Opinion of the Fiscal Council

on the implementation of the Act on the 2023 Central Budget of Hungary and the evolution of public debt

I.

Background, legal basis and publicity of the Opinion

The Fiscal Council (hereinafter: Council, FC) is governed by Act CXCIV of 2011 on the Economic Stability of the Hungary (hereinafter: Stability Act, Stab. Act) According to Section 23 (1) (c), it expresses its opinion – every six months – on the state of implementation of the Act on the Central Budget and on the development of public debt.

On this basis, the Council has reviewed the processes of the year-round implementation of Act XXV of 2022 on the Hungary's 2023 central budget, as amended by Act VI of 2023 (hereinafter: Budget Act of 2023) and the evolution of public debt.

Following its practice and working method so far, the Council has built on the precedents related to the preparation of the 2023 budget law.

- In its Opinion No 2/2022.06.03 on Hungary draft bill on the 2023 central budget, the Council stated that "revenue-side measures, in particular through extra-profit taxes, play a significant role in striking a balance, while expenditure side measures can contribute more permanently and effectively to improving balances". At the same time, it indicated that "expenditure side measures [...] are absolutely necessary for a credible and sound implementation of stabilization”.

  The Council considered it an important ambition that "in 2023 the general government sector accrual based deficit (ESA) will decrease close to the Maastricht criterion to 3.5 percent, while the general government cash flow deficit will decrease to 3.3 percent". He noted that "EU and domestic rules allow for a general government deficit of more than 3 percent in 2023", but urged "reaching a 3 percent deficit as soon as possible, if economic conditions allow". In its Opinion, the Council pointed out that "the draft budget bill for 2023 complies with the sovereign debt rule provided for in the Fundamental Law and the Stab. Act, § 4(2a)". It stated that "in accordance with the provisions of the Fundamental Law, the downward trend of the government debt ratio will remain persistent and its rate will decrease from 76.1 percent at the end of 2022 to 73.8 percent by the end of 2023, according to the draft budget bill". The FC considered it feasible to achieve this taking into account the macroeconomic and fiscal path [prepared in April and May 2022, which formed the basis of the draft budget bill].

- In its Resolution No. 3/2022.07.14 on the compliance of Single Budget Bill T/152/471 on the 2023 Central Budget with the public debt rule, the Council gave its consent to the final vote on the 2023 budget bill by stating that it acknowledges “the public debt ratio planned for 31 December 2023 [...]. It was established in accordance with the provisions of the Stability Act, in accordance with the macroeconomic and public finance processes existing at the time of drafting the bill and on which it was based. Since the value of the government debt ratio calculated by the end of 2023 in the bill is 2.3 percentage points lower than the value of the indicator expected by the end of 2022, the requirement of Article 36(5) of the Fundamental Law is also met".

  At the same time, in this Decision, the Council considered it appropriate to draw attention to the "heightened macroeconomic risks since the start of budget planning for 2023, among which budget implementation is particularly affected by higher than expected inflation, a slowdown in global economic growth, the consequences of the Russia-Ukraine war (energy crisis, etc.) and a protracted agreement with the EU". In the Council’s view, these "increase the overall risk of higher than planned deficits and debt". FC continued to call for "a 3 percent deficit to be reached as soon as possible, if economic conditions allow."
- In its Opinion No. 1/2023.01.12 on the draft bill proposing the amendment of Act XXV of 2022 on the Hungary's 2023 Central Budget, the Council stressed that "Russia's war against Ukraine, the sanctions imposed in response to it, the explosive rise in energy prices and the related uncertainty of the external economic environment pose risks to the achievement of the budgetary targets set out in the draft." It also noted that the draft bill "envisages economic growth of 1.5 percent by 2023, compared to 4.1 percent originally assumed, due to the lingering effects of war and the energy crisis, the slowdown in global growth and the dampening effect of inflation on real incomes."

  In this Opinion, the Council also drew attention to the need to "pursue a conservative policy in the use of fiscal reserves" and continued to call for "a deficit of 3 percent if economic conditions permit, since a reduction in the deficit will also help to restore balances in other areas of the economy." In addition, it stated that "thanks to the high nominal GDP growth rate of nearly 16.6 percent, the reduction of the public debt ratio will continue in 2023."

- In its Resolution No. 3/2023.03.30 on the compliance of Bill T/2667 amending Act XXV of 2022 on the Central Budget of 2023 with the sovereign debt rule, the Council gave its preliminary consent to the final vote by stating that "according to the unified proposal, the government debt ratio will decrease from 73.5 percent at the end of 2022 to 69.7 percent by the end of 2023. In the Council's view, the target reduction in the debt ratio is in line with the macroeconomic path used as a condition of the bill and with the budgetary developments set."

  In the explanatory memorandum of this Decision, the Council considered it important to draw attention to the fact that "the amended budget is also surrounded by risks. Therefore, in implementing it, it is necessary for budgetary authorities to take realistic, sustainable austerity measures without jeopardizing the performance of public tasks. Otherwise, the smooth delivery of public services will require significant additional expenditure, which risks achieving the public debt target."

  The explanatory memorandum also stated that "despite partially compensating for the increase in energy prices, the real value of appropriations financing public tasks has decreased significantly in several areas, so the management of the resulting tensions deserves further special attention during budget implementation." Here, too, the Council stressed the importance of reducing the budget deficit, "as this promotes the restoration of balances in other areas of the economy (e.g. contributes to improving external financing capacity)."
- In its Opinion 6/2023.10.03 on the state of play and expected development of the implementation of the Act on the Hungary's 2023 State Budget for 2023, the Council stated that "the domestic and European economic situation in 2023 will be primarily influenced by the aftermath of the energy crisis and the protracted Russia-Ukraine war." He noted that "in the first half of the year, the volume of domestic GDP decreased by 1.7 percent compared to a year earlier", adding that "our economy will return to growth in the second half of the year, but the annual change in GDP will not reach the rate projected when the amendment to the budget law was adopted." In its opinion, FC highlighted that "the main reason for the stalling of economic growth is the decline in domestic demand" and that "a sustained reduction in inflation is a condition for a sustainable resumption of growth."

In its assessment, the Council stressed that "the cash-flow deficit at the end of the year will be higher than proposed on the basis of developments so far and expected, excluding government measures. The cash flow deficit of the central subsystem of general government was set at HUF 3400.2 billion by the amended Budget Act of 2023. The deficit in the first half of this amount reached HUF 2896.0 billion, reaching 85.2 percent of this, and reached HUF 3299 billion by the end of August, which is 97 percent of the appropriation". He pointed out that "the lower than planned performance of VAT revenue on the revenue side of the budget as a result of the decline in consumption contributed to the deficit higher than pro rata temporis." FC stressed that "limiting access to EU funds allocated to Hungary also tends to widen the cash flow deficit and increases uncertainty for economic growth, despite budgetary advances in funding for planned programmes."

In addition, the Council noted that "the general government debt-to-GDP ratio increased from 73.9 percent at the end of 2022 to 75 percent at the end of the first half of the year due to the high cash flow deficit. [...] The cash flow deficit concentrated in the first half of the year also significantly increased the accrual deficit. In the first half of 2023, according to HCSO data, the ESA deficit amounted to 6.3 percent of half-year GDP."

