GOVERNMENT OF THE REPUBLIC OF HUNGARY

UPDATED CONVERGENCE PROGRAMME OF HUNGARY 2009-2012

Budapest, January 2010

Contents

TABLES

In line with the requirement of EU membership, Member 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.

In line with the decision the Council adopted on its meeting of 20 October 2009, instead of the usual deadline of 1 December, Member States submit their stability and convergence programmes till end-January this year.

This programme is the updated version of the December 2008 convergence programme. The Government published two reports in 2009, in May and September, on the progress of the implementation of the convergence programme. The progress reports gave detailed information on the budgetary development for 2009 and progress with structural reforms. The updated convergence programme covers the period 2009 to 2012 and takes into account the 2010 Budget adopted by Parliament on 30 November and the macroeconomic projection based on most recent information.

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 on 10 November 2009.

The cut-off date for the calculations of the convergence programme was 22 January 2010. The Government adopted the programme on its meeting of 27 January 2010, and submitted it to the European Commission and the Council after having consulted with the Economic Committee of the National Interest Reconciliation Council (OÉT).

1. Economic policy objectives

The negative impacts of the global financial crisis, later to develop into an economic downturn, which became evident in the autumn of 2008, had a severe effect on Hungary, being deeply integrated into international economic and financial flows, and have required diverse responses from economic policymakers. The objective of the new government that came into office in April 2009 was to adopt and consistently implement measures necessary to manage the crisis and to set on course structural changes with a positive medium and long term effect on the growth potential of the economy and the competitiveness of the country.

In the autumn of 2008, as the financial crisis deepened, it was vital to assure the external financing of the country and to maintain the stability of the financial intermediary system. In November 2008, in order to provide for sufficient funding, Hungary turned for assistance to international institutions (EU, IMF, World Bank); furthermore, in line with the measures coordinated at EU level, measures promoting liquidity, safe and prudent operation of the financial system have been implemented in the past year.

In Hungary, in view of the fragile external position of the country, the negative effects of the crisis could not be mitigated by fiscal stimulus measures. The Government, to partially offset the declining revenues forecasted due to the repeated downward adjustments of the growth projections, adopted several decisions on budgetary expenditure cuts. As a consequence, while the general government deficit to GDP ratio will practically remain unchanged between 2008 and 2010, the structural balance, calculated based on the cyclical position of the economy, improves by almost two and a half percentage points.

In the absence of any fiscal elbow room, reallocations within the budget as well as faster and more efficient use of EU funds promote in the short term economic stability, assistance to SMEs and their access to funding.

Partly in response to the crisis management measures, the risk assessment of Hungary has improved considerably since the second half of 2009, reflected both in declining sovereign yields and in the stabilisation of the exchange rate. Thus, as global financial developments returned to normal, the financing of public debt from the market could be resumed. In view of market financing opportunities developing more favourably than foreseen, practically no funds available under the loan agreements with international institutions were called down in the second half of 2009 and the disbursement deadline for the credit facility was modified from the original date of March 2010 to the autumn of 2010.

In line with the Council Recommendation of 7 July 2009 with a view to bringing an end to the situation of an excessive government deficit, the fiscal path of the convergence programme sets the target of reducing the general government deficit below 3% by 2011. Based on cyclical developments, this corresponds to a structural deficit of 1.5%. This results in a sustainable fiscal position over the medium term, which, taking into account the projected improvement of the international economic climate, creates favourable conditions for the growth of the Hungarian economy.

The structural changes launched in 2009, partly related to the reforms implemented since the second half of 2006 as described in previous convergence programmes and partly going well beyond such reforms have laid the foundations, through improving competitiveness and increasing the growth potential, for the resumption of the convergence path by Hungary. The tax restructuring promoting employment, the reinforcement of the sustainability of the pension system, the increased targeting of social benefits and their better incentives to take up employment enable, from the second half of the programme period, a growth rate of 3-4% to persist.

2. Macroeconomic prospects

2.1. External assumptions

The effects of the financial turbulences started in 2008 materialised in 2009 in the real economy. The EU survived the most severe crisis of its history; according to preliminary estimates, the GDP dropped by 4.1% last year. The first signs of recovery appeared in the second half of 2009: confidence indicators started improving, global trade picked up and recession came to an end in developed countries. However, fiscal stimulus packages have played a part in that improvement, thus there are still considerable risks relating to permanent long term growth.

The international environment considerably worsened in 2009 as compared to expectations before the crisis. When the 2008 December convergence programme was prepared, the external demand indicator of Hungarian exports projected a 2.6% growth for 2009. In contrast, according to current assumptions, the import demand of Hungary's main export partners fell by 13.3% in 2009.

For the forecast of the international environment, the convergence programme relies on the European Commission's 2009 Autumn Forecast. Accordingly, in 2010 developed countries may see the start of a slow growth with only gradual acceleration in 2011. The growth rate of the global economy outside the EU may be higher than previously expected, at 3.8% in 2010 and 4.1% in 2011. The import demand from developing countries was one of the driving forces behind the growth. After a substantial drop last year, global trade outside the EU is expected to grow by 4.6% in 2010 and by 5% in 2011. In the medium term, the economic performance of developed countries depends on the way countries resume a tighter fiscal policy after the increased fiscal deficits during the crisis.

According to the Commission's forecast, in 2010 growth in the European Union will be slow (at 0.7%), the GDP growth rate coming close to the pre-crisis levels first in 2011 (1.6%). The recovery will be export-driven; the conservative growth projections for forthcoming years rely on the assumption that the export expansion will have a moderate effect on components of domestic demand. An important element in the Commission's forecast in terms of Hungarian export prospects is that growth exceeding the EU average is to be expected in the Visegrád countries and Germany over the entire forecast horizon.

2.2. Cyclical position

In the period between 2001 and 2006, the Hungarian economy was growing above its potential, by a rate over 4%, which resulted in a positive output gap. The economic growth exceeding the potential was brought about primarily by the strong fiscal loosening that characterised the period. Between 2007 and 2009, due to the impact of adjustment measures and then to the global crisis, growth slowed down to a rate below potential; thus the positive output gap started to shrink. Nevertheless, output fell below the potential level only in 2009; i.e., that is when the output gap turned negative. Though growth will exceed the potential growth in 2011, the actual output level will remain below the potential level throughout the forecast period, i.e., the output gap will remain negative.

The global recession thoroughly altered the perception of actual GDP growth. These changes are also reflected in calculations of potential growth and its components. It has become clear that given the present structure determined by the level of fixed assets and technical development, the economy is able to grow at a much slower rate than previously assumed. The previously envisaged potential growth of 2.3% or higher will be attained only at the end of the forecast period, when the effects of structural measures required to stimulate the expansion of resources, i.e., labour supply and investments are reflected in potential growth. The effect of technical advancement (TFP) is expected to materialise only after 2012.

Cyclical position

	2008	2009	2010	2011	2012
GDP (growth rate, %)	0.6	-6.7	-0.3	3.7	3.8
Potential GDP (growth rate, %)	2.2	1.5	1.6	1.7	2.4
Contributions:					
Labour	0.0	-0.1	-0.1	0.0	0.0
Capital	1.3	0.9	1.1	1.1	1.8
Total factor productivity (TFP)	0.9	0.7	0.6	0.6	0.6
Output gap	**3.8**	**-4.6**	**-6.4**	**-4.6**	**-3.3**

Potential output - differences in the estimation approaches of various institutions

The potential output and the output gap are neither directly observable nor exactly defined economic indicators; therefore, different institutions often publish widely different estimates of these important indicators. There is a wide variety of estimation methods ranging from different filtering techniques to different econometric modelling. In accordance with the recommendations of the European Commission, for the convergence programme, the estimation of the potential output has been based on the Cobb-Douglas production function approach. In order to filter out the fluctuations caused by cyclical and other factors, the components of the production function have to be estimated by applying several smoothing techniques. To facilitate international comparison, when carrying out these steps and estimating the various parameters, the Commission strives to use identical models for all countries. Given the specificities of the Hungarian economy, the estimation model applied for the convergence programme slightly differs from the commonly agreed one.

The most important distinctions are as follows:

- The Commission uses, as input data, its own forecasts of economic variables up to 2011 and extrapolates them with mathematical techniques up to 2014. These extrapolations generally extend the present recession, thus in this case they distort the forecast of potential growth downwards. The calculation related to the convergence programme starts from the forecast of actual data up to 2014, which contains a phase of considerable growth, and extends these time series to a few more years.
- For the new Member States, the Commission estimates the NAIRU by adjusting the actual unemployment rate by means of the elasticity of unemployment with respect to the unit labour cost. In contrast, for the convergence programme, as Hungarian data show no significant relationship between this factor and the cycle, the unemployment rate is smoothed by a simple HP filter.

- For the estimation of the capital stock, the Commission does not take into account the actual data of the CSO published for the 1996-2007 period; (instead, it assumes that the capital stock is twice the GDP in 1995 and proceeds from that level relying on a depreciation rate and investments). In contrast, the procedure used by the Ministry of Finance extends the CSO stock figures of 1996-2007 forward in time.
- In accordance with the Solow residual approach, the TFP includes the impact of factors other than capital and labour and it has to be smoothed in order to obtain the trend TFP. While the Commission estimates a negative trend TFP growth after 2008, the more stable smoothing procedure used in the convergence programme keeps the figure above 0.6%.

The following table compares the estimates of different institutions concerning cyclical developments. It clearly shows that the Commission forecast is substantially more pessimistic than that of any other institution.

Potential growth and the output gap by various institutions

		2008	2009	2010	2011	2012
Convergence programme	growth	2.2	1.5	1.6	1.7	2.4
	gap	3.8	-4.6	-6.4	-4.6	-3.3
EU	growth	0.8	0.3	0.2	0.3	0.8
	gap	2.9	-4.0	-4.7	-2.0	-
OECD	growth	1.6	1.5	2.0	2.3	-
	gap	0.7	-7.6	-10.3	-9.6	-
IMF	growth	2.0	0.8	0.8	1.7	2.1
	gap	1.3	-6.2	-7.5	-6.2	-4.0
MNB	growth	1.9	0.5	0.5	1.9	
	gap	1.3	-5.7	-7.0	-5.6	

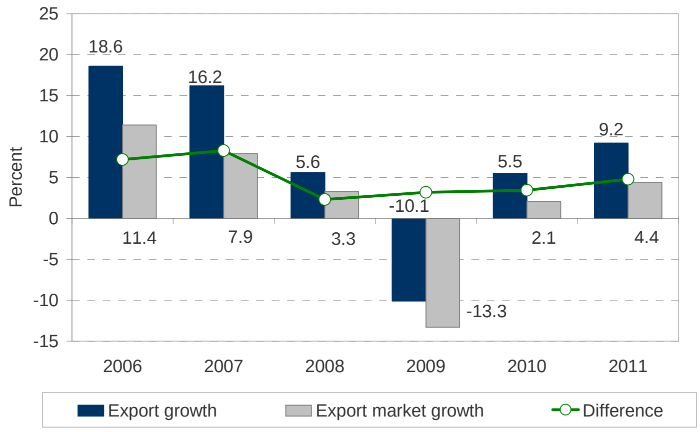
2.3. External demand and exports

To forecast the demand for Hungarian exports, the import demand of Hungary’s major export markets has been taken into account, relying on the European Commission’s 2009 Autumn Forecast. Accordingly, Hungary's export markets contracted by 13.3% in 2009 and only a slight expansion is to be expected in the years to come. Demand for Hungarian exports may grow by 2.1% in 2010 and 4.4% in 2011.

Hungarian export growth has significantly exceeded the expansion of its export markets for years. As a result of growing market shares, the decline of Hungarian exports was 3-4 percentage points lower than the negative external demand in 2009. This trend is expected to continue in the forthcoming years.

In the years preceding 2009, the share of non-EU countries and of New Member States increased considerably within Hungarian exports while the share of the EU-15 declined. In contrast, as a temporary effect of the recession, in 2009 the share of non-EU European countries within Hungary’s exports fell to 20.5%. As a result, the ratio of the EU-15 Member States in the exports of goods increased by 2 percentage points to 59.6% while the share of new Member States remained stable (19.9%). After the crisis and in the course of the recovery the former trend is expected to be resumed and Hungarian exports will become more diversified again.

The growth of export and export markets



Source: European Commission, MoF estimation

In 2009, during the global recession, Hungarian foreign trade showed considerable adjustment. In the environment of weak domestic demand, the decline of imports was almost 6 percentage points higher than that of exports, thus net exports contributed close to 5% to growth. As a result, the balance of goods and services produced a record surplus of around EUR 6 billion. In the second half of 2009, the refill of gas storage capacities improved the terms of trade, the improvement for the entire year amounting to 0.6 percentage point. Due to the repeated rise of oil prices, terms of trade are expected to worsen by 1 percentage point in 2010 and a slight deterioration is expected in the years to follow. In 2010, as a result of the improving external environment, an export growth of 5.5% is expected, while in 2011-2012 export growth may resume its pre-crisis level. Low domestic demand is likely to cause a weak import growth in 2010 again; as domestic demand picks up, the gap between the growth of imports and exports may close in 2011-2012. The outlook, however, carries considerable uncertainty subject to changes in the international environment.

2.4. Employment

In 2009, labour market developments were driven primarily by the recession and the Government's measures to mitigate its effects. The decrease in external growth and in domestic demand due to the repercussions of the sub-prime crisis forced businesses to implement adjustment measures in order to cut costs and restore profitability. Adjustment manifested itself partly in wage cuts (see section 'Incomes policy and consumption'), earnings in the corporate sector are showing a growth below the rate seen in previous years. The sector also responded to adverse developments by reducing working hours, the number of part-time employed rose continuously last year. However, in addition to wage and working time adjustments, businesses were also forced to lay off staff, thus a considerable headcount adjustment occurred in the labour market in the whole of 2009. To a limited extent this was offset by the headcount growth in the public sector, which was attributable exclusively to the Government's 'Pathway to Work' programme. Not counting the participants in that programme, headcount in the sector declined continuously as compared to the previous year. Thus, in the whole of the national economy, the number of employees fell by 2.5% and the unemployment rate (15-64 age cohort) slightly exceeded 10% last year.

Employment policy priorities and measures

The Government's employment policy will focus on two key priorities. On the one hand, similarly to previous years, it will continue to be a long-term objective to encourage the working age population to enter the labour market (that is, to increase labour supply), and to intensify the job search of the unemployed. In addition to specific programmes, employment incentives include the reduction of employer's social security contributions and the abolition of the lump-sum health contribution. In addition, the mitigation of the negative effects of the global recession also became a priority for employment policy.

There are several government measures aiming to increase the employment rate, which is very low in European comparison, and to stimulate the labour supply, the most important one being the 'Pathway to Work' programme (see the 'Structural reforms' section). This programme aims at helping permanently unemployed persons who receive regular social allowance to take up jobs as well as preventing unskilled working-age employees from being driven out of the labour market. Under the programme, a monthly average of almost 60 thousand persons were employed in 2009 and 70 thousand persons are expected to perform public work in 2010. The effects of the programme are reflected in labour statistics as employment in the public sector has been rising since April as the programme gained momentum.

In addition, the overhaul of the pension system and of the system of social benefits (see section 'Structural reforms') also serves to encourage supply.

The Government has simplified the rules of ad hoc employment by abolishing paper based administration and the 'temporary employment booklet'. As a result of simplification, unregistered employment is expected to decrease, the labour market to whiten and the legal certainty of employees to strengthen.

As another measure to stimulate employment, from 2010 on public sector institutions, if requested, will be obliged to employ persons returning from child care allowance or child care support in part-time arrangements until the third birthday of the child.

The Government continues to consider the encouragement of the *employment of persons with altered working ability* as a priority. To promote this, from 2010 on the rehabilitation contribution has been increased fivefold (to HUF 964,500/year), to be paid by businesses with more than 20 employees where the average statistical headcount of persons with altered working ability is below 5% of the total headcount. These measures may be conducive to the faster labour market integration of persons with altered working abilities.

As a result of the *changes in the tax regime*, in 2009-2010 the employer's social security contribution (SSC) and PIT rates have decreased, thus the tax wedge will narrow in the low, average as well as in the high income bracket. In the average income bracket, the tax wedge is close to the level seen in the

Visegrád countries. The 5 percentage point reduction of the employer's SSC and the abolition of the lump-sum health contribution will increase labour demand. Model calculations show that employment in the business sector will increase by at least 1% in the medium term as a result of the measure. As the burdens on businesses are eased, the preservation and creation of jobs will become easier and the competitiveness of businesses will improve.

To supplement long term and structural labour market incentives, in 2009 the Government allocated funds of about HUF 50 billion for programmes aiming to reduce, mainly in the short term, the labour market consequences of the economic crisis.

The National Employment Fund (OFA) financed the preservation of jobs with HUF 8.3 billion in total through three programmes ('Preservation', 'Back to Work' and 'New Prospects')[1]. The tender by the Ministry of Social Affairs and Labour (SZMM) entitled "*National employment preservation programme for employers in temporary financial hardship*", with a total value of HUF 10 billion, is similar to the 'Preservation' and 'Back to work' programmes in terms of its objectives and conditions. In addition to the programmes listed, the NHDP's TÁMOP tenders also serve to mitigate the negative employment impacts of the recession[2].

Furthermore, in order to promote employment in the business sector of persons eligible for availability support, from January 2010 onwards a subsidy is available to employers who undertake to employ, full time and under an employment contract, a person entitled to such support. The subsidy may be granted for a maximum of one year and its amount is identical with the sum of the availability support, currently HUF 28,500 per month.

To promote the return to work of persons losing their jobs because of the recession, the amount of the job seeking allowance payable for the remaining duration of the period of eligibility may be used to subsidise an employer undertaking to employ such jobseekers. This form of support shifts emphasis from passive benefit payment to fostering activity and return to work as soon as possible.

In the framework of the modernisation of vocational training, a scholarship has been introduced as of 2010 for persons training in trade schools skills with short supply. The purpose of the measure is to assure that the structure of training, the number and qualifications of school leavers are more flexibly adapted to the needs of the economy and of the labour market. The scholarship, in addition to orienting the choice of vocational training, contributes to reducing the drop-out rate and to encouraging students to better achievement.

