

Ministry of Finance

**First report of 2008 on the measures taken in response to
Council recommendation of 10 October 2006
under Article 104(7) of the Treaty**



April 2008

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1. Introduction

The Government made a commitment in the convergence programme of 1 September 2006 to submit reports on a six-monthly basis to the Commission and the Council on the progress made towards the correction of the excessive deficit¹, including on structural reforms.² The Government submitted progress reports in 2007 on 26 April and 27 September. On the basis of the Commission's assessment of the first report, the Council, on its meeting on 10 July 2007, set out that the Hungarian government had acted in a manner consistent with its recommendation of 10 October 2006. The Council opinion (12 February 2007) on the convergence programme submitted in November 2007 concluded that the macroeconomic and budgetary outlook presented in the updated convergence programme seemed broadly consistent with a durable correction of the excessive deficit by 2009.

The Government set the aim of 2009 and defined the path for the correction of the excessive deficit in the 1 September 2006 convergence programme. Since then, the updated convergence programmes and progress reports adopted by the Government confirmed the budgetary targets. This progress report is to provide information on the macroeconomic and budgetary developments as well as the implementation of the structural reforms underpinning the sustainability of the budgetary trajectory.

The first 2008 progress report on the implementation of the convergence programme:

- *presents the updated macroeconomic forecast for 2008 and 2009,*
- *demonstrates the results of the adjustment in 2007,*
- *updates the budgetary projections for 2008 based on figures of the first three months,*
- *presents the budgetary outlook for 2009 on a no-policy-change basis and assuming no change in the taxation system,*
- *gives an overview on the implemented and planned structural reform measures indicated in the convergence programme (in public administration, education, health care, pension system and price subsidies), which underpin the lasting expenditure and deficit reduction.*

The report was adopted by the Government on its meeting of 23 April and, following the discussion by the National Interest Reconciliation Council, submitted to the European Commission and the Council on 25 April 2008.

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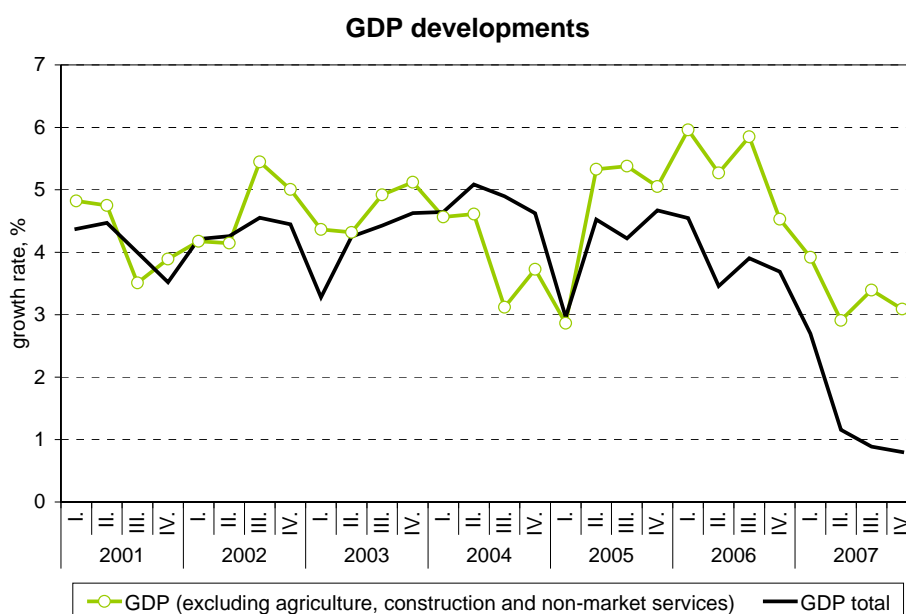
¹ *The excessive deficit procedure for Hungary was launched by the Council on 5 July 2004, as a consequence of the budget deficit higher than 3%.*

² *Council recommendation:*

„The Council welcomes the commitment of the Hungarian authorities in the adjusted convergence programme update of 1 September 2006 to submit reports on a six-monthly basis to the Commission and the Council examining progress made in complying with this recommendation, including on structural reforms. The first report is expected by mid-April 2007. The Commission and the Council will analyse these reports with a view to assessing progress made towards the correction of the excessive deficit.”

2. Macroeconomic developments

The large improvement of the general government balance naturally involved a deceleration in economic growth, observed in **2007**. Estimating based on ESA general government balances, the direct impact of the cut in the fiscal demand was more than 3% of GDP in 2007. The restraint on government expenditures, holding back the growth of public consumption, in kind benefits and public investments, was largely responsible for the decline in domestic demand. Despite a sharp fall in households' real income, the consumption expenditures of the households decreased only moderately, as households tried to 'smoothen' their consumption. In total, GDP grew only by 1.3% in 2007. The role of one-off factors in growth deceleration is indicated by the 3.3% growth of the added value in 2007, calculated without the non-market services, construction industry and agriculture.



The positive performance of foreign trade largely offset the negative growth contribution of domestic demand. Owing to the favourable international conditions, exports grew substantially, but imports only moderately given the weak domestic demand. In total, the trade balance improved by more than EUR 2 billion. Although the deficit of the income balance increased – mainly in relation to the increasing income on large direct foreign investments in Hungary –, the current account deficit dropped by 1.1 percentage points from 2006 and amounted to 5% of GDP. The external financing need declined more than the current account deficit, by 1.3 percentage points, to 4% of GDP.

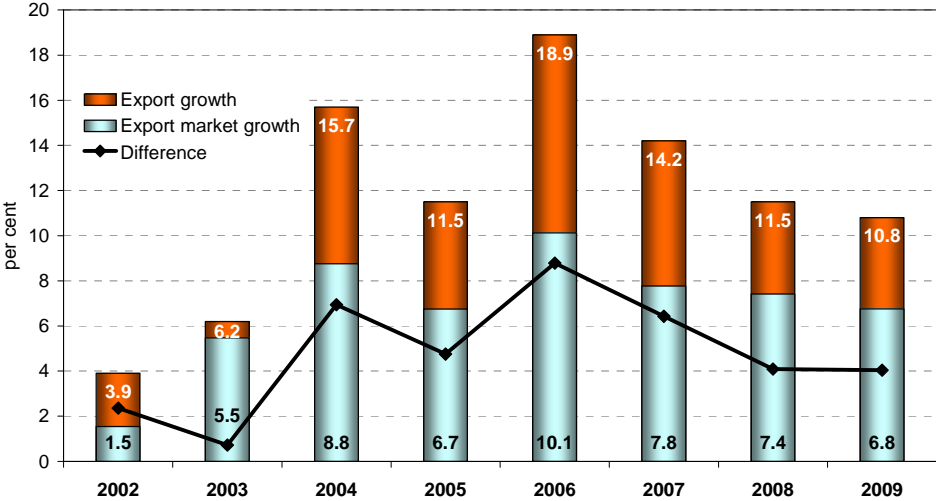
The consolidation measures also had an impact on the labour market. With the streamlining of the public sector, by the end of 2007 the number of employees in this sector fell to 716,000, with an annual average decrease of 5%. In the first half of the year, the business sector and the non-profit sector were still able to absorb some of the employees laid off in the public sector, but the headcount figures were falling also in the business sector in the second half of the year parallel with the decelerating growth. As an annual average, the unemployment rate was one decimal point lower than in 2006, but it rose in the last quarter.

Gross average wages grew by 8% in the national economy in 2007. Of the 9.1% wage increase registered in the business sector throughout the year, approximately 1.5-2 percentage points could be explained with the so-called whitening effect. This impact could be observed until Q3 of 2007 especially in those sectors where black and grey employment was traditionally high, i.e. construction, trade, catering and the real estate sector. In the whole of the national economy, net incomes rose by 2.8%, thus real income decreased by 4.8% in 2007.

