GOVERNMENT OF HUNGARY

REPORT ON THE MEASURES TAKEN IN RESPONSE TO COUNCIL RECOMMENDATION OF 13 MARCH 2012 UNDER THE EXCESSIVE DEFICIT PROCEDURE

OCTOBER 2012

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INTRODUCTION

Pursuant to the recommendation addressed to Hungary on 13 March 2012 in the context of the excessive deficit procedure, the Hungarian authorities submit a report to the European Commission and the Council presenting the progress achieved with measures adopted to bring the excessive deficit situation to an end, including the progress in the field of structural reforms.

The Council Recommendation required Hungary to correct the excessive deficit in 2012. On 30 May 2012 the Commission found that Hungary had taken effective measures to correct the excessive deficit, which assessment was confirmed by the Council on 22 June. The purpose of this Report is to present progress and achievements since that date.

The Report confirms that the Government is committed to achieving a budget deficit well below 3% of GDP and to keeping the public debt-to-GDP ratio on a permanent downward path; consequently, it is prepared to take the necessary measures even against the backdrop of considerably worsened growth prospects. However, the implementation of measures on a scale required to follow the deficit path outlined in the Convergence Programme in this markedly deteriorated external and internal growth environment would result in a demand contraction that would curb growth for a prolonged period, preventing the sustainable reduction of the deficit. Consequently, the Government has revised the deficit path of the Convergence Programme. The deficit numbers revised to 2.7% for 2012 and 2013 and to 2.2% for 2014 continue to facilitate the achievement of a deficit ratio permanently well below 3%, which is required for the abrogation of the excessive deficit procedure.

The new, conservative growth outlook described in the Report, and the structural measures to underpin the achievement of the deficit targets and the permanently declining debt ratio also substantiate the Government’s commitment to continue the negotiations with the international institutions with a view to concluding a precautionary agreement to provide a financial safety net while safeguarding the interests of Hungary.

The Report provides an overview of:

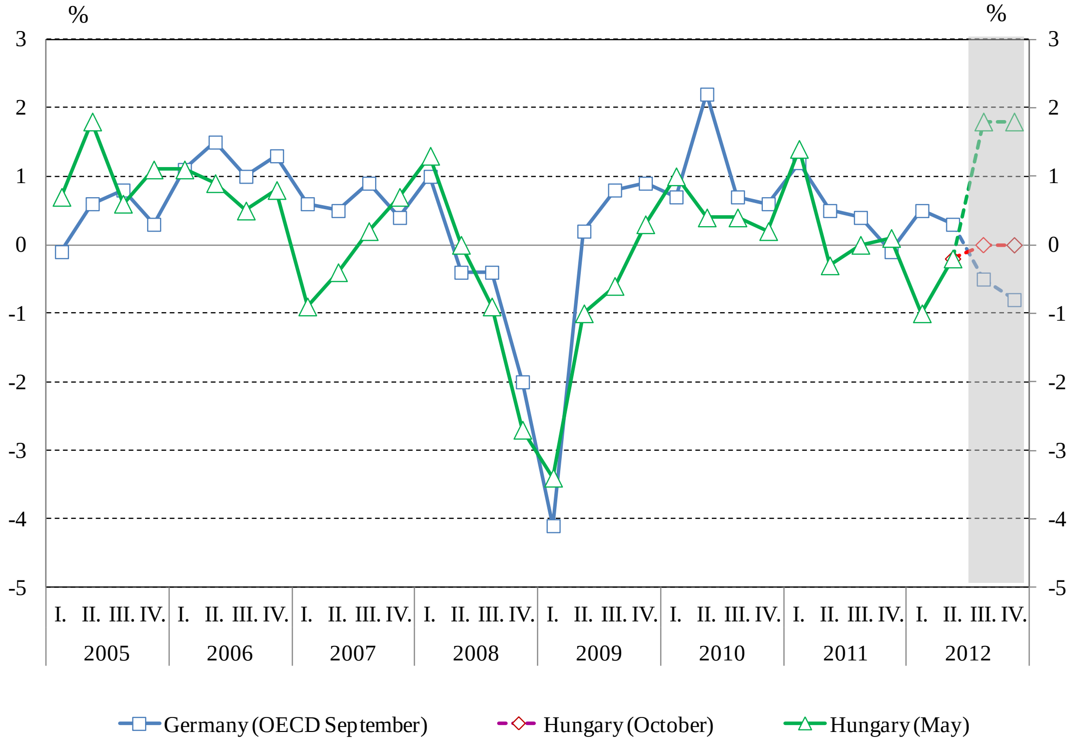
- the updated macroeconomic forecast for 2012 to 2014,
- budgetary developments and public debt trends in 2012-2014,
- the structural reforms implemented or planned to reduce the deficit with a lasting effect, as well as the changes implemented in the public finance governance in line with the Council recommendation.

The Report was discussed by the Government at its meeting of 4 October 2012, and subsequently submitted to the European Commission and the Council.

1. MACROECONOMIC DEVELOPMENTS

In 2012, due to the euro area debt crisis, growth in our main trading partner countries has been substantially lower than previously expected. According to the most recent OECD forecast (September 2012), Germany is facing negative quarter-on-quarter growth in the remaining part of the year. The 0.1% growth envisaged in the Convergence Programme and the budget proposal for this year would require such high growth in Q3 and Q4 that are highly unlikely in the present environment (see Figure 1). Meanwhile, domestic demand continues to be weak due to the continued balance sheet adjustment of households and the Government's expenditure cuts. Assuming that the Hungarian economy will stagnate in the second half of the year on quarterly basis, the volume of GDP will decrease by 1.2% on an annual basis. The carryover effect of the weak output figures of this year will have a negative impact on 2013 as well. In view of recent data releases and new fiscal measures, the Government has amended its macroeconomic forecast; the key figures are presented in Table 1.

