GOVERNMENT OF THE REPUBLIC OF HUNGARY

UPDATED CONVERGENCE PROGRAMME OF HUNGARY

2007-2011

Budapest, November 2007

Contents

In line with the requirement of EU membership, Members States submit stability programmes, and Member States, which have not yet adopted the euro submit convergence programmes to the Commission and the Council each year.

The programme is the updated version of the December 2006 convergence programme. During 2007 the Government published two reports, in April and September, on the progress of the implementation of the December 2006 convergence programme. The progress reports gave detailed information on the budgetary development for 2007 and progress in structural reform. The updated programme covers the period 2006 to 2011.

The Government consulted on the draft of the updated programme with the Economic Committee of the National Interest Reconciliation Council on 22 November. The updated programme, which was adopted by the Government on its meeting of 28 November 2007, is based on the draft 2008 budget law, the amendments submitted to the bill and the most recent macroeconomic projection.

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 updated 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 updated the programme.

1. Macroeconomic objectives and forecast

1.1. External assumptions

For the long-term forecast of the international environment, the updated convergence programme relies on the European Commission's 2007 Autumn Forecast. Accordingly, despite high oil prices, and decelerating growth in the United States, the global economic environment will remain favourable, mostly due to the performance of developing countries. In 2007, a 5.6% world economic growth is expected; that rate is to decelerate to 5.3% in 2008, then strengthen again slightly in 2009.

On the other hand, according to the Commission's forecast, the European Union has passed the peak of the economic cycle, thus a slow-down is expected in 2008-2009. Growth in the EU is expected to slow from 2.9% in 2007 to 2.4%, close to its potential level, in 2008-2009, as a result of stricter financing conditions and declining domestic demand confidence. Based on the expected labour market developments outlined in the autumn forecast of the Commission, a marked expansion of consumption, at 2.25%, is to be expected in the forthcoming period. At this time, the effect of financial conditions on consumer confidence is unclear. Importantly for Hungarian export prospects, the Commission forecast projects higher growth in the new Member States than in the old ones throughout the projection horizon.

1.2. Cyclical developments

Between 1997 and 2005, the annual GDP growth rate was around 4.5% on average. From 1999 onwards, the actual output was higher than the potential output, resulting in a positive output gap, which persisted until 2006. Actual growth is expected to slow down significantly in 2007 and 2008 as a result of the fiscal consolidation measures, and actual output will drop below its potential level. From 2009, the actual growth rate is expected to rise to its level prevailing before 2007, but the actual output level will not reach the potential one up to 2011, leaving the output gap negative over the time horizon of the updated convergence programme.[1]

Cyclical position

	2006	2007	2008	2009	2010	2011
GDP at 2005 prices (growth rate, %)	3.9	1.7	2.8	4.0	4.1	4.2
Potential GDP (growth rate, %)	4.0	3.8	3.7	3.6	3.6	3.7
Contributions:						
Labour	0.4	0.4	0.3	0.3	0.2	0.2
Capital	1.7	1.6	1.6	1.6	1.7	1.7
Total factor productivity (TFP)	1.9	1.8	1.8	1.7	1.7	1.7
Output gap	**1.2**	**-0.9**	**-1.8**	**-1.5**	**-0.9**	**-0.5**

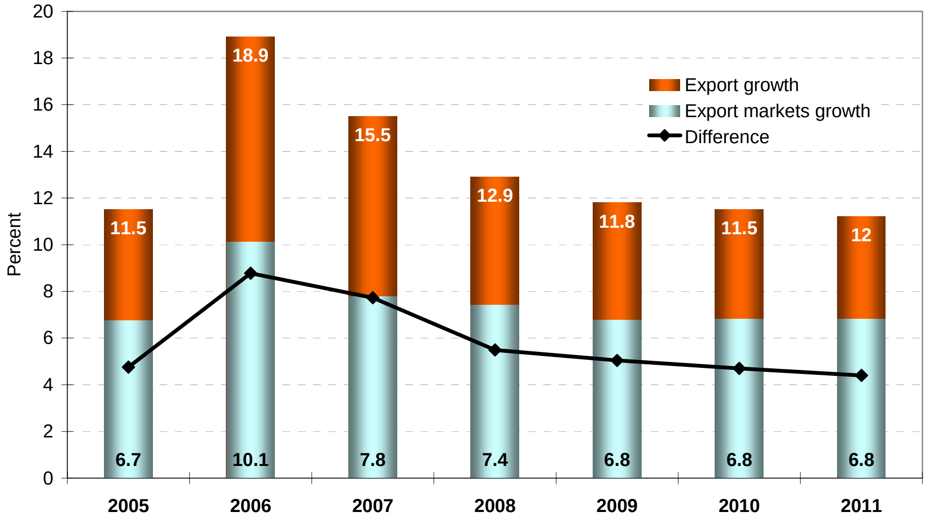
[1] Following the methodological recommendation of the European Commission, the potential GDP has been estimated using the Cobb-Douglas production function. The calculations have been based on the values of macroeconomic parameters projected up to 2011. The recent forecast of potential output is slightly lower than that in the December 2006 convergence programme due to the temporary slow-down of the growth of capital stock.

1.3. External demand and exports

For determining the demand for Hungarian exports, the import demand of the developed countries most important for Hungary's exports, and of major Eastern European countries, has been taken into account, relying on the European Commission's 2007 Autumn Forecast. On this basis, Hungary's export markets will expand by close to 8% in 2007, and at a slower rate of around 7% in 2008-2009.

The export projection is primarily based on the prognosis of external demand. The growth of Hungarian exports has exceeded the expansion of the export markets for years, but the growth differential is expected to decrease in the longer term as the convergence process progresses. Besides the EU-15 Member States – especially Germany – the share in exports of the new Member States and other non-EU European countries has increased significantly in the past few years. Trade with the new Member States is expected to grow at a record rate in 2007, and it will continue to play a major role in the export growth prospects of Hungary in 2008-2009.

The growth rate of exports and export markets



Partly relating to shrinking domestic demand, the gap between the export and import trends of monthly foreign trade turnover in euro terms practically disappeared in 2007, thus by the end of the year, the trade balance may be 1.5 billion euros better than in 2006. While in 2006 foreign trade was characterised by worsening terms of trade, in 2007 more favourable trends emerged; the figures of the first nine month indicate that the terms of trade remained unchanged. The structure of exports was also favourable in 2007, export growth being dominated by machinery and transport equipment. Deterioration in terms of trade is expected in the forthcoming years, which trend may be aggravated by high oil prices in 2008-2009. On the whole, the steeper-than-expected increase of oil prices represents an upside risk for import prices. In 2008-2009, the growth of imports is expected to be 0.8-1.8 percentage points lower than that of exports, while the contribution of net exports to growth will remain positive throughout the forecast horizon. From 2009 on, import growth will come close to export growth because of the somewhat stronger expansion of domestic use.

1.4. Employment

The Government intends to maintain an employment policy that enhances the willingness of the working age population to participate in the labour market, while at the same time promotes job creation. The attainment of that objective in the short term is hindered temporarily by the fiscal adjustment measures, but from 2008 on, when no layoffs will be implemented in the public sector and economic growth picks up, job creation may come to the fore again.

In 2007, as a result of the adjustment measures, employment in the budgetary institutions has been reduced considerably, by some 4-5%, and only a moderate expansion is projected in the private sector, due to the slow-down of economic growth. On the whole, the number of employed persons is expected to rise slightly, with the private sector practically absorbing the manpower laid off in the public sector, and the employment in the non-profit sector has also expanded.

The carry-over effect of the layoffs in the budget sector will remain perceivable in 2008 as well, thus only a modest improvement is expected in the number of employed persons next year. By the second half of the period – between 2009 and 2011 – an increase of employment can be anticipated as economic growth picks up.

The tightening of the conditions of retirement effective from 2008 may lead to increased inactivity at end-2007 and early in 2008. Based on current trends, the rise in the number of inactive persons is accompanied by a decrease in the number of the unemployed, thus the unemployment rate in 2007 may be around 7.3% instead of 7.5% projected earlier. On the whole, alongside a moderate increase in the number of employed persons and a slight decline in the number of unemployed, the participation rate will remain unchanged in 2007, followed by an expected rise from 2008 on.

The Government intends to promote faster adaptation and employment growth by improving active labour market programs, passive employment policy instruments, implementing reforms in the pension system and developing the system of education and training.

In the context of the development of active labour market programs, the Act on Job Assistance and Unemployment Benefits (henceforward referred to as Act) was amended in December 2006. As a result of that amendment, the amount of the income supplement was increased to facilitate the more efficient promotion of labour market training. The new regulations promote the start-up of new enterprises by supporting jobseekers in becoming entrepreneurs or self-employed. As an important element, the legislation has changed the rules governing wage support to encourage the employment of disadvantaged persons: some of the former wage and contribution-type subsidies have been merged into the new form of support while others have been eliminated. The Act also facilitates the application of a new active instrument (wage cost support) in the framework of labour market programmes; furthermore, as of 1 January 2007, job creation grants were also introduced, as a new element, in conjunction with these programmes.

Over and above the support provided for in the Act, the employment of certain disadvantaged groups is promoted by the START programme, which was expanded, as of 1 July 2007, with the 'START Plusz' and 'START Extra' programmes, introducing eligibility for reduced contributions when hiring persons returning to the labour market from child care or after nursing close relatives, or when hiring long-term unemployed.

To enhance the willingness of the working age population to enter the labour market, the system of disability benefits will be reformed as of 1 January 2008. In June 2007, the Parliament adopted the Act on rehabilitation benefit, which also provides for the reform of the disability pension system. The rehabilitation benefit will be separated from the disability pension. From 2008 on, persons who, based on their health, have a good chance of returning to the labour market will be eligible for the rehabilitation benefit rather than the disability pension. The benefit will be payable for a given period because its primary objective is the re-integration of persons with altered working ability into the labour market; in addition to the benefit, complex rehabilitation services will also play a part in achieving that goal after the reform of the rehabilitation system. From 2008 onwards, the National Rehabilitation and Social Expert Institute will be responsible for examining health status, assessing working capacity and the potential for rehabilitation and it will provide personalised rehabilitation advice to assist labour market re-integration. Furthermore, the Public Employment Service will expand its active employment services (job seeking assistance, incentives for taking up employment, etc.) to recipients of the disability benefit.

In order to promote return to the labour market and to avoid the poverty trap, changes were introduced in respect of the regular social assistance on 1 January 2007. On the one hand, the ceiling of the regular social assistance was set at the net minimum wage. On the other hand, since 1 January 2007, the wages of beneficiaries participating in employment schemes organised by the local government can be supplemented to reach the amount of the former benefit.

Upon the amendment of the Act on family support entering into force on 1 January 2008, the family benefit, with eligibility as a citizen's right, will be increased in a differentiated manner in order to strengthen its effectiveness in reducing child poverty. While the benefit will be increased at the rate of inflation across the board, families at the greatest risk of poverty, such as those with three or more children, and single-parent families, will receive a higher increase.

The pension reform to be introduced on 1 January 2008 contains important elements to stimulate activity; even though in the short term it may temporarily increase inactivity, in the longer run it sets out to increase the labour market presence of the elderly by tightening the conditions of early retirement and raising the effective age of retirement.

Measures that have come into effect recently, or will enter into force shortly in the field of education and training, are intended to match labour demand and supply more effectively and to improve the quality of human capital. In this context, measures have been taken to improve the efficiency of education: by 2008, primary schools operating with fewer than 6 classes shall establish associations with other primary schools which have eight classes. Furthermore, mandatory performance assessment and measurement of students and teachers was introduced. In 2007, the statutory number of lessons of teachers in public education was increased and the normative subsidies to public education institutions was re-defined based on a composite performance index. Measures have been taken to increase the role of higher education in harmonising demand and supply: from September 2007, the Government reconsidered the maximum number of state-financed students in each specialisation and tried to adjust the quotas to economic and social requirements (more students can be admitted for technical, IT and mathematical studies, fewer for economic and law studies and teacher training). In addition, measures have been taken to promote life long learning. For instance, from 2007 on, small and medium sized enterprises can use 60% of the payable vocational training contribution towards the training of their own employees. In addition to the 16 regional integrated vocational training centres established through certain measures of the Human Resource Development Operational Programme of the 1st National Development Plan promoting region-specific vocational training, the New Hungary Development Plan (NHDP) aims to set up another 30-40 such institutions. By 2010, 80% of those participating in vocational training are expected to study in such institutions. As a result of the operation of the system of institutions, costs per student are expected to decrease, interconnectivity between training locations will improve, equality of opportunities will be enhanced, the drop-out rate will be reduced and the chances of finding jobs will increase.

Employment annual percentage change

	2006	2007	2008	2009	2010	2011
Employed persons	0.7	0.1	0.2	0.6	0.6	0.6
Productivity growth	3.1	1.6	2.6	3.4	3.5	3.5
Rate of unemployment, per cent	7.5	7.3	7.3	7.2	7.1	7.1
Participation rate, per cent	62.0	62.0	62.2	62.7	63.3	63.9
GDP growth	**3.9**	**1.7**	**2.8**	**4.0**	**4.1**	**4.2**

1.5. Incomes policy

The incomes policy of 2007 was considerably influenced by the adjustment measures adopted in mid-2006 to restore the general government balance. Households were affected mainly by the staff and wage cuts in the budget sector, the increased tax and contribution rates and the temporarily accelerating inflation.

The National Interest Reconciliation Council has agreed on a 5.5-8% gross average wage increase in the business sector for 2007. Based on the data to date, that recommendation will be exceeded (in part because of the "whitening" of the economy) as the annual average wage increase in this sector will be 9-10%. In the government sector, gross average wages will increase by 6% against the background of significant staff cuts. A smaller part of that increase relates to the carry-over effects of wage hikes implemented in 2006, the bulk being caused by the payment this year of half of the 13th month salary, originally due early in 2008. (The latter item does not affect ESA expenditures.) The real wages in the national economy calculated on the basis of net average earnings will be 4-5% lower than in 2006.

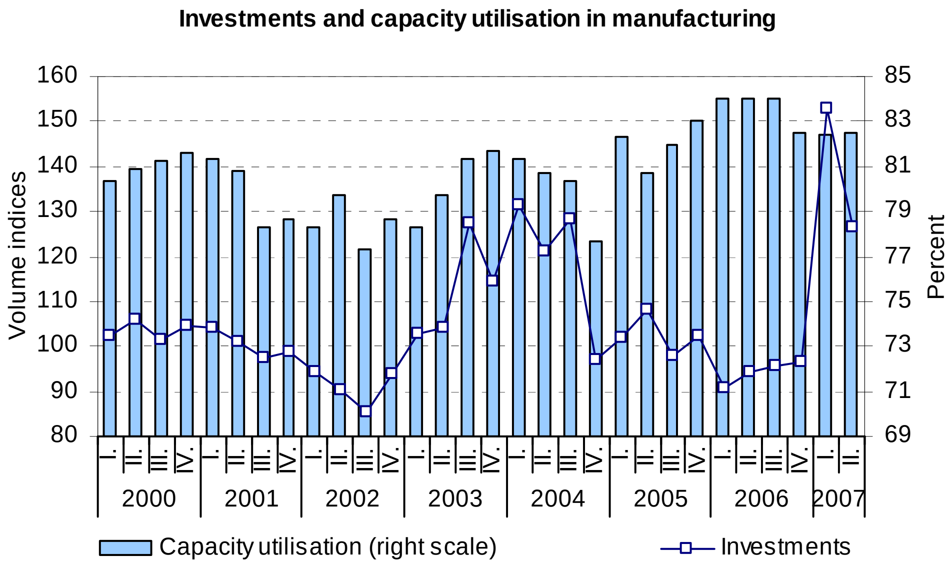
Wage negotiations for next year are ongoing. According to the macroeconomic projections, per capita real wages will stop declining in 2008, with some probability of a slight increase. With the regular annual increase, pensions will maintain their real value; indeed, corrective increases will be implemented for certain groups whose pensions were set in earlier time periods.

On the whole, the real income of households will be slightly higher in 2008 than this year. From 2009 on, declining inflation will allow real wages to increase at a gradually accelerating rate of 1.5-3% per annum both in the business and government sectors even if wage increases remain modest.

1.6. Investments

The dynamic productivity growth of the Hungarian economy, promoting fast real convergence, can be assured primarily by the continuous expansion and renewal of the capital stock. The improvement of the Hungarian economy's investment attracting capabilities continues to be a priority for the economic policy of the Government. This is promoted, inter alia, by the streamlining of administration, the reform of the vocational training system and continuous infrastructure development.

In 2006, investment growth in the national economy came to a temporary halt. In 2005-2006, controversial developments characterised the manufacturing sector: the historically high capacity utilisation (over 80%) was accompanied by low investment figures. This must have been attributable mostly to the uncertainties caused by the high general government deficit, which induced both corporations and foreign investors to “wait and see”. However, after the resolution of the temporary problems, a major correction may occur in manufacturing because of the correlation between capacity utilisation and investments. This phenomenon is already observable after the start of the fiscal adjustment, as manufacturing investments have started to pick up in 2007.



In recent years, the slow-down of corporate investments may have been due to the uncertainty of the economic environment as well as fiscal expansion. The excessive financing need of the increased government expenditures has tightened the financing conditions for the businesses. As a result of the fiscal adjustment measures and the continuation of the structural reforms, the deficit to GDP ratio will gradually decline from 9.2% in 2006 to 3.2% in 2009, which will be conducive to the restoration of the confidence of economic actors and the improvement of the economic environment. As a result of the fiscal consolidation, the financial resources increases and the interest conditions improves, which contributes to the lasting expansion of the corporate investments.

In the forthcoming period, investments are determined to a large extent by the EU funds available under the New Hungary Development Plan (NDHP). Under the operational programmes of the NHDP, new investment projects of around HUF 2800 billion may be commenced, partly through application schemes and partly in the form of 271 priority projects. The projects contribute primarily to the improvement of Hungary's competitiveness, to the expansion of existing capacities, to the improvement of the business environment and to the promotion of employment growth. Examples may include priority projects for the creation of the knowledge-based (innovative) economy, the improvement of access to capital of the SME sector, the development of industrial and logistics parks and the establishment of broad-band IT network infrastructure. Recent or ongoing projects under the Transport Operational Programme trigger a number of additional investment projects, contributing considerably to increasing labour mobility. The continuous expansion of the motorway network is promoted both by EU funds and by projects under PPP arrangements. Railway developments relate mostly to the upgrading of the main international railway lines to the country borders; furthermore, there are substantial funds available for the modernisation of equipments and the development of suburban rail transportation. The construction of Metro line 4 plays a major part in the infrastructure development of Budapest. A number of high-volume projects may be implemented also in the field of waste management, sewage treatment, flood protection and green energy. Major developments are expected in health care in order to improve the quality and efficiency of services.

