Brussels, 5.6.2019
COM(2019) 542 final

# 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 20 March 2019

This report on an enhanced surveillance mission to Hungary is transmitted to the Council pursuant to Article -11(4) of Regulation (EC) No 1466/97[1]. 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, 20 March 2019**

**Report**

## 1. Introduction

**Following a significant deviation from its medium-term budgetary objective (MTO) in 2017, a Significant Deviation Procedure (SDP) was launched for Hungary in spring 2018.** On 23 May 2018, the Commission issued a warning to Hungary and proposed to the Council to launch a SDP. In its SDP recommendation of 22 June 2018, the Council asked Hungary to take measures to ensure that the nominal growth rate of net expenditure does not exceed 2.8% in 2018; that corresponds to an annual structural adjustment of 1.0% of GDP.

**According to the Commission 2018 autumn forecast, there was a risk of a significant deviation from the MTO for both 2018 and 2019; for 2018, this also implied a risk of non-compliance with the SDP recommendation.** The Commission 2018 autumn forecast projected the 2018 headline deficit at 2.4% of GDP, in line with the official target. Thus, both the headline and the structural deficit were expected to deteriorate compared to the 2017 outturn of 2.2% of GDP, as a result of an expansionary fiscal policy. The 2019 budget, which was adopted in July 2018, aimed at a general government deficit of 1.8% of GDP for 2019. This implied an improvement not only in nominal terms but also in structural terms, as the (recalculated) output gap was projected to decrease. The Commission 2018 autumn forecast projected the government deficit in 2019 at 1.9% of GDP, broadly in line with the official target and the structural balance was estimated to improve by ½ percentage points of GDP. That forecast expected the public wage bill together with social transfers to increase below inflation and some other items of government expenditure to be restrained. The impact of those restrictive measures was however forecast to be partly offset by expansionary fiscal measures, notably a 2 percentage-point cut in social contributions in the second half of the year, in addition to similar cuts in the previous years, and an increase in public investment.

**As a consequence of no effective action taken by Hungary, the Council issued a revised SDP recommendation in December 2018.** Based on the September 2018 enhanced surveillance mission findings and on the report submitted by the authorities, the Commission concluded that the authorities did not intend to act upon the SDP recommendation in 2018, and action was expected to be taken only with respect to the 2019 general government deficit. Therefore, on 4 December 2018, the Council concluded that no effective action had been taken by Hungary and issued a revised recommendation. 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, corresponding to an annual structural adjustment of 1.0% of GDP in 2019. That recommendation translated into the need to adopt measures

[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

of a total structural yield of 0.5% of GDP in 2019, as compared to the baseline from the Commission 2018 autumn forecast. Hungary reported to the Council on action taken on 15 April 2019. The Commission's assessment of the report is being published as part of the European Semester package.

**Macroeconomic indicators for 2018 are better than expected.** Compared to both the Commission 2018 autumn forecast and the Hungarian authorities' forecast published in December 2018, data released in March 2019 show a better-than-expected macroeconomic environment in 2018, with both real and nominal GDP accelerating further compared to 2017. Private consumption benefitted from a strong labour market and large administrative wage increases. The reduction in employers' social security contributions so far mitigated the pass-through of wage increases to inflation. Nonetheless, consumer prices accelerated further in 2018 to 2.9%. As a result, major tax bases, including wages, grew faster than expected, pushing up tax revenues above the budget forecast.

