

Ministry of Finance

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



May, 2009

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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 and in 2008 on 25 April and 9 October.

As the previous Reports presented, Hungary has fulfilled the recommendation for 2008: the fiscal consolidation last year was larger than originally targeted; the general government deficit was reduced to 3.4% of the GDP in 2008. The sharp decline in the global economy caused significantly larger deterioration in the macroeconomic conditions than it was assumed at the time of the preparation of the convergence programme December 2008. The revenue shortfall as a consequence of the recession being harder than expected before, was partly compensated with government measures on expenditure side, because further expenditure cuts, which would be necessary for maintaining the original deficit target would deepen even more the economic downturn and would lead to negative growth spiral. Against this background, the change in macroeconomic conditions required a revision of the budgetary path aiming at correcting the excessive deficit.

Apart from the short term expenditure cuts, the Government decided to implement structural expenditure reduction measures, which improve the sustainability of the public finance in medium and long term, and contribute to employment growth, competitiveness and increase the potential growth.

The aim of this report is to present the revised macroeconomic and budgetary path, and it gives an overview on the measures underlying the budgetary path. The report includes both an update on the ongoing structural measures and the measures implemented since the submission of the December 2008 convergence programme.

This progress report on the implementation of the convergence programme:

- *presents the updated macroeconomic forecast for 2009 to 2011,*
- *updates the budgetary projections for 2009 based on figures of the first four months,*
- *presents the budgetary objectives for 2009 to 2011,*
- *gives an overview on the implementation of the structural reform measures indicated in the convergence programme, which underpin the lasting expenditure and deficit reduction.*

The report was adopted by the Government on its meeting of 27 May and, following the submission to the National Interest Reconciliation Council, submitted to the European Commission and the Council on 29 May 2009.

* * *

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

Background

Outlook for international economic developments has been seriously worsening compared to what was assumed in the convergence programme of December 2008. Since deep integration in global developments is prevailing for Hungary both in terms of financial and trade relations, international negative impacts are fast and strong to spill-over to the Hungarian economy. On one hand, the Hungarian economy is very much export-oriented; the share of exports to GDP is more than 80%. Accordingly, economic growth of recent years has largely been driven by the exports. Stronger-than-expected decline in imports of Hungary's major trading partners has significantly deteriorated the Hungarian export prospects. On the other hand, due to financial market stresses, external funds available to the Hungarian banking system narrowed to curb lending activity by Hungarian banks. Thus bank loans will be more expensive and conditions are being tightened. These conditions have a negative impact on households' consumption and investments financed partly from loans in the recent years.

The impact of the global recession is well reflected in the figures for the first few months of 2009. Based on preliminary estimates, exports and imports in goods fell by 22-23% and 24-25% in volume, respectively. Households' consumption expenditure dropped by 6-7%, particularly due to declining consumer credit and cautious stance of households in connection with the crisis.

Thus, both external and domestic sales opportunities are shrinking, with a consequence of deteriorating profitability in the business sector. Companies adapt to the new conditions through several channels (layoffs, wage freeze, working hours cut). Based on the figures of the last two quarters, lay-offs seem to be the first-applied form of adaptation as the headcount is continuously and intensively declining in the business sector (In March 2009, employment in the business sector was by 131 thousand less than a year earlier, and in Q1 2009 it was by 4.6% below the corresponding figure of 2008). In addition, part-time employment is spreading including the introduction of 4-day working week, wage freeze is observable (mostly for the blue-collared where their regular earnings increased only by 1.9%) as well as cutbacks on bonuses.

In the whole national economy, gross fixed capital formation fell by 2.7% in 2008, due to the drop in public investment projects and to the negative expectations emerged in the business sector in relation to the crisis. The negative tendency continued in Q1 2009. Despite the sharp decline in exports, net exports could well have contributed to GDP since the imports went down much more than exports due to the fall in domestic demand. All in all, based on preliminary figures of the CSO, GDP fell by 6.4% in Q1 2009 (by 5.8%, adjusted for the calendar effects).

At the same time, as global investment climate has improved somewhat in recent weeks, the risk assessment of Hungary could be better as well. Furthermore, the positive impact of wide-ranging fiscal and monetary policy measures is now felt and the global economy is expected to approach the trough of the current business cycle. All this is reflected in the Hungarian macroeconomic figures as well. In particular, the decline of trade as observed in the past months has been more moderate, while construction output has showed growth due to the government stimulus package.

Global and Hungarian inflationary developments significantly changed. Domestic consumer price index with a slow moderation in the first six months of 2008 started to fall fast from September 2008. The rate of inflation dropped to 3.5% by December to reach an annual average of 6.1% for 2008. Due to a strong depreciation of Hungarian forint, disinflation development will be more moderate in the first six months of 2009 (inflation on the average of the first four months was 3.1%).

In 2008, the external financial need increased by 2 percentage points over the previous year, to 7.4% of GDP.. The deterioration is explained by the worsening international conditions (strongly worsening income balance due to increased financing costs). However, Q1 2009 figures of trade in goods show significant surplus, thus contributing to an improvement in the current account.

Outlook

In the current expectations, the second half of 2009 may see a better international economic situation. Following market recovery, a slow upturn may begin in global terms as well. Trade must be likely to improve in parallel to the recovery in the advanced countries. With improving export opportunities, corporate investment in machinery and equipment as well as industrial production could recover somewhat. These positive developments may generate continuous growth in the years ahead. Furthermore, tax measures by the Government could significantly contribute to the competitiveness of export sector.

On the other hand, fiscal adjustment makes an adverse impact on domestic demand. The increase of VAT and excise tax rates, financial transfer cuts as well as tightening of public housing subsidies affect negatively the household consumption and investment with possible similar impact on public consumption as well. As a result, the Hungarian economy will bottom out in the second half of 2009. After all, GDP is expected to contract by 6-7% in 2009.

Government measures to contain the negative impact of the global crisis and to help economic recovery

In the lack of fiscal room for manoeuvre, the Government took measures by budget re-allocations, faster and more efficient utilisation of EU funds or through off-the-budget means for economic stabilisation and to ease adverse impact of global crisis. These crisis-management and investment-stimulating measures may mitigate the downturn in the business sector and public investment.

Assistance to SMEs

Additional funds for micro-, small and mid-size enterprises

- Easing conditions of Micro-loan Program: for investment loans, the longest term increased to 10 years from 6 and highest loan sum increased to HUF 10 million from HUF 6 million in addition to better interest rates. For working-capital loans, the credit-free waiting period stipulated decreased from 6 months to 1 month.
- Based on Loan Programme for SMEs, cheap refinancing facility is available for the commercial banks engaged and they may spend their assets on lending projects of SMEs at amount of HUF 10 to 100 million.
- Working-capital loans to SMEs from EU funds or through the Hungarian Development Bank's assets.
- Loans for investment projects and working-capital loans offered with the assistance of the Hungarian Development Bank are widened.

