**Government of the Republic of Hungary**

# UPDATED CONVERGENCE PROGRAMME OF HUNGARY
# 2004 - 2008

Budapest, December 2004

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## Introduction

Following the accession to the EU on May 1, 2004, Hungary submitted its convergence programme on May 15. The convergence programme was assessed and approved by the Council on July 5. In line with council regulation 1466/97 (EC), the programme has to be updated every year. Based on the Code of Conduct governing the content and format of the stability and convergence programmes, the updated programmes have to be prepared by the beginning of December, each year.

The updated Hungarian convergence programme – which was adopted by the Government on December 1, 2004 – was prepared with taking into account the 2005 budget bill submitted to the Hungarian Parliament.

As compared to the original programme, this update includes an important methodological change concerning the presentation of general government figures. Taking into account the transitional period granted in Eurostat conclusions of September 23, 2004 (Eurostat News Release, 117/2004) and similarly to the practice of several member states, the compulsory, funded pension scheme is classified inside the general government sector in the updated convergence programme. Consequently, the contribution paid to the pension funds are taken into account as revenues of the general government, thus the general government deficit and debt data differ from the ones presented in the convergence programme of May 2004. Nevertheless, for the sake of transparency and comparability, the relevant tables in the text of the updated programme continue to include also the figures resulting from the classification of the pension funds outside the general government sector[1].

## 1. Economic situation

In 2004 the Hungarian economy resumed the sustainable growth path. Economic growth started accelerating again due to the economic policy turn in 2003 and the concurrent favourable change in the external economic environment. In 2004 we reckon with higher growth than previously expected (Convergence Programme of May 2004), due to the growth of all three demand-side components of GDP being higher than originally foreseen. Within this, as another positive development, the demand-side structure of GDP continued to change in a favourable direction. After more than two years, economic growth became export and investment driven. Simultaneously with the positive trends in the real sector, there are positive as well as less favourable changes in the equilibrium indicators. Even though the reduction of the general government deficit (at around 1 percentage point) is one of the largest among Member States, the deficit will be higher than originally projected.

The Hungarian economy has been able to exploit the favourable external economic trend: **growth** in Hungary continues to be over 2 percentage points higher than the EU average. The GDP forecast for 2004 is approximately half a percentage point higher than previously, due to the aforementioned stronger improvement of demand-side factors.

The fast **export** growth, based on more favourable international environment, has been continuous in 2004, accompanied by a similar expansion of imports. However, one--off factors in the first half-year (tactical purchases before the EU accession, discharges from customs warehouses) appear to indicate inventory accumulation that makes us expect a more modest growth of imports, and therefore of the trade deficit, than in the second half-year. Because of the external changes, our projection for the entire year is still

[1] The Central Statistical Office is working on the revision of general government figures according to the methodological changes. Due to the revision, revenues and expenditures of the compulsory, funded pension scheme will be accounted as general government revenues and expenditures. The revised CSO figures will be included in the next update of the Convergence Programme.

significantly higher than it was in the CP of May 2004. For the whole of 2004, exports may grow by 14%, imports by 13.9%.

**Economic indicators** annual percentage change

| | 2003 | 2004 | | 2005 | |
|---|---|---|---|---|---|
| | actual | CP of May 2004 | Updated CP | CP of May 2004 | Updated CP |
| GDP | 3.0 | 3.3-3.5 | 3.9 | 3.5-4 | 4.0 |
| Household consumption | 7.6 | 1-2 | 2.7 | 2-3 | 3.0 |
| Gross fixed asset formation | 3.4 | 6-8 | 9.0 | 6-8 | 7.3 |
| Exports | 7.6 | 8-10 | 14.0 | 9-11 | 11.0 |
| Imports | 10.4 | 7-9 | 12.9 | 9-11 | 10.7 |
| Consumer prices | 4.7 | approx. 6.5 | 6.8 | approx. 4.5 | 4.5 |
| Growth of number of employed | 1.3 | 0-0.5 | 0.5 | 0.5-1 | 0.9 |
| Unemployment rate | 5.9 | 5.8-6 | 5.9 | 5.8-6 | 5.9 |
| General government deficit (% of GDP) | 5.5 | 3.9 | 4.5 | 3.3 | 3.8 |

In the first half of 2004 the other important factor of growth, besides exports, was **investments**, which produced a significant expansion. In this period, manufacturing investments, which are vital for future growth, increased at the extraordinary rate of 25.3%. In 2004 investment growth, due to the upswing of the international economy since last year, may be higher than the 7% forecast of May, and it may reach 9%.

**Household consumption** growth accelerated in the second quarter; however, this is in all probability attributable to one-off factors such as motor vehicle purchases, which had been postponed due to uncertainties related to the introduction of the registration tax. The data available on the income side (real wages stagnating due to the tight income policy and slightly increasing household savings) do not support any material upswing in the rate of consumption as compared to the projected level. For the whole of 2004, consumption may grow by 2.7%. The rate, somewhat higher than forecasted in May, is attributable to the fast uptake of lending for product purchases and the growth rate, in excess of inflation, of non-taxable benefits incorporated in labour income and of certain other types of income (e.g. interest, dividend).

The rate of **inflation** will move as expected in 2004. The one-off inflationary effect of tax increases implemented in the context of EU accession has caused only a temporary increase. The price index with constant tax content, as calculated by the CSO, fluctuated around 5%, differing from the CPI by some 2 percentage points. The inflation rate started going down again at mid-year. The forecast for the whole of 2004, 0.3 percentage points higher than originally projected, is explained by the record oil price increases.

The **current account deficit** is expected to exceed the level projected in May by EUR 500 million in 2004. Thus the deficit as a percentage of GDP will stay at the 9% level of 2003. The deficit is higher than expectations early in the year due to the additional imports, mainly for investment purposes, driven by higher growth.

**Fiscal developments** of the first eight months necessitated the review of the annual deficit forecast. This was attributable primarily to the revenues foregone, which could not be substantially increased even by the surplus GDP, which is positive in other aspects and which relies on exports and investments. The achievement of the 4.6% target was hindered by the fact that the extent of value added revenue foregone after the accession, considerably more than expected, became clear only in September. During the year, the Government adopted several measures to improve the fiscal balance and to reduce expenditures. Adjustment measures were taken, corresponding to almost 1% of GDP in March, somewhat less in April, 0.5% of GDP in June, and 0.2-0.3% of GDP in September. The Government considered that, amidst the tight monetary conditions, any greater fiscal tightening would jeopardise the strengthening economic growth and its sound structure. After the revaluation of processes, the former ESA95 deficit target of 4.6% was modified to 5.3% of GDP. By reviewing the deficit target and adopting the above measures, the Government intended to strengthen the credibility and predictability of economic policy. This was underpinned by the Government's statement that in the medium term it would not give up the realisation of the fiscal path embraced in the Convergence Programme of May 2004.

The **exchange rate** gradually stabilised from Q2 2004 onwards as a result of restored market confidence. Due to the continuing high interest rates, the exchange rate gradually climbed back to the 245-250 HUF/EUR range.

## 2. Macroeconomic objectives and forecast

The economic policy objectives stated in the Convergence Programme of May 2004 have remained essentially unchanged. The long-term goal of the economic strategy is the modernisation and the catching-up to the EU15 averages. The economic trends of the recent past indicate a move in this direction. Growth accelerated, the positive gap over the average GDP growth of the EU widened. Employment growth and improving competitiveness and the ability to attract capital continue to be dominant courses of action.

### 2.1 Fiscal policy, general government, external financing need

The primary objective of fiscal policy is to simultaneously, gradually and continuously reduce the size and deficit of the general government. The declining deficit allows the reduction of the debt ratio and contributes to improve the external balance. The curtailment of income centralisation and redistribution allows more manoeuvring room for the private sector and contributes to increased competitiveness. In addition, the changes in the tax and contribution system stimulate employment growth and the improvement of the participation rate, which is rather low in international comparison.

Fiscal policy continues to strive to achieve, by 2008, the deficit target set in the Convergence Program of May 2004. However, due to the higher-than-expected deficit in 2004, this requires greater - 0.6-0.7 percentage points annually - adjustments than indicated at that time. Because of the improved fiscal balance, the debt ratio will start declining again in 2005, and will fall below 50% of GDP by 2008.

The long-term sustainability of public finances is supported by the pension system reform started in 1998. The revenues lost due to the contributions paid into the compulsory funded pension funds, will cause additional deficits in the pay-as-you-go pillar during the transition years. This, however, is automatically "offset" by the savings accumulated in funded pension funds, thus it does not generate additional demand in the economy. The indicator adjusted with the pension reform loss shows the effects of fiscal policy more accurately: the deficit will be below 3% of GDP from 2007, and the primary balance will be in equilibrium already in 2005.

**Key indicators of the general government** in % of GDP

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| Deficit | 5.5 | 4.5 | 3.8 | 3.1 | 2.4 | 1.8 |
| Primary balance | -1.6 | -0.3 | 0.0 | 0.3 | 0.7 | 1.1 |
| Government gross debt | 57.0 | 57.3 | 55.3 | 53.0 | 50.6 | 48.3 |
| *Pension reform revenue loss* | *0.7* | *0.8* | *0.9* | *1.0* | *1.0* | *1.0* |
| *Deficit with the effect of pension reform* | *6.2* | *5.3* | *4.7* | *4.1* | *3.4* | *2.8* |
| *Primary balance with the effect of pension reform* | *-2.3* | *-1.1* | *-0.9* | *-0.7* | *-0.3* | *0.1* |
| *Government gross debt with the effect of the pension reform* | *59.1* | *59.9* | *58.6* | *56.8* | *54.9* | *53.2* |

In 2004 the adjustment of the adverse growth structure, that emerged in the early 2000s, will become more marked; household consumption will grow below the GDP growth rate, and wages will increase only at a moderate rate. In the coming years growth will remain export- and investment-driven, thus the most important tax bases will grow slower than GDP. This alone would cause a drop in the revenues of the government sector as a percentage of GDP, but in 2004 this is somewhat mitigated by the changes in the tax system. However, fiscal policy has the objective of perceivably reducing the rate of income centralisation in the forthcoming years. The balance will be improved though the marked reduction of expenditures.

The reduction of the size of the public sector will allow enterprises to retain more resources. Starting in 2004 the upswing of investments will go hand in hand with a rise in the financing needs of enterprises. After the fast growth of 2003, the effects of the tightening measures in the housing subsidy system are already perceivable in the slow-down of household borrowing. The net financing capacity of households will increase in 2004 over the extremely low level of the past year, but subsequently we expect no further growth in terms of GDP. Thus, in order to improve the external balance, the financing needs of the corporate sector can be met only by curbing the financing need of the general government. The current account to GDP ratio will improve gradually. This improvement lays down, in the medium term, the basis for a sound and balanced growth. Expanding EU transfers will also contribute to the lowering of the external financing need of the economy.

**External financing need** in % of GDP

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| Current account deficit | 9.0 | 9.0 | 8.5 | 7.7 | 7.2 | 6.6 |
| Capital account with EU transfers | 0.0 | 0.6 | 0.7 | 1.2 | 1.7 | 1.8 |
| of which: EU transfers | 0.1 | 0.4 | 0.5 | 1.0 | 1.5 | 1.7 |
| **External financing need** | 9.0 | 8.4 | 7.8 | 6.6 | 5.4 | 4.8 |
| Debt creating financing | 9.4 | 3.8 | 3.1 | 2.3 | 1.1 | 0.3 |
| Non debt creating financing | -0.4 | 4.6 | 4.7 | 4.3 | 4.4 | 4.5 |
| of which: net FDI | -0.7 | 3.8 | 3.8 | 3.4 | 3.4 | 3.6 |
| of which: reinvested earnings | 2.4 | 2.3 | 2.2 | 2.3 | 2.4 | 2.4 |

In the course of the capital-intensive catching-up process, the external debt to GDP ratio will start declining in 2004. The external financing need as a percentage of GDP may fall from 9% in 2003 to 4.5-5% by the end of the period, as the capital transfers from the EU, rising from less than 0.5% of GDP to almost 2% by 2008, will substantially reduce the financing need induced by the current balance. The structure of financing will change: debt creating financing will become less prevalent due to the reduced financing need of the government, leaving more room for the corporate sector. Simultaneously, the ratio of non-debt creating financing will increase, and by 2008 this item is projected to almost fully cover the external financing need. Within this, net foreign direct investments will exceed 3.5% of GDP by the end of the period.

