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COMMISSION STAFF WORKING DOCUMENT
Accompanying the documents

Recommendation for a Council Decision establishing that no effective action has been taken by Hungary in response to the Council Recommendation of 14 June 2019

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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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

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. 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.

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 medium-term budgetary objective 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 expenditure[1] does not exceed 2.8% in 2018, corresponding to an annual structural adjustment of 1.0% of GDP[2].

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 GDP[3]. It recommended Hungary to use any windfall gains for reducing its deficit, while budgetary consolidation 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

[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).

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. On 14 June 2019, the Council adopted a decision establishing that no effective action was taken by Hungary in response to the Council Recommendation of 4 December 2018.

Moreover, on 14 June 2019 the Council decided in accordance with Article 121(4) TFEU that an observed significant deviation from the adjustment path towards the medium-term budgetary objective occurred in Hungary in 2018. In view of the established significant deviation, the Council on 14 June 2019 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 3.3% in 2019 and 4.7% in 2020, corresponding to an annual structural adjustment of 1% of GDP in 2019 and 0.75% of GDP in 2020. The recommended effort for 2020 was deemed appropriate, contingent on compliance with the requested adjustment in 2019. It also recommended Hungary to use any windfall gains for deficit reduction, while budgetary consolidation measures should ensure a lasting improvement in the general government structural balance in a growth-friendly manner. The Council established a deadline of 15 October 2019 for Hungary to report on action taken in response to the recommendation.

On 9 July 2019, the Council addressed recommendations to Hungary within the context of the European Semester. In the area of public finances, the Council recommended that Hungary ensure compliance with the Council Recommendation of 14 June 2019 with a view to correct the significant deviation from the adjustment path toward the medium-term budgetary objective.

The Hungarian authorities delivered their report on action taken in response to that Council Recommendation (hereafter: "the report") on 15 October 2019. Moreover, on 26 September 2019 the Commission undertook an enhanced surveillance mission in Hungary for the purpose of on-site monitoring under the Article -11(2) of Regulation (EC) No 1466/97. The findings of the enhanced fiscal surveillance mission were subsequently made public.

Section 2 of this document presents macroeconomic developments and outlook in 2019-20. Sections 3 presents fiscal developments in 2019 and updated budgetary projections for 2020. Section 4 assesses compliance with the Council Recommendation of 14 June 2019, while Section 5 proposes a new adjustment path for 2020. Section 6 concludes.

2. MACROECONOMIC DEVELOPMENTS AND OUTLOOK 2018-2019

GDP growth in 2018 was revised by the Hungarian Central Statistical Office to 5.1% up from 4.9%. Strong growth persisted in the first half of 2019 as domestic tailwinds in construction and the automotive industry managed to offset the adverse impact of the global slowdown. However, these temporary factors are set to fade by the end of 2019 and GDP growth is expected to drop from 4.6% in 2019 to 2.8% in 2020. Slower economic growth is set to limit further employment gains while a less tight labour market is also forecast to reduce real wage growth. Consequently, household consumption growth is projected to slow in 2020. Investment growth is forecast to slow on account of a drop in public investments. Export growth is set to remain modest, in line with sluggish growth on main export markets. The current account slipped into a deficit in 2018 which is projected to widen in 2019, but then narrow in 2020 thanks to slowing import demand.

Inflation is projected to decrease due to cooling domestic demand and wage growth, as well as lower imported inflation. The Harmonised Index of Consumer Prices inflation is forecast at

3.4% in 2019 and 3.1% in 2020. Rising construction costs have fed into the GDP deflator, which is forecast to rise by 4.2% in 2019. Easing capacity constraints in construction are expected to slow the rise of prices, and this will contribute to a slowdown of the GDP deflator in 2020 to 3.7%.

The Commission GDP growth forecast for 2019 and 2020 was revised up since spring 2019, on the back of data revisions, and higher-than-projected GDP growth in the first half of 2019. In particular, investment and net export projections were increased. When assessing the level of nominal GDP and household consumption in 2020, the latest Commission forecast is broadly similar to the authorities' assessment in the 2019 Convergence Programme, whose macroeconomic scenario also provided the basis for the 2020 budget. This is the result of statistical revisions in 2018 and more favourable developments in 2019, but lower expected growth rates in 2020 than the authorities' projections. For compensation of employees the authorities' projections remain more favourable than the Commission forecast.

