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Recommendation for a

COUNCIL RECOMMENDATION

on the National Reform Programme 2011 of Hungary

and delivering a Council opinion

on the updated Convergence Programme of Hungary, 2011-2015

{SEC(2011) 725 final}

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THE COUNCIL OF THE EUROPEAN UNION,

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

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], and in particular Article 9(3) thereof,

Having regard to the recommendation of the European Commission[2],

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

After consulting the Economic and Financial Committee,

Whereas:

(1) On 26 March 2010, the European Council agreed to the European Commission's proposal to launch a new strategy for jobs and growth, Europe 2020, based on enhanced coordination of economic policies, which will focus on the key areas where action is needed to boost Europe’s potential for sustainable growth and competitiveness.

(2) On 13 July 2010, the Council adopted a recommendation on the broad guidelines for the economic policies of the Member States and the Union (2010 to 2014) and on 21 October 2010, adopted a decision on guidelines for the employment policies of the Member States[3], which together form the “integrated guidelines”. Member States were invited to take the integrated guidelines into account in their national economic and employment policies.

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1 OJ L 209, 2.8.1997, p. 1.
2 OJ C , , p. .
3 Maintained for 2011 by Council Decision 2011/308/EU of 19 May 2011.

(3) On 12 January 2011, the Commission adopted the first Annual Growth Survey, marking the start of a new cycle of economic governance in the EU and the first European semester of ex-ante and integrated policy coordination, which is anchored in the Europe 2020 strategy.

(4) On 25 March 2011, the European Council endorsed the priorities for fiscal consolidation and structural reform (in line with the Council's conclusions of 15 February and 7 March 2011 and further to the Commission's Annual Growth Survey). It underscored the need to give priority to restoring sound budgets and fiscal sustainability, reducing unemployment through labour market reforms and making new efforts to enhance growth. It requested Member States to translate these priorities into concrete measures to be included in their Stability or Convergence Programmes and National Reform Programmes.

(5) On 15 April 2011, Hungary submitted its 2011 Convergence Programme update covering the period 2011-2015 and its 2011 National Reform Programme. In order to take account of the interlinkages, the two programmes have been assessed at the same time.

(6) Hungary was severely hit by the crisis in autumn 2008, with the country losing access to market-based financing. To overcome these difficulties, Hungary implemented an adjustment programme that focused on fiscal consolidation and financial sector supervision and was supported by financial assistance from the EU and the IMF. Against this background, the country regained market access in spring 2009 and the economy emerged from recession: after a contraction of 6.7% in 2009, GDP grew by 1.2% in 2010, supported by increasing exports. At the same time, unemployment increased further to over 11% from the pre-crisis level of below 8%. In the second half of 2010, the government announced significant tax cuts to be implemented over 2010-2013. To limit the fiscal deterioration, it introduced, in parallel, extraordinary levies and decided to abolish the mandatory private pension pillar. Although this made it possible to limit the slippage in 2010 to 0.4% of GDP above the deficit target of 3.8% of GDP and will result in a surplus in 2011, the underlining position deteriorated significantly. Against this background, and with a view to strengthening the economic growth potential, the government announced a structural reform programme in March 2011 and adopted further consolidating measures.

(7) Based on the assessment of the updated Convergence Programme pursuant to Council Regulation (EC) No 1466/97, the Council is of the opinion that, based on the Commission's 2011 spring forecasts, the macroeconomic scenario underpinning the budgetary projections is slightly too favourable, in particular regarding the development of domestic demand. The update aims to correct the excessive deficit by the 2011 deadline set by the Council, to be achieved with a surplus of 2% of GDP thanks to the significant one-off revenues from the pension assets. The budget would turn into a deficit of 2.5% of GDP in 2012 and thereafter gradually decline to 1.5% of GDP in 2015, mainly based on expenditure restraint. The update confirms the country's medium-term objective (MTO) for the budgetary position in structural terms, a deficit of 1.5% of GDP. The consolidation strategy is expected to reduce the budgetary deficit in a structural way and put the debt on a downward path to reach 64% of GDP by 2015. However, it appears to be back-loaded with structural improvement starting only from 2012 whereas the cumulative structural deterioration of over 3% of GDP over 2010 and 2011 is not in line with the Council

recommendation of July 2009 asking Hungary to achieve a structural adjustment of at least 0.5% of GDP. The spring forecast shows a deficit of 3.3% of GDP in 2012, which assumes some implementation risks; on this basis it cannot be excluded that the threshold may be breached again in that year unless further measures are taken. In addition, the projected deficit path does not provide for the necessary structural adjustments that would ensure achievement of the MTO by the end of the programme period; in particular, there is no further structural adjustment beyond 2013. Finally, the abolishment of the mandatory private pension pillar and the strong incentives provided for switching over to the public pension pillar result in additional revenues in short and medium term but also increases the long-term liabilities and so may deteriorate the long-term fiscal sustainability.

(8) Fiscal consolidation remains a major challenge. Without rigorous implementation of the measures announced and additional measures of a structural nature it cannot be ensured that the excessive deficit is corrected on a sustainable basis and appropriate progress is made towards the medium-term objective. Moreover, fiscal consolidation will also help to put debt reduction on an appropriately declining path and improve long-term sustainability which appears to be at medium risk. Making full use of windfall revenues could help accelerate the fiscal consolidation. Against this background, the authorities' bi-annual Excessive Deficit Procedure progress reports will serve as a useful tool for closely monitoring progress of fiscal consolidation.

