STATE AUDIT
OFFICE OF HUNGARY

S U M M A R Y

Findings and Conclusions of the Audit on the Execution of the Budget of the Republic of Hungary for the Year 2011

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SUMMARY FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

The **execution of the 2011 budget** – according to our findings and experience – was **in compliance with the legal provisions**. The detected errors had no effect on the reliability of the final accounts.

The original revenue appropriations of the central and local government subsystems of public finances in 2011 amounted to HUF 16,284.2 billion, the expenditure appropriations amounted to HUF 17,081.6 billion and the budgeted deficit was HUF 797.4 billion. The deficit budgeted for 2011 equalled 2.8% of the GDP, but actual deficit was HUF 1,598.1 billion, equalling 5.7% of the 2011 GDP. The various components of public finances contributed to the deficit increase to different degrees, the central budget deficit was a major contributor, however.

The deficit of the subsystems of public finances in 2011, on a cash basis (HUF billion)

Name	Original appropriation	Actual figure	Difference
Central budget	-613.3	-1 727.1	-1 113.8
Separated state funds	14.6	69.2	54.6
Pension Insurance Fund	0.0	-0.2	-0.2
Health Insurance Fund	-88.7	-83.4	5.3
Central subsystem	**-687.4**	**-1 741.6**[1]	**-1 054.2**
Local government subsystem[2]	-110.0	143.5	253.5
General government total	**-797.4**	**-1 598.1**	**-800.7**

The **budget of the central subsystem of public finances** integrates the appropriations of the central budget, the separated state funds and the social security funds. In the Act on the Budget, the National Assembly has set the total revenue of the central subsystem of public finances at HUF 13,151.2 billion, its total expenditure at 13,838.6 HUF billion and its deficit at HUF 687.4 billion. In the acts on the amendment of the Act on the Budget, as of 30 December 2011 the

[1]The HUF 0.1 billion difference that results from the aggregation of the partial amounts is the result of rounding off.

[2] Without loan and security transactions.

total expenditures in the central budget changed to HUF 14 551.4 billion, total revenues to HUF 12,974.2 billion and the deficit to HUF 1577.2 billion[3].

The **central budget deficit** reached 2.8 times the original appropriation, exceeding the amended amount as well. The deficit indicator was budgeted at 2.2% of the GDP in the act submitted to the National Assembly, but the actual figure was 6.2%. The unfavourable change in the indicator was the result of the lower than expected growth of the GDP (HUF 28,080.3 billion)[4]and the one-off expenditure items of the central budget. The major components of the budget deficit, 89.3% thereof, were the MOL share purchase (HUF 498.3 billion), the VAT refund required by the decision of the European Court of Justice (HUF 250.0 billion), and the loans assumed from the county local governments, the Municipality of Budapest and MÁV Co. Ltd. (Hungarian State Railways) (HUF 246.0 billion). The central budget deficit amounted to 2.6% of the GDP (HUF 732.8 billion) without the one-off expenditure items, which is more favourable than the originally budgeted amount.

