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# HUNGARY: MACRO FISCAL ASSESSMENT

## AN ANALYSIS OF THE DECEMBER 2008 UPDATE OF THE CONVERGENCE PROGRAMME

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term budgetary programme, called “stability programme” for countries that have adopted the euro as their currency and “convergence programme” for those that have not.

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 18 February 2009. Comments should be sent to László Jankovics (Laszlo.Jankovics@ec.europa.eu) and Balázs Párkányi (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’ January 2009 interim 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 18 February 2009. The ECOFIN Council is expected to adopt its opinion on the programme on 10 March 2009.

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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**

## 1. INTRODUCTION

This document assesses the December 2008 update of Hungary's convergence programme. It takes into account all currently available information, notably the Commission services' January 2009 interim forecast, the new economic policy programme adopted in October in response to the financial crisis in Hungary and its recent revision as well as information acquired during the first review mission of the Commission services in the context of the medium-term Community financial assistance granted to Hungary. The update, which was submitted on 19 December 2008[1], covers the period 2008-2011 and builds on the 2009 budget law as adopted on 15 December by Parliament. It update was adopted by the Government on 17 December after discussion with representatives of social partners in the National Interest Reconciliation Council. It was not discussed in Parliament. An addendum to the programme was submitted on 31 December presenting the details of the economic support package as well as some structural reform measures that could mitigate the negative impact of the economic downturn. However, given the absence of fiscal space implied by the high debt ratio and deficit and the financial markets context in Hungary, it did not contain deficit-increasing stimulus measures.

## 2. MAIN CHALLENGES IN THE ECONOMIC DOWNTURN AND THE POLICY RESPONSE

In 2008, a relatively favourable net export performance in the first quarter and a surge in agricultural output in the summer alleviated somewhat the negative impact of the budgetary consolidation. However, given the decline of GDP by 0.5% in 2008Q3 and 1% in 2008Q4 compared to previous quarters the moderate recovery that was expected to start in 2008 has clearly not taken place, due to the impact of the financial crisis that hit Hungary particularly hard. Both external trade and domestic demand are foreseen to shrink further, leading to a sharp contraction in 2009. The unemployment rate also climbed up to 8.5% seasonally adjusted in December 2008 and is expected to increase further to above 9% over the forecast horizon.

The January 2009 interim forecast estimates large positive output gaps in the period between 2006 and 2008[2]. However, the growth performance of both the real GDP and its components was remarkably worse than their historical averages. As a result, the output gap has been rapidly deteriorating in the above-mentioned period, reaching zero in 2009. Furthermore, most labour market indicators, such as employment growth and labour productivity growth, also evolved below their long-term averages. Based on these factors, Hungary is likely to have entered in 2008 a period of bad economic times.

Although the rapidly deteriorating external trade performance in the second half of 2008 and a considerably worse than expected income balance are likely to have increased the current account deficit in 2008, it is likely to be reduced again in 2009 through an improvement in the trade balance. After repeated reductions in the budget deficit, which is likely to have fallen to 3¼% in 2008, fiscal policy is expected to remain tight in 2009 bringing the deficit below the 3% threshold.

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[1] The English language version was submitted on 31 December 2008.

[2] Potential GDP estimates may have sizable standard errors, especially during turbulent economic times and in case of catching-up economies, such as Hungary.

Harmonised consumer price inflation embarked on a declining trend, coming down from 7.9% in 2007 to 6% in 2008. The significant fall in energy and food prices has certainly played a role and should continue to exert downward pressure on inflation. In addition, the worsened growth outlook should also support the continuation of the disinflationary process.

Although both the budget and the current account deficit have been declining, Hungary has remained vulnerable due to high levels of government and external debt, about three quarters of the latter being denominated in foreign currency. Consequently, the financial crisis hit Hungary particularly hard at the beginning of October, with a freeze on the government primary bond market, a very sharp fall in the stock market and a marked depreciation of the exchange rate. Evidenced by the year-end data, the hitherto robust credit growth suddenly reversed as banks were forced to deleverage their portfolios which led to a dramatic slowdown in foreign-exchange-denominated lending. Extensive credit rationing could cause a severe liquidity shortage for corporations hindering production and thus further aggravating the economic downturn. Therefore, restoring investor confidence and reinstating efficient functioning of the financial markets are the most imminent tasks of economic policy. In addition, Hungary's potential growth is estimated to have declined substantially, becoming distinctively lower than in other new Member States. Consequently, developing and implementing comprehensive structural reforms is of high importance.

To mitigate the country's exposure and to contain the negative impact of the financial crisis, the Government adopted a new economic programme and the EU, the International Monetary Fund and the World Bank supported Hungary with a large (EUR 20 billion) financial assistance package.[3] The economic programme of the Government, which has been incorporated in both the 2009 budget and the convergence programme update, has contained further fiscal adjustments and tighter deficit targets.

**Box 1: Measures to help stabilise the financial system**

In addition to reducing the Government's financing need, measures addressing the problems of the financial sector were also introduced. The coverage of the deposit guarantee was increased from HUF 6 million to HUF 13 million. The authorities also adopted a banking sector support scheme, in line with agreed EU principles and in conformity with the guidance provided by the Commission on the application of EU state aid rules, which foresees the provision of interbank guarantees as well as a recapitalisation fund. The law provides a total funding of HUF 600 billion, which is to be equally divided between the two schemes; however, any remaining funds not utilised for capital enhancement will be added to the interbank guarantee scheme.

Furthermore, to overcome the heightened counterparty risk and raise liquidity in the domestic foreign-exchange swap market, a new stand-by facility for banks was offered by which the central bank can provide banks with overnight euro-forint swaps. This facility is backed up by an agreement on repurchase transactions with the ECB, by which the ECB provides the National Bank of Hungary with a facility to borrow up to EUR 5 billion. A similar Swiss franc swap facility was later introduced, supported by an agreement between the Hungarian and the Swiss national bank.

The financial sector regulation and supervision are also being strengthened. Banks' foreign currency exposure is being monitored more closely, while the supervisory authority conducts simple stress tests on daily basis on the influence of non-performing loans on the condition of the banking sector. Furthermore, the financial supervisory authority is foreseen to receive new regulatory powers to become equipped for more effective interventions in the banking sector.

[3] For details on the EU balance of payments financial assistance, see the following thematic webpage: http://ec.europa.eu/economy_finance/thematic_articles/article13488_en.htm

At the current juncture, Hungary has no fiscal space[4] to mitigate the recession by stimulating the economy. Consequently, in line with the recommendations of the European Economic Recovery Plan, the addendum presents budget-neutral measures, such as the new fiscal policy framework, a shift from passive to active labour market policies[5] and the acceleration of the absorption of EU structural funds as well as their reshuffling. Furthermore, it includes a support package to improve SME's access to financing to extend the existing preferential loan programmes of the Hungarian Development Bank as well as to provide various forms of additional financing (including microfinance and capital ventures), as well as measures to step up the operation of the state-owned Creditguarantee Co. to provide loan guarantees to the SME sector. These measures are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs. They are also in line with the conditionality attached to the EU balance of payments loan and expected to contribute to reducing the country's vulnerabilities in the longer run.

## 3. MACROECONOMIC SCENARIO

The programme's baseline macroeconomic scenario predicts a GDP contraction of 0.9% in 2009, against the 1.6% decline in GDP growth in the January 2009 interim forecast. For the outer years, the programme foresees a recovery of growth reaching 2.5% in 2011, roughly one percentage point above potential GDP growth (as recalculated by the Commission services based on the information in the programme and following the commonly agreed methodology). As the outlook for the world economy has been changing rapidly, this scenario is based on more favourable assumptions regarding world trade than those in the Commission services' January 2009 interim forecast. Also taking into account the most recent data on economic performance, the baseline macroeconomic scenario depicted in the updated convergence programme can be considered as markedly favourable.

On the domestic side, households are expected to be most afflicted by the recession and the financial crisis in the baseline scenario. Private consumption thus declines by almost 4% according to the programme, while investments and employment hold up relatively well. However, after the disruption in the Hungarian financial markets in autumn 2008, the corporations' ability to finance their activities could be limited. On this basis, the Commission services' forecast includes a stronger adjustment in both investment and on the labour market while, following three years of restrained growth, it foresees a less pronounced decline in consumption. The programme projects a benign 1.3% growth contribution from net export for 2009 with exports and imports continuing to grow (by around 4% and 2½% respectively). At the same time, the Commission services have forecasted a decline of around 3% in exports and 3¼% in imports for 2009 with external trade contributing only 0.3% to GDP growth in that year.

In light of information that became available since the January 2009 interim forecast, the macroeconomic outlook for the Hungarian economy has worsened considerably. Industrial

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[4] Due to Hungary's high exposure to the financial crisis which led to a freeze on the government bond market the financing need of the government had to be limited, thereby the possibility of a fiscal stimulus during the economic downturn had to be excluded.

[5] To this end, in December 2008, Parliament adopted the "Pathway to work" programme, which aims at creating incentives and improving employability of the low-skilled and long term unemployed, including a sharp increase in public employment, wide-ranging training programmes as well as strengthening the cooperation between disadvantaged groups and the Employment Service.

production fell by roughly 15% in December compared to the previous month and GDP fell by 1% compared to the previous quarter. Based on the revised corporate credit data, which now shows a significant decline in the fourth quarter of 2008, the reduction in investments is likely to be much larger in 2009 than what was assumed in the interim forecast. Moreover, as evidenced by the sharp depreciation of the Hungarian forint in January, financial markets continue to be fragile and hence lending to households is expected to remain subdued for a prolonged period. Consequently, the fall in consumption could be as large as envisaged by the programme. Overall, the recession in 2009 can be expected to be deeper than projected by either the programme or the interim forecast and GDP can be expected to contract by more than 3%.

Regarding inflation, the baseline scenario of the programme projects 4.5% for 2009 compared to the 2.8% in the Commission services' January 2009 interim forecast. Hence, the macroeconomic scenario of the programme appears to be favourable, especially regarding the foreseen evolution of nominal GDP. Indeed, since the 2009 budget was submitted – for which the baseline scenario was prepared – new economic data has made projections increasingly pessimistic and thus any macroeconomic forecast is subject to sizable negative risks.

Concerning the high external imbalances, the programme foresees a marked improvement in the external financing needs decreasing from 5.1% of GDP in 2008 to 1.6% of GDP by 2011, through a further reduction in the budget deficit and a continued improvement in the external trade balance.

In an alternative scenario based on more pessimistic assumptions regarding external trade, the convergence programme provides a projection for the main macroeconomic aggregates, but does not present a complete breakdown of the macroeconomic variables especially regarding the labour market nor a detailed calculation for the budgetary components. Both GDP growth and inflation in this scenario are broadly in line with the Commission services' January 2009 interim forecast.

After a period of above-potential GDP growth, the output gap in the convergence programme (as recalculated by the Commission services based on the information in the programme and following the commonly agreed methodology) deteriorates rapidly and becomes negative for the entire programme period. Taking also into account the deteriorating performance in the recent past, in particular the rapid speed at which the estimated positive output gap has been declining, Hungary is foreseen to experience bad economic times during the programme period.

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

| | 2008 | | 2009 | | 2010 | | 2011 |
|---|---|---|---|---|---|---|---|
| | COM | CP | COM | CP | COM | CP | CP |
| Real GDP (% change) | 0.9 | 1.3 | -1.6 | -0.9 | 1.0 | 1.6 | 2.5 |
| Private consumption (% change) | 0.7 | 1.1 | -2.6 | -3.8 | 0.9 | 1.1 | 1.4 |
| Gross fixed capital formation (% change) | -1.7 | -1.0 | -2.0 | -0.9 | 1.4 | 2.5 | 6.2 |
| Exports of goods and services (% change) | 5.9 | 6.1 | -2.9 | 3.9 | 2.6 | 5.8 | 8.5 |
| Imports of goods and services (% change) | 6.0 | 6.1 | -3.3 | 2.4 | 2.4 | 5.2 | 8.2 |
| *Contributions to real GDP growth:* | | | | | | | |
| - Final domestic demand | -0.1 | 0.1 | -1.8 | -2.2 | 0.8 | 1.0 | 2.1 |
| - Change in inventories | 1.0 | 1.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| - Net exports | 0.0 | 0.1 | 0.3 | 1.3 | 0.2 | 0.6 | 0.5 |
| Output gap[1] | 2.3 | 1.1 | -0.1 | -1.7 | 0.4 | -1.9 | -1.1 |
| Employment (% change) | -1.2 | -1.1 | -2.0 | -0.6 | -0.4 | 0.2 | 0.5 |
| Unemployment rate (%) | 7.7 | 7.7 | 8.8 | 8.0 | 9.1 | 7.7 | 7.2 |
| Labour productivity (% change) | 2.1 | 2.5 | 0.4 | -0.3 | 1.4 | 1.4 | 2.0 |
| HICP inflation (%) | 6.1 | 6.2 | 2.8 | 4.5 | 2.2 | 3.2 | 3.0 |
| GDP deflator (% change) | 5.3 | 5.2 | 3.1 | 3.1 | 2.8 | 3.3 | 2.9 |
| Comp. of employees (per head, % change) | 9.2 | 8.2 | 3.5 | 2.1 | 5.2 | 5.5 | 5.5 |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | -6.0 | -5.1 | -4.0 | -3.7 | -3.5 | -2.5 | -1.6 |

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

*Source*:

*Commission services' January 2009 Interim economic forecasts (COM); Convergence programme (CP)*

# 4. BUDGETARY STRATEGY

## 4.1. Budgetary implementation in 2008

The update contains a new general government deficit forecast for 2008 of 3.4% of GDP, which is lower than that contained in the previous update (4% of GDP). The Commission services' January 2009 interim forecast projects a somewhat better deficit outturn of 3.3% of GDP, which is supported by the most recent information on central budget cash-flow figures for December 2008. Based on the revenue developments during the last months of 2008, the financial crisis did not yet appear to have a considerable negative budgetary impact.

Concerning revenues, there was a strong positive base effect from 2007 (see also Table 1 in Annex 2). It was almost evenly distributed among direct taxes, indirect taxes and social security contributions. The moderate additional positive surprise compared to previous official plans in the evolution of budget receipts could be linked to a better-than-expected revenue-generating effect of the Government's measures to "whiten" the economy[6]. On the expenditure side, there was also a positive base effect from 2007, which was more than offset by more dynamic spending compared to previous plans (in absolute terms, the currently

[6] Hungary has started to implement a rather comprehensive multi-year programme to address tax evasion from the second half of 2006. The programme included the institutional and personnel strengthening of the tax authority and of related bodies to combat undeclared economic activity through improving the effectiveness of law enforcement. It also contained changes in the tax code and in reporting procedures to close some loopholes and promote compliance.

projected total expenditure broadly equals the budgeted figure). This additional elbow-room was, in particular, absorbed by increased railway-related costs (around 0.55% of GDP, partly linked to the recording of the privatisation receipts from the sale of the cargo unit[7]). Moreover, pension expenditures were also higher by close to 0.2% of GDP (because of the Swiss indexation rule[8]).

### 4.2. Near-term budgetary strategy

For 2009, the update targets a deficit of 2.6% (compared to the 3.2% of GDP contained in the previous update), which was tightened in the context of the government response to the financial crisis. The target is fully in line with the budget bill, which was adopted on 15 December by Parliament. The update foresees that this more ambitious deficit target against the background of a significantly deteriorated macroeconomic scenario (and in particular a revision of GDP growth from +3% to -1%) is achieved by additional deficit-reducing expenditure measures of around 1% of GDP compared to previous plans that are included in the budget law (see also Table II below). Given the context of the financial crisis and the absence of fiscal space, the Government did not adopt any fiscal stimulus measures[9].

On the revenue side, there are only minor changes in tax rates in the adopted budget compared to 2008 (see also Table II) since a multi-year tax-cut plan focusing on lowering the tax wedge on labour, which was included in the first version of the draft budget and expected to result in 0.55% revenue loss in 2009, was withdrawn in mid-October when the Government revised the budget and tightened the deficit target. In addition, there are a number of changes in the tax regulation, focusing on simplification (e.g. simplifying the system of different bases for social security contributions) and addressing tax evasion. Further whitening measures include, most notably, a significant increase in the maximum amount of tax penalties and stringent regulation for illegal business practices. On the expenditure side, further restraints for the operational costs of budgetary institutions and savings in the chapter-administered government programmes are contained in the budget. Moreover, there is a nominal cut in the public wage bill as well as some measures to slow down substantially the increase in social transfers in cash.

