STATE AUDIT
OFFICE OF HUNGARY

S U M M A R Y

Findings and Conclusions of the SAO Opinion on the Budget Bill of Hungary for 2013

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SUMMARY FINDINGS

Breaking with earlier practice, the **Government** has brought the **deadline for submitting** the budget proposal to the National Assembly forward from 30 September as stipulated by law to **15 June**. As a consequence, the auditing possibilities of the State Audit Office of Hungary (SAO) have also been significantly modified. As a result of the Government's decision, the already completed audit programme as well as audit assignments had to be altered. At the same time, we prepared our opinion on Hungary's 2013 budget appropriation bill in accordance with legal provisions.

The 2013 budget has been prepared in an uncertain international financial, economic environment that is unfavourable for Hungary. The financial difficulties of certain eurozone member states increase the uncertainty of money markets, which represents external risk for Hungary.

The **set-up and structure of the bill** is in compliance with the statutory criteria defining the financial management and operation of public finances, as well as the regulations contained in the new Constitution and the Stability Act pertaining to the decrease of public debt. The bill contains provisions on the reserves for extraordinary government measures and special reserves as well as the Country Protection Fund. However, there are deficiencies in the **statutory background** serving as basis; certain tax laws or the government decree regulating the social policy benefits for transport fares, replacing consumer price subsidy, have not been prepared yet.

Hungary's 2013 budget appropriation bill calculates with a total expenditure of HUF 15,477.0 billion, and a total revenue of HUF 14,799.7 billion. **Our audit covered 88% of total revenue and 82% of total expenditure.** Our assessment was based on our new methodology, according to which relevant revenue and expenditure appropriations are taken as the basis. The revenue appropriations can be considered substantiated if they are feasible and properly supported. In the case of expenditure appropriations, substantiation is sufficient. The establishment of appropriations contained in the bill and the calculations supporting them were made on the basis of economic indicators in accordance with the annex containing the general explanation. We assessed the substantiation of the various appropriations based on these indicators. At the same time, the **macro-economic path** presented in the bill or the **unfavourable development** of certain economic indicators, deviating from expectations, **could represent a risk** even in the case of the realisation of appropriations otherwise qualified as substantiated by the SAO. The slowing of world economic growth processes and the crisis phenomena of the euro area are projecting a drop in 2012 tax revenues and an increase in expenditures. This tendency can already be observed in the cash flow processes of the first five months of public finances[1].

The **2012 macro-economic conditions** that served as the basis for outlining the 2013 macro-economic path were less **favourable than projected, therefore they represent a significant risk** in terms of meeting the 2013 budgetary targets. In order

[1] The risks identified based on data from the first five months of 2012 are shown in Appendix 1.

to reduce these risks, freezing part of the reserves in 2012 was a correct decision. In order to keep the 2013 appropriations, the consequent implementation of planned revenue-increasing and expenditure curbing measures are necessary.

The planned **deficit** of the **central subsystem** of public finances is HUF 677.3 billion, which **exceeds the amount planned for 2012 by 18%**. The highest risk in 2012 with respect to keeping the deficit target is whether the economy can be kept in a state of near-stagnation; whether the economic recession of the first quarter turns into growth from the second half of the year. The risk for 2013 is primarily the keeping of the planned growth rate of export. The 2013 financing concepts, regarding the planned central budget deficit, the continuous liquidity of the Single Treasury Account as well as the advances, are arithmetically elaborated and supported. The 2.2% deficit target with the 1.6% GDP growth planned for 2013, as set out by the bill, can be maintained.

The 2013 budget appropriation bill **contains the rate of public debt i**n accordance with the provisions of the Stability Act,. The consolidated aggregate debt of public finances as expected at the end of 2013 is [1] HUF 23,573.3 billion. The value of the public debt indicator at the end of 2013, calculated with the GDP in the government projection, is 76.8%. According to the formula set out by law, this complies with the requirement of indicator decrease (the debt indicator calculated for the end of 2012 is 78.0%). The reduction of public debt continues to require **disciplined fiscal policy and the generation of significant reserves**.

