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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 18-19 September 2018

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, 18-19 September 2018
Report

1. Introduction

A Significant Deviation Procedure (SDP) was launched for Hungary in spring 2018 as a consequence of an observed significant deviation from the requirement of the preventive arm of the Stability and Growth Pact (SGP) in 2017. On 23 May 2018, the Commission issued a warning to Hungary. The Council Recommendation adopted on 22 June 2018 confirmed the Commission's assessment and called on the authorities to take the necessary action in order to restore the appropriate adjustment path towards the medium-term budgetary objective (MTO). In particular, the Council recommended taking 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% of GDP. The 2018 fiscal Country Specific Recommendation directly referred to that SDP recommendation. Hungary has reported to the Council on actions taken as requested by 15 October 2018. The assessment of action taken by Hungary has been adopted by the Commission on 21 November 2018. This report presents Commission's findings from the enhanced surveillance mission to Hungary that took place between 18 and 19 September 2018.

For 2018, the Commission 2018 spring forecast projected the headline deficit to increase to 2.4% of GDP from 2% in 2017, and the structural balance was estimated to deteriorate further. The fall of temporary revenues contributes to the increased deficit, so do additional tax cuts. At the same time, the growth of government expenditure, excluding spending from EU funds, was expected to slow down, compared to 2017. However, net primary expenditure, adjusted for one-offs and discretionary measures, was still estimated to increase above the country's medium-term rate of potential GDP growth, well exceeding the reference rate reflecting the requirement of the preventive arm.

The enhanced surveillance mission by the Commission took place on 18-19 September 2018. The aim of the mission was to learn about the views of the authorities on fiscal developments and the actions planned, and to encourage compliance with the SGP. The Commission staff met with (i) Minister Mr. Mihály Varga and State Secretaries Mr. Péter Banai and Mr. Norbert Izer, Ministry of Finance; (ii) Mr. Árpád Kovács, the president of the Hungarian Fiscal Council; and (iii) Mr. Barnabás Virág, Executive Director of the National

[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

Bank of Hungary. The mission also discussed the context and implications of the SDP with Members of the Hungarian Parliament from the Committees of Budgetary and European Affairs, and with the representatives of social partners and think tanks. This report is based on information obtained until and during the mission.

2. Findings of the mission

The Hungarian authorities do not plan major steps this year in response to the SDP Recommendation, while they seem committed to tighten the budgetary stance starting from 2019 onwards. In 2018, the authorities intend to stick to their initial general government deficit target. At the same time, the 2019 budget, which was already adopted in July 2018, aims to bring down the headline deficit by 0.6% of GDP next year. However, the SDP Recommendation does not cover 2019.

Hungary made substantial efforts to consolidate its public finances after the crisis but this process recently lost momentum, while public debt remains high, above 70% of GDP. Hungary acceded to the Union with a high deficit and was subject of an Excessive Deficit Procedure between 2004 and 2013. Since then, the government deficit has been safely kept below the 3% of GDP threshold. The mission commended this achievement, but pointed out that fiscal consolidation had recently halted. According to the Commission's assessment, the fiscal stance became highly pro-cyclical after 2016. This notably entails important risks for the future, when adverse shocks hit again. While the growth of the Hungarian economy is amongst the fastest in the EU in 2018 (i.e. 4.7% in the first half of the year) and there are already signs of overheating, the nominal deficit planned at 2.4% of GDP for this year is the third highest in the EU (and well above the EU average of 0.6% of GDP). Moreover, the level of public debt at around 73% of GDP still remains high. Some Members of Parliament as well as the economic experts who met with the Commission staff during the mission concurred that there was a need to revise pro-cyclical fiscal policy in Hungary.

While the Hungarian authorities admitted some pro-cyclicality in fiscal policy, they had a different evaluation of the gravity of the problem regarding the assessment of the 2017 budget outcome already. The Commission estimates that the output gap exceeded +1.5% of GDP in 2017. By contrast, according to the calculations of the Ministry of Finance, the negative output gap was still closing at that stage. Therefore the authorities estimate a notably better structural fiscal position than the Commission. In their assessment, the structural balance remained close to the MTO in 2017 (at -1.7% of GDP compared to the MTO of-1.5% of GDP) and thus the opening of the SDP was not warranted. In response, the Commission staff stressed that the assessment of the compliance with the provisions of the SGP must be based on the methodology commonly agreed by all Member States. The mission also pointed out that, recognising the uncertainties surrounding the estimation of the cyclical position, increased emphasis had been placed in parallel on the expenditure benchmark in the Commission's assessments. However, on that basis as well it could hardly be disputed that significant deviation was observed in 2017. Even without counting the impact of significant

tax cuts, primary expenditure (netting out EU funds and one-offs) grew well above Hungary's potential GDP growth in 2017 on any account.

Regarding the high observed expenditure growth in 2017, the authorities noted that it masked a significantly improved underlying budgetary position (i.e. the "genuine" structural balance). In 2017, the government decided to partly spend savings and higher-than-expected revenues on non-recurring discretionary items (mostly transfers to the private and non-profit sectors) at the end of the year. Despite this, the fiscal deficit turned out to be lower than the nominal target in 2017. The Commission suggested that, were such a constellation to occur again towards the end of 2018, the revenue gains should be used to reduce the structural deficit in line with the SDP Recommendation instead of incurring extra discretionary spending.

