COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 20.10.2005
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Recommendation for a

COUNCIL DECISION

Establishing, in accordance with Article 104(8) of the Treaty establishing the European Community, that the action taken by Hungary in response to the Council recommendation of 8 March 2005 pursuant to Article 104(7) of the Treaty is proving to be inadequate

(presented by the Commission)

EXPLANATORY MEMORANDUM

Background

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, as amended by Council Regulation (EC) No 1056/2005 of 27 June 2005, on speeding up and clarifying the implementation of the excessive deficit procedure, which is part of the Stability and Growth Pact.

After the accession to the Community on 1 May 2004, on the basis of data notified by Hungary in March 2004 and taking into account the Commission services' spring 2004 economic forecasts, the Commission initiated the excessive deficit procedure for Hungary in view of the fact that its deficit had exceeded 3% of GDP in 2003. Upon recommendation by the Commission, the Council decided on 5 July 2004 that Hungary had an excessive deficit and at the same time issued an Article 104(7) recommendation for its correction. The Council 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 specified in the Council Opinion of 5 July 2004 on Hungary's convergence programme submitted in May 2004. In particular, the Council recommended that the Hungarian authorities take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target.

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 and that the deficit target for 2005 was expected to be missed by a sizable margin. Hungary is a Member State with a derogation, which means that Articles 104(9) and 104(11) of the Treaty do not apply to it, although Hungary has the obligation to avoid excessive deficits. Thus further recommendations under the EDP can be addressed to the country only on the basis of Article 104(7).

On 8 March 2005, the Council adopted a new recommendation for Hungary in accordance with Article 104(7), on a recommendation by the Commission[1]. The Council recommended 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. For this recommendation, it referred to the revised path for deficit reduction as specified in the Council Opinion of 8 March 2005 on the convergence programme update which was submitted in December 2004 and also stressed its contribution to debt reduction and the improvement in the external balance. The relevant annual targets for the general government deficit were 4.4%, 3.6%, 2.9%, 2.2% and 1.6% of GDP between 2004 and 2008.[2] To that end, Hungary was in particular recommended to take effective action by 8 July 2005 regarding additional measures, as far as possible of a structural nature, in order to achieve the deficit

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[1] See http://register.consilium.eu.int/pdf/en/05/st07/st07145.en05.pdf

[2] For comparison reasons, all these figures are consistent with the decision by Eurostat of 23 September 2004 allowing a temporary classification of second pillar pension funds inside the general government of which the Hungarian authorities availed themselves, even though this is only possible until the March 2007 fiscal notification. It refers to the contributions to the second pillar pension schemes as corrected (upwards) in the March 2005 notification: 0.9% of GDP in 2004, 1.1% of GDP in 2005, and 1.2% of GDP in 2006-2008. These numbers have been revised upwards again in the September 2005 notification (see footnote 7).

target for 2005 of 3.6% of GDP[3]. The Council recommended furthermore 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, it invited the Hungarian authorities 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, and to seize every opportunity to accelerate the fiscal adjustment.

On 13 July 2005, the Commission adopted a communication to the Council[4], based on the information available at the time, including corrective measures decided by the Government in March and June totalling 1½% of GDP to compensate for slippages, and the firm commitment of the Hungarian government to carry out further measures if necessary. Against this background it appeared that the targeted deficit of 3.6% of GDP for 2005 was within reach and that the Hungarian government had taken effective action in response to the Council recommendation of 8 March 2005 regarding the measures envisaged to achieve the 2005 deficit target by the deadline of 8 July 2005. The Commission concluded that no further steps under the excessive deficit procedure were necessary at that point. However, it also stressed that the budgetary situation in Hungary remained vulnerable. In particular it emphasised that the achievement of the deficit target for 2005 required (i) the effective implementation of all the measures envisaged, and (ii) additional action to which the Government had committed itself publicly, should further overruns appear later in the year. Moreover, it underlined that the achievement of the deficit target of 2.9% of GDP in 2006 would require important adjustments and decisive action, including the adoption of a prudent budget for 2006. Hence, the Communication indicated that the Commission would have to recommend to the Council to enhance the budgetary surveillance and to take the necessary action under the excessive deficit procedure, should failures in implementing the envisaged correction emerge at a later stage.

