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Assessment of the 2017 convergence programme for

Hungary

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

This document assesses Hungary's 2017 convergence programme (hereafter called convergence programme or programme), which was approved by the Government on 26 April and submitted to the Commission on 2 May 2017.[1] The convergence programme covers the period 2016-2021.

Hungary is currently subject to the preventive arm of the the Stability and Growth Pact (SGP) and should preserve a sound fiscal position which ensures compliance with the medium-term objective (MTO). As the debt ratio reached 78.3% of GDP in 2012 (the year in which Hungary corrected its excessive deficit), exceeding the 60% of GDP reference value, Hungary is also subject to the debt reduction benchmark.

This document complements the Country Report published on 26 February 2017 and updates it with the information included in the convergence programme. Section 2 presents the macroeconomic outlook of the programme and provides an assessment based on the Commission 2017 spring forecast. The following section presents the recent and planned budgetary developments, according to the convergence programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the convergence programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the Stability and Growth Pact, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework. Section 7 concludes.

2. MACROECONOMIC DEVELOPMENTS

In 2016, real GDP growth slowed to 2.0%, down from 3.1% in 2015. The decline was due to a major drop in investment linked to the transition to the new 2014-2020 Multiannual Financial Framework of EU structural funds. The programme projects a significant acceleration in GDP growth to 4.1% and 4.3% in 2017 and 2018, gradually slowing down to 3.6% by 2021. The acceleration is expected to stem from strong investment growth, as EU-funded and nationally-funded investment in infrastructure increase. In addition, the manufacturing sector is expected to benefit from capacity upgrades and residential housing is expected to surge. Household consumption is forecast to grow at a fast pace, driven by dynamic wage growth and continuing positive labour market developments. Both private investment and consumption is expected to be supported by policy measures. As a result, domestic demand is set to become the main contributor to economic growth over the programme horizon, while the contribution of net exports to GDP growth is expected to be negative in 2017-2018.

The macroeconomic scenario incorporates the impact of a set of measures implemented after the 2016 convergence programme. The measures include (i) significant tax cuts, notably the reduction of corporate income tax, social security contribution and VAT on selected items;

[1] The English version of the Convergence Programme was not yet submitted at the time of publication of this assessment.

(ii) an increase in minimum wages, (iii) expanding public investments and (iv) pay rises in the public sector. Mainly due to these measures and the resulting looser fiscal policy, the GDP growth projection was revised upwards by 0.5-1.0 pps. for each year compared to the previous programme.

Table 1: Comparison of macroeconomic developments and forecasts

	2016		2017		2018		2019	2020	2021
	COM	CP	COM	CP	COM	CP	CP	CP	CP
Real GDP (% change)	2.0	2.0	3.6	4.1	3.5	4.3	3.8	3.7	3.6
Private consumption (% change)	5.0	4.9	4.9	6.1	3.4	5.4	4.4	4.3	4.1
Gross fixed capital formation (% change)	-15.5	-15.5	12.8	10.2	7.2	12.9	7.8	6.8	6.1
Exports of goods and services (% change)	5.8	5.8	5.0	5.4	5.8	6.5	6.0	6.2	6.9
Imports of goods and services (% change)	5.7	5.7	6.8	6.8	6.5	8.2	6.7	6.6	7.1
Contributions to real GDP growth:									
- Final domestic demand	-0.9	-0.9	4.9	5.0	3.5	5.3	3.9	3.6	3.4
- Change in inventories	2.3	2.3	-0.3	-0.3	0.0	-0.1	0.0	0.0	0.0
- Net exports	0.6	0.6	-1.0	-0.6	-0.1	-0.9	-0.1	0.1	0.2
Output gap[1]	0.2	-0.3	1.4	0.7	2.5	1.4	1.4	1.3	0.9
Employment (% change)	2.2	3.4	0.6	2.5	0.3	1.8	1.2	0.8	0.4
Unemployment rate (%)	5.1	5.1	4.1	4.0	3.9	3.6	3.5	3.4	3.4
Labour productivity (% change)	-0.2	-1.4	3.0	1.5	3.1	2.4	2.6	2.9	3.2
HICP inflation (%)	0.4	0.4	2.9	1.6	3.2	3.0	3.0	3.0	3.0
GDP deflator (% change)	1.0	1.0	2.9	2.9	3.3	3.2	3.0	2.9	2.9
Comp. of employees (per head, % change)	5.3	5.7	7.1	6.6	6.3	6.9	5.8	6.0	5.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	6.0	5.4	5.9	7.6	5.4	7.2	6.0	4.2	4.1

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 2017 spring forecast (COM); Convergence Programme (CP).

According to the Commission 2017 spring forecast, real GDP growth is projected to rise to 3.6% and 3.5% in 2017 and 2018. The Commission's projections are respectively 0.5 and 0.8 pps. lower than those of the convergence programme. The difference in the growth projections in 2017 is mainly attributable to the contribution of net exports, which is expected to fall to a greater extent according to the Commission forecast. For 2018, the Hungarian authorities assume a stronger growth contribution from household consumption and private investment. Inflation accelerates from 0.4% in 2016 to 1.6% in 2017 and to 3% in 2018 in the convergence programme. By contrast, the Commission forecast expects a markedly faster rise in inflation, reaching 2.9% already in 2017.

The output gap as recalculated by the Commission based on the information in the programme, following the commonly agreed methodology, is estimated to be slightly negative in 2016. Thereafter it turns to positive and widens further to 1.4% by 2018, but starts to narrow afterwards. Compared to the Commission 2017 spring forecast, the authorities calculate significantly higher potential growth (3.8% vs. 2.4%) and markedly lower output gaps taken at face value. The assumed significant rise in potential growth does not seem to be

sufficiently underpinned by structural measures in the programme. According to the Commission forecast, the output gap was already in the positive territory in 2016 and widens further to 2.5% by 2018.

Overall, the macroeconomic scenario of the convergence programme is favourable.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2016 and 2017

In 2016, the headline deficit reached 1.8% of GDP, somewhat above the historic low of 1.6% in 2015. Based on the Commission forecast, the structural balance is also estimated to have deteriorated by around 0.3 pps. after adjusting for one-off measures (the net impact of one-off measures amounted to -0.1% of GDP, consisting of a deficit-improving effect of assets sales of 0.3% GDP and a deficit-increasing one-effect of 0.4% of GDP related to a correction of EU funding). Nonetheless, the structural balance as estimated by the Commission (-1.9% of GDP) remained within the margin of ¼ % of GDP from the country's MTO (-1.7% of GDP in 2016).

Compared to the plans set out in the 2016 convergence programme, the official deficit target was overachieved by some 0.1 pp. in 2016. Both total government revenue and expenditure turned out to be considerably lower than planned, which was mainly due to the deficit-neutral effect of significantly lower-than-planned EU fund absorption. On the revenue side, tax and social security receipts and non-tax revenues other than EU transfers exceeded the plans altogether by 0.7 pps. of GDP. Expenditure without EU funds also exceeded the target, but to a slightly smaller extent. Domestic spending on public investment fell significantly below the target. The deficit-reducing impact of investment-related expenditure savings and higher-than-expected tax revenues was largely offset by lower-than-planned receipts from assets sales (accounted as negative expenditure in ESA terms) and additional spending, most notably on capital transfers and other current expenditure.