Figure 1: Short term economic outlook for Hungary and Germany (seasonally adjusted quarterly growth rate)



The Job Protection Action Plan to be launched in 2013 (see Section 3.1.) will cut the tax burden on labour by almost another 1% of GDP. These measures will substantially improve employment and profitability in the business sector already in the short term, and in the long term they will contribute to the strengthening of investments and consumption.

Table 1: Key macroeconomic indicators

	2011	2012	2013	2014
	fact	forecast		
	annual percentage change			
GDP volume	**1.6**	**-1.2**	**1.0**	**2.5**
Household consumption expenditure	0.0	-0.8	-0.2	1.3
Gross fixed capital formation	-5.5	-5.8	0.0	1.2
Exports	8.4	2.6	6.6	6.8
Imports	6.3	1.4	5.1	5.4
Employment growth	0.8	1.1	0.9	1.5
Unemployment rate (15-74), %	10.9	10.9	10.7	10.5

Because of the protracted balance sheet adjustment, the consumption of households is expected to continue declining both in 2012 and 2013. Retail lending is subdued, while savings continue to be driven by precautionary motives. In 2013, various tax measures (combating VAT avoidance, excise tax hikes, taxation of cash transactions, reduction of local government social grants) will curb real wage growth through inflation and directly reduce disposable income. In 2014 the balance sheet adjustment of households may come to an end, thus consumption growth will resume.

Inflation will moderate from 5.8% in 2012 to only around 5% next year. In 2013, the excise tax hike as well as the expected food price shock and the measures against VAT avoidance will significantly contribute to the increase of inflation. After the one-off shocks, the inflation may return to around the inflation target of the Magyar Nemzeti Bank in 2014.

In 2012 the minimum wage increase, the required wage minimum and the introduction of the wage compensation scheme are likely to trigger a significant growth in labour income in the business sector. These effects will fade from 2013 on; the wage compensation will be phased out (to be abolished in the private sector in 2014). Subsequently, we expect moderate wage growth in the business sector. In the public sector, the freeze on wages will remain in place while the wage adjustment started in 2012 in the healthcare sector will continue and the career path model for teachers will be introduced in 2014.

With respect to the number of employees, the private sector is expected to record a more modest employment growth in 2013-2014 due to the less favourable domestic and external environment and the spill-overs from the European debt crisis. In the public sector the public work programmes will continue expanding while positions vacated by retirement will be cut, with the exception of areas critical for public functions such as healthcare. To sum up, in the total economy, employment growth of around 1% is expected in 2013 and 1.5% in 2014.

Against the background of the reviewing of disability pensions and the abolishment of early retirement programs, temporarily unemployment will decrease only at a moderate pace in the forthcoming years. Some of the persons returning to the labour market are likely to be unable to find jobs immediately, thus they will contribute to higher unemployment for some time.

The volume of gross fixed capital formation was by 5.8% lower in the first half of 2012 than in the same period of the previous year. The decline in investments in the national economy is attributable primarily to the poor performance of the construction sector. In contrast, investments in the machinery and equipment sector produced only a slight decline from the high base of last year. In recent years significant manufacturing investments came to Hungary, mostly in the form of large automotive industry projects. The deterioration of the global growth outlook and the tight credit conditions significantly reduced the level of investment in Hungary, with no bottoming out expected during the year. The volume of gross fixed capital formation may decline by 5.8% in the whole of 2012.

Due to the balance sheet adjustment of households and the slow improvement in the labour market environment we expect no expansion in housing investments in the short term. However, a government interest rate subsidy scheme may be an effective tool to attenuate the decline while the new Labour Code and the Job Protection Action Plan will improve both labour market prospects and competitiveness, and thus the willingness and ability of the private sector to invest. Relying on EU funds, the volume of public investments will rise significantly in 2013. Similarly to previous years, the funds will be used for infrastructural investments and in agriculture. As a result, gross fixed capital formation may stagnate in 2013, to be followed by a growth of 1.2% in 2014.

The macroeconomic outlook does not take into account the positive effects of the EU-IMF agreement to be concluded shortly. Thus with technical assumptions derived from the present yield curve and exchange rates, disregarding the strengthening of consumer and business confidence and the recovery of bank lending expected from the agreement, we calculate with a more modest growth outlook than the path that can be realistically expected. This conservative planning provides additional reserves for the achievement of the fiscal deficit targets. (The macroeconomic outlook described in this chapter already includes the macroeconomic effects of the new measures discussed in the Report.)

2. BUDGETARY DEVELOPMENTS

2.1. BUDGETARY DEVELOPMENTS IN 2012

The calculations prepared for the Report substantiate a slight overrun of the deficit target set in the Convergence Programme for this year (2.5% of GDP).

After the adoption of the 2012 Budget Act, the government took several measures to improve the balance. Even though the revenue decreasing effects of the decline of some real economic indicators were to some extent offset by higher inflation, revenue developments reflect mostly effects of the revenue increasing measures adopted during the year. In the course of 2012

- the excise tax on tobacco products was increased as of 1 February, then on 1 July,
- in order to promote the whitening of some sectors of agriculture, the reverse charge mechanism introduced as of 1 July will increase VAT revenues,
- a new tax on telecommunication services (telecom tax) was imposed on 1 July.

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. At the same time, some expenditure-increasing measures have also been adopted: buy-out of PPP projects (originally HUF 15 billion) and raising the so-called EU Own Resource Fund (originally HUF 50 billion) to stimulate EU co-financed projects.

