.*

The likelihood of realising the above target is further limited as measures implemented by the government this year only reduce expenditures temporarily. Without further measures, the effect of these decisions – such as utilisation of the stability reserve, ordering of a procurement freeze and the accumulation of supplier debts – may be partially reversed in 2012.

The announced restructuring and reorganisation of functions moderately mitigates the increased risks attributable to using a tight base of 2011 for planning the 2012 budget. The discontinued functions (EU presidency in 2011 and the census) may produce HUF 30 billion in savings. Transfers between the subsectors are balance neutral in terms of the central government: while the fire fighting functions transferred from local governments to the central government involve additional costs, the transfer to other subsectors of natural gas price subsidies and payments related to the support of the Hungarian diaspora produces roughly an equivalent decrease in outlays. The government is not expecting savings in 2012 in the chapters in relation to higher education, and since the PPP contracts will not be repurchased, the annual fees payable for these will not decrease either. The 2 percentage point increase of VAT, however, may result in additional expenditures for entities and chapters of approximately HUF 20 billion. As a result of the above, savings totalling HUF 10 billion may be realised in 2012 compared to 2011.

The General Exposition of the Budget Bill defines numerous sources of expenditure cuts to be implemented, but most of these cannot be quantified; the document only notes that savings are to be realised through improved efficiency, reorganisation and staff rationalisation. On the basis of information disclosed so far, explicit savings are only possible through the freezing public sector wages, announced in the Convergence Programme, and the abolishment of the stability reserve within the base, but these only contribute to maintaining expenditures on a nominal level.

Overall, it is a major risk related to capped discretionary items that, in addition to the use of the full general reserve in connection with budget entities and chapters, additional savings of HUF 62 billion are required in comparison to 2011. Risks are increased by the constrained fiscal planning base and the lack of measures substantiating expenditure cuts. **If effective measures ensuring the fulfilment of budgetary targets are not implemented, it remains doubtful whether the balance target of budget entities and chapters and, in a wider context, that of capped discretionary items in general can be met.**

6.2 RISKS RELATED TO THE LOSS REIMBURSEMENT OF THE MNB

According to our forecast, the profit reserve accumulated earlier will cover most of the losses of the central bank expected in 2011, thus our forecast suggests that a loss reimbursement obligation of only HUF 12 billion will arise in the budget in 2012. The profit/loss of the MNB is generally determined by instruments used for implementing monetary policy (price stability and financial stability) targets. The high volume of the two-week MNB bond, in parallel with the use of government foreign exchange funds, and the level of the base rate exceeding foreign exchange interest rates result in substantial central bank losses; the loss of the MNB amounted to HUF 68 billion in the first half of the year.

At an annual level, however, notwithstanding the continuously incurred loss on interest, a much lower amount of total loss is expected in 2011, principally attributable to the central bank instrument introduced in relation to the early repayment scheme of foreign exchange loans at a fixed preferential exchange rate and the development of the forint exchange rate. When the central bank sells foreign exchange to banks, and the forint exchange rate exceeds the average cost rate of foreign exchange reserves, the central bank realises a profit. Moreover, the foreign exchange demand of banks also reduces the volume of MNB bonds that *ceteris paribus* points to lower interest expenditures. In view of the fact that the central bank cumulated HUF 33 billion in profit reserve as a result of profitable operations in recent years, pursuant to the central bank act in force, only a smaller portion (HUF 12 billion) of the approximately HUF 45 billion loss expected in 2011 is to be covered by the budget in 2012.

It is important, however, to note the risks. If the ratio of total repayments falls short of the assumed 20 per cent, or a lower ratio of the above is realised in 2011 (or the forint exchange rate remains persistently high), the profit of the central bank resulting from conversion may be lower than our forecast. This may have the result that **the loss of the MNB in 2011, and in relation thereto, the loss reimbursement increasing the 2012 budget deficit, may exceed the level we have forecast.**

If there is higher-than-assumed demand for foreign exchange funds provided by the MNB, this may only moderately improve the balance of central government in comparison to our baseline forecast, in view of the asymmetry of settlements between the central bank and the budget.

6.3 DETAILED EVALUATION OF RISKS RELATED TO GOVERNMENT MEASURES

The table at the end of the chapter (Table 14) shows measures that the government aims to implement in the 2012 budget, on the basis of announcements made in the course of preparing the Széll Kálmán Plan, the Convergence Programme and the budget. If, in our view, no fiscal risks are linked to the announced measures, these are not indicated in the table. Thus, we do not show the risks of a previously announced measure, if (a) the government does not wish to implement the measure on the basis of the Budget Bill and other information available to us, or (b) our opinion agrees with that of the government in terms of fiscal effects expected from the measure. We briefly describe some of the major risks below.

Retirement benefits

The re-assessment of disability pensioners is delayed, with neither the legislative nor the institutional background of the review system – which is expected to include employability – prepared or amended. Therefore, we do not consider any substantial savings likely in 2012. The linking of the regular increase of pensions to the price index was not implemented either, although this is currently immaterial as the law in force also stipulates price indexing if economic growth is below 3 per cent. Thus, we perceive an upside risk in relation to retirement benefits, albeit a moderate one.

Gambling tax

The effect of quintupling the itemised gambling tax levied on slot machines is uncertain and may result in a behavioural effect prolonged over time: the number of slot machines may decline at a rate higher than assumed; as a result, expected gambling tax revenues may vary downward as well as upward compared to our forecast, possibly by a substantial proportion. Our forecast of online gambling taxes is conservative and represents an upward risk.

Environmental product fee[8]

The amount indicated as the budgetary target is presumed to incorporate the revenue increases attributable to government measures (expanded tax base and tax increase) that are yet to be announced. Due to a lack of necessary detail, however, we are not accounting for these measures in our baseline forecast. Upon the actual implementation of the planned measures, budget revenues may be higher than our forecast.

