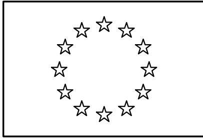

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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CONVERGENCE PROGRAMME OF HUNGARY (2004-2008)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

On 14 May 2004, Hungary submitted its first convergence programme, which was adopted by the government on 13 May and covers the period from 2004 to 2008. It largely complies with the code of conduct on the content and format of stability and convergence programmes. The programme makes reference to the planned adoption of the euro in 2010 (possibly in 2009 if economic conditions turn out more favourable than expected). Accordingly, the fulfilment of the convergence criteria is foreseen by 2008.

The general government deficit decreased from 9.3% of GDP in 2002 to 5.9% of GDP in 2003, but it is still well above the 3% of GDP Treaty reference value. On 12 May 2004, the Commission initiated an excessive deficit procedure for Hungary, with the adoption of a report in accordance with Article 104(3) of the Treaty. The Economic and Financial Committee issued its opinion on this report on 25 May. On 5 July 2004, the Council is expected, on the basis of two Commission recommendations, to decide that an excessive deficit exists in Hungary and to make recommendations to Hungary to bring this situation to an end.

The convergence programme contains two different scenarios for the macroeconomic and budgetary projections: a "baseline" and a "more optimistic" scenario. The budgetary projections are based on the baseline scenario. It foresees real GDP growth of about 3½-4% in 2004 and 2005, followed by an increase in the growth rate by some ½ percentage point each year until 2008. The recovery in economic activity is expected to be driven by strong growth in exports and fixed investment, compensating for lower private consumption growth, based on the significant deceleration of the previously high real wage growth. This would be also reflected in a gradual though moderate narrowing of the current account deficit. The briefly outlined "more optimistic" scenario shows higher growth rates based on higher exports. Taking as a benchmark the Commission 2004 Spring forecast confirms that the "baseline" scenario should be considered as the reference scenario reflecting the more plausible growth assumptions. However, while on the basis of currently available information this seems reasonable in the short term, even this scenario seems to be somewhat optimistic as far as the medium-term is concerned. In line with the robust growth and measures to increase employment, unemployment is anticipated to decrease further to around 5½% by 2008 and the participation rate is expected to increase up to 64% in 2008 (from somewhat below 6% and 60% respectively in 2003).

The convergence programme assumes a resumption of disinflation after a peak of 6½% annual average inflation in 2004 and projects inflation at about 3% by 2008. While the sharp drop in inflation in 2005 would be the result of tapering off price hikes due to indirect taxes, disinflation would be supported during the entire period by moderate real wage growth (in particular in the public sector) and restrictive fiscal policies. These projections are broadly in line with the Commission's assumptions. The convergence programme does not give indications of planned changes in the monetary or exchange rate regime for the observed period (consisting of an inflation targeting framework in combination with a +/-15% fluctuation band around the central parity). Moreover, contrary to the 2003 pre-accession economic programme, the convergence programme does not declare the aim of achieving ERM II membership immediately after EU

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[1] This assessment has been carried out on the basis of information available as of 16 June 2004.

accession. It rather acknowledges that ERM II participation needs to be supported by a credible and sustainable fiscal adjustment path.

The medium-term budgetary strategy represents a considerable departure from that in the 2003 pre-accession economic programme. While the latter aimed for a deficit below 3% of GDP by 2005, this target is postponed until 2008 in the convergence programme. The consolidation envisaged in the programme is frontloaded with the deficit decreasing from 5.9% of GDP in 2003 to 4.6% of GDP in 2004, followed by a yearly adjustment of some ½ percentage point (4.1% of GDP in 2005, 3.6% in 2006, 3.1% in 2007 and 2.7% of GDP in 2008). The consolidation strategy is expenditure-based, underpinned by structural reforms, in particular in the areas of public administration, education and health. However, neither the impact of these reforms, nor the state of their implementation is known with the necessary precision. The projected decline of the overall expenditure ratio by more than 4 percentage points between 2003 and 2008[2] would allow for a rise in the GDP share of public investment, supported by EU funding. At the same time, the fiscal consolidation is planned to be accompanied by a reduction of the weight of the public sector in the economy. This would manifest itself also in a reduction of the overall tax burden from 39% in 2004 to 37% in 2008.

A consolidation pace of some ½ percentage points of GDP annually from 2005 onwards may appear relatively modest, in particular against the background of robust growth forecast over the entire period, the relatively high level of deficit and debt ratios and the expected decline in the interest rate burden. However, this has to be set against at least three offsetting considerations. First, it is important for Hungary to restore the credibility of fiscal policy by setting objectives that are within reach and achieving them. Second, the structural reforms underpinning the strategy would, once further specified and carried out, enhance the sustainability of the fiscal consolidation and improve the quality of public finances. Third, the government budget is burdened by the costs of the pension reform (which are expected to rise from 0.7% in 2003 to 0.9% of GDP by 2008).

Nevertheless, the fact that the planned deficit should be reduced below 3% of GDP only in 2008, and then only by a small margin, is a source of concern. Any unfavourable development on the macroeconomic or on the budgetary side would compromise the achievement of this objective, with a potentially serious impact on the government's overall adjustment strategy. Therefore, the budgetary stance in the programme may not be sufficient to reduce the deficit to below the 3% of GDP deficit reference value by the end of the programme and all opportunities should be seized to accelerate the fiscal adjustment. In this context, both the experience of expenditure overruns in the past two years and the absence of clear indications about the ambitious expenditure-reducing measures for 2005-2008 are worrying signs. In addition, the whole adjustment strategy depends crucially on the success of carrying out the planned ambitious adjustment in 2004. Missing the budgetary target this year would set the whole strategy at risk. Given that unexpected expenditures, such as those seen in recent years cannot be excluded, it is important that the government sticks to its intention as announced in the convergence programme, and adopts additional and timely corrective measures if necessary in order to ensure that the 2004 deficit target is met.

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[2] This would occur abstracting from the expenditure effects of EU transfers (which are expected to increase from some 0.5% of GDP in 2004 to 2.5% of GDP in 2008).

