

+



**EUROPEAN COMMISSION**  
DIRECTORATE GENERAL  
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 6 February 2008  
ECFIN/55918/08-EN

**HUNGARY: MACRO FISCAL ASSESSMENT**  
**AN ANALYSIS OF THE NOVEMBER 2007 UPDATE OF THE CONVERGENCE**  
**PROGRAMME**

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. The most recent update of Hungary’s convergence programme was submitted on 30 November 2007.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission, was finalised on 6 February 2008. Comments should be sent to László Jankovics ([Laszlo.Jankovics@ec.europa.eu](mailto:Laszlo.Jankovics@ec.europa.eu)) and Balázs Párkányi ([Balazs.Parkanyi@ec.europa.eu](mailto:Balazs.Parkanyi@ec.europa.eu)). The main aim of the 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.

The analysis takes into account (i) the Commission services’ autumn 2007 forecast, (ii) 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) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. Technical issues are explained in an accompanying “methodological paper” prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 23 January 2008. The ECOFIN Council is expected to adopt its opinion on the programme on 12 February 2008.

\* \* \*

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

## TABLE OF CONTENTS

SUMMARY AND CONCLUSIONS.....	5
1. INTRODUCTION.....	9
2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON THE REFORM OF FISCAL GOVERNANCE.....	9
2.1. Economic performance and outlook in Hungary in comparison with the other new Member States.....	10
2.2. Fiscal governance in Hungary.....	13
2.3. The reform proposal for a comprehensive revamp of public finances.....	17
2.4. Prospects for the medium run.....	21
3. MACROECONOMIC OUTLOOK.....	22
3.1. Economic activity.....	22
3.2. Labour market and cost and price developments.....	25
3.3. Macroeconomic challenges.....	25
4. GENERAL GOVERNMENT BALANCE.....	27
4.1. Budgetary implementation in 2007.....	27
4.2. The programme's medium-term budgetary strategy.....	30
4.2.1. The main goal of the programme's budgetary strategy.....	30
4.2.2. The composition of the budgetary adjustment.....	33
4.3. Risk assessment.....	36
4.4. Assessment of the fiscal stance and budgetary strategy.....	41
5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY.....	43
5.1. Recent debt developments and medium-term prospects.....	43
5.1.1. Debt projections in the programme.....	43
5.1.2. Assessment.....	46
5.2. Long-term debt projections and the sustainability of public finances.....	48
5.2.1. Sustainability indicators and long-term debt projections.....	48
5.2.2. Additional factors.....	51
5.2.3. Assessment.....	52
6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES.....	53
7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES.....	54
Annex 1: Compliance with the code of conduct.....	58

Annex 2: Key indicators of past economic performance ..... 66

## SUMMARY AND CONCLUSIONS

As part of the preventive arm of the Stability and Growth Pact, each Member State that does not use the single currency, such as Hungary, has to submit a convergence programme and annual updates thereof. The most recent programme, covering the period 2007-2011, was submitted on 30 November 2007. Under the corrective arm of the Pact, Hungary was placed in excessive deficit by the Council in 5 July 2004. The deadline for correcting the excessive deficit is 2009.

Over the last several years, Hungary has fallen behind in the catching-up process compared to its neighbours. This has been coupled with increasing fiscal laxity, which contributed to considerable internal and external imbalances and relatively tight monetary policy. Since mid-2006, the Government has taken measures to consolidate public finances. These have set the budget deficit on a decreasing trend from a peak of over 9% of GDP in 2006 to around 6% in 2007 and have started to lead to an improvement of the external balance. At the same time, the indirect tax increases and hikes in regulated prices have put upward pressure on inflation, which should decelerate again from 2008.

Over the last 15 years, government deficits reached the highest levels in election years in Hungary, which suggest that weak fiscal governance has played a remarkable role in the recent significant deterioration of public finances. At the same time, the serious fiscal imbalances hampered economic activity through various channels, which also held back catching-up vis-à-vis the EU average. The Government recently submitted a comprehensive proposal to Parliament to reform Hungarian public finances. It represents an important step to cure these institutional weaknesses, even though there is still room for improvement. It will be crucial that the reform is based on a broad political consensus so as to ensure its durability and credibility.

The baseline macroeconomic scenario in the convergence programme update projects real GDP growth to decelerate to below 2% annual average in 2007 and to return to 4% and above from 2009 onwards. In light of currently available information, the growth assumptions appear to be plausible for 2007 and 2008, but rather favourable thereafter. In particular, starting from 2009, the programme projects a rather quick recovery and hence a somewhat favourable evolution of domestic demand, in parallel with only a moderate decline in the contribution of net exports. The envisaged robust growth after 2008 hinges on a rather optimistic assumption for the increase of labour productivity and on the projected rebound in private consumption and investment. Although the foreseen decline in inflation from 7.9% in 2007 to around 3% in the outer years is broadly plausible, higher-than-projected wages and sustained pressure from commodity prices may pose risks to the programme's inflation trajectory and thus could further delay nominal convergence. In this context, the continued implementation of structural reforms and a prudent tax policy play an important role.

While the general government deficit target for 2007 was set to 6.8% of GDP in the previous update of the convergence programme, the current update has foreseen the deficit to reach 6.2% of GDP. In mid-January however, the Government announced yet again a lower deficit forecast of 5.7% of GDP. The overachievement of the 2007 deficit target is chiefly due to a favourable base effect from 2006 as well as higher-than-expected revenues resulting from tax increases and the implementation of a set of measures addressing tax evasion. Nevertheless, the reduction in the deficit would have

been even higher had close to half of the additional room for manoeuvre not been used to raise expenditures more than planned. On the whole, the budgetary implementation in 2007 was broadly in line with the invitation in the Council opinion on the previous update of the convergence programme.

The main goal of the update is to correct the excessive deficit by 2009 (reducing it from 6.2% of GDP in 2007 to 3.2% of GDP in 2009), in line with the previous update against a background of a broadly similar macroeconomic scenario, and to further reduce it to 2.2% of GDP in 2011. The update confirms the medium-term objective (MTO) for the budgetary position of a 0.5% of GDP deficit in structural terms (i.e. cyclically-adjusted and net of one-off and other temporary measures), which is not expected to be achieved within the programme period. The budgetary consolidation is planned to be realised by reducing the expenditure-to-GDP ratio, after a drop of 1.5 percentage points in 2007, by some 6 percentage points over the programme period; this would more than offset the decrease, from 2008, in the revenue-to-GDP ratio by around 2 percentage points (chiefly driven by a reduction in the tax burden owing to a tax-poor composition of GDP growth). After the expiry of expenditure freezes in 2009, the reduction in the expenditure ratio would be achieved through the progressive phasing-in of structural reforms in the areas of public administration, education, healthcare and pensions as well as further cuts in price subsidies. Government gross debt, estimated at around 65% of GDP in 2007, i.e. above the 60% of GDP Treaty reference value, is projected to decline by 3.6 percentage points over the programme period.

The risks to the budgetary projections in the programme appear broadly balanced in 2008. The Commission services' 2007 autumn forecast projected a deficit of 4.2% of GDP for 2008, but in view of the recent information (in particular the expected better outcome in 2007), the budgetary outcome could be closer, or possibly even below, to the deficit target of 4% of GDP for 2008. However, from 2009, the budgetary outcomes could be worse than targeted. The risks stemming from the macroeconomic outlook are neutral until 2008, but from 2009 lower-than-projected GDP growth could lead to higher deficits. Some signs of relaxation in the enforcement of measures on expenditure are appearing. Additional risks on the expenditure side may arise if the planned reorganisation of the heavily-indebted national railway company does not lead to a reduction in related government expenditure. Further plans and follow-up steps for structural reforms play a crucial role in curbing expenditures but there is still a risk that they may not be fully specified and adopted. An important reform proposal improving fiscal governance, submitted to Parliament in November 2007, should help enhance the credibility of the budgetary strategy and reduce budgetary risks; however it will require adoption by qualified majority and its effectiveness in reversing the recent pattern of budgetary slippages needs to be tested. Even though the recent budgetary performance has been better than planned, starting from 2009, there is a risk of a budgetary loosening compared to plans as evidenced by past experience. The negative risks to the budgetary targets equally apply to the debt ratio, therefore its evolution is also likely to be less favourable than projected in the programme, especially after 2008.

In view of this risk assessment, the planned 2009 deficit target of 3.2% of GDP does not provide an adequate buffer against unforeseen negative budgetary developments. A sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations is not expected to be provided within the programme period. In the years following the correction of the excessive deficit, the pace of adjustment towards the MTO implied by the programme appears to be inadequate, and moreover is not backed up with measures. In particular, the annual improvement in the structural

balance is projected to be only ¼% of GDP in the outer years of the programme period. Finally, taking into account the risks to the debt projections mentioned above, the debt ratio may not be sufficiently diminishing towards the reference value over the programme period.

Hungary appears to be at high risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing on gross public expenditure is above the EU average. Recent reforms in 2006 and 2007 have helped curb the increase in age-related expenditure. However, the full materialisation of savings expected from the direct taxation of pensions from 2013 onwards crucially depends on the future tax treatment of pensions, which is not yet fully decided upon. Moreover, and importantly, the budgetary position in 2007 as estimated in the programme, while significantly improved compared to 2006, still constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. In addition, the current level of gross debt is above the Treaty reference value. Further budgetary consolidation as planned in the programme would contribute to reducing risks to the sustainability of public finances.

Hungary's national reform programme as updated in October 2006 recognises key challenges in reducing the fiscal deficit; raising the employment and the activity rate; improving active labour market policies and the situation of the disadvantaged in the labour market; reducing regional labour market disparities and in the fields of R&D and innovation; business environment; competition; infrastructure; education and training; energy and environment. In its Strategic Report the Commission's assessment was that Hungary while having made strong efforts and the pace of reform have accelerated, it has made limited progress in implementing its national reform programme over the period 2005-2007. Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that Hungary should be asked to give highest priority to the challenges in the areas of: public finances consolidation; public administration reform, health care, pension and education systems; active labour market policies; education and training. The convergence programme seems to be consistent to some extent with the October 2007 implementation report of the national reform programme, since both incorporate the structural reform plans in broad terms, although the systematic quantifications of the budgetary impacts are missing. The budgetary strategy in the programme is broadly consistent with the country-specific broad economic policy guidelines included in the integrated guidelines in the area of budgetary policies.

The overall conclusion is that the programme plans to continue the correction of high deficits of the past years through a necessary frontloaded adjustment effort and envisages modest progress towards the MTO after the planned correction of the excessive deficit in 2009. As a result of the consolidation measures and steps in structural reforms, Hungary is set to considerably outperform its deficit target for 2007 of 6.8% of GDP and to increase progress towards convergence. It also improves somewhat the target for 2008 (to 4% of GDP) compared to the previous programme, and in view of the expected better outcome in 2007 it should be feasible, and indeed desirable, to overachieve it. However, the lower deficit targets are combined with higher-than-previously-planned expenditures on the back of better-than-expected revenues, which cannot be counted on after 2008. Moreover, from 2009 the achievement of the budgetary targets is subject to increasing risks, linked mainly to possible expenditure overruns in case the announced wide-ranging reform agenda is not fully carried out. Thus, the durability of the planned adjustment hinges on the reinforcement of fiscal governance as well as on completing the structural

reforms which are key not only to attract foreign direct investment but also to improve the long-term sustainability of public finances, for which Hungary remains at high risk. Such achievements are also crucial in accelerating economic catching-up and ultimately moving towards lasting convergence.

### Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010	2011
Real GDP (% change)	<b>CP Nov 2007</b>	<b>3.9</b>	<b>1.7</b>	<b>2.8</b>	<b>4.0</b>	<b>4.1</b>	<b>4.2</b>
	COM Nov 2007	3.9	2.0	2.6	3.4	n.a.	n.a.
	CP Dec 2006	4.0	2.2	2.6	4.2	4.3	n.a.
HICP inflation (%)	<b>CP Nov 2007</b>	<b>4.0</b>	<b>7.9</b>	<b>4.8</b>	<b>3.0</b>	<b>2.9</b>	<b>2.8</b>
	COM Nov 2007	4.0	7.7	4.9	2.8	n.a.	n.a.
	CP Dec 2006	3.9	6.2	3.3	3.0	2.8	n.a.
Output gap <sup>1</sup> (% of potential GDP)	<b>CP Nov 2007</b>	<b>0.8</b>	<b>-0.8</b>	<b>-1.4</b>	<b>-1.0</b>	<b>-0.4</b>	<b>0.2</b>
	COM Nov 2007 <sup>2</sup>	1.1	0.1	-0.3	0.0	n.a.	n.a.
	CP Dec 2006	0.9	-0.4	-1.2	-0.5	0.4	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	<b>CP Nov 2007</b>	<b>-5.7</b>	<b>-4.1</b>	<b>-2.3</b>	<b>-1.7</b>	<b>-1.3</b>	<b>-0.8</b>
	COM Nov 2007	-5.7	-3.9	-1.5	-0.4	n.a.	n.a.
	CP Dec 2006	-6.1	-3.6	-1.7	-0.1	0.6	n.a.
General government balance (% of GDP)	<b>CP Nov 2007</b>	<b>-9.2</b>	<b>-6.2</b>	<b>-4.0</b>	<b>-3.2</b>	<b>-2.7</b>	<b>-2.2</b>
	COM Nov 2007	-9.2	-6.4	-4.2	-3.8	n.a.	n.a.
	CP Dec 2006	-10.1	-6.8	-4.3	-3.2	-2.7	n.a.
Primary balance (% of GDP)	<b>CP Nov 2007</b>	<b>-5.3</b>	<b>-2.2</b>	<b>0.1</b>	<b>0.6</b>	<b>0.8</b>	<b>1.1</b>
	COM Nov 2007	-5.3	-2.4	-0.2	0.1	n.a.	n.a.
	CP Dec 2006	-6.2	-2.4	0.0	0.9	1.1	n.a.
Cyclically-adjusted balance <sup>1</sup> (% of GDP)	<b>CP Nov 2007</b>	<b>-9.6</b>	<b>-5.9</b>	<b>-3.4</b>	<b>-2.7</b>	<b>-2.5</b>	<b>-2.3</b>
	COM Nov 2007	-9.7	-6.4	-4.1	-3.8	n.a.	n.a.
	CP Dec 2006	-10.5	-6.6	-3.8	-3.0	-2.9	n.a.
Structural balance <sup>3</sup> (% of GDP)	<b>CP Nov 2007</b>	<b>-8.9</b>	<b>-4.8</b>	<b>-3.5</b>	<b>-2.8</b>	<b>-2.5</b>	<b>-2.3</b>
	COM Nov 2007	-9.4	-5.5	-4.2	-3.9	n.a.	n.a.
	CP Dec 2006	-9.8	-5.6	-3.7	-3	-2.9	n.a.
Government gross debt (% of GDP)	<b>CP Nov 2007</b>	<b>65.6</b>	<b>65.4</b>	<b>65.8</b>	<b>64.4</b>	<b>63.3</b>	<b>61.8</b>
	COM Nov 2007	65.6	66.1	66.3	65.9	n.a.	n.a.
	CP Dec 2006	67.5	70.1	71.3	69.3	67.5	n.a.

**Notes:**

<sup>1</sup>Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

<sup>2</sup>Based on estimated potential growth of 3.2%, 3.0%, 3.0% and 3.0% respectively in the period 2006-2009.

<sup>3</sup>Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.7% of GDP in 2006 and 1.1% in 2007; both deficit-increasing, and 0.1% of GDP in 2008 and 0.1% of GDP in 2009; both deficit-reducing according to the most recent programme and 0.3% of GDP in 2006 and 0.9% in 2007; both deficit-increasing and 0.1% of GDP in 2008 and 0.1% of GDP in 2009; both deficit-reducing according to the Commission services' autumn forecast.

**Source:**

*Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations*



## 1. INTRODUCTION

On 30 November 2007, Hungary submitted a convergence programme update (hereafter referred to as the programme) to the Council and the Commission.<sup>1</sup> The programme covers the period from 2007 to 2011 and is based on the draft 2008 budget law. It was adopted by the Government on 28 November after discussion with representatives of social partners in the National Interest Reconciliation Council. The programme was not submitted to the Parliament.

This assessment is further structured as follows. Section 2 discusses the key challenges for public finances in Hungary, with a particular focus on the reform of fiscal governance. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the convergence programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the national reform programme and its implementation reports and with the broad economic policy guidelines. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key indicators of past economic performance (Annex 2).

## 2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON THE REFORM OF FISCAL GOVERNANCE

Over the last several years, Hungary has fallen behind in the catching-up process compared to its neighbours. This was closely linked to the increasing fiscal laxity over the recent years, culminating in a budget deficit of over 9% of GDP in 2006, despite ambitious adjustment paths announced in successive convergence programmes. The growth-hindering impact of high budget deficits, especially when coupled with a high debt stock as in the case of Hungary, is well-documented in the empirical literature.<sup>2</sup>

The economic studies on countries with unsatisfactory catching-up have also highlighted the fundamental role of well-functioning institutions in achieving sustained economic growth. This includes good fiscal governance, as the lack of fiscal discipline constitutes a sizeable drag on economic growth, in a context in which the catching-up process itself generates additional spending pressures (e.g. the need to improve infrastructure networks and to alleviate regional and sectoral disparities).

---

<sup>1</sup> The English translation was submitted on 7 December 2007.

<sup>2</sup> See for example Adam, C. S. and D. Bevan (2005), "Fiscal Deficits and Growth in Developing Countries" *Journal of Public Economics*, Vol. 89, pp. 571-597.

In its recent assessments on the Hungarian economy<sup>3</sup> the Commission emphasised the negative role that the weak fiscal governance played in the deterioration of the country's public finances. Recommendations were repeatedly addressed to Hungary to back the medium-term deficit reduction path by a strengthened national budgetary framework also in view of creating the right conditions for sustained economic growth. As part of the fiscal adjustment package, some steps were already taken in the second half of 2006 to improve budgetary control, and the Government adopted a legislative proposal for a comprehensive reform in November 2007.

The next section presents some stylized facts on the economic performance of Hungary over the last decade. Section 2.2 provides a detailed analysis of the present state of play highlighting the procedural and institutional aspects of fiscal policy. Section 2.3 discusses the recently published proposal of the Hungarian authorities to fully renew the public finance system. Finally, section 2.4 presents the outlook for the coming years and the political feasibility of the reform proposal.

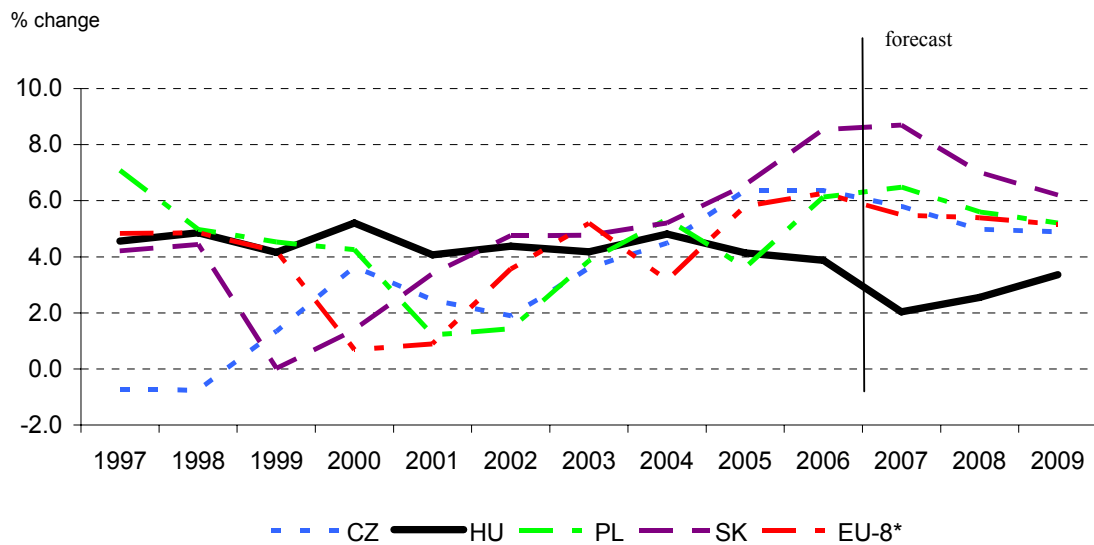
### **2.1. Economic performance and outlook in Hungary in comparison with the other new Member States**

In 1997-2006, real GDP growth in Hungary was fairly strong at an average 4.4% per year, placing Hungary in the mid-field of new Member States and slightly above the EU-8 (CZ, EE, LV, LT, HU, PL, SI, SK) average of 4.2% per year over the same period. At the same time, per capita GDP in purchasing power parity terms increased from below 50% in the mid-1990s of EU27 to 65.3% by 2006. However, the country's relative growth performance started to deteriorate already in 2003 (Figure 1). While in the 1997-2003 period annual GDP growth was 4.5% in Hungary, a full percentage point higher than in the three Visegrad countries (Czech Republic, Poland, Slovakia), in 2003-2006 the still relatively robust Hungarian growth average of 4.3% was outpaced by the rest of the Visegrad-bloc by more than half a percentage point. Looking further, these trends appear to have been aggravated. Whereas for 2007 and 2008, the Commission services' Autumn 2007 economic forecast projects an average GDP growth of 2-2.5% for Hungary, in the other three Visegrad countries growth is expected to average close to 6%, which also leads to a temporary standstill in the catching-up vis-à-vis EU averages. This results partly from the deterioration of economic potential, but it also reflects the impacts of the necessary fiscal consolidation.

