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#### COVER NOTE

From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
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To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
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Recommendation for a

**COUNCIL RECOMMENDATION**

**on the 2018 National Reform Programme of Hungary**

**and delivering a Council opinion on the 2018 Convergence Programme of Hungary**

Recommendation for a

## **COUNCIL RECOMMENDATION**

**on the 2018 National Reform Programme of Hungary**

**and delivering a Council opinion on the 2018 Convergence Programme of Hungary**

THE COUNCIL OF THE EUROPEAN UNION,

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

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

Having regard to the recommendation of the European Commission<sup>2</sup>,

Having regard to the resolutions of the European Parliament<sup>3</sup>,

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

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

Having regard to the opinion of the Social Protection Committee,

Having regard to the opinion of the Economic Policy Committee,

Whereas:

- (1) On 22 November 2017, the Commission adopted the Annual Growth Survey, marking the start of the 2018 European Semester of economic policy coordination. It took due account of the European Pillar of Social Rights, proclaimed by the European Parliament, the Council and the Commission on 17 November 2017. The priorities of the Annual Growth Survey were endorsed by the European Council on 22 March 2018. On 22 November 2017, on the basis of Regulation (EU) No 1176/2011, the Commission also adopted the Alert Mechanism Report, in which it did not identify Hungary as one of the Member States for which an in-depth review would be carried out.
- (2) The 2018 country report for Hungary<sup>4</sup> was published on 7 March 2018. It assessed Hungary's progress in addressing the country-specific recommendations adopted by

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<sup>1</sup> OJ L 209, 2.8.1997, p. 1.

<sup>2</sup> COM(2018) 416 final.

<sup>3</sup> P8\_TA(2018)0077 and P8\_TA(2018)0078.

<sup>4</sup> SWD(2018) 215 final.

the Council on 11 July 2017, the follow-up given to the recommendations adopted in previous years and Hungary's progress towards its national Europe 2020 targets.

- (3) On 30 April 2018, Hungary submitted its 2018 National Reform Programme and its 2018 Convergence Programme. To take account of their interlinkages, the two programmes have been assessed at the same time.
- (4) Relevant country-specific recommendations have been addressed in the programming of the European Structural and Investment Funds for the 2014-2020 period. As foreseen in Article 23 of Regulation (EU) No 1303/2013 of the European Parliament and of the Council<sup>5</sup>, where it is necessary to support the implementation of relevant Council recommendations, the Commission may request a Member State to review and propose amendments to its Partnership Agreement and relevant programmes. The Commission has provided further details on how it would make use of that provision in guidelines on the application of the measures linking the effectiveness of the European Structural and Investment Funds to sound economic governance<sup>6</sup>.
- (5) Hungary is currently in the preventive arm of the Stability and Growth Pact and subject to the debt rule. In its 2018 Convergence Programme, the Government plans a deterioration of the headline deficit from 2.0 % in 2017 to 2.4 % in 2018 and a gradual improvement thereafter to 0.5 % of GDP by 2022. The medium-term budgetary objective — a structural deficit of 1.5 % of GDP — is planned to be met by 2020. Based on the recalculated structural balance<sup>7</sup>, the medium-term budgetary objective would be reached by 2022. According to the Convergence Programme, the general government debt-to-GDP ratio is expected to decline gradually to slightly below 60 % by the end of 2022. The macroeconomic scenario underpinning those budgetary projections is favourable, which poses notable risks to the implementation of the deficit targets.
- (6) The 2018 Convergence Programme indicates that the budgetary impact of the security-related measures in 2017 is significant, and provides adequate evidence of the scope and nature of these additional budgetary costs. According to the Commission, the eligible additional expenditure in 2017 amounted to 0.17 % of GDP for security-related measures. The provisions set out in Articles 5(1) and 6(3) of Regulation (EC) No 1466/97 cater for this additional expenditure, in that the severity of the terrorist threat are unusual events, their impact on Hungary's public finances is significant and sustainability would not be compromised by allowing for a temporary deviation from the adjustment path towards the medium-term budgetary objective. Therefore, the required adjustment towards the medium-term budgetary objective for 2017 has been reduced to take into account these additional costs.
- (7) On 12 July 2016, the Council recommended Hungary to achieve an annual fiscal adjustment of 0.6 % of GDP towards the medium-term budgetary objective in 2017 unless the medium-term budgetary objective was respected with a lower effort. Based

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<sup>5</sup> Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006 (OJ L 347, 20.12.2013, p. 320).

