Government of the Republic of Hungary

CONVERGENCE PROGRAMME OF HUNGARY
2006 - 2010

December 2006

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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. The Hungarian Government, on the invitation of the Council, prepared an adjusted convergence programme update, out of the regular timetable, in September 2006. The objective of the programme submitted in September was to present the medium term policy objectives of the new Government, which took office in June 2006, in particular the way to consolidate public finances.

The Council on its meeting of 10th October considered the fiscal path in the convergence programme update of September appropriate to correct the excessive deficit and invited Hungary to present those structural measures, which are necessary to achieve this goal, in the up-dated convergence programme of December.

There are no changes with respect to the economic and fiscal policy objectives in this programme up-date as compared to the September programme. This updated programme is focusing on the progress made in the implementation of the structural reform agenda presented in the September update. The programme takes account of data revisions and new data released since the submission of the update of September. The programme covers the period 2005 to 2010.

The Government consulted on the draft programme with the National Interest Reconciliation Council. The programme, which was adopted by the Government on its meeting of 1 December 2006, is based on the draft 2007 budget law.

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 convergence programme is in line with the National Action Programme (NAP), in which the Government summarises the measures aiming to increase employment and productivity. 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.

1. Medium term objectives of the Government

1.1 Economic policy

The Government's most important objective is to ensure the conditions of rapid and lasting convergence of economic output and living standards to the EU average. This requires a growth and development oriented economic policy relying on sustainable public and external balances.

The restoration of the internal and external balance is imperative because

- high general government and current account deficit and debt evolved in the environment of favourable real economic trends;
- the projected aging of the Hungarian population will increase future public expenditures, which should be covered by a decreasing number of tax and contribution payers. Therefore changes are required in the short and medium term to facilitate the financing of the pension and health expenditures in the forthcoming decades.

Therefore, the medium-term economic strategy has the following characteristics:

- Parallel with the short-term fiscal measures required for the rapid consolidation of public finances, the Government creates the conditions for effective long-term equilibrium through comprehensive reforms affecting the operation of the entire public sector. The envisaged measures not only entail regulatory changes but they also require substantial changes in the attitudes of economic and social actors to key issues such as the re-assessment of the role of the state or the determination of the respective responsibilities of the community and the individual. Increasing reliance on self-provision by citizens allows the state to support those being left behind and to substantively reduce inequality of opportunities through more effective and more targeted measures, providing incentives for taking up legal employment.
- It is impossible to simultaneously attain a significant equilibrium improvement and high growth rates comparable to those seen recently. Fiscal consolidation will require a temporary growth sacrifice and a transitory halt in the reduction of the rate of inflation. Therefore the economic policy of the forthcoming period will be divided into two stages with different characteristics:
    - in 2007-2008, the conditions necessary for long-term equilibrium will be created: a major reduction in general government deficit, halting the increase of public debt, improvement of the external balance. Meanwhile, GDP growth will decelerate to 2-3%. The real income of households will decrease in 2007, followed by a slight rise in 2008.
    - from 2009 onwards, a steady economic growth of 4-5% may be resumed: real incomes will rise more markedly, the strengthening effects of increasing development funds will manifest themselves, and the equilibrium will be reinforced as reforms unfold.

Economic policy, in addition to restoring the equilibrium, will promote the exploitation of growth potentials and foster investments by the private sector and the efficient use of EU funds, which will increase significantly in the forthcoming years.

The development plans and the implementing programmes for the 2007-2013 period are summarised in the New Hungary Development Plan (NHDP) and the New Hungary Regional Development Strategic Plan (NHTDP). The main objective of these programmes, in line with the Lisbon Strategy, is the creation of conditions for sustainable growth and employment.

Stabilisation and equilibrium

	2007	2008	2009	2010	2011
	changes vis-à-vis the previous year (%)				
GDP	2.2	2.6	4.2	4.3	cca. 4.5
Domestic consumption	0.3	0.7	3.3	3.7	cca. 4
of which:					
Private consumption	-0.8	0.0	1.8	2.7	cca. 3
Gross fixed capital formation	2.4	4.0	7.5	6.8	6 – 8
External trade					
Export (goods and services)	10.6	9.7	9.4	9.3	8 – 10
Import (goods and services)	8.1	7.5	8.6	8.9	8 – 10
Real income per capita	-1.3	0.4	2.4	3.1	cca. 3.5
Employment	0.0	0.3	0.7	0.7	0.7 – 1
Consumer prices	6.2	3.3	3.0	2.8	2.5 – 3
	in % of GDP				
Current account deficit	5.0	3.3	2.3	1.5	cca. 1
Net borrowing vis-à-vis the rest of the world	3.6	1.7	0.1	-0.6	cca. -1.5
Budget deficit	-6.8	-4.3	-3.2	-2.7	-2.2
Primary balance	-2.4	0.0	0.9	1.1	cca. 1.5
Primary revenues without EU-transfers	43.7	40.5	39.7	38.5	cca. 38
Tax- and contribution revenues	38.1	37.8	37.3	37.0	36.5 – 37
Gross public debt	70.1	71.3	69.3	67.5	65 – 66

1.2 Main elements of the fiscal consolidation

In the period of rapid adjustment, the expenditure cuts 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 rapid stabilisation also required the increase of tax and contribution revenues at the start of the period.

Apart from stronger budget discipline, several measures promote the reduction in the expenditures to GDP ratio. The number of public sector employees will be reduced, and, for two years, the total wage bill paid out will remain essentially on the level of 2006 adjusted with the impact of headcount reduction. With a few exceptions (e.g., pensions, family support, social aid , co-financing necessary for the use of EU funds, etc.), there will be no room for expenditure increases in 2007.

As a result of the tax and contribution changes approved by Parliament, tax and contribution revenues expressed as a percentage of GDP will increase by over 1.5 percentage points in 2007; still, they will stay below the over 39% level seen at the late 1990’s. From 2008 onwards, the tax/GDP ratio will gradually start to fall.

The changes affect all major components of the tax system, but they increase budgetary revenues mainly through the widening of the tax and contribution base and limitations in the scope of tax avoidance.

1.3 Reforms underpinning sustainable public finances

In order to achieve a durable reduction in the budget deficit and to maintain a level to underpin balanced growth, the Government has initiated substantive structural changes in health care and in the pension and education systems. In addition to helping the attainment of deficit targets through the modification of operational parameters, these changes also bring about an economic as well as social policy turnaround by promoting a more efficient performance of public tasks, with appropriate state control, and strengthening the responsibility for payment of public dues.

- The **health care reform** relies on a more marked emphasis on the insurance principle, replacing the hitherto apparently unlimited public responsibility and public funding with the responsibility of the individual. Furthermore, it is necessary to constrain the demand for health care services where not justified by health status and to increase the operational efficiency of the system of health care institutions.
- In order to ensure the sustainability of the **pension system**, the reform commenced in 1998 must be continued. As the first step, the Government has decided to tighten the eligibility criteria for early retirement and for certain types of benefits available under the retirement age and related to the health status or to the time spent in certain positions.
- In the field of public education, the **education reform** serves the reinforcement of basic skills, equality of opportunities, and in the area of higher education, the improvement of the quality of education and better adaptation to the changing structure and volume of labour demand.
- The **local government reform** sets out to reorganise public services provided by the local government system to make them cheaper, more rational and enhance their quality and to strengthen the financing framework of the autonomy of local governments. The re-organisation of public services will be conducive to economies of scale and functions will be performed on the micro-regional and regional levels. Access to public services must be improved to citizens and businesses alike.
- The consistent enforcement of cost efficiency and performance requirements are central elements of the **reform of public administration**. In central public administration, a structure consisting of fewer units and requiring a smaller headcount is the required outcome. The first step in this direction was taken in 2006 with the transformation of the government structure by implementing staff cuts in central administration. Nationwide, regional organisations will be come less fragmented, duplications of tasks will be eliminated while stronger incentives will be introduced for the micro-regional and regional performance of tasks.

In addition to the aforementioned changes, conditions will be created for more efficient operation in the whole public sector (e-government, enforcement of performance requirements in employment and remuneration systems, streamlining of workforce). Simultaneously, price subsidy systems (energy, transport, pharmaceuticals) will be transformed to take more account of social conditions, which will also be conducive to strengthening social equity and the sustainability of the budget. In line with Community requirements, the electricity market will be fully liberalised as of 1 July 2007.

Corresponding to the reform agenda presented in the September Programme, the Government has implemented the structural reform measures scheduled for 2006 (for details, see Chapter 4 and Annex 2):

- Parliament has adopted the Act containing all the measures presented in the Convergence Programme of September 2006 for the transformation of the pharmaceutical subsidy regime.
- In respect of the health care system, the Government has submitted to Parliament the bills necessary for the implementation of the structural measures outlined in the September Programme.
- With the exception of the re-regulation of eligibility for certain benefits relating to some categories of employment, the Government has devised the measures relating to the reform of the pension system as outlined in the September Programme and submitted the relevant bills to Parliament which has already adopted some of them.
- In the field of public education, the adopted amendment of the public education act contains some of the measures listed in the September convergence programme.

Additional measures in the field of public education are detailed in the budget bill for 2007.

- In the field of higher education, the approved amendment of the higher education act provides for the introduction of the tuition fee as explained in the September convergence programme. In a resolution taken in November, the Government decided about the gradual reduction of state-financed student numbers.
- The Government has adopted regulations implementing the measures to increase the efficiency of public administration (reduction of the number of ministries and staff cuts in the institutions).
- The measures to promote more efficient local government financing and performance of tasks are incorporated in the year 2007 budget bill. The measures to strengthen the financial discipline of local governments are provided for in the amendment of the act on public finances, submitted to Parliament.

1.4 Factors ensuring fast real convergence: productivity and employment

In the past decade, the transformation of the Hungarian economy, with the renewal of the capital stock and the introduction of state-of-the-art industries, allowed for dynamic productivity growth because the former uncompetitive sectors have been replaced by competitive industries. Economic policy continues to promote technological modernisation and enhanced competitiveness in order to assure durable real convergence. The Government continues to give priority to development initiatives for domestic businesses and FDI inflow through packages containing tailor-made elements of support compatible with EU regulations and with one-stop-shop arrangements.

The road network development programme encourages the settlement of businesses requiring fast logistical links and it also increases labour mobility. The improvement of the business environment and the alleviation of administrative burdens are promoted by deregulation and the simplification of regulatory procedures. The Government will continue the privatisation process.

In addition to the increase of productivity at a rate faster than in more developed countries, employment expansion is indispensable for accelerating real convergence in light of the low participation rate. In addition to the transformation of the pension system to promote the participation of the elderly and the education reform resulting in a structure of training more responsive to needs and increasing the level of education, employment expansion is facilitated by the renewal of the content and structure of vocational training, the so-called START programme aiming to assist school leavers and unemployed persons above 50 years of age to find jobs as well as the replacement of the unemployment benefit by job seeking assistance introduced in 2005.

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.

The economic policy aims to accomplish the fiscal adjustment with the least possible growth sacrifice. Due to the stabilisation measures and the launch of reforms the general government deficit will have decreased to a sustainable level by 2009, the growth of public debt will be stopped and then it will be reduced. With the achievement of an internal equilibrium the current account deficit will decline significantly. By maintaining the equilibrium, created from 2009, the lasting economic growth will commence and the living standards will improve. The manifestation of the ever strengthening stimulating effects of the growing development funds and noticeable start of the growth in employment, real wages and real income will become perceptible.

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. In 2006 GDP growth is expected to exceed 4%, despite the fact that stabilisation measures entering into force in the second half of the year will slightly slow down growth.

The macroeconomic path, described in the previous convergence programme, has slightly changed, due to methodological improvements in national accounts, the revision of the projections concerning EU transfers and recently published figures on macro-economic developments. These changes have been taken into account in the macroeconomic path and the 2007 budget bill.

Since the submission of the previous convergence programme, the Central Statistical Office (CSO) has implemented significant methodological changes and revisions in national account statistics, in line with EU requirements and recommendations by the OECD.

The most important changes in GDP calculations are as follows:

- *Constant price data calculated on previous year's prices instead of fix base year prices (introduction of chain linking);*
- *Direct volume measure in certain activities of the government sector (education, health-care);*
- *Improvement in FISIM (Financial Intermediation Services Indirectly Measured) estimations;*
- *Modification in the estimation of consumption of fixed capital;*
- *Introduction of the estimation of certain illegal activities into the national accounts;*
- *Methodological changes in the accounting of foreign trade activities;*
- *Data revision.*

The effect of the methodological changes and data revisions has considerably modified the current price data and the volume indices of GDP between 2000 and 2005. The 2005 nominal GDP figure now exceeds by HUF 300 billion the level calculated in the previous convergence programme. Consequently, the projections in the present update have been re-calculated.

