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## **Assessment of the 2015 Convergence Programme for**

## **HUNGARY**

*(Note prepared by DG ECFIN staff)*

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## **1. INTRODUCTION**

This document assesses Hungary's April 2015 Convergence Programme (hereafter called Convergence Programme), which was submitted to the Commission on 30 April 2015 and covers the period 2014-2018. The Convergence Programme was approved by the government.

Hungary is currently subject to the preventive arm of the the Stability and Growth Pact and should ensure sufficient progress towards its MTO. As the debt ratio reached 78.5% of GDP in 2012 (the year in which Hungary corrected its excessive deficit), exceeding the 60% of GDP reference value, during the three years following the correction of the excessive deficit Hungary is also subject to the transitional arrangements as regards compliance with the debt reduction benchmark, implying that during this period it should ensure sufficient progress towards compliance. After the transition period, as of 2016, Hungary is expected to comply with the debt reduction benchmark.

This document complements the Country Report published on 26 February 2015 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 2015 spring forecast. The following section presents the recent and planned budgetary developments, according to the Stability Programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the Stability 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 and the quality of public finances. Section 7 summarises the main conclusions.

## **2. MACROECONOMIC OUTLOOK**

In the macroeconomic scenario underpinning the Convergence Programme, Hungary's economic growth is projected to decelerate in 2015 and 2016 and to rebound in 2017 and 2018. GDP growth is projected to reach 3.1% in 2015, 2.5% in 2016, 3.1% in 2017 and 2.9% in 2018. Inflation is foreseen at 0.0% on average in 2015 before rising to 1.6% in 2016. Employment is set to increase further on the back of economic growth and a further extension of the Public Work Scheme, but with a slower pace than in 2014 (i.e. 5.4% according to LFS concept). The unemployment rate could decrease to around 6% in 2016 and further to 5.5% by 2018.

The Convergence Programme foresees household final consumption expenditure to grow by 2.9% and 3.6% in 2015 and 2016, respectively. This is explained by the growth in real disposable income, reflecting growing employment, the impact of the household mortgage loan settlement scheme and a cut in the personal income tax rate. According to the Programme the projected decrease in GDP growth between 2015 and 2016 is due to the fact that from 2016 only the structural funds from the new Multiannual Financial Framework period will be available, which implies a slowing down in EU fund absorption leading to negative growth in gross fixed capital formation and public consumption. Consequently the Programme forecasts GDP in that year to grow only by 2.5%. Regarding the external sector

the Programme assumes strong growth in export market share and a sharp increase in the net lending position. Export growth is expected to decelerate slightly, from 7.5% to 7.0%, while import growth would oscillate between 7.7% and 7.1%. The macro-economic scenario of the Convergence Programme includes the estimated impact of structural reforms and this impact is duly quantified, but might be overestimated in some cases like the personal income tax rate cut.

**Table 1: Comparison of macroeconomic developments and forecasts**

	2014		2015		2016		2017	2018
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	3.6	3.6	2.8	3.1	2.2	2.5	3.1	2.9
Private consumption (% change)	1.6	1.7	3.0	2.9	2.7	3.6	2.7	2.5
Gross fixed capital formation (% change)	11.7	11.7	4.6	5.8	-1.0	-0.9	6.4	5.1
Exports of goods and services (% change)	8.7	8.7	7.3	7.5	7.5	7.4	7.1	7.0
Imports of goods and services (% change)	10.0	10.0	7.5	7.7	6.8	7.1	7.5	7.2
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	3.7	3.7	2.7	2.9	1.0	1.3	2.7	2.3
- Change in inventories	0.4	0.4	-0.3	0.0	0.0	0.2	0.0	0.0
- Net exports	-0.4	-0.4	0.4	0.3	1.2	0.9	0.4	0.6
Output gap <sup>1</sup>	-0.7	-1.0	0.2	-0.1	0.4	-0.3	0.1	0.5
Employment (% change)	3.2	5.4	1.9	2.1	1.2	2.1	1.8	1.7
Unemployment rate (%)	7.7	7.8	6.8	6.9	6.0	6.2	5.8	5.5
Labour productivity (% change)	0.4	-1.7	0.9	1.0	1.0	0.3	1.3	1.1
HICP inflation (%)	0.0	-0.2	0.0	0.0	2.5	1.6	2.5	3.0
GDP deflator (% change)	3.1	3.1	2.7	2.3	2.8	2.1	2.7	2.8
Comp. of employees (per head, %)	3.2	1.1	4.9	3.3	3.0	3.1	3.2	3.2
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	8.0	8.3	8.6	9.3	7.8	7.9	8.5	8.9
<b>Note:</b>								
<sup>1</sup> In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.								
<b>Source:</b>								
Commission 2015 spring forecast (COM); Convergence Programme (CP).								

For the period 2015-2016, the Commission forecasts 2.8% and 2.2% GDP growth, a somewhat lower growth than projected in the Convergence Programme but with a similarly declining path.

The composition of growth in the Programme is balanced although the growth of household consumption expenditure is higher than in the Commission forecast, especially in 2016. This is probably because of the personal income tax rate cut, announced after the cut-off date of the spring forecast, which can push up consumption through increased real disposable income, according to the Programme.

The inflation forecast of the programme is lower than the Commission's, but the dynamics are similar, i.e. increasing. Although real consumption growth is higher in the authorities' forecast, as the programme assumes lower inflation, the tax base in nominal terms is similar. Regarding the tax base for personal income tax and social contributions, the Commission

forecasts 5.1% and 4.7% growth for 2015-2016, while the Convergence Programme foresees the wage bill to grow by 5.6% and 5.2%. The projections of the unemployment rate for the forecast period are close (6.8% and 6.0% respectively for 2015-2016 in the Commission forecast).

Revisions compared to last year's Convergence Programme are substantial, especially for the forecast years, but this can be explained by the better-than-expected incoming data and the continuation of accommodative policies over the forecast horizon. The Convergence Programme's forecast for GDP growth in 2017 and 2018 can be considered favourable, and seems to be driven by the expected rebound in the contribution of gross fixed capital formation.

Overall, the Convergence Programme's macroeconomic scenario appears broadly plausible until 2016 and favourable thereafter.

The cyclical conditions underlying the programme's macroeconomic scenario point to increasing potential growth. The output gap as recalculated by the Commission based on the information provided in the programme, following the commonly agreed methodology, stands at -1% in 2014 and closes in 2017. In the Commission forecast, the output gap stands at -0.7% for 2014 and already closes in 2015.

### **3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS**

#### **3.1. Deficit developments in 2014**

In 2014, Hungary achieved a general government deficit of 2.6% of GDP, thus overperforming the deficit target of the 2014 budget by 0.3% of GDP. This was mainly due to positive revenue developments driven by the stronger economic recovery as well as by improvements in tax administration.<sup>1</sup> Tax and social security receipts altogether turned out to be higher by some 0.9% of GDP compared to the planned levels. The extra revenues were partly absorbed by expenditure overruns (0.4% of GDP in net terms) inter alia linked to increases in the public wage bill and higher-than-expected domestic financing needs of EU funded projects. In addition, the switch to ESA2010 accounting has also resulted in a deficit-increasing effect.<sup>2</sup>

#### **3.2. Target for 2015 and medium-term strategy**

##### **The target for 2015**

The planned general government deficit for 2015 has been lowered to 2.4% of GDP, 0.4 pp. below the target set in the 2014 Convergence Programme. Planned total revenues exceed the level projected in the previous programme by around 1.6% of GDP, reflecting favourable base effects, some revenue-increasing measures (including further steps to combat VAT

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<sup>1</sup> Note that when comparing revenue and expenditure developments with plans set out in the previous convergence programme both the denominator effect (i.e. stemming from changes in the nominal GDP) and balance-neutral statistical corrections were filtered out.

