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(Information)

COUNCIL

COUNCIL OPINION
of 10 October 2006
on the adjusted convergence programme update of Hungary, 2005-2009

(2006/C 260/01)

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies ([1]), and in particular Article 9(3) thereof,

Having regard to the opinion of the Council of 24 January 2006 on the updated convergence programme of Hungary, 2005-2008,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On 10 October 2006 the Council examined the adjusted convergence programme update of Hungary received on 1 September 2006, which covers the period 2005 to 2009. ([2])

(2) Following the adoption of a comprehensive economic reform package in the mid-nineties, the Hungarian economy enjoyed stable and relatively high rates of growth and a reduction in inflation supported by sound macroeconomic policies and appropriate structural reforms. However, starting from 2001, and more importantly over the recent years, significantly increased public expenditure coupled with tax cuts and generous public wage increases resulted each year in budget deficits well above 5 % of GDP, producing large deviations compared to the original deficit targets. In addition, end-year figures were substantially increased ex-post with virtually every fiscal notification. Instead of the planned deficit targets contained in the May 2004 convergence programme of 4,6 % of GDP in 2004, 4,1 % of GDP in 2005 and 3,6 % of GDP in 2006, the outcome was 6,6 % of GDP in 2004, 7,5 % of GDP in 2005 and is expected by the Government to be around 10,1 % of GDP in 2006, by

([1]) OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website:
http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

([2]) The adjusted convergence programme update (hereafter referred to as the programme), submitted to comply with the Council request of January 2006, broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct. The programme provides all compulsory data prescribed by the new code of conduct. Some optional data are missing. They mainly concern the general government expenditure by function, government debt developments and data on long-term sustainability of public finances.

far the highest level in the EU (all numbers including pension reform burden). A large part of the budgetary slippages stemmed from overoptimistic budgetary planning, large expenditure overruns, tax cuts and the lack of sufficient structural adjustment efforts. This highly expansionary fiscal policy has considerably damaged the credibility of the fiscal policy, and has been weighing increasingly on the economy. In particular, it has contributed to serious external imbalances and to a significant increase in the total foreign debt stock (from below 20 % of GDP in 2001 to close to 30 % of GDP in 2005), and much higher interest rate spreads compared to other recently acceded Member States.

(3) On 5 July 2004, the Council decided that Hungary was in excessive deficit and issued a first recommendation under Article 104(7) for its correction by 2008, the target year set by the Hungarian authorities in the convergence programme of May 2004. In January 2005 and once again in November 2005, the Council, based on Article 104(8), decided that Hungary did not comply with this first and the follow-up recommendation of 8 March 2005. It notably took into account the substantial deviation from the medium-term adjustment path, namely with respect to the deficit targets in 2005 and 2006.

(4) On 1 December 2005, the Hungarian authorities presented to the Commission and the Council a convergence programme update which contained a new adjustment path, while retaining the 2008 target year for correction of the excessive deficit. On 24 January 2006, the Council adopted an opinion on this 2005 update, in which it considered that the very large cut in expenditures of 7,5 % of GDP was not backed by concrete measures. Therefore, in accordance with the second paragraph of Art. 9 of section 3 of Council Regulation (EC) No 1466/97 as amended, the Council invited Hungary to present as soon as possible, and by 1 September 2006 at the latest, an adjusted convergence programme update identifying concrete and structural measures that are fully consistent with its medium-term adjustment path.

(5) After a general government deficit outcome of 7,5 % of GDP in 2005 reported in Spring 2006, the Hungarian authorities announced following the April 2006 general elections that there would be very large upward revisions of the 2006 deficit which could reach, in the absence of corrective steps, 11,6 % of GDP ([1]). The overshoot compared to the deficit target of 6,1 % of GDP set in the budget law and the 2005 convergence programme update took place almost entirely on the expenditure side (around 5 % of GDP). It mainly occurred in the areas of operational costs of central budgetary institutions, pension payments, health-care expenditure, and because of higher-than-expected investment of local governments due to the electoral cycle. Around 1½ % of GDP of the overshoot was explained on the one hand by the accounting of motorway investment inside the general government ([2]) (1,1 % of GDP), which was originally planned to be undertaken by PPPs (public private partnerships) to be recorded off budget, and on the other by the costs of military aircraft (0,3 % of GDP) purchased under a financial lease. Both of these outlays were not included originally in the official target figure.

