GOVERNMENT OF HUNGARY

CONVERGENCE PROGRAMME OF HUNGARY

2013 – 2016

April 2013

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1. Economic policy objectives

In the past decade the catching-up of the Hungarian economy came to a halt, thus Hungary failed to narrow the development gap to the more developed part of Europe. The possibilities arising from the accession to the European Union were not used efficiently and the state became seriously indebted. Between 2002 and 2010 the annual average budget deficit exceeded 6% of GDP. As a result, the rate of potential growth significantly decreased, the public debt-to-GDP ratio increased and vulnerabilities were built up in the Hungarian economy. By now – as the global financial crisis clearly pointed out – all parties of the economic and political sphere could be aware of the harmful consequences of a prolonged period of budgetary imbalances. Therefore, the Government, taking office at the end of May 2010, had to implement rapid changes in four major areas in order to stabilise the economic situation and attain a sustainable path of economic convergence:

(1) Stop and reverse the ever increasing path of the public debt

Due to the economic policy pursued since 2002, which was based on increasing indebtedness, the public debt-to-GDP ratio rose from 52.7% of GDP at the end of 2002 to 85.3% by the second quarter of 2010.

(2) Reduce the high external debt which was one of the major factors behind the financial vulnerability of Hungary

Beside the ever increasing debt of the government sector, the whole economy also became, to an increasing extent, dependent on external financing sources. The gross external debt-to-GDP ratio increased from 45% in 2002 to 111% by 2010 and the increasing indebtedness in foreign currency, which played the major role in intensifying the external vulnerability of the economy and the debt burden of households, called for immediate policy measures

(3) Attain a reversal in employment

Between 2002 and 2010 total employment in the economy decreased by 100 thousand people (in the age group of 15-64 years). Even in 2007, the last year prior to the global financial and economic crisis, the growth in employment amounted to merely 47 thousand people compared to the level registered in 2002. The employment rate was also on a declining trend, decreasing from 56.2% in 2002 to 55.4% by 2010. In European comparison the indicators of labour market participation did not show signs of improvement either: in 2002 Hungary had the second lowest, while in 2010 the third lowest participation rate among EU27.

(4) Reverse the trend of deteriorating competitiveness and that of the alarmingly decelerating growth rate of the potential output

According to present estimates, the potential growth rate of the Hungarian economy could have been 3-4% at the beginning of the past decade. A deceleration in this growth rate started already amidst the conditions of the irresponsible and unsustainable fiscal policy pursued between 2002 and 2006. This trend deceleration was amplified by the fiscal adjustment implemented from 2006 in an unfavourably composition. Reflecting also the impact of the global economic recession, hitting Hungary deeply in 2008-2009, the growth potential of the Hungarian economy became close to zero by the beginning of this decade.

The economic policy priorities of the Government since 2010 have been determined by the need to reverse past trends in the above areas. The results achieved by Hungary in this period indicate that the efforts aimed to create fiscal and financial stability, reduce public debt and adjust both the supply and the demand side of the labour market have already led to the expected positive changes.

Nonetheless, debt reduction cannot be sustainable without economic growth. Five important factors can contribute to drive GDP growth to positive territory again in 2013. First, the correction of the one-off components of the negative growth in 2012 is expected. Assuming average weather conditions, agriculture could contribute to GDP growth to a significant extent this year. Second, improving external demand is expected to result in accelerating export growth. Third, fiscal policy could also be supportive to growth, given that in 2012 extremely disciplined fiscal policy was pursued. Furthermore, Eximbank and Magyar Nemzeti Bank announced new programmes to increase lending activity. Eximbank intends to expand the lending volume by HUF 120 billion over the forthcoming twelve months to finance the export activities of the corporate sector, and Magyar Nemzeti Bank will provide HUF 250 billion loans at a low interest rate. Finally, the significantly increasing EU transfers will also have a positive impact on investment growth.

With budget deficit and public debt figures being favourable in the past three years, a number of positive factors have reflected the increasing confidence of foreign investors in the Hungarian economy. 10-year government bond yields have declined significantly since January 2012 when they reached 10 percent and now they stabilised at around 6 percent. (Undoubtedly, declining yields and interest rates will have a beneficial impact on economic activity already in the short term.) The 5-year CDS spread, the indicator of default risk, dropped from 700 basis points to around 300 basis points in the same period. Furthermore, at the beginning of 2013, a successful USD denominated bond issuance took place.

Fiscal imbalances had to be reduced in an external environment which, overall, was not supportive. The fiscal consolidation implemented amidst the conditions of the global financial crisis necessitated also some unconventional economic policy measures, since – as an important consideration – the Government strived for the dispersion of the burden of adjustment and for the inclusion of certain sectors in the burden-sharing to a larger extent than in the past. At the same time, there are already favourable signs, and, as one of the most important economic policy results, Hungary does not belong any more to the most vulnerable group of countries.

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

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

The 2013 convergence programme of Hungary takes fully into account the guidance by the March European Council on priorities for macroeconomic and fiscal policies in the context of the European Semester. Furthermore, in line with the Council recommendation adopted at the 13 March 2012 Ecofin meeting with a view to bringing an end to the situation of an excessive government deficit, the convergence programme presents the measures that ensure the fulfilment of the specific recommendations in a separate chapter.

Against this background, the Government submitted to the Council of the European Union and the European Commission the 2013 convergence programme as well as the 2013 National Reform Programme. The convergence programme sets forth in detail the medium-term macroeconomic, budgetary and debt outlook and includes in this context the supporting measures. The National Reform Programme presents in detail the measures taken and planned in order to attain the goals laid out in the framework of the Europe 2020 Strategy.

2. MACROECONOMIC DEVELOPMENTS AND OUTLOOK

2.1. EXTERNAL CONDITIONS

In the wake of the recurring financial crisis in 2011, the protracted European debt crisis gradually slowed down growth in Hungary's external markets. Fiscal adjustments significantly reduced demand in countries facing high debt levels; consequently, the entire European Union slumped into recession in 2012. Last year the dampened import demand from the Southern European countries directly involved in the debt crisis had an adverse impact on Germany, Hungary's largest trading partner. As a result of the subdued demand in Europe, Hungarian export growth decelerated during 2012 and turned negative in the last quarter.

In light of the weak international economic performance seen in 2012, one international institution after the other reduced its 2013 growth forecasts for the European Union as a whole as well as for its key economies, which are Hungary's key export markets. Consequently, growth in Hungary's export markets is expected to be even lower in 2013 than envisaged in the October EDP progress report. However, from the second half of 2013 on, the recovery of the global economy will support a gradual acceleration of growth in the European Union, bringing about an ever more dynamic expansion of demand in Hungary's export markets over the forecast horizon. The expected economic recovery of the EU has been reflected in the rise of leading indicators in recent months.

The perception of Hungary also changed favourably in the past year, in part because financial markets recognised the Government's disciplined management of the budget. Country risk premia and government bond yields decreased persistently. In addition, the central bank base rate, which has fallen to an all-time low (5%), may also support economic recovery.

2.2. COMPONENTS OF GROWTH

GDP decreased by 1.7% in 2012. The recession became more pronounced towards the end of the year: in Q4, GDP declined by 2.7% on a year-on-year basis. The economic downturn is attributable to more than one causes, some of them one-off factors. The European recession induced by the protracted debt crisis dampened external demand, which in turn slowed down Hungarian export growth to a mere 2% for the whole of the year. Subdued export growth and declining domestic demand in combination led to the stagnation of imports. Thus, on the whole, the contribution of net exports to GDP growth remained substantial in 2012. Each component of domestic demand made a negative contribution to GDP growth last year, the only exception being the actual final consumption of government, which increased due to the significant growth in the number of persons employed in public work schemes. The significantly lower-than-budgeted deficit played a role in the contraction of domestic demand. Because of the protracted deleveraging process and the temporary spike in inflation, household consumption growth remained negative. Despite the investment growth of 4.9% in the manufacturing industry and 0.9% in the general government sector, gross fixed capital formation fell short of the prior year level. In addition to the investments of the corporate sector that failed to materialize, the continuing contraction of the investments of households also played a major part in this development. In line with the weak external and domestic demand, changes in inventories also had a negative impact on GDP growth, effectively offsetting the growth contribution of net exports.

On the production side, every sector produced a decline with the only exceptions of info-communication and public administration and defence. Agriculture suffered the most severe setback due to the draught. In addition to the deteriorating external markets, one-off effects also contributed to the decline in industrial production (See Box 1). The whole sector of market services was constrained by the subdued domestic demand.

Box 1: One-off factors in the manufacturing industry

The output of the manufacturing industry, a driver of the Hungarian economy, remained below its previous year level in 2012. The decrease is attributable primarily to the major decline (around 18% during the year) of the manufacture of computer, electronic and optical products, the second largest subsector. This unfavourable performance is not linked to the competitiveness of Hungary. It is attributable to the shrinking global market shares of some companies in the electronic industry (e.g., Nokia and BlackBerry mobile phones). Consequently, several electronic manufacturing and assembly plants in Hungary implemented capacity reductions or suffered production cutbacks.

Nokia, which accounted for roughly one quarter of Hungary's production and export sales of computer, electronic and optical products in 2012, significantly cut back its production capacities in Hungary. The assembly of BlackBerry mobile phones was stopped in the assembly plants of Flextronics at the end of last year. Furthermore, Elcoteq producing also electronic products was liquidated in 2012, which also affected the subsector's performance negatively. The trends outlined above were supplemented by methodological changes to the decline of the electronic sector. Since April 2012 Philips has had its products manufactured under a contract processing arrangement. In case of processing, only the processing fee is included in statistics while intermediate consumption is not taken into account. Thus, even though the volume of television manufacture has remained practically unchanged, the volume of industrial output has declined due to the change in statistical methodology.

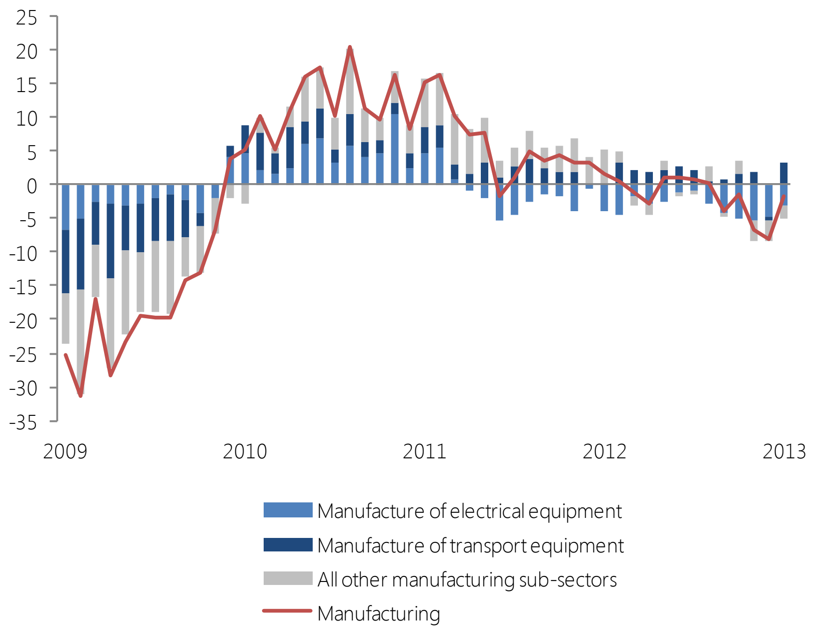
Electronics have been holding back the output of the manufacturing industry since April 2011 (see Chart 2.1.). Between 2010 and 2012 the contribution of the electronic subsector to manufacturing output fell from 22% to 15%, indicating a major output drop in the sector. Without the electronic subsector, manufacturing output showed a decline only in the last two months of the year, which is clearly linked to the deepening European recession. For the whole of last year, the surge in car production was unable to offset the dive of the electronics subsector. Due to the aforementioned output shortfall in the electronics subsector, which is mostly attributable to causes other than cyclical developments, the output level of the manufacturing industry decreased.

In contrast, from 2013 on no major lay-offs are expected in the electronics subsector accordingly the negative effect phases out. The manufacturing industry is expected to experience a gradual growth this year due to the fact that the new automotive capacities are expected to enter the production phase (expansion of the engine manufacturing facility of GM in Szentgotthárd, the increased production in the

Mercedes plant, and the return of the Suzuki plant to a two-shift regime and the expected start of the new Audi plant in 2013)

Chart 2.1: Contribution to the growth of manufacturing

(percentage point)

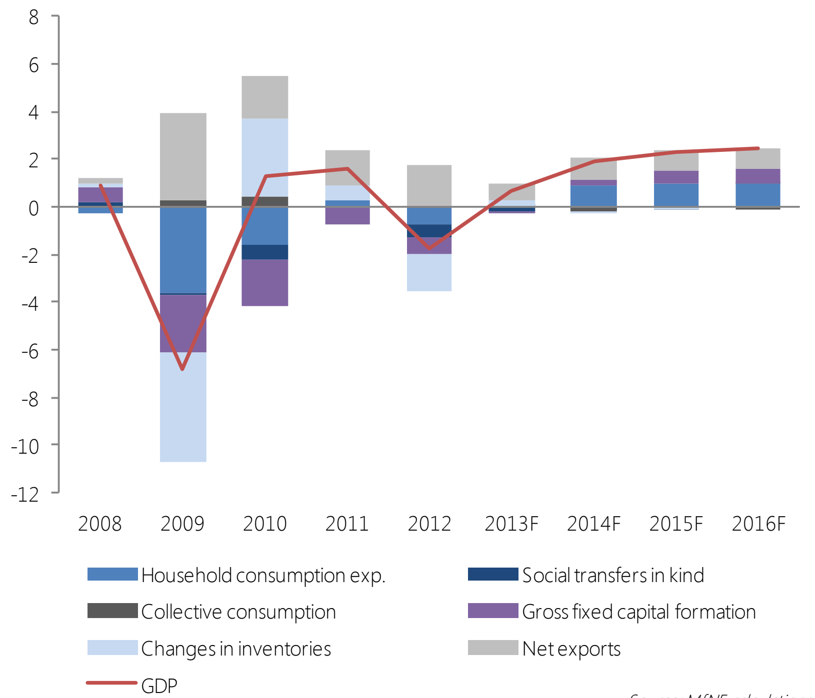


Source: CSO

In 2013 the Hungarian economy may resume its growth. The sources of growth may include the correction of the one-off effects that caused the decline in 2012. For instance, assuming average weather conditions, agriculture may contribute substantially to growth in 2013, as opposed to last year, when agricultural production was low due to the unfavourable weather. Second, the recovery of external demand accompanied by the overall stagnation of domestic demand may result in an increase in net exports. Third, in 2013 budgetary developments may also be conducive to growth due to the base effect of the deficit of 2012, amounting to a mere 2% of GDP, while the Government continues to be committed to meeting the deficit target of 2.7% of GDP. Fourth, the credit expansion programmes announced by Eximbank and the Magyar Nemzeti Bank (hereinafter referred to as 'MNB') will also have a positive effect on growth. Eximbank intends to provide new lending of approximately HUF 120 billion in the forthcoming 12 months to finance the export activities of businesses. The first pillar of MNB's Funding for Growth Scheme ensures HUF 250 billion of low-interest funding to companies. Eximbank's programme is geared towards exports while the MNB's scheme contributes to GDP growth by stimulating investment. Fifth, the EU funds, which will also increase significantly, may also stimulate investment activity. Due to the negative carry-over effect of the economic slowdown of 2012, in 2013 GDP growth is expected to be negative in the first quarter. However, by the end of the year the annualized growth rate will gradually rise to around 2%.

Chart 2.2: Contribution to GDP growth - Expenditure side

(percentage point)

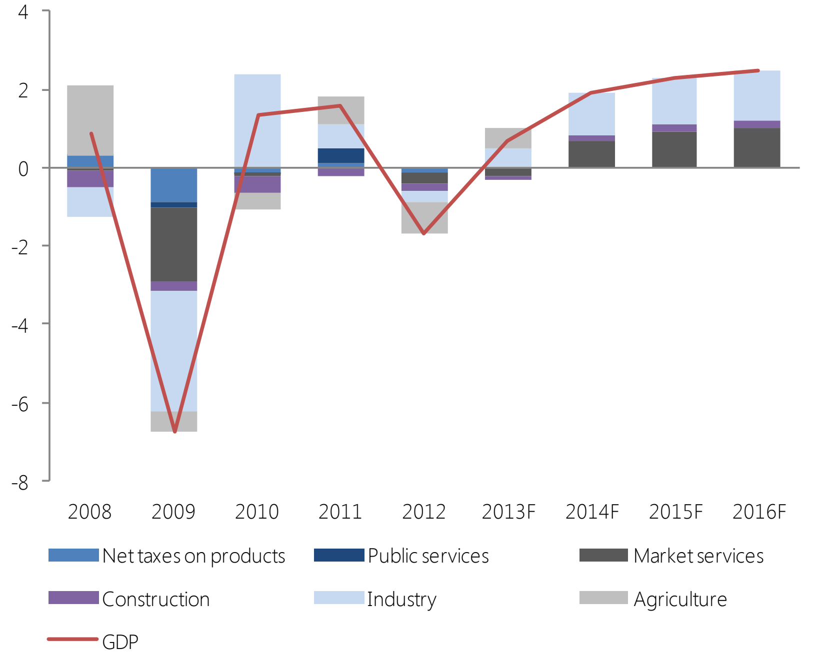


Source: MfNE calculations

From 2014 on, while growth pace is likely to accelerate, the structure of growth will also become more balanced: on the one hand, strengthening external demand will boost the volume of exports and on the other hand, domestic demand will increasingly contribute to GDP growth. The latter will be supported by the growing real household income, the slow-down of deleveraging and the easing precautionary considerations as the economic climate improves. Furthermore, the lower interest rate environment also simulates consumption. Investment growth will be promoted by the pro-borrowing effect of lower interest rates as well as the cleansing of corporate balance sheets.

Chart 2.3: Contribution to GDP growth - Production side

(percentage point)



Source: MfNE calculations

Table 2.1: GDP components (annual change, %)

	2012	2013	2014	2015	2016
GDP	*-1.7*	*0.7*	*1.9*	*2.3*	*2.5*
Household consumption expenditure	-1.4	0.1	1.8	1.8	1.8
Actual final consumption of government	0.5	0.3	-1.0	-0.2	0.0
Social transfers in kind	-4.5	-1.8	-0.5	0.0	0.3
Gross fixed capital formation	-3.8	-0.2	1.3	3.5	3.5
Exports	2.0	3.3	5.8	6.1	6.1
Imports	0.1	2.7	5.2	5.7	5.8

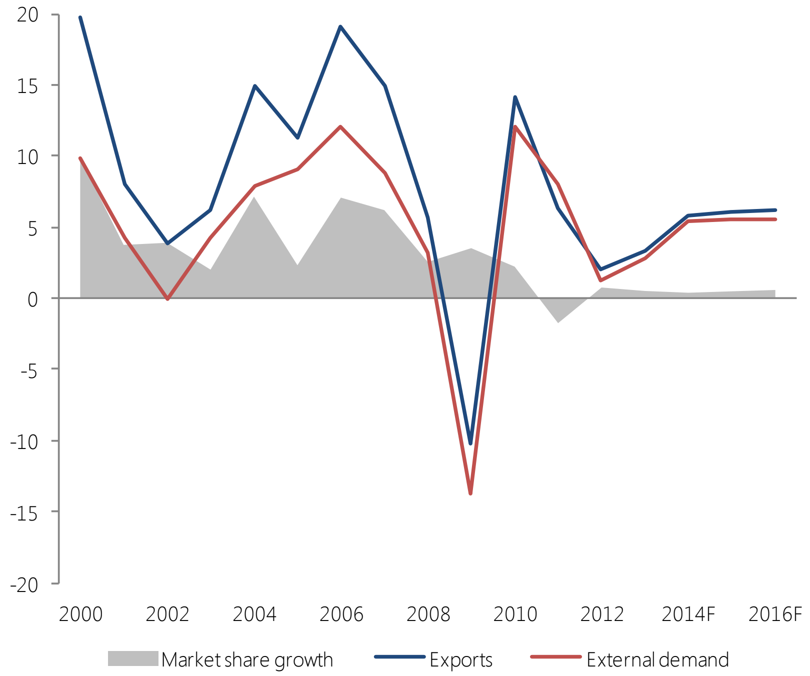
Source: MfNE calculations

FOREIGN TRADE

In 2012 the growth of Hungary's main foreign trade partners slowed down, affecting Hungarian foreign trade growth negatively. Even though export growth was low in 2012, Hungary's market share on the country's main export markets increased and the volume of exports significantly exceeded the pre-crisis level. Domestic demand has been subdued since the onset of the crisis, which contributed to import growth significantly lagging behind the growth of exports. As a result of these two factors, net exports have improved gradually over the years. The trade balance has shown a massive surplus, improving the financing capacity of the country.

