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To: Council

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Subject: Recommendation for a COUNCIL RECOMMENDATION on the 2019 National Reform Programme of Hungary and delivering a Council opinion on the 2019 Convergence Programme of Hungary

Delegations will find attached the above mentioned draft Council Recommendation, as revised and agreed by various Council committees, based on the Commission Proposal COM(2019) 517 final.

COUNCIL RECOMMENDATION

of ...

on the 2019 National Reform Programme of Hungary and delivering a Council opinion on the 2019 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 policies¹, and in particular Article 9(2) thereof,

Having regard to the recommendation of the European Commission,

Having regard to the resolutions of the European Parliament,

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,

¹ OJ L 209, 2.8.1997, p. 1.

Whereas:

- (1) On 21 November 2018, the Commission adopted the Annual Growth Survey, marking the start of the 2019 European Semester for 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 21 March 2019. On 21 November 2018, on the basis of Regulation (EU) No 1176/2011 of the European Parliament and of the Council², 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 2019 country report for Hungary was published on 27 February 2019. It assessed Hungary's progress in addressing the country-specific recommendations adopted by the Council on 13 July 2018³, the follow-up given to the country-specific recommendations adopted in previous years and Hungary's progress towards its national Europe 2020 targets
- (3) On 30 April 2019, Hungary submitted its 2019 National Reform Programme and its 2019 Convergence Programme. In order to take account of their interlinkages, the two programmes have been assessed at the same time.

² Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances (OJ L 306, 23.11.2011, p. 25).

³ OJ C 320, 10.9.2018, p. 72.

- (4) Relevant country-specific recommendations have been addressed in the programming of the European Structural and Investment Funds ('ESI Funds') for 2014-2020. As provided for in Article 23 of Regulation (EU) No 1303/2013 of the European Parliament and of the Council⁴, 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 ESI Funds to sound economic governance.
- (5) Hungary is currently in the preventive arm of the Stability and Growth Pact and subject to the debt rule. In its 2019 Convergence Programme, the government plans an improvement of the headline deficit to 1,8 % of gross domestic product (GDP) in 2019 from 2,2 % in 2018. The deficit is planned to continue gradually improving thereafter to 1,2 % in 2021 and to reach a balanced budgetary position in 2023. Based on the recalculated structural balance (⁵), Hungary would be close to its medium-term budgetary objective — which has been changed from a structural deficit of 1,5 % of GDP in 2019 to 1,0 % of GDP as of 2020 — in 2022 and would achieve it in the following year. According to the Convergence Programme, the general government debt-to-GDP ratio is expected to decline gradually to below 60 % by the end of 2022. The macroeconomic scenario underpinning those budgetary projections is plausible for 2019 and markedly favourable from 2020, which poses risks to the implementation of the deficit targets. At the same time, the measures needed to support the planned deficit targets from 2020 onwards have not been sufficiently specified.

⁴ 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).

⁵ Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

(6) On 22 June 2018, the Council found in accordance with Article 121(4) of the Treaty on the Functioning of the European Union that a significant observed deviation from the adjustment path towards the medium-term budgetary objective occurred in Hungary in 2017. In view of the established significant deviation, on 22 June 2018 the Council issued a Recommendation⁶, recommending that Hungary take the necessary measures to ensure that the nominal growth rate of net primary government expenditure⁷ did not exceed 2,8 % in 2018, corresponding to an annual structural adjustment of 1,0 % of GDP. On 4 December 2018, the Council adopted Decision (EU) 2018/2028⁸, establishing that Hungary had not taken effective action in response to its Recommendation of 22 June 2018, and issued a revised Recommendation⁹. In the Recommendation of 4 December 2018, the Council asked Hungary to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 3,3 % in 2019, corresponding to an annual structural adjustment of 1,0 % of GDP. On 14 June 2019, the Council adopted Decision (EU) 2019/1003¹⁰, establishing that Hungary had not taken effective action in response to the Council Recommendation of 4 December 2018. Moreover, based on 2018 outturn data, Hungary was found to be in significant deviation from the recommended adjustment in 2018.

