COUNCIL OF
THE EUROPEAN UNION

Brussels, 28 June 2005
(OR. en)

9650/05

ECOFIN 181
UEM 135

LEGISLATIVE ACTS AND OTHER INSTRUMENTS

Subject:	Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Hungary

COUNCIL RECOMMENDATION

of 8 March 2005

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

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 shall 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) By Council Decision 2004/918/EC[1], on 5 July 2004, it was decided, in accordance with Article 104(6) of the Treaty, that an excessive deficit existed 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[2], 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.

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1 OJ L 389, 30.12.2004, p. 27.
2 OJ L 209, 2.8.1997, p. 6.

(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 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 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.

(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 shall avoid excessive deficits but that Articles 104(9) and Article 104(11) of the Treaty do not apply to it.

(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: 4,4%, 3,6%, 2,9%, 2,2% and 1,6% of GDP between 2004 and 2008. These figures are consistent with the decision by Eurostat of 23 September 2004, which allows a temporary reclassification until the March 2007 fiscal notification of second pillar pension funds inside the general government. The Hungarian authorities decided to avail themselves of this possibility and presented the general government deficit figures excluding the second pillar burden created by the 1998 pension reform[1]. The update continues to plan to correct the excessive deficit by 2008. According to the Council Opinion of 8 March 2005 on the updated convergence programme of Hungary, 2004-2008, the adjustment path, including the deficit target for 2005 followed by a further adjustment of 2 percentage points of GDP can be considered appropriate to correct the excessive deficit by 2008, provided that it is underpinned by sufficient measures to achieve the deficit targets.

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1 Including the pension reform burden, the general government deficit path would be 5,3%, 4,7%, 4,1%, 3,4% and 2,8% of GDP between 2004 and 2008.

(9) Although this adjustment path and in particular the deficit target for 2005 followed by a further adjustment of 2 percentage points of can be considered appropriate, the current policy stance of the Hungarian authorities is not sufficient to achieve the target. Furthermore, the most pronounced expenditure reduction would occur in 2005, mainly based on a 0,5 percentage point decline in the interest burden and a 1,7 percentage point reduction of public investment expenditure. The drop in public investment expenditure would be compensated by an increased recourse to public private partnership projects. Based on the draft budget for 2005 and a projected growth rate of 3,7% in 2005, the Commission services forecasted in autumn 2004 a deficit by 0,5 percentage point higher than the official target. The main risks pointed out are 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 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. 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, additional measures are required.

(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 updated convergence programme 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 deficit target for 2005 as set in the updated convergence programme. 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