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Analysis by the Commission services of the budgetary situation in Hungary following the adoption of the Council Decision of 24 January 2012 under the Excessive Procedure for Hungary

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in Hungary

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1. INTRODUCTION

On 5 July 2004, the Council decided that Hungary had an excessive budget deficit and issued a recommendation under Article 104(7) of the Treaty establishing the European Community (TEC) setting a 2008 deadline for correction[1]. After the Council had decided twice, in January and November 2005, in accordance with Article 104(8) TEC, that Hungary had not taken effective action in response to its recommendations, it issued a third Article 104(7) recommendation to Hungary in October 2006, postponing the deadline to 2009. In July 2009, against the background of a severe economic downturn which triggered fiscal adjustment measures and the provision of EU/IMF balance of payments support, the Council concluded that Hungary had taken effective action and issued a revised recommendation under Article 104(7) TEC, setting 2011 as the new deadline to correct the excessive deficit.

In its 27 January 2010 Communication to the Council, the Commission concluded that Hungary had taken effective action in response to the latest Council recommendations, with which the Council concurred in its conclusions on 16 February 2010, notably since the deficit outcome for 2009 was expected to be very close to the target but "alerted about considerable risks attached to the 2010 deficit target, both on the revenue and the expenditure side". The Council, in its 12 July 2011 Opinion on the 2011 update of the convergence programme of Hungary, recommended that Hungary "strengthen the fiscal effort in order to comply with the Council recommendation to correct the excessive deficit in a sustainable manner […] and ensure that the budget deficit is kept safely below the 3% of GDP threshold in 2012 and beyond".

On 24 January 2012, the Council adopted a decision under Article 126(8) of the Treaty establishing that Hungary had not taken effective action in response to the Council recommendation of July 2009. The Council noted that while Hungary formally respected the 3% of GDP reference value by 2011, this was not based on a structural and sustainable correction. The budget surplus in 2011 hinged upon substantial one-off revenues of close to 10% of GDP and was accompanied by a cumulative structural deterioration of over 2% of GDP in 2010 and 2011 compared to a recommended cumulative fiscal improvement of 0.5% of GDP. Moreover, while the authorities adopted and implemented substantial structural measures, the 2012 budget deficit was foreseen not to exceed the 3% of GDP reference value again only thanks to net one-off revenues of around 0.7% of GDP. In fact, the non-durable nature of the correction was evidenced by the fact that in 2013 the headline deficit (estimated at 3¼% of GDP at the time) was expected to breach the reference value of the Treaty once more even after taking into account additional measures announced since the Commission 2011 Autumn Forecast.

On 13 March 2012, the Council adopted a new recommendation in accordance with Article 126(7) of the TFEU for Hungary to bring the excessive deficit to an end by 2012. The Hungarian authorities were asked to undertake the following steps in particular: (i) put an end to the excessive deficit situation by 2012 in a credible and sustainable manner; (ii) undertake an additional fiscal effort of at least ½% of GDP to ensure the attainment of the 2012 deficit target of 2.5% of GDP; (iii) take necessary additional measures of a structural nature to ensure that the deficit in 2013 remains well below the 3% of GDP threshold. At the same time, the government debt ratio was recommended to be brought back on a declining path as soon as possible so that it represents sufficient progress towards compliance with the debt reduction benchmark. The budgetary adjustment also needed to be supported by the proposed

[1] All documents related to the excessive deficit procedure of Hungary can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/hungary_en.htm

improvements in the fiscal governance framework. The Council established the deadline of 13 September 2012 for the Hungarian government to take effective action. Also on the day of adoption of this Council recommendation, the Council decided to suspend a part of the Cohesion Fund commitment appropriations for the year 2013 for Hungary (in line with Article 4 of Council Regulation (EC) No 1084/2006).

On 30 May, based on the 2012 convergence programme and further specification of the savings measures, the Commission concluded in a Communication that Hungary had taken effective action regarding the correction of the excessive deficit. In particular, the budget deficit was expected to reach 2.5% of GDP in 2012 and remained well below the 3% of GDP Treaty reference value in 2013 as recommended by the Council in March. Moreover, in the Communication it was acknowledged that some progress had been made on enhancing the fiscal governance framework even though in this area overall progress could be considered slow.

