COUNCIL OPINION

of 27 February 2007

on the updated convergence programme of Hungary, 2006-2010

(2007/C 71/07)

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 recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On 27 February 2007 the Council examined the updated convergence programme of Hungary, which covers the period 2006 to 2010.

(2) The programme's macroeconomic scenario expects a slow-down of economic activity for the years 2007 and 2008, as a result of the fiscal consolidation measures, with a recovery to pre-consolidation growth rates by 2009. Assessed against currently available information, this scenario appears to be broadly plausible for the years up to 2008 and might even be slightly cautious, while for the outer years it seems rather favourable. The programme projects inflation to surge in 2007 and rapidly decline thereafter; however, the projected inflation path over the entire programme horizon is somewhat favourable.

(3) For 2006, the general government deficit is estimated at 10,1 % of GDP in the Commission services' autumn 2006 forecast, in line with the revised target of the September 2006 update [2], and against a target of 6,1 % of GDP set in the December 2005 update of the convergence programme. The overshoot compared to the original deficit target took place almost entirely on the expenditure side (around 5 % of GDP), mainly operational costs of central budgetary institutions, pension and health-care expenditure and local government investment. It also reflects the inclusion of motorway investment inside the general government (1,1 % of GDP). The budgetary corrective package of 1½ % of GDP adopted in summer 2006 consists of revenue-increasing measures, together with some immediate expenditure cuts in the areas of health-care, gas price subsidies and public administration. These measures (except the withdrawal of the 0,3 % of GDP general reserve of the budget) are expected to produce important effects also in 2007 and thereafter.

(4) The main goal of the update is to correct the excessive deficit by 2009 (reducing the deficit from 10,1 % of GDP in 2006 to 3,2 % of GDP in 2009 [3]), in line with the September 2006 update

[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] In its opinion on the December 2005 update of the convergence programme, the Council had considered that the planned cut in expenditures of 7,5 % of GDP was not backed by concrete measures. Therefore, it had invited Hungary to present by 1 September 2006 at the latest an adjusted convergence programme update identifying concrete and structural measures fully consistent with its medium-term adjustment path. In accordance with this request, Hungary submitted its adjusted programme on 1 September 2006 to the Council and the Commission.

[3] The deficit target of 3,2 % of GDP in 2009 would still exceed the 3 % of GDP threshold specified in the Treaty. It is assumed in the programme that the Council and the Commission take into account 20 % of the yearly burden on the budget arising from the pension reform (which is expected to amount to 0,3 % of GDP in that year) when taking a decision on abrogating the excessive deficit procedure for Hungary (in line with Council Regulation (EC) No 1467/97 as amended, Article 2 paragraph 7, which stipulates that 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 the net cost of a pension reform that includes a fully-funded pillar on a linear degressive basis for a transitory period of five years, and taking into account the implementing provisions in the code of conduct).

against a background of a broadly similar macroeconomic scenario, with a further reduction in 2010. The improvement in the primary balance is of the same magnitude. The planned adjustment is front-loaded, with nearly half of the reduction in the deficit ratio to take place in 2007. The planned nominal adjustment over the programme period is to be achieved by increasing the revenue-to-GDP ratio by nearly 1 percentage point and by reducing the expenditure-to-GDP ratio by 6.5 percentage points. An initial increase in the tax burden by 1,6 percentage points of GDP in 2007 is progressively replaced by measures on the expenditure side. On top of the expenditure cuts and budgetary freezes adopted since summer 2006, the authorities have started to strengthen expenditure controls and enhance the institutional framework of public finances. Moreover, the programme spells out a broad structural reform agenda aimed to ensure the achievement of the deficit targets, especially in the outer years of the programme.

(5) The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve from 9¾ % of GDP in 2006 to around 3 % at the end of the programme period. The medium-term objective (MTO) for the budgetary position presented in the programme is a structural deficit of 0,5 % of GDP, which the programme does not aim to achieve within the programme period. This is somewhat more ambitious compared to the previous update of the programme, which put forward an MTO-range of a structural deficit between 0,5 % and 1 % of GDP. The MTO adequately reflects the debt ratio and average potential output growth in the long term. As the MTO is more demanding than the minimum benchmark (estimated at a structural deficit of around 1½ % of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit.