For 2017, the convergence programme plans an increase in the deficit to 2.4% of GDP. This reflects substantial tax cuts as well as spending increases. The deficit-increasing measures are projected to be partly counterbalanced by declining interest outlays and social payments as well as by additional one-off receipts from asset sales. EU fund absorption is expected to expand by some 1 pp. of GDP. Without EU funds, however, both total revenue and expenditure are planned to decrease relative to GDP (by 1.2 and 0.6 pps. respectively) against the backdrop of an expected strong economic upturn. The structural balance is set to deteriorate considerably in 2017.

The 2017 deficit target remains the same as planned in the previous convergence programme. However, this is a result of several offsetting effects. The level of EU fund absorption has been revised downwards (by some 1 pp. of GDP) and consequently both total revenue and expenditure targets decreased. At the same time, the planned amount of tax and non-tax revenues other than EU funds remained practically unchanged so as total expenditure without EU funds. It is assumed that the revenue-decreasing impact of tax-cutting measures announced after the publication of the previous programme (i.e. the reduction of employer social security contributions and the corporate income tax) is counterbalanced by favourable base-effects from 2016, higher-than-previously-planned growth of key tax bases and

additional non-tax revenues. On the other hand, projected savings resulting from decreased spending on interest, lowered investment targets and extra one-off receipts from asset sales are intended to be fully re-allocated for increased current expenditure.

3.2. Medium-term strategy and targets

Over the medium term, the convergence programme plans to stabilise the headline deficit at 2.4% of GDP in 2018 and then to bring it down gradually to reach 1.2% by 2021. The MTO set in the convergence programme, a structural deficit of 1.5% of GDP from 2017 onwards, reflects the objectives of the Pact. According to the authorities, the planned reduction in headline deficits would ensure that the structural balance reaches the country's MTO by 2020. However, the structural balance recalculated by the Commission[2] remains below the MTO throughout the programme period (improving from -3.2% of GDP in 2017 only to -1.7% in 2021).

The planned medium-term fiscal adjustment is driven by expenditure restrains, while helped by expected further decreases in interest spending and robust GDP growth. However, additional tax cuts planned over the 2018-2021 period slow down the pace of deficit-reduction. In 2018, the foreseen phasing-out of temporary receipts (including proceeds from asset sales and an extra revenue component in the corporate income tax[3]) would generate a significant deficit-increasing effect fully absorbing the impact of expenditure moderation. The level of EU funds is assumed to reach its peak in 2018 and foreseen to decline considerably thereafter. Therefore decreasing national co-financing costs also facilitate the improvement of the budget balance towards the end of the programme horizon.

The convergence programme plans the total revenue-to-GDP ratio to decline from 45.5% in 2017 to 40.2% by 2021. Filtering out the impact of EU funds, revenues from national sources are estimated to decrease by around 3.9 pps. during the same period (by some 1.2 pps. in 2018 and by a further 2.6 pps. between 2019 and 2021). Besides the impact of tax cuts, this decline in government revenue is also attributable to the shrinking expenditure ratio (i.e. the decreasing tax content of government spending) and the assumed low GDP-elasticity of non-tax revenues. At the same time, primary expenditure-to-GDP ratio without EU funds is planned to fall even more than revenues, overall by 4.6 pps. of GDP (by 1 pp. in 2018 and by 3.6 pps. over the next three years). The steady decrease of social payments relative to the GDP plays a major role in the planned fiscal adjustment. This reflects the impact of previously introduced parametric pension reforms and nominal freezes or limited indexation of several other cash benefits. Current expenditure other than social transfers (including spending on goods and services and other discretionary items) are also set to grow well below the GDP, increasing even below inflation after 2018. However, spending curbs are partly offset by the targeted levels of investment expenditure financed from national sources, which would continue to increase across the programme period even relative to GDP.

[2] Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the programme, using the agreed methodology.

[3] Corporate income tax revenues are estimated to benefit from significant temporary extra payments in 2015-2017 (involving an increasing amount during these years reaching some 0.7% of GDP by 2017). These extra receipts are mainly linked to a single discrete transaction with the tax obligation split between years.

The primary balance is planned to deteriorate further in 2018 reaching 0.2% of GDP and is then foreseen to recover to 1.2% by 2021 (albeit remaining still below the level observed in 2016). The headline deficit is expected to benefit also from an additional decline of 0.5 pps. in interest expenditure during 2018-2021.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2016	2017		2018		2019	2020	2021	Change: 2016-2021
	COM	COM	CP	COM	CP	CP	CP	CP	CP
Revenue	**45.6**	**45.6**	**45.5**	**45.3**	**45.3**	**44.3**	**41.9**	**40.2**	**-5.4**
of which:									
- Taxes on production and imports	18.3	18.5	18.4	18.4	18.2	18.0	17.8	17.6	-0.7
- Current taxes on income, wealth, etc.	7.5	7.3	7.3	6.6	6.7	6.7	6.7	6.7	-0.8
- Social contributions	13.8	12.8	12.9	12.4	12.6	12.3	11.7	11.3	-2.5
- Other (residual)	6.0	6.9	6.9	7.9	7.8	7.3	5.7	4.6	-1.4
Expenditure	**47.5**	**47.9**	**47.9**	**47.8**	**47.7**	**46.1**	**43.4**	**41.3**	**-6.2**
of which:									
- Primary expenditure	44.3	45.0	45.0	45.1	45.0	43.6	40.9	38.9	-5.4
of which:									
Compensation of employees	11.0	10.8	10.7	10.5	10.5	10.0	9.4	8.8	-2.2
Intermediate consumption	7.0	8.0	8.0	8.0	7.9	7.4	6.4	5.8	-1.2
Social payments	15.0	14.3	14.2	13.8	13.8	13.3	12.9	12.5	-2.5
Subsidies	1.4	1.4	1.3	1.3	1.3	1.3	1.2	1.1	-0.3
Gross fixed capital formation	3.1	4.5	4.7	5.6	5.5	5.8	5.6	5.6	2.5
Other (residual)	6.7	6.1	6.0	5.9	6.0	5.7	5.5	5.2	-3.2
- Interest expenditure	3.2	2.9	2.9	2.7	2.7	2.5	2.5	2.4	-0.8
General government balance (GGB)	**-1.8**	**-2.3**	**-2.4**	**-2.4**	**-2.4**	**-1.8**	**-1.5**	**-1.2**	**0.6**
Primary balance	**1.3**	**0.6**	**0.5**	**0.2**	**0.2**	**0.8**	**1.0**	**1.2**	**-0.1**
One-off and other temporary measures	-0.1	0.4	0.4	0.0	0.0	0.0	0.0	0.0	0.1
GGB excl. one-offs	**-1.8**	**-2.7**	**-2.8**	**-2.4**	**-2.4**	**-1.8**	**-1.5**	**-1.2**	**0.6**
Output gap[1]	0.2	1.4	0.7	2.5	1.4	1.4	1.3	0.9	0.7
Cyclically-adjusted balance[1]	-2.0	-3.0	-2.8	-3.7	-3.1	-2.5	-2.1	-1.7	0.3
Structural balance[2]	**-1.9**	**-3.4**	**-3.2**	**-3.7**	**-3.1**	**-2.5**	**-2.1**	**-1.7**	**0.2**
Structural primary balance[2]	1.3	-0.6	-0.3	-1.0	-0.4	0.0	0.4	0.7	**-0.6**

Notes:

[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.