- 4 preferential loan programmes are set up to agricultural businesses, 1-1 to producer organisations and food industry enterprises, each, with the assistance of the Hungarian Development Bank.
- Based on Risk Capital Program, common investments implemented from EU, government and private funds will help capital financing of small, infant firms and those in early growth phase. In the Program, the Hungarian Enterprise-financing, inc. (Magyar Vállalkozásfinanszírozási Zrt.) will channel funds to risk capital funds widening capital-raising opportunities for SMEs.

Interest subsidies:

- Based on the Széchenyi Card Programme, doubled interest subsidies may be granted to current financing up to HUF 25 million of loan amount.

Extension of credit guaranties

- Government guaranty facility provided with the assistance of Garantiqua Zrt. Increased to double from HUF 450 billion to HUF 900 billion.
- Credit guarantee from EU funds to SMEs. MV Zrt. is to take guaranty for (up to 80% of loans at HUF 100 million) to financial intermediaries.

Acceleration of utilisation of EU assistances

- Collateral burden on the entrepreneurs eased.
- Possible rate of advanced assistance increased to 40%.
- For 5 titles of the New Hungary – Rural Development Program, advance payments at 20% are available for developments to be implemented as soon as possible.
- For economic development assistances, the stipulation of expected sales revenue growth eased down with respect to the economic recession.
- For technology development tenders, the ceiling amount of the so-called automatic bids of small amount increased from HUF 20 million to HUF 50 million enabling faster implementation.
- Based on tendering facilities and priority projects, stimulating measures and projects will be launched by using EU funds and building industry regulation will be simplified.

Strengthening counselling services

- Counselling services work for export subsidies to be won or supplier status of SMEs active in the manufacturing sector to be designed and strengthened.

Easing adverse crisis effects on employment

- “Path to work” Programme
- Assuming the wage cost in 80% of a day per week for firms applying reduced working-time rather than dismissals (up to 2 times the minimum wage) or subsidy to training programs held in the period of time so released.
- Assisting employees finding new jobs after losing their former ones due to the crisis and supporting labour market services.
- (revenue-neutral) Tax refurbishment to increase competitiveness and support employment. As a result of changes, tax wedge (public charges in total in proportion to the wage in gross) will be significantly eased.

From 2010, gradual improvement is expected in relation to domestic demand as well. Revival of lending activity as well as positive income and demand effects of overhauling the tax system will sensibly improve the domestic demand. Overall, GDP in 2010 is still expected to

drop by 1% due particularly to the carry-over effect of fiscal adjustment measures on the household consumption. With the austerity package running out, the economy may expand by 3.6% in 2011.

In the labour market, moderate wage dynamics and employment cuts as observed in Q1 2009 could not fully offset the underperformance on added value giving rise to increased unit-labour cost. That means that further adaptation will remain a key element in the labour market developments of the business sector in 2009 as enterprises try to restore their profit margins. Wages of the private sector are expected to grow by about 3%, while headcount can drop by around 4%. Unemployment at the level of national economy may be over 10% as those dismissed may remain mostly in the labour market as unemployed (contrary to what has been observed in preceding years). Government measures aimed at employment creation will have an effect mostly on the medium term, thus they are expected to have a relatively small influence on this behaviour in 2009. However, as profitability of the corporate sector will improve in the end of 2010 due to more favourable external conditions, it will enable businesses to produce higher wage and headcount growth. In addition, government measures (cut in employees' social security contribution, abolition of lump sum healthcare contribution) will be strongly felt next year in terms of widening employment as a result of which the number of those employed may increase by some 0.5% in 2010 based on preliminary calculations. All this could not, however, offset the adverse developments in the first six months of 2010. Therefore, 2010 is likely to see a headcount loss at 1.5% on annual basis. Wages are expected to increase at some 3.0% similarly to 2009. In 2011, the negative fallout on the consumption and growth of spending cuts and compensation measures introduced in 2009 and 2010 will run out. Thus, employment-increasing measures should be more effective. In addition to improved domestic demand, external sales conditions will be more favourable leading to more growing employment and higher wages. All in all, the headcount and wages in the business sector may increase by 1.3% and 6.0%, respectively.

Fundamental disinflation developments rooted in the recession would result in further decreasing price indices in the second half of 2009. However, due to VAT and excise tax increases, the price index will show a marked lift that may reach over 6.0 percent by the end of the year. Thus, the rate of inflation will be around 4.5% on an annual basis. Tax increases will have a temporary effect on the price index. Early next year, the price index will be still relatively high to start a strong descend in Q3 of 2010 while in the year as a whole, inflation may reach 3.8%. In 2011 inflation is expected to be around 2.8% meeting the medium-term inflation target.

Further improvement is expected in terms of the external balance for 2009 as a whole. Falling import needs of domestic consumption and better terms of trade should result in a significant and positive contribution from the trade in goods in 2009. Because of the financial crisis, the corporate profitability must be deteriorating, therefore, profit transfers and re-invested earnings are supposed to fall as compared to 2008. In total, the current account deficit will drop to 4 to 4.5% of GDP while external financing requirement may fall to 2.0% of GDP in 2009. In 2010 and 2011, Hungary's external financing requirement may further decline due particularly to increasing EU transfers.

Main macroeconomic indicators, 2008-2011

	2008	2009	2010	2011
	<i>prelim. fact</i>	<i>forecast</i>		
	<i>annual percentage change, in per cent</i>			
real GDP	0.6	-6.7	-0.9	3.6
Domestic demand	-0.1	-7.9	-1.7	3.3
Household consumption	-0.1	-6.6	-2.6	2.5
of which: consumption expenditures	-0.7	-8.0	-2.9	3.1
Gross fixed capital formation	-2.6	-10.3	0.8	6.0
Exports (goods and services)	4.6	-15.1	3.0	9.2
Imports (goods and services)	4.0	-16.7	2.1	9.2
Gross average wage	7.5	-0.2	2.1	5.2
Net average wage	6.8	1.2	6.9	5.2
Real wage per earner	0.7	-3.2	3.0	2.3
Employment	-1.2	-2.9	-1.1	0.9
Unemployment rate (ILO), %	7.8	10.1	9.8	9.0
Consumer price, annual average	6.1	4.5	3.8	2.8
	<i>in per cent of GDP</i>			
Current account deficit	8.4	4.2	4.1	4.4
External financing need	7.4	2.2	1.6	1.3

3. Budgetary developments

Budgetary developments in 2008

According to the first notification of the KSH (Central Statistical Office of Hungary) to Eurostat, the ESA95 general government deficit was 3.4% of GDP in 2008, i.e. the deficit target revised downwards in last October was met. From 2007, the deficit fell by more than 27% in nominal terms or by 1.5 percentage points relative to GDP. Although local governments closed the year with a deficit lower than expected, the improvement in the balance was in full realised at the central government level.

