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COMMISSION STAFF WORKING DOCUMENT

Analysis by the Commission services of the budgetary situation in Hungary following the adoption of the Council Decision of 24 January 2012 under the Excessive Procedure for Hungary

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

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

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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 Article 104(7) recommendation to Hungary in October 2006, postponing the deadline 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 ensure a rigorous implementation of the adopted and announced corrective measures to respect the government deficit target of 3.9% of GDP. Moreover, it 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. 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 but "alerted about considerable risks attached to the 2010 deficit target, both on the revenue and the expenditure side". The Council, in its 12 July 2011 Opinion on the 2011 update of the Convergence Programme (CP) of Hungary, 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".

On 24 January 2012, the Council adopted a decision under Article 126(8) of the Treaty establishing that Hungary had not taken effective action in response to the Council Recommendation of July 2009. The Council noted that while Hungary formally respected the 3% of GDP reference value by 2011, this was not based on a structural and sustainable correction. The budget surplus in 2011 hinged upon substantial one-off revenues of over 10% of GDP and was accompanied by a cumulative structural deterioration in 2010 and 2011 of over 2% of GDP compared to a cumulative fiscal improvement of 0.5% of GDP recommended by the Council. Moreover, while the authorities adopted and to a large extent already implemented substantial structural measures, partly in order to compensate for the substantial tax cuts of above 2% of GDP decided in the second half of 2010, the 2012 budget deficit was foreseen not to exceed the 3% of GDP reference value again only thanks to net one-off revenues of around 0.7% of GDP. In fact, the non-durable nature of the correction was evidenced by the fact that in 2013 that the headline deficit (estimated at 3¼% of GDP at the time) was expected to breach the reference value of the Treaty once more even after taking into account additional measures announced since the Commission services' 2011 Autumn Forecast.

Following this Council decision, the Council decided 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).

This document examines the macroeconomic and budgetary outlook for Hungary to set the stage for a Commission recommendation for a new (fifth) recommendation under Article 126(7) of the Treaty to ensure a sustainable correction of the excessive deficit. In particular, it examines the macroeconomic and budgetary developments since the Council decision under Article 126(8) of the Treaty on 24 January 2012 to step up the excessive deficit procedure for Hungary[1]. The assessment takes notably into account the new macroeconomic outlook in the Commission services' 2012 February Interim Forecast and information about recent budgetary developments, including a new consolidation package of the Hungarian authorities, published on 21 February 2012 in the official Gazette.

1. ECONOMIC DEVELOPMENTS AND OUTLOOK

In 2011, GDP is expected to have continued expanding at a moderate rate of 1.7% (against 1.4% in the autumn forecast), driven exclusively by the external balance. The preliminary data on GDP growth in the second half of the year surprised on the upside, but factors that contributed to this, such as the strong rate of growth in the agricultural sector, are unlikely to repeat in 2012 as this was against the background of poor performance in 2010. Developments that occurred after the cut-off date of the Commission services 2011 Autumn Forecast paint an overall weaker picture of short-term growth prospects. The economy is now forecast to be near standstill in 2012: real GDP is expected to contract slightly by 0.1% in contrast with the 0.5% growth projected in the autumn 2011.

The external environment is worse than expected, with Hungary's largest export markets growing at a lower rate. In addition, economic policies such as the extraordinary sectoral levies and the early foreign exchange loan repayment scheme, which allowed the early repayment of foreign-currency denominated mortgages at discounted rates, are likely to have negative consequences for growth and the fiscal balance. Employment prospects are also somewhat more negative than expected in the autumn.

On the other hand, the agreement signed on 15 December 2011 between the government and the Banking Association improved on the government's original early repayment scheme. The agreement includes four pillars whose impact is likely to play out over various channels, including a cash-flow effect for FX mortgage holders. The overall effect of this scheme in combination with the December agreement is still negative for the financial sector and thus for credit supply, although less so than before as the public sector will now share part of the cost.