The Council noted that "on 3 October 2023, according to a statement from the Ministry of Finance, the Government raised its 2023 ESA deficit target to 5.2 percent of GDP", adding that "the increased deficit target [...] reflects economic and budgetary developments". In addition, "The Council sees the need for close control of expenditures even with the new deficit target".

In the Council's assessment, "despite lower than projected GDP volume growth and an increased deficit target, the government debt ratio could decline by the end of the year in line with the debt rule due to significant nominal GDP growth". Finally, FC drew attention to the fact that "a lasting improvement in the budgetary balance [...] requires measures in the future”.

During the evaluation of the implementation of the 2023 budget, the Council reviewed the information of the HCSO and the Ministry of Finance on the state of the economy and public finances, as well as the economic assessments and projections of domestic research and analyst institutes invited by the FC Secretariat, as well as certain international financial institutions

(European Commission, IMF, OECD, World Bank) and other market analysts. The Council also took into account the Convergence Programme of Hungary 2023-2027.

II.
The Opinion of the Council

At its meeting held on 16 April 2024, the Council reviewed the main processes and background for the implementation of Act XXV of 2022 on the 2023 central budget, as amended by Act VI of 2023, on the basis of Section 23 (1) (c) of Hungary Stability Act. The Council has formed its Opinion as follows:

1) In 2023, domestic economic activity contracted by 0.9 percent, below forecasts on which budget planning was based. The original budget was based on economic growth of 4.1 percent, which was reduced to 1.5 percent by the justification of the amendment adopted at the beginning of 2023. However, internal and external factors causing the slowdown proved stronger than expected, resulting in overall weaker economic activity than the EU average. The main reasons for the decline in GDP were the decline in domestic demand due to high inflation, geopolitical conflicts and the weak cyclical situation of our main foreign trade partners (in particular Germany). Among the main industries, only the output of agriculture increased, where dynamic growth occurred compared to the low base of the previous year of drought.

2) Both cash flow and accrual deficits were significantly higher than planned. The amended Budget Act set the cash flow deficit of the central subsystem of general government at HUF 3400.2 billion, where the actual cash flow deficit increased by 35.1 percent (HUF 1193.2 billion in amount) to HUF 4593.4 billion. The budget deficit on an accrual basis (ESA) was originally planned at 3.5 percent of GDP, which was increased to 3.9 percent of GDP by the revised budget. The actual deficit for 2023 was 6.7 percent of GDP, well above the government's autumn 2023 expectation of 5.2 percent.

3) High inflation and lower than planned economic activity had a significant negative impact on the fiscal situation. As a result of declining consumption due to high inflation, consumption-related tax revenues were significantly below the appropriation, while the Government adjusted pension expenditures to the higher than expected inflation in the framework of the supplementary pension increase in November, in accordance with legal

requirements. Interest expenditure significantly above the target was related to higher than planned government debt, as well as higher inflation and government bond market yields. The impact was only partially offset by lower than planned energy expenditure as a result of falling global energy prices. One-off deficit factors were the extension of funding for the home improvement program that ended in 2022 to the first half of 2023, and in terms of cash flow shortfall, the acquisition of state ownership in two major companies.

4) The cash flow deficit was increased by the fact that the government was forced to advance EU funding for developments planned under the 2021-2027 Cohesion Operational Programmes and the Recovery Plan due to the delay in approving the disbursement of EU funds for to Hungary. At the same time, it is positive that the competent bodies of the European Union approved the Hungarian Recovery Plan at the end of 2023 and also approved the judicial reform, so Hungary could start drawing the cohesion funds in December and received an RRF[1] loan advance of EUR 780 million, which does not affect the budget.

5) The government debt ratio[2] declined from 74.1 percent at the end of 2022 to 73.5 percent at the end of 2023. Following a temporary increase in 2020, the government debt ratio continued to decline again in 2021. However, this reduction fell short of the 2.3 percentage point cut envisaged in the original budget and 3.8 percentage points in the revised budget. The 0.6 percentage point decline in the debt ratio is essentially a consequence of significant nominal GDP growth, against the background of a higher-than-planned deficit and a decline in real GDP. The latter entailed, pursuant to Paragraph 7 (2) of the Stability Law, the suspension of the obligation to comply with the sovereign debt rule.

6) The significant discrepancy between the initial planning figures for the 2023 budget and the actual figures highlights the limitations of macroeconomic conditions in the preparation of the spring-summer budget, as indicated by the Council in its previous opinion, which may require replanning. The Council therefore supports that, in the event of greater uncertainty in the macroeconomic trajectory, the budget is planned and submitted closer to the year in question.

[1] Recovery and Resilience Facility

[2] According to Section 2 of Act CXCIV of 2011 on the Economic Stability of Hungary, the government debt ratio is the ratio of government debt to gross domestic product, rounded to one decimal place.

7) Based on the experience gained in implementing the 2023 budget, the Council considers it a forward-looking practice that if macroeconomic developments deviate significantly from the projections used for budgetary planning, and the deficit and debt ratios develop less favorably than targeted, the Government will initiate amendments to the budget law.

8) The Council hereby authorizes its President to make the opinion public and to represent it.

III.

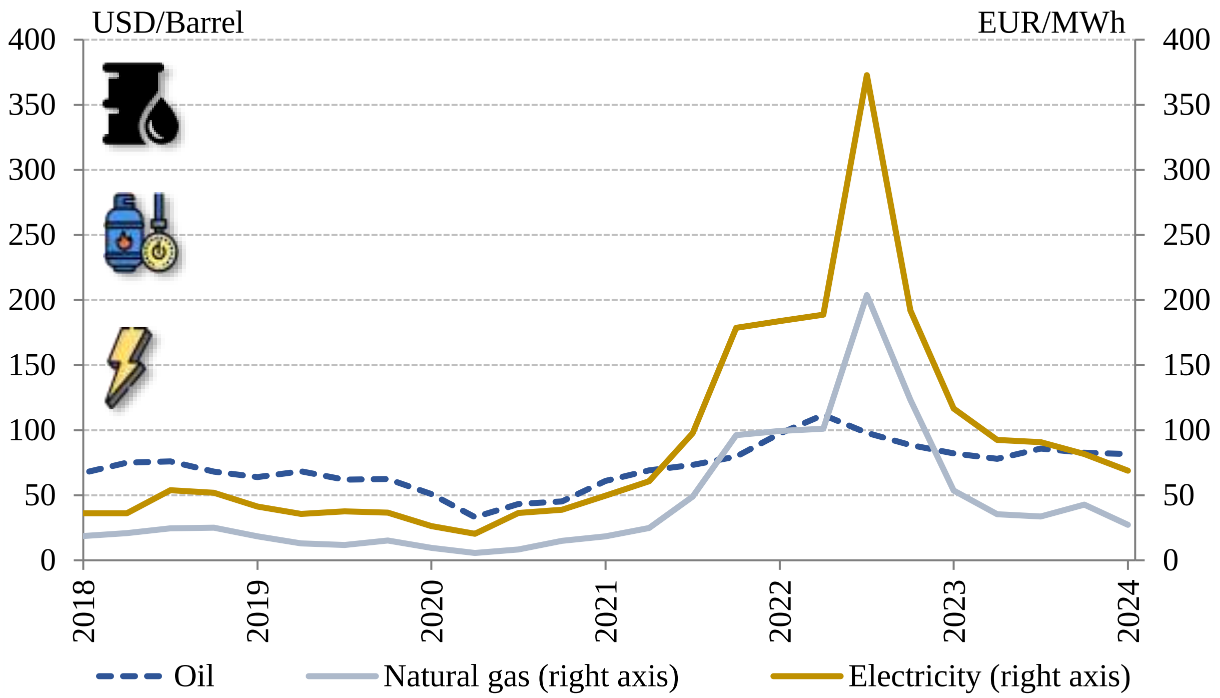
Justification

1) **Developments in macroeconomic conditions**

The original budget for 2023 was planned by the Government with an economic growth of 4.1 percent. However, the underlying global and domestic macroeconomic (budgetary) processes have changed the conditions of implementation to such an extent that the amendment of Act XXV of 2022 became inevitable. As a result, the 2023 budget law, as amended by Act VI of 2023, was based on economic expansion of 1.5 percent.