### 2.2 Employment

In the forthcoming relatively short period of 4-5 years employment policy will have to be prepared to simultaneously manage opposing trends in quick succession. In certain areas, especially among carrier starter graduates, excess supply of labour is to be expected, while in other areas, especially among skilled labourers, regional and occupational shortages may occur. Hungary allows a relatively free movement of labour, which makes most of these tensions manageable.

The Government implements an active employment policy increasing not only the number of jobs but also the willingness of the population to take on employment, and also modifying the structure of qualifications in line with the labour demand of the economy. The macroeconomic forecast reckons with a significant, 1-2% employment growth in the corporate sector annually, thus the participation rate of the population aged 15-64 may grow from 60.6% in 2003 to 63.5% in 2008. Increasing the number of person in employment is also one of the priorities with respect to the fiscal balance, as the higher employment rate would result in more revenues even against the background of lower specific tax rates.

In order to expand employment, the Government will reduce the social security contributions paid by employers of career starters, persons returning from child care benefit or unemployed persons over the age of fifty, as of 1 January 2005. The allowance, counted with a maximum gross wage of 90.000 HUF, will amount to 50% of the 29% employer contribution. As another measure aimed at improving employment, the lump-sum health contribution will have to be paid on a prorated basis in respect of part-time employees from the beginning of 2005. Further, the amount of this lump-sum payment will be reduced from HUF 3,450 to HUF 1,950 as of 1 November 2005. The increased labour supply is also promoted by the general reduction of the progressive personal income tax rates in the income brackets around the average wage.

Assuming a gradual increase of employment and a stable productivity growth of 3% per annum, the GDP growth may accelerate from 3.9% in 2004 to 4.6% in 2008. There are still considerable reserves for growth, as according to the most recent calculations using the production function, the output gap will remain negative until 2008.

**Employment and growth** annual percentage change

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| Number of employed | 1.3 | 0.5 | 0.9 | 1.0 | 1.0 | 1.4 |
| Unemployment, % | 5.9 | 5.9 | 5.9 | 5.8 | 5.7 | 5.6 |
| Participation rate, % | 60.6 | 60.8 | 61.2 | 61.6 | 62.4 | 63.5 |
| GDP growth rate | 3.0 | 3.9 | 4.0 | 4.2 | 4.3 | 4.6 |
| Potential GDP growth rate | 3.9 | 4.0 | 4.1 | 4.3 | 4.4 | 4.4 |
| Output gap | -0.4 | -0.4 | -0.6 | -0.6 | -0.7 | -0.4 |

### 2.3 Income and consumption

Between 2001 and 2003, the income and consumption of households increased considerably, much faster than labour productivity in the economy; therefore the competitiveness of the country deteriorated. In three years, the real wage per income earner rose by 32%, household consumption by 24.5%.

In order to restore the economic equilibrium and improve competitiveness, the Government set the objective of stabilising real wages for 2004. An agreement was reached in the National Interest Reconciliation Council on a moderate nominal gross average wage growth for the business sector, and a strict wage appropriation was approved by Parliament in respect of the budgetary sector.

The objective was achieved; real wages are expected to rise only moderately for the whole year. As a positive development, in response to the tightening of the terms of housing loan subsidies and the high deposit rates, households have started to increase their financial savings again, and the net financing capacity to GDP ratio increased from 0.2% last year to at least 1.5% this year.

In the medium-term, real wages may increase in line with productivity growth. According to the present forecast, the annual scheduling will be somewhat different from the Convergence Programme of May 2004. Namely, in 2005, a relatively high real wage increase, 3-4% on a net earnings basis, will occur. This is due to the lower average personal income tax burden effective for next year.

On the other hand, gross wages, which are primarily relevant for wage costs, will increase in line with productivity growth. This is indicated by the wage agreement concluded for the year 2005 on the 6% increase of gross average wages in the corporate sector. The Government has set the objective that in subsequent years wages should continue to increase in line with the wage agreements in the National Interest Reconciliation Council, and sectoral wage agreements should receive more emphasis. Declining inflation also promotes the acceptance of nominal wage targets with moderate growth rates. Wage increases in the budgetary sector may be funded from staff reductions in institutions and from more efficient financial management.

The rate of pension expenditure growth in the forthcoming years will be driven by the annual statutory pension increases, the gradual introduction of the 13th month pension, and the further increase of retirement age for women. The family allowance will grow together with the inflation in 2005. The proposed reform of the system of family grants, which will benefit mainly the lower income groups, will be implemented in the course of several years.

On the whole, real income per capita will increase by approx. 12%, and household consumption by some 13% in the 2005-2008 period. The modest future growth of income and consumption allows the economy to resume a more balanced, sustainable growth path, but even so, during the eight years between 2001 and 2008 consumption will growth by almost 45%, at 4.7% p.a. on average.

**Income and consumption** annual percentage change

| | **2003** | **2004** | **2005** | **2006** | **2007** | **2008** |
|---|---|---|---|---|---|---|
| Gross average wage | 12.0 | 8.3 | 6.4 | 7.1 | 6.6 | 6.6 |
| Net average wage | 14.3 | 7.1 | 8.4 | 6.6 | 6.1 | 6.1 |
| CPI | 4.7 | 6.8 | 4.5 | 4.0 | 3.5 | 3.0 |
| Household consumption | 7.6 | 2.7 | 3.0 | 3.0 | 3.0 | 3.4 |

## 2.4 Investments

Improving the ability of the economy to attract capital and deepening the integration of the existing foreign investments are among the most important economic policy objectives. The creation of an investor friendly environment for foreign investments is promoted primarily by the introduction of the one-stop-shop administration system, the low corporate income tax rates, the development allowances and the indispensable infrastructure investments (e.g. motorway network). The spillover from corporations, established through FDI, to the Hungarian economy and the facilitation of technology transfer are promoted by the grants available for various supplier clusters and integrated production systems relating to large corporations.

In the 2004-2008 period, as a result of improving growth prospects, the profitability of businesses will improve, creating more funding for investment projects. The continually increasing EU funding will play an ever greater role in the financing of investments: we expect such funding available for investment finance to reach 1.7% of GDP by the end of the period. We also expect the volume of FDI to increase again as a result of EU accession and because of the external economic upswing. Consequently, investment growth around 10% is possible in the corporate sector in the medium term. However, the expansion of corporate investments also requires a substantial decline in interest rates in the forthcoming period.

**Investment ratio** in % of GDP

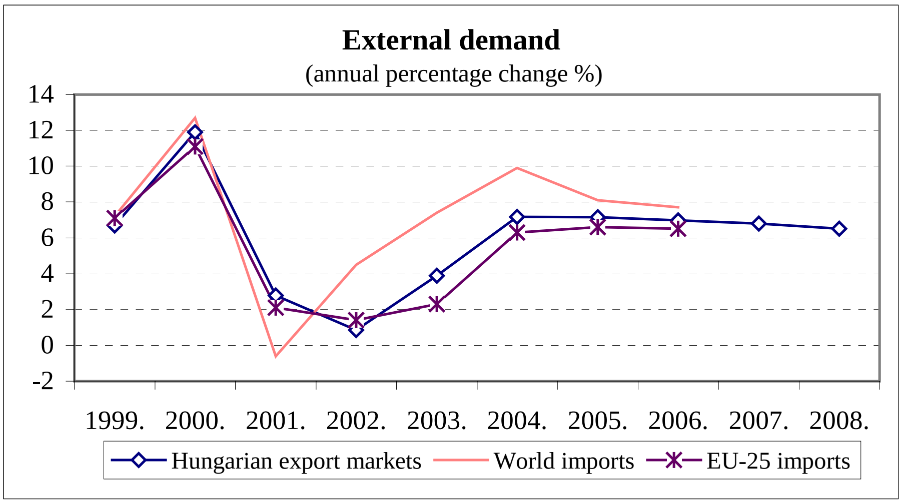
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| Investment ratio | 22.3 | 22.9 | 23.4 | 24.1 | 24.7 | 25.3 |

Within investments in the national economy, infrastructure (transport, environment, water management) investments will play a major part in 2004 and in the subsequent 1-2 years. On the whole, the investment ratio will gradually rise and by 2008 it will reach and, indeed, slightly exceed the 25% previously characteristic of the cohesion countries of the EU15.

## 2.5 Foreign trade

Commission forecasts updated in the autumn of 2004 expect the global economy to produce a more buoyant growth than previously expected. Forecasts show the possibility of an economic upswing for the next few years as well. However, the risk of forecasts have increased, mainly due to the medium term uncertainty related to oil prices, but there is also considerably risk in the growth trends of the countries most important for our EU exports.

For the forecast of our export markets, we took into consideration the import demand of the 10 developed countries most important for our exports and our 5 key Eastern European partners. On that basis, our export markets will expand significantly in 2004-2005, and at a somewhat lower rate in the subsequent three years. The lower level of export market expansion than the growth rate of global exports is attributable to the low growth rate, and consequently modest import demand, of the EU 15, which represent a high proportion in our exports, and also to the marginal role of dynamically growing Asian countries in Hungarian exports.




As a result of the tight incomes policy and the adjustments of fiscal policy, exports, alongside with investments, may become the driving force of growth again. Our export forecast follows the course of external demand, though it relies on conservative estimates. Conservativeness is justified by the aforementioned uncertainty of international forecasts. The assumption of export growth in excess of the growth rate of our export markets relies on the fact that our export growth exceeded external demand even at the bottom of the recession by some 3-4%. On the other hand, the exploitation of external growth prospects requires the continuation of the improvement of competitiveness, started at the end of last year, as well as the stimulation of foreign direct investments, market diversification and the promotion of tourism.

**Exports and external demand** annual percentage change

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| External demand | 3.9 | 7.2 | 7.2 | 7.0 | 6.8 | 6.5 |
| Export volume | 7.6 | 14.0 | 11.0 | 10.4 | 9.5 | 9.2 |
| *Difference:* | *3.7* | *6.8* | *3.8* | *3.4* | *2.7* | *2.7* |

As a result of the expected fast export growth and the expansion of domestic demand, in particular import-intensive investments, the import demand of the economy will continue to rise in the forthcoming period. However, the difference between the growth rate of exports and imports is expected to be small, therefore the foreign trade deficit will continue to increase in the medium term.

### 2.6 Components of growth

Based on the above trends, the expenditure structure of GDP will change favourable in the next few years: consumption growth will be permanently below GDP growth, and growth will be driven by dynamically expanding exports and investments. The forecast is conservative from the aspect of the budget, because growth remains below the potential rate – the output gap is negative even in 2008 – and its sound, sustainable structure is not conducive to increasing revenues.

**GDP components** annual percentage change

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| Household consumptions | 8.1 | 3.1 | 3.8 | 3.4 | 3.5 | 3.9 |
| Government consumption | 5.3 | 0.3 | -1.0 | 0.6 | 0.8 | 0.8 |
| Investments | 3.4 | 9.0 | 7.3 | 7.9 | 7.7 | 8.4 |
| *Domestic consumption* | *5.4* | *3.7* | *4.0* | *4.3* | *4.4* | *4.6* |
| Exports (goods and services) | 7.6 | 14.0 | 11.0 | 10.4 | 9.5 | 9.2 |
| *Total demand* | *6.3* | *8.1* | *7.2* | *7.2* | *6.9* | *6.9* |
| Imports (goods and services) | 10.4 | 12.9 | 10.7 | 10.1 | 9.3 | 8.9 |
| *GDP* | *3.0* | *3.9* | *4.0* | *4.2* | *4.3* | *4.6* |

### 2.7 Price trends

The macroeconomic policy for the coming years will assure the decline of inflation year by year at a rate not resulting in an output loss and taking into consideration budgetary relations. Due to liberalisation and the requirements of a market compatible regulatory regime, the role of the central government in influencing prices (and markets in general) will continue to shrink, and regulation will be maintained only in a narrow scope, typically for natural monopolies. Thus disinflation will occur autonomously, through market mechanisms. In the forthcoming period restrictive fiscal policy and incomes policy assuring wage growth in line with productivity tends, as well as monetary policy relying on the system of inflation targets and moderating inflationary expectations will play a major role. Enforced price reductions through artificial instruments are dispreferred, and in a number of areas (such as environment protection, transportation) additional tasks are to be performed, which entail price or financial effects.

