

Ministry of Finance

**Second report of 2008 on the measures taken in response  
to Council recommendation of 10 October 2006  
under Article 104(7) of the Treaty<sup>1</sup>**



**November 3, 2008**

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<sup>1</sup> The report is based on the proposal of 2 November 2008 for amending the 2009 Budget Bill submitted to the Parliament on 18 October 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 deficit<sup>2</sup>, including on structural reforms.<sup>3</sup> The Government submitted progress reports in 2007 on 26 April and 27 September and in 2008 on April 25. 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 second 2008 progress report on the implementation of the convergence programme:*

- *presents the updated macroeconomic forecast for 2008 and 2009,*
- *updates the budgetary projections for 2008 based on figures of the first nine months,*
- *presents the budgetary objectives for 2009 based on the proposal of 2 November 2008 for amending the 2009 Budget Bill submitted to the Parliament on 18 October 2008,*
- *gives an overview on the implementation of the 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 approved by the Minister of Finance on 3 November 2008, based on the authorisation by the Government. The report was submitted to the European Commission and the Council on 3 November 2008.*

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<sup>2</sup> *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%.*

<sup>3</sup> *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 international environment has become clearly more unfavourable from Q2 2008. As a consequence of the financial turbulence stemming from the US subprime mortgage market, beginning in summer 2007, the macro data of developed economies show a significant deceleration of growth and permanent weakness of the macroeconomic outlook. The financial turmoil has by now a negative effect on the whole world economy. The American and European efforts (both by central banks and governments) aiming at the stabilisation of the financial system and the moderation of the effects on real economy have not yet been able to contain the recession fears of market participants. The remedy of the problems of the financial system requires apparently more time than reckoned previously, and meanwhile a strong deceleration in the world economy is reasonable to calculate with.

In this unfavourable international environment, a revision of the previous growth forecast of the Hungarian economy became necessary. As the contribution of exports to the GDP is sizeable (more than 80%), the Hungarian economy can not remain intact from international developments. Thus the strong deceleration in the export partner economies deteriorates significantly the export outlook.

Labour market developments in the coming period are also determined by the lower demand caused by the deceleration on the external markets, which the private sector – regarding both headcount and wages – will adapt to. The effect of the narrower external market offsets the rather favourable headcount developments of 2008 in the export sectors of the manufacturing industry, while the financial turmoil may reduce headcount in the financial service sector. The mitigation in international purchasing power has a negative effect on the trade and tourism sectors. As a consequence of moderating profitability, a moderate wage increase is projected. In the public sector in the absence of wage increase and following the withholding of the so-called 13<sup>th</sup> month wages, real wages will decrease significantly. Overall, employment is expected to decrease by approx. 0.6%.

Due to the increase in financing costs and risk premium, the banking sector applies tighter credit conditions and higher interest rates, which has a negative effect on both households' and enterprises' borrowing.

Owing to the tighter and more expensive credit facilities, the fall in headcount because of the recession and the decrease in real wages, households' consumption is expected to diminish by approx 3%. Investments will also moderate somewhat in the unfavourable economic environment and because of the tighter credit conditions, notwithstanding the increasingly positive role of EU resources. The contribution of net exports to GDP in 2008 is expected to be negative as the growth of imports is expected to exceed that of exports. In 2009 export markets will recede, thus rationally calculating, export growth can only approach 4%, while the growth of imports will lag significantly behind, due to the restrained domestic demand.

The unfavourable developments necessitate the revision of the previous growth forecast: in 2008 GDP is projected to grow by 1.8%. Following the larger than planned deficit reduction, the more unfavourable global economic environment and tighter credit conditions, GDP will decrease in 2009.

The inflation in the first three quarters of 2008 was determined by the food price increase experienced in the last one and a half-two years, the depreciation of the forint in Q1, the globally observable fast increase in energy and fuel prices – and thus the significant increase in households’ electricity, gas and other fuel prices – and the carry-over effect of last year’s price developments. The Hungarian economy faced several – primarily global, cost side – shocks, whose inflationary consequences it bore relatively well. By the end of Q3 2008 the inflationary shocks of previous periods largely petered out. The domestic agricultural prices, attributable to the good harvest, began to fall sharply from the summer, which – beside the base effect – was reflected in last months’ decelerating food price inflation. After the peak reached in July, global energy prices diminished rapidly, which was translated soon in fuel price decreases, and the pressure on households’ electricity, gas and other fuel prices also eased.

Because of pricing rules, the cheaper crude oil prices can appear markedly in households’ gas prices from the middle of next year. In this context, according to the forecast, the inflation will decrease to 5% in December, and the annual average change is expected to be 6.4% in 2008. Next year, the annual average increase in consumer prices will fall below 4.5%.

#### **Main macroeconomic indicators, 2007-2009**

	<b>2007</b>	<b>2008</b>	<b>2009</b>
	<i>change from previous year, in per cent</i>		
<b>GDP growth</b>	1.1	1.8	-1.0
<b>of which: Domestic demand</b>	-1.0	2.1	-2.2
<b>Households consumption</b>	-1.8	0.9	-3.1
<b>of which: consumption expenditures</b>	0.7	1.1	-3.8
<b>Gross fixed capital formation</b>	1.5	1.0	-0.9
<b>Exports (goods and services)</b>	15.9	7.6	3.9
<b>Imports (goods and services)</b>	13.1	8.1	2.4
<b>Consumer price index</b>	8.0	6.4	4.5

### **3. Budgetary developments**

#### ***Changes in the general government figures for 2007***

According to the second notification of the CSO to Eurostat, in 2007 the ESA-95 deficit of the general government sector was 5% of GDP, 0.5 percentage point less than previously calculated. The revised figures indicate that the 9.3% deficit of 2006 was followed by an adjustment of 4.3 percentage points (or 4.5 percentage points in the primary balance). Approximately half of the improvement was attributable to higher revenues, the other half to expenditure cuts: the 2.3 percentage points increase in revenues as a percentage of GDP was accompanied by a 2 percentage points decline in the expenditure/GDP ratio.

The favourable data revision resulted from the combination of several factors. First, accounting for EU funds has been changed in accordance with the Eurostat recommendation, providing for a more neutral impact of EU transfers on the balance (the back-posting of recoveries, realised in later years, of project costs advanced from Hungarian sources). Second, for some investment expenditures, the annual investment statistics show a lower sum than indicated by the preliminary figures available in the spring. Third, the loan and equity

transactions not included among accrual-based expenditures can be identified with more precision based on the final accounts. In addition, the combination of several minor items also improved the balance.

