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**Assessment of the 2016 Convergence Programme for
Hungary**

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

This document assesses Hungary's April 2016 Convergence Programme (hereafter called Convergence Programme), which was approved by the Government on 26 April 2016 and submitted to the Commission on 30 April 2016. The Convergence Programme covers the period 2015-2020.

Hungary is 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 reached 78.3% of GDP in 2012 (the year in which Hungary corrected its excessive deficit), exceeding the 60% of GDP reference value, Hungary was subject to the transitional arrangements as regards compliance with the debt reduction benchmark up to 2015 (three years following the correction of the excessive deficit). During this period Hungary should have ensured sufficient progress towards compliance with the debt reduction benchmark. As of 2016, Hungary is expected to comply with the debt reduction benchmark.

This document complements the Country Report published on 26 February 2016 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 2016 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 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 concludes.

2. MACROECONOMIC DEVELOPMENTS

Following a growth rate of 3.7% in 2014, the Hungarian economy grew by 2.9% in 2015. The macroeconomic scenario underpinning the Convergence Programme of Hungary projects real GDP growth of 2.5% in 2016, 3.1% in 2017, 3.4% in 2018 and 3.1% in 2019. Growth is expected to be supported by robust private consumption and a decreasing contribution from net exports. The drop of GDP growth rate to 2.5% of GDP in 2016 is due to a considerable decline in public investment caused by the transition to the new 2014-2020 Multiannual Financial Framework of EU structural funds. After prices remained stable in 2015, the Convergence Programme projects inflation to increase steadily from 0.4% in 2016 to 3% in 2019. The difference in 2017 compared to the Commission 2016 spring forecast (0.9% vs 2.3%), is due to a VAT reduction, which was not incorporated in the Commission 2016 spring forecast. The Convergence Programme projects that employment growth will decelerate over the forecast horizon from 2.7% in 2015 to 0.5% in 2020. In parallel, unemployment ratio is converging to 5%.

The Convergence Programme forecasts household consumption expenditure to increase robustly supported by growing employment, the impact of the household mortgage loan settlement scheme, a 1 pp. cut in the personal income tax rate, low inflation, VAT cuts and generally the loosening of households precautionary saving attitude.

Revisions compared to the 2015 Convergence Programme are limited regarding the growth path. The main revision was made in 2018 (3.4% vs 2.8% of GDP).

The cyclical conditions underlying the Convergence Programme's macroeconomic scenario point towards increasing potential growth. The output gap as recalculated by the Commission based on the information provided in the Convergence Programme, following the commonly agreed methodology, is more negative than the one estimated in the Commission 2016 spring forecast. The Convergence Programme's output gap is around 1 pp. lower over the forecast horizon. The recalculated potential growth for the next five years is around 2.7%-2.8% on average, while the Commission's 2016 spring forecast estimated it at around 2%.

The Commission 2016 spring forecast and the Convergence Programme both project a drop of growth in 2016 triggered by the slowing down in EU fund absorption. The composition of growth in the Convergence Programme is balanced although the growth of household consumption expenditure is higher than in the Commission 2016 spring forecast in both 2016 and 2017 by 0.7 pps. This could be attributed to measures included in the Convergence Programme, but were not taken into account in the Commission 2016 spring forecast.

Although real consumption growth is higher in the Convergence Programme, 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 projects 6.2% and 5.4% growth rates for 2016 and 2017, while the Convergence Programme foresees the wage bill to grow by 7.1% and 6.8%. The projections of the unemployment rate are diverging. While the Commission 2016 spring forecast projects an unemployment ratio close to 6% over the forecast horizon, the Convergence Programme estimates it 0.9 pps. lower already in 2017 and converges to 5% until 2020.

Table 1: Comparison of macroeconomic developments and forecasts

	2015		2016		2017		2018	2019	2020
	COM	CP	COM	CP	COM	CP	CP	CP	CP
Real GDP (% change)	2.9	2.9	2.5	2.5	2.8	3.1	3.4	3.1	3.2
Private consumption (% change)	3.0	3.1	3.2	3.9	3.0	3.7	2.8	2.7	2.7
Gross fixed capital formation (% change)	1.9	1.9	-1.7	-1.8	4.0	9.1	9.6	5.5	4.0
Exports of goods and services (% change)	8.4	8.4	6.2	6.7	6.4	6.3	6.8	7.0	7.3
Imports of goods and services (% change)	7.8	7.8	6.0	6.4	6.6	7.4	7.6	7.0	7.1
<i>Contributions to real GDP growth:</i>									
- Final domestic demand	2.1	1.8	1.8	1.6	2.4	3.6	3.5	2.4	2.2
- Change in inventories	-0.3	-0.3	0.0	0.0	0.0	-0.2	0.0	0.0	0.1
- Net exports	1.2	1.2	0.7	0.9	0.4	-0.4	-0.1	0.7	0.9
Output gap ¹	0.1	0.2	0.5	0.0	1.0	0.2	0.6	0.9	1.2
Employment (% change)	2.8	2.7	0.9	2.5	0.1	1.7	1.0	0.8	0.5
Unemployment rate (%)	6.8	6.8	6.4	5.5	6.1	5.2	5.1	5.1	5.1
Labour productivity (% change)	0.1	0.3	1.6	0.0	2.7	1.4	2.3	2.3	2.6
HICP inflation (%)	0.1	-0.1	0.4	0.4	2.3	0.9	2.4	3.0	3.0
GDP deflator (% change)	1.8	1.8	2.4	1.8	2.5	2.7	2.8	2.6	2.5
Comp. of employees (per head, % change)	3.3	3.4	4.6	4.5	4.3	5.0	4.4	4.0	3.4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	9.1	8.8	7.7	8.4	7.7	8.3	9.3	8.6	7.8
<i>Note:</i>									
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.									
<i>Source:</i>									
Commission 2016 spring forecast (COM); Convergence Programme (CP).									

The macro-economic scenario of the Convergence Programme includes the estimated impact of structural reforms and this impact is duly quantified.

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

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2015

In 2015, Hungary reached a general government deficit of 2.0% of GDP, down from 2.3% in 2014 and 0.4 pps. below than what was expected in the 2015 Convergence Programme. The better-than expected deficit outturn was mainly the result of strong revenue dynamics due to a tax rich economic recovery as well as to further improvements in tax administration. Tax and social security receipts turned out to be higher by 1.4% of GDP compared to the 2015 Convergence Programme. The level of EU funds absorption (matched by an equivalent amount of expenditure) has significantly exceeded expectations, whereas there was some shortfall in other non-tax revenues. Overall, extra government revenues amounted to 2.1% of GDP. This was just partly absorbed by additional spending (altogether 1.7% of GDP). While the growth of current expenditure was more moderate than planned, investment expanded considerably. Apart from the spending of an elevated level of EU financing for public

investment, this also reflects an over-commitment of projects in order to maximise the absorption of available funds towards the end of the drawdown period of EU funding for 2007-13. This resulted in a sizeable increase in the domestic co-financing costs (around 1% of GDP).