<sup>2</sup> This statistical effect is mainly linked to the exclusion of incomes generated by swap and forward transactions from interest expenditures (amounting to around 0.2% of GDP).

avoidance) and the enhanced absorption of EU funds. At the same time, higher revenues are almost fully matched by the increase in primary expenditures (at 1.5% of GDP) despite considerable savings in social transfers. The expenditure increases include: (i) a new wage compensation scheme for the police and military service; (ii) the extension of the Public Works Scheme; (iii) spending on the debt consolidation of healthcare institutions and debt takeover of public transport companies; and (iv) a further expansion of EU co-financed projects. In addition, domestic investments are also planned to increase mainly linked to the projects of the so-called Investment Fund with the costs to be covered by one-off revenues from asset sales (amounting to 0.5% of GDP and recorded as a negative expenditure). Thus the lowering of the deficit target compared to last year's programme relies to a greater extent on the reduction of interest outlays and the denominator effect (i.e. the impact of higher nominal GDP on the deficit ratio) than on the improved the primary balance.

The Commission 2015 spring forecast projects a government deficit at 2.5% of GDP for 2015, which is just slightly above the government target. According to the programme, however, the target can be achieved by spending a budgetary buffer of 0.3% of GDP (i.e. the so-called extraordinary reserve, an uncommitted appropriation), while the spring forecast assumes that this reserve will not be spent. This implies an underlying gap of close to 0.4 pp. in the deficit projections. The main factor behind this gap is that the Commission's forecast does not include the planned one-off revenues from asset sales as the source of these revenues remains unspecified.<sup>3</sup>

### **The medium-term strategy**

In the medium term, the programme aims to bring down the general government deficit from 2.4% of GDP in 2015 to 1.6% by 2018. According to the authorities, this would ensure that the structural balance remains somewhat above the country's medium-term objective (MTO) – set at -1.7% of GDP as required by the Stability and Growth Pact – throughout the programme period following a temporary deviation in 2015. However, the structural balance as recalculated by the Commission<sup>4</sup> reaches the MTO only by 2017 and it would slightly deteriorate again in 2018. The consolidation path of the updated programme is rather frontloaded. Following a planned reduction of 0.2% of GDP in 2015, the deficit is expected to decrease further by 0.4% of GDP in 2016, and the pace of improvement would gradually decelerate afterwards. Compared to last year's programme, the deficit trajectory has been lowered despite considerable tax cuts planned from 2016 onwards, which is expected to be facilitated by the assumed higher nominal path of the economy and a downward shift of the sovereign yield curve.

Based on a no-policy-change assumption, the Commission 2015 spring forecast projects a headline deficit of 2.2% of GDP in 2016. The projected deficit is slightly higher than the deficit target set for 2016 by the programme (i.e. 2.0% of GDP). It should be noted that the Convergence Programme was published after the cut-off date of the forecast, thus it could not incorporate the new measures and assumptions underpinning the programme.

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<sup>3</sup> The Commission forecast assumes that in the absence of asset sales investment projects linked directly to the realised revenues will be scaled down as stipulated in the budget law, but only partly, which results in an 0.3 pp. deficit-increasing effect.

<sup>4</sup> 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.

The medium-term budgetary strategy of the programme is built on three broad elements: (i) moderately increasing primary expenditures (in nominal terms just marginally above inflation) against the backdrop of a relatively high economic growth; (ii) reduction of the tax burden; and (iii) an expected steady decline of interest outlays. The primary expenditure-to-GDP ratio is planned to drop from 45.5% in 2015 to slightly above 41% by 2018. Filtering out the balance-neutral effect of decreasing EU funds, this amounts to a reduction in primary spending by some 2.7% of GDP. Social transfers are foreseen to contribute significantly to this fall (accounting for about three-fifth) mainly due to the evolving impact of previously introduced parametric pension reforms and the nominal freezing of most other benefits. At the same time, government revenues are also planned to decrease by 2.6% after correcting for EU funds. Apart from the planned tax-reducing measures (with an estimated total effect of 0.8 pp.), this also reflects the impact of the shrinking expenditure ratio (i.e. the tax content of public spending), the structure of growth (affecting tax elasticity) as well as the assumed relative decline of non-tax revenues. As the budgetary elbow room created by contained spending and the economic recovery is to be largely absorbed by tax cuts, the primary balance would hardly improve during the planning horizon. Consequently, the deficit-reduction path of the updated programme strongly depends on savings in interest expenditures, which are expected to fall by 0.7% of GDP over the three years.

**Table 2: Composition of the budgetary adjustment**

(% of GDP)	2014	2015		2016		2017	2018	Change: 2014-2018
	COM	COM	CP	COM <sup>1</sup>	CP	CP	CP	CP
<b>Revenue</b>	<b>47.6</b>	<b>46.7</b>	<b>46.7</b>	<b>43.8</b>	<b>44.3</b>	<b>43.3</b>	<b>42.5</b>	<b>-5.1</b>
<i>of which:</i>								
- Taxes on production and imports	18.6	18.3	18.2	17.7	17.8	17.4	17.1	-1.5
- Current taxes on income, wealth, etc.	6.7	6.4	6.5	6.4	6.2	6.0	6.0	-0.7
- Social contributions	13.2	13.1	13.2	13.0	13.2	13.0	12.8	-0.4
- Other (residual)	9.0	8.8	8.8	6.7	7.1	6.9	6.6	-2.4
<b>Expenditure</b>	<b>50.1</b>	<b>49.2</b>	<b>49.1</b>	<b>46.0</b>	<b>46.3</b>	<b>44.9</b>	<b>44.1</b>	<b>-6.0</b>
<i>of which:</i>								
- Primary expenditure	46.0	45.6	45.5	42.6	43.0	41.8	41.2	-4.8
<i>of which:</i>								
Compensation of employees	10.6	10.5	10.5	10.5	10.7	10.8	10.6	0.0
Intermediate consumption	7.8	7.9	7.9	7.2	7.1	6.6	6.5	-1.3
Social payments	16.0	15.3	15.3	14.9	14.7	14.1	13.6	-2.4
Subsidies	1.3	1.3	1.3	1.4	1.3	1.3	1.2	-0.1
Gross fixed capital formation	5.2	4.9	5.2	3.4	4.3	4.2	4.5	-0.7
Other (residual)	5.0	5.6	5.3	5.2	5.0	4.9	4.8	-0.2
- Interest expenditure	4.1	3.6	3.6	3.4	3.3	3.1	2.9	-1.2
<b>General government balance (GGB)</b>	<b>-2.6</b>	<b>-2.5</b>	<b>-2.4</b>	<b>-2.2</b>	<b>-2.0</b>	<b>-1.7</b>	<b>-1.6</b>	<b>1.0</b>
<b>Primary balance</b>	<b>1.5</b>	<b>1.1</b>	<b>1.2</b>	<b>1.2</b>	<b>1.3</b>	<b>1.4</b>	<b>1.3</b>	<b>-0.2</b>
One-off and other temporary	0.3	-0.1	0.5	0.0	0.3	0.0	0.1	-0.2
<b>GGB excl. one-offs</b>	<b>-2.8</b>	<b>-2.4</b>	<b>-2.9</b>	<b>-2.2</b>	<b>-2.3</b>	<b>-1.7</b>	<b>-1.7</b>	<b>1.1</b>
Output gap <sup>1</sup>	-0.7	0.2	-0.1	0.4	-0.3	0.1	0.5	1.2
Cyclically-adjusted balance <sup>1</sup>	-2.2	-2.6	-2.3	-2.4	-1.8	-1.7	-1.9	0.4
<b>Structural balance (SB)<sup>2</sup></b>	<b>-2.5</b>	<b>-2.5</b>	<b>-2.8</b>	<b>-2.4</b>	<b>-2.1</b>	<b>-1.7</b>	<b>-2.0</b>	<b>0.5</b>
Structural primary balance <sup>2</sup>	1.6	1.1	0.8	1.0	1.2	1.4	0.9	-0.7
<b>Notes:</b>								
<sup>1</sup> 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.								
<sup>2</sup> Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.								
<i>Source:</i>								
Convergence Programme (CP); Commission 2015 spring forecasts (COM); Commission calculations.								