**Additional deficit-increasing measures were announced in the recent months.** In December 2018, an investment programme for small villages (the "Hungarian village programme") was announced, according to which 150 billion HUF (0.35% of GDP) will be allocated to settlements with less than 5,000 inhabitants, one-third of which will be spent on renovation of subsidiary roads. In February 2019, the authorities have announced a so-called "demography programme" targeted at boosting the birth rate. Those measures include, among others, a new subsidised "pre-natal" loan aimed at young married couples, which is convertible to a capital grant after the birth of a second and third child after taking out the loan; the expansion of a loan and subsidy programme for families with children to help them buy homes; subsidies for car purchases; and waiving personal income tax for women raising at least four children; introduction of childcare payments for grandparents, and development of nurseries. The new spending would be financed from general reserves and windfall revenues in the 2019 budget. The programme may cost up to HUF 150 billion (0.4% of GDP) in 2020, the first full year of implementation, but some budgetary impact could materialise already in 2019. In addition, new tax measures were included in a recent draft bill, amongst which the exemption of retail government bonds from interest tax and a reduction of financial transaction duty for households, with an estimated impact of around 0.02% of GDP in 2019, and 0.05% in 2020. As from 2019, in order to enhance electronic payments, a tax exemption on bank transfers up to HUF 20,000 per transaction has been introduced for private individuals. In addition, retail government bonds have been exempted from interest tax. The authorities estimate the budgetary impact of those measures to be negligible in 2019-2020. The authorities have also floated the idea of a programme supporting learning of foreign languages for pupils costing an estimated of 0.2% of GDP from 2020.

**The enhanced surveillance mission by the Commission took place on 20 March 2019.** The mission was carried out on the basis of Article 11(2) of Regulation (EC) 1466/97. Commission staff met the State Secretary for public finances at the Ministry of Finance, Mr. Peter Beno Banai; the executive director responsible for monetary policy, economic analysis, foreign reserves and risk management at the Magyar Nemzeti Bank, Mr. Barnabas Virag; and the President of the Fiscal Council, Mr. Arpad Kovacs. The aim of the mission was to receive detailed information about the fiscal measures recently announced by the authorities, 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 SDP recommendation. This report is based on information obtained until and during the mission.

## 2. Findings of the mission

**The authorities explained that the better-than-expected fiscal outcome in 2018 was due to both cyclical and structural factors.** Real GDP growth turned out better than expected (at 4.9% compared to 4.3% projected by the authorities), driven by domestic demand (both private consumption and

investment). Revenues benefitted from the buoyant macroeconomic developments and also from structural measures to improve tax compliance. In particular, as of July 2018, companies are required to report their larger invoices real-time to the tax authority. The introduction of online invoicing is estimated to have played a significant role in reducing the size of the informal economy, pushing up indirect taxes and reducing the VAT gap below the EU average. The higher-than-expected revenues were partly counterbalanced by higher-than-projected expenditure. Specifically, the government decided to use, at the end of 2018, some of the in-year savings and higher-than-expected revenues to finance non-recurrent expenditure on specific categories (culture, religion and sport) that cannot be financed by EU funds. The authorities noted that, without the non-recurrent expenditure that took place at the end of 2018, the general government deficit would have been at 1.6% of GDP. While similar one-off end-year payments have been taken by the government recurrently, the authorities stressed that they were on a decreasing trend, with the payment made in 2018 being the lowest since 2016. In addition, around 0.1% of GDP expenditure was brought forward from 2019 to 2018. The authorities also confirmed that the total amount of committed but not spent funds (mainly related to EU funds projects) remained unchanged at the end of 2018 compared to end-2017. They also agreed that for forecast purposes it would be beneficial to better align commitments and timing of expenditure of such projects, even though to do so would affect the general government deficit in accrual terms.

**The authorities underlined the steps taken to fight tax evasion and reduce the size of the shadow economy and to broaden the tax base.** The authorities stressed that public finances rely heavily on consumption taxes, and many measures were introduced to fight the shadow economy. In particular, the introduction of online invoicing as of July 2018 is estimated to have contributed significantly to diminishing the role of the informal economy and represents one of the most important actions taken in the past years. In 2018, VAT revenues (in accrual terms) increased by around 14%, of which around 4 percentage points was due to that measure and some additional impact is also expected in 2019, although to a limited extent. Additional measures for reducing the size of the informal economy are expected to be approved by Parliament in spring 2019. Steps were also taken to broaden the tax base.

**In recent years, the authorities have tended to initially underestimate revenues, but then spend most unbudgeted windfall revenues towards the end of the year.** Since the beginning of the six-year agreement with employers on wage increases and employers' social contribution cuts, the authorities have consistently used conservative estimates of planned revenues. Over the past three years, large unexpected revenues appeared compared to budgetary plans. Those revenues were typically spent towards the end of the year on non-recurrent items (including for nurseries and schools, churches, sport facilities as well as for Hungarian minorities abroad), largely in the form of current and capital transfers. The authorities argue that those non-recurrent expenditures constitute an important source of fiscal buffer (in their assessment, 0.6% of GDP in 2018), although decreasing over time.

