COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

on the public finance situation in Hungary

including a

Commission Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

on the adjusted convergence programme update of Hungary, 2005-2009

and a

Commission Recommendation for a

COUNCIL RECOMMENDATION TO HUNGARY

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

EXPLANATORY MEMORANDUM

This Communication examines the situation of the public finances in Hungary in the light of the adjusted convergence programme update submitted by Hungary on 1 September 2006 and the ongoing excessive deficit procedure. It includes two documents: first, a Commission recommendation for a Council opinion on the adjusted programme update and second, a Commission recommendation for a Council recommendation under Article 104(7) with a view to correcting the excessive deficit.

1. BACKGROUND

The Stability and Growth Pact, which entered into force on 1 July 1998, 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. In 2005, the Pact was amended for the first time. The reform acknowledged the Pact's usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

The Stability and Growth Pact has two arms. The preventive arm, laid down in Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). In accordance with the Regulation, the Council delivers an opinion on each programme on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee, taking into account the code of conduct[2], the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and the broad economic policy guidelines, and also against the background of the Commission services' forecasts. The corrective arm, laid down in Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[3], implements Article 104 of the Treaty.

In May 2004, the Hungarian authorities submitted their first convergence programme. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 endorsing the deficit adjustment path up to 2008 set by the Hungarian authorities in this programme. Also on 5 July 2004, the Council decided that Hungary was in excessive deficit and issued a recommendation under Article 104(7) for its correction by 2008, according to the same adjustment path. Following a January 2005 Council decision based on Article 104(8) establishing non-compliance and given that the last two steps of the excessive deficit procedure – covered by Article 104(9) and 104(11) - do not apply to non-euro area members

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1 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2 Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

3 OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

such as Hungary, the Council issued a new recommendation under Article 104(7) on 8 March 2005, reiterating that the excessive deficit had to be corrected by 2008, in line with the adjustment path contained in the Hungarian convergence programme update of December 2004 as endorsed in the Council Opinion of March 2005. On 8 November 2005, the Council decided based on Article 104(8) that the action taken by Hungary in response to the March 2005 Council recommendation was inadequate. It notably took into account the substantial deviation from the adjustment path referred to in the March 2005 Council recommendation namely with respect to the deficit targets of 3.6% of GDP in 2005 and of 2.9% of GDP in 2006, and even the revised target of 5.2% of GDP in the latter year (all calculated without the burden of second pillar pension schemes)[4].

On 1 December 2005, the Hungarian authorities presented a convergence programme update which contained a revised and back-loaded adjustment path while retaining the 2008 target year for correction of the excessive deficit. On 24 January 2006, the Council adopted an opinion on this update, in which it considered that while the consolidation in the programme relied on a very large cut in expenditures of 7.5% of GDP its implementation was not backed by concrete measures. The Council invited Hungary to "present as soon as possible and by 1 September 2006 at the latest an adjusted convergence programme update which identifies concrete and structural measures that are fully consistent with its medium-term adjustment path"[5].

2. COUNCIL OPINION ON THE ADJUSTED CONVERGENCE PROGRAMME UPDATE

1. On 1 September 2006, Hungary submitted an adjusted convergence programme update (hereafter referred to as the programme) to the Council and the Commission. The programme covers the period from 2005 to 2009, but also refers to the years 2010 and 2011. It broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct[6].

2. Following the adoption of a comprehensive economic reform package in the mid-nineties, the Hungarian economy enjoyed stable and relatively high rates of growth and a reduction in inflation supported by sound macroeconomic policies and appropriate structural reforms. However, starting from 2001 and more importantly over recent years, significantly increased public expenditure and generous public wage increases resulted in budget deficits well over 5% of GDP over the past four years, producing large deviations compared to the original deficit targets. In addition, end-year estimates were substantially increased ex-post with virtually every fiscal notification. Instead of the planned deficit targets contained in the May 2004

[4] These targets did not include the burden arising from the 1998 reform of the pension system, since in December 2004 the Hungarian authorities decided to avail themselves of the decision by Eurostat on 23 September 2004 allowing the classification of second-pillar pension schemes inside the general government sector for a transitory period until the 1 April 2007 notification. Using the most recent estimates of the pension reform contribution, the original deficit targets including the pension reform would have been 5% of GDP and of 4.5% of GDP, respectively.

[5] In accordance with the second paragraph of Article 9 of section 3 of Council Regulation (EC) No 1466/97 as amended.

[6] The programme provides all compulsory data prescribed by the new code of conduct. Some optional data are missing. They mainly concern the general government expenditure by function, government debt developments and data on long-term sustainability of public finances.

convergence programme of 4.6% of GDP in 2004, 4.1% of GDP in 2005 and 3.6% of GDP in 2006, the outcome was 6.6% of GDP in 2004, 7.5% of GDP in 2005 and is expected by the Government to be around 10.1% of GDP in 2006, by far the highest level in the EU (all numbers including pension reform burden). A large part of the budgetary slippages stemmed from overoptimistic budgetary planning, large expenditure overruns, tax cuts and the overall lack of sufficient structural adjustment efforts. This highly expansionary fiscal policy has considerably damaged the credibility of the fiscal policy and has been weighing increasingly on the economy. In particular, it has contributed to serious external imbalances and to a significant increase in the total foreign debt (from below 20% of GDP in 2001 to close to 30% of GDP in 2005) and much higher interest rate spreads compared to other recently acceded Member States.

3. In the adjusted programme, real GDP growth is projected to fall back in the coming years from 4.1% in 2006 to 2.2% and 2.6% in 2007 and 2008, respectively, due to the contractionary impact of the fiscal adjustment measures set out in the programme, some of which have already been implemented from July 2006. Growth is expected to recover to pre-adjustment levels by 2009. These developments are also reflected in the implicit cyclical conditions, which show negative output gaps for the years 2007 and 2008 and the return of output to its potential level by 2009. Based on currently available information and without prejudging the Commission services' Autumn 2006 forecast, this macroeconomic scenario appears broadly plausible. However, it is somewhat optimistic concerning growth in 2009 and regarding the employment developments, especially in the outer years, that do not appear to be affected by the slowdown in growth and the planned cut in public employment. The significant improvement of the external balances expected in the programme seems plausible in view of both the direct and the indirect effects of the fiscal adjustment measures. In particular, the current account deficit is expected to decrease from close to 8% of GDP in 2006 to less than 4% of GDP in 2009. Inflation is projected to peak at 6.2% in 2007 after 3.5% in 2006 and to decrease to 3% by 2009. The projected pattern can be explained by the VAT increase (adopted by Parliament on 10 July 2006) and decreases in price subsidies (adopted by ministerial decree on 30 June), as well as by other measures contained in the programme that create inflationary pressures by increasing factor costs (e.g. increases of personal income tax and social contributions). However, inflation seems somewhat underestimated over the entire horizon.