In 2021 and 2022, the global economy was hit by successive **waves of inflation**, which resulted in inflation rising to double-digit ranges in most countries around the world. Post-COVID supply-demand frictions, the energy crisis and the Russia-Ukraine war have all contributed to a rise in global inflation not seen since the 1970s. The primary cause of inflation in both Europe and Hungary was the extraordinary jump in energy prices from the summer of 2021. Dutch Title Transfer Facility (TTF) gas prices, which were still close to 18 EUR/MWh at the beginning of 2021, rose above 200 EUR/MWh by the third quarter of 2022, while the listing of German electricity Phelix increased more than sevenfold over the same period (Figure 1). The surge in energy prices was partly preceded and partly followed by widespread increases in global transportation costs and food commodity prices.

Figure 1: Changes in European electricity, oil and gas prices in recent years

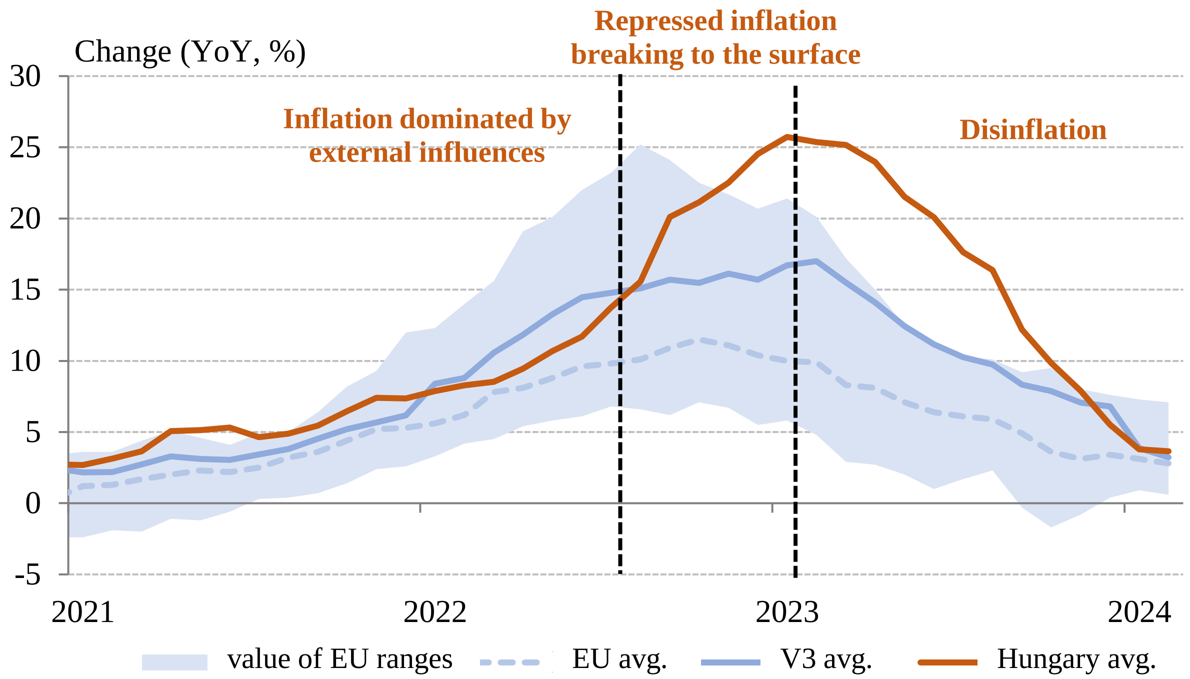


Note: Brent for oil, Dutch TTF for gas and German Phelix for electricity. Quarterly data.

Data source: Bloomberg

As a result of global developments, inflation in Hungary also accelerated significantly during 2022, peaking at 25.7 percent in January 2023. The rise in inflation was initially dominated by external factors (increases in energy, raw material and food prices) and domestic inflation developed in line with regional price dynamics. Between mid-2022 and January 2023, country-specific structural weaknesses (low productivity and weak competitiveness of the domestic food industry, lack of adequate competition in certain submarkets) emerged, through which domestic consumer prices reacted more sensitively to global inflation waves, thus Hungarian inflation broke away from regional trends from August 2022 (Figure 2).

Figure 2: Inflation developments in Hungary, the region and the European Union



Note: Based on HICP data.
Source of data: Eurostat

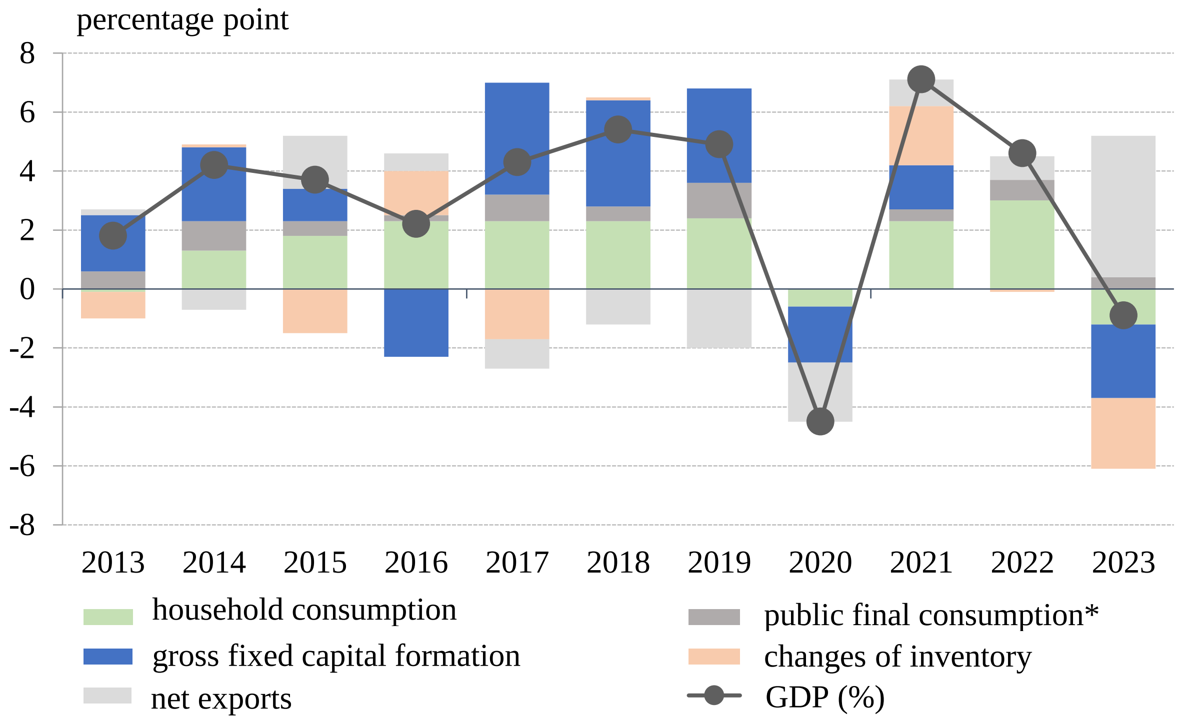
Following the peak of domestic inflation in January 2023, a period of **disinflation** has begun. Between January 2023 and February 2024, inflation declined significantly by 22 percentage points. This decline was driven by a combination of disciplined monetary policy, pro-competitive government measures, subdued demand, base effects and a significantly lower external cost environment than before. The effect of the modification of the utility price reduction ran out of the inflation base in September 2023, while the effect of the waiver of the fuel price stop ran out of the inflation base from December 2023, further accelerating disinflation. By October 2023, inflation had fallen to single digits and since January 2024 the annual rate of consumer price growth has returned to the tolerance band of the inflation target. Both household and corporate inflation expectations have moderated substantially in the course of 2023.