Public health product tax

Based on our forecast, the implementation of the public health product tax carries downward risks. A price increase constraint is substantial in relation to many product groups (e.g. energy drinks, salty snacks), strengthened by the increase of the VAT rate. This encourages tax avoidance by

[8] Upon application of the formulas (payable external cost, service charges) contained in the schedule to Act LXXXV of 2011 on the Environmental Product Fee in force, revenue may fall short of the targeted amount, as the formulas and their conditions presumably do not reflect the intentions of legislators.

manufacturers (through the reduction of ingredients named in the law below the limit, for example) and consumer demand may decrease.

Pharmaceutical subsidies

According to our forecast, the deficit attributable to pharmaceutical subsidies exceeds the budgetary target. The additional deficit is shared by general government, manufacturers and distributors. The HUF 26 billion payment obligation of manufacturers and distributors in 2012 is very high and it may create major spill-over effects. Therefore, the sustainability of such a payment obligation may be doubtful.

Road toll

The planned replacement of the highway fund with road toll revenues is possible only through a significant toll increase. The related plans and parameters of a possible toll increase are not known, and therefore the implementation risk is considered high.

6.4 OTHER RISKS

Local governments

If the adjustment capacity of local governments is weaker than assumed in our forecast or funding is less constrained, the deficit of the local government subsector may be greater than indicated. The government expects a local government deficit in 2012 that is higher than the MNB forecast by 0.2 per cent of GDP.

National contributions to projects financed with EU funds

If, contrary to our assumption, the dynamics of revenues received from the European Union significantly accelerate in 2012, the increase in the required national contributions may worsen the balance of the budget relative to our baseline forecast. The inflow of funds, higher than our forecast, also increases tax revenues; thus, the net effect on the balance of general government depends on the structure of funding.

Decision on the support of Malév and the special tax levied on the telecommunications sector

If the European Commission qualifies capital transfers to Malév provided so far as prohibited government assistance, Malév will have to repay the state aid it received in the past. If the company is unable to do so – which is a realistic assumption – Malév may even need to file for bankruptcy, resulting in additional budgetary expenditures for the main shareholder, the Hungarian State.

The European Commission has launched infringement proceedings against Hungary in relation to the special tax levied on the telecommunications sector and ordered the government to abolish the tax. According to information available to us, the government is not planning the abolishment of the tax, therefore the case may go before the European Court. In case of a negative decision, the repayment of tax and interest in 2013 (at the expected time of the court decision) could amount to additional expenditures equalling 0.6-0.7 per cent of GDP.

Table 14
Risks related to measures estimated with varying effects
(HUF billion)

Measure	Status*	Budgetary item directly affected	Improvement of the balance expected to be induced by the measure in 2012			
			Impact expected by the government	Impact estimated by the MNB	Minimum estimated impact	Maximum estimated impact
Widening of the social security tax base (1.5 times the minimum wage)	+–	Social security contributions	29	11	5	17
1 percentage point increase in health insurance contribution	+–	Social security contributions	83	69	60	80
A review of eligibility for disability pension and incapacity benefit	––	HIF – disability benefits	14	0	0	17
Increasing the efficiency of VAT collection	––	Value-added tax	40	0	0	40
Structural changes in PIT regulation	+–	Personal income tax	109	88	75	100
Limitations on loss write-offs	+–	Corporate income tax	31	22	15	40
40% increase of company car tax (on average)	+–	Company car tax	20	8	4	11
Taxing of online gambling	++	Gambling tax	30	1	0	n. a.
New product groups subject to enviromental protection product fee and tax increase	––	Enviromental protection product fee	11	0	0	n. a.
Restructuring of the environmental protection product fee system (effective regulation by 2012)	++	Enviromental protection product fee	49	38	30	50
Widening of the tax base for public health product tax	+–	Public health product tax	10	6	2	10
Accident surcharge	+–	Accident surcharge	27	30	27	33
Tightening of the eligibility rules of unemploymnet benefit and assistance	++	Unemployment benefit and unemployment assistance	70	75	70	80
Impact of increase in the minimum wage on health insurance benefits paid in cash	––	Childcare allowances, maternity and sick allowances	0	–13	0	–15
Drug's budget	+–	Drug price subsidy	97	64	36	82

* *(++) enacted regulation, implementation commenced; (+–) bill under discussion; (––) announcement only.*

7 Statutory compliance of the Bill

7.1 REAL DEBT RULE

The fiscal regulatory framework set out in Act LXXV of 2008 on prudent state finances and fiscal responsibility fundamentally aims at maintaining the real value of government debt (debt of central government pursuant to the Budget Act). With economic growth, this would result in the gradual decline of GDP-proportionate government debt. For the purpose of achieving the target, the law sets out a regulatory framework based on a three-year planning cycle that aims at maintaining the real value of debt in the medium term, but allows deviation from this path in the short term, on the basis of the unforeseeable volatility of the economy.

According to the fiscal regulatory framework, the balance of so-called discretionary items in the Budget Act must correspond to values approved one year earlier in the framework of medium-term planning. Discretionary items cover expenditures and revenues that the government is able to directly affect, that is, that principally do not depend on economic and demographic trends. In addition, the Budget Act must set out the balance of discretionary items to be fulfilled in 2013 that ensures the fulfilment of the primary balance set in 2010 for that year. Finally, a primary balance must be set in relation to 2014 that will not lead to a rise in the real value of government debt in 2014.

The bill does not comply with the fiscal responsibility act either formally or in terms of calculations, as the balance of discretionary items in 2012 is higher than that set one year earlier, and it does not contain targets relating to the balance of discretionary items for the year 2013 and the primary balance for the year 2014. According to the Budget Act for the year 2011, the balance of internal items should equal HUF −5,356 billion in 2012. The balance of discretionary items in the bill equals HUF −5,820 billion, thus it is HUF 464 billion less favourable than the target. Our forecast relating to discretionary items basically corresponds to the budgetary targets – it is only HUF 7 billion less favourable than the targets. We should note that the National Protection Fund and Interest risk reserve, recorded among reserves, are classified as discretionary items, thus if these are not used by the budget, the discretionary balance would improve by HUF 200 billion, significantly better approximating the target.

