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Assessment of the 2019 Convergence Programme for

Hungary

(Note prepared by DG ECFIN staff)

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EXECUTIVE SUMMARY

Hungary is subject to the preventive arm of the SGP. Since Hungary's public debt is above the 60% of GDP reference value of the Treaty, it also needs to ensure sufficient progress towards compliance with the debt reduction benchmark.

The Hungarian economy grew by 4.9% in 2018 but according to the Commission 2019 spring forecast the expansion is set to moderate in 2019 and 2020 as the economy reaches capacity constraints. Robust domestic demand remains the main driver of expansion, while exports increase at a moderate pace amid subdued growth in trade partners. The output gap remains significantly positive, but it is forecast to start closing in 2020. The tight labour market and capacity constraints exert upward pressure on wages and prices. The macroeconomic scenario of the Convergence Programme is plausible for 2019, but it is markedly favourable for the years 2020 and beyond. In particular, the Programme projections incorporate at face value illustrative calculations for future structural reforms which are not yet well specified.

The general government deficit remained unchanged at 2.2% of GDP in 2018. The Convergence Programme plans to decrease the deficit to 1.5% of GDP in 2020, to 1.2% in 2021 and to reach a balanced budgetary position by 2023. In structural terms, based on recalculated output gaps, the deficit increased to 3.7% of potential GDP in 2018. The structural deficit is expected to decline to 3.3% in 2019, and falling further to 2.7% in 2020. There are some differences in the assessment of the impact of one measure in 2020, although the Commission forecast are based on the usual no policy change assumption. Risks to the short-term fiscal outlook mainly come from the macroeconomic side, such as a worsening of the economic climate, which would affect tax revenue. Additional risks are linked to the fiscal impact of the 'demographic programme', which could turn out more expensive than expected. The projected increase in public expenditure on long-term care points to medium risks for long-term sustainability.

As a consequence of the observed significant deviation from the recommended adjustment path towards the medium-term objective (MTO) in 2018, the Commission recommended to the Council to open a new Significant Deviation Procedure concerning Hungary. Both in 2019 and in 2020, there is a risk of deviation from the recommended structural adjustment, both based on the Programme and based on the Commission 2019 spring forecast. At the same time, compliance with the debt reduction benchmark is confirmed and expected.

1. INTRODUCTION

On 30 April 2019[1], Hungary submitted its 2019 Convergence Programme (hereafter called Convergence Programme), covering the period 2018-2023. The Convergence Programme was approved by the government.

Hungary is currently subject to the preventive arm of the the Stability and Growth Pact (SGP) and should ensure sufficient progress towards its Medium-Term Budgetary Objective (MTO). As the debt ratio was 70.8% of GDP in 2018, exceeding the 60% of GDP reference value, Hungary is also subject to the debt reduction benchmark. In spring 2018, a significant deviation procedure (SDP) was opened for Hungary due to the significant observed deviation in 2017. On 4 December 2018, the Council found that Hungary had not taken effective action in response to the Council recommendation of 22 June 2018 and issued a revised SDP recommendation for a fiscal adjustment in 2019. On 5 June 2019, the Commission recommended a decision to the Council, which finds that Hungary had not taken effective action in response to the revised Council recommendation of 4 December 2018. On the same day, the Commission issued a warning to Hungary that a significant deviation from the adjustment path toward the medium-term budgetary objective was observed in 2018 and recommended the Council to adopt a new SDP recommendation.

This document complements the Country Report published on 27 February 2019 and updates it with the information included in the Convergence Programme.

Section 2 presents the macroeconomic outlook underlying the Convergence Programme and provides an assessment based on the Commission 2019 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 SGP, 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 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

Real GDP growth increased in 2018 to 4.9% from 4.0% in 2017, driven by domestic demand. The macroeconomic scenario of the Programme expects dynamic GDP growth to continue, with growth rates remaining around 4% until 2023. According to the Convergence Programme, the main driving force of growth in 2019 is investment; from 2020, GDP growth is increasingly driven by consumption and export. Labour productivity is projected to rise by around 3% annually while the mobilisation of remaining labour market reserves sustains employment growth and reduces the unemployment rate further, below 3%. Real wage growth remains strong in the tight labour market. The investment rate remains high, and new capacities in the export sector contribute to accelerating export growth.

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

Table 1: Comparison of macroeconomic developments and forecasts

	2018		2019		2020		2021	2022	2023
	COM	CP	COM	CP	COM	CP	CP	CP	CP
Real GDP (% change)	4.9	4.9	3.7	4.0	2.8	4.0	4.1	4.2	4.0
Private consumption (% change)	5.4	5.4	4.9	4.6	3.8	4.7	4.6	4.5	4.5
Gross fixed capital formation (% change)	16.5	16.5	10.4	10.3	2.4	3.8	3.5	4.6	3.1
Exports of goods and services (% change)	4.7	4.7	4.6	5.1	4.8	5.2	6.0	6.3	6.6
Imports of goods and services (% change)	7.1	7.1	6.8	6.5	5.1	5.4	5.5	6.1	6.0
Contributions to real GDP growth:									
- Final domestic demand	6.2	6.2	5.4	5.1	2.8	3.7	3.4	3.7	3.2
- Change in inventories	0.2	0.2	0.0	0.0	0.0	0.3	0.0	0.0	0.0
- Net exports	-1.5	-1.5	-1.6	-1.0	0.0	0.1	0.7	0.5	0.8
Output gap[1]	3.3	3.0	3.3	2.5	2.5	2.1	1.6	1.3	1.0
Employment (% change)	2.2	1.1	1.4	1.1	0.4	1.3	1.2	1.0	0.9
Unemployment rate (%)	3.7	3.7	3.5	3.3	3.5	2.9	2.8	2.8	2.7
Labour productivity (% change)	2.7	3.8	2.3	3.0	2.4	2.7	2.9	3.2	3.1
HICP inflation (%)	2.9	2.9	3.2	2.7	3.2	2.8	3.0	3.0	3.0
GDP deflator (% change)	4.5	4.5	4.0	3.8	3.4	3.2	3.0	3.0	3.0
Comp. of employees (per head, % change)	9.6	9.6	6.6	8.1	6.5	6.7	6.7	6.9	7.4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.2	2.2	1.1	1.5	1.0	2.1	2.5	2.0	1.5

Note:

[1]In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source :

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

The macroeconomic scenario of the Convergence Programme is broadly similar to the Convergence Programme submitted last year. The growth profile is nearly identical, with only some differences in components' contributions. Notably, a 0.3 percentage point growth contribution appears in 2020 from inventory accumulation, which was not yet present in last year's Programme. Export growth was revised down along the entire projection horizon. The growth contribution of net export was also lowered for 2019 and 2020, but it was increased for 2021. The 2019 Programme expects similar employment growth but a faster increase of labour compensation compared to the 2018 Programme.

The Programme expects higher GDP growth compared to the Commission 2019 spring forecast, especially for 2020. The main difference lies in the projection of private consumption. In the Commission forecast, labour market bottlenecks and capacity constraints could become more binding by 2020, limiting further employment gains and fuelling higher inflation. This may result in lower real disposable income growth and lower private consumption compared to the Programme.

Macroeconomic developments in 2018 were particularly benign for fiscal revenues, with major tax bases growing at a faster rate than projected by the 2018 Convergence Programme. That created a favourable base effect for the years ahead, which the Programme plans to use to a large extent to fund new expansionary measures.

The macroeconomic scenario of the Programme includes the effect of a recently announced "Competitiveness Programme", which includes a broad list of measures to be specified, adopted and implemented over the projection horizon. Notably, measures envisage to reduce the tax burden and ease tax administration as well as to improve employment, public services including health and education, and the business environment.[2] The Programme assumes that these will add approximately 3% to the level of real GDP by 2023. The Programme also expects the economy to be supported by new measures aimed at supporting home buying and fertility; they are estimated to add another 1% to the level of GDP by 2023.

