COUNCIL RECOMMENDATION

of 8 July 2014

on the National Reform Programme 2014 of Hungary and delivering a Council opinion on the Convergence Programme of Hungary, 2014

(2014/C 247/15)

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Articles 121(2) and 148(4) thereof,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies [1], and in particular Article 9(2) thereof,

Having regard to Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances [2], and in particular Article 6(1) thereof,

Having regard to the recommendation of the European Commission,

Having regard to the resolutions of the European Parliament,

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

Having regard to the opinion of the Economic and Financial Committee,

Having regard to the opinion of the Social Protection Committee,

Having regard to the opinion of the Economic Policy Committee,

Whereas:

(1) On 26 March 2010, the European Council agreed to the Commission's proposal to launch a new strategy for growth and jobs, Europe 2020, based on enhanced coordination of economic policies, which focuses on the key areas where action is needed to boost Europe's potential for sustainable growth and competitiveness.

(2) On 13 July 2010, the Council, on the basis of the Commission's proposals, adopted a Recommendation on the broad guidelines for the economic policies of the Member States and the Union (2010 to 2014) and, on 21 October 2010, it adopted a decision on guidelines for the employment policies of the Member States [3], which together form the 'integrated guidelines'. Member States were invited to take the integrated guidelines into account in their national economic and employment policies.

(3) On 29 June 2012, the Member States' Heads of State or Government decided on a Compact for Growth and Jobs, providing a coherent framework for action at national, EU and euro area levels using all possible levers, instruments and policies. They decided on action to be taken at the level of the Member States, in particular expressing full commitment to achieving the objectives of the Europe 2020 strategy and to implementing the country-specific recommendations.

(4) On 9 July 2013, the Council adopted a Recommendation [4] on Hungary's National Reform Programme for 2013 and delivered its opinion on Hungary's updated Convergence Programme for 2013-2016.

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[1] OJ L 209, 2.8.1997, p. 1.
[2] OJ L 306, 23.11.2011, p. 25.
[3] Maintained for 2014 by Council Decision 2014/322/EU of 6 May 2014 on guidelines for the employment policies of the Member States for 2014 (OJ L 165, 4.6.2014, p. 49).
[4] OJ C 217, 30.7.2013, p. 37.

(5) On 13 November 2013, the Commission adopted the Annual Growth Survey, marking the start of the 2014 European Semester for economic policy coordination. Also, on 13 November 2013, the Commission, on the basis of Regulation (EU) No 1176/2011, adopted the Alert Mechanism Report, in which it identified Hungary as one of the Member States for which an in-depth review would be carried out.

(6) On 20 December 2013, the European Council endorsed the priorities for ensuring financial stability, fiscal consolidation and action to foster growth. It underscored the need to pursue differentiated, growth-friendly fiscal consolidation, to restore normal lending conditions to the economy, to promote growth and competitiveness, to tackle unemployment and the social consequences of the crisis, and to modernise public administration.

(7) On 5 March 2014, the Commission published the results of its in-depth review for Hungary, under Article 5 of Regulation (EU) No 1176/2011. The Commission's analysis leads it to conclude that Hungary continues to experience macroeconomic imbalances, which require monitoring and decisive policy action. In particular, the ongoing adjustment of the highly negative net international position, the high level of public and private debt in the context of a fragile financial sector and deteriorating export performance continue to deserve very close attention with a view to reducing the important risks of adverse effects on the functioning of the economy.

(8) On 30 April 2014, Hungary submitted its 2014 National Reform Programme and its 2014 Convergence Programme. In order to take account of their interlinkages, the two programmes have been assessed at the same time.

