FLASH REPORT

4 October 2022

Budgetary data up to 2022H1 were well on track to meet this year's deficit target. However, the outlook has become more challenging.

- *Hungary's ESA-based fiscal deficit declined to 5.5% of GDP in 2022Q2, from 6.3% in 2022Q1* on a four-quarter rolling basis (4Q), the KSH statistical office said (Figure 1). The decline reflects dropping expenditure-to-GDP (-0.4 ppts) as well as higher revenues-to-GDP (+0.4 ppts) ratios. Decreasing expenditures to the largest extent reflected a lower wage bill (-0.4 ppts), where the underlying trend has been downwards, but the seasonally adjusted data also fell sharply after the extra three months' payment to law enforcement employees in Q1. Most remaining expenditure items dropped trivially compared to GDP, with the exception of interest expenditures, which has started to climb for the second quarter in a row. Other expenditures also grew. On the revenue side, income taxes increased (+0.5 ppts), mostly reflecting the fact that the PIT refund in ESA statistics is accounted for 2021, which explains the bulk of the improvement. (Figure 2)
- Importantly, with the EDP report, there have been substantial revisions to past data. Most notably, the 2021 ESA deficit was revised up by 0.3 ppts (from 6.8% to 7.1%), while the 2020 figure was revised down to same degree (from 7.8% to 7.5%).
- The fiscal balance was very close to the preliminary financial account (-5.5% on 4Q basis) figure published in mid-August, so it did not cause surprise. However, the data reinforces our view that revenue growth was very robust: VAT revenues jumped by 28.3%(!) YoY (up from 25.6% in Q1), income taxes grew by 51.9% YoY, and even if we deduct the estimated effect of PIT refund, underlying income taxes posted 27.7% YoY growth. These reflect not only the effect of high growth, but high inflation also helped the budget. However, the outlook is becoming more challenging.
- Looking forward, the *government has raised this year's deficit target by a technical item*, as it has decided to procure extra gas reserves, which burdens the budget by EUR 1,85 billion this year. *This has called for the 1.2-percentage-point increase in the 2022 deficit target, to 6.1% of GDP. Based on the H1 data and government's announcements (e.g. spending restriction at budgetary entities), we think this 6.1% ESA deficit target for this year is reachable. However, next year's fiscal position seems more challenging. The government has itself communicated that next year's budget must be revised before the end of this year, to comply with the 3.5% deficit target in the rapidly changing environment. This is warranted by the further deteriorating macro-outlook (the central bank has revised down its GDP growth projection by 1.5 percentage points since June), which will harm revenues, even if inflation stays elevated. On top of that, some additional government measures will increase expenditures as well:*
  - i The government eased down the cutbacks of the energy subsidies for households, but more importantly has announced new subsidies for energy-intensive enterprises.
  - ii The fixing of district heating prices can only be maintained with higher budget contributions because of high gas prices.
  - iii Due to increasing yields, the budget's interest expenditure will also be higher than previously thought.
  - iv The government can partly balance the aforementioned items by a decisive reduction of investments.
- As a baseline, we assume that Hungary and the EU can reach an agreement on EU funds. However, based on the recent announcement of the EU Commission, EUR 7.5 bn funds are proposed to be suspended from the EUR 22.5 bn 2021-27 MFF budget, should Hungary not respond accurately to the Commission's request by mid-November in the rule-of-law mechanism. Additionally, under this risk scenario the agreement on the Recovery and Resilience Facility (RRF) seems to be unlikely this year. This means that an additional EUR 4.6 bn could be lost permanently (even more if there is no agreement also next year). It is hard to estimate the total loss of budgetary revenues for 2022-2023 under such a scenario, as EU payments have a certain yearly payment profile. However, our working assumptions suggest that budgetary revenues would be 0.7% lower in 2023 on cash basis. For this year, the estimation is even less certain, as we are getting closer to the end of the year, so even in the baseline case, EU funds could be about HUF 800 bn or 1.3% of GDP (on cash basis) lower than original plans.

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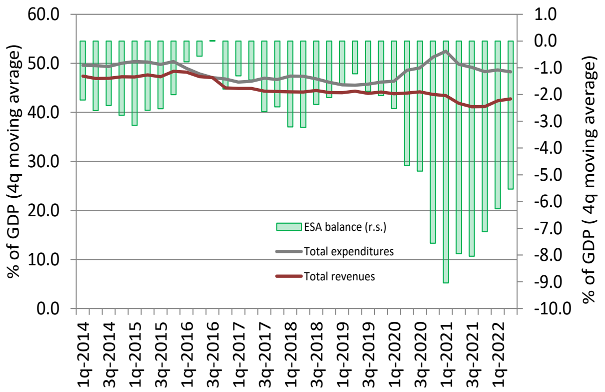
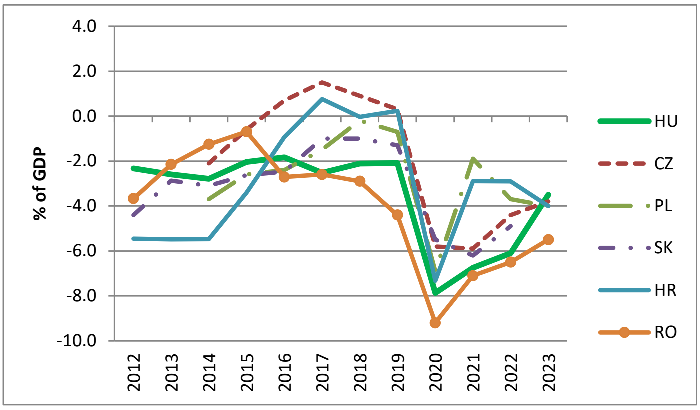
Figure 1 - Government revenues, expenditures, and ESA



