Government of the Republic of Hungary

CONVERGENCE PROGRAMME OF HUNGARY
2005 - 2009

September 2006

TABLE OF CONTENTS

In line with the requirement of EU membership, Members States submit stability programmes, and Member States, which have not yet adopted the euro submit convergence programmes to the Commission and the Council each year. Hungary prepared its convergence programme in December 2005, according to the regular timetable. The Council in its opinion expressed on the programme invited Hungary "… to present as soon as possible and by 1 September 2006 at the latest an adjusted convergence programme update which identifies concrete and structural measures that are fully consistent with its medium-term adjustment path.*" Taking into account the Council Opinion, the Government prepared the adjusted convergence programme update by September 2006. The new Government, which took office in June 2006, presents in the programme the medium term objectives of its economic policy, in particular the way to consolidate the high deficit. The programme covers the period 2005 to 2009 and, in addition, provides indicative projections until 2011.*

In the course of the preparation of the convergence programme, the Government took into consideration the opinion of the Convergence Council set up in June 2006. Broad discussion with political and social partners preceded the adoption of the programme. The Government consulted on the draft programme with the National Interest Reconciliation Council, several committees of the Parliament (the Economic and IT Committee, the Budget, financial and audit Committee and the Committee of EU affaires), the State Audit Office and the National Bank of Hungary. The Government adopted the programme on its meeting of 31 August 2006.

The updated programme was prepared with due account paid to the requirements on the content and format laid down in the Council Regulation (EC) 1466/97 as amended by Council Regulation (EC) 1055/05 and in the revised Code of Conduct endorsed by the Council in October 2005. The set of tables required in this latter are presented at the end of the programme.

In line with the requirement of the European Union, the New Hungary Development Plan (NHDP) and the National Action Programme (NAP) are being prepared simultaneously with the convergence programme. The NHDP outlines the main trends of development policy of the 2007-2013 period. The Government summarizes the measures aiming to increase employment and productivity in the NAP. As a consequence, the convergence programme does not go into the details of measures concerning sector- and development policy, however, it takes into account their effects on the macroeconomic and budgetary path presented in the programme.

The programme presents general government data on an ESA basis. As an important modification to the previous programme, the mandatory, fully funded pension funds are classified outside the general government sector in the current convergence programme. Therefore, the data on budget deficit and public debt represent higher levels. Although according to the Eurostat Conclusions of 23 September 2004 (Eurostat News Release 117/2004), the fully funded pension pillar can be recorded inside the general government sector until March 2007, the Government decided to present, in a forward-looking manner, the general government figures with the fully funded pillar being classified outside the general government sector already in the convergence programme of September 2006.

1. Medium term objectives of the Government

1.1 Stabilisation, development, growth

The Government's most important objective is to create the prerequisites of growth based on long-term equilibrium, thereby facilitating the lasting and accelerating catching-up in economic output and living standards to the EU average. Convergence must be reflected in

- the competitiveness of businesses,
- the modern economic structures reformed through developments and investments,
- employment,
- the quality of services provided by the state,
- the real wage and real income trends.

Real convergence requires a growth and development oriented economic policy relying on the long-term equilibrium of the general government. The achievement of the general government equilibrium requires not only adjustments with short-term effects but also substantive reforms of the operation of the state. Over-spending by the government must be prevented systematically and in a permanent way, and the regular imbalances of the general government and of the balance of payments hindering the convergence process must be prevented. Excessive general government deficit and increasing public debt

- increase the interest expenditures of the budget, which reduces funding available for primary public functions,
- also increase the costs of domestic or foreign funding for the private sector, thereby worsening the financing and development potentials of enterprises as well,
- represent a stability risk: increases the probability of adverse exchange rate fluctuations.

Lasting growth requires public finances that are capable of responding to challenges arising from demographic trends while maintaining the equilibrium. The expected aging of the Hungarian population will increase future public expenditures, which must be covered by a decreasing number of tax and contribution payers. Economic policy must focus on this issue when adopting reform measures that assure the affordability of pension, health care and nursing expenditures in the decades to come. This is the purpose of the requirement set out in the Stability and Growth Pact compelling Member States to set medium term objectives for budget deficit that would not lead to excessive public debt growth even if future expenditures relating to the aging of the population arise. In case of Hungary, this medium term objective corresponds to a deficit of 0.5-1% of GDP, which is expected to be achieved beyond the time horizon of the programming period.

The sustainable budget balance thus achieved will create conditions conducive to economic growth because it facilitates investment decisions by economic actors through the creation of a predictable economic policy framework. A predictable economic policy framework is a precondition of the efficient use of EU funds, which will increase significantly in the forthcoming years. The more these funds are supplemented by the development funds of the domestic business sector, the more they will contribute to long-term economic growth. The intensification of business sector investments requires a stable macro-economic environment. Business sector investment plans and the inflow of direct investments are promoted by the ongoing, dynamic infrastructure projects, primarily the road network development programme and the environmental investment projects to fulfil the EU requirements of sustainable growth.

The national development plans and the implementing programmes for the 2007-2013 period are presented in the New Hungary Development Plan (NHDP) and in the New Hungary Regional Development Strategic Plan (NHRDP), the main objectives of which, in line with the Lisbon Strategy, include laying the ground for sustainable growth and employment expansion. The NHDP and the NHRDP, using financing from the structural and cohesion funds of the EU, the rural development funds of the Common Agricultural Policy, and domestic funds facilitate substantive development in the following areas between 2007 and 2013:

- transport infrastructure development;
- economic development, innovation, promotion of knowledge intensive industries, development of the business infrastructure of small and medium sized enterprises;
- improvement of employability and adaptability, development of the education system, of human and health care infrastructure;
- development of environment and energy management;
- regional development geared towards the convergence of underprivileged regions;
- reform of the state; development of public administration and of public services;
- restructuring of agriculture, rural development.

The development plan will open up unprecedented opportunities to small and medium sized enterprises. The plan sets out to assure that SMEs modernise their operations through research and development cooperation, improve their innovation capabilities, expand their markets and gain access to international supplier networks.

The investments will reduce the infrastructure lag of the country. A high-speed motorway network satisfying European standards will be created, rail and air transport will be modernised, the quality of public services and the system of health care institutions will improve and our settlements will become attractive for investors and to job creation.

Horizontal expectations include regional and social cohesion. Development projects will reduce poverty while the considerable expansion of job seeking services and training opportunities will open the door to convergence.

The system of vocational training will be overhauled in line with the needs of the labour market. In accordance with the development directions of the economy, higher education will be improved by reinforcing its role in R&D and in innovation.

The plan sets forth the overall expectation of enforcing considerations of economic, social and environmental sustainability in development projects. The conditions for this will be laid down by the achievement of a general government equilibrium and a predictable macroeconomic path.

The improvement of the general government balance will reduce the borrowing requirement, which is expected to result in lower yield spreads, thus reducing the cost of financing of investments for the business sector. This effect will be reinforced by the expansion of EU development funds as well as the inflow of FDI, thus investments will continue to grow at a faster rate than GDP. The investment ratio will increase from the average of 23% of the past five years by over 2 percentage points by 2011, exceeding the 25% level, prevailing in cohesion countries.

The growth of economic output requires the increase of the value produced by current employees (productivity growth) and at the same time the growth of the number of employed persons. Using the funds available, the Government promotes the long term growth of employment and productivity.

Due to the stabilisation measures, economic growth will temporarily slow down in 2007-2008, but after 2009, as a result of the upcoming development projects and reforms, it will resume the approx. 4 percent level seen in the 1998-2006 period, which is above the EU average. The realisation of the reforms and the investment growth resulting from the use of development funds may further accelerate growth by 2011.

1.2 Fundamental principles of the new economic policy: responsibility, efficiency, more equitable burden sharing

The experience of the past decade has shown that in the absence of substantive reforms, any stabilisation measures can have nothing but temporary effects. After one or two years of adjustment measures requiring substantial sacrifices, the state, working in the same structure for decades, with unchanged functions, expenditures and costs, forces an increase in expenditures again, which tends to upset the hard-achieved equilibrium.

Even though the business sector of the economy underwent a radical transformation after the transition, the state, which redistributes some half of the GDP, continues to operate the old systems and takes on almost unaltered responsibilities despite the altered conditions. Even though in the past fifteen years some reforms have been undertaken in the operation of the state (such as the introduction of the treasury system), a substantive reform affecting the large redistribution systems was undertaken effectively only once, when the pension reform was launched in 1997; however, this will be reflected in reduced state expenditures only decades later.

The Government has now broken with the ‘tightening/loosening’ economic policy of the past decades postponing reforms and the conflicts entailed in them, and wishes to create the conditions of permanent equilibrium and at the same time an empowering state providing higher standard services to its citizens by implementing long overdue reforms affecting the entire state.

Even if in different degrees, reforms must extend to almost all areas of state activities, from economic involvement to the social benefit systems. However, changes require a turnaround not only in economic policy but also in social policy:

- A new, equal relationship must be achieved between the state and its citizens, clearly defining the responsibilities of the community and those of the individual. If the state takes on too many responsibilities, its funds will become fragmented, therefore it will be unable to perform any of its functions to perfection. Reinforcing the ability of citizens for self-provision allows the state to support the catching up of those being left behind and to substantively reduce the inequality of opportunities through more effective and more targeted means, providing incentives for taking up employment.
- Public functions must be performed, under appropriate state control, by the most efficient state or private actors. The more efficient cooperation of the state and business sectors is also required in the investments necessary to improve public services. In order to modernise public services, the ever-insufficient budgetary funds must be supplemented in an increasing ratio by EU development funds as well as private sector investments.
- Public tasks are financed from the tax and contribution revenues of the state. Therefore it is in the interest of the state as well as the entire society that everyone meets the obligation of tax and contribution payment. The state services the use of which is conditional upon the payment of public dues will be provided in full only to those who pay their public dues or to persons in need, for whom the state will pay such dues.

1.3 Timing of the implementation of the new economic policy: rapid adjustment and reinforcement of the equilibrium

The medium term economic policy of the Government to implement the above objectives consists of two well-defined stages:

- *2006-2009: stabilisation in a sustainable way with the least possible growth sacrifice*
    - major reduction of the general government deficit with stabilisation measures and the launch of reforms,
    - stopping the growth of public debt, then its reduction,
    - achievement of an external equilibrium, reduction of the current account deficit,
    - economic growth, expected to temporarily decline to 2-3% in 2007-2008, is expected to resume its previous 4% level in 2009, the real income of households will decline in 2007, stay level in 2008 and increase in 2009.
- *2009-2011: commencement of lasting economic growth and improvement of living standards on the basis of the equilibrium thus created*
    - as the reforms unfold, the reinforcement of the equilibrium and the further reduction of the general government deficit and of the public debt,
    - manifestation of the ever strengthening stimulating effects of the growing development funds,
    - resumption of the fast and sustainable growth path,
    - noticeable start of the growth of employment, real wages and real income.

As a shared feature of the two stages in the 2006-2011 period, the reforms will be started and brought to fruition in these years in the field of public administration, health care, education, the reform of the pension and price subsidy systems and, beyond the cycle, in general government that will assure the equilibrium necessary for the long-term real convergence of the country in the long term.

Stabilisation and equilibrium

	2006	2007	2008	2009	2010	2011
	changes vis-à-vis the previous year (%)					
GDP	4.1	2.2	2.6	4.1	4.2 - 4.5	kb. 4.5
Domestic consumption	2.0	-0.2	0.5	3.1	kb. 3.5	3.5 - 4
of which:						
Private consumption	2.4	-0.9	0.0	1.5	2.5 - 3	kb. 3
Gross fixed capital formation	6.6	2.1	3.7	7.0	5 - 6	5 – 6
External trade						
Export (goods and services)	12.0	10.9	9.9	9.4	8 - 10	8 – 10
Import (goods and services)	9.5	8.5	8.0	8.8	7 - 9	7 – 9
Real income per capita	1.9	-1.7	0.1	2.5	3 – 3.5	kb. 3.5
Employment	0.3	0.0	0.3	0.7	0.7 - 1	kb. 1
Consumer prices	3.5	6.2	3.3	3.0	2.5 - 3	2.5 – 3

	in % of GDP					
	2006	**2007**	**2008**	**2009**	**2010**	**2011**
Current account deficit	7.9	5.9	4.4	3.6	kb. 3	kb. 2
Net borrowing vis-à-vis the rest of the world	7.1	4.2	2.2	1.4	0.5 - 1	kb. 0
Budget deficit	10.1	6.8	4.3	3.2	2.7	2.2
Revenues without EU-transfers	40.9	42.6	42.7	42.2	41 – 42	40.5–41.5
of which: tax- and contribution revenues	36.9	38.8	39.0	38.6	38 – 38.5	37.5 – 38
Expenditures without EU-transfers	51.0	49.4	47.0	45.4	44 - 45	43 – 44
Primary balance	-6.3	-2.4	-0.2	0.8	kb. 1	kb. 1.5
Gross public debt	68.5	71.3	72.3	70.4	68 - 69	65 - 67

1.4 Key elements of the budgetary consolidation

In the period of the rapid adjustment, the reduction of expenditures and the increase of revenues will be implemented simultaneously. The Government is fully aware that a lasting budgetary equilibrium can be achieved only by the structural reform of the expenditure side, but the rapid stabilisation has also required the increase of tax and contribution burden. In the second half of the programming period (from 2009 onwards), the reduction of expenditures as a percentage of GDP alone will assure the continued stabilisation.

The immediate measures adopted by the Government in 2006 are in line with the direction of long term reforms to permanently reduce the operational expenditures and to reform the financing and operational systems of health care. Approximately half of the 1.5 percentage point improvement (as a percentage of GDP) in 2006 results from expenditure cuts.

The reduction of expenditures as a percentage of GDP will contribute in an increasing extent to reducing the deficit as the consolidation proceeds. This is based on the fact that the preparation of the comprehensive reforms on the main expenditure areas started already in 2006 (and implementation was actually launched in some areas), which will facilitate the long-term reduction of expenditure levels later. Expenditures, without EU transfers, will decline as a percentage of GDP by almost 6 percentage points between 2006 and 2009, thus 80% of the improvement of the budget balance will arise from expenditure cuts.

1.5 Reforms laying the foundations for long-term expenditure cuts

Public sector

In the near future, the Government will reduce the number of persons employed in central public administration, and it will launch, by introducing incentives, the staff cuts required in the local government sector (e.g., - among others - by increasing the mandatory teaching hours in public education). The sustainability of this process is promoted partly by organisational changes (to improve economies of scale) and partly by the clear definition and enforcement of performance requirements.

Tools for improving economies of scale:

- the size and internal fragmentation of the central government will be substantially reduced by the reduction of the number of ministries from 14 to 11. The number of persons employed in these areas will decline, in accordance with the decision of the Government, by 20%, while the parallel functional areas – HR, IT, asset management, operations – will be centralised as of 2007;

- the Government has decided upon the termination of unnecessary duplications between central public administration and its regional (decentralised) bodies, as well as their regional reorganisation. The reorganisation affecting close to 200 budgetary entities will result in a 10% staff cut;
- the Government will promote savings from economies of scale to curb expenditure growth by giving financial incentives to associations of local governments in the case of public administration, social and public education institution maintenance tasks;
- the spread of e-government will be accelerated (mainly in the field of services affecting the competitiveness of businesses and those defined in EU recommendations).

On the basis of the legislative amendments started pursuant to the Government's decision, the enforcement of performance requirements will be promoted by the following:

- in the entire public administration system, the across-the-board introduction of the definition and measurement of performance requirements and the relaxation of the rigid promotion and remuneration system in order to enhance motivation;
- introduction of the selection system based on a competitive examination.

As a result of the smaller headcount and the reformed institution system, the operational expenditures of the public sector will fall from the current 18.4% of GDP to 15.2% by 2009.

Health care

The purpose of the health care reform is to increase the quality of services, to reduce the inequalities in access and to keep state expenditures at a sustainable level.

The more marked emphasis on the insurance principle instead of the hitherto apparently unlimited public responsibility and public funding will make clear the responsibility of the individual for keeping his health, and the individuals' contribution to the financing of health care will become regulated.

- The use of services based on the insurance principle will be conditional on the existence of an insurance legal relationship or other registered eligible status, and on the payment of the contributions due[1]. In the absence of this, only basic services can be used such as ambulance, emergency, mother and child protection or epidemiology.
- While maintaining public financing, the Government will consider the potential opening of the health insurance market to private insurers.

International comparisons indicate that in certain cases demand for health care services is of unreasonable magnitude in Hungary. Therefore, in addition to implementing the insurance principle, it is necessary to constrain the demand for health care services where not justified by the health status and to increase the operational efficiency of the system of health care institutions. The means:

- In respect of the meetings of physicians and patients (basic care, outpatient care and the related diagnostic tests as well as active inpatient special care), a fee is to be paid by the user, and the health care provider is obliged to issue a receipt.

[1] Those persons are also eligible for in-kind health care benefits from whom their employer deducted the contribution but did not remit the payment to the health insurer.

- The subsequent (higher) level of service can typically be used based on a referral issued at the lower levels.
- Close-down of the under-utilised or unreasonably operated excess active in-patient capacities or their transformation into chronic, out-patient or nursing capacities.
- Service providers may compete for social insurance funding, and the National Health Insurance Fund will purchase only the necessary services.
- The operational framework of service providers (typically hospitals) will change, facilitating transparent book-keeping and profit accounting, the profit orientation of the owner (maintainer) and employment assuring more flexible remuneration.
- Co-ordination of basic care (family doctor) on the micro-regional level.
- In case of pharmaceutical subsidies, the modification of the subscription habits through the measures already adopted or to be introduced as of 2007, overhaul of the subsidy and co-payment system.
- Reinforcement of the control system, enhancement of the IT system.

