

*The New Equilibrium Programme*  
*2006-2008*

## *Achieving long term equilibrium in the state household*

The Hungarian economy is strong, and it is developing dynamically. However, decided steps to reduce the increasing deficit of the state household have become absolutely necessary.

Some smaller fluctuations apart, the Hungarian economy has been moving on a steady growth course since 1997. However, the balance of the state household regularly topples every 3-4 years, and one- or two-year adjustment programmes (that sometimes require some serious sacrifices) are followed by a repeated disruption of the equilibrium, and growing rates of deficit and public debt. The outstanding 8-9% budget deficit rates in the years of government changes are explained only partially by the generous policies of governments approaching an election cycle or trying to deliver on their election promises. The reasons for the disruption of the equilibrium lay deeper, in the functioning and role of the state. While there have been massive changes in the business sector in the past fifteen years, and millions of people, several hundreds of thousands businesses have learnt to adapt to the ever sharpening competition, these changes have hardly had any impact on state institutions: the state operates in an almost static state, with unchanged structure and tasks. The maintenance and operation of this large state that distributes almost half of the national income with unaltered tasks and responsibilities have forced, and repeatedly force rapid increases in spending.

It has become clear by today that the loss of budget equilibrium that resulted from the measures of the two governments between 2001 and 2003 cannot be repaired by traditional measures, or it could be done temporarily only like it had happened in the past. Unchanged tasks and institutions would, sooner or later, coerce the rapid increase of spending unless the role of the state is changed, which has been postponed for decades.

The government programme heralds a fundamental turnaround in economic policy. The government links short term measures necessary to restore the equilibrium of the state household with the overall transformation of the roles and functioning of the state, the reform of the state. The government creates the conditions for long term sustainability of the equilibrium by achieving the leaner and more efficient, performance oriented operation of central and local administration, by transforming the system of municipalities, healthcare, education and social services, i.e. by creating a leaner, modern state that provides higher quality services to the citizens.

However, achieving equilibrium is not only an economic category for the government, which is about the balance of state revenues and expenditures or the reduction of the deficit. By creating the new, modern state and by transforming the public train of thought that expects a solution for every problem from the state, we should strike a balance:

- in enforcing the values of competition and solidarity, efficiency and justice;
- the scheme of rights and obligations;
- the relationship of public and private responsibility;
- the relationship of the state and the citizen;
- the distribution of roles among the state, the economy and the non-governmental sector.

However, the reforms launched and the transformation of large systems do not yield real savings but after a few years only. This is why it is necessary to reduce wasteful spending by the state – already pointing towards reform –, and to increase revenues. In lack of these reforms, the deficit of the budget would come close to 9.6% this year, and we would even lose hope that the conditions for the equilibrium and joining the euro zone can be created by the middle of the term.

In order to achieve the equilibrium of the budget, the government introduces prompt and decided measures to reduce spending and increase revenues that will improve the balance of the budget by HUF 350 billion and more than HUF 1,000 billion this year and in 2007 respectively, as compared to the trend that would occur without the measures. In terms of the budget deficit, this will result in the following:

- the deficit comes down to 8% with the adjustment for private pension funds in 2006
- it will reach app. 5% in 2007 (already without respecting the private pension funds adjustment as required by Eurostat), and
- it reaches 3-3.5% in 2008. Regarding the fact that in case of a deficit that is only slightly higher than 3%, in this case 40% of the impact of the pension reform (0.6%) can be respected at valuation – the adjusted deficit falls under 3%.

The reforms launched immediately in public administration, municipalities, healthcare, education, and almost all areas of the operation of the state will result in achieving the conditions by 2008-2009 that can guarantee long term preservation of the equilibrium, further reduction of the deficit and public debt, and they will even allow the smaller state to claim smaller and smaller contributions to the implementation of joint objectives each year.

## „Politics to start with themselves” – reducing state expenditures

The state starts reforms and cost cutting with itself. The transformation of central administration and the municipality system results in substantially reduced costs over a period of one to two years only, however, this requires that the decisions are taken and start to be implemented without delay.