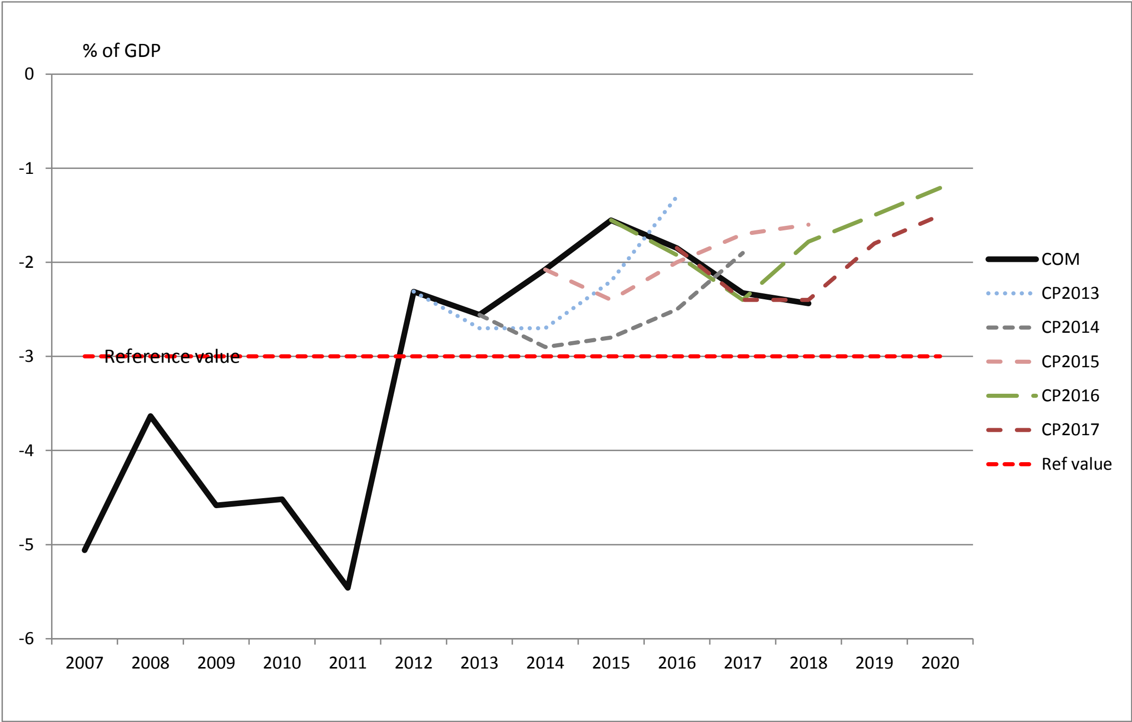
Source:

Convergence Programme (CP); Commission 2017 spring forecasts (COM); Commission calculations.

Compared to 2016 convergence programme, the updated deficit trajectory has shifted upwards and the timing of fiscal adjustment has become more back-loaded. Despite an improved economic growth outlook, the 2018 deficit target increased by 0.6 pps of GDP and target for 2019 by 0.3 pps for 2019 relative to the previous programme. The deficit of 1.2% of GDP set at the end of the programme period was previously intended to be reached one year earlier. It is noteworthy that past deficit outcomes turned out to be significantly lower than the targets set by earlier convergence programmes suggesting conservative planning (Figure 1).

The Commission 2017 spring forecast – relying on assumptions very similar to those of the convergence programme – projects a government deficit at 2.3% of GDP for 2017. This is somewhat below the current official target mainly on account of assumed lower investment expenditure, the effect of which on the deficit is partly offset by a lower-than-planned tax revenue forecast. The deficit of 2.4% of GDP projected by the Commission for 2018, which is based on the usual no-policy change assumption, is in line with the convergence programme's target of 2.4% of GDP. The programme was submitted after the cut-off date of the Commission 2017 spring forecast: therefore the forecast does not yet reflect the newly announced measures and updated spending targets.

Figure 1: Government balance projections in successive programmes (% of GDP)



Source: Commission 2017 spring forecast; Convergence Programmes

3.3. Measures underpinning the programme

On the revenue side, the updated projections for 2017 include the impact of substantial tax cuts (amounting to 2% of GDP in gross terms) linked to the following key elements: (i) 5 pps. reduction of employer social security contribution rate from 27% to 22%; (ii) cutting the corporate income tax rate to 9% replacing the previous progressive scheme with 10% and 19% tax rates; and (iii) lowering VAT rates on selected items such as poultry, eggs, milk, internet and restaurant meals. The impact of reduced taxes is partly compensated by (i) the effect of significant minimum wage increases triggering additional wage-related tax revenues; (ii) the reduction of targeted social security allowances; and (iii) measures aimed at increasing the efficiency of tax collection. Taking also into account the direct effect of lowered social security contributions and the increased minimum wage on government spending (i.e. the gross wage bill and certain social benefits), the deficit-increasing impact of the above mentioned measures is estimated at around 1.4% of GDP.

For 2018, further tax reductions are scheduled, but the net budgetary impact of planned measures is considerably lower (some 0.35% of GDP). Employers' social security contribution will be decreased by an additional 2 pps. and selective VAT cuts are intended to be extended. The effect of this is expected to be partly offset by further minimum wage rises and yields from improved tax collection efficiency. Beyond 2018, the convergence programme incorporates additional social security contribution cuts by 2-2 pps. in two consecutive steps in the second half of 2019 and 2020, with an estimated cumulative deficit-increasing impact of around 0.9% of GDP.

On the expenditure side, the convergence programme most notably includes (i) ongoing and planned pay raises in the public sector; (ii) the impact of decreasing social security contributions on the gross public wage bill (i.e. the lower tax content of expenditure); (iii) increases in certain contributory benefits due to higher minimum wages, (iv) the additional budgetary costs of the new housing support scheme introduced in 2016 as well as (v) extra spending on nationally financed investment projects. The programme counts on a similar amount of one-off receipts from agricultural lands sales than the previous one (altogether 0.7% of GDP), but more than a half of the related proceeds were shifted from 2016 to 2017. The land auctions were already completed in 2016, thus there are no risks involved.

Regarding multi-annual spending programs, the two key elements are the implementation of large-scale investment projects and new career path systems in the public sector. Expenditure on infrastructure development (including road constructions, investments linked to the "Modern cities programme" and the Paks-2 nuclear power plant project) are foreseen to expand during the programme period, slowing down only temporarily in 2018. Career path schemes involving scheduled pay increases for selected professional groups cover already around more than half of all public sector employees in 2017. The budgetary costs are expected to be partly offset by continuing wage restrains in other branches. As the impact of the selective wage schemes fades, the growth of the public wage bill is planned to moderate, even below inflation after 2019. Further savings are expected due to reduced spending on the public works scheme as of 2018 linked to the planned reduction of enrolment in the scheme by 50.000 persons until 2020. Nevertheless, measures underpinning the spending targets reflecting intensifying expenditure containment towards the end of the programme period are not fully specified.

