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Assessment of the 2014 national reform programme and convergence programme for HUNGARY

Accompanying the document

Recommendation for a COUNCIL RECOMMENDATION

on Hungary's 2014 national reform programme and delivering a Council opinion on Hungary's 2014 convergence programme

{COM(2014) 418 final}

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EXECUTIVE SUMMARY

After a GDP decline of 1.7 % in 2012, Hungary emerged from recession in 2013, with a moderate real GDP growth of 1.1 %. Domestic demand became the main driver of the economy helped by investment (5.9 % increase), thanks in part to a substantial inflow of EU funds, while household consumption remained almost stagnant. GDP growth is projected to increase to 2.3 % in 2014 and slow down to 2.1 % in 2015. Inflation declined to a historical low of 1.7 % in 2013 and is projected to decrease even further to 1 % this year, partly due to regulated price cuts and declining commodity prices, as well as a negative output gap. Employment increased by 1.6 % on account of an extension of the Public Work Scheme, an increasing number of frontier workers, and the whitening of the shadow economy. Despite increasing participation, unemployment decreased to 10.2 % in 2013.

Overall, Hungary has made limited progress in addressing the 2013 country-specific recommendations . Although the country overachieved its 2013 general government deficit target, the quality of fiscal consolidation has not improved. While there has been some progress in enhancing the fiscal governance framework, the mandatory remit of the Fiscal Council has not been broadened. Despite the central bank's subsidy scheme for small and medium enterprises, normal (i.e. non-subsidised) lending in the economy has not yet returned. The regulatory burden on the financial sector has further increased contrary to last year's recommendation. Household portfolios have continued deteriorating, partly due to the government's continuous communication on new foreign currency mortgage relief schemes that contributed to a weakening of the payment culture and increased moral hazard. There has been only limited progress in reducing the tax burden on low-income earners, despite an extension of the deduction of family tax credits, as this measure is only targeted at families with children. However, some progress could be observed with tax compliance. Overall, there was limited observable progress in improving the business environment. Although the government has addressed the recommendation on strengthening the judiciary and made strides to reduce administrative burdens, entry costs have further increased in several market segments, particularly in the service sector, where restrictions to competition have increased. Improvements have been made to encourage the participation of women in the labour market, through extended childcare facilities and regulatory amendments to facilitate the return to work after parental leave. Limited progress has been achieved towards education targets, the government's strategies still being under development. No progress was achieved with respect to the energy recommendation; gas and electricity prices remain regulated and substantial price cuts were approved in the universal service provider's segments, with possible negative spill-over effects on corporations in the open energy market.

The submitted national reform programme and convergence programme contain a detailed assessment of reform measures as well as macroeconomic and fiscal projections. As regards the projections, although the baseline path is broadly realistic, risk scenarios are narrowly focused. In particular, the adverse scenario does not contain the potential negative feedback effects that can be most important from a budgetary point of view.

Hungary's weak growth potential could be strengthened in several ways. In specific terms, the country needs to make further progress on the following challenges:

- **Fiscal policy:** The budgetary strategy still relies on a high level of expenditure and on extensive taxation of few selected sectors, which affects the overall allocative efficiency of the economy. The effectiveness of the revamped fiscal framework is yet to be proved in terms of medium-term budgetary planning and the accountability of the Fiscal Council.

- **Financial sector:** Despite the increasing share of subsidised lending schemes, normal lending can only return if banks incentives to lend are set right. Currently, banks' lending activity is hindered by the high taxes imposed on the sector and by a large share of non-performing loans. A potential, new foreign currency mortgage relief scheme also carries some risks if it were to be applied in a not-targeted manner and without proper consultation of all stakeholders. Given an already deteriorated payment culture among borrowers, an important challenge is to improve the situation of insolvent borrowers without increasing moral hazard further.
- **Taxation:** Hungary has a number of sector-specific surtaxes which distort economic incentives and investment. The corporate tax system remains complicated. The tax burden on low-wage earners still weighs on job creation, while there is still room to shift the burden to environment taxes. Measures to improve tax compliance are still needed and have to be fully implemented yet.
- **Labour market and social inclusion:** The key labour market challenge continues to be increasing the participation rate and reducing unemployment by improving the skills of the labour force. At present, training opportunities in the country are not sufficient: quality is mixed and not targeted to the needs of different jobseekers, while a high share of the working-age population does not have the skills required by the labour market. In addition, there is a clear risk that the very short length of unemployment benefit deteriorates job prospects. The dominance of the public works scheme in active labour market policies is high and increasing. This reduces the resources available for high-quality trainings that are needed to equip low-skilled job seekers with qualifications relevant for the labour market. The social situation continues worsening and the social protection system is unable to provide adequate support and services to the most deprived, including Roma**.**
- **Business environment:** Competition in the service sector remains subdued because entry barriers have not been reduced or removed. In addition, the regulatory framework still lacks transparency and predictability: stakeholder consultations are not systematically carried out and evidence-based impact assessments are often pressurised.
- **Education:** Access to a quality, inclusive mainstream primary and secondary education to provide better general competences, as required by the labour market, is another key challenge, as well as encouraging participation by pupils from all backgrounds in tertiary education.
- **Energy and transports:** Energy prices continued being regulated and the current price system does not adequately reflects the cost of energy supply, with possible consequences on sustainability of energy provision. Autonomy of the energy regulator remains limited, while enhancing energy efficiency is an important challenge. Ensuring a sustainable and efficient public transport system, while providing a good quality service, remains a challenge.

1. INTRODUCTION

In May 2013, the Commission proposed a set of country-specific recommendations (CSRs) for economic and structural reform policies in Hungary. Based on these recommendations, the Council of the European Union adopted seven CSRs in the form of a Council Recommendation in July 2013. These CSRs concerned public finances, the financial sector, taxation, the labour market, the business environment, education and network industries. This staff working document (SWD) assesses the state of implementation of these recommendations in Hungary.

The staff woking document assesses policy measures in light of the findings of the Commission's Annual Growth Survey 2014 (AGS)[1] and the third annual Alert Mechanism Report (AMR),[2] which were both published in November 2013. The AGS sets out the Commission's proposals for building the necessary common understanding about the priorities for policy action at national and EU level in 2014. It identifies five priorities to guide Member States to renewed growth: pursuing differentiated, growth-friendly fiscal consolidation; restoring normal lending to the economy; promoting growth and competitiveness for today and tomorrow; reducing unemployment and the social consequences of the crisis; and modernising public administration. The AMR serves as an initial screening device to determine whether macroeconomic imbalances exist or risk emerging in Member States. The AMR found positive signs that macroeconomic imbalances in Europe are being corrected. To ensure that a complete and durable rebalancing is achieved, Hungary and 15 other Member States were selected for a review of developments in the accumulation and unwinding of imbalances. These in-depth reviews were published on 5 March 2014 along with a Commission communication.[3]

Against the background of the 2013 Council Recommendations, the AGS, the AMR and the in-depth review, Hungary presented updates of its national reform programme (NRP) and of its CP on 30 April 2014. These programmes provide detailed information on progress made since July 2013 and on the government's plans specified in the NRP. The information contained in these programmes provides the basis for the assessment made in this staff working document.

The preparation of the 2014 convergence (CP) and national reform programmes (NRP) somewhat lacked genuine civil involvement and social partnership compared to last year's preparation process. The involvement of the national parliament was constrained by the national elections early April. One week before the submission of the final NRP to the European Commission, the National Economic and Social Council was informed about the European Semester process and received a 3-pages summary of the draft NRP under preparation. Representatives of trade unions and academia present called for an in-depth discussion of the NRP and the measures it contains once the document was adopted.

[1] COM(2013) 800 final.
[2] COM(2013) 790 final.
[3] Aside from the 16 Member States identified in the AMR, Ireland was also covered by an in-depth review, following the conclusion by the Council that it should be fully integrated into the normal surveillance framework after the successful completion of its financial assistance programme. See http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm

2. ECONOMIC SITUATION

In 2013, the Hungarian economy emerged from recession and experienced real GDP growth of 1.1 % with domestic demand becoming the main driver of the economy. After unusually weak production growth in the agricultural sector in 2012, the year 2013 brought a positive correction. Overall investments increased, for the first time since 2008, by 5.9 %, mainly as a result of public investment supported by an inflow of EU funds, but corporate investment also started to accelerate. Nevertheless, the economy is still characterised by a de-leveraging of domestic sectors, and tight lending conditions, although the process slowed down in the second half of 2013. The sharp decline in inflation to 1.7 % has contributed to increasing households' real disposable income. However, the elevated repayment burden and still high level of unemployment continued to weigh on households' consumption, which only grew by 0.2 %. In 2013 national employment increased by 1.6 % and reached its pre-crisis level, partly boosted by public works.

Since the crisis, potential output growth has been meagre, mostly on account of a low contribution from total factor productivity and capital accumulation. The weak total factor productivity contribution could stem from problems with financial de-leveraging and the low level of innovation. Capital accumulation is affected by ongoing de-leveraging in the private sector and also by an uncertain business environment.

Economic outlook

GDP growth is expected to accelerate to 2.3 % in 2014 but to slightly slow down to 2.1 % in 2015. In both years, domestic demand is set to be the main driver of growth. Overall, investment is forecast to pick up strongly to 7 % in 2014 but to decelerate to around 4.2 % in 2015, as the effect of increased EU fund absorption is expected to fade away by 2015 with the end of the 2007-2013 programming period. At the same time, private consumption is forecast to grow around 1.5 % in both years, reflecting increasing real disposable income and improving employment prospects. The unemployment rate is projected to decrease further below 9 % over the forecast horizon. Potential output growth is slightly improving towards 1 %, but it is expected to remain below the level of other countries in the region.

The growth projections in the convergence programme and in the Commission 2014 spring forecast are the same for 2014, while for 2015 the national projection is more optimistic by 0.4 pps. As regards the composition of growth, the convergence programme sees private consumption growing 0.4 pp more in both years than the Comission 2014 spring forecast. Government consumption expenditure is 0.4 pp higher for 2014 in the convergence programme, but 2.6 pps lower for 2015 which means that the convergence programme foresees it to decrease in real terms by 0.6 %. in the case of gross fixed capital formation the convergence programme projection is somewhat more conservative than the Commission 2014 spring forecast, but broadly similar for 2015. Exports and imports' projections are very close for 2014, but exports are projected to grow more in 2015 in the convergence programme than in the Commission 2014 spring forecast. the convergence programme projects inflation at 0.8 % and 2.9 %, compared to 1 % and 2.8 % in the Commission 2014 spring forecast for 2014 and 2015 respectively.

Overall it can be concluded that the convergence programme relies on a plausible macroeconomic outlook, which is a bit more optimistic for the year 2015 than the Commission 2014 spring forecast. The national reform programme is based on the same economic outlook as the convergence programme and contains the estimated macro impact of structural reforms. The impacts are quantified and the methodology used is described in detail in the convergence programme and in the decription of the model used by the Ministry for National Economy.

3. CHALLENGES AND ASSESSMENT OF POLICY MEASURES

3.1. Fiscal policy and taxation

In 2013, Hungary received a CSR on fiscal policy and fiscal governance. The analysis in this staff woking document leads to the conclusion that Hungary has made some progress on measures taken to address this recommendation. (For the full CSR assessment, see the overview table in Section 4).

Budgetary developments and debt dynamics

The 2014 convergence programme aims at a nominal deficit trajectory below the Treaty reference value, which would bring down the general government deficit from 2.9% of GDP in 2014 to 1.9% by the end of the programme period in 2017. The programme confirms the medium-term objective of -1.7% of GDP, which reflects the objectives of the Stability and Growth Pact. According to the authorities, the foreseen deficit path ensures that the structural balance remains consistent with the medium-term objective throughout the programme period. However, the structural balance recalculated by the Commission[4] points to a risk of a significant and persistent deviation from the medium-term objective (with a structural balance ranging between -2.2% and -2.4% of GDP during the programme period).

In 2013, the general government deficit reached 2.2% of GDP, thus overachieving the deficit target of 2.7% of GDP set in the 2013 convergence programme. The better-than-expected budgetary outcome reflects the fact that the total expenditures turned out to be lower than planned by 0.5% GDP, while total revenues were broadly in line with the target. Nevertheless, there was a considerable shortfall in taxes and social contributions as a whole even after the mid-year tax-increasing measures, but these revenue slippages were compensated by the substantially higher-than-projected non-tax receipts. On the expenditure side, spending overruns occurred at the central government, inter alia, reflecting the launch of a new compensation scheme for teachers, other wage-related payments and higher-than-budgeted outlays on goods and services. However, these expenditure increases adding up to around 0.5% of GDP were more than offset by the total effect of 1% of GDP resulting from the activation of the remaining extraordinary reserve (a component of current expenditures), the extra one-off receipts from the sale of telecom frequency licences as well as from cost savings by local governments.

For 2014, the convergence programme projects a deficit of 2.9% of GDP implying a relaxation of the previously set target of 2.7% of GDP. This revision reflects both the fiscal effect of changed macroeconomic conditions and budgetary measures. Revenues are estimated to fall by 0.2% of GDP due to the slow-down in inflation and the unfavourable base effects. The extension of family tax allowances also increases the deficit. Moreover, the programme incorporates additional expenditures of about 0.9% of GDP, involving extra spending on health care, higher appropriations at line ministries as well as an increased level of domestic public investment. The above-mentioned adverse impacts of around 1.3% of GDP are largely counterbalanced by expenditure-decreasing adjustments amounting to 1.1% of GDP. The offsetting factors include (i) further one-offs related to the sale of telecommunication frequency rights, (ii) the reduction of the budgeted extraordinary reserves, (iii) decreased social transfer payments (partly stemming from the lower indexation of pensions), (iv) the introduction of the teachers' new wage system in a stepwise manner rather than in one shot and (v) the assumed persistence of local government savings.

[4] 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.

Box 1: **Main budgetary measures**

Revenue	**Expenditure**
2013	
• 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, including the one-off charge to be paid in the last four months (0.8% of GDP) • Job Protection Act: targeted cuts in social contributions and introduction of two simplified taxation schcmes for SMEs (-0.5% of GDP) • Elimination of the cap for employees' pension contributions (0.15% of GDP) • Lower wage compensation (from social contributions) in private sector (0.25% GDP) • Introduction of a distance-based road toll from 1 July 2013 (0.2% of GDP) • Other tax measures (hikes in sectoral levies; introduction of new corporate surcharges (e.g. public utility tax) (0.6% of GDP)	• Nominal wage freeze in most branches of the public sector (-0.35% of GDP) • Introduction of the first step (at 60% of the legislated renumeration) of the new wage system in public education from 1 September (0.15% of GDP) • Increased outlays related to the FX mortgage support schemes agreed with the banking sector (+0.15% of GDP) • Extension of the public work scheme (0.1% of GDP) • Sale of frequency rights (recorded as negative expenditure, -0.25% of GDP)
2014	
• Extension of the deductability for family allowance (-0.15% of GDP) • Additional take-up for targeted SSC cuts and for simplified taxation schemes (-0.1% of GDP) • Full phasing out of the wage compensation (from social contributions) in the private sector (+0.15% of GDP) • Full-year effect of the distance-based road toll (0.2% of GDP) • Increase in the efficiency of tax collection, mainly through the establishment of on-line links to cash registers (0.5% of GDP, serious implementation risks)	• Nominal wage freeze in most branches of the public sector (-0.2% of GDP) • Full-year impact and additional step (10 pps) of the new wage system in public education (0.35% of GDP) • Sale of frequency rights (recorded as negative expenditure, -0.4% of GDP)
2015	
• Additional take-up for the two simplified taxation schemes (-0.05% of GDP)	• Nominal wage freeze in most branches of the public sector and operational costs are foreseen to increase below the inflation rate (net impact: -0.3% of GDP, imlementation risks) • Additional step (10 pps) of the new wage system in public education (0.15% of GDP)
2016	
• Additional take-up for the two simplified taxation schemes (-0.05% of GDP)	• Nominal wage freeze in most branches of the public sector and operational costs are foreseen to increase below the inflation rate (net impact: -0.35% of GDP, imlementation risks) • Additional step (10 pps) of the new wage system in public education (0.15% of GDP)

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.

The Commission 2014 spring forecast projects a deficit of 2.9% of GDP for 2014, which is identical to the official target. However, this similarity masks significant differences regarding the estimation of the underlying budgetary processes. Compared to the 2014 convergence programme the spring forecast factors in a slippage of 0.3% of GDP in tax receipts. This is partly related to a more pessimistic evaluation of base effects and to the somewhat weaker projected nominal growth of tax bases, but also reflects a more cautious assessment of measures aiming to enhance tax administration. The revenue shortfalls are expected to be offset by the assumed cancellation of the extraordinary reserve (0.3% of GDP). By contrast, the deficit target of the convergence programme is based on the inclusion of the extraordinary reserve on the expenditure side.

The envisaged medium-term consolidation path of the convergence programme is heavily back-loaded. The deficit is expected to decrease only slightly to 2.8% of GDP in 2015, and then with an accelerating pace of adjustment it would be reduced to 2.5% of GDP in 2016 and further to 1.9% of GDP in 2017. In 2015, the Commission 2014 spring forecast, following the no-policy-change assumption, estimates a marginal deficit improvement, which coincides again with the target. Unlike the convergence programme however, the forecast is also based on the assumption that the extraordinary reserve will not be spent.

Compared to the previous convergence programme, the deficit trajectory has significantly shifted upwards. This results in a cumulative medium-term deviation of 1.2% of GDP, with the deficit currently set at 2.5% of GDP for 2016 as opposed to the target of 1.3% of GDP in the same year of the 2013 convergence programme. This gap appears to stem from both the modified macroeconomic scenario (i.e. the reduced nominal GDP path and the lower growth elasticity of major tax bases) and the effect of measures[5].

The medium-term fiscal consolidation plan of the convergence programme is based on the policy of general expenditure containment, which is envisaged to be achieved without any further structural measures or institutional changes. Accordingly, the total expenditure-to-GDP ratio would drop from 50.1% in 2014 to 44.8% in 2017. Within this, the corrected primary expenditure-to-GDP ratio (filtering out the balance-neutral impact of declining EU funds) would decrease by 3.5% of GDP over the same period (by 1% in 2015 and by a further 2.5% between 2015 and 2017). The convergence programme anticipates this significant reduction against the backdrop of an average nominal GDP growth of 5.5% and on the basis of instituting nominal freezes or setting increases below the rate of inflation for most of the discretionary spending items (including the salaries of public employees and the operational costs of governmental institutions). Social transfers also feature strongly in the shrinking expenditure ratio due to the inflation-based indexation rule of pensions, the already enacted legal restrictions on early retirement as well as the nominal freezing of all other cash benefits. At the same time, total revenues will also go down in terms of GDP, but to a smaller extent. The corrected revenue-to-GDP ratio is projected to fall by 2.6% (by 1% in 2015 and by a further 1.6% between 2015 and 2017). This pattern does not stem from revenue-cutting measures, but rather reflects the indirect budgetary effects of the contracting expenditure ratio (i.e. the tax content of gross public spending) as well as the foreseen lower-than-unitary growth elasticity of tax bases.