Overall, the negative effects of the recession are clearly present in the employment figures of 2009 and will remain so in 2010, though these impacts are substantively mitigated by the short term crisis

[1] The "*Preservation*" programme subsidises the wages of employees at the risk of layoff for the maximum of one year and it obliges the organisation to continue employment for an additional time corresponding to the subsidised period. The programme can also be used to subsidise reduced work-time and/or employee training. The "*Back to Work*" programme subsidises organisations that hire individuals who lost their jobs due to the crisis (e.g. in mass-layoffs). The employer must agree to retain all employees (including those newly hired) until the end of the programme. Finally, the "*New Prospects*" programme provides support to organisations that are in the process of a layoff if they offer the services of an external recruitment-agency.

[2] The programme can be used to support employment trainings or for the development of so-called key competencies such as language and IT-skills. The total cost of trainings (and the loss of work-time due to the training) can be covered by the temporary subsidy programme (up to 200% of the minimum wage).

management measures of the Government. In the absence of those measures, the rate of decline in the number of employed persons and the growth of the unemployment rate would have been even more marked. Unemployment has reached 10.1% in 2009 and it is expected to continue rising in 2010. The substantial increase is attributable to the layoffs as well as to the fact that, unlike in the past, the overwhelming majority of laid-off employees (some 90%) remained in the labour market as jobseekers instead of retreating into inactivity. One reason for this is the fact that a number of primary income earners with stronger labour market ties may also have been made redundant. As another factor contributing slightly to the rise of the unemployment rate, many inactive persons may also have entered the labour market seeking jobs. All these factors increased the participation rate in 2009. Concurrently with the recovery from the recession and the pick-up of domestic and external demand, labour market trends are expected to be more favourable from 2011 onwards, which trend will be considerably strengthened by the Government's structural measures. The participation rate may continue increasing because, parallel with the decline of the unemployment rate, the number of employed persons will also start growing.

Employment data change in %

15-64 age cohort	**2008**	**2009**	**2010**	**2011**	**2012**
No. of employed	-1.2	-2.5	-1.1	0.9	0.9
Unemployment rate (%)	7.9	10.1	10.8	10.1	9.5
Participation rate (%)	61.5	61.6	61.8	62.2	62.5
GDP growth	**0.6**	**-6.7**	**-0.3**	**3.7**	**3.8**

2.5. Incomes policy and consumption

During the recession, trends in the business and public sector moved in opposite directions in terms of wages. In companies, despite a drop in profitability, regular wages have increased slightly. The salaries of white collar workers increased somewhat more dynamically than the wages of their blue-collar counterparts. As one reason, the retention of white-collar staff is more important even if higher wages need to be paid because this facilitates faster response when recovery commences. Furthermore, the number of manual workers dropped much more radically than that of white-collar employees, thus low wage earners were made redundant in greater numbers. In the business sector, after adjustment for the aforementioned composition effects, a moderate wage increase was seen for the whole of 2009. According to preliminary estimates, wage growth of around 4% occurred in the sector in aggregate.

As a result of the abolition of the 13th month salaries, or their partial and reduced compensation as well as due to the base effect and the increasing ratio of manual workers, average gross wages declined considerably in the public sector in 2009.

Thus, in aggregate, gross wages increased slightly in the whole of the national economy in 2009 while real wages remained slightly below the previous year's level. Real incomes showed a somewhat more marked decline than real wages, mostly due to the limitation of the 13th month pension in the first half-year then its abolition in the second half as well as the postponement of the pension correction measure.

Last year, as a consequence of the recession and the adjustment measures, the decline of real incomes, a major drop in consumption credits and strengthening prudence in combination resulted in an approx. 8% contraction of household consumption expenditure.

In 2010 the development of gross wages in the business sector is considerably more uncertain than usual. This is explained by the potential effects of tax changes, the declining inflation rate and the expanding labour supply. In 2010 gross wages in the business sector may increase at a rate similar to last year's while gross average earnings in the public sector will not change. At the same time, due to the favourable changes in the PIT regime[3], net earnings may increase substantially, by some 7% in the whole of the economy, thus real wages may rise by around 3% assuming the expected inflation rate of 4.1%. On the other hand, as a carry-over effect of the fiscal measures, real incomes may continue declining in the first half of 2010 but in the second half they will exceed the levels seen one year earlier.

The borrowing of households is difficult to estimate. Borrowing may be promoted by the increasingly positive international environment and the favourable net income trends of households while the delayed recovery of the labour market may work against that trend. On the whole, the forecast reckons with household borrowing remaining subdued in 2010. As a combined result, the consumption expenditure of households may remain in the negative range for the whole of the year (-2.5%).

From 2011 on, despite economic growth approaching 4%, wage growth below previous year's rates is projected while net wages will increase considerably as a result of the changes in the PIT regime. As a result of real wage increases and the phasing out of fiscal measures, real incomes may increase by 2-3% per annum from 2011 onwards. Naturally, this will also have an impact on household consumption expenditure, expected to expand by 3%.

2.6. Investment

In previous years, the maintenance of gross fixed capital formation at its previous level was attributable to investments of households and of the government as well as several mega-projects. However, the weakening of domestic and external demand, which started at the end of 2008, and the decline in lending reduced propensity to invest in the corporate, public as well as in the household sector. Still, the decline in gross fixed capital formation during the recession has not been drastic as compared with our competitors in the region. This is attributable to the more diversified economic structure and the low investment levels of previous years on the one hand. On the other hand, the crisis measures of the Government also contributed to a more moderate investment decline.

In the past year, investments of the corporate sector declined substantially due to a combination of demand and supply factors. Insufficient external and domestic demand resulted in surplus capacities in most industries, which forced enterprises to postpone investment projects. Investment decline was

[3] As a favourable effect of the PIT changes on incomes, the marginal tax rate will be reduced considerably for the approx. 1.5 million employees in the medium-income bracket, i.e., with gross monthly earnings between HUF 105 and 230 thousand; in other words, despite the rise in gross wages being moderate, the net monthly wage increase may be substantial. The net wages of persons with near-average earnings will increase by 12-14%.

most marked in the export-oriented manufacturing industry but the investments of the trade, construction, financial and accommodation sectors also lagged considerably behind the pre-crisis levels. In addition to demand-side factors, the tightening lending conditions and higher funding costs also hindered the investment activity of the business sector.

During the recession, the Government primarily strived to ease the burdens of the severely affected SME sector. In November 2008 a HUF 1400 billion programme was announced making more favourable forms of financing available in form of micro-credit, investment credit, working capital credit, credit guarantee, venture capital fund and interest subsidy. Furthermore tenders of the New Hungary Development Plan and the New Hungary Regional Development Programme provide significant non-refundable sources.

In recent years, fiscal consolidation has left limited room for the intensification of government investments. Despite the crisis, mostly due to the reallocation of EU funds, more than 600 high-volume infrastructure projects (schools, outpatient clinics, public spaces, railway and road projects) are facilitated in 2009 and 2010. The effects of this HUF 1800 billion package aimed primarily to revitalising the construction industry were already noticeable in 2009: the more modest decline of construction projects, which represent a greater weight, partly offset the marked drop in machinery investments which depend heavily on external markets.

In the first half of 2009 household investments were not affected by the recession: new housing construction was considerably above the previous year level because most of the projects started before the crisis were completed. After this, however, the number of occupancy permits declined considerably and as a result of the disappearance of favourable-term credit facilities, the deterioration of labour market trends and the increased prudence, household investments may have been considerably below the previous year level in the whole of 2009.

The crisis in the real economy will continue to slow the investment propensity of all three sectors in 2010, but from mid-year onwards investment is expected to rise slightly as a result of the recovery in external markets. In forthcoming years, a considerable gross fixed capital formation growth is expected, mostly due to the realisation of projects previously postponed. The recovery of corporate investments will rely primarily on the strengthening demand on export markets; furthermore, changes in the tax regime (reduction of taxes on labour) will also facilitate higher-value investments by businesses. The favourable changes will increase the competitiveness of companies and the capital attraction ability of the country.

The strengthened FDI attraction capacity of Hungary is indicated by the number of mega-projects to be implemented in the near future. The project of Mercedes, with a total value of almost HUF 200 billion, is an outstanding example, and it will generate additional investments. For instance, the Bosal group, one of the largest automotive supplier, will expand its operations in Hungary. Audi, which plans for the long term, continuously expands its activities, with investments of over HUF 60 billion in the next two years. The strengthening of the Hungarian motor industry is promoted, inter alia, by the relocation of the generator production of Bosch into Hungary. The rubber industry also plays a major part in manufacturing investments in Hungary. Hankook, which has been present in Hungary since 2007, will implement expansion projects of almost HUF 50 billion in the next two years.

The aforementioned mega-projects will contribute significantly to the growth of production capacities in manufacturing and to export expansion. In addition, the reinforcement of research and development in the context of investment projects and the increase in employment are also positive effects.

In 2010-2012 EU funds used in Hungary are expected to exceed all previous levels. This is the basis of infrastructure investments. In addition, considerable volumes of grants are available to businesses, which will have a positive effect on investment activity. Overall, funds from the EU may increase investment volumes by an average of approx. 2 percentage points per annum in the next two years.

In contrast with the intensifying investment activity of the corporate and public sectors, a temporary decline in housing construction is to be expected due to the disappearance of the cheap credit available in prior years and the restructuring of the housing subsidy programme. Thus a recovery in household investments is not expected before 2012.

Against this backdrop, in 2010 investment activity may remain subdued, while from 2011 onwards a strong investment growth of around 7% is to be expected.

2.7. Components of growth

As a result of the crisis, the Hungarian economy went into recession – the decline of GDP amounting to around 6.7% in 2009 – and the recovery will be a slow and gradual process. The recession may have bottomed out in Q2-3 2009, followed by the start of recovery in Q4.

The processes of the first half of 2010 will be shaped primarily by the carry-over effects of government measures, thereby temporarily restricting domestic demand growth. Nevertheless, structural measures underlying the fiscal consolidation promote the resumption of a long term growth path. Measures aimed at the reform of the tax system improve the competitiveness of businesses, which promotes the growth of investment and employment on the one hand, and the income position of household improves on the other hand, thus domestic demand is expected to gradually pick up.

Parallel with the growth of economies of the EU countries that are the main markets of Hungarian exports (primarily Germany), Hungarian export expansion will gradually approach its pre-crisis level. On the whole, the output of the Hungarian economy may increase slightly from the second half of 2010, then in 2011 the growth rate may return to the 3.5-4% level characteristic of previous years and sustainable in the long term.

Components of real growth

	2008	2009	2010	2011	2012
Household consumption expenditure	-0.5	-8.0	-2.5	3.0	2.8
Social transfers	-1.2	-1.0	-0.6	0.3	0.2
Final consumption of households	**-0.6**	**-6.6**	**-2.1**	**2.5**	**2.3**
Consumption of government	-0.3	-1.3	-1.1	0.3	0.2
Gross fixed capital formation	0.4	-7.1	1.1	7.0	6.9
Domestic use	**0.7**	**-11.5**	**-1.5**	**3.4**	**3.3**
Exports (goods and services)	5.6	-10.1	5.5	9.2	9.5
Final demand	2.9	-10.9	1.7	6.1	6.3
Imports (goods and services)	5.7	-16.1	4.5	9.2	9.5
GDP	**0.6**	**-6.7**	**-0.3**	**3.7**	**3.8**

2.8. External position

In respect of the external balance, the position of the Hungarian economy changed radically. In 2009 the improvement of the current account balance due to real economic transactions continued; however, due to the significant external trade adjustment to the recession, its rate was higher than earlier. The real economic surplus was 0.7% of GDP in 2008, which may have increased to 6.4% in 2009. The real economic surplus was also reflected in the improvement of the current account balance, showing a surplus of 0.6% in 2009 in contrast with the considerable, 7.2% deficit of 2008.

In 2009, the balance improvement was attributable to the lower import need of domestic consumption, which resulted from the decline of domestic demand as well as the reduction of the ratio of imports within domestic demand. The reduced import ratio indicates a structural change characteristic of the entire forecast horizon. Consequently, the real economic balance will show a high surplus throughout 2010-2012. The surplus may be around 6.5% of GDP in those years.

As Hungary will be in a net financing position from 2009 on, the stock of the external debt will start declining in 2010-2012. As a result of the already increased stock of external debts, in the balance of incomes the deficit of the income on debt as a percentage of GDP will presumably remain higher than in previous years. The credit extended by international institutions played a major part in the increase of external debt; its servicing and repayment will be due in the forecast period. The deficit of the income on equity continuously grew in previous years, to a considerable extent owing to the high profitability of direct investments implemented in Hungary in earlier years. In 2009, due to the financial crisis, the profitability of these investments worsened, thus the deficit of non-debt-creating income became lower than in previous years. As the global economy recovers, the deficit of income on equity to GDP ratio will gradually rise to around 5% in 2010-2012.

As a result of real economic transactions and the balance of incomes, the current account may show a surplus of around half a per cent in 2009. In 2010-2012 a slight deficit is expected in the current balance and the deficit is expected to remain moderate in 2012 as well. The EU transfers reflected in the capital account will result in a net financing capacity of over 2% in 2009 and around 1.5% in the 2010-2012 period as an annual average.

In the course of gradual recovery, during 2010-2012 net FDI will probably resume its pre-crisis level. Non-debt-creating financing may become dominant in 2011-2012.

External financing in % of GDP

	2008	2009	2010	2011	2012
Balance of good and services	0.7	6.4	6.4	6.3	6.3
Current account	-7.2	0.6	-0.2	-0.9	-1.0
Capital account including EU-transfers	1.0	1.6	1.8	2.4	2.4
External financing need(-)/capacity (+)	-6.2	2.2	1.6	1.5	1.4
Debt-creating financing*,**	6.2	-1.2	-2.6	-2.8	-3.5
Non-debt-creating financing	0.0	-0.9	1.0	1.4	2.1
of which: net FDI	2.7	1.2	2.0	2.3	2.5
of which: net reinvested earnings	1.9	0.2	0.9	1.3	1.6

**/without other capital*
***/negative amounts decrease the stock of external debt*
Due to the rounding the sum data could differ from the sum of the detailed data.

2.9. Inflationary processes

Following the global disinflationary trends, the Hungarian inflation rate started a steep fall in the second half of 2008, which continued in Q1 2009. The main reasons included a marked drop in agricultural price levels, the drastic fall of international commodity and energy prices as well as the demand-side constraint represented by the deteriorating domestic outlook due to the global recession and the shortage of credit. The substantial depreciation of the Hungarian forint late in 2008 and early in 2009, the temporary rise of unprocessed food prices and the fuel price rises due to the increase of the price of crude oil caused the inflation rate to reverse its falling trend by Q2 2009. Subsequently, inflationary processes of Q3 2009 were driven by indirect tax increases in mid-year, the petering out of the effect of the depreciation of the Forint, the continued strong presence of the disinflationary consequences of the recession as well as by a larger-than-expected fall in unprocessed food prices. In Q4, the inflation rate stayed substantially below the projected level due to the obviously severe and lasting recession. The price index was 5.6% in December, its annual average for 2009 being 4.2%.

The VAT and excise tax rate hikes in July 2009 (taking into consideration the price lowering effect of the introduction of the 18% VAT rate) increased last year's inflation by some 1 percentage point, and they will have a significant carry-over effect in 2010 as well. This latter effect was complemented by another significant increase of excise taxes early in 2010, which was only partly offset by the reduction of the VAT on district heating to 5%, thus the price index is expected to remain high (slightly rising) in Q1 2010. The rate of inflation is expected to decline in Q2, even against the background of the consumer price increasing effect of the proposed elimination of the present gas and district heating subsidy system.

In an environment of a stable exchange rate and a moderate increase in global commodity and energy prices, inflation in 2010 will be driven by weak demand (the output gap widened by the recession) and the unit labour cost growth rate dropping to an extremely low level (or turning into negative); thus after the transitional effect of the indirect tax hikes, the inflation rate will decrease by Q3 2010 significantly, falling below 2-3% by year-end according to the forecast. Due to the severe and lasting disinflationary effects of the recession and also to the favourable carry-over effects of the low inflation of 2009, the average rate of price increases is expected to be around 4%.

Consumer prices annual average change in per cent

	2008	2009	2010	2011	2012
Consumer prices	6.1	4.2	4.1	2.3	2.6

In the short term, the increase of indirect tax rates in 2009 and of excise taxes in 2010 has diverted the Hungarian inflation developments from the strong declining trend brought about by the recession. However, as the aforesaid effects wear off, Hungarian consumer price inflation may fall to an all-time low in 2011: if all the current assumptions materialize, inflation is expected to be around 2.3% next year.

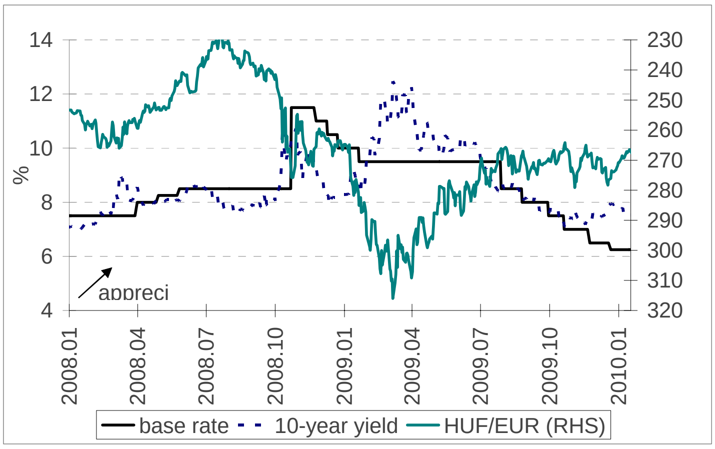
Subsequently, depending on the international economic climate and global inflationary trends, inflation in Hungary may rise slightly in 2012 (to approx. 2.6%) but it may permanently remain below the current medium term inflation target of 3%.

2.10. Monetary and exchange rate policy

Pursuant to the Central Bank Act, the central bank's primary objective is to achieve and maintain price stability. Since mid-2001, monetary policy has been operating within the inflation targeting framework, which has been supplemented by a free floating exchange rate regime since February 2008. The floating exchange rate regime creates more favourable conditions for the central bank to achieve the inflation target and thereby to meet the nominal Maastricht criteria, as well as for entering the ERM-II exchange rate system. The achievement of the inflation targets requires the continued support of fiscal policy. The monetary policy instruments are essentially harmonised with those of the Eurosystem, with the only difference that the Magyar Nemzeti Bank (MNB) applies passive rather than active-side operations.