The National Bank of Hungary (NBH) has revised the current account statistics: the methodological changes and data revisions of the CSO in the external trade of goods and services were adopted except the data revisions related to tourism of illegal activities. Due to these changes, the 2005 current account deficit was revised downwards by EUR 500 million. The settlements of off-shore companies still differ from each other in the statistics of the two institutions: the CSO in GDP calculations uses the net exports of the enterprises from the production side, while the NBH – considering the companies as residents – takes the whole turnover into account.

2.1 External assumptions

The medium-term forecast of the international environment in the convergence programme relies on the 2006 autumn forecast of the European Commission. According to the Commission's forecast robust world economic growth of 2006 will slightly weaken in 2007-2008, although it remains still considerable. From 2007 the continuing robust growth of Asian countries – particularly China – and the stabilisation of the Japanese business cycle offset the expected slowdown of the US economy. World economic growth will continue to contribute to the expansion of world trade, though to a lesser extent than in 2006

Different indicators project diverse business expectations. Surveys showing a mixed picture suggest that in the world economy including the European Union the recent trend of growth is expected to decelerate somewhat. The convergence programme relies on the Commission's forecast, which projects 2.8% growth in 2006 and 2.4% growth in the following two years. In the European Union the increase of the German VAT rate in 2007 might intensify the slowdown, however positive developments on the labour market and balanced profitability of firms suggest a stabile growth of domestic demand. Throughout the projection period, 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.

2.2 Cyclical position

During the period of 1997–2005, the GDP growth rate was over 4 percent in each year, producing a 4.5 percent average growth[1]. As a result, the real level of output rose above its potential level, thus the output gap became positive. This position is expected to last still in 2006. In 2007 and 2008, due to the stabilisation measures, real growth is expected to slow down considerably and the output level to fall below the potential. From 2009, real growth is expected to recover to its level prevailing before 2007, but the level of output will not reach that of the potential output till 2009 resulting in a slightly negative output gap[2].

Cyclical position

	2005	2006	2007	2008	2009	2010	2011
GDP at 2005 year prices (growth rate, %)	4.2	4.0	2.2	2.6	4.2	4.3	cca. 4.5
Potential GDP (growth rate, %)	4.0	4.1	4.0	3.9	3.9	3.8	3.8
Factors:							
Labour	0.3	0.4	0.4	0.3	0.2	0.2	0.2
Capital	1.8	1.8	1.8	1.9	1.9	1.9	1.9
Total factor productivity (TFP)	1.9	1.8	1.8	1.7	1.7	1.6	1.6
Output gap	**1.3**	**1.2**	**-0.6**	**-1.8**	**-1.5**	**-1.0**	**cca. -0.5**

2.3 External demand and exports

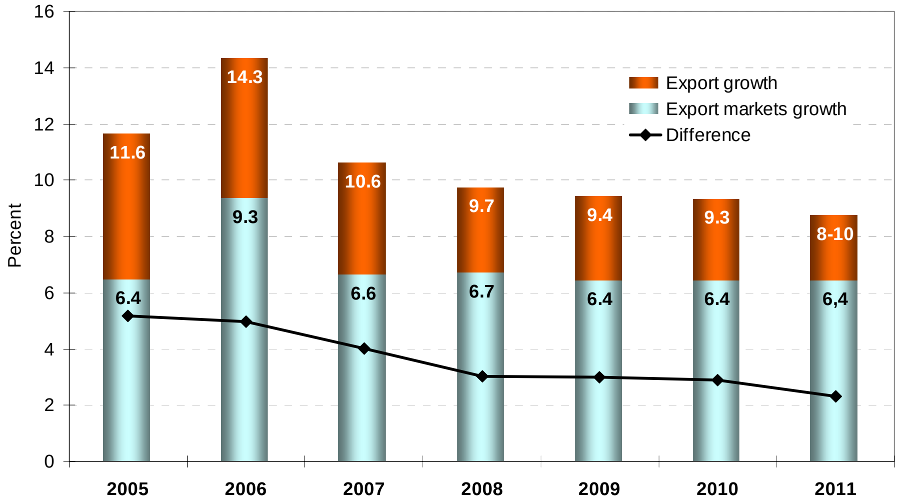
Projections of the demand for Hungarian exports relied on the import demand of 10 developed countries and the five major Eastern European partner countries, which are most important for Hungarian exports. On this basis, Hungarian export markets will expand dynamically in 2006, followed by average dynamism 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 the country's 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.

[1] Since the submission of the convergence programme in September, the CSO has significantly corrected upwards the 2002 and 2003 data according to the new methodology.

[2] According to the methodological recommendations of the European Commission, the potential GDP has been estimated using the Cobb-Douglas production function. The calculations have been based on the values of macroeconomic parameters projected up to 2011.

The growth rate of exports and export markets



2.4 Employment

In the forthcoming years the Government implements an employment policy which enhances the willingness of the active-age population to take on employment while at the same time increasing the number of jobs and further improving the qualification structure and the adaptation of the labour demand.

A key element, for encouraging job-search and work and keeping labour market activity, is to reduce disincentives of the unemployment and social benefit systems. To that end both the unemployment benefit and social allowances for active-aged were transformed in 2005. The results of the transformation have already shown in the perceptible increase of the participation rate in 2006.

In order to support the adjustment to economic and social changes the Government creates the conditions for life-long learning. The objective is to increase the number of adults participating in training, to ensure that training opportunities become available to all. In the case of supported training, low skilled people and older workers will be given a priority. In the past year, several programmes were launched, which were in line with the above principle (e.g.: the „Take a Step Forward!").

The START Programme assists school leavers in finding employment. In order to ease the entry to the labour market the state – in case of employing career starters – assumes a part of the contribution payment in the first two years. Based on the favourable experiences, the programme expands with the following elements from 2007:

- Under the EU co-financed "Start Plusz" programme the employer is exempted from a part of the contribution payment if persons returning to work following care of small children or of other dependant family members are employed.
- The EU co-financed "START Extra" Programme grants assistance to the return to the labour market for long-term unemployed, having difficulties in finding a job due to their age or to their low skills. The employer is exempted from a part of the contribution payment.

In order to increase the competitiveness and employment potential of the SMEs, the Government supports the net headcount growth of enterprises, with less than 250 employees, with a full year of contribution exemption. The condition of this allowance is that the new employee must be a registered job-seeker at least for three months and the employer must guarantee the employment for a further year. This subsidy could affect some half million private entrepreneurs, 340 thousands operating joint businesses and 60 thousands non-profit organisations.

Conditions of temporary agency work will be stricter and labour inspection will be strengthened. From 2006 compliance with employment rules has a major role in public procurement proceedings and in granting state subsidies.

It is indispensable both for improving the economy's competitiveness and increasing labour market participation that employees and enterprises are able to comply with the expectations raised by the changing economic environment and by the continuous technological innovation and have up-to-date and competitive knowledge. This requires an education and training system flexibly adaptable to the continuously changing needs of the economy both as regards structure and content

The support of region-specific training also assists the better adoption of labour market's supply and demand side. In order to grant greater cost-efficiency for this sake regional integrated vocational training centres (RIVTC) have been established (at the moment there are 16) and this continues throughout the 2007-2013 planning period.

The content and structure of the vocational training will be upgraded. In the new, modular National Qualifications Register (NQR) the number of vocational qualifications will be considerably reduced, the elaborated programme modules also serve as basis for training outside the schooling system and for distance education.

From 2007, by using EU funds, the Government intends to continue the transformation of the training offer's composition and institutional structure. Through transforming the structure of administration, the integrated control of the vocational and adult training has been implemented within the Ministry of Social Affairs and Labour, in strict integration with the labour market policies. The transforming of the information system substantiating career decisions assists the better adoption of the training institutions to the labour market and their active reaction to the labour market needs

In 2007-2008, the headcount in the public sector will be reduced and only moderate growth may be projected in the business sector. During the period of significant budget deficit reduction (between 2006 and 2008) the economic policy aims to maintain the current employment level. By the second half of the period – between 2009 and 2011 – the conditions of an employment growth will be implemented as results of the acceleration of economic growth and the measures outlined earlier. (The participation rate of people aged between 15 and 64 is expected to rise from 62.3 in 2008 – by nearly 2 percentage points – to 64% in 2011.)

Employment annual percentage change

	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Number of employed persons	0.0	0.6	0.0	0.3	0.7	0.7	0.7 – 1
Productivity growth	4.1	3.4	2.2	2.2	3.5	3.6	cca. 3.5
Unemployment rate,%	7.2	7.4	7.5	7.4	7.3	7.2	7 – 7.2
Participation rate, %	61.4	61.9	62.0	62.3	62.8	63.4	cca. 64
GDP growth	**4.2**	**4.0**	**2.2**	**2.6**	**4.2**	**4.3**	**cca. 4.5**

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. Wage and productivity growth 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. This policy must be continued in order to reach sustainable growth.

In line with the falling rate of inflation, the National Interest Reconciliation Council has agreed on 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 2006 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 in 2006 yet with household consumption increasing by approximately 2.5%. 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 2007 are going on. The most probable reactions of companies and households to various measures are shown in the baseline scenario, while Section 3.6 presents alternative scenarios assuming different reactions of economic actors and their impact on the macroeconomic and fiscal path. 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.

On the basis of described economic path from 2008 the real income will not decrease further. The level of 2007 surpassing the 2000 year's one by almost 30 percent will be sustained and consumption will be at the previous year's level. By 2009-2011, when the economy returns to the growth path of around 4%, real wages and consumption is projected to grow by 2-3% with somewhat faster 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 capital stock. FDI inflows have a major role in this process. 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, a vocational training system adjusted to market requirements and the expectedly decreasing interest rate level due to the accomplishment of convergence programme. 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.

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 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 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 riverchannel of the Danube, upgrading of the main international railway lines to the country borders, 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 and the expectedly favourable interest rate conditions, investments dynamism may rise again. The investment ratio will reach 25% by 2009, prevailing in the cohesion countries, and will exceed it by almost 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 again by more than 4% each year.

GDP components — **annual percentage change**

	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Household consumption	3.8	2.4	-0.8	0.0	1.8	2.7	cca. 3
Government consumption	0.2	2.6	-1.6	-3.3	1.6	1.6	1.5 - 2
Investment	5.6	2.8	2.4	4.0	7.5	6.8	6 – 8
Domestic consumption	**1.4**	**2.0**	**0.3**	**0.7**	**3.3**	**3.7**	**cca. 4**
Exports (goods and services)	11.6	14.3	10.6	9.7	9.4	9.3	8 - 10
Total demand	5.3	6.8	4.6	4.7	6.2	6.4	6 - 7
Imports (goods and services)	6.8	11.1	8.1	7.5	8.6	8.9	8 – 10
GDP	**4.2**	**4.0**	**2.2**	**2.6**	**4.2**	**4.3**	**cca. 4.5**

2.8 External balances

As a result of falling consumption and slower growth of corporate investments with high import demand, the import demand of the Hungarian economy is going to drop from 2007. In the period of 2006-2009, the import growth is expected to be 1-3 percentage points lower than the exports growth. In the following years the import growth rate will approach the export growth.

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 the deficit in 2005, the balance will improve by 5 percentage points in 2009 and by more than 6 percentage points in 2011 expressed as a percentage of GDP. In the beginning of the forecast period the current account deficit as a percentage of GDP will drop significantly, on average by 1-2 percentage points, and from 2009 every year by 0,5 percentage points.

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% in 2005 to below 2% by 2008. From 2009 on the increasing 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 2,5-3,5% of GDP in the whole period.

External financing need in % of GDP

	2005	2006	2007	2008	2009	2010	2011
Current account deficit	6.8	6.9	5.0	3.3	2.3	1.5	kb. 1
Capital account balance including EU transfers	0.8	0.8	1.4	1.6	2.2	2.1	kb. 2.5
of which: EU transfers	0.6	0.7	1.3	1.5	2.1	2	kb. 2.5
External financing need	6.0	6.1	3.6	1.7	0.1	-0.6	kb. -1.5
Debt-creating financing*	1.9	2.7	0.7	-1.3	-3.1	-4	kb. -5
Non-debt-creating financing	4.1	3.4	2.9	3.0	3.2	3.4	kb. 3.5
of which: net FDI	4.2	3.6	2.6	2.6	2.9	3.1	kb. 3.5
reinvested earnings	1.8	2.0	2.1	2.2	2.2	2.2	2-2.5

* without other capital

2.9 Inflation

Disinflation in the past period in Hungary was caused by several factors. Besides internal and external economic courses regarded as disinflationary environment in general and tight monetary policy, regulated price increases lower than world price and cost increases and indirect tax cuts have played an important role.