In 2013 exports will continue expanding in line with the moderate growth of external demand. From 2014 on, parallel with the strengthening external demand, export growth is expected to accelerate over the forecast horizon.

Chart 2.4: Export volume and export market growth
(per cent)



Source: MfNE calculations

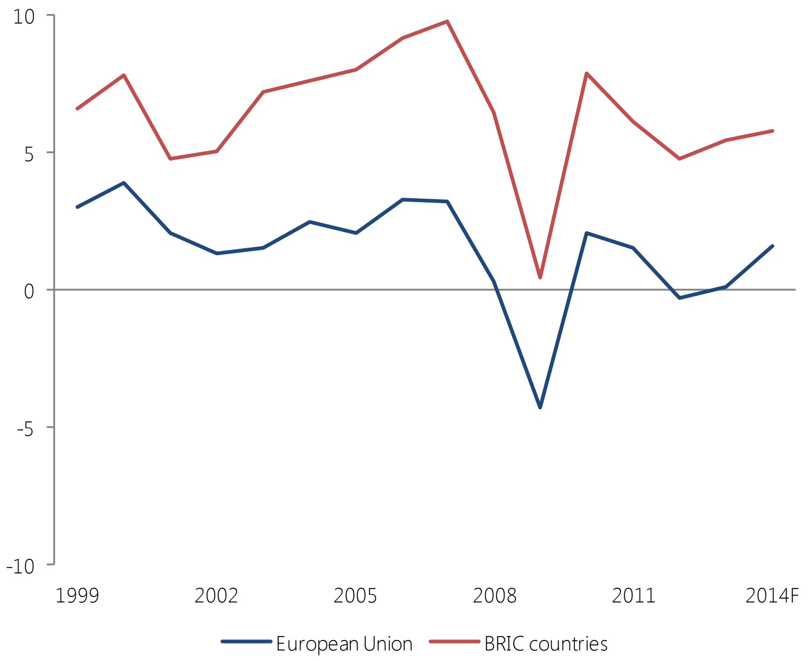
The forecast shows that the export growth rate will exceed external demand growth, that is, Hungary's market share is expected to increase moderately. The projected increase of market share is also underpinned by the substantial extra capacities in the automotive industry already implemented or in the pipeline as well as the new production capacities to be established by the corporate sector.

The import ratio of the components of the products exported from Hungary is high, thus export growth also entails an increase in imports. Moreover, domestic demand is likely to pick up from 2014 on, which also boosts imports. Nevertheless, export expansion is expected to be substantively higher than domestic demand growth, thus the net export surplus may improve year from year, albeit at a decelerating pace, over the forecast horizon.

Box 2: Changes in the orientation of Hungarian exports

An ever larger share of global growth is attributable to developing countries, in particular the so-called BRIC countries (Brazil, Russia, India, China). These countries are responsible for over half of the global GDP growth.

Chart 2.5: GDP growth in the BRICs and in the EU
(per cent)

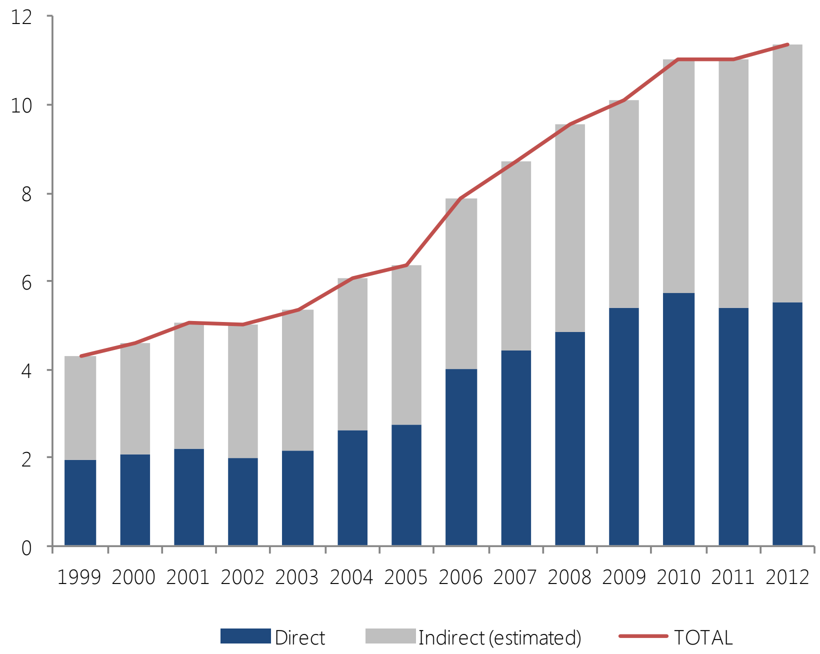


Source: Eurostat, IMF

The increasing economic importance of the BRIC countries can be observed in the structure of Hungarian exports as well: the share of direct and indirect exports into BRIC countries has increased considerably in the past decade, particularly as a result of the export growth to China and Russia. In 1999 only 4.3% of Hungarian exports went into those countries, while now the ratio has increased to 11.4%. The ratios calculated include products exported directly from Hungary as well as the estimated ratio of Hungarian exports into the EU whose destinations are BRIC countries following processing.

As a result of the rise of the export ratio into BRIC countries, Hungary's foreign trade, and thus GDP growth, is increasingly stimulated not only by performance in Germany, Hungary's main trading partner, but also in the strongly growing economies of developing and Asian countries.

Chart 2.6: Share of the BRICs in Hungarian exports
(per cent)

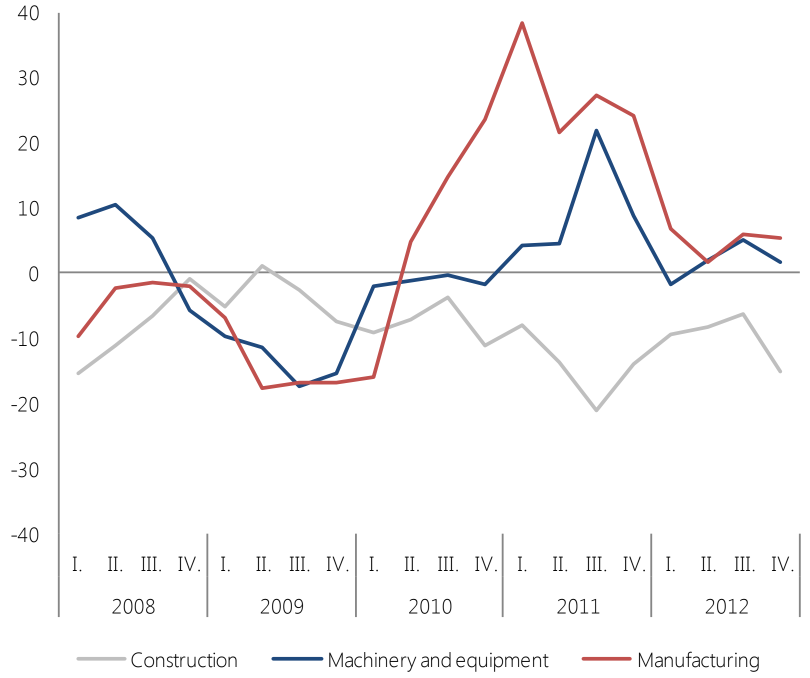


Source: Eurostat, MfNE calculations

INVESTMENT

As a result of the weak domestic economy and the subdued external demand, the slow-down of investment in the Hungarian economy continued in 2012: the volume of investment was 5.2% lower than in the previous year. Investments in the export-oriented manufacturing industry, amounting to one third of total investments in the national economy, increased in each quarter in 2012, rising by 4.9% in the whole year despite the high base. The completion of large investment projects in the automotive industry, progressing according to plan, was a major contribution to investment growth. In terms of technical composition, investments in machinery, after the substantial growth of 2011, increased again, while construction investments continued to decline.

Chart 2.7: Composition of investment
(percentage change, y/y)



Source: CSO

The downward trend of investment that started in 2008 is not yet expected to come to a turning point in 2013 but the rate of decrease can be minimal (-0.2%). The investment activity of the corporate sector, which represents some 60% in the total investments in the economy, is expected to be constrained in 2013 by interest rate levels, still high albeit on the decline, as well as by weak domestic demand. Within investments, which will still be shrinking as a whole, the growth of investments in the manufacturing industry may continue in 2013. In the second half of 2013 the investment activity of SMEs may increase markedly as a result of the preferential rate refinancing loans announced under the Funding for Growth scheme of the MNB. The scheme targets growth-oriented small and medium-sized enterprises that have a sound business model, face tight lending constraints but have no real alternative to bank financing.

In the course of 2014, as demand picks up and credit supply constraints are relaxed, corporate investment is expected to dynamically expand; at that time, in addition to businesses producing for exports, producers for the domestic markets may also be more willing to invest in response to the more favourable economic climate. This growth trend may remain for 2015 and 2016 as well; thus, driven by the investments of the corporate sector, investment in the national economy may expand by 3.5% in these years.

In the forthcoming years, as a result of the multiplier effect of successful automotive investments, Hungary may attract investment projects with considerable job creation potential, particularly through the relocation of automotive suppliers into Hungary. These expectations are reinforced by the data registered by the Hungarian Investment and Trade Agency indicating that recently investors have expressed interest mainly in opportunities in the automotive industry. Consequently, Hungary's ability to attract capital is expected to remain unchanged, supported by the country's competitiveness reinforced by Government measures: with the introduction of the flat rate PIT system, tax burdens on labour, considered high in the region, have decreased, which in turn has reduced the cost of skilled labour. The diminishing tax burden on SMEs constitutes further competitive advantage. Capacity expansion through corporate investments raises the potential GDP growth rate, laying the foundations for longer term economic growth and macroeconomic stability.

Promoted by the continuous inflow of EU transfers, the volume of public investment will increase significantly in the coming years. Disbursements under the present 7-year programming period (2007-2013) will be made until the end of 2015, thus government investment projects starting up in 2013 will generate significant additional investment in 2014 and 2015 as well.

The deceleration of household investment will continue in 2013. The housing loans announced in the framework of the Housing Programme will be one of the major tools to halt the declining trend of the number of housing units constructed. In January 2013 several elements of the interest rate subsidy system revived in 2012 were modified, allowing more people to make use of the interest-rate subsidised loans at better conditions. These factors will make their effects felt by the end of the year in the household investment figures, and from 2014 on a modest increase is possible in investment by households, to potentially strengthen in the subsequent years.

Box 3: The investment rate

Hungary has the lowest investment to GDP ratio in the CEE region at present (17.2%), though it is not much below the EU27 average (18%). Looking at developments by sector, it should be noted that much of the continuous decrease of the investment rate in Hungary has been attributable to the shrinkage of household investment since the onset of the crisis. The deleveraging process necessitated by the excessive indebtedness of households explains the persistent weakness of household lending, which resulted in the drastic drop in dwelling construction and refurbishment projects. This effect has been only partially offset by the gradual implementation of the flat-rate personal income tax system.

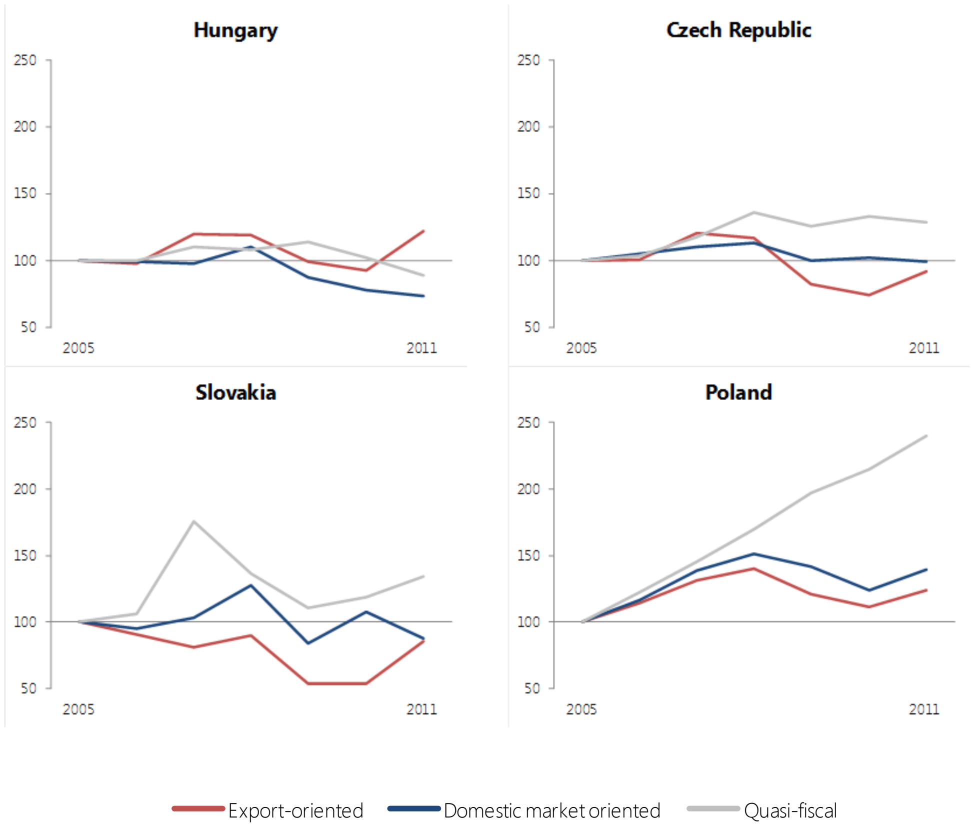
Within the region, Slovenia suffered a housing investment drop similar in magnitude to Hungary's while in other countries the decline was more moderate. In Hungary the household investment to GDP ratio was 5.2% in 2008, which was almost identical with the ratios for the Czech Republic, Poland and Slovakia as evidenced by the figures of Eurostat. In contrast, the most recent figures from 2011 show that the Hungarian household investment ratio is the lowest in the region at 3.0%. Clearly, such a decrease in the investments of the household sector had a marked negative effect on investments in the national economy as a whole.

In the corporate sector, most countries of the region encountered similar trends since the onset of the crisis. Just as in Hungary, the investments of manufacturing companies producing mostly for export that settled in the respective countries during the crisis also played a key role in the neighbouring economies as they were able to offset the declining willingness to invest of sectoral groups producing for or serving the domestic market with its weak domestic demand. As a result, similarly to the Czech Republic and

Slovakia, the corporate investment to GDP ratio in Hungary also increased in 2011 (11.9%) and, just as in recent years, it continues to be above the EU27 average (10.9%).

Thus the development of the Hungarian investment rate has been affected by the shrinkage of household investment, which was outstandingly drastic in regional comparison, while the investment activity of exporting companies remained higher than in the Czech Republic or Slovakia.

Chart 2.8: Corporate investment in the region by industries
(per cent, 2005=100)



Source: MNB Bulletin (January 2013), Eurostat

Consumption

Consumption suffered a decline in 2012. This was attributable to the continuing deleveraging of households, the tight lending conditions, the precautionary savings of households and the high inflation rate.

However, in 2013 a slight increase in consumption is to be expected (0.1%), the direct reason being the growth of real income. Real income growth is attributable partly to pensions and minimum wages increasing in excess of the inflation rate (furthermore, these groups have a higher-than-average marginal propensity to consume) and partly to the fact that in the wake of the utility rate cuts, inflation sank to the vicinity of the central bank's target. Thirdly, the implementation of the pure flat-rate PIT system may stimulate consumption also among persons with below-average income.

The turnaround in household lending is still to happen: according to the survey of the MNB, banks reckon that in the first half of 2013 the terms of consumer lending may ease but no turning point is to be expected in the terms of housing loans. However, the more favourable interest rate subsidies under the Housing Programme may act as an incentive for the housing investments of households.

In addition, the deleveraging of households still continues. Consequently, the consumption expenditures of households on the whole will grow only moderately despite a notable increase in real income. Consumption expansion is also promoted by the fixed exchange rate repayment scheme, which provides additional income to participants through lower instalment payments. By end-February close to 140 thousand borrowers entered the programme, which has been extended until the end of May, allowing more participants to join.

In 2014 consumption may gain substantial momentum. According to the Programme, real income will rise even more markedly than in 2013; one of the key drivers of this development is the implementation of the career path model for teachers, while at the same time the deleveraging process and the precautionary motive will become less focal, lowering the high savings rate of households.

In 2015 and 2016 consumption expenditures are expected to develop along the course they took in 2014. The recovery of lending and further increase in real incomes may give a boost to consumption.

2.3. Labour market

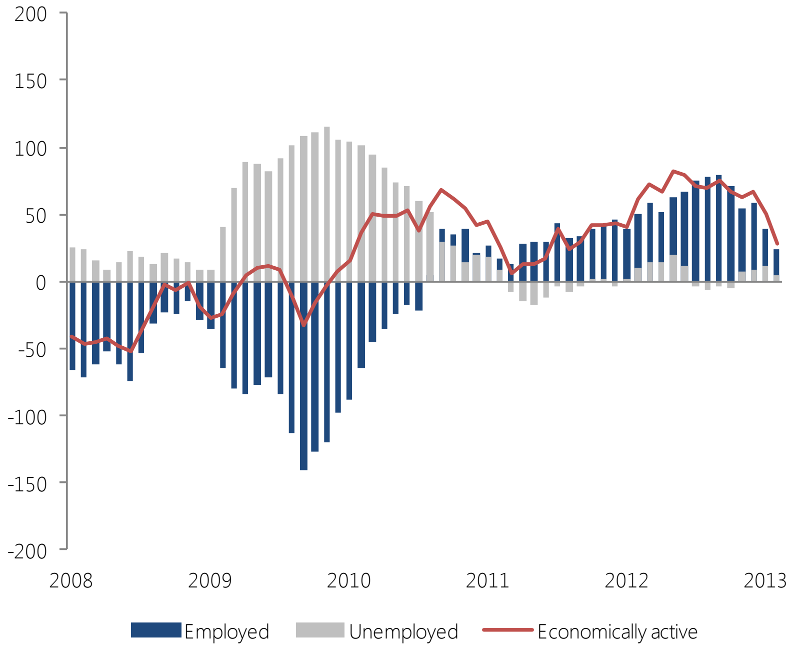
In 2012 the employment of the 15-74 age group increased by 66 thousand persons, as an annual average, over the 2011 level. It was typically the micro- and small enterprises (with fewer than 4 employees) and large corporations employing more than 300 persons that increased their headcount in 2012.

As a result of the achieved efficiency improvement, the number of employees in the public sector dropped by 2.3% in 2012 (not including participants in public employment schemes). However, public work programmes as temporary economic policy tools continued to support the demand side of the labour market. In 2012 approximately 91 thousand persons on average were involved in the public employment schemes, typically on a full-time basis as only 6- or 8-hour public work programmes could be launched since 1 January 2012.

Employment in the whole national economy rose by 1.7%. Simultaneously, due to the incentives to enter the labour market, the number of active persons has also increased significantly. Thus the participation rate increased steadily and it reached 57% in the 15-74 age group by year-end. As a result of the parallel increase of employment and labour market participation, the unemployment rate remained unchanged in 2012.

Chart 2.9: Changes in the activity

(changes in three month averages, y/y, thousand persons)



Source: CSO

In order to promote employment in the private sector, the Job Protection Action Plan was implemented in 2013 with wage cost reducing measures to assist the job search of social groups that are in the worst labour market position and that labour supply is highly flexible (persons below 25 years or above 55 years of age, long-term unemployed, mothers returning to work after maternity leave). Large investment projects in the automotive industry continue to have a positive impact on primary labour market employment while micro-, small and medium-sized enterprises are induced to increase their staff by the reform of the relevant tax regimes. All these developments will contribute to the continued, albeit moderate, growth of employment in the private sector in 2013, which increased its employment at a rate in excess of the output growth of the sector in 2012.

From 2014 on, as the external and domestic economic environment and thus corporate profitability improve, employment is expected to follow a gradually rising course.

Governmental measures are the key drivers of public sector employment: from January 2013 on. Retirement for employees above the retirement age has been compulsory and from the second half of the year on, pensions and salaries may not be disbursed simultaneously. This results in a staff cut in the public sector (excluding public work schemes), while the increase in the number of public work employees (12 thousand persons more than in 2012) means a slight employment growth in the sector as a whole. In 2014 the aforementioned measures will continue to have their effects felt though from that point on, only a modest increase in public work employment is to be expected.

The moderate pace of employment growth points to loose labour market conditions for 2013 as well. However, the temporarily expanding public work programmes, then, as economic growth picks up and corporate profit margins recover, the private sector may absorb an increasing number of working-age job seekers. Consequently, the unemployment rate may decline to 10.7% in 2013 and its downward trend is expected to continue in subsequent years.

