GOVERNMENT OF HUNGARY

CONVERGENCE PROGRAMME OF HUNGARY

2012 – 2015

April 2012

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PREFACE

In the context of the European Semester launched in the first half of 2011 under the Hungarian Presidency Member States prepare their stability or convergence programmes and National Reform Programmes and submit them annually to the European Commission and the Council by 30 April at the latest.

The European Semester allows for an ex ante economic policy coordination at EU level and provides the framework for aligning Stability and convergence programmes on macroeconomic outlook and budgetary plans and National Reform Programmes on the progress towards Europe 2020 targets. This enables the programmes to be consistent and based on the same macroeconomic assumptions, fiscal path and structural measures, in addition to the fact that an overlap of the programmes with different focuses can be avoided.

The 2012 convergence programme of Hungary takes fully into account the guidance by the March European Council on priorities for macroeconomic and fiscal policies in the context of the European Semester. Furthermore, in line with the Council recommendation adopted at the 13 March Ecofin meeting with a view to bringing an end to the situation of an excessive government deficit, the Convergence Programme presents the measures that ensure the fulfilment of the specific recommendations in a separate chapter.

Against this background, the Government adopted the 2012 convergence programme together with the 2012 National Reform Programme. The convergence programme sets forth in detail the medium-term macroeconomic, budgetary and debt outlook and includes in this context the supporting measures. The National Reform Programme presents in detail the measures taken and planned in order to attain the goals laid out in the framework of the Europe 2020 Strategy.

1. ECONOMIC POLICY OBJECTIVES

In the convergence programme of April 2011 – which was based on the Széll Kálmán Plan – the main objective set by the Government was to address the major structural problems of the Hungarian economy inherited from the past. In the context of the convergence programme, the most prominent economic policy priorities were the following:

- to reverse the permanently increasing trend in the public debt-to-GDP ratio experienced in the previous period;
- to tackle the problems arising from the ever increasing foreign currency debt stock which contributed significantly to the external vulnerability of the Hungarian economy and the increase of the debt sevices of the households;
- to raise the growth potential of the Hungarian economy and, in particular, increase the critically low level of labour market participation and employment.

In the past year, significant progress was achieved in all of the above areas.

The Széll Kálmán Plan announced in March 2011 envisaged the implementation of those structural measures affecting the expenditure side of the budget which are expected to add significantly to growth potential already in the medium term while, on the other hand, will contribute, already from 2012, to the reduction of the budget deficit in a permanent manner.

The structural reform agenda of the Széll Kálmán Plan covered the following areas: employment and labour market, pension system, public transport, higher education, pharmaceutical subsidies, and state and municipal financing.

Both market reactions and the results achieved so far confirm the success of the Széll Kálmán Plan.

Budgetary developments indicate a trend reversal: for the first time since Hungary's accession to the EU, the budget balance met the Maastricht deficit criterion. In 2011 the EDP balance showed a surplus of 4.3% of GDP. The budget deficit, net of the unplanned one-off items occurring during the year and not included in the adopted 2011 budget, was lower than the target and amounted to 2.43% of GDP. In the 2012 convergence programme the Government confirms the deficit path set in the programme last year. The annual deficit targets remained unchanged at 2.5% of GDP in 2012, 2.2% in 2013, 1.9% in 2014 and 1.5% in 2015.

Trend reversal took also place in terms of the public debt-to-GDP ratio. Since the overwhelming majority of the one-off revenues stemming from the transformation of the pension system were used for debt reduction, the debt-to-GDP ratio was set on a declining path. The debt ratio declined by close to 1 percentage point, to 80.6% of GDP in 2011. Without the impact of the temporary exchange rate volatility, the fall in the debt ratio amounted to close to 6 percentage points.

Starting from spring 2011, the Government took, in several steps, comprehensive measures to reduce the burden of households with FX loans. The distinct measures offered tailor-made solutions for the specific groups of households (including the early repayment scheme, fixed exchange rate programme, National Asset Management Company, conversion of loans and partial debt relief of FX-debtors overdue by more than 90 days, interest subsidy, Social Family Home Construction Programme). Altogether, problems of the majority of the households with FX debt were addressed in a reassuring manner. There is common feature of the measures implemented, namely the principles of social justice, solidarity and of a fair sharing of the burden caused by the exchange rate changes are equally present in them.

Non-conventional economic policy measures played an important role in these results. In order to cope with the economic and budgetary legacy the Government had to face with when taking office and with the repercussions of the sovereign debt crisis threatening some euro area Member States, the application of these unconventional measures was not only justified, but also necessary. The Hungarian economic policy gained some time through these measures to launch the much needed reforms with the aim to transform the Hungarian society and economy, and improve the competitive position of Hungary. The Government efficiently made use of this period, and the reforms launched in the Széll Kálmán Plan have created the opportunity to continue the efficiency-oriented fiscal consolidation which permanently reduces the debt ratio and contributes to raising growth potential and to increasing labour market participation. These results were achieved in such a manner that – almost unprecedentedly in international comparison – the political parties behind the Government have been able to sustain their strong backing, which enables the continuation of the reform agenda.

The 2012 convergence programme and National Reform Programme, which constitute an integral part of the framework strategy called „The next step" (Széll Kálmán Plan 2.0) adopted by the Government, are important documents signalling this strong commitment to further reforms.

In the context of the elaboration of the convergence programme, the Government worked out and adopted a fully-fledged macro-economic forecast for the period 2012-2015. In order to make it unquestionable, either by market participants or international organisations as regards the feasibility of the fiscal targets, the baseline growth path of the convergence programme is based on conservative assumptions, i.e., lower than the growth path the Government considers as most probable. The measures needed to achieve the deficit targets were identified along this conservative growth path and were adopted in Government resolution.

The updated convergence programme presents the results of those simulations which quantify the macroeconomic impacts of the main structural reforms fundamentally determining the evolution of the growth potential (reduction of the administrative burden, increasing labour market flexibility, transformation of the education system and of the tax

system). The results confirm that these main reform steps have, already in the medium-term, measurable positive impact on GDP growth and employment.

In line with the endeavours presented in the previous programme, the budgetary calculations of the convergence programme include the impact of the phasing-out of the special sectoral taxes that were introduced in 2010 for an explicitly stated temporary period. Furthermore, in line with the agreement with the Hungarian Banking Association, the financial sector levy will be halved in 2013 and thereafter will be reduced to a level commensurate with European practices. The budgetary impact of the phasing-out of these one-off and temporary revenue items is offset, on the one hand, by the savings planned for 2013 from the medium-term expenditure reduction measures of the Széll Kálmán Plan. On the other hand, the budget balance benefits from further structural expenditure cuts in the context of the renewed Széll Kálmán Plan and from new, innovative revenue measures with a permanent effect.

Based on the deficit path included in the programme and on the assumptions on the evolution of the cyclical position, the structural balance over-achieves the MTO (a structural deficit of 1.5% of GDP) by a wide margin already in 2013, and slightly improves further in 2014-2015. In line with the requirements of the Fundamental Law of Hungary and of the Law on the economic stability of Hungary, the public debt-to-GDP ratio follows a continuously declining path and drops below 73% of GDP by 2015.

Over the past year the Government implemented a successful financial and fiscal stabilisation strategy, partly relying on one-off budgetary revenues. These took place amidst global and European economic and financial conditions characterised by the escalation and, lately, slow mitigation of the sovereign debt crisis in parts of the euro area. In the still uncertain global conditions, the utmost importance of the commitment to a growth-enhancing fiscal consolidation strategy ensuring permanent debt reduction is unquestionable. At the same time, confidence in the Hungarian economy would be further strengthened if a financial safety net were in place which makes it evident to market participants that economic and financial stability in Hungary can be maintained even under extremely unfavourable global conditions. Therefore the Government continues to stand ready for a rapid launch and quick conclusion of negotiations that could lead to an agreement with the EU and the IMF on such a financial safety net.

2. MACROECONOMIC PROCESSES AND FORECAST

2.1. EXTERNAL CONDITIONS

The first half of 2011 was characterized by a rapid period of recovery from the 2008-2009 economic crisis, but in the second half of the year the unusual growth in world trade seen earlier was held back by the austerity measures of developed and developing countries. The natural disaster in Japan negatively influenced the performance of cross-border supply chains, and international performance declined as a result. The debt crisis affecting some countries in the euro area, which resumed in the autumn of 2011, negatively influenced the development of the real economy towards the end of the year, meanwhile short-term prospects became more unfavourable. Thus in 2011 the economic growth of the European Union reached 1.5%, while the growth rate of the euro area was 1.4%.

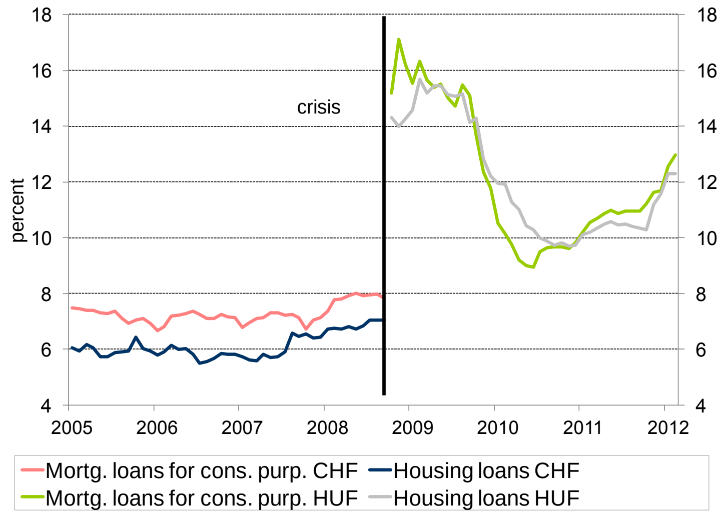
In spite of the fact that in 2012, similarly to the previous year, the world trade growth excluding the European Union might reach around 4.2%, the economic growth of the EU could drop to 0.1% as a result of the renewed debt crisis. The temporary setback will have a larger impact in the first half of 2012, while in the second part of the year gradual recovery may start again, if the debt crisis of the euro area is satisfactorily settled. In 2013 global growth excluding the EU may reach 4.3%, while the growth of the EU may rise to a rate around 1.4%.

Domestic economic developments are also sensitive to the new waves of the debt crisis through the risk premium channel because of Hungary's high external debt. Thus in addition to the worsening external demand, the more expensive financing constitutes an extra burden for domestic participants.

2.2. COMPONENTS OF GROWTH

The worldwide recession reached Hungary in October 2008. Increased exchange rate uncertainty and sovereign risk have put an end to the era of cheap, primarily CHF-based credit. Credit denominated in foreign currency practically disappeared in the household segment and was replaced by much more expensive forint denominated credit (see Figure 1), the non-price conditions of which have been constantly tightened, too. As a result, a very powerful deleveraging began across the household sector (see Figure 2). This process hits those sectors that produce for the domestic market, whereas the loose conditions in the labour market improve the country's external competitiveness, the result of which is a long-term reallocation of resources in favour of the export sector.

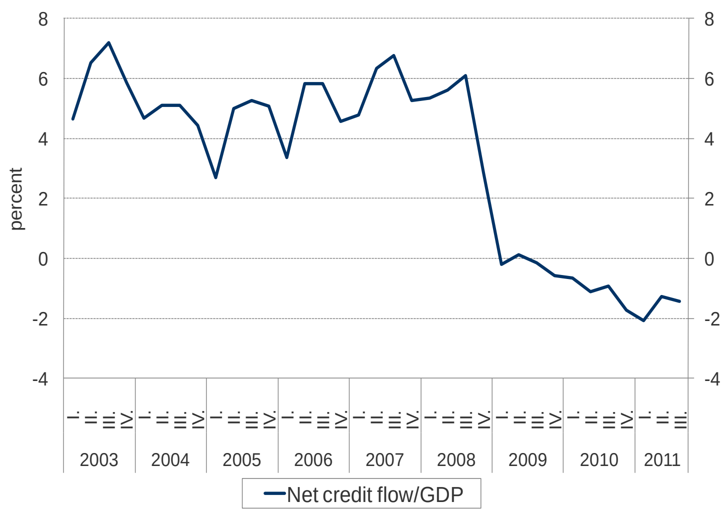
Figure 1: Retail credit interest rates (%)



Source: MNB

In accordance with the above, in the course of 2010-2011 net exports were the main driver of the growth, which compensated for the growth-limiting effect of weak domestic demand. Thus, in 2011 the Hungarian economy grew by 1.7 %.

Figure 2: Household net lending (GDP%)



Source: MNB

In 2012-13, economic growth will still be predominantly driven by net exports, but with the fading of the deleveraging process in the domestic economy, from 2014 domestic components will also significantly contribute to a sustainable and healthy growth structure.

Table 1: GDP components (%)

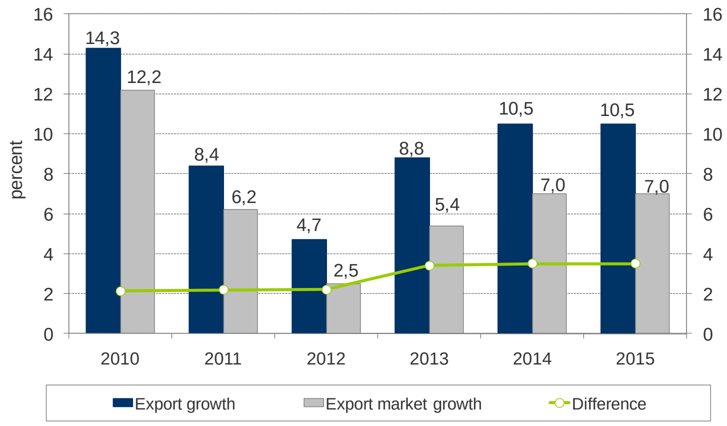
	2011	2012	2013	2014	2015
GDP	*1.7*	*0.1*	*1.6*	*2.5*	*2.5*
Private consumption expenditure	0.0	-1.4	0.7	2.6	2.6
Government consumption expenditure	-1.3	-1.0	-0.5	0.0	0.0
Social transfers in-kind	0.4	-0.5	-0.7	0.7	0.7
Gross fixed capital formation	-5.4	-2.3	0.3	3.5	3.5
Exports of goods and services	8.4	4.7	8.8	10.5	10.5
Imports of goods and services	6.3	2.8	8.1	11.0	10.9

Source: NGM calculations

Foreign trade

Whereas Hungary's import-based external demand increased by 8.4% in 2011, in 2012, as a result of the above effects, growth is not expected to exceed 2.5%. According to our forecast and in line with the expectations of the European Commission, the European debt crisis will be gradually settled by the end of 2012, which will be traceable in the upward trend in exports from the third part of the year. In 2013 gradual growth will continue, and the growth rate of external demand will reach 5.4%, whereas from 2014 on the demand for Hungarian exports may increase at an annual rate of 7%.

Figure 3: Export volume and export market growth (%)



Source: European Commission, NGM calculations

The growth in Hungarian exports has considerably exceeded that of the export markets for several years. In the course of 2011, Hungarian export performance was 2.1 percentage points higher than external demand. As a result of unique factors, from 2013 the gap between the two indicators may widen further because the capacities established through the current car manufacturing investments, which will commence production and export sales in 2012-2013.

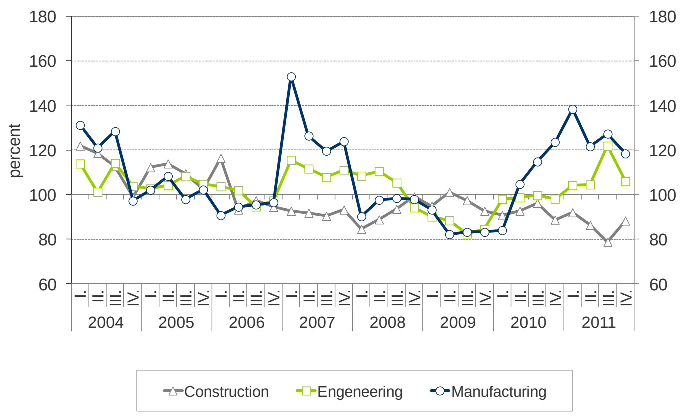
The substantial growth of domestic demand will commence in 2013, consequently the gap between export and import growth will narrow, and as of 2014 import growth may, to some

extent, exceed export growth. The crisis had presumably caused level-losses in domestic demand that will remain for a longer period, dampening imports, thus the foreign trade surplus will remain considerable in the following years.

INVESTMENT

Due to lasting weak internal demand there are serious unexploited capacities in the sectors of industry whose production is focused on the domestic market. Because of high bankruptcy rates, the banking sector is also rationing credits, thus investment dynamics is very low in these sectors. The most extreme situation can be seen in the case of construction investments, where the volume of investments decreased by 21% in 2011. By contrast, manufacturing investments increased by 24.2% in 2011, a similar example could only be seen before the crisis, in 2007, in a much more favourable global business envorinment. The significant role of manufacturing investments will remain for the complete forecast horizon, in 2012 FDI coming from huge car manufacturing investments will be far above the level achieved in the previous year. Based on the estimates of the Hungarian Investment and Trade Agency, the investment activity of other manufacturing sectors may also considerably increase in Hungary. The enhancement of the manufacturing capacities will increase Hungary's potential output, contributing to long-term economic growth and macroeconomic stability.

Figure 4: Components of investment



Source: KSH

It is expected that the use of EU funds may significantly contribute to the growth of the Hungarian gross fixed capital formation in both 2012 and 2013. Similarly to the previous years the funds will be used for infrastructural investments and agriculture.

On the whole, the decrease experienced in gross fixed capital formation abated in 2011, primarily the performance of manufacturing was outstanding, and all conditions are satisfied for this to continue in 2012. As a result of measures boosting competitiveness, and the

stabilizing international money markets on the medium term, as of 2013 gross fixed capital formation could increase, and as of 2014 it could stabilize at a level above 3%.

CONSUMPTION

In 2011 retail sales increased by 0.2 %, thus after four years in 2011 the volume of retail sales did not decrease any further, although compared to 2005, the level of the volume is still lower by 6% in real terms. The flat tax reform had a significant contribution and helped to avoid the contraction of consumption in the unfavourable market environment last year. In August and September it was the real yield payments, and during autumn it was presumably the increasing shopping tourism caused by the weakening forint that boosted turnover. In 2011 consumption was in line with retail sales data (household consumption: 0.1%) according to the latest GDP statistics.

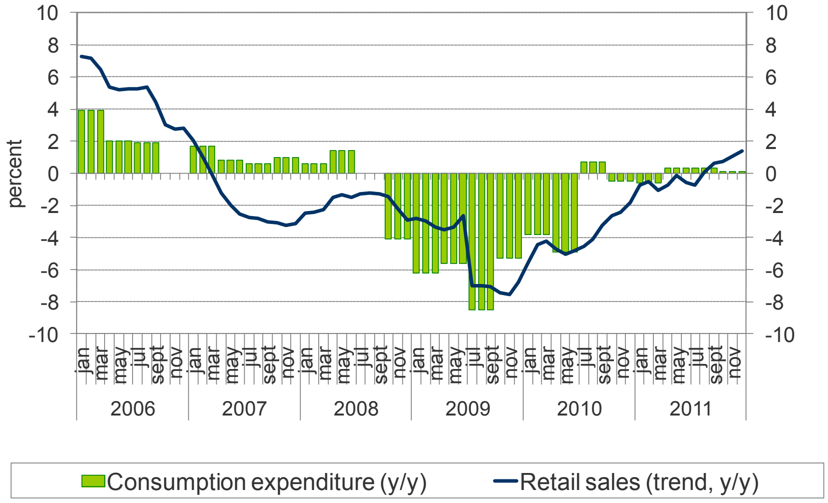
At the same time, certain factors (the forint exchange rate, inflation) had a negative impact on consumption, which was further intensified by the decline of the confidence of the households regarding their own financial position. All of these indicate that the reversal of the trend in domestic demand has not yet arrived, thus in 2012, a weaker consumption is anticipated compared to the previous expectations, which is coupled with the stronger base of last year.

The early repayment scheme and the conversion of the credits of delinquent borrowers at a fixed exchange rate will improve the net wealth position of households (the former by 370, the latter by an anticipated 150 billion forints), which will by all means have a positive effect on consumption, but probably not enough to counterbalance the effects mentioned above. In the case of those who paid back their foreign currency loan by taking a forint-based one, the improvement of the net position falls short of the advantage due to the difference between the fixed exchange rate and the current exchange rate because, although on a smaller credit amount, they are faced with a higher forint interest rate than before. The positive impact on consumption of the more favourable fixed exchange rate programme elaborated in December may be more significant than the early repayment scheme, but the conclusion that it will only take the edge of the negative effects is valid here also.

