COUNCIL OF
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LEGISLATIVE ACTS AND OTHER INSTRUMENTS

Subject:	COUNCIL RECOMMENDATION to Hungary with a view to bringing the situation of an excessive government deficit to an end **COMMON GUIDELINES** **Consultation deadline for Croatia: 13.3.2012**

COUNCIL RECOMMENDATION

of

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

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 126(7) thereof,

Having regard to the recommendation from the European Commission, Whereas:

(1) Article 126(1) of the Treaty on the Functioning of the European Union (TFEU) provides that 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[1].

(3) On 5 July 2004, by Decision No 2004/918/EC[2], the Council established, in accordance with Article 104(6) of the Treaty establishing the European Community (TEC), that an excessive deficit existed in Hungary and adopted a recommendation in accordance with Article 104(7) TEC with a view to bringing the excessive deficit situation to an end by 2008.

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

(4) On 18 January 2005, by Decision No 2005/348/EC[1] in accordance with Article 104(8) TEC, the Council established that Hungary had not taken effective action in response to its recommendation and on 8 March 2005 it issued a second recommendation in accordance with Article 104(7) TEC, confirming the 2008 deadline for the correction of the excessive deficit. On 8 November 2005, by Decision No 2005/843/EC[2] in accordance with Article 104(8) TEC, the Council established that Hungary had for a second time failed to comply with the recommendations in accordance with Article 104(7) TEC. Accordingly, on 10 October 2006, the Council addressed a third recommendation to Hungary in accordance with Article 104(7) TEC postponing the deadline for the correction of the excessive deficit to 2009. On 7 July 2009, the Council in its recommendation adopted in accordance with Article 104(7) TEC ('Council Recommendation of 7 July 2009') concluded that the Hungarian authorities could be considered to have taken effective action in response to the recommendations of 10 October 2006 and, against the background of the severe economic downturn issued a revised version of the third recommendation in accordance with Article 104(7) TEC, setting a further new deadline of 2011 for Hungary to correct the situation. On 27 January 2010, the Commission adopted a Communication to the Council[3] concluding that Hungary had taken effective action in response to the Council Recommendation of 7 July 2009, but it nevertheless gave an alert about considerable risks.

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[1] OJ L 110, 30.4.2005, p. 42.
[2] OJ L 314, 30.11.2005, p. 18.
[3] COM/2010/0010 final.

(5) On 24 January 2012, by Decision No 2012/…/EU[1*], the Council established in accordance with Article 126(8) TFEU that Hungary had not taken effective action in response to the Council Recommendation of 7 July 2009 within the period laid down therein. While the 3 % of GDP reference value for the deficit was not breached in 2011, this fact was not based on a structural and sustainable correction, but hinged upon substantial one-off revenues. This was accompanied by a structural deterioration in 2010 and 2011 of over 2 % of GDP, as compared to a recommended cumulative fiscal improvement of 0,5 % of GDP. Moreover, while the authorities were implementing structural measures in 2012 which were expected to largely offset the previous deterioration, the 3 % of GDP reference value for the deficit would again be respected in 2012 only thanks to one-off measures of close to 1 % of GDP, and although the structural deficit is reduced to 2,3 % of GDP, it would be breached in 2013. Following that Council Decision, on 13 March 2012, by Decision No 2012/…/EU[2**], the Council decided to suspend part of the commitments from the Cohesion Fund for Hungary with effect from 1 January 2013 in line with Article 4 of Council Regulation (EC) No 1084/2006 of 11 July 2006 establishing a Cohesion Fund[3].

1 OJ …
* OJ: please insert the number and the OJ reference of the Decision in doc. 5353/12.
2 OJ …
** OJ: please insert the number and the OJ reference of the Decision in doc. 6952/12.
3 OJ L 210, 31.7.2006, p. 79.

