FLASH REPORT

5 July 2023

This year's deficit may be overshot, and the government needs to make budget adjustments in 2024 to achieve its 2.9% deficit target

- **According to our projection the no-policy-change deficit could be around 6.0% of GDP in 2023, considerably higher than the 3.9% deficit target, while in 2024 the budget deficit would reach 3.8% of GDP without further adjustment. This year the main reasons behind the roughly 2 ppts slippage are lower-than-expected tax revenues due to weak demand, the necessity to adjust pensions to higher inflation, and higher-than-planned public sector wages. We think that the government might increase its deficit target later this year, and announce additional measures to lower the deficit, thus we pencil in 5% deficit for 2023. Our calculations suggest that the slippage will be smaller in 2024, around 0.9% of GDP, mainly because the majority of windfall taxes introduced in 2022 will not be phased out, energy subsidies will be lower, investments will be cut, and excise duties raised. As the Maastricht criteria come back to force next year, we expect the deficit target to be met at 2.9%, but that would require further measures. This morning it became also known that the finance ministry will reassess the expenditure side of the budget, to scale back and increase the efficiency of certain expenditure items in the medium term.**
- **Hungary's ESA-based fiscal deficit** increased to 7.9% of GDP in 2023Q1, from 6.2% in 2022Q4 on a four-quarter (4Q) rolling basis (Figure 1). The fiscal balance was slightly lower (-7.9% on 4Q basis) than the financial account figure (-8.0%) published at end-June. The higher deficit is mainly caused by higher expenditure-to-GDP (+1.5 ppts) ratio and partly by lower revenues-to-GDP (-0.2 ppts) ratio. The underlying deficit (excluding one-offs) was 7.2% on a 4Q basis.
- **Expenditures** were affected to the largest extent by growing subsidies (+1.0 ppts), presumably due to the subsidies to MVM, the state-owned Hungarian energy supplier. Interest expenses rose by 0.5 ppts because of higher interest rates, while financial transfers also rose (+0.4 ppts), because of increased spending on pensions. On the other hand, the wage bill (-0.5 ppts) decreased, partly because of the extra bonuses paid last year to the armed forces and law enforcement personnel. Other expenditure items changed between -0.1 and 0.2 ppts (Figure 3).
- **On the revenue side,** other incomes dropped by 0.7 ppts on a 4Q basis, due to declining EU transfers, while interest revenues rose by 0.3 ppts. Other revenue items changed between 0 and 0.2 ppts. (Figure 4). Revenue growth slowed down: VAT revenues increased by 8.8% YoY, which was a deceleration from the 17.0% growth rate in Q4, despite accelerating inflation, which is a sign of the slowing economy. Revenues from income taxes grew by 16.5% YoY, which was below the inflation dynamics but decent compared to wage growth. Among expenditure items, subsidies (+471.2%) and interest expenses (+113.3%) surged, and financial transfers increased by 23.4%, while the compensation of public employees fell by 8.2%, due to bonuses last year. Other items increased by less than inflation (between 8.8% and 21.7% YoY).
- **Our no-policy change projection shows that the deficit could be around 6.0% of GDP in 2023, considerably higher than the 3.9% deficit target in the budget.** Revenues are expected to be lower than planned, as the economy and consumption perform worse than the government had forecast, putting pressure on VAT and other tax revenues (excise duties, personal income taxes, and social security contributions). In our base-case scenario, tax revenues will recover in the second half of the year as the economy picks up, but there are significant downward risks to that. In case those risks materialize, the deficit could be about 0.5 ppts higher than our baseline. There are some uncertainties on the expenditure side as well. Inflation is likely to be higher than the government had forecast, which means that pensions must be hiked again this year. Declining real wages in the public sector is another problem, which may pressure the government to spend more on the renumeration of government employees. Interest expenses have also increased considerably due to higher interest rates.

  However, a reserve on the expenditure side is the National Defence Fund, which is planned to increase from HUF 842 bn in 2022 to HUF 1,309 bn in 2023 (from 1.3% to 1.7% of GDP). A part of that is tied up by asset purchases (e.g. Leopard tanks), but it cannot be ruled out that their delivery will be delayed, and the government could also cut back certain operating expenses. An advantage of lowering defence expenditure from the currently planned level would be that it would not have any negative effect on growth or inflation.

