Executive summary

- *Main findings*
- *Key recommendations*

Main findings

Hungary has exited from recession in early 2013, but the recovery will be modest. Growth potential is held back by weak investment, low employment among low-skilled workers and shortcomings in labour and product markets, making further structural reforms essential. Meagre growth and its causes harm well-being in ways that go beyond GDP per capita and concern income inequalities and the scope for social mobility. Access to international bond markets has improved significantly, but the still high foreign currency indebtedness remains a key vulnerability.

Monetary policy and financial stability. Monetary easing has helped the return to growth. Successive cuts in the policy rate to historical lows have been largely transmitted to rates on new loans. The Funding for Growth Scheme, which is being extended, has provided banks with free refinancing for SME lending. Despite strong take-up, it is still unclear whether the Scheme is creating new lending or displacing other credit. Lending remains hampered by poor bank profitability and high non-performing loans. Foreign-currency mortgage relief schemes have begun to address high foreign-currency indebtedness.

Fiscal policy. Maintaining fiscal discipline will be important to preserve market access and put public debt on a durably declining path. A number of special taxes introduced over recent years have helped bring the budget deficit below 3% of GDP, but have begun to undermine the predictability and simplicity of the tax system. In particular, the tax on banks' balance sheets is likely to have reduced lending incentives. The fiscal framework will be reinforced by the introduction of medium-term budgeting. The mandate of the fiscal council is relatively narrow and it has a potentially very powerful veto over budget laws.

Competition and the business environment. Enhancing competition and the business environment is key to stronger investment and productivity. Despite recent simplification efforts, as part of an overall strategy to improve the business environment, high administrative burdens persist and regulatory instability has worsened, partly due to poor consultation and weak impact assessment mechanisms. Competition enforcement has been weakened in some respects. Perceptions of institutional quality, including the maintenance of appropriate checks and balances, have deteriorated, which may deter investment. Barriers to entry have limited competition in retail, professional services and telecommunications, hampering productivity both within sectors and in downstream industries. Government interventions in regulated energy prices, with industry cross-subsidising households, have hurt competitiveness and the environment.

Labour market and mobility. Employment is hampered by skills mismatches and low mobility. Low-skilled labour supply greatly exceeds demand, especially in disadvantaged regions, notably because of high labour costs, despite recent targeted cuts in social contributions. The public works programme has increased employment, but has a poor record in reintegrating the non-employed to regular work. EU co-financed activation policies were upscaled, but the short duration of unemployment benefits and limited capacity of the Public Employment Service inhibit good labour matching. Education outcomes are relatively good on average, but the poor performance of disadvantaged students, notably Roma, limits their employment prospects and social mobility. Generalised homeownership, which is still encouraged by generous mortgage interest subsidies and very low recurrent property taxes, and relatively high public transport costs are obstacles to mobility.

Key recommendations

Monetary policy and financial stability

- Assess the effect of the Funding for Growth Scheme on credit and investment before extending it further. Consider linking the refinancing rate to the policy rate, or the quantity and price of funds available to participating banks to changes in their net lending to SMEs. The banks' allowed interest rate margin could also be reassessed.
- To clean up bank portfolios, tighten reporting and provisioning requirements for restructured loans and lending to the riskiest sectors, and take further steps to ease and stimulate collateral liquidation.
- Improve banks' operating environment and profitability, notably by reducing instability and tax burdens, and improving tax design.

Fiscal policy

- Gradually scale down the special taxes introduced over recent years. Instead, rely on more growth, equity and environmental-friendly instruments, such as recurring municipal property taxes and taxation of energy use, and reform family benefits.

Competition and the business environment

- To improve regulatory quality and stability, introduce mandatory consultation with experts and stakeholders for parliament-initiated legislation, and further build capacity for high-quality regulatory impact assessment of government-initiated legislation. Ensure timely and transparent related implementing regulations.
- Do not restrict the scope of competition law and ensure vigorous antitrust enforcement.
- Reduce barriers to entry in retail by substantially raising the surface threshold for the regulation of retail outlets. Reconsider training requirements and exclusive rights in professional services with a view to reducing them. Promote entry in telecommunications by ensuring that mobile virtual operators can access networks on competition-enabling conditions.
- Move towards market-based pricing in electricity and gas by vesting the right to set regulated prices in the sectoral regulator.

Labour market and mobility

- To stimulate low-skilled employment, further reduce the tax wedge on low salaries. Also, avoid increasing the minimum wage by more than warranted by inflation and productivity developments, and consider even freezing it for some time.
- Foster labour matching by scaling up the Public Employment Service (PES) and increasing somewhat unemployment benefit duration. Improve reintegration of public works' participants through carefully evaluated training and local co-operation between the PES, municipalities, non-governmental organisations and private firms.
- Enhance education outcomes and reduce inequalities by targeting more resources to disadvantaged schools, tackling school segregation, delaying tracking in secondary education and promoting participation of disadvantaged students in tertiary education.
- Reduce the fiscal bias to homeownership to encourage the emergence of a sizeable rental market.

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