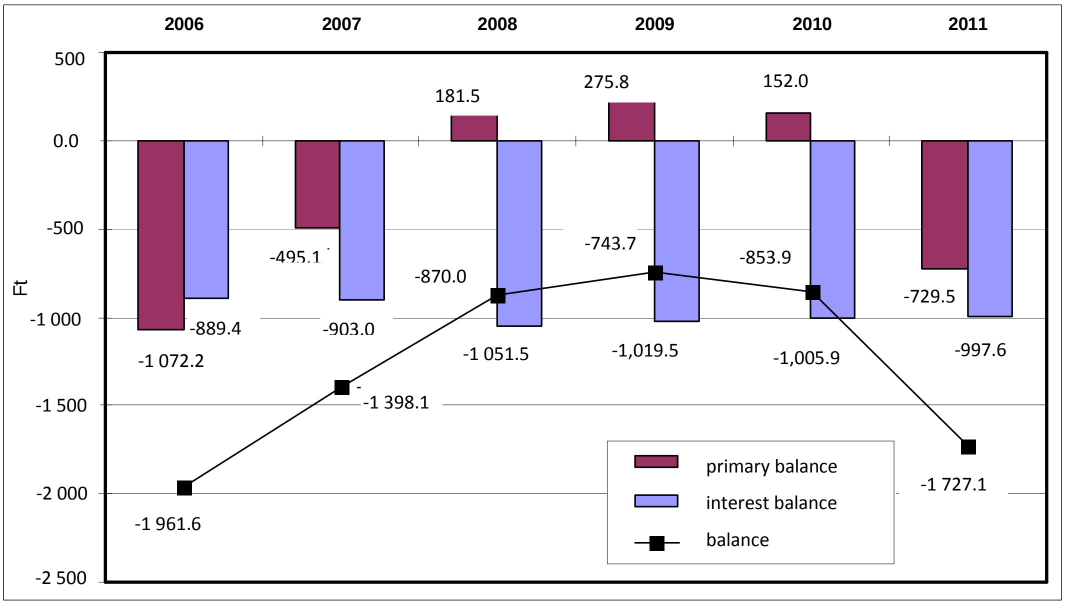
Within the aggregate deficit of public finances the central budget deficit was partially compensated by the balances of the separated state funds, the Health Insurance Fund and the local government subsystem, which were more favourable than expected. The surplus of the separated state funds was 4.7 times the budgeted amount. In the local government subsystem, instead of the budgeted deficit, the surplus that was generated was the result of the debt assumption by the central budget.

An important indicator in the **assessment of fiscal sustainability** is the **so-called primary balance**, which expresses the result of the current financial management, and takes into account the expenditures without the interest burden of the debt accumulated in the past. If the balance is negative, the expenditure of the central budget without debt service exceeds its revenues. The primary balance of the central budget in 2011 was unfavourable, it was negative (HUF -729.5 billion). Without the one-off expenditure items (MOL share purchase, decision of the European Court of Justice, debt assumptions), the primary balance was HUF +264.8 billion.

[3] These data are included in the bill on the final accounts of the Ministry for National Economy of Hungary, and are different from the revenue and expenditure appropriations, specified under Article 1 of the Act on the Budget, effective as of 30 December 2011.

[4]When the 2011 budget was submitted, the current rate of the GDP was budgeted at HUF 28,440 billion.

Development of the central budget balance



The **gross debts** of the **central budget** amounted to HUF 20,955.5 billion at the end of 2011, which was 0.5% (HUF 101.2 billion) higher than planned. Compared to the data at the end of 2010, the gross debts of the central budget increased by HUF 914.5 billion.

This increase was primarily due to exchange rate losses (to the amount of HUF 1193.4 billion). As part of handing over the assets of those reverting to the social security pension system from the private pension system, in 2011 government securities in the amount of HUF 1407.1 billion were transferred to the Pension Reform and Debt Reduction Fund, and were used to reduce the debt of the central budget.

Within the framework of our audit of the final accounts, we **qualify the planning work regarding the subject year** by reporting on implementation. We identified various risks during the planning of the 2011 revenue and expenditure appropriations of the central budget. The audit qualified 6.2% (corporate tax, credit institution contribution) of tax revenue appropriations as high risk, 14.5% (excise duty) as medium risk and 46.2% (e.g.: value added tax) as feasible. Due to lack of information, we were unable to assess the feasibility of 33.1% of tax revenue appropriations (simplified entrepreneurial tax, crisis taxes, personal income tax, duty payments). The SAO opinion was 98.7% confirmed, mostly due to a more unfavourable development of macro-economic processes than planned.

The **most significant revenues** of the central budget were generated from tax and tax-type revenues. Within the framework of our audit of the final accounts, we have found that the tax and tax-type revenues collected (such as corporate income tax, credit institution contribution, value added tax, excise duty, levy revenues) were lower than the original appropriation. The shortcoming was mainly the result of the judgement by the European Court of Justice, as a result of which HUF 250.0 billion had to be refunded in value added taxes.