In housing construction, a driving force of the investments of households, a recovery is expected from the second half of 2008 onward due to improving income prospects and declining financing costs. In the whole of the economy, investment growth will slow to around 2-4% in 2007-2008, to be followed, from 2009, by more dynamic growth relying on an increased use of EU funds and favourable financing conditions. Thus, by the end of the projection horizon, the investment ratio may gradually come close to the level prevailing in cohesion countries.

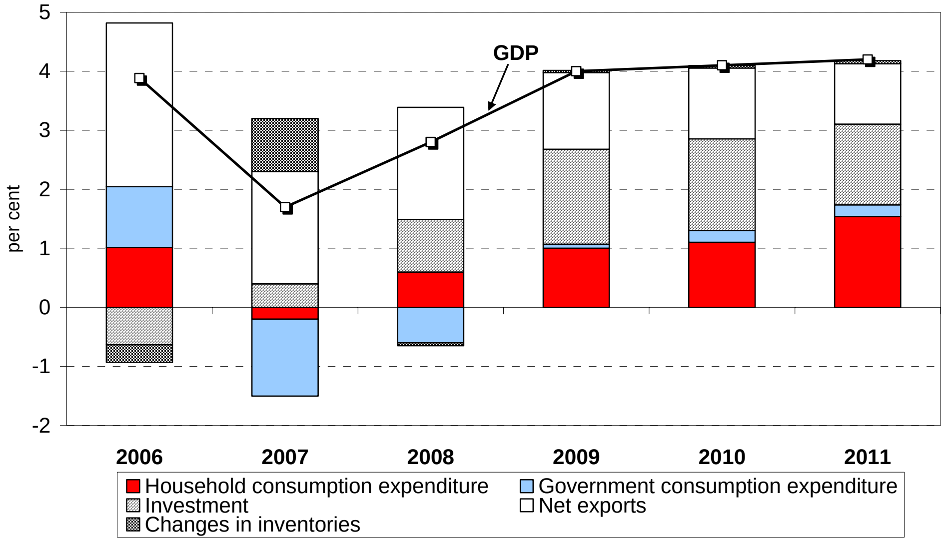
1.7. Components of growth

As a result of fiscal consolidation, from the second half of 2006, the Hungarian economy temporarily came to a slower growth path and the growth structure changed as well. In 2007-2008 domestic use will only slightly increase, while the export performance driven by the favourable economic situation on external markets will have a positive impact on Hungarian growth.

In the period of adjustment (2007-2008), the consumption expenditures of households may be slightly higher than envisaged in the previous convergence programme. This is attributable mostly to the stronger-than-expected consumption smoothing behaviour of households. Thus, despite the significant drop in real incomes due to the adjustment measures and accelerating inflation, consumption expenditures will barely decline this year, and a moderate growth may start already in 2008. The slow-down in domestic use is driven by the slump in government consumption. The more streamlined structure of public administration has a negative impact on government consumption, while the efficiency improving measures in education and healthcare have a similar effect on social transfers in kind. Investments in the national economy are expected to develop along the path forecasted earlier. The modest growth in investments is due to government expenditure cuts, while the willingness of the private sector to invest is growing. The over 10% export expansion of previous years will continue as a result of the favourable external economic environment, while import growth will increase below the export as a result of the low domestic demand. As the import demand of the economy declines, net exports will contribute significantly to GDP growth in 2007-2008.

The growth in 2007 will be affected negatively by the fact that adjustment measures and structural reforms caused considerably larger-than-expected decline in the output of the government sector (public administration, healthcare and education). As a result of the implementation of reforms in these sectors, GDP growth in 2007 is projected to be lower than envisaged in the previous convergence programme.

Contribution to GDP growth



Following fiscal consolidation, each element of domestic use is projected to pick up from 2009. Household's consumption expenditure will rise gradually as a result of their improved income position and the expansion of employment. Consumption growth will be slower than real income growth as the savings ratio of households increases gradually, resuming its pre-adjustment level by the end of the period. Government consumption will make a positive, albeit small, contribution to economic growth. As a consequence of the improved economic environment and more favourable financing conditions, investment growth will become more dynamic, which is underpinned by the increase of EU resources. The rate of import growth will approximate the growth of exports as a result of the expansion of investments, thus the contribution of net exports to GDP growth will become more modest. Based on these factors, economic growth may be permanently around 4% from 2009 onwards.

GDP components — annual percentage change

	2006	**2007**	**2008**	**2009**	**2010**	**2011**
Household consumption expenditure	1.9	-0.4	1.2	1.9	2.3	3.1
Social transfers in kind	2.7	-6.8	-2.3	0.0	0.8	1.2
Household consumption	2.1	-1.8	0.5	1.5	2.0	2.8
Government consumption	6.6	-3.7	-3.5	0.9	1.0	1.0
Investment	-2.8	2.0	4.2	7.4	7.0	6.0
Domestic consumption	**1.1**	**-0.3**	**0.9**	**2.8**	**3.1**	**3.4**
Exports (goods and services)	18.9	15.5	12.9	11.8	11.5	11.2
Total demand	8.1	6.6	6.5	7.3	7.5	7.6
Imports (goods and services)	14.5	13.2	11.1	11.0	11.1	11.1
GDP	**3.9**	**1.7**	**2.8**	**4.0**	**4.1**	**4.2**

1.8. External balance

The improvement of the current account balance due to real economic transactions will continue similarly to the previous years. The surplus of services is expected to increase mostly because of the robust growth of the exports of other services. In 2006, the balance of goods and services was already in surplus. The surplus will continue increasing throughout the programming period, first at a fast pace, then at a slower rate: by 2009, it may increase to 4.6% of GDP and by 2011, to around 5.3%. The balance of incomes is determined by the profits on foreign capital investments. In recent years, the stock of foreign direct investment in Hungary expanded at a fast pace; as a result, transfers of income on equity have increased continuously within the current account. (A part of this transfer shows up among the financing items in the form of reinvested earnings.) Altogether, the current account deficit as a percentage of GDP may decline steadily early in the period, by 0.7-0.9 percentage point on average annually. From 2009 on, the decrease in the current account deficit may be around 0.2-0.3 percentage point per year.

As a result of increasing EU transfers, the external financing need will decline faster than the current account deficit. By 2009, the annual external financing need may fall below 2% and it will continue improving due to the increasing amount of EU transfers. In 2007, the structure of financing will be modified considerably by one-off items in the private sector that worsen non-debt-creating financing. The ownership change of Budapest Airport reduced the equity investments of non-residents by EUR 1.9 billion, while the outflow of capital in equity portfolio investments may have been increased considerably by the purchases of own shares by MOL. In the forthcoming years, however, debt creating financing is expected to lose ground as the financing requirement of the government is reduced, with non-debt-creating financing increasing simultaneously. Direct capital investments into Hungary will climb slowly throughout the projection horizon as a result of the improved economic environment created by consolidation. In 2005-2006, foreign direct investments by Hungarian companies abroad rose dynamically. Such activity is expected in the forthcoming period as well, while, as investment opportunities become increasingly favourable within Hungary, its rate may be lower than in the past two years. Net foreign direct investments are estimated at around 2-2.5% of GDP throughout the period.

External financing need in per cent of GDP

	2006	**2007**	**2008**	**2009**	**2010**	**2011**
Balance of goods and services	0.4	2.5	3.9	4.6	5.1	5.3
Current account deficit	6.5	4.9	4.0	3.3	3.0	2.8
Capital account balance including EU transfers	0.8	0.8	1.6	1.5	1.7	2.0
External financing need	5.7	4.1	2.3	1.7	1.3	0.8
Debt-creating financing*	5.9	4.9	0.4	-0.4	-1.0	-1.8
Non-debt-creating financing	-0.1	-0.8	2.0	2.2	2.3	2.5
of which: net FDI	3.1	-0.5	2.0	2.1	2.3	2.4
of which: reinvested earnings	1.3	1.5	1.6	1.7	1.9	2.0

*/without other capital
Due to the rounding the sum data could differ from the sum of the detailed data

1.9. Inflation

The previous convergence programme indicated that certain fiscal consolidation would cause a temporary rise in the inflation rate from the second half of 2006. As a result of the abolition of the preferential VAT rate and other government measures, inflation rose to 6.5% by end-2006, with the annual average being 3.9%. Additional government measures (e.g., transformation of the household gas subsidy scheme and of the tariff and price subsidy system in long-distance transport, stricter pharmaceutical subsidy rules) have raised the inflation rate further in 2007. Meanwhile, as a result of the insufficient supply of agricultural products due to the extreme weather in the region and of the increasing international demand for agricultural products, agricultural product prices have increased considerably, generating substantive additional inflation in 2007 through food prices. As compared to the forecast in the December 2006 convergence programme, the higher-than expected price increase of foodstuffs will raise the annual average inflation by 1 percentage point, and the increase of automotive fuel prices by 0.4 percentage point this year. Inflation outcome has been favourably affected by the disinflationary effect of the strengthened Forint, while services inflation remained moderate throughout the year, as expected. Taking into account the expected price developments of the last months of the year, the annual average inflation rate is expected to be around 7.9% in 2007.

The updated convergence programme reckons with the halt of the fast agricultural price increases in the first half of 2008 as a result of the adjustment of domestic and regional supply, to be followed by extensive price cuts. Thus, in the second half of 2008, the food price index may fall rapidly even if agricultural prices fail to decline to their pre-shock levels; even so, additional inflation of a similar extent as this year should be expected, as an annual average, from the side of food prices. The marked increase of energy prices (oil, natural gas, petrol as well as electricity) will also add to inflation. The annual average rate of price increases will be around 4.8%, which is higher than forecast in the previous convergence programme.

The end of the agricultural price shock expected for the second half of next year means that in 2009, taking into account price statistical consequences, the annual average inflation rate will decline considerably. From 2009, the inflation path is expected to revert to the original trend, facilitating the attainment of the inflation target.

Tight monetary and fiscal policies as well as the low growth of household consumption and demand – and of aggregate demand in general – will moderate the rise of consumer prices. The updated convergence programme reckons with inflationary expectations remaining moderate as a result of the increasing credibility of economic policy, an income policy aiming at wage increases in line with productivity growth and a monetary policy applying an inflation targeting regime. If the output gap has a greater disinflationary effect than calculated or economic growth is slower than envisaged, the drop in the inflation rate may be larger than projected. The achievement of the inflation rate corresponding to the inflation target by 2009 may be hindered if food price increases are significantly above the projected level or if the adjustment of agricultural price levels occurs later than expected, or if as a result of price shocks mutually reinforcing each other, inflationary expectations get stuck at a higher level. International energy prices also represent a risk to the inflation projection.

Inflation annual average change, per cent

	2006	2007	2008	2009	2010	2011
Consumer prices	3.9	7.9	4.8	3.0	2.9	2.8

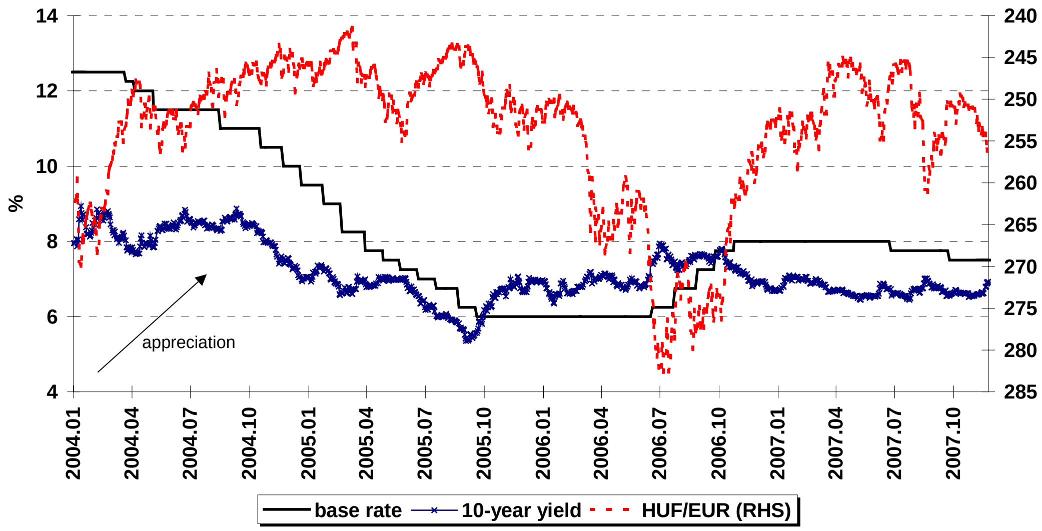
The liberalisation of energy markets eliminated the direct influence of the Government over electricity and natural gas prices. The reduction of the expenditures on gas and district heating price subsidies causes price increases for some subsidised households, which is taken into account in the projections of the updated convergence programme. The reform of long-distance public transport is also ongoing but no more radical tariff increase is necessary in this field. Local governments may increase the charges for water, sewage and garbage collection services and local public transport at an above-average rate due to the need to satisfy environmental and quality of service requirements and for financing reasons. In contrast, some local governments (e.g., in Budapest) are planning to make adjustments in district heating tariffs, which were considerably increased in 2007.

1.10. Monetary and exchange rate policy

According to the central bank law, the primary objective of the central bank (Magyar Nemzeti Bank, MNB) 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 MNB 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.

Since the widening of the fluctuation band, the HUF exchange rate has been stable, apart from brief periods of volatility; in the past six years, the HUF stayed in the stronger part of the band with the exception of a few days. Recently, the exchange rate of the Forint has been driven mostly by international news and changes in the risk aversion of foreign investors. This year, the indirect effects of the so-called sub-prime crisis are particularly worth noting: problems of the mortgage market had no direct effect on Central and Eastern Europe, including the Hungarian economy, and they did not threaten the stability of the Hungarian banking system either. Nevertheless, similarly to other high-yield currencies, the Forint also suffered a temporary depreciation. As an indication of the increased relative importance of the characteristics of the instruments in investment decisions, which had already been noted earlier, the premia of sovereign and corporate securities in similar risk categories have moved apart. When the initial general negative mood wore off, the currencies of countries directly not affected by the sub-prime crisis re-appreciated.

Yields and exchange rate developments



The market perception of Hungary improved noticeably following the start of fiscal consolidation and after its first results emerged. Both short and long-term HUF-EUR spreads declined by some one-hundred basis points in one year. The achievement of the medium term deficit reduction path of the convergence programme is essential for the continued, lasting improvement of market confidence. Responding to the favourable inflation outlook on the time horizon of monetary policy and to reduced uncertainties, the MNB deemed two times appropriate to cut the base rate by 25 basis points each. On the whole, interest rate measures were in line with market expectations; they did not affect the credibility of monetary policy; the market expects further cuts in the base rate. The one-year ex ante interest rate fluctuated around its long term average, in the 3-4% range, throughout the year. This, coupled with the appreciation of the real exchange rate as a result of the stable nominal exchange rate and the increased inflation differential to our trading partners, resulted in the tightening of monetary conditions.

In 2005, the Government and the MNB set, instead of the annual inflation targets, a 3% medium term inflation target being consistent with price stability for the converging Hungarian economy, for the period starting in 2007. As a result of the temporary inflationary effects of the stabilisation measures and in view of the medium term nature of the target, monetary policy this year concentrated on the price developments of 2008 and 2009. 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.

The Government treats the adoption of the euro as a priority. To facilitate the introduction of the common currency as soon as economic factors allow (fulfilment of the convergence criteria), the Government has started the preparation for practical changeover. As the first step, the National Euro Coordination Committee (hereinafter: NECC) has been set up, which is responsible for the creation of the organisational framework for the introduction of the euro and the preparation of the national changeover plan. The NEC is chaired by the Minister of Finance; the Governor of the MNB is the vice president, while its members include the Minister for the Economy and Transport, the Minister of Justice and Law Enforcement, the Minister in charge of the Prime Minister’s Office, the Minister of Local Government and Regional Development, the President of the Central Statistical Office and the Chairman of the Board of the Hungarian Financial Supervisory Authority.

2. Fiscal policy

2.1. Fiscal developments in 2007

The Budget Act set the 2007 ESA95 general government deficit target, in accordance with the target specified in the previous convergence programme, i.e., at 6.8% of GDP. Interim figures, however, indicated that the deficit may be smaller than originally envisaged, as monthly cash balances tended to turn out better than the monthly updated forecasts. This was attributable to higher tax and contribution revenues, which increasingly appears to be a permanent development, and to expenditures in certain areas being even lower than expected. Therefore, the Ministry of Finance has repeatedly adjusted downwards the annual deficit forecast during the year.

The report on the implementation of the convergence programme in April, reckoning on the higher revenues and changes on the expenditure side that were emerging at the time, set out an ESA95 deficit forecast of 6.6% of GDP. The forecast was reduced by another 0.2 percentage point in June. The second report on the implementation of the programme projected a deficit of 6.4%. However, the cash figures of the central budget, the social security funds and extra-budgetary funds are indicative of a further improvement in the expected balance of the central subsystems; therefore the further reduction of the forecast is justified. As compared to the calculations in the September report, the borrowing figures of local governments in the first nine months indicate a 0.1 percentage point increase in the deficit of that subsystem. In addition, the “gap” between cash and accrual based figures may be greater than previously calculated; thus, according to the current forecast, the cash deficit of the central subsystems may be around 5.6% of GDP, the general government cash deficit including local governments, 6% of GDP, and the ESA95 deficit of the general government, 6.2% of GDP in 2007.