Against this background, the Commission adopted on 30 May a proposal for lifting the suspension of the Cohesion Fund commitment appropriations. On 22 June, 2012 the Council concurred with this assessment and adopted a decision lifting the suspension of the Cohesion Fund commitment appropriations.

This document examines the macroeconomic and budgetary outlook for Hungary to set the stage for a Commission recommendation for a Council decision abrogating decision 2004/918/EC on the existence of an excessive deficit in Hungary. In particular, it examines the macroeconomic and budgetary developments since the Commission Communication of 30 May 2012 to the Council on action taken. The assessment takes notably into account the macroeconomic and fiscal impact of corrective measures adopted on 13 May 2013, following the release of the Commission 2013 Spring Forecast.

2. Recent macro-economic and budgetary developments and outlook for 2013 and 2014

2.1. Macroeconomic developments and outlook

In 2012, the Hungarian economy entered into recession with GDP contracting by 1.7%, as against the assumed slight growth underlying the adopted 2012 budget and the stagnation, which was expected in the Commission interim forecast of February 2012. After a short recovery in 2010 and 2011, domestic demand fell by 3.7%. Investment continued to contract for the fourth consecutive year, against the background of tight lending conditions, increased economic uncertainty and the deleveraging of domestic sectors. Falling disposable income and high unemployment contributed to a renewed decline in consumption. Exports cushioned the fall in GDP but their pace declined sharply on account of a deteriorating external environment. An unusually weak performance in the agricultural sector as a consequence of a drought also contributed to the recession.

For 2013, GDP growth is expected to increase slightly in the Commission 2013 Spring Forecast. Export markets are set to improve and a stabilisation of domestic demand is assumed on account of an increase in households' real disposable income, although the high unemployment rate and repayment burden still keep household spending very contained. Private investment is set to remain negative in view of the continued fall in corporate lending and high surtaxes on some capital-intensive sectors. This tendency can be somewhat counteracted by the central bank's new "Funding for Growth" scheme and the government-sponsored lending measures. In addition, public investment is foreseen to expand in view of higher inflow of EU funds.

In the Commission 2013 Spring Forecast, growth is expected to accelerate and reach 1.4% in 2014. This is explained by an increased contribution from net exports but also from some expansion in domestic demand. Household consumption is projected to increase on account of a further increase in real disposable income. Investment growth could also enter into a positive territory mostly on account of government-sponsored lending. However, in general, lending conditions are expected to remain tight and the low growth prospects keep investment demand contained.

After the adoption of new corrective measures on 13 May to bring the deficit below 3% of GDP, the growth outlook remains broadly unchanged. Although the incoming Q1 2013 data increases upside risks to the Commission 2013 Spring Forecast in the short term, corrective measures point to the opposite direction, most notably in 2014. Overall, Hungary's economic growth potential is very weak and the outlook has been even revised somewhat downwards compared to the time of the previous recommendation. At the same time, the output gap is hugely negative (currently around -4% of GDP) and is expected to improve only moderately throughout the forecast horizon, i.e. until 2014.

Despite a recession, employment increased by 1.7% in 2012, above expectations. Employment gains partly reflected an extension of the Public Works Scheme but also increased employment in small enterprises. However, employment of larger companies has been declining since early 2012. Increasing unit labour costs and weak demand have been forcing them to adjust through layoffs to maintain their profitability. In spite of increasing employment, unemployment did not decrease from its 2011 level of around 11% due to a continuous increase in participation, which mainly reflects several government measures (e.g. extension of the Public Works Scheme, increase of the retirement age). In 2013, employment is forecast to remain broadly stable. From 2014, with the rebound in economic growth, employment might start to increase again. However, as the participation rate is projected to grow further, a slight increase in unemployment is expected.

While the inflation outturn for 2012 was higher than previously forecast, a stronger-than-expected drop occurred in Q1 2013. In addition to the lower overall effect of indirect tax hikes compared to 2012, this drop is also due to the cut in regulated energy and other utility prices introduced as of January 2013. Furthermore, core inflation and unprocessed food prices were lower than previously projected. Price increases are expected to remain contained throughout the forecast horizon due to a highly negative output gap.