---

<sup>3</sup> See for example the assessments of the successive convergence programme updates and the country specific chapter of the successive Public Finance Reports (available through the Directorate-General for Economic and Financial Affairs' Hungarian country pages: [http://ec.europa.eu/economy\\_finance/eu\\_economic\\_situation/member\\_state8610\\_en.htm](http://ec.europa.eu/economy_finance/eu_economic_situation/member_state8610_en.htm).

**Figure 1. GDP growth in the Visegrad countries**



*Note:* \* Weighted in common currency. EU8: CZ, EE, LV, LT, HU, PL, SI, SK.

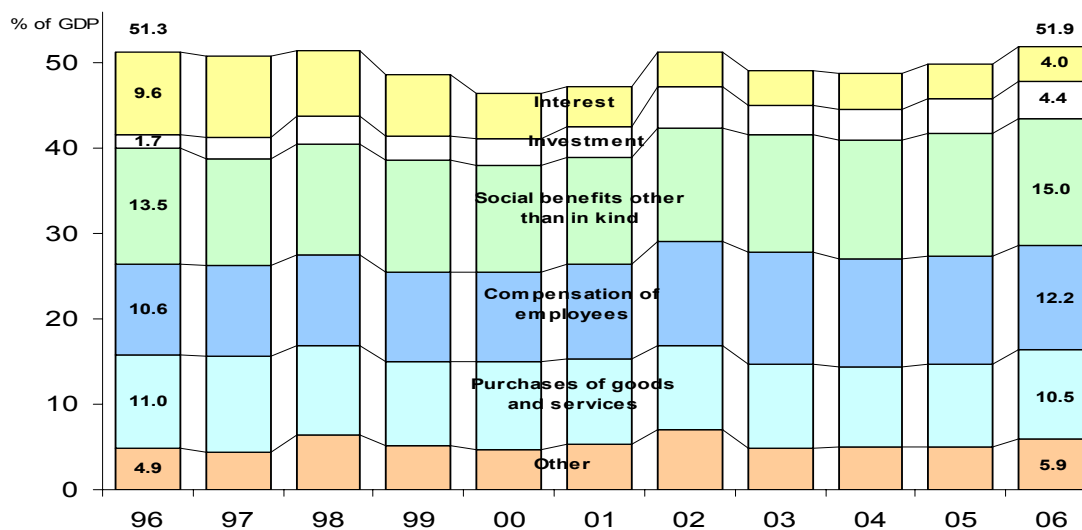
*Source:* Commission services

As part of the assessment of the December 2006 Convergence Programme, the *European Commission* (2007a)<sup>4</sup> presented a detailed analysis of the main drivers of economic performance over the last 10 years in Hungary. Among the main explanations for Hungary’s recently deteriorating economic performance and lacklustre growth outlook were the country’s severe public finance imbalances and its vulnerability to the pressures of the political cycle. In particular, generous public wage increases in 2001-2003 triggered strong spill-over effects in the private sector, which gradually led to a deterioration in cost competitiveness.<sup>5</sup> As shown by the economic classification of government expenditures in the Figure 2 there was a considerable increase over the last several years in the compensation of employees and social benefits, which is a result of a relatively large and expensive public administration system.

<sup>4</sup> See European Commission (2007a), “Economic Trends and Policy Challenges”, In: *Economic Assessment of the Convergence Program of Hungary (update of December 2006)*, Directorate-General for Economic and Financial Affairs, Brussels, pp. 9-22.

<sup>5</sup> See for example Kovács V. and L. Moulin (2004), “Hungary’s policy mix: from stabilisation to crisis to...?” European Commission Directorate General for Economic and Financial Affairs, *Country Focus*, Vol. 1, No. 9

**Figure 2. The evolution of government expenditure**



Note: "Other" includes subsidies and other current and capital transfers.

Source: Commission services

Moreover, the frequent changes in the orientation of the Hungarian fiscal policy have also created uncertainty, which may have distorted the decisions of economic agents. Linked to this, there is empirical evidence that the high budgetary deficit had a negative impact on private investment.<sup>6</sup> The expansionary fiscal policy stance also led to a sharp increase in the net foreign debt stock, and the composition of the country's net financing requirement shifted from financing of the corporate sector to the financing of the government. Finally, the fiscal imbalances were felt by recurring turbulences on the local financial and currency markets as well as by the rapid accumulation of foreign-exchange-denominated liabilities, especially in the household sector<sup>7</sup>. The latter has made the country vulnerable to changes in the global environment. As a consequence of these factors, Hungary has experienced a slight but protracted trend decline in the estimated rate of potential growth, which is by now much below that of the other Visegrad countries. As a matter of fact, Hungary's potential growth rate is expected to remain well below 4% in the coming years.

Using a large panel data set, Shi and Svensson (2005)<sup>8</sup> found that institutional features could explain a large part of the difference in the magnitude of electoral budget cycles across countries. The absence of strong institutional and procedural constraints on politicians exposes a country to an increased level of vote-buying populist promises and creates a large room for political parties to manipulate budgetary policies. The

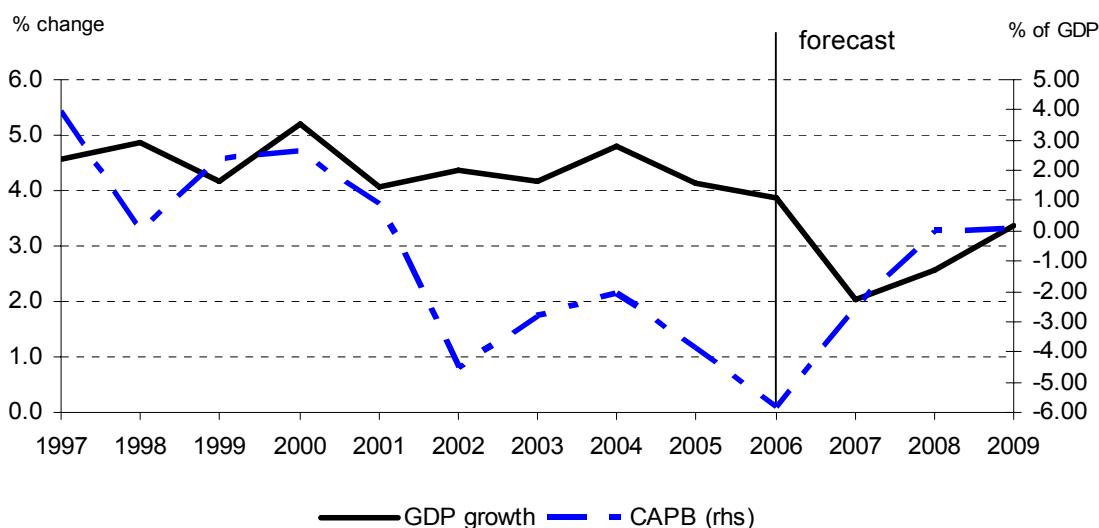
<sup>6</sup> See for example Lendvai J. (2007), "The Impact of Fiscal Policy in Hungary", European Commission Directorate General for Economic and Financial Affairs, *Country Focus*, Volume IV, Issue 11. November 2007. European Commission.

<sup>7</sup> As a share of GDP, household debt increased from around 5% in 2000 to over 25% in 2006, while the foreign-exchange denominated share of household loans increased from 6.6% in 2000 to close to 50% in 2006 (Source: National Bank of Hungary (2007), "Report on Financial Stability April 2007", Budapest).

<sup>8</sup> Shi M. and J. Svensson (2005), "Political Budget Cycles: Do they Differ across Countries and Why?" *Journal of Public Economics*, Vol. 90, No. 8-9, pp. 1367-1389

dominance of the electoral motives over the economic cycle in determining fiscal outcomes in Hungary is evident from data series after the regime change in 1990. Fiscal deficits reached the highest levels in election years (1994, 1998, 2002, and 2006). At the same time, it is evident from Figure 3 below that the periodically large fiscal stimulus in Hungary was not capable of raising economic growth, as the serious fiscal imbalances hampered economic activity through various channels as described above. This suggests that a durable consolidation of public finances through the reinforcement of the budgetary framework is a pre-requisite for achieving a rapid and sustainable economic catch-up vis-à-vis the EU average.

**Figure 3. Economic growth and budget deficit in Hungary**



*Note:* ESA data are not available before 1997.

*Source:* Commission services

## 2.2. Fiscal governance in Hungary

Since the adoption of the Public Finance Act in 1992, there have basically been no major changes in the way in which the annual budget of the Hungarian Government is planned, formulated and implemented. Regarding the calendar of the budgetary process<sup>9</sup>, after months of bilateral negotiations between the Ministry of Finance and the line ministries, the Government discusses and submits the draft budget to Parliament by end-September.<sup>10</sup> The Parliament's role is traditionally limited to a restrained reshuffling between the line ministries' budgetary appropriations without modifying the headline figures or correcting unrealistic revenue and expenditure estimations. The budget bill is usually approved by the legislation in the week before Christmas. Only thereafter the local governments start to debate their budgets until end-March (i.e. three months into the actual budget year). This sequencing opens the possibility for local authorities to adopt budgets that, in cumulative terms, could exceed the total deficit foreseen for the sub-national sector in the national budget document.

<sup>9</sup> There is a somewhat delayed schedule specified for elections years, most notably the submission of the draft budget to Parliament has a deadline of end-October.

<sup>10</sup> Substantial disagreements about the planned budgetary appropriations between the line ministries and the Ministry of Finance are regularly resolved at the Economic Cabinet and/or at the Prime Minister level.

In terms of institutional arrangements, the State Audit Office (SAO), the independent financial monitoring institution of the state, was established in 1989. The SAO assesses the draft budget in the course of the Parliamentary debate (*Annual report on the budget proposal*), monitors *ex-post* the implementation of the budget law (*Annual report on the final accounts*), and regularly points out risks concerning improper projections for revenue and expenditure items. The institution also issues recommendations and normative statements based on the findings of the audit reports of various public institutions. However, the Government is not obliged to take on board the SAO's recommendations and is free to use its own macroeconomic assumptions and fiscal projections to prepare the budget. Overall, the SAO cannot impose changes to the budgetary process, and indeed its support to fiscal responsibility over the last 18 years proved to be rather limited.

Although there were technical improvements in the budgetary framework (e.g. the establishment of the State Treasury and the Government Debt Management Agency in 1995-96 as separate organisations, or the introduction of a numerical debt rule for local governments<sup>11</sup> in 1996), there were also setbacks in the process. Most notably, in 2002, the Public Finance Act was modified to give significantly more room for manoeuvre to the Government when the budgetary outcomes deviate from plans. According to the amendment, only if the variation of the cash-flow balance of the budget (excluding local governments) from target is higher/lower than 2.5% of total expenditure does the Government have to submit a partial amendment of the annual budget law, and only if the deviation exceeds 5% of total expenditure is the Government required to submit a fully-fledged supplementary budget.<sup>12</sup>

The Hungarian budgetary framework has some characteristics, which make it particularly vulnerable to recurring fiscal slippages and fully expose it to the electoral cycle.<sup>13</sup> First, the budget formulation focuses too narrowly on the forthcoming budget year. While the deficit targets were presented to Parliament each year together with the planned medium-term figures, the latter were only of an informative character. Although the pre-accession economic programmes and, from 2004, the successive convergence programme updates repeatedly presented increasingly ambitious multi-year adjustment paths, these plans did not effectively constrain budgetary policy. Linked to this, if judged necessary, the Government has been more inclined to cut expenditure with short-term measures (budgetary freezes, unspecified across-the-board savings, fiscal gimmickry, one-off deficit reducing measures) than structural ones, which, after some time, has often resulted in a rebound in expenditure. The lack of an effective multi-annual fiscal framework thus was not conducive to achieving a sustained reduction in the expenditure-to-GDP ratio.

---

<sup>11</sup> The Local Government Act sets a ceiling on the debt stock of sub-national governments, which is specified at 70% of the "annual own revenue capacity" (calculated as receipts from local taxes and other revenues minus interest payments). It should be noted, however, that short-term liquidity loans are not covered by this provision. Furthermore, more recently, local governments started to increasingly circumvent the regulation e.g. by accumulating debt in the books of local-government-owned public companies instead of their own accounts.

<sup>12</sup> The laxity of the present regulation is shown by the fact that even in 2006 the deviation of total expenditure was less than the specified threshold, despite the massive fiscal slippage that year. The last time the Government presented a supplementary budget to the Parliament was in 1994.

<sup>13</sup> See Kraan, D., D. Bergvall, I. Hawkesworth and P. Krause (2007), "Budgeting in Hungary", *OECD Journal on Budgeting*, Vol. 6, No.3, pp. 1-63.

Second, until recently, there were no effective mechanisms in place to ensure budgetary discipline within a given year. In particular, there were no rules on how to compensate an emerging expenditure overrun or a revenue shortfall that appeared in the course of the year. Likewise, there were no clearly specified procedures about the treatment of windfall revenues or possible expenditure savings in a budgetary chapter; thereby these could have been used for new spending initiatives by the line ministries. Furthermore, within the year, decisions on new policies were mostly disconnected from the budgetary process, to the extent that there was no standard calculation about the budgetary consequences of the adopted changes. And even if the budgetary calculation was provided, the reconciliation of the costs with the Government’s multi-year budgetary targets was missing

Third, there was always a danger of a higher-than-expected deficit at the sub-national level (Figure 4). This could be explained by the central authorities’ limited supervision over the formation of the local budgets (as explained above) and the fact that, although the debt rule established in 1996 could limit the debt accumulation in the long run, it could not prevent slippages in the annual local budget. The situation even worsened over the recent years as the sub-national sector was a primary target of the Government’s across-the-board expenditure cuts. These unspecified freezes were usually not respected or led to an accumulation of liabilities in the local government’s accounts.

**Figure 4. Deficit projections for local governments and outcomes**



*Source: Pre-Accession Economic Programmes; successive Convergence Programme updates; Commission services*

Finally, another shortcoming was that the Ministry of Finance’s underlying macroeconomic and financial assumptions were not exposed to public scrutiny or examination at the Parliament.<sup>14</sup> Moreover, sensitivity analysis for fiscal outcomes to possible domestic and global economic shocks was not provided in the budget document. Therefore, occasionally these assumptions turned out to be overly optimistic entailing

<sup>14</sup> See Kiss P. G. (2007): “Simulation of fiscal institutions: passport or pass partout”, Public Finance Quarterly, Vol. 52, No. 2, pp. 377-391.

fiscal slippages (despite the repeated warnings and recommendations issued by the SAO). The lack of independent scrutiny over the budgetary process also damaged the transparency of the fiscal developments. This is exemplified by the intention to record the investment in new motorways built in public-private partnerships off-budget, which was not accepted twice by Eurostat for different reasons.

Overall, it is not surprising that based on different features of fiscal governance in the newly acceded Central and Eastern European countries, Hungary was found to have the second weakest budgetary framework in the post-socialist bloc after Romania.<sup>15</sup> Very similar results emerged from the analysis of the 2007 Public Finance report on the quality of the budgetary procedure<sup>16</sup>, which showed that Hungary scored low in the sample of 18 EU member states (15<sup>th</sup> place). In particular, the Hungarian ranking was particularly low at in the categories 'using top-down budgeting techniques', 'centralising the budgetary process' and 'applying performance-budgeting methods'<sup>17</sup>

---

<sup>15</sup> See for details Gleich H. (2003), “Budget institutions and fiscal performance in Central and Eastern European countries”, European Central Bank, *Working Paper* No. 215

<sup>16</sup> The study was based on OECD information reflecting the situation in 2003 based on self-reporting by Member States.

<sup>17</sup> See European Commission (2007b), “Strengthening Budgetary Procedures”, In: *Public Finances in EMU – 2007*, European Economy N.3, Directorate General for Economic and Financial Affairs, Brussels, pp. 118-129.



On a positive note, starting from the summer of 2006, the Government made some steps to reinforce the budgetary framework. Budgetary accounting has become more transparent as quasi-fiscal activities (e.g. motorway projects in Public Private Partnerships originally planned to be recorded off-budget and capital transfers to public transport companies) were explicitly incorporated in the government's accounts. The authorities also committed themselves in September 2006 to report twice a year to the Commission and the Council on budgetary developments until the abrogation of the excessive deficit procedure and to announce corrective steps in case of slippages. Furthermore, the Government introduced a new fiscal-control mechanism aimed at enhancing budgetary discipline as part of its consolidation package. The new rule allows for the conditional release of the chapter balance reserves<sup>18</sup> (specified for each budgetary chapter in the budget bill, e.g. line ministries, social security funds, extra-budgetary funds) to ministries following their submission of a quarterly report to the Ministry of Finance on budgetary execution. In case of an emerging overrun, the corresponding part of chapter balance reserves, amounting in total to around 0.3% of GDP, would be frozen. However, the regulation is still not sufficiently specific, and the decisions on sequencing of the releases were made on an ad-hoc basis (based on evidence during 2007<sup>19</sup>).

A further modification of the Public Finance Act (approved in December 2006) prescribed that the draft budget submitted to the Parliament should be consistent with a non-negative primary balance. However, given the projected magnitude of the debt service in the coming years of around 4% of GDP, compliance with this provision *per se* would not lead to the correction of the excessive deficit as planned, so there is clearly a need to enact stricter fiscal rules in Hungary.

### **2.3. The reform proposal for a comprehensive revamp of public finances**

After the positive but insufficient steps taken in the second half of 2006, multi-party negotiations started in June 2007 on the basis of a complete blueprint for public finance reform, including the introduction of new fiscal rules as well as institutional changes.<sup>20</sup> The Government adopted the concerned new package of laws and amendments, which was subsequently submitted to Parliament in November 2007.<sup>21</sup> The main goal of the planned reform is to prevent the recurrence of the electoral cycle in the future. The proposed elements constitute a comprehensive and interlinked system (see Table 1 for

---

<sup>18</sup> It should be noted that this new type of reserves is distinct from other types of budgetary reserves, namely the traditional general reserves and earmarked reserves. The 2007 budget also newly introduced the central balance reserve (0.2% of GDP) to provide a safeguard against unforeseen externally-driven slippages. Altogether, these steps increased the total level of budgetary reserves from around 0.5% of GDP in 2006 to around 0.9% of GDP in 2007.

<sup>19</sup> The Government elaborated on the working mechanism of this rule in successive steps (most notably see Government decrees on 13 March 2007 and on 9 May 2007), which specified the reporting mechanism of the ministries (the format and the timing of the reporting tables). However, it is still not clear whether the release of the reserves after every quarter would be certain or only a possibility and whether there would be any procedural limits for the Government to release the total sum of chapter balance reserves already within the year. All in all, the fully-fledged rule-based specification is still missing from the regulation.

<sup>20</sup> Ministry of Finance (2007): "A költségvetési rendszer megújításának egyes kérdéseiről szóló koncepció", (Blueprint for Renewal of the Fiscal System). *Ministry of Finance*, Budapest.

<sup>21</sup> The package consists of three separate documents: (i) Constitutional amendment; (ii) Amendment of the Local Government Act; and (iii) a new draft bill on fiscal responsibility and the establishment of the Legislative Budget Office.

key aspects). It is similar to a so-called Fiscal Responsibility Framework, which Kopits<sup>22</sup> (2007) advocated for Hungary based on the favourable international experience.

**Table 1. Overview of the key elements of the reform package**

Category	Description of the feature	Effective as of:	Quorum <sup>1</sup>
Constitutional embedding	Fiscal sustainability is defined as a new constitutional principle, which could be enforced by the Constitutional Court	Immediately after the adoption of relevant legislation	Qualified majority
Medium-term budgetary framework	Three-year nominal expenditure ceilings for budgetary chapters defined by the Government	2008-2010 period	Simple majority
Numerical rule for central government	“No-increase in real terms” rule for the gross central government debt, from which primary balance targets derived	New calculation for primary balance: 2011	Simple majority
Numerical rule for local government	A "golden rule"-type limit on local government borrowings for investment purposes.	Immediately after the adoption of relevant legislation	Qualified majority
Institutional changes	Establishment of the Legislative Budget Office (LBO) to provide independent macroeconomic projections and budgetary impact assessments	Starting year of operation 2008, assumption of full competencies: end-2010	Qualified majority
Procedural guarantees	Introduction of the rule of mandatory offsetting	Immediately after the adoption of relevant legislation	Simple majority
Transparency	Semi-annual governmental report on budgetary execution, publication of a detailed set of budgetary reports before national elections	Immediately after the adoption of relevant legislation	Simple majority

*Source: Draft laws submitted to the Hungarian National Assembly*

*Note:*

<sup>1</sup>*The Government intends to secure the adoption of the entire proposal in the Parliament by qualified majority. This column defines the legal minimum for enactment of certain elements of the reform plan.*

Apart from its symbolic message, the addition of fiscal sustainability to the main principles of the Hungarian Constitution aims at ensuring a fiscally responsible budget law since it provides the possibility to legally challenging it in front of the Constitutional Court if deemed otherwise. As to numerical rules, in passing the budget, the Parliament would at the same time approve the primary balance targets for the first and the second year following the budget year, which all must be in line with the requirement of preventing an increase in the central government's gross debt stock in real terms (see Box 1). The planned specification of nominal medium-term expenditure ceilings by the Government after the adoption of the budget aims at further increasing the relevance of

<sup>22</sup> Kopits Gy. (2007): “Fiscal Responsibility Framework: International Experience and Implications for Hungary”, National Bank of Hungary, *Occasional Papers* No. 62

the multi-annual budgetary framework.<sup>23</sup> In setting medium-term expenditure ceilings for line ministries, the proposal makes a difference between mandatory items (e.g. spending required by entitlement regulation such as pensions and unemployment benefits) and discretionary items; only the latter would be discussed during the budgetary debate. To complement the regulation presented above, a type of golden rule would be introduced for local governments, with a view to mitigating the risk of accumulating large deficits at the sub-national level.

