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COMMISSION STAFF WORKING DOCUMENT
Accompanying the document

Recommendation for a Council decision establishing that no effective action has been taken by Hungary in response to the Council Recommendation of 4 December 2018

Recommendation for a Council recommendation with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Hungary

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1. INTRODUCTION

Since 2013, Hungary has been subject to the preventive arm of the Stability and Growth Pact, which requires sufficient progress towards the medium-term budgetary objective (MTO). Hungary's general government debt remains above 60% of GDP and it is expected to diminish at a satisfactory pace in line with the debt-reduction benchmark.

This staff working document has a double purpose. First, it explains the reasons behind the Commission recommendation for a Council decision establishing non-effective action in 2019 in response to the Council Recommendation addressed to Hungary on 4 December 2018. Second, it supports the Commission recommendation for a Council recommendation with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Hungary in 2018, as adopted by the Commission on 5 June 2019.

On 22 June 2018, the Council decided in accordance with Article 121(4) of the Treaty on the Functioning of the European Union ("TFEU") that a significant observed deviation from the MTO occurred in Hungary in 2017. In view of the established significant deviation, the Council on 22 June 2018 issued a recommendation for Hungary to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure¹ does not exceed 2.8% in 2018, corresponding to an annual structural adjustment of 1.0% of GDP².

On 4 December 2018, the Council found that Hungary had not taken effective action in response to the 22 June 2018 recommendation and issued a revised recommendation. In the revised recommendation the Council asked Hungary to take the necessary 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 GDP³. It recommended Hungary to use any windfall gains for reducing its deficit, while budgetary consolidation

¹ Net primary government expenditure is comprised of total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a four-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

² Council Recommendation of 22 June 2018 with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Hungary (OJ C 223, 27.6.2018, p. 1).

³ Council Recommendation of 4 December 2018 with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Hungary (OJ C 460, 21.12.2018, p. 4-5).

measures should ensure a lasting improvement in the general government structural balance in a growth-friendly manner. The Council established a deadline of 15 April 2019 for Hungary to report on the action taken in response to the recommendation. The Hungarian authorities submitted their report on action taken in response to Council recommendation (hereafter: "the report") on 15 April 2019. Moreover, on 20 March 2019, the Commission undertook an enhanced surveillance mission in Hungary for the purpose of on-site monitoring under the Article -11(2) of Council Regulation (EC) No 1466/97 and subsequently reported to the Council on 5 June 2019 and made its findings public.

Based on the Commission 2019 spring forecast, Section 2 of this document presents a summary of macroeconomic developments in 2018 and the outlook for 2019 and 2020. Section 3 presents a summary of fiscal developments in 2018 and updated budgetary projections for 2019-2020. Section 4 presents an assessment of compliance with the obligations stemming from the Stability and Growth Pact in 2018, including an overall assessment of the reasons for the deviation from the requirements of the preventive arm. Section 5 assesses compliance with the Council Recommendation of 4 December 2018. Section 6 proposes a fiscal effort for 2019 and 2020 to address the significant deviation, including a new applicable expenditure benchmark rate compatible with the suggested annual improvement in the structural balance. Section 7 provides overall conclusions.

2. MACROECONOMIC DEVELOPMENTS AND OUTLOOK IN 2018-2020

GDP growth increased in 2018 to 4.9%, exceeding earlier forecasts. Growth was driven by domestic demand. High employment and wage growth supported private consumption, while investment activity expanded rapidly in both the private and the public sector. GDP growth is expected to slow in 2019 and 2020 as capacity constraints become binding. The economy is approaching full employment, administrative wage increases moderate while inflation increases, all of which lead to slower real private consumption growth. Capacity shortage in construction is expected to limit further real investment growth. The Commission 2019 spring forecast expects GDP growth to decelerate to 3.7% in 2019 and to 2.8% in 2020.

Strong internal demand growth and capacity constraints in the construction and service sectors are raising prices and further deteriorating the external balance. The tight labour market and modest productivity growth result in high unit labour cost growth (6.7% in 2018). Inflation is rising further, from 2.9% in 2018 to 3.2% in 2019 and 2020. Rising construction costs also feed into the GDP deflator, which rose by 4.5% in 2018 and is forecast to rise by 4.0% in 2019. At the same time, increasing import demand and losses in cost competitiveness result in lower net lending vis-à-vis the rest of the world.