We anticipate that from the 473 thousand people who still have foreign currency credits after the early repayment, 400 thousand will enter the new programme. Together they have foreign currency credit of 3,200 bn forints, i. e. an average debt of 8 million forints. Assuming the exchange rate and interest conditions at the beginning of April, the average monthly instalment of 83 thousand forints may be reduced to 60 thousand forints. As a result, the income position of the households in 2012 will improve by approx. 20 bn forints. In the next year the programme would bring an improvement of HUF 80 bn, which will gradually decrease every year, but even in 2016 it would bring an improvement of HUF 70 bn. Taking into consideration that the households presumably smooth their consumption and build up reserves because of the higher instalments due after 2016, concerning this type of income a

saving rate higher than average is assumed. The FX-related supporting measures of the public sector will have an additional positive impact on total consumption.

Figure 5: Retail consumption expenditure* and retail sales volume
(change compared to the same period of the previous year, percentage)



Source: KSH
**/: quarterly data*

Another factor that does not support consumption is that in 2012 the lending conditions will presumably tighten further in the household segment. Based on the MNB survey, the non-price conditions (collateral indicators, income requirement) and the price-related conditions (interests) of credits also tightened in the last quarter. As a result, we expect that in 2012 the consumption of households may decrease by 1.2%. As for 2013, the outlook is better because real incomes will begin to increase again. At the same time the tax measures slow the pace of retail consumption growth, since companies are able to shift the charges by raising the prices of telecommunication and financial services. Based on these, in 2013 private consumption volume may increase by 0.2%. As of 2014, household consumption dynamics may further intensify, and an increase of approximately 2% is expected.

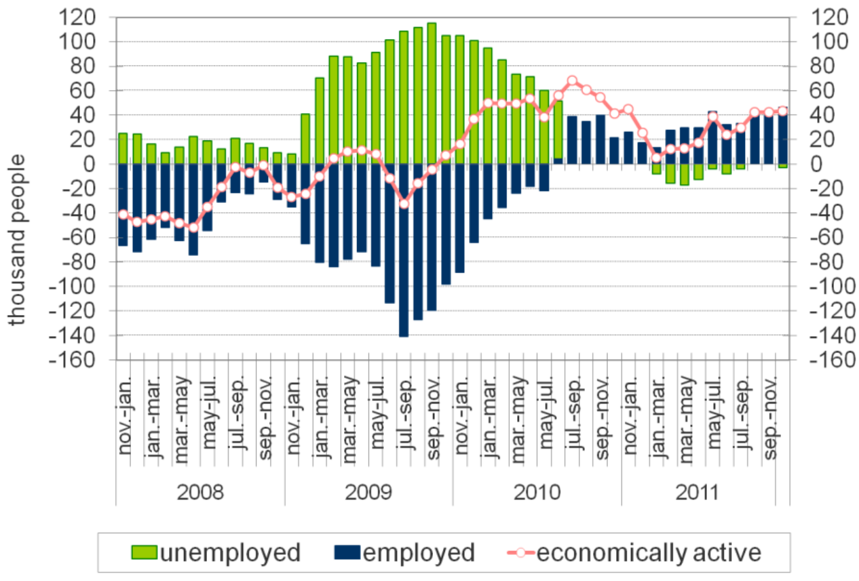
2.3. Labour market

In 2011 the growth of the number of employed persons, which started in August 2010, still continued (calculated on a yearly basis): parallel to the slow recovery of corporate profit margins, employment in the primary labour market also gained momentum. The number of unemployed persons decreased by 7 thousand people in one year, which has been unprecedented since the beginning of the economic-financial crisis. In 2012 besides the more unfavourable trend of external and internal conditions, employment is expected to

stagnate in the private sector: in order to keep their profitability and thus to reduce their expenses, companies will presumably not increase significantly the number of fulltime staff, but will rather try to keep their existing employees. Higher economic growth and the intensification of external and domestic demand lead to an increase in production and, as a result, although not immediately, in employment: from 2013 faster growth is expected in private sector employment figurs. We expect that in this period the effects of the Széll Kálmán Plan and the new Labour Code to boost labour supply will be notably visible in the private sector employment figures.

Figure 6: Changes in the activity rate

(changes in three month averages, y/y)



Source: KSH

In the public sector the new public work programme called Start Work Programme (Start Munkaprogram) started in 2012, with the purpose to provide work opportunities for at least 200 thousand people. According to the expectations, the public work programmes as temporary economic policy tools to facilitate employment in the primary labour market, will show the most dynamic increase in 2012-2013 parallel with the revision of the disabled pensions, announced as a part of the Széll Kálmán Plan. Other factors, besides public work programme, also play a role in the changes in the number of employed persons in the public sector. In the beginning of 2012 the Government decided to reduce the headcount of budgetary organizations in order to build up a more efficiently operating state. That will result in a 1% cut in headcount in the public sector (without public work programme) in 2012. However, the expanding public work programme may result in a total increase of 4.3% in 2012, respectively 5.4% in 2013 in the public sector.

As a result of a moderate increase in the employment of the private sector, and a (temporarily) higher increase in that of the public sector, the number of employed persons in the total economy will increase at a rate above 1% in 2012, and 2% in 2013.

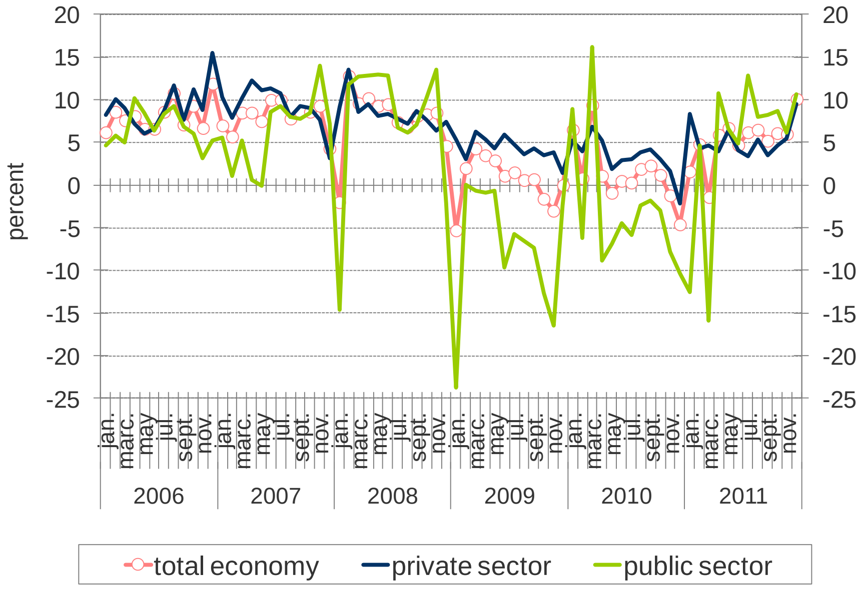
The lower number of public workers in 2011, and the unfavourable employment prospects maintain loose labour market conditions. However, temporarily the expanding public work programmes and then in parallel with the recovery of economic growth and corporate profit margins, the competitive sector will presumably absorb an increasingly larger number of the job seekers in working age. As a result, unemployment in 2012 is expected to remain at 10.9%, with a downward trend from 2013.

Table 2: Employment **changes in percentage**

	2011	2012	2013	2014	2015
Number of employed persons (15-64)	0.8	1.2	2.2	3.0	3.4
Unemployment rate (%)	10.9	10.9	10.3	9.5	8.9
Participation rate (%)	62.9	63.8	65.1	67.0	69.4

Taking into consideration the income tax allowance for children, in 2011 net average wages in the total economy exceeded the 2010 levels by 9.9% on average. Besides a 3.9% increase in the consumer prices, real wages (the purchasing power of wages) increased by 5.8% during 2011. The new family tax allowance for children introduced on 1 January 2011 had a considerable impact on the net income of the families even with only one child, and this positive impact was even higher with more children.

Figure 7: Average gross wages (y/y)



Despite loose labour market conditions, the gross average wages of the private sector are expected to increase in the next years partly as a result of the minimum wage increase and

the wage compensation system necessary to maintain net income levels, and their second round effect: in 2012 by 6.7%, in 2013 by 3.9%. The wages of the participants in public work programme was reduced on 1 September 2011 but the increase in the minimum wage and in the guaranteed wage minimum affect the public sector too, restraining the decrease in average wages caused by the composition effect coming from the growing number of employees in the public work programme. The salaries of those who earn more than the minimum wage will not be increased (wage freeze) in the public sector, and a compensation mechanism ensures that net incomes remain unchanged.

Public employment

On 1 January 2012, building on 2011, the new public work programme called Start Work Programme (Start Munkaprogram) was introduced under the exclusive direction of the Ministry of Interior. In contrast to the 64 bn HUF in the previous year, Hungary's 2012 budget allocated 132.2 bn forints for the financing of public work programmes, with the objective of providing work for more than 200 thousand people. The four-hour part-time public employment will be withdrawn; in 2012 only six- and eight-hour positions will be announced. The background of this measure is the experience gained in the previous year, which showed that valuable work can mainly be achieved with longer working hours.

Start Work Programme is based on three pillars:

1. In the national public work programme 45 thousand people may participate, with contracts for 11 months and eight-hour working days only. In the public work schemes the following authorities will participate as employers: water directorates, forestries, private forestries, directorates of national parks, Hungarian State Railways, State Motorway Management Co. Ltd., Motorway Management, National Police Department, and the National Disaster Management Directorate. Compared to 2011, a considerable increase in the number of people involved is expected in this pillar.

2. The local government's public work programmes will provide six-hour work opportunities for more than 79 thousand people. These programmes will be implemented without local government funding and will be fully financed by the state in order to facilitate and support local government's activities.

3. The local governments invited within the micro-regional pilot projects can get involved in public employment with a 100% state subsidy and choose between seven programmes depending on their own local characteristics: agricultural works, maintenance of agricultural roads and public roads, repair of inland water drainage systems and tidying up stream beds, elimination of illegal landfills, and installation and operation of biomass boilers in the framework of the biomass boilers' programme.

In 2012 education becomes increasingly important: trainings will be organised not only in the framework of national programmes, but also within micro-regional programmes. In the framework of the micro-regional pilot projects cultivation of plants and animal husbandry

will be taught with the aim of preparing the participants for future independent household farming.

The wages of public employees changed compared to 2011 only to maintain the net income levels. The monthly gross wage of full-time employees working in positions that do not require vocational qualifications or a secondary education changed from HUF 57,000 introduced on 1 September 2011 to HUF 71,800 on 1 January 2012; in the case of positions requiring at least a secondary education the guaranteed public employment wage has increased from HUF 78,000 to HUF 92,000.

The employment replacing allowance, however, was reduced to 80% of the minimum old-age pension (HUF 28,500), i. e. to HUF 22,800, thus encouraging public employment which provides a higher monthly income.

2.4. INFLATION DEVELOPMENTS

In 2011 the inflation rate in Hungary was 3.9%, close to what had been expected before. Higher fuel and food prices had a major role in the change in inflation in 2011. The former increased chiefly because of world market developments and as a result of record-high oil prices, increasing until mid-summer. As of August there was a general fear of recession because the American and European sovereign debt crises situation worsened, which reduced the world demand for oil. The increase in inflation acceleration experienced at the end of the year was caused by the depreciation of forint and the excise duty changes introduced in November. The above-mentioned developments clearly show the external and internal factors that may have had an upward pressure on prices in the course of 2012.

Of the external factors, the greatest uncertainty is related to the possible changes in oil prices (especially because of the conflict with Iran) which constitute an upward inflationary risk. Of the external factors, besides oil prices, changes in food prices have a major impact on domestic inflation in general. In this area, however, there is no further perceivable inflationary pressure in 2012. Even though food prices are still very high, the base effect of the 2011 record price levels will presumably slow the pace of the increase. (The world prices of food are almost the same level as in the period following the 2007 food price explosion.)

Domestic factors play a major role in inflation in 2012; the effect of tax changes, partly the excise duty increase introduced in 2011 on tobacco, alcohol and gasoline, and partly the VAT increase at the beginning of the year. Finally, the tax changes concerning the telecommunication services as of this year. However, the regulated prices accelerated at a slower pace than the general price index at the beginning of this year. Furthermore, the negative and further widening output gap may significantly mitigate these supply-side effects. Considering the above mentioned developments in respect of 2012, and the effects of the measures improving budget balance in respect of 2013, according to our forecast the consumer price index will gradually decrease to the central bank target by 2014.

Table 3: Consumer prices %

	2011	2012	2013	2014	2015
Consumer price index	3.9	5.2	4.2	3.0	3.0

2.5. Cyclical developments

In the period between 1998 and 2006 the growth of the Hungarian economy was higher than potential, at a yearly average of around 4%, thus the output gap became positive[1]. A parallel may be drawn between the positive output gap after 2001 and the strong fiscal expansion of this period. In the meantime the anti-employment tax and transfer system, which did not support the country's competitiveness led to a decrease in potential growth. Because of the government's austerity measures implemented in 2007 the actual GDP growth became even slower than the potential growth, and so the positive output gap started to close. The crisis caused a huge fall in GDP, turning the output gap negative.

The measures aimed at facilitating competitiveness taken in the last two years help to boost potential growth. In 2012 the temporary slow-down in world trade and the considerable improvement of the budget's structural balance will keep actual growth low. As a result of these two developments in 2012 the output gap is expected to widen. However, from 2013 actual growth is expected to exceed potential growth again, so the output gap will start to close. Still, the level of actual output will remain below potential until the end of the forecast horizon, and according to the calculations of the Convergence Programme it is expected that the output gap will only close after 2015 (Table 4).

Table 4: Cyclical developments %

	2009	2010	2011	2012	2013	2014	2015
GDP growth	-6.8	1.3	1.7	0.1	1.6	2.5	2.5
Potential growth	0.4	0.2	0.3	0.8	1.4	1.6	1.8
Factors:							
Labour	-0.6	-0.3	0.1	0.6	1.1	1.1	1.3
Capital	1.0	0.7	0.5	0.4	0.4	0.5	0.5
Total factor productivity	0.0	-0.2	-0.2	-0.2	-0.2	0.0	0.0
Output gap	-4.9	-3.9	-2.6	-3.2	-3.0	-2.1	-1.4

Some data discrepancies are due to rounding.

[1] The calculation of potential output was performed using the methodology of Output Gap Working Group (OGWG) of the European Commission differing only in the filtering of average working hours, activity rate and structural unemployment (NAWRU) where we took into account the forecasts for 2014 and 2015 to ensure consistency. The TFP trend was calculated using a Bayesian Kalman-filter that incorporates a capacity utilisation variable, whereas the NAWRU trend was calculated using the simplified methodology of the OGWG for new Member States. For further information refer to the CIRCA website: http://circa.europa.eu/Public/irc/ecfin/outgaps/library

It is important to stress that the structural measures primarily improve growth potential. A significant part of the government's measures address the labour market, and as a result the increase of the labour component of the potential growth will soon surpass the rate before the crisis and will become a decisive source of domestic growth. The capital and total factor-productivity component will make a moderate contribution to growth.

2.6. EXTERNAL BALANCE

In 2011 the external balance of Hungary improved further thanks to the real economic surplus and the inflow of EU transfers. In 2010 the real economic surplus reached 6.3% of GDP and 7.2% in 2011. The considerable improvement concerning the balance of goods and services was reflected in the current account balance; following the 1.2% surplus in 2010, in 2011 the surplus reached 1.4%. The external financing capacity has increased by more than the current account balance as a result of expanding capital transfers, reaching 3.6% of GDP in 2011.

The improvement in the balance of goods and services is still determined by the low import need of domestic demand. Despite the increase both in the consumption of households and gross fixed capital formation from 2013, the rate of imports is permanently decreased in the medium term by the level-loss of domestic demand resulting from the economic crisis. Therefore, real economic balance may produce a surplus of 9-10% of GDP over the forecast horizon.

In the income balance, interest paid on debt may remain considerable over the forecast horizon. Until 2014 income on equity is expected to be determined by individual factors. The launch of new car manufacturing production capacities in 2012-2013 is expected to use a part of the profit generated in other production units of these factories. Consequently, in 2012-2013 outbound profit transfers as well as reinvested earnings will probably stay at a low level. After 2014, however, profits will be generated from new production and thus earnings reinvested in Hungary may rise.

As the use of current EU-transfers will play a significant role until 2014, the surplus of the current balance may be around 3-4% of GDP between 2012 and 2015. Increasing incomes outflow in 2014 and the decrease in planned EU-transfers for 2015 will result in a gradual decrease in the current account balance. EU-transfers appearing in the capital account will remain significant over the forecast horizon; therefore, external financing capacity may reach 6.4-7.3% of GDP.

Changes in FDI inflow are also influenced by the individual factors mentioned above in regard to incomes. The rate of reinvested earnings will rise slowly from 2013. Banks are expected to be recapitalised from foreign sources in 2012, which will probably increase equity-type of investments as a one-off effect, but in the years to follow this inflow is expected to be just below average. Other capital inflow may exceed the average rate in the

period between 2012-2013 as a consequence of investments in car manufacturing financed from internal sources of liquidity.

Table 5: External financing **GDP %**

	2011	2012	2013	2014	2015
Balance of goods and services	7.2	9.1	10.0	10.0	10.0
Current account balance	1.4	3.4	4.1	4.0	3.7
Capital account with EU-transfers	2.1	3.2	3.2	3.3	2.7
External financing needs (-)/capacity (+)	3.6	6.5	7.3	7.3	6.4
Debt-generating financing *	-5.3	-8.3	-8.8	-8.8	-7.9
Non-debt-generating financing	1.7	1.7	1.5	1.5	1.5
including: net foreign direct investment	3.8	2.1	1.6	1.6	1.6
including: net reinvested earnings	1.5	0.9	0.9	0.9	0.9

**/without other capital, negative amounts decrease the stock of external debt*

Due to the rounding of data some aggregate figures could differ from the sum of detailed data.

2.7. Economic effects of government reform measures

The QUEST III model developed by the European Commission has been used for simulating the long-term macroeconomic effects of the Government's key economic-policy measures. In order to present credible results for the Commission, those parameters have been used in the model that the experts of the Commission calibrated in line with the special features of the Hungarian economy.

The joint effect of the following reforms and changes in the tax system has been studied:

- **Higher education reform:** it is anticipated that over a period of 20 years the number of science graduates will gradually increase from the 4.4% in the model up to 6%. In parallel, the number of other types of degrees will decrease.
- **Strengthening labour market incentives:** in line with the Széll Kálmán Plan, the transfer period of job-seeker benefits will be decreased by two-thirds.[2]
- **Cutting the administrative burdens:** a reduction of 50% in the administrative burdens in the manufacturing sector in accordance with the undertakings of the Széll Kálmán Plan is simulated.
- **New Labour Code:** thanks to the more flexible labour market, distortions are decreased, which appears in the model by decreasing the bargaining power of the household sector by 1 percentage point.
- **Tax system reform:** Table 6 contains the most important tax measures taken taken by the current government and the allocation of these into tax categories that can be interpreted in the model. Taxes on labour fell primarily due to the changes in personal income tax rate. Taxes on consumption went up due to an increase in VAT, excise duty and the new taxes. The tax revenue expected from the financial transaction levy (FTL) and telecommunication services tax (TST) will be collected from both companies and households. In the case of the

[2] It should be noted that not all government measures are modelled here that aim to increase labour supply. For example the revision of the disabled pansion system and the increase of the effective retirement age.

latter, the tax will be regarded as a tax on consumption. The change in the tax on capital is a consequence of the resultant of the reduced corporate tax rate and the increased tax rate of utilities. The modelling of those parts of the new taxes that are paid by corporates and cannot be attributed directly to labour or capital has been difficult since no such tax types exist in the model. Therefore, their influence may be best estimated by increasing the variable named "Entry cost" which increases the prices of intermediate products.

Table 6: Modelled tax measures and their respective values

	total tax revenues (% of GDP)	Distribution of tax revenues between (% of GDP)			
		consumers		firms	
		tax burden on labour	tax burden on consumption	tax burden on capital	entry cost
VAT	0.5		0.5		
Excise duty	0.3		0.3		
Personal income tax reform	-1.6	-1.6			
Contribution increase	0.4	0.4			
Targeted benefit	-0.1	-0.1			
Corporate tax rate	-0.4			-0.4	
FTL[1]	0.7	0.1	0.1	0.0	0.6
TST[2]	0.2		0.1		0.1
Corporate tax of public utilities	0.2			0.2	
Total (% of GDP)	0.2	-1.3	0.9	-0.2	0.7

[1] *Financial Transaction Levy*
[2] *Telecommunication Services Tax*

Table 7 shows the results of the simulation in percentage differences compared to the baseline scenario (levels). All in all, the reform plan significantly expands Hungarian GDP. The output level is increased by 2 percentage points over a one-year time horizon. This effect will be amplified over the total horizon, and in 20 years time it will reach over 5.5 percent. First and foremost, key economic indicators improve significantly due to the increasing labour supply and demand; consumption will be stimulated together with investment, employment and net exports. New tax types will have adverse effects on technology (TFP), as in this model it is the R&D sector that is indirectly most seriously affected. Generally speaking, the measures defined in the Széll Kálmán Plan will result in further boosting the Hungarian economy and improved financing capacity.