Table 1: Comparison of key macroeconomic projections

		2011	2012	2013	2014
Real GDP	CP 2012	**1.7**	**0.1**	**1.6**	**2.5**
	COM EDP March 2012	**1.7**	**-0.1**	**1.6**	**n.a.**
	CP 2013	**1.6**	**-1.7**	**0.7**	**1.9**
	COM SF 2013	**1.6**	**-1.7**	**0.2**	**1.4**
HICP inflation	CP 2012[1]	**3.9**	**5.2**	**4.2**	**3.0**
	COM EDP March 2012	**3.9**	**5.1**	**4.1**	**n.a.**
	CP 2013[1]	**3.9**	**5.7**	**3.1**	**3.2**
	COM SF 2013	**3.9**	**5.7**	**2.7**	**3.0**
Employment	CP 2012	**0.8**	**1.2**	**2.2**	**3.0**
	COM AF 2011	**0.5**	**1.1**	**0.0**	**n.a.**
	CP 2013	**n.a.**	**1.7**	**0.5**	**0.8**
	COM SF 2013	**0.8**	**1.7**	**0.1**	**0.4**
Current account balance	CP 2012	**1.4**	**3.3**	**4.1**	**4.0**
	COM AF 2011	**1.7**	**3.2**	**3.8**	**n.a.**
	CP 2013	**1.0**	**1.6**	**3.2**	**3.6**
	COM SF 2013	**1.0**	**1.9**	**2.5**	**2.6**
Potential output	CP 2012	**0.3**	**0.8**	**1.4**	**1.6**
	COM AF 2011	**0.0**	**0.1**	**0.3**	**n.a.**
	CP 2013	**0.0**	**0.3**	**0.9**	**1.1**
	COM SF 2013	**0.1**	**0.1**	**0.2**	**0.5**
Output gap	CP 2012	**-2.6**	**-3.2**	**-3.0**	**-2.1**
	COM AF 2011	**-2.5**	**-2.2**	**-1.1**	**n.a.**
	CP 2013	**-1.7**	**-3.6**	**-3.7**	**-2.9**
	COM SF 2013	**-2.2**	**-3.9**	**-3.9**	**-3.1**

Notes:

[1] National Consumer Price Index (CPI)

Source: *Commission 2011 Autumn Forecast (COM AF 2011); Commission March 2012 EDP SWD (COM EDP March 2012); Commission 2013 Spring Forecast (COM SF 2013); 2012 convergence programme for Hungary (CP 2012); 2013 convergence programme for Hungary (CP 2013).*

2.2. Fiscal developments and outlook

2.2.1. Budgetary developments in 2012

In 2012, on the basis of fiscal efforts amounting to around 3% of GDP, the general government deficit reached 1.9% of GDP. This was in part thanks to one-off revenues of ¾% of GDP, including the higher than budgeted one-off revenues of 0.2% of GDP related to further transfer of assets from the private to the public pension pillar.[2] The adopted 2012 budget, which targeted a deficit of 2.5% of GDP on the basis of a 0.5% growth assumption, contained an extraordinary reserve of 1.1% of GDP and numerous consolidation measures, notably: (i) revenue-increasing measures of around 1¾% of GDP, including hikes by 2 pps in the standard VAT rate and in excise duties, increases in social security contributions, as well as reform of the personal income tax scheme, (ii) structural measures on the expenditure side of ¾% of GDP (in line with the Széll Kálmán Plan announced in March 2011), in particular, cuts in unemployment benefits and pharmaceutical subsidies, review of pensions and other social benefits, (iii) expenditure constraints of ¼% of GDP in the public sector, achieved mainly through a nominal wage freeze in most sectors and the limited increase in the purchase of goods and services at the line ministries.

Faced with a constantly deteriorating macroeconomic outlook throughout 2012, the government adopted additional corrective measures of around 0.7% of GDP, of which around half was eventually implemented. First, new saving measures of 0.3% of GDP (consisting of a reduction in the appropriations of the line ministries and the introduction of a permanent extraordinary tax on the telecommunication services) were incorporated in the 2012 convergence programme. Second, further, partly temporary expenditure cuts and other saving measures of 0.4% of GDP were announced in the context of the October 2012 EDP Progress Report. At the same time, the official deficit target for 2012 was revised upwards from 2.5% of GDP to 2.7% of GDP. Altogether, effectively implemented budgeted and additional corrective measures adopted by the central government amounted to around 3% of GDP in 2012.

