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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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This Survey is published on the responsibility of the Economic and Development Review Committee (EDRC) of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Hungary were reviewed by the Committee on 12 April 2007. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 23 April 2007.

The Secretariat's draft report was prepared for the Committee by Philip Hemmings and Alessandro Goglio under the supervision of Andreas Wörgötter. The drafting team was assisted by Roland Natran (on secondment from the Hungarian Ministry of Finance).

The previous Survey of Hungary was issued in July 2005.

BASIC STATISTICS OF HUNGARY, 2006

LAND

Area (1 000 sq. km)	93	Major cities (1 000 inhabitants)	
Agriculture (%)	63	Budapest	1 698
Forest (%)	19	Debrecen	204

PEOPLE

Population (1 000)	10 076	Employment (1 000)	3 887
Inhabitants per sq. km	108	Agriculture (%)	5
Natural increase in population (1 000)	–32	Industry (%)	33
Net immigration (1 000)	15	Services (%)	62

GOVERNMENT

Public consumption (% of GDP)	23	Number of seats in Parliament	386
General government total revenue (% of GDP)	44	Share of seats held by governing coalition (%)	54
General government deficit (% of GDP)	9	Number of political parties	4
Public debt, 2005, Maastricht definition (% of GDP)	58	Last election	2006

PRODUCTION

GDP, current prices (billion HUF)	23 562	Agriculture (% of value added)	4
GDP per capita (USD, current prices)	11 121	Industry (% of value added)	30
Gross fixed investment (% of GDP)	22	Services (% of value added)	65

FOREIGN TRADE

Exports of goods and services (% of GDP)	78	Imports of goods and services (% of GDP)	77
Main exports (% of total merchandise)		Main imports (% of total merchandise)	
Machinery and transport equipment	62	Machinery and transport equipment	50
Manufactured goods	28	Manufactured goods	33

CURRENCY

Forints per $	210.40	Forints per €	264.09

Executive summary

Budget consolidation is dominating the political agenda. The Hungarian government has embarked on an ambitious four-year consolidation programme following another election-year peak in the deficit in 2006 at 9.2% of GDP. The immediate revenue increases and spending cuts are temporarily damping growth. However, if all goes according to plan, the programme will bring dividends to the economy in the longer term. This payoff is crucially dependent on:

- **Discipline in budgetary processes.** *Work needs to continue on strengthening budgetary mechanisms. A system of binding medium-term spending limits should be considered. Budgetary reform also needs to extend to the sub-national governments.*
- **Success in maintaining spending freezes.** *The re-scheduling that brought forward part of the 13th month payment to public-sector workers this year does not affect achievement of the 2007 fiscal target in accrual terms. Nevertheless, looking forward, strong resistance to spending pressures arising from revenue windfalls is of key importance.*
- **Implementation of the structural reform programme.** *The healthcare reforms that are expected to deliver a large share of fiscal savings are reasonably well advanced and a welcome cut in gas-price subsidies is already reducing government spending. The reforms in education are positive but the changes to the tuition–fee system in particular should go further. It is more uncertain, however, whether all the planned cuts in government administration will be realised.*

Successful reform of public spending requires the participation of the counties and municipal governments. There are potential savings in administrative overheads here too and sub-national governments are responsible for providing many government services. In-depth review of these issues in this Survey reveals a need to:

- **Capture economies of scale.** *Political constraints preclude widespread mergers among the large number of small municipalities. However, the joint provision of services is widespread and should be encouraged further. Efforts to rationalise through replacement of county-level governments with regional assemblies should continue.*
- **Reform financing systems.** *The financing of sub-national government needs simplification and greater transparency and oversight in accounts. Also, the benchmarking of services via output and performance indicators needs to become more widespread. Reform of local taxation should include widening of property tax and removal of the local business tax.*

Hungary's low employment rate remains a key structural handicap to economic performance. There has been welcome reform of unemployment benefits and early-retirement pensions. Planned reforms to disability pensions look promising and a concrete proposal for old-age pension reform is *in the pipeline. This Survey looks in depth at the issue of prolonged parental leave and other aspects of family policy:*

- **Current efforts to boost childcare services are welcome.** *Future reform needs to consider further strengthening of central-government provision requirements on municipalities regarding these services, matched by appropriate funding. A system of childcare vouchers for parents would be one way of increasing efficiency in the provision of services.*
- **Reform to the very long parental leaves should be considered,** *along with changes to the attendant system of additional cash benefits. Savings could be used to help fund increased childcare services.*

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Assessment and recommendations

Fiscal consolidation dominates the policy agenda

After re-election of the centre-left coalition in April 2006, the government announced ambitious plans for fiscal consolidation, following admission that its deficit could be well over 10% of GDP without consolidation measures and indication that entry to the euro area in 2010 was impossible. The 2006 deficit, at 9.2% of GDP, indeed marked another peak in Hungary's strong electoral spending cycle. The government's goals imply breaking out of this. The aim is for a deficit below 3%, and on a sustainable basis for the future, by the next election in 2010. The consolidation programme comprises immediate revenue and spending measures, many of which are intended to be temporary, combined with wide ranging structural reform to public spending. The potential payoff is large. A permanently low deficit would put public debt on a downward path and return dividends to the economy *via* lower interest rates, reduced current account imbalances and fewer problems with exchange-rate volatility.

The government's austerity programme is temporarily slowing growth

Given the size of fiscal imbalances, there was no alternative to drastic revenue-raising measures in the first phase of the programme. These began in autumn 2006 with hikes in employee social contributions, value-added tax and business taxation. The resulting squeeze on households' disposable incomes and businesses is damping demand. Indeed, real GDP growth will dip well below its long-term average of around 4% to between 2 and 3% for this year and next. The increase in value-added tax, plus reduced gas-price subsidies, have generated a spike in inflation, creating uncertainty for rate setting in monetary policy.

Long-term payoff from the programme depends crucially on success in structural reforms and in resisting spending pressures

Two major challenges lie ahead. The first is ensuring adequate delivery on structural reform. A number of key measures have yet to pass through Parliament and some reforms are inherently difficult to implement, even if the necessary legislation is in place. The second challenge is ensuring that the various temporary measures stay on track. The two challenges are interrelated, as timely progress on structural reform will help prevent the derailment or unwanted extension of temporary measures. The biggest test of the consolidation programme will be from 2009 onwards, when structural reform is supposed to deliver more of the deficit reduction but when, also, pressures for new spending measures are likely to mount due to elections in 2010.

Further development of disciplining mechanisms in the central-government budgeting process is needed

Several mechanisms helping budgetary discipline have been strengthened in 2007. Notably, reserve funds are larger and rules on state guarantees and spending on infrastructure have been tightened. Also, a new rule has been brought in requiring the annual budget submission to show a primary surplus. These are positive steps, and developments along these lines must continue. *The primary-surplus rule should be augmented so that any windfalls are used for deficit and debt reduction. Other mechanisms ought to be considered as well. As previous Surveys have suggested, a system of binding medium-term spending limits may be one way forward. More assessment of budgetary plans by independent bodies should also be considered.*

The spending freezes in public-sector pay perpetuate a stop-go cycle that eventually needs to be broken

The freeze on public-sector pay is playing an important role in the initial phase of fiscal consolidation but is already proving difficult to sustain. Agreement with the public-sector unions early this year led to 13th month salary payments being partially brought forward and additional payment in 2008 conditional on extra budgetary savings. The freeze is anyway perpetuating a stop-go cycle in public sector pay that has damaged morale and recruitment. In the longer term, the cycle should be stopped, for example through the multi-year agreements.

Some areas of public-expenditure reform should be strengthened further

The largest immediate savings *via* structural reform are coming from large cuts in the number of hospital beds, reduced spending on pharmaceuticals and lower household gas-price subsidies. All these are welcome measures, and indeed, have been recommended in previous *Surveys*. But the full range of public-expenditure reforms runs much wider than this. For instance, a general campaign to cut administrative overheads is underway. Central government introduced cuts in ministries and formulated detailed plans for other centrally controlled bodies. It is important that this campaign extends to sub-national governments. Getting the counties and municipalities on board in the reform process is also important in other areas because these governments have responsibility and control of a large share of public services (see below).

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Reforms in healthcare are encouraging

Healthcare reforms also include setting up a tiered system in which access to some types of care requires insurance coverage. There is also welcome wider application of user fees, notably a fee for doctor consultations has been introduced. In addition, changes to the hospital system are underway to bring a more structured organisation of specialist, general and outpatient services. Progress in these areas has so far been encouraging. At the same time, the authorities are moving cautiously with plans to introduce a system of multiple insurance providers. The following additional measures ought to be considered to help boost the effectiveness of reform:

- The gate-keeping role of general practitioners should be strengthened to help prevent excessive referrals to specialist units in hospitals.
- Hospital managers should be given greater flexibility and responsibility for deficits and debts.

Bad practices in transport financing have been halted

In a positive move, the 2007 budget has not assumed spending on motorways will go off-budget through a public-private partnership, unlike the previous two years. Indeed, the financial flows of both state-owned motorway constructions companies are now fully recorded in general-government accounts and a limit has been placed on the amount of debt they can accumulate. Also, there is a more rigorous approach to public-private partnerships, which will hopefully see an end to inadequate proposals aimed largely at getting spending off-budget and should be used as a vehicle for more private-sector participation. In rail transport, medium-term subsidy commitments have been made in an effort to insulate the state-owned rail company from a cycle of borrowing by the government. Also, large one-off capital injections are being made in 2007 and 2008 to help with a rationalisation programme, though there is a risk that the programme will not deliver all its promises.

More reform will be needed in education and pensions

In addition, several important reforms with longer-term payoffs are either being implemented or are in the pipeline, notably in education and pensions:

- In education, the various plans for rationalising services and altering financing arrangements look to be positive steps. In higher education, the widening application of tuition fees is welcome. *Further reform should be made to reduce the connection between fees and examination results. A system where fees are more uniformly applied that builds on the existing system of government loans ought to be considered.*
- Several reforms are underway to raise the effective age of retirement. Further tightening of eligibility for early-retirement pensions is scheduled. *Ultimately, the most popular early retirement scheme (the "advanced retirement pension") ought to be removed altogether because there is no reduction in the annual pension while the "reduced advanced retirement pension" should be checked for actuarial fairness.* In addition, reforms to the disability benefit system

look set to pick up speed, notably with the planned introduction of a new benefit that is conditional on participation in rehabilitation programmes and changes in institutional arrangements for medical assessment. To further raise the effective age of retirement, *the proposals for reform to the old-age pension system currently being developed should include increases in the statutory retirement age beyond 62 years.*

Sub-national government budgeting and financing needs to be improved

Municipal and county governments are responsible for a large share of public services so it is important that they have the motivation and the tools to make efficiency improvements and savings. Sub-national governments also initiate a large number of investment projects, and the much larger amounts of EU money now available for these activities means efficiency in the system for administering and co-ordinating development activities is critical.

Though sub-national governments are bound by tight rules to deliver balanced budgets, this does not guarantee either financing or spending efficiency. Indeed, budgeting in sub-national government lacks a longer-term perspective and there is plenty of room to increase accounting transparency and oversight. Furthermore, the whole system of financing is overly complex. The in-depth chapter on sub-national governments makes the following recommendations:

- *Budgeting.* Stronger multi-year budgeting frameworks are needed. Also, separate budget balance rules for current and capital items ought to be considered. Multi-year budgeting could also be a vehicle for removal of the deficit grant by allowing temporary deficits.
- *Transparency and oversight.* The mechanisms of account auditing ought to be widened to allow full oversight of sub-national government accounts. Oversight could also be strengthened by permitting audits by independent professionals. In addition, regulations should be introduced requiring local governments to re-submit sub-standard accounts and requiring that breaches of budget rules are accompanied by reports explaining the source of problems and plans for solving them. Finally, there should be greater transparency regarding off-budget items and increased monitoring of public procurement.
- *Benchmarking.* Much faster progress is required in the development of comparable cost, output and performance indicators.
- *Complexity.* The government must ensure it follows up on plans to reduce the number of formula based (*i.e.* normative) grants. However, the campaign to simplify the system ought to run much wider than this.
- *Specific tax issues.* A broadening of property taxation is under discussion as part of reform on the local revenue system. This reform should also include removal of the local business tax. Local "value maps" ought to be developed to help ensure the property tax is based on market prices. In addition, steps are needed to eliminate problems in the system for allocating personal income tax revenues to municipalities. In particular, the link between these revenues and funding for specific areas should be cut.

Further measures are needed to motivate sub-national governments towards greater efficiency

Other channels need to be used to encourage spending efficiency in sub-national governments. A system with far fewer municipalities would be more efficient but constitutional and political barriers preclude such reform at the moment. In general, the governments of smaller communities are making a reasonable job of overcoming efficiency issues through joint provision arrangements and flexibility in the assignment of responsibilities between municipalities and counties. The following measures would improve the system further:

- Though widespread merger between municipalities faces insurmountable barriers, efforts to achieve a consensus ought to be pursued regarding replacement of the nineteen county governments with elected assemblies in the seven NUTS II Regions.
- The central-government's system of financial encouragement for joint provision using "micro-regions" is welcome. However, stronger mechanisms for public comment on the decisions taken by councils of mayors that run these services should be considered to bolster local-government support for joint provision. Also, welcome are the rules allowing municipalities to pass on responsibilities to counties. These would be more effective if municipalities were prevented from imposing rules on how the county runs the service.
- Some central-government provision regulations should be scaled back because they are overly prescriptive – hampering rather than encouraging efficiency improvements in public services by sub-national governments.
- Sub-national governments ought to be given more leeway in designing the work contracts of their employees and in setting wage levels. The type of reforms to the remuneration and management of civil-service employees envisaged at the central-government level should be adopted by sub-national governments.

Reasonable progress is being made in supply-side reforms to encourage higher labour utilisation

Hungary's low employment rate remains a key structural handicap to achieving higher living standards. The widening of tax wedges and damping of spending due to austerity measures means a temporary weakening of labour demand. Furthermore, public-sector layoffs are initially going to increase unemployment, though the release of these resources will help output growth in the longer term. The government is nevertheless continuing with positive supply side reforms which should improve the employment response when demand picks up again. As discussed above, useful reforms have been made in the key areas, namely early retirement, disability and old-age pensions. Unemployment insurance schemes have also been improved through more front-loading of benefit. All of these reforms are along the lines recommended in detailed analysis in previous *Surveys*.

Developments on other fronts are mixed. Welcome efforts are underway to simplify active labour market programmes. The impact of the additional "guaranteed wage minima" that are based on educational and vocational qualification required for the job must be very closely monitored. The system is whitening employment through reductions in undeclared cash top-ups and in-kind benefits but is likely to be pricing some jobs out of the market and driving others fully into the hidden economy. *Other, less costly, ways of reducing grey-sector activity should be sought*. Incentive problems *via* the tax schedule remain. *The allowances aimed at cutting the income-tax bills for low-wage workers should be reformed, or replaced by an alternative mechanism, to smooth the effective average and marginal tax schedules.*

Family policy needs to focus more on childcare services

Women in Hungary take much longer periods off work when they have children compared with most other OECD countries, largely due to a family policy that focuses on providing options for lengthy parental leave backed by cash benefits. While in terms of the employment rate, this is not as important as tackling the problems of early retirement and disability, there are nevertheless relevant policy issues. International evidence that this approach helps raise low fertility rates is thin and there are economic downsides to it. Long separation from the labour market damages women's earnings and career prospects, and from a macroeconomic perspective this reduces the employment rate and weakens human capital development. Policy should therefore focus more on helping parents combine work and family roles.

Central government has stepped up provision requirements on municipalities regarding childcare services and has increased grants. This will further help overcome under-provision that, for example, arises from externalities in human capital development and social cohesion. Future policies should focus on:

- *Continued attention to childcare provision requirements*. The impact of the changes in provision regulations should be closely monitored and, if necessary, bolstered by further measures. In terms of childcare service flexibility, policy goals laid out in the government's programme ought to be followed up on. In particular, plans to encourage longer operating hours look promising.
- *Reduction in the municipalities' contribution to costs*. Further increases in the central-government grant for services could be useful, as long as savings can be found elsewhere in the system – reductions in family cash benefits being one candidate. The restrictions on parental fees should also be lightened.
- *New funding arrangements*. A system in which vouchers are given to parents to spend on childcare services (possibly in lieu of cash benefit) could be one way of widening provision and allowing subsidies to more strongly reflect parental preferences.

And reform is required to the system of cash benefits and leave

Parental leave for each child can last for up to three years and often lasts much longer than this because leave can overlap when women have more than one child. The leaves are part of a complex system of additional cash benefits for when children are below kindergarten age. The Hungarian government considers this approach reflects societal preferences for family-based childcare. However, it is expensive to run and international evidence suggests it has adverse effects on women's careers. Given the size of budgetary transfers in the family support system, cost-effectiveness would seem to merit continuing attention.

Reforms should be contemplated to reduce the duration of these provisions and savings from this channelled into childcare services. Specifically:

- *Reform could entail removal of the universal third-child benefit and significant reform of the benefits for when children are below kindergarten age. Whatever specific measures are considered, possibilities for extended leave ought to be cut back and savings in spending made to help fund childcare services. Some offset could be made through increases in the replacement rate (and perhaps raising of the cap) of the insurance benefit covering the six-month maternity leave. Increased paternity leave should also be considered.*
- *Three schemes could be removed without any significant implications for either the universal or targeted "safety net" dimensions of policy. The cash component of "child social support" is effectively redundant due to the new welfare top-up payments. Also, the maternity grant and the third-child tax allowance provide relatively small amounts of cash support that could be integrated into another benefit, such as the family allowance.*
- *Changes to the equivalence scale used in calculating the welfare top-up payments to deal with welfare trap problems should be considered. Additional measures could comprise extension of the period allowing retention of a share of the welfare top-up payments when someone gets a job, or the introduction of earned-income tax credits.*

Further work is needed in identifying and removing barriers to the creation of jobs with hours and flexibility that suit working parents. Further reforms that give more flexible choices to public-sector employees would provide a useful lead on this front. Also, when room becomes available to proceed with tax reforms, resumption of the phase-out of the lump-sum employers' healthcare contribution should be on the priority list.

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Chapter 1

Fiscal consolidation dominates the policy agenda

The government deficit reached another election-year peak in 2006 and fiscal consolidation has become the focus of policy. This first chapter of the OECD's 2007 Economic Survey of Hungary begins with examination of the impact of the poor budgetary record on the economy, why previous governments have failed to adequately address the problem and the prospects of success in the latest consolidation programme. Raising Hungary's low employment rate also remains a significant policy challenge. The chapter examines progress in unemployment, disability and early-retirement schemes, as well as reforms to active labour market policy and the new system of minimum wages. The chapter also reviews developments in business policies, in particular the ease of doing business and competition issues, as well as progress in environment policy.

The consequences of fiscal profligacy are now being felt throughout the Hungarian economy. Large deficits and rising debt have for some years been contributing to high real interest rates, current account deficits and exchange-rate volatility. Following re-election in April 2006 (Box 1.1), the centre-left coalition is making a determined effort to reverse the poor fiscal outcomes and low credibility of policy. There has been candid acknowledgement of the origins and scale of fiscal problems. Also, the government recognised that the goal of joining the euro area in 2010 was not possible and has been cautious in committing to a new date. Most important, an ambitious programme of fiscal measures and structural reforms to public spending has been underway since the autumn of 2006. This is putting a big squeeze on households, businesses and the public sector in the near term. Yet, if all goes according to plan, the programme will put fiscal policy on a more sustainable path and strengthen growth potential.

Box 1.1. **Political developments**

Parliamentary elections in April 2006 saw the centre-left coalition of the Hungarian Socialist Party (MSZP) and the Alliance of Free Democrats (SZDSZ) win a second four-year term of office. This is the first time that either of the two main political alliances has been elected for a consecutive term of office since 1990. Also, the winning coalition's majority expanded slightly with a relatively comfortable lead of 210 to 176 votes. The opposition grouping, comprising the Young Democratic Alliance – Hungarian Civic Union (FIDESZ-MPSZ), the Christian Democratic People's Party (KDNP) and the Hungarian Democratic Forum (MDF), previously held office from 1998 to 2002.

The centre-left coalition lost ground in local elections held in October 2006 (constitutional legislation states that local elections must always be held the autumn following the general election which must be held in spring). The opposition alliance now has majorities in all but one of the 19 counties and in 15 of the 23 major cities. The swing in support towards the opposition in these elections was exacerbated by the controversy arising from the leak of a post-election speech by the Prime Minister to party members that included candid admission of weaknesses in the government's previous term of office. In addition, several of the government's austerity measures were introduced in September 2006 and this may also have influenced voters.

Soon after coming into office the new government proposed several reforms to the political system. In particular, it succeeded in getting constitutional legislation passed that allows greater flexibility in the structure of ministries. Following this, the number of ministries was cut from 15 to 12 (two minister posts without portfolio were also cut). The government had several other proposals for reform: reduction in the number of members of Parliament, replacement of elected government at the county level with elected governments at the regional level and a proposal to move from a two-round to a one-round system in parliamentary elections. But these either did not end up being put to a vote or did not reach the required majority.

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The unavoidable revenue-raising measures in the first wave of fiscal consolidation are unfortunately limiting progress on dealing with Hungary's other main handicap to achieving higher living standards – its very low employment rate. The widening of tax wedges on labour and damping of aggregate demand run counter to employment creation and so for the time being the only viable option is to press on with structural reforms to improve supply-side incentives in the labour market.

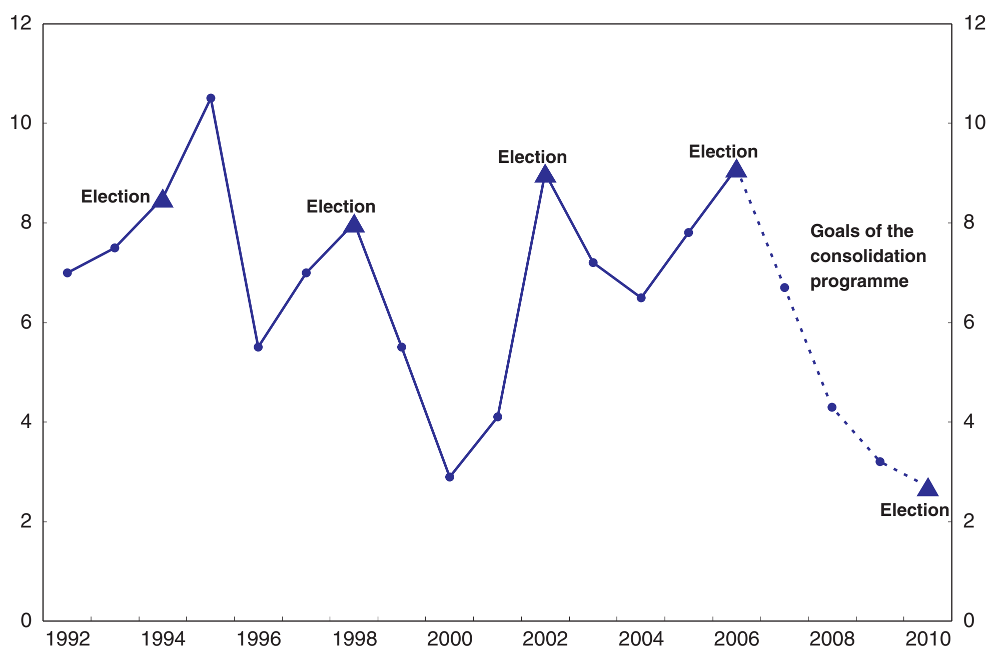
This chapter first looks at the depth of fiscal problems and the challenges faced by the government's consolidation programme. These issues are followed up in Chapter 2 with an in-depth assessment of progress in the programme and in Chapter 3 by an examination of public spending and financing issues in sub-national government. This chapter then continues with an overview of reforms in labour market policy. This review is accompanied by a focus on family policy in Chapter 4. The remaining two sections of this chapter review developments in policies affecting the business sector and environment policy. A summary of past recommendations is contained in Annex 1.A1.

The fiscal challenge

In 2006, the general government deficit turned out at 9.2% of GDP on an ESA95 accounting basis, way above the deficit target of 6.1% published in the December 2005 update of the Convergence Programme.[1] As a result, debt has risen to 66% of GDP. The fiscal balances would have been even worse had the government not begun its reform programme before the end of the year. This ambitious programme aims at four consecutive years of consolidation to bring the deficit below 3% in 2010 (Figure 1.1). If it

Figure 1.1. **General government deficit, history and goals**

% of GDP



Note: The dotted line from 2007 to 2010 shows the deficit path as outlined in the Government's Convergence Programme of December 2006.

Source: OECD estimates and Convergence Programme of Hungary 2006-2010.

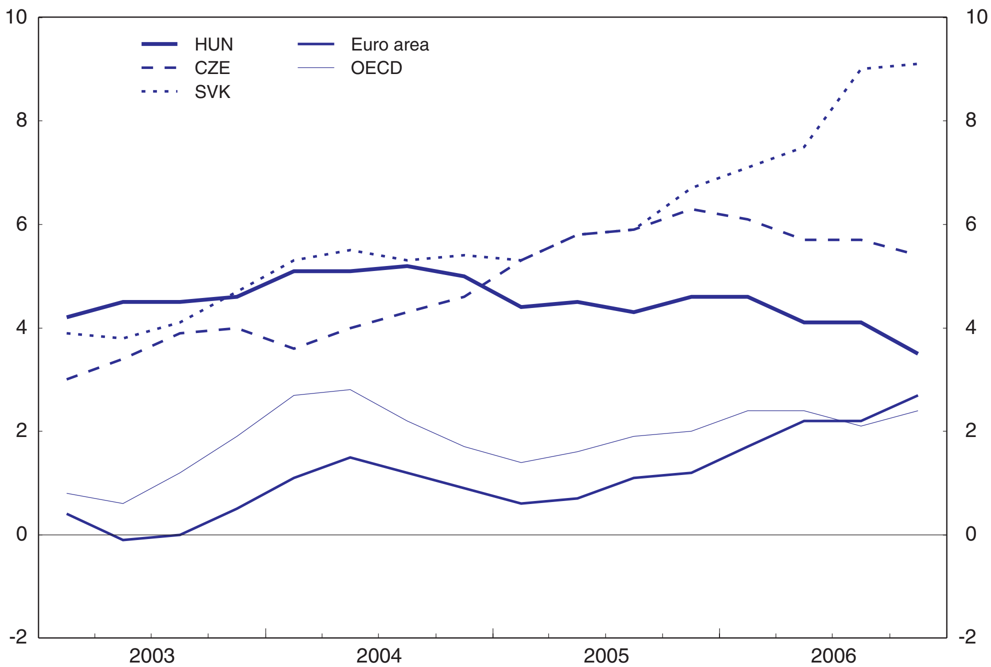
remains on course, the programme will bring the most prolonged period of deficit reduction in Hungary's recent history and imply breaking the strong electoral cycle in fiscal deficits. Chapter 2 takes a closer look at the key elements of the consolidation programme and suggests ways of boosting its effectiveness.

Economic growth is being slowed by fiscal problems

Over the past few years, real per capita GDP growth has been relatively constant, lying between 4 and 5% in year-on-year quarterly figures (Figure 1.2). This has meant a reasonable margin of growth on more advanced OECD economies. For example, this pace of growth implies catch-up with average per capita GDP in the EU within 25 years.[2] Export-based manufacturing, linked to foreign direct investment, continues to be the key motor of growth, though service industries for both domestic and foreign markets are also expanding.

Figure 1.2. **Growth in real GDP per capita**

Year-on-year changes, %



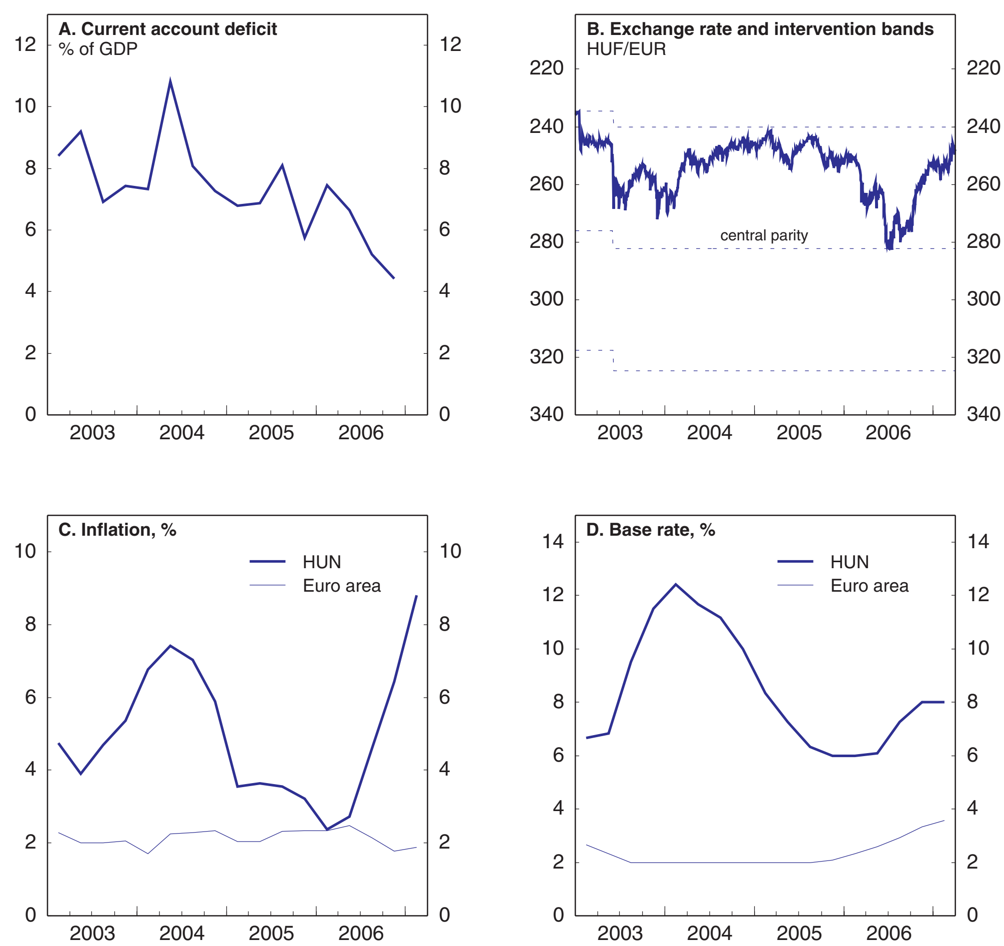
Source: OECD, National Accounts and Economic Outlook Databases.

This being said, Hungary has not experienced the acceleration in growth seen for instance in the Czech Republic and Slovakia in recent years. Also, the margins of growth on the euro area and the OECD as a whole narrowed over 2006. The fiscal imbalances have almost certainly played a key role in this relative weakening of economic performance through several channels:

- The large swings in the deficit, which are connected more with the electoral cycle than the economic cycle, have brought inappropriate fiscal boosting or damping of the economy (see Annex 1.A2).

- The fiscal imbalances have brought negative effects on the real economy through financial channels. The deficit and debt positions have boosted the current account deficit and contributed to nervousness on foreign exchange markets (Figure 1.3). These conditions have pushed up the cost of keeping price increases in check *via* the Central Bank's inflation targeting system, bringing higher costs of borrowing for households and businesses. Indeed, high real rates of interest have contributed, along with cut-backs in mortgage subsidies, to rapid increase in the number of households taking out foreign-currency loans (typically in Swiss Franc).[3] Concern that borrowers have not factored in the exchange-rate risks of these loans remains, although no concrete problems have emerged so far.[4]
- The poor fiscal performance is almost entirely to blame for the abandonment of both the 2008 and 2010 target dates for euro entry. The 2008 target was replaced by the 2010 target in 2004, and then the government admitted in June 2006 that the fiscal criteria

Figure 1.3. **Developments in the current account, exchange rate, inflation and interest rates**[1]



1. The exchange rate intervention bands are 15% either side of the central parity. The inflation rate is year-on-year growth in the Harmonised Consumer Price Index.

Source: Datastream; European Central Bank; Eurostat; Magyar Nemzeti Bank; OECD, Main Economic Indicators and National Accounts Databases.

could not be met in time and has not as yet committed to a new target date. The repeated postponement of entry plans has meant loss of anchoring effects in inflationary expectations that potentially allow monetary policy to remain on track with lower policy rates. Postponement has also delayed the prospect of increased transparency in international price and cost comparisons and the elimination of euro-forint exchange rate risk for businesses and households.

The government's effort to turn around the fiscal situation is therefore welcome even though initial consolidation effort means a period of damped growth. Private consumption growth has already fallen off with the phasing in of several revenue-raising measures (notably increases in value-added taxation (VAT) rates, energy prices and social security contributions) and real government consumption growth is expected to be negative over 2007 and 2008 according to the latest OECD projections (see Annex 1.A3). Export demand is expected to remain buoyant but is not expected to fully offset the downturn in domestic demand. As a result, real GDP growth is expected to be 2.2% in 2007 and 3.1% in 2008. At these growth rates, little progress in catch-up with living standards with the rest of the OECD will be made. While growth is expected to pick up from 2009 onwards, the level to which it will recover is uncertain. If the government succeeds in embedding the deficit cuts then the long-term growth prospects may well exceed the 4-5% historical average. If the benefits of the fiscal package turn out to be only temporary then growth will, at best, revert to the long-term average.

