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Recommendation for a

COUNCIL RECOMMENDATION

on Hungary's 2013 national reform programme

and delivering a Council opinion on Hungary's convergence programme for 2012-2016

{SWD(2013) 367 final}

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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 policies¹, 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 imbalances², and in particular Article 6(1) thereof,

Having regard to the recommendation of the European Commission³,

Having regard to the resolutions of the European Parliament⁴,

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

After consulting the Economic and Financial 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 will focus on the key areas where action is needed to boost Europe's potential for sustainable growth and competitiveness.
- (2) On 13 July 2010, on the basis of the Commission's proposals, the Council 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, adopted a decision on guidelines for the employment policies of the Member States⁵, 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 Heads of State and 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

¹ OJ L 209, 2.8.1997, p. 1.

² OJ L 306, 23.11.2011, p. 25.

³ COM(2013) 367 final .

⁴ P7_TA(2013)0052 and P7_TA(2013)0053.

⁵ Council Decision 2013/208/EU of 22 April 2013.

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 6 July 2012, the Council adopted a recommendation on Hungary's national reform programme for 2012 and delivered its opinion on Hungary's updated convergence programme for 2011-2015.
- (5) On 28 November 2012, the Commission adopted the Annual Growth Survey⁶, marking the start of the 2013 European Semester of economic policy coordination. Also on 28 November 2012, the Commission, on the basis of Regulation (EU) No 1176/2011, adopted the Alert Mechanism Report⁷, in which it identified Hungary as one of the Member States for which an in-depth review would be carried out.
- (6) On 14 March 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 10 April 2013, the Commission published the results of its in-depth review⁸ for Hungary, under Article 5 of Regulation (EU) No 1176/2011. The Commission's analysis leads it to conclude that Hungary is experiencing macroeconomic imbalances, which deserve monitoring and require decisive policy action. In particular, the ongoing adjustment of the highly negative net international investment position, largely driven by private sector deleveraging in a context of high general government debt and a weak business environment continues to deserve very close attention so as to reduce the important risks of adverse effects on the functioning of the economy.
- (8) On 24 April 2013, Hungary submitted its 2013 convergence programme covering the period 2012-2016 and, on 22 April 2013, its 2013 national reform programme. In order to take account of their interlinkages, the two programmes have been assessed at the same time.
- (9) Based on the assessment of the 2013 convergence programme (the programme) pursuant to Council Regulation (EC) No 1466/97, the Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the Programme is somewhat optimistic. The Hungarian authorities' growth projections for 2013 and 2014 of 0.7% and 1.9% are higher by around half a percentage point compared to the Commission 2013 spring forecast. The objective of the budgetary strategy outlined in the programme is to ensure the sustainable correction of the excessive deficit by the 2012 deadline and the continued respect of the medium-term objective (MTO). Hungary has undertaken significant fiscal efforts in 2012 and with a budget deficit outcome of 1.9% of GDP overachieved the deficit target of 2.5% of GDP recommended by the Council, partly on account of additional one-off revenues of 0.2% of GDP on top of those which were acknowledged already at the time of the Council recommendation. However, the corrective measures for 2012 and beyond, notably those announced in the autumn of 2012 were mainly concentrated on the revenue side, primarily focusing on selected sectors, raising questions about the

⁶ COM(2012) 750 final.

⁷ COM(2012) 751 final.

⁸ SWD(2013) 119 final.

sustainability of the consolidation efforts. According to the Commission 2013 spring forecast further efforts are needed for both 2013 and 2014 in order to correct the excessive deficit in a sustainable manner. Following the publication of the spring forecast the government adopted a new corrective package, and based on the updated assessment of the Commission, the deficit is projected to remain below the 3% of GDP threshold with the new measures in both 2013 and 2014. The programme has changed the MTO from a structural balance of -1.5% to -1.7% of GDP. The new MTO is in line with the requirements of the Stability and Growth Pact. Hungary recorded a structural balance of -0.7% of GDP in 2012, i.e. well above its revised MTO, and the Commission 2013 spring forecast foresees the structural balance to stay in line with the MTO over the forecast horizon and to stand at -1.1% in 2013 and -1.8% in 2014. Based on the measures adopted after the Commission 2013 spring forecast the structural balance could remain above the MTO in 2014 as well. The growth rate of government expenditure in 2013 and 2014, net of discretionary revenue measures, will be broadly in line with the reference medium-term rate of potential GDP growth, but is expected to significantly exceed it in 2015 and 2016. Thus, the expenditure benchmark will not be met in these two years. According to government plans, the public debt-to-GDP ratio will continuously decrease throughout the programme period from 79.2% in 2012 to 77.2% in 2014 and further to 73.4% in 2016, i.e. it will remain above the 60% of GDP reference value. In contrast, the Commission 2013 spring forecast, taking account of risks to the consolidation plans, expected only a marginal decrease to 78.9% of GDP in 2014 which should be around 0.5 pps lower with the new corrective measures. Hungary will be in a transition period from 2013 regarding compliance with the debt criterion, and according to the Commission 2013 spring forecast it is making sufficient progress towards compliance with the debt criterion in 2013 and 2014.