3.2. Medium-term strategy and targets

The Convergence Programme plans to increase the general government deficit from 2% of GDP in 2015 to 2.4% in 2017 and then to bring it down gradually to reach 1.2% by 2020. The Convergence Programme revised the MTO from -1.7% of GDP to -1.5% from 2017 onwards. The MTO reflects the objectives of the Pact. According to the authorities, the planned reduction in headline deficits would ensure that the structural balance reaches the country's MTO of -1.5% of GDP by 2019. However, the structural balance recalculated by the Commission¹ remains below the MTO throughout the programme period (improving from -2.6% of GDP in 2016 only to -1.8% in 2020).

Although the Convergence Programme counts on a considerably increased budgetary leeway, the headline deficit is set to improve only marginally, by 0.1 pps. of GDP in 2016 and to deteriorate by 0.5 pps. in 2017. Over the whole planning horizon, the budgetary position is expected to benefit from the continued cyclical upturn of the economy and the assumed steady decline of interest expenditures, as well as from a contained nominal growth of social transfers mainly reflecting previous parametric pension reforms. In addition, even though the Convergence Programme assumes an accelerated absorption of available EU transfers under the 2014-2020 programming period of EU funding, the volume of EU funded projects remains well below the level seen in recent years resulting in considerable savings in domestic co-financing costs. Furthermore, the budgetary plans incorporate sizeable one-off receipts from agricultural lands sales in 2016 (0.7% of GDP) and a large windfall to be paid under a corporate income tax arrangement in 2016 and 2017 (some 0.7% of GDP in each year). These favourable developments are planned to be largely counterbalanced in 2016 and more than offset in 2017 by the effect of tax cuts and expenditure increases.

According to the Convergence Programme, the total revenue-to-GDP ratio is projected to fall from 48.7% in 2015 to 46.7% in 2017. Filtering out the impact of declining EU funds, corrected revenues are estimated to decrease by some 0.6 pps. over the same period (by 0.5 pps. in 2016 and marginally further in 2017). Apart from tax reductions, this is also attributable to the base effects and macroeconomic assumptions, including the relatively low income elasticity of certain revenue items (e.g. non-tax revenues) and the offsetting impact of extra corporate tax receipts and the expected further increases in tax collecting efficiency with measures put in place in 2017. While the primary expenditure-to-GDP ratio is expected to contract (from 47.1% of GDP to 46.1%), primary expenditure corrected for EU funds is planned to increase by 0.4 pps. of GDP over the two years. This occurs despite a significant decline in social payments (i.e. more than 1 pp.). Substantial spending increases are planned for both, current expenditure (including operating costs and the public wage bill) and capital expenditure from purely domestic sources. Not counting the impact of one-off receipts from asset sales (recorded as negative expenditure), primary expenditure without EU funds is to expand above the rate of nominal GDP growth in 2016, while the additional increase in 2017

¹ 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].

would be slightly below this rate. The phasing out of one-off revenues coupled with the continuing dynamic spending growth generates a strong deficit-increasing effect in 2017. Thus the primary balance is set to deteriorate from 1.6% of GDP in 2015 to 1.2% of GDP in 2016 and further to 0.6% of GDP in 2017. The deterioration in the primary balance is expected to be offset by the decrease of interest expenditure in 2016 and partly offset in 2017 (which would fall altogether by 0.6 pps. of GDP over the two years).

Table 2: Composition of the budgetary adjustment

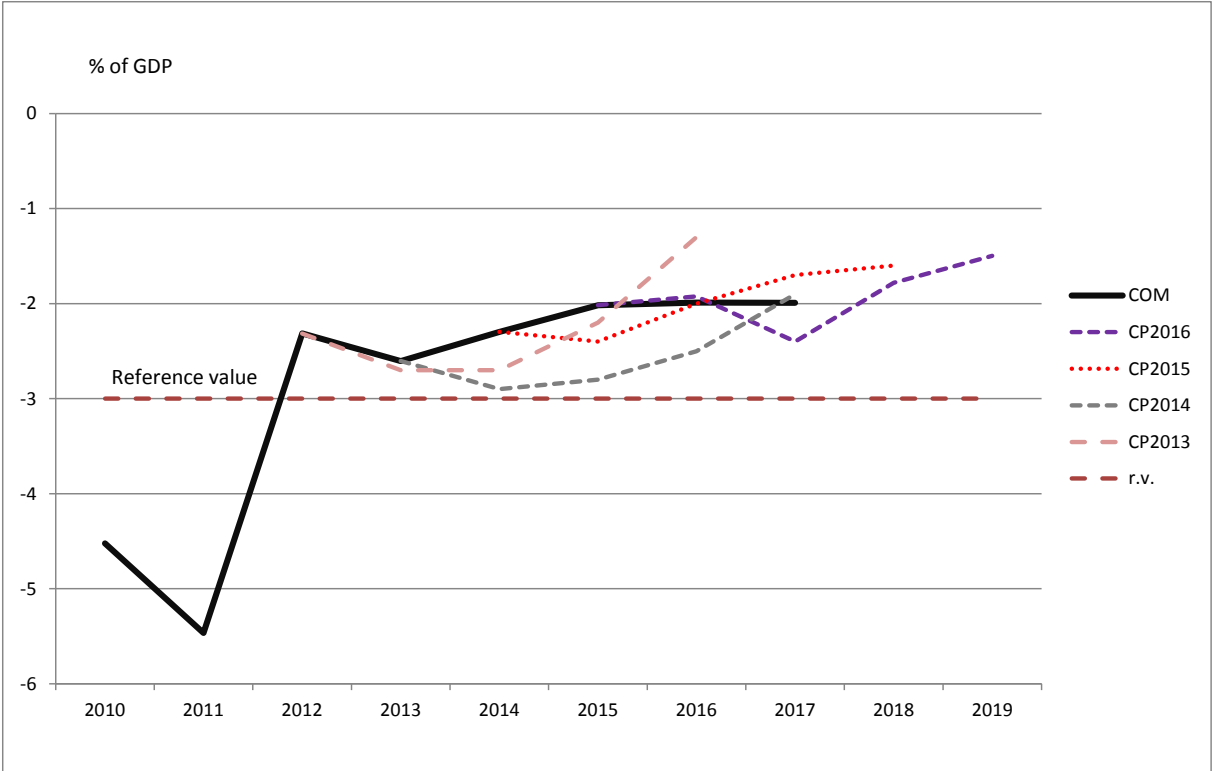
(% of GDP)	2015	2016		2017		2018	2019	2020	Change: 2015-2020
	COM	COM	CP	COM	CP	CP	CP	CP	CP
Revenue	48,7	46,4	46,6	46,1	46,7	45,9	43,4	41,8	-6,9
<i>of which:</i>									
- Taxes on production and imports	19,0	18,1	18,2	17,8	18,1	17,8	17,5	17,2	-1,8
- Current taxes on income, wealth, etc.	6,9	7,2	7,2	7,0	7,2	6,5	6,4	6,4	-0,5
- Social contributions	13,3	13,4	13,4	13,4	13,6	13,5	13,3	13,1	-0,2
- Other (residual)	9,5	7,8	7,8	7,8	7,8	8,2	6,2	5,2	-4,4
Expenditure	50,7	48,4	48,5	48,1	49,1	47,7	44,9	43,0	-7,7
<i>of which:</i>									
- Primary expenditure	47,1	45,3	45,4	45,1	46,1	45,0	42,4	40,7	-6,4
<i>of which:</i>									
Compensation of employees	10,7	11,0	11,0	10,9	10,8	10,5	10,2	9,7	-1,0
Intermediate consumption	7,1	7,4	7,4	7,4	7,7	7,6	6,7	6,1	-1,1
Social payments	15,4	14,8	14,9	14,3	14,1	13,5	13,0	12,6	-2,8
Subsidies	1,2	1,3	1,3	1,2	1,2	1,2	1,1	1,0	-0,3
Gross fixed capital formation	6,7	5,5	5,7	5,3	6,2	6,5	6,1	6,5	-0,2
Other (residual)	6,0	5,3	5,0	6,0	6,1	5,7	5,2	4,7	-3,1
- Interest expenditure	3,6	3,1	3,2	3,0	3,0	2,8	2,5	2,3	-1,3
General government balance (GGB)	-2,0	-2,0	-1,90	-2,0	-2,4	-1,8	-1,5	-1,2	0,8
Primary balance	1,6	1,1	1,2	1,0	0,6	1,0	1,0	1,1	-0,5
One-off and other temporary measures	0,0	0,7	0,7	0,0	0,0	0,0	0,0	0,0	0,0
GGB excl. one-offs	-2,0	-2,6	-2,6	-2,0	-2,4	-1,8	-1,5	-1,2	0,8
Output gap ¹	0,1	0,5	0,0	1,0	0,2	0,6	0,9	1,2	1,2
Cyclically-adjusted balance ¹	-2,1	-2,2	-1,9	-2,5	-2,5	-2,1	-2,0	-1,8	0,2
Structural balance²	-2,0	-2,9	-2,6	-2,5	-2,5	-2,1	-2,0	-1,8	0,2
Structural primary balance ²	1,6	0,3	0,5	0,5	0,5	0,7	0,6	0,5	-1,1
<i>Notes:</i>									
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.									
<i>Source:</i>									
Convergence Programme (CP); Commission 2016 spring forecasts (COM); Commission calculations.									

