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Recommendation for a

COUNCIL RECOMMENDATION

on the 2015 National Reform Programme of Hungary

and delivering a Council opinion on the 2015 Convergence Programme of Hungary

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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 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[3],

Having regard to the resolutions of the European Parliament[4],

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. The strategy 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

1 OJ L 209, 2.8.1997, p. 1.
2 OJ L 306, 23.11.2011, p. 25.
3 COM(2015) 266.
4 P8_TA(2015)0067, P8_TA(2015)0068, P8_TA(2015)0069.

guidelines for the employment policies of the Member States. Together these form the 'integrated guidelines' which Member States were invited to take into account in their national economic and employment policies.

(3) On 8 July 2014, the Council adopted a recommendation on Hungary's national reform programme for 2014 and delivered its opinion on Hungary's updated convergence programme for 2014.

(4) On 28 November 2014, the Commission adopted the Annual Growth Survey[5], marking the start of the 2015 European Semester of economic policy coordination. On the same day, on the basis of Regulation (EU) No 1176/2011, the Commission adopted the Alert Mechanism Report[6], in which it identified Hungary as one of the Member States for which an in-depth review would be carried out.

(5) On 18 December 2014, the European Council endorsed the priorities for boosting investment, accelerating structural reforms and pursuing responsible growth-friendly fiscal consolidation.

(6) On 26 February 2015, the Commission published its 2015 country report for Hungary[7]. This assessed Hungary's progress in addressing the country-specific recommendations adopted on 8 July 2014. The country report also includes results of the in-depth review under Article 5 of Regulation (EU) No 1176/2011. The Commission's analysis leads it to conclude that Hungary is experiencing macroeconomic imbalances which require decisive policy action and monitoring. Attention should be given, in particular, to the risks stemming from the net international position (which, despite some progress in the rebalancing of external accounts, is still highly negative), the high level of public debt, the significant regulatory burden on the financial sector and the high level of non-performing loans, which make deleveraging difficult.

(7) On 30 April 2015, Hungary submitted its 2015 national reform programme and its 2015 convergence programme. To take account of their interlinkages, the two programmes have been assessed at the same time.

(8) Hungary is currently in the preventive arm of the Stability and Growth Pact and subject to the transitional debt rule for 2013-2015. In its 2015 Convergence Programme, the government plans to gradually improve the headline deficit to 2.4% of GDP in 2015 and further to 1.6% in 2018, and that the medium-term objective – a structural deficit of 1.7% of GDP − is reached by 2017. According to the Convergence Programme, the government plans to gradually reduce the debt-to-GDP ratio to 74.9% in 2015 and to 68.9% in 2018. The macroeconomic scenario underpinning these budgetary projections is broadly plausible until 2016 and becomes favourable thereafter. Measures to support the planned deficit targets from 2016 onwards have not been sufficiently specified, in particular beyond 2016. Based on the Commission's 2015 spring forecast, both the structural balance and net expenditure growth point to a risk of a significant deviation from the required adjustment path towards the medium-term objective in 2015 and 2016. Therefore, further measures will be needed in 2015 and 2016. At the same time, Hungary is forecast to comply with the transitional debt rule in 2015 and, following the end of

[5] COM (2014) 902
[6] COM(2014) 904 final
[7] SWD(2015) 36 final

the transition period, the debt reduction benchmark in 2016. Based on its assessment of the Convergence Programme and taking to account the Commission's 2015 spring forecast, the Council is of the opinion that there is a risk that Hungary will not comply with the provisions of the Stability and Growth Pact. The country's fiscal governance system would benefit from the rigorous application of the already legislated medium-term budgetary framework and from assigning a more prominent analytical role to the Fiscal Council.

(9) The banking sector's main challenges persisted over the last 12 months, in particular the challenges of restoring market-based lending through better capital accumulation possibilities and more efficient portfolio cleaning. Since mid-2013, bank lending has relied mainly on subsidised schemes, including for about 40% of lending to SMEs. The combination of significant tax and regulatory burdens and a high proportion of problematic loans does not provide banks with the necessary incentives to increase their normal, non-subsidised lending activity. Hungary’s external exposure and the related financial stability risks have decreased considerably due to the recent conversion of foreign exchange denominated mortgages into local currency. At the same time, foreign-exchange indebtedness of households is still the major reason behind the high share of non-performing credit. The majority of the foreign exchange relief schemes adopted to date have not been targeted at distressed borrowers, with the exception of that of the national asset management agency in the household sector, and it is unlikely to resolve the problem of non-performing loans. Efficient portfolio cleaning is hindered by, inter alia, the lack of foreclosures and the inefficiency of in-court and out-of-court resolution proceedings. An agreement recently concluded with the European Bank for Reconstruction and Development includes a number of commitments by the government to tackle the challenges in the financial sector, including, inter alia, by gradually reducing the bank levy and respecting the prior consultation principle. Implementing rigorously these measures would be conducive to returning to a sound and predictable financial policy framework. Over the last year, Hungary has repeatedly extended its direct ownership in the banking sector. State intervention in the banking sector, carried out via increased direct ownership, may entail significant fiscal risks, even where it is only temporary.

(10) Recent changes in the area of taxation (the introduction of new taxes and increases to existing taxes) have seen a return to the earlier trend of increasing the weight of sector-specific corporate taxes. Both the unpredictability and selectivity of these changes give rise to distortions to investment across sectors. Although a number of new measures have been introduced, the tax burden on some groups of low-income earners has remained among the highest in the EU, with single people especially affected. There appears to be scope for further shifting of the tax burden towards more growth-friendly sources of revenue. Various measures introduced over the last year are helping to tighten up systems to fight tax evasion. Following the successful completion of the programme linking retail outlets’ cash registers to an online system, it is now planned to extend the programme to a number of market services in 2015. The threshold above which an itemised VAT declaration must be submitted was lowered. A system for electronic road-cargo inspection was introduced in 2015, the main aim of which is to reduce carousel VAT fraud. There is, however, still significant scope to improve the administrative efficiency of tax collection and to reduce taxation compliance costs, especially for small and medium-sized enterprises.

