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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

Assessment of the action taken by Hungary in response to the Council recommendation of 10 October 2006 according to Article 104(7) under the excessive deficit procedure

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1. The excessive deficit procedure for Hungary

On 5 July 2004, the Council adopted a decision in accordance with Article 104(6)¹ stating that Hungary had an excessive deficit and addressed a recommendation to the country under Article 104(7) specifying that it had to be corrected by 2008. However, the Council decided on 18 January 2005 based on Article 104(8) that Hungary did not comply with the recommendations of July 2004, since both the 2004 and the 2005 targets were expected to be missed by a sizeable margin. On 8 March 2005, the Council issued another 104(7) recommendation, maintaining the 2008 deadline for the correction of the excessive deficit. Given a substantial deterioration of the budgetary outlook in Hungary, the Council decided on 8 November 2005 for the second time based on Article 104(8) that Hungary did not comply with the new recommendations of March 2005.

On 10 October 2006, the Council adopted for the third time a recommendation to Hungary under Article 104(7), extending the deadline for the correction of the excessive deficit by one year to 2009. The Council recommended Hungary to reduce the deficit in a credible and sustainable manner and to ensure that the government gross debt ratio be brought onto a firm downward trajectory, in accordance with the multi-annual path for deficit reduction as specified in the Council opinion on the adjusted convergence programme update of September 2006. This path foresees the following deficit targets: 10.1% of GDP in 2006, 6.8% of GDP in 2007, 4.3% of GDP in 2008 and 3.2% of GDP in 2009². Hungary was also recommended to limit the fiscal deterioration in 2006 and to rigorously implement the necessary measures to ensure a frontloaded and sustained substantial correction of the structural deficit. In addition, Hungary was invited to adopt and implement swiftly the planned structural reforms also with a view to ensuring a lasting improvement of public finances, and to improve budgetary control by enhancing fiscal rules and by strengthening the institutional framework.

The deadline for Hungary to take effective action in response to the recommendations listed above was 10 April 2007. On 26 April, the Hungarian authorities submitted a progress report, which updates the macroeconomic scenario as well as the budgetary projections of the December 2006 update of the convergence programme and reports on progress in structural reforms. The present communication summarises the measures outlined in the progress report and assesses the action taken by Hungary in response to the Council recommendations.

¹ All documents pertaining to the excessive deficit procedure for Hungary can be found at: http://ec.europa.eu/economy_finance/about/activities/sgp/edp/edphu_en.htm

² Although the deficit target in 2009 would still exceed the 3% of GDP threshold, the Government assumes that 20% of the yearly burden on the budget arising from the pension reform would be taken into account when taking a decision on abrogation.

2. Action taken as reported by Hungary

2.1. Fiscal adjustment and structural reform measures

Following major budgetary slippages in the first five months of 2006, on 12 June the re-elected Government adopted a set of fiscal corrective measures (the so-called 'New Equilibrium' package), aimed at lowering the deficit compared to the official estimate of 11½% of GDP. The main elements on the revenue side were (i) an increase in the rate of employees' healthcare contributions from 4% to 7%, (ii) the introduction of a 4% 'separate tax' on pre-tax corporate profits, and (iii) an increase in the middle-bracket of the VAT rate from 15 to 20%. All of the tax amendments were adopted by Parliament on 10 July and most of them became effective on 1 September. Furthermore, the package announced measures to address tax evasion (e.g. the introduction of a minimum base for social security contributions). On the expenditure side, by the end of June some immediate spending cuts concerning pharmaceutical and gas price subsidies, health-care expenditures, administrative expenditures and the withdrawal of the general reserve for 2006 had been adopted.

On 21 December 2006, Parliament adopted the 2007 budget, which set a general government deficit target of 6.8% of GDP in line with the path contained in the September and confirmed in the December convergence programme. On the revenue side, the budget confirmed the tax measures of the 'New Equilibrium' package and introduced co-payments for health-care services. Expenditure restraint was planned to be reached by: (i) freezes in operational and wage expenditure of the public administration; (ii) cuts in gas price and pharmaceutical subsidies; and (iii) a reduction of public investment by close to 1 percentage point of GDP. The only exception to the wide-ranging expenditure restraint was the national railway company, which was budgeted to receive an extra 0.6% of GDP in the context of a comprehensive restructuring plan.