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[7] During the programme period, one-offs are considered only for 2008 (0.4% of GDP, deficit-increasing). Without detailed quantification the programme identifies as deficit-increasing one-offs for 2008 the following measures: severance payments stemming from the streamlining of the public administration and capital transfers to the various units of national railway company in the context of the indirect privatisation of the cargo unit. There is also deficit-reducing one-off measure, namely the extension of the GSM concession for 7.5 years.

[8] According to the Swiss (or mixed) indexation method, pension benefits are adjusted taking into account changes in both net wages and prices. In Hungary, the applicable weights of the two factors are 50%-50%.

[9] This strategy was fully in line with the Commission Communication of 26 November 2008 on the European Economic Recovery Plan (EERP), which stated: "*For those Member States, in particular outside the euro area, which are facing significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances.*"

**Table II. Main budgetary measures for 2009**

| Revenue measures[1] | Expenditure measures[2] |
|---|---|
| Measures in response to the downturn | |
| • Introducing a duty-free limit for succession at HUF 20 million (EUR 80 000) (-0.04% of GDP)<br>• Transformation of the taxation for company cars into a wealth tax (lower tax rate on a broadened tax base, revenue neutral) | • Capping the 13th monthly pension payment for pensioners at the level of the average pension and abolishing it for some groups of early pensioners (-0.2% of GDP)<br>• Partly compensated suspension of the 13th monthly salary in the public sector and a nominal freeze of public wages (net impact: -0.25% of GDP)<br>• Across-the-board cuts in the operational costs of budgetary institutions (-0.2% of GDP)<br>• Cuts in chapter-administered and other government programmes (e.g. transport development and environmental protection, -0.25% of GDP)<br>• Savings in social transfers due to the postponement of the forthcoming steps of the 5-year pension correction programme and the regular indexation of family allowances from 1 January to 1 September 2009 (-0.15% of GDP combined) |
| Other measures | |
| • Temporary 8% tax (surcharge) on the profits of energy companies (the so-called 'Robin Hood tax') for 2009 and 2010 (+0.1% of GDP) | • Modernisation and subsidy programme for district heating schemes (+0.1% of GDP, financed from the earmarked 'Robin Hood' tax) |

Note:

1 Estimated impact on general government revenue

2 Estimated impact on general government expenditure

Source: 2009 budget bill; "Annual report on the budget proposal" by the State Audit Office; Commission services estimates

Following last year's budgetary reserves of 1.3% of GDP, the Government set aside a lower level of total reserves of 0.7% of GDP for 2009[10]. The decrease in the level of reserves is chiefly due to the steep reduction in earmarked ones (reflecting the suspension of the 13$^{th}$ month bonus payment in the public sector[11]. Specifically, the composition of the total 2009

[10] In the Hungarian budgetary system, there are four different types of reserves. The *general* reserves can be used discretionally by the Government, traditionally to meet unforeseen expenditure stemming from e.g. natural catastrophes and new spending initiatives. The *earmarked* reserves are dedicated to pre-defined purposes (traditionally to cover the cost of extra payments in the public sector). Unlike the first two, the *central and chapter balance reserves* (both were introduced in 2007) could be considered as genuine budgetary buffers, as these amounts could in practice be used in case of unforeseen budgetary slippages.

[11] On 19 December, the Government agreed with the public sector trade unions on a supplementary wage package to compensate for the suspension of the 13$^{th}$ month bonus (also to prevent a general strike in the public sector). It entails a net cost of 0.25% of GDP and will be financed from the (1) earmarked reserve; (2) unused wage appropriations in various budgetary chapters; and (3) additional cuts in budgetary

reserves is the following: 0.25% of GDP earmarked reserves (planned to be almost fully used for the compensatory payments in the public sector), 0.15% of GDP general reserves, 0.3% of GDP *stability reserves* (formerly known as *central balance reserves,* see also Footnote 10). The chapter balance reserves (amounting to 0.3% of GDP since 2007) would most probably not be available for use in 2009 as they depend on the inflow of additional revenue stemming from the whitening process which may not be forthcoming[12]. The Government's genuine manoeuvring room to react to possible within-the-year budgetary deviation seems to be around 0.3% of GDP, and would encompass the stability reserves; i.e. they could effectively be frozen in response to unforeseen budgetary slippages.

According to the update, the composition of the planned adjustment of 0.8 percentage point of GDP for 2009 is chiefly revenue-based, as revenue growth would exceed the pace of nominal GDP leading to an increase of the revenue-to-GDP ratio of 0.6 pp.[13] The expenditure ratio is planned to decline by 0.2 pp. in 2009. Given that interest expenditures are projected to increase by half a percentage point of GDP in 2009, the improvement in the primary balance is planned to be correspondingly larger (1.3 pp.) than in the headline deficit (0.8 pp.). Based on the change in the structural balance as recalculated by Commission services using the commonly agreed method, the stance of fiscal policy is considerably restrictive in 2009. As to the sectoral evolution of the budgetary developments, the planned improvement in the headline deficit in 2009 is projected to practically take place through the reduction in the deficit of the central government.

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appropriations of the line ministries as adopted by a Government decree on 13 January (1001/2009). Thereby, the wage package will not lead to an increase in total expenditures compared to the budgeted figures, albeit it reduces somewhat the elbow-room of the authorities to respond to a possible budgetary slippage with additional corrective measures.

[12] According to the budget law, only if additional revenues stemming from the whitening process are realised (which is very unlikely in a depressed economic environment), the release of these reserves would correspondingly increase total expenditure i.e. these reserves are not able to operate as a budgetary buffer in this context.

[13] It should be noted that increasing EU transfers play an important role in the increase on the revenue side.

## Table III: Composition of the budgetary adjustment

| (% of GDP) | 2007 | 2008 | | 2009 | | 2010 | | 2011 | Change: 2008-2011 |
|---|---|---|---|---|---|---|---|---|---|
| | COM | COM | CP | COM | CP | COM[1] | CP | CP | CP |
| **Revenue** | **44.9** | **45.5** | **45.2** | **46.1** | **45.8** | **46.4** | **46.0** | **45.8** | **0.6** |
| *of which:* | | | | | | | | | |
| - Taxes on production and imports | 15.6 | 15.7 | 15.6 | 15.5 | 15.4 | 15.3 | 15.2 | 14.9 | -0.7 |
| - Current taxes on income, wealth, etc. | 10.2 | 10.6 | 10.5 | 10.7 | 10.7 | 11.0 | 10.9 | 11.0 | 0.5 |
| - Social contributions | 13.6 | 13.9 | 13.8 | 13.9 | 13.7 | 14.0 | 13.8 | 13.8 | 0.0 |
| - Other (residual) | 5.4 | 5.4 | 5.3 | 6.0 | 6.0 | 6.2 | 6.1 | 6.1 | 0.8 |
| **Expenditure** | **49.8** | **48.8** | **48.6** | **48.9** | **48.4** | **49.5** | **48.5** | **48.0** | **-0.6** |
| *of which:* | | | | | | | | | |
| - Primary expenditure | 45.8 | 44.7 | 44.6 | 44.4 | 43.9 | 45.0 | 44.0 | 43.5 | -1.1 |
| *of which:* | | | | | | | | | |
| Compensation of employees | 11.5 | 11.4 | 11.4 | 11.0 | 10.9 | 11.3 | 10.9 | 10.7 | -0.7 |
| Intermediate consumption | 6.7 | 6.5 | 6.6 | 6.6 | 6.6 | 6.6 | 6.4 | 6.2 | -0.4 |
| Social payments | 18.1 | 18.4 | 18.4 | 18.7 | 18.5 | 18.5 | 18.1 | 17.6 | -0.8 |
| Subsidies | 1.4 | 1.2 | 1.2 | 1.0 | 1.0 | 1.0 | 0.9 | 0.8 | -0.4 |
| Gross fixed capital formation | 3.6 | 2.9 | 2.8 | 3.1 | 3.0 | 3.5 | 3.4 | 3.6 | 0.8 |
| Other (residual) | 4.6 | 4.3 | 4.3 | 4.1 | 3.9 | 4.1 | 4.2 | 4.5 | 0.2 |
| - Interest expenditure | 4.1 | 4.0 | 4.0 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 0.5 |
| **General government balance (GGB)** | **-5.0** | **-3.3** | **-3.4** | **-2.8** | **-2.6** | **-3.0** | **-2.5** | **-2.2** | **1.2** |
| **Primary balance** | **-0.9** | **0.8** | **0.6** | **1.6** | **1.9** | **1.5** | **2.0** | **2.2** | **1.6** |
| One-off and other temporary measures | -0.9 | -0.3 | -0.4 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.4 |
| **GGB excl. one-offs** | **-4.1** | **-3.0** | **-3.0** | **-2.8** | **-2.6** | **-3.0** | **-2.5** | **-2.2** | **0.8** |
| Output gap[2] | 2.7 | 2.3 | 1.1 | -0.1 | -1.7 | 0.4 | -1.9 | -1.1 | -2.2 |
| Cyclically-adjusted balance[2] | -6.2 | -4.3 | -3.9 | -2.8 | -1.8 | -3.2 | -1.6 | -1.7 | 2.2 |
| **Structural balance[3]** | **-5.3** | **-4.0** | **-3.5** | **-2.8** | **-1.8** | **-3.2** | **-1.6** | **-1.7** | **1.8** |
| *Change in structural balance* | | *1.3* | *1.8* | *1.3* | *1.7* | *-0.4* | *0.2* | *-0.1* | |
| Structural primary balance[3] | -1.3 | 0.0 | 0.5 | 1.7 | 2.7 | 1.3 | 2.9 | 2.8 | 2.3 |
| *Change in structural primary balance* | | *1.3* | *1.7* | *1.7* | *2.2* | *-0.4* | *0.2* | *-0.1* | |

Notes*:*

[1]On a no-policy-change basis.

[2]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.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

*Source:*

*Convergence programme (CP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations*

The rapid deterioration of the growth outlook since the submission of the update (as described in Section 2) is officially estimated to trigger a revenue shortfall of around 1% of GDP in 2009 compared to the budgetary plans. On 16 February, the Government announced an expenditure-based corrective package of close to 0.7% of GDP to largely fill the budget gap. The main measures are the following: (i) further freezes in the operational expenditures and chapter-administered appropriations of budgetary chapters (0.2% of GDP); (ii) cuts in health-care expenditures (0.1% of GDP); (iii) start of the phasing out the national top-up in agricultural subsidies (0.1% of GDP); (iv) tightening of the eligibility criteria for disability benefits and housing subsidies (0.1%); and (v) savings from the gas price and district heating subsidies linked to the foreseen decline in the concerned market prices (0.1% of GDP). In addition, around 0.1% of GDP one-off extra revenue is expected from the emission trading. At the same time, the Government decided to revise slightly its deficit target to [a range of

2.7-2.9% of GDP] in view of alleviating the pro-cyclicality of the fiscal policy response. The new target is still below the 3% of GDP threshold and compares to an original target of 2.6% of GDP.

### 4.3. Medium-term budgetary strategy

The main budgetary strategy in the update is to bring the nominal deficit firmly below the 3% of GDP reference value (reducing it from 3.4% of GDP in 2008 to 2.6% of GDP in 2009, and to further reduce it in smaller steps to 2.2% of GDP in 2011). The country's medium-term objective for the budgetary position (structural deficit of 0.5% of GDP) is not expected to be achieved within the programme period and the target year is not specified.

The time profile of the consolidation is heavily front-loaded, with 2/3 of the projected nominal improvement over the entire programme horizon taking place in 2009 (¾ pp. out of 1¼ pps. of GDP). Since interest expenditures are anticipated to remain at the elevated level of 4.5% of GDP throughout the programme period, the primary balance would show a larger improvement, of 1½ pp, from a surplus of 0.6% of GDP in 2008 to a surplus of 2.2% of GDP in 2011. The structural deficit is projected to decrease from 3.5% of GDP in 2008 to 1.7% 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[14]). Hence, the fiscal policy effort as measured by the change in the structural balance is around 1¾ percentage points of GDP. Due to the projected evolution of interest expenditures described above, the improvement in the structural primary balance would even be around 2¼% percentage points of GDP. Based on the change in the structural balance as recalculated by Commission services, the stance of fiscal policy would be broadly neutral in the outer years of the programme (a small improvement foreseen for 2010 and a slight deterioration for 2011 against the strong possibility of bad economic times).

As to the sectoral evolution of the general government balance, the planned improvement of 1¼ percentage point of GDP over the programme horizon is foreseen 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 moderately increase to a surplus of 0.2% of GDP, and the deficit of the local government sector is foreseen to stabilise at around 0.5% of GDP throughout the programme horizon.

### 4.4. Risks to the budgetary targets

There are considerable risks to the official targets stemming from the macroeconomic scenario throughout the entire programme period. From 2009 onwards, lower-than-projected GDP growth, and in particular a lower employment (higher unemployment) and household consumption, could lead to revenue well below budget plans, as well as to a slightly higher expenditure ratio (due to an increased number of claimants for unemployment benefits and social allowances) and, consequently, to a higher deficit[15]. In addition, the increasingly bleak

[14] 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.

[15] For example, a 1 percentage point decrease in the growth rate could *ceteris paribus* imply a higher deficit of ¼-½% of GDP, depending on the concrete composition of the deterioration.

business climate and outlook could also exert a higher-than-projected downward pressure on gross wage dynamics in the private sector, which could endanger the achievement of the revenue targets through additional shortfalls in personal income taxes and social security contributions[16]. This latter risk is relevant for 2009 as well, given that most of the firm-level wage negotiations are scheduled to take place in the first quarter of the year. The distance between the Commission services' January 2009 deficit forecasts and the official targets for both 2009 and 2010 was chiefly explained by the different macroeconomic scenario. More specifically, the projected evolution of some important tax bases (compensation of employees, household consumption) was foreseen to be less favourable in the Commission forecast, especially in 2010. In mid-February 2009, the Government acknowledged that most of the short-term risks have materialised, and revised its official growth forecast to -3% along with the adoption of an additional corrective package of 0.7% of GDP and the revision of the deficit target to a range of 2.7-2.9% of GDP. For 2009, the genuine reserve buffer (around 0.3% of GDP as argued above) could be sufficient to correct possible additional moderate revenue shortfalls. Nevertheless, in view of the unusually large uncertainty surrounding the macroeconomic scenario also in the outer years (as described in Section 3), a full respect of the deficit target might necessitate the adoption of further corrective measures to achieve the deficit targets.[17]

Beyond the above-mentioned significant macro-economic risks, there are no further important risks to the revenue trajectory contained in the programme. The official projections from 2009 are based on an unchanged tax code[18] and generally do not count on additional revenue stemming from the Government's whitening campaign to fight undeclared economic activities (see also footnote 6). In both 2007 and 2008, there were positive surprises in the evolution of budgetary receipts, which were largely explained by this campaign. Albeit additional whitening measures have been incorporated in the 2009 budget, their impact could be fully offset by the increased risk of tax evasion/avoidance in the context of a gloomy economic environment[19].

As far as the expenditure side is concerned, there are a number of positive elements, but the risk of expenditure overruns cannot be ruled out, especially after 2009. On the positive side, budgetary control has considerably improved since 2006, partly linked to the operation of the expenditure control mechanism based on quarterly budgetary reports of line ministries effective from 2007. Furthermore, in some important areas, which were traditionally prone to overruns, the enacted reform steps and budgetary measures have structurally reversed the

[16] For illustration, one percentage lower gross wage bill in the total economy *ceteris paribus* could lead to a revenue shortfall in wage-related receipts of around 0.2% of GDP.

[17] In this context, the implementation of the recently announced reform steps in the pension, social benefit and household subsidy systems should contribute to expenditure moderation in the medium term.

[18] It should be noted that in mid-February 2009, the Government announced the launch of a broadly revenue-neutral tax reshuffle starting from 1 July 2009. The main principle of the tax reform is the decrease on the tax wedge on labour (in particular by a 5 pps cuts in employers' social security contributions) and on the corporate sector (by scrapping the 4% separate tax on corporate profits), which would be financed by increases in consumption taxes (VAT, excise duties) as well as the abolition of various tax allowances and tax exemptions in the tax code.