### 1. Reducing the operational costs of ministries

The government has reduced the number of ministries from 14 to 11, and the number of ministers from 17 to 12. This is not reflected in reorganisations – that often tend to result in further increase of the headcount – but also a *substantial cut in the headcount of ministry administration and in the operating costs* through reformulating tasks and functions.

- The number of senior managers at ministries has been cut to half, and the number of permitted ministry staff has been reduced by more than 20%.

**A minisztériumok igazgatásának létszáma**

	2006. eredeti létszám	Új minisztériumok engedélyezett létszáma	Létszám változása
Politikai és közigazgatási államtitkár (új: államtitkár)	42	15	-64%
Helyettes államtitkár (új: szakállamtitkár)	95	51	-46%
főosztályvezető	426	230	-46%
<b>felsővezetők összesen</b>	<b>563</b>	<b>296</b>	<b>-47%</b>
<b>Minisztériumok engedélyezett létszáma összesen</b>	<b>8 057</b>	<b>6 167</b>	<b>-23%</b>

- In order to save more public funds, the number of cars used by ministries is reduced by 42%, from 751 to 433.
- The combination of staff redundancies and saving measures results in a real cut in the administrative costs of ministries by 2007-2008. (There are no savings in 2006 because of the non-recurring costs of reducing staff.)

### Administrative costs of ministries

2006.	HUF 80 billion
2007.	HUF 65 billion
2008.	HUF 60 billion

All of this means that the administrative expenses of ministries that used to be more than HUF 100 billion in 2002, will be reduced to 60% of that amount on nominal value, and to less than half in real terms by 2008.

- A new government quarter will be established in order to achieve more cost efficient placement and closer professional co-operation among the ministries. These

institutions use approximately 350 thousand square meters of net useful office space, scattered around mainly in outdated buildings. Constructed from private capital, the new government quarter can host the already reduced number of the administration on 160 square meters of state of the art space.

- \* Approximately HUF 75 billion of revenue can be generated from selling vacant property.
- \* The current annual operating costs of ministries reaches HUF 5 billion, while the rental costs of the new properties, including operating costs, are estimated to reach HUF 6.5 to 7 billion at market rates. The half of the annual interest savings from the revenues generated from selling the existing properties continually covers the difference of the two sums.

## 2. Transforming central budget institutions

The regional reorganisation, consolidation of current, scattered and often overlapping institutions, the elimination of redundancies will create organisations that are more efficient than today and provide better services at lower prices.

- More than 192 county agencies will be *reorganised on a regional basis* including the Police, the Traffic Control Supervisory Authority and the county directorates of the Tax Authority.

This reorganisation makes sure by 2008 that:

- ⇒ the number of staff working at these organisations will be reduced by 4,400 persons
- ⇒ operating costs will decrease by HUF 15 billion

- A total of 119 institutions with similar tasks will be *consolidated*. For example the Central Data Processing, Registration and Election Office will merge into the Centre of Electronic Public Services.

The reorganisation will make sure by 2008 that:

- ⇒ the number of staff working at the consolidated institutions will reduce by 4,000 persons
- ⇒ operating costs will decrease by HUF 10 billion

- 32 institutions will be *terminated* because their tasks are no longer justified. Some Border Police Directorates operating on internal borders with the European Union are included.

The shutdown of these institutions will make sure by 2008 that:

- ⇒ the number of staff employed there will reduce by 4,100 persons
- ⇒ operating costs will decrease by HUF 12 billion

## 3. More efficient functioning of municipalities

The implementation of the municipality reform, the reasonable and efficient reorganisation of responsibilities of municipalities not only improves the level of services but also allows the reduction of operating costs.