(6) The budgetary outcomes could be worse than targeted in the programme, especially from 2008. The risks to the deficit path stemming from the macroeconomic outlook are broadly balanced until 2008, but lower-than-projected GDP growth in the outer years could lead to a higher deficit. Although the short-term expenditure cuts and temporary budgetary freezes were incorporated into the 2007 budget as planned, there is still some uncertainty about the effective enforcement of the expenditure freezes (also because of the poor track-record of similar controls in 2004-2006). The effectiveness of the new fiscal rules and the initial steps taken towards a multi-annual budgetary framework in reversing the pattern of regular expenditure overruns will have to be tested. The Government has taken decisions on a number of steps to reform the public administration, health, pension, price subsidies and education systems. Based on these measures the budgetary outcomes could be closer to the deficit targets for 2007 and 2008 than expected in the Commission services' autumn 2006 forecast. However, the remaining structural reform steps, necessary to replace the expenditure-curbing measures that expire at the end of 2008, still need to be further specified and fully implemented. In addition, in the outer years of the programme, there is a risk of a budgetary loosening as evidenced by past experience. Finally, should the restructuring plans of the public transport companies fail to yield the expected results, the accumulating losses of these companies might temporarily increase the deficit.

(7) In view of this risk assessment, the budgetary stance in the programme seems broadly consistent with a correction of the excessive deficit by 2009 as recommended by the Council provided that the budgetary strategy is fully implemented. This concerns in particular the full implementation of the consolidation measures announced in the 2007 budget and in the new programme as well as the further specification and timely adoption of the announced additional structural reform measures. In 2010, after the planned correction of the excessive deficit, the pace of the adjustment towards the MTO implied by the programme should be strengthened. This would also be a first step towards providing a sufficient safety margin against breaching the 3 % of GDP deficit threshold with normal macroeconomic fluctuations, which is not in place.

(8) The government gross debt is estimated to have reached 67½ % of GDP in 2006, which is above the 60 % of GDP Treaty reference value. The programme projects the debt ratio to increase to 71¼ % in 2008. After 2008, it is expected to decrease again and return to 67½ % in 2010. The evolution of the debt ratio is likely to be less favourable than projected in the programme given the risks to the budgetary targets mentioned above. In view of this risk assessment, the debt ratio would not be sufficiently diminishing towards the reference value until the end of the programme period.

(9) The long-term budgetary impact of ageing in Hungary is well above the EU average, notably as a result of the high increase in pension expenditure as a share of GDP over the long term. While first important steps have been taken, full implementation of further reform measures aimed at containing the significant increase in age-related expenditures as planned in the programme would contribute to reducing risks to the sustainability of public finances. Moreover, and importantly, the weak initial budgetary position, having deteriorated substantially compared with 2005, constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. In addition, the current level of gross debt is above the Treaty reference value. Further budgetary consolidation as planned would contribute to reducing risks to the sustainability of public finances. Overall, Hungary appears to be at high risk with regard to the sustainability of public finances.

(10) The convergence programme contains a qualitative assessment of the overall impact of the Hungarian October 2006 revised national reform programme within the overall medium-term strategy. In addition, it provides some information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme, but its budgetary projections do not explicitly take into account all the public finance implications of the actions outlined in the national reform programme. The measures in the area of public finances envisaged in the convergence programme seem consistent with those foreseen in the national reform programme. In particular, the structural reform plans and recently adopted measures outlined in the convergence programme entirely correspond to the reform agenda presented in the national reform programme, notably the reform steps adopted in the fields of public administration, health-care, pension and education and various subsidy systems.

(11) The budgetary strategy in the programme is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data ([1]).

The Council considers that the programme plans to reduce the very high deficits of the past years through a frontloaded adjustment effort and is broadly consistent with correcting the excessive deficit by 2009, the deadline set by the Council. A number of revenue-increasing and expenditure-containing measures have been taken since the summer of 2006, as well as initial reform steps in the fields of public administration, health care, pension and education reform. However, there are risks to the achievement of the deficit and debt targets, especially from 2008.

In view of the above assessment, and also in the light of the recommendation under Article 104(7) of 10 October 2006, the Council encourages Hungary to continue the highest efforts and invites Hungary to:

(i) Rigorously implement the 2007 budget and take adequate action to ensure the correction of the excessive deficit by 2009, if necessary through additional measures; and ensure, including by using any extra revenues for deficit reduction, that the gross debt-to-GDP ratio is brought onto a firm downward trajectory, preferably before 2009.

(ii) Improve budgetary control by enhancing fiscal rules and by strengthening the institutional framework of public finances, building on the first steps undertaken in the budget for 2007.

(iii) Curb expenditure in a permanent manner through the adoption and swift implementation of the announced streamlining of the public administration and healthcare systems and the envisaged reform of the education system.

(iv) In view of the level of debt and the increase in age-related expenditure, improve the long-term sustainability of public finances by making adequate progress towards the MTO and taking additional pension reform measures as announced.

