EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 10.10.2006
ECFIN/55812/06-EN

SEPTEMBER 2006 ADJUSTED UPDATE OF THE CONVERGENCE PROGRAMME OF HUNGARY (2005-2009)

AN ASSESSMENT

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not. On 24 January 2006, the Council adopted an opinion on convergence programme update of 1 December 2005, it considered that the budgetary consolidation in this update was not backed by concrete measures and invited Hungary to "present as soon as possible and by 1 September 2006 at the latest an adjusted convergence programme update which identifies concrete and structural measures that are fully consistent with its medium-term adjustment path". Hungary submitted the adjusted convergence programme update on 1 September 2006.

The attached technical analysis of the adjusted programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs of the European Commission, was finalised on 10 October 2006. Comments should be sent to László Jankovics (laszlo.jankovics@ec.europa.eu) and Júlia Lendvai (julia.lendvai@ec.europa.eu). The main aim of the technical analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

Based on this technical analysis, the European Commission adopted an assessment of the programme as well as a recommendation for a Council opinion on the programme on 26 September 2006. The ECOFIN Council adopted its opinion on the programme on 10 October 2006.

* * *

All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

Table of contents

SUMMARY AND CONCLUSIONS[1]

1. On 1 September 2006, Hungary submitted an adjusted convergence programme update (hereafter referred to as the programme) to the Council and the Commission. The programme covers the period from 2005 to 2009, but also refers to the years 2010 and 2011. It broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct.[2]

2. Following the adoption of a comprehensive economic reform package in the mid-nineties, the Hungarian economy enjoyed stable and relatively high rates of growth and a reduction in inflation supported by sound macroeconomic policies and appropriate structural reforms. However, starting from 2001 and more importantly over recent years, significantly increased public expenditure and generous public wage increases resulted in budget deficits well over 5% of GDP over the past four years, producing large deviations compared to the original deficit targets. In addition, end-year estimates were substantially increased ex-post with virtually every fiscal notification. Instead of the planned deficit targets contained in the May 2004 convergence programme of 4.6% of GDP in 2004, 4.1% of GDP in 2005 and 3.6% of GDP in 2006, the outcome was 6.6% of GDP in 2004, 7.5% of GDP in 2005 and is expected by the Government to be around 10.1% of GDP in 2006, by far the highest level in the EU (all numbers including pension reform burden). A large part of the budgetary slippages stemmed from overoptimistic budgetary planning, large expenditure overruns, tax cuts and the overall lack of sufficient structural adjustment efforts. This highly expansionary fiscal policy has considerably damaged the credibility of the fiscal policy and has been weighing increasingly on the economy. In particular, it has contributed to serious external imbalances and to a significant increase in the total foreign debt (from below 20% of GDP in 2001 to close to 30% of GDP in 2005) and much higher interest rate spreads compared to other recently acceded Member States.

3. In the adjusted programme, real GDP growth is projected to fall back in the coming years from 4.1% in 2006 to 2.2% and 2.6% in 2007 and 2008, respectively, due to the contractionary impact of the fiscal adjustment measures

---

[1] This technical analysis, which is based on information available up to 10 October, accompanies the recommendation by the Commission for a Council opinion on the update of the convergence programme, which the College adopted on 26 September 2006. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to László Jankovics (laszlo.jankovics@ec.europa.eu) and Júlia Lendvai (julia.lendvai@ec.europa.eu). The analysis takes into account (i) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005); (ii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and (iii) the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008 as part of the Reinforced Lisbon Strategy (OJ L 205/28, 6.8.2005) and the National Reform Programme of October 2005.

[2] The programme provides all compulsory data prescribed by the new code of conduct. Some optional data are missing. They mainly concern the general government expenditure by function, government debt developments and data on long-term sustainability of public finances.

set out in the programme, some of which have already been implemented from July 2006. Growth is expected to recover to pre-adjustment levels by 2009. These developments are also reflected in the implicit cyclical conditions, which show negative output gaps for the years 2007 and 2008 and the return of output to its potential level by 2009. Based on currently available information and without prejudging the Commission services' Autumn 2006 forecast, this macroeconomic scenario appears broadly plausible. However, it is somewhat optimistic concerning growth in 2009 and regarding the employment developments, especially in the outer years, that do not appear to be affected by the slowdown in growth and the planned cut in public employment. The significant improvement of the external balances expected in the programme seems plausible in view of both the direct and the indirect effects of the fiscal adjustment measures. In particular, the current account deficit is expected to decrease from close to 8% of GDP in 2006 to less than 4% of GDP in 2009. Inflation is projected to peak at 6.2% in 2007 after 3.5% in 2006 and to decrease to 3% by 2009. The projected pattern can be explained by the VAT increase (adopted by Parliament on 10 July 2006) and decreases in price subsidies (adopted by ministerial decree on 30 June), as well as by other measures contained in the programme that create inflationary pressures by increasing factor costs (e.g. increases of personal income tax and social contributions). However, inflation seems somewhat underestimated over the entire horizon.

4. The Hungarian authorities have officially abandoned 2010 as the target for euro adoption but have not yet announced a new one. Hungarian monetary policy continues to combine inflation targeting with an exchange rate band. Since February 2006, the forint/euro exchange rate has weakened substantially, by nearly 10%, amidst a receding risk appetite affecting emerging markets globally and concerns among investors about the fiscal situation in Hungary. Bond yield spreads with the euro area also widened in the summer, to around 350 basis points, partly in response to concerns among investors about the extent and feasibility of planned fiscal adjustment. Monetary policy reacted to the upward risks to inflation and to unfavourable financial market developments by increasing the base rate by 175 basis points in four steps to 7.75 % between mid-June and end-September 2006. The currency has stabilised since the beginning of August. The programme’s assumptions on interest rates appear to be on the low side, especially in view of the upside risks to the baseline inflation projections.

5. After a general government deficit outcome of 7.5% of GDP in 2005 (reported in Spring 2006), the Hungarian authorities announced following the April 2006 general elections that there would be very large upward revisions of the 2006 deficit which could reach, in the absence of corrective steps, 11.6% of GDP[3]. The overshoot compared to the deficit target of 6.1% of GDP set in the budget

---

[3] After the submission of the 2004 update of the convergence programme in December 2004 the Hungarian authorities decided to report fiscal targets and statistics excluding the cost of pension reform. The adjusted convergence programme update has discontinued this practice; Hungary has therefore decided to no longer benefit from the transitory period on the sectoral classification of pension schemes granted by Eurostat on 23 September 2004 that will in any case expire on 1 April 2007. Without the pension reform burden, the deficit outcome in 2005 would have been 6.1% of GDP and the target for 2006 would have been 4.7% of GDP.

law for 2006 and in the 2005 December convergence programme update took place almost entirely on the expenditure side (around 5% of GDP). It mainly occurred in the areas of operational and wage costs of central budgetary institutions, pension payments, health-care expenditure and because of higher-than-expected investment of local governments due to the electoral cycle. Around 1½% of GDP of the overshoot is explained on the one hand by the accounting of motorway investment inside the general government (1.1% of GDP), which originally was planned to be undertaken by PPPs (public private partnerships) to be recorded off budget, and on the other hand by the costs of military aircraft (0.3% of GDP) purchased under a financial lease. Both of these outlays were not included originally in the official target figure.

6. In June, facing a spiralling budget deficit, the new Government - in office since June following the April 2006 general elections - withdrew the remainder of its five-year tax cut programme which would have further lowered revenues by around 3% of GDP by 2010[4], and adopted a corrective fiscal package. A number of the corrective measures, including all those on the revenue side, have already been adopted by Parliament. The tax increases, together with some immediate cuts in health-care expenditure, gas price subsidies, public administration expenditure and the full withdrawal of the 0.3% of GDP general reserve of the budget, are expected by the Government to reduce the deficit overrun in 2006 by 1.5% of GDP, in order to achieve the new deficit objective which, however, at 10.1% of GDP, remains very high. These measures are also expected to produce important effects over future years.

7. The adjusted convergence programme update of September 2006 aims to correct the excessive deficit by 2009. This would be achieved by a steep and front-loaded deficit reduction of 6.9 percentage points of GDP within three years, from the high starting position of 10.1% of GDP in 2006 to 3.2% of GDP in 2009. The improvement in the primary balance over the period is of the same magnitude. The programme recognises that the deficit target of 3.2% of GDP in 2009 would still exceed the 3% of GDP threshold specified in the Treaty, but assumes that the Council and the Commission, when considering the case for an abrogation of the excessive deficit procedure for Hungary, could take into account a part of the net cost of the pension reform, in line with the revised Stability and Growth Pact.[5] Nearly half of the reduction in the deficit ratio is already to take place in 2007. The planned reduction in the nominal deficit is to be achieved by increasing the revenue-to-GDP ratio by 3 percentage points and by reducing the expenditure-to-GDP ratio by 3.9 percentage points over the programme period. As far as the revenue side is concerned, all revenue increases underpinning the projected rise in the programme's revenue-to-GDP ratio have been adopted. On top of the above-mentioned already adopted expenditure cuts,

---

4 The five-year tax cut strategy was approved by the parliament on 7 November 2005, and the first steps (most notably a 5 percentage points cut in the upper VAT rate) became effective on 1 January 2006 and led to revenue losses of around 1% of GDP in 2006.

5 According to Council Regulation (EC) No 1056/2005, Article 1 paragraph 7, if the general government deficit "…has declined substantially and continuously and has reached a level that comes close to the reference value", the Council and the Commission should consider degressively the net cost of a pension reform that includes a fully-funded pillar. For Hungary, this would correspond in 2009 to 20% of the net cost of the pension reform or an estimated 0.3% of GDP.

the Hungarian authorities plan to achieve their targets by improving budgetary discipline (through more transparent accounting, as well as the introduction of multi-annual spending caps and an expenditure rule). These plans are expected to be included and fully spelled out in the 2007 budget law which will be presented to Parliament by end-October. Moreover, the programme announces comprehensive structural reforms aimed at ensuring the achievement of the deficit targets, especially in the outer years of the programme (such as the introduction of co-payments schemes in the health-care sector, the revamping of price subsidies and a streamlining of the central public administration).

8. According to the calculations carried out by the Commission services on the basis of information provided in the programme and the commonly agreed methodology, the structural deficit (in cyclically-adjusted terms and net of one-off and other temporary measures), following an estimated deterioration in 2006 by some 2% of GDP, would fall from 9¾% of GDP in 2006 to 3¼% in 2009, with an annual improvement of around 2¼% of GDP on average over the period. The programme identifies the medium-term objective (hereafter MTO) for the budgetary position as meant in the Stability and Growth Pact as a structural deficit between 0.5% and 1% of GDP, which it does not aim to achieve within the programme period. The MTO lies within the range indicated in the Stability and Growth Pact and the code of conduct and adequately reflects long-term potential output growth and the debt ratio, but it would not be achieved within the programme period.

9. Regarding the budgetary outcome, there are a number of elements on the positive side. A large part of the measures to back the reduction of the deficit in 2006 and 2007 are either already adopted or planned to be incorporated into the 2007 budget. In addition, in recent months the Government has taken decisions on some initial steps of the planned structural reforms. Moreover, the Hungarian authorities have decided to improve the budgetary process by introducing an expenditure-control rule from 2007 onwards and multi-annual expenditure planning for budgetary institutions; they also commit themselves in the programme to report twice a year to the Commission and the Council on budgetary developments and announce corrective steps in case of slippages. However, there are also important risks. There is still some uncertainty about the effective enforcement of the planned expenditure freezes in 2007 and 2008 and about containing expenditure increases in areas not covered by the freezes. In addition, despite the planned measures, the achievement of the budgetary targets in the outer years could be subject to important risks. Although the risks to the revenue side stemming from the macroeconomic scenario appear on the whole broadly balanced, the expected revenues in the outer years and especially in 2009 are rather optimistic which is also linked to the rather optimistic employment projections. Moreover, apart from the poor track-record in expenditure control and the lack of precise information about how it will be achieved in the future, the weak institutional control of the budgetary process exposes public finances to substantial slippages. Therefore the envisaged deficit reduction is contingent on the rigorous implementation of the envisaged structural reforms and expenditure control from the early years of the programme. Finally, it cannot be excluded that the almost 2% of GDP debt accumulated by the public transport companies since end 2002 will be assumed by the Government (given that this has happened at regular intervals in the past); this would have a temporary effect on the deficit. Overall, the budgetary

outcome could be worse than projected in the programme, both in the short term and in the outer years of the programme.

10. In view of the risk assessment above, the planned correction of the excessive deficit by 2009 on a sustainable basis requires the Government to strictly achieve the budgetary targets. This hinges upon an effective implementation of all the measures announced in the programme for the years 2006 to 2009, as well as upon timely decisions on and implementation of structural reforms and expenditure control.

11. The debt-to-GDP ratio, according to the programme projections, would significantly increase in 2006 to 68.5% (from 62.3% in 2005) and further to 71.3% in 2007 and to 72.3% in 2008. The ratio is expected to start decreasing only in 2009 to 70.4%. The dynamics presented in the programme are in sharp contrast to the previous update, which anticipated the debt-to-GDP ratio, if the pension burden is included, to be in the range of 61-63% of GDP throughout the programme horizon. The update does not foresee any major operations (such as privatization or debt assumption) with a large impact on the debt. Risks to the envisaged debt path mainly stem from the above-mentioned risks of higher-than-projected deficits including due to the possible assumption of the debt of the public transport companies. In view of this risk assessment, the debt ratio does not seem to be sufficiently diminishing towards the reference value.

12. Hungary appears to be at high risk with regard to the sustainability of public finances[6]. The very weak budgetary position, in conjunction with the relatively high and rising debt ratio, constitutes a notable risk to sustainable public finances even before considering the long-term budgetary impact of an ageing population. Moreover, the long-term budgetary impact of ageing in Hungary is well above the EU average, influenced notably by a significant increase in pension expenditure as a share of GDP over the long-term. Carrying out a large consolidation of the public finances over the medium-term as planned and further strengthening the budgetary position thereafter is therefore necessary if these risks are to be reduced.

13. While there has been a serious deterioration in public finances in 2005 and especially 2006, hampering the correction of the excessive deficit in line with the planned path, the measures envisaged in the programme, if fully specified and implemented, are largely consistent with the broad economic policy guidelines included in the integrated guidelines.[7] In particular, Hungary plans to take effective actions to correct the excessive deficit and to implement reforms in order to strengthen fiscal discipline and to increase transparency. These measures should also contribute to correcting the high current account deficits. However, they need to be backed up by structural reforms to ensure fiscal sustainability.

---

[6] Details on long-term sustainability are provided in the technical assessment of the programme by the Commission services (http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm).

[7] On July 2005, the broad economic guidelines were integrated into the integrated guidelines as part of the Reinforced Lisbon Strategy (OJ L 205/28, 6.8.2005)

14. With the Implementation Report to be submitted by mid-October 2006 in the context of the renewed Lisbon strategy for growth and jobs, the Hungarian Government is planning to substantially revise reform plans contained in the October 2005 National Reform Programme (NRP), so as to reflect the Government's new strategy. The October 2005 NRP identified the following key challenges with significant implications for public finances: (a) to reduce the fiscal deficit, (b) to improve infrastructure and (c) to increase the activity and the employment rate and enhance human capital. The adjusted convergence programme update outlines plans and measures to restructure the public administration, health-care, pension and public education systems. In particular, by 2007, the programme plans to take measures to reduce the size of the public administration and improve its efficiency by exploiting economies of scale; to introduce means-testing in subsidies; to restructure pharmaceutical subsidies and to partly liberalise the trade of pharmaceutical products; to introduce co-payments for health-care services. In addition, by 2007, proposals for law amendments are to be submitted to the parliament aiming at increasing the retirement age and decreasing early retirement by improving the incentive schemes and by revamping the disability pension system; at putting health-care services on strict insurance basis and at rationalising the provision and the use of these services; at restructuring public education. These plans are still to be substantiated. The programme complements these plans by envisaged improvements to the institutional features of the public finance framework.

