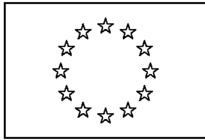

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 16.2.2005
SEC(2005) 226 final

Recommendation for a

COUNCIL RECOMMENDATION TO HUNGARY

with a view to bringing an end to the situation of an excessive government deficit

(presented by the Commission)

EN EN

EXPLANATORY MEMORANDUM

The excessive deficit procedure (EDP) is governed by Article 104 of the Treaty and by Council Regulation (EC) N°1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, which is part of the Stability and Growth Pact. These provisions are complemented by the political commitments enshrined in the Resolution of the Amsterdam European Council on the Stability and Growth Pact of 17 June 1997.

Based on the Commission services Spring 2004 forecasts, which took into consideration data reported by Hungary in March 2004 and which showed a deficit of 5.9% of GDP in 2003[1], the Commission initiated the excessive deficit procedure for Hungary on 12 May 2004 with the adoption of a report according to Article 104(3). On the Commission's recommendation, the Council decided on 5 July 2004, in conformity with Article 104(6), that Hungary had an excessive deficit and consequently, pursuant to Article 104(7), issued a recommendation to the Hungarian authorities for its correction[2]. In this recommendation, the Council invited the Hungarian authorities to implement the measures envisaged in the May 2004 convergence programme aiming at a correction of the excessive deficit by 2008. In particular, the Hungarian authorities were recommended to stand ready to introduce additional measures, if necessary, with a view to achieving the general government deficit target for 2004, and to take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target[3]. Based on the recommendation of the Commission of 22 December 2004, the Council adopted on 18 January 2005 a decision under Article 104(8) that Hungary did not take effective action in response to the 5 July 2004 Council recommendations. The Council recognised that a number of measures had been taken by the Hungarian authorities that contributed to a reduction in the deficit in 2004 and 2005, but that they were not sufficient to avoid a sizeable deviation from the targets in both years and more generally a deviation from the planned adjustment path of the May convergence programme. In this context, the Council underlined that the continued commitment of the government to have the excessive deficit corrected by 2008 needed to be underpinned by decisive measures of further fiscal consolidation and more determined pursuit of structural reforms.

Since Hungary is not yet a member of the euro area and therefore the last two steps of the excessive deficit procedure under Article 104(9) and 104(11) do not apply, the Council may issue another recommendation based on Article 104(7). Such a recommendation should take into account information concerning the budgetary strategy provided in the first update of Hungary's convergence programme submitted on 1 December 2004.

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1 The September 2004 notification corrected the general government deficit upwards from 5.9% of GDP to 6.2% for 2003.

2 See http://register.consilium.eu.int/pdf/en/04/st11/st11218.en04.pdf.

3 In addition, the Council invited the Hungarian authorities to seize every opportunity to accelerate the fiscal adjustment; to undertake the envisaged reforms of the public administration, health and education systems to ensure the foreseen reduction of the expenditure ratio and to improve the long-term sustainability of the public finances, and to ensure that planned tax cuts are adequately financed and make their implementation conditional upon the achievement of the deficit targets.

Compared to the previous programme, the update foresees the following annual targets for the general government deficit: 4.5%, 3.8%, 3.1%, 2.4% and 1.8% of GDP between 2004 and 2008. These figures benefit from the decision by Eurostat of 23 September 2004 allowing that for a transitory period, until the March 2007 fiscal notification, second pillar pension funds can be recorded inside the general government. The Hungarian authorities decided to avail themselves of this possibility and hence presented the deficit figures by subtracting the second pillar burden created by the 1998 pension reform from the general government deficit. Compared to the May 2004 programme, this lowers the yearly deficit figures by 0.8-1 percentage point between 2004 and 2008. Including the burden arising from the pension reform of 1998, as required once the transitory period provided by Eurostat expires, the projected general government deficit path would be 5.3% of GDP in 2004, 4.7% in 2005, 4.1% in 2006, 3.4% in 2007 and 2.8% of GDP in 2008; although less front loaded than the previous programme, the update keeps the target date to correct the excessive deficit. For the sake of comparison with the Commission services Autumn 2004 forecast, the previous convergence programme and Council recommendation under Article 104(7), and given that the 2008 target falls outside this transitory period, both figures with and without the pension fund burden are used.

The Commission services have carried out a technical evaluation of this update. In its draft recommendation of 16 February 2005 for a Council opinion on this update[4], the Commission considered that the adjustment path described in the update should be appropriate to correct the excessive deficit by 2008, provided that it is backed by sufficient measures minimising the risks attached to the implementation. This also concerns the new deficit target for 2005 of 3.8% of GDP (4.7% including the burden of the pension reform), which has a particular importance since slippages would have an impact on the following years and hence may undermine the capacity of moving to below 3% of GDP by 2008 as planned.