Overall, the consolidation strategy in the convergence programme seems conducive to a better quality of public finances. It is generally acknowledged that fiscal consolidation is more sustainable when based on expenditure cuts, especially if underpinned by structural reforms. Also a reduction of the high tax burden, especially on labour, seems appropriate. However, for a virtuous circle to be set in motion, it is essential that the expenditure targets are respected. Therefore, a cautious approach seems advisable regarding tax cuts, making them conditional upon the implementation of the planned reforms and the achievement of the deficit targets. Furthermore, should economic growth fall short of the expectations in the programme, additional measures are likely to be needed to keep the consolidation on track.

After peaking at nearly 60% of GDP in 2004, the debt ratio is projected in the programme to decline in line with the planned budgetary adjustment but also benefiting from a falling interest burden and negative stock-flow adjustments. Provided that the consolidation takes place as planned, and assuming no significant weakening of the exchange rate and a reduction of the interest burden as forecast in the programme, this seems plausible. The need for the consolidation to take place as planned is underscored by the necessity to ensure that public borrowing requirements continue to be met smoothly, and that debt service costs are well-contained.

Especially in view of the relatively high debt level, Hungary faces some risk of budgetary imbalances in meeting the projected costs of an aging population. While the pension reform dating back to 1998 and establishing a progressive three-tier pension system - including parametric changes to the pay-as-you-go pillar e.g. increase in the retirement age, pension indexation – has significantly mitigated the risks of long-term budgetary imbalances, it has not removed them entirely. Securing an adequate primary surplus in the medium term together with the implementation of measures to further stem the rise of age-related expenditure, particularly concerning health care, is essential to place public finances on a sustainable basis.

Table 1: **Comparison of key macroeconomic and budgetary projections**

		2003	2004	2005	2006	2007	2008
Real GDP (% change)	**CP**	**2.9**	**3.3-3.5**	**3.5-4**	**ca.4**	**4-4.5**	**4.5-5**
	COM	2.9	3.2	3.4	n.a.	n.a.	n.a.
	PEP	*ca.3.5*	*ca.3.5*	*4-4.5*	*4.5-5*	*n.a.*	*n.a.*
HICP inflation (%)	**CP**	**4.7**	**ca.6.5**	**ca.4.5**	**ca.4**	**ca.3.5**	**ca.3**
	COM	4.7	6.9	4.6	n.a.	n.a.	n.a.
	PEP	*4.8-5*	*ca.5*	*ca.4*	*ca.3*	*n.a.*	*n.a.*
General government balance (% of GDP)	**CP**	**-5.9**	**-4.6**	**-4.1**	**-3.6**	**-3.1**	**-2.7**
	COM	-5.9	-4.9	-4.3	n.a.	n.a.	n.a.
	PEP	*-4.8*	*-3.8*	*-2.8*	*-2.5*	*n.a.*	*n.a.*
Primary balance (% of GDP)	**CP**	**-2.0**	**-0.5**	**-0.2**	**0.1**	**0.3**	**0.4**
	COM	-1.8	-0.9	-0.5	n.a.	n.a.	n.a.
	PEP	*-1.2*	*-0.4*	*0.4*	*0.4*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP**	**59.1**	**59.4**	**57.9**	**56.8**	**55.6**	**53.7**
	COM	59	58.7	58.0	n.a.	n.a.	n.a.
	PEP	*57.2*	*55.3*	*54.0*	*n.a.*	*n.a.*	*n.a.*

Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

1. INTRODUCTION

On 14 May 2004, Hungary submitted its first convergence programme, which covers the period from 2004 to 2008, and was adopted by the government on 13 May. The convergence programme largely complies with the revised Code of conduct on the content and format of stability and convergence programmes. It relies on the revised government forecast of March 2004 for revenues and expenditures and takes into account some additional corrective measures taken since the adoption of the budget act for 2004.

The main goal of Hungary's fiscal policy strategy is a front-loaded reduction of the general government deficit in 2004, followed by an evenly distributed gradual reduction of some ½ percentage point between 2005 and 2008. This would lead to a reduction from 5.9% of GDP in 2003 to a level of below 3% of GDP by 2008. While these plans are considerably less ambitious than outlined in the 2003 pre-accession economic programme, which foresaw a reduction of the general government deficit below 3% already for the year 2005, they can be considered more realistic.

The gradual consolidation foreseen in the convergence programme would be accompanied by a simultaneous reduction of the weight of the government in the economy, whereby a sharp decline in the expenditure-to-GDP ratio is projected to over-compensate the impact of tax cuts. The cut in the expenditure ratio is expected to come from a strong decline of collective consumption and social benefits in kind, but also from lower interest payments. The debt-to-GDP ratio is foreseen to decline below 54% of GDP by 2008, after a peak in 2004 slightly below 60% of GDP.

2. MACROECONOMIC DEVELOPMENTS

2.1. Macroeconomic scenario

The baseline scenario of the convergence programme projects a steady real GDP growth of around 3½-4% until 2005 and an increase by ½ percentage point each successive year between 2006 and 2008. The recovery in economic activity is expected to be driven by export growth and a marked acceleration in domestic investment expenditures, as also foreseen in the Commission Spring forecast. It would compensate for lower private consumption growth, especially in 2004. The baseline scenario's estimate for real GDP growth for the years 2004 and 2005 is more optimistic than that contained in the Commission Spring 2004 forecast[3]. However, in view of recently published quarterly figures[4], the projections of the convergence programme for 2004 and 2005 appear plausible. Nevertheless, the forecast for the medium term seems still to be rather on the optimistic side, given that the baseline scenario is underpinned by the assumption of accelerating domestic demand and increasing potential real GDP growth of 3.6% in 2004 to 4.2% in 2008[5] (where the currently negative output gap would be closed by 2008). The

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[3] Differences in the forecast arise mainly from the Hungarian authorities' more positive assessment about the contribution of stock building to GDP growth. However, as many of the forecast figures in the convergence programme are given in ranges, it is relatively difficult to compare in detail.