4. The Hungarian authorities have officially abandoned 2010 as the target for euro adoption but have not yet announced a new one. Hungarian monetary policy continues to combine inflation targeting with an exchange rate band. Since February 2006, the forint/euro exchange rate has weakened substantially, by nearly 10%, amidst a receding risk appetite affecting emerging markets globally and concerns among investors about the fiscal situation in Hungary. Bond yield spreads with the euro area also widened in the summer, to around 350 basis points, partly in response to concerns among investors about the extent and feasibility of planned fiscal adjustment. Monetary policy reacted to the upward risks to inflation and to unfavourable financial market developments by increasing the base rate by 125 basis points in three steps to 7.25 %, between mid-June and end-August 2006. The currency has stabilised since the beginning of August. The programme’s assumptions

on interest rates appear to be on the low side, especially in view of the upside risks to the baseline inflation projections.

5. After a general government deficit outcome of 7.5% of GDP in 2005 (reported in Spring 2006), the Hungarian authorities announced following the April 2006 general elections that there would be very large upward revisions of the 2006 deficit which could reach, in the absence of corrective steps, 11.6% of GDP[7]. The overshoot compared to the deficit target of 6.1% of GDP set in the budget law for 2006 and in the December 2005 convergence programme update took place almost entirely on the expenditure side (around 5% of GDP). It mainly occurred in the areas of operational and wage costs of central budgetary institutions, pension payments, health-care expenditure and because of higher-than-expected investment of local governments due to the electoral cycle. Around 1½% of GDP of the overshoot is explained on the one hand by the accounting of motorway investment inside the general government (1.1% of GDP), which originally was planned to be undertaken by PPPs (public private partnerships) to be recorded off budget, and on the other hand by the costs of military aircraft (0.3% of GDP) purchased under a financial lease. Both of these outlays were not included originally in the official target figure.

6. In June, facing a spiralling budget deficit, the new Government - in office since June following the April 2006 general elections - withdrew the remainder of its five-year tax cut programme which would have further lowered revenues by around 3% of GDP by 2010[8], and adopted a corrective fiscal package. A number of the corrective measures, including all those on the revenue side, have already been adopted by Parliament. The tax increases, together with some immediate cuts in health-care expenditure, gas price subsidies, public administration expenditure and the full withdrawal of the 0.3% of GDP general reserve of the budget, are expected by the Government to reduce the deficit overrun in 2006 by 1.5% of GDP, in order to achieve the new deficit objective which, however, at 10.1% of GDP, remains very high. These measures are also expected to produce important effects over future years.

7. The adjusted convergence programme update of September 2006 aims to correct the excessive deficit by 2009. This would be achieved by a steep and front-loaded deficit reduction of 6.9 percentage points of GDP within three years, from the high starting position of 10.1% of GDP in 2006 to 3.2% of GDP in 2009. The improvement in the primary balance over the period is of the same magnitude. The programme recognises that the deficit target of 3.2% of GDP in 2009 would still exceed the 3% of GDP threshold specified in the Treaty, but assumes that the Council and the Commission, when considering the case for an abrogation of the excessive deficit

7 After the submission of the 2004 update of the convergence programme in December 2004 the Hungarian authorities decided to report fiscal targets and statistics excluding the cost of pension reform. The adjusted convergence programme update has discontinued this practice; Hungary has therefore decided to no longer benefit from the transitory period on the sectoral classification of pension schemes granted by Eurostat on 23 September 2004 that will in any case expire on 1 April 2007. Without the pension reform burden, the deficit outcome in 2005 would have been 6.1% of GDP and the target for 2006 would have been 4.7% of GDP.

8 The five-year tax cut strategy was approved by the parliament on 7 November 2005, and the first steps (most notably a 5 percentage points cut in the upper VAT rate) became effective on 1 January 2006 and led to revenue losses of around 1% of GDP in 2006.

procedure for Hungary, could take into account a part of the net cost of the pension reform, in line with the revised Stability and Growth Pact[9]. Nearly half of the reduction in the deficit ratio is already to take place in 2007. The planned reduction in the nominal deficit is to be achieved by increasing the revenue-to-GDP ratio by 3 percentage points and by reducing the expenditure-to-GDP ratio by 3.9 percentage points over the programme period. As far as the revenue side is concerned, all revenue increases underpinning the projected rise in the programme's revenue-to-GDP ratio have been adopted. On top of the above-mentioned already adopted expenditure cuts, the Hungarian authorities plan to achieve their targets by improving budgetary discipline (through more transparent accounting, as well as the introduction of multi-annual spending caps and an expenditure rule). These plans are expected to be included and fully spelled out in the 2007 budget law which will be presented to Parliament by end-October. Moreover, the programme announces comprehensive structural reforms aimed at ensuring the achievement of the deficit targets, especially in the outer years of the programme (such as the introduction of co-payments schemes in the health-care sector, the revamping of price subsidies and a streamlining of the central public administration).

8. According to the calculations carried out by the Commission services on the basis of information provided in the programme and the commonly agreed methodology, the structural deficit (in cyclically-adjusted terms and net of one-off and other temporary measures), following an estimated deterioration in 2006 by some 2% of GDP, would fall from 9¾% of GDP in 2006 to 3¼% in 2009, with an annual improvement of around 2¼% of GDP on average over the period. The programme identifies the medium-term objective (hereafter MTO) for the budgetary position as meant in the Stability and Growth Pact as a structural deficit between 0.5% and 1% of GDP, which it does not aim to achieve within the programme period. The MTO lies within the range indicated in the Stability and Growth pact and the code of conduct and adequately reflects long-term potential output growth and the debt ratio, but it would not be achieved within the programme period.