### Box 1: Interpretation of the planned numerical fiscal rules

The new regulation focuses on the central government's real debt stock (it currently covers over 95% of the public sector's total debt), which is so far an unprecedented solution for a numerical rule. The rule stipulates that the budgeting process should be carried out to suffice – based on conservative assumptions and technical projections – that the real value of the debt stock must not increase from the year after the budget year to the second year after the budget year, and at the same time it must not be larger than the real central government's debt had been two years before the budget year. The relationship is described in the following formula:

$\frac{D_{t-2}}{P_{t-2}} \geq \frac{D_{t+2}}{P_{t+2}} \leq \frac{D_{t+1}}{P_{t+1}}$ , where  $t$  is the actual budget year,  $D$  denotes the gross debt stock of the central government, and  $P$  is GDP deflator.

Compliance with the rule ensures a minimum yearly reduction in the debt-to-GDP ratio, which is determined by the annual real GDP growth. Using the usual approximation for inflation ( $\frac{P_{t+1}}{P_t} \approx 1 + \pi_{t+1}$ ) yields:

$\frac{D_{t+2}}{Y_{t+2}} \leq \frac{D_{t+1}(1 + \pi_{t+2})}{Y_{t+1}(1 + \pi_{t+2})(1 + g_{t+2})} = \frac{D_{t+1}}{Y_{t+1}(1 + g_{t+2})}$ , where  $Y$  denotes nominal GDP and  $\pi$  is the annual inflation rate, while  $g$  is the real growth rate. Indeed, the simulation provided by the Ministry of Finance projects that the debt ratio would fall to around 40% in 2020 provided that the compliance is ensured with the rule and the long-term growth assumptions (approximately 4% annual increase of the real GDP) prove to be broadly realistic.

The new system prescribes the determination of the future primary balances to comply with the real debt rule. In loose terms, it implies that the primary balance must cover the interest expenditure calculated with the real interest rate. Regarding compliance with the European numerical rules, the proposed law also contains a provision, which prescribes that the requirements of the Stability and Growth Pact should also be taken into account when the Parliament decides about the primary balance targets. Given that after the eventual ERM II and

<sup>23</sup> Although a breakdown of indicative budgetary appropriations for the period 2008-2010 was already contained in the annexes of the 2007 budget; these were however not turned into law by the Parliament and therefore were not considered to be binding for the future budgetary plans.

eurozone accession the necessary improvements towards the medium-term objective (MTO) are set in structural terms, it is important that the new system foresees a provision that ensures that the minimum structural adjustment is made.

The compliance with the envisaged adjustment path as set out in the multi-annual budgetary framework would also be supported by the introduction of mandatory offsetting. This means that the Parliament must not approve any amendments, which would reduce the primary budget surplus in the next years, without appropriate compensation. The offsetting requirement is not only related to the budgetary debate, but also to the adoption of specific bills (e.g. regulation on social benefits, employment legislation). This offsetting procedure would be made technically possible by the obligation to attach a budgetary impact assessment for every new draft bill and also for any type of legislative amendments.

As regards fiscal governance, an important change is the planned establishment of an independent budgetary authority reporting to Parliament. The new institution would be entrusted to safeguard the transparency of the budgetary process and to provide independent macroeconomic and budgetary forecasts. In addition, it would carry out a plausibility check and validate the fiscal impact assessments attached to the legislative proposals. In case of disagreement with the provided calculations, the Parliament must use the document prepared by the Legislative Budget Office. The LBO would also assume the task of providing an ex-ante evaluation of the draft budget proposal from the State Audit Office, whose role is foreseen to be limited to carrying out the financial audit of the publicly funded institutions and the performance audit on all governmental activities.

The introduction of these numerical fiscal rules is beyond doubt an important step to prevent the recurrence of electoral cycles. The reinforced budgetary framework, in particular the establishment of an independent budget office and the regular publication of budgetary reports, could increase the transparency of the budgetary process and improve expenditure control. However, there are also a number of issues that may deserve further consideration. First, there is no effective mechanism foreseen to ensure that revenue windfalls (e.g. in case of a positive growth surprise) or unexpected savings (e.g. lower-than-projected interest expenditures) are allocated to accelerate deficit reduction. As was shown also by the budgetary execution in 2007, there is a clear temptation to not fully use the extra manoeuvring room for a more rapid consolidation. Although the planned delineation of mandatory and discretionary items<sup>24</sup> would help to discipline budgetary execution, the utilisation of savings or windfall revenues for extra spending or tax cuts within the same category of budgetary items would be still possible. Therefore, especially in view of the coming years when the deficit targets are relatively high, it might be appropriate to build in a procedure, which ensures the acceleration of deficit and debt reduction in case of positive surprises.

Second, a possible reservation about the planned attachment of the budget office to the legislative power is that in any Parliamentary political system based on the representation principle (as the Hungarian one), the Parliament does not constitute a separate and autonomous power centre. As exemplified by the *de facto* allocations of competences during the budgetary process, the work of the Parliament is usually heavily subordinated to the ruling Government. From this angle, there are some valid arguments to establish

---

<sup>24</sup> It concerns primarily the provision to derive targets for the balance of the discretionary items from the primary balance targets for the two years following the budget year.

the new budgetary office independently from already existing institutions in order to insulate it from political interferences. Another alternative would be to create the new office within the State Audit Office, thereby to some extent inheriting the professional reputation accumulated by the SAO over the recent period.<sup>25</sup> However, this solution would also raise some concerns as normative assessments about the reliability of the budgetary estimates or the entire budget (which will be among the new office's tasks) may best be kept separated from purely positive tasks (e.g. financial audit) since the former could be publicly criticised by political representatives, which could eventually damage the reputation of the institution. Moreover, there is an in-built conflict of interest if the same institution carries out the *ex-ante* and the *ex-post* analysis of the public accounts, as it would be tempted to find out the same problems *ex-post* that were signaled *ex-ante*, thereby justifying the recommendations and assessments issued during the budgetary debate.<sup>26</sup>

Third, as shown by international experience, the design of the enforcement mechanisms is an important element for ensuring a successful working of fiscal rules. Actions to be taken in case of non-compliance should always be defined *ex ante* so as to make the rule credible. Moreover, the enforcement of corrective measures or sanctions should be preferably ensured by a non-partisan institution. The previously mentioned option to appeal to the Constitutional Court may not ensure an efficient and rapid enforcement, also in view of the time needed for such a complex decision. Therefore, the currently proposed system would rely primarily on the assumption that the Hungarian authorities would do their best to avoid possible further damage in their reputation. However, in the context of the recent major fiscal slippages, it might be better to spell out appropriate legal instruments (e.g. strengthening the competencies of the new fiscal office) to ensure the observance of the planned numerical rules both at the central and the local government level.

#### **2.4. Prospects for the medium run**

The analysis above highlighted a number of weaknesses of the present budgetary framework, which recurrently exposed the country's public finances to a full-blown electoral cycle, and contributed to a weakening of Hungary's catching-up process. These shortcomings are: the lack of multi-year planning, inadequate budgetary discipline, expenditure overruns at local government level and the lack of effective institutional counterbalances to the Government in the entire budgetary process. Based on the international experiences, these shortcomings could be remedied by a complete overhaul of the Hungarian public finances towards a coherent rule-based system.

With some possible corrections, the proposed draft bills for a comprehensive reform should be conducive to improving the transparency and sustainability of public finances and thereby they could contribute to decreasing the debt and expenditure ratio in a sustainable manner. The reinforcement of the budgetary process is an important step to

---

<sup>25</sup> The SAO is widely regarded as an independent institution, functioning relatively freely from political interferences. This status is enhanced by the fact that the President of the SAO is appointed for 12 years.

<sup>26</sup> For a detailed analysis of existing European fiscal institutions, including a discussion on their design see European Commission (2006), "National Numerical Fiscal rules and Institutions for Sound Public Finances", In: *Public Finances in EMU – 2006*, European Economy N. 3, Directorate General for Economic and Financial Affairs, Brussels, pp. 121-168.

prevent the repetition of past election-induced slippages also in view of the next European and national polling day scheduled for 2009 and 2010, respectively.

Regarding political feasibility, although some of the proposed changes require only a simple majority, the Government had announced its intention to seek a two-thirds majority in Parliament for the entire package (i.e. support from the opposition parties), also in view of fact that the complete system will be effective after 2010, so well into the mandate of the next Government. On a positive note, all political forces have already expressed their commitment to reinforcing the budgetary framework; however, there are still disagreements about a number of issues. Overall, whatever will be the precise features of the new fiscal system, it will be important that it is based on a broad political consensus and its implementation would start as soon as possible so as to ensure its credibility and durability.

### **3. MACROECONOMIC OUTLOOK**

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail. Finally, it describes macroeconomic vulnerabilities and how they are expected to develop according to the programme.

#### **3.1. Economic activity**

The programme's baseline macroeconomic scenario is based on assumptions that are broadly in line with those in the Commission services' autumn 2007 forecast; for the outer years, however, the interest rate conditions may turn out to be optimistic. The baseline scenario of the programme predicts that, after contained GDP growth of 1.7% in 2007, the economy fully recovers by 2009 and returns to steady growth of above 4%. The economic momentum is foreseen to be regained by a pronounced acceleration of domestic demand, and in particular by private consumption and fixed capital formation. This represents a shift towards a more balanced growth, as in 2007 net exports have contributed most to real GDP. With the return to robust growth the negative output gap gradually diminishes over the programme period. In terms of growth components, the reacceleration of household consumption appears to be optimistic as it is in line with the speeding up of real disposable income despite households' exhibited consumption smoothing behaviour. Furthermore, the growth contribution of net exports is projected to perform better than its long-term average.

**Table 2: Comparison of macroeconomic developments and forecasts**

	2007		2008		2009		2010	2011
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	2.0	1.7	2.6	2.8	3.4	4.0	4.1	4.2
Private consumption (% change)	-0.6	-0.4	0.3	1.2	1.6	1.9	2.3	3.1
Gross fixed capital formation (% change)	3.3	2.0	4.8	4.2	5.6	7.4	7.0	6.0
Exports of goods and services (% change)	13.9	15.5	10.5	12.9	9.5	11.8	11.5	11.2
Imports of goods and services (% change)	10.5	13.2	8.7	11.1	9.1	11.0	11.1	11.1
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	-0.7	-1.1	0.9	0.9	2.6	2.6	2.9	3.1
- Change in inventories	0.0	0.9	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	2.7	1.9	1.7	1.9	0.7	1.3	1.2	1.0
Output gap <sup>1</sup>	0.1	-0.8	-0.3	-1.4	0.0	-1.0	-0.4	0.2
Employment (% change)	-0.3	0.1	0.1	0.2	0.2	0.6	0.6	0.6
Unemployment rate (%)	7.3	7.3	7.0	7.3	6.9	7.2	7.1	7.1
Labour productivity (% change)	2.4	1.6	2.4	2.6	3.1	3.4	3.5	3.5
HICP inflation (%)	7.7	7.9	4.9	4.8	2.8	3.0	2.9	2.8
GDP deflator (% change)	5.9	6.4	4.0	3.9	3.3	3.0	2.9	2.8
Comp. of employees (per head, % change)	5.4	8.1	5.1	5.5	6.4	4.7	4.9	5.4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-3.9	-4.1	-1.5	-2.3	-0.4	-1.7	-1.3	-0.8
<u>Note:</u>								
<sup>1</sup> In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.								
<u>Source:</u>								
Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP)								

Real GDP growth for 2007 and 2008 predicted by the convergence programme (1.7% in 2007 and 2.8% in 2008) differs somewhat from that of the Commission services' autumn 2007 forecast (2% and 2.6% for 2007 and 2008 respectively). Nevertheless, it remains plausible for these years, also since the former incorporates more recent information. For the following years, growth returns to 4% and above according to the programme, which appears to be rather optimistic given the 3% potential growth estimate of the autumn 2007 forecast projected for 2009 (see Box 2). Overall, the programme's growth outlook is plausible for 2007 and 2008 but becomes favourable thereafter.

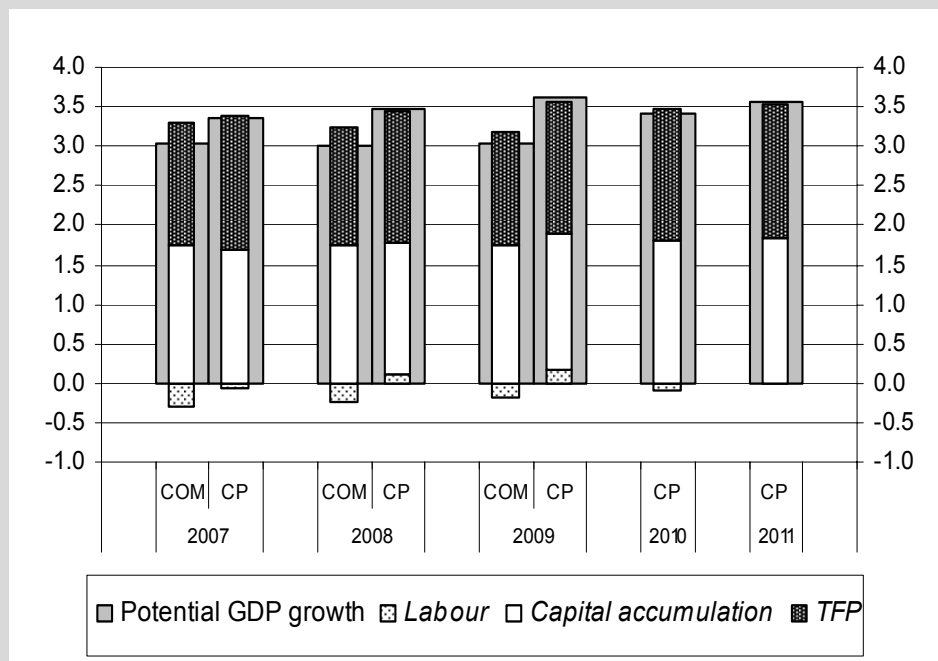
The projected composition of growth appears to be favourable in several respects. On the one hand, even though growth of final domestic demand is fully in line with that in the autumn 2007 forecast, its components have dissimilar trajectories. Although real wages increase considerably less than projected labour productivity, the programme forecasts an acceleration of private consumption. In the outer years, the programme also foresees a more rapid growth in investments. Given this structure, budget revenues from households are subject to both upside risks stemming from wage related-receipts and downside risks stemming from lower-than-expected indirect taxes. Furthermore, the programme predicts the government consumption to be more contained than what the Commission services' autumn 2007 forecast projected. Finally, although the contribution of net exports gradually declines to 1%, it remains rather optimistic compared to the 0.2% average of previous years.<sup>27</sup>

<sup>27</sup> In an alternative scenario (Section 3.3 "Slower recovery of growth") the convergence programme provides a projection for the main aggregates, which seems to be more consistent with the estimated slowdown of potential GDP. This scenario is broadly consistent with the Commission services' autumn 2007 forecast. Compared to the baseline scenario it predicts a considerably lower real GDP

### Box 2: Potential growth and its determinants

Estimates of potential output, both implied by the programme and from the Commission services' forecast, predict potential growth to be remarkably slower than the 4.3% average annual growth of real GDP in the recent past. The programme's potential GDP forecast (as recalculated by the Commission services based on the information in the programme) evolves around 3.5% throughout the projection period, with an equal contribution from capital accumulation and factor productivity and with a negligible stimulus from the labour market. According to the programme, this is supported by increasing foreign direct investments (helped by capital inflows from EU structural funds), the employees' increasing level of skills and improving business environment.

#### Potential growth and its determinants



The evolution of potential output underlying the autumn 2007 forecast is less optimistic. Comparability may be limited however, as potential GDP estimates (and hence the implied output gaps) have sizable standard error, especially for catching-up economies. Moreover, changing the estimation period can lead to substantially different potential GDP. Nevertheless, the significantly lower contribution of factor productivity foreseen in the autumn 2007 forecast highlights the risk of prolonged low growth if the structural reforms do not deliver the envisaged improvement in total factor productivity.

With regard to the cyclical position of the economy, both the output gap of the convergence programme (as recalculated by the Commission services based on the information in the programme) and that of the autumn 2007 forecast show a rapid deterioration in 2007 and 2008. However, while the former predicts a sizable negative output gap (-1.4% in 2008), which comes close to zero only by 2011, the latter remains close to zero through the projection period (2007-2009)<sup>28</sup>.

growth (2.6%, 3.2%, 3.7% and 4.3% for the period of 2008-2011) and higher budget deficits (3.4%, 3% and 2.6% for years 2009-2011).

<sup>28</sup> According to the output gap estimates that were originally reported in the convergence programme the cyclical position of the economy remains negative throughout the projection period. This difference can be explained by the slower decline in the programme's estimate of recent years' potential output .



### **3.2. Labour market and cost and price developments**

In parallel with real GDP, employment growth in the outer years of the programme horizon accelerates above the average of previous years. Such a favourable development makes the projected labour content of GDP growth higher than both the historical average and the Commission services' autumn 2007 forecast. From 2009, due to a steady growth in employment, the diminishing negative output gap is accompanied by a 0.2 percentage point decrease in the unemployment rate by the end of the programme's horizon. Wage moderation is clearly optimistic, especially from 2009, as labour productivity is foreseen to outpace the compensation of employees deflated by the harmonised consumer price index by 1-1.5% annually. Although the inflation dynamics in the baseline scenario are fully in line with the Commission services' autumn 2007 forecast, higher-than-projected wages and sustained pressure from commodity prices may pose risks to the programme's inflation trajectory and thus could further delay Hungary's nominal convergence to the EU average. These upside risks appear to be even more relevant in light of the reaccelerating inflation on the back of food and fuel prices during the last 3 months of 2007. Based on increasing market confidence as the fiscal consolidation continues, the programme assumes a continuously declining interest rate path. However, these interest rate assumptions appear to be on the low side after 2009 as the differences compared with market forward rates as of mid-December 2007 for both the short-term and the long-term interest rates are more than 100 basis points for 2010 and 2011.

### **3.3. Macroeconomic challenges**

With the correction of budgetary deficit, Hungary is making further progress in addressing two macroeconomic challenges: the twin deficits. Net borrowing of the total economy, which had peaked at 8.1% in 2004, is projected to have fallen to 3.9% in 2007 and to decline further in the coming years. This benign outlook critically hinges upon the continued fiscal consolidation and balanced growth. In particular, it is important that cost competitiveness is improved to ensure that export growth does not fall behind import growth that is strengthened by accelerating domestic demand. In this respect, the continued implementation of structural reforms and a prudent tax policy could play an important role.

However, Hungary still faces other, less apparent challenges. For instance, its progress in real convergence to the EU average may considerably slow down in view of the marked decline of potential GDP in past years (see Box 2). Among the several factors that may have affected the evolution of potential output are the slowdown in investment growth (from the long-term annual average of around 7.5% to 5.3% in 2005 and -2.1% in 2006) and in labour productivity (annual average growth is estimated to be around 2.4% in 2007, after 2.9% and 3.7% in 2006 and 2005 respectively). These in turn could be fostered by providing a business friendly environment with low inflation to promote foreign direct investments and a faster transfer of technology, as well as by the above-mentioned structural changes that would boost the participation rate and employment growth.