The expansion of quality assurance will contribute to the enhancement of the quality of health care services. To that end:

- Professional and financing protocols (patient routes) will be introduced in order to streamline the use and provision of services.
- A health insurance supervision will be established, responsible for the control of operation in accordance with protocols and also for consumer protection functions.

Pension system

The eligibility and service provisions rules of the pension system continue to be ridden with contradictions after the pension reform. Due to the permissive criteria of early retirement, the average retirement age is low, considerably below the statutory retirement age. The criteria applicable to certain types of benefits available under the retirement age and related to the health status or to the time spent in certain positions are sometimes rather generous. In the past years, the replacement rate of initial pensions increased substantially. Because of these trends, the Government has initiated that legislation facilitating the addressing of controversial phenomena is adopted in 2006 or in the first half of 2007, entering into force following the constitutional preparatory period. Those changes are necessary to bring the pension system into a near-equilibrium position in the long term. The following measures should be highlighted:

- raising the early old-age retirement age by one year, and when used, the adjustment of the benefit as justified by actuarial calculations;
- adjustment of the initial pension levels;
- termination of any further accrual of entitlement to early retirement relating to time spent in certain positions, as well as the overhaul of the disability pension system with rehabilitation in the focus;
- suspension of pension benefits below the retirement age if any income earning activity is pursued;
- by 31 December 2006, the current system of rules governing the retirement age, the indexation of pensions and the replacement rate must be reviewed.

Public education

The purpose of the public education reform is to reduce inequalities, to assure equal opportunities, to eliminate any discrimination, to reinforce basic skills (writing, reading, maths, reading comprehension), to promote the more effective operation of the system and to encourage the association of local governments. In that context:

- the establishment of new associations must be encouraged, the legal framework for which is given in the act on public education. By 31 August 2008, maintainers of institutions must operate primary schools with fewer than 8 grades as associated institutions rather than as independent entities;
- by reviewing the system of local government financing, the subsidy system must be determined in relation to the recognised tasks as defined in the act on public education;
- unjustified differences in the ratio of burdens on different maintainers of institutions – state or non-state, metropolitan or rural – must be eliminated;
- new regulations and financial incentives will provide a more flexible framework for the performance of more than one public education functions within a single institution. Thus existing staff can be utilised with considerably greater efficiency; the number of existing institutions, and of executive employees, can be reduced.
- for basic art education institutions, the financing system must be made more differentiated. The possibility for incorporating basic art instruction into school education must be assured, to significantly reduce the need for the operation and financing of independent institutions;
- as of 1 September 2006, the employer may require teachers to give two additional classes, in addition to the mandatory classroom hours, in the time not taken up by teaching, without any separate remuneration. As of 1 September 2007, the mandatory classroom hours of teachers will be increased by two units;
- as of 1 September 2006, the local government maintaining the institution may coordinate the employment of teachers, reviewing the allocation of subjects in the various institutions, considering whether individual teachers have time not taken up by teaching while in other institutions another teacher may perform identical tasks for extra remuneration;
- the system of measurement-assessment will be altered in public education. Schools will receive the national measurement and assessment results, in the form of a league table. In view of this, they must reconsider the quality assurance system of the institution.

Higher education system

The main purpose of the higher education reform is to improve the quality of education and to make it capable of adapting to the changing structure and level of labour demand. Under the reform, the following steps will be taken:

- performance orientation will be strengthened; based on the achievements of students, it will be possible to switch between state-financed and tuition fee based education.
- from 2008 onwards, students in state-financed higher education will have to pay the tuition fee introduced in 2007, and the student support and payment system will become performance-oriented and socially targeted;
- the structure of education and financing will be changed in line with the Bologna process; a new higher education financing arrangement will be devised. The qualification requirements of Master courses will be elaborated;

- the fragmentation of the system of institutions of higher education will be lessened, with the number of higher education institutions reduced. The group of maintainers may be broadened, local governments may become maintainers by taking over institutions;
- the system of accreditation will change; in line with our EU membership, foreign experts will also be involved in accreditation related decisions;
- the requirements relating to the quality assurance system will be reconsidered and tightened;
- parallel forms of education will be restricted or eliminated;
- the maximum state-financed student numbers will be reduced and their structure changed (the ceilings for lawyers, liberal arts students, teachers and economist being reduced, natural sciences, IT and technical students being increased in numbers). Normative subsidies will be adjusted to the new headcount and the budgetary frameworks, and regulatory and financing rules will become predictable;
- a feed-back mechanism will evolve, reflecting labour market demand in the number of students participating in education as well as in the nature and quality of training.

Price subsidies

The overwhelming majority of consumer price subsidies and other forms of support provided through prices result in unjust structure of support with considerable social expenditure. In case of price subsidies, those who consume more receive more support. The system encourages the inefficient use of resources rather than promoting economically reasonable management.

At present, substantial price subsidies exist in three major areas:

- pharmaceuticals, where more efficient subsidy schemes will be introduced as part of the health care reform;
- public transportation, where the tariffs and subsidy schemes will be modified in 2007, as part of the new transport development concept;
- household energy consumption, where the largest part of the subsidies is related to gas prices.

In 2006-2007, the current system of gas price support, providing substantial subsidies to every household, will gradually be replaced by the targeted, means-tested social subsidies to those in need and to large families. In this subsidy system, the Government will reduce the bills of the approx. 1.2 million eligible families using the HUF 70-80 billion mining rent generated based on domestic extraction costs being lower than world market prices and a supplementary HUF 10-30 billion budget transfer.

1.6 Measures to increase revenues

Based on the Government's assessment of the situation and the current macroeconomic forecasts, the already decided measures to increase revenues are sufficient to implement the revenue-side component of the deficit reduction programme, and – apart from the introduction of the real estate tax in 2008, which has been decided but its details have not yet been elaborated – no further measures burdening businesses or households appear to be necessary.

As an important element of increasing tax revenues, the preferential VAT rate will increase from 15% to 20%, and the rate of individual health insurance contributions and of the simplified business tax will also go up as of September 2006. The other measures taken will also increase the tax burden, while their content already reflects the new tax philosophy based on more equitable burden sharing: it places more burdens on taxpayers who are presumed to try to evade tax and contribution payment; it is aimed at expanding the tax and contribution base and it eliminates tax benefits that are no longer justified:

- A significant part of the tax changes serves to the broadening of the tax base rather than increasing tax rates; they close or at least narrow down the existing back doors of tax avoidance:
  - Hundreds of thousands of currently illegally employed persons will now have incentives to pay contributions because, as one of the important milestones of the health care reform, the social insurance character of health care will be strengthened from 2007 onwards.
  - The minimum required corporate profit tax represents additional costs to those who have disclosed losses in their businesses by offsetting their profits with expenditures, thus avoiding tax payment.
  - The tax on cash held in businesses eliminates the possibility of withdrawing personal income from a business without tax payment.
  - The contribution base set at twice the minimum wage will not place any additional burden on those actually making less money than the minimum wage; instead, it will only weigh on those who have been paying public dues for significantly less than their actual entrepreneurial income, or their employers have paid the portion of their salaries above the minimum wage illicitly into their pockets.
- Even though the changes applicable to households will place weigh on everyone, their important elements serve to promote more equitable burden sharing:
  - The 4% special tax will be payable by the highest-income individuals in respect of their income above the ceiling of the personal pension contribution base.
  - The elimination or limitation of certain tax credits will also affect mostly the higher-income people who had been able to make use of them.

On the whole, the tax changes will increase the tax burden by some 2 percentage points, but in 2009 the tax revenues to GDP ratio will still be lower than it was in 2000-2001. Assuming no changes in the tax regime and export and investment driven growth as envisaged by economic policy makers, as a result of the main tax bases growing at a rate lower than GDP growth, the tax revenue/GDP ratio will decline slightly from 2009 onwards, which trend will continue for two more years. Without endangering the deficit target, a more marked reduction would be possible only through a greater-than-projected cut in expenditures.

1.7 Strengthened budgetary discipline and transparency

Having analysed the budgetary processes of recent years, the Government decided to include any expenditure items that may be controversial from an accounting aspect in the expenditures of general government. As a result, the costs of motorway construction previously planned to be carried out by the ÁAK (State Motorway Management Co.) in a PPP arrangement will now be accounted in the Convergence Programme in the general government expenditures.

Furthermore, the transparent presentation of general government figures is enhanced by the decision that the Convergence Programme of September 2006 will present, in a forward-looking manner, the general government figures with the fully funded pension pillar not being included in the general government, even though the relevant Eurostat position requires that treatment only as of the Spring of 2007.

In the past fifteen years, the state periodically took over the debt accumulated by loss-making state-owned (mainly public transport) companies classified outside the general government sector. The Government decided to break with this practice. In the framework of the public service contracts soon to be concluded with the relevant companies, the state will pay the entire cost for the services ordered, calculated assuming the costs of efficient operation, and taking into consideration the budget constraints, which will assure that, following their reorganisation, the firms affected can operate successfully using their own resources in the long term as well. The temporary capital requirements of the structural changes are incorporated in the budgetary targets for 2007-2008. On the whole, this system will make it possible to avoid loss-making operations and the subsequent accumulation of debt, then the assumption of the debt by the state.

Starting in the year 2007 budget, the Budget Bill will define the expenditure appropriations for the various budget chapters (ministries, agencies with national competence) as well as the so-called functional budget targets in nominal terms for three years ahead. This may help budgetary institutions and sectors in their medium term budgeting, because they can adjust their spending programmes to the expected availability of resources.

The achievement of medium term budgetary expenditure targets is ensured – apart from the fiscal rules – by the structural reforms that improve the efficiency of public expenditures by improving the operational procedures in the public administration. The Government has worked out a detailed timetable for the preparation and submission of the comprehensive legislative amendments to serve as the basis for the structural changes. This timetable is set out in Chapter 4 of the Convergence Programme. Every quarter, the Government will inform the general public about the implementation of the timetable and the legislative tasks for the subsequent period.

The restoration of the credibility of fiscal policy is promoted by the Government’s decision to inform, following the submission of the Convergence Programme and until the excessive deficit is eliminated, the Commission and the Council (Ecofin) on a semi-annual basis about the developments of the budget and, in the event of departure from the planned course, about the measures to assure the resumption of the fiscal path.

1.8 Reserves to guarantee compliance with the fiscal path

The credibility of fiscal policy has been considerably undermined by the frequent modifications of the deficit targets and the failure to achieve the modified targets. To prevent such occurrences, the Convergence Programme contains a number of measures serving as security reserves that guarantee the achievement of the proposed budgetary targets even if certain expenditure overruns or revenue shortfalls emerge.

In addition to the general reserve already required by the Act on Public Finance (PFA), the chapter equilibrium reserve to be set up by the various ministries as stipulated by the most recent amendment of the PFA will constitute a systemic reserve. The Government will allow the utilisation of the latter, based on the mandatory quarterly reporting of the chapters, only if the chapter’s expenditures and revenues as well as the general government processes all develop as originally envisaged.

Additional reserves may be generated from the real estate tax to be introduced in 2008 but not yet included in revenues as well as the measures aimed at the reform of the pension system (to increase the actual retirement age and to correct anomalies of pension calculation rules). On the whole, by 2009 the reserves will reach 1% of GDP.

As compared to the programme, the public debt and the market-based financing need of the general government may be reduced by privatisation proceeds. The public debt may also be reduced by a faster-than-expected economic growth as well as the improvement of the budget balance as a result of the expected fast recovery of the confidence of the market upon the credible implementation of the programme.

In the view of the Government, the aforementioned reserves constitute adequate safeguards against any risks that can be reasonably expected. If the budget processes develop along a path so much less favourable than envisaged that the reserves set up, or proposed, prove to be insufficient, the Government is ready to adopt additional measures.

1.9 Factors ensuring fast real convergence: productivity and employment

The fast stabilisation occasionally necessitates measures in the short term that will temporarily slow down economic growth. The Government has the task to minimise the negative effect of such measures and simultaneously to launch reforms to ensure long term growth.

In international comparison, productivity improves if the added value created by an employee increases at a faster pace than in other countries. In the past decade, the fast transformation of the Hungarian economy allowed for dynamic productivity growth because the former uncompetitive sectors have been replaced by competitive industries. This was attributable to a considerable extent to the economic policy conducted from the 1990s onwards, which promoted technological modernisation through supporting start-up enterprises, privatisation and promoting FDI inflow. The Government continues to give priority to promoting the development initiatives of domestic businesses and FDI inflow through packages containing tailor-made elements of support compatible with EU regulations and with one-stop-shop arrangements.

The privatisation implemented in the past fifteen years greatly contributed to the modernisation of the Hungarian economy and of corporate governance practices as well as to the regionally high level of FDI inflow. The Government will continue the privatisation of the remaining state-owned companies. The plans for the forthcoming period include, inter alia, the sale of the remaining shares in MOL Nyrt. and in Földhitel és Jelzálogbank Nyrt (Land Credit and Mortgage Bank) as well as of MALÉV Zrt.

Productivity growth is promoted by the increase and modernisation of the capital stock and the higher investment ratio. Economic policy may affect investment growth primarily indirectly, by enhancing economic stability, adopting a balanced income and fiscal policy, improving the quality of public services, deregulating the administrative burdens of businesses, strengthening the business and innovation environment or improving the physical and human infrastructure, though certain co-financing programmes and tax benefits may also play a role.

As a result of the agricultural policy focusing on the improvement of competitiveness and the expanding funds arriving through the Common Agricultural Policy, a technological and production restructuring is under way in agriculture.

The improvement of the business environment and the alleviation of administrative burdens are promoted by deregulation and the simplification of regulatory procedures. The new Companies Act has simplified and accelerated the registration of small-sized companies already from mid-2006, and by the end of 2007, the time needed for company registration procedure will be reduced to 7 days.

The road network development programme may promote the settlement of businesses requiring fast logistical links and it may also increase labour mobility. The various environmental projects will contribute to increase productivity and efficiency, reduce energy dependency and improve investment environment.

In addition to rapid productivity growth, long-term convergence also requires the increase of labour market participation and employment, which have been growing in the past two years but are still very low in international comparison. By the second half of the programme period, the targeted programmes and the reforms launched (vocational training and higher education, pension system) may also contribute to the increase of participation rate. Higher employment also requires the reduction of the rate of taxes and contributions on labour income and, simultaneously, the increase of the share of taxes that do not add to the costs of labour (indirect and property-type taxes), that is, the re-consideration of the structure of the tax and contribution system.

In order to make the institution system of vocational training more cost efficient, 16 regional integrated vocational training centres (RIVTC) have been set up. To upgrade the content and structure of vocational training, a new, modular National Vocational Training Register (NVTR) has been prepared, reducing the number of vocational qualifications considerably. From 2007 onwards, the Government intends to continue, using EU funds, the restructuring of the composition of the types of training offered and its institutional structure.

In order to assist school leavers in finding employment, at the end of 2005 the Government launched the START programme, whereby in the first and second years of employment the Labour Market Fund assumes part of the contribution payment from employers hiring career starters.

The 'Take a Step Forward' programme aims to increase the low participation rate in adult education, promoting life long learning among employees with low school qualifications and older persons, the central budget paying the tuition fees and providing cash support to participants.

As a result of the increased effective retirement age, the participation of older generations has increased recently. In 2004, the Government introduced an effective premium: every month worked after the retirement age brings about a 0.5% increase in the pension (6% increase annually). As a measure expected to act as an incentive to continue working until the retirement age, the rate of adjustment applied to early retirement will be symmetrical to the above. The employment of the older persons is promoted by the arrangement whereby employers hiring unemployed persons above 50 years of age are eligible to a reduction in contribution payments.

The government will extend the START programme, previously covering only school leavers, to older employees; under this arrangement, the Labour Market Fund assumes contribution payment from the employer totally in the first year and partially in the second. The simplification of the administration of the contribution allowance available in respect of persons older than 50 years of age is also envisaged.

Within the entire population, the participation rate of women is lower, the gap being the greatest in case of the 20-30 age group; therefore encouraging mothers with small children to take up employment is a priority. To that end, as of 1 January 2006, women have been able to work without any limitation after the first birthday of the child without losing entitlement to the child care allowance.

The expansion of the START programme will also promote the increased activity of women (START Plusz). For persons returning from child care allowances (GYES, GYED, GYET) or nursing benefit, the Labour Market Fund will pay a part of the contributions instead of the employer, and the administration of the reduced contribution will be simplified also for this group.

The purpose of the START Extra programme is to help persons who have been long-term unemployed because of their age or because they live in an underdeveloped region to find jobs, through assuming contribution payment from the employer totally in the first year and partially in the second.

The replacement of the unemployment benefit with a two-tier job seeking assistance at the end of 2005 serves to promote employment as soon as possible:

- the job seeking assistance provided on condition of intensive job search and close cooperation with the employment service is close to the previous income in the first period of its disbursement, then it falls to a lower level.

- even if a recipient of job search assistance finds a job, he may be eligible to half of the remaining sum; furthermore, odd jobs can be taken on without losing eligibility to or suspending the payment of the job seeking allowance.

The one-stop-shop arrangement to be introduced in 2007 based on the facilities of the Public Employment Service will first acquaint unemployed persons with the available vacancies and job-search services; such persons become eligible for social benefits only if they are unable to take up employment immediately.

Several subsidised, preferential-interest-rate credit programme (Micro-credit programme, Széchenyi Card, 'For a Successful Hungary' Enterprise Development Credit Programme), as well as equity programmes assist micro, small and medium-sized enterprises being the largest employers, to improve their unfavourable position vis-à-vis large enterprises.

2. Macroeconomic objectives and forecast

Modernisation and convergence of the economy to the EU-15 averages continue to be the long-term objectives of the economic strategy but, on a short term, economic stabilisation is the most important task. Obviously, economic stabilisation will reduce domestic demand, therefore Hungary's macroeconomic developments will significantly differ from the one described in the previous programme.