The expansion of the scope of organisations classified within the government sector had no effect on the 2007 balance, though it changed the revenue and expenditure levels and the internal structure of expenditures. MÁV Start Zrt., the company set up to manage rail passenger transport, was reclassified retroactively, as of the date of its establishment (1 July 2007), in the government sector because its market revenues remain below 50% of its total revenues. As a result of the reclassification, the market revenues of the company are added to the revenues of the government. On the expenditure side, the amount of subsidies has been reduced by the sum allocated to MÁV Start, while wage, material and investment expenditures have increased.

### ***Budgetary developments in 2008***

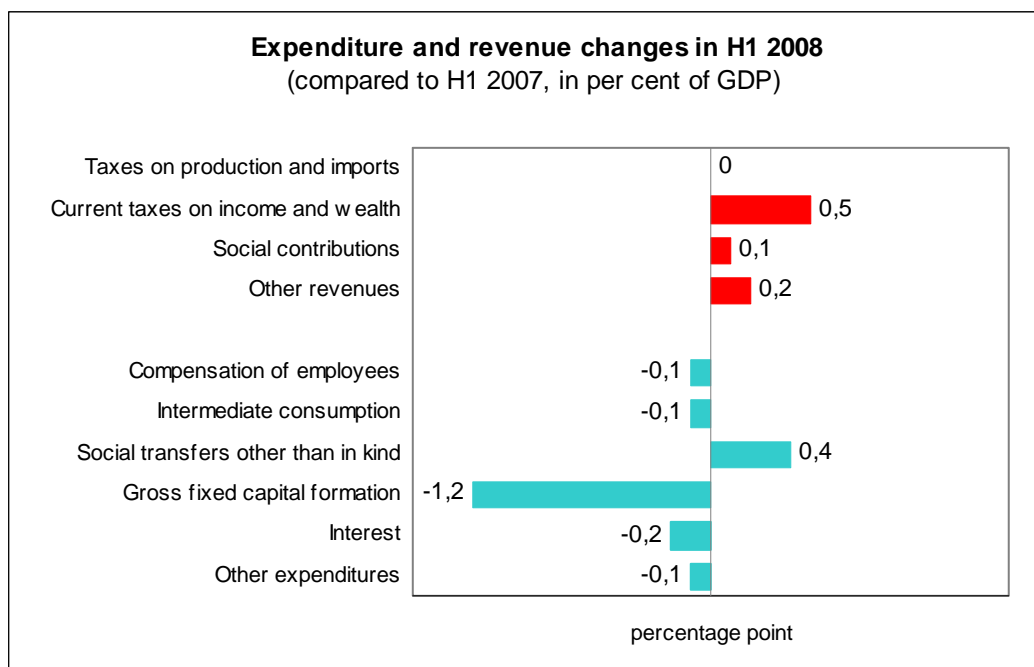
In 2008, again, the budgetary outcome has developed more favourably than envisaged. The April 2008 report on the implementation of the convergence programme envisaged, taking into account a slight increase of revenue and expenditure levels over the originally budgeted figures due to the base effect and to changes in macro-economic developments, that the deficit will be 4% of GDP, as targeted in the convergence programme. However, interim figures have increasingly indicated a lower deficit; therefore, in July, the Ministry of Finance reduced the annual deficit forecast to 3.8% of GDP. Amidst the intensifying global financial turmoil, in order to strengthen confidence and stability, the Government has revised to deficit projection further, to 3.4% of GDP. The new deficit projection is underpinned by the monthly cash flow and quarterly ESA data and the recently announced measures to curb expenditures.

By the end of Q2, the four-quarter cumulative ESA-95 deficit of the government sector had fallen to 3.8% of the GDP of the last four quarters. The deficit amounted to 2.4% and 2.1% of the seasonally adjusted GDP in the first and second quarters, respectively. In the past six and a half years, a smaller quarterly deficit was seen on one occasion only, in Q2 2007. In the whole of the half-year, the deficit amounted to 2.2% of GDP, the lowest figure since end-2001. The deficit to GDP ratio of the government sector fell to exactly half of its level in the first half of 2007.

The improvement is attributable to the growth of expenditures being significantly slower than revenue growth. While revenues were up by 9% (slightly more than 0.8 percentage point as a percentage of GDP), expenditures were only 4% higher than in the first half of 2007. The 1.3 percentage point drop in the expenditure/GDP ratio (from 47.8% to 46.5%) played a crucial role in the improvement of the balance. This year, budgetary trends were characterised by more moderate seasonal fluctuations than in previous years and, early in the year, lower-than-usual expenditure rates.

Among main expenditure items, only social cash benefits increased at a faster rate than GDP growth. This relates primarily to higher pension expenditures. The Convergence Programme expected the pension expenditure to GDP ratio to increase in 2008, taking into consideration the expected growth in the number of retirees in the first half-year due to changes in pension rules (this was the last year to retire under the former rules). Expenditures were increased further by an additional 1.1% pension rise, with retroactive effect to January, because the

pension increase depends on the inflation rate and wage growth, with a 50% weight each. In other respects expenditures, in particular investments, declined as a percentage of GDP. Investment expenditures were some 30% lower than in the first half of 2007 due to delays in EU programmes and in road construction projects and the more modest investments of central government institutions and local governments alike.



Similarly to the ESA figures, the monthly cash flow data also indicate the improvement of the general government balance. In the first three quarters, the aggregate deficit of the central budget, the social security funds and extra-budgetary funds fell to less than two thirds of the level seen in the first three quarters of 2007. In contrast to last year's deficit, the primary balance now shows a surplus. The figures indicate a substantive improvement also after adjustment for one-offs that may distort comparison (one-offs including the debt assumption and the MÁV equity increase in 2007, and the one-off receipt relating to the electricity market coming from the transmission system operator and the advanced subsidy to MÁV). The deficit in the first 9 months is substantially lower than the figure calculated on a time-proportionate manner over the original target. Compared to the annual figure, the deficit was 20% less than in 2007.

#### Cash-flow balances (without local governments)

HUF billion	Q1-Q3			Q1-Q3 / whole year	
	2007	2008	2008/2007	2007 (actual)	2008 budget
Balance	-1147	-731	64%	88%	66%
Primary balance	-408	+130			
<i>Without one-off items:</i>					
Balance	-978	-739	75%	86%	66%
Primary balance	-239	+123			

The favourable deficit development is attributable, on the one hand, to the marked increase of revenues – particularly to certain income-related taxes –, and on the other hand, to the fact that the majority of expenditures being below the time-proportionate levels.