On average, consumer prices rose by 8% in 2007 and the December inflation rate turned out to be 7.4%, following the 9% peak in March and the 6.4% low in September. Inflation increased since 2006, but the majority of this increase was generated outside the scope of core inflation. Certain measures aiming at the improvement of the budget balance (e.g. elimination of the preferential VAT rate) resulted in the acceleration of inflation from the second half of 2006, while the government measures aiming to dampen the tensions in the price and subsidy systems further increased the average rate of inflation from the beginning of 2007. In the meantime, the agricultural producer and purchase prices grew significantly as a result of the insufficient agricultural supplies caused by the unfavourable weather conditions in the region and increasing international demand for agricultural products, which gave a further considerable boost to inflation through food prices. The sustained increase in energy and raw material prices drove up the inflation significantly also in the euro zone, the impact of which may still be felt in the forthcoming period.

The growth projection for **2008** was revised downwards; the current forecast is 2.4% GDP growth, compared to the former 2.8%. The revision of the growth forecast is due to the more unfavourable expectations regarding the international environment and the related uncertainty of the growth of the main export markets. This year's growth outlook for Germany, Hungary's most important trade partner, was lowered by 0.5 percentage point to 1.6%. On the other hand, it may slightly improve the export outlook that strong growth has been projected also for this year in Member States outside the euro zone, growing faster than the EU average. Considering all these factors, export growth may be 11.5% in 2008, approximately 1.5 percentage points lower than expected in the forecast of the convergence programme. Since the data available for the first two months of the year suggest 18-19% volume increase in exports, there might be some upside risks to this projection.

Growth rate of export and export markets



As a result of the slower than expected fall of inflation and larger than expected accommodation in the headcount figures in the business sector, the real income and consumption of the households may moderately increase. Government consumption will also decline this year, but the drop will be less substantial than in 2007. In 2008, the investment outlook of the economic sectors has also improved since 2007. The investment activities of companies are still supported by the external demand and the high level of capacity utilisation. On the other hand, rising spreads, due to the uncertainties caused by financial turbulences, may increase the cost of funding. In dwelling construction, which determines the investments of the household sector, significant increase can not be projected. However, the gradual increase of EU resources and the continued expansion of the motorway network (partly within the framework of PPP arrangements) suggest an increase in public investments. Therefore, around 4% investment growth is projected for 2008. The Gripen procurement, contained in last year's base figures, slightly pulls back the import growth, yet the forecast 1% increase in domestic consumption may imply somewhat higher growth.

Production data also seem to confirm the acceleration of GDP growth compared to last year. Industrial output grew dynamically, by 8.1% also in 2007, but it seemed to come to a halt at the end of the year due to specific reasons (model change in a car factory). However, in the first two months of 2008, data indicate nearly 10% growth again. It could also be a favourable sign that despite the rather bad output figures of the construction industry, the period covered by contracts has already moved off from the historic low. Thus – taking also into account the investment projects implemented by the EU support – output may grow by 5-6%. For the time being, there are no signs in agriculture indicating that the harvested yield would not reach at least the average yield observed in the past. The demand constraining impact of the fiscal policy is projected to be mitigating in the area of non-market services, while the higher household income will most probably affect positively the output of market services.

Employment is not projected to increase this year. Lay-offs are still being made in the public sector, although at a decelerating rate, while a situation close to stagnation can be expected in the business sector. The reason behind this trend is that domestic demand is increasing only moderately, which may still result in a worsening profit position in the manufacturing industry producing for domestic markets as well as in services, involving potential further shrinking in labour demand in these sectors.

According to the forecast, gross average wages will rise by around 7%. The wage increase in the business sector is expected to be around the top end of the wage recommendation of the National Interest Reconciliation Council (5-7.5%) which provides nearly 1% real wage increase for the employees of the sector.

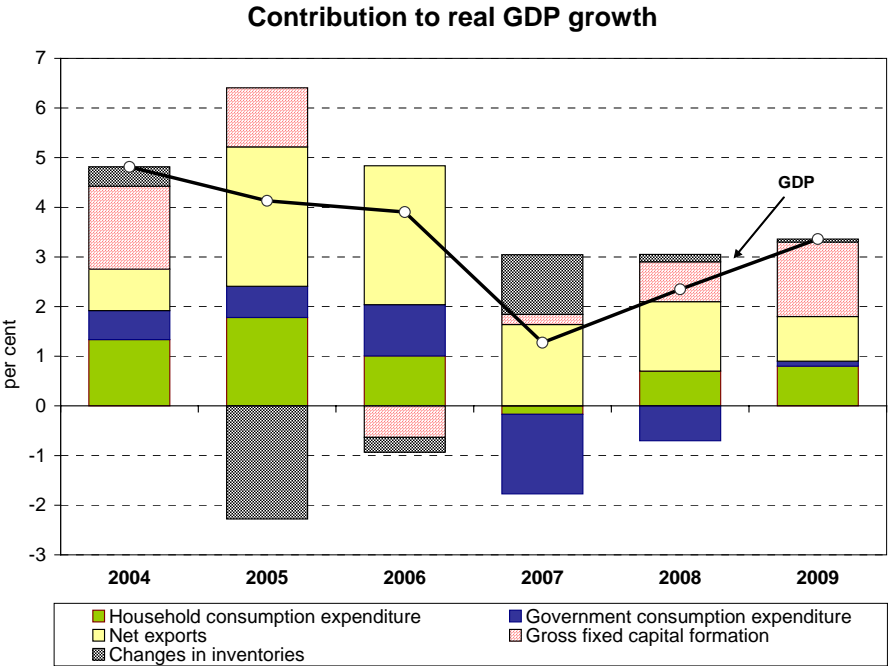
In the first few months of the year, inflation gradually dropped to a quarterly average of 6.9%. This figure was lower than in any quarter of 2007. The first wave of the inflationary shocks of the recent past has either ended or is just about to end. On the other hand, the inflationary pressure triggered by certain global price tendencies (energy and raw material price increase, fast increase of food prices) has not disappeared. All in all, inflation may drop to approximately 4.5% by December, with 6% annual average. Although the pace of deceleration in inflation is slower than projected in the convergence programme, it should be taken into account that this trend occurs in a rising international inflationary environment.

External equilibrium will further improve in 2008. The current account deficit is expected to fall to around 4.5% of GDP. The external financing need, in the ratio of GDP, may drop by 1 percentage point, in line with an increase of the capital transfers coming from the European Union.

The financial turmoil originating from the US sub-prime crisis might unfavourably affect international growth conditions also in **2009**, which can increase the uncertainties regarding the evolution of Hungary’s export markets. Thus, still a double-digit export growth, albeit somewhat lower than projected in the convergence programme, can be expected.

At the same time, following the fiscal consolidation, domestic demand might increase at a considerable pace. The income position of the household sector is expected to improve due to the wage increases, being in line with productivity gains, and to the increase in employment. Thus, household consumption may increase by more than 1%. The contribution of government consumption to growth is expected to be, although slightly, positive. Financing means, available due to the fiscal consolidation, and the increasing amount of EU funds may accelerate investment growth to around 7%. The pace of import growth will come close to that of exports, as domestic demand is set to accelerate, thus, the contribution of net exports to GDP growth is expected to moderate somewhat as compared to 2008.

Based on these trends, GDP growth may accelerate to nearly 3.5%, with the current projection being somewhat lower than the forecast in the convergence programme submitted at the end of 2007.



The disinflation may be slowed down even in 2009 due to lasting high agricultural and international energy prices. However, strict monetary and fiscal policy and the negative output gap may decelerate price increases. By the end of 2009, the inflation target of 3% can be achieved.