The economic processes of the recent past have continued to indicate a healthy structure of real growth, as the economy is primarily driven by exports and investments. This year growth is expected to be higher than 4 per cent despite the fact that stabilisation measures entering into force in the second half of the year will slightly slow down growth. On a longer term, increasing employment, enhancing competitiveness and investment attracting capability will continue to be the key lines of action.

2.1 External assumptions

While preparing a long-term forecast of the international environment in the convergence programme we relied on the 2006 spring forecast of the European Commission, as well as the changes taking place in the recent months. We expect the robust growth of the world economy to continue in 2006, although as a result of monetary tightening and volatile oil prices the growth rate will fall in the second half of the year. The robust world economic growth will be coupled with a considerable expansion in the world trade in the next few years.

Based on the continuously improving business and consumer expectations, we have concluded that growth will continue in the European Union in the second half of 2006. The Commission's projection of 2.3% growth in 2006 also reinforces this view. In 2007, the growth of the European Union will probably decline as a result of the German consolidation package. However, throughout the projection horizon, in the new EU Member States, which are increasingly important for Hungarian exports, a sustainable higher growth can be expected than in the old Member States.

The potential further increase of oil prices imposes a risk on growth projections. Oil prices went up again in the middle of July as a result of the sharpening tensions in the Near East, and longer war would aggravate further the situation in the region. On the other hand, the rise of the consumer price index experienced in the United States recently has pointed out that increasing capacity utilisation may also cause inflationary risks. The global current account imbalances have not improved either and remained a long-term factor of uncertainty.

2.2 Cyclical position

In 2004, the GDP growth rate was significantly higher than the average growth in the previous years. Consequently, in 2004 the real output was higher than the potential output, resulting in a positive output gap, which persists until 2006. Growth will significantly slow down in 2007 and 2008 as a result of the stabilisation measures and the real output level will drop below the potential output. As a result, by 2007 the output gap will become negative, reaching -2 per cent of the potential output in 2008-2009. From 2009, the real growth rate will rise to the level prevailing before 2007, but the actual output level will not reach the potential output by 2011 yet, leaving a slightly negative output gap[2].

---

[2] Following the methodological recommendation of the European Commission, the potential GDP has been estimated using the Cobb-Douglas production function.

Compared to our previous calculations, the output gap has changed significantly, while there was only a slight change in potential growth. These changes are due to three factors:

- earlier, the calculations were prepared for the old time series, without FISIM allocation;
- in the meantime, the Central Statistical Office's 2004 GDP figures have been revised upwards considerably;
- as a result of the stabilisation measures, the projections for 2007–2008 are significantly different from the previous ones.

In the previous version of the convergence programme we assumed four per cent potential output growth and close to zero, but slightly negative output gap for the projection period. According to our current calculations, the potential growth rate is 0.1-0.2 percentage points lower[3] than indicated in the previous programme despite the fact that the FISIM allocation on its own causes higher growth.

Cyclical position

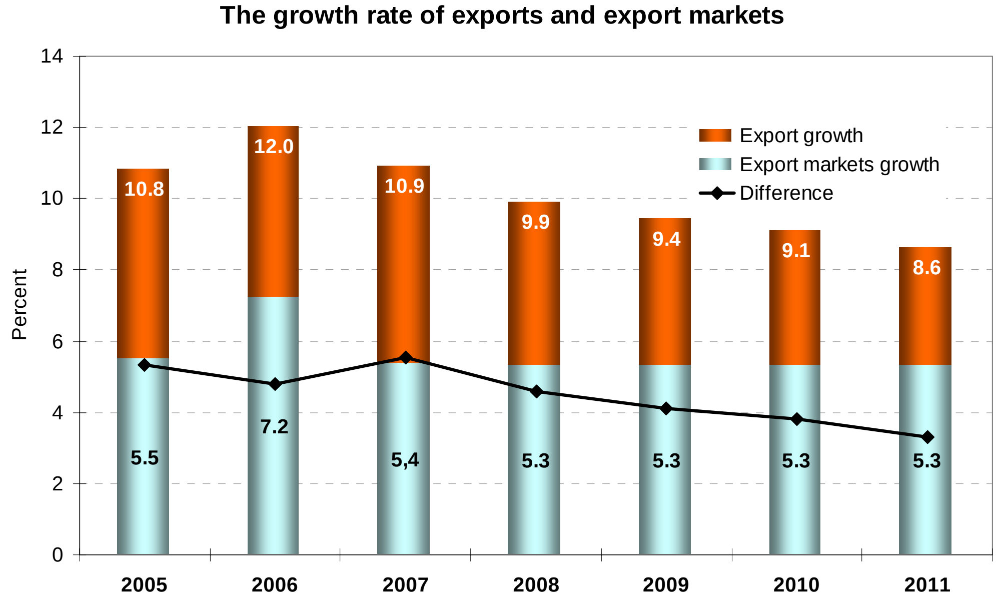
	2005	2006	2007	2008	2009	2010	2011
GDP at 2000 year prices (growth rate, %)	4.1	4.1	2.2	2.6	4.1	4.3	4.6
Potential GDP (growth rate, %)	4.1	4.0	4.0	3.9	3.9	3.8	3.9
Factors:							
Labour	0.3	0.3	0.4	0.3	0.3	0.2	0.3
Capital	2.0	2.0	2.0	1.9	1.9	2.0	2.0
Total factor productivity (TFP)	1.7	1.7	1.6	1.6	1.5	1.5	1.5
Output gap	**1.1**	**1.2**	**-0.6**	**-1.9**	**-1.7**	**-1.2**	**-0.4**

2.3 External demand and exports

For projecting the demand for Hungarian exports we relied on the import demand of 10 developed countries and the five major Eastern European partner countries, which are most important for the Hungarian exports. On this basis, our export markets will expand dynamically in 2006, followed by average dynamism between 2007 and 2011.

Apart from capital investments, growth will mainly be driven by export growth in the next few years too. The export projection is primarily based on the prognosis of external demand. The growth of Hungarian exports exceeded the expansion of our export markets for years, but the growth differential is expected to decrease in the catching-up process on a longer term. Besides the EU-15 Member States – especially Germany – the share in exports of the new Member States and other non-EU European states has increased significantly in the past few years.

[3] This is partly the result of the method recommended by the Commission, in which the potential GDP is adjusted to the actual projection.



2.4 Employment

Between 2006 and 2008, the Government strategy focuses on the stabilisation, the reduction of the general government deficit and the launch of reforms, which will have a strong impact on the labour market on the short term.

In 2007-2008, public employment will be reduced significantly and only moderate growth may be projected in the business sector too. During the adjustment period, the Government's main employment policy objective is to maintain the current employment level. By the second half of the period – between 2009 and 2011 – a considerable increase of employment can be anticipated as a result of the measures outlined earlier. In these three years, the activity rate of the people aged between 15 and 64 is expected to rise from 62.1% in 2008 – by nearly 2 percentage points – to 63.9%.

Employment annual percentage change

	2005	2006	2007	2008	2009	2010	2011
Number of employed persons	0.0	0.3	0.0	0.3	0.7	0.7	0.9
Productivity growth	4.0	3.8	2.2	2.3	3.3	3.6	3.7
Unemployment rate,%	7.2	7.3	7.5	7.4	7.3	7.2	7.2
Participation rate, %	61.4	61.7	61.9	62.1	62.6	63.3	63.9
GDP growth	4.1	4.1	2.2	2.6	4.1	4.3	4.6

2.5 Incomes policy and consumption

In the small open Hungarian economy, external competitiveness requires that wages increase in line with the growth of productivity. Between 2001 and 2003, wages increased at a significantly higher pace than productivity. The wage and productivity increase began to get in line with each other in 2004 again. This process was supported by the moderate wage policy applied in the public sector, but it must be continued in order to reach sustainable growth.

In line with the falling rate of inflation, the National Interest Reconciliation Council has agreed a relatively low, 4-5% gross average wage increase in the business sector for 2006. Based on the data to date, the recommendation will be significantly exceeded, as the annual wage increase in this sector will be 7-8%. Thus, despite a higher inflation rate than expected, the real wage increase will be around 3-4%. In the government sector, the increase of gross average wages is lower, at around 5-6%, corresponding with the projections. The mandatory minimum wages were raised by nearly 10% at the beginning of the year and a higher minimum wage was introduced for people with secondary qualifications in July.

The approved adjustment measures will not affect income or consumption significantly this year yet. Household consumption will increase by approximately 2.5% in 2006. On the other hand, in 2007 the increased tax and contribution rates, the temporarily accelerating inflation and savings introduced in the public sector will reduce real income and consumption.

The wage negotiations for the business sector for next year have not started yet. Projections about the reactions of companies and households to various measures and the influence of expectations on the propensity to consume and save include considerable uncertainty, therefore the programme shows the most probable scenario, but Section 3.5 describes alternative scenarios too. According to the preliminary projections, per capita real wages will drop by approximately 4%, while household consumption will decrease by approximately 1% in 2007 compared to 2006.

Our present calculations indicate no need for further income reduction in 2008. The level of 2007 may be sustained and consumption will not decrease further. By 2009-2011, when the economy returns to its ordinary path with more than 4% GDP growth, real wages and consumption may grow by 2-3% a year with dynamic wage increases and moderate inflation.

2.6 Investments

An important requirement of sustainable and fast economic growth, necessary for fast convergence to developed European economies, is continuous extension and renewal of the Hungarian capital stock. Hungary is in a leading position in Eastern Central Europe in terms of per capita foreign direct investments.

The primary objective of the economic policy remained the same: to improve the Hungarian economy's investment attracting capabilities and to deepen the integration of already accomplished foreign investments.

The investment environment has remained favourable in the business sector, with the support of gradually improving infrastructure, numerous investment promotion programmes, the streamlining of administration and a vocational training system adjusted to market requirements. On the other hand, the changes in the taxation environment and decreasing domestic demand have negative impacts on the investment intentions of the business sector. The lastingly high energy prices may also constitute a downside risk.

As a result of the stabilisation measures and temporarily higher inflation, household income will decline, thus there will be less corporate resources available for investment too. At the same time, the restrictions in tax benefits of housing loans could increase the cost of borrowing. The investment activity of the households is expected to slightly decline in the next three years but, as a result of a more favourable income outlook, housing construction may pick up again from 2009.

Within the national investment projects, infrastructure investments will continue to play a key role in the next few years. Owing to intensive road construction, a lot of large investment projects are being implemented in less developed regions, significantly contributing to the catch-up of those areas. Public infrastructure investments will increase partly with the use of EU funds, yet in other fields – primarily at the budgetary institutions – there will be no opportunity to increase public investments as a result of fiscal consolidation.

Apart from road construction, numerous large investment projects will be implemented between 2009 and 2011, generating long-term sustainable economic growth and contributing to the increase of employment. They include projects turning Hungary into a logistics centre, construction and modernisation of missing links of the transport system leading to logistics centres and other economic infrastructure (industrial railway lines, connecting roads), development of the regional road network, ports, and the river-channel of the Danube, upgrading of the main international railway lines to the country borders, construction of an express railway to Ferihegy, projects in the fields of agricultural energy and renewable energy sources, development of the health infrastructure. With the help of the resources promoting agricultural restructuring and rural development, a lot of micro and small enterprises operating in disadvantaged areas will have access to development resources too.

In 2007-2008, the investment dynamism of the previous years may drop to 2-4%, but from 2009, with development projects funded from an increased use of EU resources, investments dynamism may rise again. The investment ratio will reach 25% by 2009, prevailing in the cohesion countries, and will exceed it by more than 1 percentage point in 2011.

2.7 Components of growth

The growth of domestic demand will decelerate strongly between 2006 and 2008 because of fiscal consolidation. Household consumption will temporarily decline as a result of the measures that will have an impact mainly in 2007. Government consumption will still grow significantly in 2006 due to the Gripen purchase, but then, as a consequence of a more efficient public administration, some decline is projected. The investments will not grow as they did in the previous years either.

Lower domestic demand encourages businesses to follow an expansive export policy, thus the approximately 10 percent export dynamism prevailing in the former years may prove to be long-lasting. On the other hand, the import demand of the economy will fall much below the export as a result of deceleration in domestic demand. As an overall consequence, the external equilibrium indicators will improve and by the end of 2009 the external financing need will reach a sustainable level.

From 2009, all components of domestic consumption will grow. The favourable growth structure remains: besides exports investments may be the main driving force again, with a continuous increase of household consumption too. Thus, using the EU funds, Hungarian economy may grow dynamically again by more than 4% each year.

GDP components annual percentage change

	2005	2006	2007	2008	2009	2010	2011
Household consumption	1.4	2.4	-0.9	0.0	1.5	2.5 - 3	cca. 3
Government consumption	-0.9	4.4	-1.7	-4.6	1.1	1.5 - 2	1.5 - 2
Investment	6.6	6.6	2.1	3.7	7.0	5 - 6	5 - 6
Domestic consumption	**0.8**	**2.0**	**-0.2**	**0.5**	**3.1**	**cca. 3.5**	**3.5 - 4**
Exports (goods and services)	10.8	12.0	10.9	9.9	9.4	8 - 10	8 - 10
Total demand	5.3	6.7	5.3	5.4	6.5	6 - 7	6 - 7
Imports (goods and services)	6.5	9.5	8.5	8.0	8.8	7 - 9	7 - 9
GDP	**4.1**	**4.1**	**2.2**	**2.6**	**4.1**	**4.2 - 4.5**	**cca. 4.5**

2.8 External balances

As a result of falling consumption and deceleration of corporate investments with high import demand, the import demand of the Hungarian economy is going to drop from 2007. Until 2009, the import growth is expected to be 1.5-2 percentage points lower than the exports growth. In the following years the import growth rate will only be by 0.5-1 percentage point behind the export. The foreign trade deficit will drop significantly, by EUR 0.5-1 billion a year, leading to a balanced position by 2011.

The improvement of the current account balance due to real economic processes will continue similarly to the previous years; services are expected to generate an increasing surplus. Profits from foreign direct investments in Hungary, partly reinvested, are also expected to rise. In the coming years, the current account deficit will be determined by the change in the balance of trade in goods and services: in 2007, the balance of goods and services will be in surplus. From 2008, the surplus will grow by EUR 0.5-1 billion each year; compared to 1.3% deficit in 2005, the balance will improve by 4 percentage points in 2009 and by more than 5 percentage points in 2011 expressed as a percentage of GDP. The current account deficit as a percentage of GDP will drop on average by 1-2 percentage points each year: from 7.4% in 2005, it will decrease to approximately 3.5% in 2009 and 2% in 2011. This adjustment will support a sustainable growth on a medium term.

Based on the increasing EU capital transfers, the external financing need will decrease more than the current account deficit. The annual financing need as a percentage of GDP will drop from nearly 6.6% in 2005 to below 1.5% by 2009. In 2011, the EU transfers will finance the complete current account deficit. The structure of financing will also change: as the government's financing need decreases, there will be less demand for debt generating financing. Simultaneously, the proportion of non-debt generating financing will grow and exceed the financing need in 2008. Consequently, net external debt will start to fall from 2008. Net foreign direct investments are estimated at around 3% of GDP.

External financing need in % of GDP

	2005	2006	2007	2008	2009	2010	2011
Current account deficit	7.4	7.9	5.9	4.4	3.6	kb. 3	kb. 2
Capital account balance including EU transfers	0.8	0.8	1.7	2.2	2.2	kb. 2	kb. 2
of which: EU transfers	0.6	0.7	1.6	2.1	2.1	kb. 2	kb. 2
External financing need	6.6	7.1	4.2	2.2	1.4	0.5-1	kb. 0
Debt-creating financing	2.7	2.4	0.8	-1.3	-2.1	-2.5--3	-3.5--4
Non-debt-creating financing	3.9	4.7	3.4	3.5	3.5	kb. 3.5	3.5-4
of which: net FDI	4.4	4.4	3.0	3.0	3.0	3-3.5	3-3.5
reinvested earnings	2.0	2.2	2.2	2.3	2.3	2-2.5	2-2.5

2.9 Inflation

Disinflation in the past period in Hungary was somewhat artificial. Besides tight monetary policy, regulated price increases lower than world price and cost increases, and indirect tax cuts have played an important role in keeping inflation at low levels. Inflation will temporarily accelerate from these levels in the near future. This will mainly be driven by the stabilisation measures. The high oil prices directly increase the price level in the energy producer sector and in the case of fuels, causing an inflationary pressure in the other sectors of the economy too. In the recent period, the weakening HUF has also increased the risk of rising inflation. However, the estimated deceleration of household consumption and demand will reduce these impacts.

As part of the fiscal adjustment the preferential VAT rate has been increased creating upward pressures on the prices of a wide range of foodstuffs and some basic services. However, as a result of demand constraints and retail competition only a partial pass-through can be expected. The household consumer prices of some services with regulated prices (e.g., electricity, natural gas) are going up partly because of the necessary adjustment to rising costs and partly because of the transformation of the price subsidy system.

The inflation path set out in the convergence programme of December 2005 has to be modified significantly. By the end of the year, inflation will reach 5–6%, with an annual average inflation rate of approximately 3.5% in 2006. Additional government measures (e.g., restriction of subsidies in long-distance transport, in the case of pharmaceuticals, transformation of the household gas subsidy scheme) will raise consumer prices mainly in 2007. The less favourable household income position and weaker demand are expected to act as disinflationary factors, assisted also by the adjustment of the supply side and strong retail competition. All these factors will temporarily raise inflation over 7% in the first half of 2007, with a fall in the second half of the year, thus the annual average inflation rate can be projected between 6-6.5%.