In view of the above assessment, the state of the Hungarian public finances, and in particular the high deficit expected for 2006, is a matter for serious concern. It is therefore to be welcomed that in the adjusted convergence programme update of September 2006 the Hungarian authorities give priority to the reduction of the excessive deficit through a substantial front-loaded effort and commit to reporting to the Commission and Council twice a year on progress and on actions taken to stay on track. While important first steps have been taken to secure additional revenues and cut expenditures with a view to reaching the new 2007 deficit target and plans have been announced to improve expenditure control and undertake structural reforms so as to back the adjustment path, risks with respect to meeting the adjustment path remain in both the short term and the outer years of the programme. The envisaged deficit reduction is therefore contingent on the rigorous implementation of the envisaged structural reforms, on the enforcement of expenditure controls from the early years of the programme, as well as on a reinforcement of the institutional set-up of public finances in Hungary, all aspects on which it would be appropriate to for the Hungarian government to ensure the highest effort.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009
Real GDP (% change)	**CP Sep. 2006**	**4.1**	**4.1**	**2.2**	**2.6**	**4.1**
	CPDec. 2005	4.2	4.3	4.1	4.1	n.a.
	CP Dec. 2004	*4.0*	*4.2*	*4.3*	*4.6*	*n.a.*
HICP inflation (%)	**CP Sep. 2006**	**3.6**	**3.5**	**6.2**	**3.3**	**3.0**
	CP Nov. 2005	3.5	2.1	3.0	2.4	n.a.
	CP Dec. 2004	*4.5*	*4.0*	*3.5*	*3.0*	*n.a.*
Output gap (% of potential GDP)	**CP Sep. 2006[1,4]**	**0.3**	**0.8**	**-0.3**	**-0.9**	**0.0**
	CP Dec. 2005[1]	-1.0	-0.5	-0.1	0.4	n.a.
	CP Dec. 2004[1]	*-1.0*	*-0.8*	*-0.4*	*-0.2*	*n.a.*
General government balance (% of GDP)	**CP Sep. 2006**	**-7.5**	**-10.1**	**-6.8**	**-4.3**	-3.2
	CPDec. 2005	-7.4	-6.1	-4.7	-3.4	n.a.
	CP Dec. 2004	*-4.7*	*-4.1*	*-3.4*	*-2.8*	*n.a.*
Primary balance (% of GDP)	**CP Sep. 2006**	**-3.4**	**-6.3**	**-2.4**	**-0.2**	0.8
	CPDec. 2005	-3.8	-2.9	-1.7	-0.7	n.a.
	CP Dec. 2004	*-0.9*	*-0.7*	*-0.3*	*0.1*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Sep. 2006**	**-7.6**	**-10.5**	**-6.7**	**-3.9**	**-3.2**
	CPDec. 2005	n.a.	n.a.	n.a.	n.a.	n.a.
	CP Dec. 2004	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Structural balance[2] (% of GDP)	**CP Sep. 2006[3]**	**-7.6**	**-9.7**	**-5.8**	**-3.6**	**-3.2**
	CPDec. 2005	n.a.	n.a.	n.a.	n.a.	n.a.
	CP Dec. 2004	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Sep. 2006**	**62.3**	**68.5**	**71.3**	**72.3**	**70.4**
	CPDec. 2005	61.5	63.0	63.2	62.3	n.a.
	CP Dec. 2004	*58.6*	*56.8*	*54.9*	*53.2*	*n.a.*

Notes:

[1]Commission services calculations on the basis of the information in the programme

[2]Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures

[3]One off and temporary measures are taken from the programme: 0% in 2005, 0.8% of GDP in 2006, 0.9% in 2007, 0.3% in 2008; all deficit increasing. The Commission services' estimates of one-off measures are broadly in line with the programme figures, except for 2005 (0.4% of GDP, deficit reducing) and 2006 (0.3% of GDP, deficit increasing).

[4]Based on estimated potential growth of 3.7%, 3.6%, 3.4%, 3.3% and 3.2% respectively in the period 2005-2009.

Source:

Convergence programme updates (CP); Commission services' calculations

1. INTRODUCTION

On 1 September 2006, Hungary submitted an adjusted convergence programme update (hereafter referred to as the programme) to the Council and the Commission.[8] This was done in response to the Council opinion of 24 January 2006 on the December 2005 programme which concluded that the consolidation in that programme was not backed by concrete measures and invited Hungary to submit an adjusted programme by 1 September.[9] The adjusted programme covers the period from 2005 to 2009, but also refers to the years 2010 and 2011. It was discussed with the Hungarian Convergence Council[10] as well as with representatives of social partners, the Parliament, the State Audit Office and the National Bank of Hungary. The programme was adopted by the Government on 31 August 2006.

The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct. It provides all compulsory data prescribed by the new code of conduct. Some optional data are missing. They mainly concern the general government expenditure by function (Table 3 of Annex 2 in the code of conduct is entirely missing), government debt developments, and data on long-term sustainability of public finances. Annex 3 of this technical assessment provides a detailed overview of all aspects of compliance with the new code of conduct.

2. ECONOMIC OUTLOOK

Over the past ten years, real GDP growth in Hungary was relatively high at an average 4% per year placing Hungary in the mid-field of new Member States. Throughout the entire period, growth was primarily driven by domestic factors. It has become more balanced between components since 2003 when consumption growth decreased and the growth of gross fixed capital formation increased. The unemployment rate averaged around 7% between 1996 and 2005 and was below the EU25 average over the entire decade. Inflation fell from close to 25% in 1996 to 3.5% in 2005.

This apparently robust economic performance conceals several imbalances. First, while unemployment in Hungary is relatively low compared to other Member States, the employment rate is one of the lowest in the EU and has been stagnating at around 55% since 2000. Second, after the fiscal consolidation of the second half of the nineties which decreased the general government deficit from over 8% of GDP to around 3% of GDP by 2000, the deficit has significantly increased to an average of around 6½% of GDP between 2001 and 2005, and was 7.5% of GDP in 2005. As a consequence, the sharply decreasing trend in general government debt (from above 70% of GDP in 1996 to close

---

8 The English translation was submitted on 8 September 2006.

9 In accordance with the second paragraph of Art. 9 of section 3 of Council Regulation (EC) N° 1466/97 as amended.

10 The Convergence Council was set up in July 2006. Its members are three prominent Hungarian economists. It is to serve as an independent advisory body to the Government in the preparation and the implementation of the convergence programme.

to 50% in 2001) was reversed in 2001 to reach 62.3% of GDP in 2005 (including the burden of the second pillar pension funds) at the end of 2005. Third, the highly expansionary fiscal policy stance contributed to serious external imbalances. While the external deficit has been high throughout the past ten years (at around 8% of GDP), the sectoral composition of the country's net financing requirement shifted from non-debt generating corporate items to government and household debt.[11] This contributed to a substantial increase in Hungary's total (public and private) foreign debt from below 20% of GDP in 2001 to close to 30% of GDP in 2005. Finally, significant minimum wage increases (especially in 2001 and 2002, and overall by around 130% from 2000 to 2005), generous public wage policies and sustained high private wage growth resulted in a high overall wage inflation averaging around 12½% per year since 2000.[12] This led to a loss of cost competitiveness and created inflationary pressures.

The macroeconomic scenario presented in the programme covers the period 2005 to 2009 in detail and refers to the outer years 2010 and 2011 by indicating expected trends for selected variables.[13] Since a budgetary adjustment package was adopted by the Hungarian Parliament on 10 July 2006 and various other deficit reducing measures announced (including the withdrawal of a previously approved 5-year tax-cut strategy), the path of the Hungarian economy is modified compared to that in the December 2005 convergence programme and to the Commission services' spring 2006 forecast. The fiscal adjustment measures can be expected to affect GDP growth primarily by decreasing households' real disposable income (tax hikes, cuts in price subsidies, public sector lay-offs) and by increasing production factor costs. In addition, the programme announces a number of structural reforms (see Section 6), without however providing any precise assessment of their impact on the macroeconomic outlook.

The programme expects the fiscal adjustment measures to exert a contractionary impact on the Hungarian economy in the years 2007 and 2008 followed by a recovery in 2009. Thus, real GDP is forecast to grow at a rate of 4.1% in 2006, to fall back to 2.2% and 2.6% in 2007 and 2008, respectively, and to recover fully by 2009 to 4.1%. This path is also reflected in the cyclical conditions, which show negative output gaps (recalculated by the Commission services with the commonly agreed methodology on the basis of the data provided in the programme) for the years 2007 and 2008 and the return of output to its potential level by 2009 (see Tables 1 and 2). The growth of real GDP is expected to be predominantly driven by domestic demand before and after the contractionary impact of the fiscal adjustment package (i.e. in 2006 and from 2009), whereas growth is expected to be primarily driven by external factors during the years of major fiscal contraction.

---

[11] The household sector's external borrowing has been rapidly growing since 2003. As a result, the share of foreign currency loans in all outstanding household loans reached 31% at the beginning of 2006. A large part of these positions being un-hedged, this exposes households increasingly to foreign exchange rate fluctuations. At the same time, the total amount of households foreign currency borrowing is still rather low: currently, it only amounts to around 5 % of GDP.

[12] As measured by the compensation per employee, nominal wage inflation fell from 15.3 % in 2000 to 8.9 % in 2005. Real wage inflation averaged close to 7 % between 2000 and 2005, with 5.4 % in 2005.

[13] Section 3.5 of the programme presents four alternative scenarios. These scenarios are however not detailed enough to allow a thorough assessment of anything but the central baseline scenario.

Except for the HUF/euro exchange rate, the external assumptions underlying the programme's macroeconomic scenario correspond to the Commission services' spring 2006 forecast for the years 2006 and 2007 and extrapolate these for the years 2008 and 2009. The nominal exchange rate assumption takes into account the foreign exchange rate developments since the publication of the forecast and expects a weaker forint for the upcoming years.

The growth outlook described in the programme seems broadly plausible for the years up to 2008 in view of the contractionary impact of the fiscal adjustment package. At the same time, the outlook for the year 2009 and thereafter is based on general assumptions about the effect of announced structural reform measures and of EU transfers as well as positive assumptions about private agents' expectations. While the impact of these factors is very difficult to evaluate at this point, all these assumptions appear to be on the optimistic side, leading to a rather favourable growth outlook in 2009. The projected composition of aggregate demand appears plausible. In particular, it may be expected that household consumption is more negatively affected by the fiscal package than gross fixed capital formation. The programme's expectation that external demand is a main driving factor behind growth during the fiscal contraction also appears to be plausible.[14]

The programme appears to be somewhat optimistic regarding labour market developments especially for 2008 and 2009. Despite an expected substantial slowdown in growth as well as a planned layoff in the public sector of about 20 thousand employees as decided by the government in July 2006, the programme projects employment growth of 0.3% in 2006 followed by 0 and 0.3% in 2007 and 2008, respectively; the employment growth rate projected for 2009 is as high as 0.7% and further increasing thereafter. For comparison, the annual growth rate of employment averaged 0.2% between 2001 and 2005 and the private sector did not absorb more than 20 thousand persons since 2003 even though the economy was growing strongly during these years. This relative optimism regarding labour market developments is also reflected in the projected average labour content of growth implied by the programme for the years 2006 to 2008, which is slightly higher than the average labour content of the years 2001 to 2005. For the years 2009 and thereafter, the programme expects a significant improvement in labour market conditions based on the impact of employment policy measures still to be taken in the upcoming years (and planned, such as a more employment-friendly tax system).

The programme expects fiscal adjustment measures to directly and indirectly affect the HICP inflation rate. Inflation is projected to peak at 6.2% in 2007 after 3.5% in 2006 and to decrease to the 3% inflation target of the National Bank of Hungary by 2009. The projected pattern can be explained by the VAT increase (adopted by Parliament on 10 July 2006) and decreases in price subsidies (adopted by ministerial decree on 30 June 2006), as well as by other measures contained in the programme that create inflationary pressures by increasing factor costs (e.g. increases of personal income tax and social contributions). However, inflation seems somewhat underestimated over the entire horizon. Specifically, the programme's inflation forecast is based on (a) a relatively low initial inflation rate, (b) a large contribution of negative cyclical conditions to curb inflation, and (c) positive expectations about the public's inflation expectations; all these

[14] The projected large changes in inventories (close to -4% of GDP in each year 2006 to 2009) show a great degree of uncertainty around the measurement/estimation of GDP components. The contribution of changes in inventories to GDP growth is however 0 for the years 2007 to 2009.

assumptions appear to be on the optimistic side. In particular, (a) inflation in the first half of 2006, i.e. before the impact of the austerity measures, was higher than previously expected; (b) the impact of cyclical condition's on inflation appears to be of relatively little importance in Hungary; (c) inflation expectations may have a more persistent inflationary impact than expected by the programme.

Table 1: Macroeconomic developments

	2006	2007	2008	2009
	CP	**CP**	**CP**	**CP**
Real GDP (% change)	4.1	2.2	2.6	4.1
Private consumption (% change)	3.0	-0.7	0.6	1.5
Gross fixed capital formation (% change)	6.6	2.1	3.7	7.0
Exports of goods and services (% change)	12.0	10.9	9.9	9.4
Imports of goods and services (% change)	9.5	8.5	8.0	8.8
Contributions:				
- Final domestic demand	3.8	-0.2	0.5	2.9
- Change in inventories	-1.7	0.0	0.0	0.0
- Net exports	2.1	2.4	2.1	1.1
Output gap[1]	0.8	-0.3	-0.9	0.0
Employment (% change)	0.3	0.0	0.3	0.7
Unemployment rate (%)	7.3	7.5	7.4	7.3
Labour productivity growth (%)	3.8	2.2	2.3	3.3
HICP inflation (%)	3.5	6.2	3.3	3.0
GDP deflator (% change)	2.3	4.2	1.9	2.7
Comp. of employees (per head, % change)	6.4	6.5	4.0	5.6
Real unit labour costs (% change)	n.a.	n.a.	n.a.	n.a.
External balance (% of GDP)	-7.1	-4.2	-2.2	-1.4

Note:
[1]In percent of potential GDP, with potential GDP growth as reported in Table 4 below.
Source :
Convergence programme update (CP)

The programme's external balance projection takes into account the expected decreasing internal demand along with the favourable growth prospects of Hungary's main trading partners. Based on these factors, the balance of goods and services is expected to improve substantially from a 2.1% of GDP deficit in 2006 to a 2% of GDP surplus in 2009, and the current account deficit is projected to decrease from 7.9% of GDP in 2006 to 3.6% by 2009. The debt-generating net external borrowing of 2.7% of GDP in 2006 is expected to decrease and to turn into net external lending by 2008 mainly as a result of the projected fiscal consolidation. In parallel, the overall net external borrowing is expected to decrease from 7.1% of GDP in 2006 to 1.4% of GDP by 2009. This is also driven by growing EU transfers over the programme horizon.[15] The main driving factors presented in the programme are largely realistic. The projected magnitude of their impact also appears to be broadly plausible with increasing uncertainty surrounding the estimates in the outer years.

[15] The expected profile of EU transfers over the programme horizon is as follows: 1.5% of GDP in 2006, 1.6% of GDP in 2007 and 2.1% of GDP in 2008 and 3.2% in 2009.

Table 2: Sources of potential output growth

	2006	2007	2008	2009
	CP[2]	CP[2]	CP[2]	CP[2]
Potential GDP growth[1]	3.6	3.4	3.3	3.2
Contributions:				
- Labour	-0.1	-0.1	-0.1	-0.1
-Capital accumulation	2.2	2.1	2.0	2.0
- TFP	1.5	1.4	1.4	1.3

Notes:

[1]Based on the production function method for calculating potential output growth

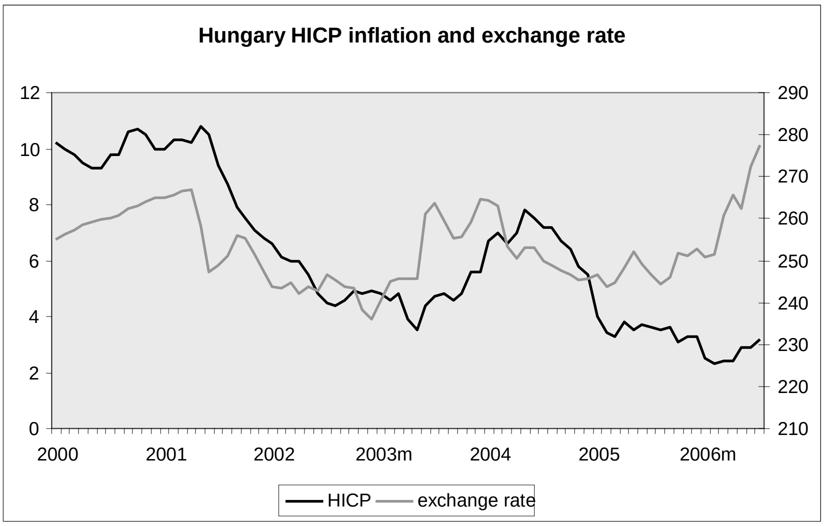
[2]Commission services' calculations on the basis of the information in the programme

Source:

Commission services' calculations

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

The Hungarian authorities have officially abandoned 2010 as the target but have not yet announced a new one. Hungarian monetary policy continues to combine inflation targeting with an exchange rate peg. The forint is pegged to the euro with a ±15% fluctuation band around the central parity (282.4 forint per euro). Since the introduction of this system in mid-2001, the forint had mostly traded in the strong end of the fluctuation band. However, between February and July 2006 the HUF/euro exchange rate weakened substantially, by around 10%, amidst a receding risk appetite affecting emerging markets globally and also reflecting concerns among investors about the development of Hungarian fundamentals, in particular the fiscal situation. Despite ongoing short-term volatility, the currency has stabilised since the summer, trading relatively close the central parity in the band as the fiscal consolidation plans and increases in policy interest rates (see below) have helped stabilise the currency.



Inflation targets are jointly defined by the government and the central bank. For 2006, the December inflation target is 3½%, with a tolerance band of ± 1%. For the period from 2007 onwards, a continuous inflation target of 3%, with a tolerance band of 1% on either side, was set in August 2005. HICP inflation fell to just above 2 percent in the first months of 2006 but increased from May onwards. Inflation is expected to pick up further in the remainder to the year, partly due to the price impact of fiscal consolidation measures. Monetary policy reacted to upward risks to inflation and to unfavourable financial market developments by increasing the base rate by 175 basis points in four steps to 7.75 %, between mid-June and end-September 2006.

Hungarian long-term interest rates remain significantly higher than in other new Member States, reflecting risk perception in the markets. Ten-year bond yield spreads with the euro area had increased markedly in October 2005, partly in response to mounting worries on the part of investors about fiscal slippages, and widened to around 350 basis points in December of last year. Subsequently, bond yield spreads with the euro area gradually receded to around 290 basis points on average in May 2006, but widened again in the summer of 2006 and reverted to levels of around 350 basis points in July-August 2006, partly in response to concerns among investors about the extent and feasibility of the planned fiscal adjustment. Overall, the interest rate assumptions appear to be on the low side, also in view of the upside risks to the programme's inflation projections.

