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REPORT FROM THE COMMISSION TO THE COUNCIL

Commission report to the Council pursuant to Article -11(2) of Regulation (EC) No 1466/97 on the enhanced surveillance mission in Hungary of 26 September 2019

This report on an enhanced surveillance mission to Hungary is transmitted to the Council pursuant to Article -11(4) of Regulation (EC) No 1466/97¹. As foreseen by Article -11(5) of Regulation (EC) No 1466/97, the provisional findings of that mission have been previously transmitted to Hungarian authorities for comments.

Hungary – Significant Deviation Procedure
Enhanced surveillance mission, 26 September 2019
Report

1. Introduction

Hungary has been under significant deviation procedures since spring 2018. In June 2018 the Council found, in accordance with Article 121(4) of the Treaty, that there had been a significant observed deviation from the medium-term budgetary objective in 2017. The Council issued a recommendation asking Hungary to take the necessary policy measures to address the deviation. In December 2018, the Council concluded that Hungary had taken no effective action and issued a revised recommendation. However, Hungary took no effective action to address the revised recommendation either².

Non-compliance with the preventive arm of the Stability and Growth Pact in 2018 led to the opening of a new significant deviation procedure in June 2019. On 5 June 2019, the Commission issued a warning to Hungary that in 2018 it had again deviated from the adjustment path to its medium-term budgetary objective and proposed to the Council to launch a new significant deviation procedure. The Council asked Hungary to take measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 3.3% in 2019 and 4.7% in 2020, corresponding to an annual structural adjustment of 1.0% of GDP in 2019 and 0.75% of GDP in 2020, with the recommended structural effort in 2020 *contingent on compliance with the requested adjustment in 2019*.

To this date there is no indication regarding any additional planned corrective action by the authorities in response to the Council Recommendation for 2019. The Commission 2019 spring forecast expected the deficit in 2019 to fall to 1.8% of GDP, from 2.2% of GDP in 2018, in line with the authorities' target included in the 2019 Convergence Programme. However, the estimated fiscal effort for 2019 pointed to non-compliance with the Council Recommendation. Macroeconomic indicators released for the first half of 2019 show a better-than-expected macroeconomic environment in 2019, with both real and nominal GDP growth exceeding forecasts of the authorities and the Commission. Private consumption benefitted from a strong labour market and the further reduction in employers' social security contributions. This resulted in favourable budgetary data for 2019, pointing to a fiscal deficit outturn of 1.8% of GDP within reach, i.e. in line with the authorities' target. However, no additional measures for 2019 were adopted in response to the Council Recommendation.

The 2020 budget, adopted on 12 July 2019, revised the fiscal deficit target to 1% of GDP, down from 1.5% in previous plans. The budget could not be taken into account in the spring assessment as it was adopted after the date of the adoption of the recommendations by the Council. The 2020 deficit target is set in the budget at 1% of GDP, 0.5 pps lower than the target of 1.5% of GDP included in the

¹ Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 209, 2.8.1997, p. 1

² Council recommendations and other related significant deviation procedure documents are available at: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/preventive-arm/significant-deviation-procedure_en#hungary

2019 Convergence Programme that was published end-April. This lower deficit target is achieved mainly by better-than-previously-forecast tax revenues and lower expenditure due mainly to a cut in investment. At the same time, the 2020 budget also includes the expansionary measures contained in the “Economic Protection Action Plan” that the government adopted on 30 May 2019.

The enhanced surveillance mission by the Commission took place on 26 September 2019. The mission was carried out on the basis of Article 11(2) of Regulation (EC) 1466/97. The mission met the State Secretary for public finances at the Ministry of Finance, Mr. Peter Beno Banai; the executive director responsible for economic sciences and priority matters at the Magyar Nemzeti Bank, Mr. Daniel Palotai; and the President of the Fiscal Council, Mr. Arpad Kovacs. The aim of the mission was to receive detailed information about the fiscal developments in 2019 and about the 2020 budget adopted by the authorities in July 2019, the fiscal actions planned by the authorities, and to point to fiscal risks related to the expected slowing down of economic growth and to encourage compliance with the significant deviation procedure recommendation. This report is based on information obtained until and during the mission.