As to the institutional framework of public finances, some steps have been taken in line with the invitation of the Council recommendations. The budget introduced a new control mechanism from 2007 onwards, which is based on the quarterly monitoring of expenditure ceilings of each budgetary chapter. Linked to this, the budget increased the overall level of budgetary reserves from 0.5% of GDP in 2006 to 0.9% of GDP in 2007. The 2007 budget also set targets for the primary balance for 2008-2010 and its annexes showed a breakdown of budgetary appropriations for this period, which have however not been turned into law. According to the progress report, further plans for a comprehensive reform of the public finance framework are being elaborated, in cooperation with the State Audit Office. These concern e.g. medium-term expenditure ceilings for ministries, obligatory budgetary impact assessments for draft bills, and the establishment of an independent parliamentary budget office which would provide independent budgetary forecasts.

In addition, the following structural reform measures were adopted by the Parliament and subsequently implemented.

- In the field of public administration, the central government has been reorganised and its size reduced (several mergers of separate institutions, centralisation of back-office

operations and personnel services)³. The 2007 budget contained financial incentives to encourage cooperation between local governments in providing services. Modifications to the Public Finance Act which entered into force on 1 January 2007 are expected to increase local governments' financial discipline.

- Regarding health care, comprehensive bills on the reform of the healthcare system were adopted by the Parliament in December 2006. The provision of services has been put on a strict insurance basis as of 1 April 2007 with a transitory period until 1 January 2008. The capacity of the system has been rationalised: resources have been relocated from inpatient care to outpatient care and rehabilitation, although only 6 out of the existing 173 hospitals have been closed, which is less than initially planned. A healthcare supervision agency was established.
- In the field of pensions, the Parliament adopted new rules in November 2006. These aim at improving the balance of social security by increasing the effective retirement age and decrease new pensions by 8% as of 1 January 2008. Further reform steps to improve the long-term sustainability of the pension system are being discussed (revision of indexation, replacement rates, retirement age, and reform of the disability pension system).
- In the field of public (primary and secondary) education, the financing of service provision was modified, small schools are to merge into bigger ones, and the number of compulsory hours taught will increase by 8-10%. Moreover, a strategy for a comprehensive reform of the public education system is currently under discussion. In higher (university) education, it was decided that the number of state-financed students would be reduced by 10% in 2007 and tuition fees would be introduced as of 1 September 2008.

2.2. Budgetary developments in Hungary

Budget balance in 2006 and 2007

In 2006, the general government deficit increased to 9.2% of GDP, after 7.8% of GDP in 2005. Although substantially higher than the original deficit target of 6.1% of GDP set in the December 2005 convergence programme update, this outcome represents a substantial improvement compared to the revised official target of 10.1% of GDP contained in the September and December 2006 convergence programme updates and underlying the October 2006 Council recommendation. Revenues from direct and indirect taxes as well as from social contributions as a result of the measures described above turned out to be higher than the official projections (by close to 0.7% of GDP). The progress report argues that the measures adopted since mid-2006 to fight tax evasion are mainly responsible for this better-than-expected result. On the expenditure side, public investment was 0.3% of GDP lower than planned and outlays on cash social benefits were 0.15 % of GDP lower than expected, while spending on subsidies was somewhat higher (0.05% of GDP).

The revenue ratio increased by 1.5 percentage point of GDP to 43.7% of GDP in 2006 and the expenditure ratio by 2.9 percentage point to 52.9% of GDP (see table). It should, however, be noted that both expenditure and revenue ratios are considerably higher than foreseen in the

³ In 2006, 10 600 employees were laid off in the central government with a further 6 600 to follow this year. Overall, the number of public administration employees decreased over 10%, concentrated in the second half of the year.

December 2006 update of the convergence programme. This is partly explained by somewhat higher expenditure financed by EU transfers, and a lower-than-projected nominal GDP. However, a substantial part of the increase in the residual categories of other revenue and other expenditure is not explained in the report; it is not clear whether it corresponds to actual budgetary developments, or to a statistical issue such as an incomplete consolidation of flows among government units in connection with institutional changes.

In 2007, the official deficit target of 6.8% of GDP represents a reduction by 2.4 percentage points of GDP and by 3.3 percentage points in structural terms⁴. As mentioned in Section 2.1, this is to be achieved through tax increases officially expected to raise the tax burden by 1.2 percentage points of GDP in 2007⁵ and the planned expenditure reduction of more than 2% of GDP mainly through operational and wage expenditure freezes, cuts in gas price and pharmaceutical subsidies and the reduction of public investment expenditures.