The Programme even sees upside risks from the Competitiveness Programme beyond its effect in the baseline scenario. The Commission 2019 spring forecast also considered some, more moderate, upside risks, stemming from higher wage and consumption growth. Both projections agree that the international environment poses downside risk to the Hungarian economy.

The output gaps as recalculated by Commission based on the information in the Programme, following the commonly agreed methodology, are positive but narrowing throughout the horizon of the macroeconomic scenario. In 2018, the recalculated output gap is 3% which decreases to 1.3% by 2023 as estimated potential growth exceeds actual GDP growth over the projection period. Taken at face value, the Programme expects the output gap to remain near zero across the entire horizon. This is due to methodological differences; the Programme deviates from the commonly agreed methodology to take into account a medium-term financial cycle. The recalculated output gap is similar to the Commission 2019 spring forecast's output gap in 2018. However, the recalculated gap closes faster than the Commission forecast, because the Programme already takes into account expected future measures boosting potential output.

The Programme's macroeconomic assumptions are plausible for 2019. In the absence of detailed information on the Competitiveness Programme, the macroeconomic assumptions from 2020 onwards are markedly favourable.

3. Recent and planned budgetary developments

3.1. Deficit developments in 2018 and 2019

In 2018, the general government deficit remained unchanged at 2.2% of GDP while the economy grew substantially above its potential. In spite of tax cuts, including a further 2.5 percentage points reduction in employers' social security contribution rate, following the previous cut (by 5 percentage points) in 2017, tax revenues grew relatively fast thanks to the high growth of nominal income and consumption. New measures to improve tax compliance, introduced in July 2018, also bolstered VAT revenues. Higher-than-budgeted revenues were largely spent at the end of the year, mostly on current transfers targeting nurseries and schools, churches, sport facilities as well as Hungarian minorities abroad. Public investment accelerated further, increasing by 1.2% of GDP, thanks also to the increased absorption of EU funds, which increased by 0.6 percentage points, reaching 1.4% of GDP. As the output gap is

[2] The Government published its action plan on 27 February 2019 with illustrative calculations for the potential effects of the proposed measures. The Programme takes these calculations at face value in the macroeconomic scenario. This document is available at the link https://www.kormany.hu/download/7/91/91000/Program%20a%20Versenyképesebb%20Magyarországért.pdf#!DocumentBrowse

estimated to have increased significantly, the structural deficit is estimated to have increased to 3.7% of GDP in 2018, from 3.4% in 2017.

The 2018 general government deficit outcome of 2.2% of GDP remained below the target of 2.4% of GDP set in the 2018 Convergence Programme. Both revenues and expenditures turned out higher than planned in the 2018 Convergence Programme. On the revenue side, the target for both direct and indirect tax revenues was overachieved, and in the case of the latter by a high margin. On the expenditure side, capital transfers and, to a lesser extent, capital investment were lower than planned, partly offset by slippages in current expenditure.

For 2019, the Convergence Programme targets the headline deficit to decrease to 1.8% of GDP. The fiscal stance is expected to become mildly countercyclical, with the structural balance estimated to improve. EU fund absorption is planned to expand by 1% of GDP. Without EU funds, both total revenue and expenditure are expected to decrease as a share of GDP, with expenditure declining to a greater extent (by 1.1 and 0.6 percentage points, respectively). Tax revenues are expected to increase below nominal GDP, despite the projected robust, albeit moderating growth of the main tax bases. Tax revenues are negatively impacted by further tax cuts, such as the additional 2 percentage points cut in social security contributions and VAT reductions for selected items (i.e. poultry, milk, eggs, internet, restaurants and fish) and for newly built houses. The reduction in the headline deficit is mostly driven by the relatively modest growth of current expenditure, with the exception of intermediate consumption. In particular, social transfers and public wages are expected to increase moderately compared to the forecast high nominal GDP growth, and marginally above inflation. At the same time, the Convergence Programme expects dynamically growing public investment in 2019. This is due to both high absorption of EU funds (which is expected to peak in 2019) and nationally financed projects as well as loan and investment subsidies in the framework of the expenditure programme for villages in 2019 and the so-called ‘demography programme’, aimed at boosting fertility rates (estimated to add 0.1% of GDP to the deficit in 2019).

The 2019 deficit target remains the same as planned in the previous Convergence Programme. In nominal terms, both revenue and expenditure were revised upwards substantially, while the upward revision in capital expenditure net of EU funds was of a minor magnitude (although with some repositioning between investment and capital transfers). Therefore, the extra revenue due to the favourable base effect and a more optimistic macroeconomic scenario are planned to be fully spent, most notably on current expenditure.

3.2. MEDIUM-TERM STRATEGY AND TARGETS

Over the medium term, the Convergence Programme plans to gradually reduce the headline deficit to 1.2% in 2021, from 1.8% of GDP in 2019, and to reach a balanced budgetary position in 2023. The new MTO set in the Convergence Programme, a structural deficit of 1.0% of GDP as of 2020, reflects the objectives of the Stability and Growth Pact. According to the authorities and based on their alternative methodology to calculate the output gap, the planned reduction in the headline deficit would ensure that the MTO is achieved in 2022, with a structural deficit of 0.5% of GDP. In particular, the headline deficit path would be consistent with a gradual improvement of the structural deficit by an average of around to 0.3% of GDP per year over 2019-2021 and a sharp reduction in 2022-2023 when the structural deficit is expected to improve on average by 0.7% of GDP. However, according to the structural deficit as recalculated by the Commission[3], Hungary would be close to the MTO in 2022 and would overachieve it in 2023 only. The primary surplus is foreseen to continue improving from 0.6% of GDP in 2019 to 2.1% in 2023.

The Convergence Programme forecasts the headline general government balance improvement to be broadly the same as in its previous edition. The consolidation planned in the Programme is somewhat back-loaded, with a reduction in the headline deficit by 0.3% of GDP in 2019-2021 and a higher pace of consolidation, of 0.6% of GDP, targeted in the outer years (see Table 2). The medium-term fiscal strategy is driven by expenditure restraints, while helped by a projected robust GDP growth. The level of EU fund absorption is assumed to decline starting from 2020. However, the decreasing national co-financing costs are expected to be more than compensated by a higher level of nationally financed projects, thus not contributing significantly to the deficit reduction.

The budgetary targets in the Programme are based on a scenario including a limited number of specified consolidation measures. Most of the consolidation is expected to be achieved thanks to a projected contained evolution of most current expenditure items. In particular, compensation of employees, intermediate consumption and social payments are expected to grow at a rate which is below the relatively high projected nominal GDP growth rate. In addition, the Programme includes new expenditure measures with a substantial expansionary fiscal impact over the programme period (see below).

The Programme plans the total revenue-to-GDP ratio to decline from 44.6% in 2019 to slightly below 39.4% by 2023 (a reduction of 5.2 percentage points). Excluding the impact of EU funds, revenues are estimated to decrease by around 2.9 % of GDP in the same period, of which 1.7% of GDP in 2022-2023. The projected decline in revenue is explained by the impact of tax cuts linked to the reduction in the social security contributions tax rate. In addition, tax revenues, particularly indirect taxes, appear to be projected rather conservatively given the projected macroeconomic scenario. The expenditure-to-GDP ratio is set to fall significantly starting from 2020. Interest expenditure is set to decrease marginally (by 0.1 percentage point of GDP) every year, despite the very low interest environment and the decreasing path of the general government debt. On average, in the period 2020-2023, around ¾ of the decrease in total expenditure as a share of GDP is explained by lower compensation of employees, intermediate consumption and social transfers. Compensation of employees and intermediate consumption are planned in the Programme to grow well below nominal GDP growth, increasing even slower than inflation. The decrease of social payments relative to GDP reflects the impact of the 2009 parametric pension reform and nominal freezes of several cash benefits. However, the effect of spending restraints is planned to be partly offset by capital expenditure financed from national sources, which would rise dynamically throughout the Programme period even as a share of GDP.

