EUROPEAN COMMISSION

Brussels, 6.3.2012
COM(2012) 104 final

Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in Hungary

{SWD(2012) 43 final}

EXPLANATORY MEMORANDUM

On 5 July 2004, the Council decided in accordance with Article 104(6) of the Treaty establishing the European Community (TEC) that an excessive deficit exists in Hungary. On 24 January 2012, the Council decided in accordance with Article 126(8) of the Treaty on the Functioning of the EU (TFEU), that Hungary has not taken effective action in response to the latest Council Recommendation according to Article 104(7) of the Treaty of 7 July 2009.

As a follow-up to the Council Decision of 24 January 2012 and in accordance with Article 126(7) TFEU and Article 3 of Council Regulation (EC) No 1467/97, on [6 March 2012] the Commission should adopt a recommendation for a new Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Hungary.

Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in Hungary

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union (TFEU), and in particular Article 126(7) thereof,

Having regard to the recommendation from the European Commission,

Whereas:

(1) According to Article 126 TFEU Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The Council has decided on 5 July 2004, in accordance with Article 104(6) of the Treaty establishing the European Community (TEC), that an excessive deficit exists in Hungary and made recommendations under Article 104(7) TEC with a view to bringing the excessive deficit situation to an end by 2008.

(4) In January 2005, in accordance with Article 104(8) TEC, the Council considered that Hungary had not taken effective action in response to its recommendation and issued another recommendation based on Article 104(7) TEC in March 2005, confirming the 2008 deadline for the correction of the excessive deficit. In November 2005, the Council decided that Hungary had for the second time failed to comply with the recommendations under Article 104(7) TEC. Accordingly, it addressed a third recommendation under Article 104(7) TEC to Hungary in October 2006, postponing the deadline for the correction of the excessive deficit to 2009. In July 2009 the Council concluded that the Hungarian authorities could be considered to have taken effective action in response to the recommendations from October 2006 and, against the background of the severe economic downturn issued revised recommendations under Article 104(7) TEC, setting once more a new deadline for correction, i.e. 2011. On 27 January 2010 the Commission concluded that Hungary had taken effective action in response to the latest Council recommendations, but alerted about considerable risks.

(5) According to the provisions of Article 126(8) TFEU, the Council decided on 24 January 2012 that Hungary did not take effective action in response to the July 2009 Council recommendation within the period laid down in this recommendation. While

the nominal 3% of GDP reference value was not breached in 2011, this was not based on a structural and sustainable correction and hinged upon substantial one-off revenues. This was accompanied by a structural deterioration in 2010 and 2011 of over 2% of GDP compared to a recommended cumulative fiscal improvement of 0.5% of GDP. Moreover, while the authorities were implementing structural measures in 2012 which were expected to largely offset the previous deterioration, the 3% of GDP Treaty reference value would again be respected in 2012 only thanks to one-off measures of close to 1% of GDP and it would be breached in 2013. [Following this Council decision, the Council decided [on 13 March] to suspend a part of the Cohesion Fund commitment appropriations for the year 2013 for Hungary (in line with Article 4 of Council Regulation (EC) No 1084/2006).]

(6) In accordance with Article 126(7) TFEU and Article 3 of Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (which is part of the Stability and Growth Pact), the Council is required to make recommendations to the Member State concerned with a view to bringing the situation of excessive deficit to an end within a given period. The recommendation has to establish a deadline of six months at the most for effective action to be taken by the Member State concerned to correct the excessive deficit as well as a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances. In deciding whether special circumstances exist, “relevant factors” as clarified in Article 2(3) of Regulation (EC) No 1467/97 should be taken into account. Furthermore, in a recommendation to correct an excessive deficit the Council should request the achievement of annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement in the structural balance, i.e. the cyclically-adjusted balance excluding one-off and other temporary measures, of 0.5% of GDP as a benchmark.

(7) The Hungarian economy emerged from recession in 2010 as GDP grew by 1.3%. The recovery was considerably faster in 2010 than the Commission services' projection in spring 2009 of -0.3% (i.e. at the time of the Council recommendation). In 2011, GDP is expected to have continued expanding at a moderate rate of 1.7%, still driven exclusively by the external balance. However, the growth outlook deteriorated over the course of 2011 due to the overall weakening of the international environment, which played out over several channels, as well as to the further contraction in domestic demand linked also to policy uncertainties. In this vein, the Commission services' February 2012 Interim Forecast projects GDP to contract slightly, by 0.1%, before it would resume growing again.

(8) Following a deficit of 4.2% of GDP in 2010, the general government balance is expected to turn into a surplus in 2011, but only thanks to substantial one-off revenues of almost 10% of GDP linked to the transfer of pension assets from private pension schemes. The official estimate for the 2011 budget surplus is 3.9% of GDP as specified in the December 2011 EDP progress report. Taking into account the recent information about better-than-expected cash-flow budgetary developments for some revenue items as well as for the local government subsector, the surplus may even be slightly higher (at around 4.1% of GDP based on the Commission services updated assessment).