In the first half of this year, disinflation was temporarily halted and the price index increased due to tax changes relating to EU harmonisation, the increase of the preferential VAT rate and the price adjustments of certain services subject to price-regulation. However, the price index, adjusted for the changes in indirect taxes, indicates no additional inflation growth. From the second half of the year, there will be a clear decline, and after the elimination of one-off effects the inflation rate will resume its original, declining trend.

The household consumption growth rate has declined, but it is still higher than envisaged. This, however, presented no inflationary pressure in the environment of the adaptability of the supply side and intensified market competition. On the other hand, the rise of oil (and other energy) prices represents an inflationary factor. As the net result of these effects, annual inflation is expected to be slightly higher than presented in the Convergence Programme of May 2004. In 2005, high energy prices will represent additional inflationary effects, including regulated household energy and transport prices, thus the forecast for next year is higher than previously presented, despite the resumption of the disinflation trend.

Along the outlined macroeconomic path, the rate of price increases will decline gradually, year by year, approximating the medium term equilibrium inflation rate (around 3%). This is slightly higher than the current EU average, owing to the fast and more marked change of the consumption structure, and also due to the fact that in the service sector productivity growth, which is lower than in the manufacturing sector, is accompanied by a wage growth similar to that of the manufacturing sector, which results in a higher rate of price increases against the background of expanding demand and less intensive service competition in the local markets.

**Inflation** annual percentage change

| | **2004** | **2005** | **2006** | **2007** | **2008** |
|---|---|---|---|---|---|
| Annual average | 6.8 | 4.5 | 4.0 | 3.5 | 3.0 |
| Dec/Dec | 5.9 | 4.0±1 | 3.5±1 | 3.0 | 3.0 |

According to the macroeconomic scenario, the criteria for joining the euro area can be satisfied by 2008 and, the introduction of the euro is possible in 2010.

### 2.8 Monetary and exchange rate policy

According to the Act on the Central Bank, the primary objective of the central bank is to achieve and maintain price stability. Since mid-2001, monetary policy has been operating within the inflation-targeting framework, accompanied by a wide-band pegged exchange rate system. Given the limits of the exchange rate band, inflation targets can be achieved only by co-ordinated monetary and fiscal policies. The monetary policy instruments are essentially harmonised with those of the Eurosystem, apart from the fact that the NBH operates on the passive, rather than the active, side. The direct impact of the interest rate channel is relatively weak for the time being because of the low indebtedness of the private sector. However, due to the rising households debt, the significance of the interest rate channel is on the increase. This is moderated by the fact that some of the borrowing is in foreign currencies. The indirect impact of monetary policy works through the exchange rate and, increasingly, via influencing inflationary expectations.

The Forint exchange rate may fluctuate against the Euro in a ±15 % band. Since the widening of the fluctuation band, the Forint has always been on the strong side of the band, in the 235-271 HUF/EUR range in recent years. This means that compared to the average of this range, maximum fluctuation was ±7.5 %. During 2004 the Forint approached the strong edge of the band, while its volatility significantly reduced compared to the previous period.

In 2004, the December/December inflation rate is expected at 6%, and at the end of 2005, at around 4.5%. The inflation targets are set together by the Government and the Monetary Council, taking into account the envisaged fiscal path. The inflation target for 2005 is 4% (with a tolerance band of ±1 %), while the longest-term target currently set is 3.5% for 2006. Subsequently, inflation targets are expected to be set at 3%, which is in line with price stability.

Joining ERM II will represent and important stage of the convergence path, which is not expected to require changes in the present monetary regime. Before achieving nominal convergence, an explicit exchange rate management should be avoided; even in ERM II, monetary policy will primarily aim to achieve the inflation targets. Exchange rate stability within the band can be assured by stabilising long-term exchange rate expectations, which requires an increasing credibility of the convergence process.

## 3. General Government

### 3.1 Fiscal developments in 2004

The 2004 Budget Act set the deficit of the general government at 3.1% of GDP (considering the effect of the pension reform), its primary balance at 0.4% of GDP. However, the unbroken expansion of housing loan scheme in the second half of 2003, the rise of the interest rates in December 2003 and the increase of yields made it obvious by early 2004 that significant additional expenditures were to be expected in interest expenditures and housing loan subsidies. Tax revenues last year fell short of the expectations that served as the basis for budget planning, thus a downward adjustment of this year's forecast also became necessary.

In February the Government, having reviewed developments, raised the expected deficit forecast by 0.8 percentage points (the pension reform adjusted deficit was raised to 3.9 % and the deficit together with the effect of pension reform to 4.6% of GDP). Simultaneously, in order to establish firm foundations for the new deficit target, it decided on expenditure cuts corresponding to almost 1% of GDP. Due to the savings on primary expenditures, the primary balance forecast was modified by only 0.2 percentage points.

To facilitate the control of developments, the Ministry of Finance publishes monthly the forecast of central government deficit updated on the basis of actual figures. The Government has committed itself to take additional measures to control expenditures if this is necessitated by figures during the year. Accordingly, a moderate additional saving (0.06% of GDP) was imposed in April, followed by another adjustment in July corresponding to 0.5% of GDP. The use of unspent appropriations from previous years represents risks for the achievement of the deficit target. The measure introduced in July tightened the conditions for the use of those unspent appropriations.

The original forecast already reckoned with the uneven development of the deficit during the year. The effects of import-related VAT settlements after the accession and the payments due at the beginning of the year and in the second quarter explained the fast deficit growth in the first half-year cash flow projection. During the third quarter, however, the risks of a deficit higher than the target set in February were clearly outlined. The achievement of the target set in February was even more difficult as the extent of the VAT revenue loss after the accession, considerably higher than originally expected, became clear only in September.

In September the Government decided to implement additional measures (sale of treasury property, dividend collection from state-owned enterprises, prevention of spending of excess revenues in extra-budgetary funds, stricter tax and excise controls). The measures will improve the balance by 0.2-0.3% of GDP. The Government considered that, under the tight monetary conditions, any greater fiscal austerity would jeopardise the strengthening, export and investment driven growth.

On the whole, the tax, tax-type and contribution revenues are expected to fall short of the February forecast by somewhat more than 0.5% of GDP. The greater-than-expected VAT loss after the accession, the shortfall of excises and consumption/registration tax, the greater-than-calculated use of tax credits in the personal income taxes were to some extent offset by the excess in corporate income tax, simplified business tax, stamp duty and contribution receipts. On the expenditure side, the aggregate excess of pension expenditures indexed to wage and inflation trends, of pharmaceutical and housing subsidies and of transfers to persons with reduced working capacity may reach 0.3% of GDP. Taking into consideration the effect of the measures adopted in September, the Government published a new forecast, which is close to market projections, increasing the forecast of the expected annual deficit by 0.6 percentage points. It set the deficit adjusted for pension reform to 4.5 % of GDP and together with the effect of pension reform to 5.3 % of GDP.

However, even though in 2004 the deficit will be greater than expected, a significant adjustment will be implemented this year. The deficit of the general government will decline by 1 percentage point, while the primary balance will improve by 1.3 percentage points.

### 3.2 Fiscal objectives for the period of 2005-2008

The main fiscal policy objective continues to be the fulfilment of the general government deficit target, set in the Convergence Programme in May, by 2008. Due to the higher deficit in 2004, it requires greater than previously expected adjustments, at 0.6-0.7 percentage points a year. The balance will be improved simultaneously with the reduction of the size of the general government. The new fiscal policy of the Government aims at a smaller but more effective public sector. The fiscal policy reduces the expenditures of the general government while also provides higher quality services.

The ratio of expenditures to GDP will be reduced by more than 4 percentage points even against the increasing EU transfers by 2008. This assures the reduction of the deficit and at the same time allows for reducing tax burdens. Between 2004 and 2008, the ratio of tax, tax type and contribution revenues to GDP will fall by almost 2 percentage points. In addition, other revenues of the general government (payment due to infrastructure, EU-refunds, etc.) will also moderate. Expenditure restraint will also have to compensate this revenue loss.

**Fiscal development** in % of GDP

| | **2003** | **2004** | **2005** | **2006** | **2007** | **2008** |
|---|---|---|---|---|---|---|
| Tax, tax-type and contribution revenues | 39.7 | 39.3 | 38.9 | 38.6 | 38.1 | 37.6 |
| Consolidated revenues | 44.3 | 44.8 | 43.6 | 43.8 | 43.2 | 43.4 |
| Revenues without EU transfers | 44.2 | 44.6 | 42.8 | 42.2 | 41.6 | 40.8 |
| Consolidated expenditures | 49.8 | 49.3 | 47.4 | 46.9 | 45.6 | 45.2 |
| Expenditures without EU transfers | 49.7 | 49.1 | 46.6 | 45.3 | 44.0 | 42.6 |
| General government deficit | 5.5 | 4.5 | 3.8 | 3.1 | 2.4 | 1.8 |
| *Effect of pension reform* | *0.7* | *0.8* | *0.9* | *1.0* | *1.0* | *1.0* |
| *General government deficit with the effect of pension reform* | *6.2* | *5.3* | *4.7* | *4.1* | *3.4* | *2.8* |

The realisation of the objectives is facilitated by the fact that as of 2005 stronger procedural safeguards will be incorporated in the Act on Public Finances, and the Minister of Finance will have greater discretionary powers:

- The Minister may initiate government measures not only if the realisation of appropriations is significantly different from the budgeted level but also to prevent such occurrences;
- The Government specifies the type and magnitude of expenditures for which commitments can be undertaken only with the approval of the Minister of Finance and with the supervision of the Treasury.

Furthermore, by altering the regulatory system, the Government intends to restrict the possibility of the reallocation of appropriations to operational costs within central public administration, in order to improve the efficiency of operations.

The more effective and targeted use of public funds allows for the execution of public functions despite the declining expenditure/GDP ratio. Furthermore, as of 2005, funds received from the European Union will play an ever-increasing role in supplementing domestic funding. In 2005, its first full year in the European Union, Hungary will receive a higher amount of EU funds than in the accession year of 2004. The growth of the amount of transfers will be accompanied by their restructuring: the non-earmarked lump sum cash refund will fall in 2005 to one fifth of the 2004 level (then disappear after 2006), simultaneously with the significant growth of funds allocated through applications. The expenditure forecast also takes into account the domestic co-financing element necessary for utilising the transfers.

In the calculation of funds available from the EU budget and items due to the EU budget, two periods have been separated:

- Transfers between 2004 and 2006 have been calculated on the basis of the payment schedule prepared from the commitment figures included in the Accession Agreement in accordance with the measures taken for receiving transfers to date. The lower-than-expected uptake of EU funds in 2004 and the proposed payments in 2005, taking into consideration the rules governing the use of funds under various EU programmes (e.g. n+2 rule), and assuming the utilisation of 100% of the EU funds, the forecast for 2006 contains a higher figure than what would result from the evenly increasing trend.

- In 2007 and 2008, apart from the payments being carried over from the period before 2006, the significant increase in EU transfers relates also to payments made on the basis of the EU financial perspective after 2007. While the amount of EU funds projected for 2007 exceeds the year 2006 figures, the ratio of the related domestic funding develops in the opposite direction between the two years. This is because the EU/domestic financing ratio for the pre-accession programmes, ending in 2006 (Sapard, Phare) is different from that of the programmes continuing in 2007. This effect is amplified by the fact that, based on the proposed legislation relating to the next financial perspective, the domestic co-financing element of the new Cohesion Fund projects starting after 2007 is projected to be lower than in the previous projects.