[5] In particular, the gradual phasing-in of the teachers' new wage system together with the piecemeal take-up of the Job Protection Act's simplified taxation schemes would increase the deficit annually by 0.1-0.2% of GDP in 2015 and beyond, while the temporary savings due to the lower initial costs are to be absorbed by other budgetary measures in 2014. By contrast, the 2013 convergence programme assumed that the full costs of the new wage system and the Job Protection Act would materialise by 2014.

Both upside and downside risks could be identified to the convergence programme deficit trajectory. On the deficit-improving side, the officially requested change for the calculation of national co-payments for EU funds from public to total cost may result in significant one-off revenues (possibly up to ½% of GDP) in the year when it is approved by the Commission. On the deficit-increasing side, it should be stressed that the bulk of the expenditure reduction is foreseen to be achieved through a nominal freeze for the wages for most branches in the public sector (in place since 2008) and a stringent expenditure restraint for the operational costs of budgetary institutions. Given that these areas have already been targeted by successive cuts and freezes over the last 7-8 years, both measures carry increasing implementation risks. Finally, the acceleration in the deficit reduction in 2017 is the result of the projected hike-up in growth, which is a rather optimistic scenario.

Further uncertainties stem from the revenue effects of the protracted introduction of online cash registers and from the balance of local governments. The new system of on-line links, if appropriately implemented and backed-up by targeted tax audits, could even result in higher revenues than currently estimated by the Commission (0.2% of GDP), although the government's expectation of a 0.5% of GDP sustained increase in VAT receipts seems to be on the high side. The balance of local governments could continue delivering positive surprises, provided that recent surpluses were due to a permanent adjustment to a lower expenditure trajectory following a wide-ranging reorganisation. However, it could imply negative risks as well if the better-than-expected outcomes were rather the result of delayed spending (such overruns could be financed from the accumulated deposits of municipalities, amounting to 1.7% of GDP at end-2013).

Box 2: **Hungary's status vis-à-vis the Stability and Growth Pact**

Hungary is subject to the preventive arm of the Pact and it is not expected to reach its medium-term objective over the programme horizon. Therefore, it should ensure sufficient progress towards its medium-term objective.

As the debt ratio was at 79.8% of GDP in 2012, exceeding the 60% of GDP reference value, during the three years following the correction of the excessive deficit Hungary is also subject to the transitional arrangements as regards compliance with the debt criterion. In this period it should ensure sufficient progress towards compliance.

For the 2013 budgetary outcome, the (recalculated) structural balance of -0.7% of GDP is significantly above the medium-term objective of -1.7% of GDP. In 2014, the (recalculated) structural balance would deteriorate by 1.5 pps to -2.2% of GDP resulting in a significant deviation from the medium-term objective. The structural balance is expected to stabilize at -2.2% of GDP in 2015, whereas the sufficient adjustment path towards the medium-term objective would require an improvement of 0.5 pps. The Commission 2014 forecast reinforces this assessment with an estimated structural balance similar to that of the convergence programme. Moreover, the programme does not foresee progress towards achievement of the medium-term objective by the end of the program horizon as the (recalculated) structural balance would deteriorate further by an additional 0.1 pp. in both 2016 and 2017.

According to the information provided in the convergence programme, the growth rate of government expenditure over 2014, net of discretionary revenue measures, will exceed the reference medium-term rate of potential GDP growth of 0.1%. Furthermore, the corresponding growth rate of expenditure over 2015 is not expected to contribute to an annual structural adjustment towards the medium-term objective by 0.5% of GDP, as expenditure growth rate is above -1.1%, i.e. the lower rate allowed under the expenditure benchmark. The deviation from the expenditure benchmark has a negative impact on the structural balance (above 0.5% of GDP in both 2014 and 2015). This conclusion is also supported by the similar assessment based on the Commission 2014 spring forecast.

Following an overall assessment of Hungary's budgetary development, with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, a significant deviation from the adjustment path towards the medium-term objective is to be expected in 2014 and 2015.

The 2014 convergence programme envisages a gradual decrease in the government debt-to GDP ratio, from 79.2% in 2013 to 74.7% in 2017. Although the foreseen primary surpluses could have allowed a faster debt reduction throughout the programme horizon, the snow-ball effect is anticipated to turn into deficit-reducing only in the outer years. The programme's debt trajectory is higher than projected in the 2013 convergence programme, where the government debt was projected to decrease to 73.4% of GDP already in 2016. This primarily reflects a lower nominal GDP path, but the higher primary deficit targets as well as the development of the stock-flow adjustments in selected years (notably in 2015, when the pre-financing of EU projects in the closing phase is projected in the convergence programme to have an important debt-increasing impact) also contributes to the upward shift in the debt path. The Commission 2014 spring forecast projects an increase in the debt ratio in 2014 to over 80% of GDP, mainly on account of the revaluation of the foreign exchange component in public debt. Thereafter, it is projected to decrease to 79.5% of GDP in 2015. Overall, the difference in the projections for 2015 appears to be moderate.

As of 2013, Hungary is in the three-year transitory period regarding the debt reduction benchmark. Despite the planned deterioration in the (recalculated) structural balance for 2014, Hungary would comply - thanks to the allowed annual deviation of 0.25 pp. of GDP - with the minimum linear structural adjustment required for the debt reduction benchmark over the transition period that, based on the convergence programme debt projections, would permit a deterioration of 1.3 % of GDP in 2014 and 1.2 % in 2015. However, according to the Commission 2014 spring forecast, which is based on a no-policy-change assumption, the transition towards compliance with the debt criterion will not be respected in 2014, nor in 2015 (with a forecast change of the structural balance of -1.4% of GDP against the minimal requirement of -0.5% in 2014, and the projected no improvement against the required adjustment of 0.5% in 2015). This would imply a significant breach of the debt-reduction requirement to be assessed in 2015, based on the validated 2014 budgetary outcome, unless further structural efforts are made.

Hungary has preserved its sound fiscal position in line with the 2013 country-specific recommendation, but has made limited progress in pursuing a growth-friendly fiscal policy focusing on expenditure savings and in putting the general government debt ratio on a firm downward path. The official deficit target and the country's MTO were overachieved in 2013 by a considerable margin, but the composition of the fiscal consolidation effort has been far from optimal. This is reflected in the sustained increase in the primary expenditure ratio (filtering out the deficit-neutral increase due to the higher absorption of EU funds) both in 2013 and 2014, each year by around 0.75 pps. These developments are partly compensated by additional non-tax revenues, while the tax burden slightly exceeds the elevated 2012 level in both of the concerned years (at around 39.2 %-39.5 %). Overall, recent fiscal policy developments, including the structure of the 2014 budget, do not indicate a significant progress towards a more credible growth-friendly fiscal strategy. Moreover, only a very gradual decrease in the debt ratio can be expected over the medium-run.

Fiscal framework

In the context of the transposition of Council Directive 2011/85/EU on requirements for national budgetary frameworks, a number of amendments to the fiscal framework legislation were approved in December 2013. These cover notably the regular publication of fiscal data at both the central and local government levels, the accessibility of planning documents, the introduction of new numerical rules and the enhancement of the medium-term budgetary framework. The government has thereby made some progress in responding to the country-specific recommendation. The authorities did not seize this opportunity, however, to further reinforce the Fiscal Council by broadening its mandatory remit.

New numerical rules have been introduced to ensure consistency with the requirements of the Stability and Growth Pact, but existing design flaws have not been corrected. Beyond the constitutionally defined requirement to have a declining debt path (until the debt-to-GDP ratio reaches 50 %), the deficit target of the projected budget must now be in accordance with both the 3 % of GDP deficit threshold and with Hungary’s medium-term objective. However, in case of an officially projected negative GDP growth rate, the escape clause would exempt the country from fulfilling the 3 % threshold, while the structural balance must still be in line, *ex ante*, with the medium-term objective. Moreover, with the debt growth rule to be in place from 2016, the previously identified design weaknesses are not yet addressed, namely the effectiveness of this set of fiscal rules is reduced by the absence of *ex post* monitoring and by the lack of a maximum level of allowed deviation, or a correction mechanism in the event of a deviation from both domestic and European numerical rules.

The long overdue strengthening of the medium-term budgetary framework should help to improve the future planning horizon, so far narrowly focused on the actual budget year. The new provisions prescribe that three-year expenditure and revenue plans (split into a baseline of no change in policy and the estimated impact of new discretionary measures) would be defined in a government resolution by 30 April each year (the issuance of this for the fist time has been delayed linked to the formation of the new government). Changing the plans would require an official justification by the government in the relevant resolution. Differences between the medium-term budgetary framework and the draft budget bill for any given year must be fully justified by changes in the macroeconomic scenario or other events falling outside the scope of the government. This ‘comply or explain’ type of rule would exercise constraint on the government only when introducing its draft budget, but it falls short of ensuring that the final budget law, as approved by the Parliament, is also in line with the medium-term budgetary framework.

No change was adopted to the mandatory tasks of the Fiscal Council. Its analytical underpinnings, therefore, are still not commensurate with its unprecedented veto right. Despite the existing broad optional mandate to comment on any relevant public finance issues, the Council has not sufficiently used this possibility over the last 30 months. Indeed, it did not publish any own analysis or opinion beyond what was strictly required by law. Broadening its mandatory remit would ensure that its work and decisions are based on publicly accessible detailed calculations and not only on qualitative risk assessments, as it has been the case so far. Doing so would enhance the accountability of this institution, and would greatly facilitate enhancing transparency of public finances; albeit there are other important aspects which could be improved on this front (e.g. publishing regularly the authorities’ mid-year quarterly cash-flow forecasts, or making available the government’s obligatory mid-year review on budgetary execution).

Long-term sustainability

Government debt (79.2% of GDP in 2013 and expected to slightly increase to 79.5% in 2015) is currently above the 60% of GDP Treaty threshold and the Commission debt sustainability model projects it to fall by 2030 below the 60%. The full implementation of the convergence programme would put debt on a further decreasing path by 2030.

Hungary appears to face low fiscal sustainability risks in the medium-term. The medium-term sustainability gap[6], showing the adjustment effort up to 2020 required to bring debt ratios to 60 % of GDP in 2030, is at -0.8% of GDP, primarily related to the projected reduction in the ageing costs (contributing with -1.3 pp. of GDP) until 2030 that more than offsets the debt requirement due to the high level of government debt (79.5% of GDP in 2015). In the long-term, Hungary appears to face low fiscal sustainability risks. The long-term sustainability gap[7] shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path, is at 0.6% of GDP.

The structural primary balance is expected to deteriorate substantially (by 2.0 pp. of GDP between 2013 and 2015), entailing high sustainability gaps compared with the 2013 scenario (i.e. maintaining the 2013 structural balance for the entire period). Risks would be higher in the event of the structural primary balance reverting to lower values observed in the past, such as the average for the period 2004-2013. It is therefore appropriate for Hungary to continue to implement measures to ensure the reduction in the government debt.

Tax system

In 2013, Hungary received a recommendation on taxation, covering its stability and predictability, sector-specific taxes, tax wedge on low-income earners and measures to improve tax compliance. The analysis in this staff woking document leads to the conclusion that Hungary has made limited progress on measures taken to address this recommendation. (For the full CSR assessment, see the overview table in Section 4).

Hungary's tax burden ranks as the 10th highest in the EU and as the highest among countries in the region, with a total tax-to-GDP ratio, excluding imputed social contributions, of 39.3 %. The tax burden on low-wage earners (particularly on single wage earners without a family) is still very high in the regional context and impedes job creation.8

[6] See Table V in Annex. The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady improvement in the structural primary balance to be introduced until 2020, and then sustained for a decade, to bring debt ratios back to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year until 2020 after the last year covered by the autumn 2013 forecast (year 2015) is required(indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

[7] See Table V. The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.

[8] In 2013, the tax-to-GDP ratio in Hungary was 38.9 %, compared with 35.4 % in the Czech Republic, 32 % in Poland and 29.2 % in the Slovak Republic. Regarding the tax wedge on a low- income earner, in 2012 it was 47.6 %, i.e. the highest in the EU except for Belgium (for an analysis of the effect of reduced social security

According to the World Bank's Paying Taxes 2014 report, the time needed to comply with tax obligations for Hungarian businesses is the 4th longest in the EU. The multitude of corporate tax regimes and rates in force also adds to the complexity of business taxation. Hungary still suffers from widespread tax non-compliance with an elevated level of undeclared work (the size of the shadow economy is 22.1% of GDP, among the highest ones and undeclared work is between 15 % and 20 %). With the standard VAT rate at 27 %, i.e. the highest in the EU, the exposure of Hungary to non-compliance in the VAT area is particularly high. The VAT compliance gap (i.e. revenue shortfall compared to the theoretical tax liability) is estimated at around 3% of GDP over the 2000-2011 period (one of the highest in the EU).[9] According to the IMF, VAT fraud amounts to 1.75 % of GDP.[10]

The 2013 recommendation called for a stable corporate tax system and for minimising distortions caused by sector-specific taxes. Although few new measures were introduced last year, corporate surtax rates have further increased. The Commission has critically assessed the extra taxes levied on specific industries (see box 3) on account of the unpredictability of their introduction, the harmful choice of tax bases and the arbitrary way surtaxes affect the allocation of resources across industries. Given a large revenue shortfall compared with the budgeted figures, in part due to over-optimistic budgetary planning, the financial transaction duty (FTD) rates were increased with effect from August 2013 from 0.3 % to 0.6 % (for cash withdrawal) and from 0.2 % to 0.3 % (for other kinds of transaction). Moreover, the government also levied an additional one-off FTD charge on banks (amounting to 0.25 % of GDP) and granted two free cash withdrawals per month to each customer at the expense of banks, starting from February 2014. The combination of these extra burdens has contributed to a pick-up in the cash usage of the economy, which entails greater risk of tax avoidance than the use of electronic payments. While cash in circulation in real terms increased by around 4% in 2012, it has increased by 6.5 % in 2013 and by 20.5% in Q1 2014, in year on year terms. Finally, as of August 2013, the rate of mining tax was increased by about one third, the tax rate on interest revenue by 6 pps (excluding government securities) and the itemised tax on telecommunication services by 50 % for corporate users. According to the 2014 convergence programme, alleviating the extra burden from sector specific taxation is not a government priority, even under a favourable fiscal scenario.

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contributions under the Job Protection Act for selected categories of workers, see section "Taxation of labour and potential for tax shifting").

See: http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee5_en.pdf.

[9] CPB (2013): Study to quantify and analyse the VAT Gap in the EU-27 Member States – Final report. Web: http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/vat-gap.pdf

[10] IMF (2013), IMF Country Report No. 13/85): Hungary: 2013 Article IV Consultation and Third Post Program Monitoring Discussions—Staff Report. p. 27.

Box 3: **Major recent tax-reforms in Hungary in 2010-2013**

Corporate Income Tax: The government introduced a progressive CIT schedule with a 10 % rate up to HUF 0.5 billion profit from 1 July 2010. Subsequently, the tax rate for the simplified enterprise tax (EVA) was increased from 30 % to 37 % as from 2012. As of January 2013, in addition to the EVA, SMEs could choose from two more simplified tax schemes: the KATA and KIVA. Under the KATA (small taxpayers' itemised lump sum tax) scheme, microbusinesses will pay a fixed HUF 50 000 (EUR 179) per month (half of this if the taxpayer is employed part-time) in place of the main taxes on profits and payroll.

The KIVA (small business tax) will be an option for businesses with 25 or less employees and annual revenue of below HUF 500 million (EUR 1.79 million). Under this scheme, the business will pay a flat 16 % on its cash-flow based profits and payroll.

Sector Taxes: The base of sector specific surtaxes, introduced in 2010, was initially turnover or balance sheet total (in the case of financial institutions). As of 2013 the turnover-type surtax in the telecom, energy and retail sectors were phased out, while the financial sector surtax, originally planned to be significantly decreased to align its size with the European average from 2012, has become permanent. In 2013, a Financial Transaction Duty (FTD) was introduced on all cash and bank transfer transactions at a rate of 0.2 % (for cash withdrawal, 0.3 %), subject to a cap of HUF 6 000. In August 2013, the rate was increased to 0.3 % (for cash withdrawal, to 0.6 %) and the cap was abolished in the case of cash withdrawal. In the insurance sector, a consumption-type tax amounting to 10 % of non-life insurance premiums (for car insurance, 15 %) was introduced in 2013. The taxpayer is the insurer. Since July 2012, a telecommunications tax of HUF 2 per minute of phone call and per text message applies, which was increased to HUF 3 for companies as of August 2013. Additionally, from 2013, pipelines and other utility networks are subject to an extra tax. In the public utilities sector, the special extra tax on utilities (first introduced in 2009) has been increased from 8 % to 31 %, with the result that the total corporate income tax rate of utility providers is now 50%. By 2013, sector specific surtaxes altogether amounted to 2.5 % of GDP. The extra taxes cause distortions by increasing the required rate of return to investment in affected sectors and suffer from additional design flaws due to the unpredictability of their introduction, modifications and duration (some of them were initially meant to be temporary), and the harmful choice of tax bases (intermediate goods and services are taxed in the case of e.g. the financial transaction duty and the pipeline tax).

Personal Income Tax: In 2011, the progressive PIT system was replaced by a 16 % single rate system. However, the employment tax credit for low to average incomes was still applied until 2012, and in both 2011 and 2012 a tax-base-increasing component (super-grossing) was in force. As from 2013, Hungary has a truly flat rate of PIT with the 16 % rate. The only major feature which deflects PIT from this single rate is a family tax allowance, introduced in 2011, which is especially generous towards families with at least three children; this is fully exploitable by higher earners. From 2014, it has been extended so that it is deductible from employees' social contributions as well.