### **Measures underpinning the programme**

On the revenue side, the 2015 budget incorporates extra receipts from a number of sector-specific taxes (most notably, a very substantial increase in the supervision fee paid by the retail companies and the introduction of a new extra tax on tobacco producers) as well as from the increase in e-tolls. Counting on further expected yields from measures enhancing tax collection efficiency and combatting tax fraud, the budgeted VAT revenues are assumed to increase by 0.3% of GDP. For 2016, the programme plans a number of tax cuts: (i) lowering the personal income tax rate by 1 pp to 15%; (ii) reducing the VAT rate on unprocessed pork meat from 27% to 5%; and (iii) reductions in administrative duties. Regarding multi-year tax plans, the bank levy is planned to be more than halved in two steps by 2017 altogether by



some 0.25% of GDP, while a doubling in the family tax allowance after two children is to be introduced in four linear steps between 2016 and 2019 (with a total cost of 0.15% of GDP).

On the expenditure side, the 2015 plans most notably include an extra appropriation for the health sector to pay down the accumulated arrears and debt assumptions from public sector-owned transport companies (from Budapest city transport and the national railway). Regarding multi-year spending programmes, the most significant development is the phasing-in and the launch of new career path wage systems in the public sector, which by 2016 will cover public education, the armed forces, and the central government administration. The corresponding deficit-increasing impacts are moderated by the planned nominal wage freezes in all other branches of the public sector. In parallel, the continuous extension of the Public Works Scheme is foreseen for the entire programme horizon. At the same time, increasingly important expenditure containment is expected from the incremental phasing-in of the 3-year increase in the statutory retirement age. Finally, the authorities plan significant one-off receipts from selling (yet unspecified) assets for both 2015 and 2016 (recorded as negative expenditures in ESA2010), amounting to some 0.5% of GDP and 0.3% of GDP, respectively. Finally, it should be noted that the measures underpinning the medium-term spending targets are not comprehensively detailed yet.

## Main budgetary measures

Revenue	Expenditure
<b>2014</b>	
<ul style="list-style-type: none"> <li>• Extension of the deductibility for family allowance (-0.1% of GDP)</li> <li>• Additional take-up for targeted social contributions cuts and for simplified taxation schemes (-0.1% of GDP)</li> <li>• Full phasing out of the wage compensation in the private sector (+0.15% of GDP)</li> <li>• Full-year effect of the distance-based road toll (+0.2% of GDP)</li> <li>• Increase in the efficiency of tax collection, mainly through the establishment of on-line links to cash registers (+0.5% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• Public wage bill: costs of the new career paths partly offset by nominal wage freeze in other branches of the public sector (+0.25% of GDP)</li> <li>• Extension of the Public Work Scheme (PWS, +0.15% of GDP)</li> <li>• Sale of frequency rights (recorded as negative expenditure, -0.4% of GDP)</li> <li>• Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)</li> </ul>
<b>2015</b>	
<ul style="list-style-type: none"> <li>• Introduction of new, smaller sector-specific corporate taxes (altogether +0.1% of GDP)</li> <li>• Increase in price and coverage of the distance-based e-toll system (+0.07% of GDP)</li> <li>• Further increase in the efficiency of tax collection, mainly linked to the establishment of the Electronic Road Cargo Inspection System (+0.3% of GDP, considerable implementations risks)</li> </ul>	<ul style="list-style-type: none"> <li>• Public wage bill: costs of the new career paths partly offset by nominal wage freeze in other branches of the public sector (+0.05% of GDP)</li> <li>• Establishment of a special fund to settle the unpaid arrears in the health sector (+0.2% of GDP)</li> <li>• Debt takeovers from public transport companies (+0.25% of GDP)</li> <li>• PWS extension (+0.05 % of GDP)</li> <li>• One-off receipts from asset sales (recorded as negative expenditure, -0.5% of GDP, serious implementations risks)</li> <li>• Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)</li> </ul>
<b>2016</b>	
<ul style="list-style-type: none"> <li>• Lowering the flat personal income tax rate by 1 pp to 15% (-0.3% of GDP)</li> <li>• Cut in the bank levy (-0.2% of GDP)</li> <li>• Reducing the VAT rate on unprocessed pork meat from 27% to 5% and reductions in administrative duties (altogether -0.1% of GDP)</li> <li>• Phasing in the increase in the family allowance after two children (first step, -0.04% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• Public wage bill: costs of the new career paths partly offset by nominal wage freeze in other branches of the public sector (+0.2% of GDP)</li> <li>• PWS extension (+0.1 % of GDP)</li> <li>• One-off receipts from asset sales (recorded as negative expenditure, -0.3% of GDP, serious implementations risks)</li> <li>• Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)</li> </ul>
<b>2017</b>	
<ul style="list-style-type: none"> <li>• Further cut in the bank levy (-0.06% of GDP)</li> <li>• Phasing in the increase in the family allowance after two children (second step, -0.04% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• Public wage bill: costs of the new career paths partly offset by nominal wage freeze in other branches of the public sector (+0.1% of GDP)</li> <li>• PWS extension (+0.1 % of GDP)</li> <li>• Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)</li> </ul>
<b>2018</b>	
<ul style="list-style-type: none"> <li>• Phasing in the increase in the family allowance after two children (third step, -0.04% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• PWS extension (+0.1 % of GDP)</li> <li>• Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)</li> </ul>
<p><i>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.</i></p>	

### 3.3. Debt developments

In 2014, the government debt-to-GDP ratio decreased only by 0.4% of GDP to 76.9%, despite a high nominal GDP growth and relatively low deficit. The limited reduction was the result of a sizeable debt-increasing stock-flow adjustment effect chiefly due to the weakening of the exchange rate.

**Table 3: Debt developments**

(% of GDP)	Average 2009-2013	2014	2015		2016		2017	2018
			COM	CP	COM	CP	CP	CP
<b>Gross debt ratio<sup>1</sup></b>	<b>79.2</b>	<b>76.9</b>	<b>75.0</b>	<b>74.9</b>	<b>73.5</b>	<b>73.9</b>	<b>71.3</b>	<b>68.9</b>
Change in the ratio	1.1	-0.4	-1.9	-2.0	-1.5	-1.0	-2.6	-2.4
<i>Contributions<sup>2</sup>:</i>								
<b>1. Primary balance</b>	<b>-0.5</b>	<b>-1.5</b>	<b>-1.1</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.3</b>	<b>-1.4</b>	<b>-1.3</b>
<b>2. “Snow-ball” effect</b>	<b>2.7</b>	<b>-0.8</b>	<b>-0.4</b>	<b>-0.4</b>	<b>-0.2</b>	<b>0.0</b>	<b>-0.9</b>	<b>-1.0</b>
<i>Of which:</i>								
Interest expenditure	4.4	4.1	3.6	3.6	3.4	3.3	3.1	2.9
Growth effect	0.6	-2.6	-2.0	-2.3	-1.6	-1.8	-2.2	-2.0
Inflation effect	-2.2	-2.2	-1.9	-1.7	-2.0	-1.5	-1.8	-1.9
<b>3. Stock-flow adjustment</b>	<b>-1.2</b>	<b>2.0</b>	<b>-0.3</b>	<b>-0.4</b>	<b>-0.1</b>	<b>0.3</b>	<b>-0.2</b>	<b>-0.1</b>
<i>Of which:</i>								
Cash/accruals diff.								
Acc. financial assets								
<i>Privatisation</i>								
Val. effect & residual								

**Notes:**

<sup>1</sup> End of period.