9. Regarding the budgetary outcome, there are a number of elements on the positive side. A large part of the measures to back the reduction of the deficit in 2006 and 2007 are either already adopted or planned to be incorporated into the 2007 budget. In addition, in recent months the Government has taken decisions on some initial steps of the planned structural reforms. Moreover, the Hungarian authorities have decided to improve the budgetary process by introducing an expenditure-control rule from 2007 onwards and multi-annual expenditure planning for budgetary institutions; they also commit themselves in the programme to report twice a year to the Commission and the Council on budgetary developments and announce corrective steps in case of slippages. However, there are also important risks. There is still some uncertainty about the effective enforcement of the planned expenditure freezes in 2007 and 2008 and about containing expenditure increases in areas not covered by the freezes. In addition, despite the planned measures, the achievement of the

9 According to Council Regulation (EC) No 1056/2005, Article 1(7), if the general government deficit "…has declined substantially and continuously and has reached a level that comes close to the reference value", the Council and the Commission should consider degressively the net cost of a pension reform that includes a fully-funded pillar. For Hungary, this would correspond in 2009 to 20% of the net cost of the pension reform or an estimated 0.3% of GDP.

budgetary targets in the outer years could be subject to important risks. Although the risks to the revenue side stemming from the macroeconomic scenario appear on the whole broadly balanced, the expected revenues in the outer years and especially in 2009 are rather optimistic which is also linked to the rather optimistic employment projections. Moreover, apart from the poor track-record in expenditure control and the lack of precise information about how it will be achieved in the future, the weak institutional control of the budgetary process exposes public finances to substantial slippages. Therefore the envisaged deficit reduction is contingent on the rigorous implementation of the envisaged structural reforms and expenditure control from the early years of the programme. Finally, it cannot be excluded that the almost 2% of GDP debt accumulated by the public transport companies since end 2002 will be assumed by the Government (given that this has happened at regular intervals in the past); this would have a temporary effect on the deficit. Overall, the budgetary outcome could be worse than projected in the programme, both in the short term and in the outer years of the programme.

10. In view of the risk assessment above, the planned correction of the excessive deficit by 2009 on a sustainable basis requires the Government to strictly achieve the budgetary targets. This hinges upon an effective implementation of all the measures announced in the programme for the years 2006 to 2009, as well as upon timely decisions on and implementation of structural reforms and expenditure control.

11. The debt-to-GDP ratio, according to the programme projections, would significantly increase in 2006 to 68.5% (from 62.3% in 2005) and further to 71.3% in 2007 and to 72.3% in 2008. The ratio is expected to start decreasing only in 2009 to 70.4%. The dynamics presented in the programme are in sharp contrast to the previous update, which anticipated the debt-to-GDP ratio, if the pension burden is included, to be in the range of 61-63% of GDP throughout the programme horizon. The update does not foresee any major operations (such as privatization or debt assumption) with a large impact on the debt. Risks to the envisaged debt path mainly stem from the above-mentioned risks of higher-than-projected deficits including due to the possible assumption of the debt of the public transport companies. In view of this risk assessment, the debt ratio does not seem to be sufficiently diminishing towards the reference value.

12. Hungary appears to be at high risk with regard to the sustainability of public finances[10]. The very weak budgetary position, in conjunction with the relatively high and rising debt ratio, constitutes a notable risk to sustainable public finances even before considering the long-term budgetary impact of an ageing population. Moreover, the long-term budgetary impact of ageing in Hungary is well above the EU average, influenced notably by a significant increase in pension expenditure as a share of GDP over the long-term. Carrying out a large consolidation of the public finances over the medium-term as planned and further strengthening the budgetary position thereafter is therefore necessary if these risks are to be reduced.

13. While there has been a serious deterioration in public finances in 2005 and especially 2006, hampering the correction of the excessive deficit in line with the planned path,

[10] Details on long-term sustainability are provided in the technical assessment of the programme by the Commission services (http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm).

the measures envisaged in the programme, if fully specified and implemented, are largely consistent with the broad economic policy guidelines included in the integrated guidelines[11]. In particular, Hungary plans to take effective actions to correct the excessive deficit and to implement reforms in order to strengthen fiscal discipline and to increase transparency. These measures should also contribute to correcting the high current account deficits. However, they need to be backed up by structural reforms to ensure fiscal sustainability.

14. With the Implementation Report to be submitted by mid-October 2006 in the context of the renewed Lisbon strategy for growth and jobs, the Hungarian Government is planning to substantially revise reform plans contained in the October 2005 National Reform Programme (NRP), so as to reflect the Government's new strategy. The October 2005 NRP identified the following key challenges with significant implications for public finances: (a) to reduce the fiscal deficit, (b) to improve infrastructure and (c) to increase the activity and the employment rate and enhance human capital. The adjusted convergence programme update outlines plans and measures to restructure the public administration, health-care, pension and public education systems. In particular, by 2007, the programme plans to take measures to reduce the size of the public administration and improve its efficiency by exploiting economies of scale; to introduce means-testing in subsidies; to restructure pharmaceutical subsidies and to partly liberalise the trade of pharmaceutical products; to introduce co-payments for health-care services. In addition, by 2007, proposals for law amendments are to be submitted to the parliament aiming at increasing the retirement age and decreasing early retirement by improving the incentive schemes and by revamping the disability pension system; at putting health-care services on strict insurance basis and at rationalising the provision and the use of these services; at restructuring public education. These plans are still to be substantiated. The programme complements these plans by envisaged improvements to the institutional features of the public finance framework.

In view of the above assessment, the state of the Hungarian public finances, and in particular the high deficit expected for 2006, is a matter for serious concern. It is therefore to be welcomed that in the adjusted convergence programme update of September 2006 the Hungarian authorities give priority to the reduction of the excessive deficit through a substantial front-loaded effort and commit to reporting to the Commission and Council twice a year on progress and on actions taken to stay on track. While important first steps have been taken to secure additional revenues and cut expenditures with a view to reaching the new 2007 deficit target and plans have been announced to improve expenditure control and undertake structural reforms so as to back the adjustment path, risks with respect to meeting the adjustment path remain in both the short term and the outer years of the programme. The envisaged deficit reduction is therefore contingent on the rigorous implementation of the envisaged structural reforms, on the enforcement of expenditure controls from the early years of the programme, as well as on a reinforcement of the institutional set-up of public finances in Hungary, all aspects on which it would be appropriate to for the Hungarian government to ensure the highest effort.