4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part contains a brief overview of the fiscal developments in the last ten years and discusses budgetary implementation in the year 2006. The second part presents the budgetary strategy in the new update, including the programme’s medium-term objective (MTO) for the budgetary position. The third analyses the risks attached to the budgetary targets in the programme. The final part contains the assessment of the fiscal stance and of the country’s position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Public finance developments and budgetary implementation

4.1.1. Brief overview of public finance developments over the last ten years

In 1995, a comprehensive stabilisation package introduced a set of dominantly expenditure-reducing fiscal measures, which paved the way for the general government deficit to narrow from over 8% of GDP to around 3% of GDP in 2000. The fiscal retrenchment contributed, together with large privatisation receipts, to the significant drop in the debt-to-GDP ratio from a peak of over 85% of GDP in 1995 to close to 50% in 2001. However, from 2001 onwards the orientation of fiscal policy was sharply reversed in Hungary and, especially over the recent years, public finances became an important source of concern and factor of instability.

In 2001, the deficit rose by 1.2 percentage points of GDP to 4.2% of GDP and since 2002 each year the budget deficit has been well over 5% of GDP. Moreover, the debt-to-GDP ratio quickly approached and then in 2004 passed the 60% of GDP threshold (including the burden of the pension reform[16]). Significantly increased current spending items that were subject to discretionary policy action, in particular social transfers and generous

[16] For the sake of comparability, all figures include the burden of the pension reform. After the submission of the 2004 update of the convergence programme in December 2004, the Hungarian authorities decided to report fiscal targets and statistics excluding the cost of pension reform, as allowed by the Eurostat decision of 23 September 2004 that will expire in any case on 1 April 2007. The adjusted convergence programme update has discontinued this practice.

public wage increases, produced large deviations compared to the original deficit targets. In addition, end-year estimates were substantially increased ex-post with virtually every fiscal notification. This reflects the limited transparency in fiscal governance, including the frequent recourse to changes in statistical methodology.

In 2005, the general government deficit increased to 7.5% of GDP from 6.6% of GDP in 2004. This was substantially higher than the deficit target of 4.7% of GDP (3.3% of GDP without the burden of pension reform) set in the 2004 update of the convergence programme, despite some corrective measures taken in the first half of the year. The sizeable deviation with respect to this target was partly due to a significant revenue shortfall, compared to overly optimistic budget assumptions, and an expenditure overrun due to the underestimation of open-ceiling expenditures. The Hungarian authorities had originally intended to reduce the deficit through the sale of motorways to Public Private Partnerships (PPPs), for an amount that eventually reached 1.9% of GDP (which does not necessarily reflect their actual value). However, in September 2005, Eurostat clarified that this could not be counted as a deficit-reducing measure and the authorities subsequently announced a new deficit target which exceeded the previous one by 2 ½% of GDP.

In July 2004, Hungary was placed by the Council under the Excessive Deficit Procedure on the grounds that the deficit in 2003 was significantly above the 3% of GDP threshold. Since then the Council decided twice that Hungary did not follow its (original and second) recommendations, given that the intermediate targets for the correction of the deficit were repeatedly missed by a substantial margin (see Box 1 in section 4.2.1. for further details on the EDP).

Successive convergence programme updates between May 2004 and December 2005 all aimed for a correction of the excessive deficit by 2008, but increasingly backloaded the adjustment, and also lacked concrete consolidation measures. Despite the deteriorating fiscal stance, a number of tax cuts exacerbated the growing macroeconomic imbalances. Structural adjustment efforts were replaced by temporary measures, controversial accounting practices, and optimistic budgetary planning. This strategy has noticeably undermined confidence in the credibility of the fiscal policy and contributed to an evolving twin deficit problem, leading also to recurring downward pressures on the forint and consecutive downgrades of sovereign debt by the major rating agencies.

4.1.2. Budgetary implementation in 2006

The December 2005 update of the convergence programme specified a target of 6.1% of GDP for 2006 (or 4.7% of GDP without the burden of pension reform[17]). Large budgetary slippages in the first months of 2006 led to a massive increase in the government deficit. The Government, re-appointed after the April elections, announced

[17] Since end-2005, the projected costs of the pension reform for 2006 has been revised upwards by 0.1% of GDP, and now it stands at 1.5% of GDP.

that without corrective measures the end-year deficit would be around 11.6% (10.1% without the burden of pension reform) of GDP.[18]

Only around 0.3% of GDP of the total estimated deviation of 5½% of GDP compared to the initial target of 6.1% of GDP is due to a revenue shortfall, mainly in the area of social contributions, with the remainder explained by expenditure overruns. Close to 2½% of GDP of current expenditure overruns occurred in the areas of pension payments, preventive care, pharmaceutical subsidies, operational costs of central budgetary institutions and other current expenditures. In addition, higher-than-expected local government investment due to the election cycle increased the deficit by 0.5% of GDP. Interest expenditure was also higher than budgeted by 0.3% of GDP due to the higher debt level and the substantial increase in interest rates by 100-150 basis points. The Hungarian authorities attributed another 0.5% of GDP to one-off and other temporary measures (debt cancellation and flood-related expenditure). Finally, 1½% of GDP extra spending was explained by accounting of motorway investment inside the general government (around 1% of GDP)[19] and the costs of military aircraft (0.3% of GDP) purchased under a financial lease. Both these outlays were not included in the official target.

When the Government announced the huge budgetary slippage, it also declared that fiscal adjustment measures would be taken, reducing the deficit in 2006 by 1½% of GDP, with a broadly even composition between expenditure- and revenue-side measures. On 12 June, the government adopted a fiscal corrective package which was turned into law by Parliament on 10 July.[20] The main elements of the revenue-increasing part of the consolidation package are increases in social contributions, in the middle VAT rate and in corporate taxes. Regarding the spending cuts, some immediate steps concerning health-related expenditure, gas price subsidies, operational expenses of central government institutions and the full withdrawal of the 0.3% of GDP general reserve for 2006 had been taken by Government decrees by the end of June. With the exception of the withdrawal of the general reserve (which is a one-off measure), all these measures are expected to produce significant effects also in 2007 and beyond (for further details on the consolidation package see Box 2 below). In the adjusted convergence programme update a revised deficit target of 10.1% of GDP[21] has been confirmed, which represents by far

[18] At first, the Hungarian authorities announced in June a deficit of 11% of GDP (9.5% without pension reform burden) in the absence of corrective measures. In the June estimate the Government had already included ½ percentage point of GDP of the 1.1% of GDP motorway investment inside the general government sector. In July, the authorities further increased their deficit forecast to 11.6% of GDP for 2006 after Eurostat clarified that ongoing PPP projects of 0.6% of GDP for motorway construction ('programme roads') could not be recorded outside the general government sector as was originally planned by the Government.

[19] Originally this investment was planned to be undertaken by Public Private Partnerships to be recorded off budget.

[20] The consolidation package does not include most of the structural reform plans, which were progressively unveiled by the Government in subsequent months.

[21] This is considerably higher than the Commission services' 2006 Spring budget deficit forecast of 8.2% of GDP (including the burden of pension reform), in which motorway investment of 1.1% of GDP was considered outside the general government sector, in line with the Spring 2006 fiscal notification of the Hungarian authorities. However, the corresponding commentary pointed to substantial upward risks, among others linked to the planned shift of motorway construction into off-budget PPP operations, which had been expected to improve the budget.

the highest deficit in the EU; on the basis of currently available information and without prejudging the Commission services autumn 2006 forecast this revised target appears within reach.

4.2. The programme's medium term budgetary strategy

This section covers the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

4.2.1. The main goal of the programme's budgetary strategy

The update aims to correct the excessive deficit by 2009. This would be achieved by a steep deficit reduction of 6.9 percentage point of GDP within a period of three years from 10.1% of GDP in 2006 to 3.2% of GDP in 2009[22] (see Table 3). All fiscal targets and statistics in the programme include the burden of the pension reform.[23] The primary balance would show an improvement of the same magnitude, from a deficit of 6.3% of GDP in 2006 to a surplus of 0.8% of GDP in 2009. The time profile of the consolidation is substantially front-loaded, with half of the projected improvement taking place in 2007 (3.3% of GDP).

The deficit target of 3.2% of GDP in 2009 would still exceed the 3% of GDP threshold specified in the Treaty. It is assumed in the programme that the Council and the Commission could take into account 20% of the yearly burden on the budget arising from the second pillar pension reform (which is expected to amount to 0.3% of GDP in that year) when taking the decision on the excessive deficit procedure for Hungary.[24] Even in this case, there would be no safety margin for possible slippages.

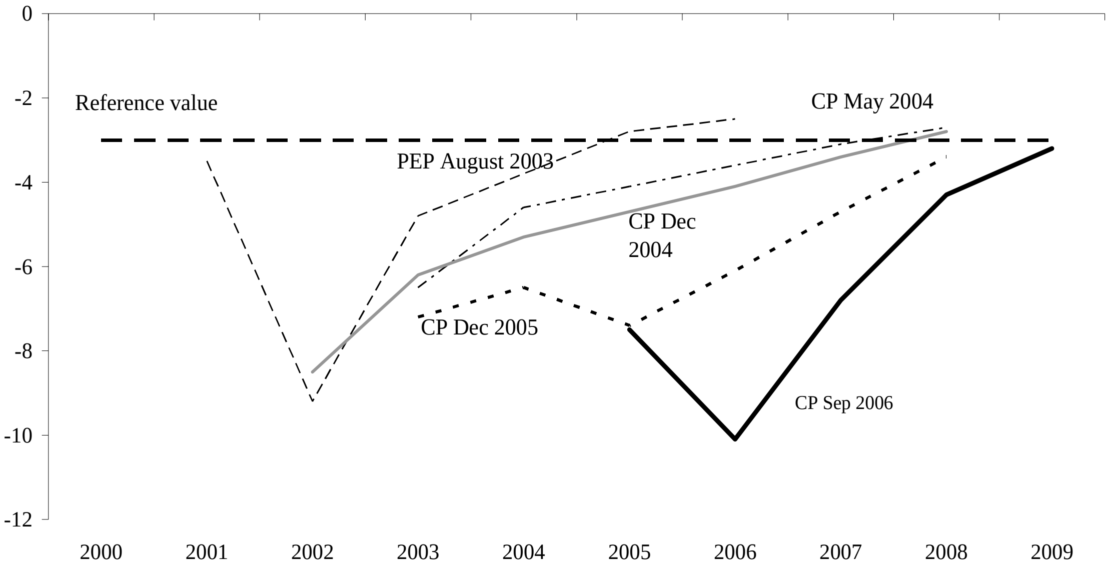
---

[22] The update also refers to 2010-2011 for which it projects a steady annual deficit reduction of 0.5 percentage point of GDP.

[23] As underlined in the adjusted convergence programme, Hungary has decided no longer to benefit from the transitory period on the sectoral classification of pension schemes (allowing to report budgetary and government debt targets excluding the cost of pension reform) granted by Eurostat on 23 September 2004 that will expire in any case with the notification due by 1 April 2007.

[24] According to Council Regulation (EC) No 1056/2005, Article 1 paragraph 7, if the general government deficit "*…has declined substantially and continuously and has reached a level that comes close to the reference value*", the Council and the Commission could consider degressively the net cost of a pension reform that includes a fully-funded pillar. In the previous programme it was assumed that 40% of the pension reform burden could be taken into account in 2008 (at the time the envisaged year of correction). In 2009, the corresponding figure is 20%. As pension costs are estimated at 1.6% of GDP in 2009, 20% deduction would correspond to around 0.3% of GDP.

Figure 1: General government balance projections in successive convergence programmes (% of GDP)



Source : Successive convergence programmes (CP), Pre-Accession Economic Programme (PEP)
Note: For the sake of comparability, all deficit targets include the burden of the pension reform.

Table 3: Evolution of budgetary targets in successive programmes

		2005	2006	2007	2008	2009
General government balance (% of GDP)	**CP Sep 2006[1]**	**-7.5**	**-10.1**	**-6.8**	**-4.3**	**-3.2**
	CP Dec 2005[2,3]	-7.4	-6.1	-4.7	-3.4	n.a.
	CP Dec 2004[4]	*-4.7*	*-4.1*	*-3.4*	*-2.8*	*n.a.*
General government expenditure (% of GDP)	**CP Sep 2006**	**50.6**	**52.5**	**51.0**	**49.1**	**48.6**
	CP Dec 2005[3]	51.2	47.2	45.8	43.6	n.a.
	CP Dec 2004	*47.4*	*46.9*	*45.6*	*45.2*	*n.a.*
General government revenues (% of GDP)	**CP Sep 2006**	**43.1**	**42.4**	**44.2**	**44.8**	**45.4**
	CP Dec 2005[3,5]	43.8	41.1	41.1	40.2	n.a.
	CP Dec 2004[5]	*42.7*	*42.8*	*42.2*	*42.4*	*n.a.*
Real GDP (% change)	**CP Sep 2006**	**4.1**	**4.1**	**2.2**	**2.6**	**4.1**
	CP Dec 2005	4.2	4.3	4.1	4.1	n.a.
	CP Dec 2004	*4.0*	*4.2*	*4.3*	*4.6*	*n.a.*

Notes:

[1] The programme reports fiscal targets and statistics including the costs of pension reform.

[2] For the sake of comparability, all deficit targets include the burden of the pension reform. The deficit targets of the programme excluding the currently-known pension reform burden would be: 6.0% of GDP in 2005, 4.6% in 2006, 3.0% in 2007, 1.8% in 2008.

[3] The ratios were calculated on the basis of GDP series without FISIM allocation.

[4] For the sake of comparability, all deficit targets include the burden of the pension reform. The deficit targets of the programme excluding the currently-known pension reform burden would be: 3.3% of GDP in 2005, 2.6% in 2006, 1.7% in 2007, 1.2% in 2008.

[5] For the sake of comparibility revenue figures include private pension funds as government revenue.

Source:

Convergence programmes (CP)

Box 1: The excessive deficit procedure for Hungary

According to the excessive deficit procedure (EDP), the Commission and the Council monitor the development of the budgetary position in each Member State, notably in relation to the reference values of 3% of GDP for the deficit and 60% of GDP for the debt, in order to assess the existence (or risk) of an excessive deficit and to ensure its correction. The EDP is laid down in Article 104 of the Treaty and further clarified in the Stability and Growth Pact.

On 5 July 2004, the Council adopted a decision stating that Hungary had an excessive deficit in accordance with Article 104(6). At the same time, the Council addressed a recommendation to Hungary under Article 104(7) specifying that the excessive deficit had to be corrected by 2008 at the latest in line with the adjustment path outlined in the country's May 2004 convergence programme. However, the Council decided on 18 January 2005 based on Article 104(8) that, despite the adoption of some measures reducing the deficit in 2004 and 2005, Hungary did not comply with the recommendations of July 2004, since both the 2004 and the 2005 targets were expected to be missed by a sizeable margin.

On 8 March 2005, the Council issued another recommendation based on Article 104(7), since Hungary is not yet a member of the euro area and therefore the next two steps of the excessive deficit procedure under Article 104(9) and 104(11) do not apply. The Council recommended the Hungarian authorities to "take effective action by 8 July 2005 regarding additional measures, as far as possible of a structural nature, in order to achieve the deficit target for 2005 as set in the updated convergence programme". Furthermore, the Hungarian authorities should make the timing and implementation of any tax cuts conditional upon the achievement of the deficit targets of the convergence programme update submitted in December 2004 that were endorsed in the Council Opinion thereupon also on 8 March 2005.

On 13 July 2005, the Commission adopted an assessment stating, based on the information available at the time that the Hungarian authorities had taken effective action regarding the 2005 budget deficit within the four-month deadline set by the Council in its new 104(7) recommendations of 8 March 2005. The assessment underlined that the achievement of the deficit target of 3.6% of GDP might require further action later in the year and that important adjustments and decisive action would be needed to achieve the target of 2.9% of GDP in 2006 of the authorities (numbers are calculated without the pension reform burden; including the burden they would amount to 5% of GDP and 4.5 % of GDP, respectively).

However, given a substantial deterioration of the budgetary outlook in Hungary, based on a Commission recommendation of 2 October 2005 incorporating the new information, the Council decided on 8 November 2005 for the second time based on Article 104(8) that Hungary did not comply with the new 104(7) recommendations of March. Thereby it notably took into account the fact that both deficit targets of 3.6% of GDP in 2005 and of 2.9% of GDP in 2006 (excluding in both cases the pension reform burden) would be missed by a sizable margin and that the implementation of the tax cuts starting from 2006 was contrary to the Council recommendation as far as tax cuts were concerned.

On 26 September 2006 the Commission adopted a recommendation for a third Council recommendation under Article 104(7), and the Council accordingly adopted such a recommendation on 10 October 2006.

More details can be found at:

http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp/edphu_en.htm

The budgetary strategy of the programme represents a substantial break with the previous update. The 2005 update of the convergence programme envisaged a deficit reduction of 1.4 percentage points of GDP year throughout the programme horizon, targeting the correction of the excessive deficit in 2008. Due to huge budgetary slippages in 2006, the starting point of the adjustment has been increased significantly, by 4 percentage points of GDP, which, despite a substantial frontloading of the adjustment, entailed a one-year postponement of the target date for correcting the excessive deficit.