(9) The recently adopted Constitution establishes a constitutional debt brake at 50% of GDP and gives the Fiscal Council a veto right over the annual budget, which could be a first step forward improving the budgetary framework. However, important details will only be specified in the subsequent 'cardinal' laws (e.g. what the temporary numerical rules will be until the debt ratio declines to 50%, the precise interpretation of the escape clause, etc.). The imposition of a nominal debt cap if used as an all-purpose device could, ceteris paribus, lead to a pro-cyclical fiscal stance. In addition, the remit of the revamped fiscal body is relatively narrow (preparing an opinion on the draft budget, with a right to veto) and does not cover the entire budgetary cycle (e.g. through real-time assessments of new policies with major budgetary implications). Finally, other aspects of fiscal governance, such as the medium-term orientation of fiscal policy and the issue of transparency have not yet been clarified.

(10) The employment rate is among the lowest in the EU (60.4%). The employment rate of women is also low (55.0%), while the gap between the employment rates of women with and without 0-6-year old children is the second biggest in the EU (33.6, against the EU average of 12.1 percentage points). There are deficiencies both in the capacity and in the quality of day-care services in Hungary, with particularly scant provision outside the larger cities, and in regions with very high unemployment. Improving day-care provision would be an important measure to facilitate both parents' participation in the labour force.

(11) Hungary has had a relatively high tax burden on labour. The new personal income tax system partly addresses its negative effects on employment, but the tax burden on low earners without children has in fact increased, especially when taking into account the phasing out of employment tax credits.

(12) The public employment services (PES) suffer from insufficient administrative capacity, and previous injections of funds have not improved the efficiency of services

in integrating the unemployed into the labour market. The funding of employment programmes is not sufficiently linked to results. The duration of unemployment benefits has recently been reduced to the lowest levels in the EU. The impact of this measure on the labour market needs to be assessed, in particular to determine its effectiveness in raising employment participation.

(13) Poverty and related factors such as joblessness or low education levels continue to affect some disadvantaged groups, particularly the Roma, disproportionately. The low-skilled have a particularly low employment rate (36.8%, compared with the European average of 53.4%), especially among men. According to estimates, 70% of the Roma population live under the poverty threshold. A great majority of them live in deprived regions, with little access to labour market opportunities and public services.

(14) SMEs have been hindered by the complexity of the regulatory framework, a heavy administrative burden and limited accountability and transparency in public administration. SMEs' access to early-stage financing has been more scant than the EU average. The National Reform Programme includes a number of measures to reduce administrative burdens. The role of non-banking funding mechanisms is lagging behind that played in other European countries. The effectiveness of prior programmes to support the sector has not been systematically evaluated.

(15) The Commission has assessed the Convergence Programme and National Reform Programme for Hungary and has also taken into account the government's intention to shadow the Euro Plus Pact[4]. It has taken into account not only their relevance for sustainable fiscal and socio-economic policy in Hungary but also their conformity with EU rules and guidance, given the need to reinforce the overall economic governance of the European Union by providing EU-level input into future national decisions. It considers that the fiscal adjustment strategy mainly based on the expenditure side is back-loaded. Hence, the 2011 deadline set by the Council for bringing the deficit below the 3% of GDP threshold is only met due to the significant one-off revenues from the pension assets. Structural improvement will not begin until 2012 and, taking into account the implementation risks, it cannot be excluded that the threshold may be breached again in that year unless further measures are taken. Moreover, in the longer term the Convergence Programme does not secure further progress towards the MTO. Further measures to increase labour market participation and modernise employment services would help to increase job opportunities. Further reductions in administrative burdens would help improve the business environment and help SMEs grow.

(16) In light of this assessment, also taking into account the Council Recommendation under Article 126(7) of the Treaty on the Functioning of the European Union of 7 July 2009, the Council has examined the 2011 update of the Convergence Programme of Hungary and its opinion[5] is reflected in particular in its recommendation under (1) and (2) set out below. Taking into account the European Council conclusions of 25 March 2011, the Council has examined the National Reform Programme of Hungary,

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[4] SEC(2011) 725.

[5] Foreseen in Article 9(3) of Council Regulation (EC) No 1466/97.

HEREBY RECOMMENDS that Hungary should take action within the period 2011-2012 to:

(1) Strengthen the fiscal effort to reduce the structural deterioration in 2011 implicit in the planned 2% of GDP budget surplus and avoid that the budget balance breaches the 3% of GDP threshold again in 2012. Adopt additional fiscal measures of a permanent nature at the latest in the 2012 budget to secure the budgetary targets for 2012 and 2013 in the Convergence Programme. Ensure progress towards the medium-term objective by at least 0.5% of GDP annually until the end of the programme horizon and use possible windfall revenues to accelerate the fiscal consolidation.

(2) Adopt and implement regulations specifying the operational aspects of the new constitutional fiscal governance framework, including, inter alia, the numerical rules that will be implemented at the central and local level until the debt ratio has declined to below 50% of GDP. Broaden the remit of the Fiscal Council to cover the entire budgetary cycle, in particular through real-time assessments of new policies with major budgetary implications and strengthen the fiscal framework to cover multiannual fiscal planning and to improve the transparency of public finances.

(3) Enhance participation in the labour market by alleviating the impact of the tax reform on low earners in a budget-neutral manner. Strengthen measures to encourage women's participation in the labour market by expanding childcare and pre-school facilities.

(4) Take steps to strengthen the capacity of the Public Employment Service and other providers to increase the quality and effectiveness of training, job search assistance and individualised services. Link funding of programmes to results. In consultation with stakeholders, introduce tailor-made programmes, for the low skilled and other particularly disadvantaged groups.

(5) Improve the business environment by implementing all the measures envisaged for regulatory reform and lowering administrative burdens in the National Reform Programme; assess the effectiveness of current SME support policies and adjust public programmes in order to improve access to non-bank funding.

Done at Brussels,

For the Council
The President