[4] The first release of the real GDP growth rate for the first quarter of 2004 revealed the unexpectedly high figure of 4.2% year-on-year.

[5] Estimated with the Hodrick-Prescott filter method in the programme.

external assumptions of the convergence programme are in line with the external assumptions of the Commission's Spring 2004 forecast (until 2005).

The convergence programme also briefly outlines a more favourable alternative scenario, assuming higher exports due to the more pronounced effect of competitiveness boosting government policies. It forecasts real GDP growth rates to be some ½ percentage point higher than in the baseline scenario. Bearing in mind that a prudent fiscal strategy should be based on a relatively cautious macro-economic scenario, the following assessment concentrates only on the projections under the baseline scenario.

At less than 6%, Hungary has one of the lowest unemployment rates of the EU-25. At the same time, it has a very low participation rate. This is being successfully tackled by government policies and the convergence programme envisages a continuation of increasing employment in the business sector. It targets an increase in the participation rate of the age bracket 15-64 from 60.7% in 2003 to 63.5% in 2008. This seems indeed crucial, as the budgetary projections in the programme assume that employment growth also contributes to compensating the loss in budgetary revenues that is expected to occur as a result of the envisaged change in the tax policy.

The convergence programme assumes a resumption of disinflation after a peak of 6½% in 2004 (annual average consumer price inflation) and projects inflation at about 3% by 2008. While the sharp drop in inflation in 2005 would be the result of tapering off price hikes due to indirect taxes, disinflation would be supported during the entire period by moderate real wage growth and restrictive fiscal policies.

Table 2: Comparison of macroeconomic developments and forecasts

	2003		2004		2005		2006		2007		2008	
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**
Real GDP (% change)	2.9	2.9	3.2	3.3-3.5	3.4	3.5-4	n.a.	4	n.a.	4-4.5	n.a.	4.5-5
Contributions:												
- Final domestic demand	6.5	5.4	2.7	2-2.5	3.5	3-3.5	n.a.	3.5-4	n.a.	4-4.5	n.a.	4.5-5
- Change in inventories	-0.3	0.3	0.3	0.5-1	-0.4	0.5-1	n.a.	ca.0.5	n.a.	ca.0.5	n.a.	ca.0
- External balance on g&s	-3.3	-2.8	0.2	0-0.5	0.3	-0.5-0	n.a.	-0.5-0	n.a.	-0.5-0	n.a.	-0.5-0
Employment (% change)	0.5	1.0	0.6	0-0.5	0.7	0.5-1	n.a.	ca.1	n.a.	ca.1	n.a.	ca.1.5
HICP inflation (%)	4.7	4.7	6.9	ca.6.5	4.6	ca.4.5	n.a.	ca.4	n.a.	ca.3.5	n.a.	ca.3
GDP deflator (% change)	5.3	7.8	6.4	ca.6	5.3	ca.4.5	n.a.	ca.4	n.a.	ca.3.5	n.a.	ca.3
Current account (% of GDP)	-5.7* -8.9	n.a	-5.4*	-8.5	-5.1*	-8	n.a.	-7.5-8	n.a.	-7-7.5	n.a.	-6.5-7

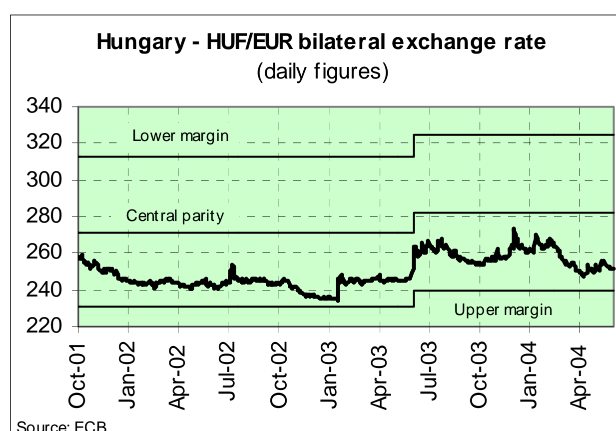
* Figures of the Commission forecast are still based on the old balance of payment methodology. The differences to the old methodology mainly result from the inclusion of reinvested earnings of direct investment enterprises
Sources:
Convergence programme (CP); Commission services spring 2004 forecasts (COM)

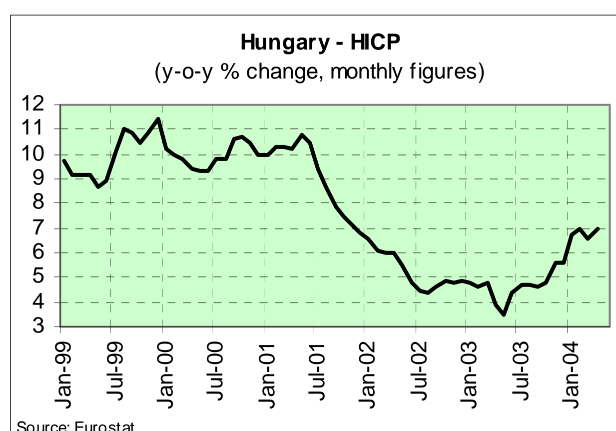
2.2. External accounts

The external position of Hungary deteriorated in 2003, with a widening of the current account deficit to 8.9% of GDP from 7.1% in 2002. The figures reflect a negative contribution from net exports due to strong consumption-driven import growth, the slowdown in EU demand and the appreciation of the exchange rate by about 10% since 2001.

The convergence programme does not provide a detailed forecast of the development of the current account deficit over the programme period. It forecasts a continuous, moderate improvement in the current account deficit. Taking into account the improvement of the capital and financial account benefiting from EU transfers[6], the programme foresees a reduction in the external financing need (from 8% of GDP to about 5% by 2008). Furthermore, it assumes a positive change in the financing structure of the debt. In 2003 debt-creating inflows accounted for nearly two-thirds of financing. In contrast, the convergence programme forecasts a decrease in debt-creating financing due to a drop in the general government borrowing requirement expected for the observed period. These assumptions seem plausible. However, the forecast continuous growth of domestic demand engenders uncertainty about the medium-term dynamics of the private savings-investment balance and increases the risk for higher current account imbalances, which calls even stronger for prudent fiscal policy.