Global GDP growth moderated in 2023 compared to the previous year, with growth of 3.5 percent in 2022 followed by growth of 3.1 percent last year, according to OECD data. GDP grew by 2.5 percent in 2023 in the United States after growing 2.1 percent in 2022, while GDP in China grew by 5.2 percent after 3.0 percent. At the same time, the eurozone, which is of key importance for Hungary, recorded a significant slowdown, with GDP growing by just 0.5

percent in 2023, after expanding by 3.4 percent in 2022. In addition to high inflation, global economic activity in 2023 was affected by a number of negative factors: the continuing Russia-Ukraine war, generally high geopolitical tensions and the situation in the Red Sea in the final months of the year weighed on global trade and posed risks looking ahead.

In the course of 2023, after three quarters of moderation, domestic economic activity stagnated in the fourth quarter year-on-year, resulting in an overall decline of 0.9 percent in **Hungarian GDP** during 2023 (Figure 3). The decline in domestic activity was mainly driven by subdued domestic demand due to high inflation. The decline was dampened by the historically outstanding growth of agriculture, as the volume of agricultural production increased by 68.5 percent last year. The significant contribution of agriculture to growth of 2.2 percentage points was mainly due to the low base of the drought-hit year of 2022, while average yields were close to the historical average last year. Overall, the value added of services decreased by 1.6 percent in 2023. Within this, the value added of state-related services (public administration, defense; compulsory social security, education, human health and social care) increased by 1.9 percent overall, while that of market services decreased by 2.8 percent.

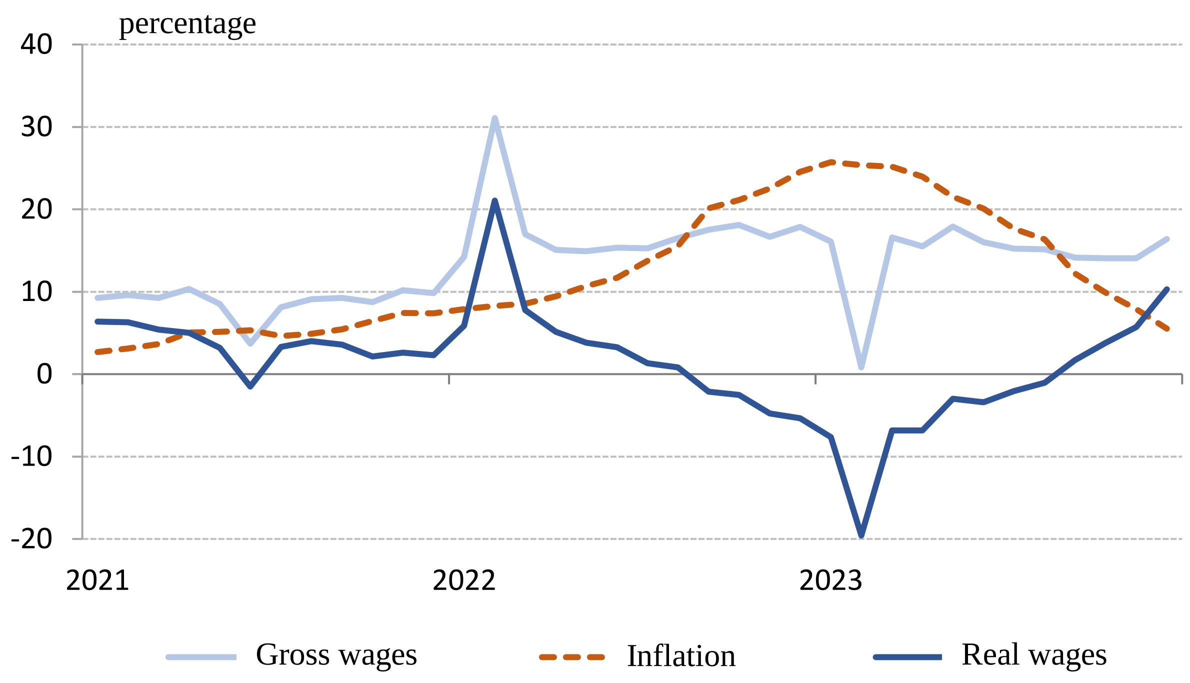
Figure 3: Contribution of main use items to annual changes in GDP



*Note: * Including social benefits in kind from non-profit institutions and government.*
Source of data: HCSO

In 2023, **domestic demand** declined. Household consumption expenditure declined by 2.5 percent, driven by real wage dynamics turning negative as a result of surging inflation and low levels of consumer confidence (Figure 4). The purchasing value of wages changed negatively between September 2022 and August 2023, resulting in subdued private consumption coupled with low consumer confidence. Meanwhile, nominal wage dynamics remained high, so that after inflation moderated, real wage values increased again, from the fourth quarter of 2023 (Figure 4). The **labour market** remained strong despite a decline in economic activity, with employment expanding by 0.6 percent throughout 2023. At the same time, labour market tightness eased by the end of the year, pointing to an adjustment to changes in economic activity. According to HCSO data, the number of new vacancies posted has decreased. The unemployment rate rose to 4.5 percent by January 2024 amid increased activity, remaining low by EU standards.

Figure 4: Development of wage dynamics (annual change)



Source of data: HCSO

The value added of **investments** decreased by 8.7 percent last year, within which construction investments decreased by 15.7 percent, while investments in machinery and equipment increased by 2.4 percent. In parallel with weak domestic demand, investments in the domestically producing and services sectors declined more sharply, while investment activity in the sectors producing mainly for exports increased overall, although it gradually deteriorated during the year. Last year, high inflation, increased costs, declining demand and a shortage of properly qualified workers weighed on companies' business and investment intentions. Public investment moderated throughout 2023, despite growth in the fourth quarter. The weak performance of investments last year is reflected in the development of the construction sector, as the value added of the construction industry was overall 5.6 percent below the level of 2022. The decline was widespread, with building construction falling by 5.2 percent and other structures by 4.5 percent last year.