ESA95 deficit of the general government

in per cent of GDP	2007	2008
Central subsystems	4.9	3.3
Local governments	0.0	0.1
General government	4.9	3.4

While the deficit target was met, the details contained several differences from the projection in the convergence programme of last December. The deficit target was achieved along with higher interest expenditures (0.2% of GDP) and higher primary surplus. Due to accelerating deterioration of macroeconomic environment in Q4 2008, the accrual-based tax and contribution revenues were behind not only the forecast in the updated convergence programme but somewhat even behind the original appropriations. For corporate income tax, the risk around the December tax payments supplementing interim advances proved to be stronger than expected. The revenue from CIT was HUF 40 billion lower than projected with a drop even in nominal terms from 2007. In addition, for certain items (*e.g.* VAT and social contributions) the difference between cash-based and accrual-based figures was larger than

estimated in the convergence programme. All in all, even despite an unfavourable corporate tax performance, income-related taxes showed the smallest shortfall while taxes related to production and imports produced the greatest one. On the expenditure side, public spending on compensation of employees was somewhat lower while on intermediate consumption was higher than forecast by the convergence programme. Social benefits other than in kind were as projected while in the case of social transfers in kind supplied via market producers, subsidies and investments small savings could be achieved. The revenues and expenditures to GDP ratios, however, moved upwards strongly because the preliminary fact figure of GDP had been much lower than formerly estimated (GDP increased only by 4.1% at current prices with a volume growth at 0.6%).

2008 actual figures and the updated convergence programme forecast

in per cent of GDP	Convergence programme (2008)	Preliminary fact	Difference	of which:	
				surplus / shortfall	GDP effect
Taxes and social contributions	39.9	40.3	0.4	-0.5	0.9
Other	5.3	6.2	0.9	0.8	0.1
Total revenues	45.2	46.5	1.3	0.2	1.1
Compensation of employees	11.4	11.6	0.2	-0.1	0.3
Intermediate consumption	6.6	7.0	0.4	0.3	0.1
Social transfers	18.4	18.7	0.3	-0.1	0.4
Subsidies	1.2	1.1	-0.1	-0.1	0.0
Gross fixed capital formation	2.8	2.8	0.0	-0.1	0.1
Other	4.3	4.5	0.2	0.1	0.1
Total primary expenditures	44.6	45.6	1.0	0.0	1.0
Interest expenditures*	4.0	4.3	0.3	0.2	0.1
Total expenditures*	48.6	49.9	1.3	0.2	1.2
Balance	-3.4	-3.4	0.0	0.0	0.0
Primary balance	0.6	0.8	0.2	0.2	0.0

*/: According to the EDP-methodology

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

The composition of the balance improvement made a significant difference from the previous year with some role therein of the unfavourable nominal GDP development. While in 2007, deficit cut was half due to increase in revenues as a percentage of GDP and half to decline in the expenditures to GDP ratio, 2008 saw a balance improvement from exclusively the revenues increased relative to GDP. Revenues grew at some 1½ percentage points (from 44.8% to 46.5% of GDP) while the ratio of public expenditure to GDP was practically stagnant despite the last year spending reduction measures (49.9% following 49.7% in 2007) However, primary expenditures decreased by ½ percentage point excluding the year-end one-off item (leaving privatisation receipts of MÁV Cargo with the railways company and increasing ESA-based expenditures as capital transfer).

In context of primary expenditure, the most dynamic growth was shown for social benefits other than in kind (by 8.8% from 15.2% to 15.9% of GDP) while investments fell strongly (by 17.9%, from 3.6% of GDP in the previous year to 2.8% of GDP).

Budgetary developments in 2009

In line with the target specified in the updated convergence programme, the 2009 budget set out an ESA95 general government deficit of 2.6% of GDP. However, global recession has proved deeper than foreseen at last year-end making it inevitable to review the macroeconomic and budget forecasts. With respect to international forecasts revised downwards and deteriorating domestic outlook, the Government modified the projection of expected economic contraction in two steps in February and May from around 1% to 3-3.5% and 6-7%, respectively.

To avoid further output loss arising from expenditure cuts necessary for fully offsetting the revenue shortfall caused by worsening macroeconomic environment, the Government revised the deficit target in agreement with the international institutions (first, to 2.9% of GDP in February then to 3.9% in May). At the same time, the Government decided on expenditure cuts that push down the level of public spending, and – to an increasing extent over medium-term – result in structural reforms of government expenditures. The tax restructuring which will start in the second half of 2009 and continue in 2010, will have no significant impact on the balance (revenue neutrality). The purpose of the changes is to ease the negative recessionary impact on employment and to improve competitiveness. Increasing consumption and wealth related taxes should offset the reduction of the tax burden on labor and on corporate income.

Given the revision on the size of the contraction of the economy to 3-3.5% in February, revenue shortfall of just above 1% of GDP had to be calculated. In order to keep the deficit below 3%, the Government decided on expenditure reducing measures of 0.7% of GDP. The main elements are as follows:

- ~ Freezing in the expenditures of budgetary chapters,
- ~ Savings of the receipts from environmental protection quota sold,
- ~ Subsidy cut to public media,
- ~ Reduction in the national top-up payments to agricultural subsidies provided by the EU,
- ~ Savings to be realised on subsidies related to gas and distance-heating prices,
- ~ Tightening housing subsidies,
- ~ Tightening the eligibility criteria for disability benefits,
- ~ Savings in health expenditure (pharmaceutical subsidies and curative-preventive care).

Based on the further revision of the the macroeconomic forecast, expenditure-cuts announced in February would not have ensured the fulfilment of the deficit target of 2.9%. In the general government as a whole, shortfall of accrual-based tax and contribution revenues may be even 2.5 times as high as projected in the beginning of the year. The projection does not dispense with the European Court's ruling that subsequent VAT refunds would be available on purchases with government subsidies in 2004 to 2005. Taxpayers may apply for refunds by means of self-audit to be submitted until 20 October 2009. The decision's budget impact could be estimated at 0.2% of GDP (including interest expenses) offset somewhat by the tax restructuring package with revenue neutrality in 2010 and slight revenue increase in 2009.

Considering the expected revenue shortfall, the Government decided on further expenditure cuts of 0.7% of GDP. New elements of the augmented package in 2009:

- ~ Cancellation of second instalment of 13th months pension benefits and postponement of pension correction,

~ Restructuring of the public sector's wage compensation,

The 2009 budget calculated with a public sector wage bill of 2008 reduced by the sum of the 13th month salaries. Apart from the 13th month salaries, the earnings were assumed to remain on the previous year's level. In particular, the amount of non-regular disbursements made in 2008 (including a half-month wage in January 2008, inflation-related compensation in July and December) were assumed be paid out in 2009 in the form of wage completion. The budget included funds necessary for the purpose in the form of specific reserves available for personal remuneration and as a part of local government subsidies. These two items were largely sufficient for financing the agreement with the trade unions on partial compensation of 13th month salaries. The remaining (minor) part was offset by freezing in the expenditures of budgetary chapters. The newly decided measure to restructure the wage compensation will diminish the necessary funds.