- The establishment of *regional municipalities* – a measure that requires two-third majority support in the Parliament – could substantially reduce the costs of administration. County governments – not including duty offices – spend approximately HUF 35 billion on administration. The concentration of these tasks onto the regional level could result in savings of HUF 11 to 13 billion, and the reorganisation of relevant institutions can yield additional cost efficiency benefits.
- The mandatory requirement to establish sub-regional *intercommunal associations* could result in saving several tens of billions of forint; and it would allow simpler, more transparent financing with a smaller number of combined normative payments and more allocated income. If no two-third majority can be achieved in the Parliament, incentives and regulatory measures can still be used to motivate the establishment of intercommunal associations to provide better services and more cost efficient operations.
- The government proposes that independent mayor's offices should cease to operate in settlements with less than 1,000 inhabitants, and they should join *district clerks' offices* compulsorily. Currently there are 300 settlements with less than 1,000 inhabitants where the municipalities maintain independent offices, and their operating costs reach HUF 6 billion. The establishment of district clerks' offices will result in savings of at least HUF 2 billion. The government will incentivise the further spreading of district clerks even if the necessary two-third majority support cannot be attained.
- It is reasonable that *local municipalities also reduce their operating costs by 5%*. Looking at the level of municipality spending of HUF 450 billion on administration in 2005, this may lead to another HUF 20-25 billion in savings.
- In the current system, 25,000 local municipality deputies receive a total of HUF 20 billion gross in remunerations, and another HUF 5 billion in cost reimbursements. If the *number and fees of deputies can be reduced*, this could lead to HUF 8-10 billion saved at municipalities.

#### 4. Cost cutting in the current year

The *government also takes immediate actions to reduce the costs by HUF 150-170 billion already this year* in addition to the reform-type changes that can have an impact over 1-2 years only. These measures include the freezing of funds at central budget institutions, ministry allocations and the state household reserves; measures are taken to lower the excessive cost level of the pharmaceutical budget and therapeutic and preventive measures.

## **„Wealth is an obligation” – More responsibility**

Achieving equilibrium requires efforts and additional contributions from all. However, justice and equitableness require that those who have more should also carry a bigger liability for our joint burdens. Those who have more opportunities also carry a bigger responsibility for the community.

### **1. More just distribution of public burdens – whitening skimmed incomes**

People are right when their sense of justice is hurt that there are many who, having massive wealth and living in visible luxury, make less contributions to the joint expenses, or do not pay in proportion to their real incomes, while employees must pay tax and contributions after every penny. The government wants to take decided action to strengthen tax and, through that, civil discipline and liability, but it will also allow that “omissions” from previous years be remedied by the tax subjects at preferential conditions, thus whitening their concealed incomes and wealth.

- ***Wealth accumulation reviews at 10,000 taxpayers***

There were but a few hundred reviews into the accumulation of wealth of persons, a comparison of their wealth against their incomes in the past few years. The amount of tax arrears determined reached up to HUF 10 million for an individual taxpayer in these audits. The Tax Authority will order a review of wealth accumulation at 10,000 taxpayers in 2007. These audits will compare the wealth of the given person against their incomes as declared in the tax returns in the 5+1 years of statutory limitation for tax purposes.

Prior to the conduct of such audits there will be a possibility to declare, through self-audit, previously unpaid taxes at particularly preferential conditions. Those who use this opportunity of self-audit by 31 December 2006,

⇒ will be released from not only the fines but also the payment of the self-audit fee.

⇒ can be granted a five-year period to pay the tax arrears in instalments.

The payment of taxes after several tens of billions of previously concealed income is expected as the result of self-audits and wealth accumulation reviews.

- ***Taxing unreasonably high amounts kept as in-house cash at hand***

There is no limitation to the amount of cash kept as in-house cash at hand today, so that a large portion of businesses declares unreasonably high amounts kept as cash, which sums, however, do not really exist. These amounts are, more often than not, used by the shareholders of the businesses for their own purposes, as tax free personal income. In order to reduce the volumes kept as cash, i.e. to rule out the possibility of hiding personal income from taxation, there will be 20% (tax or fine, depending on the legislation) introduced from 2007 on the average daily closing amounts kept as cash at hand beyond the amount reasonable for business purposes.

Those who want to reduce the cash at hand before the introduction if this tax can do so at a preferential tax rate of 10% and with payment by instalments.

The economically unreasonable amounts kept as cash at hand may amount to HUF 100 billion. The reduction of this at the preferential rate could result in tax revenues of HUF 10 billion.

- ***Expected tax – introducing the lump sum corporate tax***

A substantial portion of businesses pretend to make negative profit for years; and thereby they completely exempt themselves from the obligation to pay corporate tax. All tax subjects under the purview of the corporate tax are required to pay corporate tax after a certain minimum profit that can be expected for economical viability.