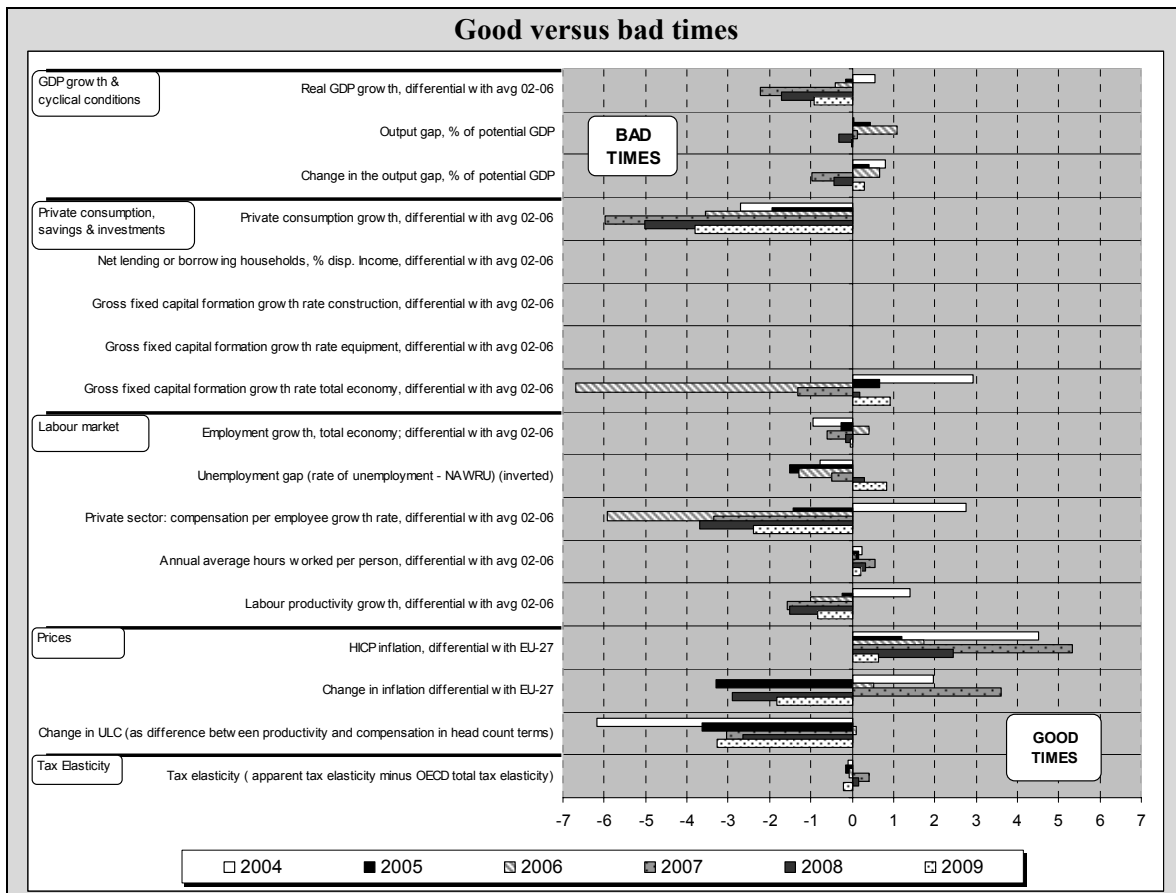
Hungary's gross external debt had been increasing in the past five years and reached 94.2% of GDP in 2006. This trend is in part a reflection of the easing liquidity constraints faced by household to finance for consumption and housing investment resulting in an increasing share of households' outstanding debt. About half of this debt is denominated in foreign currency. However, unlike non-financial corporations,

households have accumulated their foreign currency liabilities without hedging against currency risks. Hence, households are becoming more and more exposed to negative wealth effects should the exchange rate considerably depreciate. This risk is becoming all the more important as households have already suffered a negative impact to their real disposable income in the context of the fiscal adjustment package, to which they reacted by further increasing their indebtedness. However, the reduction of government deficits and debt in a durable manner, should over time contribute to a diminishing interest rate differential of the Hungarian forint vis-à-vis foreign currencies and thus to a possible shift back to local currency credits, thereby reducing the private sector's exposure to exchange rate fluctuations. Such prudent fiscal policy could also provide more room for manoeuvre for monetary policy, which in turn may facilitate wage moderation and cost competitiveness by successfully reducing inflation expectations.

### **Box 3: Good or bad economic times?**

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecast. Overall, taking also into account tax elasticities in the period 2007-2009, the economy seems to be in bad economic times in 2007 and 2008,

The output gap estimate of the Commission services' autumn 2007 forecast stays fairly close to zero on the entire forecast horizon. Moreover, no significant difference from the estimated OECD figures is predicted in the tax elasticities with the exception of 2007, which however could be linked to increases in taxes and social contributions as well as other measures of the fiscal consolidation programme addressing tax evasion. Thus, these indicators suggest that economy is expected to be in "neutral" economic times in the period of 2007-2009. However, growth differentials with long-term average in real GDP, private consumption and fixed capital formation adequately show that the economy is expected to experience bad times in 2007 and 2008.



#### 4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new update. The third analyses the risks attached to the budgetary targets in the programme. The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

##### 4.1. Budgetary implementation in 2007

Table 3 compares the 2007 revenue and expenditure targets (as a percentage of GDP) from the previous update of the convergence programme with the results of the Commission services' autumn 2007 forecast. The difference between the revenue and

expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect on the denominator and a revenue / expenditure growth effect<sup>29</sup>:

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update in the programme (either because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect of revisions to the GDP series.
- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections for 2007 turning out higher or lower than anticipated in the previous update of the programme (therefore reducing / increasing the denominator of the revenue and expenditure ratio).
- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme. This would typically be due to GDP developments different from those expected in the previous update of the programme, or as a result of apparent tax elasticities different from the ex ante tax elasticities (or both).

---

<sup>29</sup> A fourth, residual component is usually small, except if there are very large differences between the autumn forecast and the target (the full mathematical decomposition is in the methodological paper mentioned above).

**Table 3: Budgetary implementation in 2007**

	2006		2007	
	Planned	Outcome	Planned	Outcome
	CP Dec 2006	COM	CP Dec 2006	COM
Revenue (% of GDP)	41.9	42.6	43.1	43.9
Expenditure (% of GDP)	52.0	51.8	49.9	50.3
Government balance (% of GDP)	-10.1	-9.2	-6.8	-6.4
Nominal GDP growth (%)			7.0	8.1
Nominal revenue growth (%)			10.1	11.4
Nominal expenditure growth (%)			2.7	4.9
<b>Revenue surprise compared to target (% of GDP)</b>				<b>0.8</b>
<i>Of which</i> <sup>1</sup> : 1. Base effect				0.8
2. GDP growth effect				-0.4
3. Revenue growth effect on the denominator				0.5
<i>Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than 1</i> <sup>2</sup>				0.1
<b>Expenditure surprise compared to target (% of GDP)</b>				<b>0.4</b>
<i>Of which</i> <sup>1</sup> : 1. Base effect				-0.1
2. GDP growth effect on the denominator				-0.5
3. Expenditure growth effect				1.0
<b>Government balance surprise compared to target (% of GDP)</b>				<b>0.4</b>
<i>Of which</i> : 1. Base effect				0.9
2. GDP growth effect on the denominator				0.1
3. Revenue / expenditure growth effect				-0.5
<b>Notes:</b>				
<sup>1</sup> A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive GDP growth effect (on the denominator) indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.				
<sup>2</sup> Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.				
<i>Source:</i> Commission services				

The December 2006 update of the convergence programme set a general government deficit target of 6.8% of GDP for 2007. The new programme contains a lower deficit target of 6.2% of GDP for 2007 than the previous one. For this year, the Commission services autumn 2007 forecast projected a 6.4% of GDP deficit. In light of the most recent information (continued trend of higher-than-expected revenues and the central budget cash-flow figures in the last months of 2007), the new target could even be surpassed.<sup>30</sup>

As visible from the Table 3 above, there was a particularly strong base effect on the revenue side from 2006, with a relatively even distribution among direct taxes, indirect taxes and social security contributions. The additional positive surprise in the evolution of tax receipts and social security contributions during 2007 was largely linked to the better-than-expected revenue-generating effect of the Government's measures to "whiten" the economy, which address tax evasion. However, it seems that around half of the higher-than-expected revenues compared to the budgeted figures were spent by

<sup>30</sup> Indeed, the Ministry of Finance announced on 18 December 2007 that given better-than-expected budgetary developments on both the expenditure and the revenue side, it further lowered its deficit forecast for 2007 by 0.2% of GDP to 6.0% of GDP. Moreover, based on the better-than-expected cash-flow figures for the central budget in 2007, on 14 January 2008 the Minister of Finance announced yet again a lower deficit forecast of 5.7% of GDP.

within-the-year extra spending measures of around ½% of GDP, and were not used for further deficit reduction.<sup>31</sup>

The Council opinion of 27 February 2007 on the previous update of the convergence programme asked Hungary to “rigorously implement the 2007 budget and take adequate action to ensure the correction of the excessive deficit by 2009, if necessary through additional measures; and ensure, including by using any extra revenues for deficit reduction, that the gross debt-to-GDP ratio is brought onto a firm downward trajectory, preferably before 2009”. This policy invitation was largely followed by the Hungarian authorities as the country is on track to overachieve by around 1% of GDP its deficit target for 2007 set in the previous update. However, the improvement could have been larger had the Government fully followed the Council’s advice and used all extra revenues for deficit reduction.

## **4.2. The programme’s medium-term budgetary strategy**

This section describes the medium-term budgetary strategy outlined in the programme - and how it compares with the one in the previous update - as well as the composition of the budgetary adjustment, including the broad measures envisaged.

### *4.2.1. The main goal of the programme’s budgetary strategy*

The update aims to correct the excessive deficit by 2009 (reducing it from 6.2% of GDP in 2007 to 3.2% of GDP in 2009), to bring the deficit below the 3% of GDP reference value (2.7% of GDP) in 2010, and to further reduce it to 2.2% of GDP in 2011. The update confirms the country’s medium-term objective (MTO) for the budgetary position in structural terms as a deficit of 0.5% of GDP. The MTO is expected to be achieved after the end of the programme period, without specifying a target year.

The deficit target of 3.2% of GDP in 2009 would still exceed the 3% of GDP threshold specified in the Treaty. As in previous updates, 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 an abrogation of the excessive deficit procedure for Hungary.<sup>32</sup> Even in this case, there would be no safety margin for possible slippages. There are of course some built-in reserves on the expenditure side, but from 2009 their level is not yet known and it is unclear whether they would be sufficient enough to correct for such slippages (see Box 4 for more details on the excessive deficit procedure for Hungary).

---

<sup>31</sup> Even if we take into account the most recent estimates for the 2007 budgetary outturn of 5.7% of GDP, it is still correct that part of the better-than-expected revenues were spent by the Government (½% of GDP versus around 1.2% of GDP extra revenues).

<sup>32</sup> According to Article 2(7) of Council Regulation 1467/97 as amended, which is part of the Stability and Growth Pact, if the general government deficit “...has declined substantially and continuously and has reached a level that comes close to the reference value” [of 3% of GDP], the Council and the Commission could consider degressively the net cost of a pension reform that includes a fully-funded pillar. Taking into account the implementing provisions in the code of conduct, the applicable figure according to this degressive scale in 2009 is 20%. As pension costs are estimated at 1.4% of GDP in 2009, a 20% deduction would correspond to around 0.3% of GDP.

#### **Box 4: The excessive deficit procedure (EDP) for Hungary**

On 5 July 2004, the Council adopted a decision stating that Hungary had an excessive deficit in accordance with Article 104(6) and 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. On 18 January 2005, the Council decided 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.

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) to Hungary to take "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". 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 based on Article 104(8) that Hungary also did not comply with the new recommendations under Article 104(7).

On 10 October 2006, the Council adopted for the third time a recommendation to Hungary under Article 104(7), extending the deadline for the correction of excessive deficit by one year to 2009 which seems appropriate in view of the substantial correction of the structural deficit by more than 6½% of GDP over three years. The Council asked Hungary to reduce the deficit in a credible and sustainable manner and to ensure that the government gross debt ratio be brought onto a firm downward trajectory, in accordance with the multi-annual path for deficit reduction as specified in the adjusted convergence programme update of September 2006. In addition, Hungary was invited to adopt and implement swiftly the planned structural reforms also with a view to ensuring a lasting improvement of public finances. Finally, Hungary was asked to improve budgetary control by enhancing fiscal rules as well as by strengthening the institutional framework.

On 13 June 2007, the Commission adopted a Communication to the Council assessing compliance with the recommendations of October 2006, also taking into account the Hungarian authorities' first progress report of April 2007. The Commission concluded that Hungary had taken effective action within the six-month deadline set by the Council but it underlined that the planned adjustment was still subject to risks and crucially hinged upon further specifying and implementing the structural reform plans and on reinforcing the budgetary framework. It also stressed that a better-than-targeted outcome in 2007 was possible and desirable building on the better-than-expected budgetary outcome in 2006. No further steps in the excessive deficit procedure were deemed necessary at that stage. In its meeting of July 2007, the Council concurred with this assessment. Since then, the authorities have submitted their second progress report of September 2007, reporting on the implementation of the fiscal consolidation measures and on progress with the structural reforms, which also did not provoke any further steps in the excessive deficit procedure.

**Table 4: Evolution of budgetary targets in successive programmes**

		2006	2007	2008	2009	2010	2011
General government balance (% of GDP)	CP Nov 2007	-9.2	-6.2	-4.0	-3.2	-2.7	-2.2
	CP Dec 2006	-10.1	-6.8	-4.3	-3.2	-2.7	n.a.
	COM Nov 2007	-9.2	-6.4	-4.2	-3.8	n.a.	n.a.
General government expenditure (% of GDP)	CP Nov 2007	51.8	50.3	48.2	46.5	45.1	44.2
	CP Dec 2006	52.0	49.9	47.2	46.6	45.5	n.a.
	COM Nov 2007	51.8	50.3	48.9	48.7	n.a.	n.a.
General government revenue (% of GDP)	CP Nov 2007	42.6	44.1	44.2	43.3	42.4	42.0
	CP Dec 2006	41.9	43.1	43.0	43.4	42.8	n.a.
	COM Nov 2007	42.6	43.9	44.7	44.9	n.a.	n.a.
Structural balance <sup>1</sup> (% of GDP)	CP Nov 2007	-8.9	-4.8	-3.5	-2.8	-2.5	-2.3
	CP Dec 2006	-9.8	-5.6	-3.7	-3.0	-2.9	n.a.
	COM Nov 2007	-9.4	-5.5	-4.2	-3.9	n.a.	n.a.
Real GDP (% change)	CP Nov 2007	3.9	1.7	2.8	4.0	4.1	4.2
	CP Dec 2006	4.0	2.2	2.6	4.2	4.3	n.a.
	COM Nov 2007	3.9	2.0	2.6	3.4	n.a.	n.a.

Note:

<sup>1</sup>Cyclically-adjusted balance excluding one-off and other temporary measures. Cyclically-adjusted balances according to the programmes as recalculated by the Commission services on the basis of the information in the programmes. One-off and other temporary measures are 0.7% of GDP in 2006 and 1.1% in 2007; both deficit-increasing, and 0.1% of GDP in 2008 and 0.1% of GDP in 2009; both deficit-reducing according to the most recent programme and 0.3% of GDP in 2006 and 0.9% in 2007; both deficit-increasing and 0.1% of GDP in 2008 and 0.1% of GDP in 2009; both deficit-reducing according to the Commission services' autumn forecast.

Source:

Convergence programmes (CP); Commission services' autumn 2007 economic forecasts (COM)

Between 2007 and 2011, the primary balance would show an improvement from a deficit of 2.2% of GDP in 2007 to a surplus of 1.1% of GDP in 2011. The structural balance is projected to decrease from a deficit of 4.8% of GDP in 2007 to a deficit of 2.3% of GDP at the end of the programme period (Commission services' calculations on the basis of the information in the programme according to the commonly agreed methodology<sup>33</sup>). Hence, the fiscal policy effort as measured by the change in the structural balance is around 2½ percentage points of GDP. Since interest expenditure as a percentage of GDP is projected to decline by around ¾ percentage point of GDP from the peak of 4.1% of GDP in 2008 to 3.3% of GDP at the end of the programme horizon, if the fiscal policy effort was measured by the change in the structural *primary* balance, the improvement would be around 1¾ percentage points of GDP.

The time profile of the consolidation is front-loaded, with more than half of the projected nominal improvement over the entire programme horizon taking place in 2008 (2.2% of GDP). Based on the change in the structural balance as recalculated by Commission services, the stance of fiscal policy would be restrictive until 2009 (especially in 2008 and less so in the following year), and turning to broadly neutral in the outer years of the programme. It should be noted that the elimination of deficit-increasing one-offs by 2008 also contributes to the expected improvement in the general government balance from that year.

<sup>33</sup> It should be noted that there are uncertainties linked to the calculations of cyclically-adjusted and structural balances, notably due to the difficulty of contemporaneous output gap estimates and budgetary elasticity volatility. Thus, any interpretation should be made with caution (see Box 2 for further details).



Compared with the previous programme, the new update broadly confirms the planned adjustment against a broadly unchanged macroeconomic scenario. Nevertheless, the improvements in the nominal balance in 2007 (better-than-expected outcome) and 2008 (revised, more ambitious target compared to the previous programme) are not foreseen at this stage to be carried over to 2009 and beyond. Moreover, given that interest expenditures are expected to be lower by 0.3% of GDP in both 2009 and 2010 compared to the previous update, primary balance targets are less ambitious for these years when the deficit targets remained unchanged.

**Table 5: Composition of the budgetary adjustment**

(% of GDP)	2006	2007	2008	2009	2010	2011	Change: 2011-2007
<b>Revenue</b>	<b>42.6</b>	<b>44.1</b>	<b>44.2</b>	<b>43.3</b>	<b>42.4</b>	<b>42.0</b>	<b>-2.1</b>
<i>of which:</i>							
- Taxes on production and imports	15.0	15.5	15.3	14.9	14.7	14.5	<b>-1.0</b>
- Current taxes on income, wealth, etc.	9.3	10.0	10.1	9.9	9.7	9.6	<b>-0.4</b>
- Social contributions	12.6	13.5	13.5	13.4	13.2	13.1	<b>-0.4</b>
- Other (residual)	5.7	5.1	5.3	5.1	4.8	4.8	<b>-0.3</b>
<b>Expenditure</b>	<b>51.8</b>	<b>50.3</b>	<b>48.2</b>	<b>46.5</b>	<b>45.1</b>	<b>44.2</b>	<b>-6.1</b>
<i>of which:</i>							
- Primary expenditure	47.9	46.3	44.1	42.7	41.6	40.9	<b>-5.4</b>
<i>of which:</i>							
Compensation of employees	12.2	11.5	11.0	11.0	10.7	10.5	<b>-1.0</b>
Intermediate consumption	7.0	6.6	5.8	5.6	5.6	5.4	<b>-1.2</b>
Social payments	18.5	18.4	18.2	17.8	17.3	16.7	<b>-1.7</b>
Subsidies	1.4	1.7	1.5	1.3	1.2	1.2	<b>-0.5</b>
Gross fixed capital formation	4.4	3.5	3.5	3.2	3.3	3.2	<b>-0.3</b>
Other (residual)	4.5	4.6	4.1	3.8	3.5	3.9	<b>-0.7</b>
- Interest expenditure	3.9	4.0	4.1	3.8	3.5	3.3	<b>-0.7</b>
<b>General government balance (GGB)</b>	<b>-9.2</b>	<b>-6.2</b>	<b>-4.0</b>	<b>-3.2</b>	<b>-2.7</b>	<b>-2.2</b>	<b>4.0</b>
<b>Primary balance</b>	<b>-5.3</b>	<b>-2.2</b>	<b>0.1</b>	<b>0.6</b>	<b>0.8</b>	<b>1.1</b>	<b>3.3</b>
One-off and other temporary measures	-0.7	-1.1	0.1	0.1	0.0	0.0	<b>1.1</b>
<b>GGB excl. one-offs</b>	<b>-8.5</b>	<b>-5.1</b>	<b>-4.1</b>	<b>-3.3</b>	<b>-2.7</b>	<b>-2.2</b>	<b>2.9</b>
Output gap <sup>1</sup>	0.8	-0.8	-1.4	-1.0	-0.4	0.2	<b>1.0</b>
Cyclically-adjusted balance <sup>1</sup>	-9.6	-5.9	-3.4	-2.7	-2.5	-2.3	<b>3.5</b>
<b>Structural balance<sup>2</sup></b>	<b>-8.9</b>	<b>-4.8</b>	<b>-3.5</b>	<b>-2.8</b>	<b>-2.5</b>	<b>-2.3</b>	<b>2.4</b>
<i>Change in structural balance</i>		<i>4.1</i>	<i>1.3</i>	<i>0.6</i>	<i>0.3</i>	<i>0.2</i>	
Structural primary balance <sup>2</sup>	-5.0	-0.8	0.6	1.0	1.0	1.0	<b>1.7</b>
<i>Change in structural primary balance</i>		<i>4.2</i>	<i>1.4</i>	<i>0.3</i>	<i>0.0</i>	<i>0.0</i>	
<b>Notes:</b>							
<sup>1</sup> Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.							
<sup>2</sup> Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.							
<b>Source:</b>							
<i>Convergence programme; Commission services' calculations</i>							

#### 4.2.2. The composition of the budgetary adjustment

The consolidation is projected to be achieved by reducing the expenditure-to-GDP ratio by 6.1 percentage points, which should more than offset the decrease in the revenue-to-GDP ratio by 2.1 percentage points (driven by a close to 2 percentage point reduction in the tax burden). The planned reduction in primary expenditure is somewhat less as interest expenditure is projected to decline by 0.7 percentage point of GDP until the end of the programme period.