External balances continue to improve in 2009 as well, primarily due to the improving balance in real economic transactions. The current account deficit is expected to drop to 4.3% of GDP, while the external financing need to 2.7% of GDP. The composition of financing is also set to improve: as the government financing need decreases, the debt-generating financing will decline and the share of non-debt generating financing will increase.

In sum, the main risks to the macroeconomic projections for 2008-2009 are much more related to growth than to equilibrium, with the global economic environment being the main factor of uncertainty.

The updated macroeconomic projections are summarised in the table below:

Main macroeconomic indicators

<i>annual percentage change</i>	2007	2008	2009
GDP (at constant prices of previous year)	1.3	2.4	3.4
GDP (at current prices)	6.8	7.7	6.8
Domestic demand	-0.3	1.0	2.6
of which: household consumption expenditure	-0.3	1.3	1.6
government consumption expenditure*	-6.4	-3.2	0.4
gross fixed capital formation	1.0	4.0	7.2
Foreign trade turnover			
Exports (goods and services)	14.2	11.5	10.8
Imports (goods and services)	12.2	10.0	10.2
Consumer price index, annual average	8.0	5.9	3.6
<i>in per cent of GDP</i>			
Current account deficit	5.0	4.5	4.3
External financing need	4.0	2.9	2.7

* including social transfers in kind from non-profit institutions serving households

3. Budgetary developments

Budgetary developments in 2007

The accrual-based deficit of the general government dropped more than expected in 2007. The cash-based data during the year suggested, with increasing certainty, that the deficit could be lower than the originally targeted 6.8% of GDP. The Ministry of Finance made several downward revisions in the forecast but, in the end, even the 6.2% projection in the convergence programme updated in November turned out to be prudent. The central budget, the social security funds and extra-budgetary funds closed the year with a 0.5 percentage point better cash balance (in terms of GDP) and the deficit of the local governments also turned out to be much lower than projected when the programme was prepared.

According to the first data reported by CSO to Eurostat, the ESA95 general government deficit represented 5.5% of GDP in 2007. The 0.7 percentage point improvement compared to

the convergence programme forecast related to the central and local levels of the general government in almost equal proportions.

ESA95 deficit of the general government in 2007

in per cent of GDP	convergence programme (2007)	Preliminary fact	Difference
Central subsystems	5.7	5.3	0.4
Local governments	0.5	0.2	0.3
General government	6.2	5.5	0.7

The 1.3 percentage points lower deficit than the target set at the beginning of the fiscal consolidation programme was significantly due to a more than 1% of GDP surplus of tax and contribution revenues compared to the original projection. However, the lower deficit than forecast in the updated convergence programme was exclusively due to lower expenditures. The November forecast contained reserve representing nearly 0.5% of GDP to cover expenditures from the unused appropriations of the budget chapters, carried forward from the previous years. The stock of unspent appropriations, however, did not change significantly and the expenditures were lower than projected in the programme. The local governments also spent less on household transfers, as well as intermediate consumption and investments than projected. In addition, the social security expenditures were also slightly below the projections made when the programme was prepared. In total, the expenditure side improved by 0.8% of GDP.

On the other hand, the revenues- and expenditures to GDP ratios were strongly influenced by the much lower than forecast actual nominal GDP figure. The revenues practically turned out as calculated in the updated convergence programme, but their proportion to the lower GDP increased by 0.5 percentage point. Of the savings achieved on the expenditure side, the GDP effect offset 0.6 percentage point of the expenditures/GDP ratio:

2007 actual figures and the updated convergence programme forecast

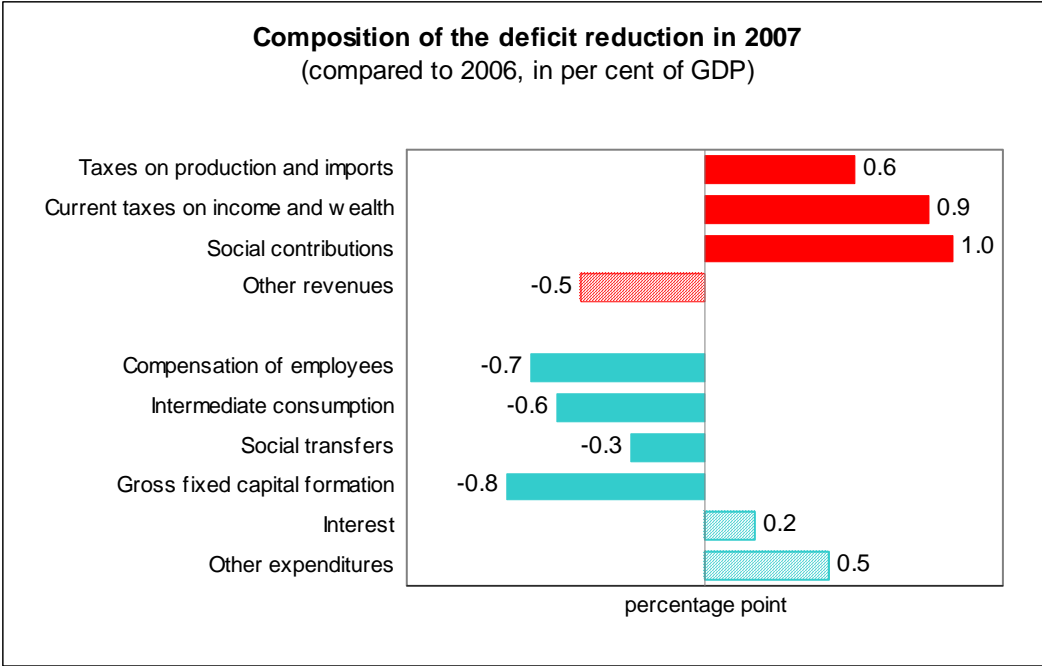
in per cent of GDP	Convergence programme (2007)	Preliminary fact	Difference	of which:	
				surplus / shortfall	GDP effect
Taxes and social contributions	39.1	39.5	0.4	-0.1	0.5
Other	5.0	5.1	0.1	0.1	0.0
Total revenues	44.1	44.6	0.5	0.0	0.5
Current operational expenditures	18.1	17.9	-0.2	-0.4	0.2
Social transfers	18.4	18.2	-0.2	-0.4	0.2
Gross fixed capital formation	3.5	3.6	0.1	0.0	0.1
Other	6.3	6.4	0.1	0.0	0.1
Total primary expenditures	46.3	46.0	-0.3	-0.9	0.6
Interest expenditures	4.0	4.1	0.1	0.0	0.1
Total expenditures	50.3	50.1	-0.2	-0.8	0.6
Balance	-6.2	-5.5	0.7	0.8	-0.1
Primary balance	-2.2	-1.4	0.8	0.8	0.0

Due to the rounding the sum data could differ from the sum of the detailed data.

Following the 9.2% deficit in 2006, 3.7 percentage points adjustment was achieved in 2007 (3.9 percentage points in the primary balance). The fiscal consolidation made a strong impact on the expenditures of the general government, nearly 50% of the improvement resulted from

the reduction of the expenditures/GDP ratio. The re-distribution ratio dropped from 51.9% to 50.1%. The primary expenditures grew by only 2.5%, and fell from 47.9% in the previous year to 46% of GDP. More specifically, the current operational expenditures (compensation of employees, intermediate consumption) decreased slightly, but investments, compared to the outstanding figure of the previous year, dropped significantly also in nominal terms. On the other hand, the social transfers other than in kind grew by 8.5%, from 15% to 15.2% of GDP.

Revenues increased from 42.6% of GDP in 2006 to 44.6%. Within revenues, tax and contribution revenues increased somewhat higher, by 2.5 percentage points, from 37% to 39.5% of GDP. The other revenues of the government declined compared to the previous year both in terms of GDP, and in nominal terms.



