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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

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

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1. BACKGROUND

After the accession to the Community on 1 May 2004, on the basis of Commission services' spring 2004 economic forecasts, which took into account data reported by Hungary in March 2004, 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 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.

On 18 January 2005, the Council, acting pursuant to Article 104(8) of the Treaty, 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, the Council adopted a new recommendation for Hungary, in accordance with Article 104(7)[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[2]. To that end, it was 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 target for 2005 of 3.6% of GDP[3]. In particular, the Council recommended

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

[2] 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 submitted in December 2004. The convergence programme update contains annual targets for the general government deficit which are 4.4%, 3.6%, 2.9%, 2.2% and 1.6% of GDP between 2004 and 2008. These figures are consistent with (i) the decision by Eurostat of 23 September 2004 allowing a temporary reclassification until the March 2007 fiscal notification of second pillar pension funds inside the general government of which the Hungarian authorities availed themselves; (ii) the slightly adjusted pension reform burden as shown in the March 2005 notification. Abstracting from the pension fund correction the new target is 0.6 percentage point of GDP higher than the original target for 2005 contained in the May convergence Programme and referred to in the July 2004 Council recommendations.

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

that the "emergency" reserve package in the 2005 budget could be increased substantially, its use be as limited as possible and made conditional upon clear evidence on the attainment of the deficit target for 2005. 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.

2. RECENT DEVELOPMENTS AND MEASURES ADOPTED BY THE HUNGARIAN AUTHORITIES TO CORRECT THE DEFICIT

Shortly after the adoption of the new 104(7) recommendations by the Council, the *Hungarian authorities implemented a first set of additional corrective measures*. Notably, on 12 March the government announced the increase of the "emergency reserve package" from 0.5 percentage point of GDP (that had already been included in the 2005 budget as a safe-guard against a possible missing of the 2005 target) to 0.8 percentage point of GDP. This package consisted of a general across-the-board cut of some main expenditure items. Some additional revenues were also identified, notably 0.1 percentage point of GDP from the extension of already existing mobile phone licences. The Commission services 2005 Spring forecast, which took these new measures partly into account, came to a projection of a deficit of 3.9% of GDP for 2005 compared with the official target of 3.6% of GDP. This forecast was based on a projection for GDP growth of 3.9% in 2005, also incorporating the information contained in the 2005 budget and in the convergence programme update of December 2004: in particular, the expectation that the interest burden and public investment would decline by ½ and 1½ percentage point of GDP, respectively, and that an increased recourse to public-private partnership (PPP) projects would be sought. The forecast also pointed to a number of risks for further slippages in the area of revenues (mainly VAT and social security) and operational expenditure.

In recent months, evidence emerged that economic activity has slowed down somewhat, and therefore, the projected GDP growth now looks somewhat optimistic. However, also according to the authorities, this should have only marginal budgetary effects thanks to a re-composition of revenues: higher real wages due to faster-than-assumed disinflation lead to higher consumption and hence to higher indirect tax revenues, compensating the shortfall in corporate taxes. In addition, as new budgetary data have become available, the authorities recognised in May that several revenue and expenditure assumptions of the 2005 budget were considerably optimistic. Against this background an overall slippage of 1½ percentage point of GDP compared to the 3.6% of GDP target[4] seemed likely (table 1).

[4] While the identified slippages largely correspond to those taken into account in the Spring forecast of the Commission services which also incorporated the assumption that the majority of the 0.8% of GDP emergency reserve fund would be permanently frozen, the overall slippage is nonetheless higher than in the Commission forecast.

Table 1: Expected shortfall and overspending in the 2005 budget			
Expected revenue shortfall	Percentage point of GDP	Expected overspending	Percentage point of GDP
Value added tax	-0.4	Pension payment	+0.1
Personal income tax	-0.1	Pharmaceutical subsidies	+0.2
Social security contribution	-0.15	Higher operational expenditures of the central budget	+0.55
Excise tax	-0.15		
Total revenue shortfall	**-0.8**	**Total overspending**	**0.85**
Source: Hungarian authorities, Commission assessment.			

In order to compensate for this expected slippage, *the Hungarian government announced in June 2005 a second set of compensating measures*. The identified slippage of somewhat above 1½ percentage point of GDP would be compensated by corrective measures of the same order, including the measures of March (see table 2).

Table 2: Corrective measures compensating the identified slippages			
Revenue side	Percentage point of GDP	*Expenditure side*	Percentage point of GDP
Use of revenue for deficit reduction from the extension of expired GSM licences	0.1	Definitive freeze of expenditures of 0.6 percentage points set aside in emergency reserve fund	0.6
Increase of the gambling tax as of 1 September 2005	0.015	Tightening of the use of carry over appropriations	0.25
Widening of the social security tax base as of 1 October 2005	0.02		
Increase of border control for tabacco products	0.04		
Change in the VAT method of imports from third countries	0.025		
Additional one-off revenues resulting from the sale of state property and the higher recourse to PPP projects	0.6		
Total	**0.8**	**Total**	**0.85**
Source: Hungarian authorities, Commission assessment.			