In the programme, the revenue measures in the 2008 budget are projected to lead to a stabilisation of revenue-to-GDP ratio in 2008. The enacted increases in personal income tax allowances and corporate tax exemptions are projected to be offset by the revenue-generating effect of enhanced tax surveillance as well as the enforcement of the insurance principle in the provision of health services (see Box 5 for details). After 2008, taxes and social contributions are expected to decline as a percentage of GDP. This decline is most pronounced in 2009, which may to some extent be linked to the fact that the substantial export and investment-driven pick-up in nominal GDP growth (which in Hungary tends to lead to a decline in the tax-to-GDP ratio) is not very tax-rich. This downward impact on the revenue-to-GDP ratio is further accentuated by the modest decrease in other revenues. This category incorporates the increasing EU transfers, which would not offset the continuous decline of the remaining – and relatively stable in real terms – items included in other revenues. Overall, the revenue ratio will decrease by 2.1 percentage points of GDP during the programme period as a result of a 1.8% of GDP decrease in the tax-to-GDP ratio and a 0.3% of GDP decrease in other revenues. The Government plans to start a revenue-neutral wide-ranging tax reform in 2009 including the introduction of the central real estate tax; its implications on relevant revenue categories are, however, not incorporated into the programme. The Government had previously announced the establishment of this new tax as of 1 January 2008 in the September 2006 convergence programme.

The planned decline in the expenditure-to-GDP ratio by 6.1 percentage points of GDP over the programme period is expected to be achieved through: (i) a reduction in the operational and wage costs of the public sector by about 2.2 percentage points of GDP, reflecting a broad range of measures aimed at streamlining the institutional system of public administration; (ii) 1.7 percentage points of GDP savings on social payments, both in-cash and in-kind, the latter underpinned through further reform of the different price subsidy systems; (iii) 0.7 percentage point of GDP savings on the debt service on the account of yields converging towards the eurozone level, especially in the outer years of the programme; and (iv) 0.5 percentage points of GDP savings on subsidies, reflecting chiefly the successful reorganisation of the national railway company.

As far as the specification of the measures underpinning the budgetary strategy is concerned, the programme's revenue projections are based on an unchanged tax code after 2008. On the expenditure side, the programme foresees that especially after 2008 the expenditure containment, which has been achieved so far mainly through short-term stabilisation measures, would be replaced and reinforced by the deficit-reducing impact of structural reforms. Since mid-2006, the Hungarian authorities have taken numerous steps in these planned structural reforms (in particular streamlining the public administration through regionalizing the decentralized bodies; revamping gas and pharmaceutical price subsidies; restructuring the institutions of the health care system and introducing a new system for health insurance; and deciding on stricter conditions for early pensioners).<sup>34</sup> However, the reform agenda will have to appropriately reinforced by follow-up steps in order to achieve a sustained expenditure reduction in the areas of public administration and health-care, and expenditure containment in the fields of public education and pension. In particular, this concerns the continued streamlining of public administration and the provision of further incentives to promote the joint service provision at sub-national level to consolidate the expected result of the across-the-board budgetary freezes of around 1 percentage point of GDP in 2007 in this area

---

<sup>34</sup> See Section 6 for further details on structural reforms.

and, more importantly, to prevent the rebound of expenditure in subsequent years. Further steps towards fully means-tested price subsidy systems are also needed to cement the lower expenditure level in price subsidies (a reduction of 0.6 percentage point of GDP is set to be achieved in 2007, and a further 0.2 percentage point of GDP is planned for 2008). Moreover, the completion of the reform of the health-care system by revamping its financing as well as by strictly re-enforcing the insurance basis could also contribute to expenditure containment in that field. In addition, the previously announced review of the parameters of the regular pension system is still missing (currently agenda of the Roundtable on pension issues), and the full implementation of the disability benefit reform needs to be ensured.

During the programme period, one-offs would amount to 1.1% of GDP in 2007 (deficit-increasing effect) and 0.1% of GDP in both 2008 and 2009 (the latter two are deficit-reducing). No one-offs are foreseen for the outer years of the programme. Without detailed quantification the programme identifies as deficit-increasing one-offs for 2007 the following measures: the purchase of Gripen fighters, severance payments stemming from the streamlining of the public administration, and capital injections as well as additional subsidies to the national railway company in the framework of a restructuring programme. For both 2008 and 2009, the deficit-reducing one-offs are explained by sales of Government's real estate in the context of the "New Government Quarter" project. However, this assumption is called into question by the decision to suspend the project announced on 8 January 2008 by the Government.

As to sectoral evolution of the general government balance, the planned improvement of 4 percentage point of GDP in the headline deficit is projected to be almost exclusively driven by the reduction in the deficit of the central government. At the same time, the balance of social security funds is expected to be very stable at a surplus of 0.1% of GDP, and the deficit of the local government sector is foreseen to be at around 0.5% of GDP throughout the programme horizon.

#### **Box 5: The budget for 2008**

The 2008 draft budget was presented on 28 September 2007. It was adopted by Parliament on 17 December 2007. It targets a budget deficit of 4% of GDP, which is 0.3% of GDP lower than the deficit target set in the December 2006 convergence programme update. The reduction is largely due to lower-than-expected debt service in 2008, while the primary balance is projected to be in small surplus (0.1% of GDP). It is the first time since 2001 that the primary balance is planned to be non-negative, which is prescribed by the 2006 amendment of the Public Finance Act.

On the revenue side, following higher-than-expected revenue inflows in 2007, the tax-to-GDP ratio is projected to remain stable in 2008 at around 39%. The proposed changes in the budget are aimed at simplifying and consolidating taxation. The budget originally put forward a revenue-neutral replacement of so-called "minor taxes" (vocational training, innovation and rehabilitation contributions), but eventually it was rejected in Parliament linked to strong opposition from both the trade unions and employers' interest groups.

On the expenditure side, the biggest improvement comes from the elimination of one-off deficit increasing measures of close to 1% of GDP. The within-the-year extra spending measures of 0.5% of GDP taken in September 2007 are also not planned to be repeated in 2008. There will be a phasing out of motorway investments, which reduces expenditures by around 0.3% of GDP. As a result of the increased debt stock, interest expenditures are projected to rise by 0.4% of GDP compared to the expected outcome in 2007 (which is still 0.2% of GDP less than foreseen in the December 2006 CP update). The budget set aside an increased level of reserves of 1.3% of GDP for 2008. Nevertheless, based on recent experience and in view of the recent wage agreement, the

general and earmarked reserves (0.9% of GDP altogether) are likely to be fully spent during the course of 2008, leaving in practice only the chapter balance reserves and central balance reserves (0.4% of GDP in total) to be frozen in case of unforeseen budgetary slippages. On the other hand, this in-built buffer seems to be sufficient to correct moderate revenue shortfalls or expenditure overruns.

### Main measures in the budget for 2008

Revenue measures*	Expenditure measures**
o Increase in the limit on the spending on investment to be exempt from corporate taxation from 25% to 50% up to a maximum of HUF 0.5 bln (-0.05% of GDP)	o Savings on the operational expenditures of public administration (-0.3% of GDP)
o Introduction of tuition fees in higher education as of 1 September 2008 and adjustment of co-payments in health-care services (combined +0.08% of GDP)	o Further revamping in gas, pharmaceutical and public transport price subsidies (combined -0.2% of GDP)
o Extension of the preferential corporate tax rate (10% instead of the standard 16%) for small and micro companies that invest and/or create jobs (-0.08% of GDP)	o Indexation of pensions through the Swiss-indexation mechanism and the implementation of the long-term pension correction programme (+0.2% of GDP)
o Sale of government property linked to the “New Government Quarter” programme (+0.12% of GDP)	o Cuts in public education expenditure as a result of the new financing mechanism encouraging school mergers (-0.15% of GDP)
o Broadening the base for social security contributions by more rigorously enforcing the insurance principle in the provision of health-care services (+0.1% of GDP)	o Increase in EU funds co-financing expenditures (0.2% of GDP), overcompensated by the reduction in motorway investment projects (-0.3% of GDP) – combined impact on government investment expenditure: -0.1% of GDP
o Merge of two different types of personal income tax credits (-0.12% of GDP)	

\* Estimated impact on general government revenues.

\*\* Estimated impact on general government expenditure.

Sources: Commission services; Draft budget for 2008; “Annual report on the budget proposal” by the State Audit Office;

### 4.3. Risk assessment

This section discusses the plausibility of the programme’s budgetary projections by analysing various risk factors. For the period until 2009, Table 6 compares the detailed revenue and expenditure projections in the Commission services’ autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the updated programme.

The risks to the deficit path stemming from the macroeconomic scenario are broadly balanced for 2008. However, from 2009, lower-than-projected GDP growth and in particular a lower-than-projected employment and household consumption could lead to a lower revenue as well as to a higher expenditure ratio and consequently to a higher deficit.<sup>35</sup> In addition, in view of the programme’s rather optimistic interest rate

<sup>35</sup> It should be noted that in 2009, despite the 0.6 percentage point lower growth projection in the Commission services’ Autumn 2007 forecast, the forecasted tax-to-GDP ratio is the same as in the programme’s figure. However, this is explained by the fact that the Commission projected higher gross wage increases for 2009 than the new update (6.4% versus 4.7%), reflecting the one-off assumption of a stronger rebound after two years of real wage decreases both in the public and the private sector. In terms of tax revenues, this higher wage dynamics compensates for the lower growth in that year, but this phenomenon could not be extrapolated to the outer years of the programme period, as wage increases could not be plausibly decoupled from the strength of the economy for a longer period.

assumptions for both the short- and long-term after 2009, a higher-than-expected debt service might result in higher deficits. (see also Section 3.2) .

Concerning the evolution of total revenue and total expenditure, it should be noted that throughout the entire forecast horizon, the Commission services' forecast assumed that a significantly larger part of EU transfers goes through the accounts of central budget compared to the programme, which contains downwardly revised projections for these categories compared to what was foreseen in previous update. The recording of these transactions leads to a symmetrical increase in the revenue and the expenditure ratio (chiefly through the residual categories of other revenues and other expenditures), without, however, any impact on the deficit projections.<sup>36</sup>

The programme presents a sensitivity analysis with respect to the baseline scenario with three different scenarios, presenting the effects of a higher path for nominal variables, of a negative shock in foreign demand and of different assumptions about the reaction of economic agents to fiscal retrenchment. In the higher inflation-higher nominal wages scenario, higher tax receipts and social security contributions would lead to a 0.2 percentage point of GDP improvement in the general government budget balance by 2011. In one of the pessimistic scenarios, external demand is lower compared to the central scenario, which results in a 0.3-0.4 percentage point of GDP higher budget deficit from 2009 onwards. In the other pessimistic scenario, slower recovery of growth driven by a sharper decrease in household consumption and investment would result in a 0.4 percentage point of GDP deterioration in the general government budget balance at the end of the programme horizon.

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 2007-2011 period; (ii) trend output based on the HP-filter and (iii) no policy response (notably, the expenditure level is as in the central scenario), reveal that, by 2011, the cyclically-adjusted balance is 1 percentage point of GDP above/below the central scenario. Hence, in the case of persistently lower real growth, which cannot be excluded, additional measures of around 1 percentage point of GDP would be necessary to keep the public finances on the path targeted in the central scenario.

---

<sup>36</sup> According to the Eurostat decision on EU transfers, the recording of these amounts should not have an impact on the balance of the general government sector.

**Table 6: Comparison of budgetary developments and projections**

(% of GDP)	2006	2007		2008		2009		2010	2011
	COM	COM	CP	COM	CP	COM <sup>1</sup>	CP	CP	CP
<b>Revenue</b>	<b>42.6</b>	<b>43.9</b>	<b>44.1</b>	<b>44.7</b>	<b>44.2</b>	<b>44.9</b>	<b>43.3</b>	<b>42.4</b>	<b>42.0</b>
<i>of which:</i>									
- Taxes on production and imports	15.0	15.1	15.5	15.0	15.3	14.7	14.9	14.7	14.5
- Current taxes on income, wealth, etc.	9.3	9.9	10.0	10.2	10.1	10.5	9.9	9.7	9.6
- Social contributions	12.6	13.1	13.5	13.3	13.5	13.0	13.4	13.2	13.1
- Other (residual)	5.7	5.8	5.1	6.1	5.3	6.8	5.1	4.8	4.8
<b>Expenditure</b>	<b>51.9</b>	<b>50.3</b>	<b>50.3</b>	<b>48.9</b>	<b>48.2</b>	<b>48.7</b>	<b>46.5</b>	<b>45.1</b>	<b>44.2</b>
<i>of which:</i>									
- Primary expenditure	47.9	46.4	46.3	44.9	44.1	44.8	42.7	41.6	40.9
<i>of which:</i>									
Compensation of employees	12.2	11.4	11.5	10.5	11.0	10.4	11.0	10.7	10.5
Intermediate consumption	7.0	6.5	6.6	6.2	5.8	6.1	5.6	5.6	5.4
Social payments	18.5	18.4	18.4	18.4	18.2	18.3	17.8	17.3	16.7
Subsidies	1.4	1.7	1.7	1.6	1.5	1.6	1.3	1.2	1.2
Gross fixed capital formation	4.4	3.6	3.5	3.5	3.5	3.6	3.2	3.3	3.2
Other (residual)	4.5	4.9	4.6	4.8	4.1	4.9	3.8	3.5	3.9
- Interest expenditure	4.0	3.9	4.0	4.1	4.1	3.9	3.8	3.5	3.3
<b>General government balance (GGB)</b>	<b>-9.2</b>	<b>-6.4</b>	<b>-6.2</b>	<b>-4.2</b>	<b>-4.0</b>	<b>-3.8</b>	<b>-3.2</b>	<b>-2.7</b>	<b>-2.2</b>
<b>Primary balance</b>	<b>-5.3</b>	<b>-2.4</b>	<b>-2.2</b>	<b>-0.2</b>	<b>0.1</b>	<b>0.1</b>	<b>0.6</b>	<b>0.8</b>	<b>1.1</b>
One-off and other temporary measures	-0.3	-0.9	-1.1	0.1	0.1	0.1	0.1	0.0	0.0
<b>GGB excl. one-offs</b>	<b>-8.9</b>	<b>-5.5</b>	<b>-5.1</b>	<b>-4.3</b>	<b>-4.1</b>	<b>-3.9</b>	<b>-3.3</b>	<b>-2.7</b>	<b>-2.2</b>
Output gap <sup>2</sup>	1.1	0.1	-0.8	-0.3	-1.4	0.0	-1.0	-0.4	0.2
Cyclically-adjusted balance <sup>2</sup>	-9.7	-6.4	-5.9	-4.1	-3.4	-3.8	-2.7	-2.5	-2.3
<b>Structural balance<sup>3</sup></b>	<b>-9.4</b>	<b>-5.5</b>	<b>-4.8</b>	<b>-4.2</b>	<b>-3.5</b>	<b>-3.9</b>	<b>-2.8</b>	<b>-2.5</b>	<b>-2.3</b>
<i>Change in structural balance</i>		3.8	4.1	1.4	1.3	0.3	0.6	0.3	0.2
Structural primary balance <sup>3</sup>	-5.5	-1.6	-0.8	-0.1	0.6	0.0	1.0	1.0	1.0
<i>Change in structural primary balance</i>		3.9	4.2	1.5	1.4	0.1	0.3	0.0	0.0
<b>Notes:</b>									
<sup>1</sup> On a no-policy-change basis.									
<sup>2</sup> Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.									
<sup>3</sup> Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.									
<i>Source:</i>									
Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations									

As far as the revenue side is concerned, apart from the macro-economic risks from 2009 mentioned above there are no significant risks to the revenue trajectory contained in the programme. Although the programme does not mention any more the plan to introduce a central real estate tax, it is known from other official announcements that the Government intends to enact it as of 1 January 2009 as part of a revenue-neutral wide-ranging tax reform (i.e. one year later than announced in previous updates, in which it had been considered a safeguard against worse-than-planned budgetary developments). The planned strategy to change the internal structure by shifting revenues from taxes on labour towards wealth taxes should be conducive to promoting growth and employment, but the offsetting measures for any tax cuts needs to be appropriately implemented not to endanger the achievement of the deficit targets of the envisaged adjustment path. After 2008, the programme's tax projections become increasingly cautious as shown by the projected decreases in the tax-to-GDP ratio (see Table 7). In the programme this is explained by the fact that, as in the past, the projected healthy growth of over 4% is not

expected to be tax rich. Overall, the officially estimated revenue trajectory appears to be broadly realistic.<sup>37</sup>

**Table 7: Assessment of tax projections**

	2008			2009			2010	2011
	CP	COM	OECD <sup>3</sup>	CP	COM <sup>1</sup>	OECD <sup>3</sup>	CP	CP
Change in tax-to-GDP ratio (total taxes)	-0.1	0.5	0.1	-0.8	-0.5	0.1	-0.6	-0.4
Difference (CP – COM)	-0.6		/	-0.3		/	/	/
<i>of which<sup>2</sup>:</i>								
- discretionary and elasticity component	-0.8		/	0.1		/	/	/
- composition component	0.3		/	-0.2		/	/	/
Difference (COM - OECD)	/	0.4		/	-0.6		/	/
<i>of which<sup>2</sup>:</i>								
- discretionary and elasticity component	/	0.5		/	-0.5		/	/
- composition component	/	-0.1		/	0.1		/	/
p.m.: Elasticity to GDP	1.0	1.2	1.0	0.7	0.8	1.0	0.8	0.8
<b>Notes:</b>								
<sup>1</sup> On a no-policy change basis.								
<sup>2</sup> The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.								
<sup>3</sup> OECD ex-ante elasticity relative to GDP.								
<i>Source:</i>								
Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).								

As far as the expenditure side is concerned, there are a number of positive elements so far, but the negative risks prevail. On the positive side, expenditure control has improved over 2007 as exemplified by the fact that no overruns are projected in the area of price subsidies which had been a regular source of slippages in the past. The improvement in the budgetary implementation is also linked to the operation of the new expenditure control mechanism based on quarterly budgetary reports of line ministries (see section 2.2 for more details of the present fiscal framework). On the other hand, there is already evidence that the expenditure level has started to catch up with the higher-than-expected revenues, a trend that is further boosted by the signs that the planned expenditure freezes (in particular for public wages) will not be enforced in 2008 (a new public wage agreement was concluded on 5 December 2007, the implications of which, however, had been already incorporated into the programme's figures). This creates risks especially from 2009 (for 2008, the budgeted budgetary reserves could cover the extra costs).

Although the Commission services' autumn 2007 forecast had a somewhat different assessment of one-off measures for 2006-2007<sup>38</sup> (see also Table 6 above), this does not modify significantly the perceived risks linked to the adjustment path.

<sup>37</sup> The Commission services' autumn 2007 forecast projects a somewhat less tax-rich economic environment for 2008 than the programme's macroeconomic scenario; however this is more than offset by the much more favourable assessment of the elasticity factors by Commission services. However, it should be seen against the projected different starting level at end-2007 (the more favourable tax projection for 2007 in the programme), as this would still lead to a broadly similar tax-to-GDP ratio in 2008. For 2009, there are overall minor differences, with the Commission services forecast being somewhat more optimistic about revenue developments.

The envisaged deficit path does not include any debt takeovers from state-owned public transport companies. The largely state-guaranteed debt stock currently amounts to around 1.4% of GDP, accumulated since end-2002.<sup>39</sup> The largest part of this debt (over 1% of GDP) belongs to the national railway company (MÁV) for which the Government has started a restructuring scheme, including the sale of the cargo unit (the proceeds of this operation is planned to be used for new investment projects and to pay off of the company's debt).<sup>40</sup> 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 and successful restructuring of the public transport companies, the practice of accumulating losses and thus, implicit government liabilities, would be likely to continue.

Hungary's track record of fiscal policy was poor until mid-2006, as shown by budgetary developments in the last several years and the repeated slippages compared to targets adopted by the Government and recommended by the Council under the excessive deficit procedure. More recently, there has been an improvement on this front as the overachievement of the revised 2006 deficit objective and the lowered deficit targets for both 2007-2008 have been important steps towards regaining credibility.