(9) The objective of the budgetary strategy outlined in the 2014 Convergence Programme is to bring down the headline deficit from 2,9 % of GDP in 2014 to 1,9 % by the end of the programme period. This is to be achieved with a strongly back-loaded consolidation path, while the deficit targets have been significantly revised upwards compared to the previous Convergence Programme. The Convergence Programme confirms the medium-term objective of - 1,7 % of GDP, which reflects the objectives of the Stability and Growth Pact. However, on the basis of the recalculated structural balance, the medium-term objective is not expected to be attained by the end of the programme period. The (recalculated) structural balance is expected to deteriorate by 1,5 percentage points in 2014, thereby significantly deviating from the medium-term objective, and is set to stabilise in 2015, implying a shortfall of 0,5 % of GDP from the required improvement towards the medium-term objective. The expenditure benchmark shows a significant deviation in both 2014 and 2015. The (recalculated) structural balance is expected to deteriorate further in both 2016 and 2017. Overall, a significant deviation from the adjustment path towards the medium-term objective is expected as of 2014. The Convergence Programme projects a gradual but continuous decrease in government debt from 79 % of GDP in 2013 to around 75 % of GDP in 2017. The macroeconomic scenario underpinning the budgetary projections in the Convergence Programme is broadly plausible for 2014-2016, with GDP projected to grow by 2,3 % and 2,5 % in 2014 and 2015 respectively, against 2,3 % and 2,1 % according to the Commission services 2014 spring forecast. However, the Convergence Programme is too optimistic for 2017.

Risks to the budgetary targets are broadly balanced in 2014, but there are increasing risks that the deficit may turn out higher than targeted as from 2015. Particular risks stem from the fact that the planned reduction in the expenditure ratio is foreseen to be achieved by instituting across-the-board nominal freezes or restraining increases below the inflation rate for most of the discretionary spending items. The Commission services 2014 spring forecast projects a headline deficit for 2014 and 2015 identical to the targets of the Convergence Programme. With a projected structural deficit of 2,2 % of GDP in 2014 and 2,3 % in 2015, the Commission forecast confirms the risk of significant deviation from the medium-term objective as from 2014. Moreover, the Commission forecast also points to non-compliance with the debt reduction benchmark in 2014 and 2015. In 2014, the projected deterioration of the structural balance (- 1,4 % of GDP) is larger than what is allowed to comply with the debt rule (- 0,5 % of GDP). Based on its assessment of the Convergence Programme and the Commission forecast, pursuant to Regulation (EC) No 1466/97, the Council is of the opinion that there is a need for additional structural consolidation efforts in view of the risks of significant deviation from the medium-term objective as well as of non-compliance with the debt rule as from 2014.

(10) The medium-term budgetary framework has been strengthened by extending the planning horizon beyond the current budget year. Its effectiveness and binding nature are however not yet ensured. New numerical fiscal rules have been introduced, but design weaknesses have not been corrected, linked mainly to the absence of systematic ex post monitoring, the lack of a maximum permissible deviation levels and sound correction mechanisms. The Fiscal Council's narrow list of mandatory tasks and its analytical capacity are still not commensurate with its budgetary veto right. Further strengthening the medium-term budgetary framework and broadening the Fiscal Council's mandatory mandate would help improve the credibility, transparency and effectiveness of the overall fiscal framework.

(11) Notwithstanding the Central Bank's subsidised 'Funding for Growth' scheme for small and medium-sized enterprises, normal lending to the economy has not picked-up in a sustainable manner. The regulatory burden on the financial sector has been further increased, thus limiting the capacity for capital accumulation. Measures like the increase of the financial transaction duty have contributed to a pick-up in the cash usage of the economy. The household portfolio has further deteriorated and the high proportion of non-performing loans currently represents one of the biggest challenges for the financial sector. Portfolio cleaning is hindered by the weak efficiency of resolution proceedings. No substantial new measure has been taken to remove bad assets from banks' balance sheets. The combination of a heavy regulatory burden and a high share of non-performing loans have led to a squeeze on available credits. The Government repeatedly announced its intention to introduce a new relief scheme to assist foreign currency borrowers; in most cases, these have not targeted distressed borrowers and have a negative impact on the payment culture of households, due to the expectation of further government help. Financial regulation and supervision has been strengthened by integrating the Financial Supervisory Authority into the central bank structure and giving the central bank the responsibility for macroprudential oversight. Preparatory work has started on establishing a bank resolution regime.