Changes of the 2007 deficit projections in per cent of GDP

	Previous convergence programme (December 2006)	April 2007 report	September 2007 report	Updated convergence programme
Cash-flow deficit of the central subsystems	6.6	6.2	6.0	5.6
Cash-flow deficit of the general government	6.9	6.5	6.3	6.0
ESA95 deficit of the general government	6.8	6.6	6.4	6.2

Up to end-October, the cash deficit and the primary deficit of the central subsystems were at or better than the time proportionate part of the annual projection. Based on the ten-month balances, the projection can be safely realised; indeed, it even contains sufficient reserves (the central equilibrium reserve and the risk reserve together amount to 0.4% of GDP). In the last two months of the year, expenditures are increased by the payment of the second half of the 13^{th} month pension and the costs of the supplementary pension increase in November, relating to the wage and inflation developments. This additional expenditure, however, is more than offset by the tax payments of December (according to the profit tax payment rules, over 40% of the profit tax is paid in December).

The better-than-expected fiscal position is partly attributable to the fact that the "whitening" reflected in the wage figures, which was more pronounced than originally expected, had a beneficial effect on general government revenues. Items related to income developments, personal income tax and social contribution payments are expected to be higher by more than 0.5% of GDP. Consumption related taxes may also generate more revenues, party due to the higher-than-projected consumption expenditures at current prices and partly as a result of tightened controls. On the whole, the ratio of accrual based tax and contribution revenues to GDP may be 1 percentage point higher than envisaged in the previous convergence programme as a net result of additional revenues and greater nominal GDP.

On the expenditure side, against the backdrop of the better-than-expected exchange rate and yield developments, and the lower debt level, interest expenditures may be considerably lower (by almost 0.5% of GDP, or by 0.3% on an accrual basis).

The balance of net expenditures (without expenditures covered by own revenues or EU funds) and budget contributions of central budgetary institutions and chapter managed appropriations (i.e., the deficit-increasing effect of the system of budgetary institutions) was below the time-proportionate level in the first ten months. The deficit-increasing effect of institutions will become stronger at year-end, as indicated by the seasonal changes seen in previous years, which is incorporated in the forecast.

The budget position facilitated the raise of subsidies to the passenger transport public services of MÁV (state-owned railway company). This measure may improve, through the reduction of the debt stock, the financial position of the railway company next year.

In social security, expenditures in healthcare developed in line with expectations or, mostly in case of pharmaceutical subsidies, even slightly below them. As compared to 2006, the costs of pharmaceutical subsidies dropped in nominal terms as a result of the measures taken. In contrast, pension expenditures will be higher than originally proposed due to the trends of inflation and income developments. Changes in the macroeconomic forecast and the increase in the number of recipients will result in additional expenditures amounting to 0.3% of GDP.

The ESA95 general government revenues and expenditures, with two important exceptions, will develop in line with the changes in the cash forecast. (Accrual based expenditures do not reflect the effects of the wage agreement concluded with the unions of public sector employees on the advance payment of 13th month salaries. Similarly, the ESA deficit was not affected by changes in the debt assumption transactions relating to motorway projects.)

2.2. The 2008 budget

The budget bill submitted to Parliament contains not only the appropriations for 2008 but also the detailed expenditure projections for the three subsequent years. As opposed to previous practice, the three-year outlook is no longer for information only. The ongoing amendment of the Act on Public Finances will allow the Government to exercise tighter control over multi-annual planning. Based on the outlook, the Government, within two months of the adoption of the Budget Act, publishes in a public resolution the expenditure limits of the chapters under its control and supervision for the three years following the current year. The Ministries may amend the ceilings disclosed in the resolution only with the permission of the Government.

The target set for 2008 in the December 2006 convergence programme was to achieve equilibrium in the primary balance of the general government. However, the achievements since the launch of the adjustment programme allow for a slightly higher improvement; consequently, the Bill provides for a primary surplus of 0.1% of GDP. As the factors determining interest expenditures (debt level, yields, exchange rate) developed more favourably than projected in the previous convergence programme, given the smaller interest expenditures, the general government deficit may be 4%, rather than the originally planned 4.3%, of GDP in 2008.

The smaller deficit will be achieved against the background of higher revenue and expenditure levels. In addition to the base effect of the 2007 surplus of tax and contribution revenues, changes in macroeconomic developments also increase the tax/GDP ratio. As compared to the previous convergence programme, the current forecast envisages a more dynamic wage increase, a 0.5 percentage point upward adjustment in household consumption expenditures (which is still moderate) and faster consumer price rises.

Consumption and wage growth percentage change

	2007	**2008**
Household consumption expenditure (at current prices)		
2007 Convergence Programme	7.1	6.1
2006 December Convergence Programme	5.5	4.0
Wages and salaries		
2007 Convergence Programme	7.5	5.7
2006 December Convergence Programme	6.6	3.8

In 2008, there will be no major changes in the tax system comparable to those implemented in 2006 and 2007. Tax rules will be amended as follows:

- Approximation to the EU rules will continue (VAT, excise tax, energy tax, personal income tax);
- The broadening of the tax base will continue (personal income tax, vehicle tax, luxury tax);
- In personal income taxation, the tax credit system will change and the marginal tax rate will be reduced for incomes close to the average; The income brackets will remain unchanged;

- In the case of the corporate income tax, in order to improve competitiveness, promote investments and expand employment, the tax-free development reserve will be increased and the ceiling of eligibility for the preferential rate will also be raised;
- The measures taken so far to whiten the economy will be supplemented by new ones (higher fines, further extension of the control powers of the tax and customs authorities, expansion of reverse taxation in the value added tax regime, etc.);

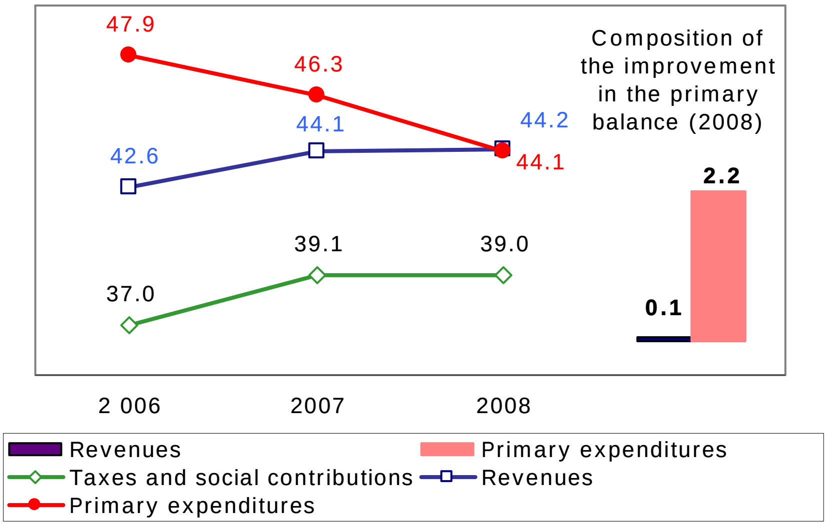
The tax to GDP ratio is also affected by the following changes, which are neutral in respect of the general government balance:

- pursuant to the new VAT Act, national road and rail transport infrastructure investment projects and related asset transfers will not be exempt from VAT,
- contribution revenues are increased by the fact that the budgetary contribution paid to cover the preferential pension benefit to armed forces will be doubled.

It is partly due to these factors that tax centralisation will decline only slightly in 2008, even though the major tax bases (consumption, wages), which determine revenues, grow at a rate below GDP growth.

The 2.3 percentage point improvement in the primary balance is attributable to a slight increase in the revenue/GDP ratio, and the over 2 percentage point decrease in the expenditures to GDP ratio.

Main indicators of the general government
(in per cent of GDP)



The expenditure/GDP ratio for 2008 relies on the following elements in the budget appropriations:

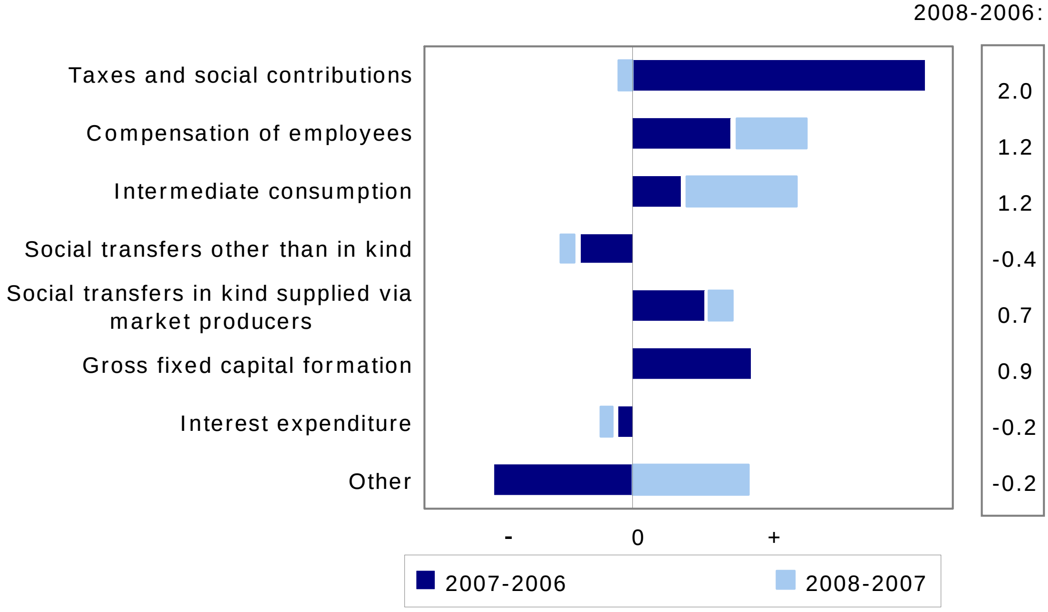
- Public expenditures will have to increase in some areas even during the period of fiscal consolidation:
    - o there will be an increase in pension expenditures, family support and social aid in line with legislation. Due to changing pension regulations, the forecast reckons with an increased number of applicants in the first half of 2008, while retirement under the current rules is still possible. This is the main reason why pension expenditures are expected to increase by almost 0.2 percentage point as a percentage of GDP;
    - o the budget will provide the co-financing that allows for the use of increasing EU funds;

- appropriations contain the additional items relating to the Act on Higher Education, the meeting of NATO obligations and the reinforcement of control bodies (Tax Authority, Customs and Excise Authority, Hungarian State Treasury, National Labour Inspectorate);
- interest expenditures are expected to increase by 0.1 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:
  - subsidies to rail and road passenger transport will be adjusted to the actual cost of the service but its level will be lower than this year's subsidy after its rise during the year. Furthermore, in 2008 the one-off expenditure on the equity increase of the railway company will no longer be present in the appropriations. The 0.2 percentage point reduction, as a percentage of GDP, in the subsidy and capital transfer type general government expenditures each is attributable mostly to developments in passenger transport related expenditures;
  - the overhaul of price subsidies was successful in curbing expenditure growth already in 2007. In 2008, means-testing will become even more prominent in the gas and district heating subsidisation system. The appropriation for public transport related consumer price subsidy expenditures reckons with unchanged price subsidy items. Pharmaceutical subsidies as a percentage of GDP will remain on the reduced 2007 levels. On the whole, savings corresponding to over 0.1% of GDP can be achieved on price subsidies in 2008;
  - in the case of housing subsidy expenditures, the appropriation provides for a nominal reduction. Both interest subsidies and the subsidised debt stock are expected to be reduced. The subsidised debt stock is lowered by the fact that households replaced their previously borrowed home loans in increasing numbers by foreign currency denominated loans, for which no interest subsidy is available, and most of the new loan agreements are also foreign currency denominated. The interest subsidy is reduced by the lower yield of government securities, which governs the rate of subsidy. In addition, the subsidies on loans taken out before 2004, which have a higher relative subsidy rate, are also reduced due to re-pricing after the first five years of repayment;
  - the forecast for compensation of employees takes into account the effects of staff cuts and wage agreements. Real earnings on average will stay on the previous year level in 2008. A specific reserve has been set aside in the budget to cover the major part of expenditures necessary to maintain the real value of earnings. The bonuses payable under the performance assessment system introduced in the public sector are also financed from that reserve. On the whole, expenditures on compensation of employees as a percentage of GDP will be 0.5 percentage point lower than in the previous year.
  - with the above exceptions, appropriations tend to remain on their year 2007 levels reduced by the adjustments for the basis. The adjustment means the deletion of the equilibrium reserves and allowance for the impact of the headcount reduction implemented in the central government and in the municipalities sector.

Composition of the deficit reduction in 2007 and 2008

(in per cent of GDP, + / - : decrease/increase of the deficit)



The budget contains reserves under several titles:

- The general reserve serves to cover unforeseen expenditures (HUF 47 billion, 0.2% of GDP).
- The specific reserve provides funding mostly for various personal outlays (additional sums depending on the interest reconciliation talks with unions, severance payments and performance incentives). Of the specific reserve, HUF 80 billion (0.3% of GDP) may be included in accrual based expenditures. In addition, the remaining part of the 13th month salary accruing in 2007 may be paid from that reserve; however, this item affects cash-based expenditure figures only. (According to cash accounts, the budget contains provisions of HUF 164 billion, or 0.6% of GDP.)
- An additional HUF 109 billion (0.4% of GDP) so-called equilibrium reserve serves to assure compliance with the deficit target (HUF 89 billion chapter equilibrium reserve that ministries are required to set aside and HUF 20 billion central equilibrium reserve). The budget bill provides that the chapter equilibrium reserve may only be used for the purpose specified by the Government, taking into account expenditure trends and expected revenue developments. The Government decides on the application of the central equilibrium reserve at its own discretion, in light of fiscal and economic developments.

For 2008, the budget bill no longer requires that the stock of the carried-over unspent appropriations of budget chapters should not decline. This has added more flexibility to the financial management of ministries. However, the system of mandatory quarterly reports continues to allow the Government to keep budgetary developments on the course set in the budget.

2.3. Medium-term fiscal path

The fiscal consolidation programme started in the second half of 2006, in addition to the rapid decrease in the budget deficit, underpins lasting improvement in the government balance with structural reforms. The fiscal path has the following key features on the time horizon of the programme period:

- the adjustment is front-loaded, more than 70% of the deficit reduction being realised in 2007-2008, and 85% by 2009,
- in 2007, the first complete year of the adjustment, half of the improvement is attributable to revenue growth, while from 2008 on it will be assured by the cut of expenditures as a proportion to GDP.

The consolidation programme has proved successful; the general government deficit in 2007 will decline even more than originally envisaged, and it may also be smaller in 2008 than planned earlier. From 2009 onwards, the deficit will develop along the course set in the previous convergence programme.

Main indicators of the general government in per cent of GDP

	2006	**2007**	**2008**	**2009**	**2010**	**2011**	**Change 2011-2006**
Taxes and social contributions	37.0	39.1	39.0	38.3	37.6	37.2	0.2
Revenues	42.6	44.1	44.2	43.3	42.4	42.0	-0.6
Expenditures	51.8	50.3	48.2	46.5	45.1	44.2	-7.6
Primary expenditures	47.9	46.3	44.1	42.7	41.6	40.9	-7.0
Balance	-9.2	-6.2	-4.0	-3.2	-2.7	-2.2	7.0
Primary balance	-5.3	-2.2	0.1	0.6	0.8	1.1	6.4
General government gross debt	65.6	65.4	65.8	64.4	63.3	61.8	-3.8

Along this fiscal path, the excessive deficit in terms of the Treaty can be corrected by 2009, also taking into account the possibility of the partial, regressive inclusion of the costs of the pension reform.

Effect of the pension reform in per cent of GDP

	2006	**2007**	**2008**	**2009**	**2010**	**2011**
on deficit	1.4	1.5	1.4	1.4	1.4	1.4

Hungary must 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. A deficit reduction in excess of an annual 0.5 percentage point is not supported either by the structure of economic growth or by cyclical developments. Even though the Hungarian economy is expected to resume a dynamic growth path from 2009, output will not reach its potential level even in 2011 and the output gap will remain negative. The internal composition of GDP is also not conducive to a faster improvement in the budget balance. Growth is driven by exports and investments, thus the growth of tax revenues is slower than that of GDP. Between 2009 and 2011, tax centralisation will be reduced by slightly more than 1 percentage point.