Main budgetary measures

Revenue	**Expenditure**
2016	

Revenue	Expenditure
• Lowering the flat personal income tax rate by 1 pp to 15% (-0.3% of GDP) • Phasing in the increase of the family allowance after two children - first step (-0.04% of GDP) • Cutting the banking tax (-0.2% of GDP) • Reducing VAT rate on unprocessed pork meat and newly built houses (-0.1% of GDP) • Reduction in administrative duties and other cuts in production taxes (-0.1% of GDP)	• Public wage bill: effect of career paths/selective wage increases and offsetting wage restraints in other branches (+0.7% of GDP) • New housing grant scheme and VAT rebate for self-built new family houses (+0.15% of GDP) • One-year extra benefit to pensioners (+0.1) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)) • One-off receipts from asset sales (recorded as negative expenditure, -0.4% of GDP)
2017	
• Reduction of employer social security contribution from 27% to 22% (-1.5% of GDP) • Cutting the corporate income tax rate (-0.4% of GDP) • Additional selective VAT rate cuts on poultry, eggs, milk, internet and restaurant meal (-0.15% of GDP) • Other smaller tax measures, including the second step in increasing family allowances (-0.1% of GDP) • Extra tax revenues due to minimum wage increases – direct and spill-over effects (+0.6%) • Reduction of targeted social security allowances (+0.1% of GDP) • Further increase in the efficiency of tax collection (+0.1% of GDP)	• Gross wage bill: effect of career paths/selective pay rises, minimum wage increases and offsetting wage restraints in other branches (+0.7% of GDP) • Gross wage bill: the effect of reduced employer social security contribution (-0.4% of GDP) • Increased take up of the housing grant scheme (+0.15% of GDP, some uncertainty) • Expansion of new investment projects (+1.1% of GDP) • Increase of certain social benefits due to minimum wage increases (+0.05% of GDP) • One-year "growth premium" for pensioners (+0.1% of GDP) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified) • One-off receipts from asset sales (recorded as negative expenditure, -0.4% of GDP)
2018	
• Further cut of employer social security contribution to 20% (-0.6% of GDP) • Additional selective VAT rate cuts on restaurant meal, fish and internet (-0.1% of GDP) • Other smaller tax measures, including the second step in increasing family allowances (-0.1% of GDP) • Extra tax revenues due to minimum wage increases – direct and spill-over effects (+0.3%) • Further increase in the efficiency of tax collection (+0.15% of GDP)	• Gross wage bill: the effect of career paths/selective pay rises, minimum wage increases and offsetting wage restraints in other branches (+0.5% of GDP) • Gross wage bill: the effect of further employer social security contribution cut (-0.2% of GDP) • Public works scheme: gradual reduction of enrolment (-0.1% of GDP) • Increased take up of the housing grant scheme (+0.15% of GDP, some uncertainty) • Slow-down of investment projects (-0.1% of GDP) • Increase of certain social benefits due to minimum wage increases (+0.05% of GDP) • One-year "growth premium" for pensioners (+0.1% of GDP) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
2019	
• Further cut of employer social security contribution to 18% as of 1st July (-0.3% of GDP) • Phasing in the increase in the family allowance	• Gross wage bill: effect of career paths/selective wage increases and offsetting wage restraints in other branches (+0.05% of GDP))

Revenue	Expenditure
after two children - final step (-0.04% of GDP)	• Gross wage bill: the effect of further employer social security contribution cut (-0.1% of GDP) • Public works scheme: further reduction of enrolment (-0.05% of GDP) • Expansion of investment projects (+0.5% of GDP) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
2020	
• Full year effect and further cut of employer social security contribution to 16% as of 1st July (-0.6% of GDP) • Phasing out VAT reduction on newly built houses (not specified).	• Public wage bill: effect of career paths/selective wage increases and offsetting wage restraints in other branches of the public sector (-0.1% of GDP) • Gross wage bill: the effect of the reduced employer social security contribution (-0.2% of GDP) • Public works scheme: further reduction of enrolment (-0.05% of GDP) • Expansion of investment projects (+1% of GDP) • Phasing out VAT rebate for self-built new family houses (not specified) • Phasing in increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
2021	
• Full year effect of the social security contribution cut (-0.3% of GDP)	• Public wage bill: effect of career paths/selective wage increases and offsetting wage restraints in other branches of the public sector (-0.2% of GDP) • Gross wage bill: the effect of the reduced employer social security contribution (-0.1% of GDP) • Expansion of investment projects (+0.6% of GDP) • Phasing in increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
Note: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.	

3.4. Debt developments

In 2016, the government debt-to-GDP ratio decreased by 0.7 pps. reaching 74.1% of GDP. The reduction of debt was helped by a high primary surplus and favourable stock-flow adjustments, while negatively affected by a slowdown of nominal GDP growth.

Overall, the convergence programme projects a steep decrease of the government debt. The debt ratio is expected to decline gradually to close to 61% by the end 2021 (i.e. equivalent to an average annual debt reduction of more than 2.5% of GDP). The snowball effect supports the reduction of the debt ratio in the programme due to the expected high nominal GDP growth and continuing decreases of the implicit nominal interest rates on the debt stock. The primary balance also contributes to the decreasing debt path as it is expected to remain in surplus over the programme period. On the other hand, the convergence programme foresees unfavourable stock-flow adjustment developments up to 2018 with sizeable below-the-line debt-increasing effects. This is expected to occur mainly on account of the anticipated lags in the actual payment of EU transfers as the absorption of funds in accrual terms accelerates. By

contrast, the cash-flow effect of EU transfers is expected to incur a debt-reducing impact starting from 2019 as the accumulated arrears gradually decrease. Compared to the previous programme, the higher nominal growth rate projected in the updated macroeconomic scenario implies faster debt reduction by around 2.5 pps., while the contribution of the primary balance and stock-flow adjustment effects to debt reduction are lower by 1.2 pps. between 2016-2020.

The Commission 2017 spring forecast projects a debt reduction path, which is broadly similar to the debt dynamics expected by the convergence programme. The debt-to-GDP ratio is forecast to decrease to 72.6% of GDP in 2017 and to 71.2% of GDP in 2018, somewhat more slowly than in the official plans, reflecting the Commission's lower GDP growth forecast.

Table 3: Debt developments

(% of GDP)	Average 2011-2015	2016	2017		2018		2019	2020	2021
			COM	CP	COM	CP	CP	CP	CP
Gross debt ratio[1]	**77.2**	**74.1**	**72.6**	**72.0**	**71.2**	**70.5**	**67.3**	**64.0**	**61.2**
Change in the ratio	-1.2	-0.7	-1.5	-2.1	-1.4	-1.5	-3.2	-3.3	-2.8
Contributions [2] :									
1. Primary balance	**-1.4**	**-1.3**	**-0.6**	**-0.5**	**-0.2**	**-0.2**	**-0.8**	**-1.0**	**-1.2**
2. “Snow-ball” effect	**0.8**	**1.1**	**-1.6**	**-1.9**	**-1.9**	**-2.4**	**-1.9**	**-1.7**	**-1.5**
Of which:									
Interest expenditure	4.2	3.2	2.9	2.9	2.7	2.6	2.6	2.5	2.4
Growth effect	-1.4	-1.4	-2.5	-2.8	-2.3	-2.9	-2.5	-2.3	-2.2
Inflation effect	-2.0	-0.7	-2.0	-2.0	-2.2	-2.1	-2.0	-1.8	-1.7
3. Stock-flow adjustment	**-0.5**	**-0.4**	**0.7**	**0.5**	**0.8**	**1.2**	**-0.4**	**-0.6**	**0.0**

Notes:

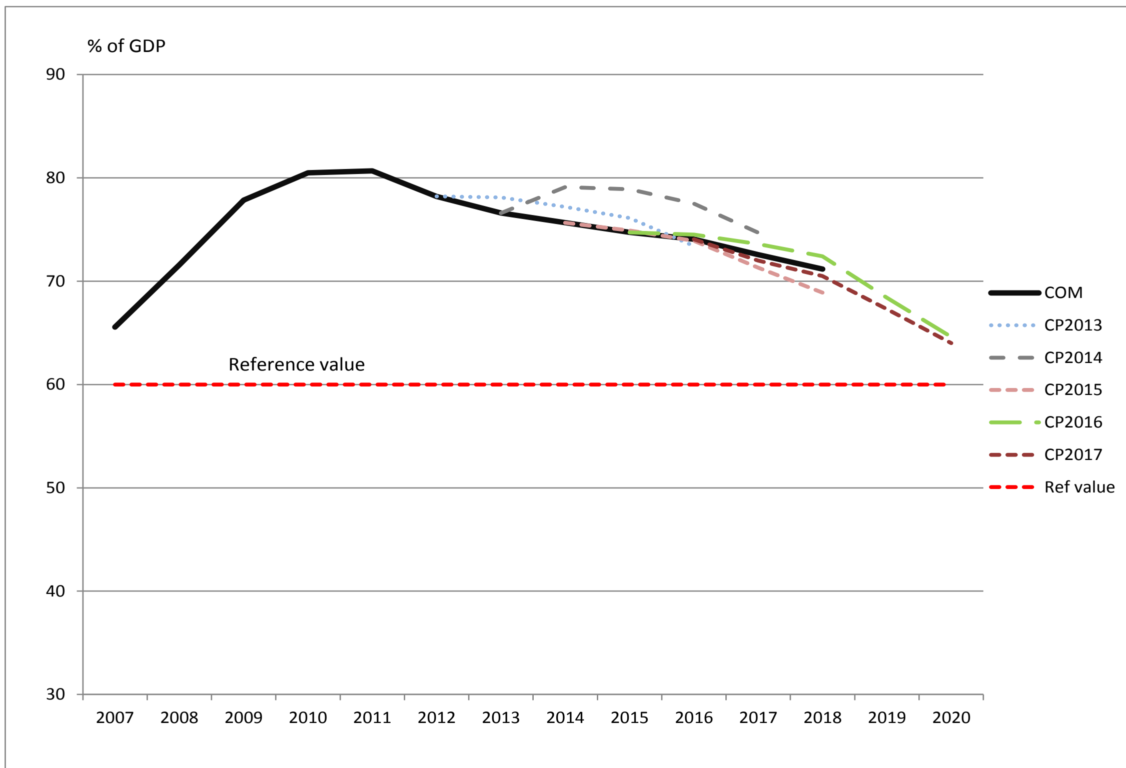
[1] End of period.

[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 2017 spring forecast (COM); Convergence Programme (CP), Comission calculations.

Figure 2: Debt projections in successive programmes (% of GDP)



Source: Commission 2017 spring forecast; convergence programmes

3.5. Risk assessment

The budgetary risks linked to the macroeconomic scenario of the programme are to the downside pointing to potentially higher-than-planned deficit outcome. The assumed growth potential of the economy underpinning official plans exceeds the Commission's potential growth estimate by more than 1 pp. annually over the programme period. In the light of this, GDP growth may turn out markedly lower than planned. This in turn could result in an increasing deficit gap due to an accumulating shortfall of revenues assuming an unchanged level of expenditure. The relatively strong reliance of the planned fiscal adjustment on the decline of interest spending is another vulnerability factor if the current loose stance of global monetary policies was reversed more abruptly than anticipated. Similarly, the pass-through of wage increases may be higher and faster than expected, which could trigger a monetary policy reaction leading to higher-than-expected interest rates.

Conditional fiscal measures incorporated in the convergence programme can potentially offer a buffer against negative macroeconomic risks to the deficit targets. The agreement between the government and social partners signed on 24 November 2016, set conditions for reducing employer social security contributions after 2018. Accordingly, further cuts in employers' social security contributions should be implemented amounting to 2 pps. on each occasion (involving overall not more than four steps), when *real* wages in the private sector increase by at least 6% compared to a reference quarter (i.e. for the first occasion the first quarter of 2018 and then quarters triggering a following step). As each step involves an estimated annual budgetary cost of some 0.45% of GDP, it can provide a non-negligible offsetting effect, if cuts scheduled to start in the second half of 2019 and 2020 are postponed because the agreed

condition is not met yet.[4] Yearly pension growth premiums (which are triggered by actual real GDP growth above 3.5%) are similar conditional measures in the programme, albeit involving a relatively modest spending (less than 0.1% of GDP).

Regarding measures other than the macro-conditional ones which were discussed above, the associated risks appear to be rather positive in the short term, whereas they tend to be negative towards the end of the programme period. On the revenue side, additional yields targeted for 2017-2018 from improved efficiency of tax collection entail a noteworthy uncertainty. Nevertheless, previous steps in this area generated considerable extra receipts and current plans are underpinned with tangible measures. Risks are more significant on the expenditure side. The open-ended nature of the recently introduced housing scheme is one factor, involving a risk of potential expenditure slippages. At the same time, spending on both EU co-financed investments and other infrastructure developments may turn out significantly lower than planned in the short term, especially in 2017 and 2018, due to delays in implementation. However, the accumulating carry-overs of related expenditure commitments are likely to pose negative risk for further years. Looking ahead, the planned construction of the Paks-2 nuclear power plant is an additional source of investment-related risks. The project is scheduled to start as of 2019 involving annual costs estimated at around 1.5% GDP, which are subject to potential expenditure overruns. Although investments from domestic sources are foreseen to rise until the end of the programme period, it is not spelled out to what extent those plans reflect the additional costs of the nuclear plant construction. Finally, planned spending restrains (with the public wage bill and operating budgets set to increase below inflation in the final years of the programme) are exposed to significant implementation risks.

The risks to the planned debt trajectory are largely similar to those impacting the deficit target. However, macroeconomic risks can affect debt-to-GDP ratios in an amplified manner, simultaneously through a higher-than-planned deficit and a lower denominator (i.e. a weaker "snow-ball" effect). Additional risks stem from the sensitivity of the debt level to exchange rate movements as currently still around 29% of government debt is denominated in foreign currency. However, the proportion of debt held in foreign currency is planned to be reduced below 20% by 2021 resulting in a progressively diminishing exposure to exchange rate risks. The debt trajectory of the programme is also shaped by the cash-flow effects of EU transfers. A slower-than-planned implementation of EU funded projects would imply that the debt-reduction path will not slow down due to the lags in the receipt of EU funds during 2017-2018 as much as anticipated. At the same time, this would also imply that the favourable impact of ex-post reimbursement of EU funds on the reduction of debt in further years will be equivalently smaller than assumed. Finally, it should be noted that the plans for the debt ratio do not yet reflect the effect of operations by the Eximbank (i.e. a state owned export-import bank), which according to the assessment of Eurostat, need to be reclassified as part of general government.

[4] Note, however, that the convergence programme does not spell it out as to whether the triggering condition is expected to be met for reducing social security contributions as of 1st July in 2019 and then again 12 months later or social security contribution are, in fact, planned to be cut unconditionally.

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

4.1. Compliance with the debt criterion

In 2016, after the end of the transitory period, Hungary complied with the debt reduction benchmark as the notified debt-to-GDP ratio remained below the debt reduction benchmark. Therefore, according to the Commission's assessment based on notified data, Hungary achieved compliance with the debt criterion in 2016.

According to information provided in the convergence programme, Hungary is expected to be compliant with the debt criterion in 2017 and 2018, since the debt-to-GDP ratio is planned to remain below the debt reduction benchmark throughout the programme horizon. The same conclusion is reached on the basis of the Commission 2017 spring forecast for 2017 and under a no-policy-change scenario for 2018.

Table 4: Compliance with the debt criterion

	2016	2017		2018	
		CP	COM	CP	COM
Gross debt ratio	**74.1**	**72.0**	**72.6**	**70.5**	**71.2**
Gap to the debt benchmark [1]	-1.2	-3.7	-0.8	-4.9	-1.2

Notes:

[1] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

Source :

Commission 2017 spring forecast (COM); Convergence Programme (CP), Comission calculations.