Compared to 2018 Convergence Programme, the planned deficit trajectory did not change. Past deficit outcomes (including the 2018 deficit) turned out to be slightly lower than the targets set by earlier programmes (see Figure 1), with some differences in the revenue and expenditure components.

[3] 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 commonly agreed methodology.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2018	2019		2020		2021	2022	2023	Change: 2018-2023
	COM	COM	CP	COM	CP	CP	CP	CP	CP
Revenue	**44.2**	**44.6**	**44.6**	**44.0**	**43.3**	**41.9**	**40.2**	**39.4**	**-4.8**
of which:									
- Taxes on production and imports	18.3	18.2	18.2	18.1	18.0	17.8	17.4	17.2	-1.1
- Current taxes on income, wealth, etc.	6.9	7.0	6.9	7.0	7.0	7.1	7.2	7.3	0.4
- Social contributions	12.2	12.0	12.0	11.8	11.7	11.4	11.0	10.7	-1.5
- Other (residual)	6.8	7.5	7.5	7.1	6.6	5.6	4.6	4.2	-2.6
Expenditure	**46.5**	**46.4**	**46.4**	**45.6**	**44.8**	**43.1**	40.7	**39.4**	**-7.1**
of which:									
- Primary expenditure	43.9	44.0	43.9	43.2	42.4	40.9	38.5	37.3	-6.6
of which:									
Compensation of employees+Intermediate	17.7	17.3	17.6	17.3	16.7	15.9	15.1	14.5	-3.2
Compensation of employees	10.5	10.1	10.1	9.9	9.8	9.3	8.9	8.5	-2.0
Intermediate consumption	7.1	7.3	7.5	7.3	6.9	6.6	6.3	6.0	-1.1
Social payments	13.5	12.9	12.8	12.6	12.5	12.2	11.8	11.4	-2.1
Subsidies	1.3	1.2	1.2	1.2	1.3	1.4	1.1	1.1	-0.2
Gross fixed capital formation	5.8	6.7	6.8	6.2	6.3	6.1	4.8	4.9	-0.9
Other (residual)	5.8	5.9	5.5	6.0	5.7	5.3	3.3	3.1	-2.7
- Interest expenditure	2.5	2.4	2.5	2.4	2.4	2.2	2.2	2.1	-0.4
General government balance (GGB)	**-2.2**	**-1.8**	**-1.8**	**-1.6**	**-1.5**	**-1.2**	**-0.5**	**0.0**	**2.2**
Primary balance	**0.3**	**0.7**	**0.6**	**0.8**	**0.8**	**1.0**	**1.7**	**2.1**	**1.8**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-2.2**	**-1.8**	**-1.8**	**-1.6**	**-1.5**	**-1.2**	**-0.5**	**0.0**	**2.2**
Output gap[1]	3.3	3.3	2.5	2.5	2.1	1.6	1.3	1.0	-2.3
Cyclically-adjusted balance[1]	-3.7	-3.3	-3.0	-2.7	-2.5	-1.9	-1.1	-0.4	3.3
Structural balance[2]	**-3.7**	**-3.3**	**-3.0**	**-2.7**	**-2.5**	**-1.9**	**-1.1**	**-0.4**	**3.3**
Structural primary balance[2]	-1.2	-0.9	-0.5	-0.4	-0.1	0.3	1.1	1.7	2.8

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 2019 spring forecasts (COM); Commission calculations.

The Commission 2019 spring forecast projects a government deficit at 1.8% of GDP for 2019, which is in line with the projection of the authorities. Total current revenue planned by the authorities as a share of GDP is marginally lower than in the Commission forecast (difference of 0.1 percentage point). The main difference between the Commission forecast and the authorities' forecast lies in the composition of current expenditure, with the Commission expecting lower intermediate consumption compensated by higher other current expenditure than the authorities. For 2020, the deficit target of 1.5% of GDP set by the authorities is marginally lower than in the Commission forecast. As a share of GDP, the authorities project lower expenditure by 0.8% of GDP compared to the Commission forecast. The difference is mainly explained by lower intermediate consumption and other current expenditure in the authorities' projections, while the authorities include a higher fiscal impact of the "Családi Otthonteremtési Kedvezmény" (Family Allowance for Home Building, CSOK) programme included under the 'demography programme', assuming a higher uptake of the subsidies than in the Commission forecast. In 2019-2020, the cumulated impact of the CSOK programme is estimated to increase the deficit by 0.3% of GDP in the Convergence Programme compared to 0.1% of GDP in the Commission assessment. The lower expenditure projections by the authorities are, however, compensated by lower current revenue and lower EU funds by around 0.7% of GDP compared to the Commission's projections.

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

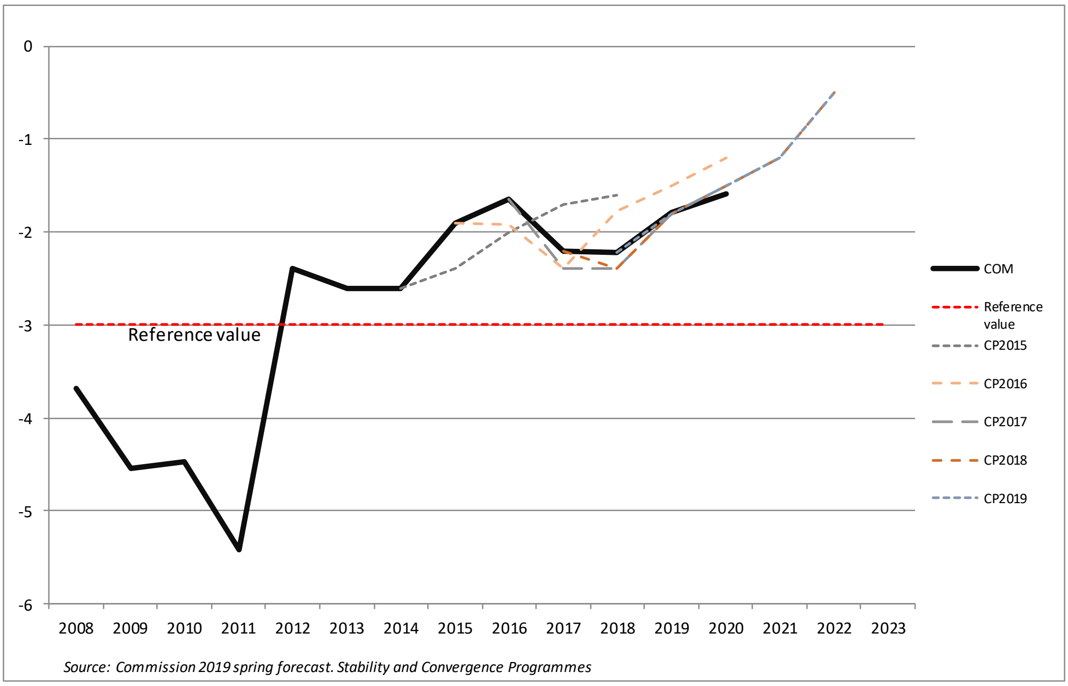
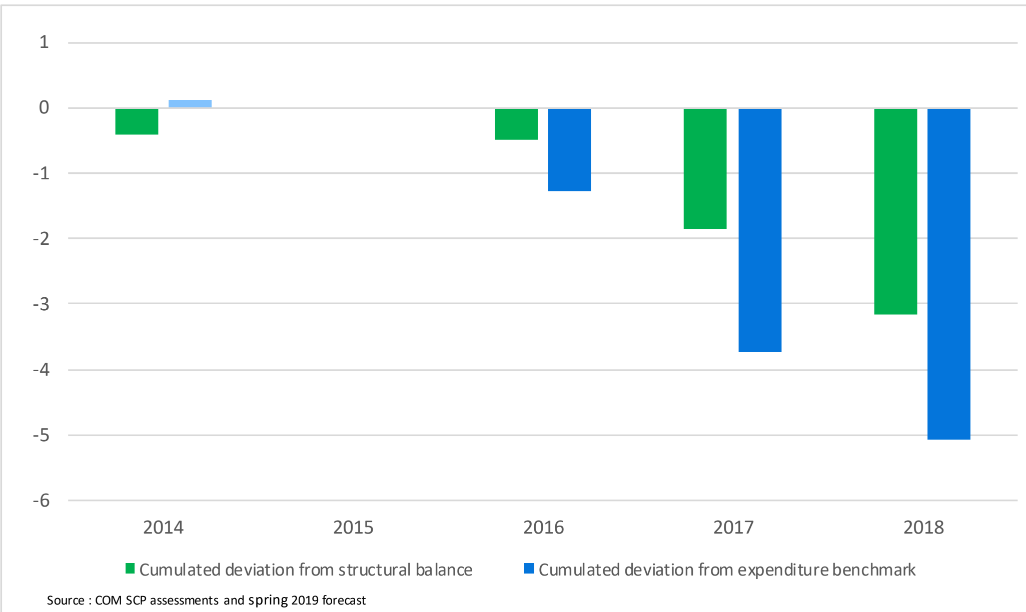