[11] In July 2005, the broad economic guidelines were integrated into the integrated guidelines as part of the Reinforced Lisbon Strategy (OJ L 205, 6.8.2005).

3. COUNCIL RECOMMENDATIONS CONCERNING THE CORRECTION OF THE EXCESSIVE GOVERNMENT DEFICIT - ARTICLE 104(7)

The analysis presented in the preceding section is pertinent for the recommendation for the correction of the excessive government deficit.

The original deadline for the correction of the excessive deficit, 2008, was based on the consideration that "special circumstances" in the meaning of Article 3(4) of Council Regulation (EC) No 1467/97[12] – allowing for a correction in a medium-term framework - were deemed to exist in the case of Hungary, notably in view of the size of the deficit and the ongoing structural shift of the economy.

While originally the correction of the deficit was to take place within a medium-term framework ending in 2008, this target date can no longer be regarded as realistic given the recent large budgetary slippages in Hungary which have considerably damaged the credibility of the fiscal policy and have been weighing increasingly on the economy. The new medium-term framework for the correction, laid down in the adjusted convergence programme update, puts forward 2009 as the deadline for the correction. In view of the recent slippages, this new deadline, which implies a substantial correction of the structural deficit by more than 6% of GDP over three years, seems appropriate.

To this end, it would seem necessary for the Hungarian Government (i) limit the deterioration of the fiscal position in 2006 by ensuring a rigorous implementation of the adopted and announced corrective measures, and by allocating possible windfall gains to this end. This would lead to a nominal deficit of, at most, 10% of GDP in 2006 which would be still exceptionally high; and to (ii) rigorously implement the necessary measures to ensure a frontloaded and sustained substantial correction of the structural deficit by taking a very substantial step in 2007 followed by continued significant adjustment efforts until the correction of the excessive deficit, the magnitude of the effort being that foreseen in the Council opinion on the adjusted convergence programme update; to stand ready to adopt additional measures which may be necessary to achieve the correction of the excessive deficit by 2009 and also to (iii) incorporate sufficient reserve provisions in the forthcoming budget laws to avoid slippages even in case of unforeseen events. Although the programme presents some potential budgetary security buffers of an increasing magnitude throughout the programme period, it remains to be seen, how effectively these plans will be translated into concrete measures and implemented. At the same time, the government debt ratio will have to be brought on a firm downward trajectory in line with the multi-annual path for deficit reduction laid down in the convergence programme and preferably before 2009.

The budgetary adjustment needs to be framed within a comprehensive structural reform strategy, including the reform of the public administration, health-care, pension and education systems with a view to containing and reducing expenditure until the end of and beyond the programme horizon. In addition, the correction should be supported by enacting decisively measures to improve budgetary control, to introduce fiscal rules and to strengthen the institutional framework of the budgetary process. The Government is expected to report twice a year on the implementation of this strategy and the fiscal targets in line with its commitments made in the adjusted convergence programme update of September 2006, starting by 1 April 2007.

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[12] OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

ANNEX

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009
Real GDP (% change)	**CP Sep. 2006**	**4.1**	**4.1**	**2.2**	**2.6**	**4.1**
	CPDec. 2005	4.2	4.3	4.1	4.1	n.a.
	CP Dec. 2004	*4.0*	*4.2*	*4.3*	*4.6*	*n.a.*
HICP inflation (%)	**CP Sep. 2006**	**3.6**	**3.5**	**6.2**	**3.3**	**3.0**
	CP Nov. 2005	3.5	2.1	3.0	2.4	n.a.
	CP Dec. 2004	*4.5*	*4.0*	*3.5*	*3.0*	*n.a.*
Output gap (% of potential GDP)	**CP Sep. 2006[1,4]**	**0.3**	**0.8**	**-0.3**	**-0.9**	**0.0**
	CP Dec. 2005 [1]	-1.0	-0.5	-0.1	0.4	n.a.
	CP Dec. 2004 [1]	*-1.0*	*-0.8*	*-0.4*	*-0.2*	*n.a.*
General government balance (% of GDP)	**CP Sep. 2006**	**-7.5**	**-10.1**	**-6.8**	**-4.3**	**-3.2**
	CPDec. 2005	-7.4	-6.1	-4.7	-3.4	n.a.
	CP Dec. 2004	*-4.7*	*-4.1*	*-3.4*	*-2.8*	*n.a.*
Primary balance (% of GDP)	**CP Sep. 2006**	**-3.4**	**-6.3**	**-2.4**	**-0.2**	**0.8**
	CPDec. 2005	-3.8	-2.9	-1.7	-0.7	n.a.
	CP Dec. 2004	*-0.9*	*-0.7*	*-0.3*	*0.1*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Sep. 2006**	**-7.6**	**-10.5**	**-6.7**	**-3.9**	**-3.2**
	CPDec. 2005	n.a.	n.a.	n.a.	n.a.	n.a.
	CP Dec. 2004	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Structural balance[2] (% of GDP)	**CP Sep. 2006[3]**	**-7.6**	**-9.7**	**-5.8**	**-3.6**	**-3.2**
	CPDec. 2005	n.a.	n.a.	n.a.	n.a.	n.a.
	CP Dec. 2004	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Sep. 2006**	**62.3**	**68.5**	**71.3**	**72.3**	**70.4**
	CPDec. 2005	61.5	63.0	63.2	62.3	n.a.
	CP Dec. 2004	*58.6*	*56.8*	*54.9*	*53.2*	*n.a.*

Notes:

[1]Commission services calculations on the basis of the information in the programme

[2]Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures

[3]One off and temporary measures are taken from the programme: 0% in 2005, 0.8% of GDP in 2006, 0.9% in 2007, 0.3% in 2008; all deficit increasing. The Commission services' estimates of one-off measures are broadly in line with the programme figures, except for 2005 (0.4% of GDP, deficit reducing) and 2006 (0.3% of GDP, deficit increasing).

[4]Based on estimated potential growth of 3.6%, 3.6%, 3.3%, 3.2% and 3.2% respectively in the period 2005-2009.