### 3.2.1 Fiscal objectives for 2005

In 2005, the general government deficit to GDP ratio will decline by 0.7 percentage point, to 3.8%s. Declining interest expenditures will contribute to the improvement, and primary balance will be in equilibrium.

**Key indicators of the general government sector** in % of GDP

| | 2003 | 2004 | 2005 |
|---|---|---|---|
| Tax, tax-type and contribution revenues | 39,7 | 39,3 | 38,9 |
| Primary expenditures | 45.6 | 44,9 | 43,5 |
| Primary expenditures without EU transfers | 45,5 | 44,7 | 42,7 |
| Primary balance | -1.6 | -0.3 | -0.0 |
| Consolidated revenues | 44.3 | 44.8 | 43.6 |
| Revenues without EU transfers | 44.2 | 44.6 | 42.8 |
| Consolidated expenditures | 49.8 | 49.3 | 47.4 |
| Expenditures without EU transfers | 49.7 | 49.1 | 46.6 |
| Deficit | 5.5 | 4.5 | 3.8 |
| General government debt | 57.0 | 57.3 | 55.3 |

There is a much more marked expenditure cut underlying the improvement of the deficit and the primary balance. Primary expenditures as a % of GDP will fall by 1.4 percentage points, or by 2 percentage points calculated without the EU transfers that increase both the revenue and expenditure sides of the budget. The adjustment on the expenditure side offsets the decline in the revenues to GDP ratio, which is partly autonomous and partly results from changes in the tax regime. Against the smaller deficit, the debt ratio will start declining again in 2005.

In order to achieve the deficit target, a special reserve amounting to approx. 0.5% of GDP was built into the expenditures, which serves to offset any revenue-side risks. This can be utilised only if revenues are in line with projections.

The prevention of overspending is also underpinned by procedural safeguards:

- In case of chapter managed appropriations, only the ratio of transfer appropriations determined by the Government can be used in the first half-year. (The aim of the measure is to prevent overspending by the chapters in the first half of the year);

- In order to create a smaller government and realise long-term savings, the number of persons employed in the public sector will decline. To cover the related one-off expenditures (which can be seen as investment into the future), the budget includes a special reserve provision corresponding to approx. 0.2% of GDP (of which 0.1% appears in local governments). The provision cannot be exceeded;

- A ceiling will be imposed on the appropriation of normative subsidies for social and public education purposes; any overspending will have to be covered by reallocation within the chapter. Financing needs in excess of the appropriations may be satisfied only if Parliament modifies the Budget Act;

- In case of adverse deficit developments or as a preventative measure, the Government may block, reduce or cancel appropriations, with the exception of those for which Parliament retains the right of amendment during the year;

- In case of extra-budgetary funds, the Budget Act sets out the obligation to maintain a balance;

- In case of the in-kind benefits of the Health Insurance Fund, appropriations may be exceeded during the year, time-proportionately, only with the consent of the Minister of Finance or of the Government. (The purpose of the measure is to control expenditures right from the beginning of the year);

- In order to control the appropriation for pharmaceutical subsidies, the manufacturers and the central budget will share the risk. Above a specified ceiling, the manufacturers bear all the risk.

To reduce risks and achieve long-term savings, the Government also proposes additional changes in the regulatory system. The unspent appropriations of budgetary institutions and chapter-managed programmes represent a risk for increasing the deficit. The regulation will assure that at the end of 2005 the amount of unspent appropriations cannot be greater than at end-2004, that is, the deficit cannot grow due to the use of these appropriations.

For the development of the general government deficit, the financial management of local governments may also entail certain risks. The planned deficit of the sub-system is 0.2% of GDP for 2005. As in recent years the deficit of local governments was generally around 0.1-0.2% of GDP (with the exception of 2002), the forecast for next year is realistic. The autonomy of the 3200 local governments is enshrined in an Act requiring 2/3 majority in Parliament for its amendment, thus the Government has no direct instruments to limit their financial management. However, there are a number of areas where they can be influenced indirectly, through regulatory tools.

The following government priorities are enforced in the 2005 budget and the modification of the tax and contribution system:

Social policy priorities
- increasing employment;
- more equitable support to families with children, with emphasis on the means-testing principle;
- more equitable system of housing subsidies for young people;
- improving the situation of pensioners.

Development policy priorities
- maximum utilisation of EU funds;
- infrastructure development;
- promotion of innovation.

### 3.2.2 Revenue side

Changes in the tax and contribution system in 2005 serve to

- reinforce the equity in the tax system, mitigate excessive differences in taxation,
- reduce burdens on labour, improve the conditions for employment,
- provide incentives to investments,
- promote research and IT developments,
- simplify tax and social security administration,
- modernise tax administration, improve its efficiency

The most important changes implemented to attain tax policy objectives are as follows:

- In the personal income tax system, the targeted modification of the tax schedule into a two-rate system assures a growth of the real income of employed person with average or below-average incomes at a rate in excess of the average for the national economy. The middle rate of the three-tier tax schedule of 2004 (14-26-38%) will be dropped, thus the ceiling of the bottom bracket will be increased to HUF 1.5 million. The minimum wage continues to be tax-free. In order to align the tax burdens on capital and labour income and to approximate tax burdens, the linear tax rate of separately taxed income items will increase from 20% to 25%.

There will be additional limitations imposed on the eligibility criteria for tax benefits;

- In the corporate tax system, the tax benefits relating to employment, investments and research and development will be expanded. The possibility of deducting 50% (rather than the current 25%) of the local business tax from the corporate income tax base improves the investment capacities of corporations;

- Among social security contributions, to reduce the burdens on labour, the flat-rate health contribution will be reduced as of November 2005. Furthermore, some of the planned regulatory changes promote the employment of selected employee groups (career starters, persons returning from child care benefit and persons above 50), and the expansion of part-time employment.

- In local taxation, the ceiling of the flat-rate tax will be increased so that local governments make better use of the revenue potentials in the taxation of real property and that real properties are taxed based on their value. A new, job-creation-related allowance will be incorporated in the business tax.

- Within stamp duties, the principle of wealth-proportionate taxation will be emphasises through the expansion of the scope of inheritance and gift duty. The procedural duties will gradually be replaced by cost-based judicial service fees.

In 2005, general government revenues as a percentage of GDP will decline by 0.35 percentage points, which is only partly related to the changes in the tax regime. 0.15% of the shortfall is explained by the fact that after accession the average level of customs duties decreased and only 25% of customs revenues constitute part of the Hungarian budget revenues. In order to support disinflation, in 2005 no general valorisation of excise rates will be implemented (except for cigarettes, the level of excises already reached the minimum duty applied by the EU on excise goods). Revenues from excise taxes will decline by 0.16% as a percentage of GDP. On the other hand, additional revenues will be generated from the temporary special tax imposed on financial institutions for 2005-2006. The tax is applicable to credit institutions and financial enterprises. By default, the tax is levied on the interest margin, but the pre-tax profit can also be selected as the tax base instead. The rate of tax is 6% if the interest margin is selected, and 8% if pre-tax profits are chosen.

The 0.12-percentage-point drop of PIT revenues as a percentage of GDP reflects the complex effects of tax rate changes and the limitation of tax benefits. Some of the tax benefits cannot be claimed in the tax year, these can be reclaimed only in the tax returns submitted in March of the subsequent year. For the year 2005 tax revenues, tax benefits on the repayments of housing loans and the changes of benefits on the acquisition of IT equipment (Sulinet), introduced for the year 2004, will have the most significant effects. Benefits of that kind alter the ESA95 revenues with a delay of one year, as the correction for accrual is implemented using the method of pre-defined delay (one month) (this method has been accepted by Eurostat). Thus the effects of the changes, together with the cash flow implications, will present themselves in the year after the fiscal year concerned.

Revenues in 2005 are increased by the tightening of the terms of the aforementioned tax benefits at the beginning and during 2004:

- As of 1 January 2004, the ceiling of the tax benefit available for the repayment of housing loans was reduced by fifty percent, its rate in the case of second-hand housing units fell from 40% to 30%, and it can no longer be split between co-debtors. Eligibility depends on an income ceiling, and the loans eligible have also been restricted;

- As of 1 July 2004, the rate of tax deduction for the acquisition of IT equipment was reduced from 100% to 50%, and its use made conditional on an income ceiling. Furthermore, the scope of eligible equipment was narrowed on several occasions during the year.

Taking into account the stricter measures, the revenue-reducing effect of the two tax benefits will be smaller in 2005 than it was this year. This is also supported by the slowing growth rate of housing loans. The additional restrictions of tax benefits in 2005 (introduction of an aggregate ceiling, income ceiling) will increase revenues in 2006.

The major tax and contribution revenues are shown in the following table:

**Major tax and contribution revenues** in % of GDP

| | 2003 | 2004 | 2005 |
|---|---|---|---|
| Corporate profit tax | 2.23 | 2.13 | 2.10 |
| Simplified business tax | 0.24 | 0.32 | 0.34 |
| Customs duties | 0.71 | 0.20 | - |
| VAT | 9.06 | 9.26 | 9.22 |
| Excise duties | 3.27 | 3.19 | 3.03 |
| Consumption/registration tax | 0.33 | 0.30 | 0.28 |
| Special tax on financial institutions | | | 0.17 |
| Personal income tax | 7.12 | 6.82 | 6.70 |
| Local taxes | 1.73 | 1.73 | 1.72 |
| Fees | 0.78 | 0.76 | 0.72 |
| Social security, employer and employee contributions | 12.64 | 12.55 | 12.50 |
| Contributions paid into the second pillar | 0.70 | 0.82 | 0.95 |

### 3.2.3 Expenditures

In 2005, major expenditure-side adjustments will be implemented to improve the budget balance. The realisation of a smaller but more efficient public sector is facilitated by measures resulting in long-term savings as well:

- In the case of operational expenditures, financing pressures will ensure higher performance and more effective staff management in the public sector. Institutions will have to manage the financing for the 6% wage increases and the 13th month salaries of civil servants using their own resources (staff cuts, reorganisation). In case of public servants, the central budget provides for the 4.5% wage increase and for the 13th month salaries, while 1.5% must be covered from savings;

- The expenditure appropriations of central budgetary institutions contain an approx. 5.5% nominal cut on cash basis. (On accrual basis it represents more than 2,5% cut. The main reason of this difference is that the 13th month salaries are taken into account differently in the 2004 figures in line with the recent changes in the law.) The rules of spending the own revenues of institutions will become more stringent, thereby encouraging more efficient financial management;

- In case of the chapter managed appropriations, zero-based budgeting has been introduced: following tendering, the Government decides, item by item, about programmes and the extent of their financing. Due to the new budgeting technique, the expenditures of chapter managed appropriations will essentially remain unchanged in nominal terms as well in 2005;

- Modernisation and realignment of the organisations in the area of public safety and public order;

- Elimination of the parallelism in the public administration in the field non-core activities;

- In public education, the modification of normative grants aims to achieve better teacher/student ratios and the creation of larger student groups;

- The promotion of micro-regional co-operation in the local government subsystem;

- In the long-term, the expansion of managed care in health care serves to enhance cost-efficiency;

- Some of the infrastructure investments already started or planned in the public sector will continue, or start, in a public private partnership arrangement. Through PPP projects, the social benefit of the more efficient operation of the private sector may prevail. At the same time, the allocation of costs over time is favourable for the expenditure side of the budget. In 2005, the value of PPP projects will reach around 1.3% of GDP. The new projects to start may be only such that do not increase the general government deficit according to the Eurostat requirements.

The implementation of infrastructure projects under a PPP arrangement makes it possible to reduce not only current expenditures in 2005 but also the capital expenditures of the government as a percentage of GDP, while development objectives can be achieved as planned. Both current-, and capital expenditures (capital formation and capital transfer) to GDP will decrease by approximately 1 percentage point as compared to the 2004 levels.

In the case of the „Public Private Partnership" model, the government purchases the long-term provision of public services from the private sector. The government pays the private corporation a service fee, which is distributed over time, predictable, and depends either on use or on availability.

