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**Assessment of the 2013 national reform programme and convergence programme for
HUNGARY**

Accompanying the document

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**

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1. EXECUTIVE SUMMARY

Economic outlook

In 2012, Hungary entered a recession and its GDP decreased by 1.7 %. According to the Commission's spring 2013 forecast, growth is expected to pick up in 2013 by 0.2% and to regain momentum in 2014, rising to 1.4%. Due to increasing participation, despite the 1.7% increase in the employment, the unemployment rate remained in double digits (10.9%) in 2012, and is projected to increase slightly to 11.4% in 2013 and 11.5% in 2014.

Although the headline fiscal deficit stood at 1.9% in 2012, the Commission 2013 spring forecast projects a deficit increasing above the Treaty reference value by 2014. After the May 2013 consolidation package (subject to some implementation risks) the headline deficit is projected to remain sustainably below 3% (2.7% and 2.9% of GDP in 2013 and 2014). Hungary's structural balance (excluding cyclical fluctuations and one-off factors) improved by 3.4% of GDP in 2012, which substantially exceeds the recommended fiscal effort of 2.4% of GDP. The Commission 2013 spring forecast projects only a slight reduction in public debt to 78.9% of GDP by 2014 (from 79.2% of GDP in 2012), which could decrease to 78.4% of GDP if the new corrective measures are taken into account.

Key issues

A weak country growth potential related to a worsening business environment, which is to a large extent driven by the lack of predictability and distortive effects of government policies. These measures have contributed to a quick pace of banking sector deleveraging and declining investment demand, resulting in a historically low investment rate and reduced lending. Moreover, a number of recently adopted laws – most notably the fourth amendment to the Fundamental Law and restrictions in the service sector - have raised serious concerns over their compatibility with EU legislation and with the principles of the rule of law. Finally, Hungary was identified by the Commission this year as experiencing macroeconomic imbalances.

After fiscal loosening in 2010 and 2011, the government made considerable consolidation efforts and reached a deficit of 1.9% of GDP in 2012, well below the target of 2.5%. While the Commission 2013 Spring Forecast projects a renewed breach of the 3% of GDP by 2014, consolidation steps announced on 13 May for 2013 and 2014 should sustainably correct the excessive deficit.

However, Hungary faces serious challenges in the short- to medium term, related to the business and legal environment and economic growth potential, which could also undermine the success of fiscal consolidation.

- **Fiscal consolidation:** Despite substantial progress with consolidation, the quality of the fiscal correction raises concerns, with a high share of revenue side measures targeted most notably towards few selected sectors. Moreover, although Hungary achieved a deficit of 1.9% of GDP in 2012 (the deadline for bringing the deficit below 3%) and over-achieved the recommended structural effort of 2.4% of GDP, high public and external debt levels (close to 80% and 100% of GDP respectively) and a

weak growth potential associated with high financing costs keep the economy vulnerable. Fiscal governance needs further improvements as the medium term budgetary framework remains purely indicative and in spite of some reinforcement to the Fiscal Council.

- **Business environment:** The recent deterioration of the business environment, most notably because of an increase in corporate surtaxes with varying rates across sectors, has affected Hungary's growth potential and productivity. A new duty on bank transactions of around 0.5% of GDP adds to the permanent bank levy (0.5% of GDP), which is already the highest tax of its kind in Europe. The energy profit surtax increased from 8% to 31% and was extended to public utility companies, raising overall taxation of profits in these sectors to 50%. Meanwhile, the tax structure has become more complex, with six corporate income tax regimes now in place, while public administration reform has been delayed. Furthermore, higher entry costs in the service sector and increasing segmentation could contribute to weakening competition and productivity.
- **Labour market:** Unemployment remains high in spite of government's labour market reforms. The main problems for labour supply are the difficulties in moving from education to work (youth unemployment stood at 28.1% in 2012), skills mismatches that could not be adequately addressed by the dominant public work schemes among active labour market measures (accounting for over half of related spending in 2012), the still high tax burden on certain groups of low income earners (despite improvements introduced by the Job Protection Act) as well as the low availability of childcare services. In addition, labour demand is held back by a historic low investment rate and weak productivity growth. Poverty and social exclusion are also high, with 23% of the population facing severe material deprivation, which is exacerbated by the cut in the length of unemployment benefits. In spite of recent improvements, the number of students in higher education is still below the EU average. Early School Leaving has started to increase again, from a low of 10.5 % in 2010 to 11.5 % in 2012. Vocational education is not efficient enough and participation in lifelong learning is amongst the lowest in the EU.
- **Energy/transport:** Hungary is still well above the EU average in terms of energy and carbon intensity, which contribute to a persistently high energy trade deficit (-5.4 % GDP a year on average in 2007-11, compared to -2.4 % in the EU). This is partly caused by heavily regulated energy prices and the lack of independence of the National Regulator. Inefficient public transport continues to weigh on the budget, and reforms have been delayed for too long, which is affecting economic growth and the environment.
- **Judiciary:** Recent developments in Hungary have increased concerns about the judiciary's independence, most notably after the fourth amendment to the Fundamental Law. Following a detailed assessment of the various provisions, the European

Commission sent administrative letters requesting further clarification on this issue in May.

1. INTRODUCTION

In May 2012, the Commission proposed a set of country-specific recommendations (CSRs) for economic and structural reform policies for Hungary. On this basis, the Council of the European Union adopted seven CSRs in the form of a Council Recommendation. These CSRs concerned public finances, taxation, the labour market, the business environment, education and the network industries. This Staff Working Document (SWD) assesses their state of implementation in Hungary.

The SWD assesses policy measures in light of the findings of the Commission's 2013 Annual Growth Survey (2013 AGS)¹ and the second annual Alert Mechanism Report (2012 AMR),² which were published in November 2012. The 2013 AGS sets out the Commission's proposals for building the necessary common understanding about priorities for action at national and EU levels in 2013. It identifies five priorities to guide Member States towards renewed growth: pursuing differentiated, growth-friendly fiscal consolidation; restoring normal lending to the economy; promoting growth and competitiveness for today and tomorrow; tackling unemployment and the social consequences of the crisis; and modernising public administration. The 2012 AMR serves as an initial screening device to determine whether macroeconomic imbalances exist and whether risks are emerging in Member States. It found positive signs of macro-economic imbalances in Europe being corrected. To ensure that a complete and durable balance is achieved, Hungary and 13 other Member States were selected for a review of developments in the accumulation and unwinding of imbalances.³

Against the background of the 2012 Council Recommendations, the 2013 AGS and the 2013 AMR, Hungary presented updates of its national reform programme (NRP) and its convergence programme (CP) in April 2013. These provide detailed information on progress made since July 2012 and on the government's future plans. The information contained in these programmes provides the basis for the assessment made in this Staff Working Document.

The programmes submitted went through a limited consultation process involving civil society stakeholders and business associations.

Overall assessment

The analysis of this SWD leads to the conclusion that Hungary has made some progress on measures taken to address the CSRs of the Council Recommendation but major concerns remain regarding the business environment and financial intermediation. In particular, the recommendation on public finances (CSR1) was broadly implemented, the recommendation on fiscal governance (CSR2), taxation (CSR3) and labour market reform (CSR4) were partly implemented, while limited progress was achieved on education (CSR6) and on the network industries (CSR7) and no progress was observed as regards the business environment (CSR5).

¹ COM(2012)750 final

² COM(2012)751 final

³ 13 in-depth reviews were published on 10 April 2013. While selected for an IDR in the 2012 AMR, Cyprus was ultimately not reviewed under the MIP due to the preparations for a financial assistance programme

After fiscal loosening in 2010 and 2011, additional fiscal consolidation measures were approved and contributed to closing the fiscal gap for 2012 (the deficit turned out to be 1.9% of GDP, i.e. well below the 3% of GDP reference value, although including one-off measures amounting to 0.75% of GDP). The public debt ratio decreased from 81.4 % in 2011 to 79.2 % in 2012. The Fiscal Council was reinforced both in terms of (optional) tasks and human resources.

Challenges are mainly linked to the need for a more business friendly environment, conducive to growth and for improving competitiveness. Recent policy measures have in effect increased surtaxes on the financial sector and on certain non-financial businesses. A sizeable new duty on bank transactions (around 0.5% of GDP) was added to the permanent bank levy (0.5% of GDP), already the biggest tax of this kind in Europe. The surcharge profit tax on energy was increased from 8% to 31% and extended to public utility companies, therefore raising the overall taxation of profits in these sectors to 50 %. There have been some sensible steps with the adoption of new simplified business taxes, but the tax structure has become more complex, as Hungary now has six corporate income tax regimes. The government's intervention in energy prices has continued, as the right to set retail prices and network tariffs is only formally in the hands of the National Regulator. The public transport system continues to be inefficient, with delays affecting the overall reorganisation and implementation of savings plans for national railways and the Budapest Transport Company, which have a direct effect on the government's fiscal objectives.

As a response to CSR3, the government introduced the Job Protection Act which reduces social contributions for certain categories of disadvantaged people. A number of measures to improve women's participation have been taken, e.g. the expansion of day-care facilities for 0-3 years-olds and promotion of flexible forms of employment. In addition, the government strengthened active labour market policies, but the public work scheme (PWS) remains the main pillar of employment policy, even though it seems to be an ineffective job activation measure.

While the 2012 outcome was practically at the 2020 target (29.9% as opposed to 30.3%), recent changes in higher education entail a strong risk that the number of entrants, particularly from disadvantaged background, will decrease. Also, a national strategy on early-school leaving has not been adopted yet.

The policy plans submitted by Hungary address some of the challenges identified in last year's Staff Working Document. The underlying macroeconomic path underpinning the convergence programme (CP) appears optimistic and the deficit targets are not fully supported by well specified measures, according to the Commission 2013 spring forecast. The CP confirms the commitment to correcting the excessive deficit by the 2012 deadline, but did not include new fiscal consolidation measures, and based on the budgetary projections included in the Commission's forecast, this was not yet ensured. However, after the adoption of a new corrective package on 10 May the fiscal deficit is projected to remain below 3% over the forecast horizon. The national reform programme confirms Hungary's commitment to addressing labour market issues but could contain more detailed measures to improve the business environment and to restore normal lending to the economy.

2. ECONOMIC DEVELOPMENTS AND CHALLENGES

1.1. Recent economic developments and outlook

Recent economic developments

In 2012 and early 2013, growth in Hungary was strongly affected by the deleveraging of domestic sectors, weakening global activity and tight lending conditions. Despite an increase in the participation and employment rates, unemployment remained in double-digit territory (10.9% for 2012) and is projected to increase slightly more on account of increased participation and a slightly decreasing employment rate.

In 2012, the Hungarian economy entered a recession and GDP decreased by 1.7%. After a short-lived recovery in 2011, domestic demand fell by 3.7%. Investment continued to contract for the fourth year in a row against a background of tight lending conditions, uncertain business environment and deleveraging. Falling disposable income and a high unemployment rate, which reached 10.9 % in spite of a 1.7 % increase in total employment, contributed to a decrease in consumption. GDP was also dragged down by unusually weak production in the agricultural sector. Export growth cushioned the fall in output but it then sharply decreased on account of a deteriorating external environment.

Economic outlook

For 2013, a mild recovery is forecast (+0.2% of GDP). Export markets are set to improve and stabilisation of domestic demand is expected due to an increase in real disposable income, although the high unemployment rate and on-going deleveraging would keep household spending contained. Private investment is projected to remain negative in view of policy uncertainty, the continued fall in lending and high surtaxes on some capital intensive sectors, while government investment would be boosted by a higher inflow of EU funds.

In 2014, growth is expected to reach 1.4% due to a positive contribution from net exports and domestic demand. Household consumption is set to increase on account of further improvement in real disposable income and looser lending conditions. Investment growth is projected to turn positive on account of government-sponsored lending and the central bank's new "Funding for Growth" scheme."

While the labour market participation rate is projected to grow further, the employment level is foreseen to remain broadly stable, so that unemployment is expected to stay in the double digits, and even increase slightly to 11.4 % in 2013 and 11.5% in 2014. Companies are expected to adjust to weaker profitability conditions, partially through lay-offs, though this will be counteracted by the growing public work scheme⁴ and the rise in employment possibilities for small and medium-sized enterprises (SMEs).

The macroeconomic forecast in the CP seems somewhat optimistic. The GDP projection is around half a percentage point (pp.) higher than the Commission 2013 spring forecast. This

⁴ Government sponsored employment schemes in the public sector for those people in working age who are able to work and do not have a regular job.

reflects a higher forecast for both domestic demand and net exports compared to the Commission's assessment. The government's outlook for employment is also more optimistic than the forecast by the Commission, by around half pp. of GDP in both 2013 and 2014. Finally, the CP projects somewhat higher inflation than the Commission's forecast does.

The CP contains the government's assessment of the estimated macroeconomic impact of structural reforms. According to the analyses, recent policy steps could increase GDP growth by around 1% in 3 years' time, mainly through higher employment, while investment and total factor productivity will decline. However, in simulations the positive GDP effects are presented as a result of fiscal measures that actually increase the burden on the corporate sector and on households' consumption and only slightly reduce the burden on employment (+0.4% and +0.8% of GDP as opposed to -0.1% of GDP), which does not seem coherent. In addition, the simulations do not contain some recently adopted significant measures, such as keeping the bank levy at its initial level or an increased level of the financial transaction duty.

While a changing composition of economic growth toward a more labour-intensive economy, as assessed in the CP, seems to be warranted, the Commission's assessment is much more pessimistic on the overall growth effect of recent economic policy steps compared to that of the Hungarian authorities. As indicated in the latest in-depth review on Hungary⁵, the recent deterioration of the business environment, most notably in relation to an increase in corporate surtaxes has contributed to a loss in the country's economic growth potential. While Hungary's economic policy has been successful in increasing the participation rate and enhancing SME employment, the very low level of investment and productivity growth holds back labour demand among larger corporations.

1.2. Challenges

Hungary faces significant challenges, which remain broadly the same as last year's and largely correspond to the 2013 Annual Growth Survey priorities and are further analysed in the 2012 AMR and the 2013 in-depth review (see box 1).

In particular, Hungary has to continue its fiscal consolidation. In 2012, which was the deadline for Hungary to bring its excessive deficit procedure to an end, a deficit of 1.9% of GDP was achieved and the structural effort substantially exceeded the recommended effort of 2.4% of GDP. In addition, based on the Commission 2013 spring forecast and subsequently adopted additional measures, the general government deficit is projected to remain slightly below 3% of GDP in 2013 and in 2014. At the same time, the high public and external debt levels (close to 80 % and 100% of GDP respectively), which together with high financing costs and weak growth potential, keep the economy vulnerable.

Weak growth is related to a worsening business environment, to a large extent driven by the lack of predictability of government policies and the quality of corporate taxation (i.e. high sector specific surtaxes). The high administrative burden on businesses is also a key factor, including in the field of taxation. Investment stands at a low level (below 17 % of GDP), as compared to other countries in the region and even to pre-crisis years (above 20 % of GDP in both cases). In the World Economic Forum Global Competitiveness Index (GCI), Hungary fell from the 48th position in 2011-12 to the 60th in 2012-13 (out of 144 countries).

⁵ See European Commission (2013) 119 final at http://ec.europa.eu/europe2020/pdf/nd/idr2013_hungary_en.pdf

While the public administration reform is on-going with some delays, corruption and the lack of competition in public procurement continue to affect government spending.

Key policy challenges include restoring normal lending to the economy and avoiding a banking sector deleveraging that is too quick, as this could be detrimental to growth. However, the high surtaxes in the financial sector and the high level of non-performing loans in banks' balance sheets make it more difficult to accumulate internal capital and hinder incentives to providing credit.

The global financial crisis demonstrated the urgent need for national authorities' efficient surveillance over their financial systems. So far, the legislator has not equipped the Hungarian Financial Supervisory Authority with regulatory powers based on the comply-or-explain principle. Also resolution tools currently in effect are inadequate to restructure financial institutions in emergency situations.

Hungary's Europe 2020 employment target seems too ambitious given the current employment rate and projected economic and demographic trends. Labour market conditions remain similar to last year, with the employment rate being generally low, although increasing from 60.7 % in 2011 to 62.1% in 2012⁶, i.e. just below pre-crisis levels. Labour market barriers for Hungary are due to both supply and demand factors. The main problems for labour supply include skills mismatches, a high tax burden on certain groups and low availability of childcare services for children under three. Labour demand is hindered by a negative productivity growth rate and by historically low investment, both partly linked to financial disintermediation. While the average tax rate decreased, the tax burden on low income earners (who have one of the lowest employment rates as compared to the rest of the EU) remains high in the regional context, even taking into account the recent targeted social contribution reductions.

Despite a moderate increase in the overall active labour force⁷, poverty and social exclusion are still high and 23% of people face severe material deprivation⁸. The reduction of the length of unemployment benefits has exacerbated poverty and social exclusion⁹. Although in principle employment and social benefit reforms may incentivise a return to the labour market, in some regions it has resulted in increasing poverty and social exclusion, aggravated by lack of services. Specific labour market challenges affect some parts of the population, among them: young, low skilled and workers over 50 years old. Within the framework of the Job Protection Act, a social contribution reduction was introduced for these groups, but targeting could be improved.

While the tertiary educational attainment has increased substantially in recent years, practically achieving the country's Europe 2020 target, it is still well below the EU average. At the same time, early school leaving has started again to increase. Hungary had succeeded in reducing the proportion of early school leavers in the last decade (from 13.9 % in 2000 to 10.5 % in 2010), but this trend was reversed in 2011 (11.2 % in 2011 and 11.5 % in 2012). Hungary's education system is unable to minimise the disparities that stem

⁶ In 2011 and 2012, the number of public workers changed significantly, which influenced employment trends.

⁷ According to Labour Force Survey (LFS) statistics, it increased by +2 pps. between the end of 2007 and 2011, see: <http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home>

⁸ Severe material deprivation is defined as being deprived of at least four of the nine basic items that are used to measure material deprivation.