4.2. Compliance with the required adjustment path towards the MTO

Box 1. Council recommendations addressed to Hungary

On 12 July 2016, the Council addressed recommendations to Hungary in the context of the European Semester. In particular, in the area of public finances the Council recommended to Hungary to achieve a fiscal adjustment of 0.3 % of GDP towards the medium-term budgetary objective in 2016 and of 0.6 % of GDP in 2017, unless the medium-term budgetary objective is respected with a lower effort, by taking the necessary structural measures.

The convergence programme indicates that the budgetary impact of exceptional security-related measures in 2016 and 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 concerning security-related measures amounted to 0.04% of GDP in 2016. In 2017, the additional budgetary impact of the security-related measures is currently estimated at 0.14% of GDP. The provisions set out in Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97 cater for this additional expenditure, in that the severity of the terrorist threat are unusual events, their impact on Hungary's public finances is significant and sustainability would not be compromised by allowing for a temporary deviation from the adjustment path towards the medium-term budgetary objective. Therefore, the required adjustment towards the medium-term budgetary objective for 2016 has been reduced to take into account additional security-related costs. Regarding 2017, a final assessment, including on the eligible amounts, will be made in spring 2018 on the basis of observed data as provided by the Hungarian authorities.

In 2016, based on the Commission 2017 spring forecast, Hungary is considered to be at its MTO as the structural balance is estimated to be within a margin of ¼ % of GDP from the MTO. Starting from a position of -1.6% of GDP in 2015 (above the MTO), the structural balance is estimated to have deteriorated by 0.3% of GDP, pointing to a risk of some deviation from the recommended structural adjustment of a stable structural balance (deviation of -0.1% of GDP). At the same time, the growth of government expenditure, net of discretionary revenue measures and one-offs, is calculated to be well above the applicable expenditure benchmark rate, pointing to a risk of a significant deviation (deviation of -1.4% of GDP). This calls for an overall assessment in order to identify the reasons behind so different sizes of the deviations measured by the two indicators and to confirm the existence or not of a significant deviation.

The fiscal effort measured by the expenditure benchmark pillar is negatively affected by two factors: the presence of an outlier in the smoothed investment series and a relatively low medium-term potential growth rate compared to current potential growth estimates. First, the dynamics of the smoothed investment (i.e. the four-year average of nationally-financed investment) used in the expenditure benchmark pillar is distorted by an outlier effect related to a hike in nationally financed investment prior to 2016. This resulted from an over-commitment of projects in order to maximise EU fund absorption of the financing cycle. Second, the medium-term potential growth rate used in the expenditure benchmark, affected by post-crisis years, is too low (1%) compared to the point estimate as coming from the Commission 2017 spring forecast. Therefore it is not considered as representative at the

current juncture, especially given that the potential growth rate is still increasing in future years. Correcting for these factors, the expenditure benchmark pillar would point to some deviation. On the other hand, the fiscal effort estimated by the structural balance pillar is positively affected by a decrease of interest outlays and an apparent revenue windfall. However, the latter is explained by a sharp drop in the GDP deflator falling out the trend, while tax bases, most notably the overall economy wage bill, increased at faster pace than the nominal GDP. Correcting for these factors and investment volatility not explained by the above-mentioned outlier effect, the structural balance pillar still points to some deviation.

Based on outturn data for 2016 and the Commission 2017 spring forecast, therefore the ex-post assessment suggests some deviation from the adjustment path towards the MTO in 2016.

In 2017, the recalculated structural balance based on the convergence programme is expected to deteriorate by 1.5% of GDP to -3.2%, whereas the required adjustment is 0.3% of GDP. The structural balance pillar thus points to a risk of significant deviation from the required adjustment path (a gap of -1.8% of GDP). As the net government expenditure is planned to grow significantly above the applicable benchmark rate of 0.9% real growth, the risk of significant deviation is also indicated by the expenditure benchmark pillar (a gap of -1.2% of GDP). The assessment over the years 2016 and 2017 together also points to a risk of significant deviation based on both pillars (i.e. with two-year deviations of -0.8% and -1.3% of GDP for the structural balance and expenditure benchmark pillars, respectively). Therefore, according to information provided in the programme, there is a risk of significant deviation from the required adjustment towards the MTO in 2017.

The assessment based on the Commission 2017 spring forecast leads to a similar conclusion for 2017. In 2017, the structural balance is forecast to deteriorate by 1.6% of GDP, pointing to a risk of a significant deviation (deviation of -1.9% of GDP) from the recommended structural adjustment of 0.3% of GDP. The growth of government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the expenditure benchmark, also pointing to a risk of a significant deviation (deviation of -2.8% of GDP).

According to the Commission forecast, the difference between deviations implied by the two indicators is mainly related to two factors in 2017. First, revenue windfalls play a significant role positively affecting the structural balance pillar, but only partly so. The estimated revenue windfalls reflect to a considerable extent extra tax revenues generated by the spill-over (or ripple) effect of significant minimum wage increases on earnings above the statutory minimum. This indirect effect is not considered as discretionary measure in the Commission forecast, yet contributes to a permanent revenue increase and as such has a negative bias on the deviation estimated by the expenditure benchmark pillar. Second, there is a difference between the two potential GDP growth benchmarks used in each pillar, with the expenditure benchmark pillar providing a more negative reading of the fiscal effort due to the use of the medium-term potential GDP growth rate, which is lower than the potential GDP growth rate emerging from the Commission 2017 spring forecast. Correcting for these factors, both pillars would still point to a risk of a significant deviation from the requirements. Therefore, an overall assessment points to a risk of a significant deviation in 2017 on basis of the Commission 2017 forecast. This conclusion would not change if we would take into account the impact of additional security-related expenditure on the required fiscal adjustment.

In 2018, the recalculated structural balance based on the convergence programme is estimated to improve by 0.1% of GDP, 0.9% of GDP below the required adjustment (1% of GDP),

which points to a risk of significant deviation. The growth of adjusted net expenditure as planned is calculated to exceed the nominal benchmark rate of 2.8% implying a risk of some deviation (a gap of -0.4% of GDP). Over 2017 and 2018 taken together, the average deviation for the structural balance pillar is well above the critical threshold of 0.25% of GDP (an average deviation of -1.4% of GDP) pointing to a risk significant deviation. The expenditure benchmark also points to a risk of significant deviation over 2017 and 2018 taken together (an average gap of -0.9% of GDP). Therefore, based on information provided in the programme, there is a risk of significant deviation from adjustment path towards the MTO in 2018. This result would not change if the requirement would be corrected for the expected additional security-related expenditure in 2017.

Based on the Commission 2017 spring forecast for 2018, the structural balance is expected to deteriorate by 0.2% of GDP pointing to a risk of significant deviation (deviation of -1.2% of GDP). The growth of government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the expenditure benchmark, also pointing to a risk of a significant deviation (deviation of slightly above -0.5% of GDP). Taking 2017 and 2018 together, the two-year average deviations also point to a risk of significant deviation for both pillars (an average deviation of around -1.6% of GDP in both cases).

An overall assessment focusing on 2018 alone shows that the structural balance pillar is negatively affected by a significant revenue windfall, which does not impact the expenditure benchmark pillar. At the same time, the relatively low ten-year average potential growth rate negatively affects the expenditure benchmark pillar compared to the structural balance pillar. Correcting for these factors, the one-year deviations would point to a risk of some deviation. However, an overall assessment over 2017 and 2018 taken together would still point to a risk of significant deviation even after adjusting for the above-mentioned factors impacting the difference between the two pillars in each year. Therefore, an overall assessment points to a risk of a significant deviation in 2018. The conclusion would remain the same on the basis of the requirement corrected for the expected additional security-related expenditure as well.