(6) In accordance with Article 126(7) TFEU and Article 3 of Regulation (EC) No 1467/97, the Council is required to make recommendations to the Member State concerned with a view to bringing the situation of excessive deficit to an end within a given period. The recommendation has to establish a maximum deadline of six months for effective action to be taken by the Member State concerned to correct the excessive deficit, as well as a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances.

(7) In deciding whether special circumstances exist, "relevant factors" as clarified in Article 2(3) of Regulation (EC) No 1467/97 should be taken into account. Furthermore, in a recommendation to correct an excessive deficit, the Council should request the achievement of annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement in the structural balance, i.e. the cyclically adjusted balance excluding one-off and other temporary measures, of 0,5 % of GDP as a benchmark.

(8) The Hungarian economy emerged from recession in 2010 as GDP grew by 1,3 %. The recovery was considerably faster in 2010 than the Commission services' projection in spring 2009 of -0,3 % (i.e the most recent one at the time of the Council Recommendation of 7 July 2009). In 2011, GDP is expected to have continued expanding at a moderate rate of 1,7 %, still driven exclusively by the external balance. However, the growth outlook deteriorated over the course of 2011 due to the overall weakening of the international environment, which played out over several channels, as well as to the further contraction in domestic demand linked also to policy uncertainties. In this vein, the February 2012 Interim Forecast of the Commission services projects GDP to contract slightly, by 0,1 %, before it resumes growing again.

(9) Following a deficit of 4,2 % of GDP in 2010, the general government balance is expected to turn into a surplus in 2011, but only thanks to substantial one-off revenues of almost 10 % of GDP linked to the transfer of pension assets from private pension schemes. The official estimate for the 2011 budget surplus is 3,9 % of GDP as specified in Hungary's December 2011 EDP progress report. Taking into account the recent information about better-than-expected cash-flow budgetary developments for some revenue items as well as for the local government subsector, the surplus may even be slightly higher, at around 4,1 % of GDP based on the Commission services' updated assessment.

(10) Regarding 2012, the adopted budget targets a deficit of 2,5 % of GDP to be achieved on the back of a number of consolidation packages – to a large extent these were announced in the Széll Kálmán structural reform programme ('Széll Kálmán Plan') and the updated convergence programme of Hungary, 2011-2015 ('updated Convergence Programme') – in part intended to correct the effect of the sizeable tax cuts decided in the second half of 2010, that amounted to somewhat over 2 % of GDP, while setting aside an extraordinary reserve buffer (contingent expenditure cuts) of 1,1 % of GDP. The achievement of the target is also supported by net one-off revenues of 0,7 % of GDP from the temporary extraordinary taxes. Based on recent economic and budgetary developments, the updated Commission services' forecast currently expects the deficit to be at 3 % of GDP, thus above the authorities' official target. Compared to the adopted budget, this higher deficit forecast reflects, among other things, lower economic growth by half a percentage point, as well as a more prudent assessment of revenue and expenditure developments. At the same time, it assumes that the extraordinary reserves will not be used (i.e. contingent expenditure cuts will be carried out). The updated Commission services' forecast of the deficit at 3 % of GDP is 0,2 % of GDP higher than the projection at the time of the adoption of the Commission recommendation of 11 January 2012 for a Council decision under Article 126(8) TFEU. This is explained by the fact that the better-than-expected base effect from 2011 is not sufficient to counterbalance the budgetary impacts of the further downward revision in the 2012 economic outlook and the impact of the higher bond yields. In line with established practice in the fiscal surveillance of the Union, the new consolidation plans of 0,4 % of GDP published by the Hungarian authorities on 21 February 2012 cannot be incorporated in the Commission services' forecast since they have not been sufficiently substantiated yet.