⁹ In mid-2012, 54% of registered job seekers were left without benefits.

from differences in socio-economic backgrounds. National and international surveys¹⁰ show particularly large gaps between the best and worst performing pupils. Though tertiary education attendance is improving, vocational education studies are either insufficient or not developed enough to address the skills mismatch on the job market. As detailed in the 2013 AGS, lifelong learning is key to improving labour market conditions, yet Hungary has one of the lowest participation rates in adult education among EU Member States. This negative trend is also reflected in the workforce's low occupational mobility and low adaptability to change.

Hungary faces substantial challenges in network industries. The economy is still well above the EU average in terms of energy and carbon intensity, which contributes to a persistently high energy trade deficit. This is partly caused by heavily regulated energy prices and by a lack of independence of the National Regulator. Inefficient public transport continues to weigh on the government's budget. Reforms in both sectors have been delayed for too long, which is detrimental to public finances and economic growth, as well as to the environment. As pointed out in the 2013 in-depth review (IDR), a reform of the transport and energy systems is necessary for fiscal sustainability and economic efficiency.

Recent developments in Hungary have further increased concerns about the judiciary's independence, most notably after the fourth amendment to the new Fundamental Law.¹¹ Notably, the power to transfer cases from one court to another was granted to the President of the National Judicial Office, aggravating concerns about the independence of the judiciary. As the independence of the judiciary assures the predictability, certainty, fairness and stability of the legal system in which businesses operate, such perceived lack of independence can deter investments. In addition, the fourth amendment introduced provisions on European Court of Justice's judgements and restrictions on political advertisements in the media which have also raised concerns about compliance with EU law.

Innovation, in particular of SMEs, remains limited primarily because of a lack of funds. A secondary challenge is the mismatch between qualifications in the labour market and those that are needed in sectors at the forefront of Research and Development (R&D) and innovation. The potential of eco-innovation remains largely untapped.

Box 1: Summary of the 2013 in-depth review (IDR) under the Macroeconomic Imbalance Procedure (MIP)

The second IDR in the macro-imbalances procedure for Hungary (2013 IDR) stated that the country is experiencing macroeconomic imbalances, which require monitoring and decisive policy action. In particular, the on-going adjustment of the highly negative net international investment position, largely driven by private sector deleveraging in the context of high public debt and by a deteriorating business environment, which has contributed to reduced

¹⁰ The OECD's 2009 Programme for International Student Assessment (PISA) report (see <http://www.oecd.org/pisa/pisaproducts/pisa2009>); the IEA's (International Association for the Evaluation of Educational Achievement) Trends in International Mathematics and Science Study (i.e. TIMSS); and the Progress in International Reading Literacy Study (i.e. PIRLS) from 2011 (see <http://timss.bc.edu/>)

¹¹ See the Commission's press release: http://europa.eu/rapid/press-release_IP-13-327_en.htm

investments, still need very close attention to reduce the significant risks of adverse effects on the functioning of the economy.

The IDR concludes that, despite the on-going adjustment process, Hungary's growth potential has unnecessarily suffered due to a number of non-market-friendly policies and the country remains vulnerable as a result of a combination of a high level of debt and low growth.

Net International Investment Position (NIIP): External imbalances have decreased as the current account is in surplus for the third year in a row. Therefore, the NIIP has been improving steadily, but at -103% of GDP in 2012 it remained significantly above the -35% of GDP threshold. This is expected to be the case in the years to come as well. The current account turnaround that started in 2009 was caused mainly by a fall in domestic demand; export competitiveness has somewhat deteriorated. After a marked decline during the 2009 recession, the deficit in the factor income has started widening again, though it remains below pre-crisis levels. Both elements suggest that the external correction is partly cyclical.

Private sector debt: Most of the recent external adjustment reflects a deleveraging of the private sector which is necessary to correct imbalances, most notably in the household sector. At the same time, the rapid fall in corporate credit, against a background of policy uncertainty and sectorial surtaxes, especially in the financial sector, has contributed to historically low investment and productivity growth rates, and therefore eroded the country's growth potential.

Public sector debt: Public debt was reduced from close to 82 % of GDP to around 79 % of GDP over the period 2010 to 2012, thanks to one-off capital transfers and consolidation measures. However, it is still very high as compared to regional peers. Due to the high share of foreign ownership of public debt securities and the relatively high gross financing needs, public sector deleveraging is a vulnerable process.

Unemployment: The high unemployment rate (persistently above 10 %) is less of a concern as it mainly reflects an increase in participation rate; the employment rate is back at pre-crisis level. Private sector employment also improved in the SME sector, but this is strongly linked to the public work scheme (PWS). As there are no visible signs of movement from the PWS to the open labour market, it seems unlikely that GDP will sustainably increase, partly due to insufficient training. Also, the sustainability of increased private sector employment is at risk due to low investment and productivity.

3. ASSESSMENT OF POLICY AGENDA

3.1. Fiscal policy and taxation

The 2013 Convergence Programme aims at a nominal deficit of 2.7% of GDP in 2013 and 2014 and its reduction in later years (2.2% and 1.3% of GDP in 2015 and in 2016, respectively). This means an upward revision of the deficit targets compared to the 2012 CP (see Table 1). According to the 2013 CP, the medium-term objective (MTO), which was revised from a structural balance¹² of -1.5% to -1.7% of GDP in the 2013 CP, is overachieved in 2013 (similarly to 2012) and should be achieved in the coming years. This fiscal trajectory

¹² 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.

is set to fulfil the requirements of the fiscal rules at national and EU levels. In particular, according to the 2013 CP, the foreseen deficit path could bring the excessive deficit to an end, since the deficit was below the 3% Treaty reference value in 2012 (deadline set by the Council), and is expected to remain below this threshold over the forecast horizon. Moreover, it would be in line with the provisions of the preventive arm of the Stability and Growth Pact, in particular as the MTO reflects the Pact's objectives.

Table 1: Nominal general government deficit targets (% of GDP)

	2013	2014	2015	2016
2012 CP	2.2	1.9	1.5	n.a.
2013 CP	2.7	2.7	2.2	1.3

The government renewed its fiscal consolidation effort in 2012 following some fiscal loosening in 2010 and 2011 as exemplified by a cumulative structural deterioration of close to 2% of GDP over this period. In the latter year the impact of the tax cuts of around 2% of GDP on the headline balance was masked by substantial one-off revenues of close to 10% of GDP, stemming from the transfer of the private pension assets.

In 2012, the actual budget deficit of 1.9% of GDP was lower than the deficit target of 2.5% of GDP set in the 2012 CP. Compared to the adopted 2012 budget, the 2012 CP already contained deficit-improving measures of around 0.3% of GDP adopted in February and April 2012, including savings in line ministries and the introduction of a tax on telecommunication services, to compensate slippages both on the expenditure and the revenue side. In the context of the October 2012 EDP Progress Report (Report), further measures of around 0.4% of GDP were announced partly to counterbalance earlier expenditure increases of 0.2% of GDP in selected areas. At the same time, the report revised the official target upwards, to 2.7% of GDP. Overall, the deficit target for 2012 was overachieved thanks to budgeted savings measures of close to 2.75% of GDP, to further corrective measures implemented in the course of 2012 as well as to the improvement of the local government sector's balance¹³ by 0.4% of GDP compared to the previous year.¹⁴ In addition, the full activation of the budgeted extraordinary reserves of 1.1% of GDP as well as the higher than budgeted one-off revenues of 0.2% of GDP related to the transfer of assets from the private to the public pension pillar counterbalanced the budgetary slippages, which were partly related to a worse-than-expected macroeconomic environment.

¹³ The lower deficit in the local government sector could reflect the lower investment in institutions that were taken over by the central government in the course of 2012 or at the beginning of 2013 and the impact of legislative changes aimed at limiting their indebtedness.

¹⁴ Importantly, corrective measures were adopted in the course of 2012 to improve the 2012 deficit, against the backdrop of the following factors: (i) starting from the 2011 autumn forecast, the Commission consistently projected in all publications that the 2012 deficit would be in line with the 3% of GDP threshold; (ii) the EDP staff working document on effective action of 30 May 2012 and the Commission's 2012 autumn forecast envisaged that the original deficit target of 2.5% of GDP would be attained with available reserves, which could even ensure a lower deficit if eliminated as eventually happened; and (iii) the 2013 winter forecast included a deficit calculation of 2.4% of GDP, i.e. again below the original deficit target of 2.5% of GDP and the revised target of 2.7% of GDP.

The magnitude of the 2012 fiscal effort measured by the improvement of the adjusted structural balance (3.5% of GDP), is supported by a detailed assessment of discretionary measures, which indicates a fiscal effort of around 3% of GDP. Approximately two-thirds of this effort was made on the revenue side (e.g. VAT-rate hike to 27%, increased social contribution by 1 pp., elimination of the employment tax credit) and one-third on the expenditure side (e.g. spending restraints in line ministries, cuts in social transfers to households).

For 2013, the latest CP expects a deficit of 2.7% of GDP, which is higher than the target of 2.2% of GDP included in the 2012 CP, but in line with the revised target of the Autumn 2012 EDP Progress Report, which was also integrated into the 2013 budget. Compared to the 2012 CP, expected lower economic growth (close to -4% in nominal terms) increased the deficit by 1¼% of GDP mainly due to the higher expenditure ratio. Stimulus measures (introduction of a fully flat personal income tax system, targeted social contribution cuts and new preferential corporate tax systems for SMEs) and higher government consumption in selected areas also increased the deficit by close to 1% of GDP. These were partly compensated by the revenue-based corrective packages of 1¾% of GDP announced in three steps in the autumn 2012 and on the context of the 2011 and 2012 CPs. These corrective measures placed the highest burden of adjustment on the financial (e.g. repealing an earlier commitment to halve the bank levy while increasing the financial transaction duty), energy and utility sectors. The remaining gap of ½% of GDP resulted in the higher 2013 deficit target. The 2013 CP confirmed the implementation of all planned consolidation measures, but did not include further deficit-improving measures.

The Commission 2013 Spring Forecast projects a deficit of 3% of GDP in 2013. Compared to the 2013 CP, it factors in a budgetary slippage of 0.9% of GDP. This includes lower revenues of 0.6% of GDP, mainly related to VAT in light of the assumed lower impact of measures aimed at enhancing tax administration, the financial transaction duty, gambling tax and the distance-based road toll. It also includes foreseen slippages of 0.3% of GDP on the expenditure side, mainly pertaining to the transport sector. The projected revenue shortfalls and expenditure overruns were expected to be only partly off-set by the assumed activation of the remaining extraordinary reserves of 0.6% of GDP.

On 13 May 2013, following the release of the Commission's forecast, the government adopted further corrective measures of more than 0.3% of GDP for 2013. Notably, these included the temporary cut of the expenditures of selected budgetary institutions, which would become permanent unless favourable budgetary developments provide fiscal space. The net deficit-improving effect of these saving measures is estimated by the Commission to close to 0.25% of GDP, taking into account their direct revenue side impact and second-round effects. Taking into consideration all the available information, the 2013 deficit is projected to be 2.7% of GDP, in line with the official target.

In 2014, the 2013 CP targets a deficit of 2.7% of GDP. Compared to the previous year, the slight increase of the revenue ratio in 2014 mainly reflects the envisaged increase in the absorption of EU funds and the effect of introducing the distance-based road toll system in mid-2013. On the expenditure side, public wages are set to increase significantly in light of the launch of a new wage-compensation system in the education sector. In addition, public investment is assumed to increase in line with increasing absorption of EU funds. The rise of other expenditures altogether, however, is set to lag behind the economic growth because of

maintained fiscal discipline as announced and enhanced in the 2013 CP (e.g. nominal freeze of the public wages except in the public education sector, moderate increase of the social transfers) and to the protracted impact of earlier structural reforms. It is important to note that, one-off items are not included in this projection.

According to the Commission 2013 Spring Forecast, the 2014 deficit, based on the usual no-policy change assumption, is projected to increase further to 3.3% of GDP. Compared to the 2013 CP, the Commission's forecast includes lower revenues of 0.6% of GDP, mainly related to the same measures which explain the different forecasts in 2013 (i.e. VAT, the financial transaction duty, gambling tax and the distance-based road toll). On the expenditure side, the foreseen slippages of close to 0.5% of GDP, partly related to the operationalisation of the no-policy-change assumption¹⁵, are off-set by the assumed activation of the planned extraordinary reserves of 0.5% of GDP.

When incorporating the net deficit-improving impact of around 0.4% of GDP of the new corrective package adopted on 13 May (which also reflects direct revenue side impacts and some implementation risks as opposed to the officially estimated 0.7% of GDP gross impact), the Commission's 2014 deficit projection could be revised down to 2.9% of GDP. The additional measures includes the following elements: (i) for budgetary institutions, the reduced expenditure level will serve as the basis for the 2014 budgetary appropriations; (ii) both cash transfers to households and the purchase of selected goods and services on the central budgetary sub-sector will be frozen at their 2013 nominal level; (iii) selected major public investment projects could only be continued if financed from the additional revenues from the sale of non-financial state assets.

¹⁵ For example most expenditure items are forecast to increase with the nominal potential growth rate barring the adoption of specific measures.

Box 1. Main budgetary measures

Revenue	Expenditure
2012	
<ul style="list-style-type: none"> • Hike in the VAT standard rate from 25% to 27% (+0.6% of GDP) • Increase in social contributions (+0.4% of GDP) • Net effect of the reform of PIT (+0.2% of GDP) • Other tax increases, including raising excise duties and the introduction of a tax on telecom services (+0.9% of GDP) <p>Wage compensation to the private sector provided through social contribution allowances (-0.4% of GDP)</p>	<ul style="list-style-type: none"> • Implementation of structural reform steps laid down in the Szell Kalman Programme (unemployment benefits, sick pay, disability pensions, pharmaceutical and public transport subsidies, -0.8% of GDP) • Nominal wage freeze in the public sector together with wage compensation (-0.4% GDP) • Outlays related to the agreement with the banks (+0.25% of GDP, similar effect as in 2011) • Extension of the public works programme (+0.2% of GDP)
2013	
<ul style="list-style-type: none"> • Phasing out of extraordinary sector levies on the telecom, retail and energy sectors (-0.55% of GDP) • Narrowing of tax base of PIT (-0.35% of GDP) • Introduction of a financial transaction duty (0.75% of GDP) • Job Protection Act: targeted cuts in social contributions and introduction of two simplified taxation schemes for SMEs (-0.6% of GDP) • Maintenance of the financial sector levy at its original size (+0.25% of GDP) • Hikes in sectoral levies and introduction of new corporate surcharges (0.55% of GDP) • Increase in the efficiency of tax collection, mainly through the establishment of on-line links to cash registers (0.55% of GDP, serious implementation risks) • Introduction of a distance-based road toll from 1 July (0.25% of GDP, considerable implementation risks) • Increase of excise duties (0.1% of GDP) • Elimination of cap of pension contributions (0.15% of GDP) • Lower wage compensation in the private sector (0.2% of GDP) 	<ul style="list-style-type: none"> • Further implementation of the Szell Kalman Programme (pension system, pharmaceutical subsidies, rationaliation of institutions, -0.4% of GDP) • Nominal wage freeze in the public sector (-0.2% of GDP) • Increase of appropriations for certain budgetary chapters (0.4% of GDP) • Outlays related to the agreement with the banking sector (+0.2% of GDP) • Further extension of the public work programme (+0.1% of GDP)
2014	
<ul style="list-style-type: none"> • Additional take-up in the two simplified taxation schemes (-0.2% of GDP) • Full year effect of the electronic road toll (0.25% of GDP, implementation risks) • Full phasing out of the wage compensation in the private sector (+0.2% of GDP) 	<ul style="list-style-type: none"> • New wage system in the public education sector (0.6% of GDP) • Nominal freeze of selected expenditures of the budgetary chapters (e.g. wages, purchase of goods and services, subsidies; -0.4% of GDP)
<p>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.</p>	

On top of the factors explaining the differences between the 2013 CP and the Commission's updated assessment, further risks that could significantly affect future deficit outcomes can be identified. On the deficit-improving side, these include potentially higher savings related to the full implementation of structural measures (e.g. introduction of a more sophisticated distance-based tolling system in line with initial plans; accelerated review of disability pensions) as well as lower-than-planned take-up of the targeted social contributions reductions and of the preferential corporate tax systems for SMEs introduced from 2013. On the deficit-increasing side, the following could be highlighted: higher expenditure related to road maintenance, further financing for higher education; capital transfers to offset losses of the central bank; higher subsidies to the state-owned public transport companies and potential adverse decisions of the EU court related to the tax on telecommunication services.

Overall, the first part of the CSR1 made in 2012 was broadly fulfilled. The 2012 deficit was brought well below the reference value of 3% of GDP due to the rigorous implementation of the 2012 budget and the adoption of further measures. The adjusted structural balance improved by 3.5% of GDP, which substantially exceeds the recommended fiscal effort of 2.4% of GDP. This is also reflected in the fact that the MTO was significantly overachieved in 2012. Moreover, based on the updated assessment of the Commission taking into account the new corrective measures, the deficit is expected to stay below the 3% of GDP Treaty reference value in both 2013 and 2014. This fiscal performance should be seen against the backdrop of a deteriorated macroeconomic environment compared to the scenario underpinning the most recent EDP recommendation made in March 2012. Despite substantial progress with consolidation, the quality of the fiscal correction raises concerns, with a high share of revenue side measures targeted most notably towards some selected sectors.

In 2013, the (recalculated) structural balance of -1% of GDP is well above the MTO of -1.7% of GDP and identical to it in 2014. Although it slightly deteriorates further in 2015 and in 2016, it remains close to the MTO and can be assessed as achieved. The 2013 and 2014 structural deficit predicted in the Commission 2013 Spring Forecast slightly exceeds the one projected by the 2013 CP, but remains above or close to the MTO. After the most recent corrective measures, the structural deficit is expected to improve by around 0.3 pp. compared to the Commission 2013 Spring Forecast to -¾% and -1½% of GDP in 2013 and 2014, respectively. At the same time, the projected deficit path, which includes a cumulative structural deterioration of over 1% of GDP between 2012 and 2016, does not provide considerable fiscal space on top of the automatic stabilizers to off-set any potential adverse developments (e.g. less tax-rich economic growth). In addition, in 2016, in light of the Hungarian national fiscal numerical rule, the nominal deficit will have to be significantly improved, which would require a considerable fiscal effort, in particular assuming that economic growth will not exceed its potential level by as much as was projected in the 2013 CP.