(6) In June, facing a spiralling budget deficit, the Government — re-appointed following the April 2006 general elections — withdrew the remainder of its five-year tax cut programme which would have further lowered revenues by around 3 % of GDP by 2010 and adopted a corrective fiscal package. A number of the corrective measures, including all those on the revenue side, have already been adopted by Parliament. The tax increases, together with some immediate cuts in health-care expenditure, gas price subsidies, public administration expenditure and the full withdrawal of the 0,3 % of GDP general reserve of the budget, are expected by the Government to reduce the deficit overrun in 2006 by 1,5 % of GDP, in order to achieve the new deficit objective of 10,1 % of GDP. These measures are also expected to produce important effects over the future years.

(7) The macroeconomic scenario presented in the programme projects real GDP growth to fall back in the coming years from 4,1 % in 2006 to 2,2 % and 2,6 % in 2007 and 2008, respectively, due to the contractionary impact of the fiscal adjustment measures set out in the programme, some of which have already been implemented from July 2006. Growth is expected to recover to pre-adjustment levels by 2009. These developments are also reflected in the implicit cyclical conditions, which show

([1]) Hungary has decided no longer to benefit from the transitory period on the sectoral classification of pension schemes granted by Eurostat on 23 September 2004, that will in any case expire on 1 April 2007. Without the pension reform burden, the deficit outcome in 2005 would have been 6,1 % of GDP and the target for 2006 would have been 4,7 % of GDP.

([2]) Originally this investment was planned to be undertaken by PPPs (public private partnerships) to be recorded off budget.

negative output gaps for the years 2007 and 2008 and the return of output to its potential level by 2009. Based on currently available information, and without prejudging the Commission services' Autumn 2006 forecast, this macroeconomic scenario appears broadly plausible although it is somewhat optimistic concerning 2009. The significant improvement of the external balances expected in the programme seems plausible in view of both the direct and the indirect effects of the fiscal adjustment measures. In particular, the current account deficit is expected to decrease from close to 8 % of GDP in 2006 to less than 4 % of GDP in 2009. Inflation is projected to peak at 6,2 % in 2007 after 3,5 % in 2006 and to decrease to 3 % by 2009. The projected pattern can be explained in the light of the VAT increase and of the decreases in price subsidies decided in Summer 2006. However, the level of inflation seems somewhat underestimated over the entire horizon despite the dampening effect of the economic slowdown.

(8) The programme aims to correct the excessive deficit by 2009. This would be achieved by a steep and front-loaded deficit reduction of 6,9 percentage points of GDP within three years, from the high starting position of 10,1 % of GDP in 2006 to 3,2 % of GDP in 2009. The improvement in the primary balance over the period is of the same magnitude. The programme recognises that the deficit target of 3,2 % of GDP in 2009 would still exceed the 3 % of GDP threshold specified in the Treaty, but assumes that the Council and the Commission, when considering the case for an abrogation of the excessive deficit procedure for Hungary, could take into account a part of the net cost of the pension reform, in line with the revised Stability and Growth Pact. [1] Nearly half of the reduction in the deficit ratio is already to take place in 2007. The planned reduction in the nominal deficit is to be achieved by increasing the revenue-to-GDP ratio by 3 percentage points and by reducing the expenditure-to-GDP ratio by 3,9 percentage points over the programme period. [2] As far as the revenue side is concerned, all revenue increases underpinning the projected rise in the programme's revenue-to-GDP ratio have been adopted. On top of the above-mentioned already adopted expenditure cuts, the Hungarian authorities plan to achieve their targets by implementing strict multi-annual spending caps for most expenditure items and to strengthen budgetary expenditure controls. These plans are expected to be included and fully spelled out in the 2007 budget law, which will be presented to parliament by end-October. Moreover, the programme announces comprehensive structural reforms aimed to ensure the achievement of the deficit targets, especially in the outer years of the programme (such as the introduction of co-payment schemes in the health-care sector, the revamping of price subsidies and a streamlining of the central public administration).