Budgetary developments in 2008

In line with the target set in the convergence programme and the 2008 budget, the deficit of the general government will fall by further 1.5 percentage points, to 4% of GDP this year. There will be no more increase in income centralisation, while expenditures will continue to grow more slowly than the GDP.

The cash-based figures of Q1 and the changes of the macroeconomic forecast indicate that the targeted 4% may be achieved. The aggregate deficit of the central budget, the social security funds and extra-budgetary funds dropped to two thirds of Q1 2007 in the first quarter of 2008. The primary balance is only slightly higher than one third of the last year’s figure. Even if the figures are adjusted for the debt assumption and the one-off expenditures related to MÁV last year, the deficit and the primary deficit both dropped significantly compared to 2007:

Cash-flow balances (without local governments)

Billion HUF	2007 Q1	2008 Q1	2008 Q1 / 2007 Q1
Balance	-762	-508	67%
Primary balance	-487	-177	36%
<i>Excluding debt assumption and MÁV-related one-off expenditures:</i>			
Balance	-657	-507	77%
Primary balance	-382	-176	46%

The quarterly deficit reached 46% of the annual target, which is favourable taking into account the seasonal pattern of the budget (in 2007, the deficit in the first three months was 59% of the annual figure). The distribution of revenues and expenditures within the year is not even:

- The disbursement of half of the 13th-month wages and pensions, energy price subsidies and national agricultural subsidies supplementing EU payments and the higher contributions to EU budget at the beginning of the year generate additional expenditures over 1% of GDP in the first few months;
- On the other hand, revenues are collected at an accelerated pace in the second half of the year. This is explained partly by the seasonality of macroeconomic developments (salaries, trade turnover) and partly by the fact that a considerable amount of the corporate profit tax is collected at the end of the year in compliance with the tax regulations³. In addition, the revenues of the second half of the year are not affected by tax refunds based on the preceding declaration period.

The cash-based deficit was slightly more favourable than the projections updated monthly also in the first quarter of 2008. In total, tax and contribution revenues were slightly over the forecasts each month. Their proportion compared to the annual projection was the same as last year (quarterly/annual actual figures). Including also the change in the payment schedule of 13th-month wages⁴ and the impact of the temporarily high VAT refunds reducing revenues, the same ratio as last year suggests a surplus for the entire year. This is also supported by the base effect of the higher than expected revenues in certain tax types (primarily corporate profit tax and solidarity tax) at the end of 2007.

Although the growth projection has also been revised downwards, the changes of certain components of the macroeconomic forecasts suggest higher than projected revenues in income and consumption-based taxes. As a result of the higher wage projections, the wage bill may increase by approximately 1 percentage point faster than estimated during the budget preparation period even if the employment figures turned out to be less favourable than had been expected earlier. Similarly, although the volume of household consumption expenditures may correspond to the previous forecast, the growth calculated at current prices may be approximately 1 percentage point faster. Based on the macroeconomic and fiscal developments of the first quarter, the surplus of tax and contribution revenues is expected at 0.3% of GDP.

³ In compliance with the advance payment rules, the corporations must pay a considerable portion of profit tax (more than 40%) in December.

⁴ In January 2008, additional wages were disbursed only for two weeks compared to the monthly wages paid last year.

The first quarterly figures do not indicate any 'overrun' on the expenditure side. The deficit increasing impact of budgetary institutions (the balance of the net expenditures and budget contributions of the central budgetary institutions and chapter managed appropriations) was under the time-proportionate level until March, with a decrease of 25% from 2007. Healthcare expenditures corresponded to the forecasts each month and pharmaceutical expenditures turned out to be even a few billion lower than expected. On the other hand, the changes of the macroeconomic forecast also trigger some growth in certain expenditures.

In comparison to the convergence programme updated in November 2007, the current forecast calculates with the following changes in the revenues and expenditures of the general government on accrual basis.

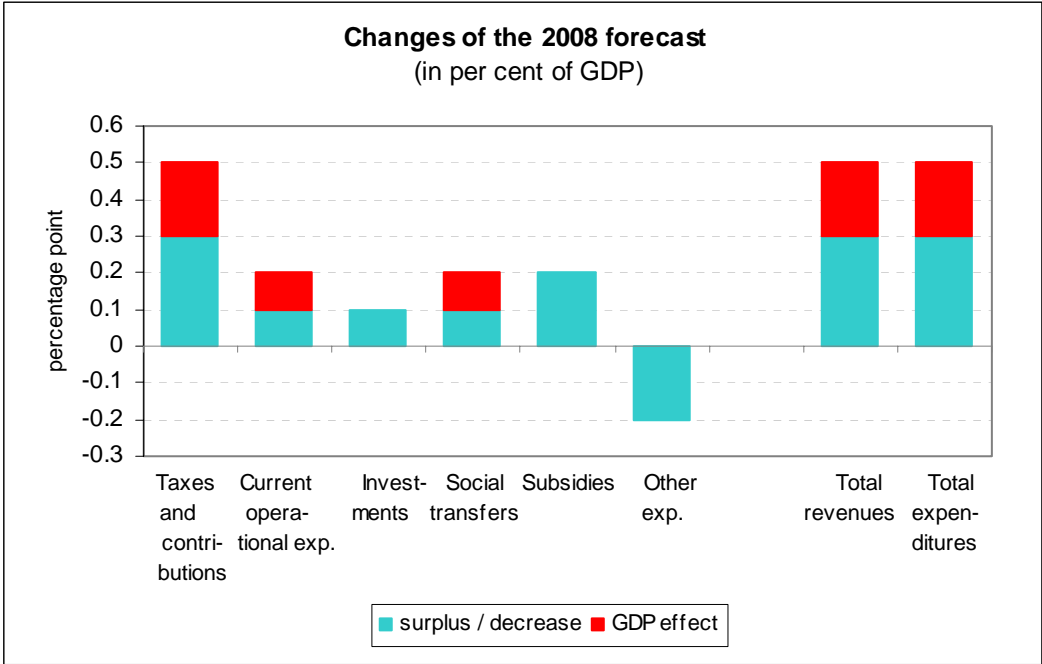
- As a result of the 0.3% of GDP surplus of tax and contribution revenues and lower nominal GDP, tax centralisation will not change compared to 2007;
- Pension expenditures will be higher than originally budgeted in relation to expected inflation and wages. In May, pensions will be increased by 1.1% retroactively, which will drive up the expenditures by 0.1% of GDP for the whole year;
- According to the wage agreement concluded in the public sector, real wages will not change in 2008. Considering the estimated higher inflation, this will result in additional expenditures equivalent to 0.1% of GDP. (However, the net impact on the balance will only be approximately half of it.)
- An upside risk of 0.1% of GDP may be forecast in investments expenditures;
- Among the accrual-based subsidies, the forecast includes an upside risk of 0.2% of GDP in relation to railway passenger transportation;
- The abolition of the daily hospital charge and the visit fee on 1 April will not affect the social security balance, as the result of the March referendum has the same impact on the revenue and expenditure sides;
- The increase in the yield of government securities observed during the last few months will not yet affect the interest expenditures for 2008 on accrual basis⁵. In addition to the risk reserve integrated into the convergence programme forecast, this can be explained by the fact that the majority of the interest expenditures for this year was already determined when the programme was prepared and that the nominal debt stock at the end of 2007 turned out to be lower than expected at that time (although the debt ratio based on the lower nominal GDP was higher).
- However, as a result of higher government securities yields, the interest subsidy on housing loans will increase slightly already in 2008.

The additional expenditures are covered by the higher revenues and the reserves on the expenditure side. In compliance with the provisions of the Act on Public Finances, ministries prepare quarterly reports on their actual revenues and expenditures and annual forecasts. Pursuant to the provisions of the Budget Act, the equilibrium reserve of the budget chapters may only be used for purposes defined and approved by the government. The first quarterly report based on the ministry reports is expected by the end of April.