Tax and contribution revenues of the central budget, social security funds and extra-budgetary funds increased by close to 9% over Q1-Q3 2007. Within this, the revenues from corporate income tax (including the special tax on corporates) increased by close to 30%, those from personal income tax (including the special tax on individuals) by close to 13%, while revenues from social security contributions by 7.5%. The revised annual projection reckons with the additional revenues based on the actual figures for Q1-Q3 and on the macro-economic developments (slower disinflation, stronger wage growth than projected at the turn of 2007/2008). Nonetheless, it also takes into account the increased uncertainties related to the downward revision of growth and employment projections. The topping-up of the down-payments during the year of corporate income tax, due in December, may be influenced by the changing macro-economic environment (slow down in industrial production worsening export outlook). Additional revenues from social contribution might be smaller than expected, while revenues from consumption-related taxes might be lower. Altogether, tax and contribution revenues could be 0.4% of GDP higher than in the budget. (Based on Q1 data, the April report indicated a 0.3% of GDP higher revenues.) Besides, non-tax revenues are also expected to exceed the figure in the budget and – as mentioned above – the re-classification of the rail passenger transport company also increases the revenues of the general government sector.

Most of the expenditures categories, except for some items (like the specific and normative subsidies for public transport companies – due to the changed time profile of payments – housing subsidies, subsidies for local governments, interest expenditures), were below 75% of the annual appropriation at the end of September. The deficit increasing effect of the system of budgetary institutions (the balance of the revenues, expenditures and budget contributions of central budgetary institutions and chapter managed appropriations) has been lower, in each month, than the time proportionate level. The savings occurred at the chapter managed appropriations, mainly due to the delay in the implementation of certain EU programmes. The health care expenditures of the social security system have developed in line with the budget; indeed, savings are expected in pharmaceutical subsidies as compared to the budgetary appropriations. Pension expenditures have so far been also below the time proportionate level; however, outlays, as every year, will increase in the last quarter as a result of the payment of the second half of the 13<sup>th</sup> month pension.

The budget reserves have been utilised as follows:

- Around 1/5 of the HUF 47 billion the general reserve is still available;
- The rules of the utilisation of the chapter equilibrium reserve are laid out in the annual budget act. The budget chapters that may use their equilibrium reserves at their own discretion if their revenue targets are met have decided about the use of more than half of the almost HUF 5 billion at their disposal. For the chapters that may utilise their equilibrium reserves with the approval of the Government, the Government has authorised the use of only approx. one third of the HUF 84 million available (Government resolutions No. 2060/2008. (V.16.), 1040/2008. (VI.19.), 2123/2008. (IX.9)).
- The central equilibrium reserve has not been used

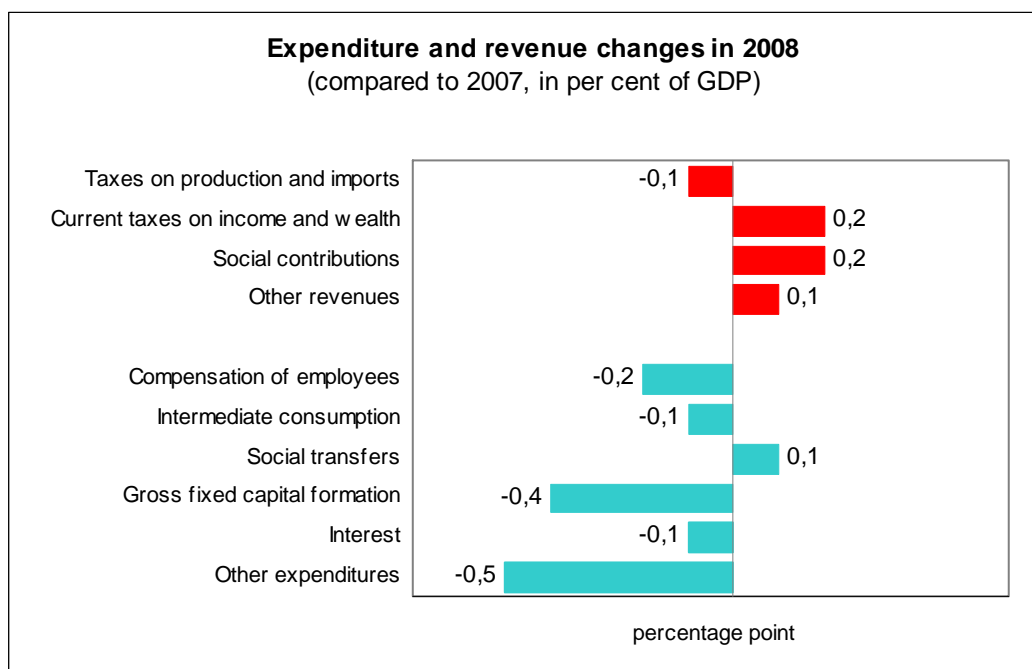
Despite the favourable interim expenditure figures, some items are expected to show additional expenditures relating to macro-economic and financial developments. In the case of other items, however, some savings are to be expected. In addition, in order to fulfil the revised deficit projection, the remaining part of the chapter equilibrium reserve was blocked, and the projection does not reckon with the use of the central equilibrium reserve. Since some savings are expected in the case of expenditures from extra-budgetary funds, and the co-financing need is expected to be lower due to the delay in the implementation of some EU programmes, the lower deficit target is underpinned by a decrease in expenditures by HUF 103 billion (close to 0.4% of GDP). The forecast reckons with the following main changes in ESA-95 expenditures:

- The spring report on the implementation of the convergence programme already indicated that pension expenditures would be higher than originally proposed due to the expected trends of inflation and income developments. Interim figures, however, indicate that inflation will be slower to subside than expected in spring and wage growth has also been more robust. Following the 1.1% pension increase in May, another supplementary increase will be called for at the end of the year, bringing additional pension expenditures to 0.2% of GDP;
- The remaining elements of social cash benefits and social transfers in kind are likely to produce changes in opposite directions. In pharmaceutical subsidies, savings of 0.1% of GDP are emerging. Savings are expected in consumer price subsidies, in social benefits and sick pay disbursements. In contrast, housing subsidy expenditures have increased due to higher government security yields. On the whole, the social benefits to GDP ratio will be at the level envisaged in the convergence programme, slightly higher than in 2007.
- According to the wage agreement concluded in the public sector, real earnings will stay on the previous year level in 2008. Taking into account the expected higher inflation rate, this represents additional expenditure of 0.1% of GDP. (The net effect on the balance, however, is only half that figure.) The additional payments, in the form of a one-off wage supplement, take place in two stages. In addition, the forecast, in view of the re-classification of MÁV Start Zrt. into the general government sector, contains the expenditures of the company but the wage and contribution expenditures to GDP ratio has still decreased compared to the previous year. (The re-classification of the company affected only the second half-year figures in 2007, while in 2008 it will increase employee compensation expenditures for the whole of the year.);
- As compared to the figures envisaged in the previous report, the increase of the expenditures on the purchase of goods and services and the decline of subsidies was also attributable primarily to the re-classification of the railway company;
- Actual figures justify a downward adjustment of the investment expenditure projection;
- Due to the increase of government security yields, cash-based interest expenditures will be higher, but this is not expected to affect this year's accrual-based interest expenditure figures<sup>4</sup>. Accrual-based expenditures may, in fact, be slightly lower than the level foreseen in the convergence programme.