After 2017, the deficit trajectory is planned to revert to a declining path, decreasing by 1.2% of GDP during the next three years. This would be driven by expenditure restrains and helped by high GDP growth. EU funds reach their peak in 2018 and will decline thereafter. The total revenue-to-GDP ratio is expected to fall steeply to around 42% by 2020. Within this, revenues excluding EU funds are projected to drop by 2.9 pps. of GDP, reflecting mainly the phase out of the tax windfall in corporate income tax as well as the impact of the shrinking expenditure ratio (i.e. the tax content of public spending) rather than revenue side measures. At the same time, the primary expenditure-to-GDP ratio corrected for EU funds is planned to decrease at a

faster rate (overall by 3.4 pps). While all key components of current expenditure are set to grow in nominal terms below the inflation rate in the second half of the planning horizon, capital expenditure financed from domestic sources would continue to increase even relative to GDP. The primary balance is foreseen to recover, improving by 0.5 pps. to 1.1% of GDP by 2020. The headline deficit is expected to benefit also from an additional 0.7 pps. cumulative decline in interest expenditure.

Overall, the deficit trajectory presented in the Convergence Programme relies significantly on savings in interest expenditure. Compared to 2015, the headline deficit is to be reduced by 0.8% of GDP by 2020, whereas the spending on interest is projected to decrease by 1.3% of GDP. Compared to the 2015 Convergence Programme, the updated deficit-reduction path has been shifted upwards and become back-loaded. Despite the better-than-expected outturn in 2015, the currently planned deficit is higher by 0.7 pps. of GDP in 2017 and by 0.2 pps. in 2018 than in the 2015 Convergence Programme.

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



Source: Commission 2016 spring forecast; Convergence Programmes

The Commission 2016 spring forecast – relying on very similar assumptions to those of the Convergence Programme – projects a government deficit at 2% of GDP for 2016, which is just marginally above the target in the Convergence Programme. On the other hand, the deficit of 2% of GDP projected by the Commission for 2017, which is based on the usual no-policy-change assumption, is considerably lower than the Convergence Programme's target of 2.4% of GDP. The Convergence Programme was submitted after the cut-off date of the Commission 2016 spring forecast, thus the new measures and the updated spending targets are not incorporated in the latter.

3.3. Measures underpinning the programme

On the revenue side, the 2016 budget incorporates a number of tax cuts amounting to more than 0.7% of GDP. The 2016 tax package contains the following main elements: i) the lowering of the personal income tax rate; ii) the gradual doubling of the family tax allowance for families with two children (to be introduced in four linear steps between 2016 and 2019); iii) the reduction of the VAT rate on unprocessed pork meat and newly built houses; iv) the reduction of administrative duties; and v) the halving of the bank levy. For 2017, in addition to the previously announced several less significant tax cuts (i.e. pertaining to family tax allowances and the bank levy), the Convergence Programme envisages further VAT reductions with a budgetary impact of 0.2% of GDP. The VAT rates on poultry, eggs, milk, internet and restaurant meals are to be lowered (the latter is planned to be implemented in two steps in 2017 and 2018). These tax cuts are expected to be partly offset by the planned increase of the excise duty on tobacco. Furthermore, counting on yields from additional measures enhancing tax collection efficiency, VAT revenues are assumed to increase by 0.4% of GDP. Taken together, the planned measures are estimated to result in a slight revenue-increasing effect in 2017 (around 0.15% of GDP). For further years no significant additional revenue side measures are foreseen in the Convergence Programme.

On the expenditure side, the Convergence Programme includes additional spending on infrastructure investments (including road reconstructions and urban developments) as well as on launching a new housing scheme providing non-refundable grants to families buying or building new houses. The public works scheme is extended further and a higher-than-initially budgeted appropriation is planned for the education sector. On the other hand, the Convergence Programme envisages significantly higher one-off receipts (0.7% of GDP) from agricultural lands sales (recorded as negative expenditures in ESA2010) than the 2015 Convergence Programme. The land auctions are close to completion and the higher receipts are plausible. In 2017, the planned spending increases comprise the expansion of infrastructure development projects and an increased operating budget for healthcare institutions as well. Regarding multi-year spending programmes, the most significant element is the implementation of new career path wage systems in the public sector, which by 2017 will cover teachers and university lecturers, the armed forces, civil servants in territorial offices as well as healthcare and social workers. The budgetary costs are moderated by continuing wage restraints in other branches of the public sector and partly by foreseen savings resulting from layoffs in public administration. As the impact of the selective wage compensation schemes gradually fades, the growth of the public wage bill is planned to moderate below inflation. However, measures underpinning the spending targets and indicating increasing expenditure containment efforts in the medium-term are not comprehensively detailed yet.

