COUNCIL OF
THE EUROPEAN UNION

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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

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 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) of the Treaty, that an excessive deficit exists in Hungary.

(4) Having so decided, 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[1], 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.

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[1] 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).

(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 sizeable margin.

(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 be addressed to Hungary only 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) of the Treaty, 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)[1] would be missed by a sizeable margin and that the implementation of tax cuts starting from 2006 was contrary to the Council recommendation.

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[1] 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 4,5 % of GDP, respectively.

(8) According to Article 3(4) of Regulation (EC) No 1467/97, a recommendation made in accordance with Article 104(7) has to 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, thus 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 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 and there is no safety margin for the 2009 target. 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, contrary to 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. This new deadline, which implies a substantial correction of the structural deficit by more than 6 % of GDP over three years, seems realistic.

(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; stand ready to adopt the additional measures which may be necessary to achieve the correction of the excessive deficit by 2009; and

(iii) incorporate sufficient reserve provisions in the forthcoming budget laws and report them in the programme updates to avoid and fully compensate any slippages even in the 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 Hungarian Government to strictly achieve 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, are to 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 THE FOLLOWING:

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

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 thereon; 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 and the further specification of the multi-annual programme of budgetary consolidation. 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 forthcoming budget laws and be reported in the programme updates to avoid slippages even in the case of unforeseen events.

4. The Hungarian authorities should ensure that the government gross debt ratio is brought on to 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 on a six-monthly basis to the Commission and the Council examining progress made in complying with this recommendation, including on structural reforms. The first report is expected by midApril 2007. The Commission and the Council will analyse these reports with a view to assessing progress made towards the correction of the excessive deficit.

This recommendation is addressed to the Republic of Hungary.

Done at Brussels,

For the Council
The President