- ~ Postponement of increasing family allowances and decreasing the general rate of sick-pay,
- ~ Elimination of housing subsidies related to newly-signed contracts from the second half of the year,
- ~ Improving the balance of certain extra-budgetary funds (Labour Market Fund, Research and Technology Innovation Fund).

In addition, the decrease of employer contributions is also to moderate public expenditure, and, due to the significant modification in debt financing, the accrual-based interest expenditures will be smaller than originally planned as well. However, due to the deteriorating projection on macroeconomic conditions, unemployment benefits and sick-pay expenses are projected to be higher. To deal with risks, the budget continues to contain a so-called "stability reserve" of 0.3% of GDP.

Modification of the 2009 deficit target (ESA95, in per cent of GDP)

Target in the December 2008 convergence programme	-2.6
February 2009 projection	
Revenue shortfall (taxes and social contributions)	-1.1
Expenditure cuts	
Freezes in the expenditures of budgetary chapters, saving from the use of „Kyoto receipt”	0.3
Health care expenditures, disability benefits	0.2
Gas price and district heating subsidies, tightening of housing subsidies	0.1
Agricultural subsidies, media	0.1
<i>Total expenditure cuts</i>	<i>0.7</i>
Other (net)	0.2
Lower nominal GDP	-0.1
Modified target (February)	-2.9
May 2009 projection	
Revenue shortfall (compared to February projection)	-1.7
Expenditure cuts	
Pensions, public sector wages	0.5
Family allowances, sick-pay benefits, housing subsidies	0.1
Improving of the balance of extra budgetary funds	0.1
<i>Total expenditure cuts</i>	<i>0.7</i>
Additional expenditures due to the worsening of macroeconomic environment (unemployment, sick-pay)	-0.2
Lower accrual-based interest expenditures	0.3
Lower nominal GDP	-0.1
Modified target (May)	-3.9

Although revenues and expenditures will be much lower, a declining nominal GDP, more than HUF 1500 billion lower than forecast in the convergence programme will increase the revenues and expenditures to GDP ratios. Despite significant spending cuts, the redistribution ratio will remain around 50% in 2009.

General government revenues and expenditures

in per cent of GDP	2008	2009
Total taxes and social contributions	40.3	39.8
of which: taxes on production and imports	15.7	15.9
current taxes on income and wealth	10.6	10.6
social contributions	13.9	13.3
Other	6.2	6.7
Total revenues	46.5	46.5
Compensation of employees	11.6	11.4
Intermediate consumption	7.0	6.9
Social transfers	18.7	19.3
Subsidies	1.1	0.9
Gross fixed capital formation	2.8	3.2
Other	4.5	4.2
Total primary expenditures	45.6	45.9
Interest expenditures*	4.3	4.4
Total expenditures*	49.9	50.3
Balance	-3.4	-3.9
Primary balance	0.8	0.6

*/: According to the EDP-methodology

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

The accrual-based deficit of 3.9% of GDP implies, a cash-based deficit of HUF 994 billion (3.8% of GDP) at the central government's level. Cash-based accounts of central government were generally in line with the expectations except for April in which the deficit had been much lower than projected. Despite this favourable figure in April, the proportion of the four-month deficit to the annual figure is a few percentage points more unfavourable than the last year's and the primary balance is still in deficit against the surplus expected for the year as a whole. However, the budget projection *ab ovo* reckoned with an assumption that since the impact of the expenditure-cutting measures will be present in the second half of the year, the time-profile of the deficit path will be front loaded within the year.

Cash-flow balances (without local governments)

HUF billion	1-4. months		1-4. moths / year	
	2008	2009	2008	2009
Balance	-522	-604	58%	61%
Primary balance	-79	-159		

The interim deficit, larger than the last year's, is related particularly to the revenues. Apart from a modest rise observed in one and a single month of March, the cash-based taxes and contributions has continuously been behind payments a year earlier, dropping more than 5% in the first four months in total.

In context of large expenditure-side items, net expenditure of central government institutions and chapter-administered appropriations (other than covered by own revenues or EU-

transfers) fell until April-end compared to the previous year (although the impact of freezing and other measures will be effective mostly in the second half of the year). In social security, due to the limitation on 13th month pension benefits, payments increased just over 2% in the first four months while health care expenditures increased to a pace similarly moderate.

Medium-term budgetary developments

Structural measures will make an increasingly large weight in the expenditure-cutting package from 2010 on (see in detail in the chapter presenting structural reforms). As a result of the reform measures:

- Sustainability of the pension system will be strengthened:
 - ~ Pension indexation rules will change from 2010,
 - ~ 13th month pension benefit will be eliminated, conditional pension premium is put in place upon GDP growth,
 - ~ Statutory retirement age will be gradually increased to 65 years from 2012 ,
 - ~ Malus rule will come into effect on early retirement from 2011,
 - ~ Disability pension correction – planned originally for 2010 – is cancelled.
- Social benefits will be more targeted and effective:
 - ~ Child-care allowances are available for a year less than before,
 - ~ Maximum entitlement period to family allowance will be 3 years lower,
 - ~ Energy price subsidies will be eliminated.
- Efficiency of the public institutions will be strengthened:
 - ~ Significant savings may be achieved by encouraging efficiency gains and reviewing duties and responsibilities in the system of local governments,
 - ~ By improving efficiency and reviewing price subsidies, public railways can work more cost-efficiently.

In addition to structural reforms, further measures serve the purpose of permanently bringing down the level of government expenditure:

- ~ In the public sector, gross wage bill will remain unchanged for two years. Abolished 13th month salary may be replaced later by a conditional supplementary remuneration in relation to GDP growth,
- ~ Family allowances and social benefits related to the old-age pension minimum will not be increased for two years,
- ~ National top-up of EU agricultural subsidies will be eliminated.

Since the impact of expenditure cuts started in 2009 is considered effective in the following years as well, the measures should result in lower expenditure – by some 3½% of GDP – in 2010 compared to the convergence programme. Expenditure is further moderated by reduction of employer contributions, although the increase of spending will also be present in conjunction with the deterioration of macroeconomic conditions in 2010 like in 2009, namely due to unemployment benefits and sick-pay expenses. At the same time, the higher inflation prognosis must neutralise some of expenditure-cutting impact of the measures on pension benefits.

Large-scale expenditure cuts cannot even fully compensate for the shortfall of tax and contribution revenues. After this year's deep recession, GDP may somewhat further contract in 2010. Thus, the level of tax and contribution revenues may be some 4½% of GDP lower

than the forecast in the convergence programme. Higher-than-planned expenditure cuts would however aggravate the GDP decline and delay economic recovery. Under the conditions changed, the general government deficit could be 3.8% of GDP in 2010. The new deficit target for the next year is in compliance with the condition laid down in the Fiscal Responsibility Law. In particular, the deficit will be lower both in nominal terms and relative to GDP. (Given the widening negative output gap, the structural balance will improve faster).