⁶ Council Recommendation of 22 June 2018 with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Hungary (OJ C 223, 27.6.2018, p. 1).

⁷ 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 four-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.

⁸ Council Decision (EU) 2018/2028 of 4 December 2018 establishing that no effective action has been taken by Hungary in response to the Council Recommendation of 22 June 2018 (OJ L 325, 20.12.2018, p. 29).

⁹ Council Recommendation of 4 December 2018 with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Hungary (OJ C 460, 21.12.2018, p. 4).

¹⁰ Council Decision (EU) 2019/1003 of 14 June 2019 establishing that no effective action has been taken by Hungary in response to the Council Recommendation of 4 December 2018 (OJ L 163, 20.6.2019, p. 64).

- (7) In line with Article 121(4) of the Treaty and Article 10(2) of Regulation (EC) No 1466/97, the Commission issued a warning to Hungary on 5 June 2019 that a significant deviation from the adjustment path towards the medium-term budgetary objective was observed in 2018. On 14 June 2019, the Council adopted a subsequent Recommendation¹¹ confirming the need for Hungary to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 3,3 % in 2019, corresponding to an annual structural adjustment of 1,0 % of GDP. Based on the Commission 2019 spring forecast, there is a risk of a deviation from that Recommendation in 2019.
- (8) In its Recommendation of 14 June 2019, the Council recommended Hungary to take the measures necessary to ensure that the nominal growth rate of net primary government expenditure does not exceed 4,7 % in 2020, corresponding to an annual structural adjustment of 0,75 % of GDP. This would put Hungary on an appropriate adjustment path towards the medium-term budgetary objective. Based on the Commission 2019 spring forecast under unchanged policies, there is a risk of a deviation from that requirement in 2020. Overall, the Council is of the opinion that significant further measures will be needed as of 2019 to comply with the provisions of the Stability and Growth Pact, in line with the Council Recommendation of 14 June 2019, with a view to correcting the significant observed deviation from the adjustment path towards the medium-term budgetary objective.

¹¹ Council Recommendation of 14 June 2019 with a view to correcting the significant observed deviation from the adjustment path towards the medium-term budgetary objective in Hungary (OJ C 210, 21.6.2019, p. 4).

- (9) The overall employment rate has improved significantly amid strong economic expansion but has not benefited all groups equally. The gaps in employment and wages between skills groups and men and women remain wide in comparison with the Union average. The gender employment gap is wide partly due to the limited supply of good quality childcare. Labour market outcomes for various vulnerable groups, including Roma and people with disabilities, are weak. Despite its reduction, the Public Works Scheme, which is not effective in leading participants to the jobs in the primary labour market, remains sizeable. Other policies to help unemployed or inactive people find work or training are insufficiently targeted. Developing digital skills could help improve employability. Recent measures are designed to get more retired workers back into jobs and to increase their number over time. Hungary's overall poverty situation has been improving since 2013. The duration of unemployment benefits is the shortest in the Union, at a maximum of three months, which is well below the average amount of time needed to find a job.
- (10) The share of people at risk of poverty and social exclusion is falling. There has been a clear shift from social benefits towards work-related family support and in-kind benefits, which are however not sufficiently targeted to the poor. While home-ownership subsidies have expanded, there has been no improvement in the supply of social housing.

(11) Education outcomes are below the Union average and show wide territorial disparities. Early school leaving is higher and the tertiary education attainment rate lower than the Union average. The education system hinders social mobility. Pupils are streamed early into different types of schools, with wide gaps in education outcomes and employment paths. The proportion of primary schools with majority Roma participation increased from 10 % in 2008 to 15 % in 2017. The impact of recent measures targeting the even distribution of disadvantaged pupils across schools is limited by the exemption of non-state schools from the requirement to take disadvantaged pupils. Disadvantaged children tend to be concentrated in vocational secondary schools where poorer levels of basic skills, higher dropout rates and lower pay and career prospects are more prevalent. The low participation of disadvantaged groups, in particular Roma, in quality education is a missed opportunity to build up human capital. The shortage of teachers also remains a challenge. Teachers' salaries have risen in recent years but are still relatively low, compared to other tertiary education graduates. The low number of students participating in higher education is not in line with the strong demand for highly skilled workers and the wage premium of tertiary graduates, which is the highest in the Union. Hungarian higher education institutions have the lowest financial autonomy in the Union. In addition, the April 2017 amendment of the Higher Education Act, which set additional requirements for international universities to operate in Hungary, raised further concerns over academic freedom. In 2018, the internationally highest ranked Hungarian university signalled its intention to leave the country because of the regulatory uncertainty created by this amendment.

