COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 22.12.2004
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Recommendation for a

COUNCIL DECISION

establishing, in accordance with Article 104(8), whether effective action has been taken by Hungary in response to recommendations of the Council in accordance with Article 104(7) of the Treaty establishing the European Community

(presented by the Commission)

EXPLANATORY MEMORANDUM

The excessive deficit procedure (EDP) is governed by Article 104 of the Treaty and by Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, which is part of the Stability and Growth Pact. These provisions are amplified by the political commitments enshrined in the Resolution of the Amsterdam European Council on the Stability and Growth Pact of 17 June 1997.

Following a reported deficit of 5.9% of GDP in 2003[1], the Commission initiated the excessive deficit procedure for Hungary on 12 May 2004. On the Commission's recommendation, the Council decided on 5 July 2004, in conformity with Article 104(6), that Hungary had an excessive deficit and consequently, pursuant to Article 104(7), issued a recommendation to the Hungarian authorities for its correction[2]. In this recommendation, the Council invited the Hungarian authorities "*to put an end to the present excessive deficit as rapidly as possible*" and "*to take action in a medium-term framework as foreseen in the convergence programme submitted in May 2004*" (with the following annual targets: 4.6% of GDP in 2004, 4.1% of GDP in 2005, 3.6% in 2006, 3.1% in 2007 and 2.7% of GDP in 2008). The Council established the deadline of 5 November 2004 to "*take effective action regarding the measures envisaged to achieve the 2005 deficit target*". Hungary was also recommended to "*implement with vigour the measures envisaged in the May 2004 convergence programme, in particular to stand ready to introduce additional measures, if necessary, with a view to achieving the general government deficit target for 2004*". In addition, the Council invited the Hungarian authorities "*to seize every opportunity to accelerate the fiscal adjustment; to undertake the envisaged reforms of the public administration, health and education systems to ensure the foreseen reduction of the expenditure ratio and to improve the long-term sustainability of the public finances*"; and "*to ensure that planned tax cuts are adequately financed and make their implementation conditional upon the achievement of the deficit targets*".

According to Article 4(2) of Regulation (EC) No 1467/97, the Council, when considering whether effective action has been taken in response to its recommendations made in accordance with Article 104(7), must base its decision on publicly announced decisions by the Government of the Member State concerned.

While the deadline of 5 November set in the recommendation concerns the 2005 budget, performance in implementing the 2004 budget plays a major role in this context. The convergence programme envisaged a frontloaded consolidation path, concentrating the largest consolidation in 2004 (in order, among other things, to restore the credibility of Hungarian economic policy), such that the 2004 target of 4.6% of GDP was therefore particularly important[3]. Therefore, the Council recommended to the Hungarian authorities to stand ready to introduce additional measures, if necessary, on top of the two expenditure-cutting measures of January and March which totalled 1.2% of GDP with a view to achieving the general

1 It was based on the Commission Spring 2004 economic forecast, which took into consideration data reported by Hungary in March 2004. The September 2004 notification corrected the general government deficit upwards from 5.9% of GDP to 6.2% for 2003.

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

3 The targets took into account the costs incurred by the general government stemming from the pension reform of 1998 (which are expected to rise from 0.7% in 2003 to 1% of GDP by 2008).

government deficit target for 2004 of 4.6% of GDP[4]. In July 2004, following the Council recommendation, the Hungarian authorities decided to restrict the use of carried-over appropriations of ministries, indicated as a risk in the convergence programme (possible effect of up to 0.5% of GDP); this was intended to limit the expenditure slippages. In September, the authorities adopted a corrective package, with direct balance-improving effects amounting to 0.2% of GDP.

In spite of this correction, in September 2004 the official target of 4.6% of GDP was revised to 5.3% of GDP. Failure to achieve the 4.6% target can be attributed to three factors: an upward revision of the 2003 deficit in the September fiscal notification (by 0.3% of GDP), expenditure slippages and over-optimistic revenue forecasts (mainly for VAT). According to the Commission Autumn forecast there will be an even higher 2004 deficit, at 5.5% of GDP (essentially due to further risks on both the revenue and expenditure sides). The target has been missed (by 0.9 percentage point according to the Commission forecast) despite better-than-projected GDP growth.