Table 7: Macroeconomic effects of the Széll Kálmán Plan (% differences in levels from baseline scenario)

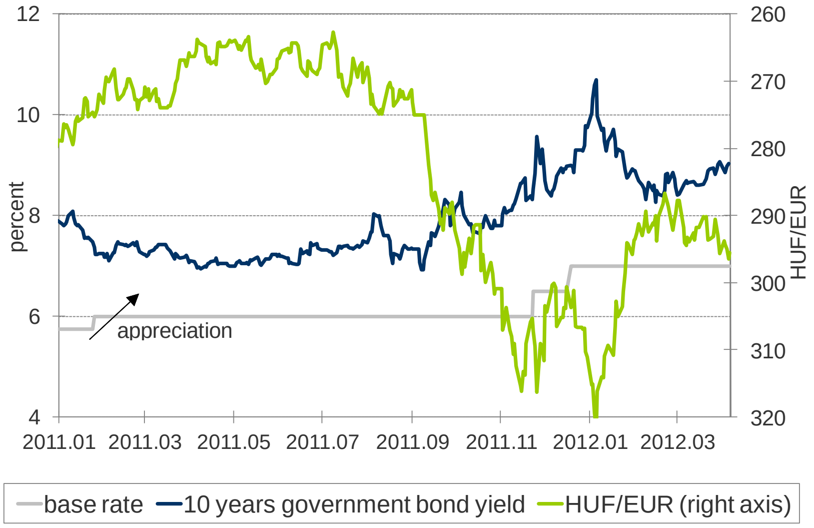
	Year						
	1	2	3	4	5	10	20
GDP	2.18	3.64	4.33	4.63	4.74	4.99	5.66
TFP	-0.23	-0.51	-0.73	-0.89	-1.00	-1.18	-1.02
Capital	0.05	0.17	0.31	0.46	0.62	1.29	2.13
Employment	0.36	2.50	3.72	4.26	4.47	4.58	4.71
-low-skilled	2.79	6.84	9.85	11.74	12.76	13.18	13.03
-semi-skilled	0.17	1.90	2.77	3.09	3.17	3.17	3.26
-highly-skilled	-2.96	0.01	1.38	1.60	1.49	1.24	0.48
Consumption	1.36	1.64	1.71	1.77	1.82	1.95	2.02
Exports	2.07	3.53	4.22	4.52	4.63	4.88	5.53
Imports	0.71	1.10	1.27	1.38	1.46	1.66	1.82

2.8. MONETARY AND EXCHANGE RATE POLICY

The new Act on the MNB (the central bank of Hungary), coming into effect on 1 January 2012 stipulates that the primary objective of the MNB remains to achieve and maintain price stability. Act CCVIII of 2011 on the MNB prescribes macroprudential supervision as a new responsibility of the Central Bank, and for this purpose, it will, in particular, reveal the business and economic risks to the financial intermediary system as a whole, promote the prevention of the development of systemic risks, and mitigate or eliminate systemic risks. Since 2001 the MNB has defined monetary policy within the regime of inflation targeting. Within its framework the Monetary Council sets a numerical inflation target in line with price stability, which is currently 3% as a continuous target.

The nominal exchange rate of the forint against the euro has shown a much wider fluctuation than in the previous period. In the period since the 2011 convergence programme, the strongest daily exchange rate was 262.7, the weakest 321.9 HUF/EUR. The yield of Hungarian government bonds varied significantly with the lowest daily yield being 6.9% and the highest 10.7% in the case of the 10-year government bonds. The expectations related to the euro area crisis, programmes of the government, and the interpretation and reception of measures contributed to the fluctuations of both the exchange rate and at the government bond market.

Figure 8: Government bond yields and exchange rate developments



Following the increase in the central bank base rate by 25 basis points in January 2011, the base rate of the MNB remained unchanged until November. However, at the end of the year the Monetary Council at two consecutive meetings raised the base rate by 50-50 basis points respectively to 7%.

Primary market issuances were low in connection with the modest increase in the forint-based mortgage lending, thus the mortgage bond purchase programme of the MNB was only partly successful. The MNB therefore decided not to continue this programme in 2011. At the end of 2010, the system of a flexible reserve ratio amendable every 6 months was introduced.

In February 2012 the MNB declared that it would stand ready to offset the recent weakening in the banks' lending capacity by introducing a long-term covered loan facility and a new mortgage bond purchase scheme. The MNB will stand ready to provide two-year variable-rate refinancing to credit institutions at its prevailing policy rate against securities delivered as collateral with conditions that have been designed to facilitate an expansion in bank lending to the corporate sector. The MNB seeks to promote lending to the household sector by re-introducing a mortgage bond purchase scheme in case the universal structure for mortgage bond issuance is introduced. The MNB expanded the range of eligible collateral in order to increase the banks' liquidity buffers. From April 2012 it accepts securities with identical or higher rating than the debt rating of the Hungarian state, as collateral. By accepting the bonds in foreign currency meeting the criteria adopted in the case of forint-denominated bonds issued by Hungarian companies and foreign currency-denominated securities issued by the Hungarian state as collateral, the MNB can alleviate liquidity constraints potentially impeding lending to the corporate and household sectors through an increase in banks' liquidity buffers.

Hungary has not yet set the target date for the introduction of the euro.

3. General government balance and debt

3.1. Fiscal policy objectives

In line with the Fundamental Law and the Cardinal Act on the Stability of the Hungarian economy, the primary fiscal policy objective of the Government is to continuously reduce the inherited debt of the government sector.

In order to carry this out the Széll Kálmán Plan, published in March 2011 envisaged the introduction of structural measures that essentially affect the expenditure side of the budget, and will result in additional growth already noticeable in the mid-term. On the other hand, from 2012 these measures will meaningfully contribute to the sustainable decrease of the deficit and debt of the government sector.

In addition to the measures of the Széll Kálmán Plan announced in March 2011, aimed at the permanent improvement of the budget balance (as the result of less favourable macroeconomic processes than forecast in the previous convergence programme, evolving due to the deterioration of the global and particularly the European economic environment) the Government took several measures during the past year that guaranteed the achievement of set target deficits. These measures provide a basis for the accomplishment of the primary fiscal policy objective defined in the Széll Kálmán Plan, i.e. debt reduction under less favourable circumstances for growth too.

The governmental measures taken for the full implementation of the Széll Kálmán Plan (the 2011 convergence programme, the government decisions taken in September 2011 underpinning the 2012 budget proposal and the decisions made in December for the safe implementation of the 2012 budget, as well as the resolutions approved in February and April 2012) ensure that the deficit targets defined in the convergence programme last year are still achievable. The extent of savings determined in the Széll Kálmán Plan in March 2011 will be considerably exceeded, by three times in 2012 and over two times in 2013, as a result of the above measures. The expenditure side comprises over half of the savings in both years.

Figure 9: Measures in 2012

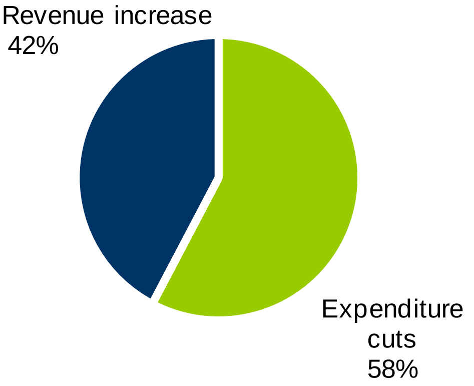
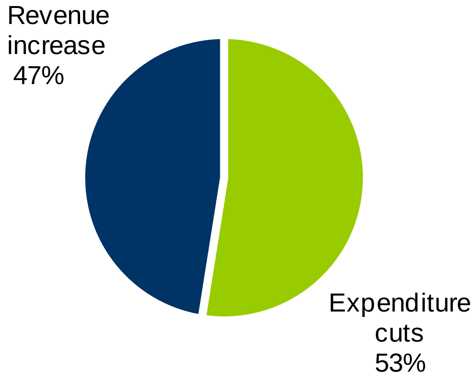


Figure 10: Measures in 2013



The sector-specific taxes introduced in 2010 specifically on a temporary basis and for a fixed period will be repealed in 2013, and in line with the agreement concluded with the Hungarian Banking Association, the special tax on financial institutions will be decreased by 50% and to a level in line with European practice by 2014. Consequently, the improvement in the budget balance will be guaranteed by durable measures, also serving growth-friendly fiscal consolidation.

Based on the deficit path confirmed in the current convergence programme and the assumptions related to the cyclical position of the economy, the structural budgetary deficit is close to the Medium Term Objective (MTO) defined in 1.5% structural deficit as a percentage of GDP in 2012, and easily accomplishes the same in 2013. In line with the Stability Act, the improvement of the structural balance would continue after the accomplishment of the MTO for the successful implementation of debt reduction plans.

Table 8 summarises the measures adopted in order to attain the 2012 and 2013 deficit targets. The detailed measures are presented in Chapter 6.

Table 8: Measures affecting the budgetary position **HUF billion**

	2012	2013
Reduction of expenditures of budgetary institutions, chapter-and other centrally administered appropriations	44.7	44.7
Reduction of pharmaceutical subsidies	10.0	40.0
Balance improvement of local governments	60.0	90.0
Introduction of a telecommunication services tax	30.0	52.0
Introduction of reverse charge VAT in agriculture	10.0	15.0
Launching the electronic road toll at an increased level	0.0	75.0
Reduction of central subsidies to metropolitan public transportation	0.0	10.0
Elimination of central subsidies to the Research and Technological Innovation Fund	0.0	25.2
Amendment of public tasks performed by state-owned companies	0.0	20.0
Introduction of a financial transaction levy	0.0	130.0-228.0
Maintaining and extending the income tax levied on energy providers	0.0	55.0
Merging and transforming current taxes levied on insurance companies	0.0	15.0
Reduction of the number of minor taxes	0.0	-5.0
Total:	**154.7**	**567-665**

3.2. BUDGETARY DEVELOPMENTS IN 2011

According to the 2012 spring data provided by the Hungarian Central Statistical Office (HCSO) for Eurostat, compared to the 2% expected in the 2011 April Convergence Programme and the 3.9% estimated in the 2011 autumn data provision, the EDP balance of the government sector showed a surplus of 4.3% of GDP in 2011.

There are several reasons for this better-than-expected balance. Firstly, local governments, even excluding the assumption of county governments' debts, closed the year with a much better balance than expected. Secondly, the Government adopted within the year several measures offsetting the effect of the more adverse macroeconomic environment, thus the underlying budgetary processes were kept under strict control. Thirdly, the transformation of the PIT system resulted in higher tax and contribution revenues than previously foreseen. Furthermore, the balance-improving effect of one-off items not planned in the original budget appropriations, and only emerging during the implementation of the budget, was more powerful than estimated in the previous convergence programme.

Table 9: Balances in 2011 **% of GDP**

	April 2011 convergence programme	Spring 2012 notification	
			(without takeover of local government debts)
Central government balance (EDP)	2.5	3.5	(4.2)
Local governments balance (EDP)	-0.5	0.8	(0.1)
General government balance (EDP)	**2.0**	**4.3**	**4.3**

One-off items of considerable size and emerging during the implementation of the budget influenced the budget balance of 2011. The deficit target of 2.9% of GDP defined in the budget was based on the assumption that within the framework of pension reform, the transfer of the property portfolio of private pension fund members opting for the pay-as-you-go system only constituted a revenue of approximately 2% of GDP in 2011. The amount, however, was much higher than expected in the budget; the assets transferred to the Pension Reform and Debt Reduction Fund exceeded 9.5% of GDP. Besides the income surplus resulting from the pension reform, unforeseen one-off items also emerged on the expenditure side (VAT reimbursements due to the financially unsettled procurements, based on the decision of the European Court of Justice, debt assumption from MÁV, part of the capital increase of the Hungarian Development Bank accounted for as loss compensation, and the assumption by the state the banks' loss in 2011 resulting from the one-off repayment of loans denominated in foreign currency).

In order to achieve the deficit target of 2.9% net of one-off items as originally defined in the budget, the Government took several measures (the creation of the HUF 250 billion stability reserve and later its cancellation, blocking an additional HUF 37 billion of expenditure appropriation, the requirement to maintain unused appropriations and stop purchases of goods and services, increasing the gambling tax and excise duty, the introduction of public health product tax, increasing the efficiency of tax collection). Thanks to the above measures the deficit calculated net of one-off items occurring within the year was lower than originally planned and amounted to 2.4% of GDP.

Table 10: Achievement of the 2011 deficit target **% of GDP**

	Preliminary data
General government (EDP)	**4.3**
One-off items within the year* affecting the balance	6.7
of which: Higher receipts from the pension system reform and Public Debt Reduction Fund	7.9
One-off expenditures	1.2
General government balance (EDP) not including one-off items within the year	**-2.4**

* One-off items taken in to account in the calculation of the structural balance are described in Chapter 3.6

3.3. BUDGETARY DEVELOPMENTS IN 2012

Under the Budget Act, in 2012 the ESA95 deficit may not exceed 2.5% of GDP. Based on the appropriations in the adopted budget, primary expenditures net of EU transfers (which show-up in both revenues and expenditures and are increasing more than one and a half times in 2012) will decrease by over 1 percentage point compared to 2011 as a share of GDP, due to the balance improving measures underpinning the 2012 budget. Moreover, within the framework of the structural reform programme published in the spring of 2011 (Széll Kálmán Plan) and the stabilisation measures planned in the previous convergence programme as well as reflecting the additional corrective measures, expenditures on the purchase of goods and services, social transfers in-kind provided via market producers, subsidies to companies, and compensation of employees (excluding the impact of the extended public work programmes) will be decreased both as a share of GDP and nominally. The planned decrease of social transfers other than in-kind is equivalent to 0.8 percentage points as a share of GDP.

The budget expects an almost 7 percentage point (nearly 8 percentage points calculated without the EU supports) decrease in the revenue as a share of GDP, reflecting the wearing-off of the one-off effect of the transfer of public pension fund assets in 2011. However, this means that the measures aimed at increasing revenue (expanding the tax revenue base, raising VAT, excise duty, and contributions, etc.) would result in an increase of tax and contribution revenues.

The adopted budget was based on a macroeconomic path assuming a 1.5% GDP increase; but for the purpose of neutralizing the risks arising from the macro-economic and financial market environments, so-called “extra” reserves have been included in the budget (interest risk reserve, Country Protection Fund). Last December the Government revised the macroeconomic forecast to a GDP growth of 0.5%, taking into account the deterioration of the global economic environment, and at the same time introduced an additional measure equivalent to 0.4% of GDP to improve the budget balance. As a part of this, an amount of 0.2% of GDP was allocated as a reserve from the expenditure appropriations of the budgetary chapters, which, similarly to the already existing “extra” reserves, may only be used if the deficit forecast for 2012, in the 2012 autumn report to be compiled on the deficit and debt of the government sector does not exceed 2.5% of GDP. An additional 0.2% improvement in the balance has been guaranteed by an increase in the excise duty of tobacco products and the redirection of private pension fund members’ payments into the pay-as-you-go system. These measures and the “extra” reserves provided sufficient cover to offset the loss of revenues related to the less favourable macroeconomic scenario and the costs resulting from the agreement concluded with the Hungarian Banking Association in order to provide assistance for households FX loans.

The 2012 March Council recommendation to bring an end to the excessive deficit situation expected Hungary to take measures to improve the balance by 0.5% of GDP. The forecast of the European Commission preparing the recommendation did not yet consider those

additional measures the Government approved in February for the safe achievement of the deficit target (Government Decree No. 1036/2012 (21 February) on additional measures required to guarantee the target deficits for 2012 and 2013). Regarding 2012, this Government Decree orders the decrease of pharmaceutical subsidies and chapter expenditures, and prohibits the purchase of certain goods and services by budgetary institutions. The budgetary effect of these measures, taken into account already in the February decree, is HUF 30 billion in the 2012 budget (0.1% of GDP).

Taking into consideration the Council recommendation, the Government approved additional measures in April which, together with the measures taken in February and the forecast of a better-than-calculated balance for the 2012 budget at the local government subsystem, will jointly guarantee the expected improvement of the balance:

REDUCING EXPENDITURES

- Saving HUF 10 billion on pharmaceutical subsidies in line with the implementation of Government Decree No. 1036/2012 (21 February).
- Approximately HUF 45 billion (about half of which based on Government Decree No. 1036/2012 (21 February) is saved by the blocking of an additional HUF 37.4 billion of appropriations of central budgetary institutions and chapter-administered appropriations, ordering the saving of HUF 3 billion in the budgetary chapter of state-owned assets, HUF 4 billion in terms of local government support, and HUF 0.3 billion from the budgetary organs of the Social Security Funds

INCREASING REVENUE

- Introduction of telecommunication services tax (budgetary impact: HUF 30 billion)
- Introduction of reverse charge VAT in agriculture (budgetary impact: HUF 10 billion due to improved tax collection).

IMPROVING BALANCE OF LOCAL GOVERNMENTS

The combined budgetary impact of the base effect of the more favourable balance of 2011, the implemented structural reforms (institutions placed under central control) and the constraints in the legal framework limiting borrowing can be estimated at HUF 60 billion.

The total improvement in the balance of HUF 155 billion makes it possible to re-establish the “extra” reserves of the budget. Therefore, even if the originally planned risk reserves serve, to a large extent, as an offset to the lost revenue from taxes and contributions and the expected additional expenditure, thanks to the additional measures the “extra” reserve of close to 0.4% of GDP remains available in the budget to cover macroeconomic and financial risks.

Table 11: Achievement of the deficit target **% of GDP**

	2012
Budget balance in the 2012 Budget	**-2.5**
Lower tax and contribution revenues (reflecting partly the impact of the agreement with the Banking Association) without the new measures	-0.65
Increase of other revenues (sale of broadcasting frequencies, interest incomes, mining fees, etc.)	0.29
Partial assumption of bank losses for 2012 resulting from the one-off repayment of FX loans, National Asset Management Agency	-0.32
Higher interest expenditures	-0.29
Interest risk reserve	0.33
Public transport companies	-0.10
Pension-related expenditure	-0.17
Wage settlements in the health sector	-0.10
Funding wage settlements in the health sector partly from available appropriations, partly from increased efficiency	0.10
Extra reserves (Country Protection Fund, additional reserves in budgetary chapters)	0.74
Better than expected balance of local governments	0.20
Measures in February and April	0.32
Increasing reserves	-0.37
Expected balance in 2012*	**-2.50**

* The projection does not include revenues related to additional private pension fund members opting for the pay-as-you-go system in 2012, i.e. the deficit target is attained without them.

3.4. Budgetary developments in 2013

In accordance with the fiscal path based on the Széll Kálmán Plan and defined in the previous convergence programme and in Act CXCIV of 2011 on Hungarian Economic Stability, the budget deficit will be reduced to 2.2% of GDP in 2013. The attainment of the deficit target is ensured, firstly, by enforcing fiscal discipline in the operating expenditure of the public sector, secondly, by savings implemented in areas determined in the Széll Kálmán Plan, and thirdly, by the additional measures for augmenting the Széll Kálmán Plan.

In the case of savings in the Széll Kálmán Plan, major delays identified until the end of 2011 are related to the following: the reform of wage replacement allowances (employment and labour market), the reform of benefits related to disability and impairment to health (pension system), the organisational reform affecting public transport, and the introduction of an electronic toll payment system next year.

Without taking additional measures, a more adverse macroeconomic environment than expected in the previous convergence programme, the above-mentioned delays and the repeal of temporary sector-specific special taxes and the decrease in the special tax on financial institutions would result in a budget deficit reaching 3.6% of GDP in 2013. Consequently, in order to keep the deficit target, the Government has adopted new measures which together with the previous ones would contribute to achieving savings 2.5 times higher than the extent determined in the Széll Kálmán Plan in March 2011 for 2013. This enables the deficit to fall to 2.2% of GDP; moreover, in 2013 also to incorporate an

"extra" reserve in the budget in order to tackle macroeconomic risks. Besides the decrease in expenditures, the new measures include actions aimed at increasing revenues.