Finally, the pace of inflation will again rise in 2012 due to in large part to increases in indirect taxes. Although the rise in inflationary expectations could ceteris paribus have reduced the real interest rate (which indeed happened temporarily following a peak in August 2011), interest rates have climbed up again because of increases in the policy rate and the risk premia. (For further details, see the February 2012 Interim Forecast[2].)

[1] For more details regarding this recommendation see the accompanying Commission Staff Working Document at: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/other_documents/2012-01-11_hu_communication_swp_en.pdfp

[2] The latest interim forecast of the Commission services was published on 23 February 2012. For details see: http://ec.europa.eu/economy_finance/articles/eu_economic_situation/2012-02-23-interim-forecast_en.htm

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
	2012 Budget	*1.2*	*1.9*	*1.5*	*na*
	COM IF 2012	**1.3**	**1.7**	**-0.1**	**1.6**
Current account balance (% of GDP)	*CP April 2011*	*2.1*	*1.6*	*2.8*	2.7
	2012 Budget	*2.1*	*2.5*	*3.7*	*na*
	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
	2012 Budget[1]	*4.9*	*3.8*	*4.2*	*na*
	COM IF 2012	**4.7**	**3.9**	**5.1**	**4.1**

Notes:
[1] National Consumer Price Index (CPI)
Source: *2011 update of Convergence Programme (CP); Commission services' 2012 Autumn Forecast (COM AF 2011); Commission services' 2012 Interim Forecast (COM IF 2012); 2012 budget for Hungary.*

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

2.1. Estimated outturn for 2011

In 2011, a budgetary surplus of 4.1% of GDP is now expected, which is achieved primarily thanks to one-off revenues of almost 10% of GDP linked to the elimination of the obligatory private pension scheme.[3] The headline deficit net of one-off effects is estimated to be around 5½% of GDP. It may be useful to note that the elimination of the obligatory private pension scheme did not only result in one-off revenues due to the asset transfer but also in permanent revenues of 1¼% of GDP since the pension contributions of the employees are paid to the public pension pillar instead of the private one. In the long run, however, this permanent deficit improving effect will be gradually counterbalanced and eventually exceeded by the higher public pension expenditures.

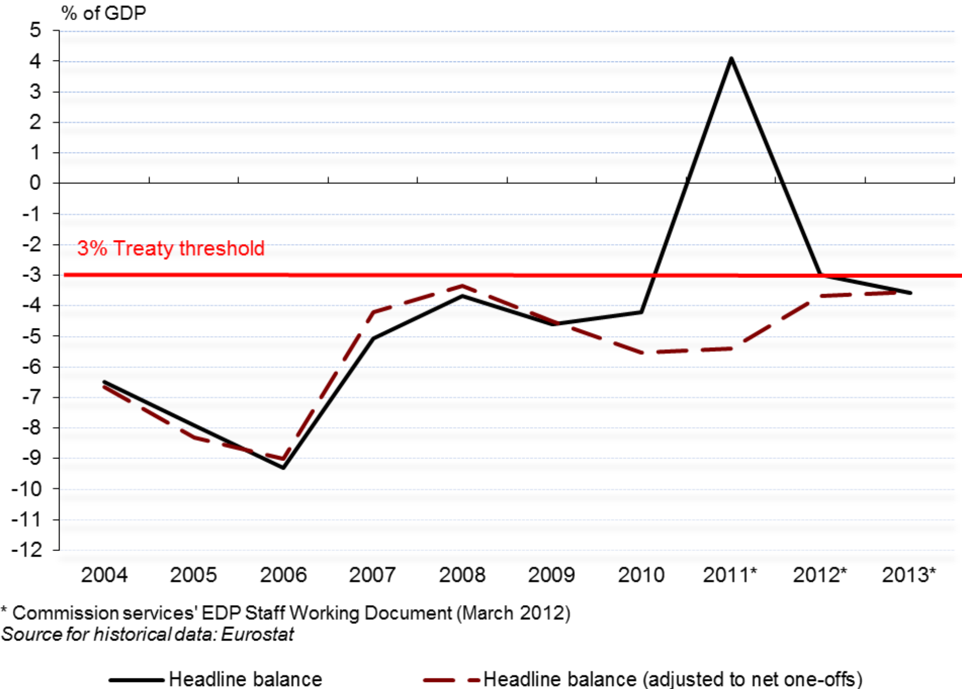
The surplus currently expected for 2011 is more favourable than the surplus of 3½% of GDP included in the January SWP accompanying the Commission recommendation for a Council decision under Article 126(8) of the Treaty, which is explained by: (i) the balanced budget of the local government sector suggested by the official preliminary data submitted to the Commission on 14 February 2012 instead of the earlier expected deficit of ½% of GDP; and (ii) the better than expected budgetary revenue developments by 0.3% of GDP, especially in December 2011 (notably from VAT and CIT)[4]. These developments are only partly