7.2 DEBT RULE SET OUT IN THE CONSTITUTION

Pursuant to the Constitution entering into force in January 2012, the Budget Act must ensure that central government debt (debt of the central government of general government) decreases in proportion to GDP until it reaches 50 per cent thereof. As a result of the entry into force of the Constitution in January 2012, it would not be mandatory to apply it to the current proposal, but according to our forecast, **central government debt may decrease by 1.0 per cent of GDP in 2012. The bill contains a higher, 1.9 per cent debt reduction, basically attributable to difference in assumptions relating to the financing of the deficit.**

The high level of debt reduction contained in the bill is partly attributable to the fact that nominal debt in the bill increases by a smaller extent than the cash flow deficit, indicating that the debt management agency would use some of the financing reserves (foreign exchange deposits

Table 15
Fulfilment of the balance of discretionary items targeted in 2010 in the bill
(HUF billion)

	2012
1. Government's target in 2011	−5,356
2. Figure in Budget Bill	−5,820
3. Difference (2–1)	−464
4. MNB forecast	−5,827

Table 16
Government debt
(% of GDP)

	2010	2011	2012
Central government debt			
Projection in Budget Bill	74.1	68.3	66.4
MNB forecast	74.1	71.0	70.0
General government debt			
MNB forecast	81.3	78.5	77.5

and assets transferred from private pension funds). We are of the view that we should be aware of the burden on the budget caused by significant maturities in 2013 and 2014, and thus reserves could play a role in the debt management over the medium term. According to our forecast, GDP-proportionate central government debt would decrease in 2012 even without the use of financing reserves.

The difference between forecasts relating to the GDP-proportionate level of debt is primarily attributed to the difference between assumptions on the exchange rate of the forint. The bill uses the forint exchange rate measured prior to the weakening of the currency in September in its forecast that would substantially reduce the forint value of foreign exchange debts in comparison to their amount calculated with the current exchange rate. It follows that by the end of 2011, the debt forecast of the bill is lower than our estimate by approximately 3 per cent of GDP. The difference increases further in 2012, as we do not forecast the use of financing reserve and the resulting debt reduction effect.

The EDP debt of total general government may equal 78.5 per cent of GDP at the end of 2011, significantly exceeding the government forecast. The difference is principally attributable to the fact that GDP that is lower than the government estimate and the higher euro exchange rate. The debt rate may decrease by 1 per cent of GDP in 2012.

Appendix 1
Background tables

Table A1
MNB forecast and budgetary target – revenues
(HUF billion)

REVENUES	2011		2012		
	statutory target	MNB	statutory target	MNB	difference
CENTRAL BUDGET					
PAYMENTS BY BUSINESSES					
Corporate income tax	288	279	356	289	–67
Surtax of corporations	0	–17	0	0	0
Fees of financial institutions	11	9	8	8	0
Special tax of financial institutions	187	186	187	186	
Sector-specific taxes	161	158	155	160	5
Simplified entrepreneurial tax	180	172	179	173	–6
Green taxes	27	24	26	24	–2
Mining royalty	88	106	93	99	6
Gambling tax	51	47	82	53	–30
Other payments	32	32	33	33	0
Other centralized payments	110	120	179	157	–22
Income tax of energy companies	20	17	14	14	0
Company car tax	28	25	46	33	–13
TOTAL	**1,183**	**1,158**	**1,359**	**1,231**	**–128**
CONSUMPTION TAXES					
Value-added tax	2,489	2,142	2,698	2,648	–49
Excise duties	881	866	898	900	2
Registration tax	32	35	39	37	–2
TOTAL	**3,402**	**3,043**	**3,635**	**3,586**	**–49**
PAYMENTS BY HOUSEHOLDS					
Personal income tax	1,363	1,385	1,551	1,539	–12
Fees and duties	82	75	103	100	–3
Other taxes	1	4	0	0	0
TOTAL	**1,446**	**1,464**	**1,654**	**1,639**	**–15**
CENTRAL BUDGETARY INSTITUTIONS AND CHAPTER ADMINISTERED APPROPRIATIONS					
Revenues of central budgetary institutions	567	817	678	678	0
Chapter administered professional appropriations	81	311	15	15	0
EU support of chapter administered professional appropriations and central investments	1,147	900	1,528	1,139	–389
TOTAL	**1,795**	**2,028**	**2,221**	**1,832**	**–389**
PAYMENTS FROM FUNDS OF THE GENERAL GOVERNMENT	33	43	49	49	0
PAYMENTS RELATED TO STATE PROPERTY	44	49	50	50	0
OTHER REVENUES	24	24	20	20	0
REVENUES FROM EU	29	29	49	53	4
REVENUES OF PENSION REFORM AND DEBT REDUCTION FUND	96	96	0	0	0
REVENUES RELATED TO DEBT SERVICE	60	96	59	77	17
TOTAL REVENUES OF CENTRAL BUDGET	**8,111**	**8,028**	**9,096**	**8,537**	**–560**

Table A1
MNB forecast and budgetary target – revenues (cont'd)
(HUF billion)