Figure 2: Cumulative deviations of the preceding five years from the upper limit for net growth of government expenditure and from structural effort requirements (in % of GDP)



Since Hungary entered the preventive arm of the SGP in 2013, it has registered deviations from the required adjustment on the basis of the structural balance and/or the expenditure benchmark every year.

In 2017, Hungary was recommended to maintain its structural deficit position vis-à-vis 2016 and to ensure an annual structural adjustment of 1.0% of GDP towards the MTO in 2018. However, in both years, the structural balance deteriorated significantly, by an average of 0.8% of GDP each year, thus deviating from the recommended effort by around 1.4% of GDP each year. Therefore, the cumulative deviation over 2017-2018 has increased substantially, reaching 3.6 percentage points of GDP in 2018. The expenditure benchmark pointed to an even higher deviation in both years, in addition to the deviations cumulated in the period 2014-2016 (which averaged at around 1.4% of GDP each year). In 2017 and 2018, expenditure growth deviated from the expenditure benchmark by more than 2% of GDP each year. The structural balance was negatively impacted by investment volatility in both years, while the volatility of revenue (with windfalls in 2017 and shortfalls in 2018 of almost the same magnitude) had a neutral effect on this indicator. The expenditure benchmark, which provides a more negative picture in both 2017 and 2018, was negatively impacted by both the medium-term rate of potential growth and the deflator underlying its calculation.

Overall, over the past 5 years, the structural balance has not progressed towards the MTO and it has deviated further in 2017-2018. Hungary would already have reached its MTO, if it had implemented the repeated recommendations of the Council in this respect. As regards the evolution of the expenditure benchmark, this indicator has been more stringent in recent years than the structural balance requirement for Hungary, mostly because of the lower underlying medium-term potential growth rate underlying its calculation. This has led to an increasing divergence between the cumulative deviation from the requirements for the two pillars in 2017-2018.

3.3. MEASURES UNDERPINNING THE PROGRAMME

On the revenue side, the updated budgetary plans for 2019 incorporate measures with an estimated overall deficit-increasing effect amounting to around 0.4% of GDP. In particular, the revenue-reducing measures include: (i) a 2 percentage-point reduction of the employer social security contribution rate from 19.5% to 17.5% from July 2019; and (ii) an increase in family tax allowance in the case of two children; (iii) some changes in corporate taxation (group taxation, incentives for investment); (iv) the increase in the threshold for small businesses' tax (KIVA); (iv) the reduction of the bank levy and of financial transaction duty for households. These measures are only partly compensated by increases in road tolls. The Programme also mentions measures aimed at increasing the efficiency of tax collection, without quantifying their impact. Beyond 2019, the Programme entails further employer social security contribution cuts in consecutive steps, involving additional 2 percentage-point rate reduction in each phase, with an estimated cumulative impact at around 2.2% of GDP on revenues.

On the expenditure side, the Convergence Programme includes measures with an estimated deficit-increasing impact of around 0.2% of GDP. The main maeasures include: (i) the ongoing and planned pay raises in the public sector; (ii) the "growth premium" for pensioners (one-off payments linked to economic growth); (iii) extra spending related to the so called 'demography programme', including expanding subsidies for home building. Regarding the wage bill, the pay increases in 2019 under the ongoing career-path schemes are expected to be partly offset by wage restraint in other branches of general government. As the impact of the selective schemes fades, the growth of the public wage bill is set to slow down, even below inflation as of 2019. Additional budgetary savings are projected due to the planned reduction of participants in public works scheme.

The Programme makes reference to the recently adopted medium-term "Competitiveness Programme" which aims to boost the long-term growth potential through structural measures in the areas of taxation, labour market, public services and the business environment. Based on that, the government published an action plan on 27 February which proposes measures in over 40 wide-ranging areas to boost economic competitiveness.[4] Many of these are not yet concrete, quantifiable measures but proposals for future action to achieve policy goals. Nonetheless, this document also contains illustrative calculations for the costs and macroeconomic effects of the entire package of measures. The budgetary cost estimated by the authorities amounts to approximately 1% of GDP annually between 2020 and 2023; however, taking into account second-round effects the measures are argued to have a net deficit-reducing impact by 2023. The 2019 Convergence Programme takes these calculations at face value in its macroeconomic and budgetary projections. In the absence of more detailed information on the proposed measures, these calculations cannot be assessed at this point.

Overall, measures underpinning the planned deficit reduction after 2019 are not spelled out in sufficient detail.

Main budgetary measures

Revenue	**Expenditure**
2018	
• Further cut of employer social security contributions to 19.5% (-0.7% of GDP) • Additional selective VAT rate cuts on internet services, restaurant services, fish, edible offal of swine, Braille-displays and printers (-0.2% of GDP) • Decrease of VAT rate to 5% on new built houses and on pork (-0.1% of GDP) • Other smaller tax measures, including the third step in increasing family allowances after two children (-0.1% of GDP) • Further increases in the efficiency of tax collection (+0.4% of GDP)	• Gross wage bill: the effect of a further employer social security contribution cut (-0.2% of GDP) • Gross wage bill: the effect of career paths/selective pay rises, minimum wage increases and offsetting wage restraints in other branches (+0.4% of GDP) • One-year extra benefit and "growth premium" for pensioners (+0.15% 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 17.5% as of 1st July (-0.3% of GDP) • Increase in road tolls (+0.1% of GDP) • Other measures, including: social security contribution exemption of retired employees; the final step in increasing family allowances after two children; exemption of retail government bonds from interest tax and reduction of financial	• Gross wage bill: the effect of a further employer social security contribution cut (-0.1% of GDP) • Gross wage bill: effect of career paths/selective wage increases and offsetting wage restraints in other branches (-0.05% of GDP) • One-year "growth premium" for pensioners (+0.05% of GDP) • Demography programme, including the allowance

[4] The document is available at the link https://www.kormany.hu/download/7/91/91000/Program%20a%20Versenyképesebb%20Magyarországért.pdf#!DocumentBrowse