The planned appropriations of **tax revenues** are not comprehensively supported by detailed calculations in the 2013 budget appropriation bill; furthermore, certain legal regulations were missing or some bills were yet to be passed by the National Assembly. Of the tax revenues of the budget, **58% are substantiated**, 12% are partially substantiated and 30% are unsubstantiated.

Based on our audit experience, we qualified 30% (HUF 303 billion) of the budget payments of economic organisations as substantiated, including the special tax of financial organisations, the mining rent, ecotax, the income tax of energy providers, the rehabilitation contribution and the special tax of the various sectors. Among the taxes linked to consumption, we qualified VAT and excise duty appropriations that amount nearly to 91% (HUF 3739.5 billion) of revenues as substantiated.

Partially substantiated [2] **qualification was given to 47%,** HUF 472.4 billion, **of the budget payments of economic organisations** (corporate income tax, gambling tax, other payments); as well as 2%, HUF 96.5 billion, of taxes linked to consumption (telecommunications tax, insurance tax); 9%, HUF 154.5 billion, of payments by private individuals (duties paid by the population, vehicle tax), and other budget revenues (HUF 117.4 billion). The partially substantiated assessment was related to the insufficient supporting of the appropriations, however, based on last year's trends and the projected

[1] Aggregate data for the central subsystem, the municipal subsystem and the government sector.

[2] Feasible and partially supported.

amounts, these are still feasible. The calculation required for new taxes as well as the statutory background required for their introduction have been completed[1].

Of the tax revenues, we qualified 23% (HUF 225.3 billion) of payments by economic organisations, including credit institution contribution, company car tax and simplified entrepreneurial tax as **unsubstantiated**[2]. Of taxes linked to consumption, also unsubstantiated are the registration tax (HUF 15.0 billion), the financial transaction levy (HUF 283.0 billion) and **among budget payments by the population, 91% (HUF 1541.4 billion) of personal income tax**, other household taxes and the special tax related to private individuals' termination of employment. We also qualified the HUF 75.0 billion amount of electronic road toll revenues as unsubstantiated. In the case of appropriations qualified as unsubstantiated, the required legal regulations for introducing the given revenue types were missing, planning basis was not appropriate, certain calculations and documents were missing, therefore, the revenue cannot be realised.

Of the **direct expenditures** of the central budget, **56%** (HUF 1261.6 billion) was **substantiated**, 37% partially substantiated and **7% unsubstantiated**.

We qualified as **substantiated** the interest subsidy of the Student Loan 2 scheme, the enforcement of guarantees and counter guarantees undertaken by the state, as well as extraordinary government expenditures, the guarantee and contribution to social security services and the costs of claims management.

We qualified as **partially substantiated** the appropriations of current support of enterprises, housing subsidies, other budgetary expenditures and international accounts. The partial substantiation is related to the uncertainties of the forms of support established on the basis of the agreement between the Government and the Banking Association, as well as incomplete background calculations and the lack of documentation.

We qualified as **unsubstantiated** the social policy benefits for transport fares, replacing consumer price subsidy as of July this year, because the implementing legislation is missing[3].

In the chapter on revenues and expenditures of the **debt service**, the HUF 1325.5 billion amount of the 2013 interest cost appropriation is **14% higher than the 2012 appropriation**. This increase is due to the higher than expected planned rate of market financing.

The conclusion of the loan agreement with the IMF/EC as planned by the Government could have direct as well as indirect effects on the rate of interest and debt management expenditures. Indirect impact can be achieved by reducing interest premiums and

[1] The National Assembly has yet to pass the bills on the financial transaction levy and the insurance tax.

[2] Not feasible and unsupported.