These measures would have an overall positive impact on the 2005 budget deficit and should allow the attainment of the deficit target of 3.6% of GDP. Although it should be noted that a substantial part of such adjustment relies on one-off measures, it should also be acknowledged that some of these measures are expected to have a positive impact also on the 2006 budget. This is the case for the increase in the gambling tax, the widening of the social security base, and also for the permanent freeze of expenditures of 0.6% of GDP set aside in the emergency reserve fund, since the government committed itself to take these lower levels as a basis for the 2006 budget.

In addition, with a view to making progress on structural reform, the government recently submitted to the parliament proposals for a the so-called 100 steps programme which is planned to enter into force for a large part in 2006. One part mainly addresses the labour market and the health care sector. It aims to achieve higher social security contributions, the inclusion of a wide range of inactive or undeclared working population into the active labour market and to improve the quality of the health system. The other part of the 100 steps, however, contains a comprehensive medium-term tax reform, with significant revenue loss effects for 2006 and the year onwards. The government plans to compensate for the shortfalls, which will reach about 1 percentage point of GDP only in 2006, by not yet specified expenditure cuts. This is all the more important since there is moreover a need to compensate for shortfalls in revenues resulting from the expiry of about 1% of GDP of one-off measures taken in 2005 and since investment is planned to increase also in the light of co-financing requirements, which will also require corrective action. The Budget for 2006 should contain all the measures needed to achieve the 2.9% of GDP deficit target.

3. ASSESSMENT

On the basis of current information and the above mentioned corrective measures decided in March and June, which are partly of a permanent nature, and against the firm commitment of the Hungarian government to carry out further measures in the course of the year if necessary, it appears that the targeted deficit of 3.6% of GDP for 2005 is within reach and that the Hungarian government has 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. Accordingly, the Commission concludes that no further steps are necessary at this point under the excessive deficit procedure.

However, the budgetary situation in Hungary remains vulnerable. Correction of the excessive deficit in 2005 demands effective implementation of all the measures envisaged and of additional action, to which the Government has committed itself publicly, should further overruns appear later in the year. Moreover, since in 2006 revenue will decrease due to the expiry of one-off revenues taken in 2005 and to the planned tax cuts and investment expenditure is expected to increase again, important adjustments and decisive action, including with the adoption of a prudent budget for 2006, will be needed to achieve the deficit target of 2.9% of GDP for that year. Should failures in implementing the envisaged correction emerge at a later stage, the Commission would have to recommend to the Council to enhance the budgetary surveillance and to take the necessary action within the provisions of the Treaty and the Stability and Growth Pact.

ANNEX

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP	**CP Dec. 2004**	**3.9**	**4.0**	**4.2**	**4.3**	**4.6**
(% change)	COM	4.0	3.9	3.8	n.a.	n.a.
HICP inflation	**CP Dec. 2004**	**6.8**	**4.5**	**4.0**	**3.5**	**3.0**
(%)	COM	6.8	3.8	3.6	n.a.	n.a.
General government balance	**CP Dec. 2004**					
	corrected[1]	**-4.4**	**-3.6**	**-2.9**	*-2.2*	*-1.6*
(% of GDP)	*not corrected*[2]	*-5.3*	*-4.7*	*-4.1*	**-3.4**	**-2.8**
	COM	-4.5	-3.9	-4.1	n.a.	n.a.
Primary	**CP Dec. 2004**					
balance	**corrected**[1]	**0.4**	**0.0**	**0.2**	*0.6*	*1.0*
(% of GDP)	*not corrected*[2]	*-1.1*	*-0.9*	*-0.7*	**-0.3**	**0.1**
	COM	-0.0	-1.1	-0.7	n.a.	n.a.
Government gross debt	**CP Dec. 2004**					
	corrected[1]	**56.7**	**55.5**	**53.0**	*50.6*	*48.3*
(% of GDP)	*not corrected*[2]	*59.9*	*58.6*	*56.8*	**54.9**	**53.2**
	COM	57.8	58.9	57.9	n.a.	n.a.

Note:

[1] The Hungarian authorities decided to use the transitional period granted by Eurostat to classify the second pillar pension funds inside the government sector. Compared to the May 2004 programme, this lowers the yearly figures for the government deficit by 0.9-1.2 percentage point between 2004 and 2008. The transitional period ends with the March 2007 notification.

[2] These figures are not adjusted, i.e. they include the burden of the pension reform. They are presented for the sake of comparison with the previous programme and with the Commission services autumn 2004 forecast, and given that the 2007 and 2008 target will not benefit from this re-classification of the second pillar pension funds.

Sources:

Convergence programme (CP); Commission services Spring 2005 economic forecasts (COM); Commission services calculations.