The one-off revenue from the sale of telecommunication frequencies (HUF 44 billion) will not be realised in 2012 and the methodological change in the recording of EU transfers ("back-posting" the HUF 58 billion received in January to 2011) will also worsen the balance. The asset transfer relating to the step-back of private pension fund members into the state pension pillar this year increased the revenues (HUF 59 billion).

The encouraging half-year data indicate an improvement in the balance of local governments in addition to the level envisaged by the Convergence Programme.

The CSO figures on the accrual-based deficit on the first two quarters showed a favourable picture: the deficit in the first half of the year was slightly less than half of the deficit expected for the entire year. Nevertheless, mainly to alleviate tensions in some expenditure items (so-called human normatives, pharmaceutical subsidies, pension expenditures where supplementary increases will be implemented as required by law because of the higher inflation forecast), at its meeting of 4 October 2012 the Government decided on balance improving measures (mostly freezes) amounting to 0.4% of GDP in aggregate, which have already been incorporated in the forecast:

- freezes in the expenditure appropriations of central budgetary institutions and chapter-administered appropriations (HUF 49 billion),
- freezing some of the general reserve for extraordinary government measures (HUF 20 billion),
- freezes in the PPP and EU Own Resource Fund appropriations (HUF 3+20 billion),

- savings in the asset chapter and the expenditures of the National Land Fund (HUF 5 billion in total),
- balance improvement in the National Employment Fund (HUF 16 billion),
- improvement of the balance of the National Cultural Fund and the Research and Technological Innovation Fund (RTIF) (HUF 4 billion in total)
- bringing forward the date of the excise tax hike on tobacco products to 1 December (HUF 2 billion),
- changes in the rules applicable to the innovation contribution (HUF 15 billion).

As a conservative estimate, if the downside risks relating to both budgetary expenditures and revenues materialize in the remaining part of the year, the deficit is expected to be 2.7% of GDP. If, however, the upside risks of the forecast prevail, the deficit may decrease to 2.5% of GDP.

2.2. FISCAL OBJECTIVES FOR 2013 AND MEASURES UNDERPINNING THEIR ACHIEVEMENT

The Budget Bill for 2013 submitted to Parliament was built on a macroeconomic projection assuming GDP growth of 1.6% with modest household consumption growth. In line with the path set in the Convergence Programme, the Budget Bill defined the deficit target at 2.2% of GDP and it also contained the measures described in the Convergence Programme. Major changes were implemented in the first stage of the parliamentary debate:

- In 2013 the wage adjustment that was launched this year will continue in the healthcare sector, to be financed from the excise tax hike and the higher revenues from the tax on unhealthy food.
- A Job Protection Action Plan amounting to a total of HUF 300 billion (or HUF 270 billion net excluding the public sector) has been announced in order to boost employment, improving the position of the most disadvantaged labour market groups and reducing the burden on the SME sector, which provides a substantial part of jobs (In light of the adoption of the rules governing the small business tax in October, the revenue shortfall may be HUF 15 billion lower). The main elements of the Action Plan include the targeted reduction of the cost of employing persons below 25 or above 55 years of age employed for unskilled jobs, as well as mothers and long-term unemployed returning to the labour market; the reduction of the taxes and administrative burdens on self-employed micro-entrepreneurs and the introduction of the small enterprise tax offering significant benefits to businesses with no more than 25 employees.
- The Parliament identified the funding for the Action Plan partly in the improved efficiency of tax collection and partly in the reduction of interest expenditures resulting from the expected better yield environment after the conclusion of the EU/IMF agreement. The scope of the financial transaction tax has been extended beyond the commercial banks to the Hungarian State Treasury and the Magyar Nemzeti Bank (MNB).

The fiscal balance indicators in the Report do not reckon with any financial transaction tax receipts from the MNB while, in order to prevent excessive demand contraction in the present macroeconomic environment, they continue to take into account the favourable effects of the successful conclusion of the negotiations on interest expenditures. It can be concluded that in light of the macroeconomic scenario being worse than had been expected at the time of preparing the Budget Bill, additional balance improvement measures are required to keep the deficit well below 3%. (The amendment of the Act on Public Finance and the Stability Act creates the possibility to modify the budget's headline figures approved in the first stage of the parliamentary debate before the final round of voting.)

The fiscal effects of the proposed new measures, calculated on a gross basis, amount to HUF 397 billion (1.3% of GDP). Measures are concentrated in seven areas:

INCREASING THE EU CO-FINANCING RATE OF PROJECTS

With the conclusion of the EU/IMF agreement Hungary will be able to make use of the so-called top-up mechanism during the period of the agreement. This will reduce the domestic co-financing rate from 15% to 5%. This mechanism is facilitated by EU legislation and has been used by other Member States and formerly also by Hungary.

REDUCTION OF GOVERNMENT BUREAUCRACY

One of the Government's priorities is to create a cheaper state, performing public functions with fewer persons and higher efficiency. To that end, a three-year hiring freeze will be introduced in the public sector, effectively amounting to the mandatory retirement of persons reaching the retirement age and a prohibition of filling the vacancies thus created. In addition, it will no longer be possible to receive both wage and pension (or early retirement benefit) simultaneously in the public sector.

In order to obtain a conservative estimate of the expected savings, the calculations also consider the possibility that some areas may have to be partially or fully exempted from the hiring freeze to assure the uninterrupted performance of their functions.

MORE EFFICIENT WAGE CONTROLS IN THE PUBLIC SECTOR

The Government Resolution No. 1122/2012. (IV. 25.) on certain measures to be implemented in the framework of the expansion of the Structural Reform Programme (Széll Kálmán Plan) already stated the Government's intention to delay the introduction of the new career path model for teachers, as described in the Act on National Public Education, from September 2013 to January 2014 in light of the macroeconomic and budgetary conditions. This measure achieves savings in September-December 2013.