**During the mission, Commission staff noted that the economy is in good times and additional effort should be put in reducing the general government deficit and debt.** The mission acknowledged the good macroeconomic performance of Hungary in 2018, with part of the extra growth achieved in 2018 being explained also by the fiscal stimulus. However, economic growth in Hungary seems to have reached the peak and it is expected to moderate in the medium term, due also to the worsening external environment. As a result, fiscal buffers are expected to decrease in the next years. It is to be noted that the Hungarian authorities do not agree with the estimation of the cyclical component by the Commission: in their view, based on a methodology that takes into account both financial and real economic cycles, the output gap would be negative. The mission recalled that the Council asked for an additional structural effort in 2019 and, in light of the expected moderation of the economic conditions in the next years, Hungary should seize the opportunity of the positive

momentum to secure its fiscal position and reduce further the general government debt, which remains high for a small open economy.

**The authorities do not plan to take additional steps in 2019 in response to the revised SDP recommendation.** Despite the better-than-expected outcome in 2018, the authorities do not plan to revise the deficit target for 2019. 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. In particular, the base effect related to the better fiscal outturn in 2018, implies lower expenditure on the Public Work Scheme and other items; however, they are expected to be entirely absorbed by the above-mentioned recently announced deficit-increasing measures. The impact of the demographic programme is expected to be limited in 2019 and to reach 0.4% of GDP in 2020, even though its take-up can only be assessed with great uncertainty. 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. In the authorities' view, this will ensure that the deficit is reduced and that the relatively high debt-to-GDP ratio remains on a declining trend.

**Long-term sustainability of public finances is an issue in Hungary.** In the medium- to long-term, Hungary appears to face fiscal sustainability risks mainly related to the budgetary position, the projected ageing costs as well as to possible shocks to economic growth. The authorities stressed that the demographic programme is part of a long-term sustainability programme. The competitiveness programme is also a medium-term project, focussed on many areas, with the aim to bring GDP growth to the EU average + 2 pp. over a longer term. So far, no concrete measure has been adopted. Finally, the authorities agreed that the high level of public investment has an impact on prices in some areas (i.e. construction).

**Discussions at Magyar Nemzeti Bank mainly focused on growth challenges in the coming years.** MNB argued that recent high wage growth will induce companies to raise productivity, thus a loss in external competitiveness can be avoided. It also argued that Hungary is in a good position to carry out structural reforms, for which there appears to be momentum among decision-makers. According to the MNB, the general government deficit is expected to remain around 1.5% of GDP in both 2019 and 2020. The positive development in tax revenues is anticipated to offset newly announced expansionary measures. In the assessment of the MNB, the fiscal stance, which was accommodative in 2017-2018, is estimated to become countercyclical in 2019. The general government debt is also forecast to decline by around 2 pps every year.

**High public investment contributes to rising house prices.** Overall, total investment in the economy has reached a high level, at around 25% of GDP. Public investment is also high, potentially contributing to a crowding-out of private investment as well as to an increase in prices (rather than output). In addition, the quality of those investments is of some concern. At the same time, the risk of bubbles in the private sector seems limited given that the household credit-to-GDP ratio remains low with the rapid growth in nominal income.

**According to the Fiscal Council, the budget aims to balance growth and stability objectives.** The Fiscal Council pointed out that the current period of high growth without external indebtedness is unique in the country's economic history, and the constellation of strong growth with low vulnerability should be preserved. Therefore, the budget should remain cautious with spending commitments. Nonetheless, because of the need to progress with economic convergence, it was not politically feasible to push for faster debt reduction. The Council argued that the budget has sufficient

fiscal space to manage a milder than expected growth slowdown, thanks to the larger amount of budgetary reserves in 2019 compared to 2018. In the Council's view, the government may indeed announce further stimulus measures, in case a slowdown materialises.