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY





Since spring 2001, the National Bank of Hungary has operated an inflation targeting framework in combination with an exchange rate peg vis-à-vis the euro with a +/-15% fluctuation band around the central parity. Monetary policy has been aiming at controlling inflation by keeping the exchange rate in the upper half of the fluctuation band, while not allowing it to breach the upper limit. With the forint reaching the upper bound in early 2003, policy rates were brought down from 8.5% to 6.5%. In June 2003, the government decided, in agreement with the central bank, to devalue the central parity of the forint by 2.26% in an effort to stop a further appreciation of the currency and to preserve competitiveness. The ensuing capital outflows triggered a depreciation of the forint beyond what was judged to be desirable from the perspective of controlling inflation. Policy rates were increased by a cumulative 300 basis points in June 2003 and again in November to 12.5%. In the first four months of 2004, despite inflationary pressures, the central bank gradually lowered policy rates to 11.5%.

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[6] An increase in EU transfers from 0.5% up to 2% of GDP is expected for the observed period.

The process of gradual disinflation that Hungary had embarked upon since mid-2001 came to a halt in mid-2003, after inflation had reached monthly year-on-year levels below 4%. Inflation started to accelerate following expansionary fiscal and wage policies, the depreciation of the currency since mid-2003 and hikes in unprocessed food prices. It reached 5.7% in December 2003, averaging 4.7% for the year as a whole. In 2004, the pick-up in inflation was reinforced by increases in indirect taxes, which accounted for 40% of the average increase in prices in the first four months of the year. In May 2004, consumer price inflation reached 7.6% percent year-on-year. The convergence programme foresees after a peak in 2004, rapid disinflation to an average of 4½% in 2005 and a level of about 3% in 2008. Assuming no second-round effects of the tax hikes, no significant weakening of the currency from the present level and a tightening of fiscal policy, this is broadly in line with the Commission 2004 Spring forecasts, which project a decline in inflation to 4.6% in 2005.

The 2003 pre-accession programme had set 1 January 2008 as the target date for euro adoption, with the aim of a participation in ERM II as early as possible. Following the budgetary outcome for 2003, the euro adoption strategy was revised. The convergence programme makes reference to the adoption of the euro in 2010 under the baseline scenario (or possibly already in 2009 if economic conditions turn out more favourable than expected), based on the expectation that the budgetary, inflation and other criteria are met in 2008. Moreover, the convergence programme does not contain any more the aim of achieving ERM II membership immediately after EU accession. It Is rather acknowledged that a credible and sustainable fiscal adjustment path is a prerequisite for joining ERM II.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1. Budgetary developments until 2003

Since 1998, the general government deficit has shown large fluctuations, particularly in the last three years. After a process of continuous deficit reduction until 2000, ending with a level of 3.0% of GDP, the general government deficit started to increase again in 2001. In 2002, the deficit peaked at 9.3% of GDP[7]. The large deterioration in Hungarian government finances after 2000 can be explained by the slowdown in economic activity in the years 2001 to mid-2003 and to the implementation of an expansionary fiscal policy in 2001-2002. In particular, there was a significant increase in the current expenditure to GDP ratio, as the public wage bill and social transfers increased by 2 and 1½ percentage points of GDP respectively between 2001 and 2003. However, it is noteworthy that these deficit figures incorporate an increasing annual revenue loss due to the reform of the pension system in 1998[8]. The Hungarian authorities estimated that this additional burden to the general government finances reached 0.7% of GDP in 2003.

[7] This high figure includes statistical operations implying a one-off increase in the deficit by about 3 percentage points of GDP.

[8] Since the reform, a part of the pension contributions flows into the funded pillar outside of the general government instead of the pay-as-you go pillar of the pension system.

Table 3: **General government balance and debt, 1998-2003 (% of GDP)**

	1998	1999	2000	2001	2002	2003
General government balance	-8.0	-5.6	-3.0	-4.4	-9.3	-5.9
General government gross debt	61.9	61.2	55.4	53.5	57.1	59.1
Source: *Commission services*						

In 2003, the general government deficit was reduced from 9.3% in 2002 to 5.9% of GDP. Despite the achieved deficit reduction, the original budgetary target of a deficit of 4.5% of GDP, as well as the revised target set in the 2003 pre-accession economic programme of 4.8% of GDP were exceeded by a large margin, namely by about 1½% of GDP compared to the initial target. This can be attributed to an overrun in general government expenditures. Main reasons for overspending were: (i) higher-than-planned increases in social benefits, mainly in the areas of pension payments[9] and an unexpected contribution to the cost of child care of former years; (ii) a large increase in subsidies notably for housing[10] and prescribed medicines and; (iii) higher-than-forecast interest rate payments[11]. Despite real GDP growth being lower than projected in the 2003 budget and in the 2003 pre-accession programme (growth is now estimated to have reached 2.9% in 2003), developments in overall tax revenues turned out to be better than expected at 44.5% of GDP instead of 43.2% of GDP. This was mostly due to the dynamism of VAT and excise duties (reflecting higher-than-forecast consumption growth) and higher revenues from the simplified corporate tax scheme, which more than compensated for the shortfall in personal income tax, corporate profit taxes and social security contributions.

4.2. Programme overview

The budgetary strategy underlying the programme aims at reducing the general government deficit to below 3% of GDP by 2008. To this end, the programme envisages a frontloaded consolidation with a reduction of the government deficit from 5.9% of GDP in 2003 to 4.6% of GDP in 2004, followed by a yearly adjustment of some ½ percentage point. The cornerstone of the strategy is a consolidation on the expenditure side, based on structural reforms, notably concerning public administration, education and health sectors (general government expenditures[12] would fall from about 50% of GDP in 2003 by some 4% percentage points of GDP until 2008). However, the ratio of public investment to GDP – strongly supported by EU-funds – would still increase during the whole programme period. At the same time, fiscal consolidation is planned to be accompanied by a reduction of the weight of the general government in the economy. This would manifest itself also in a reduction of the overall tax burden.