---

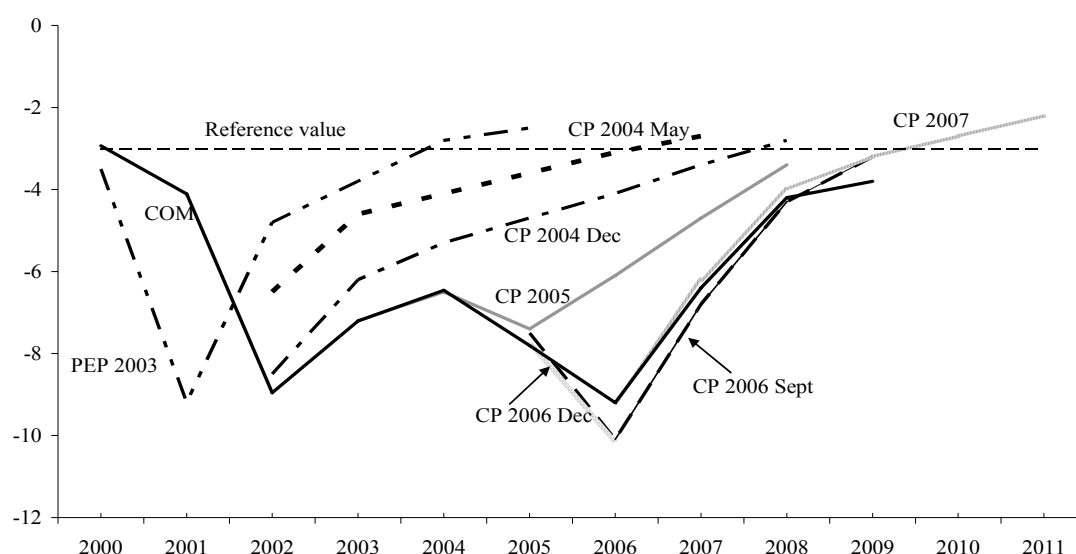
<sup>38</sup> In 2006, the programme does not consider as deficit-reducing one-offs the withdrawal of the general reserve in June (which was fully spent in the previous years), the sale of government property, and additional mining grants from MOL, with a total deficit-decreasing impact of 0.4% of GDP 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 0.7% of GDP (also deficit-increasing). For 2007, the 0.2% of GDP difference between the programme's figure and that of the forecast might largely be linked to the fact that the Government included some extra subsidies to the national railway company decided on September 2007, which would not qualify as deficit-increasing one-offs according to the Commission services' assessment.

<sup>39</sup> More than half of these debts are State guaranteed. Note however that in the past, the Government assumed the entire debt of these companies, irrespective of the existence of a guarantee or not.

<sup>40</sup> In 2007, the railway company received a capital injection of 0.4% of GDP. The Government also increased subsidies to the company by another 0.4% of GDP, of which around half is foreseen to permanently increase railway subsidies as a share of GDP from 2008 onwards.



**Figure 5: Government balance projections in successive programmes (% of GDP)**



*Source: Commission services' autumn 2007 forecast (COM), successive convergence programmes (CP) and Pre-Accession Economic Programme (PEP).*

However, starting from 2009, there is a risk of an electoral cycle in public finances, due to the proximity of the next Parliamentary elections in 2010 as evidenced by past experience. A comprehensive proposal to reform fiscal governance, including the introduction of numerical rules and the establishment of an independent fiscal body, was adopted by the Government in November 2007 and submitted to Parliament. The reform should be conducive to improving the transparency of public finances and to contributing to a decrease in the expenditure ratio in a sustainable manner. However, a qualified majority needs to be ensured and the effectiveness of the new set-up in reversing the recent pattern of budgetary slippages needs to be tested (see Chapter 2 for a detailed description of the planned reform and its tentative assessment).

Overall, the risks to the budgetary targets contained in the programme appear broadly balanced in 2008, but from 2009 they could be worse than targeted.

#### **4.4. Assessment of the fiscal stance and budgetary strategy**

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 and, second, the final assessment also taking into account risks.

**Table 8: Overview of compliance with the Stability and Growth Pact**

	<b>Based on programme<sup>3</sup></b> (with the targets taken at face value)	<b>Assessment</b> (taking into account risks to the targets)
a. Consistency with correction of excessive deficit by 2009	yes, if part of the pension reform burden (0.3% of GDP in 2009) is considered by the Council	conditional on taking additional measures to reduce the deficit and addressing risks as well as assuming that part of the pension reform burden (0.3% of GDP in 2009) is considered by the Council
b. Safety margin against breaching 3% of GDP deficit limit <sup>1</sup>	not within programme period	not within programme period
c. Achievement of the MTO	not within programme period	not within programme period
d. Adjustment towards MTO in line with the Pact <sup>2</sup> ? (after the correction of the excessive deficit)	should be strengthened	should be strengthened and backed up with measures
<p><u>Notes:</u></p> <p><sup>1</sup>The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the above mentioned minimum benchmark (estimated as a deficit of around 1½% of GDP for Hungary). These benchmarks represent estimates and as such need to be interpreted with caution.</p> <p><sup>2</sup>The Stability and Growth Pact requires Member States to make progress towards their MTO (for countries in the euro area or in ERM II, this has been quantified as an annual improvement in the structural balance of at least 0.5% of GDP as a benchmark). In addition, the structural adjustment should be higher in good times, whereas it may be more limited in bad times.</p> <p><sup>3</sup>Targets in cyclically adjusted terms (for b) and in structural terms (for c and d) as recalculated by Commission services on the basis of the information in the programme.</p> <p><u>Source:</u> Commission services</p>		

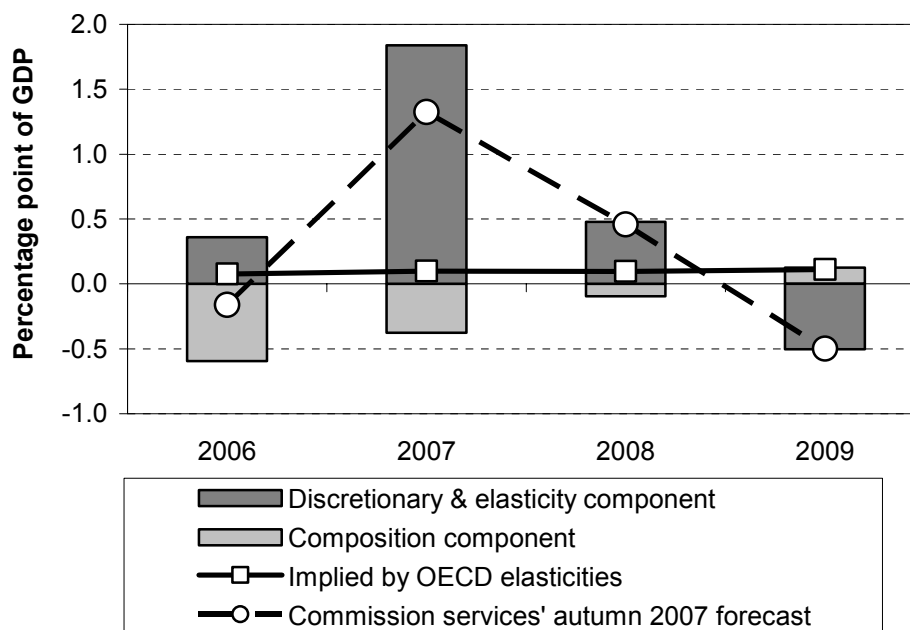
The update confirms the new medium-term budgetary framework, laid down in the adjusted convergence programme update of September 2006, which puts forward 2009 as the deadline for the correction of the excessive deficit. In the light of the risk assessment in Section 4.3, the budgetary stance in the programme seems broadly consistent with the recommended adjustment path for the correction, provided that additional budgetary measures as well as the structural reform steps announced in the programme are fully and effectively implemented and expenditures are 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<sup>41</sup>, the deficit target in 2009 leaves no safety margin against unforeseen slippages or other negative budgetary developments.

In the outer years of the programme after the correction of the excessive deficit, the planned structural improvement is small (around ¼% of GDP). Therefore the progress towards the MTO appears insufficient and – also in view of risks – should be backed up with measures. The strengthening of the structural effort after 2009 appears to be justified, even after taking into account the projected decrease in the tax-to-GDP ratio

<sup>41</sup> The revised Stability and Growth Pact provides this possibility. As discussed above, the allowed deduction of pension reform costs would amount to some 0.3% of GDP in 2009.

implied by slightly negative tax elasticities (already appearing in 2009 – see Figure 6). The acceleration of the structural improvement is all the more important, as the structural position at the end of the programme period would not provide a safety margin against the occurrence of an excessive deficit. It should also be noted that the programme does not provide reasons for the planned modest narrowing of the structural deficit in the outer years.

**Figure 6: Changes in the tax-to-GDP ratio:  
actual/projected changes vs. changes implied by OECD elasticity**



Note:

The dashed line displays the change in the tax ratio in the Commission services' 2007 autumn forecast (for 2009, on a no-policy-change basis). The solid line shows the change in the tax ratio implied by the ex-ante OECD elasticity with respect to GDP. The difference between the two is explained by the bars. The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

Source:

*Commission services*

## 5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes 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 the debt-to-GDP ratio to stabilise at around 65.5% in 2007 and 2008 (65.4% in 2007 and 65.8% in 2008). After 2008, the debt ratio is expected to decrease gradually to 61.8% in 2011. With the exception of 2007, the projections result from the

planned deficit and nominal growth developments, without any significant stock-flow adjustment. The considerably lower debt projections relative to the December 2006 update for the entire programme period are explained by the following factors: (i) the new update takes into account the better-than-expected 2006 outcome and the downwardly revised deficit targets for 2007-2008; (ii) it uses higher GDP deflators for the 2007-2010 period; and (iii) the stock-flow adjustment was much favourable for 2006 and it is projected to be even more favourable in 2007 compared to what was foreseen in the previous update.

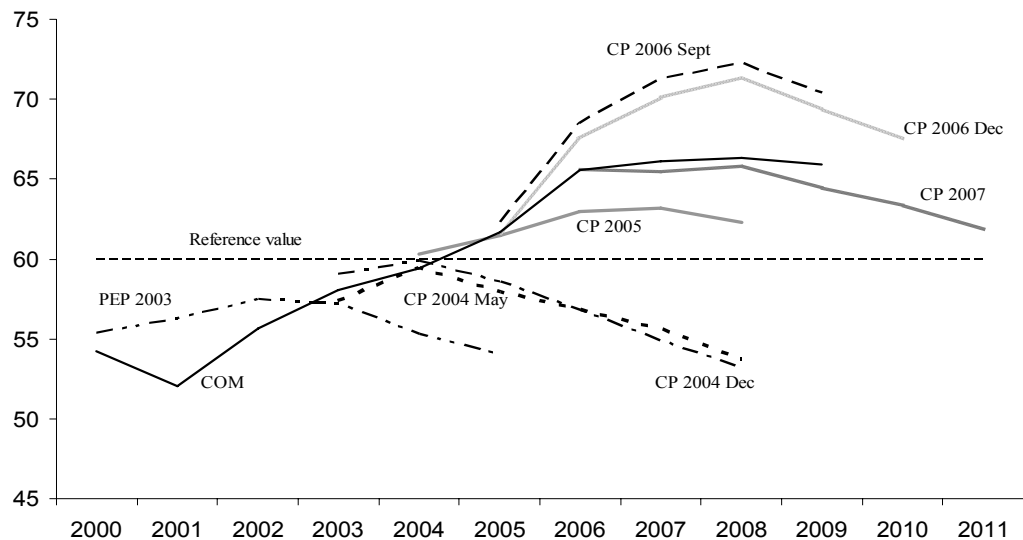
The expected small 0.2 percentage point decrease in the debt ratio in 2007 compared to 2006 is due to the fact that the debt-increasing impact of the budgetary deficit is more than offset by the combination of the “snowball” effect and the negative stock-flow adjustments. The Commission services’ autumn 2007 forecast projects half a percentage point increase in the debt ratio to 66.1% for 2007, which is 0.7% of GDP higher than the official forecast. The difference is linked to the more favourable assessment of the stock-flow adjustment and the lower deficit target for 2007 in the programme (see Table 9). The remarkably large negative stock-flow adjustment of 1.5% of GDP in 2007 is partly due to the reduction in the single treasury deposit by around 0.6% of GDP in 2007. Besides this, the privatisation receipts (0.2% of GDP) and some not quantified other effects (e.g. revaluation due to exchange rate changes, EU pre-financing) are also expected to contribute to the debt reduction.

Like the deficit targets, the debt targets set in 2004-2005 were also repeatedly missed by a large margin (see Figure 7). However, since the announcement of the revised adjustment path in the adjusted September 2006 convergence programme, this trend has been reversed as the revised debt target for 2006 was considerably outperformed. Therefore, and against the background of the most recent information on budgetary execution in 2007, even the new debt target of 65.4% of GDP for 2007 could be within reach.<sup>42</sup>

---

<sup>42</sup> Based on the better-than-expected cash-flow figures for the central budget, on 14 January 2008 the Minister of Finance announced a new deficit forecast of 5.7% of GDP for 2007, which is considerably lower compared to the programme's projection of 6.2% of GDP.

**Figure 7: Debt projections in successive programmes (% of GDP)**



*Source: Commission services' autumn 2007 forecast (COM), successive convergence programmes (CP) and Pre-Accession Economic Programme (PEP).*

**Table 9: Debt dynamics**

(% of GDP)	average 2002-05	2006	2007		2008		2009		2010	2011
			COM	CP	COM	CP	COM	CP	CP	CP
<b>Gross debt ratio<sup>1</sup></b>	<b>58.7</b>	<b>65.6</b>	<b>66.1</b>	<b>65.4</b>	<b>66.3</b>	<b>65.8</b>	<b>65.9</b>	<b>64.4</b>	<b>63.3</b>	<b>61.8</b>
Change in the ratio	2.4	4.0	0.5	-0.2	0.1	0.4	-0.4	-1.4	-1.1	-1.5
<i>Contributions<sup>2</sup>:</i>										
<b>Primary balance</b>	<b>3.5</b>	<b>5.3</b>	<b>2.4</b>	<b>2.2</b>	<b>0.2</b>	<b>-0.1</b>	<b>-0.1</b>	<b>-0.6</b>	<b>-0.8</b>	<b>-1.1</b>
<b>"Snow-ball" effect</b>	<b>-0.6</b>	<b>-0.4</b>	<b>-0.9</b>	<b>-0.9</b>	<b>0.0</b>	<b>0.0</b>	<b>-0.3</b>	<b>-0.5</b>	<b>-0.8</b>	<b>-0.8</b>
<i>Of which:</i>										
Interest expenditure	4.1	3.9	3.9	4.0	4.1	4.1	3.9	3.8	3.5	3.3
Growth effect	-2.2	-2.2	-1.2	-1.0	-1.6	-1.7	-2.1	-2.5	-2.5	-2.5
Inflation effect	-2.5	-2.1	-3.6	-3.9	-2.5	-2.4	-2.0	-1.9	-1.8	-1.6
<b>Stock-flow adjustment</b>	<b>-0.3</b>	<b>-0.7</b>	<b>-0.9</b>	<b>-1.5</b>	<b>0.0</b>	<b>0.6</b>	<b>0.0</b>	<b>-0.2</b>	<b>0.5</b>	<b>0.5</b>
<i>Of which:</i>										
Cash/accruals diff.	0.6	0.4		n.a.		n.a.		n.a.	n.a.	n.a.
Acc. financial assets	-0.9	-1.1		n.a.		n.a.		n.a.	n.a.	n.a.
Privatisation	-0.8	-1.3		-0.2		0.0		0.0	0.0	0.0
Val. effect & residual	0.1	-0.1		n.a.		n.a.		n.a.	n.a.	n.a.

Notes:

<sup>1</sup>End of period.

<sup>2</sup>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 (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

*Source:*

*Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations*

The programme foresees for 2008 and afterwards some moderate stock-flow adjustments, chiefly debt-increasing, but the impact of the mentioned explanatory factors (e.g. pre-financing of EU direct payments) are not quantified in the programme. According to the update, no privatisation proceeds are expected from 2008 onwards, although it used to be an important debt-reducing factor over the past years.

After the stabilization of the debt ratio in 2008, the projected debt dynamics would be induced by both the envisaged adjustment path (gradual shift to a primary surplus of around 1% of GDP in 2011) and the “snow-ball” effect (driven by a strong pick-up in growth), with a roughly even contribution to the expected reduction in the debt-to-GDP ratio.

### *5.1.2. Assessment*

The Commission services’ autumn 2007 forecast projects a small increase in the debt ratio to 66.3% in 2008 and a modest decrease to 65.9% in 2009, against official debt targets of 65.8% and 64.4%, respectively. The difference primarily reflects the higher deficit projections of the Commission forecast, albeit the programme’s higher nominal GDP projections also explains a part of the distance (the difference in 2009 is around 0.6 percentage point of GDP).

According to the update, a steady 1 percentage point deviation in the primary balance from 2008 onwards compared to the baseline target would lead to a 4 percentage point increase in the debt-to-GDP ratio by the end of the programme period. Given that the reduction in the debt ratio to a large extent depends on achieving primary surpluses starting from 2008, 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.

Moreover, there are other specific risks. In particular, the accompanying text of the 2008 budget law raises the option of reclassifying the passenger unit (MAV Start) of the national railway company into the general government sector in the context of the reorganisation of the national railway company (including the sale of the cargo unit). The reason for putting MAV Start into a watch-list by the Hungarian authorities is the uncertainty around the categorization of its revenues (market-based or not), which might then necessitate a statistical reclassification from the corporation to the government sector. This scenario could lead to the addition of the debt stock of MAV Start<sup>43</sup> to the gross debt of the general government sector, without any change in the deficit figures. However, the clarification of this complex issue would certainly need more time, in particular until the public service contract between the railway company and the Government is concluded, including the finalisation of the new subsidy system for public transport subsidies.

In addition, given the relatively large share of foreign currency denominated debt (around 18% of GDP or close to one third 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.

---

<sup>43</sup> The Government expects the debt of the entire MAV to decline to 1.05% of GDP by end-2007 from around 1.3% in 2006, even without taking into account the revenue from the sale of the cargo unit (0.4% of GDP), which is also planned to be partly used to further reduce debt.

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 of a 1 percentage point increase along the yield curve from the beginning of 2008 would result in an approximately 0.9 percentage point higher debt ratio by 2011. In view of the programmed debt developments until 2009 and the above risk assessment for the whole programme period, the debt ratio may not be sufficiently diminishing towards the reference value although it is programmed to fall by around 1-1.5 percentage points of GDP from 2009 onwards (see Box 6).

The Council opinion of 27 February 2007 on the previous update of the convergence programme asked Hungary to "... ensure, including by using any extra revenues for deficit reduction, that the gross debt-to-GDP ratio is brought onto a firm downward trajectory, preferably before 2009". Although the debt reduction could have been larger in 2007 and there could be a slight increase in 2008, the debt ratio has been broadly stabilised at lower levels than previously planned. Moreover, it is expected to start falling in 2009 assuming that the announced expenditure control and structural reform steps will be implemented.

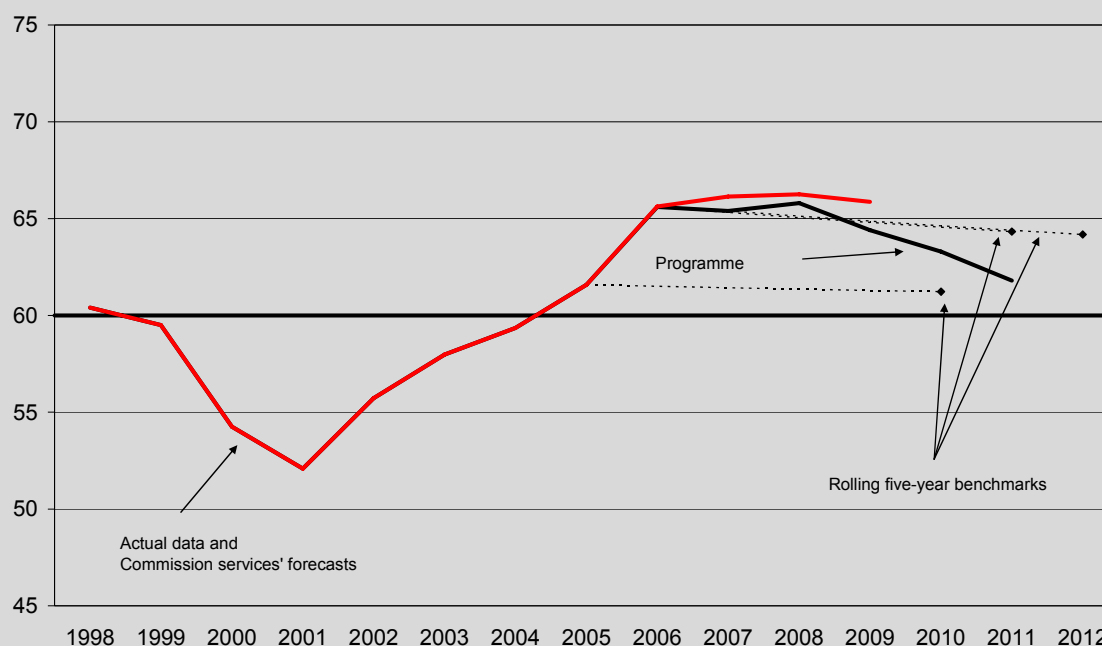
#### **Box 6: The rolling debt reduction benchmark**

The debt ratio has exceeded the 60% of GDP reference value since 2005.

A tentative assessment of the pace of debt reduction over a medium-term horizon is presented in the accompanying graph. It shows historical data, the Commission services' autumn 2007 forecasts until 2009 (which are on a no-policy change scenario) 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 2008 is compared with the value obtained for the same year by applying the formula starting in 2003. 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 (although in the last year of the programme period the benchmark is planned to be fulfilled).