Modification of the 2010 deficit target (ESA95, in per cent of GDP)

Target in the December 2008 convergence programme	-2.5
Revenue shortfall (taxes and social contributions)	-4.5
Expenditure cuts	
Pension reforms	0.8
Family allowances, social benefits, sick-pay	0.2
Housing subsidies, price subsidies	0.4
Agricultural subsidy	0.3
Public sector wage bill remain unchanged	0.8
Efficiency gains (local governments, public transport)	0.7
Base effect of previous year's expenditure cuts	0.4
<i>Total expenditure cuts</i>	<i>3.6</i>
Reduction of employer contributions	0.3
Additional expenditures due to the worsening of macroeconomic environment	-0.3
Lower nominal GDP	-0.4
Modified target	-3.8

In the light of the fact that the national economy will return to the export- and investment-driven path, the revenues to GDP ratio may drop some ½ percentage point in 2011 (assuming unchanged tax system and excluding EU transfers appearing both on revenue- and expenditure-side of the budget). Due to structural reforms, the expenditures to GDP ratio may drop 1½ percentage points based on a significant GDP growth. Driven by the adjustment on expenditure side, the general government deficit may decrease by 1 percentage point, below 3% of GDP.

Medium-term deficit path

ESA95 deficit in per cent of GDP	2008	2009	2010	2011
Convergence programme	3.4	2.6	2.5	2.2
Modified forecast	3.4	3.9	3.8	2.8

4. Public debt

Based on the April 2009 notification, public debt was HUF 19 320 billion at the end of 2008 with an annual increment of HUF 2 589 billion. In 2008, the gross debt ratio was 73%. The significant increase of nominal debt took place along with a deficit of HUF 905 billion. In addition to the deficit, the gross debt figure increased due to the depreciating exchange rate¹ and to the large increase of financial assets explained by the loans granted by the international institutions but not used for financing purposes. The latter impact greatly increased the gross

¹ From the level of HUF/EUR 253.35 at end 2007, the exchange rate depreciated to 264.78.

public debt. Debt ratio netted for the FX deposit with the National Bank of Hungary was 67.4% at end 2008. According to the information by the Government Debt Management Centre, the year-end deposit amounted to HUF 1 484 billion.

In Q1 2009, beside the budget deficit, further depreciation of the currency and increasing financial assets lifted the level of indebtedness. Based on preliminary financial accounts, the gross debt was HUF 21 789 billion in the end of Q1. Only 10% of the increase calculated from the beginning of this year is explained by the net borrowing requirement.

Debt developments in the upcoming 2 years are heavily affected by changes in the nominal GDP. According to the new projection, in 2009 a significant increase in the debt ratio will take place, followed by some a moderate increase in 2010. Based on the forecast, this ratio will turn to a declining path from 2011 as a consequence of resuming economic growth and low deficits. Relative to the forecast of the convergence programme, the changes in the key factors of the debt ratio are as follows::

Main assumptions in the convergence reports

		2008	2009	2010	2011
<i>Nominal GDP growth (%)</i>	<i>12-2008</i>	6.6	2.2	5.0	5.5
	<i>05-2009</i>	4.1	-2.1	1.2	6.1
<i>End year exchange rate (HUF/EUR)*</i>	<i>12-2008</i>	260			
	<i>05-2009</i>	264.8	295		
<i>Deficit (per cent of GDP)</i>	<i>12-2008</i>	3.4	2.6	2.5	2.2
	<i>05-2009</i>	3.4	3.9	3.8	2.8
<i>Gross debt ratio</i>	<i>12-2008</i>	71.1	72.5	72.2	69.0
	<i>05-2009</i>	73.0	80.2	82.2	78.3

* technical assumption. The 295 HUF exchange rate is the April 2009 average. This has been held constant over the projection horizon.

At the time of the convergence programme prepared, measures to improve functioning of the government securities market were still unknown. Interest expenditures are largely influenced by the large scale bond buy-back programme of ÁKK² starting from mid-March 2009. Because of the increased weight of FX financing and the negative net HUF issuance (beside the buy-back operations, smaller amount of bonds will be offered relative to bonds maturing), accrual-based interest expenditure may be expected to be significantly lower than indicated in the convergence programme.

² ÁKK's bond buy-back programme amounted to almost HUF 500 billion, securities in the programme were due to mature between 2009 to 2012.

General government debt developments*

Per cent of GDP	2008	2009	2010	2011
Gross debt	73.0	80.2	82.2	78.3
Change in gross debt	7.2	7.2	2.0	-3.9
Contributions to changes in gross debt				
Primary balance	-0.8	-0.6	-1.1	-1.7
Interest expenditure	4.3	4.4	4.9	4.5
Stock-flow adjustment	6.4	1.7	-0.8	-2.0
Nominal GDP growth	-2.6	1.6	-1.0	-4.7
<i>Implicit interest rate on debt (%)</i>	<i>6.2</i>	<i>5.7</i>	<i>6.1</i>	<i>5.8</i>
<i>Net public debt**</i>	<i>67.4</i>	<i>75.8</i>	<i>78.6</i>	<i>76.6</i>

* Contains rounding effect

** Gross debt netted by loans from international institutions not used for financing purposes

5. Structural measures

Since the second six months of 2008, the Government has taken numerous measures aiming at ensuring sufficient short-term financing for the public sector in the short term, while increasing growth potential in the medium and long term; in particular, measures improving employment and competitiveness. These measures are partly related to the reforms implemented by the Government from the second half of 2006, in the fields of pension, healthcare, public administration, social subsidies and education, partly they go even beyond, since structural steps have also been taken in new areas, in particular in order to improving employment and efficiency of the social system.

This chapter presents measures already underway and new steps in the following areas:

- Tax changes
- Social services other than in kind
- Pension system
- Employment, 'Path to Work' Programme
- Changes planned in public administration and local governments
- Curative-preventive care and pharmaceutical subsidies
- Education
- Renewal of planning and execution of the budget.

Taxation changes

The Government is now to establish a taxation system where the use of hidden incomes shall be even more difficult than it has been. This has the aim to whiten the economy, to satisfy public demand for reducing tax avoidance as well as to increase tax revenues.

Tax wedge on labour in Hungary are too high, both in international and regional comparison. The Government's intent is to significantly reduce the difference in this field to improve

competitiveness. As from 1 January 2010, the employer contribution cut by 5 percentage points – to be introduced up to twice the minimum wage from 1 July 2009 – will be extended to all incomes, and the fixed health care contribution will be eliminated. As a result of the measures, total wage cost³ should fall by 5.7% and 4.5% on the minimum wage and on the average wage, respectively. With falling burden on the employment, entrepreneurs will have more funds remaining to spend more on development, hiring further labour force increasing the number of jobs available for the employees and job seekers.