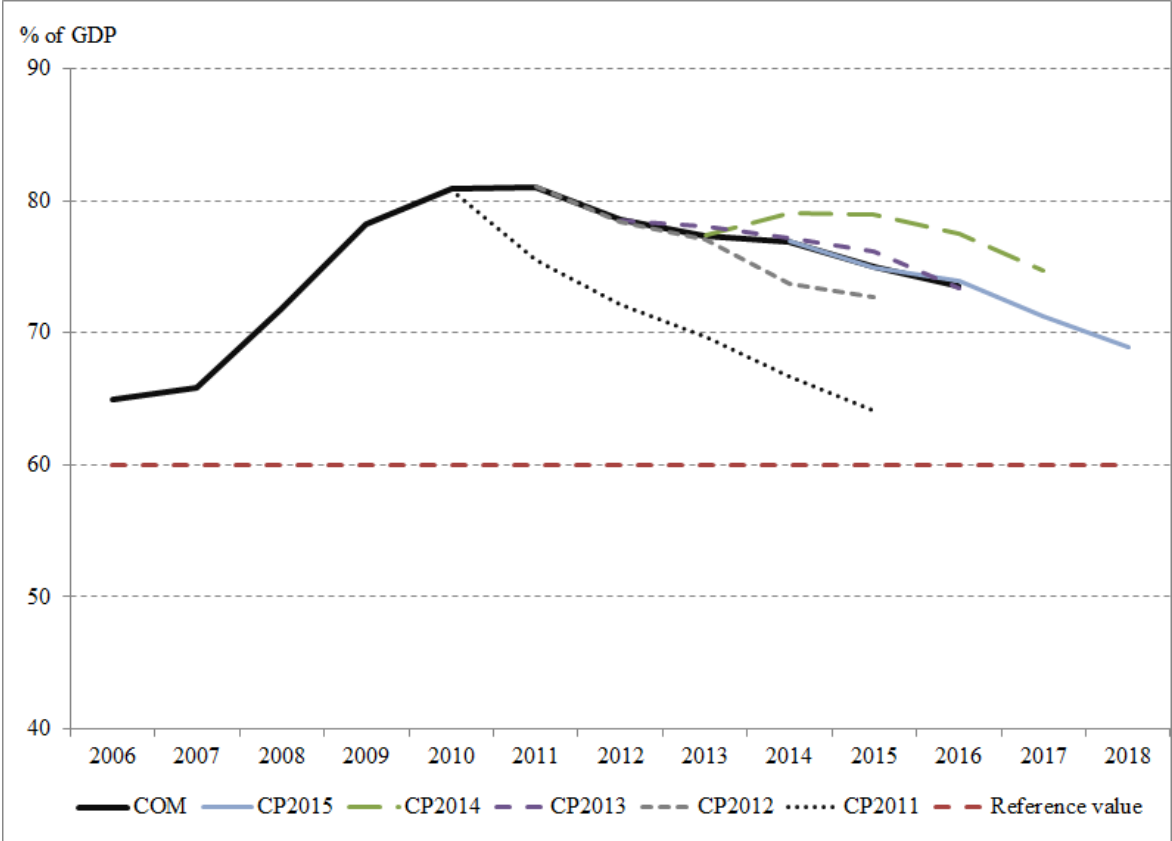
<sup>2</sup> The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial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

**Source:**  
Commission 2015 spring forecast (COM); Convergence Programme (CP), Commission calculations.

The 2015 Convergence Programme envisages a rather steep decrease in the government debt ratio, which would decline to 74.9% in 2015 and then to around 69% by 2018 (i.e. equivalent to an average annual debt reduction of 2.0% of GDP). This is foreseen to be underpinned by the positive primary balance even though it would deteriorate somewhat relative to the level achieved in 2014. The snowball effect would also facilitate the reduction of the debt ratio especially in later years thanks to the anticipated acceleration of nominal growth and the steady decline of implicit nominal interest rates on the debt stock. The updated debt trajectory is considerably lower than the one presented in the 2014 Convergence Programme, where the public debt-to-GDP ratio was projected to decrease to only somewhat below 75% by 2017 (a

difference of around 3½ pps). This primarily reflects a higher nominal GDP path<sup>5</sup> and the decreased interest expenditures. Moreover, the updated programme projects more favourable stock-flow adjustment developments, mainly on account of the expected revaluation of the forint. Taking also into account the impact of the appreciating exchange rate, the Commission’s 2015 spring forecast projects a debt reduction, which is broadly similar to debt dynamics expected by the authorities. The debt-to-GDP ratio is forecast to decrease to 75% in 2015 and to 73.5% in 2016, somewhat below the level projected by the programme.<sup>6</sup>

**Figure 1: Debt projections in successive programmes (% of GDP)**



Source: Commission 2015 spring forecast; Convergence Programmes

**3.4. Risk assessment**

The risks involved in the programme's budgetary adjustment appear to be increasingly tilted towards a higher government deficit over the planning horizon, which is linked to the assumed favourable macroeconomic outlook posing negative revenue-side risks. The available monthly outturn data for 2015 seem to indicate some upward risks in the tax receipts this year compared to the targeted level. However, the Commission’s forecast already suggests a potential over-estimation of tax revenues in 2016 (in the magnitude of some 0.1 pp.) even judged on the basis of the growth path outlined in the programme With the

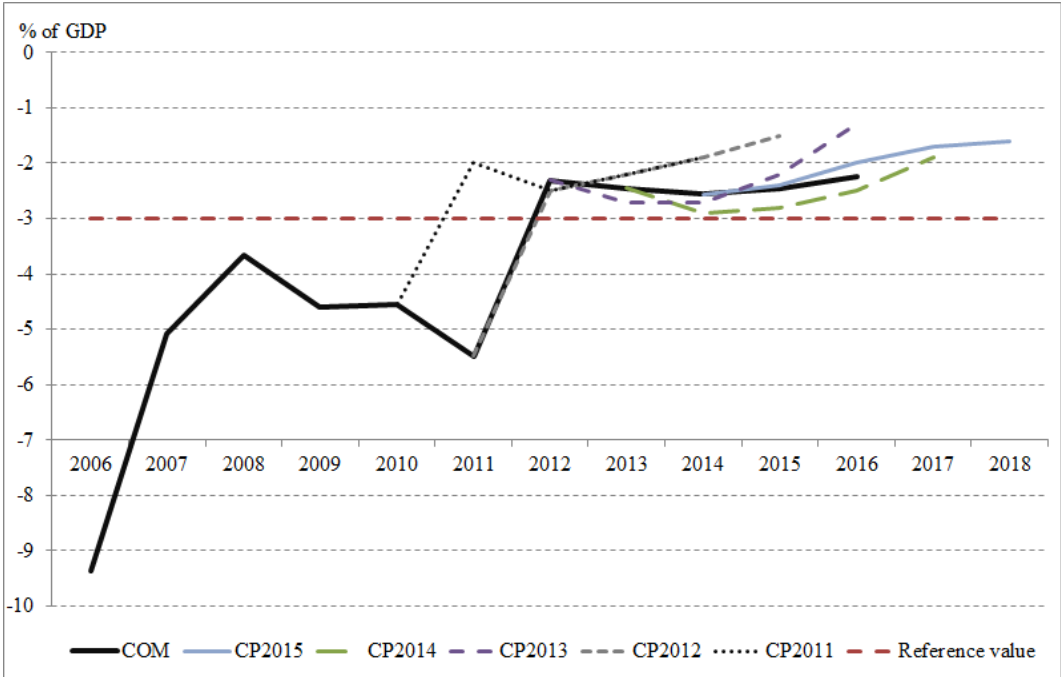
<sup>5</sup> Changes in accounting also contributed to a favourable denominator effect. Notably, the switch to ESA2010 has resulted in significant upgrading of the estimated GDP, which ceteris paribus lowered the government debt ratio by close to 2 pps.