Main budgetary measures

Revenue	Expenditure
2015	
<ul style="list-style-type: none"> • Increase in price and coverage of the distance-based e-toll system (+0.1% of GDP) • Further increase in the efficiency of tax collection, mainly linked to the establishment of the Electronic Road Cargo Inspection System (+0.3% of GDP) 	<ul style="list-style-type: none"> • Public wage bill: net effect of the costs of new career paths/selective wage increases and offsetting wage restraints in other branches of the public sector (+0.6% of GDP) • Public works scheme extension (+0.1 % of GDP) • Establishment of a special fund to settle arrears in the health sector and debt takeovers from state owned companied (+0.4% of GDP) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
2016	
<ul style="list-style-type: none"> • Lowering the flat personal income tax rate by 1 pp to 15% (-0.3% of GDP) • Phasing in the increase of the family allowance after two children - first step (-0.04% of GDP) • Cut bank levy (-0.2% of GDP) • Reducing VAT rate on unprocessed pork meat and newly built houses from 27% to 5% (-0.1% of GDP) • Reduction in administrative duties and other cuts in production taxes (-0.1% of GDP) 	<ul style="list-style-type: none"> • Public wage bill: net effect of the costs of new career paths/selective wage increases and offsetting wage restraints in other branches of the public sector (+0.6% of GDP) • PWS extension (+0.2 % of GDP) • New housing grant scheme and VAT rebate for self-built new family houses (+0.3% of GDP, considerable uncertainty) • New infrastructure development projects – “Modern cites” and road reconstruction (+0.35% of GDP) • Increased budgetary appropriation for state education (not specified) • One-off receipts from asset sales (recorded as negative expenditure, -0.7% of GDP) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
2017	
<ul style="list-style-type: none"> • Further cut in the bank levy (-0.04% of GDP) • Full year effect of PIT reduction and phasing in the increase in the family allowance after two children - second step, (-0.07% of GDP) • Reducing the VAT rate on poultry, eggs and milk from 27% to 5% as well as on internet and restaurant meal to 18% (-0.2% of GDP) • Increasing the excise duty on tobacco (+0.06% of GDP) • Further increase in the efficiency of tax collection, linked to the extended coverage of online cashiers and the introduction of point-of-service terminals (+0.4% of GDP, noteworthy implementation risks) 	<ul style="list-style-type: none"> • Gross wage bill: net effect of the costs of new career paths/selective wage increases and offsetting wage restraints in other branches of the public sector and layoffs (+0.3% of GDP) • Increased take up of the new housing grant scheme (+0.05% of GDP, considerable uncertainty) • Increased appropriation for the operating budget of healthcare institutions (circa +0.2 of GDP) • Expansion of new infrastructure development projects (+0.3% of GDP) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
2018	
<ul style="list-style-type: none"> • Reducing further the VAT on restaurants to 5% (-0.04% of GDP) 	<ul style="list-style-type: none"> • Gross wage bill: net effect of the costs of new career paths/selective wage increases and offsetting wage restraints in other branches of the

<ul style="list-style-type: none"> Phasing in the increase in the family allowance after two children - third step (-0.04% of GDP) 	<ul style="list-style-type: none"> public sector (+0.1% of GDP) Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
2019	
<ul style="list-style-type: none"> Phasing in the increase in the family allowance after two children - final step (-0.04% of GDP) 	<ul style="list-style-type: none"> Gross wage bill: net effect of the costs of new career paths/selective wage increases and offsetting wage restraints in other branches of the public sector(-0.1% of GDP) Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
2020	
<ul style="list-style-type: none"> Phasing out VAT reduction on newly built houses (not specified). 	<ul style="list-style-type: none"> Public wage bill: net effect of the costs of new career paths/selective wage increases and wage restraints in other branches of the public sector (-0.2% of GDP) Phasing out VAT rebate for self-built new family houses (not specified) Phasing in increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
<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>	

3.4. Debt developments

In 2015, the government debt-to-GDP ratio decreased by 0.9% of GDP reaching 75.3%. However, the debt ratio was adversely affected by stock-flow adjustment effects, most notably reflecting delays in the receipt of EU funds in cash terms.

Overall, the Convergence Programme projects a steep decrease of the government debt. The debt ratio is expected to decline gradually to 73.6% in 2017 and to below 65% by the end 2020 (i.e. equivalent to an average annual debt reduction of more than 2% of GDP). The snowball effect would also facilitate the reduction of the debt ratio from 2017 onwards thanks to the anticipated acceleration of nominal growth and the steady decline of implicit nominal interest rates on the debt stock. Nevertheless, the debt trajectory has shifted up markedly compared to the one presented in the 2015 Convergence Programme, where the public debt ratio was projected to decrease below 69% by 2018 (a difference of around 3½ pps.). This partly reflects lower-than-previously-planned primary surpluses. In addition, the Convergence Programme foresees unfavourable stock-flow adjustment developments up to 2018 with sizeable below-the-line debt-increasing effects. This is expected to occur mainly on account of the anticipated lags in the actual payment of EU transfers as the absorption of funds in accrual terms accelerates. By contrast, the cash-flow of EU transfers is expected to incur a debt-reducing impact starting from 2019 as the accumulated arrears are to be gradually reduced.

The Commission 2016 spring forecast projects a debt reduction, which is broadly similar to the debt dynamics expected by the Convergence Programme. The debt-to-GDP ratio is forecast to decrease to 74.3% of GDP in 2016 and to 73.0% of GDP in 2016.

Table 3: Debt developments

(% of GDP)	Average 2010-2014	2015	2016		2017		2018	2019	2020
			COM	CP	COM	CP	CP	CP	CP
Gross debt ratio¹	78.5	75.3	74.3	74.5	73.0	73.6	72.4	68.4	64.6
Change in the ratio	-0.4	-0.9	-1.0	-0.8	-1.4	-0.9	-1.2	-4.0	-3.8
<i>Contributions²:</i>									
1. Primary balance	-0.9	-1.6	-1.1	-1.2	-1.0	-0.6	-1.0	-1.0	-1.1
2. “Snow-ball” effect	1.2	0.2	-0.4	0.0	-0.8	-1.1	-1.5	-1.4	-1.3
<i>Of which:</i>									
Interest expenditure	4.3	3.6	3.1	3.2	3.0	3.0	2.8	2.5	2.3
Growth effect	-0.9	-2.1	-1.8	-1.8	-2.0	-2.2	-2.4	-2.1	-2.1
Inflation effect	-2.2	-1.3	-1.7	-1.3	-1.7	-1.9	-1.9	-1.8	-1.6
3. Stock-flow adjustment	-0.7	0.6	0.6	0.4	0.4	0.9	1.4	-1.5	-1.3

Notes:

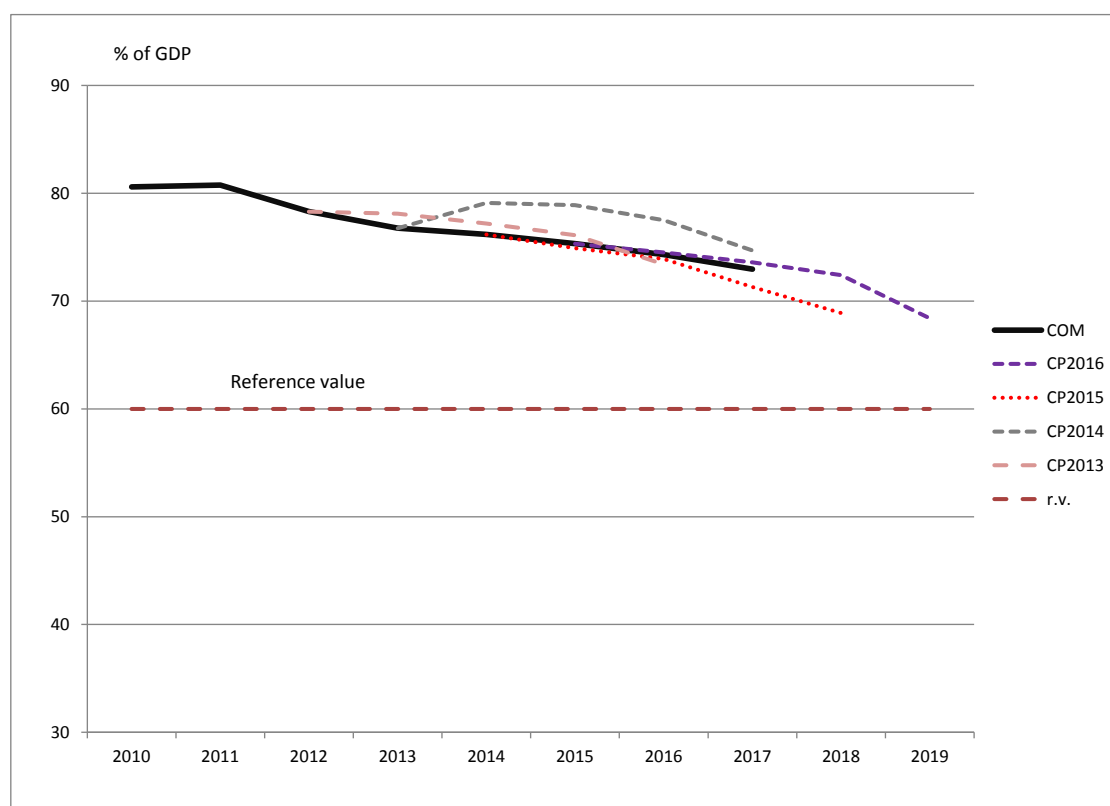
¹ End of period.

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 2016 spring forecast (COM); Convergence Programme (CP), Commission calculations.

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



Source: Commission 2016 spring forecast; Convergence Programmes

3.5. Risk assessment

The risks involved in the Convergence Programme's budgetary adjustment appear to be increasingly tilted towards a higher deficit over the planning horizon. This is linked to the assumed favourable macroeconomic outlook of the plan posing negative revenue-side risks. A further macroeconomic risk stems from the strong reliance of the planned fiscal adjustment on savings in interest outlays, which carries negative risks if the current loose stance of global monetary policies would be reversed quicker or more abruptly than anticipated.

Regarding discretionary measures, the risks appear to be broadly symmetric or even slightly positive in the short term, whereas they tend to be rather negative in outer years. The most important revenue side risk is related to plans to achieve sizeable yields with the help of further measures combatting VAT avoidance from 2017 onwards. Nevertheless, previous steps in this area seem to have generated considerable extra revenues. Risks appear to be more significant on the expenditure side. The open-ended nature of the recently introduced new housing scheme is a source of budgetary uncertainty and with a higher-than-expected take up may lead to expenditure slippages. On the other hand, the assumed accelerated absorption of EU funds may turn out to be too ambitious, implying that the costs of co-financing may be lower than planned at the start, while equally higher during the second half of the programme period. Similarly, the completion of the newly initiated infrastructure development projects may be slower than planned, while resulting in an increased level of spending commitments in future years. Looking ahead, the planned expenditure restraint incorporated in the medium-term targets, affecting in particular current expenditure (including operating budgets and the wage bill), is exposed to significant implementation risks without further measures. Finally, further negative risks are linked to the foreseen construction of the Paks nuclear power plant, which is scheduled to begin in 2018 with an estimated annual deficit-increasing effect of 1-2% of GDP in the investment phase. Although government investments from domestic sources are planned to grow, it is not spelled out in the Convergence Programme to what extent the spending targets reflect the extra costs of the nuclear power plant project.

The risks related to the planned debt trajectory also arise mainly from the above mentioned factors. However, a less favourable macroeconomic scenario with a lower-than-planned GDP growth could have a stronger impact on the debt dynamics than on the level of deficit through a more adverse denominator effect. Additional risks stem from the sensitivity of the debt level to exchange rate movements as currently more than 30% of the Hungarian public debt is denominated in foreign currency. However, the proportion of debt held in foreign currency is planned to be reduced to around 20% by 2020 progressively leading to diminished exposure to exchange rate risks. The planned debt trajectory is also significantly affected by the cash-flow effects of EU transfers. A slower-than-planned implementation of EU funded projects would imply that the debt-reduction path will be slowed down to a lesser extent by the lags in the receipt of EU funds than it is anticipated during the period 2016-2018, while the debt-reducing impact of ex post reimbursement will be smaller than assumed for further years. Finally, a further risk stems from the pending reclassification of Eximbank into the general government as proposed by the Eurostat. If Eximbank is deemed to be a captive financial institution in terms of ESA2010, the incorporation of Eximbank's liabilities within the general government debt is estimated to lift up the debt trajectory by some 2 pps. of GDP.

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

4.1. Compliance with the debt criterion

In 2013, Hungary entered the three-year transitory period regarding the debt reduction benchmark. In 2015, the final year of transition, the required Minimum Linear Structural Adjustment (MLSA) is calculated to allow 0.4 % of GDP deterioration in the structural balance, while the structural balance is estimated to have improved by 0.2% of GDP. According to the Commission's assessment based on notified data, Hungary made sufficient progress towards compliance with the debt criterion in 2015 as measured by the MLSA.

As of 2016, after the end of the transition period, Hungary is expected to comply with the debt reduction benchmark. According to information provided in the Convergence Programme, Hungary is expected to be compliant in 2016 as well as in 2017 and 2018 since the debt-to-GDP ratio is planned to be below the debt reduction benchmark throughout the programme period. The same conclusion is reached on the basis of the Commission 2016 spring forecast for 2016 and under a no policy change scenario for 2017.

Table 4: Compliance with the debt criterion

	2015	2016		2017		2018
		CP	COM	CP	COM	CP
Gross debt ratio	75	74.5	74.3	73.6	73.0	72.4
Gap to the debt benchmark ^{1,2}	n.r.	-0.6	-0.5	-3.8	-0.8	-5.7
Structural adjustment ³	0.2	n.r.	n.r.	n.r.	n.r.	n.r.
<i>To be compared to:</i>						
Required adjustment ⁴	-0.4	n.r.	n.r.	n.r.	n.r.	n.r.

Notes:

¹ 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.

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.

⁴ 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 (S/CP) budgetary projections for the previous years are achieved.

Source:

Commission 2016 spring forecast (COM); Convergence Programme (CP), Commission calculations.