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 become wider in 2019 and to narrow in 2020.

Table 1: Macroeconomic developments and forecast

	2018		2019		2020	
	CP 2019	Revised	CP 2019	COM	CP 2019	COM
Real GDP (% change)	4.9	5.1	4.0	4.6	4.0	2.8
Private consumption (% change)	5.4	4.8	4.6	4.9	4.7	3.8
Gross fixed capital formation (% change)	16.5	17.1	10.3	17.0	3.8	2.1
Exports of goods and services (% change)	4.7	4.3	5.1	5.1	5.2	4.0
Imports of goods and services (% change)	7.1	6.8	6.5	6.2	5.4	4.0
Contributions to real GDP growth:						
- Final domestic demand	6.2	6.4	5.1	6.7	3.7	2.6
- Change in inventories	0.2	0.4	0.0	-1.4	0.3	0.0
- Net exports	-1.5	-1.7	-1.0	-0.6	0.1	0.2
Output gap[1]	3.3	3.4	2.5	3.7	2.1	2.5
Employment (% change)	2.2	2.4	1.1	1.9	1.3	0.2
Unemployment rate (%)	3.7	3.7	3.3	3.4	2.9	3.4
Labour productivity (% change)	2.7	2.9	3.0	2.8	2.7	2.7
HICP inflation (%)	2.9	2.9	2.7	3.4	2.8	3.1
GDP deflator (% change)	4.5	4.5	3.8	4.2	3.2	3.7
Comp. of employees (per head, % change)	9.6	6.2	9.2	7.8	8.1	6.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.2	2.1	1.5	0.6	2.1	1.2

Note:

[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.

Source :

Commission 2019 autumn forecast (COM); 2019 Convergence Programme (CP 2019).

3. FISCAL DEVELOPMENTS AND OUTLOOK 2018-2019

On 26 September 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 20 November 2019 and made its findings public. The Commission report finds that, despite a better carry-over from 2018 and higher than expected nominal growth in the first two quarters of 2019, the Hungarian authorities continue to target a headline deficit of 1.8% of GDP in 2019 that had been approved with the 2019 budget in July 2018 and confirmed in the 2019 Convergence Programme. That policy implies an improvement in the underlying structural deficit in 2019 which, however, is far from the adjustment required by the Council recommendation.

The mission also finds that the government's target for 2020 is a headline deficit of 1.0% in ESA (accrual) terms, the same as announced in the 2020 budget adopted on 12 July 2019, and 0.5% of GDP better than the target of 1.5% of GDP included in the 2019 Convergence Programme. The improvement builds on expected strong growth, improvement in tax collection and contained expenditure growth. However, some revenue measures that underpin the 2020 deficit target remain to be specified. That policy implies an improvement in the underlying structural deficit in 2020 which is above the adjustment required by the Council recommendation.

Updated budgetary projections for 2019 and 2020 and reported action

In their report on action taken, the authorities maintain the general government deficit target from the 2019 Convergence programme of 1.8% of GDP in 2019. This is despite the more favourable macroeconomic and fiscal developments so far in 2019. For 2020, the authorities confirmed the target of a headline deficit of 1.0% of GDP, in line with the 2020 budget, and 0.5% of GDP better than the target included in the 2019 Convergence Report. As a result, the budget is planned to reach a deficit of 0.7% of GDP in 2021 and 0.4% of GDP in 2022 and a balanced position in 2023.

The report highlights that the unchanged 2019 deficit target is accompanied by changes in the revenue and expenditure sides of the budget. Compared to the 2019 Convergence Programme, the authorities expect higher tax revenues, partly compensated by reduced financing from EU funds by 0.3% of GDP on EU-funded projects due to financial corrections related to projects completed in 2017 and 2018. However, the deficit-improvement resulting from these developments is expected to be fully absorbed by extra spending. In particular, higher expenditure is expected in relation to nationally-financed investment, the extension of the housing subsidies and measures included in the Family Protection Action Plan (known also as the 'demography programme'[4]), in particular the pre-natal baby support and the car purchase subsidy). Higher expenditure is also linked to pensions, due to the payment of the pension supplement and pension premium following higher inflation and economic growth than anticipated by the government.

