GOVERNMENT OF HUNGARY

SUPPLEMENTARY REPORT
ON THE MEASURES TAKEN IN RESPONSE TO
COUNCIL RECOMMENDATION OF 13 MARCH 2012
UNDER THE EXCESSIVE DEFICIT PROCEDURE

OCTOBER 2012

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INTRODUCTION

Pursuant to the recommendation addressed to Hungary on 13 March 2012 in the context of the excessive deficit procedure, the Hungarian authorities submit a report to the European Commission and the Council presenting the progress achieved with measures adopted to bring the excessive deficit situation to an end, including the progress in the field of structural reforms.

On 5 October, the Government submitted the Report on the measures planned in the 2013 Budget ensuring the achievement of a deficit ratio permanently well below 3% of GDP. The Government also expressed its commitment to continue the negotiations with the international institutions with a view to concluding a precautionary agreement to provide a financial safety net while safeguarding the interests of Hungary. The budgetary forecast in the 5 October Report, besides the balance improving impact of the measures, took also into account the positive effects related to an EU-IMF agreement (lower interest expenditures due to a permanent improvement in market confidence, reduced domestic co-financing rate of investments co-financed from EU funds etc.).

Nevertheless, in order to ensure that the deficit path remains permanently well below 3% even according to the Commission forecast as necessary for the abrogation of the excessive deficit procedure, the Government decided on its meeting of 17 October 2012 on further measures not included in the former Report. These ensure the safe attainment of the deficit targets even with an eventual materialization of macroeconomic and budgetary risks higher than the government deems realistic and even without the expected balance improving effects of an EU-IMF agreement which are not included in figures of the Commission due to its forecasting methodology. The budgetary impact of the new measures amounts to HUF 367 bn (1.2% of GDP), which could increase extra reserves (Country Protection Fund) covering macroeconomic risks.

MACROECONOMIC DEVELOPMENTS

The Government has revised its short term macroeconomic projection incorporating the impact of the new fiscal measures underpinning the budgetary targets and taking into account the IMF's latest World Economic Outlook (published on 9 October 2012) in which growth prospects of Hungary's main trading partners were cut significantly. Details of the new forecast are shown in Table 1.

Table 1: Main economic indicators

	2011	2012	2013	2014
	data	projection		
	annual percentage change			
real GDP	**1.6**	**-1.2**	**0.9**	**2.0**
Household consumption exp.	0.0	-0.8	-0.5	1.0
Gross fixed capital formation	-5.5	-5.8	-1.0	0.3
Exports	8.4	2.6	6.2	6.4
Imports	6.3	1.4	4.5	5.3
Employment	0.8	1.1	0.7	1.3
Unemployment rate (15-74), %	10.9	10.9	10.8	10.7
Inflation, %	3.9	5.8	5.2	3.0

Part of the measures (delaying the halving of the bank levy, raising the rate of the financial transaction levy, extension of buildings tax on wires and pipelines, measures to whiten the economy) decrease the profitability in the corporate sector thus may lead to slower wage and employment dynamics, and delay in the turnaround in investment. Inflation is driven by two major factors: a negative output gap closing slower than expected; and increases in corporate costs. The combined effect is dominated by the latter one, which may lead to a somewhat higher inflation in 2013. Due to the adverse effects on households' income, consumption growth has been revised downward for both 2013 and 2014. However, the less favourable growth prospects for 2014 are mostly attributable to the slower trade dynamics of Hungary's major trading partners based on the most recent forecast of the international organizations (i.e. 9 October 2012 IMF WEO). Against this background, growth rates of 0.9 and 2% are expected for 2013 and 2014, respectively, which is in line with the expectations of market analysts and with the forecasts of international institutions. These revisions may worsen the budget balance by only about 0.1 percentage point, which can be safely covered by the Country Protection Fund.

ADDITIONAL MEASURES IMPROVING THE BUDGET BALANCE

TAX ON FINANCIAL INSTITUTIONS

Due to the persistence of the crisis and with an aim of ensuring the balance of the budget, the Government delays the halving of the tax on financial institutions which was planned for 2013. As a result of the measure, revenues from this tax will increase from HUF 72 to HUF 144 bn in 2013.