Similarly, according to the information provided in the 2013 CP, 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 (indicative reference rate of 0.1%), but is expected to significantly exceed it in 2015 and 2016. While the breach of the expenditure benchmark can be justified by the overachievement

of the MTO before 2014, it can also reflect the fact that the 2013 CP assumed higher potential economic growth than the Commission did.¹⁶

Box 2. Excessive deficit procedure for Hungary

On 5 July 2004, the Council decided that Hungary had an excessive budget deficit and issued a recommendation under Article 104(7) of the Treaty establishing the European Community setting a deadline for correction of 2008. After the Council had decided twice, in January and November 2005 that Hungary had not taken effective action in response to its recommendations, it issued a third Article 104(7) recommendation to Hungary in October 2006, postponing the deadline to 2009. In July 2009, against the background of a severe economic downturn which triggered fiscal adjustment measures and the provision of EU/IMF balance of payments support, the Council concluded that Hungary had taken effective action and issued revised recommendations setting 2011 as the new deadline to correct the excessive deficit. On 24 January 2012, the Council adopted a decision under Article 126(8) of the Treaty establishing that Hungary had not taken effective action in response to the Council Recommendation of July 2009. The most recent Council Recommendation under Art. 126(7) TFEU was adopted on 13 March 2012. The Council recommended that the Hungarian authorities should put an end to the present excessive deficit situation by 2012 in a credible and sustainable way. Hungary was asked to undertake an additional fiscal effort of at least 0.5% of GDP to ensure attainment of the 2012 deficit target of 2.5% of GDP and put in place the necessary additional structural measures to ensure that the deficit remains well below the 3% threshold in 2013. At the same time, the government debt ratio was recommended to be brought back on a declining path as soon as possible, to show sufficient progress towards compliance with the debt reduction benchmark. The Council recommended that the budgetary adjustment be supported by improvements to the fiscal governance framework.

An overview of the current state of the excessive deficit procedure, including also additional EDP steps adopted after the finalisation of this staff working paper, is available on: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/hungary_en.htm.

Following an overall assessment of Hungary's budgetary plans, with the structural balance as a reference and including an analysis of expenditures, net of discretionary revenue measures, the adjustment path towards the MTO seems to be appropriate.

The deficit path included in the 2013 CP would result in a gradual decrease in public debt, from 79.2% of GDP in 2012 to 73.4% of GDP in 2016. This debt trajectory is higher than projected in the 2012 CP, where the public debt was projected to decrease to 72.7% of GDP already in 2015. This reflects the higher primary deficit targets, the lower nominal GDP path as well as the development of the stock-flow adjustments in selected years. The Commission 2013 Spring Forecast projects only a slight reduction of public debt, to 78.9% of GDP by 2014, mainly due to a higher primary deficit and lower nominal growth, which is estimated to decrease to 78.4% of GDP if the impact of the new corrective measures is

¹⁶ In addition, in 2016, the breach of the expenditure benchmark is also explained by the methodology applied. The drop in absorption of EU funds due to the new financial cycle is asymmetrically calculated, i.e. government expenditure on EU programmes fully matched by EU funded revenue are fully deducted from total government expenditure, while the related reduction of public investment is only partly taken into account.

incorporated. Despite a declining debt path, the public debt-to GDP ratio is still well above that of regional peers.

In 2013 and 2014, the debt reduction benchmark could be expected to be met based on the Commission 2013 Spring Forecast, since the deterioration of the (recalculated) structural balance of 0.3% of GDP and 0.6% of GDP, respectively, is identical to or below the minimal linear structural adjustment (MLSA) of -0.3% in 2013 and -0.7% in 2014. The deterioration of the structural balance of 0.1% in 2013 and of 0.6% of GDP in 2014, as calculated by the Commission taking into account the impact of the corrective measures adopted on 13 May 2013, also suggests that the debt reduction benchmark is expected to be met.

Long-term sustainability

Overall, Hungary does not face a risk of fiscal stress in the short and medium term.¹⁷ Risks to fiscal sustainability are also low in the long term, but depend on Hungary fully implementing its planned ambitious fiscal consolidation and the primary balance being maintained at 2014 level well beyond that year. Government debt (79.2 % of GDP in 2012 and expected to fall to 78.9 % in 2014) is above the 60 % of GDP threshold specified in the Treaty. The risks would be much higher if the structural primary balance reverted to the lower values seen in the past, such as the average for the period 1998 to 2012. The focus should therefore be on reducing government debt.

At the same time, the Commission's illustrative medium-term calculations¹⁸ show that the recent slight decrease in public debt could turn into an increase if financing conditions deteriorate. In particular, debt sustainability analysis that incorporates alternative interest rate and growth assumptions, as compared to a baseline scenario based on current (market) conditions, reveals some vulnerability. For instance, if long-term interest rates permanently stay at around 8.5 % (a level comparable to the severe financial market stress in the first quarter of 2012), debt would already start to increase in 2014 and would reach 85 % of GDP in 2020.

Fiscal framework

In 2011, Hungary completely revamped its fiscal governance system. With the adoption of the new Basic Law and subsequent laws (the cardinal Law on Economic Stability and the new Public Finance Act), virtually all elements of the promising system¹⁹ established in the framework of the 2008-2010 EU-IMF financial assistance programme were replaced. In addition to the re-regulation of numerical rules, institutions and budgetary procedures, the system includes certain new provisions that may weaken the institutional safeguards of domestic economic governance, namely severe restrictions on the competences of the

¹⁷ European Commission (2012): Fiscal Sustainability Report 2012. European Economy, No. 8., Brussels. Web: http://ec.europa.eu/economy_finance/publications/european_economy/2012/fiscal-sustainability-report_en.htm

¹⁸ http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp137_en.pdf

¹⁹ For a description of the previous system and the new constitutional provisions, see: European Commission (2012): *Fiscal governance in Hungary*. In: Fiscal frameworks across Member States: Commission country fiches from the 2011 EPC peer review. Occasional Papers, No 91, European Commission, Directorate General for Economic and Financial Affairs, p. 20-26.

Constitutional Court²⁰ and a requirement for a two-thirds parliamentary quorum to change the features of tax policy.²¹

Overall, while the 2011 changes include elements that help reduce government debt, a number of significant aspects need to be adjusted to ensure a stable and credible fiscal framework. The new set-up has strengthened certain aspects of the fiscal governance system, by providing it with a strong constitutional basis and constraining municipalities' debt accumulation by making sure that local governments get central authorisation before taking out loans.²² However, other aspects have been weakened, for example the forward-looking medium-term real debt rule has been replaced with a nominal debt ceiling and, although the Fiscal Council was granted veto rights over the budget, its mandatory analytical mandate and practical work focused only on qualitative assessments published in the context of the budgetary debate. These drawbacks may impede the new system's credibility and its effectiveness in guiding fiscal expectations. This is why last year's CSR called for revising the cardinal Law on Economic Stability to include the numerical rules in a binding medium-term budgetary framework, and to broaden the analytical remit of the Fiscal Council.

As regards fiscal rules, there has been no policy response so far, thus the medium-term budgetary framework (MTBF) remains purely indicative. Significant improvements are being planned in this area²³. A structural balance rule and a correction mechanism to be used in case of deviations are being considered, possibly as part of a more binding MTBF, in order to define the adjustment path to the medium-term objective. The 2013 Convergence Programme did not confirm these specific reform avenues, but stated that the related legislative amendments are to be submitted to parliament before the autumn session.

On the institutional side, further improvements are still needed to ensure that the Fiscal Council's analyses are commensurate with its strong veto competence. The Hungarian Fiscal Council has an unprecedented (in the EU and OECD) and constitutionally enshrined veto right over the annual budget bill. The September 2012 amendments to the cardinal Law on Economic Stability reinforced it, both in terms of optional tasks and resources. More specifically, a small analytical team is being set up within the Office of the Parliament and informal expert networks are being established. However, further improvements are still needed, as the credibility of fiscal policy would benefit from assigning the systematic ex-post monitoring of compliance with numerical fiscal rules to an independent body, and from ensuring that the work of this body would be based on thorough quantitative analysis

²⁰ The Court only retained the right to review and annul legislation concerning budgetary or taxation matters if it conflicted with certain human rights. This restriction does not apply if public debt falls below 50% of GDP (laws exempted from the constitutional review should not be subject to it even if the debt ratio falls below 50 %).

²¹ The Law on Economic Stability prescribes that the personal and corporate income tax system be proportionate and that family tax allowances cannot decrease. These unusual provisions significantly limit the ability of the current or any future government to change the tax system and adapt it to fiscal necessities.

²² In its first year of operation, the new procedure proved to be an effective tool. In total, an aggregate amount of 0.2% of GDP was authorised, of which 80 % was accounted for by renegotiations of existing loans.

²³ Based on information provided in October 2012 for the Commission's Interim Progress Report on the transposition of the budgetary frameworks Directive. The document is available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SWD:2012:0433:FIN:EN:PDF> .

(especially through the mandatory preparation of macro-fiscal baseline projections and assessments of major fiscal policy proposals²⁴).

Tax system

According to the Commission 2013 spring forecast, the total tax-to-GDP ratio is expected to increase to around 39% in 2013, from 37% in 2011. Revenue from indirect taxes is expected to increase to close to 19% of GDP, up from 17% in 2011, which was the 3rd highest EU figure at the time. This in part reflects the increase in standard VAT rate to 27% in 2012, the highest in the EU. The Commission predicts that revenues from direct taxes will reach around 7.5% of GDP in 2013, which is only a slight increase compared to the 2011 level of 6.9 %, well below the EU average of 12.9 %. At the same time, despite declining on high income earners and employees with family, the tax burden on single low earners (at 67% of the average wage) stood at 46.7%, the second highest value in the EU in 2012. Due to sector-specific taxation, the overall tax level in the corporate sector is also high as compared to the rest of the EU, despite the low level of corporate income taxes (CIT).

In 2012, the Council Recommendation for Hungary contained CSRs concerning a tax shift away from labour taxes on low-income earners (CSR3) and the establishment of a non-distortive and stable framework for corporate taxation (CSR5).

Overall, the government did not follow the 2012 recommendation to establish a non-distortive and stable framework for taxation of corporations and has increased the tax burden on selected corporate sectors by introducing further permanent sectoral surtaxes. In particular, although the crisis taxes adopted in 2010 for the telecom, energy and retail sectors were phased out as of 2013, new surtaxes were introduced on the telecom, energy and public utilities sectors. Moreover, the *crisis tax* on the banking sector (the bank levy) has become permanent, contrary to an earlier agreement with the banking sector to halve it in 2013 and to further reduce it in 2014. In addition, a financial transaction duty is now levied on all cash and bank transfer transactions at a rate of 0.2 % (0.3 % in case of cash withdrawals), although with a cap. International experience with bank transaction taxes is negative and shows that they lead to reduced bank deposits and to weaker lending. Moreover, in most cases no stakeholder consultation was carried out before adopting these measures, which further harmed the investment climate.

Varying tax rates between corporate sectors hamper an effective allocation of resources and affect investment and lending. The heavy tax burden placed on corporations, and in particular the taxation of production inputs, have a direct negative impact on investment and returns.²⁵ In addition, frequent tax changes have a detrimental effect on investment by contributing to an uncertain business environment. Moreover, Hungarian companies face a decreasing credit supply, which is partly caused by the impact of surtaxes on financial institutions. In the meantime, the corporate taxation framework has become more complex, increasing the tax compliance burden and distortions.²⁶ According to the World Bank,

²⁴ For instance, draft changes above a certain threshold, including those legislative initiatives that are outside the standard budgetary cycle.

²⁵ See also the "In-depth Review on Hungary", European Commission (2013).

²⁶ The corporate tax system now consists of six different schemes or rates, most of them combined with a local business tax. Two new simplified corporate tax schemes were introduced in 2013, on top of an already existing simplified business tax scheme and a preferential CIT rate of 10 % for businesses below a HUF 500 million (EUR 1.7 million) tax base. These are the lump-sum tax for small businesses and the small

businesses need an average of 12 tax payments and spend 277 hours per year on paying taxes, with Hungary ranking as the 118th country in the world in terms of easiness of paying taxes²⁷.

Importantly, some less distorting revenue-increasing potential is still available. Tax expenditure is close to 3 % of GDP, and mainly related to VAT and personal income tax.²⁸ Moreover, the government sees tax non-compliance as having a major impact on revenues and intends to tackle it with various measures, including the compulsory connection of all cash registers in the country with the tax authority.

As a response to CSR3, and after the 2011 introduction of a single 16% rate for the private income tax to replace the previous rates of 17% and 32%²⁹ and the abolition of the general tax allowance, the Hungarian government has reduced social contribution rates for selected target groups through the "Job Protection Act" (JPA). Since January 2013 low-skilled workers, women returning from maternity leave, young and old people are eligible for reduced social security payments. These groups were selected because of their low participation rates and in order to minimise wage underreporting, typically associated with wage support schemes for low income earners. The JPA was introduced to alleviate the effect of an increased labour tax burden on low earners, caused by the elimination of the general tax allowance previously granted to low and medium earners³⁰.

In general, from the point of view of economic growth and employment, reducing specific groups' social contributions is a step in the right direction. However, high wage earners and people with high employability (e.g. highly educated elderly employees) are eligible under the JPA and the proportion of low-income earners not explicitly included in the scheme might be non-negligible. Additionally, even if a low income earner (i.e. single earner at 67% of the average wage) is eligible for the JPA, the tax wedge of such a worker is reduced to about 41 %, still a high value in regional comparison. As the JPA has only been in place since 2013, there is no evaluation of it yet, but an impact assessment would be useful.

Although the CSR3 recommended shifting the tax burden to energy or property taxes, government policies went in a different direction. Recurrent taxes on immovable property are significantly smaller in Hungary than in the EU (0.3 % of GDP compared to 1.3 % of GDP in 2011³¹) as not all municipalities levy the building tax³². The government, however, has so far ruled out the introduction of a centrally administered recurrent property tax. Given that real estate prices have been falling since 2004 and that housing investment stands at historically low levels, it may actually be worth postponing such a tax until the housing market has regained momentum. Regarding energy taxation, a special corporate income tax rate of 31% has been introduced in the public utility sector. In addition, an extra tax is now levied on the stock of pipelines and other utility networks, which is a disincentive for investment into the capital stock. These measures cannot be considered an adequate reply to

business tax. In addition, a separate corporate rate (of 50 %) is applied to the energy sector, instead of the standard 19 % corporate income tax rate.

²⁷ <http://www.doingbusiness.org/>

²⁸ Commission estimate based on the 2013 budget.

²⁹ These PIT rates were subject to the practice of super-grossing (multiplying by 1.27) in 2011 and above a certain income threshold half-super-grossing (multiplying by 1.135) in 2012. In this way, the effective PIT rates were higher than the official rates.

³⁰ Additionally, the minimum wage was also raised both in 2012 and in 2013 by more than 20% in total

³¹ Source: 2013 edition of the "Taxation trends in the European Union"

³² Some richer townships could afford not to apply it.

CSR3, as they do not provide incentives to reduce energy consumption and have distortionary effects unlike, for example, energy consumption taxes.

3.2. Financial sector

The Hungarian financial sector is deleveraging at a very quick pace. With assets totalling 183% of GDP, the relative size of Hungary's financial sector lags behind that of the euro area (weighted average of 330% GDP). During the pre-crisis years, it grew quickly mainly thanks to external funding, net external debt of the banking sector reached 30% of GDP in the fourth quarter of 2008. A rapid deleveraging has been on-going since mid-2010, with banks' net external debt falling by close 50% (to 15% of GDP), until the fourth quarter of 2012.

Banks do not support economic growth through lending. The stock of outstanding corporate loans fell by 25% between the last quarter of 2008 and 2012. Based on the central bank's analysis³³, this seems to be mostly caused by banks' low willingness to lend. In a general climate of uncertainty, banks cite high credit risk, negative internal capital generation capacity and recessionary pressures, as the main reasons for tightening conditions on new lending.³⁴ In contrast to corporations, households are simply not willing to borrow as long as their monthly repayment burden remains high and uncertainty in the general economic environment prevails.

Government measures have had a strong negative impact on bank's profitability, which contributed to deleveraging and tight credit conditions. The bank levy remains the biggest tax of its kind in Europe (at around 0.5% of GDP)³⁵. Besides the levy, loan loss provisioning weighed heavily on the banking sector's profitability, resulting in a loss of around 0.5% of GDP in 2012. This loss has followed an even worse result in 2011, mainly caused by one-off losses related to the early repayment scheme in 2011, valued at around 0.9% of GDP³⁶. With the introduction of a financial transaction duty in 2013, the current tax structure in the financial sector has become even less sustainable, as total sector surtaxes now stand above 1% of GDP, compared to the sector's added value, which is less than 4% of GDP. Moreover, most of these measures were taken without proper consultation of sector stakeholders and often violate earlier government commitments, as was the case with the promised decrease in the size of the bank levy.

In addition to the early repayment scheme, the government adopted several other measures to help households with foreign currency loans.³⁷ Introduction of the exchange rate cap for non-distressed borrowers allows them to pay their monthly instalment at a fixed

³³http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Kiadvanyok/mnben_infrep_en/mnben_inflation_20120927/infl_jelentes_201209_en.pdf

³⁴ Foreign banks (owning around three-quarters of total assets) are more bearish on Hungary and plan to further deleverage from their Hungarian subsidiaries, while domestic banks plan to increase somewhat their share in corporate lending.