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<sup>4</sup> The cash based interest expenditures are different from accrual-based expenditures for methodological reasons. In an environment of increasing yields, the issuer incurs a price loss on fix-coupon bonds. The price loss is recorded in the GFS interest balance at the time of the issue, while the ESA recognises it throughout the term of the security.

The major components of the more than 1.5 percent improvement in the budget balance over 2007 are illustrated in the figure below:



### ***Budgetary outlook for 2009***

The adverse effects of the financial turbulences in the world economy, the deterioration of the real economy outlook and the fast increase in risks necessitated the revision of the 2009 budget bill. Despite the fact that in October the Government has lowered the macroeconomic projections significantly in two paces, it cut down the 3.2% deficit target of the convergence programme first to 2.9%, then to 2.6% in order to strengthen the confidence and the stability on the markets.

The expected downturn and the need for improving the balance do not allow the implementation of the previously planned tax reduction – with a net effect of 0.5% of GDP; the tax code alters only in favour of simplification and further whitening of the economy. The main measures are the following:

- Extension of mandatory invoicing (broadening the number of persons who can be fined for the failure of invoicing, extension of the mandatory invoice-keeping);
- Restriction in cash transaction (cash limit prescription for taxpayers having bank account, limitation of the end-of-the-day cash stock);
- Tightening the rules for suspension of tax register code (e.g. in case of failure of tax return and payment);
- Tightening the rules aiming at avoiding fictitious invoicing, extension of invoicing (in case of advance payment) to the VAT.

Following the deterioration of the economic outlook, tax revenues fall short of the projections of the convergence programme by close to 1% of GDP. (Nonetheless, the nominal GDP being smaller by more than HUF 1500 billion, with changes also in its components, would increase

the revenue to GDP ratio by more than 2 percentage points.) Yet, revenues compared to the budget bill submitted at the end of September are expected to be lower by 1.5% of GDP. The alteration of the macroeconomic forecast implies a decrease of 2%, out of which 0.5% is compensated by withdrawal of the tax package. As a result of the different effects, the tax centralisation roughly stagnates compared to 2008 (increases marginally by 0.1 percentage point). Calculating with rising interest expenditures despite the lower deficit, the improvement in the balance is attributable to the even larger than previously planned cut in primary expenditures.

The cut in expenditures is achieved through the reduction of central government chapters spending financed from subsidies (i.e. not from own revenues and not from EU-resources), the cutback in public sector wages and containing pension and social expenditure growth.

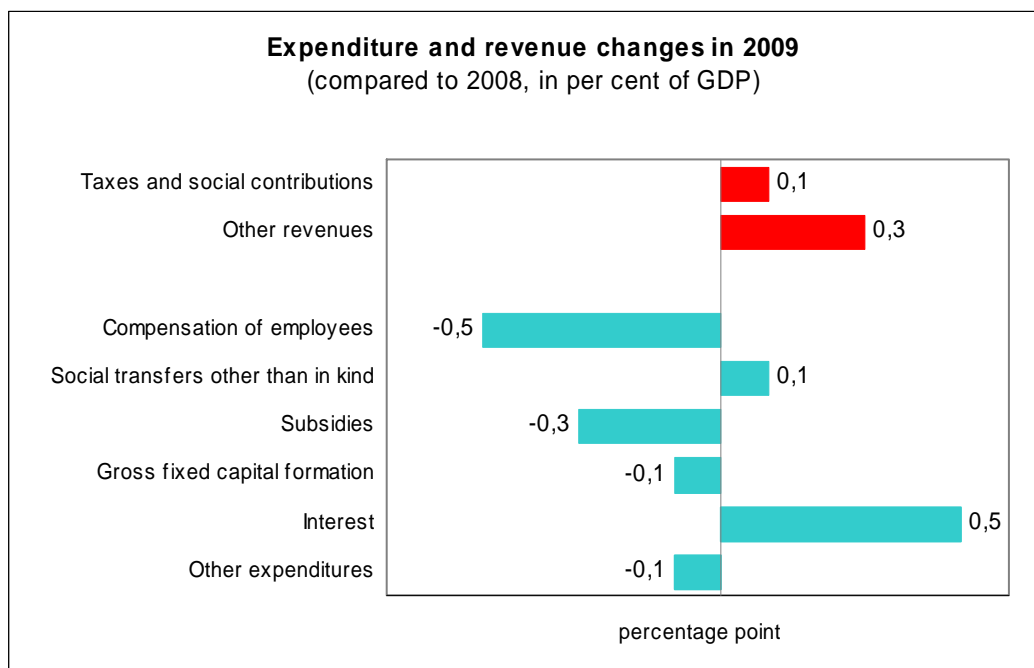
- In 2009 public sector wages remain unchanged (the effect of which amounts to 0.5% of GDP compared to the small real wage increase originally planned). Furthermore, the 13<sup>th</sup> month wages will not be paid next year, which implies further savings (amounting to 0.7% of GDP). The Government intends to use also fiscal instruments in order to mitigate the fall in employment. The objective of the National Employment Programme is to quadruple the number of persons who participate in public purpose jobs instead of living on social benefits. The significant expenditures transferred to finance public purpose jobs increase the spending on wages and contributions in terms of GDP by 0.1 percentage point, thus the level of the compensation of employees to GDP ratio diminishes by 0.5 percentage point compared to 2008.
- The 2009 budget bill includes significantly (by 1% of GDP) lower figures for the central government chapters spending financed from subsidies than the 2008 appropriations. Institutional measures supporting the “smaller and more efficient state” objective have been largely implemented. The achieved permanent savings and the disappearance of one-off tasks helped the reduction of the expenditure appropriations. Furthermore chapters were allowed to plan their 2009 appropriations on a basis lowered by close to 0.4% of GDP. The subsidy appropriations in the new budget bill (not including the change in wage expenditures) were reduced further by 0.2% of GDP. Savings are increased also by the fact that HUF 80 billion (0.3% of the GDP) of the chapters’ subsidies are transferred to the frozen chapter balance reserve, which will not be spent. The appropriations in the frozen chapter balance reserve can only be spent if windfall revenues occur, but whatever is the amount of the windfall revenue, the increase in expenditures could not surpass the amount of the frozen chapter balance reserve. Moreover those windfall revenues to which an expenditure item is attached could not be spent as well.
- Pensions will increase by 1 January according to the relevant legislation, however, the so-called pension correction programme will continue only from 1 September. Payment rules of the 13<sup>th</sup> month pension changes. The 13th month pension is capped to HUF 80000, and it can be only paid after the normal retirement age of 62 years. These measures cut expenditures by 0.3% of the GDP. In addition, due to the revision of the wage and inflation projections, the Swiss index, which defines the extent of the increase of the pensions, is also lower than planned originally (it has been lowered from 5.6% to 3.9% and than 3.1%); total savings amount to 0.5% of the GDP;
- The annual valorisation of the family support and social benefits to level of the inflation will take place from 1 September; social transfers attached to the minimum pension remain unchanged (savings of 0.1% of the GDP). Measures related to pensions and social transfers decrease social payments other than in kind by 0.6% of the GDP. The slight increase of the