## Hungary: rolling five-year debt benchmark



Source: Convergence programme and Commission services

(\*) The rolling debt reduction benchmark 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:

$$\left(\frac{D_{t+1}}{Y_{t+1}}\right)_{\text{benchmark}} = \left(\frac{D_t}{Y_t}\right)_{\text{benchmark}} - 5\% \times \left[\left(\frac{D_t}{Y_t}\right)_{\text{benchmark}} - 60\right], \text{ where } t \text{ is a time subscript and } D \text{ and } Y \text{ are the stock of}$$

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

This section analyses the long-term sustainability of public finances. It uses long-term projections of age-related expenditures to calculate sustainability gap indicators and make long-term government debt projections so as to assess the sustainability challenge the country concerned is facing.

### 5.2.1. Sustainability indicators and long-term debt projections

Table 10 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections and property income received by general government according to an agreed



methodology.<sup>44</sup> Non age-related primary expenditure and primary revenue is assumed to remain constant as a share of GDP.

**Table 10: Long-term age-related expenditure: main projections**

(% of GDP)	2004	2010	2020	2030	2040	2050	Change 2004-50
<b>Total age-related spending</b>	21.3	21.7	22.7	24.0	27.1	28.6	7.3
- Pensions	10.4	11.1	12.1	13.1	15.6	16.8	6.4
- Healthcare	5.5	5.7	6.0	6.3	6.4	6.5	1.0
- Long-term care	0.6	0.8	0.8	0.9	1.1	1.2	0.6
- Education	4.5	3.9	3.5	3.5	3.7	3.8	-0.8
- Unemployment benefits	0.2	0.2	0.2	0.2	0.2	0.2	0.0
<b>Property income received</b>	0.9	0.7	0.6	0.5	0.5	0.5	-0.4

*Source: Economic Policy Committee and Commission services.*

Hungary has implemented a pension reform in 2006 and new projections of age-related gross expenditure have been endorsed by the EPC in November 2007.<sup>45</sup> This reform has reduced the increase in age-related expenditure by 0.3 p.p. of GDP between 2004 and 2050. The impact of the 2006 pension reform is included in the baseline calculations below.

The projected increase in age-related spending in Hungary is above the average of the EU, rising by 7.3 percentage points of GDP between 2004 and 2050. This is particularly due to expenditure on pensions, which in gross terms are projected to increase more than on average in the EU, by 6.4 percentage points of GDP. The increase in health-care expenditure is projected to be 1.0 percentage point of GDP, lower than on average in the EU. For long-term care, the projected increase of 0.6 percentage point of GDP up to 2050 is below the EU average.

**Table 11: Sustainability indicators and the required primary balance**

Value	2007 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value	4.7	6.9	6.3	2.7	5.0	6.2
<i>of which:</i>						
Initial budgetary position (IBP)	1.7	2.0	-	-0.2	0.1	-
Debt requirement in 2050 (DR)	0.2	-	-	0.0	-	-
Long-term change in the primary balance (LTC)	2.8	4.9	-	2.8	4.9	-

*Source: Commission services.*

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 11 shows the sustainability indicators for the two scenarios; the 2007 scenario assumes that the structural primary balance in 2007 is unchanged for the rest of the programme period and the programme scenario assumes that the programme's budgetary plans are fully attained.

In the "2007 scenario", the sustainability gap (S2), which satisfies the intertemporal budget constraint, would be 6.9 percentage point of GDP.<sup>46</sup> Compared with the results of

<sup>44</sup> See the accompanying "methodological paper" for a description of the property income projections.

<sup>45</sup> See EPC opinion of 16 November 2007, CEFCPE01/2007/REP/55065. The projections do not include the most recent amendments adopted by the Parliament, adopted in November 2007.

<sup>46</sup> The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 4.7% of GDP.

the assessment of the previous update of the convergence programme, the sustainability gap is significantly smaller in the present assessment, by about 5½ percentage points of GDP. This is mainly due to the improvement of the structural primary balance in 2007 (-0.8% of GDP) compared with the structural primary balance in 2006 estimated in the previous assessment (-5.9% of GDP). The pension reform reduces the sustainability gap to a lesser extent, by around 0.2 percentage point of GDP.

The initial budgetary position, with a structural primary deficit, is not sufficiently high to stabilise the debt ratio over the long-term and entails a risk of unsustainable public finances even before considering the long-term budgetary impact of ageing.

According to both sustainability gaps, the long-term budgetary impact of ageing is still high. The programme plans a structural primary budgetary consolidation of 1.8 percentage points of GDP between 2007 and 2011. If achieved, such a consolidation would appreciably reduce risks to long-term sustainability of public finances by lowering the S2 sustainability gap to 5.0 percentage points of GDP (“programme scenario”). The difference between the initial budgetary position in the ‘2007 scenario’ and the ‘programme scenario’ illustrates how the full respect of the convergence programme targets would contribute to tackling the budgetary challenges raised by the demographic developments.

The required primary balance (RPB) is about 6% of GDP, which is higher than the structural primary balance of 1.0% of GDP in the last year of the programme period.

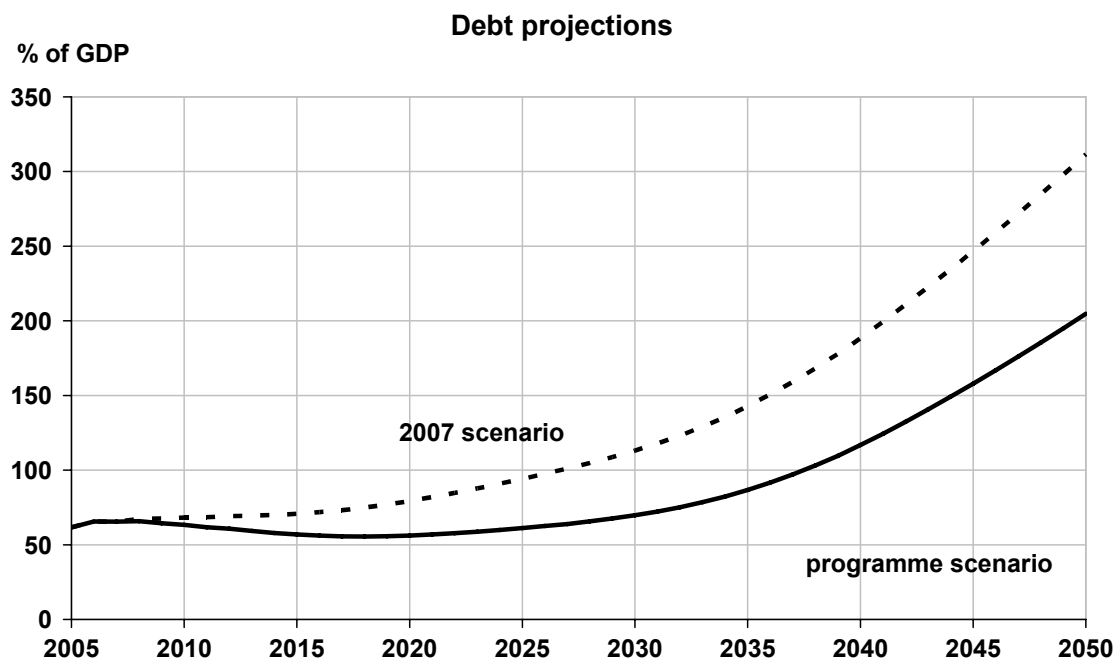
The sustainability gap indicator would increase by more than ½ % of GDP if the planned budgetary adjustment was to be postponed by 5 years, highlighting that budgetary savings can be made if action is taken sooner rather than later.

Another way to look at the prospects for long-term public finance sustainability is to project the debt-to-GDP ratio over the long-term using the same assumptions as for the calculations of the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 8. The gross debt ratio is currently above the 60% of GDP reference value, which is estimated in the programme at close to 65% of GDP in 2007. According to both scenarios, the debt ratio is projected to remain above the Treaty threshold over most of the projection period.<sup>47</sup> The debt projection in the current assessment is significantly different from the long-term debt projections included in the convergence programme. This results essentially from the inclusion of direct taxes on pension in the Hungarian simulations while the debt projections in Figure 8: only consider the 6 commonly agreed items (pensions, health care, long-term care, education, unemployment benefits and property income received by the general government) as for all other EU countries. This explains a difference of 100 percentage points of GDP in the 2050 debt ratio.

---

<sup>47</sup> It should be recalled, however, that being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, 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 8: Long-term projections for the government debt ratio**



*Source: Commission services*

### 5.2.2. 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 appreciate where the main risks to sustainability are likely to stem from.

First, Hungary's current level of debt is higher than 60% of GDP. A reduction of debt to below the 60% of GDP reference value at a rapid pace would strengthen the resilience of the public finances to adverse shocks and reduce the risks to public finance sustainability.

Second, new pensions awarded from 2013 onwards will be subject to income tax, instead of being tax exempt. According to the Hungarian authorities, direct taxes paid by pensioners will amount to 3.6% of GDP in 2050. This reduces the S2 sustainability indicator by 2.8 percentage points of GDP<sup>48</sup> reaching 4.1 percentage points of GDP in the '2007' scenario'.

The principle of taxing new pensions as of 2013 has been enacted. However, the tax treatment of pensions is not fully fixed yet and, in order to make projections, the Hungarian authorities assume that the average income tax rate on pension is determined so as to leave the net replacement rate and hence the budgetary gains of the reforms in 2013 unchanged when taxation of new pensions is introduced and new pensions are calculated on gross wages instead of net wages. This assumption leads to an average tax

<sup>48</sup> The S1 indicator is reduced by 2.0 percentage points of GDP reaching 2.7 percentage points of GDP in the 2007 scenario. The RPB is reduced to 3.5 percentage points of GDP and the debt in 2050 is reduced by 100 % of GDP.

rate on pensions of 21% in 2013. As noted by the AWG and the EPC<sup>49</sup>, “*while the Members of the AWG recognized that this assumption reflected the current policies of the Hungarian government (reduction of the replacement rate of new pensioners), it was felt that such a level of tax would be difficult to reach in practice as the average tax rate on pensions is assumed to be close to the average tax rate on wages even though the average pension is significantly lower than the average wage.*” It is therefore likely that further changes to the pension formula will be necessary before 2013, to ensure the materialization of the full budgetary gains of the 2006 pension reform as currently modelled by the Hungarian authorities.

Third, since the 2006 reform (whose effects are included in the sustainability indicators), further amendments were adopted by the Parliament: (i) the earliest date of retirement for men will not be reduced to 59 years of age between 2009 and 2012, remaining at 60 years; (ii) a higher penalty for early retirement will be implemented, leading, according to the Hungarian authorities to long-term savings of around 0.3 percentage point of GDP; and (iii) more stringent rules for disability schemes should, according to the programme, save 0.4 percentage point of GDP cumulated for a period of 10 years. The impact on those additional measures could reduce the sustainability indicator S2 by up to 0.3 percentage point of GDP.

### 5.2.3. Assessment

Hungary appears to be at high risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing on gross public expenditure is above the EU average. Recent reforms in 2006 and 2007 have helped to curb the increase in age-related expenditure. However, the significant savings expected from the direct taxation of pensions crucially depend on the exact tax treatment of pensions, which is not fully established yet.

Moreover, and importantly, the initial budgetary position, while significantly improved compared to 2006, still constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. In addition, the current level of gross debt is above the Treaty reference value. Further budgetary consolidation as planned in the programme would contribute to reducing risks to the sustainability of public finances.

---

<sup>49</sup> See EPC opinion of 16 November 2007, CEF/CPE01/2007/REP/55065 which endorsed the impact of the 2006 pension reform on gross expenditure.

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

Since reversing its policy in mid 2006, the Government has been successful in significantly reducing the budget deficit. Whereas initially the deficit reduction was chiefly relying on revenue increases and across-the-board expenditure freezes, it is planned to be increasingly based on the positive impact of the structural reforms. To this end, the convergence programme announces the continued implementation of the planned reforms in the pension and health care systems, while permanent efficiency gains are foreseen through the continued restructuring of the public administration, further reduction in price subsidies and the undertaken reorganisation of public education.

In the field of **public administration**, the *central government* has been reorganized and its size reduced. In 2006, 10,700 employees out of 280,000 employed were laid off followed by 12,500 officers in 2007. For 2008, a net outflow of 500 is planned, through a general reduction of the number of public servants by 3000 and the hiring of new staff of 2500 for the Tax Office and other institutions in charge of combating tax evasion and enforcing labour legislation. The 2007 budget allocated an increased amount of resources (0.1% of GDP) to provide financial incentives for cooperation between *local governments*, thereby improving the cost efficiency of local public services. In addition, the local distribution of social transfers has become more closely controlled in order to eliminate regional disparities. Finally, the modifications to the Public Finance Act are expected to increase local governments' financial discipline by a more regular audit to ensure efficient usage of resources.

Most new regulations in the field of **public education** were adopted already in 2006. Some further measures were specified in the budget for 2007. In particular, the financing of service provision was modified, small schools are to be increasingly merged into bigger ones, and the number of compulsory hours taught was increased as of September 2007. In higher education, tuition fees were introduced and will be effective as of 1 September 2008, and the number of newly admitted state-financed students was reduced by around 10% in 2007. Furthermore, starting from 2008 institutions will have to conclude a three-year maintenance agreement according to which budget transfers will be explicitly linked to performance indicators.

In January 2008, the **regulated prices** of gas and central heating has been further increased and the mean-tested subsidy system, which entered into force as of 1 January 2007, has been rescaled to yield lower transfer for households in the upper two income brackets.

In the field of **pensions**, a modifications were adopted by the Parliament in November 2006. These introduced stricter regulation for early retirement, a lower starting pension, and levied a pension contribution on income received by old-age pensioners. In 2007, these measures were augmented by the annulment of the temporary (between 2009 and 2012) decrease in the age limit for early retirement of men and pension benefits for early retirees were reduced (effective from 2013). On the other hand, the previously announced review of the key parameters (retirement age, indexation) had been postponed and the issue is now debated by the Roundtable on pension issues (an expert group set up by the Government).

The reform of the **disability pension system** was adopted by the Parliament in June 2007. In the new regulation, disability benefits would be replaced by rehabilitation allowances with a maximum of three years of eligibility). The new system is in operation from 1 January 2008, and – coupled with enhanced and more available rehabilitation services – would encourage the return to the labour market.

Bills on the reform of the **healthcare system** were adopted by the Parliament in December 2006. The provision of services was put on strict insurance basis as of 1 April 2007 with a transitory period until 1 January 2008. Furthermore, a new act introducing a multi-fund system in health-care services is expected to be adopted when resubmitted to the Parliament in February 2008. Visit fee and inpatient co-payment were introduced (1.2 to 4 euros) in mid February 2007. The capacities of the system were rationalized: resources were relocated from acute inpatient care to outpatient care, rehabilitation and chronic inpatient care. The network of hospitals has been reduced and their operational framework has been renewed, allowing for more profit-oriented operation and more flexible remuneration of staff. However, it is still not clear whether the planned medium-term budgetary savings could be achieved through the measures adopted so far. A healthcare supervision agency was established.

In early 2007 **pharmaceutical subsidies** were revamped: subsidy rates were reduced and stricter eligibility rules for subsidies were implemented. Payment obligations of the pharmaceutical producer and retailers were standardised and fixed by a new act. New rules were also established to control pharmaceutical and medical aid prescription. To promote competition on the medicine market restrictions on the opening of pharmacies have been eased and selling of certain non-prescription drugs have been liberalised.

Finally, **fiscal governance** is being strengthened. Fiscal rules that put limits on the debt accumulation of local governments already exist. As described in detail in section 2, a package of new draft acts was submitted to the Parliament in November 2007, which includes a switch to multi-annual budgeting, a real government debt rule and the establishment of a new institution to ensure transparent and prudent fiscal policy.

Since mid-2006 a number of measures were taken to improve the quality of public finances and to reduce the risks associated with the ageing of the population. Other planned reforms such as the restructuring of the taxation system and the liberalisation of the health-care insurance market have been delayed. The rigorous implementation of the announced structural reforms should facilitate long-term fiscal sustainability. Furthermore, raising credibility by adopting the proposed fiscal framework should contribute to increasing potential growth and thereby speeding up Hungary's real convergence to EU average.

## **7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES**

Measures in the convergence programme as described in preceding sections are broadly in line with the 2006 update of the National Reform Programme and its October 2007 implementation report (IR-NRP). In particular, both include the restructuring of the public administration and also reforms related to the health-care and pension systems.

The programme discusses the impact of a number of reform steps outlined in the IR-NRP in qualitative terms; including, for certain measures, their effect on potential growth,

employment or productivity. In some cases the positive implications for the sustainability of public finances are also highlighted.

The programme offers a more detailed description and provides figures for the budgetary impact of the reforms envisaged in the pension and the health-care systems. For other measures of the IR-NRP however, it does not quantify the expected result in a comprehensive or systemic way.

Overall, the convergence programme seems to be consistent to some extent with the IR-NRP.

**Box 7: The Commission assessment of the October 2007 implementation report of the national reform programme**

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which included an assessment of the October 2007 implementation report of Hungary's national reform programme. This can be summarised as follows.

Hungary's national reform programme as updated in October 2006 recognises key challenges in reducing the fiscal deficit; raising the employment and the activity rate; improving active labour market policies and situation of the disadvantaged in the labour market; reducing regional labour market disparities and in the fields of R&D and innovation; business environment; competition; infrastructure; education and training; energy and environment.

The Commission's assessment was that Hungary, while having made strong efforts and the pace of reform having accelerated, has made limited progress in implementing its national reform programme over the period 2005-2007.

Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that Hungary is recommended to give highest priority to the challenges in the areas of: public finances consolidation; public administration reform, health care, pension and education systems; active labour market policies; education and training.

In addition, Hungary should also focus on the areas of: further reform of the public research system; reducing and redirecting state aids; improving the regulatory environment through further reducing administrative burden and legislative simplification; introducing further incentives to work and to remain in the labour market; ensuring better reconciliation of work and private life; completing the establishment of the integrated employment and social services system; transforming undeclared work into formal employment; and implementing the lifelong learning strategy.

The tables below provide an overview of whether the strategy and policy measures in the convergence programme are consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs. The first table makes the assessment against the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005. The second table makes the assessment against the country-specific recommendations and points to watch, adopted by the Council in March 2007. The budgetary strategy in the convergence programme is broadly consistent with the country-specific recommendations and points to watch.

**Table 12: Consistency with the broad economic policy guidelines (integrated guidelines)**

Broad economic policy guidelines (integrated guidelines)	Yes	Steps in right direction	No	Not applicable
<b>1. To secure economic stability</b>				
– 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 <sup>1</sup> .		X		
– Member States should avoid pro-cyclical fiscal policies <sup>2</sup> .				X (not yet in MTO)
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits <sup>3</sup> .		X		
– Member States posting current account deficits that risk being unsustainable should work towards (...), where appropriate, contributing to their correction via fiscal policies.		X		
<b>2. To safeguard economic and fiscal sustainability</b>				
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		
<b>3. To promote a growth- and employment-orientated and efficient allocation of resources</b>				
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		
<p><u>Notes:</u></p> <p><sup>1</sup>As further specified in the Stability and Growth Pact and the 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.</p> <p><sup>2</sup>As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in “good times”.</p> <p><sup>3</sup>As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.</p> <p><u>Source:</u> Commission services</p>				



**Table 13: Consistency with the broad economic policy guidelines (country-specific recommendations and points to watch)**

Broad economic policy guidelines (country-specific recommendations and points to watch)	Yes	Steps in right direction	No	Not applicable
<b>1. Country-specific recommendations</b>				
– “continue to implement the necessary measures to ensure a durable reduction of the government deficit and of the public debt ratio, with increased reliance on the expenditure side, including through the establishment of more thorough and comprehensive expenditure rules;”		X		
– “continue to reform the public administration, health care, pension and education systems with a view to ensuring long-term fiscal sustainability and improving economic efficiency. This should include steps to further limit early retirement, reduce the number of new recipients of disability pensions and further restructure health care;”		X		
<b>2. Points to watch</b>				
– none				X

\* \* \*

## Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

### (i) Model structure

The model structure for the programmes in Annex 1 of the code of conduct has been broadly followed. The numbering of the programme is different, because the 1<sup>st</sup> chapter of the model structure (Overall policy framework and objectives) is incorporated into the 1<sup>st</sup> chapter (Macroeconomic objectives and forecast) of the Convergence Programme of Hungary.

### (ii) Data requirements

The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).

Among the compulsory information the nominal effective exchange rate and the level of one-off for 2006 are missing.

The programme provides almost all the optional information in these tables except for the following cases: Table 3 (“General government expenditure by function”) is entirely missing, as well as data on hours worked in Table 1c., data related to the breakdown of stock-flow adjustment in Table 4 and some data on the long-term sustainability of public finances (Table 7).