Following the abolition of the fluctuation band in February 2008, the HUF exchange rate first strengthened, then, mostly in the period after the default of Lehman Brothers, weakened considerably. Thus the Forint exchange rate achieved both the strongest and weakest levels of the past decade in the less than one year between mid-2008 and early 2009. As a result of the normalization of the international financial markets as well as the measures taken by Hungarian economic policy and the already present results of some of those measures, the Forint became stable again.

Yield and exchange rate developments



In the environment of general lack of confidence in the money and capital markets, the market perception of Hungary was very unfavourable at the peak of the crisis despite the fiscal consolidation started in 2007. However, from April 2009 onwards, similarly to the exchange rate developments, also debt financing conditions returned to normal: the Government Debt Management Agency (ÁKK) was able to sell government bonds at auctions again, and the spreads fell considerably (by 4-5 percentage points). The country's default risk also decreased substantively, even though the CDS spread failed to return to the pre-crisis levels. In view of the expected favourable inflationary developments and the reduction of the premium required from Hungary, the Monetary Council cut the base rate eleven times, by a total of 5.5 percentage points, between November 2008 and January 2010.

The almost EUR 13 million[4] called down from the credit facility of approx. EUR 20 billion provided by the European Union, the International Monetary Fund and the World Bank directly contribute to the financing of the debt; furthermore, the satisfaction of the conditions set by these organisations and checked and acknowledged by international institutions also contributed to the strengthening of confidence in the country.

Similarly to other developed countries, banks in Hungary faced liquidity problems after the outbreak of the crisis. In order to address the problem, the MNB introduced a number of non-conventional measures. These included general liquidity enhancing measures such as the reduction of the reserve ratio (from 5% to the 2% applied by the ECB), the expansion of the range of eligible collateral, as well as the purchase of government bonds in the secondary market. In addition, banks could have access to HUF credit with longer maturities than usual among the normal instruments; furthermore, owing to the agreement with the ECB and the Swiss National Bank, the banking sector also has access to foreign exchange liquidity through FX swaps. The return of the liquidity situation to normal is indicated by the major reduction in the uptake of the aforementioned non-conventional facilities, some of them remaining completely unused for a long time. The Monetary Council has also restored the normal width of the interest rate corridor (±1%).

[4] Excluding the IMF credit drawn down by the MNB in June 2009.

On the whole, the banking system weathered out the critical times without any major shocks. Though lending activity has declined and the portfolio quality of banks deteriorated, their capital position is stable and profitability is excellent.

In 2009, monetary conditions produced hectic changes. The real exchange rate was driven primarily by the nominal HUF exchange rate, the real interest rate by the changes in yield levels. On the whole, both the consumer price based real exchange rate and the one-year ex ante real interest rate resumed their pre-crisis levels.

The Government considers the adoption of the euro as a priority. To facilitate the introduction of the common currency as soon as economic factors allow (satisfaction of the convergence criteria), the Government has continued preparation for practical changeover. In this context, at its meetings in 2009 the National Euro Coordination Committee reviewed the required measures and prepared the first update of the National Changeover Plan, approved by the Government in December 2009.

3. General government balance and debt

3.1. Medium-term fiscal path

As a result of the fiscal consolidation programme started in the second half of 2006, the ESA95 general government deficit dropped from 9.3%[5] in 2006 to almost half that level, 5%, in 2007. Subsequently, in 2008 balance improvement of another more than 1 percentage point was achieved even though the deficit in the second notification of the CSO to Eurostat was modified upwards, mostly due to the adjustment to EU transfers relating to large infrastructure projects, by 0.4 percentage points as compared to the first data disclosure and the figure included in the previous convergence programme.

The severe financial crisis, which reached Hungary in the autumn of 2008, narrowed the manoeuvring room of fiscal policy to the extreme. The vital need to strengthen financial market confidence and stability did not allow for the mitigation of recession by fiscal stimulus measures, thus as a result of the expenditure cuts to offset revenue shortfalls, the general government deficit effectively remained unchanged between 2008 and 2010: after 3.8% in 2008 and 3.9% expected for 2009, it may be 3.8% again in 2010. Taking into account cyclical effects, there is considerable fiscal consolidation underlying the stabilisation of the balance. As a result of the deep recession of last year, economic output dropped below the potential level, and as a slight decline is also expected for 2010, the output gap will continue widening. Against the background of a widening output gap, the cyclically adjusted deficit net of one off and other temporary measures will decrease by almost two and a half percentage points in 2009 and 2010 in aggregate.

Form 2011 on, growth is expected to return, thus the general government deficit may fall below 3% of GDP. In view of the output gap still being negative despite the improvement of the cyclical position, the structural balance in 2011 may reach the new medium term budgetary objective set in line with the Stability and Growth Pact (1½% deficit). In 2012 the fiscal path envisages a deficit reduction of the extent necessary to keep the structural deficit level.

Medium-term fiscal path in per cent of GDP

	2008	2009	2010	2011	2012
General government deficit	3.8	3.9	3.8	2.8	2.5
Structural deficit	4.5	2.5	2.2	1.5	1.5
Output gap	3.8	-4.6	-6.4	-4.6	-3.3

[5] According to the methodology used in the Excessive Deficit Procedure.

Change in the medium-term budgetary objective (MTO)

Pursuant to the Stability and Growth Pact, in November 2009 the Council adopted the new methodology to be used in future by Member States to set the medium-term budgetary objective. (MTO)*. As the most important element of change, implicit liabilities, namely future expenditures relating to the ageing population, also need to be taken into account when determining the MTO. This has the purpose of enforcing a long term approach.

Based on the new methodology, the medium-term budgetary objective of Hungary is a structural fiscal deficit of 1½% of GDP, as opposed to the 0.5% used in previous convergence programmes. The change resulting in greater fiscal manoeuvring room is explained by the fact that the pension measures adopted in recent years have considerably decreased the long term expenditures of the general government.

* For details, see the 'Code of Conduct':

At the start of consolidation, a fast equilibrium improvement necessitated expenditure cuts as well as the increase of revenues. This was promoted by the broadening of tax and contribution bases, the raise of certain tax rates and incentives to the whitening of the economy. In addition, expenditure cuts started in the second half of 2006 and structural reforms were launched in public administration, health care, education, the social benefit and pension systems.

Thus in 2007-2008, the increase of revenues as a percentage of GDP and decline of the expenditures to GDP ratio had a near-even contribution to deficit reduction and to the improvement of the primary balance. Subsequently, however, only expenditure side measures served as the basis for reaching the fiscal path envisaged in the programme.

In order to mitigate the negative effects of the crisis on employment and to improve the competitiveness of the economy, a tax restructuring was implemented starting in the second half of 2009 and completed in 2010, under which the tax burden on labour and on corporate profits have been reduced while taxes on consumption have increased. As the restructuring of the tax system is practically revenue neutral, fiscal policy will adapt to the reduction of revenues due to the recession by cutting expenditures and accelerating structural reforms in 2009-2010. As a result, as compared to the nominally declining GDP, expenditures will move parallel with revenues and the rise of the centralisation and redistribution rates in 2009 is attributable exclusively to a significant increase in EU transfers.

In the last two years of the programming period, the economic growth structure, and in 2011 the continued reduction of the personal income tax burden will result in revenues increasing at a rate below GDP growth. The balance improvement is assured by the decrease of expenditures as a percentage of GDP being more marked than that of revenues.

Main indicators of the general government in per cent of GDP

	2006	2007	2008	2009	2010	2011	2012
Taxes and social contributions	37.0	39.5	40.1	39.4	38.9	37.9	37.4
Revenues	42.6	44.8	45.5	45.9	45.0	44.2	43.3
Expenditures*	51.9	49.8	49.3	49.8	48.8	47.0	45.8
Primary expenditures	48.0	45.7	45.1	45.5	44.5	43.2	42.1
EU-transfers	0.7	0.7	0.6	1.7	1.6	2.3	2.1
Balance*	-9.3	-5.0	-3.8	-3.9	-3.8	-2.8	-2.5
Primary balance	**-5.4**	**-0.9**	**0.4**	**0.5**	**0.5**	**1.0**	**1.2**

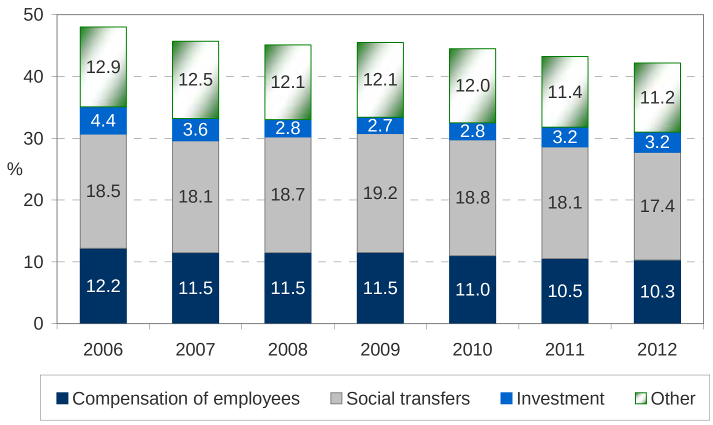
**: According to the EDP methodology, corrected with the net effect of swap transactions.*
Differences are explained by the rounding.

Between 2006 and 2008, the primary government expenditures to GDP ratio declined by almost 3 percentage points, or by 4.5% in real terms. In central public administration, the number of ministries was reduced and a number of large networks were reorganised on a regional basis. The financing of public education was changed and the number of state-financed students in higher education was reduced. The changes implemented in health care and promotion of micro-regional associations in the local government system aimed to improve cost efficiency. As a result of these measures, in 2007-2008 the number of public sector employees fell by more than 8% and the limitation on wage growth was also conducive to expenditure reduction. In those two years, the general government expenditures on compensation of employees fell by more than 7% in real terms. The overhaul of price subsidies (pharmaceutical and energy price subsidies, subsidies to public transport) resulted in an over 10% nominal drop in transfers in kind to households through market producers. The changes in the pension system reinforced long term sustainability, but up to 2008, due to the rise of pension expenditures and social benefits as required by legislation, the increase of in-cash social transfers offset the savings achieved in in-kind transfers, thus on the whole, social transfers as a percentage of GDP slightly increased between 2006 and 2008. The reduction of investment and other expenditures from the high initial level also contributed to the fall of primary expenditures.

Between 2008 and 2010, as a result of the strict fiscal austerity measures, primary expenditures fell by over 8% in real terms and by over 1.5% in nominal terms, even when including EU transfers, which increase both revenues and expenditures. Some of the measures (such as freezing the total public sector wage bill on a reduced level for two years, the reduction of the expenditures of line ministries, the considerable strengthening of housing subsidies, the postponement of raising various social benefits, etc.) have a long-term effect of reducing expenditure levels. Furthermore, accelerating structural reforms, through the further enhancement of the sustainability of the pension system (alteration of the indexation rule, abolition of the 13^{th} month pension, gradual retirement age increase from 2012 on) as well as the more accurate targeting of some social benefits (child care benefits, family allowance, energy price subsidies) and the improvement of the operational efficiency of public institutions (local governments, public transport companies) will also result in expenditure cuts. The level of social transfers will be effectively the same in 2010 as it was in 2008; the slight rise in its ratio to GDP relates to the smaller nominal GDP figure. Expenditures on compensation of employees are also reduced by the decreasing employer contribution rates.

The maintenance of fiscal discipline assures that in 2011 and 2012 each element of the expenditure side, except investments, decline as a percentage of the rising GDP. After the crisis, public sector earnings may start increasing at a moderate rate below GDP growth. As a result of the changes implemented by 2010, the social transfers to GDP ratio will decline substantively. In contrast, investment expenditures, partly as a result of the considerable increase in EU transfers, may resume the level required for catching-up, at slightly above 3% of GDP.

Main components of primary expenditures
(in per cent of GDP)



3.2. Budgetary developments in 2009

To increase the financial market stability, the previous convergence programme and, accordingly, the 2009 budget envisaged to reduce the general government deficit despite the worsening real economic outlook. The deficit target of 2.6% of GDP necessitated significant expenditure cuts of almost 600 billion HUF as compared to the pre-crisis forecasts, affecting mostly wage expenditures, central budget chapter expenditures financed from subsidies (i.e. not from own revenues or EU funds) as well as pension and social benefit expenditures. The budget reckoned that the wage scale would remain unchanged in the public sector and earnings on the whole would decrease by an amount corresponding to the 13th month salaries. The subsidy appropriations of chapters decreased in nominal terms compared to the previous year's level, and the so-called chapter-level equilibrium reserves have been frozen. The budget postponed the valorisation of the family allowance and the continuation of the so-called pension correction programme to September and restrictions were introduced concerning the amount of the 13th month pension and its eligibility criteria.

However, the global recession turned out to be deeper than foreseen at the time of the preparation of the budget; therefore the Government, taking into consideration the downward adjusted international forecasts and the worsening Hungarian macroeconomic indicators, modified the forecast for the expected rate of economic decline in two steps (from the 1% envisaged in the previous convergence programme to 3-3.5% in February and to 6-7% in May). At the same time, in order to prevent an additional output loss arising from expenditure cuts required to offset the whole of the revenue shortfall resulting from the more severe recession, the deficit target was raised in agreement with international organisations first to 2.9% of GDP, the in May to 3.9%.

The amended deficit targets also demanded additional expenditure cuts; therefore in February and May, packages of measures were adopted corresponding to 0.7% of the GDP each; their most important elements included freezing in the expenditures of central budget chapters, restricting the use of carried-over unspent appropriations remaining from previous years, reduction of wage compensation in the public sector, withdrawal of the second half-year portion of the 13th month pension, postponement of the family allowance raise and pension correction, the considerable tightening of the housing subsidy system, savings to be achieved in the gas and district heating subsidy system, reduction of the general sick pay rate, tightening of the review of disability benefits and the improvement of the balance of various extra-budgetary funds.

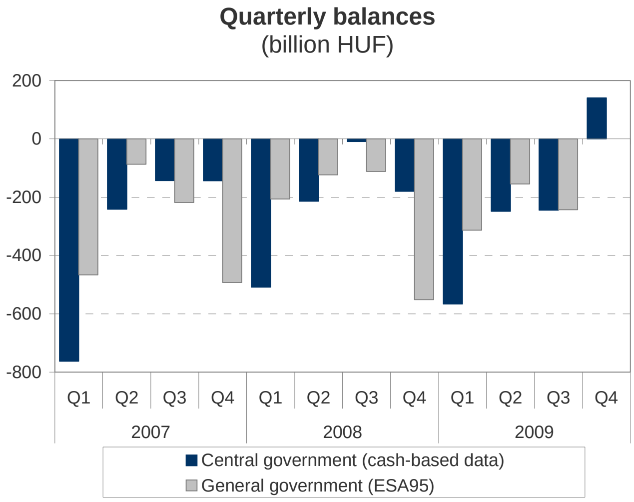
To assure that the expenditures of budget chapters remain within the expected levels, a new so-called treasurer system was introduced in September. The treasurers appointed by the Prime Minister monitor the financial management of budget chapters (and the related budgetary institutions) and extra-budgetary funds in order to prevent unnecessary commitments and payments The operation of the treasurer system proved to be successful and it played a major part in the proposed approx. 300 billion HUF savings, as compared to 2008, achieved in the net expenditures of budgetary institutions and chapter managed appropriations (i.e. in the balance of the revenues, expenditures and budget contributions of budget chapters).

Preliminary cash-flow data indicate that central government expenditures in general developed in line with expectations while revenues, partly due to one-off items, produced better results than expected. The deficit of the central government turned out to be some 70 billion HUF less than expected. As a result, the balance did not deteriorate substantively despite the recession and the primary surplus was 20 billion HUF higher than a year before. No final figures are available yet on the local governments but interim figures indicate that the balance of the subsystem may be somewhat better than originally envisaged. Even though the accrual based figures for the general government will not be available before end-March, cash figures indicate that the deficit target of 3.9% of GDP may be achieved.

Changes of the 2009 deficit forecast in per cent of GDP

	Dec. 2008	February 2009	May 2009	Sep. 2009	January 2010
Cash-based deficit of the central subsystems	2.3	2.7	3.8	3.8	3.5
Cash-based deficit including local governments	2.8	3.2	4.3	4.1	-
ESA95 deficit of the general government	**2.6**	**2.9**	**3.9**	**3.9**	**3.9**

The estimates of the accrual-based deficit are also underpinned by the quarterly figures. Within the year, in December the central government balance closed with approximately three times higher surplus than in 2008, thus a substantial cash flow surplus of 140 billion HUF was achieved in the whole of Q4. Based on the CSO's First Release, the ESA deficit in the first three quarters corresponded to 3.7% of the (seasonally adjusted) three-quarter GDP. In previous years, the accrual-based deficit of Q4 tended to be the highest within the year, while in Q4 2009, taking into account the previously unseen cash surplus of the central government, the accrual-based deficit of the whole of the government is likely to be considerably smaller.



The change in the usual seasonality relates to the fact that the impact of the two largest expenditure cut measures (cancellation of the second instalment of the 13th month pension and spending restrictions on budgetary institutions) appeared in the last months.

The better-than-expected cash-flow balance was attributable primarily to the surplus in receipts from state property and the transfers due to the return of private pension fund members to the pay-as-you-go pillar[6]. The cash-based tax and contribution revenues of the central government declined by 5% in 2009. The greatest drop of approx. 20% occurred in corporate income taxes (even though this was partly explained by the greater-than-usual "overpayment" at the end of 2008, which reduced 2009 revenues through reimbursements during the year). PIT and contribution revenues fell short of the 2008 levels by 5-6% due to the easing of the tax burden in the second half-year and mostly the deterioration of the employment rate. Moving in opposite direction as income taxes, consumption related taxes slightly increased as the net result of several factors. VAT revenues were boosted by the raise of the standard rate in July and the lower proportion of refunds than in the previous year. (The latter may relate to the decrease of stocks in the economy.) In addition, excise tax receipts were also favourably affected by the brought-forward purchases of tax stamps for imported tobacco products in anticipation of the excise tax rise of 2010. In contrast, the ex post VAT refunds made possible pursuant to the decision of the European Court of Justice had the opposite effect[7].