expenditures in proportion of the GDP (0.1% of the GDP) compared to 2008 is caused by the significantly lowered nominal GDP figure.

- The subsidy of the passenger transport is lower than planned earlier, expenditures of the Labour Market Fund and expenditures related to state wealth decreased. In addition, other small items improves the deficit further;
- In the Budget priority is given to the project partly financed by the EU. The restructuring of the expenditure side could help revitalising the economy and maintaining workplaces, therefore more emphasis will be given to the project supporting SMEs.

Reserves of 0.7% of GDP ensure the safe execution of the budget (general, specific and the so called stability reserves).

The revenues and expenditures of the general government in accrual terms are higher than projected in the convergence programme due to the broadening the institutions recorded in the general government sector, and mainly to the smaller nominal GDP figure. The main components of the 0.8 percentage point improvement of the budgetary balance compared to 2008 are presented in the following figure.



#### 4. Structural measures

In line with the Council recommendation of October 2006, the Government has adopted a number of measures affecting the subsystems of the general government to assure the observance of budget ceilings in the fields of public administration, health care, the pension system, education and the gas subsidy scheme.

## ***Public administration***

### **Central public administration**

The reform measures started in 2006 (reorganisations, staff cuts and the introduction of the performance measurement system) have all contributed to cutting costs and raising the efficiency of public administration. The main thrust of the organisational measures adopted early in the term of the government was to regionalise large networks; these have been implemented between 2006 and 2008. The remaining measures and objectives, mostly attained by now, all aimed to improve the efficiency and effectiveness of operations. These include the following: the reduction of the size and internal segmentation of the institution system; the close-down of institutions and business associations where the performance of functions by the public sector is not justified; the elimination of duplications; merger of financial services supporting professional activities, of professional functions and physical support organisations, and the performance of functions with concentrated and more limited capacities. Actual figures indicated that in 2006-2007, the measures brought about a net reduction (i.e., taking into account any staff increases in some fields) of 13,604 in the number of persons employed, representing some 5% of the total authorized employee numbers for 2006. The sustainable annual savings for the budget amounted to HUF 47 billion, which thus serves to improve the equilibrium.

- The number of employees of the central government fell to 5787 by the end of 2007, corresponding to an approximately 27% reduction from the staff numbers at the beginning of 2006 (7936 persons);
- in the framework of the centralisation of parallel functional areas, in order to make the performance of tasks more effective and economical, the management of public assets was integrated in a single entity (Hungarian National Asset Management Zrt.) as of 1 January 2008. Central service providers have gradually taken over support functions in the course of 2007-2008;
- 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, or later in the year. As a result of the reorganisation, instead of the 430 central budgetary institutions affected, only 184 have continued their operation.

The quality improvement of public services has been promoted by the introduction of the definition and measurement of performance requirements across the board in the entire public administration (establishment of a new type of performance assessment procedure (TÉR)).

In order to gradually reduce the administrative burdens of market and non-market actors alike, the assessment of the administrative burdens imposed by the effective legal regulations has started based on the Standard Cost Model method. The aim is to reduce burdens by at least 25% by 2012.

In order to prevent the regeneration of the aforementioned administrative burdens, it will be necessary to introduce the prior measurement of expected administrative burdens imposed by proposed draft regulations. Accordingly, the preparation for the systematic use of the SCM

method and for its inclusion in the government's decision making mechanism is ongoing, with the deadline on 31 December 2008.

To eliminate procedural law obstacles to maintaining electronic contacts between clients and authorities and between various authorities and to promote such electronic contacts, it is necessary to amend the act on the rules governing the regulatory administrative procedure and service provision; the draft of the legislation has been completed, to be discussed by the Government in October 2008.

The purpose of the review of the role of specialised authorities in every regulatory procedure is to reduce the participation of specialised authorities in the various procedures, applying a notification obligation instead of a licensing procedure while introducing strict controls. With the final deadline on 30 November 2008, the review of procedures has made time proportionate progress and the amendment of the relevant laws is under way. As a result, the contribution of specialised authorities is expected to be reduced by 20%.

With a view to reducing the administrative burdens of market and non-market actors and of public administration and to assure faster case administration, progress has started on making the forms used in public authority and regulatory procedures electronically available for downloading or completion. The technical tool is available for the conversion of forms into electronic format, and the guidelines for their required content have been completed. The preparation of the electronic versions of the various forms is under way, with the final deadline on 31 March 2009.

## **Local government**

In 2008, Parliament approved HUF 28.1 billion for funding the performance of tasks in micro-regions. In 2007, HUF 22.5 billion was available for funding multifunctional micro-regional associations, as opposed to HUF 15.4 billion in 2006. The main areas of cooperation continue to be public education and social functions. As an indication of the intensity of cooperation, the number of associations maintaining public education institutions and the number of local governments participating in such increased considerably in the 2007/2008 school year.

In addition to multifunctional micro-regional associations, the increase in the number of district town clerk offices also indicates a move towards a more rational allocation of functions.