[3] According to information from the Ministry for National Economy, the preparation of the relevant government decree is in progress at the Ministry of National Development.

strengthening exchange rates, or the amount of interest costs could be reduced directly if the loan is drawn with interest that is more favourable than the market yields.

The **amount of revenues related to state property** (HUF 37.8 billion) is **fully substantiated**, while **46% of the expenditures** related to state property (HUF 113.0 billion) are **unsubstantiated**. Within the above, this qualification was given to real estate purchases performed by the Hungarian National Asset Management Inc. (HUF 33.0 billion), the funding provided to state-owned companies (HUF 7.3 billion) and the appropriation serving as financial incentive for employees of the MÁV Group (HUF 11.6 billion).

The amount of planned **revenues** (HUF 11.8 billion) **related to the National Land Fund**, which is part of state property, and the planned **amount of expenditure** (HUF 18.7 billion) are **substantiated**. The appropriation ensures sufficient funding to perform the tasks.

The amount of the central budget **reserves** of the bill is HUF 300.0 billion, which is 83% of the 2012 appropriation and 149% of projected utilisation in 2012.

An appropriation of HUF 100.0 billion was planned for extraordinary government measures, which amount represents 0.6% of the total expenditure of the bill on the central budget. This is in line with the rate set out by statutory provisions[1].

In its opinion on the draft bill, the **Fiscal Council recommended raising** the HUF 50.0 billion **appropriation** for the **Country Protection Fund**. The bill fulfils this requirement, and the amount for the Country Protection Fund in the bill is HUF 100.0 billion.

In our opinion, the fact that the 2013 appropriation of the **Country Protection Fund** is HUF 70.0 billion lower than its 2012 appropriation constitutes a risk. Another risk is that the bill contains no separate interest risk reserve, as opposed to the 2012 budget act, which appropriated HUF 98.00 billion for this purpose. In 2012, the appropriations of the Country Protection Fund and the interest risk fund will probably have to be spent entirely on offsetting revenue losses and expenditure increases that are the result of the increasingly unfavourable macro-economic situation. **Compared to the base**, therefore, the **amount of reserves that could be used to offset macro-economic risks will drop by HUF 168.0 billion**, while global economic uncertainties endure.

When assessing the situation, we must take into account that the bill determines the **appropriation for interests payable after public debt** by assuming the 80 basis point drop in average yield. However, a grater increase could be achieved in 2013 compared to 2012, if the agreement between Hungary and the IMF/EU is concluded. This represents a sort of implicit reserve in the 2013 budget.

An **argument against the further increase of the Country Protection Fund** is that for the most part macro-economic risks are related to domestic utilisation; and

[1] According to Article 21 (2) of the Act on Public Finances, the appropriation for the reserve for extraordinary government measures cannot exceed 2% of the total expenditure of the Act on the Central Budget and cannot be lower than 0.5% of said total expenditure.

raising the Country Protection Fund appropriation further would actually narrow down domestic consumption and accumulation opportunities. In light of this, we do not recommend the further increase of the Country Protection Fund in spite of the risk.

The audit covered 11 chapters. Comprehensive, detailed background calculations were made by the Ministry of Defence, the Ministry of the Interior and the Ministry of National Development. The bill approved the additional demands of audited chapters in an amount of HUF 120.8 billion. The security of the performance of tasks assigned to these chapters was increased by additional funding.

In the interest of ensuring the 2012 and 2013 fiscal deficit targets, the chapters implemented the measures contained in the relevant government decisions. All chapters concerned took structural changes and levelling into account. The bill includes already approved structural changes, as well as the tasks reallocated between the various chapters and corresponding appropriations.

The planned **total revenue** of the 2013 budget of **audited chapters** is HUF 1191.1 billion, while the **total expenditure** is HUF 3831.1 billion, **77% of which was audited by SAO.** We qualified 49% of audited **revenue appropriations** and 86% of **expenditures** as **substantiated**. We qualified 51% of revenues and 15% of expenditures as partially substantiated.