REDUCING EXPENDITURES

- The additional review of the pharmaceutical subsidy scheme would represent HUF 40 billion savings.
- The almost HUF 45 billion savings defined in the appropriations for 2012 would be incorporated in the basis of the 2013 plan.
- In the expenditures of the budgetary chapter of state-owned assets, HUF 20 billion savings is produced by rationalising the activity and organisational framework of majority state-owned economic organisations and the amendment of their obligations to fulfil public duties.
- Replacing subsidies provided for the Research and Technological Innovation Fund with EU funds, thus generating savings of HUF 25 billion.
- Decreasing the support provided for metropolitan public transport from the central budget by HUF 10 billion as currently the users of individual means of transport do not contribute to the operation of the system to a proper extent, though they benefit from it. This will be revised.

INCREASING REVENUE

- From the beginning of 2013 the introduction of a financial transaction levy with a high revenue effect even at a low tax rate, as its tax base is broad. It is difficult to project the tax revenue to be collected from this new type of tax in the first period, particularly with regard to the fact that in the case of certain high-value transactions the tax will be maximised. In order to attain the 2013 deficit target, tax revenue of HUF 130 billion would be sufficient from this type of tax, which is achievable with a tax rate of 0.1% and a cap of HUF 30 000 per transaction. Revenues exceeding this amount can be used for increasing the budgetary reserves.
- The mid-year introduction of the telecommunication services tax in 2012 will improve the fiscal balance by HUF 52 billion in 2013.
- Maintaining the income tax levied on energy providers and broadening its base represent HUF 55 billion revenue.
- A new, uniform insurance tax will be introduced generating HUF 15 billion surplus on the revenue side including the replacement of three types of tax currently imposed on insurance companies (a special tax on financial organisations, accident tax, and fire protection contribution).
- In 2013 already HUF 15 billion additional revenue can be expected as a result of the introduction of reverse charge VAT in agriculture.
- Budgetary expenditure is indirectly affected by the launch of the electronic road toll from mid-2013 at a higher level (expected budgetary effect: HUF 75 billion).

In addition to the above, the balance of local governments may be more favourable than expected in the previous convergence programme by HUF 90 billion as a consequence of the lower than expected base effect of non-wage and capital expenditure in 2011, structural reforms and constraints in the legal framework limiting borrowing.

3.5. BUDGETARY DEVELOPMENTS IN 2014-15

The planned improvement in the balance will be guaranteed by the improving macroeconomic environment and the maintenance of fiscal discipline based on the results of the fiscal consolidation to be realised by 2013. Aside from the assumed decrease in the rate of special tax on financial organisations in 2014, in the last two years, the convergence programme does not expect any significant changes in the tax system. Tax revenues, and the total budget revenue calculated without EU support, will expand slightly behind GDP. Thus the balance may only be improved with a more pronounced decrease in expenditure.

According to the assumptions in the programme

- Salaries in the public sector meet legal requirements. The changes in the expenditure on wages and contributions also reflect the increasing number of participants in public work programmes.
- Thanks to efficient budget management non-wage expenditures will expand over the time horizon of the programme less than GDP.
- As a result of the pension system and social spending reforms, the GDP-ratio of social benefits will be narrowed to the greatest extent from among the major items of expenditure even in the last two years of the programme.
- The local government subsystem will achieve a balanced position, as the local government system becomes more proportionate to its size, its specific duties are revised and its borrowing is limited.
- Capital expenditure will stabilise over 4% of GDP over the whole time horizon.

3.6. STRUCTURAL BALANCE, MEDIUM TERM BUDGETARY OBJECTIVE, EXPENDITURE AGGREGATE

The calculations of the convergence programme apply a sensitivity coefficient of 0.46, i.e. the budget balance will change by a 0.46 percentage point as a result of a 1% change of GDP (in unchanged composition). Since this value has been applied by the European Commission, the use of a new coefficient would facilitate the comparison of the calculations on the cyclical component of the budget balance.

The convergence programme also expects that the closure of the highly negative output gap created during the economic crisis starting in 2011 will temporarily halt in 2012 and continue from 2013 until the end of the programme, but the actual output will be well below the

potential level even in 2015. As a consequence of the negative output gap characterising the whole time horizon of the programme, the cyclically-adjusted balance is always more favourable than the actual ESA-balance.

One-off items were significant both on the expenditure and revenue sides in 2011, and relatively substantial in 2012.

In 2011 the most significant one-off item increasing the revenue was the transfer of public pension fund assets as a consequence of the pension reform and the interest and dividend income generated on the transferred assets and realized by the Pension Reform and Debt Reduction Fund (a total of 9.7% of GDP). The temporary sector-specific tax introduced in 2011 meant an additional one-off item increasing revenue (0.6%), and a part of the special tax imposed on the financial sector (0.3%), which was lowered by the tax deduction related to the early repayment of FX loans[3]. Among the one-off deficit increasing items, the decision of the European Court of Justice referring to the negative VATHad the largest impact on the balance (0.7%). The debt assumption of MÁV and the loss compensation of the Hungarian Development Bank appeared as one-off items increasing expenditure (total 0.3%).

In 2012 the calculations of the convergence programme the following one-off items are included: the sector-specific crisis taxes and the remaining part of special tax on the financial sector corrected with the tax deduction related to the early repayment FX loans, and the revenue from the sale of broadcasting frequencies (0.1%).

In 2013, in line with the plans in the 2011 programme and the agreement concluded with the Hungarian Banking Association, the special tax on financial organizations shall be reduced by 50%. Based on this agreement, in 2014 the special tax on financial institutions may only reach the rate of bank tax accepted in the legal system of the European Union or in line with the practice of Member States. The difference in the projections of the two 2013-2014 revenue streams form this is regarded as one-off item in 2013. The calculations of the 2011 convergence programme did not contain one-off items for 2013. This was because the 2011 convergence programme calculations assumed a higher amount becoming permanent from 2013 than what the program update assumes to become permanent from 2014 in line with the agreement with the Banking Association.

No one-off items are included in the budget for the last two years of the programme period.

The structural deficit, i.e. the cyclically adjusted balance net of one-off and temporary items, will decrease significantly in 2012 by international comparison. It is projected to come close to the medium term budgetary objective (MTO) defined as structural deficit of 1.5% of GDP, and following an additional marked drop, it will overachive the MTO in 2013. In the last two years of the programme period, the structural balance will continue to improve slightly.

[3] This latter item has been accounted for as capital transfer to households.

Table 12: Structural balance **% of GDP**

	2011	2012	2013	2014	2015
Output gap	-2.6	-3.2	-3.0	-2.1	-1.4
General government balance	4.3	-2.5	-2.2	-1.9	-1.5
Cyclically adjusted balance	5.5	-1.0	-0.9	-0.9	-0.8
One-off items*	9.4	0.8	0.2	0.0	0.0
Structural balance	**-3.9**	**-1.8**	**-1.0**	**-0.9**	**-0.8**

** A plus sign means deficit-improving one-off measures.*

The expenditure aggregate (primary expenditures excluding EU transfers) is projected to drop between 2012 and 2015 by two percentage point as a share of GDP. In 2012 – i.e. the year of over-achieving the MTO – the growth rate of the expenditure aggregate will be below the reference growth rate of potential GDP.

3.7. GENERAL GOVERNMENT DEBT

According to the convergence programme of April 2011 the government debt-to-GDP ratio would have dropped to 75.5% by the end of 2011, but it actually decreased only to 80.6% of GDP, primarily due to the temporary weakness of the currency.

The first half of 2011 saw an increase in risk appetite, but towards the end of the year government bond yields started to increase in the wake of the deepening euro area crisis. Nevertheless, apart from smaller market turbulences the government bond market was stable throughout the year. In 2011 the coverage of HUF government bond auctions was generally 260% in the case of Treasury Bonds and 250% in the case of Treasury Bills. This, however, cooled down by the second half of the year, and coverage remained low in the first three months of 2012 as well. Following a moderate decrease in the beginning and then a peak point at the end of the year, in March 2012 mid- and long-term yields increased by 60-70 basis points, and short-term yields increased by 120-130 basis points compared to the beginning of 2011. The favourable conditions in 2011 and the highly beneficial impact of the Széll Kálmán Plan announced in March 2011 are demonstrated by the fact that the Hungarian State issued FX-denominated bonds amounting to nearly USD 4.25 billion in March and April and EUR 1 billion in May.

In December 2011 Hungary repaid the first part of the loan granted by the European Commission (amounting to EUR 2 bn), and then in February 2012 it started to reimburse the IMF loan (SDR 527 million) in accordance with the repayment schedule stated in the contract. Within the framework of the agreement Hungary will repay a further SDR 2.4 bn in 2012.

In November 2011 Hungary requested the European Union and the International Monetary Fund to help restore market confidence through providing a precautionary credit line. In the

case of realization of the agreement the interest expenditures and the trajectory of the public debt may be more favourable than projected in the current programme. The Government considers the future agreement as a standby credit line, since Hungary is currently capable of financing itself from the markets.

Public debt was markedly influenced by the receipt of private pension fund assets as well.

- In May-June 2011 private pension fund assets accumulated by people opting for the state-run system (nearly 97% of the private pension fund members) were shifted to the Pension Reform and Debt Reduction Fund (hereinafter: Fund), specifically created for this purpose. The initial capital of the Fund was 10.5% of GDP which was later extended by a smaller portion of assets (transferred by the Guarantee Fund of Pension Funds on 30 June).
- During the year Hungarian government securities (as a part of the private pension fund assets) were neutralized in several phases to the amount of 5% of GDP, which reduced debt ratio by the same rate.
- The Fund paid out the accumulated real earnings and supplementary contributions to the amount of 0.8% of GDP.
- The Fund completed a 1.6% GDP-proportionate payment to the budget.
- The Fund's assets as of the end of December 2011 accounted for 2.4% of GDP, which will be used for further debt reduction in the future.

According to the Government's decision in 2011 a HUF 50 bn debt of the Hungarian State Railways (MÁV) and a HUF 196 bn debt of county governments were assumed by the state. As local government debt was already part of the Maastricht debt, it did not add to that but only to the central government debt.

In addition, the Government considers it as important to broaden the investor base which could increase the security of state debt financing. In this respect the Government drafted an action plan to encourage the households' purchase of government bonds [Government Resolution 1101/2012 (5 April) on Measures to Increase Public Purchase of Government Bonds].

In the external environment the escalation of the euro area debt crisis was a dominant factor, in the second half of 2011 major disturbances manifested in the government bond market of certain euro area member states.

Partly as a result of the tender implemented in December 2011 and February 2012 in the framework of the European Central Bank's Long-Term Refinancing Operation (LTRO), and partly due to Greece's successful bond swap deal government bond market conditions have significantly improved in recent months in the European Union, and the risk appetite has also strengthened. Furthermore the fiscal compact that was signed by 25 member states of

the EU (including Hungary) contributed to global stability as member states demonstrated a strong commitment to fiscal adjustments and structural reforms.

The Government's key priorities included from the beginning the reduction of the excessive accumulated debt, to which end it has taken several measures. Public debt was lowered by 5 percentage points in 2011 through withdrawing the government bond assets of the transferred private pension fund assets. The determined fiscal path will continue to reduce the debt rate significantly in the coming years.

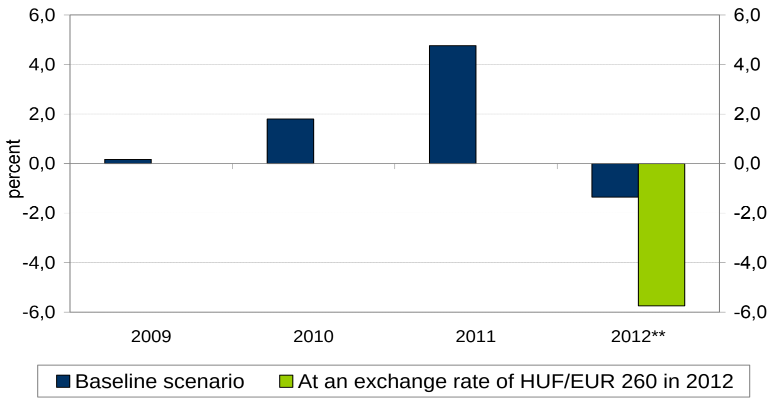
Based on the events of the past period and on recent prognoses the debt trajectory is expected to vary, compared to the previous year. Certain factors in the change of the debt trajectory:

- According to the convergence programme of April 2011, in 2012-2013 the Pension Reform and Debt Reduction Fund would sell its remaining assets (amounting to 2.4% of GDP) for debt reduction purposes subject to market conditions. By contrast, the current convergence programme conservatively presumes the Fund will not sell any of its remaining assets between 2012 and 2015. The value of the Fund's assets accounted for HUF 684 bn at the end of 2011, which is equivalent to 2.4% of GDP.
- The 2011 April Convergence Programme calculated that the Government would assume part of the debt accumulated by MÁV and BKV in recent years (up to HUF 378 bn), and would replace part of the PPP contracts (up to HUF 200 bn). These one-off items would account for 2% of GDP. Contrary to this, only the Hungarian Railways' debt was partly assumed by the state, amounting to HUF 50 bn. In addition, the state also assumed the debt of county governments, which however had already been part of the Maastricht debt.
- The prognosis of GDP-proportionate interest expenditures is currently higher than in the previous Programme: this is generated by the sum of higher debt stock and presumed yield level.
- In respect of nominal GDP the current convergence programme presumes lower growth rates both for 2012 and 2013. This is a result of the slowing down of real growth, as inflation expectations rose by 2012 compared to the previous year. Consequently, the changed nominal GDP path will result in a higher debt rate in 2012 and 2013 compared to the rate forecasted in 2011.
- Similarly to the 2011 convergence programme, no substantial revenue is expected from privatisation in the examined time horizon. The technical exchange rate assumption in the prognosis uses a HUF exchange rate (HUF/EUR 299.4) which is 9% weaker than the rate indicated in the 2011 convergence programme (HUF/EUR 274.8). This will again result in a higher debt trajectory than the one forecasted in the 2011 convergence programme. Another changing factor is that FX-deposits generated from the IMF-EU loans are expected to be deducted in another path. A key issue in this field is that the

state used the foreign exchange deposit to cover the reacquisition of the MOL shares (to an amount of nearly HUF 500 bn) in 2011.

- The constantly rising amount of state-financed student loans introduced by the state from 2012 to cover training costs will increase public debt by 0.7% of GDP by 2015.

Figure 11: The effect of the revaluation of the FX-denominated debt on the debt ratio



** The effect of revaluation is compared to the exchange rate at the end of the previous year*

*** Estimated rate*

The future debt ratio is sensitive to the following major factors (ceteris paribus):

- Primary balance: permanent 1 percentage point annual change in the primary balance effective until the end of the trajectory will induce a change in the portfolio amounting to around 1 percentage point in the first year, and 5 percentage points by 2015.

- Exchange rate: the foreign currency denominated portion of the total gross debt rose to 50% by the end of 2011, which will be reduced below 45% by 2015, due to the increased weight of HUF in debt financing. Accordingly, a 10% change in the real exchange rate will always modify the gross debt rate by 3.7-3.3 percentage points between 2012 and 2015.

- Yield curve: yield change is gradually reflected in interest rate expenditure through the renewed instruments. The cumulative effect of the changed interest rate expenditure on the debt ratio each year between 2011 and 2015, and calculated with a yield change of 100 base points, is 0.1, 0.3, 0.7, 1.1 percentage point (change in interest rate expenditure in GDP %: 0.1, 0.2, 0.3, 0.4 percentage point).

- Economic growth: a permanent change in the nominal GDP growth rate, starting at 1 percentage point in 2012 and having an effect throughout the curve, would change the

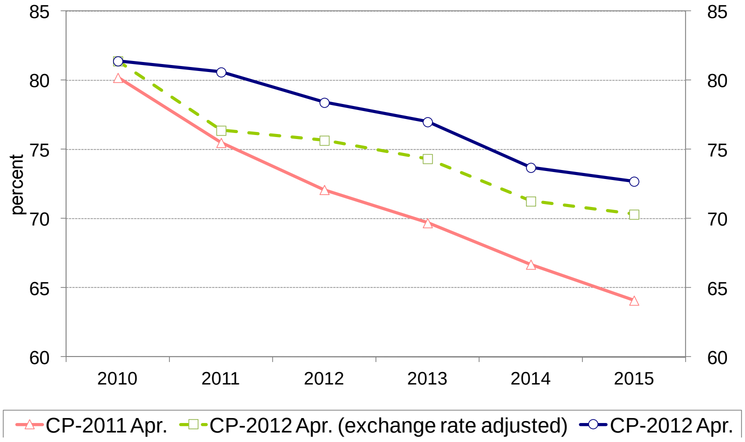
gross debt ratio by 0.7 percentage point in 2012, and the discrepancy would gradually go up to 2.8 percentage points by 2015.

- Guarantees provided by the state accounted for approx. 8.5% of GDP at the end of 2011, and the rate was rather stable in the past years. The Government's intention is to stimulate bank lending through further guarantees. This is not expected to have any particular risk on public debt, since experience shows that, apart from a few irregular years, only around 1-1.5% of the guarantees were called annually.

Table 13: Major presumptions in the convergence programmes **GDP %**

		2011	2012	2013	2014	2015
Nominal GDP growth (%)	CP-2011 Apr.	6.1	5.8	5.4	5.6	5.8
	CP-2012 Apr.	5.3	4.3	4.5	5.5	5.3
Government balance	CP-2011 Apr.	2.0	-2.5	-2.2	-1.9	-1.5
	CP-2012 Apr.	4.3	-2.5	-2.2	-1.9	-1.5
Government debt ratio	CP-2011 Apr.	75.5	72.1	69.7	66.7	64.1
	CP-2012 Apr.	80.6	78.4	77.0	73.7	72.7
	Revaluation included	4.2	2.7	2.6	2.5	2.4
	CP-2012 Apr. (exchange rate filtered)	76.4	75.7	74.3	71.3	70.3

Figure 12: Debt ratio in the Convergence Programme in April 2011 and currently



4. Sensitivity analyses

Risk factors suggest three possible alternative scenarios, which provided the basis for the sensitivity analyses. Table 14 presents the effects of i) external demand shock, ii) global risk appetite shock, and iii) the scenario that would unfold if positive risks around the baseline forecast manifested.

1. **Less favourable external demand:** the scenario presents the situation if Germany, Hungary's most significant foreign trade partner, grew 1 percentage point slower throughout a whole year. In the present uncertain economic environment such an event would have a significant and immediate negative impact on export production, employment and incomes. Deteriorating company profits and less favourable credit conditions would draw back investments and consumption even further in the following year. International uncertainty and rising risk premium would weaken the currency and thus increase inflation in the second year.

2. In the construction of the baseline forecast an internationally accepted assumption was taken that the European sovereign-debt crisis is going to settle in a satisfying manner during the course of 2012, and starting from the end of the year a gradual pick-up is going to take place. The further escalation of the debt crisis resulting in a **further deterioration of global risk appetite** is considered as an alternative scenario. If the VIX index, the indicator of global risk aversion is increasing by 5 percentage points for a year, GDP might decrease significantly in the first and even more the second year following the shock. The drop back of investments and foreign trade is the most pronounced effect of declining risk appetite, narrowing real income, due to more unfavourable company profits and increasing unemployment, constrains consumption significantly in the second year. The depreciating forint overshoots its

equilibrium level in the first year and corrects with an appreciation in the second year, which enhances the anti-inflationary effect of the reduced demand.

3. The conservative baseline scenario is affected both by **positive external and internal risks.** The renewed debt crisis' negative impact on the international real economy is still uncertain. Compared to the interim forecasts issued in January-February, however, the spring figures seem to paint a slightly more favourable picture for the global economy. If positive risks manifest, there may be a faster upswing in production with the established new production capacities in a better business environment. With uncertainty reduced, revived lending would boost production in the construction sector and stimulate investments. If domestic consumer confidence improves, households may consume a much larger proportion of their income than the high savings rate which was calculated in the baseline scenario. This trend would be reinforced by the fact that households have large amounts of delayed consumptions, and that their net wealth substantially improved due to the early repayment scheme and the introduction of the fixed exchange rate program. The strengthening of the Hungarian currency will have a more significant influence on inflation in a 2-year period than the growth of demand.