The convergence programme reckons with inflation expectations remaining moderate, as a result of the increasing credibility of economic policy, an income policy aiming at wage increases in line with productivity growth and a monetary policy applying an inflation targeting regime. Consequently, following temporary acceleration, inflation will drop to a 3.3% annual rate in 2008. Parallel with the stabilisation, from 2009 the inflation path will revert to the original trend, reaching the inflation target.

Inflation annual average, change in per cent

	2005	2006	2007	2008	2009	2010	2011
Consumer prices	3.6	3.5	6.2	3.3	3.0	2.5–3	2.5–3

The direct regulation of prices (and generally, markets) by the central government will decrease in the next few years because of liberalisation and a market conform regulatory practices. Regulation will remain only within a limited scope, typically with regard to natural monopolies. The institutional and legal conditions of complete liberalisation will be established in the energy sector in 2007.

2.10 Monetary and exchange rate policy

According to the Act on the Central Bank, the primary objective of the National Bank of Hungary (NBH) 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. The HUF exchange rate may fluctuate against the euro within a band of +/- 15%. Given the limits of the exchange rate band, - compared to a pure inflation targeting regime - inflation targets can be achieved only by the support of fiscal policy. The monetary policy instruments are essentially harmonised with those of the Eurosystem apart from the fact that the NBH applies passive rather than active-side regulation. The indebtedness of the private sector has increased, but the direct effect of the interest rate channel is weakened by the fact that the majority of new borrowing is foreign currency denominated. The indirect effect of monetary policy works through influencing the exchange rate and, increasingly, inflationary expectations. The inflationary credibility of the central bank has improved in recent years.

Following the widening of the fluctuation band, the HUF exchange rate was markedly stable until 2005 autumn, apart from some volatility in 2003. Then the exchange rate began to weaken but, with some short-term exceptions, the HUF stayed in the stronger part of the band. Both external and internal factors have contributed to the recent developments. The external factors include the higher risk-aversion due to the US interest rate increases; international investors are more sensitive to imbalances in various countries. Apart from international factors, the market sentiment towards economic developments of individual countries has become increasingly important in determining the fluctuation of exchange rates. In Hungary, the economic imbalances – increasing budget and current account deficits – have led to negative investor reactions.

Based on the favourable disinflationary developments of the recent past, the Government and the NBH has set a medium-term 3% inflation target, consistent with price stability for a catching-up economy, like Hungary, replacing the annual inflation targets for the period of 2007-2009. As a result of recent monetary tightening, inflation, rising temporarily due to stabilisation measures, may get close to the medium-term target by 2008 again. If it is necessary for meeting the Maastricht inflation criterion, the central bank and the Government will review the medium-term inflation target when Hungary enters the ERM II exchange rate system.

Joining ERM II is an important step of the convergence path. Monetary policy will continue to focus on reaching the inflation targets in ERM II, as well. A necessary condition for entering the ERM II is the recovery of the fiscal policy's credibility indicated by a major decline in exchange rate volatility and a durable decrease in the spreads between HUF and FX yields. The achievement of the 2007 budget targets and the approval of a 2008 annual budget corresponding with the convergence programme are indispensable for this objective.

3. Fiscal policy

As indicated in the introduction, the mandatory fully funded pillar of the pension system is classified outside the general government sector in the programme. This change in the methodology by itself implies higher deficit and debt levels than in the previous programme. This change in the methodology, however, is purely of a statistical nature, and the resulting increase in the deficit or debt has no macroeconomic effect.

Effect of the pension reform in % of GDP

	2005	2006	2007	2008	2009
on deficit	1.4	1.5	1.7	1.6	1.6
on public debt	4.0	4.8	5.7	5.7	6.4

3.1 Fiscal developments in 2006

Based on the 2006 annual budget act, the ESA-95general government deficit target was 6.1% of GDP (4.7% with a pension funds inside the government sector). This deficit target did not contain the cost of the Gripen purchase and assumed that the PPP-schemes designed for motorway construction from 2006 would comply with Eurostat rules.

Taking into account the Eurostat decisions and the efforts of the new Government to increase transparency and eliminate the methodological uncertainties of deficit calculations, the methodological and accounting changes have increased this year's deficit by 1.4 percentage points.

- Expenditures were raised by 0.3% of GDP as a result of the cost of the Gripen purchase, because, according to a decision by Eurostat in Spring 2006, it had to be accounted in the year of delivery,
- the costs of motorway construction represent further 1.1% of GDP, including
  - the investment costs related to the already opened motorway sections, accounted at Nemzeti Autópálya Rt., and
  - the motorway projects of Állami Autópálya Kezelő company, originally planned outside the budget (so-called programme roads).

However, fiscal development in the first half of 2006 have also shown that apart from the impact of methodological changes, this year's target deficit cannot be maintained partly as a result of one-off factors, and partly as a result of some estimated overspending. The following events will have one-off impact deteriorating the balance:

- cancellation of the Iraqi debt and flood protection expenditures (0.5% of GDP);
- temporary increase of the deficit of municipalities (0.5% of GDP).

Apart from these, the expenditures of budgetary institutions financed from carried-over appropriations of the previous years would have also increased the expected deficit by 0.5% of the GDP;

- in addition, as a result of a yield increase and exchange rate changes, interest expenditures will probably be higher than indicated in the Act, deteriorating the balance by approximately 0.3% of GDP;
- on top of these, expenditure overruns representing approximately 2% of GDP were expected in pensions, pharmaceutical subsidies and in health expenditures, as well as in un-capped human normatives, while the projected shortfall of revenues equalled to 0.3% of GDP.

Based on these fiscal developments, without corrective measures this year's deficit could have reached 11.6% of GDP. In June 2006 the Government decided to introduce immediate measures to improve the balance.

In order to cut expenditures,

- a resolution was adopted to cut the operational spending of budgetary institutions and some appropriations managed at chapter level (0.1-0.1% of GDP);
- based on a government resolution, headcount reduction and organisational restructuring was started and partly already implemented in budgetary institutions (these measures will result in savings in the next few years);
- by withdrawing the budget reserves, the savings will reach 0.3% of GDP;
- restructuring of the subsidy scheme related to specific pharmaceuticals and the review of the agreement with producers will mitigate the increase of pharmaceutical subsidies (the savings will amount to 0.2% of GDP);
- the measures introduced in curative-preventive healthcare and the transformation of hospital financing will result in savings of 0.1% of GDP.

In addition to cuts in the expenditure, the tax and contribution changes will improve the balance by 0.7% of GDP in 2006.

The measures applied in the last four months of the year will bring an adjustment of 1.5% of GDP. The expenditure measures announced and planned by the Government and the revenue measures approved by Parliament will bring down the deficit under the ESA'95 methodology to 10.1% of GDP (8.6% with private pension funds in the government sector) in 2006. The 1.5% adjustment will take place in four months, corresponding to 4.5% annual adjustment.

3.2 The budgetary consolidation strategy

Despite the 1.5 percentage point correction in 2006, this year's deficit is significantly higher than the figure projected for 2006 in the convergence programme of December 2005. The fiscal path for the next few years had to be reviewed because of the much higher starting level. Consequently, the Government has launched its new equilibrium programme which, apart from the rapid decrease in the budget deficit, underpins lasting improvement in the government balance with structural reforms. The new fiscal path has been designed with the following requirements and considerations:

- the deficit must be reduced significantly,
- the equilibrium must be improved to an extent and in a composition which, although definitely decelerating the economy, will not lead to negative output growth,
- the profile of the adjustment has to clearly be front-loaded (partly because of the high starting level, and partly in order to quickly restore the credibility of economic policy),
- although the budget balance cannot be improved without increasing revenues, on a medium term basis the adjustment should mostly affect the expenditure side of the budget.

On the basis of the above principles, the programme period consists of the following two phases:

- 2006-2009 is the period of fast fiscal consolidation, during which the budget deficit will be rapidly reduced, public debt stops increasing and from 2009 is put on a declining path;
- in the years coming after 2009, the equilibrium will be stabilised with a gradual decline of the government deficit and debt figure.

Main indicators of the general government in % of GDP

	2005	2006	2007	2008	2009	Change 2009-2006	2010	2011
Tax and contribution revenues	37.7	36.9	38.8	39.0	38.6	1.7	38-38.5	37.5-38
Revenues	43.1	42.4	44.2	44.8	45.4	3.0	44-45	43.5-44.5
Expenditures	50.6	52.5	51.0	49.1	48.6	-3.9	47-48	46-47
EU-transfers	0.9	1.5	1.6	2.1	3.2	1.7	3-3.5	3-3.5
Revenues without EU-transfers	42.2	40.9	42.6	42.7	42.2	1.3	41-42	40.5-41.5
Expenditures without EU-transfers	49.7	51.0	49.4	47.0	45.4	-5.6	44-45	43-44
Primary expenditures without EU-transfers	45.6	47.2	45.0	42.9	41.4	-5.8	cca. 40.5	cca. 40
Deficit	7.5	10.1	6.8	4.3	3.2	-6.9	2.7	2.2
Primary balance	-3.4	-6.3	-2.4	-0.2	0.8	7.1	cca. 1	cca. 1.5
General government gross debt	62.3	68.5	71.3	72.3	70.4	1.9	68-69	65-67

Compared to the annual average 1.4 percentage point deficit reduction envisaged in the convergence programme of December 2005, the adjustment will reduce the deficit by 3.3 percentage points in 2007, followed by further 2.5 and 1.1 percentage point improvement in the subsequent years. Along this fiscal path, the excessive deficit in terms of the Treaty can be corrected by 2009, taking also into account the possibility of partial pension adjustment.

Hungary has to continue the reduction of deficit after the correction of the excessive deficit until the country-specific medium-term objective defined in line with the Stability and Growth Pact (around 0.5-1 per cent deficit for Hungary) is reached. In the years following 2009, the budget deficit will drop by 0.5 percentage point a year.

From 2007, the increase in the debt ratio will slow down, due to improvement in the general government deficit and, particularly, in the primary balance. After 2008, the primary balance will show a surplus and the debt ratio will start to decline. From 2009, the debt ratio will decline consistently.

An increasing revenue/GDP ratio (contrary to the continuous decline of the revenue side assumed in the previous convergence programme) will contribute significantly to the adjustment in 2007, and the same trend is expected to continue to a lower extent in 2008 too. As a result of the postponement of the five-year tax reduction programme announced in 2005 and the tax and contribution changes approved by Parliament and announced on 17 July, the tax and contribution revenues expressed as a percentage of GDP will improve by 1.9 percentage points next year, and further 0.2 percentage point in 2008. From 2009, the tax/GDP ratio will start to gradually fall below the 39%, typically prevailing by the beginning of the millennium.

The adjustment measures will have a stronger impact on the expenditure side. Without EU transfers – increasing both the revenues and expenditures of the budget – the primary expenditures to GDP ratio will drop by nearly 6 percentage points by 2009. The more than 7 percentage point improvement in the primary balance in three years stems from a cut in primary expenditures in approximately 80% and only roughly 20% results from the increase of revenues. The cut in expenditure will exceed the growth rate of tax and contribution revenues by 0.3 percentage point in 2007 and 1.9 percentage points in 2008. In the last few years of the programme period, any further deficit reduction will result from lower expenditures.

3.3 General government expenditures

The most important task of the programme period is to cut the expenditures of the general government. Between 2006 and 2009, the primary expenditures to GDP ratio P (without EU transfers) must shrink by nearly 6 percentage points. By 2011, it will be followed by further 1-2 percentage points drop in expenditures. In addition to the comprehensive reforms described in detail in Chapters 4-5, sound implementation requires stronger budgetary discipline too. Stricter control over the appropriations will be achieved through new fiscal rules (e.g., chapter equilibrium reserve and quarterly reporting).

Apart from stronger budget discipline, the specific measures underlying the reduction in the expenditures to GDP ratio are as follows (se Annex No. 1 for details)):

- The number of public sector employees will be reduced. As a result of headcount reduction and organisational streamlining and restructuring, already decided concerning central budgetary institutions (mergers and termination of tasks), in 2006-2007 the number of employees will drop by approximately 21,000. The government encourages regional and small regional co-operation of municipalities and their more effective operation with a lower staff and at lower cost with financial instruments;
- More flexible wage regulations will be implemented from 2007 with stronger performance incentives. The total wages paid out in the public sector in the next two years will correspond to the 2006 figure adjusted with the impact of headcount reduction. From 2009, public sector wages may already increase, but this increase will be below the GDP growth rate;
- The majority of severance payments will be made in 2007, therefore the wage bill will decrease only by approximately 0.5 percentage point of the GDP in 2007. In 2008, when nominal effective savings are expected, the wage (and contribution) expenditures will drop by nearly 1 percentage point of the GDP, followed by in total approximately 0.5 percentage point savings in the next three years;
- The organisational measures and structural reforms will lead to a more economic institutional system. Spending on the purchase of goods and services will be cut in nominal terms, as the institutional system is being transformed and streamlined. These expenditures will drop by approximately 0.5 percentage point of the GDP in the next two years. From 2009, purchase of goods and services will be maintained in real terms, generating approximately 0.2 percentage point savings expressed as a percentage of GDP.

In total, the current operational expenditures of the public sector (wages, contributions, purchase of goods and services) will drop from 18.4% in 2006 by more than 3 percentage point, to 15.2% GDP, by 2009, followed by a further more than 0.5 percentage point decline, to approximately 14.5% of GDP in subsequent years.

Operational expenditures of the public sector in % of GDP

	2005	2006	2007	2008	2009	2010	2011
Compensation of employees	12.6	12.1	11.4	10.5	10.2	10-10.2	cca. 10
Intermediate consumption	6.2	6.3	5.7	5.2	5.0	cca. 4.8	cca. 4.6

- There will be changes in the price subsidy system:
  - there will be a gradual shift to subsidies based on social considerations in the case of gas price subsidies;

- the continuation of the generic programme, the restructuring of the subsidy schemes and measures reducing demand for pharmaceutical consumption will hold back the increase of pharmaceutical subsidies;
- the public transport support system will be transformed.

- Public expenditures will have to increase in some areas even during the period of fiscal consolidation. In line with legislation, there will be an increase in pension expenditures, family support and social aid. In total, social benefits other than in kind will slightly increase by 2008 as a percentage of GDP. From 2009, however, nominal GDP will grow faster than inflation, as a result of accelerating growth. Since most of the benefits (except for pensions) are indexed by inflation, there will be an annual decrease by several decimals of a percentage point of GDP.
- Public transport subsidies will also be transformed. Simultaneously with the railway reform, the Government will adjust the amount of subsidy to the actual cost of the service, thus making personal transportation by rail self-financing on a long term. From 2006, the subsidies to the Budapest transport company cover the actual costs, but limit any future needs for increase.
- The budget will provide Hungarian co-financing for the increasing EU transfers. The ratio of co-financing as a percentage of GDP will increase from 0.4% in 2005 to 0.7% in 2006 as a result of the more intensive use of the funds. The figure will practically remain at the same level until 2009, because the share of co-financing will decrease according to the rules related to the funds available from 2007. The programme reckons with the full utilisation of funds that became available after EU accession and not used until 2006 as well as a gradual utilisation of the funds available from 2007 under the new financial perspective. Thus in 2007 the use of funds available for Hungary under the accession agreement in the period 2004-2006 will substantially exceed the use of funds available from 2007. This ratio will for change only in 2008. With respect to the funds, financed from public sources, available from 2007, the programme foresees 85% community financing and 15% domestic budgetary sources in the case of structural support, and 80% community financing and 20% domestic budgetary sources in the case of rural development.
- Adjustment cannot be achieved by cutting investments on a long term due to the role of public investments in underpinning economic growth and catching-up. Although in 2007 the investments of the government sector will fall compared to this year's high figures, in the next few years they may consistently represent approximately 3.5% of GDP.

During the years of fast budget consolidation, as a result of various measures and reforms, the cut of expenditures will be implemented in the following composition:

Composition of the expenditure cuts **annual changes** in % of GDP

	2007	**2008**	**2009**	**2006-2009 together**
Compensation of employees	-0.73	-0.90	-0.22	-1.85
Intermediate consumption	-0.64	-0.47	-0.18	-1.29
Social transfers other than in kind	0.13	0.02	-0.30	-0.15
Social transfers in kind supplied via market producers	-0.25	-0.14	-0.10	-0.49
Investments and other spending programmes implemented exclusively from domestic sources	-0.74	-0.75	-0.49	-1.98
Total primary expenditures (without EU-transfers)	**-2.23**	**-2.24**	**-1.29**	**-5.76**

3.4 General government revenues

In order to rapidly improve the government balance, apart from the cut in expenditures, revenues also have to be raised and the tax burden needs to be increased temporarily at the beginning of the programme period. The postponement of the tax reduction programme and the approved tax and contribution changes will increase the tax revenues to GDP ratio by approximately 2 percentage points in the next two years compared to the lower 2006 figure.

The introduced changes affect all main components of the tax system but they increase the revenues of the general government primarily through the widening of the tax and contribution base and limitations in the scope of tax avoidance:

- the minimum contribution base will be raised to twice of the minimum wages as a main rule (exceptions may be made with a report submitted to the tax authority by people with proved lower income);
- a minimum taxation requirement will be introduced in corporate taxation;
- the cash tax payable on the unnecessarily high cash stock held by businesses will put a stop to the withdrawal of personal income from the enterprise free of tax;
- the scope of tax credits and tax-free benefits will be reduced in personal income tax.

The rest of the changes aim at better enforcement of the principle of just tax burden distribution:

- taxpayers capable of paying more tax than the average tax liability will have a special tax payment liability based on solidarity among both private individuals and corporate entities;
- the interest and capital gain tax will make the tax burden on capital closer to that on labour;
- the simplified corporate tax rate will be increased to become close to the tax imposed on income earned in various forms.