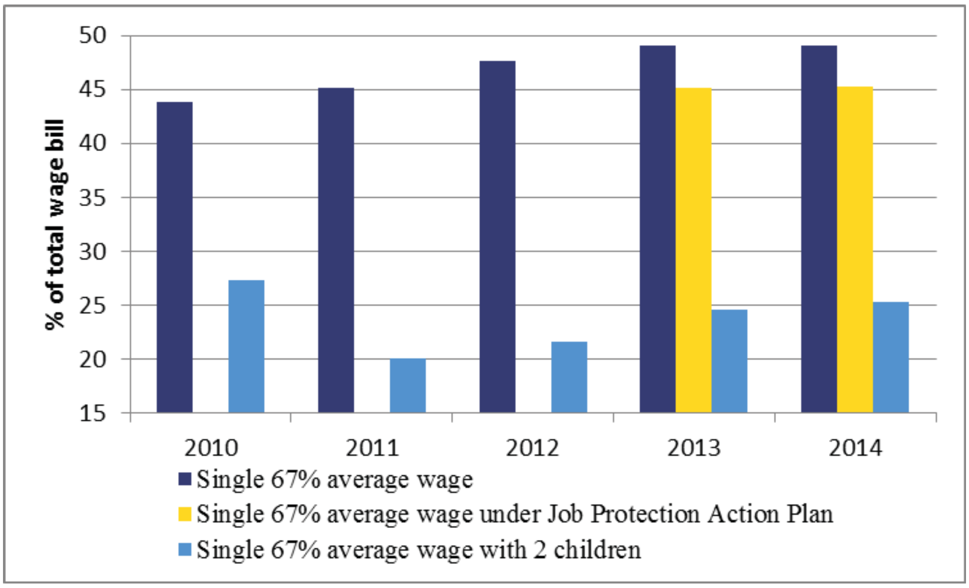
As part of the 'Job Protection Act', in force as of 2013, the social contribution tax and vocational training contribution up to a gross wage of HUF 100 000 per month is halved or fully removed for targeted labour groups: below 25 years; above 55 years; 'elementary occupations'(requiring basic skills); former long-term unemployed, women parents returning from maternity parental leave and career starters. From August 2013, a 6 % health-care contribution was introduced to interest income (effectively increasing the tax rate from 16 % to 22 %).

VAT: As from 2012, the standard VAT rate was raised from 25 % to 27 % (highest in the EU).

Taxation of labour and potential for tax shifting

The 2014 AGS priority of pursuing differentiated, growth-friendly fiscal consolidation explicitly recommends inter alia shifting the tax burden away from labour. In Hungary, this is also a pressing priority as the tax burden on labour is high by international comparison,11 in particular for low wage earners.

Graph 1: The development of the labour tax wedge for selected low-wage categories



Source: OECD data and Commission calculations

Despite the recommendation on refining the eligibility criteria for the Job Protection Act, the system has remained substantially unchanged.[12] The tax burden on high-income earners and employees with three or more children declined significantly, with full abolition of the employment tax credit in 2011-12. However, the labour tax wedge on single low-income earners (i.e. at 67 % of the average wage) went up from 43.8 % in 2010 to 47.6 % in 2012, the second highest rate in the EU. In fact, the low-income tax wedge in general (i.e. for someone not eligible for the Job Protection Act) is estimated to increase further to 49 % in 2013 and 2014. For low-income earners covered by the Job Protection Act, the overall tax burden is lowered to 45.2 %, but still above the level seen in 2010 (see Graph 1). Moreover, beneficiaries include some highly employable and well-paid people, but not all vulnerable workers (e.g. middle-aged, relatively low-skilled ones). By December 2013, the Job Protection Act had 735 000 beneficiaries out of a work force of about four million. Nevertheless, according to the 2014 convergence programme, only some 40 % of all low-income earners are beneficiaries.

A new tax relief measure has been adopted: an extension of the family tax credit benefitting households with dependent children, but that only indirectly affects low-wage earners. The government widened the family tax credit, which as of 2014 can also be deducted from employees' social security contributions besides the personal income tax. However, the impact chiefly depends on the number of children, with a significant tax burden

[11] According to the latest available international statistics, in 2012, Hungary had the fifth highest implicit tax rate on labour in the EU — 39.8 % in 2012, despite a considerable decrease from its peak level of 42.3 % in 2008.

[12] There are only slight modifications. One modification is related to an extension of the duration of the social security contribution allowance to five years for parents with at least three young children. The other relates to the introduction of a tax deduction for those employees of companies under the newly introduced small business tax (KIVA) who otherwise would be eligible for an extra social security contribution allowance (i.e. former long-term unemployed, women returning from maternity leave and career starters).

reduction effect only for families with three or more children, even at relatively high wage levels.[13] Even though a part of low-wage earners are also indirectly affected via the family tax credit, a specific measure targeting especially this group is lacking. The 2014 convergence program has indicated that in the medium term, Hungary foresees further reduction in the labour tax burden in case of a favourable fiscal situation.

Shifting taxation away from labour, especially from low-income earners, towards less distortive forms of taxes remains a challenge. VAT is already at the highest level in the EU. Environmental tax revenues are already around the EU average. The existing energy sector surtaxes (i.e. levied on the stock of pipelines and the special extra corporate tax on energy providers) have distortive effects and do not provide incentives to reduce the high domestic energy consumption. Hence, a sustainable tax shift could affect the latter, also because there has been no energy excise duty increase since 2012 and given that the implicit tax rate on energy is among the lowest in the EU.[14] Recent environmental measures, such as the introduction of a distance-based, electronic toll system on heavy duty vehicles and the waste deposit fee, are steps in the right direction. These can provide considerable additional revenues, while internalising negative externalities. Revenues from recurrent taxes on immovable property in Hungary are well below the EU average (0.4 % of GDP compared to 1.5 %). However, given the depressed state of the housing market and the high share of distressed mortgage borrowers, resulting in wide-ranging negative effects on the economy, a cautious approach is warranted.

Tax compliance

According to the government, all tax-related elements included in the 'Cutting Red Tape Programme' launched in 2011, inter alia to reduce the complexity of the Hungarian tax system, have been implemented with an estimated annual effect of some HUF 60 billion. These include a simpler electronic filing for tax returns and the reduction in the number of documents required and extending online services for taxpayers. However, there is no methodologically sound, publicly available assessment on the impacts of these measures and a continuing perception by businesses of high administrative burden. See also section 3.5.

Within the context of fighting tax fraud, one of the AGS 2014 priorities, Hungary has indicated that it had introduced the VAT reverse charge mechanism in some of the most affected industries. However, the reverse charge mechanism is not a long-term solution, notably in the case of goods subject to final consumption. As a result, there is still scope for improvement in the functioning of the tax administration in particular by enhancing conventional control and collection processes. It is against this background that the Commission recently rejected two requests by Hungary to introduce the reverse charge mechanism (in the pig-farming and animal fodder industry and for supplies of sugar) as it concluded that the problem of VAT fraud in Hungary is of a more structural nature. In addition, administrative cooperation with other Member States' revenue authorities, especially those of neighbouring countries, could be improved in order to tackle cross-border VAT fraud. According to a recent report on VAT administrative cooperation in the EU, Hungary tends to reply late to requests for information coming from other Member States.[15]

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[13] In practice, there is no effect on families with one child. Among families with two children, it has some very marginal effect only for the very low wage earners (3 percentage points reduction in the labour tax wedge for minimum wage earners which fades at 120 % of the minimum wage).

[14] http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee5_en.pdf.

[15] European Commission (2014) Commission Staff Working Document accompanying the document Report from the Commission to the Council and the European Parliament on the application of Council Regulation (EU)

In late 2012, the government prescribed the mandatory online connection to the tax authority of all retail and service sector cash registers. This aimed at reducing the size of the shadow economy. This is a commendable initiative: international experiences show its important revenue-generating potential for the budget. The electronic connection should enable the tax authority to monitor the daily turnover of each cash register, which may significantly reduce the possibility of fraud and increase the effectiveness of tax authority audits. However, the establishment of online links has suffered repeated delays, partly owing to an unrealistic original timetable. The initial deadline for the complete switch-over was set for 1 April 2013, while by early April 2014 only around 65 000 registers were reported to be online by the Tax Authority. The remaining, approximately 110 000, machines will be operational by September 2014, according to the National Retail Association.

3.2. Financial sector

As assessed in the 2014 in-depth review, financial de-leveraging has been ongoing in Hungary since the start of the financial crisis. On the demand side, this is due to a high level of household and, to some extent, corporate debt accumulated before the crisis. On the supply side, decreasing risk tolerance, a high level of external financing and deterioration in the operating environment of banks could be mentioned. Although the sector seems adequately capitalised and its liquidity position relatively strong, the combination of a high level of tax and regulatory burdens, and a high share of problematic loans, does not seem to provide incentives for banks to increase lending. 79 % of mortgage non-performing loans are based on foreign exchange, but the non-performing loan rate for the non-subsidised HUF segment is equally high at around 20 %. While the authorities' endeavour to revive lending with a series of policy initiatives (the central bank's subsidised lending scheme 'Funding for Growth', different programmes financed by the EXIM bank and the Hungarian Development Bank) is commendable, the challenge to improve normal (i.e. non-subsidised) lending in a sustainable manner remains.

In 2013, Hungary received a CSR concerning the financial sector with specific focus on restoring normal lending, improving portfolio quality and enhancing financial regulation and supervision. After reviewing the 2014 national reform programme, the analysis in this staff woking document leads to the conclusion that Hungary has made limited progress on measures taken to address this recommendation. (For the full assessment, see the overview table in Section 4).

Restoring normal lending

The aggregated balance sheet of the Hungarian commercial banking sector had been shrinking since mid-2010, but the process ended by the close of 2013. This reflects on the one hand the allocation of the Funding for Growth scheme,[16] but possibly also the effect of

No 904/2010 concerning administrative cooperation and combating fraud in the field of VAT, SWD(2014)39 final.

[16] In April 2013, the Hungarian National Bank (MNB) approved the Funding for Growth scheme (FGS) which is built around three pillars. Pillar 1: granting new loans to SMEs — the MNB offers commercial banks funds at 0 % interest rate, which banks can lend to SMEs at a maximum of 2.5 %. Pillar 2: conversion of existing foreign currency loans into forint loans, with interest rates capped at 2.5 %. Pillar 3: decrease the outstanding amount of two-week MNB bills by 20 % to reduce Hungary's gross external debt. In the first phase of the FGS, HUF 701bn were utilised (of a total available of HUF 750bn), out of which HUF 290bn (1 % of GDP) was recorded as new credit; the rest was used to refinance debt (of which HUF 229bn was foreign currency). After the first phase, the FGS was expanded to a maximum potential size of HUF 2.75 trillion (i.e. close to 10 % of GDP or two thirds of the 2012 SME loan stock) running until end-2014. However as a first step a HUF 500 bn envelope was announced in the second phase, where only 10 % of loans could be used for refinancing. Eventually in this

more structural factors: with a loan to deposit ratio around 110 % (down from 160 % in early 2009) banks could naturally slow down their de-leveraging. However, the aggregate picture masks huge differences in the characteristics of individual banks: a decreasing market share and low profitability for most foreign-owned big banks, compared with an increasing market share and better rates of return for the rest of the sector. Nevertheless, foreign-owned big banks still have a dominant market share in private sector lending (at 62 % in Q1 2013).

Net lending flows in the corporate sector moved temporarily into a positive territory in Q3 2013 following the first allocation of the Funding for Growth scheme, but returned to negative values thereafter. Tightening credit supply contributed primarily to a fall in corporate lending and particularly in the SME sector since Q4 2008. In addition to decreasing risk tolerance, the combination of a high share of regulatory burdens and an increasing share of problematic portfolio are hindering a return to normal lending. [17] As highlighted in the 2014 in-depth review, although the central bank's Funding for Growth scheme has eased credit conditions to SMEs, this could only bring temporary relief and it does not substitute usual financial intermediation on a permanent basis (see box 5). Moreover, the scheme has certain risk elements, especially if applied on an extended scale. These include the fiscal costs related to the zero-cost financing provided to banks, and the capped interest rate margin, which is set at a level much lower than the average lending margin for the SME sector. In parallel to the central bank's Funding for Growth scheme, the government has continued several subsidised lending programmes targeted toward SMEs.[18]

Despite the extension of housing subsidy schemes and a low interest rate environment, lending to households continued to shrink without interruption. The loan stock of households stood at 24 % of its pre-crisis level in Q4 2013. As opposed to the corporate sector, the declining lending stock primarily reflects a low level of credit demand due to the high share of distressed borrowers, a still high repayment burden and a depressed housing market.

Capital accumulation, non-performing assets and moral hazard of relief schemes

Portfolio quality has declined in both the corporate and household segments since the start of the financial crisis. Close to 20 % of corporate loans are classified as 'delinquent' and although the stock reached a standstill in Q2 2012, it is not expected to decrease visibly until 2015. In the case of households, non-performing credit increased further in 2013 and currently, if shorter maturity delinquencies (below 90 days) are included, more than one third of the banking sector's household portfolio presents some problems. On a positive note, the coverage ratio of non-performing loans is relatively high (close to 60%) in international comparison. Nevertheless the high share of restructured loans (at 16% of the total portfolio in Q4 2013) raises some questions regarding the true quality of the loan portfolio, especially given that 24,6% of restructured loan became non-performing again. Given that provisioning rules are relatively loose[19] the coverage ratio behind restructured loans is relatively low (at

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second phase of the program (until March 2014) only a limited amount (HUF 85 bn) was allocated. Possibly as a response to this the MNB loosened some criteria of the scheme in early April. See details at: http://english.mnb.hu/Monetaris_politika/funding_for_growth_scheme

[17] According to composite indicators devised by Cuerpo et. al. (2013), credit supply pressures in Hungary are among the strongest in the EU. Moreover, the magnitude of extra taxes and regulatory burdens on financial corporations stands in the range of 1.25-1.5 % of GDP while the sector has a value added of less than 4 % of GDP. For a more detailed analysis see the 2014 in-depth review.

[18] These include: (i) the Szechenyi -card programme which provides credit-card based, low-interest loans for SMEs. Moreover, it has also made available EUR 0.75bn for export credit refinancing. (ii) programmes of the Hungarian EXIM bank in the magnitude of HUF 500 bn for export financing. (iii) special subsidized schemes for agricultural financing. Venture capital continues to be available mostly via the JEREMIE programme.

[19] See box 6 in the 2011 April issue of the central bank's Report on Financial Stability.

20%). In general, portfolio cleaning is also hindered by the weak efficiency of in-court and out-of-court resolution proceedings: the average time to settle disputes is high in international comparison, while the expected recovery is relatively low.[20] As a response to the high share of problematic loans in the corporate sector, the central bank has opened the possibility in the Funding for Growth Scheme to buy commercial real estates that served as collateral of non-performing loans.

Although household indebtedness and the share of foreign exchange debt have declined, foreign exchange indebtedness of households is still the major reason behind the continued increase in non-performing loans. This reflects on the one hand the weak economic situation of the country since the start of the financial crisis, and the fact that most of the foreign exchange relief schemes adopted so far have not been targeted towards distressed borrowers. At the same time, the practice of repeated introduction of new foreign exchange relief schemes has deteriorated the payment culture.[21] One programme targeted to distressed borrowers is the set-up of the National Asset Management Company, which could purchase around 25 000 flats owned by distressed borrowers. However this falls short of the number of flats owned by problematic borrowers; in the magnitude of 150 000. In November 2013, the government extended the exchange rate cap scheme to delinquent borrowers. In addition, it communicated the need for a final solution of the foreign exchange problem, but has been waiting for a clear legal picture before adopting any new package. Depending on the coverage or possible retroactive nature, a new scheme could endanger financial stability, especially if not consulted with relevant stakeholders.[22] In May 2014, the foreclosure moratorium was extended until a new, comprehensive FX relief scheme is adopted by the government.

The capital accumulation environment for the banking sector deteriorated due to further regulatory burdens and increasing non-performing loans. New measures include the increase in the financial transaction duty and the request to banks to allow two free monthly cash withdrawals. After negative values in 2011 and 2012, the return on equity of banks re-entered positive territory (i.e. around 2 % in 2013), however this improvement largely reflects the effect of one specific transaction.[23] Without one-off effects, the banking sector would have produced a slightly negative return on equity**.**

Financial supervision

There has been some progress in regulatory changes to the supervisory environment; preparatory work for a bank resolution regime has started. The Hungarian Financial Supervisory Authority was integrated into the central bank structure on 1 October; this may lead to positive synergies. The Hungarian National Bank has been equipped with the right to use macro-prudential tools and is now responsible for macro-prudential oversight. As one of the major reasons behind the widespread increase in foreign exchange lending was an inefficient macro-prudential set-up,[24] this seems a step in the right direction.[25] Moreover, the

[20] See box 8 in the 2012 April issue of the central bank's Report on Financial Stability.
[21] For example, based on the Report on Financial Stability of November 2013 by MNB, 25 % of the respondents who did not apply for the exchange rate cap system said that they are waiting for a newer and better scheme. http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Kiadvanyok/mnben_stabil/stabilmnben_stab_jel_201311/Report%20on%20Financial%20Stability%20November%202013.pdf
[22] See more details in the 2014 in-depth review on Hungary at box 3.2.
[23] This one-off effect is related to one bank, which has converted parent bank funding to equity. http://www.portfolio.hu/vallalatok/penzugy/titokzatos_akcio_miatt_taltosodott_meg_a_magyar_bankszektor.195773.html.
[24] Magyar Nemzeti Bank (2013) "Report on Financial Stability", November
[25]While generally being supportive of a unified macro- and micro-prudential authority, the European Central Bank (ECB) expressed some concerns about the way the new integrated supervisory framework was

preparatory work for a swift and accurate implementation of the Directive on bank resolution and recovery has already started and is expected to be completed by 2014 (submission to the Parliament in 2014, taking effect from January 2015).

3.3. Labour market[26], education and social policies

Hungary faces significant labour market challenges due to a number of structural problems and low economic growth. In particular, despite visible improvements in recent years, the overall employment rate is still well below the EU average (63.2 % against 68.3 %) and far from the Europe 2020 target of 75%. Major challenges remain concerning the employment rate of: young career starters (i.e. 20-29 years old; 52.3 % in Hungary against an EU average of 59.5%); low skilled (38.2 % vs. 51.4% in the EU); Roma (29 %); women with young children (37.1% vs. 61.6%) and the share of long-term unemployed (i.e. 12 months or more) among unemployed people is 48.6%. In recent years, Hungary introduced a number of reforms to address the persistently low activity rate, including: increasing retirement age and restricting early retirement, a review of the disability pension and benefit system, changes in unemployment and social assistance system, widened public work and easing return from parental leave. Thanks to the measures, the activity rate has been rising and this is expected to continue. While many of these reforms go in the right direction, there have been few attempts to assess their actual effects on labour market outcomes and poverty. The education system does not prepare people for continuous improvement of their skills or for future labour market transitions. Low achievements in basic competences hinder participation in higher education and training. A considerable mismatch still exists between the offer of the education and training system and labour market needs. Participation in lifelong learning is low, contributing to a poor quality supply to the labour market. Since the start of the crisis, the social situation has continued worsening with an increasing number of people living at risk of poverty and social exclusion; this affects children and the Roma in particular.