The expected tax:

- ⇒ is based on 2% of the total revenues less the price of goods sold, if the corporate tax base does not reach that amount.
- ⇒ The rate of tax is, according to the rules of the corporate tax law, 10% up to and 16% beyond a tax base of HUF 5 million. (The obligation to pay the 4% solidarity tax also applies to tax subjects who pay the expected tax.)
- ⇒ The taxpayer may request exemption from the payment of this tax in the cases defined in the law.

The introduction of the expected tax will increase the revenues from corporate tax by app. HUF 55 billion in 2007.

- ***Allowing the transfer of wealth kept in abroad at the payment of a one-off tax***

Private persons and businesses have accumulated substantial wealth in abroad for various reasons over the past fifteen years. Some estimates say that the total of that wealth reaches HUF 1,000 billion. It is our national interest that this wealth returns to the country. Therefore, not unlike other countries of the European Union, we shall allow private persons and businesses one opportunity to transfer their money kept in abroad back to Hungary against the payment of a single tax and under an amnesty.

A separate law will provide on the terms and conditions of such transfer back, which provides that:

- ⇒ wealth can be returned from countries only that are compliant with the international requirements on money laundering;
- ⇒ the rate of tax is 10% of the amount transferred, to be deducted by the bank and forwarded to the Tax Authority;
- ⇒ the preferential transfer back option applies to all private persons and businesses, except for the members of the government and members of parliament.

We expect that HUF 50-100 billion will be returned to the country under this preferential scheme, thus resulting in revenues of HUF 5-10 billion.

- ***More efficient action against tax fraud***

The currently fragmented investigative system of tax fraud (police, customs guard) will be centralised into one organisation. An armed law enforcement agency, the Customs and Finance Guard holds investigational and examining authorities over

customs and excise matters, which will be extended to other event of tax fraud that belong under any other tax authority.

## 2. Solidarity tax

In the spirit of a just distribution of public burdens, profitable businesses and private persons with an annual income over HUF 6 million must pay special solidarity tax.

- *Special solidarity tax of private persons*

Private persons with a combined annual income of more than HUF 6 million must pay a special tax from January 2007.

⇒ The tax base is the portion of the income over HUF 6 million

⇒ The tax rate is 4% of the income over HUF 6 million

The solidarity tax of private persons generates an income of HUF 24 billion in the budget in 2007.

- *Special solidarity tax of businesses*

All corporate tax subjects, profitable businesses and sole traders must pay solidarity tax from September 2006.

⇒ The tax base is the profit before tax of the business, and no credits or allowances apply.

⇒ The tax rate is 4% of the tax base.

The solidarity tax of businesses results in HUF 40 billion and HUF 170 billion extra revenues in 2006 and 2007 respectively.

- The substantial portion of the profit of *credit institutions and insurance companies* derives from the demand generated by interest subsidies and tax incentives provided by the state. In order to make sure that these institutions make an extra contribution to the restoration of the equilibrium in equitable proportion to the extra income they achieve, they will be obliged to make additional payments beyond the solidarity tax also in 2007.

HUF 50 billion will be collected from the special tax in 2007.

## 3. Carrying public burdens according to the actual wealth

The real financial situation and possibilities of families are defined, in addition to their income, by their inherited or acquired wealth. Justice requires that people should contribute to the public burdens not only on the basis of their sometimes only partly visible incomes, but also in line with their real wealth and financial standing. For this purpose the government introduces the property tax on residential and recreational properties that exceed the average value from 2008. The rate of tax will be different according to the value of the property.

## The balance of the state household

In order to achieve equilibrium quickly, it is absolutely essential that, beyond reducing expenditures, the state also increases its revenues instead of reducing them in the next one or two years. While the tax reduction programme must be postponed, certain measures are also necessary to enforce the principle of just distribution of public burdens, which will raise the level of contribution to certain areas by the citizens and companies. But these measures also serve our long term social political and developmental objectives.

