FLASH REPORT

2 July 2024

This year's deficit might overshoot the modified 4.5% target without further measures, and achieving the 3.7% target in 2025 also requires adjustments

- **Hungary's ESA-based fiscal deficit** decreased to 5.7% of GDP in 2024Q1, from 6.7% in 2023Q4 on a four-quarter (4Q) rolling basis (Figure 1). This was 0.1 ppts better than the figure published in the financial accounts one day earlier. The smaller deficit is mainly caused by lower (-0.9 ppts) expenditure-to-GDP ratio and slightly higher revenue-to-GDP ratio (+0.1 ppts).
- **Expenditures** on a 4Q basis were affected to the largest extent by declining (energy) subsidies (-0.5 ppts), as energy prices have normalized. Other expenses have declined by 0.3 ppts, investments and operating expenses by 0.2 ppts as the government has tried to keep in check both, even if we saw a spike in investment in Q4 2023. In the longer term, however, this trend is hardly sustainable without the significant deterioration of public services. On the other hand, interest expenses rose by 0.2 ppts. The remaining expenditure items increased between 0 and 0.1 ppts (Figure 3).
- **On the revenue side** on a 4Q basis**,** taxes on production dropped by 0.2 ppts, which is better than the -0.4 ppts in the previous quarter. The reason for this positive turn was that VAT revenues increased faster than inflation in Q1 for the first time since Q3 2022. As mentioned in our latest GDP report, the only encouraging item in the Q1 GDP data was household consumption, which surely helped VAT revenues, even if the increase in VAT was mainly due to declining VAT refunds (based on monthly data, VAT revenue before refund dropped by 1.8% YoY in the first three months of the year). Interest revenues declined by 0.1 ppts after increasing steeply during the last couple of quarters (from 0.5% of GDP at the end of 2021 to 2% of GDP in Q4 2023) due to high inflation and dividend payments by state-owned enterprises (e.g. the large dividend by the Hungarian electricity and gas company MVM). The remaining revenue items changed between 0 and +0.1 ppts (Figure 4).
- **Our forecast shows that the no-policy-change deficit would be 5.0% of GDP in 2024, which warrants further adjustment to reach the 4.5% deficit target set by the government in the latest Convergence Programme.** Since our previous flash report the government has announced to postpone HUF 675 billion of investments, which lowers the deficit by ~0.66% of GDP this year. It is also favourable that VAT revenues seem to be higher than our previous expectation. VAT revenues continued to increase this year so far, which was mainly due to declining VAT reimbursement, but the latest data in May showed some signs that gross VAT revenue (income before refunds) could also follow an increasing trend during the rest of the year, as rising consumption has a positive effect, which is expected to balance the effect of rising refunds later this year. On the other hand, the Court of Justice of the EU had imposed an EUR 200 million penalty on Hungary and further EUR 1 million/day in case of delayed payment. We suspect that the dispute between the Court and Hungary will not be settled this year, so this fine will increase the outlays of the budget by 0.2% of the GDP in 2024. (Table 1)
- Compared to last year's 6.7% deficit, lower energy subsidies are expected to reduce the deficit by 1.6 ppts because of lower energy prices. Excise duties on fuel were hiked from the beginning of this year, which narrows the deficit by 0.4 ppts. On the other hand, net interest payments will boost the deficit by 1.2 ppts. This is a result of higher interest rate on the popular inflation-indexed bonds, while interest and dividend revenues are expected to be lower, as for example the state-owned Hungarian electricity company MVM is not expected to pay an extraordinarily high dividend this time, plus lower interest rates mean that the government will realize less interest revenue on its cash holdings. The partial cutback of extra-profit taxes (if implemented as promised) and higher public wages will also boost the deficit. The latter, however, is partly financed from EU transfers, which lowers the budget shortfall and is included in other items in Table 2.
- **In our no-policy-change scenario, the deficit can stagnate at 5.0% of GDP in 2025 but the pressure on the government to ease fiscal policy before the elections in 2026 is a negative**

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risk. We assume that the dispute over the penalty between Hungary and the Court of Justice of the EU will be settled by the end of this year, so that will not affect the budget in 2025. We also think that the investment deferral in 2024 will not cause an investment spike in 2025, which is supported by the latest Convergence Programme as it calculates with lower investment in 2025 compared to this year. This means, however, further implicit investment cuts by the government. Interest expenses will be lower than this year, as a percentage of GDP, as interest payment on inflation-indexed bonds will decline because of lower inflation. Energy subsidies will also fall further as energy prices stabilized at a lower level. On the other hand, taxes on production will be lower as the government promised further cuts to extra-profit taxes, which would add ~0.9 ppts to the deficit.

- While the no-policy-change deficit would stabilize near 5% in 2024 and 2025 according to our forecast, we suspect that the government will be inclined to create some fiscal space before the general elections in 2026. For this reason, it is a likely scenario that some extra-profit taxes will be extended or even hiked, excise duties will be increased, or further investments will be delayed before the elections, to bring down the deficit before the elections in 2026.
- **As a result of the new rules of the excessive deficit procedure, there is less pressure on the government to correct the budget.** The EDP against Hungary and several other EU members started this summer, but penalties were delayed by the EU. According to the new rules adopted in February, debt must be on a well-founded downward path only at the end of a four-year budget adjustment period. Moreover, this period can be extended to seven years if the government makes investments that improve the growth potential.
- As a baseline, we still assume that Hungary and the EU can reach an agreement with respect to all allocated funds, in accordance with the government's plan in the Convergence Programme. The release of around EUR 12.2 billion from the EUR 30 billion EU funds by the European Commission is a cause for optimism in this respect; however, the European Parliament's litigation against the Commission is a risk from this aspect. In the case of the RRF funds, the tight schedule is also a risk as all projects must be finished till the end of 2026, otherwise a part of the funds will be lost. As the Partnership Agreement, the operational programmes, and Hungary's RRF plan were signed late last year, a delay in the actual payment of EU money does not have an effect on the ESA deficit.