At present, the PPP projects in the most advanced stage are in the following areas in Hungary:
- ongoing projects in motorway construction: M5, M6. Projects expected to start in 2005: M3, M7, M8-Danube bridge. The estimated NPV of these project amounts to HUF 1,000 billion.
- prison construction. The estimated NPV of this project amounts to HUF 71.7 billion
- construction and modernisation of student hostels (planned NPV amounting to HUF 52.1 billion), establishment and development of education and research infrastructure.

There are several projects in the pipeline, primarily in the following areas:
- construction and operation of the new Hungarian Television Rt. headquarters (amounting to HUF 25 billion),
- development of central- or local-government-owned sports facilities,
- construction and operation of cultural facilities, renovation of buildings.

The Government's priorities with respect to public expenditures are as follows:

- In line with the objective of creating a more efficient public sector, within the general public functions the nominal value of the expenditures of general public services will be unchanged;
- In accordance with social policy priorities, the social security and welfare expenditures will increase essentially in line with GDP growth. In accordance with legislation, pensions will increase in line with the expected wage increases and the average inflation (Swiss indexation). Furthermore, the portion of the 13$^{th}$ month pension corresponding to the 3$^{rd}$ week will also be paid.
- In development policy, the modernisation of infrastructure is assisted by the use of EU funds and private funding.

## 3.3 Fiscal developments in the period of 2006-2008

### 3.3.1 Revenues – tax policy

In the medium term, the growth of household consumption will be slower than that of GDP, while wages will increase in line the productivity. Due to the improving tourism balance, purchased consumption will increase slightly faster, and the improved employment will increase the total amount of wages and salaries. Even so, the major tax bases, which have a decisive effect on revenues, will increase slower than GDP. The tax, tax-type and contribution revenues of general government, as a percentage of GDP, will decline by an annual 0.5 percentage points on average, reflecting the combined effect of macroeconomic developments and of the principles of tax policy.

**Consumption, wages, tax revenues** in % of GDP

| | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|
| Household consumption expenditure | 53.1 | 52.6 | 52.1 | 51.5 |
| Purchased consumption | 52.3 | 52.0 | 51.8 | 51.6 |
| Wages and salaries | 35.0 | 34.8 | 34.7 | 34.7 |
| Tax, tax-type and contribution revenues | 38.9 | 38,6 | 38,1 | 37,6 |

In the 2006-2008 period, the comprehensive modernisation of the tax system will continue. It aims to assure that the tax regime contributes to

- increasing the potential of the economy,
- expanding employment,
- creating a business environment conducive to SMEs,
- promoting savings and investments,
- strengthening the ability of the country to attract and retain capital.

To that end, the following principles will remain in focus:

- Strengthening the neutrality of the tax system, more consistent application of the principle of proportionality;

- The reduction of social security burdens is conducive to the expansion of employment. The reduction or restructuring of payment obligations of employers on wages is especially justified. This means the review and modification of the social security contributions, the health contribution and the employer contribution (vocational training contribution);

- Reduction of other tax obligations of enterprises. No further reduction in the low profit tax (corporate income tax) is justified. On the other hand, the dividend tax will be abolished as of 2006, primarily to encourage foreign investments and in particular the settlement of financial and regional headquarters into Hungary, and to retain the activities of such enterprises in the country;

- In the value added tax system, a gradual reduction of the normative tax rate from the end of the period, subject to changes in EU requirements, and taking into consideration the budget position;

- Excises taxes remain unchanged except those of the cigarette. According to the planned schedule aiming to reach the required EU minimal tax level, the tax on cigarette will increase 11-12% and 5.1% in 2006-2007 and 2008 respectively.

- To simplify the system of taxation, the narrowing of the unnecessarily wide variety of tax types;

- The continued reduction of the obligations of private individual taxpayers relating to tax declarations also in order to alleviate the administrative burdens on employers.

### 3.3.2 Expenditures

In the medium term, the government's main objective is to reduce the general government expenditures to GDP ratio. The utilisation of EU funds has a priority; therefore structural changes are required in other expenditure areas. The changes focus on the reform of the staff and wage structure of the public sector.

The revision of the state's function will go on in the 2006-2008 period. During this period the parallelism and unnecessary functions will be abolished. Therefore in a smaller public sector good performance could be better recognised without increasing expenditures.

The development of the motorway network will continue under PPP arrangements. This allows the active participation of the private sector in the development of trans-European road networks.

Through the stabilisation of the 2005 appropriations, the reorganisation of the armed forces will continue intensively. The professional personnel must be capable of performing the functions delegated to Hungary by NATO.

Hungary is prepared for receiving EU agricultural subsidies. The amount of the agricultural and rural appropriations from the EU budget, according to the Accession Treaty and in line with the accomplishment of the already accepted projects, has increased gradually, while the proportion of the contribution of the domestic budget has decreased continuously and consistently with the provisions of the CAP.

## 3.4 Public debt

The HUF- and FX-denominated debt issues to finance the deficit and the maturing budget debt repayments are determined by the annual financing plan of the central budget; the framework and directions for this are set in the debt management strategy approved by the Minister of Finance. The objective of the debt management strategy is to provide funding for the financing needs of the budget with cost minimisation and reasonable risk-taking in the long term. For the definition of the debt management strategy, the aggregate consideration of risk and costs is a fundamental criterion. To this end, a system of interrelated benchmarks has been devised for the entire public debt portfolio. As an important feature, the new benchmarks, instead of the former system of determining directions in the portfolio structure, specify more concrete targets (target ranges):

- the ratio of FX debt may fluctuate in the 25-32% range in the coming years,
- for the fix/floating composition of the HUF portfolio, in line with the previous range, a 61-83% fix-interest debt ratio is determined,
- the HUF duration target is set at 2.5+/-0.5 years.

The strategy relies on the following main principles:

- maturing FX debt must be refinanced in FX, HUF debt in HUF, and the currency structure of the net financing requirement may be modified depending on the macroeconomic and market positions at any time. In determining the structure of issues, the following objectives apply: expansion of the investor base, preparation for Hungary's EMU membership, and the alleviation of any domestic capital

market tensions. The currency structure of the FX portfolio is determined at 100% in EURO; any deviation from this is managed by hedging transactions.
- improving the structure of the debt, standardising maturities and developing the government securities market continue to be major objectives.

In Hungary, the debt to GDP ratio has been below 60% since 1999, but the declining trend of the debt ratio was reversed in 2002-2003. The adverse developments are attributable to the increasing general government deficit due partly to real interest rates exceeding economic growth, the deceleration of growth and valuation losses on the FX debt. Because of those factors, as well as the one-off VAT revenue loss related to our EU accession and the pre-financing of the agricultural subsidies received from the EU, the debt to GDP ratio will continue increasing in 2004.The continuous decrease of the general government financing requirement and the gradual convergence of yields on the government securities market will assure that the debt to GDP ratio will start declining from 2005.

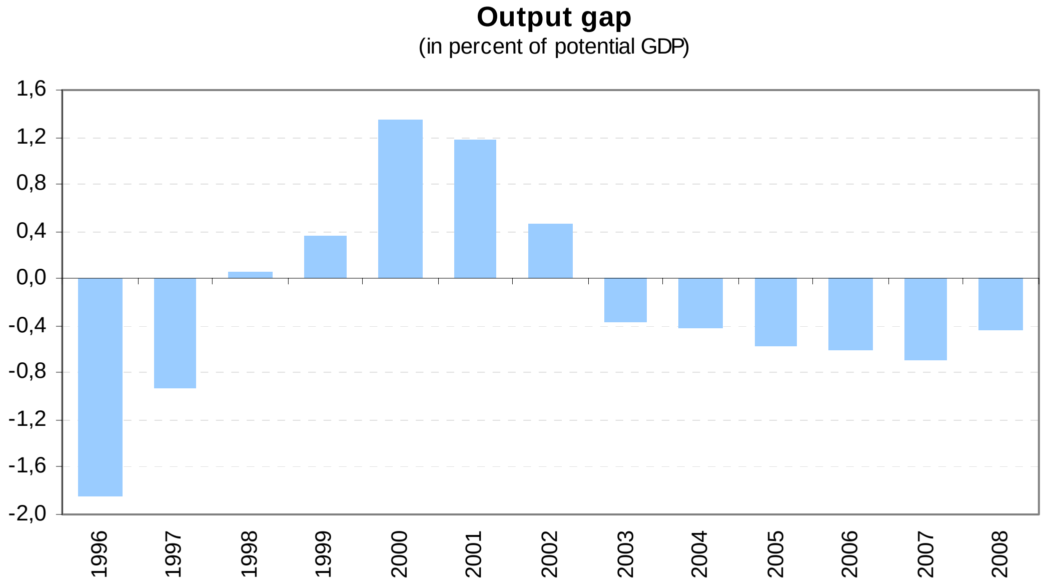
The debt level at the end of 2004 will be higher than envisaged in the May Convergence Programme because of the increased financing requirement for 2004. This higher starting debt level and the annual net financing requirements being higher than in the May Convergence Programme will have their effect on the entire convergence path, which will be offset in the medium term by the new yield projections which take into account yield developments since May 2004. According to our new projection, in 2007 and 2008 the debt ratio will be below the level indicated in May.

The size of the public debt is sensitive, apart from the primary balance, to the following factors:
- *Exchange rate effect:* changes in the exchange rate of HUF may increase or decrease the debt stock, depending on the direction of the exchange rate change, due to valuation losses or gains on the FX debt, which represents over one fourth of the total debt stock. In the medium term, an exchange rate change of HUF 1 may result in a HUF 13-18 billion variation in the debt stock.
- *Yield effect:* The yield curve underlying the calculations relies on the assumption that economic policy attains credibility and market confidence is restored. The accrual-based net interest expenditure projection contains a risk corresponding to 0.3-0.4 % of GDP, as compared to market expectations Fulfilling the fiscal path in the updated Convergence Programme, the credibility of the economic policy will strengthen and lower yield curve will be realised than the one reflecting current market expectations. The debt financing burdens can be further mitigated by adequate debt management, the development of the government securities market, and the use of a wider variety of instruments. In the framework of the new debt management strategy, the ratio of FX debtwill increase, while its recalculation period will decline in 2005. Due to these two factors interest payments could decline by 0.1-0.2 % of GDP in 2005 compared to interest payments calculated under the assumption of an unchanged debt management strategy.

## 4. Sensitivity analyses

### 4.1 Cyclically adjusted balance

The most recent calculations using the production function, similarly to former calculations, indicate that the positive output gap accumulated during the period of rapid economic growth of the late 1990's disappeared by 2003. In spite of the resumption of growth in 2004, actual GDP will not reach potential output even in 2008.




The negative output gap will worsen the general government deficit and the primary balance by 0.2 percentage points until 2007 and 0.1 percentage points even in 2008. The cyclically adjusted deficit and the primary balance show a 0.1-0.2 percentage point more favourable picture. Beginning with 2006, the cyclically adjusted deficit corrected by the impact of the pension reform will be below 3 percent of GDP, while the primary balance corrected in the same way will already be positive by 2005.

While previously the potential output (potential GDP) was estimated using the Hodrick-Prescott filter, the present calculations have been made using the Cobb-Douglas production function.

For the estimation of "potential labour supply", i.e. the labour component of the function, we smoothed the actual and projected time series of the participation rate and unemployment for the 1994-2005 period, then extended the trends to 2008. (The NAIRU cannot be estimated from a model relying on economic relationships on the basis of currently available data. This is because, since 1995, inflation and unemployment have been simultaneously declining, and only one cycle of the unemployment can be detected.) For the population from age 15 to 64, we relied on the forecasts of the Demographic Institute.

The time series of net capital stock was derived from the gross fixed capital stock survey of the CSO for 2000, taking into account the depreciation of capital (using a combined rate of discarding and depreciation and the time series of investments).

The total factor productivity (TFP) coefficient was derived by H-P filtering the Solow residual, which was obtained from the labour and capital components of the production function and the actual GDP. By our estimation, the annual growth of the trend TFP proves to be slightly above the growth rate estimated by the European Commission. This result seems to be reasonable for a catching up country.