FINANCIAL TRANSACTION LEVY

With a focus on increasing the weight of turnover type taxes, the Government will introduce the financial transaction levy with a 0.2 percentage point tax rate instead of 0.1 as planned earlier. In order to avoid a shift of transactions towards cash payments, a 0.3 percentage point tax rate will be applied for cash withdrawals. As a result of the measure, revenues paid by commercial banks and providers of postal services will increase to HUF 260 bn. Revenues paid by the Treasury will increase to HUF 80 bn as a result of the higher rate. New measures regarding the financial transaction levy will result additional HUF 130 bn of revenue, compared to the scenario in the report published on 5 October.

LOCAL BUSINESS TAX

With the aim of broadening the base of local business tax, the Government decided to limit the deductibility of certain expenses from the tax base. In line with the planned regulation, the deduction after the acquisition cost of goods sold and mediated services may not exceed 80% of the firms' total sales revenues. The measure will result in a HUF 35 bn increase of revenues. A high share of the additional tax burden will be paid by the retail and the energy sector.

EXTENSION OF BUILDINGS TAX

As an extension of the local buildings tax, a tax of HUF 100 per meter will be possible to be levied on wires (electricity, phone, television, internet) and pipelines (gas, water, conduit) owned by the providers of utilities. The measure will result in a HUF 30 bn increase of the revenues of municipalities.

UNIFICATION OF THE TAXATION OF FRINGE BENEFITS

With the aim of broadening tax bases and simplifying the tax system, the taxation of preferentially taxed fringe benefits will be unified with the taxation of other fringe benefits. As a result of the measure, a 27% healthcare contribution will be levied on preferentially taxed fringe benefits. For employers, it is still worth providing these benefits with the increased tax rate as the total tax wedge will remain only 34% on fringe benefits while the tax wedge on wages is 49%. As a result of the measure, additional revenue of HUF 40 bn is expected.

FURTHER MEASURES TO WHITENING THE ECONOMY

Further to the introduction of the on-line supervision of cash-registers, the Government decided on several additional measures in order to whiten the economy.

As from 2013, severe restrictions will be introduced on cash payments between enterprises. In the same calendar month based on the same business transaction between the same parties only HUF 1.5 million (approx. EUR 5,400) can be paid in cash.

In order to reduce VAT fraud the VAT return detailed at invoice level will be introduced as of 2013. In the year of the introduction in case of invoice value above HUF 2 million (approx. EUR 7,100) both the issuer of the invoice and the taxable person exercising the right of deduction based on that invoice shall make a detailed report in its VAT return on the data contained in the invoice. The model of this measure has been the recapitulative statement required for cross-border transactions within the EU. This measure proved to be an effective mean for the reduction of VAT fraud within the EU.

Several further measures have been introduced in order to strengthen the legal means of the state tax authority. Strong filtering (risk assessment) mechanism was established in 2012, thus the National Tax and Customs Administration can impede the foundation/registration of the companies aiming at avoiding taxation. Reaction on the new type of VAT fraud requires immediate action and very fast control mechanism. Therefore the control of the realness of the single economic events has been introduced in order to cope with the above mentioned requirement from this year.

Much stricter rules related to sanctions linked to tax avoidance have been introduced, e.g. the tax fine can reach 200% of the tax in case of tax-loss resulted from hiding the business income. The effective, fast reactive tax authority and the improved sanctions can significantly increase the general preventive effect.

The introduction of the new tax types with simpler administration and lower tax burden in relation to the SME sector as of 2013 – besides the significantly increased risk related to tax avoidance – contribute considerably to the fight against black economy.

As a result of the measures a HUF 60 billion revenue surplus is expected.

Table 2: Budgetary impact of the additional balance improving measures in 2013 (HUF bn)

Measure	Gross effect
Delaying the halving of tax on financial institutions	72
Raising the general tax rate of the financial transaction levy to 0.2% – commercial banks (tax rate on cash withdrawals unchanged at 0.3%)	90
Raising the general tax rate of the financial transaction levy to 0.2% – Treasury	40
Introduction of a minimum tax base for local business tax (with limiting the deductibility of certain expenses)	35
Extension of buildings tax on wires and pipelines	30
Unification of taxation of preferentially taxed fringe benefits with the taxation of other fringe benefits	40
Further measures to whiten the economy	60
Total	367