Revenue	Expenditure
transaction duty for households; increase in the threshold for KIVA; reduction of the bank levy; changes to corporate taxation (-0.2% of GDP)	for home building (+0.3% 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 15.5% as of 1st July (-0.5% of GDP) • Personal income tax exemption for women with 4 children (-0.1% of GDP) • Increase in road tolls (+0.1% of GDP) • Other smaller tax measures, including the phasing out of VAT reduction on newly built houses and the increase in excise duty for tobacco products (+0.1% of GDP)	• Gross wage bill: the effect of the reduced employer social security contribution (-0.15% of GDP) • Gross wage bill: effect of career paths/selective wage increases and offsetting wage restraints in other branches of the public sector (-0.05% of GDP) • Demography programme, including the allowance for home building (+0.6% of GDP) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
2021	
• Full year effect and further cut of employer social security contribution to 13.5% as of 1st July (-0.5% of GDP)	• Gross wage bill: the effect of the reduced employer social security contribution (-0.15% of GDP) • Gross wage bill: effect of career paths/selective wage increases and offsetting wage restraints in other branches of the public sector (-0.2% of GDP) • Demography programme, including the allowance for home building (-0.2% of GDP) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
2022	
• Full year effect and further cut of employer social security contribution to 11.5% as of 1st October (-0.7% of GDP)	• Gross wage bill: the effect of the reduced employer social security contribution (-0.1% of GDP) • Gross wage bill: effect of career paths/selective wage increases and offsetting wage restraints in other branches of the public sector (-0.2% of GDP) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
2023	
• Full year effect and further cut of employer social security contribution to 9.5% as of 1st October (-0.5% of GDP)	• Gross wage bill: the effect of the reduced employer social security contribution (-0.1% of GDP) • Gross wage bill: effect of career paths/selective wage increases and offsetting wage restraints in other branches of the public sector (-0.2% of GDP) • Demography programme, including the allowance for home building (-0.1% of GDP)
Note: The table refers to the main measures included in the 2019 Convergence Programme that have an incremental budgetary impact over the programme period. 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 2018, the general government debt-to-GDP ratio decreased to 70.8% of GDP from 73.4% in 2017, mainly driven by the high nominal GDP growth. This debt level is well below the target set in the 2018 Convergence Programme (73.2% of GDP), also thanks to the higher-than-expected nominal economic growth. The sizeable debt-increasing stock-flow-adjustment effect turned out lower than anticipated in the 2018 Convergence Programme thanks to an improvement in liquidity management. However, higher cash holdings at the end of the year added to the debt level.

The Convergence Programme projects a decrease of the debt ratio as a share of GDP, which is expected to fall below 60% by the end of 2022 and to reach 55.9% of GDP in 2023. On average, this corresponds to an annual reduction of 3 percentage points of GDP over the forecast horizon, with a stronger decline in the 2021-2023 period.

The decline in the debt-to-GDP ratio continues to be strongly supported by a favourable snowball effect, although to a declining extent over the forecast horizon. This is due to a projected high nominal GDP growth and continuing decreases in interest spending. The improvement in the primary balance is also increasingly contributing to the debt-reduction path. The stock-flow adjustment is foreseen to be unfavourable over the Programme period. In particular, a sizable debt-increasing stock-flow adjustment is projected for 2019, on account of advances of EU funds. In 2020, the stock-flow adjustment is expected to remain unfavourable but to a lesser extent. Projected stock-flow adjustments have overall a neutral effect during the remaining years of the Programme period.

Compared to the previous plan, the pace of reduction of the debt-to-GDP ratio has slowed down. The 2018 debt was 2.4 percentage points lower than planned in the previous Programme. Nevertheless, the target for 2022 has only marginally changed. This is mainly explained by a lower reduction of the debt ratio in 2019 due to a higher stock-flow adjustment in that year compared to the previous programme. In the remaining years, the average pace of reduction has remained unchanged.

The Commission 2019 spring forecast projects a similar debt-to-GDP ratio for 2019 compared to the Convergence Programme. The debt is forecast to further decrease to 67.7% of GDP by 2020, decreasing at a slower pace compared to the Convergence Programme, reflecting a lower nominal GDP growth and a somewhat higher debt-increasing stock-flow adjustment.

Table 3: Debt developments

(% of GDP)	Average 2013-2017	2018	2019		2020		2021	2022	2023
			COM	CP	COM	CP	CP	CP	CP
Gross debt ratio[1]	**76.0**	**70.8**	**69.2**	**69.2**	**67.7**	**66.7**	**62.8**	**59.3**	**55.9**
Change in the ratio	-1.0	-2.6	-1.6	-1.6	-1.5	-2.5	-3.9	-3.5	-3.4
Contributions [2] *:*									
1. Primary balance	**-1.4**	**-0.3**	**-0.7**	**-0.6**	**-0.8**	**-0.8**	**-1.0**	**-1.7**	**-2.1**
2. "Snow-ball" effect	**-0.6**	**-3.8**	**-2.6**	**-2.7**	**-1.6**	**-2.3**	**-2.2**	**-2.0**	**-1.8**
Of which:									
Interest expenditure	3.6	2.5	2.4	2.5	2.4	2.5	2.2	2.2	2.1
Growth effect	-2.4	-3.3	-2.5	-2.6	-1.8	-2.6	-2.6	-2.5	-2.2
Inflation effect	-1.9	-3.0	-2.6	-2.5	-2.2	-2.0	-1.9	-1.7	-1.7
3. Stock-flow adjustment	**1.1**	**1.7**	**1.8**	**1.8**	**1.0**	**0.7**	**-0.7**	**0.3**	**0.5**

Notes:

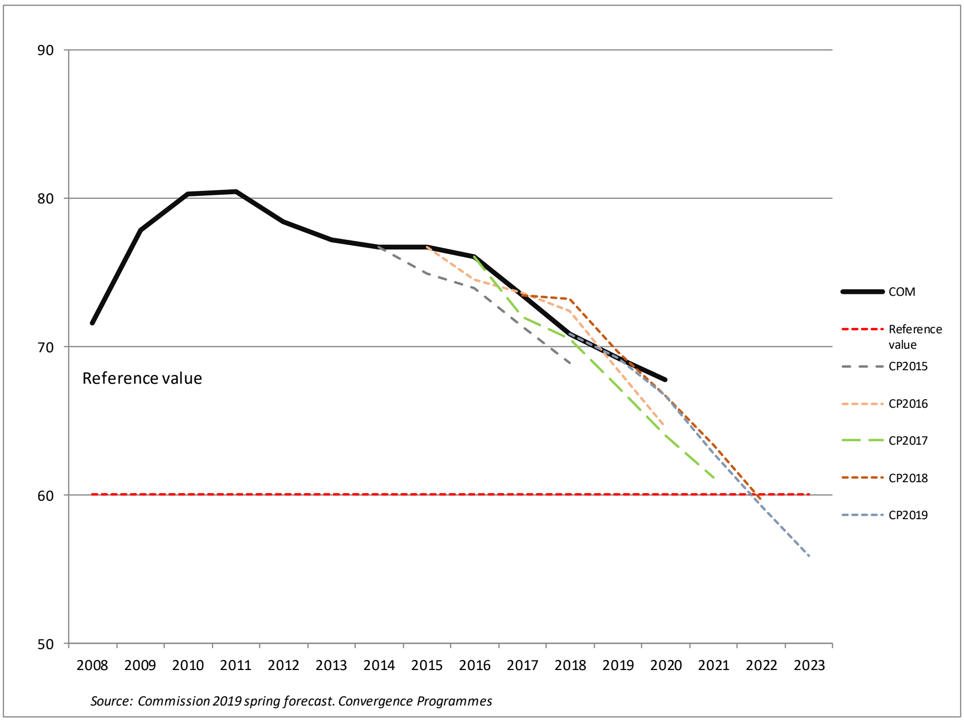
[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Commission 2019 spring forecast (COM); Convergence Programme (CP), Comission calculations.

Figure 3: Government debt projections in successive programmes (% of GDP)



3.5. RISK ASSESSMENT

The budgetary risks linked to the macroeconomic scenario of the Programme are on the downside pointing to potentially higher-than-planned deficit outcomes. The assumed growth potential of the economy underpinning official plans exceeds the Commission's potential growth estimate. In light of this, GDP growth may turn out lower than expected, resulting in an increasing deficit gap due to an accumulating shortfall of revenues while the level of expenditure is assumed to be largely unaffected.

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 percentage points 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. As each step involves an estimated annual budgetary cost of some 0.45% of GDP, it can provide a non-negligible buffer, if cuts scheduled to start in the second half of 2020 are postponed because the agreed condition is not met yet. 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 additional spending (less than 0.1% of GDP).