In order to improve cooperation between municipalities and to promote the joint performance of functions, and to improve the material conditions for the schools of small settlements and district town clerk's offices and to procure community buses, the central budget has provided funding of HUF 3.5 billion in 2008. This grant has opened up new opportunities for small settlements to implement some minor investments for which there is a real need but which, due to their size, are not eligible for EU funding. Based on 342 successful applications, 905 settlements and 38 micro-regions received funds to achieve the aforesaid objectives.

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 almost fifty percent.

The Government has approved HUF 1.6 billion for the infrastructure development and capacity expansion of nurseries and kindergartens and the infrastructure development of primary schools. The grant serves the infrastructure development of settlements in the 47 most disadvantaged micro-regions. The objective is to ensure that care for and education of children and students in these micro-regions is the highest possible quality, with particular attention to providing equal opportunities to children with multiple disadvantages.

The amendment of the act on public finance altered the system of on-site inspection of requesting and accounting for the funds received by local governments from the central budget, in the framework of the Treasury review, as well as the terms of the mandatory on-site inspection:

- In respect of the application for grants and contributions at the beginning of or during the year, by default, the Treasury conducts an on-site inspection if the difference between the aggregate amount indicated in the local government reporting on the one hand and shown in the Treasury records on the other hand exceeds 2% and is not less than HUF 1 million. In respect of the review of the year-end accounts, the Treasury conducts on-site inspections at every local government at least once every four years.
- By way of exception, stricter rules apply to local governments with budgets in excess of HUF 400 million. In that case, on-site inspection is performed annually in respect of at least 50% of the titles of revenues from the central budget.

### *Curative-preventive care*

The declining trend of the expenditures on curative-preventive care to GDP in recent years satisfies the requirements of the convergence programme and in the long term it lays the foundations for the sustainable funding of health care.

#### Expenditures on curative-preventive care

	HUF billion, current prices	GDP, HUF billion, current prices	as of GDP
2006	713.95	23785	3%
2007	718.72	25419	2.8%
2008	740.77	27220	2.7%

The reforms of 2006 and 2007, the introduction of the new capacity regulation and financing systems facilitated the equilibrium of the Health Insurance Fund. In 2007, the Health Insurance Fund closed with a surplus of HUF 27.4 billion. For 2008, a surplus of around HUF 15-20 billion is expected.

The revenue side of the Health Insurance Fund has been strengthened mainly through the verification of insured status, which continues to be an important reform element in 2008. Persons not paying contributions continue to receive any required health care, but from 1 January 2008 on, the Tax Authority, based on the data supplied by the NHIF, has paid special attention to controlling residents failing to sort out their legal relationship. Failure to submit a notification triggers a default fine, and failure to pay contributions results in the imposition of a penalty. In order to assist with controls, the scope of data exchange between the NHIF and the Tax Authority has been broadened.

Health care service providers are obliged to verify the existence of an ensured status in advance. The NHIF will withdraw 10% of the financing of service providers failing to perform the verification. In order to improve the efficiency of the insured status check, under the system introduced in 2008, if the family doctor or the service provider offering dental, outpatient or in-patient services verifies the insured status of a patient, he receives HUF 50 remuneration per case to recognise the additional effort required.

The insurance principle of the social security system is also reinforced by the fact that there is actual contribution payment in respect of persons entitled to health care services on a solidarity basis (e.g., pensioners, recipients of maternal benefits, full time students, homeless persons) as the central budget pays a health service contribution of HUF 4350 per month and per person into the Health Insurance Fund. In 2008, the funds thus remitted from the central budget amounted to HUF 307 billion, in contrast with HUF 289 billion in 2007.

In the rationalisation of the curative-preventive care, the account statement plays a major role, serving to curb the financing of reported but unjustified output. Under the threat of sanctions, all health service providers must issue account statements to insured persons if they make use of in-patient care, specialised outpatient care or basic dental care. In the account statement, the insured person is informed about the services or treatments the health service provider intends to charge to the insurer as well as the amount charged.

Following the abolition of the visit fee/daily hospital charge payment obligation, there was a slight increase in the number of patient-doctor meetings, but this does not endanger compliance with the curative-preventive care appropriation.

The standards of care can be maintained also among the tighter fiscal boundary conditions considering that

- as a result of the relevant measures (account statement), invalid, fictitious procedures no longer burden the benefit system, thus capacities can 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);
- continued promotion of forms of care that create less burden for the budget but that are better for patients (day surgery, day hospital).

The savings in expenditures facilitated increasing the financing of providers of basic health care services, the improvement of forms of day surgery and the shortening of waiting lists that evolved in certain specialisations.

### ***Pharmaceutical subsidies***

The reform of the pharmaceutical subsidy system in 2007 was an important measure for the implementation of the Convergence Programme.

Upon the entry into force of the provision of the Act on the secure and efficient supply of pharmaceuticals and medical aids and on the general rules of pharmaceutical trade as well as the rules on the contributions of pharmaceutical companies, 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 created a new, more equitable system of the joint responsibility of pharmaceutical producers (the beneficiaries of the marketing license of pharmaceuticals), traders, prescribing physicians, patients and the health insurance system.

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

Major changes implemented 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). Producers can now submit price cut offers through the internet (NHIF Web Bidding system), using electronic signatures. This is a major step forward and it also accelerates processes;
- the criteria for remaining in the subsidised pharmaceutical category have become more stringent;
- in line with regulations promoting efficient prescription, physicians receive regular feedback about how their prescription practice relates to the average. The amendment of the legal regulation on the promotion of quality and effective subscription practices is under way; the new rules are expected to be applicable based on prescriptions redeemed after 31 march 2009. On this basis, physicians will not be sanctioned financially; instead, they will be required to attend training;
- the payment obligation 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 per year after medical representatives, tiered payment in the event of the overrun of the appropriation for pharmaceutical sales in pharmacies). Of these, the payment obligation in respect of medical representatives was abolished by the Constitutional Court as of 18 June 2008. Due to the favourable developments, no tiered payment obligation has arisen in 2007 or 2008;
- the on-line verification of prescription rights and eligibility has started;
- 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 long-standing, dynamic growth trend of pharmaceutical subsidy expenditures was interrupted. Expenditures fell by 16.7% from the level of subsidies paid in 2006. In 2007, HUF 323.6 billion of pharmaceutical subsidies were paid, the payments of pharmaceutical producers and traders showed a balance of HUF 27.8 billion, and the pharmaceutical-related balance of the Health Insurance Fund was HUF 295.8 billion. The latter represented 1.17% of GDP, which was a major, 0.38 percentage point decline from the previous year level.