The changes in the excise duty are mainly related to the approximation of EU rules. In addition, in order to improve the government balance,

- the preferential and ordinary VAT rate will be standardised whereby the 15% VAT rate will be raised to 20%;
- the contributions paid by individuals will also be raised.

Apart from the measures aimed at revenue increases, in line with the government programme, legislation also encourages job creation in the small and medium-sized enterprise sector and disadvantaged regions through the tax system as well. (Annex No. 2 for the details of the changes of the tax system.)

In addition the changes already adopted by Parliament, the Government decided to introduce a property tax in 2008. As no decisions have been made on the details of the regulation yet, the property tax revenues are not included in the revenue calculations, but instead they increase the contingency reserve of achievement of the deficit targets.

The following table shows the ratio of tax and contribution revenues compared to GDP and their internal composition, assuming no changes in the tax system. The revenue/GDP ratio will start to fall slightly from 2009 beside export and investment-driven economic growth. The tax and contribution revenues could only decrease more in the second half of the programme period without imposing any risk on the deficit target with larger than projected cuts in expenditure. Without changing the overall tax burden, the Government considers that the tax system needs to be made more simple, transparent and fair than at present, thus it will promote better growth, employment increase and improvement of competitiveness.

Tax and contribution revenues in % of GDP

	2005	2006	2007	2008	2009	2010	2011
Taxes	24.9	24.1	25.3	25.5	25.2	cca. 25	24.5-25
of which:							
Taxes on production and imports	15.6	14.6	14.8	14.7	14.4	14-14.5	cca. 14
Current taxes on income and wealth	9.2	9.4	10.4	10.7	10.7	cca.10.5	cca.10.5
Capital taxes	0.1	0.1	0.1	0.1	0.1	cca. 0.1	cca. 0.1
Social contributions	12.8	12.8	13.5	13.5	13.4	13-13.5	cca. 13
Total tax and contribution revenues	37.7	36.9	38.8	39.0	38.6	38-38.5	37.5-38

Similarly to the average of the new Member States, in Hungary the ratio of turnover related (indirect) taxes is relatively high in a European comparison. The current more than 60% share of taxes on production and imports within the total tax revenues is approximately 10 percentage points higher than the figure generally prevailing in the old Member States. In the next few years, the internal composition of tax revenues will change in line with the macroeconomic tendencies, beside the impact of regulatory changes.

3.5 Alternative budgetary scenarios

The biggest uncertainty of the macroeconomic path is the behaviour of economic actors: it is very difficult to judge their reaction on the stabilisation measures. The convergence programme should be based on the growth projection achievable with the highest certainty, but calculations have also been made for different macroeconomic tendencies. The first two scenarios indicate potential reactions of domestic actors without any change in the external conditions. In the third scenario it is assumed that the performance of foreign trade partners will be less favourable than the baseline scenario in 2007-2009, and describes its impact on growth and the budget deficit. In the fourth scenario, the impact of 10 percentage points higher oil prices than currently expected is explored.

More favourable domestic demand – higher growth

The majority of Hungarian research institutes assume higher growth for 2007 than the baseline scenario of the programme. It is mainly because with the baseline scenario the behaviour of the actors of the economy is judged prudently. Another version is possible too, which starts out from the assumption that businesses will react to the stabilisation measures significantly more favourably than assumed in the baseline scenario. In this case, as a response of continued favourable external boom and capital transfers received from the European Union, the investment dynamism of the corporate sector will only be held back to a lesser extent, providing an opportunity for the employment of a larger number of employees released from the public sector. As a result of the more favourable economic environment, households will also have more positive reaction: they will prefer smoother consumption at the expense of savings.

In total, the dynamism of economic growth will decline less in the first few years than in the baseline scenario, but this difference in the pace will already disappear in 2009. As a result of higher employment and consumption, the budget deficit figure will also be more favourable, 0.2–0.3 percentage point lower annually than shown in the baseline scenario.

Lower domestic demand – lower growth

If the gross wages of the business sector do not follow the temporarily high inflation rates and the sector is unable to generate excess demand for the workforce released from budgetary institutions, then household disposable income may decrease more. A considerable increase in the disposable income puts the brake on household investments too, yet companies are expected to have similar reactions to a lower domestic demand.

In total, the investments of the national economy may grow almost by 1 percentage point more slowly than in the baseline scenario.

As a result of these processes, between 2007 and 2009 economic growth may be somewhat lower than it is assumed in the baseline scenario. Lower domestic use would explain a higher drop in growth, but lower import utilization partially offsets this fall. This growth scenario has an unfavourable impact on the revenues of the general government, but no such non-materialised growth will increase the deficit by more than 0.3 percentage points, which is covered by the envisaged reserve.

Unfavourable external demand – lower growth

Lower external demand can be the result of a higher than expected fall in the demand of our major trade partners, within which the economic performance of the new EU Member States, becoming increasingly important for Hungarian exports, will not meet the expectations. In the alternative scenario, the external demand is lower than in the baseline scenario by 0.2 percentage point in 2007 and 0.5 percentage point in the subsequent years.

Export dynamism will fall below the level projected in the baseline scenario already in 2007 as a result of lower external demand. With more moderate export growth, the investments of companies producing for export, their direct capital utilization and import consumption will also grow at a lower rate. The more unfavourable export sales outlook will only allow for a more moderate increase of the staff of the business sector and wages will also fall below those expected in the baseline scenario, thus household consumption will fall even more than assumed in the baseline scenario. In total, the real GDP growth will be below the potential growth, therefore from the second year inflation could be lower.

The lower inflation and higher output gap may also reduce interests, as a result of which investments and employment may increase. In relation to lower interest rates, the interest expenses of the general government will also fall, slightly offsetting the loss of revenues related to lower growth, thus the budget deficit expressed as a percentage of GDP will 0.1-0.2 percentage point higher than in the baseline scenario.

Higher oil price – higher inflation

Import prices would rise very quickly from the beginning of the analysed period with oil prices 10% higher than expected. Inflation will rise as a result of an external price shock which, through falling real income, also reduces household consumption and corporate investments, thus with lower real wages, in total there will be no changes in employment.

Falling domestic demand presses companies to increase their exports. It can be assisted with a favourable impact of faster growth of oil exporting countries on world demand. If export growth is slightly higher, the Hungarian foreign trade balance with unchanged prices will improve, yet the deterioration in the terms of trade will worsen the current account balance.

There will be hardly any reaction in total GDP beside the changes in the internal structure. The slight decline of economic activity and household consumptions will moderately worsen the budget balance.

Summary of alternative scenarios

Difference from the baseline scenario percentage point

	2007	2008	2009
More favourable domestic demand – higher growth			
Household consumption	+0.7	+0.3	0.0
Gross capital formation	+0.9	+0.7	+0.4
Export (goods and services)	0.0	0.0	0.0
Import (goods and services)	+0.3	+0.2	0.0
GDP	+0.3	+0.2	0.0
Inflation	+0.1	0.0	0.0
Employment	+0.1	+0.2	+0.2
Budget balance	+0.1	+0.2	+0.3
Lower domestic demand – lower growth			
Household consumption	-0.4	-0.2	-0.1
Gross capital formation	-0.9	-1.1	-0.3
Export (goods and services)	0.0	0.0	0.0
Import (goods and services)	-0.3	-0.1	-0.1
GDP	-0.4	-0.1	-0.1
Inflation	0.0	0.0	0.0
Employment	-0.2	-0.1	-0.1
Budget balance	-0.3	-0.4	-0.4
Unfavourable external demand – lower growth			
Household consumption	0.0	-0.4	-0.2
Gross capital formation	-0.2	-0.2	-0.1
Export (goods and services)	-1.3	-1.0	-0.6
Import (goods and services)	-1.0	-0.9	-0.5
GDP	-0.4	-0.3	-0.3
Inflation	0.0	-0.3	-0.1
Employment	-0.2	-0.3	-0.2
Budget balance	-0.1	-0.1	-0.2
Higher oil price – higher inflation			
Household consumption	-0.1	-0.2	-0.1
Gross capital formation	-0.1	-0.3	-0.1
Export (goods and services)	+0.2	+0.2	+0.1
Import (goods and services)	+0.1	+0.1	0.0
GDP	0.0	0.0	0.0
Inflation	+0.2	+0.3	+0.1
Employment	0.0	0.0	0.0
Budget balance	-0.1	-0.1	-0.1

The risks of alternative scenarios, less favourable for the budget, may be offset with reserves. These include the chapter equilibrium reserve (0.3% of GDP), the property tax to be introduced in 2008, but not contained in the revenues for the time being (also 0.3% of GDP), and the measures aiming at the restructuring of the pension system serve the same aim, as with their introduction savings can reach 0.3-0.4 per cent of GDP in 2008-2009. These reserves can secure that the budget deficit should not be higher than set in the programme even if the macroeconomic path takes a less favourable turn.

3.6 Cyclically adjusted and structural balance

According to the calculations for the convergence programme, the sensitivity factor is 0.26 taking into account the estimated tax revenues in 2007, i.e., the budget balance will change by 0.26 percentage point with 1% change of GDP (assuming no changes in the composition of GDP). This figure is higher compared to the convergence programme of

December 2005. One of its reasons is the increase of the tax burden. On the other hand, in the calculations the approach recommended by the European Central Bank is followed and only the tax revenues from the private sector are taken into account to use them to weight the individual taxes/contributions. The relative share of the private sector is growing because of the stabilisation measures, thus tax revenues from the private sector will increase more than on average.

The cyclically adjusted balance will decrease more significantly between 2006 and 2009 than the total budget deficit, because adjustment will take place with slower economic growth and an increasing output gap. The structural balance will improve less spectacularly than the cyclical balance in this period because between 2006 and 2008 one-off deficit increasing items will occur.

In economic sense, the following expenditure items can be considered one-off items:

- Accounting of the Gripen purchase (2006-2007)
- Cancellation of the Iraqi debt (2006)
- Additional expenditures related to flood protection (2006)
- sSeverance payments arising from headcount reduction in 2006 (2007)
- MÁV capital injection (2007-2008)

Structural balance in % of GDP

	2005	2006	2007	2008	2009
Output gap	1.1	1.2	-0.6	-1.9	-1.7
General government balance	-7.5	-10.1	-6.8	-4.3	-3.2
Primary balance	-3.4	-6.3	-2.4	-0.2	0.8
Cyclically adjusted balance	-7.8	-10.4	-6.6	-3.8	-2.8
Cyclically adjusted primary balance	-3.7	-6.6	-2.2	0.3	1.2
One -offs (deficit increasing)	0	0.8	0.9	0.3	0
Structural balance	-7.8	-9.6	-5.7	-3.5	-2.8

3.7 Public debt

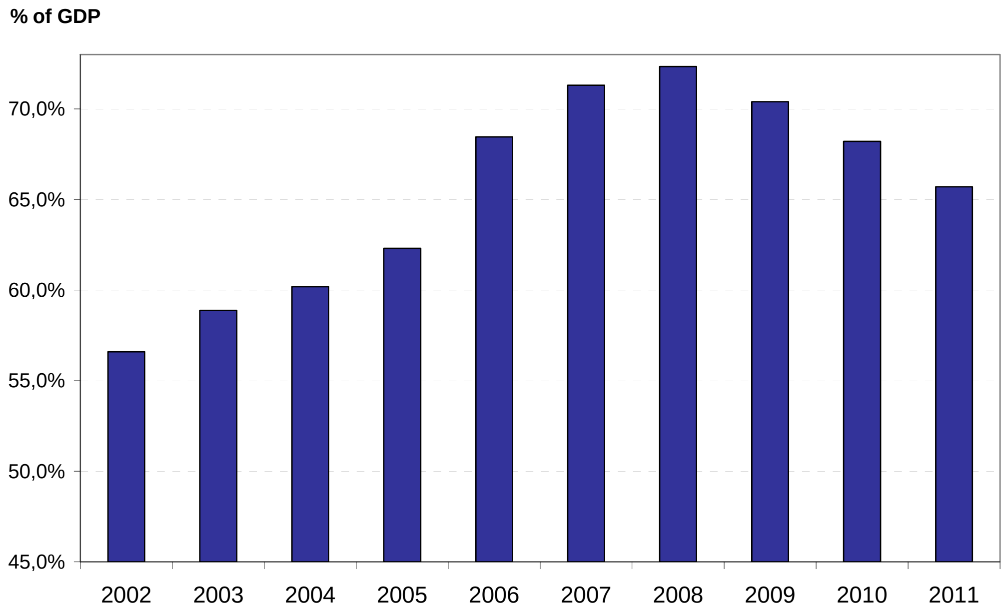
As it was indicated in the introduction, private pension funds are not included in the general government sector in this convergence programme contrary to the previous one. This methodological change has a significant impact on the debt ratio too, yet the statistical difference does not reflect any macroeconomic impacts, because part of the public debt embodied in the stock of government securities accumulated by pension funds is financed automatically.

Debt ratio in % of GDP

	2005	2006	2007	2008	2009
Private pension funds outside the general government	62.3	68.5	71.3	72.3	70.4
Private pension funds inside the general government	58.3	63.7	65.6	66.6	64.0

Due to the increasingly unfavourable international financial environment, the rising yields and the depreciation of the exchange rate, and mainly because of the higher primary deficit, in 2006 the debt ratio is expected to exceed 68% of GDP.

Public debt



The medium-term economic policy objective is a consistent decline of the debt ratio following a temporary rise. The conditions of turning around the trend of indebtedness can be put in place primarily with measures improving the primary balance, economic growth, falling yields and the expected stabilisation of the exchange rate[4]. Despite considerable improvement of the primary balance, by 2008 only the increase of the debt ratio can be decelerated. Then the ratio will start to fall on average by 2 percentage points a year.

In the recent past and this year, the *primary balance* was also deteriorated by single impacts (non-recovered prefinancing of agricultural support, Gripen purchase).

The *interest expenditure was* projected with the assumption that at the beginning yields will reflect market expectations then converge gradually to the euro yield curve. The interest burden compared to GDP will still increase by approximately 0.6 percentage point in 2007, then it will start to fall from 2008 and, following more than 0.5 percentage point decline by 2010, it will fall below 4% again. The estimated increase in interest expenditure will occur because of the significant determination of the higher yield curve and a sudden increase in the debt. Moving forward in the convergence path, the interest expenditure as a percentage of GDP will also begin to fall as a result of a lower budget deficit and, as we expect, yield curves turning into a favourable direction as well as stabilisation of the exchange rate.

Apart from the budget deficit, the future debt ratio will also be influenced by the stock-flow adjustment. Privatisation revenues reduce the public debt. In 2006, their impact is HUF 260 billion. Although the Government intends to continue privatisation in the next few years, debt projections do not contain such revenues for those years, thus privatisation revenues may reduce debt compared to the baseline scenario. In 2005, the revaluation impact resulting from the depreciation of the exchange rate was significant and we expect the same to occur this year too. From 2007, the programme assumes no

[4] Following the practice of various forecasting institutions, the convergence programme applies a technical assumption for the HUF/EUR exchange rate. The HUF 267 average exchange rate of 2006 was calculated based on the actual data of 18 August and extrapolating the HUF 272.5 average of the actual exchange rates between 18 May and 18 August to the total outstanding programme period. Following this method, we used the unchanged HUF 272.5 exchange rate for the period of 2007-2011.

changes in the exchange rate, yet the credibility of the adjustment programme may even result in some exchange rate appreciation.

The future debt ratio is sensitive to changes in the following main factors[5]:

- Primary balance: the annual 1 percentage point change of the primary balance from 2006 till the end of the projection period will induce 2 percentage points change in 2007 and 3.8 percentage points change by the end of 2009 in the debt ratio.
- Exchange rate: approximately 30% of the debt portfolio is denominated in foreign currency (because of the hedging transactions it is essentially in euro). Consequently, 1% exchange rate change will have 0.18-0.22 percentage point impact on the debt ratio. In absolute terms, 10% revaluation will induce a change of HUF 450-600 billion on the public debt and approximately 2 percentage points on the debt ratio.
- Yield curve: lasting shift in yields has a gradual impact on interest expenditure, with a delay in the changes of the debt ratio too. A durable 100 basis points shift of the HUF market yield curve, applicable to all maturities from January 2007, would change the interest expenditure and deficit by 0.11 percentage point in 2007; 0.2 in 2008 and 0.31 in 2009 with cumulative effects of the annual fluctuation of interest expenditure on the debt ratio (0.11; 0.34; 0.63 percentage point, respective).
- Economic growth: the steady 1 percentage point change of nominal GDP starting in 2006 would have an impact on the debt ratio of 0.6 percentage point in 2006; 1.4 in 2007; 2.1 in 2008 and 2.7 in 2009.

[5] The analysis assumes no changes in the other factors (*ceteris paribus assumption)*.

4. Structural measures

The Hungarian Government has adopted or is working on structural measures affecting a wide range of public services. The purpose of those measures is to

- assure the long-term sustainability of the financing of the various public services and of public services as a whole within the public expenditure constraints defined in the Convergence Programme,
- improve the quality of public services provided by the central/local governments, in particular in areas (public education, vocational training) that play a key role in raising the below-average employment level of undereducated groups,
- reduce the existing inequalities in access to public services, strengthening social inclusion,
- strengthen, in aggregate, the motivation for earning an income in the legal labour market and to correct the present disproportionalities of burden sharing,
- have public services adjust to the intensifying demographic trends (shrinking size of age groups in public and higher education, aging population).