<sup>6</sup> This is largely explained by the technical assumption of the Commission’s forecast that state cash deposits remain unchanged in year t+1.

projected rebound of growth in later years, which is a rather optimistic scenario compared to the country’s estimated growth potential, the possibility of revenue shortfalls may increase. A further macroeconomic risk stems from the strong reliance of the planned consolidation strategy on savings in interest outlays (i.e. the primary surplus would be kept broadly constant in the medium term), which carries some inevitable downside risks if the loose stance of global monetary policies would be reversed quicker or more abruptly.

Regarding budgetary risks related to discretionary measures, the maintenance and planned further increase of the revenue gains by policies enhancing tax compliance are subject to uncertainty given the inherent unpredictability of potential tax-avoidance strategies in the face of new controls. In addition, the achievement of the 2015 and 2016 deficit targets is partly based on sizeable one-off revenues from asset sales, while the realisation of these planned receipts remain uncertain as the potential sources are yet unspecified. In the short term (particularly in 2015), deficit-increasing risks also pertain to EU-funded projects as both the pending financial corrections (resulting in potential negative one-off effects) and the domestic financing requirements (linked to the overbooking of the available envelopes to ensure maximum absorption) may turn out higher than currently planned. Looking ahead, the updated medium-term spending targets appear to be more plausible compared to the previous programme (where most of the expenditure items were planned to grow below inflation), yet implementation risks remain. In particular, implementation risks emerge regarding the sustainability of the restricted public healthcare budget as well as the planned persistence of nominal wage freezes for a large part of public sector employees not covered by the selective wage-compensation/career-path schemes. Finally, the expenditure targets do not contain the costs of the planned Paks II. nuclear power plant project, which is foreseen to start already in the final year of the programme period (with an estimated deficit-increasing effect of around 1% of GDP annually during the construction phase).

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



Source: Commission 2015 spring forecast; Convergence Programmes

Although the above assessment suggests that the risks surrounding the consolidation path of the 2015 Convergence Programme tend to be on balance negative, the likelihood of substantial slippages remains limited. This is due to the fact that the updated fiscal plan incorporates relatively sizeable budgetary buffers/reserves<sup>7</sup>, which can provide a safeguard to mitigate potential deviations from the deficit targets in case of adverse events.

The risks related to the planned debt trajectory arise mainly from the above mentioned factors. However, a less favourable macroeconomic scenario could have a more outspoken impact on the debt dynamics (via the snow-ball effect) than on the level of deficit, especially with a relatively high debt-to-GDP ratio. Indeed, debt simulations suggest that Hungary's debt-reduction path is relatively fragile against adverse economic shocks. The sensitivity of the debt ratio is particularly high to exchange rate movements as currently around 40% of debt is denominated in foreign currency. The updated programme confirms the strategic goal to significantly reduce the proportion of public debt held in foreign currency (to somewhat above 20% by 2018), which would contain the exposure to exchange-rate risks.

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

##### **Box 1. Council recommendations addressed to Hungary**

On 8 July 2014, the Council addressed recommendations to Hungary in the context of the European Semester. In particular, in the area of public finances the Council recommended Hungary to reinforce the budgetary measures for 2014 in the light of the emerging gap relative to the Stability and Growth Pact requirements, namely the debt reduction rule, based on the Commission 2014 spring forecast. In 2015, and thereafter significantly strengthen the budgetary strategy to ensure reaching the medium-term objective and compliance with the debt reduction requirements in order to keep the general government debt ratio on a sustained downward path. The Council also recommended Hungary to further enhance the binding nature of the medium-term budgetary framework through systematic ex-post monitoring of compliance with numerical fiscal rules and the use of corrective mechanisms. Improve the transparency of public finances, including through broadening the mandatory remit of the Fiscal Council, by requiring the preparation of regular macro-fiscal forecasts and budgetary impact assessments of major policy proposals.

##### **4.1. Compliance with the debt criterion**

As of 2013, Hungary is in the three-year transitory period regarding the debt reduction benchmark. In 2014, the required Minimum Linear Structural Adjustment (MLSA) allows a 1.1 % of GDP deterioration in the structural balance, while the structural balance is estimated to have deteriorated by 1.3% of GDP. Hence, according to the Commission's assessment based on notified data, Hungary made sufficient progress towards compliance with the debt

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<sup>7</sup> The 2016 budget is foreseen to contain an extraordinary reserve of 0.2% of GDP (i.e. an appropriation which can be spent only if the deficit target can be achieved). In addition, the programme counts on a specific "tax reduction and development" reserve (amounting to 0.4% and 0.5% of GDP in 2017 and 2018, respectively), which could be used either for further tax cuts or investments depending on future decisions in the light of the evolving budgetary situation.

criterion in 2014 as measured by the MLSA, thanks to the allowed annual deviation of 0.25% of GDP.

In 2015, the deterioration of the recalculated structural balance (0.5% of GDP) as planned in the 2015 Convergence Programme is below the deterioration allowed by the recalculated MLSA (1.3% of GDP). Thus according to the national plans, the country will make sufficient progress towards compliance with the debt criterion, and the debt benchmark is expected to be met at the end of the transition period. A similar conclusion is reached on the basis of the Commission 2015 spring forecast.

In 2016, after the end of the transition period, Hungary is expected to satisfy the debt criterion as the debt-to-GDP ratio is projected to be below the debt reduction benchmark on the basis of the national plans and the Commission 2015 spring forecast as well.

**Table 4: Compliance with the debt criterion**

	2014	2015		2016	
		CP	COM	CP	COM
Gap to the debt benchmark <sup>1,2</sup>	n.r.	n.r.	n.r.	-3.1	-1.3
Structural adjustment <sup>3</sup>	-1.3	-0.5	0.0	n.r.	n.r.
<i>To be compared to:</i>					
Required adjustment <sup>4</sup>	-1.1	-1.3	-0.8	n.r.	n.r.
<b>Notes:</b>					
<sup>1</sup> Not relevant for Member States that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.					
<sup>2</sup> 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.					
<sup>3</sup> Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.					
<sup>4</sup> Defines the remaining annual structural adjustment over the transition period which ensures that - if followed - Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections for the previous years are achieved.					
<b>Source :</b>					
<i>Commission 2015 spring forecast (COM); Convergence Programme (CP), Commission calculations.</i>					

#### **4.2. Compliance with the required adjustment path towards the MTO**

Hungary needs to respect the requirement of the Stability and Growth Pact under the preventive arm. Starting from a position well above the MTO, the structural balance is estimated to have deteriorated by 1.3% of GDP in 2014 to -2.5% of GDP. This indicates some deviation from the MTO (a gap of 0.4% of GDP). At the same time, based on outturn data, the growth rate of government expenditure, net of discretionary revenue measures, did not exceed the applicable expenditure benchmark rate of 2.1% (resulting in a positive margin of 0.3% of GDP over the requirement of the expenditure benchmark pillar). This calls for an overall assessment. The detailed analysis reveals that the difference between the two pillars is mainly

due to a revenue-shortfall leading to the potential underestimation of fiscal effort as measured by the structural balance. Based on the outturn data and the Commission 2015 spring forecast, the ex-post assessment therefore suggests that the adjustment path towards the MTO was appropriate and compliant with the requirement of the preventive arm of the Pact in 2014. However, the structural balance is estimated to be below the MTO, implying the need for structural adjustment in subsequent years.