The Hungarian authorities indicated that they did not see it reasonable to implement the substantial fiscal adjustment recommended by the Council for the second half of 2018. In their view, the budgetary outcome in 2018 was already largely determined by previous decisions and the proposed adjustment in the rest of the year would harm the economy. Nonetheless, they mentioned certain actions, which could improve the budgetary position already in 2018 or at least pose some positive risks (e.g., the mandatory e-invoice system for inter-company transactions as of 1st July 2018 aiming at enhancing tax-collection efficiency), or facilitate spending restraint planned for 2019 (e.g. starting the rationalisation of staffing levels in public administration). The authorities stated that only a temporary departure was expected from the MTO in 2018, which was to be reversed in 2019.

The Commission delegation noted that the adoption of the 2019 budget was a step in the right direction. At the same time, the mission warned that the government plans for 2019 still involved a risk of significant deviation from the required adjustment taking 2018 and 2019 together as shown by the Commission's assessment of the 2018 Convergence Programme. In other words, the implementation of the 2019 budget as foreseen is expected to result in an improved structural balance, but does not seem sufficient to reverse the effects of the preceding pro-cyclical fiscal policy on the budgetary position, especially if there was no notable improvement in 2018. It also noted that the budgetary plans for next year seem to rely strongly on an optimistic macroeconomic scenario assuming a sustained GDP growth at around 4%. In this respect, the authorities highlighted that the budgeted level of stability reserves was increased to provide a buffer in case of a less favourable situation.

There is a risk that the medium-term impact of recent tax cuts on fiscal revenues could be higher than the Hungarian authorities assume. Hungary has recently implemented a series of sizeable tax cuts. It included in particular successive reductions of employer social security contributions in 2017 and 2018, which are also planned to continue next year. The budgetary effect of the reductions in social contributions to date remains dampened, given the tight labour market and fast rising wages. The mission cautioned that the impact of these cuts may become larger when these conditions wither with the economic cycle. The authorities agreed that such risks existed but argued that the impact of dynamic wage growth on the

revenue-to-GDP ratio seen so far could be regarded as largely permanent. The wage share in the economy is on a recovery path reversing the decline seen after the crisis. This might also have been helped by the recent substantial minimum wage increases, which also provided a "whitening effect" by curbing undeclared incomes.

The dynamics of public investment are highly pro-cyclical. Hungary is accelerating the execution of government investments, including both nationally and EU funded projects. Total public investment expenditure is set to rise rapidly during 2018 and 2019, reaching a historic high of around 7% of GDP in 2019. The Commission noted that this heavily frontloaded schedule did not seem to be consistent with the cyclical position of the economy. Given the current tight capacity constraints in construction, this can result in a crowding-out effect adversely affecting private sector investments, while also pushing up the costs of public projects. Moreover, if a sufficient fiscal space is not secured during the economic expansion, the government would be forced into a rapid unwinding of investments when the next recession occurs. This would accentuate output fluctuations at the wrong moment and in the wrong direction. In that regard, think tanks and social partners expressed their concern that the strong acceleration of public investments could negatively affect the quality of public spending.

The Hungarian Fiscal Council warned that the budgetary plans for 2017-2019 did not comply with the national domestic rule pertaining to the structural balance. The structural balance rule of the Hungarian Stability Law prescribes that the budget bill submitted by the government should be in conformity with the MTO each year. In its opinions issued on the draft budgets, the Fiscal Council compares the MTO with the structural balance as estimated by the government prior to the budget execution. As the budgetary plans for the years 2017-2019 contained an estimated structural deficit exceeding the MTO, the Fiscal Council consequently stated that those plans were in breach of the corresponding domestic rule.[2] The Fiscal Council did not expect an improvement in 2018 in that regard. In its report on the 2018 fiscal developments, which was published during the mission, the Fiscal Council was of the opinion that the budgetary target for the 2018 general government deficit set in ESA terms can be achieved. At the same time, it called the authorities to resort to strict budgetary control in the rest of the year, especially concerning spending by central budgetary institutions and chapters. The Fiscal Council also noted that there was a high risk that the cash-flow deficit will turn out to be considerably higher than planned. This was due to substantial advance payments towards EU funded projects coupled with a much lower-than-expected rules-based disbursement of transfers by the EU.

The National Bank of Hungary (MNB) agreed that fiscal policy became pro-cyclical after 2016, albeit to a lesser extent than assessed by the Commission, and projected a counter-cyclical fiscal stance in 2019 and 2020. The MNB emphasised the importance of

[2] The MTO of Hungary is a structural deficit of 1.5% of GDP. The three successive budget bills adopted between 2016 and 2018 were based on a planned structural deficit of 2.1% of GDP for 2017, 2.4% for 2018 and 1.7% for 2019 as calculated by the government. Therefore in each budgetary round there was a planned deviation from the MTO.

the structure of the fiscal impulse. In its assessment, significant temporary effects also contributed to fiscal loosening particularly in 2018, including the phasing-out of land sales and extraordinary corporate income tax receipts under the Growth Tax Credit scheme. In addition, the MNB stressed the uncertainties regarding the assessment of the output gap. While capacity utilisation and labour market indicators suggest diminished slack, financial variables (including the positive current account balance and the low credit-to-GDP ratio) do not point to overheating. Regarding the macroeconomic policy mix, the MNB argued that while fiscal and monetary policy has been loose until recently, this stance will gradually change, and that macro-prudential policy has remained tight in order to contain financial vulnerabilities.