Box 1. Council recommendations addressed to Hungary

On 14 July 2015, the Council addressed recommendations to Hungary in the context of the European Semester. In particular, in the area of public finances the Council recommended to Hungary to achieve a fiscal adjustment of 0.5 % of GDP towards the medium-term budgetary objective in 2015 and of 0.6 % of GDP in 2016.

4.2. Compliance with the required adjustment path towards the MTO

Assessment of eligibility to the "unusual events" provision

The Convergence Programme indicates that the budgetary impact of the exceptional inflow of refugees is significant and an addendum of 6 May provides adequate evidence of the scope and nature of these additional budgetary costs. According to the Commission's 2016 spring forecast taking into account only reported costs directly linked to the immediate consequence of refugee inflows, the eligible additional expenditure amounted to 0.04% of GDP in 2015.² Currently no further incremental costs are expected in 2016. The provisions defined in Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97 allow catering for this additional expenditure, in that the inflow of refugees is an exceptional event, its impact on Hungary's public finances is significant and sustainability would not be compromised by allowing for a deviation from the adjustment path towards the medium-term budgetary objective. Therefore, the required adjustment towards the medium-term budgetary objective for 2015 has been reduced to take into account these costs. Regarding 2016, a final assessment, including on the eligible amounts, will be made in spring 2017 on the basis of observed data as provided by the authorities.

Adjustment towards the MTO

In 2015, the structural balance is estimated to have improved by 0.2% of GDP reaching -2% of GDP, while the required adjustment was set at 0.5% of GDP. This indicates some deviation from the required adjustment path towards the MTO (gap of -0.3% of GDP). At the same time, based on outturn data, the growth rate of government expenditure net of discretionary revenue measures exceeded the benchmark rate benchmark of -1% by 4.3% (resulting in a gap of -1.7% of GDP), pointing to a significant deviation from the required adjustment. Moreover, the annual average deviation measured over the years 2014 and 2015 is estimated at -0.3% of GDP for the structural balance pillar and at -0.7% of GDP for the expenditure benchmark pillar, above the threshold for significance set at 0.25% of GDP. On this basis, the estimated two-year average deviations lead to a strong presumption of significant deviation.

An overall assessment over 2014 and 2015 taken together shows that the fiscal effort as assessed on the basis of the structural balance has been underestimated by a revenue shortfall strongly impacting on 2014 and only partly counterbalanced by a windfall in 2015. Correcting

² The Convergence Programme indicates that the extra refugee related budgetary costs amounted to HUF 46 billion (or 0.14% of GDP). According to the detailed breakdown by functional categories (Table 8), more than two-third of the reported costs are classified as "other costs and measures" (Table 8.), mostly related to border control and the construction of security barriers, which in general are not regarded as expenditure to be taken into account for the purpose of the refugee clause.

for this effect, the structural balance pillar would point to some deviation over 2014 and 2015 taken together. In addition, the expenditure benchmark is not adjusted for the effect of one-off measures impacting on 2014 and 2015. Correcting for these effects, the expenditure benchmark would also point to some deviation over 2014-2015 taken together.

An overall assessment focusing on 2015 alone shows that the structural balance was positively impacted by a revenue windfall which to a considerable extent can be attributed to the improved tax administration. The spring forecast records as a fiscal measure the estimated yields directly linked to more effective VAT collection, but reduced VAT avoidance is likely to have spill-over effects on other revenue items as well. Taking this into account, the structural balance pillar still points only to some deviation. At the same time, the expenditure benchmark pillar is negatively impacted by one-off measures and the above mentioned unaccounted effect of improved tax collection. It should also be taken into account that both pillars were strongly affected by a peak in domestic co-financing of EU funded projects in 2015, the final year of the 2007-2013 programming period. While the expenditure benchmark smoothes upswings in investments financed from national sources, the effect of increased domestic co-financing costs to the private sector is not corrected in any of the pillars.³ Adjusting for this as well, the expenditure benchmark would also signal some deviation in 2015.

Based on outturn data for 2015 and the Commission 2016 spring forecast, therefore the ex-post assessment suggests some deviation from the adjustment path towards the MTO in 2015.

In 2016, the recalculated structural balance based on the programme is expected to deteriorate by around 0.6% of GDP to -2.6%, whereas the required adjustment is 0.3% of GDP. The structural balance pillar thus points to a risk of significant deviation from the required adjustment path (a gap of -0.8% of GDP). As the net government expenditure is planned to grow significantly above the applicable benchmark rate of 0.4%, the risk of significant deviation is also indicated by the expenditure benchmark pillar (a gap of -0.7% of GDP). The assessment over the years 2014 and 2015 together also points to a risk of significant deviation based on both pillars (i.e. with average gaps of -0.6% and -1.2% of GDP for the structural balance and expenditure benchmark pillars, respectively). According to information provided in the Convergence Programme, therefore there is a high risk of significant deviation from the required adjustment towards the MTO in 2016.

The assessment based on the Commission 2016 spring forecast leads to the same conclusion for 2016. The projected deterioration of the structural balance is 0.8% of GDP (resulting in a gap of -1.1% of GDP), while the projected growth of corrected expenditure would well exceed the reference rate (leading to a gap of -1% of GDP). At the same time, the expenditure benchmark pillar is positively impacted by one-off measures. Therefore an overall assessment suggests that there is a risk of significant deviation from the adjustment path towards the MTO in 2016 on the basis of the Commission 2016 spring forecast.

In 2017, the recalculated structural balance based on the programme is estimated to improve by 0.1% of GDP, almost 0.5% of GDP below the recommended effort (0.6% of GDP), which

³ The extra costs of domestic co-financing of EU funded projects amounted to around 1% of GDP in 2015. It is estimated that around 35% of this amount is classified as expenditure other than gross fixed capital formation (i.e. current and capital transfers paid).

points to some deviation. On the other hand, the growth of net expenditure as planned is calculated to exceed considerably the reference rate of 0.2% leading to a significant gap (-2.0% of GDP). Over 2016 and 2017, the structural balance is estimated to deteriorate on average, which points to a risk of significant deviation based on the structural balance pillar (average gap of -0.7% of GDP). The expenditure benchmark also points to a risk of significant deviation over 2016 and 2017 (average gap of -1.3% of GDP). Based on information provided in the programme, therefore the two-year average deviations computed for the two pillars suggest a high risk of significant deviation in 2017.

According to the Commission 2016 spring forecast, which follows a no-policy-change assumption, the structural balance is projected to improve by 0.4% of GDP in 2017, which points to a risk of some deviation (a gap of -0.2% of GDP). At same time, the expenditure benchmark points to a risk of significant deviation as the growth of corrected net expenditure is expected to exceed the applicable reference rate (gap of -1.4% of GDP). Moreover, both the structural balance and expenditure benchmark pillars point to a risk of significant deviation over two years (with average gaps of -0.7% and -1.2% of GDP, respectively). The deviations measured over the years of 2016 and 2017 taken together would exceed the 0.25% of GDP threshold significance even after correcting for the effect of an estimated shortfall impacting the structural balance pillar in 2017 as well as of a relatively low growth assumption and one-off measures impacting the expenditure benchmark pillar. Therefore, the overall assessment confirms the risk of significant deviation from the required adjustment path towards the MTO over the years 2016 and 2017 taken together.