REVENUES	2011		2012		
	statutory target	MNB	statutory target	MNB	difference
EXTRABUDGETARY FUNDS					
LMF – Health insurance and labour market contributions	188	187	197	201	4
LMF – Vocational contributions	49	48	51	51	0
RDF – Innovation contributions	23	24	23	25	2
NCF – Revenues from lottery	9	10	10	10	0
Revenues of other funds	148	157	55	55	0
TOTAL REVENUES OF EXTRABUDGETARY FUNDS	**416**	**426**	**337**	**342**	**5**
SOCIAL SECURITY FUNDS					
PENSION INSURANCE FUND	**3,074**	**3,091**	**2,797**	**2,815**	**18**
Contributions	2,593	2,610	2,681	2,699	18
Benefits and subsidies from central budget	0	0	68	68	0
Revenues from Pension Reform and Debt Reduction Fund	433	433	0	0	0
Other revenues	47	47	47	47	0
HEALTH INSURANCE FUND	**1,371**	**1,404**	**1,721**	**1,759**	**38**
Contributions (Per capita health contribution incl.)	673	685	817	805	−12
Benefits and subsidies from central budget, transfers from Pension Insurace Fund	642	642	775	775	0
Public health product tax	0	4	30	27	−4
Accident sucharge	0	0	27	30	3
Other revenues	55	73	72	122	50
TOTAL REVENUES OF SOCIAL SECURITY FUNDS	**4,444**	**4,494**	**4,518**	**4,574**	**56**
TOTAL REVENUES OF CENTRAL GOVERNMENT	**12,971**	**12,949**	**13,951**	**13,452**	**−499**

Table A2
MNB forecast and budgetary target – expenditures
(HUF billion)

EXPENDITURES	2011		2012		
	statutory target	MNB	statutory target	MNB	difference
CENTRAL BUDGET					
SUBSIDIES TO ECONOMIC UNITS	215	215	238	238	0
SUPPORT TO THE MEDIA	59	59	65	65	0
CONSUMER PRICE SUBSIDY	109	109	93	93	0
HOUSING GRANTS	126	126	120	120	0
NATIONAL SOCIAL POLICY FUND					
Family benefits, social subsidies	628	624	551	550	–1
Benefits under retirement age	n. a.	n. a.	313	321	9
GOVERMENT AGENCIES AND CHAPTERED-ADMINISTERED APPROPRIATIONS					
Expenditures of central budgetary institutions	1,849	2,133	2,025	2,025	0
Chapter-administered professional appropriations	2,233	2,264	2,444	2,016	–428
EXPENDITURES RELATED TO MNB	0	0	0	12	12
RESERVES	124	0	454	454	0
TRANSFERS TO FUNDS OF GENERAL GOVERNMENT	1,898	1,925	1,772	1,772	0
SUPPORT TO CIVIL ORGANISATIONS	4	4	4	4	0
EXPENDITURES RELATED TO STATE PROPERTY	594	613	110	110	0
EXTRAORDINARY AND OTHER GOVERNMENTAL EXPENDITURES	36	36	32	32	0
EXPENDITURES RELATED TO STATE GUARANTEES	35	35	41	41	0
DEBT ASSUMPTION AND RELEASE	0	0	0	0	0
CONTRIBUTION TO EU BUDGET	258	258	264	286	22
DEBT SERVICE, INTEREST PAYMENT	1,079	1,081	1,079	1,119	41
TOTAL EXPENDITURES OF CENTRAL BUDGET	**9,249**	**9,483**	**9,603**	**9,259**	**–345**
EXTRABUDGETARY FUNDS					
LMF – Passive allowances	135	120	69	64	–5
LMF – Active and other expenditures	176	175	239	239	0
Expenditures of other funds	62	72	64	64	0
TOTAL EXPENDITURES OF EXTRABUDGETARY FUNDS	**374**	**367**	**371**	**367**	**–5**
SOCIAL SECURITY FUNDS					
PENSION INSURANCE FUND	**3,074**	**3,048**	**2,797**	**2,799**	**2**
Pensions	3,054	3,029	2,555	2,557	2
Other expenditures	19	19	242	242	0
HEALTH INSURANCE FUND	**1,459**	**1,457**	**1,756**	**1,860**	**104**
Sick allowance	86	68	73	73	0
Child care allowances	146	136	140	145	5
Drugs	344	375	276	359	83
Medical and preventive care	770	774	825	825	0
Disability and rehabilitation benefits	0	0	342	359	17
Other provisions and expenditures	112	105	99	99	0
TOTAL EXPENDITURES OF SOCIAL SECURITY FUNDS	**4,532**	**4,505**	**4,553**	**4,659**	**107**
TOTAL EXPENDITURES OF CENTRAL GOVERNMENT	**14,155**	**14,354**	**14,527**	**14,285**	**–243**

Appendix 2
Measures considered in our forecast

Table A3
Measures considered in our forecast

	Incorporated in our forecast			Not incorporated in our forecast, no enacted legislation
	Own estimatation based on regulation enacted or proposal submitted to parliament	Applying statutory target/ appropriation (strong governmental control on items)	Based on own estimate, but not on legislation	
Széll Kálmán Plan				
Employment and labour market				
Shortening disbursement period of unemploymnet benefit and removal of unemployment assistance	x			
Overhaul of the wage supplement system		x		
Partial substitution of the financing of active labour market policies with EU funds		x		
Modification of sick pay eligibility rules	x			
Capping social benefits		x		
Nominal freezing of family benefits	x			
Reform of pension system				
Pension benefit increase based on CPI	x			
Review of early retirement pension benefits	x			
Termination of special pension rules for members of the armed forces	x			
Review of disability pension eligibility rules				x
Public transport				
MÁV–Volán integration and cost-efficiency improvement of MÁV		x		
Review of the preferential tariff system	x			
Higher education				
Reducing the enrollment in tertiary education and capacity downsizing		x		
Drug's budget				
Revenue increase: raising the payment by pharmaceutical companies (tax increase, physician visiting fee)	x			
Review and price fixing of composite drugs	x			
Enhancement of the effectiveness of the subsidy system	x			
Modified rules for risk-sharing payments by pharmaceutical companies	x			

Table A3
Measures considered in our forecast (cont'd)