By August 2007, pharmaceutical subsidies of HUF 218.6 billion were paid, while in 2008 the corresponding figure was HUF 212.6, representing a drop of 2.8%; this is only 61% of the original subsidy appropriation of HUF 347.9 billion, which included the pharmaceutical subsidy reserve. Based on trends so far, and in view of the Constitutional Court decision, the payments of pharmaceutical producers and traders are expected to be around the envisaged level.

Based on the time proportional performance values of previous years it is likely that the pharmaceutical-related balance of the Health Insurance Fund will turn out to be more favourable than budgeted despite the fact that the demand for pharmaceuticals has risen by a few percentages due to the involuntary abolition of the visit fee.

The reduction of the subsidy levels triggered a considerable increase in the co-payment in mid-January 2007. As a result of the price competition on the generic market, however, prices of the subsidised products declined continuously, affecting 960 preparations in total between 15 January 2007 and 31 August 2008; producer prices fell by 25% in this category. The 18.5% average consumer price increase of 2007 for the full range of pharmaceuticals (both subsidised and non-subsidised products) fell to 2.3% in the first eight months of 2008.

On the whole, the expenditures of the in-kind services of the Health Insurance Fund (curative-preventive, pharmaceutical subsidies, medical aids subsidies and other expenditures) are expected to fall, from 4.9% in 2006, to 4.1% in 2008 as a percentage of GDP.

### *Pension system*

In the pension system, the Hungarian general government faces considerable long-term expenditure growth as a result of demographic trends. In the forthcoming 50 years, the old-age dependency ratio (ratio of the population above retirement age to the active age population) will increase substantially. Therefore the ratio of pensioners to persons in employment will also develop along an unfavourable course as the improvement of the employment rate will only moderately alleviate the demographic problem. Thus firm measures are required to assure the long-term sustainability of public finances. The best tool for improving sustainability is to curb expenditures, which will increase in the future. This demands reforms, primarily in the pension system. In addition, as indicated in the previous sub-chapter, the gradual reduction of the government debt will also improve, indirectly, the long term sustainability of public finances.

The measures implemented in the 2006-2008 period will, in the medium and long term, considerably reduce the expenditures to be incurred in the pension system in the next 50 years, thereby continuously improving the position of the central budget as well as the sustainability indicators of the mandatory pension system. Most of the measures are set out in the amendments of the Act on social security pension benefits adopted in 2006 and 2007. The approved and effective measures include the following:

1. Persons going into early retirement after 1 January 2008 will be allowed to take up regular employment with earnings above minimum wage only if they simultaneously suspend their pensioner status. The new rule is applicable to persons retiring after 1 January 2008, while from 2010 onwards it will also be extended to all persons in early retirement.

2. After 1 April 2007, pension contributions in accordance with the general contribution rules must be paid also in respect of income earning activities pursued by pensioners. This contribution gives rise to eligibility for additional pension: pensioners receive a pension increase corresponding to 0.4% of their annual income (0.5% after 2008) for each year of contribution payment.
3. From 2008 on, for incomes earned in previous years, instead of the current partial valorisation, full valorisation will be applicable in pension calculation (to the level of the year directly preceding retirement); furthermore, the calculated tax must be deducted from the earnings reduced by the contributions payable by the individual. As a combined effect, the replacement ratio of initial old-age pensions may decline from 82% to around 76%.
4. From 2007, businesses employing persons in jobs with potential health hazards have had to pay a special contribution to cover eligibility for early retirement. Between 2007 and 2010, the central budget will assume the related burdens from the employers, on a regressive scale, while from 2011, the 13% contribution will be payable fully by employers.
5. In case of men, the earliest date of early old age retirement will not be reduced to 59 years of age between 2009 and 2012; instead, it will remain at 60 years. The adjustment is estimated to result in expenditure savings of HUF 120 billion between 2009 and 2012;
6. From 2009 on, the criteria of early retirement will become considerably more stringent: instead of the previous 38 years of service, or 33 years for a reduced benefit, 40 and 37 years, respectively, will be required from next year, which is expected to significantly increase the mean age.
7. As of 2013, the early retirement age will increase to a uniform 60 years of age, and at least 37 years of service will be required for a reduced pension benefit.
8. From 2013 on, the rules governing the reduction of old age pension in case of early retirement will be modified. The rate of reduction, depending on the time remaining until retirement age, will be 0.3% per month for the 61-62 age group and 0.4% per month below the age of 61.

Apart from the ones listed in points 3 and 4, all the measures aim to increase the mean age of retirement, which means that the effect of these measures can be assessed in the positive change in the actual age of retirement (male, female). In respect of 2008 it should be emphasised that of the measures listed, the ones explained in points 1-4 have already made their effects felt. Of these, the altered pension calculation rules that came into effect on 1 January 2008 will have a substantial long-term impact. The new early retirement contribution 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 long term effects of the measures on public finances were explained in the convergence programme of 2007. The updating of the calculation of the effects is under way. The updated figures will be presented in the next, updated convergence programme.

It must be emphasised, however, that the tightening of the rules will temporarily go hand in hand with an increase in the numbers of the newly retired. The majority of those who had a choice between retiring under the old or new rules is likely to have chosen the old rules; moreover, persons originally intending to retire later may have brought their application for retirement forward. The number of applications for pension in the own right of the applicant awarded in 2007 increased by approximately 16%, or close to 20 thousand, over the previous year figures (19,715 persons), and this figure is even higher for old age pensions: almost 25%

more people retired in 2007 than a year before (an increase of 19,630 persons), while at the same time, the number of disability pensions awarded fell by some 12% (by 4,825 persons).

It is also worth noting that retirements for employment policy purposes also showed a marked increase in 2007. In contrast with the 3300 persons in 2006, 8210 persons were awarded pensions under such heading in 2007, and this trend continued in 2008: in the first half of the year, 7808 persons retired in this category, almost as many as in the entire previous year.

#### Number of pensions awarded in the given year

Year	Employment policy purpose*	Old-age**	Disability	Total
2005	3 830	77 425	42 877	124 132
2006	3 300	78 923	39 211	121 434
2007	8 210	98 553	34 386	141 149
H1 2008	7 808	34 645	15 151	57 604

\* Includes miners' early pension and early pensions subsidised by the employer

\*\* Including general early old-age pensions

In addition to the aforementioned amendments of the retirement rules, the act on the reform of the disability pension system, effective from 2008 and focusing on a rehabilitation approach, contains additional measures to promote the long term sustainability of public finances. The new regulations have modernised the system of assessment of altered working capacity, concentrating on the remaining working capacity while providing for the background for complex rehabilitation. Persons having remaining working capacity will receive a rehabilitation benefit rather than a disability pension in the future. This benefit may be granted during the rehabilitation procedure but for no more than 3 years. The new benefit rules, supplemented by the reform of the system of rehabilitation instruments and institutions, are expected to yield the first savings in 5 or 6 years, to increase to an appreciable level within 8-10 years of their introduction.