Box 4: Job Protection Action Plan

Following the reforms under the Széll Kálmán Plan to stimulate the supply side of the labour market in 2011, the Government adopted measures to promote labour demand by announcing the **Job Protection Action Plan** in 2012. The new measures could be grouped around three topics: tax incentives to employers, new optional tax regimes for companies and measures to help enterprises in the fields of administration and financing.

The incentives targeting employers in the Job Protection Action Plan focus on the employment of groups in respect of which Hungary's employment figures show the largest divergence in international comparison. These are also the groups that are in the worst labour market position and that have high labour supply flexibility, such as persons below 25 or above 55 years of age, unskilled persons, long term unemployed as well as mothers with small children (returning to the labour market after maternity leave). The employment of such persons results in deductions from the social contribution tax up to the income ceiling of HUF 100 thousand.

The aggregate 28.5% rate of the social contribution tax and the vocational training contribution payable by the employer is reduced to 14% in case of employing persons younger than 25 years or older than 55 years and workers employed in unskilled positions. If the employee below 25 years of age is also a career starter, the employer is exempted from all of these taxes in the first two years of employment. Similarly, two years of full exemption is available in respect of employees considered to be long-term unemployed (who have been registered as unemployed for over 6 months) and persons hired after having received child care fee or during or after the disbursement of child care allowance or child raising support. In case of this group, a 50% tax reduction applies to the third year as well (which translates into a tax rate of 14%).

The tax allowances are available both in respect of new hiring and current employees, thus they act as incentives for job creation and job retention at the same time.

The Action Plan significantly lowers the tax charges on businesses. The savings achieved by the companies facilitate new hiring or gross wage increases; moreover, they have a positive effect on the implementation of corporate investments by improving corporate cash-flows. The direct macroeconomic impacts are supplemented by second-round effects (for instance, the increase of the disposable income of households and consequently of their consumption expenditure, presumably) through which the Job Protection Action Plan contributes to the expansion of economic output and to sustainable growth.

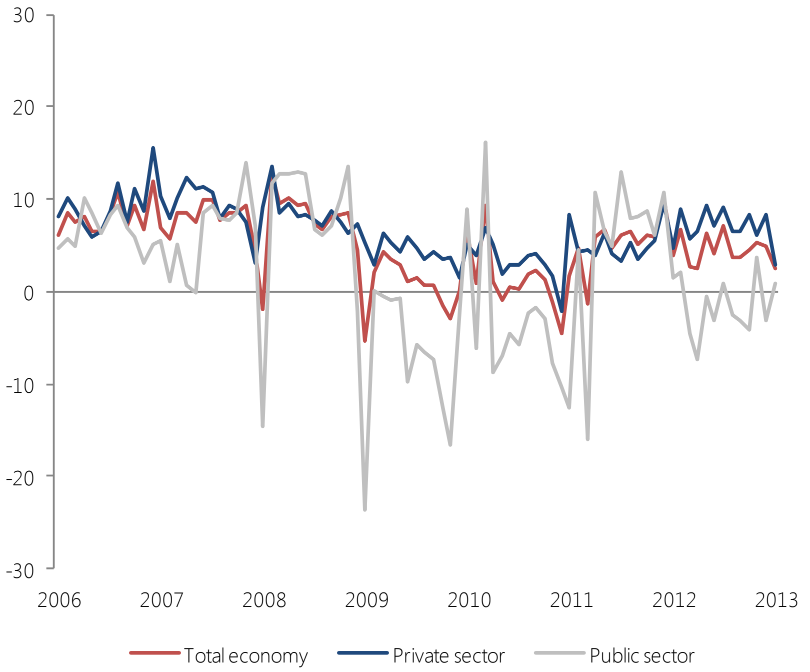
In 2012 in the private sector, gross wages increased by 7.2%, a rate in excess of inflation. This was attributable partly to the more than 19% minimum wage increase and partly to the wage compensation scheme introduced in January 2012 to maintain the level of net earnings.

On the whole, gross wages in the public sector decreased by 1.7% in 2012 as an annual average. However, this setback is explained by the composition effect, that is, the growing weight of relatively low-earning public work scheme participants. Without that scheme, gross wages in the public sector increased by 3.7%. Public sector earnings were also influenced by the substantial increase of the minimum wage and the guaranteed wage minimum (19% and 15%, respectively) as well as the wage increase of healthcare workers started during the year. The wages of public work scheme participants rose from HUF 57,000 as introduced on 1 September 2011 to HUF 71,800 as of 1 January 2012 to maintain the level of net earnings.

Taking into consideration the income tax allowance for children, net average wages in the whole national economy exceeded the 2011 levels by 2.1% on average in 2012.

Chart 2.10: Average gross wages

(percentage change, y/y)



Source: CSO

2013 is the first year for the pure flat-rate personal income tax system, which in itself increases the net wage bill. The wage compensation scheme is still in effect, even though it is being phased out. Thus the tendency observed in regular and non-regular wage elements in 2012 is expected to continue in 2013. As of 1 January 2013, the minimum wage rose by 5.4% to HUF 98,000 and the guaranteed wage minimum by 5.6% to HUF 114,000. These developments in themselves would shift the growth rate of salaries upward. However, companies are likely to adapt to the lower inflation and even if wages tend to be rigid in the short term, they will probably adjust their wage decisions to the lower inflation level from Q2 2013 onwards.

From 2014 on, as a result of the more favourable economic environment, wages may grow at a rate in excess of the rate of consumer price increases.

In the public sector the wages of public work scheme participants rose by 5.2% as of 1 January 2013. The increase of salaries in healthcare will continue in 2013, while in January 2014 the career path model for teachers will enter into force, introducing wage growth in the education sector as well. Gross wages will remain level in nominal terms in other segments of the public sector.

2.4. Inflation developments

In 2012 average inflation was 5.7%. This is significantly higher than the 3.9% seen in 2011, for two main reasons: the appearance of the VAT rate increase of January in consumer prices, and the price of non-processed food rising above the already high level of the previous year in the second half of 2012 due to unfavourable weather conditions.

A correction is expected in the price of unprocessed food in 2013, while the cold and wet spring is likely to drive the prices of early crops upwards, thus the adjustment of non-processed food prices will be modest.

The baseline projection of exchange rates points to a weaker exchange rate than envisaged in the EDP progress report of October, which may pass through into the prices of imported products. However, the subdued domestic demand will curb the rise of the market prices of goods and services in 2013.

The 10% reduction of regulated household energy prices is a major factor in the development of the annual price index for 2013. It brings about an approximately 0.8 percentage point decline in the annual index, while another few tenths of a percentage point drop comes from the cuts in the charges on garbage collection and water supply entering into force in the middle of the year, which have a lower weight in the consumer basket. The inflationary effect of tax changes will be much more limited in 2013 than the approximately 2.1 percentage points seen in 2012. The figure for the year may be around 0.9 percentage point due to excise tax changes. The tax content will increase only minimally in 2014 due to the proposed changes in the excise tax rate.

As the minimum tax change effect and the major drop in regulated prices due to the utility rate cuts of 2013 wear off, inflation in 2014 is likely to be slightly higher than in 2013, with GDP growth accelerating and the output gap narrowing. For subsequent years, price increases consistent with the medium-term inflation target of the MNB are projected (3%).

Table 2.2: Inflation %

	2010	2011	2012	2013	2014	2015	2016
Inflation	4.9	3.9	5.7	3.1	3.2	3.0	3.0

Source: CSO, MfNE calculations

2.5. CYCLICAL DEVELOPMENTS

Hungary's output gap changed in the positive direction between 1998 and 2006 owing to the relatively fast growth (4%).[1] In the post-2001 years growth was also promoted by fiscal expansion. However, due to the austerity measures necessitated by the accumulated public debt from 2007 onwards and the crisis that hit the country in 2008, economic growth came to a halt and the positive output gap started narrowing. The output gap turned negative in 2009, the year of a 6.8% economic setback, and it has been gradually narrowing ever since, with the exception of 2012.

The government measures of the past three years have contributed to increasing the growth rate of potential output. The measures were geared primarily to expanding the potential workforce. Even though the size of the working age population is predetermined by demographic processes, increased participation in the labour market can be stimulated in the short term as well. Consequently, the new measures aiming for the structural reform of the labour market are extremely important; they are described in detail in Box 4. However, as an important turning point for growth contribution, in 2012, for the first time in years, the contribution of labour to potential growth was positive again.

In 2013 the output gap is expected to continue widening slightly as the growth rate will be below the potential growth rate. In subsequent years in the projection horizon, however, economic growth will exceed the potential growth in each year, thus the output gap will gradually narrow. The Hungarian economy is expected to reach the level of its potential output in 2017.

As most government measures affect the labour market, the labour force will have the greatest contribution to potential growth. Nevertheless, the contribution of capital and productivity will also climb continuously across the projection horizon.

Table 2.3: Cyclical developments **%**

	2010	2011	2012	2013	2014	2015	2016
GDP growth	1.3	1.7	-1.7	0.7	1.9	2.3	2.5
Potential growth	0.0	0.0	0.3	0.9	1.1	1.3	1.5
Factors:							
Labour	-0.4	-0.2	0.1	0.4	0.6	0.7	0.7
Capital	0.7	0.5	0.4	0.4	0.4	0.4	0.5
Total factor productivity	-0.3	-0.3	-0.2	0.0	0.1	0.2	0.4
Output gap (as a percentage of GDP)	-3.4	-1.7	-3.6	-3.7	-2.9	-2.0	-1.1

Source: MfNE calculations

[1] The calculation of potential output was performed using the methodology of the Output Gap Working Group of the European Commission, with the variation that the calculation used for the programme takes into account the forecasts for 2014 and 2015 for the filtering of average working hours, activity rate and structural unemployment in order to ensure consistency. The programme calculates the TFP trend using a Bayesian Kalman-filter that incorporates a capacity utilisation variable, whereas the trend of structural unemployment is calculated using the Working Group's simplified methodology for new Member States. For further information please refer to the website of the European Commission: https://circabc.europa.eu/faces/jsp/extension/wai/navigation/container.jsp

2.6. EXTERNAL POSITION

The net external position of the country (balance of payments and the capital account) moved from the massive deficit of the pre-crisis years to a surplus from 2009 on; since that time, the position, as a percentage of GDP, has been improving continuously; in 2012 it was above 4%. Such an improvement of the external equilibrium is attributable primarily to the favourable performance of exports and the low import requirement due to the weakness of domestic demand. In addition, growing EU transfers have also contributed to the improvement of the balance in the past period.

Past trends of the items of the balance of payments are likely to continue in the future. The balance of goods and services is likely to improve in the coming years as well. However, the rate of improvement may decline because from 2014 on, dynamic export growth may be accompanied by higher import requirement due to rising domestic demand. Consequently, the net export surplus may stabilise at a level corresponding to 9% of GDP. The income balance is expected to be driven by the combination of two conflicting developments. On the one hand, the decreasing public debt and lower interest rates are conducive to the reduction of interest payments made to the rest of the world. On the other hand, as corporate profitability improves, profit transfers out of the country and reinvested earnings may both rise. As a net result, the deficit of the income balance will stabilise around 6-7% of GDP. Finally, the stable inflow of EU transfers is expected to continue until 2015. In 2016, however, this item may suffer a temporary decline due to the so-called n+2 rule.

As a combined result of these factors, the programme envisages the external financing capacity to be 6% of GDP as an annual average, resulting in the fast reduction of the external debt and the significantly reduced vulnerability of the country.

Table 2.4: External financing **% of GDP**

	2012	2013	2014	2015	2016
Balance of goods and services	7.6	8.5	9.0	9.2	9.4
Current account balance	1.6	3.2	3.6	3.3	3.2
Capital account	2.7	3.2	3.3	3.5	1.5
External net lending/borrowing	4.3	6.3	6.9	6.8	4.7

Source: MNB, MfNE calculations
The total figures may not reconcile with the total of the components due to rounding.

2.7. ECONOMIC EFFECTS OF GOVERNMENT MEASURES

The QUEST III model developed by the European Commission has been used for simulating the long-term macroeconomic effects of the key economic policy measures adopted by the Government. For the purposes of simulation the model uses the parameters that the experts of the Commission calibrated to reflect the special characteristics of the Hungarian economy.

The combined effects of the following reforms and taxation changes are examined:

- More efficient wage controls in the public sector.
- Abandonment of the regressive rates for pension contributions. In line with the introduction of the linear taxation of labour, the cap on the pension contribution payable by employees will be abolished. Thus additional revenues can be generated without imposing additional burdens on low-income earners, consequently without substantively lowering employment or consumption.

- Whitening the economy, combating tax avoidance, measures for the substantive improvement of the efficiency of tax collection.
- Excise tax raise.
- Job Protection Action Plan. Its purpose is to reduce taxes on labour in a structure conducive to increasing employment without providing incentives to under-report income.
- Pursuant to the Government's decision, with a view to expanding the base of the local business tax, the deductibility of certain items will be limited from 2013 on. Under the proposed rules, the aggregate amount of the cost of goods sold and intermediary services_can be deducted with certain limitations only, under a progressive regime.
- Introduction of a utility tax for line and sewage networks.
- A measure for the standardisation of fringe benefits and some other specified benefits in order to expand tax bases and increase the neutrality of the tax system. As a result of the measure, a 14% health care contribution will be imposed on fringe benefits as well.
- Through the exchange rate cap the Government has assisted borrowers in foreign currency, making the financial position of participating families more stable and predictable. The measure has stabilised the saving habits adopted due to the exchange rate fluctuations and improved the income positions of households.

Table 2.5: Modelled fiscal measures and their respective values

	Total tax revenues (% of GDP)	Distribution of tax revenues between		
		consumers		firms
		tax burden on labour	tax burden on consumption	
Wage control in the public sector	+0.3%	+0.3%		
Pension contribution reform	+0.2%	+0.2%		
Excise tax raise	+0.1%		+0.1%	
Expanding the base of the local business tax	+0.1%			+0.1%
Utility tax for line and sewage networks	+0.2%			+0.2%
Standardisation of fringe benefits	+0.1%	+0.1%		
Whitening the economy	+0.6%		+0.6%	
Energy sector	+0.1%			+0.1%
Gambling tax	+0.1%		+0.1%	
Job Protection Plan	-0.7%	-0.7%		
Total (% of GDP)	+1.1%	-0.1%	+0.8%	+0.4%

Source: MfNE calculations

Note: The total figures may not reconcile with the total of the components due to rounding.

Table 2.6 shows the results of the simulation in percentage differences compared to the baseline scenario (levels). It should be noted that the starting point is the equilibrium of the economy, that is, the simulation does not reckon with the employment growth arising simply from the narrowing of the output gap, for instance. Thus the baseline scenario assumes the gradual narrowing of the output gap and the maintenance of the potential growth observed before the reforms. All in all, the reform plan expands Hungarian GDP. According to the simulation, it increases the output level by 0.25 percentage points already over a one-year time horizon. This effect becomes stronger in subsequent periods, and the volume of GDP increases by 1.1 percentage points in five years' time as a result of the measures. Key economic indicators will improve spectacularly, mostly due to the increasing labour supply and demand; both consumption and employment will rise. The slight decrease of TFP is attributable to the taxation of enterprises; however, these measures will significantly improve the general government balance.

In summary, the measures will set the Hungarian economy on a higher output course and improve the country's financing capacity.

Table 2.6: Macroeconomic effects of the Széll Kálmán Plan (% differences in levels from baseline scenario)

	Year				
	1	2	3	4	5
GDP	0.25	0.76	1.01	1.11	1.13
TFP	-0.01	-0.02	-0.02	-0.03	-0.03
Capital	-0.05	-0.18	-0.33	-0.48	-0.63
Employment	0.52	1.29	1.75	1.98	2.07
-low-skilled	1.16	2.73	3.90	4.64	5.05
-semi-skilled	0.44	1.09	1.44	1.59	1.64
-highly-skilled	0.09	0.58	0.82	0.88	0.87
Consumption	0.87	1.14	1.24	1.31	1.35
Exports	0.22	0.72	0.99	1.09	1.10
Imports	0.24	0.29	0.30	0.32	0.33

Source: MfNE calculations

2.8. Monetary and exchange rate policy

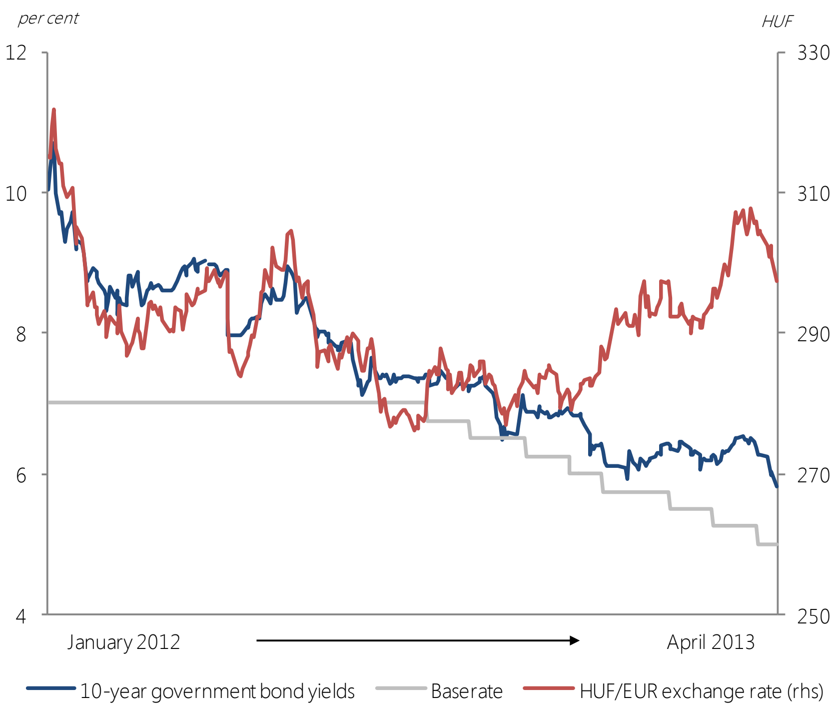
The Act on the MNB that entered into force on 1 January 2012 stipulates, similarly to its predecessor, that the primary objective of the MNB is to achieve and maintain price stability. Since 2001 the MNB has defined monetary policy within the regime of inflation targeting. Within its framework the Monetary Council sets a medium term inflation target in line with price stability, which is currently 3% as a continuous target.

A floating exchange rate regime has been in place since early 2008, allowing the central bank to resort to foreign exchange intervention operations. The floating exchange rate proved to be successful during the crisis, offering sufficient flexibility; therefore, no change in the regime is envisaged. In the period since the convergence programme of 2012, the HUF/EUR exchange rate has fluctuated between 277 and 308.

In the past year 10-year Hungarian government bond yields decreased considerably from their January 2012 level above 10%; at present they have stabilised around 6%.

In the first half of 2012 the central bank base rate was 7%. The stabilisation measures of the Government, its firm commitment to achieving the deficit target and, on the other side, positive global investor sentiment have reduced the yield required from government securities. This allowed the Monetary Council of the MNB to start an interest rate cut cycle in August 2012, reducing the interest rate in 8 steps by 200 basis points in aggregate. Accordingly, the central bank base rate sank to 5%, an all-time low, at the end of March 2013. Analysts expect the interest rate cut cycle to continue; the market has priced in an even lower base rate of around 4.5% for the end of 2013.

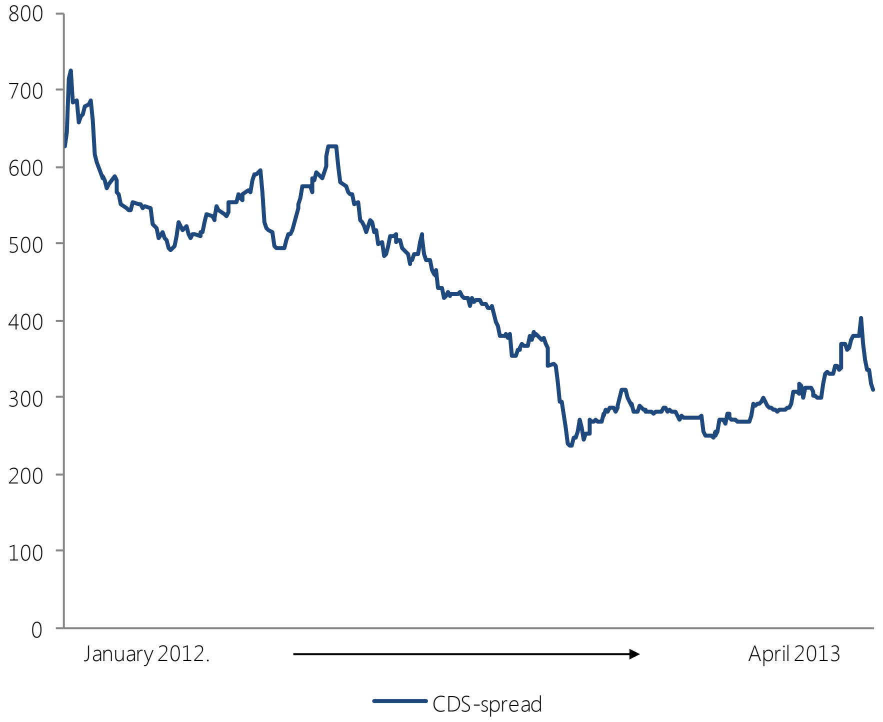
Chart 2.11: Government bond yields and exchange rate



Source: MNB, Reuters

As a result of the improved market perception due to the fiscal discipline exhibited and the liquidity-providing measures of leading global central banks, the 5-year CDS spread, which quantifies the risk of default of a country, has sunk from 700 basis points to 300.