	Incorporated in our forecast			Not incorporated in our forecast, no enacted legislation
	Own estimatation based on regulation enacted or proposal submitted to parliament	Applying statutory target/appropriation (strong governmental control on items)	Based on own estimate, but not on legislation	
State and municipal financing				
Reorganisation of local government duties by economies of scale, restriction and control of borrowing	x			
Strengthening of tax authority, simplification of tax procedures				x
Rationalisation of central and background institutions		x		
Government Debt Reduction Fund				
Introduction of a new electronic road toll system		applies to 2013		
Unchanged regulation on special tax of financial institutions	x			
Corporate income tax rate reamins unchanged in 2013		applies to 2013		
Convergence programme measures				
Cancellation of stability reserve		x		
Nominal freezing of wages in public sector		x		
Maintaining the nominal level of material expenditures in chapters in central budget		x		
Announcements related to Budget Act				
Partial removal of super-gross PIT base	x			
Elimination of tax credits in PIT	x			
Classification of entertainment under PIT	x			
Compensation for government sector employees		x		
Corporate income tax: limitation on loss write-offs	x			
VAT increase	x			
Increase of excise duties	x			
Road toll increase		x		
Reduction of social benefits and assistances		x		
Reduction of public transport subsidies		x		
Increase of company car tax	x			
Increase of taxes on slot machines	x			
Taxing online gambling	x			
1 percentage point increase of employee contribution	x			
Health insurance contribution paid at least after 1.5 times of the minimum wage	x			
Accident surcharge	x			
Increase of environmental protection product tax, expanding its tax base				x
Expansion of the base of public health product tax	x			
Increase of titling tax for motor vehicles	x			
Increase of minimum wage			x	

Appendix 3
Applied estimation methods

Table A4
Applied estimation methods – revenues

REVENUES	Applied methodologies
CENTRAL BUDGET	
PAYMENTS BY BUSINESSES	
Corporate income tax	estimation based on effective tax rate and tax base (without corporations in the finance sector), corrected for the estimated effects of government measures (e.g. stricter rules for writing-off losses) and economic cycle; expert judgement on tax payment of financial sector (consistent with assumption concerning effect of early repayment scheme on profits of financial institutions)
Surtax of corporations	estimation based on actual development of tax refund
Fees of financial institutions	2011: estimation based on actual development of quarterly revenues; 2012: assuming a 10% decrease compared to 2011
Special tax of financial institutions	2011: statutory target and taking into account actual revenue development, 2012: kept fixed at 2011 base
Sector-specific taxes	product of estimated weighted total net revenues of sectors involved and expected base 2010
Simplified entrepreneurial tax	base 2011 increased with the growth rate of real GDP
Green taxes (energy tax, etc.)	base 2011 multiplied by the average growth rate of real GDP and nominal GDP
Mining royalty	corrected base 2010, oil price futures assumption for the exchange rate, trend of oil and gas exploitation
Gambling tax	projected change in real disposable income for lottery games taking into account recent price-policy, tax revenues from slot machines is projected using historical trend of the number of such machines online gambling: low level of revenues
Other payments	statutory target
Other centralized revenues	
Rehabilitation contribution	for 2011 estimation based on ARIMA-modell; for 2012 estimation historical trend
Enviromental protection product fee	2011 statutory target of sub-items augmented by tax increase, modified with the estimated effect of possibly stricter tax-exemption rules
Other revenues	statutory target for discretionary items; correction for items involved due to changes in number of slot-machines operated (consistent with the estimation of gambling tax)
Income tax of energy companies	expert estimation for 2011; statutory target for 2012
Company car tax	base 2011 multiplied by the growth rate of real GDP 2011: estimation based on actual data development
CONSUMPTION TAXES	
Value-added tax	base 2010 multiplied by household consumption expenditure corrected by government consumption and investment expenditure; correction using expert judgement for the effects of certain measures (eg. simplified clearance procedure)
Excise duties	expert judgement on volume of fuel consumption and tax reinbursement; in case of tobacco: estimated behavioral effect due to tax increase, assuming no change in volume consumed; alcoholic beverages: expected base 2011 indexed by forecasted volume of consumption
Registration tax	base 2011 muliplied by the growth rate of nominal GDP with some minor corrections based on expert judgement
PAYMENTS BY HOUSHOLDS	
Personal income tax	calculated tax liability indexed by the growth of wage bill corrected by the effect of changes in tax rate; expert judgement on tax allowance in line with tax code; for income items taxed separately tax base indexed by nominal GDP growth rate; estimation for all separable items' tax base in the case of witholding tax; sum of claimed tax credit given in the tax proposal corrected by expert judgment

Table A4
Applied estimation methods – revenues (cont'd)

REVENUES	Applied methodologies
Fees and duties	statutory target with corrections (taking into account actual revenue development)
Other taxes	statutory target
CENTRAL BUDGETARY INSTITUTIONS AND CHAPTER ADMINISTERED APPROPRIATIONS	
Revenues of central budgetary institutions	statutory target and correction based on expert judgement
Chapter administered professional appropriations	statutory target and correction based on expert judgement
EU support of chapter administered professional appropriations and central investments	statutory target and correction based on expert judgement
PAYMENTS FROM FUNDS OF THE GENERAL GOVERNMENT	statutory target with corrections (taking into account actual revenue development)
PAYMENTS RELATED TO STATE PROPERTY	statutory target
OTHER REVENUES	statutory target
REVENUES FROM THE EU	statutory target
REVENUES OF PENSION REFORM AND DEBT REDUCTION FUND	statutory target
REVENUES RELATED TO DEBT SERVICE	estimation (based on yields curves, exhange rates and expected issuance schedule)
EXTRABUDGETARY FUNDS	
LMF – Health insurance and labor market contributions	base 2011 muliplied by forecasted groth of wage bill, modified with the effect of measures and changes in effective level of tax compliance
LMF – Vocational contributions	base 2011 muliplied by forecasted growth of wage bill
RDF – Innovation contributions	base indexed by nominal GDP growth rate
NCF – revenues from lottery	consistent with the estimated gambling tax revenue for regarding lottery game
Revenues from other funds: wage-guarantee repayment	historical seasonal pattern of wage-guarantee payment
Revenues of other funds: other revenues	statutory target
PENSION INSURANCE FUND	
Contributions	base 2011 muliplied by forecasted growth rate of wage bill, modified with the effect of measures and changes in effective level of tax compliance
Revenues of Pension Reform and Debt Reduction Fund	statutory target (discretionary item)
Other revenues	statutory target (discretionary item)
HEALTH INSURANCE FUND	
Contributions	base 2011 muliplied by forecasted growth rate of wage bill, modified with the effect of measures and changes in effective level of tax compliance
Per capita health contribution	base 2011 indexed by forecasted growth rate of nominal GDP
Benefits and subsidies from central budget	statutory target (discretionary item)
Public health product tax	forecasting volumes and turnovers (relevant CPI and consumption) of taxed products based on HKF-database, estimated price-elasticities
Accident surcharge	based on estimated gross insurance premium from third-party liability for motor vehicles
Other revenues	payments of the pharmaceutical companies is assumed to be consistent with projected pharmaceutical expenditures and expected relevant, other revenues are assumed to meet the statutory targets