The government's fiscal measures are also having a major impact on inflation. The increase in VAT rates and reduced subsidies on household gas prices in particular are pushing up inflation in the first half of 2007. This spike in the consumer price index is one of a number of uncertainties for monetary policy (Box 1.2) relating to the fiscal programme. These include: the magnitude of price damping due to the squeeze on demand, uncertainties about wage increases and a possible shift in the political risk premium. This has resulted in a "wait and see" period by the Monetary Council from late 2006 to early 2007. On a technical level, in line with recommendations made in in-depth analysis in the previous *Survey*, a continuous medium-term inflation target was announced in 2005. In addition full inflation reports are now semi-annual instead of quarterly.

The large allocations available from the 2007-2013 EU Budget are potentially going to bring significant cash injections to the economy (see Annex 1.A4). The combined inflows available from Structural and Cohesion Funds as well as the Common Agricultural Policy are equivalent to nearly 5% of nominal GDP for each year of the budget period, while outflows due to contributions will average about 1% of GDP. Though the effect on real GDP growth is almost certainly positive, its magnitude and distribution over time is highly uncertain. For a start, the degree of success in absorbing the allocations ("absorption capacity") is unclear and the timing of inflows is complex. Furthermore, in terms of immediate demand impact, the injections will to some extent substitute current spending and be diverted into price (or wage) increases and imports, rather than domestic output. The potential effects on long-run growth potential are also hard to establish. A large share of the funds is directed at development projects which are at least purported to be growth-enhancing, such as transport networks but the impact of these types of investment on growth potential is difficult to establish.[5]

At the same time, economic pressures due to ageing are set to increase. The old-age dependency ratio is set to accelerate over the next decade, putting pressure on pension and

Box 1.2. **Developments in monetary policy**

In terms of recent rate-setting decisions, as of mid-April 2007 the policy rate had been on hold for some time following a series of hikes from June to October 2006 that raised the rate from 6 to 8%. Uncertainties in several inflation channels have been important in debates on rate setting:

- Possible transmission into inflationary expectations from the spike in inflation due to increase in VAT and hikes in regulated prices.
- The impact on inflation of the squeeze on demand. First, there is a fairly wide confidence interval surrounding the estimated size of the demand squeeze itself. Second, the large size of the squeeze and other differences in the economic environment have raised questions about whether model-based coefficients can be applied.
- Wage setting. Hikes in the regular wage components in recent months and the belated tripartite agreement of 5.5 to 8% wage hikes reached in February 2007 may pose a risk to disinflation in the medium run. However, it is difficult to assess the magnitude of wage growth and its likely impact on inflation, as adjustment to changes in labour-market and tax regulations may bias statistical data upwards.
- Possible reduction in the risk premium following the general election and the start of fiscal reforms.

Changes in the composition of the monetary policy council have prompted speculation on the general tone of monetary policy. In August 2005, four additional experts were added to the Monetary Council, expanding it from nine to thirteen members. Andras Simor, previously head of the Hungarian unit of the international consulting firm Deloitte, took over from Zsigmond Jarai as Governor in March this year. In addition, one of the Council members was replaced in March this year and two more mandates will expire in July, thus decreasing the council to eleven members.

On a technical level, there have been two notable changes in the inflation-targeting system. A continuous medium-term inflation target of 3% for the CPI was announced in 2005, replacing the system of end-of-year targets. The end-of-year targets were appropriate for guiding down the past levels of relatively high inflation but meant variation in the time lag between rate-setting and target (see the 2005 *Survey* for further discussion). Also, in 2006 changes were made to the system of inflation reports. Comprehensive reports are now semi-annual instead of quarterly and are supplemented by two interim reports. Otherwise, the inflation-targeting system is largely unchanged and notably continues to include a 15% intervention band on the euro-forint exchange rate (as shown in Figure 1.3). It was introduced on the grounds that an intervention band would provide a useful transition into the Exchange-Rate-Mechanism II (ERM II). While there has been no explicit conflict between the inflation targets and the exchange rate band in the past two years, destabilising speculation can intensify whenever the currency approaches the strong edge of the band.

health systems.[6] According to the December 2006 Convergence Programme (Government of Hungary, 2006), public spending on old-age and early-retirement pensions will have increased from 8% of GDP 2005 to 9.6% by 2020 and spending on healthcare will have increased from 5.5 to 6% over the same period. Reform of the old-age pension system in the late 1990s introduced a two-pillar pension that reduces long-term public spending commitments on pension payouts. However, transition to the new system is adding to the government deficit.[7] Furthermore, even beyond this transition, long-term projections such as those shown in the government's Convergence Programmes point to a widening gap between public contributions and spending on pensions under current policy settings.

Fiscal developments in 2006 typify the problems in budget discipline

The large gap between the original deficit goal and outturn for 2006, equivalent to 3.1 percentage points of GDP, was partly due to technical items and unexpected developments. A decision by Eurostat during 2006 concerning the treatment of military purchases raised expenditures by the equivalent of 0.3 percentage points of GDP. Also, there were some one-off surprise items that pushed up spending, including cancellation of a debt item with Iraq and unanticipated costs of flood damage.

At the same time, there were rather more questionable "surprises" in the course of the budget year that more prudent budgeting would arguably have avoided. The government's original budget did not include a large item on motorway spending on the assumption that this would go off-budget through a public-private partnership (PPP). However, during 2006 the government decided to put this spending into the government's accounts because it had become clear that the proposed PPP would not pass Eurostat's rules on PPP classification. There was a similar episode in 2005 (see Chapter 2). In addition, spending on pensions, pharmaceuticals and healthcare, as well as interest payments, was higher than the government budgeted. Finally, line ministries made greater use of funds carried over from previous years than expected.

Details aside, the 2006 budget story exemplifies long-term weakness in commitment to fiscal consolidation. As Figure 1.1 shows, a strong electoral spending cycle has a lot to do with the country's fiscal problems (see Annex 1.A2). Promises for spending increases and tax cuts have resulted in peaks in the deficit around the time of all four general elections held since 1990. These have typically been in line with sensible strategies for fiscal and structural reform but the scale or timing of measures has often been inappropriate. The cut in the top rate of VAT from 25 to 20% in January 2006 and the hikes in public-sector wages of 2000 and 2002 fall into this category. Other measures have arguably been purely populist, for example the generous mortgage subsidy scheme introduced in 2001 and, more recently, the introduction of the 13th month pension payment.[8]

The deficit problem has been countered periodically by fiscal reform packages (such as the "Hundred Steps" programme of 2005). Though these have contained largely positive reforms, they have thus far failed to permanently reduce fiscal imbalances. Furthermore, transparency and credibility in policy have sometimes been damaged by excessive exploitation of accounting rules. The deficit peaks in some election years have not only been driven by the fulfilment of spending promises but also by accounting techniques that tended to inflate the size of deficit problems inherited from the outgoing administrations.

The past record on previous fiscal reform suggests it will be a challenge to keep the current programme on course. There is a good chance the deficit for 2007 will come in a little below target (6.8% of GDP) and the outcome for 2008 is likely to come close to the target of 4.3%. This is because all the main measures needed to reach the targets are either in place or are very likely to be implemented. Up to this point, therefore, the consolidation effort looks set to repeat a past pattern of two-year post-election deficit reductions (Figure 1.1). Reaching the deficit targets for 2009 and 2010 (3.2 and 2.7%, respectively) and putting government debt on a sustained downward track is more at risk because of uncertainties in the implementation of the planned measures to fulfil them and because a decisive break with past experience in pre-election spending is required.

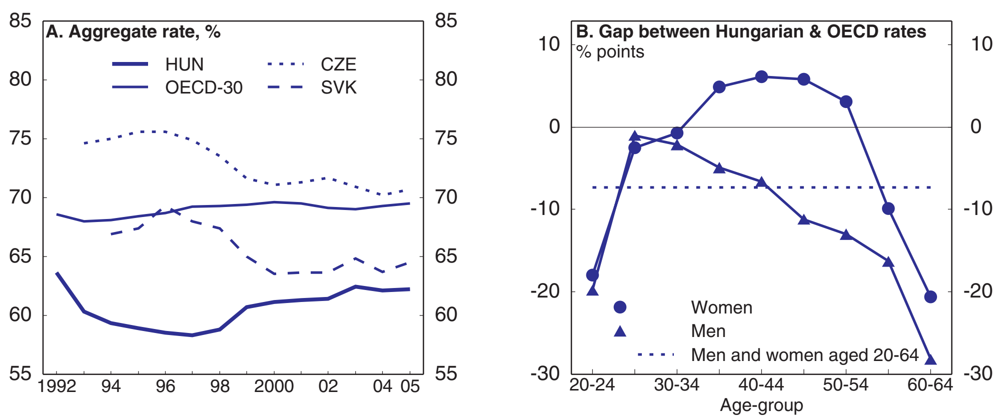
Successful consolidation requires the participation of sub-national government

Many of the central government's plans for structural reform necessarily involve county and municipal level government because of their direct responsibilities in providing services. For instance, sub-national governments are responsible for a large share of healthcare services and the central government has to get them on board in the reform process, or at least to successfully pressure them into taking measures. The fact that about 60% of all public-sector workers are paid out of county and municipal budgets underscores that initiatives cutting administrative and operational staff at the central-government level need to be applied to lower levels of government.[9] In this light, Chapter 3 explores avenues for improving the role of sub-national government in making efficiency gains to public spending.

Raising the employment rate needs to remain a focus of policy

Economic transition involved major industrial restructuring that brought a major shakeout of labour and a large drop in the employment rate (Figure 1.4). Though labour utilisation has been recovering since the late 1990s it is nevertheless below the OECD average by a substantial margin. For instance, the employment rate of those aged 20 to 64 is around 62% compared with an OECD average of nearly 70%. In contrast, survey-based unemployment rates have typically been a lot closer to the OECD average in recent years (the rate is currently around 7.5%). Unfortunately, this more reflects abandonment of jobs search by the non-employed, rather than positive progress in labour utilisation.[10] Much of the gap in employment rates is because the effective age of retirement in Hungary is low, generating employment rates among those in their late fifties and early sixties well below the OECD average (Figure 1.4). However, employment rates are also relatively low among prime-age men and those in their early twenties.[11]

Figure 1.4. **Employment rate among 20-64 year-olds**[1]



1. The employment rate is employment of age-group X as a percentage of the population of age-group X. The OECD employment rate is the total employment across member countries as a percentage of the total population. Negative values in panel B mean that Hungarian rates are lower than OECD rates in 2005.

Source: OECD (2006), Labour Force Statistics Database.

Substantial progress in narrowing the gap in labour utilisation is unlikely, at least this year and next, due to the damping of growth. But supply-side measures that get the incentive structures right in unemployment benefit and early-retirement schemes and improve other policies affecting labour markets should help strengthen employment growth when the economy picks up again.

Positive progress in unemployment, disability and early-retirement schemes

The main challenges to raising the employment rate are to narrow channels for early retirement and to ensure that standard unemployment benefits and social welfare play the primary role in providing financial support. The system for providing financial support for the unemployed became significantly distorted in coping with the industrial re-structuring of the 1990s. Schemes not intended for mass unemployment were allowed to absorb claimants, most notably the disability pension and the several early retirement schemes. Indeed, unemployment benefit and regular social welfare ended up playing a secondary role. Detailed analysis in the 2005 *Survey* shows there are only about 250 000 claimants for these schemes compared with over 600 000 claimants for disability and early retirement schemes.

The unemployment benefit system has been improved. Reforms made in November 2005 made the system more "front loaded" (as recommended from in-depth analysis in the 2005 *Survey*). The maximum possible duration of benefit has been reduced from 15 to 12 months and only up to the first three months of benefit are now related to previous earnings. Furthermore, the possibility of a lump-sum payment for those who get a job before the exhaustion of benefit (the "job search allowance") has been brought forward (see Annex 1.A5).

In addition, several of the structural reforms in government's programme aim to raise the effective age of retirement (see Chapter 2 for further details):

- Further tightening of the eligibility conditions for the universally available early retirement schemes has been scheduled and measures are being taken to limit access to occupational schemes.
- The pace of reform to the disability pension system is set to pick up speed from its previously sluggish pace. In particular, a "rehabilitation benefit" is planned as an alternative to the disability pension.
- The government is assessing options for changing the old-age pension system with the aim of presenting a detailed proposal for reform in late 2007.

Getting incentives right in family policy

In Hungary there is a relatively wide gap between the employment rates for women with children and those without (Figure 1.5), reflecting generous options for taking time off work to raise children on a full time basis. While in the context of raising the employment rate, this issue is not as important as tackling the problems early retirement and disability, there are nevertheless important and complex policy issues. The government considers the approach to family policy reflects societal preferences. It is also argued that current policies are helping address the low birth rate which, similar to many former eastern-bloc countries, declined rapidly in the 1990s. However, encouraging long separation from the labour market has downsides for women's careers and the international evidence casts doubt on the effectiveness of this type of policy on fertility. Furthermore, the system is

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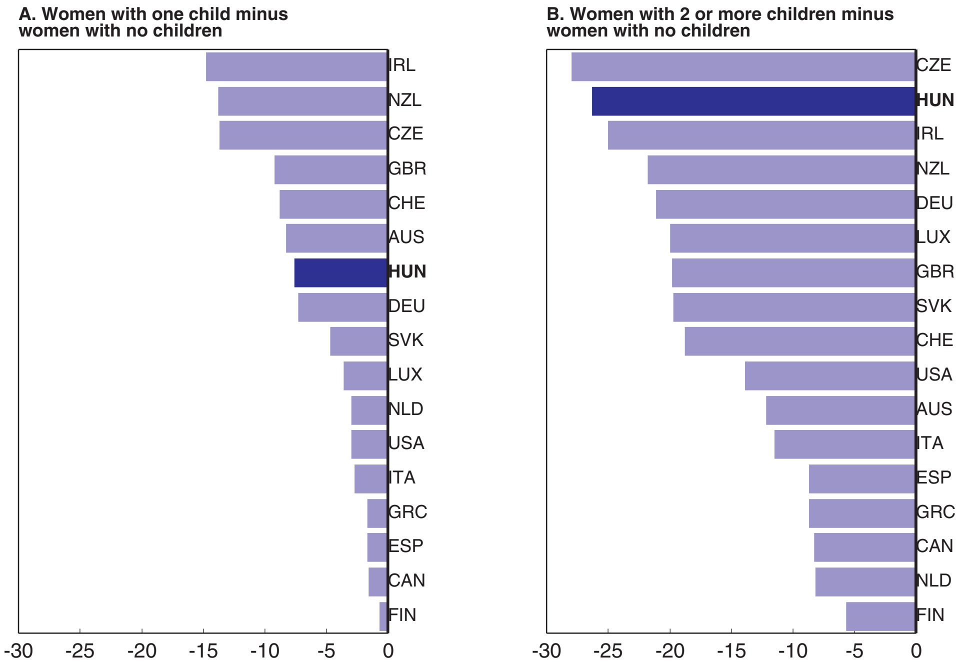
Figure 1.5. **Gaps in employment rates between women with and without children**[1]

Percentage point differences



1. For example, the employment/population ratio for women with one child is the ratio of employed women aged 25-54 with one child to total number of women aged 25-54 with one child. Children aged 14 years or under are counted in the data.

Source: OECD, Society at a Glance 2006.

relatively expensive to run. Chapter 4 of this *Survey* looks in depth at the different aspects of family policy and suggests ways of improving the reconciliation between work and family.

The low-wage allowances on personal income tax remain a problem

As discussed in the 2005 *Survey*, the strategy on personal income tax (PIT) needs rethinking because the system of tax allowances for low-wage earners is creating an overly erratic effective tax schedule. The PIT schedule is, at first glance, simple with only two rates of taxation (18 and 36%). But there are two allowances whose primary aim is for those earning the minimum wage, or close to it, to pay zero or only small amounts of income tax. Phase-out of the allowances influences average and marginal taxes for a substantial range of earnings. As a result, the effective tax schedule is very erratic. Indeed, there is a range of earnings where the marginal tax rate rises to over 50% (excluding employees social security contributions, which are typically 17% of the gross wage).

Welcome efforts to eliminate duplication in active labour market policies

In January 2007, the Employment Act was amended. The changes included welcome steps to eliminate duplication among the approximately 40 different schemes providing either wage subsidies, incentives for job creation (including self-employment) or support for training – there are now about 30 programmes under 16 headings. The amendment also brought alterations to the rules governing the schemes. In part these are in response to the application of EU regulations on labour subsidies that are designed to limit industry subsidies but which can also affect active-labour-market policies. Under these regulations, in particular, certain forms of wage subsidy cannot exceed 50% of labour costs (60% for the disabled) and can only run for the first year of employment.

The new system of wage minima

As part of the 2005 tripartite wage negotiations, the government supported a three-year agreement that set increases in the minimum wage up to 2008 but also introduced a system of "guaranteed minima".[12] In July 2006, guaranteed minima were introduced for jobs requiring a secondary school or vocational training qualification with two levels, depending on experience. Also, wage minima for jobs requiring tertiary level education were recommended. According to OECD calculations, the 2005 agreement implies the basic minimum wage will remain at about 45% of the median wage. However, assuming the schedule agreed in the 2005 agreement to go ahead, the guaranteed minima for jobs requiring secondary school or vocational training will be equivalent to around 55% of the median by 2008 (see Annex 1.A5).

The government claims that the guaranteed minima help cut back on the grey economy and raise (scarce) skilled labour supply. With regard to the grey economy, the authorities hope that the minima will bring substantial reduction in undeclared earnings and in-kind payments among employees without an overly serious negative impact on the demand for labour. It is indeed true that a sizeable minority of workers (at least 10% in the private sector) are recorded as earning the minimum wage. It is also clear that a much larger share of workers is being affected once the guaranteed minima are taken into account.[13, 14] But little is known about the incidence or value of the cash payments or in-kind benefits among low-wage workers, so the net benefit of the system is hard to evaluate. Countering the plus-sides are risks that the new minima are pricing some genuine low-wage jobs out of the market and driving others completely underground.[15] Both the upsides and downsides of the system are potentially softened by a rule that sectoral agreements can override the guaranteed minima though, as yet, it is not clear to what extent this provision will be used.[16] In sum, the impact of the new system needs to be carefully evaluated and other, less costly, ways of reducing grey-sector activity sought.

Update on the business environment

Ensuring the business environment compares favourably with other countries and encourages entrepreneurial activity for domestic enterprise is important for the future of the Hungarian economy because business-sector growth has to be the main engine to further capital deepening and increased labour utilisation. Foreign direct investment (FDI) is a key driver of business-sector growth, much of it financing manufacturing plants and service centres that are part of global production chains (total inward FDI was equivalent to 5.5% of GDP in 2006).[17] As in many other countries, government is playing a direct role through support for large investments and minimal restrictions on FDI.[18] However, such measures are not the only influences on business location decisions, and governments also need to encourage domestic business. In terms of overall economic conditions, the consolidation package is bringing a slowdown in domestic demand growth and increasing business and labour taxes. Whether this will adversely affect long-term investment depends very much on investors' views as to whether the package will deliver a sustainable fiscal position that raises growth potential and allows for lower tax burdens in the long run.

The overall "ease" of doing business and good regulation of competition also matters for business-sector growth; developments on these fronts are examined below.

Assessing the ease of doing business: results from OECD indicators

The ease of setting up businesses and the flexibility employers have in hiring and firing workers are two of the most important areas where government policy has considerable influence. An indicator developed for the OECD's *Going for Growth* series suggest that there has been room for improving the general administrative burden for business start-ups, most notably in the time taken to process the necessary paperwork. At the same time, Hungary has not been significantly out of line with the OECD average in an indicator reflecting regulatory demands in specific sectors or in one measuring legal barriers to entry. The two OECD indicators for employment protection legislation (EPL) show Hungary to be more lightly regulated than the OECD average, suggesting, *prima facie,* that this area does not need major reform.[19]

The problem of red tape for business start-ups has been getting some welcome attention. New Acts on business associations and company registration came into force in July 2006 that aimed to modernise legislation, speed-up processing and reduce administrative burdens.[20] Notably, the legislation on company registration provides the legal framework for registering and establishing businesses by electronic means as well as the establishment of standardised contract forms. This legislation also reduces the time limits of standard registration proceedings from 30 to 15 days, and to 8 days in the case of using standard contract forms (as from October 2007). A simplified registration procedure for private limited companies is also possible which as of July 2006 only takes two working days.[21] In early 2007, the government submitted a proposal for further reform to parliament. This comprises a number of measures that aim to further ease business registration including another reduction in time limits for the courts regarding company registration.[22]

Developments in competition policy

In broad terms, Hungary has now caught up with typical OECD practice in terms of competition legislation and oversight. Progress has been spurred on by entry to the European Union and policy is backed by EU legislation and institutions. In-depth assessment in the 2004 *Survey* found no serious problems in the structure or operation of the main competition authority (the *Gazdasági Versenyhivatal*, GVH) but did point to a number of weak points in legislation. Some of these were dealt with in 2005 by amendment of legislation on unfair and restrictive market practices. The amendment included introduction of the possibility of private enforcement of competition law (previously only the GVH could take legal action) and an increase in the threshold for merger notification (from HUF 10 billion to HUF 15 billion).

Difficulties remain in bringing a level playing field for competition in the network industries. The problems are not unique to Hungary and reflect the inherent challenges in introducing market competition to these activities. The most important issues lie in the gas and electricity sectors.

In the electricity sector, 2005 saw the re-integration of the system operator (MAVIR Rt) into the incumbent (MVM Rt). MVM already has a strong presence, controlling about 80% of electricity production and sales (IEA, 2007). In addition, there has been little progress in breaking up the long-term power-purchase-agreements set up by MVM which are stifling the development of retail markets. The continuation of these agreements means it is unlikely that the legal opening up of the retail market to households in June 2007 will soon widen market-based provision.

In the gas sector, 2005 saw a welcome separation of pipeline transport from other activities in the sell-off by the previous incumbent (MOL Rt) to the energy group EON. EON purchased storage facilities and the import contract with Panrusgas (which has links to Gazprom) and the company continues to be involved in part of the regional distribution and supply business. Following a ruling by the European Commission, MOL Rt retained the pipeline network. The import contract with Panrusgas provides a large share of total gas supply and is limiting opportunities to set up competing contracts because it ties up the main import pipeline (from the Ukraine). However, there are efforts to diversify supply pipelines, though this is a difficult task given the number of stakeholders and countries involved. Interestingly, Gazprom has offered to provide financial support for additional storage capacity, which would help prolong supplies in the event of a failure in pipeline supply such as in 2006. In distribution, the legal opening up of the market in July 2007 will, in principle, put some pressure on the five regional companies to compete. This being said, the room for competition is fundamentally limited because of the narrow supply options. The replacement of the universal subsidy on the retail price of gas for households with targeted support is not only a positive step in terms of public spending (see Chapter 2) but will also encourage more efficient energy use.

Outside the network industries, various campaigns against anti-competitive practices continue. The GVH has for some time been putting professional bodies under pressure to lighten regulations. For instance, it recently succeeded in getting the Hungarian Medical Chamber to remove some provisions in its Code of Ethics that were restricting price competition. Suspicion about the high profitability in the banking sector continues. The high profits can in part be attributed to the high base-rate and other temporary conditions but there have also been concerns about the degree of competition, though little hard evidence has come to light so far. The latest investigations have drawn attention to barriers to switching accounts between banks.[23] A government commission highlighted this issue in a report issued in early 2007 and this is being followed up by the GVH.

Update on environment policy

Issues in environmental energy policy

Policies to promote more environmentally friendly energy production focus on electricity. There is a two-pronged approach. Participation in the EU's Emission Trading Scheme means there is an implicit environmental tax on generation methods that produce carbon dioxide. Furthermore, electricity produced from combined-heat-and-power plants and renewable energy is supported by a system of "feed-in tariffs" which guarantee prices to producers. The tariffs were introduced in 2003 and have had a substantial impact on renewable energy production. Renewable energy sources are now equivalent to around 4% of total energy consumption, more than five times the share in the early 2000s. Most of this increase comes from greater use of wood fuel, which now accounts for about 70% of renewable electricity supply.

A recent review by the International Energy Agency (IEA, 2007), confirms problems in the feed-in tariff system discussed in the 2004 *Survey*. The biggest issue is the relatively high level of these tariffs. For instance, electricity from wind generators is guaranteed a

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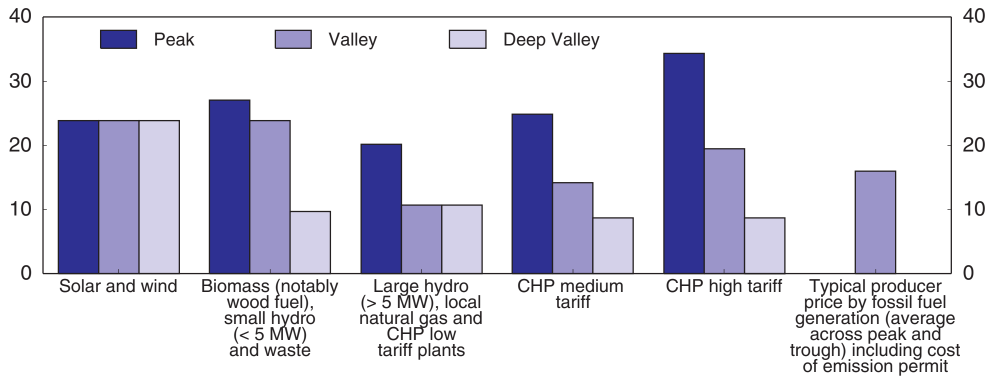
price close to HUF 24 per kilo-watt-hour (kWh) while the producer price of electricity *via* fossil-fuel production is roughly HUF 15 with the implicit costs of emission permits included (Figure 1.6). Indeed, the feed-in tariffs are comparable with the pre-tax *retail* price of energy; this was just over HUF 24 per kWh on average over peak and trough. The high level of the tariff has several downsides, in particular:

- End-users are paying a substantial margin in their electricity bills due to the tariffs. The tariffs are incorporated into the transmission system operating charge and account for close to 10% of the retail price and an even higher percentage of the price charged to industrial and large commercial users (IEA, 2007).[24]
- The tariffs guarantee high profit margins for wind-power generation and have led to more commercial interest than is needed to meet capacity. Technical difficulties in handling the variation in electricity output from wind power mean a cap has been put on capacity. As a result, for instance, the 2006 licensing round led to either refusal of permits or reductions in permitted capacity. The permits are granted for a 15-year period and because all of the capacity is allocated this leaves little room for wind-power generation to benefit from future technological developments.
- The tariffs are reportedly leading to instances of "heat dumping" by some CHP producers, despite regulation and monitoring systems. Incentives for dumping can arise where the tariffs guarantee such high profits from sale of electricity from CHP units that there is no incentive to generate revenue from the sale of heat production.

Figure 1.6. **Guaranteed prices for renewable energy producers ("feed-in tariffs")**[1]

HUF per kWh



1. The three rate schedules for CHP depend on the capacity, input fuel and whether the plant is part of a district heating system. "Peak", "Valley" and "Deep Valley" refer to different times of the day. For example, Peak prices are paid during the morning and early evening.

Source: Hungarian Government website and IEA (2007).

The issues in combined-heat-and-power are not confined to the level of feed-in tariffs. It is questionable whether some CHP units ought to be given environmental support. The justification for supporting CHP is that this helps promote the use of efficient technologies. But the efficiency requirements for units to be eligible for support are fairly low, such that in some cases separate electricity and heat production may in fact be more economically and environmentally efficient.

Developments in other areas of environment policy

The strategy on environment policy is laid out in the National Environmental Programme, 2003-2008 and the government is currently preparing strategic documents on sustainable development and climate change. Between 2004 and 2006, policy focussed on implementation of the National Waste Management Plan. This included investment in infrastructure and legislation covering the waste treatment of various products and changes to regulations on dump sites. In line with previous recommendations (see Annex 1.A1), there has been further development of economic instruments in this area. In particular, environmental product charges were extended to more items of electronic equipment and were introduced for drink packaging in 2005. Framework rules allowing producers to use deposit charges for items such as batteries and packaging were laid out in 2005. A review is underway that will likely lead to rules obligating producers to use deposit charges for some items.

Currently, there is considerable focus on the management of water resources.[25] In part, this is on specific measures to improve flood protection of the Tisza river basin, for example through the construction of temporary reservoirs. However, more general issues in the management of water resources are also getting attention, particularly drinking water and waste-water management. A large share of the 2007-2013 EU budget has been allocated to these issues and it is therefore important that plans and frameworks are in place to ensure high absorption capacity. The Ministry of Environment and Water sees some challenges in co-financing because many potential applicants for the EU-funds are small municipalities that could find it difficult to raise these funds (though a special central-government fund is available that will help ease this problem and user charges can be used for cost recovery). Also, in light of past experience in accessing EU funds, the Ministry sees a need for further training and expertise in fund application. Finally, the "n+2" rule also presents challenges for the management of funds by the Ministry and the National Development Agency (see Annex 1.A4). Parallel to infrastructure development, the authorities are aiming for various regulatory reforms to increase the efficiency of water-related services. Plans include encouraging consolidation among the approximately 400 water utility companies currently in operation, the introduction of unified rules on the pricing of water services and stronger vetting of the utility companies.

Notes

1. The official deficit target for 2006 shown in the December 2005 Convergence Programme was in fact 4.7% because at that time mandatory contributions to private-sector pensions were included in the official notification of fiscal balances to Eurostat. However, deficit figures excluding these revenues were also included in the Programme. Following the general election, the government decided to move ahead of Eurostat's deadline for ending this practice. For several years Eurostat has allowed countries where pension reform has involved the switch of contributions from pay-as-you-go (PAYG) pillar to mandatory private pension funds to count these switched contributions as revenues in ESA95 government accounts. The savings from this type of pension reform (in the form of reduced PAYG payouts) only come on stream after several years while revenues are reduced immediately. As a result, a number of EU member countries have argued for inclusion of the mandatory contributions on the basis that this makes for a fairer comparison of fiscal performance. Agreement with the EU authorities means that the contributions had to be taken out of government balances by spring 2007 but that the influence of pension reform nevertheless might be taken into account in assessment of fiscal performance.
2. Eurostat estimates Hungarian GDP per capita to be 63.5% of the EU25 average in 2007 on a purchasing-power-parity basis. Based on this figure, and assuming a margin of growth of 2 percentage points on the EU, then the mathematics of growth implies catch-up to the EU-average

will take nearly 25 years. A margin of growth of 3 percentage points would imply catch-up in a little over 15 years while a margin of only 1 percentage point implies catch up will take over 45 years.

3. The developments in mortgage subsidies have been complex. In 2001, subsidies on mortgages were introduced in which the interest rate households had to pay was capped and the government paid banks the difference with market rates. The scheme was very popular but also unsustainably expensive and subject to some abuse. This led to several rule changes. Most importantly, from early 2004 households have paid a reference rate plus part of the difference with market rates (thus reducing the size and volatility of the subsidy for the government). This new subsidy formula was not applied retrospectively and its introduction was preceded by a significant increase in new mortgages. As a result, though there was then significant reduction in subsidy applications, the government's financial commitment remains quite significant (the total payouts of this scheme are currently equivalent to roughly ½ per cent of GDP). The scheme (especially under the old rules) is widely believed to not only subsidise households but also banks. It should be noted that there are two additional mortgage subsidy schemes, one to help young families purchase housing and another to help disabled persons. However, neither scheme involves significant expenditure.
4. The forint would have to devalue to unlikely levels (below the lower boundary of the 15% intervention band) for the foreign-currency loans to become more costly than forint loans, so from this perspective the foreign-currency loan products are a logical choice. But, there are concerns that households do not fully appreciate the implications of exchange-rate risk and have not allowed for the possibility of increased repayments in their financial planning.
5. See MNB (2006) for an assessment of the impact of the structural and cohesion funds on growth potential.
6. According to United Nations population data, the old-age dependency ratio (calculated as the ratio of those aged 65+ to those aged 20 to 64) is currently rising at 1% a year but this will accelerate over the coming decade, with a peak rate of increase in 2018 of nearly 3.5%.
7. See footnote 1.
8. The mortgage-loan subsidy is described in an earlier footnote. The 13th month pension was introduced gradually from 2003 and has been paid in full from 2006. This measure, along with reductions in contribution rates, have significantly increased the future fiscal burden of the pension system (Orban and Palotai, 2005).
9. As of 2005 there were 806 000 public-sector employees (roughly 20% of total employment) of which 524 000 were paid out of local budgetary organs.
10. Hungarian survey-based unemployment is counted in the same way as in other OECD countries, *i.e.* respondents are classified as unemployed according to the replies to a standardised set of questions about job-search activities.
11. Comparison of employment rates among those in their early twenties or late teens is complicated by international differences in school-leaving ages, tertiary education enrolment rates and the length of tertiary courses. In addition, there can be differences in the incidence and statistical recording of temporary and part-time working by students.
12. An in-depth account of the 2005 wage agreement can be found on the *European Industrial Relations Observatory* ("eiroline") website. This system had been mooted in the "100 Steps" programme published by the government in June 2005. Trade unions had long been pushing for such a system while employers were reluctant to adopt it. The system of "guaranteed minima" is established only by the 2005 agreement and in this sense does not have the same legal standing as the standard minimum wage.
13. Data from the National Employment Office show that in 2005 the gross earnings of 12% (and the basic earnings of 22%) of employees in private-sector workplaces with more than five employees were at the minimum wage or within 2% of it. These data report that from 2003, no public sector employees have been on the minimum wage (due to the large pay increases of the early 2000s).
14. Research by government experts published in early 2006 (Benedek *et al.,* 2006) estimates that increase in the basic minimum and the introduction of two-tier system could in combination affect about one third of enterprises with 5 or more employees and between 25 and 40% of employees in smaller enterprises and the self employed. The biggest impacts are likely to have been in agriculture and tourism. The impact on construction and retail, where wages are also low, is thought to be less because relatively buoyant demand is pushing up the market wage anyway.