Chart 2.12: 5-year CDS spread
(basis point)



Source: Reuters

In April 2012 the MNB expanded the range of eligible collateral in order to increase the banks' liquidity buffers: now it accepts securities with identical or higher rating than the debt rating of the Hungarian state, as collateral.

In April 2013 the MNB expanded its monetary policy toolset to support the Government’s measures to stimulate lending without jeopardising the independence of the central bank and its primary objective of achieving and maintaining price stability. The Funding for Growth Scheme (FGS) consists of the following programme points:

1. *Preferential central bank refinancing for forint-based lending to SMEs*

The MNB will provide refinancing loans with a preferential interest rate to commercial banks for a temporary period. The total amount of the programme is HUF 250 billion; the interest rate on the central bank loan is 0%. Credit institutions wishing to participate in the programme will have to onlend the central bank loan at a preferential interest rate with a fixed premium to small and medium-sized enterprises (hereinafter referred to as SMEs). This premium may not be higher than 2 percentage points, thus the interest rate on the corporate loan may not exceed 2%. To achieve this, recourse to guarantee programmes may become necessary. Regarding this and further details of the programme, the MNB is conducting negotiations with credit institutions.

2. *Preferential central bank refinancing for converting SME foreign currency loans into forints*

The MNB intends to provide, also with the involvement of credit institutions and on a temporary basis, preferential refinancing loans for the conversion of SME’s outstanding foreign currency loans into forints. The total amount of the programme is HUF 250 billion; the interest rate on the central bank loan is 0%. The other conditions of the programme (total amount, interest rate, size of the premium and targeting) are also identical with those of the previous programme point. The maximum amount of the low-interest-rate refinancing that can be provided under the programme is limited again: it may not exceed 15% of domestic banks' total foreign currency loans to SMEs. In order to assure that the conversion of the foreign currency loans into forints does not result in exchange rate volatility, the MNB provides foreign exchange to credit institutions from its foreign exchange reserves at market rates for the currency conversion of the loans on condition that credit institutions undertake to use it for repaying their short-term external liabilities.

3. *Reducing the vulnerability of the economy and the related interest expenditures*

This programme aims to reduce the country's short-term external debt by HUF 1,000 billion, which lowers the foreign exchange reserve requirement of the central bank, in line with the rules hitherto applied. Simultaneously, the total stock of two-week MNB bills will be reduced by a similar volume. In compliance with the Guidotti rule, reserve adequacy is ensured by the fact that the use of the foreign currency reserves of the MNB and external maturing within one year are reduced at the same rate. Using up to one-tenth of the foreign exchange reserves is in full compliance with the fundamental principles of holding central bank reserves condoned by financial markets. At the same time, the gross external debt of the country would also decline during the programme.

4. *Suspension of the two-year liquidity-providing loan tender*

Taking account of the permanently favourable external money and capital market environment as well as banks' persistently stable liquidity situation, the MNB has suspended the two-year secured loan tender for an indefinite period of time. This instrument has only been suspended rather than abolished, thus it can be reactivated quickly in the event of money market turbulences.

Hungary has not yet set the target date for the introduction of the euro. The convergence criteria should be met while also promoting economic growth to the maximum extent possible.

3. General government balance and debt

3.1. Fiscal policy objectives

In line with the Fundamental Law_and the cardinal act on the stability of the Hungarian economy, fiscal policy continues to consider the reduction of the high public debt inherited from the previous period to be a key priority. The Government that came into office in May 2010 set the debt ratio on a declining course in 2011 through the stabilisation of the budget and the use of the overwhelming majority of the one-off receipts from the reform of the pension system towards the reduction of the public debt. The gross debt-to-GDP ratio declined from 81.8% in 2010 to 79.2% in 2012. In the convergence programme the Government has set a deficit path for the coming years that assures the continued reduction of the debt ratio.

2011 also marked a trend reversal in budgetary developments. Hungary has been subject to an excessive deficit procedure since 2004, the date of EU accession. Pursuant to the relevant Council Recommendation, the excessive deficit should be corrected by 2012. Following the 4.3% deficit in 2010, the general government balance met the Maastricht criterion in 2011 (with a surplus of 4.3%) and also in 2012, when one-off revenues similar in magnitude to the previous year's were not realised, it closed with a deficit of only 2%, well below the reference value. The deficit will remain well below 3% in 2013 and subsequent years as well.

The balance had to be restored in an external economic environment that had a negative effect on the conditions of Hungarian growth due to the protracted financial and economic crisis. The fiscal consolidation implemented in the midst of the crisis called for the use of non-conventional economic policy measures as it was important to disperse the burdens and to more intensively involve in burden sharing the sectors with a higher capacity to bear them.

However, fiscal policy has used the instruments available to it in the past almost three years to support the growth potential of the economy, improve competitiveness and promote employment. The structural reform of the tax system improves competitiveness and employment through reducing taxes on labour, mitigating the burdens on small and medium-sized enterprises and promoting the employment of workers in disadvantageous labour market positions. In light of the macroeconomic trends becoming more favourable and the economy recovering, the convergence programme does not reckon with any substantive changes in the tax system in the forthcoming years.

The Széll Kálmán Plan announced in March 2011 helps the sustainability of fiscal consolidation through the growth-friendly restructuring of expenditures. The Széll Kálmán Plan had a major influence on the structure of the budgets of 2012 and 2013; moreover, measures stimulating growth already in the short term were also adopted (e.g. the announcement of the Housing Programme to promote home construction, purchase and renovation and the expansion of public work schemes).

Preserving the achievements of fiscal consolidation, the revised deficit path of the convergence programme sets objectives that will not hinder economic recovery through fiscal demand restriction. Throughout the programme horizon, the structural deficit of the general government will remain below the medium term budgetary objective (a structural deficit corresponding to 1.7% of GDP), thus fiscal policy is left with slightly more room for manoeuvre.

The deficit path takes into account and meets EU requirements and Hungarian rules alike. In line with the Stability and Growth Pact (SGP), the deficit targets set for each year assure that the structural balance complies with the medium term objective and that the public debt-to-GDP ratio is reduced along the deficit path in accordance with the debt rule of the reformed SGP. In addition, the deficit targets also satisfy the requirement laid down in the Fundamental Act that the public debt-to GDP ratio must decrease year from year, as well as the numerical debt rule set out in the Act on the economic stability of Hungary that will become effective in 2016. Furthermore, the deficit targets take into account the reference value of 3% of GDP set out in the Treaty on the Functioning of the European Union as well as the Council recommendation of March 2012 for Hungary in the context of the excessive deficit procedure.

Table 3.1: Medium-term fiscal path **% of GDP**

	2012	2013	2014	2015	2016
General government balance (EDP)	-2.0	-2.7	-2.7	-2.2	-1.3
Structural balance	-1.0	-1.1	-1.4	-1.3	-0.8
General government gross debt	79.2	78.1	77.2	76.1	73.4

Source: CSO, MNB, MfNE calculations

3.2. BUDGETARY DEVELOPMENTS IN 2012

The first notification[2] of the Hungarian Central Statistical Office (hereinafter called 'CSO') to Eurostat registered a balance more favourable than the target set in the previous convergence programme or the forecast in the autumn of 2012: the general government deficit according to the EDP methodology was only 2% of GDP in 2012. The lower-than-anticipated deficit was attributable mostly to the large (0.7% of GDP) surplus of local governments. In light of the interim data, the forecast of autumn 2012 already reckoned with the possibility of the balance of the subsystem turning out more favourable than the figure envisaged in the previous convergence programme, but eventually even this forecast proved to be conservative. Local governments closed the year with a substantial surplus even without the budget transfer provided in December to communities with fewer than 5000 inhabitants for the repayment of their debt. In the central subsystems, where, unlike in the case of local governments, the Government can directly influence budgetary developments, the deficit was close to the targets set owing to the fiscal measures adopted during the year to offset risks arising from the adverse macroeconomic environment and to tight fiscal management.

Table 3.2: Balances in 2012 **% of GDP**

<table>
<tr><th rowspan="2"></th><th rowspan="2">April 2012 convergence programme</th><th rowspan="2">Autumn 2012 notification</th><th colspan="2">Spring 2013 notification</th></tr>
<tr><th></th><th>(without budget transfer provided for the repayment of local government debt)</th></tr>
<tr><td>Central government and SS balance</td><td>-2.2</td><td>-2.6</td><td>-2.7</td><td>(-2.5)</td></tr>
<tr><td>Local government balance</td><td>-0.3</td><td>-0.1</td><td>0.7</td><td>(0.5)</td></tr>
<tr><td>General government balance (EDP)</td><td>-2.5</td><td>-2.7</td><td>-2.0</td><td>-2.0</td></tr>
</table>

Source: CSO, MfNE calculations

[2] The standard methodological reconciliation with Eurostat is still under way.

The deterioration of the internal and external macroeconomic environment left its mark on fiscal developments throughout 2012. The budget was hit not only by the shrinking tax bases due to the recession but also by yields rising mostly due to uncertainties on international capital markets as well as the adverse inflationary trends. Because of the unfavourable growth prospects, reserves had to be increased already at the end of 2011, in the final phase of budgeting, by constraining the expenditures of budget chapters and adopting measures to increase consumption-type tax revenues. The risk reserves thus increased to HUF 320 billion in aggregate (1.1% of GDP) (Country Protection Fund, interest rate risk reserve, chapter balance reserve) were eventually not used. During the year the Government took several measures to improve the balance. In the second half of the year the telecommunications tax was introduced, together with reverse charge VAT in certain sectors of agriculture. Revenue-increasing measures were supplemented by expenditure cuts, mostly in the form of freezes on the expenditure appropriations of central budgetary institutions and chapter-administered appropriations.

In light of the outturn of budgetary expenditure and the downside risk relating to the realisation of revenues, in the autumn of 2012 the Government decided to raise the deficit target from 2.5% to 2.7% to avoid an excessive demand contraction with lasting effects on economic growth. Towards year-end, however, the uncertainty surrounding tax revenues, downward in aggregate, was reduced considerably and the chapters cut back expenditures more than originally envisaged. Consequently, certain urgent expenditures could be authorised, previous blockings were released, certain unspent carry-over appropriations with commitments attached were paid and healthcare expenditures were increased.

Regarding the structure of the budget, due to the combined effect of the GDP decline and the revenue increasing measures, tax and contribution revenues fell 0.4% of GDP short of the figures set out in the convergence programme of April 2012. Another 0.3% was attributable to a balance-neutral methodological change following a legislative amendment: the contribution cover of the early retirement of members of the armed forces is not longer included in the figures. In contrast, expenditures decreased much more markedly, by 1.5% of GDP, partly due to expenditure cuts but mostly because of the restrained spending of local governments. (The decrease of local government expenditures is justified mostly by the reallocation of functions between the central and local governments, but its effects can be quantified with any certainty only when the final accounts are submitted.) The category of expenditure that fell short of expectations by the widest margin was investment. In addition, GDP-proportionate indicators were influenced by the effects of GDP being more than HUF 1000 billion lower at current prices, which was attributable to the worse growth figures and the revision of CSO data.

Table 3.3: Changes in the 2012 general government accounts **% of GDP**

	April 2012 convergence programme	Preliminary fact	Difference	of which		
				metho-dology	overrun/ shortfall	GDP effect
Taxes and social contributions	37.9	38.7	0.8	-0.3	-0.4	1.5
Other revenues	8.0	7.8	-0.2		-0.5	0.3
Total revenues	**46.0**	**46.5**	**0.5**	**-0.3**	**-0.9**	**1.7**
Compensation of employees	10.1	9.9	-0.2	-0.3	-0.2	0.3
Intermediate consumption	6.9	7.6	0.7		0.4	0.3
Social transfers	17.1	17.6	0.5		-0.1	0.6
Gross fixed capital formation	4.3	3.0	-1.3		-1.4	0.1
Other expenditures	10.2	10.3	0.1		-0.2	0.3
Total expenditures	**48.5**	**48.5**	**0.0**	**-0.3**	**-1.5**	**1.8**

Source: CSO, MfNE calculations

The total figures may not reconcile with the total of the components due to rounding.

The base effect of the year 2012 deficit, which turned out significantly lower than expected, is favourable for the 2013 balance. In contrast to the small deficit (-0.05% of GDP) envisaged in the budget, the balance of local governments may show a surplus of 0.2%, as a conservative estimate, even without the effect of the debt assumption of 2013. A more favourable balance is to be considered an upward risk in the forecast.

3.3. BUDGETARY DEVELOPMENTS IN 2013

In view of the external and internal macroeconomic developments being less favourable than envisaged when the previous convergence programme was drafted, in the autumn of 2012 the Government increased the deficit target for 2013 to 2.7% of GDP and simultaneously decided on the additional balance improving measures required for its achievement. The deficit target needed to be increased because the attainment of the original 2.2% target in the deteriorating macroeconomic environment would have required adjustments of a magnitude that would have jeopardised the nascent, still fragile economic recovery.

The appropriations approved by Parliament incorporated the revenue-increasing and expenditure-reducing measures described in the previous convergence programme as well as the balance-improving decisions adopted in several steps in the autumn of 2012, the gross effect of which is estimated to be HUF 854 billion (2.9% of GDP) in the budget.

Table 3.4: Additional balance-improving measures in the budget **HUF billion**

	2013
Increasing the EU co-financing rate of projects	55
Hiring freeze, ban on parallel payment of wages and pensions	30
Postponement of the implementation of the career path model for teachers to January 2014	73
Improved targeting of social benefits	8
Abandonment of the regressive rates for social security contributions	51
Expansion of financial transaction tax to cash withdrawal, raising the payment required from the Treasury	60
Whitening of the economy (extension of reverse charge VAT to the swine sector, electronic connection of cash registers to the tax authority) and changes in the regulation of small business taxation	120
Halving of the special tax on financial institutions abandoned	72
Rate increase of financial transaction tax	130
Broadening of the local business tax base	35
Introduction of the utility tax	30
Increase of the healthcare contribution on fringe benefits	40
Further whitening of the economy (restriction of cash transactions between businesses, introduction of invoice level VAT return, reinforcement of the tax authority, more severe sanctions)	60
Increasing the dividends of Szerencsejáték Zrt.	10
Increasing revenues from the tax on on-line gambling	10
Expansion of the utility tax	30
Increase of the income tax levied on energy providers	40
Total	**854**

Source: MfNE calculations

The additional balance improving measures allowed for the increase of the extra reserve (Country Protection Fund) for the management of macroeconomic risks. In addition to the reserve for extraordinary government measures (unforeseeable expenditures and/or revenue shortfalls) and the specific reserve for the wage compensation of low income earners in the public sector (0.7% of GDP in aggregate), the budget also sets aside a safety reserve of HUF 400 billion (1.4% of GDP) to neutralise macroeconomic risks.

The additional balance improvement also creates room for measures to stimulate economic growth. The most important such measure is the Job Protection Action Plan targeting hard-to-employ workers and Hungarian SMEs and offering significant tax reductions and simplification. This year, housing subsidies will increase due to the 'rescue measures' for borrowers (fixed exchange rate programme, interest rate subsidy for borrowers converting their foreign currency loans to forints) as well as measures to help home creation (subsidised forint loans, introduction of social policy benefits). Pursuant to the agreement on the minimum wage increase, the costs will be covered by the budget for half a year in most sectors while in healthcare the wage increases started in 2012 will continue.

Apart from the wage consolidation in healthcare, no across-the-board salary rise will be implemented in the public sector. The growth of the expenditures for the purchase of goods and services and for investment is attributable mostly to rising EU transfers. Investment expenditures are boosted by investments in the e-toll scheme and the property purchases of the National Asset Management Company. The salaries of teachers may be increased from September 2013 only if macroeconomic and fiscal processes develop more favourably. However, adopting a conservative approach, the convergence programme does not reckon with such an increase in 2013. The expansion of public work schemes will continue this year. The appropriation available for this purpose is more than 15% higher than in the previous year, reflecting the increase of the number of participants and the 5.2% raise in the wages of public work scheme participants in line with the inflation expected in the budget. Social benefits will develop along the directions laid down in the Széll Kálmán Plan, their growth is driven by the increase of pension expenditures. Pensions were increased in January 2013 at the expected inflation rate of 5.2%. At the lowest rate of inflation considered realistic today, the real value of pensions would in effect increase.

The cash-based figures for the first three months evolved positively. In the first quarter the aggregate deficit of the central government, the social security funds and the extra-budgetary funds amounted to 56% of the annual appropriation, which is the lowest outturn in years. (Due to the customary seasonality of revenues and expenditures, the distribution of the cash-based deficit within the year is typically front-loaded.) However, there are risks attached to some items, which must be taken into account in the calculations for the convergence programme:

- In case of the financial transaction tax, payments have been behind the time proportionate amount expected based on the transaction data of banks that served as the basis for budget planning. Accordingly, a HUF 80 billion shortfall is to be expected in the accrual-based revenue for the whole of the year;
- The European Commission did not approve the request for the extension of the reverse charge VAT to the swine sector, thus the effect expected from the whitening of the economy may be HUF 10 billion less. The convergence programme reckons with no further shortfall in revenues expected from the whitening of the economy as preparations are ongoing for the migration to the new system required for the connection of cash registers to the tax authority; furthermore, regulatory changes and the reinforcement of the tax authority are also conducive to achieving the expected results;
- The tax returns submitted indicate that receipts from the tax on utility networks may also fall a few billion forints short of the budgeted level;
- The base effect of the actual figures of the previous year and changes in the macroeconomic forecast (particularly slower wage growth and lower inflation, which reflects the effects of the utility rate cuts as well) foreshadows additional shortfalls in tax revenues. The number of those switching to the two new preferential tax regimes (small business tax - KIVA, lump-sum tax of small businesses - KATA) was significantly lower than envisaged in the budget. These two taxes may generate HUF 173 billion less revenues, but this shortfall will be overcompensated by the additional social contribution tax and corporate profit tax revenues collected because of the low number of participants in the preferential tax schemes. The base effect and the impact of macroeconomic developments are most pronounced on VAT revenues, where HUF 60 billion less receipts are to be expected in addition to the revenue foregone because of the reverse charge VAT mechanism. On the whole, the shortfall of accrual-based tax and contribution revenues may reach 0.6% of GDP (or HUF 164 billion), taking into account the effects outlined above.
- The savings achieved from the ban on the simultaneous disbursement of pensions and wages and from mandatory retirement may be significantly less than originally envisaged because of authorisations to continue employment and the wage supplement system.
- It was assumed in the budget that central budgetary institutions would cover the Treasury transaction tax from their appropriations for the purchase of goods and services. Indeed, this is

what budgetary institutions did while the Debt Management Agency met this expectation only to a limited extent;

- The additional expenditure required in higher education in 2013 (approximately HUF 50 billion) can be assured within the budget, therefore this item does not worsen the balance;
- Regarding EU transfers, the convergence programme does not reckon with the planned reduction of the Hungarian co-financing rate because of the absence of an agreement with the IMF/EU. However, the risk related to the lower interest expenditure expected from the more favourable yield environment as a result of the agreement has decreased considerably because given the currently required yields, interest expenditure is expected to be much lower even in the absence of an agreement with the IMF/EU than the level forecasted at the time of the drafting of the budget.

There are also signs pointing to a balance improvement: the housing subsidies, expenditures on early retirement benefits and on wage compensation may all be lower than budgeted (by approximately HUF 50 billion, HUF 35 billion and HUF 20 billion, respectively).

In addition, the balance of local governments may also be better than expected. In 2013 the debt of local governments with a population over 5,000 will be assumed by the Government (in a differentiated manner). This is one of the reasons that the balance of the local government subsystem will generate a surplus in excess of 2% of GDP this year. However, the balance of local governments may improve not only due to the debt assumption but also because of the base effect of the developments of 2012, by 0.2% of GDP.