[3] In 2011 the balance of the one-off components was 9.5% of GDP. Beside the revenues of 9.9% of GDP from the elimination of the obligatory private pension scheme, the full amount of the extraordinary sectoral levies of ½% of GDP (in the energy, telecommunication and retail sector) and the half of the extraordinary levy on the financial institutions amounting to 0.3% of GDP contributed to the one-off or temporary revenues in 2011. At the same time, one-off or temporary expenditures include the VAT reimbursement of 0.9% of GDP due to the decision of the Court of Justice of the European Union, the capital injection of 0.1% of GDP into the Hungarian Development Bank and the tax rebate of 0.2% of GDP on the bank levy in the light of the agreement with the banks.

[4] The higher VAT revenues can be also partly explained by the temporary enhancement of the Tax authority in this field and the advanced purchases due to the VAT rate increase in 2012. Regarding the higher than expected CIT revenues, its permanent effect can be significantly lower since the potentially higher than required tax payments at the end of 2011 may be reclaimed (mainly) in the course of 2012. All in all, the higher than earlier expected tax revenues at the end of 2011 indicates better budgetary outcome also in the outer years, which is enhanced also by the January cash-flow data. However, this permanent effect will be probably significantly less than the impact in 2011.

counterbalanced by the higher than earlier projected 2011 budgetary cost (0.2% of GDP) of the "burden-sharing" agreement between the government and the banks related to the foreign exchange loans issue.

Graph 1: General government balance



2.2. Update of deficit projections for 2012

Based on the latest developments, the budgetary deficit in 2012 is foreseen at around 3% of GDP while it was expected to be 2¾% of GDP in the January SWP accompanying the Commission recommendation for a Council decision under Article 126(8). This higher deficit forecast is mainly explained by the lower tax revenues in light of the downward revision of the Commission services' growth forecast (currently a slight recession of 0.1% is foreseen instead of a recovery of 0.5% with a corresponding decrease in nominal GDP) resulting in broadly unchanged revenue-to-GDP ratio, while the expenditure-to-GDP ratio goes up; and the higher interest expenditures altogether amounting to 0.3% of GDP. Regarding budgetary measures, the higher-than-expected outlays related to the public transport companies currently anticipated by the Commission services, in particular for the state-owned railway company, may increase the deficit further by 0.15% of GDP. Other developments, such as foreseen slippages related to pharmaceutical subsidies as well as a more severe than projected behavioural adjustment of the companies to the tax hikes contained in the 2012 budget are foreseen to contribute to the higher deficit by another ¼% of GDP.[5]

These adverse developments are estimated to be only partly compensated by the base effect (i.e. the permanent impact) of the better than earlier expected 2011 outcome (around ¼% of GDP)[6] as well as higher than budgeted one-off revenues from licence fees (0.1% of GDP).[7]

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[5] This is notably indicated by the high proportion of companies that have decided to stop operations in the gambling sector.