Of the chapters in question, the Prime Minister's Office, the Ministry of Rural Development, the Ministry of Human Resources and the Ministry of Public Administration have generated reserves in order to decrease risks. **In 2012, the chapters had chapter-specific balance-ensuring reserves**, the rate of which amounted to 1-5% of their total expenditures. In our opinion, the fact that **only four chapters planned for chapter reserves represents a risk**. The factual data from the past seven years show that chapters regularly attempt to use the appropriations for extraordinary government measures (previously general reserves) to generate funds for expenses that, though were known at the time of planning, have not been planned. Furthermore, as a result of interim blockings and the obligation to retain residual amounts, there are no funds for this purpose at the chapters. This practice, however, is irregular. (Since 2005, the SAO has objected to this during the audits of the final accounts in every single year.) According to the provision in Article 21 (1) of the Act on Public Finances, the reserves for extraordinary government measures must be planned for budgetary expenditures that cannot be anticipated and planned for, and replacing appropriated revenue losses due to unavoidable reasons. In our opinion, the **central reserves** only **provide appropriate cover for unplanned expenditures** that **must be implemented in conjunction with chapter reserves**.

The central budget resource part of the **EU grants** mentioned in the bill is HUF 258.4 billion, which according to plans will be supplemented by EU funds of HUF 1555.9 billion. The planned amount of the contribution to the EU budget for 2013 is HUF 283.6 billion, which represents 107% of the original appropriation of the previous year. Implementation may deviate from the appropriation without a separate regulation, thus ensuring the feasibility of the payment of Member State contribution.

The fact that the utilisation of EU funds is below the 2012 pro-rata performance represents a risk. The approved limit must be committed by the end of 2013 in the interest of the 100% utilisation of EU funds.

The planned expenditure appropriation of **separated state funds** for the year 2013 is HUF 435.1 billion. The expenditure and revenue appropriations of the Innovation Fund for Research and Technology are partially substantiated. The innovation contribution representing 93.9% (HUF 47 950.0 million) of the revenue appropriation is an estimate; the background calculations, arising from the statutory change and the termination of allowances, are missing. The expenditure appropriation of the National Employment Fund is only partially substantiated due to the lack of calculations.

The total revenue and total expenditure of the 2013 budget of the **Pension Insurance Fund** is HUF 2874.5 billion. The planned total expenditure and revenue of the Pension Insurance Fund is substantiated. The bill calculates with an inflation-indexed pension raise of 4.2%. Should the development of inflation deviate from the calculated value in any direction, it would represent a risk. The substantiated cover of pension expenditures, which amount to 97% (HUF 2777.5 billion) of total expenditure appropriations, is ensured through budgetary contributions built into the total revenue. The fund's budget can be realised – if the indicators of the macro-economic path considered during planning remain unchanged. The main appropriations are in line with the Széll Kálmán Plan and the Convergence Programme.

The **total revenue** of the 2013 budget of the **Health Insurance Fund** is **HUF 1649.4 billion**, its **total expenditure is HUF 1675.0 billion**, while the **balance** of the budget is **HUF 25.7 billion deficit**.

The Health Insurance Fund's revenues can be realised – if the revenue indicators of the macro-economic path considered during planning are also achieved. Income-based contribution revenues represent close to 45% of 2013 revenues. Of the revenues of the Health Insurance Fund, 37.5% are funds transferred from the central budget and the Pension Insurance Fund for the purposes of disability provisions, which given their nature, are not considered risky. Within other revenues, HUF 30.0 billion has been determined for payments by pharmaceutical companies and distributors.

For **therapeutic and preventive care**, the bill **ensures 50%** of the Health Insurance Fund's planned **expenditures**. The total amount of financial allocations, determined for 2013 financing, is HUF 833.5 billion, which is HUF 8.6 billion more than the amount of the original 2012 appropriation. When planning therapeutic and preventive care, structural changes, levelling, the fund requirements of additional capacities accepted and developments were all taken into account. The amount of the planned appropriation includes HUF 4.6 billion for the additional capacities accepted and HUF 0.7 billion for developments. The **amount planned for cash benefits**, that make up one third (HUF 558.3 billion) of the total expenditure of the Health Insurance Fund, can be realised.