**Cyclical conditions** in % of GDP

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| Output gap | -0.4 | -0.4 | -0.6 | -0.6 | -0.7 | -0.4 |
| General government balance | -5.5 | -4.5 | -3.8 | -3.1 | -2.4 | -1.8 |
| Primary balance | -1.6 | -0.3 | 0.0 | 0.3 | 0.7 | 1.1 |
| Cyclically adjusted balance | -5.4 | -4.4 | -3.6 | -2.9 | -2.2 | -1.7 |
| Cyclically adjusted primary balance | -1.5 | -0.2 | 0.2 | 0.5 | 0.9 | 1.2 |

### 4.2 Other sensitivity analyses

According to our estimation, the sensitivity coefficient of the government balance related to 1 percentage point change in GDP is 0.299 (see Annex).

According to the calculations, the deficit is less sensitive to inflation. One additional percent of inflation causes 0.11 percentage points lower deficit. For the calculation of inflation sensitivity, we assumed an identical consumer price inflation rate for all products contained in the basket.

Regarding interest sensitivity, we assumed identical changes in the base rate of the central bank, BUBOR and government securities yields. An upward shift of 1% in the yield curve raises the deficit by 0.10 percentage points (in the first and second year as well).

Assuming identical changes in the annual average and end-of-year exchange rates, as well as constant cross rates, a HUF 1 stronger exchange rate improves the balance insignificantly, in the ten thousandths of a percent range.

## 5. Long-term sustainability of public finances

### 5.1 Pension system

According to the most recent demographic projections, the proportion of the population over the retirement age compared to the population of working age will, following a temporary decline due to an increase in the retirement age until 2009, increase significantly from 32.0% in 2004 to 55.1% in 2050. Improvement in the employment rate implies that the share of retired people compared to those employed will develop somewhat more favourably (from 62.3 % 84.8 %).

Apart from the demographic and macroeconomic situation, three measures of the pension reform will have an important effect on pension expenditures: introduction of mixed financing, application of the Swiss indexation formula (50% wage increase, 50% inflation), and the raise of the retirement age. In 2003, the expenditure related to social security pensions amounted to 9.2% of GDP. It should be noted that these are mainly financed from the Pension Insurance Fund (8% of GDP) but certain benefits (primarily disability pension below the retirement age) are financed from the Health Insurance Fund (1.2% of GDP), which is not covered by the long-term projections.

The introduction of the funded system will have a significant impact on expenditures from the 2020s onwards. By that time, newly retired people will retire as members of the two-pillar system in growing numbers, and as such, they will only be eligible for a reduced amount of pension from the pay-as-you-go pillar. According to the forecast prepared in October 2004, in 2050 private pension funds will relieve the Pension Insurance Fund from pension expenditures representing 1.8% of GDP (compared to the situation without reform). The increase in social security expenditures is held back by the raise in the retirement age, and indexation of pensions below the GDP growth rate. As a result of these factors, gross pension expenditures of the Pension Insurance Fund are not expected to be higher than they were in 2000 (7.6%).

Regarding revenues, it should be emphasised that members of the mixed system pay a reduced amount of contribution into the pay-as-you-go pillar. Due to this, there will be an additional deficit in this pillar, which will increase until the 2020s, parallel with a growing percentage of the active population joining pension funds. The other most important effect reducing revenues is the decrease of the absolute number of employees due to demographic factors. Later on, the reform will have an impact on the expenditures as well. The mixed system is expected to be fully mature around 2060. It is also important that in the same period the funded pillar will achieve savings (accumulation) in the same amount as the temporary deficit of the Pension Insurance Fund.

**Effect of the pension reform on the long-term sustainability of public finances**

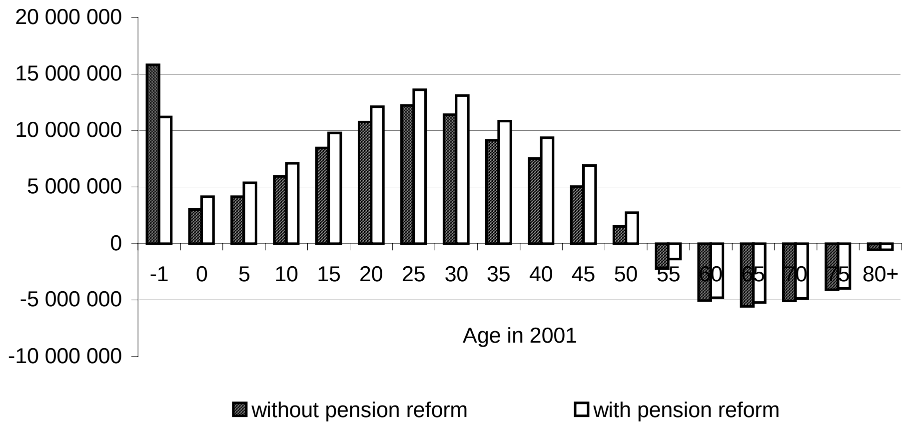
The pension reform launched in 1997 greatly contributed to the improvement of the long-term position of the budget, which we shall present using the so-called 'generational accounts', also used by the Commission. The system of generational accounts measures the long-term sustainability of public finances.

According to this method, the net tax burdens (the difference of taxes paid and transfers received during a person's lifetime) are broken down to individual age cohorts, and the allocation of burdens in the base year is projected into the future. Thus, relying on projections for the number and age composition of the population, one can establish the tax burden on future generations, as compared to currently living ones.

The method of generational accounts reveals the effects of already known changes in the public finance system on long term sustainability. The pension reform launched in 1997 is one of those changes; its main elements include the raising of retirement ages, the introduction of the so-called Swiss indexation formula, the gradual elimination of the degressive scales previously used in income calculation, and the introduction of a new pension formula as of 2013. Since 1 January 1998, some of the mandatory pension contributions have been collected in the newly established fully funded private pension funds.

The figure below reveals that the pension reform has significantly reduced the generational imbalance (the difference between the accounts of the new-born, i.e., aged 0, and those of the not yet born), as it has reduced the burdens on generations not yet born while shifting the additional burdens on the already living generations (see Figure).

**Generational accounts with and without pension reform**
(base year: 2001, HUF)




Note: the account of the age -1 shows the average of net payments to be made by generations not yet born. For simplicity, we only present the data for selected age years.

An average member of the future generations will be a net contributor to the amount of HUF 11.2 million, instead of the HUF 15.9 million without the reform, while the burdens on the present generations have increased by 1.2 million HUF on average. The imbalance (the burden of future generations as a ratio of the burden of currently living ones) declines from 5.3 to 2.7.

As a result of the effects on both expenditures and revenues, the deficit of the Pension Insurance Fund (including also the temporary deficit arising from the lost contribution revenues) will fall until 2009 – due to the raise in retirement age -, and increase after that. In 2050, the deficit calculated with gross pension expenditures amounts to 2.8% of GDP.

In sum, it may be concluded that demographic developments have an unfavourable impact on the Hungarian pension system. However, this unfavourable effect will be mitigated in the long run by the measures adopted in the context of the pension reform of 1997.

**Pension expenditures in Hungary**
(Without pensions financed from the Health Insurance Fund)

| | 2000 | 2005 | 2010 | 2020 | 2050 |
|---|---|---|---|---|---|
| Gross pension expenditures (as a % of GDP) | 7.6 | 8.2 | 7.3 | 7.9 | 9.8 |
| Of which: First pillar | 7.6 | 8.2 | 7.2 | 7.7 | 7.6 |
| Second pillar | 0.0 | 0.0 | 0.1 | 0.2 | 2.2 |
| Deficit of the first pillar (as a % of GDP) | 0.5 | 1.7 | 0.8 | 1.7 | 2.8 |
| Of which: temporary excess deficit due to reform | 0.5 | 0.9 | 1.2 | 1.4 | 0.0 |
| Number of pensioners (million) | 2.4 | 2.3 | 2.3 | 2.6 | 2.8 |
| Of which: in the first pillar | 2.4 | 2.3 | 2.3 | 2.4 | 0.8 |
| in the mixed system | 0.0 | 0.0 | 0.0 | 0.2 | 2.0 |

### 5.2 Health care, social policy

Between 2001 and 2003 the expenditures-in-kind of the health insurance system increased faster than the GDP. This was the result of the fast dissemination of proprietary drugs, wage adjustments for employees in health care and the fast increase of health provisions.

Because of the strict budgetary requirements in 2004, a number of short- and medium-term measures were adopted (freezing of pharmaceutical prices, followed by a three-year agreement with producers, degressive financing techniques, introduction of cost-volume agreements in curative-preventative care), which had the combined effect of significantly decreasing growth rate of pharmaceutical subsidy expenditures while curative-preventative expenditures are incurred below the projected rate.
In view of the objectives set out in the Convergence Programme, the new government programme prioritised and rescheduled the goals of the health care reform. Because of this, and due to the aforementioned measures and changes in the financing system, the in-kind expenditures of health care will increase below the GDP growth rate in the forthcoming years.

Based on the claims occurred during the course of the parliamentary debate of the year 2005 budget preparation of a long- and medium-term strategic developing and restructuring plan of the health care system – in line with the updated Convergence Programme – has started, in which:

- restructuring plan of the health care provision system will be developed according to the demographic changes, and modelling – similarly to the 50-year pension forecast model - of the health care expenditures and economic growth will be set up;
- regional and local development and restructuring programmes will be developed;
- financial and regulation incentives that allow for enhanced enforcement of the requirements of cost-effectiveness will be set out;
- in order to advance the restructuring the 2005 budget of the Health Care Fund will contain funds for tenders to promote one-day surgery and personal services.

In addition to maintaining the real value of benefits, we propose the following major changes within the reform of social benefits for the 2005-2008 period:

- mitigation of the negative redistribution effect of the family tax benefit;
- enhancing social security for the poorest by rationalising the social benefit system and improving the measures and services assisting re-entering the job-market;
- modernisation of social administration by the establishment of uniform social and child protection agencies;

- reform of basic social services providing personal care to make basic services more flexible and to give priority to arrangements involving partnerships;
- reform of the free means-tested medication system that is under process. Reform of the social assistance system will enhance monitoring and review of the list of subsidised medication will assure that everyone gets the pharmaceuticals most necessary.

The fundamentals of the supporting system of the employment of disable people were set down according to the old socio-economic conditions, therefore they are in line with the quantitative, full-employment perspective. However it is theoretically and financially unfeasible under the current, altered conditions. We plan to converge the regulation gradually towards the EU norms, but it takes several steps. New regulation will probably take effect in 2006.

The government will spend HUF 55 billion expectedly on the employment of disabled people in 2005 – including VAT-compensation - which is 14 % less than the 2004 forecast. The 2005 regulation is transitional as, by setting out strict requirements it intends to prepare organisations for the to-be-enacted regulation regarding quality employment of the disabled. The new regulation is expected to be enacted in 2006. It will replace the current support provided to economic organisation without any restrictions on the utilization by a new system that is based on accounting and assist employment of the disabled people by putting the real remaining abilities and health status in focus.

## 6. Structural reforms

### 6.1 Sustainability of central budgetary expenditures

Expenditures of the central budget, the largest sub-system of general government, relate approx. 50% to the institutional and 50% to the so-called chapter managed appropriations. In 2004, the expenditure reducing tendencies of the coming years are well-founded in both categories.

*1) Central budget institutions*

In the past 15 years the number of central budgetary institutions fell by 40%.

| | **1991** | **1996** | **1999** | **2004** |
|---|---|---|---|---|
| Total number of central budgetary institutions | 1516 | 1343 | 1125 | 909 |

**In 2004**, in order to improve the conditions of efficient financial management and to limit the scope of wasteful management, the Government adopted the following **measures**:

a) It identified specific organisations to close down, restructure, or to be considered as candidates for such measures (see table below).
b) It commissioned a general organisational review and, based on its findings, measures, on the basis of the criteria issued by the Minister of Finance.
c) It ordered the development of a policy paper for the elaboration of organisation forms most conducive to efficient operation and most suited for public functions, as well as the development of the relevant regulations.

| Number of organisations | 2004 | No. of units selected for review or measure | No. of units closed until 30 September 2004 |
|---|---|---|---|
| Central budgetary institutions | 909 | 190 | 17 |
| Public benefit companies | 89 | 43 | 5 |
| Foundations, public foundations | 82 | 30 | 1 |
| Economic associations | 113 | 43 | 0 |

Review and implementation of the first phase of measures, will be completed by the end of 2004.

