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From:	Mr Mihály VARGA, Minister of Finance, Ministry of Finance
date of receipt:	16 October 2019
To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
Subject:	Hungary: Report on effective action taken by Hungary in response to the Council recommendation of 14 June 2019 under Article 121(4) TFEU, as laid down in Article 6(2) of Council Regulation (EC) 1466/97

Delegations will find attached the Report on effective action taken by Hungary in response to the Council recommendation of 14 June 2019 under Article 121(4) TFEU, in English.

GOVERNMENT OF HUNGARY

Report

on the Council Recommendations under the Significant Deviation Procedure

15 October 2019

Content

1. Introduction

On 5 June 2019, the European Commission found that in 2018 a significant observed deviation from the medium-term objective (MTO) existed in Hungary. With respect to the established deviation, the Council issued a Recommendation[1] on 14 June 2019. According to the Recommendation, measures setting Hungary on an appropriate adjustment path leading to achievement of the MTO need to be taken. In this context, any windfall gains must be used for reducing the deficit and the budgetary consolidation measures must secure a lasting improvement in the general government structural balance in a growth-friendly manner. Hungary must report by 15 October 2019 on action taken in response to the Recommendation.

According to the legal regulations relating to the significant deviation procedure (SDP) (Article 121(4) of the TFEU and Article 10(2) of Council Regulation (EC) 1466/97), Hungary submits the following Report to the Council and the Commission in response to the Council's recommendations within the foregoing deadline.

[1] Council Recommendation (14 June 2019) with a view to correcting the significant observed deviation from the adjustment path towards the medium-term budgetary objective in Hungary (OJ C 210, 21.6.2019, p. 4)

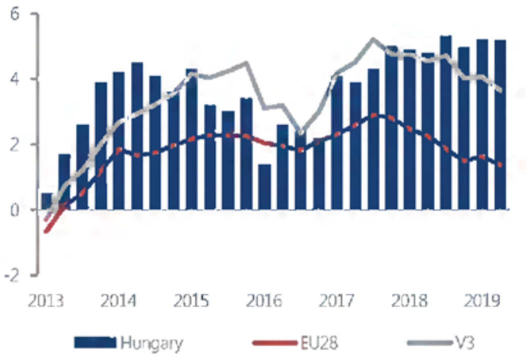
2. Macroeconomic processes

2.1 The components of growth

Since the growth turnaround in 2013, Hungary's GDP has been increasing dynamically. The economic growth has continued this year at a quick pace. In the first half of 2019 gross domestic product increased by 5.2% according to seasonally adjusted data. Recently, Hungary has displayed nearly four times as fast growth as the EU average, also exceeding the average of the Visegrad countries (*Chart 1*). As a result, the economy has continued to catch up with the EU average.

The growth path continues to be stable and sustainable. This is proven, on the one hand, by the growth taking place in a wide range of sectors, and on the other hand, by the favourable financing position, as a result of which the debt accrued earlier is continuously decreasing. The growth is becoming increasingly capital-intensive: in addition to employment dynamics, the growth of the economy is supported by the fast expansion of capital stock, also ensuring the improvement of productivity.

Chart 1: GDP growth in the EU
(seasonally and calendar adjusted, YoY, %)



Source: Eurostat, MoF calculation

On the expenditure side, the cumulative increase of consumption recorded in the past few years has exceeded the performance of both the EU and the other Visegrad countries. Consumption increased by 4.8% in the first half of the year *(Chart 2)*. All of this is supported by the dynamic increase of households' disposable income, thanks to continued employment growth and outstanding wage dynamics as a result of the wage and tax agreement concluded at the end of 2016, as well as of the moderate inflation environment. Furthermore, the elevated purchasing power of households is also backed by the funds that have been made available in the framework of the Family Protection Action Plan. The strong consumer confidence is also indicated by the fact that an increasing share of the growth in domestic consumption expenditure is related to the purchase of durable and semi-durable products.