Accrual-based tax and contribution revenues of general government are estimated to have fallen by some 4%. As a result, tax centralisation may have been reduced by a few percentage points to 39.4% even compared to the falling nominal GDP.

Despite a significant growth in EU transfers reflected both in revenues and expenditures, the total accrual based revenues and expenditures of the general government could have been more than 1% lower than in the previous year. As a result of the expenditure cuts, in-cash social benefits effectively

[6] Pursuant to the altered regulations, private pension fund members after the age of 52 may return to the pay-as-you-go pillar until end-2009. The portfolio of such persons was transferred to the general government.
[7] Taxpayers could ex post request refunds of VAT on purchases make using government subsidies in 2004-2005 under self-correction submitted to the tax authority by 20 October 2009. On an accrual basis, the refunds may have worsened the balance by around 0.2% of GDP, but the cash flow effect for 2009 was less than that figure.

remained on the year 2008 level (pension expenditures declining by 2%), investment expenditures were reduced and expenditures on compensation of employees are estimated to have fallen by 2.5%.

3.3. The 2010 budget

The budget act approved by Parliament set the ESA95 general government deficit at 3.8% of GDP for 2010. This year, structural reforms (for details, see the chapter on structural reforms) will have a higher weight in the expenditure cut package underlying the budget and additional measures also serve to assure the permanent reduction of public expenditure levels.

- In order to strengthen the sustainability of the pension system, the rules of pension indexation have changed as of 2010, thus the pension increase was in line with expected inflation. As a result of the abolition of the 13^{th} month pension, the total pension expenditure will increase at a lower rate, by less than 2.5%.
- Social benefits will become more targeted and more effective. Child care benefits will be available for a shorter period and the maximum period of eligibility for the family allowance will be shortened by 3 years. In addition, the family allowance and social benefits linked to the old-age pension minimum will not be raised in 2010 either.
- The budget reckons with the altered regulations resulting in an over 10% drop in sick pay expenditures.
- As a result of better targeting, housing subsidies will be reduced considerably, by about one quarter.
- Expenditures on means-tested gas and district heating subsidies will drop to about one third of the previous level. The subsidy is financed from the income tax payable by energy suppliers in 2010 for the last time (so-called ‘Robin Hood tax’). The sum of other price subsidies (pharmaceutical subsidy, consumer price subsidy) shows a minimal increase on a year-on-year basis.

The aforementioned measures result in social benefits other than in kind staying at previous year’s level and in-kind social transfers through market producers declining. Both components of social transfers will decrease as a percentage of GDP, by almost half a percentage point in aggregate.

The budgeting of the system of public institutions was also subject to strict cost controls:

- The wage scale in the public sector will not be increased in 2010 either and the 13^{th} month salary will be abolished. Taking into account the financing of public work under the ‘Pathway to Work’ programme and the effects of the reduced contribution rates, expenditures on compensation of employees will decrease by half a percentage point of GDP.
- The effects of the freezing and other withdrawals will be incorporated permanently into the expenditures of central budget chapters. For the expenditures of chapters financed from subsidies (i.e. not from own revenues or EU funds), the 2010 budget contains an almost 7% lower amount than the 2009 appropriations.

Changes concerning local governments and public transport companies aim to further improve operational efficiency:

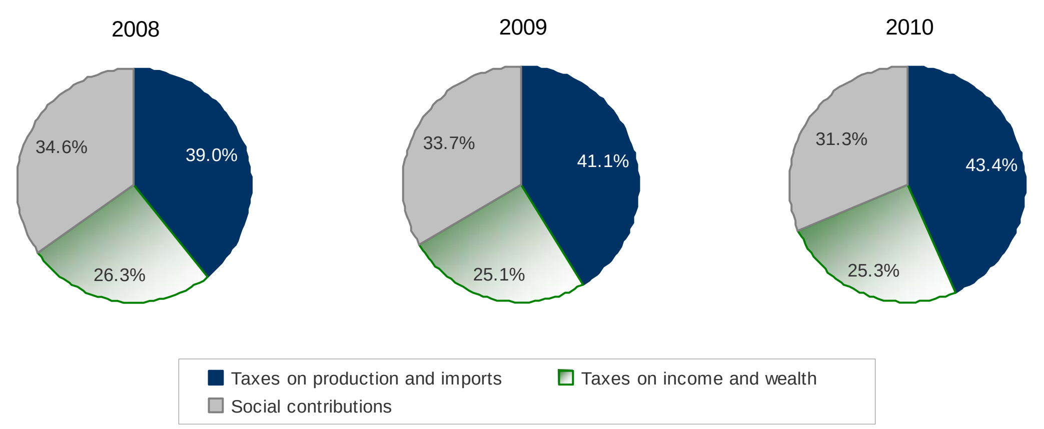
- The reduction of central budgetary transfers to the local governments will be supported by more flexible conditions for operation, but the appropriation also reckons with the effects of lower social contributions, the expected decrease in the number of pupils, the reallocation of certain task to central budgetary chapters, etc. (According to the 2010 budgetary forecast, the local government subsystem will respond to the reduction of central subsidies partly by efficiency gains and partly by a higher deficit.)
- Long distance public transport can be made more efficient by organisational and operational changes.

The budget gives priority to projects co-financed by the EU in 2010 as well, thus investment expenditures may rise slightly after the decline in 2009.

As a result of the packages of expenditure reducing measures in a number of areas, the budget envisages the consolidated primary expenditures of the central government (excluding expenditures covered from EU transfers or the own revenues of institutions) to be some 8% below the "ceiling" determined in the fiscal responsibility law. Pursuant to the law, in 2010 (and in 2011) the ESA-95 general government deficit must be lower than in the previous year. The 2010 budget satisfies that requirement: the deficit will decrease both in nominal terms and, if only slightly, as a percentage of GDP.

The achievement of the deficit target will be assured by the savings on the expenditure side, as the projected macroeconomic development will result in a few tenth of percentage point decline of tax centralisation (ratio of the accrual based tax and contribution revenues of the general government to GDP) due to the growth of major tax bases (wage bill, consumption expenditure) falling behind that of nominal GDP growth. The tax restructuring started in the second half of 2009 and completed in 2010 has changed the structure of revenues: the weight of social contributions and taxes on income has decreased, the ratio of taxes on consumption has increased.

Change of the tax structure

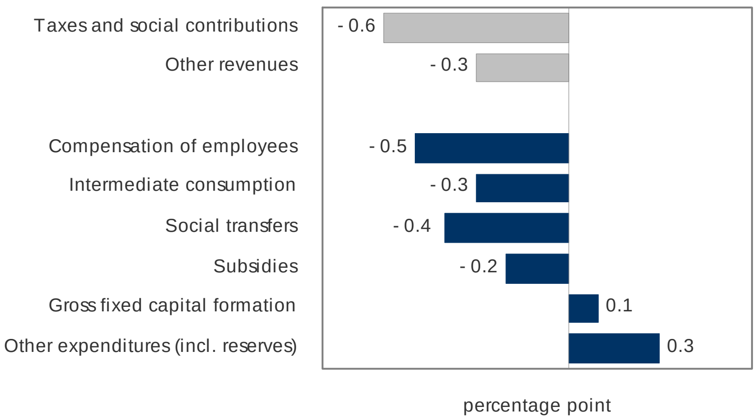


Macroeconomic figures that have become available since the preparation of the budget indicate that economic decline this year may be more moderate than the 0.9% assumption used in the forecast underlying the budget. However, the more favourable forecast relates mostly to the better external economic outlook and the resulting better export performance as well as a slight improvement in investment expectations, thus no substantive revenue surplus is to be expected. In contrast, the tax revenue developments of 2009 will have a negative effect on this year's budget: income related taxes were lower than assumed during budgeting while the surplus of consumption related taxes was partly attributable to one-off factors (greater-than-expected advance purchases of tobacco sales). In combination, the adverse base effect and the Constitutional Court's decision affecting personal income tax receipts[8] may cause a shortfall of 0.3% of GDP in accrual-based tax revenues in 2010.

The revenue shortfall may be offset by additional savings in the expenditure of budget chapters, lower interest expenditures facilitated by a more favourable yield environment as well as the revenues due to the return of private pension fund members into the pay-as-you-go pillar, which were not incorporated in the budget.

In order to cover risks, built-in reserves in the 2010 budget are higher than in previous years. The general, stability and interest risk reserves in combination amount to 0.8% of GDP. To promote compliance with the deficit target, the Government considers that the stability reserve amounting to 0.4% of GDP can be used only if revenue appropriations are expected to be achieved at a rate of over 102%.

Expenditure and revenue changes in 2010
(compared to 2009, in per cent of GDP)



3.4. 2011-2012 budgetary objectives

In the last two years of the programming period, the export and investment driven growth, and in 2011 the continued reduction of the personal income tax burden will result in revenues increasing at a rate below GDP growth. Between 2010 and 2012, tax and contribution revenues may decline by some 1.5 percentage points as a percentage of GDP. The attainment of the deficit targets requires the decrease of expenditures as a percentage of GDP being more marked than that of revenues.

[8] The Constitutional Court annulled the regulation on including in the tax base the family allowance as a non-taxable emolument.

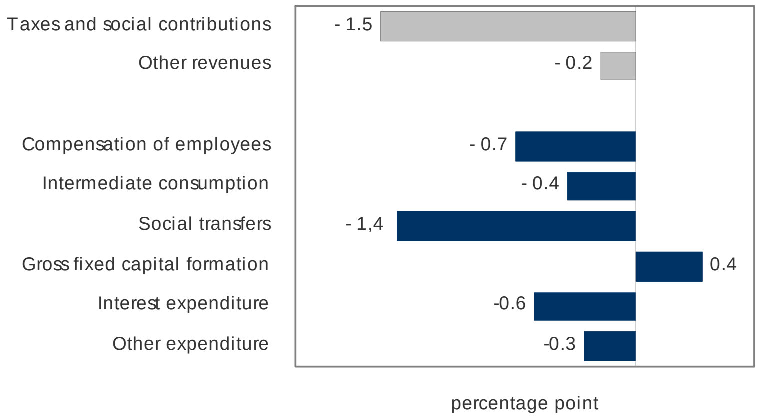
Taking into account the expected development of revenues and interest expenditures, the forecast in the convergence programme assumes the primary expenditures of the central budgetary subsystems to be lower than it would be allowed under the fiscal responsibility law. The maintenance of fiscal discipline and the effects on forthcoming years of the reforms of the expenditure side implemented by 2010 will result in an almost two and a half percentage point drop in the primary expenditures of the general government.

The forecast relies on the following assumptions:

- From 2011 on, public sector earnings may start rising but only at a moderate rate below GDP growth;
- Strict discipline continues to be maintained in the management of central budget chapters. In order to achieve the deficit targets, the expenditures of chapters financed from subsidies (i.e. not from own revenues or EU funds) may start rising only in 2012, but even then they will stay below the 2010 level as a percentage of GDP. Partly as a result of this, the expenditures on intermediate consumption of the general government will decrease in both years as a percentage of GDP;
- As a result of changes reinforcing the sustainability of the pension system and the improved targeting of other social transfers, social benefits other than in kind will decrease by one percentage point as a percentage of GDP. On the whole, the programme reckons that this item will remain level in real terms.
- After the crisis, from 2011 on unemployment-related expenditures may start declining;
- Due to the changes introduced in 2009, housing subsidy expenditures will be declining year from year;
- As a result of the "phasing out" of means-tested energy price subsidies and the moderate growth of other price subsidies, social transfers in kind supplied via market producers will decrease as a percentage of GDP;
- On the whole, the reform of social transfers implemented by 2010 will yield the most substantial savings on the expenditure side in 2011-1012.

Given the austerity measures, and also reckoning with a substantial increase in EU transfers, the only large expenditure items to grow faster than GDP are investment expenditures and in the last two years of the programming period they may resume the level required for catching-up, at slightly above 3% of GDP.

Expenditure and revenue changes in 2011-2012
(compared to 2010, in per cent of GDP)



3.5. Structural balance and one-off items

According to the calculations of the convergence programme, the sensitivity coefficient is 0.28[9], that is, the balance of the general government changes by 0.28 percentage point upon a 1% change in GDP (with its structure unchanged).

The output gap will remain in the negative throughout the period of the convergence programme. The output gap will widen continuously in 2009 and 2010. GDP growth in 2011 is expected to exceed potential growth, thus the gap will start narrowing but it will still be significant in 2012. As a consequence of the significantly negative output gap, the cyclically adjusted deficit tends to be smaller than the actual ESA deficit.

The expenditures and revenues of the general government were affected by one-off items in 2008, 2009 and 2010. In 2008, expenditures were increased by one-off costs related to layoffs in the public sector and one-off items relating to MÁV, the railway company, while revenues were increased by the one-off item of the GSM concession receipts. In 2009, the VAT refund pursuant to the decision of the ECJ and the relating default interest were recorded as one-off expenditure items while revenues were increased by the transfers due to the return of private pension fund members into the state pension system. The latter item will also be present in revenues in 2010. In 2010 the sale of another frequency concession will constitute another one-off revenue item.

The structural deficit, which takes into account the economic cycle as well as one-off items affecting the budgetary balance, will improve continuously between 2008 and 2011, until the medium term budget objective (MTO) is achieved. Between 2008 and 2011, the rate of improvement will be 1% of GDP on average. In 2012 the programme sets the target of maintaining the level of the MTO.

[9] The calculation of the cyclical coefficient is described in detail in Chapter 4.

Structural balance in per cent of GDP

	2008	2009	2010	2011	2012
Output gap	3.8	-4.6	-6.4	-4.6	-3.3
General government balance	-3.8	-3.9	-3.8	-2.8	-2.5
Cyclically adjusted balance	-4.9	-2.6	-2.0	-1.5	-1.5
One-offs*	-0.4	-0.1	0.2	0.0	0.0
Structural balance	**-4.5**	**-2.5**	**-2.2**	**-1.5**	**-1.5**

** A plus sign means deficit-reducing one-off items.*

3.6. Public debt

At the end of 2008, the debt ratio of the government sector was 72.9%. The dramatic increase of the rate as compared to previous years was caused, in addition to the budget deficit, by the credit drawn down from the EU and the IMF but not used for financing purposes. These credits were used to finance two funds earmarked for the strengthening of the banking system and the funds made available to banks, but in the tight money market situation the state also used the facility temporarily to finance the debt.

In respect of public debt financing, the developments of 2009 can be divided into two markedly different periods. Up until March-April, the market of government securities was characterised by several waves of strong turbulence, tight liquidity and a significant outflow of foreign capital. In this situation, the debt manager announced a significant bond buy-back programme, which stabilised the market and also reduced the refinancing risk of the public debt (mostly government securities maturing between 2009 and 2012 were repurchased). After April the money market situation improved gradually; in July a Euro bond was issued successfully and the government bond auctions, suspended in October 2008, were also restarted, with rising volumes of sale. The financing plan for 2010 reckons with no new credit drawdowns from the facility provided by international institutions. In the baseline scenario, the public debt can be sufficiently financed using existing sources and market opportunities.

IMF and EU loan drawdowns of the state*

	IMF (million SDR)	EU (million EUR)
2008	4 215	2 000
2009	2 158	3 500

** Excluding the MNB loan drawn down from IMF in July 2009.*

As compared to the convergence programme of 2008, the debt path has been changed considerably, with the debt ratio increasing through the entire time horizon. As the most important factor underlying the dramatic debt growth, is the nominal GDP being considerably lower due to the recession than it was used in the previous programme. The debt ratio is also increased by the higher deficit assumed for 2010-2011.

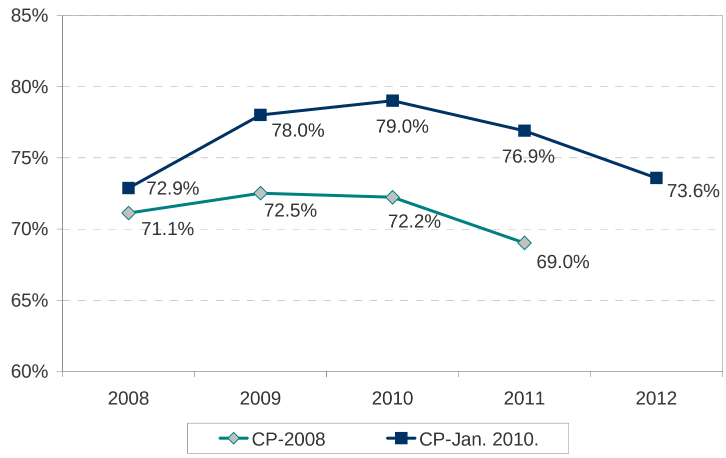
The medium term economic policy objective is to decrease the debt ratio after a temporary rise. In 2010, the debt ratio, as the net result of a slightly growing nominal GDP and the fiscal deficit, is expected to continue rising by 1 percentage point, peaking at 79%. From 2011 on, the debt will start to fall as a combined result of three factors: the start of growth, tight fiscal policy and the commencement of the repayment of credits from international institutions.

Main assumptions in the convergence programmes in terms of GDP %

		2008	2009	2010	2011	2012
Nominal GDP growth (%)	CP-2008	6.6	2.2	5.0	5.5	
	CP- Jan. 2010	4.4	-2.3	2.0	5.6	6.5
General government deficit	CP-2008	3.4	2.6	2.5	2.2	
	CP- Jan. 2010	3.8	3.9	3.8	2.8	2.5
Debt ratio	CP-2008	71.1	72.5	72.2	69.0	
	CP- Jan. 2010	72.9	78.0	79.0	76.9	73.6
	CP-2008 net*	65.4	67.8	67.8	66.9	
	CP-Jan. 2010 net*	67.3	73.7	76.3	75.2	73.1

** IMF and EU loans drawn down but not used for financing purposes decrease the netted debt ratio.*

Debt ratio in the December 2008 and in the current convergence programmes



The various factors in the development of public debt:

- *Primary balance :* in 2010-2011, as a result of the different deficit path, the primary balance will be 1.5 and 1.2 percentage points lower, respectively, than envisaged in the convergence programme of 2008.
- *Interest expenditure:* the present programme reckons with interest expenditure being slightly lower in 2009-2010, and considerably lower for 2011, than envisaged in the 2008 programme. Against the higher debt, this is explained by a more favourable yield environment. The yield curve 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.
- *Stock-flow adjustments:* apart from the budget deficit. the future debt ratio will also be influenced by the stock-flow adjustment:
  1.) The baseline scenario reckons with no further substantial privatisation receipts on the time horizon of the convergence programme (apart from some minor sales by local governments),

2.) The exchange rate at end-2009 was more than 2% lower than one year before, which increased the year-end debt level in Forint terms. The technical exchange rate assumption used for the debt forecast is almost identical with the Forint rate at end-2009, thus we expect no revaluation effect in 2010,

3.) Stock-flow adjustments are affected by financing items not recorded in the deficit but influencing government debt (e.g., EU pre-financing; year-end change in the Single Treasury Account and other HUF or foreign exchange accounts), as well as the difference between cash and accrual based accounting. Throughout the time horizon of the programme, stock-flow adjustment is dominated by the proposed use and reduction of the IMF and EU credits.

