MINISTRY
FOR NATIONAL ECONOMY

Minefield:

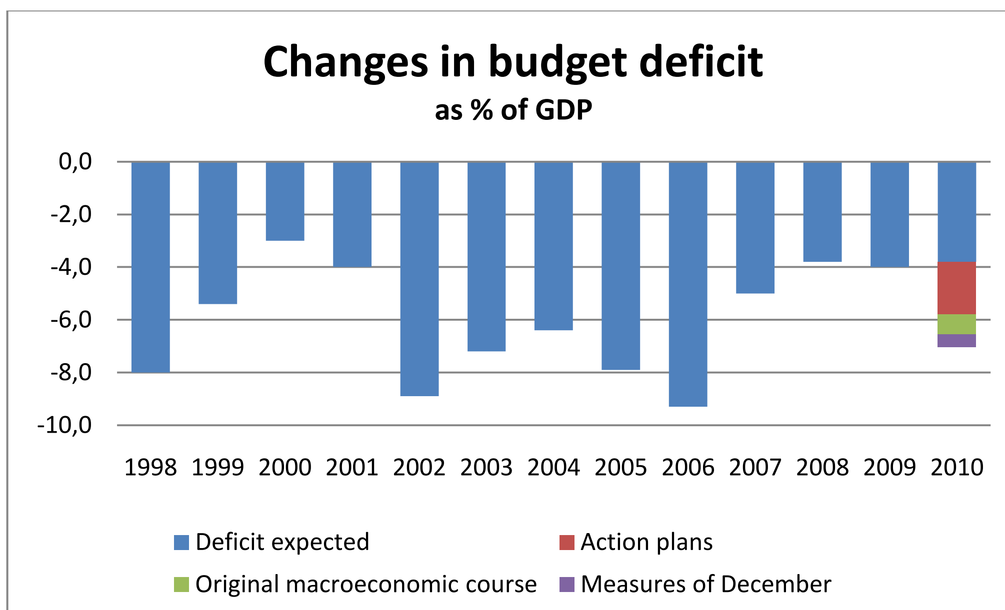
the black holes of the 2010 budget

Focus

The 2010 budget constructed and left behind by the Socialist government is characterized by overestimated revenues, underestimated expenditures and, thus, an unrealistic deficit target. The landmines hidden in this year's budget have been overlooked by, among other financial organizations, the Fiscal Council. The 500bn HUF "problem" has been corrected by the extraordinary measures taken by the Government of National Issues to keep the deficit target of 3.8, which is an exceptionally low figure in the EU.

Background

To sum it up, we can say with absolute certainty that the budget the previous government proposed for this year has been based on entirely unrealistic data. As the figure shows, without the extraordinary measures of the Orban government, the budget deficit would have reached, if not surpassed, 7% in 2010.



Economic growth, which has turned out to be about 2% higher than forecast, improved the balance by about 0.7%. The net income gained through the two action plans reduced deficit by another 2%, and the measures of December improved the budget by about 0.5%. Consequently, the budget gap due to underestimated expenditures and overestimated revenues had to be plugged with extraordinary measures.

Decision	Revenue/Saving	Announced in
Savings in the Budget	120bn HUF	Action plan 1
Tax on banks	187bn HUF	Action plan 1
Sectoral extra taxes	161bn HUF	Action plan 2
Suspension of the payment of private pension fund contributions	60bn HUF	Action plan 2
Mining royalties paid by MOL Ltd.	32bn HUF	18.12.2010.
Measures in December	100bn HUF	03.12.2010.

These facts are already well-known for all. Those crying foul at the approval of the budget were proven right. The institutions, however, responsible for monitoring and forecasting budget developments failed to mention it, and besides pointing out a couple of risks, they have as a whole found the deficit target realistic.

'Cornerstones'

By 201 votes and the almost unanimous support of the MSZP-SZDSZ coalition, this year's budget was approved by the previous government on 30.11.2009. The cabinet calculated with negative GDP growth of 0.9%, they forecast a 2.4% fall in household expenditure, a 1.8% fall in domestic consumption, and a 3% rise in exports.