- (10) The medium-term budgetary framework is still merely indicative so the horizon of fiscal planning is focusing only on the actual budget year. In addition, despite some recent improvements, the mandatory tasks and the analytical resources of the Fiscal Council are still not commensurate with its unprecedented veto power and the need for the systematic ex-post assessment of compliance with numerical fiscal rules. Strengthening the medium-term budgetary framework and widening the mandatory remit of the Fiscal Council would help to improve the solidity and credibility of the recently revamped fiscal governance framework.
- (11) The Hungarian financial sector is deleveraging at a very quick pace, partly due to some policy measures that have had a strong negative impact on the profitability of banks and contribute to tight credit conditions. Managing the deteriorating portfolio quality represents one of the biggest challenges for the financial sector, associated with an increasing number of non-performing loans. In the last years, the government adopted several measures to help foreign currency borrowers, in several cases without a consultation of stakeholders in the banking sector. However, these measures were not always targeted toward distressed borrowers. The adoption of a series of measures in a short time might increase moral hazard among borrowers due to the continuous expectation of further government help. The global financial crisis demonstrated to which extent the existing banking system may force national authorities to act to safeguard financial stability. The first financial assistance programme to Hungary advocated the need for a state-of-the-art supervision including effective emergency powers to the financial supervisor and the establishment of a resolution mechanism. While over the past three years the powers of the Hungarian Financial Supervisory Authority have been substantially increased, the legislator has not equipped it with sufficient monitoring powers.

- (12) Hungary has not followed the 2012 recommendation to establish a non-distortive and stable framework for the taxation of corporations and has increased the tax burden on selected corporate sectors by introducing further permanent sectoral surtaxes. While the new small business tax introduced as part of the Job Protection Act has a favourable design, the existence of several different tax rates across corporate sectors hampers effective allocation of resources and affects investment and lending. The introduction of reduced social security contribution rates under the Job Protection Act is a step in the right direction to reduce the tax wedge on labour. However, the tax wedge on low wage earners is still high and a refining of the system to better target this group would be desirable. Hungary also plans to tackle tax non-compliance with several measures, such as the compulsory connection of all cash registers with tax authorities. Regarding energy taxation, measures taken do not provide incentives to reduce energy consumption and have distortionary effects.
- (13) The low employment rate is associated with a very low rate of labour-market participation. Youth unemployment has increased from 11% in 2001 to 28.1% in 2012. The Public Work Scheme uses the bulk of budgetary resources to provide the long-term unemployed with work-related income instead of social benefits, while its long-term benefits on employability are yet to be proven. Hungary has strengthened active labour market policies but some disadvantaged people should have more access to them and adult participation in lifelong learning is still one of the lowest in the EU. In the last five years, the employment rate of women remained approximately at the same low level. In order to encourage women to participate in the labour market, the government expanded child-care facilities and promoted flexible working arrangements. The social situation continues to worsen: 31% of the population is at risk of poverty or social exclusion and a high percentage of people face severe material deprivation. Poverty continues to disproportionately affect disadvantaged territories and communities, in particular the Roma
- (14) The business environment in Hungary has constantly deteriorated in the last three years due to a series of measures including restrictions on investors and an unstable regulatory framework, in particular in the services sector. Recent restrictions which affect disproportionately foreign investors are focussed mainly on the services sector, including retail. The Simple State programme included 114 measures to reduce the administrative burden on businesses by approximately HUF 500 billion but its implementation has been somewhat delayed. Low levels of competition in public procurement persist, although a new law entered into force on 1 January 2012. The anti-corruption programme is a central element to the Magyar Programme. However, the programme does not tackle either the issue of insufficient law-enforcement in this area or the stricter checks on party financing, a key area of concern. Moreover, most of the announced steps have not yet been undertaken. Lack of monitoring of implemented measures also remains problematic. The developments in Hungary in 2012 and 2013 have increased concerns about the judiciary's independence. The Innovation Union Scoreboard ranks Hungary as a moderate innovator. Business R&D investments are driven primarily by foreign-owned enterprises.
- (15) Hungary succeeded in reducing the number of early school leavers. Since there are still major regional differences, the new elements of the centralised public-education system, if not implemented carefully, might have a negative impact and increase social inequalities and segregation. Although the number of students entering higher education has grown significantly in recent years, further work is needed to reach the

EU average and the national Europe 2020 target. It is doubtful whether the ongoing higher-education reform can improve access for disadvantaged pupils.