Source:

Convergence programme updates (CP); Commission services' calculations

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

on the adjusted convergence programme update of Hungary, 2005-2009

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[13], and in particular Article 9(3) thereof,

Having regard to the opinion of the Council of 24 January 2006 on the updated convergence programme of Hungary, 2005-2008,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [10 October 2006] the Council examined the adjusted convergence programme update of Hungary received on 1 September 2006, which covers the period 2005 to 2009.

(2) Following the adoption of a comprehensive economic reform package in the mid-nineties, the Hungarian economy enjoyed stable and relatively high rates of growth and a reduction in inflation supported by sound macroeconomic policies and appropriate structural reforms. However, starting from 2001, and more importantly over the recent years, significantly increased public expenditure and generous public wage increases resulted each year in budget deficits well above 5% of GDP, producing large deviations compared to the original deficit targets. In addition, end-year figures were substantially increased ex-post with virtually every fiscal notification. Instead of the planned deficit targets contained in the May 2004 convergence programme of 4.6% of GDP in 2004, 4.1% of GDP in 2005 and 3.6% of GDP in 2006, the outcome was 6.6% of GDP in 2004, 7.5% of GDP in 2005 and is expected by the Government to be around 10.1% of GDP, by far the highest level in the EU (all numbers including pension reform burden). A large part of the budgetary slippages stemmed from

[13] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

overoptimistic budgetary planning, large expenditure overruns, tax cuts and the lack of sufficient structural adjustment efforts. This highly expansionary fiscal policy has considerably damaged the credibility of the fiscal policy, and has been weighing increasingly on the economy. In particular, it has contributed to serious external imbalances to a significant increase in the total foreign debt stock (from below 20% of GDP in 2001 to close to 30% of GDP in 2005), and much higher interest rate spreads compared to other recently acceded Member States.

(3) On 5 July 2004, the Council decided that Hungary was in excessive deficit and issued a recommendation under Article 104(7) for its correction by 2008, the target year set by the Hungarian authorities in the convergence programme of May 2004. Following a decision of no compliance in January 2005 based on Article 104(8), the Council issued new recommendations under Article 104(7) on 8 March 2005, reiterating that the excessive deficit had to be corrected by 2008 in line with the adjustment path contained in the Hungarian convergence programme update of December 2004 and endorsed in the Council Opinion of March 2005. On 8 November 2005, the Council decided based on Article 104(8), that the action taken by Hungary in response to the March 2005 Council recommendation was inadequate. It notably took into account the substantial deviation from the adjustment path referred to in the above-mentioned Council recommendation (on the December 2004 update of the convergence programme), namely with respect to the deficit targets of 3.6% of GDP in 2005 and of 2.9% of GDP in 2006 (both calculated without the burden of second pillar pension schemes).

(4) On 1 December 2005, the Hungarian authorities presented to the Commission and the Council a convergence programme update which contained a new adjustment path, while retaining the 2008 target year for correction of the excessive deficit. On 24 January 2006, the Council adopted an opinion on this 2005 update, in which it considered that while the consolidation in the programme relied on a very large cut in expenditures of 7.5% of GDP its implementation was not backed by concrete measures. Therefore, in accordance with the second paragraph of Article 9 of section 3 of Council Regulation (EC) No 1466/97 as amended, the Council invited Hungary to present as soon as possible, and by 1 September 2006 at the latest, an adjusted convergence programme update identifying concrete and structural measures that are fully consistent with its medium-term adjustment path.

(5) After a general government deficit outcome of 7.5% of GDP in 2005 reported in Spring 2006, the Hungarian authorities announced following the April 2006 general elections that there would be very large upward revisions of the 2006 deficit which could reach, in the absence of corrective steps, 11.6% of GDP[14]. The overshoot compared to the deficit target of 6.1% of GDP set in the budget law and the 2005 convergence programme update took place almost entirely on the expenditure side (around 5% of GDP). It mainly occurred in the areas of operational and wage costs of central budgetary institutions, pension payments, health-care expenditure, and because of higher-than-expected investment of local governments due to the electoral cycle.

[14] Hungary has decided no longer to benefit from the transitory period on the sectoral classification of pension schemes granted by Eurostat on 23 September 2004, that will in any case expire on 1 April 2007. Without the pension reform burden, the deficit outcome in 2005 would have been 6.1% of GDP and the target for 2006 would have been 4.7% of GDP.

Around 1½% of GDP of the overshoot was explained on the one hand by the accounting of motorway investment inside the general government[15] (1.1% of GDP), which was originally planned to be undertaken by PPPs (public private partnerships) to be recorded off budget, and on the other by the costs of military aircraft (0.3% of GDP) purchased under a financial lease. Both of these outlays were not included originally in the official target figure.

(6) In June, facing a spiralling budget deficit, the Government – re-appointed following the April 2006 general elections – withdrew the remainder of its five-year tax cut programme which would have further lowered revenues by around 3% of GDP by 2010 and adopted a corrective fiscal package. A number of the corrective measures, including all those on the revenue side, have already been adopted by Parliament. The tax increases, together with some immediate cuts in health-care expenditure, gas price subsidies, public administration expenditure and the full withdrawal of the 0.3% of GDP general reserve of the budget, are expected by the Government to reduce the deficit overrun in 2006 by 1.5% of GDP, in order to achieve the new deficit objective of 10.1% of GDP. These measures are also expected to produce important effects over the future years.

(7) The adjusted convergence programme update (hereafter referred to as the programme), submitted to comply with the Council request of January 2006, broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct[16].

(8) The macroeconomic scenario presented in the programme projects real GDP growth to fall back in the coming years from 4.1% in 2006 to 2.2% and 2.6% in 2007 and 2008, respectively, due to the contractionary impact of the fiscal adjustment measures set out in the programme, some of which have already been implemented from July 2006. Growth is expected to recover to pre-adjustment levels by 2009. These developments are also reflected in the implicit cyclical conditions, which show negative output gaps for the years 2007 and 2008 and the return of output to its potential level by 2009. Based on currently available information, and without prejudging the Commission services' Autumn 2006 forecast, this macroeconomic scenario appears broadly plausible. However, it is somewhat optimistic concerning growth in 2009 and regarding the employment developments, especially in the outer years, that do not appear to be affected by the slowdown in growth and the planned cut in public employment. The significant improvement of the external balances expected in the programme seems plausible in view of both the direct and the indirect effects of the fiscal adjustment measures. In particular, the current account deficit is expected to decrease from close to 8% of GDP in 2006 to less than 4% of GDP in 2009. Inflation is projected to peak at 6.2% in 2007 after 3.5% in 2006 and to decrease to 3% by 2009. The projected pattern can be explained in the light of the VAT increase and of the decreases in price subsidies decided in Summer 2006, as well as by other measures contained in the programme and expected to create inflationary pressures by

[15] Originally this investment was planned to be undertaken by PPPs (public private partnerships) to be recorded off budget.