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- **In 2024, the deficit could be 3.8%, which is 0.2 pps higher than in our previous forecast, in spite of the excise duty hikes, as the macro outlook is deteriorating** (Table 1). To recap, the main factors behind the declining deficit next year are the following (Table 2):
  - The favourable effect of declining energy prices will appear in the budget only next year, as energy procurement was hedged at a high price for 2023.
  - The government will keep most of the extra-profit taxes in 2024, despite its earlier promise,
  - and plans to cut back public investment considerably.

  It was not known at the time of our previous flash note, however, that the income side of the budget will be boosted by excise duty hikes, as tax regulations behind the budget were published only a couple of days later than the budget itself. This would lower the deficit by about 0.4% of GDP. However, higher interest rate expenses and the deteriorating macro outlook increase the deficit compared to our previous projection. It should be also noted that under the current legislation, the government must transfer funds to the central bank if the latter's capital decreases below zero. We are aware that there are consultations between the government and the MNB about the currently needed recapitalization, which was not planned in the budget, but until this consultation concludes, we assume that HUF 400 bn will be reimbursed by the government in 2024 from the MNB's loss.

  This morning it became known that the finance ministry will have to reassess health-care expenses, family and housing subsidies until the end of 2023, as well as education and investment expenditures until the end of 2024. Then the reassessment of expenditures will be made regularly every year. The aim of this process is to increase the efficiency and reduce the expenses, in order to structurally strengthen the budget.
- As a baseline, we still assume that Hungary and the EU can reach an agreement on EU funds. However, the risks associated with this became higher, as the government has passed the 31 March deadline to adopt key legislation needed to unlock EU funds. However, as the Partnership Agreement, the operational programmes, and Hungary's RRF plan were signed late last year, the delay of actual payment of EU money does not have an effect on the ESA deficit. As long as the government can pre-finance EU-financed investment programmes, it will not have a significant effect on GDP either. However, it increases the financing need of the budget: the currently foreseen 6.3% of GDP deficit in 2023 (on cash basis) would grow to 7.3%, and as a result would boost government debt as well. However, assuming Hungary's application for the RRF loan is approved, the advance payment from that could partly fill this gap in 2023.

Table 1 - Our updated deficit forecast*

	HUF BN		% of GDP	
	2023	2024	2023	2024
(A) Government's ESA deficit targets	3 028	2 472	3.9	2.9
(B) Our baseline deficit forecast in the previous flash note (assuming all anounced government measures are delivered)	*4 446*	*2 996*	5.8	3.6
(C) Higher excise duty on fuels (including VAT effect)		-302		-0.4
(D) Higher reimbursement of pharmaceutical companies	-20	-45	0.0	-0.1
(E) Higher interest expense forecast	76	161	0.1	0.2
(F) Effect of the change in macro outlook	85	323	0.1	0.4
(G=B+C+D+E+F) ESA deficit outlook	4 587	3 133	6.0	3.8

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Table 2 – Main items affecting the 2024 budget*

	% of GDP
2023 deficit	-6.0%
Lower energy subsidies	1.5%
Partial cut back of extra-profit taxes	-0.6%
Net interest payment	-0.7%
Reimbursement of central bank loss	-0.5%
Non-personnel costs	0.3%
Social benefits other than social transfer in kind	0.3%
Lower investment expenses	1.4%
Higher excise duties	0.4%
Other items	0.2%
2024 deficit	-3.8%