The future debt ratio is sensitive to changes in the following main factors (ceteris paribus[10]):

- Primary balance: a permanent, 1 percentage point annual change in the primary balance prevailing from 2010 to the end of the path will induce a 2 percentage point change in 2010, and a 3 percentage point change in 2012 in the debt stock (which includes the accumulated interest expenditure as well).
- Exchange rate: the currency structure of the debt portfolio has changed significantly due to the drawdown of IMF and EU funds. Within gross debt, the share of foreign currency increased to around 42% at the end of 2009; as a result of the increasing weight of HUF financing, the FX ratio will fall to around 35-36% by 2012. Accordingly, between 2010 and 2012, a 10% exchange rate change would move the gross debt ratio by 3.2-2.6 percentage points, respectively. If we look at the debt ratio net of the foreign exchange assets not used for debt financing, the foreign exchange ratio will be 39-35% along the path, thus a 10% exchange rate change would have an effect of 3 - 2.6 percentage points.
- Yield curve: yield curve changes appear gradually in interest expenditures through renewed instruments. In the various years, the cumulative effect of the altered interest expenditure on the debt ratio between 2010 and 2012 would be, in the event of a 100 basis point yield change in HUF government securities: 0.1, 0.3, 0.5 percentage point (change in interest expenditure in terms of GDP: 0.1, 0.2, 0.3 percentage point).
- Economic growth: a steady 1 percentage-point change of nominal GDP starting from 2010 and continuing throughout the period would have an impact of 0.8 percentage point in 2010 on the gross debt ratio, 1.5 in 2011, and 2.2 in 2012.

[10] Examining the impact of changes in specific items on the debt ratio, under the assumption that other variables remain unchanged.

4. Sensitivity analyses

Macroeconomic processes affect the general government balance through the total wage cost, consumption and other variables. This effect is generally measured by the cyclical sensitivity index, showing how the general government balance changes as a result of a one per cent change in GDP. The sensitivity index takes into account the main taxes (PIT, CIT as well as taxes related to consumption, i.e., VAT, local business tax, excise taxes and simplified business tax) as well as social security contributions (SSC) on the revenue side; and unemployment benefits and pensions (subject to the Swiss indexation formula before 2010) on the expenditure side.

Cyclical sensitivity of the public sector balance

Budget item	GDP elasticity of the tax base (1)	Base elasticity of the budget item (2)	Budget item as share of GDP (%) (3)	Sensitivity of the budget balance (4)=(1)*(2)*(3)
		REVENUES		
	GDP wage cost	wage cost PIT revenue		
PIT	0.42 (0.93*)	1.7 (1.36*)	7.53 (7.3*)	0.05 (0.09*)
	GDP wage cost	wage cost SSC revenue		
SSC	0.42 (0.93*)	0.96 (0.86*)	13.96 (11.6*)	0.06 (0.09*)
	GDP profits	profits CIT revenue		
CIT	1.89 (0.90*)	1.00 (1.22*)	1.83 (2.3*)	0.04 (0.03*)
	GDP household consumpt.	household consumpt. rev. from cons.-rel. taxes and levies		
Consumption taxes	0.85 (0.94*)	1.00 (1.00*)	13.68 (13.9*)	0.12 (0.13*)
Sum				0.27 (0.34*)
		EXPENDITURES		
	GDP GDP	GDP Improvement in primary balance		
Net interest expenditures	(-0.51*)	(1.00*)	(3.6*)	(-0.02*)
	GDP unempl. rate	unempl. rate unemployment benefits		
Unempl. benefits	-3.30 (-0.55*)	1.00 (1.00*)	0.34 (0.4*)	-0.01 (-0.002*)
	GDP mean wage	mean w. pensions		
Pension exp.	0.28 (0.93*)	0.00 (0.47*)	10.89 (9.2*)	0.00 (0.04*)
Sum				-0.01 (0.02*)
BALANCE				**0.28 (0.32*)**

Source: Ministry of Finance
**Sensitivity index calculated following the method published in Convergence Program of Hungary, May 2004.*

The table summarizes the results of the calculation, with the sensitivity index in the convergence programme of May 2004 in parentheses. According to the present estimates, a one-percentage increase in GDP improves the public sector balance by 0.28% of GDP.

In departure from the estimates in the convergence programme of May 2004, the new estimate shows the wage bill to be relatively less sensitive to GDP changes - this is attributable to the statistical characteristics of the new time series as well as the assumption that wages in the public sector are exogenous. As another difference, the previous programme took into account an item (net interest expenditures) for the calculation of the sensitivity index that is not included in the present calculation because of the indirect nature of the effect.

Methodology of the calculation of the sensitivity index

The contribution of a given budget item to the cyclical sensitivity of the public sector balance is the product of three factors. The first factor is the GDP elasticity of the tax base relating to the budget item concerned. These elasticities are estimated based on quarterly data at current prices in the period 2000Q1-2009Q1.[11] The calculations are based on the assumption that only private-sector wages respond to faster growth while those in the public sector do not (changes in these depend on government decisions).[12] The GDP elasticity of corporate profits can be calculated indirectly from the GDP elasticity of the total wage cost using the methodology recommended by the OECD.[13]

The second factor is the elasticity of the given revenue item with respect to the relevant tax base. The elasticity of the PIT revenue with respect to the total wage cost is greater than one due to the progressivity of the tax. This elasticity is calculated according to a formula that takes into account the marginal and average tax rates, as deduced from the tax code, and the wage distribution. (The calculations were done in the METR model of the Ministry of Finance.) Social security contributions are almost perfectly proportional to income. It is only because of the lump-sum health insurance contribution (teho) and the pension contribution ceiling that their elasticity to the wage sum falls short of unity. The elasticity of the CIT to corporate profits is unity as the tax is flat. The elasticity of the revenues from consumption-related taxes with respect to consumption can be, according to the OECD, assumed to be unity. On the expenditure side, the elasticity of unemployment-related expenditures with respect to unemployment is also unity; the elasticity of pension expenditures with respect to the average wage is 0.5 due to the indexation rule in effect until 2009 – while this direct relationship will no longer apply from 2010 on. The third factor needed to calculate the contribution of a budgetary item to the cyclical sensitivity of the public sector balance is the size of that item relative to the GDP (based on 2008 data).

The GDP elasticity of various tax bases were calculated based on short term correlations observable in the time series of the past ten years. These correlations show the average effect of various supply- and demand-side shocks. Thus, when analysing the effects of potential macroeconomic shocks, these may be different from the 'average' effect reflected in the table. Below, we look at the medium term implications on the budget of two alternative paths. The figures can be interpreted both as the analyses of specific scenarios or more generally: as the analysis of the effects of typical shocks, which may in theory occur in different magnitudes or directions.

[11] The statistical properties of these estimates are superior to those based on constant prices.
[12] Thus, in the case of the PIT and contributions, the estimated GDP elasticity of the private wage bill (0.51) has to be multiplied by the proportion of private employment among total employment (0.81); while in the case of pension expenditures the GDP elasticity of the average private sector wage (0.4) has to be multiplied by the proportion of private-sector wage-earners among all wage-earners (0.7).
[13] Girouard, N. és André, C. (2005). Measuring cyclically-adjusted budget balances for OECD countries. OECD Economics Dept. Working Papers No. 434.

An external demand driven shock would impact the Hungarian economy through exports. The faster recovery of the euro area would directly increase GDP and the profitability of companies though the rise of net exports while it would have only an indirect effect on the wage bill of the private sector and, through that factor, on disposable income and consumption. Calculations show that a positive effect from the external economy resulting in an immediate 1.1% export growth would increase GDP by almost half a per cent as compared to the baseline, and the general government balance would improve by 0.1% of GDP in the first year. In later years, however, after smaller additional export growth, as the effect ripples through the economy (increasing wages and employment in the corporate sector and raising inflation), the balance would improve by 0.3-0.4 percentage points.

The other shock tested relates to credit supply. Under this scenario, households and companies would have reduced access to credit as compared to the baseline scenario. As a result, the level of consumption and investment would stay some 0.5% of GDP each below the baseline in 2011. (The shortfall of investments would relate mostly to corporate investments and to a lesser extent to the fixed capital formation of households.) Most of the effect would materialise in the first year, reducing household consumption by 0.6% and gross fixed capital formation by 1.5%. As a result, in 2010 GDP would be 0.3% less and the general government balance 0.1 percentage point worse than in the baseline. In 2011-2012, because of carry-over and direct ripple effects, however, the balance could be 0.3-0.4 percentage point worse than in the baseline scenario.

Deviation from baseline scenario* percentage points

	2010	2011	2012
External demand shock			
Household consumption	0.0	+0.2	+0.1
Gross fixed capital formation	+0.2	+0.2	0.0
Export (goods and services)	+1.1	+0.5	-0.1
Import (goods and services)	+0.7	+0.4	0.0
GDP	+0.4	+0.2	0.0
Inflation	+0.1	+0.2	+0.1
Employment in the private sector	+0.2	+0.1	0.0
Government budget balance (as % of GDP)	+0.1	+0.3	+0.4
Credit supply sock			
Household consumption	-0.6	-0.3	-0.1
Gross fixed capital formation	-1.5	-0.7	0.0
Export (goods and services)	0.0	-0.2	-0.3
Import (goods and services)	-0.3	-0.3	-0.2
GDP	-0.3	-0.2	-0.1
Inflation	0.0	0.0	-0.1
Employment in the private sector	-0.1	-0.2	-0.2
Government budget balance (as % of GDP)	-0.1	-0.3	-0.4

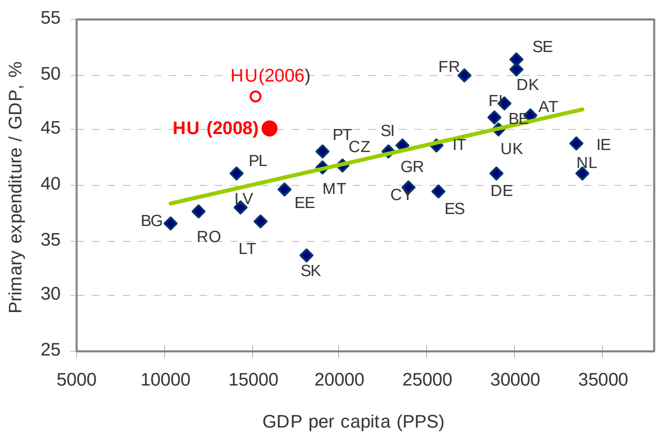
** Percentage deviation of macroeconomic variables from their baseline values*

5. Quality of public finances

5.1. Composition of public expenditures

As a result of the fiscal consolidation programme, between 2006 and 2008 the primary expenditures/GDP ratio fell by almost 3 percentage points. Consequently, even though the size of the Hungarian general government remained larger than medium sized even in 2008, the difference to the average of Member States was reduced to 1 percentage point. However, compared to the Member States most similar to Hungary in terms of GDP per capita, the difference remained significant. The expenditure cuts accelerated during the crisis are expected to substantively reduce differences by 2010.

Primary expenditures in per cent of GDP and GDP per capita
(2008)



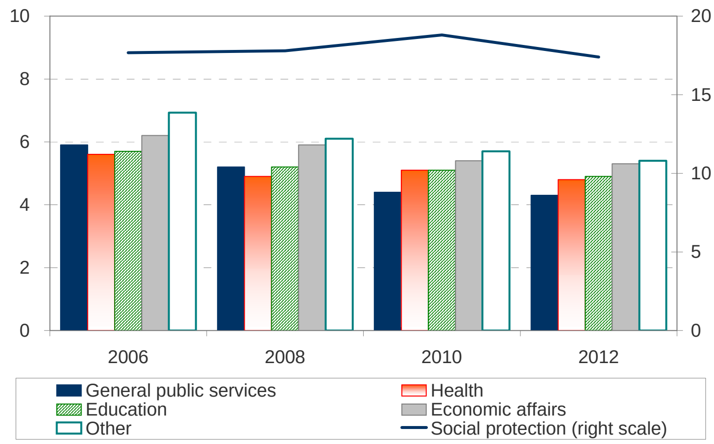
Source: Eurostat
Luxemburg is not recorded due to the high GDP per capita level

Adjustment measures aimed to reduce the size of the general government as well as to change the structure of expenditures. In 2006, the functional composition of primary expenditures showed that, in view of the level of development of the country, considerably more than average was spent on tasks related to social protection, general public services and economy-related tasks while the level of education and health care expenditures was essentially average. The structural measures launched between 2006 and 2008 considerably reduced the share of general public services within expenditures and they also brought about effective savings in health care and education. In 2009 and 2010 the general austerity measures and the wage expenditure cuts (as well as the reduction of employer contributions) offset the effects of the nominal decline of GDP in most areas' GDP-proportionate figures. As a result of the acceleration of the structural reforms aiming at the sustainability of the pension system and the better targeting of social benefits, in the last years of the programming period the decline of the total primary expenditures/GDP ratio is increasingly attributable to the social protection function.

- Between 2006 and 2008, about one quarter of the decrease of primary expenditures related to cuts in general public service expenditures. Changes implemented in public administration resulted in

- The decline of the expenditure/GDP ratio (excluding interest expenditures) of over half a percentage point. The forecast reckons with more decline in the expenditure/GDP ratio until 2012;
- The rate compared to GDP of expenditures relating to social protection increased by some 3 percentage points between 2001 and 2006; although it still lagged somewhat behind the EU average, it significantly exceeded the level observable in Member States with a similar level of development. Expenditure growth slowed down between 2006 and 2008, and in 2009-2010 the expenditure ratio growth is explained mostly by the GDP drop at current prices. As a result of the 2009-2010 package of measures, the expenditures on this function may decline by almost one and a half percentage points in relation to a rising GDP between 2010 and 2012;
- The expenditures on economic affairs to GDP ratio will fall as compared to the peak level of 2006, but, partly attributable to EU co-financed projects, the weight of this function within the diminishing total expenditure figure may become stable in the last years of the programming period;
- In education the expenditures/GDP ratio was reduced by half a percentage point between 2006 and 2008 due to a stronger emphasis on economies of scale. In view of the outstanding importance of the area, the programme reckons with expenditures on education growing in line with GDP on average in the programming period;
- Within health care, improved economies of scale and cost efficiency in curative-preventative care as well as the revision of the pharmaceutical subsidy system, resulting in permanent lower expenditure levels, brought about significant savings between 2006 and 2008. Similarly to education, the health expenditure/GDP ratio may also remain level on average between 2008 and 2012.

Primary expenditures by function
(in per cent of GDP)



5.2. Tax regime

The Government strives to promote improved competitiveness also by the modernisation of the tax regime. As a result of the tax measures adopted in 2009, tax centralisation (the ratio of tax and contribution revenues of the government sector to GDP) decreased from over 40% in 2008 to 39.4% in 2009, and it will continue declining to below 39% in 2010 and below 38% in 2011. The tax measures involve a considerable shift of the tax burden from taxes and contributions on labour to consumption related taxes: as a result of the measures, the share of taxes on labour within GDP will fall from 20-21% in 2007-2008 to around 19% in 2010 and to around 18% in 2011, while the share of taxes on consumption within GDP will increase from 15% to 16%. Taxes on capital income will remain around 4-4.5% of GDP. Thus the ratio of taxes on consumption to GDP will continue to exceed the EU-27 average (11.1%) while that of taxes on labour will decline below the EU average (19.4%) and the share of taxes on capital income will be way below the EU average (9.4%).

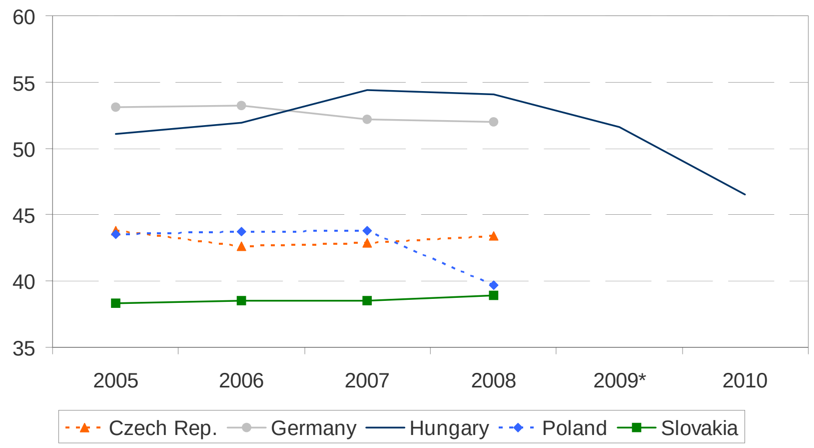
In previous years the tax and contribution burden was too high in the Hungarian tax system in international and regional comparison. One of the priorities of the tax restructuring announced by the Government in mid-2009 was to considerably reduce the difference in the taxation of labour to improve the competitiveness of the country. To achieve the former objective, the 5 percentage point employer contribution cut, which was introduced on 1 July 2009 up to twice the minimum wage, has been extended to all income as of 1 January 2010, furthermore, the lump-sum health contribution has been abolished.