In 2012, the balance of the local government sector, after filtering out the impacts of debt assumptions by the central government, improved by around 0.7% of GDP compared to the budgeted plans and also by around 0.4% of GDP compared to the previous year, mainly due to their low investment activity. Local public investment declined by over ½% of GDP last year compared to 2011 as capital formation financed exclusively from domestic sources shrank dramatically. This is likely to reflect the new legislations aiming at limiting the debt accumulation of the local government sector and the centralisation of selected institutions (mainly in the education and health care sector), which could have discouraged municipalities to undertake investments in these areas.

Overall, the deficit target for 2012 was overachieved thanks to corrective measures adopted by the central government and to the better than expected local government sector's balance. In addition, the full activation of the budgeted extraordinary reserves counterbalanced the budgetary slippages, partly related to the worse than earlier expected macroeconomic environment.

[2] One-off revenues in 2012 included selected extraordinary sector taxes, take-over of further private pension assets and sale of telecommunication licences, which were partly counterbalanced by tax rebates after the extraordinary levy on selected financial institutions.

2.2.2. Budgetary developments in 2013

The 2013 budget was adopted on 11 December 2012 and targeted a deficit of 2.7% of GDP, in line with the revised fiscal path presented in the October 2012 EDP Progress Report. The budget included a 1.3% of GDP extraordinary reserve to be activated in case of emerging budgetary slippages. The 2013 convergence programme confirmed the official target, while it acknowledged that more than 0.7% of GDP of the buffer was not available anymore in light of the slippages in net terms in the first quarter of 2013, mainly related to the lower than budgeted revenues from VAT and the financial transaction duty.

The Commission 2013 Spring Forecast projects a deficit of 3% of GDP in 2013. The 1.1 pps increase in the deficit compared to 2012 can be mainly attributed to an increase in expenditures, with the expenditure ratio increasing from 48.4% to 49.6% of GDP. This would mainly reflect higher investments partly in view of the increasing absorption of the EU funds. Consolidation measures on the expenditure side, such as the further impact of the review of selected social benefits started in 2011 and the freeze of the public wages in general, are expected to be broadly offset by deficit-increasing measures, for instance by the extension of the Public Works Scheme and the increase in the expenditures of the budgetary institutions.

The Commission 2013 Spring Forecast projects the revenue ratio to slightly exceed its 2012 level, at 46.6% of GDP. Overall, revenue-decreasing and increasing elements would almost counterbalance each other. The revenue-decreasing elements include the phasing-out of one-off revenues of ¾% of GDP and stimulus measures of close to 1% of GDP, i.e. the introduction of a fully flat personal income tax system as well as targeted cuts of social contributions combined with new preferential corporate taxes for SMEs. This would be partly offset by revenue-increasing corrective measures of 1½% of GDP announced (i) in the context of the 2011 and 2012 convergence programmes, e.g. the introduction of the distance-based road toll system and the financial transaction duty, as well as (ii) in three successive packages during autumn 2012, such as higher taxes on energy and utility service providers. In addition, the increasing absorption of the EU funds is expected to increase the revenues by close to ½% of GDP.

Compared to the 2013 convergence programme, the Commission 2013 Spring Forecast factors in an overall budgetary slippage of 0.9% of GDP. This consists of lower revenues of 0.6% of GDP, mainly related to the VAT in light of the assumed lower impact of measures aiming at enhancing tax administration, the financial transaction duty, the gambling tax and the distance-based road toll system. It also includes foreseen slippages of 0.3% of GDP on the expenditure side, mainly pertaining to the transport sector. The projected revenue shortfalls and expenditure overruns would be only partly offset by the assumed activation of the remaining extraordinary reserves of 0.6% of GDP.

