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This Survey *is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.*

The economic situation and policies of Hungary were reviewed by the Committee on 11 December 2013. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 20 December 2013.

The Secretariat's draft report was prepared for the Committee by Álvaro Pina and Stéphane Sorbe under the supervision of Pierre Beynet. Research assistance was provided by Desney Erb. The report also benefitted from the co-operation of Gábor Horváth, seconded from the Hungarian Ministry for National Economy.

The previous Survey *of Hungary was issued in March 2012.*

BASIC STATISTICS OF HUNGARY, 2012

(Numbers in parentheses refer to the OECD average)[a]

LAND, PEOPLE AND ELECTORAL CYCLE

Population (million)	10.0		Population density per km²	107.3	(34.3)
Under 15 (%)	14.5	(18.1)	Life expectancy (years, 2011)	75.0	(80.0)
Over 65 (%)	17.0	(15.3)	Men	71.2	(77.3)
Foreign-born (%, 2011)	4.7		Women	78.7	(82.8)
Latest 5-year average growth (%)	-0.2	(0.5)	Last general election		April 2010

ECONOMY

Gross domestic product (GDP)			Value added shares (%)		
In current prices (billion USD)	124.9		Primary sector	4.7	(2.5)
In current prices (billion HUF)	28 082		Industry including construction	30.6	(27.4)
Latest 5-year average real growth (%)	-1.1	(0.6)	Services	64.7	(69.7)
Per capita, PPP (thousand USD)	21.9	(37.2)			

GENERAL GOVERNMENT

Per cent of GDP

Expenditure	48.6	(42.8)	Gross financial debt	90.0	(102.3)
Revenue	46.5	(36.4)	Net financial debt	61.1	(64.0)

EXTERNAL ACCOUNTS

Exchange rate (HUF per USD)	224.8		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	128.5		Machinery and transport equipment	51.6	
In per cent of GDP			Manufactured goods	10.4	
Exports of goods and services	94.6	(53.8)	Chemicals and related products, n.e.s.	9.9	
Imports of goods and services	87.2	(50.4)	Main imports (% of total merchandise imports)		
Current account balance	0.9	(-0.5)	Machinery and transport equipment	41.6	
Net international investment position (2010)	-111.6		Manufactured goods	12.8	
			Mineral fuels, lubricants and related materials	12.7	

LABOUR MARKET, SKILLS AND INNOVATION

Employment rate (%) for 15-64 year-olds	57.2	(65.0)	Unemployment rates (%)		
Men	62.5	(73.1)	Total (age 15 and over)	10.9	(7.9)
Women	52.1	(57.0)	Youth (age 15-24)	28.1	(16.2)
Average hours worked per year	1 888	(1 776)	Long-term unemployed (1 year and over)	5.1	(2.7)
Gross domestic expenditure on R&D (% of GDP, 2011)	1.2	(2.4)	Tertiary educational attainment 25-64 year-olds (%, 2011)	21.1	(31.5)

ENVIRONMENT

Total primary energy supply per capita (toe)	2.4	(4.2)	CO_2 emissions from fuel combustion per capita (tonnes, 2011)	4.7	(10.0)
Renewables (%)	8.0	(8.5)	Water abstractions per capita (1 000 m^3, 2008)	0.5	
Fine particulate matter concentration (urban, PM10, $\mu g/m^3$, 2010)	15.0	(20.1)	Municipal waste per capita (tonnes, 2011)	0.4	(0.5)

SOCIETY

Income inequality (Gini coefficient, 2009)	0.272	(0.305)	Education outcomes (PISA score, 2012)		
Relative poverty rate (%, 2009)	6.8	(10.7)	Reading	488	(497)
Public and private spending (% of GDP)			Mathematics	477	(494)
Health care (2011)	7.9	(9.5)	Science	494	(501)
Pensions (2009)	10.5	(8.7)	Share of women in parliament (%, November 2013)	8.8	(26.0)
			Net official development assistance (% of GNI)	0.1	(0.4)

Better life index: *www.oecdbetterlifeindex.org*

a) Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exists for at least 29 member countries.

Source: Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, World Bank, International Monetary Fund and Inter-Parliamentary Union.

Executive summary

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.

Assessment and recommendations

- *Stronger and more inclusive growth*
- *Monetary policy and financial stability*
- *Fiscal policy*
- *Enhancing competition and the business environment*
- *Improving the efficiency and inclusiveness of the labour market*

Stronger and more inclusive growth

After being in recession in 2012, Hungary has returned to growth. Gradual monetary easing has helped the recovery without preventing a decline in inflation expectations. Progress in fiscal consolidation helped the country return to international bond markets in early 2013. Amidst more benign global financial conditions and reduced external vulnerabilities, interest rate spreads have trended downwards for most of the past 18 months and the forint has remained broadly stable since early 2012.