(12) Although the frequency of tax changes has decreased compared to the previous year, no substantial progress was made in making the corporate tax system more balanced. Some of the existing sector-specific taxes were even increased. The application of different tax rates across sectors is an obstacle to the effective allocation of resources and thus negatively affects growth. To make taxation more employment-friendly, Hungary has widened eligibility for the personal income tax family tax credit, which can help wage earners. The tax wedge on single low-income earners is one of the highest in the Union. Despite some broadening of the scope for mothers with three or more children the eligibility criteria for the Job Protection Act have remained in essence unchanged, even though a significant proportion of low earning workers remain outside the scope of the measure. It will be important to evaluate the impact and cost-effectiveness of the scheme and to adapt it as necessary to enhance its capacity to bring people into employment. Some progress was made in shifting taxation away from labour towards environmental taxes, but additional measures are needed. The online connection of cash-registers to the tax authority is gradually being implemented, after repeated delays in the past. However, Hungary still suffers from a high level of tax non-compliance, with a sustained level of undeclared work and a VAT compliance gap. Control measures should be strengthened in particular with a view to improving the efficiency of combatting VAT fraud.

(13) The youth unemployment rate has decreased in 2013, while the rate of young people who are not in employment, education or training has increased. An efficient coordination of the Public Employment Service branch offices with educational institutions and local stakeholders could increase outreach. Capacity-building in the public employment service, including preparation of a client profiling system, has started, while active labour market policies for the open labour market should be evaluated to assess their efficiency and effectiveness and if necessary adapted to improve access to the labour market for some disadvantaged groups. The activation element in different labour market and social measures (Public Work Scheme, unemployment benefits, and social assistance) needs to be strengthened. The Public Work Scheme attracts the bulk of budgetary resources available for employment measures, but in 2013 11,54 % of its participants were able to return to the open labour market after exiting the scheme. This raises the question of whether the scheme should be adapted, for example by building stronger links to activation, training and job search support, to secure a more lasting employment impact. Women's labour market participation has been encouraged by increased flexibility in the paid parental leave system and the provision of childcare capacities, but further efforts are needed as employment levels among women remain below 60 %. The period of eligibility for unemployment benefit is shorter than

the average time required by job seekers to find employment. The number of people at risk of poverty or social exclusion in Hungary is growing steadily and currently represents close to a third of the whole population. Poverty continues disproportionately to affect disadvantaged groups, in particular children and the Roma. While a National Social Inclusion Strategy is in place, policy measures in most fields do not systematically promote the goals defined by that strategy. Integrated and streamlined policy measures are needed to reduce poverty effectively.

(14) The business environment in Hungary is characterised by frequent changes in the regulatory framework and limited competition in an increasing number of sectors. New barriers have been introduced in the services sector and existing ones have not been removed (e.g. pharmacies, waste management, mobile payment, retail tobacco and textbooks). Investment has declined particularly strongly in those sectors where sector-specific surtaxes have been imposed in recent years. Between 2010 and 2013, nominal investment declined by 44 % in energy, 28 % in finance and 18 % in the communication sectors, while increasing by 3,4 % overall. Some progress has been made in improving competition in public procurement, but further efforts are needed. For example, greater reliance on e-procurement could generate significant cost savings, improve the transparency of public procurement and increase competition. Steps have been taken to implement integrity strategies and to promote better transparency standards in the public administration, but further efforts are needed to tackle corruption effectively.

(15) The proportion of early school leavers is on the rise and the adoption of an early school leaving prevention strategy has been repeatedly delayed. Further efforts are needed to equip pupils with basic skills, competences and qualifications that are relevant for the labour market. Equal access to mainstream quality education still remains a major problem for disadvantaged children, in particular Roma. A new law on vocational training, which inter alia introduces a new 'dual model', has been enacted to reduce the still-difficult transition from education to the labour market, the effects of which need to be closely monitored.