[9] Higher than forecast real wage growth and inflation implied a retroactive correction of pensions, determined by the Swiss indexation.

[10] A significant tightening of the eligibility criteria of the previously very generous housing subsidy policy was decided in December 2003. This resulted from mid- to end-December 2003 in an unexpected run for housing loans, applications under the old rules. As the rights on these loans have been claimed by the households only in 2004, the full restrictive fiscal effect of this change of eligibility can only be expected from 2005 onwards.

[11] There was an upwards move of the entire yield curve due to a loss confidence in the markets as a result of exchange rate turbulences and fiscal uncertainty. In addition, short-term yields rose following interest rate hikes by a cumulated 600 basis points since June 2003.

[12] including EU transfers

Table 4: Comparison with 2003 pre-accession economic programme and Commission forecasts (% of GDP)

	2003	2004	2005	2006	2007	2008
General government balance						
CP	**-5.9**	**-4.6**	**-4.1**	**-3.6**	**-3.1**	**-2.7**
COM	-5.9	-4.9	-4.3	n.a.	n.a.	n.a.
PEP	*-4.8*	*-3.8*	*-2.8*	*-2.5*	*n.a.*	*n.a.*
General government expenditure						
CP	**50.4**	**48.8**	**47.5**	**46.5**	**46.3**	**46.7**
CP (excluding EU transfers)	**n.a.**	**48.2**	**46.5**	**45.5**	**44.5**	**44**
PEP	*48.0*	*48.2*	*47.0*	*46.1*	*n.a.*	*n.a.*
General government revenues						
CP	**44.5**	**44.2**	**43.4**	**42.9**	**43.2**	**44.0**
CP (excluding EU transfers)	**n.a.**	**43.6**	**42.5**	**41.7**	**41.5**	**41.2**
PEP	*43.2*	*44.4*	*44.2*	*43.6*	*n.a*	*n.a.*

Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

The consolidation pace of some ½ percentage point of GDP from 2005 onwards seems to be on the cautious side, in particular against the background of: (i) robust growth forecast over the entire period; (ii) the relatively high level of the deficit and gross-debt ratios; (iii) the declining interest burden projected in the programme; (iv) the 2003 pre-accession programme adjustment path. However, this has to be seen against a number of other factors. First, it is important for Hungary to restore the credibility of fiscal policy and it is therefore important that objectives are realistic, so that they can be reached. Second, the expenditure cuts are underpinned by structural reforms and take place against the background of increasing public investment. Third, the budget carries the burden of the costs of the pension reform, which are expected to rise from 0.7% in 2004 to 0.9% by 2008.

Nevertheless, the fact that the deficit is planned to be reduced to only marginally below 3% of GDP in 2008 (2.7% of GDP), is a source of concern. Indeed, any unfavourable developments on the macroeconomic or on the budgetary side would rapidly compromise the achievement of this objective. Therefore, the budgetary stance in the programme may not be sufficient to reduce the deficit to the below 3% of GDP deficit threshold by the end of the programme and all opportunities should be seized to strengthen it. Moreover, the attainment of the fiscal consolidation programme relies heavily on the precondition that the 2004 target is met and that growth will develop as favourably as projected. The budgetary strategy of the convergence programme seems reasonable from an economic point of view. It is generally acknowledged that fiscal consolidation is more sustainable when based on expenditure cuts, especially when underpinned by structural reforms. However, while a reduction of the high tax burden seems appropriate, especially on labour, recent experience raises some concerns on the achievability of the expenditure targets, as those of the last two years set by the Hungarian government were missed by a large margin. Furthermore, a deficiency of the programme is that the foreseen expenditure cuts for the period 2005-2008 rely to a significant extent on measures which still have to be designed and implemented, particularly the reform of the public administration and the health insurance system. Therefore, a cautious, gradual approach seems advisable regarding tax cuts, based on the implementation of the planned reform

steps, and conditional upon the attainment of the expenditure and annual deficit targets. Finally, should economic growth fall to rates below what is currently envisaged, additional measures might be needed to achieve the deficit targets.

Table 5: Composition of the budgetary adjustment (% of GDP)

	2003	2004	2005	2006	2007	2008	Change: 2008-2003
Revenues	**44.5**	**44.2**	**43.4**	**42.9**	**43.2**	**44.0**	**-0.5**
of which:							
- Taxes & social security contributions	39.2	39	37.9	37.5	37.3	37	-2.2
- Other	5.3	5.2	5.5	5.4	5.9	7.0	1.7
Expenditure	**50.4**	**48.8**	**47.5**	**46.5**	**46.3**	**46.7**	**-3.7**
of which:							
- Primary expenditure	46.3	44.4	43.4	42.5	42.8	43.5	-2.8
of which:							
Gross fixed capital formation	4.0	4.0	4.4	4.8	5.0	5.5	1.5
Collective consumption	7.9	7.2	6.9	6.6	6.5	6.4	-1.5
Social benefits in kind and other than in kind & subsidies	28.5	27.8	27.0	26.3	25.5	24.6	-3.9
Other	5.9	5.4	5.1	4.8	5.8	7.0	1.1
- Interest payments	4.1	4.4	4.1	3.8	3.5	3.2	-0.9
Budget balance	**-5.9**	**-4.6**	**-4.1**	**-3.6**	**-3.1**	**-2.7**	**3.2**
Primary balance	**-2.0**	**-0.5**	**-0.2**	**0.1**	**0.3**	**0.4**	**2.4**
Sources: *Convergence programme; ECFIN calculations*							

4.3. Targets and adjustment in 2004

Most of the deficit reduction targeted in the original budget was to be achieved through tight expenditure control. The budget included notably a real wage freeze in the public sector, which, together with the ongoing reduction of the number of public employees, should trigger a significant deceleration in the increase of the public wage bill. On the revenue side, the 2004 budget incorporated a tax reform which came into effect at the beginning of 2004. While direct tax rates (both personal income and corporate taxes) were lowered[13], numerous tax allowances and credits were eliminated to compensate for the loss of fiscal revenues and to increase the transparency in the tax system. Furthermore, lower VAT rates were raised. Overall, the tax burden was foreseen to remain stable.