Housing construction activity was also subdued, with a total of 18,647 new homes built for the year as a whole, which is 9.2 percent lower than in the previous year. The number of building permits issued last year was 21,501, a decrease of 38.6 percent on an annual basis.

The added value of **industry** decreased by 5.2 percent, within which the value added of manufacturing decreased by 4.1 percent last year. The dynamics of production and sales reflected macroeconomic developments. The slowdown in domestic demand first dampened output in domestically producing sectors, but weak activity in external markets gradually dampened exports. Industrial export sales declined in the second half of the year, while new export orders fell more than domestic orders in December. The volume of export sales to the manufacturing industry stagnated overall compared to the previous year, but within this, exports of vehicle production increased by 9.0 percent and that of electrical equipment by 14.7 percent. Domestic sales of industry were 15.4 percent lower in 2023, within which those of manufacturing were 8.1 percent lower than in the previous year. The output of vehicle manufacturing, the largest subsector, grew by 8.4 percent, while the production of electrical equipment including battery production grew by 8.9 percent (both subsectors experienced a significant slowdown in the last quarter of the year).

Exports stagnated over the past year, while **imports** declined as domestic demand declined, resulting in a positive contribution from net exports to growth. The slowing economic activity of most of our foreign trade partners was also reflected in domestic exports, with exports of goods declining by 0.9 percent, which was nearly offset by a 3.0 percent increase in exports of services, resulting in a total decrease of 0.1 percent in total exports. Overall, imports declined by 5.1 percent in line with the decline in domestic demand items. The balance of foreign trade in goods showed a surplus of HUF 3800 billion in 2023, which was nearly HUF 6700 billion higher than in 2022. The terms of trade improved by 6.7 percent, with the correction in mineral fuel prices contributing the most. As a result of declining domestic demand, the moderation in imports exceeded that of exports, in line with which the country's external equilibrium indicators improved in 2023. The **current account** balance as a share of GDP increased by more than 8 percentage points at an unprecedented rate. As a result, the current account closed with a slight surplus of 0.2 percent in 2023, following a high deficit in the previous year, while the external financing capacity of the economy stood at 1.2 percent of GDP.

2) **Developments of the government deficit and reasons for deviation from the deficit target**

The cash flow deficit of the central budget amounted to HUF 4593.4 billion, or 6.1 percent of GDP. Thus, the deficit exceeded the value set out in the amended budget law by HUF 1193.2 billion, or 35.1 percent. Compared to the previous year, the cash flow deficit decreased by HUF 78.7 billion. More than half (55.9 percent) of the deficit of the central subsystem in 2023 arose in the three months of the first half of the year (February-April), while 65.2 percent (HUF 1,105.8 billion) of the deficit of the central subsystem in the second half of the year (HUF 1,697.3 billion) arose in the last two months of the year.

The accruals-based deficit, like cash flow, exceeded the planned deficit. The ESA deficit of general government amounted to 6.7 percent of GDP (HUF 5,018 billion). In the amended budget law, the accrual-based (ESA) deficit of the general government sector for 2023 was 3.9 percent of GDP. According to a statement from the Ministry of Finance on October 3, 2023, the Government raised the deficit target to 5.2 percent of GDP, which was exceeded by 1.5 percent of GDP. This halted the deficit reduction process, as the deficit was 7.6 percent in 2020, 7.2 percent in 2021 and 6.2 percent in 2022. The deficit is considered high within the European Union. According to available data, only Italy has a higher deficit, reaching 7.2 percent of GDP.

According to preliminary data, a **primary deficit**[3] of 2.0 percent of GDP was realized for the year as a whole , while interest expenditure amounted to 4.7 percent of GDP.

The Maastricht deficit criterion was allowed to be exceeded in 2023 by the escape clauses in both the EU and domestic fiscal frameworks. EU fiscal rules were suspended on the basis of the general escape clause and, accordingly, the relevant paragraph of the Stability Law was amended in 2021, according to which the rule that sets the maximum budget deficit and the medium-term budgetary objective between 2021 and 2023 do not apply.

[3] The difference between general government revenue and expenditure, excluding interest payments.

The **structural deficit**[4] continued to exceed the medium-term budgetary target (1 percent) under Section 3/A(2)(a) of the Stability Act in 2023, but this requirement did not apply in 2023 either.

The main reason for the higher-than-expected budget deficit was that declining domestic demand due to high inflation led to a loss of tax revenues, in particular consumption taxes, while interest and pension expenditures were higher than expected. However, their impact was partly offset by lower than planned energy expenditures as a result of lower global energy prices.

- The cash flow tax and contribution revenues of the central subsystem were approximately HUF 1720 billion below the appropriations included in the amended budget law. The main reason for the high budget deficit is that, instead of the more than 16 percent net VAT revenue increase expected in the budget due to inflation, the actual increase was less than 2 percent in 2023. As a result, VAT revenues fell short of expectations set out in the Budget Act by more than HUF 1000 billion last year, and consumption taxes by more than HUF 1130 billion in total. The payments of business organizations were lower by HUF 306 billion, while tax and contribution revenues from labour were HUF 258 billion lower than the amended statutory appropriation.
- As a further adverse budgetary impact of the high inflationary environment, accrual-based government interest expenditures as a proportion of GDP increased by nearly HUF 1660 billion to around 4.7 percent in 2023 from 2.8 percent in 2022. Based on its structure, the cost of government debt is made up of a combination of factors, such as inflation, inflation expectations, the country's risk perception, exchange rate developments and yields on domestic and international government debt markets. Almost half of the increase in accruals-based interest expenditure was driven by high inflation and an increase in inflation-tracking government securities[5]. Net cash interest expenses increased by almost HUF 250 billion than expected by law, and the difference is further increased by accrual statistical adjustments.

[4] The balance net of the effects of the general government cycle and individual items (Section 1 (e) of Act on Stab.). Its exact value for 2023 will be known in the month of May.
[5] For more details on the factors determining the increase in government interest expenditures, see priority topic 6.2 of the MNB's December 2023 Inflation Report.

- Pension expenditures exceeded the statutory expenditure level by more than HUF 200 billion, mainly due to the additional mid-year correction required due to higher inflation than expected by law.
- The net expenditure of budgetary bodies and appropriations managed by chapters, including individual and normative subsidies, exceeded the amended statutory appropriation by a total of HUF 387 billion.
- As a result of the moderation in global energy prices, energy expenditure decreased compared to the previous year and also fell short of the appropriation, resulting in savings of some HUF 450 billion for the budget, part of which was used for other purposes.

The cash flow balance was significantly affected by the time difference between the payment and receipt of EU funds. Overall, the allocation for EU revenue was met at 99% due to higher accounting of funds for the 2014-2020 cycle, but the receipt of funds for the new cycle was significantly lower than expected. Nearly half of the funds essentially corresponding to the appropriation, some HUF 1,000 billion, were received in the last month of the year.