(9) Over the programme period, the structural balance (in cyclically-adjusted terms and net of one-off and other temporary measures) calculated according to the commonly agreed methodology and based on programme figures is planned to improve on average by around 2¼ % of GDP per year, falling from 9¾ % of GDP in 2006 to 3¼ % in 2009. The programme sets the medium-term objective (hereafter MTO) for the budgetary position as a structural budget deficit between 0,5 % and 1 % of GDP, which it does not aim to achieve within the programme period. The MTO lies within the range indicated in the Stability and Growth Pact and the code of conduct and adequately reflects long-term potential output growth and the debt ratio.

(10) Regarding the budgetary outcome, there are a number of elements on the positive side. Large part of the measures to back the reduction of the deficit in 2006 and 2007 are either already adopted or planned to be incorporated into the 2007 budget. In addition, in recent months the Government has taken decisions on some initial steps of the planned structural reforms. Moreover, the Hungarian authorities have decided to improve the budgetary process through more transparent accounting and by introducing an expenditure-control rule from 2007 onwards and multi-annual expenditure planning for budgetary institutions; they also commit themselves in the programme to report twice a year

[1] According to Council Regulation (EC) No 1056/2005, Article 1 paragraph 7, if the general government deficit '…has declined substantially and continuously and has reached a level that comes close to the reference value', the Council and the Commission should consider degressively the net cost of a pension reform that includes a fully-funded pillar. For Hungary, this would correspond in 2009 to 20 % of the net cost of the pension reform or an estimated 0,3 % of GDP.

[2] It should be noted in this context that the trajectory of the total revenues and total expenditure ratios includes projected EU transfers which raise both the expenditure and revenue ratios by some 1,7 percentage points over the programme period (by 1,1 percentage point in 2009 alone); thus adjusted for these transfers, the revenue-to-GDP ratio increases by 1,3 percentage points, while the expenditure-to-GDP ratio falls by 5,6 percentage points.

to the Commission and the Council on budgetary developments and announce corrective steps in case of slippages. However, there are also important risks. There is still some uncertainty about the effective enforcement of the planned expenditure freezes in 2007 and 2008 and about containing expenditure increases in areas not covered by the freezes. Moreover, despite the planned measures, the achievement of the budgetary targets in the outer years could be subject to important risks. Although the risks to the revenue side stemming from the macroeconomic scenario appear on the whole broadly balanced, the expected revenues in the outer years and especially in 2009 are rather optimistic. Moreover, apart from the poor track-record in expenditure control and the lack of precise information about how it will be achieved in the future, the weak institutional control of the budgetary process exposes public finances to substantial slippages. Therefore, the envisaged deficit reduction is contingent on the rigorous implementation of the envisaged structural reforms and expenditure control starting from the early years of the programme.

Finally, it cannot be excluded that the almost 2 % of GDP debt accumulated by the public transport companies since end 2002 will be assumed by the Government (given that this has happened at regular intervals in the past), should the restructuring and partial privatisation plans of the national railway company fail to yield the expected results; this would have a temporary effect on the deficit. Overall, the budgetary outcome could be worse than projected in the programme, both in the short term and the outer years of the programme.

(11) In view of the risk assessment above, the planned correction of the excessive deficit by 2009 on a sustainable basis requires the Government to strictly achieve the budgetary targets. This hinges upon an effective implementation of all the measures announced in the programme for the years 2006 to 2009, as well as upon a further specification and implementation of structural reforms and expenditure control.