³⁵ The tax has now become an integral part of the Hungarian banking sector's taxation and continues to be levied on 0.53% of banks' assets over HUF 50 billion (EUR 170 million). With business volumes shrinking on average by 12% since 2009 and for some banks by as much as 25%, the levy is indeed an extremely damaging tax.

³⁶ The Hungarian government introduced a scheme allowing early repayment of foreign currency-denominated mortgages at a discounted exchange rate, with banks which had to cover the difference, although they were allowed to reduce their 2011 profit up to 30% from the losses in the scheme.

³⁷ However, participation in all of these schemes fell short of earlier expectations.

exchange rate level.³⁸ A further measure converted nonperforming foreign exchange (FX) mortgages to HUF loans with 25% debt relief.³⁹ Finally, the National Asset Management Company was set up to purchase flats owned by distressed borrowers who met certain eligibility conditions.⁴⁰ While the government's endeavour to help distressed FX debtors is legitimate, it may increase borrowers' moral hazard and decrease their willingness to pay due to the expectation of further support.

Managing the deteriorating portfolio quality represents the biggest challenge as non-performing loans (NPLs) have been increasing since 2009. The rise slowed down the second half of 2012; however, asset quality is likely to further weaken throughout 2013 due to weak economic activity.⁴¹ Meanwhile, banks are unwilling to recognise the full extent of potential losses in capital resulting in a low loan loss coverage compared to regional peers and loan restructuring is becoming a way to avoid further provisioning⁴². Portfolio cleaning is extremely low as the mortgage market is frozen.

A high capital adequacy ratio in the banking system ensures resilience against adverse shocks. At 15%, the capitalisation of Hungarian banks has reached unprecedented levels of almost double the regulatory minimum of 8%. Capital buffers place banks in their comfort zone when it comes to withstanding even an extremely adverse shock and digesting the mounting pile of NPLs trapped on their balance sheets.

As conditions for Hungarian SMEs to obtain market-based loans have once more worsened in 2012, EU-funded SME support programmes became an even more important means of financing. To facilitate SMEs' access to finance and to revitalise the economy, the government has implemented some measures⁴³ while a reformed JEREMIE⁴⁴ programme has been successful in disbursing EU Structural Funds. However, due to far-reaching absorption, Hungary is running out of these funds and in 2013 only limited supplies are still available.⁴⁵ Therefore, it is increasingly important for the government to prioritise its action and to use additional resources such as the European Social Fund, where payments to beneficiaries are still slow. In addition, integration of the export insurance bank into the

³⁸ The debt resulting from the difference between this fixed exchange rate and the market rate is accumulated on a separate account, while the debt's interest expense is covered by the government and the lenders.

³⁹ In this case, banks again covered the losses from the scheme, although they were again allowed to deduct 30% of their losses from their possible profits.

⁴⁰ Based on the debtor's social situation, see http://www.netzrt.hu/?page_id=148 for more details.

⁴¹ In The last quarter of 2012, household NPLs stood at 16.1%, corporate ones at 19% of loan value (13% and 17.4% a year earlier). Corporate loan portfolios have genuinely worsened, household bad loans have remained stable in absolute terms and the increase in the NPL ratio is mainly attributable to a contraction in the outstanding loan stock.

⁴² 12% of all corporate loans have already been restructured, while in the household segment this ratio is already equal to almost one third.

⁴³ The Széchenyi Card Programme provides credit-card based low-interest loans for micro- to medium-sized enterprises at Hungarian credit institutions. By 2012, over 218000 cards have been issued. In the spring of 2012, the programme was extended to help SMEs participate in EU tenders (Széchenyi Önerő Kiegészítő Hitel and Széchenyi Támogatást Megelőlegező Hitel – Szechenyi, i.e. *own contribution supplementary loan and pre-grant advancement loan*). In December 2012, the government decided to continue to invest in this programme.

⁴⁴ Joint European Resources for Micro- to Medium-sized Enterprises.

⁴⁵ This occurred in particular through the Combined Microcredit Programme, which provides loans combined with non-refundable grants to very small enterprises. New calls have also been published under JEREMIE's Venture Capital Programme, focusing on seed financing.

Hungarian EXIM bank, together with the planned expansion of its balance sheet, point to increased state-funding of export financing for SME, as detailed in the 2013 NRP .

Besides, as reported in the NRP, the central bank announced the "Funding for Growth Scheme" to give zero-cost refinancing to the commercial banking sector to be used for fixed margin interest rate loans to SMEs, both for new loans and for financing the conversion of FX loans into HUF based ones.⁴⁶ The central bank's endeavour to intervene in SME lending is partly understandable. Based on the MNB's former analyses⁴⁷ it can be argued that lending rates to SMEs without government guarantees stand at prohibitively high levels (around 12%). This level (and also the corresponding difference compared to the base rate) is much higher than in other European countries. While it is clear that there is a problem with the underlying business environment and the high sovereign funding cost, which determines the cost of bank lending, SMEs suffer particularly from the high interest rate environment, as their credit risk has disproportionately increased during the crisis. This level of interest rate is hard to cover from revenues even for expanding and well-functioning SMEs. By the same token, the share of unhedged FX debt among SMEs is also prohibitively high at around 75% of total FX debt, which also poses a permanent liquidity problem in the sector. The programme is relatively market-friendly as MNB does not try to circumvent the commercial banking sector. However, capping the interest rate margin on loans can be problematic from the commercial banks' point of view. Given the inherent risk in the sector it is questionable whether a 200bp interest margin (after 50bp guarantee fee) is attractive to banks. The high current lending margins towards SMEs at 5-6% are probably in pair with possible losses given default track records. However, a substantially reduced margin can raise the question of who will bear possible losses, and with an increasing government's involvement in the SME sector, future fiscal costs can also increase.

The global financial crisis demonstrated the extent to which the existing banking system may force national authorities to act to preserve value and safeguard financial stability. The first financial assistance programme to Hungary advocated the need for a state-of-the-art supervision, including granting effective emergency powers to the financial supervisor and establishment of a resolution mechanism. The latter aimed to facilitate rapid pre-emptive action by the authorities to preserve business continuity if a financial institution needed restructuring, in a way that allocates all losses to shareholders and creditors in line with Hungary's financial stability objectives. While the Hungarian Financial Supervisory Authority's powers have been substantially increased over the past three years, the legislator has not equipped it with regulatory powers based on the comply-or-explain principle. Also, resolution tools and the framework for an effective resolution of financial groups never became law, leaving Hungary with an insolvency regime that is ill-equipped to restructure financial institutions or to mitigate disruption due to financial institution failure.

3.3. Labour market, education and social policies

In 2012, the Council Recommendation for Hungary contained CSRs concerning taxation of labour, women's participation in the labour market (CSR3), the Public Employment Service, the public work scheme and the national social inclusion strategy (CSR4).

⁴⁶ Both programmes are capped at HUF 250 billion (EUR 850 million), around 0.8% of GDP.

⁴⁷ See for example Report on Financial Stability, November 2012.

Although it has increased over the past years partly thanks to the government's policy measures, such as restrictions on early retirement and reduction of social benefits, the participation and employment rates in Hungary are still among the lowest in the EU. The pension reform has not been supported by active ageing measures to enhance older workers' employability. In addition, unemployment risks are higher for certain people, in particular for: low-skilled workers (only 36.5 % are employed, compared to an EU average of 53.4 %); youth (50.8 % of 20-29 year-olds are employed, compared to 61.2 % in the EU); women, especially with young children⁴⁸; older workers (only 36.9% of 55-64 year-olds are employed, compared to an EU average of 48.9%); and Roma (only one in three are in employment). Long-term unemployment is also a source of concern. In 2012, 47 % of unemployed people looked for a job for one year or longer, with the average length of time in unemployment lasting 18 months. Yet, in 2011, the maximum period covered by unemployment benefits was reduced from nine to three months, on average not long enough to find an employment.

To boost employment, the government introduced the Job Protection Act (JPA), alongside the Public Work Scheme (PWS) and the single rate Personal Income Tax⁴⁹, as described in the National Reform Programme. The JPA is a step towards *more employment-friendly taxation of labour*, as recommended in the 2012 CSR (see section 3.1), but is not properly targeted, hence it does not directly address *reducing the tax wedge of low income earners*.

Even if the NRP states that the PWS will not increase public sector employment as from 2014, at present the bulk of Hungary's budgetary resources on labour market policies are used for this programme. As the primary aim of the government is to provide the long-term unemployed with work-related income instead of social benefits, the proper targeting of PWS on long-term unemployed or inactive people is essential. While PWS advantages on improving activity level should be acknowledged, its long-term benefits on employability are yet to be proven. In 2012, only around 10 % of the approximately 260 000 participants could return to the labour market after exiting the scheme and most had no access to activation services; only 2.9% of them received training. Government plans in the NRP to substantially increase the share of participants in trainings should be welcomed. However it should be also noted that by having wages below the official minimum wage, public works may negatively affect competition and crowd out private sector companies in certain labour-intensive industries, such as agriculture and construction.

In line with CSR4 and the Annual Growth Survey, the government has strengthened active labour market policies (ALMP). According to the NRP, available European Social Fund resources have been reallocated to the most successful programmes implemented by the Public Employment Service (PES)⁵⁰ and non-governmental service providers and, by doing so, have strengthened their capacities. In the meantime, other state institutions (responsible for rehabilitation and social inclusion) have been created, which make the system more complex for individuals. As the PES must manage active labour market policies and the PWS, it would benefit from further capacity development, including a sound system of profiling its clients.

⁴⁸ Hungary's employment rate of women with young children is among the lowest in the EU.

⁴⁹ The Hungarian personal income tax rate was lowered to 16%, replacing the 2010 tax rates of 17% and 32%

⁵⁰ Active labour market programme supporting the employability of disadvantaged people (SoROP 1.1.2 and 1.1.4) under the Social Renewal Operational Programme, priority axis 1.

Despite a number of training measures listed in the NRP, adult participation in lifelong learning is still one of the lowest in the EU. As detailed in the 2013 AGS, lifelong learning is a key tool for addressing skills bottlenecks, reducing mismatches between job supply and demand, and boosting productivity. Low participation in trainings and professional requalification limits the Hungarian workforce's mobility, the promotion of active ageing and shows low adaptability to change and to labour market needs.

As highlighted in the NRP, youth unemployment (under the age of 25) is worrying, having increased from 11.9 % in 2001 to 28.1 % in 2012, while youth employment rate is 18.6%. When implementing the Council recommendation on establishing a Youth Guarantee,⁵¹ particular attention should be paid to quality apprenticeship programmes and to adopting additional ALMP that decrease the number of people 'not in education, employment, or training'. The European Social Fund will remain the main EU source of funding for youth employment policies, in particular through the support of the Youth Employment Initiative.

In order to encourage women's participation, the government promoted flexible working arrangements through labour code regulation, specific small-scale programmes introduced by 2012 NRP and expanded childcare facilities. There is still no comprehensive impact assessment of these new measures, but the available facilities can only care for less than 8% of children under 3 years old in Hungary, against 28% at EU level. The 2013 NRP identifies scarce capacity of day-care services and lack of flexible jobs as the main obstacles faced by women with small children who want to return to the labour market. Integrating women into the labour market is crucial because Hungary's total workforce is expected to shrink⁵², while in the last 5 years the employment rate of women remained approximately the same. The impact of parenthood on women's employment is three times higher than in the EU⁵³. This may be linked to the long parental leave people are entitled to (up to 3 years with cash benefits), which may act as a powerful disincentive to return to work, especially for low-income-earning women.

Education and Training

In 2012, the Council Recommendation for Hungary contained a CSR concerning implementing a strategy on early school leaving (ESL) and reforming higher education to improve access for disadvantaged young pupils.

A national strategy on ESL has not been adopted yet, although it is under preparation as indicated in the 2013 NRP. While Hungary achieved some progress in lowering the number of ESL prior to 2010, this trend has been reversed in the past two years. An increasing number of disadvantaged pupils, a high proportion of which are of Roma origin may reinforce this negative trend. In order to improve school attainment for disadvantaged

⁵¹ Council Recommendation of 22 April 2013 on establishing a Youth Guarantee (2013/C 120/01) to ensure that all people under the age of 25 receive a high quality offer of employment, continued education, or apprenticeship/traineeship within 4 months of becoming unemployed or leaving formal education, in line with the Council Recommendation agreed on 28 February 2013

⁵² According to the OECD's paper on "Closing the Gender Gap: Act Now" (December 2012), if women's labour force participation reached that of men, the labour force would decrease by 2.2% (instead of by 10% if there is no policy change) and GDP per capita would increase by 0.6 of a percentage point per year.

⁵³ The difference in percentage points between the employment rate of women (20-49 year-olds) without children and women with dependent children aged 0-6. It is -33.6 pps for Hungary; for the EU it is -11.7 pps.

pupils and reduce ESL in the long run, the government made kindergarten compulsory for children over three years old. Affordable quality childcare providing early childhood development from the earliest age contributes to breaking the cycle of disadvantage, thus improving social inclusion. However, success will depend on providing the required kindergarten places, as well as on tackling other barriers to access (e.g. distance, transportation and financial ones). The lowering of the compulsory school age from 18 to 16, might lead to an increased number of young people leaving education without secondary level qualifications. According to the NRP, as from September 2013 trainings will be provided for those who are below the compulsory schooling age limit and have not been admitted to secondary education, with an aim to motivating learning and developing the skills necessary for the acquisition of a profession.

The recently adopted Public Education Act and the shift to a centralised public education system, if not implemented carefully, might increase social inequalities and segregation. Pupils in disadvantaged micro-regions perform considerably worse than the national average and the registered increase in the share of students entering secondary education in Hungary affected only marginally children with multiple disadvantages and Roma students. Also, the percentage of students from these groups applying to secondary school programmes offering a chance to undergo a final examination is rising only slowly⁵⁴. Only 22% of Roma students complete upper-secondary education and the number of schools with a Roma majority among pupils has increased by 43 % since 2004⁵⁵. In these schools, the quality of education and the number of classes taught by subject teachers is lower. As indicated in the 2013 NRP a series of targeted measures such as equal opportunity scholarships are being implemented to support disadvantaged students, but more efforts are needed to reduce inequalities through mainstream education policy. At the same time, the total national budget allocated to schools education was decreased by 17%.⁵⁶

Although the number of students entering higher education has grown significantly in recent years, further work is needed to reach the EU average. According to the NRP the main target groups of the planned measures in higher education aimed at attaining the Europe 2020 target are students aged between 20 and 24 who are already in higher education while further increase of tertiary attainment level is not promoted. The on-going higher education reform is not clear on its mid-term strategy and it is doubtful that besides old measures it can further improve access for disadvantaged pupils, as recommended in the 2012 CSR. Recent changes, uncertain plans on the number of state-financed scholarships and on tuition fees resulted in a severe drop in the number of applicants⁵⁷. As referred to in the 2013 NRP, new forms of scholarships and a student loan programme (Diakhitel II) provide support for higher education studies in fields with societal importance. However, current state-financed scholarships are offered only to students who agree to work in Hungary after they graduate, which raises questions about compliance with workers' freedom of movement in the EU. Finally, students from lower socio-economic backgrounds tend to be more averse to financial risks so their access to higher education will still be difficult despite the new government's student loan system.

⁵⁴ See 2013 NRP, page 27.

⁵⁵ National Social Inclusion Strategy

⁵⁶ This makes Hungary one of the top three countries in Europe in terms of school expenditure reduction (from pre-primary to upper secondary). Source: Eurydice: Funding of Education in Europe 2000-2012, Figure 2.6a

⁵⁷ From 141.000 in 2011 to 95.000 in 2013. See www.felvi.hu

Implementation of the 2011 reform of the vocational education and training system should be closely monitored to ensure labour market relevance and to facilitate the transition between various educational levels and vocational tracks, particularly in the light of high ESL rate. According to the NRP, the drop-out rate in vocational schools reaches 30%, particularly in disadvantaged regions. Recently, the duration of vocational education was shortened and time devoted to the acquisition of key competences substantially decreased. At present, it is planned to reinforce the apprenticeship system and to better involve the business sector⁵⁸, to reduce the gap between skills supply and needs. The full launch of the new system is planned as from September 2013, by this time the preparation for the necessary organizational changes will also be completed.

Social policies

Since the start of the financial crisis, the social situation in the country has worsened. According to the NRP, some 220,000 people more live in poverty than in 2008. 31% of the population is at risk of poverty or social exclusion, and 23% faces severe material deprivation⁵⁹, according to the NRP, because of the economic crisis, growing unemployment and of the negative effects of austerity measures on low-income people. In order to create an incentive for returning to the labour market, Hungary reduced the maximum amount of unemployment benefits and shortened the related entitlement period⁶⁰. However this step has left most registered job seekers without an allowance or a job in 2012. In parallel, eligibility for social benefits has been restricted which further increased the number of people in need.

Box 3 —Health

The health status of the Hungarian population is among the lowest in the EU

The health status of the Hungarian population is lower than the EU average and among the lowest in the OECD. Life expectancy at birth and healthy life expectancy at birth⁶¹ are lower than the EU average, while child mortality is well above it. Non-communicable diseases are the leading causes of morbidity and mortality. Moreover, the incidence of major communicable diseases in Hungary is negatively evolving. Lifestyle-related risk factors are highly prevalent, particularly related to smoking, an unhealthy diet and lack of physical activity.

The health sector workforce is shrinking

A significant number of health professionals have left the country, thus threatening the sustainability of services. Latest analyses available on the Hungarian health system point out that the absolute number of physicians working in inpatient and outpatient care has dropped substantially between 2003 and 2010 and that increased professional mobility may contribute to the overall decline in the number of physicians in the near future as well. To encourage medical specialists to stay in Hungary, the

⁵⁸ The Hungarian Chamber of Commerce and Industries (HCCI), the Chamber of Agriculture and other actors

⁵⁹ 23.1% of Hungary's population is affected by severe material deprivation, compared to only 8.4 % in the EU.

⁶⁰ The maximum period for unemployment benefits has been reduced from 270 to 90 days. The upper limit of the benefit was decreased from 120 % of the minimum wage to the minimum wage. So far, no impact assessment is available on the effects of the measure.