- (12) Health outcomes lag behind most other Member States, reflecting both unhealthy lifestyles and the limited effectiveness of healthcare provision. The prevalence of smoking, alcohol use disorder and obesity is one of the highest in the Union. Hungarians are among the most likely in the Union to suffer premature death due to bad air quality. The number of avoidable deaths is one of the highest in the Union, partly due to inadequate screening and primary care management. There are significant socio-economic disparities in access to quality care. Public spending on healthcare is below the Union average, and citizens rely on out-of-pocket payments to access quality care, which risks further widening the socio-economic health divide. The system remains strongly hospital-centred, with weaknesses in primary care, in particular early detection and prevention of chronic diseases. A sizeable shortage of healthcare staff, in particular general practitioners and nurses, thwarts access to care in poorer areas.
- (13) Increasing research and innovation capacities could improve Hungary's modest innovation performance and increase productivity. The low level of intellectual asset accumulation is reflected in the low number of patent, trademark and design applications, the small number of innovative businesses and the low level of internationalisation by small and medium-sized enterprises. Smaller firms are especially reluctant to innovate, hindering their involvement in global value chains. Business R&D is concentrated in a few large, mainly foreign-owned companies and benefits from generous government support. Supporting science-business cooperation would contribute to better innovation performance and technology transfer. The quality of public science is suffering from inefficient R&D policies and underfunding as public sector R&D expenditure is well below the Union average. Recent policy measures aiming to cut the funding and limiting the independence of academic and research fora are creating uncertainty in those fora, which may result in the emigration of top research talent and risk a persistent decline in research quality.

- (14) Weak local public transport connectivity and high commuting costs are contributing to unemployment in disadvantaged areas. The poor condition of the road and rail networks hampers mobility and reduces travel safety, with more than half of the road network in bad condition, especially in disadvantaged regions. Transport networks are centred on Budapest, while local networks and transversal connections through the country are not well developed. Road congestion is a growing challenge and a barrier to productivity in Hungary's urban areas. Moreover, greenhouse gas emissions from road transport have increased strongly in the last 5 years.
- (15) Energy efficiency in the residential sector remains weak. The electricity network needs to be prepared for the growing role of decentralised renewable electricity generation. Half of Hungary's territory is significantly exposed to climate change risks including drought and floods, which create the need for investment in water management on the main rivers. Air pollution and water quality remain a concern. The main sources of pollution are residential solid fuel combustion, agriculture and transport emissions. The circular economy is still in an initial phase, recycling of municipal waste is underdeveloped and economic instruments are insufficient to address Hungarian environmental challenges.
- (16) Concerns remain over the prevention and prosecution of corruption. Several indicators suggest that Hungary's exposure to corruption has increased in recent years. Corruption risks and favouritism distort the allocation of resources as these are not channelled to the most productive firms. The functioning of the prosecution service is of crucial importance to fighting corruption. While measures to fight low-level corruption appear to have been applied with some success, there are still no signs of determined action to prosecute corruption involving high-level officials or their immediate circle when serious allegations arise. Accountability for decisions to close investigations is a matter of concern, as there are no effective remedies to contest such decisions. The prevention of corruption is further hindered by public institutions applying restrictions, including dissuasive fees for access to information.