[6] That is, the Commission services assume that the lower than earlier expected deficit of the local government sector in 2011 will decrease the 2012 and 2013 budgetary deficit also by around 0.15% of GDP, while the permanent deficit improving impact of the higher tax revenues at the end of 2011 is around 0.1% of GDP.

Compared to the adopted 2012 budget, the Commission services now foresee slippages of more than 1½% of GDP. The Commission services' 2011 Autumn Forecast of 2.8% of GDP already reflected lower revenues mainly linked to the lower real GDP growth, the higher outlays chiefly related to state-owned transport enterprises and maintenance of roads as well as higher expenditures due to the weaker exchange rates and higher bond yield assumptions. These slippages amounting altogether to 1% of GDP were assumed to be largely counterbalanced by the eventual elimination of the extraordinary budgetary reserve of 0.7% of GDP, which was created on top of the usual general reserve of 0.3% of GDP. The Commission services assumed that the extraordinary reserve would not be spent, while the general reserve, based on historical evidence, was expected to be eventually spent. [8]

The projection in the January 2012 SWP accompanying the Commission recommendation for a Council decision of a 2012 budget deficit of 2¾% of GDP included further slippages of 0.35% of GDP mainly due to the budgetary effect of the agreement with the banking sector, fully counterbalanced by measures resulting at increasing the extraordinary reserves by 0.4% of GDP to 1.1% of GDP.[9] The updated deficit outlook of 3% of GDP incorporates additional deficit increasing developments of ¼% of GDP. This brings total slippages to more than 1½% of GDP compared to the budget, which can be counterbalanced by the extraordinary reserves increased from 0.7% of GDP to 1.1% of GDP resulting in a higher deficit by ½% of GDP than targeted (2.5% of GDP). That is, Commission services assume that the full amount of the extraordinary reserve of 1.1% of GDP will be eventually eliminated.

Table 2: Evaluation of the 2012 budgetary forecast

[7] Deutsche Telekom's Magyar Telekom and the local units of Telenor and Vodafone, Hungary's three current mobile operators, won extra frequency capacities. Moreover, Postal service Magyar Posta, power company Magyar Villamos Muvek and development bank Magyar Fejlesztesi Bank offered HUF 10 billion for 5 megahertz of the 900 MHz frequency. These state-owned companies may pay fewer dividends into the budget in the coming years due to the direct cost of the licence fee and the expected investment costs.

[8] This approach takes into account the 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, only a limited contingency buffer, the general reserve of 0.3% of GDP remains to offset any unforeseen adverse impacts. However, based on historical evidence, and also since the use of it is not linked to any strict condition, the Commission services assumed that the general reserve would be eventually spent.

[9] These measures are indicated as "consolidation package at the end of 2011" in Table 2.

	2012
2011 draft budget	**-2.5**
Worse growth outlook and more cautious revenue forecast	-0.50
Higher subsidy to the public transport companies and maintanance of roads	-0.25
Assumption of a weaker exchange rate and higher yields on T-bonds and bills	-0.25
Extraordinary reserve (assumed as a contingent expenditure cut)	0.70
2011 Autumn Forecast	**-2.8**
Net effect of the adopted amendments submitted to the 2012 draft budget	-0.15
Consolidation package at the end of 2011	0.40
Agreement with the banks (including secondary effects)	-0.20
January SWP	**-2¾**
Base effect	**0.25**
Better than expected tax revenues at the end of 2011	*0.10*
Better than targeted balance of the local government sector	*0.15*
Measures	**-0.10**
Higher road toll	*0.05*
Additional financing gap for public transport companies	*-0.15*
Macroeconomic and financial market developments	**-0.30**
Further deterioration in the growth outlook (real GDP forecast -0.1% vs +0.5%)	*-0.25*
Higher yields on T-bonds and bills	*-0.05*
Other developments	**-0.15**
Recent data on the adjustment of the economic agents to the tax changes	*-0.10*
Expenditure slippages at pharmaceutical subsidies	*-0.15*
Higher licence revenues	*0.10*
Smaller transfer to compensate the loss of the central bank	*0.05*
Denominator effect	*-0.05*
Current forecast update	**-3.0**