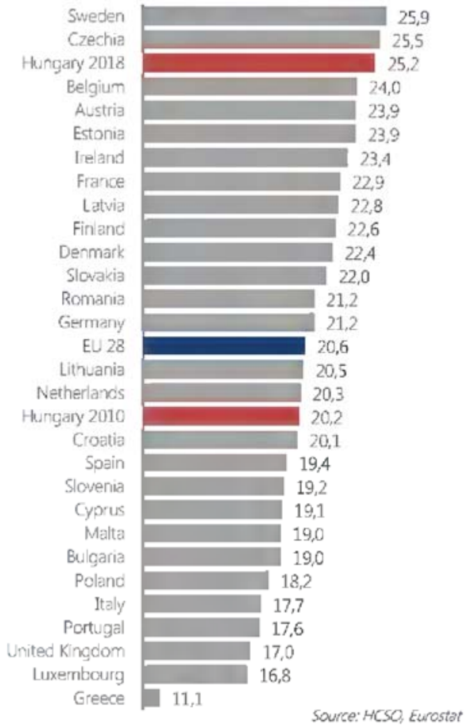
Chart 2: Households' consumption expenditure
(2013=100, volume growth, %)

Source: Eurostat, MoF calculation

Hungary's investment rate is in the top ranks of the European Union's Member States. Last year's buoyant investment growth of over 17% has also continued in the first half of 2019: as a result of this 20.6% increase in investments amounting to nearly HUF 5,700 billion were implemented *(Chart 3)*. The increase in investments can be considered balanced from several aspects: on the one hand, the performance of all three sectors contributed to the booming growth, while on the other hand, a double-digit dynamic was also registered with respect to both building and machinery-type developments (the latter directly increases production capacities). The increase in almost all branches of the national economy supports the favourable economic outlook, not just with respect to the current year but also in the medium term, as after production capacities are finished and production commences, these expansions will give a push to the growth processes once again.

Chart 3: Investment rates in 2018

(in % of GDP)



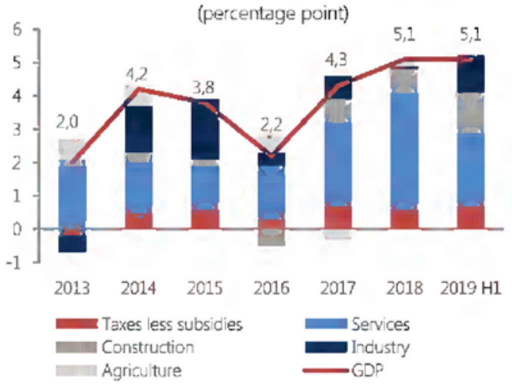
Source: HCSO, Eurostat

The developments of the competitive sector had a significant role in the dynamic growth experienced recently, as capacity expansions are strongly supported by the low corporate tax rate – reduced to 9% as of 2017, which is the lowest in the entire EU – that substantially reduces capital costs and at the same time intensifies Hungary's ability to attract capital. Also, the investment activity of households increased further as a result of the steadily low interest rate environment, the permanent improvement of the employment and income situation and the government subsidies provided in the form of the Family Housing Allowance ("CSOK"). This is underpinned by the fact that during the last year altogether 17.7 thousand dwellings were built in the country, which means a 23% increase as compared to the previous year. Additionally, the growth of public investments related to the 2014–2020 EU funds or realised from budgetary resources were also significant factors in growth, given that by the end of September 2019 HUF 6,400 billion had already been paid from the new EU financial frameworks available to Hungary. Nevertheless, by the end of the first half of 2019 only one-third of the available EUR 29.6 billion limit had been realised in the form of economic output.

Simultaneously with the favourable performance of industry and in spite of subdued external markets, the volume of the goods exported from Hungary increased by 5.5% in the first half of this year. The volume of the import of goods rose by 6.4% as a result of the strong domestic demand, and particularly in the investments. According to the external trade statistics, the main product group, machinery and transport equipment recorded a 4.8% increase in imports and 4.6% in exports in the first half of this year. Regarding to services, imports increased by 0.9%, while exports by 3.2%. The most significant contributors to growth in the case of exports were tourism and transportation services, whereas with respect to imports, the group of business services had the largest share in this growth in addition to tourism. As a result of the foregoing, contribution of net export to the GDP growth was slightly negative. Based on the data of the first half of the year, Hungary's external trade balance reached 5.1% of GDP. While the surplus decreased as compared to last year, its rate remains high in international comparison.