⁵ There is a methodological reason for separating the cash-based interest expenditures from the accrual-based interest expenditures. If yields are increasing, the issuer incurs a valuation loss on pre-defined fixed-coupon bonds. The total loss affects the GFS interest balance at the time of the issue, while under the ESA this loss is distributed on the total maturity of the government securities.

The Budget Act also refers decision-making on the use of the central equilibrium reserve depending on fiscal and economic developments into the competence of the government. The total amount of the central equilibrium reserve appropriation will be blocked as a result of additional expenditures.

In total, the general government deficit continues to be expected at 4% of GDP, with slightly higher than budgeted revenues and expenditures. Apart from the surpluses, the impact of the lower nominal GDP also implies changes in the revenues- and expenditures to GDP ratio.



Budgetary developments in 2009

In accordance with the three-year outlook prepared for the 2008 budget, the Government, in its Resolution 2032/2008 (III.11.) defined the expenditure limits for the subsequent years under its control and supervision. (In budget preparation period, the ministries may amend these ceilings only with the permission of the government.) The 2009 general government projections are based on the Government Resolution. Compared to the convergence programme updated in November, the budget outlook for 2009 only contains modifications arising from changes in the macroeconomic and financial developments and the base effect of the 2008 fiscal developments. The following assumptions were used:

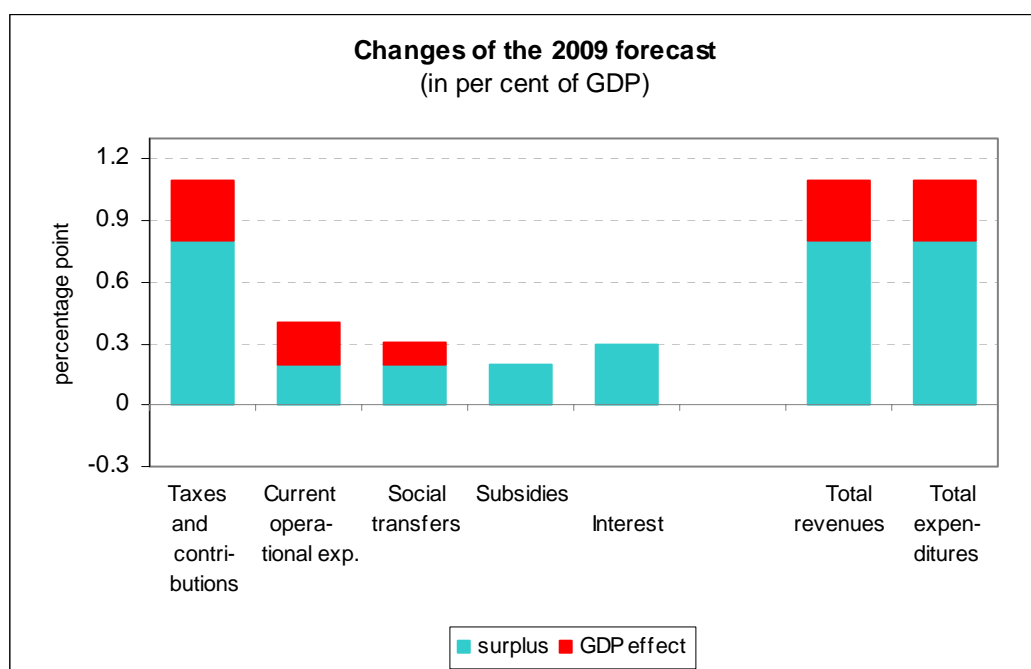
- Following the decrease in 2007 and preservation of the real value of wages in 2008, real wages may increase moderately in the public sector in 2009 (by around 1%). Considering the base effect of this year’s wages and the slightly increased inflation projection, the additional expenditure related to the compensation of employees may amount to 0.2% of GDP.
- In relation to an increase of pensions linked to inflation and wages (Swiss indexation) and, to a lesser extent, as a result of the change of other inflation-based social transfers, the social transfers other than in kind will increase by 0.2% of GDP.

- Similarly to 2008, the current forecast reckons with an upside risk of approximately 0.2% of GDP in the subsidy of railway passenger transportation.
- The interest expenditure forecast changes most compared to the calculations under the convergence programme. The increase in the yield of government securities observed in 2008 will have its impact in subsequent years. In 2009, interest expenditures could be 0.3% of GDP higher than estimated in the convergence programme.

The projections did not change in the other components of the expenditure side. The expected larger revenues will cover the additional expenditures.

- Due to the base effect of the higher 2008 figures and approximately 1 percentage point more dynamic increase of the wage bill than expected before, the additional tax and contribution revenues may make up 0.8% of GDP. The calculation is based on the assumption that the parameters of the tax and social security contribution system will not change compared to 2008. Tax centralisation will ease slightly compared to 2008;

As the additional primary expenditures (compensation of employees, social transfers other than in kind, subsidies) are lower than the expected rise of revenues, the primary balance will improve more than calculated earlier. In line with the target set in the convergence programme, the general government deficit will decline to 3.2% of GDP in 2009. The impact of the lower nominal GDP will be reflected in the ratio of revenues and expenditures relative to GDP also in that year. In total, revenues may drop by 0.3 percentage point and expenditures by more than 1 percentage point of the GDP compared to the previous year.



The updated calculations are shown in the following table:

General government revenues and expenditures

in per cent of GDP	2007	2008	2009
Taxes	25.9	25.8	25.7
Social contributions	13.6	13.7	13.7
Total tax and contribution revenues	39.5	39.5	39.4
Other	5.1	5.2	5.0
Total revenues	44.6	44.7	44.4
Current operational expenditures	17.9	17.0	17.0
Social transfers	18.2	18.4	18.1
Subsidies	1.5	1.6	1.5
Gross fixed capital formation	3.6	3.6	3.2
Other primary expenditures	4.8	4.0	3.8
Total primary expenditures	46.0	44.6	43.5
Interest expenditures	4.1	4.1	4.1
Total expenditures	50.1	48.8	47.6
Balance	-5.5	-4.0	-3.2
Primary balance	-1.4	0.1	0.8

Due to the rounding the sum data could differ from the sum of the detailed data.

4. Public debt

According to the EDP notification government debt was HUF 16,735.5 billion at the end of 2007,, constituting an annual increase of HUF 1,143 billion. Primarily owing to the more favourable financing situation resulting from the lower deficit, the debt level was lower than estimated in the 2007 convergence programme, although the debt ratio was 0.6 percentage point higher, representing 66% of GDP. The main factor behind the higher than projected debt ratio is the lower than expected nominal GDP.

A new development in 2007 was that municipalities significantly over-financed their annual deficit, i.e. their gross debt increased more than their financing need, with a parallel increase in their financial assets (thus, their net debt showed also a smaller increase). This effect increased the debt through the stock-flow adjustment.

Convergence programme projection and EDP notification on debt developments in 2007

	<i>Convergence programme 2007</i>	<i>Progress report April 2008</i>	<i>Difference*</i>
Debt ratio	65.4	66.0	0.6
Change in debt ratio (compared to 2006)	-0.2	0.3	0.6
- deficit	6.2	5.5	-0.7
- stock-flow adjustment	-1.5	-1.0	0.5
- effect of GDP growth	-5.0	-4.2	-0.8

* Due to the rounding the difference data could differ from the difference of the detailed data.

With new information about 2007 and beginning of 2008, the debt projection was revised both for 2008 and 2009. The revision is explained by the higher 2007 actual debt ratio,

different nominal GDP path, weaker exchange rate⁶, and different assumption for the developments of other financing items.