The budget concept of the Bajnai government had been seemingly more pro-balance than his predecessor's and substantially weakened domestic demand. The most important of these measures are the following:

1. Public sector: they froze salaries and abolished the 13th-month wages.
2. Pension and welfare benefits: they abolished the 13th-month pension benefits that had been introduced seven years before.
3. High taxes on consumption: due to the implementation of restrictive measures in July 2009, there has been a VAT of 25% on all consumer goods, the highest in the EU. The other key

tax on consumption, the excise tax on tobacco, fuels and alcoholic drinks, was increased once again after an increase in 2009. These tax increases have seriously damped retail sales already in recession since 2007, and the entire sector with it.

Dissenting voices -- and quiet supporters

Autumn 2009 – the budget is submitted

As soon as the Budget Law had been submitted, some independent economists and the biggest opposition party, Fidesz, called attention to the unrealistic deficit target as of 3.8% of GDP, and the fact that without taking further steps, this figure can be as much as 7 or 8%. The December 2009 publication by twenty-nine economists entitled **"Report of the tricks of the 2010 budget"** [1] also states that, *"The 2010 budget approved by the Parliamentary majority has been misguiding Hungary and the Hungarian economy: it does not help the country out of the economic crisis and neither does it propose steps to increase competitiveness. Moreover, it is full of tricks, it is built upon unrealistic macroeconomic predictions and it contains fictitious data about would- be revenues and expenditures alike. Thus, there is no real chance to meet the targeted budget deficit of 3.8% of GDP; it may rather be 7 or 8%."*

Meanwhile, the **Hungarian Fiscal Council** ,established in 2008 with a budget of almost one billion HUF, – in their own words the body "aspiring to contribute to the transparency of the budget policy with analyses and forecasts and thus serving the interest of the population" – issued the following statement assessing the preliminary budget on 25 September 2009, *"Based on the conclusions analyzed above, in the opinion of the Fiscal Council, there are no items in the plans of the government affecting the relevant central subchapter which might endanger the deficit target of 3.8% as of GDP as calculated by the methodology of ESA-95.* [2]*"*

The **International Monetary Fund (IMF)** assessing the sustainability of the budget as part of the 2008 credit agreement could not detect factors potentially destabilizing the budget, either. The IMF made the following statement[3] in December 2009, *"The 2010 budget adopted by the Parliament is*

[1] http://vg.hu/lapokkepek/fileok/0/420_A5_fuzet_net.pdf
[2] http://www.mkkt.hu/download/000/067/Jelentes_a_Magyar_Koztarsasag_2010_evi_koltsegveteserol_szolo_torvenytervezetrol_2009.09.25.pdf; Page 24.
[3] http://www.imf.org/external/pubs/ft/scr/2009/cr09330.pdf; Page 9.

consistent with the agreed target and reflects the full implementation of the previously agreed structural reforms (LOI ¶14). A modest reduction of the general government deficit to 3.8 percent of GDP in 2010 is needed to preserve a credible commitment to debt sustainability, while avoiding an excessively negative impulse to economic activity."

In their report on inflation[4], the **National Bank of Hungary (NBH)** called attention to some minor discrepancies too, but they did not recognize any grave dangers, either: *"According to our basic forecast, a temporary reduction in the higher-than-usual reserves can ascertain that the budget deficit will be met in 2010."*

There was a deficit target of 4.2% in the forecast of the **European Commission** published[5] on 22 October 2009.

Spring 2010 – before the Parliamentary elections

Fidesz and the twenty-nine economists kept insisting that the previously submitted and approved budget had been deficient and the deficit could substantially surpass the targeted figure in 2010. However, international institutions and the Fiscal Council were still of the opinion that the deficit target could be reached with some minor interventions.