[19] See for example: World Bank (2008), "Reducing Undeclared Employment in Hungary", *Synthesis Report of the World Bank Study*, Washington

recurring pattern of budgetary slippages[20]. However, in both 2007 and 2008, the Government used part of its extra budgetary manoeuvring room created mainly by the higher-than-expected revenue mentioned above for some discretionary spending. Moreover, the planned expenditure moderation might not be backed by follow-up steps in the reforms of the public administration, health and education systems. This implementation risk is accentuated in view of the minority position of the governing coalition as there is an increased uncertainty around ensuring the Parliamentary majority for the necessary decisions to continue the adjustment programme. On the other hand, the above-mentioned expenditure side risks could considerably be mitigated if the recently announced steps to reform the pension and social support system as well as to increase efficiency in the local government sector will be spelled out and adopted. Finally, the official projections do not incorporate the impact on the deficit and on the debt of a possible takeover by the State of the debt of MÁV, the state-owned railway holding company (close to 1% of GDP), nor any additional capital injections to MÁV or its units. The risks linked to the financing need of the passenger unit of the company (classified inside the general government sector) remain substantial, also in view of the very slow progress with its functional reorganisation (e.g. the planned streamlining of the railway network has been repeatedly postponed).

Hungary's track record of fiscal policy was poor until mid-2006, as was exemplified by the repeated slippages compared to targets adopted by the Government and recommended by the Council under the excessive deficit procedure. However, after the re-appointment of the Government in 2006, there has been considerable improvement on this front linked to a long overdue turnaround in fiscal policy. This increased fiscal discipline was also exemplified by the over-performance of the adjustment path in both 2006-2007 as well as the tightening of the headline deficit targets for 2008 and 2009.

In spite of the positive trends of the recent years, the risk of an electoral cycle in public finances (ahead of the next Parliamentary elections in Spring 2010) cannot be fully excluded. Although a comprehensive reform of fiscal governance, including the introduction of numerical rules and the establishment of an independent fiscal body, was adopted by Parliament in November 2008, its effectiveness in reversing the clear pattern of electoral cycles needs to be tested (see Chapter 6 for the description of the adopted reform). In addition, given that the planned "golden rule" for local governments was eventually left out from the budgetary set-up, the subnational sector would still be in a position to exceed their expenditure targets set in the budget bill, potentially derailing the adjustment path[21].

Overall, the risks to the budgetary targets contained in the programme are subject to downside risks throughout the entire programme period, especially from 2010.

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[20] Such areas notably are the open-ended appropriations of the budgetary institutions and the price subsidies (for example, in 2006 both pharmaceutical subsidies and gas subsidies were much higher than budgeted, by 0.3% of GDP and 0.35% of GDP, respectively).

[21] The present debt rule for local governments (adopted in 1996) is not effective to stop the increasing indebtedness of the local government sector, see for detailed arguments: D. Homolya and G. Szigel (2008), 'Lending to local governments: Risks and behaviour of Hungarian banks', *MNB Bulletin*, September, pp. 20-29., National Bank of Hungary, Budapest

## 5. DEBT DEVELOPMENTS AND LONG-TERM SUSTAINABILITY

### 5.1. Debt developments

Following the stabilisation of the gross debt-to-GDP ratio at around 65½ - 65¾% in 2006 and 2007, the update projects the debt ratio to steeply increase to around 71% of GDP (see also Table IV below). This increase is explained by the fact that the first tranches of the EU financial assistance (EUR 2 bn) and the IMF stand-by arrangement (EUR 4.9 bn) were withdrawn by the State and deposited in National Bank of Hungary (MNB). The dominant parts of the first instalments (around 85%) were used only for reserve build-up in the central bank[22] in response to the fragilities in Hungary's financial sector and balance of payments. These amounts were recorded as a debt-increasing stock-flow adjustment (accumulation of financial assets). Without the drawings of the international loan package, the debt ratio would have declined somewhat.

In 2009, the debt ratio is projected to increase further to 72½% due to the snowball effect, which is driven by the combination of meagre nominal GDP growth and increased interest expenditure. Looking forward, it is foreseen to start declining somewhat in 2010, to then fall more rapidly at the end of the programme period (to 69% of GDP), supported also by the gradual pick-up in growth. It is assumed in the update that further tranches from EU and WB loan package in 2009 and 2010 will be entirely used for debt financing[23], hence these amounts would not add separately to the gross debt stock. The remaining tranches of the IMF credit line (around EUR 7.6 bn) are currently foreseen to be withdrawn by the MNB for pure reserve build-up, thus they would not increase the debt ratio.[24]

In 2011, more than half of the projected decline in the debt ratio would come from the redemption of that part of the international loan, which was used to build up reserves.

The update foresees considerably higher debt projections for the entire programme period relative to the previous update and a tighter adjustment path. This is mainly explained by the following factors: (i) the stock-flow adjustment is anticipated to be much more debt-increasing linked to the utilisation of the international financial assistance package; and (ii) the new programme projects a significantly lower nominal GDP trajectory for the entire period 2008-2011.

The Commission services' January 2009 interim forecast projects an even larger increase in the debt ratio to 71.9% of GDP for 2008, which is 0.8% of GDP higher than the official forecast. The difference is linked to the weaker HUF/EUR exchange rate assumption as well as the lower nominal GDP projection contained in the Commission forecast. The distance in the debt ratio projections increases further in both 2009 and 2010, mainly as a result of the lacklustre nominal GDP outlook and higher deficit projections in the Commission forecast compared to official plans. With the exception of 2008, the Commission services' projections

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[22] It should be noted that this deposit could later be used for deficit-financing and to roll over debt that matures.

[23] This scenario implies a significant change in the Hungarian debt management strategy as the long-established numerical benchmark for the share of foreign currency denominated debt in total debt (25-32%) will be well exceeded (possibly over 40%) in the coming period.

[24] According to the ESA95 rules, central banks are classified in the financial corporation sector (S.12) rather than in the general government sector (S.13). Therefore, the part of the credit line directly withdrawn by the MNB is not recorded in the government accounts.

result from the planned deficit and nominal growth developments, without any significant stock-flow adjustment (i.e. in line with the programme's projections, the forecast does not assume a further debt-increasing impact from the withdrawal of the international loan).

**Table IV: Debt dynamics**

| (% of GDP) | average 2002-06 | 2007 | 2008 | | 2009 | | 2010 | | 2011 |
|---|---|---|---|---|---|---|---|---|---|
| | | | COM | CP | COM | CP | COM | CP | CP |
| **Gross debt ratio**[1] | **58.8** | **65.8** | **71.9** | **71.1** | **73.8** | **72.5** | **74.0** | **72.2** | **69.0** |
| Change in the ratio | 2.4 | 0.3 | 6.1 | 5.3 | 1.8 | 1.4 | 0.3 | -0.3 | -3.2 |
| *Contributions* [2] *:* | | | | | | | | | |
| **1. Primary balance** | **3.4** | **0.9** | **-0.8** | **-0.6** | **-1.6** | **-1.9** | **-1.5** | **-2.0** | **-2.2** |
| **2. “Snow-ball” effect** | **-0.6** | **-0.1** | **0.2** | **0.0** | **3.4** | **3.0** | **1.8** | **1.1** | **0.7** |
| *Of which:* | | | | | | | | | |
| Interest expenditure | 4.1 | 4.1 | 4.0 | 4.0 | 4.5 | 4.5 | 4.5 | 4.5 | 4.4 |
| Growth effect | -2.2 | -0.7 | -0.5 | -0.8 | 1.1 | -0.3 | -0.7 | -1.1 | -1.7 |
| Inflation effect | -2.5 | -3.5 | -3.3 | -3.2 | -2.2 | -1.2 | -2.0 | -2.3 | -2.0 |
| **3. Stock-flow adjustment** | **-0.3** | **-0.5** | **6.7** | **6.0** | **0.1** | **0.3** | **0.0** | **0.7** | **-1.6** |
| *Of which:* | | | | | | | | | |
| Cash/accruals diff. | 0.6 | 0.4 | | n.a. | | n.a. | | n.a. | n.a. |
| Acc. financial assets | -0.9 | -1.1 | | n.a. | | n.a. | | n.a. | n.a. |
| *Privatisation* | -0.8 | -1.3 | | -0.1 | | -0.1 | | -0.1 | -0.1 |
| Val. effect & residual | 0.1 | -0.1 | | n.a. | | n.a. | | n.a. | n.a. |

Notes:

[1]End of period.

[2]The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). 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’ January 2009 Interim economic forecasts (COM); Commission services’ calculations*

According to the update, an annual one percentage point weaker primary balance, from 2009 onwards, compared to the baseline target would lead to a 3.1 percentage point increase in the debt-to-GDP ratio by the end of the programme period. Given that the reduction in the debt ratio in the outer years depends to a large extent on achieving healthy primary surpluses of around 2% of GDP, the debt path contained in the update is subject to the risks attached to the budgetary targets discussed above. In addition, given the relatively large and recently increasing share of foreign currency denominated debt (possibly over 40% of the debt stock) a weaker-than-expected HUF/EUR 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 2.5 percentage points at the end of the year. Furthermore, based on the information provided in the programme, the impact of one percentage point increase along the yield curve from the beginning of 2009 would result in an around 0.4 percentage point higher debt ratio by 2011.

Despite the fact that the programme foresees a reduction of the debt ratio by 3.5 percentage points of GDP in 2010 and 2011, there are considerable risks that the reduction will not materialise to this extent. In view of the risk assessment and the Commission services' debt forecast, it is assessed that the debt ratio is not sufficiently diminishing towards the reference value.

The Council recommendation under Article 104(7) on 10 October 2006 asked Hungary, inter alia, to '*ensure that the government gross debt ratio is brought onto a firm downward trajectory, in line with the multi-annual path for deficit reduction laid down in the convergence programme and preferably before 2009.*' The debt ratio was brought to considerably lower levels in 2006 and 2007 than previously planned. The sharp increase in 2008 is due to the drawings from the international loan with the aim of increasing reserves, while the further rise in the debt ratio in 2009 is explained by the snowball effect. These developments reversed the previous trend and a new stabilisation of the debt ratio is foreseen only from 2010 onwards.

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

This section presents sustainability indicators based on the long-term age-related government spending as projected by the Member States and the EPC in 2006 according to an agreed methodology.[25] Hungary has implemented a number of pension reform steps in 2006[26] and new projections of age-related gross expenditure have been endorsed by the EPC in November 2007. More recently, the Government announced ambitious further (parametric) reform measures, which will require Parliamentary approval in the coming months[27], and its positive impacts could not be taken into account in the present analysis.

Table 4 in Annex 2 shows that age-related spending is projected to rise by 6.9% percentage points of GDP between 2010 and 2050, which is above the EU average. Sustainability indicators for two scenarios are presented in Table 5 in Annex 2. Including the increase of age-related expenditure and assuming that the structural primary balance remained at its 2008 level, the sustainability gap (S2)[28] would amount to 5.7% of GDP; about 1.2 percentage point of GDP less than in last year's assessment, which is mainly due to an improvement in the estimated structural primary balance in the starting year. Yet, the starting budgetary position is not sufficient to stabilize 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. If the 2009 budgetary position of the Commission services' January 2009 forecast was

[25] Economic Policy Committee and the European Commission (2006), 'The impact of aging on public expenditure: projections for the EU-25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-50)', European Economy − Special Report No. 1/2006. European Commission (2006), The long-term sustainability of public finances in the European Union, European Economy No. 4/2006. European Commission (2008), Public finances in EMU – 2008, European Economy No. 4/2008.

[26] The measures adopted in 2006 included notably a stricter regulation for early retirement, a lower starting pension as of 2008, and a pension contribution levied on income received by old-age pensioners. In 2007, these steps were augmented by the annulment of the temporary (between 2009 and 2012) decrease in the age limit for early retirement of men and the reduction of pension benefits for early retirees (effective from 2013).

[27] Most notably, the following steps are planned to be adopted by the middle of 2009: (i) a shift of the current Swiss indexation mechanism to a system giving more weight to inflation indexation from 2010 (depending on the official growth projection: the higher the growth rate, the higher the weight of net wage growth); (ii) increase in the mandatory retirement age gradually from 2016 to 2025 (by 4 months in every year, from 62 to 65 year); (iii) incorporation of the capped 13th month pension into the regular pension payments and abolishment for new claimants from 2010; (iv) reducing the size of the last phase of the pension correction programme originally foreseen for 2010.

[28] The S2 indicator is defined as the change in the current level of the structural primary balance required to make sure that the discounted value of future structural primary balances (including the path of property income) covers the current level of debt.

taken as the starting point, the projected budgetary improvement would narrow the sustainability gap to about 4½% of GDP.

In contrast to the "2008 scenario", the "programme scenario", which is based on the projected end-of-programme structural primary balance, shows a smaller gap. If the budgetary consolidation planned in the programme was achieved, risks to long-term sustainability of public finances would be mitigated.

Based on the assumptions used for the calculation of the sustainability indicators, Figure 4 in the Annex 2 displays the projected debt/GDP ratio over the long-term.

For an overall assessment of the sustainability of public finances, other relevant factors are taken into account, as shown in Table 6 in the Annex 2. Notably, the programme presents the country's contribution to the current process of updating of the common EPC projections, including in particular revenue projections from pension taxation. However, until the updated projections are not finally validated by the EPC, they can only be considered as "national projections".

A number of pension reform steps have recently been implemented, which are expected to moderate somewhat the increase in future pension expenditure, but more needs to be done to this end. The budgetary position in 2008 as estimated in the programme improved from the estimated starting position of the previous programme, however, the budgetary impact of population ageing remains high. The current level of gross debt is still above the Treaty reference value. Ensuring higher primary surpluses over the medium term, as already foreseen in the programme, as well as further pension reform steps as recently announced would contribute to reducing the medium risks to the sustainability of public finances.

## 6. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

Until recently, the Hungarian budgetary framework was very vulnerable to fiscal slippages and recurrently became fully exposed to the electoral cycle, resulting in very high deficits before and in election years. This is corroborated in various empirical studies that found that Hungary had one of the weakest budgetary frameworks in the EU.[29] With a view to strengthen the budgetary framework, the Government presented a comprehensive proposal for the reform of fiscal governance in November 2007, including the introduction of medium-term fiscal rules and the establishment of an independent fiscal institution. As the new legislation has to be approved by qualified majority in Parliament, it was however not adopted due to a number of disagreements between the political parties and a deadlock in the discussion in Spring 2008. In mid-October, enhanced fiscal governance was raised again as an important issue and became part of the Government's reform programme in reaction to the financial crisis. The new strategy was to incorporate the most important elements of the alternative proposals of opposition parties (e.g. binding multiannual expenditure ceilings and the establishment of a

[29] On the shortcomings of the Hungarian budgetary system, see Section 2 of the following analysis: European Commission, Directorate-General for Economic and Financial Affairs (2008), 'Hungary: Macro Fiscal Assessment. An Analysis of the November 2007 update of the Convergence Programme', Brussels. Available at: http://ec.europa.eu/economy_finance/publications/publication_summary11856_en.htm

Fiscal Council) in the Government's plan. The law on fiscal responsibility was finally adopted by Parliament on 17 November 2008 by simple majority.[30]

The new system stipulates that as a general rule (fully effective as of 2012 budget) the determination of the future primary balances in a medium-term framework should be consistent with a real debt rule.[31] For the transition period, 2010- 2011, the draft law specifies that the ESA headline deficit must be reduced compared to the previous year. In addition, the annual expenditure ceilings may be increased in real terms not by more than half the expected real GDP growth rate for that year (i.e. maximum half the official growth projection of the macroeconomic scenario underlying the budget). Compliance with this rule would thereby lead to successive reduction in the expenditure-to-GDP ratio in both 2010 and 2011. As regards institutional matters, the new law also includes the establishment of a Fiscal Council, i.e. an independent body consisting of three members assisted by a Secretariat with economic and fiscal analysts (adequate staffing still needs to be ensured by the Government).[32] Overall, the new fiscal set-up is expected to contribute to improving transparency and sustainability of public finances; and thus contribute to realising the planned fiscal consolidation as outlined in the update.

As regards the quality of public finances, not only the relative preponderance of the public sector compared to regional peers (e.g. Czech Republic, Poland, Slovakia), but also the composition of both revenue and expenditure would seem to warrant comprehensive reform. On the revenue side, there is a considerable scope for a shift in tax revenues from labour towards other types of taxes (in particular, the increase in the weight of capital and wealth taxes could be advocated[33]) that would be broadly revenue-neutral. A reduction of the very high tax wedge on labour should also be conducive to promoting employment creation. Albeit the update did not contain concrete plans for a tax reform to this end, in mid-February the Government announced that it will launch a major tax reshuffle from 1 July 2009 along the principles discussed above (see also Footnote 16).

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[30] This approach – while proved to be more realistic politically – had an obvious cost: important parts of the planned interlinked system (e.g. the solid constitutional basis of the new fiscal body; the "golden rule"-type limit on local government borrowings) could not be at this stage enacted, which might reduce the effectiveness of the enforcement mechanisms.