The Commission GDP growth forecast for 2019 and 2020 was revised up since autumn 2018, on the back of higher-than-projected GDP growth in 2018 and high-frequency indicators. In particular, household income and consumption growth were revised up. When assessing the path of nominal GDP and main tax bases, the Commission forecast for 2019 is broadly similar to the authorities' assessment. For 2020 the macroeconomic scenario of the 2019 Convergence Programme is more favourable. The Commission forecast expects that capacity constraints exert a stronger effect on prices and the external balance, which in turn limits real GDP growth.

Based on the Commission 2019 spring forecast and the commonly agreed methodology for calculating the cyclical position of the economy, the positive output gap is projected to stabilise in 2019 and then narrow in 2020.

Table 1. Macroeconomic developments and forecast

| | 2017 | 2018 | | 2019 | | | 2020 | | |
|---|---------|---------|---------|---------|---------|------|---------|---------|-----|
| | Outturn | CP 2018 | Outturn | CP 2018 | CP 2019 | COM | CP 2018 | CP 2019 | COM |
| Real GDP (% change) | 4.1 | 4.3 | 4.9 | 4.1 | 4.0 | 3.7 | 4.0 | 4.0 | 2.8 |
| Private consumption (% change) | 4.8 | 5.2 | 5.4 | 4.8 | 4.6 | 4.9 | 4.7 | 4.7 | 3.8 |
| Gross fixed capital formation (% change) | 18.2 | 12.8 | 16.5 | 7.5 | 10.3 | 10.4 | 3.8 | 3.8 | 2.4 |
| Exports of goods and services (% change) | 4.7 | 7.2 | 4.7 | 6.9 | 5.1 | 4.6 | 6.7 | 5.2 | 4.8 |
| Imports of goods and services (% change) | 7.7 | 9.2 | 7.1 | 7.4 | 6.5 | 6.8 | 6.3 | 5.4 | 5.1 |
| <i>Contributions to real GDP growth:</i> | | | | | | | | | |
| - Final domestic demand | 6.2 | 5.5 | 6.2 | 4.2 | 5.1 | 5.4 | 3.3 | 3.7 | 2.8 |
| - Change in inventories | -0.2 | 0.0 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.3 | 0.0 |
| - Net exports | -1.9 | -1.1 | -1.5 | 0.0 | -1.0 | -1.6 | 0.7 | 0.1 | 0.0 |
| Output gap ¹ | 1.8 | 1.7 | 3.3 | 1.5 | 2.5 | 3.3 | 1.1 | 2.1 | 2.4 |
| Employment (% change) | 2.0 | 1.5 | 2.2 | 1.5 | 1.1 | 1.4 | 1.3 | 1.3 | 0.4 |
| Unemployment rate (%) | 4.2 | 3.4 | 3.7 | 3.1 | 3.3 | 3.5 | 2.8 | 2.9 | 3.5 |
| Labour productivity (% change) | 2.1 | 2.8 | 2.7 | 2.6 | 3.0 | 2.3 | 2.7 | 2.7 | 2.4 |
| HICP inflation (%) | 2.4 | 2.5 | 2.9 | 2.7 | 2.7 | 3.2 | 2.9 | 2.8 | 3.2 |
| GDP deflator (% change) | 3.8 | 2.7 | 4.5 | 3.1 | 3.8 | 4.0 | 3.0 | 3.2 | 3.4 |
| Comp. of employees (per head, % change) | 6.2 | 9.1 | 9.6 | 7.9 | 9.2 | 6.6 | 6.3 | 8.1 | 6.5 |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | 4.3 | 5.9 | 2.2 | 5.9 | 1.5 | 1.1 | 4.1 | 2.1 | 1.0 |
| <i>Note:</i> | | | | | | | | | |
| ¹ In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology. | | | | | | | | | |
| <i>Source:</i> | | | | | | | | | |
| Commission 2019 Spring forecast (COM); 2018 Convergence Programme (CP 2018), 2019 Convergence Programme (CP 2019). | | | | | | | | | |

3. FISCAL DEVELOPMENTS AND OUTLOOK IN 2018-2020

In 2018, the general government deficit remained unchanged at 2.2% of GDP while the economy grew significantly above its potential. In spite of tax cuts, including a further 2.5 percentage points reduction in employers' social contribution rate following similar cuts in 2017 (by 5 percentage points) and in 2018 (by 2.5 percentage points), tax revenues grew relatively fast thanks to the high growth of nominal income and consumption. New measures to improve tax compliance, introduced in July 2018, also bolstered VAT revenues. Higher-than-budgeted revenues were largely spent at the end of the year, mostly on current transfers targeting nurseries and schools, churches, sport facilities as well as Hungarian minorities abroad. Public investment accelerated further, increasing by 1.2 percentage points of GDP, thanks also to the increased absorption of EU funds, which amounted to 1.4% of GDP. As the output gap is calculated to have increased significantly, the structural deficit is estimated to have increased to 3.7% of GDP in 2018, from 3.4% in 2017.