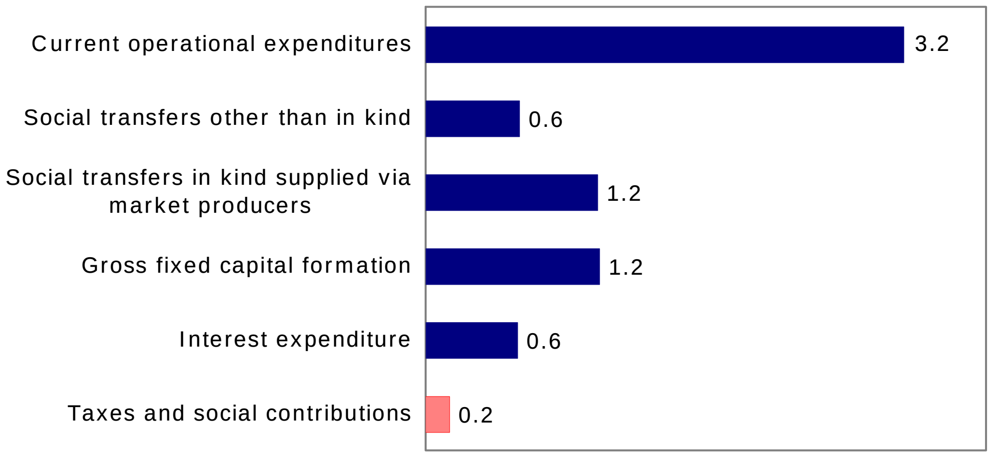
The most important task of the programme period is to cut the expenditures of the general government. The achievement of this is promoted by the structural reforms and fiscal rules assuring financial discipline as well as the following measures:

- The number of public sector employees will be reduced. In addition to the headcount reduction and organisational streamlining and restructuring, already implemented or currently ongoing in central budgetary institutions (mergers and termination of tasks), the Government uses financial measures to encourage regional and micro-regional co-operation of municipalities and their more effective operation with lower staffing and at lower cost;

- Public sector wage payments are influenced by the decision on the advance payment of the 13th month salaries payable on the years of 2007 and 2008. In 2007 half, while in 2008 the total of the 13th month salaries, originally due in January of the subsequent year, are paid in advance. This change does not affect the wage expenditures under ESA95 as the 13th month salaries were originally included in the year 2007 and 2008 expenditures in the accrual based accounts. However, maintaining the real value of salaries in 2008 will also mean an increase in accrual based expenditures; even so, outlays on compensation of employees will be reduced by 0.5 percentage point in relation to GDP. From 2009, public sector real wages may already increase, but in a slower pace than the GDP growth rate to respect the deficit reduction targets. Nevertheless, the decline of the ESA wage bill to GDP ratio will temporarily come to a halt in 2009, as the base effect of previous advance payments will appear in expenditure figures in that year. However, additional payments can be made only if this does not jeopardise the deficit target. In subsequent years, against the background of wage increases being below GDP growth, expenditures may start to fall again, thus savings in excess of 1.5 percentage points are expected for the entire programming period.
- The organisational measures and structural reforms will lead to a more economical institutional system. Until 2011, spending on the purchase of goods and services will be cut by over 1.5 percentage points as a percentage of GDP, as the institutional system is being streamlined. The distribution of expenditures between years is uneven: in 2008, the expenditure/GDP ratio decline will be reinforced by military acquisitions coming to an end, while in 2010 the increased availability fees for PPP projects will temporarily slow down that process;
- In total, the current operational expenditures of the public sector (wages, contributions, purchase of goods and services) will drop from over 19% in 2006 to below 16% of GDP in 2011. Over 40% of the planned expenditure cut will result from reductions in the current operational expenditures of the general government.
- By 2011, savings in excess of 1 percentage point can be achieved in the ratio of social transfers in kind to households through market producers to GDP, almost entirely arising from the overhaul of the price subsidy system. The overhaul of price subsidies includes the following:
  - the introduction of social considerations in the gas and district heating subsidy system, with increased emphasis on means testing;
  - in the field of public transport related consumer price subsidies, the introduction of a lump-sum subsidy scheme and the review of allowances;
  - in the field of pharmaceutical subsidies, the promotion of generic price competition, reduction of the subsidy rates and increasing of payments by producers. The level of price subsidies declined already in 2007, and the measures laid the foundations for long term expenditure cuts and promoted holding back unjustified demand for subsidised pharmaceuticals.
- Pension expenditures, family support and social aid, which represent almost 90% of social benefits other than in kind, will increase as provided in legislation. Due to the changing pension regulations, the number of applicants will increase in 2007 and probably also in the first half of 2008, while retirement under the current rules is still possible. The increase of the social transfers other than in kind to GDP ratio in 2007 and 2008 is explained primarily by pension expenditures. From 2009 on, pension expenditures may decline, in relation to GDP, by 0.1-0.2 percentage point per annum. In total, social benefits other than in kind will drop at a faster rate as a percentage of GDP in the last three years of the programming period, when, in the environment of accelerating growth, nominal GDP will grow faster than inflation, and benefits (with the exception of pensions) will follow suit. In addition, the interest subsidies on housing loans will decline continuously, thus a total drop of 0.3-0.4 percentage points per annum is to be expected.

- Subsidies to long distance passenger transport 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 in the long term. Since 2006, subsidies to the Budapest transport company have covered the actual costs while limiting any future needs for subsidy 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 0.6% in 2007 to 0.8% in 2008 as a result of the more intensive use of the funds and the closing of certain programmes. 2008 is the "year of transition" in the sense that, in addition to the outlays of the 2007-2013 period, it also contains the use of support made available in 2004-2006. Between 2009 and 2011, apart from some Cohesion Fund projects financed from the funds of the 2004-2006 period and some projects of the so-called Transition Facility, the updated convergence programme reckons only with the use of support for the 2007-2013 period. From 2009 on, despite the increase of EU funds, taking into account the altered structure of EU programmes, the ratio of co-financing as a percentage of GDP will effectively remain on the year 2007 level.
- The investments of the general government as a percentage of GDP will decline from the record level of 2006. The continued slight decline in the investment/GDP ratio after 2008 is attributable to the gradual "phasing out" of motorway projects. In the financing of motorway projects, budgetary and EU funds will be supplemented by private funds.

Composition of the deficit reduction: 2011-2006
(in per cent of GDP, +: decrease of the deficit)



The net effect of the other revenues and expenditures is zero in the programming period.

Even though in order to rapidly improve the government balance, revenues also had to be increased at the start of the fiscal consolidation process, from this point on the adjustment will have to focus exclusively on cuts on the expenditure side. Against the background of export and investment driven growth, the tax and contribution revenue to GDP ratio will gradually decline from 2009 on, and by the last year of the programme period tax centralisation will only be marginally above 37% (the level of 2006).

The calculations for the updated convergence programme were made on the assumption of an unchanged tax system after 2008. As a result of the greater-than-expected whitening of the economy and the altered macro-economic developments, tax centralisation in 2007 is stronger than planned in the previous convergence programme. However, the current forecast also reckons with a similar decline in the tax/GDP ratio as earlier calculations indicated, even though its level is slightly higher. The Government considers that the tax system needs to be made more simple, transparent and fair in order to promote growth, employment expansion and improved competitiveness. The internal ratios of tax revenues may change in the future, but the tax level set in the updated convergence programme will remain unchanged. Tax and contribution revenues could be decreased more without imposing any risk on the deficit target only if expenditures were to be cut by more than projected.

2.4. Structural balance and one-off budget items

According to the calculations for the updated convergence programme, the sensitivity factor is 0.26[2] taking into account the estimated tax revenues in 2007, i.e., the budget balance will change by 0.26 percentage point upon a 1% change of GDP (assuming no changes in the composition of GDP).

Due to the stabilisation measures, economic growth temporarily slows down in 2007-2008 and output falls under its potential level. The output gap will remain negative up to 2011, but it will gradually narrow from 2009 on. As a result, the cyclically adjusted balance shows a substantially greater improvement until 2008, and a slightly smaller improvement between 2009-2011, than the headline deficit.

General government expenditures were increased in 2006-2007 by sizable one-off items (accounting of the Gripen purchase, cancellation of the Iraqi debt, additional flood protection expenditures, one-off costs relating to staff cuts in the public sector, one-off expenditures relating to MÁV (state-owned railway company)). Therefore, the structural deficit was considerably below the cyclically adjusted deficit in those years. In 2008-2009, the updated convergence programme reckons with a slight net deficit reducing effect in the case of one-off items (one-off deficit reducing items include receipts from the sale of government real property in both years, while in 2008, the GSM concession revenues will have a one-off deficit reducing effect, and staff cut related one-off items, in a substantially smaller volume than in the previous year, will continue to have a one-off deficit increasing effect.) The calculations include no one-offs for 2010—2011.

In 2007, the structural balance will improve by 3.9 percentage points. In the forthcoming four years, the updated convergence programme calculates with an annual 0.7 percentage point balance improvement on average.

Structural balance in per cent of GDP

	2006	2007	2008	2009	2010	2011
Output gap	1.2	-0.9	-1.8	-1.5	-0.9	-0.5
General government balance	-9.2	-6.2	-4.0	-3.2	-2.7	-2.2
Cyclically adjusted balance	-9.5	-6.0	-3.5	-2.8	-2.5	-2.1
One-offs**	-0.7	-1.1	0.1	0.1	0.0	0.0
Structural balance	-8.8	-4.9	-3.7	-2.9	-2.5	-2.1

* Due to the rounding the sum data could differ from the sum of the detailed data.
** A plus sign means deficit-reducing one-off items.

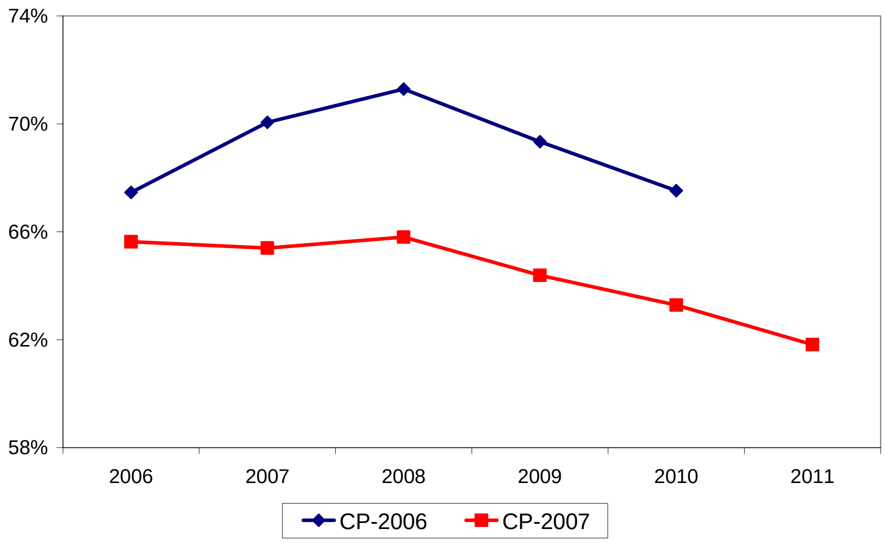
2.5. Public debt

As a result of several factors in 2006, the government debt to GDP ratio turned out to be more favourable than estimated in the December 2006 convergence programme. The close to 2 percentage point difference is attributable to the lower deficit, the appreciation

[2] In the calculation of the sensitivity coefficient, the Convergence Programme follows the approach recommended by the European Central Bank and only the tax revenues from the private sector are taken into account to use them to weight sensitivity of the individual taxes/contributions.

of the currency and the higher nominal GDP, which was partly offset by the less favourable development of the stock-flow adjustment[3]. The lower initial debt ratio shifted the entire path downwards.

Debt ratio in the 2006 Convergence Programme and in the current Programme



Developments during 2007 had positive effects on the factors that influence debt dynamics:

- As compared to the forecast in the previous convergence programme, the updated programme projects a 0.6 percentage point lower budget deficit, which is justified by the favourable developments during the year: interest expenditures became considerably lower due to lower yields and the reduced financing requirement,
- Nominal GDP expected for 2007 is higher than the previous forecast mainly due to the higher GDP deflator,
- As a result of interim trends, the programme applies a stronger exchange rate than last year's technical assumption[4].

The medium-term economic policy objective is a consistent decline of the debt ratio following a temporary rise, so that it declines below the 60% benchmark as soon as possible and remains below that level in the long term. This objective can be attained assuming that the medium term fiscal plans are achieved and the nominal GDP growth is in line with the forecast. In 2007, the debt ratio is expected to show a slight decline. According to current projections, the ratio will peak in 2008 and then fall to 61.8% by 2011.

The *primary balance* is better in 2007-2008, and slightly worse through the rest of the programme horizon, than assumed in the previous convergence programme. Interest expenditure is 0.2-0.4 percentage points lower than forecast in 2006. The *interest expenditure was* projected with the technical assumption that in the beginning yields will reflect market expectations (based on forward rates) then converge gradually to the euro yield curve. Applying the principle of prudence, the updated convergence programme assumes a pessimistic yield scenario for 2008, which represents a risk

[3] Stock-flow adjustment means the difference between the change in the debt stock and the deficit. The most significant items are: privatisation receipts, difference between cash and accrual basis accounting of the deficit, revaluation effect due to exchange rate changes, changes in government liquid assets.

[4] The convergence programme applies a technical assumption for the HUF/EUR exchange rate (the exchange rate used is the same as the figure of the 2008 budget proposal). The HUF 251 exchange rate for end 2007 is the average of the actual exchange rates between 11 June and 10 September. The calculations for the remaining part of the program horizon were made by fixing this figure.

reserve. This is because in the event of a change in the market sentiment, for instance if the sub-prime crisis escalates, yields and risk premia may rise. In a predictable market environment, moving forward on the convergence path, the improving macro-economic fundamentals, in particular the improving primary balance of the general government, will contribute to declining yields, which in turn may lower the interest expenditure to GDP ratio.

Apart from the budget deficit, the future debt ratio will also be influenced by the *stock-flow adjustment*:

- Privatisation proceeds of HUF 53 billion are calculated for 2007. The baseline scenario reckons with no further substantial privatisation receipts on the programme horizon (apart from some minor sales by local governments),
- The technical exchange rate is somewhat appreciated than at the end of 2006, thus the updated programme reckons with a slight positive revaluation effect for 2007. From 2008, the programme assumes no changes in the exchange rate.
- The stock-flow adjustment is affected by financing items not recorded in the deficit but affecting the government debt (e.g., EU pre-financing, year-end change in the stock of the Treasury account), and the difference between cash and accrual based accounts.

Main changes compared to the December 2006 convergence programme are as follows:

Main assumptions in the programmes

		2007	**2008**	**2009**	**2010**	**2011**
Nominal GDP growth (per cent)	*CP-2006*	7.0	5.1	7.3	7.3	7.0
	CP-2007	**8.2**	**6.8**	**7.2**	**7.2**	**7.1**
*Year-end exchange rate (HUF/EUR)**	*CP-2006*			271		
	CP-2007			**251**		
Budget deficit (in per cent of GDP)	*CP-2006*	6.8	4.3	3.2	2.7	2.2
	CP-2007	**6.2**	**4.0**	**3.2**	**2.7**	**2.2**

* technical assumption

The future debt ratio is sensitive to changes in the following main factors (*ceteris paribus*[5]):

- Primary balance: the annual 1 percentage point change of the primary balance from 2008 till the end of the projection period will induce a 2 percentage point change in 2009 and a 4 percentage point change by the end of the period in the debt ratio (which includes the accumulated interest expenditure as well).
- Exchange rate: close to 30% of the debt portfolio is foreign currency denominated, 100% of this being in euro (due to the various derivative exchange rate contracts). Consequently, a 1% exchange rate change will have an approximately 0.2 percentage point impact on the debt ratio, depending on the exact currency composition.
- Yield curve: yield changes appear gradually in interest expenditures through renewed instruments. The cumulative effect of the altered interest expenditure on the debt ratio between 2008 and 2011 would be, in the event of a 100 basis point yield change: 0.1, 0.3, 0.6, 0.9 percentage point (change of interest expenditure in terms of GDP: 0.1, 0.2, 0.3, 0.3 percentage point).
- Economic growth: the steady 1 percentage point change of nominal GDP starting in 2008 and lasting throughout the period would have an impact on the debt ratio of 0.6 percentage point in 2008; 1.2 in 2009; 1.8 in 2010 and 2.4 in 2011.

[5] Examining the effect of changes in the various items on the debt ratio, assuming all other variables being constant.

3. Alternative scenarios

In the baseline scenario, economic growth accelerates from 2.8% in 2008 to 4.0-4.2% in 2009-2011. The pick-up in growth is partly attributable to the fact that following the adjustment, the value added of the government sector may start increasing again, and the growth rate of the GDP produced by the private sector will also increase – to approximately its average growth rate observed between 2000 and 2006. The main driving force behind private sector growth is the increased demand due to the inflow of EU funds and the continued strong export growth on the expenditure side, and the favourable trend of labour utilisation, capital stock and their combined productivity (total factor productivity or TFP) on the production side.

According to the projections, the number of economically active persons may grow slightly more quickly than in the first half of the decade on average. The labour force available for the private sector is expected to expand even faster due to the decline, then stagnation, of the number of public employees. The qualification of the labour force will also improve: while in 2006, 27.5% of the 55-59 age group had at most lower secondary (ISCED 1-2) education, this ratio was only 14% among the 25-29 year old, and an increasing ratio of the younger generations complete their tertiary studies.

Thus, one of the driving forces behind total factor productivity growth is the improved qualification of the population, and consequently improved labour productivity, but the more streamlined administration and the continued deregulation also have a similar effect. In addition, foreign direct investments also underpin TFP growth. On the whole, it seems probable that from 2009 on, the growth of the Hungarian economy can approximately resume its rate observed in the first half of the decade.

The baseline scenario of the updated convergence programme describes this most likely case; however, we should also examine the risks that the change of external assumptions and the uncertainties in the behaviour of economic agents would present for economic growth and, consequently, for the general government balance. Thus, the updated convergence programme presents three alternative scenarios: one with temporarily higher nominal variables, one reflecting a slow-down in the world economy, and one assuming that it takes longer than in the baseline scenario for the growth to resume its higher rate (due to supply-side reasons). The latter two scenarios, which have an adverse effect on the general government, would increase the deficit by no more than 0.4 percentage point in the medium term, for which the reserves built into the budget provide adequate cover.

3.1. Scenario with temporarily higher nominal variables

In 2008, inflation may be temporarily higher than projected, mainly for external reasons such as a higher-than-expected rise in food or oil prices (analysts consider that on the whole, upside risks to the baseline scenario are greater than downside ones). There also exist some risks related to wage development: wages in the private sector may be higher than outlined in the baseline scenario due to a temporarily higher inflation rate or wage persistence.

The resulting scenario assumes that in 2008, consumer prices would grow some 0.9 percentage point faster, and private sector wages some 0.6 percentage point faster than in the baseline case, and in 2009 the growth rate of both nominal variables would be slightly above the baseline course. Thus in 2008, the rate of growth of the real consumption expenditure of households would be some 0.3 percentage point lower, and both investments and real exports slightly lower. However, imports would also decline, therefore the overall negative effect on real GDP growth is small. On the other hand, tax and contribution revenues are higher due to higher-than-expected nominal wages and consumption at current prices, which is only partly offset by the growth of social transfers in cash, thus in the medium term the general government balance to GDP ratio would improve by around 0.1-0.2 percentage point.

3.2. Slow-down in the world economy

A slow-down in the world economy triggered by financial market developments would affect the Hungarian economy mostly through shrinking external demand but the external slump would probably go hand in hand with decreasing external inflation. Under this scenario, external demand growth would be considerably lower in 2008, and slightly lower in 2009, than in the baseline scenario.

Since the short term external market elasticity of the Hungarian economy is probably higher than one, export growth would drop by more than 1 percentage point in 2008 and by 0.5 percentage point in 2009, moving roughly along the baseline path thereafter. As investments in sectors producing for export will fall short of the forecast level, gross capital formation will also be 0.2-0.3 percentage point slower to grow in these two years. Slower GDP growth will also be reflected in employment and, over time, also in private sector wages, which in turn foreshadows a lower growth rate of household consumption. Inflation in Hungary would be slightly lower due to the external negative price shock and the drop of domestic demand, while the general government balance would deteriorate by 0.1-0.4 percentage point mainly due to the tax and contribution revenues falling short of the baseline scenario.