Table A5
Applied estimation methods – expenditures

EXPENDITURES	Applied methodologies
CENTRAL BUDGET	
SUBSIDIES TO ECONOMIC UNITS	statutory target
SUPPORT TO THE MEDIA	statutory target
CONSUMER PRICE SUBSIDY	statutory target and taking into account actual revenue developments
HOUSING GRANTS	statutory target
NATIONAL SOCIAL POLICY FUND	
Family benefits, social subsidies	estimation using trends of reference population and number of recipients and expected developments of specific benefits (typically kept fixed at 2011 level)
Benefits under retirement age	estimated using age-distribution and average benefits of recipients, average benefit increased by pensioner's CPI without concerning measures
GOVERMENT AGENCIES AND CHAPTERED-ADMINISTERED APPROPRIATIONS	
Expenditures of central budgetary institutions	statutory target with corrections based on expert judgement
Chapter-administered professional appropriations	statutory target with corrections based on expert judgement
RESERVES	statutory target with corrections based on expert judgement
TRANSFERS TO FUNDS OF GENERAL GOVERNMENT	statutory target with corrections based on expert judgement
SUPPORT TO CIVIL ORGANISATIONS	statutory target
EXPENDITURES RELATED TO MNB	MNB forecast
EXPENDITURES RELATED TO STATE PROPERTY	statutory target
EXTRAORDINARY AND OTHER GOVERNMENTAL EXPENDITURES	statutory target
EXPENDITURES RELATED TO STATE GUARANTEES	statutory target
DEBT ASSUMPTION AND RELEASE	statutory target
CONTRIBUTION TO EU BUDGET	statutory target and taking into account actual revenue developments
DEBT SERVICE, INTEREST PAYMENT	estimation (based on yields curves, exhange rates and expected issuance schedule)
EXTRABUDGETARY FUNDS	
LMF – Passive allowances	expected base 2011 muliplied by forecasted growth rate of wage bill and change in the number of unemployed, corrected with effect of recent measures and that of the increased minimum wage; transfer items from central budget: appropriation
LMF – Active and other expenditures: wage-gaurantee payments	base 2011 increased by the forecasted growth rate of wage bill
LMF – Active and other expenditures: other payments	statutory target
Expenditures of other funds	statutory target
SOCIAL SECURITY FUNDS	
PENSION INSURANCE FUND	
Pensions	base 2011 muliplied by pensioners' CPI corrected with actual data and seasonal developments based on past recent years
Other expenditures	statutory target (discretionary item)
HEALTH INSURANCE FUND	
Sick allowance	base 2011 muliplied by forecasted growth of wage bill, modified with the effect of measures come into force recently
Child care allowances	base 2011 muliplied by forecasted growth of wage bill augmented by the effect of measures and demographical development
Drugs	projected using the corrected subsidy-outflow on monthly basis, taking into account the effects of expected measures
Disability and rehabilitation benefits	base 2011 muliplied by pensioners' CPI corrected with actual data and seasonal developments
Medical and preventive care	statutory target (discretionary item)
Other provisions and expenditures	statutory target (discretionary item)

Appendix 4
Terms and definitions of general government

Act on public finances Act XXXVIII of 1992 on public finances, adopted by simple majority, sets out rules relating to the operation and monitoring of general government. Accordingly, the Budget Act of the given year may overwrite its provisions.

Augmented (SNA) balance The analytical indicator of the MNB has been used for fifteen years to carry out adjustments that support the adaptation of Hungarian budgetary settlement to the standard payment framework. This includes the adjustment of the late performance of payments, tax refunds, the non-funded financing requirement of certain state-owned companies, PPP investments and capital revenues in excess of real asset sales. It serves the settlement of similar economic events each year, with a similar method and at the same time, that is, the filtering of the effects of creative accounting.

Budgetary authorities and chapters In the balance sheet of the central government, this item includes the revenues/expenditures of central budgetary authorities (budgetary institutions, ministries, authorities) and the revenues/expenditures of budgetary targets managed under chapters (programme financing under direct ministerial supervision).

Capped discretionary item Discretional item among expenditure budgetary targets, where the budgetary target may only be exceeded with separate regulation. Over-spending requires transfers, the use of reserves or carryover funds or the amendment of the Budget Act.

Carry-forward, write-off of loss Under certain conditions, business organisations subject to corporate taxation may offset their cumulated loss arising in the reference year (negative tax base) with profit arising in a subsequent profitable year, that is, reduce future profit up to the amount of cumulated loss carried forward, but for up to the amount of profit.

Carryover funds (budget carryover funds) In relation to authorities and chapters, if budgeted amounts are unspent at the end of the year, these are settled as carryover funds and, under certain conditions, these can be carried over to the next year. The budgetary targets specified in the Budget Act can be implemented by maintaining the level of carryover funds.