In January 2004, after re-assessing the risks on the expenditure and revenue sides, the original general government deficit target of 3.8% of GDP for 2004 was revised to 4.6% of GDP. At the same time, the government adopted a series of expenditure freezes of 1.1% of GDP relative to the budget baseline. Since January, the government has taken further measures aimed at supporting its expenditure control strategy. In particular, in March 2004 the government decided a freeze of subsidies for prescribed pharmaceutical products. The targeted fiscal consolidation from 5.9% of GDP in 2003 to 4.6% in 2004 is an ambitious step in the right direction. However, a slippage compared with the revised

[13] The marginal rates for personal income taxes were reduced and bands were increased. The rate of corporate taxes was reduced from 18% to 16%.

expenditure forecast might still occur. The Commission Spring forecast[14] projected a deficit of 4.9% of GDP for 2004.

Nevertheless, meeting the target for 2004 seems crucial. Beside its importance for restoring the credibility of fiscal policy, the strategy of gradual consolidation from 2005 onwards relies heavily on the precondition that the 2004 target is met – given its relevance as an anchor for the following years. Furthermore, about 70% of the debt service falls due in the years to 2008, with a significant share due in 2005 and 2006. Given that a large share will be in longer-term maturities with fixed interest rates, it is in Hungary's financial interest to front load the consolidation effort in order to reduce the interest rate burden for the coming years. Therefore, it is to be welcomed that the government has indicated its intention to adopt additional corrective measures on the expenditure side, if they appear necessary. These measures should be adopted well in time in order to prevent a repetition of the situation of 2003, where the slippage became evident when it was already too late to take appropriate measures.

4.4. Targets and adjustment in 2005 and beyond

The gradual and even deficit reduction of some ½ percentage point of GDP annually after the front-loaded consolidation of 2004 would lead to a general government deficit of 2.7% of GDP in 2008. As this pace of consolidation seems to be on the cautious side for the period from 2005 onwards and the budgetary stance in the programme may not be sufficient to reduce the deficit to the below 3% of GDP deficit threshold by the end of the programme, all opportunities should be seized to strengthen it. It is noteworthy that the share of government investment expenditures is foreseen to be raised from 4% to 5.5% of GDP between 2004 and 2008 (essentially driven by transfers from the EU), while most of the reduction in the deficit is planned to be achieved through a tight control of expenditures (general government expenditures, without EU transfers, would fall at the same time from 48.2% of GDP to 44% of GDP). Beside a decrease of interest expenditures by some 1 percentage point between 2003 and 2008, the reduction would manifest itself mainly in public administration, education and the health care sector. A significant reduction of employment in the public administration was carried out at the end of 2003[15], with a deficit reducing effect from 2004 onwards. Furthermore, based on an ongoing review of the current system, a rationalisation of budgetary appropriations is foreseen to result in – not further quantified - savings. Apart from these indications, there is barely any information on the implementation and the quantitative effect of the indicated structural reforms behind the expenditure savings. The convergence programme reveals only that savings should result in a drop of collective consumption and social benefits in kind by 1.2 and 1.9 percentage points, respectively, between 2004 and 2008.

At the same time, with a view to reducing the average tax burden, which is generally considered as too high, and to improving competitiveness, the convergence programme foresees a reduction in the tax burden. Apart from general intentions to further simplify

[14] While the Parliament decided for a second time on a temporary freeze of pharmaceutical prices after the suspension of the Constitutional Court of its previous decision, this second freezing might be suspended again. This in turn, might endanger the deficit target (the overspending on pharmaceutical subsidies in 2003 was 0.2% of GDP).

[15] Based on a Government resolution from October 2003, the reduction in public employment (10% in ministries and 6% in public background institutions) took already place until the end of 2003.

the tax system and make it more transparent, the programme envisages the following concrete, though unquantified tax related measures: (i) a reduction in the average tax burden of personal income tax, (ii) a gradual reduction in the total tax burden for enterprises (while maintaining the recently decreased corporate profit tax rate of 16%), and (iii) a reduction of the social security burden, mainly on employers', also with a view to promoting employment. As a result, tax and tax-type revenues are planned to be reduced to 37% of GDP by 2008 from the present 39%.

4.5. Debt ratio

Under the programme's projections, the debt, which reached 59.1% at the end of 2003, will remain below 60% of GDP throughout the period covered. After a peak just below 60% of GDP in 2004, a gradual reduction would start in 2005 towards 54% by 2008, in line with the planned budgetary adjustment but also benefiting from a falling interest burden and negative stock-flow adjustments.

Provided that the consolidation takes place as planned, and assuming no significant weakening of the exchange rate and the foreseen reduction of the interest burden, this seems plausible.

Table 6: Debt dynamics

	2003		2004		2005		2006	2007	2008
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**CP**	**CP**	**CP**
Government gross debt ratio	59	59.1	58.7	59.4	58.0	57.9	56.8	55.6	53.7
Change in debt ratio (1 = -2+3+6)	1.9	2.1	-0.3	0.3	-0.7	-1.5	-1.1	-1.2	-1.9
Contributions:									
- primary balance (2)	-1.8	-2.0	-0.9	-0.5	-0.5	-0.2	0.1	0.3	0.4
- snow-ball effect (3 = 4+5)	-1.5	-1.7	0.0	-1.0	-1.0	-0.7	-0.7	-0.7	-0.9
- interest expenditure (4)	4.1	3.9	4.0	4.1	3.8	3.9	3.7	3.4	3.1
- nominal GDP growth (5)	-5.6	-5.6	-4.0	-5.1	-4.8	-4.6	-4.4	-4.1	-4.0
- stock-flow adjustment (6)	1.6	1.8	-1.2	0.8	-0.2	-1.0	-0.3	-0.2	-0.6