The Commission noted that there is a risk of worse-than-projected budgetary outcomes so that the budgetary stance in the programme appears insufficient to implement this path. As far as 2005 is concerned, the Commission services projected in Autumn 2004 a deficit of 5.2% for 2005 (4.3% excluding the burden of the pension reform), the main risks are that: (1) interest expenditures could turn out higher than forecast; (2) the newly introduced rules for expenditure restriction may turn out to be insufficient. There is also a risk concerning the timely adoption of further intended measures to reform the public administration, health and education systems as announced in the May 2004 convergence programme and its update which are key to the planned adjustment; (3) assumptions for certain revenues (mainly VAT and social contributions) appear overly optimistic. There also appeared to be a risk that VAT refunds originating from 2004 would be carried over to 2005, but the authorities have committed to accelerate the payments so as to not burden the 2005 budget. The budget contains an “emergency” reserve package of 0.5% of GDP against a possible overshooting of the 2005 target. It is intended to cover unforeseen adjustments to processes which cannot be influenced by the government. While the existence of this reserve is welcome, the amount allocated to it seems insufficient in view of the risks surrounding the 2005 Budget. Furthermore, the freeing of these reserves at a too early stage in the year may reduce the incentives to apply rigorously the budget. A further risk might arise from ongoing investments intended to be transferred into private public partnership arrangements. If these transfers are possibly not realised in time, they would have to be financed from the budget. Moreover, any possible cut in VAT rates in the framework of the ongoing tax reforms could increase the risk

[4] SEC(2005) 229.

to revenues, even if compensated by an increase in other rates. Without a careful consideration of its timing, such move may jeopardize the attainment of the revised 2005 target and hence undermine the deficit reduction path[5]. This analysis suggests that, in order to reach the 2005 target of 3.8% of GDP (4.7% of GDP including the burden of the pension reform), additional measures of half a percentage point of GDP would be needed.

In view of this assessment it seems necessary that the Hungarian authorities: (i) take additional measures, as far as possible of a structural nature, in order to achieve the new deficit target of 3.8% of GDP (4.7% of GDP, including the burden arising from the pension reform of 1998 as required when the transitory period provided by Eurostat for the accounting of such item will expire) in 2005; in particular, the "emergency" reserve package could be increased substantially and its use be as limited as possible and made conditional upon clear evidence on the attainment of the deficit target for 2005; (ii) make the timing and implementation of any tax cuts conditional upon the expected achievement of the deficit targets of the convergence programme update submitted in December 2004; (iii) progress with the envisaged reforms of the public administration, health and education systems as committed also with a view to improving the long-term sustainability of the public finances.

Against this background, the Commission is herewith submitting to the Council a recommendation for a new Council recommendation to be addressed to Hungary with a view to bringing the situation of an excessive deficit to an end, according to Article 104(7) of the Treaty.

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5 The final 2004 deficit figure is still subject to risks stemming from the uncertainty regarding the difference between the cash and the accrual based data. In particular, there are remaining accounting uncertainties related to agricultural subsidy payments and the payment of the 13th salary to public employees which could still lead to an increase in the accrual based deficit in 2004 and have an impact on the 2005 deficit.

Recommendation for a

COUNCIL RECOMMENDATION TO HUNGARY

with a view to bringing an end to the situation of an excessive government deficit

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(7) thereof

Having regard to the recommendation from the Commission

Whereas:

(1) According to Article 104 of the Treaty, Member States are to avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) On 5 July 2004, the Council decided, in accordance with Article 104(6), that an excessive deficit exists in Hungary.

(4) Having decided on the existence of an excessive deficit in Hungary, the Council, in accordance with Article 104(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[6], recommended that the Hungarian authorities take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2008 in a credible and sustainable manner, in accordance with the path for deficit reduction as specified in the Council Opinion of 5 July 2004 on the convergence programme submitted in May 2004. Notably it recommended that the authorities stand ready to introduce additional measures with a view to achieving the deficit target for 2004, and take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target.

(5) On 18 January 2005, the Council recognised that a number of measures had been taken to reduce the government deficit in 2004 and 2005 by the deadline of 5 November 2004. However, it considered that they were not sufficient to achieve the targets and would not avoid a deviation from the planned adjustment path of the May 2004 convergence programme. It considered that that the continued commitment of the government to correct the excessive deficit by 2008 needed to be underpinned by decisive measures of further fiscal consolidation and a more determined pursuit of

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[6] OJ L 209, 2.8.1997, p.6.

structural reforms. Against this background, the Council, acting pursuant to Article 104(8) of the Treaty, decided that by 5 November 2004 Hungary had not taken effective action in response to its recommendation of 5 July 2004[7].