Table 5: Compliance with the requirements under the preventive arm

(% of GDP)	2015	2016		2017	
Initial position¹					
Medium-term objective (MTO)	-1.7	-1.7		-1.5	
Structural balance ² (COM)	-2.0	-2.9		-2.5	
Structural balance based on freezing (COM)	-2.0	-2.9		-	
Position vis-a-vis the MTO³	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	2015	2016		2017	
	COM	CP	COM	CP	COM
Structural balance pillar					
Required adjustment ⁴	0.5	0.3		0.6	
Required adjustment corrected ⁵	0.5	0.3		0.6	
Change in structural balance ⁶	0.2	-0.6	-0.8	0.1	0.4
<i>One-year deviation from the required adjustment⁷</i>	-0.3	-0.8	-1.1	-0.5	-0.2
<i>Two-year average deviation from the required adjustment⁷</i>	-0.3	-0.6	-0.7	-0.7	-0.7
Expenditure benchmark pillar					
Applicable reference rate ⁸	-1.0	0.4		0.2	
<i>One-year deviation⁹</i>	-1.7	-0.7	-1.0	-2.0	-1.4
<i>Two-year average deviation⁹</i>	-0.7	-1.2	-1.3	-1.3	-1.2
Conclusion					
Conclusion over one year	Overall assessment	Significant deviation	Significant deviation	Overall assessment	Overall assessment
Conclusion over two years	Significant deviation	Significant deviation	Significant deviation	Significant deviation	Significant deviation
Notes					
<p>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.</p> <p>² Structural balance = cyclically-adjusted government balance excluding one-off measures.</p> <p>³ Based on the relevant structural balance at year t-1.</p> <p>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.).</p> <p>⁵ Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.</p> <p>⁶ Change in the structural balance compared to year t-1. Expost assessment (for 2014) is carried out on the basis of Commission 2015 spring forecast.</p> <p>⁷ The difference of the change in the structural balance and the corrected required adjustment.</p> <p>⁸ Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.</p> <p>⁹ 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>					
<p><u>Source:</u> Convergence Programme (CP); Commission 2016 spring forecast (COM); Commission calculations.</p>					

5. FISCAL SUSTAINABILITY

Hungary does not appear to face fiscal sustainability risks in the short run, as measured by the S0 indicator.

Government debt stood at 75.3% of GDP in 2015. Based on the Commission 2016 spring forecast and under a no-policy-change scenario beyond forecasts, it is projected to decline to 64% in 2026 remaining somewhat slightly above the 60% of GDP Treaty threshold. Sensitivity tests (related to interest, growth and exchange rate shocks) suggest that the country's debt-reduction path still displays some fragility to potential adverse macroeconomic developments. Medium risks are therefore highlighted for the country from debt sustainability analysis in the medium term. The full implementation of the programme would put debt on a similar decreasing path by 2026, leading to a value somewhat below the 60% of GDP reference value in 2026.

Based on the Commission 2016 spring forecast and no-policy change scenario, the medium-term fiscal sustainability risk indicator S1 is at -0.2 pp. of GDP, mainly due to the projected medium-term savings in ageing costs (which are estimated to reduce the additional required effort by 1 % of GDP), thus indicating low risk in the medium term.. The full implementation of the Convergence Programme would put the sustainability risk indicator S1 at -0.7 pp. of GDP leading to similarly low medium-term risks. However, sensitivity tests (related to interest, growth and exchange rate shocks) suggests that the country's debt-reduction path still displays some fragility to potential adverse macroeconomic developments. Taking this into account, the medium-term sustainability risks overall are at a medium-level.

Based on the Commission projection, the long-term sustainability risk indicator S2 (which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path) is at 1.7% of GDP.. In the longer term, Hungary therefore appears to face low fiscal sustainability risks, related to the initial budgetary position and the projected ageing costs contributing only with 1pp. of GDP to the sustainability gap over the very long run. On the other hand, full implementation of the programme would put the S2 indicator at 2.2 pps. of GDP, leading to a somewhat higher, medium level long-term risk.

Risks would be higher in case the structural primary balance would revert to lower values as observed in the past, such as the average for the period 2005-2014. There are also remaining budgetary risks to the planned fiscal adjustment path. 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

<i>Time horizon</i>	No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term	LOW risk			
S0 indicator ^[1]	0.2			
Fiscal subindex (2015)	0.1	LOW risk		
Financial & competitiveness subindex (2015)	0.2	LOW risk		
Medium Term	MEDIUM risk			
DSA ^[2]	MEDIUM risk			
S1 indicator ^[3]	-0.2	LOW risk	-0.7	LOW risk
<i>of which</i>				
IBP	-0.2		-0.6	
Debt Requirement	1.0		0.5	
CoA	-1.0		-0.5	
Long Term	LOW risk		MEDIUM risk	
S2 indicator ^[4]	1.7		2.2	
<i>of which</i>				
IBP	0.7		0.5	
CoA	1.0		1.7	
<i>of which</i>				
Pensions	0.3		0.8	
HC	0.5		0.5	
LTC	0.3		0.3	
Other	-0.1		0.1	
Source: Commission services; 2016 stability/convergence programme.				
Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2016 forecast until 2017. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.				
[1] The S0 indicator 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.				
[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. See Fiscal Sustainability Report 2015.				
[3] 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 2017) 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.				
[4] 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.				

6. FISCAL FRAMEWORK

The so-called constitutional debt rule, which stipulates a continuous reduction in the public debt-to-GDP ratio until the 50% national threshold is achieved, is likely to have been fulfilled in 2015. A definitive assessment cannot be provided as the delineation of debt set out in the Hungarian legislation differs from the Maastricht concept in several aspects.⁴ Nonetheless, based on the decrease in the Maastricht debt ratio from 2014 to 2015 by 0.9 pps., it may be safely concluded that the prescribed reduction have indeed taken place. Unfortunately, the authorities do not publish the outcome for the adjusted debt ratio, also linked to the fact that no ex post monitoring is foreseen by the legislation. As regards the Fiscal Council, both at the time of the adoption of the 2015 budget bill (December 2014) and at the mandatory mid-year review (September 2015) the body assessed that this debt reduction rule to be complied with. Looking forward, assuming an unchanged exchange rate, the Convergence Programme envisages a continuously decreasing debt trajectory for the entire horizon (2016-2019); thus the official plans are in accordance with the requirements of the constitutional debt rule.⁵

As regards the national rules on the structural budget balance and nominal budget balance (prescribing conformity with the country's MTO and the 3% of GDP reference value, respectively), these cover only the preparation of the draft budget as submitted to the Parliament. In 2015, the budget bill for year 2016 complied with both of the rules. Regarding the headline deficit targets for years 2017-2019 contained in the Convergence Programme, the 3% of GDP threshold is planned to be respected with an increasing margin. As regards the structural balance rule, the draft budget for 2017 tabled to the Parliament on 26 April breaches the rule, as the structural deficit according to the calculations of the government is 2.1% of GDP, which is clearly lower than the MTO of -1.7% of GDP. Looking further, and in light of Hungary's tightened MTO of -1.5% of GDP effective from 2017, the structural balance trajectory set in the programme will comply with this domestic requirement only from 2019.