The 2018 general government deficit outcome of 2.2% of GDP remained below the target of 2.4% of GDP set in the 2018 Convergence Programme. Both revenues and expenditures turned out better than planned in the 2018 Convergence Programme. On the revenue side, the target for both direct and indirect tax revenues was overachieved, and by a high margin in the case of the latter. On the expenditure side, capital transfers and, to a lesser extent, capital investment were lower than planned, partly offset by slippages in current expenditure.

On 20 March 2019, the Commission undertook an enhanced surveillance mission in Hungary for the purpose of on-site monitoring under Article -11(2) of Council Regulation (EC) No 1466/97. After having transmitted its provisional findings to the Hungarian authorities for comments, the Commission reported its findings to the Council on 5 June 2019 and made its findings public. The Commission report finds that the Hungarian authorities do not intend to

act upon the Council recommendation of 4 December 2018. The authorities confirmed that their target for 2019 remained the headline deficit of 1.8% of GDP that had been approved with the 2019 budget in July 2018. That policy implies an improvement in the underlying structural deficit which, however, is far from the adjustment required by the Council recommendation.

In their report on action taken, the authorities reiterate their target for the general government deficit of 1.8% of GDP in 2019, representing 0.4% of GDP reduction compared to the 2018 outturn. The 2019 deficit target is unchanged compared to the target set in the 2018 Convergence Programme despite the more favourable macroeconomic scenario and the better fiscal outturn in 2018. The fiscal space made available thanks to the better-than-expected fiscal outturn in 2018 and the more favourable macroeconomic outlook is expected to be fully absorbed by new expansionary measures announced/adopted by the government at the beginning of 2019. In particular, according to the report, an important priority for 2019 is to increase potential growth and to promote competitiveness; other priorities include the improvement of demographic developments and increasing tax compliance. Contrary to what was required by the Council recommendation, the report does not contain projections of individual budgetary items or categories. Moreover, the authorities provide only a broad list of discretionary measures and spending programmes, without quantifying their budgetary impact. On the revenue side, those measures include the additional 2 percentage points cut in employers' social contribution rate from July 2019, the exemption of working pensioners from social contributions and an improved taxation regime for companies engaging in research and development activities. Those measures are partly offset by an increase in the levy on unhealthy products and foods and by measures to fight corporate tax evasion. The report also refers to ongoing efforts aimed at enhancing VAT collection efficiency, most notably the introduction of the online invoicing system as of July 2018 as well as initiatives at international level to fight aggressive tax planning. On the expenditure side, the report lists several already existing spending programmes (e.g. Modern Cities Programme, Irinyi plan, Supplier development programme), investment areas (road infrastructure, rail network renewal, health, education, cultural investment and support for business efficiency investment), wage increases matched by rationalization in the public sector and the savings related to the lower take up of the Public Work Scheme. The report also lists the newly announced measures, namely the Hungarian Village Programme, the rise in the allowance for home care and the Family Protection Action Plan (known also as the 'demography programme') aimed at improving the fertility rate mainly through expanded house purchase subsidies and a subsidised pre-natal loan for young women, which is convertible to a capital grant after the birth of a second and third child. According to the report, the costs of the new spending programmes are covered through the better-than-expected revenue developments. Table 2 presents those measures listed in the report with their estimated impact coming from subsequent exchanges with the authorities and the 2019 Convergence Programme.

Based on the Commission spring 2019 forecast, which takes into account the measures described in the report received from the authorities to the extent they are already enacted or credibly announced in sufficient detail, previously adopted measures, as well as information from all available sources, the general government deficit is projected to decrease to 1.8% of GDP in 2019. This is in line with the authorities' budgetary target. In the Commission spring 2019 forecast, total current expenditure is expected to increase rather moderately compared to GDP, thus representing the key driver of the reduction in the headline deficit. The projected expenditure restraint affects the main spending items at a varying degree, with the public wage bill and social payments expected to increase rather moderately. By contrast, due to