In view of all these factors, barely more than half of the macroeconomic risk reserve built into the budget will be sufficient to cover the risks currently perceivable in the whole of the general government. The Government considers that the remaining reserve corresponding to 0.6% of GDP provides sufficient cover to neutralize any macroeconomic risk that may emerge. Should macroeconomic and fiscal developments in the remaining part of the year necessitate this, the Government stands ready to implement further measures to meet the fiscal targets.

3.4. BUDGETARY DEVELOPMENTS IN 2014

According to the fiscal path set out in the convergence programme, in 2014 the accrual-based deficit of the general government may remain at the previous year level at 2.7% of GDP. The structure of the budget is determined by several key factors. In 2014 the convergence programme, assuming that macroeconomic and fiscal developments move along the projected path, already reckons with the effects of the career path model for teachers, which in itself increase expenditures for the compensation of employees by some 1% of GDP. Furthermore, in an effort to maximise the utilisation of the committed funds in the two years following the 2007-2013 programming period, EU transfers will increase significantly, with the rising rate of Hungarian co-financing due to the developments of 2013. On the other hand, as a result of the structural reforms under the Széll Kálmán Plan social benefits and subsidies will expand at a rate below GDP growth, leaving room for expenditure surpluses in other areas.

Due to the structure of economic growth, tax revenues may increase slower than GDP growth, and GDP proportionate revenues will increase only because of rising EU transfers. Interest expenditures may be slightly lower than in the previous year even in nominal terms, offsetting the diminishing tax centralisation in the GDP-proportionate figures. Primary expenditures net of EU transfers will remain at the previous year level relative to GDP; within this, the growth of the compensation of employees and of Hungarian co-financing will be offset by the decline of social benefits and subsidies.

Table 3.5: Key general government indicators **% of GDP**

	2013	2014	Difference
Taxes and social contributions	39.0	38.8	-0.2
Total revenues without EU transfers	43.9	43.5	-0.3
Total expenditures without EU transfers	46.6	46.2	-0.3
Interest expenditure	4.1	3.8	-0.3
Primary expenditures without EU transfers	42.5	42.5	0
of which: compensation of employees	9.6	10.2	+0.6
social transfers and subsidies	18.8	18.1	-0.7
other primary expenditures without EU transfers	14.1	14.2	+0.1

Source: MfNE calculations
The differences in the table are due to rounding.

In view of the factors described above, for 2014 the convergence programme expects that

- wages in the public sector will not be increased in 2014 either, with the exception of public education. In the case of low-income employees, the wage compensation scheme to offset the abolition of the tax credit will be retained in the same form and amount;
- as the economic environment improves, no substantive expansion of public work schemes will be necessary;
- apart from the increase of co-financing, the outlays of central budgetary institutions for the purchase of goods and services will remain unchanged and local governments may increase their spending only at a rate below the expected inflation;
- subsidies to public transport will increase in line with inflation, social policy fare subsidies will be fixed at the nominal amounts of 2013;
- the growth of pharmaceutical subsidies and subsidies for therapeutic equipment and of expenditures on free medication to the needy will be below the expected inflation rate;
- housing subsidies will start decreasing as a result of the repayment of existing subsidised forint loans and declining interest rates;
- expenditures relating to state property will decrease as compared to the previous year due to the phase-out of one-off items (such as the investment expenditure relating to the e-toll system);
- pensions and pension-type benefits will retain their real value, increasing at the rate of expected inflation;
- the income statement of the central bank for 2013 will not necessitate any loss reimbursement.

Even though macroeconomic risks will be lower in 2014, the convergence programme assumes that in addition to the reserve appropriation for extraordinary government measures (unforeseeable expenditures and/or revenue shortfalls) and the specific reserve for the wage compensation of low income earners in the public sector, the 2014 budget will also set aside a safety reserve (0.5% of GDP) to neutralise macroeconomic risks.

3.5. BUDGETARY DEVELOPMENTS IN 2015-16

The macroeconomic forecast indicates that tax revenues will expand at a rate below GDP growth in the last two years of the programming period as well and tax centralisation will continue decreasing in excess of half a percentage point. Revenues (net of EU transfers) are determined by tax revenues. Consequently, any balance improvement requires more pronounced expenditure cuts. Interest payments will continue falling in 2015-2016 but the targeted deficit reduction also requires the decrease of the primary expenditure/GDP ratio, particularly in 2016, when the numeric debt rule set out in the Act on the economic stability of Hungary requires a more prominent balance improvement than in the previous year.

Table 3.6: Key general government indicators **% of GDP**

	2014	2015	2016
Taxes and social contributions	38.8	38.5	38.1
Total revenues without EU transfers	43.5	43.0	42.5
Total expenditures without EU transfers	46.2	45.2	43.8
Balance	-2.7	-2.2	-1.3
Interest expenditure	3.8	3.6	3.4
Primary expenditure without EU transfers	42.5	41.6	40.4
Primary balance	1.1	1.4	2.1

Source: MfNE calculations
The differences in the table are due to rounding.

In 2015, the second year after the 2007-2013 programming period, sizeable EU transfers similar to the previous year's volume are expected. However, in 2016, as the so-called n+2 rule for the use of EU transfers is phased out, only funds from the envelopes available in the new programming period can be used, thus the EU transfers and the related domestic co-financing portion will raise the redistribution rate to a considerably smaller extent.

Apart from EU transfers, the expenditure forecast of the convergence programme relies on the following main assumptions:

- salaries in the public sector will remain on the 2014 level in the last two years of the programming period, expenditures for the compensation of employees will increase at a rate below GDP growth;
- expenditures for the purchase of goods and services will continue to be subject to the fiscal discipline pursued in the previous years. Intermediate consumption expenditures as a percentage of GDP will diminish considerably, particularly in 2016, in parallel with the decrease of EU transfers;
- subsidies for public transportation will develop in line with inflation while price subsidies (social policy fare subsidy, pharmaceutical subsidies) in aggregate will increase at a lower rate;

- pensions and pension-type benefits will retain their real value, social transfers will increase at a rate below GDP growth;
- even though the efficiency of the use of EU funds will improve considerably in the 2014-2020 period, in 2016 lower investment expenditures are to be expected due to the EU-financed projects started in the 2007-2013 period coming to an end (n+2 rule);
- as a result of the reorganisation of local governments and the strict borrowing limit, the balance of the subsystem will reach an equilibrium and stabilise.

3.6. STRUCTURAL BALANCE

The convergence programme uses a semi-elasticity of 0.44 for the calculation of the cyclically adjusted balance, which is in line with the methodology adopted by the Output Gap Working Group of the EU. This means that the general government balance changes by 0.44 percentage points as a result of a 1% change in GDP (assuming no change in the composition of GDP).

The convergence programme expects that the closure starting in 2011 of the highly negative output gap that emerged during the economic crisis will come to a temporary halt in 2012-2013, then continue from 2014 on until the end of the programme period, and the gap will close in 2017. As a consequence of the negative output gap characterising the whole programme horizon, the cyclically adjusted balance is more favourable than the actual ESA balance in each year.

One-off items are only present in 2013 over the forecast horizon, but even in that year, with counteracting effects, and in aggregate they do not change the structural balance.

In 2012 the program considers the sectoral taxes phased out from 2013 and the revenue from the takeover of part of the assets of private pension funds as one-off items increasing revenues and thus the structural deficit. In 2012 the capital transfer to households relating to the early repayment scheme to mitigate the bank levy constitutes a one-off expenditure item. In 2013 the small-volume, counteracting one-off items have a negligible net effect, while no one-off item is included in the budget in the outer years of the programme.

The structural deficit, i.e. the cyclically adjusted balance net of one-off and temporary items, has shrunk in 2012 at a rate that is exceptional in international comparison and is considerably lower than the medium term budgetary (MTO) objective. The structural balance will remain below the MTO, set at a structural deficit of 1.7% of GDP, throughout the programme period.

Table 3.7: Structural balance **% of GDP**

	2012	2013	2014	2015	2016
Output gap	-3.6	-3.7	-2.9	-2.0	-1.1
General government balance	-2.0	-2.7	-2.7	-2.2	-1.3
Cyclically adjusted balance	-0.4	-1.1	-1.4	-1.3	-0.8
Net one-off items*	-0.6	0.0	0.0	0.0	0.0
Structural balance	**-1.0**	**-1.1**	**-1.4**	**-1.3**	**-0.8**

Source: MfNE calculations

**A plus sign means one-off items improving the structural balance.*

As the structural deficit will overachieve the MTO throughout the programme period, the expenditure aggregate (primary expenditures net of EU transfers) may increase at a rate in excess of the reference benchmark.

3.7. GENERAL GOVERNMENT DEBT

The reduction of the high debt accumulated before 2010 continues to be a priority for the Government; to this end a number of measures have been adopted. In 2012 the Maastricht debt was HUF 22,381 billion, HUF 310 billion lower than in 2011. In the same period the debt ratio decreased by 2.2. percentage points to 79.2% but it still exceeded the 78.4% projected in the 2012 convergence programme by 0.8 percentage points.

2012 was a balanced and stable year in the Hungarian government securities market. In the first days of January 2012 the reference yields on the secondary market went up by 100-200 basis points, but during the year as a whole the yields of government securities followed a markedly declining trend: by year-end the short end of the yield curve shifted 220-260 basis points downwards while its medium-term section and long end moved down by 350-380 basis points relative to the levels at the beginning of the year. The declining yields on longer maturities are attributable mostly to the increased global liquidity and the improving perception of the Hungarian economy. The positive fiscal figures and money market developments increased the room for monetary easing. This was incorporated into investors' expectations through the rate cuts of the MNB and led to the lowering of short term government security yields.

The yields in the primary markets followed the yield developments on secondary markets: in the shorter maturities they fell from 8% to 5.5%, at the medium and longer term auctions from over 9% to below 6% by year-end. In the first quarter of 2013 yields continued declining, eventually sinking to an all-time low. The coverage of HUF government bond auctions was 250% on average in the entire year. In response to the high demand, the value of government bonds issued by the Debt Management Agency exceeded the originally planned amount by 50% in 2012.

The Government considers it important to broaden the investor base and to reinforce the role of domestic entities in debt financing, which can increase the safety of the financing of public debt. Accordingly, it adopted a number of measures starting in 2012, as a result of which the stock of government securities held by households increased from HUF 473 billion early in 2012 to HUF 985 billion at end-2012 and rising to almost HUF 1,200 billion by March 2013.

Repayment of the loans granted by the European Union and the International Monetary Fund in 2008-2009 started in December 2011, imposing a severe burden on debt financing. In 2012 Hungary repaid principal equivalent of almost HUF 1,000 billion. Nevertheless, the funding of the public debt was stable throughout 2012 and investors' confidence in Hungary remained unbroken. In the favourable market environment dollar bonds with aggregate value of USD 3.25 billion were issued in February 2013. This provides funding for approximately two-thirds of the foreign currency debt maturing in 2013. The dollar bonds were oversubscribed several times, which proved that the Hungarian state is able to finance itself on the bond markets at favourable conditions.

In response to the events of the past year and the most recent forecasts, the debt path has shifted slightly upwards relative to the path outlined in the convergence programme of 2012 while it retained its declining trend. This was the combined result of the following factors:

(1) General government deficit

In 2012 the primary balance was more favourable than envisaged in the previous convergence programme while the balances for subsequent years were revised downwards. Even though interest expenditures are expected to be lower from 2013 on due to declining government bond yields, this does not offset the effect of the primary balance being lower than indicated in the previous programme. Consequently, the deficit path of the 2012 programme was shifted upwards except 2012, resulting in a somewhat slower reduction of the debt stock.

(2) Nominal GDP

The convergence programme of 2013 reckoned with lower nominal GDP growth than the 2012 programme due to lower growth and the revised CSO figures. Lower nominal GDP has caused an upward shift in the debt path.

(3) Other items

The debt path was also modified by the divergence of the balance of other items (stock-flow adjustments). (Among other items, revaluation due to exchange rate changes is included among the adjustments.) Between 2013 and 2016 these items changed the debt ratio by -0.4, 0.5, 0.1 and -0.7 percentage point, respectively.

- Similarly to the 2012 convergence programme, no substantial revenue is expected from privatisation in the time horizon covered.
- The technical exchange rate assumption used for the debt projection implies an around 2 percentage point stronger HUF relative to the EUR; while the 2012 convergence programme assumed a HUF/EUR rate of 299.4, the present programmes' technical assumption is a 293.1 HUF/EUR exchange rate for the 2013-2016 period.
- The 2012 convergence programme assumed that the assets of the Pension Reform and Debt Reduction Fund (PRDRF) would not be disposed of in the 2012-2015 period. HUF 248 billion worth of assets were sold in 2012. Some elements of the PRDRF portfolio, with market value of HUF 132 billion, were transferred to the Hungarian National Asset Management Zrt. in 2012.
- The 2013 programme reckons with a lower value for special transactions because the imputed debt assumption of HUF 24 billion relating to the government guarantee to MÁV that was included in the 2012 convergence programme did not take place; furthermore, the 2013 convergence programme assumes that the HUF 35 billion debt assumed in 2011 under similar conditions will be repaid in 2014.
- Changes in the stock of the assets of the state (Single Treasury Account and foreign currency deposited with the MNB from the proceeds of the loan from the international institutions), advances on EU transfers as well as the difference between the cash-based and accrual-based balance of the budget have also been modified relative to the forecast in the previous convergence programme.

The take over of the debt of municipalities with fewer than 5,000 inhabitants added almost HUF 80 billion to the debt of the central budget in 2012; however, as the local government debt also constitutes part of the Maastricht debt, this measure has no effect on the debt of the government sector. Similarly, the debt consolidation of municipalities with more than 5,000 inhabitants in 2013, affecting more than HUF 600 billion of debt, represents a simple reallocation of debt between subsystems.

Table 3.8: Main assumptions in the convergence programmes

		2012	2013	2014	2015	2016
Nominal GDP growth (%)	CP-2012 April	4.3	4.5	5.5	5.3	-
	CP-2013 April	1.4	4.3	5.3	4.6	4.7
General government balance (% of GDP)	CP-2012 April	-2.5	-2.2	-1.9	-1.5	-
	CP-2013 April	-2.0	-2.7	-2.7	-2.2	-1.3
General government debt (% of GDP)	CP-2012 April	78.4	77.0	73.7	72.7	-
	CP-2013 April	79.2	78.1	77.2	76.1	73.4

Source: CSO, MNB, MfNE calculations

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

(1) Primary balance

The upward shift of the GDP-proportionate primary balance by 1 percentage point from 2013 until the end of the horizon would reduce the gross debt ratio by 1 percentage point in 2013 and by 4.1 percentage points in 2016.

(2) Exchange rate

The share of foreign currency debt within gross debt was approximately 40% at the end of 2012, which is expected to decline to almost 36% by 2016. In view of this, a 1% nominal exchange rate change (HUF/EUR rate of 290.2 rather than 293.1) would reduce the gross debt ratio by 0.3-1.6 percentage points between 2013 and 2016.

(3) Yield curve

Yield changes are reflected in interest rate expenditures gradually as maturing debt is renewed. Due to the cumulative effect of the change in interest expenditure on the debt ratio, a 1-percentage-point downward shift in the yield curve would reduce the gross debt ratio by 1.6 percentage point by 2016.

(4) Economic growth

If the nominal GDP growth rate were increased permanently throughout the horizon, starting in 2013, by 1 percentage point, the gross debt ratio would decline by 0.7 percentage point in 2013 and the impact would gradually climb to 2.7 percentage points by 2016.

4. SENSITIVITY ANALYSES

The conservative baseline scenario is subject to both positive and negative risks. From these scenarios, the two most likely alternative scenario sensitivity analyses were completed. During the identification of risks, the possible directions of change in Hungary's surrounding economic environment were identified. In the first scenario the negative effects of a less dynamic external demand resulting from a slower economic growth in Europe was modelled. In the second scenario, the recovery of loans was modelled.

The growth of the economies within the European Union has gradually slowed down, on yearly basis, during 2012. The prolonged debt crisis' unresolved factors are increasing the uncertainty in financial markets and reducing the opportunity of future growth. The first scenario examined the case, when the external demand is 1-1 percentage point lower than expected in the baseline scenario for 2013 and 2014. The direct effect of lower external demand is the lower volume of export. The high import content within the export causes a significant drop in the import-level. The impaired profitability of the corporate sector results in a decreasing labour demand, thus a decrease in employment and wages. Due to the worsening outlook investment shrinks and as a consequence of decline in real wages the level of consumption decreases. The economic feedbacks amplify the unfavourable economic developments. As a result of this the volume of GDP remains at lower level permanently.

The baseline assumes a continuous balance-sheet adjustment and low credit activities. At the same time the low lending activities might take a different turn. The implementation of this scenario is possible, due to the stable economic environment, the lower bond yields and the measures of the Government (i.e. more favourable conditions of the Housing Programme, and increased housing subsidies). In this alternative scenario, the increase of the credit supply can stimulate corporate and household investments, thus increasing the level of potential output of the economy. The rising domestic demand can stimulate the labour market, the employment and the wages. As a result of the rising income, household consumption is also expected to expand. The trade balance is worsening due to the increasing domestic demand through imports.

Table 4.1: Risk scenarios

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

External demand shock	2013	2014	2015	2016
GDP	-0,1	-0,3	-0,3	-0,3
Household consumption	0,0	-0,1	-0,2	-0,2
Corporate investment	-0,2	-0,6	-0,8	-0,6
Export	-0,7	-1,9	-2,3	-2,3
Import	-0,8	-1,9	-2,4	-2,3
Inflation	0,0	0,0	-0,1	-0,1
Private sector employment	0,0	-0,1	-0,2	-0,2
Private wage	0,0	-0,1	-0,2	-0,3
Government balance (GDP %)	0,0	-0,1	-0,1	-0,1
Credit shock				
GDP	0,1	0,3	0,5	0,5
Household consumption	0,1	0,3	0,4	0,4
Corporate investment	0,9	2,4	2,9	3,2
Export	0,0	0,0	0,0	0,0
Import	0,1	0,3	0,4	0,5
Inflation	0,0	0,0	0,1	0,1
Private sector employment	0,0	0,2	0,2	0,2
Private wage	0,0	0,1	0,3	0,5
Government balance (GDP %)	0,0	0,1	0,1	0,1

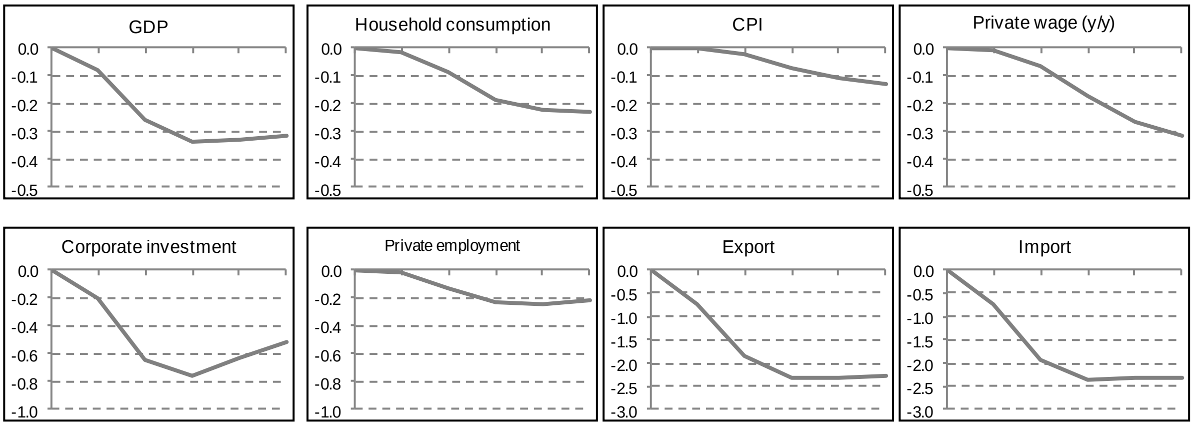
Source: MfNE calculations

Box 5: Impulse response functions of MfNE's forecasting

The differences between the alternative scenarios and baseline were demonstrated by the MfNE's macro-econometric forecasting model. The model describes the long run neoclassical growth path, to which the catching-up is hampered in the short term.

Chart 4.1 shows the impacts of the alternative scenarios, in which the increase in external demand for two years is lower by 1-1 percentage points. As it can be seen, through export, this shock has a significant negative impact on the components of growth.