The income bracket of the personal income tax (PIT) rose to HUF 1.9 million with retroactive effect to 1 January 2009. From 2010 on, the PIT base is gross income plus employer contributions. From 2010 the highest bracket has been increased to HUF 5 million (which corresponds to HUF 3.9 million net of employer contributions). Tax rates were modified from 18 and 36% in 2009 to 17 and 32% in 2010, and the tax credit ceiling was increased to HUF 3,188,000 in 2010. At the same time, the 4% special tax on private persons was abolished in 2010. In 2011, the tax bracket will increase to HUF 15 million. As a result of these measures, over 90% of taxpayers will fall into the lower income bracket in 2010 and the tax burden on employed persons will be reduced (the net wages of around-average income earners will rise by 12-14%), while in 2011 effectively all taxpayers will be subject to the lower tax rate.

As a result of the simultaneous reduction of burdens on employers and employees, the tax wedge will decrease from 54.1% in 2008 to below 47% in 2010 and 2011, coming close to the levels seen in other countries in the region. The decrease will be the most substantial around the average wage (more than seven percentage points), while the tax wedge will decrease by around four percentage points at the minimum wage and at twice the average earnings.

Continuing the simplification measures started in previous years, from 2010 on PIT tax allowances are abolished with the exception of the family allowance, small agricultural producer's allowance and the allowance of the disabled as well as the tax refund relating to long term savings. Some of the non-taxable benefits remain exempt, such as the means-tested benefits. Another segment becomes fully taxable, for instance the previously exempt portion of per diems. Some of the in-kind and other fringe benefits are subject to a lower 25% PIT rate from 2010 on. In case of benefits not subject to this preferential rate, employers have to pay 54% personal income tax and 27% social security contribution from 2010 on.

Evolution of the tax wedge at the average wage in Hungary and other countries



**: 2009 H2*
Source: OECD, and MoF estimate for 2009-2010

Effects on labour demand, labour supply and income returns

The reduction of the rates of taxes and contributions payable on labour will have a positive effect on the labour demand of companies and labour supply of workers as well as their willingness to report their income.

Effects on labour demand

If contractual gross wages are inelastic (e.g. due to wage agreements or minimum wages), the reduction of employer contributions directly improves incentives for job creation and weakens those for layoffs. The macroeconomic path examining the effects of proposed tax changes also assumes that gross wages will move along the same path with the reduction in employer contributions as they would in the absence of the reduction, thus the cut in the employer contribution rate is immediately reflected in a lower total wage cost. Hence the contribution rate cut does not have any direct effect on the disposable income of households but it increases labour demand through the lower wage cost.

The contribution rate cut and the abolition of the lump-sum health contribution in 2010 will reduce the wage cost by 4.5% in case of average wages and by 5.7% in case of the minimum wage (compared to the 2008 levels). On the whole, the wage cost of low wage-earners will decrease somewhat more, which is favourable for the change of employment as international experiences and Hungarian estimates both indicate that demand for low-earning, unskilled labour responds more strongly to changes in wage costs. According to estimates, the wage elasticity of labour demand is at least around (-0.3)-(-0.4), thus, as compared to the baseline scenario without the contribution-related legislative changes, a 1.4-1.8% employment growth is to be expected in the corporate sector in the medium term (though only part of that will be realised in 2010, the first full year). However, the estimates of employment growth are downward amended by compensatory measures adopted on the revenue side, such as the expected effects of the five-percentage-point VAT rate hike, which, through the real wage decrease, will reduce consumption and GDP and, consequently, the labour demand of businesses..

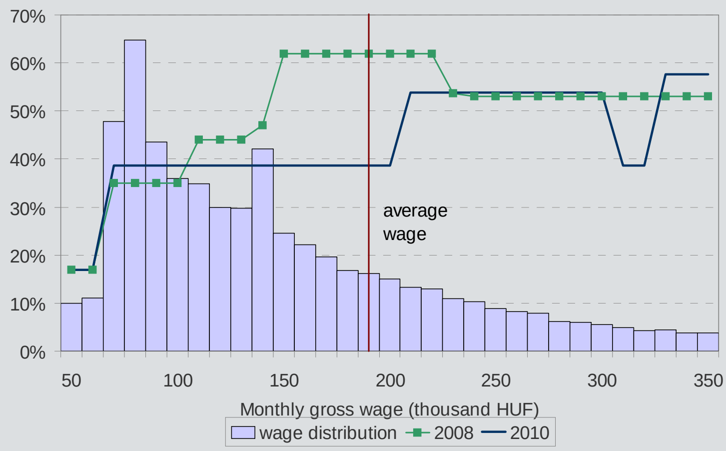
Gain from the change in contribution payment rules in 2010 in per cent of total wage cost by wage level, with the wage distribution also shown

Source: MoF calculations

The effects of tax restructuring on labour supply and the reporting of income

As a favourable effect of the VAT changes, the marginal tax rate is decreasing considerably for the approx. 1.5 million employees in the medium-income category, i.e., with gross earnings between HUF 105 thousand and 230 thousand. The marginal tax rate for the entire working population is decreasing by 4-5 percentage points. The decrease of the marginal tax rate in the medium-income category will have a beneficial effect on labour supply and the willingness to report income, which in the medium term may bring significant additional budget revenues.

Marginal tax rates by wage level, for employees without children, with the total wage distribution



Source: MoF calculations

In order to more strongly enforce the constitutional requirement of a balanced distribution of the tax burden, from 2010 on sole proprietors must supplement the entrepreneurial withdrawal, and personally contributing members of partnerships the remuneration for their work, from the dividend base or from the dividend of the personally contributing members of partnerships if the withdrawal or remuneration is below the level of remuneration generally payable on the market of the concerned main activity. In conjunction with the previous rules, the contribution payment floor corresponding to twice the minimum wage has been replaced, from 2010, by a new floor corresponding to the real market value of the work in case of full-time sole proprietors or members of partnerships. From 2010 onwards, a health contribution of 27% will be payable on the entrepreneurial withdrawal supplement and on a certain part of the personal contributor's compensation supplement, as well as on the share of the after-tax income shown in the financial statements allocated to the personally contributing member which could have been withdrawn as dividend

Furthermore, also to combat tax avoidance, the profits (not only the dividends distributed) of controlled foreign corporations (corporations registered in tax havens) have become taxable at the private person owner from 2010 on if his direct or indirect ownership/voting share is 25% or more in such a corporation. In 2010 the transfer or lending of a share in a corporation in possession of real property or the divestment of such share has become taxable in case of foreign private persons. The payment of interest, royalty or service fee to non-resident private persons is subject to a 30% withholding tax from 2010 as long as there is no double taxation treaty with the country of residence of the private person. (Similar rules apply to partnerships.)

The purpose of the government is to create an attractive investment environment for business associations, with a transparent, simple corporate income tax regime as an essential prerequisite. In order to ease the burdens on capital income and to introduce uniform corporate income taxation, from 2010 the CIT base has been widened; accordingly, certain items ceased to be deductible but benefits relating inter alia to investments, employment and R&D have remained. In 2010 the standard CIT rate increased to 19%, while the 4% special tax on businesses has been abolished. On the other hand, the 10% tax rate applicable up to a tax base of HUF 50 million remained applicable where certain conditions are satisfied. Some measures serve the purposes of direct crisis management, for instance the easing of the conditions of eligibility for the development tax concession or the changes in the rules applicable to accounting loss of value of receivables. To promote R&D activities, from 2010 businesses engaging in such activities may reduce their local business tax base with the direct costs of R&D. The rate of the Simplified Business tax increased from 25% to 30% as of 2010.

With a view to tax simplification, from 1 January 2010 the labour market contribution replacing the employer, employee and entrepreneurial contributions must be paid into the tax account together with the health insurance contribution.

To promote the integrated employment of persons with altered working capacity, the rehabilitation contribution has been increased fivefold from 2010 on: going from HUF 192,900/person/year to HUF 964,500/person/year, while the mandatory employment level (5%) has remained unchanged. This former measure promotes the evolution of a more socially responsive entrepreneurial environment.

As of 1 July 2009, the standard VAT rate increased by 5 percentage points on the one hand, and milk, dairy products, bread and bakery products were reclassified into a new 18% preferential rate, followed by commercial accommodation services on 9 July and district heating on 1 August. As of 15 January 2010, district heating was reclassified from 18% to the 5% preferential VAT rate. As part of the tax package, the excise tax has been increased in two steps. As of 1 July 2009, the excise tax rate for petrol increased by 5.3%, that of diesel oil by 6.5% and the average for alcoholic beverages by 6.5%. In case of cigarettes, the flat and minimum taxes were increased, the excise tax rate for the most sought-after price category growing by 4.9%. The tax rate of smoking tobacco has risen by 10.7% on average due to the minimum tax hike. As of 1 January 2010, the excise tax rate for petrol increased by another 10%, that of diesel oil by 7.6% and alcoholic beverages by a uniform 10%. In case of cigarettes, the flat and minimum taxes were increased, the excise tax rate for the most sought-after price category growing by 8.9%. The tax rate of smoking tobacco has risen by 10.7% on average due to the minimum tax hike. We reckon with no further tax increases on the 2010-1012 time horizon as the next EU law harmonisation obligation we have under the tobacco directive adopted at the end of last year has a deadline of 1 January 2018. The energy tax rate rose by 17% as of 1 January 2010.

In order to simplify tax returns and tax payments, the tax administration tasks related to the local business tax have been moved to the central tax authority in 2010.

The standard rate for the duty on the transfer of property was decreased from 10% to 4% as of 1 January 2010 while in case of residential property, the rate for the portion of the price above HUF 4 million was reduced from 6% to 4% also. Simultaneously with the rate change, in order to prevent the avoidance of duty payment relating to the acquisition of real property, the acquisition of share of capital in companies possessing real property in Hungary has become subject to duty with the proviso that an obligation of reporting and duty payment arises only if the total share of capital owned by the acquirer is at least 75% of the total capital.

In 2010 a tax on certain high-value items of property has been introduced (vessels, aircraft, high capacity passenger cars). Act LXXVIII of 2009 adopted by Parliament also contained tax on residential property, however, the Constitutional Court annulled the relevant provisions on 26 January 2010. At present the Government is looking at possible measures to offset the revenue loss[14].

5.3. Structural reforms

Financial management system of general government institutions

In December 2008, Parliament adopted the Act on the legal status and financial management of budgetary institutions; its new financial rules are applicable from 1 January 2010. The Government decree on the implementation of the Act was completed and published in December 2009.

The decree supplements the existing and well-functioning rules with a number of new elements. First we should mention the new process and contents of the planning of central institutions, which assures the economical and efficient allocation of the available funds already in the year of planning on the

[14] Calculations for the convergence programme were closed on 22 January 2010; therefore, the effects of the Constitutional Court decision (approx. 0.2% of GDP) could not be reflected in these.

level of budgetary institutions by bringing forward the start of the institutional planning process by about six months. As a result, financial anomalies and shortages of funds in the course of operation are considerably more likely to be predictable and thus preventable. Furthermore, it is conducive to providing sound foundations to the types of plans (implementation and performance plan) aimed at the conscious and detailed consideration and documentation of the harmonisation of funds and functions.

Furthermore, implementing the provisions of the Act, the Decree also contains detailed operational and financial management rules for the various types of budgetary institutions; examples include the provisions for the use of personal benefits, provision for the funding for public procurement procedures or the particular rules governing the financial management of organisation units with legal personality.

The implementing regulation lays special emphasis on the commitments of the general government subsystems, containing more detailed regulations that are better adapted to real life. The new provisions pay special attention to organisational neutrality, i.e., they are applicable to all entities that dispose of government funds, irrespective of their organisational form.

Moreover, the new decree devotes a separate chapter to the rules of subsidies from the central budget (from chapter managed appropriations or extra-budgetary funds), providing a uniform framework in respect of the use of both Hungarian and EU funds.

The new 'system of state tasks and activities' designed in 2008 and fine-tuned in 2009 based on the special requirements that arose must be applied in planning, financial management, financing and reporting from 1 January 2010. The new system lays the methodological foundations for task based planning and financing, makes the use of public funds more transparent and assists decision makers in the allocation of public funds both in central and local governments.

Local governments

Savings in local governments (reduction of subsidies from central government) are fundamentally assured by three tools:

- the range of functions to be performed by local governments has been narrowed,
- regulatory changes have been implemented to improve the efficiency of local government,
- subsidies for projects financed exclusively from domestic sources have been reduced.

1. Restriction of the mandatory tasks of local governments. Several sectoral acts have been amended to reduce the obligations of local governments and the tasks of town clerks.
    - Alarm-based home help became a central government task in 2010 and the funding for the tenders will be provided under the auspices of the Ministry of Social Affairs and Labour.
    - Providing meals has been removed from the tasks of day care, thus the possibility of application for that service simultaneously with social meal services will be terminated.

2. The operating conditions of social institutions have become more flexible, which also contributes to the capacity regulation and expansion of social services on the basis of requirements, improving the efficiency of financing and care in the short and medium term:

- o in the framework of the so-called home-based services (social meals, home help and the day care of the elderly) a service structure more responsive to local needs can be devised, which may more flexibly adapt to the needs of beneficiaries who need help in the everyday life in their homes;
- o changes in the service fee: introduction of a family/household-centred income test, increase of the maximum of the personal service fee (meals and home help);
- o differentiated contributions depending on the income of the beneficiary will be abolished, the system of normative grants will be simplified, administration reduced;
- o in the field of child protection, a new form of service, the 'family childcare' has been introduced, contributing to providing cheaper day care to the largest number of children possible, thus the potential for the employment of women with small children in the labour market may also improve;
- o the duration of child protection after-care has been reduced from the present 24 to 21 years of age in case of young adults not in higher education.

3. Subsidies to projects implemented only from domestic funds have been suspended or in certain cases abolished. New projects will be implemented exclusively with co-financed EU funding, with the exception of the infrastructure projects relating to nurseries, kindergartens and primary schools. The objective continues to be to ensure that the quality of care and education of children and pupils living in micro-regions and the equality of opportunities of children with multiple disadvantages improve.

The amendments of the sectoral acts regulating the large benefit systems are described in detail in the chapters 'Public Education' and 'Transforming regular social allowance under the "Pathway to Work" programme'.

In addition to the measures assuring savings in the local government system, the promotion of cooperation to make the operation of the local government system more efficient continues to be a priority. The subsidies for this purpose have increased in a comparative structure, i.e., adjusted for the contribution cuts bringing about automatic expenditure reductions. As a result, the micro-regional cooperation in public education and social functions will become even more prominent and the number of jointly maintained institutions will increase.

Upon the amendment of the Act on public finances, the provisions concerning the planning and reporting of local governments have changed as of 2010. Local governments must approve the amount and way of financing of the budget deficit in their regulation on budget or final accounts. The responsibility of all decision making local assemblies is highlighted by the fact that the management of the budget position of the local government must be addressed already at the planning stage.

Public education

The new performance-indicator-based financing, introduced on 1 September 2007, was extended, as of 1 September 2008, to basic art education, education and care in dormitories and hostels, day school and study room activities and boarding school education as well. The basis of calculations in respect of these functions is also the education organisation parameters specified in the Act on public education. Essentially, as a result of this funding system, maintainers (mostly local governments) will have to face the consequences if they employ more teachers than justified by these parameters (mandatory classroom hours of teachers, average student group sizes, weekly time allocated to study).

In respect of kindergarten education, school instruction and theoretical studies in vocational training, the parameters defined for the 2007/2008 school year will become more stringent in the new school year as we move up in grades. The provisions of the public education act will be fully applicable in financing in the 2010/2011 school year.

The rules governing transfers to promote the association of local governments maintaining institutions have been fine-tuned; an obligation of planning public education tasks in micro-regions has been set forth. Funding to micro-regional public education functions are conditional on the multifunctional micro-regional association possessing an approved micro-regional action plan setting out, in respect of the settlements participating in performing the public education functions, all the requirements that need to be included in the action plans of local governments as well.

The amendment of the Act on public education aims at broadening the discretion of local governments in the efficient and professional organisation of public education services. To that end,

- the organisation in joint institutions of tasks closely related to child raising but under the competence of another sector has become possible. A new type of multi-purpose institution was introduced, called integrated kindergarten-nursery;
- the conditions of organising classes and study groups have become more flexible (combined classes can be organised from four consecutive classes, rather than the former three); the maximum number children in a nursery group, class or dormitory group can be exceeded by 30% rather than 20%.
- the requirement of the admission of all applicants into kindergartens has been postponed by one school year to 1 September 2011;
- the launch of language preparation courses can also be postponed from 1 September 2010 to the 2012/2013 school year;
- the sum to be made available to teachers to buy technical literature has been reduced;
- compliance with the provisions in the list of mandatory teaching tools and equipment has been postponed to the 2012/2013 school year.

In addition, the Government continues to treat as priority the implementation of the programme 'New Knowledge – Education for Everyone'. The main objectives of the programme include that every child should start school with equal opportunities and that the school system should not increase social differences but rather it should allow persons in disadvantageous positions to improve their plight; furthermore, the teaching profession should be made more attractive and the work of teachers should receive more recognition.

Higher education

The key objective of the measures taken in higher education is to improve the quality of education and make it more capable of adapting to the changing structure and level of labour demand. Under the reform, new steps have been taken.

The quality of education is improved on the input side by the change of certain application rules in the admission procedure. For instance, from the 2011 admission year on, fewer additional scores not relating to school grades will be can be taken into account. The 25% increase in the minimum score required for admission will be effective already in the year 2010 admission procedure.

The act on higher education has introduced new elements of quality assurance by the modification of the role of the Hungarian Accreditation Committee, the introduction of the title “Special College Centre of Excellence”, the specification in law of the key criteria for obtaining the status of research university (e.g., academic work, nurturing talent, international relations). In line with the status and financial management of budgetary institutions, the regulation of the operation and finances of state higher education institutions has also changed. Depending on the structure of tasks and funding of institutions, differentiated organisational arrangements and financial powers are possible. The regulation does not stand in the way of the autonomy of higher education institutions while it sets reasonable limits to financial management, promoting the efficient use of public property, transparency and the provision of public services.

Pension system

In 2006/2007 significant parametric reforms have been implemented in the pension system, considerably reducing the burdens on public finances relating to future pension outlays. In addition, in May 2009 Parliament adopted legislative amendments introducing further important parametric changes in the pension system. The adopted Acts contains the following key elements: (The detailed budgetary effects of the measures are described in Chapter 6.)