Carryover obligation An instrument of budgetary payments control. Ordering of a budgetary institution or chapter to save a portion of its budgetary amount at the end of the year, increased with the carryover funds of the previous year. In practice, this typically means that the budgetary carryover funds should not decrease from one year to another (the use of carryover funds should not increase).

Central government Pursuant to the provisions of the Act on public finances in force, the central government in the general government includes the Hungarian State, as the subject of obligations and rights under public law, central budgetary authorities, and unless provided otherwise by law, budgetary authorities that are founded by the Government or legal entity belonging to the central government. Within the central government, three main subsectors are distinguished in payment settlements: the central budget, extrabudgetary funds and the social security fund.

Contribution effectiveness
It shows how actually collected contribution revenue relates to theoretical revenue calculated on the basis of the wage bill of the national economy and the percentage rates set out in legislation.

Cyclical component
Effect of the economic cycle on the general government balance, manifested predominantly through the fluctuation of tax revenues and to a lesser extent through changes in unemployment benefits and expenditures (e.g. pension) indexed to real variables.

Cyclically adjusted augmented (SNA) balance
Analytical indicator calculated by the MNB, indicating the balance expected after the end of the economic cycle's effect without further measures, provided that the effect of "creative accounting" – reversed by itself in the long term – does not distort the balance.

Debt rule set out in the Constitution
Pursuant to the Constitution effective as of 1 January 2012, Parliament may not adopt a law on the central budget, where government debt would exceed half of the gross domestic product. As long as government debt exceeds half of the gross domestic product, Parliament may only adopt a law on the central budget that sets out the reduction of government debt-to-GDP ratio.

Designated reserves
Statutory target specified in the budget, serving as cover for central (government) measures in the given subsector, the aim and purpose of which is concurrently defined, where the distribution of the budgeted amount's spending according to chapter, title and sub-title is not yet specified in the Budget Bill. It is principally used in 2011 and 2012 to provide compensation for the phasing out of tax credits.

Discretionary items
Discretionary items are budgetary expenditure and revenue items that are approved by Parliament in the form of the Budget Act (these are also defined as "discretional" items). Public sector wages, for example, are discretional expenditures, while fine revenues of budgetary authorities are discretionary revenues.

EDP balance
Indicator of general government balance used in the framework of the excessive deficit procedure (EDP). Methodologically the EDP balance almost fully corresponds to the ESA balance, only the settlement of interest expenditures varies (see EDP based interest expenditures), but the resulting difference between the two indices is less than 0.1 per cent of GDP.

EDP based interest expenditure
The EDP and ESA based interest expenditure differ methodologically in that the EDP methodology accounts for interest payments modified by swap and FRA transactions, while the ESA methodology accounts for interest payments related to original issues. The sign of the difference may vary year to year; its value did not reach 0.1 per cent of GDP in recent years. Our forecast assumes that the expected value of the difference is zero.

Efficiency of tax collection
Ratio of actual tax revenue and revenue collectible pursuant to tax legislation.

ESA balance
Index defined by the European System of National Accounts (ESA). It differs in several points from the indicator defined in the Act on public finances. See ESA-GFS methodological bridge. Key differences: 1) use of accrual-based instead of cash-flow accounting, 2) expansion of institutional scope defined by the Act on public finances with non-profit organisations and state-owned companies.

ESA-GFS methodological bridge
Difference between the ESA deficit and the indicator defined in the Act on public finances. The difference is attributable, among others, to the difference between cash flow and accrual accounting and variation between institutions covered by the two indices. In the forecast, the MNB applies the official ESA-GFS difference published by the Ministry for National Economy, based on the Eurostat notification or exposition of the Budget Bill. Since our interest rate forecast differs from that of the government, our accrual adjustment with accrued interest accordingly also differs, and we thereby modify the methodological bridge published by the Ministry for National Economy.

Eurostat notification
Pursuant to legislation relating to the excessive deficit procedure (EDP), balance and debt data reported by the national statistical offices to Eurostat, verified and published by Eurostat.

Exogenous items
Primary revenues and expenditures that are clearly determined by macroeconomic and demographic trends and laws establishing individual rights or obligations. These include, for example, tax revenues and retirement benefits.

Extrabudgetary funds
Pursuant to the provision of the Act on public finances in force, Extrabudgetary Funds are funds that finance certain duties of the state partly from non-general government funds, necessitating appropriated financing within general government due to the nature of its operation. The Budget Bill for the year 2012 lists the Central Nuclear Financial Fund, Labour Market Fund, National Cultural Fund, Wesselényi Miklós Flood and Inland Waterway Protection Compensation Fund, Bethlen Gábor Fund and the Research and Technological Innovation Fund as extrabudgetary funds.

General government
According to the provision of the Act on public finances in force, general government consists of the central government and local government subsector. General government covers a narrower scope of fiscal processes than the government sector defined according to the methodology of the European Union (see government sector). Thus, the Pension Reform and Debt Reduction Fund, for example, managing the asset portfolio transferred from private pension funds, is not part of general government, but belongs to the government sector.

General government debt
According to the Act on Public Finances, general government debt is the sum of government debt and local government debt, where debts between the subsectors must be consolidated.

General reserve (Reserve serving exceptional government measures)
Pursuant to provisions of the Act on public finances in force, general reserve is a reserve set aside by the central budget, covering contingent, unforeseeable expenditures, structural transformation and the supplementing of budgeted, but unexpected revenue shortfalls. According to the provision in force, the budgeted reserve may not exceed 2 per cent of aggregate expenditures of the central budget or be less than 0.5 per cent thereof. Obligations undertaken in H1 may not exceed 40 per cent of the reserve.

GFS balance
Payment balance prepared according to the methodology of the International Monetary Fund issued in 1986. With some differences (e.g. in relation to the management of privatisation revenues), it approximates the balance defined by the effective provisions of the Act on Public Finances. For the sake of simplicity, we define the balance under the Act on Public Finances as the GFS balance.

Government debt
According to the Act on public finances, government debt is the consolidated debt of the central government in the general government.