In 2015, the recalculated structural balance based on the programme is expected to deteriorate further by 0.5% of GDP to 2.8%, pointing to a risk of significant deviation from the required adjustment path (a gap of 1% of GDP). As the net government expenditure is planned to grow significantly above the applicable benchmark rate of -1.1%, this conclusion is also confirmed by the expenditure benchmark pillar (a gap of -1.3% of GDP). According to information provided in the Convergence Programme, therefore there is a risk of significant deviation from the required adjustment towards the MTO in 2015. The assessment based on the Commission 2015 spring forecast also reveals the risk of a significant deviation from the MTO in 2015. The structural balance is forecast to remain unchanged compared to the required adjustment of 0.5% of GDP (resulting in a gap of 0.5% of GDP based on the structural balance pillar), while the projected growth of expenditure would exceed the reference rate (a gap of 2% of GDP).

In 2016, the recalculated structural balance along the programme's consolidation path would improve by 0.7 pp., above the requirement. At the same time, the growth of net expenditure as planned is calculated to exceed the benchmark rate of -0.3% leading to a significant gap (-1.5% of GDP). Moreover, the average deviation measured over the years 2015 and 2016 taken together based on both pillars is estimated to be above the threshold for significance set at 0.25% of GDP. According to information provided in the programme, this points to a risk of significant deviation from the adjustment path required by the preventive arm in 2016. Based on the Commission 2015 spring forecast, based on a no-policy-change assumption, Hungary is also found to be at risk of significantly deviating from the MTO in 2016 as both the structural balance and net expenditure growth point to a risk of significant deviation from the required adjustment path over two years (a gap of -0.5% and -0.9% of GDP, respectively).



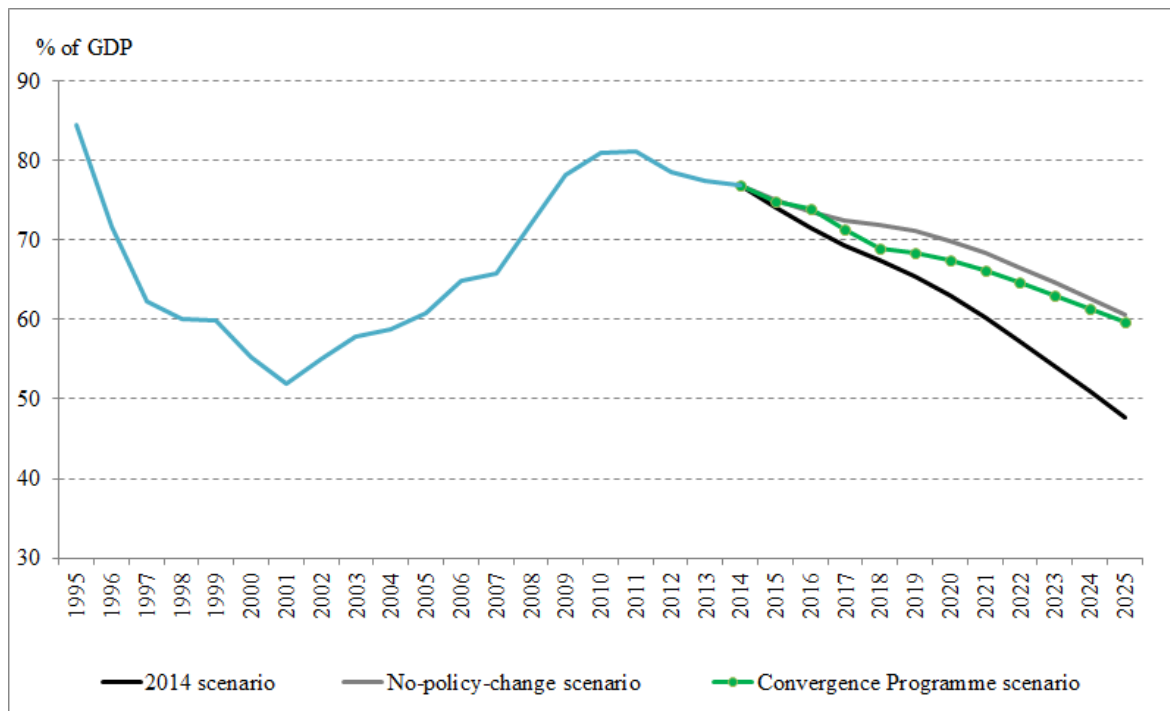
**Table 5: Compliance with the requirements under the preventive arm**

(% of GDP)	2014	2015		2016	
<b>Initial position<sup>1</sup></b>					
Medium-term objective (MTO)	-1.7	-1.7		-1.7	
Structural balance <sup>2</sup> (COM)	-2.5	-2.5		-2.4	
Structural balance based on freezing (COM)	-2.2	-2.5		-	
<b>Position vis-a-vis the MTO<sup>3</sup></b>	At or above the MTO	Not at MTO		Not at MTO	
(% of GDP)	<b>2014</b>	<b>2015</b>		<b>2016</b>	
	<b>COM</b>	<b>CP</b>	<b>COM</b>	<b>CP</b>	<b>COM</b>
<b>Structural balance pillar</b>					
Required adjustment <sup>4</sup>	0.0	0.5		0.6	
Required adjustment corrected <sup>5</sup>	-0.9	0.5		0.6	
Change in structural balance <sup>6</sup>	-1.3	-0.5	0.0	0.7	0.1
<i>One-year deviation from the required adjustment<sup>7</sup></i>	-0.4	-1.0	-0.5	0.1	-0.5
<i>Two-year average deviation from the required adjustment<sup>7</sup></i>	0.3	-0.7	-0.5	-0.5	-0.5
<b>Expenditure benchmark pillar</b>					
Applicable reference rate <sup>8</sup>	2.1	-1.1		-0.3	
<i>One-year deviation<sup>9</sup></i>	0.3	-1.3	-2.0	-1.5	0.2
<i>Two-year average deviation<sup>9</sup></i>	1.0	-0.5	-0.9	-1.4	-0.9
<b>Conclusion</b>					
Conclusion over one year	Overall assessment	Significant deviation	Significant deviation	Overall assessment	Overall assessment
Conclusion over two years	Compliance	Significant deviation	Significant deviation	Significant deviation	Significant deviation
Notes					
<p><sup>1</sup> 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 is allowed in order to be evaluated as having reached the MTO.</p> <p><sup>2</sup> Structural balance = cyclically-adjusted government balance excluding one-off measures.</p> <p><sup>3</sup> Based on the relevant structural balance at year t-1.</p> <p><sup>4</sup> 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 28.).</p> <p><sup>5</sup> Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.</p> <p><sup>6</sup> Change in the structural balance compared to year t-1.</p> <p><sup>7</sup> The difference of the change in the structural balance and the required adjustment corrected.</p> <p><sup>8</sup> 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 not at its MTO.</p> <p><sup>9</sup> 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.</p>					
<i>Source:</i>					
<i>Convergence Programme (CP); Commission 2015 spring forecasts (COM); Commission calculations.</i>					

## 5. LONG-TERM SUSTAINABILITY

The analysis in this section includes the new long-term budgetary projections of age-related expenditure (pension, health care, long-term care, education and unemployment benefits) from the 2015 Ageing Report<sup>8</sup> published on 12 May. It therefore updates the assessment made in the Country Reports<sup>9</sup> published on 26 February.

**Figure 3: Gross debt as % of GDP – Medium-term projections**



Source: Commission 2015 spring forecast; Convergence Programme; Commission calculations

Government debt stood at 76.9% of GDP in 2014. Based on the Commission's 2015 spring forecast and under a no-policy-change scenario, it is projected to decline to 60.7% in 2025 remaining just slightly above the 60% of GDP Treaty threshold. The full implementation of the programme would put debt on a similar decreasing path, which would already reach the 60% of GDP reference value in 2025.