Increase in inflation rate in the second half of 2006 was mainly due to the consolidation measures. The VAT rate of 15% was raised to 20% in September, which increased the consumer prices of many foods and some basic services. In case of certain services with regulated price (e.g. electricity, natural gas) consumer prices have increased due to compulsory cost-revision or transformation of the subsidy system. Inflation rate will be around 6.4% by the end of 2006 according to the revised forecast based on latest monthly data, thus annual average will be around 3.9%.

Additional government measures (transformation of the price subsidy schemes on pharmaceuticals, gas and long-distance passenger transport) will increase the consumer price level mainly in 2007. Tight monetary and fiscal policy as well as the development of household consumption and demand, and, in general, development of aggregated demand will restrain the temporary acceleration in inflation. Stronger forint and lower oil price will reduce the expected inflation. Inflation will rise to 7–8 % in first half of 2007, then it will significantly lessen, therefore the annual average rate of price increase is forecasted to be 6–6.5%.

Inflation expectations may remain 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 in 2007, 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	3.9	6.2	3.3	3.0	2.8	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 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.

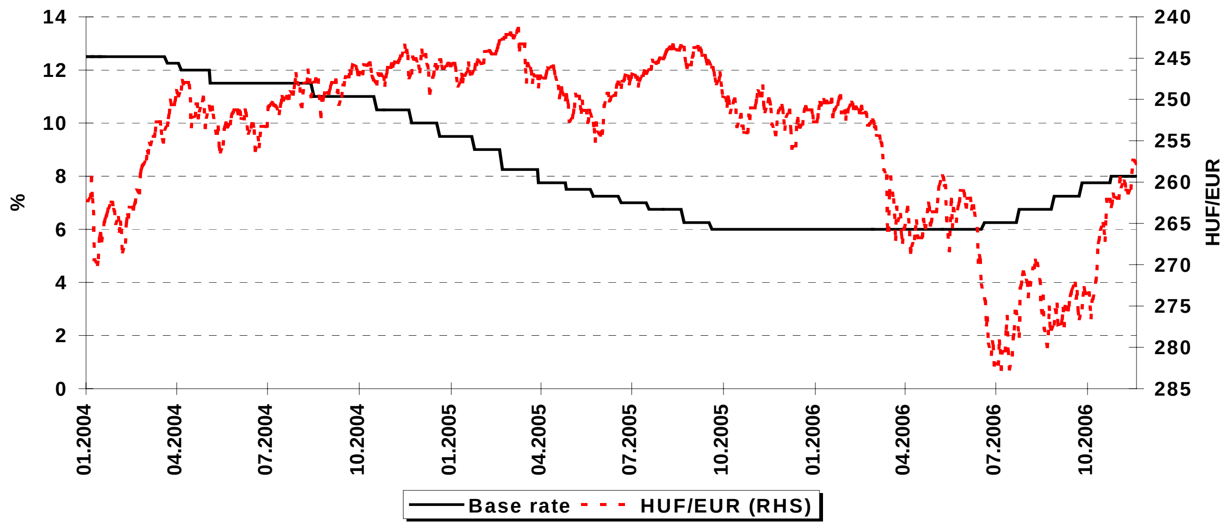
2.10 Monetary and exchange rate policy

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.

The already implemented fiscal adjustment measures and the announcement of the details of further steps, combined with central bank decisions taken recently have resulted in a favourable turnaround in market perception. The central bank raised its base rate from June through October by a total of 200 basis points, responding to the unfavourable inflation outlook and to the change in financial markets' sentiment. Long-term yields declined compared to their end-June level despite the interest rate hikes which means that the steps put in place have contributed to the stabilisation of financial markets. The one-year ex ante real interest rate remained below the level experienced in recent years despite the rate hikes. However, the loosening of monetary conditions in the second half of 2005 and in the first half of 2006 have been partly offset by the exchange rate appreciation in the Autumn. The positive trend was intensified by regional effects.

Central bank interest rate and HUF/EUR



Based on the favourable disinflationary developments of the past years, the Government and the central bank 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 the decrease of the budget deficit and the 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. Restoring fiscal policy's credibility, indicated by a major decline in exchange rate volatility and a durable decline in the spreads between HUF and FX yields, is a necessary condition for entering the ERM II. The attainment of the 2007 budget targets and the adoption of a 2008 budget corresponding with the convergence programme are indispensable for this objective.

3. Fiscal policy

Similarly to the September convergence programme, the mandatory, fully funded pillar of the pension system is classified outside the general government sector in the present programme update[3].

Effect of the pension reform[4] in % of GDP

	2005	2006	2007	2008	2009	2010
on deficit	1.3	1.4	1.5	1.4	1.4	1.5
on public debt	3.9	4.7	5.2	5.3	5.3	5.7

[3] In line with Eurostat conclusions of of 23 September 2004 (Eurostat News Release 117/2004), the fully funded pillar can be classified within the general government sector in the EDP Notification until the spring of 2007. Accordingly, the CSO will submit to the Eurostat the national accounts of the government sector for the years 2002-2006, calculated without the private pension funds, by April 2007, the date of the first Notification in 2007.

[4] The divergence from the figures included in he September convergence programme is explained parlty by the effect of the upward revision of nominal GDP data, partly by the changes in the regulation on the investment policies of the pension funds.

3.1 Fiscal developments in 2006

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

However, by mid-year, the upwards revision of the deficit target became inevitable partly due to methodological and accounting changes and partly because of the developments in public finances in the first half-year.

- The Eurostat decision concerning the accounting treatment of defence purchases and the incorporation of motorway construction projects into the scope of the budget to improve transparency resulted in an expenditure increase corresponding to approx. 1.5 % of GDP in aggregate.
- Over and above methodological changes, some non-recurring factors (flood protection expenditures, cancellation of the Iraqi debt, temporary increase of the deficit of municipalities, etc.) as well as some estimated overspending (interest, pension and health care expenditures, household gas price compensation, expenditures of central budgetary organisations, etc.) also pointed to a potential increase in the deficit.

Therefore, in June the Government decided to introduce immediate measures to improve the balance, simultaneously raising the ESA95 deficit forecast to 10.1% of GDP.

In order to cut expenditures,

- a resolution was adopted to cut the operational subsidies to budgetary institutions and some chapter managed appropriations (0.2% of GDP in aggregate);
- 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);
- general government reserves corresponding to 0.3% of GDP have been withdrawn;
- in the field of health care, expenditure increases are curbed by the measures aimed at the transformation of hospital financing, while the increase of net subsidies on pharmaceutical will be contained by the transformation of the structure of subsidy categories and the payments of producers of pharmaceuticals.

In addition to expenditure cuts, increases in revenues will also assist in reaching the new deficit target. The five-year tax reduction programme announced in 2005 has been postponed, and the new tax and contribution rules passed by Parliament have increase budgetary revenues already in the fourth quarter of 2006 (increase of the 15% VAT rate and the simplified business tax rate, broadening of the tax base for personal income taxation, introduction of special tax for corporations, etc. - the details of the tax changes are described in Annex 1).

The bill on the amendment of the budget act of 2006 records in the cash-flow appropriations the expected changes in expenditures and the effects of the amendments of the tax and contribution legislation. The assumption of loans for the financing of motorway construction by the budget will increase the cash deficit to some 9.5% of the GDP. This transaction has no effect on the accrual-based deficit as the cost of motorway construction was already incorporated in the ESA95 deficit. As a result of the legislative amendment, the difference between the ESA95 deficit and the cash-flow deficit calculated in accordance with the act on public finances will be reduced significantly.

The 10.1% accrual-based deficit of the general government corresponds, according to the projections of the Ministry of Finance, to HUF 2058 billion cash-flow deficit in the aggregate balance of the central budget, the social security system and the extra-budgetary funds. In the first ten months, the deficit amounted to 73.4% of the annual projection. Although the ten-month deficit is slightly above the time-proportionate level (without the debt assumption accruing at the end of the year), the seasonality of the receipt of tax revenues must also be taken into consideration. Corporate income tax and simplified business tax payments are supplemented in December to reach the expected annual tax charge; furthermore, the bonus payments and increased trade turnover boost the value added tax, personal income tax and contribution receipts. Consequently, the projection of the Ministry of Finance (excluding debt assumption) reckons with only a minimal deficit increase in December (in recent years, the December balance tended to produce a surplus).

3.2 The budgetary consolidation strategy

Notwithstanding the corrective measures, the 2006 deficit is significantly higher than originally targeted. 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	2010	Change 2010-2006	2011
Tax and contribution revenues	37.2	36.5	38.1	37.8	37.3	37.0	0.5	36.5 - 37
Revenues	42.2	41.9	43.1	43.0	43.4	42.8	0.9	43 – 43.5
Expenditures	50.0	52.0	49.9	47.2	46.6	45.5	-6.5	45 – 45.5
EU-transfers	0.9	1.4	1.8	2.4	2.8	3.2	1.8	3.5 - 4
Primary expenditures without EU-transfers	45.0	46.7	43.7	40.5	39.7	38.5	-8.2	cca. 38
Balance	-7.8	-10.1	-6.8	-4.3	-3.2	-2.7	7.4	-2.2
Primary balance	-3.7	-6.2	-2.4	0.0	0.9	1.1	7.3	cca. 1.5
General government gross debt	61.7	67.5	70.1	71.3	69.3	67.5	0	65 - 66

Compared to the September convergence programme, the figures expressed in percentage of GDP have changed considerably. This is primarily due to the fact that the nominal GDP figures used in the macro-economic projections are – mainly for methodological reasons (see Box on page 8) – are higher in the present programme update than in the September programme. In terms of the upwardly revised nominal GDP, the revenue and expenditure ratios are lower, the change in the revenue/GDP ratio is smaller, and the drop in the expenditure/GDP ratio is more pronounced.

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 two 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 reform 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 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 considerable surplus and the debt ratio will start to decline consistently.

An increasing revenue/GDP ratio will contribute significantly to the adjustment in 2007. As a result of the tax and contribution changes, the tax and contribution revenues expressed as a percentage of GDP will improve by more than 1.5 percentage points next year. Nevertheless, the tax/GDP ratio will not achieve the more than 39%, typically prevailing at the end of the 1990's. From 2008 the tax/GDP ratio will start to gradually decline.

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 more than 8 percentage points by 2010. The cut in expenditure will exceed the growth of tax and contribution revenues by 1.4 percentage point in 2007. In the following years of the programme period, any further deficit reduction will result from lower expenditures.

3.3 The 2007 budget

The budget bill of 2007 submitted to Parliament was prepared in line with the measures described in the September convergence programme, in accordance with the fiscal path set out therein. As a major improvement over the practices of previous years, the budget contains not only the appropriations for 2007 but also indicative projections for the period up to 2010: it describes, in an annual breakdown, medium term plans in nominal terms by title (or often subtitle). The text of the bill contains the ESA 95 GDP-proportionate primary balance requirement for the years of 2007-2010. Thus the 2007 budget act determines the medium term manoeuvring room of the budget.

In 2007, the deficit of the government sector may reach 6.8% of the GDP. The primary balance will produce half a percentage point more improvement (at 3.8%) in 2007 than the total balance, then the primary deficit will disappear in 2008. By 2010, the surplus of the primary balance will be slightly over 1% of GDP.

The following considerations were taken into account when designing the appropriations for 2007.

- Public expenditures will have to increase in some areas even during the period of fiscal consolidation:

- there will be an increase in pension expenditures, family support and social aid in line with legislation. On the whole, these expenditures will be over 6% higher in nominal terms than the 2006 level;
- due to increasing EU transfers, expenditures implemented with EU support may increase. The budget will provide the co-financing that allows for the use of EU funds;
- expenditure increases pursuant to the act on higher education and availability fees for PPP projects for which contracts have been concluded are incorporated in the appropriations, and the investment promotion appropriation will be increased;
- the funds available for financing the public service activities of railways – assuming restructuring – will increase to 0.4% of GDP from 0.2% in 2006. In addition, there will be one-off capital injections corresponding to 0.4% of GDP in 2007 (and another 0.1% in 2008);
- interest expenditures will increase by half a percentage point as compared to GDP.