Chart 4: Growth contribution by branches

(percentage point)



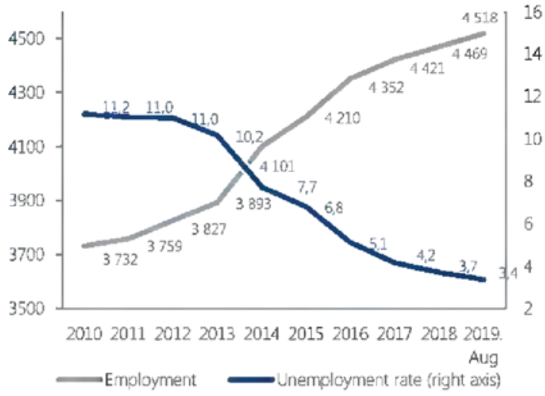
Source: HCSO, MoF calculation

As to production-side processes, with the significant growth of internal demand, the performance of sub-sectors classified as market services continued to improve *(Chart 4)*. In the first half of 2019, every service sub-sector showed growth. The most significant increase took place in trade and tourism activities (7.1%), professional, scientific activities (7.1%) and information and communication (6.2%). The rate of growth in industrial production was 5.0% with the largest, 4.5% rate of growth realised in the manufacturing industry. The construction industry also showed significant growth (34.4%), to which the use of Family Housing Allowance and EU funds also contributed substantially. Agricultural production decreased by 1.6% in the first half of 2019.

2.2 Labour market

The labour market reforms implemented since 2010 were successful in promoting the growth of employment and labour market participation. The favourable tendencies also continued this year: after the 1% growth registered in the first eight months of the year, the number of employed people reached 4,517,000 by the end of the period, which resulted mainly from the 1.8% (+77,300 persons) employment increase in the domestic primary labour market.

Chart 5: Employment and unemployment rate
(thousand people, % of population aged 15-74)



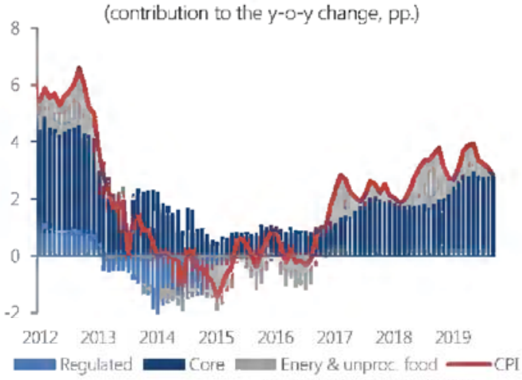
Source: HCSO

Thanks to the high labour demand of the private sector, more and more people in public employment managed to find a job. As a result, in the first seven months of the year their number decreased by 31,100 as compared to last year. The labour market participation increased by a further 0.7% (34,100 persons) in the first eight months. Simultaneously with the increase of employment in the private sector, the unemployment rate decreased to 3.4% by the end of August. The significant increase of wages reflects the supportive effect of the hike of the minimum wage and the guaranteed wage minimum concluded in the framework of the wage and tax agreement proposed by the Government and, at the same time, the substantial reduction of the social security tax. In the first seven months of 2019, in the private sector, gross average earnings increased by 11.4%, while net real earnings by 7.7%, as result of moderate inflation.

2.3 Inflation

Consumer prices increased by 2.8%. During the first months of 2019, the inflation rate was higher than in the previous years, which could be attributed to several, basically temporary effects. On the one hand, the increased rates of some indirect taxes (public health product tax, excise tax) appeared in prices while on the other hand food prices that are driven by international markets showed massive price increase over the year. Finally, in the case of services, pass through from the upswing of domestic demand also became stronger. In the first nine months of 2019 inflation was 3.3%. In recent months, however, inflation has decelerated partly due to base effect, and partly as a result of the slower rate of general price increase. In September, the consumer price index indicated an increase of 2.8%, which basically corresponds to the processes that can be observed in the region, and is essentially in line with the medium-term inflation target of the central bank (MNB) *(Chart 6)*.

Chart 6: Main factors affecting inflation
(contribution to the y-o-y change, pp.)



Source: HCSO, MoF calculations

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2.4 External balance

Following the record-high surplus achieved in 2016, the current account balance has narrowed gradually. In 2018, the current account balance already showed a slight deficit, but with respect to lending/borrowing vis-à-vis the rest of the world Hungary could still be characterised by considerable surplus. The first half of 2019 witnessed a change, i.e. the deterioration of the trade balance slowed, mostly due to higher export, and it is foreseen to become stabilised in the second half of the year. Hungary is still in a favourable position with respect to the external balance, in a regional comparison. In the past years, considerable financing capacity was coupled with the substantial reduction of external debt. Accordingly, Hungary's net debt decreased from the 54% registered at the end of 2010 to 9% of the GDP, which is the second lowest, after the Czech Republic, in the region.