[16] The programme provides all compulsory data prescribed by the new code of conduct. Some optional data are missing. They mainly concern the general government expenditure by function, government debt developments and data on long-term sustainability of public finances.

increasing factor costs (e.g. increases of personal income tax and social contributions). However, the level of inflation seems somewhat underestimated over the entire horizon.

(9) The programme aims to correct the excessive deficit by 2009. This would be achieved by a steep and front-loaded deficit reduction of 6.9 percentage points of GDP within three years, from the high starting position of 10.1% of GDP in 2006 to 3.2% of GDP in 2009. The improvement in the primary balance over the period is of the same magnitude. The programme recognises that the deficit target of 3.2% of GDP in 2009 would still exceed the 3% of GDP threshold specified in the Treaty, but assumes that the Council and the Commission, when considering the case for an abrogation of the excessive deficit procedure for Hungary, could take into account a part of the net cost of the pension reform, in line with the revised Stability and Growth Pact[17]. Nearly half of the reduction in the deficit ratio is already to take place in 2007. The planned reduction in the nominal deficit is to be achieved by increasing the revenue-to-GDP ratio by 3 percentage points and by reducing the expenditure-to-GDP ratio by 3.9 percentage points over the programme period. As far as the revenue side is concerned, all revenue increases underpinning the projected rise in the programme's revenue-to-GDP ratio have been adopted. On top of the above-mentioned already adopted expenditure cuts, the Hungarian authorities plan to achieve their targets by implementing strict multi-annual spending caps for most expenditure items and to strengthen budgetary expenditure controls. These plans are expected to be included and fully spelled out in the 2007 budget law, which will be presented to parliament by end-October. Moreover, the programme announces comprehensive structural reforms aimed to ensure the achievement of the deficit targets, especially in the outer years of the programme (such as the introduction of co-payment schemes in the health-care sector, the revamping of price subsidies and a streamlining of the central public administration).

(10) Over the programme period, the structural balance (in cyclically-adjusted terms and net of one-off and other temporary measures) calculated according to the commonly agreed methodology and based on programme figures is planned to improve on average by around 2¼% of GDP per year, falling from 9¾% of GDP in 2005 to 3¼% in 2009. The programme sets the medium-term objective (hereafter MTO) for the budgetary position as a structural budget deficit between 0.5% and 1% of GDP, which it does not aim to achieve within the programme period. The MTO lies within the range indicated in the Stability and Growth Pact and the code of conduct and adequately reflects long-term potential output growth and the debt ratio.

(11) Regarding the budgetary outcome, there are a number of elements on the positive side. Large part of the measures to back the reduction of the deficit in 2006 and 2007 are either already adopted or planned to be incorporated into the 2007 budget. In addition, in recent months the Government has taken decisions on some initial steps of the planned structural reforms. Moreover, the Hungarian authorities have decided to

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[17] According to Council Regulation (EC) No 1056/2005, Article 1(7), if the general government deficit "…has declined substantially and continuously and has reached a level that comes close to the reference value", the Council and the Commission should consider degressively the net cost of a pension reform that includes a fully-funded pillar. For Hungary, this would correspond in 2009 to 20% of the net cost of the pension reform or an estimated 0.3% of GDP.

improve the budgetary process through more transparent accounting and by introducing an expenditure-control rule from 2007 onwards and multi-annual expenditure planning for budgetary institutions; they also commit themselves in the programme to report twice a year to the Commission and the Council on budgetary developments and announce corrective steps in case of slippages. However, there are also important risks. There is still some uncertainty about the effective enforcement of the planned expenditure freezes in 2007 and 2008 and about containing expenditure increases in areas not covered by the freezes. Moreover, despite the planned measures, the achievement of the budgetary targets in the outer years could be subject to important risks. Although the risks to the revenue side stemming from the macroeconomic scenario appear on the whole broadly balanced, the expected revenues in the outer years and especially in 2009 are rather optimistic which is also linked to the rather optimistic employment projections. Moreover, apart from the poor track-record in expenditure control and the lack of precise information about how it will be achieved in the future, the weak institutional control of the budgetary process exposes public finances to substantial slippages. Therefore, the envisaged deficit reduction is contingent on the rigorous implementation of the envisaged structural reforms and expenditure control starting from the early years of the programme. Finally, it cannot be excluded that the almost 2% of GDP debt accumulated by the public transport companies since end 2002 will be assumed by the Government (given that this has happened at regular intervals in the past); this would have a temporary effect on the deficit. Overall, the budgetary outcome could be worse than projected in the programme, both in the short term and the outer years of the programme.

(12) In view of the risk assessment above, the planned correction of the excessive deficit by 2009 on a sustainable basis requires the Government to strictly achieve the budgetary targets. This hinges upon an effective implementation of all the measures announced in the programme for the years 2006 to 2009, as well as upon a further specification and implementation of structural reforms and expenditure control.

(13) The debt-to-GDP ratio, according to the programme projections, would significantly increase in 2006 to 68.5% (from 62.3% in 2005), above the 60% of GDP Treaty reference value. The programme projects the debt ratio to increase further to 71.3% in 2007 and to 72.3% in 2008. The ratio is expected to start decreasing in 2009 to 70.4%. Risks to the envisaged debt path mainly stem from higher-than-expected deficits in the primary balance including due to the possible assumption of the debt of the public transport companies. In view of this risk assessment, the debt ratio would not be sufficiently diminishing towards the reference value during the programme period.

(14) Hungary appears to be at high risk with regard to the sustainability of public finances. The very weak budgetary position, in conjunction with the relatively high and rising debt ratio, constitutes a notable risk to sustainable public finances, even before considering the long-term budgetary impact of an ageing population. Moreover, the long-term budgetary impact of ageing in Hungary is well above the EU average, influenced notably by a significant increase in pension expenditure as a share of GDP over the long-term. Carrying out a large consolidation of the public finances over the medium-term as planned, further strengthening the budgetary position thereafter, and addressing the significant increases in pension expenditure is therefore necessary if these risks are to be reduced.