Government sector	Scope of institutions defined in accordance with the rules of the ESA methodology. Reclassification from the corporate sector is conditional on 1) state control, and 2) less than half of the production costs of the company are covered with sales revenue (including state support provided to all similar producers). On the basis of this criterion, the units of BKV and MÁV producing the largest losses remain in the corporate sector.
Interest risk reserve	Appropriated reserve among budget expenditures to cover the risk of higher-than-budgeted interest expenditures. The actual value of interest expenditures significantly depends on unforeseeable economic trends, particularly changes in the forint exchange rate and yields on the government securities market. The reserve ensures that higher-than-planned interest expenditures do not cause an increase in the budget deficit up to the amount of the reserve.
Local government debt	Debt jointly encumbering local governments and local minority governments; when calculating such debt, debt between the individual local governments has to be consolidated.
Local government subsector	Pursuant to the provision of the Act on public finances in force, the local government subsector of general government covers the following legal entities: local governments, local minority governments, local government budgetary authorities, legal entities classified by law in the local government subsector and budgetary authorities, where the founder is classified in the local government subsector.
Medium-term objective (MTO)	Budgetary deficit objective defined in the Stability and Growth Pact of the European Union, varying for each country. The MTO defines the medium-term, cyclically adjusted deficit objective, filtered from one-off items. It is in all cases more stringent than the Maastricht criteria to ensure that the deficit does not exceed 3 per cent of GDP in an adverse economic environment either, and ensure the long-term sustainability of the budget. In relation to Hungary, the MTO is 1.5 per cent of GDP.
National Protection Fund	Reserve appropriated in the 2012 budget for the management and offsetting of macroeconomic and other external risks.
Net expenditures of budgetary authorities and chapters	In the balance sheet of the central government under the Act on public finances, the arithmetical difference between the expenditure and revenue rows related to budgetary authorities and budgetary targets managed under chapters (accordingly, for example, payments from central budgetary authorities to the central budget are accounted for among revenues). Expenditures calculated in this manner are basically deemed to be consolidated expenditures. The analysis of net expenditures is justified instead of the separate analysis of revenues and expenditures, as the funding requirement in the scope of institutions and chapters, not covered with own revenues in the reference year, as well as the amount of budgetary support necessary for the performance of duties can be directly determined. Net expenditures also effectively reflect fiscal trends if substantial funds are transferred between authorities. The reorganisation of public administration, the delivery-acceptance of duties between institutions and chapters, namely, increases both revenues and expenditures (accumulation), but the budget balance remains unchanged.
Open-ended discretionary item	Discretionary expenditure item, in relation to which the Budget Bill contains a budgetary target which, however, may be exceeded without separate regulation or with government approval (e.g. pharmaceutical subsidies).
Pension indexing	Statutory annual increase of retirement benefits and pension-type benefits. According to regulations in force, if GDP growth remains below 3 per cent, pensions increase by the rate of the pensioner consumer price index. If GDP growth is between 3 and 4 per cent, the ratio of inflation and net average wage increase equals 80-20 per cent in the pension increase; this

ratio is 60-40 per cent if growth is between 4 and 5 per cent. If GDP growth reaches 5 per cent, the net average wage-inflation ratio equals 50-50 per cent.

Pensioners' consumer price index
Annual change in the price of products and services in the pensioner consumer basket.

PPP investment
Investment implemented through cooperation between the government and private sectors. Its most common form, the PPP contract, applies to the formation, as well as the operation of fixed assets. Uniquely in Hungary, in some cases in the past, the private partner was also a state-owned company, thus Eurostat classified these investments as government investments.

Primary balance
In this publication, we interpret the primary balance as the balance calculated without interest expenditures and interest revenues. According to the definition of the MNB, the MNB payments and loss reimbursements are excluded from the primary balance as well, but in this case, we included these as part of the primary balance to ensure comparability with the Bill.

Real debt rule
The fiscal regulatory framework set out in Act LXXV of 2008 on prudent state finances and fiscal responsibility fundamentally aims at maintaining the real value of government debt (debt of central government pursuant to the Act on public finances). For the purpose of achieving the target, the law sets out a regulatory framework based on a three-year planning cycle that aims at maintaining the real value of debt in the medium term, but allows deviation from this path in the short term, on the basis of the unforeseeable volatility of the economy.

Reserve serving exceptional government measures
See General reserve.

Semi-super grossing, super grossing
In Hungary, semi-super grossing defines a form of the personal income tax system, where personal income tax is paid on the "super-gross" wage increased with employer contributions, but the simple gross income is the contribution base. In a consistent super-gross system, all contributions would also be taxed on the basis of total labour cost (i.e. super-gross income). From 2010 to 2011, and partially in 2012, however, only the tax base of personal income tax, and not of contributions is raised in Hungary; the system was termed as "semi-super grossing" as a result of the "semi-sided" tax base.

Social security funds
These include the Pension Insurance and Health Insurance Funds. The social security funds function as an insurance system based on risk pooling; most of their revenues are covered by contributions and to a lesser extent by budgetary funds and other revenues.

Super grossing
See Semi-super grossing, super grossing.

Supplier debt
Financial obligation of government institutions (generally vis-à-vis enterprises).

Tax avoidance, tax evasion
Avoidance of tax obligation. For example declaring labour incomes as capital incomes; its illegal form is a simulated contract, its legal form is present when private entrepreneurs voluntarily determine lower labour income. The illegal form is called tax evasion, while the form exploiting loopholes in the tax system is termed as tax avoidance.

Tax credit
Item decreasing personal income tax, provided on a monthly basis in Hungary, up to a certain level of eligibility based on wage income.

Wage bill index

The gross wage bill of the national economy, i.e. annual change in the amount of the basic wage including personal income tax, health insurance and pension contributions and employee contributions, and wage elements paid under other titles (wage supplement, supplementary salary, premium, bonus, 13th month and additional monthly wages).

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