higher level of reserves in the budget, and the authorities explicit intention to use all available reserves by the end of the year, other current expenditure is expected to increase substantially. In addition, capital expenditure net of EU funds is expected to accelerate substantially and to increase as a share of GDP, partly related to spending on the Hungarian Village Programme and the demography programme. The general government deficit is projected by the Commission spring 2019 forecast to decrease marginally in 2020 to 1.6% of GDP. The decrease is driven by a moderate increase in spending for social transfers, which is expected to grow below the inflation rate, and by a moderate increase in public wages as well as in capital expenditure, due to the phasing out of the Hungarian Village Programme and a lower absorption of EU funds. As a consequence of the fiscal developments described above, according to the Commission spring 2019 forecast, the fiscal expansion seen in the past two years is estimated to be partly reversed with the structural deficit estimated to improve from 3.7% of GDP in 2018 to 3.3% in 2019 and 2.7% in 2020 (see Table 2).

Table 2. Discretionary revenue measures included in the Commission 2019 spring forecast (fiscal impact in % of GDP)

| | 2019 | 2020 |
|--|-------------|-------------|
| Revenues | | |
| Increase in road tolls | 0.1 | |
| Reduction of employer's social security contribution (SSC) rate (rate reduction from 22% to 19.5% in 2018 and to 17.5% from 1st July 2019) | -0.3 | -0.3 |
| Social security contribution exemption of retired employees and exemption of retail government bonds from interest tax and reduction of financial transaction duty for households | -0.1 | |
| Other smaller tax measures, including: (i) the third step in increasing family allowances after two children; (ii) increase in the threshold for KIVA; (iii) changes to corporate taxation (group taxation, incentives for investment); (iv) reduction of financial transaction duty for households; (v) exemption of newly issued retail government bonds from income tax; (vi) reduction of the bank levy; (vii) selective VAT rate cuts on internet services, restaurant services, fish, edible offal of swine, Braille-displays and printers | -0.2 | -0.1 |
| Expenditure | | |
| One-year extra benefit and "growth premium" for pensioners | 0.2 | 0.0 |
| Demography programme, including the extension of homebuying subsidies | 0.1 | 0.2 |
| Foreign language strategy | | 0.2 |
| Hungarian Village programme | 0.3 | |
| Net impact on the deficit | -1.2 | -0.8 |
| <p>Note:</p> <p>The budgetary impact in the table as included in the Commission 2019 autumn forecast. A positive sign implies that revenue/expenditure increases as a consequence of this measure. The net impact on the deficit is calculated as a difference between revenues and expenditure.</p> <p><u>Source</u>:</p> <p>Commission 2019 spring forecasts (COM); Commission calculations.</p> | | |

In the 2019 Convergence Programme, the Hungarian authorities confirm a headline deficit target of 1.8% of GDP for 2019. Total current revenue as a share of GDP is marginally lower

than in the Commission forecast (difference of 0.1 percentage point). The main difference compared with the Commission forecast is in the composition of current expenditure, with a higher forecast for public wages and intermediate consumption compensated by lower other current expenditure in the authorities' forecast. For 2020, the 2019 Convergence Programme confirms a deficit of 1.5% of GDP, which is marginally lower than in the Commission forecast. As a share of GDP, the authorities project lower expenditure by 0.8 percentage points of GDP, mainly explained by intermediate consumption and other current expenditure, compensated by lower revenue by 0.7 percentage points of GDP, explained by both lower current revenue and EU funds. It should be noted that the Hungarian authorities have a track record of under-budgeting general government revenues over the past years. Better-than-budgeted revenues have subsequently been spent on ad-hoc non-recurrent expenditure items in the last month of the calendar year.