Name	Original appropriation (HUF billion)	Adjusted appropriation (HUF billion)	Actual figure (HUF billion)	Actual figure - original (HUF billion)	Actual figure - amended (HUF billion)
Payments by business organisations	1 282.6	1 182.6	1 210.2	-72.4	+27.6
Consumption-related taxes	3 471.4	3 402.4	3 132.3	-339.1	-270.1
Payments by households	1 452.8	1 446.2	1 462.0	+9.2	+15.8
Total tax and tax-type revenues	**6 206.8**	**6 031.2**	**5 804.5**	**-402.3**	**-226.7**

Tax revenues are also influenced by the changes in arrears. By the end of 2011, the arrears managed by the National Tax and Customs Administration dropped by 3.9% (to HUF 2268.2 billion) compared to the 2010 closing value. The tax arrears under the scope of responsibility of the tax department decreased by 14.9% compared to 2010.

Expenditures of the central subsystem mostly comprise the expenditures of the central budgetary institutions (chapters) and the appropriations managed by them, the social security funds and the separated state funds, as well as other items, related to debt service, assets and EU accounts.

Under expenditures, the so-called **'uncapped' expenditure appropriations may carry a risk**, because the actual spending thereof may differ from the appropriation without modification. At the same time, in 2011 no risks materialised in connection with these appropriations, because expenditures were lower by 7.6% (HUF 624.8 billion) compared to the modified appropriations.

The **EU funds** appearing in the Hungarian budget of 2011 were realised in the amount of HUF 913.0 billion[5], which was 21.7% (HUF 253.7 billion) lower than planned. The contribution to the EU budget amounted to HUF 233.0 billion.

The overall commitments fulfilled within the 2007-2013 programming period under the operational programmes of the **National Strategic Reference Framework** from 2007 until the end of 2011 fell short of the pro-rata figures,

[5] Taken together with the subsequent recovery of EU grants (HUF 22.9 billion).

reaching 66% of the HUF 8209.3 billion[6] (EUR 29.3 billion) available to Hungary, which corresponds to HUF 5415.9 billion. Absorption rates were adversely affected by the funds that were released as a result of projects that were removed from EU financing due to an irregularity, or projects that have been cancelled from the action plans. The cumulative payments made for operational programmes fell even shorter from pro- rata delivery, reaching only 28.3% of the overall amount available which corresponds to HUF 2322.9 billion[7]. The remaining 71.7% has to be paid by the end of 2015.[8] Based on commitments and payments fulfilled until now, the **risk of loss of funds is high in case of several operational programmes**.

In the case of the **New Hungary Rural Development Programme**[9], the fulfilment of commitments is close (76.6%) to pro-rata performance. The execution of payments, however, falls short of pro-rata performance, and reached 44.6% of the total allocation, HUF 656.3 billion, in the period between 2007 to the end of 2011. The **risk of loss of funds is high** in the case of the New Hungary Rural Development Programme's Axis IV, **LEADER**, given that commitments amounted to 29.7% (HUF 22.7 billion) of the available HUF 76.4 billion (EUR 273.2 million), while payments amounted to 9.9% of total allocations, HUF 7.6 billion[10].

The actual total revenues of the **Social Security Funds** amounted to HUF 4451.7 billion; while total expenditures reached HUF 4535.3 billion. The 2011 deficit of the social security funds (Pension Insurance and Health Insurance Fund) was HUF 83.6 billion, of which the deficit of the Health Insurance Fund amounted to HUF 83.4 billion (99.8%). The deficit of the Health Insurance Fund was HUF 5.3 billion lower than originally planned. The more favourable deficit figures were reached in spite of the fact that during the year unplanned governmental measures (ad-hoc wage supplements, debt consolidation support, responding to a temporary shortage in pharmaceutical supply) incurring HUF 33.1 billion in additional expenditure were also carried out.

The expenditures of the Funds are used to finance health insurance and pension insurance services. 99.3% of the total expenditures of the Pension Insurance Fund were spent on pension payments, which was 0.9% (HUF 3,028.1 billion) below the appropriation set forth by law. The appropriation also provided coverage for the additional November (0.5%) pension increase (HUF 14.5 billion) which was not planned for in the appropriation.

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[6] Total amount of EU commitments available and the related Hungarian co-financing.

[7] Source: NDA certificate.

[8] The government took measures in order to accelerate payments in Government Decree No. 1423/2011 (XII.6.). The decree set out deadlines between December 2011 and 15 January 2013; the implementation of tasks is in progress.

[9] As of 2012, the Darányi Ignác Plan.