Regarding measures other than the macro-conditional ones discussed above, significant deficit-increasing risks appear related to the expenditure side. The take up of the pre-natal loan under the 'demography programme' can only be assessed with great uncertainty, especially after 2020. There are risks that the take up could be higher than planned and moral hazard issues could also pose a risk for the government debt. The planned spending restraints are exposed to significant implementation risks related to the planned subdued wage increases in the public sector amid the projected fast growth of real wages in the private sector. In addition, over the last three years, significant non-recurrent spending appeared towards the end of the year, in the form of current and capital transfers, as a way of using the fiscal buffer cumulated in the previous months due to under-budgeted revenues. In 2019, the risk of additional non-recurrent spending is also exacerbated by local elections. Looking ahead, the planned construction of the Paks-2 nuclear power plant, which has been already subject to some delays, is an additional source of expenditure-related risks.

On the other hand, some elements could turn out better than expected for the headline deficit. Expenditure related to the take-up of housing subsidies in villages could be lower than anticipated, as demand seems limited so far and the group of potential beneficiaries partially overlaps with the target group of the pre-natal loan. On the revenue side, revenue projections in recent years were somewhat cautious, leading to significant under-budgeted revenue ex-post. This, together with higher-than-targeted yields from improved efficiency of tax collection, represent a positive risk, since previous steps in this area generated considerable extra receipts and the Programme confirms the continuation of efforts in this direction.

Overall, while risks related to the fiscal targets seem balanced, there could be substantial differences in the components of government revenue and expenditure relative to those presented in the Convergence Programme, especially towards the end of the Programme period.

The risks to the planned debt trajectory are largely similar to those affecting 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 23% of government debt is denominated in foreign currency. However, the proportion of debt held in foreign currency is planned to be reduced further, resulting in a progressively diminishing exposure to exchange rate risks, at the expenses of a higher implicit interest rate. 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 a slower debt reduction than anticipated. Finally, in the medium-to-long term, debt could be subject to risks linked to potential issues linked to the 'demography programme' (see above).

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

Box 1. Council Recommendations addressed to Hungary

On 22 June 2018, the Council decided in accordance with Article 121(4) of the Treaty that a significant observed deviation from the adjustment path toward the medium-term budgetary objective occurred in Hungary and issued a recommendation for Hungary to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 2.8% in 2018, corresponding to an annual structural adjustment of 1.0% of GDP.

On 13 July 2018, 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 "ensure compliance with the Council recommendation of 18 June 2018 with a view to correcting the significant deviation from the adjustment path towards the medium-term objective." The Council recommended to Hungary to "ensure that the nominal growth rate of net primary government expenditure does not exceed 3.9% in 2019, corresponding to an annual structural adjustment of 0.75% of GDP."

On 4 December 2018, the Council found that Hungary had not taken effective action in response to the 22 June recommendation and issued a revised recommendation. In the new recommendation the Council asked Hungary to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 3.3% in 2019, corresponding to an annual structural adjustment of 1.0% of GDP. It recommended Hungary to use any windfall gains for reduction of its deficit, while budgetary consolidation measures should ensure a lasting improvement in the general government structural balance in a growth-friendly manner. The Council established a deadline of 15 April 2019 for Hungary to report on the action taken in response to the recommendation.

4.1. Compliance with the debt criterion

As the debt ratio exceeds the 60% of GDP reference value, Hungary is subject to the debt reduction benchmark of the Stability and Growth Pact.

Table 4: Compliance with the debt criterion

	2018	2019		2020		2021	2022
		CP	COM	CP	COM	CP	CP
Gross debt ratio	**71**	**69.2**	**69.2**	**66.7**	**67.7**	**62.8**	**59.3**
Gap to the debt benchmark [1,2]	-3.0	-5.2	-2.8	-6.2	-2.3		
Structural adjustment [3]	-0.3	0.6	0.4	0.5	0.6	0.5	0.8

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] 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.

[3] Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

Source:
Commission 2019 spring forecast (COM); Convergence Programme (CP), Comission calculations.

In 2018, 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 is compliant with the debt criterion in 2018.

According to information provided in the Convergence Programme, Hungary is expected to meet the debt reduction benchmark in 2019 and 2020, 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 2019 spring forecast for 2019 and under a no-policy-change scenario for 2020.

4.2. Compliance with the MTO or the required adjustment path towards the MTO

Hungary's MTO is defined as a deficit of 1.5% of GDP in structural terms until 2019. According to the Convergence Programme, it is to become more demanding as of 2020, set as a deficit of 1.0% of GDP in structural terms.

Adjustment towards the MTO

On 22 June 2018, the Council issued a recommendation for Hungary to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 2.8% in 2018, corresponding to an annual structural adjustment of 1.0% of GDP.

In 2018, the growth rate of net primary government expenditure (at 6.3%) was well above the expenditure benchmark, pointing to a significant deviation (deviation of 1.3% of GDP). In parallel, the structural balance deteriorated to -3.7% of GDP from a position of -3.4% of GDP in 2017, also pointing to a significant deviation from the recommended structural adjustment (deviation of 1.3% of GDP). The size of the deviation indicated by the structural balance is negatively influenced by substantial revenue shortfalls and higher investment expenditure amidst an overheating economy, while it is estimated to have marginally benefitted from falling interest expenditure. The expenditure benchmark is strongly negatively impacted by the medium-term potential GDP growth applied in its calculation, which includes the very low potential GDP growth rates in the aftermath of the crisis. It therefore appears more appropriate to consider as a benchmark for growth of net primary expenditure the medium-term potential GDP growth rate of 2.4% arising from the Commission 2019 spring forecast for the same reference period (2012-2021), instead of the benchmark of 1.8%. In addition, the GDP deflator underlying the expenditure benchmark does not seem to account properly for the increased cost pressures affecting government spending. After adjusting for these factors, the expenditure benchmark appears to adequately reflect the fiscal effort and still points to a significant deviation. Therefore, the overall assessment confirms a significant deviation from the recommended adjustment path towards the MTO in 2018. This assessment is also in line with the earlier conclusion of 4 December 2018, in which the Council found that Hungary had not taken effective action in response to the Council recommendation of 22 June 2018 and issued a revised recommendation.

Based on this, on 5 June 2019, the Commission issued a warning to Hungary and recommendation for a Council recommendation in accordance with Article 121(4) TFEU and Article 10(2) of Regulation (EC) No 1466/97, with a view to correcting the significant observed deviation from the adjustment path towards the medium-term budgetary objective[5]. It includes fiscal requirements for 2019 and 2020. The delivery of effective action under the SDP requires compliance with the required adjustment, based on an economic reading of the two pillars. However, there is no notion of broad compliance with recommendations under an SDP.

In 2019, on the basis of the Convergence Programme, both pillars point to a risk of a deviation from the required adjustment. The growth of net primary expenditure is projected to be well above the recommended reference rate in 2019 (deviation of 1.2% of GDP). The structural balance is estimated to improve by 0.6% of GDP, falling short of the recommended adjustment (deviation of 0.4%). Therefore, according to the information provided in the Convergence Programme, both pillars point to a risk of a deviation from the required adjustment. The assessment based on the Commission 2019 spring forecast leads to a similar conclusion, although pointing to a higher deviation on the basis of the strcutural balance. The growth of net primary expenditure is projected to be well above the recommended reference rate in 2019 (deviation of 1.2% of GDP). The structural balance is estimated to improve by 0.4% of GDP, to -3.3% of GDP, falling short of the recommended adjustment (deviation of 0.6%). Therefore, both pillars point to a risk of a deviation from the recommended adjustment. The structural balance is negatively influenced by some revenue shortfalls. The expenditure benchmark is negatively impacted by both the lower medium-term average potential GDP growth and GDP deflator underlying this indicator. After adjusting for these factors, the expenditure benchmark appears to adequately reflect the fiscal effort and still points to a deviation. Taking this into account, the overall assessment confirms the risk of a deviation from the recommended adjustment.