Table 14: Compared to the baseline scenario* percentage point

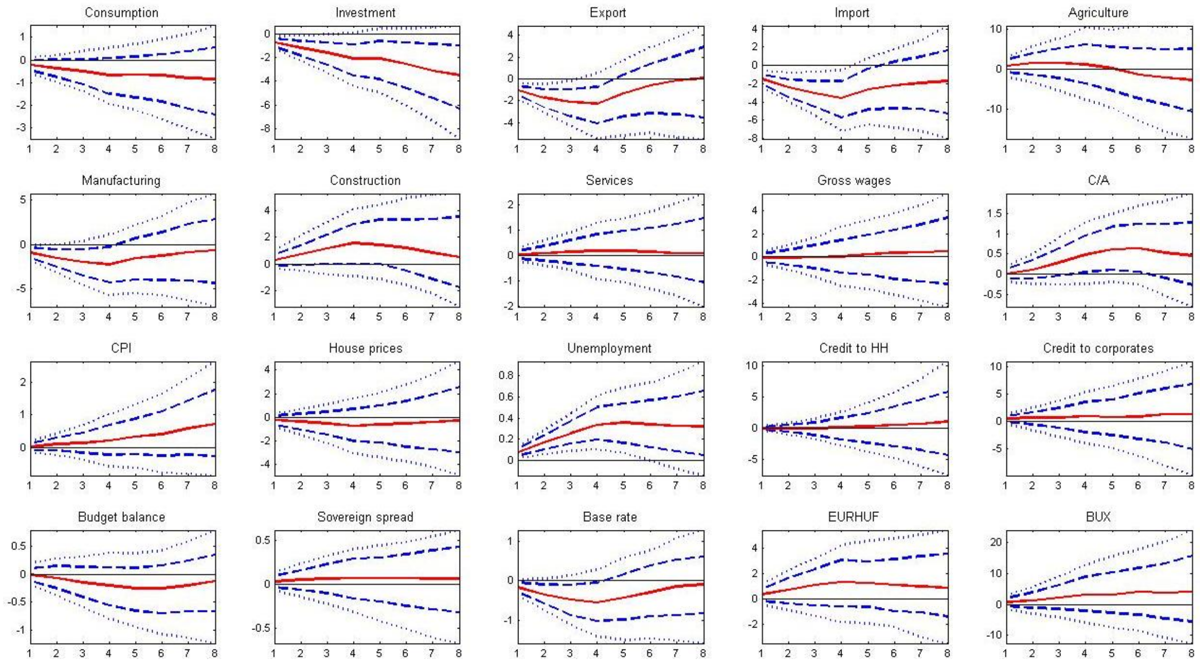
External demand shock	2012	2013	2014	2015
GDP	-0.3	-0.3	-0.1	0.0
Private consumption expenditure	-0.3	-0.6	0.0	0.0
Gross fixed capital formation	-2.0	-3.3	-0.5	-0.1
Export	-1.5	0.0	0.0	0.0
Import	-1.9	-0.6	0.0	0.0
Inflation	0.2	0.5	0.0	0.0
Private sector employment	-3.6	0.0	0.0	0.0
Government balance (GDP %)	-0.1	-0.2	0.0	0.0
Risk appetite shock				
GDP	-1.0	-1.3	-0.3	0.0
Private consumption expenditure	-0.6	-1.5	-0.2	0.0
Gross fixed capital formation	-2.0	-3.0	-1.3	0.0
Export	-2.5	-1.0	-0.2	0.0
Import	-2.2	-1.1	-0.2	0.0
Inflation	-0.2	-1.0	-0.3	0.0
Private sector employment	-0.5	-0.1	0.0	0.1
Government balance (GDP %)	-0.1	-0.4	-0.2	0.0
Positive risks				
GDP	0.6	0.5	-0.1	-0.1
Private consumption expenditure	0.6	0.9	0.1	-0.1
Gross fixed capital formation	1.8	1.0	0.0	-0.1
Export	1.5	0.7	0.0	0.0
Import	1.7	0.9	0.1	0.0
Inflation	-0.3	-0.8	0.1	0.0
Private sector employment	0.0	0.2	0.2	0.0
Government balance (GDP %)	0.3	0.2	0.0	0.0

** Difference between macroeconomic indicator growth rates and the baseline scenario in percentage point*

Simulations with MNE's BVAR model

Alternative scenarios were based on BVAR simulations. The model is a modified Litterman prior BVAR containing 20 endogenous and 5 exogenous variables developed within MNE. It must be emphasized first that however budget deficit explicitly included as an endogenous variable in the model, its path cannot be used for the sensitivity analysis, since in the model the endogenous reaction of fiscal policy is also taken into account. If an unfavorable shock hits the economy the government takes the necessary steps to avoid the deterioration in fiscal balance. In chart 13 the effect of a weaker German growth (1% level shift in German GDP for a year) is plotted. It is clear that external trade shrinks dramatically as a result of the shock, however secondary effects to domestic sectors are significant too. Only construction benefits from the lower interest rate.

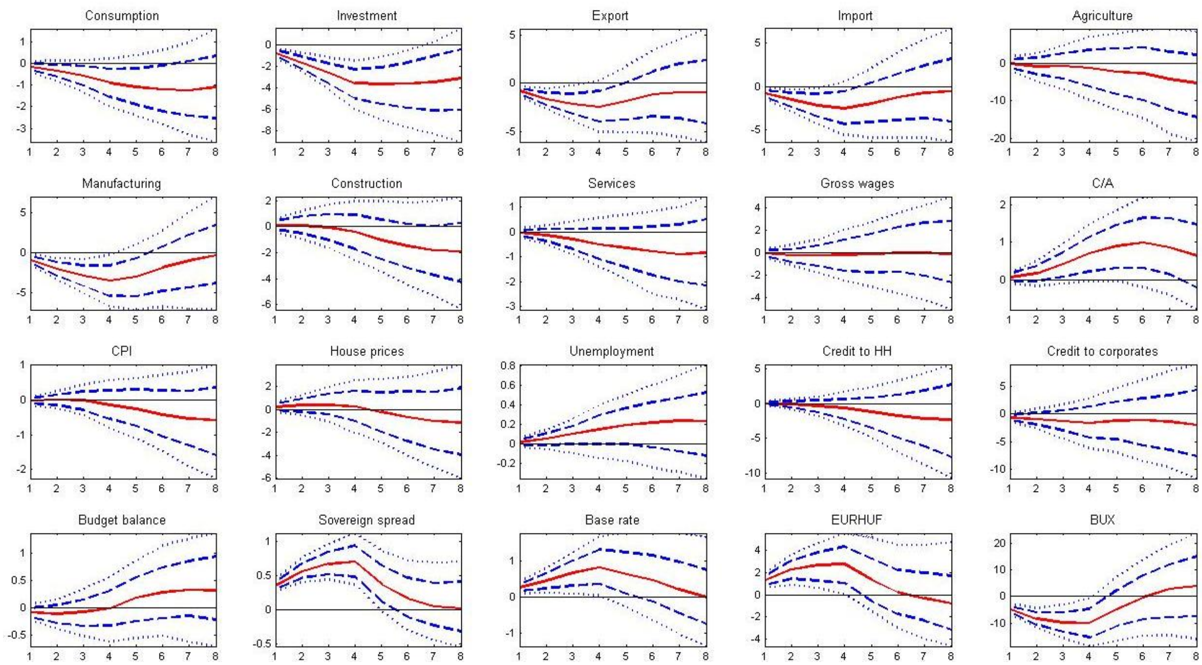
11. Chart: 1 percentage lower German GDP for a year*



***Percentage point deviations in levels from the baseline. The frequency is quarterly. The red line is the mean impulse response. Dotted lines show the 5-95, dashed lines show the 16-84 percentile probability intervals.**

In chart 14 domestic effects of a global financial shock are shown. It is modeled as a 5 points increase in the VIX that lasts for a year. The VIX-index is considered as a good proxy for global risk aversion. This shock has negative, sometimes very significant effect on all sectors of the economy. Manufacturing and investment are hit hardest, but consumption, services and construction are affected too.

12. Chart: 5 points temporary increase in VIX*



*** Percentage point deviations in levels from the baseline. The frequency is quarterly. The red line is the mean impulse response. Dotted lines show the 5-95, dashed lines show the 16-84 percentile probability intervals.**

5. Sustainability of Public Finances

The sustainability of public finances is primarily determined by the current fiscal stance (budgetary position, public debt, also as a percentage of GDP), future age related expenditures and demographic trends.

The Government fosters the improvement of long-term sustainability of public finances through several channels with complex and targeted measures. The Government's priority is to significantly reduce the debt-to-GDP ratio. Low level of public debt creates favourable conditions to tackle the challenges of an ageing population in the long run. In this context, the Government has implemented numerous parametric changes to the pension system which have considerably reduced long-term pension expenditures and the cost of other age related spending. The Government has introduced family-friendly incentives which could mitigate budgetary consequences of the projected ageing of Hungarian society.

The Fundamental Law, effective as of 1 January 2012, stipulates that the public debt-to-GDP ratio shall be constantly reduced until it reaches 50%. The achievement of this target was significantly facilitated by the termination of the mixed system, composed of a compulsory, fully funded private pension pillar and a state-run, social security based, pay-as-you-go pillar, introduced in 1998. This affects the sustainability of public finances in several ways. On the one hand, public debt was immediately and significantly cut due to the assets transferred from the private pension funds, on the other hand the contributions paid by members stepping back into the public pillar are now paid to the budget, thereby permanently improving the fiscal position.[4] In addition to the need for reducing public debt, further factors suggested to terminate the mixed system. With high costs and low yields the second pension pillar introduced in 1998 would have been unable to compensate for the lost social security based pensions.

Owing to the parametric changes, which were implemented in several phases in 2006-2007, 2009 and 2011, future public pension expenditures were significantly reduced. In conformity with best international practices, the main direction of the measures is to raise retirement age in line with rising life expectancy, a significant increase in effective retirement age and change of indexation. The retirement age increases gradually to 65 by 2021, while pursuant to new regulation adopted in 2011 reforming provisions for persons under the retirement age, the effective retirement age will adapt to the legal retirement age. All these measures have a beneficial effect not only on the pension system but also on employment. In addition to the parametric changes, further measures fostered transparency and ease of presentation in the budget of the pension system and other age related provisions.

Long-term demographic trends have a major impact on expenditures relating to long-term sustainability. Demographic trends forecast the ageing of the population which entails an

[4] The contributions paid to private pension funds generated an annual revenue loss of 1.5% of GDP in the general government balance.

increase in age-related expenditures and thus (if not prevented by appropriate measures) an increase in public debt in the long run. One of the key causes of adverse demographic trends is the low fertility rate. The fertility rate in Hungary is one of the lowest in Europe, accounting for only 1.3% compared to a 1.6% EU average. In order to increase the willingness to have children the Government reinforced the family-friendly incentive system and Parliament adopted the Act on Family Protection. Decisive elements of the measures included various forms of pecuniary support to families, such as family allowance, maternity support, cash supports for parenthood, life-starting support, child protection benefit, gas price subsidy for families with three or more children, or the family tax relief introduced in 2011. These measures are expected to mitigate the projected ageing of the Hungarian population.

Calculations of other age-related expenditures were based on the estimates for the Aging Report prepared by the Economic Policy Committee. Estimates by the Ministry for National Economy also include the most recent parametric measures, in particular the reform of early retirement schemes. These measures are expected to significantly slow down the rise of pension expenditures in the long run. Public expenditures on pensions are projected to increase from 11.9% to 12.6% of GDP between 2010 and 2060.

Further expenditure figures with relevance to long-term sustainability are taken from calculations prepared for the report to be issued by the EPC in 2012. According to these calculations, health care expenditures will increase from 4.9% to 6%, long term care expenditures will rise from 0.8% to 1.4% and expenditures on education will shrink from 4.3% to 3.9% of GDP between 2010 and 2060 in Hungary.

6. Structural measures

Expenditure side

6.1. Local governments

The Széll Kálmán Plan prescribes a total of HUF 100 billion in savings for the local government subsystem between 2011 and 2013. Part of these savings (HUF 15 billion) is already included in the 2012 Budget, and the remaining part is underpinned by the following measures:

- Under Act CLXXXIX of 2011 on Local Governments, as from 2013 localities with no more than two thousand residents and located within the same county district shall set up a joint local government office. The settlements affiliated to a joint local government office established in this way shall have at least two thousand residents in total or a joint local government office shall cover at least seven settlements, which may even include a settlement with more than two thousand residents. The budgetary effect of the measures accounts for around HUF 15 billion on wage and non-wage expenditures.

- As of 1 January 2012 institutions operated by counties and public health institutions operated by the Municipality of Budapest were transferred to state operation. Formerly, county local governments spent around HUF 120 billion for the functioning of their institutions. From 1 January 2012 the central budget has appropriated HUF 20 billion less for institution operation, which will be compensated for through increasing the efficiency of central task management and which will permanently improve the general government balance even in the years to follow. The decrease in expenditures entailed by the measure is approximately HUF 20 billion.

- Act CXCIV of 2011 on Economic Stability of Hungary subjected loan requests by local governments to the Government's approval, which is to mitigate the deficit of the local government subsystem. The budgetary impact of the measure accounts for around HUF 20-23 billion.

Thus, out of the 100 billion saving prescribed by the Széll Kálmán Plan a total of HUF 73 billion has been underpinned by measures. The remaining HUF 27 billion may be generated by the further revision of development subsidies, making social provisions more targeted, and in the case of certain services related to public education requiring greater burden taking by service users.

LOCAL GOVERNMENT BALANCE

The deficit planned for 2012 is HUF 90 billion which includes an expected balance improvement of HUF 60 billion compared to the original plan and the Commission's forecast in March. This improvement will be incorporated in the 2012 basis in the course of the 2013 planning.

All this is supported by the fact that, according to preliminary data for 2011 reported by local governments within the framework of the general government information system, the balance of the subsystem shows a surplus of around HUF 9 billion.[5] The balance improvement is attributed to the lower-than-expected figures on the expenditure side. More specifically, non-wage and investment expenditures were lower than the original estimates, while financing expenditures (debt servicing) grew significantly. The large-scale debt expansion of recent years was brought to a halt in 2011 (partly due to the consolidation of county governments); substantial debt increase was not experienced, and no extra money flowed into the system, thus debts could be serviced mainly through cutting expenditures.

Following the trend experienced in 2011, as a result of the considerable improvement in the structural balance compared to the originally planned deficit, a deficit of HUF 90 billion can be calculated in 2012.

[5] It should be stressed that this forecast is based on preliminary data. Final data will be available at end April, which may imply changes to the balance figure to either directions.

The above mentioned Stability Act, effective as of 1 January 2012, also supports this positive trend as it stipulates that local governments may only take loans with the Government's approval. This is also expected to mitigate the subsystem's deficit through containing newly generated debt. Further factors suggesting a shrinking deficit include the fact that by transferring institutions of local governments and public health institutions of the Municipality of Budapest to state operation at the end of the previous year, the deficit of these local governments no longer burdens the entire subsystem.

Consequently, no significant flow of money is expected to the local government subsystem that could be spent freely and would support the appearance of greater deficit. In this context, debt reduction is expected to be continued in 2013, partly owing to the effects of the measures introduced in the previous years. In addition, the new financing system, effective as from 2013, will provide resources for local governments in a much more targeted and task-bound manner, better ensuring resources required for obligatory responsibilities of local governments. The provision of the Act on Local Governments effective as of 1 January 2013 that stipulates that the decree on local government balance can no longer contain a deficit suggest further an improvement of the balance. Against this backdrop, a further balance improvement of HUF 30 billion is expected in 2013, implying an estimated deficit of around HUF 60 billion for 2013.

REFORM OF THE LOCAL GOVERNMENT SYSTEM

Key objectives in the local government include the full renewal of the local and territorial public administration system, the improvement of its low efficiency, a more cost-efficient operation of institutions, and increased transparency in the structure.

An important element of the renewal is that a significant part of local government tasks will be taken over by the state from 2013. Local governments will provide such public services for the residents which require real local task management decisions and which can be best performed locally. County governments will hold a key role in territorial development.

- From 2013 the state will take over professional responsibilities of public education institutions (except for kindergartens): the employment of teachers and assistant personnel necessary to fulfil the professional responsibilities (basic responsibilities); the provision of the necessary school equipment and materials; the payment of all related wages and non-wage costs. The local government is responsible for the operation of the public education institution's infrastructure, the safe operation of institutions serving public education, and the child feeding programme.
- Based on a 2012 Government Decision, more than 50 local governments transferred their health institutions providing in-patient care to the state. This serves the aim of ensuring high level healthcare services meeting the same standard throughout the whole country. At the same time the state also took over local government debts related to the duty, institution or assets taken over.

- In contrast with the currently effective regulation, from 2013 the greater part of public administration tasks and competences will be assumed by public administration bodies. Local governments may retain such responsibilities and competences only if they require knowledge of local circumstances and the capacity to act immediately, which greatly reduce the burden of local governments.
- As of 1 January 2012, the state took over the operation of official fire brigades from local governments within the framework of the single disaster protection system.
- A significant part of public administration duties within the competence of village or city clerks (partly from April 2012 (irregularity), partly from January 2013) will be transferred to the competence of government offices. Setting up government offices at county district level will make the performance of specific duties more cost-efficient, more proportionate to their size and thus they will ensure the same quality of performance of public administrative duties in the entire country.

Parallel to the reorganisation of duties, 2013 will see the reform of the local government financing system with task financing becoming an important element of it. The reason behind and the essence of switching to task financing is clearly demonstrated by the “trap” of recent years’ financing: resource management has existed only in relation to the central budget and the local government budget. This means that while the state finances local governments in a revenue-oriented manner, local governments pursue expenditure-oriented budget planning. The principle of revenue-oriented resource management makes the presupposition that local governments have an appropriate set of assets to bridge the gap created between the two schemes, but experience shows that this is not the case. Consequently, task financing is not only a financing method, but also a response to be given to the anomalies of the regulation of local governments.

SOCIAL PROVISIONS GRANTED BY LOCAL GOVERNMENTS

In the 2012 Budget Act two important principles are applied to the provision of social aid by local governments. On the one hand, the intention to involve people in employment is more markedly emphasized, and the effect that wage replacement supports received in the social provision system took away the incentive from beneficiaries to find employment is also eliminated. On the other hand, groups in real need can expect protection from the social network, but the aiding of beneficiaries not meeting the normative (statutory) requirements will be reduced to the minimum extent.

Employment is strengthened by reducing the amount of employment replacement support (ERS) by 20% in 2012. The contribution of local governments remains at 20% of the ERS. In addition, beneficiaries of the support are obliged to accept the job or training opportunity offered by the local branch. The ERS may be disbursed only to persons able to prove at least 30 days of employment in a year and who meet the other requirements set forth in local ordinances, such as taking care of the immediate environment where they live.

In the past, beneficiaries could receive up to 90% of the net minimum wage as regular social aid. From 2012 the amount of the aid may not exceed 90% of the net wage paid for public work if only one person receives regular social aid in the family, while if a person receives both ERS and regular social aid in a family, the cumulative amount of these provisions may not exceed 90% of the net wage paid for public work.

Revenue opportunities of operators were further expanded by the amendment of the Child Protection Act, which stipulates that from 2012 kindergartens may charge fees not only for meals but also for providing care.

The elimination of the anomalies of the Hungarian social and child welfare system and the rationalisation of the system may improve efficiency even further. The Government's key priority is to review and simplify the system of cash benefits. A characteristic feature of the Hungarian benefits system is that in addition to the so-called "normative" benefits (granted to all persons by law) there is another type of benefit which is provided "on equity grounds". This resulted in a situation whereby wealthier local governments provided such benefits in large numbers, but their "poorer" counterparts could not afford to do so. In order to abandon this unfair practise one type of benefits provided on equity grounds was abolished in 2012, and the state also reduced its contribution in this field significantly (by HUF 10 bn). As a next step, from 2013 only one type of crisis aid would remain in the hands of local governments.

The state assumes an important role in providing provisions to vulnerable people and the responsibility of relatives is underemphasised (i.e. the state supports persons in need, while such support would be reasonably expected for instance from his or her children). To remedy this situation, the Government particularly aims to increase the responsibility of relatives.

Changes to be effected in the above mentioned larger problematic areas from 2013 will obviously result in a more economical and smarter provision system which may also reduce expenditures.

RULES OF LOCAL GOVERNMENT DEBT CONTROL

Article 34 (5) of the new Fundamental Law, becoming effective in 2012, makes it possible to subject future commitments of local governments to conditions or Government consent.

Based on this mandate, Act CXCIV of 2011 on the Economic Stability of Hungary (hereinafter: Stability Act), passed in December 2011, stipulates that the payment obligations of local governments resulting from debt-generating transactions in a year may not exceed 50% of their own revenues in the same year, in none of the years until the end of the term of such obligation. This rule is meant to ensure that local governments will not become insolvent because of their debt service obligations. At the same time, by prohibiting local governments going in excess of this barrier from borrowing, the provision also prevents the further

increase of debt exposure of the local government concerned. In addition, it has also been regulated that local governments may enter into transactions with development and operating purposes only with the prior consent of the Government.