From 1 January 2009, retroactively, the upper bracket of PIT will be increased to HUF 1.9 million with family allowance and maternity support making a part of the tax base and being non-chargeable to tax. As of 2010, the tax base for PIT will be the gross wage increased by employers' contributions. The upper bracket will grow to HUF 5 million (or HUF 3.9 million excluding contribution charges). Tax rates will be modified from 18% and 36% to 17% and 32%, the eligibility end of tax credit will grow to HUF 3.188 million. In this context, the solidarity tax at 4% on individuals will be eliminated.

As a result of the measures, 90% of the taxpayers will be liable to the lower rate (with the exception of the earners above ten-fold the average wage). For mid-income earners, the marginal tax rate will also be significantly lower⁴ with a favourable effect on propensity to income returns.

Due to the simultaneous reduction in burden of employers and employees, the tax wedge at the average wage will descend from 54.1% in 2008 to below 46% by 2010, coming close to levels in other countries in the region. With the reduction in tax wedge on labour, Hungary's regional competitiveness should improve, encouraging also investments in Hungary.

As a continuation of simplifying the tax system, which started in the previous years, PIT tax benefits will be eliminated from 2010 with the exception of the family benefit, the disability benefit and tax allocation on long-term savings. As a result, the allowances on tuition, foundation, original producers, household services as well as seasonal employment and life insurances, additional payment to private pension funds and those entitlements based on Social Security agreement. A part of tax-free benefits will remain in this category such as social benefits while other allowances will become taxable in full such as savings on daily allowances and unused fuel. For benefits in kind, mixed modifications are made with preferential rate (32%) on certain cafeteria elements while the rest will carry a tax of 54% and social security contributions payable by the employer.

From 1 July 2009, the entrepreneur's contribution will fall by 1.5 percentage points. From 1 January of 2010, for simplification purposes, independent employer, employee and entrepreneur contributions will be replaced by an integrated contribution.

The Government's intent is to establish attractive environment for enterprises a fundamental pre-requisite of which is transparent and simple corporate tax system. To ease burden on the capital and to introduce uniform corporate taxation, the tax base of corporate income will be widened, certain tax benefits will be eliminated while some of them will remain (on investment, employment and R&D activities). A preferential tax rate of 10% up to HUF 50 million will continue to prevail. The tax rate will increase to 19% temporarily, but the special tax on the enterprises (4.0%) will be eliminated. A few measures serve for the purpose of

³ Assuming unchanged gross wage dynamics

⁴ While for higher-income earners, it will slightly go up.

direct crisis management such as easing eligibility criteria of development tax allowance and changing rules of accounting for valuation loss of assets. EVA tax rate will increase to 30% from 25%.

From 1 July of 2009, VAT will increase by 5 percentage points while milk and dairy products, bread and bakery products as well as district heating will be taxable at a preferential rate of 18%. Excise tax is growing as well. From 1 January 2010, the minimum tax on fuel oil and cigarettes will be further increased by 7.6% and 8.3%, respectively. In addition, excise tax both on gasoline and alcoholic drinks will be 10% higher

Social benefits

On international comparison, Hungary spends much more on social subsidies while the funds concerned are not always got into hands of those mostly in need as analysts say. Planned and adopted measures are intended for making the system more targeted and supporting and encouraging work and employment. Key moves here:

- Nominal freeze of social subsidies Restructuring child-care supports, modification of child-care aid (GYES) and child-care allowance (GYED) in context of eligibility period
- Modifying eligibility age of family allowance
- Reducing the rate of sick-pay by 10 percentage points
- Review of terms and conditions of disability pension
- Suspending housing subsidies for new applications from 1 July 2009
- Gradual phasing out the natural gas and district heating price subsidies

Keeping amounts of social subsidies unchanged

The eligibility limit and amounts of social benefits are defined in relation to the minimum pension. Due to freezing the old-age minimum pension benefit, the number of those eligible to benefit will be lower and the amounts of benefit will remain unchanged.

Restructuring salary related child allowance

Minimum insurance period entitling to the child-care allowance (GYED) will grow to 1 year and the allowance will be available only until the child turned to age 2 years. Due to this measure, the number of eligible to GYED and its length will fall. Savings in the budget will appear from 2012.

Restructuring family allowance

The amount of family allowance will not increase for two years resulting HUF 4 billion and some HUF 17 billion savings in 2009 and 2010, respectively. The entitlement to family allowance will fall from 23 years of age to 20 from 1 September 2010. This measure will result in saving HUF 2 billion and HUF 8 billion in 2010 and 2011, respectively. From now, family allowance may be provided in kind in order to support the proper use of the family allowance with special regard to families where children must be administratively protected. Notary (administrative chief) in local governments may decide that the family allowance be granted in kind up to 50% thereof at the same time with the administrative protection or in the course thereof. The restriction period is 1 year. The Hungarian State Treasury shall transfer the family allowance in kind to the current account opened to the local government. The curator appointed by the Notary shall provide for spending of the amount on the account. This measure has no government budget impact.

Changing sick-pay rules

The rate of sick-pay will fall from 70% to 60% for employment status longer than 2 years or from 60% to 50% for all the shorter insurance periods. Regulation of passive sick-pay will be tightened (the period will fall from 45 days to 30 days with the upper limit defined as 1.5 times of the minimum wage). This measure will result in some HUF 3 billion and HUF 16 billion savings in 2009 and 2010, respectively.

Tightening disability pension criteria

This measure does not require legislative changes. Savings will emerge from restricted practices. Starting to restructure the disability system for rehabilitation purposes resulted in granting rehabilitation benefit for 5984 people by the end of 2008 replacing the disability pension and encouraging re-integration in the labour market. Saving on 10,000 new disability pensions will entail some HUF 9.5 billion annually.

Suspension of housing subsidies

Housing subsidy (the so-called 'social policy subsidy') and interest subsidy for housing loans will no longer be applied from 1 July 2009. This measure is intended for reducing spending housing subsidies. It requires amendments in government decree.

Price subsidy to natural gas and district heating

From 1 January 2009, fundamentals of the subsidy have not changed. The appropriation for 2009 (HUF 62.8 billion) is to be increased (by HUF 17.7 billion). This additional spending is financed from a temporary special tax on energy companies (the so-called 'Robin Hood' tax). According to the amendment effective from March 2009, at the same time with reduction of the market price of natural gas, the unit-based subsidy rates granted for unit of energy consumed will fall by the same extent (for distance heating, the amount of subsidy will fall by half the so-called big consumers of natural gas price). From 1 July 2009, the concept of public utility natural gas price will be removed but the change to the price of natural gas will result in the modification of the subsidy. The number of subsidy beneficiaries shows a declining trend (2007: 2,096,000; 2008: 1,842,000; April 2009: 1,616,000 households – 1,336,000 for natural gas and 280,000 for distance heating received compensation) explained by the controlling activity by the Hungarian State Treasury on justification of entitlements as well as by the retentive force of the penalties applied.