3.3. Slower recovery of growth

Under this scenario, the GDP growth rate would be lower than assumed in the baseline scenario in 2009 and 2010, and return to the above-4-percent range only in 2011. On the production side, the protracted adaptation could be attributable to the slower recovery of business confidence and therefore the slower emergence of productivity improving effects of FDI projects, and smaller employment growth in the business sector.

On the expenditure side this means that both exports and investments would be considerably below the forecast level, representing a shortfall of more than 1 percentage point in 2009 and 0.4 percentage point in 2010. Temporarily, inflation would be higher than in the baseline scenario, while the wage increase in the private sector would be somewhat lower due to lower labour productivity. Consequently, consumption growth would also be lower (by about 0.5 percentage point in 2010). On the whole, GDP growth would be 0.8 percentage point lower in 2009 and 0.4 percentage point lower in 2010, while in 2011 it would be similar to the baseline scenario but with more modest consumption and more dynamic investments and exports. Mostly due to the shortfall in tax and contribution revenues and lower GDP, the balance may worsen by 0.4 percentage point by 2011.

Difference from the baseline scenario*				percentage point
	2008	**2009**	**2010**	**2011**
Scenario with temporarily higher nominal variables				
Household consumption	-0.3	-0.1	0.0	-0.1
Gross fixed capital formation	-0.3	-0.1	-0.1	-0.1
Exports (goods and services)	0.0	-0.1	-0.1	-0.1
Imports (goods and services)	-0.2	-0.1	-0.1	-0.1
GDP	-0.1	-0.1	-0.1	-0.1
Inflation	+0.9	+0.4	0.0	0.0
Employment in the private sector	-0.2	+0.1	+0.1	0.0
Budget balance (in per cent of GDP)	+0.1	+0.2	+0.2	+0.2
Slow-down in the world economy				
Household consumption	-0.1	-0.2	-0.1	0.0
Gross fixed capital formation	-0.3	-0.2	0.0	0.0
Exports (goods and services)	-1.1	-0.5	+0.1	0.0
Imports (goods and services)	-0.6	-0.4	0.0	0.0
GDP	-0.5	-0.3	0.0	0.0
Inflation	-0.1	-0.2	-0.2	-0.3
Employment in the private sector	-0.2	-0.1	0.0	0.0
Budget balance (in per cent of GDP)	-0.1	-0.3	-0.4	-0.4
Slower recovery of growth				
Household consumption	0.0	-0.2	-0.4	-0.2
Gross fixed capital formation	-0.3	-1.5	-0.4	+0.3
Exports (goods and services)	-0.3	-1.4	-0.4	+0.2
Imports (goods and services)	-0.2	-1.0	-0.4	+0.1
GDP	-0.2	-0.8	-0.4	+0.1
Inflation	0.0	+0.1	+0.1	0.0
Employment in the private sector	0.0	-0.2	-0.1	0.0
Budget balance (in per cent of GDP)	0.0	-0.2	-0.3	-0.4

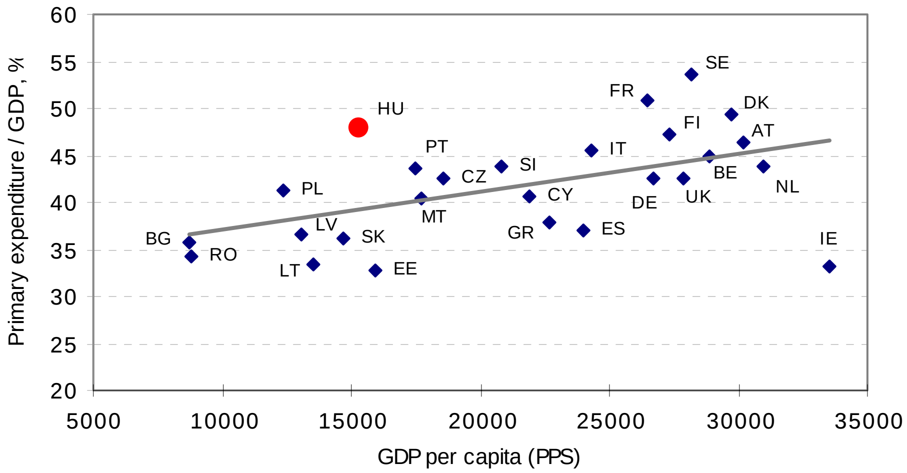
* Percentage point deviation of macroeconomic variables from the baseline path

4. Quality of public finances

4.1. Expenditure side

By European standards, the Hungarian general government sector is larger than medium-sized. In 2006, the expenditure/GDP ratio was some 5 percentage points, the primary expenditure/GDP ratio more than 3.5 percentage points, higher than the EU average. In terms of re-distribution, Hungarian figures come close to those of continental welfare states. Compared to the Member States most similar to Hungary in terms of GDP per capita, the difference in the ratio of primary expenditures increases to 5-10 percentage points.

Primary expenditure / GDP and GDP per capita (2006)

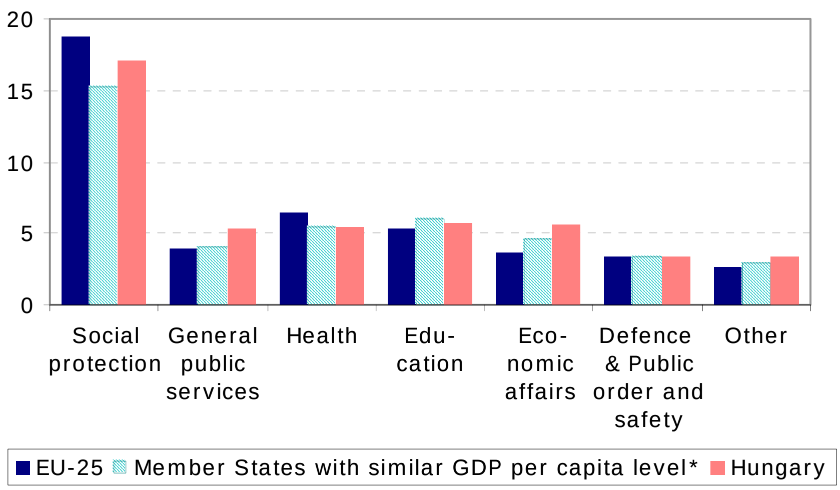


Source: Eurostat
Luxembourg is not recorded due to the high GDP per capita indicator.

During the programme period, primary expenditures will drop below 41% of GDP, and their internal composition is also expected to change. Based on the year 2005 figures[6], the breakdown of expenditures by function shows differences from the average at several points. The ratio of social protection expenditures to GDP has increased by almost 2.5 percentage points since 2001 but it is still below the average of the Member States. In contrast, expenditures on general public services, economic affairs and education were relatively higher. The ratio of healthcare expenditures was below average.

The picture is different comparing the Hungarian figures with the data of Member States at a similar level of economic development. In this context, the level of education and health care expenditures is average, but, more than average is spent on tasks related to social protection, general public services and the economic affairs.

Primary expenditure by function in 2005
(in per cent of GDP)



Source: Eurostat
*: GDP per capita (PPS): 10000-20000

[6] International expenditure figures by functional classification are currently available up to 2005.

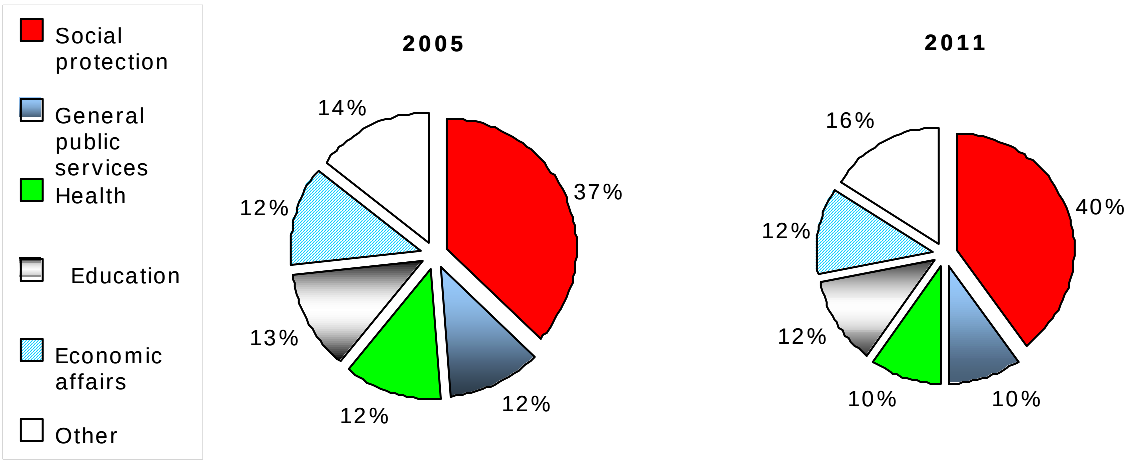
In 2006, primary expenditures increased by some 2 percentage points. Within this, the growth of pension expenditures and price subsidies related to energy consumption as well as the reform of the family support system further increased the share of social protection. In addition, mostly due to transport infrastructure projects, expenditures on economic affairs also increased in weight.

The objective of the structural reforms launched within the framework of fiscal consolidation is to perform public tasks more efficiently, at lower cost and in higher quality.

- The ratio of expenditures on general public services will decline both as compared to GDP and to total expenditures, reflecting the changes implemented in public administration;
- The expenditures on economic affairs to GDP ratio, following a rise in 2006, will be reduced due to the "phasing out" of motorway projects; the ratio of this function to GDP will return to the average of cohesion countries at a similar level of development as Hungary;
- In education, as a result of the emphasis on economies of scale and the reform of higher education, expenditures will represent a smaller portion of the growing GDP, but in view of the outstanding importance of the area, the share of expenditures on education within total expenditure will barely change. Funding available for education will be increased by the introduction of the tuition fee;
- In health care, initial reform measures halted, then reversed the increase of expenditures to GDP. Even though expenditures on health are effectively average for the level of development of the economy in international comparison, the spending of the government and households on pharmaceuticals was outstandingly high (highest as a per cent of GDP among OECD countries)[7]. The overhaul of the subsidy system induced a reduction of unjustified demand for pharmaceuticals. Consequently, and also as a result of the economies of scale and improved cost efficiency in curative-preventative care, expenditures will grow at a rate below GDP growth throughout the programme period. Similarly to education, health care funding is also expanded by the introduction of private payments;
- Pensions represent the largest part of social protection expenditures. There will be an increase in pension expenditures, family support and social aid in line with legislation. After 2008, expenditures are expected to fall as a percentage of GDP, but within shrinking total expenditures, the share of social spending may increase by some 3 percentage points;
- The rise of the share of other expenditures is attributable to increased environment protection spending, which will grow at a rate exceeding GDP growth in the forthcoming years.

[7] Source: Health at a Glance 2007 (OECD)

Changes in shares within primary expenditures

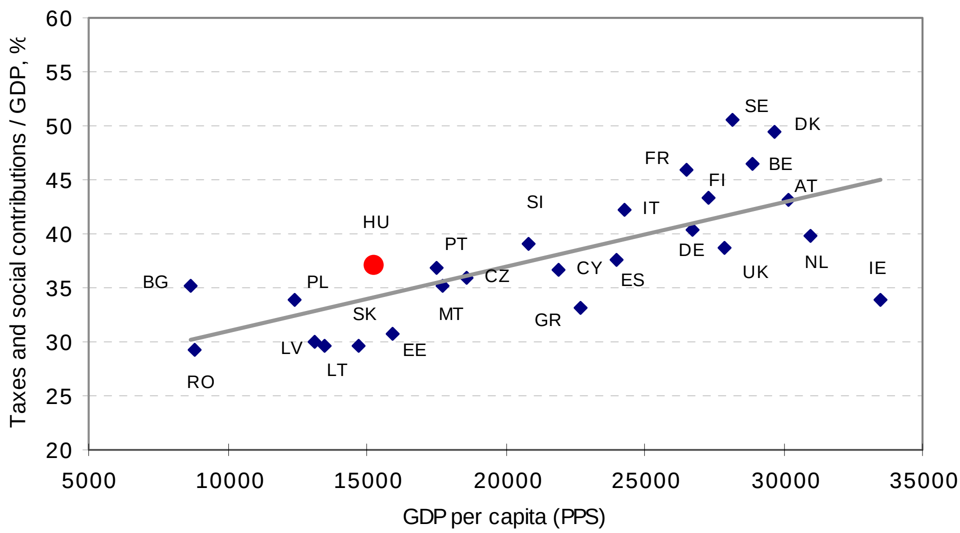


4.2. *Revenue side*

In Hungary, tax centralisation was 37.2% of GDP in 2005 and 37.0% in 2006, which will rise to around 39% in 2007-2009 as a result of the adjustment, then fall according to the current forecasts to approximately 37% by 2011.

Figures for the Member States show that there is a positive correlation between the ratio of tax revenues and per capita GDP. According to the 2006 figures, tax centralisation was somewhat higher in Hungary than typical for Member States at a similar level of development.

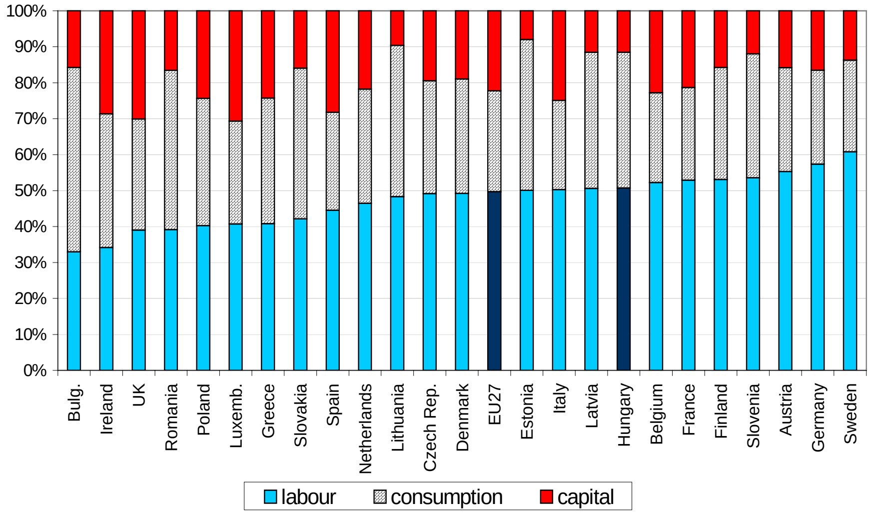
Tax centralisation and GDP per capita (2006)



Source: Eurostat
Luxembourg is not recorded due to the high GDP per capita indicator.

Regarding taxes by their economic function (taxes on labour, consumption or capital income), 2005 data show that in Hungary the ratio of taxes on capital is substantially below the EU average, while taxes on consumption have an above-average share, and the share of taxes on labour income (including social security contributions) is around average.[8] As compared to the position of Central European countries in 2005, the only significant difference is that in Hungary the ratio of taxes on capital is lower.

Tax revenues on labour, consumption and capital as a percentage of total tax revenue, 2005

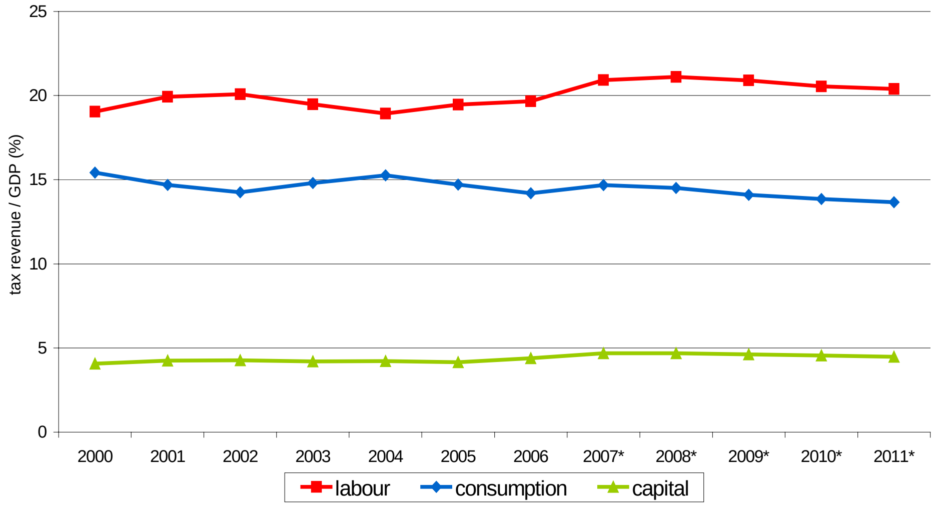


Source: European Commission

In terms of the trends of the ratio of various types of taxes to GDP, the calculations of the updated convergence programme, which assume an unchanged tax system, indicate that the ratio of labour taxes to GDP will peak in 2007-2008, then decline slightly (to below 20.5%) until 2011. The rise in 2007 is caused mostly by the increase of social contribution rates and the whitening of the economy. The weight of taxes on consumption will start decreasing in 2008, falling to approximately 13.5% of GDP by 2011. Taxes on capital will remain below 5% of GDP.

[8] Taxes are classified by their economic function in accordance with the methodology described in the Commission publication "Taxation trends in the European Union" (2007). The main items in taxes on consumption are VAT, consumption taxes, the local business tax, the simplified business tax, the gambling tax, the part of the vehicle tax paid by households, as well as customs and import duties. Taxes on labour include most of the PIT and social security contributions, as well as the training levy, the rehabilitation contribution and some other minor items. Taxes on capital include the corporate income tax, a small part of the PIT, the social security contributions of self-employed persons, the duty on the transfer of property, wealth taxes, some of the vehicle taxes and some other items. When allocating the PIT between labour and capital taxes, the programme uses the weight disclosed by the Commission throughout the entire time horizon, while the social security contribution of self-employed persons was calculated based on our estimates. In line with the Commission methodology, contributions paid into private pension funds are regarded as taxes on labour.