15. According to the Hungarian authorities, statutory certification requirements for jobs are common and this will help prevent evasion of the guaranteed minima through employers reducing qualification requirements and limit opportunities for completely hidden employment arrangements.
16. As of April 2007, one wage agreement, covering agricultural employees, had been struck that set minima below those set in the guaranteed minima system.
17. Inward FDI to Hungary was €4.9 billion in 2006 according to statistics of the Hungarian National Bank.
18. Hungary scores well in all the key components of the OECD's indicator on regulatory restrictions on foreign direct investment (OECD, 2007a). This indicator comprises sector-by-sector measures of limits on the share of foreign equity allowed in firms, screening and approval procedures. The indicator also factors in residency or nationality restrictions applying to directors and managers and the ease with which foreign employees can work in the country. Hungary has a score close-to or well below the OECD average in most components of the indicator. There are two exceptions; in transport and electricity sectors where the scores are notched up by limits on foreign equity ownership that relate to public ownership. The overall score is middle-ranking in a comparison of OECD countries plus Brazil, Russia, India and China.
19. See OECD (2007b) for results of the indicators. The indicator for the administrative burden on business start-ups is based on the time taken for various forms of business registration. The latest update of this indicator refers to 2003 and Hungary was then significantly above the OECD mean. The indicator of sector specific administrative burdens uses responses to questions about licensing requirements in transport and retailing. The indicator of legal barriers is based on a range of questions about access to markets. Hungary is slightly above the OECD average in this indicator because of issues in the network industries, not to businesses as a whole. EPL indicators for both regular and temporary jobs were updated in 2006 and are both below the OECD average, indicating lighter legislation.
20. The legislation comprises Act IV, 2006 on Business Associations and Act V, 2006 on Public Company Information, Company Registration and Winding-up Proceedings.
21. The two-day fast track procedure for business registration requires applicants to submit standard contract forms electronically and to have made name registration in advance.
22. In addition to further reductions in time limits, the government's proposal aims to make electronic registration compulsory, simplify the administrative requirements needed to prepare applications for registration, ease access to buying "ready-made" firms, reduce administrative charges and minimum capital requirements and cut back on the number of documents required for applications.
23. For example, a recent report by researchers at the Central Bank (Molar *et al.*, 2007) finds high price-cost margins in the markets for some retail banking products and concludes that this might reflect collusive activity but that other factors, including switching costs, may also explain the results.
24. Table 20 of IEA (2007) shows renewable and co-generation support to add about HUF 2 per kWh which is nearly 10% of the pre-tax residential tariff.
25. Current policies are also aiming to increase the number of nature parks. Steps include legislative measures to make it easier for local governments to set up such areas.

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ANNEX 1.A1

Progress in structural reforms

This table reviews action taken on recommendations from previous *Surveys*. Recommendations that are new in this *Survey* are listed in the relevant chapter.

Past recommendations	Actions taken and current assessment
FISCAL CONSOLIDATION	
Budgeting practices	
A more strategic medium-term outlook in budgeting is needed that has better prioritisation among central government programmes and more closely involves local and regional governments.	No significant action, budget plans beyond the budget year are made but there are no regulations to ensure strong commitment to them. However, a new system of reserve funds has been introduced in 2007.
Clarify macroeconomic assumptions used in budgets.	Policy from mid-2006 has taken a more prudent approach to macroeconomic assumptions but no regulatory changes have been made to insure against a reversion to poor practice.
Tax strategy	
Aim for greater transparency, neutrality, simplicity and stability in the tax system.	There have been no sweeping improvements and developments are mixed. There have been positive moves, in particular the introduction of the simplified tax treatment for small businesses. At the same time, the introduction of temporary taxes as part of the consolidation programme demonstrates continuing recourse to short-term *ad hoc* measures that add complexity and uncertainty for taxpayers. The implied average and marginal rates of tax on earned income remain erratic over the earnings distribution because of tax allowances for low-wage earners.
Further broaden the tax base notably through the introduction of taxes on currently untaxed capital revenues.	A tax on interest income has been introduced. Also, the consolidation programme includes several new measures to "whiten" employment but these are unlikely to fully resolve the tax-base issues.
Public expenditure	
Make greater use of performance benchmarks in the supply of public services and replace input-orientated financing with output-orientated financing.	Performance benchmarking is not yet widespread but there have been positive developments. For example, in education a new system for evaluating school and pupil performance has been introduced.
Make tendering for public-sector contracts more competitive, particularly in local and regional government.	A general amendment of the Public Procurement Act has been in force since January 2006. The amendment aims at correspondence with the relating EU directives through improved transparency and control of public expenditures.
Seek solutions to excessively fragmented public-service provision structures at the municipal level, for example through encouraging more voluntary co-operation or through shifting responsibilities to regional or central level.	Positive incentives for joint provision among municipalities are being strengthened and access to special deficit funds can be denied for municipalities that fail to embark on sufficient joint provision.

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Past recommendations	Actions taken and current assessment
Pensions	
Increase the effective age of retirement by reforming early retirement and by de-emphasising the standard age of retirement.	Previous reforms mean there are ongoing increases in women's retirement age and tighter eligibility criteria for getting early retirement are scheduled to take place in 2009. In addition, legislation made in 2006 has brought some immediate measures and further tightening in 2013. However, further reform should be considered to remove the "advanced retirement pension". Reform of the old-age pension system remains at the planning stage.
Healthcare (in-depth review in the 2005 Survey)	
Reforms need to focus on: Increasing the efficiency of hospital care, – preventing uneconomic hospitalisation and – cutting back on drug prescriptions.	Good progress is being made in cutting hospital beds and cutting back on subsidies for pharmaceuticals as part of the government's fiscal programme.
LABOUR MARKET	
Taxes and benefit	
Continue efforts to reduce the tax wedge on labour.	Efforts to reduce the deficit have resulted in some planned tax-wedge cuts being put on hold. Indeed, some elements of the tax wedge have been increased.
In disability benefit, tighten the assessment criteria and make assessment take into account the type of work performed and remaining work capacity.	A new set of guidelines has been distributed which are aimed as a first step towards a system that takes more account of remaining abilities and encourages rehabilitation to the workforce. Otherwise, progress has been slow. It is planned for legislation to be passed in the second half of 2007.
Monitor the new unemployment benefit system that includes the Job Search Allowance.	Assessment of the Allowance and other aspects of unemployment benefit have led to welcome reform towards a more "front loaded" benefit schedule and a more appropriate role for the Allowance.
Wage formation	
Keep increases in the minimum wage low.	Increases in the national minimum wage are modest in 2007 and 2008, while large increases are underway through the "guaranteed minima" introduced in 2006.
Avoid a "stop-go" cycle to public sector pay.	Year-by-year negotiation continues and the government's fiscal consolidation programme is perpetuating the cycle with a new freeze.
THE BUSINESS ENVIRONMENT	
Reform both the turnover-based local business tax and the non-residential property tax – both have inappropriate bases and add unpopular complexity to Hungary's tax system.	Legislation that would remove the local business tax has been repealed as part of fiscal consolidation. Reform of property taxation is under discussion.
Assess the efficiency of the programmes that increase access to finance for SMEs with a view to elimination or reform.	A cut back in the number of schemes has been made (from about 40 to 30) in an effort to cut back duplication in the system.
THE BUSINESS ENVIRONMENT: INNOVATION POLICY (IN-DEPTH REVIEW IN THE 2005 SURVEY)	
Following the reform of targeted financial support a period of assessment and fine-tuning is needed. The cost effectiveness of the Innovation Fund and the increased R&D tax allowances should be closely monitored.	No significant monitoring exercise has yet been conducted.
The Hungarian Academy of Science in particular needs further encouragement to reform through changes to regulation and financing.	No significant action.
COMPETITION (IN-DEPTH REVIEW IN 2004 SURVEY)	
Competition legislation and enforcement	
Introduce the right of individuals to enforce Hungarian competition law before the courts.	This was enacted in 2005 as part of amendment to legislation on unfair and restrictive market practices.
Increase the power of competition law in deterring hard-core cartels.	Several steps were taken in 2005 including stronger investigative powers and reinforcement of the Competition Authority's cartel unit.
Make procedural reforms in competition law to accelerate decision making (particularly in merger cases) and to allow more flexibility (particularly in cartel investigations).	A distinction between "simplified" and "full procedure" treatment of merger cases has been made that should help speed up many merger cases.

Past recommendations	Actions taken and current assessment
Network industries	
Increase the strength and efficiency of the industry regulators. In particular: 1) insulate regulators' decisions on pricing from political and budgetary interference, 2) make decisions based more on market information than technical regulation, and 3) reduce the role of the government in setting network access charges.	Modification of legislation in 2005 increased the Hungarian Energy Office's powers and independence as regards the electricity market. Proposals for further legislative changes currently before parliament will also increase the Office's powers.
Phase out price-setting for gas and electricity.	Phase out continues according to a schedule worked out with the European Commission for market-based pricing in both household and business markets by mid-2007. There has also been scaling back of subsidies to household gas prices in 2007.
Continue to reduce the size of government shareholdings.	The government sold its remaining shareholding in the previously fully state owned energy company MOL.
Electricity. Deepen markets by dismantling long-term contracts and increase connection to the international grid.	A government decree in 2002 obliges renegotiation of existing contracts but the parties concerned have yet to complete any re-negotiation. The parties argue that legal obligations for "security of supply" obstruct renegotiation. Though the market is deepening over time, the Competition Authority thinks that a new market model may be needed to deal more effectively with the problem of long-term purchasing agreements.
Telecoms. Reduce the power of the incumbent, particularly in fixed-line services, through better enforcement of rules on carrier selection, price squeezes and interconnection fees.	A new Act on Electronic Communication was introduced in 2004 that aims to intensify competition between services providers and in 2005 the Competition Authority imposed new obligations on some market players.
Rail services. Make further progress in privatisation and liberalisation.	Several new railway companies have been granted licences since the opening of freight traffic to competition in 2004 and from mid-2005 four companies have been operating.
Postal services. Make further progress in dealing with over-staffing and non-viable rural post offices.	Re-structuring is underway, though progress is rather slow. Privatisation of the incumbent is not planned by the present government and full liberalisation is not scheduled to begin until 2009.
Other industries and sectors	
Retailing. Abandon minimum prices for certain foods.	No action, indeed the present administration says it has no intention of removing them.
Professional services. Reduce entry restrictions and price setting behaviour.	The Competition Authority is conducting bilateral discussions with professional bodies as well as legal proceedings to remove restrictive rules.
ENVIRONMENT ISSUES (IN-DEPTH REVEW IN 2004 SURVEY)	
Take greater account of the price of emissions permits when deciding on methods of reducing greenhouse-gas emission (particularly renewable energy) are economic.	There has been no significant change in the strategy for reducing greenhouse-gas emissions.
Use more economic instruments to contain air pollution emission.	Several measures in environmental taxation were introduced in 2005, including a change in the annual car tax to reflect emission levels. Furthermore, an environmental load charge has been introduced for some air pollutants.

ANNEX 1.A2

Regression analysis of the fiscal spending cycle

A simple regression exercise confirms the presence of an electoral spending cycle. Based on a monthly time-series model by De Mello and Moccero (2006) the following model was used:

$$\log\left(\frac{SPE_i}{SPE_i^{HP}}\right) = a_0 + D_0 + \sum_{j=1}^{1} a_{1j} Dum_j + \sum_{j=1}^{2} a_{2j} \log\left(\frac{SPE_i}{SPE_i^{HP}}\right)_{t-j} + \sum_{j=0}^{2} a_{4j} \log\left(\frac{IPI}{IPI^{HP}}\right)_{t-j}$$

where:

SPE = Cash current spending of central government institutions (the superscript HP indicating approximation to trend using a H-P filter);

Dum = Seasonal dummy;

IPI = Industrial production index (again the superscript HP indicating trended values);

D = Vector of dummy variables that take the value of 1 in the six month period before general elections (these were 1998, 2002 and 2006) and 0 otherwise.

The results are shown in the table below. The coefficient on the electoral dummy variable (D) implies that, controlling for autoregressive processes and spending related to the business cycle, the gap between actual and trend spending widens by 7% in the six months prior elections. This exercise of course does not capture electoral spending prior to the six months before an election. Nor does it capture spending promises that result in increased spending after elections or vote buying *via* tax reductions.

	Coefficient[1]
Sum of lagged values of log $\left(\frac{SPE}{SPE^{HP}}\right)$	0.24
Sum of contemporaneous and lagged values of $\left(\frac{IPI}{IPI^{HP}}\right)$	–0.73
Dummy variable for six month preceding each election (D)	0.07
R-squared	0.76
F-stat.	22.47

1. All variables statistically significant at the 10% level. Seasonal dummies are included in the regression but not reported. The sample period is 1996:1 to 2006:8.

ANNEX 1.A3

Demand, output and prices: OECD projections to 2008

	2003	2004	2005	2006	2007	2008
	Current prices HUF billion	Percentage changes, volume (2000 prices)				
Private consumption	10 513.6	3.1	3.9	1.6	–0.2	1.2
Government consumption	4 402.9	1.9	1.9	–2.6	–1.5	–2.8
Gross fixed capital formation	4 156.0	7.7	5.6	–1.8	1.0	4.1
Final domestic demand	19 072.5	3.8	3.8	–0.1	–0.2	1.0
Stockbuilding[1]	601.3	0.5	–2.4	0.7	0.1	0.0
Total domestic demand	19 673.7	4.2	1.0	1.0	0.0	1.0
Exports of goods and services	11 496.6	15.7	11.6	18.0	13.1	10.9
Imports of goods and services	12 234.7	14.1	6.8	12.6	8.3	8.7
Net exports[1]	–738.1	0.5	2.8	3.4	3.8	2.1
GDP at market prices	18 935.7	4.9	4.2	3.9	2.5	3.1
GDP deflator	. .	4.3	2.0	2.9	6.4	3.4
Memorandum items						
Consumer price index	. .	6.7	3.6	3.9	7.2	3.7
Private consumption deflator	. .	4.5	3.6	3.2	5.9	3.7
Unemployment rate	. .	6.2	7.3	7.5	7.6	7.5
General government financial balance[2]	. .	–6.4	–7.8	–9.2	–6.7	–4.8
Current account balance[2]	. .	–8.4	–6.9	–5.8	–3.6	–2.2

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see OECD Economic Outlook Sources and Methods, *(http://www.oecd.org/eco/sources-and-methods)*.

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.

Source: OECD Economic Outlook 81 database.

ANNEX 1.A4

EU transfers under the 2007-2013 EU budget period

The budget allocations

Hungary's allocation from the 2007-2013 Financial Framework of the European Union is equivalent to about 2½ times the average yearly amount available in the years 2004-2006. The total available amount over the budget period will be € 33 billion (2004 prices), which would require around € 5 billion of statutory domestic co-financing.* Altogether, this implies an annual allocation equivalent to 4.8% of GDP per year and the net financial inflow to the economy could be equivalent to about 4% of GDP (see table below). Complexities in the timing of allocations and contributions and other issues mean that the net financial flow will vary over time and differ between cash and accrual accounting.

Cohesion and Structural Fund support accounts for the largest share of Hungary's allocation (close to € 22.4 billion). Allocation of the support is based on the New Hungary Development Plan and consists of seven Thematic Programmes, seven Regional Programmes and a supplementary Technical Assistance Operational Programme. Unlike the previous system, the Cohesion Fund is now integrated into the Development plan along with plans for Structural Funds. But, as before, the Cohesion Fund can only be allocated to transport and environment while the Structural Fund can be allocated to any of the Operational Programmes.

Under the Common Agricultural Policy, Hungary is entitled to € 9.6 billion of which close to € 3.4 billion is allocated under the Rural Development Programme by the government and requires co-financing. The remainder is divided between agricultural market-related expenditures (notably intervention prices) and direct payments under a system agreed in 2002 by the European Council. Direct support to producers will be around € 5.5 billion in the whole budget period.

The system for making allocation decisions and administering funds has become more centralised. The Structural Fund Managing Authorities that were previously operated by line Ministries have been put under the authority of the National Development Agency (the NFÜ – the successor of National Development Office, the NFH). There has also been some restructuring in intermediate bodies in order to improve their effectiveness. Paying functions have remained under the scope of National Authorising Office (NAO) in the case of cohesion support and under the Agricultural and Rural Development Office (MVH) for CAP subsidies.

* All of the figures for EU budget allocation quoted in this annex are in 2004 prices. These are the most commonly used reference in these accounts. See the footnotes to the table below for details on the deflator used.

Table 1.A4.1. **Budgetary transfers between Hungary and the European Union, 2007-2013 – Commitment Appropriations**

€ millions, at 2004 prices

	2007	2008	2009	2010	2011	2012	2013	2007-2013
	Budget items							
Transfers under Cohesion Policy	2 860.8	2 983.4	3 113.6	3 219.4	3 294.4	3 405.9	3 517.8	22 395.3
Structural Funds	*2 474.8*	*2 174.7*	*1 842.5*	*1 680.4*	*1 714.1*	*1 772.2*	*1 830.4*	*13 489.1*
Cohesion Fund	*386.0*	*808.7*	*1 271.1*	*1 539.0*	*1 580.3*	*1 633.7*	*1 687.4*	*8 906.2*
Rural Development	537.9	496.6	451.6	452.2	476.7	480.8	484.2	3 380.0
Others (*e.g.* fisheries, environment protection, etc.)	40.4	42.6	20.6	21.2	23.8	26.1	27.9	202.6
	Items out of budget							
Transfers under the title of Competitiveness for Growth and Employment	125.1	134.3	144.2	154.7	166.1	178.4	191.5	1 094.2
Agricultural market measures	133.3	119.9	113.9	106.8	101.3	94.4	87.9	757.5
Direct payments to agricultural producers	479.0	586.5	689.8	788.7	883.5	974.3	1 061.2	5 463.0
Total EU support	4 176.4	4 363.4	4 533.7	4 743.1	4 945.8	5 159.9	5 370.4	33 292.6
As a % of GDP[2]	4.7	4.8	4.8	4.8	4.8	4.9	4.9	37.7
Contribution to the EU budget[1]	747.3	789.9	746.0	791.0	774.5	809.1	805.9	5 463.6
As a % of GDP[2]	0.8	0.9	0.8	0.8	0.8	0.8	0.7	6.2

1. Calculation made by the experts of Ministry of Finance.
2. The GDP ratio is calculated on the basis of OECD estimates for nominal GDP. To help comparability, a fixed deflator of 2% a year was used to adjust support and contribution values, in accordance with the Inter institutional Agreement between European Parliament, the Council and the Commission. For the whole 2007-2013 period the aggregated and adjusted amounts are compared to the provisional nominal GDP of 2007. Calculations are made with a technical value of 271.0 HUF/EUR exchange rate in accordance with the Convergence Programme of Hungary, December 2006.

Source: Ministry of Finance.

Factors affecting absorption capacity

Some important alterations to financing regulations mean accessing funds in the 2007-2013 budget will be easier:

- The compulsory national contribution to both the Cohesion and Structural Fund supports has been decreased to 15% (from 20% and 25% respectively) and non-reimbursable VAT will count as eligible expenditure. In total these changes are estimated to decrease the burden on the national budget by around € 3.5 billion over the whole budget period. But the reduced co-financing requirements implies increased per-project EU financing and therefore fewer funded projects can be run from the same total of EU finances.
- The "n+2" rule has been replaced by an n+3 rule for the period of 2007-2010 which will help absorption capacity. The "n+2" rule says that the accumulation of amounts included in the payment request for the EU commitment of a given year (year "n") must be issued no later than the end of the second subsequent year. The difference between the commitment of year n and the amount requested for payment from the Commission will be "decommitted". The rule does not limit the length of individual projects but does present a challenge for the managing authorities in scheduling EU-funded projects.
- The European Union, in principle, directs more funds to poorer regions (the cut-off criteria is 75% of GDP per capita on a purchasing-power basis). Six of the seven NUTS II Regions are below the cut-off while Central Hungary (which includes Budapest) is above. However, the mechanism for directing funds has been partially overridden by side

agreements between EU Member States. This has resulted in Central Hungary having greater access to Funds.

At the same time "additionality" is being more stringently applied and a financial penalty has been introduced. In order to limit the subsidy of fiscal balances with EU-funding, the provisions on Structural Funds have clauses requiring them to be additional to national structural expenditures. Specifically, structural spending over the period 2004-2005 will be used to benchmark assessment of additionality for 2007-2013. There has been some debate on this issue. In particular, the Hungarian authorities have argued that the government's structural spending over this benchmark period comprised unaffordable commitments and is therefore not a reasonable point of comparison.

Pre-financing for the Structural and Cohesion Funds is helped considerably by the system of advanced payments from the EU. The advanced payments available in 2007 will be 4.5% of the total allocation for Structural and Cohesion Funds for 2007-2013 and will be 17.5% available from 2009 onwards. These funds mean that problems in the timing of transfers from the EU for projects are unlikely. However, there is no system of advanced payment for agricultural market measures and direct payments to agricultural producers. For some areas this is not a problem because the gap between payment and receipt of money from the EU is short (typically around 2 months). But the gap for intervention pricing in agricultural support can be several years and this is estimated to have increased state debt by 1 percentage point of GDP in 2006. Furthermore, the interest costs of pre-financing is only partly refunded by the EU.

Assessing the impact of EU transfers on government budgets

A key distinction in the EU financing system is whether funds pass through central-government accounts or not:

- All the funds that pass through the central-government budget are subject to obligatory co-financing and allocation decisions are made by the government. The Structural and Cohesion Funds are treated this way as well as funds for the Rural Development Programme.
- Funds that do not pass through the central-government budget are not co-financed and are distributed directly either on a formula basis or at the discretion of the European Commission; the national authorities play only an administrative role. Agricultural market measures and direct payments, as well as transfers under the title of Competitiveness for Growth and Employment, fall into this category. This being said, the funds can emerge in government accounts; if the beneficiary of an out-of-budget EU transfer is a budgetary institution the transfer is included in its budget and the item will appear in general-government accounts.

For a given activity, assessing the total amount of EU support, the role of national subsidies and the budgetary implications can be complex. For example in agricultural support:

- EU financed direct payments of agricultural producers are off-budget, but nationally funded voluntary "top-up payments" are in-budget.
- The off-budget agricultural subsidies have to be pre-financed by the national authorities. Neither the subsidies nor the pre-financing of them are shown in the budget (they are treated as financial operations) but the interest costs of pre-financing are in-budget.

- Most of the agricultural market measures are out-of-budget items, while those supplemented by national co-financing are presented inside the budget.

Ongoing efforts are being made to help transparency on this front through supplementary information to the annual budget submitted to the Parliament.

Budgetary compensation paid by EU ceased to exist in 2006 and since then all of the budgeted EU support appears on both the revenue and expenditure side. The co-financing and the contribution to the EU budget increase budgetary spending roughly in equal measure (however, it is possible that some resources spent on co-financing would anyway fund similar projects even without EU contributions, in these instances, therefore, co-financing does not imply supplemental budgetary spending). Experts at the Ministry of Finance do not see co-financing as an insurmountable problem. For instance, co-financing needs are estimated to represent only 20-30% of spending on development and similar projects (*i.e.* chapter-managed appropriations). However, uncertainty in the annual amount of Funds that will be accessed in a given budget year generates uncertainty in co-financing needs. For instance, if access to Funds is 10% higher than estimated for a given budget year, then co-financing will worsen the budget deficit by about 0.1% of GDP.

Estimates of the overall budgetary impact of EU-related financial flows are wide ranging. Hallet and Keereman (2005) for example calculate the impact of EU transfers to Hungary over 2004 to 2006 as slightly positive for Hungary while Rosenberg and Sierhej (forthcoming) estimate a fiscal drag of about 0.5 percentage points of GDP. According to the calculations and methodology of the Hungarian Ministry of Finance the direct impact of EU financial flows between 2007 and 2013 on the Hungarian budget is neutral (taking out of consideration the contribution to the EU budget), while indirect impacts are positive (through higher GDP growth rate, etc.).

ANNEX 1.A5

Further information on labour market reforms

The new unemployment benefit system

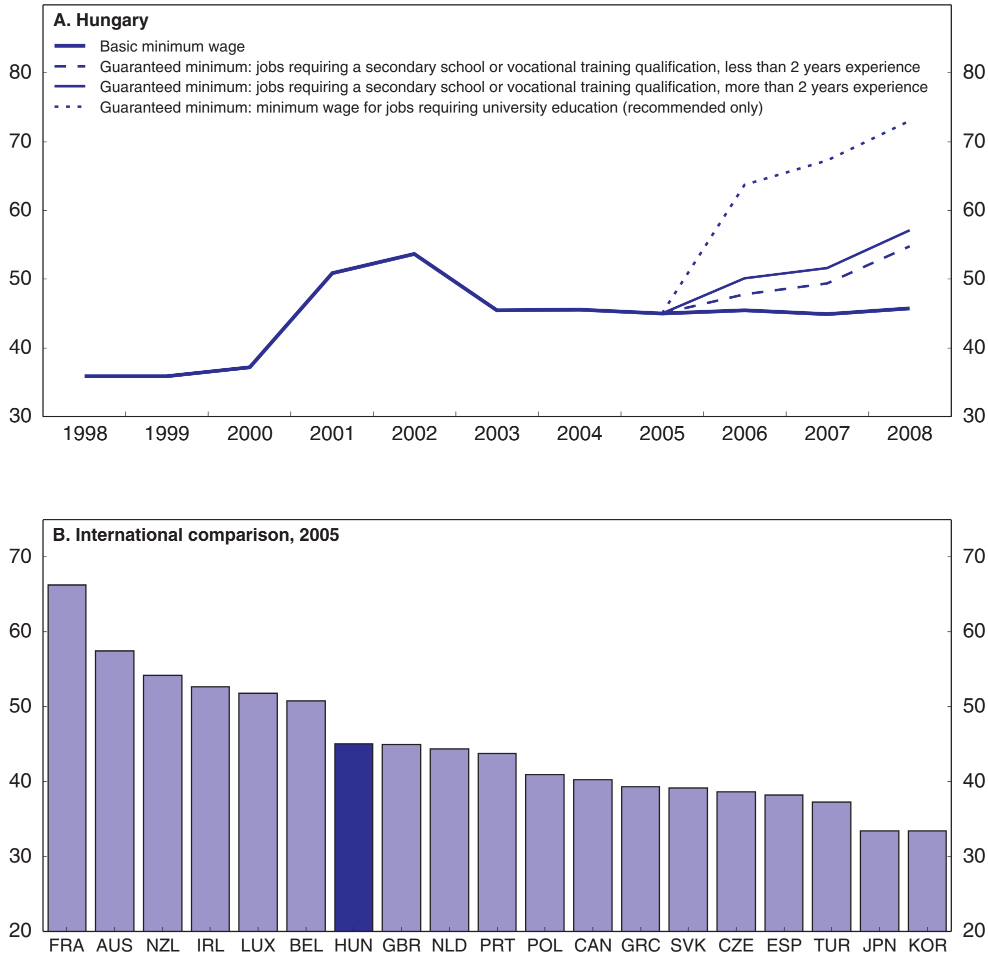
	Before November 2005	After November 2005
Standard unemployment insurance benefit (*Álláskeresési Járadék* or "jobseekers benefit")	**Eligibility.** At least 200 days insurance in the previous four years before becoming unemployed.	**Eligibility.** As before except required insurance days increased to 365 days.
	Duration. 1 day of benefit for every 5 days insurance with a limit of nine months. By implication the shortest duration was 200/5=40 days.	**Duration.** As before except by implication the shortest duration is now 365/5=73 days.
	Payout. 65% of previous earnings (ceiling 180% of the minimum old-age pension), throughout the benefit period.	**Payout.** 60% of the benefit base (generally the previous earnings) for half of the recipient's eligible duration (with a maximum of 91 days). Following this, the payout is 60% per cent of the mandatory minimum wage prevailing on the first day of eligibility for the benefit. If the claimant gets a job within the insurance period they choose between a lump sum equal to half the remaining benefit and keeping their remaining insurance days.
Second-tier scheme (*Álláskeresési Segély* or "reactivation allowance")	**Eligiblity.** Only after at least 180 days insurance benefit.	**Eligibility.** Either have at least 200 days insurance or exhaustion of UI benefit.
	Duration and payout. 180 days payout at a flat rate of 85% of the minimum old-age pension. Lump-sum payment of half the remaining benefit if the claimant gets a job (the original Job Search Allowance).	**Duration and payout.** 90 days payout at a flat rate of 40% of the minimum wage. Payouts are extended by three months for those over 50. Also, those who are no more than five years from retirement age can get the benefit until retirement.

The relationship between the new system of wage minima and the median wage

The 2005 agreement set rates for the minimum wage for the period 2006 to 2008 and introduced the guaranteed minima, with rates for these set in relation to the minimum wage. The figure below expresses these minima as a percentage of the median wage. Calculation in relation to the *average* wage (a comparison often used by the Hungarian authorities) lowers these ratios. For instance, according to OECD calculations by 2008 the minima as a percentage of the average wage would be 39% for the minimum wage, 46 and 48% for the jobs requiring secondary school or vocational training and 62% for jobs requiring tertiary education. Because the relationship between the median and average wage is relatively constant over time, the equivalent figure expressed in average wages has a similar shape to that shown below.

Figure 1.A5.1. **The ratio of minimum to median wages**

Per cent



Source: Magyar Nemzeti Bank (MNB); OECD, Earnings Database and OECD estimates for 2007-2008.

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Chapter 2

Assessing the government's strategy for fiscal consolidation

This chapter takes an in-depth look at the Hungarian government's consolidation programme. The plan is ambitious, the deficit was over 9% of GDP in 2006 and the aim is for a deficit below 3% in 2010. The various new measures to tighten fiscal discipline in budget processes are examined and suggestions for further changes are made. Revenue-raising measures have been necessary for the initial phase of consolidation but in the longer term there is a need to get back on track with reducing tax burdens on businesses and households. The spending freezes are proving difficult to maintain but reasonable progress is being made on the wide range of structural reforms, though further reforms need to be considered.

The government's consolidation programme involves a series of fiscal measures with immediate impact on the budget deficit (many of them intended to be temporary) and a simultaneous process of widespread structural reform to cut public spending. This chapter assesses the key measures with a view to helping progress towards a full completion of the government's consolidation strategy. The assessment begins with an analysis of immediate spending measures and new initiatives to strengthen budget discipline. This is followed by sections on the key areas of structural reform, namely, public administration, healthcare, education, early retirement and pensions, and finally transport. The policy recommendations are summarised in Box 2.1.

Box 2.1. **Policy recommendations concerning strategy for fiscal consolidation**

The new measures to tighten fiscal discipline

The new rule requiring a primary-balance surplus is useful but should be augmented by safeguards against misuse of revenue and expenditure windfalls. Other mechanisms to strengthen longer-term fiscal commitment should also be considered. As previous *Surveys* have suggested, a system of binding medium-term spending limits may be one way forward.

Immediate spending measures

An agreement to a re-scheduling in the payment of the 13th month salary was concluded in February 2007. Any further pressures to spend anticipated "windfalls" need to be strongly resisted and some form of ring-fencing round unexpected gains should be made. For example, if the deficit is on track to being below target then funds should be used for deficit and debt reduction.

The freeze on public-sector pay is anyway perpetuating a stop-go cycle in public sector pay that has damaged morale and recruitment. In the longer term, the cycle should be stopped, for example through the multi-year agreements.

Public administration reforms

There are plans for a more flexible system of pay for civil servants with a stronger element of performance evaluation. Currently, the basic wage is augmented by various mandatory additional payments – the 13th month salary, payments for language proficiency, a "clothing bonus", and so on. These components should be de-restricted so as to allow managers to reward their employees more freely according to performance.

The further diffusion of e-government is also important for public administration reform. However, the existing regulatory framework needs to be closely monitored if e-government is to be introduced both swiftly and effectively.

Healthcare reforms

The implementation of the new regional hospital network needs to be supported by measures to strengthen the gate-keeping function of general practitioners.

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Box 2.1. **Policy recommendations concerning strategy for fiscal consolidation** *(cont.)*

The financial responsibilities of the National Health Insurance Fund Administration (NHIFA) could be better defined in ensuring good decisions in choices between hospitalisation and outpatient treatment.

Hospital managers should be given greater responsibilities for deficits and debts. Such a move would also help hospitals adjust their workforce to suit requirements.

Education

The connection between fees and examination results should be reduced. The majority of students should pay back a large share of the tuition costs but with safety nets to prevent exclusion. A system where fees are more uniformly applied that builds on the existing system of government loans ought to be considered.