Pension system

In 2006 and 2007 in the pension system, significant parametric reforms were implemented, largely cutting back the burden on public finances due to the future pensions to be paid. A Joint Report by the Member States and the European Commission, published in April 2009, on the increasing burden caused by the ageing population showed that measures in 2006 to 2007 were effective. According to the report, budget expenditure related to the pension system will increase from 10.9% in 2007 to 13.8% in 2060 compared to GDP. The global recession made it clear that for both short-term savings and long-term sustainability of the pension system, further moves were required to ensure the transformation of the pension system. It is not only a matter of budget. Holding the older people in work and employing them would increase the low participation rate of the older generations.

The Parliament adopted law amendments in May 2009 that imply further parametric modifications of the pension system in relation to the reforms in 2006 and 2007 with the following key elements:

▪ **Increasing statutory retirement age:**

From 2012, the retirement age will gradually ascend six months each year both for women and men until 65 years of age. In addition to improving long-term sustainability of the pension system, this measure will contribute to higher level of employment as well, also justified by the increasing expected period of time in life.

▪ **For early retirement , malus rule will enter into force from 2011:**

Malus system related to the advanced old-age retirement will come into effect from 2011. This rule stipulates lower pension for early retirement. The impact of the measure is that the effective retirement age will increase in line with the statutory retirement. The purpose of the measure is to hold back active employees from retirement before turning the statutory retirement age.

▪ **New rules of indexation:**

In the indexation of pension benefit, the wage growth component represents a smaller weight. New indexation rules will be effective from 2010. Changes to consumption prices and net earnings continue to determine the annual regular increase of pension benefits, with the weight of the two components depending on the rate of economic growth, however. Under 3% of GDP growth, benefits should be increased by the price index. Based on 3 to 3.9% of GDP growth, mixed indexation should be applied in a proportion of 20% to 80%; for 4 to 4.9% of GDP growth the proportion would be 40 to 60%, and for 5% or higher growth, the Swiss indexation would apply.

▪ **Cancellation of disability pension correction planned for 2010**

▪ **Abolishment of 13th month pension benefit from 1 July 2009.**

Employment

One of the main reasons of the weak growth in Hungary is the very low level of employment. In Hungary, just slightly more than half the population is at work, i.e. 57% of those of active age significantly lagging behind the average of the European Union. To ease employment losses caused by the recession, efforts should be focussed on maintaining jobs and help those becoming unemployed as a result of the crisis or preserving activity of those losing their jobs. In addition, measures should be taken to design incentives, which result in higher level of employment and activity in the medium term contributing to the sustainability of welfare systems and sustainable economic growth.

In context of the 'Path to work' program, it was a key priority that those able to work but permanently unemployed and receiving social benefits should more extensively take part in some form of public employment and receive regular earned income and get more familiar with the labour market. According to the program, the persons of active age having disadvantageous situation in the labour market may receive entitlement to active age benefits instead of regular social aid. Details of the programme are included in the Convergence Programme of December 2008. The implementation of the programme has already started and the local governments reviewed beneficiaries and prepared plans for public employment. The employment of those entitled to standby assistance is gradually provided. Evaluation in detail of the results may be made after having figures of the first six months.

Public administration

The Parliament adopted the law on the status and management of government agencies. The principal result expected is to more intensively help fiscal requirements to prevail by generally re-regulating the system of operations and management at the level of the government agency and of the budgetary chapter. On the other hand, unlike the approach followed by the whole law of public finances, the new law supports efficient public services (administration, defence and justice, etc.) as well as public authority tasks to be carried out meeting the challenges of our times.

The most important objectives and principles of new regulation are laid down in the Convergence Programme of December 2008. The new rules concerning establishment, registration, transformation or termination ensure law security and transparent operations, applicable from 1 January 2009. To this end, statutes of all the 13,000 government agencies have to be amended until 1 June based on uniform stipulations. Guidance issued by the Ministry of Finance to the Ministries and local governments for the purpose summed up the necessary information giving training programs including consultation as well upon request. In addition, the Ministry of Finance will issue a series of statement to help implementation. Based on the registration records of new contents, the whole system of government agencies is reviewed.

The new rules providing for more efficient operations and management, also with differentiated flexibility, should be applicable from 2010. Agency level budget plans should be prepared in line with these new rules. The annual budget will contain two documents in which the supervising agency (typically a ministry or local government) shall agree with the supervised agency including an approved amount, quality and expected result of public services to be granted in return for government funds. This makes a fundamental shift, embodied in specific regulations towards the general implementation of public services and performance principle of guaranteed substance and cost.

Reform measures launched in 2006 (reorganisations, the introduction of smaller headcount and performance benchmarks) will contribute to the reduction of public expenditure and increase the efficiency of public administration. Measures aimed at increasing the efficiency of public administration continued after the Report issued in 2008 autumn. In order to reduce administrative burden of market and non-market actors and to prevent the reproduction thereof, the Government adopted a package of measures in 2008 autumn. The package aims at lowering burdens by at least 25%.

Local governments

Renewal of local government system

Key elements of a complex proposal relevant to the directions of renewing the local government system prepared by the Government:

- Cutting the number of local representatives by 23%,
- Local government services fulfilled in partnership, based on legal regulations,
- Modifying the rules concerning consolidated notary offices (easing establishment regulations and prescription of mandatory establishment of consolidated notary offices),

- Tightening conditions necessary for establishing new locality ,
- Change in audit schemes of local government management,
- Extension of property management rights, re-settlement of development support system.

To adopt these, two thirds majority is necessary on the proposal. The proposal concerning the headcount reduction of local representatives is submitted to the Parliament and the Government will decide on further submissions in the near future. List of administrative, official duties and responsibilities or mandates was compiled in which cancellation or devolvement of duties could be also raised including rescheduling deadlines of timely obligations. Temporary suspension of duties for a well-circumscribed group of activities or easing requirements are to be considered. Implementation of such proposals should increase the room for manoeuvre of local governments.

Multifunctional micro regional associations

The main source of internal contradictions of the Hungarian local government system is the exaggerated subdivision coupled with wide responsibilities and duties of local governments. For facilitating coordinated development of small regions and for the public services to be fulfilled by local governments to be raised at an equalized level, adopted was the Act CVII of 2004 on micro regional associations with effect from 1 December 2004.

Fixed standard subsidies as incentives to micro regional associations are implemented in jointly-operated local agencies. As a result of subsidy incentives, micro-region organisation of services in the two major human branches (education and social policy) showed a strong progress in the years 2006 to 2009 as expressed very seemingly by the fact that the headcount of pupils educated in the institutions operated or maintained directly by the multifunctional micro-regional associations increased from 3000 in 2006 to almost 40,000 in 2009.