Certain transactions may be made without the permission of the Government. Advanced payments of EU development supports and debts necessary to provide the own resources in related tenders were excluded from the list of permission-bound transactions, because these are related to important EU funded investments and the collateral for any bridging loan is the development aid received from the EU, which thus will not add to the public debt. Operating loans maturing within the year are not subject to permission either, since on the one hand these loans have no effect on public debt at the end of the year, and on the other hand the permission process would cause a major delay in the transactions and block the liquidity of local governments. Transactions relating to reorganization loans borrowed for the arrangement with the creditor during a debt settlement procedure may also be concluded without the Government's permission. In addition, permission is not required for development transactions with a total value remaining below HUF 10 million (HUF 20 million in the case of minority local-governments with nation-wide competence, HUF 100 million in the case of Budapest) either. The evaluation of these investments of minor value would result in a major administrative burden, though their effect on public debt is not significant.

The procedure of contribution to the transactions of local governments is regulated by Government Decree 353/2011 (30 December) on the Detailed Rules of Contributions to Transactions Generating Debt. This decree provides for the list of revenue items that may be used as collateral for debt-generating transactions.

6.2. DEVELOPMENT OF THE PUBLIC EDUCATION SYSTEM

The new education policy measures of the Public Education Act (e.g. physical education every day, full-day elementary school education, compulsory kindergarten attendance) will be gradually introduced so that costs saved due to the reform can cover the necessary expenditures. The career model of teachers will come into force in September 2013 if the groundwork is laid for it by the macroeconomic and budgetary conditions. If circumstances are not favourable, the possibility that it will be introduced in January 2014 has to be examined.

The state will take over all professional duties of public education institutions (except for kindergartens): the employment of teachers and assistant personnel necessary to fulfil the professional responsibilities (basic responsibilities); the provision of the necessary school equipment and materials; the payment of all related wages and non-wage costs. The local government is responsible for the operation of the public education institution's infrastructure, the safe operation of institutions serving public education, and the child feeding programme.

As a special case of public education contracts, it is reasonable to create the institution of "joint contracting". This provides an option for local governments to make education and management decisions. Accordingly, the local government may participate in such decision-making if it requires extra services surpassing the state-guaranteed and financed level of education, and if it is capable of paying for such extra services. If it intends to employ teachers or professional personnel e.g. to provide advanced level language courses, information technology classes or other special classes, or to improve the technical-professional background, such teachers or professional staff may be employed by the local government as their own employee, from its own budget.

To achieve the above reform of the public education system, it is necessary from a budgetary perspective to reallocate certain resources relating to the education and management solutions of the currently effective Public Education Act from local governments to the state.

6.3. CHANGES IN SOCIAL SERVICES

Hungary spends a lot more on welfare services than most other countries, while analyses show that benefits do not always reach the needy.

The aim of the adopted and planned measures is to change this situation, making the system more targeted in the short term and promoting and supporting economic activity and a return to work. The measures are also aimed at strengthening the role played by social transfers in-kind in order to better ensure that resources are used for the purpose they were allocated for.

Eligibility for, and the amount of, social benefits is tied to the minimum pension. The "freezing" of the minimum old-age pension reduces the number of people eligible for benefits, and it prevents the amounts paid as benefits from rising.

Among family benefits, the sums paid as family allowance, maternity support, child-care allowance, child-rearing allowance, life-starting support and monetary forms of child welfare support will not rise in 2012 according to the 2012 budget. The preservation of the nominal value of benefits can still be ensured in the manner presented in the Széll Kálmán Plan.

The most widely provided type of family benefit is family allowance, which, pursuant to the regulations in force, encompasses two types of support: child-rearing support and schooling support. The disbursement of schooling support is conditional on the child attending school on a regular basis. The disbursement of schooling support is suspended if the child in question fails to participate in 50 or more compulsory classes without adequate justification, and can only be disbursed to the family if the child stops missing classes without adequate justification.

This system was changed by Act CXCI of 2011 on the Support Provided to Incapacitated Persons and the Amendment of Certain Acts and Act CXVI of 2011 on the Amendment of

Certain Acts on the 2012 Budget: as of 1 January 2012, the regulations on the conditionality of family allowance on the schooling of children have changed, and in the case of the absence from school of children over the age of 16, the support is now not suspended, but temporarily revoked (the decision on revocation is reviewed every three months). This means that the support is not received on the family support account, and cannot be retroactively disbursed to the family.

In another change, as of 1 January 2012, in the case of children who are in children's homes or live-in social institutions and children who are in reformatory institutions or penitentiary institutions and are under guardianship for child protection, the beneficiary of family allowance is always the head of the institution, and the total sum of the family allowance must be spent on supplementing the full range of care provided to the child.

6.4. HIGHER EDUCATION

The structural reform of higher education is based on Act CCIV of 2011 on National Higher Education. The main aims of the reform are the following: improving the competitiveness of higher education, meeting the needs of the economy and the labour market, prioritizing the education of natural sciences, engineering and IT, improving the structure of education and ensuring appropriate returns on the social costs invested in higher education.

The Széll Kálmán Plan, along with the cuts in the support of higher education already made in 2012 and planned for 2013, emphasises the necessity of well designed, thoroughly planned decisions and the reviewing of the role of the state, including the strengthening of its role in some areas, in order to achieve the above goals. The Government places special emphasis on setting the number and composition of state-financed student positions in accordance with the needs of the economy: the reduction of the total numbers (e.g. in order to reduce the excessive "graduate unemployment" in some programmes) and the setting of institutional limits (relying on the Government's role as the 'customer') both serve this purpose. For the academic year 2012/2013, the Government reduced the number of students that can be accepted for state-financed education from 53,450 to 34,087, introduced partially state-funded education with an upper limit of 15,550 students (for preferred areas of training that also provide good employment opportunities, with 50% state funding), with other students paying the full cost of their education. This decision also adapted the internal structure of higher education, increasing the weight of natural sciences, engineering and IT education.

Significant changes are expected in regard to the manner, beneficiaries, grounds for eligibility and other parameters of state financing (such as normative grants), ensuring that state support serves the purpose of ensuring the execution of the tasks of the state. 2012 is a transition year when it comes to financing (support is provided based on the old normative model, but the regulations on student numbers already follow the new Act); work is currently on-going on drawing up the new financing model that will be in force from 2013.

There are plans to use financing instruments in order to place limits upon state involvement and optimize the size of the institutional framework and improve its efficiency and effectiveness.

Government Decision no. 1355/2011. (X. 21.) serves these latter aims as well, requiring the review of the system of state-owned higher education institutions. This task is to be carried out based on the institutional development plans, to be prepared by higher education institutions by 30 June 2012.

6.5. RESEARCH AND DEVELOPMENT

Subsidies to the Research and Technology Fund (KTIA) are determined by article 7 of the Act XC of 2003 on KTIA. It sets as a lower limit the total innovation contributions paid in the previous 2 years. This provision has been suspended for 2012 by the Act CLXVI of 2011 on the amendment of certain acts underlying the 2012 Budget (no public subsidy in 2012), nonetheless based on the legislation in force it is again effective as of 2013. The suspended subsidies in 2012 are offset by the significantly increased contributions paid following the changes in the tax system. As from 2013 the obligation for subsidies from the budget shall be eliminated by the amendment of the act XC of 2003 on KTIA (providing public subsidies would still be possible, only their amount would not be determined by the act). Furthermore possibilities for use of EU funds need to be explored. Based on the amount of contributions paid in recent years, with the amendment of the regulation on the amount of subsidies, savings of HUF 25.2 billion in 2013 and HUF 48 billion in 2014 are expected.

Rationale of the changes is that primordial task of the state is to subsidise basic researches. Subsidising innovations is primarily a coordinative public task; this is mainly done by innovative companies in partnership with research and development institutes. In this context public as of 2012 subsidies to the Hungarian Scientific Research Fund under the chapter of Hungarian Academy of Sciences tailored to subsidise basic researches are increased by approximately 40% (from HUF 5.4 billion to HUF 7.7 billion). The reduction of subsidies to the KTIA is compensated for by the new regulation enacted as of 2012 following the changes to the former less efficient system that prohibits any reduction of the innovation contribution. As a result of this measure subsidies available from the KTIA do not decrease.

6.6. HEALTHCARE

The good health of the Hungarian population is indispensable for the social and economic convergence of Hungary with the developed states of the European Union. This requires that the preconditions for good health be ensured, including effective health development, health protection and an appropriate healthcare system. To this end, Hungary is working on setting up a healthcare system that provides high quality services, and which every person living in Hungary can access on an equal footing, irrespective of their health and financial

means. The aim is to reduce the regional inequalities present in healthcare, improve access to services and increase the efficiency of healthcare services.

The fundamental principles of the reorganization of healthcare and the direction of the steps to be taken are set down in the Semmelweis Plan. In order to ensure the implementation of the measures contained in the Plan, the Government issued Decision 1208/2011. (VI.28.) on the related tasks, on their schedule and on the entities responsible for each task. Some of the tasks listed in the Government Decision have already been executed, and the execution of the others is in progress using Hungarian and European Union resources.

One of the most important measures is to make specialized outpatient and inpatient care a state responsibility. This allows for the reorganization of the system following a more reasonable structure that ensures the efficiency of services. The affected healthcare institutions will be transferred to state ownership on 1 January 2012 and 2013. As of 1 January 2013, the only responsibility of local governments in the area of healthcare will be to provide basic healthcare services.

The coordination of hospitals' medicine and medical equipment purchases creates a more efficient and nationally transparent system, which allows for significant savings due to the large scale of procurement and the creation of real competition [Government Decision 16/2012. (II. 16.) on the special rules pertaining to the public procurement of medicines and medical equipment, and Government Decision 46/2012. (III. 28.) on the centralised system of procurement of medicines, medical equipment and disinfectants for institutions of specialized inpatient care].

The structural changes in institutions provide an opportunity to coordinate the developments planned in the health sector and the social sector, to strengthen basic healthcare and specialized outpatient care and to clarify the scope of each, and to reorganize emergency medical care.

6.7. PHARMACEUTICAL SUBSIDIES

Several steps have been taken in order to increase revenues and reduce expenditures in the pharmaceutical budget.

Pharmaceutical-related revenues were increased by raising the monthly payments required of pharmaceutical manufacturers based on their monthly turnover from 12% to 20%. The fee paid to medical sales representatives was raised from 5 million HUF to 10 million HUF. The renewing of support volume contracts by an approximately 10% lower threshold will also increase payments by manufacturers.

Expenditure on pharmaceutical is reduced by the prioritization of reference products, providing an incentive for distributors to reduce prices in order for their products to become reference products. The system provides preferential treatment not only for reference products, but also for other products that are 5% more expensive, still falling in the

reference price range fixed group, and for products in the therapy fixed group that are 10% more expensive than the reference product at a maximum. Significant savings can be made due to the expiry of the patents of several high-turnover products in the next few years, clearing the way for the more widespread use of generic medicines. This positive effect is enhanced by the fact that the generic products marketed after the expiry of the patents can become reference products after only 3 months instead of 6 as before. Further advantages can be derived from the introduction of financing rules of procedure in the widest possible range of areas and the review of the support percentages of various areas. Thus far, reviews have concentrated on combination medicines and cholesterol-reduction medicines.

As of January 2012, further efficiency gains can be provided by a change in the financing of high-value therapies. The change is as follows: the state or the insurer provides financing based not on the results of clinical trials, but on proven results achieved in practice in Hungary among the patent group in question, and, if it is not able to provide such proof, the manufacturer is obliged to pay back the support received. Savings are expected in the area of public healthcare from making only the healthcare insurer's preferred reference medicines available for Prescription Exemption Certificate holders in areas where setting up fixed groups of medicines is possible. Further savings will come from the exploitation of the low price of bio similar medicines. Positive effects are expected from improved patient cooperation, as well. In certain disease groups, non-cooperative patients, i.e. patients who do not reach the target values, will receive reduced funding for their medicines, as their failure to change their lifestyle reduces the effectiveness of the medicine they are taking. The financing of medicines through the hospitals with a tracked procedure (patient registry) using state procurement is expected to provide significant savings as well.

The effectiveness of the generics programme is further improved by the gradual introduction of pharmaceutical ordering based on active ingredient. Savings are also expected from only allowing patients to receive one month's worth of medicine in the pharmacy even if the doctor prescribes three months' worth at a time. Thus there will be no unnecessary use of financing and no waste if the therapy ends earlier. Further savings are expected from the requirement to issue the medicine for one month based on a single prescription in the packaging unit closest to a one-month quantity.

The Government decree of 1036/2012 (II.21.) requires the elaboration of measures ensuring the meeting of the deficit targets in 2012 and 2013. This necessitates the repeated review of the pharmaceutical subsidy system (e.g. the introduction of the so-called Spanish model whereby in certain groups of drugs which have been subsidised for more than 10 years mandatory price reduction is applied, increase in the charge, paid by the consumer, on certain groups of drugs, and the introduction of a minimum charge.

6.8. STEPS OF THE EORGANIZATION OF THE PENSION SYSTEM

In 2011, the Hungarian Government made significant and successful efforts in the field of pension reform. Ensuring the sustainability and secure financing of the pension system was one of the primary goals. This was embodied by the requirement to change the financing so as to make the system self-sufficient and ensure the future balance of the Pension Insurance Fund. Ensuring appropriate pensions and the adequate adaptability of the system remain important goals as well.

The first significant step was to expand the scope of the system by abolishing compulsory private pension insurance, following which nearly 100% of members of private pension insurance funds returned to the state pension system. The second important step was reorganizing the various forms of pension within the state pension system.

- As of 1 January 2012, everyone with pension insurance pays pension contributions into the compulsory state pension system. This provides structural revenue of approximately 1.5%. Those with private pension policies also pay contributions matching their private pension policy fee to the compulsory system, making the payment to private funds complementary – however, all private pension funds can set the sum of voluntary fees themselves through their own statutes.
- As of 2012, the indexing method for pensions has changed; yearly pension increases will match the planned increase of the consumer price index set in the Budget Act.
- Introduction of the “40 years for women” rule: as of 1 January 2011, women who have an eligible period of at least 40 years are eligible for old-age pension regardless of their age. Apart from the periods of payment of contributions, the periods spent bringing up children also count towards the eligible period. As a general rule, at least 32 of the 40 years of service time have to be eligible based on the payment of contributions, and no more than 8 years of service time can be admitted based on bringing up children.
- Marking a significant change in the state pension system, as a general rule as of 1 January 2012, only those who have reached the age limit for an old-age pension or are receiving a pension based on the “40 years for women” rule are considered pensioners. Pension-type benefits provided before retirement age and disability pensions are no longer considered pensions, nor financed from the Pension Insurance Fund.

As per the previous regulations, there were various types of special allowances permitting people to receive a pension before reaching the retirement age. This extensive system of special allowances was one of the factors that caused the age at which people actually retire to approach the statutory retirement age only slowly, and, despite the rules being tightened several times, early retirement was widespread.

Pensions received through early retirement were transformed into non-pension benefits while continuing the payment of previously conceded benefits and with a guarantee of the

future acknowledgement of acquired rights. The benefits affected by the change[6] will not be considered pensions in the future, but they will be raised at the same rate as pensions, and their recipients can work in accordance with the rules pertaining to early pension.

For the future, the possibility of an early pension will be completely abolished, and the state pension system will exclusively be made up of the old-age pension and the benefits provided to family members. The eligibility and disbursement rules for benefits provided before reaching the retirement age, and, after the reform of the system of benefits for the incapacitated, the benefits provided to those with a diminished capacity for work and their eligibility and disbursement rules will be regulated in specific Acts.

The system of disability pensions and other benefits provided to the incapacitated has been transformed based on a single, unified approach. Previously, the focus was on the passive provision of benefits, but is now being shifted to rehabilitation, building on the remaining abilities of the person who has experienced impairment in their health. The aim of the changes is to carry out a complex review of the condition of those claiming support and provide them with the tools necessary for improving their condition so that they can live an active life and seek employment. Based on the complex evaluation of their condition, the incapacitated will be eligible for rehabilitation and invalidity benefits. Those eligible for rehabilitation receive financial support and services aimed at facilitating their entry into the labour market during the rehabilitation, while those eligible for invalidity benefits receive financial support. The period of time spent in employment while receiving rehabilitation benefits or incapacity benefits is counted towards service time. As a transitional rule, those who already receive benefits and will reach retirement age in 5 years and those who are in the poorest state of health will now receive the same sum they have been receiving as incapacity pension or temporary allowance, as invalidity benefit. The status of younger people may change in accordance with the new evaluation and certification system.

The changes in the pension system will make it possible to finance all pensions from employer and employee contributions from 2012. Support paid to family members (widow's pension, orphan's benefits, parent's benefits) will continue to be financed from the Pension Insurance Fund. As a special allowance, the opportunity for women to retire after 40 years of service, justified by a long period of payment of contributions, will remain in place.

Pursuant to the Act on the Central Budget of Hungary, the budget of the Pension Insurance Fund is already a "pure" budget for pensions only, and the benefits that are not considered pensions anymore have been moved to two other Funds: the National Family and Social Policy Fund and the Health Insurance Fund.

[6] The change affects the following benefits: advanced old-age pension, reduced advanced old-age pension, pension with age allowance, miners' and artists' pension, service pension, pension of Members of Parliament and Mayors and early retirement pension.

6.9. Public Transport

Long distance transport

In terms of local public transport the Széll Kálmán Plan envisages a significant reduction in budgetary expenditure (HUF 45 billion for 2012, including consumer price subsidy reduction, and HUF 60 billion by 2013).

Only partial results could have been achieved in 2012: the consumer price subsidy spending plan was cut back by HUF 16 billion, and the budgetary appropriations for public passenger transport services declined in real terms by HUF 10 billion (by HUF 2.3 billion nominally), without following inflation (passenger transport subsidy to MÁV Start Plc. was reduced, while due to the increased activity caused by the expanded supply area, GySEV Plc's passenger transport subsidy increased).

In order to improve MÁV's cost-efficiency, the Government is planning significant internal transformation measures dedicated to reduce the necessary amount of passenger transport subsidies:

- Rationalising the inter-subsidiary network and accounts of MÁV Plc. in order to increase transparency, reviewing outsourced operations, and "redemption" if necessary and justified,
- Internal organisational changes, eliminating duplications, rationalising internal processes and the number of personnel at the management centre, transformation of the wage and bonus system,
- Measures improving the efficiency of MÁV Plc. (procurements, investments, external partnership agreements etc.),
- Transformation of the discount and pricing system, stricter ticket control (in order to increase MÁV Plc's ticket-sales revenue, and to reduce the state subsidy).

The rationalisation of railway timetables (the alignment of long-distance passenger rail and coach timetables, the elimination of redundancies, and the more unified management of the public service based passenger transport) also contributes to the reduction of financial support.

In order to achieve the required savings, managements of MÁV and other related companies, are not entitled to performance-based bonuses, until the targets set out in the convergence programme are reached.

Railway track operation contracts were signed during 2011. The operators are entitled to a reimbursement of justified costs not covered by revenues, financed from a budgetary expenditure appropriation of HUF 21 billion in 2011, and HUF 47 billion in 2012. Justified claims above this sum may be covered by loans – for which the state provides a joint and several guarantee.

Pursuant to the amendment of the 2011 Budget Act adopted by Parliament on 21 November 2011, the minister responsible for the budget has been authorised to on behalf of the state take over a maximum of HUF 64 billion of capital debt from MÁV Plc. originating from loans and its associated costs until 30 December 2011. Government Decision 1451 of 2011 (22 Dec) finally ordered HUF 50 billion of debt to be taken over, and this measure was carried out by the established deadline. This government decision, and the legislative amendment that followed, contribute significantly to the improvement of MÁV Plc's financial situation.

LOCAL TRANSPORT

In recent years, significant (in the case of Budapest, partially unplanned) support was provided from the central budget in order to ensure continued operation.

The state's role was redefined and put on new footings by the 2012 Budget Act.

Financing from the central government budget can only be ensured by the long-term sustainable financing concept accepted and adopted by both the capital city (Budapest) and the Government.

The sustainable financing model of Budapest's public transport is complete.

In this context, public involvement will focus on promoting revenue-generating activities (introducing an electronic ticketing system, purchasing new vehicles), with the direct budgetary support for operating costs reduced from 2013 on and eliminated in the longer term.