[10] Source: Financial allocation based on the Financial Plan of the 7 March 2011 version of the New Hungary Rural Development Programme, whereas the sources of the total amount of EU commitments available and the related domestic co-financing, and the performance data are the certificates issued by the Ministry of Rural Development to the SAO.

The budgetary impact of the majority of the **measures of the Széll Kálmán Plan**, announced in March 2011, is expected in 2012. Two measures affected the 2011 financial management. Instead of the HUF 3.0 billion in savings planned through the decrease in sick pay expenditures, significantly more, HUF 14.0 billion was reached. Instead of the HUF 12.0 billion in savings expected from the changes in services for disability and damage to health, actual savings as compared to the appropriations amounted to HUF 2.2 billion, which were not the result of legislative measures, rather caused by other reasons. Of the twenty programme items with deadlines of 1 January 2012, fourteen were fully and three partially implemented. Among the priority areas affected by deadline delays was the review of the disability pension scheme[11], the establishment of the new sustainable pension scheme and the measures to transform community transport.

The reallocation of the **appropriation of the reserves to cover extraordinary governmental measures** – in line with the experience of audits on the final accounts of recent years – was performed in several instances (in an amount of HUF 19.5 billion, representing 20.8% of the annually reallocated appropriation) in a manner that diverged from the conditions set out in the relevant legislation. That is because the additional funding needs[12]of the chapters were foreseeable and budgetable. The utilisation of reserves contrary to legal regulations could have been avoided with more circumspect budgeting and better foresight for blockings.

In order to establish the balance of public finances, the Government set out blocking, payment, reserve accumulation and residual amount retaining obligations as well as imposed a ban on procurement and contracting. The blocked amounts (HUF 214.2 billion) were permanently withdrawn, and the National Assembly did not authorise the utilisation of generated reserves. 8.1% (HUF 17.4 billion) of blockings affected the expenditure appropriations of administrations; 40.2% (HUF 86.1 billion) affected chapter-managed appropriations; and 51.7% (HUF 110.7 billion) affected institutions. The data clearly show that **the blockings primarily affected the institutional level**. The impact of blockings further exacerbated the financial management difficulties of institutions with high volumes of debt. In spite of all this, the institutional system remained viable and operational. The ban on procurements and new contracts resulted in savings on the expenditure side, however, as a result of curbing capital expenditures, assets were not replaced. It has been a discernible trend for years that – in order to push the central budget deficit in a more favourable direction – the measures taken by the current government created an increasingly higher residual amount at the chapters. The end-of-year

[11] The adoption of the legislation and establishment of the institutions necessary for the new system of disability classification have not occurred until 1 July 2011. Act CXCI of 2011 on the benefits for persons with changed working capacity and amendments of certain other acts was passed at the end of the year.

[12]The facts from the past seven years show that chapters regularly attempt to use the appropriations of reserves for extraordinary government measures (previously general reserves) to generate cover 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.

residue amounted to HUF 481.4 billion in 2009, HUF 528.7 billion in 2010 and HUF 556.4 billion in 2011.

We issued approving opinions for the **financial statements of audited budgetary institutions and chapter-managed appropriations** — with the exception of the chapter-managed appropriations of the National Development Agency and the EU developments chapter —, to which we added emphasis of matter paragraphs in the case of 7 chapters and 2 budgetary institutions (in the case of the administrative titles and chapter-managed appropriations of the **Ministry of the Interior**, the **Ministry for National Economy of Hungary** and the **Ministry of National Resources** chapters, the administrative titles of the **Ministry of Rural Development** and the **Ministry of National Development** chapters; the chapter-managed appropriations of the **Ministry of Public Administration and Justice** and the **Ministry of Foreign Affairs** chapters, as well as the financial statements of the **Hungarian Intellectual Property Office** and the **Hungarian Energy Office**). In the period under review, the reliability of the financial statements improved significantly. The number of financial statements given a qualified opinion decreased perceptibly compared to 2009 and 2010.[13] Chapter-managed appropriations were utilised for the objectives set. The findings resulting from the audit of the budgetary institutions were predominantly related to the categorisation errors revealed during the audit of the books, irregularities found related to the payments booked under personal allowances, employment under an agency relationship, countersigning of a commitment, and the irregular utilisation of residuals.