In 2020, on the basis of the Convergence Programme, both pillars point to a risk of a deviation from the required adjustment. The growth of net primary expenditure is projected to be well above the recommended reference rate in 2020 (deviation of 1.1% of GDP). The structural balance is estimated to improve by 0.5% of GDP, but falling short of the recommended adjustment (deviation of 0.3%). Therefore, according to the information provided in the Convergence Programme, both pillars point to a risk of a deviation from the

[5] For more information, see the Comission Staff Working Document accompanying the Recommendation for a Council Decision establishing that no effective action has been taken by Hungary in response to the Council Recommendation of 4 December 2018 and the Recommendation for a Council Recommendation with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Hungary.

required adjustment in 2020. The assessment based on the Commission 2019 spring forecast has a similar implication for 2020. The growth of net primary expenditure is projected to be well above the recommended reference rate in 2020 (deviation of 1.0% of GDP). The structural balance is estimated to improve by 0.6% of GDP, but falling short of the recommended adjustment (deviation of 0.2%). With the deviation of the structural balance positively impacted by lower expenditure on public investment, the expenditure benchmark pillar appears to better reflect the fiscal effort. Therefore, according to the Commission 2019 spring forecast, there is a risk of a deviation from the recommended adjustment in 2020.

To conclude, based on the outturn data and the Commission 2019 spring forecast, the ex-post assessment suggests a significant deviation from the adjustment path towards the MTO in 2018. Following an overall assessment, there is a risk of deviation from the requirements under the SDP in 2019 and 2020. This entails a risk of a significant deviation from the adjustment path towards the MTO in 2019 and in 2020, putting at risk the compliance with the requirements of the preventive arm of the Pact.

Table 5: Compliance with the requirements under the preventive arm

(% of GDP)	2018	2019		2020	
Background budgetary indicators[1]					
Medium-term objective (MTO)	-1.5	-1.5		-1.0	
Structural balance[2] (COM)	-3.7	-3.3		-2.7	
Setting the required adjustment to the MTO					
Structural balance based on freezing (COM)	-3.6	-3.3		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
Required adjustment[4]	1.0	1.0		0.75	
Required adjustment corrected[5]	1.0	1.0		0.75	
Corresponding expenditure benchmark[6]	2.8	3.3		4.7	
Compliance with the required adjustment to the MTO					
	COM	**CP**	**COM**	**CP**	**COM**
Structural balance pillar					
Change in structural balance[7]	-0.3	0.6	0.4	0.5	0.6
One-year deviation from the required adjustment[8]	-1.3	-0.4	-0.6	-0.3	-0.2
Two-year average deviation from the required adjustment[8]	-1.3	-0.9	-0.9	-0.3	-0.4
Expenditure benchmark pillar					
Net public expenditure annual growth corrected for one-offs[9]	6.3	6.5	6.5	7.7	7.3
One-year deviation adjusted for one-offs[10]	-1.3	-1.2	-1.2	-1.1	-1.0
Two-year deviation adjusted for one-offs[10]	-1.9	-1.3	-1.3	-1.1	-1.1
Finding of the overall assessment	**Significant deviation**	**Deviation**	**Deviation**	**Deviation**	**Deviation**

Legend

'*Compliance*' - the recommended structural adjustment or a higher adjustment is being observed.

'*Some deviation*' - a deviation from the recommended structural adjustment is being observed, but it is below the threshold for a significant deviation.

'*Significant deviation*' - a deviation which has reached or breached the threshold for a significant deviation (i.e. 0.5% of GDP over one year, 0.25% of GDP over two years on average).

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.). In case of a SDP, the requirement corresponds to the Council recommendation when available, otherwise it refers to the Commission recommendation to the Council.

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

[6] 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.

[7] Change in the structural balance compared to year t-1. Ex post assessment (for 20XX-1) is carried out on the basis of Commission 20XX spring forecast.

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

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

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Convergence Programme (CP); Commission 2019 spring forecast (COM); Commission calculations.

5. DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS

Hungary does not appear to face fiscal sustainability risks in the short run. Nonetheless, there are some indications that the fiscal side of the economy poses potential challenges.[6]

Based on the Commission 2019 spring forecast and a no-fiscal policy change scenario beyond the forecast horizon, government debt, projected at 69.2% of GDP in 2019, is expected to decrease to 63.8% in 2029, thus remaining above the 60% of GDP Treaty threshold. Over this horizon, government debt is projected to decline until 2027 and stabilise thereafter. Sensitivity analysis shows similar risks.[7] Overall, this debt sustainability analysis highlights medium risks for the country in the medium term. The full implementation of the Convergence Programme would put debt on a more clearly decreasing path by 2029, leading to a debt ratio below the 60% of GDP reference value in 2029.

The medium-term fiscal sustainability risk indicator S1[8] is at 0.5 percentage points of GDP, primarily related to the high level of government debt, contributing 0.6% of GDP. This indicator thus signals medium risks in the medium term. The full implementation of the Convergence Programme would put the sustainability risk indicator S1 at -3.0 percentage points of GDP. Based on the debt sustainability analysis and the S1 indicator, overall medium-term fiscal sustainability risks are, therefore, medium. Fully implementing the fiscal plans in the Convergence Programme would decrease those risks.

The long-term fiscal sustainability risk indicator S2 is at 3.9 percentage points of GDP. In the long term, Hungary therefore appears to face medium fiscal sustainability risks, primarily related to the projected ageing costs, contributing 2.7% of GDP. Full implementation of the programme would put the S2 indicator at 1.9 percentage points of GDP, leading to a lower long-term risk.[9] The debt sustainability analysis discussed above points to medium risks so that, overall, long-term fiscal sustainability risks are assessed as medium for Hungary.

[6] This conclusion is based on the short-term fiscal sustainability risk indicator S0. See the note to Table 7 for a definition of the indicator.

[7] Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Fiscal Sustainability Report 2018 for more details).

[8] See the note to Table 7 for a definition of the indicator.

[9] The projected costs of ageing that are used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the projections of the 2018 Ageing Report.

Table 6: Debt sustainability analysis and sustainability indicators

Time horizon			Commission Scenario		Stability / Convergence Programme Scenario	
Short-term			**LOW risk**			
S0 indicator [1]			0.3			
Fiscal subindex			0.5	HIGH risk		
Financial & competitiveness subindex			0.2	LOW risk		
Medium-term			**MEDIUM risk**			
DSA [2]			MEDIUM risk			
S1 indicator [3]			0.5	MEDIUM risk	-3.0	LOW risk
of which	Initial Budgetary Position		0.1		-2.4	
	Debt Requirement		0.6		-0.4	
	Cost of Ageing		-0.2		-0.2	
	of which	Pensions	-0.4		-0.3	
		Health care	0.2		0.2	
		Long-term care	0.1		0.0	
		Other	-0.1		0.0	
Long-term			**MEDIUM risk**			
DSA [2]			MEDIUM risk			
S2 indicator [4]			3.9	MEDIUM risk	1.9	LOW risk
of which	Initial Budgetary Position		1.2		-0.9	
	Cost of Ageing		2.7		2.8	
	of which	Pensions	1.5		1.7	
		Health care	0.6		0.5	
		Long-term care	0.3		0.3	
		Other	0.3		0.3	

Source: Commission services; 2019 stability/convergence programme.

Note: the 'Commission' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2019 forecast until 2020. 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 2018 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 2033. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2021 for Commission 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 2018.

6. FISCAL FRAMEWORK

Based on the 2018 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 somewhat differs from the Maastricht concept. Nonetheless, following the decline by 2.6 percentage points in the Maastricht debt ratio in 2018, it can be concluded that the prescribed reduction had indeed taken place. The escape clause defined for the debt reduction formula was invoked again for 2018 (third time in a row), which led to a requirement to achieve at least a 0.1% of GDP reduction in the adjusted debt-to-GDP ratio.[10] The Convergence Programme envisages a progressively decreasing path with a reduction in the debt ratio by almost 15 percentage points between 2018 and 2023. Therefore, the official plans are in line with the requirements of the domestic debt rules.