Recent developments that considerably worsen the budgetary situation and outlook

On 20 September 2005 the Hungarian authorities submitted a revised September EDP notification announcing a 2005 deficit of 6.1% of GDP instead of the targeted 3.6% of GDP although no significant change in the macro-economic scenario occurred. This revised notification took into account that the planned sale of existing motorways to the state owned motorway company (AAK) including those under construction until end 2005 could not be considered as a deficit-reducing measure and that the payment of the 13th month public salary should still be recorded in the year to which it pertains despite its postponement to the beginning of the following year[5], worsening the deficit in 2005 by 1.9% and 0.1% of GDP, respectively. The notification also contained an additional slippage of 0.5% of GDP. About

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3 At the time, the Commission services expected the deficit in 2005 to reach 4.1% of GDP.

4 Communication from the Commission to the Council concerning the action taken by Hungary in response to the Council recommendation of 8 March 2005 according to Article 104(7) under the excessive deficit procedure (SEC(2005) 951) http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp/com_actkhu_en.pdf

5 In September 2005, the Hungarian Constitutional Court declared this postponement (and the fact that public sector employees who had stopped working at the end of 2004 were not entitled to the 13th month salary) to be unconstitutional.

half of this shortfall comes from lower VAT revenues, in part due to policy action[6]. The other half of the slippage reflects an expenditure overrun. The Government informed the Commission that it had no intention to take action to correct such developments, contrary to earlier commitments. Apart from the statistical clarification and the acknowledged uncompensated slippages, it is also worth noting that compared to the March notification the contribution for 2005 to the second pillar pension scheme was increased by 0.2% of GDP (from 1.1% of GDP to 1.3% of GDP) so that the underlying deterioration of the notified deficit figure of 6.1% of GDP compared to the 3.6% of GDP target contained in the March 2005 Council recommendation actually amounts to 2.7% of GDP.[7] The outcome for 2005 will be worse if further slippages occur (not excluded particularly on the expenditure side) and are also not compensated by corrective measures. According to the September notification, the debt-to-GDP ratio in 2005 will remain below the 60% threshold, at 57.1%. However, almost one third of the debt is denominated in foreign currency and hence its ratio to GDP is sensitive to exchange rate volatility.

Regarding the 2006 deficit, the Communication of July 2005 had already indicated that even if the target of 3.6% of GDP for 2005 would be met, the achievement of the 2.9% of GDP target in 2006 would be difficult, especially in view of the expiry of the above-mentioned one offs related to the motorways and the above-mentioned planned tax cuts (expected revenue loss of the latter measure estimated at 1.1% of GDP). However, at the time it was considered that corrective measures could still be taken as committed by the Government. The Government submitted on 30 September a budget proposal for 2006 which contains a deficit target of 4.7% of GDP. However, it appears that this deficit target does not fully include the recording of military aircraft which will be delivered in 2005. According to ESA95 accounting rules, this expenditure should be booked in 2005, though a large part of effective payments is postponed to later periods. The revised new deficit target of 5.2% of GDP (including full recording of military aircraft delivery) is substantially higher than the target of 2.9% of GDP referred to in the Council recommendation based on Article 104(7) of March 2005 (as endorsed by the Council in its opinion on the December 2004 update of the convergence programme and in its recommendation). The underlying difference between the original and the new target is expected to be even higher than 2.3% of GDP assuming a similar increase in the pension fund contribution as notified recently for 2005.

Moreover, even the considerably higher 2006 deficit target is at risk: On top of the higher deficit level in 2005 (reflecting the decision that the sale of motorways are not considered as general government revenue in 2005) which has a base effect for 2006, and the need to record the purchase of military airplanes in the year of delivery to be compatible with ESA95 rules which therefore adds 0.5% of GDP in 2006, there are the following elements: (i) the negative revenue impact of the tax reform (of 1.1% percentage point of GDP), and (ii) the impact of

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6 A revenue loss of about 0.015 percentage point of GDP can be attributed due to the recent decision to advance, but only for petrol, the general VAT cuts that will be implemented starting from 1 January 2006.