After the adoption and publication of the Commission 2013 Spring Forecast, on 13 May 2013, the Hungarian government adopted further corrective measures of more than 0.3% of GDP in 2013 in gross terms, aiming at bringing the deficit well below 3% of GDP. Notably, the new fiscal package includes a temporary cut of the expenditures of selected budgetary institutions, which would become permanent unless favourable budgetary developments ensure fiscal space. The net deficit-improving effect of these savings measures is estimated by the Commission to be close to 0.25% of GDP, taking into account their direct revenue impact and the second-round effects. This means that the full activation of the remaining extraordinary reserves, which increased to around 0.9% in light of the recently adopted corrective measures, could entirely counterbalance the budgetary slippages foreseen by the Commission in its 2013

Spring Forecast. Consequently, taking into account the new consolidation measures, the general government deficit is expected to stand at 2.7% of GDP in 2013, i.e. below the Treaty reference value of 3% of GDP and in line with the government's deficit target of 2.7% of GDP.

2.2.3. Budgetary developments in 2014

The 2013 convergence programme has revised upwards the deficit target for 2014 from 2.2% to 2.7% of GDP, which is identical to the 2013 deficit target. By contrast, the Commission 2013 Spring Forecast, based on the usual no-policy-change assumption, projects the 2014 deficit to increase to 3.3% from 3.0% of GDP in 2013. This would be mainly due to a further increase in the expenditure ratio from 49.6% to 50.3% of GDP, partly on account of the launch of a new wage compensation system in the public education sector. In addition, the public investment ratio is assumed to increase in line with the growing absorption of the EU funds. The rise of other expenditures altogether, however, is projected to lag behind the nominal economic growth due to fiscal discipline reinforced in the 2013 convergence programme (e.g. nominal freeze of the public wages as a general rule, moderate increase of the social transfers) and to the further impact of earlier launched structural reforms. Compared to the previous year, the slight increase of the revenue ratio in 2014, as projected by the Commission, mainly reflects the expected increase of the absorption of EU funds and the full year effect of the introduction of the distance-based road toll system in the middle of 2013. The tax-to-GDP ratio is expected to remain at its 2013 level, also in light of the expected increasing impact of the enhancement of the tax administration.

For 2014, compared to the 2013 convergence programme, the Commission 2013 Spring Forecast includes lower revenues of 0.6% of GDP. The latter are mainly related to the measures that also explain the different forecasts for 2013, i.e. VAT, the financial transaction duty, the gambling tax and the distance-based road toll system. On the expenditure side, the foreseen slippages of close to 0.5% of GDP, partly related to the application of the no-policy-change assumption (i.e. most expenditure items are forecast to increase with the nominal potential growth rate barring the adoption of credible well-specified measures), are expected to be offset by the assumed activation of the planned extraordinary reserves of 0.5% of GDP.

The corrective measures adopted by the Hungarian government on 13 May 2013, i.e. following the publication of the Commission 2013 Spring Forecast, aim at bringing the deficit well below 3% of GDP also in 2014. These measures, amounting to around 0.7% of GDP in gross terms, include: (i) the incorporation of the 2013 cut of the expenditures of selected budgetary institutions into the 2014 budget, (ii) a nominal freeze of selected expenditures of the budgetary institutions in the central budgetary sub-sector at their 2013 level, (iii) a nominal freeze of selected social cash allowances from 2013 to 2014, and (iv) the suspension of selected public investment projects unless they can be financed from the sale of non-financial state assets.

According to the Commission, the net budgetary impact of these measures could be estimated at around 0.45% of GDP, which would result in a deficit forecast of 2.9% of GDP in 2014. This assessment takes into account (i) all information publicly announced, notably the government decree of 1259/2013, published on 13 May 2013, (ii) implementation risks, (iii) the direct revenue impact, as well as (iv) the second-round effects of the measures. In particular, this assessment assumes only a partial implementation of the nominal freeze of selected expenditures of the budgetary institutions and of the suspension of certain public investment projects.

Table 2: Calculations of the budgetary impact of measures adopted on 13 May 2013 (% of GDP)[1]