In 2013, Hungary received CSRs concerning the labour market, training, the public works scheme, social policies and education. The analysis in this staff woking document leads to the conclusion that Hungary has made some progress on measures taken to address the CSR on labour, while it only made limited progress on the education and social issues CSR. (For the full assessment, see the overview table in Section 4).

Labour Market

Hungary still faces significant labour market challenges because of a number of structural problems. Labour taxation that is not employment-friendly for certain employee categories constitutes an important barrier, particularly for low-wage earners (see section on taxation). The short length of unemployment benefit (at three months) is in contrast with the average time required to find employment for job seekers (over one year). While lowering the level of unemployment benefit can enhance job search, such a short period of the entitlement could result in a low-income trap as well as labour market mismatches. It is because the unemployed, facing the limited benefit duration and not having adequate financial savings,

implemented. The critical opinion was driven by the insufficient time allowed to the ECB to examine the draft legislative provisions and by the lack of time for the transfer of supervisory tasks for the HFSA. The ECB also raised its concerns about the central 'bank's financial independence and issues related to the prohibition of monetary financing after its merger with the HFSA. See details at http://www.ecb.europa.eu/ecb/legal/pdf/en_con_2014_15_f_sign.pdf and http://www.ecb.europa.eu/ecb/legal/pdf/en_con_2013_71_f_sign.pdf.

[26] For further details, see the 2014 Joint Employment Report, COM(2013)801, which includes a scoreboard of key employment and social indicators.

may be forced as a last resort to join the public works scheme. As the outflow from this scheme to the open labour market is limited, the unemployed easily find themselves outside of the open labour market for long periods. To avoid this outcome, some of the unemployed may be forced to accept job offers which do not fit their qualifications, which results in inferior labour-market matching, or could be left without any social assistance.

The youth unemployment rate has decreased, also thanks to a number of government measures, but is still above the EU average, while the rate of youth NEET (young people not in employment, education or training) increased. In 2013, youth unemployment decreased to 27.2 % from 28.1 % in 2012, while the NEET rate of the relevant population increased to 15.4 % from 14.7 % in 2012. This is at least partially due to the decreasing number of students enrolled in tertiary education and to a simultaneous increase in the number of early school leavers. As described in the 2014 NRP, some measures have been undertaken in the last years to promote labour market integration of young people: such as retargeting Active Labour Market Policy resources to young job seekers, support schemes for young entrepreneurs or a new type of wage subsidy for career starters below 25 years-old within the framework of the First Job Guarantee Programme. Previously launched apprenticeship programmes were reformed in 2013 to better respond to employers' needs. Moreover in 2013 Hungary presented a Youth Guarantee Implementation Plan.

Box 4: **The delivery of a Youth Guarantee in Hungary**

Important challenges to deliver a Youth Guarantee (YG)[27] in Hungary are:

- Limited capacity of the Public Employment Service, foreseen as the main Youth Guarantee service provider, in particular to set up a profiling system for steering the provision of individualised services and the immediate implementation of the planned capacity development of youth mentor network;

- Efficient coordination of Public Employment Service branch offices -serving as only Youth Guarantee entry point- with educational institutions and youth NGOs active at local level to reach out to NEETs the furthest away from the labour market;

- Improvement of the quality and preventive mechanism in education and training particularly to the very low skilled, including a large share of Roma people;

The bulk of the national budget available for employment measures is still used for the public works scheme, while according to the NRP, EU resources have been used for financing other types of active labour market policies and adult training programmes to improve lifelong learning participation of both employed and unemployed people, particularly low skilled. However, the up-skilling and re-skilling measures would need to be rigorously assessed to improve efficiency of active labour market policies and lifelong programmes and to reduce existing mismatches.

As a targeted measure to decrease entry costs in the labour market, the government prepared the assessment of the whole Hungarian secondary vocational qualification system. As a result of the Action Plan approved in December 2013, 43 qualification requirements are planned to be eliminated and 90 more simplified by August 2014.

[27] Pursuant to the Council Recommendation of 22 April 2013 on establishing a Youth Guarantee (2013/C 120/01): "ensure that all young people under the age of 25 years receive a good-quality offer of employment, continued education, an apprenticeship or a traineeship within a period of four months of becoming unemployed or leaving formal education". Hungary presented a Youth Guarantee Implementation Plan in December 2013, updated in April 2014.

The capacity building in the public employment service is ongoing and the introduction of a profiling system has been postponed. An IT system is under preparation, but a client profiling system will only be available as from 2016. An accelerated launch could ease the administrative burden of public employment service caseworkers and improve the personalised service provision to achieve better results and target resources on active labour market policies more efficiently.

Despite last year's recommendation calling for a reduction in the dominance of the public works scheme, its size has further increased. Its budget allocation has increased[28] and the scheme has continued providing temporary work-related income for almost 390 000 people in 2013 (9.6 % of the workforce), compared with 316 262 in 2012, with some 30 % of them working for one year or more. Labour Market research indicates that the outflow from public work to market employment stood around 5%, while close to 60% remained in the scheme, 30% returned to inactivity and 7% returned to registered unemployment.[29] The authorities own data, which could be subject to a potential multiple accounting, shows that in 2013, 13.3% of fostered workers who had left the PWS could find a job on the private market within 180 days after leaving the scheme. Even this higher figure demonstrates that the scheme cannot improve significantly the employability of enrolled workers. In 2013, the activation element has been strengthened mainly through a one-off measure providing training opportunities for 100 000 participants during the winter months.[30] While this can be considered as a positive development, such short-term, non-personalised training opportunities do not fill the skills gap of participants and have little long-term impact on their employability outside the public work scheme.

The labour market in Hungary is marked by low employment levels of women, particularly with young children. Given the long parental leave scheme still represents a disincentive for young mothers to return to the labour market, the government has taken steps to improve the flexibility of the paid parental leave system. As presented in the 2014 NRP, modification of the childcare benefit (*GYED*) allows mothers (or fathers) of young children to work and to receive the allowance at the same time while their child is between 1 and 2 year-old. The capacity of crèches and family day care centres has been gradually increased in the last few years[31] and it is set to expand further in 2014-20, according to the NRP. However, at present family support is still more focused on cash benefits, while a relatively low share of spending is devoted to in-kind benefits (e.g. childcare).

Education and Training

Tackling early school-leaving is a challenge, as shown by an increasing share of students leaving school early (from 10.5 % in 2010 to 11.9 % in 2013), being particularly high in vocational schools. Since the reduction of the school-leaving age from 18, pupils are now allowed to leave the education system at 16, while the new, shorter three-year vocational training model normally provides a qualification only at the age of 17. The announced early school-leaving strategy is still under preparation.

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[28] From HUF 64 billion in 2011; HUF 132 billion in 2012; to HUF 171 bn in 2013. The allocation for 2014 is set at HUF 183.3 bn

[29] Károly Fazekas (et al.), The Hungarian Labour Market 2013 - Centre for Economic and Regional Studies, Hungarian Academy of Sciences & National Employment Non-profit Public Company Ltd.

[30] Half of the training participants received basic training in competence development, one third become semi-skilled worker and 20 % gained a professional qualification, responding to the needs of the public work employers. Altogether 200 000 people have been involved in the winter scheme between 1/11/2013 and 30/04/2014.

[31] In 2009, the capacity was 29 449, rising to 44 464 (+51 %) in 2012. The capacity of crèches increased by 39 % and that of family day care centres by 167 % (source: Central Statistical Office of Hungary).

The government is implementing a far-reaching reform, while basic skills attainment is declining. The 2012 OECD Programme for International Student Assessment shows that Hungary performs below the EU average in achievements on basic skills and that the correlation between socio-economic status and performance appears very strong.[32]The poor performance of disadvantaged pupils in primary and secondary education thus also explains their low rate of application to higher education. In order to ensure early childhood education, the government plans to introduce obligatory pre-school attendance from the age of three, which is a positive step, but its implementation has been postponed to 2015. The government is implementing an ambitious and contested reform concerning the governance of the education and training system, which addresses: financing, quality evaluation, curriculum regulation (including limited choice for textbooks), human resources management and teachers' career paths. The impact of all these measures, including developments for the textbook market (see section 3.4), needs close monitoring.

The segregation of Roma pupils increased during the last decade and access to inclusive mainstream education has not improved. In Hungary, 45 % of Roma children attend segregated classes (where all or most classmates are Roma). At present, the drop-out rate for Roma pupils is more than seven times higher than that for the non-Roma and less than one in five completes secondary education, whether general or vocational, while a mere 0.5 % completes tertiary education.[33] A major challenge is to improve effective and equal access to quality, inclusive, mainstream education and to foster continued education for disadvantaged students, in particular for the Roma. The National Social Inclusion Strategy identifies a number of positive measures for desegregation, but their outreach remains limited and a systematic approach is missing. As stated in the 2014 NRP, the application of "the equal opportunities of public education institutions programme" has been available for every public education institution from kindergarten to secondary school since 2003. The programme supports integrated education in those institutions educating at least 15 % children with multiple disadvantages; 25 % of schools were participating.

To improve labour market skills, the government enacted a new law on vocational education in September 2013 by introducing a shift to a 'dual model' accompanied by a reform of the qualification system. This is a positive development. However, while focus on training related to the labour market is important to acquire job-related skills, the reduced curriculum content and the shorter time devoted to basic competences (such as mathematics and languages) in the shortened school models hinders students' chances for further education and future jobs. This is particularly the cause of concern for disadvantaged students, who are over-represented in these schools. The implementation of the 'dual model' thus deserves close monitoring.

Participation rates in higher education show a significant increase in the past 13 years but the level of tertiary educational attainment is still substantially below the EU average. Changes in higher education introduced since 2012 focus on cost-effectiveness, accompanied by an approach supporting mainly the most talented students (competence-oriented approach). As a consequence, government expenditures on education decreased in real terms in 2012 by 6.1 %, while in the EU overall by only 1.1 %. [34] The number of students applying to Hungarian universities has dropped by 6% in 2012/2013,[35] which is related to the

[32] http://ec.europa.eu/education/policy/strategic-framework/doc/pisa2012_en.pdf

[33] FRA (2014), Poverty and Employment: The situation of Roma in 11 EU Member States. Roma Survey and the National Social Inclusion Strategy.

[34] http://ec.europa.eu/europe2020/pdf/themes/01_public_finances_growth_friendly_expenditure.pdf

[35] http://www.kormany.hu/download/8/f9/b0000/Oktat%C3 %%%A1si_%C3 %%%89vk%C3 %%%B6nyv_2011_2012.pdf http://www.kormany.hu/download/c/93/21000/Oktat%C3 %%%A1si_%C3 %%%89vk%C3 %%%B6nyv_2012.pdf.

uncertain policy environment and, to a certain extent, to demographic changes. The results of the scholarships priority setting for certain disciplines, such as science, engineering and informatics, have also contributed to a reduction in the number of students and the introduction of a new student loan system has not curbed this development either. [36]

The rate of disadvantaged pupils applying to higher education is very low. This is mainly due to their poor performance in the primary and secondary education, showing that mainstream education is not able to compensate disadvantages stemming from family background. In the NRP 2014 it is stated that the support of disadvantaged students has priority in order to increase the share of the people with tertiary or equivalent educational qualifications. However the documents states also that the institutions can only reach 3% of the students with multiple disadvantages. It is important to monitor carefully the impact of measures on vulnerable groups and to adapt policy as needed.

Social polices

The overall social situation continues deteriorating for various reasons. People living at risk of poverty and social exclusion already represents one third of the population, affecting in particular children and the Roma.[37] Those people affected by severe material deprivation are the fastest growing sub-group. In 2013, it affected more than a quarter of all Hungarian residents (more than a third of all children). Housing deprivation among children is growing and despite some improvement in 2013 the share of children living in low work intensity households is still higher than EU average. The stagnating economy is one cause. The other main causes were: the inability of the social protection system to respond to social needs; a persistent level of unemployment; frozen social transfers since 2008; reduced amount of employment substitute benefit (HUF 22 800 per month) with tightened eligibility criteria; and a reduction in the maximum duration of unemployment benefit to three months (the shortest in the EU). Social assistance benefits are among the lowest in the EU, while the capacity of the social safety net to alleviate poverty decreased significantly between 2007 and 2012.[38] This is reflected in increasing relative poverty rates after cash transfers are accounted for, despite decreasing relative poverty rates before cash transfers.

Poverty continues to affect disadvantaged regions and communities disproportionately, in particular the Roma. There are considerable sub-regional socio-economic disparities in Hungary, not only in terms of GDP per capita, but also in terms of access to public services (e.g. healthcare, early childhood education, etc.). Roma are particularly affected by unemployment, discrimination in the labour market and poor living and health conditions, with 60 % living without basic amenities. Since 2011, the government has taken a number of measures in order to improve social inclusion under the guidance of the Hungarian National Social Inclusion Strategy, but results have been insufficient to date. The strategy and its action plan have been recently revised.

In the meantime, the government has not taken steps to mainstream the objectives of the National Social Inclusion Strategy into all policy fields to reduce poverty, as recommended last year. In particular, the previous steps taken by the government in recent years on social transfers and allowances, fail to meet the objectives set out in the Strategy, and were not repealed.

[36] Number of higher education students decreased from 359.824 in 2012 to 338.467 in 2013.

[37] 43% of the 0-17 age-group population is at risk of poverty or social exclusion (33.5% for the total population in 2013) and 81 % of Roma. See also FRA (2014), *Poverty and Employment: The situation of Roma in 11 EU Member States*.

[38] Employment and Social Development in Europe 2013(European Commission)

Healthcare

Despite an improving trend, Hungary ranks systematically low in terms of headline health status indicators, such as life expectancy at birth. Also, the capacity of the health system to improve the health status of the population is suboptimal, as can be derived from indicators such as early life health outcomes,[39] which are less related to population lifestyle factors. Although estimates of healthcare spending efficiency are subject to considerable uncertainty, Hungary was singled out amongst the five countries where margins for improving health outcomes without increasing spending are the largest.[40] Evaluations of the recent comprehensive reform of the healthcare sector are not available yet.

The disproportionately high level of out-of-pocket payments, coupled with widespread informal payments,[41] is a particular cause of concern, especially from an access to care point of view. This translates in health inequalities affecting especially vulnerable groups. Moreover, the role of primary and outpatient secondary care seems to be under-developed and to suffer from a suboptimal geographic distribution of doctors (including GPs) and nurses.

3.4. Structural measures promoting sustainable growth and competitiveness

Hungary is currently experiencing a relatively low growth potential. This is partly a consequence of debt overhang and de-leveraging, reflecting a very low rate of total factor productivity growth but also a weak business environment, which contributed to tightening credit supply and reduced investment in sectors burdened by excessive and distortive taxation. A number of regulatory steps were taken in the last years, but usually without consultation of affected stakeholders. In several instances, these have reduced competition in the service sector. Hungary is a 'moderate innovator' according to the Innovation Union Scoreboard 2014 and its companies are generally poorly integrated in the value chain of big multinational ones active in the country. Inefficient public transport weighs on the budget and reforms have been delayed.

In 2013, Hungary received CSRs concerning the business environment, energy and state- owned enterprises in transport. The analysis contained in this staff working document leads to the conclusion that the country has made limited progress on measures taken to address these recommendations. (For the full assessment, see the overview table in Section 4).

Overall, the business environment in Hungary has not improved. In addition to increased sector-surtaxes, no barrier in the service sector has been removed, whereas new ones were introduced and competition in previously open markets has been cut back. Examples include: household waste treatment, pharmacies, mobile payment services, retail tobacco, savings banks sector and publication of school textbooks. Coupled with previously introduced (e.g. retail, meal vouchers) measures, these steps have artificially limited the presence of economic actors in the service sector, thus substantially restraining competition.

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[39] Hungary ranks among the seven worst performing Member State in the following areas: perinatal mortality, avoidable mortality (which includes colon cancer, cancer of cervix uteri, cerebrovascular disease and ischaemic heart disease), and breast cancer screening. (Source: Eurostat, ECDC, OECD, WHO, Commission services).

[40] OECD (2010), *Health Care Systems: Efficiency and Policy Settings*, OECD Publishing.

[41] According to the 2014 Special Eurobarometer on corruption, bribery and informal payments are particularly prevalent in Hungary's healthcare sector: http://ec.europa.eu/public_opinion/archives/ebs/ebs_397_en.pdf.

The deterioration in the business environment partially explains why, despite a substantial inflow of EU funds (at 3% of Gross National Income per year), the Hungarian investment rate declined in the 2007-12 period. Although investment picked up again in 2013, partly thanks to an increasing absorption of EU funds, so far the investment rate is still well below pre-crisis levels (at 17.5 % of GDP as opposed to around 23-24 %).

As explained in the 2014 in-depth review, a major challenge for Hungary is to attract foreign direct investment (FDI) and to boost the number of domestic SMEs incorporated into the supply chain of large foreign investors, thereby increasing their capacity to innovate and to internationalise. Although the level of the FDI stock in Hungary is already relatively high in international comparison, in the last decade the country has lagged behind in terms of FDI inflows and has also been performing worse than other Visegrád countries in terms of the depth of the value chain. [42]

Although inward FDI flows increased in 2011-2013, these to a large extent reflected the effect of capital in transit and the recapitalisation needs of the banking sector. Correcting for these effects, and for another one-off factor,[43] FDI inflows stood at around 2.5 % and 1.7 % of GDP in 2012 and 2013, which is well below pre-crisis levels. Moreover, a substantial part of this increase was due to investment in the automobile industry, whose decisions were already made around 2008-2010.

Overall investment has declined particularly strongly in those sectors where sector-specific surtaxes have been imposed in recent years. Between 2010 and 2013, nominal investment declined by 44 % in energy, 28 % in finance and 18 % in the communication sectors, while increasing by 3.4 % overall.[44]

Market competition and the stability of the regulatory framework

Frequent legislative changes have led to legal uncertainty. Policy instability, together with taxes and government over-regulation, is cited as one of the most prominent obstacles to doing business in Hungary.[45] In several cases, stakeholders had little time to react to legislative changes. Many of the affected investors are foreigners, with possible further repercussions on country attractiveness to foreign direct investment.[46] An empirical analysis based on the QUEST model indicates that closing half of the competition difference in the service sector compared to the level of the most performing EU Member States could add as much as 1 % of GDP in the next ten years (see box 6).