The report argues that the February 2007 agreement with public sector employees, and in particular bringing forward half of the regular 13th month bonus payment into 2007, is neutral to the ESA deficit. Nevertheless, the agreement would *ceteris paribus* lead to higher pension expenditure (by 0.05% of GDP in 2007 and close to 0.1% of GDP in 2008) reflecting the Swiss indexation method (based 50% on inflation and 50% on net nominal wages). On top of this, the increased inflation projections from 6.2% to 7% in 2007 are expected to raise pension expenditure in the current year by around 0.2 percentage point of GDP. The report also refers to a positive impact on the 2007 budget due to the decreasing yields on the Hungarian financial market since early November 2006, which will lower the debt service by 0.3% of GDP compared to plan.

In the first quarter of 2007, the cumulative cash-based budget deficit of the central government amounted to 3.0% of (annual) GDP (against an original forecast of 3.5% of GDP for the same period announced in January 2007) which according to the report reflects a better-than-expected inflow of tax receipts and a halt in the practice of recurrent slippages of the organizational and wage costs of public institutions and health-care expenditure. On this basis and also in view of the better outcome in 2006, in the progress report the Hungarian authorities have increased their tax revenue projections by 0.2% of GDP and revised their deficit forecast for 2007 downwards to 6.6% of GDP, which suggests that they expect to slightly outperform their deficit target of 6.8% of GDP.

Budget balance in 2008 and beyond

The progress report confirms the deficit targets of the adjustment path endorsed by the Council in October 2006. It does not cover budgetary developments beyond 2007, and contains neither a comprehensive budgetary impact assessment of the already implemented measures nor of the planned reform steps. The report argues that the positive budgetary impact of the ongoing structural reforms should increasingly kick in starting from 2008 when the wage freeze and other across-the-board budgetary freezes expire. However, it does not quantify the impact.

⁴ The cyclically adjusted balance net of one-off and temporary measures, as estimated by the Commission services on the basis of the data provided in the progress report.

⁵ The revenue shortfall resulting from the cancellation by the Constitutional Court in February 2007 of the so-called "expected tax" is planned to be compensated by stricter controls of the tax authority (0.05% of GDP) and part of the central balance reserve (0.15% of GDP).

General government debt

The progress report covers the evolution of the debt-to-GDP ratio up to 2007. After the strong increase in the debt ratio from 61.7% in 2005 to 66% in 2006, only a marginal increase to 66.2% is expected in 2007, much less than envisaged in the December 2006 update of the convergence programme. This revision is ascribed in the report to the better-than-expected public finance outcome in 2006, the reassessment of stock-flow adjustments (chiefly linked to a reduction in the single treasury deposit by around 1% of GDP in 2007), and the increased nominal GDP projections.

Table: Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008
Real GDP (% change)	Report April 2007	4.2	3.9	2.2	2.6
	COM May 2007	4.2	3.9	2.4	2.6
	CP Dec 2006	4.2	4.0	2.2	2.6
HICP inflation (%)	Report April 2007	3.5	4.0	7.0	3.5
	COM May 2007	3.5	4.0	7.5	3.8
	CP Dec 2006	3.5	3.9	6.2	3.3
Output gap (% of potential GDP)	Report April 2007 ¹	0.6	1.1	0.1	-0.4
	COM May 2007 ⁵	0.5	1.0	0.2	-0.4
	CP Dec 2006 ¹	0.5	0.9	-0.4	-1.2
General government balance (% of GDP)	Report April 2007	-7.8	-9.2	-6.6	n.a.
	COM May 2007	-7.8	-9.2	-6.8	-4.9
	CP Dec 2006	-7.8	-10.1	-6.8	-4.3
Primary balance (% of GDP)	Report April 2007	-3.7	-5.3	-2.5	n.a.
	COM May 2007	-3.7	-5.3	-2.7	-1.0
	CP Dec 2006	-3.7	-6.2	-2.4	0.0
Revenues (% of GDP)	Report April 2007	42.2	43.7	43.8	n.a.
	COM May 2007	42.2	43.7	44.0	44.1
	CP Dec 2006	42.2	41.9	43.1	43.0
Expenditure (% of GDP)	Report April 2007	50.0	52.9	50.4	n.a.
	COM May 2007	50.0	52.9	50.9	49.0
	CP Dec 2006	50.0	52.0	49.9	47.2
Cyclically-adjusted balance (% of GDP)	Report April 2007 ¹	-8.1	-9.7	-6.7	n.a.
	COM May 2007	-8.0	-9.6	-6.9	-4.7
	CP Dec 2006 ¹	-8.0	-10.5	-6.6	-3.8
Structural balance ² (% of GDP)	Report April 2007 ³	-8.1	-9.0	-5.7	n.a.
	COM May 2007 ⁴	-8.4	-9.4	-6.1	-4.6
	CP Dec 2006 ³	-8.0	-9.8	-5.6	-3.7
Government gross debt (% of GDP)	Report April 2007	61.7	66.0	66.2	n.a.
	COM May 2007	61.7	66.0	67.1	68.1
	CP Dec 2006	61.7	67.5	70.1	71.3

Notes:

¹ Commission services calculations on the basis of the information in the programme.

² Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.

³ One-off and other temporary measures taken from the convergence programme (0.7% of GDP in 2006, 1.0% in 2007 and 0.1% in 2008; all deficit increasing).

⁴ One-off and other temporary measures taken from the Commission services' spring 2007 forecast (0.4% of GDP in 2005, deficit reducing; 0.2% of GDP in 2006; 0.9% in 2007 and 0.1% in 2008; all deficit increasing).

⁵ Based on estimated potential growth of 3.8%, 3.4%, 3.2% and 3.2% respectively in the period 2005-2008.

Source:

Convergence programme (CP); April 2007 Progress report (Report); Commission services' spring 2007 economic forecasts (COM); Commission services' calculations

3. Assessment of the action taken by Hungary

The assessment of compliance with the Council recommendations under Article 104(7) is carried out against the background of the April 2007 progress report and the convergence programme of December 2006 as well as the Commission services' spring 2007 economic forecast.

Macroeconomic assumptions

After real GDP growth of 3.9% in 2006, the progress report projects economic activity to decelerate to 2.2% in 2007 and 2.6% in 2008. This growth projection, which is the same as the one underlying the Council recommendation, seems broadly plausible in view of the temporary dampening impact of the fiscal adjustment package. The report expects HICP inflation to reach 7% in 2007 and 3.5% in 2008 which is somewhat lower than the Commission services' spring forecast.

Budget balance in 2006 and 2007

The deficit outcome of 9.2% of GDP in 2006 represents an increase of 1.4 percentage points compared to 2005. Nevertheless, it is almost 1% of GDP better compared to the revised deficit target of the September 2006 convergence programme. Judging from the developments in the main revenue and expenditure categories, two thirds of the better-than-expected outcome can be attributed to higher-than-expected revenues from the recently adopted tax-increasing measures and one third to lower-than-expected expenditure mainly in public investment. This assessment holds, even after taking into account that data on the residual categories of other expenditure and other revenue provided in the first notification for 2006 are exceptionally high.

The Commission services' spring 2007 forecast projects a deficit of 6.8% of GDP for 2007 which is the same as the official target and 0.2% of GDP higher than the most recent official forecast of 6.6% of GDP. Both the Commission services' spring 2007 forecast and the latest official forecast build on the most recently available information, but the Commission forecast assumes the expenditure freezes to be less effective, also in view of the past experience with similar measures. Based on current information, Hungary seems to be on track to meet the 2007 headline deficit target underlying the Council recommendation. It should be possible to build on the better-than-expected outcome in 2006 and outperform the target for 2007 which at the time of the recommendations had implied a structural adjustment of around 4 percentage points of GDP compared to 2006. This would appear feasible and indeed desirable, also in view of making further progress towards the correction of the excessive deficit as recommended by the Council. Achieving such an adjustment in 2007 would represent an important step towards restoring credibility for sound budgetary behaviour.

Budget balance in 2008 and beyond

The Commission services' spring 2007 no-policy change forecast for the 2008 deficit is 4.9% of GDP against the official target of 4.3% of GDP. The forecast does not take into account measures that were announced in the convergence programme update of December 2006 and confirmed in the progress report, as the measures were provided only in broad terms and not yet enacted. The difference between the Commission services' forecast and the official target also reflects the uncertainties around the full enforcement of the planned freezes of the public wage bill and operational expenditures. In this context, it should be noted that the

effectiveness of the new budgetary mechanisms/rules aimed at expenditure containment (see below) is yet to be confirmed.

In addition, in the Commission services' spring 2007 forecast, the budgetary impact of the February 2007 public wage agreement is only reflected in higher pension expenditure (through the Swiss indexation mechanism), as estimated also in the progress report. However, there were also other provisions in the agreement that could affect the budgetary outcomes from 2008 onwards and thus constitute a new risk factor. In particular, this concerns the promise that "*public sector wages should maintain their real value in 2008*". If the conditional half-a-month extra bonus were to be paid out in the first months of 2008 (which is subject to good budgetary performance), this would result in an additional 0.2% of GDP wage expenditure. For 2009, there would be substantial pressures for higher wages in the public sector both due to the phasing out of the two-year freeze and as a result of the public wage agreement.