The report recalls the high reserve (1% of GDP) included in the 2020 deficit target, which is aimed at managing external risks and which could be used only if the deficit target is to be met. The report lists the expansionary fiscal measures contained in the "Economic Protection Action Plan" that the government adopted on 30 May 2019, which the government expects to

[4] The 'demography programme' includes measures such as expanded house purchase subsidies; a subsidised pre-natal loan for young women, which is partly convertible to a capital grant after the birth of a second additional child after taking the loan, and fully convertible after the third additional child; a car purchase subsidy for large families; the increase of places in nurseries; and the exemption of women with four or more children from personal income tax.

support dynamic growth in the years to come and thereby to ensure a high level of revenues. The report also recalls that the key priority of the 2020 budget is to support demographic developments through the expansionary 'demography programme'. On the consolidation side, the report refers to efforts aimed at enhancing collection efficiency undertaken in the past, 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 and the changes implemented by the authorities following the EU Anti Avoidance Tax Directive. These measures also contributed to the reduction in the estimated VAT gap (from 21% in 2013 to 9% in 2018). For 2020, according to the report, tax compliance measures are currently under development, in line with the authorities' plan to boost competitiveness, aimed at simplifying administrative tax obligations, increase the efficiency of tax collection and extend the use of electronic means of payment. A timeline for these measures is missing. Finally, the report recalls the measures introduced in recent years to reduce labour taxation, improve tax collection and simplifying the tax system. Among these, the reduction in employer's social security contribution rate, the introduction of simplified tax schemes (Kata and Kiva), and additional simplifications in the taxation system for SMEs.

Contrary to what was required by the Council recommendation, the report does not contain any fiscal projection, neither of aggregates nor of individual budgetary items or categories. Moreover, the authorities do not quantify the budgetary impact of the discretionary measures and spending programmes listed in the report. 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.

Table 2: Discretionary revenue measures included in the Commission 2019 autumn 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	-0.5
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
Other revenue measures in the Economic Action Protection Plan		-0.1
TOTAL	**-0.5**	**-0.7**

Note:

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 renevues and expenditure.

Source :

Commission 2019 spring forecasts (COM); Commission calculations.

Table 3: Discretionary fiscal measures listed in the report (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	-0.5
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
Other revenue measures in the Economic Action Protection Plan		-0.1
Expenditure		
Expenditure measures in the Economic Action Protection Plan	0.2	0.0
Demography programme, including the extension of homebuying subsidies	0.3	0.7
Hungarian Village programme	0.3	
Net impact on the budget balance	**-1.3**	**-1.3**

Note:

The budgetary impact in the table as estimated by the authorities. 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 renevues and expenditure.

Based on the Commission autumn 2019 forecast, the general government deficit is projected to decrease to 1.8% of GDP in 2019. This is in line with the authorities' budgetary target. Tax revenues remain buoyant, on the back of favourable macroeconomic developments. The increase remains, however, below nominal GDP growth, partly due to a 2 percentage point cut in employers' social security contributions. Despite a financial correction of 0.3% of GDP, the absorption of EU funds is also expected to increase compared to 2018, reaching its peak over the current Multiannual Financial Framework. The only factor contributing to the deficit's reduction is the moderate increase in total current expenditure compared to GDP, taking also into account the full use of free reserves in the budget. Interest expenditure is expected to remain stable as a share of GDP, due to the high premium offered by new retail bonds launched in June 2019. The deficit-reducing contribution of current spending is only partly offset by an increase in capital expenditure resulting from the implementation of the programme to develop villages, the take-up of the pre-natal loan under the 'demography programme' and to higher-than-foreseen national co-payments to EU funded projects.