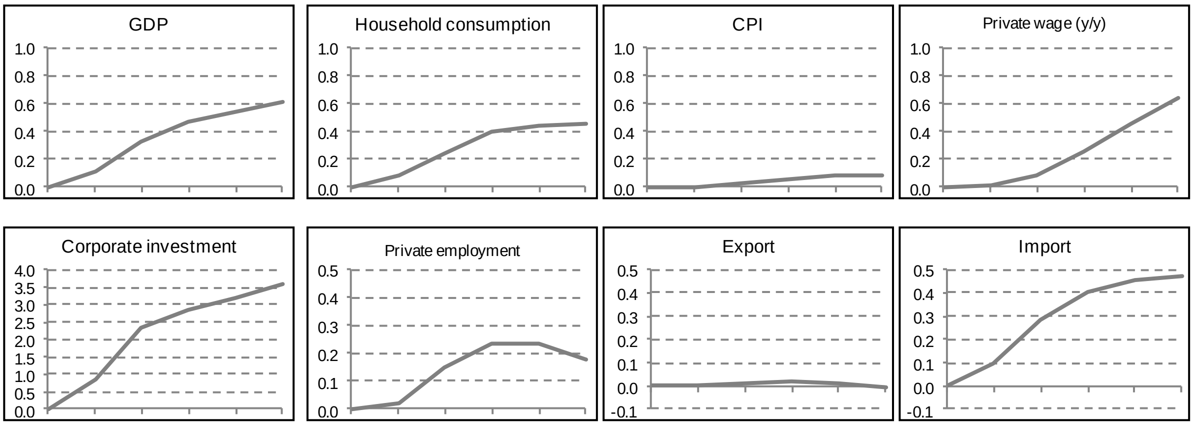
Chart 4.1: For two years the external demand is 1-1 percentage points lower *



** Difference between macroeconomic indicator growth rates and the baseline scenario in percentage point. The horizontal axis divisions represent years after the shock, in this case, the first division represents the year 2012, the last represents the year 2016.*

In Chart 4.2, the effects of a stronger lending activity compared to the baseline scenario can be observed. This has an effect on the economy through two channels. First, the households' disposable income of net borrowing is constantly higher by 1 percentage point compared to the baseline scenario. This increases consumption. Second, companies can access to credit at 1 percentage point lower interest rate constantly, compared to the baseline scenario, thus an increase in corporate investments is expected. Overall, the increase in domestic demand will result in rising wages and increasing employment.

Chart 4.2: Permanent increase in lending activity*



** Difference between macroeconomic indicator growth rates and the baseline scenario in percentage point. The horizontal axis divisions represent years after the shock, in this case, the first division represents the year 2012, the last represents the year 2016.*

5. Sustainability of Public Finances

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

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

The Fundamental Law, effective as of 1 January 2012, stipulates that the public debt-to-GDP ratio shall be constantly reduced until it reaches 50%. The achievement of this target was significantly facilitated by the termination of the mixed system, composed of a compulsory, fully funded private pension pillar and a state-run, social security based, pay-as-you-go pillar, introduced in 1998. This affects the sustainability of public finances in several ways. On the one hand, public debt was immediately and significantly cut due to the assets transferred from the private pension funds, on the other hand the contributions paid by members stepping back into the public pillar are now paid to the budget, thereby permanently improving the fiscal position.[3] In addition to the need for reducing public debt, further factors suggested to terminate the mixed system. With high costs and low yields the second pension pillar introduced in 1998 would have been unable to compensate for the lost social security based pensions.

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

Long-term demographic trends have a major impact on expenditures relating to long-term sustainability. Demographic trends forecast the ageing of the population which entails an increase in age-related expenditures and thus an increase in public debt in the long run. One of the key causes of adverse demographic trends is the low fertility rate. The fertility rate in Hungary is one of the lowest in Europe, accounting for only 1.3 compared to a 1.6 EU average. In order to increase the willingness to have children the Government reinforced the family-friendly incentive system and Parliament adopted the Act on Family Protection. Decisive elements of the measures included various forms of pecuniary support to families, such as family allowance, maternity support, cash supports for

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

parenthood, life-starting support, child protection benefit, gas price subsidy for families with three or more children, or the family tax relief introduced in 2011. These measures are expected to mitigate the projected ageing of the Hungarian population.

In the long run, pension expenditures are expected to increase at a much slower pace due to the measures implemented in the pension system. According to calculations approved by the European Commission and the EU Economic Policy Committee, pension expenditures are expected to grow between 2010 and 2060 from 11.9% only to 12.4% in percent of GDP, which is one of the best results in the European Union as regards the rise in pension expenditures. The positive results of the Government's measures are also confirmed by the most recent Sustainability Report prepared by the European Commission in December 2012. In its report, the European Commission states that Hungary is a low-risk country regarding the sustainability of the public finance in the short, medium and long term alike. Only 4 other countries received such a favourable rating. Apart from that, the European Commission also claims that the debt rate will decrease well below 60% of GDP by 2030, provided that the Government maintains the level of structural primary balance planned for 2014.

Further expenditure figures with direct relevance to long-term sustainability are included in the Ageing report of the EU Economic Policy Committee in 2012. According to these calculations, health care expenditures will grow from 4.9% to 6.1%, long term care expenditures will rise from 0.8% to 1.4%, and education costs will decrease from 4.3% to 3.7% of GDP between 2010 and 2060 in Hungary.

6. QUALITY OF PUBLIC FINANCES

6.1. STRUCTURE AND EFFICIENCY OF EXPENDITURES

The expenditures of the main provision systems financed from the state budget in 2013 and in the following years are basically determined by the reorganisation launched via the Széll Kálmán Plan. These changes are aimed at improving the quality of public services, in compliance with the principles of cost efficiency and economies of scale, enforcing the requirements for the long-term sustainability of the public finances. The measures of the Széll Kálmán Plan, launched in 2011, reached the stage of full implementation during the years 2012 and 2013, and were described in previous convergence programmes. This chapter presents the changes that have been implemented since the adoption of the 2012 convergence programme, as well as those still in progress.

LOCAL GOVERNMENTS

It is a key objective of the Government to review and renew the central, regional and local systems of the performance of public tasks, to improve efficiency, and to make structures more transparent. In accordance with the directions laid down in Act CLXXXIX of 2011 on the local governments of Hungary, the reorganisation of the structure of tasks of local governments covers the already implemented redefinition of the responsibilities of county governments and the clarification of the system of responsibilities of municipal governments, largely to be performed from 2013.

Consolidation of municipal governments

The harmonisation of responsibilities and financing and the clarification of the system of responsibilities of municipal governments in 2012-2013 covered the following areas: healthcare, administration, public education, social care and child protection, community culture, and disaster management.

As a result of the reorganisation, local governments will only retain those tasks where local decision-making is indispensable, or for which the required funds are available. In parallel with the transformation of the system of responsibilities, it also seemed justified to take over a part of debts in proportion with the volume of responsibilities transferred from local governments. Therefore, the Government decided to take over the entire debt of local governments with a population of 5,000 or less in 2012, and then to consolidate, in 2013, part of the debt accumulated by local governments with a population over 5,000 in a differentiated manner. Considering the fact that a major part of the responsibilities of local governments with a population of 5,000 or less is taken over by the state from 2013, the entire debt of the overwhelming majority of these local governments was paid back on 28 December 2012 by means of repayment support, directly to the lending financial institutions. As a result, a total debt of 73.7 billion HUF, accumulated by 1,710 local governments, was paid back. Nearly one-third of this amount was denominated in foreign currencies, largely in Swiss francs, , while the rest was denominated in Hungarian forints.

Because the aim of the programme was to consolidate the debt related to performing the mandatory tasks of local governments, the debts of 14 highly indebted municipalities - whose debts had not typically financed mandatory tasks or income-generating investments - were not fully taken over by the state in 2012. The debts of these local governments will be paid back, in whole or in part, by 28 June 2013 after a detailed investigation and depending on Government decision.

In case of larger local governments with a population over 5,000, only a smaller part of their responsibilities will be transferred to the state, and their financial capacity is also larger than that of their smaller counterparts. The Government will take over the debts of such municipalities only partially. However, the elements of local debt related to specialised inpatient care institutions, as well specialised social care and child protection institutions will be fully taken over by the state even for these municipalities. All in all, the consolidation of debts for these municipalities amounts to approx. 610 billion HUF. To enable the smooth debt consolidation of local governments, a moratorium was imposed for taking up loans between 31 December 2012 and 31 March 2013.

Reorganisation of the financing system of local governments

In parallel with the reorganisation of tasks, the local government financing system will also be reformed with task-based financing becoming an essential element of it. The rationality of the shift to such a system is shown by the fact that while the state financed local governments in a revenue-oriented manner, local governments applied expenditure-oriented budget planning.

In three key areas of local responsibilities (administration, operation of kindergartens, specialised social care), a fundamental element in the new task-oriented financing system is the determination of the number of staff working in the given special field allowed by the state budget. In all three special fields, “the number of staff allowed” is a measure calculated in light of relevant legislation, on the basis of which the state budget finances the wage costs associated with the given responsibility for the local government, based on appropriate criteria. Wage financing is complemented by separate support specifically provided for other operating expenses of the relevant field.

The Act on the local governments of Hungary, the Budget Act, and other legislation on the state budget were all created along the basic principle that the new type of financing should be aligned with the responsibilities. Now that the state has an overview of both the tasks and the financing, it is in a position to establish the necessary conditions more reasonably and with less expenditure.

Rules of local government debt control

To maintain the balance of the budget, the Fundamental Law makes it possible to subject future commitments of local governments to certain conditions or Government consent by means of a separate piece of legislation.

Based on this authorisation, the Stability Act stipulates that the payment obligations of local governments resulting from debt-generating transactions in any year may not exceed 50% of their own revenues in the same year, which condition must be met until the end of the term of such obligation. Local governments whose indebtedness exceeds this limit are not allowed to take up further loans. As a general rule applicable from 2012, local governments may enter into or modify debt-generating transactions only with the Government’s prior consent.

The transaction will be approved by the Government only on condition that it does not endanger the reduction of public debt as prescribed by the Fundamental Law, and that repayment by the local government is guaranteed. However, certain transactions, such as those involving smaller amounts or related to EU projects, may be carried out without the permission of the Government. In 2012, the Government approved a total of 75 debt-generating transactions in a value of 57.3 billion HUF, and rejected approval for 8 local debt-generating transactions (in a value of 2.1 billion HUF). As a result of the new regulatory environment and the debt consolidation programme, based on preliminary data for 2012, the debt of the subsystem was, without liabilities to suppliers, 1,077 billion HUF, approx. 120 billion HUF (10%) lower than in 2011. The projected debt of local governments in 2013 is 450-480 billion HUF, taking into account the effects of debt consolidation.

Local government balance

Based on preliminary data reported by local governments for 2012, the cash balance of the subsystem in 2012 was, without loan and securities transactions, in a surplus of 124.9 billion HUF.

The 2012 ESA95 balance of local governments was, based on preliminary data, 207.6 billion HUF. Out of this balance, 65 billion HUF was due to the reorganisation of tasks between local governments and the state (takeover of institutions and employees by the state), meaning that this positive change resulted in the opposite effect on the central government budget in 2012.

The cash balance of local governments in 2012 was improved by the early repayment of the total debt of local governments with a population below 5,000as a one-off effect, at the same time, there were also some long-term effects positively influencing the balance:

- The takeover by the state of local institutions operated by county governments and hospitals run by municipalities took off a lot of burden from the whole subsystem of local governments.
- On the expenditure side, the balance of local governments shows a reduction, but it is not possible to make a distinction between the effects of reforms in local governments and those of the reasonable and economical management of municipalities, the two components cannot be separately quantified (additional information may be yielded by the multi-sectional analysis of elementary reports). Both the material expenditures and accumulation expenditures of local governments were underperformed, the former to a lesser extent, the latter to a larger extent.
- The balance of the subsystem was further improved indirectly by the fact that, since the entering into force of the Stability Act on 1 January 2012, local governments, with only a few exceptions, may only take up loans subject to approval by the Government.

The 2013 cash balance of local governments was influenced by the following factors:

- The partial consolidation of the debt of local governments in 2013 significantly reduces the interest expenditures of municipalities.
- According to the debt consolidation schedule for 2013, a total of 30 billion HUF state support is expected to be disbursed, improving the 2013 balance of the subsystem of local governments (and, at the same time, exerts a negative effect on the central government subsystem, resulting in a neutral overall effect on the state budget).
- The enforcement of the regulations of the Stability Act may also have a positive influence on the balance because, due to the requirement of approval by the Government, only loans that are absolutely necessary will be taken up and spent.
- As of 2013, local governments are not allowed to plan their annual budget with an operating deficit.

As a consequence of the above measures, which exert their effects continuously in every year after their introduction, the cash balance of local governments can be planned with an expected surplus of

40 billion HUF for 2013. The expected ESA95 balance of local governments may show a surplus of about 700 billion HUF due to the accrual-based accounting of wage and material expenses arising from the takeover by the state of social and public education institutions. At the same time, the latter items have an equivalent negative effect on the accrual-based balance of the central government subsystem.

HIGHER EDUCATION

The structural reform of higher education is based on Act CCIV of 2011 on national higher education. The main aims of the reform are the following: to improve the competitiveness of higher education, to meet the needs of the economy and the labour market, to improve the structure of education, and to ensure appropriate returns on the social costs invested in higher education.

Compared to the previous year, the number of admissible students receiving a state scholarship in the academic year 2012/2013 changed in line with the above principles, and a supported loan scheme called “Student Loan 2” was made available for students in higher education paying their own education costs in whole or in part.

The measures taken within the framework of the Széll Kálmán Plan induced higher education institutions to revise their established educational structure from an economical and labour market point of view, as well as their role and position in Hungarian and international higher education. To support this inevitable process, the Government requested state-run institutions to prepare institutional development plans, which also served as a basis for the revision of the institutional system by the operator. State-run higher education institutions took various measures to accomplish the above objectives, including a revision of the training courses, the discontinuation of some of their training locations, organisational reforms, re-negotiation of contracts, reduction in staff and benefits, modernisation and streamlining of the building stock (developments for better energy efficiency, moving functions into a single building), increased participation in tenders, and exploration and utilisation of the areas of cooperation with economic players.

In December 2012, the Government declared in Government Resolution No. 1668/2012 (XII. 21.) (Resolution) its commitment to the quality-oriented renewal of higher education, and adopted further measures to that end. According to the Resolution, the limit of the number of admissible students receiving a state scholarship is, in line with the results of the entrance exam procedure in 2012, 55 thousand; however, no courses were announced for students receiving a partial scholarship. Normally, the upper limit is determined by the capacity of the institution and the general minimum score to be achieved at the entrance exam; however, in certain areas of education (for instance, economic sciences, law, communication and media science), special minimum admission scores will be applied, which are significantly higher than the general one. Simultaneously, institutions also responded to the changed behaviour of the operator, discontinuing courses which are uneconomical or which provide a kind of knowledge that is difficult to sell on the labour market, and increasing the minimum number of students for starting a course.

The Resolution specifies the areas where assistance is to be provided by the state to improve the financial situation of institutions: taking over co-financing funds for EU sources, substitution of PPP investments, settling debts. In this respect, only targeted measures are taken with regard to the institutions affected by the relevant problem; the decision helping the use of EU funds has already been adopted (Government Resolution No. 1112/2013 (III. 8.).

The above objectives are further promoted by the Higher Education Structural Reform Fund established at the beginning of March 2013. The support to be provided from the Fund and the associated conditions for structural reform will be specified in the agreements to be concluded with the state-run higher education institutions concerned. The review of the institutional network and the preparation of agreements based on the negotiations conducted with the institutions are underway. Institutions performing well in the educational and scientific fields and playing a prominent international role receive further help through additional resources that may be granted for titles and qualifications awarded in the "system of national higher education excellence".

HEALTHCARE

Healthcare provision

Hungary is working on setting up a healthcare system that provides high-quality services, which are equally accessible to every person living in Hungary, irrespective of their health or financial conditions. The aim is to reduce the regional inequalities present in healthcare, to strengthen the prevention activity of primary care, to improve access to services, and to increase the efficiency of the healthcare provision system. One of the tools for that purpose is a new system of external audits for inpatient and outpatient care and pharmacies. As another means to promote efficiency and patient security, the legislative framework and the professional basis for pharmacist care have been established and introduced in everyday practice.

One of the most significant measures was that the state took over specialised inpatient care as a state responsibility. This allows the reorganisation of the system following a more reasonable structure that ensures the efficiency of services. The operation of inpatient care institutions was taken over by the state in two stages in 2012. As of 1 January 2013, the only responsibility of local governments in the area of healthcare will be to provide primary healthcare services, and, with the underlying responsibility of the state for specialised care, the operation of specialised outpatient care institutions. The coordination of the hospitals' medicine and medical equipment purchases creates a more efficient and transparent system, which creates room for significant savings due to the large scale of procurement and the creation of real competition.

Pharmaceutical subsidies

The measures under the Széll Kálmán Plan for the improvement of the pharmaceutical support system significantly reduced state expenditures, while the quality of pharmaceutical supply did not change; moreover, within the generic programme, the price of several pharmaceuticals (the amount to be paid by the patients) fell sharply.

In addition to the measures described in the convergence programme of spring 2012, an additional payment of 10% was introduced as of 1 August 2012 in the case of products without a generic competitor which have been supported for more than six years (the so-called Spanish model). After the regulatory amendments made in early 2013, a systematic therapeutic review was launched (regarding pharmaceuticals and products used for psychiatric or oncology purposes, cholesterol reduction, or the reduction of the risk of thrombosis). Based on the results of the blind bidding in early 2013, organised with a view to strengthening price competition between pharmaceutical manufacturers and distributors, it can be established that the regulation on generic products will have more benefits than merely the carry-over effects for the given year, which may be further reinforced by the expiry of patents during the year.

PENSION SYSTEM

In the reorganisation of the pension system, the Government regarded as a key objective to ensure the sustainability and secure financing of the pension system and the creation of long-term balance in the Pension Insurance Fund.

To comply with that principle,

- as of 1 January 2012, every insured person pays pension contributions into the mandatory state pension system.
- the indexing method for pensions has changed; since 2012 it corresponds to the increase of the consumer price index.
- benefits provided before reaching the regular old-age retirement age and, , disability pensions (former terminology) are now considered "other benefits" rather than pensions, which are financed from outside the Pension Insurance Fund.
- the possibility of early retirement has been abolished, but the benefits determined earlier are further disbursed and the future use of special pension rights obtained earlier are guaranteed.

The above steps contributed to a large extent to the long-term stability of the public finances, while still preserving the value of pensions on real terms. In addition to the gradual increase in the statutory old-age retirement age, the number of those entitled to pension benefits is also influenced by people retiring based on the so-called "women after 40 years" rule. As of 1 January 2011, women who have an entitlement period of at least 40 years are eligible for old-age pension, regardless of their age. This regulation satisfies a real need, because long careers of over 40 years are quite frequent due to the very early age of starting work, the number of concerned is also very high. Therefore, after the first two years following the introduction in 2011, the number of women retiring under this rule rose considerably (more than one hundred thousand people received this kind of benefit in February 2013). The rise in the number of beneficiaries is gradually slowing down, and a significant increase is no longer expected in 2013.

As of 1 July 2013, it is not allowed for persons working in the public sector to receive both wage and pension (or benefits before retirement age). During the period of employment in the public sector, retired persons are still regarded as pensioners, but their pension payments are suspended. The regulation applies to those employed as public servants, in an employment relationship with the Government, in a high state office, in a public service employment relationship, in a judge service employment relationship, in a judicial staff employment relationship, in a prosecutor employment relationship, in an employment relationship with the armed forces as a professional, or as a professional or contracted employee of the Hungarian Defence Forces.

TRANSPORT

Local transport

The Agreement between the Government and the Capital signed on 27 April 2012 set up the guidelines for a sustainable financing model based on income-generating developments in the future public transport system of Budapest (e-tickets, renewal of the vehicle fleet) and the gradually decreasing direct operating support from the state budget. Pursuant to the Agreement, the capital was able to launch, with the assistance of the Government, a number of public transport development investments in 2012.

As a next step in reorganising public transport in Budapest, the Government and the Municipality of Budapest signed a cooperation agreement entitled “Budapest 21” on 8 March 2013. The Government is committed to the stabilisation of the financial situation of Budapesti Közlekedési Zrt., the renewal of the fairly run-down vehicle fleet, and agrees with the introduction of electronic tickets and the uniform system of tickets and season tickets for the agglomeration and the capital.

By 31 August 2013, the Government will reach an agreement with the capital on the elimination of the deficit arising from the M4 underground project and the financing of additional costs related to the investment. The Parties will cooperate in the review to be conducted in connection with the introduction of the congestion charge mentioned in the Metro 4 contract, concluded with the European Commission.