[31] The real debt rule stipulates that the budgeting process should be carried out to suffice – based on conservative assumptions and technical projections – the principle that the real value of the central government's real debt stock (it currently covers over 95% of the public sector's total debt) must not increase from the year after the budget year (t+1) to the second year after the budget year (t+2), and at the same time it must not be larger than the real central government's debt of two years before the budget year (t-2).

[32] The new body will be entrusted to carry out independent macroeconomic and budgetary forecasts and to evaluate the Government's draft budget proposal as well as the adopted budget. It would also make plausibility checks as regards the fiscal impact assessments of all legislative proposals. In mid-January, the President of the Republic nominated György Kopits (member of the Monetary Council of the central bank) as the founding president of the newly established Fiscal Council. The proposals for the other two members are Gábor Oblath (member of the Monetary Council, nominated by the Governor of the central bank) and Ádám Török (professor of economics, previously chair of the Competitiveness Roundtable; nominated by the President of the State Audit Office). The members of the Fiscal Council were be appointed by full political consensus in the Parliament for a 9-year non-renewable period on 16 February.

[33] The introduction of a value-based mandatory property tax was contemplated for some time by the Government as it was even announced to be implemented as of 1 January 2008 in the 2006 September adjusted convergence programme update, but then the authorities abandoned the idea. For a succinct overview on the possible economic and budgetary implications of such a measure, see: G. Kiss – G. Vadas (2008), "Considerations on the introduction of residential property tax", *Public Finance Quarterly*, Vol. 53. No. 3. pp. 4465-474.

On the expenditure side, in terms of the public wage bill and social cash benefits, Hungary clearly overspends its regional peers and to some extent also the EU 15 average (see also Figure 3 in Annex 1). In this context, it should be noted that in mid-February, the Government announced additional reform steps to curb social transfers, achieved through adjustment of the parameters of the pension system and revamping as well as streamlining social support schemes. At the same time, as one of the main elements of the fiscal adjustment programme was to reduce capital expenditure (the reduction in public investment was over 1.5 percentage point of GDP over the last two years), growth-enhancing public investment lags behind the level in most other new member states. The update foresees some moderate improvements with regard to expenditure prioritisation, in so far as organisational and wage costs of the public sector as well as social transfers are planned to decline as a share of GDP, while public investment is plausibly projected to gradually increase from the low point reached in 2008.

## 7. ASSESSMENT

This section assesses the budgetary strategy, taking into account risks, in the light of (i) the adequacy of the fiscal stimulus package in response to the Commission Communication of 26 November 2008 on the European Economic Recovery Plan (EERP) as endorsed by the European Council conclusions on the European Economic Recovery Plan (EERP) on 16 December 2008 and the overall fiscal stance (ii) the criteria for short-term action laid down the above mentioned Commission Communication, and (iii) the objectives of the Stability and Growth Pact.

In the light of the need for reducing the public sector's financing need, the Hungarian authorities did not adopt any fiscal stimulus measures over the last months. This policy is fully in line with the EERP, which advocates the correction of the significant external and internal imbalances in case the starting position is not appropriate for an expansionary budgetary policy. The achievement of the deficit target of 3.4% of GDP in 2008 and a deficit below 3% of GDP in 2009 (even though slightly above the budgeted 2.6% of GDP reflecting the much worse economic prospects) would represent additional important steps towards restoring the credibility of economic policy.

The update is broadly consistent with the commitments made in the context of EU balance-of-payments assistance. The recently announced slight revision of the 2009 deficit target seems to be appropriate in view of the anticipated deep recession with GDP is expected to contract over -3% this year. It should be emphasized that a large part of the revenue shortfall implied by the downwardly revised growth forecast will be corrected by additional budgetary measures; therefore the fiscal effort policy as measured by the structural improvement will certainly be considerably higher than foreseen in the update.

After 2009, the planned deficit reduction envisaged in the programme is limited and not backed up with measures. On a positive note the recent additional corrective package adopted on 15 February, and more importantly the announced reforms in the pension and social support system as well as the planned streamlining of the local government subsector could help to achieve further sustained reduction in the expenditure radio. If implemented fully and with determination, these structural steps could decisively contribute to keeping the deficit below the 3% of GDP threshold throughout the coming years.

In the light of the risk assessment in Section 4.4, the budgetary stance in the programme seems broadly consistent with the recommended adjustment path for the correction[34], provided that all budgetary measures and the structural reform steps announced in the programme and at mid-February by the Government are fully implemented as well as possible within-the-year deviations are effectively corrected. As regards debt developments, the debt ratio is not sufficiently diminishing towards the reference value, despite the programmed large decrease at the end of the programme period.

[34] The relevant Council recommendation under Article 104(7) adopted on 10 October 2006 contained a general government deficit target of 3.2% of GDP for 2009.

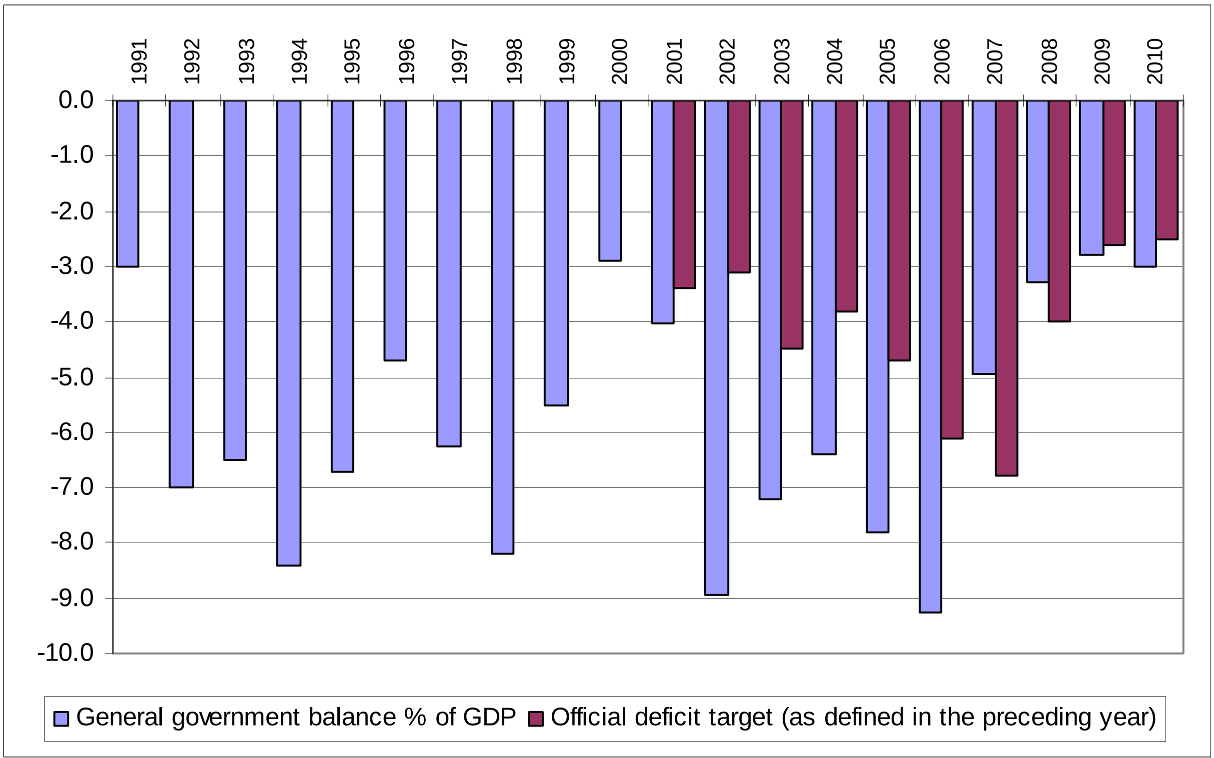
## ANNEX 1. SPECIAL TOPIC: THE ROLE OF STRUCTURAL REFORMS IN HUNGARY'S FISCAL ADJUSTMENT PROGRAMME

### 1. INTRODUCTION

Since the re-elected Government announced in mid-2006 a frontloaded fiscal consolidation programme, it has been clear that the durability of the adjustment would be dependent on the extent to which it would be underpinned by structural measures. The strong connection between the success of the fiscal adjustment and the corresponding structural reform steps is well-established both in the theoretical and empirical economic literature[35]. Hungary's experience between 2001 and mid-2006 provides evidence of the importance of this link and of the difficulty to achieve durable fiscal consolidation without structural reforms. Indeed, successive Pre-Accession Economic Programmes and Convergence Programme updates had announced structural reforms in the area of public administration, education, pension and health systems, which were not followed up by concrete measures. For example, the recurrent promises of curbing the administrative costs of the public sector through unspecified freezes usually resulted only in delayed spending and/or the accumulation of debt in the network of budgetary institutions rather than a sustained reduction in the level of expenditure. Consequently, Hungary repeatedly missed expenditure targets in that period, which coupled with revenue losses (due to unfunded tax cuts) led to upward revisions of fiscal targets and a continuous backload of the necessary fiscal adjustment (see figure 1).

[35] For a comprehensive overview, see for example: European Commission, Directorate-General for Economic and Financial Affairs, (2007), "Lessons from successful fiscal consolidations", In: *Public Finances in EMU – 2007*, European Economy No. 3, Brussels, pp. 193-238.

**Figure 1: Budgetary outcomes and targets since the regime change in Hungary**




Note: 1991-1995: cash flow figures, 1996-2010: ESA figures (in 1998 and 2002, some sizeable one-off operations were also incorporated into the deficit)

*Source: Successive Pre-Accession Economic Programmes and Convergence Programmes updates; Commission services' January 2009 interim economic forecast*

Aware of this relationship, the Hungarian authorities outlined a wide-ranging structural reform agenda in the adjusted September 2006 Convergence Programme update which constituted the beginning of significant fiscal consolidation efforts. This reform agenda was later complemented with microeconomic and labour market reform steps as included in the country's revised 2006 National Reform Programme. Over the recent years, the Hungarian authorities sent updated Convergence Programme updates as well as semi-annual EDP progress reports[36], informing, inter alia, on the recent progress with the structural reform agenda and also announcing some further measures and follow-up steps in a more gradual way. On the other hand, it should be mentioned that progress in some areas was slower than initially planned (e.g. parametric pension reform) or even backtracked in other areas (health care reform).

The next section will present some stylised facts about the characteristics of the Hungarian public expenditures in a European and regional comparison. The remainder of this special

[36] In the September 2006 adjusted Convergence Programme update, the Hungarian authorities committed to present semi-annual progress reports to the Commission and the Council on the implementation of their fiscal consolidation and reform programmes until the abrogation of the excessive deficit procedure. So far, four progress reports were submitted by the country (in April and September 2007, and in April and November 2008).

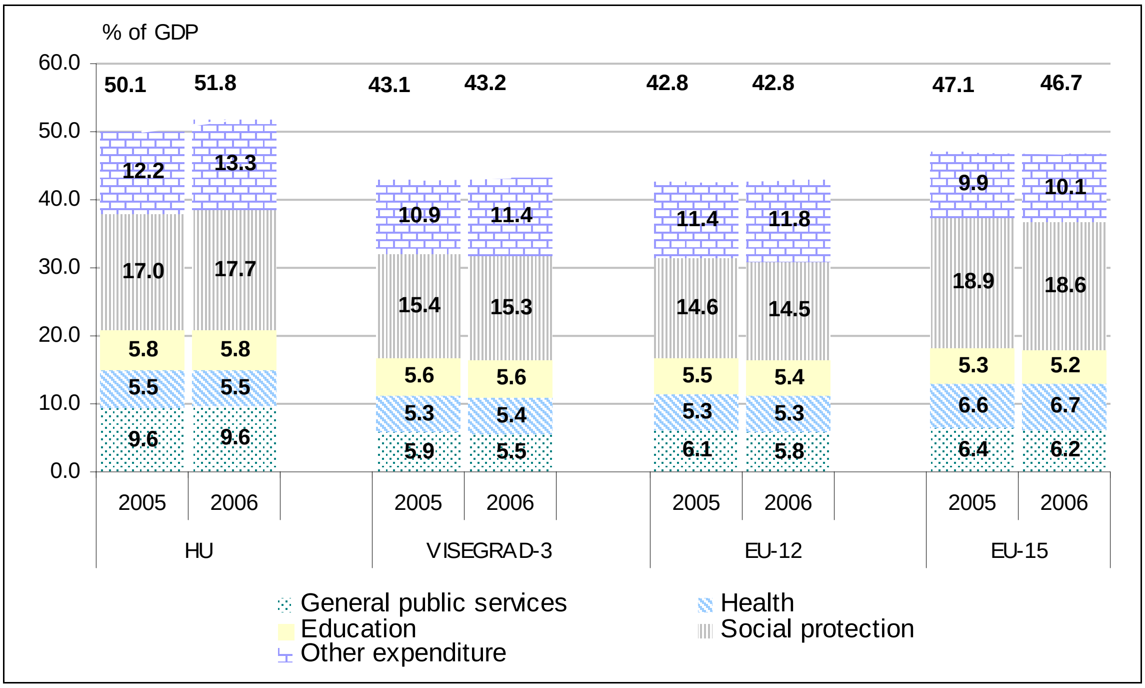
topic paper will provide a brief account of the achievements as well as the remaining challenges of the Government’s reform programme in the four main areas: public administration, public (primary and secondary) and higher education, health-care and pension. The last section will conclude. It should be clarified that given the lack of sufficient details, the Government's recently announced further structural reform plans are not assessed here, only briefly mentioned at relevant places.

## 2. THE STRUCTURE OF PUBLIC EXPENDITURE IN A EUROPEAN COMPARISON

If one compares both the overall size and the composition of the expenditure side of the Hungarian budget with corresponding European figures (e.g. Member States averages)[37] the need for underpinning the fiscal consolidation process by structural steps is evident. The relative preponderance of the public sector in Hungary is even more apparent if the neighbouring regional peers (in particular, the other three Visegrad countries) are used as benchmarks. As visible from the figures below, Hungary has clearly been overspending its regional peers and somewhat also the EU 15 averages. The latest available data for functional classification (2005-2006) suggests that the difference vis-à-vis the countries in the region or other new Member States chiefly stems from higher spending on public and economic affairs (driven by the sheer size of the state and the considerably higher debt service) on one hand, and more generous welfare spending on the other (albeit the differences are less remarkable compared to the averages of old Member States). It is also noteworthy that in the education and health sectors the distance is much smaller and this relative divergence is likely to have entirely diminished over the last two years as Hungary carried out some important expenditure restraints in these areas.

[37] For a detailed comparison, see A. Kármán (2008), "The structure of the Hungarian budget's expenditure side in international comparison", Review of Credit Institutions, Vol. 7. No. 6. pp. 665-677.

**Figure 2: Functional classification of expenditure in European perspective (% of GDP)**




*Source: Commission services*

Analogous conclusions can be drawn from a comparison based on economic classification. For instance, even after the implementation of a nominal freeze in public wages in 2007 followed by a stagnation in real wages in the public sector in 2008, the size of the public wage bill as a share of GDP is clearly higher in Hungary compared to the other Visegrad countries, and also (although much more moderately) vis-à-vis old member states. A quite similar picture could be drawn by comparing social benefits in cash (in the Hungarian case, pension expenditures account for close to 70% of this category).[38] In this context, it should be noted that the effectiveness of targeting social programmes is often very poor in Hungary (chiefly due to the widespread tax evasion which blurs the reliability of official data on income distribution). This environment complicates the long overdue extension of means-testing in the provision of social support. This is all the more problematic as the share of means-tested social allowances is well below the European average: without pension expenditures, it was less than 6% in 2004[39] compared to the old member state average of 14%.[40]

On the other hand, growth-enhancing public investment lags behind the level of most the other new member states as one of the main elements of the fiscal adjustment programme was a reduction in capital expenditure. This trend is expected to have become even more pronounced in 2008, when public investment is projected to have been somewhat below 3% of GDP in the December 2008 update.

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[38] It should be noted that the main expenditure measures in the 2009 budget (e.g. reduction in 13th month pension and cuts in public wage bill) are targeting exactly those categories, where Hungary is still significantly overspends its regional peers.

[39] It should be noted that the Hungarian figure must have increased somewhat recently as the provision of gas price subsidies was put on a means-tested basis in 2007.