⁶¹ Life expectancy at birth for women (78.7 years vs. 83.2 years in the EU-27) and for men (71.2 years vs. 77.5 years in the EU-27). Healthy life years at birth for women (59.1 years vs. 62.2 years EU27) and for men (57.6 years vs. 61.8 years EU27). These data are part of the 2011, European Community Health Indicators

Resident Physician Support Programme was introduced and provides scholarship grants. However, solving the problem of the health sector workforce requires a more comprehensive intervention.⁶²

Hungary's public spending on healthcare remains below the EU average

Hungary's total healthcare spending and public spending on healthcare remain below the EU average, with public funding currently decreasing. Projections of current public health spending per capita do not point to a significant burden on public finances in the medium- or long-term either.⁶³ However, formal and informal out of pocket payments are high and constitute an additional barrier as there are no exemptions for low income or high risk groups. The system is hospital-centric. Hungary spends only 17% of its public healthcare budget on ambulatory care (as compared to an EU average of 25%) and has few general practitioners per capita. This may lead to cost-inefficiencies as patients are opting hospital in-patient care instead of out-patient care or for more resource-intensive specialists.

Increasing cost effectiveness and sustainable investments in healthcare can have positive spill-over effects by potentially increasing the effective retirement age, as Hungary currently has one of the lowest "healthy life expectancies at age 50" in the EU. Consequently, any successful move towards the Europe 2020 employment target will also require improving the population's health.

Healthcare reform has been initiated but no progress was reported in the 2013 NRP

The government took steps to reform healthcare in line with the "Simmelweis Plan". Nevertheless, further improvement of the system to make it more sustainable and transparent is necessary to ensure access to good quality care and to optimise care delivery across different socio-economic groups and regions. A clear action plan and continuous monitoring would help avoiding new inefficiencies.

The NRP highlights that poverty continues to disproportionately affect disadvantaged territories⁶⁴ and groups, in particular the Roma, more than 90% of whom are at risk of poverty,⁶⁵ as well as children. The number of people at risk of poverty has increased during the international financial crisis, from 2.83 million in 2008 to 3.1 million in 2011. They are affected by a high level of unemployment, low education levels, poor housing and poor health.

Hungary adopted a National Social Inclusion Strategy (also covering Roma) in 2011 and started its implementation, as reported by the NRP, but results are still unclear. The strategy aims at improving employment, education, health and housing conditions, but the counteracting mainstream policy developments and limited national resources allocated to it could severely affect its efficiency and sustainability, while the worsening poverty situation calls for further integrated efforts and monitoring based on pre-determined quantitative targets, which are currently being set up.

⁶² The 2013 NRP underlines a lack of resources of HUF 624 million for 2013-2015, needed to achieve the expected results

⁶³ Long-term healthcare expenditure projections show an expected increase in healthcare expenditure of 1.1 pp of GDP by 2060 (2012 Ageing Report EPC/EC)

⁶⁴ Regional economic disparities are important. The Budapest region is the only one with a GDP per capita above the EU-27 average. The labour market has a strong regional dimension as well, with particularly high (long-term) unemployment rates in North Hungary and North Great Plain. Significant differences also exist between urban and rural areas, as a high proportion of marginalised people, mainly Roma, live in the latter.

⁶⁵ According to a recent survey, the percentage of households at risk of poverty is more than double for marginalised Roma households than for marginalised non-Roma households. See FRA report: <http://fra.europa.eu/en/publication/2012/situation-roma-11-eu-member-states-survey-results-glance>.

3.4. Structural measures promoting growth and competitiveness

Business environment

In 2012, the Council Recommendation for Hungary contained a CSR concerning a stable regulatory and business-friendly environment for financial and non-financial enterprises, including foreign direct investors (CSR5).

However, the general business environment has deteriorated due to an unpredictable policy environment as evidenced by a series of measures that imposed additional burdens and a growing number of restraints on investors. Examples include sector specific surtaxes (see also section 3.1 – *Taxation*) and restrictions on various services, namely waste treatment, the pharmaceutical retail sector, meal voucher providers and the financial sector (see also section 3.2 – financial sector).

As regards sector specific surtaxes, although the crisis taxes adopted in 2010 for the telecom, energy and retail sectors were phased out as of 2013, new surtaxes were introduced on the telecom, energy and public utilities sectors. Moreover, the *crisis tax* on the banking sector (the bank levy) has become permanent, contrary to an earlier agreement with the banking sector to halve it in 2013 and to further reduce it in 2014. In addition, a financial transaction duty is now levied on all cash and bank transfer transactions at a rate of 0.2 % (0.3 % in case of cash withdrawals), although with a cap.

Hungary has taken no steps to remove the persisting restrictions to the freedom of establishment in the retail sector⁶⁶, which will be applied until the end of 2014 despite the economic importance of the sector for Hungary.⁶⁷ The 2013 NRP does not foresee to address the restrictions either.

Further entry restrictions in the service sector have been also introduced. The government has imposed restrictive conditions for issuing hot meal vouchers (*de facto* excluding existing foreign operators from the market) and a state monopoly has been imposed on issuing cold meal vouchers. In addition, amendments to the pharmaceutical sector law (Gyftv) by limiting foreign investors' presence on the market with a compulsory sell-off of their stake can further harm investor confidence.⁶⁸ These amendments seem unjustified, and may cause the end of pharmacy chains in Hungary and increase product costs. They are also discriminatory towards foreign companies, as most chains are owned by foreign investors (the law suggests keeping medicine supplies 'within national interest'). Furthermore, waste management was completely remodelled by a bill which has entrusted the organization of public service waste management to the state and provided that the public service of household waste management (collection and recycling) should be made by companies majority-owned by the state or its communities. For these reasons, the Commission has initiated an EU pilot procedure regarding restrictions on the freedom of establishment in July 2012. Although the bill was partially modified in November 2012, the condition of the

⁶⁶ The so called 'plaza-stop law' prescribes prior approval for building commercial facilities exceeding 300 m².

⁶⁷ Retail accounts for 4 % of GDP and 9.1 % of the workforce.

⁶⁸ According to them, one shareholder may not hold shares in more than four pharmacies and must sell any pharmacy above the limit of four to one of the pharmacists working in that pharmacy. Each pharmacist should progressively increase his/her share from 1 % now to 25% in 2014 and 50 % in 2017.

majority ownership of state enterprises in the management of household waste was not removed. Moreover, the activity has been reserved exclusively for non-profit entities.

According to international observers the situation has deteriorated over the last three years. In the 2011 World Bank Doing Business report⁶⁹, Hungary ranked as the 46th easiest country to do businesses in; two years later it has reached the 54th position. If the investor protection ranking is taken into account, Hungary is the 128th best country in the world (down from 120th in 2011) and the worst in the whole EU. Also, last year the country fell by 12 places on the World Economic Forum Global Competitiveness Index. Recently introduced restrictions and artificially created monopolies disproportionately hurt foreign investors, mainly in the service sector. Furthermore, corruption⁷⁰ and diversion of public funds⁷¹ remain significant problems and add to the unfavourable business climate⁷² hence making Hungary difficult for both domestic and foreign operators and hampering investment and competition. Finally, a generally unstable and volatile regulatory environment remains a hurdle for business, an issue which according to the 2013 NRP, the government is aware of and is trying to tackle by increasing the predictability of legislation.

Research and innovation

Business sector R&D spending has been increasing from 0.36% of GDP in 2004 to 0.75% in 2011. This has contributed to an increase of the R&D intensity up to 1.21 % of GDP in 2011, in line to achieve the Europe 2020 target of 1.8 % of GDP. However, the negative trend in the governmental budget for R&D since 2009 is a matter of concern.

The Innovation Union Scoreboard ranks Hungary as a moderate innovator. Business R&D investment is driven primarily by foreign-owned companies. Two-thirds of industrial innovation is concentrated around Budapest, with a strong sectoral presence in pharmaceutical, electronics, informatics and automotive industries. The smart specialisation strategy announced in the 2013 NRP may contribute – with its strong regional focus – to stimulating innovation in lagging behind regions. This effort of spreading innovation processes more widely throughout Hungary is very relevant and ambitious and could mitigate the heavy concentration of RDI in Budapest. At the same time, low rates of government investment in environmental and energy R&D, green early-stage investment and total R&D personnel put Hungary among the lowest scoring countries on eco-innovation⁷³.

There have been frequent changes in the governance of Science, Technology and Innovation (STI) policies⁷⁴ and the new National Innovation Strategy (2013-2020) is significantly delayed. According to the 2013 NRP, the strategy is expected to be adopted in the first quarter of 2013, following an inter-ministerial consultation stage, which does not

⁶⁹ <http://www.doingbusiness.org/>.

⁷⁰ 96% of Hungarians think corruption is a major problem in their country. There are only three countries where people have worst perceptions in the EU, see the special Eurobarometer on corruption.

⁷¹ For this indicator, Hungary ranks 106th in the WEF Global Competitiveness Report for 2012-2013

⁷² http://ec.europa.eu/enterprise/policies/industrial-competitiveness/monitoring-member-states/improving-public-administration/files/pa_report_en.pdf

⁷³ Eco-Innovation Observatory, see <http://www.eco-innovation.eu/>

⁷⁴ The high-level political body in the field of STI policy, the National Research, Innovation and Science Policy Council (NKITT), was dissolved in July 2012, when the Governmental Development Cabinet, a body chaired by the prime minister, was set up.

seem to be achievable anymore. The draft strategy, based on the critical challenges it identifies⁷⁵, sets the following priorities: support for globally competitive research centres; ensuring stable financing⁷⁶; intensifying knowledge flows; efficiently targeting support measures to boost the research, development and innovation (RDI) activity of both large and SME companies. The strategy also plans to tackle the projected shortage of human resources in technical sciences and engineering, partly caused by brain drain, as these are urgently needed in sectors at the forefront of RDI⁷⁷. As detailed in the 2013 NRP, the National Innovation Strategy will be complemented by a Smart Specialization Strategy by the end of 2013, establishing regional priorities. Moreover, it will play a key role in preparing for Horizon 2020, in drawing up a comprehensive RDI promotion system, and is going to be a framework for planning the Smart Specialisation Strategy, which is expected to be adopted in the second half of 2013. A timely implementation of the Strategy is essential to maximise the effectiveness of RDI expenditure and its impact on growth and jobs in 2014-2020.

In 2012, CSR5 recommended that Hungary develop ‘targeted incentive schemes to support innovative SMEs’, as only 13% of Hungarian SMEs carry out innovation activities.⁷⁸ The available support schemes must be more targeted and focused on innovation. For example, despite a number of funding mechanisms being directed towards eco-innovation through various public programmes, the amount of available funding is still insufficient for strengthening the Hungarian eco-innovation market. Hungary has had significant experience with the financial instruments (FIs) under the EU’s cohesion policy funds in the period 2007-2013. To boost innovation and growth, the use of EU funds should shift further away from classical grant schemes and move towards financing corporate RDI activities. Currently, financial instruments are mainly used to support SMEs in their general business activity, e.g. for the purchase of new machinery. Another impediment to growth is Hungarian SMEs’ lack of integration into the global value chain of the numerous multinationals present in the country. These multinationals would also benefit from being better integrated into the national and local economic networks and innovation systems. EU cohesion policy can play a crucial role here, for example through targeted business advisory services, partnering approaches and cluster policies. In this context, the NRP 2013 NRP announces a major focus of the new Hungarian strategy for SME policies 2014-20 (currently being finalised) on SMEs’ innovation potential, networking, cooperation and entrepreneurial skills which can contribute to enhance competitiveness.

Hungary has not fully seized the growth and jobs potential of the digital economy. Whereas it is doing relatively well as regards rolling out of broadband, its take-up remains below the EU average. The take-up of mobile broadband is the lowest in the EU. Overall, lack of frequencies for wireless communications, a continued and increasing fiscal burden on operators, and regulatory uncertainty may put the necessary investment at risk.

⁷⁵ Challenges are grouped into 3 main areas: knowledge generation (lack of competitive knowledge centres, researcher capacity, obsolete R&D infrastructure, inadequate financing); knowledge flows (weak inter-sectoral links, inadequate international embeddedness and technology transfer); and knowledge utilisation (the striking gap between foreign and domestic companies)

⁷⁶ funding for basic research, availability of venture capital, seed capital

⁷⁷ According to the World Economic Forum Global Competitiveness Index, among EU Member States only Romania is more severely hit by brain drain than Hungary. Only 15 countries worldwide (out of 144 in the report) suffer from it more than Hungary, according to the Executive Opinion Survey on which the report is based.

⁷⁸ As opposed to an EU average of 30%

Transport

Implementation of the measures included in the Szell Kalman Plan, which is aimed at improving the cost-efficiency and performance of transport, is prone to considerable delays. Although the introduction of a distance-based e-toll system for heavy-duty vehicles has been confirmed for 1 July by the latest Convergence Programme as well as by the proposed road toll act, given that the technology of the system is being still unknown and there are concerns about the procurement process, the risk of implementing a sub-optimal system (i.e. which is not based on the most advanced technology that is able to extend the effective coverage to most transport routes in the country) is high. Also, last year the parliament voted against the introduction of a congestion charge planned for the centre of Budapest and there is no certainty on when it will be back on the government's agenda. If well-designed, these two measures could also contribute to reducing the significant external cost of road transport.

The lack of a comprehensive transport strategy hinders the financial sustainability of the transport systems and of projects of key importance. As for collective transport, financing the Hungarian State Railways (MÁV) and the Budapest Transport Company (BKV) has become unsustainable over the last years. Although the new CP refers to a recent agreement between the government and Budapest, it contains no concrete plans about the reform of public transport in the capital, and a long-term solution is still to be found for the financing of BKV. The restructuring and streamlining of MÁV announced in the 2011 NRP has started; at the same time the budgeted appropriation for track operation in 2013 seems to cover all due costs (after a long period of underestimating these costs). In 2012, a more flexible tariff system was introduced, but no substantial changes have been made to discounts, which impede cost recovery.⁷⁹ As a response to last year's CSR, the 2013 NRP states that the revision of the tariff system has been completed, while it concedes that "discounts offered on social basis, however, can only be reviewed gradually due to social and transport policy reasons." The 2013 NRP and CP also reiterate other measures previously announced (e.g. reviewing preferential tariffs, the congestion charge or the modernisation of ticketing) without including any details, except for the procurement of more environmentally-friendly buses. This could attenuate the problem of old rolling stock, which continues to cause regular disruptions, high energy consumption and pollution. However, although this is a step in the right direction, it appears isolated; such actions should be reinforced and complemented with policy means to encourage the use of public transport in the 2014-2020 Partnership Agreement and relevant operational programme(s). The lack of own resources of public transport companies may endanger the success of the call in question. Finally, there seem to be no plans to improve the conditions for navigation on the Danube, which remains a barrier to competitiveness.

Energy and the environment

In 2012, the Council Recommendation for Hungary contained a CSR concerning cross-border capacities of the electricity network, the independence of the energy regulator and regulated energy prices (CSR7).

⁷⁹ According to MÁV, 90 % of passengers need a ticket to travel. In 2012, 40 % of them travelled at full price, the rest benefitted from one of the 43 available reductions. In the case of BKV, the number of those travelling for free is not even known.

Hungary adequately increased interconnections with its neighbours, as was recommended. The Hungarian power grid is now linked with Austria, Slovakia, Ukraine, Serbia, Romania and Croatia, and four new programmes with Slovakia are currently under discussion. Interconnection already amounts to some 30% of domestic electricity generation capacity, which is higher than the 10% requirement⁸⁰ referred in the NRP. In the case of natural gas, it is important to complete the interconnector between Hungary and Slovakia by January 2015, as planned.

The energy regulator's lack of full independence still raises concerns. The right to set retail prices and network tariffs is only formally in the hands of the National Regulator (the Hungarian Energy Office), though the NRP claims that the new Energy Office, created by a recently adopted law in March 2013, is exclusively subordinated to legislative acts and it is an independent regulatory organ. In reality, in order to calculate tariffs, the Regulator must apply the methodology detailed in ministerial decrees. In addition, recent amendments to the Hungarian electricity and gas acts do not allow network operators to recover incurred costs, as is required by internal market rules.⁸¹

Instead of gradually abolishing regulated prices, the government continued price regulation. At the outset of 2013, the government forced a 10 % reduction of end-user retail electricity and gas prices on all providers. This move does not provide incentives to investors in the energy sector and increases the probability of cross-subsidising consumers under regulated tariffs by other consumers (not falling under universal service provision). Following a court decision, which allowed energy providers to set higher tariffs, the government increased the powers of the new Energy Office⁸² so that its decisions can only be appealed at the level of the Constitutional Court.⁸³ The 2013 NRP mentions the opportunity to phase-out the regulated energy prices only on a longer time horizon, in parallel with the accomplishment of the European internal energy market, leading to converging national wholesale electricity and gas prices and by further installation of adequate cross-border capacity.

Government intervention may be one of the causes of the retail market not functioning properly. It takes an average of 252 days for a company to get access to electricity,⁸⁴ which makes Hungary the second slowest country in the EU and the ninth slowest worldwide.

Hungary is still way above the EU average in terms of energy and carbon intensity, and its excessive energy consumption causes external imbalances. The household sector has one of the highest energy and carbon intensities in the whole EU, which shows scope for improving efficiency across the board, from household appliances to building efficiency. Doing so would have a positive impact on Hungary's external account, which presents one of the highest energy trade deficits in the EU (-5.4 % GDP per year on average, compared with -2.4 % of GDP in the EU in 2007-11). The country is heavily dependent on imported fossil energy sources and has the highest gas trade balance deficit in the EU (-2.5 % GDP), which also points to possible supply risks.

⁸⁰ Council Presidency Conclusions of the Barcelona European Council, 15-16 March, 2002

⁸¹ Art.14(1) of Reg. 714/2009 requires that network tariffs reflect actual costs of the network operators. Fees and surcharges that can be passed on to consumers have been limited (e.g. banking transaction fees, tax on wires and pipelines cannot be passed on).