IMPROVED TARGETING OF SOCIAL BENEFITS

A cap will be introduced on the aggregate amount of certain cash benefits (social assistance and grants) within the competence of the town clerk, local governments or district government payable to a single household/family. The aggregate amount of the regular social assistance and the employment substitute benefit is already capped; the measure aims to expand the scope of benefits falling under the ceiling on payments. Incentive to take up employment will be strengthened as substantially higher income from labour will be available than through social transfers. To that end, the ceiling may be set at the level of the public employment net wage.

Elimination of the regressive rates for social security 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 burden on low-income earners, consequently without substantively lowering employment and consumption, while the social security contribution will also become linear.

Financial transaction levy

The financial transaction levy payment obligation of the Hungarian State Treasury will be increased and a 0.3% rate on cash withdrawals will be introduced to limit the use of cash, which, in addition to its direct revenue impacts, is conducive to whitening the economy.

Whitening the economy, combating tax avoidance, substantive improvement of the efficiency of tax collection and different rules for the small business tax

The reverse charge mechanism, which was successfully introduced in some sectors in 2012, will be expanded to the swine sector as of 1 January 2013.

The annual value added tax revenue shortfall attributable to the shadow economy is estimated to be close to HUF 350-550 billion (13-20%). Encouraged by the positive experience of other countries, the electronic connection of cash registers to the tax authority (NAV) will be introduced in order to repress VAT fraud.

The regulation of the small business tax as it was adopted in October deviates from the original proposal in some elements. For instance, it will be possible to defer losses without limitation in the case of costs relating to new investments; this element is meant to promote investments. In addition, in order to assure the integrity of the tax system and to prevent tax optimisation, the definition of the taxable income has been clarified in several instances. As a result of the changes, the revenue shortfall for the budget will be less than originally expected.

Table 2: Fiscal effects of additional balance improving measures in 2013 (HUF Bn)

Measure	Gross effect
1. Increasing the EU co-financing rate of projects	**55**
2. Reduction of bureaucracy	**30**
3. More efficient wage controls in the public sector	**73**
4. Improved targeting of social benefits	**8**
5. Elimination of the regressive rates for social security contributions	**51**
6. Financial transaction tax	**60**
a. Increased payment obligation of the State Treasury	*30*
b. 0.3% financial transaction levy on cash withdrawal	*30*
7. Whitening the economy, combating tax avoidance, substantive improvement of the efficiency of tax collection and different rules for the small business tax	**120**
a. Combating tax avoidance: expansion of reverse charge VAT to swine trade	*10*
b. Combating tax avoidance: connecting cash registers to the NAV	*95*
c. Different regulation of the small business tax	*15*
Total	***397***

Using a conservative estimate, in the worsening macroeconomic environment the deficit of the general government, excluding revenues from financial transaction levy from the MNB, could rise above 3% of GDP without additional fiscal consolidation measures. The Government, however, is committed to the reduction of the public debt and the sustainable correction of the excessive deficit, therefore the budget will include such consolidation measures.

Furthermore, the increased uncertainty in the macroeconomic environment necessitates the increase of the extra reserves to cover unexpected risks.

The transaction levy collected from the Hungarian State Treasury and the levy on cash withdrawals significantly contribute to the generation of the extra reserves (the HUF 160 billion Country Protection Fund) which is higher than originally planned.

The additional balance improving measures assure that the general government deficit remains well below the 3% threshold in 2013 as well. In the Government’s view a greater adjustment, which would be required to achieve the original deficit target of 2.2%, would endanger the still fragile economic recovery to start next year.

Table 3: Main components affecting the 2013 deficit (% of GDP)

	2013
Balance in the Convergence Programme and in the submitted budget bill	**-2.2**
Wage adjustment in healthcare	-0.2
Funding for wage adjustment in healthcare (excise tax, tax on unhealthy food)	+0.2
Job Protection Action Plan	-0.9
Reduced interest expenditure as a result of the agreement	+0.3
Increased tax collection efficiency, others	+0.6
Reduction of tax revenues (macro path, elimination of risks, MNB transaction levy)	-1.2
Surplus of primary expenditures (macro path, elimination of risks)	-0.4
Revenue from frequency sale originally planned for 2012	+0.1
Cancellation of extra reserves (Country Protection Fund)	+0.3
Without balance improving measures and the Country Protection Fund	**-3.4**
Net effect of additional measures	+1.2
Restoring and increasing of extra reserves (Country Protection Fund)	-0.5
2013 balance	**-2.7**

2.3. Fiscal objectives for 2014

For 2014, the Report envisages a deficit target of 2.2% of GDP, slightly above the figure included in the Convergence Programme. The achievement of this target is assured by the long-term expenditure cuts and revenue increasing measures already adopted.

Even though household consumption and employment will both grow in 2014, the structure of growth will continue to be driven by exports. Large tax bases will expand at a rate below GDP growth, thus the ratio of tax revenues-to-GDP will decline.

However, the expenditure-to-GDP ratio will fall at an even higher rate, assuring the improvement of the balance. Despite the additional expenditures incurred through the introduction of the career path model for teachers, the growth of the wage bill will not exceed nominal GDP growth, and no significant real growth is expected in the purchase of goods and services either. Social benefits, which represent the most sizeable item on the expenditure side, are expected to expand at a rate below GDP growth in view of the legal regulations and the adopted or proposed measures (preservation of the real value of pensions, improved targeting of social benefits, etc.).

2.4. Public debt developments

Taking into account the most recent figures, at end-2012 the debt ratio may be 78.3% as opposed to the 81.4% at end-2011, and it may continue falling in subsequent years in line with the debt reduction objectives.