However, large short-term risks persist. As evidenced by increased financial market volatility since May 2013, following prospects of monetary policy normalisation in the United States, the region remains vulnerable to shifts in investor confidence (IMF, 2013a). Foreign currency indebtedness, which is still high, and sizeable public debt refinancing needs heighten Hungary's risk profile. Looking ahead, growth potential remains worryingly low. Deleveraging and policy instability keep private investment depressed, while high barriers to entry and other restrictive product market regulations hamper productivity growth. Labour market performance is held back by mismatches, the largest of which is reflected in the very low employment rate of low-skilled workers. Meagre growth and its causes harm well-being in ways that go beyond gross domestic product (GDP) per capita and concern income inequalities, housing conditions and the scope for social mobility.

This *Survey* examines how Hungary can enjoy stronger and more inclusive growth. Improving regulation and strengthening competition to make Hungarian firms more productive and give efficient small and medium-sized enterprises (SMEs) better chances to grow is discussed in Chapter 1. There is then an analysis of how reforms in labour market policies, education, housing and public transport can lead to a better matching of labour supply and demand in Chapter 2.

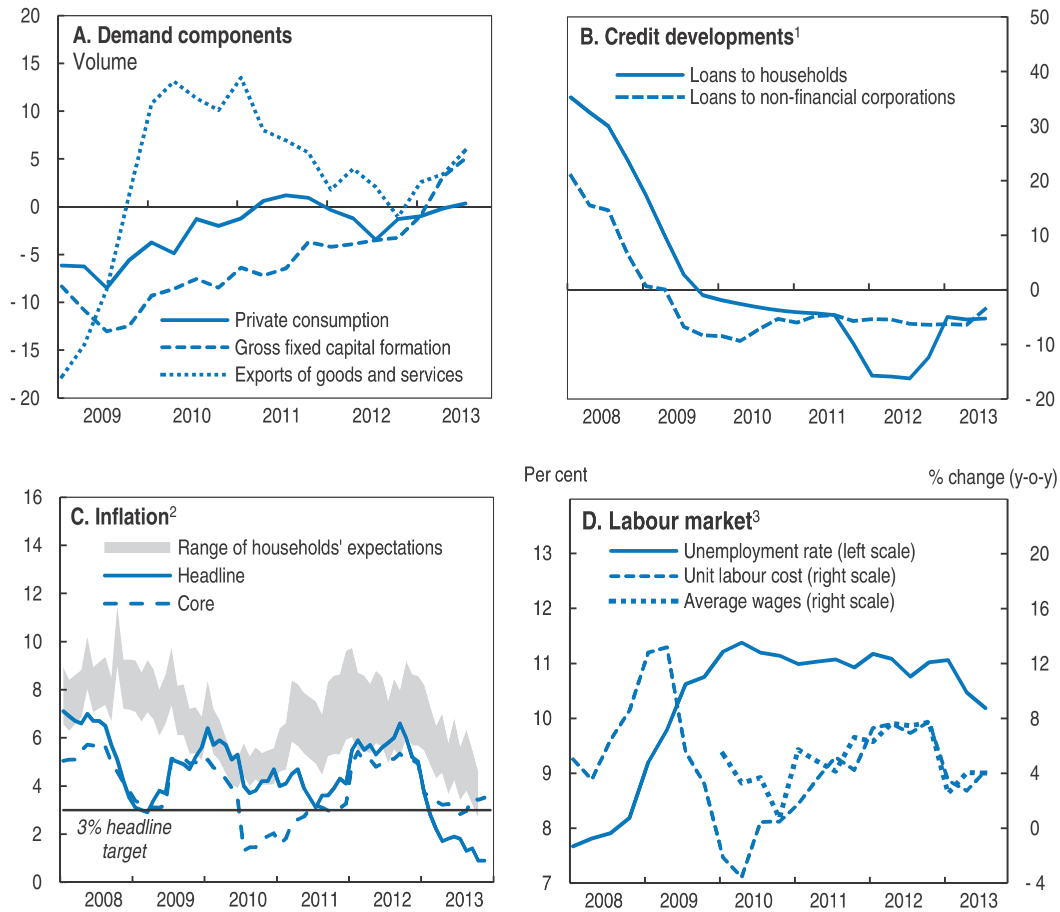
The pressing policy challenge is to stabilise the economy

GDP began growing again in early 2013. Over the course of the year, dynamism has gradually broadened from exports to domestic demand (Figure 1, Panel A). Public investment has strongly increased and, especially in manufacturing, private investment has also started to recover. However, the latter remains hampered by poor business confidence and tight credit (Figure 1, Panel B). The decrease in unemployment since the spring of 2013 is largely accounted for by the stepping up of public works schemes. Inflation has declined after the effects of a value-added tax (VAT) hike in 2012 dissipated and as administered prices of utilities were cut in 2013 (Figure 1, Panel C). Over the past year, inflation expectations have gradually adjusted to a lower inflation environment, though they remain higher than actual inflation and could help explain the sizeable wage growth in the private sector, where unit labour costs have outpaced prices (Figure 1, Panel D).