Sources:
Convergence programme (CP); Commission services spring 2004 forecast (COM); ECFIN calculations
Note:
The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} + \frac{SF_t}{Y_t}$$

where t is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and *i* and *y* represent the average cost of debt and nominal GDP growth

5. THE QUALITY OF THE PUBLIC FINANCES

The budgetary adjustment is to a significant extent foreseen to be achieved through a reduction in the expenditure-to-GDP ratio. It is generally acknowledged that fiscal consolidation is more sustainable when based on expenditure cuts, especially when underpinned by structural reforms. The programme mentions a comprehensive reform of the public sector (on general and local government levels) with the aim to improve its efficiency, and the government plans a comprehensive reform of the health sector. It is also noteworthy that despite the cut in expenditures, the programme foresees a significant increase of investment expenditure over the period (supported by EU-transfers). This is particularly important, given Hungary's catching-up status in terms to infrastructure

compared to the EU average. Concerning the planned tax cuts, the reduction of the high tax burden on labour should contribute to employment growth.

However, in order to assess the intended reform measures, further details and specifications of the planned measures would be needed. Their specification and subsequent implementation seem particularly important, as they are the basis for the significant expenditure cuts from 2005 onwards.

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The section on the long-term sustainability of public finances of the Hungarian convergence programme includes only little information on long-term demographic developments and projections for public pension expenditures.

According to the programme, the old-age dependency ratio is set to worsen substantially in the long term (from 32.6% in 2004 to 53.4% in 2050). In order to curtail demographic pressure resulting from an aging population on future economic prospects, the Hungarian authorities have increased the retirement age. This should be beneficial for the total participation rate which is planned to increase, thereby temporarily reversing the unfavourable demographic dynamics and slightly delaying the effects of ageing. Given that in the programme no projections are available on the trends of other age-related expenditures such as health care or education, it is impossible to estimate the overall pressure on the long-term sustainability of public finances resulting from population ageing in Hungary.

In order to reduce the budgetary impact of ageing, the Hungarian authorities have continuously adjusted the pension system to the ongoing demographic changes. This does not only include parametric changes to the pay-as-you-go pillar (e.g. increase in the retirement age, pension indexation – 50% wage increase, 50% inflation) but also the establishment of a progressive multi-tier pension system. A further restructuring of the health care system is required if its sustainability is to be maintained beyond 2050. Currently, only measures of a short-term nature are being implemented to curtail the expenditures in line with the budgetary requirements, whereas durable reduction in the expenditures should result from the envisaged reform of the health care system. In addition, measures related to the labour market (the foreseen reduction of social security burden) should contribute to increased employment rates and hence to the long-term sustainability of public finances.

Summing up, especially in view of the relatively high debt level, Hungary faces some risk of budgetary imbalances in meeting the projected costs of an aging population. While the progressive three-tier pension system has significantly mitigated the risks of long-term budgetary imbalances, it has not removed them entirely. Securing an adequate primary surplus in the medium term together with the implementation of measures to further stem the rise of age-related expenditure, particularly concerning health care is essential to place public finances on a sustainable basis.

* * *

ANNEX: SUMMARY TABLES FROM THE CONVERGENCE PROGRAMME

Table 1. Growth and associated factors

	2003	2004	2005	2006	2007	2008
GDP *growth* at *constant* market prices (7+8+9)	2.9	3.3-3.5	3.5-4	ca.4	4-4.5	4.5-5
GDP *level* at *current* market prices	18573.9	20300-20400	22000-22100	23800-23900	25700-25800	27700-27800
GDP deflator	7.8	ca.6	ca.4.5	ca.4	ca.3.5	ca.3
HICP change	4.7	ca.6.5	ca.4.5	ca.4	ca.3.5	ca.3
Employment growth	1.0	0-0.5	0.5-1	ca.1	ca.1	ca.1.5
Labour productivity growth	1.9	3-3.5	ca.3	ca.3	3-3.5	3-3.5
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure	7.6	1.5-2	ca.3	3-3.5	ca.3.5	ca.4
2. Government consumption expenditure	1.8	ca.-1.5	ca.-1.5	ca.0.5	0.5-1	0.5-1
3. Gross fixed capital formation	3.0	6-8	6-8	6-8	7-9	8-10
4. Changes in inventories and net acquisition of valuables as a % of GDP	1.2	ca.2	ca.2.5	ca.3	3-3.5	3-3.5
5. Exports of goods and services	7.2	8-10	9-11	8-10	8-10	8-10
6. Imports of goods and services	10.3	7-9	9-11	8-10	8-10	8-10
Contribution to GDP growth						
7. Final domestic demand (1+2+3)	5.4	2-2.5	3-3.5	3.5-4	4-4.5	4.5-5
8. Change in inventories and net acquisition of valuables (=4)	0.3	0.5-1	0.5-1	ca.0.5	ca.0.5	ca.0
9. External balance of goods and services (5-6)	-2.8	0-0.5	-0.5-0	-0.5-0	-0.5-0	-0.5-0

Table 2. General government budgetary developments

% of GDP	2003	2004	2005	2006	2007	2008
Net lending by sub-sectors						
1. General government	-5.9	-4.6	-4.1	-3.6	-3.1	-2.7
2. Central government	-4.3	-3.0	-2.5	-1.6	-1.1	-0.8
3. State government	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	0.2	0.0	-0.2	-0.4	-0.3	-0.3
5. Social security funds	-1.8	-1.5	-1.4	-1.6	-1.6	-1.7
General government						
6. Total receipts	44.5	44.2	43.4	42.9	43.2	44.0
7. Total expenditures	50.4	48.8	47.5	46.5	46.3	46.7
8. Budget balance	-5.9	-4.6	-4.1	-3.6	-3.1	-2.7
9. Net interest payments	-3.9	-4.1	-3.9	-3.7	-3.4	-3.1
10. Primary balance	-2.0	-0.5	-0.2	0.1	0.3	0.4
Components of revenues						
11. Taxes	26.6	26.4	25.7	25.6	25.6	25.4
12. Social contributions	12.6	12.6	12.2	11.9	11.7	11.6
13. Interest income	0.2	0.3	0.2	0.1	0.1	0.1
14. Other	5.1	4.9	5.3	5.3	5.8	6.9
15. Total receipts	44.5	44.2	43.4	42.9	43.2	44.0
Components of expenditures						
16. Public consumption	7.9	7.2	6.9	6.6	6.5	6.4
17. Social transfers in kind	11.8	11.3	10.8	10.5	10.2	9.9
18. Social transfers other than in kind	13.4	13.4	13.1	12.8	12.5	12.1
19. Interest payments	4.1	4.4	4.1	3.8	3.5	3.2
20. Subsidies	3.3	3.1	3.1	3.0	2.8	2.6
21. Gross fixed capital formation	4.0	4.0	4.4	4.8	5.0	5.5
22. Other	5.9	5.4	5.1	4.8	5.8	7.0
23. Total expenditures	50.4	48.8	47.5	46.5	46.3	46.7