The general government deficit is projected by the Commission 2019 autumn forecast to decrease in 2020 to 1% of GDP, in line with the authorities' budgetary target. The level of EU funds absorption is assumed to decline by 0.5% of GDP. Tax revenues are expected to continue increasing but at a lower rate compared to the previous year, as the economy is expected to slow and following the measures included in the Economy Protection Action

Plan, in particular the further cut of employers' social security contributions by 2 percentage points. Except for interest spending, current expenditure growth is expected to remain moderate, thus contributing to the deficit reduction. The drop in capital expenditure (by 1% of GDP), following also a lower absorption of EU funds, is only partly offset by higher capital transfers due to the increasing take-up of the 'demography programme'. These projections assume almost the full use of the substantially high level of free reserves (1% of GDP) foreseen in the budget.

As a consequence of the fiscal developments described above, according to the Commission autumn 2019 forecast, the structural deficit is estimated to improve from 3.8% of GDP in 2018 to 3.3% in 2019. The net impact of one-off measures amounted to -0.2% of GDP, consisting of a deficit-improving effect of assets sales of 0.1% GDP and a deficit-increasing one-effect of 0.3% of GDP related to a correction of EU funding. In 2020, the structural deficit is estimated to improve to 2.1% (see Table 4).

A positive risk to the 2020 budget balance forecast comes from possibly higher revenues, in case some of the currently unspecified revenue measures are adopted in time. On the other hand, higher expenditure could materialize in relation to public investments and the measures in the 'demography programme', whose take-up was higher than expected in 2019.

The composition of the budget and its adjustments in nominal and structural terms are presented in Table 4.

General government debt developments

In 2018, the general government debt-to-GDP ratio reached 70.2%. The general government debt-to-GDP ratio is projected by the Commission to further decrease to 68.2% in 2019 and 66.7% in 2020, thanks to the improving budgetary position and the projected high nominal GDP growth.

In 2018, Hungary complied with the debt rule as the government debt-to-GDP ratio remained below the debt-reduction benchmark. A similar conclusion is reached for 2019 and 2020 on the basis of the Commission 2019 autumn forecast.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2018	2019			2020		
	Outturn	**CP 2019**	**Update October 2019**	**COM**	**CP 2019**	**2020 Budget**	**COM**
Revenue	**44.4**	**44.6**	**44.7**	**44.1**	**43.3**	**43.6**	**43.3**
of which:							
- Taxes on production and imports	18.4	18.2	18.4	18.1	18.0	18.5	18.1
- Current taxes on income, wealth, etc.	6.7	6.9	7.0	6.8	7.0	7.2	6.9
- Social contributions	12.3	12.0	12.0	12.0	11.7	11.7	11.8
- Other (residual)	7.0	7.5	7.3	7.1	6.6	6.3	6.5
Expenditure	**46.7**	**46.4**	**46.5**	**45.9**	**44.8**	**44.6**	**44.3**
of which:							
- Primary expenditure	44.3	43.9	44.1	43.5	42.4	42.3	41.9
of which:							
Compensation of employees+Intermediate consumption	18.1	17.6	17.9	17.5	16.7	16.7	17.1
Compensation of employees	10.5	10.1	10.3	10.1	9.8	9.8	10.0
Intermediate consumption	7.5	7.5	7.6	7.3	6.9	6.9	7.2
Social payments	13.1	12.8	13.0	12.6	12.5	12.5	12.3
Subsidies	1.7	1.2	1.2	1.6	1.3	1.2	1.5
Gross fixed capital formation	5.8	6.8	6.5	6.4	6.3	5.5	5.4
Other (residual)	5.6	5.5	5.6	5.5	5.7	6.4	5.5
- Interest expenditure	2.4	2.5	2.4	2.4	2.4	2.4	2.4
General government balance (GGB)	**-2.3**	**-1.8**	**-1.8**	**-1.8**	**-1.5**	**-1.0**	**-1.0**
Primary balance	**0.1**	**0.6**	**0.6**	**0.6**	**0.8**	**1.4**	**1.4**
One-off and other temporary measures	0.0	0.0	-0.2	-0.2	0.0	0.0	0.0
GGB excl. one-offs	**-2.3**	**-1.8**	**-1.6**	**-1.6**	**-1.5**	**-1.0**	**-1.6**
Output gap[1]	3.4	2.5	n.a.	3.7	2.1	n.a.	2.5
Cyclically-adjusted balance[1]	-3.8	-3.0	n.a.	-3.5	-2.5	n.a.	-2.1
Structural balance[2]	**-3.8**	**-3.0**	n.a.	**-3.3**	**-2.5**	n.a.	**-2.1**
Structural primary balance[2]	-1.4	-0.5	n.a.	-0.9	-0.1	n.a.	0.2

[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 autumn forecasts (COM); Commission calculations.