In order to increase the audit coverage of the 2011 final accounts, the institutional chapters of the Ministry of the Interior have been fully included in the audit [14]– with one exception –, and the regularity of financial management was rated for every budgetary title.[15]

In the course of the financial (regularity) audit, based on the detected errors, the SAO added a limited opinion to the 2011 annual report of the **National Development Agency**. The National Development Agency prepares a summary report on the utilisation of the **chapter-managed appropriations of the 'EU Developments' chapter**, which is supported by 32 partial general ledger statements, because the aggregation of the general ledger statements is not

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[13] In 2009, 10 statements received limited qualifications, and 3 statements received adverse opinions. In 2010, 10 statements received limited qualifications, and 2 statements received adverse opinions.

[14] Due to reasons of cost-efficiency, we did not include the No. 6 low total expenditure, uni-institutional budgetary title of the Law Enforcement Management Training and Research Institute of the Ministry of the Interior in our audit.

[15] An approving opinion was issued for the following titles: Title 2: National Defence Service, Title 8: Constitution Protection Office, Title 9: National Security Service, Title 12: National Directorate General for Disaster Protection, Title 13: Office of Immigration and Nationality and Title 15: International Training and Civilian Crisis Management Centre. We have added an emphasis of matter paragraph to our approving opinion for the following titles: Title 4: Counter Terrorism Office, Title 5: Hungarian Prison Service, Title 7: Police, Title 10: Coordination Centre Against Organised Crime, and Title 11: Police College.

possible in the accounting system. The practice is not in compliance with the provisions contained in Articles 7 (5) and 50 (1) of the Government Decree on Specialities of the General Government Organisations' Reporting and Public Accounting Rules. The SAO issued an adverse opinion on the consolidated report concerning the 2011 utilisation of chapter-managed appropriations for EU development projects. The errors found could be traced back to the area of accounting, and the inadequate functioning of internal controls related to the IT systems supporting accounting functions, as a result of which correspondence between general ledger accounting and the analytical records was not ensured. The errors revealed during the cash-based audit were caused by non-compliance with the provisions of the Government Decree on the Rules of Operation of Public Finances and the Government Decree on Specialities of the General Government Organisations' Reporting and Public Accounting Rules.

The **data on the execution of the expenditure and revenue appropriations in the national accounts** are reliable, with the exception of revenues and expenditures associated with the National Land Fund and the appropriations of housing subsidies, which were given limited qualification.[16]

It has been a recurring deficiency for several years now that certain credit institutions were disbursed housing subsidies without having a new contract as required by law. Credit institutions that have a framework agreement but have not signed a new contract were disbursed grants on these grounds in a total amount of HUF 6.1 billion in 2011. In November 2011, the Ministry for National Economy and the Treasury concluded the agreement with the credit institutions.

The limited qualification on the 2011 final accounts report of the National Land Fund was justified by the deficiencies in internal controls, the inadequate reliability of records related to revenues and expenditures, as well as its internal organisational and operational deficiencies. In 2011, the National Land Fund had no separate, independent record-keeping system regarding agreements, which hindered the transparent management thereof. We have found that the transfer of the real estate properties, worth HUF 324.8 billion, not managed directly by the Hungarian State Holding Company, subject to Point b), Paragraph (3) of Article 34 of the National Land Fund Act, was not performed by the 31 August 2011 deadline, specified for the 31 December 2010 accounting date.

The Act on the Budget provided for the adoption of 15 **decrees concerning grants for local governments**. The deadline for adopting the decrees was not observed[17] by sectoral ministers in 11 cases (Ministry of the Interior, Ministry of National Development, Ministry of National Resources and Ministry of Rural Development), and as a result the time available for local governments to prepare tenders has shortened significantly.

During the auditing of tax revenues, we revealed errors at the National Tax and Customs Administration (NTCA) in connection with internal controls for irrecoverability declarations, preferential payment arrangements and tax

[16] In 2009 and 2010, the titles of Housing Subsidies, as well as Revenues and Expenditures Related to State Property received limited qualifications.