In conclusion, based on the information provided in the Convergence Programme and in budget documents, the past, planned and forecast fiscal performance in Hungary appears to comply only partially with the requirements of the applicable national numerical fiscal rules.

The Fiscal Council is not involved in the endorsement or assessment of macroeconomic scenario underpinning the Convergence Programme.

As regards the first test of effectiveness of the recently established medium-term budgetary framework, it appears that the 2-year expenditure and revenue plans for each budgetary chapter contained in the government resolution of December 2015 played only a limited role in the preparation of the 2017 budget. For some budgetary chapters (in particular for large ministries), the differences between the medium-term figures and the planned 2017 budgetary appropriations are sizeable, i.e. in the range of 0.5%-1% of GDP, especially against the

⁴ The Hungarian debt rule is based on a debt stock concept which filters out i) the revaluation effects of foreign currency debt; ii) the pre-financing of EU funds; and iii) debts taken out to finance obligation maturing in the next calendar year.

⁵ The debt reduction formula, effective from 2015 to operationalise the constitutional debt reduction requirement, covers none of the years assessed (2015-2019) due to its lenient escape clause (in case either the official growth projection or the official inflation projection underlying the budget bill for year T+1 does not reach 3%, the rule is suspended).

backdrop that only 4 months passed between the adoption of the resolution and the submission of the draft budget. Furthermore, the compulsory written justifications for the differences are missing for a number of budgetary chapters. Where explanations are provided, in some instances, they are not detailed enough to fully capture the relative weights of the factors behind the deviation or they refer to decisions taken before the adoption of the resolution. The justifications typically recall changing policy priorities, partly mirroring the 0.7% of GDP fiscal loosening decided in the meantime.

7. CONCLUSIONS

In 2015, starting from an initial position below the MTO, Hungary's structural deficit is estimated to have improved by 0.2% of GDP, which points to some deviation from the required adjustment towards the MTO. However, a significant deviation was observed for the expenditure benchmark pillar in 2015 and for both pillars over 2014 and 2015 taken together. Taking into account the relevant factors affecting the estimated deviations for the two pillars, the overall assessment suggests some deviation from the required adjustment path towards the MTO in 2015. At the same time, Hungary met the requirement of the transitional debt rule in 2015.

Both on the basis of the debt-reduction path of the Convergence Programme and the Commission 2016 spring forecast, Hungary's debt-to-GDP ratio is expected to meet the debt reduction benchmark from 2016 onwards.

The Convergence Programme assumes that the revised MTO will be reached by 2019. Based on the programme data recalculated by the Commission, however, the structural balance would not reach the MTO by the end of the programme period. According to the Commission 2016 spring forecast, the structural balance is expected to deteriorate considerably below the MTO in 2016 and 2017. Overall, the adjustment path planned in the programme is not in line with the requirement of the preventive arm of the Stability and Growth Pact with a high risk of a significant deviation in 2016 and 2017. Based on the Commission 2016 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 2016 and 2017.

8. ANNEX

Table I. Macroeconomic indicators

	1998-2002	2003-2007	2008-2012	2013	2014	2015	2016	2017
Core indicators								
GDP growth rate	4.0	3.5	-1.0	1.9	3.7	2.9	2.5	2.8
Output gap ¹	-0.6	2.7	-2.0	-2.4	-0.7	0.1	0.5	1.0
HICP (annual % change)	9.7	5.4	4.9	1.7	0.0	0.1	0.4	2.3
Domestic demand (annual % change) ²	4.7	2.6	-2.6	1.5	4.2	1.9	2.0	2.7
Unemployment rate (% of labour force) ³	6.6	6.8	10.2	10.2	7.7	6.8	6.4	6.1
Gross fixed capital formation (% of GDP)	24.9	23.8	21.1	20.5	21.7	21.3	20.6	20.8
Gross national saving (% of GDP)	20.5	17.2	20.2	24.6	24.4	26.9	26.2	25.9
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	-5.7	-7.1	-4.1	-2.6	-2.3	-2.0	-2.0	-2.0
Gross debt	56.4	61.4	77.8	76.8	76.2	75.3	74.3	73.0
Net financial assets	-33.8	-45.6	-60.6	-70.5	-71.8	-69.3	n.a	n.a
Total revenue	43.3	42.7	45.4	47.0	47.5	48.7	46.4	46.1
Total expenditure	49.0	49.8	49.5	49.6	49.8	50.7	48.4	48.1
<i>of which: Interest</i>	5.5	4.1	4.3	4.5	4.0	3.6	3.1	3.0
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	-3.4	-1.1	3.4	7.2	5.1	6.4	7.1	7.8
Net financial assets; non-financial corporations	-107.3	-109.5	-120.9	-113.6	-109.2	-103.3	n.a	n.a
Net financial assets; financial corporations	-1.1	-3.0	6.8	15.9	15.3	5.2	n.a	n.a
Gross capital formation	18.0	15.6	13.6	13.2	13.7	12.5	12.9	13.0
Gross operating surplus	21.0	23.5	24.5	25.6	26.3	25.5	26.4	27.1
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	2.3	0.4	1.6	2.9	3.4	4.6	2.6	1.8
Net financial assets	66.4	64.1	69.4	84.7	90.2	97.6	n.a	n.a
Gross wages and salaries	32.7	35.0	34.9	36.0	35.4	35.6	36.2	36.1
Net property income	5.3	4.0	3.4	3.6	3.4	3.9	1.7	0.7
Current transfers received	16.7	18.5	19.2	18.5	17.7	16.8	16.1	15.5
Gross saving	7.2	5.5	5.1	5.4	5.7	6.7	4.9	4.0
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	-6.8	-7.9	0.9	7.5	6.0	9.1	7.7	7.7
Net financial assets	75.8	94.0	105.3	83.6	75.6	70.0	n.a	n.a
Net exports of goods and services	-2.3	-2.1	4.5	7.3	7.3	8.6	9.2	9.2
Net primary income from the rest of the world	-5.1	-5.4	-4.9	-2.9	-4.4	-2.8	-3.5	-3.2
Net capital transactions	0.1	0.4	1.9	3.6	3.8	4.2	2.7	3.2
Tradable sector	47.6	45.7	45.1	46.0	46.0	45.6	n.a	n.a
Non tradable sector	38.6	40.3	39.7	38.3	38.2	38.2	n.a	n.a
<i>of which: Building and construction sector</i>	4.5	4.6	3.8	3.4	3.7	3.7	n.a	n.a
Real effective exchange rate (index, 2000=100)	83.1	105.7	102.1	95.5	93.1	93.1	94.5	94.4
Terms of trade goods and services (index, 2000=100)	102.7	101.1	99.0	98.2	98.8	99.5	99.9	99.9
Market performance of exports (index, 2000=100)	60.9	81.4	99.7	102.8	105.9	108.6	110.2	111.2
Notes:								
¹ The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.								
² The indicator on domestic demand includes stocks.								
³ Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.								
<i>Source:</i>								
AMECO data, Commission 2016 spring forecast								