The tables on the following pages show the data presented in the November 2007 update of convergence programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

### (iii) Other information requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

The SCP...	Yes	No	Comments
<i>a. Involvement of parliament</i>			
... mentions status vis-à-vis national parliament.		X	
... indicates whether Council opinion on previous programme has been presented to national parliament.		X	
<i>b. Economic outlook</i>			
... (for euro area and ERM II Member States) uses “common external assumptions” on main extra-EU variables.			Not applicable
... explains significant divergences with Commission services’ forecasts <sup>1</sup> .			Not applicable, since there is no significant divergences between the national and the Commission services’ forecast.
... bears out possible upside/downside risks to economic outlook.		X	Chapter 3 presents alternative scenarios, these are however not detailed enough to clearly bring out possible risks.
... analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.	X		External balance is analysed in the text, sectoral balances are only presented in Annex table 1.
<i>c. Monetary/exchange rate policy</i>			
... (CP only) presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
<i>d. Budgetary strategy</i>			
... presents budgetary targets for general government balance	X		

The SCP...	Yes	No	Comments
in relation to MTO and projected path for debt ratio.			
... (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.			Not applicable
... (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).			Not applicable
... backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.		X	The broad structural measures are indicated in the programme, but the comprehensive assessment of their quantitative budgetary impacts are missing
... specifies state of implementation of measures.	X		
<i>e. "Major structural reforms"</i>			
... (if MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.			Not applicable
... includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.			Not applicable
<i>f. Sensitivity analysis</i>			
... includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.	X X X		
... (in case of "major structural reforms") analyses how changes in assumptions would affect budget and potential growth.		X	Not applicable
<i>g. Broad economic policy guidelines</i>			
... provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.	X		
<i>h. Quality of public finances</i>			
... describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
<i>i. Long-term sustainability</i>			
... outlines strategies to ensure sustainability.	X		
... includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).	X		With the exception of pension projections, which is given in net terms
<i>j. Other information (optional)</i>			
... includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		
<p><b>Notes:</b> SCP = stability/convergence programme; CP = convergence programme</p> <p><sup>1</sup>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.</p> <p><i>Source:</i> Commission services</p>			

Table 1a. Macroeconomic prospects

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Real GDP</b>	B1*g	22910.6	3.9	1.7	2.8	4.0	4.1	4.2
<b>2. Nominal GDP</b>	B1*g	23757.2	7.7	8.2	6.8	7.2	7.2	7.1
<b>Components of real GDP</b>								
<b>3. Private consumption expenditure</b>	P.3	11986.3	1.9	-0.4	1.2	1.9	2.3	3.1
<b>4. Government consumption expenditure</b>	P.3	5546.1	4.3	-5.5	-2.8	0.4	0.9	1.1
<b>5. Gross fixed capital formation</b>	P.51	4877.1	-2.8	2.0	4.2	7.4	7.0	6.0
<b>6. Changes in inventories and net acquisition of valuables (% of GDP)</b>	P.52 + P.53	128.8	0.6	1.4	1.3	1.3	1.3	1.3
<b>7. Exports of goods and services</b>	P.6	17369.1	18.9	15.5	12.9	11.8	11.5	11.2
<b>8. Imports of goods and services</b>	P.7	16996.8	14.5	13.2	11.1	11.0	11.1	11.1
<b>Contributions to real GDP growth</b>								
<b>9. Final domestic demand</b>		-	1.4	-1.1	0.9	2.6	2.9	3.1
<b>10. Changes in inventories and net acquisition of valuables</b>	P.52 + P.53	-	-0.3	0.9	0.0	0.0	0.0	0.0
<b>11. External balance of goods and services</b>	B.11	-	2.8	1.9	1.9	1.3	1.2	1.0

Table 1b. Price developments

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. GDP deflator</b>		<i>n.a.</i>	3.7	6.4	3.9	3.0	2.9	2.8
<b>2. Private consumption deflator</b>		<i>n.a.</i>	3.2	7.6	4.8	3.0	2.9	2.8
<b>3. HICP<sup>1</sup></b>		<i>n.a.</i>	4.0	7.9	4.8	3.0	2.9	2.8
<b>4. Public consumption deflator</b>		<i>n.a.</i>	4.8	6.3	4.1	3.5	4.2	4.2
<b>5. Investment deflator</b>		<i>n.a.</i>	5.7	5.0	4.3	3.5	3.0	3.0
<b>6. Export price deflator (goods and services)</b>		<i>n.a.</i>	6.5	-4.0	1.2	1.2	1.1	0.9
<b>7. Import price deflator (goods and services)</b>		<i>n.a.</i>	8.0	-4.7	1.3	1.4	1.2	1.0

<sup>1</sup> Optional for stability programmes.

**Table 1c. Labour market developments**

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Employment, persons<sup>1</sup></b>		3906	0.7	0.1	0.2	0.6	0.6	0.6
2. Employment, hours worked <sup>2</sup>		<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
<b>3. Unemployment rate (%)<sup>3</sup></b>		<i>n.a.</i>	7.5	7.3	7.3	7.2	7.1	7.1
<b>4. Labour productivity, persons<sup>4</sup></b>		<i>n.a.</i>	3.1	1.6	2.6	3.4	3.5	3.5
5. Labour productivity, hours worked <sup>5</sup>		<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
<b>6. Compensation of employees</b>	D.1	10754.7	4.9	8.3	5.8	5.3	5.6	6.1
<b>7. Compensation per employee</b>		3.1	4.1	8.1	5.5	4.7	4.9	5.4

<sup>1</sup>Occupied population, domestic concept national accounts definition.

<sup>2</sup>National accounts definition.

<sup>3</sup>Harmonised definition, Eurostat; levels.

<sup>4</sup>Real GDP per person employed.

<sup>5</sup>Real GDP per hour worked.

**Table 1d. Sectoral balances**

% of GDP	ESA Code	2006	2007	2008	2009	2010	2011
<b>1. Net lending/borrowing vis-à-vis the rest of the world</b>	B.9	-5.7	-4.1	-2.3	-1.7	-1.3	-0.8
<i>of which :</i>							
- Balance on goods and services		0.4	2.5	3.9	4.6	5.1	5.3
- Balance of primary incomes and transfers		-6.9	-7.4	-7.9	-7.8	-8.1	-8.2
- Capital account		0.8	0.8	1.6	1.5	1.7	2.0
2. Net lending/borrowing of the private sector	B.9	3.5	2.1	1.7	1.5	1.4	1.4
3. Net lending/borrowing of general government	EDP B.9	-9.2	-6.2	-4.0	-3.2	-2.7	-2.2
<b>4. Statistical discrepancy</b>		0.2	optional	optional	optional	optional	optional

Table 2. General government budgetary prospects

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
<b>Net lending (EDP B.9) by sub-sector</b>								
<b>1. General government</b>	S.13	-2188.2	-9.2	-6.2	-4.0	-3.2	-2.7	-2.2
<b>2. Central government</b>	S.1311	-1938.1*	-8.2	-5.8	-3.7	-2.9	-2.3	-1.9
<b>3. State government</b>	S.1312	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>4. Local government</b>	S.1313	-158.2	-0.7	-0.5	-0.4	-0.5	-0.5	-0.4
<b>5. Social security funds</b>	S.1314	-91.9*	-0.4	0.1	0.1	0.1	0.1	0.1
<b>General government (S13)</b>								
<b>6. Total revenue</b>	TR	10128.8	42.6	44.1	44.2	43.3	42.4	42.0
<b>7. Total expenditure</b>	TE <sup>1</sup>	12316.9	51.8	50.3	48.2	46.5	45.1	44.2
<b>8. Net lending/borrowing</b>	EDP B.9	-2188.2	-9.2	-6.2	-4.0	-3.2	-2.7	-2.2
<b>9. Interest expenditure</b>	EDP D.41	927	3.9	4.0	4.1	3.8	3.5	3.3
<b>10. Primary balance<sup>2</sup></b>		-1261.1	-5.3	-2.2	0.1	0.6	0.8	1.1
<b>11. One-off and other temporary measures<sup>3</sup></b>		-	-0.7	-1.1	0.1	0.1	0.0	0.0
<b>Selected components of revenue</b>								
<b>12. Total taxes (12=12a+12b+12c)</b>		5799.9	24.4	25.6	25.5	24.9	24.4	24.1
<b>12a. Taxes on production and imports</b>	D.2	3560.6	15.0	15.5	15.3	14.9	14.7	14.5
<b>12b. Current taxes on income, wealth, etc</b>	D.5	2217.9	9.3	10.0	10.1	9.9	9.7	9.6
<b>12c. Capital taxes</b>	D.91	21.4	0.1	0.1	0.1	0.1	0.1	0.1
<b>13. Social contributions</b>	D.61	2996.9	12.6	13.5	13.5	13.4	13.2	13.1
<b>14. Property income</b>	D.4	248.1	1.0	0.8	0.7	0.5	0.5	0.4
<b>15. Other<sup>4</sup></b>		1083.8	4.6	4.2	4.4	4.4	4.2	4.4
<b>16=6. Total revenue</b>	TR	10128.8	42.6	44.1	44.2	43.3	42.4	42.0
<b>p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)<sup>5</sup></b>			37.0	39.1	39.0	38.3	37.6	37.2
<b>Selected components of expenditure</b>								
<b>17. Compensation of employees + intermediate consumption</b>	D.1+P.2	4548.8	19.1	18.1	16.8	16.6	16.3	15.9
17a. Compensation of employees	D.1	2889.7	12.2	11.5	11.0	11.0	10.7	10.5
17b. Intermediate consumption	P.2	1659.1	7.0	6.6	5.8	5.6	5.6	5.4
<b>18. Social payments (18=18a+18b)</b>		4398.5	18.5	18.4	18.2	17.8	17.3	16.7
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	845.4	3.6	3.0	2.9	2.7	2.6	2.4
18b. Social transfers other than in kind	D.62	3553.1	15.0	15.3	15.4	15.1	14.7	14.3
<b>19=9. Interest expenditure</b>	EDP D.41	927	3.9	4.0	4.1	3.8	3.5	3.3
<b>20. Subsidies</b>	D.3	330	1.4	1.7	1.5	1.3	1.2	1.2
<b>21. Gross fixed capital formation</b>	P.51	1044.8	4.4	3.5	3.5	3.2	3.3	3.2
<b>22. Other<sup>6</sup></b>		1067.8	4.5	4.6	4.1	3.8	3.5	3.9
<b>23=7. Total expenditure</b>	TE <sup>1</sup>	12316.9	51.8	50.3	48.2	46.5	45.1	44.2
<b>p.m.: Government consumption (nominal)</b>	P.3	5430	22.9	21.3	19.8	19.4	19.0	18.4

<sup>1</sup> Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

<sup>2</sup> The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

<sup>3</sup> A plus sign means deficit-reducing one-off measures.

<sup>4</sup> P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

<sup>5</sup> Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

<sup>6</sup> D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

**Table 3. General government expenditure by function**

% of GDP	COFOG Code	2005	2010
1. General public services	1	n.a.	n.a.
2. Defence	2	n.a.	n.a.
3. Public order and safety	3	n.a.	n.a.
4. Economic affairs	4	n.a.	n.a.
5. Environmental protection	5	n.a.	n.a.
6. Housing and community amenities	6	n.a.	n.a.
7. Health	7	n.a.	n.a.
8. Recreation, culture and religion	8	n.a.	n.a.
9. Education	9	n.a.	n.a.
10. Social protection	10	n.a.	n.a.
11. Total expenditure (=item 7=23 in Table 2)	TE <sup>1</sup>	n.a.	n.a.

<sup>1</sup>Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

**Table 4. General government debt developments**

% of GDP	ESA Code	2006	2007	2008	2009	2010	2011
<b>1. Gross debt<sup>1</sup></b>		65.6	65.4	65.8	64.4	63.3	61.8
<b>2. Change in gross debt ratio</b>		4.0	-0.2	0.4	-1.4	-1.1	-1.5
<b>Contributions to changes in gross debt</b>							
<b>3. Primary balance<sup>2</sup></b>		5.3	2.2	-0.1	-0.6	-0.8	-1.1
<b>4. Interest expenditure<sup>3</sup></b>	EDP D.41	3.9	4.0	4.1	3.8	3.5	3.3
<b>5. Stock-flow adjustment</b>		-0.7	-1.5	0.5	-0.2	0.5	0.6
<i>of which:</i>							
- Differences between cash and accruals <sup>4</sup>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- Net accumulation of financial assets <sup>5</sup>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<i>of which:</i>		-	-	-	-	-	-
- privatisation proceeds		-1.2	-0.2	0.0	0.0	0.0	0.0
- Valuation effects and other <sup>6</sup>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>p.m.: Implicit interest rate on debt<sup>7</sup></b>		6.4	6.4	6.4	6.0	5.7	5.4
<b>Other relevant variables</b>							
6. Liquid financial assets <sup>8</sup>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
7. Net financial debt (7=1-6)		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

<sup>1</sup>As defined in Regulation 3605/93 (not an ESA concept).

<sup>2</sup>Cf. item 10 in Table 2.

<sup>3</sup>Cf. item 9 in Table 2.

<sup>4</sup>The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

<sup>5</sup>Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

<sup>6</sup>Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

<sup>7</sup>Proxied by interest expenditure divided by the debt level of the previous year.

<sup>8</sup>AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

**Table 5. Cyclical developments**

% of GDP	ESA Code	2006	2007	2008	2009	2010	2011
<b>1. Real GDP growth (%)</b>		3.9	1.7	2.8	4.0	4.1	4.2
<b>2. Net lending of general government</b>	EDP B.9	-9.2	-6.2	-4.0	-3.2	-2.7	-2.2
<b>3. Interest expenditure</b>	EDP D.41	3.9	4.0	4.1	3.8	3.5	3.3
<b>4. One-off and other temporary measures<sup>1</sup></b>		-0.7	-1.1	0.1	0.1	0.0	0.0
5. Potential GDP growth (%)		4.0	3.8	3.7	3.6	3.6	3.7
contributions:							
- labour		0.4	0.4	0.3	0.3	0.2	0.2
- capital		1.7	1.6	1.6	1.6	1.7	1.7
- total factor productivity		1.9	1.8	1.8	1.7	1.7	1.7
6. Output gap		1.2	-0.9	-1.8	-1.5	-0.9	-0.5
7. Cyclical budgetary component		0.3	-0.2	-0.5	-0.4	-0.2	-0.1
8. Cyclically-adjusted balance (2 - 7)		-9.5	-6.0	-3.5	-2.8	-2.5	-2.1
9. Cyclically-adjusted primary balance (8 + 3)		-5.6	-2.0	0.6	1.0	1.0	1.2
10. Structural balance (8 - 4)		-8.8	-4.9	-3.7	-2.9	-2.5	-2.1

<sup>1</sup>A plus sign means deficit-reducing one-off measures.

**Table 6. Divergence from previous update**

	ESA Code	2006	2007	2008	2009	2010	2011
<b>Real GDP growth (%)</b>							
<b>Previous update</b>		4.0	2.2	2.6	4.2	4.3	n.a.
<b>Current update</b>		3.9	1.7	2.8	4.0	4.1	4.2
<b>Difference</b>		-0.1	-0.5	0.2	-0.2	-0.2	n.a.
<b>General government net lending (% of GDP)</b>	EDP B.9						
<b>Previous update</b>		10.1	6.8	4.3	3.2	2.7	n.a.
<b>Current update</b>		9.2	6.2	4.0	3.2	2.7	2.2
<b>Difference</b>		-0.9	-0.6	-0.3	0.0	0.0	n.a.
<b>General government gross debt (% of GDP)</b>							
<b>Previous update</b>		67.5	70.1	71.3	69.3	67.5	n.a.
<b>Current update</b>		65.6	65.4	65.8	64.4	63.3	61.8
<b>Difference</b>		-1.9	-4.7	-5.5	-4.9	-4.2	n.a.



**Table 7. Long-term sustainability of public finances**

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which: age-related expenditures	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Pension expenditure	9.1	10.4	10.6	10.7	10.7	13.0
Social security pension	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Old-age and early pensions	6.7	8.3	8.9	9.5	9.4	11.7
Other pensions (disability, survivors)	2.4	2.1	1.7	1.3	1.3	1.3
Occupational pensions (if in general government)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Health care	5.0	5.5	5.7	6.0	6.3	6.5
Long-term care ( <i>this was earlier included in the</i>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Education expenditure	n.a.	4.4	3.9	3.5	3.5	3.8
Other age-related expenditures	n.a.	0.2	0.2	0.2	0.2	0.2
Interest expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total revenue	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which: property income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which : from pensions contributions (or social contributions if appropriate)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Pension reserve fund assets	6.9	6.4	8.4	9.9	10.0	10.3
Of which : consolidated public pension fund assets (assets other than government liabilities)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Assumptions</b>						
Labour productivity growth	4.2	4.0	3.5	2.9	2.7	1.7
Real GDP growth	5.2	4.1	4.1	2.5	2.1	1.1
Participation rate males (aged 20-64)	67.5	67.9	70.6	73.9	73.4	71.8
Participation rates females (aged 20-64)	52.6	55.1	56.8	61.8	62.9	61.6
Total participation rates (aged 20-64)	59.9	61.4	63.4	67.8	68.2	66.7
Unemployment rate	6.4	7.2	7.1	4.8	4.8	4.8
Population aged 65+ over total population	15.0	15.6	16.7	20.3	22.3	28.1

**Table 8. Basic assumptions**

	2006	2007	2008	2009	2010	2011
Short-term interest rate <sup>1</sup> (annual average)	6.9	7.6	6.9	6.3	5.7	5.2
Long-term interest rate (annual average)	7.1	6.7	6.5	6.1	5.6	5.2
USD/€ exchange rate (annual average) (euro area and ERM II countries)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Nominal effective exchange rate	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	264.2	251.0	251.0	251.0	251.0	251.0
World excluding EU, GDP growth	6.0	5.6	5.3	5.4	5.4	5.4
EU GDP growth	3.0	2.9	2.4	2.4	2.4	2.4
Growth of relevant foreign markets	10.1	7.8	7.4	6.8	6.8	6.8
World import volumes, excluding EU	8.0	7.8	7.1	7.7	7.7	7.7
Oil prices (Brent, USD/barrel)	66.2	70.6	78.8	76.0	76.0	76.0

<sup>1</sup>If necessary, purely technical assumptions.

## Annex 2: Key indicators of past economic performance

This annex displays key economic indicators that summarise the past economic performance of Hungary. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the recently acceded Member States (EU12).

**Table 14: Key economic indicators**

	Hungary						Recently acceded Member States					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
<b>Economic activity</b>												
Real GDP (% change)	4.2	4.0	4.3	4.1	3.9	2.0	3.8	3.6	4.1	4.8	6.3	6.0
<i>Contributions to real GDP growth:</i>												
<i>Domestic demand</i>	4.3	4.5	4.1	1.3	1.1	-0.6	4.4	4.6	4.1	4.1	7.3	7.8
<i>Net exports</i>	-0.2	-0.5	0.2	2.8	2.8	2.7	-0.5	-1.0	-0.1	0.8	-0.9	-1.8
Real GDP per capita (PPS; EU27 = 100)	58	54	62	65	66	66	47	45	49	52	54	56
Real GDP per capita (% change)	4.4	4.3	4.6	4.3	4.0	2.3	4.1	3.8	4.4	4.9	6.4	6.1
<b>Prices, costs and labour market</b>												
HICP inflation (%)	10.5	15.2	5.9	3.5	4.0	7.7	7.8	12.9	5.7	3.8	3.4	4.0
Labour productivity (% change)	3.5	2.9	4.1	3.7	2.9	2.4	4.2	4.3	4.1	3.3	3.6	3.5
Real unit labour costs (% change)	-0.3	-2.0	1.3	1.0	-3.9	-2.8	-1.3	-1.4	-1.3	-0.6	-1.5	0.4
Employment (% change)	0.7	1.2	0.2	0.0	0.7	-0.3	-0.3	-0.6	0.0	1.4	2.6	2.4
Unemployment rate (% of labour force)	7.1	8.1	6.1	7.2	7.5	7.3	11.3	9.7	12.9	11.9	9.9	7.8
<b>Competitiveness and external position</b>												
Real effective exchange rate (% change)	3.5	-0.2	7.3	2.6	-7.4	6.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) <sup>1</sup>	6.3	8.2	4.4	4.6	8.1	5.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-7.3	-7.7	-6.8	-6.0	-5.7	-3.9	-4.5	-4.8	-4.3	-4.3	-5.0	-6.1
<b>Public finances</b>												
General government balance (% of GDP)	-6.1	-5.4	-6.9	-7.8	-9.2	-6.4	-4.2	-3.8	-4.4	-3.5	-3.3	-2.7
General government gross debt (% of GDP)	59.5	61.6	57.3	61.6	65.6	66.1	37.7	35.4	39.0	39.6	38.8	37.9
Structural balance (% of GDP) <sup>2,3</sup>	-5.8	-4.9	-7.3	-8.4	-9.4	-5.5	n.a.	n.a.	-3.8	-3.3	-3.6	-3.0
<b>Financial indicators</b>												
Short-term real interest rate (%) <sup>4</sup>	3.4	3.3	3.5	4.4	3.4	0.7	3.9	6.3	2.9	1.4	1.0	0.5
Long-term real interest rate (%) <sup>4</sup>	1.1	0.1	1.6	4.3	3.3	0.7	n.a.	n.a.	n.a.	n.a.	1.6	1.1
<p>Notes:</p> <p><sup>1</sup>Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.</p> <p><sup>2</sup>Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.</p> <p><sup>3</sup>Due to lack of ESA data for structural balances before 2003, for the calculation of averages cyclically-adjusted balances are used.</p> <p><sup>4</sup>Using GDP deflator.</p> <p>Source: Commission services</p>												