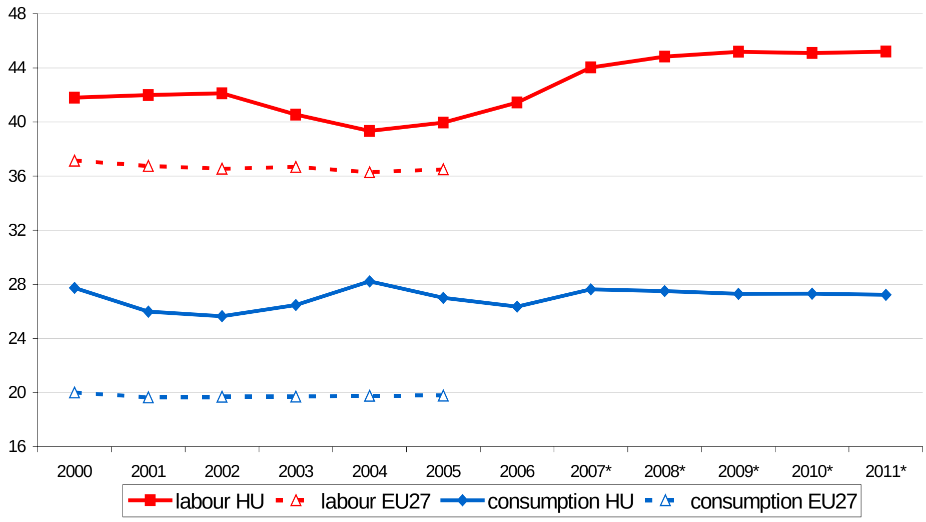
Tax revenues on labour, consumption and capital in Hungary, as per cent of GDP, 2000-2011



The examination of implicit tax rates[9] reveals that in Hungary the implicit rate of taxes on consumption is high: in 2005, it was 7 percentage points above the EU average. In 2007, it will increase only slightly as a result of stabilisation, and it will not reach the record level of 2004.

The implicit tax rate on labour income is also above the EU average, partly due to the low number of taxpayers (i.e. the high inactivity). The rate – and the difference to the EU average - declined steadily until 2004-2005, then, as a result of the adjustment, it started rising from 2006, and by 2007 it surpasses the year 2000 level. It is projected to remain near-stagnant until 2011. One reason for the growth of the implicit tax rate is that the ratio of compensation of employees to GDP continuously declines between 2005 and 2011.

Evolution of implicit tax rate on labour and consumption in EU27 and Hungary

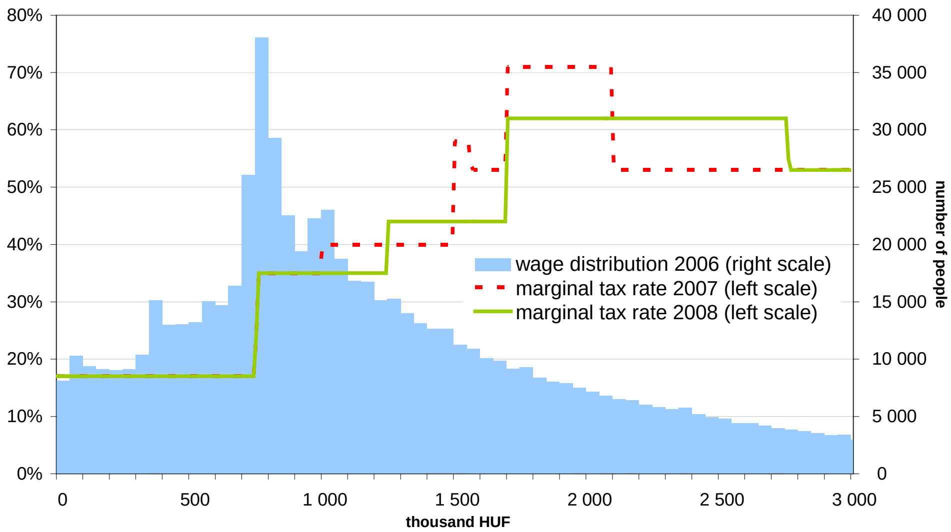


Source: European Commission and calculations based on the projections of the updated convergence programme

[9] For international comparability the implicit tax rate on labour is defined as the ratio of collected tax revenues and the compensation of employees, whilst in the case of tax on consumption it is the ratio of tax revenues and (domestic) household consumption expenditures.

The rules of tax credits within the personal income tax system will change in 2008. The measure will slightly increase the income of persons earning between HUF 1 million and HUF 2.762 million (this category includes approximately 40% of all taxpayers). The analysis of marginal tax rates, which indicate labour supply incentives in the tax and contribution system, shows that, as a result of the adjustment, the high (71%) marginal rate[10] on earnings around the average will drop to 62%, while a similar drop occurs in a lower-income bracket. These developments may help increase labour supply and reduce the incentives to hide income. (The marginal tax rate will increase for persons earning between 2.1 million and 2.762 million HUF.) The average marginal tax rate for the entire population will fall by 0.9 percentage point.

Marginal effective tax rates in 2007 and 2008, and the wage distribution



Note: The marginal effective tax rate takes into account the PIT and the contribution of employees. The wage distribution is estimated from tax authority data.

4.3. Structural measures

4.3.1. Central public administration

Within the framework of the re-organisation of central public administration:

- in the course of the significant reduction of the size and internal segmentation of central government, the number of ministries was reduced to 11 in mid-2006, while the number of employees fell by approximately 30% by the end of 2006.
- within the framework of the centralisation of parallel functional areas, in order to make the performance of tasks more effective and economical, new institutions were set up on 1 January 2007;
- in the course of the consolidation and regional re-organisation of the central administration and its regional (decentralised) bodies, a number of large networks were re-organised with a regional focus mostly as of 1 January 2007, in some cases later in the year. As a result of the re-organisation, instead of the 415 central budgetary institutions affected, only 176 continue their operation.

[10] Taking into consideration the PIT and the contribution of employees.

The quality improvement of public services may be promoted by the fact that the definition and measurement of performance requirements will be introduced across the board in the entire public administration. The Act on the registration, control and data management rules relating to performance assessment and the Government Decree on the new performance assessment procedure for civil servants working in state administration bodies has been effective since 1 January 2007. The PA system must be employed in respect of

- senior civil servants of ministries as of 1 January 2007,
- non-senior civil servants of ministries as of 1 July 2007,
- civil servants of central agencies and government offices as of 1 January 2008,
- civil servants working for the regional and local organs of any central public administration bodies as of 1 January 2009.

The reform measures started in 2006 (re-organisations, staff cuts and the introduction of the performance measurement system) have all contributed to cutting costs and raising the efficiency of public administration. In 2006, the headcount of central budgetary institutions was reduced by 10,700 persons, partly as a result of the mandatory staff cuts and mainly through organisational measures. The staff cuts will continue in 2007, affecting some 12,500 persons this year, with another 3,000 cut forecast for 2008. The increased staff needs of the control bodies participating in the fight against the black economy will be around 2,500 persons in 2008.

4.3.2. Local government system

From 2007 on, the annual Budget Act has introduced financial incentives to promote economies of scale in the framework of micro-regional cooperation.

- Since 1 September 2007, public education has been financed on the basis of public education school year and according to new performance indicators, taking into account the class/group size and the number of lessons of teachers and pupils. Simultaneously, the amendment of the new public education act entered into force in September 2007, raising the teaching units of teachers by 10% on average, which is expected to yield savings of almost HUF 8 billion this year.
- In 2007, based on the supplementary claim of July as provided in the Act on Public Finances, HUF 22.5 billion will be available for funding the performance of tasks in micro-regions, as opposed to HUF 15.4 billion in 2006. 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. This process started in 2007; multi-purpose micro-regional associations took over a significant number of institutions. Joint maintenance of institutions brings about major savings in staff management (e.g., smaller number of heads of institutions, flexible forms of employment).

The MRES (Managed Regional Equalisation System) was introduced in the field of social services, child welfare and child protection as of 1 January 2007; under this regime, the existence of an operating license in itself does not guarantee financing. The Minister of Social Affairs and Labour decides, upon the proposal of the expert committee operating at the Ministry of Social Affairs and Labour, on the eligibility of new services or capacities for normative government grants. The purpose of the measure is to reduce or eliminate the regional imbalances in social services, to eliminate deficiencies in service provision and, through greater contribution to services for persons most in need of social assistance, to more equitably allocate funds and slow down the growth of applications for funding that are not justified in social terms.

As part of the reform of the system of social services, in November 2007, Parliament adopted the Act on the amendment of certain acts in the field of social services, which places more emphasis on enforcing the principle of means testing in social services. To this end, in the field of nursing services, nursing needs are surveyed and established by an independent body operating with the participation of the National Rehabilitation and Social Expert Institute. In the field of the normative financing of services, as of 2008, a lower normative will be available in respect of persons in poorer wealth and income positions, and a higher normative available in respect of higher income and wealth positions, and, in the field of fees payable for residential services, the new rules will take into account the income as well as the wealth of the beneficiaries.

The amendment of the Act on Public Finances, effective as of 1 January 2007, has strengthened the financial discipline of local governments:

- The regional directorate of the Hungarian State Treasury may, before the year-end accounts of local governments are submitted, examine the development of performance indicators and the soundness of applications for normative grants.
- In respect of the unjustified disbursement of normative grants , the local government is obliged to pay a disbursement interest, provided that the sum of normative contributions and grants applied for and related to task indicators was at least 3%, instead of 5% as earlier, in excess of the amount legitimately due to the local government.
- The Treasury will not forward to decision-making bodies any applications for grants that fail to comply with legal requirements unless the deficiency is corrected upon request.

The purpose of the measure is to increase the reliability of local government budgeting and to assure that only applications for funding complying with legal regulations are forwarded to decision makers, thereby making the distribution of support more efficient and reducing the need for support.

Upon the adoption of the amendment of the Act on the multi-purpose micro-regional associations of local governments, the classification into micro-regions was reviewed and amended. To promote regional equalisation, in November 2007 the Government adopted the Government Decree on the classification of regions enjoying preferential treatment in respect of regional development.

The budget bill of 2008 underpins the continuation of measures taken so far:

- In public education, the effects of the increase of mandatory teaching units, all through the year, and, linked to the new school year, the impact of the performance indicator based financing system will be present in 2008.
- The improvement of the normative support system of social tasks will continue: a differentiated benefit system will be introduced, which takes into account the income of recipients in relation to the minimum pension in the field of meal provision, assistance in the home and home nursing of the elderly.
- The performance of tasks in micro-regions continues to be encouraged, mainly in public education and social functions.
- In order to improve co-operation between municipalities and to promote the joint performance of functions, the material conditions for the schools of small settlements and district town clerk’s offices will improve.
- Taking into account the investment needs arising from the commitments related to transitory arrangements on the side of local governments, the resources available for helping local governments’ access to EU funds will increase in 2008.

4.3.3. Public education

In order to establish the organisational (institutional) framework of task performance, with a view to economies of scale, the financing of public education was changed in 2006. Since September 2007, public education tasks have been financed based on new performance indicators; primary schools with less than 8 forms will gradually be merged, as member institutions, into 8- or 12-form schools, and the performance of tasks in micro-regions is promoted by additional transfers in public education as well.

From 1 September 2008, pursuant to the budget bill, the use of new performance indicators (depending on the mandatory classroom hours of teachers and the time allocated to courses) will be extended to basic art education, education and care in dormitories and hostels, day school or study room activities and boarding school education as well. The certification of basic art education institutions is ongoing, to be completed by 31 December 2007.

The regulatory framework has been created for associations of institutions assuring a higher-quality and more efficient performance of the mandatory public education tasks of local governments and for multi-purpose institutions maintained by multi-purpose micro-regional associations.

To promote more rational employment, the mandatory weekly classroom hours of teachers have been increased by two units as of 1 September 2007, while the 2 hours overtime that employers could demand has been abolished. Through the more streamlined work organisation and cut in overtime payments, these measures may lead to long-term savings; savings are reckoned some HUF 7.8 billion already in 2007 and HUF 26.4 billion in 2008. The size of the system of public education institutions has been reduced and the performance of tasks has become more efficient. In the 2007/2008 school year, the number of service providers has fallen by some five hundred (merger or close-down of institutions, other re-organisation measures) and the number of teaching positions has gone down by about 10 thousand.

In July 2007, Parliament adopted the bill to provide the foundations for future measures announced in the field of public education. Its key elements include the following:

- more possibilities for multi-purpose institutions and task performance on the micro-regional level;
- new system of employment of teachers (allowing for more efficient labour management, re-allocation of workforce among institutions of the same maintainer/owner);
- increased efficiency of vocational training (creation of a regional organisational level, possibility of vocational training organisation associations);
- a regulatory framework for the career follow-up of students (regulation of data management, data supply tasks, regulation of data supply into career follow-up system).

4.3.4. 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 have been taken:

- The regulatory framework has been created for the introduction of the tuition fee; state-financed students who enrolled in 2007 will start to pay tuition fees from 2008 onwards. Institutions will be able to keep the tuition fees received, and they can be used towards investments or scholarships. From September 2008, according to the adopted legislation, state-financed students will pay a tuition fee of HUF 105 thousand in undergraduate studies and HUF 150 thousand when they work towards master degrees. In the 2008 fiscal year, the revenues of higher education institutions, which they can spend on institution development or on student grants, will increase by HUF 2-3 billion.

- In 2007, a new admission procedure has been introduced, based on the choice of the student, and the administrative allocation of state-financed student ceilings was terminated. These measures force institutions to adapt and the smaller number of institutions is conducive to the evolution of a more efficient and competitive higher education structure. The admission results of 2007 show that competition is keen, and the concentration of institutions has started; the majority of students applied to larger universities and to institutions in provincial cities and in Budapest. To promote the transformation of the system of higher education institutions, a state-run university and college, and a church-financed university and college have been merged.
- The maximum state-financed student numbers have been reduced and their structure changed. According to the Government's decision and as a result of the new admission procedure, in September 2007 the quota of students that can be admitted to state-financed BA education fell from 62 thousand to 56 thousand (and will remain at that level in 2008). Within that figure, despite intensive labour market demand, the number of applicants to post-secondary vocational training fell some 6 thousand persons short of the quota, and the number of state-financed students actually admitted declined even further in 2007. The ceilings for lawyers, liberal arts students, teachers and economists have been reduced, natural sciences, IT and technical student numbers have been increased. Simultaneously with the cut, a multi-cycle (BA, BSc, MA, MSc.) education structure is being introduced in a bottom-up approach; as a result, the increase of state-financed total student numbers will come to a halt, to be followed by a drop of approximately 5 thousand per year from 2008 onwards.

From 2008 on, unjustified determinants in financing will be eliminated, and the quality requirements of training will be tightened.

- With the amendment of the Act on Higher Education, the regulation that set out determining factors for the financing of higher education has been eliminated. While the fundamental principles of support are retained, from January 2008 onwards state-financed higher education institutions will receive their budget transfers pursuant to performance-indicator-based, three-year agreements with their maintainers (owners).
- The quality of higher education may be improved by the new rule that restricts the possibility of the concurrent employment of lecturers by more than one institution.
- Higher education institutions are now allowed to perform certain functions in the framework of business associations and, accordingly, to employ staff under the rules of the Labour Code rather than under a public service relationship.

4.3.5. Gas and district heating subsidies

By the reform of the energy price subsidy regime, subsidies, formerly due to all direct or indirect household gas consumers, have been replaced by income-dependent compensation as of 1 January 2007. The purpose of the measure is to make the subsidy structure fairer so that persons who can afford to pay the market price for the service are not subsidised.

Accordingly, only those households are eligible for the subsidy, where the monthly net income per consumption unit does not exceed three and a half times the minimum old age pension (HUF 94,955 in the case of applications submitted in 2007, and HUF 99,610 expectedly in 2008). Following the evaluation of applications submitted, the Treasury establishes eligibility in a resolution. The service providers credit the awarded subsidy to the account of the consumers concerned, based on the data provided weekly by the Treasury.

Eligibility is established for one year – until 31 December of the year concerned -, therefore at the end of the eligibility period the subsidy must be re-applied for, which allows the repeated means-testing of consumers.

The use of subsidies has become more targeted as, from 1 January 2007, 40% of households have paid a market price for the gas or district heating service. In the case of the lowest-income households (approx. 20% of all households), the subsidy has remained unchanged, while the rate of subsidy decreased for 60% of subsidy recipients.

Under the subsidy regime of 2008, the number of subsidised households (the definition of the income brackets) will remain substantively unchanged, but the ceiling of subsidised gas volume will be lowered from 3,000 m^3 to 2,000 m^3 (from 5,000 m^3 to 4,000 m^3 for large families). Furthermore, the specific subsidy rates in the top two income brackets will be reduced by 14% and 20%, respectively.

As a result of the transformation of the subsidy system, budget expenditures to GDP ratio will fall from 0.4% in 2007 to 0.3% in 2008.

4.3.6. Disability benefits

In June 2007, Parliament adopted the Act on Rehabilitation Benefit, which added a new benefit category to supplement the present disability pension system consisting of three categories, to apply to persons with altered working capacity who have significant health impairment and are deemed to be candidates for rehabilitation.

Pursuant to the Act, the duration of the rehabilitation benefit is shorter than that of the disability pension; its purpose is to lead recipients back to the labour market; to that end, it provides not only cash benefits but also active, complex rehabilitation services. The new benefit system will start its operation on 1 January 2008.

The rehabilitation-centred transformation of the benefits paid to persons with altered working ability necessitates the modernisation of the system of expert assessment of altered working capacity; therefore, the National Institute of Medical Experts has been transformed into the National Rehabilitation and Social Expert Institute as of 15 August 2007; the preparation of experts for their new functions is under way. From 2008 onwards, the expert institute will asses the degree of health impairment, the professional working capacity and the possibility of rehabilitation, and it will make recommendations for rehabilitation; it is also expected to have social expert functions.

4.3.7. Public transport

The continued reform of the railways has created a multi-player market model. In the course of the re-organisation of MÁV Zrt. (state-owned railway company), rail freight transport was spun off into a separate economic organisation (MÁV Cargo Zrt.) in 2006. The passenger transport business of MÁV was transferred to MÁV Start on 1 July 2007.

In 2007, the Hungarian State implemented a HUF 111.6 billion equity increase in MÁV Zrt. to replenish the capital eroded in previous years and to comply with the capital adequacy requirement concerning the ratio of registered capital and owner’s equity.