On 15 October 2004, the Hungarian government submitted the draft Budget Law for 2005 to the Hungarian parliament. It sets a target of a general government deficit of 4.7% in 2005 on the assumption of real GDP increasing by 4% in 2005. This represents an improvement by 0.6 percentage point compared to the revised 2004 target of 5.3%. This deficit reduction is expected to come mainly from savings resulting from lower interest on debt service (net interest expenditure would decrease by 0.4% of GDP), but also from some expenditure restraint. On the revenue side the 2005 Budget calculates a decline in the revenue-to-GDP ratio of 1 percentage point of GDP, from 44.5% to 43.5% of GDP, due in large part to one-off and carry-over effects from 2004. The cut in personal income tax in the 2005 Budget would be largely compensated by other tax measures, so the changes in the tax system are assumed to have a neutral impact on revenues. The budget contains an “emergency” reserve package of 0.5% of GDP against a possible overshooting of the 2005 target. It is intended to cover unforeseen adjustments to processes which cannot be influenced by the government. While the existence of this reserve is welcome, the amount allocated to it seems modest, in view of the risks surrounding the Budget 2005, as noted by the Commission Autumn forecast. Notably: (1) interest expenditures could turn out higher than forecast, (2) the newly introduced rules for expenditure restriction may turn out to be insufficient or ineffective, as suggested by the ongoing parliamentary debate on the 2005 budget, (3) there is a risk of overly optimistic assumptions for certain revenues (mainly VAT). Against this background, the Commission forecasts a 2005 deficit of 5.2% of GDP, which would amount to a total slippage of 0.5 percentage point with respect to the budget and of 1.1 percentage point compared to the target (of 4.1%) in the convergence programme submitted only last May.

The convergence programme announced comprehensive structural reforms (mainly in the public administration and in the health and education sectors), which would support medium-term expenditure control measures. The 2005 Budget contains a few structural measures, but they do not appear to be sufficiently comprehensive or far-reaching to ensure the expenditure restraint required by the 2005 budget and, more generally, by the medium-term adjustment path presented in the convergence programme and endorsed by the Council. This applies especially in the health sector, where comprehensive health reform has been postponed.

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4 This was already a revised target compared to the 3.8% of GDP target originally budgeted for 2004. The first revision of the 2004 target in January 2004 was made in response to the large slippage in the last months of 2003, which proved that the assumptions of the 2004 budget had been too optimistic.

In conclusion: (i) while some consolidation will be achieved in 2004, the action of the Hungarian authorities in response to the Council recommendation to meet the crucial 2004 target can be considered inadequate, since the target set in the convergence programme is expected to be missed by a sizeable margin; (ii) the new official 2005 target is 0.6 percentage point higher than the original deficit target in the recommendation and in the convergence programme. According to the Commission's Autumn forecast there will be a further 0.5 percentage point slippage, which would bring the total slippage compared to the plans to 1.1 percentage point, and reduce the adjustment compared to 2004 (estimated in the Commission forecast at 5.5% of GDP) to a mere 0.3 percentage point. (iii) The deviation from the planned adjustment path, with the deficit next year likely to be still above 5% of GDP, and the slow progress in structural reforms, put at risk the completion of the correction of the excessive deficit in 2008, unless the government steps up the pursuit of its declared macro-economic policy objectives. This development can be attributed to insufficient action on the part of the Hungarian authorities.[5]

The debt ratio is expected to remain slightly below 60% in both 2004 and 2005 (the Commission Autumn forecast projects 59.7% and 59.5% of GDP respectively).

Key budgetary figures 2003-2006 (% of GDP)

	2003	2004	2005	2006
General government deficit				
- convergence programme	-5.9	-4.6	-4.1	-3.6
- revised government targets		-5.3	-4.7	
- Commission forecasts	-6.2	-5.5	-5.2	-4.7
General government debt				
- convergence programme	59.1	59.4	57.9	56.8
- revised government targets	59.1	59.6	58.6	
- Commission forecasts	58.9	59.7	59.5	58.9
p.m. real GDP growth (%)				
- convergence programme	2.9	3.3-3.5	3.5-4	ca.4
- authorities' forecasts	3.0	3.8-3.9	4.0	4.0-4.5
- Commission forecasts	3.0	3.9	3.7	3.8

Source: Commission services Autumn 2004 economic forecasts; May 2004 Convergence Programme; 2005 budget

According to the provisions of Article 104(8) of the Treaty and of Article 4(1) of Regulation (EC) No 1467/97, if the Council considers that no effective action has been taken in response

[5] This assessment does not change if, following a recent decision of the Hungarian government, the deficit is reclassified - for the transitional period permitted by EUROSTAT - without the costs incurred under the pension reform of 1998 which had been included in the deficit adjustment path of the government's convergence programme of May 2004 endorsed by the Council recommendation of 5 July 2004. This transitional classification affects temporarily the deficit level, but the change to the adjustment between 2004 and 2005 is negligible. Moreover, the multi-annual adjustment effort leading to the target below 3% in 2008 should be assessed taking into account these costs since starting with the notification of March 2007 the authorities will have to report the deficit according to the standard classification.

to the recommendations addressed under Article 104(7) by the deadline of 5 November 2004, it must take a decision to that effect immediately after the expiry of the deadline. In the light of these findings, the Commission is of the opinion that there has been no effective action in response to the Council recommendations in accordance with Article 104(7) within the period laid down in the recommendation, and it recommends that the Council decide accordingly.