The measures cover

- the systematic overview of the central/local government tasks from the aspects of legislation and financing, so that tasks that are no longer necessary can be eliminated and the manner and/or scope of service provision can be streamlined,
- the reasonable regulation of demand for public service with incentives and occasionally with administrative measures, in order to reduce unjustified excessive demand,
- the removal of unjustified capacities of the central/local government institution system providing public services, as well as the elimination of existing scarce capacities by the reallocation of resources,
- the improvement of the operational efficiency of the institution system, primarily through the clear definition of performance requirements, the measurement of their achievement, the publicity of the outcomes of such measurement and the consistent enforcement of sanctions necessitated by the scores achieved (client charters),
- consistent enforcement of economies of scale considerations in the performance of public functions,
- the elimination of monopolies in public services in order to create conditions for competition between public service providers in the broadest scope possible,
- in order to encourage/enforce income earning in the legal labour market, the reinforcement of record keeping and control systems and the exclusion of social security “free riders” from the services,
- promotion of self-provision, in particular its forms based on long term savings,
- strengthening the targeting of social benefits in order to cleanse the profile of social services,
- wide-spread and systematic use of IT in the course of providing public services and in customer relations,
- the comprehensive amendment of the legal system based on the customer-oriented deregulation of processes and on its better regulation.

It is the Government’s intention to have the regulatory and administrative tasks necessary to enforce/encourage the above requirements (adoption of laws and decrees, organisational measures and other necessary acts) during 2006-2007, so that the full effects of these measures can manifest themselves in 2008-2009. These measures are necessary to assure that the expenditure cuts described above can be continued while the operability of the systems is retained. The fiscal effects of the reforms are described in the programme in certain cases, but these are obviously not additional to the expenditure cuts explained previously.

The operational programme(s) devised under the New Hungary Development Plan will contribute to the implementation of the structural reforms with funding of HUF 130-160 billion, which facilitates the financing of the necessary institution development and retraining tasks and creates the system of government databases to underpin equitable taxation and e-administration. It is the Government's intention to assure that the development funds of the 2007-2013 period are used as required by the proposed changes.

Key structural measures – adopted and proposed

I. Public administration

Measure	Timing
1.a) Significant reduction of the size and internal fragmentation of the central government: the number of ministries will go form 14 to 11, the number of employees will decline by 20%. **1.b)** Centralisation of parallel functional areas – HR, IT, asset management, operations.	1.a) completed 1.b) 1 January 2007
2.) Consolidation and regional reorganisation of the central administration and its regional (decentralised) bodies (affecting almost 200 budgetary organisations), entailing a 10% staff cut.	Decision: completed Implementation: by 31 December 2006
3.) In the entire public administration, the across-the-board introduction of the definition and measurement of performance requirements and the relaxation of the rigid promotion and remuneration system.	Submission of bills to Parliament: 2006 and first half of 2007
4.) Introduction of a selection system based on competitive examination.	Submission of bill to Parliament: 2006
5.) Financial incentives to associations of local governments to reach reasonable economies of scale in public administration.	Submission of bill to Parliament: 2006
6.) Setting up integrated micro-regional customer service centres.	Decision: 2006 Implementation starting in 2007
7.) The spread of e-government (in the field of services affecting the competitiveness of businesses as defined in EU recommendations).	Decision: 2006 Implementation starting in 2007

II. Local government tasks and financing

Measure	Timing
1.) Instead of the dominance of task performance on the level of small settlements or counties, the promotion of services performed on the micro-regional or regional level, in the framework of cooperation based on law or encouraged with financial incentives to enforce economies of scale. In case of micro-regions, this is particularly relevant in public education, public administration and the maintenance of social institution.	Submission of bill to Parliament: 2006
2.) The re-allocation and streamlining of the performance of tasks will be assisted by the substantial reduction of normative grants available for local governments, the alteration of their content and the use of supplementary transfers conditional on the efficient performance of tasks, simultaneously with the review of responsibilities imposed by sectoral legislation.	Submission of bill to Parliament: 2006
3.) The introduction of value-based real estate taxation will reinforce the financial independence of local governments.	Decision: 2006 Implementation starting in 2008
4.) Introduction of central capacity regulation in case of certain tasks within public services (education, social care, child protection).	Submission of bill to Parliament: 2007

III. Health care

Measure	Timing
1.) Reinforcement of the social insurance character of health care: the use of services based on the insurance principle will be conditional on the existence of an insurance legal relationship or other eligible registered status, and the payment of the contributions due[6]. In the absence of these, only basic services such as ambulance, emergency, mother and child protection and epidemiology can be used.	Submission of bill to Parliament: 2006
2.) In order to limit demand, in respect of the meetings of physicians and patients (basic care, outpatient care and the related diagnostic tests as well as active inpatient special care), a fee is to be paid by the user, and the health care provider is obliged to issue a receipt.	Submission of bill to Parliament: 2006
3.) Introduction of professional and financing protocols (patient routes) in order to streamline the use and provision of services.	Submission of bill to Parliament: 2006
4.) The subsequent (higher) level of service can typically be used based on a referral issued at the lower levels	Submission of bill to Parliament: 2006

[6] Those persons are also eligible for in-kind health care benefits from whom their employer deducted the contribution but did not remit the payment to the health insurer.

Measure	Timing
5.) Close-down of the under-utilised or unreasonably maintained excess active in-patient capacities or their transformation into chronic/nursing or social service capacities.	Submission of bill to Parliament: 2006
6.) The contracting obligation of the National health Insurance Fund will be terminated, service providers may compete for the social insurance funding, and the NHIF will purchase only the necessary services.	Submission of bill to Parliament: 2006
7.) The operational framework of service providers (typically hospitals) will change, facilitating transparent book-keeping and profit accounting, the profit orientation of the owner (maintainer) and employment assuring more flexible remuneration of staff.	Submission of bill to Parliament: 2007
8) Health insurance supervision will be created.	Submission of bill to Parliament: 2006
9.) Co-ordination of basic care (family doctors) on the micro-regional level.	Submission of bill to Parliament: 2006
10.) While maintaining public financing, the Government will consider the potential opening of the health insurance market to private insurers.	Decision: 2006 Submission of bill to Parliament: 2007

IV. Pharmaceuticals

Measure	Timing
1.) Change of the rates of subsidy (facilitating savings corresponding to 0.2% of GDP). Following the alteration of rates, a fee will be payable in respect of every prescription drug.	Government decision: 31 August Introduction: 2007
2.) Gradual liberalisation of the opening of pharmacies, the current monopolistic constraints removed.	Submission of bill to Parliament: 2006
3.) The sale of non-prescription drugs will be allowed for a broad group of entities.	Submission of bill to Parliament: 2006
4.) The "fixing" of the subsidy will become general, at the level of the subsidy to the cheapest benchmark product.	Submission of bill to Parliament: 2006
5.) The criteria for remaining in the subsidised pharmaceutical category will become more stringent.	Submission of bill to Parliament: 2006
6.) An individual prescription limit will be set for family doctors.	Submission of bill to Parliament: 2006
7.) The new rules will assure that patients leaving hospitals are prescribed generic products as a rule (unless there is a counter-indication).	Submission of bill to Parliament: 2006
8.) The comprehensive regulation, transparency and publicity of the process of acceptance for subsidisation, classification, fixing, volume rules and purchasing.	Submission of bill to Parliament: 2006

Measure	Timing
9.) Establishment of a strict, closed and automated on-line control system and its consistent operation through the application of objective sanctions, in order to monitor compliance with requirements concerning the prescription and redemption of pharmaceuticals (including professional and financing protocols and substitution rules).	Submission of bill to Parliament: 2006

V. Pension system

The Government is aware of the short-term deficit generation of the current pension system and its long-term sustainability issues; therefore it intends to carry on the pension reform started successfully in 1997, comprehensively, systematically and in compliance with constitutional requirements. The relevant detailed decisions will be taken by end-2006. Even before that date, the Government will take action to solve or alleviate certain problems as described below and it will create the legislative framework of the measures this year. The entry into force of these measures will be timed taking into account the constitutional preparatory period.

Measure	Timing
1.) The terms of retirement before the statutory retirement age (62) will change so that the resulting financial burdens, based on actuarial calculations, are borne by the persons concerned. The age of eligibility for early old-age retirement benefits will also change as of 2009.	Submission of bill to Parliament: 2006
2.) The regulation will make it clear that early retirement is an allowance, and no income earning activity can be pursued while in that status.	Submission of bill to Parliament: 2006
3.) After 2007, entitlement for early retirement, in line with the effective legal regulations, can be accrued only under the new rules, without encumbering the pension fund.	Submission of bill to Parliament: 2006
4.) The unjustified differences between the various occupational groups in terms of the time of service and mode of income computation to obtain pension entitlement will be gradually eliminated.	Submission of bill to Parliament: 2006
5.) The tax and contribution rules applicable to working while in retirement will be the same as the general rules, therefore the payment of pension contribution will give rise to entitlement to benefits.	Submission of bill to Parliament: 2006
6.) Various anomalies of the pension award rules will be eliminated (valorisation, netting).	Submission of bill to Parliament: 2006

VI. Disability benefits

Measure	Timing
1.) In the framework of the "theoretical clarification" of the social insurance system, disability benefits will become an independent benefit category, and they will be removed both from the health care and pension systems.	Submission of bill to Parliament: 2007
2.) The present benefits to persons suffering from partial	Submission of bill to

Measure	Timing
disability will be replaced by a temporary benefit that, when supplemented with appropriate rehabilitation, creates a strong incentive to remain in or return to the legal labour market.	Parliament: 2007
3.) The rules of the award and control of reduced working capacity status will change so as to prevent the currently wide-spread abuses.	Submission of bill to Parliament: 2007
4.) Establishment of new target groups and control techniques for review among the current disability pensioners. Assuring the independence of the reviewing institutions from the health insurance system.	Submission of bill to Parliament: 2007

VII. Public education

Measure	Timing
1.) Increase of the mandatory teaching hours of teachers in 2007; two hours of overtime can be required in 2006.	Completed
2.) Simplification of employment rules (more rational work organisation).	Submission of bill to Parliament: 2006
3.) Establishment of the regulatory conditions of performing tasks in associations (micro-region level).	Submission of bill to Parliament: 2006
4.) Financial incentives to the establishment of more efficient school structures (member institutions, consolidated schools, micro-regional association).	Submission of bill to Parliament: 2006
5.) In the context of the local government (financing) reform, the transformation of the normative grant system of public education. Funding based on calculated teacher positions (status), where the principles and requirements set out in the public education act concerning the formation of classes and groups (average student number, time frame) as well as the mandatory weekly teaching units of teachers (including the additional hours that can be required by the employer) must be taken into account.	Submission of bill to Parliament: 2006
6.) Reform of the regulatory and financing system of basic arts education in order to reduce the state's obligations.	Submission of bill to Parliament: 2006
7.) Elimination of unjustified differences in the burden sharing ratios of different institution maintainers (government, non-government, capital city, rural).	Submission of bill to Parliament: 2006
8.) Improvement of measurement-assessment, publication of results, preparation of league tables.	Submission of bill to Parliament: First half of 2007

VIII. Higher education

Measure	Timing
1.) From 2008 onwards, students in state-financed higher education will have to pay the tuition fee introduced in 2007. The student grant and payment system will be changed. Performance orientation will be strengthened. Based on the performance of students, it will be possible to switch between state-financed and tuition fee based education.	1 September 2007 Completed
2.) The structure of education and financing will be changed in line with the Bologna process; a new arrangement will be elaborated for the financing of higher education. The educational and output requirements of Master education will be elaborated.	Submission of bill to Parliament: 2007
3.) The fragmentation of the system of higher education institutions will be reduced, the number of such institutions will be decreased. The scope of maintainers may be broadened; local governments may become maintainers by taking over institutions.	Submission of bill to Parliament: 2007
4.) The requirements relating to the quality assurance system will be reconsidered and tightened.	Submission of bill to Parliament: 2007
5.) Parallel forms of education will be restricted or eliminated.	To be reviewed: 2007.
6.) The state-financed student numbers will be reduced and structurally changed (the ceilings for lawyers, liberal arts students, teachers and economist being reduced, natural sciences, IT and technical student numbers being increased).	Gov. decree: 31 October 2006
7.) A feed-back mechanism will evolve, reflecting the labour market demand in the number of students participating in education as well as in the nature and quality of training.	Introduction: 2nd half of 2007

IX. Burden sharing – collection of taxes and contributions

Measure	Timing
1.) Personalised records will be kept of the payment of social insurance contributions.	Implementation: 2007
2.) Uniform, value-based real estate tax to be introduced both for households and for businesses.	Decision: 2006 Submission of bill to Parliament: 2007 Introduction: From 2008 onwards
3.) The collection of duties will be taken over by the central tax authority.	1 January 2007
4.) The Government will consider the comprehensive and systematic reform of public dues which, leaving the tax centralisation rate unchanged, would distribute burdens across a substantially broader spectrum, it would encourage more investments and savings, thereby contributing to a higher growth rate.	Decision: 2007

In the above areas, the State Reform Committee, established by the Government in June 2006, coordinates the preparation of reforms.

In addition to these areas, important reforms have been started in public transport as well. The fundamental objective is to create a transport system adapted to the budgetary capacitates of the. The reform consist of the following key elements:

- the implementation of a uniform tariff and allowance system in bus and rail passenger transport;
- the systematic review of consumer price subsidies to interurban public transport and the separation of social considerations;
- introduction of a surcharge system that encourages carriers to provide higher quality services;
- elimination of duplications in interurban road and rail public transport;
- in order to promote rail freight transport and to reduce budget expenditures, the establishment of a regionally competitive rail track use charge system.
- increasing the efficiency of the operation of service providers: in this framework, the regional merger of Volán (coach) companies, and the streamlining of the central governance and administration structure of MÁV (railway company).

The purpose of the continuation of the railway reform is to establish a multi-player market model. In the course of the reorganisation of MÁV Zrt., the track operator to perform state functions in the long term, rail passenger transport, which can be performed on a commercial basis, and the management of real property will be transferred to different companies. With the sale of MÁV Cargo Zrt., the liberalisation of rail freight transport will be completed.

5. Sustainability of public finances

Demographic processes have a significant impact on public expenditures. Pension and health expenditures will increase with the aging of the population. For the sake of long term sustainability, far-reaching reforms are needed in these areas. Below we shall overview, partly reiterating the contents of the chapter on structural reforms, the current situation of the pension and health systems and the measures taken or proposed to improve operational capacities.

5.1 Pension system

Since 1998, the mandatory Hungarian pension system has consisted of two pillars: the pay-as-you-go social insurance pension system and the fully funded private pension fund system. Career starters become insured in a mandatory manner in both pillars (so-called mixed system), and they pay a significant part (8 of the 8.5%) of their individual pension contributions into the private pension fund of their choice. On the other hand, persons who have not joined any private pension fund continue to be insured exclusively in the social insurance pillar. They pay the full amount of their pension contribution to the pay-as-you-go system, and their benefits will also be provided exclusively from the first pillar. On the other hand, members of the mixed system receive 25% less benefit from the first pillar, however, that sum is supplement by the annuity paid by the private fund.

The sustainability of the pension system is supported by the implemented or announced measures of the comprehensive pension reform launched in 1997: These measures include the following:

- the rate of indexation of pension benefits (50% wage increase, 50% inflation);
- the gradual increase of the retirement age, announced in 1997 and continuing until 2009
- as of 2009, the eligibility criteria for early retirement will become considerably stricter;
- the reference period in the calculation of pensions will become longer every year;
- incentives to work longer have become stronger in the pension system (higher bonus for retiring after the statutory retirement age; after 2013 contribution years for pension eligibility will enter pension calculations linearly and not regressively as before).

The eligibility and benefit rules of the pension system continue to be ridden with contradictions even after the pension reform. The average retirement age is low due to the permissive criteria of under-age retirement, staying considerably below the statutory old-age retirement age. The criteria applicable to certain types of benefits available under the retirement age and related to the health status or to the time spent in certain positions are rather generous. In recent years, the replacement ratio of initial pensions has increased substantially. Old age pension is used not only by persons who are no longer able to work but also by persons who continue their active earning activities after their retirement. Because of these trends, the Government has initiated that legislation facilitating the addressing of controversial phenomena is adopted in 2006 or in the first half of 2007, entering into force following the constitutional preparatory period. Those changes are necessary to bring the pension system into a near-equilibrium position in the long term. The following measures should be highlighted:

- raising the early old-age retirement age by one year, and the reduction of pensions when retiring before the statutory retirement age to adjust the benefit in accordance with actuarial calculations;
- adjustment of the initial pension levels;

- termination of any further accrual of entitlement to early retirement relating to time spent in certain positions, as well as the overhaul of the disability pension system with rehabilitation in the focus;
- suspension of pension benefits below the retirement age if any income earning activity is pursued;
- termination of the individual exemption from contribution payment of income earning activities during retirement.

In the long term, the introduction of the mandatory fully funded system will significantly improve the sustainability of the social security system. Voluntary entrants to the new system and people starting their careers will receive one quarter less benefits from the first pillar (pay-as-you-go system). The measures aimed at increasing the employment rate also contribute to the sustainability of the pension system.

For the analysis of the sustainability of the pension system, the Convergence Programme relies on the results of Hungarian fiscal projections for the period up to 2010, while for the longer term it has used the long term pension forecast expanding to 2050 as approved by the Economic Policy Committee (EPC) of the European Union, taking into account the effects of the stabilisation measures of 2006-2007. According to the forecasts, the old-age dependency ratio (ratio of the population above retirement age to the active age population) will increase substantially, from 28.6% in 2004 to 59.2% in 2050. Therefore the ratio of pensioners to persons in employment will also develop along an unfavourable course, as the improvement of the employment rate will only moderately alleviate the demographic problem.