[17] In 2010, the deadline for adopting the decrees was not adhered to in 14 out of 17 cases.

overpayments, but these had no effect on reliability. In the case of 56% of the audited items of irrecoverability declarations, while in the case of 42% of preferential payment arrangements, the NTCA's internal controls did not operate comprehensively. In the case of close to a third of preferential payment arrangements, the NTCA stipulated procedural duty payment obligation with a delay or did not stipulate such obligations at all on the respective current account. In past years, the SAO has revealed the deficiency regarding the stipulation of procedural duty every single year. Based on the data transferred by the NTCA, according to the assessment of the SAO audit, the collection costs are disproportionately high for the procedural duties, which may contribute to the shortfall of the procedural duties stipulated.

We found that despite the 1 January 2011 merger of the Hungarian Tax and Financial Control Administration and the Hungarian Customs and Finance Guard, the bank accounts of the two organisations have not been integrated, and this had an adverse effect on increasing the efficiency of the collection of outstanding customs amounts.

The National Tax and Customs Administration is the owner of information assets of strategic importance. The regulation regarding the security classification and auditing of the NTCA's information assets has yet to be created. Furthermore, no provisions are made on the definition of the security levels of the applications, nor are there any provisions on the risk analysis based security rating of the applications. The definition of the needs of the professional areas and the preparation of the related regulations (e.g.: business continuity plan) are the basic prerequisites for the preparation of these documents.

The financial statements of separated state funds and the Health Insurance Fund were given an approving opinion by the auditors, whereas the consolidated report of the Pension Insurance Fund received an approving opinion from the SAO. We also attached an emphasis of matter paragraph to the consolidated report of the **Pension Insurance Fund** on account of the errors and deficiencies detected during the audit of the operating and service provision reports. We issued a qualified opinion on the report on the operation of the Pension Insurance Fund for the erroneous booking of vouchers in an amount of HUF 0.4 billion, because the vouchers that were not distributed in the current year were shown under non-regular personal allowances instead of pending, carry-over or offsetting expenditures.[18] In the case of the Labour Market Fund and the Innovation Fund for Research and Technology, internal auditing did not function properly. In the case of the Innovation Fund for Research and Technology, an internal audit was launched in 2011 under the name 'The Systems Audit of the Handover of the Innovation Fund for Research and Technology' which was carried over to 2012.

During our audit, we paid particular attention to the utilisation of our recommendations made during the audit of the execution of the 2010 budget. We found that of our 42 recommendations, 22 were fully utilised and 9 were utilised in part. Within the framework thereof, the content and formal requirements of the final accounts bill were met at the legislative level with the entry into force of

[18] In 2010, the report of the Innovation Fund for Research and Technology was issued an adverse opinion.

Articles 89-91 of the Act on Public Finances. Article 23 of the Government Decree on the Operational Rules of Public Finances, in force as of December 2011, contains the reallocation, booking and refunding requirements of grants, awarded from the reserves generated for extraordinary government measures as well as to protect those reserves. The Ministry for National Economy and the Treasury concluded the agreements on housing subsidies with the credit institutions concerned. Furthermore, the arrears managed by the National Tax and Customs Administration decreased as a result of the measures taken as the result of the SAO recommendation.

At the same time, some of our recommendations regarding European Union accounts were not put to use. During the investigation period of irregularity procedures, the suspension of payments did not become mandatory. Subsidies for the own resources, financed by the National Development Agency to four universities under the operational programmes, was not refunded by the universities. Also, among the recommendations that remained unutilised were those applicable to the transfer of assets related to the K-600 communication system, the compliance with deadlines for adopting decrees related to grants provided to local governments or the improvement of reports within the central payroll-development system. With respect to topics where our recommendations were unutilised, the SAO will send a warning letter to the heads of the institutions concerned[19].

Pursuant to Section 33 (1) of Act LXVI of 2011 on the State Audit Office of Hungary, the head of the audited entity shall develop an action plan in response to the findings in the Report and send that plan to the State Audit Office of Hungary within thirty days from the receipt of the report. If the organisation fails to send the action plan by the deadline set or if it remains to be unacceptable, the President of the SAO shall be entitled to enforce the provisions of paragraphs a)-b) of Article 33 (3) of the Act.

[19] Ministry of Public Administration and Justice, Ministry of National Development, Ministry of Human Resources, National Development Agency, Central Administration of National Pension Insurance, Treasury.