Hungary appears to face low fiscal sustainability risks as measured by the Commission's sustainability indicators. The medium-term sustainability gap is at -0.8% of GDP, implying that no further effort would be needed to achieve the Treaty's threshold until 2030 despite a relatively high level of initial debt (75.0% of GDP in 2015). This is mainly due to the projected medium-term savings in ageing costs which are estimated to reduce the additional required effort by 1.1 % of GDP. In the long term, Hungary also appears to face low fiscal sustainability risks, primarily related to the structural primary balance in 2015 and the projected ageing costs contributing only with 0.7 pp. of GDP to the sustainability gap over the very long run. The long-term sustainability gap is at 1.1 % of GDP, which shows the

<sup>8</sup> See [http://ec.europa.eu/economy\\_finance/publications/european\\_economy/2015/ee3\\_en.htm](http://ec.europa.eu/economy_finance/publications/european_economy/2015/ee3_en.htm)

<sup>9</sup> See [http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index\\_en.htm](http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm)

adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path.

Risks would be higher in the event of the structural primary balance reverting to higher values observed in the past, such as the average for the period 2004-2013. Furthermore, the 2015 Country Report shows that under plausible assumptions identifiable fiscal policy-related risks (i.e. related to further company takeovers by the state, the wage pressures in the public sector and to the planned Paks II. nuclear power plant project) could largely or fully counteract the favourable medium-term effect of declining ageing costs on government debt. 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**

	Hungary			European Union		
	2014 scenario	No-policy-change scenario	Convergence Programme scenario	2014 scenario	No-policy-change scenario	Stability/Convergence Programme scenario
S2*	-0.2	1.1	1.1	1.4	1.7	0.4
<i>of which:</i>						
Initial budgetary position (IBP)	-0.3	0.3	-0.1	0.4	0.5	-0.7
Long-term cost of ageing (CoA)	0.1	0.7	1.2	1.0	1.1	1.1
<i>of which:</i>						
pensions	-0.5	0.0	0.4	0.0	0.1	0.1
healthcare	0.6	0.6	0.5	0.8	0.7	0.6
long-term care	0.3	0.3	0.3	0.7	0.7	0.6
others	-0.3	-0.1	0.0	-0.4	-0.3	-0.2
S1**	-2.3	-0.8	-0.9	1.4	1.8	0.5
<i>of which:</i>						
Initial budgetary position (IBP)	-1.7	-0.6	-0.8	-0.4	-0.3	-1.6
Debt requirement (DR)	1.0	0.9	0.7	1.7	1.9	1.8
Long-term cost of ageing (CoA)	-1.7	-1.1	-0.9	0.1	0.3	0.4
S0 (risk for fiscal stress)***	0.14	:		:		
Fiscal subindex	0.08	:		:		
Financial-competitiveness subindex	0.17	:		:		
Debt as % of GDP (2014)	76.9			88.6		
Age-related expenditure as % of GDP (2014)	20.3			25.6		
Source: Commission, 2015 Convergence Programme						
Note: the '2014' scenario depicts the sustainability gap under the assumption that the structural primary balance position remains at the 2014 position according to the Commission 2015 spring forecast; the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commission 2015 spring forecast until 2016. The 'stability 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.						
* The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.						
** The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2016) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.						
*** The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.						

## 6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES<sup>10</sup>

### 6.1. Fiscal framework

The application of the reinforced medium-term budgetary framework (approved in December 2013) has been further delayed. The new system of embedding the annual budget figures into rolling three-year plans issued by a government resolution by end-April in each year<sup>11</sup> was not put into place neither for the preparation of the 2015 budget bill, nor for the 2016 one. The recent decision on the acceleration of the preparation and adoption of the 2016 budget bill cannot be regarded as a substitute for the application of a medium-term framework as it implies the continuation of the traditionally narrow planning horizon, but with much shorter deadlines. The draft budget was submitted to Parliament on 13 May 2015 (instead of the stipulated deadline of mid-October). The final vote is foreseen to take place before the summer recess of Parliament (i.e. end of June or early July, instead of the usual mid-December date).

The Convergence Programme does not aim to further reinforce the Fiscal Council neither to revise the domestic set of numerical rules. As explained in the Country Report, the Fiscal Council's analytical remit is still not commensurate with its strong veto right over the annual budget. The authorities argue in the Convergence Programme that the Council has recently significantly increased the number of commissioned external studies (covering short-term forecasts and economic papers) and continue to receive high-quality analytical inputs from the State Audit Office and the central bank to build up a solid basis for its opinions. However, these undertakings (even the insightful papers) could not replace the function of a genuine quantitative analysis of the official macro-fiscal projections. Concerning the domestic fiscal rules, the final element of the set-up, namely the debt reduction formula has entered into force on 1 January 2015 and should be in principle binding for the 2016 budget<sup>12</sup>. However, based on the parameters of the official macroeconomic scenario, a significantly tighter 2016 headline target would be consistent with the rule than the laid down 2% of GDP. The programme does not acknowledge this inconsistency, and does not refer to the way how to settle this issue (e.g. revising the formula, postponing its date of effect, etc.)<sup>13</sup>.

### 6.2. Quality of public finances

The Convergence Programme refers to different reforms improving the quality of public finances. In the field of public administration, the Convergence Programme refers to the major centralisation-driven revamp in the Hungarian subnational system and the related re-organisation of public service provision and financing (including the new rules and debt assumptions at the local level) that has been carried out since 2010. The programme does not specify the fiscal gains achieved, and the headcount in public administration has even

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<sup>10</sup> This section complements the Country Report published on 26 February 2015 and updates it with the information included in the Convergence Programme.

<sup>11</sup> See a brief description in section 3.1. of the Country Report.

<sup>12</sup> The rule specifies that the growth of nominal general government debt shall be not higher than the projected inflation rate less half of the projected real GDP growth rate. See the 2012 European Semester Staff Working Document for a detailed discussion, including criticisms on the rule's design features (on pp. 14-15):

[http://ec.europa.eu/europe2020/pdf/nd/swd2012\\_hungary\\_en.pdf](http://ec.europa.eu/europe2020/pdf/nd/swd2012_hungary_en.pdf)

<sup>13</sup> On 20 May 2015, the government submitted to Parliament a draft amendment to the debt reduction formula, which creates a waiver in case either the official growth projection or the official inflation projection does not reach 3% (i.e. applicable for the 2016 budget).

increased slightly over the last five years. The document offers a detailed description of the latest reform step, namely the system of welfare benefits, effective from March 2015: the administration of income-type benefits has been shifted up to the district level, while the various types of ‘expense compensating’ benefit were replaced by one single scheme and local governments were granted more discretion in awarding benefits. In the area of the new set-up for public education, the Convergence Programme announces some fine-tuning to better respond to the signals of the labour market: from mid-2015, the institutional oversight on vocational training institutions will be re-assigned from the recently established central Institution Maintenance Centre to the Ministry for National Economy.

Public investment is expected to decrease from over 5% of GDP in 2014 and 2015 to below 4.5% for the outer year of the programme, mirroring the anticipated fall in EU fund absorption. It is worth pointing out that the domestic budgetary resources for investments are planned to be kept broadly stable at around 2.8% of GDP throughout the programme horizon.