With internal revenue generation, financing of running costs will be based on – gradually reduced – support to capital's municipality, potentially complemented by new targeted revenue sources (e.g. congestion charge).

The financing model based on resources from the central government is unsustainable in the future, therefore Government Decision no 1036 of 2012. (21 Feb) stipulates that subsidies to local public transport of Budapest shall be decreased in 2013 by HUF 10 billion.

The long-term sustainable financing model for the local public transport of Budapest is being finalised based on the results of the negotiations between the representatives of the Government and the capital, for which the following principles were adopted by the Government on its 11 April 2012 meeting:

- The Government will use available EU funds to support the development projects set for the renewal of the outdated vehicle-park of the public transport system of Budapest (tram and trolley-bus procurement programme).
- The Government supports the establishment of the electronic ticketing system with the use of the EU funds in order to increase ticket-sales revenues.
- The Government supports the development of the congestion charge system's infrastructure with the use of EU funds, however it considers necessary to examine the

possibility to implement the system from resources of Budapest to ensure it could enter operation, together with the national road toll system from 1 July 2013.

- The Government supports the Transport OP preparation projects to ensure that Budapest have well prepared projects, that could be immediately started in the 2014-2020 financial period.
- Consumer price subsidy will continue to be granted.
- The state's involvement in the financing of the capital's local public transport – as the revenue-generating developments enter into the financing model – will decrease in the medium term (4-5 years), and be eliminated in the longer term.
- The Government agrees that Budapest should integrate the cost increases and the inflation into ticket prices.
- Following the adoption of the new financing model, significant and sustained commitment will still be needed from Budapest, until all the revenue-generating elements start to yield, and as a result, the direct capital financing requirements will be terminated in the future.
- The Government agrees that the agglomeration and the Districts of Budapest should take a significant role in the financing of the local public transport of Budapest.

ELECTRONIC ROAD TOLL

The Széll Kálmán Plan requires the enforcement of the "user pays" principle in transport so as to ensure that the operation, maintenance and renovation costs of the Hungarian road network can be covered from the revenue collected from road users, while also generating revenue for other actions in the area of transport. Eliminating the need for budget support in this area improves the balance of the central budget. To this end, a decision has been made to introduce an electronic toll payment system by 1 July 2013 at the latest, as the current (e-sticker) toll payment system does not make it possible for road users to pay for the real operation, maintenance and renovation costs caused by their road use. The expected revenue surplus must reach HUF 150 billion. According to the proposal of the Ministry for National Development responsible for this area and discussed and accepted by the Government in first reading, the fee for the usage of the state roads involved to this system must be set to be proportional to the distance covered considering the followings:

- Classification of vehicles over 3.5 ton total load will be carried out by number of axles, where j2 will be the trucks with 2 axles, j3 the trucks with 3 axles and j4 those with 4 or more axles;
- Vehicles under 3.5 ton total load remain in the d1 fee category regardless their tows;
- Buses over 3.5 ton total load belong until further decision to b2 fee category regardless their axles and tows;

- From the introduction of e-toll system trucks of j2, j3 and j4 categories will pay proportional to the distance travelled, as the functions of the controlling system integrated into the toll system is established gradually;
- For d1 and b2 categories the current time based (e-sticker) toll payment system remains with the open possibility to voluntarily join the new e-toll system after 6 months of its introduction;
- From the offset the trucks of j2, j3 and j4 categories must pay the fee proportional to the distance travelled on all highways and the main state open roads;
- The starting fee level will be that of j4 imposed upon the cost calculation according to the eurovignetta directive;
- The fee level for j2 and j3 must be proportional to the category factors of cost causing rates set in the eurovignetta directive;
- The environmental subcategories in the j2 and j3 fee categories will be launched with +/-15%, and in the j4 category with +/-20% fee diversion, further on it will be revised every half year considering the composition of the domestic vehicle pool and expecting to reach the maximum 100% fee diversion rate of the eurovignetta directive within 6-10 years;
- The fee levels will be raised in real terms every 1 January and 1 July;
- After half a year of its introduction the e-toll system will be supplemented with a frequent user's allowance up to 13%.

The Government assigns the national development minister responsible for transportation to supervise the preparation and operation of the e-toll system,

To substantiate the introduction of the system from 1 July 2013 the national development minister

- immediately after the acceptance of the proposal by the Government provides for the preparation of all contracts necessary, the designation of the auditor supporting the governmental supervision, the detailed data supply necessary to launch the procurement procedure of the e-toll system, the determination of the fee collecting and fee control services,
- disposes until 31 May the launch of the quick procurement procedure necessary for purchasing and operating the instruments for the e-toll system and for the consultancy,
- prepares until 30 June the organisational and financial model of the e-toll system including controls, concepts and legislative proposals necessary for the control duties of the e-toll system, and designates the institutions responsible for the collecting and controlling of e-toll system,

- prepares until the 31 December the joining of Hungary the European Electronic Toll Service (EETS) according to the 2004/52/EC directive of the European Parliament and Council, prepares all related proposals, sets up the electronic fee collecting conciliatory committee mediating in disputes between the EETS providers and the domestic fee collectors.

As a result of the introduction of a toll system proportional to the distance travelled, the cost paid by the users of the Hungarian road system will be proportional to the load their use is causing. The introduction of an electronic toll payment system proportional to use can reduce the advantage of road transport compared to rail transport. If the new electronic toll payment system is not launched by the above-mentioned deadline, the savings that have already been decided upon will be provided by a reform of substantial extension of the present sticker system until the launch of the e-toll system.

6.10. DECREASE IN EXPENDITURES RELATED TO PUBLIC ASSETS

A growing proportion of expenditures related to public assets are attributable to financing provision of public tasks by state owned entities as the owner and programmes that do not necessarily require public involvement.

Restoring sectoral financing of public tasks may both enhance transparency and result in more rationalised requirements by the relevant ministries. With separating financing as owner and as procurer problems in financial management of enterprises become clearer therefore determination and enforcement of rationalisation requirements become easier.

The Act on national wealth stipulates the centralisation of maintenance and investment related to real estates used by budgetary entities as of 2013, which may reduce costs with efficient implementation. Accelerating of sale of spare real estates in case of a recovery on the market may improve the fiscal position through revenues as well as through reduction of maintenance and security costs.

6.11. FURTHER EXPENDITURE SIDE MEASURES TO IMPROVE THE BALANCE

Pursuant to paragraph 5 of Government Resolution no 1036 of 2012 (21 Feb) chapter managed appropriations and other central government expenditures shall be reduced. In line with the recommendations from the Ecofin Council this needs to be extended to budgetary entities of the central government.

The reduction of appropriations amounts to close to HUF 45 billion encompassing subsidies to institutional and professional chapter managed appropriations managed by the Government (HUF 38 billion), revenues and expenditures related to public assets (HUF 3 billion) as well as subsidies to local governments and personal income taxes remaining at local governments (HUF 4 billion).

Appropriations where overrun is possible without amendment are exempt of the reduction – appropriations containing EU funds, those with normative funding and PPP as well as international membership fees and chapter balance safeguard reserves. Amounts determined by the resolution shall be further broken down within the chapters by the relevant entities without the involvement of exempted appropriations.

The freeze of appropriations also reduces figures for the 2013 Budget, thus the measure has a structural impact on the fiscal stance in 2012, 2013 and in the outer years.

REVENUES

6.12. REVENUE INCREASING MEASURES WITH A VIEW TO IMPROVING THE BUDGET BALANCE

Improving the balance of the national budget through revenues will be accomplished substiantially by five new tax measures. When deciding on the measures to be taken, the Government has attributed great importance to increasing the proportion of indirect, consumption/turnover taxes. Solutions by other EU Member States as well as recent international developments in the field of taxation of the financial sector were taken into consideration when outlining the measures.

INTRODUCTION OF A FINANCIAL TRANSACTION LEVY

As of the start of 2013, a new levy on financial transactions will be introduced with the aim of improving the balance of the budget. The planned general tax rate is 0.1 percent. The new tax will essentially be a kind of turnover tax, and as such, is in line with the Government's taxation strategy of increasing the share of indirect taxes. As a further benefit, it is levied on a very wide tax base, and thus it can result in significant budgetary revenues even at quite a low tax rate. In order to avoid tax evasion, measures aimed at encouraging electronic payments will be introduced along with the new tax. (See the chapter regarding the efficiency of tax collection.)

The new tax is similar to the financial transaction tax recommended by the European Commission both in terms of its type and in terms of its rate. However, levying the tax at a less mobile base is a key in order to avoid certain financial activities moving abroad. Thus, the tax will be basically levied on transactions carried out by households and enterprises (such as cash withdrawals and deposits, bank transfers of economic actors, direct debits, bank card payments and postal financial services). In case of transactions of extremely high value, either regressive rates or a cap is required. 130-228 bn HUF of revenue is expected from the introduction of the tax. 130 bn HUF of revenue can be achieved by placing a cap at not less than 30,000 HUF per transaction. Higher revenue can be achieved by increasing the abovementioned cap; by introducing a 0.01 percent higher band instead of maximizing the amount paid by transactions; as well as by levying a higher tax rate for cash withdrawals which can be an incentive encouraging electronic payments.

INTRODUCTION OF A TELECOMMUNICATION SERVICES TAX

The introduction of an indirect tax levied on telecommunication services is also aimed at increasing revenues. In order to ensure the balance of the 2012 budget, the tax is to be introduced starting from mid-2012. The tax is in line with the Government's policy of reducing the proportion of income-based taxes and increasing the proportion of indirect taxes within the tax system. A similar consumption-based telecommunication tax exists in several states of the United States and in Malta. The general tax rate will be 2 HUF per started minute and 2 HUF per SMS/MMS message. This tax is expected to generate 30 bn HUF of extra revenue in 2012, and 52 bn HUF a year from 2013 on.

MAINTAINING THE INCOME TAX LEVIED ON ENERGY PROVIDERS

In accordance with the original plans, the sector-specific tax levied on the electricity sector, which was introduced in 2010 and generated 99bn HUF of revenue for the national budget last year, will be abolished in 2012. However, the income tax for energy providers, introduced in 2009, will remain in place with a 16% rate instead of the current 8%. The tax base – with some minor differences – is essentially the same as that of the Corporate Income Tax. In order to widen the tax base, this type of tax will be expanded to cover certain other public utility services as well. The elimination of sector-specific taxes will also contribute to the widening of the tax base, as the sums paid in sector-specific taxes could be deducted from the tax base. The maintenance of this type of tax in this form is expected to generate 55 bn HUF of extra revenue compared to the scenario of abolishing this tax.

INTRODUCTION OF A UNIFORM INSURANCE TAX BASED ON EUROPEAN EXAMPLES

Although the special tax on financial organisations will be abolished by 2014 in accordance with the Government's original plans, the long-term existence of a tax on insurance is justified both by the established practice in several EU Member States and the economic distortions caused by the VAT exempt status of the insurance sector. Therefore, the Government plans to introduce a new, uniform insurance tax to replace the three taxes currently levied on insurance services (special tax on financial organisations, accident tax and fire protection contribution). When establishing the new tax, the general practices and rates applied regarding taxes levied on insurance in other European countries is taken into consideration, and, tax rates will be differentiated according to the type of insurance. Life insurances will be exempt from the new tax – a measure that is aimed at incentivising self-reliance and long-term savings. The planned rate is 10% for property and accident insurance, 15% for casco motor vehicle insurance and 30% for compulsory motor vehicle liability insurance (including accident tax, which will be merged into this tax). These changes are expected to generate 15 bn HUF of extra revenue compared to the baseline scenario of halving the rate of the tax on financial institutions.

INTRODUCTION OF REVERSE CHARGE VAT IN AGRICULTURE

The government plans to introduce reverse charge taxation in the cereal, the oil seeds and the protein plants sector. Due to the significance of tax fraud and the seasonality of the above-mentioned sectors (the start of harvest), Hungary intends to apply reverse charge VAT as of 1 July 2012, which the European Commission was notified of in a separate request. The introduction of reverse charge VAT is expected to generate extra revenue of 10 bn HUF in 2012 and 15 bn HUF in 2013 on accrual.

REDUCTION OF THE NUMBER OF MINOR TAXES

With a view to the simplification of the tax system, the number of taxes is to be reduced again by eliminating the ones that impose a significant administrative burden without generating a significant amount of revenue. The abolition of the special taxes as well as affiliating the accident tax and the fire protection contribution are measures that practically reduce the number of taxes. Beside these, the following taxes are to be eliminated:

- pharmacy solidarity tax
- 98% special tax paid by private persons
- disaster-relief contribution

The elimination is expected to result in 2 bn HUF of loss of revenue.

6.13. IMPROVING THE EFFICIENCY OF TAX COLLECTION

IMPROVING THE EFFICIENCY OF TAX COLLECTION – CURBING THE BLACK ECONOMY AND TAX EVASION

The Government considers improvement of the tax collection efficiency of the National Tax and Customs Administration (NAV by its Hungarian acronym) and extension of its tools to combat the shadow economy as indirect means of public debt reduction, hence a priority goal.

The new statutory provisions that came into force on 1 January 2012 extended the Tax Authority's assets of auditing, and introduced new efficiency-enhancement measures. For instance, the tax registration procedure that eliminates the possibility of establishing new enterprises for persons who pose a significant risk in terms of taxation; or the increased surveillance of taxpayers with an enhanced risk in terms of taxation. The positive effect of the new legislation will be quantifiable in respect of the budget in the medium term.

From 2013 further legal regulations are planned to be implemented with a view to promote the fight against the shadow economy:

DOMESTIC RECAPITULATIVE VAT STATEMENT

From 1st January 2013 the obligation of the domestic recapitulative VAT statement will be introduced. Under the provisions of Act XCII of 2003 on the Rules of Taxation adopted in 2011 - similarly to the EU recapitulative VAT statement -, VAT payers will have to submit a statement of their domestic sales of goods and services, as well as the data or their invoices issued and/or received in respect of which they are liable to pay, or entitled to deduct, VAT.

As a tool for risk management and selection for audit, the database consisting of the domestic recapitulative VAT statements will be a major step forward in detecting VAT abuse and fraud, and in eradicating “fake invoice production plants”. However, the measure requires substantial IT development at the level of both the state tax authority and taxable persons subject to VAT payment, and will also increase administrative burdens. Currently the Ministry for National Economy, together with NAV, is exploring ways in which the scope of liabilities can be narrowed to an optimum in order to reduce excessive administrative burdens to a minimum while maintaining an adequate level of audit efficiency (e.g. by setting a threshold for invoices, or designating specific economic sectors).

E-INVOICING

Hungary introduced the option of electronic invoicing in 2004. Beside substantially reducing costs, this option also expedites the invoicing process, yet few of the businesses avail themselves of the opportunity. Council Directive 2010/45/EU of 13 July 2010 amending Directive 2006/112/EC on the common system of value added tax as regards the rules on invoicing - to be introduced with mandatory effect as of 1 January 2013 - would mean significant simplification and technological facilitation in e-invoicing. The Ministry for National Economy is examining the possibility of granting certain preferences to certain taxpayers (e.g. the option of allowing VAT to be accounted on cashflow basis, more favourable allocation deadlines, etc.), thereby creating an incentive, or in certain cases mandating the application of e-invoicing rules. The introduction of the system may contribute to the transparency of taxpayers’ economic activity, which in turn improves the efficiency of audits on the one hand, and makes them more cost-effective on the other hand. It has the further benefit of reducing taxpayers’ administrative burdens in the longer term, as it will reduce the costs of storing documentation.

CURTAILING CASH PAYMENTS

In Hungary the prevalence of cash payments is exceptionally high. Besides the high costs involved, this also curbs the transparency of economic processes, and the traceability and verifiability of financial transactions, thereby leaving room for the shadow economy. Based on the trend of cash payments as opposed to card transactions (transfers), Hungary would only reach the EU average by 2068; therefore state intervention appears necessary. Curtailing cash payments is basically necessary in business-to-business transactions.

The Ministry for National Economy is examining the possibility of reintroducing a limitation on cash transactions, with sufficient rollout time for preparation, contemplating a ceiling that would not hinder economic life. Introduction could take place in several stages, and efforts should be made gradually in establishing the ceiling, as well as the determination of business categories, in terms of size, falling under the scope of the measure.

(In 2010, France imposed a maximum of EUR 5,000 on B-to-B cash payments; payments in excess of this ceiling must be discharged electronically. Similar regulations exist in Italy, Turkey and Bulgaria, where the limits are around EUR 7,500.)

Gradually introduced limitation on cash payments can also be considered in retail sales of goods above a set value. In this segment a blanket limitation/ban might lead to transferring consumption to other countries, therefore the implementation has to be particularly careful. In addition, promotion, or in certain areas, mandating the creation of conditions for card payment may be even more expedient. The introduction of this measure would only be possible with state involvement in the promotion of POS terminals (tenders, regulation of the bank commission system, etc.).

ESTABLISHMENT OF THE FINANCIAL PUBLIC OVERSIGHT

A precondition for achieving the Government's intention is the consistent enforcement of statutory provisions related to taxation, as well as contribution to public revenue and financial discipline. Currently this task is performed essentially by NAV and the local tax authorities, mainly through *ex post* audits of taxpayers. Due to its nature, this form of supervision should encompass millions of taxable persons and typically reveals infringements only after the event. Given the limited capacities of tax authorities, it is inevitable to find a new approach to roll back the infringements caused by abuses and mistakes. A substantial improvement of the efficiency of collection would require significant additional resources at the level of tax authorities. Instead, introduction of a new approach to supervision may be an effective way complementing the audits performed by the NAV and the local tax authorities, and may improve the tax morale in Hungary.

By setting up the institution of a financial public oversight, Hungary creates an oversight in the fiscal, accounting, financial sector, which is to exercise supervision of professionals providing fiscal, accounting and financial services to taxpayers. Initially, the new institution's scope of authority would encompass auditors. Later on, it would be extended to providers of accountancy and book-keeping services, tax consultants, tax experts and certified tax experts.

Additionally acting as a qualification supervision entity, the new authority would keep the professional qualifications in the financial sector (in the field of taxation, accounting, customs and financial services) up-to-date, would issue licenses, and, in justified cases, would ban holders of such qualifications from professional activities. Furthermore, it would determine professional and ethical standards, conduct regular quality assessment, and would sanction infringement. In this way the new supervisory authority would help

taxpayers have access to homogeneous professional services of high quality, and the "finished product", i.e., *inter alia,* accounts, financial statements and returns would be prepared with appropriate professionalism, in an ethical fashion and fully in compliance with the relevant statutory provisions. To implement these goals the new supervisory authority would also undertake to continue the education and training of the above professionals.

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

REGULATION OF PUBLIC FINANCES

In order to meet the challenges put out by the lingering economic and financial crisis in the European Union putting public finances on a sustainable path and reforming public finances in general, including the transformation of budgetary planning were of vital importance. In accordance with the Government's priority, revamping public finances and the budgetary planning extended the horizon of planning to include credible medium-term budgeting; moreover, excessive administration related to the functioning and finance of budget entities is considerably reduced; guarantees have been implemented in public spending to protect public assets and limit corruption; and enforcers have more intelligible and readable budgetary regulations to work with.

The Fundamental Law contains a separate chapter on public finances, the debt brake rule, the act on the central government budget, the Fiscal Council and national assets. It sets forth that Parliament may not adopt an Act on the central government budget that allows the public debt to exceed half of the Gross Domestic Product. As long as the public debt exceeds half of the Gross Domestic Product, Parliament may only adopt an Act on the central government budget that provides for the reduction of the debt-to-GDP ratio. The Government may derogate from the above fiscal rules only in special circumstances, and only to the extent that is justified by such circumstances.

Adopted by Parliament in December 2011, the Act on Hungary's Economic Stability includes detailed provisions, *inter alia,* on reducing the public debt and fiscal rules and also determines rules on the functioning of the Fiscal Council. The debt reduction provision sets out that the annual increase in nominal public debt cannot exceed half of the difference between the projected inflation and projected (real) GDP growth; it ensures the continuous reduction of the public debt-to-GDP ratio in the event of positive economic growth (down to the 50% threshold), and contains an anti-cyclical element as it automatically handles the provision of the Fundamental Law allowing derogation from the debt reduction principle if there is a significant and enduring economic recession. The 50% threshold set out in the Fundamental Law and the rule of enforcement set out in the Stability Act practically imply even more stringent constraints than the EU thresholds and benchmarks. The Government biannually reviews the compliance with the debt reduction rule, and in the event of a deviation it proposes amendments to the budget. Another new feature introduced by the Stability Act is the provision whereby any debt generating transaction on behalf of the state can only be concluded if authorized by virtue of legislation; this imposes central control over debt generating transactions. Local governments may enter into debt generating transactions only with the Government's prior consent, and in the case of public organisations, the prior consent of the minister responsible for the state budget is required.