On March 2010, the standpoint of the **Fiscal Council**[6] was the following: *"On the basis of external items and net interest liabilities, for 2010 the targeted deficit as percentage of GDP will be presumably surpassed by 0.4%. This could be counterbalanced by some one-off or permanent measures which would more favourably influence internal items than previously forecast. Such steps may be the return of the private pension fund members to the state pension pillar or the blocking of budgetary reserves."*

The **IMF** issued the following statement[7] in March 2010 about the budget deficit:

"*The general government deficit target for 2010 of 3.8 percent of GDP remains appropriate to preserve a credible commitment to debt sustainability, while avoiding an excessively negative impulse to economic activity (LOI*

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[4] http://www.mnb.hu/Root/Dokumentumtar/MNB/Kiadvanyok/mnbhu_inflacio_hu/mnbhu_inflation_20091125/infl_jelentes_2009nov_pub20091125hu.pdf; Page 58.
[5] http://ec.europa.eu/economy_finance/db_indicators/gen_gov_data/documents/2009/automn2009_part2_en.pdf; Page 143.
[6] http://www.mkkt.hu/download/000/147/Technikai_kivetites.pdf , Page 12.
[7] http://www.imf.org/external/pubs/ft/scr/2010/cr1080.pdf, Page 9.

¶13). Compared to the Fourth Review, tax revenue is expected to be lower, as the fiscal impact of the Constitutional Court's rulings related to the property tax and the taxation of family allowances are only partly offset by additional revenue stemming from the improvement in the macroeconomic outlook. These lower tax revenue and higher primary spending are expected to be broadly offset by lower projected interest payments, reflecting lower yields, and additional one-off revenue related to the shift from the second pillar to the first pillar of the pension system."

The inflation report[8] of the **NBH** in February this year describes the budget situation as follows: "*There are various items counterbalancing two-thirds of the impacts triggering a 1.2% higher-than-forecast deficit, so according to our basic prediction, the deficit can be 0.4% more than set in the Budget Law. If it were possible to achieve that the outstanding 0.2% reserve is worked off, the deficit could be reduced to 4% and, as such, it would be only 0.2% higher than planned.*"

In the 20 April 2010 forecast of the **European Commission**[9], there was a deficit figure of 4.1%, so the expected deficit was even reduced in relation to their forecast issued half a year ago.

The extraordinary measures of the second Orban government

After the new government had entered office, the gravity of the situation became clear and the cabinet acted quickly and efficiently, publishing their **first action plan of 29 points**. In this, the prime minister promised to keep the budget deficit and issued several measures to boost the economy, from which the only ones with a negative impact on the budget were the 70bn HUF reduction of the corporate income tax and the 35bn HUF deduction of the crisis taxes paid from the corporate tax base. Besides, he announced an extra tax on financial institutions from which revenues of 187bn HUF are expected this year. Additionally, it became necessary to raise the general budget reserves by 120bn HUF by means of an amendment to the Budget Law.

Later on, however, it was revealed that there had been a bigger gap between the 2010 proposal and reality than it could be fathomed on entering office, so the government had to make further decisions. As part of the second action plan, the crisis tax affecting three sectors and bringing in

[8] http://www.mnb.hu/Root/Dokumentumtar/MNB/Kiadvanyok/mnbhu_inflacio_hu/mnbhu_inflation_20100224/infl_jelentes_2010feb_pub20100224hu.pdf , Page 56.
[9] http://ec.europa.eu/economy_finance/db_indicators/gen_gov_data/documents/2010/spring2010_series_en.pdf; Page 155.

161bn HUF, was announced and the transfer of the private pension fund contributions was suspended, resulting in 60bn HUF extra revenues.

Autumn 2010

The crisis measures of the government can secure the sustainability of this year's budget. In order to have a realistic chance for meeting the deficit target for this year, there had to be substantial spending cuts and extraordinary measures to increase revenues. After the steps announced in summer and autumn, the **IMF** had the following to say[10] on the budget at the end of October 2010:

"The temporary measures recently adopted appear sufficient to limit the fiscal deficit to 3.8 percent of GDP in 2010. To compensate for significant revenue shortfalls and spending slippages in 2010, the government is relying mainly on temporary measures, such as levies on financial institutions, energy, telecommunication, and retailers, and on the redirection of pension contributions from the second to the first pillar of the pension system. These measures, along with the expenditures cuts announced in July, appear sufficient for the government to meet its fiscal deficit target, while financing additional spending on state-owned enterprises and outlays related to recent floods and environmental damage."