The equity increase and the cost reimbursement given by the state to the track operator and passenger transport activities have offset the effects of factors that caused the losses, and assure, for 2007, a balance sheet profit close to the break-even point for both the parent company and the passenger transport firm.

The improved capital position has allowed the company to reduce its indebtedness and to repay some of its debt, in particular working capital loans. The modernisation of the organisation and of operations, resulted in the improved transparency of the company. The efficiency improvements started by the company (zero-based budgeting, BPR) are expected to make the subsequent years more profitable and more balanced financially.

5. Sustainability of public finances

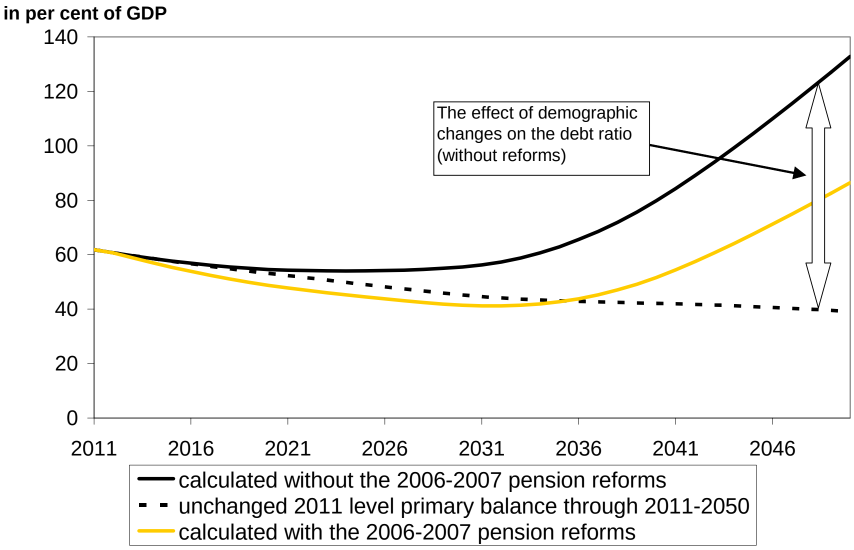
In its opinion on the convergence programme of December 2006, the Council stated that Hungary appears to be at high risk with regard to the sustainability of public finances. This assessment did not take into account the measures (relating to the pension system) resulting in cuts in long term expenditures that were adopted and implemented in 2006 and 2007[11].

Expenditures related to long term sustainability are determined by the pension, health care, old-age nursing and education systems, as well as the unemployment benefit system and long-term demographic trends. As a result of demographic trends, without the reform of the pension and health care systems, expenditures are certain to increase with the ageing of society, which induces a long-term growth of the government debt. The level of government debt calculated for 2050 is determined by the current position of the general government (budget balance, current government debt) and the size of ageing-related fiscal expenditures, which will grow in the future. The medium term reduction of the general government deficit as provided for in the updated convergence programme also improves sustainability, but the growth rate of expenditures relating to the ageing society must also be curbed so that the government debt 2050 can be reduced.

If expenditures relating to the ageing society were increased in the long term, then the debt ratio would fall to 39% by the end of the period, assuming the primary surplus projected for 2011 to remain unchanged up to 2050. Without the pension measures adopted since the second half of 2006, ageing-related expenditures would drive the debt ratio to almost 133% by 2050, which is reduced to 78.1% by the long term expenditure reduction effects of the measures adopted in 2006-2007.

[11] In its analysis underlying the assessment, the Commission took into account the switch to gross pension payments from 2013 on the expenditure side only. In contrast, the projection in the updated convergence programme show the so-called net pension expenditures, also taking into account the effects of the switch on revenues.

Debt ratio projections
and aging society expenditures[12]



5.1. Pension system

Since 1998, the mandatory Hungarian pension system has consisted of two pillars: the pay-as-you-go social insurance pension system and the fully funded private pension fund system. Career starters become insured in a mandatory manner in both pillars (so-called mixed system), and they pay a significant part (8% of the total, which is to be raised to 9.5% as of 2008) 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 contribution to the pay-as-you-go system, and their benefits will also be provided exclusively from the first pillar. Members of the mixed system will 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 becoming considerably stricter as of 2009;
- continuous extension of the period of income computation;
- 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).
- introduction of the mandatory fully funded system (the members of the mixed system will receive one quarter less benefits from the first pillar).

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

[12] The projection of the updated convergence programme assumes the same value for real GDP growth, real interest rate as the Commission does and uses the net pension expenditures. The graph shows a baseline scenario and one that uses 2011 level fixed aging expenditures through the projection period – till 2050. The difference between these two scenarios shows the magnitude of the sustainability risks stemming from aging. The effect of the pension reforms implemented in 2006-2007 on the debt ratio is also shown

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. The possibility of early retirement was also open to those who pursue income earning activities after their retirement. In recent years, the replacement ratio of initial pensions has increased substantially.

The Government has decided on legislation facilitating the addressing of controversial phenomena, entering into force following the constitutional preparatory period. The legislative amendment related to the social insurance pension benefits, adopted by Parliament in November 2006, contains the following key elements:

- 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.
- 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.
- After 1 April 2007, pension contributions in accordance with the general contribution rules must be paid also in respect of income earning activities pursued by pensioners. This contribution gives rise to eligibility for additional pension: pensioners receive a pension increase corresponding to 0.4% of their annual income (0.5% after 2008) for each year of contribution payment.
- From 2008 on, for incomes earned in previous years, instead of the current partial valorisation, full valorisation will be applicable in pension calculation (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 a combined effect, the replacement ratio of initial old-age pensions may decline from 85% to around 80%.
- From 2007, businesses employing persons in jobs with potential health hazards have to pay a special contribution to cover eligibility for early retirement. Between 2007 and 2010, the central budget will assume the related burdens from the employers, on a regressive scale, while from 2011, the 13% contribution will be payable fully by employers.

In November 2007, Parliament adopted amendments resulting in the further approximation of actual retirement to the legal retirement age and the actuarially correct treatment of early retirement pensions.

- In the case of men, the earliest date of early old age retirement will not be reduced to 59 years of age between 2009 and 2012; instead, it will remain at 60 years. The adjustment is estimated to result in expenditure savings of HUF 120 billion between 2009 and 2012;
- From 2013 onward, the rules governing the reduction of old age pension in the case of early retirement will be modified. The rate of reduction, depending on the time remaining until retirement age, would be 0.3% per month for the 61-62 age-group and 0.4% per month below the age of 61. The proposal is estimated to reduce expenditures in the longer term by 0.3% of GDP. Newly awarded old age pensions will be 3-4% lower on average.

As a result of these measures, by 2050, potential future expenditures will be reduced substantially, by approximately 1.6 percentage points, and the measures in the pipeline promise additional savings. The 1.6 percentage point drop does not reckon with the effects of the new early retirement contribution because it will reduce expenditures only if employers apply for, and receive, exemption from its payment by assuring appropriate working conditions, and therefore fewer employees will be entitled to early retirement benefits. The reduction of expenditures lowers the risk of long term sustainability.

The budgetary impact of measures

Measure	**Impact on the net long term expenditures until 2050** (in per cent of GDP)
Increase of the early retirement age:	-0.22
Suspension of pension in case of working:	-0.02
Alteration in calculation of pensions:	-1.08
Introduction of actuarially correct treatment of early retirement pensions:	-0.3
Total:	***-1.6***

In June 2007, Parliament adopted the Act on the reform of the disability pension system, which puts rehabilitation in focus. The regulation, which will be effective from 2008, modernises the system of assessment of altered working capacity. In this context, the assessment will cover not only the change in working capacity but also the remaining working capacity and the potential for rehabilitation. Persons who suffer a major impairment of working capacity but also have substantial remaining working capacity may in future receive rehabilitation benefit rather than a disability pension. This benefit may be granted for a limited term; it is payable during the rehabilitation procedure but for no more than 3 years. The new benefit rules, supplemented by the reform of the system of rehabilitation instruments and institutions, are expected to yield the first savings in 5 or 6 years, to increase to an appreciable level within 8-10 years of their introduction (at that point, aggregated savings may amount to HUF 100 billion).

The analysis of the sustainability of the pension system is based on the long term pension forecast expanding to 2050 as approved by the Economic Policy Committee (EPC) of the European Union and updated in November 2007, which takes into account the effects of the stabilisation measures adopted in 2006. According to the forecast, by 2050 the ratio of the net pension expenditures of the social insurance funds to GDP is expected to increase by approximately one-third. Simultaneously, 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 deficit calculated with net pension expenditures may reach 2.7% of GDP in 2050.

Pension expenditures

	2000	**2005**	**2010**	**2020**	**2050**
Net pension expenditures (in per cent of GDP)*	9.1	10.4	10.6	10.7	13.0
of which: expenditures of social security funds	8.6	9.7	10.0	10.2	12.7
Expenditures of private pension funds (in per cent of GDP)	0.0	0.0	0.0	0.1	2.7
Number of pensioners (million)*	3.1	3.1	3.2	3.2	3.4
of which**: in the pay-as-you-go system	2.8	2.8	2.9	2.9	1.3
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 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 begun; both the key parameters (retirement age, replacement rate, indexation) and systemic changes (e.g., individual accounts) will be reviewed and assessed.

5.2. Healthcare

5.2.1. Curative-preventive care

The objective of the healthcare reform started in 2007 is to reduce the regional and structural imbalances in the care system and to improve economies of scale and cost efficiency. To that end:

- The social insurance character of healthcare will be strengthened. The use of services based on the insurance principle will be conditional on the existence of an insurance relationship or other registered eligible status, and on the payment of the contributions due. Persons not paying contributions will continue to receive the necessary healthcare services. The Tax Administration will pay special attention to controlling residents failing to sort out their legal relationship and to collect any past due contributions upon the imposition of default fines or penalties.
- 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 rationalise the use and provision of services.
- The subsequent (higher) level of service can typically be used on the basis of a referral issued at the lower levels.
- Excess active in-patient capacities have been transformed into chronic, nursing or outpatient capacities or have been closed down.
- 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 has been established.
- The Government has decided on the liberalisation of the health insurance market.

The gross expenditures of curative-preventive care (taking into account the visit fee and the daily hospital charge) will be reduced, as a percentage of GDP, from 3% in 2006 to 2.8% in 2007 and 2.7% in 2008.

The acts relating to structural reforms – with the exception of transformation into economic associations and the liberalisation of the insurance market – were adopted by Parliament in 2006; the Bill on the liberalisation of the insurance market has been submitted to Parliament.

From the regulatory aspect, the social insurance character of healthcare has been reinforced. The new regulation specifies a three-tier benefit system. Persons in need of care will receive the necessary services even in the absence of an insurance relationship. The level subject to an insurance relationship covers a large section of curative-preventive care. With some exceptions, the use of the benefits is subject to a visit fee and daily hospital charge. Tertiary care includes supplementary (extra) services which can be used for a fee.

The system is expected to have a beneficial effect on the continued whitening of the economy and on the strengthening of the relationship between insurance and use. The new rules are implemented in two stages.

- 1 April – 31 December 2007: verification of eligibility for care, payment and records, notification to persons not paying contributions, possibility for making up for arrears.
- Until year-end, "non-payers" will not have any detriment.
- From 1 January 2008, non-insured persons will be entitled to services but the Tax Authority, based on the data supplied by the NHIF, will pay special attention to controlling residents failing to sort out their legal relationship and to collecting any past due contributions upon the imposition of default fines or penalties.

In order to limit demand,

- in the case of primary care, outpatient care and the related diagnostic tests as well as specialised inpatient care, as of 15 February 2007, the patient must pay a visit fee (HUF 300, 600 or 1000) or a daily hospital charge (HUF 300).
- In in-patient care as of 1 January 2007, and in outpatient care as of 1 January 2008, the service provider must give the patient an account statement about the service used.

As a result of the visit fees and other financing measures, the volume of services reported has decreased, remaining below the designated volume ceiling in the case of several service providers.

Pursuant to the Act on the professional and financing protocols (patient routes) and the rationalisation of the use and provision of services, in the case of the existing examination and therapeutic procedure, the provisions of the financing protocol must also be taken into account as long as a procedure has been devised in that respect. The latter specifies, based on any given indication, what services an insured person can use to what extent to be debited to the Health Insurance Fund. The majority of examination and therapeutic protocols have been completed while the development of financing protocols, taking into account cost efficiency and financing capability, is under way.

In the framework of the implementation of the Act on the development of the healthcare benefit system, the number of active hospital beds has been reduced considerably, partly by transforming active beds into chronic or nursing capacities. Outpatient care capacities have also been expanded. Thus, the structure of care has changed so that services are provided in fewer institutions, with greater economies of scale, in a more cost efficient structure and under relatively better financial conditions. The major reform process and adaptation to the altered conditions will happen gradually but the first beneficial results of the reform are already apparent.

The health insurance supervision was established at end-February 2007 in formal term as well, and it has started its operations. Its initial tasks consisted of the investigation of specific complaints by insured persons against the reform measures.

In summary, following the reform measures taken in the area of the health care reform, the standards of care can be maintained also under the tighter fiscal boundary conditions:

- As a result of the measures (visit fee, daily hospital charge, account statement, prescription rules), unjustified procedures no longer burden the benefit system, thus capacities can be used to satisfy real needs.
- The monitoring of care has become more efficient through the institutional background (Health Insurance Supervision) and the new legal instruments introduced (waiting list, scheduled appointment system).
- The promotion of forms of care, that create less burden for the budget but that are better for patients (day surgery, day hospital), continues.

The Government has submitted to Parliament the Bill on health care funds and on the rules of the use of in-kind services of the mandatory health insurance system, aimed at the reform of the health insurance system.

5.2.2. Pharmaceutical subsidies

Upon the entry into force of the provision of the Act 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) and the rules on the contributions of pharmaceutical companies, framework rules were introduced promoting the achievement of a more rational consumption level and structure, the enhanced transparency of the subsidy and admission systems and the reduction of pharmaceutical expenditures. A new, more equitable system of the joint responsibility of pharmaceutical producers (the beneficiaries of the pharmaceuticals marketing licence), traders, prescribing physicians, patients and the health insurance system has been created.

In 2007, the following important changes were introduced in the field of the pharmaceutical subsidy system and pharmaceutical market, in line with the Convergence Programme:

- the free supply of indication-related pharmaceuticals in priority subsidy groups has been abolished;
- subsidy rates have been lowered;
- in order to accelerate generic competition and to assure transparency, the rules of "fixing" of the subsidy have changed (formation of fixed subsidy groups and announcement of price cuts continuously, fixing on a quarterly basis);
- the criteria for remaining in the subsidised pharmaceutical category will become more stringent;
- in line with regulations promoting efficient prescription, physicists receive regular feedback about how their prescription practice relates to the average;
- the payment obligations of pharmaceutical producers and traders is set in an act (payment obligation of 12% of the producer-price-proportionate part of the subsidy, 2.5% of the wholesale margin of subsidised pharmaceuticals, HUF 5 million per year after medical representatives, tiered payment in the event of the over-run of the appropriation for pharmaceutical sales in pharmacies);
- the restraints on the opening of pharmacies have been eased and the sale of certain non-prescription drugs outside pharmacies has been allowed;
- a visit fee has been introduced to encourage a more rational behaviour of patients.

The reduction of the subsidy levels triggered a considerable increase in the co-payment early in the year. As a result of the price competition on the generic market, however, prices declined continuously during the year.

As a consequence of the measures affecting the pharmaceutical subsidy system and the pharmaceutical market, in 2007 the long-standing growth trend of pharmaceutical subsidy expenditures was interrupted, and there is a realistic chance that pharmaceutical subsidies do not exceed the relevant budget appropriation.

In 2007, the gross amount of pharmaceutical subsidies is expected to be around HUF 325-330 billion, which does not exceed the sum of the appropriation (minus the subsidy reserve) adjusted for the payments of producers and wholesalers. Thus producers need not make tiered payments. The balance of the payments of producers and wholesalers is expected to be around HUF 20-25 billion, the pharmaceutical-related balance of the Health Insurance Fund, HUF 305 billion. The ratio of gross and net pharmaceutical subsidies to GDP is expected to decline by 0.3-0.4 percentage points on a year-on-year basis.

In 2008, the main targets include the stabilisation of the achievements in pharmaceutical expenditures, the maintenance of the lower expenditure levels. The budget bill of 2008 contains a minor increase of pharmaceutical subsidies, the levels effectively remaining unchanged as a percentage of GDP.

Based on the expected results of the Act on Economy in Pharmaceuticals and the measures set out in its implementing regulations in 2007, no overall review of the regulation is called fall. However, the part of the act relating to the payments of producers and wholesalers may be amended early in 2008 to clarify or simplify the regulations. Such changes would not relax the payment obligations.

In order to retain the achievements in the long term, the following tasks continue to be important:

- Maintenance of competition between producers based on the lump-sum subsidy regime. The terms of the public bidding procedure should be clarified to assure efficient implementation;
- Promotion of high-quality and effective prescription practices. Based on the analysis of the experience gained, the fine-tuning of the system is called for;
- Maintenance and enforcement of the rules concerning the joint risk bearing of pharmaceutical producers (beneficiaries of the marketing pharmaceuticals marketing licence) and wholesalers;
- In the course of assessing the eligibility of new drugs for subsidies, the consistent application of the techniques of technological assessments. Framework rules for the eligibility of high specific cost technologies for financing from the Health Insurance Fund should be developed and enforced;
- The review of the subsidisation of drugs already admitted in order to achieve a balance in funding and rational use; increasing the efficiency of the control system, roll-out of the control system for the on-line monitoring of prescription and eligibility.

According to the Bill submitted to Parliament, the proposed reform of the health insurance system would not substantively affect the pharmaceutical market or the system of pharmaceutical subsidies. However, in the first year of the reform, probably in 2009, special attention must be paid to keeping emphasis on the monitoring of developments affecting pharmaceutical subsidies.

6. Institutional features of public finances

6.1. Budgetary procedure

The Hungarian Parliament is a unicameral legislative body. Its Standing Order is passed with a two-third majority of votes while the Committee of the House decides on the details in specific cases. The opposition is entitled to a proportionate representation in the Committee of the House where decisions are general understanding made unanimously.

The constitution stipulates that “the Parliament determines the government balance sheet and approves the government budget as well as its execution”. The budget law (Act on Public Finance, dated from 1992) and its implementing decrees regulate the budget process.