[42]The so called Visegrád countries (V4) are: Poland, The Czech Republic, Slovakia and Hungary. Based on UNCTAD data on inward FDI stock to GDP, the country stood at the 42nd place among the 198 countries in the sample. Although these figures are also affected by the effect of capital in transit, Hungary's net FDI to GDP position was also relatively high at the 53rd place.

[43] The effect of the purchase of E.ON's stakes by the Hungarian state-owned energy company MVM, which increased FDI outflows in 2013.

[44] Calculations based on the Hungarian Central Statistical Office's STADAT database.

[45] Those are cited by 75% of the interviewed CEOs as the main threats to their businesses: http://www.pwc.com/hu/hu/kiadvanyok/magyarorszagi_vezerigazgato_felmeres/2014/assets/ceo-survey-2014-en-online.pdf. Moreover, in the World Economic Forum 2013-2014 Global Competitiveness Report, the most problematic factors for doing business reported by CEOs are: i) Access to financing (16.3 % of respondents); ii) policy instability (15.9 %); iii) Tax rates (12.1 %); iv) Tax regulations (10.7 %); v) Inefficient government bureaucracy (9.9 %); and Corruption (9.4 %).

[46] For example, in 2012, the annual survey carried out by the Hungarian-German Chamber of Commerce showed the lowest level ever of respondents who would 'again choose Hungary as preferred location for their investment' and Hungary now ranks as the 10th most attractive country for German entrepreneurs in the Central and Eastern European region, whereas it used to be among the top four investment destinations until 2008.

Box 5: **Conclusions from the March 2014 In-Depth Review of Hungary (IDR)**

The third in-depth review on Hungary under the Macroeconomic Imbalance Procedure was published on 5 March 2014.[47] Based on this review, the Commission concluded that Hungary continues to experience macroeconomic imbalances that require monitoring and decisive policy action. In particular, the ongoing adjustment of the highly negative net international investment position (NIIP), the high level of public and private debt in the context of a fragile financial sector and deteriorating export performance deserve close attention to reduce the risks of adverse effects on the economy. The IDR found that:

- **Despite a lacklustre export performance (a cumulative 16 % fall in market share in the 2008-13 period), the NIIP has been improving and is expected to continue.** In the past, this mainly reflected private sector de-leveraging. Looking ahead, as the output gap closes, improvements in the structural balance compared to its pre-crisis levels are expected to further support the process. Nevertheless, despite recent encouraging signs in the automobile industry, export performance is predicted to remain rather weak. Therefore, a NIIP improvement is expected on account of contained domestic demand rather than strong external competitiveness.
- **A high government debt is a primary source of concern.** Despite substantial one-off capital transfers at 7 % of GDP used for debt reduction in the 2011-2013 period and improvements in the structural fiscal balance, the debt has remained broadly constant because of a weakened exchange rate, poor growth potential and elevated financing costs. In the baseline scenario, the debt is forecast to decline slowly; in case of a more negative external environment or a negative shock to domestic confidence, it will start increasing again.
- **The imbalance and risks related to private sector indebtedness still persist.** Although the level of debt has declined, a high share of distressed borrowers, a depressed housing market, a fragile financial sector, a substantial share of loans in foreign currency and prevailing business uncertainty all contribute to fragilities.
- **The situation in the financial sector continues to raise concerns.** Although the sector seems adequately capitalised and its liquidity position is relatively strong, the combination of a high level of burdens and problematic loans does not provide the right incentives to banks to increase their lending activity. While the central bank's subsidised lending scheme gave some temporary relief in access to credit for SMEs, financial intermediation conditions have not improved on a sustainable basis.

The IDR also discusses possible policy responses:

- Improving export performance would require more foreign direct investment inflows as well as a broadening of the value chain in the export sector.
- Continued fiscal consolidation efforts combined with a more growth-friendly structure of the adjustment would also be warranted.
- The negative feedback loop between households, banks and the housing market could possibly be tackled by a final debt relief scheme targeted to insolvent borrowers, while mitigating risks of moral hazard and limiting the additional tax burden on the financial sector.
- Improving capital accumulation possibilities and giving incentives to portfolio cleaning are essential to ease supply-side conditions in bank lending. In addition to a better operating environment for the financial sector, a more predictable and competitiveness-oriented policy and regulatory framework would be warranted.

Hungary continues restricting the establishment of new, large-scale retail stores, having introduced a general prohibition lasting at least until the end of 2014. [48] Such restrictive regulation can also impede an efficient allocation of resources in the economy, and the allocative efficiency indicator (measuring the extent to which the most productive firms have the largest market shares) for wholesale and retail trade in Hungary is among the lowest in the EU.[49] While the size of mark-ups in the retail sector were among the highest in the OECD even before the crisis[50], barriers to entry in the sector increased continuously between 2008 and 2013 as evidenced by the OECD's Product Market Indicator's for the service sector.

In July 2013, a law was adopted which restructured the savings cooperative sector. The state has obtained a majority stake in Takarékbank, the central bank of the savings banks sector and set-up a new unified institutional fund with state support. These measures has been criticised by local stakeholders claiming that they were stripped from ownership rights. Lawsuits are currently in the court process. In January 2014, the government launched a tender to sell its majority stake, although legal disputes have delayed the deal.

Other market segments have also been restricted and several new market entry barriers have been introduced in the service sector in recent years, usually with short notice. Strict shareholding requirements for pharmacies have been introduced as from 2014, requiring incumbents to sell a significant portion of their investments. A licensing system for tobacco sales was introduced in July 2013, thereby artificially reducing and redistributing market positions, with no compensation paid to those who ceased business. Companies operating in the household waste management sector had to sell the majority of their shares to the state or to local government or to continue as sub-contractors. The government decided in September 2013 to switch to a centralised system of textbook development, publishing and distribution thereby limiting the number of authorised textbooks used in public schools to two per subject.

In November 2013, amendments to the Hungarian competition law were adopted. These include a provision according to which mergers regarded as of 'strategic national interest' are exempt from scrutiny by the Hungarian competition authority.[51] The government can declare merger as of "strategic national interest" and relieve the competition authority of its supervisory competence. In 2014, the government declared three mergers (in the energy, financial and IT sectors) to be of strategic national interest, thereby bypassing competition analysis, which may negatively affect competition and the functioning of the internal market.

While some steps have been taken to increase the use of regulatory impact assessments (RIA) and public consultations in the regulatory process, these can be circumvented. The RIA system that has been introduced in 2011 is operational, but assessments are often carried out rapidly and without incorporating evidence-based supporting documents. RIAs and public consultations are often pressurised because of very rapid legislation procedures, hence their quality varies widely.[52]***Research, development and innovation***

R&D activities are highly concentrated regionally[53] and into large foreign companies active in high-tech and medium-tech sectors. Hungary could profit more from the presence of multinationals to promote an effective national R&D ecosystem. The country has just started preparing a 'smart specialisation' strategy to improve research capacities in all regions.

The rather modest level of innovation in the business sector, particularly among SMEs, remains an obstacle to increased competitiveness. The innovation capacity of SMEs is limited[54] and the repeal of the state's contribution to the Innovation Fund two years ago has reduced incentives for R&D activities. As from January 2014, Hungary reintroduced some forms of financial support, namely deductibility of R&D carried out by linked enterprises and an increase of tax relief applicable on SMEs investment loans. Two strategies adopted in

2013-2014 plan to stimulate R&D demand and support measures, including for SMEs. However, the Smart Specialisation Strategy, a pre-requisite to obtain EU Structural funds in 2014-20, has not been approved yet.

Box 6: **Potential impact of structural reforms on growth – a benchmarking exercise**

Structural reforms are crucial for boosting growth. It is therefore important to know the potential benefits of these reforms. Benefits of structural reforms can be assessed with the help of economic models. The Commission uses its QUEST model to determine how structural reforms in a given Member State would affect growth if the Member State narrowed its gap vis-à-vis the average of the three best EU performers on key indicators such as labour market participation or the degree of competition in the economy. Improvements on these indicators could raise Hungary's GDP by about 5 % in a 10-year period. Some reforms could have an effect even within a relatively short time horizon. The model simulations corroborate the analysis of Sections 3.3 and 3.4, according to which the largest gains would likely stem from increasing the participation rates of women and the elderly. This outcome supports the priority placed by the authorities on labour market reforms such as the Job Protection Action Plan and the new Labour Code. The growth impact of measures to reduce final goods mark-ups (e.g. via increased competition on product markets) is also significant. In the very long run, moreover, improving education could also have a noticeable impact on GDP, yielding a potential benefit of 6.5% over a 50-year horizon (see note).

Table: Structural indicators, targets, and potential GDP effects[55]

Reform areas		HU	Average 3 best EU performers	GDP % relative to baseline: 5 years	GDP % relative to baseline: 10 years
Market competition	Final goods sector markups (price-cost margin)	0.16	0.13	0.6	0.8
Market regulation	Entry costs	7.60	0.13	0.1	0.2
Tax reform	Implicit consumption tax rate	26.8	28.6	0.0	0.0
Skill enhancing reforms*	Share of high-skilled	4.9	10.7	0.1	0.2
	Share of low-skilled	17.9	7.5	0.0	0.1
Labour market reforms	Female non-participation rate (25-54ys):			0.6	1.3
	- low-skilled	44.2	26.4		
	- medium-skilled	20.6	10.5		
	- high-skilled	17.8	4.3		
	Low-skilled male non-participation rate (25-54ys)	27.1	7.7	0.0	0.1
	Elderly non-participation rate (55-64ys):			0.9	1.8
	- low-skilled	26.2	13.4		
	- medium-skilled	14.3	4.8		
	- high-skilled	7.0	3.3		
	ALMP (% of GDP over unemployment share)	7.3	37.4	0.3	0.3
	Benefit replacement rate**	30.8	52.6	0.0	0.0
Total				2.6	4.9

Source: Commission services. Note: Simulations assume that all Member States undertake reforms which close their structural gaps by half. The table shows the contribution of each reform to total GDP after five and ten years. If the country is above the benchmark for a given indicator, we do not simulate the impact of reform measures in that area; however, the Member State in question can still benefit from measures taken by other Member States.[56] *The long-run effect of increasing the share of high-skilled labour in the population could be 4 % of GDP and of decreasing the share of low-skilled labour could be 2.5 %. **EU average is set as the benchmark.

The emergence of an effective national R&D environment requires a strong public research system, but public R&D decreased from 0.48 % in 2009 to 0.43 % in 2012 — below the level of most Central and Eastern European countries. This threatens an already weak supply of human resources for science and technology, and the quality of the science base.[57] Moreover, the allocation of institutional funding to higher education institutions and research organisations has until now not been based on performance.[58]

Energy

Energy price regulation was maintained over the last year, contrary to the 2013 recommendation. During 2013, the government implemented two rounds of price reductions in final retail prices of electricity and gas for households, while other customers also benefited from the reductions forced on network tariffs. In February 2014, the Parliament adopted a third legislative package for utility price cuts.[59]

Retail end-user price cuts, in combination with the high tax burdens, have had a severely negative impact on companies' capacity to recover costs. Already ahead of the 2013 price cuts, corporations operating in the 'universal service provider' consumer segment produced severe losses, especially in the gas sector.[60] Most companies used to recover losses under public service obligations on their distribution system operations (DSO), but given that most of the recent government-mandated price cuts have directly affected DSO tariffs, this kind of cross-subsidisation is becoming less possible.

Repeated regulatory steps have worsened the overall investment climate in Hungary with repercussions on the corporate sector's competitiveness in general. Energy companies in the regulated energy provision markets can no longer rely on distribution tariffs to generate profits. This has resulted in relatively higher industrial prices compared to household prices than in most of the EU, pointing to a cross-subsidisation from industries to households. The ratio of industrial to household prices for medium-level gas consumers is the 2nd highest in the EU (and 44 % above the EU28 average). For the same segment in electricity, it is the 5th highest (24 % above the EU28 average), whereas it was 10th at the end of 2012.[61]

Regulatory independence has not improved as the national energy regulator cannot autonomously set tariffs. No amendment to the law adopted in March 2013 on the national energy regulator was introduced to reinforce the independence of the authority. Therefore, decision on setting network access conditions and key parameters of network tariffs is still subject to ministerial approval.

Further challenges — energy efficiency and renewables

Energy intensity remains high by EU standards, especially for households. The country's final energy consumption in 2012 was already lower than the Europe 2020 target, but the "business as usual" scenario used in the 2014 NRP by the government would actually project an abnormal 53% increase in consumption to 22.5 Mtoe by 2020. Government-imposed reductions of energy bills are a potential further disincentive for energy efficiency. Households have a share of 35 % of all energy consumption — among the highest in the EU — mainly due to inefficient buildings and transports, which have one of the highest (and still increasing) energy intensity rates in the EU. Combined heat and power generation is not supported as required by EU legislation. Also because of these factors, the energy dependency of the country and the deficit in Hungary's energy trade balance are high. Several key actions announced in the 2011 National Energy Efficiency Action Plan are still delayed and the new plan, required by the Energy Efficiency directive, has not been approved yet.

Hungary has reached its interim renewable energy target, but the level of consumption from renewable energy decreased. The proportion of renewable energy sources in energy consumption fulfilled the 2011-12 interim target and has reached 9.6 %. However, this was achieved only by a decrease in the overall energy consumption, as this was 10% lower in 2012 than in 2011 (down from 16.8 Mtoe to 15.4 Mtoe), while consumption of renewable energy sources (in the electricity and transport sectors) in 2011-12 contracted. Although Hungary plans to substantially increase its financial support in this field, so far a consistent and comprehensive programme to support energy efficiency and renewables is lacking.

Transport

Reform of state-owned enterprises in transport has started but the tariff system has not substantially changed. Steps have been taken to streamline the organisation of MÁV (state railways) and Volán (interurban bus) groups. The year 2013 was the first when there was no need to provide additional state financing to MÁV, and its debt stock is now on a downward path. The current 24 Volán companies will be consolidated into seven regional ones in 2015. No substantial changes have been adopted to the tariff system, although a systematic review was announced in the Széll Kálmán Plan and the NRP acknowledges that revenues can be increased by increasing the number of paying passengers. The express train supplements introduced in 2013 do not appear to be the appropriate substitute for a tariff reform.

Sustaining an adequate level of public service continues to be a challenge. Annual operational costs of the Budapest transport company (BKV) are expected to increase by 5.6 %, mostly due to the launch of the new metro line (March 2014). In this context, the 10 % reduction in the price of monthly tickets from January 2014 does not seem to be well justified. For 2013, BKV's financing need from the central state budget was HUF 24 billion, that is broadly the same as in previous years. Their own revenue-generating capacity is expected to be reinforced only after the introduction of a new electronic ticketing system in 2017. At the same time, although preparatory works have been completed, the decision on the introduction of congestion charging is still being delayed. The fact that, in Budapest, a third of commuters travel more than an hour to work[62] emphasises the need for efficient (public) transport, if the city is to preserve its competitiveness. While the NRP gives no indication on plans for local transport, government decision on Budapest public transport (1164/2014) may be linked to the preparation of revenue increasing measures. For rail, the direct award of public service contracts for the entire network will de facto prevent competition in the sector for the next decade. [63]

The maintenance of transport infrastructure and rolling stock, causing high operating costs and pollution, is an issue of increasing concern. The state of the rail and waterway infrastructure continues to be a barrier to competitiveness and the implementation of EU programmes supporting them are considerably delayed. Furthermore, Hungary intends to reduce drastically the support to urban transport in the next programme phase. An important step to raise revenues was the introduction of distance-based charging of heavy goods vehicles, but it does not provide incentives for fleet renewal. The draft Hungarian National Transport Strategy identifies an increase of navigable days among measures offering outstanding utility; there seem to be no plans to ensure stable fairway dimensions for the Danube throughout the year, resulting in significantly reduced transport volumes.

Environment

Recycling is not adequately developed in Hungary. In 2012, Hungary landfilled as much as 65 % of its municipal waste and recycled only 21 %; this latter figure is below the EU average.[64] Managing waste efficiently and fulfilling the obligations under the EU Directives on waste remains a challenge.[65]

Environmental protection can substantially reduce public contributions. Between 2002 and 2013, the total direct costs recorded for the 10 major floods were at least € 1 400 million. Air pollution in Hungary is responsible for 11 400 premature deaths a year with total external costs in the range of € 5-17 billion/year and a substantial part of this is attributable to road traffic.[66] While the details of the electro-mobility plan announced in the NRP are not known yet, it may only be considered as part of a possible long-term solution to the problem.

3.5. Modernisation of public administration

Low levels of government effectiveness and high administrative burden have been long-standing problems in Hungary. As assessed in the 2014 in-depth review, Hungary's position in international competitiveness rankings continues to deteriorate over time and the institutional set up plays a role in this.[67] As from 2011, the government has been tackling some of these challenges by implementing the Magyary programme in the area of public administration modernisation and the Cutting Red Tape programme. Corruption is perceived as a widespread problem, while public procurement lacks transparency and competition. Moreover, Hungary was called by the Council to strengthen its judiciary.

In 2013, Hungary received a CSR concerning public administration, competition in public procurement, corruption and the judiciary. The analysis in this staff woking document leads to the conclusion that Hungary has fully addressed the recommendation on judiciary, made some progress on measures taken to address the administrative burden reduction and limited progress on the other elements of this recommendation.

Administrative burden

The Magyary programme brought about significant improvements in the responsiveness of public administration and further improvements are planned in the 2014 NRP which announced a tenfold extension of the one-stop shops ("government windows"). On the other hand, administrative capacities, especially human resources skills, could be further improved to increase public administration effectiveness. The development of the public service career model, the continuation of which is announced in the 2014 NRP, is a key element in this area[68]. The NRP also announces the development of a new Magyary programme 2014-20 to provide a strategic framework of the public administration modernisation in parallel with the EU development policy cycle.

The Cutting Red Tape programme was introduced to reduce the administrative burden on businesses. Most of the planned measures have been implemented and the government has announced that the initial target of a 25 % reduction of administrative burden has been achieved. Nevertheless, the business sector continues to report a high level of administrative burden.[69] Moreover, the estimation of programme results is based on an ex-ante estimate and there are neither publicly available data from the monitoring phase nor evaluations to support it. Most notably, the estimated impact does not take into account newly emerging burdens and compliance costs stemming from the introduction of new regulations, e.g. a number of new corporate surcharges. The government has announced a new simplification package, but details are still unknown. The main measure announced is an expansion of the business portal, but its first version is still under development. A well-structure portal could contribute significantly to the reduction of the administrative burden on businesses, especially SMEs.