- (17) The independence, efficiency and quality of the justice system are crucial to attracting business and enabling economic growth. Checks and balances, which are crucial to ensuring judicial independence, are seen to be under further pressure within the ordinary courts system. The National Judicial Council faces increasing challenges in counter-balancing the powers of the President of the National Office for the Judiciary. Questions have been raised regarding the consequences of this for judicial independence. With regard to the Administrative Courts Law, it is noted that the government tabled a bill withdrawing the Act on the entry into force and transitional rules for the administrative courts on 30 May 2019.
- (18) The public procurement framework has improved in recent years but obstacles to competition remain. These include the use of procedures with limited publicity and systemic irregularities in the tendering processes, in particular related to inadequate selection and award criteria and unequal treatment of tenderers. While some indicators show improvements, the number of procedures with a single bidder are still high. The effective use of e-procurement could further increase efficiency and transparency.
- (19) Hungary's social dialogue structures and processes remain underdeveloped and do not allow for meaningful involvement of the social partners in policy design and implementation. The deficiencies in stakeholder engagement and limited transparency undermine the evidence base for, and the quality of, policymaking. This results in frequent and unpredictable changes in regulations and discourages high-value-added investments.
- (20) Measures have been taken to further improve the tax system but some challenges remain. The tax burden on labour has decreased but remains high for low-income earners. Sector-specific taxes and a large number of small taxes complicate the tax system and raise compliance costs, in particular for smaller firms.

- (21) Regulatory barriers and State involvement in product markets hinder the selection of efficient enterprises and limit competition. The authorities continue to entrust certain services to State-owned firms or private firms specifically created for these purposes. Certain tailor-made legislation and measures and ad hoc exemptions from competition scrutiny hinder the functioning of the market and hamper investment. The unpredictability of the legal framework is a further problem, especially in the retail sector, which in recent years has faced frequent changes to regulations. Legislation imposing an additional special authorisation for modifications to the use or design of retail premises has been introduced in the past year. Regulation of professions also remains restrictive. The lack of competition in these sectors may become detrimental to innovation and efficiency.
- (22) The fight against aggressive tax planning is essential in making tax systems more efficient and fairer. Spillover effects of taxpayers' aggressive tax-planning strategies between Member States call for a coordinated action of national policies to complement Union legislation. Hungary has taken measures against aggressive tax planning, but records relatively high capital inflows and outflows through special-purpose entities, which have no or little effect on the real economy. The absence of withholding taxes on outbound (i.e. from Union 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.
- (23) The programming of Union funds for the period 2021-2027 could help address some of the gaps identified in the recommendations, in particular in the areas covered by Annex D to the 2019 country report. This would allow Hungary to make the best use of those funds in respect of the identified sectors, taking into account regional disparities.

- (24) In the context of the 2019 European Semester, the Commission has carried out a comprehensive analysis of Hungary's economic policy and published it in the 2019 country report. It has also assessed the 2019 Convergence Programme, the 2019 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 into future national decisions.
- (25) In the light of this assessment, the Council has examined the 2019 Convergence Programme and its opinion¹² is reflected in particular in recommendation (1) below,

HEREBY RECOMMENDS that Hungary take action in 2019 and 2020 to:

1. Ensure compliance with the Council Recommendation of 14 June 2019 with a view to correcting the significant deviation from the adjustment path towards the medium-term budgetary objective.
2. Continue the labour market integration of the most vulnerable groups, in particular through upskilling, and improve the adequacy of social assistance and unemployment benefits. Improve education outcomes and increase the participation of disadvantaged groups, in particular Roma in quality mainstream education. Improve health outcomes by supporting preventive health measures and strengthening primary healthcare.
3. Focus investment-related economic policy on research and innovation, low-carbon energy, transport infrastructure, and waste management and energy and resource efficiency, taking into account regional disparities. Improve competition in public procurement.

¹² Under Article 9(2) of Regulation (EC) No 1466/97.

4. Reinforce the anti-corruption framework, including by improving prosecutorial efforts and access to public information, and strengthen judicial independence. Improve the quality and transparency of the decision-making process through effective social dialogue and engagement with other stakeholders and through regular, appropriate impact assessments. Continue simplifying the tax system, while strengthening it against the risk of aggressive tax planning. Improve competition and regulatory predictability in the services sector.

Done at Brussels,

For the Council

The President