One of the main directions of the measures is the reform of the county-level institutional systems:
a) transformation to regional level where functions require decentralised originations for reasons of economies of scale, but no direct local presence is necessary,
b) integration into the county administration offices where the small individual capacity requirement of tasks justifies it,
c) integration into national centres where the function requires neither regional nor local presence.

*2) Chapter-managed appropriations*

In respect of the appropriations managed by the entity supervising the chapter, in 2004 the Government abandoned the incremental budgeting method and switched to a zero-base planning system, re-prioritising the competing needs. Chapters had to formulate their needs as programmes, and "apply", taking into consideration the deficit requirements as well, for a pre-defined governmental facility. This new method is conducive to the creation of a smaller and more efficient state because

- it allows for the quantification and continuous management of determinants,
- on the government level, it can periodically prioritise needs, thus assuring the allocation of resources in line with government objectives and priorities,
- it compels ministries and agencies disposing of public funds to engage in introspection,
- it helps political decision making because it facilitates decision on programmes, rather than on additional financing requests.

In **2005**, the following measures will be adopted to strengthen fiscal discipline in the management of public funds:

- reduction of the number of automatically fulfilled expenditure appropriations (apart from the co-financing of EU programmes),
- the role of the Ministry of Finance will increase in the incurring of expenditures: it will be responsible for the approval of commitments in a certain range and definition of their timing, control of financial processing during the year in case of divergence from the budget, or preventatively in the likely event of divergence,
- tighter control on the use of payments carried over from the previous year (unused appropriations),
- higher budget reserves.

## 6.2 Reform of the local government system

The rationalisation of the organisation of local government public services, which started in 2004, will continue to be implemented by voluntary, multi-purpose council partnerships. The purpose is to bring to full capacity the 74 multipurpose council partnerships created in the geographically defined 168 micro-regions, involving almost 1600 settlements in 2004, and to have as many local governments perform as broad a range of fundamental functions in partnerships as possible. As a result, the economic efficiency of the performance of functions can be increased, in addition to enhancing the quality of services requiring special expertise and considerable financial resources, such as elementary education, social, child protection and health care services.

At present the approximately 3200 local governments cannot be compelled to form partnerships, as their autonomy is preserved by an Act requiring qualified parliamentary majority for its amendment. However, the government may encourage the establishment of multi-purpose partnerships with regulatory means. On the one hand, the government provides one-off financial support for the establishment of new partnerships and continuous support for the operation of existing ones[2], and on the other hand, it incorporates economies of scale considerations concerning the organisation of tasks, in sectoral acts and legal regulations. Thus, already in 2005, a local government will receive supplementary funding if it starts kindergarten, 1st or 5th form classes with higher average pupil numbers. In the subsequent years, the requirements will be extended to higher classes to achieve higher average student numbers.

The more efficient organisation of functions is also promoted by the greater discretionary powers provided to local governments in the field of employment safeguards[3]. The central budget provides a special grant for expenditures relating to layoffs resulting from reorganisation measures of local governments (severance pay, salary payable for the term of notice).

It is not our objective to remove from the local government system the funds released by the more efficient performance of functions, because we intend to use the savings achieved for the implementation of rather expensive environmental investments (sewage disposal and treatment, waste management) by the local governments.
Thereby the borrowing needs of local governments may be reduced, which has a favourable effect on their financial balance.

### 6.3 Education, vocational training

It is a priority to organise the tertiary education in a structure and extent that assures financial sustainability and adjust the regulation on higher education according to that.

The introduction of the qualification structure appropriate for labour market needs and demographic trends is promoted by

- introduction of a normative financing structure that promotes optimal group or class size and brings along decreasing need for teachers and equipments.
- cuts in state-financed student headcount (annually declining limit for admission; in training systems consisting of interrelated cycles, cyclically declining student headcount limits)
- priority treatment of tertiary vocational training (post-secondary training).
- gradual extension of the two-level higher education system that allows the ratio of the students participating at the lower-cost level (similar to the current college degree) compared to the students at the higher-cost master level to converge to 80:20[4]
- possibility of decreasing the vocational contribution by the amount of the development contribution that enterprises can transfer to the institution providing the preferred vocational training.

[2] In 2005, existing partnerships will receive HUF 9 billion, newly created partnerships, HUF 6.5 billion in transfers.
[3] Starting from 2005 the employer will be able to set mandatory tasks for teachers for the part of the statutory weekly working time that is not taken up by the mandatory classroom hours (remedial courses for disadvantaged pupils, child and youth protection tasks).
[4] Currently the ratio of students participating in state financed college and university level education is 48:52.

Principles of the new model of the financing promoting cost efficiency:

- definition of the elements of normative financing from the organisational parameters of training (by cost),
- making supplementary targeted subsidies (e.g. academic activity) dependent on performance requirements,
- keeping the commitments of institutions within acceptable limits, by setting ceilings; curbing and preventing the indebtedness processes by clear regulation of the frameworks of financial management,
- clarification of the principles of supporting non-state run institutions (elimination of unjustified elements of financing),
- in case of tuition fees, the definition of fees equivalent to the state contribution, covering the costs relating to the training, etc.

Measures necessary for the rationalisation of the institutional and internal organisation structures and employment:

- elimination of the duplication of functions,
- immediate closing of institutions and organisation units left without adequate numbers of students because of student choice,
- detachment of entities relating to training but viable on their own (practical training workshops, hostels) from the mother-institution, and provision of their services to students in an appropriate form (under contracts),
- clear and consistent regulation of the requirements for teachers and researchers,
- elimination of multiple public service and other employment of researchers or teachers (which unnecessarily multiplies the financing requirement),
- elimination of the employment of retired professors/researchers (resulting in payments under both entitlements), or strict limitation to exceptional cases, etc.
- setting up an independent committee responsible for financial-strategic decisions

In case of vocational and adult education convergence towards real labour market needs and better employment opportunities will be enhanced by:

- filtering out double financing
- improving efficient use of sources by the implementation of the comprehensive monitoring system
- tightening the controlling system
- increasing the utilisation of the educational capacities by promoting the co-operation of the institutions.

The central budget gives normative contributions to churches, foundations and other entities that, alongside local governments, perform public education and certain social functions for these activities. The amount of such contributions was not clearly defined in the annual budgets of previous years (headcount of students or beneficiaries). In recent years, these contributions regularly exceeded the budgeted levels, therefore increased the deficit. In the future the foundation of such institutions and entitlement for contribution will be linked to tighter criteria and channels of double financing will be eliminated by clear regulation.

In the future several new measures will be implemented with the aim of preventing “under-budgeting”.

a) in the 2005 budget, the budgetary appropriations from which transfers are paid have been given a ceiling, and any additional needs must be financed from the funds otherwise available for the chapters;
b) in the future, budgetary funding can only be given to activities closely related to the performance of specialised functions, following the review of the objectives;
c) by extending the legal regulations available for control and the scope of entities obligated to implement, tighter control of the eligibility and amount of support will be introduced.

### 6.4 Health care

The ultimate objective of the reform of the health care system is to increase efficiency and transparency, and to create sustainable financing in the long term. To attain this, a number of measures have been taken in recent years. In 2005, the following measures will bring about considerable progress in the field of pharmaceutical subsidies and curative-preventative expenditures:

- the 2005 Budget Bill proposes HUF 284 billion for outpatient pharmaceutical expenditures. Above that limit, a staggered risk allocation system between the government and the producers will be triggered, degressive from the aspect of the government, as a result of which the sum of expenditures may not exceed HUF 297 billion as any overrun would be covered fully by the producers. In 2006, the ceiling of the state contribution will be HUF 311.5 billion;

- the producers have committed themselves to fix producer prices of pharmaceuticals eligible for social security subsidies in euros, for the period of 1 July 2004 and 31 December 2006. They may initiate price increase only once a year, ex post, in accordance with the chronological average, and only if the exchange rate changes by more than 6.25 percent. The 251.24 HUF/EUR exchange rate of 1 June 2004 was accepted as the benchmark;

- the expenditures on outpatient and inpatient care provisions are clearly stated in the budget appropriation for the year, as the transfers are determined prorated to actual performance, that is, the funds have a cap. Performance volume limits have been installed to prevent excessive, unjustified services by hospitals; above a certain level, degressive financing is provided.

- modernisation of the free means-tested medication system is under process. This special in-kind benefit assists health promotion for the beneficiaries and contributes to the health and social rehabilitation. The reform of the system does not require no additional funding but the objectives can be attained by the reallocation of existing funds even with the saving of some HUF 1 billion.

December 1st, 2004.

## Estimation method of the sensitivity factor of the general government

The *budget sensitivity factor*, required for the calculation of the cyclically adjusted budget balance, *was estimated in the following manner*:

On the *revenue* side, the personal income tax, corporate profit tax, four types of contributions, three consumption taxes and the local business tax were taken into account. Among *expenditures*, three items were examined: interest payments, pension and unemployment related expenditures. (In Hungary, because of the Swiss indexation, pensions depend significantly on wages) When determining elasticity indicators, we compared the recent OECD estimations with the figures provided by MoF experts and our own econometric estimations. For the calculation of the sensitivity factor, we relied on the tax structure of 2005. The results are shown in the table below:

**Calculation of the general budget sensitivity**

| | *Elasticity* | *share of item (in GDP)* | *Sensitivity* |
|---|---|---|---|
| | (1) | (2) | (3) = (1)*(2) |
| **Revenues** | | | |
| Personal income tax | 1.35 | 6.7% | 0.091 |
| Social security contributions | | | |
| *Health insurance* | 0.83 | 4.1% | 0.034 |
| *Pension insurance* | 0.81 | 5.1% | 0.042 |
| *Labour market* | 0.90 | 1.0% | 0.009 |
| *Vocational training* | 0.95 | 0.1% | 0.001 |
| Corporate tax | 0.97 | 2.4% | 0.024 |
| VAT | 1.00 | 9.2% | 0.092 |
| Excises | | | |
| *Excise on fuels* | 0.00 | 1.8% | - |
| *Excise on tobacco* | 0.46 | 0.9% | 0.004 |
| *Other consumption taxes* | 1.00 | 0.3% | 0.003 |
| Registration tax | 1.00 | 0.3% | 0.003 |
| Local business tax | 1.00 | 1.4% | 0.014 |
| **Total** | | 33.5% | **0.317** |
| **Expenditures** | | | |
| Net interest payment | -0.58 | 4.0% | -0.024 |
| Pensions | 0.47 | 9.4% | 0.044 |
| Unemployment benefits | -0.55 | 0.4% | -0.002 |
| **Total** | | 13.7% | **0.018** |
| ***Balance*** | | *19.7%* | ***0.299*** |

According to our calculations, the sensitivity coefficient of the government balance related to a 1 percentage point change in GDP is 0.299.