(12) The debt-to-GDP ratio, according to the programme projections, would significantly increase in 2006 to 68,5 % (from 62.3 % in 2005), above the 60 % of GDP Treaty reference value. The programme projects the debt ratio to increase further to 71,3 % in 2007 and to 72,3 % in 2008. The ratio is expected to start decreasing in 2009 to 70,4 %. Risks to the envisaged debt path mainly stem from higher-than-expected deficits in the primary balance including due to the possible assumption of the debt of the public transport companies. In view of this risk assessment, the debt ratio would not be sufficiently diminishing towards the reference value during the programme period.

(13) Hungary appears to be at high risk with regard to the sustainability of public finances. The very weak budgetary position, in conjunction with the relatively high and rising debt ratio, constitutes a notable risk to sustainable public finances, even before considering the long-term budgetary impact of an ageing population. Moreover, the long-term budgetary impact of ageing in Hungary is well above the EU average, influenced notably by a significant increase in pension expenditure as a share of GDP over the long-term. Carrying out a large consolidation of the public finances over the medium-term as planned, further strengthening the budgetary position thereafter, and addressing the significant increases in pension expenditure is therefore necessary if these risks are to be reduced.

(14) While there has been a serious deterioration in public finances in 2006, hampering the correction of the excessive deficit in line with the planned path, the measures envisaged in the programme, if fully specified and implemented, are broadly consistent with the broad economic policy guidelines included in the integrated guidelines. ([1]) In particular, Hungary plans to take effective actions to correct the excessive deficit and to implement reforms in order to strengthen fiscal discipline and to increase transparency. These measures should also contribute to correcting the high current account deficits. However, they need to be backed up by structural reforms to ensure fiscal sustainability.

(15) With the Implementation Report to be submitted by mid-October 2006 in the context of the renewed Lisbon strategy for growth and jobs, the Hungarian Government is planning to substantially revise reform plans contained in the October 2005 National Reform Programme (NRP) to reflect the Government's new strategy. The adjusted convergence programme update outlines plans and measures to restructure the public administration, health-care, pension and public education systems. In particular, by 2007, measures are planned to reduce the size of the public administration and

([1]) On July 2005, the broad economic policy guidelines were integrated into the integrated guidelines as part of the Reinforced Lisbon Strategy (OJ L 205, 6.8.2005, p. 28)

improve its efficiency by exploiting economies of scale; to introduce means-testing in subsidies; to restructure pharmaceutical subsidies and to partly liberalise the trade of pharmaceutical products; to introduce co-payments for health-care services. In addition, by 2007, proposals for law amendments are to be submitted to the parliament aiming at increasing the retirement age and decreasing early retirement by improving the incentive schemes and by revamping the disability pension system; at putting health-care services on strict insurance basis and at rationalising the provision and the use of these services; at restructuring public education. These plans are still to be substantiated. The programme complements these plans by envisaged improvements to the institutional features of the public finance framework.

The high and widening budget deficit in Hungary in recent years, and in particular in 2006, has created serious concern and calls for urgent, determined and sustained action. It is therefore to be welcomed that in the adjusted convergence programme update of September 2006 the Hungarian authorities give priority to the reduction of the excessive deficit through a substantial front-loaded effort and commit to reporting to the Commission and Council twice a year on progress and on actions taken to stay on track. While important first steps have been taken to secure additional revenues and cut expenditures with a view to reaching the new 2007 deficit target and plans have been announced to improve expenditure control and undertake structural reforms so as to back the adjustment path, risks with respect to meeting the adjustment path remain in both the short term and the outer years of the programme. The planned deficit reduction is contingent on the rigorous implementation of the envisaged structural reforms, on the enforcement of expenditure controls from the early years of the programme, as well as on a reinforcement of the institutional set-up of public finances in Hungary, all aspects on which the Council urges the Hungarian government to ensure the highest effort.

A recommendation addressed to Hungary to tackle the large budgetary imbalances is adopted by the Council at the same time under Article 104(7) of the Treaty.