3. Budgetary processes

3.1 The 2019 budget forecast

In 2019, the reduction of the GDP-proportionate budget deficit remains the Government's priority in fiscal policy alongside the moderation of public debt at least at a pace required by the domestic and EU fiscal rules, the realisation of balanced economic growth, the expansion of employment and improvement of competitiveness. The accomplishment of the set 1.8% deficit target is confirmed by the most recent forecasts which predict that the rate of economic growth will surpass the planned 4.1% level. In the first nine months of the year, the cash flow deficit arrived at 30.4% of the annually planned volume, which is a time-proportionate figure that is in line with the revenues and expenditures expected for the upcoming months.

The favourable developments in the labour market and the budgetary measures are expected to result in tax revenues exceeding the budget appropriation by approximately HUF 300 billion. In the first half of 2019, revenues from taxes and contributions increased significantly due to the higher-than-expected wage dynamics and more favourable employment data. In association with the Government's measures towards whitening the economy, accrual-based VAT revenues increased by 9.7%. Based on the data of the tax returns this was typical of most sectors, but was mainly connected to domestic sales, and within that in particular to trade, as well as the manufacturing industry. In comparison with the previous year, the upward trend in the revenues on tobacco products has been determined by a larger volume cigarette sales and the increased tax rate. Thanks to the increased turnover, excise duty revenue increased in relation to all three product groups, and the increase was highest for tobacco. Owing to the favourable macroeconomic tendencies, revenues from other taxes related to consumption (financial transaction duty, telecommunication services tax, public health product tax collected as proceeds for the Health Insurance Fund) have also increased as compared to the previous year.

Among expenditures, there are two determining factors that have brought about change in comparison to the Budget Act. On the one hand, the measures announced by the Government and designed to promote a demographic turnaround, the family protection action plan and the extended scope of Housing Subsidy Scheme generate approximately HUF 120 billion expenditures in excess of the plans. On the other hand, the balance of budgetary relations with the EU can potentially be around HUF 150 billion less favourable.

In spite of the more advantageous growth processes, keeping the deficit target unchanged is in part economically justified by the measures (e.g. broadening the scope of Housing Subsidy Scheme) that are designed to support long-term sustainability.

3.2 The 2020 budget forecast

The 2020 budget is aligned with the set of targets that have been followed by the Government so far. In order to achieve a balanced budget, the Government has determined the deficit target in conformance to the European Union's methodology at a much lower level than the 1.5% value indicated in the Convergence Programme, i.e. as 1% of the GDP. Even for 2021, the medium-term outlook of the budget anticipates 0.7% deficit, which is half a percentage point under the earlier level, and then for 2022 0.4% GDP-proportionate deficit is projected, leading to balanced, deficit-free public finances in 2023.

To meet the deficit target, as well as counteract and manage external risks, the budget is backed by much larger budgetary reserves than before, at a rate corresponding to 1% of the GDP. In accordance with the Budget Act, the major part of these reserves can be utilised on condition that the annual deficit target is expected to be met.

The Government has launched an economy protection action plan in order to sustain a level of economic growth 2% above the EU average in the long term, even with the given risks in international money markets and the real economy. The realisation of this objective is one of the key priorities of fiscal policy.

The components of the economy protection action plan are as follows:

- 2 percentage point reduction of the rate of the social contribution tax in order to moderate the tax burden of businesses and promote the catch-up of wages.
- 1 percentage point reduction of the rate of small business tax (kiva) to promote the competitiveness of small businesses.
- Reduction of the rate of the advertisement tax to 0%.
- Moderation of tax administration: phase-out of the simplified business tax (EVA), merging of certain taxes, contributions.
- Abolishment of the requirement to top up tax advances for corporate income tax, innovation contribution, income tax of energy suppliers.
- Extension of the scope of the subsidisation programme for the encouragement of the construction of workers' accommodation to include privately owned business entities.
- Broadening of the scope of development tax benefits, including the smaller investment projects of small and medium-sized enterprises (reaching a value limit of HUF 300–400 million) in order to encourage investments related to the improvement of productivity , as well as increasing the supports of research and development (R&D) and also support innovation.
- Capital increase at the credit guarantee institutions that support the provision of credits and loans to businesses.
- Provision of support for the encouragement of developments in agricultural areas.