(9) Regarding 2012, the adopted budget targets a deficit of 2.5% of GDP to be achieved on the back of a number of consolidation packages – to a large extent these were announced in the *Széll Kálmán Plan* and the 2011 update of the Convergence Programme (CP) – in part intended to correct the effect of the sizeable tax cuts decided in the second half of 2010, that amounted to somewhat over 2% of GDP, while setting aside an extraordinary reserve buffer (contingent expenditure cuts) of 1.1% of GDP. The achievement of the target is also supported by net one-off revenues of 0.7% of GDP from the temporary extraordinary taxes. Based on recent economic and budgetary developments the updated Commission services' forecast currently expects the deficit to be at 3% of GDP, i.e. above the authorities' official target. Compared to the adopted budget, this higher deficit forecast reflects, among others, lower economic growth by half a percentage point as well as a more prudent assessment of revenue and expenditure developments. At the same time, it assumes that the extraordinary reserves will not be used (i.e. contingent expenditure cuts will be carried out). The updated Commission services' forecast of 3% of GDP is 0.2% of GDP higher than the projection at the time of the adoption of the recommendation for a Council decision under Article 126(8). This is explained by the fact the better-than-expected base effect (from 2011) is not sufficient to counterbalance the budgetary impacts of the further downward revision in the 2012 economic outlook and the impact of the higher bond yields. In line with established practice in EU fiscal surveillance, the new consolidation plans of 0.4% of GDP published by the authorities on 21 February 2012 cannot be incorporated in the Commission services' forecast since they have not been sufficiently substantiated yet.

(10) In 2013, the deficit is expected to rise again to around 3.6% of GDP (up from 3% of GDP), which exceeds the Commission services' forecast of 3¼% of GDP at the time of the adoption of the Council decision that Hungary has not taken effective action based on Article 126(8) TFEU. This higher deficit number is mainly due to deficit increasing developments of 0.4% of GDP (such as lower tax revenues due to the lower growth forecast in 2012) that also contributed to the higher 2012 deficit forecast. Moreover, interest expenditures will increase more in 2013 than in 2012 (by 0.1% of GDP). These effects are expected to be only partly offset by other effects such as the lower than earlier expected financing need of the central bank in 2013 (by ¼% of GDP). When compared to 2012, the deficit increase to 3.6% in 2013 stems essentially from the phasing out of sectoral levies with a net budgetary effect of 0.7% of GDP in 2013, the higher debt service expenditures of ½% of GDP as well as the tightening of the tax base of the PIT with a budgetary effect of 0.3% of GDP. These deficit increasing effects, totalling some 1½% of GDP of GDP are expected to be only partly counterbalanced by the further implementation of the Széll Kálmán structural reform programme resulting in savings of 0.4% of GDP and other savings of 0.4% of GDP, such as the nominal freezing of the wages in the public sector. Finally, the budget is expected to benefit somewhat from the foreseen economic recovery.

(11) According to the latest Commission services' estimates, after a deterioration by 1½% in 2010 and by ½% in 2011, the structural balance is expected to improve by close to 2% in 2012 before deteriorating again by ½% of GDP in 2013. If the government would take the necessary measures to achieve its fiscal targets in 2012 and 2013, the structural improvement would amount to broadly 2½% of GDP in 2012 and ½% of GDP in 2013.

(12) The budgetary outlook described above could be improved by more than ½% of GDP in 2013 if reforms foreseen in the Széll Kálmán Plan would be sufficiently specified and implemented. Further expenditure savings published on 21 February 2012 need to be substantiated, in particular in the areas of reduction of the subsidy of the public transport companies and pharmaceuticals, whereas additional revenues could be expected from the planned introduction of the electronic road tolls. Beyond these measures, in order to achieve a durable correction of the excessive deficit, Hungary could benefit from better targeting the universal child benefit (possibly in connection with the recently introduced generous family tax allowances), introducing a centralised, value-based property tax and from enhancing the progressive nature of the flat income tax scheme; the latter issue was covered by the Council Recommendation to Hungary of July 2011 in the context of the European Semester.

(13) After having increased from 79.7% of GDP in 2009 to 81.3% in 2010, the government gross debt slightly decreased to 80.3% of GDP, in 2011. This slight improvement reflects the significant primary surplus of 8% of GDP, generated by the one-off revenue from the takeover of the private pension assets, which is largely offset by the exchange rate depreciation. Looking further, given the anticipated deficit numbers and based on a stronger technical exchange rate assumption compared to the level at the end of 2011 as well as assuming a further sale of the former private pension fund assets of 1% of GDP, government gross debt is expected to be around 76% of GDP in 2012 but it is expected to increase again from 2013.