As to the nominal budget balance rule (prescribing conformity with the 3% of GDP reference value), the 2018 budgetary developments complied with this rule. Based on the headline deficit targets for the years 2019-2023 contained in the Convergence Programme, the 3% of GDP threshold is planned to be respected with an increasing margin. However, the structural budget balance rule (prescribing conformity with the MTO in each year) was again breached in 2018 both ex ante and ex post, for the third year in a row. The adopted budget for that year was based on a structural deficit of 2.1% of GDP as estimated by the authorities, well above the country's MTO. The ex-post breach is estimated to be higher despite the overachievement of the headline deficit target. Moreover, the fiscal plan for 2019-2021, as reported in the Convergence Programme, breaches the structural balance rule again, as – according to the calculations of the government – the planned structural deficit is estimated to be above the applicable MTO. These figures are worse than the estimates included in the previous Programme. Looking ahead, the structural balance trajectory set in the Programme will comply with the domestic requirement in 2022 and 2023, taking the plans at a face value as estimated by the authorities. As also reported in the Programme, the Fiscal Council was explicitly mandated in 2018 to prepare an ex-post assessment for all domestic rules, and the first of such compliance report is expected to be published in the context of the forthcoming budgetary season.

Based on the information provided in the Convergence Programme and in budget documents, the past and planned fiscal performance in Hungary appears to comply only partially with the requirements of the national fiscal rules. The Fiscal Council has not been involved in the endorsement or assessment of the macroeconomic scenario underpinning the Programme.

7. SUMMARY

In 2018, Hungary further deviated from the adjustment path towards the MTO. The structural balance deteriorated by 0.3% of GDP, thus deviating by 1.3% of GDP from the required adjustment towards the MTO requested by the Council recommendation under the SDP.

[10] The escape clause stipulates that if one of the official growth and inflation projection for year t+1 as included in the draft budget bill for t+1 does not exceed 3%, the rule is suspended for that year. Also in the light of the 3% middle rate defined for the central bank's inflation target, the design of this escape clause is loose, which is further demonstrated by the fact that the debt reduction formula has so far never become binding since its entry of force in 2015.

Similarly, the growth rate of government expenditure, net of discretionary revenue measures, exceeded the applicable expenditure benchmark rate by 1.3% of GDP. Following an overall assessment, this points to a significant deviation from the recommended adjustment path towards the MTO requested by the Council recommendation under the SDP.

Hungary plans a growth rate of government expenditure, net of discretionary revenue measures, which is not in line with the applicable expenditure benchmark rate in both 2019 and 2020. Hungary also plans an improvement of the structural balance of 0.6% and 0.5% of GDP respectively in 2019 and 2020. This path implies a deviation of 0.4% and 0.3% of GDP on the basis of the structural balance from the required adjustment path towards the MTO in 2019 and 2020. The expenditure benchmark is expected to deviate in both years by, respectively, 1.2% and 1.1% of GDP. The Commission 2019 spring forecast confirms the risk of deviation both in 2019 and 2020, following an overall assessment. At the same time, according to both the information provided in the Convergence Programme and the Commission 2019 spring forecast, compliance with the debt reduction benchmark is ensured in 2019 and 2020.

8. ANNEXES

Table I. Macroeconomic indicators

	2001-2005	2006-2010	2011-2015	2016	2017	2018	2019	2020
Core indicators								
GDP growth rate	4.3	-0.2	2.0	2.3	4.1	4.9	3.7	2.8
Output gap [1]	0.9	-0.4	-2.1	0.6	1.8	3.3	3.3	2.5
HICP (annual % change)	5.9	5.3	2.3	0.4	2.4	2.9	3.2	3.2
Domestic demand (annual % change) [2]	4.2	-1.8	1.3	1.0	6.8	7.0	5.6	2.9
Unemployment rate (% of labour force) [3]	6.1	8.8	9.3	5.1	4.2	3.7	3.5	3.5
Gross fixed capital formation (% of GDP)	24.2	22.6	20.9	19.6	22.2	25.5	27.6	27.5
Gross national saving (% of GDP)	18.1	18.7	23.5	26.2	25.7	27.5	27.7	27.4
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-6.9**	**-5.4**	**-3.0**	**-1.6**	**-2.2**	**-2.2**	**-1.8**	**-1.6**
Gross debt	**56.9**	**71.9**	**77.9**	**76.0**	**73.4**	**70.8**	**69.2**	**67.7**
Net financial assets	**-38.3**	**-54.6**	**-68.0**	**-65.9**	**-62.9**	**-57.6**	**n.a**	**n.a**
Total revenue	42.1	44.5	46.4	45.1	44.7	44.2	44.6	44.0
Total expenditure	49.0	49.9	49.4	46.8	46.9	46.5	46.4	45.6
of which: Interest	4.2	4.1	4.2	3.2	2.8	2.5	2.4	2.4
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-1.9**	**0.1**	**3.3**	**3.3**	**2.9**	**0.2**	**0.4**	**0.4**
Net financial assets; non-financial corporations	**-105.3**	**-117.1**	**-114.3**	**-109.4**	**-105.0**	**-102.5**	**n.a**	**n.a**
Net financial assets; financial corporations	**-2.9**	**1.0**	**10.5**	**10.2**	**5.5**	**3.6**	**n.a**	**n.a**
Gross capital formation	15.6	14.3	13.6	13.4	14.2	16.6	16.3	16.3
Gross operating surplus	21.3	23.0	24.3	24.6	25.1	24.7	24.9	24.8
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**1.2**	**2.1**	**5.2**	**4.5**	**3.6**	**4.3**	**2.4**	**2.2**
Net financial assets	**64.5**	**67.3**	**86.7**	**106.3**	**109.3**	**109.6**	**n.a**	**n.a**
Gross wages and salaries	35.4	36.0	36.7	36.8	37.6	39.0	39.3	39.7
Net property income	4.1	3.6	3.5	3.4	2.8	2.9	3.1	3.3
Current transfers received	17.6	19.2	18.1	17.0	16.8	16.1	15.5	15.3
Gross saving	6.7	6.5	6.9	7.3	6.8	8.0	7.4	7.3
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-7.5**	**-3.2**	**5.5**	**6.2**	**4.3**	**2.2**	**1.1**	**1.0**
Net financial assets	**81.9**	**103.4**	**85.1**	**58.7**	**53.0**	**46.8**	**n.a**	**n.a**
Net exports of goods and services	-2.7	1.9	6.8	10.0	7.6	4.8	3.1	2.9
Net primary income from the rest of the world	-5.0	-5.4	-4.0	-2.4	-4.0	-4.0	-4.0	-4.0
Net capital transactions	0.3	1.2	3.4	0.0	1.3	1.8	2.3	2.4
Tradable sector	45.6	45.2	45.9	46.2	45.7	45.2	n.a	n.a
Non tradable sector	40.6	40.5	38.4	38.4	39.0	39.1	n.a	n.a
of which: Building and construction sector	4.8	4.2	3.4	3.1	3.6	4.5	n.a	n.a
Real effective exchange rate (index, 2000=100)	98.8	105.0	94.5	90.8	94.5	96.4	97.0	98.4
Terms of trade goods and services (index, 2000=100)	102.2	99.6	98.7	100.9	100.9	99.8	99.9	99.9
Market performance of exports (index, 2000=100)	73.2	96.1	102.0	106.2	105.3	106.4	107.8	109.0

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2010 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 2019 spring forecast

Mandatory variables not included in the Convergence Programme

The Convergence Programme does not include some mandatory variables. Namely, data gaps concern total expenditure at unchanged policies and revenues increased mandated by law. In addition, the Convergence Programme uses employment data coming from the Labour Force Survey, while the Commission uses data coming from national accounts, which makes the comparison of the macro scenarios somewhat difficult. Not included mandatory variables do not impede the Commission's ability to assess the Convergence Programme on the basis of the Programme's assumptions.