([1]) In particular, data are missing on government expenditure by function as well as on hours worked, the government's financial assets and financial debt; some data on the long-term sustainability of public finances are also not provided.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009	2010
Real GDP (% change)	**CP Dec 2006**	**4,2**	**4,0**	**2,2**	**2,6**	**4,2**	**4,3**
	COM Nov 2006	4,2	4,0	2,4	2,7	n.a.	n.a.
	CP Sep 2006	*4,1*	*4,1*	*2,2*	*2,6*	*4,1*	*n.a.*
	CP Dec 2005	*4,2*	*4,3*	*4,1*	*4,1*	*n.a.*	*n.a.*
HICP inflation (%)	**CP Dec 2006**	**3,6**	**3,9**	**6,2**	**3,3**	**3,0**	**2,8**
	COM Nov 2006	3,5	3,9	6,8	3,9	n.a.	n.a.
	CP Sep 2006	*3,6*	*3,5*	*6,2*	*3,3*	*3,0*	*n.a.*
	CP Dec 2005	*3,5*	*2,1*	*3,0*	*2,4*	*n.a.*	*n.a.*
Output gap (% of potential GDP)	**CP Dec 2006** (1)	**0,5**	**0,9**	**− 0,4**	**− 1,2**	**− 0,5**	**0,4**
	COM Nov 2006 (5)	0,6	1,0	0,1	− 0,5	n.a.	n.a.
	CP Sep 2006 (1)	*0,3*	*0,8*	*− 0,3*	*− 0,9*	*0,0*	*n.a.*
	CP Dec 2005 (1)	*− 1,0*	*− 0,5*	*− 0,1*	*0,4*	*n.a.*	*n.a.*
General government balance (% of GDP)	**CP Dec 2006**	**− 7,8**	**− 10,1**	**− 6,8**	**− 4,3**	**− 3,2**	**− 2,7**
	COM Nov 2006	− 7,8	− 10,1	− 7,4	− 5,6	n.a.	n.a.
	CP Sep 2006	*− 7,5*	*− 10,1*	*− 6,8*	*− 4,3*	*− 3,2*	*n.a.*
	CP Dec 2005 (6)	*− 7,4*	*− 6,1*	*− 4,7*	*− 3,4*	*n.a.*	*n.a.*
Primary balance (% of GDP)	**CP Dec 2006**	**− 3,7**	**− 6,2**	**− 2,4**	**0,0**	**0,9**	**1,1**
	COM Nov 2006	− 3,7	− 6,1	− 2,9	− 1,4	n.a.	n.a.
	CP Sep 2006	*− 3,4*	*− 6,3*	*− 2,4*	*− 0,2*	*0,8*	*n.a.*
	CP Dec 2005 (6)	*− 3,8*	*− 2,9*	*− 1,7*	*− 0,7*	*n.a.*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Dec 2006** (1)	**− 8,0**	**− 10,5**	**− 6,6**	**− 3,8**	**− 3,0**	**− 2,9**
	COM Nov 2006	− 8,1	− 10,5	− 7,4	− 5,4	n.a.	n.a.
	CP Sep 2006 (1)	*− 7,6*	*− 10,5*	*− 6,7*	*− 3,9*	*− 3,2*	*n.a.*
	CP Dec 2005	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*

		2005	2006	2007	2008	2009	2010
Structural balance (2) (% of GDP)	**CP Dec 2006** (3)	**– 8,0**	**– 9,8**	**– 5,6**	**– 3,7**	**– 3,0**	**– 2,9**
	COM Nov 2006 (4)	– 8,5	– 10,3	– 6,5	– 5,1	n.a.	n.a.
	CP Sep 2006	*– 7,6*	*– 9,7*	*– 5,8*	*– 3,6*	*– 3,2*	*n.a.*
	CP Dec 2005	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Dec 2006**	**61,7**	**67,5**	**70,1**	**71,3**	**69,3**	**67,5**
	COM Nov 2006	61,7	67,6	70,9	72,7	n.a.	n.a.
	CP Sep 2006	*62,3*	*68,5*	*71,3*	*72,3*	*70,4*	*n.a.*
	CP Dec 2005 (6)	*61,5*	*63,0*	*63,2*	*62,3*	*n.a.*	*n.a.*

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 programme (0,7 % of GDP in 2006 and 1,0 % of GDP in 2007 and 0,1 % of GDP in 2008; all deficit increasing).

(4) One-off and other temporary measures taken from the Commission services' autumn 2006 forecast (0,4 % of GDP in 2005, deficit reducing; 0,3 % of GDP in 2006; 0,9 % of GDP in 2007 and 0,3 % in 2008; all deficit increasing).

(5) Based on estimated potential growth of 3,7 %, 3,6 %, 3,4 % and 3,2 % respectively in the period 2005-2008.

(6) For the sake of comparability, the budgetary figures of the December 2005 Convergence Programme were adjusted to include pension reform-related costs.

Source:

Convergence programme (CP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations