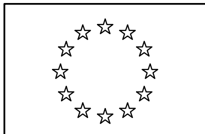

EUROPEAN COMMISSION

Brussels, 11.1.2012
SEC(2012) 53 final

COMMISSION STAFF WORKING DOCUMENT

Analysis by the Commission services of the budgetary situation in Hungary in response to the Council Recommendation of 7 July 2009 with a view to bringing an end to the situation of excessive deficit

Accompanying the documents

COMMUNICATION FROM THE COMMISSION

Assessment of budgetary implementation in the context of the ongoing excessive deficit procedures after the Commission services' 2011 Autumn Forecast

Recommendation for a

COUNCIL DECISION

Establishing that no effective action has been taken by Hungary in response to the Council Recommendation of 7 July 2009

{COM(2012) 4 final}
{SEC(2012) 49 final}
{SEC(2012) 50 final}
{SEC(2012) 51 final}
{SEC(2012) 52 final}

COMMISSION STAFF WORKING DOCUMENT

Analysis by the Commission services of the budgetary situation in Hungary in response to the Council Recommendation of 7 July 2009 with a view to bringing an end to the situation of excessive deficit

Accompanying the documents

COMMUNICATION FROM THE COMMISSION

Assessment of budgetary implementation in the context of the ongoing excessive deficit procedures after the Commission services' 2011 Autumn Forecast

Recommendation for a

COUNCIL DECISION

Establishing that no effective action has been taken by Hungary in response to the Council Recommendation of 7 July 2009

1. INTRODUCTION

On 5 July 2004, the Council decided that Hungary had an excessive budget deficit and issued a recommendation under Article 104(7) of the Treaty establishing the European Community (TEC) setting a deadline for correction of 2008. After the Council had decided twice, in January and November 2005, in accordance with Article 104(8) TEC, that Hungary had not taken effective action in response to its recommendations, it issued a third recommendation to Hungary based on Article 104(7) TEC in October 2006, postponing the deadline for the correction of the excessive deficit to 2009.

In July 2009, against the background of a severe economic downturn which triggered fiscal adjustment measures and the provision of EU/IMF balance of payments support, the Council concluded that Hungary had taken effective action and issued revised recommendations under Article 104(7) TEC, setting 2011 as the new deadline to correct the excessive deficit.

In particular, the Council recommended Hungary to limit the deterioration of the fiscal position in 2009 by ensuring a rigorous implementation of the adopted and announced corrective measures to respect the government deficit target of 3.9% of GDP. Starting in 2010, Hungary was recommended to rigorously implement the necessary consolidation measures to ensure a continued reduction of the structural deficit and a renewed decline of the headline deficit, with an increased reliance on structural measures, in view of warranting a lasting improvement of public finances. Moreover, the Council recommended spelling out and adopting in a timely manner the consolidation measures necessary to achieve the correction of the excessive deficit by 2011 and ensuring, at least, a cumulative 0.5% of GDP fiscal effort in 2010-2011. Finally, the Council invited the Hungarian authorities to ensure that budgetary consolidation towards its medium-term objective of a structural deficit of ½% of GDP sustained after the correction of the excessive deficit. In line with Article 3(4) of Regulation

(EC) No 1467/97, the Council established the deadline of 7 January 2010 for the Hungarian authorities to take effective action.

In its 27 January 2010 Communication to the Council, the Commission concluded that Hungary had taken effective action in response to the latest Council recommendations, notably since the deficit outcome for 2009 was expected to be very close to the target and a budget in line with the 3.8% of GDP target had been adopted for 2010. However, the Council "alerted about considerable risks attached to the 2010 deficit target, both on the revenue and the expenditure side". In view of the announcements of the government to cut personal and corporate income tax rates, on 28 October 2010, the Commissioner responsible for Economic and Monetary Affairs asked the government to communicate as a matter of urgency the consolidation measures it was planning to take to compensate for the revenue losses stemming from the tax cuts. In March 2011, the government announced a package of consolidation and structural reform measures, essentially starting from 2012 and reaching its peak in 2013.

The Council, in its 12 July 2011 opinion on the 2011 update of the Convergence Programme (CP) of Hungary, concluded that the fiscal adjustment strategy was mainly based on the expenditure side and that the 2011 deadline set by the Council for bringing the deficit below the 3% of GDP reference value of the Treaty would only be met thanks to the significant one-off revenues, notably from the pension assets, and the structural improvement would begin only in 2012. Taking into account the implementation risks, it could not be excluded that the threshold might be breached again in that year unless further measures would be taken. The Council recommended that Hungary "strengthen the fiscal effort in order to comply with the Council recommendation to correct the excessive deficit in a sustainable manner … and ensure that the budget deficit is kept safely below the 3% of GDP threshold in 2012 and beyond, contributing to the reduction of the high public debt ratio". Moreover, Hungary was asked to fully implement the already announced fiscal measures and "adopt additional measures of a permanent nature if needed at the latest in the 2012 budget to secure the budgetary target for that year".

This paper examines progress made by Hungary towards a timely and sustainable correction of the excessive deficit. In particular, it examines the budgetary developments since the Commission Communication to the Council of 27 January 2010 on action taken. The assessment takes into account all decisions publicly announced by the Government on budgetary developments in Hungary, and in particular the information contained in the 9th EDP progress report submitted to the Commission and the Council on 15 December 2011 and published on 6 January 2012.

2. ECONOMIC DEVELOPMENTS AND OUTLOOK

The post-2007 global economic and financial crisis hit Hungary particularly hard, also in the context of the previously accumulated external and internal vulnerabilities. The major frictions in the domestic financial systems, a sudden decline in external demand and the lack of fiscal space for stimulus measures (further budget cuts were in fact necessary to stabilise the deficit) were contributing factors to a recession that saw GDP contract by 6.7 % in 2009. This outturn was close to the 6.3% contraction expected in the Commission services' 2009 Spring Forecast, which was the latest available at the time of the Council recommendation to Hungary under Article 126(7) of the Treaty. The economy emerged from recession in 2010, supported by recovering exports on the back of better-than-expected global trade demand. Without the balance of payments support from the IMF and the EU (the latter released EUR

5.5 billion between end 2008 and mid 2009) the recession would have been considerably deeper and the recovery slower[1]. The current account deficit, which averaged over 7 % in the last decade preceding the crisis, turned into surplus owing to a strong performance of the export sector coupled with still contracting domestic demand.

The economic recovery was considerably faster in 2010 than expected as GDP grew by 1.3% vs. the 0.3% contraction expected at the time of the Council recommendation. However, the growth outlook deteriorated over the course of 2011 due to the weakening of the external environment, which played out over several channels, as well as to the further contraction in domestic demand linked also to policy uncertainties. The Commission services' 2011 Autumn Forecast projects economic growth at 1.4% in 2011 and a mere 0.5% in 2012, with risks clearly tilted to the downside. Domestic demand is set to be affected in 2012 by consolidation measures that are more than offsetting the overall personal income tax (PIT) cut – which appears to have failed to stimulate consumption in 2011 – and contracting credit due largely to the government's financial sector policies. In 2013, GDP is projected to grow by slightly below 1.5% again, aided by the assumption of an improving external environment and the dissipation of associated uncertainties, with cautiously recovering domestic demand.

By contrast, when preparing the 2012 budget the Hungarian authorities projected GDP to expand by 1.5% in 2012 and by 2.9% of GDP in 2013 (see also table below). The divergence between this official forecast underlying the budget and the Commission services' autumn forecast was mainly on account of different expectations regarding private consumption and investment: for example, the authorities were markedly more optimistic about the impact of the early foreign exchange (FX) loan repayment scheme and the minimum wage raise. More recently, on 15 December 2011, the government revised down its growth forecast to 0.5% in 2012, acknowledging that the contribution of domestic demand will be negative so that, overall, the updated official macroeconomic scenario for 2012 has become very close to the trajectory of the Commission services' 2011 Autumn Forecast. However, the macro-sensitive budgetary items have not been updated (e.g. tax revenue estimates were not revised downwards) but instead deficit-improving measures of 0.4% of GDP were adopted and the extraordinary buffers[2] were increased with the corresponding amount of 0.4% of GDP to compensate for the impact of lower growth and a weaker exchange rate on the budget. This being said, given the latest developments both in the international and national environment even these forecasts now appear optimistic (see budgetary risks below).

---

[1] The Council Decision of 4 November 2008 providing Community medium-term financial assistance for Hungary" can be found at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32009D0102:EN:NOT

[2] According to the adopted regulation, the extraordinary reserves cannot be used before September 30, 2012 and the government may decide on the use only if in the Autumn 2012 Notification the expected EDP deficit for 2012 does not exceed 2.5% of GDP.

Table 1: Comparison of key macroeconomic projections

		2010	2011	2012	2013
Real GDP (% change)	CP April 2011	1.2	3.1	3.0	3.2
	Draft 2012 Budget - Sept	*1.2*	*1.9*	*1.5*	*2.9*
	COM AF 2011	**1.3**	**1.4**	**0.5**	**1.4**
Current account balance (% of GDP)	*CP April 2011*	*2.1*	*1.6*	*2.8*	2.7
	Draft 2012 Budget - Sept	*2.1*	*2.5*	*3.7*	*2.1*
	COM AF 2011	**1.0**	**1.7**	**3.2**	**3.8**
HICP inflation (% change)	CP April 2011	4.7	4.0	3.4	3.0
	Draft 2012 Budget – Sept[1]	*4.9*	*3.8*	*4.2*	*3.0*
	COM AF 2011	**4.7**	**4.0**	**4.5**	**4.1**

Notes:
[1] National Consumer Price Index (CPI)
Source: *2011 update of Convergence programme (CP); Commission services' 2011 Autumn Forecast (COM AF 2011); Draft 2012 budget submitted to Parliament on 30 September 2012.*

3. BUDGETARY SITUATION AND PROJECTIONS FOR THE PERIOD 2011-2013

3.1. Estimated outturn for 2011

The 2010 update of the CP set the deficit targets at 3.8%, 2.8% and 2.5% of GDP in 2010-2012 in line with the Council recommendation of July 2009 based on a somewhat more favourable macroeconomic scenario than the Commission services forecast at the time. In 2010, the actual deficit of 4.2% of GDP exceeded the target in light of expenditure slippages mainly in the local government sector[3].

In 2011, the deadline for correcting the excessive deficit, the 2011 update of the CP expects the general government balance to turn into surplus despite significant tax cuts of 2½% of GDP in the second half of 2010 and in 2011. The budgetary surplus is achieved primarily thanks to huge one-off revenues (amounting to 9¾% of GDP according to the autumn 2011 notification) linked to the elimination of the obligatory private pension scheme. In order to maximise the number of people switching from the private to the public pension pillar, strong incentives were provided and penalties were imposed[4]. The elimination of the obligatory private pension scheme did not only result in one-off revenues stemming from the transfer of the accumulated assets but also in permanent revenues of around 1.3% of GDP since the pension contributions of those who switch to the public pillar are permanently paid into the public pillar instead of the private one.

The headline budgetary outcome also reflects temporary extraordinary levies of 0.9% of GDP introduced in 2010. At the same time, the budget integrates permanent saving measures of

[3] The deficit outcome exceeded the target not only in 2010 but also in 2009 by 0.7% of GDP according to the latest data. It is also worth highlighting that the 2008 and 2009 deficit numbers were significantly revised upwards compared to the first notification (from 3.4% of GDP to 3.7% of GDP regarding 2008 and from 4.0% of GDP to 4.6% of GDP as far as 2009 is concerned).

[4] For instance, real yields accumulated in the private pension funds were paid out for those who switched to the public pillar, while people had to personally indicate if they wanted to stay in the private pillar (the default option was the transfer to the public pillar). Importantly, for those choosing to remain in the private pillar pension rights were no longer going to accrue on the basis of contributions paid by their employers.[4] Consequently, 97% of the private fund members switched to the public pension pillar.

close to 1% of GDP at the line ministries which at the time compensated for the lower than earlier expected economic growth.

The Commission services' 2011 Autumn Forecast shows a somewhat lower surplus of 3.6% of GDP in 2011 than the official target of 3.9% of GDP, notably since it includes an assumption of part of the debt of public transport companies (0.2% of GDP), which was decided after the most recent update of the official deficit forecast[5]. The government deficit net of one-off effects is estimated to be around 6% of GDP. This is very substantially above the 3% of GDP reference value of the Treaty and implies that without these one-offs the deadline would not have been met. Based on recent information on one-offs, the surplus in the headline balance will be lower than 3.6% of GDP given (i) a capital injection into the Hungarian Development Bank; (ii) higher than previously expected reclaims of VAT payments related to an EU Court decision[6]; and (iii) tax rebates from the financial sector levy linked to the partial compensation of banks' losses from the early repayment of FX loans (such recording, in particular the accounting year of the tax rebate in ESA terms is subject to confirmation)[7].

In its latest recommendation of 9 July 2009, in view of the economic crisis, the Council postponed the deadline for correcting the excessive deficit by two years to 2011 and invited Hungary to ensure, at least, a cumulative fiscal effort of 0.5% of GDP over 2010 and 2011 and that budgetary consolidation towards its medium-term objective is sustained after the excessive deficit has been corrected. Instead, in the light of significant tax cuts that were not sufficiently compensated by structural measures, the structural balance deteriorated by 1½% of GDP in 2010 and a further expected 1¼% of GDP in 2011. This has occurred against a slightly better macro environment than projected by the Commission services around the time of the recommendation. Therefore, the cumulative fiscal effort was strongly negative over 2010 and 2011 (around -2¾% of GDP - see Table 2) against the recommended cumulative 0.5% of GDP structural adjustment. The measures announced after the 2011 Autumn Forecast do not change this assessment, since they impact from 2012 onwards.

[5] The public transport sector (in particular the state-owned railway sector) has been making a loss for decades, which has necessitated numerous ways of state intervention including debt assumption, capital injection as well as extraordinary budgetary support.

[6] Following a ruling of the European Court of Justice in July 2011 establishing that the Hungarian regulation on VAT refunds is against the VAT rules, the authorities made possible for corporations to reclaim the outstanding amount of VAT this autumn, resulting in a one-off revenue loss of close to 1% of GDP.

[7] In the last month of 2011 the indirect tax and corporate tax revenues exceeded the earlier expectations by around 0.3% of GDP. However, it is largely off-set by higher expenditures, in particular by the reduction of the budgetary institutions' arrears.

Table 2: Comparison of fiscal efforts (change in the uncorrected and corrected structural balance, % of GDP)

Cumulative change in structural balance over 2010 and 2011		Cumulative change in structural balance over the entire EDP period (again 2010 and 2011)		Fiscal effort recommended by the Council	Deadline for correction
Uncorrected	Corrected	Uncorrected	Corrected		
-2.8	-2.4	-2.8	-2.4	at least cum. 0.5% in 2010-2011	2011

Notes:
The uncorrected cumulative change in the structural balance is the estimated change in the structural balance from the Commission services' 2011 Autumn Forecast. The corrected cumulative change in the structural balance is the uncorrected cumulative change in the structural balance plus a correction factor capturing the effect of revisions to potential output growth between the projections at the time of the EDP recommendations and the Commission services' 2011 Autumn Forecast (see European Commission (2004) Public Finances in EMU – 2004, European Economy, Brussels; and European Commission (2006) Public Finances in EMU – 2006, European Economy, Brussels).
Source: Commission services.

3.2. Deficit projections for 2012

The Hungarian authorities submitted the 2012 draft budget to Parliament on 30 September 2011. It targets a deficit of 2.5% of GDP in line with the latest CP, which assumes the continuation of temporary sectoral levies of 0.9% of GDP.

It incorporates, first of all, several structural measures on the expenditure side, mainly in line with the *Széll Kálmán Plan* announced in March 2011. In particular, passive labour market benefits were reduced in the second half of 2011, while disability pensions, pharmaceutical subsidies and price subsidies in the public transport sector are going to be reviewed. Nevertheless, as acknowledged in the official estimations, the expected expenditure cuts of close to 1¼% of GDP are 0.3% of GDP lower than originally planned; in net terms (i.e. taking into account also second-round macroeconomic effects and filtering out taxes paid on public expenditure) this would lead to a deficit improvement of around 1% of GDP.

Second, in line with the 2011 update of the CP, additional measures of around 1¼% of GDP are also budgeted, such as the nominal wage freeze and the limited increase in the purchase of goods and services in the government sector.

Third, the budget contains additional (i) revenue increasing measures of around 2% of GDP, including a hike by 2 pps. in the standard VAT rate and excise duties, the increase of the social security contribution rate and the full elimination of the employment tax credit as well as (ii) expenditure saving measures of ½% of GDP at the line ministries. At the same time, these deficit improving measures are partly offset by deficit-increasing decisions of around 1% of GDP, such as the expansion of the public works programme and the faster than previously planned narrowing of the personal income tax (PIT) base ("phasing out of the supergrossing").

Finally, in order to counterbalance the negative budgetary effect of potential unforeseen adverse developments, the government created a substantial extraordinary budgetary reserve of 0.7% of GDP (on top of the standard general reserve[8] of 0.3% of GDP).

Overall, the authorities estimate the deficit-decreasing effect of the measures incorporated in the draft budget to be around 4% of GDP.

Table 3: Comparison of key fiscal projections

		2010	**2011**	**2012**	**2013**
General government balance (% of GDP)	CP April 2011	-4.2	2.0	-2.5	-2.2
	Draft 2012 Budget - Sept	*-4.2*	*3.9*	*-2.5*	*-2.2*
	COM AF 2011	**-4.2**	**3.6**	**-2.8**	**-3.7**
Government gross debt (% of GDP)	CP April 2011	80.2	75.5	72.1	69.7
	Draft 2012 Budget - Sept	*81.3*	*73.9*	*71.8*	*n.a.*
	COM AF 2011	**81.3**	**75.9**	**76.5**	**76.7**
Structural balance[1] (% of GDP)	CP April 2011	-3.1	-4.2	-2.5	-1.8
	Draft 2012 Budget - Sept	*n.a.*	*n.a.*	*n.a.*	*n.a.*
	COM AF 2011	**-3.8**	**-5.0**	**-2.6**	**-3.2**

Notes:
CP April 2011= 2011 update of Convergence Programme, COM AF 2011= Commission services' 2011 Autumn Forecast
[1] Cyclically-adjusted budget balance excluding one-off and other temporary measures.
Source: National authorities and Commission Services..

The Commission services, in their 2011 Autumn Forecast, project the 2012 general government deficit to reach 2.8% of GDP, also taking into account the 0.9% of GDP one-off revenues. Compared to the draft budget this higher deficit forecast reflects:

(i) lower revenue projections of 0.4% of GDP, in particular for consumption-related taxes, linked to the lower real GDP growth by 1 pp.in the Autumn Forecast compared to the budget;

(ii) a more cautious assessment of revenue changes by around 0.1% of GDP, most notably for personal income tax and gambling tax; The lower personal income tax revenue mainly reflects the somewhat larger net deficit increasing impact (0.05% of GDP) of the reshuffling of the personal income tax system (gradual phasing-out of the so-called supergrossing[9] in parallel with the full elimination of the employment tax credit) The foreseen shortage of the gambling tax revenue is linked to the expected behavioural adjustment both to the tax hike and the widening of the tax base;

(iii) higher outlays of ¼% of GDP chiefly related to state-owned transport enterprises and maintenance of roads. Regarding the state-owned public transport enterprises the Commission services estimated higher-than-budgeted financing needs based on

[8] The inclusion of this type of reserve appropriation into the budget law is prescribed by the Public Finance Act. The main function of this reserve is to meet unforeseen expenditures and could be used rather discretionally by the Government (the only constraint that maximum 40% of the total annual appropriation could be released in the first half of the year).

[9] Supergrossing is used as term when the base of the personal income tax includes the social security contributions paid by the employers.

historical data. As far as the maintenance of roads is concerned, the budgetary support was halved without changing the tasks which raised some doubts to realise these savings;

(iv) higher expenditures of ¼% of GDP due to the fact that the technical assumptions of the Autumn Forecast for nominal exchange rates and bond yield are higher than the assumption underlying the draft 2012 budget (even if they do not reflect the latest financial market developments).

These revenue shortfalls and expenditure slippages amounting altogether to 1% of GDP are assumed to be largely counterbalanced by the extraordinary additional budgetary reserve of 0.7% of GDP. This approach takes into account the governing regulation contained in the budget bill which is expected to ensure a cautious use of this reserve. According to the adopted regulation, the extraordinary reserves cannot be used before September 30, 2012 and the government may decide on its use only if in the Autumn 2012 notification the expected EDP deficit for 2012 does not exceed 2.5% of GDP, which is not expected according to the Commission services assessment. As a consequence of this approach, only a limited contingency buffer remains to offset any unforeseen adverse impacts (i.e. based on historical evidence, only part of the general reserve of slightly over 0.3% of GDP).

On 20 December 2011, Parliament adopted the 2012 budget. The amendments compared to the draft budget and the detailed legislations altogether could decrease the 2012 deficit by ¼% of GDP. This mainly reflects:

(i) the additional consolidation package of 0.4% of GDP, which was announced on 15 December 2011 in parallel with the downward revision of the official macroeconomic forecast. The consolidation package includes the diversion of the employees' pension contributions of 0.15% of GDP from the private pension schemes to the state pillar, higher excise duties of 0.05% of GDP as well as savings of 0.2% of GDP from the appropriations of line ministries, which are fully taken into account in this updated assessment despite some implementation risks[10].

(ii) Moreover, in the context of the discussion of the draft budget, other revenue increasing measures of ¼% of GDP were adopted, such as the introduction of an extra tax on fringe benefits in the form of a health contribution and the hike in the simplified business tax. These budgetary improvements are to a large extent offset by additional deficit increasing effects of 0.4% of GDP, in particular the more generous than earlier assumed wage compensation schemes[11] as well as decisions on other extra expenditures (e.g. wage increases for judges and public prosecutors).[12]

---

[10] The releated provisions were submitted to Parliament on 19 December 2011 and were voted into law on the same day. In practice, the entire amount of 0.4% of GDP was added to the different types of extraordinary reserves (thus by now, it amounts to 1.1% of GDP), which can only be released in Q4 2012 if the attainment of the official deficit target of 2.5% of GDP is ensured (as explained also in footnote one).

[11] These budgetary support schemes are available for those private companies that increase wages by more than 5%, partly triggered by the sizeable (18%) increase of the minimum wage and aimed at offsetting the elimination of the employment tax credit.

[12] In contrast to the Commission services' calculations, the government expects a net deficit decreasing impacts of 0.4% of GDP as a result of the above mentioned measures. This is explained by the official assumption that the adopted amendments to the budget were deficit-neutral, and the wage compensation would not cost more than originally envisaged.

Regarding both revenues and expenditures, the authorities have a more optimistic view, in particular they expect more revenue from the tax hike related to the simplified business tax although it is questionable in the light of historical data.

(iii) Finally, the budgetary outlook for 2012 is also impacted through the budgetary effects of the agreement between the government and the banking sector on how to share the burden stemming from the support schemes for distressed mortgage borrowers possessing FX loans concluded on 15 December 2011. Apart from the tax rebate of around 0.3% of GDP mentioned above (the recording of which should be clarified), the fiscal costs include (i) the introduction of interest subsidies for the overflow accounts of the fixed exchange rate support scheme; (ii) a five-fold extension of the operation of the National Asset Management Company; (iii) the deductibility of banks' losses stemming from the 25% debt forgiveness for non-performing loans as well as the potential reduction of this levy for those financial institutions that increase the credit supply in 2012; and (iv) the extension of the recently adopted housing subsidy scheme.

Based on the calculations of the Commission services, these direct costs (both higher expenditures and lower revenues) related to the agreement between the government and the banks would amount to 0.4% of GDP in 2012, which appears to be in line with the projections of the government. At the same time, this deficit-increasing effect is expected to be partly counterbalanced by growth-increasing second-round effects (which are difficult to quantify at this stage) as well as the increase in corporate income tax (given that the bank levy is deductible from the tax base). According to the calculations of the Commission services, roughly half of the costs (deficit-increasing impact of 0.4% of GDP) could be recouped through these positive impacts, in particular through a more favourable credit expansion compared to the baseline scenario, thus the net deficit-increasing effect of the recently agreed various schemes is estimated at 0.2% of GDP.[13] For 2012, this would imply an updated deficit forecast of 2¾% of GDP, i.e. below the 3% of GDP reference value of the Treaty.

However, it should be stressed that this updated forecast of 2¾% of GDP takes into account one off revenues of 0.9% of GDP from sectoral levies without which the 3% of GDP Treaty threshold would also be breached in 2012. Moreover, it does not take into account the recent deterioration of the macro economic outlook and the recent deterioration of financial markets (which - taken in isolation - would also push the deficit above the 3% of GDP threshold.)

3.3. Deficit projections for 2013

The Hungarian government in the 2011 update of the CP reiterated its commitment to reduce the budget deficit in 2013 to 2.2% of GDP despite the planned phasing out of the temporary extraordinary levies (0.9% of GDP). This reduction is mainly predicated on additional savings expected from the *Széll Kálmán Plan* in the following areas: introduction of the electronic road toll, reform in the local government sector, review of the disability pension system and the pharmaceutical subsidies and reforms of the higher education and public transport

[13] For the macroeconomic indirect impacts, the Commisson services accepted the model-consistent estimations published in the December 2011 Inflation Report of the National Bank of Hungary, which showed that around 0.1% of GDP additional improvement can be expected from the agreed schemes. On top of this, Commission staff estimated the positive impact on corporate income taxes stemming from the improved banking balance sheets and from the fact that less extraordinary bank tax can be deducted from the pre-tax profits to be around 0.1% of GDP.

systems. These measures were originally expected by the government to produce an additional savings of 1.2% of GDP in 2013, but this was later revised to 1.1% of GDP.

Since at the time of the Commission services' 2011 Autumn Forecast, most of the structural reform measures were not yet sufficiently specified, based on the usual no-policy change assumption and the need for taking into account well specified measures, only 0.2% of GDP of the 1.1% of GDP was incorporated at that time. In particular, the information was not sufficient regarding plans for (i) the introduction of the electronic road toll, which the Hungarian authorities expected to increase by 0.3% of GDP (a very recent announcement seems to acknowledge that this plan cannot be implemented as planned),; (ii) streamlining of the institutional network of the local government for which details were not yet clear (savings of 0.3% of GDP); (iii) further savings from the reorganisation of the public transport sector (0.05% of GDP); (iv) the further savings from the reform of the disability pension system (0.1% of GDP); as well as deficit-decreasing measures of 0.15% of GDP related to the pharmaceutical sector. This, coupled with a considerably worse (1.4%) than officially expected (around 3%) GDP growth outlook for 2013 as well as the carry-over of the higher-than-officially expected deficit in 2012 resulted in a deficit forecast of 3.7% of GDP in the Commission services' 2011 Autumn Forecast.

The outlook contained in the 2011 Autumn Forecast could be updated on account of a number of factors. First, the measures adopted in the 2012 budget compared to the draft budget decrease the 2013 budget deficit by around 0.3% of GDP[14]. Second, based also on the information contained in the recently submitted EDP progress report, a number of decisions were recently taken with the structural reform programme which could lower the deficit forecast by an additional 0.3% of GDP in 2013.[15] In particular, local government expenditure is expected to decrease somewhat due to the merger of local government administrative offices and thanks to central administration control of local government debt accumulation based on cardinal laws adopted by Parliament. In addition, the recently adopted launch of a gradual review of the working capability of disability pensioners (whose health damage is less serious and who are under the age of 57) may lead to lower expenditure on social benefits. Furthermore, the cut in the number of students with full state scholarship is expected to bring additional savings in 2013. Finally, the net deficit-increasing impact of the agreement with banking sector for 2013 (0.1-0.15% of GDP as estimated by the Commission services, for explanation see the calculations for 2012 above) will need to be also incorporated. These factors taken together, the 2013 forecast could be updated to 3¼% of GDP.

[14] The deficit-decreasing effect in 2013 is larger than in 2012 as the wage compensation mechanisms are assumed to be continued in a reduced size, although there may be implementation risks regarding the further unsubstantiated cuts in appropriations.

[15] It may be noted that the impact of the planned reforms could be further deepened and contribute to a reduction of the deficit forecast by over ½% of GDP if certain measures now under preparation would be sufficiently specified and decided, which is currently planned to take place only in the course of 2012. For instance, concerning the local government reform the authorities project further savings from merging institutions in the primary and secondary education and the health care sectors as well as other institutions currently maintained by the county level administration. This would be facilitated by the recently adopted takeover of the ownership of these institutions by the central government from the LGs. In the area of the pension system a nominal freeze of the early pensioners' benefits may result in further savings, which is a possibility from 2012 due to the regulation contained in the new constitution. As far as higher education is concerned, less outlay would stem from the review of the capacities of the institutions. Finally, further revenues are expected from the extension of the road toll system.

To sum up, the difference between this updated assessment and the official target (2.2% of GDP) notably stems from the following elements:

(i) In the absence of specific, steps about half of the structural reform programme could not be taken into account (about ½% of GDP).

(ii) The remainder is related to a higher expenditure forecast notably in the area of state-owned transport enterprises and the maintenance of roads (more than ¼% of GDP).

(iii) There is a difference in growth assumptions regarding 2013 (more than ¼% of GDP).

Table 4: Budgetary overview table

Budgetary measures/forecasts	Budgetary impact (% of GDP) as estimated by the			
	Hungarian authorities		Commission services	
	2012	2013	2012	2013
Starting point: budgetary balance at the time of the publication of the 2011 Autumn Forecast	-2.5	-2.2	-2.8	-3.7
Further specification of planned structural measures following the 2011 Autumn Forecast	0.0	0.0	0.0	0.3
Net impact of the amendments to the 2012 draft budget incorporated in the 2012 budget adopted by Parliament on 20 December	0.0	0.0	-0.15	-0.1
Consolidation package announced on 15 December, incorporated in the 2012 budget adopted by Parliament on 20 December	0.4	0.4	0.4	0.4
Expenditure cuts at the line ministries	*0.2*	*0.2*	*0.2*	*0.2*
Increase of the employees' pension contribution revenues	*0.15*	*0.15*	*0.15*	*0.15*
Increase in excise duties on tobacco products	*0.05*	*0.05*	*0.05*	*0.05*
Budgetary implications of the agreement with the banking sector concluded on 15 December, net impact	n.a.	n.a.	-0.2	(-0.1)-(-0.15)
p.m. Budgetary implications of the agreement with the banking sector, gross impact (not additive)	*-0,4*	*-0,25*	*-0.4*	*-0.25*
Total of new measures announced since the cut-off date of the 2011 Autumn Forecast (net sum of the above new measures)	n.a.	n.a.	0.05	0.45-0.50
Updated forecast of the general government budget balance (without update of the macroeconomic scenario)	n.a.	n.a.	-2¾	-3¼

In view of the developments explained above, including in particular the insufficient specification of the structural reform programme but also the related implementation risks, the deficit would exceed the 3% of GDP reference value of the Treaty in 2013 (at 3¼% of GDP, see also Table 4 and 5). Thus, the correction of the excessive deficit in 2011, which is based on very large one-off revenues and is followed by a deficit of just below 3% of GDP that still depends on substantial one-off revenues, is not of a sustainable nature.

Table 5: Comparison of budgetary projections, including impact of measures announced/taken post Commission services' 2011 Autumn Forecast, general government balance (% of GDP)

	2010	2011	2012	2013
COM AF 2011	-4.2	3.6	-2.8	-3.7
National authorities	-4.2	3.9	-2.5	-2.2
COM Jan 2012	-4.2	3.5	(-)2¾%	(-) 3¼

Notes: COM AF 2011= Commission services' 2011 Autumn Forecast. National authorities= Projections by the national authorities dated as of 30 September 2011 (confirmed in the 15 December EDP report); COM JAN 2012: Commission services' assessment as of Jan 2012; takes into account the measures contained in the 2012 draft Budget and a further consolidation package of 15 December.
Sources: National authorities and Commission services.

The above estimates do not take into account a number of deficit-increasing risks. Firstly, based on the latest available information, in particular concerning a deteriorating external outlook, a more realistic growth forecast for 2012 would be around zero. Indeed, the latest projections of the National Bank of Hungary released on 20 December 2011 already show a meagre 2012 growth figure of 0.1% (while its 2013 projection is still 1.6%, i.e. slightly higher than the Commission services' 2011 Autumn Forecast). As regards budgetary implications, a worse growth in 2012 by half a percentage point compared to the 2011 Autumn Forecast, chiefly on the account of less positive net exports, can be estimated to have a deficit-increasing impact of 0.1% of GDP for both 2012 and 2013. Secondly, an update of the debt service projections (short-term yields are currently around 100 bps. higher, long-term yields are 150-200 bps. higher, while the exchange rate against the euro is around 4-5% weaker at the end of 2011 than the technical assumptions used in the Commission services' 2011 Autumn Forecast), would increase the budget deficit further by 0.3% in 2012 and 0.4% of GDP in 2013.

Moreover, if the tax rebates of around 0.3% of GDP from the financial sector levy linked to the banks' losses from the early repayment of FX loans have to be (partly) accounted for in 2012 in ESA terms (rather than all attributed to 2011 which is currently the case), the updated 2012 figure would also increase well above 3% of GDP. In addition, possible EU court decisions linked to the extraordinary sectoral levies may also potentially result in one-off expenditures.

On the other hand, there are also some positive risks as revenues from indirect taxes over the recent months as well as the intake from the corporate income tax in December 2011 exceeded previous expectations. Moreover, based on cumulative data for Q1-Q3 2011, the budgetary discipline at the local government level was also better than expected. The continuation of these trends represents a positive risk from 2012 onwards. Finally, the possible pressures on those who are still members of the earlier obligatory private pension scheme may result in a new round of stepping back into the public pension pillar (this option was opened up again by 31 Mach 2012). This can generate additional one-off revenues of up to ¾% of GDP in 2012, although the eventual size is highly uncertain and significantly affected by the behavioural response of the private pension funds and their members.

3.4. Debt developments

The Council recommended that the authorities should ensure that the government gross debt ratio be brought onto a firm downward trajectory. According to the deficit forecasts and the exchange rate assumptions of the Commission services' 2011 Autumn Forecast, gross public

debt was expected to increase again to nearly 77% of GDP following a temporary drop in 2011 due to the takeover of the private pension assets. However, based on the end-2011 HUF/EUR exchange rate of 311 (i.e. around 12% weaker than the technical assumption used in the Autumn Forecast) and the slightly revised deficit projections for 2012 and 2013, the debt ratio could be around 80%, while it is now anticipated to stabilise at around 78.5% in both 2012 and 2013.

Beyond 2013 and under the assumption of no further policy changes on top of the Commission services' 2011 Autumn Forecast, the debt ratio would be on an increasing path and reach 88% of GDP by 2020. An additional annual structural fiscal consolidation of 0.5 % of GDP from 2014 onwards in order to reach the Medium-Term Budgetary Objective (MTO) – in the case of Hungary a deficit of 1.5% of GDP in structural terms - would bring the gross debt ratio onto a downward trajectory from 2017, reaching 76% of GDP in 2020.

3.5. Fiscal governance

Finally, the Hungarian authorities were invited to implement with vigour the fiscal responsibility law, including the compliance with the new numerical rules, as well as improve budgetary planning procedures and monitoring of the budget execution with a view to enhancing the medium-term budgetary framework. Until mid-2010, the new fiscal governance system was phased in relatively successfully in line with original plans. However, in the second half of 2010, the new government took a number of steps that effectively watered down the framework. In particular, in December 2010, it abolished the technical staff of the Fiscal Council and replaced the independent members of the body. More recently, the authorities adopted the key elements of a changed set-up in the new Constitution (in effect as of 1 January 2012), providing a welcome Constitutional base for rule-based fiscal policy making. Most notably, a nominal debt ceiling was set at 50% of GDP and veto right over the budget was granted to the rearranged Fiscal Council. A follow-up legislation to establish the new operational numerical rules both at the central and the local level of government as well as the stipulation on the governing arrangements of the Fiscal Council was adopted late 2011 in a 'cardinal law' despite a request by the Commission to postpone this law until it could be verified that it is in line with the new EU governance framework. Moreover, some of its provisions do not seem to be in line with the Council's relevant country specific recommendation addressed to Hungary in July 2011.