<sup>6</sup> COM(2014) 494 final.

<sup>7</sup> Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

on 2017 outturn data Hungary was found to be in significant deviation from the adjustment path toward the medium-term budgetary objective. In line with Article 121(4) TFEU and Article 10(2) of Council Regulation (EC) No 1466/97, the Commission issued a warning to Hungary on 23 May 2018 that a significant deviation from the adjustment path toward the medium-term budgetary objective was observed in 2017. On XX June, the Council adopted a subsequent recommendation confirming the need for Hungary to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure<sup>8</sup> does not exceed 2.8 % in 2018, corresponding to an annual structural adjustment of 1 % of GDP. Based on the Commission 2018 spring forecast, there is a risk of a deviation from the recommended effort.

- (8) In 2019, in view of Hungary's general government debt ratio above 60 % of GDP and projected output gap of 2.3 %, the nominal growth rate of net primary government expenditure should not exceed 3.9 %, in line with the structural adjustment of 0.75 % of GDP stemming from the matrix of requirements under the Stability and Growth Pact. Based on the Commission 2018 spring forecast, there is a risk of a significant deviation from that requirement in 2019. Overall, the Council is of the opinion that significant further measures will be needed as of 2018 to comply with the provisions of the Stability and Growth Pact, in light of a strongly deteriorating fiscal outlook, in line with the recommendation addressed to Hungary on XX June 2018 with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective.
- (9) The overall employment rate has improved significantly and the favourable economic trend provides an opportunity to reintegrate notably unemployed people into the labour market. The gender employment gap is wide, especially in the 25-39 age group, which can in part be explained by a limited supply of good quality childcare. The level of participation in childcare for children under the age of 3 is well under the Barcelona target and the EU average. Although the public work scheme remains the main active labour market policy, the number of participants in it having decreased significantly represents a positive development. Nonetheless, the scheme remains insufficiently focused and its effectiveness in reintegrating participants into the open labour market continues to be limited considering the labour market situation. Active labour market policies which focus more on up- and reskilling are under-developed.
- (10) The proportion of people at risk of poverty and social exclusion has decreased to 26.3 % in 2016 but remains above the EU average. Children in general are more exposed to poverty than other age groups. The level of minimum income benefits is below 50 % of the poverty threshold for a single household, making it among the lowest in the EU. The adequacy of unemployment benefits is very low: the maximum duration of 3 months ranks as the shortest in the EU, and represents only around a quarter of the average time required by job seekers to find employment. In addition, the levels of payment are among the lowest in the EU.

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<sup>8</sup> Net primary government expenditure comprises total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a 4-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

- (11) The Hungarian social dialogue structures and processes remain underdeveloped and do not allow for a meaningful involvement of social partners in policy design and implementation. The deficiencies in stakeholders' engagement and the limited transparency have an impact on the evidence base for and quality of policy making, creating uncertainty for investors and slowing down convergence.
- (12) Measures have been implemented to improve the tax system, but some problems remain. Although decreasing, the tax wedge on labour, especially for certain low-income groups, is still high in EU comparison. The overall complexity of the tax system, coupled with the continued presence of sector-specific taxes, remains a weakness. Measures against taxpayer's aggressive planning strategies are essential to impede distortions of competition between firms, provide fair treatment of taxpayers and safeguard public finances. Spill-over effects of taxpayer's aggressive planning strategies between Member States call for a coordinated action of national policies to complement EU legislation. Hungary records relatively high capital inflows and outflows through special purpose entities, which are disconnected from the real economy. The absence of withholding taxes on outbound (i.e. from EU residents to third country residents) dividend, interest and royalty payments made by companies based in Hungary may lead to those payments escaping tax altogether, if they are also not subject to tax in the recipient jurisdiction. The Commission takes note that Hungary acknowledges that outbound payment may lead to aggressive tax planning if misused. Based on recent exchanges, the Commission will continue its constructive dialogue to fight against taxpayers aggressive planning strategies.
- (13) Regulatory barriers in services, and retail trade in particular, impact on the sector's performance and hamper the efficient reallocation of resources, productivity and innovation. There is a continuous trend to entrust certain services to state-owned firms specifically created for these purpose, to the detriment of open competition. Unpredictability of the legal framework is a further problem, especially in the retail sector, which in recent years has been faced with frequent changes to regulations. As the proposed regulations are often tailored to turnover or floor size, they mainly affect foreign retail chains. This increases uncertainty among business operators and can deter investment. A stable regulatory environment favourable to competition is needed. Restrictive regulation of professions remains high in Hungary, in particular with respect to key professions like accounting and legal services.
- (14) Concerns remain regarding preventing and prosecuting corruption. According to several indicators, Hungary's exposure to corruption appears to have increased over the past years and the risks of corruption could negatively affect the country's growth potential. The functioning of the prosecution service is of crucial importance to fight corruption and money laundering and while measures to fight low-level corruption appear to have been applied with some success, there is not enough focus on starting investigations into high-level cases. Limited transparency and restrictions on access to information further hinder measures to prevent corruption. Significant steps have been taken regarding public procurement, but there is scope to further improve transparency and competition in tendering processes.
- (15) Education outcomes for basic skills are significantly below the EU average, especially for children from disadvantaged socioeconomic background. Pupils are streamed early into different types of schools, with wide gaps in education outcomes and employment paths. Disadvantaged children, including Roma children, tend to be concentrated in vocational secondary schools which are characterised by poorer levels of basic skills and higher dropout rates, and people who leave these schools receive lower wages on