(15) While there has been a serious deterioration in public finances in 2006, hampering the correction of the excessive deficit in line with the planned path, the measures envisaged in the programme, if fully specified and implemented, are broadly consistent with the broad economic policy guidelines included in the integrated guidelines[18]. In particular, Hungary plans to take effective actions to correct the excessive deficit and to implement reforms in order to strengthen fiscal discipline and to increase transparency. These measures should also contribute to correcting the high current account deficits. However, they need to be backed up by structural reforms to ensure fiscal sustainability.

(16) With the Implementation Report to be submitted by mid-October 2006 in the context of the renewed Lisbon strategy for growth and jobs, the Hungarian Government is planning to substantially revise reform plans contained in the October 2005 National Reform Programme (NRP), so as to reflect the Government's new strategy. The October 2005 NRP identified the following key challenges with significant implications for public finances: (a) to reduce the fiscal deficit, (b) to improve infrastructure and (c) to increase the activity and the employment rate and enhance human capital. The adjusted convergence programme update outlines plans and measures to restructure the public administration, health-care, pension and public education systems. In particular, by 2007, the programme plans to take measures to reduce the size of the public administration and improve its efficiency by exploiting economies of scale; to introduce means-testing in subsidies; to restructure pharmaceutical subsidies and to partly liberalise the trade of pharmaceutical products; to introduce co-payments for health-care services. In addition, by 2007, proposals for law amendments are to be submitted to the parliament aiming at increasing the retirement age and decreasing early retirement by improving the incentive schemes and by revamping the disability pension system; at putting health-care services on strict insurance basis and at rationalising the provision and the use of these services; at restructuring public education. These plans are still to be substantiated. The programme complements these plans by envisaged improvements to the institutional features of the public finance framework.

In view of the above assessment, the high general government deficit in Hungary expected for 2006 is a matter for serious concern. It is therefore to be welcomed that in the adjusted convergence programme update of September 2006 the Hungarian authorities give priority to the reduction of the excessive deficit through a substantial front-loaded effort and commit to reporting to the Commission and Council twice a year on progress and on actions taken to stay on track. While important first steps have been taken to secure additional revenues and cut expenditures with a view to reaching the new 2007 deficit target and plans have been announced to improve expenditure control and undertake structural reforms so as to back the adjustment path, risks with respect to meeting the adjustment path remain in both the short term and the outer years of the programme. The planned deficit reduction is contingent on the rigorous implementation of the envisaged structural reforms, on the enforcement of expenditure controls from the early years of the programme, as well as on a reinforcement of the institutional set-up of public finances in Hungary, all aspects on which the Council urges the Hungarian government to ensure the highest effort.

[18] In July 2005, the broad economic guidelines were integrated into the integrated guidelines as part of the Reinforced Lisbon Strategy (OJ L 205, 6.8.2005).

A recommendation addressed to Hungary to tackle the large budgetary imbalances is adopted by the Council at the same time under Article 104(7) of the Treaty.

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[19], 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. In particular, it recommended that the Hungarian authorities take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target.

(5) On 18 January 2005, the Council acting pursuant to Article 104(8) of the Treaty on a recommendation by the Commission, decided that Hungary had not taken effective action in response to its recommendation of 5 July 2004, particularly since the deficit target for 2005 was expected to be missed by a sizable margin.

[19] OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

(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; further recommendations can only be addressed to Hungary on the basis of Article 104(7).

(7) On 8 March 2005, upon a recommendation by the Commission, the Council adopted, in accordance with Article 104(7), a new recommendation to the Hungarian authorities to 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. On 8 November 2005, the Council decided for the second time, pursuant to Article 104(8) on a Commission recommendation, that Hungary's action was inadequate. Thereby it notably took into account the fact that the deficit targets of 3.6% of GDP in 2005 and of 2.9% of GDP in 2006 (without the burden arising from the 1998 pension reform)[20] would be missed by a sizable margin and that the implementation of tax cuts starting from 2006 was contrary to the Council recommendation.

(8) 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 six months at most and that the correction of the excessive deficit should be completed in the year following its identification unless there are special circumstances. Where special circumstances exist, the Member State concerned may be allowed to correct the excessive deficit in a medium-term framework. Such special circumstances - namely, the size of the deficit and the ongoing structural shift in the economy - were considered to be in place when Hungary was placed in excessive deficit and therefore a framework for its correction until 2008 was established in line with the Hungarian strategy set out in the convergence programme of May 2004.

(9) The adjusted convergence programme update, submitted by Hungary on 1 September 2006 in response to the invitation in the January 2006 Council opinion on the convergence programme update of December 2005, provides a revised framework for the correction of the excessive deficit in the medium term. The adjusted update aims to correct the excessive deficit by 2009, one year later than in the previous programmes. The annual targets for the general government deficit in the adjusted convergence programme update are the following: 10.1% of GDP in 2006, 6.8% in 2007, 4.3% in 2008 and 3.2% in 2009. These figures include the burden of the pension reform discontinuing the practice of the December 2004 and December 2005 convergence programme updates. The Hungarian authorities have hence decided to no longer benefit from the transitory period on the sectoral classification of pension schemes granted by Eurostat on 23 September 2004 that would in any case expire on 1 April 2007. The planned reduction in the nominal deficit is to be achieved by increasing the revenue-to-GDP ratio by 3 percentage points and by reducing the expenditure-to-GDP ratio by 3.9 percentage points over the programme period. Following an estimated

[20] These targets did not include the burden arising from the 1998 reform of the pension system since in December 2004 the Hungarian authorities decided to avail themselves of the decision by Eurostat on 23 September 2004 allowing the classification of second-pillar pension schemes inside the general government sector for a transitory period until the March 2007 notification. Using the most recent estimates of the pension reform contribution, these deficit targets including the pension reform burden would have been 5% of GDP and of 4.5% of GDP, respectively.

deterioration in 2006 by some 2 percentage points of GDP, the structural balance (i.e. the cyclically-adjusted balance excluding one-off and other temporary measures) is planned to improve by around 6½% of GDP over the period 2006-2009. About half of this substantial improvement is planned to occur in 2007. After the expected correction of the excessive deficit, the adjustment is expected to continue towards the medium-term objective of the budgetary position which is set at a structural deficit in the range of ½ to 1% of GDP. The debt ratio would continue to rise to 72.3% of GDP by 2008, well above the 60% of GDP reference value, and it is only planned to start decreasing in 2009.