Early retirement and pensions

The scheduled changes to early retirement schemes are welcome. But, as recommended in the previous *Survey*, the "advanced early retirement pension" ought to be eventually removed altogether because there is no reduction in the annual pension payout, while the "reduced advanced early retirement pension" should be checked for actuarial fairness.

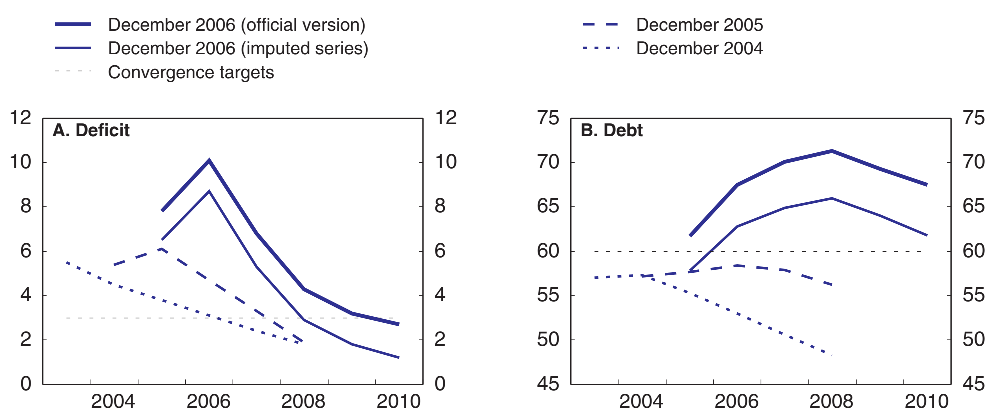
The proposals for reform to the old-age pension system currently being developed should include increases in the statutory retirement age beyond 62 years.

Overview of the government's strategy

The speed of the government's planned fiscal adjustment is impressive, with the plan envisaging to cut the general government deficit by some 5 percentage points of GDP between 2007 and 2008, and another 1½ points over the following two years (Figure 2.1). The projected improvement of the primary balance over the period is of roughly the same magnitude. All in all, this effort is expected to bring the level of the deficit down to 2.7% of

Figure 2.1. **Deficit and debt objectives under successive Convergence Programmes**[1]

% of GDP



1. Figures show the ESA general government deficits and debts outlined in the Convergence Programmes. The official series in the Programmes for 2004 and 2005 included contributions to second-pillar pensions in revenues. This practice was abandoned in 2006; the imputed series enable comparison with the previous series.

Source: Convergence Programme of Hungary (various issues).

GDP by 2010 and to result in a primary balance surplus. The level of the general government debt is set to start falling towards the 60% benchmark used in the EU's convergence assessments in 2009.

With the immediate steps of the programme in place (Table 2.1), the government's priority is now on structural reforms. These are mainly aimed at improving spending efficiency but some also aim to improve the tax base by narrowing the grey economy (see Box 2.2). There are two interrelated challenges:

- *Adequate delivery on structural reform*. Many measures require legislation that has yet to be passed by Parliament and, even when this is successful, structural reform is often inherently slow to implement and the speed with which efficiency gains are realised is uncertain. Furthermore, some areas of reform are likely to meet considerable political opposition.[1]
- *Ensuring temporary measures expire*. Spending freezes account for a large share of the budgetary savings; unless they are backed by structural reform measures, the longer these are sustained, the greater the build up of future spending pressure. Some other measures should also be reconsidered if the competitiveness of Hungary's export sectors is to be sustained, although there are no immediate plans to lower the overall tax burden. Negative surprises in fiscal outcomes and poor progress in structural reform would likely mean such temporary steps end up as permanent.

Table 2.1. **The initial measures of the government's consolidation programme**[1]

% of GDP

	2006	2007	2008
A. Increase in revenues			
Value added tax	0.2	0.6	0.6
Personal income tax (including special solidarity tax)	0.1	0.4	0.4
Taxes on business	0.3	1.1	2.7
Social security contributions	0.3	2.3	2.0
Other taxes	0.3	0.2	0.1
Total revenue gains	1.2	4.5	5.8
Of which:			
Withdrawal of planned tax cuts	0.1	1.2	2.7
Active revenue gains	1.2	3.3	3.1
B. Reduction in expenditure			
Permanent measures			
Employment cuts	0.0	0.2	0.4
Severance payments	0.0	–0.2	–0.1
Health care reform and cuts in drug subsidies	0.3	0.7	0.8
Cuts in energy and transport subsidies	0.1	0.5	0.6
Other permanent spending cuts	0.0	0.1	0.2
Temporary measures			
Public sector wage freezes	0.0	0.2	0.4
Temporary cuts in operational expenditures	0.2	0.2	0.1
Nominal freezes of specific non-wage items	0.0	0.5	0.4
Other temporary measures	0.3	0.0	0.0
Total spending cuts	0.8	2.1	2.8
Total fiscal adjustment	2.0	6.6	8.6

1. Fiscal adjustment measures relative to a path assuming no policy change.
Source: OECD calculations based on figures provided by the Ministry of Finance.

Box 2.2. **Estimates of the grey economy and recent measures to combat it**

Recent Hungarian research estimates that the hidden (or "grey") economy currently accounts for close to 20% of GDP but is probably trending downwards (in 1993 the hidden economy was perhaps one third of GDP).* Hidden activities are thought to most commonly take the form of unregistered employment, un-invoiced services and underreporting of wages.

The government is intensifying its campaign against these types of activities. The measures focus on reducing the underreporting of wages which typically takes the form of declared wages being topped up by cash payments and in-kind benefits. Some of the measures planned are straightforward, in particular:

- More checks on individuals whose wealth or lifestyle appears inconsistent with their personal income tax declarations.
- Introduction of a "double minimum wage rule" whereby by default the employer is required to pay contributions on the double minimum wage, unless it is proved that the employee actually gets less than the amount of the minimum wage.
- Increase in the number of labour inspectors allocated to checking salary arrangements.

Other measures are more indirect. A system of "guaranteed wage minima" based on educational and vocational qualification for the job has been introduced that is to some extent forcing a "whitening" of employment (see Chapter 1). Also, in healthcare reform, it is hoped the proposed tiered coverage based on social-security contributions will have a similar effect.

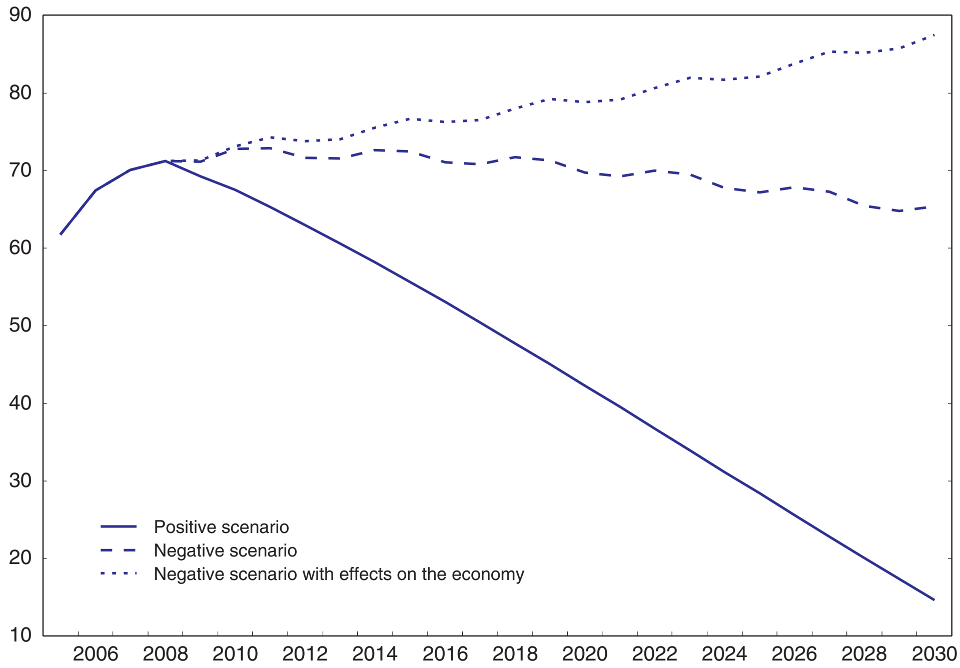
* Lackó (2000) and Tóth (2006).

The long-run gains of reaching the goals of the consolidation programme and the consequences of alternative scenarios involving continued strong electoral cycles in deficits can be seen in simulations of public sector debt developments. Figure 2.2 shows simulations up to 2030 for the following scenarios (see Annex 2.A1):

- *Positive scenario*. This assumes that the objectives of the consolidation programme for the period 2007-10 are fully met. Thereafter, stable public sector revenue and spending levels (as a percentage of GDP) are assumed, as well as a stable annual rate of real GDP growth (4.3%, *i.e.* somewhat above recent trend growth). The results show that, after peaking at 71% of GDP in 2008, public debt would decline rapidly and be below the Maastricht debt qualifying criterion as early as 2014. It would then decline further, reaching 15% by 2030.
- *Negative scenario*. This assumes objectives of the consolidation programme are met for 2007 and 2008. However, in the following two years (up to the 2010 election), total public revenues as a percentage of GDP are assumed to decline, while primary spending (*i.e.* total spending once having deducted interest payments) increases. This fiscal expansion is followed by another temporary episode of budgetary consolidation and a new electoral boost, with the same stop-go policies continuing over the remainder of the scenario. In the process public debt declines only gradually so that it would still approximate 70% of GDP by the early 2020s, coming in at around 65% by 2030.
- *Negative scenario with adverse effects to the economy*. The "negative scenario" does not factor in possible adverse effects of government deficit and debt developments on the rest of the economy. These are potentially important since a stop-go fiscal policy would likely lower growth potential and increase the interest-rate risk premium. Factoring in

Figure 2.2. **Debt dynamics under different policy assumptions**

General government debt as % of GDP



Source: OECD calculations based on *Convergence Programme of Hungary*, December 2006.

plausible values for these effects implies debt would be on a permanently upward trend, reaching nearly 90% of GDP by 2030.

These are mechanical scenarios. Importantly, they omit to take into account the fiscal effects of ageing related developments. If these were included, additional impacts would materialise around 2015 (Chapter 1). This underscores the importance of staying within the positive scenario if the benefits of fiscal consolidation are to be fully achieved.

The new measures to tighten fiscal discipline

The most important immediate initiative has been strengthening the system of reserve funds for 2007. The budget for this year is backed up by a system of reserves worth nearly 1% of GDP. Roughly half of these reserves are set aside to meet unforeseen expenditures and to fund the costs of staff layoffs, while the other half is envisaged as a contingency reserve to assure compliance with the deficit target. Under the budget, line ministries are authorised to use 60% of the latter contingency reserves only if spending and revenues develop according to initial objectives. To help monitoring, ministries have to submit quarterly reports of spending and revenue developments.

Most of the mechanisms brought in to help budget discipline in previous years have been maintained and many have been tightened:

- Rules restricting line ministries from running down stocks of unspent appropriations remain in place for 2007. Unspent appropriations may only be used with the authorisation of the government.

- The Ministry of Finance has successfully pressured line ministries to provide more details in the medium-term spending plans (three years beyond the budget year) that must be contained in annual budget submissions. But, as before, there is no formal commitment to stick to these plans.
- Rules on state guarantees have been tightened. Expenditures that qualify for a guarantee have been more precisely defined and a ceiling has been imposed on the total value of guarantees (HUF 150 billion for 2007, equal to 0.7% of GDP). Moreover, any new state guarantee has become conditional upon Parliamentary approval. The central government can only take over debt-creating transactions that have been explicitly authorised in the annual budget.
- Budgeting rules for infrastructure spending (notably public-private partnership projects) have also been tightened. The budgetary cost of these commitments cannot exceed 3% of total central budgetary revenues in a given year. Also, requirements for formal government approval of projects have been increased. A central inventory system managed by the Treasury has been created to keep track of spending in this area.

In addition, a requirement that the annual budget bill shows a primary surplus for the forthcoming budget year has been introduced via legislation passed at the end of 2006. In the 2007 budget submission the government has reported targets for the primary balance for 2008-2010. This rule is aimed at increasing discipline in reaching deficit goals but will also help towards debt reduction.

These recent efforts to tighten budget discipline are welcome but whether they will make a real difference to fiscal discipline remains to be seen (previous measures have led to no obvious improvement). *Ex ante*, there appear to be some potential difficulties that ought to be addressed in further development of budgetary mechanisms:

- The effectiveness of the reserve system is somewhat undermined by the fact that the government can allocate the reserves available even in cases in which budgetary outcomes are better than expected.
- It is reasonable for the rules on carryover spending to be renewed each year, but they should be adjusted as needed to prevent excessive build-up of unspent appropriations.
- The commitment to a primary surplus is useful. However, the primary surplus rule should be augmented by conditions to safeguard against misuse of revenue and expenditure windfalls. Other mechanisms to strengthen longer-term fiscal commitment should be considered as well. As previous *Surveys* have suggested, a system of binding medium-term spending limits may be one way forward.

Revenue measures: many should eventually be reversed

Key elements in the expected revenue gains are changes in healthcare contributions for employees, increased income taxes for both households and business and the rise in the middle value added tax rate (Table 2.1).[2] Further to these active tax measures, revenue "gains" are being made by the suspension of a five-year strategy to cut taxes that was originally approved by the parliament at the end of 2005. The most notable example is the suspension of the decision to abolish the local business tax, a step initially scheduled to take effect in 2008.[3] All in all, revenue-raising measures make for a considerable proportion of fiscal improvement in 2007 and 2008. Indeed, these account for about 70% of the overall fiscal consolidation package in both years. Excluding the impact of the withdrawal of previously announced tax measures, the split between revenue-raising measures and spending cuts is more even for 2007, while for 2008 spending cuts play a dominant role.

Reducing the tax burden, particularly the tax wedge on labour, needs to be an important part of the long-term fiscal strategy, so as to improve growth prospects. Progress on this front has clearly been reversed by the revenue-raising measures and ought to be resumed as soon as fiscal room is available. Much of this depends of course on progress in generating savings from structural reforms to public spending. The risk is that even those measures that are labelled as temporary might become permanent features of the tax system.

Immediate spending measures: wage freezes are difficult to maintain

Expenditure cuts for 2007 and 2008 reflect a mix of temporary and permanent measures. The largest temporary measure in terms of fiscal savings is a two-year freeze on pay increases for all public sector employees and various cuts in operating costs. The largest immediate spending cuts from permanent measures are coming from reduced pharmaceutical subsidies, cut-backs in hospital beds, both of which are part of wider structural reforms to the healthcare system (see below), and a large reduction in spending on household gas-price subsidies. Other spending measures include reduced transport subsidies and cuts in government employment.

The reduction in gas-price subsidies is particularly welcome. As of January 2007, the system of subsidies based purely on consumption was replaced by a scheme that takes into account household income. Only households with a per capita income below a certain threshold are allowed to apply for the subsidy.[4] For those that are eligible, the subsidy then varies according to per capita income. There are also ceilings to the amount of gas consumption receiving a subsidy. The new system is a positive step; it is less costly for the budget and better targets the subsidies to low income families. Subsidy reduction is also underway in public transport with a revision of the target groups eligible for discounted fares.

Cracks in the wage freeze have already emerged. The government has been aiming for a two-year unchanged level in public-sector pay. The core of this policy remains intact in the form of a freeze on the gross basic wage (on which all pay scales are based). However, in February 2007 the government agreed with the public sector trade unions to a complicated re-scheduling in the payment of 13th month salaries that brings spending forward. The 2007 payment was initially intended to be paid in one instalment in January 2008, whereas now half of it will be paid in monthly instalments during the second half of 2007. The new agreement also requires that the payment for 2008 is paid in monthly instalments during the course of the year (rather than in a single payment in January 2009). In addition, if budgetary developments evolve better than expected and contingent upon remaining within the target of the *Convergence Programme*, public-sector workers will receive an extra-half month salary during the first half of 2008. For 2009 and onwards the payment will be made in a single instalment in December of each year.

For 2007, the new agreement is estimated to increase the average gross earnings of public-sector employees by 3.5-4.0% in nominal terms.[5] While this will not alter the ESA budget deficit – in ESA95 accounting terms the 13th month salary payments due in January have to be accounted for in the preceding years – it will widen the gap between cash and accrual accounts.[6] In 2008, there is a chance of further increase, depending on fiscal

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outcomes. Furthermore, the agreement has arguably increased the risk of strong wage demands for 2009 because the reversion to a single instalment in 2009 will mean monthly pay checks below those of 2008 until December.

Any further pressures to spend anticipated "windfalls" need to be strongly resisted and some form of ring-fencing round unexpected gains ought to be made. For instance, if the deficit is on track to being below target then funds should be used to pay off debt. The freeze on public-sector pay is anyway perpetuating a stop-go cycle in public sector pay that has damaged morale and recruitment. In the longer term, the cycle should be stopped, for example through the multi-year agreements.

Assessment of the main structural reforms

Ambitious public administration reforms

Administrative reform began soon after the election with changes to legislation on pay and conditions for parliamentary members and local government representatives. These changes included stricter reimbursement and immunity rules. The same bill also altered regulations on the duties of senior public officials, specifically *via* new rules limiting the accumulation of responsibilities with a view to reducing conflicts of interest. But plans to cut the number of parliamentary members and local representatives did not go ahead (these changes would require a two-thirds parliamentary majority).

The government also began streamlining ministries shortly after the election. The number of ministries was reduced from 15 to 12 and the two ministerial posts without portfolio were axed. This rationalisation is expected to help towards reductions in ministerial staff. By the end of 2007, nearly 2000 posts are expected to be cut, with the largest downsizing in Economy and Transport (303 staff), Education (241 staff) and Agriculture and Rural Development (227 staff). There is plan to build a new government headquarters, which will reduce operational costs and open the possibility for the sale of the government's many city-centre properties.

There are plans for the centralisation of services in several areas. Operation and procurement tasks, including the purchase and maintenance of IT equipment, will be run by a newly created umbrella institution (the Central Service Directorate), rather than by each ministry independently. Similarly, the co-ordination of e-government services will be centralised. There will also be a single human resource office responsible for assisting ministries in staff policy. Furthermore, the State Treasury of the Ministry of Finance will take responsibility for the administration of all public employees' wages.

Networks of offices for various aspects of state administration are to be rationalised.[7] At present, there are over 800 offices in these networks and there are plans to re-organise them on a regional basis and reduce the number by about one third. It is also planned to reduce the number of state-owned non-budgetary organs (*e.g.* public foundations and service companies). Achieving these objectives will be assisted by the *New Hungary Development Plan* for the 2007-13 period, which includes funding the training of public employees, the renewal of recruitment procedures and improving work organisation methods.

The cut of some 15 000 staff in central budgetary institutions, corresponds to roughly 6% of total employment in this sector. Central-government is clearly attempting large cut-backs in areas where it has direct control over staffing and it is likely that there is similar room for economies among civil servants in local government and in administrative overheads in the public-sector services run by local government. This underscores the importance of widening the scope of public administration reforms to county and municipal governments (see Chapter 3).[8]

Parallel to staff reductions, there are plans for a more flexible system of pay for civil servants with a stronger element of performance evaluation. The system started this year and is being used for about 1000 managerial staff with plans for extending it throughout the civil service. This programme would be helped if the existing additional payments were more strongly linked to performance. Currently, the basic wage is augmented by various mandatory additional payments – the 13th month salary, payments for language proficiency, a "clothing bonus", and so on. These components should be de-restricted to allow managers to reward their employees more freely according to performance.

The further diffusion of e-government is also important for public administration reform. Indeed, recent OECD work suggests that Hungary has some way to go before catching up with the levels of e-government seen in leading OECD countries (OECD, 2006b). More resources are to go into the development of e-government under the *New Hungary Development Plan* (2007-2013) (Government of Hungary, 2006a).[9] However, as the OECD study points out, the existing regulatory framework needs to be closely monitored if e-government is to be introduced both swiftly and effectively. E-government diffusion has been hampered at least in the past by complex and overly burdensome regulations which have reduced the capacity for benchmarking and the identification of good practices across sectors and levels of government.

Major reforms of healthcare

Detailed assessment in previous *Surveys* has underscored that Hungary's healthcare system suffers from serious structural problems and inefficiencies, in particular the following (OECD, 2005):

- Hospital care is overly dominant in the system. In particular, there has been little progress in preventing uneconomic access to hospital services and the exploitation of cheaper outpatient alternatives to hospital care has been limited so far. As a result, long patient stays in hospital are common.
- Moreover, there are problems within the hospital sector because of limited scope and incentives for making efficiency improvements. Incentives to stimulate competition between suppliers are low.
- Problems of resource misallocation, with key indicators of service levels showing that there are wide disparities across regions in the quality of treatments.
- Overspending of the pharmaceutical budget, linked to a lack of cost effective prescription by both general practitioners and specialists and low cost-awareness of patients. Hungary spends roughly one third of total medical expenditure on medical goods and ranks second in the OECD in terms of consumption of these products as a share of total health spending.[10]

Healthcare reform occupies a large part of the government's programme and progress has been rapid, so far. A blueprint of specific measures was finalised by the Ministry of Healthcare shortly after the appointment of the new government in June 2006 and five Healthcare Acts were passed in the autumn. The Acts' aims are twofold, namely to make permanent savings in government spending and to improve the efficiency of healthcare services. The remainder of this section concentrates on these issues.

Cutting back on drug expenditure

The new bill on pharmaceuticals intends to contain the growing financial burden of drugs on the public sector, as well as to achieve more responsible uses of drugs. The 2007 pharmaceutical budget was set at HUF 287 billion, which is significantly below the actual pharmaceutical spending for 2006 (HUF 389 billion).[11] From 2007, pharmaceutical producers have been encouraged to strike three-year purchasing price deals with the National Health Insurance Fund Administration (NHIFA). For those producers wishing to remain within the current annual purchase system, purchasing contracts will be contingent upon offering a substantial price reduction or accepting the payment of a 12% compulsory rebate on the selling price. Any medicine expense above specified limits will be paid jointly by the state and the producers according to a risk sharing scheme involving a regressive government contribution. This will apply for the first 9% of spending in excess of budgeted levels while above this any government contribution will be discontinued.

Other measures have been adopted to contain pharmaceutical spending:

- As a measure to raise patients' awareness on pharmaceutical costs, a small co-payment fee of HUF 300 per prescription has been introduced (applicable to drugs fully reimbursed, so far, by the NHIFA).[12]
- The reimbursement system has been changed. The previous system, which used a uniform 90% reimbursement rate, has been replaced by a system involving three rates (90%, 70% and 50%, respectively).
- Inclusion procedures of pharmaceuticals in the reimbursement list have been made more transparent, with price negotiations being conducted via the internet. Also, general practitioners will have access to online data comparing pharmaceutical prices and therapeutic benefits, which can be expected to help competition among generics.
- Concerning drugs promotion and advertising, producers will pay a registration fee of HUF 5 million and a regular annual fee of HUF 1 million per medical representative. Also, rules on the level and types of allowances and benefits physicians can accept from the pharmaceutical companies have been tightened.
- Regulations on pharmacies are being lightened in an effort to improve access and stronger retail competition. Population and proximity based restrictions have been lifted for any new pharmacy willing to provide extra-services, such as extended opening hours. Also, non-prescription drugs (pain killers, for example) can now be sold outside pharmacies, though this is to some extent controlled by a certification system.

Increasing the efficiency of hospital care

Reforming the network of almost 200 hospitals is a difficult challenge. Hungary's hospitals are excessively focussed on acute care (*e.g.* injuries and care during the recovery from a surgery) and smaller hospitals often suffer shortages in specialised and experienced personnel. A recent Act on the efficiency of hospital care aims to close 10% of beds in 2007 as part of a shift away from acute care to chronic inpatient care (*i.e.*, more rehabilitation and long-term care).[13] A mixture of direct financial incentives and structural reform is being used to encourage the conversions and cuts in hospital beds. For a limited period, a one-off cash payment to operators for each acute care bed that is cut or converted into chronic or outpatient care was offered. This scheme is estimated to have prompted 4 000 acute bed cuts, but few conversions.[14]

Legislation aimed at re-organising hospital services is promoting greater specialisation within regions with the aim of achieving scale economies. The new structure will be organised around three levels: "high priority" specialist hospitals, "territorial hospitals" that provide more general services *(e.g.,* maternity services) and outpatient healthcare centres offering, diagnostic tests and one day-surgery, for instance.[15]

The Ministry of Health prepared specific proposals for changing the hospital network, including details about the distribution between acute and chronic beds in each hospital. The Regional Health Council in each of the seven NUTS II regions was asked to agree or propose modifications within a tight deadline of 30 days. The time frame was kept tight on purpose: the sooner operators are informed about closures and the new structure of assigned functions, the quicker they can prepare to re-direct patients and to transfer professional teams. A rapid adjustment will be needed to ensure that the delivery of care services continues without interruptions.

The new hospital structure will be used as the basis for funding hospital services and all new contracts for services between the operators and the NHIFA. Indeed, it has already been announced that from April 2007 five hospitals in Budapest will no longer have a contract, while one hospital will be converted to only chronic care and all acute services will be suspended.[16] Yet, all the regions have not only publicly refused the proposals but also to submit any alternative plan. As a result, the final decision with regard to re-structuring was with the Ministry of Health. Even so, reform may get stalled. In March 2007, many hospitals submitted a request to the Ministry of Health for alteration of the ministerial decrees concerning referral areas for hospitals and the number of beds.

Enforcing the insurance principle of healthcare services

Formally, Hungary's healthcare system is insurance-based with access to services contingent on contributions. But in practice, the link between service entitlements and contribution obligations is extremely weak. Coverage is close to universal (implying roughly 10 million beneficiaries) but only about 3.5 million people contribute to the system (Government of Hungary, 2006). Several of the steps adopted or announced for 2007 intend to re-affirm the insurance character of the system:

- Health services have been re-organised according to a tiered structure. One tier covers basic services (*e.g.* emergency care) and continues to be universally available, no matter whether the individual is insured or not. Another tier of services is contingent on insurance coverage and the payment of small user charges.[17] This tier will mainly cover preventive care and most hospital treatment. In addition, services not directly related to health and recovery, such as extra comfort services (*e.g.* separate hospital rooms), will require full fee payments, or will have to be covered by a supplementary insurance scheme. It is hoped that this new differentiated system will not only generate economies but also help discourage grey-sector employment by adding a "cost" to avoiding taxes and social contributions.
- The contribution base has been extended. The default minimum contribution base has been increased to double the level of the minimum wage (HUF 131 000, at present).[18] It is thought this will in fact bring payments more in line with actual incomes because of widespread use of cash top-ups to reported earnings. However, individuals can apply for a reduction in the contribution subject to proof of earnings. Employees with dependent

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relatives who are of working age but not entitled to any insurance coverage must now pay an extra healthcare contribution equal to 9% of the minimum wage.

The new law requires hospitals to introduce a waiting list with a view to increasing transparency and fairness in access to services. These will reduce the use of personal connections and loopholes in the system and may also reduce the widespread practice of under-the-table "gratitude money" to doctors.

Oversight of the system has been strengthened. A new body, the Health Insurance Supervisory Authority, was created in 2007. The Authority's main duties are inspecting contribution payments, supervising quality, ensuring the protection of clients and providing information about healthcare services. These responsibilities were previously under the NHIFA, whose activities are now more strongly focussed on funding issues.

Funding issues

One problem with the current purchaser-provider system is that it leaves limited scope for the efficient allocation of resources across providers. A review of the protocols governing healthcare processes and treatments is underway, with the aim of improving efficiency. Once new protocols are defined, the plan is to use these as the basis for adjusting funding parameters. For instance, this process has already been completed for oncology.

Assessment

The new measures to put downward pressures on public spending for drugs are welcome. However, it is important that government action is also focused on creating an environment that encourages innovation for which competition in the marketplace is needed. The proposed tiered approach to reinforce the insurance character of the healthcare system is also a positive step as it is the expansion of user fees. Current steps to reduce the heavy dependence on hospitalisation are also necessary. Yet, the implementation of the new regional hospital network needs to be supported by measures to strengthen the gate-keeping function of general practitioners. Without stricter prior-to-visit referral requirements, patients would directly visit the specialists of the "high priority" hospitals, when in many cases cheaper and more effective care treatments would be available at the level of the new local healthcare centres. This underscores that strengthening the "dispatching role" role of general practitioners is a key to the success of the current hospital care reforms.

The review of the protocols is important for establishing clear conditions for the minimum provision of treatments, based on the application of economically viable medical parameters. Using the protocols as benchmarks, hospitals should feel that they can organise their treatments more freely, aware that by exceeding the minimum standards they will qualify for more reimbursements. The government has plans to make hospitals' funding become more selective but details concerning this move are still unknown. In this regard, the financial responsibilities of the NHIFA could be better defined in ensuring good decisions in choices between hospitalisation and outpatient treatment.

One complementary step to raise the credibility of the reform of the hospital network would be to expand the scope for managing resources. In particular, managers should be given greater responsibilities for deficits and debts. Such a move would also help hospitals adjust their workforce to suit requirements.

A strategy of moving to a system of multiple insurance providers is under consideration, with the government being expected to take a decision on this issue in 2007. But international experience suggests that in countries such as Hungary, where the institutional structure is centralised, more effort could rather be put on trying to reinforce the effectiveness of the single purchaser. Based on this, the 2005 *Survey* noted that the single purchaser could use its monopsonistic power to pressure caregivers into following best practices. There is *a priori* no reason to expect that in the future the NHIFA will not perform this function efficiently, provided that the division of responsibilities between the NHIFA and the newly created Health Insurance Authority is properly defined.

Welcome reforms in education

A number of regulatory changes have been introduced in primary education that will lead to some budgetary savings and an improvement in the quality of the service.[19] The number of teaching hours per teacher has been increased from 22 to 24 hours per week, though this is still below the OECD average. Central-government grants to municipalities for primary education have been altered in a way that encourages school mergers – primary schools are highly dispersed at present (Chapter 3). Also, village schools with less than eight classes have been given two years to establish co-operation agreements with the bigger schools operating in the same area that cover the full primary education programme.[20] This measure does not aim for school closures but is intended to reduce administrative costs. Also, it will likely result in wider access to education as village schools are often too small to offer a full primary education programme.

Major changes are underway to the way central-government funds for teaching are allocated to higher-education providers, and regulatory changes on student tuition fees will come into force later this year. The measures do not aim to make savings in government spending and focus rather on improving the mix of higher education on offer and widening the share of students who make a contribution to tuition fees. The potential economic returns in this instance therefore come from improvement to human capital, rather than by helping fiscal conditions.

Under the previous system for allocating central-government funds for teaching, the government provided funding to cover around 62 000 free places in public higher education establishments. These places were largely based on precedent. In 2007, a new two-step procedure has been introduced in which the central government first sets the allocation of places by subject areas. Then, within each subject area the data on student applications is used to determine the allocation of funding across providers. Therefore, the new system makes use of demand signals and this will put additional pressure on providers to improve the supply and content of courses.

In addition, from the beginning of the 2007 academic year, more students are going to pay a contribution to tuition costs and it is going to be tougher for students to remain eligible for support during their studies. Under the current system, free places (*i.e.* with no tuition fees) in public universities for undergraduate courses are allocated according to the school grade.[21] In the new system the government will fund fewer places (around 56 000), which is equivalent to about 60% of undergraduate places. In addition, a significant share of these students will have to pay a contribution to tuition costs set by central government. Universities will be allowed to charge between HUF 60 000 and HUF 180 000 per semester for each student. An element of merit-based support is nevertheless maintained because the universities must spend at least one third (but not more than a half) of the amount collected in these fees on scholarships that can partly or fully offset the contribution. The universities have been given discretion in how places for nominal contributions and scholarships are allocated. They can, for example, evaluate students continuously and give out scholarships for welfare reasons as well as for academic performance.

Other aspects of tuition fees will remain broadly the same. The roughly 40% of students who do not make the grade for one of the government funded places will remain partly catered for by unregulated fee-paying places offered by the public universities. These fees are set at the discretion of the universities and typically amount to several hundred thousands forint per year (and higher than the fees that will be charged for the funded places)[22]. Though these fees are essentially market based they probably do not reflect full cost recovery because the fixed costs in teaching are partly covered by the government funded places. The remainder of students are in private higher education establishments where the fees are typically much higher still.

While these are positive developments, further reform is needed to bring the tuition fees more in line with the average cost of provision. The system is still overly focused on providing a majority of students with places that are free or at low-cost on the basis of merit. A preferable system would be one where the connection between fees and examination results is reduced. The majority of students should pay back a large share of the tuition costs but with safety nets to prevent exclusion. A system where fees are more uniformly applied that builds on the existing system of government loans ought to be considered.[23]

Progress in early retirement and pensions

Options and incentives to use early retirement schemes are being reduced. The main thrust of the changes is to raise the effective age of retirement. At present the vast majority of men retire at age 60 or below (the statutory age of retirement is 62) while women effectively retire at age 57 or below (the statutory age of retirement is currently 61 but will increase to 62 years by 2009). The key features of reform are as follows (Annex 2.A2):

- The eligibility conditions for the two universally available schemes (the "advanced early retirement pension" and the "reduced advanced early retirement pension") are scheduled to be tightened in 2009 and 2013 *via* increased contribution-year requirements and reductions in the number of years' early retirement. These are positive changes but, as recommended in the previous *Survey*, the "advanced early retirement pension" should eventually be removed altogether because there is no reduction in the annual pension payout, while the "reduced advanced early retirement pension" should be checked for actuarial fairness.
- Measures are being taken to limit use of special provisions for additional years of early retirement on top of those provided by the two universal schemes for those in "damaging occupations".
- Disincentives to work while receiving an early-retirement pension (notably a cap on earnings) are being introduced. Given that early retirement is already overly attractive, these measures will help somewhat in cutting back take-up. Ideally, reform should work towards actuarial neutrality in early retirement pensions, thus removing the need for such measures.

In addition, the government is currently assessing options for changing the old-age pension system. The plan is to present a detailed proposal by the end of 2007. As stressed in previous OECD assessments, whatever type of reform is chosen ought to include a schedule for further increases in the statutory age of retirement that under current legislation is set to remain at 62 years for men and women from 2009 onwards.

The pace of reform of the system of support for those with disabilities is set to pick up speed from its previously sluggish pace. The government plans for legislation to be passed in the second half of 2007 that will push reform ahead on three fronts:

- Further reform of the medical assessment system towards a focus on remaining work capacity rather than lost work capacity. This process has already begun with transfer of the National Institute for Medical Assessment from under the National Health Insurance Fund to the Ministry of Social Affairs and Labour in January 2007. The aim is that this transfer will allow stronger links between the Institute and employment offices. New guidelines for medical assessment issued in 2004 (and discussed in the 2005 *Survey*) will form the basis of a new assessment procedure.
- Introduction of a "rehabilitation benefit" in parallel to the disability pension. The plan is for existing disability pension recipients, as well as new applicants for disability support, to be considered for this new benefit. The objective is for the benefit to provide support for those with potential to return to the labour market, thus stemming inflows and reducing the stock of those on the disability pension. It is likely that the government will propose introducing this benefit in January 2008.
- Expansion of rehabilitation services and schemes, such as training programmes and wage subsidies for employers taking on workers with reduced work capacities. The main wage subsidy currently comes via the Start Plus programme and gives 50% reductions on social contributions to employers taking on persons with reduced work capacity.

These reforms are a sensible way forward in tackling the disability issue but it will be important to maintain momentum in implementation and monitor the impact of measures. Some aspects of the reform by nature take time to introduce, notably changes to medical assessment systems and the expansion of rehabilitation services. If these reforms are only partial, then there is a risk that the rehabilitation benefit will be ineffective.

In transport, financing has become more transparent

Motorways

Further development of road infrastructure is important for Hungary's growth prospects but requires large investments, particularly in motorways. These have typically been fully government financed; only two motorways have been financed using public-private partnership (PPP) agreements involving four separate arrangements. The recording of government spending on motorways is complex and has sometimes been massaged to help official deficit outcomes. As discussed in Chapter 1, both the 2005 and 2006 budgets, booked large items of spending on motorway construction off-budget on the grounds that they would be funded using PPPs. But the intended arrangements had little chance of passing Eurostat rules, basically because the proposal involved partnership with a state-owned company. In 2005, in compliance with a Eurostat's decision that the sale of already existing motorways should not affect the year's deficit, the revenues generated by this sale were not registered in the budget. For 2006, the spending associated to new motorway constructions was put in budget in the middle of the year.

When the government brought the large item of motorway spending for 2006 in-budget, this involved a fundamental change in the treatment of motorway financing. The

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financing of motorway construction is made *via* two-state owned companies, National Motorway Co. (NA Zrt.) and the State Motorway Management Co. (ÁAK Zrt.). In mid-2006 the accounts of ÁAK were incorporated in the government accounts (those of NA have been incorporated since 2002). Also, a limit of HUF 5 billion has been imposed on the debt of the two motorway companies, which forces government to fund motorway construction by regular budget appropriations and should help increase transparency. Total motorway construction for 2007 comprises an appropriation of HUF 205 billion for construction and HUF 50.7 billion for service fees paid for the PPP-run motorways (roughly 1% of GDP).

The government has established more formal procedures for selecting PPP projects to ensure that these fulfil Eurostat's risk-sharing criteria and, more generally, are based on sound economic principles. This ought to enable greater success in PPP financing of motorways infrastructure as well as other areas (*e.g.* the railway network).

Rail transport

In rail transport there are efforts to prevent debt accumulation by the state owned railway company (Hungarian State Railways, MÁV). Freight services have already been separated from the incumbent, prompted by EU commitments to liberalisation.[24] MÁV is therefore left with network operation and passenger services, and continues to get substantial transfers from central government. The rail subsidies comprise payments to compensate for discount tickets (*e.g.* for students and pensioners) and a subsidy is made for the overall shortfall between revenues and costs in passenger transport services. A cycle has emerged in which the government has economised on these subsidies to help its fiscal position (MÁV's deficit and debt is off-budget) but has then been periodically obliged to pump extra resources to help MÁV cope with accumulated losses (with the latter resources being recorded in the budget).

In an attempt to break out of this cycle, the government has doubled its subsidy in 2007 (the subsidy is equivalent to 0.4% of GDP) and it is planned to maintain this. In addition one-off capital injections are being made for 2007 and 2008 (equivalent to 0.4 and 0.1% of GDP, respectively) to cover the costs of a rationalisation programme (*e.g.* closure of underutilised branch lines). The government has direct leverage on this rationalisation programme because the Ministry of Economy and Transport has strong rights of managerial control on MÁV. Nevertheless, the "returns" on these injections are uncertain because the rationalisation programme has yet to get fully underway and the long-term savings of some measures are hard to assess. Furthermore, these injections do not address the issue of financing the modernisation of the rail network. Even with the support of EU funds, the level of government support needed for this project is estimated to be large.

Notes

1. An overview of international evidence on the political economy of structural reform can be found in the latest edition of Going for Growth (OECD, 2007, Chapter 7).
2. In October 2005 the VAT rate of 25% was reduced to 20%, effective as of January 2006. Subsequently, the rate of 15% was raised to 20% as of September 2006. Following the above measures, about 86% of consumer goods are taxed with the standard rate of 20%, while 4% fall under a reduced rate of 5% and the remaining goods are tax exempt.
3. Alone, this policy change is estimated to yield some HUF 420 billion more fiscal revenues in 2008, corresponding to 1.6% of GDP.

4. Specifically, in order to qualify for the subsidy the household's *per capita* income cannot exceed 3.5 times the amount of the minimum old age pension and its annual gas consumption cannot exceed 3 000 cubic metres. For larger families the consumption criteria is extended to 5 000 cubic metres per annum. For example, for a couple with two children and one income earner with a net monthly salary of HUF 110 896 (corresponding to the 2006 average monthly salary), the *per capita* family income is HUF 31 685 (this is based on equivalence scale with weights of 1 for the income earner, 0.9 for the other partner and 0.8 for each of the two children). At this level of per capita income the family qualifies for the highest monthly subsidy which equals HUF 6 192.
5. It is important to consider that the official expectation was for an annual increase of about 2.5% in the average gross nominal earnings of public employees for 2007, reflecting the carry-over of wage increases implemented in the course of 2006. Therefore, the new change implies that the overall increase in gross earnings during 2007 will be about 6.0%.
6. This being said, there are indirect effects to consider, as total wage growth for the economy as a whole will accelerate faster than initially expected. With the pension indexation formula assigning a 50% weight to nominal wage growth (the other 50% being accounted for by consumer inflation), the agreement will result in extra pension expenditures. However, the government expects that this additional spending will be relatively limited, in the order of 0.1% of GDP.
7. Such entities include, for example, the network of agricultural administration, as well as the offices of the pension and health insurance and the National Public Health and Medical Officer Service, which is responsible *inter alias* for food safety and epidemiology.
8. Not all areas of the central administration will be negatively affected by the new measures. Specifically, strengthening the revenue raising capacities of the Tax Authority will require 1850 additional employees. Moreover, the planned development of a new healthcare information technology system implies that the National Health Insurance Fund Administration (NHIFA) will be entitled to recruit some 280 more employees.
9. These resources amount to € 375.5 million (at 2004 prices) and will be draw from Structural Funds.
10. Hungary is unique in the European Union context in that of the total amount of public resources spent in healthcare, roughly the same proportions are destined to drug subsidies and hospital care. Elsewhere in the European Union, the proportion spent in hospital care is higher than in Hungary.
11. It should be noted, however, that, unlike in the past, the 2007 budget includes a special reserve fund of HUF 55 billion for drug subsidies.
12. Co-payments now apply to all prescribed drugs, except for individuals "in distress" who are entitled to a special medical cards.
13. The goal is for a cut of about 16 300 acute care beds, with some 7 400 being converted for chronic care. Overall, this implies cut of some 8 900 beds out of the total of 80 200 beds.
14. The scheme offered operators a one-off payment of HUF 2 million for each acute bed cut and smaller amounts for conversions to chronic or outpatient care. Altogether, HUF 6.5 billion was allocated to the scheme, equivalent to about 0.03% of GDP.
15. General rules about catchment areas for each type of hospital are being applied; it is aimed that specialist hospitals will operate within a radius of 55km, the general hospitals 30km and the healthcare centres 20km.
16. It is important to note, in this context, that Budapest hosts fifty hospitals that are heavily specialised on acute care, at present.
17. HUF 300 will be charged per day for primary, paediatric, dental and outpatient specialist care, alongside for hospitalisation. Those who are not up to date with contributions will be charged the full price of the service (except for basic services).
18. By default, the minimum *combined* social contribution from employers and employees has been doubled to that paid on twice the minimum wage with the employer paying the full amount of the increase. Employers can avoid the default level of contributions simply by sending a letter to the tax authority (APEC), which allows them to pay social contributions as before. Indeed, about one million such letters have already been sent, many of which from the self employed. However, sending the letter increases the chance of investigation by APEC.
19. Sutherland *et al.* (2007) discuss public spending efficiency indicators in primary and secondary education in the OECD context.
20. In Hungary, "primary education" usually refers to the first eight years of schooling. This is three years longer than under the international standard classification of primary education. The reason

is that under the Hungarian system primary education also includes secondary lower education which international classification treats separately.

21. During the summer of each year the public universities announce the school-leaving grades that students need for a free place in one of the programmes they have applied for. Students typically register several preferences. The fee for applications is the equivalent to HUF 9 000 for the first 3 preferences together and HUF 2 000 each for additional preference.

22. Universities' fees cannot be lower than 50% of actual teaching cost per student.

23. A student loan mechanism is already in place and could be expanded to cater further widening of tuition fees. In the current loan system a maximum equivalent to around HUF 150 000 or HUF 200 000 for fee-paying students can be taken out each semester (there are two semesters per academic year). All students under the age of 40 are guaranteed access to these loans and the State acts as guarantor. In addition, the payback conditions are favourable. Repayments in the first two years after the graduation are 6% of the minimum wage and after that are set at 6% of wages (or remain at 6% of the minimum wage for those who are not working). Interest is charged but at below the market rate for an equivalent loan.

24. Legal separation of freight services from MÁV was made in 2006 with the creation of *MÁV Cargo Zrt.* and the freight market has been legally open to competition since 2004.

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ANNEX 2.A1

Simulations of debt development

The simple framework used for discussing the long term dynamic implications of Hungary's strong electoral cycles assumes that the evolution of public sector net debt is given by:

$$D_t = D_{t-1} - NLG_t \tag{1}$$

Where, D_t indicates the value of net public sector debt at time t and NLG_t is the net lending of the general government. NLG_t can be rewritten as follows:

$$NLG_t = YRG_t - (YPGX_t + INT_t) \tag{2}$$

In equation (2) INT_t stands for the level of interest payments, YRG_t is the level of total public sector revenues and finally $YPGX_t$ indicates the level of total primary spending, *i.e.* public spending excluding interest payments. Interest payments are driven by the following relation:

$$INT_t = i_t * D_{t-1} \tag{3}$$

Where i_t denotes the apparent interest rate which is given by the sum of three components, the long term interest rate, the short term interest rate (respectively with weights of 0.8 and 0.2) and the risk premium.

Dividing equation (1) by the level of gross domestic product (GDP_t) and assuming that $GDP_t = GDP_{t-1}(1 + g)$, with g denoting the nominal rate of GDP growth, yields:

$$d_t = d_{t-1}\frac{(1+i)}{(1+g)} - yrg_t + ypgx_t \tag{4}$$

Within equation (4), *yrg* and *ypgx* denote the ratios to *GDP* of, respectively, *YRG* and a *YPGX* while *d* is the ratio to *GDP* of *D*.

This debt accounting framework has been used to study the evolution of Hungary's debt to *GDP* ratio based on a set of different assumptions concerning the following variables:

(1) Total public revenues as a percentage of *GDP (yrg)*;

(2) Total primary spending as a percentage of *GDP (ypgx)*;

(3) The level of the apparent interest rate (*i*);

(4) The rate of real *GDP* growth (*G*) (with the nominal rate of *GDP* growth then specified as $g_t = G_t * deflGDP_t$, where *deflGDP* is the *GDP* deflator).

Three different scenarios have been created, all extending over the period 2011-30. The basis for the construction of the scenarios is the December 2006 *Convergence Programme of Hungary* for the period 2006-10. Table 2.A1.1 details the key features of each scenario.

Table 2.A1.1. **Debt scenario assumptions**[1]

Assumptions \ Scenarios	*G*	*Ypgx*	*yrg*	*i*
1. Positive scenario *Technical characteristics*: The scenario assumes that all fiscal goals for the period 2007-10 are met and maintained over the scenario.	Constant at 2010 level	Constant at 2010 level	Constant at 2010 level	Starting from 2010, the short-term interest rate, the long-term interest rate and the level of the interest rate premium decline by a decimal per year.
2. Negative scenario *Technical characteristics:* The scenario assumes that the goals of the consolidation programme are met only for 2007 and 2008 and the deficit widens in the run up to 2010 election. After 2010 election there is again a temporary (two-year) consolidation period. This "boost and bust" electoral cycle is then replicated until 2030.	As under 1	For 2009 and 2010, spending equals the level a year earlier plus 0.6% of GDP. For 2011 and 2012, spending equals the level a year earlier minus 0.6%. This sequence is replicated until 2030.	For 2009 and 2010, revenues equal the level a year earlier minus 0.6% of GDP. For 2011 and 2012, revenues equal the level a year earlier plus 0.6%. This sequence is replicated until 2030.	As under 1
3. Negative scenario with effects to the economy *Technical characteristics:* The negative scenario does not take into account the effects to the economy of "boost and bust" cycles, notably *via* the impact on real GDP growth and the interest rate premium. The present scenario is a variant of the negative scenario that takes into account the latter two effects.	Real GDP growth accelerates during each two year "boost period" (up to a rate of 4% and 4.5% in the first and second year, respectively).It then decelerates during each two year "bust period" (down to a rate of 2% and 2.5% in the first and second year, respectively).	As under 2	As under 2	The risk premium increases by 0.5% during each two year "boost period". It declines by the same amount during each two year "bust period".

1. All scenarios assume the same rate of GDP inflation. This is set at 2.9% (corresponding to the level for 2010 presented in the *Convergence Programme of Hungary*) and maintained constant over the scenario period.

Source: OECD.

ANNEX 2.A2

Early retirement pensions

There are two universally available options for early retirement pension:

- The "advanced retirement pension" (ARP) This allows men to retire two years early (*i.e.* age 60) and women five years early (age 57 in 2007) on a full pension as long as they have accumulated at least 38 years pension contributions. In 2005, there were roughly 130 000 beneficiaries.
- The "reduced advanced retirement pension" (RARP) allows the same length of early retirement but with up to five years fewer contributions than required for the ARP. However, the pension payout is permanently reduced (see schedule below). For example, a woman retiring five years early with 33 years contributions will have her pension payout reduced by 30%. In 2005, there were roughly 10 000 beneficiaries.

"Missing" contribution years	1	2	3	4	5
Reduction per year of early retirement	1.2%	2.4%	3.6%	4.8%	6%

Two rounds of changes to the ARP/RARP system are scheduled:

- In 2009 (from legislation passed in the late 1990s) three years early retirement will be possible under ARP/RARP (*i.e.* early retirement will be possible at age 59 for men and women). But, contribution years for eligibility will be increased. For the ARP, 40 years service will be required and for the RARP a minimum 37 service years (*i.e.* a maximum of three "missing" years will be allowed).
- In 2013 (from legislation passed in late 2006), only two years early retirement will be possible (*i.e.* age 60) and 41 service years will be required for ARP while the minimum service-years for RARP will remain the same (therefore, allowing up to four "missing" contribution years).

In addition to the ARP/RARP system there are several occupation-specific provisions:

- Special provisions for "damaging occupations". People can retire one year early for every four years (for women) or five years (for men) spent in certain occupations (with a minimum of 8 and 10 working years, respectively). These provisions can be combined with the ARP/RARP provisions. So, for instance, a man working 20 years in one of the designated occupations could retire at age 55 as long as he has accumulated at least 33 years contributions in total. In December 2006, legislation was passed that will introduce an additional 13% pension contribution in these occupations in 2007. This will initially be paid by central government, but then responsibility for payment will gradually transferred to employers, such that by 2011 they will pay all of the additional contribution. The legislation will allow employers to apply for an opt-out from this system based on proof of certain health and safety standards. As of 2005, there were roughly 50 000 beneficiaries and below the standard age of retirement there were roughly 20 000 beneficiaries.

- In addition to the above schemes there is a special "employer financed" early retirement scheme which allows up to five years early retirement and there are special schemes for certain groups (these are separate from the "damaging occupations" provisions) including the armed forces, miners and artists. At present, there is a focus on reforming the armed-forces pension. Currently, they can retire with 25 years service, only earnings in the final year count and the starting pension is about twice the standard pension payout. The "employer financed" scheme only has about 4 000 beneficiaries and there are several thousands in the other schemes.

Two measures are being introduced that will affect the approximately 15% of early-retirees who continue to work:

- Since April 2007, those working and getting a pension have had to pay the 8.5% pension contribution out of earnings but are compensated by a pension increase equal to 0.4% of the average monthly earnings for each full year of contributions.
- From January 2008, pension payments for those working and receiving an early-retirement pension will be suspended when earnings that have been cumulated in the year reach the annual amount of the national minimum wage. "Suspended" means that no further pension payouts will be made for the rest of the year. Those working beyond the age of retirement will not be subject to such restrictions.

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Chapter 3

Encouraging sub-national government efficiency

Hungary's counties and municipalities face difficult challenges. Participation in cost-cutting structural reforms initiated by the central government means cutbacks to administrative overheads and tough decisions in public services. At the same time, there are also challenges in modernising local infrastructures and in making full use of the EU funds for development projects. This chapter first looks at how meeting these challenges can be helped by better budgeting, in particular regarding the transparency and oversight of accounts. Financing arrangements are also examined and this reveals a general problem of complexity. Assessment of spending responsibilities suggests room for improving the roles of counties and regions and a need for cutbacks in central-government influence on service provision and public-sector wages at the local level.

Hungarian sub-national governments are facing difficult challenges. Many of the cost-cutting structural reforms to public services being initiated by central government involve the municipal and county governments through their responsibilities in providing services. In addition, these governments face ongoing investment challenges in raising the quality of local infrastructures to address social and economic issues. There are wide regional disparities in GDP per capita across Hungary, reflecting an uneven pace of economic development. Local governments in poorer areas in particular need to be successful in accessing EU-funds aimed at narrowing gaps in development through infrastructure investment.

This chapter looks at how meeting these challenges can be helped by changes to budgeting systems, financing arrangements and spending responsibilities in the municipal and county governments. Policy recommendations are summed up in Box 3.1.

Box 3.1. **Policy recommendations for local government reforms**

Budgeting issues

- The authorities should consider reinforcing budgetary rules: separate budget balance rules for current and capital items should be specified and, in parallel with developments in central-government practice, multi-year budgeting at the local level should be introduced.
- Hungary could follow the example of several OECD countries (Austria, some Canadian provinces, Poland and Spain) which have recently made local governments move "off-budget" items into their accounts.
- On budgetary transparency, efforts should be made to improve the quality of reporting, for example by regulations requiring local governments to re-submit when reports fail to meet standards. One way of giving more teeth to sanctions would be *via* provisions requiring local governments to provide an explanation for breaching the budget rules and to submit a plan describing the measures they intend to implement in order to rectify the situation.
- The deficit grant is unfitted to deal with cyclical pressures. A good opportunity to remove it appears to be offered by the ongoing shift to the multi year budgeting framework in central government. Specifically, a municipality in difficulty could be allowed a temporary deficit as long as its multi-year budget remains in balance.
- The audit powers of the State Audit Office should be bolstered by extending them to cover all local government accounts, rather than being restricted, as at present, to the use of transfers received from the central government.

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Box 3.1. **Policy recommendations for local government reforms** *(cont.)*

Spending assignment issues

- Efforts to find consensus on the issue of replacing the county-level of government with elected assemblies in the seven NUTS II Regions should continue. The replacement would help overcome problems of overlapping responsibilities and allow for savings in administrative overheads.
- Reconsideration of central and sector specific laws is needed to cut back on regulations that hamper rather than encourage improvements in public services by sub-national governments.
- The regulations on passing over responsibilities for services from municipalities to counties would be more effective if municipalities were prevented from imposing rules on how the county uses the infrastructure. Support from the municipalities for joint provision *via* the system of "micro regions" (*mikro-régió*) would be helped by stronger mechanisms for public comment on the decisions taken by the councils of mayors that run these services.
- On benchmarking, much faster progress is required in the development of comparable cost, output and performance indicators.
- Sub-national governments should be given more leeway in designing the work contracts of their employees and in setting wage levels so as to reflect local conditions better.

Funding arrangements for local governments

- The number of formula based earmarked grants should be further reduced as part of a broad re-assessment of the structure of the "basic package" of services covered by these grants.
- Steps are needed to eliminate problems in the PIT allocation. First, the link between the funding of a range of services to PIT revenue runs against principles of efficiency and flexibility in financing and should be severed. Second, if formula-based funding is retained for those areas currently funded (at least partly) by the PIT allocation, a review of the formulae should be conducted because at least some of them appear to run counter to encouraging the joint provision of services.
- Ongoing efforts to increase the role of service quality in funding represent good progress. However, the use of quality indicators remains limited and more work is needed to widen this approach.
- A broadening of property taxation is under discussion as part of reform on the local revenue system. The reform should also include removal of the local business tax. Local "value maps" ought to be developed to ensure that the new property tax is levied on values that reflect market developments. The tax base should be broadened to include home owners.

The sub-national government system

Hungary, a unitary state, has three layers of elected governments –central government (*központi kormányzat*), counties (*megyei önkormányzat*) and municipalities (*helyi önkormányzat*). There are 3 167 municipalities, 19 counties and 20 city-counties (including Budapest) which have a special dual status as a municipality and a county (Table 3.1, left column). Elections to the respective assemblies are held every four years and always (at least so far) in the same year as the general elections. Established in 1990, this structure replaced a centrally controlled system comprising three levels: communities, districts and counties.[1]

Table 3.1. **The structure of public administration in Hungary**

Elected bodies	Appointed Councils, notably on development, education and health
Parliament	*Councils in the national and regional level.*
	There are three National Councils covering Development, Education and Healthcare, respectively. Most of their members are appointed by the central government. For example, the Development Council includes representatives from 9 ministries, the presidents of the Regional Development Councils (see below) and the Mayor of Budapest.
	There are also 7 Regional Development Councils (NUTS II regions) and 7 Regional Healthcare Councils. Most of their members are appointed by the central government.
19 county governments	*19 County Development Councils.* These Councils include members appointed by the central government and county governments.
3 167 municipalities plus 20 cities with county status (including Budapest)	*Development Councils of micro-regions* (166 in total) *and other forms of local government associations.* These Councils are appointed by the municipalities.

Source: OECD, based on M. Kopány and D. Wetzel (2004).

Unlike under the previous system, which granted significant powers on spending rights and funding allocations to the counties, the municipalities today benefit from a considerable degree of autonomy. Municipal governments are no longer subordinated to county governments; notably, a county cannot overrule the decisions of a municipality. The institutional foundations of the present framework are the Constitution and the 1990 Act on Local Governments. Both legal instruments have *organic* law status, meaning that they can only be amended by a qualified parliamentary majority of two-thirds, rather than a simple majority.

Understandably, the qualified majority requirement is intended as a safeguard against the risk of excessively frequent and possibly disruptive changes. As in other countries, however, it may occasionally generate tensions and even hold back opportunities to introduce changes with a potential to raise the effectiveness of service delivery. This is particularly the case in Hungary at present, where following the recent local elections the opposition has a majority in most local governments (Box 3.2).

Box 3.2. **Political developments in local government**

The local government elections were held in October 2006, about six months after the general elections. The opposition Young Democratic Alliance – Hungarian Civic Union (FIDESZ-MPSZ) won 18 out of 19 counties and 15 out of 23 major cities (with the notable exception of Budapest), taking over almost all seats previously held by the Hungarian Socialist Party (MSZP), the leading government coalition partner. At the time of the local elections the public was still digesting the implications for household incomes of the government's fiscal austerity package. In addition, around the time of the local elections there was controversy over a leaked recording of a speech by the Prime Minister.

Following the local government elections some political analysts argued that Hungary was exposed to the risk of a dual government power, in which Fidesz-led local governments would attempt to block all of the central government's austerity and reform measures. However, this view may be exaggerated. First, access to the European budget allocations raises the motivation of the local governments to co-operate with the central government. Second, accelerated progress on some local government reforms might turn out to reinforce support for Fidesz. At present, every broad policy priority of Fidesz is on local government matters.

Many local activities, particularly in infrastructure development, education and healthcare, are initiated and co-ordinated *via* a system of local Councils and micro-regions (Table 3.1, right column). A National Development Council and 19 County Development Councils were created in 1996, along with seven Regional Development Councils for the "NUTS II" regions which provide the interface with the EU's regional funding mechanism. However, the regions (*régiók*) not only play a policymaking role in development but also other areas of spending. For example, there are Regional Healthcare Councils that include representatives from counties and municipalities.

Since 2004, there are also 166 "NUTS IV" micro regions (*mikro-régiók*), comprising groups of municipalities that plan and implement various local activities, mainly with an aim to expand the provision of joint services. Most changes at the regional and micro region levels were initiated as part of Hungary's process towards joining the European Union (Temesi, 2000).

Budgeting issues

There are several mechanisms that aim to make local governments deliver balanced budgets and these include the requirement for balanced budget submission and a "deficit grant" (Annex 3.A1). As a result, the combined budget of sub-national governments has typically been close to balance or even in a slight surplus. Also, Hungary's local governments have not accumulated much debt (Table 3.2).

Table 3.2. **Gross public debt**

End of year per cent of GDP

	2000	2001	2002	2003	2004	2005
Central government	54.3	52.0	55.0	57.1	58.4	60.3
Social security funds	0.9	0.4	0.8	2.0	2.1	2.2
Local governments' gross debt	1.0	1.1	1.5	1.5	1.6	1.9
Consolidation within general government	*1.9*	*1.4*	*1.6*	*2.7*	*2.8*	*2.7*
General government consolidated gross debt	*54.2*	*52.1*	*55.6*	*58.0*	*59.4*	*61.7*

Source: Magyar Nemzeti Bank (MNB).

However, it is hard to draw a firm conclusion about the quality of financial management from this. Given the strong reliance of the local system on central government transfers, these positive budgetary outcomes could reflect a tendency for central government to respond to local budgetary slippages with increased funding. The following sections look in more depth at various aspects of budgetary management.

Making use of stronger budgeting rules

Strategic prioritisation in sub-national government budgeting is rather weak. Indeed, local governments focus almost exclusively on ensuring the budget meets legal and procedural obligations, and medium- and long-term policy goals tend to take a back seat. Most municipalities only fulfil minimum presentation requirements which just require classification by spending units (salaries, goods and services, capital expenses). Only a few municipalities specify their spending objectives by services or programmes (education, child care, water, garbage collection and so on). The basic objectives of public spending are therefore not transparent in most municipalities' accounts. Various steps could be taken to rectify this:

- Specification of separate budget balance rules for current and capital items.[2] Local governments must present budget proposals that differentiate between capital and operating items, but there is only one budget balance requirement (which applies to the aggregate budget). The city of Budapest has taken a welcome lead with a self-imposed rule that any surplus on current spending can only be used to finance infrastructure investment.[3]
- Introduction of multi-year budgeting at the local level, in parallel with developments in central-government practice (see Chapter 2). Several OECD countries (including Finland, Norway and Spain) have introduced multi-annual budgeting to both central and local government either simultaneously or following a defined timetable, rather than targeting the central budget alone.

A need to widen the coverage of budgets

Several OECD countries (Austria, some Canadian provinces, Poland and Spain) have recently made local governments move "off-budget" items into their accounts and Hungary could follow this example. The financial flows associated with certain important activities are not fully reflected in local-government accounts. The accounts of local public utility holdings (notably in transport) and non-profit foundations created to run housing and welfare assistance services are off-budget. In addition, the motivation for outsourcing some activities is questionable as this also can take accounts off-budget. Off-budget status makes it difficult to find out the amount being spent in these areas and obscures the true status of local-government debt given the likelihood of implicit guarantees. Both local holdings and non-profit foundations are governed by commercial law and are therefore free to finance themselves in the capital market. In addition, off-budget accounts widen the scope for circumventing fiscal rules through accountancy gimmickry. Reportedly, more than one third of the non-profit organisations receiving local financial support do not report the full extent of financial assistance (State Audit Office, 2006).

Better monitoring during the budget year is required

Municipalities must submit annual and semi-annual budget updates to the Ministry of Finance but there are problems in the format of the reports. According to the State Audit Office (SAO), more than two thirds of the local governments implement registration systems that are unsuited to allowing precise assessment of liabilities (State Audit Office, 2006). Efforts should therefore be made to improve the quality of reporting, for example by regulations requiring local governments to re-submit when reports fail to meet standards.

In addition, the sanctions against municipalities that break budget rules are rather soft. At present the Ministry of Finance can only send out signals or make recommendations when it sees that a sub-central government is in breach of fiscal rules. One way of giving more teeth to sanctions would be to introduce provisions that require local governments to provide an explanation for breaching the budget rules and to submit a plan describing the measures to rectify the situation.

At the same time, in some respects too much budgetary information is demanded and a review of the budgetary information that municipalities have to provide to the central government should be carried out. A frequent complaint of municipal officers is that a great amount of unnecessary information must be attached to the budget documentation. Several hundreds of expenditure and revenue variables are collected annually by the central government. The level of detail is such that the Ministry of Finance lacks enough means to scrutinise that such expenditures cater effectively to their objectives. Not surprisingly, much of the information sent is incomplete or unreliable and is kept confidential at the national level.

The deficit grant is unsuited to deal with cyclical pressures

The deficit grant aims to provide relief to municipalities due to unforeseeable financial developments (see Annex 3.A1). In 2007, the eligibility criteria of the deficit grant have been tightened. However, improving local budget management would probably require abolishing it. This grant has to date amounted to about three quarters of a percentage point of GDP per year and it has adverse incentive effects for local governments.

The introduction of multi-year budgeting at the local level, as suggested above, could be used as a vehicle for removing the deficit grant. Specifically, a municipality in difficulty could be allowed a temporary deficit as long as its multi-year budget remains in balance. In the Netherlands, where a similar mechanism is in place, if a municipality is unable to show a balance budget over the official multi-year budgetary period of three years it has to submit the budget to the higher level of government for approval.

Enhancing the effectiveness of the auditing system

The auditing system was reformed in 2003 and included a requirement that over each parliamentary cycle the SAO must audit each local government at least once. Though the new auditing framework also included changes intended to raise the visibility of the link between the budget and the quality of service delivery, little progress on this front has been achieved so far. Reportedly, this reflects the problem that many of the municipalities surveyed by the SAO have yet to implement internal audit systems or, when in place, the internal auditors are not independent of the local governments.

However, the scope of the SAO's audits is narrow. The SAO's evaluations of local government are restricted to the use of transfers received from central government. These audits could be bolstered by extending them to cover all local government accounts.

Spending assignment issues

Decentralisation of spending responsibilities to the municipalities and the counties in the early 1990s was significant. The municipalities were made responsible for several core services, most prominently primary education, water supply and various areas of healthcare including general practices, non-specialist hospitals and ambulatory services. The counties are notably responsible for secondary education, research hospitals and other specialised healthcare services. All in all, 20 key tasks are allocated to sub-national governments (Table 3.3), a fairly large number in the OECD context. Indeed, Hungary's municipalities perform broadly the same range of tasks as in the European Nordic countries, even though local systems are much less dispersed in these countries, based on the overall number of municipalities.[4] In terms of the share of total public spending, Hungary's sub-national governments are not exceptional. The counties and municipalities combined account for about a quarter of general government spending, a similar level to Poland, the Czech Republic and the UK (Figure 3.1).

Table 3.3. **The assignment of competences to the local governments**

Functions	Municipalities	Counties/Urban governments	Local administrative units of the central state
Education			
Preschool and primary	X		
Secondary		X	
Social welfare			
Nurseries, kindergartens and welfare homes	X		
Social care services (elderly, disabled, special services for homeless and families in crisis)	X		
Social housing		X	
Healthcare			
Primary healthcare	X		
General hospitals		X	
Preventive care			X
Leisure			
Culture, leisure and sport		X	
Parks and cultural centres	X		
Water and energy			
Water supply and waste water treatment	X		
Gas supply and heating			X
Electricity supply			X
Environment and public sanitation			
Refuse collection and disposal	X		
Street cleaning		X	
Cemeteries	X		
Environmental protection	X		
Roads and transports			
Local roads and public lighting	X		
Secondary and national roads			X
Public transport services		X	X
Urban planning and development			
Town planning	X		
Regional planning		X	
Local economic development	X	X	
Tourism	X		X
Administration and emergency services			
Licences and administrative services	X		X
Law enforcement and emergency services (police, fire brigades, etc.)	X		X
Consumer protection			X

Source: OECD, Based on Temesi (2003).