(11) In 2013, the deficit is expected to rise again to around 3,6 % of GDP, up from 3 % of GDP, which exceeds the Commission services' forecast of 3,25 % of GDP at the time of the adoption of the Council decision of 24 January, 2012 under Article 126(8) TFEU. This higher deficit number is mainly due to deficit increasing developments of 0,4 % of GDP, such as lower tax revenues due to the lower growth forecast in 2012, that also contributed to the higher 2012 deficit forecast. Moreover, interest expenditures will increase more in 2013 than in 2012, by 0,1 % of GDP. These effects are expected to be only partly offset by other effects such as the lower than earlier expected financing need of the central bank in 2013 (by 0,25 % of GDP). When compared to 2012, the deficit increase to 3,6 % in 2013 stems essentially from the phasing out of sectoral levies with a net budgetary effect of 0,7 % of GDP in 2013, the higher debt service expenditures of 0,5 % of GDP as well as the tightening of the tax base of the personal income tax with a budgetary effect of 0,3 % of GDP. These deficit increasing effects, totalling some 1,5 % of GDP are expected to be only partly counterbalanced by the further implementation of the Széll Kálmán Plan resulting in savings of 0,4 % of GDP and other savings of 0,4 % of GDP, such as the nominal freezing of the wages in the public sector. Finally, the budget is expected to benefit somewhat from the foreseen economic recovery.

(12) According to the latest Commission services' estimates, after a deterioration by 1,5 % in 2010 and by 0,5 % in 2011, the structural balance is expected to improve by close to 2 % in 2012 before deteriorating again by 0,5 % of GDP in 2013. If the government would take the necessary measures to achieve its fiscal targets in 2012 and 2013, the structural improvement would amount to broadly 2,5 % of GDP in 2012 and 0,5 % of GDP in 2013.

(13) The budgetary outlook described above could be improved by more than 0,5 % of GDP in 2013 if reforms foreseen in the Széll Kálmán Plan would be sufficiently specified and implemented. Further expenditure savings published by the Hungarian authorities on 21 February 2012 need to be substantiated, in particular in the areas of reduction of the subsidy of the public transport companies and pharmaceuticals, whereas additional revenues could be expected from the planned introduction of the electronic road tolls. In order to achieve a durable correction of the excessive deficit, Hungary could benefit from measures in the area of the universal child benefit (possibly in connection with the recently introduced family tax allowances), a centralised, value-based property tax and from the progressive nature of the flat income tax scheme; the latter issue was covered by the Council Recommendation of 12 July 2011 on the National Reform Programme 2011 of Hungary and delivering a Council Opinion on the updated convergence programme of Hungary, 2011-2015 ('Council Recommendation of 12 July 2011') in the context of the European semester.

(14) After having increased from 79,7 % of GDP in 2009 to 81,3 % in 2010, the government gross debt slightly decreased to 80,3 % of GDP in 2011. This improvement reflects the significant primary surplus of 8 % of GDP, generated by the one-off revenue from the takeover of the private pension fund assets, which is largely offset by the exchange rate depreciation. Looking further, given the anticipated deficit numbers and based on a stronger technical exchange rate assumption compared to the level at the end of 2011 as well as assuming a further sale of the former private pension fund assets of 1 % of GDP, government gross debt is expected to be around 76 % of GDP in 2012 but it is expected to increase again from 2013.

(15) Past fiscal developments point to a weakness in fiscal governance and in the transparency of budgetary planning and implementation. After changes of the fiscal governance framework that was still in its infancy, the authorities introduced the key elements of a changed set-up in the new Constitution which entered into force on 1 January 2012. Most notably, a nominal debt ceiling was set at 50 % of GDP (to be achieved through a continous debt reduction from the current high level), and a veto right over the budget was granted to a rearranged Fiscal Council. However, the efficiency and effectiveness of its operations under normal conditions may have been weakened. Follow-up legislation to establish the new operational numerical rules both at the central and the local level as well as the stipulation on the governing arrangements of the Fiscal Council was adopted in December 2011 in a 'cardinal law', the Economic Stability law. The adopted new annual numerical rule appears to focus too much on the annual budgetary cycle and does not seem to be conducive to medium-term budgetary planning, which was recommended to be strengthened by the Council Recommendation of 12 July 2011 in the context of the European semester. In that same country-specific recommendation the Council also recommended Hungary to broaden the analytical remit of the Fiscal Council, which is not yet ensured, even after the adoption of the Economic Stability law.