The European Commission and ECOFIN endorsed Hungary's Recovery Plan at the end of 2023 and the adopted judicial reform. While Hungary received an RRF loan advance of EUR 780 million in December that did not affect the budget, it was also able to start drawing down cohesion funds. However, the programmes launched under the Recovery Plan were still financed by the central budget in 2023, as the Commission made access of RRF funds conditional on the preliminary completion of the 27 super milestones selected from the Plan. In total, some HUF 600 billion was paid out from the central budget for the RRF and the 2021-2027 cohesion policy operational programmes in 2023, the majority of which was advances.

The cash flow deficit was also affected by one-off expenses. On the one hand, this was the case with the extension of funding for the home renovation program, which ended in 2022, to the first half of 2023. On the other hand, unplanned expenses in the 2023 budget were increased by the HUF 360.2 billion funding allocation of Corvinus International Investment Plc., which was accounted for as state asset related expenditure, which was related to the acquisitions of the Hungarian State by in Vodafone Hungary Zrt. and Magyar Posta Life Insurance Zrt., as well as in Magyar Posta Insurance Zrt. At the same time, the annual allocation for payments related to state assets of the budget was 149.7 percent, which was contributed in the second half of the year by the payment of MVM Zrt.'s HUF 309.0 billion dividend advance and the repayment of advances on rescheduled state investments.

3) **Government debt developments**

The Maastricht-defined gross debt-to-GDP ratio declined to 73.5 percent by the end of 2023, compared with 79.3 percent at the end of 2020, 76.7 percent at the end of 2021 and 74.1 percent at the end of 2022. The decline in the government debt ratio was mainly supported by the high GDP deflator, while the budget deficit, the debt growth of Eximbank, which is included in government debt, and the contraction of the real economy increased debt. At the same time, the decline in the general government debt ratio fell short of the 2.3 percentage point reduction envisaged in the original budget and the 3.8 percentage points envisaged in the revised budget.

The government debt ratio at the end of 2023 **complies with the debt rule of the Fundamental Law**[6] and shows a better result than the 0.1 percentage point reduction commitment required by the Stability Act. This was despite the fact that, pursuant to Article 7(2) of the Stability Law, the obligation to comply with the public debt rule could have been suspended in the event of a fall in the real value of GDP.

The share of foreign currency in central government debt rose to 26.9 percent by the end of 2023 from 25.0 percent a year earlier, due to significant foreign currency bond issuances.

Factors of change in the government debt ratio

In 2020, owing to the real economic downturn and the high budget deficit, the debt-to-GDP ratio increased by 13.9 percentage points before declining from 2021 onwards. In 2020, only the GDP deflator supported the reduction of the debt ratio, while all other factors increased public debt. In the following two years, nominal GDP growth exceeded the debt-increasing effect of the high primary deficit and rising government interest expenditure, resulting in a decrease in the government debt ratio of 2.6-2.6 percentage points.

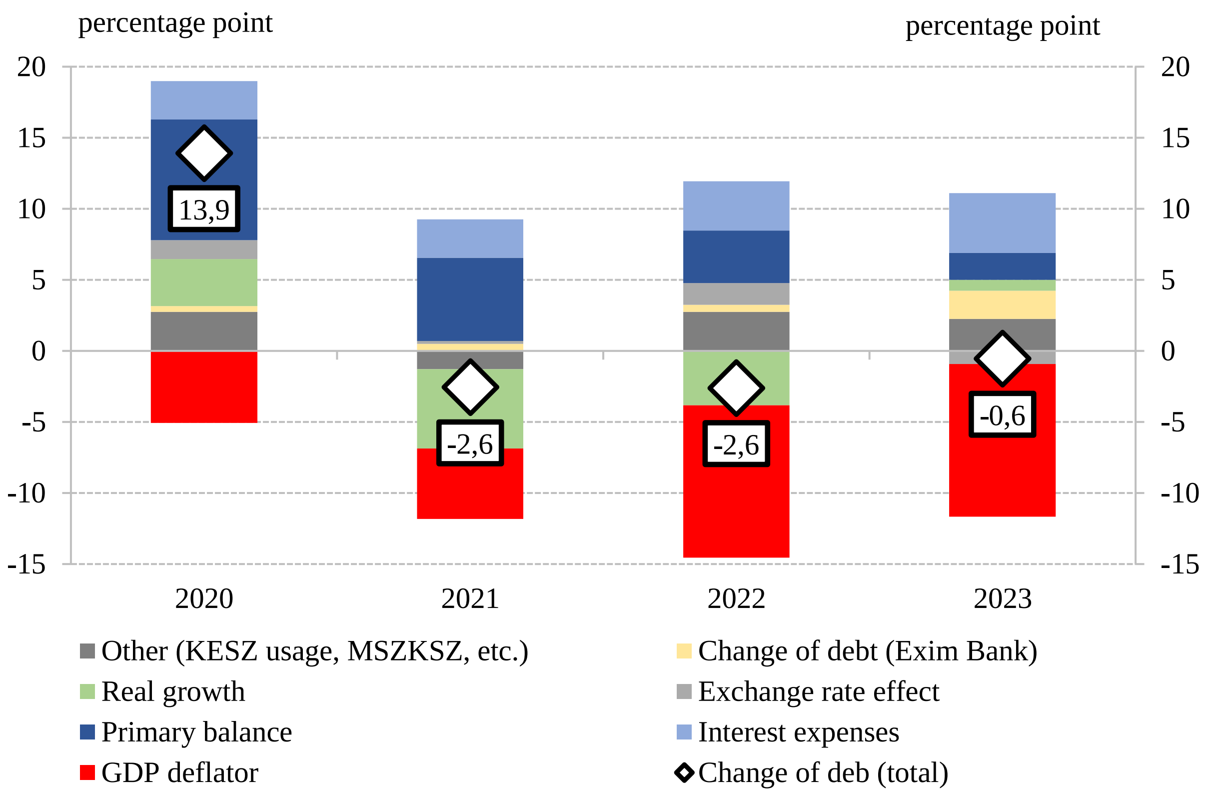
At the end of 2023, preliminary data suggest that the debt-to-GDP ratio stood at 73.5 percent, a decrease of 0.6 percentage points compared to the end of 2022.

[6] Article 36(4) and (5) of the Fundamental Law contains the sovereign debt rule as the most important element of rules-based budgeting. According to this, Parliament cannot adopt a law on the central budget that would result in government debt exceeding half of GDP. As long as government debt exceeds half of the gross domestic product, Parliament may only adopt a law on the central budget that contains a reduction in the ratio of state debt to gross domestic product.

Last year, the largest contributor to the reduction of the government debt ratio was the GDP deflator, which alone would have reduced the value of the ratio by 10.7 percentage points. The strengthening of the forint exchange rate, which reduced the debt-to-GDP ratio by 0.9 percentage points, also had an impact on the decline in the debt ratio. The decline in the debt ratio in 2023 therefore does not reflect fiscal measures, but rather an extraordinary increase in its denominator.

In 2023, the positive impact of the high GDP deflator and exchange rate strengthening was significantly worsened by the high budget deficit, the debt growth of Eximbank, classified as government debt, and the contraction in the real economy. The primary cash flow deficit, which is important for debt change, increased government debt by 1.9 percentage points and gross cash interest expenditures by 4.2 percentage points. Eximbank's debt growth alone amounted to 2 percent of GDP.