These assessments are based on the matrix of preventive arm requirements agreed with the Council, which takes into account (i) the cyclical position of the economy, as assessed on the basis of output gap estimates using the commonly agreed methodology as well as the projected real GDP growth rate, and (ii) debt sustainability considerations. Given the current cyclical conditions and the uncertainty surrounding them, it is important that the fiscal stance strikes the right balance between both safeguarding the ongoing recovery and ensuring the sustainability of Hungary's public finances. The Commission noted that, in carrying out its future assessments, it stands ready to use its margin of appreciation in cases where the impact of large fiscal adjustment on growth and employment is particularly significant. In that context, it will make use of any updated information regarding the projected position in the economic cycle of each Member State and work closely with the Council to that effect.

Table 5: Compliance with the requirements under the preventive arm

(% of GDP)	2016	2017		2018	
Initial position[1]					
Medium-term objective (MTO)	-1.7	-1.5		-1.5	
Structural balance[2] (COM)	-1.9	-3.4		-3.7	
Structural balance based on freezing (COM)	-1.9	-3.4		-	
Position vis-a -vis the MTO[3]	At or above the MTO	Not at MTO		Not at MTO	
(% of GDP)	**2016**	**2017**		**2018**	
	COM	**CP**	**COM**	**CP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.4		1.0	
Required adjustment corrected[5]	-0.2	0.3		1.0	
Change in structural balance[6]	-0.3	-1.5	-1.6	0.1	-0.2
One-year deviation from the required adjustment[7]	-0.1	-1.8	-1.9	-0.9	-1.2
Two-year average deviation from the required adjustment[7]	-0.2	-0.8	-1.0	-1.4	-1.5
Expenditure benchmark pillar					
Applicable reference rate[8]	1.5	0.9		2.8	
One-year deviation adjusted for one-offs[9]	-1.4	-1.2	-2.8	-0.4	-0.5
Two-year deviation adjusted for one-offs[9]	-1.4	-1.3	-2.1	-0.8	-1.6
PER MEMORIAM: One-year deviation[10]	-1.5	-1.1	-2.3	-0.8	-0.9
PER MEMORIAM: Two-year average deviation[10]	-1.6	-1.5	-1.9	-1.0	-1.6
Conclusion					
Conclusion over one year	Overall assessment	Significant deviation	Significant deviation	Significant deviation	Significant deviation
Conclusion over two years	Overall assessment	Significant deviation	Significant deviation	Significant deviation	Significant deviation

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.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2014) is carried out on the basis of Commission 2015 spring forecast.

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

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[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.

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law 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 :
Convergence Programme (CP); Commission 2017 spring forecast (COM); Commission calculations.

5. LONG-TERM SUSTAINABILITY

Hungary does not appear to face fiscal sustainability risks in the short run, as measured by the S0 indicator. Nonetheless, there are some indications that the fiscal side of the economy poses potential challenges (Table 6).

Government debt stood at 74.1% of GDP in 2016. Based on the Commission 2017 spring forecast and under a no-policy-change scenario beyond forecasts, it is projected to decline to 72.9% in 2027 remaining above the 60% of GDP Treaty threshold. The full implementation of the programme would put debt on a steeper decreasing path by 2027, leading to a debt ratio below the 60% of GDP reference value in 2027. However, sensitivity tests (related to interest and growth shocks) suggest that the country's debt-reduction path displays considerable fragility to potential adverse macroeconomic developments. This highlights high risks for the country from debt sustainability analysis in the medium term.

Based on the Commission 2017 spring forecast and no-policy change scenario, the medium-term fiscal sustainability risk indicator S1 is at 1.3 pps. of GDP. This is mainly due to the estimated initial budgetary position (the estimated primary structural deficit in 2018), the still high level of debt and the offsetting effect of the projected medium-term savings in age-related budgetary costs (which are estimated to reduce the additional required effort by 0.9 % of GDP). This indicates medium risk in the medium term. Taking also into account the revealed fragility of the projected debt-reduction path, risks to fiscal sustainability over the medium term are overall high. The full implementation of the convergence programme would put the sustainability risk indicator S1 at -0.9 pp. of GDP leading to low medium-term risks.

Based on the Commission 2107 forecast and debt projection, the long-term sustainability risk indicator S2 (which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path) is at 3.2% of GDP. In the longer term, Hungary therefore appears to face medium fiscal sustainability risks, related to the initial budgetary position and the projected ageing costs contributing with 2.1 pps. and 1.2 pps. of GDP, respectively, 0to the sustainability gap over the very long run. On the other hand, full implementation of the programme would put the S2 indicator at 2.1 pps. of GDP, leading to a somewhat lower long-term risk, but leaving the risk classification unchanged.

It is therefore appropriate for Hungary to continue to implement measures that reduce risks to fiscal sustainability in both the short and medium term.

Table 6: Sustainability indicators

Time horizon				No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term				**LOW risk**			
S0 indicator [1]				0.3			
	Fiscal subindex			0.5	HIGH risk		
	Financial & competitiveness subindex			0.3	LOW risk		
Medium Term				**HIGH risk**			
DSA [2]				HIGH risk			
S1 indicator [3]				1.3	MEDIUM risk	-1.2	LOW risk
of which							
	Initial Budgetary Position			1.4		-0.9	
	Debt Requirement			0.8		0.1	
	Cost of Ageing			-0.9		-0.5	
	of which						
		Pensions		-0.9		-0.6	
		Health-care		0.2		0.1	
		Long-term care		0.0		0.0	
		Other		-0.2		-0.1	
Long Term				**MEDIUM risk**		**MEDIUM risk**	
S2 indicator [4]				3.2		2.1	
of which							
	Initial Budgetary Position			2.1		0.3	
	Cost of Ageing			1.2		1.8	
	of which						
		Pensions		0.4		0.9	
		Health-care		0.5		0.5	
		Long-term care		0.3		0.3	
		Other		0.0		0.1	

Source: Commission services; 2017 stability/convergence programme.

Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2017 forecast covering until 2018 included. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.

[1] The S0 indicator of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49*.

[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections*.

[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2031. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2019 for No-policy Change scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively*.

[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively*.

* For more information see Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2016.

6. FISCAL FRAMEWORK

Based on the 2016 budgetary outcomes, the constitutional debt rule, which stipulates a continuous reduction in the public debt-to-GDP ratio until the 50% national threshold is achieved, is very likely to have been fulfilled. The delineation of debt set out in the Hungarian legislation differs from the Maastricht concept in several aspects. [5] Nonetheless, the notified decrease in the Maastricht debt ratio by 0.6 pps. should allow us to conclude that the prescribed reduction have indeed taken place. The escape clause defined for the debt reduction formula had been invoked for 2016, which is tantamount with a requirement to achieve at least 0.1% of GDP reduction in the adjusted debt-to-GDP ratio. [6] This rule was also likely to have been met in 2016. Unfortunately, neither the authorities nor the Fiscal Council did publish the outcome for the 2016 adjusted debt ratio, also linked to the fact that no ex post monitoring mechanism is prescribed by the legislation. The recurrent lack of ex-post assessment might erode the credibility of the Hungarian debt rules, in particular by assuming a hypothetical year when the evolution of the Maastricht and domestic debt ratios point to different directions.

Looking forward, the convergence programme projects a steadily decreasing trajectory for the debt ratio falling by around 10 pps. between 2017 and 2021. The plan assumes an unchanged exchange rate across the programme horizon, which in this regard corresponds with the adjusted debt concept applied for the domestic rules. Therefore it can be concluded that the official plans are in accordance with the requirements of the two domestic debt rules.