Online public services in Hungary are in general not very user-friendly and it is possible to further improve e-governance services.[70] Currently, take-up by citizens and businesses is reasonable, reflecting their interest in the digitalisation of paper-based public services. Recently, improvements have been introduced in the Point of Single Contact portal, but it is still far from realising its full potential in terms of administrative simplification, in particular because of the low number of electronic procedures that can be completed online. Due to the limited information available to non-Hungarian speakers, it is of limited usefulness for Foreign Service providers.

The country has significant potential to improve its performance with customs. The time taken to process imports and exports could be reduced to cut business costs and facilitate trade.[71]

Corruption

Corruption in public administration remains a matter of concern. A few studies have examined corruption in Hungary. [72] The Anticorruption Report points to a long-lasting presence of *'institutionalised legal corruption'* driven primarily by political cycles. Such corruption does not involve direct bribery; rather 'it operates through contractual relationships which benefit the highest echelons of the political and business elite.'[73] Earlier research examining local government corruption shows a similar picture: business and government corruption has become institutionalised, it is spreading and getting more complex, i.e. "simple bilateral relations" have been replaced by chains with many actors. The political elite and the government in particular, have a determining role in the development of corruption and its fight.[74] In the 2013 Transparency International Corruption Perception Index,[75] Hungary ranks 20th among EU Member States. Among the most prominent cited weaknesses, there is legislation often serving political interests instead of the common good and favouritism towards certain economic interest groups. These outcomes can partially be explained by shortcomings in the system of financing to political parties and by the low effectiveness of control mechanisms, especially for public procurement.

At local level, there are persistent concerns related to close informal relations between businesses or individuals and members of the public administration. The EU Anti-corruption Report shows that corruption is perceived as widespread (89 % of respondents). A high number of people (the 3rd highest in the EU) indicate that they have had personal experience of bribery in Hungary, but with a clear concentration on a limited number of sectors, namely healthcare (which provides the bulk of instances of bribery), construction, water and waste management and training services.[76] Such informal ties could influence procurement outcomes. For example, a recent study has shown that bid-rigging is encountered relatively frequently in Hungary.[77]

Regarding the EU's Structural Funds, the current project selection procedures are in general compliant with the rules but are rather complex and not transparent. In the first place, there is a high concentration of priority projects in Hungary, under which competition is restrained.[78] Since July 2012, following a limited absorption of EU funds under the 2007-13 programmes, important decisions on the use of EU funds, in particular grant decisions for projects of national or regional importance, are taken by the government's National Development Committee. This reorganisation of the implementation system coupled with the ambitious spending targets for 2014-15 could considerably weaken transparency in terms of selecting the best quality projects. EU audit findings provide evidence of cases where EU funds in Hungary in the 2007-13 programming period have been used not in accordance with the rules, for example through consortia or companies with unclear ownership structures which were set up only to obtain a contract.[79]

Some steps have been taken to implement integrity strategies and to promote better transparency standards within the public administration, but implementation may be complicated. Hungary has approved the Code of Professional Ethics and is implementing an integrity and prevention-oriented programme within its public administration. It also took steps to promote higher transparency standards. Moreover, a whistle-blower act was approved, but it lacks adequate measures to support whistle-blowers.[80] The NRP 2014 proposes a new, secured, electronic whistleblowing system to protect the anonymity of whistle-blowers. The two announced measures, an information campaign and the examination of corruption risks as part of the mandatory impact assessments, are steps in the right direction, but their usefulness will have to be proved in practice.

Judiciary

Hungary has addressed the concerns raised in the 2013 European Semester process in relation to the judiciary. It has removed from the Fundamental law the clause on European Court of Justice judgments entailing payment obligations and the clause giving powers to the President of the National Judicial Office to transfer cases from one court to another. Hungary has also taken measures following the judgment of the European Court of Justice[81] in which the Court ruled that the sudden lowering of the mandatory retirement age for judges, prosecutors and public notaries violated EU equal treatment rules.

Public procurement

A low level of competition in public procurement persists. Although the new Public Procurement Act has repealed a non-transparent and discriminatory rule according to which only SMEs could be invited to submit offers below a certain procurement threshold, the implementation still suffers from significant shortcomings. Available evidence suggests that direct award of contracts continue to be extensively used, in some cases on questionable grounds.[82] It significantly raises costs of procurement, reduce value for money, and distort the functioning of the market by excluding potential contractors. This is of particular concern as it prevents the Single Market for public procurement from delivering its full economic potential and from ameliorating the current Hungarian fiscal situation. A 'soft law' instrument is currently being drafted by the Ministry of National Development and may enhance transparency in low-value procurements.[83]

Public procurement plays a crucial role in EU-funded projects but it is not effective enough in preventing corruption. The administrative burden on tenderers is highin Hungary and this results in a low number of bids per public tender. In fact, Hungary ranked 4th lowest in market competitiveness according to the 'Cost-effectiveness study' with an average of 3.5 bids per tender (EU average 5.4). The high frequency of tenders obtained by some specific contractors and bidding by consortia involving the major actors of the market are signs for limited or distorted competition that materialise in investment costs being often higher in Hungary than the EU average, as assessed by JASPERS experts.

In fact, empirical analysis of public procurement under EU funds in Hungary[84] suggests that, on average, a fifth of available public procurement budget is lost, with corruption explaining 69 % of this direct public loss. Such direct public losses are due to limited performance of projects, and are mostly due to a high occurrence of cost overruns (77 % of all available cases), but can also be caused by delays in implementation or loss of effectiveness (including inferior quality and questionable usefulness).

E-procurement could generate significant cost savings, improve the transparency of public procurement and increase competition. Overall, the introduction of e-procurement would be an opportunity to rethink the way public procurement is organised and a key element for leveraging smart procurement. Hungary is one of the few EU Member States in which the electronic submission of tenders is not used in practice, although theoretically available. Since July 2013, a public procurement database is available online and must be updated by all tenderers. However, it is not completely transparent, as due to design weaknesses data is sometimes not coherent and the database does not allow for meaningful searches or researches.[85]

4. CONCLUSIONS

Following a long period of low or negative GDP growth rates started already before the financial crisis, the Hungarian economy is experiencing positive growth in recent quarters. The weak growth until end 2012 was mainly due to subdued domestic demand on account of a rapid pace of de-leveraging and an uncertain business environment. The latter mainly concerns certain subsectors of the service sector, where specific taxes have been extended and restrictions to competitions increased. Economic activity has picked up again in 2013, propelled by a substantial inflow of EU funds, and unemployment has started decreasing. At the same time, the general government deficit reached 2.2% of GDP in 2013 and the debt-to-GDP ratio declined to 79.2 %, but the latter is not on a firm decreasing path yet.

The analysis in this staff working document leads to the conclusion that Hungary has made limited overall progress in addressing the 2013 country-specific recommendations. Challenges identified in July 2013 remain broadly valid. Even though some progress has been made regarding fiscal consolidation, the composition of the fiscal adjustment has not been restructured towards more growth friendly policies. A sustained increase in the primary expenditure ratio was partly compensated by additional non-tax revenues, while the tax burden slightly exceeded the 2012 level. Fiscal policy heavily relies on surtaxes in few service sectors, affecting firms providing intermediate inputs for most corporates, thus hampering the competitiveness of the Hungarian economy and diverting investments. In the financial sector, the tax burden, coupled with a high share of non-performing loans has discouraged banks from expanding lending activities. The Funding for Growth scheme has brought temporary relief, but cannot substitute for a normal operating environment on a permanent basis. Overall, corporate taxation remains complex and high in regional terms. The still high tax burden on low-income earners constitutes a disincentive to employ low-skilled workers. The Public Work Scheme aims at employing long-term unemployed, including low skilled people. This Scheme, together with economic growth and steps taken to increase women's participation into the labour market, has helped curbing unemployment and raising the country's persistently low employment rate. However, the expansion of the Public Work Scheme is not a sustainable policy approach as it absorbs the majority of resources for active labour market policies, without being an efficient measure for open labour market integration. Despite an improved employment rate, the social protection system, including tightened social transfers and the very short entitlement period for unemployment benefit, has a limited effect on reducing poverty. To address the existing skills mismatch on the labour market, and therefore sustainably improve employment level, the government introduced a new dual vocational education system and increased training opportunities. In the business environment, while entry costs in the service sector have further increased, measures to tackle corruption were enacted and steps were taken to increase transparency of public procurement and to reduce the administrative burden. An effective implementation of those measures will be required to increase efficiency of public spending, also for programmes to be co-financed by EU funds.

The 2014 national reform and CPs contain a detailed assessment of reform measures as well as macroeconomic and fiscal projections. However, the documents rather give account of previous reform efforts, while proposing future reform plans only in very few cases. The CP headline deficit targets have been significantly revised upwards since last year; Hungary now aims to bring the deficit down from 2.9% of GDP in 2014 to 1.9% in 2017 mainly through a policy of general expenditure containment.

OVERVIEW TABLE

2013 commitments	Summary assessment[86]
Country-specific recommendations (CSRs)	
CSR 1: Implement a credible and growth friendly fiscal strategy by specifying the necessary measures focusing on expenditure savings and preserve a sound fiscal position in compliance with the medium-term objective over the programme horizon. Building on the above steps, put the general government debt ratio on a firm downward path, also with a view to mitigating the accumulated macroeconomic imbalances. Enhance the medium-term budgetary framework by making it more binding and by closely linking it to numerical rules. Broaden the mandatory remit and enhance the transparency of the Fiscal Council, including through systematic ex post monitoring of compliance with numerical fiscal rules as well as the preparation of regular macro-fiscal forecasts and budgetary impact assessments of major policy proposals.	Hungary has made **some progress** in addressing CSR 1: • Some progress in fiscal consolidation. In 2013, the deficit target and the country's medium-term objective were overachieved by a considerable margin. The deficit is expected to be kept below the 3% of GDP deficit threshold in subsequent years as well, but it is projected to rebound close to 3% with the structural balance deviating significantly from the medium-term objective. Decreasing only very gradually, the debt ratio is not yet on a firm downward path. The composition of fiscal adjustment remained largely unchanged. Primary expenditures show an increase both in 2013 and 2014, while the tax burden slightly exceeds the elevated 2012 level • Some progress on fiscal governance. Amendments approved to the fiscal framework in December 2013 include, among others, new numerical rules to ensure compliance with the Stability and Growth Pact provisions and the long overdue strengthening of medium-term budgetary framework as well. Design flaws with domestic rules, however, still exist and the effectiveness of the new set-up is yet to be ensured. Further reinforcement of the Fiscal Council by broadening its mandatory remit is still lacking and not intended to change for the time being, which does not conducive to improving the transparency of public finances..
CSR 2: Help restore normal lending to the economy primarily by improving the capacity for capital accumulation in the financial sector, inter alia by lowering the extra burden currently imposed on it. Improve portfolio quality by removing bad assets from banks' balance sheets, closely consult stakeholders on new policy initiatives and make sure that new policy measures do not increase moral hazard among borrowers. Enhance financial regulation and supervision, notably by giving more effective emergency powers to the Hungarian Financial Supervisory Authority, and by establishing a bank resolution regime.	Hungary has made **limited progress** in addressing CSR 2: • Limited progress on restoring normal lending. Net lending flows to the corporate sector became positive in Q3 2013 purely due to influence of Funding for Growth scheme; they returned to negative levels in Q4 2013 and Q1 2014. Net lending flows toward households remained negative. Hence, normal lending has not yet been restored. • No progress on reducing the regulatory burden on the financial sector, as it was actually increased. • Limited progress on removing bad assets. Portfolio quality declined for households. The government has opened the possibility for borrowers overdue by 90 days to enter into the exchange rate cap scheme. The central bank has announced it will

	start a project to investigate obstacles to portfolio cleaning. As a response to the high share of problematic loans in the corporate sector, the central bank has opened the possibility in the Funding for Growth Scheme to buy commercial real estates that served as collateral of non-performing loans. • No progress on moral hazard. Government has announced it will prepare a 'final' foreign exchange relief scheme. However, details are not yet available. • Substantial progress on supervision. A law was adopted to merge the Hungarian Financial Supervisory Authority and the central bank (MNB). The new MNB law equips the central bank with macro-prudential policy tools, as it has become the dedicated macro-prudential authority. Under the new law, the MNB is equipped with the 'comply or explain principle'. Work on a bank resolution regime is in progress, expected to be adopted in 2014.
CSR 3: Ensure a stable, more balanced and predictable corporate tax system. Streamline corporate taxation and minimise distortions of resource allocation created by sector-specific taxes, so as to foster growth and employment. Continue making taxation of labour more employment-friendly by alleviating the tax burden on low-wage earners, inter alia by refining the eligibility criteria for the Job Protection Act, and by shifting taxation away to environmental taxes. Fully implement and step up the already announced measures to improve tax compliance and reduce the cost of tax compliance.	Hungary has made **limited progress** in addressing CSR 3: • No progress on corporate taxation. No sector-specific taxes (e.g. energy, telecoms and finance sectors) have been phased out or reduced, and no streamlining has taken place in the corporate taxation area, with all existing corporate tax regimes which were maintained. Moreover, a significant increase in the rate of the financial transaction duty (FTD) was adopted in 2013 and a one-off charge has been levied on economic actors affected by FTD. • Limited progress on labour taxation. Very marginal modification has been made for improving labour market participation of parents with three or more children returning to the labour market in the Job Protection Act. No other step to refine the eligibility has been taken. Extension of the family tax credit to employees' social security contribution helps in reducing the tax burden of families who could not previously use the benefits of the family tax credit. However, it is not specific to low income earners. On environmental taxation: although Hungary is already in line with the EU average, there is still potential for additional revenue from it, especially in view of the fact that the implicit tax rate on energy is significantly below the EU average. Hungary has made some progress in addressing the recommended tax shift to environmental taxes: in the waste sector, procedures for paying landfill as contribution fees entered into force. • Some progress on tax compliance. According to the government, all tax-related elements announced in

	the administrative burden reduction programme launched in 2011 have been implemented, but there is no methodologically sound, publicly available assessment on the impacts of these measures. Although the government has started the online connection of all retail and service sector cash registers to the tax authority, in order to reduce the size of the shadow economy, the establishment of online links has suffered repeated delays. Measures were supposed to be fully rolled out by 1 April 2013, but by early April 2014, only some 30 % of cash registers were online.
CSR 4: Address youth unemployment, for example through a Youth Guarantee. Strengthen active labour market policy measures and enhance the client profiling system of the Public Employment Service. Reduce the dominance of the public works scheme within employment measures and strengthen its activation elements. Reinforce training programmes to boost participation in lifelong learning. Continue to expand childcare facilities to encourage women's participation. Ensure that the objective of the National Social Inclusion Strategy is mainstreamed in all policy fields in order to reduce poverty, particularly among children and Roma.	Hungary has made **some progress** in addressing CSR 4: • Some progress has been made in the field of youth employment. The government has taken a number of measures to increase their participation in the labour market, including The Youth Guarantee implementation plan which has been launched. Some fine-tuning of the implementation and monitoring system is needed and acceleration of the full launch is to be considered. • Some progress on active labour market policies as further resources have been earmarked coming from EU funds for service provision, training and capacity development of the public employment service. Launch of profiling system needs to be accelerated. • Limited progress in strengthening activation (training) elements of the public works scheme; further improvement is needed to provide better services and differentiated training pathways. • No progress in reducing public works scheme dominance, as its size was even increased. • Substantial progress in expanding childcare facilities. Sufficient funding should be scheduled in the coming years, and results are to be assessed in the longer term. • Limited progress in implementation and alignment of the National Social Inclusion Strategy into other policies. Poverty situation calls for further efforts.
CSR 5: Create a supportive business environment, in particular restore an attractive environment for foreign direct investors, by making the regulatory framework more stable and by fostering market competition. Ensure the full implementation of measures envisaged to reduce the administrative burden, improve competition in public procurement and take further adequate measures to tackle corruption. Strengthen further the judiciary. Remove recently introduced barriers in the services sector, including in retail services. Provide targeted incentives to support innovative enterprises.	Hungary has made **limited progress** in addressing CSR 5: • The business environment has not improved as indicated inter alia by most recent international competitiveness surveys. • No progress was achieved on services, including retail. No barrier was removed; on the contrary new ones were introduced in 2013 and early 2014.

	• Some progress on administrative burden reduction. Implementation of the Cutting Red Tape programme has been started in ten areas (e.g. taxation, administrative procedures, public procurement, statistical data collection, etc.). While the Cutting Red Tape programme is a step in the right direction, the desired impact is yet to be felt by businesses. Hungary's ranking in international competitiveness reviews is deteriorating.. • Limited progress on corruption. Corruption is a long-lsting problem in the country, and government's efforts to tackle corruption have to be consistently supported in the medium term, as so far only limited progress has been made by implementing elements of the anti-corruption programme. • Some progress on public procurement. Concerns regarding the rule according to which below certain thresholds only SMEs could participate have been partially addressed. A 'soft law' instrument is also planned to be adopted. The situation regarding direct awards and overall transparency of public procurement has not improved, including under EU funds financed programme. • Some progress on innovation. Research and Development expenditures in Hungary have constantly increased in the last 3 years and Hungary seems more or less in line with its 2020 target. However, the public R&D intensity (public sector expenditures on R&D, as % of GDP) decreased from 0.48 % in 2009 to 0.43 % in 2012. Some positive signs linked to the approval of National Research and Development and Innovation Strategy (2013-2020) 'Investment into the Future' (RDI strategy 2013-2020). However, there is clearly still a possibility to improve the framework conditions to support young and fast-growing innovative companies, and to exploit the presence of large multinational companies active in high-tech and medium-tech sectors in Hungary. The smart specialisation strategy is considerably delayed as well as the market failure analysis for identifying financing needs of innovative enterprises. • Fully implemented the recommendation on judiciary. Hungary has adopted the Fifth Amendment to the Hungarian Fundamental law, which inter alia removed from the Fundamental Law the clause on Court of Justice judgments entailing payment obligations and the clause giving powers to the President of the National Judicial Office to transfer cases from one court to another. Hungary has also taken measures following the judgment of the Court of Justice in case C-286/12 in which the Court ruled that the sudden lowering of the mandatory retirement age for judges, prosecutors and public notaries violated EU equal

	treatment rules.
CSR 6: Implement a national strategy on early school-leaving and ensure that the education system provides all young people with labour-market-relevant skills, competences and qualifications. Improve access to inclusive mainstream education, for those with disadvantages, in particular Roma. Support the transition between different stages of education and towards the labour market. Implement a higher-education reform that enables greater tertiary attainment, particularly by disadvantaged students.	• Hungary has made **limited progress** in addressing CSR 6: • No progress on Early School Leaving. The approval of the national strategy on early school-leaving is still delayed, so there was real no possibility to implement it. The rate of early school leavers increased in 2013, yet again. • Some progress on labour-market-relevant skills, competences and qualifications. Vocational and educational training reform has been launched to ensure better labour market skills for students through a dual model. Monitoring of the changes is essential for timely intervention if needed. Schools do not equip their pupils with the basic skills needed to join the labour market and to participate in lifelong learning programmes. • No progress on access to inclusive mainstream education, in particular for Roma. Equal access to mainstream quality education is still a major problem for disadvantaged children. The number of Roma majority schools has increased. • Limited progress on higher-education reform that enables greater tertiary attainment. Hungary would need to do more to ensure that implementing the higher education reform improves access to education for disadvantaged people.
CSR 7: Gradually abolish regulated energy prices while ensuring the effective protection of economically vulnerable consumers. Take further steps to ensure the independence of the national regulator. Ensure the financial sustainability of state-owned enterprises in the transport sector by reducing operating costs and increasing revenues.	• Hungary has made **limited progress** in addressing CSR 7: • No progress on energy. Regulated energy prices were cut by 20 % in 2013 and further cuts in the regulated price are scheduled in 2014, for both electricity and gas. In combination with other measures (e.g. taxes in the energy sector), these price cuts have had a negative impact on the investment climate in Hungary in the energy sector and possibly beyond. They have resulted in a more concentrated energy sector with less competition and opportunity for investment and in higher industrial costs in relative terms. • The independence of the national regulator has not improved in practice, as the minister can dismiss its proposals. • Limited progress on state-owned transport enterprises. Some progress in restructuring the state-owned enterprises (MÁV and Volán), in harmonising their operations through the elimination of competition between rail and bus services, but only limited progress was achieved on

	the implementation of potentially revenue increasing measures.