It is important to highlight that this deficit forecast takes into account the 0.7% of GDP temporary revenues from the sectoral and financial levy, which is the net effect of the gross one-off revenues of 0.9% of GDP and the tax rebate on the bank levy of around 0.2% of GDP in 2012. Additional one-off revenues from the licence fee of 0.1% of GDP are also incorporated in the forecast. However, the decision to permanently divert the employers' pension contributions for those who are still members of the former obligatory private pension pillar to the state pension pillar, which was adopted at the end of 2011 and which contributed to the further increasing of the extraordinary reserves by 0.15% of GDP at the end of 2011, turned an earlier one-off revenue into a permanent one. That is, the de facto elimination of the previously obligatory private pension pillar altogether resulted in permanent revenue of close to 1½% of GDP, which will be gradually counterbalanced by increasing pension expenditures and in the long run exceeded by those expenditures.

It has to be highlighted that the pressures on those who are still members of the earlier obligatory private pension scheme (such as the above mentioned diversion of the pension contributions of those who are still members of the former obligatory pension pillar to the state pension pillar as well as the fact that employees will be eligible for public pension benefits contrary to the earlier legislation)[10] may result in a further round of stepping back to

[10] This option is open until 31 Mach 2012.

the public pension pillar also due to the decreasing likelihood that the private pension pillars will survive since they do not receive pension contributions. This could eventually generate additional one-off budgetary revenues of up to ¾% of GDP in 2012 due to the transfer of the accumulated assets from the private to the public pension pillar, although the final size is highly uncertain and significantly affected by the behavioural response of the private pension funds and their members.

The government possesses an additional tool to off-set unforeseen adverse developments: the bulk of the standard general reserve of 0.3% of GDP[11] is still untouched, although a cautious approach is warranted regarding its treatment as a real buffer since historical evidence suggests that the general reserve was eventually spent in the course of the year independently from the macro and fiscal developments.

[11] The main function of this reserve is to meet unforeseen expenditures and could be used rather discretionally by the Government (the only constraint is that a maximum 40% of the total annual appropriation could be released in the first half of the year).

Table 3: Comparison of key macroeconomic projections

		2010	2011	2012	2013
General government balance (% of GDP)	CP April 2011	-4.2	2.0	-2.5	-2.2
	COM AF 2011	-4.2	3.6	-2.8	-3.7
	HU 2012 Budget	*-4.2*	*3.9*	*-2.5*	*-2.2*
	COM EDP JAN SWP	***-4.2***	***3.6***	***-2¾%***	***-3¼***
	Current COM assessment	**-4.2**	**4.1**	**-3.0**	**-3.6**
Government gross debt (% of GDP)	CP April 2011	80.2	75.5	72.1	69.7
	COM AF 2011	81.3	75.9	76.5	76.7
	HU 2012 Budget	*81.3*	*73.9*	*71.8*	*n.a.*
	Current COM assessment	**81.3**	**80.3**	**76.2**	**76.4**
Cyclically-adjusted balance (% of GDP)	CP April 2011	-2.1	3.5	-1.6	-1.8
	COM AF 2011	-2.4	4.8	-1.8	-3.2
	HU 2012 Budget	*n.a.*	*n.a.*	*n.a.*	*n.a.*
	Current COM assessment [1]	**-2.3**	**5.6**	**-1.6**	**-2.7**
Structural balance[2] (% of GDP)	CP April 2011	-3.1	-4.2	-2.5	-1.8
	COM AF 2011	-3.8	-5.0	-2.6	-3.2
	HU 2012 Budget	*n.a.*	*n.a.*	*n.a.*	*n.a.*
	Current COM assessment	**-3.6**	**-4.2**	**-2.3**	**-2.7**
cf. IMF, Article IV Staff Report, January 2012					
General government balance (% of GDP)			3.5	-3.9[3]	-4.1[3]
cf. Consensus Economics, January 2012					
General government balance (% of GDP)			n.a.	-3.4	-3.0
cf. OECD, EO No. 90, November 2011					
General government balance (% of GDP)			4.0	-3.4	-3.3