- The reduction of expenditures as a percentage of GDP (or, occasionally, their nominal decrease) will result from the following factors:
  - revision of the gas and district heating subsidy regime: a means-tested compensation regime will be introduced in 2007. The appropriation contains a nominal reduction, amounting to a 0.2 percentage point decrease as a percentage of GDP;
  - overhaul of the pharmaceutical subsidy regime. Pharmaceutical subsidy expenditures will decline also in nominal terms, falling by 0.2 percentage points as a percentage of GDP;
  - expenditure on curative-preventive healthcare as a percentage of GDP will be reduced by 0.2 percentage points compared to the actual expenditure expected for 2006;
  - public transport related consumer price subsidy expenditure will remain on the level expected for 2006. This is promoted by the replacement, as of mid-2006, of the former percentage subsidy by a lump-sum subsidy;
  - the current financing of public transport in Budapest will remain on the 2006 (elevated) level covering actual costs in 2007;
  - expenditures in other areas will remain at the level of the 2006 appropriations, reduced by the adjustments to the basis. The adjustment reflects the withdrawal of the HUF 70 billion general government reserve (0.3% of GDP), the blocking of HUF 42 billion (0.2% of GDP), removal of the costs of one-off tasks for 2006 (elections, etc.), as well as the impact of the headcount reduction implemented in the central government and the municipalities sector;
  - in 2007, the remuneration base of civil servants will not increase, and the wage scale and supplement base for public servants will remain unchanged.

The vast majority of dismissal allowances and severance payments related to the financing of headcount reduction in 2006-2007 will incur in the 2007 budget expenditures; a minor part of this amount will be paid in 2008. A provision has been set aside for this purpose.

The 2007 budget contains reserves of HUF 225 billion (0.9% of GDP) in total. In addition to the general reserve for unforeseen expenditures and the specific reserve for the cost of staff cuts, an additional almost HUF 130 billion (0.5% of GDP) so-called equilibrium reserve serves to assure compliance with the deficit target (HUF 79.6 billion chapter equilibrium reserve that ministries are required to set aside and HUF 50 billion central equilibrium reserve). The budget bill provides that the Government will allow the utilisation of the equilibrium reserves, based on the mandatory quarterly reporting of the chapters, only if the chapter's expenditures and revenues as well as general government processes all develop as originally envisaged. Furthermore, the budget bill also requires that in 2007 the stock of the carried-over unspent appropriations of budgetary organisations may not decline. The unspent appropriations may be used only with the permission of the Government.

3.4 General government expenditures

The most important task of the programme period is to cut the expenditures of the general government. Between 2006 and 2010, the primary expenditures to GDP ratio (without EU transfers) must shrink by approximately 8 percentage points and the drop in expenditures will continue also in 2011. In addition to the comprehensive reforms described in detail in Chapter 4, sound implementation requires stronger budgetary discipline too. Stricter control over the appropriations will be achieved through new fiscal rules. In order to avoid the narrowing of the budgetary room for manoeuvre, apart from the equilibrium reserves and the quarterly reporting, an amendment to the public finance law (submitted to Parliament) will regulate the rules pertaining to the authorisation, undertaking and registration of long-term public spending commitments, with special regard to private-public-partnership projects. According to these rules, the annual spending originating from spending commitments beyond the current year must not exceed an upper limit determined in the annual budget law. When submitting the draft budget and the bill on the closing accounts of the budget, respectively, the Government will have to inform the Parliament on the stock of long-term spending commitments broken down by budgetary chapters and projected annual payments.

Apart from stronger budget discipline, the specific measures underlying the reduction in the expenditures to GDP ratio are as follows:

- The number of public sector employees will be reduced. In addition to headcount reduction and organisational streamlining and restructuring, already decided concerning central budgetary institutions (mergers and termination of tasks), 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 essentially 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 more than 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 1.5 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 annual 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 19% in 2006 by nearly 4 percentage points, to 15.2% of GDP, by 2010, and they may increase below the GDP growth rate in subsequent years.

Operational expenditures of the public sector in % of GDP

	2005	2006	2007	2008	2009	2010	2011
Compensation of employees	12.6	12.0	11.4	10.5	10.2	10.0	cca. 9.8
Intermediate consumption	6.4	7.0	6.0	5.6	5.4	5.2	cca. 5

- There will be changes in the price subsidy system:
  - there will be a 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.
- In terms of GDP, expenditures on social transfers in kind supplied via market producers will be cut by 1% till 2010, resulting mainly from the re-structuring of the price subsidy schemes.
- Expenditures on pensions, family support and social aid – constituting almost 90% of social benefits other than in kind – will be increased in line with legislation. In total, social benefits other than in kind will decrease only marginally, by 0.1. percentage point in terms of GDP, till 2008. 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 approximately 0.5 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 nearly 0.8% 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. 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 the investments of the government sector will fall compared to this year's high figures, in the last years of the programme period the investment/GDP ratio may reach approximately 4%.

3.5 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 approved tax and contribution changes will increase the tax revenues to GDP ratio by more than 1.5 percentage points in 2007compared 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 mainly through the widening of the tax and contribution base and limitations in the scope of tax avoidance (see Annex No. 1 for the details of the changes of the tax system.):

- 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 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 15% VAT rate was raised to 20%;
- the contributions paid by individuals was 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.

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 2008 beside export and investment-driven economic growth. The tax and contribution revenues could only decrease more 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	24.6	24.1	25.0	25.0	24.6	24.5	24 - 24.5
of which:							
Taxes on production and imports	15.5	14.8	14.9	14.7	14.3	14.1	cca. 14
Current taxes on income and wealth	9.0	9.2	10.0	10.2	10.3	10.4	10 - 10.5
Capital taxes	0.1	0.1	0.1	0.1	0.1	0.1	cca. 0.1
Social contributions	12.6	12.4	13.1	12.9	12.6	12.5	cca. 12.5
Total tax and contribution revenues	37.2	36.5	38.1	37.8	37.3	37.0	36.5-37

* Due to the rounding the sum data could differ from the sum of the detailed data

Similarly to the average of the new Member States, in Hungary the ratio of turnover related (indirect) taxes is relatively high in 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.

3.6 Alternative budgetary scenarios

The biggest uncertainty of the macroeconomic path is the behaviour of economic actors: it is very difficult to predict 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.

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. Due to higher employment households will favour maintaining a higher consumption level 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 tax and contribution revenues are 0.4-0.7 percentage higher than in the baseline scenario, but partly indexed social transfers in cash increase only by a small amount. In total the budget deficit figure will also be a bit more favourable, 0.2–0.3 percentage point lower annually than shown in the baseline scenario.

Slower accommodation of wages – lower growth

If the gross wages of the business sector grow slower than in the baseline scenario, and no excess demand is generated for the workforce released from budgetary institutions, then household disposable income may decrease more. A higher than the baseline increase in the disposable income puts the brake not only on household investments, but

– in reaction to the lower domestic demand – on business investments as well. The investments of the national economy in 2007 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. The growth of GDP falls less than the growth of domestic use from the baseline case due to the moderation of import demand. In this growth scenario the tax and contribution revenues of the budget are smaller than in the baseline scenario, but no such non-materialised growth will increase the deficit by more than 0.3-0.4 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 the 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 baseline scenario, 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. The slower growth of wages, employment, and household consumption generates less personal income tax, contribution, and VAT revenues, thus the budget deficit expressed as a percentage of GDP will 0.1-0.3 percentage point higher than in the baseline scenario.

Summary of alternative scenarios

Difference from the baseline scenario percentage point

	2007	2008	2009
More favourable domestic demand – higher growth			
Household consumption	+0.5	+0.3	+0.1
Gross capital formation	+0.7	+0.4	+0.3
Export (goods and services)	0.0	0.0	0.0
Import (goods and services)	+0.3	+0.2	+0.1
GDP	+0.3	+0.1	+0.1
Inflation	+0.1	0.0	0.0
Employment	+0.1	+0.1	+0.1
Tax and contribution revenues*	+0.4	+0.6	+0.7
From this: VAT*	+0.7	+1.0	+1.1
PIT and contribution revenues*	+0.1	+0.3	+0.4
Social transfers in cash*	+0.1	+0.1	+0.1
Budget balance (in % of GDP)	+0.2	+0.2	+0.3
Slower accommodation of wages – lower growth			
Household consumption	-0.6	-0.1	0.0
Gross capital formation	-1.0	-0.9	-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	-0.2	0.0
Inflation	0.0	0.0	0.0
Employment	-0.2	-0.1	0.0
Tax and contribution revenues*	-0.2	-0.9	-1.1
From this: VAT*	-0.1	-0.6	-0.8
PIT and contribution revenues*	-0.3	-1.1	-1.4
Social transfers in cash*	-0.2	-0.2	-0.2
Budget balance (in % of GDP)	-0.3	-0.4	-0.4
Unfavourable external demand – lower growth			
Household consumption	0.0	-0.4	-0.2
Gross capital formation	-0.2	-0.1	-0.1
Export (goods and services)	-1.3	-0.9	-0.6
Import (goods and services)	-1.0	-0.8	-0.5
GDP	-0.3	-0.3	-0.3
Inflation	0.0	-0.3	-0.1
Employment	-0.2	-0.2	-0.2
Tax and contribution revenues*	-0.3	-0.6	-0.9
From this: VAT*	+0.0	-0.6	-0.9
PIT and contribution revenues*	-0.5	-0.7	-0.9
Social transfers in cash*	-0.1	0.0	0.0
Budget balance (in % of GDP)	-0.1	-0.3	-0.3

*Percentage change at current prices

The risks of alternative scenarios, less favourable for the budget, may be offset with reserves and reserve measures which are built in the 2007 budget. 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. 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.

3.7 Cyclically adjusted and structural balance

According to the calculations for the convergence programme, the sensitivity factor is 0.25[5] taking into account the estimated tax revenues in 2007, i.e., the budget balance will change by 0.25 percentage point with 1% change of GDP (assuming unchanged composition).

Due to the stabilisation measures, economic growth will temporarily slow down in 2007-2008 and output fall under its potential level. The output gap remains negative until 2010, however it will be narrowing. As a result, the cyclically adjusted balance until 2008 shows a larger, while in 2009-2010 a somewhat lower improvement than the headline deficit.

Deficit-increasing one-off items play significant role in the development of the structural deficit between 2006 and 2008. Due to this fact, the structural deficit is lower than the cyclically adjusted one, however its improvement remains smaller, because there are no one-offs in 2009-2010.

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

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

Structural balance in % of GDP

	2005	**2006**	**2007**	**2008**	**2009**	**2010**
Output gap	1.3	1.2	-0.6	-1.8	-1.5	-1.0
General government balance	-7.8	-10.1	-6.8	-4.3	-3.2	-2.7
Primary balance	-3.7	-6.2	-2.4	0.0	0.9	1.1
Cyclically adjusted balance	-8.1	-10.4	-6.7	-3.9	-2.8	-2.5
Cyclically adjusted primary balance	-4.0	-6.5	-2.3	0.5	1.3	1.4
One-offs (deficit increasing)	0.0	0.7	1.0	0.1	0.0	0.0
Structural balance	-8.1	-9.7	-5.7	-3.8	-2.8	-2.5

3.8 Public debt

The decreasing trend of the debt ratio reversed in 2001. The growing dynamics was partly because of the remarkable increase in social and infrastructural expenses; tax and contribution revenues declined due to the change of tax and contribution rules. Moreover one-off effects (like the revaluation effect) and higher interest expenditure on the increased debt in a high-yield environment supported this negative tendency. The increase was however partly offset by privatisation revenues.