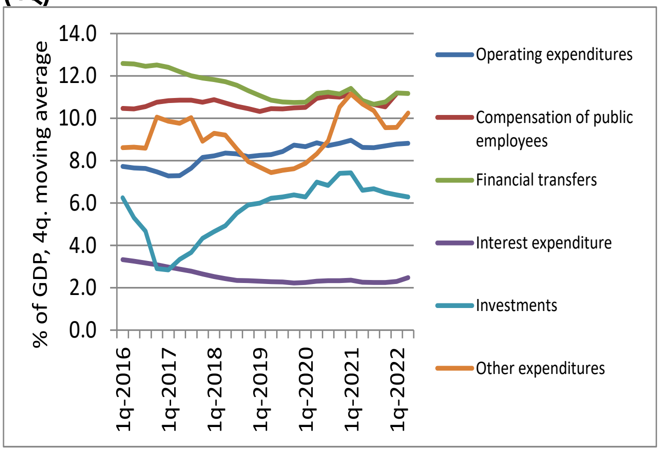
**KSH and OTP Research calculations*

Figure 2 - Regional comparison of ESA-based budget balance projections*



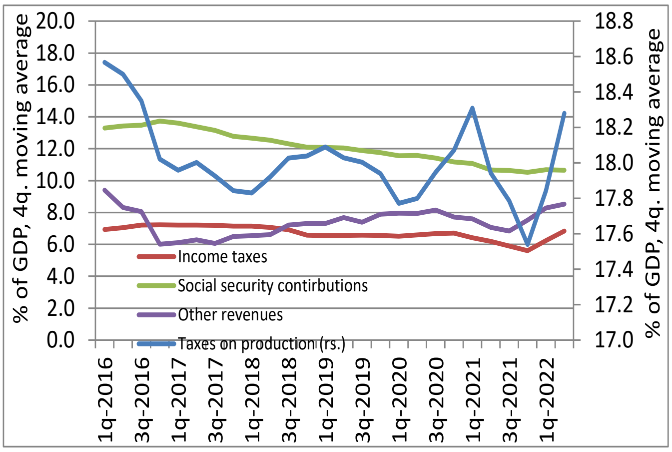
**KSH and OTP Research calculations, Focus Economics*

Figure 3 - Government expenditure items (4Q)*



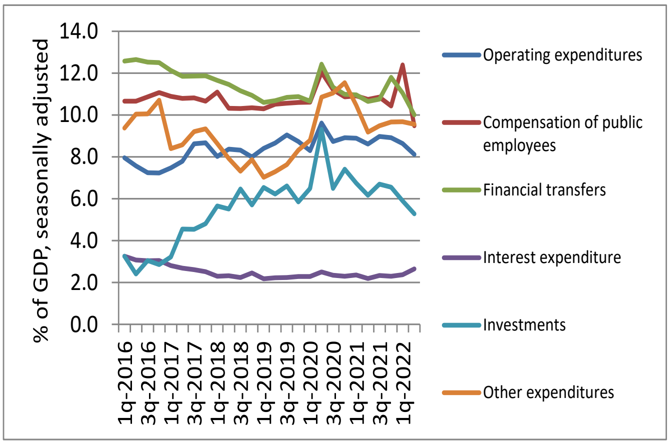
** KSH and OTP Research calculation*

Figure 4 - Government revenue items (4Q)*



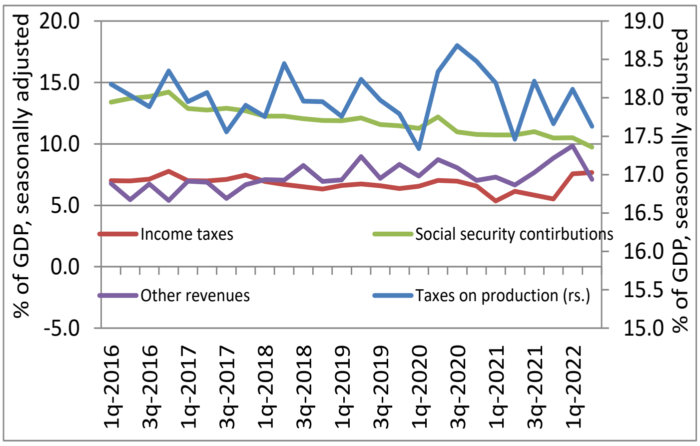
** KSH and OTP Research calculation*

Figure 5 - Government expenditure items (seasonally adjusted)*



** KSH and OTP Research calculation*

Figure 6 - Government revenue items (seasonally adjusted)*



** KSH and OTP Research calculation*

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