Table 3. Composition of the budgetary adjustment

| (% of GDP) | 2017 | 2018 | | 2019 | | | 2020 | | |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | Outturn | CP 2018 | Outturn | CP 2018 | CP 2019 | COM | CP 2018 | CP 2019 | COM |
| Revenue | 44.7 | 45.5 | 44.2 | 45.1 | 44.6 | 44.6 | 42.9 | 43.3 | 44.0 |
| <i>of which:</i> | | | | | | | | | |
| - Taxes on production and imports | 18.0 | 18.1 | 18.3 | 17.9 | 18.2 | 18.2 | 17.6 | 18.0 | 18.1 |
| - Current taxes on income, wealth, etc. | 7.4 | 6.9 | 6.9 | 7.0 | 6.9 | 7.0 | 7.1 | 7.0 | 7.0 |
| - Social contributions | 12.8 | 12.7 | 12.2 | 12.6 | 12.0 | 12.0 | 12.2 | 11.7 | 11.8 |
| - Other (residual) | 6.6 | 7.8 | 6.8 | 7.6 | 7.5 | 7.5 | 6.0 | 6.6 | 7.1 |
| Expenditure | 46.9 | 47.9 | 46.5 | 46.9 | 46.4 | 46.4 | 44.4 | 44.8 | 45.6 |
| <i>of which:</i> | | | | | | | | | |
| - Primary expenditure | 44.1 | 45.3 | 43.9 | 44.5 | 43.9 | 44.0 | 42.1 | 42.4 | 43.2 |
| <i>of which:</i> | | | | | | | | | |
| Compensation of employees+Intermediate consumption | 18.9 | 17.8 | 17.7 | 17.0 | 17.6 | 17.3 | 15.7 | 16.7 | 17.3 |
| Compensation of employees | 10.9 | 10.5 | 10.5 | 9.9 | 10.1 | 10.1 | 9.3 | 9.8 | 9.9 |
| Intermediate consumption | 7.9 | 7.3 | 7.1 | 7.1 | 7.5 | 7.3 | 6.4 | 6.9 | 7.3 |
| Social payments | 13.9 | 13.8 | 13.5 | 13.1 | 12.8 | 12.9 | 12.7 | 12.5 | 12.6 |
| Subsidies | 1.3 | 1.4 | 1.3 | 1.4 | 1.2 | 1.2 | 1.3 | 1.3 | 1.2 |
| Gross fixed capital formation | 4.6 | 6.0 | 5.8 | 7.0 | 6.8 | 6.7 | 6.5 | 6.3 | 6.2 |
| Other (residual) | 5.5 | 6.3 | 5.8 | 6.0 | 5.5 | 5.9 | 6.0 | 5.7 | 6.0 |
| - Interest expenditure | 2.8 | 2.6 | 2.5 | 2.4 | 2.5 | 2.4 | 2.3 | 2.4 | 2.4 |
| General government balance (GGB) | -2.2 | -2.4 | -2.2 | -1.8 | -1.8 | -1.8 | -1.5 | -1.5 | -1.6 |
| Primary balance | 0.6 | 0.2 | 0.3 | 0.6 | 0.6 | 0.7 | 0.8 | 0.8 | 0.8 |
| One-off and other temporary measures | 0.4 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| GGB excl. one-offs | -2.6 | -2.4 | -2.2 | -1.8 | -1.8 | -1.8 | -1.5 | -1.5 | -1.6 |
| Output gap ¹ | 1.8 | 1.7 | 3.3 | 1.5 | 2.5 | 3.3 | 1.1 | 2.1 | 2.5 |
| Cyclically-adjusted balance ¹ | -3.0 | -3.2 | -3.7 | -2.6 | -3.0 | -3.3 | -2.1 | -2.5 | -2.7 |
| Structural balance² | -3.4 | -3.2 | -3.7 | -2.6 | -3.0 | -3.3 | -2.1 | -2.5 | -2.7 |
| Structural primary balance ² | -0.6 | -0.6 | -1.2 | -0.2 | -0.5 | -0.9 | 0.2 | -0.1 | -0.4 |
| Notes: | | | | | | | | | |
| ¹ Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology. | | | | | | | | | |
| ² Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures. | | | | | | | | | |
| Source: | | | | | | | | | |
| Convergence Programme (CP); Commission 2019 spring forecasts (COM); Commission calculations. | | | | | | | | | |

The Commission includes a lower fiscal impact of the “Családi Otthontermelési Kedvezmény” (Family Allowance for Home Building) (CSOK) programme included under

the ‘demography programme’, assuming a lower uptake of the subsidies than the authorities. In 2019-2020, the cumulated impact of that programme is estimated to increase the deficit by 0.08% of GDP in the Commission assessment compared to 0.25% of GDP in the 2019 Convergence Programme.

General government debt developments

In 2018, the general government debt-to-GDP ratio decreased to 70.8% of GDP from 73.4% in 2017, mainly driven by high nominal GDP growth. That debt level is well below the target set in the 2018 Convergence Programme (73.2% of GDP), also thanks to the higher-than-expected nominal economic growth. The sizeable adverse stock-flow-adjustment effect turned out lower than anticipated in the 2018 Convergence Programme thanks to an improvement in liquidity management. However, higher cash holdings at the end of the year added to the debt level.

According to the Commission 2019 spring forecast, debt is forecast to further decrease to 67.7% of GDP by 2020, thanks to the improving budgetary position and the projected high nominal GDP growth.

In 2018, Hungary complied with the debt criterion as the debt-to-GDP ratio remained below the debt-reduction benchmark. Compliance with the debt criterion is also expected in 2019 and 2020 on the basis of the Commission 2019 spring forecast.