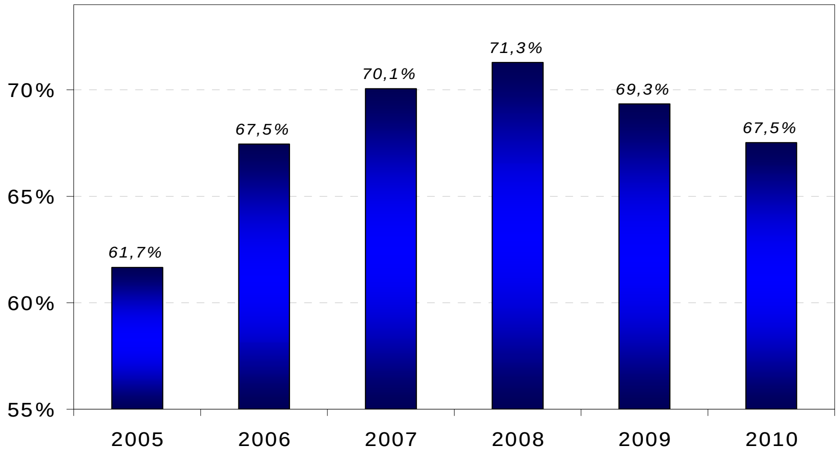
Higher yields because of the contraction of international liquidity in the second half of 2006 and rising 2007 inflationary expectations, the depreciation of the exchange rate, and mainly because of the higher primary deficit, the debt ratio is expected to exceed 67% of GDP in 2006.

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, nominal

[5] The sensitivity factor was 0.26 in the convergence programme of September 2006. The change is due to the revision of GDP figures and the new information coming from the submitted draft budget.

economic growth and falling yields[6]. 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 gradually from a level exceeding 70%.

Debt ratio (2005-2010)



In the recent past and in 2006, the *primary balance* was deteriorated by many one-off effects (Gripen purchase, excess expenditures related to flood protection etc.).

The *interest expenditure* was projected with the assumption that at the beginning yields reflect market expectations then converge gradually to the euro yield curve. According to this assumption the interest burden as a share of GDP will still increase by approximately 0.5 percentage point in 2007, then it will start to fall from 2008 and, following more than 0.6 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 an increase in the debt stock. Moving forward on 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 yield curves turning into a favourable direction as well as the stabilisation of the exchange rate. A potential change in the currently experienced optimistic sentiment of international markets or the increase of risk premium may slow down the positive tendencies.

Apart from the budget deficit, the future debt ratio will also be influenced by the *stock-flow adjustment*. In 2006 the public debt is expected to be reduced by more than 1 percent of GDP through privatisation revenues. Apart from some asset sales by local governments the baseline scenario is not calculating with significant privatisation revenues through the rest of the programme period. Higher than expected privatisation receipts may reduce the public debt in the future. In 2005, the revaluation impact resulting from the depreciation of the exchange rate was significant and the same is expected for 2006[7]. From 2007, the programme assumes no changes in the exchange rate. Due to the fiscal adjustment better fundamentals may even result in a durable exchange rate appreciation.

[6] The convergence programme applies a technical assumption for the HUF/EUR exchange rate. The HUF 266.5 average exchange rate of 2006 was calculated based on the actual data till 9 November and extrapolating the HUF 271 average of the actual exchange rates between 9 August and 9 November to the total outstanding programme period. Following this method, a constant HUF 271 exchange rate is assumed for the period of 2007-2010, which implies no revaluation effect in the debt projections from 2007.

[7] In recent months, the exchange rate appreciated significantly. The technical exchange rate assumption for the programme period can only partly reflect such a change due to the applied methodology. If the exchange rate remains on the HUF 257-258 level by the end of 2006, the revaluation effect would decrease the debt stock by around HUF 200 billion (nearly 1% of GDP).

The nominal level of public debt through the programme period is somewhat higher than in the September convergence programme, but the debt ratio is lower due to the revised nominal GDP figures.

The debt ratio is sensitive to changes in the following main factors[8]:

- Primary balance: the annual 1 percentage point change of the primary balance from 2007 till the end of the projection period will induce 2.1 percentage point change in 2008 and 4.1 percentage point change by the end of the period 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, 10% exchange rate change will have about 2.0 percentage point impact on the debt ratio and HUF 440-570 billion on the debt stock.
- Yield curve: lasting shift in yields has a gradual impact on interest expenditure, with a delay in the changes of the debt ratio. A durable 100 basis points shift of the HUF yield curve, applicable to all maturities from January 2007, would change the debt ratio by 0.1 percentage point in 2007; 0.3 in 2008; 0.6 in 2009 and 0.9 in 2010.
- Economic growth: the steady 1 percentage point change of nominal GDP starting in 2007 would have an impact on the debt ratio of 0.7 percentage point in 2007; 1.4 in 2008; 2.0 in 2009 and 2.6 in 2009.

4. Medium and long term sustainability of public finances

In its opinion on the convergence programme of September 2006, the Council stated that in respect of the long term sustainability of public finances, Hungary belongs to the high-risk category. As a result of demographic trends, without the reform of the pension and health care systems, such expenditures will increase at a fast pace with the ageing of the population. For the sake of long term sustainability, far-reaching reforms are needed in these areas. Furthermore, the currently high budget deficit and the high public debt, which will continue to increase until 2008, must be reduced for the sake of long term sustainability through long-term expenditure reduction measures for which the foundations are laid by structural reforms.

This chapter describes the measures promoting long term sustainability in the pension and health care systems, then the structural measures to be implemented in other fields. The other structural measures are conducive to reducing the expenditure/GDP ratio as well as improving the qualitative characteristics of public finances by enhancing efficiency. The directions of structural reforms and the time schedule of their implementation were laid down in the September 2006 programme. This programme reiterates the implementation schedule of the reform steps in Annex 2, updating and supplementing them with the measures adopted or implemented since the previous programme.

4.1 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. Employers' pension contributions constitute receipts for the pay-as-you-go pillar in their entirety. 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

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

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 pay-as-you-go pillar; however, that sum is supplemented by the annuity paid by the private fund.

The sustainability of the pension system is supported in part by the implemented or announced measures of the comprehensive pension reform launched in 1998:

- 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;
- the eligibility criteria for early retirement, to become considerably stricter as of 2009;
- changing rules of pension calculation (the reference period in the calculation of pensions will become longer every year);
- strengthened incentives to work longer (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 decided on legislation facilitating the addressing of controversial phenomena, 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 legislative amendment related to the social insurance pension benefits, adopted by Parliament on 27 November 2006, contains the following key elements:

- As of 2009, the early retirement age, in line with existing regulations, will be 59 years for both sexes. The minimum service period required for early retirement will increase from the present 33 years to 37 years; however, if the time of service is less than 40 years, a reduced benefit is payable. As of 2013, the early retirement age will increase to a uniform 60 years of age, and at least 41 years of service will be required for the full pension benefit. 37 years of service continues to be required for eligibility for reduced pension benefit. The rate of reduction will depend on the time remaining until the legal retirement age (62 years) and the number of years of service missing (0.1-0.3 percent per month).
- Persons going into early retirement after 1 January 2008 will be allowed to take up regular employment with earnings above minimum wage only if they simultaneously suspend their pensioner status. The new rule is applicable to persons retiring after 1 January 2008, while from 2010 onwards it will also be extended to all persons in early retirement.
- If income earning activity is pursued by a pensioner, pension contributions will be payable after 1 April 2007, which will give right to a pension increase of 0.4% per annum. In order to assure time for preparation, the regulation will not be mandatory as of 1 January 2007, but it can be elected, in order to increase the pension, between 1 January and 31 March 2007.
- The legislative amendment also contains adjustments to some controversial elements of the pension calculation, effective as of 1 January 2008. For incomes earned in previous years, instead of the current partial valorisation, full valorisation will be

applicable (to the level of the year directly preceding retirement), furthermore, the calculated tax must be deducted from the earnings reduced by the contributions payable by the individual. As the aggregate result, the initial pension level will be 7-8% lower, and the disproportions of future pensions will be alleviated. In order to provide incentives to increase the period of contribution payment, long service periods (in excess of 40 years) will be taken into consideration with more weight in the future. Thus, for persons with more than 40 years of service, the pension increase for each year of service will go from 1.5% of the average income to 2% as of 1 January 2008.

As a result of the changes, in 2007 pension contribution receipts are expected to increase by HUF 2 billion; the cumulative savings from the measures, at 2006 prices, will amount to HUF 9 billion in 2008, HUF 20 billion in 2009, HUF 40 billion in 2010, HUF 48 billion in 2011 and HUF 55 billion in 2012. These effects are reflected in the calculations concerning public finances.

The bill regulating the issue of the transformation of the early retirement benefit available to persons working in jobs with potential health hazards has been submitted to Parliament. Accordingly, employers of such jobs will have to pay additional contributions to the Pension Insurance Fund to cover the early retirement benefit. Between 2007 and 2010, the central budget will assume the related burdens from the employers, on a regressive scale.

The review of the pension allowances to certain special employment categories is also in progress. Work is also ongoing on the review of certain elements of the disability pension system, such as the form of financing, the benefit structure, the rules of establishing and controlling reduced working capacity as well as the transformation of the system of institutions. The Government will submit the relevant bill to Parliament in 2007. As the first step of the transformation of the financing structure, all the disability retirement benefits will be financed by the Pension Insurance Fund from 2007 onwards.

In the long term, the functioning 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).

For the analysis of the sustainability of the pension system, the convergence programme relies on the results of projections of the Ministry of Finance 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. The ratio of pensioners to employed persons will also increase. As a result of the measures aimed to increase employment, the projections show an improvement in the employment rate, but this will not be sufficient to offset the adverse demographic trends.

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 mixed system being eligible to a reduced benefit from the pay-as-you-go pillar. According to the projections, private pension funds will relieve the general government from pension expenditures of 2.6% of GDP in 2050, as compared to a scenario without the reform[9]. 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

[9] The future expenditures of private pension funds are higher than the amount which they take over from the general government (see table), because the private pension fund, due to higher expected yields, pays higher benefits than the pay-as-you-go pillar.

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, aggravated by the fact that 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, from the aspect of the macro-economic equilibrium, that during this period the temporary deficit of the pay-as-you-go system will be counterbalanced by savings (capital formation) of the same magnitude in the private pension fund pillar.

Pension expenditures in % of GDP

	2000	**2005**	**2010**	**2020**	**2050**
Net pension expenditures*	9.1	10.4	10.3	10.7	13.5
o/w: expenditures of social security funds	8.4	9.8	9.7	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).

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, these will be moderated in the long term by the measures of the pension reform started in 1998 and of the adjustments of 2006-2007. Even so, the deficit of the pay-as-you-go pension pillar is expected to grow, necessitating further measures to assure the sustainability of the pension system. Expert-level preparatory work has been started; both the key parameters (retirement age, replacement rate, indexation) and systemic changes (e.g., individual accounts) will be reviewed and assessed.

4.2 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 expected impact 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.

Curative-preventive care

Curative-preventive 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 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, Hungary spends relatively more than we could afford or that would be optimal, while the funds used in this distorted structure yield lower professional and quality improvement benefits than it would be desirable. Furthermore, in recent years the escalation of recorded outputs has caused ever growing problems.

The state finances curative-preventive care in several forms. In 2006, the public expenditures used for that purpose will reach 3% of GDP. Health service providers receive a lump-sum 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 an overrun in reported performance, the manager of the Health Insurance Fund may reduce fees/rates. This system assures that the curative-preventive care appropriation in the budget of the Health Insurance Fund cannot be exceeded.

In the forthcoming years, the reduction of expenditures on curative-preventive care as a percentage of GDP is required in order to improve the government balance. 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 serves 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) have considerably lowered 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 manifested in 2006 in the fourth quarter only, but the expenditure cuts will be 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 and setting out to moderate the existing regional and structural imbalances of the health care system and to improve economies of scale and efficiency:

- Reinforcement of the social insurance character of health care. In the bill submitted, the Government proposed to Parliament that the use of services based on the insurance principle be conditional on the existence of an insurance legal relationship or other eligible registered status and the payment of the contributions due[10]. In the absence of this, only basic services can be used such as ambulance, emergency, mother and child protection or epidemiology.
- 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 (visit fee or daily hospital charge) is to be paid by the user, and the health care provider is obliged to issue an account statement.
- 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.

[10] 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.

- Service providers may compete for the social insurance funding. The National Health Insurance Fund (NHIF) will purchase only the necessary services. In the new system, capacities will be restricted, and their distribution and financing will also change.
- 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.

The bills relating to structural reforms – with the exception of transformation into economic associations and the liberalisation of the insurance market – are expected to be passed by Parliament in 2006.

As a result of the implementation of the structural reform, 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.

The bill concerning the measure aimed at shortening the period of passive sick pay (payable after the termination of the insurance relationship) will also be approved by Parliament in 2006.

Pharmaceutical subsidies

The steep increase 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 budget balance. To that end, the subsidy 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 accounting of subsidies and the control of the use of subsidies must be improved. The act adopted by Parliament on 20 November 2006 on the secure and efficient supply of pharmaceuticals and medical aids and on the general rules of pharmaceutical trade (hereinafter: act on economy in pharmaceuticals) enforces the aforesaid criteria.