The expenditure reducing effect of the pension measures introduced in 2006-2007 has a beneficial effect on the long term sustainability of public finances; it is clear, however, that additional reforms are required to improve the long term sustainability of the system.

In October 2008, the Government submitted a legislative proposal to Parliament envisaging the 2009 steps of the so-called pension correction programme to be applicable from September, instead of January, as previously planned. The adoption of the proposal by Parliament would lower the pension expenditures in 2009.

In order to assure the sound implementation of such additional measures, the Government has set up the Pension and Old Age Roundtable to promote a consensus on issues of great import affecting the entire society in the medium and long term. It initiates the preparation and extensive discussion of analyses that may result in recommendations effectively supporting the work of governments and the legislative process. In the course of expert-level preparatory work, both the key parameters (retirement age, replacement rate, indexation) and systemic changes (e.g., individual accounts) will be reviewed and assessed.

The Round Table has initiated impact assessments on the reform of the pension system. This includes, on the one hand, the long term projection of the effects of the current system (parametric reforms) as well as the thorough examination of scenarios relying on assumptions

based on the various paradigms. Furthermore, the impact assessments cover the expedient methods of managing the transition and the examination of the effects of external factors relevant for the pension system (taxation, flexible retirement age, improved willingness to pay contributions, etc.). When completed, the impact assessments may provide orientation to the preparation of government decisions. The Round Table is expected to complete the impact assessments by end-2008.

## ***Education***

### **Public education**

The new performance indicator based financing, introduced on 1 September 2007, has been extended, as of 1 September 2008, pursuant to the budget act, to basic art education, education and care in dormitories and hostels, day school and study room activities and boarding school education as well. The basis of calculation for these functions is also the education organisation parameters specified in the act on public education. Essentially, as a result of this funding system, maintainers (mostly local governments) will have to face the consequences if they employ more teachers than justified by these parameters (mandatory classroom hours of teachers, average student group sizes, weekly time allocated to study).

In respect of kindergarten education, school instruction and theoretical studies in vocational training, the parameters defined for the 2007/2008 school year will become more stringent in the new school year as we move up in grades. The provisions of the public education act will be fully applicable in financing in the 2010/2011 school year.

The rules governing transfers to promote the association of local governments maintaining institutions have been fine-tuned; the obligation of planning public education tasks in micro-regions has been set forth. From 1 September 2008 on, funding to micro-regional public education functions has been conditional on the multifunctional micro-regional association possessing an approved micro-regional action plan setting out, in respect of the settlements participating in performing the public education functions, all the requirements that need to be included in the action plans of local governments as well.

The objectives of the Government's programme 'New Knowledge – Education for Everyone' include, inter alia, that every child should start school with equal opportunities and that the school system should not increase social differences but rather it should allow persons in disadvantageous positions to improve their plight; furthermore, the teaching profession should be made more attractive and the work of teachers should receive more recognition.

### **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 new steps have been taken:

- Pursuant to the amendment of the act on higher education in 2007, the government programme for the quality-driven development of higher education, in view of the requirements of mobility in higher education within the European Higher Education Area,

as a new means of adaptation gives universities and colleges the choice of a three-year maintainer agreement between the higher education institution and the maintainer ministry, which provides more independence as well as greater responsibility and helps the financial management of the institution. Thus, on the one hand, the safety of budget planning is improved, and on the other hand, qualitative performance expectations are set out for financed institutions in areas such as training, R&D, financial management, regional economic and social integration and cooperation.

- Under the agreements signed in December 2007, the central budget funding consists of two parts: the core funding for the duration of the agreement and the annually changing funding tied to performance indicators.
- The pro-competitive effect of the admission procedure, based on student choice and limiting the role of the government to setting admission ceilings for areas of specialisation was already noticeable in the 2007 admission results: the majority of students applied to larger universities and to institutions in cities and in Budapest. In the admission procedure of 2008, the numbers of both applications and admissions were more balanced between the country and Budapest than in the first year of the new admission system, even though due to a demographic decline, some ten thousand persons fewer applied to institutions of higher education. The continued concentration of applications, which is limited only by the maximum capacity of institutions, is expected to bring about an involuntary reduction in the number of institutions, promoting a more efficient, more competitive structure in higher education.
- The deadline for the review of capacities of higher education institutions, as related to the admission ceiling and the functions to be performed, has been moved from 1 September 2009 to 31 March 2008. Admission into higher education institutions in 2008 was conducted in light of the outcome of the new capacity accreditation procedure.
- In preparation for the master education to start in some three hundred majors in September 2009, the state-financed master quota of 21,700 persons will be allocated among institutions in an application scheme in September 2008.
- On 1 January 2008, the number of institutions was reduced by one state-financed and one church-maintained institution, and more integration initiatives are under way.

As a result of the definitive referendum of 9 March 2008, the provisions of the higher education act on the tuition fee payable by state-financed students were repealed as of 1 April 2008, before the provision would have been put into practice. In September 2008 a provision entered into force whereby students failing to reach achievement targets in the state financed system may continue their studies on a tuition fee payment basis, and they may be replaced by the best performing tuition-paying students. The reclassification, promoting higher achievements, affects 15% of the students.

### ***Gas and district heating price subsidy***

The subsidy regime, transformed on a means-tested basis in 2007, became more targeted in 2008, and elements promoting efficiency were introduced. The ceiling of subsidies gas volume was reduced from 3000 m<sup>3</sup> to 2000 m<sup>3</sup> (or from 5000 m<sup>3</sup> to 4000 m<sup>3</sup> for large

families), and the specific subsidy rates in the top two income brackets were reduced by 14% and 20%, respectively. As a result of the checks performed, the number of applicants fell. As a combined result of these developments, the appropriation for 2008 is certain to cover the payment of subsidies.

The improvement of the control function of the Treasury also serves to enforce the appropriation, which, together with the better targeting of the support system (amendment of the eligibility rules) played a role in the reduction of the subsidy recipient households by 19% (by some 400 thousand) as compared to 2007.

As a result of the transformation of the subsidy system, the budget expenditures to GDP ratio is expected to fall from 0.4% in 2007 to 0.3% in 2008. In 2009, the contribution to the energy costs of households will continue to decrease.