The expenditures incurred with the programme will amount to 1% of the GDP in 2020. In the forthcoming years, these measures are expected to substantially further the sustenance of dynamic economic growth, and consequently the maintenance of tax revenues at higher levels.

Another priority of the 2020 budget is the facilitation of positive demographic processes, which reinforces the long-term sustainability of public finances. To this end, the Government is determined to give unprecedented support to the realisation of young people's plans in establishing families and having children with reliance – among others – on i) interest-free loans (Pre-natal Funding Scheme), ii) a broader scope of interest-subsidised housing loans, iii) reduction of the housing mortgage loan debts of families with several children, iv) Family Housing Subsidy Scheme to be introduced in the framework of the Hungarian Village Programme, v) subsidisation of the purchasing of passenger cars with sufficient seating capacity for large families. In addition to supporting plans to have children, as from 1 January 2020 the employment of women is facilitated by the allowance of mothers raising four or more children – granting a life-long personal income tax exemption, grandparents not yet of retirement age also become eligible for child care fee. Moreover, the nursery development programme is also set to be extended in order to increase the combined capacity of nurseries to 70,000 children by 2022.

With all these measures, the structural position of the budget will see gradual improvement. GDP-proportionate public debt is foreseen to continue to decrease at a larger rate than what is prescribed in the national and European Union debt reduction requirements.

Orientation of tax policy

The positive, revenue-increasing outcomes of efforts towards the whitening of the economy, as well as the growth of the economy in recent years have opened up the opportunity for the consistent reduction of taxes on labour and capital. The agreement concluded between the Government and the interest promotion organisations of employers and employees at the end of 2016 targeted the further substantial reduction of the employers' burdens and the tax wedge. Within the meaning of the agreement and in consideration of the budgetary elbow room, the social contribution tax rate was reduced by 5 percentage points in 2017, by 2.5 percentage points in 2018 and then by a further 2 percentage points in July 2019, while the minimum wage and the minimum guaranteed wage increased significantly. According to the agreement, the tax burdens of employers could decrease on further three times if the increase of real wages in the private sector reaches 6% per year. The next reduction of 2 percentage points can be potentially effectuated during 2020. Owing to the agreement, wages and employment have shown strong upward trends, and budgetary revenues have also increased even with the given impacts of tax cuts. After the full-scale implementation of the agreement, the tax wedge calculated as net of benefits can potentially shrink by more than 7 percentage points in comparison with the rate in 2016, and reach a level that is near to our competitors in the region.

In January 2019, new, separate legislation on social contribution tax was introduced, including the revision of the allowances for this type of taxes. Adapted to the changed labour market situation, the newly enacted system of allowances focuses on the involvement of new entrants to the labour market, and at the same time it simplifies administration for the employers. Besides the above allowances, since January 2019 retired people wishing to work have been exempt from the payment of personal and employers' taxes and contributions.

In order to reduce the tax burdens on SMEs, new, optional tax regimes, the small business tax (kiva) and the lump sum tax of small enterprises (kata) were introduced in 2013 . In order to strengthen the growth-friendliness of the tax system, significant changes have been put into effect with regard to the above-mentioned two special taxes that are available to SMEs, which have a key role in employment.

On the one hand, in order to promote the competitiveness of the smallest enterprises and to whiten the economy, the revenue threshold for the lump sum tax of small enterprises was increased from HUF 6 million to HUF 12 million in 2017. Concurrently, in order to reduce administrative burdens, the value threshold of exemption from VAT was increased from HUF 6 million to HUF 8 million in 2017, and then from HUF 8 million to HUF 12 million in 2019. As a result of the beneficial measures, revenue from this type of taxes has increased significantly since December 2016, and the number of enterprises using the "kata" scheme has increased by nearly 180 thousand.