Notes:
[1] Commission services' estimates based on commonly agreed methodology.
[2] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures according to the Commission services' assessment are 1.3% of GDP in 2010, deficit-reducing; 9.5% of GDP in 2011, deficit-reducing; 0.7% of GDP in 2012, deficit-reducing; 0.0% in 2013. The structural balance was -2.2% of GDP in 2009, according to the Commission services estimation.
[3] The IMF forecasts for both 2012 and 2013 include ¾% of GDP extraordinary budgetary reserves (if unspent, the deficit will be reduced accordingly).
Source: Convergence programme update (CP); Commission services' autumn 2011 economic forecasts (COM AF); 2012 budget bill (adopted in December 2011); Commission services' EDP Staff Working Document January (published on 11 January, COM EDP JAN SWP);

2.3. Deficit projections for 2013

Updating the deficit forecast for 2013 contained in the January 2012 SWP accompanying the Commission recommendation for a Council decision under Article 126(8) of the Treaty of 3¼% of GDP on the basis of recent information, the deficit would be at 3.6% of GDP. The higher deficit number is mainly due to a base effect from permanent deficit increasing factors of 0.4% of GDP already having an impact in 2012 (such as lower tax revenues mainly due to the lower growth forecast in 2012 and foreseen expenditure slippages related to the drug subsidies). Moreover, the recent increase of the yields on the government securities increases interest expenditures more in 2013 than in 2012 by 0.1% of GDP. These effects are expected to be only partly offset by the lower than earlier expected transfer to the central bank in 2013

compensating for its loss[12] and the slightly faster recovery than earlier projected, altogether decreasing the deficit by ¼% of GDP.

Having incorporated all these elements, the budget deficit is still expected to increase in 2013 on the previous year, but now from 3% of GDP to 3.6% of GDP. This mainly reflects the phasing out of the sectoral levies of close to 0.9% 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 are expected to be partly counterbalanced by the further implementation of the Széll Kálmán structural reform programme resulting in savings of over 0.4% of GDP, additional savings of ¼% of GDP due to the nominal freezing of the wages in the public sector as well as lower expenditures of 0.15% of GDP in light of the less generous wage compensation in the private sector. In addition, the lower direct cost of the agreement with the banking sector in 2013 compared to 2012 as well as the economic recovery (also partly related to the agreement with the banks) will altogether decrease the deficit by around ½% of GDP. All in all, compared to 2012, the deficit increasing effects of 1¾% of GDP are foreseen only partly offset by the deficit improving developments of 1¼% of GDP in 2013.

The government published on 21 February 2012 further consolidation plans. The measures of 0.4% of GDP include further savings in pharmaceutical subsidies, lower subsidies for the Budapest Public Transport Company in 2013, the introduction of the electronic road toll system from the middle of 2013 as well as further across-the-board expenditure reduction at the line ministries. However, for the time being these measures cannot be incorporated in the forecast since they have not been sufficiently substantiated yet. In addition, the quality of a part of these measures (such as the across-the-board savings at the line ministries) and thus the sustainability of the potential saving is questionable. According to the Commission services' estimation, the maximum deficit-improving effect of these measures might be 0.3% of GDP in 2013, taking also into account the second-round effects (there might also be a negligible effect in 2012). But even if these measures were taken at face value the Commission services deficit forecast would still exceed the reference value in 2013 based on the updated budgetary forecast. Similarly, there are elements in the Széll Kálmán plan that cannot be taken into account for the time being as some of the measures are not yet sufficiently specified. [13]