The most significant change is planned in the **pharmaceutical subsidy** title. As part of this change, funding provided to the legal title has been decreased by 29% compared to the original 2012 appropriation. The feasibility of reducing pharmaceutical subsidy carries uncertainty due to the scheme change. The reduction of the appropriation is not supported by regulatory concepts or background calculations. Further uncertainty may be caused by changes in prescription and consumer behaviour if the household compensation system remains unchanged.

The 2013 central budget provides HUF 647.2 billion for the financial management of local governments. This is 60.7% of the amended appropriation for 2012 (HUF 1066.9 billion). **The support provided to the local government subsystem is 4.2% of the total expenditure** (HUF 15 477.0 billion) **of the 2013 budget; and it is 2.8 percentage point lower than the value of the previous year.**

The performance of local government tasks, along with the system of financing, will change fundamentally as of 2013. Some of the tasks previously performed by local governments will be taken over by the state (the Ministry of Human Resources and Ministry of Public Administration and Justice chapters). The redistribution of tasks will appear in public education and the social and administration sectors alike. The reorganisation of tasks significantly impacts the amount of funds, planned in the 2013 budget and provided to local governments from the central budget.

Parallel to these changes, the regulation of funds will also be transformed with respect to the remaining tasks. The financing structure of the local government support chapter will break away from the current normative grant system; it will follow the logic of sectoral-professional acts in structure and will introduce task-based financing in the case of certain public services.

Of the subsidy appropriation of local governments, **6,6%** (HUF 43.0 billion) is **substantiated**, **62.7%** (HUF 405.9 billion) **partially substantiated** and **30.7%** (HUF 198.4 billion) **unsubstantiated**.

We **qualified as substantiated** the centralised appropriations available to local governments as well as force majeure funding.

We **qualified as partially substantiated** the appropriations for subsidies of the sectoral tasks of local governments as well as intended user and target subsidies.

We **qualified as unsubstantiated** the subsidies of the general operation of local governments and the supplementary subsidies of local governments.

The transformation of the structure and financing of the local government subsystem and the reorganisation of related funding has not been completed at the time the bill was submitted. HUF 464.4 billion of funds have been withdrawn from the subsystem. The background calculations supporting this have been completed – with the new task sharing taken into account –, however, they do not comprehensively take the changes and their impact into account. Therefore, it poses a risk that the unsubstantiated withdrawal of funds does not affect the various groups of local governments in proportion to the reduction of tasks. All in all, it is unclear whether the performance of tasks and the financing are aligned. The bill appropriates a reserve of HUF 85.6 billion for the management of the uncertainty factors of task reorganisation, which, however, cannot be utilised until tasks have been redistributed on the basis of tenders. This means the financing opportunities of local government tasks narrow down. As a result, the conditions of task performance by local governments are not ensured comprehensively and continuously, which in turn endangers viability. However, the reserves available to manage these can only be utilised from May 2013 at the earliest and only for purposes defined by the government.

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With its opinion on the budget appropriation bill, the SAO – in accordance with the provisions of Article 1(4) of the Act on the State Audit Office of Hungary – strives to assist the work of the National Assembly through its observations based on audit experience.

Through the itemised qualification of the substantiation of budgetary appropriations, the SAO opinion points out the risks that still exist in the current phase of the budget approval process. With the above, it calls on decision makers to reduce these risks through a more detailed assessment of the impact of planned measures, by adopting further legal regulations, amending certain appropriations and creating further reserves; thereby, being able to pass a Budget Act that accomplishes the debt reduction set out in the Fundamental Law and the Stability Act with greater security.