(16) Hungary continued to implement reductions in end-user electricity and gas prices in 2013 and 2014. These price cuts, coupled with the extra tax burden on energy companies, have negatively affected energy providers' capacity to recover costs and energy investments and network maintenance. At present, households' energy intensity is among the highest in the Union and energy efficiency could be improved in particular in the residential sector. The lack of independence of the energy regulator in setting access-to-network conditions and tariffs still raises concerns. Some steps have been taken to streamline the organisation of public transport companies, but sustainability could be further improved by tackling operating costs and changing the tariff system.

(17) In the context of the European Semester, the Commission has carried out a comprehensive analysis of Hungary's economic policy. It has assessed the National Reform Programme and the Convergence Programme. It has taken into account not only their relevance for sustainable fiscal and socio-economic policy in Hungary but also their compliance with EU rules and guidance, given the need to reinforce the overall economic governance of the Union by providing EU-level input into future national decisions. Its recommendations under the European Semester are reflected in recommendations (1) to (7) below.

(18) In the light of this assessment, the Council has examined the Convergence Programme, and its opinion [1] is reflected in particular in recommendation (1) below.

[1] Under Article 9(2) of Regulation (EC) No 1466/97.

(19) In the light of the Commission's in-depth review and this assessment, the Council has examined the National Reform Programme and the Convergence Programme. Its recommendations under Article 6 of Regulation (EU) No 1176/2011 are reflected in recommendations (1), (2), (3) and (5) below,

HEREBY RECOMMENDS that Hungary take action within the period 2014-2015 to:

1. 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. Ensure 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.

2. Help restore normal lending flows to the economy, inter alia by improving the design of and reducing the burden of taxes imposed on financial institutions. Adjust the financial transaction duty in order to avoid diverting savings from the banking sector and enhance incentives for using electronic payments. Investigate and remove obstacles to portfolio cleaning inter alia by tightening provisioning rules for restructured loans, removing obstacles to collateral foreclosure as well as increasing the speed and efficiency of insolvency proceedings. In this respect, closely consult stakeholders on new policy initiatives and ensure that these are well-targeted and do not increase moral hazard for borrowers. Further enhance financial regulation and supervision.

3. Ensure a stable, more balanced and streamlined tax system for companies, including by phasing out distortive sector-specific taxes. Reduce the tax wedge for low-income earners, inter alia by improving the efficiency of environmental taxes. Step up measures to improve tax compliance — in particular to reduce VAT fraud — and reduce its overall costs.

4. Strengthen well-targeted active labour market policy measures, inter alia by accelerating the introduction of the client profiling system of the Public Employment Service. Put in place the planned youth mentoring network and coordinate it with education institutions and local stakeholders to increase outreach. Review the public works scheme to evaluate its effectiveness in helping people find subsequent employment and further strengthen its activation elements. Consider increasing the period of eligibility for unemployment benefits, taking into account the average time required to find new employment and link to activation measures. Improve the adequacy and coverage of social assistance while strengthening the link to activation. In order to alleviate poverty, implement streamlined and integrated policy measures to reduce poverty significantly, particularly among children and Roma.

5. Stabilise the regulatory framework and foster market competition, inter alia by removing barriers in the services sector. Take more ambitious steps to increase competition and transparency in public procurement, including better use of e-procurement and further reduce corruption and the overall administrative burden.

6. Implement a national strategy on early school leaving prevention with a focus on drop-outs from vocational education and training. Put in place a systematic approach to promote inclusive mainstream education for disadvantaged groups, in particular Roma. Support the transition between different stages of education and towards the labour market, and closely monitor the implementation of the vocational training reform. Implement a higher-education reform that enables greater tertiary attainment, particularly by disadvantaged students.

7. Review the impact of energy price regulation on incentives to invest and on competition in the electricity and gas markets. Take further steps to ensure the autonomy of the national regulator in establishing network tariffs and conditions. Take measures to increase energy efficiency in particular in the residential sector. Further increase the sustainability of the transport system, inter alia by reducing operating costs and reviewing the tariff system of state-owned enterprises in the transport sector.

Done at Brussels, 8 July 2014.

For the Council

The President

P. C. PADOAN