⁸² Magyar Energetikai és Közmű-szabályozási Hivatal.

⁸³ Contrary to the right to appeal principle established under Dir.2009/72/EC (art. 37 — par. 16 and 17) concerning common rules for the internal market in electricity.

⁸⁴ World Bank Doing Business 2013 report

At the same time, end-user electricity and gas price cuts do not give incentives for sustainable energy consumption and efficiency measures. The National Energy Efficiency Action Plan (NEEAP) was adopted, but some of its elements are still delayed, such as green procurement and the national strategy for energy efficiency of buildings. EU Structural Funds co-finance national energy efficiency projects, although they fall short on demand and are quickly depleted after calls are published. Alternative financing mechanisms are under-used (including revolving funds and energy performance contracting). In addition, regulated prices do not facilitate broader deployment of renewable energy sources or reduction of external fossil fuel dependency, so they should be limited to vulnerable customers only.

The regulatory environment to support co-generation has deteriorated. The abrupt discontinuation of the purchase obligation scheme for electricity from co-generation in 2011, without proper measures to replace it, resulted in a sharp and significant drop of 7.4% in the share of cogeneration in just two years (from 20.9% in 2010 to 13.4%, whereas the national economic potential is 25%). The general price regime coupled with heat price regulation is not conducive to improving efficiency in energy production and consumption. The regulatory framework and support system do not follow the strengthened requirements of the new Energy Efficiency Directive⁸⁵, and do not promote co-generation either, in particular in district heating and cooling.

Hungary still faces significant challenges to reaching its 2020 renewable energy sources target. The country has not finished transposing the Renewable Energy Sources Directive, but in 2011 it nearly doubled the proportion of renewable sources in its gross final energy consumption between 2005 and 2011; these now account for 8.1 % of Renewable Energy Sources.

Hungary is well positioned to meet its 2020 greenhouse gas emissions target for emissions outside the Emissions Trading Scheme (ETS). Projections of 2020 emissions, based on existing measures, show that Hungary will meet its target by reducing greenhouse gas emissions by 26 %. Nevertheless, while emissions in other sectors are falling, transport sector emissions have increased since 2005. This trend also leads to high fine-particle pollution⁸⁶, which is currently the highest risk to public health, especially in Budapest, and is responsible for 2200 premature deaths per year.⁸⁷

3.5. Modernisation of public administration

The 2013 Annual Growth Survey notes the importance of improving the transparency and quality of public administration. In 2012, the Council Recommendation for Hungary contained a CSR concerning public administration reform (CSR5). According to the 2012 National Reform Programme, this is one of the Hungarian government's priorities.

To this end, the Simple State programme included 114 measures to reduce the administrative burden on businesses by approximately HUF 500 billion (EUR 1.7 billion)⁸⁸. While the programme is on-going the implementation has been somewhat delayed. The programme was announced in 2011 (originally with 114 measures) and most

⁸⁵ Directive 2012/27/EU of the European Parliament and of the Council of 25 October 2012 on energy efficiency

⁸⁶ PM10 i.e. particulate matter, 10 micrometres, a type of air pollution.

⁸⁷ See http://gamapservr.who.int/gho/interactive_charts/phe/oap_mbd/atlas.html.

⁸⁸ Approximately 1.7 % of GDP.

(93) measures were completed by February 2013. However a few measures have been delayed, some even beyond 2014 (e.g. e-governance); according to the 2013 NRP, and eight were cancelled. By the first half of 2013, 93 measures have been adopted⁸⁹, saving HUF 288 billion (EUR 988 million), while another 13 are expected to be implemented by the end of the year⁹⁰, with expected savings of around HUF 100 billion (EUR 342 million). However, the slowed down reform and unclear monitoring arrangements⁹¹ point to a risk for the programme to not achieving the expected impact. The 2013 NRP mentions that further measures are in the pipeline, mainly focusing on increasing the stability of the regulatory environment, without detailing the exact nature of these measures.

Reforms have been on-going in the framework of the Magyar Program in order to increase the efficiency of public administration vis-à-vis citizens. In this case 98% of planned measures have already been adopted by April 2013. The government's anti-corruption programme⁹² is a central element. Regrettably however, the programme which focuses on prevention through measures such as training and the introduction of codes of ethics, does not tackle the issue of insufficient law-enforcement in this area, nor does it address reinforcement of party financing control, a key area of concern.⁹³ The 2013 NRP does not foresee such measures to be covered in the coming years either. Moreover, the achievements listed in the NRP cover only a fraction of the entire programme; most of the announced steps have not been started yet and according to 2013 NRP implementation is expected by the end of 2014. Lack of monitoring of implemented measures also remains a problem.

Administrative simplification through business portals can significantly improve efficiency for businesses and for the public administration by transforming paper-based public services into user-friendly digital ones. The 2013 NRP mentions the government intentions to develop the Points of Single Contact (PSC) required under the Services Directive, but does not provide details on how the authorities intend to address its limitation. In particular, not all procedures are supported online, and PSCs are of limited use to cross-border service providers for linguistic reasons (information is only available in Hungarian) and because they require a Hungarian electronic signature.

Successful implementation of cohesion policy may also be threatened due to insufficient administrative capacity (mainly at the level of EU fund beneficiaries). The amount at risk of de-commitment in 2013 is estimated at EUR 500-600 million and is related mainly to the transport, energy and environment sectors. The announced change in the institutional setup responsible for implementing the 2014-20 programmes⁹⁴ further exacerbates this risk.

A low level of competition in public procurement persists, although a new law entered into force on 1 January 2012 with the aim of streamlining public procurement rules and

⁸⁹ Savings achieved by the end of 2012 are estimated at HUF 190-250 billion (EUR 650-857 million), taking into account measures already implemented before the launch of the Simple State Programme

⁹⁰ With expected savings of around HUF 100 billion (EUR 342 million) according to government's estimates

⁹¹ No information on the work of the committee that oversees the Simple State programme is publicly available

⁹² Government decree 1104/2012(IV.6.) on anticorruption measures and the adoption of the Programme on Preventing Corruption in Public Administration.

⁹³ <http://media.transparency.org/nis/cogs/?Country=hu>.

⁹⁴ According to government decree 1600/2012. (XII. 17) the managing authorities will be relocated to the line ministries (instead of the current National Development Agency containing the managing authorities of all Operational Programmes), with coordination ensured by the Prime Minister's office.

ensuring more transparency in spending public funds. However, the 2013 NRP does not announce new measures to address remaining concerns. In particular, these relate to the fact that below a certain threshold only SMEs can submit offers, which has a negative impact on competition in public tenders, and negative repercussions for taxpayers. Moreover, a very high proportion of public procurement procedures involved one single bidder: 54.3 % in 2010 and 49.1 % in 2011. This figure was even higher when a negotiated procedure was used (on average 61 %). Furthermore, questionable direct awards continue to surface. The electronic submission of tenders is currently not possible in Hungary, so the economic benefits of e-procurement⁹⁵ are currently not being exploited.

The 2013 Annual Growth Survey also underlined the importance of improving the quality, independence and efficiency of judicial systems, to enhance trust and stability. This is an important component of an attractive business environment and ensures the effective and timely enforcement of contracts and competition rules.

The developments in Hungary in 2012 and 2013 have increased concerns about the judiciary's independence. In January 2012, the mandatory retirement age for judges, prosecutors and public notaries was lowered by 8 years. In November 2012, the EU Court of Justice ruled (C-286/12) that such a sudden lowering of the retirement age violates EU equal treatment rules. With the aim of bringing the domestic law in line with this ruling, Parliament adopted amendments in March 2013 to gradually decrease the retirement age from 70 to 65 over a 10-year period, as well as to offer various help for the judges concerned (including reinstatement to their former positions and one-off compensations).

Moreover, in March 2013, the Hungarian parliament adopted the fourth amendment to the Fundamental Law in the last two years, including new provisions that raise serious concerns related to the principle of the rule of law, EU law and Council of Europe standards⁹⁶. Notably, the power to transfer cases from one court to another was granted to the President of the National Judicial Office, aggravating concerns about the independence of the judiciary. This issue was brought to the attention of the Hungarian government by the Commission on several occasions in 2012, and was also highlighted by the Venice Commission of the Council of Europe. Following a detailed assessment of the adopted various provisions, on 2 May the European Commission sent administrative letters requesting further clarification on this issue, as well as regarding two other new articles: the clause on European Court of Justice judgements entailing payment obligations and the restrictions on the publication of political advertisements.

⁹⁵ For example: greater transparency, faster procedures and more competition.

⁹⁶ See the Commission's press release: http://europa.eu/rapid/press-release_IP-13-327_en.htm

4. OVERVIEW TABLE

2012 commitments	Summary assessment
Country-specific recommendations (CSRs)	
<p>CSR 1: Correct the excessive deficit by 2012 in a durable manner, by implementing the 2012 budget and the subsequently approved consolidation measures, while reducing the reliance on one-off measures. Thereafter, specify all structural measures necessary to ensure a durable correction of the excessive deficit and to make sufficient progress towards the MTO, including meeting the expenditure benchmark, and ensure sufficient progress towards compliance with the debt reduction benchmark. Also to help mitigate the accumulated macroeconomic imbalances, put the public debt ratio on a firm downward path</p>	<p>Hungary has broadly implemented this CSR.</p> <p>Most of the budgeted consolidation measures and additional ones announced in the course of the year were rigorously implemented in 2012, which was the deadline for Hungary to bring the excessive deficit to an end. As a result, the deficit came out at 1.9% of GDP, well below the Council endorsed deficit target of 2.5% of GDP. The structural effort, corrected for the effects of revised potential output growth and windfall revenues compared to the time the Council recommendation was issued, is estimated to be at 3.5% of GDP in 2012, which substantially exceeds the recommended effort of 2.4% of GDP. The public debt ratio decreased from 81.4 % in 2011 to 79.2 % GDP in 2012.</p> <p>Therefore, the government was sufficiently ambitious as it repeatedly committed itself to fiscal consolidation. However, the new fiscal measures were increasingly concentrated on the revenue side, raising questions about the sustainability of the consolidation efforts. Based on the Commission 2013 spring forecast, the general government deficit is projected to increase to 3% of GDP in 2013 and to worsen further to 3.3% in 2014, assuming no-policy-change. On 13 May, following the release of the 2013 spring forecast, the government adopted further corrective measures of 0.3% of GDP for 2013 and 0.7% of GDP for 2014 (in gross terms) in order to keep the deficit both in 2013 and 2014 below the 3% of GDP reference value.</p>
<p>CSR 2: Revise the cardinal law on economic stability by putting the new numerical rules into a binding medium-term budgetary framework. Continue to broaden the analytical remit of the Fiscal Council, with a view to increasing the transparency of public finances</p>	<p>Hungary has partially implemented this CSR.</p> <p>There was no change to the medium-term budgetary framework (MTBF), which is purely indicative. Hungary would benefit from a revised general (central) government numerical rule whose design focuses on the structural deficit, as this would be more conducive to effective multi-year planning. The Hungarian authorities are of the opinion that the numerical rules (linking debt reduction to economic growth) that are currently in place are well-founded and appropriately strict, but they</p>

	<p>acknowledged that strengthening the MBTF is necessary to make it binding, at least to some extent (related amendments are planned to be submitted to parliament before the autumn session, as part of the package on transposing the Directive on the minimum requirements of national budgetary frameworks).</p> <p>As for institution building, an amendment to the cardinal law was adopted in September 2012 and reinforced the Fiscal Council (FC) both in terms of (optional) tasks and resources (5-strong staff should be hired from the allocated budgetary appropriation to work in the Office of the Parliament). So far, the FC has relied primarily on analytical input provided by the Hungary National Bank (quantified estimates for macro and fiscal variables) and the State Audit Office (qualitative risk assessments). It is crucial to monitor whether the on-going reinforcement of the FC will make it strong enough to be able to perform its analytical role.</p>
<p>CSR 3: Make the taxation of labour more employment-friendly by alleviating the impact of the 2011 and 2012 tax changes on low earners in a sustainable, budget-neutral manner, for example by shifting part of the tax burden to energy taxes and recurrent taxes on property. Strengthen measures to encourage women's participation in the labour market, particularly by expanding childcare and pre-school facilities.</p>	<p>Hungary has partially implemented this CSR.</p> <p>The Job Protection Act, which came into force in 2013, is an adequate step towards last year's CSR because it lowers social contributions for certain categories of workers, thus reducing the tax wedge. However, it does not efficiently target low-income earners as the criteria are not set on the basis of income. Therefore, a non-negligible share of lower productivity workers does not have access to the programme. At the same time, as a no-income ceiling is applied, certain groups of high income earners are also eligible for contribution cuts.</p> <p>In 2012, the government implemented several measures aimed at further improving the labour market participation of women. This includes the creation of new places in nurseries and the development of day-care facilities. The new Labour Code that was enforced in mid-2012 includes time off for breastfeeding, job protection for mothers, the right to unpaid leave for childcare reasons, and the obligation for employers to hire employees returning from parental leave and with children under three part-time, upon the employee's request.</p>
<p>CSR 4: Strengthen the capacity of the Public Employment Service to increase the quality and effectiveness of training, job search assistance and individualised services, with particular regard for disadvantaged groups. Strengthen the activation element</p>	<p>Hungary has partially implemented the CSR.</p> <p>The government strengthened active labour market policies and the capacities of the Public</p>

<p>in the public work scheme through effective training and job search assistance. Implement the National Social (Roma) Inclusion Strategy, and mainstream it with other policies.</p>	<p>Employment Service by reallocating available European Social Fund resources to the most successful programmes targeting disadvantaged people.</p> <p>However, the public work scheme is still a major pillar of employment policy, although it seems an ineffective way of reintegrating people into the labour market.</p> <p>Although training was planned as part of the scheme, it was poorly implemented and did not have successful results. The activation element is still missing.</p> <p>While a system to monitor the social inclusion strategy was presented, mid-term targets were set only in part. Certain elements of the new laws on public and vocational education risk further segregating the Roma, which is not in line with the strategy.</p> <p>Although a number of targeted measures are available to help disadvantaged people get access to education, mainstream education policy does not seem to appropriately address the needs set out in the National Social Inclusion Strategy.</p>
<p>CSR 5: Implement measures envisaged to reduce the administrative burden. Ensure that public procurement and the legislative process support market competition and ensure a stable regulatory and business-friendly environment for financial and non-financial enterprises, including foreign direct investors. Reduce tax compliance costs and establish a stable, lawful and non-distortive framework for corporate taxation. Remove unjustifiable restrictions on the establishment of large-scale retail premises. Provide specific well-targeted incentive schemes to support innovative SMEs in the new innovation strategy.</p>	<p>Hungary has partially implemented the CSR, but no progress was achieved on improving the business environment.</p> <p>The system of applying special taxes to certain sectors and the restriction of large-scale retail enterprises has been maintained. Entry costs in the service sector have increased further.</p> <p>The bulk of measures aimed at reducing the administrative burden should have been implemented by the end of 2012, but there have been delays and the deadline was moved to 2014, which shows that the reform has slowed down somewhat. By mid-2013, 93 measures have been adopted, but further delay is expected in important areas, most notably in e-government. Lack of effective monitoring and of transparency as regards practical implementation and actual impact remains a problem.</p> <p>Low level of competition in public procurement persists, although a new law entered into force on 1 January 2012.</p> <p>The new innovation strategy was drafted and a consultation was launched at the end of 2012. The</p>

	<p>incentive schemes proposed in support of innovative SMEs are still to be assessed. The potential of eco-innovation has to be further explored.</p>
<p>CSR 6: Prepare and implement a national strategy on early school-leaving by ensuring adequate financing. Ensure that the implementation of the higher education reform improves access to education for disadvantaged groups.</p>	<p>Limited progress was achieved on this CSR</p> <p>The early school leaving strategy will only be ready at the end of 2013. The number of early school leavers decreased from 13.9 % in 2000 to 10.5 % in 2010, but this trend reversed in 2011, when the number of early school leavers reached 11.2 % and 11.5% in 2012. The government is aware of the increasing challenge posed by the number of early school leavers and has started implementing some measures embedded in the National Public Education Act, but results are not visible yet.</p> <p>Exclusion from quality education is a major problem for Roma children. The number of Roma-majority schools has increased, but their quality of education remains below average. The schools do not equip their pupils with the basic skills needed to join the labour market and to participate in lifelong learning programmes.</p> <p>Hungary would need to do more to ensure that implementing the higher education reform improves access to education for disadvantaged people.</p> <p>The tertiary education strategy and thus the entire higher education reform is not clear on its mid-term strategy and the uncertainties around state-financed places and additional loan schemes further limit access of disadvantaged youth to tertiary education.</p> <p>Hungary's tertiary attainment rate is increasing, due to the substantial expansion of higher education between 2002 and 2010. However, current policy developments might lead to a decrease of the number of students in higher education.</p>
<p>CSR 7: Reform the public transport system to make it more cost efficient. Increase the cross-border capacities of the electricity network, ensure the independence of the energy regulator and gradually abolish regulated energy prices.</p>	<p>Limited progress was achieved on this CSR</p> <p>Implementation of the reform in the transport sector is slow at best. Based on the limited amount of information available on measures that are being considered, both effectiveness and ambition seem to be limited. The policy response is not sufficiently</p>