On the other hand, "kiva" has been devised to impose a single, uniform tax to replace the tax obligations of employers and corporate income tax. The tax base is the total of the wage bill and the profit of the business enterprise. And the profit is not taxed in case it is re-invested; thereby this tax regime encourages investments. The tax rate is determined in the range between the actual rate of the corporate income tax and the actual rate of burdens on wages, which is beneficial for businesses paying considerable amounts of wage bills. For this reason, in parallel to the reduction of the social contribution tax rate, 2017 and 2018 also saw reduction of the small business tax rate (from 16% to 14% and then to 13%), and the rate will be reduced by another 1 percentage point in 2020. In addition to lowering the rate, the conditions of kiva have been considerably simplified and eased. In 2017, the upper headcount limit was raised to 50 employees, and then in 2019 the requirements concerning the revenue threshold were relieved, meaning that this regime can now be selected up to HUF 1 billion in revenues. Besides the positive changes resulting from the latest regulations, recent years also witnessed several campaigns for the propagation of kiva, as a result the number of taxpayers selecting the regime has become more than six times larger since 2016.

The corporate tax rate was reduced to a uniform rate of 9% as of 2017, which – by promoting investments in the next years – may also result in an increase of productivity and consequently, of wage levels – thus generate surplus in budgetary revenue. The tax policy of Hungary continues to focus on reducing taxes on labour and the tax and administrative burdens of enterprises, increasing the efficiency of tax collection and simplifying the tax system.

3.3 Measures increasing tax revenue in 2019 and 2020

In order to enhance the effectiveness of tax collection, from 1 July 2018 the use of online invoicing became mandatory, and it is the year of 2019 when the effect of this measure towards the whitening of the economy first contributes to the increase of budgetary revenues for the entire year. As a result of the measures taken in earlier years, the estimated VAT gap – that is the rate of uncollected VAT budgetary revenues – decreased from 21% in 2013 to 9% in 2018 based on the preliminary estimate given in the European Commission's related study[2]. From 2020, further measures for the whitening of the economy, which are currently being worked out, are expected to be introduced in line with the document titled Programme for a More Competitive Hungary, approved by the Government. These measures take the orientation to reduce tax administration burdens, improve the effectiveness of tax collection and extend the use of electronic payment systems.

In order to get closer to the EU tax minimum on cigarettes, since September 2018 the rates of the excise duty imposed on cigarettes and consumer tobacco have already been increased in three steps (September 2018, January and July 2019), and will be further increased in three additional steps (January and July 2020, January 2021).

In 2019, i) subsidies furnished through the corporate income tax scheme for performing arts organisations were abrogated, ii) for compliance with the EU minimum tax rates the rate of commercial gasoil refund decreased, and iii) the innovation contribution was also imposed on all the enterprises that do not qualify to be micro- or small businesses for the purposes of the SME Act.

From 1 January 2019, the following changes were introduced with respect to the public health product tax: i) tax rates increased on average by 20% for all products subject to tax, ii) fruit spirits and herbal beverages became subject to tax, iii) the conditions for subsidisation available in relation to health promotion programmes were made more stringent, and iv) the tax bracket thresholds for alcoholic beverages were modified.

The European Union's Anti-Tax Avoidance Directive (ATAD) requires Member States to adopt measures for the protection of their tax bases in order to counteract international tax evasion by business entities. In 2018, Hungary amended the rules concerning controlled foreign companies in accordance with this Directive, and implemented rules for limitations to the deductibility of interests, effective from 1 January 2019. According to the new provisions, the interest expenditures of companies are deductible from the tax base only up to a certain level, and any amount in excess is taxable, and increases budgetary revenues. Moreover, the other provisions of the Directive, including the rules pertaining to the handling of hybrid instruments (tax evasion as a result of differences in the legal evaluation of the same factual circumstances) and capital withdrawals, have been transposed this year. Apart from establishing rules to prevent tax evasion and artificial redistribution of profits, Hungary is also seeking to build up extensive cooperation in the field of tax information exchange. In this context, the new EU regulations on cross-border tax arrangements have been put into force in 2019.

The tax payment practice of individuals and companies – and consequently the budgetary revenues – could be indirectly improved by the extension of the regulations on information exchange with respect to taxes and the more effective use of the available data by the tax authority. In 2017, Hungary implemented the rules pertaining to Country-by-Country Reporting, as a result of which since 2019 the tax authority has been in possession of such information regarding the operation of company groups that will make it possible to combat aggressive tax planning practices more effectively.

[2] CASE (2019): Study and Reports on the VAT Gap in the EU-28 Member States: 2019 Final Report. Warsaw, September 2019