Figure 5: Breakdown of changes in the general government debt-to-GDP ratio



Source: MNB calculation based on ÁKK, KSH, MNB data

The Council considered it appropriate to draw attention to the forecasting limitations of macroeconomic conditions occurring during the preparation of the spring-summer budget, as indicated by it the previous year, in view of the significant discrepancy between the original planning figures and actual figures of the 2023 budget. As a result of these constraints, forecast risks increase significantly and may require a redesign of the overall budget. The Council therefore considers it to be supported that, in order to mitigate these risks at a time of greater uncertainty in the macroeconomic trajectory, the budget is planned and submitted closer to the year in question.

In its opinion, based on the experience gained in 2023, the Council also considered it justified to state that it considers it a forward-looking practice for the Government to initiate amendments to the Fiscal Act if macroeconomic developments differ significantly from the projections used for fiscal planning and if deficit and debt indicators also move away from target values.

4) Detailed analysis of revenues and expenditures of the central subsystem

The **central subsystem of general government** received **revenues** of HUF 36,515.7 billion, which is 100.4 percent of the appropriation.

Similarly to revenues, without consolidation, a **combined expenditure** of HUF 41,109.1 billion was realized, which was 3.4 percent higher than the appropriation.[7]

In 2023, **tax and contribution revenues** of the budget were met in 93.2 percent of the statutory appropriation. Among the major tax types, **corporate tax** revenues were met in 100.9 percent of the appropriation, the main reason for which was that the 2022 profit of enterprises was more favourable than what was taken into account when determining the 2022 tax advance. Therefore, an additional payment was made when accounting for tax, as well as a higher advance tax calculated on the basis of the 2022 tax from July 2023 onwards. The 87.0 percent of the 2023 revenue from the **itemized tax for small taxpayers** is related to a larger than planned decrease in the number of taxpayers. **Retail tax** revenues accounted for 118.1 percent of the appropriation. This was influenced by two factors: firstly, the tax rate increased in 2023 and, secondly, the tax advance was based on the previous net sales in 2022, so the fulfilment of the appropriation was not affected by the decrease in retail sales in 2023.

In 2023, **VAT revenues** were HUF 1,004.1 billion lower than planned, driven by a 2.5 percent decline in household consumption expenditures and an 8.7 percent decline in gross fixed capital formation compared to the previous year. Accumulation expenditures in the general government

[7] Appropriation means statutory amended appropriation. Where the benchmark is different, it is indicated.

sector were met in the planned 76.3 percent. Net VAT revenues were further reduced by a higher proportion of VAT allocations than in previous years. 92.8 percent of **excise revenues** were affected by a 19.5 percent drop in retail sales of motor vehicle fuel and a decrease in the volume of alcohol and certain tobacco products traded.

Personal income tax revenues reached 98.4 percent of annual appropriation in 2023. Tax breaks accounted for 10.9 percent of revenue.

In 2023, 9.9 percent of the budget's tax and contribution revenues came from taxes remaining subject to the **Extra-Profit Tax** Regulation, and with the exception of telecom tax and retail tax, revenues from extra-profit taxes did not reach the planned rate. The share of expenditures of budgetary bodies amounted to HUF 7,920.6 billion in 2023, which exceeded the planned amount by 36.9 percent. Budgetary bodies received significant additional resources from transfers from the Central Residual Settlement Fund and the Public Utility Protection Fund.

For **appropriations managed by chapters,** expenditure amounted to 101,0 % of the appropriation. Significant overruns of appropriations only happened for economic, investment and railway developments aimed at maintaining economic growth.

In 2023**, the budget chapters paid** 4.2 percent more than planned for personal allowances plus contributions, and material expenses by 34.0 percent.

In 2023, HUF 1177.1 billion was spent on **supporting local governments**, which was 21.5 percent more than originally planned. Expenditures were increased by a total of HUF 102.5 billion in the 13 new grant titles created in the first half of the year and 10 more in the second half. Among the new items, the wage subsidy due to the increase in the number of nursery places and the increase in the subsidy due to the Act on the Teachers' Careers (HUF 75.8 billion) should be highlighted. The municipal solidarity contribution revenue paid by municipalities with outstanding tax capacity per inhabitant amounted to HUF 247.3 billion in 104.3% of the appropriation.

Within the **central reserve appropriations**, HUF 466.7 billion, or 90.7 percent of the planned amounts, was used. From the reallocation of the second half of the year, support for the salary increase of non-state maintainers in public education and vocational training should be highlighted (HUF 26.4 billion). HUF 253.9 billion was transferred from the **Extraordinary Government Measures** appropriation in 2023, which corresponds to 99.6 percent of the planned appropriation. Among the redeployments in the second half of the year, it should be highlighted that the costs incurred during the transformation of the primary care on-call system (HUF 10.6 billion), the provision of additional funds for the MÁV-Volán Group (HUF 25.0 billion) and the reimbursement of the development costs of the toll system review (HUF 18.4 billion). The **Investment Fund** was used in a total amount of HUF 156.5 billion, 78.3% of the original appropriation.

Among the direct expenditures of the budget**,** HUF 444.8 billion was paid under the heading of **Housing subsidies**, exceeding the appropriation by 16.1 percent. Expenses were increased by HUF 122.7 billion due to the carry-over effect of accounting for home renovation grants closed in 2022 until the first half of 2023, however, due to declining housing market demand, the size of various subsidies provided for housing construction and purchase was HUF 60.9 billion lower than the target amount.

The **Social Policy Fare subsidy** exceeded the planned appropriation by HUF 19.5 billion, amounting to HUF 124.5 billion.

The expenditures of **the National Family and Social Policy Fund** amounted to HUF 754.3 billion, which is 99.9% of the appropriation. Within this, 99.1 percent of the appropriation, HUF 404.9 billion, was paid as **family allowances**. The largest item (HUF 306.7 billion) is child benefit, where the decrease in the number of claimants had an impact on expenses. A significant amount, HUF 122.9 billion, was spent **on social tasks in districts**, exceeding the appropriation by 2.2 percent. Performance was affected by the fact that from November 2023, with retroactive effect from 1 January, the amount of several benefits was increased by 3.1 percent, in connection with the similar retroactive increases in pensions during the year.

For the cohesion operational programmes of the 2014-2020 **EU budget cycle**, **revenues** amounted to HUF 1316.5 billion, 38.8 percent higher than planned. The higher than planned revenue was mainly due to the fact that part of the Commission transfers sent during 2022 was not cleared until later, in 2023. From the appropriation of the Cohesion Operational Programmes planned for the period 2021-2027, HUF 270.2 billion was received into the budget, which means 56.3 percent completion. The reason for the backlog is that applications started late due to the delay in the adoption of operational programmes, resulting in a significant reduction in expenditure and a significant loss of revenue in connection with this. There was also no revenue from the Recovery and Resilience Facility (RRF) allocation in 2023. Together, these resulted in revenues 0.7 percent less than the target of HUF 2244.5 billion. At the end of 2023, the European Commission and ECOFIN adopted the Hungarian Recovery Plan and judicial reform, and Hungary could receive an RRF loan advance of €780 million, not affecting the budget.