Table 5: Debt developments

(% of GDP)	2018	2019			2020		
	Outturn	**CP 2019**	**Update October 2019**	**COM**	**CP 2019**	**2020 Budget**	**COM**
Gross debt ratio[1]	**70.2**	**69.2**	**68.5**	**68.2**	**66.7**	**66.7**	**66.7**
Change in the ratio	-2.7	-1.6	-1.8	-2.0	-2.5	-2.5	-1.5
Contributions [2] :							
1. Primary balance	-0.1	-0.6	-1.4	-0.6	-0.8	-1.4	-1.4
2. “Snow-ball” effect	-4.1	-2.7	-3.0	-3.4	-2.3	-1.8	-1.8
3. Stock-flow adjustment	1.6	1.8	2.6	2.0	0.7	0.7	1.7

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 autumn forecast (COM); Convergence Programme (CP), Comission calculations.

4. COMPLIANCE WITH THE COUNCIL RECOMMENDATION OF 14 JUNE 2019

On 14 June 2019, 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 and 4.7% in 2020, corresponding to an annual structural adjustment of 1% of GDP in 2019 and 0.75% of GDP in 2020. The recommended effort for 2020 was deemed appropriate, contingent on compliance with the requested adjustment in 2019.

In 2019, based on the Commission 2019 autumn forecast, both pillars point to a risk of a deviation from those requirements. The nominal growth rate of net primary government expenditure is projected to be well above the recommended reference rate in 2019 (deviation of 1.3% of GDP). The structural balance is estimated to improve by 0.5% of GDP, to -3.3% of GDP, falling short of the recommended adjustment (deviation of 0.5% of GDP). The expenditure benchmark is negatively impacted by the use of a lower GDP deflator underlying that indicator compared to current estimates. Also the smoothing of nationally financed investment impacts marginally and negatively the reading of the expenditure benchmark. The structural balance, in turn, is positively impacted by the higher potential growth estimate underlying that indicator but negatively impacted by revenue shortfalls. Taking into account these factors, the overall assessment confirms that both indicators point to a risk of a deviation in 2019 from the requirements of the Council Recommendation of 14 June 2019.

In 2020, based on the Commission 2019 autumn forecast, the nominal growth rate of net primary government expenditure is expected to exceed the applicable expenditure benchmark of 4.7%, leading to a deviation of 1% of GDP from the requirement set in the Council Recommendation for 2020. On the contrary, the structural balance is expected to improve by 1.2% of GDP, reaching a deficit of 2.1% of GDP. This improvement is above the effort of 0.75% of GDP recommended by the Council by 0.4% of GDP (Table 6). Therefore, the expenditure benchmark points to a risk of a deviation from the required adjustment while the structural balance points to compliance, with a relatively large discrepancy. Public investment has been steadily increasing in recent years to reach a level of 6.4% of GDP in 2019, by far the highest in the EU. In this context, the planned reduction in 2020 is seen as a longer lasting normalization of the public investment rate. While the reduction in investment is fully reflected in the change of the structural balance, the smoothened profile of investment in the expenditure benchmark results in an overly negative indication of the fiscal effort given by the expenditure benchmark. The expenditure benchmark is also negatively impacted by the use of a lower GDP deflator compared to current estimates. When taking into account these factors, the expenditure benchmark would point to compliance with the requirement. At the same time, the structural balance is positively influenced by a higher point estimate of potential GDP growth (3.9%) underlying its calculation compared to the medium-term average (3.0%) underlying the expenditure benchmark. Taking into account these considerations, the overall assessment concludes that Hungary would deliver the recommended adjustment in 2020.