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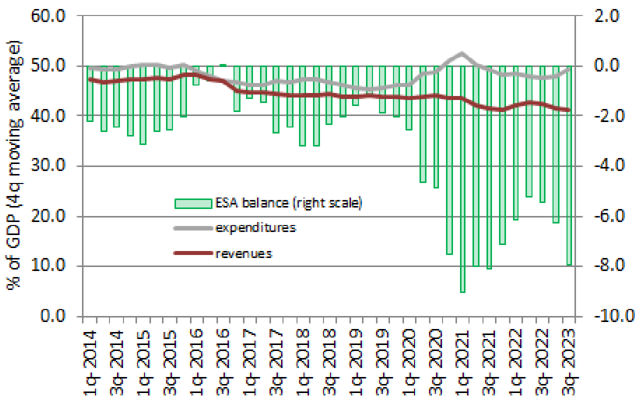
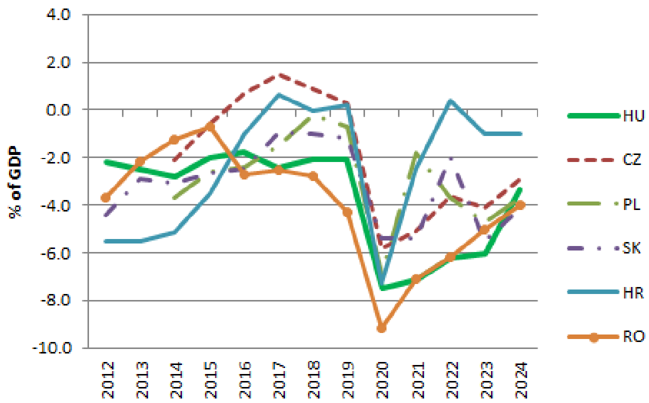
Figure 1 - Government revenues, expenditures, and ESA



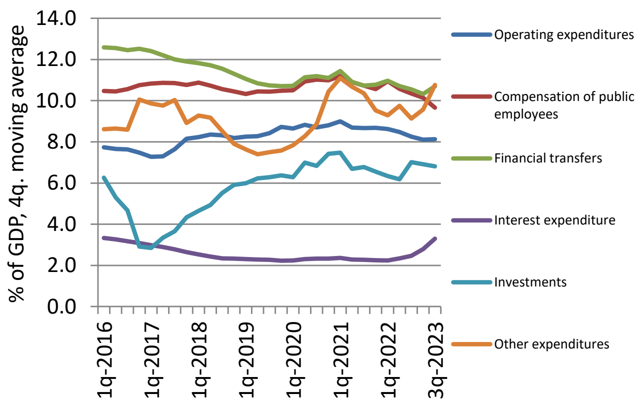
**KSH and OTP Research calculations*

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



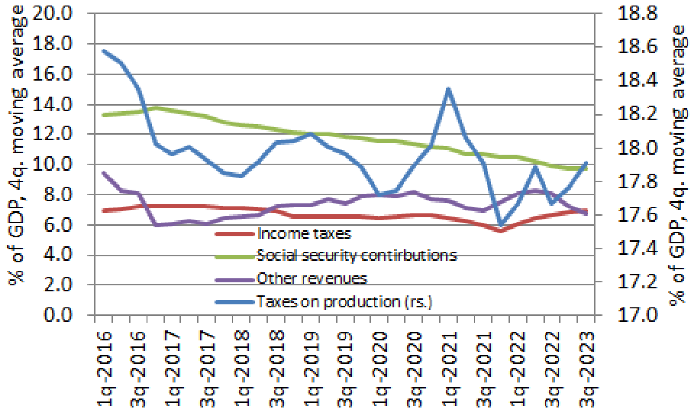
**KSH, OTP Research, Focus Economics*

Figure 3 - Government expenditure items (4Q)*



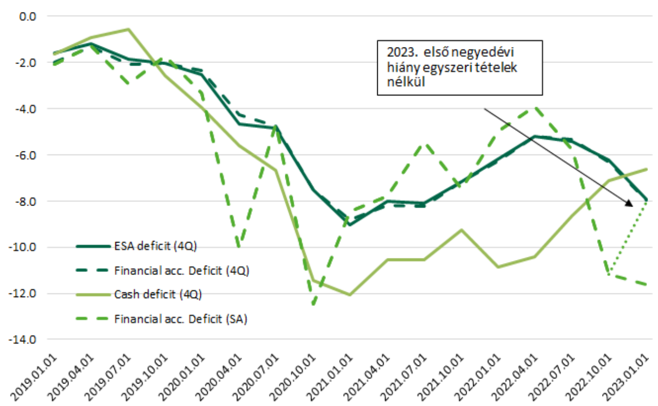
* *KSH and OTP Research calculation*

Figure 4 - Government revenue items (4Q)*



* *KSH and OTP Research calculation*

Figure 5 – Deficit indicators*



* *KSH, MNB and OTP Research calculation*

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