(14) Past fiscal developments point to a weakness in fiscal governance and the transparency of budgetary planning and implementation. After effectively weakening the previous fiscal governance framework that was still in its infancy in the second half of 2010, the authorities introduced the key elements of a changed set-up in the new Constitution (in effect as of 1 January 2012). Most notably, a nominal debt ceiling was set at 50% of GDP (to be achieved through a continous debt reduction from the current high level), and a veto right over the budget was granted to a rearranged Fiscal Council (FC). Follow-up legislation to establish the new operational numerical rules both at the central and the local level as well as the stipulation on the governing arrangements of the FC was adopted late 2011 in a 'cardinal law'. The adopted new annual numerical rule still appears to focus too much on the annual budgetary cycle and does not seem to be conducive to medium-term budgetary planning, which was recommended to be strengthened by the Council in its recommendation of July 2011 in the context of the European semester. In that same country-specific recommendation the Council also asked Hungary to broaden the analytical remit of the Fiscal Council (e.g. through the preparation of regular macro-fiscal baseline projections), which is not yet ensured, also after the adoption of the Economic Stability law in December 2011.

(15) Regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy for correcting the excessive deficit is supported by Article 10a of Council Regulation (EC) No 1497/67, which foresees that the Member State concerned shall provide all necessary information. In this context, a separate chapter in the update of Hungary's Convergence Programme should be prepared in 2012 and subsequently as well as in the regular bi-annual reporting on progress until the end of the Excessive Deficit Procedure, in line with the Hungarian authorities' commitment.

(16) Budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy,

HAS ADOPTED THIS RECOMMENDATION:

(1) The Hungarian authorities should put an end to the present excessive deficit situation by 2012.

(2) The Hungarian authorities should bring the general government deficit below the 3% of GDP reference value in a credible and sustainable manner in accordance with the multi-annual path outlined in Hungary's updated convergence programme of 15 April 2011 as endorsed by the opinion expressed by the Council on 12 July 2011. Specifically to this end, the Hungarian authorities should:

(a) Ensure the attainment of the 2012 defict target of 2.5% of GDP compared to the expected outcome of 3% of GDP based on the macroeconomic framework after the 2012 February Interim Forecast of the Commission services, which would require an additional fiscal effort of at least ½% of GDP on top of the 1.9% of GDP that is already foreseen; in particular, this should be done through a further specification and rigorous implementation of the deficit-decreasing measures included in the *Széll Kálmán Plan* and the 2011 update of the Convergence Programme as well as the adoption of further consolidation measures of a structural nature as necessary. Allocate possible windfall gains for improving the headline balance, including possible one-off revenues stemming from the step back of beneficiaries from the private to the public pension pillar.

(b) Take necessary additional measures of a structural nature as needed to ensure that the deficit in 2013, estimated to exceed the 3% of GDP threshold of the Treaty by 0.6% of GDP based on the macroeconomic framework after the 2012 February Interim Forecast of the Commission services, remains well below the threshold even after the expected and recommended full phasing out of one-off revenues of close to 1% of GDP. These measures could include a further specification and implementation of the planned structural reforms included in the *Széll Kálmán Plan.*

(c) Incorporate sufficient reserve provisions in the forthcoming budget laws (on top of the general reserve prescribed by the Public Finance Act), to ensure the achievement of the budgetary targets even in case of unforeseen events.

(3) The above-mentioned budgetary adjustment should contribute to bringing the government gross debt ratio on a declining path. In particular, sufficient progress toward compliance with the debt reduction benchmark should be ensured throughout the three years following the correction of the excessive deficit, in accordance with Article 2 (1a) of Regulation 1467/97.

(4) As recommended by the Council in July 2011, the Hungarian authorities should operationalise the key constitutional fiscal rules by adapting the cardinal law on economic stability. The numerical rules should ensure that

the budget process is embedded into a binding medium-term framework and the analytical remit of the Fiscal Council should be broadened .

(5) The Council establishes the deadline of [13 September 2012] for the Hungarian government to take effective action and to specify the measures that will be necessary to progress towards ensuring a durable correction of the excessive deficit. The assessment of effective action will take into account economic developments compared to the updated outlook presented in the Staff Working Document accompanying the Commission recommendation for this Council recommendation.

The Hungarian authorities should report on progress made in the implementation of these recommendations in a separate chapter in the update of the Convergence Programme, which will be prepared in 2012 and subsequently, as well as in the regular bi-annual reporting on progress until the end of the Excessive Deficit Procedure, in line with Hungary's commitment.

In addition, the Council highlights the importance of achieving the medium-term objective (MTO) for ensuring the sustainability of public finances or a rapid progress towards such sustainability. It therefore invites the Hungarian authorities to take the necessary structural effort to reach its budget target of a deficit of 2.2% of GDP for 2013 in a way that ensures that the MTO – currently a structural balance of -1.5% of GDP – is sustained alongside the durable correction of the excessive deficit.

This recommendation is addressed to Hungary.

Done at Brussels,

For the Council
The President