Change in factors influencing debt dynamics

		2007	2008	2009
<i>Nominal GDP growth (%)</i>	<i>2007 CP</i>	8.2	6.8	7.2
	<i>April 2008</i>	6.8	7.7	6.8
<i>Exchange rate. end year (HUF/€)*</i>	<i>2007 CP</i>	251		
	<i>April 2008</i>	253.4	258	
<i>Deficit (per cent of GDP)</i>	<i>2007 CP</i>	6.2	4.0	3.2
	<i>April 2008</i>	5.5	4.0	3.2

* technical assumption

The forecast calculates with higher interest expenditures resulting from the increased yields. The effect of an increase in the domestic yield curve appears only gradually in the interest expenditure through the substantial determination. The 2007 convergence programme used a conservative yield curve estimate for 2008 calculating with the possibility of an indirect yield increase due to the escalation of sub prime turbulences. The ESA interest expenditure forecast for 2008 did not change significantly⁷ (a positive effect for the interest expenditure is due to the lower than expected 2007 debt level). The increase in the 2009 interest expenditure forecast is attributable to the determination of past developments and the relatively higher forward yield curve compared to the 2007 convergence program.

General government debt developments

per cent of GDP	2007	2008	2009
1. Gross debt ratio	66.0	66.6	65.6
2. Change in gross debt ratio	0.3	0.6	-1.0
Contribution to changes in gross debt			
3. Primary deficit	1.4	-0.1	-0.8
4. Interest expenditure	4.1	4.1	4.1
5. Stock-flow adjustment	-1.0	1.3	0.0
of which:			
- difference between cash and accrual basis accounting	-1.2		
- net acquisition of financial assets	0.2		
- revaluation effect and others	0.0		
Implicit interest rate on debt (%)	6.4	6.4	6.4

⁶ The Report uses similar methodology for the HUF/EUR technical exchange rate assumption as the convergence programme. The HUF 258 average exchange rate is calculated from data between 10 December 2007 and 7 March 2008.

⁷ See footnote Nr 5.

5. Structural measures

In line with the Council recommendation of October 2006, the Government has introduced numerous measures with regard to the subsystems of the general government which ensure compliance with the budgetary targets – in the field of public administration, health care, pension system, education and household gas subsidies. In addition, reforms were implemented and proposed to improve the groundwork and efficiency of public finances, such as, the Act on State-owned Assets or the Bill on Fiscal Responsibility and the Legislative Budget Office reflecting primarily and directly the fiscal regulatory framework. The details of the latter one were already presented in the convergence programme of November 2007.

Public administration

Central public administration

The reform measures launched in 2006 (restructuring, lower headcount and introduction of a performance assessment system) have contributed to expenditure cuts and improved the efficiency of public administration. In terms of the headcount figures of central budgetary institutions, approximately 20,000 people were laid off in 2006-2008 and, as a result of the measures, considerable operating and maintenance expenses were saved. The budget impact is nearly HUF 50 billion, which was reflected in the 2007-2008 budgets.

- The number of central government employees dropped to 5,817 at the end of 2007, which was approximately 27% lower than the headcount at the beginning of 2006 (7,936).
- An integrated organisation was established for state-owned asset management (Hungarian National Asset Management Company) on 1 January 2008 in the framework of centralisation of parallel functions for the purpose of more efficient and economic operation. The central service providers gradually adopt the supporting tasks in 2007 and 2008.
- In the course of the consolidation and regional reorganisation of the central administration and its regional (decentralised) bodies, a number of large networks were reorganised with a regional focus mostly as of 1 January 2007, while similar efforts were completed during the year. As a result of the reorganisation, instead of the 429 central budgetary institutions affected, only 184 will continue their operation⁸.
- The quality improvement of public services is promoted by the fact that the definition and measurement of performance requirements has been introduced across the board in the entire public administration (new performance assessment procedure (TÉR)).

⁸ Figure of 1 April 2008.

Local governments

- Parliament approved HUF 28.1 billion funding for support of micro regional activities in 2008. In 2007, the multipurpose micro regional associations received approximately HUF 22.5 billion funding compared to the HUF 15.4 billion in 2006. The main areas of co-operation continue to be public education and social services. The intensity of co-operation is illustrated by the increase in the number of associations operating public education institutions and the local governments participating in them for the 2007/2008 school year.

Apart from the multipurpose micro regional associations, the increase in the number of district clerks also indicates progress towards more reasonable operation.

HUF 3.5 billion is provided from the central budget in 2008 for the improvement of the infrastructure of small village schools and district clerk offices and procurement of community buses for the purpose of improving co-operation between municipalities and promoting the joint provision of services. Taking into account the investment needs arising from the derogation commitments on the side of local governments, the resources available to the EU Own Funding fund have increased by nearly 50%.

- Amendments of several pieces of regulations, effective from 1 January 2008, have further strengthened the financial discipline of local governments. The purpose of these measures is to improve the foundation of municipality planning and to finance only such funding claims that comply with the legal requirements.
- The amendment of Act XXXVIII of 1992 on public finances changed the procedures of on-site audits of local government applications for funding from the central budget and the review of the settlement of such funding by the Treasury as well as the conditions of mandatory on-site audits.

The main principle for the application of support and contributions at the beginning of, and during the year is that the Treasury conducts an on-site audit if the difference between the total amount reported by the local government and the total amount recorded by the Treasury is more than 2%, or at least HUF 1 million. During the year-end settlement review, the Treasury conducts on-site audits at least once every 4 years.

- There is a stricter rule for local governments managing a budget of more than HUF 400 million. In the case of such local governments, at least 50% of the titles of their revenues from central budgetary relations are audited annually.
- Pursuant to the amendments of Act CXXXV of 1997 on the associations and co-operation of local governments, the association agreements must contain provisions for the procedures applicable if the local governments participating in the association do not fulfil their financial commitments. The association may decide to use immediate collection orders in such cases.
- The Act sets out a more rigorous rule in case the local governments form an association with a legal entity for development and investment purposes. In such a case, the association agreement must specify that if a local government does not fulfil a payment obligation assumed by it in relation to a development or investment project, then the municipality serving as the registered seat of the association or the local government

defined under the association agreement may submit an immediate collection order from the 15th day after the payment deadline.

- Pursuant to the amendment of Act CVII of 2004 on the multipurpose micro regional association of local governments, the multipurpose micro regional association agreement must also contain provisions for the procedures applicable if the local governments participating in the association fail to fulfil their financial commitments. The association may decide to use immediate collection orders in such cases.
- Based on the amendment of Act XXV of 1996 on the debt settlement proceedings of local governments, the proposal for a debt settlement procedure has been supplemented with a sanction associated with the amendment of the Act on Associations. Consequently, if a local government or a local government budgetary agency does not pay its debt to another local government within 60 days from the issue of the immediate collection order based on the agreement with the local government or the association agreement, then proceedings may be started against it.

Curative-preventive care

The Act on the Development of the Health Care System defined new capacities for the institutions as of 1 April 2007. The government decree on the implementation of the Act stated that the performance volume of active inpatient health care providers, effective on 31 March 2007 had to be modified according to the capacity change defined for them under the Act from 1 April 2007. The government decree provided for the specific performance volume for the performance period between 1 April 2007 and 30 September 2007.

Performance volume limits had to be defined for active inpatient health care providers for the period from 1 October 2007 to 30 September 2008. In this context, strict compliance with the budget appropriations was a very important aspect. The performance volume limits were defined on the basis of the performance volume reduced with the temporary supplementary performance volume for the period between July and September 2007, effective on 30 September 2007.

A new financing method was introduced, which – while took account of the requirement of budget balance improvement – was also better adjusted to the requirements of the health care provision system. In this context, a health care provider that had a financing contract for a capacity of at least 50 active inpatient care beds and at least four professions and at least 92% of its performance volume effective for the period from 1 April 2007 to 30 June 2007 received a performance volume limit increase in addition to the basic performance volume. The outpatient care institutions also receive the performance volume increase.