The fully funded system will start to have a substantial effect on the expenditure side from the 2020's. After that time, an increasing part of the newly retired persons will be members of the two-pillar system being eligible to a reduced benefit from the pay-as-you-go pillar. According to the projections, the private pension funds will relieve the general government from pension expenditures corresponding to 2.6% of GDP in 2050 (as compared to a scenario without the reform). The growth of social security expenditures is moderated by the increase of the retirement age and the indexation of pensions at a rate below the growth of GDP, as well as the legislative changes to be enacted in 2006-2007 to address the controversial issues of early retirement and the award of initial pensions. On the other hand, expenditures are increased by the introduction of the full 13th month pension, and the measures aimed at correcting disproportions of benefits awarded before 1999 will cause a temporary increase (up to 2020). As a result of these factors, in 2050 the ratio of the net pension expenditures of the social insurance funds to GDP is expected to exceed the year 2005 level by 3 percentage points.

The revenue side of the public (pay-as-you-go) pillar is affected by the lower contributions of the mixed system's members. As a result, a substantial additional deficit, increasing until the 2020's, is generated in the pay-as-you-go system, as a growing part of the active population becomes pension fund member. The second most important revenue-reducing effect comes from the decreasing number of employed persons due to demographic causes. The effects on the expenditure side will show up later. The mixed system is expected to reach full maturity around 2060. It is important to note, however, that during this period the temporary deficit of the pay-as-you-go system will be counterbalanced by savings (accumulation) of the same magnitude in the private pension fund pillar.

In the future, the deficit of the Pension Insurance Fund (including the temporary deficit due to the payment of contributions to the second pillar) will increase steadily. The balance of the Fund will be improved by 0.7% of GDP through the additional receipts coming from the 3-percentage-point increase of the employer's pension contributions to be implemented in 2007. Nevertheless, the deficit calculated on the basis of net pension expenditures is projected to be at round 3.9% of GDP in 2050.

As a conclusion, the demographic trends will have an unfavourable effect on the Hungarian pension system. However, the adverse demographic effects will be moderated in the long term by the measures of the pension reform of 1997 and of the adjustments of 2006-2007. Nonetheless, the deficit of the pay-as-you-go pension system is expected to rise, requiring an increasing contribution of the central budget.

Pension expenditures in % of GDP

	2000	2005	2010	2020	2050
Net pension expenditures*	9,3	10,5	10,3	10,7	13,5
o/w: expenditures of the social security funds	8,6	9,9	9,8	10,2	13,2
Expenditures of private pension funds	0,0	0,0	0,0	0,1	2,7
Number of pensioners (million)*	3,1	3,0	3,0	3,1	3,3
o/w**: in the pay-as-you-go system	2,8	2,7	2,7	2,7	1,2
in the mixed system	0,0	0,0	0,0	0,2	2,0

* pension expenditures financed by the Pension and Health Insurance Funds and by the central budget (including pension-type benefits) and their beneficiaries.
** number of beneficiaries receiving social security pensions (without pension-type benefits).

5.2 Health care system

At present, the health expenditures line of Table 6, which shows the factors of long term sustainability, includes the projections published by the EPC in February 2006, therefore these figures do not reflect the impacts of the measures taken recently by the Government. The Government will initiate the preparation of national projections as well, with the involvement of experts, about the long term development of such expenditures.

Simultaneously, a decision is required about the desirable ratio of the state’s share of the expenditures, which will continue to rise in the long term for demographic reasons. The Government has set the target of reducing the expenditures of the Health Insurance Fund by 0.9 percentage points (as a percentage of GDP) between 2006 and 2009.

Curative-preventive care

Curative-preventative care is a neuralgic point of the health insurance system. In recent years, the dominance of active hospital care has not lessened in Hungary, and the regional imbalances, which have been around for decades, have not improved; indeed, in certain areas they have even worsened. There are substantial shortfalls in the use of cost efficient therapeutic procedures and many hospitals suffer from economies of scale problems. As a result, we spend relatively more than we could afford or that would be optimal, while the funds used in this distorted structure yield less professional and quality improvement benefits than it would be desirable. Furthermore, in recent years the escalation of outputs has caused ever growing problems.

The state finances curative-preventative care in several forms. In 2006, the public expenditures used for that purpose will reach 3% of GDP. Health service providers receive a flat-rate and/or performance-based fee based on their own accounts, depending on the service provided. The setting of the fees is within the competence of the Government. The financing system also contains certain safeguards. In case of a performance overrun, the manager of the Health Insurance Fund may reduce fees/rates.

This system assures that the curative-preventative care appropriation in the budget of the Health Insurance Fund cannot be exceeded. In such a case, compliance with the appropriation is conditional on the application of such combinations of capacity expansion, performance accounting rule modifications and rate setting which keep the expenditure obligations of the Fund within the appropriation despite the intensive attempts of service providers to generate more revenues.

The Government has set the target of reducing the expenditures of the Health Insurance Fund for the forthcoming years. That reduction is possible without the deterioration of the quality of services as the measures serve primarily to assure the more efficient use of funds and the elimination of wasteful management.

The first group of adjustment measures announced by the Government in July 2006 serve to improve the balance in the short term. From October onwards, these measures (lowering the eligible output limit, restriction on the eligibility of output growth, more intensive controls, stopping of the capacity expansion of the service provider network, freezing of fees) will considerably lower the payment obligations of the Health Insurance Fund, while also constraining the possibilities of service providers to increase their output by putting a ceiling on eligible output. The resulting savings will be manifested in 2006 in the fourth quarter only, therefore the expenditure cuts will be several times greater in the forthcoming years.

The second group of measures is aimed at assuring the longer term sustainability of the nominal expenditure levels achieved as a result of the aforementioned measures, replacing the short-term measures, and setting out to moderate the existing regional and structural disproportionalities of the health care system and to improve economies of scale and efficiency:

- Reinforcement of the social insurance character of health care (the use of services based on the insurance principle will be conditional on the existence of an insurance legal relationship or other eligible registered status) and the payment of the contributions due[7]. In the absence of these, only basic services such as ambulance, emergency, mother and child protection and epidemiology can be used.
- In order to regulate demand, in respect of the meetings of physicians and patients (primary care, outpatient care and the related diagnostic tests as well as active inpatient specialised care), a fee is to be paid by the user, and the health care provider is obliged to issue an invoice.
- The use of professional and financing protocols will become standard practice in order to streamline the use and provision of services.
- The subsequent (higher) level of service can typically be used based on a referral issued at the lower levels.
- Excess active in-patient capacities will be transformed into chronic, nursing or outpatient capacities or they will be closed down.
- Service providers may compete for the social insurance funding, and the NHIF will purchase only the necessary services; the National Health Insurance Fund will no longer be under a contracting obligation.
- The operational framework of service providers (typically hospitals) will change, facilitating transparent book-keeping and profit accounting, the profit orientation of the owner (maintainer) and employment assuring more flexible remuneration of staff. (Though the measure brings no direct improvement to the balance of the Health Insurance Fund, it may contribute to improving the financial position of the local governments or government bodies maintaining the institutions).
- Health insurance supervision will be established.
- The Government will consider the potential opening of the health insurance market.

[7] Those persons are also eligible for in-kind health care benefits from whom their employer deducted the contribution but did not remit the payment to the health insurer.

As a result of the implementation of the structural reform, the active in-patient capacities will be reduced considerably (mainly in Budapest, in the Western and Southern Transdanubian regions, primarily in small towns). The cuts in active hospital capacities will be partly offset by the chronic and nursing capacity expansion as needed, but hospital capacities will diminish on the whole. Services will shift towards less cost intensive forms of care.

As a prerequisite of the reform, normative rates must be set in the act regulating the specialized care provision obligation, at a uniform level across the country and with less active hospital capacities and more chronic facilities than today. The eligible output must be re-allocated in accordance with the normatives. The implementation of the transformation and the introduction of state-of-the-art, cost efficient therapies should result in perceivable financial gains.

The introduction of some form of payment by patients, proposed for 2007, will facilitate the reduction by a few percents of current fees paid in family doctor services and dental care, hitherto not affected by tightening measures. The resulting savings can be used towards improving the cost efficiency of the transformation of secondary care. In secondary outpatient care, the funds removed by the measures of July 2006 may be substituted for, in part or in whole, by the introduction of a payment obligation.

A measure aimed at reducing the social insurance payments for dental care and the shortening of the period of passive sick pay is in the pipeline. These measures are intended to promote the structural transformation of secondary care.

The achievement of expenditure targets is supported by legislative safeguards.

Pharmaceutical subsidies

The steep climb of pharmaceutical subsidies has been a major driver of the growing deficit of the Health Insurance Fund for years.

A significant reduction of the growth rate of pharmaceutical subsidies is a key requirement for the improvement of the general government balance. To that end, the subsidisation system must be rationalised, the requirements of cost efficiency and long term financial sustainability must be enforced, incentives must be created for producers to intensify price competition, households as well as physicians must be made more cost sensitive, and the efficiency of prescription, the settlement of subsidies and the control of the use of subsidies must be improved.

The pharmaceutical subsidy regime will be changed along the following principles:

- The purpose of the pharmaceutical subsidy system is to assure that, following the subsidy cuts of this year, the pharmaceutical fund appropriation is not exceeded. To that end, the regulation covers relations with producers, influencing prescription habits and restricting unjustified demand.
- The “fixing” of the subsidy will become general practice (within classes of drugs with the same active substance), at the level of the subsidy to the cheapest (benchmark) product.
- An individual prescription limit will be set for family doctors.
- The new rules will assure that patients leaving hospitals are prescribed generic products as a rule (unless there is a counter-indication).
- Consistent operation of a strict and closed control system to monitor prescription and subsidy entitlements on line.

In the forthcoming years, the observation of the expenditure appropriation for pharmaceutical subsidies will be promoted by the following specific measures:

2006

- adjustment of the subsidy system in line with the so-called "transparency" decree and the agreement concluded with pharmaceutical companies and effective until the end of 2006 (channelling of the 7.5% co-payment cut back into the non-fixed group, re-fixing based mostly on more favourably priced products, 2.7% subsidy cut in the fixed categories);
- more intensive control over prescription practices;

2007

- the carry-over effects of the subsidy rationalisation and prescription control measures implemented during 2006;
- as a result of the introduction of the visit fee and the obligation of the health providers to issue an invoice, the number of prescriptions may fall by some 4-5%, which may curb the outflow of subsidies considerably.
- the introduction of a system favouring the insurer by the adoption of the act on economy in pharmaceuticals;
- change of price and admission rules to bring about lower prices (continuous fixing and comprehensive review for subsidised pharmaceuticals, setting the maximum price of the first generic product, acceleration of the admission of generic drugs by reducing the 90-day time limit of admission to 30 days);
- termination of free access;
- tightening the conditions of remaining in the subsidised category, termination of the subsidisation of non-cost-efficient pharmaceuticals;
- introduction of a pharmaceutical limit for family doctors;
- universal introduction of a control system to monitor prescription and subsidy entitlements on line;

2008

- further corrections in the regulatory regime

6. Institutional features of public finances

6.1 Budgetary procedure

The Hungarian parliament is a unicameral legislative body. Its Standing Order shall be passed on a two-third majority while the Committee of the House shall decide on the details in specific cases. The opposition is entitled to a proportionate representation in the Committee of the House where decisions shall, on a general understanding, be made unanimously.

The constitution stipulates that "the Parliament determines the government balance sheet and approves the government budget as well as its execution". The organic budget law (Act on Public Finance, dated from 1992) with its execution decree regulates the budget process.

The Standing Orders of the Parliament contain quite detailed rules of the budget debate, which consists of two rounds. In the first round principally any sort of amendment can be submitted to the bill, while amendments in the second round cannot affect the headline figures accepted at the end of the first round.

Time table of the budget process

Unit of measurement: month	Date (election year)	Relative date
The Government adopt the guidelines of the budgetary planning.	15 April (30 June)	t-8,5 (t-6)
The Minister of Finance submits the draft budget bill to the Government.	31 August (15 October)	t-4 (t-2,5)
The Government submits the draft budget bill to the Parliament At the same time the State Audit Office (SAO) submits its report on the draft budget bill to the Parliament. The report is discussed together with the draft budget bill.	30 September (31 October)	t-3 (t-2)
The Government submits the chapter detailed figures and their explanation to the Parliament.	15 October (15 November)	t-2,5 (t-1,5)
The Parliament adopts the headline figures and the second stage of Parliamentary debate begins.	30 November	t-1
The Parliament adopts the Budget Bill.	December	t
End of the fiscal year	Next December	t+12
The Government submits the final accounts to the SAO.	June in two years' time	t+18
The Government submits the final accounts; the president of the SAO submits the report on the final accounts to the Parliament.	August in two years' time	t+20

6.2 Public finance statistical governance

The Hungarian Central Statistical Office (HCSO) and the National Bank of Hungary (NBH) compile the statistics on the government sector. In the current division of labour, the HCSO is responsible for non-financial accounts, the NBH for financial accounts.

The above mentioned division of labour applies to the compilation of data up to the (t-1) period within the Excessive Deficit Procedure, while the deficit and debt of the (t) period is calculated by the Ministry of Finance (MoF). The change of the deadline for the first Notification from end-February to end-March allowed the HCSO to take over the calculation of the deficit figure for the (t-1) period, thus conformity with the national accounts can be assured.

The statistical working group comprising the representatives of the HCSO, the NBH and MoF operates on the management and expert level, and a cooperation agreement sets out procedural issues of data flow, division of labour and methodological assessment.

Key data sources of the statistics of the government sector include the government finance information system, the annual and interim reports of the units of legal government (incl. local governments), statistical data collection from corporations and non-profit entities classified within the general government sector as well as the statistical collection of banking and securities data for the entire government sector.

The detailed description of the compilation methodology of Notification data under the Excessive Deficit („EDP Inventory”) procedure will be updated in September 2006 and will be published on the HCSO's homepage.

According to the current practice, the MoF dedicates an individual chapter for the explanation of the difference between the official national and the Maastricht deficit and debt indicators, as part of the general explanation attached to the annual budget and the final accounts submitted to the Parliament.

6.3 Fiscal rules, independent institutions supporting budgetary planning

Fiscal rules

The amendments of Act XXXVIII of 1992 on public finance in July 2006 introduced new fiscal rules to strengthen fiscal discipline and transparency. One of the main elements of the new rules is the ‘chapter balance reserve’ generated by budgetary chapters and the other one is a quarterly reporting obligation of the ministers who are responsible for the chapter on the outcome of the revenues and expenditures and its projected development to the Government. In the draft budget bill the Government proposes appropriations in each chapter, which can only be used if the quarterly report shows that the budgetary development of the chapter and the general government will allow it. Any part of the chapter equilibrium reserve not approved for utilisation may be withdrawn.

Fiscal rules regulate certain commitments of municipalities in Hungary. According to the Local Government Act, debt-creating commitments of local governments (borrowing and related charges, as well as bond issues, guarantees and sureties issued, leasing arrangements) should not exceed their adjusted own revenues. Loans up to the maturity of one year or taken out to assure continuous operation of public services and public administration tasks are exempt from the restriction.

State Audit Office

The State Audit Office (SAO) represents an independent control for the budget. The SAO prepares forecasts and retrospective analyses of the budget. In these analyses it reviews the operation of the general government, including the reliability of the draft budget bill, the feasibility of revenue appropriations, the final accounts on the execution of the central budget, and the utilisation of social security funds and extra-budgetary funds. Whenever there is an inconsistency between plans and forecasts, it calls the Government’s attention to the potential risks.

7. Annexes

Annex no. 1.: Details of the expenditure side measures, 2007-2009

Starting from 2007, general government expenditure figures will be based on the following measures and decisions:

- compared to this year's appropriations, nominal increase will be possible only in the following areas in 2007-2008:
    - pension expenditure and payments linked to pensions increase (e.g. child care support, motherhood support), pension-type allowances,
    - family support (e.g. child care allowance, family allowance),
    - social aid,
    - payments to the European Union and co-financing that allows for using EU funds,
    - inclusion of the motorway construction ('programme roads') originally planned to be implemented in PPP scheme in the budget (the 2006 budget, as adopted in December 2005, did not include the expenditure for motorway construction ('programme roads'),
    - government subsidies for public transport,
    - availability fees for PPP projects for which contracts have been concluded,
    - expenditure increases pursuant to the Act on higher education,
    - investment promotion appropriations,
    - interest expenditure on public debt;
- Expenditure in the other areas will remain at the 2006 level in nominal terms, reduced by the following items:
    - removal of the HUF 70 billion (0.3% of GDP) general government reserves,
    - blocking of HUF 40 billion (0.2% of GDP),
    - removal of the costs of one-off tasks for 2006 (elections),
    - the impact of the headcount reduction implemented in the central government and the municipalities sector;
- The vast majority of dismissal allowances and severance payment related to the financing of headcount reduction in 2006-2007 will incur in the 2007 budget expenditures; a minor part of this amount in 2008. The cover for this will be included in special provisions;
- As of 2007, a shift will be made in the public sector to wage bill management and performance incentives;
- The basis for maintaining the expenditure target of pharmaceutical subsidies will be the increased enforcement of the principle of cost efficiency and long-run financing requirement, increased interest of pharmaceutical producers to take part in the price competition, as well as enhancing the cost sensitivity of the consumers and the medical community, as well as the more efficient control of prescription practices and of the use of subsidies;
- Expenditure on curative-preventive healthcare will be reduced in terms of GDP every year, compared to the actual expenditure expected for 2006;
- As of 2007, a gradual shift to providing subsidies on a solely social basis will be implemented for expenditures on gas price compensation;

- The funds available for financing the public service activities of railways (MÁV, GySEV) – assuming restructuring – will increase to 0.4% of GDP from 0.2% in 2006. In addition, there will be one-off capital injections in 2007 and in 2008;
- In 2006, current financing for the Budapest Public Transport Company will be increased to the cost-recovery level. It will remain at that level in the forthcoming years, limiting future demands for subsidies.