4.2.2. The composition of the budgetary adjustment

The planned reduction of the nominal deficit by almost 7 percentage points of GDP between 2006 and 2009 is projected to be achieved by increasing the revenue-to-GDP ratio by 3 percentage points and by reducing the expenditure-to-GDP ratio by 3.9 percentage points (see Table 4). Therefore the adjustment relies somewhat more on expenditure cuts but also has an important revenue component which may be explained by the magnitude of the budgetary shortfall to be corrected.[25] It should be noted in this context that the trajectory of the total revenues and total expenditure ratios includes projected EU transfers which raise both expenditure and revenue ratios by some 1.7 percentage points over the programme period (by around 1 percentage point in 2009 alone). Previous updates of Hungary's convergence programme all envisaged a decrease of both overall revenues and expenditures as a percentage of GDP, with the latter considerably exceeding the former (see Table 3).

In the wake of a massive increase in the budget deficit, in July 2006 the Parliament withdrew the remaining steps of the five-year tax cut strategy (which would have reduced revenues by around 3 percentage points of GDP by 2010)[26] and introduced new taxes and a series of tax increases, with most measures being effective from 1 September 2006. At the same time, the Government adopted some immediate expenditure cuts through a series of decrees, with other measures announced for the following years (see Box 2 for details).

The already adopted revenue-increasing measures are projected to lead to a large increase in the revenue-to-GDP ratio of 1.8 percentage points in 2007. More moderate additional increases of 0.6 percentage point are projected for both 2008 and 2009. The dynamics of the <u>tax revenues</u> are driven on the one hand by the significant increases in the tax rates of VAT, income taxes and social security contributions, coupled with some small increases in the tax base of social security contributions and the personal income tax and the introduction of some new taxes, all of which contribute to a strong increase in the revenue-to-GDP ratio.

---

[25] The evaluation of the composition of the adjustment takes into account the total change in the revenue and expenditure ratios between end 2006 and end 2009. Therefore, the immediate effect of the adjustment package – which takes place already in 2006 – is not included in the calculation. Moreover, the assessment refers to the trajectory of total revenues and total expenditure, thus including the projected interest expenditures and EU transfers which contribute to raising expenditure and revenue, respectively, for all years throughout the programme period.

[26] The five-year tax cut strategy was approved by the parliament on 7 November 2005, and the first steps (most notably a 5 percentage points cut in the upper VAT rate) became effective on 1 January 2006 and led to revenue losses of around 1% of GDP in 2006.

Box 2: Consolidation package

Following major budgetary slippages in the first five months of 2006, on 12 June the Government adopted a set of fiscal corrective measures (the so-called 'New Equilibrium' package). The package is expected to lower the budget deficit in 2006 by around 1½% of GDP, and to importantly contribute to achieving the envisaged adjustment path in the 2007-2009 period. It does not include most of the structural reform plans that were announced in subsequent months. On 10 July Parliament adopted the tax amendments, most of which became effective on 1 September and are expected to increase revenues by 0.7% of GDP already in 2006. At the same time, Parliament withdrew the remainder of the five-year tax cut plan.

The main elements on the revenue side of the 'New Equilibrium' package concern *social contributions* (increase in the rate of employees' healthcare contribution from 4% to 7% in two steps), the *corporate profit tax* (an extra 4% 'separate tax' on the base of pre-tax corporate profits), and the *VAT rate* (increase in the middle-bracket of the VAT rate from 15 to 20%). In addition, the package contains increases in the *personal income tax* (an extra 4% 'separate tax' for annual incomes above HUF 6 million and reduction of tax allowances), hikes in *excise duties* for tobacco and alcohol, the introduction of a *20% tax on interest income* and *capital gains* as well as a *special tax on the financial sector*. The Government also announced *measures to address the heightened risk of tax evasion*, in particular the centralisation of the fragmented investigative system of tax fraud (police, customs guard) and a twenty-fold increase in the number of reviews into the accumulation of personal wealth in 2007 compared to previous years.

On the expenditure side, by the end of June some *immediate spending cuts* concerning *pharmaceutical and gas price subsidies, health-care expenditures*, *public administration expenditures* and the *withdrawal of the general reserve* for 2006 were adopted by Government decrees. These measures are officially estimated to produce expenditure savings of 0.8% of GDP in 2006. In subsequent years the package outlines further expenditure savings to be generated by substantial *additional cuts in administrative costs* (reduction in general government employment and merging institutions); by the *nominal freeze of public wages* and other *across-the-board nominal freezes* of a number of expenditure items until 2008; as well as by further *reform of the universal price subsidy schemes*. The expected impact of various types of freezes (on the public wage bill, on operational expenditures of public administration, and on other budgetary appropriations) would amount to around 1.3% of GDP in 2008. In order to achieve the planned expenditure cuts, the Government announced it would *introduce an expenditure rule* from 2007 onwards, enhancing ministerial responsibilities for expenditure ceilings, which will be monitored on a quarterly basis. In case of non-compliance the *chapter balance reserves*, specified for each budgetary chapter in the budget law, would be frozen.

On the other hand, as a result of the fiscal consolidation, lower household consumption and compensation of employees are likely to exert a downward pull on tax revenues, an effect which will play an increasing role in the outer years of the programme on account of the lagged impact of the slowdown on some tax receipts. Overall, the tax-to-GDP ratio will increase by 1.7 percentage points of GDP during the programme period. The increase in other revenues (which includes EU transfers) will contribute by 1.3 percentage points of GDP[27] to the total increase in revenues. In 2008 and even more so in 2009, the dynamics of other revenues drive the increase in total revenues.

[27] The increase in EU transfers is estimated to be 1.7 percentage points of GDP over the programme period (1.1 percentage points in 2009 alone). As other projected revenues will be decreasing as a share of GDP, this leads to an overall increase in "other revenues" reported in Table 4 of 1.3 percentage points between 2006 and 2009.

The expenditure-to-GDP ratio is projected to decrease by 3.9 percentage points of GDP over the programme period.[28] The planned expenditure cuts are expected to be achieved through: (i) a sharp cut in public consumption, by about 3½ percentage points of GDP, reflecting a broad range of measures, in particular aiming at curbing the wage bill; (ii) savings on transfers and subsidies, particularly through a complete revamping of the subsidy systems; and (iii) an overall decrease in gross fixed capital formation of 0.9 percentage points of GDP over the programme period, which takes place already in 2007, probably in part reflecting a normalisation after the electoral public investment cycle of 2006, and accompanied by a progressive shift from public investment programmes exclusively financed from domestic sources to programmes supported by EU financing.

Table 4: Composition of the budgetary adjustment

	2005	2006	2007	2008	2009	Change: 2009-2006
Revenues	**43.1**	**42.4**	**44.2**	**44.8**	**45.4**	**3.0**
of which:						
- Taxes & social contributions	37.7	36.9	38.8	39.0	38.6	**1.7**
- Other (residual)	5.4	5.5	5.4	5.8	6.8	**1.3**
Expenditure	**50.6**	**52.5**	**51.0**	**49.1**	**48.6**	**-3.9**
of which:						
- Primary expenditure	46.5	48.7	46.6	45.0	44.6	**-4.1**
of which:						
Consumption	23.5	23.5	22.0	20.5	20.0	**-3.5**
Transfers other than in kind & subsidies	16.4	16.9	17.1	17.0	16.7	**-0.2**
Gross fixed capital formation	3.4	4.5	3.6	3.3	3.6	**-0.9**
Other (residual)	3.2	3.8	3.9	4.2	4.3	**0.5**
- Interest expenditure	4.1	3.8	4.4	4.1	4.0	**0.2**
General government balance (GGB)	**-7.5**	**-10.1**	**-6.8**	**-4.3**	**-3.2**	**6.9**
Primary balance	**-3.4**	**-6.3**	**-2.4**	**-0.2**	**0.8**	**7.1**
One-off and other temporary measures[1]	0.0	0.8	0.9	0.3	0.0	-0.8
GGB excl. one-off & other temporary measures	**-7.5**	**-9.3**	**-5.9**	**-4.0**	**-3.2**	**6.1**

Note:
[1]One off and temporary measures are taken from the programme.
Source:
Convergence programme update; Commission services' calculations

While all revenue-enhancing measures to back the reduction of the deficit in 2006 and subsequent years are already adopted, only a few of the expenditure-side measures had been taken by the Hungarian authorities by the time of the submission of the programme. Therefore, a large part of the planned measures on the expenditure side would need to be further specified and fully incorporated into the 2007 budget. In recent months, the government has taken decisions on some initial steps of the planned structural reforms (reducing the size of the central administration; introducing some means-testing in gas

[28] The foreseen trajectory reflects the total impact of the Government's expenditure-reducing measures (amounting to 5.6 percentage points of GDP) and the expenditure-increasing effect of the EU transfers (amounting to 1.7 percentage points of GDP).

price subsidies; introducing co-payments for health-care services and restructuring pharmaceutical subsidies). However, for the outer years the expenditure-reducing impacts of the programme's structural reform plans (concerning health-care, pension, public administration, primary, secondary and higher education, public transport)[29] would need to be concretely specified and implemented in order to compensate for the expiry at the end of 2008 of the planned across-the-board expenditure freezes of approximately 1¼% of GDP and to reach the planned deficit reduction by 2009.

According to the programme, no one-off and other temporary measures took place in 2005. During the programme period, one-offs (all with a deficit-increasing effect) would amount to 0.8% of GDP in 2006, 0.9% in 2007 and 0.3% in 2008. No one-offs are foreseen in 2009. The Commission services have a somewhat different assessment of one-off measures[30] for 2005 and 2006; however, this does not modify significantly the perceived risks linked to the adjustment path given the assessment's essentially forward-looking nature. In 2005, the budget received revenues from the national oil company MOL (extra mining grants due to accelerated extraction of natural gas and concession for the extension for extracting rights) and from the sale of government property, altogether of around 0.4% of GDP deficit- reducing one-off revenues. In 2006, the programme does not consider as deficit-reducing one-offs the withdrawal of the general reserve in June (which was fully spent in the previous years)[31], the sale of government property and additional mining grants from MOL, with a total deficit-decreasing impact of 0.5% of GDP in 2006. Therefore, the total impact of one-off and other temporary measures in 2006 would be 0.3% of GDP (deficit-increasing), compared to the programme's figure of 0.8% of GDP (also deficit-increasing).[32]

4.2.3. The medium-term objective (MTO) and the structural adjustment

Unlike the previous update, the programme identifies its medium-term objective (MTO) as specified in the Stability and Growth Pact, targeting a general government balance in structural terms (i.e. cyclically-adjusted and net of one-off and other temporary measures) in the range of 0.5-1% of GDP deficit. The MTO is expected to be achieved after the end of the programme period, without specifying a target year. By the end of the programme period, the programme projects a structural deficit of 3.2% of GDP (Commission services' calculations on the basis of the programme according to the commonly agreed methodology)[33]. This objective is 2.2 percentage points of GDP above the upper level of the targeted MTO range. After 2009, the update plans further

---

29 See Section 6 for further details on structural reforms.

30 For a definition of one-off and other temporary measures, including an indicative list, see Chapter 4.2 of the 2006 Public Finance Report (available at: http://ec.europa.eu/economy_finance/publications/publicfinance_en.htm).

31 The inclusion of this appropriation into the budget law is prescribed by the Public Finance Act.

32 The special tax on the financial sector, which was originally levied for a specified time period of two years (2005-2006) is no longer considered a one-off by the Commission services, since with the consolidation package adopted by Parliament in July, it has become a permanent measure.

33 It should be noted that output gap calculations presented in the update are considerably higher than those resulting from the Commission services' calculations on the basis of the programme according to the commonly agreed methodology, which explains why the structural balances presented in the programme are lower than the Commission services' figures.

reductions of the general government deficit in *nominal* terms of 0.5 percentage point per year until the MTO is achieved.

Box 3 : The medium-term objective (MTO) for the budgetary position

According to the Stability and Growth Pact, stability and convergence programmes must present a medium-term objective (MTO) for the budgetary position. The MTO is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances.

The MTO should fulfil a triple aim. First, it should provide a safety margin with respect to the 3% of GDP deficit limit. Second, it should ensure rapid progress towards sustainability. Third, taking into account the first two goals, it should allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the 3% of GDP deficit reference value. Member States are free to set an MTO that is more demanding than strictly required by these provisions.

The MTO is defined in structural terms, i.e. it is adjusted for the cycle, and one-off and other temporary measures are excluded. For countries belonging to the euro area or participating in the exchange-rate mechanism (ERM II), the MTO should be in a range between a deficit of 1% of GDP and balance or surplus.

As the MTO chosen by the Hungarian authorities is more demanding than the minimum benchmark[34] (estimated at a structural deficit of around 2% of GDP in the case of Hungary), its observance would fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. As regards appropriateness, the MTO lies within the range indicated in the Stability and Growth Pact and the code of conduct and adequately reflects long-term potential output growth and the debt ratio.[35]

According to the Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the update foresees a sharp reduction by 6½ percentage points for the structural balance until 2009, which is around ½ a percentage point less than the foreseen change in the nominal balance. Since interest expenditure as a percentage of GDP is projected to be higher (varying from 0.6 to 0.2 percentage points) than the current yearly level of around 3.8% of GDP throughout the programme horizon, the fiscal policy effort as measured by the change in the structural primary balance is even slightly greater. Based on the evolution of the structural balance, the fiscal adjustment is front-loaded with close to 2/3 of the reduction planned to take place in the first year (2007), followed by a more gradual improvement in the outer years.

---

[34] The minimum benchmark is the estimated budgetary position in cyclically-adjusted terms that provides a sufficient safety margin for automatic stabilisers to operate freely during normal economic downturns without breaching the 3% of GDP deficit reference value.

[35] This assessment is in line with that made with respect to the previous convergence programme, which referred to the same range, and takes into account debt figures excluding the burden of pension reform (below 60% of GDP in both 2004 and 2005). Taking into account debt figures including the burden of pension reform (above 60% of GDP in both 2004 and 2005), the MTO should be set at a more ambitious level.

Table 5: Output gaps, cyclically-adjusted and structural balances

% of GDP	2005	2006	2007	2008	2009	Change: 2009-2006
	C.P.[1]	CP[1]	CP[1]	CP[1]	CP[1]	CP[1]
Gen. gov't balance	-7.5	-10.1	-6.8	-4.3	-3.2	6.9
One-offs[2]	0.0	0.8	0.9	0.3	0.0	-0.8
Output gap[3]	0.3	0.8	-0.3	-0.9	0.0	-
CAB[4]	-7.6	-10.5	-6.7	-3.9	-3.2	7.3
change in CAB	-2.3	-2.8	3.8	2.8	0.7	-
CAPB[4]	-3.5	-6.7	-2.3	0.2	0.8	7.5
Structural balance[5]	-7.6	-9.7	-5.8	-3.6	-3.2	6.5
change in struct. bal.	n.a.	-2.0	3.9	2.2	0.4	-
Struct. prim. bal.[6]	-3.5	-5.9	-1.4	0.5	0.8	6.7

Notes:

[1]Output gaps and cyclical adjustment according to the convergence programme (CP) as recalculated by Commission services on the basis of the information in the programme.

[2]One-off and other temporary measures. See Table 5 above.

[3]In percent of potential GDP. See Table 2 above.

[4]CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance.

[5]CAB excluding one-off and other temporary measures

[6]Structural primary balance = CAPB excluding one-off and other temporary measures

Source :

Convergence programme update; Commission services' calculations

Based on the change in the structural balance as recalculated by Commission services, the stance of fiscal policy is planned to be restrictive until 2008, and to turn to mildly restrictive in 2009. It should be noted that the elimination of deficit-increasing one-offs by the last year of the programme also contributes to the expected improvement in the general government balance.

4.3. Risk assessment

The budgetary targets contained in the programme are subject to a number of risks.

At the beginning of the programme period, the risks to the deficit path stemming from the macroeconomic scenario are broadly balanced. However, in the outer years, lower-than-projected GDP growth and in particular a negative reaction of employment could lead to a lower revenue as well as higher expenditure ratio and consequently to a higher deficit. In addition, given that the programme's interest rate assumptions appear to be on the low side, especially in the outer years, a higher-than-expected debt service might also result in higher deficits.

The programme presents a sensitivity analysis with respect to the baseline scenario with four not fully-fledged different scenarios, presenting the effects of different assumptions about the reaction of economic agents to fiscal retrenchment, and of negative shocks in foreign demand and in oil prices.[36] Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2006-2009 period, (ii) trend output based on the HP-filter, and (iii) no policy response to the above mentioned growth deviation (notably, the expenditure level is as in the central scenario), reveal that, by 2009, the cyclically-adjusted balance is 0.8 percentage point of GDP above/below the central scenario. Hence, in the case of persistently lower real growth, additional measures of around 0.8 percentage point of GDP would be necessary to keep the public finances on the path targeted in the central scenario.