The curative-preventive expenditures dropped from 3% in 2006 to 2.8% of GDP in 2007, and they are expected to decrease further, to 2.7% in 2008, in compliance with the requirement stated in the convergence programme.

The control of health insurance contracts will continue also in 2008. The service depends on the eligibility to the service and not on contribution payment. People not paying any contribution will continue to receive the necessary health care services, but from 1 January 2008 APEH (the tax administration) will pay special attention to controlling residents failing

to sort out their legal relationship based on data supplied by the National Health Insurance Fund (NHIF) The failure to comply with the reporting obligation will be sanctioned with a negligence penalty, while the failure to pay contribution payment is sanctioned with a default penalty. In order to promote the controls, data exchange has improved between the NHIF and the tax administration. The health care providers must check the existence of an insurance relationship in advance. NHIF withdraws 10% of the financing of the service providers failing to run such checks.

The purpose of the account statement is to reduce financing of unjustifiably accounted performance. Each health care provider must issue an account statement to patients using inpatient care, outpatient care or dental care services. In the account statement, insured patients are informed of the treatment and service the health care provider intends to settle with the insurer and the amount it requires for it. Two copies of the account statement must be signed by the insured patient. The health care provider must report the signature of the statement. If the health care provider fails to report it or it is proved in an audit that the patient did not sign the account statement, then the insurer withdraws 10% of the financing provided for the specific service or it must be reimbursed to it.

The social insurance based character of the service provision is supported by the fact that the central budget contributes to the Health Insurance Fund on a per capita basis, in a transparent and predictable manner. The transfer is HUF 4,350/person/month. Consequently, the funds transferred from the central budget under the title of contribution amount to HUF 307 billion in 2008 compared to the HUF 288.9 billion in 2007.

The standards of health care can be maintained also under the tighter fiscal conditions, as:

- owing to the specific measures (account statement), inappropriate and unjustified services no longer burden the health care provision system, thus capacities may be used to satisfy real needs,
- the monitoring of care has become more efficient through the institutional background (Health Insurance Supervision), and the new legal instruments introduced (waiting list, scheduled appointment system),
- those forms of health care that create less burden for the budget while are more favourable for the patients (one-day surgery, daytime hospital) continue to be promoted.

The reform of the health insurance system continues to contribute to the achievement of the expenditure targets set in the convergence programme

Pharmaceutical subsidies

The most important measure laying down the foundation for the implementation of the convergence programme was the restructuring of the system of pharmaceutical subsidies in 2007.

Upon the entry into force of the provisions of Act XCVIII of 2006 on the secure and efficient supply of pharmaceuticals and medical aids and on the general rules of pharmaceutical trade (hereinafter Act on Economy in Pharmaceuticals) of 29 December 2006 on the rules of contributions of pharmaceutical companies on 15 January 2007, framework rules were introduced promoting the achievement of a more rational consumption level and structure, the enhanced transparency of the subsidy and admission systems and the reduction of

pharmaceutical expenditures. The Act on Economy in Pharmaceuticals introduced a new, more equitable system of the joint responsibility of pharmaceutical producers (the beneficiaries of the pharmaceuticals marketing licence), traders, prescribing physicians, patients and the health care insurance system.

Decree No. 32/2004 (IV. 26) ESzCsM, on the criteria of eligibility for social security subsidies of registered pharmaceuticals and nutrition for special nutritional needs and on the alteration of eligibility or of the rate of support, the most important implementation decree of the Act on Economy in Pharmaceuticals specifies the detailed rules of the formation of the fixed therapeutic and active substance-based groups and of their eligibility for subsidies.

Major changes affecting the pharmaceutical subsidy system and the pharmaceutical market:

- the free supply of indication related pharmaceuticals in priority subsidy groups has been abolished;
- subsidy rates have been lowered;
- in order to accelerate generic competition and to assure transparency, the rules of fixing of the subsidy have changed (formation of fixed subsidy groups and announcement of price cuts continuously, fixing on a quarterly basis.). Manufacturers can submit price reduction through the internet (NHIF Web Bidding System) with a digital signature. This option represents considerable progress and also accelerates the processes;
- the criteria for remaining in the subsidised pharmaceutical category have become more stringent;
- in line with regulations promoting efficient prescriptions, physicians receive regular feedback about how their prescription practice relates to the average. The effective sanctioning of incentives for quality and effective pharmaceutical prescription has been postponed until 1 July 2008, because the system requires further clarification and fine tuning;
- the payment obligations of pharmaceutical producers and traders is set in an act (payment obligation of 12% of the producer price-proportionate part of the subsidy, 2.5% of the wholesale margin of subsidised pharmaceuticals, HUF 5 million/year after medical representatives, tiered payment in the event of the overrun of the appropriation for pharmaceutical sales in the pharmacies). As the developments were favourable in 2007, no tiered payment liability occurred;
- online controls of prescription and insured patient eligibilities have begun;
- the restraints on the opening of pharmacies have been eased and the sale of certain non-prescription drugs outside pharmacies has been allowed.

As a consequence of the measures affecting the pharmaceutical subsidy system and the pharmaceutical market, in 2007 the lasting growth trend of pharmaceutical subsidy expenditures was interrupted. Expenditures dropped by 16.7% compared to the subsidies disbursed in 2006. In 2007, HUF 323.6 billion pharmaceutical subsidies were disbursed, the contribution payment balance of pharmaceutical manufacturers and traders was HUF 27.8 billion and the pharmaceutical balance of the Health Insurance Fund amounted to HUF 295.8 billion. The 1.17% share of the GDP of the latter balance represented a large, 0.38 percentage point drop from the previous year.

In Q1 2008, HUF 77.2 billion pharmaceutical subsidy was disbursed, 22.2% of the annual appropriation of HUF 347.9 billion, calculated with the pharmaceutical subsidy reserve. Based on the pro rata performance figures of the previous years, it can be assumed that if the

contributions of pharmaceutical manufacturers and traders into the Health Insurance Fund are around the budgeted HUF 35.5 billion, the pharmaceutical balance of the Health Insurance Fund will be favourable despite the fact that the demand for pharmaceuticals may increase by a few percentage points due to the abolition of the visit fee.

The reduction of the subsidy levels in mid-January 2007 triggered a considerable increase in the co-payment from the population. As a result of the price competition on the generic market, however, prices declined continuously during the year. The average consumer price increase of all pharmaceuticals in 2007 was 18.5%, weighted according to the base year (13.23% for the subsidised pharmaceuticals). The co-payment increase in January 2008 was 7.9% due to the carry-over effect of the subsidy decrease in 2007, while in February consumer prices were 0.4% lower than one year before.

Pension system

The pension measures introduced in 2006 and 2007, reduced the expenditures to be incurred in the pension system until 2050, improving the sustainability of public finances and increasing employment in older age groups.

According to the calculations of the converge programme the steps taken so far will have the following quantified effects until 2050.

The budgetary impact of the measures

Measure	Impact on long-term net expenditures until 2050 (as a per cent of GDP)
Increase of early retirement age:	-0.22
Suspension of pension during employment:	-0.02
Change of pension calculation:	-1.08
Introduction of actuarially correct treatment of early retirement pensions	-0.3
Total:	-1.6

The 1.6 percentage point decrease indicated above does not take into account the effects of the new early retirement contribution because it will reduce expenditures only if employers apply for, and receive, exemption from its payment by assuring appropriate working conditions and therefore fewer employees will be entitled to early retirement benefits. The reduction of expenditures lowers the risk of long-term sustainability.