The pharmaceutical subsidy regime is revised along the following principles:

- The objective of the revision of the pharmaceutical subsidy system is to assure that, following the subsidy cuts implemented in 2006, the planned level of appropriations on pharmaceutical subsidies is not exceeded in 2007 and beyond. To that end, the regulation covers relations with producers, influencing prescription habits and restricting unjustified demand.
- Lump-sum subsidies will become general practice (within classes of drugs with the same active substance), the level of the subsidy adjusted to the cheapest (benchmark) product.
- New rules conducive to high quality and efficient pharmaceutical and medical aid prescription enter into force.
- The new rules assure that for patients leaving hospitals generic products are prescribed 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 2007, the keeping of the expenditure appropriation for pharmaceutical subsidies will be ensured by the following specific measures:

- The carry-over effects of the subsidy rationalisation and prescription control measures implemented during 2006 will be present.
- As a result of the introduction of the visit fee and daily hospital charge, and the obligation of health care providers to issue account statements, the number of prescriptions may fall by some 4-5%, which may curb amount 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 60 days).
- Pursuant to the act on economy in pharmaceuticals, pharmaceutical producers (beneficiaries of the marketing licence of pharmaceuticals) are obliged to make the following payments:
    - 12% of the producer price proportionate part of subsidy to prescription pharmaceuticals filled by pharmacies;
    - HUF 5 million per year and per person in respect of medical representatives employed;
    - in case of over-spending in the appropriation calculated with the deduction of the aforesaid payments, under a multi-tier burden sharing system.
- Pursuant to the act on economy in pharmaceuticals, wholesale traders of pharmaceuticals have an obligation to make payments of 2.5% of the wholesale margin of publicly financed pharmaceuticals sold to pharmacies.
- Termination of free access.
- Tightening the conditions of remaining in the subsidised category, termination of the subsidisation of non-cost-efficient pharmaceuticals.
- Introduction of rules conducive to safe and efficient prescription practices.
- Universal introduction of a control system to monitor prescription and subsidy entitlements on line.

4.3 Other structural measures

Central public administration

As a result of the implementation of the resolutions of the Government adopted in June 2006 on the staffing level of administrative bodies and the restructuring measures promoting the efficient operation of the public sector, the number of central budgetary entities and their employees has decreased. The main thrust of the changes was towards regionalisation, the horizontal merger of institution systems within a single sector, the centralisation of support functions, the elimination of duplications and, in some cases, the closing of institution because of unnecessary functions, as well as other mergers or modifications of operating structures or legal status to promote more efficient operation.

Depending on the mode of implementation and the outcome of detailed analyses, the 823 central budgetary entities in operation at the beginning of 2006 will be reduced by some 200-300, or by 25-35%. According to the reports of the monitoring system set up in the Prime Minister's Office to keep track of the implementation of these tasks, pursuant to the adopted legislative amendments, almost 60 entities will be closed down by the end of 2006, with at least another 150 to follow in 2007.

As a result of headcount reduction and organisational streamlining and restructuring, already decided concerning central budgetary institutions, the number of employees will drop by approximately 21,000 in 2006-2007. In the 2007 budget, the headcount proposed by the ministries shows an approximately 15,400 person net decrease as compared to 2006. The staffing plan includes the additional staff required by various government decisions, the most important ones being the transfer of stamp offices and their tasks from local governments to the Tax and Financial Administration Office (APEH), the reinforcement of control activities, as well as the increase due to the enhancement of IT systems in the National Health Insurance Fund. Thus, the gross reduction in the central budgetary sub-system comes close to 17,500 persons. Further staff cuts are to be expected as a function of the organisational measures under review or taken under discretionary powers, and as the military reform progresses.

The number of non-budgetary organisations (foundations, public foundations, non-profit and economic associations) is expected to fall by one fifth from the 305 seen in 2005 as a result of the organisational measures. According to the reports of the monitoring system, nearly 40 organisations are expected to close down by the end of 2007 (half of them in 2006); the required legislative amendments have already been made in case of 15 of these.

Local government system

The transformation of the financing system of local governments is linked to the reform of the entire local government system, which requires a broad social consensus as the adoption of the fundamental acts regulating this sector requires a 2/3 majority in the Parliament.

During the review of the current levels of service provision, the main consideration is to assure that tasks and decisions are delegated to the level where they can be made the most efficiently, and where the most information is available. This requires decentralisation in several areas, and centralisation in others.

Some of the current tasks of municipalities should be organised efficiently on a micro-regional level. This level should be responsible for public education (with the potential exception of the first four grades) and for administrative activities supporting municipal government assemblies that require special expertise. In 2004 Hungary made considerable progress in this area by encouraging the establishment of multi-purpose micro-regional associations. The regional level should be responsible, inter alia, for the organisation of health care (in particular the optimisation and development of the hospital network), the maintenance and improvement of the public road network (with the exception of motorways and speedways) and the operation of long-distance bus transport.

In order to implement the above tasks, the Government continues to strive for the amendment of Acts requiring a two-third Parliamentary majority to assure the regulatory framework of the aforesaid reallocation of tasks.

In the absence of the support of a two-third majority in Parliament, other instruments must be mobilised to assure the more efficient performance of tasks. The 2007 Budget Act takes firm steps towards financial incentives to reasonable forms of association with economies of scale – in particular, multi-purpose micro-regional associations: the system of central subsidies provides positive and negative incentives to local governments to perform tasks in micro-regional associations with economies of scale. The support to multi-purpose micro-regional associations rose from HUF 15.4 billion in 2006 to HUF 18.3 billion in 2007.

The additional funding serves primarily the joint maintenance of public education and social institutions, providing special support to multi-purpose micro-regional associations if they take over the maintenance of institutions. Thus, in the short and medium term, more public education institutions will be merged, which goes hand in hand with the reduction of teaching and non-teaching staff alike. Joint maintenance of institutions brings about major savings in staff management (e.g., smaller number of heads of institutions, flexible forms of employment).

In the field of social services, child welfare and mobile libraries, the incentive system also serves to improve economic efficiency; however, no major savings are to be expected in these fields, rather, the expansion of services and the improvement of their quality is to be hoped for.

The main objective of supporting multi-purpose micro-regional associations is to encourage the rationalisation of the performance of municipal tasks, therefore savings cannot be quantified in themselves; instead, the results should be reflected in the performance of tasks on the sectoral level.

Public education

In order to establish the organisational (institutional) framework of task performance, with a view to economies of scale, the approved amendment of the public education act has changed the financing of public education:

- the mandatory weekly teaching units of teachers have been increased by 8-10%, in a differentiated manner,
- small schools are obliged to integrate, as member institutions, into 8- or 12-form schools,
- eligibility for free second vocational training has been narrowed.

Under the new system to be introduced in September 2007, the budget will finance educational institutions based on the so-called “public education performance indicator": The method takes into account the principles of the public education act concerning the formation of classes and groups (average student number, time allocated to courses), the mandatory weekly teaching units of teachers, as well as the institutional coefficient expressing the social cost intensity of the various types of institutions (kindergarten, primary school, secondary school).

The new system will be started in the 2007-2008 school year in the first grade of the kindergarten as well as in the first, fifth and ninth grades of school education, moving up in grades, expanding to the whole system by 2011. In aggregate, these measures, starting in September 2007, will bring about savings to the central budget of HUF 7.6 billion in 2007 and HUF 34.2 billion for the whole of 2008.

The financing and regulation of basic art education will also be tightened. Eligibility for normative subsidy will be conditional on the certification of institutions, and normative grants will be differentiated according to performance.

Higher education

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 individually financed (purely tuition fee based) education.
- from 2008 onwards, students in state-financed higher education will have to pay the tuition fee introduced in 2007. 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;
- state-financed student quotas will be distributed through a new allocation mechanism from 2007 on. No quotas by institution will be set; instead, the Government will decide only about quotas by specialisation. The number of students an institution may admit will be determined by the performance of students and the order of preference of institutions they have indicated. The new system is based on the performance principle, promoting the differentiation of institutions by quality considerations and the restriction or elimination of parallel forms of education;
- according to the Government decision of November 2006, 56 thousand state-financed students may enter higher education in 2007, 6 thousand fewer than in 2006. Within this number, in view of the demands of the labour market, the quotas for lawyers, liberal arts, teacher and economist studies have been reduced significantly, while the quotas for natural sciences, information technology and technical studies have been increased;
- 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.

Gas price subsidies

The budget bill for 2007 contains HUF 112 billion for household energy subsidy, which is substantially lower in nominal terms than the amount projected for 2006. In the course of the reform of the gas and district heating subsidy system, a means-tested compensation will be introduced instead of the across-the-board subsidy. The subsidy will be granted and implemented in accordance with a Government decree entering into force on 1 January 2007: consumers will apply for the subsidy in accordance with the provisions of the decree, which the gas and district heating suppliers will credit in the bill sent to the consumer.

In 2007, almost two thirds of the households (approximately 2 million households) will continue to be recipients of subsidies. Within eligible persons, consumers will be classified into four categories based on their income. All those households are eligible to the subsidy, at a rate depending on their income, where the monthly net income per consumption unit does not exceed 3.5 times the minimum old-age pension (HUF 93,900). In case of the most needy, low-income households (some 900 thousand households in total), the gas bill will remain unchanged or will be reduced. The government provides subsidies to 1.1 million more households, while for some 1 million households the gas bill to be paid will increase by 40-65%, depending on the volume of consumption.

Public transport

The budget bill has earmarked HUF 120 billion, the same as in 2006, for the consumer price subsidies to public transport. The meeting of the expenditure target is assured by the lump-sum subsidy scheme introduced in July 2006 to replace the former percentage subsidy.

The ultimate objective of the reform of the inter-urban public transport system is to establish a public transport system that is in line with the capacity of the budget. The continued reform of the railways will create a multi-player market mode.

In the course of the reorganisation of MÁV Zrt., rail freight transport has been spun off into a separate economic organisation (MÁV Cargo Zrt.). With the sale of MÁV Cargo Zrt., expected for the second half of 2007, the liberalisation of rail freight transport will be completed. MÁV Zrt. will be able to use the entire proceeds from the sale for the repayment of its debt. Under a service contract, the Government will pay, between 2007 and 2009, compensation amounting to approx. 0.4% of the GDP each year as compensation for the passenger transport services to the passenger transport company to be established during the reorganisation of MÁV Zrt, as opposed to 0.2% in 2006. Furthermore, as a one-off item, the Government will provide a capital injection to MÁV for the organisational reform, the setting-up of the new companies in 2007 and 2008 (amounting to 0.4% and 0.1% of GDP, respectively). The companies established in the framework of reorganisation, providing services to the public under reduced-scope service agreements and operating more efficiently, will be able to finance their debt without resorting to government funding.

Improving the legislative framework: reducing the administrative burden and deregulation

Administrative burden will be reduced as a result of the continuous and systematic review of the effective legislation, resulting in alleviating the unnecessary burdens on households and businesses and reducing unwarranted bureaucracy in public administration. In this context, ministers will review the legal regulations containing regulatory procedures within their competence with a view to reducing administrative burdens and computerising procedures, and they will start the deregulation of certain legal norms. Further reduction of administrative burdens is expected, in case of burdens resulting from EU regulations, from programmes to be implemented by the Commission.

Legal obstacles will be removed in respect of the most frequently used 20 (in the case of Hungary: 27) public services as defined in the communication of the Commission to reduce the related administrative burdens. In order to provide comprehensive IT support to public services, operation flow models must be devised and they must be taken into account during legislative procedures.

A clear, transparent, balanced system of high quality legislation, relying on broad social consensus and corresponding to the prevailing social structures, will evolve by the mandatory and consistent enforcement of procedures assuring high quality legislation and the application of monitoring procedures to support legislation. In order to prevent the increase of administrative burdens and to assess the potential social, economic and environmental impact of legal regulations, multi-aspect impact assessments and the measurement of administrative burdens will be compulsory already in the stage of legislative preparation in accordance with the methodological guidelines provided.

5. Institutional features of public finances

5.1 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.

Timetable of the budget process

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

5.2 Public finance statistical governance

The Hungarian Central Statistical Office (CSO) and the National Bank of Hungary (NBH) compile the statistics on the government sector. In the current division of labour, the CSO 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 CSO, 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 was updated in September 2006 and published on the MoF's and CSO'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.