	<p>clear and precise, which raises questions about the reform's credibility.</p> <p>Increasing cross-border electricity capacities is ongoing. Independence of the National Regulator is still an issue, as are regulated prices, with decisions on which powers should be re-delegated to the regulator being made at ministry level.</p>
Europe 2020 (national targets and progress)	
Employment rate target set in the 2013 NRP: 75 %	The employment rate was 60.4 % in 2010, 60.7 % in 2011 and 62.1% in 2012. It has increased slightly since 2010, but is still far behind both the EU average and Hungary's national target.
R&D target: 1.8 %	In 2011, R&D intensity increased to 1.21 % of GDP, from 1.17 % in 2010. Reaching the target is realistic, although very challenging in the present economic context. Hungary should maintain the 4.5 % average annual rate of increase it had in the last decade in order to reach the Europe 2020 target.
Greenhouse gas (GHG) emissions target: +10 % (compared to 2005 emissions, ETS emissions not covered by this national target)	<p>Non-ETS greenhouse gas emissions decreased by 16 % between 2005 and 2011</p> <p>Based on the latest national projections submitted to the Commission, and if existing measures are taken into account, it is expected that the target will be reached: -26 % in 2020 compared to 2005 (with a margin of 36 percentage points).</p>
Renewable energy target: 13 % Share of renewable energy in all modes of transport: 10 %	Share of total renewable energy in gross final energy consumption was 8.1 % in 2011 and 0.5 % in the transport sector. (Source: Eurostat's estimate. April 2013. For 2011, only formally reported biofuels compliant with Art. 17 and 18 of Directive 2009/28/EC are included).
Indicative national energy efficiency target for 2020: 1113 PJ primary energy consumption in 2020 (236 PJ savings compared to BAU), resulting in 760 PJ final energy consumption. This implies reaching a level of 26.584 Mtoe primary consumption in 2020 and 18.152 Mtoe final energy consumption.	In 2011 the primary energy consumption in Hungary was 1,044 PJ. Hungary has set an indicative national energy efficiency target in accordance with Articles 3 and 24 of the Energy Efficiency Directive (2012/27/EU). It has also expressed it, as required, in terms of an absolute level of primary and final energy consumption in 2020 and has provided information on the basis on which data this has been calculated.
Early school leaving target: 10 %	Although Hungary succeeded in reducing the

	<p>number of early school leavers in the last decade (from 13.9 % in 2000 to 10.5 % in 2010), progress has stalled in the last few years and the trend has even reversed in 2011 (11.2 %) and slightly deteriorated in 2012 (11.5%).</p>
<p>Tertiary education target: 30.3 %</p>	<p>Hungary is very close to reach the national target which is one of the lowest among EU Member States.</p> <p>Tertiary educational attainment was 23.9 % in 2009, 25.7 % in 2010, 28.1 % in 2011 and 29.9% in 2012.</p> <p>Hungary has not yet reached the national target and is below the EU target of 40 %.</p> <p>Current policy developments are likely to decrease instead of increase the number of students.</p>
<p>Target on the reduction of population at risk of poverty or social exclusion in number of persons: 450 000</p>	<p>The number of people at risk of poverty increased to 3.1 million in 2011 (against the 2008 baseline of 2.83 million).</p> <p>The poverty rate has therefore not been improved. On the contrary, now there are some 150000 more people at risk of poverty, compared against the baseline.</p>

5. ANNEX

Table I. Macroeconomic indicators

	1995-1999	2000-2004	2005-2009	2010	2011	2012	2013	2014
Core indicators								
GDP growth rate	2.4	4.2	0.4	1.3	1.6	-1.7	0.2	1.4
Output gap ¹	-1.4	1.4	2.1	-3.7	-2.2	-3.9	-3.9	-3.1
HICP (annual % change)	16.5	7.1	5.1	4.7	3.9	5.7	2.6	3.1
Domestic demand (annual % change) ²	1.9	4.5	-1.7	-0.5	0.1	-3.7	-0.2	0.8
Unemployment rate (% of labour force) ³	8.9	5.9	8.0	11.2	10.9	10.9	11.4	11.5
Gross fixed capital formation (% of GDP)	22.3	23.3	21.7	18.3	17.9	17.2	16.9	16.6
Gross national saving (% of GDP)	20.0	17.7	16.5	19.9	20.5	19.3	19.8	19.2
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	-6.5	-6.0	-6.2	-4.3	4.3	-1.9	-3.0	-3.3
Gross debt	68.5	56.6	69.5	81.8	81.4	79.2	79.7	78.9
Net financial assets	-28.4	-36.4	-52.7	-61.5	-52.7	n.a	n.a	n.a
Total revenue	45.2	43.2	44.6	45.4	53.8	46.5	46.6	47.0
Total expenditure	51.7	49.2	50.8	49.7	49.5	48.4	49.6	50.3
<i>of which: Interest</i>	8.3	4.5	4.2	4.1	4.1	4.2	4.2	4.0
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	-4.1	-2.3	-0.4	4.7	4.6	3.7	5.0	5.9
Net financial assets; non-financial corporations	-104.2	-104.7	-113.3	-120.4	-114.8	n.a	n.a	n.a
Net financial assets; financial corporations	-0.9	-2.3	-3.4	5.2	10.0	n.a	n.a	n.a
Gross capital formation	16.8	15.4	13.8	11.3	13.4	11.4	10.5	8.9
Gross operating surplus	16.8	20.1	22.3	23.4	24.5	21.4	21.4	20.2
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	5.9	1.1	1.4	2.7	-5.5	2.6	2.3	2.3
Net financial assets	58.7	62.3	63.0	67.5	59.0	n.a	n.a	n.a
Gross wages and salaries	33.5	35.5	36.8	37.2	36.5	37.3	37.3	37.4
Net property income	5.7	4.2	3.5	2.8	2.7	1.2	1.0	0.3
Current transfers received	16.9	17.5	19.5	19.4	18.9	19.4	19.5	19.1
Gross saving	10.8	6.4	6.1	6.4	6.1	5.2	4.9	4.9
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	-4.8	-7.4	-5.2	3.0	3.4	4.5	5.6	6.1
Net financial assets	75.0	81.9	106.8	110.4	99.5	n.a	n.a	n.a
Net exports of goods and services	-0.3	-2.8	0.6	6.5	6.7	7.8	8.2	8.4
Net primary income from the rest of the world	-4.7	-5.0	-5.7	-4.7	-5.0	-6.5	-6.3	-6.4
Net capital transactions	0.0	0.2	0.9	1.8	2.3	2.6	3.1	3.5
Tradable sector	47.7	45.8	45.3	44.6	46.3	45.5	n.a	n.a
Non tradable sector	37.8	40.0	40.3	39.9	38.6	38.5	n.a	n.a
<i>of which: Building and construction sector</i>	4.2	4.7	4.3	3.6	3.4	3.1	n.a	n.a
Real effective exchange rate (index, 2000=100)	69.8	86.6	100.1	94.7	94.4	93.8	90.2	92.9
Terms of trade goods and services (index, 2000=100)	101.8	101.3	99.0	99.0	97.6	96.7	96.8	96.6
Market performance of exports (index, 2000=100)	68.2	88.8	112.8	125.7	126.3	128.4	130.6	132.0

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.

Source:

Commission services' 2013 spring forecasts (COM); Convergence programme (CP).

Table II. Comparison of macroeconomic developments and forecasts

	2012		2013		2014		2015	2016
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	-1.7	-1.7	0.2	0.7	1.4	1.9	2.3	2.5
Private consumption (% change)	-1.4	-1.4	0.2	0.1	1.0	1.8	1.8	1.8
Gross fixed capital formation (% change)	-3.8	-3.8	-1.5	-0.2	0.8	1.3	3.5	3.5
Exports of goods and services (% change)	2.0	2.0	3.2	3.3	6.2	5.8	6.1	6.1
Imports of goods and services (% change)	0.1	0.1	3.0	2.7	6.1	5.2	5.7	5.8
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	-1.9	-1.9	-0.3	-0.2	0.8	1.0	1.5	1.6
- Change in inventories	-1.6	-1.6	0.1	0.2	0.0	0.0	0.0	0.0
- Net exports	1.7	1.7	0.4	0.7	0.6	0.9	0.8	0.9
Output gap ¹	-3.9	-4.0	-3.9	-3.5	-3.1	-2.2	-0.6	1.1
Employment (% change)	0.1	1.7	0.0	0.5	0.4	0.8	0.9	0.9
Unemployment rate (%)	10.9	10.9	11.4	10.7	11.5	10.5	10.2	9.8
Labour productivity (% change)	-1.8	-3.4	0.2	0.2	1.0	1.1	1.5	1.5
HICP inflation (%)	5.7	5.7	2.6	3.1	3.1	3.2	3.0	3.0
GDP deflator (% change)	3.2	3.2	3.3	3.5	3.5	3.4	2.2	2.2
Comp. of employees (per head, % change)	4.6	0.4	-0.4	1.7	5.4	6.0	4.1	3.7
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	4.5	4.3	5.6	6.3	6.1	6.9	6.8	4.7
Note:								
¹ In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.								
Source:								
Commission services' 2013 spring forecasts (COM); Convergence programme (CP).								

Table III. Composition of the budgetary adjustment

(% of GDP)	2012	2013		2014		2015	2016	Change: 2012-2016
	COM	COM	CP	COM ¹	CP	CP	CP	CP
Revenue	46.5	46.6	46.9	47.0	47.1	46.8	43.1	-3.4
<i>of which:</i>								
- Taxes on production and imports	18.0	18.6	18.9	18.6	18.5	18.3	18.0	0.0
- Current taxes on income, wealth, etc.	6.9	6.9	6.9	7.0	7.0	7.0	7.1	0.2
- Social contributions	13.2	12.9	12.8	12.8	12.8	12.8	12.6	-0.6
- Other (residual)	8.4	8.2	8.3	8.6	8.8	8.7	5.4	-3.0
Expenditure	48.4	49.6	49.6	50.3	49.8	49.0	44.4	-4.0
<i>of which:</i>								
- Primary expenditure	44.2	45.4	45.5	46.3	46.0	45.4	41.0	-3.2
<i>of which:</i>								
Compensation of employees	9.9	9.8	9.6	10.4	10.2	9.9	9.6	-0.3
Intermediate consumption	7.6	7.8	7.7	8.0	7.7	7.4	6.3	-1.3
Social payments	17.6	17.5	17.5	17.2	17.0	16.8	16.5	-1.1
Subsidies	1.3	1.3	1.3	1.3	1.1	1.0	1.0	-0.3
Gross fixed capital formation	3.0	4.0	4.0	4.8	4.8	4.8	1.8	-1.2
Other (residual)	4.8	4.9	5.4	4.6	5.3	5.6	5.8	1.0
- Interest expenditure	4.2	4.2	4.1	4.0	3.8	3.6	3.4	-0.8
General government balance (GGB)	-1.9	-3.0	-2.7	-3.3	-2.7	-2.2	-1.3	0.6
Primary balance	2.3	1.2	1.4	0.7	1.1	1.4	2.1	-0.2
One-off and other temporary measures	0.7	0.0	0.0	0.0	0.0	0.0	0.0	-0.7
GGB excl. one-offs	-2.6	-3.0	-2.7	-3.3	-2.7	-2.2	-1.3	1.3
Output gap ²	-3.9	-3.9	-3.5	-3.1	-2.2	-0.6	1.1	5.0
Cyclically-adjusted balance ²	0.0	-1.1	-1.0	-1.8	-1.7	-1.9	-1.8	-1.8
Structural balance (SB)³	-0.7	-1.1	-1.0	-1.8	-1.7	-1.9	-1.8	-1.1
<i>Change in SB</i>	<i>3.4</i>	<i>-0.4</i>	<i>-0.3</i>	<i>-0.7</i>	<i>-0.6</i>	<i>-0.2</i>	<i>0.1</i>	<i>-</i>
<i>Two year average change in SB</i>	<i>1.3</i>	<i>1.5</i>	<i>1.5</i>	<i>-0.6</i>	<i>-0.5</i>	<i>-0.4</i>	<i>-0.1</i>	<i>-</i>
Structural primary balance ³	3.4	3.1	3.1	2.1	2.1	1.7	1.6	-1.8
<i>Change in structural primary balance</i>		<i>-0.4</i>	<i>-0.4</i>	<i>-0.9</i>	<i>-0.9</i>	<i>-0.4</i>	<i>-0.1</i>	<i>-</i>
Expenditure benchmark								
Applicable reference rate ⁴	-0.57	0.54	0.54	0.08	0.08	0.08	0.08	-
Deviation ⁵ (% GDP)	7.2	-0.9	-1.1	0.3	0.2	0.5	2.4	-
Two-year average deviation (% GDP)	-1.4	3.2	-1.6	-0.3	-0.4	0.4	1.4	-
Notes:								
¹ On a no-policy-change basis.								
² Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.								
³ Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.								
⁴ 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 lower rate applies as long as the country is adjusting towards its MTO, including in year t. The reference rates applicable to 2014 onwards have been updated in 2013.								
⁵ Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A positive sign implies that expenditure growth exceeds the applicable reference rate.								
Source:								
<i>Convergence programme (CP); Commission services' 2013 spring forecasts (COM); Commission services' calculations.</i>								

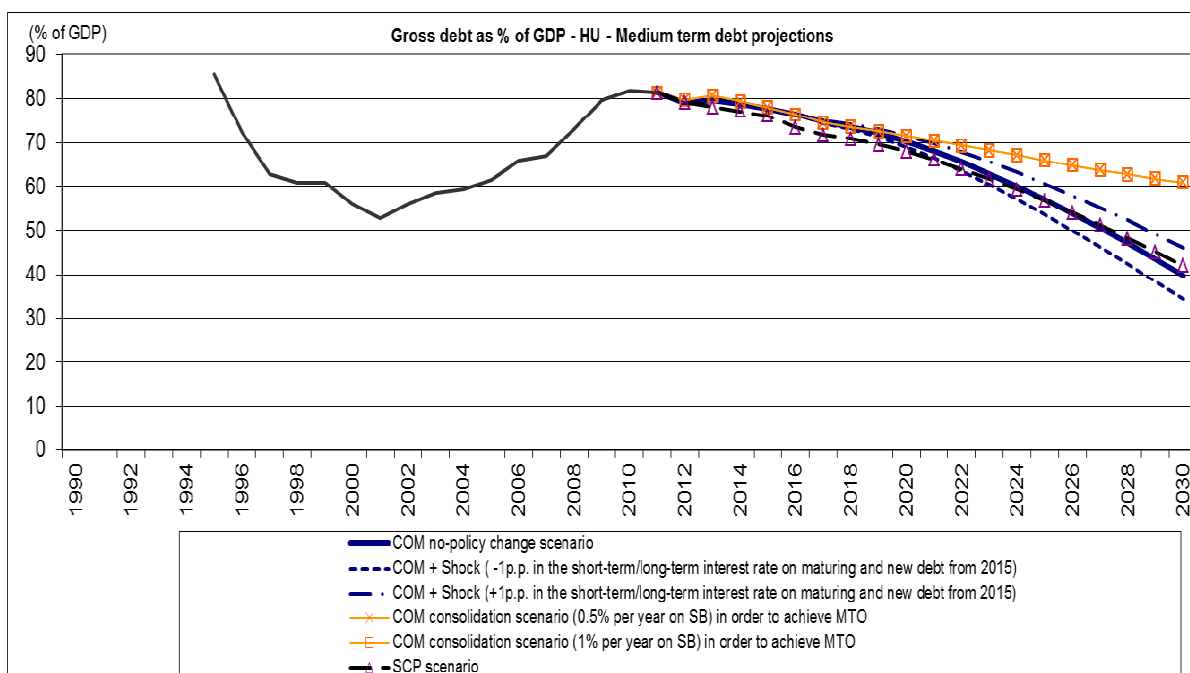
Table IV. Debt dynamics

(% of GDP)	Average 2007-2011	2012	2013		2014		2015	2016
			COM	CP	COM	CP	CP	CP
Gross debt ratio ¹	76.6	79.2	79.7	78.1	78.9	77.2	76.1	73.4
Change in the ratio	3.1	-2.2	0.6	-1.1	-0.8	-0.9	-1.1	-2.7
<i>Contributions</i> ² :								
1. Primary balance	-1.5	-2.3	-1.2	-1.4	-0.7	-1.1	-1.4	-2.1
2. “Snow-ball” effect	1.9	3.0	1.4	0.9	0.3	-0.1	0.2	0.0
<i>Of which:</i>								
Interest expenditure	4.3	4.2	4.2	4.1	4.0	3.8	3.6	3.4
Growth effect	0.4	1.4	-0.2	-0.5	-1.1	-1.4	-1.7	-1.8
Inflation effect	-2.7	-2.6	-2.5	-2.7	-2.6	-2.5	-1.7	-1.6
3. Stock-flow adjustment	2.7	-3.0	0.3	-0.5	-0.3	0.3	0.1	-0.6
<i>Of which:</i>								
Cash/accruals diff.								
Acc. financial assets								
Privatisation								
Val. effect & residual								
			2013		2014		2015	2016
		2012	COM/ CP ³	CP ⁴	COM/ CP ³	CP ⁴	CP	CP
Gap to the debt benchmark ^{5,6}		n.r.	n.r.	n.r.	n.r.	n.r.	-1.8	-2.0
Structural adjustment ⁷		n.r.	-0.3	-0.3	-0.7	-0.7	n.r.	n.r.
<i>To be compared to:</i>								
Required adjustment ⁸		n.r.	-0.8	-0.8	-1.2	-1.1	n.r.	n.r.
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.								
³ Assessment of the consolidation path set in CP assuming growth follows the COM forecasts.								
⁴ Assessment of the consolidation path set in the CP assuming growth follows the CP projections.								
⁵ 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.								
⁶ 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.								
⁷ Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.								
⁸ Defines the remaining annual structural adjustment over the transition period which ensures that - if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections for the previous years are achieved.								
<i>Source:</i>								
Convergence programme (CP); Commission services' spring 2013 forecasts (COM); Commission services' calculations.								