As regards the structural budget balance and nominal budget balance rules (prescribing conformity with the country's MTO and the 3% of GDP reference value, respectively), these cover only the preparation of the draft budget as submitted to the Parliament. The draft budget bill for year 2017 complied with the nominal rule, but the estimated structural deficit at the time (2.1% of GDP) was significantly above the country's MTO of 1.7% of GDP. Based on the headline deficit targets for years 2018-2021 contained in the convergence programme, the 3% of threshold is planned to be respected with an increasing margin. However, the draft budget for 2018 submitted to the Parliament on 2 May 2017 breaches the structural balance rule, as the structural deficit according to the calculations by the government is at 2.4% of GDP. This is clearly below the recently tightened MTO of -1.5% of GDP. Looking further, the structural balance trajectory set in the programme will comply with this domestic requirement only from 2020, taking the plans at a face value as estimated by the authorities.

Based on the information provided in the convergence programme and in budget documents, the past, planned and forecast fiscal performance in Hungary appears to comply only partially with the requirements of the applicable national numerical fiscal rules. The Fiscal Council has not been involved in the endorsement or assessment of the medium-term macroeconomic scenario underpinning the convergence programme.

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[5] The domestic debt rule filters out (i) the revaluation effects of foreign currency debt; (ii) stock-flow adjustment effects related to the pre-financing of EU funds.

[6] The debt reduction formula, which is to operationalise the constitutional debt reduction requirement, incorporates a lenient escape clause. Notably, if the official growth or inflation projection for year t+1 as included in the draft budget bill does not exceed 3%, the rule is suspended for that year. Based on the plans contained in the convergence programme, the escape clause remains in force across the full programme period.

7. CONCLUSIONS

In 2016, based on the Commission 2017 spring forecast, Hungary is considered to be at the MTO, given that its structural balance is within a margin of ¼ pps. of GDP from its MTO. In 2016, starting from an initial position above the MTO, Hungary's structural balance is estimated to have deteriorated by 0.3% of GDP, which points to some deviation from the required adjustment. However, a significant deviation was observed for the expenditure benchmark pillar in 2016. Taking into account the factors affecting the estimated deviations for the two pillars, the overall assessment suggests some deviation from the required adjustment path towards the MTO in 2016. At the same time, Hungary met the requirement of the debt reduction benchmark in 2016.

Both on the basis of the debt-reduction path of the convergence programme and the Commission 2017 spring forecast, Hungary's debt-to-GDP ratio is expected to be below the debt reduction benchmark in 2017 and 2018 implying compliance with the debt rule.

The convergence programme assumes that the revised MTO will be reached by 2020. Based on the programme data recalculated by the Commission, however, the structural balance would not reach the MTO by the end of the programme period. According to the Commission 2017 spring forecast, the structural balance is expected to deteriorate considerably below the MTO in 2017 and 2018. Overall, the adjustment path planned in the programme is not in line with the requirement of the preventive arm of the Stability and Growth Pact with a risk of a significant deviation in 2017 and 2018. The structural balance and net expenditure growth based on the Commission 2017 spring forecast also point to a risk of a significant deviation from the required adjustment path towards the MTO in 2017 and 2018.

ANNEX

Table I. Macroeconomic indicators

	1999-2003	2004-2008	2009-2013	2014	2015	2016	2017	2018
Core indicators								
GDP growth rate	3.9	2.9	-0.7	4.0	3.1	2.0	3.6	3.5
Output gap [1]	-0.2	3.1	-3.4	-0.9	0.1	0.2	1.4	2.5
HICP (annual % change)	7.8	5.7	4.0	0.0	0.1	0.4	2.9	3.2
Domestic demand (annual % change) [2]	4.4	1.5	-2.2	4.6	1.4	1.5	5.2	3.9
Unemployment rate (% of labour force) [3]	6.0	7.2	10.7	7.7	6.8	5.1	4.1	3.9
Gross fixed capital formation (% of GDP)	24.8	23.7	20.6	21.8	21.7	17.8	19.7	21.1
Gross national saving (% of GDP)	19.3	17.5	21.6	24.9	24.8	24.1	23.7	24.4
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-5.6**	**-6.4**	**-3.9**	**-2.1**	**-1.6**	**-1.8**	**-2.3**	**-2.4**
Gross debt	**55.8**	**64.1**	**78.8**	**75.7**	**74.7**	**74.1**	**72.6**	**71.2**
Net financial assets	**-34.8**	**-48.2**	**-64.4**	**-70.9**	**-66.9**	**-66.0**	**n.a**	**n.a**
Total revenue	43.0	43.3	45.7	46.9	48.5	45.6	45.6	45.3
Total expenditure	48.6	49.7	49.5	49.0	50.0	47.5	47.9	47.8
of which: Interest	4.9	4.1	4.4	4.0	3.5	3.2	2.9	2.7
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-2.4**	**-1.4**	**5.1**	**3.0**	**4.2**	**2.8**	**3.9**	**5.2**
Net financial assets; non-financial corporations	**-106.1**	**-111.2**	**-120.9**	**-109.6**	**-102.6**	**-106.7**	**n.a**	**n.a**
Net financial assets; financial corporations	**-1.4**	**-2.1**	**3.7**	**-15.6**	**-23.3**	**-26.2**	**n.a**	**n.a**
Gross capital formation	16.9	16.0	13.1	14.5	12.3	12.9	12.4	12.5
Gross operating surplus	21.3	24.0	24.8	26.4	26.6	25.6	25.5	26.4
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**0.9**	**0.5**	**2.4**	**4.8**	**5.2**	**5.1**	**4.4**	**2.7**
Net financial assets	**65.3**	**63.4**	**74.3**	**89.5**	**97.9**	**105.3**	**n.a**	**n.a**
Gross wages and salaries	33.3	34.9	35.2	35.6	35.4	36.3	37.5	38.0
Net property income	4.8	3.9	3.5	3.4	3.4	3.7	2.2	-1.4
Current transfers received	17.0	18.7	19.0	17.6	16.8	16.6	15.8	15.1
Gross saving	6.0	5.4	5.3	6.1	5.3	5.4	5.2	3.8
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-7.1**	**-7.3**	**3.6**	**5.8**	**7.8**	**6.0**	**5.9**	**5.4**
Net financial assets	**77.1**	**98.1**	**107.2**	**106.5**	**94.9**	**93.6**	**n.a**	**n.a**
Net exports of goods and services	-2.7	-1.2	5.8	6.9	8.9	10.3	8.0	7.2
Net primary income from the rest of the world	-4.9	-5.7	-4.1	-4.2	-4.7	-3.4	-2.5	-3.1
Net capital transactions	0.1	0.7	2.4	3.7	4.7	1.0	2.5	2.6
Tradable sector	46.6	45.8	45.0	46.3	46.4	46.7	n.a	n.a
Non tradable sector	39.5	40.2	39.5	38.0	37.5	37.7	n.a	n.a
of which: Building and construction sector	4.6	4.5	3.6	3.6	3.5	2.9	n.a	n.a
Real effective exchange rate (index, 2000=100)	88.3	108.0	98.5	92.7	90.7	94.5	96.7	97.6
Terms of trade goods and services (index, 2000=100)	102.4	100.3	98.9	99.1	99.8	101.2	100.2	99.8
Market performance of exports (index, 2000=100)	64.5	87.1	99.9	105.2	107.0	108.7	108.9	109.8

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.

[2] The indicator on domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source:
AMECO data, Commission 2017 spring forecast