2. Findings of the mission

The Commission delegation noted that the economy is in good times, with an improvement in the overall fiscal situation (both the general government deficit and debt decreasing). The mission acknowledged the good macroeconomic performance of Hungary in 2018 and in the first half of 2019. Together with the new ambitious 2020 fiscal target, these developments point to an improvement compared to recent years. However, looking ahead, both external and cyclical factors, which have been supporting growth in recent years, are expected to gradually wear off, following the slowdown in some core Western economies and in sectors that play an increasingly important role for the Hungarian economy. The Hungarian authorities agreed that, in a context of decelerating EU growth, it will be challenging for Hungary to maintain growth rates observed in past years, and recognised that the main concern of the Hungarian government was future growth rather than fiscal policy. The mission, finally, recalled the Council Recommendation addressed to Hungary, pointing to the need to seize the opportunity of the positive momentum to secure its fiscal position and reduce further the general government debt.

Despite the better-than-expected macroeconomic and fiscal data so far, the authorities confirmed that they do not plan to revise their deficit target for 2019 nor to reduce further public debt. In 2019, the authorities intend to stick to their initial general government deficit target of 1.8% of GDP as set in the 2019 budget approved in July 2018 and confirmed in the 2019 Convergence Programme. Compared to the originally approved 2019 budget, there are significant extra revenues. At the same time, these are expected to be entirely absorbed by higher expenditure, in particular, by the financial correction on EU funds recently agreed with the Commission related to the fraudulent use of EU funds. The correction in 2019 relates to projects implemented over the period from 2017 to 2019 and is expected to deteriorate the budget balance by 0.3% of GDP. The remaining amount of the financial correction, i.e. about 0.3% of GDP will fall on future years. Also, the take up of the ‘demographic programme’ (following both a higher number of requests and a higher average value of the requested prenatal loan) is expected to be higher than planned. For the latter, the authorities have also increased the estimation for the following year.

The authorities acknowledged recurrent end-of-year spending spurs, however, they pointed out that the size of it decreased last year, taking into account the significant deviation procedure Recommendation. Over the last three years (2016-2018), the authorities have based their budget on systematically cautious fiscal projections and used the fiscal space accumulated over the year on unbudgeted end-year spending. The Hungarian authorities pointed out that these end-year expenditures

were non-recurrent spending on investment and that, at end-2018, the government decided not to use the full room for manoeuvre that was available, in line with the significant deviation procedure Recommendation. Without this spending, the fiscal position could have been better.

The 2020 deficit target is more ambitious than previously planned, using good times to accelerate fiscal consolidation as recommended by the Council. The 2020 budget revised the deficit target to 1% of GDP, making it more ambitious than the 1.5% of GDP target indicated in the 2019 Convergence Programme. The authorities stressed the better-than expected macroeconomic scenario, measures to increase tax compliance yet to be defined and expenditure containment as major factors to ensure the reaching of the more ambitious 2020 fiscal target. At the same time, the authorities have maintained 2023 as the year by which they aim to reach a balanced budget in nominal terms. Thus, the revised deficit target for 2020 implies a faster path towards this target. Namely, the authorities target a deficit of 0.7%, 0.4% and 0.0% of GDP for 2021, 2022 and 2023, respectively. In the 2019 Convergence Programme, the deficit trajectory was planned at 1.2% and 0.5% and 0.0% of GDP for the same years. Overall, according to the calculations of the Ministry of Finance, the new headline targets imply, for 2020, a greater improvement in structural terms than the effort recommended by the Council, and the overachievement of the medium-term budgetary objective – set as a structural deficit of 1.0% of GDP – already in 2021.

The authorities expect significantly higher-than-budgeted revenue in 2019, with a positive base effect in 2020. The revenue projection in 2020 is only partly underpinned by discretionary revenue or spending measures, with the only newly specified measure being an increase in excise duties. While the macroeconomic scenario was not revised by the authorities, revenue growth already takes into account the higher revenue expected in 2019, with a significant positive base effect for 2020. However, it remains unclear whether new measures will be introduced and if yes, at which point in time.