Table 4: Development of public debt

Debt ratio (per cent of GDP)	2012	2013	2014
2012 CP	78.4	77.0	73.7
October 2012 Report	78.3	77.5	74.4

The shift in the debt path since the 2012 Convergence Programme is attributable to the combined effect of offsetting factors. The most notable factors include the following:

Budget deficit

The Convergence Programme envisaged a deficit of 2.2% of GDP for 2013, while the present forecast is based on a 2.7% deficit – which increases the debt ratio by 0.5 percentage points. For 2014, the Report reckons with a deficit of 2.2% as compared to the 1.9% in the Convergence Programme, which adds another 0.3 percentage points to the debt ratio for 2014.

Exchange rate

Instead of the 299.4 HUF/EUR exchange rate of the Convergence Programme, this projection uses 283.4 HUF/EUR in line with the most recent technical exchange rate assumption. This resulted in a HUF 500 billion lower debt stock forecast for end-2012, that is, a drop in the debt ratio of 1.7 percentage points. The appreciation has a similar result on 2013 and 2014 as well.

Growth

The present forecast contains lower GDP growth than the Convergence Programme. The lower nominal GDP shifted the projected debt ratios upwards, by 0.9 percentage points in 2012 and by 0.8 percentage points in 2013. For 2014, however, the updated nominal GDP forecast is higher than the figure included in the Convergence Programme, which results in a 0.1 percentage point lower debt ratio.

3. Structural Reforms

3.1. Reforms in the Tax System

When designing the measures implemented since the Convergence Programme, the Government has attributed great importance to combating the shadow economy and to increasing the proportion of indirect taxes and reducing, as far as possible, the ratio of taxes on labour. This promotes the attainment of the objective of fostering employment stated in the Structural Reform Programme (Széll Kálmán Plan).

REVENUE INCREASING MEASURES

INTRODUCTION OF A FINANCIAL TRANSACTION LEVY

As of 1 January 2013, a levy on financial transactions will be introduced with the aim of improving the general government balance; this plan was already outlined in the Convergence Programme. The new levy is a kind of turnover tax, with a broad base, a rate of 0.1% and a threshold of HUF 6 thousand. The levy is regulated by Act CXVI of 2012 on the financial transaction levy. With a view to combating tax avoidance, measures to encourage electronic payments will be introduced along with the introduction of the levy. Furthermore, in order to prevent a shift from wired transactions to cash based transactions and to repress the use of cash which strengthens the grey economy, a higher rate of 0.3% will be applicable to cash withdrawals, which will add another HUF 30 billion to the proposed revenues from the levy.

Revenues of HUF 140 billion are expected from the levy on the taxable transactions of commercial banks, postal money orders and currency exchange transactions. Pursuant to the agreement with the Banking Association, the regulation of the levy may be reviewed in 2013 in light of revenue developments. In order to address implementation risks, the Government, in cooperation with the Banking Association, will review the time proportionate development of revenues at mid-year and decide on raising the rate of the transaction levy if deemed necessary.

The Hungarian State Treasury may pay HUF 40 billion of levy (which is effectively an expenditure-side structural measure), while at present the Government reckons with no transaction levy receipts from the Magyar Nemzeti Bank among the balance improving measures listed in Table 2.

IMPROVING THE EFFICIENCY OF TAX COLLECTION

The annual value added tax revenue shortfall attributable to the shadow economy is estimated to be close to HUF 350-550 billion (13-20%). In order to repress VAT fraud, cash registers will be connected electronically to the National Tax and Customs Administration (NAV), i.e., the connection will link points of sale with the tax authority. In Europe, similar systems have been implemented in various sectors in Bulgaria and Sweden, and Croatia is also considering the introduction of such a system. The experience of other countries has shown a marked, 7-20% increase in reported sales.

To combat the grey economy in the swine sector, the introduction of a reverse charge mechanism for VAT is proposed from 1 January 2013 (to be approved by Parliament at its autumn session); this may contribute another HUF 10 billion to the budget by whitening the economy.

In the view of the Government, the improvement of tax collection efficiency by the NAV and the expansion of its toolset to combat the shadow economy is an indirect means of public debt reduction, hence a priority goal.

The regulation that entered into force on 1 January 2012 added a number of new instruments to the audit tool box of NAV (tax registration procedure, more intensive tax control over high-risk taxpayers).

In 2013 more regulation will be implemented to support the fight against the shadow economy: as of 1 January 2013, the domestic recapitulative VAT statement will be introduced, e-invoicing will be simplified and the cap on cash payment between taxable persons will be lowered to HUF 1.5 million.

EXCISE TAX RAISE

From December 2012 on, the rise of the tax on tobacco products will have additional annual effects of around HUF 20 billion; the relevant Bill is currently being drafted. The excise tax on alcohol will be increased in January 2013 and the excise tax on LPG will be raised in two steps in 2013, yielding an additional HUF 10 billion excise tax revenue per year. (This proposal has already been submitted to Parliament, expected to be approved in the autumn session.)

ABOLISHMENT OF THE CEILING ON SOCIAL SECURITY CONTRIBUTIONS

The abolishment of the cap on social security contributions is in compliance with the establishment of a linear system of taxes on labour. The annual fiscal effect of the measure: HUF +51 billion.

MEASURES RESULTING IN THE REDUCTION OF REVENUES

JOB PROTECTION ACTION PLAN

The purpose of the Job Protection Action Plan approved by the Government and adopted by Parliament is to reduce taxes on labour in a structure conducive to increasing employment without providing incentives to under-report income. The Action Plan has the following key elements:

The **targeted social contribution tax benefits** are intended to protect the jobs of people in the worst labour market positions and to facilitate their entry in the labour market and their job search. When identifying the target groups[1], we considered the findings of a number of Hungarian and international empirical studies, which show that tax incentives have the most marked effect on the employment of these groups. The cost efficiency of the measure is assured by the careful selection of the target groups. As a result, there is no need to phase out benefits in higher income categories. In addition to simplifying the system, this arrangement also avoids penalising additional work or overtime and provides no incentive to conceal income. The simplicity of the system is assured through the simple set of criteria applied.