Table V. Sustainability indicators

	HU		EU27	
	No-policy change scenario	Programme (SCP) scenario	No-policy change scenario	Programme (SCP) scenario
S2	-0.1	0.4	3.0	1.3
<i>of which:</i>				
Initial budgetary position (IBP)	-0.4	-0.1	0.8	-0.9
Long-term cost of ageing (CoA)	0.3	0.5	2.2	2.2
<i>of which:</i>				
Pensions	-0.2	0.0	1.0	1.1
Health care	0.7	0.7	0.9	0.8
Long-term care	0.4	0.3	0.6	0.6
Others	-0.5	-0.5	-0.4	-0.3
S1 (required adjustment)*	-1.4	-1.4	2.2	0.5
<i>of which:</i>				
Initial budgetary position (IBP)	-1.2	-0.8	0.0	-1.8
Debt requirement (DR)	1.1	0.9	1.9	1.9
Long-term cost of ageing (CoA)	-1.3	-1.5	0.3	0.4
S0 (risk for fiscal stress)**	0.28		:	
Debt, % of GDP (2012)	79.2		87.0	
Age-related expenditure, % of GDP (2012)	22.2		25.8	
Note:				
The 'No-policy change' scenario depicts the sustainability gap under the assumption that the budgetary position evolves according to the Commissions' spring 2013 forecast until 2014. The 'Programme (SCP)' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented.				
* The required adjustment of the primary balance until 2020 to reach a public debt of 60% of GDP by 2030.				
** The critical threshold for the S0 indicator is 0.44.				
Source :				
Commission services; 2013 stability programme.				

Table VI. Taxation indicators



	2002	2006	2008	2009	2010	2011
Total tax revenues (incl. actual compulsory social contributions, % of GDP)	38.0	37.3	40.3	40.1	37.9	37.0
Breakdown by economic function (% of GDP) ¹						
Consumption	14.2	14.0	14.4	15.2	14.9	14.5
of which:						
- VAT	7.8	7.6	7.8	8.6	8.7	8.5
- excise duties on tobacco and alcohol	1.1	1.3	1.4	1.5	1.3	1.3
- energy	2.2	2.1	2.0	2.0	2.1	2.0
- other (residual)	3.0	3.0	3.2	3.1	2.8	2.7
Labour employed	18.8	18.0	19.8	18.8	17.5	17.2
Labour non-employed	0.3	0.3	1.0	0.6	0.5	0.3
Capital and business income	3.7	3.7	3.8	4.0	2.6	2.4
Stocks of capital/wealth	1.0	1.3	1.5	1.5	2.5	2.5
<i>p.m.</i> Environmental taxes ²	2.8	2.8	2.7	2.7	2.7	2.5
VAT efficiency ³						
Actual VAT revenues as % of theoretical revenues at standard rate	45.2	55.0	57.1	49.8	52.4	52.3

Note:

¹ Tax revenues are broken down by economic function, i.e. according to whether taxes are raised on consumption, labour or capital. See European Commission (2013) Taxation trends in the European Union, for a more detailed explanation.

² This category comprises taxes on energy, transport and pollution and resources included in taxes on consumption and capital.

³ The VAT efficiency is measured via the VAT revenue ratio. The VAT revenue ratio is defined as the ratio between the actual VAT revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption. A low ratio can indicate a reduction of the tax base due to large exemptions or the application of reduced rates to a wide range of goods and services ('policy gap') or a failure to collect all tax due to e.g. fraud ('collection gap'). See European Commission (2012), Tax reforms in EU Member States, European Economy 6/2012 and Taxation Papers 34/2012 for a more detailed explanation.

Source: Commission

Table VII. Financial market indicators

	2008	2009	2010	2011	2012
Total assets of the banking sector (% of GDP)	121.3	142.6	130.3	114.7	112.8
Share of assets of the five largest banks (% of total assets)	54.4	55.2	54.6	54.6	...
Foreign ownership of banking system (% of total assets)	64.0	54.1
Financial soundness indicators:					
- non-performing loans (% of total loans) ^{1),2)}	3.0	6.7	9.8	13.4	15.8
- capital adequacy ratio (%) ^{1),3)}	12.3	13.9	13.9	14.2	15.9
- return on equity (%) ¹⁾	16.4	8.3	0.4	-4.0	-1.2
Bank loans to the private sector (year-on-year % change)	8.3	-5.4	-5.2	-13.2	-5.5
Lending for house purchase (year-on-year % change)	9.8	-1.1	-4.4	-18.9	-9.4
Loan to deposit ratio	139.2	132.4	138.4	128.1	110.7
CB liquidity as % of liabilities	0.6	0.0	0.1	0.4	0.6
Banks' exposure to countries receiving official financial assistance (% of GDP)
Private debt (% of GDP)	65.2	71.5	67.7	58.7	...
Gross external debt (% of GDP) ⁴⁾					
- Public	36.8	47.8	46.8	48.0	53.4
- Private	72.9	88.9	69.7	77.0	76.9
Long term interest rates spread versus Bund (basis points)*	4.3	5.9	4.5	5.0	6.4
Credit default swap spreads for sovereign securities (5-year)*	205.8	338.3	288.3	382.4	463.1
Notes:					
¹⁾ Latest data (December 2012).					
²⁾ Overdue loans declared nonperforming before 90 days.					
³⁾ Basel I and Basel II being applied simultaneously.					
⁴⁾ Latest data 2012Q3.					
* Measured in basis points.					
Source:					
Bank for International Settlements and Eurostat (exposure to macro-financially vulnerable countries), IMF (financial soundness indicators), Commission (long-term interest rates), World Bank (gross external debt) and ECB (all other indicators).					

Table VIII. Labour market and social indicators

Labour market indicators	2007	2008	2009	2010	2011	2012
Employment rate (% of population aged 20-64)	62.6	61.9	60.5	60.4	60.7	62.1
Employment growth (% change from previous year)	0.7	-1.8	-2.5	0.7	0.4	0.1
Employment rate of women (% of female population aged 20-64)	55.5	55.1	54.4	55.0	54.9	56.4
Employment rate of men (% of male population aged 20-64)	70.2	69.0	67.0	66.0	66.8	68.1
Employment rate of older workers (% of population aged 55-64)	33.1	31.4	32.8	34.4	35.8	36.9
Part-time employment (% of total employment, 15 years and more)	4.1	4.6	5.6	5.8	6.8	7.0
Part-time employment of women (% of women employment, 15 years and more)	5.8	6.2	7.5	8.0	9.2	9.7
Part-time employment of men (% of men employment, 15 years and more)	2.8	3.3	3.9	3.9	4.7	4.7
Fixed term employment (% of employees with a fixed term contract, 15 years and more)	7.3	7.9	8.5	9.7	8.9	9.4
Transitions from temporary to permanent employment	6.5	4.4	3.3	2.9	2.2	:
Unemployment rate ¹ (% of labour force, age group 15-74)	7.4	7.8	10.0	11.2	10.9	10.9
Long-term unemployment rate ² (% of labour force)	3.4	3.6	4.2	5.5	5.2	4.9
Youth unemployment rate (% of youth labour force aged 15-24)	18.1	19.9	26.5	26.6	26.1	28.1
Youth NEET rate (% of population aged 15-24)	11.3	11.5	13.4	12.4	13.3	14.7
Early leavers from education and training (% of pop. 18-24 with at most lower sec. educ. and not in further education or training)	11.4	11.7	11.2	10.5	11.2	11.5
Tertiary educational attainment (% of population 30-34 having successfully completed tertiary education)	20.1	22.4	23.9	25.7	28.1	29.9
Formal childcare (from 1 to 29 hours; % over the population less than 3 years)	2.0	2.0	2.0	1.0	1.0	:
Formal childcare (30 hours or over; % over the population less than 3 year)	6.0	5.0	5.0	8.0	7.0	:
Labour productivity per person employed (annual % change)	-0.6	2.7	-4.4	0.6	1.2	-1.8
Hours worked per person employed (annual % change)	-0.3	0.2	-0.8	-0.3	0.9	-4.4
Labour productivity per hour worked (annual % change; constant prices)	-0.3	2.6	-3.6	1.0	0.4	2.8
Compensation per employee (annual % change; constant prices)	0.1	1.9	-5.0	-2.7	-0.1	1.4
Nominal unit labour cost growth (annual % change)	6.2	4.4	2.8	-0.9	1.8	6.5
Real unit labour cost growth (annual % change)	0.7	-0.9	-0.7	-3.3	-1.3	3.2

Notes:

¹ 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.

² Long-term unemployed are unemployed persons for at least 12 months.

Sources:

Commission (EU Labour Force Survey and European National Accounts)

Expenditure on social protection benefits (% of GDP)	2006	2007	2008	2009	2010
Sickness/Health care	6.35	5.67	5.62	5.68	5.69
Invalidity	2.16	2.15	2.10	2.09	1.91
Old age and survivors	9.30	9.77	10.19	10.45	10.47
Family/Children	2.83	2.85	2.86	3.02	2.92
Unemployment	0.67	0.77	0.83	0.97	0.91
Housing and Social exclusion n.e.c.	0.54	0.92	0.72	0.69	0.53
Total	22.00	22.26	22.45	23.03	22.55
of which: means tested benefits	0.96	1.42	1.22	1.24	1.06
Social inclusion indicators	2007	2008	2009	2010	2011
At-risk-of-poverty or social exclusion ¹ (% of total population)	29.4	28.2	29.6	29.9	31.0
At-risk-of-poverty or social exclusion of children (% of people aged 0-17)	34.1	33.4	37.2	38.7	39.6
At-risk-of-poverty or social exclusion of elderly (% of people aged 65+)	21.1	17.5	17.5	16.8	18.0
At-Risk-of-Poverty rate ² (% of total population)	12.3	12.4	12.4	12.3	13.8
Severe Material Deprivation ³ (% of total population)	19.9	17.9	20.3	21.6	23.1
Share of people living in low work intensity households ⁴ (% of people aged 0-59)	11.3	12.0	11.3	11.8	12.1
In-work at-risk-of poverty rate (% of persons employed)	5.8	5.8	6.2	5.3	6.1
Impact of social transfers (excluding pensions) on reducing poverty	58.0	59.2	57.1	56.7	52.2
Poverty thresholds, expressed in national currency at constant prices ⁵	624000	614800	624955	599141	601200
Gross disposable income (households)	14546172	15059911	15012489	15276712	16343730
Relative median poverty risk gap (60% of median equivalised income, age: total)	19.8	17.3	16.3	16.5	18.3

Notes:

¹ People at-risk-of poverty or social exclusion (AROPE): individuals who are at-risk-of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in household with zero or very low work intensity (LWI).

² At-risk-of poverty rate (AROP): share of people with an equivalised disposable income below 60% of the national equivalised median income.

³ Share of people who experience at least 4 out of 9 deprivations: people cannot afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish, or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour tv, or ix) have a telephone.

⁴ People living in households with very low work intensity: share of people aged 0-59 living in households where the adults (excluding dependent children) work less than 20% of their total work-time potential during the previous 12 months.

⁵ For EE, CY, MT, SI, SK, thresholds in nominal values in Euros; HICP - index 100 in 2006 (2007 survey refers to 2006 incomes)

Sources:

For expenditure for social protection benefits ESSPROS; for social inclusion EU-SILC.

Table IX. Product market performance and policy indicators

Performance indicators	2003-2007	2008	2009	2010	2011	2012
Labour productivity ¹ total economy (annual growth in %)	3.2	2.7	-4.4	0.6	1.2	-1.8
Labour productivity ¹ in manufacturing (annual growth in %)	7.9	-1.5	-12.8	15.8	0.0	-0.1
Labour productivity ¹ in electricity, gas, steam and air conditioning supply (annual growth in %)	2.9	-11.2	-8.1	2.0	-4.7	n.a.
Labour productivity ¹ in the construction sector (annual growth in %)	-3.1	-6.9	1.8	-3.3	-3.3	-3.8
Total number of patent ² applications per million of labour force	36.9	42.5	46.0	47.7	n.a.	n.a.
Policy indicators	2003-2007	2008	2009	2010	2011	2012
Enforcing contracts ³ (days)	335	335	395	395	395	395
Time to start a business ³ (days)	39	5	4	4	4	5
R&D expenditure (% of GDP)	1.0	1.0	1.2	1.2	1.2	n.a.
Tertiary educational attainment (% of 30-34 years old population)	18.4	22.4	23.9	25.7	28.1	29.5
Total public expenditure on education (% of GDP)	5.51	5.10	5.12	4.88	n.a.	n.a.
	2007	2008	2009	2010	2011	2012
Product market regulation ⁴ , Overall (Index; 0=not regulated; 6=most regulated)	n.a.	1.3	n.a.	n.a.	n.a.	n.a.
Product market regulation ⁴ , Retail (Index; 0=not regulated; 6=most regulated)	n.a.	2.1	n.a.	n.a.	n.a.	n.a.
Product market regulation ⁴ , Network Industries ⁵ (Index; 0=not regulated; 6=most regulated)	1.8	n.a.	n.a.	n.a.	n.a.	n.a.
Notes:						
¹ Labour productivity is defined as gross value added (in constant prices) divided by the number of persons employed.						
² Total number of patent applications to the European Patent Office (EPO) per million of labour force						
³ The methodologies, including the assumptions, for this indicator are presented in detail on the website http://www.doingbusiness.org/methodology .						
⁴ The methodologies of the product market regulation indicators are presented in detail on the website http://www.oecd.org/document/1/0,3746,en_2649_34323_2367297_1_1_1_1,00.html . The latest available product market regulation indicators refer to 2003 and 2008, except for Network Industries.						
⁵ Aggregate Energy, Transport and Communications Regulation (ETCR).						
*figure for 2007.						
Source:						
Commission, World Bank - <i>Doing Business</i> (for enforcing contracts and time to start a business) and OECD (for the product market regulation indicators).						

Table X. Green Growth

		2002-2006	2007	2008	2009	2010	2011
Green Growth performance							
<i>Macroeconomic</i>							
Energy intensity	kgoe / €	0.45	0.42	0.41	0.42	0.42	0.41
Carbon intensity	kg / €	1.33	1.18	1.13	1.11	1.11	n.a.
Resource intensity (reciprocal of resource productivity)	kg / €	2.55	1.84	2.05	1.80	n.a.	n.a.
Waste intensity	kg / €	n.a.	n.a.	0.26	n.a.	0.26	n.a.
Energy balance of trade	% GDP	-3.2%	-4.6%	-6.3%	-4.9%	-5.2%	-6.0%
Energy weight in HICP	%	n.a.	13	14	14	15	15
Difference between change energy price and inflation	%	n.a.	15.4	7.5	3.1	1.6	1.9
Environmental taxes over labour taxes	ratio	15.3%	13.9%	13.0%	13.5%	14.3%	n.a.
Environmental taxes over total taxes	ratio	7.5%	6.9%	6.7%	6.7%	6.9%	n.a.
<i>Sectoral</i>							
Industry energy intensity	kgoe / €	0.19	0.15	0.15	0.14	0.14	n.a.
Share of energy-intensive industries in the economy	% GDP	10.8	11.1	11.2	11.2	n.a.	n.a.
Electricity prices for medium-sized industrial users**	€ / kWh	n.a.	0.11	0.12	0.13	0.11	0.10
Gas prices for medium-sized industrial users***	€ / kWh	n.a.	0.03	0.04	0.04	0.03	0.04
Public R&D for energy	% GDP	n.a.	0.01%	0.01%	0.01%	0.00%	0.01%
Public R&D for the environment	% GDP	n.a.	0.01%	0.02%	0.02%	0.01%	0.01%
Recycling rate of municipal waste	ratio	13.4%	20.4%	23.8%	24.9%	31.3%	n.a.
Share of GHG emissions covered by ETS*	%	n.a.	35.3%	37.0%	33.2%	33.8%	33.9%
Transport energy intensity	kgoe / €	n.a.	0.72	0.77	0.80	n.a.	n.a.
Transport carbon intensity	kg / €	n.a.	1.96	2.05	2.13	n.a.	n.a.
Security of energy supply							
Energy import dependency	%	n.a.	61.3%	63.4%	58.7%	58.3%	52.0%
Diversification of oil import sources	HHI	n.a.	0.67	0.67	0.64	0.70	n.a.
Diversification of energy mix	HHI	n.a.	0.27	0.27	0.25	0.25	0.25
Share renewable energy in energy mix	%	n.a.	5.1%	5.9%	7.2%	7.5%	7.5%
Country-specific notes:							
The year 2012 is not included in the table due to lack of data.							
General explanation of the table items:							
Source: Eurostat unless indicated otherwise; ECFIN elaborations indicated below							
All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2000 prices)							
Energy intensity: gross inland energy consumption (in kgoe) divided by GDP (in EUR)							
Carbon intensity: Greenhouse gas emissions (in kg CO ₂ equivalents) divided by GDP (in EUR)							
Resource intensity: Domestic Material Consumption (in kg) divided by GDP (in EUR)							
Waste intensity: waste (in kg) divided by GDP (in EUR)							
Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP							
Energy weight in HICP: the share of the "energy" items in the consumption basket used in the construction of the HICP							
Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual %-change)							
Environmental taxes over labour or total taxes: from DG TAXUD's database "Taxation trends in the European Union"							
Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in 2005 EUR)							
Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP							
Electricity and gas prices medium industrial users: consumption band 500 - 2000MWh and 10000 - 100000 GJ; figures excl. VAT.							
Recycling rate of municipal waste: ratio of municipal waste recycled over total municipal waste							
Public R&D for energy or for the environment: government spending on R&D (GBAORD) for these categories as % of GDP							
Share of GHG emissions covered by ETS: based on greenhouse gas emissions as reported by Member States to EEA (excl LULUCF)							
Transport energy intensity: final energy consumption of transport activity (kgoe) divided by transp industry gross value added (2005 EUR)							
Transport carbon intensity: greenhouse gas emissions in transport activity divided by gross value added of the transport sector							
Energy import dependency: net energy imports divided by gross inland energy consumption incl. energy consumption international bunkers							
Diversification of oil import sources: Herfindahl index (HHI), calculated as the sum of the squared market shares of countries of origin							
Diversification of the energy mix: Herfindahl Index over natural gas, total petrol products, nuclear heat, renewable energies and solid fuels							
Share renewable energy in energy mix: %-share in gross inland energy consumption, expressed in tonne oil equivalents							
*Provisional data (15 April 2013). Commission Services and EEA.							
** For 2007 average of S1 & S2 for DE, LU, NL, FI, SE & UK. Other countries only have S2.							
*** For 2007 average of S1 & S2 for IT, NL, FI, SE & UK. Other countries only have S2.							