2.4. Debt developments

Taking into account the recent forecast and assuming a stable HUF/EUR exchange rate of around 295 and that one-third of the transferred pension assets will be sold in 2012, the gross public debt is expected to decrease to around 76.5% of GDP in 2012 from the 80.3% of GDP in 2011. In 2013, the debt ratio is expected to increase again slightly based on the current deficit outlook.

[12] The lower projected 2012 loss of the central bank is explained by the weaker than earlier expected exchange rate, which is anticipated to result in higher realised gains in foreign exchange transactions.

[13] In 2013, savings related to the Széll Kálmán structural reform programme are less by around 0.8% of GDP according to the Commission services than projected by the government. This is the result of a gap of 0.2% of GDP already present in 2012 and a further difference of around 0.6% of GDP related to the additional saving plans, which have not been substantiated by detailed measures yet.

2.5. Future budgetary policies

The updated deficit projection for this year of 3% of GDP exceeds the government's deficit target of 2.5% of GDP, according to the 2011 update of the Convergence Programme, the budget as well as the economic stability law. Thus reaching this target would require some additional adjustment of ½% of GDP on top of the already expected 1.9% of GDP.

Currently, the expected outcome in 2013 of 3.6% of GDP suggests that at least ¾% of GDP are needed to ensure that the deficit is below the 3% of GDP Treaty reference value and another ¾% of GDP would be required to meet the deficit target of 2.2% of GDP included in the latest update of the Convergence Programme. Assuming that the above mentioned measures of ½% of GDP are already taken in 2012, the additional reduction would be 1% of GDP. Based on current calculations, achieving the government's deficit target of 2.2% of GDP would imply a fiscal effort of ½% of GDP in 2013 compared to the 2.5% of GDP target and would result in a structural deficit of 1¼% of GDP, slightly below the current MTO of 1½% of GDP. It would also ensure a decreasing gross public debt in 2013.

Possible expenditure reductions could be partly based on the appropriate substantiation and implementation of those reforms foreseen in the context of the Széll Kálmán structural reform programme that have not yet been sufficiently specified. So far this concerns 0.1% of GDP in possible measures in 2012 and 0.8% in 2013. Moreover, a further specification of already announced savings of 0.4% of GDP cuts could be foreseen, assuming that they are of a structural nature to ensure a lasting effect. In addition, further measures could be identified. In particular, they could include the means-testing of the universal family tax allowance and/or universal family benefits. On the revenue side, the introduction of a value based residential property tax scheme and the enhancement of the progressivity of the personal tax system could be considered.

The authorities introduced the key elements of a new fiscal governance framework in the Constitution (in effect as of 1 January 2012). Most notably, a nominal debt ceiling was set at 50% of GDP and a veto right over the budget was granted to a rearranged Fiscal Council (FC). A 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 rules appear to focus too much on the annual budgetary cycle and are not conducive to medium-term budgetary planning. The adequate operation of the Fiscal Council, commensurate to its strong veto right, is not yet ensured (e.g. through the preparation of regular macro-fiscal baseline projections). Consequently, it seems necessary that the operationalisation of the key constitutional fiscal rules is carried out in a way as recommended by the Council in July 2011: the budget process is embedded into a binding medium-term framework and the analytical remit of the Fiscal Council is broadened and the body is appropriately reinforced.

Enhanced surveillance under the EDP will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy. The Commission and the Council shall monitor the implementation of action taken by Hungary in response to this recommendation, in accordance with Article 10 (a) of Regulation (EU) No 1467/97, including on the basis of the continued submission of regular progress reports by the authorities and the information contained in a separate chapter of the Hungarian convergence programme updates.