Table 3. General government debt developments

% of GDP	2003	2004	2005	2006	2007	2008
Gross debt level	59.1	59.4	57.9	56.8	55.6	53.7
Change in gross debt	2.1	0.3	-1.5	-1.1	-1.2	-1.9
Contributions to change in gross debt						
Primary balance	2.0	0.5	0.2	-0.1	-0.3	-0.4
Interest payments	3.9	4.1	3.9	3.7	3.4	3.1
Nominal GDP growth	-5.6	-5.1	-4.6	-4.4	-4.1	-4.0
Other factors influencing the debt ratio [1]	1.8	0.8	-1.0	-0.3	-0.2	-0.5
Of which: Privatisation receipts	-0.3	-0.8	-0.7	0.0	0.0	0.0
p.m. implicit interest rate on debt	8.1	7.7	7.3	7.1	6.6	6.2

[1] Stock-flow adjustment

Table 4. Cyclical developments

% of GDP	2003	2004	2005	2006	2007	2008
1. GDP growth at constant prices	2.9	3.3	3.6	4.0	4.3	4.7
2. Actual balance	-5.9	-4.6	-4.1	-3.6	-3.1	-2.7
3. Net Interest payments	-3.9	-4.1	-3.9	-3.7	-3.4	-3.1
4. Potential GDP growth	3.5	3.6	3.7	3.9	4.1	4.2
5. Output gap	-0.1	-0.4	-0.5	-0.5	-0.3	0.1
6. Cyclical budgetary component	0.0	-0.1	-0.2	-0.1	-0.1	0.0
7. Cyclically-adjusted balance (2-6)	-5.9	-4.5	-3.9	-3.5	-3.0	-2.7
8. Cyclically-adjusted primary balance (7-3)	-2.0	-0.4	0.0	0.2	0.4	0.4

Table 5. Divergence from previous update

% of GDP	2003	2004	2005	2006	2007	2008
GDP growth						
PEP [1]	ca.3.5	ca.3.5	4-4.5	4.5-5	n.a.	n.a.
CP [2]	2.9	3.3-3.5	3.5-4	ca.4	4-4.5	4.5-5
Difference	ca.-0.6	ca.-0.2-0	-1-0	ca.-0.5--1	n.a.	n.a.
Actual budget balance						
PEP [1]	-4.8	-3.8	-2.8	-2.5	n.a.	n.a.
CP [2]	-5.9	-4.6	-4.1	-3.6	-3.1	-2.7
Difference	-1.1	-0.8	-1.3	-1.1	n.a.	n.a.
Gross debt levels						
PEP [1]	57.5	57.2	55.3	54.0	n.a.	n.a.
CP [2]	59.1	59.4	57.9	56.8	55.6	53.7
Difference	1.6	2.2	2.6	2.8	n.a.	n.a.

[1] PEP, August 2003
[2] CP, May 2004

Table 6. Long-term sustainability of public finances [1]

% of GDP	2004	2005	2010	2020	2030	2040	2050	2060	2070
Total expenditure	48.8	47.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Old age pensions	8.0	n.a.	6.9	7.6	n.a.	n.a.	11.0	n.a.	n.a.
Health care (including care for the elderly)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Transfers payments [2]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total revenues	44.2	43.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which: Tax on net pension payments	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
National pension fund assets [3]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Assumptions [4]									
Nominal GDP per person employed	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Nominal GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rate males (aged 20-64)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rates females (aged 20-64)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total participation rates (aged 20-64)	n.a.	61-61.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate	n.a.	5.8-6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

[1] Level for 2003, and per cent changes compared to 2003 thereafter
[2] Transfers from social security funds (ATP etc.) are not included.
[3] Percentage of GDP
[4] Percentage change

Table 7. Basic assumptions

	2003	2004	2005	2006	2007	2008
Short-term interest rate (annual average)	8.16	10.5	8.0	6.5	5.5	5.5
Long-term interest rate (annual average)	6.82	7.5	6.5	6.25	6.25	6.25
United States: short-term (three-month money market)	1.2	1.2	1.7	n.a.	n.a.	n.a.
United States: long term (10-year government bonds)	4.0	4.2	4.6	n.a.	n.a.	n.a.
USD/€exchange rate (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
HUF/€exchange rate (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
World GDP growth, excluding EU	4.4	5.1	4.7	4.7	4.5	4.4
United States, GDP growth	3.1	4.2	3.2	3.2	3.0	2.9
Japan, GDP growth	2.7	3.4	2.3	2.0	2.0	2.0
EU-15 GDP growth	0.8	2.0	2.4	2.6	2.4	2.2
Growth of relevant foreign markets	3.1	6.0	7.0	7.0	6.6	6.6
World import volumes, excluding EU	7.3	9.7	8.5	8.5	8.0	8.0
World import prices (goods, in USD)	8.8	6.4	0.7	3.0	3.0	3.0
Oil prices (Brent, USD/barrel)	28.5	31.1	28.9	28.0	28.0	28.0
Non-oil commodity prices (in USD)	6.6	15.6	-2.6	3.0	3.0	3.0