The devolution of responsibilities for public services has been a broadly positive step but has also generated some challenges. The following sections look at problems in co-ordination, challenges in overcoming economies of scale and issues in wage setting for public-sector workers.

Costly co-ordination failures

Getting the "middle level" of government right: counties or regions?

The middle level of government and administration (*i.e.* the level between the municipalities and the central government) has become rather complicated. Entry to the EU required the formation of the regions based on Eurostat NUTSII criteria as an administrative tool in EU funding. As mentioned above, the resulting system of seven

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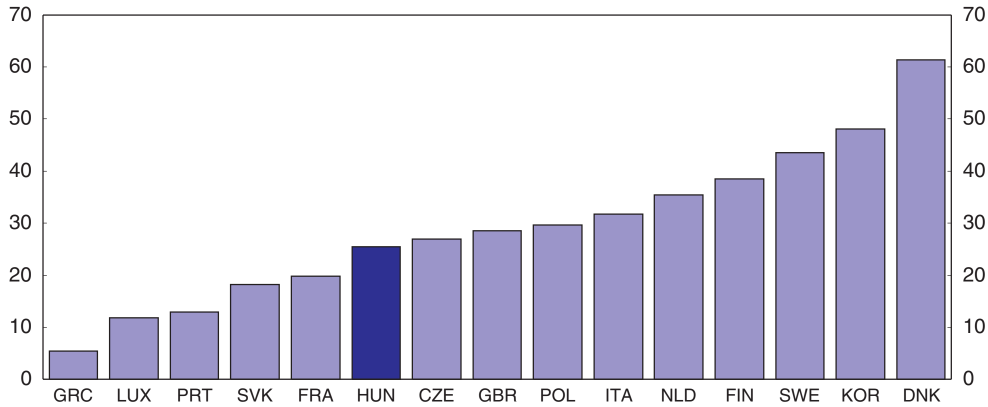
Figure 3.1. **Local governments' shares in general government expenditure**[1]



1. Secretariat estimates based on the latest available national accounts figures (2005 for most countries) and excluding the transfers paid to other levels of government.

Source: OECD, National Accounts Database.

regions has been used by central government to set up regional councils, which are made up of representatives from counties and municipalities and which cover issues in development, health and education. This has further narrowed the role of the counties which, as noted, was already significantly reduced by decentralisation in 1990.[5]

The co-existence of decision-making bodies at the regional level *via* the councils with county and municipal governments has generated overlapping responsibilities, especially between the councils and the large urban municipalities which also have county status. This is slowing decision making considerably, particularly in infrastructure development where it is difficult to agree upon the boundaries of a given project *(e.g.,* road projects, water services and energy supply).

A proposed amendment to the constitution that would set up elected assemblies in the seven regions and see the end of elected assemblies at the county assemblies level failed to get the required two-thirds majority in 2006. However, efforts to find consensus on this issue should continue. This would help overcome the problems of overlapping responsibilities and allow for savings in administrative overheads. Fewer elected assemblies in middle government would also allow more tasks to be passed on from central government because of increased capacities for specialised decision making and expertise.

Co-ordination failures between central government and sub-national government

Hungary's constitutional law provides a large degree of autonomy to municipalities, but freedom in policymaking is affected by several other factors. A key role is played by the provision regulations laid down in sector specific laws, on which line ministries have strong influence. These laws have come under increasing criticism for going beyond the core mission of enforcing or supporting nationwide standards and priorities.[6] Compared with local government laws, sector-specific laws can be passed relatively quickly, namely by means of a simple parliamentary majority.

The Act on Public Education, for example, imposes overly restrictive rules on closing, or modifying the use of education facilities that restrain the room for adjusting the provision of services to local conditions. In particular, the Act confers special veto power to both providers and users of the service on any proposal to dissolve a public education institution.[7] The impact of the mechanisms encouraging joint provision in education (see below) is likely to be weakened in these circumstances.

In healthcare, most hospital workers are public-sector employees and have to be paid using central funding.[8] This framework considerably limits the scope for introducing performance management and performance-based compensation in the hospitals. Also, it exacerbates the problem of so called "gratitude money" (under-the-table compensation payments), which is widespread, though illegal. Other aspects of the legislation are also overly prescriptive on issues which should be at the discretion of local decision makers. For example, the sector specific act in healthcare states that patients must be able to access hospitals using regular public transport.

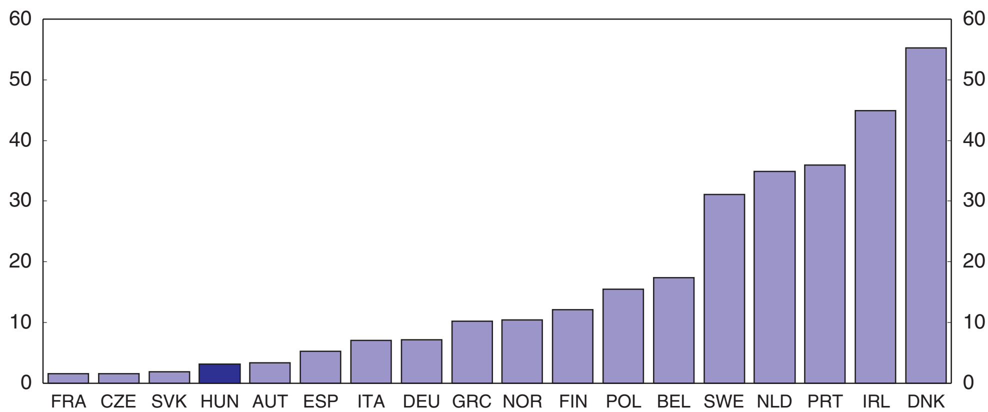
Reconsideration of central and sector specific laws is needed to cut back on regulations that hamper, rather than encourage improvements in public services by sub-national governments. Over-regulation generates inefficiencies in the sector they apply. It also creates a more general problem of weak incentives in local governments to initiate reform because they feel they are merely the executors of central-government policy, tightly bound by the provision rules and detailed formula-based grants (so-called "normative subsidies").

Economies of scale

The average size of Hungarian municipalities is one of the lowest of the European Union (Figure 3.2). The small size of many municipalities, especially given the wide range of responsibilities they have to cover, raises the question as to whether the scale of operation in administrative overheads and public services is efficient.

Figure 3.2. **International comparison of the average number of inhabitants per municipality**

Thousands



Source: Denmark, Ministry of the Interior and Health website; Dexia Bank.

Though a precise picture of the relationship between size and efficiency in local government is difficult to establish, it seems that many Hungarian municipalities are relatively inefficient reflecting the small scale of their administrative capacities and client populations. Empirical studies broadly agree that efficiency begins to drop off significantly below 5 000 inhabitants.[9] Among them, Solé-Ollé and Bosch (2003) estimate that spending needs per head in Spain's municipalities with 1 000 inhabitants are 23% higher than in municipalities with 5 000 inhabitants. Research on small local governments in Swiss cantons (a system often held up as a case where small-scale government works well) suggests that costs and quality are severely compromised below a population of 500 (Ladner and Steiner, 2003). Evaluated against these benchmarks, the number of municipalities below critical minimum sizes in terms of efficiency is relatively large in Hungary (Table 3.4).[10]

Table 3.4. **The size distribution of municipalities**

Population range	Number of municipalities	Number of municipalities (cumulative)	Percentage of total municipalities (cumulative)	Total population	Total population (cumulative)	Percentage of total population (cumulative)
Below 200	312	312	9.9	38 030	38 030	0.4
201-499	705	1 017	32.1	241 942	279 972	2.7
500-999	682	1 699	53.6	497 662	777 634	7.6
1 000-4 999	1 157	2 856	90.2	2 445 773	3 223 407	31.6
5 000-10 000	146	3 002	94.8	1 012 533	4 235 940	41.6
Above 10 000	165	3 167	100.0	5 957 446	10 193 386	100.0

Source: Ministry of Finance.

The most obvious solution to the Hungarian problem of economies of scale would be through mergers. However, this is easier said than done. Many argue that mergers will never get political support because the setting up of local democracy is one of the main achievements of transition.[11] Local democracy is indeed strongly protected; the constitution prohibits the central government from decreeing the merger of municipalities. Given this, policy has to work more indirectly so that joint provision is encouraged through suasion and incentive mechanisms.

A good feature of the local-government system is that it allows municipalities to transfer their service responsibilities to the county level on the grounds that they are unable to meet the related operating costs.[12] While this helps avoid costly duplications of specialised services, some regulatory fine tuning is required. At present, the ownership of the asset is not transferred along with the transfer of the utilisation rights. Transfer of ownership requires approval by the municipality following a request from the recipient county but this is rarely carried out. The municipalities are often reluctant to introduce changes in the use of their infrastructures and this limits the counties room for manoeuvre in reform (Box 3.3). The regulations on passing over responsibility for services would be more effective if municipalities were prevented from imposing rules on how the county uses the infrastructure.

In addition, the joint provision of services by municipalities is common.[13] There exist various legally recognised forms of associations. These allow for the joint delivery of services, the delivery of services by one of the member municipalities and the formation of joint administrative districts (*e.g.* covering local tax offices and internal audit). Box 3.4 provides a summary of OECD experiences with local government co-operation.

The system of 166 "micro-regions" (based on Eurostat's NUTS IV criteria), set up in 2004, has been used to bring more structured joint provision in key areas of public spending,

Box 3.3. **Consequences of the split between service provision and asset ownership**

Reportedly, the split between service provision and asset ownership hampers healthcare reform, particularly regarding hospitals. There has been little progress in preventing uneconomic access to hospital services and hospital care remains overly dominant in the system (OECD, 2005a). Progress on this issue requires a significant degree of autonomous control and co-ordination of capital as well as current spending. For example, introducing lighter day-to-day care treatment means alterations to existing buildings or even a switch to new premises as well as the re-allocation of staff. The implementation of such reforms can however be held up because, for example, the county running the health services can find it difficult to persuade the municipalities (as owners of the hospitals) to consider such changes.

Changes in the regulations on the transfer of property rights when provision is passed over to the county level, would likely also favour restructuring in education. As in the Czech Republic, Poland and Slovakia, reflecting demographic developments Hungary faces the twin challenge of reducing numbers of primary and secondary school childrenbut rising demand for tertiary and adult education.* The transferability of property rights along with utilisation rights could, for example, facilitate the transformation of the primary schools into centres for adult education.

* Useful background indicators illustrating the issue can be found in OECD (2006b) and specifically Table A1.31, p. 39.

including development projects. Central government is encouraging municipalities to use the micro-regions as a basis for joint provision. The broad aim is to encourage co-operation between small villages and larger settlements, something the former have often been reluctant to accept for fear of losing autonomy. Several incentive mechanisms have been introduced:

- *Progressively increasing grants.* Grants for some services are progressively increased with the population coverage of the associations of municipalities. For example, for sewage networks serving between 2000 and 15 000 residents, the central-government grant covers 40% of total costs, this is increased to 50% if population exceeds 15 000.
- *Threshold requirements in investment grants.* Access to special investment grants is sometimes contingent upon meeting a minimum population or consumption threshold.
- *One-off and formula based compensations.* These are provided when associations are formed and later on to help cover operating and development costs. This compensation represents only about 2% of total central-government transfers to municipalities but the experience so far suggests that even this modest compensation can be enough to motivate small settlements to co-operate.
- *Deterrents.* From 2007, some penalties have been introduced. For example, the "deficit grant" will no longer be available to those municipalities that are not in an association for the joint provision of education services.

There is welcome flexibility in the micro-region system. Borders can be altered through legislation that allows municipalities to switch to an adjacent micro-region.[14] In addition, central government is taking a flexible approach in its application of the incentive mechanisms described above. Associations do not have to comprise all municipalities in a

Box 3.4. **OECD experiences with local government co-operation**

Several approaches have been taken within the OECD to the problem of numerous small local governments. A number of member countries have encouraged amalgamation, while others have encouraged co-operation. Common themes have emerged about the potential returns of such policies:*

- The efficiency gains from merger or co-operation can require changes in work processes and municipal organisation that take a long time to materialise, while costs may rise in the short-run. For instance, the Japanese experience with mergers suggests it takes perhaps a decade for all the efficiency gains to work through.
- Incentive mechanisms need to avoid side-rules and "lock-in-effects" that alter the benefits of mergers or co-operation. For instance, in Finland merged municipalities cannot reduce the combined workforce for the first five years following amalgamation. Thus, the incentives themselves limit economies and efficiency gains.
- The boundaries of joint provision needs to be flexible to reflect that scale economies differ across public services.
- Mergers or joint provision need to be treated interactively and tailored to circumstances. Co-operation is likely to be more appealing in countries where the municipalities have wide responsibilities. The weakest or poorest municipalities have comparatively more to gain from the benefits of co-operation but may also find more difficult to find suitable partners. For a municipality located close to a big city it may be preferable to purchase services from the larger municipality, rather than establish a formal co-operation agreement. Also, co-operation and merger are not necessarily alternative solutions as decisions regarding mergers could be informed by knowledge gathered during co-operation.

* For a broader discussion see OECD (2006), Workshop Proceedings: The Efficiency of Sub-central Spending.

micro-region to be eligible for the incentives and the joint provision of public services can even span the boundaries of the micro-regions.

The general perception is that these mechanisms are indeed encouraging a more efficient scale of operations. Virtually, all the micro regions are now being used for joint provision and are running at least three services. The most common joint provision is in education (Table 3.5). The government is carrying out case-studies of the micro-regions. Particularly revealing is the experience of the *Koppány* Valley Multi-purpose Sub-regional Partnership, which shows that network-wide gains can be quite substantial, measured in terms of expenditure savings.[15] Local government teaching expenditure per class is reported to have declined by an average of 30% following the establishment of the association and there has also been a 50% cut in administrative costs. Three schools have been closed without altering education levels for the inhabitants of the association taken as a whole.

Though the micro-region system seems to be running well, there is some scope for improving governance. The micro regions are typically run by the association councils comprising only the mayors from the participating municipalities. Reportedly, in some instances this is leading to excessive marginalisation of the municipal assemblies. The law allows the establishment of a separate organisation – a joint municipal authority – to oversee joint services. However, very few have been created because their powers are vaguely defined. Oversight of the association councils could be strengthened by provisions

Table 3.5. **Distribution of micro-regions by type of activity**
As of February 2007

Purposes	Number of micro regions with joint provisions	In per cent
Educational	162	98
Social institutional	21	13
Social basic service	113	68
Children-protection service	2	1
Children-welfare basic service	136	82
Moving library	77	46
Inner audit	152	92
Total number of micro regions with joint provision	**165**	**99**
Total number of micro regions	166	100

Source: Ministry of Finance.

allowing for comment on preliminary council decisions from all stakeholders. This however would also require allowing local stakeholders access to the relevant details of the councils' work.

Additional mechanisms for encouraging joint provision should be explored. Adjustment of tax allocation formula is one candidate. For example, the Czech Republic is considering adjustment of its tax allocation formula to reward joint provision (OECD, 2006c). However, the returns to both existing and new schemes need to be carefully evaluated. It can be prove tricky to ensure that co-operation agreements result in concrete economies in service provision and not just superficial organisational changes to fulfil eligibility criteria. Also, the returns from a fiscal perspective may be limited if efficiency gains emerge in improved service quality rather than cost savings.

Lack of accountability vis-à-vis citizens and poor information sharing

Effective and efficient local government requires not only incentives from central government but also strong oversight by local citizens. This can be helped by regulations ensuring transparency in actions and outcomes of local government and participation in decision making (Box 3.5). Unfortunately, these are arguably inadequate in Hungary. Regulations stipulate that only one public hearing per year must be held, while virtually all municipalities comply, only a small fraction of them exceed this obligation. There are no strict rules for the organisation of such public hearings, meaning that meeting agendas can be set out in such a way to avoid sensitive issues (Soós, 2003). Moreover, public hearings are often poorly advertised and, as a result, meeting attendance can be low. Although there are some *ad hoc*, bilateral discussions between municipalities, local government officials find the sharing of good and bad experiences at the sub-national level is too limited and informal.[16]

More benchmarking would help. Experience from a number of OECD countries suggests that information sharing enhances competitive pressures on sub-national governments (Box 3.5). But in Hungary this is poorly developed. For instance, there are no standardised measures for elderly care facilities or for school performance. While there are plans to bring in indicators, for example there is intention to publish adjusted mortality rates by region, progress is slow. EU funding may provide one way of speeding up this process. Central government should also step up its support, for instance with subsidies to cover the initial costs of participation.

Box 3.5. **National approaches to information sharing**

OECD countries have been paying increasing attention to stimulating competitive pressures and cross-learning at the local level through information sharing.*

Examples of information sharing

- Australia regularly collects a comprehensive set of information and statistics on government services (such as in education, justice, emergency management, healthcare, community services and housing) for each state and local territory, as well as the national level.
- Denmark, Norway and Turkey collect comparative statistics on a variety of municipal data and this is available on line. The data published by Denmark, for example, describe social conditions, economic background, local financial data, and output measures, such as students per teacher.
- The Association of Netherlands Municipalities launched in 2006 a pilot website – *What is your municipality doing?* –, to enable citizens to compare municipal services. The site aims to increase transparency, quality and uniformity of a variety of services. One problem encountered is that data available on the internet can be too technical to digest by the general public.
- Finally, Italy uses performance based indicators to promote regional institutional capacity. The main feature of this system, which was launched in 1998 in the context of the reform of regional development policies, is that it uses the indicators to reward or sanction the regions.

Policy challenges

The effectiveness of performance indicators is contingent on establishing clearly defined and quantifiable targets – itself a difficult issue. A key issue is *who chooses* the indicators. Local participation is important for building commitments, not least because the financial and administrative burdens of data collection fall upon the local administrations. The leverage of the central government to require data submission is generally lower in cases such as Spain, Austria and Canada where regional governments are highly autonomous. Leverage is also low where a relatively high proportion of central government transfers come in the form of non-earmarked grants, with Hungary falling into this category. The national government can play a constructive role by tackling co-ordination failures, for example, where there is no standard presentation of municipal budgets, again a situation that applies to Hungary. In addition, national government's oversight can be necessary to ensure the validity, reliability and comparability of data. National government can also help by setting standards for the presentation of information to the public.

* The Box draws from discussions held at a recent workshop on the efficiency of sub-national spending jointly organized by the OECD Network on Fiscal Relations across Levels of Government and the French Budget Directorate of the Ministry of Economy and Finance. For further information, see OECD (2006), *Workshop Proceedings: The Efficiency of Sub-central Spending*.

Local governments carry out a significant share of public procurement, so ensuring the legal and administrative frameworks to allow small administrations sufficient flexibility while safeguarding against abuse is important. Hungary scores fairly well in OECD indicators of procurement policy.[17] It has been one of the first countries to set-up an independent Public Procurement Council and there is also an independent body handling appeals and complaints on procurement (the Public Procurement Arbitration Board, PPAB).

A recent report by the SAO concludes that most local public procurements follow the rules of open tendering procedures (SAO, 2006). However, it also points out that half of these local governments have yet to comply with the obligation to establish an internal code of conduct. Public procurement practices also feature among the complaints of foreign investors along with other aspects of red-tape and administrative procedures (OECD, 2005b). Although PAC has been applying its sanctioning powers more strongly, increased monitoring of these practices is needed.[18]

Issues in wage setting and employment flexibility

Wage setting and employment conditions for public-sector employees are strongly centralised. The central government imposes a limit on the increase in the number of permanent employees at the sub-national level and sets salary scales and wage adjustments. Thus, most sub-national government wage scales factor in educational and seniority levels in the same way as wages in central government. And, for instance, the 50% public-sector pay increase over 2002-2003 was agreed at central level and applied to most local-government employees. Only a small share (less than 10%) of total local government employees are currently hired under the standard labour code that applies to the business sector. However, there has been some increase in outsourcing which has indirectly meant increased use of more flexible work arrangements.

Sub-national governments should be given more leeway in designing the work contracts of their employees and in setting wage levels so as to reflect local conditions better. In line with developments in other OECD countries, reliance on life-long job contracts should be lowered and barriers to mobility within the public sector scrapped. Central government is moving ahead with reforms to remuneration and management for civil-service employees (see Chapter 2) and similar systems should be adopted by sub-national governments.

Funding arrangements for local governments

Aside from the structure of spending assignments, *de-facto* levels of self-determination in the municipalities and the counties are influenced by the system of intergovernmental financing. Most sub-national government funding goes to the municipalities, reflecting the much wider range of responsibilities compared with the counties. The key features of the system are as follows (Figure 3.3):

- *Grants from central government*. Grants are by far the most important source of revenues for sub-national governments. These are the sole source of revenue for counties and account for a large share of municipal funding. Grants account for roughly 45% of the aggregate revenues of municipalities, equivalent to about 6% of GDP.
- *Tax sharing*. About 40% of revenues from personal-income tax (PIT) are distributed to the municipalities. These account for 15% of total sub-national government revenues (some 2% of GDP).
- *Local taxes*. Local taxes make for roughly another 15% of total revenues, though there is considerable variation across sub-national governments. Particularly important is a tax on business turnover which totals approximately 80% of overall local tax revenues at the sub national level (this is discussed further below).
- *Other revenue sources*. The remainder (roughly 25% of total revenue) comes from various items, in particular asset sales, revenues from local fees and fines, and the

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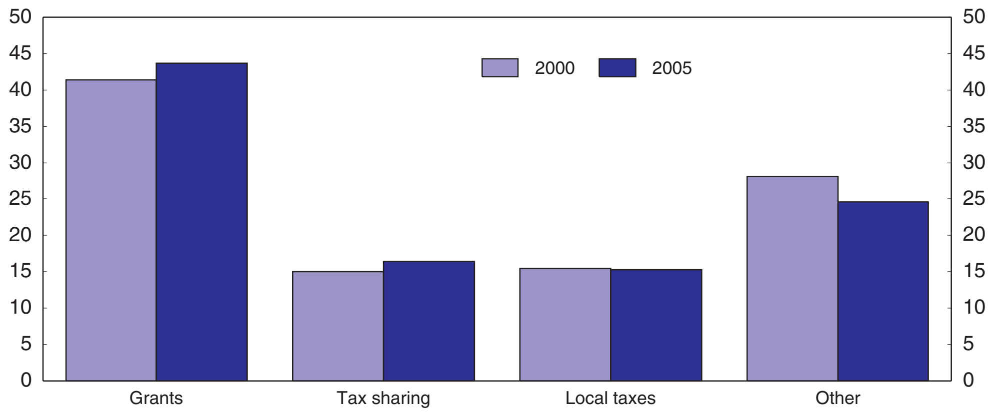
Figure 3.3. **Revenues of local governments by type**

% of total revenue



Source: Ministry of Finance.

reimbursement of value added taxes (for instance that paid on the purchase of inputs used for services).[19]

In broad terms, the system of financing is overly complex. This problem has been recognised by the government, particularly regarding the grant system (see, for example, Government of Hungary, 2006b). This is discussed in detail below along with the use of performance indicators in financing, the PIT tax allocation, local business taxes and the funding of investment.

An administratively costly grant system

The largest grant transfers are so-called normative subsidies, *i.e.* they are formula based grants. Around 40% of these transfers are for primary education. A large share of grants are not-earmarked (*i.e.* they go into general sub-national government revenues). Recent OECD work (Blöchliger and King, 2006) calculates that 43% of total grant transfers are non-earmarked, a share roughly in line with the OECD countries' average (45%).

Some important grants are however earmarked (*i.e.* the local authority must spend the allocation on the designated activity) and stipulate matching funding (*i.e.* the local authority has to make a contribution to the funding of the activity). The largest earmarked grant is the social security transfer for healthcare which is paid directly to the healthcare institutions. Supplementary funding allotted to education (*e.g.* special programmes for Roma children) and grants for large infrastructure projects are also earmarked. This is the case, at present, with the Budapest's fourth Metro line.

A major source of concern in the grant system is with the large number of detailed financial normatives applied. It is usual for grant systems to be complex because of the need to tailor the grants to suit the services being funded. However, excessive complexity and administrative costs are added to the Hungarian system due to the large number of specific characteristics and sector requirements. This is exemplified by the numerous formula based grants, of which there are over 200.[20] The education grant alone results from the aggregation of some 30 normatives, each one associated to a mandatory service.[21]

The government is taking some steps to cut back on the number of formula based grants. The latest Convergence Programme of Hungary (Government of Hungary, 2006b) contains a commitment to reforms, beginning with education. From September 2007 (the beginning of the school year), kindergartens and primary schools will be financed using a single normative subsidy instead of the ten normatives used to-date. Unlike the present system, where the normative is calculated on a per-child basis, the new formula will be based on organisational parameters with the objective of increasing the number of classes taught per-teacher and the number of pupils per-class. The government expects that, once fully implemented, the uniform grant will replace 70% of all state grants in public education.

Further to these measures, the current OECD assessment of good practices with grant management (Bergvall *et al.*, 2006) suggests that other options should be considered:

- Further reducing the number of earmarked grants as part of a broad re-assessment of the structure of the "basic package" of services covered by these grants. Switzerland, for instance, has had some success in removing perverse incentives by replacing earmarked grants with non-earmarked general purpose grants. In the Netherlands, a more selective approach has been taken: switches from earmarked to non-earmarked grants are only made in areas where municipalities are unlikely to cut back services drastically.
- Simplifying the system of obligations and minimum standards. Reducing the number of normative subsidies can be facilitated if detailed and superfluous standard requirements are eliminated. It also facilitates the calculation of the aggregate non-earmarked grant.

The need for more performance-based funding

Progress in introducing measures of output in funding formulae has been modest so far. Indeed, the largest subsidies put a very strong emphasis on the per capita component and items reflecting outcomes or quality carry little, or no, weight. For example, grants for secondary education remain largely based on the number of students in the classroom with no penalties or rewards based, for example, on student performance in national tests or on the number of successful students who have access to higher education. In addition, central government authorities like the Ministry of Finance or the Ministry of the Interior do not verify outcomes. As a result, quality standards are not enforceable, even when they are set in the sector specific laws.

The government sees the fiscal adjustment programme as providing opportunity to make grant transfers more conditional on performance. For example, since 2007 funding of local social welfare services has made half of the grant dependent on the fulfilment of provision standards. Similar quality-focussed incentives have been introduced in education, notably affecting the numerous secondary art schools.

The ongoing efforts to increase the role of quality and output in determining funding for mandatory services are welcome. This is a positive feature because these are services that contribute to established central government objectives. However, the use of quality indicators remains limited and more work is needed to widen this approach.

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Fine tuning the allocation of personal income tax

The share of PIT revenues allocated to the municipalities has declined and is now roughly 40% of total PIT revenue. The allocation mechanism is complex. The calculation is based on total PIT revenue collected two years previously and has several components:

- *Own-base component*. The "cessation level", *i.e.* the share allocated according to the PIT collected within the municipality (own-based revenues), will equal 8% of overall PIT revenues in 2007.
- *Equalisation component*. Another part of PIT is spent on an equalisation mechanism. In this process, the annual state budget law sets averages of per capita tax revenues according to several size-classes of municipality (the calculations factor in revenues from PIT as well as the local business tax). Municipalities with per capita revenues below the average for their size-class receive a supplement that fully covers the shortfall. Those with per capita revenues above the average have to contribute to the equalisation scheme according to a schedule in which the share of the difference with the average that is retained increases with the size of the gap. For 2007, the equalisation will cost the equivalent of 8.3% of total PIT revenue.
- *Formula based (normative) component*. The remainder of the municipalities' share of the PIT is used to fully fund a range of administrative services and to top-up funding in some other areas (*e.g.* welfare services). The allocation uses formulae similar to those used in the grant system. This component is relatively important; for the 2007 budget it will amount to 23.7% of total PIT revenues and for the past fifteen years it has never been below 20%.

The formula based component of the PIT allocation should be reconsidered. First, the link between the funding of a range of services to PIT revenue runs against principles of efficiency and flexibility in financing and should be severed. For instance, the link to PIT means strong exposure in funding for these activities to fluctuations that are unlikely to relate to cost or output variation. One way forward would be to drop this indirect allocation of PIT to municipalities and to fund these services from general government revenues (as is the case for other formula based funding for municipalities). Another approach would be to re-direct the allocation into the own-base and equalisation components and to drop the specific funding for these activities. The need for simplification in this area of municipality financing is echoed in a recent World Bank report on local-government financing in central and Eastern Europe (World Bank, 2006).[22] Indeed, of the eight countries surveyed, only Hungary has a two-tier system in which revenue redistribution on an origin basis and general purpose grant transfers are combined together.

Second, if formula based funding is retained for those areas currently funded (at least partly) by the PIT allocation, a review of the formulae should be conducted because at least some of them appear to run counter to encouraging the joint provision of services. For example, under the 2007 budget each municipality with less than 500 inhabitants is entitled to receive a PIT-related normative for "administrative, communal, and sport-related tasks" that is twice the value of larger municipalities, which weakens the objective of municipal co-operation. Similar adverse signalling mechanisms are contained in the grants allocated for the issuance of official documents (passports, identity cards, car plates, birth certificates, etc.).[23]

Problems with local tax-raising capacity

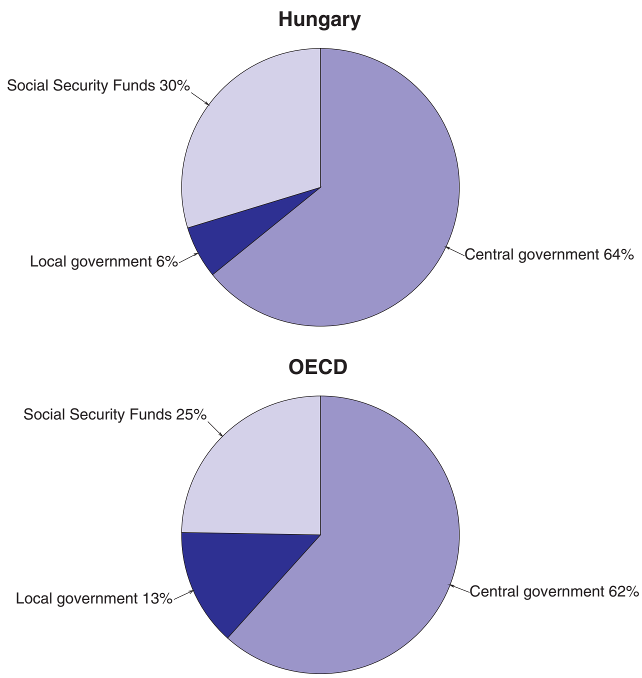
Local government own tax revenues are well below the average of the sample of unitary OECD countries (Figure 3.4). In addition, the most important local tax is a local business tax, rather than a property tax (Table 3.6). Hungary has a local property tax, based on the size of plots or buildings, but its contribution is negligible, as is the case with the tourist tax. Under the current legal framework the local authorities have a relatively wide margin of discretion about how to shape their local taxes.[24]

There are a number of problems with the business tax:

- It erodes the local tax base as it is imposed on mobile assets and increases pressure on tax competition. This is visible in the trend increase in the number of local municipalities that choose to set the level of the local business tax rate below the statutory maximum ceiling of 2%.
- Since it applies to business operations that can last for short periods – such as construction – the basis of the tax is subject to variability.
- To the extent that the regional disparity in the local business tax basis broadly matches that of wealth, the strong reliance on local business taxation aggravates regional income disparities. At present Budapest and surrounding municipalities collect most of the local business tax and, indeed, four districts within Budapest alone account for 30% of total business tax revenues.[25]

Figure 3.4. **Taxes by level of governments**[1]

% of total tax revenue



1. Estimates for 2004. Central government includes supranational taxes (attribution less than 0.5%) collected on behalf of the European Union by its member states. OECD is an unweighted average of unitary countries. The figures do not take into account the transfer of revenue from central to local government which in Hungary's case is partly derived from the local government's tax base.

Source: OECD (2006), Revenue Statistics 1965-2005.

Table 3.6. **Local taxes**

As of 2005

Type of tax	Number of municipalities levying the tax	Number of municipalities levying the tax as a percentage of total number of municipalities levying at least one tax	Amount of revenues raised as a percentage of total local revenues
Building tax	734	23.6	11.2
Land tax	402	12.9	1.3
Communal tax for private individuals	2 190	70.5	2.0
Communal tax for business	703	22.6	0.3
Tourism tax	519	16.7	1.3
Local business tax	2 639	85.0	84.0
Total number of municipalities having at least one tax	3 106	100.0	100.0

Source: Ministry of Finance.

- The base is questionable. Because the tax is based on turnover it runs counter to the principle of taxing incomes or profits. Furthermore, the legality of the local business tax in the context of European Union rules has been challenged.[26] The argument is that the base could overlap with that of the value added tax and as such contravenes a principle of EU tax regulation that countries cannot impose more than one turnover based tax. While a final decision remains pending, the European Court of Justice has nevertheless ruled in a recent resolution that bears some resemblance with the Hungarian situation that Italy's turnover-based local business tax is in compliance with EU regulations.[27]

Acknowledging these problems, the government announced in 2005 that firms would be able to fully deduct the local-business tax in the calculation of corporate income tax in 2006 and that the local business tax would be completely eliminated in 2008. However, only the first step has been implemented so far, while the elimination of the local business tax has been suspended as part of the government's measures to rein in the fiscal deficit.