Health care

Curative-preventive care

Interim savings in the budget of Health Insurance Fund for 2008 allowed for the development of one-day service forms, waiting lists to be shortened in some branches and financing of basic services to be enhanced, the compensation of increased fuel prices, the remuneration of insurance-specific audit to be extended to the system of in-patients and out-patients services, the modification of special factors of chronic rehabilitation services and the financing fee of urgency services to be raised. Revenue surplus provided funds for the hospitals' liquidity position to be improved. The allocation of the surplus preferred priority institutions and the participation in data-gathering for expenditure.

Within the title Curative-preventive care, more than HUF 13 billion has been re-allocated to title 'Advance for operating cost' in 2009 implying practically a financial blocking of the amount. Based on this re-allocation, the contribution revenue shortfall due to economic recession could be offset.

2009 savings have been based on the following measures:

- The amendment entered into force on 1 January 2009 to the Act on the development of health care services clarified the definition of territorial service obligation; determined the rules of re-allocation and conversion, the obligation to review annually capacities and

ensured possible re-allocation thereof. Also, it drafted technical substance of priority hospitals and settled the issues of cross-the-region services and progressive nature.

- According to Gov. Decree no. 337/2008.(XII.30.) implementing the Act CXXXII of 2006 on the development of health care services, in connection with adoption process, surplus capacity should be meant if it comes to capacity adoption resulting in demand for additional funds. This principle is in line with the system of EU projects' terminology. Adoption of additional capacity may only be taken within tenders called for by the Ministry and embodying health-specific policy priorities. In this way, not only financing decisions may be made since technical and qualitative expectations are specified as well.
- The performance limit in volume (TVK) was eliminated for health care services as of 1 April 2009. All performances reported will be settled and paid on variable value, floated beyond certain performance limit (performance financed with a basic fee specified in advance). Monthly breakdown of the performance financed with a basic fee specified in advance shall be made on the basis of the seasonal index set out by the service provider. Both for in-patient and out-patient services, 70% of basis performance shall be the value corresponding to the performance financed with a basic fee specified in advance; exceeding performances are settled with a floated value. Both in out-patient and in-patient services, performances formerly free of TVK will be financed with a basic fee specified and announced in advance. Reference period is the financing year preceding the relevant period. Reported performance shall be the basis on which to establish the reference performance (benchmark) with reservations that allow for performances possibly reported unreasonable to be picked out.

Pharmaceutical subsidies

Major changes implemented in the first months of 2009, concerning the subsidy system and pharmaceutical market are as follows:

- Reintroduction of the fee on pharmaceutical prospectuses (HUF 416,000 or, for medical aid facilities /GYSE/, HUF 83,000 per month), also specifying exemptions from the liability,
- Bringing down the rate of subsidy (the rate of above average subsidies fell to 80% from 85%),
- Cutting the rate of subsidy or the elimination thereof for products used for treating the upper digestive system diseases (proton-pumping inhibitors), pharmaceuticals against allergies, for memory disorders and problems in peripheral vascular system,
- In the framework of the generic programme, formation of fixed subsidy groups, announcement of price cuts continuously, changing rules applying to reference products and extending fixation of active substance and therapies,
- Care by pharmacists as documented activity undertaken voluntarily with responsibility was defined with the objective to facilitate the secure and cost-efficient pharmaceutical therapy,

The changes should result in savings in the magnitude of HUF 10 billions compared to the appropriation of pharmaceutical expenditures of HUF 343 billion in 2009.

To keep up the results achieved in the longer term it should remain a key objective:

- Encouraging the high-quality and efficient pharmaceutical prescriptions. Objective values underlying evaluation were promulgated at first in December 2008 in a ministerial guide. The evaluation would have started originally for the prescriptions honoured after 31

March 2009, however, expenditure cuts necessary due to the economic crisis affected the pharmaceuticals involved in the evaluation as well. Therefore, objective values in relation to the second quarter could not be promulgated. For this reason, the evaluation will start for the prescriptions honoured after 30 June 2009.

- Observing indicative points of prioritised and key prioritised subsidies are more and more thoroughly audited by the NHIF by means of in-process audit procedures and also for pharmaceuticals prescribed on specialist proposals, targeted audits become possible.
- Price competition maintained between manufacturers of products receiving fixed subsidies,
- Maintenance and enforcement of the rules concerning the joint risk bearing of pharmaceutical producers (beneficiaries of the marketing pharmaceuticals marketing licence) and wholesalers.

Education

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.

Rules of subsidies encouraging local governments' multifunctional micro-regional associations are tightened as from 1 September 2009, in order to reinforce real cooperation. The regulation has two key elements. Subsidy is due only if

- the public education institution, maintained by the association, fulfilling also elementary school functions, provides education with 8 classes, where it has its basis, or
- the association maintains an independent institution, with a separate so-called Ministry of Education Identifier, for the same public education service (kindergarten, primary and secondary education).

As a result of public education services fulfilled in the multifunctional micro-regional associations, the number of children educated in these institutions increased by around 50% during the last three years.

In 2008, the objective of the amendment to the public education law adopted by the Parliament is to further increase the room for manoeuvre for the local governments to organise public education services efficiently and professionally. In this context, it will be possible:

- to organise tasks closely related to education of children, falling under other sectors, within a joint agency, furthermore
- to establish a new multifunctional type with a uniform crèche-kindergarten name, the necessary detailed rules of which are laid down in the implementing rules of the public education law.

Thus, local governments maintaining public education institutions can ensure rational planning and more efficient services in appropriate quality.

The key objective of the higher education reform is to improve the quality of education and make it more capable of adapting the changing structure and level of labour demand. Under the reform, new steps are taken.

In 2009, multi-cycle training will become general; in September courses start also in Master education. 35% of students admitted three years earlier to state-financed BA education may continue their studies in the master courses of the second cycle. In Master courses paid by tuition fee, there is no such restriction. The number of applicants increased by some 30,000 from the previous year. Last classes of students attending the old system graduate this year, the old type university studies will phase out in 2010. In the education based on the credit system, the individual study period may be even longer. Thus, the temporary period may be extended. The number of public higher educational institutions fell again on 1 January 2009 as a result of integration.

Fiscal Council

According to the Fiscal Responsibility Act adopted in November 2008, the Parliament elected, by unanimous vote, the three members of the Fiscal Council in February 2009. The Fiscal Council's mission is to ensure transparency of budget planning and methodology basis in the context. A Secretariat, led by the Member appointed by the President of the Republic of Hungary, will assist the Council in fulfilling its main tasks, which are as follows:

- Preparing and disclosing macroeconomic forecasts;
- Preparing and disclosing baseline projections for the budget figures;
- Preparing and disclosing methodological recommendations related to fiscal planning and forecasting;
- Preparing independent estimates concerning budgetary impacts of draft bills and amendatory motions negotiated by the Parliament.

The Secretariat of the Fiscal Council has begun the recruitment of the staff and the Government made available, from the general reserves, resources necessary for the functioning in the first half of 2009. The Council shall have to fulfil its first task from July 2009, namely preparing a macroeconomic forecast.