In their inflation report in August, the **NBH** had the following opinion[11] about the budget**:** ***"****According to our forecast, the ESA deficit will rise to 4.3% in 2010, to 4.1% in 2011, and it will fall to 3.7% in 2012. In the first half of 2010, there was a budget revenue shortfall relative to the government's expectations, and expenditure was higher than planned. Although the measures approved by the new government substantially improve the budget balance relative to the situation without such steps, we forecast a higher eventual ESA deficit than anticipated by the government even with these measures."*

In other words, the view of the **NBH** team after the measures of the first action plan aimed at significantly correcting imbalances is that there is more to be done. According to the latest inflation report[12] of November 2010, however, together with the second action plan the deficit target can be met: *"During the period since the inflation report of August, there has been a shortfall primarily in corporate tax*

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[10] http://www.imf.org/external/np/ms/2010/102510.htm

[11] http://www.mnb.hu/Root/Dokumentumtar/MNB/Kiadvanyok/mnbhu_inflacio_hu/mnbhu_inflation_20100825/infl_jelentes_201008_hu.pdf, Page 59.

[12] http://www.mnb.hu/Root/Dokumentumtar/MNB/Kiadvanyok/mnbhu_inflacio_hu/mnbhu_inflation_20101201/infl_jelentes_201012_hu.pdf, Page 81.

revenues relative to our forecast, and publicly financed institutions have so far failed to cut nominal expenditures, therefore we have raised our relevant deficit expectations. However, sectoral extra taxes and private pension fund contributions accounted as temporary budget revenue can improve the budget balance by 1% as of GDP. Thus, the ESA deficit may turn out around 3.8% as of GDP."

Shoring up reserves in December 2010

Constantly seeking to reach the deficit target safely, the government issued a decree in the central budget subchapter about the measures necessary to achieve the proposed budgetary balance of 2010. As a result, government agencies under the control of the budgetary chapters, chapter-administered appropriation, social security executive bodies and special state funds controlled by the government could spend 100bn HUF less in 2010. By these measures Hungary can surely keep the budget deficit of 3.8% in 2010.

Conclusion

The situation of the government was not easy, as they had inherited a shaky budget from their MSZP-SZDSZ predecessor.

The unreal projection for revenues and expenditures resulted in a substantial increase in deficit expectations already at the beginning of this year. The key items behind this rise are the following:

1. The tax revenues of 2009, the basis for planning the budget of 2010, had been overestimated.
2. Rulings of the Constitutional Court on issues affecting tax revenues (childcare allowance, the abolition of residential property tax).
3. The delayed, 2010 payment of tax reimbursements, i.e. see Parat issue on VAT or early dividend-payments.
4. A lot of expenditures had not been planned.

At the beginning of July, the new government estimated the extra deficit at 250-280bn HUF. Therefore, they immediately introduced measures in the first action plan so that the targeted budget deficit could be kept. The extra budget reserves and revenues from the tax on banks announced in

this plan improved the budget balance by 307bn HUF. The changes in corporation tax caused a debit of 105bn HUF. Thus, the net extra revenues gained by the first action plan were 202bn HUF.

During the months after these developments, tax revenues kept coming in lower than forecast, and a number of issues turned up which had to be financed. (The costs of EU presidency, BKV, MAV, churches, NATO, flood and red mud damages, additional funding of the healthcare and public safety systems.)

To this end, the measures of the second action plan aimed at improving the budget balance have been announced. There are extra revenues of 161bn HUF from the sectoral tax and 60bn HUF from funneling private pension fund contributions to the state pension system, so the second action plan will bring in 221bn HUF altogether.

However, the total of 423bn HUF in net extra revenues due to the measures of the two action plans (plus the unforeseen payment of 32bn HUF as MOL's mining royalties) were still insufficient to reach the deficit target, so the government decided on an additional cost-cutting package of 100bn HUF on 3 December.

Budapest, 4 January 2011.

Ministry for National Economy