Europe 2020 (national targets and progress)	
Policy field target	**Progress achieved**
Employment rate target: 75%	Employment rate 60.7 % in 2011, 62.1 % in 2012 and 63.2 % 2013. The employment rate has further increased in 2013, but the pace of improvement is still not enough to achieve the Europe 2020 target and substantially reduce the difference from the EU average. Open labour market participation is still a concern. Youth unemployment is still worrying.
Early school-leaving target: 10 %	Early leavers from education and training (percentage of the population aged 18-24 with at most lower secondary education and not in further education or training): 2010 - 10.5 %, 2011 - 11.2 %, 2012 - 11.5 %, 2013 - 11.8%. The figures are particularly high among vocational school students (30 %) and among Roma (seven times higher than in the non-Roma population; i.e. 82 %).
Tertiary education target: 30.3 %	Tertiary educational attainment: 28.1 % in 2011, 29.9 % in 2012 and 31.9 % 2013. Therefore, Hungary has already overachieved the national target, which is one of the lowest among EU Member States. Risks stem from a declining number of applicants to higher education due to policy uncertainties.
R&D target: 1.8% of GDP and 3% by 2030	Hungary seems on track to reach its R&D intensity target for 2020, thanks to an increasing trend in business expenditure on R&D. However, public R&D intensity (public sector expenditures on R&D, as % of GDP) decreased from 0.48 % in 2009 to 0.43 % in 2012. Data for 2013 are not available yet. R&D intensity grew in 2007-12 by 5.7 % a year reaching 1.3 % in 2012. The average annual growth required to hit the 2020 target is slightly lower at 4.2 %. According to the commitments (new Research and Development and Innovation strategy), Hungary will increase its research and development expenditures to 1.8 % of GDP by 2020 and 3 % by 2030. A complementary target is that business expenditure on R&D will reach 1.2 % by 2020.
Target on the reduction of population at risk of poverty or social exclusion in number of persons: 450 000	3.05 million People were at risk of poverty or social exclusion in 2011, close to 3.19 million in 2012 and

	3 285 in 2013 (against a 2008 baseline of 2.83 million). The trends are worsening; even more people are at risk of poverty than before. No improvement was achieved in this target.
Greenhouse gas (GHG) emissions target: +10 % (compared to 2005 emissions, ETS emissions not covered by this national target)	Change in non-ETS greenhouse gas emissions between 2005 and 2012: -21 %. According to the latest national projections and taking into account existing measures, the target is expected to be achieved: -16 % in 2020 compared to 2005 (with a margin of 26 percentage points).
2020 renewable energy target: 14.65 % Share of renewable energy in all modes of transport: 10 %	Proportion of renewable energy sources in 2012: 9.6 % Proportion of renewable energy sources in transport in 2012: 4.6 %
Energy efficiency target: By 2020: level of 26.6 million tonnes of oil equivalent (Mtoe) primary consumption and 18.2 Mtoe final energy consumption.	Hungary's primary energy consumption was 23.57 Mtoe in 2012, and its final energy consumption was 14.74 Mtoe, according to preliminary data from Eurostat. Hungary notified the policy measures it plans to adopt to implement Article 7 of the Energy Efficiency Directive. However, the National Energy Efficiency Action Plan and the Building Renovation Strategy (both due on 30 April 2014) are still missing. In the 2014 NRP, the government has revised from 10 % to 18% its energy saving target, but compared to the 2012 consumption, the target actually allows a 24% increase. This appears as "saving" because the "business as usual" scenario forecasts a worrying 53% increase in 8 years.

ANNEX

Standard tables

Table I. Macro-economic indicators

	1996-2000	2001-2005	2006-2010	2011	2012	2013	2014	2015
Core indicators								
GDP growth rate	3.0	4.2	-0.2	1.6	-1.7	1.1	2.3	2.1
Output gap [1]	-0.6	2.3	0.4	-2.5	-4.2	-3.4	-2.1	-1.0
HICP (annual % change)	15.2	5.9	5.3	3.9	5.7	1.7	1.0	2.8
Domestic demand (annual % change) [2]	3.5	4.1	-1.9	-0.5	-3.5	0.8	2.5	2.2
Unemployment rate (% of labour force) [3]	8.2	6.1	8.8	10.9	10.9	10.2	9.0	8.9
Gross fixed capital formation (% of GDP)	23.0	23.0	20.9	17.9	17.4	18.1	18.8	19.3
Gross national saving (% of GDP)	20.1	17.1	17.2	19.8	18.6	20.7	21.1	21.4
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-5.4**	**-7.0**	**-5.4**	**4.3**	**-2.1**	**-2.2**	**-2.9**	**-2.8**
Gross debt	**62.6**	**57.7**	**73.6**	**82.1**	**79.8**	**79.2**	**80.3**	**79.5**
Net financial assets	**-30.5**	**-39.2**	**-55.8**	**-53.3**	**-61.2**	**n.a**	**n.a**	**n.a**
Total revenue	44.7	42.7	45.3	54.3	46.6	47.6	47.3	46.5
Total expenditure	50.1	49.6	50.7	50.0	48.6	49.8	50.2	49.3
of which: Interest	7.6	4.3	4.2	4.1	4.3	4.2	3.8	3.8
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-5.3**	**-1.3**	**0.6**	**4.1**	**3.4**	**5.6**	**6.2**	**5.6**
Net financial assets; non-financial corporations	**-107.1**	**-104.8**	**-115.0**	**-118.2**	**-114.6**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**-1.4**	**-3.2**	**-1.2**	**10.0**	**9.1**	**n.a**	**n.a**	**n.a**
Gross capital formation	17.7	14.8	13.1	13.0	11.1	11.2	11.3	12.5
Gross operating surplus	17.8	20.8	22.6	23.9	22.9	23.0	23.8	25.0
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**4.7**	**0.9**	**1.5**	**-5.4**	**2.5**	**3.5**	**3.2**	**3.2**
Net financial assets	**61.6**	**61.5**	**64.1**	**59.7**	**67.5**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	33.5	36.0	36.9	37.0	37.1	37.8	37.9	37.8
Net property income	5.7	3.9	3.3	2.8	3.1	3.6	2.9	2.5
Current transfers received	16.6	17.9	19.6	19.2	19.0	18.6	18.3	18.6
Gross saving	9.7	6.3	5.9	6.4	4.4	4.9	4.5	4.4
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-5.8**	**-7.4**	**-3.2**	**2.9**	**3.7**	**6.6**	**6.1**	**5.7**
Net financial assets	**77.7**	**86.4**	**108.5**	**102.7**	**99.8**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-1.1	-2.5	2.2	6.5	7.3	8.0	8.1	8.2
Net primary income from the rest of the world	-5.0	-5.1	-5.6	-5.3	-5.4	-5.3	-5.5	-5.6
Net capital transactions	0.1	0.3	1.1	2.3	2.6	3.5	3.1	2.9
Tradable sector	47.8	45.5	45.2	45.9	45.5	44.9	n.a	n.a
Non tradable sector	37.9	40.4	40.1	38.9	38.2	39.0	n.a	n.a
of which: Building and construction sector	4.2	4.7	4.1	3.4	3.2	3.4	n.a	n.a
Real effective exchange rate (index, 2000=100)	70.4	92.2	99.0	95.4	91.2	92.6	91.3	91.9
Terms of trade goods and services (index, 2000=100)	101.5	101.3	98.8	97.6	96.6	97.2	97.5	97.8
Market performance of exports (index, 2000=100)	72.7	92.4	117.3	125.3	127.1	132.6	134.6	135.2

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.

[2] The indicator on domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source:

Commission 2014 spring forecast (COM); Convergence programme (CP).

Table II. Comparison of macroeconomic developments and forecasts

	2013		2014		2015		2016	2017
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	1.1	1.1	2.3	2.3	2.1	2.5	2.1	3.1
Private consumption (% change)	0.2	0.2	1.4	1.8	1.6	2.0	2.0	2.1
Gross fixed capital formation (% change)	5.9	5.9	7.0	6.2	4.3	4.1	-0.9	8.5
Exports of goods and services (% change)	5.3	5.3	5.7	5.8	6.1	6.8	6.7	6.6
Imports of goods and services (% change)	5.3	5.3	6.2	6.2	6.5	6.5	5.8	7.2
Contributions to real GDP growth:								
- Final domestic demand	1.4	1.4	2.3	2.4	2.1	1.7	0.6	2.9
- Change in inventories	-0.7	-0.7	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	0.4	0.4	0.1	0.0	0.1	0.9	1.5	0.1
Output gap[1]	-3.4	-3.5	-2.1	-2.3	-1.0	-1.2	-0.4	1.1
Employment (% change)	0.4	1.6	0.7	1.2	0.6	0.9	0.9	0.9
Unemployment rate (%)	10.2	10.2	9.0	9.1	8.9	8.8	8.5	8.2
Labour productivity (% change)	0.7	-0.4	1.6	1.2	1.5	1.7	1.2	2.1
HICP inflation (%)	1.7	1.7	1.0	0.8	2.8	2.9	3.0	3.0
GDP deflator (% change)	2.7	2.7	2.2	2.4	2.6	2.7	2.9	2.9
Comp. of employees (per head, % change)	4.7	3.5	3.6	3.6	3.4	3.8	4.0	4.2
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	6.6	6.5	6.1	7.2	5.7	6.0	6.1	7.4

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 2014 spring forecast (COM); Convergence programme (CP).

Table III. Composition of the budgetary adjustment

(% of GDP)	2013	2014		2015		2016	2017	Change: 2013-2017
	COM	COM	CP	COM[1]	CP	CP	CP	CP
Revenue	**47.6**	**47.3**	**47.2**	**46.5**	**46.1**	**43.6**	**42.9**	**-4.7**
of which:								
- Taxes on production and imports	18.3	18.2	18.4	18.0	18.1	17.7	17.4	-0.9
- Current taxes on income, wealth, etc.	6.9	6.8	6.9	6.8	6.7	6.7	6.7	-0.2
- Social contributions	13.4	13.4	13.4	13.2	13.2	13.0	12.8	-0.6
- Other (residual)	9.0	8.9	8.5	8.6	8.1	6.2	6.0	-3.0
Expenditure	**49.8**	**50.2**	**50.1**	**49.3**	**48.9**	**46.1**	**44.8**	**-5.0**
of which:								
- Primary expenditure	45.5	46.4	46.4	45.5	45.3	42.5	41.2	-4.3
of which:								
Compensation of employees	10.3	10.4	10.4	10.2	10.0	9.7	9.4	-0.9
Intermediate consumption	7.9	8.4	8.4	8.3	8.1	7.5	7.5	-0.4
Social payments	17.5	17.0	17.0	16.7	16.4	16.1	15.6	-1.9
Subsidies	1.5	1.4	1.4	1.4	1.3	1.3	1.2	-0.3
Gross fixed capital formation	3.9	4.4	4.5	3.8	3.9	2.8	2.8	-1.1
Other (residual)	4.5	4.8	4.7	5.2	5.7	5.1	4.6	0.1
- Interest expenditure	4.2	3.8	3.7	3.8	3.6	3.6	3.6	-0.6
General government balance (GGB)	**-2.2**	**-2.9**	**-2.9**	**-2.8**	**-2.8**	**-2.5**	**-1.9**	**0.3**
Primary balance	**2.1**	**0.9**	**0.8**	**1.0**	**0.8**	**1.1**	**1.8**	**-0.3**
One-off and other temporary measures	0.2	0.3	0.4	0.0	0.0	0.0	0.0	-0.2
GGB excl. one-offs	**-2.4**	**-3.2**	**-3.3**	**-2.7**	**-2.8**	**-2.5**	**-1.9**	**0.5**
Output gap[2]	-3.4	-2.1	-2.3	-1.0	-1.2	-0.4	1.1	4.5
Cyclically-adjusted balance[2]	-0.6	-1.9	-1.8	-2.3	-2.2	-2.3	-2.4	-1.8
Structural balance (SB)[3]	**-0.8**	**-2.2**	**-2.2**	**-2.3**	**-2.2**	**-2.3**	**-2.4**	**-1.7**
Change in SB	*0.0*	*-1.4*	*-1.5*	*0.0*	*0.0*	*-0.1*	*-0.1*	-
Two year average change in SB	*1.6*	*-0.7*	*-0.7*	*-0.7*	*-0.7*	*0.0*	*-0.1*	-
Structural primary balance[3]	3.4	1.5	1.5	1.5	1.4	1.3	1.2	-2.3
Change in structural primary balance		*-1.9*	*-2.0*	*0.0*	*-0.1*	*-0.1*	*-0.1*	-
Expenditure benchmark								
Applicable reference rate[4]	0.54	0.08	0.08	-1.08	-1.08	n.a.	n.a.	-
Deviation[5] (% GDP)	1.7	-1.1	-0.9	-1.4	-1.3	n.a.	n.a.	-
Two-year average deviation (% GDP)	n.a.	0.3	0.0	-1.3	-1.1	n.a.	n.a.	-

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 negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Convergence programme (CP); Commission 2014 spring forecast (COM); Commission calculations.

Table IV. Debt dynamics

(% of GDP)	Average 2008-2012	2013	2014		2015		2016	2017
			COM	CP	COM	CP	CP	CP
Gross debt ratio1	**79.4**	**79.2**	**80.3**	**79.1**	**79.5**	**78.9**	**77.5**	**74.7**
Change in the ratio	2.6	-0.6	1.0	-0.1	-0.7	-0.2	-1.4	-2.8
Contributions2:								
1. Primary balance	**-2.2**	**-2.1**	**-0.9**	**-0.8**	**-1.0**	**-0.8**	**-1.1**	**-1.8**
2. "Snow-ball" effect	**2.6**	**1.3**	**0.3**	**0.1**	**0.1**	**-0.3**	**-0.2**	**-0.6**
Of which:								
Interest expenditure	4.3	4.2	3.8	3.7	3.8	3.6	3.6	3.7
Growth effect	0.8	-0.9	-1.8	-1.7	-1.6	-1.9	-1.6	-2.3
Inflation effect	-2.5	-2.0	-1.7	-1.8	-2.0	-2.1	-2.2	-2.1
3. Stock-flow adjustment	**2.2**	**0.1**	**1.6**	**0.6**	**0.1**	**1.0**	**-0.1**	**-0.3**
Of which:								
Cash/accruals diff.								
Acc. financial assets								
Privatisation								
Val. effect & residual								

	2013	2014		2015		2016	2017
		COM	CP	COM	CP	CP	CP
Gap to the debt benchmark[3,4]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Structural adjustment[5]	0.0	-1.4	-1.5	0.0	0.0	n.a.	n.a.
To be compared to:							
Required adjustment[6]	-0.3	-0.5	-1.3	0.5	-1.2	n.a.	n.a.

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]Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[4]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.

[5]Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[6]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/CP) budgetary projections for the previous years are achieved.

Source :

Convergence programme (CP); Commission 2014 spring forecast (COM); Commission calculations.

Table V. Sustainability indicators

	Hungary			European Union		
	2013 scenario	**No-policy-change scenario**	**Convergence programme scenario**	**2013 scenario**	**No-policy-change scenario**	**Convergence programme scenario**
S2*	-1.7	0.6	0.9	2.4	2.4	0.7
of which:						
Initial budgetary position (IBP)	-1.9	0.2	0.2	0.5	0.4	-1.3
Long-term cost of ageing (CoA)	0.2	0.4	0.7	1.9	2.0	2.0
of which:						
pensions	-0.4	-0.1	0.1	0.7	0.8	0.9
healthcare	0.8	0.7	0.7	0.9	0.9	0.8
long-term care	0.4	0.3	0.3	0.6	0.6	0.6
others	-0.5	-0.6	-0.5	-0.4	-0.4	-0.3
S1**	-3.5	-0.8	-0.4	1.5	1.7	-0.2
of which:						
Initial budgetary position (IBP)	-3.1	-0.7	-0.2	-0.2	-0.4	-2.0
Debt requirement (DR)	1.0	1.2	1.1	1.5	1.8	1.5
Long-term cost of ageing (CoA)	-1.4	-1.3	-1.2	0.2	0.3	0.3
S0 (risk for fiscal stress)***	0.25	:		:		
Debt as % of GDP (2013)	79.2			88.9		
Age-related expenditure as % of GDP (2013)	22.1			25.8		

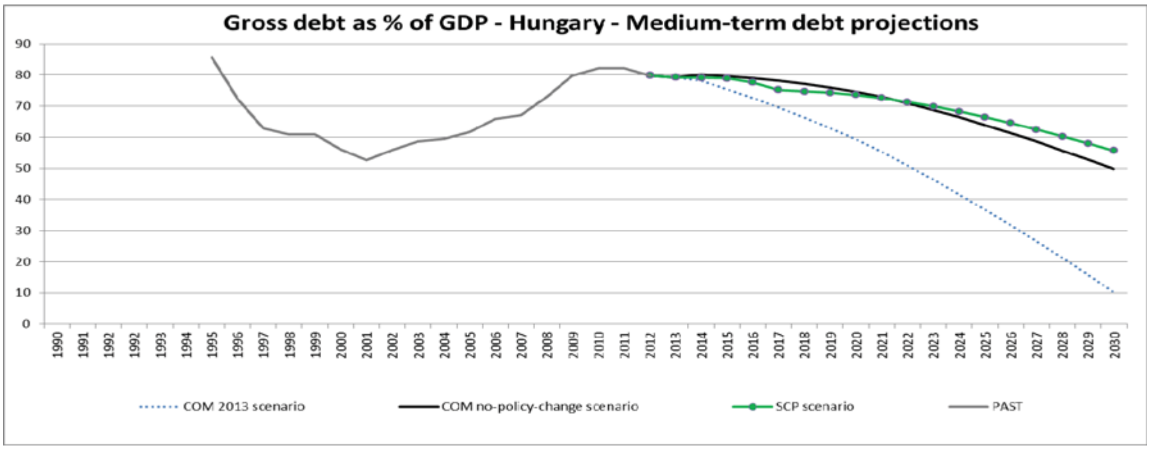
Source *: Commission; 2014 convergence programme.*

Note : The 2013 scenario depicts the sustainability gap under the assumption that the budgetary position evolves until 2013 in line with the Commission's 2014 spring forecast. The 'no-policy-change' scenario depicts the sustainability gap under the assumption that the budgetary position evolves until 2015 in line with the Commission's 2014 spring forecast. The 'stability programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented. Age-related expenditure as given in the 2012 Ageing Report.