	2013	2014
1a: Expenditure cuts of selected budgetary institutions		
Gross effect, estimated by the national authorities	0.32	0.31
Gross effect, estimated by the Commission	0.32	0.31
Direct impact on the tax revenues	0.08	0.08
Net effect	0.24	0.23
1b: Nominal freeze of selected expenditures in the central budgetary sub-sector		
Gross effect, estimated by the national authorities		0.16
Gross effect, estimated by the Commission		0.08
Direct impact on the tax revenues		0.02
Net effect		0.06
1.c Nominal freeze of selected cash transfers to households		
Gross effect, estimated by the national authorities		0.07
Gross effect, estimated by the Commission		0.07
Direct impact on the tax revenues		0.00
Net effect		0.07
2. Cut of selected public investments		
Gross effect, estimated by the national authorities		0.20
Gross effect, estimated by the Commission		0.13
Direct impact on the tax revenues		0.01
Net effect		0.12
Second-round effects of measures 1a-c and 2	-0.01	-0.04
Total gross fiscal impact	**0.32**	**0.74**
Total net fiscal impact, including implementation risks, direct impact on tax revenues and second-round effects	**0.23**	**0.44**

[1]Positive numbers indicate an improvement in the deficit.

The structural general government balance, following a cumulative deterioration of close to 2% of GDP in 2010 and 2011, improved by 3½% of GDP in 2012. According to the Commission 2013 Spring Forecast, the general government structural balance is expected to deteriorate to -1% and -1¾% of GDP in 2013 and 2014, respectively. Taking into account the impact of the additional corrective measures adopted on 13 May 2013, the structural balance is foreseen to stand at -¾% and -1½% of GDP this year and next, respectively, i.e. in line with the revised medium-term objective of -1.7% of GDP.

2.2.4. Public debt developments

Regarding debt developments, the debt-to-GDP ratio decreased from a peak of 82% in 2010 to 79.2% in 2012, thanks to substantial one-off capital transfers linked to the abolition of the mandatory private pension pillar and a number of consolidation measures, which were partly offset by the revaluation of the foreign exchange denominated part of the public debt by a weaker forint. According to the 2013 convergence programme, the debt-to-GDP ratio will continue to decline, falling to 78.1% and 77.2% in 2013 and 2014, respectively, and remaining on a downward path thereafter. In 2013 and 2014, based on the deficit outlook contained in the Commission 2013 Spring Forecast and assuming the gradual sale of the remaining transferred pension assets, it is forecast to stabilise at around 79%. Taking into account the impact of the new corrective measures, the debt ratio is estimated to decrease to 79.4% and 78.4% in 2013 and 2014, respectively.

2.2.5. Fiscal governance

As to fiscal governance, the Council asked the Hungarian authorities to adapt the law on economic stability, in particular by establishing a truly binding medium-term framework (MTBF) and broadening the analytical remit of the Fiscal Council in view of its unprecedented (in the EU and OECD) veto right over the annual budget. In the area of fiscal rules, there has been no policy response so far, thus the MTBF remains purely indicative. Significant improvements were reported to be planned in this area in the framework of the transposition of the Directive of the minimum requirements for national budgetary frameworks.[3] Notably, a structural balance rule is being considered, possibly as part of a more binding MTBF. Although the 2013 convergence programme does not confirm these specific reform avenues, it announces that the related legislative amendments are to be submitted to Parliament before the autumn session.

On the institutional side, the September 2012 amendments reinforced the Fiscal Council both in terms of optional tasks and resources. More specifically, a small analytical team is being set up within the Office of the Parliament and informal expert networks are being established. However, further improvements are still needed, as the credibility of fiscal policy would benefit from assigning the systematic ex-post monitoring of compliance with numerical fiscal rules to an independent body and ensuring that the workings of this body would be based on thorough quantitative analysis (also through the mandatory preparation of macro-fiscal baseline projections and assessments of major fiscal policy proposals).

[3] See the information provided in October 2012 for the Commission's Interim Progress Report on the transposition of the budgetary frameworks Directive. The document is available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SWD:2012:0433:FIN:EN:PDF .

3. CONCLUSION

After a fiscal loosening in 2010 and 2011, considerable consolidation efforts were achieved in 2012, bringing the general government deficit down to 1.9% of GDP, well below the Treaty reference value and below the target of 2.5% recommended by the Council on 13 March 2012.

Based on information available until the cut-off date, the Commission 2013 Spring Forecast projects a deficit of 3.0% and 3.3% of GDP in 2013 and 2014, respectively. According to the Commission's updated assessment, taking into account the additional savings measures adopted on 13 May 2013, the deficit is expected to stand at 2.7% and 2.9% of GDP in 2013 and 2014, respectively, i.e. below the Treaty reference value throughout the forecast horizon.