(6) Having joined the Community on 1 May 2004, Hungary is a Member State with a derogation, within the meaning of Article 122(1) of the Treaty, which means that it is to avoid excessive deficits but that Articles 104(9) and Article 104(11) of the Treaty do not apply to it. Therefore it is appropriate to issue a new recommendation pursuant to Article 104(7).

(7) According to Article 3(4) of Regulation (EC) No 1467/97, a recommendation made in accordance with Article 104(7) must specify that effective action is to be taken by the Member State concerned within four months and that the correction of the excessive deficit should be completed in the year following its identification unless there are special circumstances. Such special circumstances continue to be present in the case of Hungary namely because the general government deficit upon accession was significantly above the 3% of GDP reference value and because of the ongoing structural shift in the economy.

(8) Where special circumstances exist, the Member State concerned may be allowed to correct the excessive deficit in a medium-term framework. The convergence programme update submitted by Hungary in December 2004 provides a revised framework with the following annual targets for the general government deficit: 4.5%, 3.8%, 3.1%, 2.4% and 1.8% of GDP between 2004 and 2008. Including the burden arising from the pension reform of 1998, as required when the transitory period provided by Eurostat until the March 2007 notification for the accounting of such item will expire, the projected general government deficit path would be 5.3%, 4.7%, 4.1%, 3.4% and 2.8% of GDP between 2004 and 2008. Hence the update continues to plan to correct the excessive deficit by 2008. According to the Council Opinion of [8 March 2005], the adjustment path, including the deficit targets of 3.8% of GDP (4.7% of GDP including the burden of the pension reform) in 2005 and, including the burden of the pension reform, of 2.8% of GDP in 2008, can be considered appropriate to correct the excessive deficit by 2008, provided that it is underpinned by sufficient measures to achieve the deficit targets.

(9) Although this adjustment path and in particular the new deficit target for 2005 of 3.8% of GDP (4.7% of GDP including the burden of the pension reform) can be considered appropriate, the current policy stance of the Hungarian authorities is not sufficient to achieve the target. Based on the draft budget for 2005 and a projected growth rate of 3.7% in 2005, the Commission services forecast in autumn 2004 a deficit of 5.2% of GDP in 2005 (including the burden of the pension reform). The main risks pointed out are were that (i) interest expenditure may turn out higher, (ii) the newly introduced rules for expenditure restraint may be insufficient and there is a risk concerning the timely adoption of further intended measures to reform the public administration, health and education systems as announced in the May 2004 convergence programme and its update which are key to the planned adjustment; and (iii) some revenue items, especially VAT and social security contributions, might fall short of projections. Concerning VAT, an additional risk has been identified that refunds originating from

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[7] See http://register.consilium.eu.int.

2004 would be carried over to 2005, but given the recent commitment by the authorities to accelerate the payments, it is assumed that this will not burden the 2005 budget and hence not require additional adjustment. A further risk might arise from ongoing investments intended to be transferred into public private partnership arrangements. If these transfers are possibly not realised in time, they would have to be financed from the budget. The budget contains an "emergency" reserve package of 0.5% of GDP against a possible overshooting of the 2005 target. While the existence of this reserve is welcome, the amount allocated to it seems insufficient in view of the risks to the 2005 budget and there are concerns that these reserves might be freed too early in the year. This analysis suggests that, in order to reach the 2005 target of 3.8% of GDP (4.7% of GDP including the burden of the pension reform), additional measures of half a percentage point of GDP would be needed.

(10) Budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy —

HEREBY RECOMMENDS:

- that the Hungarian authorities put an end to the present excessive deficit situation as rapidly as possible;

- That the Hungarian authorities take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2008 in a credible and sustainable manner, in accordance with the path for deficit reduction as specified in the Council Opinion of [8 March 2005] on the convergence programme update submitted in December 2004;

- that the Hungarian authorities take effective action by [8 July 2005] regarding additional measures, as far as possible of a structural nature, in order to achieve the new deficit target of 3.8% of GDP in 2005 set in the convergence programme (4.7% of GDP including the burden arising from the pension reform of 1998, as required when the transitory period provided by Eurostat until the March 2007 fiscal notification for the accounting of such item will expire). In particular, the "emergency" reserve package in the 2005 budget could be increased substantially and its use be as limited as possible and made conditional upon clear evidence on the attainment of the deficit target for 2005;

- that the Hungarian authorities make the timing and implementation of any tax cuts conditional upon the achievement of the deficit targets of the convergence programme update submitted in December 2004.

In addition, the Council invites the Hungarian authorities:

– to seize every opportunity to accelerate the fiscal adjustment;

– to progress with the envisaged reforms of the public administration, health and education systems as committed also with a view to improving the long-term sustainability of the public finances.

This recommendation is addressed to the Republic of Hungary.

Done at Brussels, [8 March 2005].

For the Council
The President