7 In line with the authorities' decision regarding the temporary classification of second pillar pension funds referred to in footnote 2, the target of 3.6% of GDP in 2005 was calculated after taking into account the contribution to the second pillar pension scheme of 1.1% of GDP as notified in March 2005, whereas the reference deficit reduction path, including the original target of 4.7% of GDP, in the convergence programme update of December 2004 was still without this pension fund contribution. To compare the recently notified deficit with the original target contained in the convergence programme update, the higher pension fund contribution of 1.3% of GDP as notified in September has to be removed which results in a deficit of 7.4% of GDP.

the decision to raise family allowances by 0.4% of GDP in the framework of the "100 steps" reform programme. All this suggests that the deficit could increase very significantly above the revised target for 2006 unless corrective measures are taken. So far the Government has signalled that – in contrast to the plans contained in the updated convergence programme - it would shift expenditure related to the construction of new motorway to a PPP-style framework, and thus lower government investment expenditure in 2006 by 1.2% of GDP and that this shift would be compatible with ESA rules. Even if this compatibility is confirmed (which would nevertheless raise questions about the sustainability of the adjustment), a correction of about 2% of GDP would still be required in order to meet the revised 2006 deficit target. However, the draft budget recently adopted by the Government does not contain measures of a structural nature that would support such a substantial reduction.

The revision of both the 2005 and 2006 deficit targets are furthermore clearly breaching another element of the March Council recommendation, notably to make the timing and implementation of any tax cuts conditional upon the achievement of the deficit targets of the convergence programme update. Not only does the 2006 budget contain a substantial tax cut, but there has also been an advancement of the VAT cuts (on petrol) to October 2005.

In conclusion:

(i) the action of the Hungarian authorities in response to the March 2005 Council recommendation to meet the 2005 deficit target is proving to be inadequate since the target referred to in the Council recommendation of March 2005, will be missed by a sizeable margin. This is due to the appropriate statistical treatment of the planned sale of motorways and to slippages amounting to about ½ % of GDP. The Government has decided not to take action to correct these developments contrary to previous commitments. It should be noted that the target of 3.6% for 2005 was contained in the December 2004 update of the convergence programme[8] and endorsed by the Council in its opinion thereupon.

(ii) the target for 2006 contained in the convergence programme update and March 2005 Council recommendation has been abandoned in the recent budget for 2006. Moreover, even the substantially higher new target could be missed;

(iii) the planned implementation of tax cuts especially in 2006 is contrary to the Council recommendation to 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; and

(iv) the substantial deviation both in 2005 and 2006 from the planned adjustment path aiming at correcting the excessive deficit by 2008, which was set by the Hungarian government and endorsed in the Council Recommendation of March 2005, puts into question the credibility of this correction and, together with the slow progress in structural reforms, deepens the macro-economic imbalances.

According to the provisions of Article 104(8) of the Treaty and of Article 4(1) of Council Regulation (EC) No 1467/97 (as amended by Council Regulation (EC) No 1056/2005), if the Council considers that no effective action has been taken in response to the recommendations

[8] This includes the contribution to the second pillar pension scheme (which was notified at 1.1% of GDP in March 2005) whereas the original target set in the convergence programme update of December 2004 of 4.7% of GDP was still without this contribution.

addressed under Article 104(7), it must take a decision to that effect. In the light of these findings, the Commission is of the opinion that there has been no effective action in response to the March 2005 Council recommendation in accordance with Article 104(7) within the period laid down in the recommendation, and it recommends that the Council decide accordingly.

Recommendation for a

COUNCIL DECISION

Establishing, in accordance with Article 104(8) of the Treaty establishing the European Community, that the action taken by Hungary in response to the Council recommendation of 8 March 2005 pursuant to Article 104(7) of the Treaty is proving to be inadequate

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) 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. The Stability and Growth Pact includes Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[9], which was adopted in order to further the prompt correction of excessive general government deficits.

(3) The Resolution of the European Council on the Stability and Growth Pact in Amsterdam of 17 June 1997[10] 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 Council Decision 2004/918/EC of 5 July 2004, the Council decided, in accordance with Article 104(6), that an excessive deficit exists in Hungary[11].

(5) In accordance with Article 104(7) of the Treaty and Article 3(4) of Council Regulation (EC) No 1467/97, on 5 July 2004 the Council also adopted a Recommendation[12] addressed to the Hungarian authorities and calling on them to bring the existence of an excessive deficit to an end as rapidly as possible and to take action in a medium-term

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

10 OJ N° C 236, 2.8.1997, p.1.

11 http://ue.eu.int/ueDocs/cms_Data/docs/pressData/en/ecofin/81342.pdf#page=8 (OJ L 389/27 of 30 December 2004, p.27).