[40] See: Benedek D., R. Firle and Á. Scharle (2006): "A jóléti újraelosztás mértéke és hatékonysága" (The size and effectiveness of welfare spending), *Research Papers*, No. 17., Ministry of Finance, Budapest

**Figure 3: Economic classification of expenditure in European perspective (% of GDP)**


*Source: Commission services; for 2008: Commission services' January 2009 interim economic forecast*

Given the lack of systematic information provided by the Hungarian authorities about the budgetary impacts of the adopted structural and budgetary measures, the estimated expenditure reduction of around 3 percentage points of GDP between 2006 and 2008 can not comprehensively be disaggregated into (i) short-term austerity measures (e.g. budgetary freezes), (ii) structural measures, and (iii) normalisation in political cycle related spending after an election year (e.g. correction in public investments, which was over one percentage point of GDP at the previous election episode in 2002). Nevertheless, the reform steps described below suggest that the role of the structural component has been meaningful in the fiscal adjustment, albeit its share could have been higher if all the initially planned reform measures would have been fully and effectively implemented.

## 3. Assessment of structural reforms since 2006 by main areas

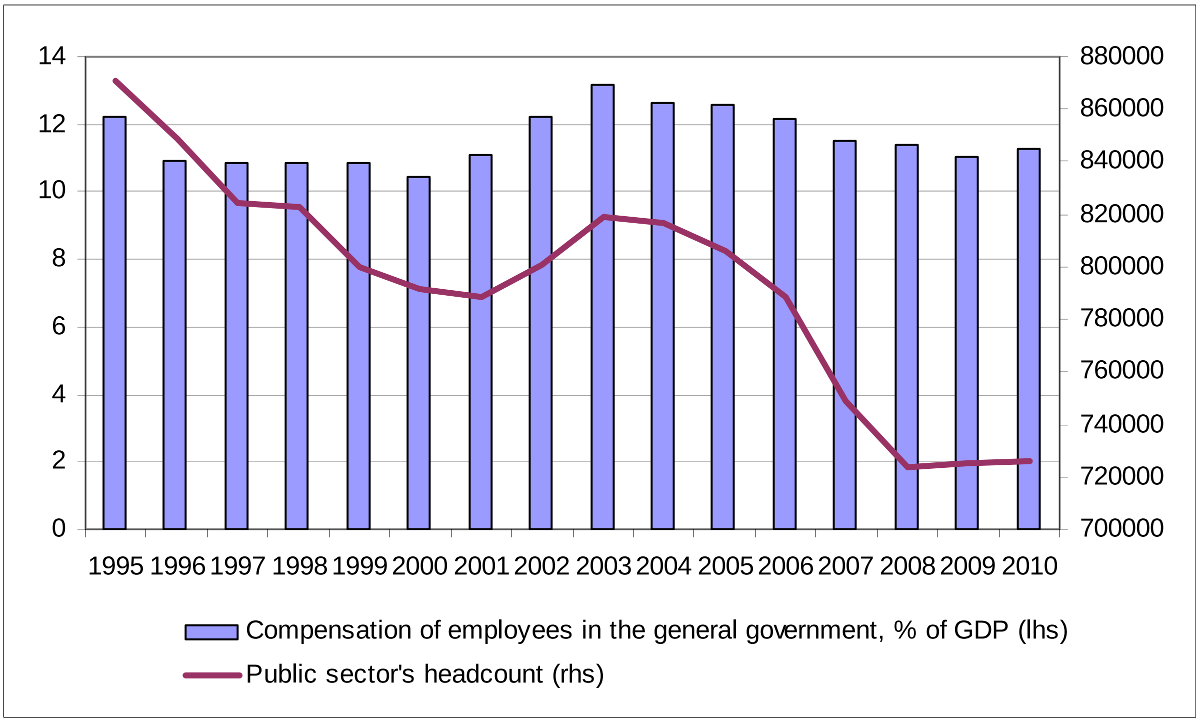
### 3.1. Public administration

The size of the Hungarian public sector has been relatively large in international comparison, especially until 2006. In 2005, Hungary had one of the highest ratios of public employees to private sector employees in the OECD (26%). Around 2/3rd of the public sector employees in Hungary work at sub-national level (for local and regional administrations), over which the central government has only indirect competences.

### 3.1.1. Central administration

Starting from mid-2006, a major restructuring and streamlining programme was implemented, which concerned both the central and the local government level (see also figure 4 for some results). At the central government level, the number of ministries was reduced from 14 to 11 immediately after the April 2006 elections. The significant streamlining of the institutional framework was achieved mainly through the consolidation and reorganisation of the decentralised bodies. This rationalisation process was progressively carried out from mid-2006 until mid-2008. As a result of the mergers, the number of budgetary institutions in the central administration was reduced from 430 to 184. This process was also reflected in the marked decline in public employment.[41] The most recent step was taken in the field of the management of state-owned assets through the merger of different agencies into the Hungarian National Asset Management Company as of January 2008. The progressive phasing-in of the performance assessment system in public administration started in 2007. In the first year, it only covered officials working for the line ministries, but as from 2008 it also covers public servants employed by the decentralized bodies.

**Figure 4: Headcount and wage bill in the public sector 1995-2010**




*Source: Commission services; for 2008-2010: Commission services' January 2009 interim economic forecast*

As regards the future avenues for reform, a detailed review of the state's functions was started in 2007, based on the "Catalogue of public tasks", which was a result of a comprehensive stocktaking exercise carried out by the State Reform Committee.[42] This strategic review process was initiated with the cooperation of the line ministries and the work is coordinated

[41] According to the official statistical data, the largest reduction from the overall decline in the public sector's headcount over the 2006-2007 period was recorded in the public administration (approx. 30 000).

[42] See at: http://www.allamreform.hu/letoltes_feladatkataszter.html (available only in Hungarian).

by the Prime Minister's Office. Based on preliminary indications, a significant narrowing of the functions should not to be expected from this exercise, but the actual operation and implementation mechanisms of the public bodies are foreseen to be reorganised. To this end, the Parliament adopted the Law on the Legal Status and Management of Budgetary Institutions in December 2008, aiming to further strengthen the effectiveness of financial management in the public sector as well as to move towards performance-based budgeting. The law is expected to provide increased management autonomy for budgetary units as institutions will be differentiated by the nature of their activities. For instance, agencies responsible for the provision of "marketable" public services (e.g. hospitals, universities) would have regulations closer to those of the private entities. This regulatory amendment is also interlinked with the efforts to move increasingly towards using output indicators and quality management in carrying out the public functions.

### *3.1.2. Subnational administration*

On the sub-national level, the genuine reform measures (e.g. the regionalization of the subnational system by restructuring the 19 counties into 7 regions and the prescription of mandatory associations for municipalities) would require a two-thirds majority. The opposition parties had rejected the related draft reform laws in summer 2006, chiefly on the account that it was deemed to endanger the autonomy of local entities and the new regional system would not be an organic development in view of the county-based administrative traditions. In a similar way, the various proposals aiming at a substantial reduction in the number of elected politicians and representatives at all levels from both the Government and the opposition parties are also at a serious deadlock.

Instead of the planned far-reaching reform, the Government started a gradual reorganisation of the local government structure via financial incentives laid down in the successive budgets (most notably, the threshold requirements for special investment grants was increased, in order to ensure a larger population coverage for certain development projects). These incentives encourage micro-regional and regional co-operation and the rationalisation of service provision within the currently highly fragmented system, especially in the areas of public education, social care and administration services. Both the 2007 and the 2008 budget contained somewhat increased financial incentives (by 0.03%-0.03% of GDP) to encourage cooperation and other measures aimed at increasing the financial discipline of local governments. Further plans foresee among others the introduction of central capacity regulation for some public services (education, social care, child protection) and the streamlining of the local government's financial controlling system. However, this indirect way of reform represents a very piecemeal approach with naturally limited efficiency and fiscal gains; therefore, further initiatives to gather the required consensus for a comprehensive restructuring of the local government system appear to be warranted.

### 3.2. Education

Based on both domestic and international performance measurement studies, the effectiveness of the Hungarian education system is considered to be fairly low[43]. One of the major problems is that approximately 1/3rd of Hungarian pupils completely lack or barely have the fundamental skills necessary for orienting themselves in everyday matters (close to functional illiteracy). According to PISA test results, the achievement of Hungarian pupils in mathematical literacy and in reading literacy was below the international average. Because of this weakness, the employability of the concerned working age groups is very poor, which is hindering the build-up of the country's human capacity. A further alarming finding of the PISA programme was that Hungarian education system is the worst performer among the participating countries in terms of creating equal opportunities by compensating the inequalities produced by the different social background of pupils. This means that the qualification of parents and other features of family background have the largest impact on a pupil's educational achievement. These weak results were produced by a comparatively high level of public spending: while in the first half of the decade Hungary spent more on education compared to its regional peers, the PISA results were broadly the same (see table 1).

**Table 1: Public expenditure (per pupil in % of GDP per capita) and performance in public education**

| | | 2000 PISA ranking | | | | | 2003 PISA ranking | | | | 2006 PISA ranking | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2000 | Upper rank | Lower rank | 2001 | 2002 | 2003 | Upper rank | Lower rank | 2004 | 2005 | Upper rank | Lower rank |
| Hungary | 21.8 | 18 | 23 | 22.0 | 22.7 | 26.2 | 17 | 21 | 23.6 | 23.9 | 14 | 19 |
| Visegrad-3 | 17.6 | 18 | 22 | 18.0 | 19.9 | 20.2 | 14 | 19 | 20.5 | 19.6 | 16 | 20 |

*Sources: PISA results – OECD; data on expenditure - UNESCO Institute for Statistics*

The Government's reform programme also contained a series of measures in the education area, which mainly focused on the rationalisation of the existing school network, also in view of the need to achieve some expenditure reduction. In primary and secondary education, the following main measures were adopted in 2006: (i) minimum regulation of 8 classes per primary school; (ii) by around 20% increase in the mandatory hours taught by teachers; and (iii) phasing in of incentives to streamline the school structure also through the revamping of the financing system. Throughout 2007 and 2008, the coverage of this performance-based financing method was progressively extended to include art schools, dormitories, boarding schools and after–school institutions. In order to increase cost efficiency, the new financing formula also favors the collaboration between local governments to run schools jointly. The cooperation is further encouraged by the adopted design of the related EU operational programmes as educational development projects target the association of municipalities.

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[43] See also: Hungarian Institute for Educational Research and Development (2007), "Education in Hungary 2006", Comprehensive report on public education, Budapest

In higher education, it was decided to introduce universal tuition fees as of 1 September 2008, but this measure was abolished as a result of the March 2008 referendum on co-payments. The number of state-financed students entering higher education decreased considerably from 62,000 in 2006 to 56,000 in 2007 and then stabilised at this level in 2008. The financing structure across disciplines was somewhat changed so as to adjust education better to labour market needs (increased financing for technical and science degrees while reducing it for law, agrarian and humanities degrees). In order to create a stable working environment for higher education and increase its responsiveness to changing labour market needs, three-year comprehensive operational agreements were concluded in December 2007 between the concerned institutions and the Government. The main novelty of the agreement is that the larger part of the state financing (around 70%) is foreseen to be based on the fulfillment of various output indicators. The Government plans to further reduce the fragmentation of the current system in line with the Bologna process.

## 3.3. Health-care

The general health condition of the population is poor. Life expectancy at birth was 73.5 years in 2006 which is the 6th worst figure in the EU, and the gender gap is also significant (69.2 for males vs. 77.8 years for females). Indicators on self-perceived health show substantial inequalities in the health status of groups with different income position. Moreover, extensive informal ("gratitude") payments affect especially the poorer groups of the society; thereby they have to pay proportionally much more for the "theoretically free" public health care. Consequently, the universal health-care system, which is based on mandatory health insurance scheme administered by the National Health Insurance Fund, has been considered to be increasingly inadequate both by experts and the public opinion. Despite the above mentioned widely acknowledged problems, the most disputed part of the Government's reform agenda was presumably the health-care programme.

### *3.3.1. Restructuring of the institutional framework and the insurance side*

In addition to the immediate expenditure reducing measures (chiefly through across-the-board cuts in funding through the reduction of the maximum quantity of service provision which is eligible for public financing) introduced in summer 2006, comprehensive bills on the reform of the healthcare system measures to reorganise the health-care system were adopted by Parliament in early December 2006. The use and provision of services were rationalised including through the introduction of co-payments for doctoral visits and hospital care (300 HUF ≈ 1.2 euro per visit/day) as of 15 February 2007. The provision of services has been put on a strict insurance basis as of 1 April 2007 with a transitory period until 1 January 2008. Thereby access to services are conditional on contributions paid, mitigating the problem of wide-spread free riding[44]. As regards institutional changes, a healthcare supervision agency was established to monitor the output of the sector and to promote patients' rights. The capacity of the system has been rationalised: resources have been relocated from inpatient care to outpatient care and rehabilitation. Eventually, only 6 out of the existing 173 hospitals were closed completely, which is less than initially expected.

[44] As a result of the enhanced surveillance mechanism, the number of contributors has increased by around 200 000 by mid-2008 compared to the end-2006 figure.

The structural anomalies of the system were also shown by the internal breakdown of health-care expenditure. In 2006, close to 1/3rd of all health-related public expenditure was spent on pharmaceutical subsidies. This ratio was considerably decreased over the last two years and it came below 1/4th in 2008. As inpatient care was before the reform characterised by one of the highest numbers of acute hospital beds in the EU, it led to excessive use of hospital care and a relatively high weight of hospital financing within the health envelope. The relocation of capacities starting from 2006 led to some moderate reshuffle between in-patient and outpatient care, a trend that is expected to be continued due to the modernisation of outpatient care centres in the coming years (also supported by EU regional development funds).

As regards the health insurance reform, after a long and heated social debate (also within the governing coalition) Parliament approved the bill on 18 February 2008 for the second time after the President had returned it to Parliament for further consideration at the end of 2007. The adopted reform included the establishment of 22 health insurance funds on a regional basis. Minority (49%) stakes in them were planned to be offered to private investors, while the state would retain majority control. Proceeds from the tenders were tentatively estimated at around 0.4% of GDP; this sum was prescribed to be reinvested in the healthcare sector. The new institutions were foreseen to become operational as of April 2009. Health insurance contributions were still decided by Parliament and collected centrally by the national tax authority.

However, the reform process was seriously challenged by the March 2008 referendum, which abolished doctor visit fees and daily hospitalization fees (roughly one year after the introduction of these co-payments). The political consequences were also significant as three weeks after the referendum the coalition government broke up, most probably also because of the disagreement over health issues between the ruling parties.. Moreover, in May 2008, based on the initiative of the new minority Government, Parliament annulled the previously approved health insurance reform.

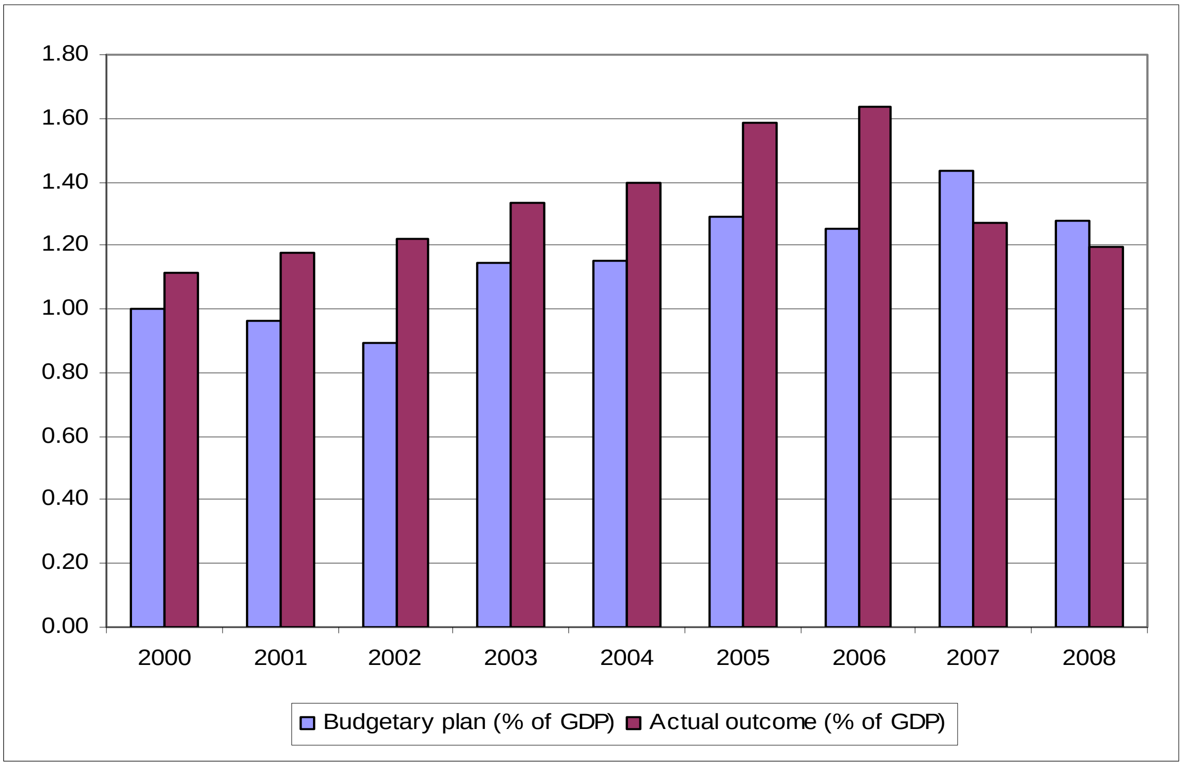
In early summer 2008, the Government put forward a new reform concept. The plan foresees the replacement of the role of co-payments in controlling demand by the review of patient route regulations and protocols with a view of strengthening the 'gate-keeper' function of general practitioners. As regard the insurance reform, the new concept foresees that the National Health Insurance Fund will remain intact (unlike the withdrawn plan), and this institution will establish regional branches with the primary aim to mitigate regional disparities. The newly established regional insurance branches (planned to be fully operational from the second half of 2009) would have more leeway to decide with which healthcare providers they would enter into or end a contractual relationship, and would also have more control and means for supervising the supply side of the sector. Finally, after the considerable streamlining of the hospital system, the focus has been progressively shifted to wards the follow-up steps, such as the improvement of outpatient care (e.g. the network of regional and micro-regional outpatient care centres is still to be completed). The relevant steps still need to be spelled out and implemented.