### 1. Raising the preferential rate of VAT

From 1 September 2006

- the current 15% rate of VAT is increased to 20%.
- there will be no change at the 5% VAT rate and the products in this category.
- The deductible VAT portion of telephone bills will be increased from 50% to 70% due to the approximation of laws to the European Union. However, as a counter measure, the private use of company telephone connections will become taxable as an in-kind benefit.

This increase of the VAT rate will improve the revenues of the budget by HUF 60 billion and HUF 170 billion this year and next year respectively.

### 2. Excise duty changes

From 1 September 2006:

- the excise duty on cigarettes increases by 5.7%;
- the excise duty on all alcoholic beverages except for wine increases by 7%.

On 1 April 2007 and on 1 September 2007 the following increases will be implemented:

- the excise duty on cigarettes by an additional 2.7% each time.

These changes in the excise duty will result in approximately HUF 3 billion additional revenues in each of 2006 and 2007.

### 3. Personal income tax

*From 1 September 2006:*

- ***The interest tax and the capital gains tax will be introduced.***

In order to secure more just distribution of public burdens between incomes from work and incomes from capital, the interest and capital gains tax will be introduced earlier than devised originally:

- ⇒ The rate of the tax will be 20% of interest and capital gains
- ⇒ No portion of these incomes is exempted from tax, however, savings kept in long term government securities and investment notes are exempted from the payment of the tax.
- ⇒ The tax on interest gains is withheld by the payer, and the tax on capital gains in stock exchange deals is declared and paid by the private individual in their tax return.

The introduction of this tax is expected to generate HUF 2 billion and HUF 26 billion in revenues in 2006 and 2007 respectively.

- ***The tax on taxable in-kind benefits – manager packages – increases***

Currently, the payer pays 44% tax on taxable in-kind benefits. The rate of this tax increases to 54% on in-kind benefits from 1 September. These in-kind benefits are typically given to the management and top executives of businesses, so that the tax burden on these benefits after the tax increase will be identical with the 36% tax burden on pecuniary incomes, but it will still remain more preferential because no social security contributions are payable. (Fringe benefits taxable at the employer are also levied the same tax rate from 2007.)

This modification generates HUF 10 billion and HUF 20 billion additional revenues for the budget in 2006 and 2007 respectively.

- ***The use of company telephones for private purposes qualifies as taxable in-kind benefit***

One can choose to keep a separate record of private use for tax accounting purposes, or in lack of that, 20% of the total cost of the service is deemed an income.

### **From January 2007**

- ***The personal income tax tariff***

⇒ The limit for the lower rate of 18% will increase – according to the original modification planned for 2007 – from the current HUF 1,550,000 to 1,700,000, so that already 76% of all taxpayers will pay tax in the lowest tier.

⇒ The amount of tax credit will not change: tax exemption remains available up to HUF 63,000 per month.

- ***The range of tax credits and allowances will be reduced and changed***

⇒ The allowance on intellectual activities (currently HUF 100,000 p.a.) will be eliminated, and the same applies to the HUF 60,000 allowance on adult training and the purchase of computers (these measures were bound to a limit in income so far).

⇒ The income-related allowance on the repayment of housing loans will be eliminated such way that those who became eligible until 31 December 2006 can use this allowance for five more years.

⇒ The annual income limit for allowances that were available up to HUF 100,000 annually so far (tuition fee, original farmers, public donations, life and pension insurance) will be reduced from HUF 6 million to HUF 3.4 million. This limited range of allowances will include contract based payments, private pension fund membership fees, and the credit on the top-up of the same.

- ***The range of tax free incomes will reduce***

⇒ The sale of the right to operate an independent medical practice will qualify as taxable income for the original beneficiary, and the funds paid out with the Corvin Chain will also become taxable.

⇒ Pensions will become payment without tax levied – it is part of the tax base, but the tax calculated on this portion can be deducted according to the tax tariff –,if the private individual also has other income under consolidated taxation.

This measure will generate additional revenues of HUF 32 billion in 2007.

⇒ Holiday vouchers will only be tax free in the future if the employer allocates the vouchers to their employee or pensioner, or a close relative of them with who the employee shares a household, and if the vouchers are used to pay for holiday accommodation or related catering services. Payments by employers into voluntary mutual insurance funds to the benefit of employees were tax free up to the monthly amount of the minimum wage (or up to 130% of the same at several funds), however, it will be 20% of the minimum wage from 2007 onwards.