Annex no. 2.: Revenue measures 2006-2009

The most important changes valid from *1 September 2006* are as follows:

- Changes in value added tax serve to improve the equilibrium of general government, as well as the goals of legal harmonisation with the European Union; in this spirit:
  - the 15% VAT rate will increase to 20%;
  - the deductible portion of VAT on telephone charges will increase from 50% to 70%.
- Pursuant to the obligation of harmonising excise laws
  - excise duty on cigarettes will increase by 5.7%;
  - excise duty on alcohol and all alcoholic beverages (except for wine) will increase by 7%.
- In personal income taxation, approximation of the tax charges on income earned on various grounds and the broadening of the tax base will continue. In the framework of this, as of September 2006
  - the rate of tax on benefits in kind will increase from 44% to 54%;
  - the rate of tax on income from interest and stock exchange deals will change from 0% to 20%.
- In order to approximate the tax charges on income earned in various forms, the rate of simplified business tax will increase from 15% to 25% from October 2006.
- In order to improve the balance of the budget, as of September 2006, corporate businesses will pay a special tax of 4% on their adjusted profit before taxes.
- Individual health insurance contribution will increase from 4 to 6%.
- Both the employer's and the employee's health insurance contribution will be divided by each risk: of the 11% employer's health insurance contribution, 7% will be health insurance contribution in kind and 4% will be pecuniary health insurance contribution, while out of the 6% individual health insurance contribution, 4% will be health insurance contribution in kind and 2% will be pecuniary health insurance contribution.
- Pensioners who are in employment will have to pay a 4% health insurance contribution in kind.
- Instead of paying the 5% accident contribution applicable up until now, individual entrepreneurs and members of corporate businesses who are engaged in auxiliary activities (pensioners) will pay a health care service contribution of 10%.
- Persons who are not insured but have income will pay 15% health care service contribution (instead of the former 11% health insurance contribution).
- The minimum base for contributions will be introduced for employers and full-time individual and incorporated entrepreneurs (meaning that as the main rule, contributions will have to be paid on an amount of HUF 125,000 per month).

Exceptions to this rule are allowed if the grounds for exception are reported to the tax authority. The tax authority will verify that the report is real.

- In order to strengthen the financing stability of the fund that finances employment promotion and support that promotes job-seeking (the Labour Market Fund), individual employee contribution will increase from 1% to 1.5% from 1 September 2006.

As of 1 November 2006

- The specific health care contribution payable by employers will not cease to exist (employers will have to continue paying an amount of HUF 1,950/person/month).

Major changes valid *from 2007* are as follows:

- For excise tax, pursuant to the obligation to harmonise laws
  - excise tax for cigarettes will increase by 2.7% from 1 April and by another 2.7% from 1 September.
- In personal income taxation
  - the first income bracket in the progressive rate structure will increase from HUF 1.55 million to HUF 1.7 million;
  - as of 2007, pensions will be taxed as remuneration not charged with taxes, meaning that private individuals who earn other income to be combined in addition to pensions will have to take into account pensions as well when determining their tax liability;
  - the tax relief system will be modified: the relief for intellectual activities, adult education and computer purchase will be terminated. No tax relief will be available for the repayment of loans for housing purposes taken after 1 January 2007. Instead of the former limit of HUF 6 million as aggregate annual income, tax relief may be used only up to an aggregate annual income of HUF 3.4 million for higher education tuition fees, donations for public purposes, life assurance and pension insurance, contributions paid based on agreement, membership fees in private pension funds and supplements to such fees;
  - the scope of certain tax-free supports will be restricted, by limiting the group of persons eligible for such support.
- In respect of corporate taxation, if the tax base determined according to the general rules fails to reach 2% of the total revenue for the given tax year (less the purchase cost of goods sold and sales revenue of permanent establishments abroad), the 2% of the total revenue for the given tax year shall be deemed to be the tax base. The concept of expected tax will also apply to individual entrepreneurs.
- In vehicle taxation, the tax base and the tax rate will change, and the tax charge will be aligned to the „value” of passenger cars and motorcycles.
- The duty payable on the acquisition of vehicles for a consideration will increase by some 20 per cent, and the duty payable on purchases of trailers will increase by the same proportion.
- As of 2007, the following items/entities will be subject to a separate tax liability:
  - private individuals who have an aggregate tax base that exceeds the top limit of the base for individual pension contribution. The 4% tax shall be paid on the portion of income in excess of the top limit of the base of contribution;
  - credit institutions, which shall pay a 20% annuity on interest income from loans associated with state subsidies.

- In order to reduce cash movement, as of 2007, corporate businesses will have to pay a petty cash tax of 20% on unreasonably high amounts held in petty cash.
- The minimum base for contributions will increase from HUF 125,000 to HUF 131,000 per month.
- Individual health insurance contribution will increase from 6 to 7%.
- The health care service contribution liability of individual entrepreneurs and members of corporate businesses engaged in auxiliary activities (pensioners) will increase from 10 to 16%.
- The health care service contribution liability of persons who are uninsured but earn income will increase from 15 to 16%.
- Small agricultural producers will become insured.
- The percentage of the individual health contribution liability determined as a percentage will increase from 4% to 14%, and the limit to which this liability has to be paid on an annual basis will increase from HUF 400,000 to HUF 450,000 per year.
- Churches will pay a 4% individual health insurance contribution in kind for members of the clergy.
- The 3% decrease in employer's contribution planned from 1 January 2007 will not take place.
- In order to increase the stability of financing social insurance pension (pillar I), the distribution of the percentage of health insurance and pension insurance contributions within the 29% employer's social insurance contribution liability will change: the 11% health insurance contribution will decrease to 8%, while the 18% pension insurance contribution will increase to 21%.

In accordance with legislation adopted by Parliament, local income tax will not be terminated in *2008*, and the additional 2 per cent point reduction of the employer's social security contribution assumed under the previous programme will not take place in 2009.

TABLES

Table 1

Macroeconomic prospects

	ESA code	2004	2004	2005	2006	2007	2008	2009
		HUF bn	percentage change					
1. Real GDP at 2000 prices	B1g	15 637,1	5,2	4,1	4,1	2,2	2,6	4,1
2. Nominal GDP	B1g	20 429,5	9,5	6,7	6,5	6,5	4,5	6,9
Components of real GDP								
3. Private consumption expenditure	P3	9 033,0	3,6	1,7	3,0	-0,7	0,6	1,5
4. Government consumption expenditure	P3	3 554,3	2,1	-0,4	1,7	-1,8	-3,8	1,4
5. Gross fixed capital formation	P51	4 021,3	8,0	6,6	6,6	2,1	3,7	7,0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+ P53	-100,6	-0,6	-2,3	-3,9	-3,8	-3,8	-3,6
7. Exports of goods and services	P6	13 535,8	15,8	10,8	12,0	10,9	9,9	9,4
8. Imports of goods and services	P7	14 406,7	13,5	6,5	9,5	8,5	8,0	8,8
Contribution to real GDP growth								
9. Final domestic demand		-	4,6	2,6	3,8	-0,2	0,5	2,9
10. Changes in inventories and net acquisition of valuables	P52+ P53	-	-0,3	-1,7	-1,7	0,0	0,0	0,0
11. External balance of goods and services	B11	-	0,9	3,3	2,1	2,4	2,1	1,1
Price developments								
12. GDP deflator			4,1	2,5	2,3	4,2	1,9	2,7
13. Private consumption deflator			3,7	6,2	3,7	6,2	3,3	3,0
14. HICP			6,8	3,6	3,5	6,2	3,3	3,0
15. Public consumption deflator			4,5	5,7	5,3	2,0	0,1	2,9
16. Investment deflator			3,2	2,5	4,6	4,4	3,1	2,9
17. Export price deflator (goods and services)			-1,4	-0,6	6,9	3,1	1,0	1,0
18. Import price deflator (goods and services)			-0,9	1,1	8,9	2,9	0,8	0,8
Labour market developments								
19. Employment ('000)		3 900,4	-0,5	0,0	0,3	0,0	0,3	0,7
20. Unemployment rate (%)		-	6,1	7,2	7,3	7,5	7,4	7,3
21. Labour productivity, persons		-	5,8	4,0	3,8	2,2	2,3	3,3
22. Compensation of employees	D.1.	9 419,7	9,6	7,8	6,4	6,5	4,0	5,6
Sectoral balances (in percent of GDP)								
23. Net lending/borrowing vis-à-vis the rest of the world	B.9.		-8,3	-6,6	-7,1	-4,2	-2,2	-1,4
of which:								
- Balance of goods and services			-2,9	-1,3	-1,2	0,6	2,2	2,8
- Balance of primary incomes and transfers			-5,7	-6,1	-6,7	-6,5	-6,5	-6,4
- Capital account	B.9./ EDP B.9.		0,3	0,8	0,8	1,7	2,2	2,2
24. Net lending/borrowing of the private sector	B.9.		-1,7	0,9	3,0	2,6	2,1	1,8
24a. of which: statistical discrepancy			0,7	0,8	..	..	..	..
25. Net lending/borrowing of general government	B.9.		-6,6	-7,5	-10,1	-6,8	-4,3	-3,2

Table 2

General government budgetary prospects

	ESA code	2004	2 004	2 005	2006	2007	2008	2009
		HUF bn	Percentage of GDP					
Net lending (EDP B.9) by sub-sector								
1. General government	S.13.	-1338,6	-6,6	-7,5	-10,1	-6,8	-4,3	-3,2
2. Central government	S.1311.	-886,7	-4,3	-4,8	-8,4	-5,3	-2,7	-1,9
3. State government	S.1312.	-	-	-	-	-	-	-
4. Local government	S.1313.	-46,7	-0,2	-0,6	-0,7	-0,4	-0,5	-0,5
5. Social security funds	S.1314.	-405,2	-2,0	-2,1	-1,0	-1,1	-1,1	-0,8
General government (S13)								
6. Total revenue	TR	8781,4	43,0	43,1	42,4	44,2	44,8	45,4
7. Total expenditure	TE[1]	10120,0	49,6	50,6	52,5	51,0	49,1	48,6
8. Net lending/borrowing	EDP B.9.	-1338,6	-6,6	-7,5	-10,1	-6,8	-4,3	-3,2
9. Interest expenditure (incl. FISIM)	EDP D.41.+ FISIM	892,9	4,4	4,1	3,8	4,4	4,1	4,0
pm: 9a. FISIM		20,8	0,1	0,1	0,1	0,1	0,1	0,1
10. Primary balance		-445,7	-2,2	-3,4	-6,3	-2,4	-0,2	0,8
Selected components of revenues								
11. Total taxes		5 206,0	25,5	24,9	24,1	25,3	25,5	25,2
11a. Taxes on production and imports	D.2.	3 308,2	16,2	15,6	14,6	14,8	14,7	14,4
11b. Current taxes on income, wealth, etc	D.5.	1 879,2	9,2	9,2	9,4	10,4	10,7	10,7
11c. Capital taxes	D.91.	18,6	0,1	0,1	0,1	0,1	0,1	0,1
12. Social contributions	D.61.	2 557,7	12,5	12,8	12,8	13,5	13,5	13,4
13. Property income	D.4.	219,8	1,1	0,8	0,5	0,4	0,3	0,3
14. Others (14=15-(11+12+13))		797,9	3,9	4,6	5,0	5,0	5,5	6,5
15.=6. Total revenue	TR	8781,4	43,0	43,1	42,4	44,2	44,8	45,4
Tax burden (D.2.+D.5.+D.61.+D.91.-D.995.)		7763,7	38,0	37,7	36,9	38,8	39,0	38,6
Selected components of expenditure								
16. Collective consumption	P32	2 171,5	10,6	10,4	10,3	9,8	9,1	8,9
17. Total social transfers	D.62 + D.63.	5 562,2	27,2	27,9	28,7	27,8	27,0	26,4
17a. Social transfers in kind	D63	2 677,2	13,1	13,1	13,2	12,2	11,4	11,1
17b. Social transfers other than in kind	D62	2 885,0	14,1	14,8	15,5	15,6	15,6	15,3
18.=9. Interest expenditure (incl. FISIM)	D41+ FISIM	892,9	4,4	4,1	3,8	4,4	4,1	4,0
19. Subsidies	D3	324,7	1,6	1,6	1,4	1,5	1,4	1,4
20. Gross fixed capital formation	P51	730,7	3,6	3,4	4,5	3,6	3,3	3,6
21. Other (21=22-(16+17+18+19+20)		438,0	2,2	3,2	3,8	3,9	4,2	4,3
22=7. Total expenditure	TE[1]	10120,0	49,6	50,6	52,5	51,0	49,1	48,6
Pm: compensation of employees	D.1.	2612,8	12,8	12,6	12,1	11,4	10,5	10,2

[1] corrected with the net effect of the swap transactions TR-TE=EDP B.9.

Table 3

General government debt developments

Percentage of GDP	ESA code	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
1. Gross debt		60,2	62,3	68,5	71,3	72,3	70,4
2. Change in gross debt		6,4	5,9	10,0	7,0	4,1	2,7
Contributions to changes in gross debt							
3. Primary balance		2,2	3,4	6,3	2,4	0,2	-0,8
4. Interest expenditure (incl. FISIM)		4,4	4,1	3,8	4,4	4,1	4,0
5. Stock-flow adjustment		-0,2	-1,6	-0,1	0,2	-0,2	-0,5
of which: privatisation receipts		-0,8		-1,1			
Implicit interest rate on debt (%)		7,7	6,9	6,0	6,4	5,9	5,7

Table 4

Cyclical developments

Percentage of GDP	ESA code	2004	2005	2006	2007	2008	2009
1. Real GDP growth at 2000 prices (%)		5,2	4,1	4,1	2,2	2,6	4,1
2. Net lending of general government	B9	-6,6	-7,5	-10,1	-6,8	-4,3	-3,2
3. Interest expenditure (incl. FISIM recorded as consumption)	D41 + FISIM	4,4	4,1	3,8	4,4	4,1	4,0
4. Potential GDP growth (%)		4,1	4,1	4,0	4,0	3,9	3,9
contributions:							
- labour		0,4	0,3	0,3	0,4	0,3	0,3
- capital		1,9	2,0	2,0	2,0	1,9	1,9
- total factor productivity		1,8	1,7	1,7	1,6	1,6	1,5
5. Output gap		1,0	1,1	1,2	-0,6	-1,9	-1,7
6. Cyclical budgetary component		0,3	0,3	0,3	-0,2	-0,5	-0,4
7. Cyclically-adjusted balance (2-6)		-6,9	-7,8	-10,4	-6,6	-3,8	-2,8
8. Cyclically-adjusted primary balance (7-3)		-2,5	-3,7	-6,6	-2,2	0,3	1,2

Table 5

Divergence from previous update

	2005	2006	2007	2008	2009
Real GDP growth (%)					
Previous update	4,2	4,3	4,1	4,1	-
Current update	4,1	4,1	2,2	2,6	4,1
Difference	-0,1	-0,2	-1,9	-1,5	-
General government net lending (% of GDP)					
Previous update*	7,4	6,1	4,7	3,4	-
Current update	7,5	10,1	6,8	4,3	3,2
Difference	0,1	4,0	2,1	0,9	-
General government gross debt (% of GDP)					
Previous update*	61,5	63,0	63,2	62,3	-
Current update	62,3	68,5	71,3	72,3	70,4
Difference	0,8	5,5	8,1	10,0	-

* figures from the Convergence programme of December 2005; in order to ensure comparability, private pension funds are accounted outside the general government.

Table 6

Long-term sustainability of public finances

Percentage of GDP	2000	2005	2010	2020	2030	2050
Pension expenditure (net)[1]	9,3	10,5	10,3	10,7	10,7	13,5
Old-age and early pensions[2]	6,7	8,0	8,0	9,6	9,8	12,6
Other pensions (disability, survivors)	2,5	2,4	2,3	1,1	0,9	0,9
Health care[3]	5,0	5,5	5,7	6,0	6,3	6,5
Education expenditure[4]		4,4	3,9	3,5	3,5	3,8
Other age-related expenditures[4]		0,2	0,2	0,2	0,2	0,2
Pension contribution revenue	7,0	6,5	7,1	6,8	6,8	7,0
Assumptions						
Labour productivity growth	4,2	4,0	3,6	2,9	2,7	1,7
Real GDP growth	5,2	4,1	4,3	2,5	2,1	1,1
Participation rate, males (15-64)	67,5	67,9	69,1	73,6	73,1	71,5
Participation rate, females (15-64)	52,6	55,1	57,6	61,5	62,6	61,3
Total participation rate (15-64)	59,9	61,4	63,3	67,5	67,8	66,4
Unemployment rate	6,4	7,2	7,2	4,8	4,8	4,8
Population aged 65 +over / total population	15,0	15,6	16,7	20,3	22,3	28,1

[1] Including pension payments from other funds than Social Security Fund. Projection of the Ministry of Finance until 2010, projection of the EPC AWG afterwards, corrected with the effect of the stabilisation measures of 2006-2007.

[2] Including survivor pension paid after the retirement age and other pension-type benefits.

[3] 2005-2050: projection of the EPC AWG, 2000: OECD Health Data 2005.

[4] Projection of the EPC AWG.

Table 7

Basic assumptions

	2005	2006	2007	2008	2009
Hungary: short-term interest rate (annual average)	6,8	6,8	7,1	6,5	5,8
Hungary: long-term interest rate (annual average)	6,6	7,4	6,8	6,1	5,6
HUF/EUR exchange rate (annual average)	248,1	267,0	272,5	272,5	272,5
World excluding EU, GDP growth	5,4	5,2	4,9	4,8	4,7
EU GDP growth	1,6	2,3	2,2	2,0	2,0
Growth of foreign markets of Hungary	5,5	7,2	5,4	5,3	5,3
World import volumes, excluding EU	8,1	9,6	8,2	8,0	8,0
Oil prices (Brent, USD/barrel)	54,1	68,9	71,0	70,0	70,0