### *3.3.1. Revamping of the pharmaceutical subsidy system*

Another key element of the reform was the revamping of the pharmaceutical subsidy scheme adopted in December 2006. The new regulation aimed at curbing expenditures through the following measures: (i) eligibility criteria for subsidies will become more stringent; (ii) subsidy rates are decreased; (iii) fixed subsidy limits will be extended; (iv) prescription drugs which were formerly subsidised by 100%, will cost the customer at least HUF 300 (EUR 1.2); and (v) overruns of the pharmaceutical fund are to be co-financed by pharmaceutical companies[45]. As a result, the amount of pharmaceutical subsidies was decreased from a peak of 1.65% of GDP in 2006 to 1.2% of GDP in 2008 (see figure 5 below). In addition, the establishment of pharmacies and the trade in non-prescription drugs was progressively liberalised. As regards implementation, expenditure control has considerably improved due also to the reform as exemplified by the fact that instead of an overrun in this open-ended budgetary appropriation (which proved to be a regular source of slippages in the past), close to 0.1% of GDP savings were achieved in both 2007 and 2008 (see also figure below). In December 2008, some amendments in the concerned law took place (e.g. revised regulation for the contributions paid by pharmaceutical companies), also in view of solidifying the budgetary savings stemming from the reform of pharmaceutical subsidies.

[45] According to the adopted regulation, pharmaceutical companies and wholesale traders have to pay contributions proportional to the subsidies on their products. On top of this, pharmaceutical companies are obliged to co-finance overruns of the pharmaceutical funds contingent on their products' share in subsidies.

**Figure 5: Pharmaceutical subsidies: budgetary plans and outcomes 2000-2008**




*Note: All figures are on cash-flow basis. From 2003 onwards, both plans and outcomes include the contributions paid by pharmaceutical companies (0.03% of GDP in 2003, 0.04% of GDP in 2004, 0.1% of GDP in 2005, 0.09% of GDP in 2006, 0.12% of GDP in 2007, and 0.14% of GDP in 2008).*

*Source: Successive budget bills and laws on final accounts*

### 3.4. Pensions

Until 1998, Hungary operated a public and comprehensive pension system, which was financed on a Pay-As-You-Go basis. As the insurance principle i.e. the link between contributions and benefits was weak, the incentives were strong to evade proper contributions (see also table 2 below). This systemic shortcoming was further aggravated in the early 1990s by the declining employment levels as well as the increasing trend towards early retirement, which altogether started to undermine the financial balance of the pension system. In order to address these problems, in 1998, a new, three-pillar pension system was introduced in Hungary. The reform established a funded private pillar, which was foreseen to replace 1/4$^{th}$ of the existing unfunded public system starting from 2013. The participation in the private scheme has been obligatory for people entering the labour market after the start of the reform and optional for others (currently, around 2/3$^{rd}$ of the employed population are members of the private pillar). At the same time, the public pillar was also reformed, most notably by increasing the statutory retirement age significantly but smoothly and by replacing wage indexation by the so-called Swiss indexation system (see footnote 8 in section 4.2). The reform also encouraged the use of voluntary retirement savings plan by different form of tax credits (third pillar). As a result, currently 1/3$^{rd}$ of the employed population participates in the third pillar; however, the average amount set aside is approximately HUF 600 000 (~ € 2100), which appears to be insufficient to be a meaningful source of complementary pensions.

**Table 2: Main characteristics of the Hungarian pension system (1970-2006)**

| | *Pension expenditure (% of GDP)* | *Entitlement ratio (%)* | *Contribution ratio (%)* |
|---|---|---|---|
| 1970 | 3.5 | 66.7 | 91.2 |
| 1980 | 6.9 | 93 | 87.3 |
| 1990 | 8.8 | 109.9 | 86.4 |
| 1996 | 9.7 | 131.6 | 58.9 |
| 2001 | 9.3 | 146.1 | 60.5 |
| 2006 | 10.6 | 151.7 | 60.3 |

*Source: Simonovits (2008)*[46]

Some reform steps were taken in 2006 and 2007 (most notably, the downward adjustment of the initial pension levels by around 8% on average for new pensioners as of 1 January 2008, the overhaul of the disability pension system with focus on labour market reintegration, and stricter rules of early retirement e.g. a higher penalty for early retirement) with a positive, albeit moderate, impact on long-term pension expenditure in gross terms (see also Section 5.2. for an updated assessment of the sustainability of public finances). Moreover, legislation was already enacted establishing that new pensions awarded from 2013 onwards will be subject to income tax, instead of being tax exempt, which would bridge the sustainability gap to a considerable extent, although the details of the tax treatment of pensions have not yet been established.

A systemic renewal of the pension system as well as the long overdue review of the key parameters (indexation, retirement age) is on the agenda of the "Pension and Old Age Roundtable" (an expert group set up by the Government in early 2007). The main weaknesses of the current system are the very low effective retirement age (it was 58.6 years in 2007, but calculated together with disability pensions, it was an even lower at 56.7 years), and the relatively low statutory retirement age (62 years for both women and men). The latter should also be seen against the increasing life expectancy of the population (between 1993 and 2007, life expectancy has increased by 4 months in each year on average).The comprehensive reform blueprints (most likely in the form of several alternative proposals) are scheduled to be sent to the Government over the course of this year.[47] However, more recently, the Government announced further parametric reform steps in the public pillar as part of its revised economic programme (see also footnote 25 for a brief description of the main measures). With a view to reinforce the Government's plans, the main steps to further improve the sustainability of the system have been included in the economic policy conditionality of the EU medium-term financial assistance.

[46] Simonovits, A (2008), "The reform of the Hungarian pension system: 1996-2007", *Foreign Trade*, Vol. 52. No. 1-2. pp. 82-109.

[47] It is worth recalling that the September 2006 adjusted convergence programme update announced end-of-2006 as the deadline for the Government to submit concrete legislative proposals to Parliament to start a parametric pension reform.

## 4. Conclusions and prospects for the medium run

In light of both the internal composition of the Hungarian budget and the experiences drawn from durable fiscal adjustment programmes, there is a need to improve the quality of both public finances in general and the composition of further fiscal consolidation. The foreseen medium-term expenditure reduction should be increasingly based on structural measures. To this end, further reforms are needed in all subsystems, but meaningful fiscal gains can mainly be expected from a (parametric) pension reform and a decisive reform of the subnational level of public administration. It is welcomed that the recently announced structural reform measures broadly point to this direction.

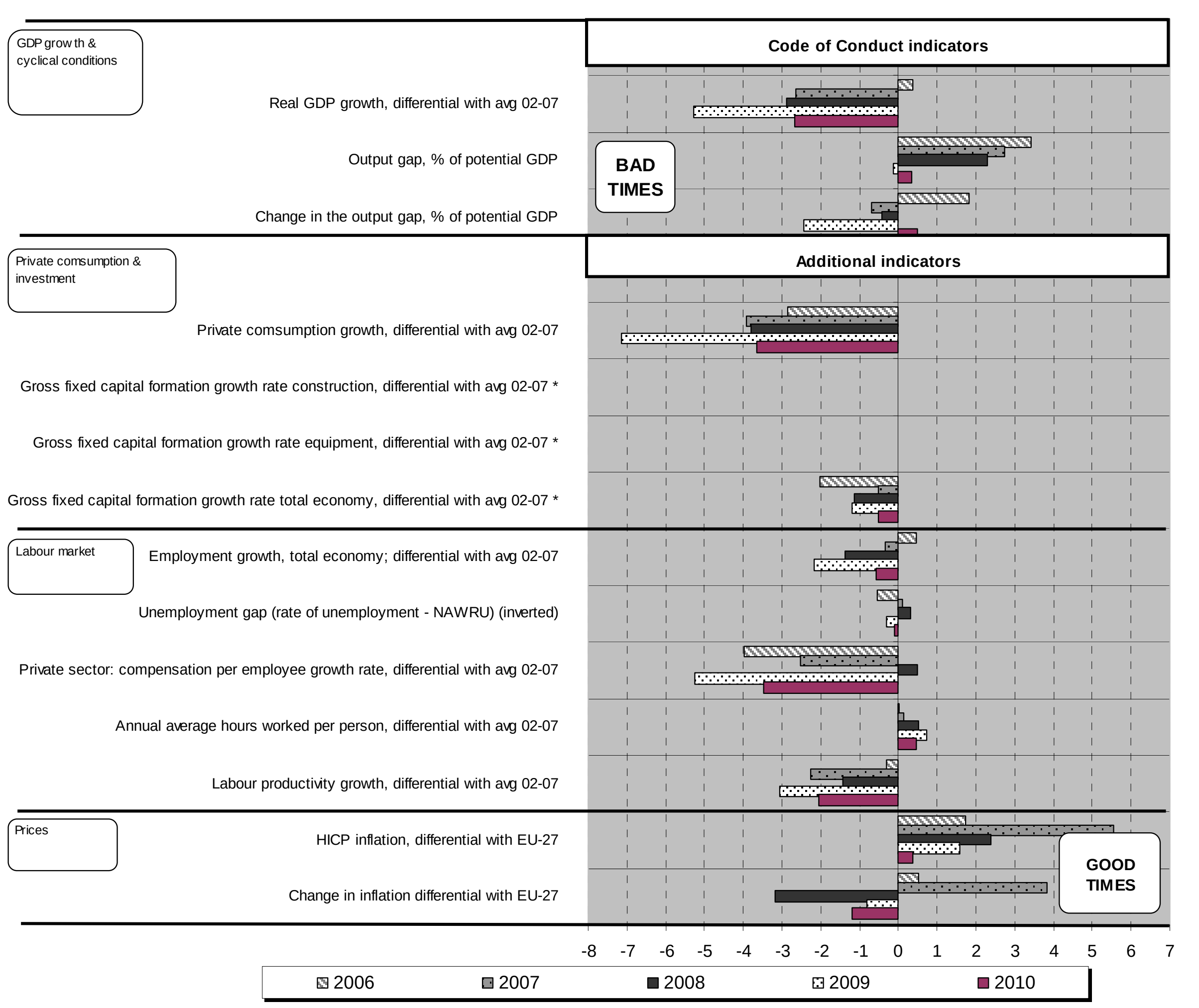
The continuation of structural reforms could open a possibility for the creation of a virtuous circle, also in view of addressing some of the deep-rooted problems in the Hungarian economy. Additional reductions in the expenditure ratio backed by structural steps could provide appropriate budgetary elbow room for a major tax reform, including a significant reduction in the tax wedge on labour. Such a tax reform would promote employment, and would possibly help to reduce the grey economy also through formalising undeclared activities.[48] The whitening of the economy should lay the foundation for a meaningful and socially equitable reform of social benefits by moving from the universal entitlements towards means-tested systems. The regained credibility of economic policy will also contribute to reducing the high debt service. Through this sequence of steps, the quality of public finances would also improve due to the tax reform focusing on cuts in labour-related taxes and the augmented room for manoeuvre to increase the weight of growth-enhancing expenditure within the expenditure side.

It is therefore a key issue that Hungary keeps the momentum on structural reforms even under the current difficult economic times. The determined implementation of further measures would improve the long-term sustainability of public finances and thereby create a solid basis for a return to a robust growth path (as experienced in the late 1990s). In view of the fact that the conditionality attached to the EU balance of payment loan includes a large number of structural measures, it can be concluded that the EU financial assistance is supportive of important progress in this area.

[48] The recently announced revenue-neutral tax reshuffle appears to be a good step in this direction (see also footnote 16 for the main planned measures).

## ANNEX 2. ADDITIONAL TABLES AND FIGURES

### Figure 1: Good and bad economic times




* These variables have been divided by their standard deviation over the period 2003-2010, with a view to reducing their variability relative to other variables in the graph.

Source: Commission services' January 2009 interim forecast

## Table 1: Budgetary implementation in 2008

| | 2007 | | 2008 | |
|---|---|---|---|---|
| | Planned<br>CP Nov 2007 | Outcome<br>COM | Planned<br>CP Nov 2007 | Outcome<br>COM |
| Government balance (% of GDP) | -6.2 | -5.0 | -4.0 | -3.3 |
| **Difference compared to target** | **1.2** | | **0.7** | |
| *Of which* : due to a different starting position end 2007 | | | 1.2 | |
| due to different revenue / expenditure growth in 2008 | | | -0.5 | |
| p.m. Denominator effect and residual [2,3] | | | 0.0 | |
| *p.m. Nominal GDP growth (planned and outcome)* | | | 6.8 | 6.2 |
| Revenue (% of GDP) | 44.1 | 44.9 | 44.2 | 45.5 |
| **Revenue surprise compared to target [1]** | **0.8** | | **1.3** | |
| *Of which* : due to a different starting position end 2007 | | | 0.8 | |
| due to different revenue growth in 2008 | | | 0.2 | |
| p.m. Denominator effect [2] | | | 0.2 | |
| p.m. Residual [3] | | | 0.0 | |
| *p.m. Revenue growth rate (planned and outcome)* | | | 7.0 | 7.6 |
| Expenditure (% of GDP) | 50.3 | 49.8 | 48.2 | 48.8 |
| **Expenditure surprise compared to target [1]** | **0.5** | | **-0.6** | |
| *Of which* : due to different starting position end 2007 | | | 0.4 | |
| due to different expenditure growth rate in 2008 | | | -0.7 | |
| p.m. Denominator effect [2] | | | -0.3 | |
| p.m. Residual [3] | | | -0.1 | |
| *p.m. Expenditure growth rate (planned and outcome)* | | | 2.3 | 3.9 |

Notes:

[1] A positive number implies that the outcome was better (in terms of government balance) than planned.

[2] The denominator effect captures the mechanical effect that, if GDP turns out higher than planned, the ratio of revenue or expenditure to GDP will fall because of a higher denominator. Although the denominator effect can be very significant for revenue and expenditure separately, on the balance they usually largely cancel against each other.

[3] The decomposition leaves a small residual that cannot be assigned to the previous components. The residual is generally small, except in some cases where planned and actual growth rates of revenue, expenditure and GDP differ significantly.