Table 4. Debt developments

| (% of GDP) | 2017 | 2018 | | 2019 | | | 2020 | | |
|-------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | Outturn | CP 2018 | Outturn | CP 2018 | CP 2019 | COM | CP 2018 | CP 2019 | COM |
| Gross debt ratio¹ | 73.4 | 73.2 | 70.8 | 69.6 | 69.2 | 69.2 | 66.7 | 66.7 | 67.7 |
| Change in the ratio | -2.6 | -0.4 | -2.6 | -3.6 | -1.6 | -1.6 | -2.9 | -2.5 | -1.5 |
| <i>Contributions²:</i> | | | | | | | | | |
| 1. Primary balance | -0.6 | -0.2 | -0.3 | -0.6 | -0.6 | -0.7 | -0.8 | -0.8 | -0.8 |
| 2. “Snow-ball” effect | -2.8 | -2.2 | -3.8 | -2.6 | -2.7 | -2.6 | -2.3 | -2.3 | -1.6 |
| <i>Of which:</i> | | | | | | | | | |
| Interest expenditure | 2.8 | 2.6 | 2.5 | 2.4 | 2.5 | 2.4 | 2.3 | 2.5 | 2.4 |
| Growth effect | -2.9 | -3.0 | -3.3 | -2.8 | -2.6 | -2.5 | -2.6 | -2.6 | -1.8 |
| Inflation effect | -2.7 | -1.8 | -3.0 | -2.2 | -2.5 | -2.6 | -2.0 | -2.0 | -2.2 |
| 3. Stock-flow adjustment | 0.9 | 2.1 | 1.7 | -0.4 | 1.8 | 1.8 | 0.3 | 0.7 | 1.0 |

Notes:

¹ End of period.

² The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:

Commission 2019 spring forecast (COM); Convergence Programme (CP), Commission calculations.

4. COMPLIANCE WITH THE ADJUSTMENT TOWARDS THE MTO IN 2018

Hungary’s MTO is defined as a deficit of 1.5% of GDP in structural terms until 2019. It is becoming more demanding as of 2020, set as a deficit of 1.0% of GDP in structural terms.

On 22 June 2018, the Council issued a recommendation for Hungary to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 2.8% in 2018, corresponding to an annual structural adjustment of 1.0% of GDP.

In 2018, the growth rate of net primary government expenditure (at 6.3%) was well above the expenditure benchmark, pointing to a significant deviation (deviation of 1.3% of GDP). In parallel, the structural balance deteriorated to -3.7% of GDP from a position of -3.4% of GDP in 2017, also pointing to a significant deviation from the recommended structural adjustment (deviation of 1.3% of GDP). The size of the deviation indicated by the structural balance is negatively influenced by substantial revenue shortfalls as well as higher investment expenditures amidst an overheating economy, while it is estimated to have marginally benefitted from falling interest expenditure. The expenditure benchmark is strongly negatively impacted by the medium-term potential GDP growth applied in its calculation, which includes the very low potential GDP growth rates in the aftermath of the crisis. It therefore appears more appropriate to consider as a benchmark for growth of net primary expenditure the medium-term potential GDP growth rate of 2.5% arising from the Commission 2019 spring forecast for the same reference period (2012-2021). In addition, the GDP deflator underlying the expenditure benchmark does not seem to account properly for the increased cost pressures affecting government spending. After adjusting for those factors, the expenditure benchmark appears to adequately reflect the fiscal effort but it still points to a significant deviation. Therefore, the overall assessment confirms a significant deviation from the recommended adjustment path towards the MTO in 2018. This assessment is also in line with the earlier conclusion of 4 December 2018, in which the Council found that Hungary had not taken effective action in response to the Council recommendation of 22 June 2018 and issued a revised recommendation.

5. COMPLIANCE IN 2019 WITH THE COUNCIL RECOMMENDATION OF 4 DECEMBER 2018

On 4 December 2018 the Council recommended Hungary to take the necessary 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.

Based on the Commission 2019 spring forecast, both pillars point to a deviation from those requirements. The growth of net primary expenditure is projected to be well above the recommended reference rate in 2019 (deviation of 1.2% of GDP). The structural balance is estimated to improve by 0.4% of GDP, to -2.7% of GDP, falling short of the recommended adjustment (deviation of 0.6%). Therefore, both pillars point to a deviation from the requirements set in the revised Council recommendation. The structural balance is negatively influenced by some revenue shortfalls. The expenditure benchmark is strongly negatively impacted by the medium-term average potential GDP growth underlying that indicator and by the GDP deflator underlying that indicator. After adjusting for those factors, the expenditure benchmark appears to adequately reflect the fiscal effort but it still points to a deviation. Taking this into account, the overall assessment confirms the deviation from the recommended adjustment.