Domestic demand will likely accelerate in the near future, driven by large pay increases for teachers and medical professionals, a new round of energy price cuts, hikes

Figure 1. **Key indicators**

Year-on-year percentage change



1. Seasonally unadjusted net change in outstanding bank loans with rolling exchange rate adjustment.
2. Core inflation (national definition) excludes unprocessed food, energy and administered prices.
3. Unit labour costs and average wages in the business sector. Average wages covers gross monthly earnings of employees (without premiums or bonuses). The strong increases in 2012 are partly explained by a 19% rise in the minimum wage.

Source: Magyar Nemzeti Bank; Hungarian Central Statistical Office; OECD (2013), *OECD Economic Outlook: Statistics and Projections* and *Main Economic Indicators* (databases), December.

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in family benefits and EU-funded public investment. The economy is then expected to return to a more subdued pace of expansion, gradually closing the output gap (Table 1). Growth, however, will likely be held back by the factors behind low potential growth. As the cyclical slack wanes and firms start passing through cost pressures, inflation is projected to gradually pick up.

Negative risks mainly pertain to feedbacks between financial markets and the real economy. Change in investor sentiment associated with the tapering of quantitative easing in the United States or renewed tensions in the euro area could lead to capital outflows, higher interest rate spreads (Figure 2, Panel A) and forint depreciation *vis-à-vis* the euro and the Swiss franc. Depreciation would depress consumption and investment due to still high foreign currency indebtedness (Figure 2, Panel B) and worsen the negative feedback loop between credit contraction and non-performing loans (NPLs). Weaker external demand would hold back growth, especially if downside risks were to materialise in the

Table 1. **Macroeconomic indicators and projections**

Annual percentage change, volume (2005 prices)

	2010 Current prices (billion HUF)	2011	2012	2013	2014	2015
GDP	**26 513**	**1.6**	**-1.7**	**1.2**	**2.0**	**1.7**
Private consumption	14 074	0.4	-1.6	0.5	1.4	1.2
Government consumption	5 827	0.0	-1.2	-0.6	-0.2	-0.1
Gross fixed capital formation	4 920	-5.9	-3.7	0.0	1.1	1.4
Housing	659	-27.4	-11.8	-9.2	-2.6	-0.9
Final domestic demand	24 821	-1.0	-1.9	0.2	1.0	1.0
Stockbuilding[1]	190	0.4	-1.5	1.0	0.2	0.0
Total domestic demand	25 012	0.1	-3.7	1.6	1.2	0.9
Exports of goods and services	22 552	8.4	1.7	3.9	5.2	5.5
Imports of goods and services	21 050	6.4	-0.1	4.6	4.5	5.1
Net exports[1]	1 502	2.1	1.6	-0.3	1.0	0.8
Other indicators (growth rates, unless specified)						
Potential GDP	..	0.2	0.1	0.3	0.6	1.1
Output gap[2]	..	-1.8	-3.5	-2.6	-1.2	-0.7
Employment	..	0.8	1.7	1.3	0.9	0.0
Unemployment rate	..	10.9	10.9	10.4	10.1	10.3
GDP deflator	..	2.6	3.2	3.3	2.4	3.2
Consumer price index	..	3.9	5.7	1.9	2.1	3.5
Core consumer prices	..	1.0	3.9	3.7	3.2	3.5
Household saving ratio, net[3]	..	5.4	1.9	2.4	3.2	2.8
Current account balance[4]	..	0.4	0.9	1.8	2.1	2.4
General government financial balance[4]	..	4.2	-2.1	-2.7	-2.9	-2.9
Underlying general government financial balance[2]	..	-4.1	-1.6	-2.0	-2.8	-2.6
Underlying general government primary balance[2]	..	-0.4	2.3	2.0	1.3	1.4
Gross government debt (Maastricht)[4]	..	82.1	79.8	78.5	78.4	77.8
General government net debt[4]	..	53.3	61.2	61.3	61.6	61.6
Three-month money market rate, average	..	6.0	6.9	4.2	3.4	3.9
Ten-year government bond yield, average	..	7.6	7.9	5.8	5.0	4.9

1. Contribution to changes in real GDP.
2. As a percentage of potential GDP.
3. As a percentage of household disposable income.
4. As a percentage of GDP.