- Abolition of the 13th month pension as of 1 July 2009 (replacing it by a pension premium linked to GDP growth);
- Introduction of new indexation rules: in the event of GDP growth being below 5%, the wage growth component has a lower weight in the indexing of pensions. The new indexation rules are effective as of 2010. The regular annual pension increases continue to be driven by changes in consumer prices and net earnings but the weight of the two components depend on the GDP growth rate. Below GDP growth of 3%, pensions are increased in line with the consumer price index. In case of a 3-3.9% GDP growth, net earnings represent 20% and consumer prices 80% in the combined index; if GDP growth is between 4% and 4.9%, the respective weights are 40% and 60%, while in case of GDP growth of 5% or above, Swiss indexation is to be used.
- The re-scheduling of the pension correction proposed for 2009 to 2010.
- Increase of the retirement age: Starting with the age cohort born in 1952, the effective retirement age will increase gradually, by half a year per annum, until the age of 65 is reached for both men and women. The early retirement age will also gradually increase to 63 years of age, with transitory

rules. The measure contributes not only to the long term sustainability of the pension system but also to increasing the employment rate.

- In case of pensions requested before the retirement, reduced benefit rules will be introduced, for men already in 2011. Accordingly, early retirement will result in lower pension benefits. This measure is inevitable to assure that the increase of the retirement age postpones the actual time of retirement at a similar rate. The purpose of the measure is to prevent economically active employees from retiring before the old-age retirement age.

The transformation of the pension system and assuring its sustainability is not only a fiscal issue. The increased activity of the elderly and their retention in their jobs contributes in the long term to the maintenance and expansion of labour supply, which is a fundamental pillar of economic growth. This is promoted, inter alia, by the implementation programme of the National Strategy for the Elderly adopted by the Government.

Health care

Social transfers in kind provided by the Health Insurance Fund for 2009 were below the appropriations in aggregate. The increased deficit of the Fund was due to revenue shortfalls, which resulted from two factors: on the one hand, the revenue drop caused by the economic downturn, and on the other hand, the reduction by 3 percentage points of the health insurance contribution payable by employers up to twice the minimum wage as of 1 July 2009. In 2010 appropriations can be fulfilled, through the cost saving measures adopted in pharmaceutical subsidies, curative-preventative care and medical aid subsidies.

Social benefits

In international comparison, Hungary spends rather a lot on social benefits while analysts claim that the benefits do not necessarily go to people needing it the most. The purpose of the adopted measures is to change that situation, to improve the targeting of the system already in the short term and to encourage and support economic activity and taking up employment. The most important measures in this area:

- Preservation of the nominal value of social benefits
- Reform of child care related benefits, modification of the maximum duration of the child care support and child care allowance (GYES, GYED)
- Modification of the maximum age of eligibility for family allowance
- Reduction of the general sick pay rate by 10 percentage points
- Review of the terms of disability pensioner status

No change in the amounts of social benefits

The eligibility for and amount of social benefits is linked to the minimum pension. Due to the “freezing” of the minimum old age pension, the number of eligible persons will decline and the amounts of benefits will not increase. In case of family support, pursuant to the 2010 Budget, the amount of the family allowance, maternity support, child care allowance, child raising support, life-start support and the in-cash child protection benefit will not increase in 2010.

Reform of the child care support

The system of child care benefits has changed considerably. The period of eligibility for GYES has been reduced from 3 to 2 years for children born after 30 April 2010, while in case of the insurance-based GYED, the eligibility criteria have been tightened. As a result of the measure, the number of persons eligible for GYED has declined, and so has the average time of use of the GYED.

Reform of the family allowance

The amount of the family allowance will not increase for two years. The eligibility ceiling for the family allowance will be reduced from 23 years of age to 20 as of 1 September 2010, part of the family allowance can be provided in kind. The purpose of the measure is to promote the indented use of the family allowance by families where children are placed under protection. The clerk of the local government may, either at the time of placement under protection or during its term, order the provision of no more than 50% of the family allowance as allowance in kind. The duration of the limitation is one year. The Hungarian State Treasury transfers the in-kind family allowance to the family support bank account accessible to the local government, its use decided by an ad hoc trustee appointed by the town clerk.

Changes in the rules on sick pay

The general rate of sick pay has been reduced from 70% to 60% in case of insurance relationship of more than 2 years, and from 60% to 50% in the event of a shorter insured status. The duration of passive sick pay has been shortened (from 45 days to 30 days, its ceiling set at 150% of the minimum wage).

Tightening of the terms of disability pensioner status

The measure requires no legislative change, savings being achieved through the stricter application of existing rules. As a result of the start of the reform of the disability system, by the end of 2008 rehabilitation benefit, replacing the disability pension and promoting reintegration into the labour market, was awarded to almost 6000 persons.

Transforming regular social allowance under the "Pathway to Work" programme

Under the "Pathway to Work" programme it has been formulated as a priority objective that the participation of permanently unemployed persons capable of working and receiving social allowance should be increased in some form of public work to enable them to obtain regular labour income and get closer to the world of labour.

Under the programme, the persons in active age who are at a disadvantage on the labour market may obtain entitlement to the benefit for active-age persons instead of regular social allowance. In accordance with the new rules, there are two groups of persons entitled to the active-age benefit:

1. Persons capable of performing work who can be employed in public work schemes, or if no such work is available, are entitled to availability support. Persons in this category are obliged to report to the Public Employment Service (hereinafter referred to as ÁFSZ) for registration, enter into a job-seeking agreement with the ÁFSZ, fulfil the terms of such agreement and take part in public work. A special cooperation rule will be applicable to young people under 35 who have not completed the 8^{th} class of the primary school. In their case, with a view to preventing benefit dependency, the key form of fulfilling the obligation to cooperate is attending training rather than public work. Persons eligible for the active-age benefit and capable of working receive a so-called availability support for the time when they do not participate in public work. The monthly sum of the availability support is fixed, its amount, irrespective of the number of members and composition of the family, is equal to the monthly old-age minimum pension.

2. Persons incapable of working cannot be compelled to perform work; in light of their social situation, they are eligible for regular social allowance. The programme classifies in this group persons qualified as disabled due to their health status as confirmed by the expert opinion of the institute of medical experts, people receiving blind people's allowance or support for the handicapped and are therefore incapable of working as well as persons raising a child under 14 where no day care facility can be provided to the child. Furthermore, the local government may, in a bylaw, set further conditions for exemption from 2010 on.

The calculation of the regular social allowance has remained unchanged: it continues to be determined on the basis of the composition and income of the family; its monthly amount shall not exceed the net minimum wage.

In order to ensure public work, local governments, in consultation with labour agencies, must prepare a public work plan every year. The plan must contain the composition by qualification of the persons entitled to the availability support, the description and time schedule of public services that the municipality intends to perform either in part or in whole through public work, and the headcount necessary for performing them as well as the resources available for financing the public work.

In order to encourage public work, while financing does not change in case of persons receiving social allowance (i.e., the ratio of central funds remains at 90%), the central funding rate for the availability support is 80%. Municipalities may claim 95% of personnel expenditure incurred regarding public employment (wages and contributions) from the central budget.

The programme entered into force on 1 January 2009 and, after the appropriate time for preparation, was launched on 1 April. As a result, the benefits to active age persons have been restructured considerably: the number of recipients of regular social assistance declined from the average 180 thousand in 2008 to 33 thousand, the number of persons in public work increased from 16 thousand to approx. 70 thousand (in summer months, local governments employed more than 90 thousand persons), while some 160 thousand people received availability support.

Based on the experiences of the first year, the professional conditions of the programmes have been altered as follows:

- The transitory rule effective in 2009 under which, in respect of persons for whom the amount of the availability support (RÁT) is lower than the benefit received in December 2008 the amount of RÁT in 2009 must be equal to the sum of the former benefit, has been abolished.
- Partial payment of the RÁT will not be possible to those finding jobs in the labour market.
- Only one person per family will be eligible for the active age support, with the proviso that, in addition to one RÁT recipient, one family member may also receive regular social assistance if certain conditions are satisfied. In other words, no family may have more than one RÁT recipient members.

The programme has been altered with a view to increasing the efficiency of the public work organised by local governments. To that end, from 2010 on people in public work may also participate in local government services performed pursuant to legislation by economic associations with majority local government ownership or NGO's as well as in central government services performed by central budgetary organisations or by economic associations with majority state ownership.

Housing subsidies

As of 1 July 2009, home loans with interest subsidies and the housing construction allowance have been suspended in respect of new credit agreements. The required amendments are set out in Government Decree no. 125/2009. (VI. 15.). The new measures will exert their effects in a full year first in 2010; therefore, following the HUF 199.3 billion actual figure in 2009, the 2010 Budget contains housing support appropriations of HUF 147.3 billion.

Gas and district heating price subsidy

In 2009 the Government decided on the gradual elimination of household energy subsidies. The revision of the government decree regulating the terms of support has been completed, and the subsidy system will be terminated on 1 May 2010. The amended legislation clearly specifies, both for gas and district heating consumption, the gross unit amount of the subsidy, furthermore, the district heating charge granted in the heating season to consumers not eligible for energy consumption support, previously applicable to district heating services, will be abolished. The payment of the gas and district heating price subsidies is covered by the appropriation of HUF 20 billion for 2010 and the unspent appropriation from 2009.

Public transport

The 2010 Budget contains a reduction of HUF 40 billion of subsidies to long-distance public transport. Some of the required changes have already been implemented, including the rationalisation of lines and the review of parallel services (of bus and train transport) when schedules are prepared. Others are still in progress, such as, MÁV Zrt. has concluded an agreement with the National Asset Management Zrt. (MNV) for the settlement of its real property issues, the implementation of the agreement and the review of the property portfolio is under way. To promote the regional cooperation between Volán (long-distance bus) companies, MNV Zrt. has defined the 7 regions and appointed their respective chief executive officers. In the course of the business planning of Volán companies, the government's expectations for efficiency will be enforced. The transformation of the MÁV group is also under way, focusing on efficiency gains and cost cutting; to that end, the new management of MÁV Zrt. has already taken steps. The legal regulations for rate hikes and the introduction of the so-called 'registration ticket' have been completed for both rail and bus long-distance transport.

6. Long term sustainability of public finances

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 developments, without reforming the pension and health care systems, expenditures are certain to increase with the ageing of society, inducing the growth of public debt in the long term. The level of government debt calculated for 2060 is determined by the current position of the general government (budget balance, current government debt) and the size of ageing-related budgetary expenditures, which will grow in future.

The pension measures introduced in the years 2006 and 2007 have reduced the growth of age-related expenditures incurred in the long run significantly, by approx. 1% of GDP, improving the sustainability of the public finance.

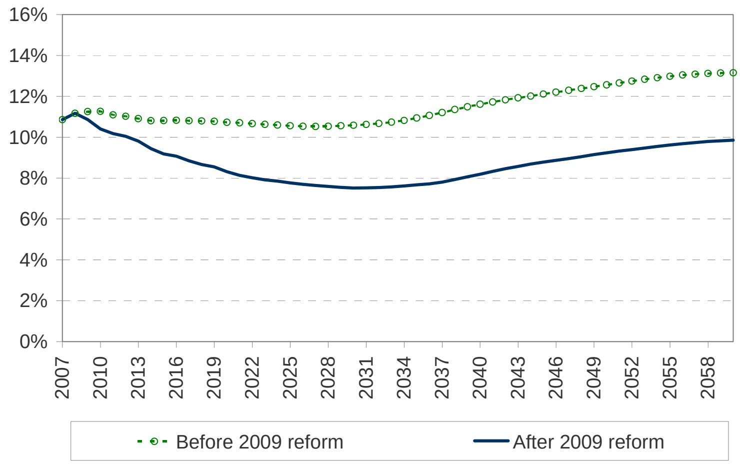
In 2009, more significant pension measures were adopted. The new legislation enacted in May 2009 provides for the increase of the retirement age, the tightening of the reduced benefit rule (malus) applicable to early retirement (resulting in lower pension for early retirement), new indexation rules and the abolition of the 13th month pension. All these measures in aggregate will reduce the general government pension expenditures by another 3.2 percentage points as a relation to GDP in 2060.

Public pension expenditures (net) in per cent of GDP

	2007	2010	2020	2030	2040	2050	2060
Before 2009 reform	10.9	11.3	10.7	10.5	11.4	12.2	13.2
After 2009 reform	10.9	10.5	8.3	7.6	8.3	9.4	10.0

Source: EPC Ageing Report 2009, MoF calculation, it includes the projection for the old age allowances as well

Development of the public pension expenditures before and after 2009 reform
(in per cent of GDP)



Source: EPC Ageing Report 2009, MoF calculation

The raise of the retirement age also has a beneficial effect on employment, in addition to the reduced expenditure. The increase of retirement age will reduce the growth of pension expenditures by some 0.9% of GDP by 2060 and in the long term it will increase employment, particularly in the age cohort of 55-65 years, which is conducive to a higher potential growth. The new indexation rule and the abolition of the 13th month pension will reduce expenditures by 1.5%, by 0.8% of GDP, respectively.

Effect of the measures on expenditures in per cent of GDP

	2020	2030	2040	2050	2060
Increase of retirement age	-0.9	-0.9	-1.1	-0.9	-0.9
New indexation rule	-0.8	-1.4	-1.5	-1.5	-1.5
Abolition of the 13th month pension	-0.7	-0.7	-0.7	-0.8	-0.8

The total figure includes the effect of the tightening of the malus rule and the cancellation of disability pension correction planned for 2010

According to the calculations of the Ministry of Finance, the pension expenditures to GDP ratio will fall by 0.9 percentage point, from about 10.9% to 10.0%, between 2007 and 2060. The figures concerning other expenditure areas related to long term sustainability are disclosed in the Report of the Economic Policy Committee (EPC) of the European Union published in 2009 (Ageing Report 2009). According to the Report, between 2007 and 2060 the health expenditures to GDP ratio will increase by 1.3 percentage points from 5.8% to 7.1%, the long term care from 0.3% to 0.6%, while education expenditures will decline from 4.4% to 4%.

7. Institutional features of public finances

7.1. Fiscal rules

In November 2008 Parliament adopted the Fiscal responsibility Act (Act on the economical government management and fiscal responsibility). The new Act set forth new fiscal policy rules for the central subsystem of the legal government, established the Fiscal Council and introduced certain safeguards. The 2010 budget and the new rules of the Act on public finance entering into force on 1 January 2010 further enhanced the transparency of fiscal policy and the medium term focus of fiscal planning.

Increasing transparency

The structure of the subsystems of general government has been simplified. Formerly, legislation treated social security funds and extra-budgetary funds also having functions in providing the services of the Hungarian State separately from the central budget, as independent subsystems. From 2010 on, the three subsystems are presented in aggregate as the central subsystem of the legal government (state budget: the consolidated budget of the central government subsystem). For 2010 the Parliament approved the budget of that central subsystem.

The budget of 2010 also contains the consolidated balance sheet of the central government subsystem of the legal government. The consolidation presents expenditures and revenues net of transfers between the formerly separated subsystems, assuring the visibility of the actual deficit of pension insurance and health insurance.

The budget differentiates between items that can be substantively influenced by the budget act and those determined by other pieces of legislation or macroeconomic factors (discretionary/mandatory items). The 2010 budget contains an itemised listing of the mandatory items determined by "external" factors (other pieces of legislation, macroeconomic factors).

Pursuant to the Fiscal Responsibility Act, the three-member Fiscal Council has been set up with the mandate of assuring the transparency of fiscal planning and sound professional and methodological foundations, supported by a Secretariat.

Rules of medium term budgeting

Medium term limits based on the so-called real debt rule

In short, the so-called real debt rule provides that medium term balance targets must be specified for two years in advance that assure that the real value of the government debt does not increase.

In the autumn of 2009, through the macroeconomic outlook, the estimation of the end-2011 debt stock and the net interest expenditures of 2012, Parliament determined in the 2010 Budget the primary balance level at which the real debt stock at end-2012 would not exceed the level expected for end-

2011. This is the target for the 2012 primary balance (according to the rule, the primary balance must not show a deficit).

The rule also sets a mechanism for the balance target of discretionary items; however, this will be applicable across the board only to the budget of 2011. At that time, the expectation for the development of mandatory items in 2012 will arise from the forecasts prepared in the autumn of 2010. The discretionary balance requirement for 2012 arises as the difference of the discretionary and mandatory balances, which is fixed in the 2011 Budget adopted at the end of 2010.

The 2010 Budget will also contain a balance requirement for discretionary items in 2011, which are determined taking into account the requirement set for 2010 regarding the value of the Maastricht deficit indicator.

Medium term expenditure ceiling

The 2010 Budget specifies the change allowed in the adjusted total of the primary expenditures of the central subsystem of the legal government in 2012 compared to the adjusted sum total budgeted for 2011. Alongside the balance requirements, the limitation on expenditures is only a supplementary rule but it contributes to the stability of the budgeting system.

Definition of the medium term commitment and subsidy ceilings

Pursuant to another new provision of the Act on public finance effective as of 1 July 2009, upon the submission of the budget bill, the Government shall inform Parliament about the detailed restrictions it intends to impose, in line with the medium term plans for at least three years, on commitments during the subject year if the bill is accepted.

The Government fulfilled its information obligation relating to the submission of the budget bill by presenting the limits for 2011-2013. The decree required to be published after the adoption of the budget act is expected to be issued in February 2010.

The Government sets in a resolution, by the end of February every year, the subsidy limits of the chapters under its control and supervision in respect of the 3 years following the current year. The Government determines in a government decree the proposed expenditure and revenue amounts for the 2 years following the current year. The latter is done in a structure corresponding to the approved budget act,; that is, determining by chapter, in respect of the chapters under the control of the Government, the proposed expenditure and revenue limits of the various chapters in aggregate for 2 years in advance.

7.2. 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 Hungary. 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 the MoF operates on the management and expert levels, and a co-operation agreement regulates procedural issues of data flow, division of labour and methodological treatment.

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 the legal government, 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 as updated by Hungarian authorities from time to time ("EDP Inventory") are published on the homepages of the CSO and the MoF, simultaneously with the press release of Eurostat. From the next Notification, however, the CSO will publish the tables of the EDP Notification already at the time of it is sent out (by the end of March and September). According to the current practice, the MoF dedicates a separate 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. As from 2008, the CSO discloses quarterly data of the general government sector in its publications on national account statistics.