In December 2011 Parliament also adopted the new Act on Public Finances replacing the repeatedly amended former Act on Public Finances (Act XXXVIII of 1992) in effect for almost twenty years. The new Act on Public Finances provides for a coherent and transparent system of legal standards. The rules of annual and multi-annual planning have been revamped. An important principle of the Act and the related decree on implementation was aligning the structure with the planning-implementation-reporting procedure, in an attempt to create a “user friendly” Government decree that follows the structure of the Act.

Pursuant to Council Directive 85/2011/EC as part of the “six-pack” domestic regulations must be harmonised with EU regulations by 31 December 2013. This concerns, *inter alia,* the legal regulations relating to public finances and planning. The Government has drawn up the schedule of harmonisation. Accordingly, concepts laying the foundations of the necessary amendments will be developed in the second half of 2012, and legislation will follow in 2013.

MEDIUM-TERM BUDGETARY PLANNING

The budget procedure fulfils its role if it manages to integrate and operationalise the competing financing needs appropriately, while at the same time making decision-makers be aware of the actual budget constraints. One of the main tools to achieve this is to develop a multi-annual fiscal framework, medium-term planning. In accordance with the recommendation of the Council the new Act on Public Finances puts particular emphasis on planning. The most important new feature is related to the planning system as it determines the framework of medium-term planning: it sets as an obligation to determine headline figures for revenues, expenditures and balance of the central government for the three years following the budget year. Thus, it provides for the determination and updating of medium-term budgetary framework. The framework has a dual significance. On the one hand, it determines the target figures for the coming years (primarily in terms of the balance), on the other hand, it requires that the expenditures determined for each chapter should be broken down by the budgetary institution managing the chapter to central and chapter-based appropriations at the level of budgetary institutions, which will, at the same time, serve as the limits of commitments undertaken for the next years. In the course of budgetary planning local governments, minority self-governments and local government associations will also determine their expected revenues and expenditures for three years in advance, for what the details are provided for in the Act on the Economic Stability of Hungary.

THE FISCAL COUNCIL

The Fundamental Law provides for the composition and main tasks of the Fiscal Council. The members of the Fiscal Council are the President of the Fiscal Council, the Governor of the Magyar Nemzeti Bank and the President of the State Audit Office. The President of the Fiscal Council is appointed for six years by the President of the Republic. The provisions regarding the Fiscal Council’s operation are set out in the Act on the Economic Stability of Hungary. The core activity of the Fiscal Council is to examine the budget bill and the proposed

amendments to the Budget Act. Regarding the examination of the budget bill the Council's power is greater than formerly, as it has the right to veto in cases where the debt reduction rule is not met. In addition, the Council expresses its opinion on the planning and implementation of the central government budget, and on any issue related to public finances.

At the preparatory stage the Government submits the draft budget bill to the Fiscal Council together with the underlying calculations and figures on fiscal impacts of legislative changes. The Government can submit the bill to Parliament only after receiving the Council's opinion, or, if no opinion is expressed, after the relevant deadline expires. During the parliamentary debates once the appropriations for the chapters are set, the Fiscal Council examines Parliament's resolution and expresses its opinion. At this stage, the Fiscal Council examines whether Parliament respected the public debt limit set by the Fundamental Law when determining the appropriations. Under the Fundamental Law before the adoption the Speaker of Parliament sends the budget bill to the Fiscal Council for approval prior to the final vote, and the Council decides to give its prior consent or to refuse it in case the provision of the Fundamental Law on the public debt-to-GDP ratio is not met. Thus at the parliamentary stage the Fiscal Council has a more limited scope of examination than at the preparatory state, as its mandate is limited to the examination of compliance with the debt brake rule; on the other hand, it has very strong powers as it has the right to veto in respect of approving the budget.

THE GOVERNANCE OF PUBLIC FINANCE STATISTICS

In Hungary public sector related statistics are prepared by the Hungarian Central Statistical Office (CSO) and the Magyar Nemzeti Bank (MNB). According to the current division of tasks the CSO is responsible for non-financial accounts and the MNB for financial accounts. Data provision in the context of the Excessive Deficit Procedure (EDP Notification) the above division of work prevails in compiling the actual figures up to the period before the reported period (t-1) while the expected deficit and debt of the current (t) period are calculated by the Ministry for National Economy. The statistical working group comprised of the representatives of the CSO, the MNB and the Ministry for National Economy operates on the management and expert levels, and a co-operation agreement regulates procedural issues of data flow, division of labour and methodological treatment. The cooperation agreement was updated in 2012.

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 EDP Notification report is published on the CSO website when it sends the data to Eurostat, after which follows a three week period of harmonisation with Eurostat. Eurostat, and the CSO simultaneously on its own website, then publishes the approved EDP Notification tables as well as their time series and the detailed

description of its compilation methodology as updated by Hungarian authorities from time to time ("EDP Inventory"), together with the press release of Eurostat. According to current practice, the Ministry for National Economy 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 2010), 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

With a view to debt reduction, as of 2012 the Government controls debt generation by local governments and non-budgetary entities classified within the general government sector through the introduction of a monitoring and authorisation system.

8. Council recommendation adopted on 13 March 2012 in the context of the excessive deficit procedure

In line with the Council recommendation adopted on 13 March 2012 in the context of the excessive deficit procedure, the present excessive deficit situation should be put an end to by 2012.

- In this context further balance improving measures are needed in 2012 and 2013.

Chapters 3 and 5 of the updated convergence programme present the budgetary measures underpinning the fiscal targets, including further structural measures decided upon by the Government in April, inter alia, incorporating sufficient reserve provisions for 2013, in line with the recommendation. Based on the calculation presented in the convergence programme the MTO (structural deficit of 1.5% of GDP) is expected to be achieved by 2013, in line with the recommendation. The calculations in the convergence programme do not include one-off revenues stemming from the step back of beneficiaries from the private to the public pension pillar. The attainment of the deficit target is ensured by the measures described in the Programme.

- That budgetary adjustment should contribute to bringing the government gross debt ratio onto a declining path.

The gross debt-to-GDP ratio has already declined in 2011. Chapter 3.7 of the updated convergence programme presents in detail developments underlying the further permanent reduction of the public debt ratio. In accordance with the recommendation and paragraph 1a of Article 2 of Regulation (EC) No 1467/97 referred to therein, the public debt path ensures sufficient progress toward compliance with the debt reduction benchmark for a period of three years from the correction of the excessive deficit.

- The key constitutional fiscal rules should be operationalised by adapting the Cardinal Act on Economic Stability. The numerical rules should ensure that the budget process is within the context of a truly binding medium-term framework and the analytical remit of the Fiscal Council should be broadened.

Chapter 7 of the updated convergence programme presents the institutional framework of the budgetary planning and implementation and includes detailed descriptions on provisions of the Fundamental Law, the Act on Economic Stability of Hungary, the Act on Public Finances and the government decree on the implementation of the budget that strengthen the medium term perspective of the budgetary planning. In order to reinforce the role of the Fiscal Council, as a novelty, it shall biannually publish assessments on the planning and implementation of the budget, management of public finances or any related issues. Due to an amendment to the law, the President of the Fiscal Council became eligible for remuneration performing his/her task.

Following the assessment of the functioning of the new regulatory framework, the Government will submit to the Parliament the necessary amendment during the spring session.

TABLES

Table 1a. Macroeconomic prospects

	ESA-code	2011 HUF bn	2011	2012	2013	2014	2015
			percentage change				
1. Real GDP (at constant prices)	B1g	27200.2	1.7	0.1	1.6	2.5	2.5
2. Nominal GDP	B1g	28154.3	5.3	4.3	4.5	5.5	5.3
Components of real GDP							
3. Private consumption expenditure	P.3	13857.6	0.0	-1.4	0.3	2.5	2.6
4. Government consumption expenditure*	P.3	6209.4	-0.4	-0.7	0.2	0.4	0.4
5. Gross fixed capital formation	P.51	4544.6	-5.4	-2.3	0.3	3.5	3.5
6. Changes in inventories and net acquisition of valuables (per cent of GDP)	P.52+ P.53	260.0	1.0	1.7	1.2	1.0	0.9
7. Exports of goods and services	P.6	25090.6	8.4	4.7	8.8	10.5	10.5
8. Imports of goods and services	P.7	22762.0	6.3	2.8	8.0	10.9	10.9
Contribution to real GDP growth							
9. Final domestic demand		-	-1.1	-1.3	0.2	1.9	2.0
10. Changes in inventories and net acquisition of valuables	P.52+ P.53	-	0.5	-0.6	-0.1	-0.1	-0.1
11. External balance of goods and services	B.11	-	2.2	2.0	1.5	0.7	0.7

*/: Including government and NPISHs as well

Table 1b Price developments

	2011	2012	2013	2014	2015
	percentage change				
12. GDP deflator	3.5	4.2	2.9	3.0	2.7
13. Private consumption deflator	4.5	5.2	4.2	3.0	3.0
14. HICP	3.9	5.2	4.2	3.0	3.0
15. Public consumption deflator	0.3	2.3	1.4	5.2	3.7
16. Investment deflator	3.8	5.6	3.3	2.7	2.8
17. Export price deflator (goods and services)	3.5	8.0	1.0	0.9	0.9
18. Import price deflator (goods and services)	5.0	8.3	1.2	1.1	1.1

Table 1c Labour market developments

	ESA-code	2011 level	2011	2012	2013	2014	2015
			percentage change				
19. Employment (‘000;15-64)		3779.0	0.8	1.2	2.2	3.0	3.4
20. Unemployment rate (%)		-	10.9	10.9	10.3	9.5	8.9
21. Labour productivity. persons		-	0.9	-1.1	-0.6	-0.5	-0.8
22. Compensation of employees (HUF bn)	D.1	12393.3	4.0	3.6	5.7	7.6	6.8
22a. Compensation per employees (HUF million)		3.3	3.2	2.4	3.5	4.5	3.3

Table 1d Sectoral balances

	ESA-code	2011	2012	2013	2014	2015
		per cent of GDP				
23. Net lending / borrowing vis-á-vis the rest of the world	B9.	3.6	6.5	7.3	7.3	6.4
of which						
- Balance of goods and services		7.2	9.1	10.0	10.0	10.0
- Balance of primary incomes and transfers		-5.8	-5.8	-5.9	-6.0	-6.3
- Capital account		2.1	3.2	3.2	3.3	2.7
24. Net lending / borrowing of the private sector	B9.	-0.7	9.0	9.5	9.2	8.9
25. Net lending / borrowing of general government	EDP B9.	4.3	-2.5	-2.2	-1.9	-1.5

Table 2a General government budgetary prospects

	ESA code	2011 HUF bn	2011	2012	2013	2014	2015
			Per cent of GDP				
Net lending (EDP B.9.) by sub-sector							
1. General government	S.13	1204.6	4.3	-2.5	-2.2	-1.9	-1.5
2. Central government	S.1311	957.3	3.4	-2.3	-1.9	-1.8	-1.5
3. State government	S.1312		-	-	-	-	-
4. Local government	S.1313	212.6	0.8	-0.3	-0.2	0.0	0.0
5. Social security funds	S.1314	34.7	0.1	0.1	-0.1	-0.1	-0.1
General government (S.13)							
6. Total revenue	TR	14883.4	52.9	46.0	45.2	45.3	44.9
7. Total expenditure	TE[1]	13678.8	48.6	48.5	47.4	47.2	46.4
8. Net lending/borrowing	EDP B.9	1204.6	4.3	-2.5	-2.2	-1.9	-1.5
9. Interest expenditure	EDP D.41	1145.0	4.1	4.1	4.2	4.1	3.7
10. Primary balance		2349.6	8.3	1.6	2.0	2.2	2.2
11. One-off and other temporary items[2]			9.4	0.8	0.2	0.0	0.0
Selected components of revenues							
12. Total taxes (12=12a+12b+12c)		6601.0	23.4	24.9	24.6	24.4	24.2
12.a. Taxes on production and imports	D.2	4662.0	16.6	17.5	17.6	17.4	17.1
12.b. Current taxes on income. wealth, etc.	D.5	1791.6	6.4	6.9	6.8	6.9	7.0
12.c. Capital taxes	D.91	147.4	0.5	0.5	0.2	0.0	0.0
13. Social contributions	D.61	3669.5	13.0	13.0	13.0	13.0	12.9
14. Property income	D.4	315.5	1.1	1.0	0.7	0.6	0.5
15. Other		4297.4	15.3	7.1	6.9	7.3	7.4
16=6. Total revenue	TR	14883.4	52.9	46.0	45.2	45.3	44.9
Tax burden[3] (D.2+D.5+D.61+D.91-D.995)		10341.4	36.7	38.2	37.9	37.5	37.1
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	4954.3	17.6	17.0	16.4	16.6	16.4
17.a. Compensation of employees	D.1	2835.9	10.1	10.1	9.9	10.2	10.2
17.b. Intermediate consumption	P.2	2118.4	7.5	6.9	6.5	6.4	6.2
18. Social payments (18=18a+18b)		5040.8	17.9	17.1	16.6	16.2	15.9
of which: Unemployment benefits[4]		125.8	0.4	0.2	0.2	0.2	0.2
18.a. Social transfers in kind via market producers	D.6311. D.63121. D.63131	723.5	2.6	2.2	2.0	1.9	1.8
18.b. Social transfers other than in kind	D.62	4317.3	15.3	14.8	14.7	14.3	14.1
19.=9. Interest expenditure	EDP D.41	1145.0	4.1	4.1	4.2	4.1	3.7
20. Subsidy	D.3	329.6	1.2	1.0	1.0	0.9	1.1
21. Gross fixed capital formation	P.51	810.6	2.9	4.3	4.4	4.4	4.2
22. Capital transfers	D.9	600.8	2.1	1.4	1.1	1.0	1.0
23. Other		797.7	2.8	3.6	3.7	3.9	4.1
24.=7. Total expenditure	TE[1]	13678.8	48.6	48.5	47.4	47.2	46.4

Due to the rounding the sum data could differ from the sum of the detailed data.
[1]: Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9
[2]: A plus sign means deficit-reducing one-off measures.
[3]: Including revenues collected by the EU
[4]: Cash benefits of National Employment Fund

Table 2b Breakdown of revenue

		2011	2011	2012	2013	2014	2015
		HUF bn	per cent of GDP				
1. Total revenue at unchanged policies		12697*	45.1*	44.2	44.5	45.1	44.9
2. Discretionary revenue measures		-536	-1.9	1.8	0.7	0.2	0.0

** Figures for 2011 do not include revenues stemming from asset transfers related to persons stepping back from the private pension pillar to the public pillar.*

Table 2c Expenditure to be excluded from the expenditure benchmark

		2011	2011	2012	2013	2014	2015
		HUF bn	per cent of GDP				
1. Expenditure on EU programmes fully matched by EU funds revenue		539.1	1.9	3.3	3.2	3.4	3.6
2. Expenditure fully matched by mandated revenue increases		-	-	-	-	-	-
3. Non-discretionary changes in unemployment benefit expenditure		-	-	-	-	-	-

Table 3 General government debt developments

	ESA-code	2011	2012	2013	2014	2015
		per cent of GDP				
1. Gross debt		80.6	78.4	77.0	73.7	72.7
2. Change in gross debt ratio		-0.8	-2.2	-1.4	-3.2	-1.0
Contribution to changes in gross debt						
3. Primary deficit		-8.3	-1.6	-2.0	-2.2	-2.2
4. Interest expenditure	EDP D.41	4.1	4.1	4.2	4.1	3.7
5. Stock-flow adjustment		7.5	-1.4	-0.3	-1.1	1.1
of which: - privatisation receipts		-0.1	0.0	0.0	0.0	0.0
- international institutions stand-by credits not used for financing purpose		-1.7	-0.1	0.0	-0.5	0.0
Implicit interest rate on debt (%)		5.1	5.2	5.6	5.7	5.4

Table 4 Cyclical developments

	ESA-code	2011	2012	2013	2014	2015
		per cent of GDP				
1. Real GDP growth (%. at constant prices)		1.7	0.1	1.6	2.5	2.5
2. Net lending of general government	EDP B.9	4.3	-2.5	-2.2	-1.9	-1.5
3. Interest expenditure	EDP D.41	4.1	4.1	4.3	4.2	3.7
4. One-off and other temporary items[1]		9.4	0.8	0.2	0.0	0.0
5. Potential GDP (%)		0.3	0.8	1.4	1.6	1.8
contributions: - labour		0.1	0.6	1.1	1.1	1.3
- capital		0.5	0.4	0.4	0.5	0.5
- total factor productivity (TFP)		-0.2	-0.2	-0.2	0.0	0.0
6. Output gap		-2.6	-3.2	-3.0	-2.1	-1.4
7. Cyclical budgetary component		-1.2	-1.5	-1.4	-1.0	-0.7
8. Cyclically-adjusted balance (2-7)		5.5	-1.0	-0.9	-0.9	-0.8
9. Cyclically-adjusted primary balance (8+3)		9.5	3.1	3.4	3.2	2.9
10. Structural balance (8-4)		-3.9	-1.8	-1.0	-0.9	-0.8

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 previous update

	ESA-code	2011	2012	2013	2014	2015
Real GDP growth (%)						
1. April 2011 Convergence Programme		3.1	3.0	3.2	3.3	3.5
2. April 2012 Convergence Programme		1.7	0.1	1.6	2.5	2.5
3. Difference		-1.4	-2.9	-1.6	-0.8	-1.0
General government net lending (% of GDP)						
1. April 2011 Convergence Programme	EDP B.9	2.0	-2.5	-2.2	-1.9	-1.5
2. April 2012 Convergence Programme	EDP B.9	4.3	-2.5	-2..2	-1.9	-1.5
3. Difference		2.3	0.0	0.0	0.0	0.0
General government gross debt (% of GDP)						
1. April 2011 Convergence Programme		75.5	72.1	69.7	66.7	64.1
2. April 2012 Convergence Programme		80.6	78.4	77.0	73.7	72.7
3. Difference		5.1	6.3	7.3	7.0	8.6

Table 6 Long-term sustainability of public finances

	2007	2010	2020	2030	2040	2060
	per cent of GDP					
Pension expenditure[1]		11.9	10.6	9.8	10.5	12.6
Old-age and early pensions		10.1	9.1	8.4	9.2	11.4
Other pensions (disability, survivors)		1.8	1.5	1.4	1.3	1.2
Health care, education and other age-related expenditure[2]		10.4	10.3	10.3	10.6	11.6
Health care expenditures		4.9	5.1	5.4	5.7	6.1
Long-term care expenditures		0.8	0.9	1.0	1.1	1.4
Education expenditures		4.3	3.9	3.6	3.5	3.8
Other age-related expenditures		0.4	0.4	0.3	0.3	0.3
Pension contribution revenue		8.6	9.9	9.9	10	9.9
Assumptions [3]						
Labour productivity growth	0.2	1.3	0.9	2.1	2.1	1.5
Real GDP growth	0.1	1.3	1.4	1.9	1.2	0.9
Participation rate, males (20-64)		74.7	78.6	78.6	76.9	77.4
Participation rate, females (20-64)		61.4	67.5	68.7	67.2	67.7
Total participation rate (20-64)		68.0	73.0	73.6	72.1	72.6
Unemployment rate	7.4	11.2	11.4	7.8	7.4	7.3
Population aged 65 + over / total population	15.9	16.7	20.0	21.8	25.1	32.2

[1]: Projections for pension expenditures (old-age and other) are calculations of the Ministry for National Economy based on the 2012 projections prepared by the EPC (Economic Policy Committee) taking also account of changes since December 2011.
[2]: Data from the 'AWG reference scenario' and 'Baseline scenario' of the 2012 EPC projections
[3]: Data are based on projections by the Ageing Working Group.

Table 6a Contingent liabilities

per cent of GDP	2011
Public guarantees	8.6

Table 7 Basic assumptions

	2011	2012	2013	2014	2015
Hungary: Short-term interest rate (annual average)	6.6	7.0	6.1	5.4	4.9
Hungary: Long-term interest rate (annual average)	7.6	8.4	7.6	6.9	6.1
World excluding EU, GDP growth	4.2	4.2	4.3	4.3	4.3
EU27 GDP growth	1.5	0.1	1.4	1.4	1.4
Growth of relevant foreign markets	6.2	2.5	5.4	7.0	7.0
World import volumes, excluding EU	7.5	5.6	6.2	6.2	6.2
Oil prices (Brent, USD/barrel)	111.5	119.9	113.5	113.5	113.5
HUF/EUR	279.2	299.4	299.4	299.4	299.4