#### **4. Corporate tax**

- Already described in detail above, the expected corporate tax will be introduced to promote the more just distribution of public burdens from 2007. (HUF 55 billion additional revenues in 2007.)

- The rules on the availability of developmental tax incentives will be modified to promote employment.

⇒ In case of value related tax credits (minimum HUF 3 billion investment, or HUF 1 billion worth of development in backward regions) the requirement will apply that the tax subject must have minimum 150 (75 in case of backward regions) more employees in the four years after availing of the tax credit.

⇒ The allowances and credits on job creation will be extended further in the 48 most backward small regions. So far, large businesses, medium sized businesses and small companies had to increase the number of their staff by 150, 75 and 15 respectively in backward regions. From next year on, this condition on increasing the number of headcount will reduce to 20 for large businesses and 5 for SME's in the 48 backward small regions.

#### **5. Simplified corporate tax**

- The rate of the simplified corporate tax (EVA) will increase from 15% to 25% effective from 1 October 2006.

The law allows the companies to apply a proportionate distribution of their revenues from this year by choosing between the two methods: the increased tax has to be paid on the revenues received after the introduction of the law.

- The rules on EKHO remain unaltered.

The increase of the rate of the EVA generates HUF 10 billion and HUF 53 billion additional revenues for the budget in 2006 and 2007 respectively.

## 6. Car tax

- Taxation will shift from weight-based to performance-based from 2007.
- The transfer duty on cars will also increase from 2007.

The combined effect of the two measures results in HUF 9 billion additional revenues.

## 7. Contributions

### *Employers' contributions and healthcare contribution*

- The contributions paid by employers will not change, however, as opposed to the earlier tax cut programme:

⇒ The current HUF 1,950 flat healthcare contribution will not be eliminated in November 2006.

As expected, this will increase the revenues of the state budget by HUF 7 billion in 2006 and by HUF 88 billion in 2007.

⇒ The reduction of the employers' social security contribution planned from 2007 is postponed.

Compared to the original concept, this decision will result in an increase of HUF 210 billion in central budget revenues.

- The basis for contribution payments will be widened. There are several hundreds of thousands of people today who pay contributions after the minimum wage, while their true incomes exceed that amount by far. In order to secure a just distribution of public burdens, the rules on contributions payment will change from September 2006 to make sure that those who can afford on the basis of their income pay contributions after the double of the minimum wage.

The widening of the contribution payment base will result in HUF 20 billion and HUF 80 billion additional revenues for the central budget in 2006 and 2007 respectively.

- From September 2006, entrepreneurs who work in retirement will pay healthcare contribution of 15% in 2005 and 16% in 2007 instead of the 5% accident contribution applied so far.

This change generates additional revenues for the budget of HUF 2 billion in 2006 and HUF 9 billion in 2007.

### *Employee contributions*

#### *From September 2006*

- The rate of individual healthcare insurance contribution increases from 4% to 6%

- The rate of employee contribution increases from 1% to 1.5%.

***From January 2007***

- The rate of individual healthcare contribution increases from 6% to 7%.

The combined effect of these increases in employee healthcare contributions will be HUF 38 billion and HUF 220 billion in additional revenues for the central budget in 2006 and 2007 respectively.

**8. Revisiting price subsidies**

Approximately HUF 250-300 billion is spent on the price subsidies of household energy and transport prices today. The main beneficiaries of these subsidies are not those who are in real need, but rather those who consume more. In addition to the gradual elimination of subsidies provided to everybody through pricing policy, the government wants to offer social support that is an actual contribution to the reduction of the costs of living to those who are in real need of help.

- The consumer prices of gas and electricity will increase in August 2006
  - ⇒ The consumer price of gas will increase by 30% on average, so that the price for households with lower consumption will grow at a lower rate, while high consumption households will be charged a higher increase.
  - ⇒ The consumer price of electricity increases by 10-14%.
- The transformation of the system of transport allowances and tariffs will be commenced, while the subsidies for pensioners will be retained.

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