As to Hungary’s tax system, the Convergence Programme presents the important changes that have taken place in the tax structure since 2010: revenue losses in labour-related taxes, chiefly due to the introduction of a flat personal income tax regime subsequently complemented by targeted social security allowances, were chiefly offset by the increase in indirect taxes (including environmental taxes). This tax reform has markedly reduced the tax wedge for many taxpayers (with the notable exception of certain groups of low-paid workers) and played a role in the recent favourable labour market trends. However, the compensating tax increases were only partly related to standard type of consumption taxes (paid only by households), the bulk of these additional revenues has stemmed from the introduction of turnover/service-linked, asset, or profit-linked sector-specific taxes, which have created a number of distortionary effects<sup>14</sup>. The Convergence Programme foresees a further reduction in the personal income tax rate and an increase in the family allowance from 2016, while in parallel the presumably most distortive sector-specific tax (the bank levy) would be more than halved by 2017. Concerning the fight against tax evasion, the successful completion of the establishment of on-line links to cash-registers has brought about significant extra revenues in the magnitude of ½% of GDP in 2014. The authorities are planning to extend this requirement to a number of market services in the course of 2015. Finally, to further improve the efficiency of tax collection, a new real-time surveillance tool, the Electronic Controlling System for Road Transport has been established from 2015.

## 7. CONCLUSIONS

In 2014, starting from an initial position well above the MTO, Hungary's structural deficit is estimated to have deteriorated by 1.3% of GDP, which points to some deviation from the medium-term objective. On the other hand, the expenditure benchmark pillar was respected. The overall assessment suggests compliance with the requirements of the preventive arm. Hungary also met the requirement of the transitional debt rule in 2014, thanks to the allowed margin of deviation. Nevertheless, the structural balance is estimated to have moved below the country's MTO, requiring further adjustment.

According to the debt-reduction path of the Convergence Programme, Hungary is expected to meet the transitory debt rule in 2015. Following the transition, the debt-to-GDP ratio is also

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<sup>14</sup> For details, see section 3.1. of the Country Report.

projected to remain below the debt benchmark. The Commission 2015 spring forecast is in line with this conclusion.

At face value, the national plans assume that the MTO will be respected in all years over the programme period except for a temporary deviation in 2015. Based on the programme's data recalculated by the Commission, however, the MTO is reached by 2017, and the structural balance would deteriorate somewhat in 2018. Moreover, according to the Commission 2015 spring forecast the structural balance will remain considerably below the MTO (-2.5/-2.4% of GDP vs. -1.7%) in 2016 and 2015. Overall, the planned adjustment path is not in line with the requirement of the preventive arm of the Pact with a risk of a significant deviation in 2015 and 2016. Based on the Commission 2015 spring forecast, the structural balance and net expenditure growth also point to a risk of a significant deviation from the required adjustment path towards the MTO in 2015 and 2016.

## ANNEX

Table I. Macroeconomic indicators

	1997-2001	2002-2006	2007-2011	2012	2013	2014	2015	2016
<b>Core indicators</b>								
GDP growth rate	3.8	4.3	-0.5	-1.5	1.5	3.6	2.8	2.2
Output gap <sup>1</sup>	-0.6	2.5	-1.1	-3.7	-2.8	-0.7	0.2	0.4
HICP (annual % change)	12.3	4.8	5.3	5.7	1.7	0.0	0.0	2.5
Domestic demand (annual % change) <sup>2</sup>	4.2	4.1	-2.1	-3.0	1.2	4.3	2.6	1.1
Unemployment rate (% of labour force) <sup>3</sup>	7.3	6.4	9.5	11.0	10.2	7.7	6.8	6.0
Gross fixed capital formation (% of GDP)	24.6	24.0	22.0	19.1	19.9	21.3	21.7	21.1
Gross national saving (% of GDP)	21.1	17.6	19.3	20.9	24.0	26.4	27.3	27.4
<b>General Government (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>-5.1</b>	<b>-7.9</b>	<b>-4.7</b>	<b>-2.3</b>	<b>-2.5</b>	<b>-2.6</b>	<b>-2.5</b>	<b>-2.2</b>
<b>Gross debt</b>	<b>57.9</b>	<b>59.5</b>	<b>75.6</b>	<b>78.5</b>	<b>77.3</b>	<b>76.9</b>	<b>75.0</b>	<b>73.5</b>
<b>Net financial assets</b>	<b>-31.3</b>	<b>-42.5</b>	<b>-55.1</b>	<b>-60.1</b>	<b>-61.6</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>
Total revenue	43.7	42.3	45.3	46.4	47.3	47.6	46.7	43.8
Total expenditure	48.8	50.2	49.9	48.7	49.8	50.1	49.2	46.0
<i>of which: Interest</i>	6.4	4.1	4.2	4.6	4.6	4.1	3.6	3.4
<b>Corporations (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>-5.2</b>	<b>-1.1</b>	<b>1.2</b>	<b>2.3</b>	<b>6.3</b>	<b>6.6</b>	<b>7.9</b>	<b>7.2</b>
<b>Net financial assets; non-financial corporations</b>	<b>-107.3</b>	<b>-104.4</b>	<b>-115.6</b>	<b>-109.1</b>	<b>-101.1</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>
<b>Net financial assets; financial corporations</b>	<b>-1.4</b>	<b>-4.5</b>	<b>2.4</b>	<b>8.9</b>	<b>8.2</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>
Gross capital formation	18.5	15.4	13.9	12.5	12.6	14.1	14.1	15.0
Gross operating surplus	19.6	22.2	23.1	22.9	24.0	24.9	25.6	27.1
<b>Households and NPISH (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>4.0</b>	<b>1.3</b>	<b>2.3</b>	<b>4.3</b>	<b>3.9</b>	<b>3.9</b>	<b>3.2</b>	<b>2.9</b>
<b>Net financial assets</b>	<b>62.5</b>	<b>60.5</b>	<b>62.1</b>	<b>66.3</b>	<b>70.9</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>
Gross wages and salaries	33.3	35.9	36.3	37.6	37.7	37.3	38.0	37.7
Net property income	5.6	4.1	3.5	3.8	3.5	3.2	3.5	3.2
Current transfers received	16.4	18.1	19.4	19.1	18.7	18.1	17.3	16.7
Gross saving	8.9	6.6	6.3	6.1	6.3	6.0	5.4	5.1
<b>Rest of the world (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>-6.3</b>	<b>-7.7</b>	<b>-1.2</b>	<b>4.3</b>	<b>7.8</b>	<b>8.0</b>	<b>8.6</b>	<b>7.8</b>
<b>Net financial assets</b>	<b>78.1</b>	<b>91.5</b>	<b>107.0</b>	<b>94.5</b>	<b>83.9</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>
Net exports of goods and services	-1.7	-2.7	3.3	6.9	7.6	7.4	8.5	9.8
Net primary income from the rest of the world	-5.2	-4.9	-5.3	-4.3	-2.9	-2.5	-1.3	-1.4
Net capital transactions	0.1	0.3	1.6	2.6	3.6	3.6	3.1	1.5
Tradable sector	48.3	45.6	45.4	45.5	45.9	45.7	n.a	n.a
Non tradable sector	37.8	40.5	39.8	38.4	38.3	38.4	n.a	n.a
<i>of which: Building and construction sector</i>	4.3	4.6	3.8	3.2	3.3	3.6	n.a	n.a
Real effective exchange rate (index, 2000=100)	77.7	101.5	104.4	96.7	95.1	93.5	96.3	97.8
Terms of trade goods and services (index, 2000=100)	102.6	101.7	99.4	97.7	98.4	99.1	100.7	101.2
Market performance of exports (index, 2000=100)	56.9	76.4	98.5	99.5	103.1	107.5	110.1	111.8
<b>Notes:</b>								
<sup>1</sup> The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.								
<sup>2</sup> The indicator on domestic demand includes stocks.								
<sup>3</sup> 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.								
<i>Source :</i>								
<i>AMECO data, Commission 2015 spring forecast</i>								