The distance between the Commission services' no-policy change deficit forecast for 2008 (4.9% of GDP) and the corresponding target endorsed by the Council (4.3% of GDP) indicates the need for further action by the Hungarian authorities. The draft budget for 2008, which should be presented to Parliament by 30 September 2007, should set out the measures supporting the target and possibly over-achieve it, building on a better-than-targeted result also in 2007.

Beyond 2008, the correction of the excessive deficit by 2009 on a sustainable basis hinges on a rigorous implementation of wide-ranging structural reform measures, especially since wage and other expenditure freezes will have come to an end. In particular, in line with the announced reform agenda of the Government, this should include (i) further steps towards fully means-tested price subsidy systems (a nominal cut of 0.6% of GDP is planned in cumulative terms in 2007 and 2008); (ii) a continued streamlining of the institutional setup of the public administration to underpin the budgetary freezes of 0.6% of GDP in 2007; (iii) overhaul of the financial allocation mechanism in the health-care system; and (iv) the review of the parameters of the pension system to achieve more than the planned savings of around 0.1% of GDP in 2009.

General government debt

According to the Commission services' spring 2007 forecast, the debt-to-GDP ratio is projected to continue to increase throughout the forecast horizon: to 67.1% in 2007 and 68.1% in 2008. This is a more moderate pace than expected at the time of the Council recommendation mainly because of the lower deficit outcome in 2006 and hence demonstrates progress, but the debt ratio is higher than the progress report's forecast of 66.2% for 2007.

Structural reforms

Overall, most of the previously announced measures have in the meantime been adopted and implemented according to the planned schedule although, especially in the field of healthcare, they do not entirely correspond to the government's initial plans. Further structural reforms will need to be specified and implemented to ensure the successful correction of the excessive deficit by 2009. Additional reform steps are currently being discussed in the fields of pension and education. A comprehensive budgetary impact assessment of the structural reforms is still lacking.

Budgetary rules and institutions

In view of the Government's poor track record over the past years in expenditure control, the enhancement of the institutional framework of the public finances appears to be crucial in restoring fiscal credibility. While some fiscal rules were adopted from summer 2006 onwards, the progress in this area does not match with the more ambitious plans that had been announced in the September 2006 convergence programme. In addition, there are still uncertainties about the specification and enforcement of the already adopted rules (e.g. the way in which the new expenditure rule based on quarterly budgetary reports should work is not fully specified and the medium-term budgetary planning is only indicative). The further plans to improve the institutional framework outlined in the progress report, such as the establishment of an independent parliamentary budget office, are promising but no calendar has yet been specified for the reform process.

4. Conclusions

Based on current information, the Hungarian government has taken, by the deadline of 10 April 2007, decisions consistent with the Council recommendation addressed to Hungary in October based on Article 104(7). Specifically, it took revenue-enhancing as well as short-term expenditure-containing measures that helped limit the widening of the deficit in 2006, to a still high 9.2% of GDP but almost 1 percentage point below the target underlying the recommendation thereby taking a first step towards regaining credibility and correcting the excessive deficit by 2009. It also adopted and started to implement the 2007 budget law, which incorporated additional corrective measures (including freezes and other expenditure cuts) and seems consistent with the target of 6.8% of GDP for 2007 underlying the recommendation. In fact, in view also of the better-than-expected 2006 outcome and the lower 2007 deficit forecast in the progress report, an even better 2007 outcome should be feasible and indeed desirable, also in view of the structural adjustment recommended by the Council. The planned narrowing of the deficit in 2007 would entail a substantial slowdown in the increase of the debt ratio. Furthermore, various structural reform measures have been adopted by Parliament and subsequently implemented. In addition, Hungary has taken some initial steps to enhance the institutional framework of public finances.

In view of the above assessment, the Commission considers that no further steps are needed at present in the excessive deficit procedure of Hungary.

Looking forward however, the correction of the excessive deficit by the 2009 deadline is still subject to risks and uncertainties, also in view of the past track record. In particular, as highlighted by the Commission services' spring 2007 forecast, the achievement of the deficit targets beyond 2007 crucially hinges upon the further specification and implementation of the wide-ranging structural reform agenda and the effective enforcement of the expenditure cuts, including through reinforced budgetary rules. In the light of the fragile situation of public finances in Hungary, the Commission will continue to closely monitor its budgetary developments, among other things on the basis of the forthcoming biannual progress reports of the authorities.