The purpose of the **lump-sum tax for enterprises with a small tax base** is to significantly reduce the tax burden on self-employed micro-entrepreneurs after the foundation of the enterprise, as it represents a barrier to entry, and to radically cut administrative burdens. The measure may also facilitate the inclusion of large groups in the - formal - labour market.

[1] Persons below 25 or above 55 years of age; persons employed in unskilled positions; persons returning to work after long-term unemployment or child care fee/child care allowance/pregnancy-confinement allowance

The **small business tax** aims to reduce the burdens on the sector of typically highly labour-intensive small businesses, which maintain a sizeable portion of jobs and which are severely hit by the crisis, and to make the system more employment-friendly. The small business tax is imposed, at a rate of 16%, on the cash-based profits of the enterprise plus the gross wage bill of its employees. This represents a reduction of levies as besides the corporate income tax, the tax replaces the social contribution tax payable on the wage bill and the vocational training contribution; the 16% tax rate is significantly lower than the aggregate rate of 28.5% of these levies. Furthermore, the replacement of the three taxes also reduces the administrative burden on businesses.

The uniform tax rate on profits and on the wage bill is intended to promote employment and wage growth. Under this regime, the tax liability of the business does not grow when a new employee is hired as long as only the wage costs increase at the expense of profits but the new employee produces no additional revenues. The tax liability of the business also remains unchanged in the event of a wage increase financed from profits.

This tax intends to promote business growth and investment through the new, cash-based definition of corporate profits rather than through tax benefits to capital income. This arrangement assures that any profit reinvested for capital investment purposes can be immediately deducted from the tax base. As another advantage, the cash basis is relatively simple to calculate; furthermore, the chargeability of the tax is better adapted to the current liquidity position of the company.

Also importantly, event through the taxable amount must not fall below the wage bill, losses can be deferred in the small business tax regime as well: any negative profit can be deducted in equal instalments from profits in the ten years after the loss occurs. Furthermore, the regulation affords special preferential treatment to investments for the acquisition or production of new, previously not used assets or intellectual property, in that any deferred losses can be set off without any limitation against profits or the wage bill.

The introduction of the **cash accounting scheme for VAT** (in line with the EU VAT Directive) allows enterprises selecting this regime to pay VAT only after the invoice is settled. The regulation also assures that the purchaser can apply for a VAT refund only after the settlement of the invoice, thus the arrangement has no substantive fiscal impact. The measure promotes the preservation of jobs through improving the liquidity of SMEs.

In a static approach, and taking into account the impact of the approved amendment of the regulation on the small business tax, the Job Protection Action Plan devotes a total of HUF 285 billion (HUF 255 billion net without the public sector), on an accrual basis, to retaining existing jobs and creating new ones; however, its direct macroeconomic effects also add HUF 70-80 billion to tax and contribution revenues.

Table 5: Effect of measures compared to the calculations in the Convergence Programme, 2013 (ESA, HUF billion)

Measure	effect
Measures to increase revenues	
Effect of the introduction of the FTL (without MNB, compared to the lower edge of the band in the Convergence Programme)	80
Electronic connection of cash registers	95
Reverse charge VAT (swine)	10
Excise tax raises	30
Abolition of social security contribution ceiling	51
Total	**266**
Measures resulting in the reduction of revenues	
Job Protection Action Plan static net	-255
Total	**-255**
Balance	**11**

BAN ON SLOT MACHINES

Though not a taxation measure, the ban on slot machines is expected to cause a direct gambling tax shortfall of approximately HUF 30 billion. To offset this effect, the Government is proposing to adopt regulations facilitating the taxation of on-line gambling. Furthermore, the income of households (which tend to have a high propensity to consume) available for consumption may increase as a result of the decision, which is an upside risk for VAT revenues, but this effect is not taken into consideration in the macroeconomic outlook.

3.2. LOCAL GOVERNMENTS

The Structural Reform Programme requires total savings of HUF 100 billion to be achieved in the local government subsystem for 2012 and 2013. Of which:

- more than HUF 20 billion comes from the improvement of the balance of local governments, and thus of the general government, mostly because, as a general rule, local governments have not been allowed to borrow or issue bonds without the consent of the Government since 1 January 2012,
- another HUF 20 billion is realised in central chapters through the takeover by the state of institutions previously maintained by county governments,
- HUF 56 billion will be saved on budget transfers, consisting of the following items:
    - HUF 15 billion incorporated in the base in the 2012 Budget (reduction or abolition of certain transfers);
    - HUF 12 billion is moved from the appropriations for centralised development subsidies into the balance reserves of chapters pursuant to the 2012 Budget;

- HUF 4 billion comes from the freezing of the supplement to certain income substitution benefits;
- HUF 25 billion in the 2013 Budget Bill: HUF 10 billion by reducing subsidies to the local public transport of Budapest, HUF 15 billion through the reduction of the normative transfers for administration due to the centralization of offices, because of the abolition of such transfers, the reduction of the transfers incorporated into the general budget transfer.

PUBLIC EDUCATION

Local governments will be responsible for kindergarten provisions, the maintenance of schools in settlements with more than 3000 inhabitants as a general rule, as well as provision for the meals of children in both kindergartens and schools. The central government will be responsible for the financing of the salaries of teachers and persons directly assisting their work, the maintenance of vocational training institutions and, as a general rule, the operation of schools in settlements with fewer than 3000 inhabitants.