12 http://register.consilium.eu.int/pdf/en/04/st11/st11218.en04.pdf#page=2.

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 2004[13]. That recommendation established the deadline of 5 November 2004 for the Hungarian government to take effective action regarding the measures envisaged to achieve the original 2005 deficit target of 4.1% of GDP.

(6) On 18 January 2005, in accordance with Article 104(8) of the Treaty, on the basis of a recommendation by the Commission, 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 Hungarian convergence programme of May 2004. Moreover, 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 that background, the Council decided that Hungary had not taken effective action by 5 November 2004 in response to the recommendation of 5 July 2004.

(7) In accordance with Article 104(7) of the Treaty and Article 3(4) of Council Regulation (EC) No 1467/97, on 8 March 2005 the Council adopted a second Recommendation[14] addressed to the Hungarian authorities and calling on them 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 update submitted by the Hungarian authorities in December 2004 and endorsed in the Council Opinion of 8 March 2005. Among other things, that recommendation established the deadline of 8 July 2005 for the Hungarian government to take effective action regarding the measures envisaged to achieve the 2005 deficit target of 3.6% of GDP[15].

(8) On 13 July 2005 the Commission adopted a Communication on Hungary. On the basis of the information available at the time, including corrective measures decided by the Government in March and June totalling 1½% of GDP to compensate for slippages and the firm commitment of the Hungarian government to carry out further measures if necessary, it stated that the Hungarian authorities had taken effective action by the deadline of 8 July 2005, although the situation remained fragile and further measures would be needed in the future.

(9) However, the recent developments show that the action taken by the Hungarian authorities is now proving to be inadequate:

– The 2005 target of 3.6% of GDP referred to in Council recommendation (and endorsed in the Council Opinion of March 2005 December 2004 update of the convergence programme) will be missed by a sizeable margin and the Government has decided not to take new action to correct any slippages

13 http://register.consilium.eu.int/pdf/en/04/st11/st11194.en04.pdf#page=2.
14 http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp/com_ass_hu_22_dec_en.pdf
15 The difference to the previous target of 3.8% of GDP is based on the increase in the contribution to the second pillar pension scheme by 0.2 percentage point of GDP in the March 2005 fiscal notification.

contrary to earlier commitments; this is confirmed by the revised EDP notification by the Hungarian authorities on 20 September 2005 of a deficit of 6.1% of GDP for 2005. The outcome for 2005 will be worse if further slippages occur (not excluded particularly on the expenditure side) and are also not compensated by corrective measures. According to this notification, the debt-to-GDP ratio in 2005 will remain below the 60% threshold, at 57.1%. However, almost one third of the debt is denominated in foreign currency and hence is sensitive to exchange rate volatility.

– The target for 2006 contained in the convergence programme update and the recommendation adopted by the Council on 8 March 2005 that the deficit be brought to 2.9% of GDP has been abandoned by the authorities. Even the substantially higher new target of 5.2% of GDP[16] contained in the draft budget for 2006 could be missed also since the planned tax reform is expected to reduce revenues by 1.1% of GDP and the recently adopted draft budget for 2006 does not contain measures of a structural nature that would support such a substantial reduction in expenditure

– The implementation of tax cuts in 2006 in particular is contrary to the Council recommendation that the timing and implementation of any tax cuts be made conditional upon the achievement of the deficit targets of the convergence programme update submitted in December 2004.

– The substantial deviation, both in 2005 and 2006, from Hungary's deficit adjustment path aiming at correcting the excessive deficit by 2008, which was set by the Hungarian government and endorsed in the Council Recommendation of 8 March 2005, puts into question the credibility of this correction and, together with the slow progress in structural reforms, deepens the macro-economic imbalances.

(10) In line with the Resolution of the European Council of the Stability and Growth Pact, Hungary agreed to make the Council's recommendation of 8 March 2005 public.

HAS ADOPTED THIS DECISION:

Article 1

The action taken by Hungary is proving to be inadequate in response to the Council Recommendation of 8 March 2005.

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[16] This includes the standard recording of the purchase of military aircraft that add 0.5% of GDP to the announced new deficit target of 4.7% of GDP in 2006.

Article 2

This decision is addressed to the Republic of Hungary.

Done at Brussels,

For the Council
The President