(11) Overall, the Hungarian labour market improved in 2014, with employment recovering in the private sector thanks to the economic upturn. Significant challenges remain with regard to the public work scheme, which has been significantly extended since 2011. The scheme appears to be an inefficient and ineffective active labour market policy, that risks distorting the proper functioning of the labour market. The same resources if spent differently could potentially be more beneficial to the Hungarian economy. The budgetary cost of the scheme has quadrupled over the last four years, to 0.8 % of GDP, and is expected to double again between now and 2018, preventing resources from being used for essential improvements to training and to services required to facilitate participation in the open labour market. There is a risk of public works of such a magnitude creating significant 'lock-in' effects and permanently replacing the system of welfare benefits for the low-skilled. The scheme is not adequately coordinated with other active labour market policy measures and does not sufficiently promote the reintegration of participants into the open labour market. The rate of successful exit from the public work scheme was only 13.8% in the first half of 2014, which suggests that public works do not sufficiently support the reintegration of participants into the labour market. Although the scheme is targeted to the long-term unemployed and low skilled, in 2013 47% participants had secondary or tertiary education. The period of eligibility for unemployment benefits (three months) has not been increased and thus does not match the average time (over a year) that job seekers need to find employment. A number of programmes have been implemented to improve the inclusion of Roma in the labour market and a monitoring system has been put in place. Streamlined, coordinated policy measures, capable of significantly reducing poverty, are, however, still lacking. Poverty indicators, although suggesting moderately improving trends, still show poverty to be at a worryingly high level, especially among Roma and children. Gaps remain in both the adequacy and coverage of social assistance.

(12) Barriers introduced in recent years to market entry in the service sector have not been removed; rather, further barriers were introduced in 2014, hampering the efficient allocation of economic resources, increasing uncertainty for investors and restricting competition. The new barriers include, for example, the requirement for all retail establishments to be centrally authorised. The corruption and lack of transparency affecting public administration, decision-making and public procurement remain a cause of concern. The low level of competition in public procurement and the extensive use of direct awarding of contracts both persisted in 2014. A reorganisation of public procurement administration was undertaken in 2014, the results of which are to be closely monitored. In November 2014, Hungary submitted an action plan for transposing the new public procurement directives and promoting competition and transparency. Several measures to improve the anti-corruption framework have also been announced.

(13) Although some measures have been implemented to support the education of Roma children, a systematic approach to promoting inclusive mainstream education is yet to be developed. The proportion of Roma children attending schools or classes where the majority of pupils are Roma remains high, and the educational attainment of Roma pupils is lower than the national average. Teachers are not trained to provide sufficient support to disadvantaged groups. More needs to be done to improve the transition between different forms and stages of education, and from education to the labour market. The planned changes to the allocation of state-funded places in secondary education and the increasing admission requirements for higher education may further limit the opportunities for transition between different forms of

education, especially for disadvantaged groups. Hungary has the highest drop-out rate in higher education in the EU, at 47 %. The government announced the adoption of a national higher education strategy in December 2014. The strategy included raising the national target for tertiary attainment to 34 %. Overall, recent measures have failed to improve the participation of disadvantaged groups in higher education, and to tackle non-completion of education. The current funding system does not guarantee equitable access.

(14) In the context of the European Semester, the Commission has carried out a comprehensive analysis of Hungary's economic policy and published it in the 2015 country report. It has also assessed the Convergence Programme and the National Reform Programme and the follow-up given to the recommendations addressed to Hungary in previous years. It has taken into account not only their relevance for sustainable fiscal and socioeconomic policy in Hungary but also their compliance with EU rules and guidance, given the need to strengthen the overall economic governance of the European Union by providing EU-level input into future national decisions. The recommendations under the European Semester are reflected in recommendations 1 to 5 below.

(15) In the light of this assessment, the Council has examined Hungary's convergence programme, and its opinion[8] is reflected in particular in recommendation 1 below.

(16) 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 to 3 below,

HEREBY RECOMMENDS that Hungary take action in 2015 and 2016 to:

1. Achieve a fiscal adjustment of 0.5% of GDP towards the medium-term objective in 2015 and of 0.6% of GDP in 2016.

2. Take measures to restore normal lending to the real economy and remove obstacles to market-based portfolio cleaning; considerably reduce the contingent liability risks linked to increased state ownership in the banking sector.

3. Reduce distortive sector-specific taxes; remove the unjustified entry barriers in the service sector, including in the retail sector; reduce the tax wedge for low-income earners, including by shifting taxation to areas less distortive to growth; continue to fight tax evasion, reduce compliance costs and improve the efficiency of tax collection. Strengthen structures in public procurement that promote competition and transparency and further improve the anti-corruption framework.

4. Reorient the budget resources allocated to the public work scheme to active labour market measures to foster integration into the primary labour market; and improve the adequacy and coverage of social assistance and unemployment benefits.

5. Increase the participation of disadvantaged groups in particular Roma in inclusive mainstream education, and improve the support offered to these groups through targeted teacher training; strengthen measures to facilitate the transition between

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

different stages of education and to the labour market, and improve the teaching of essential competences.

Done at Brussels,

For the Council
The President