Long-distance transport

The internal restructuring of the MÁV Group is to be continued, along with measures aimed at improving cost efficiency. The next step will be the establishment of a passenger transport business unit integrated with traction (Trakció) and maintenance (Gépészet) functions, as well as the transfer of the railway track operation activities into a separate entity. The preparation of these organisational changes has finished.

As a result of the steps taken so far, the costs of the passenger rail transport public service were successfully kept within the appropriated budget in 2012. In the long run, the need to provide budgetary support for the passenger rail transport public service is expected to fall. This is further helped by the rationalisation and coordination of timetables, as well as an increase in the income received from passengers through minor modifications in the fare system.

The first phase in the reorganisation of Volán companies has been implemented: instead of the earlier twenty-four firms, seven regional companies have been established, leading to cost reductions in terms of centralised procurement, maintenance, operational management and control.

Based on the railway track operation contracts concluded in 2011, the railway track operators are entitled to a reimbursement of justified costs not covered by revenues. To prevent MÁV Zrt. from accumulating further debts, the amount of reimbursement provided to the company increased in 2012 from the originally planned 41.9 billion HUF by 25.1 billion HUF. In conformity with the performance in the previous year, the 2013 appropriation is 70 billion HUF (out of that, GySEV Zrt. and MÁV Zrt. have a share of 4.4 billion HUF and 65.6 billion HUF, respectively), which should represent for both companies the total reimbursement of justified costs.

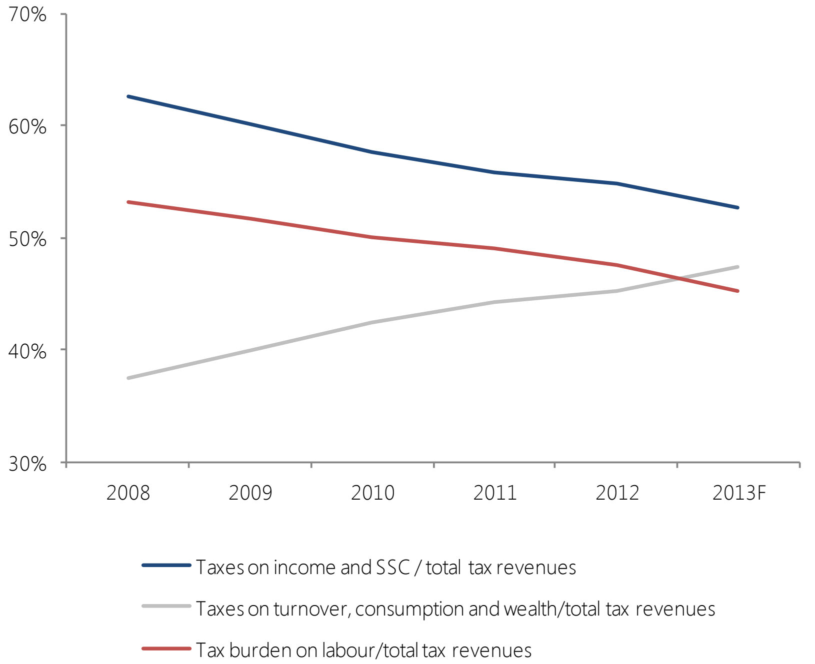
6.2. STRUCTURE AND EFFICIENCY OF REVENUES

TAX STRUCTURE

Over the previous years, the Government realised the consolidation of the budget in a way that the total taxes and contributions imposed on the economy decreased to around 39%, from 41% of GDP prevailing in the pre-crisis years. Simultaneously, a restructuring of the tax system was also carried out, focusing on decreasing the weight of taxes on labour. As a consequence, taxing will be focused more on taxes on consumption, turnover, or harmful externalities. An increase in the weight of indirect taxes is justified by the generally less distortive nature of such tax types, as well as their smaller influence on the competitiveness of Hungarian products, thereby causing less harm to growth than taxes on income. Another important aspect is that the tax system take into consideration the actual tax-paying capacity of taxpayers. Also, the Government considers the improvement of the tax collection efficiency of the National Tax and Customs Administration (NAV) and enhancing the tools for combating the shadow economy as a key objective.

Chart 6.1: Change in the taxation structure

(per cent of total tax revenues)



Source: MfNE

Following the reforms, the weight of taxes on labour income decreased to a significant extent. While in 2010 the taxes on labour had an 8 percentage point higher share within the total amount of tax revenues than taxes on turnover/consumption and wealth, in 2013 the rate of taxes on labour is expected to fall below that of taxes on turnover/consumption and wealth (Chart 6.1). This reduction is mainly a result of the introduction of a flat-rate personal income tax system and the family tax allowance, the cancellation of base supplement scheme (super-grossing) of wages, and the measures of the Job Protection Action Plan.

Overall, the weight of taxes on capital income did not change, but certain structural changes have also occurred in this respect. Currently, its share is about 7% of total tax revenues, which is a sufficiently competitive level compared to regional peers. At the same time, as a response to the duality of the Hungarian economy, the burdens of the SME sector have decreased considerably. Simultaneously, the Government attempted to involve more intensively some highly profitable service provider industries, often dominated by a few large companies in the domestic market, in contributions to public burdens. This realignment is fostered by moving the lower threshold of the

10% corporate tax rate to 500 million HUF, the introduction of two new tax types for small enterprises (KATA, KIVA), as well as the growth of tax burdens on certain sectors.

The weight of taxes (mostly on consumption) promoting environmental protection/healthcare purposes has increased. For example, the rate of excise duty and certain product taxes has grown, the public health product tax and accident tax have been introduced, and the company car tax and the registration tax have been modified, taking into consideration environmental aspects.

The weight of consumption-/turnover-based taxes has increased. One of the factors contributing to this growth was the rise of the standard VAT rate. Also, further consumption-/turnover-based taxes, such as the telecommunications tax, the insurance tax and the financial transaction levy have also been introduced.

In addition, the Government made significant efforts to broaden the tax base and increase the number of taxpayers. As part of these endeavours, important measures have been taken to reduce the share of the shadow economy. These primarily focused on preventing corporate income from being concealed, since prevention of concealed income also entails a reduction in other forms of fraud (profit and wage concealment). Similarly, the expansion of the tax base is also supported by stricter regulations on deferring losses in the corporate tax, the revision of tax reliefs in the personal income tax, a reduction in the tax advantage for fringe benefits, and the limitation of the deductibility of items decreasing the local business tax base.

REFORM OF TAXES ON LABOUR INCOME

The 2010 tax system was by far the most progressive tax system representing the highest tax burden in the region. In that system, the marginal tax wedge was 64-67% already slightly above the average wage. However, the burdens of those with the highest incomes were relatively lower; since for them, the above mentioned rate was less than 60% due to the cap on social security (pension) contribution. The above highly progressive rate imposed a disproportionately high tax on income received for extra work (such as overtime work, shift allowance, bonus, income from secondary jobs), greatly encouraging the concealment of income, and representing an obstacle to attracting jobs with high added value to Hungary. In addition, a disadvantage was that the system did not take into account the number of persons in the same household.

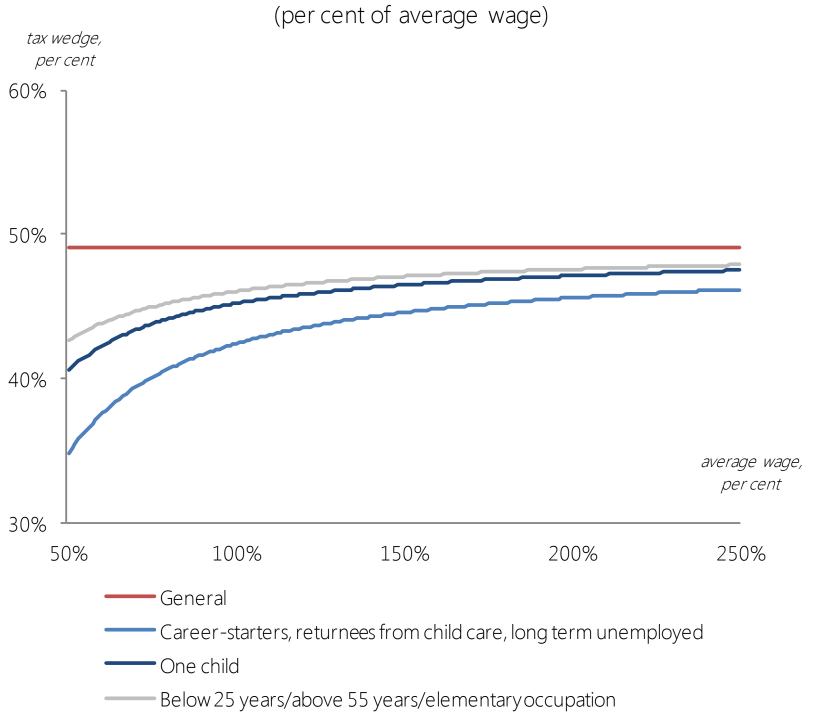
Between 2011 and 2013, taxes on labour were radically restructured. The main element was the introduction of a flat rate personal income tax system and a family tax allowance (2011), the cancellation of the general employment tax credit (2011-12), the cancellation of base supplement scheme (super-grossing) of wages (2012-13), the cancellation of the pension contribution cap (2013), and the introduction of the measures of the Job Protection Action Plan (2013). By 2013, the flat-rate, proportionate tax system has become complete. As a result of the reform, the marginal tax wedge fell below 50% in every income category. The modified tax system already took into account the number of persons in a household, and also provided assistance to the most disadvantaged to find employment.

Tax systems used in the region are progressive in the lower income categories, and then degressive for those with the highest incomes, whereas the Hungarian system is, as a rule, completely linear. This is because the system introduced in Hungary does not contain any general tax credit or basic tax relief, and the pension contribution cap, which favoured those with the highest incomes, has also been abolished. However, through the family tax allowance and the targeted tax reliefs of the Job

Protection Action Plan, the system provides more favourable conditions for the most disadvantaged groups of the labour market.

Chart 6.2: Average tax wedge in Hungary, 2013

(per cent of average wage)



Source: MfNE

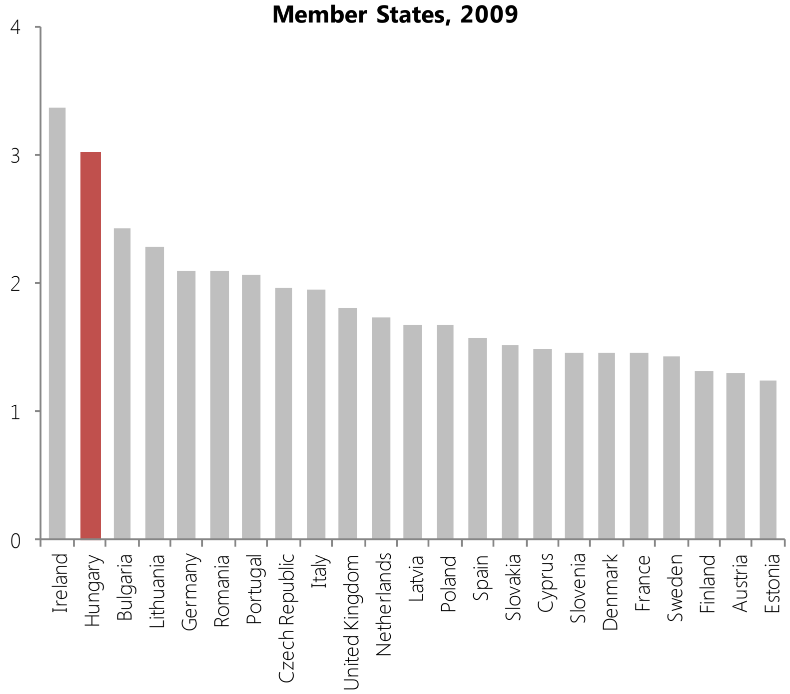
For groups with low level of labour force participation, the restructuring aims at increasing the activity. The participation rate in Hungary is the 3rd lowest in the EU, following Malta and Italy. The largest share of the difference can be attributed to the groups of workers in elementary occupations, the elderly, the young and women at a child-bearing age, while the activity of other groups is much closer to the EU average. Based on existing Hungarian and international surveys, it can be established that the activity and employment rate of the above groups are usually more responsive to various tax incentives. Earnings of workers in elementary occupations, young employees, and those returning to work after a longer period of time are typically lower; as a result, these are the groups where the probability of tax evasion is lower in case of a lower official wage. Against this backdrop, the targeted tax reliefs of the Job Protection Action Plan aim primarily at helping these employees to find employment.

For those in employment, the objective is to increase work intensity and reducing incentives for wage concealment. The high rate of people officially earning minimum wages or slightly higher wages is also a problem among those finding a job. Therefore, the most important aspects for them were an increase in work intensity and the reduction of elements penalizing earnings from additional work (part-time job, overtime, bonus) and incentives for wage concealment. This has been done by the introduction of the flat-rate tax system and the termination of the general employment tax credit, which encouraged registration with low wages. Another way of stimulating growth in work intensity is that the tax reliefs introduced via the Job Protection Action Plan are not phased out for higher wages. When establishing the target criteria, the minimisation of administrative burdens has also been an important aspect.

REFORM OF TAXES ON CAPITAL INCOME

The Hungarian economy is characterised by the duality of a well-developed corporate sector and an underdeveloped SME sector. Even though this duality is an existing phenomenon also in other countries of the region, the difference in productivity is prominently high in Hungary. The duality is well illustrated by the fact that, according to Eurostat data, the difference between the productivity of companies in foreign and domestic ownership is the second highest in Hungary, following Ireland. The large difference is due partly to the high level of development of the corporate sector in a regional comparison, and partly to the relatively underdeveloped SME sector.

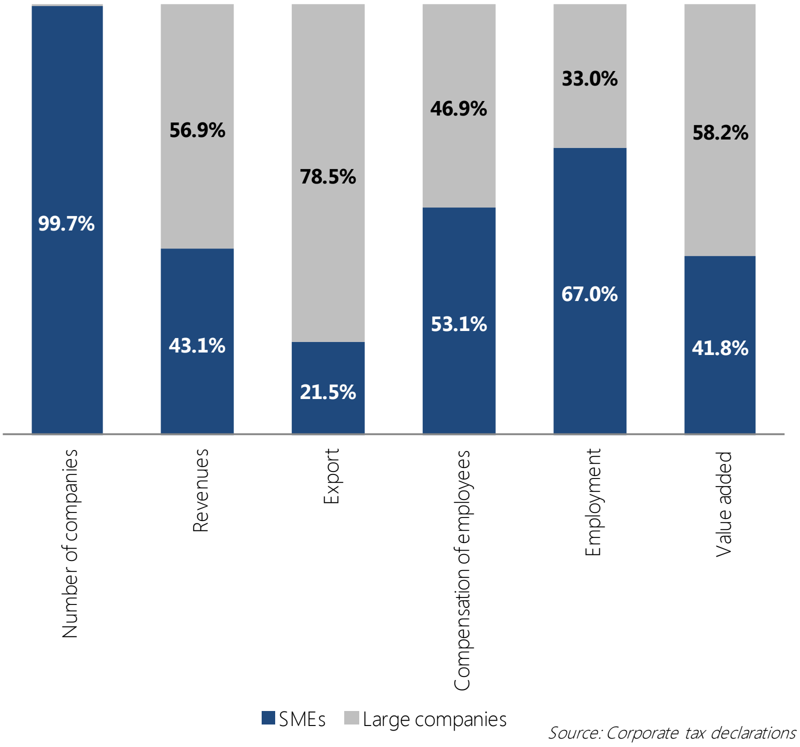
Chart 6.3: Ratio of productivity of foreign-owned companies to that of domestic-owned ones in EU Member States, 2009



Source: Eurostat

The settlement of the most competitive large corporations in Hungary contributes greatly to the increase in the productivity of the Hungarian economy, and, especially in the productive sectors, the expansion of export market share. However, the organic development of the economy and an economic policy aiming at employment growth are requires the strengthening of the SME sector, since about two-thirds of employees in the competitive sector is employed in this group.

Chart 6.4: The weight of SMEs in the economy



Source: Corporate tax declarations

The above mentioned considerations played a key role in the tax policy formulation of the Government. Accordingly, the reduction of tax burdens making the tax system more employment and growth-friendly, as well as simpler, are top priorities for small enterprises. To that end, the corporate income tax rate was reduced to 10%, and two new types of taxes were introduced through the Job Protection Action Plan. At the same time, the tax burden on certain sectors with higher capacity, in many cases strongly dominated by large corporations with a significant weight in the domestic market, was increased.

The lump sum tax for small taxpayers (KATA) is an option for the smallest businesses with sales revenues below HUF 6 million, which are typically self-employed entrepreneurs. The lump sum tax of HUF 50 thousand results in a minimum level of administration related to taxation. The favourable conditions and simplicity of this tax may contribute to the whitening of the economy.

The primary target group of the small business tax (KIVA), introduced as part of the Job Protection Action Plan, are small enterprises with growth prospects, which also play an important role in employment. In case of the enterprises opting for this tax, the tax burdens on labour and profits are equalised, meaning that a wage increase or the employment of a new employee does not influence the overall tax burdens of the business. Furthermore, due to the cash-based accounting tax base, incomes reallocated for the development of the business, e.g. investment, can immediately be deducted from the tax base, which is ideal for enterprises that are able to grow and develop. In addition, the cash-based determination of results greatly simplifies the preparation of tax returns.

To offset the loss of revenues during the crisis, the Government levied a temporary surtax on the banking sector and certain highly profitable sectors. Out of these, the surtax, on certain sectors was discontinued as of 2013. However, the Government continues to count on the increased contribution of sectors with higher capacity to public burdens. Accordingly:

- The tax on financial institutions will be retained.
- The income tax on energy suppliers will be retained, with a rate increased to 31% as of 2013.
- The newly introduced consumption-/turnover-based taxes (telecommunications tax, accident tax, insurance tax) are usually imposed on services provided by industries with higher tax bearing capacity.
- In 2013, the public utility tax was also introduced, which is payable by the owners of electricity, gas, water, sewage and telecommunications (phone, cable TV, Internet) lines (routes).

MEASURES TO REDUCE THE SHARE OF THE SHADOW ECONOMY

To reduce the share of the shadow economy, the Government has introduced, and plans to introduce in the near future, a number of measures. These measures primarily focus on preventing corporate income from being concealed, since the prevention of concealed income also entails a reduction in other forms of fraud (profit and wage concealment).

- An estimated value-added tax revenue of about HUF 350-550 billion (13-20%) is not realised as revenue in the budget due to the presence of the shadow economy. To lower the rate of VAT evasion, cash registers will be electronically linked up to the system of the Tax Authority (NAV) in 2013, following positive international examples. As a consequence of the measure, NAV will be capable of keeping track of the daily turnover of every cash register, which is a major deterrent to fraud and a key driver increasing the efficiency of audits conducted by NAV. There is international evidence for the efficiency of this measure. During the months in which various elements of the system were introduced in Bulgaria (August-October 2011 and January-March 2012), the increase in VAT revenue was as high as 10-40%. In Croatia, where cash registers were linked up to the system of the tax authority as of 1 January 2013, the industries concerned reported in January a turnover that was 31% higher than in the same month of the previous year. The connection of cash registers to the system of the tax authority will be implemented on the basis of the applicable government resolutions and NGM Decree No. 3/2013 (II.15.) in a scheduled manner. The authorities affected by the new regulation, as well as the cash register manufacturers, repair workshops and operators are currently preparing for the switch to the new system, there is no information on any obstacle to the switch. The revenues expected from this measure are further underpinned by instruments for the enforcement of taxpayers' compliance.
- As of 2013, strict limitations entered into force concerning cash transactions between businesses. Within a single transaction between the same parties, a maximum of HUF 1.5 million may be paid in cash monthly.
- The system of reverse charge VAT has been introduced in certain industries strongly affected by VAT fraud (cereals, protein crop and oil seed sectors). The measure exerted a noticeable effect on the trade of cereals already in the first month, in terms of both volume and value. Based on the experience gained in the first audits, there was a clear and abrupt reduction in the declared turnover of taxpayers subject to an audit with respect to earlier periods. This is especially noticeable in intra-community turnover, where abuse has previously caused significant damage to the budget.