(10) In its opinion of [10 October 2006] on the adjusted convergence programme update of September 2006, the Council reviews the plans of the Hungarian authorities to reduce the deficit, including through a programme of structural reforms. Important first steps have been taken in 2006 to secure additional revenues and cut expenditures with a view to reaching the 2007 deficit target. In addition, plans have been announced to improve budgetary discipline (by more transparent accounting as well as by the introduction of multi-annual spending caps and of an expenditure rule) and to undertake structural reforms. However, risks remain in both the short term and the outer years of the programme. In particular, there is still considerable uncertainty about the effective enforcement of the planned expenditure freezes and, more generally, about containing expenditure increases. Moreover, despite the planned measures, the achievement of the budgetary targets in the outer years of the programme could be at risk also in the light of a weak institutional framework for the budgetary process, the fact that announced fiscal rules have not yet been fully specified and of repeated evidence of substantial slippages in public finances. Hungary is considered to be at high risk with regard to the sustainability of the public finances which requires a large consolidation over the medium term as planned and further strengthening of the budgetary position thereafter. The opinion also notes the commitment by the Hungarian authorities to reporting twice a year to the Commission and the Council on budgetary developments and announcing corrective steps in case of slippages.

(11) In general, 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. In the case of Hungary, the correction of the excessive deficit needs to be framed within a comprehensive reform strategy including the reform of public administration, health-care, pension and education systems as well as measures to improve budgetary control.

(12) While originally the correction of the deficit was to take place within a medium-term framework ending in 2008, this target date can no longer be regarded as realistic given the recent large budgetary slippages in Hungary which, in violation of the Council recommendation, led to a massive increase in the government deficit. The new medium-term framework for the correction, laid down in the adjusted convergence programme update, puts forward 2009 as the deadline for the correction. In view of the recent slippages, this new deadline, which implies a substantial correction of the structural deficit by more than 6% of GDP over three years, seems appropriate.

(13) To this end, the Hungarian Government should (i) limit the deterioration of the fiscal position in 2006 by ensuring a rigorous implementation of the adopted and announced corrective measures, and by allocating possible windfall gains for this purpose. This

would lead to a nominal deficit of, at most, 10% of GDP in 2006 which would be still exceptionally high; (ii) rigorously implement the necessary measures to ensure a frontloaded and sustained substantial correction of the structural deficit by taking a very substantial step in 2007 followed by continued significant adjustment efforts until the correction of the excessive deficit, the magnitude of the effort being that foreseen in the Council opinion on the adjusted convergence programme update; to stand ready to adopt the additional measures which may be necessary to achieve the correction of the excessive deficit by 2009; and also (iii) incorporate sufficient reserve provisions in the forthcoming budget laws to avoid slippages even in case of unforeseen events. At the same time, the government debt ratio will have to be brought on a firm downward trajectory in line with the multi-annual path for deficit reduction laid down in the convergence programme and preferably before 2009.

(14) The planned correction of the excessive deficit by 2009 will require the Government to strictly achieving its budgetary targets which hinges upon an effective implementation of all the measures announced in the programme for the years 2006 to 2009 as well as upon timely decisions on and implementation of structural reforms and expenditure control.

(15) The Commission and the Council, in accordance with Article 10 of Regulation (EC) No 1467/97, shall monitor the implementation of action taken by Hungary in response to this recommendation, including on the basis of the regular reports announced by the Hungarian authorities.

HEREBY RECOMMENDS:

1. The Hungarian authorities should put an end to the present excessive deficit situation as rapidly as possible and by 2009 at the latest;

2. The Hungarian authorities should reduce the deficit in a credible and sustainable manner, in accordance with the multi-annual path for deficit reduction as specified in the Council Opinion of [10 October 2006] on the adjusted convergence programme update submitted on 1 September 2006. Specifically, to this end, the Hungarian authorities should:

   (a) Limit the deterioration of the fiscal position in 2006, by ensuring a rigorous implementation of the adopted and announced corrective measures, and by allocating possible windfall gains to this end;

   (b) Rigorously implement the necessary measures to ensure a frontloaded and sustained substantial correction of the structural deficit as foreseen in the adjusted programme and the Council opinion thereupon; and stand ready to adopt the additional measures which may be necessary to achieve the correction of the excessive deficit by 2009;

   (c) Adopt and implement swiftly the planned reforms of the public administration, healthcare, pension and education systems with a view to containing and reducing expenditure until the end of and beyond the programme horizon in order to ensure a lasting improvement of public finances.

3. The Council establishes the deadline of [10 April 2007] for the Hungarian authorities to take effective action regarding the measures to achieve the deficit targets for 2006 and 2007. In particular, the envisaged expenditure-reducing measures should be entirely incorporated into the 2007 budget law and timely implemented to ensure the strict implementation of the planned major deficit reduction in 2007. Moreover, sufficient reserve provisions should be incorporated in the budget law to avoid slippages even in case of unforeseen events.

4. The Hungarian authorities should ensure that the government gross debt ratio is brought onto a firm downward trajectory, in line with the multi-annual path for deficit reduction laid down in the convergence programme and preferably before 2009.

5. The Hungarian authorities should improve budgetary control by enhancing fiscal rules, namely by specifying and enforcing the planned expenditure rule and spending caps, and by strengthening the institutional framework.

In addition, the Council invites the Hungarian authorities to ensure that budgetary consolidation towards its medium-term objective of a structural deficit of ½ to 1% of GDP is sustained after the excessive deficit has been corrected.

The Council welcomes the commitment of the Hungarian authorities in the adjusted convergence programme update of 1 September 2006 to submit reports to the Commission and the Council examining progress made in complying with this recommendation on a six-monthly basis, with the first report expected by 1 April 2007.

This recommendation is addressed to the Republic of Hungary.

Done at Luxembourg, [10 October 2006].

For the Council
The President