Besides the risks stemming from the macroeconomic environment, a number of risks can be identified concerning the envisaged adjustment path. As far as the revenue side is concerned, the officially estimated revenue trajectory appears to be broadly realistic. In particular, all revenue-enhancing measures to back the reduction of the deficit in 2006 and 2007 are already adopted by the Hungarian authorities. The programme also refers to the planned introduction of a real estate tax in 2008 with expected annual revenue of 0.3% of GDP, but this is only a Government intention at this stage and its estimated impact has not been included in the programme's revenue projections (so that it could be considered a safeguard against worse-than-planned budgetary developments). However, concerns might arise from the fact that a number of pressure groups have questioned the constitutionality of the 'expected tax' on corporations (with an expected revenue increasing impact of 0.2% of GDP) and the special tax on the financial sector (with an expected revenue increasing impact of 0.1% of GDP) and have brought the case before the Constitutional Court. If the Constitutional Court were to rule against the Government, there would be a need to replace these measures and revenues raised through such taxes may need to be repaid retroactively by the budget. The rulings are expected to take place in Autumn 2006. In addition, it cannot be ruled out that the tax increases and other revenue measures, in particular the increased social security contributions, may raise the risk of tax evasion/avoidance. This will need to be addressed by the Hungarian authorities, particularly, if the announced measures to fight tax evasion were to prove ineffective.[37]

As far as the expenditure side is concerned, there are a number of positive elements but the negative elements prevail, so that important risks remain with respect to meeting the budget targets of the programme period, especially for the outer years. On the positive side, some measures are either already adopted or announced in broad terms and planned to be incorporated into the 2007 budget (see Box 2). In addition, in recent months the Government has taken decisions on some initial steps of the planned structural reforms

36 In the optimistic scenario, non-Keynesian effects in consumption and investment would lead to higher growth dynamics and an 0.3 percentage point of GDP improvement in the general budget balance by 2009. In the first pessimistic scenario, households are less actively smoothing out consumption, which leads to lower trend growth and a 0.3-0.4 percentage point of GDP deterioration in the general budget balance throughout the programme horizon. In the second pessimistic scenario, external demand is lower compared to the central scenario, which results in a slightly higher budget deficit by 2009. In the last scenario, oil prices are higher by 10% compared to the assumption of the baseline scenario, which leads to higher inflation, lower consumption and a broadly unchanged fiscal outlook.

37 The Government announced in June that the fragmented investigative system of tax fraud (police, customs guard) will be centralised into one organisation. Moreover, reviews into the accumulation of wealth of persons, comparing wealth against income, will involve 10 000 taxpayers in 2007, a marked increase compared to the past.

(restructuring of the price subsidies systems, introduction of various co-payments for health-care services, streamlining of the central administration). Moreover, the Hungarian authorities intend to improve the budgetary process by establishing compulsory multi-annual expenditure planning for budgetary institutions. The Government intends to introduce an expenditure rule, effective from 2007 onwards. In this framework, all the ministries will have to report on the state of budgetary affairs on a quarterly basis to the Ministry of Finance, and 'chapter balance reserves' (totalling 0.2-0.3% of GDP) to be specified in the 2007 budget law could be used only on condition that outlays for these chapters have been kept under control. While this reform is a step in the right direction, the new mechanism (still to be specified) will have to prove its effectiveness in reversing the record of regular expenditure overruns. The update also illustrates the possibility of introducing stricter eligibility rules in the pension system by 2009, with expected savings of 0.3-0.4% of GDP. This measure, the impact of which is not included in the planned expenditure trends presented in the programme, could be considered as a safeguard against unforeseen negative budgetary developments (similarly to the planned introduction of a real estate tax discussed above).

On the negative side, there is first of all a non-negligible risk that the planned expenditure freezes may not be enforced as intended. In particular, it is uncertain whether the envisaged two-year freeze of the public wage bill will be fully implemented both in 2007 and also 2008, given that approximately 85% of the public sector is not under direct control of the central government, and that the local and regional governments and their budgetary units can be regulated only indirectly (e.g.: through financial incentives). Moreover, the government's plan to keep most of the expenditure items constant at their present nominal level until 2008 may also be questioned given past experience with similar expenditure control: unspecified freezes were usually not respected or led to an accumulation of liabilities in the relevant budgetary chapters.

Second, given that a large share of the planned expenditure reduction can be attributed to measures having temporary effects (expenditure freezes set to expire at the end of 2008), the effective implementation of the Government's structural reform plans is crucial to achieving a lasting improvement in public finances. The Government's wide-ranging reform agenda may be increasingly faced with resistance, particularly as concerns the envisaged restructuring of the price subsidies schemes (which requires further price increases in gas, pharmaceuticals and public transport services) and the introduction of various co-payments in the healthcare sector. The risk that the Government does not implement the planned structural reforms from the early years of the programme would affect the durability of the adjustment and be particularly evident in the final year. This makes it all the more important that the reform agenda set out in the programme is pursued rapidly.

In addition, Hungary's track record of fiscal policy is poor, as shown by budgetary developments in the last several years. In 2006, the original deficit target will have been significantly missed for the fifth year in a row by a large margin, with yet another substantial upward revision of the adjustment path compared to the previous convergence programme updates. Hungary has repeatedly failed to comply with the Council's opinion and recommendations on the correction of the excessive deficit. Finally, the new deficit path does not include any debt takeovers from state-owned public transport companies. The largely state-guaranteed debt stock currently amounts to close to 2% of GDP, accumulated since end-2002. The largest part of this debt (around 1.5% of GDP) belongs to the national railway company (MÁV), for which the Government has devised a restructuring plan outlined in the programme. It envisages a partial privatisation and some paying-off of the company's debt through the proceeds of this operation.[38] The streamlined and partially privatized company is then expected to be able to service the remaining part of its debt. If the operation does not yield the expected outcome, some debt assumption (with a temporary deficit-increasing effect) may still take place at some point in time. In addition, without a significant restructuring of the public transport companies, the practice of accumulating losses and thus, implicit government liabilities, would be likely to continue.

Overall, the budgetary outcome could be worse than projected by the Hungarian authorities, both in the short term and the outer years of the programme.

4.4. Compliance with the Stability and Growth Pact

The Table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value is made (middle column) and, second, the final assessment that also takes into account risks (final column).

Table 6: Overview of compliance with the Stability and Growth Pact

	Based on programme (with targets taken at face value)	**Assessment** (taking into account risks to targets)
Correction of excessive deficit by 2009 deadline on track?	yes, if part of the pension reform burden is considered by the Council (0.3% of GDP in 2009)	yes, conditional on addressing implementation and credibility risks, and assuming that part of the pension reform burden is considered by the Council (0.3% of GDP in 2009)
<u>*Source*</u>: *Commission services*		

The original deadline for the correction of the excessive deficit, 2008, was based on the consideration that "special circumstances" in the meaning of paragraph 3 of Article 4 of Council Regulation (EC) No 1467/97 Council Regulation (EC) No 1467/97[39] – allowing for a correction in a medium-term framework - were deemed to exist in the case of Hungary, notably in view of the size of the deficit and the ongoing structural shift of the economy.

While originally the correction of the deficit was to take place within a medium-term framework ending in 2008, this target date can no longer be regarded as realistic given

---

38 In both 2007 and 2008, the Government plans a capital injection of 0.3-0.3% of GDP into MÁV, and to increase subsidies to the company by 0.2% of GDP from 2007 onwards. The railways' only profitable affiliate, MÁV Cargo, is to be privatised in 2007 and the privatisation proceeds (expected to amount to around 0.4% of GDP) are planned to be used to pay off part of MÁV debt

39 OJ L 209, 2.8.1997, p.6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p.5).

the recent large budgetary slippages in Hungary which have considerably damaged the credibility of the fiscal policy and have been weighing increasingly on the economy. The new medium-term framework for the correction, laid down in the adjusted convergence programme update, puts forward 2009 as the deadline for the correction. In view of the recent slippages, this new deadline, which implies a substantial correction of the structural deficit by more than 6% of GDP over three years, seems appropriate.

In the light of the risk assessment in Section 4.3, the budgetary stance in the programme seems consistent with the recommended adjustment path, provided all measures announced in the programme are effectively implemented and expenditures strictly controlled. In 2009, the programme's deficit target of 3.2% of GDP would still exceed the 3% threshold specified in the Treaty. Even assuming, in line with the programme, that the Council and the Commission, when considering the case for an abrogation of the excessive deficit procedure for Hungary, could indeed take into account a part of the net cost of the pension reform, in line with the revised Stability and Growth Pact[40], the deficit target in 2009 leaves no safety margin against unforeseen slippages.

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

Government debt is the result of the financing needs of government over the years. It corresponds primarily to an accumulation of deficits, though the build up of financial assets and other adjustments may also play a role.[41] The reform of the Stability and Growth Pact has raised attention to the crucial importance of government debt and of sustainability in fiscal surveillance.

This section is in two parts: a first part presents recent developments and the medium-term prospects for government gross debt; it describes the convergence programmes targets, and assesses the associated risks. A second part looks into the government debt from a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

The update projects that the debt-to-GDP ratio would significantly increase in 2006 to 68.5% from 62.3% in 2005 and further to 71.3% in 2007 and to 72.3% in 2008 (all

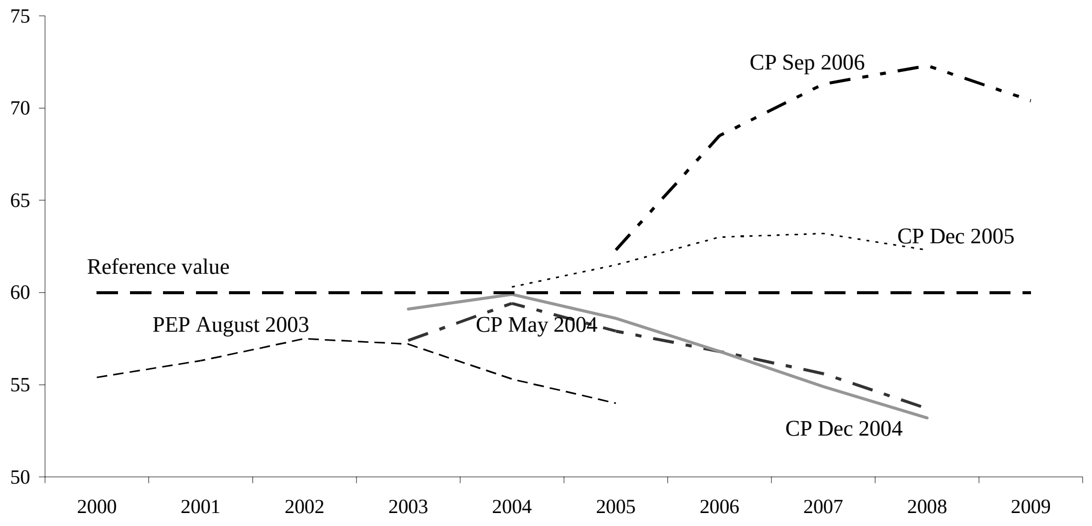
---

40 As discussed above, the allowed deduction of pension reform costs would amount to some 0.3% of GDP in 2009.

41 On the factors other than the deficit which explain the evolution of the government debt, see “The dynamics of government debt: decomposing the stock-flow adjustment”, chapter II.2.2 of *Public Finances in EMU 2005*, European Economy, N°3/2005.

government debt targets include the cost of pension reform)[42]. The ratio is expected to start decreasing only in 2009, to 70.4%. The dynamics presented in the programme are in sharp contrast to the previous update, which, if the pension reform is included, anticipated the debt-to-GDP ratio to be in the range of 61-63% of GDP throughout the programme horizon (see Figure 2).

Figure 2: Debt projections in successive convergence programmes (% of GDP)



<u>Source</u> : Successive convergence programmes (CP), Pre-Accession Economic Programme (PEP)
Note: For the sake of comparability, all deficit targets include the burden of the pension reform.

The large increase in the debt ratio in 2006 (over 6 percentage points) is due to the massive budgetary slippage. The most recent (end-July 2006) data on the debt stock of the central government appear to be in line with the programme's projection. The stock-flow adjustment is expected to be marginally negative in 2006 (see Table 7), as the revaluation of the foreign-exchange denominated debt due to the weakening exchange rate is assumed to largely offset the debt-reducing impact of the sale of the remaining state-owned shares of the national oil company (MOL) in May for around 1.1% of GDP.[43]

---

[42] For the sake of comparability, the debt targets of the previous convergence programmes have also been adjusted to take into account the impact of the reform on debt developments. See footnote 15 for further details. The impact of the pension reform, and of the classification of the new pension scheme outside government, correspond to the accumulation of government bonds by the new pension scheme. If the new pension scheme was classified in government (as it was until recently) the government bonds held by the new pension scheme would consolidate.

[43] In 2005, the high negative stock-flow adjustment was mainly due to the sale of the operating rights of the Budapest Airport company.

Table 7: Debt dynamics

(% of GDP)	average 2000-04*	2005	2006 CP	2007 CP	2008 CP	2009 CP
Gross debt ratio**	**60.2**	**62.3**	**68.5**	**71.3**	**72.3**	**70.4**
Change in the ratio	-0.4	2.1	6.2	2.8	1.0	-1.9
Of which						
Primary balance	**1.1**	**3.4**	**6.3**	**2.4**	**0.2**	**-0.8**
"Snow-ball" effect	**-1.6**	**0.3**	**0.0**	**0.2**	**1.0**	**-0.7**
Of which:						
Interest expenditure	4.4	4.1	3.8	4.4	4.1	4.0
Growth effect (real GDP)	-2.2	-2.3	-2.4	-1.4	-1.8	-2.8
Inflation (GDP deflator)	-3.9	-1.5	-1.4	-2.8	-1.3	-1.9
Stock-flow adjustment	**0.2**	**-1.6**	**-0.1**	**0.2**	**-0.2**	**-0.4**
Of which:						
Cash/accruals diff.	-0.2					
Acc. financial assets	0.5					
Privatisation	-0.7		-1.1			
Val. effect & residual	-0.1					

*The column reporting the average debt dynamics for the 2000-2004 period is based on the April 2006 fiscal notification. Therefore, except for the first line, data in this column are not consitent with the rest of the table as they do not include the burden of the pension reform.

** End of period. In the column average 2000-04, all data are averages except first line which is end of period, that is 2004.

Note:

The change in the gross debt ratio can be decomposed as follows:

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

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. The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes temporary differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Convergence programme update (CP); Commission services' calculations

For future years, the update does not specify any major operations with a large impact on the debt. The programme foresees that after 2006 the government will continue to sell some of its remaining shares of state-owned companies (e.g: Hungarian Airlines Malév, Land Credit and Mortgage Bank). However, the impact of expected privatization proceeds is not included in the debt ratio projections for the period 2007-2009, and rather considered as a possible security reserve against unforeseen adverse developments. In the first years of the programme, the projected debt dynamics would be mainly induced by the envisaged deficit path. The "snow-ball" effect becomes important from 2008, when it is largely responsible for the projected rise in the debt ratio for that year. In 2009, both the shift to a primary surplus and the strong pick-up in growth contribute to the reduction in debt-to-GDP ratio.

5.1.2. Assessment

According to the update, a steady 1 percentage point deviation from 2006 onwards compared to the baseline deficit path would lead to 3.8 percentage points increase in the debt-to-GDP ratio by the end of the programme period. Given that the reduction in the debt ratio crucially depends on achieving lower primary deficits until 2008 and a small primary surplus in the final year of the programme, the debt path contained in the update is subject to the same risks as those attached to the budgetary targets, discussed in

Section 4.3. In particular, as indicated therein, any debt assumptions from state-owned public transport companies (e.g. if the restructuring and partial privatisation plan of the national railway company does not yield the expected results) would have implications for the debt ratio as well. The total debts of these companies are currently estimated to amount to around 2% of GDP (1.5% of GDP of the national railway company alone), more than half of which is state guaranteed. In the past, the Government has assumed the entire debt of these companies, irrespective of the existence or not of a state guarantee.

Moreover, there are also specific risks. Given the relatively large share of foreign currency denominated debt (around 30% of the debt stock) a weaker-than-expected HUF/euro exchange rate would lead to an upward revaluation of the gross debt. A 10% depreciation of the forint in any given year is estimated in the programme to produce an increase in the debt ratio of around 2 percentage points at the end of the year.

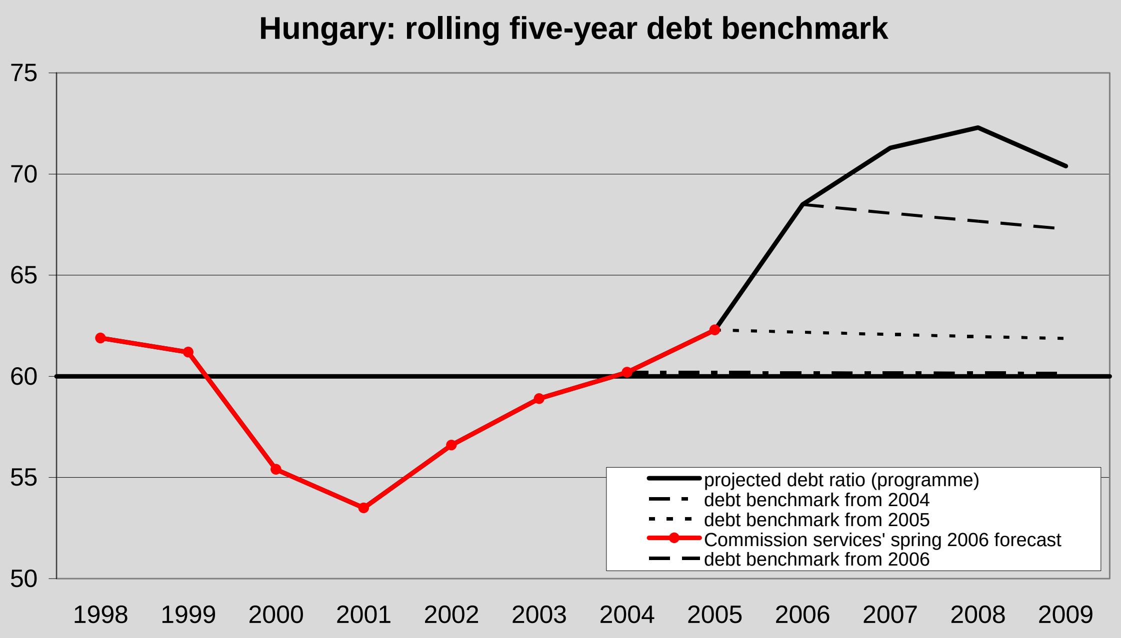
Furthermore, despite the fact that the Hungarian debt is being increasingly financed with long-term bonds, close to 40% of forint-denominated debt (or around 30% of total debt) still has a residual maturity of less than 1 year, which exposes it to possible risks stemming from adverse interest rate changes. Based on the information provided in the programme, the impact from a 1 percentage point increase in interest rates from the beginning of 2007 would result in an approximately 0.6 percentage point higher debt ratio by 2009. In view of the programmed debt developments until 2008 and the above risk assessment for the whole programme period, the debt ratio would not appear to be sufficiently diminishing towards the reference value, although it is expected to fall by around two full percentage points of GDP in the final year of the programme.