During its latest visit (in July 2008), Eurostat reviewed the institutional background of data reporting related to the Excessive Deficit Procedure, the cooperation of peer authorities, the data sources, the applied methodology and procedure as well as the disclosure policy.

Annex: Council recommendation in the framework of the excessive deficit procedure

The Council in its recommendation adopted in July 2009[15]

"continues to welcome the commitment of the Hungarian authorities announced originally in the adjusted convergence programme update of 1 September 2006 to submit reports to the Commission and the Council examining progress made in complying with this recommendation on a six-monthly basis. Moreover, it invites the Hungarian authorities to report on progress made in the implementation of these recommendations in a separate chapter in the updates of the convergence programmes until the excessive deficit is corrected."

This annex of the updated convergence programme summarises the main points and refers to the respective parts of the programme regarding the progress made in line with the recommendations. This annex can also be seen as the report due in the first half of 2010.

"1. On the basis of the macroeconomic outlook of the Commission services' spring 2009 forecast, the Hungarian authorities should put an end to the present excessive deficit situation as rapidly as possible and by 2011 at the latest."

In line with the Council Recommendation, according to the fiscal path presented in the convergence programme general government deficit in 2011 will be under the reference value.

"2. The Hungarian authorities should reduce the deficit in a credible and sustainable manner. Specifically, to this end, the Hungarian authorities should:

(a) Limit the deterioration of the fiscal position in 2009 by ensuring a rigorous implementation of the adopted and announced corrective measures to respect the target of 3.9% of GDP as presented in the most recent EDP progress report, and by allocating possible windfall gains for improving the headline balance;"

Preliminary cash-flow data indicate that central government deficit as a percentage of GDP was lower than foreseen (3.8%); it reached only 3.5% of GDP. Furthermore interim figures indicate that the balance of the local government subsystem may have been somewhat better than originally envisaged. Thus cash figures indicate that the deficit target of 3.9% of GDP was probably achieved – even though accrual based figures for the general government will only be available at end-March. (On 2009 budgetary developments, see chapter 3.2.)

[15] http://register.consilium.europa.eu/pdf/en/09/st11/st11404.en09.pdf

"(b) Starting from 2010 (when the deficit should not exceed 3.8% of GDP as foreseen in the EDP progress report), rigorously implement the necessary consolidation measures to ensure a continued reduction of the structural deficit and a renewed decline of the headline deficit, with an increased reliance on structural measures, in view of warranting a lasting improvement of public finances;"

The Budget Act adopted on 30 November 2009 by Parliament set the 2010 ESA95 general government deficit target at 3.8% of GDP. The expenditure cuts underpinning the budget represent changes of structural nature in an increasing proportion: improvement of the functioning of institutions of the general government and the local government subsystem, reform of the pension system with the aim to improve long term sustainability of public finances, better targeting of social benefits promoting economic activity and taking up employment, reform and better targeting of housing as well as gas and district heating price subsidies, transforming regular social allowance in order to foster employment and enhancing efficiency of the public transport system. (Main characteristics of the 2010 Budget are presented in chapter 3.3. Structural reforms are detailed in chapter 5.3.)

"(c) Spell out and adopt in a timely manner the consolidation measures necessary to achieve the correction of the excessive deficit by 2011 and ensure, at least, a cumulative 0.5 percentage points of GDP fiscal effort over 2010 and 2011, in light of the significant effort made and effective action taken in 2009."

Measures underpinning the deficit target (2.8% of GDP), in line with the correction of the excessive deficit by 2011 are presented in chapter 3.4. Detailed revenue and expenditure projections in line with the deficit target will be included in the 2011 Budget Bill. Calculations underlying the programme indicate that the structural balance improves by 1 percentage point in 2010-2011 on the whole.

"3. The Council establishes the deadline of 7 January 2010 for the Hungarian authorities to take effective action regarding the measures to achieve the deficit targets for 2009 and 2010. In particular, the envisaged expenditure-reducing measures should be entirely incorporated into the 2010 budget law and be implemented in a timely manner. Moreover, sufficient reserve provisions should be incorporated in the budget law to avoid slippages even in case of unforeseen events. The assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' spring 2009 forecast."

The 2010 Budget was adopted taking into account of the planned expenditure cuts. In order to cover risks, built-in reserves in the 2010 budget are higher than in previous years. The general, stability and interest risk reserves in combination amount to 0.8% of GDP.

"4. The Hungarian authorities should ensure that the government gross debt ratio is brought onto a firm downward trajectory, in line with the multi-annual path for deficit reduction laid down in the progress report and if possible before 2011. Also against this background, the country should stand ready to seize every opportunity to accelerate the fiscal adjustment, especially as regards 2011."

Debt path of the updated convergence programme (see chapter 3.6) is in line with deficit reduction path. Gross debt to GDP ratio will decrease from 2011 on.

“5. The Hungarian authorities should implement with vigour the recently adopted fiscal responsibility law, including the compliance with the new numerical rules, as well as improve budgetary planning procedures and monitoring of the budget execution with a view to enhancing the medium-term budgetary framework.”

Chapter 7.1 of the updated convergence programme presents steps enhancing the transparency of fiscal policy and the medium term focus of fiscal planning, in the light of the Fiscal Responsibility Act adopted by Parliament in November 2008, the 2010 Budget and the new rules of the Act on public finance entering into force on 1 January 2010.

“In addition, the Council invites the Hungarian authorities to ensure that budgetary consolidation towards its medium-term objective of a structural deficit of ½ of GDP is sustained after the excessive deficit has been corrected.”

Calculations of the updated convergence programme indicate that in 2011 (year when the excessive deficit will be corrected) the structural deficit will reach the MTO (1½% of GDP) calculated using the new methodology adopted by the Council in November 2009. In 2012, the programme calculates with maintaining the structural deficit achieved in the previous year.

TABLES

Table 1

Macroeconomic prospects

	ESA code	2008 HUF bn	2008	2009	2010	2011	2012
			Percentage change				
1. Real GDP (at constant prices)	B1g	25571.7	0.6	-6.7	-0.3	3.7	3.8
2. Nominal GDP	B1g	26543.3	4.5	-2.3	2.0	5.6	6.5
Components of real GDP (at constant prices)							
3. Private consumption expenditure	P.3	13186.9	-0.5	-8.0	-2.5	3.0	2.8
4. Government consumption expenditure*	P.3	5732.3	-0.8	-1.1	-0.8	0.3	0.2
5. Gross fixed capital formation	P.51	5404.2	0.4	-7.1	1.1	7.0	6.9
6. Changes in inventories and net acquisition of valuables (per cent of GDP)	P.52+ P.53	858.3	3.4	-3.2	-2.2	-1.7	-1.5
7. Exports of goods and services	P.6	21580.2	5.6	-10.1	5.5	9.2	9.5
8. Imports of goods and services	P.7	21190.2	5.7	-16.1	4.5	9.2	9.5
Contribution to real GDP Growth							
9. Final domestic demand		-	-0.4	-5.9	-1.3	3.1	3.0
10. Changes in inventories and net acquisition of valuables	P.52+ P.53	-	1.0	-5.5	-0.1	0.0	0.1
11. External balance of goods and services	B.11	-	0.0	4.8	1.1	0.6	0.7
Price developments							
12. GDP deflator		-	3.8	4.7	2.3	1.8	2.6
13. Private consumption deflator		-	5.6	4.2	4.1	2.3	2.6
14. HICP		-	6.1	4.2	4.1	2.3	2.6
15. Public consumption deflator		-	7.4	0.0	-0.2	1.6	4.2
16. Investment deflator		-	2.9	4.0	2.9	2.2	2.2
17. Export price deflator (goods and services)		-	1.0	2.5	0.5	1.2	1.0
18. Import price deflator (goods and services)		-	1.7	1.9	1.5	1.5	1.1
Labour market developments							
19. Employment (‘000;15-64)		3849.1	-1.2	-2.5	-1.1	0.9	0.9
20. Unemployment rate (%)		-	7.9	10.1	10.8	10.1	9.5
21. Labour productivity, persons		-	1.9	-4.3	0.7	2.7	2.9
22. Compensation of employees (HUF bn)	D.1	12549.8	5.4	-4.1	-0.6	3.7	5.9
22a. Compensation per employees (HUF million)		3.7	6.5	-1.0	0.4	2.8	5.0
Sectoral balances (per cent of GDP)							
23. Net lending / borrowing vis-á-vis the rest of the world of which	B9.		-6.2	2.2	1.6	1.5	1.4
- Balance of goods and services			0.7	6.4	6.4	6.3	6.3
- Balance of primary incomes and transfers			-7.9	-5.8	-6.6	-7.2	-7.3
- Capital account			1.0	1.6	1.8	2.4	2.4
24. Net lending / borrowing of the private sector	B9.		-2.4	6.1	5.4	4.3	1.1
25. Net lending / borrowing of general government	EDP B9.		-3.8	-3.9	-3.8	-2.8	-2.5

**/: Including government and NPISHs as well*

Table 2

General government budgetary prospects

	ESA code	2008 HUF bn	2008	2009	2010	2011	2012
			Per cent of GDP				
Net lending (EDP B.9.) by sub-sector							
1. General government	S.13	-1002.5	-3.8	-3.9	-3.8	-2.8	-2.5
2. Central government	S.1311	-963.8	-3.6	-3.1	-2.7	-2.3	-2.1
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	41.8	0.2	-0.3	-0.7	-0.4	-0.3
5. Social security funds	S.1314	-80.5	-0.3	-0.4	-0.3	-0.1	0.0
General government (S.13)							
6. Total revenue	TR	12076.7	45.5	45.9	45.0	44.2	43.3
7. Total expenditure	TE[1]	13079.2	49.3	49.8	48.8	47.0	45.8
8. Net lending / borrowing	EDP B.9	-1002.5	-3.8	-3.9	-3.8	-2.8	-2.5
9. Interest expenditure	EDP D.41	1109.7	4.2	4.3	4.3	3.8	3.7
10. Primary balance		107.2	0.4	0.5	0.5	1.0	1.2
11. One-off and other temporary items[2]		-99.5	-0.4	-0.1	0.2	0.0	0.0
Selected components of revenues							
12. Total taxes (12=12a+12b+12c)		6971.8	26.3	26.2	26.7	26.0	25.5
12a. Taxes on production and imports	D.2	4153.0	15.6	16.2	16.9	16.9	16.5
12b. Current taxes on income, wealth, etc.	D.5	2802.3	10.6	9.9	9.8	9.1	9.0
12c. Capital taxes	D.91	16.5	0.1	0.0	0.0	0.0	0.0
13. Social contributions	D.61	3682.1	13.9	13.3	12.2	11.9	11.8
14. Property income	D.4	296.5	1.1	1.2	0.9	0.6	0.6
15. Others		1126.3	4.2	5.3	5.2	5.7	5.4
16=6. Total revenue	TR	12076.7	45.5	45.9	45.0	44.2	43.3
Tax burden[3] (D.2+D.5+D.61+D.91-D.995)		10748.0	40.5	39.7	39.1	38.2	37.6
Selected components of expenditures							
17. Compensation of employees + intermediate consumption	D.1+P.2	4949.0	18.6	18.9	18.1	17.3	17.0
17a. Compensation of employees	D.1	3064.3	11.5	11.5	11.0	10.5	10.3
17b. Intermediate consumption	P.2	1884.7	7.1	7.4	7.1	6.8	6.7
18. Social payments (18=18a+18b)		4953.6	18.7	19.2	18.8	18.1	17.4
18a. Social payments in kind via market producers	D.6311, D.63121, D.63131	738.4	2.8	3.0	2.7	2.6	2.5
18b. Social transfers other than in kind	D.62	4215.2	15.9	16.3	16.0	15.5	15.0
19.=9. Interest expenditure	EDP D.41	1109.7	4.2	4.3	4.3	3.8	3.7
20. Subsidies	D.3	302.3	1.1	0.9	0.7	0.7	0.7
21. Gross fixed capital formation	P.51	750.5	2.8	2.7	2.8	3.2	3.2
22. Other		1014.1	3.8	3.8	4.1	3.9	3.8
23.=7. Total expenditure	TE[1]	13079.2	49.3	49.8	48.8	47.0	45.8

Due to the rounding the sum data could differ from the sum of the detailed data.
[1]: corrected with the net effect of the swap transactions TR-TE=EDP B.9.
[2]: a plus sign means deficit-reducing one-off item
[3]: including revenues entitled to the European Union

Table 3

General government debt developments

per cent of GDP	ESA code	2008	2009	2010	2011	2012
1. Gross debt		72.9	78.0	79.0	76.9	73.6
2. Change in gross debt		7.1	5.1	1.0	-2.1	-3.3
Contribution to changes in gross debt						
3. Primary balance		-0.4	-0.5	-0.5	-1.0	-1.2
4. Interest expenditure	EDP D.41	4.2	4.3	4.3	3.8	3.7
5. Stock-flow adjustment		6.1	-0.4	-1.3	-0.8	-1.1
of which: - privatization receipts		-0.1	0.0	0.0	0.0	0.0
- international institutions stand-by credits not used for financing purpose		5.6	-1.4	-1.6	-0.8	-1.2
Implicit interest rate on debt (%)		*6.2*	*5.7*	*5.5*	*5.1*	*5.1*

Table 4

Cyclical developments

per cent of GDP	ESA code	2008	2009	2010	2011	2012
1. Real GDP growth (%, at constant prices)		0.6	-6.7	-0.3	3.7	3.8
2. Net lending of general government	EDP B.9	-3.8	-3.9	-3.8	-2.8	-2.5
3. Interest expenditure	EDP D.41	4.2	4.3	4.3	3.8	3.7
4. One-off and other temporary items[1]		-0.4	-0.1	0.2	0.0	0.0
5. Potential GDP (%)		2.2	1.5	1.6	1.7	2.4
contributions: - labour		0.0	-0.1	-0.1	0.0	0.0
- capital		1.3	0.9	1.1	1.1	1.8
- total factor productivity (TFP)		0.9	0.7	0.6	0.6	0.6
6. Output gap		3.8	-4.6	-6.4	-4.6	-3.3
7. Cyclical budgetary component		1.1	-1.3	-1.8	-1.3	-0.9
8. Cyclically-adjusted balance (2-7)		-4.9	-2.6	-2.0	-1.5	-1.5
9. Cyclically-adjusted primary balance (8+3)		-0.7	1.8	2.3	2.3	2.1
10. Structural balance (8-4)		-4.5	-2.5	-2.2	-1.5	-1.5

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

Table 5

Divergence from the 2008 convergence programme

	ESA code	2008	2009	2010	2011	2012
Real GDP growth (%)						
1. 2008 convergence programme		1.3	-0.9	1.6	2.5	-
2. 2010 January convergence programme		0.6	-6.7	-0.3	3.7	3.8
4. Difference		-0.7	-5.8	-1.9	1.2	-
General government net lending (per cent of GDP)						
1. 2008 convergence programme	EDP B.9	3.4	2.6	2.5	2.2	-
2. 2010 January convergence programme	EDP B.9	3.8	3.9	3.8	2.8	2.5
4. Difference		0.4	1.3	1.3	0.6	-
General government gross debt (per cent of GDP)						
1. 2008 convergence programme		71.1	72.5	72.2	69.0	-
2. 2010 January convergence programme		72.9	78.0	79.0	76.9	73.6
4. Difference		1.8	5.5	6.8	7.9	-

Table 6

Long-term sustainability of public finances

per cent of GDP	2007	2015	2020	2030	2040	2060
Pension expenditure (net)[1]	10.9	9.1	8.3	7.6	8.3	10.0
Old-age and early pensions[2]	9.0	8.0	7.4	6.6	7.4	9.1
Other pensions (disability, survivors)	1.9	1.1	0.9	1.0	0.9	0.8
Health care, education and other age-related expenditure[3]	10.7	10.3	10.3	10.7	11.0	11.5
Health care expenditures	5.8	5.9	6.0	6.4	6.7	6.9
Long-term care expenditures	0.3	0.3	0.3	0.4	0.4	0.5
Education expenditures	4.4	3.8	3.8	3.7	3.7	3.8
Other age-related expenditures	0.3	0.3	0.2	0.2	0.2	0.2
Pension contribution revenue[4]	8.6	8.7	8.6	8.6	8.6	8.5
Assumptions[5]						
Labour productivity growth	3.2	2.6	2.6	2.7	2.1	1.7
Real GDP growth	2.9	3.1	2.6	2.3	1.1	1.0
Participation rate, males (15-64)	68.7	71.4	73.4	73.0	71.6	71.7
Participation rate, females (15-64)	55.0	61.6	63.6	64.8	64.3	64.4
Total participation rate (15-64)	61.7	66.4	68.5	68.9	67.9	68.1
Unemployment rate	7.4	7.0	6.2	6.2	6.2	6.2
Population aged 65 + over / total population	14.8	17.7	19.8	22.0	25.0	31.9

[1] Including pension payments from other funds than Social Security Fund. Pension expenditure (old-age and other) data from the 2009 long term pension projection model of the Ministry of Finance. It includes the projection for the old age allowances as well.

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

[3]: Data from the scenarios of the 2009 EPC (Economic Policy Committee) projections named for „AWG reference scenario" and „Baseline".

[4]: Contribution revenue data from the 2009 long term pension projection model of the Ministry of Finance.

[5]: Table contains projection used by the 2009 long term pension projection model of the Ministry of Finance.

Table 7

Basic assumptions

	2008	2009	2010	2011	2012
Hungary: short-term interest rate (annual average,%)	8.8	8.3	5.6	4.9	4.0
Hungary: long-term interest rate (annual average,%)	8.2	9.1	7.2	6.4	5.6
World (excluding EU) GDP growth (%)	3.8	-0.4	3.8	4.1	4.1
EU-27 GDP growth (%)	0.8	-4.1	0.7	1.6	1.6
Growth of foreign markets of Hungary	3.3	-13.3	2.1	4.4	4.4
World import volumes (excluding EU)	4.6	-12.6	4.6	5.0	5.0
Oil prices (Brent – USD / barrel)	97.2	61.6	78.7	84.5	86.1
HUF/EUR	251.6	280.4	270.9	270.9	270.9