In 2023, **expenditures related to EU programmes** were about 6 percent lower than in 2022, and the HUF 2812.2 billion performance was almost 26 percent lower than appropriated. In the case of the cohesion policy operational programmes of the 2014-2020 EU budget cycle, expenditures amounted to HUF 1366.7 billion, 16.5 percent higher than planned. Expenditures were increased by the postponement to 2023 of a significant share of payments planned for 2022 and the additional payments from the increased envelope for some applications. For the cohesion policy operational programmes of the 2021-2027 budget cycle, spending was 70.4% below planned, as calls planned for 2023 could not be published or could only be published later than planned. RRF expenses amounted to HUF 270.5 billion, 46.5 percent below the appropriation. This was partly due to delays and cancellations of planned calls, a decrease in investment amounts, and a long duration of evaluation and related processes. The expenditure was fully financed by the domestic budget.

Interest income related to debt service was 4.3 percent higher than planned, while **interest expenses** were 10.6 percent higher. Net interest expense was HUF 247.2 billion, 11.9 percent higher than planned, and HUF 476.8 billion higher than the balance amount for 2022. There are essentially two main reasons for exceeding the target interest expenditure: on the one hand, additional output due to higher financing needs and, on the other hand, a higher inflation and yield environment. In 2023, there is an increase of 96.3 percent compared to net interest expenses in 2021 and 31.4 percent compared to 2022. One of the main sources of high interest income is the interest paid by the MNB on the state's forint and foreign currency deposits with the central bank, on which approximately HUF 170 billion of state interest income was generated. In addition, the budget realized interest income amounting to HUF 130 billion on the issuance of forint bonds and approaching HUF 90 billion when selling retail bonds.

Accrual interest expenses increased more than cash expenditure, because the impact of high inflation in 2022 increased accruals-based expenditure already in 2023, while interest expenditure on cash flows will only increase in 2024. Based on the EDP report, accrual gross interest expense amounted to HUF 3530 billion in 2023, which is approximately HUF 500 billion higher than cash flow expenditure.

The reasons behind the strong increase in interest payments in 2023 will also have an impact on high interest expenditure in the coming years. Interest expenditure on inflation-tracking retail government securities gradually decreases after inflation moderates, which occurs after 1 year in accruals-based interest expenditures and after 2 years in cash flow expenditure.

Revenues related to state assets were fulfilled in 149.7 percent of the statutory appropriation. The higher revenues in the second half of the year were driven by MVM Zrt.'s HUF 309 billion interim dividend paid by its founders' decision dated 24 November. The revenues from quota sales amounted to HUF 167.6 billion (HUF 6.6 billion above the plan). Under the heading of priority state investments, HUF 215.5 billion of initially unplanned revenue was received into the budget from the repayments of government investment projects that had been anticipated but later stopped or rescheduled. Of the revenues related to the National Land Fund, revenues from the sale of real estate amounted to 7.9 percent of the statutory appropriation, due to the ineffectiveness of some of the real estate auction invitations put up for auction.

The 2023 appropriation for **state assets-related expenditures** – including priority state investment expenditures from 2023 – was HUF 1430.6 billion, which amounted to HUF 1750.5 billion (122.4 percent of the statutory appropriation). HUF 936.7 billion of expenses were incurred in the second half of the year. The expenditures related to the exercise of ownership rights by the Ministry of Economic Development amounted to HUF 394.5 billion (95.0 percent of the CCTV. appropriation). Of these, Corvinus International Investment Plc. received HUF 360.2 billion in funding in connection with the acquisition of the Hungarian State in Vodafone Hungary Zrt. and Posta Insurance Company (Magyar Posta Life Insurance Plc. and Magyar Posta Insurance Zrt.).

80.2 percent **(**HUF 2,069.1 billion) of the 2023 revenue appropriations of the **Public Utility Protection Fund** have been met, while 90.6 percent of its expenditure appropriations (HUF 2337.5 billion) have been redeployed.

60.7% (HUF 434.7 billion) of the appropriation was met from the **Energy sector payments appropriation,** as the tax base of the Ural-Brent differential tax, which is part of the appropriation, decreased due to the development of oil prices on the world market. 72.4 percent (HUF 241.9 billion) of the Mining Royalty allocation was fulfilled as a result of the provision providing more favorable tax conditions for mining entrepreneurs.

Resources were transferred from the expenditure appropriations of the Public Utility Protection Fund on the basis of 31 government decisions. While in the first half of the year transfers were mainly made from appropriations for household utility protection, compensation for local governments and support for church and civil institution maintainers, in the second half of the year central budgetary bodies and state-owned and competitive companies could receive higher amounts of support.

The revenues of the **Separated State Funds** were 102.9 percent (HUF 777.8 billion) and expenditures 112.2 percent (HUF 665.6 billion) compared to the statutory appropriation. The balance of these amounted to a surplus of HUF 112.3 billion, which was HUF 50.4 billion below planned. In 2023, the balance of all five funds deteriorated compared to the plan, with the largest amount of HUF 31.5 billion at the National Employment Fund. The loss of income on the reimbursement of expenditure under pre-financed EU programmes and on the part of social security contributions due to the National Employment Fund, as well as additional expenditure on appropriations for passive expenditure, jobseeker's allowance and wage guarantee payments, contributed to the reduction in the balance of this Fund. In addition, HUF 89.1 billion spent on other expenses was 54.4 percent more than appropriated. Over-implementation was largely due to employment and training grants due to the temporary advance payment of unreceived EU funds from this fund and the use of higher own revenue than planned. The increase in wage guarantee items by mid-year legislation also contributed to the increase in expenditure.

The **Pension Insurance Fund** incurred a deficit of HUF 327.8 billion. Two-thirds of the deficit occurred in the second half of the year. A significant part of the deficit was due to the pension increase in November, as it did not go hand in hand with an increase in the income estimate. The revenues of the Fund amounted to HUF 5439.4 billion, 97.9% of the statutory appropriation. The 2.1 percent revenue gap was reflected in tax and contribution revenues, as gross wage and earnings growth in 2023 fell short of planned. Expenditures amounted to HUF 5767.2 billion, which exceeded the appropriation by 3.8 percent (HUF 212.7 billion). The additional expenditure for 2023 mainly came from the pension increase in November, the additional expenditure of the 13th month pension due to the retroactive pension increase in November.

The revenues of the **Healthcare Fund** were 99.9 percent (HUF 4028.7 billion) and expenditures 102.0 percent (HUF 4113.2 billion). The revenue shortfall of HUF 4.6 billion was mainly due to tax and contribution revenues, as wage and salary growth did not reach the planned rate. The revenue shortfall was reduced by the additional revenue resulting from the more favorable development of the turnover of the taxable product range in the case of the public health product tax and from the increase in the tax rate for pharmaceutical manufacturers' payments. The expenditure of the Health Insurance Fund in 2023 of HUF 4,113.2 billion exceeded the target by 2.0 percent (HUF 79.9 billion) by the end of December. 58.6 percent of expenditures came from spending on curative and preventive care, which exceeded the appropriation by HUF

104.5 billion (4.5 percent). The additional expenditure of 19.3 percent of the target appropriations, which was used for reimbursements based on equity, wage increases for health care workers, income supplements and the settlement of supplier debts, which was made possible by the increase in appropriations carried out under the authority of the Government and the Minister.

Budapest, 16th of April, 2024.

György Matolcsy
Member of the Fiscal Council

László Windisch
Member of the Fiscal Council

Gábor Horváth
Chairman of the Fiscal Council