Box 4: The rolling debt reduction benchmark

The debt ratio has been exceeding the 60% of GDP reference value since end-2004.

A tentative assessment of the pace of debt reduction over a medium-term horizon is presented in the accompanying graph. It shows historical data and the multi-annual debt projections in the update and compares them with the paths obtained by applying an illustrative “rolling debt reduction benchmark” (*). The benchmark reflects the idea that a minimum debt reduction should be ensured not year after year but over a medium-term horizon (five years in the graph). For instance, the debt projection for 2007 is compared with the value obtained for the same year by applying the formula starting in 2002. Debt level projections in the programme exceeding those obtained by applying the benchmark are taken as an indicator of a slow reduction in the debt ratio.

The graph clearly shows that the planned reduction of the debt ratio in the update is less than implied by the five-year rolling debt reduction benchmark.



Source: *Stability programme and Commission services*

(*) The rolling debt reduction benchmark discussed in this box for successive five-year periods is defined as a reduction in the difference between the debt ratio and the 60% of GDP reference value of 5 percent per year: $\left(\frac{D_t}{Y_t}\right)_{benchmark} = \left(\frac{D_t}{Y_t}\right)_{benchmark} - 5\% \times \left[\left(\frac{D_t}{Y_t}\right)_{benchmark} - 60\right]$, where t is a time subscript and D and Y are the stock of government debt and nominal GDP, respectively. In the first year of the five-year period, the debt ratio in the previous year is the actual debt ratio. Given the usual approximation of the change in the debt ratio $\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{DEF_t}{Y_t} - \frac{y_t}{1+y_t} \times \frac{D_{t-1}}{Y_{t-1}} \cong \frac{DEF_t}{Y_t} - y_t \times \frac{D_{t-1}}{Y_{t-1}}$ and assuming that the stock-flow adjustment is zero, it is easy to show that the rolling debt reduction benchmark describes the path for convergence of the debt ratio towards 60% of GDP which would take place with the deficit at 3% of GDP and nominal GDP growth at 5%. In other words, the 5 percent per year benchmark is the value that makes consistent a continuous respect of the 3% of GDP deficit threshold and an asymptotic respect of the 60% of GDP debt reference value.

5.2. Long-term debt projections and the sustainability of public finances

5.2.1. Basics of long-term sustainability analysis

The issue of long-term sustainability is a multi-faceted one. It involves avoiding imposing an excessive burden on future generations and ensuring the country's capacity to appropriately adjust budgetary policy in the medium and long run.

Debt sustainability is derived from the government's *intertemporal budget constraint*. It imposes that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, should be covered by the discounted value of future government revenue. Based on the projected expenditure trends, deficit and debt levels are projected over the long term. If current policies ensure that the solvency condition is fulfilled, current policies are sustainable. To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account which in addition allows to better qualify the assessment with regard to where the main risks are likely to stem from.

The approach adopted by the Commission services and the Ageing Working Group of the Economic Policy Committee is to project the debt, and to calculate the associated sustainability indicators (see Box 5), on the basis of two different scenarios.

Box 5 – Properties of the sustainability indicators

- The **sustainability gap S1** shows the difference between the current revenue ratio and the constant revenue ratio required to reach a debt ratio in 2050 of 60% of GDP.
- The **sustainability gap S2**, shows the difference between the current revenue ratio and the constant revenue ratio that guarantees the respect of the intertemporal budget constraint of the government, i.e. that equates the actualised flow of revenues and expenditure over an infinite horizon. In order to estimate S2, the revenue and expenditure ratios (age-related and non age-related) after 2050 are assumed to remain constant at the 2050 level.
- The sustainability indicators can be decomposed into the: (i) **Initial Budgetary Position (IBP)**; (ii) **Long-Term Change in the budgetary position (LTC)**; and, (iii) **Debt Requirement in 2050 (DR)**, see Table 8.
- In addition, the **required primary balance (RPB)** can be derived from the S2 indicator. It measures the average primary balance over the first five years of the long-term projection period that results from a permanent budgetary adjustment carried out to comply fully with the S2 indicator*.

Table 8: Summarizing the indicators

	Impact of				
	Initial budgetary position		**Debt requirement in 2050**		**Long-term changes in the primary balance**
S1=	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to reach a debt target of 60% of GDP in 2050	+	Additional adjustment required to finance the increase in public expenditure *up to 2050*
S2=	Gap to the debt-stabilizing primary balance	+	0	+	Additional adjustment required to finance the increase in public expenditure *over an infinite horizon*

* For a complete description of the sustainability indicators, see Annex 11 and 12 of in 'The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)', European Economy, Special Report No 1, 2006.

The first scenario assumes that the structural primary balance will remain unchanged from 2005 through 2009, the final year of the convergence programme; it is called the

"2005 scenario". The second scenario assumes that the macroeconomic and budgetary plans until 2009 provided in the convergence programme will be fully respected. This is the "programme scenario".

5.2.2. *Sustainability indicators and long-term debt projections*

Table 9 shows the evolution of government spending on pensions, healthcare, long-term care, education and unemployment benefits under the "programme scenario" according to the EPC's projections[44]. Non age-related primary expenditure and revenue is assumed to remain constant as a share of GDP.

Table 9: Long-term budgetary projections, % of GDP

Main assumptions - programme scenario (as % GDP)	**2005**	**2010**	**2020**	**2030**	**2040**	**2050**	**% change 2050-2005**
Total age-related spending	21.6	21.8	23.1	24.4	27.5	28.9	7.3
Pensions	10.7	11.1	12.5	13.5	16.0	17.1	6.4
Health care	5.5	5.7	6.0	6.3	6.4	6.5	1.0
Long-term care*	0.7	0.8	0.8	1.0	1.2	1.2	0.6
Education	4.4	3.9	3.5	3.5	3.7	3.8	-0.6
Unemployment benefits	0.2	0.2	0.2	0.2	0.2	0.2	0.0

*This projection was not included in the Ageing Report. Since the completion of the common projections, Hungary has provided the required data so that the Commission could run the projection for long-term care.

The projected increase in age-related spending in Hungary is higher than the EU average, rising by 7.3% points of GDP between 2005 and 2050. The increase is mainly due to the significant increase in pension expenditure of 6.4% points of GDP. The increase in health-care expenditure is projected to be 1% point of GDP, lower than on average in the EU. For long-term care, the projected increase of 0.6% points of GDP up to 2050 coincides with the average rise in the EU. Based on the long-term budgetary projections, sustainability indicators can be calculated[45].

---

[44] These assumptions cover labour productivity growth, real GDP growth, participation rates, unemployment rate, demographic developments, government spending in pensions, health-care, long-term care for the elderly, education and unemployment benefits. See Economic Policy Committee and European Commission (DG ECFIN) (2006), "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health-care, long-term care, education and unemployment transfers (2004-2050)", European Economy, Special Report No 1, 2006. Since the completion of the common projections, Hungary has provided the required data so that the Commission could run the projections for long-term care expenditure. This projection is included in this assessment.

[45] For a complete description of how these indicators are calculated, see Annex 11 and 12 of European Economy, Special Report No 1, 2006.

Table 10: Sustainability indicators

	Sustainability indicators and RPB								
	2005 Scenario					Programme scenario			
	S1	S2		RPB		S1	S2		RPB
Value (of which)	**7.5**	**9.6**		**6.1**		**3.0**	**5.2**		**6.0**
initial budgetary position	*4.3*	*4.6*				*-0.1*	*0.2*		
debt requirement in 2050	*0.3*	*:*				*0.2*	*:*		
long-term change in budgetary position	*2.9*	*5.0*				*2.9*	*5.0*		

Note: the indicators are described in Box 5.

Table 10 shows the sustainability indicators for the two scenarios. In the “2005 scenario”, the sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be at about 7½% of GDP. The sustainability gap (S2) which satisfies the government's intertemporal budget constraint would be 9½% of GDP. Since the structural deficit in 2005 is very high, at 7.6% of GDP, the initial budgetary position is weak and presents a risk to the sustainability of public finances even before considering the impact of the increase in age-related expenditure up to 2050. The large structural government deficit prevents a rapid reduction of the debt ratio. According to both sustainability gap indicators, the long-term budgetary impact of ageing is influenced by the considerable projected increase in pension expenditure over the long-term. The case where the 2006 budgetary position is the starting point for the analysis is presented in Box 6.

Box 6: Impact of changing the base year

As noted above, the "2005 scenario" illustrates the sustainability gap under the assumption that the structural primary balance in 2005 is unchanged throughout the programme period (2009). In the typical case, this scenario takes the estimated budgetary position for the current year according to the programme as the starting point. However, since more than half of 2006 has already passed, the impact of the update's estimated budgetary position in 2006 is given in Table 11 below.

Table 11: Sustainability indicators, "2006 scenario"

	Sustainability indicators and RPB								
	2006 Scenario					Programme scenario			
	S1	S2		RPB		S1	S2		RPB
Value (of which)	**10.2**	**12.1**		**6.2**		**3.0**	**5.2**		**6.0**
initial budgetary position	*6.8*	*7.1*				*-0.1*	*0.2*		
debt requirement in 2050	*0.5*	*:*				*0.2*	*:*		
long-term change in budgetary position	*2.9*	*5.0*				*2.9*	*5.0*		

As a result of the worsening in the structural budgetary position in 2006, being 2.6 percentage points lower compared with 2005, the sustainability indicators show a higher sustainability gap. In the "2006 scenario", both sustainability gap indicators exceed 10% of GDP as a result of the higher deficit. This confirms that pursuing budgetary consolidation is a matter of urgency in Hungary.

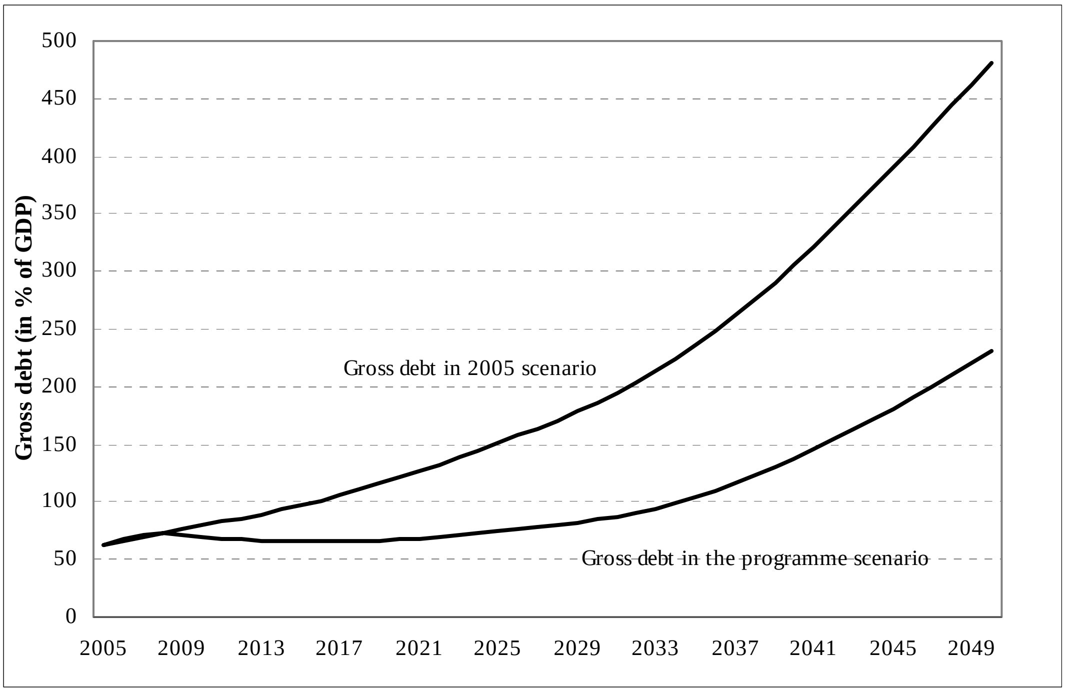
The programme plans a structural budgetary consolidation of 4.4% of GDP between 2005 and 2009 and of 6.5% points of GDP between 2006 and 2009, which, however, is subject to some uncertainty. If achieved, such a consolidation would reduce risks to long-term sustainability of public finances by reducing both sustainability gaps ("programme scenario"). A significant sustainability gap would nonetheless still remain; with the S2 indicator at 5¼% of GDP. The difference between the initial budgetary position in the "2005 scenario" and the "programme scenario" illustrates how the full respect of the convergence programme targets will contribute to tackling the budgetary challenges raised by the demographic developments. The required primary balance (RPB) is 6% of GDP, significantly higher than the structural primary balance of 0.8% of GDP projected in the last year of the programme period.

Moreover, the sustainability gap in the 2005 scenario, as measured by the S2 indicator, would increase by about ¾% GDP if the (budgetary or structural) adjustment were to be postponed by 5 years, highlighting a non-negligible 'cost-of-delay' (see table A3 in Annex 4).

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of S1 and S2. The long-term projections for government debt under the two scenarios are shown in Figure 3. The current gross debt ratio is above the 60% of GDP reference value, at close to 62.3% of GDP in 2005. According to the "2005 scenario", the debt ratio would increase very significantly throughout the long-term projection period and reach some 480% of GDP in 2050. In the "programme scenario" the debt ratio would increase significantly too, though to a lesser degree than in the "2005 scenario"[46].

[46] It should be recalled that, being a mechanical, partial-equilibrium analysis at unchanged policies, the long-term debt projections are bound to show highly accentuated profiles. Consequently, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.

Figure 3: Long-term projections for the government debt ratio



5.2.3. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account which in addition allow to better qualify the assessment with regard to where the main risks are likely to stem from.

- The budgetary outlook has deteriorated further in 2006 and the level of debt is expected to reach more than 70% of GDP in 2007 and remain high throughout the programme period. The high level of government debt constitutes a risk to the sustainability of public finances even before considering the long-term budgetary impact of ageing. This underlines the need to strengthening the budgetary position so as to reduce the debt ratio (See Box 6).

- With regard to the long-term projections, they are based on the underlying assumptions commonly agreed and used by the EPC[47], but the programme's pension projections include additional measures that have not yet entered into force, which, if fully implemented, are estimated according to the update to reduce the increase in pension expenditure by 1.1% point of GDP over the period 2005-2050;

- Finally, as of 2013, pensions will be taxed in Hungary. According to the Hungarian projections[48], this will reduce the net cost for public finances by around 2½% of GDP by 2050, which in turn reduces the S2 sustainability indicator by around 2% of GDP and the S1 indicator by around 1.5% of GDP. Nevertheless, a significant sustainability gap remains.

---

[47] See the Ageing Report (2006).

[48] See http://ec.europa.eu/economy_finance/epc/documents/2006/ageing_hungary_fiche_en.pdf

5.3. Overall assessment

The long-term budgetary impact of ageing in Hungary is above the EU average, influenced notably by a significant increase in pension expenditure as a share of GDP over the long-term.

Moreover and importantly, the initial budgetary position is very weak: the very high structural deficit constitutes a risk to sustainable public finances even before considering the long-term budgetary impact of an ageing population; the current level of gross debt is above the Treaty reference value and is projected to increase significantly in 2006 and remain above 70% of GDP over the programme period. Carrying out a large consolidation of the public finances over the medium-term as planned, further strengthening the budgetary position thereafter, and addressing the significant increase in pension expenditure is therefore necessary in view of reducing risks to the sustainability of public finances.

Overall, Hungary appears to be at high risk with regard to the sustainability of public finances.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

As discussed in section 4.2.2, the measures announced in the programme for the reduction of public expenditure in between 2006 and 2008 are largely based on nominal expenditure freezes and are hence temporary. In order to ensure their implementation and the continuity of such expenditure cuts after 2008, the budgetary adjustment needs to be backed up by structural reforms. This is all the more important as the ageing population represents a major risk to the sustainability of public finances in Hungary.

To address these issues, the programme presents a number of structural reform plans in the areas of public administration, health care, pension and public education. It also contains plans to restructure the subsidy system moving from current distortionary price subsidies towards a more efficient means-tested system. Finally, the programme foresees to take steps in order to strengthen the budgetary discipline and transparency. In particular, the plans outlined in the programme are the following.

Price subsidies: The current system of price subsidies is going to be restructured. First, pharmaceutical subsidies are being revamped in the framework of the health-care reform (see below). Second, household energy price subsidies are planned to be replaced by a more socially oriented means-tested subsidies in the course of 2006 and 2007. In this context, non-market energy prices are being raised to world-market price levels. A first-round increase of gas, electricity and central-heating prices took place as of 1 August 2006. Further increases should follow. Finally, the public transport fee and discount system is planned to be restructured in 2007 in the framework of a new transport development concept.