Since the Commission autumn 2018 forecast, which was the basis for the Council recommendation of 4 December 2018, the authorities have announced new expansionary measures on the expenditure side. In addition, public wages grew at a faster pace in 2018 and new wage increases for some categories were announced since autumn 2018. Finally, higher reserves in the budget, with a clear intention for them to be fully spent by the end of the year,

have added to the expenditure projections for 2019. As a result, the deviation of the expenditure benchmark is expected to be much larger compared to the assessment performed in autumn 2018.

Table 5. Compliance with the MTO or the required adjustment towards it

| (% of GDP) | 2018 | 2019 | 2020 | | |
|--|------------------------------|------------------|------------------|------------------|------------------|
| Background budgetary indicators¹ | | | | | |
| Medium-term objective (MTO) | -1.5 | -1.5 | -1.0 | | |
| Structural balance ² (COM) | -3.7 | -3.3 | -2.7 | | |
| Setting the required adjustment to the MTO | | | | | |
| Structural balance based on freezing (COM) | -3.6 | -3.3 | - | | |
| Position vis-a-vis the MTO ³ | Not at MTO | Not at MTO | Not at MTO | | |
| Required adjustment ⁴ | 1.0 | 1.0 | 0.75 | | |
| Required adjustment corrected ⁵ | 1.0 | 1.0 | 0.75 | | |
| Corresponding expenditure benchmark ⁶ | 2.8 | 3.3 | 4.7 | | |
| Compliance with the required adjustment to the MTO | | | | | |
| | COM | CP | COM | CP | COM |
| Structural balance pillar | | | | | |
| Change in structural balance ⁷ | -0.3 | 0.6 | 0.4 | 0.5 | 0.6 |
| One-year deviation from the required adjustment ⁸ | -1.3 | -0.4 | -0.6 | -0.3 | -0.2 |
| Two-year average deviation from the required adjustment ⁸ | -1.3 | -0.9 | -0.9 | -0.3 | -0.4 |
| Expenditure benchmark pillar | | | | | |
| Net public expenditure annual growth corrected for one-offs ⁹ | 6.3 | 6.5 | 6.5 | 7.7 | 7.3 |
| One-year deviation adjusted for one-offs ¹⁰ | -1.3 | -1.2 | -1.2 | -1.1 | -1.0 |
| Two-year deviation adjusted for one-offs ¹⁰ | -1.9 | -1.3 | -1.3 | -1.1 | -1.1 |
| Finding of the overall assessment | Significant deviation | Deviation | Deviation | Deviation | Deviation |
| Legend | | | | | |
| 'Compliance' - the recommended structural adjustment or a higher adjustment is being observed. | | | | | |
| 'Some deviation' - a deviation from the recommended structural adjustment is being observed, but it is below the threshold for a significant deviation. | | | | | |
| 'Significant deviation' - a deviation which has reached or breached the threshold for a significant deviation (i.e. 0.5% of GDP over one year, 0.25% of GDP over two years on average). | | | | | |
| Notes | | | | | |
| ¹ The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO. | | | | | |
| ² Structural balance = cyclically-adjusted government balance excluding one-off measures. | | | | | |
| ³ Based on the relevant structural balance at year t-1. | | | | | |
| ⁴ Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.). In case of a SDP, the requirement corresponds to the Council recommendation when available, otherwise it refers to the Commission recommendation to the Council. | | | | | |
| ⁵ Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers. | | | | | |
| ⁶ Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t. | | | | | |
| ⁷ Change in the structural balance compared to year t-1. Ex post assessment (for 20XX-1) is carried out on the basis of Commission 20XX spring forecast. | | | | | |
| ⁸ The difference of the change in the structural balance and the corrected required adjustment. | | | | | |
| ⁹ Net public expenditure annual growth (in %) corrected for discretionary revenue measures, revenue measures mandated by law and one-offs (nominal) | | | | | |
| ¹⁰ Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate. | | | | | |
| Source: | | | | | |
| Convergence Programme (CP); Commission 2019 spring forecast (COM); Commission calculations. | | | | | |