(16) Regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy for correcting the excessive deficit is supported by Article 10*a*(2) of Regulation (EC) No 1497/67, which provides that the Member State concerned should provide all necessary information. In this context, a separate chapter in the updated Convergence Programme should be prepared in 2012 and subsequently as well as in the regular bi-annual reporting on progress until the end of the excessive deficit procedure, in line with the Hungarian authorities' commitment.

(17) 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:

(1) The Hungarian authorities should put an end to the present excessive deficit situation by 2012.

(2) The Hungarian authorities should bring the general government deficit below the 3 % of GDP reference value in a credible and sustainable manner in accordance with the multi-annual path outlined in the updated Convergence Programme as endorsed by the opinion expressed by the Council on 12 July 2011. Specifically to this end, the Hungarian authorities should:

(a) Ensure the attainment of the 2012 deficit target of 2,5 % of GDP, which based on the macroeconomic framework after the 2012 February Interim Forecast of the Commission services would require an additional fiscal effort of at least 0,5 % of GDP on top of the 1,9 % of GDP that is already foreseen. In particular, this should be done through a further specification and rigorous implementation of the deficit-decreasing measures included in the Széll Kálmán Plan and the updated Convergence Programme as well as the adoption of further consolidation measures of a structural nature as necessary.

(b) Allocate possible windfall gains for improving the headline balance, including possible one-off revenues stemming from the step back of beneficiaries from the private to the public pension pillar.

(c) Take necessary additional measures of a structural nature as needed to ensure that the deficit in 2013, estimated to exceed the 3 % of GDP reference value by 0,6 % of GDP based on the macroeconomic framework after the 2012 February Interim Forecast of the Commission services, remains well below the threshold even after the expected and recommended full phasing out of one-off revenues of close to 1 % of GDP. These measures could include a further specification and implementation of the planned structural reforms included in the Széll Kálmán Plan.

(d) Incorporate sufficient reserve provisions in the forthcoming budget laws (on top of the general reserve prescribed by the Public Finance Act), to ensure the achievement of the budgetary targets even in case of unforeseen events.

(3) That budgetary adjustment should contribute to bringing the government gross debt ratio onto a declining path. In particular, sufficient progress toward compliance with the debt reduction benchmark should be ensured for a period of three years from the correction of the excessive deficit, in accordance with paragraph 1a of Article 2 of Regulation (EC) No 1467/97.

(4) According to the Council Recommendation in 12 July 2011, the Hungarian authorities should operationalise the key constitutional fiscal rules by adapting the cardinal law on economic stability. The numerical rules should ensure that the budget process is within the context of a truly binding medium-term framework and the analytical remit of the Fiscal Council should be broadened.

(5) The Council establishes a deadline of 13 September 2012 for the Hungarian government to take effective action and to specify the measures that will be necessary to progress towards ensuring a durable correction of the excessive deficit. The assessment of effective action will take into account economic developments compared to the updated outlook presented in the staff working document accompanying the Commission recommendation for this Recommendation.

The Hungarian authorities should report on progress made in the implementation of these recommendations in a separate chapter to be prepared in 2012 and subsequently in the updated Convergence Programme , as well as in the regular bi-annual reporting on progress until the end of the excessive deficit procedure, in line with Hungary's commitment.

In addition, the Council highlights the importance of achieving the medium-term objective (MTO) for ensuring the sustainability of public finances or a rapid progress towards such sustainability. It therefore invites the Hungarian authorities to take the necessary structural effort to reach its budget target of a deficit of 2,2 % of GDP for 2013 in a way that ensures that the MTO – currently a structural balance of -1,5 % of GDP – is sustained alongside the durable correction of the excessive deficit.

This Recommendation is addressed to Hungary.

Done at Brussels,

For the Council
The President