The authorities are working on new measures to increase tax compliance and curb the shadow economy, however, without any clear timeline for adoption. New measures will build on the success of similar measures introduced in recent years. The authorities stressed the impressive reduction in the VAT gap which is estimated to have decreased from 21% in 2013 to 9% in 2018, well below the EU average of around 10% (source: European Commission). In particular, the introduction of online invoicing for major companies in July 2018 is estimated to have contributed to the reduction of the VAT gap, and the measure is expected to have some carry-over effect in 2019. For small and medium sized enterprises, in 2013 the authorities introduced two simplified tax schemes (Kata and Kiva) aimed at fighting the shadow economy which have proven quite successful so far in collecting revenues. The authorities are currently working on two fronts: (i) new measures to fight the shadow economy, for example incentives for the use of electronic means of payment; and (ii) simplifying administrative tax obligations for enterprises estimated, among others, to reduce the number of hours spent by companies on tax-reporting obligations (from the actual 277 (Source: Paying taxes 2019, PwC) to below 100 hours) and introducing the pre-filled VAT system, tentatively in 2021. The authorities could not yet reveal the details of the new measures, while on the timeline, in their view a modification of the tax bill could start in autumn 2019, which would make the measures effective in the second half of 2020.

Fiscal consolidation in 2020 is expected to be achieved mostly thanks to a projected contained evolution of expenditure items. The 2020 budget specified expenditure ceilings, with the main area of expenditure cuts being public investment, especially in the construction sector (buildings) which is in a boom phase. The cut of state-funded projects is not expected to have any negative impact on economic growth as there are observed capacity constraints in the supply side of the economy and the

expected crowd-in of private investments. As an example of the projects that were cut, the authorities mentioned the Modern City Programme, with a lower-than-expected expenditure in 2020 (from initially estimated HUF 135 bn to HUF 85 bn). At the same time, other expenditure items were expected to be more dynamic, e.g. due to a higher take up of the ‘demographic programme’ and the extension of the housing programme.

The authorities stressed that the 2020 budget includes an unusually high level of reserves and that, excluding these reserves, the budget could be at balance. The 1% of GDP deficit target for 2020 includes a significant level of budgetary reserves, amounting to 1% of GDP (against 0.5% of GDP in 2019). Overall, total reserves are set at 1.4% of GDP, against 0.8% of GDP in 2019. The increase compared to the previous year is due to a significantly higher so-called “Country Protection Fund”, which is set at almost 0.8% of GDP, against 0.1% of GDP in 2019. The authorities stressed that the large amount of reserves could cover the potential additional risks in the risk scenario. Main risks were stemming from a possibly worse-than-expected macroeconomic developments as well as from higher-than-budgeted spending such as related to the ‘demography programme’ and/or measures of the “Economic Protection Action Plan” (see below). The authorities also recalled the rules and safeguards that are in place for the within-year use of the reserves. If all went according to the projections and if the reserves are not spent, this could eventually result in a balanced budget in nominal terms in 2020. Commission staff expressed doubts about that possibility, noting that the reserves have been recurrently spent at the end of the year in the past years and pointed to suboptimal budgeting practices.

The “Economic Protection Action Plan” aims at sustaining economic growth ‘at 2 percentage points above the EU average’. The “Economic Protection Action Plan” adopted by the government on 30 May 2019 has an estimated deficit-increasing impact of 1% of GDP in 2020. The main measure included in the Plan is the continuation of the stepwise reduction of employers’ social security contributions that started in November 2016: the budget includes a further cut by 2 percentage points. According to the authorities, the Plan serves the protection of the results achieved so far by the Hungarian economy and aims at sustaining economic growth at above the EU average by 2 pps even in the event of a slowdown in the euro area and other partner countries. While agreeing on the general macroeconomic framework characterized by a worsening external environment, the authorities emphasised that they intended to keep economic growth high through the adoption of economic policy measures. The authorities admitted that, given that Hungary is an open economy, closely linked to the EU, a significant slowdown in economic growth at the EU level would not leave Hungary unaffected. Therefore, they do not exclude the possibility of an additional Plan in 2020, which had already been mentioned by the Prime Minister. The delegation, thus, recalled that the government’s loose fiscal policy in recent years has likely contributed to excess demand in the economy leading to sustained inflation. Given that Hungary has one of the highest expenditure-to-GDP ratio and investment ratio in the EU, the mission underlined the risk of inflationary effects that additional expenditure could trigger.