Table 1 - Our updated deficit forecast*

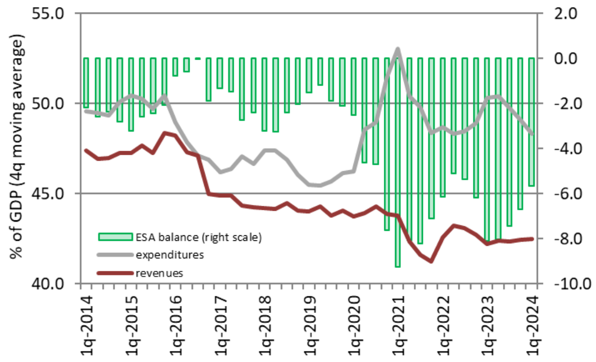
	HUF BN		% of GDP	
	2024	2025	2024	2025
(A) Government's ESA deficit targets	3,655	3,272	4.5	3.7
(B) Our baseline deficit forecast in the previous flash note (assuming all anounced government measures are delivered)	*4,492*	*4,385*	*5.6*	*5.1*
(C) Investment deferral (net effect)	-531		-0.7	
(D) Penalty by the European Court of Justice	158		0.2	
(E) Change in the macro outlook	-95	-186	-0.1	-0.2
(F=B+C+D+E) ESA deficit outlook	4,024	4,199	5.0	4.9

Table 2 - Our deficit forecast*

	% of GDP
2023 deficit	-6.7%
Lower energy subsidies	1.6%
Partial cut back of extra-profit taxes	-0.6%
Net interest payment	-1.6%
Public wages	-0.7%
Invetsment cuts and deferrals	1.0%
Higher excise duties	0.4%
Penalty by the Court of Justice of the EU	-0.2%
Higher EU transfers	0.8%
Other items	0.9%
2024 deficit (OTP est.)	-5.0%

**OTP Research*

Figure 1 - Government revenues, expenditures, and ESA



KSH and OTP Research calculations

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

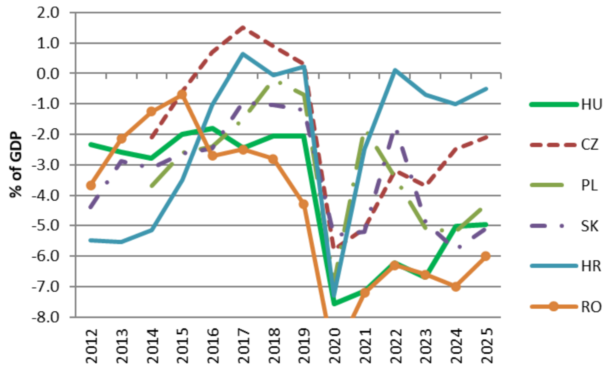


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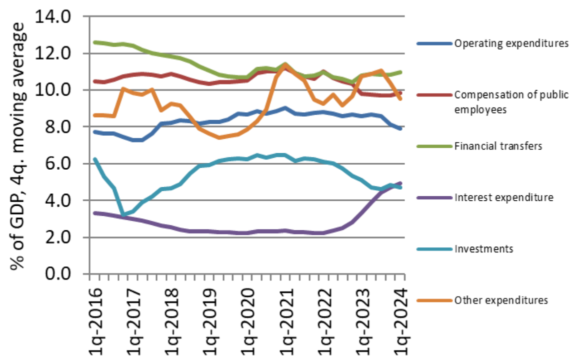
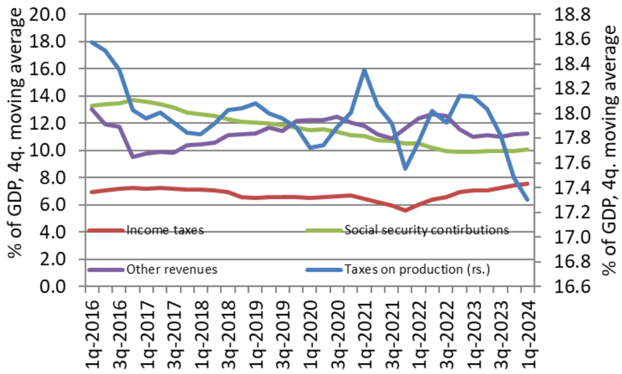
Figure 3 - Government expenditure items (4Q)*



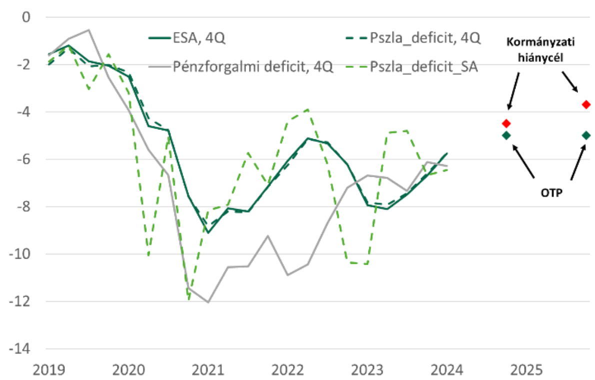
* *KSH and OTP Research calculation*

Figure 4 - Government revenue items (4Q)*



* *KSH and OTP Research calculation*

Figure 5 – Deficit indicators*



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