The cost implication of the tasks taken over by the central government is HUF 371 billion in total, of which HUF 346 billion was reallocated in the planning phase into the budget chapter of the Ministry of Human Resources (MHR). The reallocation of another HUF 25 billion into the MHR chapter is required for the maintenance of schools in settlements with fewer than 3000 inhabitants, the maintenance of vocational training institutions and the cost of the administrative staff of the Klebelsberg Institution Maintenance Centre.

SOCIAL AND CHILD PROTECTION SPECIALIZED CARE

From 2013 on, the central government will take over the maintenance of institutions of specialised care for disabled persons, psychiatric patients and victims of addiction and institutions of child protection, together with the related functions. The specialised care (residential care) obligation of local governments will be limited to elderly and homeless persons.

The cost of the social and child protection care functions taken over by the central government amounts to HUF 16.3 billion overall. The financing of the old age allowance and the caregiver fee, also moved to the state (into the competence of district government offices), requires HUF 18.3 billion based on the 2012 disbursement figures (to be funded in its entirety from the year 2012 transfers).

Simultaneously with the reallocation of public tasks and the rearrangement of funding, the system of moderating the differences in revenues will also be abolished. Instead, the entire revised system of transfers and in particular general operational subsidies assist local governments to have equal opportunities in performing their tasks.

Administrative tasks moved to district government offices

The number of public administration tasks currently performed by local government entities (town clerk, mayor, in exceptional cases officials) will be reduced, some of the cases being moved to the district level government offices to be set up on 1 January 2013. Most of the functions transferred relate to the tasks of the official documentation bureaus and public guardianship offices.

Through the district government offices the Government intends to establish a more streamlined and cost efficient system, thus the necessary staffing had to be determined based on the future structure of responsibilities of the district offices rather than the figures of the present local government operations. It was also a consideration that no wage increase or reclassification should be applicable to the staff transferred and only the essential purchases of goods and services can be recognized.

Based on model calculations, the government offices are planned to have 10 thousand staff, and the transfers to the offices was determined based on the “per capita” sums adjusted for that level.

For this purpose, some HUF 30 billion was moved from the local government chapter to the chapter of the Ministry of Public Administration and Justice (MPAJ) to provide for the operation of government offices in districts and in Budapest. In addition to those funds, the Government made an additional HUF 13.8 billion available to the MPAJ (partly for the operation of the government offices and partly to establish ‘government windows’). Thus in 2013 close to HUF 43.8 billion is available for the operation of district government offices.

3.3. Pharmaceutical subsidies

On 1 August 2012 the new Section 40/A (1) of the Act on the secure and efficient supply of pharmaceuticals and medical aids and on the general rules of the distribution of pharmaceuticals entered into force. It provides that the marketing authorisation holder of a pharmaceutical is under an obligation to pay 10% of the amount of social security reimbursement, calculated from the prescription data for the current month, as a proportion of the producer price or import price (hereinafter collectively: producer price) (producer price/consumer price) with respect to each pharmaceutical product that is sold in pharmacies, has been reimbursed for at last 6 years and has a price exceeding HUF 1000 as the basis for reimbursement, provided that there is no other reimbursed product that contains the same active ingredient, has the same pharmaceutical intake form, has another brand name and a different marketing authorisation holder. The payment obligation must be calculated by product and subsidy title. Thus the new rule imposes a payment obligation on products that have been on the market for a length of time and are unique in the market – similarly to the practice in other European countries. In addition to this new measure, previous measures announced under the Structural Reform Programme (e.g., the so-called blind bidding held twice a year) also contribute to the continuous reduction of budget expenditures.

3.4. PUBLIC TRANSPORT

REFORM OF LONG DISTANCE PUBLIC TRANSPORT

The Structural Reform Programme stated that the government would “reorganise rail transport so that the operation of the national railway company complies with the operating policies of a normal economic association”. Accordingly, the Minister for National Development ordered that preparation for the reorganisation of the MÁV group should be started. To implement that decision, working groups have been set up under the auspices of the National Asset Management Zrt. (MNV) and with the participation of the ministries, the MNV, the MÁV as well as experts from the government and elsewhere.

The purpose of the reorganisation is to create an independent track operator and an integrated passenger transport company, parallel with the divestment of assets not required for railway operations. At the completion of their work, the working groups will make recommendations for specific steps to be taken in the course of the reorganisation. The reorganisation is expected to result in the increased cost efficiency and greater profitability of both the track operation and the passenger transport public service, eventually leading to the reduction of the required reimbursements from the budget.

Preparation is also under way for the reorganisation, into regional holding companies, of the Volán companies performing long-distance passenger transport by coaches, which also serves to improve operational efficiency through mergers and the elimination of duplications.

At the same time, in the course of the preparation of the 2013 budget the expenditure appropriation for the cost reimbursement for passenger transport public services was frozen in real terms, thus it does not keep up with the expected increase in costs, which is the manifestation of efficiency expectations.

The substantial increase of the appropriation for the reimbursement of the operating costs of the railway track network from HUF 47 billion in the previous year to HUF 70 billion in 2013 serves to assure that the legitimate expenditures of the operation of railway tracks not covered by revenues can be fully reimbursed, to also prevent the steady growth of the debt stock of MÁV Zrt.

FINANCING OF PUBLIC TRANSPORT IN BUDAPEST (BKV)

To promote a new, sustainable system of financing based on investment projects that sets the public transport of Budapest on a development course, the Government and the Municipality of Budapest concluded an agreement on the sustainable local public transport of Budapest (hereinafter: Agreement).