The HCSO prepares national account of the years 2002-2006 in which the mandatory funded pillar of the pension system will be classified outside the general government sector by April 2007, by the first notification in 2007.

5.3 Fiscal rules, independent institutions supporting budgetary planning

Fiscal rules

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.

The amendment 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’ to be set aside by budgetary chapters and the other one is a quarterly reporting obligation of the ministers responsible for the chapter on the outcome of the revenues and expenditures and their projected development to the Government. When submitting the draft budget, the Government put forward proposal on the amount of the chapter balance reserve in each chapter. The reserves 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 balance reserve not approved for utilisation may be withdrawn.

Further amendment of the Act on public finance is expected to be adopted by the Parliament in parallel with the discussion of the draft budget of 2007. According to this amendment, the draft budget submitted by the government each year should be consistent with the assumption that the Maastricht primary balance is zero or positive This does not override the rule already submitted to Parliament in the 2007 draft budget prescribing a primary surplus of 0.9% and 1.1% of GDP in 2008 and 2009, respectively (see chapter 3.3).

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.

Annexes

Annex 1: Revenue measures

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 increased to 20%;
  - the deductible portion of VAT on telephone charges increased from 50% to 70%.
- Pursuant to the obligation of harmonising excise laws
  - excise duty on cigarettes increased by 5.7%;
  - excise duty on alcohol and all alcoholic beverages (except for wine) increased 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 increased from 44% to 54%;
  - the rate of tax on income from interest and stock exchange deals changed from 0% to 20%.
- In order to approximate the tax charges on income earned in various forms, the rate of simplified business tax increased from 15% to 25% from October 2006.
- In order to improve the balance of the budget corporate businesses and individual entrepreneurs pay a special tax of 4% on their adjusted profit before taxes.
- Individual health insurance contribution increased from 4 to 6%.
- Both the employer's and the employee's health insurance contribution were divided by each risk: of the 11% employer's health insurance contribution, 7% is health insurance contribution in kind and 4% is pecuniary health insurance contribution, while out of the 6% individual health insurance contribution, 4% is health insurance contribution in kind and 2% is pecuniary health insurance contribution.
- Pensioners who are in employment 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) pay a health care service contribution of 10%.
- Persons who are not insured but have income pay 15% health care service contribution.
- The minimum base for contributions was introduced for employers and full-time individual and incorporated entrepreneurs (meaning that as the main rule, contributions 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 verifies 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 increased from 1% to 1.5% from 1 September 2006.
- The duty payable on the purchase of cars and trailers increased by some 20%.

As of 1 November 2006

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

Major changes applicable *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.
- Provisions which do not result less revenue on the whole and aiming at EU harmonisation will be incorporated in the expected corporate tax and special tax of corporations, from 2007.
- 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.
- 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 5% annuity on interest income from loans associated with state subsidies.

- In order to stimulate investment and R&D, without affecting substantially revenues from special tax, the tax base of the 4% special tax can be reduced by the direct cost of R&D, and by the capital gain on the sale of reported shares.
- 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%.
- 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 (pay-as-you-go pillar), 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%.

As of 1 April 2007

- New entitlements for early retirement for people working in jobs with potential health hazards will be linked to a special contribution to be introduced for employers of such people and the self-employed working in such jobs. The base of the early retirement contribution is equal to that of the social security contribution; its rate is 13%. In 2007, payment of this contribution will be undertaken by the central budget from the employers in its full amount and later in a decreasing proportion until end 2010.
- People working while in retirement are required to pay 8.5 per cent pension contribution on the basis of their income which is liable to contribution payment according to the general rules.
- Dependent people supported by close relatives will be required to pay health service contribution in order to acquire eligibility for in-kind health services. In the case of people who are neither insured nor entitled to health services under any other arrangements, the base of the payment obligation will be the national minimum wage; its rate will be 9 per cent.
- The eligibility period of the so called passive sick-pay (payable after discontinued insurance relationship) falls to 45 days.

In accordance with legislation adopted by Parliament, local income tax will not be terminated in *2008,* and the 2 per cent point reduction of the employer's social security contribution assumed under the convergence programme of December 2005 will not take place in *2009*.

Annex 2: **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%. ▪ Act LV. 2006 on enumeration of Ministries of the Republic of Hungary provided for the reduction of the number of Ministries. ▪ Government decree 2117/2006 (VI. 30.) on the number of employees in Prime Minister Office, Ministries and central budgetary administration institutions ordered the reduction of the staff. **1.b)** Centralisation of parallel functional areas – HR, IT, asset management, operations. ▪ Government decree 2118/2006 (VI. 30.) on restructuring of the public administration in order to improve the effective operation of the general government and on the measures which ensure their implementation.	1.a) completed 1.b) 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. ▪ Government decree 2118/2006 (VI. 30.) on restructuring of the public administration in order to improve the effective operation of the public finances and on the measures which ensure their implementation.	Decision: completed Implementation: 2007
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. ▪ I. and II. set of amendments of the so called 'status laws' (Act XXIII. 1992. on civil servants, Act XXXIII. 1992. on public servants, Act XLIII 1996., Act XCV. 2001.) and the Act XXXVIII. 1992. on public finance	Submission of bills to Parliament: 2006 and first half of 2007
4.) Introduction of a selection system based on competitive examination. ▪ I. and II. set of amendments of the so called 'status laws'	Submission of bill to Parliament: 2006
5.) Financial incentives to associations of local governments to reach reasonable economies of scale in public administration. ▪ T/1145 draft budget for 2007	Submission of bill to Parliament: 2006 Completed
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
8.) Revision of the regional classification.	First half of 2007
9.) Relocation of notary duties in the public administration to the notary of the capital of the micro-region	Submission of bill to Parliament: 2007

II. Local government tasks and financing

Measure	Timing
1.) 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 cooperation of micro-regions, this is particularly relevant in public education, public administration and the maintenance of social institution. ▪ T/1145 draft budget for 2007	Submission of bill to Parliament: 2006 Completed
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. ▪ T/1145 draft budget for 2007	Submission of bill to Parliament: 2006 Completed
3.) The introduction of value-based real estate taxation will reinforce the financial independence of local governments.	Submission of bill to Parliament: 2007 Implementation starting in 2008
4.) Introduction of central capacity regulation in case of certain tasks within public services (education, social care, child protection). Introduction of the ascending system in the public education from 2007. ▪ Act LXXIX. 1993 on public education, Act III. 1993. on social transfers, Act XXXI. 1997. on chid protection	Submission of bill to Parliament: 2007
5.) Measures reinforcing the fiscal discipline in local government. ▪ Bill amending Act XXXVIII. 1992. on public finance	Submission of bill to Parliament: 2006 Completed
6.) Streamlining the controlling system of the local government. ▪ Act. LXV. 1990. on local governments	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[11]. In the absence of these, only basic services such as ambulance, emergency, mother and child protection and epidemiology can be used. ▪ T/1297 bill on certain financial type laws, and T/1093 draft bill on the amendment of certain laws on healthcare concerning healthcare reform	Submission of bill to Parliament: 2006 completed

[11] 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
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. ▪ T/1093 bill on the amendment of certain laws on healthcare concerning healthcare reform	Submission of bill to Parliament: 2006 completed
3.) Introduction of professional and financing protocols (patient routes) in order to streamline the use and provision of services. ▪ T/1093 bill on the amendment of certain laws on healthcare concerning healthcare reform	Submission of bill to Parliament: 2006 Completed
4.) The subsequent (higher) level of service can typically be used based on a referral issued at the lower levels ▪ T/1093 bill on the amendment of certain laws on healthcare concerning healthcare reform	Submission of bill to Parliament: 2006 completed
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. ▪ T/1375 bill on the development of healthcare provider system	Submission of bill to Parliament: 2006 completed
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. ▪ T/1375 bill on the development of healthcare provider system	Submission of bill to Parliament: 2006 Completed
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. ▪ T/1035 bill on surveillance of activities in the field of health protection	Submission of bill to Parliament: 2006 Completed
9.) Co-ordination of basic care (family doctors) on the micro-regional level.	Submission of bill to Parliament: 2007
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

The measures in the table below are included in the Act on the general rules of the safe and economical supply of pharmaceutical and medical aids as well as pharmaceutical dealers, which was adopted by Parliament on 20 of November 2006.

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.	Introduction: 2007
2.) Gradual liberalisation of the opening of pharmacies, the current monopolistic constraints removed.	Introduction: 2007
3.) The sale of non-prescription drugs will be allowed for a broad group of entities.	Introduction: 2007
4.) The "fixing" of the subsidy will become general, at the level of the subsidy to the cheapest benchmark product.	Introduction: 2007
5.) The criteria for remaining in the subsidised pharmaceutical category will become more stringent.	Introduction: 2007
6.) The government is invited to make rules stipulating effective and quality subscription of pharmaceuticals and medical aids. (Instead of individual prescription limit for family doctors.)	Introduction: 2007
7.) The new rules will assure that patients leaving hospitals are prescribed generic products as a rule (unless there is a counter-indication).	Introduction: 2007
8.) The comprehensive regulation, transparency and publicity of the process of acceptance for subsidisation, classification, fixing, volume rules and purchasing.	Introduction: 2007
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).	Introduction: 2007

V. Pension system

Measure	Timing
1.) The terms of retirement before the statutory retirement age (62) will not change. As from 2013, the age of eligibility for early old-age retirement benefits will change. ▪ Act on amending the act LXXXI of 1997 on social security pension provision and some related acts	Act passed by Parliament
2.) The regulation will make it clear that early retirement is an allowance, and income earning activity can be pursued while in that status to the extent of the national minimum wage only. ▪ Act on amending the act LXXXI of 1997 on social security pension provision and some related acts	Act passed by Parliament

Measure	Timing
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. ▪ T/1304 bill on amending the act LXXXI of 1997 on social security pension provision	Submission of bill to Parliament: 2006 (submitted)
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: 2007
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. ▪ T/1296 bill on amending acts in connection with government budget of 2007 ▪ Act on amending the act LXXXI of 1997 on social security pension provision and some related acts	Submission of bill to Parliament: 2006 (submitted), and Act passed by Parliament, respectively
6.) Various anomalies of the pension award rules will be eliminated (valorisation, netting). ▪ Act on amending the act LXXXI of 1997 on social security pension provision and some related acts	Act passed by Parliament
7.) The suspension of early retirement pensions in the case of income earning activity with income above the national minimum wage will be applicable to all early retirement pensions as of 2010. ▪ Act on amending the act LXXXI of 1997 on social security pension provision and some related acts	Act passed by Parliament

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 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.	Submission of bill to 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. ▪ Act LXXIX. 1993.on public education	Completed
2.) Simplification of employment rules (more rational work organisation). ▪ First set of amendments of the so called 'status laws'	Submission of bill to Parliament: 2006
3.) Establishment of the regulatory conditions of performing tasks in associations (micro-region level). ▪ Act LXXIX. 1993.on public education	Completed
4.) Financial incentives to the establishment of more efficient school structures (member institutions, consolidated schools, micro-regional association). ▪ T/1145 draft budget for 2007	Submission of bill to Parliament: 2006 Completed
5.) In the financing of local government (), the normative grant system of public education is changing: Funding based on normative system, 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 must be taken into account. ▪ T/1145 draft budget for 2007	Submission of bill to Parliament: 2006 Completed
6.) Reform of the regulatory and financing system of basic arts education in order to reduce the state's obligations. ▪ T/1296 bill on certain amendments of laws substantiating budget bill of 2007	Submission of bill to Parliament: 2006 Completed
7.) Elimination of unjustified differences in the burden sharing ratios of different institution maintainers (government, non-government, capital city, rural). ▪ T/1145 draft budget for 2007	Submission of bill to Parliament: 2006 Partially completed
8.) Improvement of measurement-assessment, publication of results, preparation of league tables. ▪ Act LXXIX. 1993.on public education	Submission of bill to Parliament: First half of 2007
▪ **9.)** Targeted measures in order to increase low employment rate (early monitoring (at the ages 0-6 years), basic skills, reform of teacher formation, assessment of schools, restructuring the financing of the public education based on performance, revision of the vocational training system, reducing segregation)	Submission of bill to Parliament: 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. ▪ Act CXXXIX 2005. on higher education	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.	Submission of bill to Parliament: 2007
4.) The requirements relating to the quality assurance system will be reconsidered and tightened. ▪ Act CXXXIX 2005. on higher education	Submission of bill to Parliament: 2007
5.) Parallel forms of education will be restricted or eliminated.	Review: 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). ▪ 1108/2006 (XI. 20.) government decree	Completed
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.	Submission of bill to Parliament: 2007 Implementation starting in 2008
3.) The collection of duties is 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