The Standing Orders of Parliament contain fairly detailed rules on the budget debate. In the first round, any type of proposed 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

	Date (election year)	Relative date (in month)
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

6.2. Public finance statistical governance

The Hungarian Central Statistical Office (CSO) and the central bank (Magyar Nemzeti Bank, MNB) compile the statistics on the government sector. In the current division of labour, the CSO is responsible for non-financial accounts, the MNB 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 (EDP Notification), while the expected deficit and debt of the current (t) period are calculated by the Ministry of Finance (MoF). Previously, the deficit for the (t-1) period was also calculated by the MoF, but since 2006, when the Notification deadlines were changed, the CSO has been able to take on this task, which assures consistency with the national accounts. The statistical working group comprised of the representatives of the CSO, the MNB and MoF operates on the management and expert levels, and a co-operation agreement regulates procedural issues of data flow, division of labour and methodological assessment.

Key data sources of the statistics of the government sector include the general government information system, the annual and interim reports of the units of legal government (including 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 Notification submitted under the Excessive Deficit Procedure, its time series and the detailed description of its compilation methodology ("EDP Inventory") are published and updated on the homepages of the CSO and the MoF, simultaneously with the press release of Eurostat. Since the autumn of 2007, the CSO has published brief press releases together with the Notification. According to the current practice, the MoF dedicates an individual chapter to 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 Parliament. The temporary possibility for the accounting of private pension funds as part of the government sector has ended; since April 2007, private pension funds have been classified in statistical reports within the sector of financial corporations.

6.3. Fiscal rules

Fiscal rules regulate certain commitments of municipalities in Hungary. According to the Local Government Act, the 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 own revenues adjusted for some items. 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 that restriction. In November 2007, the Government submitted to Parliament the Bill amending the Act on Local Governments. The Bill re-regulates the commitments of local governments. Commitments for development purposes are set at the amount of disposable funds (disposable funds are the positive difference of the revenues of the given year plus unspent appropriations from the previous year on the one hand and of expenditures on the other hand). For operational purposes, local self-governments may borrow exclusively liquid loans, which must be repaid within the calendar year.

The amendments of the Act on Public Finances, in July 2006, introduced new fiscal rules to strengthen fiscal discipline and transparency. One of the key elements of the new rules is the ‘chapter equilibrium reserve’ to be set up by budgetary chapters; the other one is a quarterly reporting obligation of the heads of bodies responsible for the chapter, on actual revenues and expenditures and their projected development to the Government. Upon the submission of the annual budget bill, the Government made proposals concerning the size of chapter reserves. The application of chapter reserves may be authorised based on the quarterly report of the chapter concerned, if budgetary developments of the chapter and of the entire general government allow such application. Any part of the chapter equilibrium reserve not approved for utilisation may be withdrawn.

Pursuant to the amended Act on Public Finances effective since 1 January 2007, the Government may only submit to Parliament a budget bill that assures the primary surplus of the Maastricht balance indicator of the government sector.

The 2008 budget bill further strengthens the medium term budgetary planning. The medium-term expenditure ceilings to be introduced will set the appropriation and expenditure figures for ministries three years in advance, thus Parliament will be able to decide about expenditure levels each year for another year. The chapter volumes of the 2008 budget bill contain the budgeted figures of the three-year outlook detailed by the ministries. The Government will publish the expenditure limits in a resolution at the beginning of next year, based on the 2008 Budget Act to be adopted by Parliament (i.e., following the incorporation of any changes required by the adopted budget act). The chapters may amend the limits published in the resolution only with the permission of the Government.

6.3.1. The Bill on Fiscal Responsibility and the Legislative Budget Office

Following extensive political discussions, in November 2007 the Government submitted to Parliament the Bill aiming to comprehensively reform the fiscal planning and implementation system, which requires a two-third majority in Parliament. The Bill sets new fiscal policy rules for the central sub-system of the legal government, sets up the Legislative Budget Office subordinated to Parliament, and introduces safeguards in the course of fiscal planning which assure that expenditure requirements additional to the approved medium-term expenditure ceilings can be proposed only if their balance-worsening effects can be offset by cutting other expenditures or increasing revenues.

According to the Bill, the fiscal balance targets must be set based on the requirement of public debt not increasing in real terms, and the provisions of the Stability and Growth

Pact. Medium-term fiscal planning is reinforced by the arrangement whereby Parliament, as a particular fiscal year approaches, sets figures of increasing detail, which must be complied with during the planning process:

- the primary balance target is set three years in advance (no deficit allowed);
- the discretionary balance requirement is set two years in advance (discretionary items are the budget items the sum of which, for the relevant year, is not exactly determined by substantive legislation or by trends in the private sector or by demographic trends, therefore they are set in the Budget Act);
- the detailed breakdown of discretionary items is set one year in advance.

According to the Bill, these rules will have to be applied from Autumn 2008 to set the primary balance requirement for 2011. Under the Bill, as a transitory provision, the primary balance requirements for 2009 and 2010 will be defined by Parliament in line with the convergence programme rather than by the application of the aforesaid rules.

The Legislative Budget Office to be set up pursuant to the Bill is meant to assure the transparency of budget planning and the professional and methodological soundness of the process. According to the Bill, the Office, similarly to the State Audit Office, is an independent institution reporting to Parliament, relying on individual responsibility, headed by the President elected by a two-thirds majority of the votes of the Members of Parliament.

According to the Bill the key responsibilities of the Office include:

- preparation and publication of macroeconomic forecasts;
- preparation and publication of baseline projections for the budget figures;
- preparation and publication of methodological recommendations relating to fiscal planning and forecasting;
- preparation of independent estimates concerning the fiscal effects of bills discussed by Parliament;
- preparation of independent estimates concerning the fiscal effects of motions for amendment discussed by Parliament.

The offset requirement set out in the Bill provides that, after the primary balance target has been set three years in advance, no legislation may be adopted that would result in the deterioration of the balance: simultaneously with any proposal for measures resulting in additional expenditures or revenue cuts, measures must be proposed to offset the fiscal effects of the former.

TABLES

Table 1

Macroeconomic prospects

	ESA code	2006	2006	2007	2008	2009	2010	2011
		HUF bn	percentage change					
1. Real GDP at 2005 prices	B1g	22 910.6	3.9	1.7	2.8	4.0	4.1	4.2
2. Nominal GDP	B1g	23 757.2	7.7	8.2	6.8	7.2	7.2	7.1
Components of real GDP								
3. Private consumption expenditure	P.3	11 986.3	1.9	-0.4	1.2	1.9	2.3	3.1
4. Government consumption expenditure	P.3	5 546.1	4.3	-5.5	-2.8	0.4	0.9	1.1
5. Gross fixed capital formation	P.51	4 877.1	-2.8	2.0	4.2	7.4	7.0	6.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	128.8	0.6	1.4	1.3	1.3	1.3	1.3
7. Exports of goods and services	P.6	17 369.1	18.9	15.5	12.9	11.8	11.5	11.2
8. Imports of goods and services	P.7	16 996.8	14.5	13.2	11.1	11.0	11.1	11.1
Contribution to real GDP growth								
9. Final domestic demand		-	1.4	-1.1	0.9	2.6	2.9	3.1
10. Changes in inventories and net acquisition of valuables	P.52+ P.53	-	-0.3	0.9	0.0	0.0	0.0	0.0
11. External balance of goods and services	B.11	-	2.8	1.9	1.9	1.3	1.2	1.0
Price developments								
12. GDP deflator		-	3.7	6.4	3.9	3.0	2.9	2.8
13. Private consumption deflator		-	3.2	7.6	4.8	3.0	2.9	2.8
14. HICP		-	4.0	7.9	4.8	3.0	2.9	2.8
15. Public consumption deflator		-	4.8	6.3	4.1	3.5	4.2	4.2
16. Investment deflator		-	5.7	5.0	4.3	3.5	3.0	3.0
17. Export price deflator (goods and services)		-	6.5	-4.0	1.2	1.2	1.1	0.9
18. Import price deflator (goods and services)		-	8.0	-4.7	1.3	1.4	1.2	1.0
Labour market developments								
19. Employment ('000)		3 906.0	0.7	0.1	0.2	0.6	0.6	0.6
20. Unemployment rate (%)			7.5	7.3	7.3	7.2	7.1	7.1
21. Labour productivity, persons			3.1	1.6	2.6	3.4	3.5	3.5
22. Compensation of employees (HUF bn)	D.1	10 754.7	4.9	8.3	5.8	5.3	5.6	6.1
23. Compensation per employee (HUF million)		3.1	4.1	8.1	5.5	4.7	4.9	5.4
Sectoral balances (% of GDP)								
24. Net lending/borrowing vis-à-vis the rest of the world	B.9		-5.7	-4.1	-2.3	-1.7	-1.3	-0.8
of which:								
- Balance of goods and services			0.4	2.5	3.9	4.6	5.1	5.3
- Balance of primary incomes and transfers			-6.9	-7.4	-7.9	-7.8	-8.1	-8.2
- Capital account	B.9/ EDP B.9		0.8	0.8	1.6	1.5	1.7	2.0
25. Net lending/borrowing of the private sector	B.9		3.5	2.1	1.7	1.5	1.4	1.4
25a. of which: statistical discrepancy			0.2	...	...	...	...	...
26. Net lending/borrowing of general government	EDP B.9		-9.2	-6.2	-4.0	-3.2	-2.7	-2.2

Table 2

General government budgetary prospects

	ESA code	2006	2006	2007	2008	2009	2010	2011
		HUF bn	per cent of GDP					
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	-2 188.2	-9.2	-6.2	-4.0	-3.2	-2.7	-2.2
2. Central government	S.1311	-1938.1*	-8.2	-5.8	-3.7	-2.9	-2.3	-1.9
3. State government	S.1312	-	-	-	-	-	-	-
4. Local government	S.1313	-158.2	-0.7	-0.5	-0.4	-0.5	-0.5	-0.4
5. Social security funds	S.1314	-91.9*	-0.4	0.1	0.1	0.1	0.1	0.1
General government (S13)								
6. Total revenue	TR	10 128.8	42.6	44.1	44.2	43.3	42.4	42.0
7. Total expenditure	TE[1]	12 316.9	51.8	50.3	48.2	46.5	45.1	44.2
8. Net lending/borrowing	EDP B.9	-2 188.2	-9.2	-6.2	-4.0	-3.2	-2.7	-2.2
9. Interest expenditure	EDP D.41	927.0	3.9	4.0	4.1	3.8	3.5	3.3
10. Primary balance		-1 261.1	-5.3	-2.2	0.1	0.6	0.8	1.1
11. One-off and other temporary items[1]			-0.7	-1.1	0.1	0.1	0.0	0.0
Selected components of revenues								
12. Total taxes (12=12a+12b+12c)		5 799.9	24.4	25.6	25.5	24.9	24.4	24.1
12a. Taxes on production and imports	D.2	3 560.6	15.0	15.5	15.3	14.9	14.7	14.5
12b. Current taxes on income, wealth, etc	D.5	2 217.9	9.3	10.0	10.1	9.9	9.7	9.6
12c. Capital taxes	D.91	21.4	0.1	0.1	0.1	0.1	0.1	0.1
13. Social contributions	D.61	2 996.9	12.6	13.5	13.5	13.4	13.2	13.1
14. Property income	D.4	248.1	1.0	0.8	0.7	0.5	0.5	0.4
15. Others		1 083.8	4.6	4.2	4.4	4.4	4.2	4.4
16.=6. Total revenue	TR	10 128.8	42.6	44.1	44.2	43.3	42.4	42.0
Tax burden (D.2.+D.5.+D.61.+D.91.-D.995.)		8 796.8	37.0	39.1	39.0	38.3	37.6	37.2
Selected components of expenditure								
17. Compensation of employees + intermediate consumption	D.1+P.2	4 548.8	19.1	18.1	16.8	16.6	16.3	15.9
17a. Compensation of employees	D.1	2 889.7	12.2	11.5	11.0	11.0	10.7	10.5
17b. Intermediate consumption	P.2	1 659.1	7.0	6.6	5.8	5.6	5.6	5.4
18. Social payments (18=18a+18b)		4 398.5	18.5	18.4	18.2	17.8	17.3	16.7
18a. Social payments in kind via market producers	D.6311, D.63121, D.63131	845.4	3.6	3.0	2.9	2.7	2.6	2.4
18b. Social transfers other than in kind	D.62	3 553.1	15.0	15.3	15.4	15.1	14.7	14.3
19.=9. Interest expenditure	EDP D.41	927.0	3.9	4.0	4.1	3.8	3.5	3.3
20. Subsidies	D.3	330.0	1.4	1.7	1.5	1.3	1.2	1.2
21. Gross fixed capital formation	P.51	1 044.8	4.4	3.5	3.5	3.2	3.3	3.2
22. Other		1 067.8	4.5	4.6	4.1	3.8	3.5	3.9
23.=7. Total expenditure	TE[2]	12316.9	51.8	50.3	48.2	46.5	45.1	44.2
Government consumption	P.3	5430.0	22.9	21.3	19.8	19.4	19.0	18.4

/*: in 2006, without the assumption of debt of HUF 468.8 bn of the social security funds by the central government, which in the notification according to Eurostat rules worsened the balance of the central government and improved that of the social security funds

[1] A plus sign means deficit-reducing one-off item.

[2] 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

per cent of GDP	ESA code	2006	2007	2008	2009	2010	2011
1. Gross debt		65.6	65.4	65.8	64.4	63.3	61.8
2. Change in gross debt		4.0	-0.2	0.4	-1.4	-1.1	-1.5
Contributions to changes in gross debt							
3. Primary balance		5.3	2.2	-0.1	-0.6	-0.8	-1.1
4. Interest expenditure	EDP D.41	3.9	4.0	4.1	3.8	3.5	3.3
5. Stock-flow adjustment		-0.7	-1.5	0.5	-0.2	0.5	0.6
of which: privatisation receipts		-1.2	-0.2	0.0	0.0	0.0	0.0
Implicit interest rate on debt (%)		6.4	6.4	6.4	6.0	5.7	5.4

Table 4

Cyclical developments

per cent of GDP	ESA code	2006	2007	2008	2009	2010	2011
1. Real GDP growth at 2005 prices (%)		3.9	1.7	2.8	4.0	4.1	4.2
2. Net lending of general government	B.9	-9.2	-6.2	-4.0	-3.2	-2.7	-2.2
3. Interest expenditure	D.41	3.9	4.0	4.1	3.8	3.5	3.3
4. One-off and other temporary items[1]		-0.7	-1.1	0.1	0.1	0.0	0.0
5. Potential GDP growth (%)		4.0	3.8	3,7	3,6	3.6	3.7
contributions:							
- labour		0,4	0,4	0,3	0,3	0,2	0,2
- capital		1.7	1,6	1,6	1,6	1.7	1.7
- total factor productivity		1,9	1,8	1,8	1,7	1,7	1,7
6. Output gap		1.2	-0.9	-1.8	-1.5	-0.9	-0.5
7. Cyclical budgetary component		0.3	-0.2	-0.5	-0.4	-0.2	-0.1
8. Cyclically-adjusted balance (2-7)		-9.5	-6.0	-3.5	-2.8	-2.5	-2.1
9. Cyclically-adjusted primary balance (8+3)		-5.6	-2.0	0.6	1.0	1.0	1.2
10. Structural balance (8-4)		-8.8	-4.9	-3.7	-2.9	-2.5	-2.1

[1] A plus sign means deficit-reducing one-off item
Due to the rounding the sum data could differ from the sum of the detailed data

Table 5

Divergence from the December 2006 Convergence Programme

		2006	2007	2008	2009	2010	2011
Real GDP growth (%)							
December 2006 Convergence Programme		4.0	2.2	2.6	4.2	4.3	-
2007 Convergence Programme		3.9	1.7	2.8	4.0	4.1	4.2
Difference		-0.1	-0.5	0.2	-0.2	-0.2	-
General government net lending (% of GDP)							
December 2006 Convergence Programme		10.1	6.8	4.3	3.2	2.7	-
2007 Convergence Programme		9.2	6.2	4.0	3.2	2.7	2.2
Difference		-0.9	-0.6	-0.3	0.0	0.0	-
General government gross debt (% of GDP)							
December 2006 Convergence Programme		67.5	70.1	71.3	69.3	67.5	-
2007 Convergence Programme		65.6	65.4	65.8	64.4	63.3	61.8
Difference		-1.9	-4.7	-5.5	-4.9	-4.2	-

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	10.6	10.7	10.7	13.0
Old-age and early pensions[2]	6.7	8.3	8.9	9.5	9.4	11.7
Other pensions (disability, survivors)	2.4	2.1	1.7	1.3	1.3	1.3
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[5]	6.9	6.4	8.4	9.9	10.0	10.3
Assumptions[5]						
Labour productivity growth	4.2	4.0	3.5	2.9	2.7	1.7
Real GDP growth	5.2	4.1	4.1	2.5	2.1	1.1
Participation rate, males (15-64)	67.5	67.9	70.6	73.9	73.4	71.8
Participation rate, females (15-64)	52.6	55.1	56.8	61.8	62.9	61.6
Total participation rate (15-64)	59.9	61.4	63.4	67.8	68.2	66.7
Unemployment rate	6.4	7.2	7.1	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.

[5] Projection of the Ministry of Finance until 2010, projection of the EPC AWG afterwards.

Table 7

Basic assumptions

	2006	2007	2008	2009	2010	2011
Hungary: short-term interest rate (annual average)	6.9	7.6	6.9	6.3	5.7	5.2
Hungary: long-term interest rate (annual average)	7.1	6.7	6.5	6.1	5.6	5.2
HUF/EUR exchange rate (annual average)	264.2	251.0	251.0	251.0	251.0	251.0
World excluding EU, GDP growth	6.0	5.6	5.3	5.4	5.4	5.4
EU GDP growth	3.0	2.9	2.4	2.4	2.4	2.4
Growth of foreign markets of Hungary	10.1	7.8	7.4	6.8	6.8	6.8
World import volumes, excluding EU	8.0	7.8	7.1	7.7	7.7	7.7
Oil prices (Brent, USD/barrel)	66.2	70.6	78.8	76.0	76.0	76.0