Table 6: Compliance with the Medium-Term Budgetary Objective or the required adjustment towards it

(% of GDP)	2018	2019	2020
Background budgetary indicators[1]			
Medium-term objective (MTO)	-1.5	-1.5	-1.0
Structural balance[2] (COM)	-3.8	-3.3	-2.1
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
Corresponding expenditure benchmark[5]	2.8	3.3	4.7
Compliance with the required adjustment to the MTO			
Structural balance pillar			
Change in structural balance[6]	-0.3	0.5	1.2
One-year deviation from the required adjustment[7]	-1.3	-0.5	0.4
Two-year average deviation from the required adjustment[7]	-1.3		
Expenditure benchmark pillar			
Net public expenditure annual growth corrected for one-offs[8]	6.3	6.8	7.5
One-year deviation adjusted for one-offs[9]	-1.3	-1.3	-1.0
Two-year deviation adjusted for one-offs[9]	-1.9		
Finding of the overall assessment	**Significant deviation**	**Deviation**	**Compliance**

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] Reference rate for the growth of net government expenditure. It is expressed in real terms until 2017 and in nominal terms from 2018 onwards.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2018) is carried out on the basis of Commission 2019 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Net public expenditure annual growth (in %) corrected for discretionary revenue measures, revenue measures mandated by law and one-offs (nominal)

[9] 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 *:*

Commission 2019 autumn forecast; Commission calculations.

5. PROPOSED ADJUSTMENT PATH TO THE MEDIUM-TERM BUDGETARY OBJECTIVE AND REQUIRED FISCAL EFFORT

Based on the Commission 2019 autumn forecast, Hungary's structural balance is estimated to improve from -3.8% of GDP in 2018 to -3.3% of GDP in 2019 and -2.1% in 2020, approaching albeit still far away from its medium-term budgetary objective. Hungary is projected to remain in good economic times, as its projected output gap of +2.5% in 2020 well exceeds +1.5% of potential GDP. In addition, in 2020, real GDP growth (at 2.8%) is forecast to be lower than the growth potential (at 3.9%). 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[5] of requirements, which factors in the prevailing economic circumstances and sustainability concerns, amounts to 0.75% of GDP in 2020. That fiscal effort seems appropriate, in light of the overall macro-fiscal developments against the backdrop of the expected deceleration of economic activity in the next years as cyclical factors, which have been supporting growth in recent years, are expected to gradually wear off.

The Commission 2019 autumn forecast expects Hungary's structural deficit to improve by 1.2% of GDP in 2020, while the expenditure benchmark points to a deviation from the requirement. Taking into account the factors influencing both the structural balance and the expenditure benchmark, a structural improvement of 0.75% of GDP in 2020 does not translate into the need to adopt additional structural measures in 2020 compared to the current baseline in the Commission 2019 autumn forecast. Based on current projections, the budget for 2020 adopted by the Hungarian government is expected to deliver the required effort.

Based on the Commission forecast, the above-mentioned 0.75% of GDP structural adjustment in 2020 is consistent with a nominal growth rate of net primary government expenditure of 4.7% of GDP.

6. CONCLUSION

On 14 June 2019, 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 and 4.7% in 2020, corresponding to an annual structural adjustment of 1% of GDP in 2019 and 0.75% of GDP in 2020.

In the report on action taken in response to the recommendation, the authorities retain their initial general government deficit target of 1.8% of GDP for 2019. At the same time, for 2020 the authorities plan to reach a deficit, of 1% of GDP, which is lower compared to the target of 1.5% of GDP set in the 2019 Convergence Programme.

The Commission 2019 autumn forecast projects a general government deficit for 2019 and 2020 in line with the authorities' current target. This implies an improvement of both the headline and structural balance in both years. However, while in 2019, based on the Commission 2019 autumn forecast, both the expenditure benchmark and the structural balance pillars point to a deviation from the fiscal effort recommended by the Council, for 2020, the overall assessment concludes that Hungary would deliver the recommended adjustment. Overall, Hungary has not delivered the recommended improvement in the structural balance, nor has it contained net primary government expenditure as requested by the Council in June.

In light of an insufficient response to the Council Recommendation of 14 June 2019 overall, it is appropriate to address to Hungary a revised recommendation. A revised recommendation to improve Hungary's structural balance by 0.75% of GDP in 2020 relative to 2019 would put Hungary on an appropriate adjustment path towards the medium-term budgetary objective . Such an improvement is consistent with a nominal growth rate of net primary government expenditure not exceeding 4.7% of GDP in 2020.

[5] "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