X. Improving the legislative framework: reducing the administrative burden and deregulation

Measure	Timing
1.) Reduction of the administrative burden on individuals and enterprises and deregulation through taking stock of legislation in effect.	First set of amendments: March 2007
2.) Preparation of workflows of basic public services identified in Communication of the European Commission (COM/2001/01410 final) and the full-scale introduction of e-administration.	2007
3.) Deregulation, quality legal regulation, compulsory use of impact studies, working out a framework for the professional discussion with bodies outside the public sector, IT system supporting the process of the legislation and ensuring a better access to legal documents.	30 June 2008
4.) Broad and systematic revision of public services (central and local): ▪ the scope and range of public services, reasonable role of the state ▪ differentiation and definition of the levels of public services (central, regional, micro-regional, local) ▪ the provision of public services (through own budgetary institutions, or other profit oriented/non-profit actors) ▪ using the economy of scope in the public services provided by public institutions The proposals resulted by this revision will be incorporated in the legislative programme of the government, and thus contribute to the containment of the expenditures in the budget of 2008.	Revision: First half of 2007 Implementation: Second half of 2007

Table 1

Macroeconomic prospects

	ESA code	2005	2005	2006	2007	2008	2009	2010
		HUF bn	percentage change					
1. Real GDP at 2000 prices	B1g	22026.8	4,2	4,0	2,2	2,6	4,2	4,3
2. Nominal GDP	B1g	22026.8	6,3	7,3	7,0	5,1	7,3	7,3
Components of real GDP								
3. Private consumption expenditure	P3	11827.0	3,7	3,1	-0,6	0,7	2,1	3,0
4. Government consumption expenditure	P3	5 352,4	2,5	0,8	-1,6	-2,9	1,2	1,6
5. Gross fixed capital formation	P51	4 995,3	5,6	2,8	2,4	4,0	7,5	6,8
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52 + P53	157,8	0,7	0,2	0,6	0,7	0,7	0,7
7. Exports of goods and services	P6	14 626,2	11,6	14,3	10,6	9,7	9,4	9,3
8. Imports of goods and services	P7	14 932,0	6,8	11,1	8,1	7,5	8,6	8,9
Contribution to real GDP growth								
9. Final domestic demand		-	3,8	2,5	-0,2	0,6	3,1	3,4
10. Changes in inventories and net acquisition of valuables	P52+ P53	-	-2,4	-0,5	0,5	0,0	0,0	0,0
11. External balance of goods and services	B11	-	2,8	2,0	1,9	1,9	1,0	0,8
Price developments								
12. GDP deflator		-	2,0	3,2	4,8	2,4	3,0	2,9
13. Private consumption deflator		-	3,6	3,9	6,2	3,3	3,0	2,8
14. HICP		-	3,6	3,9	6,2	3,3	3,0	2,8
15. Public consumption deflator		-	4,8	6,6	1,6	-0,7	1,7	2,5
16. Investment deflator		-	2,2	5,5	5,5	3,3	3,3	3,3
17. Export price deflator (goods and services)		-	-0,4	6,9	2,8	1,0	1,0	1,0
18. Import price deflator (goods and services)		-	1,1	8,8	2,6	0,9	0,9	0,9
Labour market developments								
19. Employment ('000)		3 901,5	0,0	0,6	0,0	0,3	0,7	0,7
20. Unemployment rate (%)		-	7,2	7,4	7,5	7,4	7,3	7,2
21. Labour productivity, persons		-	4,1	3,4	2,2	2,2	3,5	3,6
22. Compensation of employees	D.1.	10 171,9	7,1	6,7	6,6	3,8	5,7	6,4
Sectoral balances (in percent of GDP)								
23. Net lending/borrowing vis-à-vis the rest of the world	B.9.		-6,0	-6,1	-3,6	-1,7	-0,1	0,6
of which:								
- Balance of goods and services			-0,8	-0,2	1,7	3,5	4,4	4,9
- Balance of primary incomes and transfers			-6,0	-6,7	-6,7	-6,8	-6,7	-6,4
- Capital account	B.9./ EDP B.9.		0,8	0,8	1,4	1,6	2,2	2,1
24. Net lending/borrowing of the private sector	B.9.		1,8	4,0	3,2	2,6	3,1	3,3
24a. of which: statistical discrepancy			0,5	..	..	..	..	..
25. Net lending/borrowing of general government	B.9.		-7,8	-10,1	-6,8	-4,3	-3,2	-2,7

Table 2

General government budgetary prospects

	ESA code	2005	2005	2006	2007	2008	2009	2010
		HUF bn	Percentage of GDP					
Net lending (EDP B.9) by sub-sector								
1. General government	S.13.	-1 719,2	-7,8	-10,1	-6,8	-4,3	-3,2	-2,7
2. Central government	S.1311.	-1 164,2	-5,3	-8,8	-6,5	-3,7	-2,7	-2,1
3. State government	S.1312.	-	-	-	-	-	-	-
4. Local government	S.1313.	-100,7	-0,5	-0,8	-0,4	-0,4	-0,5	-0,6
5. Social security funds	S.1314.	-454,3	-2,1	-0,6	0,0	-0,2	-0,1	0,1
General government (S13)								
6. Total revenue	TR	9 300,6	42,2	41,9	43,1	43,0	43,4	42,8
7. Total expenditure	TE[1]	11 019,8	50,0	52,0	49,9	47,2	46,6	45,5
8. Net lending/borrowing	EDP B.9.	-1 719,2	-7,8	-10,1	-6,8	-4,3	-3,2	-2,7
9. Interest expenditure (incl. FISIM)	EDP D.41.+ FISIM	905,7	4,1	3,9	4,4	4,3	4,1	3,8
pm: 9a. FISIM		5,3	0,0	0,1	0,1	0,1	0,1	0,1
10. Primary balance		-813,5	-3,7	-6,2	-2,4	0,0	0,9	1,1
Selected components of revenues								
11. Total taxes		5 421,3	24,6	24,1	25,0	25,0	24,6	24,5
11a. Taxes on production and imports	D.2.	3 416,2	15,5	14,8	14,9	14,7	14,3	14,1
11b. Current taxes on income, wealth, etc	D.5.	1 984,2	9,0	9,2	10,0	10,2	10,3	10,4
11c. Capital taxes	D.91.	20,9	0,1	0,1	0,1	0,1	0,1	0,1
12. Social contributions	D.61.	2 777,8	12,6	12,4	13,1	12,9	12,6	12,5
13. Property income	D.4.	178,8	0,8	0,8	0,7	0,6	0,5	0,5
14. Others (14=15-(11+12+13))		922,7	4,2	4,6	4,3	4,5	5,6	5,4
15.=6. Total revenue	TR	9 300,6	42,2	41,9	43,1	43,0	43,4	42,8
Tax burden (D.2.+D.5.+D.61.+D.91.-D.995.)		8 199,1	37,2	36,5	38,1	37,8	37,3	37,0
Selected components of expenditure								
16. Collective consumption	P32	2 169,4	9,8	10,0	9,4	8,6	8,3	8,1
17. Total social transfers	D.62 + D.63.	5 986,4	27,2	28,4	27,1	26,6	25,6	24,8
17a. Social transfers in kind	D63	2 784,0	12,6	13,2	12,0	11,7	11,1	10,8
17b. Social transfers other than in kind	D62	3 202,4	14,5	15,2	15,1	15,0	14,5	14,0
18.=9. Interest expenditure (incl. FISIM)	D41+ FISIM	905,7	4,1	3,9	4,4	4,3	4,1	3,8
19. Subsidies	D3	297,0	1,3	1,2	1,3	1,3	1,2	1,1
20. Gross fixed capital formation	P51	876,9	4,0	4,8	3,5	3,0	3,9	4,0
21. Other (21=22-(16+17+18+19+20)		784,4	3,6	3,7	4,1	3,4	3,5	3,7
22=7. Total expenditure	TE[1]	11 019,8	50,0	52,0	49,9	47,2	46,6	45,5
Pm: compensation of employees	D.1.	2 770,9	12,6	12,0	11,4	10,5	10,2	10,0

[1] corrected with the net effect of the swap transactions TR-TE=EDP B.9.
Due to the rounding the sum data could differ from the sum of the detailed data

Table 3

General government debt developments

Percentage of GDP	ESA code	2005	2006	2007	2008	2009	2010
1. Gross debt		61,7	67,5	70,1	71,3	69,3	67,5
2. Change in gross debt		5,8	10,0	7,0	4,6	2,9	2,9
Contributions to changes in gross debt							
3. Primary balance		3,7	6,2	2,4	0,0	-0,9	-1,1
4. Interest expenditure (incl. FISIM)		4,1	3,9	4,4	4,3	4,1	3,8
5. Stock-flow adjustment		-2,0	-0,1	0,2	0,3	-0,3	0,2
of which: privatisation receipts		-0,1	-1,1	-0,2	-0,1	0,0	0,0
Implicit interest rate on debt (%)		7,0	6,2	6,6	6,3	6,0	5,7

Table 4

Cyclical developments

Percentage of GDP	ESA code	2005	2006	2007	2008	2009	2010
1. Real GDP growth at 2005 prices (%)		4,2	4,0	2,2	2,6	4,2	4,3
2. Net lending of general government	B9	-7,8	-10,1	-6,8	-4,3	-3,2	-2,7
3. Interest expenditure (incl. FISIM recorded as consumption)	D41 + FISIM	4,1	3,9	4,4	4,3	4,1	3,8
4. Potential GDP growth (%)		4,0	4,1	4,0	3,9	3,9	3,8
contributions:							
- labour		0,3	0,4	0,4	0,3	0,2	0,2
- capital		1,8	1,8	1,8	1,9	1,9	1,9
- total factor productivity		1,9	1,8	1,8	1,7	1,7	1,6
5. Output gap		1,3	1,2	-0,6	-1,8	-1,5	-1,0
6. Cyclical budgetary component		0,3	0,3	-0,2	-0,5	-0,4	-0,3
7. Cyclically-adjusted balance (2-6)		-8,1	-10,4	-6,7	-3,9	-2,8	-2,5
8. Cyclically-adjusted primary balance (7-3)		-4,0	-6,5	-2,3	0,5	1,3	1,4

Table 5

Divergence from Convergence programme September 2006

		2005	2006	2007	2008	2009	2010
Real GDP growth (%)							
Previous update		4,1	4,1	2,2	2,6	4,1	4,3
Current update		4,2	4,0	2,2	2,6	4,2	4,3
Difference		0,1	-0,1	0,0	0,0	0,1	0,0
General government net lending (% of GDP)							
Previous update		7,5	10,1	6,8	4,3	3,2	2,7
Current update		7,8	10,1	6,8	4,3	3,2	2,7
Difference		0,3	0,0	0,0	0,0	0,0	0,0
General goverment gross debt (% of GDP)							
Previous update		62,3	68,5	71,3	72,3	70,4	68,5
Current update		61,7	67,5	70,1	71,3	69,3	67,5
Difference		-0,6	-1,0	-1,2	-1,0	-1,1	-1,0

Table 6

Long-term sustainability of public finances

Percentage of GDP	2000	2005	2010	2020	2030	2050
Pension expenditure (net)[1]	9,1	10,4	10,3	10,7	10,7	13,5
Old-age and early pensions[2]	6,7	8,0	7,9	9,6	9,8	12,6
Other pensions (disability, survivors)	2,4	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	6,9	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	4,2	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	57,7	61,5	62,6	61,3
Total participation rate (15-64)	59,9	61,4	63,4	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	2010
Hungary: short-term interest rate (annual average)	6,8	6,8	8,2	7,0	6,1	5,2
Hungary: long-term interest rate (annual average)	6,6	7,2	7,2	6,6	5,9	5,5
HUF/EUR exchange rate (annual average)	248,1	266,5	271,0	271,0	271,0	271,0
World excluding EU, GDP growth	5,6	5,7	5,2	5,2	5,0	5,0
EU GDP growth	1,7	2,8	2,4	2,4	2,2	2,2
Growth of foreign markets of Hungary	6,4	9,3	6,6	6,7	6,4	6,4
World import volumes, excluding EU	7,3	8,8	8,2	7,7	7,5	7,5
Oil prices (Brent, USD/barrel)	54,1	68,9	71,0	70,0	70,0	70,0