The authorities pointed to methodological remarks concerning the statistical treatment of some items, complaining about double standards in the application of the rules. In the authorities’ view, the end-of-year spending should be considered as a one-off type of expenditure. The authorities acknowledged the commonly agreed methodology used by the European Commission for the estimation of the output gap. However, given its procyclicality, in their view the methodology used by the Hungarian Ministry of Finance seems to better reflect the situation of the Hungarian economy. In addition, the authorities also mentioned the reservations that Eurostat expressed on the classification of certain institutions: (1) the long-standing issue regarding the sector classification of the MNB’s foundations and their subsidiaries, because of which Eurostat expressed reservations on the quality of data reported by Hungary for EDP purposes; and (2) the nature of the Hungarian Hydrocarbon

Stockpiling Association (Magyar Szenhidrogen Keszletezo Szovetseg - MSZKSZ). In Eurostat's view, which is not shared by the authorities, both the MSZKSZ and the MNB foundations should be classified inside the general government, which would increase government debt while the deficit figure would remain unchanged. In the authorities' view, Eurostat is not applying rules of classification in a transparent and objective manner, leading to an unequal treatment between Member States. Finally, the authorities reassured that they will follow Eurostat's guidance in the classification, thereby allowing Eurostat to remove the reservations in the next EDP notification. The delegation took note of the authorities' complaints while insisting that Eurostat had clear rules of classification which were applied equally to all and stressing that such technical issues needed to be discussed with Eurostat.

While on a decreasing trajectory, Commission staff pointed to challenges related to high financing costs of the general government debt. The delegation acknowledged the positive developments in the recent years, including in the structure of the general government debt, with a shift towards HUF-denominated assets and domestic ownership. At the same time, this came at a cost of relatively high financing costs, due also to high premiums offered on retail bonds. This also has distributional effects, since the benefits tend to go to richer households, while the high costs are paid by all tax payers. The delegation encouraged the authorities to use unspent budgetary reserves to pay back some more expensive bonds. According to the authorities, this is a political decision. They emphasised that, in spite of slippages in terms of structural effort, the public debt remained on a downward trajectory also thanks to higher nominal GDP growth. The lower deficit target for 2020 also goes into the direction of a lower debt-to-GDP level.

The Fiscal Council praised the economic achievements of recent years. The economy was performing well, with an improvement in the sustainability, both of public finances and of the economy. The potential growth rate of the economy had increased significantly during the years (reaching the actual 3-3.5%), supported by external factors (foreign trade and exchange rate) and EU funds. In the future, potential growth would have to rely more on competitiveness and on less EU funds. In the Fiscal Council's view, the country would be able to manage a milder growth slowdown, as opposed to a global crisis or a bigger slump in the German economy which would be more difficult to manage. Concerning the fiscal situation, the Fiscal Council stressed that this is the first time ever that the authorities have mentioned the possibility to reach a balanced budgetary position in nominal terms. The Fiscal Council repeated the authorities' arguments that reaching a balanced budget in 2020 was a matter of political decision. Questioned about the high level of reserves in the 2020 budget, the Fiscal Council stressed the importance to maintain social peace. If the reserves were not spent, some programmes would inevitably suffer, namely in sensitive areas like public investments and the health care system.

Discussions with the central bank focused on potential signs of overheating in the economy. The central bank discussed its recently published macroeconomic projections with the mission. The central bank argued that despite fast economic growth and labour shortages, no signs of overheating have appeared in the economy and therefore it preferred to describe the situation as 'high-pressure' economy. Fiscal policy was becoming increasingly restrictive in 2020, while monetary conditions are set to remain accommodative. At the same time, the attractively priced new retail bond was encouraging household saving and curbed limiting speculative demand for housing. Low household debt contains risks in the housing market. Inflation appears to have peaked as external disinflationary forces are strengthening. The central bank argued that Hungarian industry managed to decouple from the German manufacturing thanks to changes in the product structure of the automotive industry. The central bank also confirmed that the early take-up of the 'demography programme' exceeded expectations, but they argued that it was mostly related to timing and the total size of the programme

may not be increased by the same magnitude. At the same time, the take-up of extended housing subsidies remained below expectations in the first months.