average. The early school leaving rate increased to 12.4 % on average, and is particularly high among Roma children. These challenges are especially pressing in the context of quality and inclusive education. The shrinking pool of applicants and high drop-out rates in tertiary education will further limit attainment rates at a time when the demand for highly-skilled workforce is growing.

- (16) Poor health outcomes, aggravated by unhealthy lifestyles, persist, having a negative impact on human capital. Low levels of healthcare spending, coupled with an inefficient allocation of resources, limit the effectiveness of the Hungarian healthcare system. This, together with a high reliance on out-of-pocket payments, has negative equity implications for the timely access to affordable, preventive and curative health care of good quality. Shortage of health care workers also hampers access to care, although recent salary increases have mitigated this challenge. Ongoing reform efforts are focused on tackling excessive use of hospital care services, a key cause of which is that primary care providers are not appropriately equipped to act as effective gatekeepers. Further rationalisation of hospital resources use, together with targeted investments to strengthen primary care services, would enable the reduction of disparities in access to care, drive efficiency gains and effectively improve health outcomes.
- (17) In the context of the 2018 European Semester, the Commission has carried out a comprehensive analysis of Hungary's economic policy and published it in the 2018 country report. It has also assessed the 2018 Convergence Programme and the 2018 National Reform Programme and the follow-up given to the recommendations addressed to Hungary in previous years. The Commission has taken into account not only their relevance for sustainable fiscal and socioeconomic policy in Hungary but also their compliance with Union rules and guidance, given the need to strengthen the Union's overall economic governance by providing Union-level input for future national decisions.
- (18) In the light of this assessment, the Council has examined the 2018 Convergence Programme and its opinion<sup>9</sup> is reflected in particular in recommendation 1 below.

HEREBY RECOMMENDS that Hungary take action in 2018 and 2019 to:

- 1. In 2018, ensure compliance with the Council recommendation of XX June 2018 with a view to correcting the significant deviation from the adjustment path toward the medium-term budgetary objective. In 2019, ensure that the nominal growth rate of net primary government expenditure does not exceed 3.9 %, corresponding to an annual structural adjustment of 0.75 % of GDP.
- 2. Continue simplifying the tax system, in particular by reducing sector specific taxes. Improve the quality and transparency of the decision-making process through effective social dialogue and engagement with other stakeholders and by regular, adequate impact assessments. Reinforce the anti-corruption framework, strengthen prosecutorial efforts and improve transparency and competition in public procurement inter alia through making data gained from the e-procurement system accessible to the public. Strengthen competition, regulatory stability and transparency in the services sector, notably in retail.
- 3. Unlock labour reserves through improving the quality of active labour market policies. Improve education outcomes and increase the participation of

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<sup>9</sup> Under Article 5(2) of Council Regulation (EC) No 1466/97.

disadvantaged groups, in particular Roma, in quality and inclusive mainstream education. Improve the adequacy and coverage of social assistance and unemployment benefits.

Done at Brussels,

*For the Council*  
*The President*