* The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: (i) the initial budgetary position (IBP), which gives the gap vis-à-vis the debt-stabilising primary balance and (ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that, in an infinite horizon, the growth in the debt ratio is bound by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60 % debt threshold. The following thresholds were used for the S2 indicator: (i) if the value of S2 is lower than 2, the country is classed as low risk; (ii) if it is between 2 and 6, it is classed as medium risk; and (iii) if it is greater than 6, it is classed as high risk.

** The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady improvement in the structural primary balance in the period to 2020 and then sustained for a decade, to bring debt ratios back to 60% of GDP in 2030, including financing for any additional expenditure by the target date, arising from population ageing. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is classed as low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 pp of GDP per year until 2020 after the last year covered by the 2014 spring forecast (2015) is required (indicating a cumulated adjustment of 2.5 pp), it is classed as medium risk; and (iii) if the S1 value is greater than 2.5 (i.e. a structural adjustment of more than 0.5 pp of GDP per year is necessary), it is classed as high risk.

*** The S0 indicator reflects up-to-date evidence on the role played by fiscal and financial competitiveness variables in creating potential fiscal risks. The methodology for the S0 indicator differs fundamentally from that for the S1 and S2 indicators. Unlike S1 and S2, S0 is not a quantification of the required fiscal adjustment effort, but a composite indicator which estimates the extent to which there might be a risk of fiscal stress in the short term. The critical threshold for the S0 indicator is 0.43.



Gross debt as % of GDP - Hungary - Medium-term debt projections
COM 2013 scenario
COM no-policy-change scenario
SCP scenario
PAST

Table VI. Taxation indicators

	2002	2006	2008	2010	2011	2012
Total tax revenues (incl. actual compulsory social contributions, % of GDP)	38.0	37.3	40.3	38.1	37.3	39.2
Breakdown by economic function (% of GDP)[1]						
Consumption	14.1	13.9	14.3	14.8	14.6	15.7
of which:						
- VAT	7.8	7.6	7.8	8.8	8.6	9.4
- excise duties on tobacco and alcohol	1.1	1.3	1.4	1.3	1.3	1.5
- energy	2.2	2.1	2.0	2.1	2.0	1.9
- other (residual)	2.9	2.9	3.1	2.7	2.7	2.9
Labour employed	18.8	18.0	19.8	17.5	17.3	18.0
Labour non-employed	0.3	0.3	1.0	0.5	0.3	0.2
Capital and business income	3.7	3.7	3.8	2.6	2.5	2.5
Stocks of capital/wealth	1.1	1.4	1.6	2.6	2.6	2.8
p.m. Environmental taxes[2]	2.8	2.8	2.7	2.7	2.5	2.5
VAT efficiency[3]						
Actual VAT revenues as % of theoretical revenues at standard rate	45.2	55.0	57.1	52.9	52.4	52.7

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 (2014), 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. It is defined as the ratio between the actual VAT revenue collected and the revenue that would be raised if VAT was applied at the standard rate to all final (domestic) consumption expenditures, which is an imperfect measure of the theoretical pure VAT base. 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'). It should be noted that the relative size of cross-border shopping compared to domestic consumption also influences the value of the ratio, notably for smaller economies. See European Commission (2012), Tax Reforms in EU Member States and OECD (2012), Consumption tax trends for a more detailed discussion.

Source: Commission

Table VII. Financial market indicators

	2009	2010	2011	2012	2013
Total assets of the banking sector (% of GDP)	142.7	135.5	121.9	121.6	118.4
Share of assets of the five largest banks (% of total assets)	55.2	54.6	54.6	54.0	-
Foreign ownership of banking system (% of total assets)	54.3	53.1	54.6	50.0	-
Financial soundness indicators:					
- non-performing loans (% of total loans)[1),2)]	6.7	9.8	13.4	15.8	17.6
- capital adequacy ratio (%) [1), 3)]	13.9	13.9	13.8	16.3	16.9
- return on equity (%) [1)]	8.4	0.4	-7.7	-1.4	4.4
Bank loans to the private sector (year-on-year % change)	-5.4	-5.2	-13.2	-5.5	-4.3
Lending for house purchase (year-on-year % change)	-1.1	-4.4	-18.9	-9.4	-5.6
Loan to deposit ratio	132.4	136.9	128.0	110.6	102.1
CB liquidity as % of liabilities	0.0	0.0	0.1	0.5	3.0
Banks' exposure to countries receiving official financial assistance (% of GDP)	-	-	-	-	-
Private debt (% of GDP)	149.1	133.3	147.6	131.4	120.8
Gross external debt (% of GDP)					
- Public	47.8	47.0	48.5	53.1	48.8
- Private	88.9	69.9	79.0	79.5	74.1
Long term interest rates spread versus Bund (basis points)*	590.1	453.8	502.7	639.6	435.3
Credit default swap spreads for sovereign securities (5-year)*	334.5	282.1	342.5	418.0	269.8

Notes:

1) Latest data 2013Q3.

2) Overdue loans declared nonperforming before 90 days.

3) Basel I and Basel II being applied simultaneously.

* 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	2008	2009	2010	2011	2012	2013
Employment rate (% of population aged 20-64)	61.9	60.5	60.4	60.7	62.1	63.2
Employment growth (% change from previous year)	-1.8	-2.5	0.8	0.3	0.0	0.4
Employment rate of women (% of female population aged 20-64)	55.1	54.4	55.0	54.9	56.4	57.0
Employment rate of men (% of male population aged 20-64)	69.0	67.0	66.0	66.8	68.1	69.7
Employment rate of older workers (% of population aged 55-64)	31.4	32.8	34.4	35.8	36.9	38.5
Part-time employment (% of total employment, 15 years and more)	4.6	5.6	5.8	6.8	7.0	6.7
Part-time employment of women (% of women employment, 15 years and more)	6.2	7.5	8.0	9.2	9.7	9.3
Part-time employment of men (% of men employment, 15 years and more)	3.3	3.9	3.9	4.7	4.7	4.4
Fixed term employment (% of employees with a fixed term contract, 15 years and more)	7.9	8.5	9.7	8.9	9.4	10.8
Transitions from temporary to permanent employment	50.9	49.9	39.2	39.3	:	:
Unemployment rate[1] (% of labour force, age group 15-74)	7.8	10.0	11.2	10.9	10.9	10.2
Long-term unemployment rate[2] (% of labour force)	3.6	4.2	5.5	5.2	4.9	5.0
Youth unemployment rate (% of youth labour force aged 15-24)	19.9	26.5	26.6	26.1	28.1	27.2
Youth NEET rate (% of population aged 15-24)	11.5	13.4	12.4	13.3	14.7	15.4
Early leavers from education and training (% of pop. 18-24 with at most lower sec. educ. and not in further education or training)	11.7	11.2	10.5	11.2	11.5	11.8
Tertiary educational attainment (% of population 30-34 having successfully completed tertiary education)	22.4	23.9	25.7	28.1	29.9	31.9
Formal childcare (from 1 to 29 hours; % over the population less than 3 years)	2.0	2.0	1.0	1.0	2.0	:
Formal childcare (30 hours or over; % over the population less than 3 year)	5.0	5.0	8.0	7.0	6.0	:
Labour productivity per person employed (annual % change)	2.7	-4.4	0.2	1.3	-1.7	0.7
Hours worked per person employed (annual % change)	0.2	-0.8	-0.3	0.9	-0.3	-0.3
Labour productivity per hour worked (annual % change; constant prices)	2.6	-3.6	0.5	0.4	-1.4	1.0
Compensation per employee (annual % change; constant prices)	1.9	-5.0	-2.8	1.0	-2.3	2.0
Nominal unit labour cost growth (annual % change)	4.4	2.8	-0.7	2.3	2.5	4.0
Real unit labour cost growth (annual % change)	-0.9	-0.7	-3.0	-0.3	-0.6	1.3

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)	2007	2008	2009	2010	2011
Sickness/Health care	5.7	5.6	5.7	5.7	6.3
Invalidity	2.1	2.1	2.1	1.9	1.7
Old age and survivors	9.8	10.2	11.3	10.4	10.5
Family/Children	2.8	2.9	3.0	3.0	2.9
Unemployment	0.8	0.8	1.0	0.9	0.8
Housing and Social exclusion n.e.c.	0.9	0.7	0.7	0.5	0.4
Total	22.3	22.5	23.9	22.6	22.8
of which: means tested benefits	1.4	1.2	1.2	1.1	1.0
Social inclusion indicators	**2008**	**2009**	**2010**	**2011**	**2012**
At-risk-of-poverty or social exclusion[1] (% of total population)	28.2	29.6	29.9	31.0	32.4
At-risk-of-poverty or social exclusion of children (% of people aged 0-17)	33.4	37.2	38.7	39.6	40.9
At-risk-of-poverty or social exclusion of elderly (% of people aged 65+)	17.5	17.5	16.8	18.0	20.6
At-Risk-of-Poverty rate[2] (% of total population)	12.4	12.4	12.3	13.8	14.0
Severe Material Deprivation[3] (% of total population)	17.9	20.3	21.6	23.1	25.7
Share of people living in low work intensity households[4] (% of people aged 0-59)	12.0	11.3	11.9	12.2	12.8
In-work at-risk-of poverty rate (% of persons employed)	5.8	6.2	5.3	6.1	5.3
Impact of social transfers (excluding pensions) on reducing poverty	59.2	57.1	56.7	52.2	48.3
Poverty thresholds, expressed in national currency at constant prices[5]	614 800	624 955	599 141	601 200	614 952
Gross disponsable income (households)	15 059 911	15 012 489	15 282 537	16 342 483	16 536 454
Relative median poverty risk gap (60% of median equivalised income, age: total)	17.3	16.3	16.5	18.3	21.0

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	2004-2008	2009	2010	2011	2012	2013
Labour productivity[1] total economy (annual growth in %)	2.4	-4.5	0.5	1.4	-1.8	1.0
Labour productivity[1] in manufacturing (annual growth in %)	4.9	-12.8	14.7	-2.7	2.0	0.5
Labour productivity[1] in electricity, gas, water (annual growth in %)	-2.2	-8.1	1.0	-6.0	1.0	n.a.
Labour productivity[1] in the construction sector (annual growth in %)	-3.8	1.8	-3.8	4.2	-3.7	7.3
Patent intensity in manufacturing[2] (patents of the EPO divided by gross value added of the sector)	39.1	42.7	43.4	42.7	n.a.	n.a.
Policy indicators	**2004-2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Enforcing contracts[3] (days)	335.0	395	395	395	395	395
Time to start a business[3] (days)	29.8	4	4	4	5	5
R&D expenditure (% of GDP)	1.0	1.2	1.2	1.2	1.3	n.a.
Tertiary educational attainment (% of 30-34 years old population)	19.6	23.9	25.7	28.1	29.9	31.9
Total public expenditure on education (% of GDP)	5.3	5.1	4.9	4.7	n.a.	n.a.
	2008	**2009**	**2010**	**2011**	**2012**	**2013**
Product market regulation[4], Overall (Index; 0=not regulated; 6=most regulated)	1.4	n.a.	n.a.	n.a.	n.a.	1.3
Product market regulation[4], Retail (Index; 0=not regulated; 6=most regulated)	1.4	n.a.	n.a.	n.a.	n.a.	2.1
Product market regulation[4], Network Industries[5] (Index; 0=not regulated; 6=most regulated)	2.1	n.a.	n.a.	n.a.	n.a.	1.7

Notes:

[1] Labour productivity is defined as gross value added (in constant prices) divided by the number of persons employed.

[2] Patent data refer to applications to the European Patent Office (EPO). They are counted according to the year in which they were filed at the EPO. They are broken down according to the inventor's place of residence, using fractional counting if multiple inventors or IPC classes are provided to avoid double counting.

[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.

[5] Aggregate ETCR.

Source:

Commission, World Bank - *Doing Business* (for enforcing contracts and time to start a business) and OECD (for the product market regulation indicators).

Table X. Green Growth

		2003-2007	2008	2009	2010	2011	2012
Green Growth performance							
Macroeconomic							
Energy intensity	kgoe / €	0.44	0.41	0.42	0.42	0.40	0.39
Carbon intensity	kg / €	1.30	1.14	1.12	1.11	1.07	n.a.
Resource intensity (reciprocal of resource productivity)	kg / €	2.52	2.11	1.81	1.64	1.60	n.a.
Waste intensity	kg / €	n.a.	0.26	n.a.	0.26	n.a.	n.a.
Energy balance of trade	% GDP	-3.7%	-6.3%	-4.9%	-5.2%	-6.1%	-6%
Energy weight in HICP	%	13	14	14	15	15	17
Difference between change energy price and inflation	%	6.22	7.5	3.1	1.6	1.9	0.3
Environmental taxes over labour taxes	ratio	15.2%	13.2%	13.9%	14.8%	14.4%	n.a.
Environmental taxes over total taxes	ratio	7.4%	6.8%	6.7%	7.0%	6.8%	n.a.
Sectoral							
Industry energy intensity	kgoe / €	0.18	0.15	0.14	0.14	n.a.	n.a.
Share of energy-intensive industries in the economy	% GDP	10.9	11.2	11.2	n.a.	n.a.	n.a.
Electricity prices for medium-sized industrial users**	€ / kWh	n.a.	0.12	0.12	0.10	0.10	0.09
Gas prices for medium-sized industrial users***	€ / kWh	n.a.	0.04	0.04	0.03	0.04	0.04
Public R&D for energy	% GDP	n.a.	0.01%	0.01%	0.00%	0.00%	0.01%
Public R&D for the environment	% GDP	n.a.	0.02%	0.02%	0.01%	0.01%	0.01%
Recycling rate of municipal waste	ratio	15.8%	23.8%	24.9%	29.6%	32.7%	34.6%
Share of GHG emissions covered by ETS*	%	n.a.	37.2%	33.5%	34.0%	34.1%	34.5%
Transport energy intensity	kgoe / €	0.71	0.77	0.80	n.a.	n.a.	n.a.
Transport carbon intensity	kg / €	1.96	2.05	2.13	n.a.	n.a.	n.a.
Security of energy supply							
Energy import dependency	%	62.0%	63.2%	58.5%	58.1%	51.8%	52.3%
Diversification of oil import sources	HHI	n.a.	0.67	0.64	0.69	0.76	n.a.
Diversification of energy mix	HHI	0.29	0.27	0.25	0.25	0.25	0.24
Share renewable energy in energy mix	%	4.2%	6.0%	7.3%	7.6%	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 CO2 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

* Commission and EEA.

** For 2007 average of S1 & S2 for DE, HR, LU, NL, FI, SE & UK. Other countries only have S2.

*** For 2007 average of S1 & S2 for HR, IT, NL, FI, SE & UK. Other countries only have S2.

List of indicators used in on Box 6 on the potential impact on growth of structural reforms.

Final goods sector mark-ups: Price-cost margin, i.e. the difference between the selling price of a good or service and its cost. Final goods mark-ups are proxied by the mark-ups in selected services sectors (transport and storage, post and telecommunications, electricity, gas and water supply, hotels and restaurants and financial intermediation but excluding real estate and renting of machinery and equipment and other business activities[87]).
Source: Commission services estimation using the methodology of Roeger, W. (1995). "Can imperfect Competition explain the Difference between primal and dual Productivity?" *Journal of Political Economy* Vol. 103(2) pp. 316-30, based on EUKLEMS 1996-2007 data.

Entry costs: Cost of starting a business in the intermediate sector as a share of income per capita. The intermediate sector is proxied by the manufacturing sector in the model.
Source: World Bank, Doing Business Database. www.doingbusiness.org; 2012 data.

Implicit consumption tax rate: Defined as total taxes on consumption over the value of private consumption. In the simulations it is used as a proxy for shifting taxation away from labour to indirect taxes. The implicit consumption tax-rates are increased (halving the gap vis-à-vis the best performers) while labour tax-rates are reduced so that the combined impact is ex-ante budgetary neutral.
Source: European Commission, Taxation trends in the European Union, 2013 edition, Luxembourg, 2013. 2011 data.

Shares of high-skilled and low-skilled: The share of high skilled workers is increased, the share of low-skilled workers is reduced (halving the gap vis-à-vis the best performers). Low-skilled correspond to ISCED 0-2 categories; high-skilled correspond to scientists (in mathematics and computing, engineering, manufacturing and construction). The remainder is medium-skilled.
Source: EUROSTAT. 2012 data or latest available.

Female non-participation rate: Share of women of working age not in paid work and not looking for paid work in total female working-age population
Source: EUROSTAT. 2012 data or latest available.

Low-skilled male non-participation rates: Share of low-skilled men of working age not in paid work and not looking for paid work in total male working-age population
Source: EUROSTAT. 2012 data or latest available.

Elderly non-participation rates (55-64 years): Share of the population aged 55-64 years not in paid work and not looking for paid work in total population aged 55-64 years.
Source: EUROSTAT. 2012 data or latest available.

ALMP: Active Labour Market Policy expenditures as a share of GDP over the share of unemployed in the population.
Source: EUROSTAT. 2011 data or latest available.

Benefit replacement rate: Share of a worker's pre-unemployment income that is paid out by the unemployment insurance scheme. Average of net replacement rates over 60 months of unemployment.
Source: OECD, Benefits and Wages Statistics.
www.oecd.org/els/benefitsandwagesstatistics.htm. 2012 data.