Article 104(8) states that, when the Council establishes that there has been no effective action in response to its recommendation according to Article 104(7), it may decide to make this recommendation public. However, in line with the Stability and Growth Pact Resolution of the European Council, Hungary already agreed to make the recommendation public in July 2004.[6].

As to further steps of the procedure, if the Council is of the opinion that no effective action has been taken in response to the recommendations addressed under Article 104(7), it may address another recommendation based on a Commission recommendation, in accordance with Article 104(7) to Hungary, since Hungary is not yet a member of the euro area (it is a Member State with a derogation) and therefore the last two steps of the excessive deficit procedure under Article 104(9) and 104(11) do not apply (see Article 122(3) of the Treaty). Such a recommendation would take into account the update of Hungary's convergence programme.

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6 Council document 11218/04 of 6 July 2004, available in Council's public register of documents, entitled "Council Recommendation to Hungary with a view to bringing an end to the situation of an excessive government deficit –Application of Article 104(7) of the Treaty".

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THE COUNCIL OF THE EUROPEAN UNION

Having regard to the Treaty establishing the European Community, and in particular Article 104(8) thereof,

Having regard to the recommendation from the Commission,

Whereas:

(1) In accordance with Article 104 of the Treaty, Member States are to avoid excessive government deficits;

(2) 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. The Stability and Growth Pact includes Council Regulation (EC) No 1467/97[7] on speeding up and clarifying the implementation of the excessive deficit procedure set out in Article 104 in order to further the prompt correction of excessive general government deficits;

(3) The Amsterdam Resolution of the European Council on the Stability and Growth Pact of 17 June 1997[8] solemnly invites all parties, namely the Member States, the Council and the Commission, to implement the Treaty and the Stability and Growth Pact in a strict and timely manner;

(4) By Decision 2004/xxx/EC of 5 July 2004, the Council decided, in accordance with Article 104(6), that an excessive deficit exists in Hungary[9].

(5) In accordance with Article 104(7) of the Treaty and Article 3(4) of Regulation (EC) No 1467/97, on 5 July 2004 the Council adopted a Recommendation to the Hungarian authorities to bring the existence of an excessive deficit to an end as rapidly as possible and to take action in a medium-term framework to achieve the objective of bringing the deficit below 3% of GDP by 2008 in a credible and sustainable manner, in accordance with the path for deficit reduction specified in the convergence programme submitted by the authorities and endorsed in the Council Opinion of 5 July

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7 OJ L 209, 2.8.1997, p.6.
8 OJ C 236, 2.8.1997, p.1.
9 Not yet published in the Official Journal.

2004. This recommendation established the deadline of 5 November 2004 for the Hungarian government to take effective action regarding the measures envisaged to achieve the 2005 deficit target of 4.1% of GDP. In this document, the Council also recommended Hungary to implement with vigour the measures envisaged in the May 2004 convergence programme, and in particular to stand ready to introduce additional measures, if necessary, with a view to achieving the general government deficit target for 2004 of 4.6% GDP. In addition, the Council invited the Hungarian authorities to seize every opportunity to accelerate the fiscal adjustment; to undertake the envisaged reforms of the public administration, health and education systems; and to ensure that planned tax cuts were adequately financed and make their implementation conditional upon the achievement of the deficit targets.

(6) According to Article 4(2) of Regulation (EC) No 1467/97, the Council, when considering whether effective action has been taken in response to its recommendations made in accordance with Article 104(7), must base its decision on publicly announced decisions by the Government of the Member State concerned.

(7) The assessment of the publicly announced decisions taken by Hungary from the Council Recommendation issued in accordance with Article 104(7) until the deadline set in that Recommendation leads to the following conclusions:

- While a number of additional measures were adopted by the Hungarian government after the Council recommendation, the action taken was not effective to achieve the 2004 budget target of 4.6% of GDP, which is expected to be missed by a sizeable margin;
- While a number of measures have been announced in the 2005 Budget, they will not be sufficient to meet the deficit target of 4.1% of GDP, which is also expected to be missed by a sizeable margin;
- The measures taken so far by the Hungarian authorities will not avoid a deviation from the planned adjustment path which, together with the slow progress in the structural reforms envisaged in the May convergence programme, and particularly in the area of health, may put at risk the completion of the correction of the excessive deficit by 2008, unless the government steps up the pursuit of its declared macro-economic objectives.

(8) Article 104(8) states that when the Council establishes that there has been no effective action in response to its recommendation according to Article 104(7), it may decide to make this recommendation public. However, in line with the Stability and Growth Pact Resolution of the European Council, Hungary already agreed to make the recommendation public in July 2004.

HAS DECIDED AS FOLLOWS:

Article 1

Hungary has taken no effective action in response to the Council Recommendation of 5 July 2004 within the period laid down in that Recommendation.

Article 2

This decision is addressed to the Republic of Hungary.

Done at Brussels,

For the Council