# Table 1. Growth and associated factors

| Percentage unless otherwise indicated | ESA code | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|
| GDP growth at constant market prices (7+8+9) | B1g | 3.0 | 3.9 | 4.0 | 4.2 | 4.3 | 4.6 |
| GDP level at current market prices, HUF billion | B1g | 18 568 | 20 450 | 22 270 | 24 200 | 26 150 | 28 280 |
| GDP deflator | | 7.6 | 6.0 | 4.7 | 4.3 | 3.6 | 3.4 |
| CPI change (annual average) | | 4.7 | 6.8 | 4.5 | 4.0 | 3.5 | 3.0 |
| Employment growth | | 1.3 | 0.5 | 0.9 | 1.0 | 1.0 | 1.4 |
| Labour productivity growth | | 1.7 | 3.5 | 3.0 | 3.2 | 3.2 | 3.2 |
| Investment ratio | | 22.3 | 22.9 | 23.4 | 24.1 | 24.7 | 25.3 |
| **Sources of growth: percentage changes at constant prices** | | | | | | | |
| 1. Private consumption expenditure | P3 | 8.1 | 3.1 | 3.8 | 3.4 | 3.5 | 3.9 |
| 2. Government consumption expenditure | P3 | 5.3 | 0.3 | -1.0 | 0.6 | 0.8 | 0.8 |
| 3. Gross fixed capital formation | P51 | 3.4 | 9.0 | 7.3 | 7.9 | 7.7 | 8.4 |
| 4. Changes in inventories and net acquisition of valuables as a % of GDP | P52+P53 | -0.1 | -0.3 | 0.1 | 0.4 | 0.7 | 0.7 |
| 5. Exports of goods and services | P6 | 7.6 | 14.0 | 11.0 | 10.4 | 9.5 | 9.2 |
| 6. Imports of goods and services | P7 | 10.4 | 12.9 | 10.7 | 10.1 | 9.3 | 8.9 |
| **Contribution to GDP growth** | | | | | | | |
| 7. Final domestic demand | | 6.6 | 4.1 | 3.9 | 4.2 | 4.3 | 4.8 |
| 8. Change in inventories and net acquisition of valuables | P52+P53 | -1.0 | -0.2 | 0.4 | 0.3 | 0.3 | 0.0 |
| 9. External balance of goods and services | B11 | -2.5 | 0.0 | -0.3 | -0.3 | -0.3 | -0.2 |

# Table 2. General government budgetary developments

| Percentage of GDP | ESA code | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|
| **Net lending (B9) by sub-sectors** | | | | | | | |
| 1. General government | S13 | -5.5 | -4.5 | -3.8 | -3.1 | -2.4 | -1.8 |
| 2. Central government | S1311 | -4.1 | -3.2 | -2.9 | -1.3 | -0.7 | -0.6 |
| 3. State government | S1312 | - | - | - | - | - | - |
| 4. Local government | S1313 | 0.0 | 0.1 | -0.2 | -0.4 | -0.3 | -0.2 |
| 5. Social security funds | S1314 | -1.4 | -1.4 | -0.7 | -1.4 | -1.4 | -1.0 |
| **General government (S13)** | | | | | | | |
| 6. Total receipts | ESA | 44.3 | 44.8 | 43.6 | 43.8 | 43.2 | 43.4 |
| 7. Total expenditures | ESA | 49.8 | 49.3 | 47.4 | 46.9 | 45.6 | 45.2 |
| 8. Budget balance | B9 | -5.5 | -4.5 | -3.8 | -3.1 | -2.4 | -1.8 |
| 9. Net interest payments | | -3.9 | -4.2 | -3.8 | -3.4 | -3.1 | -2.9 |
| 10. Primary balance | | -1.6 | -0.3 | 0.0 | 0.3 | 0.7 | 1.1 |
| **Components of revenues** | | | | | | | |
| 11. Taxes | D2+D5 | 26.4 | 25.9 | 25.5 | 25.4 | 25.2 | 24.7 |
| 12. Social contributions | D61 | 12.8 | 12.6 | 12.5 | 12.2 | 11.9 | 11.9 |
| 12a. Contributions payed in second pillar | | 0.7 | 0.8 | 0.9 | 1.0 | 1.0 | 1.0 |
| 13. Interest income | D41 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 |
| 14. Other | | 4.2 | 5.3 | 4.6 | 5.1 | 5.0 | 5.7 |
| 15. Total receipts | ESA | 44.3 | 44.8 | 43.6 | 43.8 | 43.2 | 43.4 |
| **Components of expenditures** | | | | | | | |
| 16. Collective consumption | P32 | 10.5 | 9.6 | 9.3 | 8.8 | 8.6 | 8.3 |
| 17. Social benefits in kind | P31 | 12.1 | 11.2 | 11.0 | 10.4 | 10.1 | 9.8 |
| 18.Social transfers other than in kind | D62 | 14.2 | 14.1 | 14.1 | 14.1 | 13.7 | 13.2 |
| 19. Interest payments | D41 | 4.2 | 4.4 | 3.9 | 3.5 | 3.2 | 3.0 |
| 20. Subsidies | D3 | 1.5 | 2.6 | 2.5 | 2.5 | 2.5 | 2.9 |
| 21. Fixed capital expenditures | | 3.4 | 3.5 | 1.8 | 2.9 | 2.7 | 2.9 |
| 22. Other | | 3.9 | 3.9 | 4.8 | 4.7 | 4.8 | 5.1 |
| 23. Total expenditures | ESA | 49.8 | 49.3 | 47.4 | 46.9 | 45.6 | 45.2 |

## Table 3. General government debt developments

| Percentage of GDP | ESA code | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|
| 1. Gross debt level | | 57.0 | 57.3 | 55.3 | 53.0 | 50.6 | 48.3 |
| 2. Change in gross debt | | 7.1 | 5.5 | 2.8 | 2.1 | 1.5 | 1.5 |
| **Contributions to change in gross debt** | | | | | | | |
| 3. Primary balance | B9 | 1.6 | 0.3 | 0.0 | -0.3 | -0.7 | -1.1 |
| 4. Net interest payments | D41 | 3.9 | 4.2 | 3.8 | 3.4 | 3.1 | 2.9 |
| 5. Nominal GDP growth | B1g | -5.5 | -5.2 | -4.7 | -4.4 | -4.0 | -3.8 |
| 6. Other factors influencing the debt ratio | | 1.6 | 1.0 | -1.1 | -1.0 | -0.8 | -0.3 |
| *Of which* : Privatisation receipts | | -0.3 | -0.9 | -0.5 | 0.0 | -0.1 | -0.1 |
| *8. p.m.* implicit interest rate on debt (%) | | 7.7 | 8.1 | 7.3 | 6.7 | 6.4 | 6.2 |

# Table 4. Cyclical developments

| Percentage of GDP | ESA code | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|
| 1. GDP growth at constant prices | B1g | 3.0 | 3.9 | 4.0 | 4.2 | 4.3 | 4.6 |
| 2. Actual balance | B9 | -5.5 | -4.5 | -3.8 | -3.1 | -2.4 | -1.8 |
| 3. Net interest payments | D41 | -3.9 | -4.2 | -3.8 | -3.4 | -3.1 | -2.9 |
| 4. Potential GDP growth | | 3.9 | 4.0 | 4.1 | 4.3 | 4.4 | 4.5 |
| 5. Output gap | | -0.4 | -0.4 | -0.6 | -0.6 | -0.7 | -0.4 |
| 6. Cyclical budgetary component | | -0.1 | -0.1 | -0.2 | -0.2 | -0.2 | -0.1 |
| 7. Cyclically-adjusted balance (2-6) | | -5.4 | -4.4 | -3.6 | -2.9 | -2.2 | -1.7 |
| 8. Cyclically-adjusted primary balance (7-3) | | -1.5 | -0.2 | 0.2 | 0.5 | 0.9 | 1.2 |

## Table 5. Divergence from previous update

| Percentage of GDP | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| **GDP growth (%)** | | | | | | |
| Previous update | 2.9 | 3.3 - 3.5 | 3.5 - 4 | cca. 4 | 4 - 4.5 | 4 - 4.5 |
| Latest update | 3.0 | 3.9 | 4.0 | 4.2 | 4.3 | 4.6 |
| **General government deficit (% of GDP)** | | | | | | |
| Previous update | 5.2 | 3.9 | 3.3 | 2.7 | 2.2 | 1.8 |
| Latest update | 5.5 | 4.5 | 3.8 | 3.1 | 2.4 | 1.8 |
| **Gross debt levels (% of GDP)** | | | | | | |
| Previous update* | 57.0 | 56.7 | 54.6 | 53.0 | 51.2 | 48.8 |
| Latest update | 57.0 | 57.3 | 55.3 | 53.0 | 50.6 | 48.3 |

* Data in the May Convergence Programme adjusted for the effects of pension reform (in order to insure the comparison)

# Table 6. Assumption of the external economic environment

| Annual growth rates in %, if not otherwise indicated | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| **Interest rates (in % p.a., annual averages)** | | | | | | |
| Hungary: short-term | 8.20 | 11.21 | 7.84 | 6.06 | 5.66 | 5.45 |
| Hungary: long-term | 6.82 | 8.26 | 7.12 | 6.49 | 6.08 | 5.75 |
| Euro area: short-term (3-months money markets) | 2.30 | 2.10 | 2.60 | 3.50 | … | … |
| Euro area: long-term (10-year govt bonds, lowest one prevailing in euro area) | 4.10 | 4.20 | 4.60 | 4.80 | … | … |
| USA: short-term (3-months money markets) | 1,20 | 1.60 | 2.90 | 3.60 | … | … |
| USA: long-term (10-year govt bonds) | 4.00 | 4.30 | 4.70 | 5.30 | … | … |
| **Exchange rate** | | | | | | |
| HUF/EUR exchange rate | 253.5 | 254.5 | 254.5 | 254.5 | 254.5 | 254.5 |
| **GDP (in real terms)** | | | | | | |
| World, excluding EU | 4.4 | 5.7 | 4.8 | 4.6 | 4.4 | 4.2 |
| USA | 3.0 | 4.4 | 3.0 | 2.9 | 2.8 | 2.7 |
| Japan | 2.5 | 4.2 | 2.1 | 2.3 | 2.3 | 2.3 |
| EU 15 | 0.8 | 2.5 | 2.3 | 2.4 | 2.3 | 2.2 |
| **World trade (in real terms)** | | | | | | |
| Hungarian export markets | 3.9 | 7.2 | 7.2 | 7.0 | 6.8 | 6.5 |
| World imports | 5.1 | 11.6 | 8.8 | 8.3 | 8.0 | 6.8 |
| **International prices** | | | | | | |
| World import prices (goods, in USD) | 8.8 | 10.4 | 3.7 | 0.5 | 0.5 | 0.5 |
| Oil Prices (Brent - USD per barrel) | 28.8 | 39.3 | 45.1 | 40.1 | 40.0 | 40.0 |
| Non-oil commodity prices (in USD) | 6.5 | 12.9 | -2.9 | -0.5 | 0.0 | 0.0 |

## Table 7. Long-term sustainability of public finances

| Percentage of GDP | 2000 | 2005 | 2010 | 2020 | 2030 | 2050 |
|---|---|---|---|---|---|---|
| Total expenditure | 47.7 | 47.4 | 43.8 | … | … | … |
| Old age pensions* | 7.6 | 8.2 | 7.2 | 7.9 | 8.2 | 9.6 |
| Health care (including care for the elderly) | … | … | … | … | … | … |
| Interest payments | 5.6 | 3.9 | 2.8 | … | … | … |
| Total revenues | 45.2 | 43.6 | 43.0 | … | … | … |
| of which: from pension contributions | 7.5 | 7.5 | 7.6 | 7.6 | 7.3 | 6.3 |
| National pension fund assets (if any) | 1.3 | 4.6 | 8.7 | 19.0 | 27.6 | 32.3 |
| **Assumption** | | | | | | |
| Labour productivity growth | 4.2 | 3.0 | 3.5 | 2.8 | 2.8 | 2.7 |
| Real GDP growth | 5.2 | 4.0 | 4.5 | 2.5 | 2.2 | 2.0 |
| Participation rate males** | 69.3 | 69.3 | 69.9 | 71.9 | 71.3 | 70.5 |
| Participation rate females** | 54.0 | 55.4 | 56.2 | 59.5 | 60.4 | 59.5 |
| Total participations rate** | 61.5 | 62.2 | 62.9 | 65.6 | 65.8 | 65.0 |
| Unemployment rate | 6.4 | 5.9 | 5.5 | 5.0 | 5.0 | 5.0 |

* Including old age and survivor pensions, disability pensions above retirement age
and I. class disability pensions under retirement age (ie. pensions for fully disabled)
** The economically active population ( at least aged 18 and younger than the retirement age)