- (16) Implementation of the measures included in the Szell Kalman Plan, which is aimed at improving the cost-efficiency and performance of public transport, is prone to considerable delays and the lack of a comprehensive transport strategy hinders the financial sustainability of the transport system. While Hungary has adequately increased power grid interconnections with its neighbours as recommended in 2012, the lack of independence of the energy regulator in setting energy tariffs and the high share of regulated energy prices still raise concerns.
- (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 convergence programme and national reform programme and presented an in-depth review. 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 European 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 Hungary's convergence programme, and its opinion⁹ is reflected in particular in recommendation (1) below.
- (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), (4), (5), (7) below,

HEREBY RECOMMENDS that Hungary should take action within the period 2013-2014 to:

- 1. Implement a credible and growth friendly fiscal strategy by specifying the necessary measures focusing on expenditure savings and preserve a sound fiscal position in compliance with the medium-term objective over the programme horizon. Building on the above steps, put the general government debt ratio on a firm downward path, also with a view to mitigating the accumulated macroeconomic imbalances. Enhance the medium-term budgetary framework by making it more binding and by closely linking it to numerical rules. Broaden the mandatory remit of the Fiscal Council, including through systematic ex-post monitoring of compliance with numerical fiscal rules as well as the preparation of regular macro-fiscal forecasts and budgetary impact assessments of major policy proposals.
- 2. Help restore normal lending to the economy primarily by improving the capacity for capital accumulation in the financial sector, inter alia by lowering the extra burden currently imposed on it. Improve portfolio quality by removing bad assets from banks' balance sheets, closely consult stakeholders on new policy initiatives and make sure that new policy measures do not increase moral hazard among borrowers. Enhance financial regulation and supervision, notably by giving more effective emergency powers to the Hungarian Financial Supervisory Authority and by establishing a bank resolution regime.
- 3. Ensure a stable, more balanced and predictable corporate tax system. Streamline corporate taxation and minimise distortions of resource allocation created by sector-

⁹ Under Article 9(2) of Council Regulation (EC) No 1466/97.

specific taxes, so as to foster growth and employment. Continue making taxation of labour more employment-friendly by alleviating the tax burden on low-wage earners, inter alia by refining the eligibility criteria for the Job Protection Act, and by shifting taxation away to environmental taxes. Fully implement and step up the already announced measures to improve tax compliance and reduce the cost of tax compliance.

4. Address youth unemployment, for example through a Youth Guarantee. Strengthen active labour market policy measures and enhance the client profiling system of the Public Employment Service. Reduce the dominance of the public works scheme within employment measures and strengthen its activation elements. Reinforce training programmes to boost participation in lifelong learning. Continue to expand child-care facilities to encourage women's participation. Ensure that the objective of the National Social Inclusion Strategy is mainstreamed in all policy fields in order to reduce poverty, particularly among children and Roma.
5. Create a supportive business environment, in particular restore an attractive environment for foreign direct investors, by making the regulatory framework more stable and by fostering market competition. Ensure the prompt implementation of measures envisaged to reduce the administrative burden, improve competition in public procurement and take adequate measures to tackle corruption. Address concerns about the independence of the judiciary. Remove recently introduced barriers in the services sector, including in retail services. Provide targeted incentives to support innovative enterprises.
6. Implement a national strategy on early school-leaving and ensure that the education system provides all young people with labour-market-relevant skills, competences and qualifications. Improve access to inclusive mainstream education, in particular for Roma. Support the transition between different stages of education and towards the labour market. Implement a higher-education reform that enables greater tertiary attainment, particularly by disadvantaged students.
7. Gradually abolish regulated energy prices while ensuring the effective protection of economically vulnerable consumers. Take further steps to ensure the independence of the national regulator. Ensure the financial sustainability of state owned enterprises in the transport sector by reducing operational costs and increasing revenues.

Done at Brussels,

*For the Council
The President*