6. PROPOSED ADJUSTMENT PATH TO THE MTO AND REQUIRED FISCAL EFFORT

Based on the Commission 2019 spring forecast, Hungary's structural balance is estimated to improve to -3.3% of GDP in 2019 and to -2.7% in 2020, slowly approaching albeit still far away from its MTO. Hungary is projected to remain in good economic times, as its projected output gap of +3.3% in 2019 and +2.5% in 2020 well exceeds +1.5% of potential GDP. While in 2019, real and potential GDP growth are estimated to be the same (at 3.7%), in 2020, real GDP growth (at 2.8%) is forecast to be lower than the growth potential (at 3.6%). Finally, the general government debt is set to remain above the 60%-of-GDP threshold. The required structural effort prescribed by Regulation (EC) No 1466/97 and the matrix of requirements⁴, which factors in the prevailing economic circumstances and sustainability concerns, amounts to 0.75% of GDP in both 2019 and 2020.

An additional effort, necessary to correct for the cumulated deviations and to bring Hungary back on an appropriate consolidation path following the slippages since 2017, should complement the minimum adjustment requirement in 2019. Hungary's structural balance has increased by 1.6% of GDP in 2017 and by 0.3% of GDP in 2018, to 3.7% of GDP in 2018. An additional effort of 0.25% of GDP in 2019 seems appropriate given the magnitude of the observed significant deviation from the recommended adjustment path towards the MTO and to accelerate the adjustment towards the MTO. For 2020, the minimum adjustment requirement of 0.75% of GDP seems appropriate, contingent on compliance with the requested adjustment in 2019. Given the current strong cyclical position of the economy, GDP growth is expected to remain robust despite the fiscal correction, particularly if the adjustment is carried out in a growth-friendly manner.

Based on the Commission forecast, the above-mentioned 1.0% of GDP structural adjustment in 2019 is consistent with a nominal growth rate of net primary government expenditure of 3.3% of GDP, in contrast to a growth rate of 6.5% projected by the Commission. In 2020, the 0.75% of GDP structural adjustment target is consistent with a nominal growth rate of net primary government expenditure of 4.7%, in contrast to a growth rate of 7.3% projected by the Commission.

The Commission 2019 spring forecast projects an improvement of the structural balance by 0.4% of GDP in 2019 and by a further 0.6% of GDP in 2020. Therefore, a structural improvement of 1.0% of GDP in 2019 and 0.75% of GDP in 2020 translates into the need to adopt measures of a total structural yield of 0.6% of GDP in 2019 and additional measures of a structural yield of 0.2% of GDP in 2020 compared to the current baseline in the Commission 2019 spring forecast.

7. CONCLUSIONS

On 22 June 2018 the Council issued a recommendation for Hungary to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 2.8% in 2018, corresponding to an annual structural adjustment of 1.0% of GDP. On 4 December 2018, the Council issued a revised recommendation for Hungary to take the necessary measures to ensure that the nominal growth rate of net primary government

⁴ "Commonly agreed position on Flexibility within the SGP", formally endorsed by ECOFIN Council on 12 February 2016, available at: <http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf>

expenditure does not exceed 3.3% in 2019, corresponding to an annual structural adjustment of 1.0% of GDP.

In the report on action taken in response to the recommendation, the authorities retain their initial general government target of 1.8% of GDP despite the better-than-expected outturn in 2018 and the more positive macroeconomic outlook. Moreover, the base effect due to a better 2018 outturn is planned to be fully offset by the newly adopted expansionary measures in 2019. The Commission 2019 spring forecast projects a general government deficit for 2019 at 1.8% of GDP, in line with the authorities' current target.

In 2018, the structural deficit is estimated to have increased to 3.7% of GDP from 3.4% of GDP. Both the structural balance and the expenditure benchmark pillars point to a significant deviation from the recommended adjustment path towards the MTO in 2018. An overall assessment confirms that the observed deviation in 2018 is significant. In 2019, according to the Commission 2019 spring forecast, both the structural balance and the expenditure benchmark pillars point to a deviation from the recommended adjustment path towards the MTO, which is confirmed also by an overall assessment.

An improvement in Hungary's structural balance by 1.0% of GDP in 2019 and 0.75% of GDP in 2020 would put Hungary on an appropriate adjustment path towards the MTO. Such an improvement is consistent with the nominal growth rate of net primary government expenditure not exceeding 3.3% in 2019 and 4.7% in 2020. This translates into a need to adopt measures of a total structural yield of 0.6% of GDP in 2019 and additional measures of a structural yield of 0.2% of GDP in 2020 compared to the current baseline from the Commission 2019 spring forecast.