*Source : Commission services*

## Table 2: Evolution of budgetary targets in successive programmes

| | | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| General government balance (% of GDP) | **CP Dec 2008** | **-5.0** | **-3.4** | **-2.6** | **-2.5** | **-2.2** |
| | *CP Nov 2007* | *-6.2* | *-4.0* | *-3.2* | *-2.7* | *-2.2* |
| | COM Jan 2009 | -5.0 | -3.3 | -2.8 | -3.0 | n.a. |
| General government expenditure (% of GDP) | **CP Dec 2008** | **49.8** | **48.6** | **48.4** | **48.5** | **48.0** |
| | *CP Nov 2007* | *50.3* | *48.2* | *46.5* | *45.1* | *44.2* |
| | COM Jan 2009 | 49.8 | 48.8 | 48.9 | 49.5 | n.a. |
| General government revenue (% of GDP) | **CP Dec 2008** | **44.9** | **45.2** | **45.8** | **46.0** | **45.8** |
| | *CP Nov 2007* | *44.1* | *44.2* | *43.3* | *42.4* | *42.0* |
| | COM Jan 2009 | 44.9 | 45.5 | 46.1 | 46.4 | n.a. |
| Structural balance[1] (% of GDP) | **CP Dec 2008** | **-4.9** | **-3.5** | **-1.8** | **-1.6** | **-1.7** |
| | *CP Nov 2007* | *-4.9* | *-3.7* | *-2.9* | *-2.5* | *-2.1* |
| | COM Jan 2009 | -5.3 | -4.0 | -2.8 | -3.2 | n.a. |
| Real GDP (% change) | **CP Dec 2008** | **1.1** | **1.3** | **-0.9** | **1.6** | **2.5** |
| | *CP Nov 2007* | *1.7* | *2.8* | *4.0* | *4.1* | *4.2* |
| | COM Jan 2009 | 1.1 | 0.9 | -1.6 | 1.0 | n.a. |

Note:

[1]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 0.9% of GDP in 2007 and 0.4% in 2008; all deficit-increasing, according to the most recent programme and 0.9% of GDP in 2007 and 0.3% of GDP in 2008; all deficit-increasing, according to the Commission services' January 2009 interim forecast.

*Source* :
*Convergence programmes (CP); Commission services' January 2009 interim forecasts (COM)*

## Table 3: Assessment of tax projections

| | 2009 | | | 2010 | | | 2011 |
|---|---|---|---|---|---|---|---|
| | **CP** | **COM** | **OECD**[3] | **CP** | **COM**[1] | **OECD**[3] | **CP** |
| Change in tax-to-GDP ratio (total taxes) | -0.1 | 0.0 | 0.0 | 0.1 | 0.2 | 0.1 | -0.2 |
| Difference (CP – COM) | -0.1 | | / | -0.1 | | / | / |
| *of which*[2] *:* | | | | | | | |
| *- discretionary and elasticity component* | *0.1* | | / | *0.1* | | / | / |
| *- composition component* | *-0.2* | | / | *-0.1* | | / | / |
| Difference (COM - OECD) | / | -0.1 | | / | 0.1 | | / |
| *of which*[2] *:* | | | | | | | |
| *- discretionary and elasticity component* | / | *0.2* | | / | *-0.1* | | / |
| *- composition component* | / | *-0.1* | | / | *0.5* | | / |
| p.m.: Elasticity to GDP | 0.9 | 1.0 | 1.0 | 1.1 | 1.1 | 1.0 | 0.9 |

Notes:

[1]On a no-policy change basis.

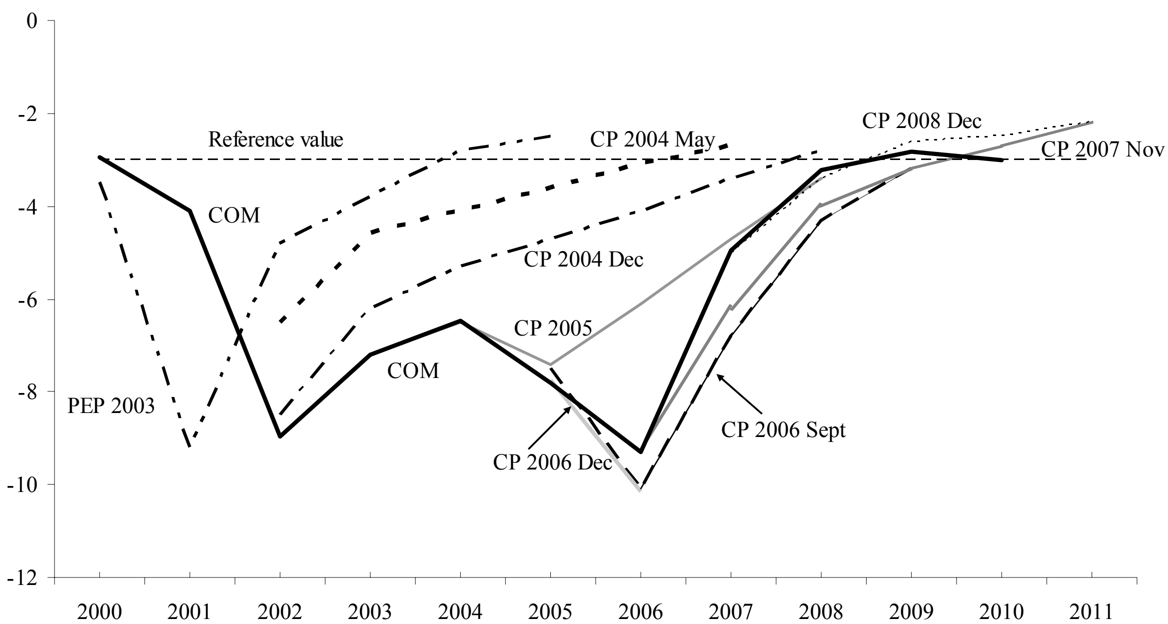
[2]The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system 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.

[3]OECD ex-ante elasticity relative to GDP.

Source :

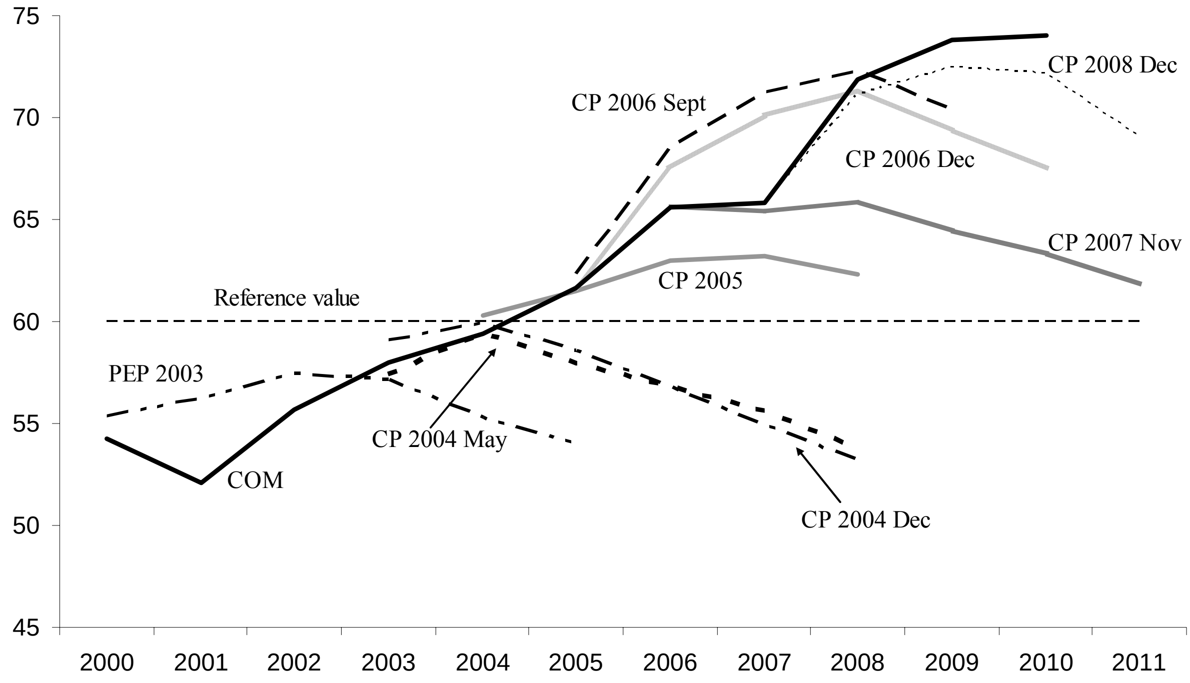
*Commission services' January 2009 Interim economic forecasts (COM); Convergence programme (CP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).*

## Figure 2: Government balance projections in successive programmes (% of GDP)




*Source: Commission services' January 2009 interim forecast (COM); successive convergence programmes (CP) and Pre-Accession Economic Programme (PEP).*

**Figure 3: Debt projections in successive programmes (% of GDP)**




*<u>Source</u>: Commission services' January 2009 interim forecast (COM), successive convergence programmes (CP) and Pre-Accession Economic Programme (PEP)*

## Table 4: Long-term age-related expenditure: main projections

| (% of GDP) | 2004 | 2010 | 2020 | 2030 | 2040 | 2050 | Change 2010- 50 |
|---|---|---|---|---|---|---|---|
| **Total age-related spending** | **21.3** | **21.7** | **22.7** | **24.0** | **27.1** | **28.6** | **6.9** |
| - Pensions | 10.4 | 11.1 | 12.1 | 13.1 | 15.6 | 16.8 | 5.7 |
| - Healthcare | 5.5 | 5.7 | 6.0 | 6.3 | 6.4 | 6.5 | 0.8 |
| - Long-term care | 0.6 | 0.8 | 0.8 | 0.9 | 1.1 | 1.2 | 0.4 |
| - Education | 4.5 | 3.9 | 3.5 | 3.5 | 3.7 | 3.8 | -0.1 |
| - Unemployment benefits | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.0 |
| **Property income received** | **0.9** | **0.7** | **0.6** | **0.5** | **0.5** | **0.5** | **-0.2** |

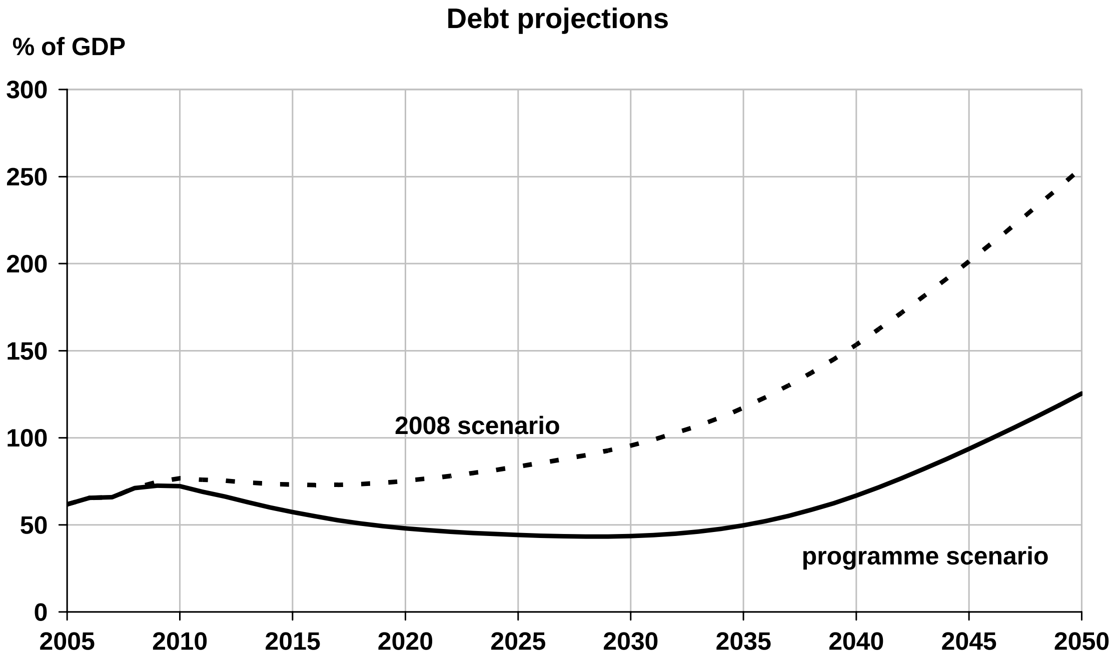
*<u>Source:</u> Economic Policy Committee and Commission services*

## Table 5: Sustainability indicators and the required primary balance

| | 2008 scenario | | | Programme scenario | | |
|---|---|---|---|---|---|---|
| | **S1** | **S2** | **RPB** | **S1** | **S2** | **RPB** |
| Value | 3.6 | 5.7 | 6.4 | 1.2 | 3.4 | 6.3 |
| *of which:* | | | | | | |
| Initial budgetary position (IBP) | 0.5 | 0.8 | - | -1.8 | -1.5 | - |
| Debt requirement in 2050 (DR) | 0.3 | - | - | 0.2 | - | - |
| Long-term change in the primary balance (LTC) | 2.8 | 4.9 | - | 2.8 | 4.9 | - |

*<u>Source:</u> Commission services*

**Figure 4: Long-term projections for the government debt ratio**




*Note:* 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.
*Source: Commission services*

## Table 6: Additional factors

| | Impact on risk |
|---|---|
| Debt and pension assets | - |
| Decline in structural balance until 2010 in COM January 2009 interim forecast | + |
| Significant revenues from pension taxation | + |
| Alternative projection of cost of ageing | + |
| Strong decline in benefit ratio | na |
| High tax burden | na |
| Non-age related budgetary measures with intertemporal effect | na |

Note: '-': factor tends to increase the risk to sustainability, '+': factor tends to decrease the risk to sustainability.
'na': not applicable.
Alternative projections are often presented in the programmes, whose assumptions often diverge from the common method. Projections currently discussed in the Economic Policy Committee but not yet published, are for the time being also considered "unofficial".
An explanation on these factors can be found in chapter IV of: European Commission (2006), The long-term sustainability of public finances in the European Union, European Economy No. 4/2006.
*Source: Commission services*

## ANNEX 3. COMPLIANCE WITH THE CODE OF CONDUCT AND TABLES FROM THE PROGRAMME

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 the model structure (Annex 1 of the code of conduct) and the formal data provisions (Annex 2 of the code of conduct are concerned.

The model structure for the programmes in Annex 1 of the code of conduct has been entirely followed. 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 2007 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) furthermore data on the exchange rate vis-à-vis the euro in the general assumptions table (Table 8) are equally missing.

The tables on the following pages show the data presented in the December 2008 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.

**Table 1a. Macroeconomic prospects**

| | ESA Code | 2007 Level | 2007 rate of change | 2008 rate of change | 2009 rate of change | 2010 rate of change | 2011 rate of change |
|---|---|---|---|---|---|---|---|
| **1. Real GDP** | B1*g | *24039,5* | 1,1 | 1,3 | -0,9 | 1,6 | 2,5 |
| **2. Nominal GDP** | B1*g | *25419,2* | 6,9 | 6,6 | 2,2 | 5,0 | 5,5 |
| **Components of real GDP** | | | | | | | |
| **3. Private consumption expenditure** | P.3 | *12468,6* | 0,7 | 1,1 | -3,8 | 1,1 | 1,4 |
| **4. Government consumption expenditure** | P.3 | *5373,2* | -7,2 | -0,9 | 0,2 | -0,1 | 0,3 |
| **5. Gross fixed capital formation** | P.51 | *5207,8* | 1,5 | -1,0 | -0,9 | 2,5 | 6,2 |
| **6. Changes in inventories and net acquisition of valuables (% of GDP)** | P.52 + P.53 | *663,5* | 2,8 | 3,7 | 3,7 | 3,6 | 3,5 |
| **7. Exports of goods and services** | P.6 | *21244,2* | 15,9 | 6,1 | 3,9 | 5,8 | 8,5 |
| **8. Imports of goods and services** | P.7 | *20917,7* | 13,1 | 6,1 | 2,4 | 5,2 | 8,2 |
| **Contributions to real GDP growth** | | | | | | | |
| **9. Final domestic demand** | | - | -1,1 | 0,1 | -2,2 | 1,0 | 2,1 |
| **10. Changes in inventories and net acquisition of valuables** | P.52 + P.53 | - | 0,1 | 1,1 | 0,0 | 0,0 | 0,0 |
| **11. External balance of goods and services** | B.11 | - | 2,1 | 0,1 | 1,3 | 0,6 | 0,5 |

**Table 1b. Price developments**

| | ESA Code | 2007 Level | 2007 rate of change | 2008 rate of change | 2009 rate of change | 2010 rate of change | 2011 rate of change |
|---|---|---|---|---|---|---|---|
| **1. GDP deflator** | | *n.a.* | 5,7 | 5,2 | 3,1 | 3,3 | 2,9 |
| **2. Private consumption deflator** | | *n.a.* | 6,4 | 6,2 | 4,5 | 3,2 | 3,0 |
| **3. HICP**[1] | | *n.a.* | 7,9 | 6,2 | 4,5 | 3,2 | 3,0 |
| 4. Public consumption deflator | | *n.a.* | 7,0 | 4,8 | -0,1 | 3,9 | 3,2 |
| 5. Investment deflator | | *n.a.* | 2,6 | 4,2 | 3,9 | 2,7 | 2,5 |
| **6. Export price deflator (goods and services)** | | *n.a.* | -4,0 | 2,4 | 4,8 | 1,5 | 1,5 |
| **7. Import price deflator (goods and services)** | | *n.a.* | -4,3 | 2,5 | 5,1 | 1,4 | 1,4 |

[1] Optional for stability programmes.