Public administration: Restructuring plans in this field concern both the central and the local government level. On the *central* government level, the number of ministries has been reduced from 14 to 11 after the April 2006 elections. Moreover, a consolidation and reorganisation of the decentralised bodies of the central administration is to be implemented by the end of this year. The Government expects these measures to support a planned decrease in the number of employees by 20% in ministries and by 10% in the decentralized agencies. Some lay-offs have started to take place already in summer and are planned to continue until 2007. At this stage, it is however too early to assess whether the overall number of employees is decreasing as expected.

The programme also foresees to reduce the current fragmentation of the *local* government in order to improve its efficiency by exploiting economies of scale. After initial regionalisation plans were rejected by the Parliament in July 2006, the Government now plans to achieve the streamlining and rationalisation of the local government via financial incentives and by the introduction of central capacity regulation in certain public services including public education and social care. Draft bills are planned to be submitted to the Parliament in the course of 2006 and 2007, respectively.

Health care: In August 2006, the Government decided to introduce co-payments for public health-care services from 1 January 2007.[49] In addition, the health-care system is to be put on a strict insurance basis, the provision and use of services is to be rationalised and a health-insurance supervision is to be established (draft bill to be submitted to Parliament by end 2006). Subsidies on pharmaceutical products are being restructured. From 1 July 2006, monthly subsidy limits have been introduced for persons entitled to receive drugs free-of-charge. As of 1 January 2007, subsidy rates on prescription drugs will change; currently existing full refunding of certain drugs will be abolished. Furthermore, the fixing of pharmaceutical subsidies will be revised and generalised, the currently existing monopolistic constraints to the establishment of pharmacies gradually removed, and the trade of non-prescription drugs liberalised (draft bill to be submitted to Parliament in the course of 2006).

Pension: According to the programme, the Government plans to review the current rules on the retirement age, pension indexation and the replacement rate. These plans are not further specified. In addition to this, the Government plans to address the issue of early retirement which is a serious problem in Hungary and represents a heavy burden on the budget.[50] Plans to decrease early retirement primarily concern the restructuring of incentive schemes (e.g. by the downward actuarial adjustment of the pension benefit to early retirement; suspension of retirement benefits below retirement age if any income earning activity is pursued). These measures are to be backed by the restructuring of the disability benefit system with the aim of creating incentives to stay in the legal labour market, and of preventing currently widespread abuses (draft bill on early retirement regulation to be submitted to Parliament by end 2006, draft bill on the disability benefit system to be submitted in the course of 2007).

Public education: Plans in this field concern primary and secondary education on one hand and higher education on the other hand. In *primary and secondary* education, an amendment to the Public Education Bill approved by the Parliament in August 2006 prescribes the increase of the number of mandatory hours taught by teachers as from 2007 by roughly 10%. In addition, the Government foresees to rationalise work organisation and to encourage the establishment of more efficient school structures by

---

[49] The amount of the co-payment is fixed at 300 HUF (around 1 euro) per consultation and per day in hospital. This measure is expected to reduce demand for health-care services.

[50] The very low participation among the older generations can be tracked back to massive outflow from the labour market into pension schemes in the early nineties.

financial incentives. Related to the local government financing reforms, the subsidy system of public education is planned to be restructured.[51] The unjustified differences in the burden-sharing ratios across institution-financing entities (government, non-state institutions, capital, rural) are to be eliminated as well (draft bills to be submitted to Parliament in 2006). In *higher education*, tuition fees have been introduced as of 1 September 2007. In addition, the structure and the financing of the higher education programmes is to be changed in line with the Bologna process and measures are planned to be taken in order to reduce the fragmentation of the system and decrease redundancies (draft bill to be submitted to Parliament in 2007). The total number of state-financed students is planned to be decreased and the structure of financing across different fields to be modified (Government decree to be issued by 31 October 2006).

Budgetary process: In addition to the plans described above, the programme foresees an improvement of fiscal discipline and an increase in transparency by the following measures. An amendment to the Public Finance Act approved in July 2006 requires budgetary chapters to set up a chapter balance reserve in addition to the general reserve. The utilization of these reserves is subject to Government authorisation conditional on the quarterly reporting by ministers to the Government. It is expected that this new fiscal rule will be specified in the draft budget to be submitted by the end of October. This rule, the operational mechanism of which is as yet unspecified, is expected to be clarified in the draft budget which will be submitted by the end of October. In addition, starting from the 2007 Budget Bill, expenditure appropriations and the functional budget targets are planned to be defined three years ahead in order to enhance multi-annual budgeting. Public service contracts are planned to be concluded with state-owned (primarily public transport) companies according to which the State will pay the entire cost of the services ordered. Accounting is to become more transparent. Moreover, the Government proposes to report bi-annually to the Commission and the Council about budgetary developments until the abrogation of the excessive deficit procedure.

Overall, the announced reform plans should be conducive to increasing the efficiency of public administration and service provision. Thereby, they may contribute to decreasing public expenditures in a sustainable manner. Some steps have already been taken in major reform areas and a timeline is indicated for the announced reforms. Nevertheless, the majority of the indicated reform steps still remain to be spelled out in detail and to be substantiated. The present budgetary situation requires timely decision on and implementation of these reforms early in the programme period in order to ensure that they achieve their purpose of containing and reducing expenditures by 2009 and beyond, and of restoring fiscal credibility. If fully specified and implemented, these plans may also contribute over the medium term to raising the Hungarian economy's growth potential and enhancing real convergence to EU average.

With the Implementation Report to be submitted by mid-October 2006 in the context of the renewed Lisbon strategy for growth and jobs, the Hungarian Government is planning to substantially revise the reform plans contained in the October 2005 National Reform Programme (NRP), so as to reflect the Government’s new strategy. The NRP identified the following key challenges with significant implications for public finances: (a) to reduce the fiscal deficit, (b) to improve infrastructure and (c) to increase the activity and

[51] The currently existing financing norms based on pupil numbers are to be based on the number of teachers in institutions taking into account the Public Education Bill's regulations of class formation and mandatory hours taught.

the employment rate and enhance human capital. These key challenges were judged appropriate by the January 2006 Annual Progress Report and are likely to remain unchanged. Nevertheless, so far the progress made on the key challenge to reduce the fiscal deficit has been insufficient.

The structural reform measures outlined in the convergence programme are in line with the key challenge related to public finances. The reform measures which have already been implemented, have been accounted for in the public expenditure projections. However, most reforms have not yet been entirely specified and therefore their individual budgetary impact is not included in the programme.

7. CONSISTENCY WITH THE BROAD ECONOMIC POLICY GUIDELINES

The Table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances, which are included in the integrated guidelines for the period 2005-2008.

Overall, the budgetary strategy in the convergence programme is largely consistent with the broad economic policy guidelines.

Table 12: Overview of compliance with the BEPG in the area of public finances

Integrated guidelines	Yes	No	Not applicable
1. To secure economic stability			
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].	X[4]		
– Member States should avoid pro-cyclical fiscal policies[2].			X (not yet in MTO)
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].	X[4]		
– Member States posting current account deficits that risk being unsustainable should work towards correcting them by implementing structural reforms, boosting external competitiveness, where appropriate, contributing to their correction via fiscal policies.	X[5]		
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,			
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.		X	
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible	X[5]		

3. To promote a growth- and employment-orientated and efficient allocation of resources			
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.		X	
Notes: [1]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States. [2]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times". [3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.			
Comments: [4] Conditional on addressing a number of risks discussed in section 4.3. [5] Some reform steps have already been introduced in 2006 and further reform intentions which are to be decided on in the course of 2006 and 2007 are outlined in the programme.			

* * *

ANNEX 1: GLOSSARY

Automatic stabilisers Various features of the tax and spending regime which tend to have a dampening effect on economic fluctuations without requiring a discretionary intervention of fiscal authorities. As a result, the budget balance in % of GDP tends to improve in years of high growth and deteriorate during economic slowdowns. See also *cyclically-adjusted balance, structural balance* and *minimum benchmark*.

Broad economic policy guidelines (BEPGs) Guidelines for the economic and budgetary policies of the Member States. Together with the Employment Guidelines, they form the Integrated Guidelines, prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN). See also *Lisbon strategy*.

Budget balance The balance between total public expenditure and revenue (according to *ESA95*); with a positive balance indicating a surplus and a negative balance indicating a deficit. Also known as *government net borrowing*. For the monitoring of Member State budgetary positions, the EU uses *general government* aggregates. See also *cyclically-adjusted balance, primary balance, structural balance* and *reference values*.

Budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, borrowing or changes in the monetary base; the latter is prohibited in the EU. See also *stock-flow adjustment* and *long-term sustainability*.

Budgetary sensitivity The variation in the *budget balance* brought about by a change in the *output gap*. In the EU, it is estimated to be 0.5 on average, i.e. for any percentage point of GDP below or above potential, the budget-balance-to-GDP ratio deteriorates or improves by half a percentage point. The size of the budgetary sensitivity essentially reflects (i) the revenue and expenditure elasticities of the budget and (ii) the size of discretionary government expenditure. See also *cyclically-adjusted balance, structural balance* and *tax elasticity*.

Code of conduct Policy document adopted by the Economic and Financial Committee (an advisory committee gathering high-level officials from national governments, national central banks, the European Central Bank and the European Commission which prepares the meetings of the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN)) and endorsed by the ECOFIN Council in October 2005, containing specifications on the implementation of the *Stability and Growth Pact* and guidelines on the format and content of *stability programmes* and *convergence programmes*.

Contingent liabilities A possible government obligation to pay the existence of which will be confirmed by the occurrence of one or more uncertain events in the future not wholly under the control of government. For instance, government guarantees on debt issued by private or public companies are contingent liabilities, since the government obligation to pay depends on the non-ability of the original debtor to honour its obligations. See also *implicit liabilities*.

Convergence programme Medium-term budgetary and monetary strategy presented by each Member State that has not yet adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programme, code of conduct* and *medium-term objective*.

Cyclically-adjusted balance The *budget balance* adjusted for its cyclical component (which captures the part of public revenue and expenditure that is linked to the *output gap*), i.e. the budget balance that would prevail if GDP were at its potential level. See also *structural balance, budgetary sensitivity* and *output gap*.

Cyclically-adjusted primary balance The *cyclically-adjusted balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Debt dynamics The evolution of *government debt* as a ratio to GDP; it depends on the *primary deficit*, the debt-increasing impact of interest payments, the dampening effect of GDP growth on the ratio and the *stock-flow adjustment*.

EDP notification See *notification of deficit and debt (or EDP notification).*

ERM II Exchange rate mechanism linking some currencies of non-euro Member States to the euro, which is the centre of the mechanism. For the currency of each Member State participating in the mechanism, a central rate against the euro and a standard fluctuation band of ±15% are defined.

ESA95 European accounting standards for the compilation and reporting of macroeconomic (including budgetary) data by the EU Member States.

Excessive deficit procedure (EDP) A procedure, laid down in the EC Treaty, according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in relation to the *reference values*, in order to assess the existence (or risk) of an excessive deficit in each Member State and to ensure its correction. Its application has been further clarified in the *Stability and Growth Pact*.

Fiscal stance A measure of the thrust of discretionary fiscal policy such as, in this document, the change in the *structural balance* relative to the preceding year. When the change is positive (negative) the fiscal stance is said to be restrictive (expansionary).

Funded pension scheme Pension system in which current pension expenditures are financed by running down assets accumulated over the years on the basis of contributions by the scheme beneficiaries. According to *ESA95*, defined-contribution funded pension schemes are not considered as part of the *general government* sector. See also *pay-as-you-go pension scheme*.

General government The focus of EU budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure* is on general government aggregates, with the general government sector covering national, regional and local government, as well as social security. In principle, public enterprises are excluded.

Government debt See *public debt*.

Government net borrowing See *budget balance*.

Implicit liabilities Future government expenditure which have not yet been funded, even when future expenditure is not backed by law or contractual obligations, but is simply grounded in strong expectations of the public. To be meaningful for economic analysis, implicit liabilities should be assessed net of future revenue assuming that the government will keep collecting taxes (and other non-tax revenue) at rates comparable to current levels. See also *contingent liabilities*.

Interest burden *General government* interest expenditure on *government debt* as a share of GDP.

Lisbon strategy Partnership between the EU and Member States for growth and more and better jobs. Originally approved in 2000, the Lisbon Strategy was revamped in 2005. Based on the Integrated Guidelines (merger of the *broad economic policy guidelines* and the employment guidelines, dealing with macro-economic, micro-economic and employment issues) for the period 2005-2008, Member States drew up 3-year national reform programmes at the end of 2005. They reported on the implementation of the national reform programmes for the first time in autumn 2006. The Commission analyses and summarises these reports in an EU Annual Progress Report each year, in time for the Spring European Council.

Long-term sustainability A combination of budget deficits and debt that ensures that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Maturity structure of public debt The profile of debt in terms of when it is due to be paid back. Interest rate changes affect the *budget balance* directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *public debt*.

Medium-term objective (MTO) According to the *Stability and Growth Pact*, *stability programmes* and *convergence programmes* must present a *medium-term objective* for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances, and is defined in structural terms (see *structural balance*).

Minimum benchmark Estimated budgetary position (in *cyclically-adjusted* terms) that provides a “safety margin” that is enough for the *automatic stabilisers* to operate freely during normal economic slowdowns without breaching the 3% of GDP deficit *reference value*. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks.

National reform programme (NRP) See *Lisbon strategy*.

Notification of deficit and debts (EDP notification) Twice a year (by 1 April and 1 October), EU Member States have to notify their *general government* deficit and debt figures (and a number of associated data) to the Commission, the quality of which is then checked by Eurostat, the Commission department in charge of statistics. See also *budget balance* and *public debt*.

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position. See also *structural balance*.

Output gap The difference between actual GDP and *potential GDP* in any given year, usually expressed as a percent of *potential GDP*. Potential GDP is an unobserved variable and needs to be estimated from actual data. See also *production function method*.

Pay-as-you-go pension scheme (PAYG) Pension system in which current pension expenditures are financed by the contributions of current employees. Also known as *unfunded pension scheme*. See also *funded pension scheme*.

Potential GDP The level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *production function method* and *output gap*.

Primary balance The *budget balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by lowering the *structural balance* when the *output gap* is positive or improving, or by increasing when the *output gap* is negative or widening, as opposed to a counter-cyclical fiscal policy stance. A neutral fiscal policy keeps the *structural balance* unchanged over the economic cycle by letting the *automatic stabilisers* work.

Production function method A method to estimate *potential GDP* typically based on a Cobb-Douglas production function. Potential GDP is estimated as the level of GDP consistent with a full utilisation of capital, an unemployment rate that does not accelerate inflation and factor productivity at its trend level. See also *output gap, cyclically-adjusted balance, budgetary sensitivity*.

Public debt (or government debt) Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by government units, except that part of the debt which is owed to government units in the same Member State. It is a gross debt measure meaning that government financial assets on other sectors are not netted out. See also *debt dynamics* and *reference values*.

Public investment The component of total public expenditure which consists in the acquisition of durable assets and through which governments increase and improve the stock of capital employed in the production of the goods and services they provide. Also known as government gross fixed capital formation (GFCF).

Public-private partnerships (PPP) Agreements between government and corporations according to which the latter build and operate public-use infrastructure (roads, tunnels, bridges, but also hospitals, prisons, concert halls, etc.) which were traditionally directly controlled by government. In exploiting the infrastructure, the corporation receives prices paid by final users, rentals or fees from the government or both. Infrastructure built under PPPs is considered as either government investment or corporate investment depending on a number of specific criteria.

Quality of public finances A multi-dimensional concept which refers to the contribution that public finances make to the efficient allocation of resources in the economy and to achieving the government's strategic objectives (sustainable growth, macroeconomic stability, competitiveness, social cohesion etc.). It concerns notably the overall level of expenditure and taxation, their composition, the budgeting and control mechanisms and the institutional arrangements for deciding on public finance issues.

Reference values for public deficit and debt Respectively, a 3 percent *general government* deficit-to-GDP ratio and a 60 percent *general government* debt-to-GDP ratio. See also *excessive deficit procedure, government debt* and *budget balance*.

Sensitivity analysis An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection to changes in the underlying assumptions.

'Snow-ball' effect The self-reinforcing effect of *public debt* accumulation or decumulation arising from a positive or negative differential between the implicit interest rate on public debt and the GDP growth rate. See also *debt dynamics*.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005, the SGP clarifies the provisions on budgetary surveillance in the EC Treaty. The "preventive" arm of the SGP obliges Member States to submit annual *stability and convergence programmes*, while the "corrective" arm of the SGP clarifies and speeds up the *excessive deficit procedure*.

Stability programme Medium-term budgetary strategy presented by each Member State that has already adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *convergence programme, code of conduct* and *medium-term objective*.

Stock-flow adjustment (SFA) The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between *government net borrowing*, which is a flow variable, and the variation in *government debt*, which is a stock variable. It includes differences between cash and accrual accounting, accumulation of financial assets, changes in the value of debt denominated in foreign currency and remaining statistical adjustments. See also *debt dynamics.*

Structural balance The *budget balance* in *cyclically-adjusted* terms and excluding *one-off and temporary measures*. See also *fiscal stance*.