- To fight against VAT fraud, a VAT return must be detailed on a per invoice basis as of 2013. For invoices above a limit of HUF 2 million, both the issuer of the invoice and the taxpayer exercising the right of tax deduction must prepare a detailed report on the data of the invoice in their VAT return. The recapitulative statement, already well-known in the EU for cross-border transactions, was used as a model, which has proved to be an effective tool against VAT fraud within the European Union.
- Currently, a large number of other instruments are also at the disposal of the state tax authority. During 2012, an efficient filtering mechanism, the so-called tax registration procedure, was introduced, which is used by NAV to prevent business associations formed with the purpose of tax evasion from being established. New types of VAT fraud can only be counteracted through instant action and rapid control mechanisms; for that purpose, the inspection of the realness of certain economic transactions was introduced in 2012, which is a fast and modern form of control meeting the above conditions. In 2012, the concept of increased tax authority supervision was introduced, and a number of legislative amendments entered into force enabling the acceleration of tax authority procedures, the prevention of malevolent procrastination, the efficient and dedicated use of NAV's audit capacities (extension of the presumption of delivery; extension of the right of proxies to take over documents; development of an estimation database; possibility of the processing of publicly available data by the tax authority; termination of mandatory audits; changes in the interest payment obligations of NAV; making the selection of VAT frequencies stricter; introduction of unrevealed trial purchases, extension of the mandatory electronic path; possibility of compulsory attendance by a witness; etc.).
- The sanctions associated with tax evasion have become significantly stricter, such as the 200% penalty in relation to the tax default if such tax default arose from revenue concealment. An efficient tax authority quickly responding to infringements of law and increased sanctions result in a considerably stronger general preventive effect.

ELECTRONIC TOLL

The Széll Kálmán Plan requires the enforcement of the "user pays" principle in transport so as to ensure that the operation, maintenance and renovation costs of the Hungarian road network can be covered from the revenue collected from road users, while also generating revenue for other actions in the area of transport. Eliminating the need for budget support for these purposes improves the budget balance.

The current (so-called e-sticker) toll payment system does not make it possible for road users to pay for the real operation, maintenance and renovation costs caused by their road use; therefore, the Government has decided to introduce an electronic toll payment system by 1 July 2013 at the latest.

The preparation and implementation of the investment necessary for introducing the system are being performed according to a schedule established in a Government Resolution: the appropriately qualified personnel necessary for the operation of the system will be available by 31 May 2013, while the launch of the complete system, along with toll collection and control functions, should take place on 1 July 2013 (after a test run).

In the system to be introduced, the various amounts of toll to be paid have been determined by the Government based on, inter alia, the following aspects:

- the basic toll is the J4 tariff level according to the cost calculation method stipulated in the Eurovignette Directive (which is the maximum level of toll that may be levied);
- the environmental subcategories start with a difference of ±15% in the J2 és J3 tariff categories, and ±20% in the J4 tariff category, while later, depending on the composition of the Hungarian vehicle fleet, they will reach the maximum 100% tariff difference according to the Eurovignette Directive in 6-10 years, with modifications every six-months;
- within six months after the introduction of the electronic toll system, a discount scheme will be launched for frequent users with the maximum level of 13%.

According to the relevant decision, the annual income from tariffs proportional to the distance travelled should result (after deducting the costs of operation) in a revenue surplus of HUF 150 billion annually (improving the budget balance) (i.e. HUF 75 billion for 2013 on a pro rata temporis basis).

As a result of the introduction of a toll system proportional to the distance travelled, the cost paid by the users of the Hungarian road system will be proportional to the load their use is actually causing. By launching a road toll system proportional to the distance travelled, the disadvantage of rail transport to road freight transport will become less pronounced.

7. Institutional features of public finances

Regulation of public finances

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

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

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

In accordance with the deadline set for the application of Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States, transposition will take place in the second half of 2013. Related legislative amendments, such as the proposals for the amendment of the act on the state budget or that of the act on the economic stability of Hungary, are planned to be discussed by the Parliament in October and will be adopted by the end of 2013.

In the framework of the transposition of the Directive, in the second half of 2012 a new state budget accounting system was set up, which will enter into force as of 2014 (Government Decree No. 4/2013 (I.11)). The new system will be able to manage cash-based accounting and accrual-based accounting with regard to public finances as a whole within a single system; in addition, a transparent and uniform economic and functional (COFOG-based) classification will be introduced.

The Fundamental Law provides for the composition and main tasks of the Fiscal Council. The members of the Fiscal Council are the President of the Fiscal Council, the Governor of the Magyar Nemzeti Bank and the President of the State Audit Office. The President of the Fiscal Council is appointed for six years by the President of the Republic. The provisions regarding the Fiscal Council's operation are set out in the Act on the Economic Stability of Hungary. The core activity of the Fiscal Council is to examine the budget bill and the proposed amendments to the Budget Act. Regarding the examination of the budget bill the Council's power is greater than formerly, as it has the right to veto in cases where the debt reduction rule is not met. In addition, the Council expresses its opinion on the planning and implementation of the central government budget, and on any issue related to public finances.

There is no change as regards the Hungarian statistical system of public finance.

8. Council recommendation adopted on 13 March 2012 in the context of the EDP

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

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

Chapters 3 and 6 of the updated convergence programme present the budgetary measures underpinning the fiscal targets. According to the spring 2013 EDP notification sent by the Central Statistical Office to Eurostat, the general government deficit was 2% of GDP in 2012, which is well below the deficit of 2.5% included in the EDP recommendation. In 2012, the deficit remained below the reference value even without the effects of one-off items still improving the balance. According to the calculations of the updated convergence programme, the structural balance improved by 3% of GDP compared to 2011 clearly exceeding what was recommended by the Council, and the MTO deriving from the Stability and Growth Pact has been significantly overachieved. In conformity with the EDP recommendation, the Government incorporated high reserve provisions (1.4% of GDP) in the 2013 budget. According to the convergence programme, in compliance with the EDP recommendation, the structural balance will continue to fulfil the MTO in 2013 (structural deficit of 1.7% of GDP).

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

The gross debt-to-GDP ratio has already declined in 2011, and, after further reduction, reached 79.2% in 2012 (this rate is only marginally higher than the backward-looking debt benchmark). Chapter 3.7 of the updated convergence programme presents in detail developments underlying the further permanent reduction of the public debt ratio. Based on the structural balance consistently overachieving the MTO over the horizon of the convergence programme, the public debt path, in accordance with the recommendation and paragraph 1a of Article 2 of Regulation (EC) No 1467/97 referred to therein, ensures sufficient progress toward compliance with the debt reduction benchmark for a period of three years from the correction of the excessive deficit.

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

Chapter 7 of the updated convergence programme presents the institutional framework of planning and implementation, and describes in detail the measures taken for the strengthening of such framework. In addition to the measures already described in the 2012 convergence programme, the Parliament adopted the amendment of the act on the economic stability of Hungary (Stability Act) on 24 September 2012. This amendment clarifies the scope of the Government regarding the assessment of compliance with the debt rule, and, at the same time, brings provisions in line with the Fundamental Law. The amendment primarily contains the clarification of certain provisions on the powers and functioning of the Fiscal Council in order to ensure that the conditions for the practical enforcement of the debt rule stipulated in the Fundamental Law are fully met. This amendment was adopted after consultation with the members of the Fiscal Council, with their agreement. The amended Stability Act includes the following main new provisions with respect to the enhancement of the powers and the operation of the Fiscal Council:

- The Fiscal Council examines compliance with the debt rule, delivering an opinion every six month on the state of play of the budget and the trends in public debt; furthermore, it is entitled to express an opinion on any issue related to the planning and implementation of the budget, as well as to management of other public spending. The amendment results in a broader scope of authority for the Fiscal Council; the Government shall submit to the Council for an opinion, in addition to the budget, the proposals which the budget is based on, including proposals for acts establishing payment obligations (taxes), and the Fiscal Council may express an opinion on such proposals.

- The operation of the Fiscal Council is supported by a secretariat of 5 persons. Besides the remuneration of the President, all other expenditures related to the functioning of the Council, as well as the remunerations of the employees of the unit supporting the operation of the Council are financed from the budget of the Office of Parliament.

- The State Audit Office and the Magyar Nemzeti Bank provide assistance to the Fiscal Council by providing it with studies and statements.

To strengthen medium-term budgetary planning, and in accordance with the deadline set for the application of Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States, transposition will take place in the second half of 2013. Related legislative amendments, such as the proposals for the amendment of the act on public finances or that of the Stability Act, are planned to be discussed by the Parliament in October and may still be accepted during 2013. In the context of the transposition of the Directive, in the second half of 2012 a new budgetary accounting system was set up, which will enter into force as of 2014 (Government Decree No. 4/2013 (I.11)). The new system will be able to manage cash-based accounting and accrual-based accounting with regard to public finances as a whole within a single system; in addition, a transparent and uniform economic and functional (COFOG-based) classification will be introduced.

TABLES

Table 1a. Macroeconomic prospects

	ESA-code	2012	2012	2013	2014	2015	2016
		HUF bn	percentage change				
1. Real GDP (at constant prices)	B1g	27,404	-1.7	0.7	1.9	2.3	2.5
2. Nominal GDP	B1g	28,276	1.4	4.3	5.3	4.6	4.7
Components of real GDP							
3. Private consumption expenditure	P.3	14,157.9	-1.4	0.1	1.8	1.8	1.8
4. Government consumption expenditure*	P.3	6,078.4	-2.2	-0.8	-0.8	-0.1	0.2
5. Gross fixed capital formation	P.51	4,796.1	-3.8	-0.2	1.3	3.5	3.5
6. Changes in inventories and net acquisition of valuables (per cent of GDP)	P.52+ P.53	19.1	-1.6	0.2	0.0	0.0	0.0
7. Exports of goods and services	P.6	25,981.9	2.0	3.3	5.8	6.1	6.1
8. Imports of goods and services	P.7	23,629.5	0.1	2.7	5.2	5.7	5.8
Contribution to real GDP growth							
9. Final domestic demand		-	-1.9	-0.2	1.0	1.5	1.6
10. Changes in inventories and net acquisition of valuables	P.52+ P.53	-	-1.6	0.2	0.0	0.0	0.0
11. External balance of goods and services	B.11	-	1.7	0.7	0.9	0.8	0.9

*/: Including government and NPISHs as well

Table 1b. Price developments

	2012	2013	2014	2015	2016
	percentage change				
12. GDP deflator	3.2	3.5	3.4	2.2	2.2
13. Private consumption deflator	5.1	3.1	3.2	3.0	3.0
14. HICP	5.7	3.1	3.2	3.0	3.0
15. Public consumption deflator	3.0	2.8	5.5	2.1	1.5
16. Investment deflator	1.1	2.7	2.7	2.5	2.5
17. Export price deflator (goods and services)	3.1	2.7	2.3	1.9	1.9
18. Import price deflator (goods and services)	4.0	2.6	2.5	2.4	2.3

Table 1c. Labour market developments

	ESA-code	2012 level	2012	2013	2014	2015	2016
			percentage change				
19. Employment, persons ('000;15-64)		3,842.8	1.7	0.5	0.8	0.9	0.9
20. Unemployment rate (%)		-	10.9	10.7	10.5	10.2	9.8
21. Labour productivity, persons		-	-3.4	0.2	1.1	1.5	1.5
22. Compensation of employees (HUF bn)	D.1	12,877.7	2.0	2.2	6.8	5.0	4.6
23. Compensation per employee (HUF million)		3.3	0.4	1.7	6.0	4.1	3.7

Table 1d. Sectoral balances

	ESA-code	2012	2013	2014	2015	2016
		per cent of GDP				
24. Net lending/borrowing vis-à-vis the rest of the world	B9.	4.3	6.3	6.9	6.8	4.7
of which						
- Balance of goods and services		7.6	8.5	9.0	9.2	9.4
- Balance of primary incomes and transfers		-6.0	-5.4	-5.4	-5.8	-6.2
- Capital account		2.7	3.2	3.3	3.5	1.5
25. Net lending/borrowing of the private sector including statistical discrepancy	B9.	6.3	9.0	9.6	9.0	6.0
26. Net lending/borrowing of general government	EDP B9.	-2.0	-2.7	-2.7	-2.2	-1.3

Table 2a. General government budgetary prospects

	ESA code	2012 HUF bn	2012 per cent of GDP	2013	2014	2015	2016
Net lending (EDP B.9.) by sub-sector							
1. General government	S.13	-566.7	-2.0	-2.7	-2.7	-2.2	-1.3
2. Central government	S.1311	-771.1	-2.7	-6.0	-2.9	-2.5	-1.5
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	207.6	0.7	2.4	-0.1	0.0	0.1
5. Social security funds	S.1314	-3.2	0.0	0.9	0.4	0.3	0.1
General government (S.13)							
6. Total revenue	TR	13,147.8	46.5	46.9	47.1	46.8	43.1
7. Total expenditure	TE[1]	13,714.5	48.5	49.6	49.8	49.0	44.4
8. Net lending/borrowing	EDP B.9	-566.7	-2.0	-2.7	-2.7	-2.2	-1.3
9. Interest expenditure	EDP D.41	11,80.3	4.2	4.1	3.8	3.6	3.4
10. Primary balance		613.6	2.2	1.4	1.1	1.4	2.1
11. One-off and other temporary measures[2]			0.6	0.0	0.0	0.0	0.0
Selected components of revenues							
12. Total taxes (12=12a+12b+12c)		7,205.4	25.5	26.3	26.0	25.7	25.5
12a. Taxes on production and imports	D.2	5,088.7	18.0	18.9	18.5	18.3	18.0
12b. Current taxes on income. wealth, etc.	D.5	1,961.0	6.9	6.9	7.0	7.0	7.1
12c. Capital taxes	D.91	155.7	0.6	0.5	0.5	0.4	0.4
13. Social contributions	D.61	3,736.7	13.2	12.8	12.8	12.8	12.6
14. Property income	D.4	273.4	1.0	1.0	0.7	0.6	0.6
15. Other		1,932.3	6.8	6.9	7.6	7.7	4.3
16.=6. Total revenue	TR	13,147.8	46.5	46.9	47.1	46.8	43.1
Tax burden[3](D.2+D.5+D.61+D.91-D.995)		10,942.1	38.9	39.3	39.1	38.7	38.4
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	4,948.2	17.5	17.3	18.0	17.3	15.9
17a. Compensation of employees	D.1	2,801.7	9.9	9.6	10.2	9.9	9.6
17b. Intermediate consumption	P.2	2,146.5	7.6	7.7	7.7	7.4	6.3
18. Social payments (18=18a+18b)		4,980.7	17.6	17.5	17.0	16.8	16.5
of which: Unemployment benefits[4]		65.0	0.2	0.2	0.2	0.2	0.2
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	617.0	2.2	2.2	2.1	2.0	2.0
18b. Social transfers other than in kind	D.62	4,363.7	15.4	15.3	14.9	14.7	14.5
19.=9. Interest expenditure	EDP D.41	1,180.3	4.2	4.1	3.8	3.6	3.4
20. Subsidies	D.3	355.9	1.3	1.3	1.1	1.0	1.0
21. Gross fixed capital formation	P.51	861.4	3.0	4.0	4.8	4.8	1.8
22. Capital transfers	D.9	509.8	1.8	1.5	1.5	1.4	1.4
23. Other		878.2	3.1	3.9	3.8	4.2	4.4
24.=7. Total expenditure	TE[1]	13,714.5	48.5	49.6	49.8	49.0	44.4

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

Table 2b. No-policy change projections

		2012	2012	2013	2014	2015	2016
		HUF bn	per cent of GDP				
1. Total revenue at unchanged policies		13,147.8	46.5	46.9	47.1	46.8	43.1

The table contains revenue projections based on measures till 15 April 2013.

Table 2c. Amounts to be excluded from the expenditure benchmark

		2012	2012	2013	2014	2015	2016
		HUF bn	per cent of GDP				
1. Expenditure on EU programmes fully matched by EU funds revenue		728.7	2.6	3.0	3.6	3.8	0.6
2. Cyclical unemployment benefit expenditure							
3. Effects of discretionary revenue measures		513.2	1.8	1.0	-0.1	0.0	0.0
4. Revenue increases mandated by law							

Table 3. General government debt developments

	ESA-code	2012	2013	2014	2015	2016
		per cent of GDP				
1. Gross debt		79.2	78.1	77.2	76.1	73.4
2. Change in gross debt ratio		-1.7	-1.0	-1.0	-1.0	-2.7
Contribution to changes in gross debt						
3. Primary deficit		-2.2	-1.4	-1.1	-1.4	-2.1
4. Interest expenditure	EDP D.41	4.2	4.1	3.8	3.6	3.4
5. Stock-flow adjustment		-3.1	-0.5	0.3	0.2	-0.6
Implicit interest rate on debt (%)		5.2	5.4	5.0	4.7	4.6

Table 4. Cyclical developments

	ESA-code	2012	2013	2014	2015	2016
		per cent of GDP				
1. Real GDP growth (%. at constant prices)		-1.7	0.7	1.9	2.3	2.5
2. Net lending of general government	EDP B.9	-2.0	-2.7	-2.7	-2.2	-1.3
3. Interest expenditure	EDP D.41	4.2	4.1	3.8	3.6	3.4
4. One-off and other temporary measures[1]		-0.6	0.0	0.0	0.0	0.0
5. Potential GDP (%)		0.3	0.9	1.1	1.3	1.5
contributions: - labour		0.1	0.4	0.6	0.7	0.7
- capital		0.4	0.4	0.4	0.4	0.5
- total factor productivity (TFP)		-0.2	0.0	0.1	0.2	0.4
6. Output gap		-3.6	-3.7	-2.9	-2.0	-1.1
7. Cyclical budgetary component		-1.6	-1.6	-1.3	-0.9	-0.5
8. Cyclically-adjusted balance (2-7)		-0.4	-1.1	-1.4	-1.3	-0.8
9. Cyclically-adjusted primary balance (8+3)		3.8	3.1	2.5	2.3	2.6
10. Structural balance (8-4)		-1.0	-1.1	-1.4	-1.3	-0.8

Due to the rounding the sum data could differ from the sum of the detailed data.
[1]: a plus sign means one-off item improving the structural balance.

Table 5. Divergence from previous update

	ESA-code	2012	2013	2014	2015	2016
Real GDP growth (%)						
1. April 2012 Convergence Programme		0.1	1.6	2.5	2.5	-
2. April 2013 Convergence Programme		-1.7	0.7	1.9	2.3	2.5
3. Difference		-1.8	-0.9	-0.6	-0.2	-
General government net lending (per cent of GDP)						
1. April 2012 Convergence Programme	EDP B.9	-2.5	-2.2	-1.9	-1.5	-
2. April 2013 Convergence Programme	EDP B.9	-2.0	-2.7	-2.7	-2.2	-1.3
3. Difference		0.5	-0.5	-0.8	-0.7	-
General government gross debt (per cent of GDP)						
1. April 2012 Convergence Programme		78.4	77.0	73.7	72.7	-
2. April 2013 Convergence Programme		79.2	78.1	77.2	76.1	73.4
3. Difference		0.8	1.1	3.5	3.4	-

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

	2007	2010	2020	2030	2040	2060
	per cent of GDP					
Pension expenditure		11.9	10.5	9.3	9.8	12.4
Old-age and early pensions		10.1	9.3	8.1	8.6	11.1
Other pensions (disability, survivors)		1.8	1.2	1.1	1.0	1.0
Health care, education and other age-related expenditure		10.4	10.4	10.4	10.7	11.6
Health care expenditures		4.9	5.1	5.4	5.7	6.1
Long-term care expenditures		0.8	0.9	1.0	1.1	1.4
Education expenditures		4.3	3.9	3.5	3.5	3.7
Other age-related expenditures		0.4	0.4	0.3	0.3	0.3
Pension contribution revenue		8.3	10.2	10.1	10.1	10.0
Assumptions						
Labour productivity growth		1.3	0.9	2.1	2.1	1.5
Real GDP growth		1.3	1.5	1.9	1.2	0.8
Participation rate, males (20-64)		74.7	79.5	80.2	79.0	79.2
Participation rate, females (20-64)		61.4	68.6	70.0	68.8	69.1
Total participation rate (20-64)		68.0	74.0	75.1	73.9	74.2
Unemployment rate	7.4	11.1	11.2	7.7	7.3	7.2
Population aged 65 + over / total population	15.9	16.7	20.0	21.8	25.1	32.2

[1]: Projections adopted by the EPC (Economic Policy Committee) in October 2012

Table 6a. Contingent liabilities

per cent of GDP	2012
Public guarantees	8.6

Table 7. Basic assumptions

	2012	2013	2014	2015	2016
Hungary: Short-term interest rate (annual average)	6.7	4.7	4.0	3.6	3.6
Hungary: Long-term interest rate (annual average)	7.7	6.0	5.2	4.8	4.8
HUF/EUR	288.8	293.1	293.1	293.1	293.1
World excluding EU, GDP growth	3.5	3.7	4.1	4.3	4.4
EU27 GDP growth	-0.3	0.1	1.6	1.7	1.8
Growth of relevant foreign markets	1.3	2.8	5.4	5.6	5.6
World import volumes, excluding EU	5.3	5.3	6.5	6.7	6.9
Oil prices (Brent, USD/barrel)	111.86	110.80	103.64	99.01	95.71