In addition to the steps taken so far, further measures are required for decelerating the longer-term increase of pension expenditures. In order to carefully consider further measures, the Government has established the Pension Round Table. The purpose of the Round Table is to promote consensus in key issues, affecting the whole society on both mid and long term. The Round Table proposes analyses and extensive discussions thereof, as a result of which recommendations can be made to provide effective help to the administration and in the legislation process. The Round Table does not have a decision-making competence. Representatives of the administration attend its meetings with a consultation right.

The practical arrangements for the functioning of the Round Table are ensured by the Prime Minister's Office. The Round Table consists of academic researchers and experts. The chairman of the Round Table is appointed by the Prime Minister.

The main responsibility of the Round Table is to elaborate paradigmatic reforms. Within the framework of the preparatory work of experts, the most important parameters (age, substitution rate, indexation), as well as possible systemic changes (e.g. individual accounts) are analysed and evaluated. The Round Table is expected to develop its detailed proposal by the end of 2008; currently there are several options and concepts on the agenda.

Education

Public education

The performance indicator-based financing introduced on 1 September 2007 will be extended to basic art education, education and care in dormitories and hostels, day school or study room activities and boarding school education as well from 1 September 2008. With regard to these tasks, the calculation is also based on the education and organisation parameters defined under the Public Education Act.

The certification of basic art education institutions was completed by 31 December 2007. In 2008, transfers to certified institutions are calculated on the basis of this certification.

From 1 January 2008, the operators of basic art education institutions can use 100% of the normative budget transfer only if they have obtained the title of a 'Certified basic art education institution' or an 'Excellent basic art education institution' in a certification process.

The amendments of the Public Education Act, effective since September 2007, affect a lot of sectoral and professional aspects, based on which the quality of public education can be improved with the available resources.

Higher education

The main purpose of the higher education reform is to improve the quality of education and to make it capable of adapting to the changing structure and level of labour demand. Under the reform, the following steps have been taken:

- Pursuant to the amendments of Act CXXXIX of 2005 on higher education in 2007, the government programme of quality-based development of higher education provides for a 3-year operational agreement concluded between higher education institutions and the ministry performing the operator's tasks promoting institution management with a higher degree of independence and responsibility, as a new adaptation option of universities and colleges in the changes market economy environment, in line with the requirements of higher education mobility, developing within the European Higher Education Area.

According to the agreements, signed in December 2007, the central budget support consists of two parts: the first part is a basic support for the effective term of the

agreement, and the other part is support, varying year by year in relation to the task indicators.

- The competition boosting effect of the new admission procedure, based on the choice of the student and limiting the role of the Government in the definition of quotas by educational field, was already present in the 2007 admission results: the majority of students applied to large universities in large towns and to institutions in Budapest. Any further concentration of applications, which may only be limited by the maximum capacity of the institutions, will probably force a reduction in the number of institutions, thus promoting the development of a more effective and competitive higher education structure.

The deadline of assessment of the capacity of higher education institutions, in line with the number of admissible students and the tasks to be performed, has been modified from 1 September 2009 to 31 March 2008 (as a result of the amendment of the implementation decree of the Higher Education Act in December 2007).

On 1 January 2008, the number of institutions decreased by one public and one church institution.

As a result of the referendum held on 9 March 2008 the provisions of the Higher Education Act on the tuition contribution of state subsidised students were revoked on 1 April 2008, before even being implemented in practice.

Gas and district heating subsidies

In 2008, the subsidy regime became more targeted and introduced new elements, which encourage savings. The ceiling of subsidised gas volume was lowered from 3000 m³ to 2000 m³ (and from 5000 m³ to 4000 m³ for large families), and the specific subsidy rates in the top two income brackets were reduced by 14% and 20%, respectively. The number of applicants decreased as a result of the completed checks. These conditions together ensure that the appropriation available for 2008 covers the payment of subsidies.

Another factor serving compliance with the appropriation is the development of the controlling activity of the Treasury, which, together with the more targeted nature of the subsidy regime (amendment of the eligibility rules), has contributed to the fact that the number of households receiving subsidy has declined by 19% (approximately by 400,000) since 2007.

As a result of the transformation of the subsidy regime, budget expenditures to GDP will fall from 0.4% in 2007 to 0.3% in 2008.

Reorganisation of MÁV

As a result of the government measures taken in 2007, MÁV Zrt., operating the railway tracks, and MÁV Start Zrt., responsible for personal transportation by rail, are expected to have registered slight profits in 2007. This is primarily due to the supply of additional budget transfers and savings measures of the MÁV group driven by the state in its better co-ordinated position as an asset manager and client. The reorganisation of MÁV Zrt. continues in 2008 by transferring the traction and maintenance activities into separate companies, which will further improve the transparency of the operation of MÁV.

The Act on state-owned assets

Act CVI of 2007 on state-owned assets (State Assets Act) entered into force on 25 September 2007, followed by its implementation decree [254/2007 (X. 4) government decree on the management of state-owned assets (Government Decree)].

The State Assets Act brought in consistent rules for the management and utilisation of state-owned assets and created one single national asset management organisation replacing the previous three agencies. The three state-owned asset managing companies (ÁPV Zrt., KVI and NFA) were terminated effectively on 31 December 2007 and succeeded by their general legal successor, a new organisation under the name of National Asset Management of Hungary (MNV Zrt.).

The decision-making competences with regard to state-owned assets have changed fundamentally. Apart from a few exceptions, the owner's decisions related to state-owned assets are basically adopted by the National Asset Management Council, which also operates as the managing body of MNV Zrt. The Government has a very limited scope of direct decision-making in relation to state-owned assets. Pursuant to the provisions of the new act, the Government can define procedural rules for the management of state-owned assets primarily in the form of decrees.

It is an exceptional rule with regard to the decision-making competence of the Council that the Minister of Finance, responsible for the state-owned assets, exercising also the shareholder's rights in the state-owned asset management organisation may make a decision on any matter and instruct the Council in writing to execute it. However, in such a case, the Minister is fully responsible for the decision.

Direct control is exercised on the management of state-owned assets by the supervisory committee, comprising delegates of the parliamentary parties and interest groups of employers/employees, fulfilling also the functions of the Supervisory Board of MNV Zrt. Parliamentary control is exercised through the audit of the State Audit Office and the reporting obligation of the Council towards Parliament, through the Government.

An important provision of the State Assets Act is that it sets conditions and limits to shares of the state in companies, whereby the state may have shares only in companies and may only found new companies in which its liability cannot be higher than its capital contribution and

in which it holds at least more than 50% of the votes. The procedure for the sale of existing minority participations must be launched by no later than 31 December 2008.

It is a general principle under the State Assets Act that the responsibility of the management, as well as asset management reflecting public interests must be strengthened in companies and other economic organisations operating with state participation. The provisions of the State Assets Act intend to enforce this principle through specific rules applicable to the management, control, remuneration and the obligation to issue wealth declarations.

An important change is that central budgetary institutions, apart from limited exceptions, cannot acquire participations; they can only be asset managers, lessees, other users of state-owned assets or organisations representing the owner in the case of participations in companies pursuant to a contract concluded with MNV Zrt.

Another important objective of the new regulation is to considerably reduce the excessive size of state-owned assets and, in this context, to define the assets, in a law, which cannot be sold at all (treasury assets), which the state intends to hold on a longer term and the state-owned assets which must be sold within a foreseeable time (business assets).

It is also a relevant change that the revenues and expenditures related to state-owned assets are contained in a new separate chapter in the Annual Budget Act, thus increasing the transparency of the budgetary relations towards state-owned assets. The increased monitoring of revenues related to state-owned assets is ensured by the fact that budgetary institutions can no longer withhold the sales proceeds of state-owned assets managed by them. According to the new provisions, all such revenues must be credited to the newly established assets chapter of the central budget.