A system more focussed on the local property tax would ultimately be better. Property taxes have low avoidance and relatively stable and predictable revenues. In addition, the "benefit principle" is more strongly adhered to since the local property tax is imposed directly on the local taxpayers and is difficult to avoid. A broadening of property taxation is under discussion as part of reform on the local revenue system. The reform should also include removal of the local business tax. The following issues should be considered in the proposals:

- Development of up-to-date local "value maps" to ensure that the new property tax is levied on values that reflect market developments. At present, properties are valued using arbitrary point values, such as per-square metre and location in the case of land, or in the case of buildings, per-square metre and according to use (whether office or residential). Such values were deliberately set low in the early 1990s when Hungary lacked a properly functioning property market and have never been re-evaluated since.
- Broaden the tax to include home owners. A broader tax base would more closely align the tax with the local electorate, thus bringing it more in accordance with the benefit principle. It would entail corresponding widening of valuation to include residential premises. Much of the framework necessary to do this is already in place. The cadastral mapping and the legal property registry are unified and all land and real estate properties in the country have been registered. One source of possible problems is that

while the information-technology systems in the land offices are operational, the national network of registries is yet to be connected. An ongoing programme to produce digital cadastral maps is expected to be finalised by 2008, though putting digital maps in a fully harmonised format should take longer.

Issues in investment funding

Hungary's sub-national governments initiate a lot of investment and local development is one of the main pillars of the new government strategy to use EU funding (Annex 3.A2). Assessments by the government and the World Bank conclude however that the system is highly fragmented and somewhat un-coordinated (Government of Hungary, 2006a; World Bank, 2000). While the allocation process stimulates competition among municipalities, engaging in local investment funding requires substantial administrative costs and local priorities are not always well identified.

In response to these issues, the latest Development Plan of Hungary (Government of Hungary, 2006a) sets out clearer local objectives and brings in new approaches to manage funding. Investment activities will not only focus on traditional "hard" infrastructures (*e.g.* roads and railways), but also on boosting local human resources and skills (*e.g.* education and training). In transport, there is the intention to widen the scope beyond motorways and to invest more in local roads, the expectation being that, by helping local labour mobility, this will support employability. Local policymakers will have to submit development strategies that involve more co-operation and close ties between local governments, the business community and local institutions, such as universities. According to the Development Plan, several large municipalities will act as "hubs" for development.[28]

To improve co-ordination, the allocation of EU funding will become more centralised. So far, programmes have been divided up between line ministries. Under the new approach, the ministries' role will be more that of intermediary bodies, both during the planning stage and as executors of programmes. Otherwise, any funding decisions will be taken centrally.

Notes

1. For earlier discussions of Hungary's structure of governance see Wetzel and Papp (2003), OECD (2001a), OECD (2001b) and World Bank (2000).
2. Sutherland *et al.* (2005). Drawing mainly on questionnaire responses, this paper gives a detailed picture of fiscal rules for sub-central governments in a number of OECD countries.
3. The City of Budapest's self-imposed rule on use of the current surplus has been in place since 1995 and surpluses on current spending have been recorded since then. For 2006, Budapest's gap between current revenue income and spending was 13%, with the plan being to widen the gap further to 20% before 2010.
4. In Finland, for example, a system of grants has provoked some mergers. In Denmark, the number of municipalities was cut quite dramatically from January 2007 from 271 to 98, with an average population of 55 000 compared with 20 000 previously. The 14 counties have been merged to five regions responsible for healthcare (OECD, 2006a). It should be noted, however, that compared with Hungary municipalities enjoy much less constitutional protection in Denmark.
5. For further discussion about the role of counties, Vigvàri (2002), Fekete *et al.* (2002) and Pálné Kovács (2005).
6. The issue was originally raised in World Bank (2000). Peteri (2006) suggests that the power of line ministries may have lead to less "objective" local grants, basically reflecting strong ministries' control of sector laws.

7. For example, the dissolution of a public education institution is conditional upon a consultation involving the staff of the institution, the school board, the parents and the school's student council, with all these players having veto rights.
8. The law allows local governments to contract out the operations of their hospitals but this does not happen very often. In this case, the hospital becomes a private company and the healthcare workers are no longer public employees.
9. These estimates should be considered with caution, since larger municipalities tend to offer more services, resulting in higher average spending per capita. For recent surveys of economies of scale issues, see Fox and Gurley (2006) and Lotz (2006).
10. Excluding Budapest and the largest cities, Hungary's municipalities average only 1 258 inhabitants. There are 1 020 municipalities with populations of less than 500 and 1 700 of less than 1 000. A number of papers have argued that although mergers and joint provision may allow scale economies to be exploited, such solutions are not without drawbacks. In France, for example, where joint provision is very common, concerns have been raised that they could lead to a failure of democratic control because joint bodies are not elected by the population and are often perceived as lacking transparency (le Saout, 1998). Citizens may therefore be left with little influence over local services. However, these views apply only weakly to countries, such as Hungary, where citizens from small municipalities do not exert a strong voice with regard to local affairs (see below).
11. Before the transition there were 1 500 municipalities and Budapest, which counts as many as 23 districts, was considerably more centralised than at present.
12. The municipalities can only transfer duties that were passed on to them in 1990 as part of decentralisation. Over the past fifteen years many secondary schools as well as a number of hospitals were transferred from the municipalities to the counties by this means. Also, municipal governments have the right to take over the control of any county service as long as it can be proved that over at least the previous four years it has been mostly used by local residents.
13. Joint provision is covered by Act on Local Governments which permits the establishment of inter-communal partnerships on a voluntary basis. Adherence to a joint association requires approval by a qualified majority of the local council and the law does not impose any specific requirement with regard to the sectors the association is going to cover.
14. Notably, boundaries can be adjusted with a four year frequency, within 6 months from the general local government elections. During this period, local governments can opt to join an adjacent micro-region if this is seen as leading to better public services for their inhabitants.
15. The information about the experience of the Koppány Valley Multi-purpose Sub-regional Partnership have been made available to the OECD's Secretariat by the Ministry of Local Government and Regional Development.
16. One would expect that residents of small municipalities can take advantage of proximity to approach local leaders. In practice, at least in Hungary, this does not seem to be a significant advantage. Indeed, a survey data reveals that face-to-face contacts between local representatives and citizens are less frequent than in the larger municipalities. In addition, unlike their larger peers, small municipalities cannot benefit from other oversight mechanisms (*e.g.* stronger competition between political parties, associations of local citizens and media coverage). See Soòs (2002 and 2003) for discussions of citizens' participation in Hungary based on survey data.
17. For assessment details of Hungary's position in OECD policy indicators in procurement see (see OECD, 2005b; Gjersem *et al.*, 2004).
18. For example, in early 2007 the PPAB sanctioned Budapest's District XXIII for failing to call a tender for renovating its buildings. The renovations had been carried out by the same company, which for 2005 alone was given 34 separate procurement projects. In its explanation the PPAB reaffirmed that the law requires local councils to call public procurement tenders for any project whose cost is estimated to exceed HUF 10 million. The amount of the fine equalled roughly 6.5% the combined cost of the 34 renovation projects.
19. These VAT revenues are to be initially paid to the State Tax Authority, implying that also the expenditure-side of the sub national government balance sheet contains this item.
20. "Only" 50 normatives are presented in a special annex attached to the draft budget. See Fox (2004) for more details on this issue.
21. As an illustration of the practical difficulties the system may create, Fox (2004) reports the case of a school that had to follow 23 normatives. Because the primary education normatives are based on the average number of students each day, counts had to be run on a daily basis. Moreover, since the

academic year is affected by two budgetary years, schools and local governments are forced to follows two different sets of definitions and normative values in the same school year.

22. Notably the World Bank report concludes that Hungary has the most complex system among the eight countries surveyed (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia). Lithuania, for example, which has the simplest system in the region according to the World Bank study, targets a fixed level of equalisation using a single parameter. Specifically, the PIT is distributed entirely on an origin basis, with the richer jurisdictions then being required to share part of their revenues with the poorer ones. See World Bank (2006, p. 68).

23. In this case, the 2007 budget law states that the grant is evaluated at 513 HUF per document processed (roughly equivalent to 2€), but at the same time it requires that the total grant value cannot be less than HF 6 million which implies funding for processing 12 000 documents. It seems unlikely that municipalities with only a few hundred inhabitants require processing on this scale.

24. The institutional setting is defined by the Act on Local Taxes under which the central government defines the ceiling but not the floor of local taxes. As a result, the local governments have the right but not the obligation to introduce certain taxes (OECD, 2006e).

25. It should be noted that the local business tax is not subject to horizontal equalisation.

26. The Budapest city hall received 79 letters of complaint during the spring of 2006. Many were from big companies such as German energy provider E.ON, the French supermarket chain Auchan, Hungary's largest bank OTP and more recently the mobile telecom group Vodafone Hungary and the medical group Innomed Medical. In a number of cases, companies brought legal action before national courts against the tax authorities claiming the reimbursement of past payments.

27. However, it is difficult to assess the extent to which this resolution amounts to a precedent since there are also differences between the two taxes. For example, the Italian local business tax also takes into account changes in the value of assets, rather than being solely turnover-based like in Hungary. These differences could lead to a different ruling. In April 2007, responding to a request for an expert opinion from the Europena Court of Justice, the European Commission suggested that the local business tax is not in breach of the EU rule prohibiting more than one turnover based tax.

28. For example, Győr and its surroundings, which make for the automotive centre of Hungary, will focus on the engineering industry and renewable energies. Miskolc, where many chemical companies are already located, will act as an R&D pole in the area of nano-technologies and alternative energies.

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ANNEX 3.A1

The budget balance rules in municipal accounts

By law sub-national governments have to submit a balanced budget. In addition, there is a "deficit grant", that provides immediate relief to municipalities experiencing temporary financial pressures because of unforeseeable developments.

Moreover, there are strict regulations limiting the amount of debt sub-national governments can carry. Annual debt service is limited to "corrected own revenues", namely 70% of own source revenues (defined to exclude revenue sharing) after subtracting the amount of short-term liabilities. The legal framework imposes limitations on the assets and revenue sources that can be used as collaterals and loan guarantees.

Municipal bankruptcy is subject to special legislation under which the creditor or the local government can initiate a bankruptcy proceeding each time a debt is 60 or more days overdue (World Bank, 2006). Cases are examined by a court which can:

- Order the start of debt settlement procedures and designate a financial trustee; or alternatively,
- Determine that the local government can meet its obligations from existing cash flows and assets and establish the conditions for the reimbursement.

The legislation mainly works as a deterrent and has been used relatively sparingly so far. Since the end of the 1990s, there have been eleven municipal bankruptcy cases approved by court decision. Nine cases resulted in a voluntary debt settlement agreement between the parties. In two cases the court followed the recommendation of the trustee and ordered the liquidation of the assets. Interestingly, procedures have never been initiated by the creditors. All were launched by the local governments themselves, most of which were small municipalities with a population below 5 000 inhabitants.

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ANNEX 3.A2

EU transfers to Hungary's municipalities under the 2007-13 budget

Within the 2007-13 EU budget, the most important funds for local governments are the Structural Funds (SF) and the Cohesion Fund (CF), which together sum to € 22.4 billion, (roughly equivalent to 25% of GDP in 2006). These funds are allocated as follows:

- Thematic Operational Programmes (€ 16.2 billion) notably covering enterprise development, transport, human capital, environment and energy. These programmes are funded by a mix of the Structural and Cohesion Funds, plus national contributions.
- Regional Operational Programmes (€ 5.2 billion) that provide funds directly for local development. Only the EU's Structural Funds (plus national contributions) are used here.
- Reserves as well as funds for technical assistance purposes and European Territorial Co-operation (€ 0.9 billion in total).

Municipalities are allowed to apply for both Thematic and Regional Operational Programmes. While for priority projects funding will be decided following a more centralised process, other SF projects will be allocated via open tender procedures. For open-to-tender projects, local government will not only compete with other municipalities, but also with non-governmental organisations (*e.g.* universities, civil associations or private business entities).

It is difficult to predict how much EU development funds will finally be allocated to the municipalities, largely because of the length of the budgetary period and uncertainties about the results of tender procedures. Municipalities received about one quarter of the SF in the 2004-06 EU budget. However, this will probably be higher in the new budgetary period because the municipalities are now more experienced with application procedures and there are greater opportunities opened up by the focus on Regional Operational Programmes. Officials in the Ministry of Finance expect that municipalities will qualify for 30% of all the SFs and 50% of all CF available, roughly equal to 12% of GDP in 2006.

The national contribution comprises a statutory 15% matching grant ("co-financing") to the EU funds (*i.e.* nearly € 4 billion during the seven year period). In addition for some projects additional funds are required to fully finance projects ("own resources of the beneficiary"). The role that municipalities will play in providing co-financing has not yet been finalised, though it is likely that at least as large a share of co-financing will be provided by central government funds. For "own resources" a fund has been in place since 2004 to help poorer municipalities and micro-regions. Municipalities applying jointly can also be eligible for assistance from this fund. For 2007, HUF 10.1 billion is allocated to this fund.

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Chapter 4

Improving reconciliation between work and family

Hungarian family policy focuses on providing generous options to take time off work to look after children. This system not only contributes to Hungary's low employment rate but encourages long separation from the labour market, has largely failed to significantly influence fertility rates and is relatively expensive to run. This chapter looks at how to shift the policy focus towards reconciling work and family life. Reasons for under-provision in childcare by local governments are discussed and recommendations for further central-government intervention to improve supply are made. Recommendations for reform are also made regarding the complex system of family cash benefits and leave allowances.

Hungarian family policy faces significant challenges in improving the reconciliation between work and family life. The current system focuses on providing generous options for women to take time off work and look after children on a full time basis. As Chapter 1 points out, in the context of raising the aggregate employment rate, this issue is not as significant as problems relating to disability and early retirement pensions. However, the long separations from the labour market that the system encourages have downsides for women's careers. Also, claims of significant positive effects on fertility are questionable and the system involves relatively high levels of public spending. The chapter first looks at trends in the number and composition of families and then describes the various forms of financial and in-kind family support. This is followed by an assessment of current policy and detailed recommendations on how the system could be reformed (these are summarised in Box 4.1).

Box 4.1. **Key recommendations on family policy**

The most immediate barrier to better reconciliation of work and family life is under-provision of childcare services which, for example, arises from externalities in human capital development and social cohesion. The following measures should be considered:

- Continued attention to provision requirements. The impact of the changes in provision regulations should be closely monitored and, if necessary, bolstered by further measures. In terms of service flexibility, policy goals laid out in the government's programme, *New Hungary*, should be followed up. In particular, plans to encourage longer operating hours of childcare facilities look promising.
- Reduction in the municipalities' contribution to costs. Further increases in the central-government grant for services could be useful, as long as savings can be found elsewhere in the system – reductions in family cash benefits is one candidate. The restrictions on parental fees could also be lightened.
- New funding arrangements. A system in which vouchers are given to parents to spend on childcare services (possibly in lieu of cash benefit) could be one way of widening provision and allowing subsidies to more strongly reflect parental preferences.

Assessment of the system of cash benefits for families and leave options suggests reforms should be considered that contain the following elements:

- Removal of the universal third-child benefit and significant reform of the benefits for when children are below kindergarten age. Whatever specific changes are considered, possibilities for extended leave ought to be cut back and savings in spending made to help fund childcare services. Some offset could be made through increases in the replacement rate (and perhaps raising of the cap) of the insurance benefit covering standard maternity leave. Increased paternity leave should also be considered.

Box 4.1. **Key recommendations on family policy** *(cont.)*

- Further simplification of the system. Three schemes could be removed without any significant implications for either the universal or targeted "safety net" dimensions of policy. The cash component of the "child social support" is effectively redundant due to the new welfare top-up payments. Also, the maternity grant and the third-child tax allowance provide relatively small cash support that could be integrated into another benefit, such as the family allowance.
- Removal of welfare-traps. Changes to the equivalence scale used in calculating the welfare top-up payments should be considered. Additional measures could comprise extension of the period allowing retention of a share of the welfare top-up payments, or the introduction of earned-income tax credits.

Further work is needed to identify and remove any barriers to the creation of jobs with hours and flexibility that suit working parents. Further reforms that give more flexible choices to public-sector employees would provide a useful lead on this front. Also, when room becomes available to proceed with tax reductions, resumption of the phase out of the lump-sum employers' healthcare contribution ought to be on the priority list.

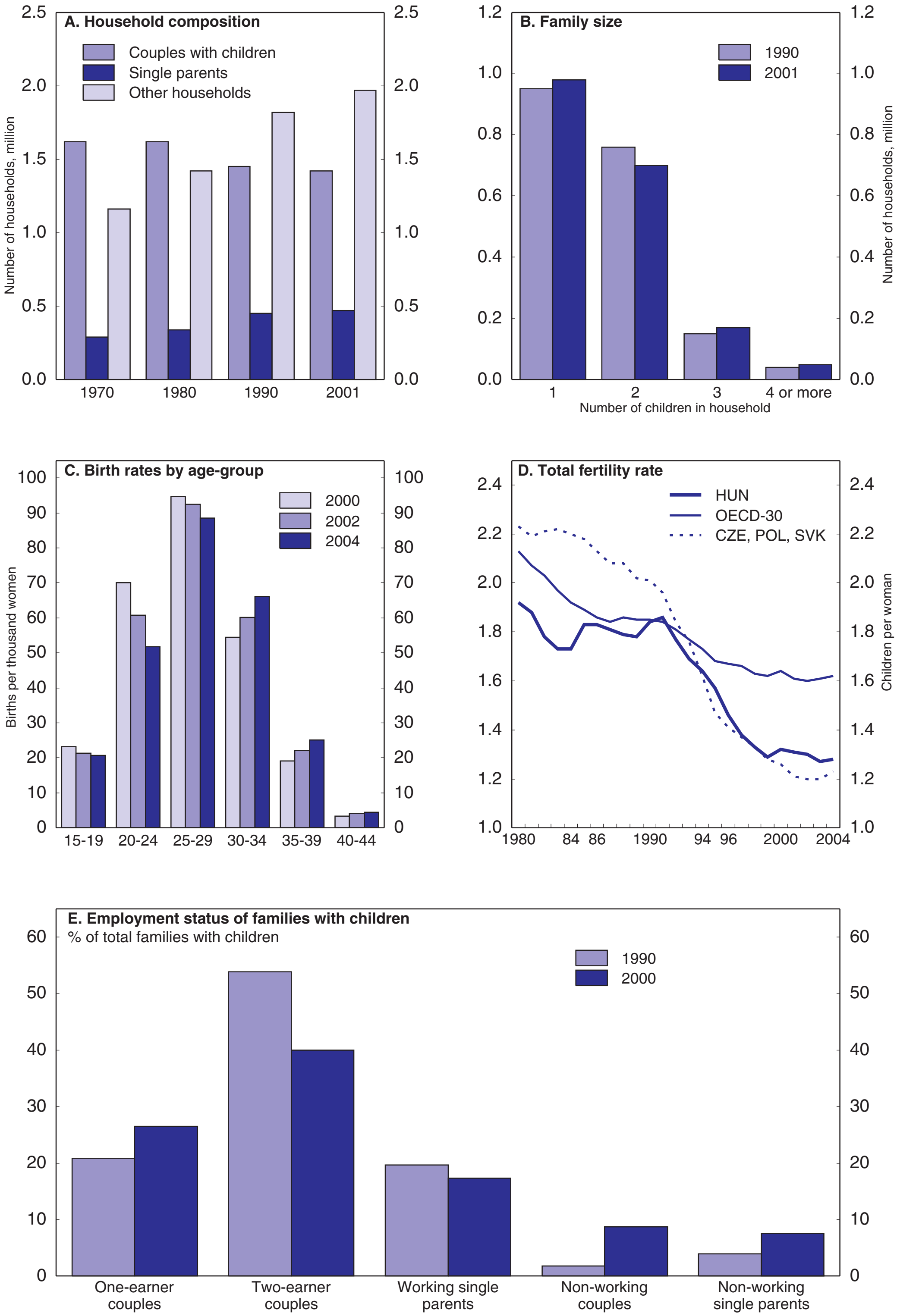
Families in Hungary: some basic facts

Family policy affects a large share of the population. Households with children represent about half of Hungary's 4 million households (Figure 4.1). Furthermore, even among the growing number of households without children, family policy is often relevant, either because of family ties or because children are planned at some point in the future. As elsewhere, single-parent families are now relatively common. Indeed, about one quarter of households with children are headed by single parents.

The shift towards starting families later is still under way. For instance, as shown in Figure 4.1 even since 2000 there have been large changes in birth rates in specific age groups. The birth rate among women aged 20-24 fell substantially between 2000 and 2004 whilst the rates among 30 to 34 and 35 to 39 year olds rose. These figures largely reflect women starting families later (the postponement process), which has been a major factor driving the fall in the total fertility rate (Figure 4.1). Though fertility is expected to start rising in the coming years as the postponement process works through, the pace of increase is uncertain and the eventual "steady state" is likely to be below pre-postponement fertility levels. For a start, postponement means an increased chance that ambitions to have children will be unfulfilled. Furthermore, past trends probably reflect more than just postponement, with increasing numbers of women planning never to have children or, if they do, to have fewer than previous generations.[1]

The changing fertility patterns are affecting the size of families. Comparing census results for 1990 and 2001, the number of households with one child has been increasing while the number of two-child households has fallen (Figure 4.1). Some of this reflects growth in the number of women who, by either choice or circumstance, only have one child. But such shifts can also be temporary, caused by changing fertility patterns such as postponement. The number of households with three or more children is relatively low; totalling less than 20 000 compared with about 170 000 households with one or two children. The slight increase in households with three children shown in Figure 4.1 possibly reflects the effects of several explicit incentives to have a third child.

Figure 4.1. **Key features of families in Hungary**[1]



1. The total fertility rate is the expected number of children that would be born per woman, in her child-bearing years (15 to 49), based on current age-specific fertility rate data. A total fertility rate of 2.1 children per woman ensures broad stability of the population, on the assumptions of no migration flows and unchanged mortality rates. Rates for regions are averages of country rates.

Source: Hungarian Central Statistical Office; OECD, *Society at a Glance*, 2006.

In terms of family working arrangements, two-earner couples remain the most common, accounting for around 40% of households with children (Figure 4.1). However, the share of two-earner families has fallen since the early 1990s due to increasing numbers of single-earner couples as well as non-working couples and single parents. Much of this is due to economic developments. As discussed in Chapter 1, the restructuring of industry in the 1990s has resulted in high levels of structural unemployment (and low employment rates). This has affected the number of earners within families and contributed to weak female labour supply. Indeed, econometric analysis has found female labour-market participation to be strongly influenced by local unemployment rates (Scharle, 2007).

Key features of family support

Hungarian family support can be grouped into long-term financial support, additional financial support for the first years of parenthood and non-financial support. Full details of the schemes are shown in Annex 4.A1 and scenarios illustrating how the system of cash benefits works are shown in Annex 4.A2.

Long-term financial support

The most important universal long term support comes from family allowances. The per-child allocations increase with the number of children (up to the third child) and are higher for single-parent households. From January 2006, more long-term financial support has been channelled *via* family allowances. The per-child allocations were raised while a 13th month family allowance payment was scrapped, tax credits were cut back (there is now only a credit for a third child) and monthly means-tested social support for children was reduced to two small biannual payments. These changes aimed at simplifying the system rather than changing the total level of support to families (see Annex 4.A3).

A system of welfare top-up payments (the "guaranteed social minimum", Rendszeres szociális segély), introduced in June 2006, is now the main element of targeted support to low-income households (with or without children). The top-up covers any gap between reported income and the guaranteed social minimum, which is a multiple of the minimum pension based on family size (see Annex 4.A1). The applicant must be non-employed and typically must agree to engage in certain activation measures to be eligible for benefit.[2] Prior to the introduction of this system safety-net provision was more piecemeal, comprising social security payments for parents and a separate scheme of "child protection support" (which, as discussed above, has been cut back) plus whatever universal benefits the family was eligible for.

Housing support schemes provide implicit support for families because the means tests for eligibility are based on household size. The schemes are administered by local authorities and take the form of cash payments and free, or heavily subsidised, rental accommodation.

Additional financial support for the first years of parenthood

A universal one-off payment is provided at the birth of each child (the "maternity grant"), though this is relatively small in value compared with the other benefits. One scheme, GYES, is available to all families with children aged under three and benefit can be extended beyond age three when there is a third child under a follow-up scheme (GYET). Women covered by social insurance can claim more generous benefits under two schemes:

TGYAS, an earnings-related benefit that spans maternity leave and GYED, which is also earnings-related and can last until the child is two years old.

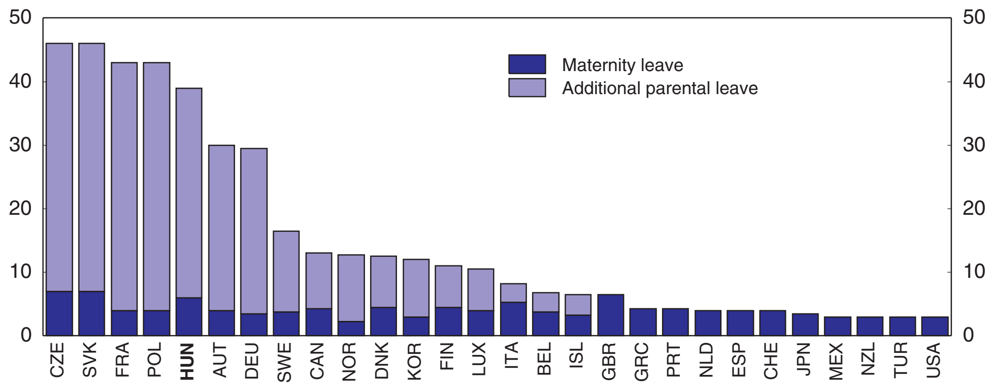
A welcome and potentially important change to the GYES scheme has been made. From early 2006, women have been able to receive GYES while working full time once their child is one year old. Previously, women could only work up to 20 hours per week and be eligible for benefit. Given the small market for part-time jobs in Hungary, the former provision was probably little used. Therefore, it is possible that the relaxation of the rules is bringing about a significant increase in the number of women choosing to work while their children are pre-kindergarten age. However, experts generally agree that it is too early to gauge impact of this change.

Non-financial support

Leave options are generous. The maternity leave allowance is six months. However, being on GYES necessarily involves leave and claimants to GYED have entitlement to leave (claimants to the GYET benefit for third children however forfeit any entitlement to return to their previous employer). In most cases these benefits are claimed by the mother, therefore extending leave entitlement up to three years for each child. This is long compared with most other OECD countries (Figure 4.2).

Figure 4.2. **International comparison of the duration of paid maternity and parental leave**[1]

Duration, months



1. Employment-protected, paid leave of absence for employed parents. Maternity leave is for women at around the time of childbirth (or adoption in some countries). Additional parental leave is additional to specific maternity and paternity leave periods.

Source: OECD, Family Database.

There are relatively few public childcare places available for infants. There are legal obligations for municipalities to provide childcare services. This obligation can be fulfilled through dedicated nursery facilities (*bölcsöde*), licensed day-care centres catering for a small number of children, home care for children on an individual basis, or in some cases through running an integrated system of kindergarten and nursery. Since the early 1990s, the number of places in publicly run or supported childcare services has fallen dramatically. For instance, according to a recent OECD report, only 4% of one to two year-olds are now placed in nurseries or day-care centres (OECD, 2006). The costs of running the nurseries and other types of childcare for infants are partially covered by central-government grants and by revenues from a regulated fee for children's meals. From age three onwards, childcare and early childhood education services are comprehensive. From age three to five there is a system of kindergarten (*óvoda*), with once again only limited fee burdens for parents. Legally, children must go to kindergarten for at least one year but most children attend for the full three years.

Low-income families can be eligible for various forms of means-tested support. These include waivers on the fees for meals in childcare centres and kindergartens, free meals in primary and secondary schools, free textbooks and subsidised travel costs. Families can also get support to cover living costs for children in tertiary education.

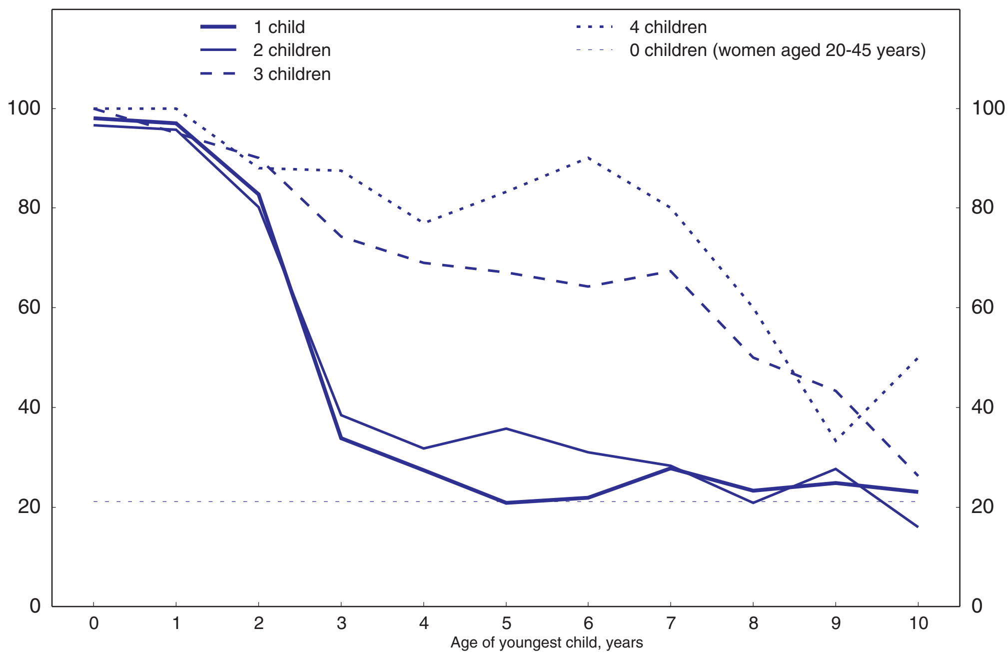
Policy needs to focus more on reconciliation between work and family life

The long leave provisions, backed by cash benefits, and the paucity of childcare services are influencing on mothers' decisions on whether (or when) to join (or return to) the labour force.[3] Though there is no dedicated data that tracks the employment history of women with children, the indirect evidence is compelling. Labour force survey data shows that women's inactivity rates are over 80% whilst there is at least one child aged under three in the family (Figure 4.3).[4] Furthermore, given that about 40% of birth intervals are shorter than three years and a majority of women have two children once they start a family, actual leaves in Hungary are often a lot longer than three years.[5]

There are several difficulties with this approach to family policy. A big risk is that the relatively small number of childcare places reflects poor supply rather than low demand,

Figure 4.3. **Inactivity rates of mothers by the number of children**[1]

Per cent



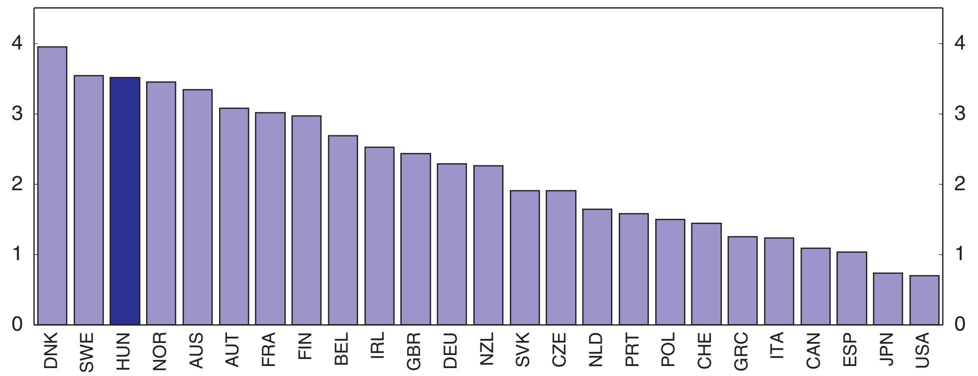
1. Inactivity rate is 100x (1- employment/population ratio). Calculations are based data from the Central Statistical Office's Labour Force Survey for Q2 2005.

Source: Ministry of Finance.

implying that some parents are being denied the opportunity to combine working while bringing up infants. From an economic perspective, very long separation from the labour market reduces women's earnings and career prospects, implying a lower employment rate and weakened human capital development at the aggregate level.[6] Furthermore, the policies are expensive to run. Total spending on cash benefits is relatively high, on a par with Nordic countries and much higher than peer countries, such as the Czech Republic and Slovakia (Figure 4.4). Given the strong need to make improvements in cost-effectiveness in all areas of public spending to help bring government deficits down, this large item of expenditure should therefore anyway come under scrutiny.

Figure 4.4. **International comparison of expenditure on family support**[1]

% of GDP



1. Includes family allowances, parental leave and home-help services and is for 2003.

Source: OECD (2006), Social Expenditure Database.