Structural primary balance The *structural balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

ANNEX 2: SUMMARY TABLES FROM THE PROGRAMME UPDATE

Table 1a. Macroeconomic prospects

	ESA Code	2004 Level	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change
1. Real GDP	B1*g	**15637.1**	**4.1**	**4.1**	**2.2**	**2.6**	**4.1**
2. Nominal GDP	B1*g	**20429.5**	**6.7**	**6.5**	**6.5**	**4.5**	**6.9**
Components of real GDP							
3. Private consumption expenditure	P.3	**9033**	**1.7**	**3.0**	**-0.7**	**0.6**	**1.5**
4. Government consumption expenditure	P.3	**3554.3**	**-0.4**	**1.7**	**-1.8**	**-3.8**	**1.4**
5. Gross fixed capital formation	P.51	**4021.3**	**6.6**	**6.6**	**2.1**	**3.7**	**7.0**
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	**-100.6**	**-2.3**	**-3.9**	**-3.8**	**-3.8**	**-3.6**
7. Exports of goods and services	P.6	**13535.8**	**10.8**	**12.0**	**10.9**	**9.9**	**9.4**
8. Imports of goods and services	P.7	**14406.7**	**6.5**	**9.5**	**8.5**	**8.0**	**8.8**
Contributions to real GDP growth							
9. Final domestic demand		**-**	**2.6**	**3.8**	**-0.2**	**0.5**	**2.9**
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	**-**	**-1.7**	**-1.7**	**0.0**	**0.0**	**0.0**
11. External balance of goods and services	B.11	-	**3.3**	**2.1**	**2.4**	**2.1**	**1.1**

Table 1b. Price developments

	ESA Code	2004 level	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change
1. GDP deflator			**2.5**	**2.3**	**4.2**	**1.9**	**2.7**
2. Private consumption deflator			6.2	3.7	6.2	3.3	3.0
3. HICP[1]			**3.6**	**3.5**	**6.2**	**3.3**	**3.0**
4. Public consumption deflator			5.7	5.3	2.0	0.1	2.9
5. Investment deflator			2.5	4.6	4.4	3.1	2.9
6. Export price deflator (goods and services)			**-0.6**	**6.9**	**3.1**	**1.0**	**1.0**
7. Import price deflator (goods and services)			**1.1**	**8.9**	**2.9**	**0.8**	**0.8**

Table 1c. Labour market developments

	ESA Code	2004 Level	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change
1. Employment, persons[2]			**0.0**	**0.3**	**0.0**	**0.3**	**0.7**
2. Employment, hours worked[3]			n.a.	n.a.	n.a.	n.a.	n.a.
3. Unemployment rate (%)[4]			**7.2**	**7.3**	**7.5**	**7.4**	**7.3**
4. Labour productivity, persons [5]			**4.0**	**3.8**	**2.2**	**2.3**	**3.3**
5. Labour productivity, hours worked[6]			n.a.	n.a.	n.a.	n.a.	n.a.
6. Compensation of employees	D.1		**7.8**	**6.4**	**6.5**	**4.0**	**5.6**

Table 1d. Sectoral balances

% of GDP	ESA Code	2005	2006	2007	2008	2009
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	**-6.6**	**-7.1**	**-4.2**	**-2.2**	**-1.4**
of which:						
- Balance on goods and services		-1.3	-1.2	0.6	2.2	2.8
- Balance of primary incomes and transfers		-6.1	-6.7	-6.5	-6.5	-6.4
- Capital account	B.9/ EDP B.9	0.8	0.8	1.7	2.2	2.2
2. Net lending/borrowing of the private sector	B.9	0.9	3.0	2.6	2.1	1.8
3. Net lending/borrowing of general government		-7.5	-10.1	-6.8	-4.3	-3.2
4. Statistical discrepancy[1]		0.8	n.a.	n.a.	n.a.	n.a.

[1] statistical discrepancy included in item 2 net lending/borrowing of private sector

Table 2. General government budgetary prospects

	ESA code	**2004**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
		HUF bn	Percentage of GDP					
Net lending (EDP B.9) by sub-sector								
1. General government	S.13.	**-1338.6**	**-6.6**	**-7.5**	**-10.1**	**-6.8**	**-4.3**	**-3.2**
2. Central government	S.1311.	**-886.7**	**-4.3**	**-4.8**	**-8.4**	**-5.3**	**-2.7**	**-1.9**
3. State government	S.1312	-	-	-	-	-	-	-
4. Local government	S.1313.	**-46.7**	**-0.2**	**-0.6**	**-0.7**	**-0.4**	**-0.5**	**-0.5**
5. Social security funds	S.1314.	**-405.2**	**-2.0**	**-2.1**	**-1.0**	**-1.1**	**-1.1**	**-0.8**
General government (S13)								
6. Total revenue	TR	**8781.4**	**43.0**	**43.1**	**42.4**	**44.2**	**44.8**	**45.4**
7. Total expenditure	TE	**10120.0**	**49.6**	**50.6**	**52.5**	**51.0**	**49.1**	**48.6**
8. Net lending/borrowing	EDP B.9.	**-1338.6**	**-6.6**	**-7.5**	**-10.1**	**-6.8**	**-4.3**	**-3.2**
9. Interest expenditure (incl. FISIM)	EDP D.41.+ FISIM	**892.9**	**4.4**	**4.1**	**3.8**	**4.4**	**4.1**	**4.0**
9a. FISIM		**20.8**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**
10. Primary balance		**-445.7**	**-2.2**	**-3.4**	**-6.3**	**-2.4**	**-0.2**	**0.8**
Selected components of revenue								
11. Total taxes (11=11a+11b+11c)		5206.0	**25.5**	**24.9**	**24.1**	**25.3**	**25.5**	**25.2**
11a. Taxes on production and imports	D.2.	3308.2	**16.2**	**15.6**	**14.6**	**14.8**	**14.7**	**14.4**
11b. Current taxes on income, wealth, etc.	D.5.	1879.2	**9.2**	**9.2**	**9.4**	**10.4**	**10.7**	**10.7**
11c. Capital taxes	D.91.	18.6	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**
12. Social contributions	D.61.	2557.7	**12.5**	**12.8**	**12.8**	**13.5**	**13.5**	**13.4**
13. Property income	D.4.	219.8	**1.1**	**0.8**	**0.5**	**0.4**	**0.3**	**0.3**
14. Others (14=15-(11+12+13))		797.9	**3.9**	**4.6**	**5.0**	**5.0**	**5.5**	**6.5**
15.=6. Total revenue	TR	8781.4	**43.0**	**43.1**	**42.4**	**44.2**	**44.8**	**45.4**
Tax burden (D.2.+D.5.+D.61.+D.91.-D.995.)		7763.7	38.0	37.7	36.9	38.8	39.0	38.6
Selected components of expenditure								
16. Collective consumption	P32	**2171.5**	**10.6**	**10.4**	**10.3**	**9.8**	**9.1**	**8.9**
17. Total social transfers	D.62 + D.63.	**5562.2**	**27.2**	**27.9**	**28.7**	**27.8**	**27.0**	**26.4**
17a. Social transfers in kind	D63	2677.2	13.1	13.1	13.2	12.2	11.4	11.1
17b. Social transfers other than in kind	D62	2885.0	14.1	14.8	15.5	15.6	15.6	15.3
18.=9. Interest expenditure (incl. FISIM)	D41+ FISIM	892.9	**4.4**	**4.1**	**3.8**	**4.4**	**4.1**	**4.0**
19. Subsidies	D3	324.7	**1.6**	**1.6**	**1.4**	**1.5**	**1.4**	**1.4**
20. Gross fixed capital formation	P51	730.7	**3.6**	**3.4**	**4.5**	**3.6**	**3.3**	**3.6**
21. Other (21=22-(16+17+18+19+20))		438.0	**2.2**	**3.2**	**3.8**	**3.9**	**4.2**	**4.3**
22=7. Total expenditure	TE[1]	10120.0	**49.6**	**50.6**	**52.5**	**51.0**	**49.1**	**48.6**
Pm: compensation of employees	D.1.	2612.8	12.8	12.6	12.1	11.4	10.5	10.2

[1] corrected with the net effect of SWAP transactions (TR-TE= EDP B.9.)

Table 3. General government expenditure by function

% of GDP	COFOG Code	Year X-2	Year X+3
1. General public services	1		
2. Defence	2		
3. Public order and safety	3		
4. Economic affairs	4		
5. Environmental protection	5		
6. Housing and community amenities	6		
7. Health	7		
8. Recreation, culture and religion	8		
9. Education	9		
10. Social protection	10		
11. Total expenditure	TE[11]		
(= item 7=26 in Table 2)			

Table 4 . General government debt developments

Percentage of GDP	ESA code	2004	2005	2006	2007	2008	2009
1. Gross debt		**60.2**	**62.3**	**68.5**	**71.3**	**72.3**	**70.4**
2. Change in gross debt ratio		**6.4**	**5.9**	**10.0**	**7.0**	**4.1**	**2.7**
Contributions to changes in gross debt							
3. Primary balance		**2.2**	**3.4**	**6.3**	**2.4**	**0.2**	**-0.8**
4. Interest expenditure (incl. FISIM)		**4.4**	**4.1**	**3.8**	**4.4**	**4.1**	**4.0**
5. Stock-flow adjustment		**-0.2**	**-1.6**	**-0.1**	**0.2**	**-0.2**	**-0.5**
of which:							
Differences between cash and accruals							
Net accumulations of financial assets							
of which privatization revenues		-0.8		-1.1			
Valuation effects and other							
Implicit interest rate on debt (%)		**7.7**	**6.9**	**6.0**	**6.4**	**5.9**	**5.7**
Other relevant variables							
6. Liquid financial assets							
7. Net financial debt							

Table 5. Cyclical developments

Percentage of GDP	ESA code	2004	2005	2006	2007	2008	2009
1. Real GDP growth at 2000 prices (%)		**5.2**	**4.1**	**4.1**	**2.2**	**2.6**	**4.1**
2. Net lending of general government	**B9**	**-6.6**	**-7.5**	**-10.1**	**-6.8**	**-4.3**	**-3.2**
3. Interest expenditure (incl. FISIM recorded as consumption)	**D41 + FISIM**	**4.4**	**4.1**	**3.8**	**4.4**	**4.1**	**4.0**
4. Potential GDP growth (%)		4.1	4.1	4.0	4.0	3.9	3.9
contributions: - labour		0.4	0.3	0.3	0.4	0.3	0.3
- capital		1.9	2.0	2.0	2.0	1.9	1.9
- total factor productivity		1.8	1.7	1.7	1.6	1.6	1.5
5. Output gap		1.0	1.1	1.2	-0.6	-1.9	-1.7
6. Cyclical budgetary component		0.3	0.3	0.3	-0.2	-0.5	-0.4
7. Cyclically-adjusted balance (2-6)		-6.9	-7.8	-10.4	-6.6	-3.8	-2.8
8. Cyclically-adjusted primary balance (7-3)		-2.5	-3.7	-6.6	-2.2	0.3	1.2

Table 6. Divergence from previous update

	2005	2006	2007	2008	2009
Real GDP growth (%)					
Previous update	4.2	4.3	4.1	4.1	-
Current update	4.1	4.1	2.2	2.6	4.1
Difference	-0.1	-0.2	-1.9	-1.5	-
General government net lending (% of GDP)					
Previous update[1]	7.4	6.1	4.7	3.4	-
Current update	7.5	10.1	6.8	4.3	3.2
Difference	0.1	4.0	2.1	0.9	-
General government gross debt (% of GDP)					
Previous update[1]	61.5	63.0	63.2	62.3	-
Current update	62.3	68.5	71.3	72.3	70.4
Difference	0.8	5.5	8.1	10.0	-

[1] The December 2005 programme was published excl. pension fund reforms. To make the table comparable, in this table they are included in both lines

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Pension expenditure (net)[1]	9.3	10.5	10.3	10.7	10.7	13.5
of which:						
Social security pension	9.3	10.5	10.3	10.7	10.7	13.5
Old age and early pensions[2]	6.7	8.0	8.0	9.6	9.8	12.6
Other pensions	2.5	2.4	2.3	1.1	0.9	0.9
Health care expenditure[3]	5.0	5.5	5.7	6.0	6.3	6.5
Education expenditure		4.4	3.9	3.5	3.5	3.8
Other age related expenditure[4]		0.2	0.2	0.2	0.2	0.2
Revenues of pension contributions	7.0	6.5	7.1	6.8	6.8	7.0
Assumptions						
Labour productivity growth	4.2	4.0	3.6	2.9	2.7	1.7
Real GDP growth	5.2	4.1	4.3	2.5	2.1	1.1
Participation rate, males	67.5	67.9	69.1	73.6	73.1	71.5
Participation rate, females	52.6	55.1	57.6	61.5	62.6	61.3
Total participation rate	59.9	61.4	63.3	67.5	67.8	66.4
Unemployment rate	6.4	7.2	7.2	4.8	4.8	4.8
Population aged 65 +over / total population	15.0	15.6	16.7	20.3	22.3	28.1

[1] Including pension payments from other funds than Social Security Fund. Projection of the Ministry of Finance until 2010, projection of the EPC AWG afterwards,corrected with the effect of the stabilisation measures of 2006-2007.

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

[3] 2005-2050: projections of the EPC AWG 2000: OECD Health data 2005

[4] Projection of the EPC AWG

Table 8. Basic assumptions

	2005	2006	2007	2008	2009
Hungary: short-term interest rate (annual average)	6.8	6.8	7.1	6.5	5.8
Hungary: long-term interest rate (annual average)	6.6	7.4	6.8	6.1	5.6
HUF/EUR exchange rate (annual average)	248.1	267.0	272.5	272.5	272.5
World excluding EU, GDP growth	5.4	5.2	4.9	4.8	4.7
EU GDP growth	1.6	2.3	2.2	2.0	2.0
Growth of foreign markets of Hungary	5.5	7.2	5.4	5.3	5.3
World import volumes, excluding EU	8.1	9.6	8.2	8.0	8.0
Oil prices (Brent, USD/barrel)	54.1	68.9	71.0	70.0	70.0

ANNEX 3: COMPLIANCE WITH THE CODE OF CONDUCT

The Table below provides a detailed assessment of whether the programme respects the requirements of Section II of the new code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements.

Guidelines in the new code of conduct	Yes	No	Comments
1. Submission of the programme			
The adjusted programme was submitted 1 September as specified by the Council Opinion on the previous update[1].	X		
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	X		
The programme provides all compulsory information in these tables.	X		
The programme provides all optional information in these tables.		X	
The concepts used are in line with the European system of accounts (ESA).	X		
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.		X	Before the 1 September submission of the update, a number of permanent Parliamentary committees participated in the social dialogue about the programme.
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.		X	
b. Economic outlook			
Euro area and ERM II Member States uses the “common external assumptions” on the main extra-EU variables.			not applicable
Significant divergences between the national and the Commission services’ economic forecasts are explained[2].			not applicable
The possible upside and downside risks to the economic outlook are brought out.	X		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.	X		Sectoral balances only in Annex table 1
c. Monetary/exchange rate policy			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
d. Budgetary strategy			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	X		

In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.		X	The ruling coalition has been re-elected, but the large slippages and the much higher starting deficit required a new adjustment path.
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.	X		
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.		X	The broad measures are indicated in the programme, but the assessment of quantitative effects missing of planned structural measures.
Information is provided on one-off and other temporary measures.	X		
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	X		
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.	X		
e. "Major structural reforms"			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible 'major structural reforms' over time.			not applicable
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			not applicable
f. Sensitivity analysis			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.	 X X X		 not applicable
In case of "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			not applicable
g. Broad economic policy guidelines			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.	X		
h. Quality of public finances			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	X		
i. Long-term sustainability			
The programme outlines the country's strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.	X		

Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary additional information. (…) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.	X		
j. Other information (optional)			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	X		The specifics of the new expenditure rule are not provided.
Notes: [1]The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on “budget day”, i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December. [2]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services’ autumn forecast and the submission of the programme.			

ANNEX 4: INDICATORS OF LONG-TERM SUSTAINABILITY

Table A1: Long-term projections compared

	2005	2010	2020	2050	change 2050-2005
AR gross pensions	10.7	11.1	12.5	17.1	6.4
AR net pensions	10.7	11.1	11.7	14.6	3.9
CP 2005bis pensions	10.5	10.3	10.7	13.5	3.0

Source: Ageing Report (2006), 2005bis updated convergence programme of Hungary

Table A2: The cost of a five-year delay in adjusting the budgetary position according to the S1 and S2

	S1	**S2**
2005 scenario	1.2	0.7
Programme scenario	0.5	0.4

Note: The cost of a delay shows the increase of the S1 and S2 indicators if they were calculated five years later.

Table A3: Projected debt developments

Results (as % GDP)	**2005**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Programme scenario							
Gross debt	62.3	69.3	67.2	84.3	137.4	230.6	168.3
*Gross debt, i + 1**		*70.0*	*74.7*	*100.6*	*170.2*	*293.8*	*293.8*
*Gross debt, i - 1**		*68.7*	*60.4*	*70.8*	*112.2*	*185.0*	*185.0*
2005 Scenario							
Gross debt	62.3	79.3	120.9	185.9	305.8	481.6	419.3
*Gross debt, i + 1**		*80.0*	*131.4*	*213.4*	*367.5*	*605.7*	*605.7*
*Gross debt, i - 1**		*78.6*	*111.3*	*162.5*	*256.8*	*389.1*	*389.1*

* *i + 1* and *i + 1* represents the evolution of debt under the assumption of the nominal interest rate being 100 basis points higher o1r lower throughout the projection period.