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COVER NOTE

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| From: | Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director |
| date of receipt: | 28 May 2018 |
| To: | Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union |

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| No. Cion doc.: | C(2018) 3183 final |
| Subject: | COMMISSION RECOMMENDATION of 23.5.2018 with a view to giving warning on the existence of a significant observed deviation from the adjustment path toward the medium-term budgetary objective to Hungary |

Delegations will find attached document C(2018) 3183 final.

Encl.: C(2018) 3183 final



Brussels, 23.5.2018
C(2018) 3183 final

COMMISSION RECOMMENDATION

of 23.5.2018

**with a view to giving warning on the existence of a significant observed deviation from
the adjustment path toward the medium-term budgetary objective**

to Hungary

COMMISSION RECOMMENDATION

of 23.5.2018

with a view to giving warning on the existence of a significant observed deviation from the adjustment path toward the medium-term budgetary objective

to Hungary

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 121(4) thereof,

Having regard to Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies¹, and in particular Article 10(2), first sub-paragraph, thereof,

Whereas :

- (1) Article 121 of the Treaty on the Functioning of the European Union (TFEU) sets the framework of the preventive arm of the Stability and Growth Pact (SGP) whose objective is to promote sound public finances over the medium term through the coordination of economic policies and multilateral surveillance. The operation of the preventive arm is further specified in Regulation (EC) No 1466/97 and in the Code of Conduct of the SGP².
- (2) In order to ensure sustainable public finances and to avoid the occurrence of excessive budget deficits, Member States should achieve a country-specific medium-term budgetary objective for their budgetary position set in structural terms, and maintain it over the economic cycle. For Member States that are not at their medium-term budgetary objective, an appropriate adjustment path towards the medium-term budgetary objective is defined.
- (3) Within the framework of the European Semester, the Council annually addresses guidance to the Member States making full use of the legal instruments provided under Articles 121 and 148 TFEU, and under Regulations (EC) No 1466/97 and (EU) No 1176/2011³.
- (4) Based on Article 10 of Regulation (EC) No 1466/97, the Commission conducts an ex-post assessment of progress towards the medium-term budgetary objective for the previous year by comparing fiscal outturn data with the required pace of adjustment towards the medium-term budgetary objective with a view to identifying actual significant divergences of the budgetary position from the medium-term budgetary objective, or from the appropriate adjustment path towards it as recommended by the Council.

¹ OJ L 209, 2.8.1997, p. 1.

² "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes", 5 July 2016, http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf

³ Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances (OJ L 306, 23.11.2011, p. 25).

- (5) Based on Article 10 of Regulation (EC) No 1466/97, the Commission evaluates progress towards the medium-term budgetary objective on the basis of an overall assessment with the expenditure, net of discretionary revenue measures and one-offs as the reference, including an analysis of the structural balance.
- (6) The overall assessment of whether a deviation from the medium-term budgetary objective or the adjustment path towards it is significant includes, in particular, whether a deviation in expenditure developments, net of discretionary revenue measures and one-offs, having a total impact on the government balance of at least 0.5% of GDP in a single year or cumulatively in two consecutive years or there is a deviation in the structural balance of at least 0.5% of GDP in a single year or at least 0.25% of GDP on average per year in two consecutive years.
- (7) In the case of a significant observed deviation from the adequate adjustment path towards the medium-term budgetary objective, the Commission is to address a warning to the Member State concerned in accordance with Article 121(4) TFEU.
- (8) On 12 July 2016, the Council recommended Hungary to achieve a fiscal adjustment of 0.6% of GDP in 2017 unless the medium-term objective was respected with a lower effort.
- (9) The 2018 Convergence Programme indicates that the budgetary impact of the security-related measures in 2017 is significant, and provides adequate evidence of the scope and nature of these additional budgetary costs. According to the Commission, the eligible additional expenditure for security-related measures in 2017 amounted to 0.17% of GDP. The provisions set out in Articles 9(1) and 10(3) of Regulation (EC) No 1466/97 cater for this additional expenditure, in that the severity of a terrorist threat is an unusual event, the impact of which on Hungary's public finances is significant, while sustainability should not be compromised by allowing for a temporary deviation from the adjustment path towards the medium-term objective. Therefore, the required adjustment towards the medium-term budgetary objective for 2017 has been reduced to take into account these additional costs. Adding also the three-year carry-forward of the allowance for refugee and security related costs granted in 2015 and 2016, implies that Hungary is eligible for a temporary deviation under the unusual event clause amounting to 0.25% of GDP from the required adjustment path in 2017.
- (10) Based on the matrix⁴ of requirements, and taking into account the distance from the medium-term objective in the initial position as well as the application of the unusual event clause, Hungary was required to maintain its structural deficit position in 2017 vis-a-vis 2016. This is equivalent to the requirement to ensure a growth of government expenditure, net of discretionary revenue measures and one-offs, not higher than 1.5% in real terms.
- (11) Based on the Commission 2018 spring forecast and the 2017 outturn data validated by Eurostat, the observed deviation from the required structural adjustment path in 2017 was above the threshold of significance of 0.5% of GDP according to both indicators.
- (12) An overall assessment is required in line with Article 10(3) of Regulation (EC) No 1466/97.. The growth of government expenditure, net of discretionary revenue measures and one-offs, was well above the applicable expenditure benchmark rate of

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>

1.5% in 2017, pointing to a significant deviation from the required structural adjustment (deviation of 2.4% of GDP). The structural balance deteriorated from a position of -1.8% of GDP in 2016 to -3.1% of GDP in 2017, also pointing to a significant deviation (deviation of 1.4% of GDP). The expenditure benchmark is negatively affected by three elements. First, the medium-term growth rate applied as a reference underlying the expenditure benchmark is negatively impacted by the low estimated potential growth rates in the aftermath of the crisis. Second, the expenditure benchmark is also negatively affected by the use of a too low GDP deflator compared to the one reflecting the actual cost pressures on government expenditure. Third, the expenditure benchmark appears to underestimate the fiscal effort because some of the revenue windfalls could be considered permanent. After taking into account these factors, the expenditure benchmark appears to adequately reflect the fiscal effort and still points to a significant deviation. This is confirmed by the assessment of the structural balance pillar, which after adjusting for the impacts of decreasing interest expenditure, investment volatility and a revenue windfall, filtering out the above mentioned permanent effect, still points to a significant deviation.

- (13) The overall assessment therefore leads to the conclusion that the observed deviation from the medium-term budgetary objective in 2017 is significant,

HAS ADOPTED THIS RECOMMENDATION:

The Commission hereby warns Hungary that a significant deviation from the medium-term budgetary objective was observed in 2017.

Done at Brussels, 23.5.2018

*For the Commission
Pierre MOSCOVICI
Member of the Commission*