The extended leave and cash support is sometimes justified on the grounds that it encourages women to have children and is thus helping to resuscitate Hungary's low fertility rate. However, it is doubtful whether this strategy is very effective. The fertility trends shown in Figure 4.1 suggest the impact of these policies on the birth rate has at best been marginal; there appear to be common forces at work on fertility in east-European countries, which are having a dominant effect over any country-specific influences. Econometric evidence also suggests that the influence of cash benefits and leave allowances on fertility is relatively small and contingent on getting other areas of policy right, such as childcare (Box 4.2). Furthermore, any positive impact on fertility from generous leave and cash benefits is probably becoming weaker over time because of the opportunity cost of taking time off work is rising due to increasing education and earnings potential.

Much greater focus on helping parents reconcile work and family life is needed. Childcare provision has to be flexible; capable of meeting current demand and changes in the volume and type of service required by parents. In addition, the right incentives structures have to be in place to encourage parents to work and this suggests a review of the core elements of family support, namely leave and family cash benefits, is needed. Finally, barriers to the creation of part-time jobs and other forms of work that help parents combine work and childrearing need to be removed and, more generally, employers need

Box 4.2. **Recent research on the influences on fertility**

Cross-country evidence on the driving forces behind fertility by d'Addio and Mira d'Ercole (2005) underscores that cash benefits for families to have children are by no means guaranteed to have any significant impact on women's decisions on how many children they have. This is partly because there are stronger policy influences, such as the availability of childcare. This implies that achieving a balanced package can be cheaper and work better than one with ill-matched components. Also, this research on fertility underscores that there are other, more powerful, forces acting on fertility patterns. Most notably, increasing educational attainment and, linked to this, more attractive job and career opportunities for women have been depressing birth rates. This is echoed in time-series regressions on Hungarian data explaining the total fertility rate over past decades by Gal and Gabos (2005) where the coefficient relating to female employment rates is the largest among the explanatory variables. Conversely, the coefficient relating to family benefit, though statistically significant, is relatively small. This research also underscores the possibility of more complex causal connections than those implied by the regressions. For instance, the authors suggest that there may be reverse causality between fertility and women's employment rates.

to be encouraged to develop family friendly work environments. The following sections discuss recent policy measures on these fronts and detail options for additional reform.

Promoting flexible supply responses in public childcare

The very low use of public childcare is plausibly due, in part, to weak demand. Because remaining at home to care for infants has been made relatively attractive, this is likely to have reduced the demand for childcare places. However, a number of factors point to inadequate supply. Several theoretical arguments suggest there may be under provision of childcare services. There can be free-rider problems because municipalities may have to accept children from neighbouring local authorities. Also, negative externalities can arise if the returns to childcare in terms of education and social cohesion are felt outside local community. In addition, local democracies may simply not work very effectively in this instance, such that the voters' demand for childcare do not get appropriately factored into local decision makers' policies. In terms of evidence of under provision, the low number of places, particularly in rural areas is telling. For instance there are only about 50 childcare facilities among the very large number of small municipalities.[7] There are also reports of long waiting lists for childcare places.

Under provision of childcare limits families' options for combining work and family, but it also contributes to social disadvantage, notably for the Roma population. Lack of access to childcare for infants from poor backgrounds is thought to contribute to problems further down the track, such as non-attendance in kindergarten. Overall, there appear to be strong returns to measures that improve municipalities' response to demand for childcare and cater for changing requirements in the type of service offered.

Central government has already stepped up pressure on municipalities to provide services. A regulation requiring localities with a population of more than 10 000 to provide nurseries (*bölcsöde*) was introduced in 2005. Financial support has also been boosted through a significant increase in central-government grants to municipalities for childcare services.[8] Nevertheless, the Ministry of Social Affaires and Labour estimates these grants still only cover about 50% of the costs of running services. According to a recent OECD report, the fees for meals mean that parents effectively pay for about 10-15% of the costs; implying 35-40% is covered by municipalities (OECD, 2006).

Central government should continue to work on providing regulatory pressures and improved incentives for childcare services. Reforms should focus on:

- Continued attention to provision requirements. The impact of the changes in provision regulations should be monitored and, if necessary, bolstered by further measures to increase supply. In terms of service flexibility, an increasing number of childcare centres are reportedly catering for a wider variety of working arrangements on a voluntary basis. Nevertheless, policy goals laid out in the government's programme (Government of Hungary, 2006) to encourage more flexible services should be followed up. The plan to encourage longer operating hours of childcare facilities looks particularly promising.
- Reduction in the municipalities' contribution to costs. Further increases in the central-government grant for childcare services could be considered if savings can be found elsewhere in the system – reductions in family cash benefits is one candidate (see below). The restrictions on fees could also be lightened. The typical fee for meals is around HUF 6 000 per month. This is low compared with other countries. The fees are equivalent to only about 5% of average-production-worker (APW) earnings while in most OECD countries the fees are equivalent to at least 10% of APW earnings and over 20% in several countries (Immervoll and Barber, 2005). If fees were de-regulated, the current system of waivers (or a similar mechanism) would clearly have to be retained to ensure access for low-income households.
- More radically, a voucher system could be considered. At present, competition and diversity in childcare services is weak because subsidies are channelled into either direct provision or providers chosen by the local authority, and fees are regulated. A system for childcare in which vouchers are given to parents to spend on childcare services (possibly in lieu of cash benefit) could be one way of widening provision and allowing the distribution of central-government resources to more strongly reflect parental preferences.

Improving the system of initial financial support and leave allowances

The Hungarian government considers the system of long parental leave allowances and associated cash benefits reflects societal choices for family-based childcare and has no plans for significant change. However, given the high level of spending on cash benefits, the adverse effects on women's careers of long career breaks and the questionable impact on fertility, reforms should be considered. Specifically, options for reducing the duration of leave and benefit provisions should be explored and savings from this channelled into boosting childcare services. A wide range of alternative adjustment packages could be devised to reform the system, but the following common elements should be considered:

- Removal of the GYET benefit. From the childcare perspective, GYET is somewhat superfluous because it comes on stream after all the children have reached an age when they can attend kindergarten. If the financial support from GYET is considered important, it could be replaced by an increase in the per-child family allowance.
- Significant reform of the GYES and GYED benefits. The insurance benefit GYED is currently designed as a purely "stay at home" incentive as women are only eligible if they remain off work and they are not even supposed to claim the benefit if they put their

children in childcare. GYES, with the new rules that allow women to work and claim benefit, does not have this problem. But it does pay out indiscriminately to all families with infants no matter whether the mother has any demonstrable opportunity cost in being a full-time child carer. One way forward would be to introduce vouchers for childcare as discussed above.

- Whatever specific changes are considered, possibilities for extended leave ought to be cut back and savings should sought to help fund increased support for childcare services. Looking at Figure 4.2, a combined maximum length of maternity and parental leave of 12 months, for example, would bring Hungary in line with the norm for a number of other OECD countries. The advantage of keeping maximum paid leave entitlements to one year or less is that overlapping leaves are less likely.

These suggested measures imply radical change to the amount of benefit and length of leave allowances. Indeed, if all extensions to leave were cut then Hungary would swing from having one of the longest leave entitlements to among the shortest. Therefore, some offsetting measures could be built into a reform package. Two possible routes are:

- Increases in the replacement rate (and perhaps raising of the cap) of the insurance benefit covering standard maternity leave (TGYAS).
- Increased paternity leave. In principle, fathers (and other grandparents) can claim GYES or GYED benefit (and the associated leave entitlements) instead of the mother, thus allowing for some flexibility in the organisation of childcare within families. However, provisions for fathers to take leave in the first months following the birth of the child ("paternity leave") are relatively limited (fathers can take up to five days leave in the two months following the birth of each child). A number of OECD countries have sought to help families combine work and childcare by increasing paternity leave entitlements. For instance Belgium, Denmark and Finland allow up to 2-3 weeks paternity leave while in Norway and Sweden as many as 6 weeks can be taken (OECD, 2006).

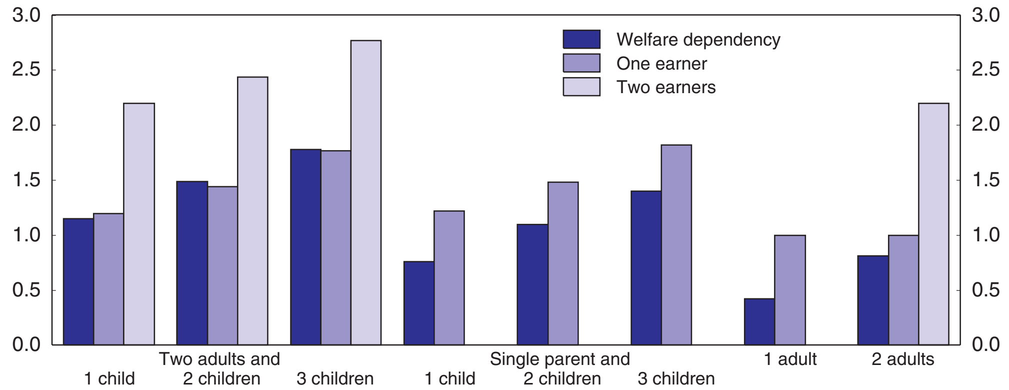
Dealing with welfare traps

As discussed earlier, Hungary's low employment rate means a sizeable minority of households are fully dependent on welfare payouts. The new system of social assistance makes for a more stable income through top-up payments but it does not solve, and may indeed have deepened, welfare traps. There are some provisions to prevent the welfare system from making work financially unattractive. If someone in a welfare-dependent household gets a job, the household receives 50% of the previous top-up payment for the first three months and then 25% for the following three months. After six months, the top-up is withdrawn completely. Though this is better than an immediate 100% withdrawal of benefit, the provision is unlikely to have much influence on families looking at the long-term returns to working.

Simulation results suggest there is indeed little incentive to work once the longer-term situation is considered, particularly given that welfare-dependent households are likely to get only low-wage job offers. This is illustrated in Figure 4.5 that shows the incomes of households in three situations: one where nobody works, another where one person has a minimum-wage job and a third where two people have minimum-wage jobs. In terms of family benefits the calculations only include family allowances, in other words the scenario represents the situation after children start kindergarten, a time when parents are likely to contemplate entering the labour force. As can be seen the welfare trap is deepest

Figure 4.5. **The welfare trap problem**

Family income as a multiple of the net minimum wage



Note: The scenarios assume earners are on the minimum wage. The calculations factor in the minimum family income guaranteed in the top-up system.

Source: OECD calculations.

when only one parent works; family income in this instance is virtually the same as when neither parent works.

The welfare-trap problem could be tackled on two fronts:

- Alteration of the weighting system used in calculating the "social welfare guarantee". The weights used in the equivalence scale are somewhat higher than those used in other OECD countries. The weight of 0.9 for the second (and subsequent) adult in a household is higher than used elsewhere, as are the weights of 0.8 for each of the first two children and 0.7 for third and subsequent children (see Box 4.3).
- Extension of the period allowing retention of a share of the welfare top-up payments when someone gets a job. More radically, earned-income tax credits could be introduced to increase the returns to a single-earner household.

Welfare trap problems aside, the new top-up system may well suffer from targeting problems and this issue needs to be carefully monitored and dealt with as appropriate. Some Hungarian policymakers are sceptical about means-tested benefits in general because of low take-up rates among genuinely needy households and possibilities of abuse due to underreporting of earnings and undeclared in-kind forms of income. Reportedly, these problems are amplified by inadequate administrative structures for means testing.

There also appear to be targeting problems in housing support schemes. Research by the Ministry of Finance cites evidence that housing support does not reach many who are genuinely needy, and that comparatively well off households are among the main beneficiaries (Benedek *et al.*, 2006). Fortunately, the sums involved are not large and so the wastage is not significant in a fiscal sense, nor is the support likely to be distorting household behaviour. Nevertheless, this issue ought to be on the list of priorities in welfare reform.

The various means-tested waivers of education costs can potentially aggravate the welfare traps by further narrowing the gap between effective family income under full welfare dependency and that when one or both parents work. However, there has recently been considerable widening of the waivers, which should reduce this problem. The Ministry of Education has increased access to free textbooks in the 2006-2007 school year

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Box 4.3. **The debate about east-European equivalence scales**

The equivalence scales used by east-European countries in benefit formula such as Hungary's top-up welfare payments tend to use higher weights than in other OECD countries. For example, international comparisons of living standards and poverty commonly use the "modified OECD scale" which attaches a weight of only 0.5 to additional family members. Part of the reason for the high east-European weights is purely historical; relatively generous weighting scales were a feature of the pre-1990s socialist regimes and either inattention to the issue or political difficulties in reducing the weights have prevented reform. But there are technical reasons why higher weights may be appropriate for east-European countries:

- High rates of home ownership imply the differences in equivalence scale weights for family members should be narrower than elsewhere. Full home ownership (*i.e.* without outstanding loans) is common, even among low-income households. Hence, accommodation costs typically do not feature in household living expenses. Because housing is a key source of scale-economies in spending, this implies differences in weights across family members should be narrower in eastern-European countries compared to countries where low-income households pay rent or have housing loan repayments. However, this also implies that the overall generosity of safety-net transfers ought to be lower in east-European countries than elsewhere because housing costs do not have to be covered.
- The relatively low GDP per capita of east-European countries means households spend a lower share of their incomes on consumer durables and more on items, such as food, where economies of scale are weaker. This again suggests the gaps between equivalence scale weights should be relatively narrow. But this also implies that the gaps should be widened over time as these countries catch-up with living standards and spending patterns elsewhere.

and over half of students are expected to be covered. Eligibility for discounted or free meals has also been widened.

Avenues for further simplification

With eight schemes of long and short-term financial support, the system of cash benefits could do with some further simplification. Indeed, three schemes could be scrapped without any significant implications for either the universal or targeted "safety net" dimensions of policy:

- With the introduction of the social welfare guarantee in June 2006, the cash component of "child social support" scheme is now effectively redundant and has anyway been reduced to relatively small biannual payments.
- The maternity grant makes only a small contribution to the total value of financial support. As such, the grant represents unnecessary clutter in family policy and could be factored into one of the other benefits, such as the family allowance.
- The third-child tax allowance – the only allowance remaining following the changes made in January 2006 – could also be scrapped. If deemed necessary this move could be compensated by an adjustment of family allowances.

Encouraging the creation of family-friendly jobs and work environments

The government has recently implemented, or is planning, a range of active measures that focus on encouraging employers to take on working parents and to develop family friendly work environments. Most notably, under the Start Plus programme, as of July 2007, significant reductions in social contributions will be available to employers taking on parents who are receiving the GYES benefit, or whose GYES, GYED or GYET benefit has recently expired. Past initiatives have included the introduction of an annual award (the *Family-Friendly Workplace* Award) to companies and institutions implementing outstanding family-friendly measures and the preparation of a handbook on creating family friendly workplaces as part of an EU sponsored project. Further research on good practice is underway. In addition, some EU Structural Funds are being allocated to support training and other services that help women return to the labour market or to set up businesses, and to disseminate information on creating family-friendly work environments.[9]

The government is also using its role as an employer to promote family friendly working arrangements with the introduction of provisions for working from home for central-government employees. Further reforms that give more flexible choices to public-sector employees would not only directly affect a large number of workers but also provide a lead for changes in working arrangements elsewhere.

In addition to active measures, the authorities should seek to remove barriers that may be preventing the creation of jobs that can more easily be combined with childcare. In Hungary, the market for part-time and other non-standard working arrangements is small.[10] One reason for this could be that the leave entitlements have so far meant little demand for such jobs. The lump-sum healthcare contribution is also thought to have dissuaded the creation of short-hours jobs. The final phase-out of the contribution is on hold as part of the government's austerity package. However, when fiscal room allows some tax reduction, resumption of the phase out ought to be given priority.

Notes

1. Demographic projections produced for the Hungarian Central Statistical Office (Hablicsek, 2006) have a baseline where total fertility rises and then stabilises at 1.5 from 2020 onwards and two variants in which fertility remains roughly constant at 1.3 and where it stabilises at 1.8 from 2025 onwards. These figures suggest that, at best, the recovery in fertility will indeed be below that required to maintain population constant (abstracting from the effects of net migration and increases in life expectancy).
2. Households with earned income are not precluded from applying for the top-up. For instance a non-employed person can apply for the top-up while their partner is working. However, in practice, eligibility in such circumstances is rare because with only one full-time earner at the minimum wage, total family income will typically exceed the guaranteed social minimum once other benefits are taken into account.
3. The role of childcare and cash benefits on women's choices for a number of OECD countries is reviewed in the OECD's *Babies and Bosses* series (Hungary has yet to be covered in this project). The Austrian system (*Babies and Bosses, Volume 2*), for instance, has some similarity with the Hungarian system in that cash benefits and parental leave options encourage full-time parental care when children are young.
4. In the Hungarian data only during the first months of maternity leave are women classified as being in employment. In some countries both maternity and parental leave is classified this way, making for apparently much higher activity rates.
5. Statistics on birth intervals produced by the Hungarian Statistical Office show less than 5% of birth intervals are less than one year while a large share of intervals (about 40%) are longer than one year but less than three.

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6. A number of econometric studies have looked at the relationship between maternity leave and earnings. A study by Rhum (1998), for example, finds that the earnings of women entitled to nine months leave are 3% lower compared with when leave entitlements are only up to three months.
7. This figure is taken from Hungarian Central Statistical Office (2002). This publication also illustrates the wide disparities in the supply of childcare places between urban and rural areas. For instance, the statistics show there are roughly 20 childcare places per 100 children aged 0 to 2 years in Budapest while in villages there is, on average, only one place per hundred children.
8. There has been a 50% increase in the per-child grant for nurseries and a 250% increase in the grants for family day-care between 2004 and 2007. In 2007, the per child central-government grant is HUF 547 000 for nurseries and HUF 250 000 for family day-care.
9. Plans to use Structural Funds to support the labour market participation of women are outlined in Section 5.5 of the *National Development Plan of Hungary 2004-2006* and similar proposals are made in the *2007-2013 Plan*. Six working groups have been set up to implement the European Commission's Roadmap for Equality between Women and Men 2006-2010, and another working group is dealing with the question of wage inequalities.
10. Less than 5% of employees in Hungary have jobs involving fewer than 30 work hours per week. In most OECD countries the share is at least 10% and in many it is over 20%.

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ANNEX 4.A1

*Details of family support**

Table 4.A1.1. **Long-term financial support for families**

(benefit amounts as of 2006)

	Duration and nature of benefit	Benefit amount	Other considerations
Family allowance (*Családi pótlék*)	Universal benefit for each child up to completion of secondary education (with an age limit of 23).	Two-parents families (monthly amounts per child): One child, HUF 11 000; Two children, HUF 12 000; Three or more children, HUF 14 000. Single parents: One child, HUF 12 000; Two children, HUF 13 000; Three or more children, HUF 15 000.	The allowance is not counted as taxable income and no other deductions are made (such as pension contribution). A 13th month payment was abolished in January 2006. When children are no longer eligible, the per-child allowance is not reduced for younger siblings.
Family tax credit (*Családi adókedvezmény*)	Available to families with three or more children. The age limits are the same as for the family allowance.	HUF 4 000 per month per child. The credit can be split between both parents but it is non-refundable.	Tax credits for families with one or two children were scrapped in January 2006.
Child social support (*Rendszeres gyermekvédelmi kedvezmény*)	Per capita household income must be below 120% of the minimum old-age pension (130% for single parents).	Biannual payments of 5 000 HUF (in July and in November). Support also entails various in-kind benefits.	This scheme replaced a more generous system of monthly means-tested child protection support in January 2006.
Supplementary child social support *(Kiegészít gyermekvédelmi támogatás)*	Only guardian's (*e.g.* grandparents) of children who are receiving Child social support are eligible.	22% of the minimum old-age pension per month per child, plus biannual payments of HUF 7 500 (in July and in November).	The scheme was introduced in April 2006.
Guaranteed social minimum (*Rendszeres szociális segély*)	A top-up payment that brings family income up to a specified level. The applicant must not be employed and typically must agree to engage in certain activation measures. This requirement does not apply to those with disabilities.	A multiple (the "per capita equivalent") of 90% of the minimum monthly pension based on the following scale: 1 for first adult; 0.9 for second (or other) adults; 0.8 for each of the first two children; 0.7 for the third and subsequent children (each).	This system was introduced in June 2006. If the claimant gets a job, the family gets 50% of the previous top-up payment for the first three months and 25% for the following three months.
Home maintenance support (*Lakásfenntartási támogatás*)	Two means-tested schemes operate, one centrally defined and one locally defined. Both are administered locally.	Eligibility is based on per capita income and the size of the apartment or house. Some benefits are in-kind (for example, rent-free or reduced-rent accommodation).	Payout amounts are not typically very large. For example, a household budget survey by the Hungarian statistical office for 2003 puts the average value of support at about HUF 3 800 per recipient household.

* The tables describe the system in place in 2006 and aims to show the support available for the large majority of households. Notably, details of additional financial support for disabled children are not included.

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Table 4.A1.2. **Additional financial support for the first years of parenthood**

(benefit amounts as of 2006)

	Duration and nature of benefit	Benefit amount	Other considerations
Maternity grant (*Anyasági támogatás*)	One-off payment at birth.	225% of the monthly minimum pension.	Not counted as taxable income.
Pregnancy and confinement benefit (***Terhességi gyermekágyi segély,*** **TGYAS).**	Payable up to 24 weeks and designed to cover statutory maternity leave. Eligibility requires claimant is insured. Insurance requires 180 days contributions over the previous two years. Time spent in secondary and tertiary education count.	70% of daily average *gross* earnings over the 180 days prior to the birth of the child. If another child is born before the mother goes back to work then there is a ceiling to the benefit of 70% of twice the minimum wage.	Not eligible if the claimant has any other form of income (with exception of the family allowance). The benefit is taxable and the pension contribution (8.5%) is deducted.
Childcare benefit (***Gyermekgondozási díj,*** **GYED).**	Available from end of pregnancy and confinement benefit until the child reaches two years of age. Eligibility requires claimant is insured (as for TYGAS).	Same benefit level as TGYAS, except that the ceiling of 70% of twice the minimum wage always applies. The benefit can be paid to fathers instead of the mother.	Subject to the same conditions regarding other forms of income as TYGAS. The claimant is not eligible if they put their child in nursery school. Taxable but the pension contribution (8.5%) is deducted.
Childcare allowance (***Gyermekgondozási segély*****, GYES)**	Available from birth of child until aged three years.	The value of the minimum old-age pension (HUF 25 800) per child. The benefit can be paid to fathers or grandparents instead of the mother.	As of January 2006, once the child is 1 year old claimants can work full time with no loss of benefit (previously the claimant could only up to 20 hours per week and remain eligible). Not taxed if there are no earnings but pension contribution (8.5%) is deducted. The benefit is included in taxable income if any earnings are claimed.
Child raising support (***Gyermeknevelési támogatás*****, GYET).**	Available to families where there are three or more children and the youngest is aged between 3 and 8 years.	The value of the minimum old-age pension (HUF 25 800).	Same as GYES.

Table 4.A1.3. **Other forms of support for families**

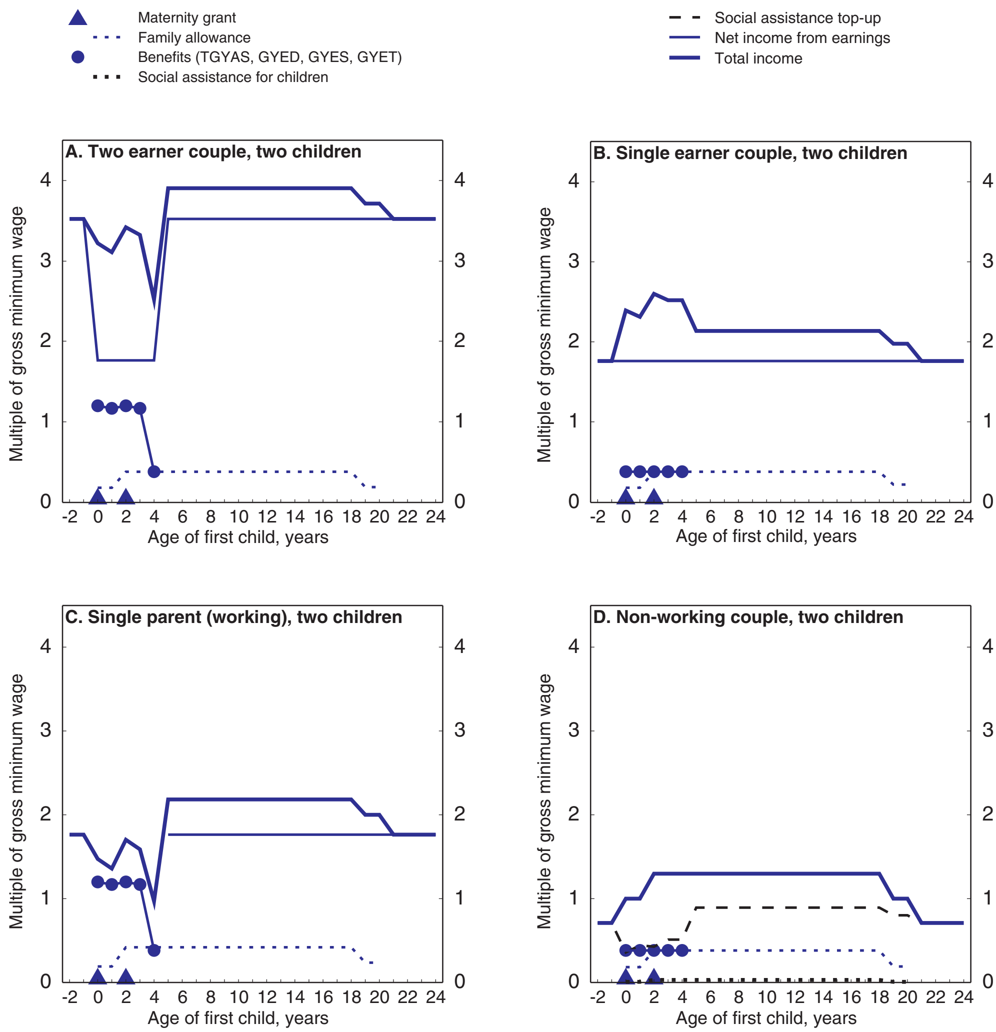
Medical care	• Pregnancy and childbirth as well as children's medical care are covered by the state. In the plans for a tiered healthcare system formulated following the 2006 general election, medical care associated with childbirth and children would have universal coverage. There are no special waivers on fees for prescription drugs for children. There are no significant barriers to establishing private clinic services for pregnancy and childbirth.
Maternity, paternity and parental leave	• Maternity leave is 24 weeks and is typically taken from 4 weeks before childbirth until 20 weeks after (a minimum of 6 weeks must be taken). Employers must place those returning to work back in their original post, or an equivalent position, and at same pay grade (or higher). • Paternity leave of 5 days can be taken within the first two months after childbirth. • Claimants to either GYES or GYED benefit (but not GYET) are entitled to leave from their employer with the same rights as under maternity leave. • Two supplementary days annual holiday for one child aged under 16, four days for two children and 7 days for more than two children. • During the first 6 months of nursing a working mother is entitled to an extra hour off work, twice a day, followed by one hour off until the ninth month.
Childcare centres and kindergarten	Childcare centres • There are legal obligations for municipalities to provide childcare for pre-kindergarten age children (*i.e.* aged under 3 years). As of 2005, there are also requirements that municipalities with populations over 10 000 have to set up nurseries (*bölcsöde*) which typically have 20 to 100 places. Otherwise, childcare services typically take the form of smaller day-care centres catering for up to 7 children, or through the employment of child carers to run day-care or help families on an individual basis. The day-care centres can be run from private homes or by non-governmental organisations. • Childcare facilities are typically open 8-10 hours per day and close in the summer for 4 to 5 weeks. Working parents usually get priority in the allocation of places. Service quality is maintained by a system of licences, a register of childcare experts and by external checks and evaluations. Kindergarten • One year of kindergarten (*óvoda*) covering ages 3 to 5 is compulsory (most children are in fact sent for the full three years), municipalities are responsible for provision and get state financial support for this (provision rules are lighter for small communities). The Ministry of Education is responsible for overall regulation and policymaking. Kindergartens are open 10 hours per day for 50 weeks of the year. Fees • For both kindergarten and day-care there are only fees for meals (indeed, the local authorities are not allowed to charge any other type of fee). Children from families getting the "child protection support" are exempted and families with three or more children get a 50% reduction. Quality assurance • A uniform system of quality assurance applies to both public and private providers of childcare and includes regulations on carers' qualifications and a system of licensing involving annual checks on services.
Primary and secondary schooling	• Available free-of-charge in state schools. Private schools (relatively small in number) are subsidised by the state. • Schools must provide after-school supervision for students up to age 12. • School meals, text books and travel costs are provided free of charge, subject to means-testing.
Tertiary schooling	• The state subsidies tuition costs in public universities (see Chapter 2). • Support for student living expenses is available based on family income. Indirect subsidy is also *via* state-supported loans (see Chapter 2).

ANNEX 4.A2

The influence of cash benefits on family income

To illustrate how the system of family benefits works, Figure 4.A2.1 shows the components of family income under various scenarios. All the scenarios assume children are born two years apart (approximately the median birth interval), that full use is made of

Figure 4.A2.1. **Family incomes: some illustrative scenarios**



Source: OECD calculations.

available benefits and leave options and that earners are on the average wage (an estimated figure of HUF 110 000, net, per month is used). To provide a metric, all components of income are expressed in multiples of the gross minimum wage (HUF 62 500 in 2006).

The first panel of Figure 4.A2.1 shows the income of a working couple who have two children. First off, the family gets the universal maternity grant with the birth of each child. More importantly, family allowance payments also begin at the birth of the first child and increase when the second child is born. On top of this, for the first six months after the birth of each child the women gets the earnings-related TGYAS benefit and this is followed up by the second component of insurance benefit, GYED, which lasts until both children are at least two years old. After GYED expires, the family is eligible for one year of GYES benefit because the youngest child is not yet three years old. When both children are over three (and eligible to go to kindergarten), the mother is assumed to return to work (leave has totalled 5 years) and the family allowance is the only benefit.

The second panel of Figure 4.A2.1 illustrates the case of a single-earner couple, the second most common form of household. The mother is assumed to have not worked before starting a family and does not enter the labour force when the children start school. The main difference with the two-earner couple is that additional financial support for the early years comes from the GYES benefit only – this lasting from the birth of the first child until the second child reaches kindergarten age (five years in this scenario). The third panel shows a scenario for a working single parent. The structure of benefits and length of leave is the same as for the working couple, but the family allowances are higher. The fourth panel illustrates the case of a welfare dependent couple with two children. On top of the universal maternity grant, family allowance and GYES benefit, the family gets biannual social support payments. However, the most important influence on family income is the top-up under the new social guarantee.

ANNEX 4.A3

Impact of the January 2006 changes to financial support for families

In January 2006, the per child family allowances were increased significantly but at the same time several cuts in financial support were made: a 13th month family allowance payment was scrapped, tax allowances were removed (except for when families have a third child) and child social-security support was cut back from monthly payments to a relatively small biannual payment.

The Table below illustrates the impact of these changes by comparing the value of benefits in January 2005 with those in January 2006. As can be seen the impact on the total value of benefit is relatively small.

Table 4.A3.1. **Comparison of family support between 2005 and 2006**

All benefit amounts in HUF 000 per month	Number of children		
	1	2	3
Example 1: Very low income family (family allowance plus child protection support but no tax credit)			
Value of support January 2005	10.9	24.2	41.6
Value of support January 2006	11.8	25.7	44.5
Difference	0.9	1.4	3.0
Example 2: Other families (family allowance plus tax credit but no child protection support)			
Value of support January 2005	8.5	21.4	55.4
Value of support January 2006	11.0	24.0	54.0
Difference	2.5	2.6	–1.3

Source: OECD.

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Glossary

ÁAK	State Motorway Management Company
APW	Average production worker
ARP	Advanced Retirement Pension
CAP	Common Agricultural Policy
CF	Cohesion Fund
CHP	Combined heat and power
EPL	Employment protection legislation
ESA95	European System of Accounts
ERM II	Exchange-rate mechanism II
FIDESZ-MPSZ	Young Democratic Alliance-Hungarian Civic Union
GYED	Childcare benefit
GYES	Childcare allowance
GVH	Hungarian Competition Authority
GYET	Childcare raising support
HUF	Hungarian forint
IEA	International Energy Agency
KDNP	Christian Democratic Peoples' Party
MÁV	Hungarian State Railways
MAVIR	Hungarian Transmission System Operator Company
MDF	Hungarian Democratic Forum
MNB	Magyar Nemzeti Bank (the Central Bank)
MSZP	Hungarian Socialist Party
MVH	Agricultural and Rural Development Office
MVM	Hungarian power companies
NA	National Motorway Company
NAO	National Authorising Office
NFÜ	National Development Agency (successor of the National Development Office, NFH)
NHIFA	National Health Insurance Fund Administration
NUTS	Nomenclature of territorial units for statistics
PAYG	Pay-as-you-go
PIT	Personal income tax
PPP	Public-private partnership
SAO	State Audit Office
SF	Structural Funds
SME	Small and medium-sized enterprise
SZDSZ	Alliance of Free Democrats
TGYAS	Pregnancy and confinement benefit
VAT	Value-added tax

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