**Table 1a. Macroeconomic prospects**

| | ESA Code | 2007 Level | 2007 rate of change | 2008 rate of change | 2009 rate of change | 2010 rate of change | 2011 rate of change |
|---|---|---|---|---|---|---|---|
| **1. Real GDP** | B1*g | *24039,5* | 1,1 | 1,3 | -0,9 | 1,6 | 2,5 |
| **2. Nominal GDP** | B1*g | *25419,2* | 6,9 | 6,6 | 2,2 | 5,0 | 5,5 |
| **Components of real GDP** | | | | | | | |
| **3. Private consumption expenditure** | P.3 | *12468,6* | 0,7 | 1,1 | -3,8 | 1,1 | 1,4 |
| **4. Government consumption expenditure** | P.3 | *5373,2* | -7,2 | -0,9 | 0,2 | -0,1 | 0,3 |
| **5. Gross fixed capital formation** | P.51 | *5207,8* | 1,5 | -1,0 | -0,9 | 2,5 | 6,2 |
| **6. Changes in inventories and net acquisition of valuables (% of GDP)** | P.52 + P.53 | *663,5* | 2,8 | 3,7 | 3,7 | 3,6 | 3,5 |
| **7. Exports of goods and services** | P.6 | *21244,2* | 15,9 | 6,1 | 3,9 | 5,8 | 8,5 |
| **8. Imports of goods and services** | P.7 | *20917,7* | 13,1 | 6,1 | 2,4 | 5,2 | 8,2 |
| **Contributions to real GDP growth** | | | | | | | |
| **9. Final domestic demand** | | - | -1,1 | 0,1 | -2,2 | 1,0 | 2,1 |
| **10. Changes in inventories and net acquisition of valuables** | P.52 + P.53 | - | 0,1 | 1,1 | 0,0 | 0,0 | 0,0 |
| **11. External balance of goods and services** | B.11 | - | 2,1 | 0,1 | 1,3 | 0,6 | 0,5 |

**Table 1b. Price developments**

| | ESA Code | 2007 Level | 2007 rate of change | 2008 rate of change | 2009 rate of change | 2010 rate of change | 2011 rate of change |
|---|---|---|---|---|---|---|---|
| **1. GDP deflator** | | *n.a.* | 5,7 | 5,2 | 3,1 | 3,3 | 2,9 |
| **2. Private consumption deflator** | | *n.a.* | 6,4 | 6,2 | 4,5 | 3,2 | 3,0 |
| **3. HICP**[1] | | *n.a.* | 7,9 | 6,2 | 4,5 | 3,2 | 3,0 |
| 4. Public consumption deflator | | *n.a.* | 7,0 | 4,8 | -0,1 | 3,9 | 3,2 |
| 5. Investment deflator | | *n.a.* | 2,6 | 4,2 | 3,9 | 2,7 | 2,5 |
| **6. Export price deflator (goods and services)** | | *n.a.* | -4,0 | 2,4 | 4,8 | 1,5 | 1,5 |
| **7. Import price deflator (goods and services)** | | *n.a.* | -4,3 | 2,5 | 5,1 | 1,4 | 1,4 |

[1] Optional for stability programmes.

**Table 2. General government budgetary prospects**

| | ESA Code | 2007 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|
| | | Level | % of GDP | % of GDP | % of GDP | % of GDP | % of GDP |
| **Net lending (EDP B.9) by sub-sector** | | | | | | | |
| **1. General government**[1] | S.13 | *-1260,8* | -5,0 | -3,4 | -2,6 | -2,5 | -2,2 |
| **2. Central government**[2] | S.1311 | *-1306,7* | -5,1 | -3,1 | -2,2 | -2,0 | -1,9 |
| **3. State government** | S.1312 | *n.a.* | n.a. | n.a. | n.a. | n.a. | n.a. |
| **4. Local government** | S.1313 | *-0,4* | 0,0 | -0,3 | -0,5 | -0,6 | -0,4 |
| **5. Social security funds** | S.1314 | *46,4* | 0,2 | 0,0 | 0,1 | 0,1 | 0,2 |
| **General government (S13)** | | | | | | | |
| **6. Total revenue** | TR | *11410,5* | 44,9 | 45,2 | 45,8 | 46,0 | 45,8 |
| **7. Total expenditure**[3] | TE[1] | *12671,3* | 49,8 | 48,6 | 48,4 | 48,5 | 48,0 |
| **8. Net lending/borrowing** | EDP B.9 | *-1260,8* | -5,0 | -3,4 | -2,6 | -2,5 | -2,2 |
| **9. Interest expenditure** | EDP D.41 | *1033,3* | 4,1 | 4,0 | 4,5 | 4,5 | 4,5 |
| **10. Primary balance**[4] | | *-227,4* | -0,9 | 0,6 | 1,9 | 2,0 | 2,2 |
| **11. One-off and other temporary measures**[5] | | *n.a.* | -0,9 | -0,4 | 0,0 | 0,0 | 0,0 |
| **Selected components of revenue** | | | | | | | |
| **12. Total taxes** (12=12a+12b+12c) | | *6577,5* | 25,9 | 26,1 | 26,2 | 26,1 | 25,9 |
| **12a. Taxes on production and imports** | D.2 | *3975,6* | 15,6 | 15,6 | 15,4 | 15,2 | 14,9 |
| **12b. Current taxes on income, wealth, etc** | D.5 | *2584,8* | 10,2 | 10,5 | 10,7 | 10,9 | 11,0 |
| **12c. Capital taxes** | D.91 | *17,1* | 0,1 | 0,1 | 0,0 | 0,0 | 0,0 |
| **13. Social contributions** | D.61 | *3465,4* | 13,6 | 13,8 | 13,7 | 13,8 | 13,8 |
| **14. Property income** | D.4 | *230,7* | 0,9 | 1,0 | 0,9 | 0,7 | 0,6 |
| **15. Other**[6] | | *1137* | 4,5 | 4,3 | 5,0 | 5,4 | 5,4 |
| **16=6. Total revenue** | TR | *11410,5* | 44,9 | 45,2 | 45,8 | 46,0 | 45,8 |
| **p.m.: Tax burden** (D.2+D.5+D.61+D.91-D.995)[5] | | | 39,5 | 39,9 | 40,0 | 39,9 | 39,8 |
| **Selected components of expenditure** | | | | | | | |
| **17. Compensation of employees + intermediate consumption** | D.1+P.2 | *4608,6* | 18,1 | 17,9 | 17,5 | 17,2 | 16,9 |
| 17a. Compensation of employees | D.1 | *2917,9* | 11,5 | 11,4 | 10,9 | 10,9 | 10,7 |
| 17b. Intermediate consumption | P.2 | *1690,7* | 6,7 | 6,6 | 6,6 | 6,4 | 6,2 |
| **18. Social payments** (18=18a+18b) | | *4599,2* | 18,1 | 18,4 | 18,5 | 18,1 | 17,6 |
| 18a. Social transfers in kind supplied via market producers | D.6311, D.63121, D.63131 | *726,9* | 2,9 | 2,9 | 3,0 | 2,9 | 2,6 |
| 18b. Social transfers other than in kind | D.62 | *3872,4* | 15,2 | 15,5 | 15,5 | 15,3 | 15,0 |
| **19=9. Interest expenditure** | EDP D.41 | *1033,3* | 4,1 | 4,0 | 4,5 | 4,5 | 4,5 |
| **20. Subsidies** | D.3 | *358,7* | 1,4 | 1,2 | 1,0 | 0,9 | 0,8 |
| **21. Gross fixed capital formation** | P.51 | *903,4* | 3,6 | 2,8 | 3,0 | 3,4 | 3,6 |
| **22. Other**[8] | | *1168,1* | 4,6 | 4,3 | 3,9 | 4,2 | 4,5 |
| **23=7. Total expenditure** | TE[1] | *12671,3* | 49,8 | 48,6 | 48,4 | 48,5 | 48,0 |
| p.m.: Government consumption (nominal) | P.3 | *5369,7* | 21,1 | 20,8 | 20,5 | 20,1 | 19,6 |

1Corrected with the net effect of the swap transactions TR-TE=EDP B.9. Due to the rounding the sum data could differ from the sum of the detailed data.

2In 2007, without the assumption of debt of HUF 130.8 bn of the social security funds by the central government, which in the notification according to Eurostat rules worsened the balance of the central government and improved that of the social security

[3]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[4]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

[5]A plus sign means deficit-reducing one-off measures.

[6] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

[7]Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[8] 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 | 2006 | 2011 |
|---|---|---|---|
| 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[1] | n.a. | n.a. |

[1]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 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| **1. Gross debt[1]** | | 65.8 | 71.1 | 72.5 | 72.2 | 69.0 |
| **2. Change in gross debt ratio** | | 0.3 | 5.3 | 1.4 | -0.3 | -3.2 |
| **Contributions to changes in gross debt** | | | | | | |
| **3. Primary balance[2]** | | 0.9 | -0.6 | -1.9 | -2.0 | -2.2 |
| **4. Interest expenditure[3]** | EDP D.41 | 4.1 | 4.0 | 4.5 | 4.5 | 4.5 |
| **5. Stock-flow adjustment** | | -0.5 | 6.0 | 0.3 | 0.8 | -1.6 |
| *of which:* | | | | | | |
| - Differences between cash and accruals[4] | | n.a. | n.a. | n.a. | n.a. | n.a. |
| - Net accumulation of financial assets[5] | | n.a. | n.a. | n.a. | n.a. | n.a. |
| *of which:* | | | | | | |
| *- privatisation proceeds* | | -0.4 | -0.1 | -0.1 | -0.1 | -0.1 |
| *- international institutions stand-by credits not used for financing purpose* | | n.a. | 5.8 | n.a. | n.a. | -2.1 |
| - Valuation effects and other[6] | | n.a. | n.a. | n.a. | n.a. | n.a. |
| **p.m.: Implicit interest rate on debt[7]** | | 6.4 | 6.0 | 6.3 | 6.4 | 6.5 |
| **Other relevant variables** | | | | | | |
| 6. Liquid financial assets[8] | | 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. |

[1]As defined in Regulation 3605/93 (not an ESA concept).

[2]Cf. item 10 in Table 2.

[3]Cf. item 9 in Table 2.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[5]Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[6]Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[7]Proxied by interest expenditure divided by the debt level of the previous year.

[8]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 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| **1. Real GDP growth (%)** | | 1,1 | 1,3 | -0,9 | 1,6 | 2,5 |
| **2. Net lending of general government** | EDP B.9 | -5,0 | -3,4 | -2,6 | -2,5 | -2,2 |
| **3. Interest expenditure** | EDP D.41 | 4,1 | 4,0 | 4,5 | 4,5 | 4,5 |
| **4. One-off and other temporary measures[1]** | | -0,9 | -0,4 | 0,0 | 0,0 | 0,0 |
| 5. Potential GDP growth (%) | | 2,9 | 2,6 | 2,4 | 2,3 | 2,3 |
| contributions: | | | | | | |
| - labour | | 0,1 | 0,1 | 0,1 | 0,1 | 0,1 |
| - capital | | 1,4 | 1,3 | 1,2 | 1,2 | 1,2 |
| - total factor productivity | | 1,3 | 1,2 | 1,1 | 1,1 | 1,1 |
| 6. Output gap | | 1,4 | 0,1 | -3,1 | -3,8 | -3,6 |
| 7. Cyclical budgetary component | | 0,4 | 0,0 | -0,8 | -1,0 | -0,9 |
| 8. Cyclically-adjusted balance (2 - 7) | | -5,4 | -3,4 | -1,8 | -1,5 | -1,3 |
| 9. Cyclically-adjusted primary balance (8 + 3) | | -1,3 | 0,6 | 2,7 | 3,0 | 3,2 |
| 10. Structural balance (8 - 4) | | -4,5 | -3,0 | -1,8 | -1,5 | -1,3 |

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

**Table 6. Divergence from previous update**

| | ESA Code | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| **Real GDP growth (%)** | | | | | | |
| **Previous update** | | 1,7 | 2,8 | 4,0 | 4,1 | 4,2 |
| **Current update** | | 1,1 | 1,3 | -0,9 | 1,6 | 2,5 |
| **Difference** | | -0,6 | -1,5 | -4,9 | -2,5 | -1,7 |
| **General government net lending (% of GDP)** | EDP B.9 | | | | | |
| **Previous update** | | 6,2 | 4,0 | 3,2 | 2,7 | 2,2 |
| **Current update** | | 5,0 | 3,4 | 2,6 | 2,5 | 2,2 |
| **Difference** | | -1,2 | -0,6 | -0,6 | -0,2 | 0,0 |
| **General government gross debt (% of GDP)** | | | | | | |
| **Previous update** | | 65,4 | 65,8 | 64,4 | 63,3 | 61,8 |
| **Current update** | | 65,8 | 71,1 | 72,5 | 72,2 | 69,0 |
| **Difference** | | 0,4 | 5,3 | 8,1 | 8,9 | 7,2 |

**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[1] | 9,1 | 10,4 | 11,3 | 10,7 | 10,6 | 12,6 |
| Social security pension | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Old-age and early pensions[2] | 6,7 | 8,3 | 9,5 | 9,5 | 9,2 | 11,1 |
| Other pensions (disability, survivors) | 2,4 | 2,1 | 1,8 | 1,1 | 1,2 | 1,2 |
| Occupational pensions (if in general government) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Health care[3] | n.a. | 10,1 | 9,8 | 9,7 | 10,0 | 10,5 |
| Long-term care *(this was earlier included in the health care)* | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Education expenditure | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Other age-related expenditures | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| 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)[4] | 6,9 | 6,4 | 8,9 | 8,6 | 8,6 | 8,6 |
| Pension reserve fund assets | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| *Of which* : consolidated public pension fund assets (assets other than government liabilities) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| **Assumptions[5]** | | | | | | |
| Labour productivity growth | 4,2 | 4,0 | 2,5 | 2,6 | 2,7 | 1,7 |
| Real GDP growth | 5,2 | 4,1 | 3,3 | 2,4 | 2,1 | 0,8 |
| Participation rate males (aged 20-64)[6] | 67,5 | 67,9 | 69,5 | 72,1 | 70,7 | 69,3 |
| Participation rates females (aged 20-64)[7] | 52,6 | 55,1 | 57,5 | 61,2 | 61,1 | 60,5 |
| Total participation rates (aged 20-64)[8] | 59,9 | 61,4 | 63,4 | 66,6 | 65,9 | 64,9 |
| Unemployment rate | 6,4 | 7,2 | 7,7 | 6,2 | 6,2 | 6,2 |
| Population aged 65+ over total population | 15,0 | 15,6 | 16,6 | 19,8 | 22,0 | 29,4 |

[1] Including pension payments from other funds than Social Security Fund. Pension expenditure (old-age and other) data from the 2008 long term pension projection model of the Ministry of Finance. It includes the projection for the old age allowances as well.

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

[3] Data from the 2006 EPC (Economic Policy Committee) projection. Health care, education and other age-related expenditure.

[4] Contribution revenue data from the 2008 long term pension projection model of the Ministry of Finance.

[5] Table contains projection used by the 2008 long term pension projection model of the Ministry of Finance.

[6] In case of Hungary, the country reports 15-64

**Table 8. Basic assumptions**

| | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| **Short-term interest rate[1] (annual average)** | 7,6 | 9,0 | 9,7 | 8,7 | 7,9 |
| **Long-term interest rate (annual average)** | 6,8 | 8,8 | 9,9 | 8,9 | 7,8 |
| **USD/€ exchange rate (annual average) (euro area and ERM II countries)** | n.a. | n.a. | n.a. | n.a. | n.a. |
| **Nominal effective exchange rate** | 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)** | n.a. | n.a. | n.a. | n.a. | n.a. |
| **World excluding EU, GDP growth** | 5,6 | 4,3 | 2,9 | 3,8 | 4,3 |
| **EU GDP growth** | 2,9 | 1,4 | 0,2 | 1,1 | 1,8 |
| **Growth of relevant foreign markets** | 7,9 | 5,2 | 2,6 | 4,2 | 6,2 |
| **World import volumes, excluding EU** | 7,2 | 6,0 | 3,1 | 4,7 | 6,7 |
| **Oil prices (Brent, USD/barrel)** | 72,4 | 100,0 | 85,0 | 85,0 | 85,0 |

[1]If necessary, purely technical assumptions.

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