According to the Agreement, the direct operational subsidies from the government will decline only as new funding sources are identified. The Municipality of Budapest, in turn, undertook to make available, to the best of its abilities, the amounts required for the operation of the public transport of Budapest that may remain to be covered despite the investments and new funding sources. In addition, the Government undertook to provide sovereign guarantee to the cash liquidity of Budapest relating to the consolidation of the debt of BKV Zrt.

The two parties have delivered on their undertakings, or are in the process of doing so, with respect to the main items. As collateral for the roll-over of the debt stock of BKV Zrt, the Municipality of Budapest concluded a surety agreement with each bank involved, followed by the Government's secondary surety agreement to back up the Municipality's suretyship on 12 July 2012.

Because of the HUF 10 billion cut required by the Structural Reform Programme (Széll Kálmán Plan 2.0), the budgetary support for the public transport of Budapest and in particular for the operation of BKV Zrt. would have been reduced to HUF 23.2 billion in 2013, however, partly due to termination of the system of moderating differences in revenues, which left exactly such a sum with Budapest, the 2013 Budget Bill no longer contains a separate heading for the support of local public transport.

The Government is looking into other expedient ways of raising funds to finance the public transport of Budapest, in accordance with the Agreement. The operation of BKV Zrt. is assured in 2012 while the other elements of the new financing system to be introduced in 2013 will be provided for by the Government within the time limits specified in the Agreement.

3.5. INTRODUCTION OF A USAGE-BASED ELECTRONIC TOLL SYSTEM

The Structural Reform Programme provides that "the costs of the use of the high speed road network will be made proportionate with use, thus in the future the government will not let relinquish an important revenue source that has severe underlying costs - in the form of noise, deteriorating road conditions and air pollution." To this end, the Government has decided to introduce an electronic toll payment system (e-toll) by 1 July 2013 at the latest. The Government Resolution No. 1138/2012. (V. 3.) on the introduction of an electronic toll system proportionate to the distance covered set out the framework for the new e-toll system to be implemented. Pursuant to the 2012 Convergence Programme, the expected revenue surplus must be at least HUF 150 billion. Accordingly, the year 2013 Budget Act reckons with a balance improving revenue of HUF 75 billion for 2013 (6 months).

The Government Resolution No. 1363/2012. (IX. 14.) of 14 September 2012 on the tariff policy of state-of-the-art electronic toll collection proportionate to the distance covered and on the terms and financing of the acquisition of the system specifies the essential elements required for start-up as well as other details of the system, including the fact that pursuant to the Government's decision, the design and implementation of the e-toll system is covered by the 2013 budget, the procured system will be in direct state ownership and the revenues from the operation of the system will constitute revenues of the central budget. The public procurement procedure for the system will be organised by the ÁAK (State Motorway Management Co.), the process has already started with the publication of the invitation to tender and is expected to be completed at the end of October. The costs of the procurement and the implementation of the system is included in the present year 2013 expenditure forecast and, pursuant to the Government's resolution, the possibility of obtaining EU funding retroactively for the investment costs is being examined.

3.6. PUBLIC FINANCE GOVERNANCE

STABILITY ACT

On 24 September 2012 Parliament adopted the Act on the amendment of Act CXCIV of 2011 on the Economic Stability of Hungary (Stability Act). The amendment clarifies the competence of the Government concerning the verification of the observance of the debt rule, also assuring compliance with the provisions of the Constitution. The amendment primarily clarifies certain provisions concerning the competence and work of the Fiscal Council (FC) so that the practical enforcement of the debt rule enshrined in the Constitution is assured in full. The amendment was adopted following consultation with the members of the FC, with their consent. The amended the Stability Act contains the following new key provisions concerning the broadening of the competences of the FC and its operation:

- The FC oversees the enforcement of the debt rule; in this context, it expresses its opinion twice a year on the position of the budget and the development of the debt; furthermore, it may comment on any issue relating to the planning or implementation of the budget or the use of public funds in any other manner. The amendment broadens the competence of the FC, it states that the Government submits to the Council the budget as well as the draft of various acts underlying the budget for comments, including bills imposing payment obligations (tax bills), which the FC may comment on.
- The FC is assisted by a secretariat of five persons. The remuneration of the Chairman as well as any other costs relating to the operation of the Council and the remuneration of the employees of the organisation supporting the work of the Council are financed from the budget of the Office of Parliament.
- The State Audit Office and the National Bank of Hungary assist the work of the FC by making available analyses and findings.
- In view of the short time limit for comments (1 day), the Council may exercise some of its competences by way of electronic means of communication.

Other provisions of the amendment of the FS Act in the autumn of 2012 that are worth noting as potentially having significant positive effects on the fiscal balance:

- The modified Stability Act unambiguously states that local governments need the Government's permission not only to conclude loan agreements but also to amend existing ones. As the amendments of contracts may modify substantive elements of existing agreements (term, transaction value, interest rate) that may change the amount of debt or debt servicing obligation of the local governments, the approval of the Government must be sought just as in the case of new borrowing.
- When examining the enforcement of the debt rule, effects arising from exchange rate fluctuations must be filtered out. For clarification, it is now required that the Annual Budget Act must specify the exchange rates to be used for the calculation of the public debt in the budget year.

Budgetary framework

The provisions of Council Directive 2011/85/EU on requirements for budgetary frameworks shall be transposed into Hungarian law by 31 December 2013. The coordination of the harmonisation work required by the Directive has started. The transposition of the Directive will greatly promote the progress of compliance with the recommendations issued under the EDP procedure, particularly in respect of the numerical fiscal rules and the establishment of a truly binding medium term budgetary framework. The provisions of the Directive affect the following fields: budgetary accounting and statistical reporting, macroeconomic and budgetary forecasts, numerical fiscal rules, medium-term budgetary framework, procedures, mechanisms and rules to assure the transparency of general government finances and the comprehensive scope of budgetary frameworks.