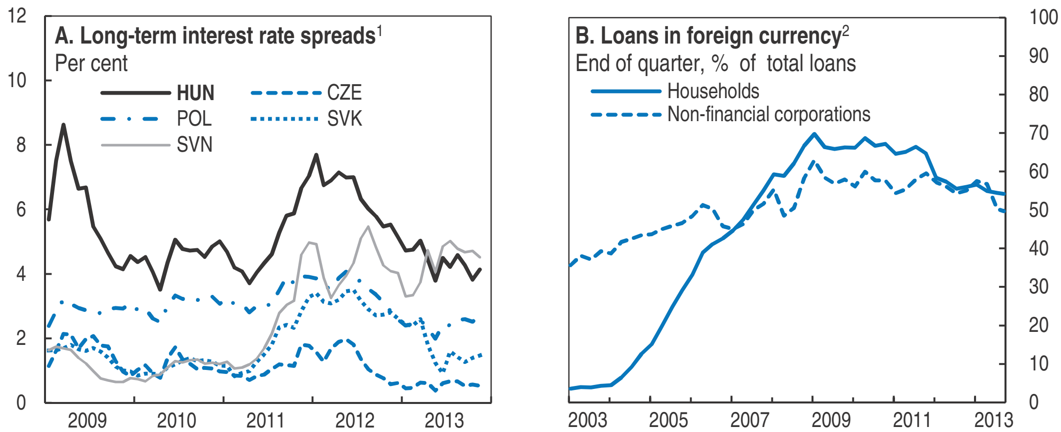
Source: OECD (2013), *OECD Economic Outlook: Statistics and Projections* (database), November.

euro area and spill over to the rest of Europe (which as a whole absorbs almost 90% of Hungarian gross exports), but also if negative shocks were to originate in the rest of the world. The latter is an important market for Hungarian value added through the gross exports of other European countries, notably Germany (OECD and WTO, 2013). On the upside, ongoing efforts by the central bank to foster lending to SMEs (see below) could induce a significant improvement in credit conditions and investment.

Achieving sustainable and equitable growth is the long-run challenge

Stronger long-run growth is the key to raising living standards and rejoining neighbouring countries in the process of convergence towards high income levels. Developments in Hungary's potential output have disappointed since the mid-2000s, reflecting falling total factor productivity growth and, more recently, a substantial decline in the pace of capital accumulation, as investment shrank from 2009 to the first quarter of 2013 (Figure 3). Long underperforming, potential employment started to expand in 2010

Figure 2. **Financial vulnerabilities**



1. Ten-year national currency-denominated government bond spreads relative to the German rate.
2. Loans of monetary and financial institutions. Data for November for fourth quarter of 2013.

Source: OECD (2013), *Main Economic Indicators* (database), December and MNB (2013), "Monetary and Other Balance Sheet Statistics", *Statistical Time Series*, Magyar Nemzeti Bank, December.

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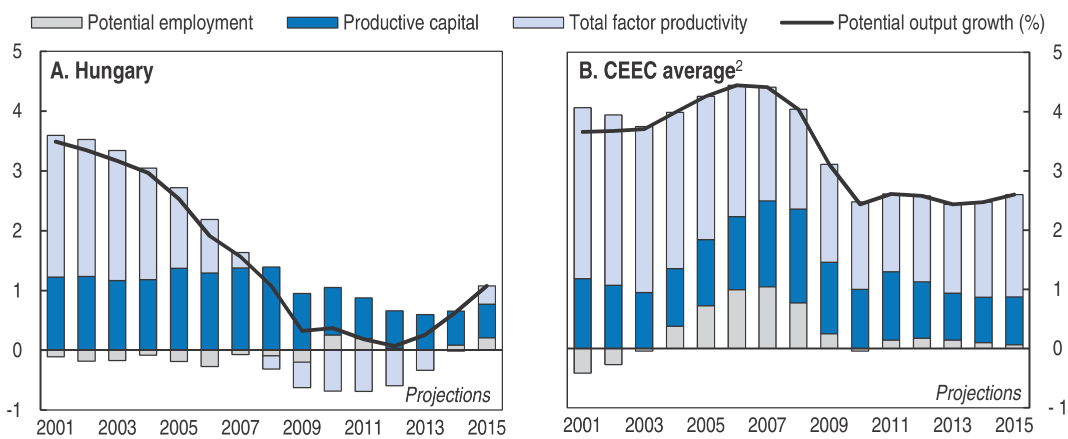
Figure 3. **Potential growth**

Contributions to potential output growth, percentage points[1]



1. Contributions to growth are calculated using a weight of 0.67 for potential employment and 0.33 for productive capital; total factor productivity is calculated as a residual. Productive capital excludes investment in housing, while potential employment abstracts from cyclical variations in the labour force and unemployment.
2. Unweighted average of other Central and Eastern European countries (Czech Republic, Poland and Slovak Republic).

Source: OECD (2013), *OECD Economic Outlook: Statistics and Projections* (database), December.

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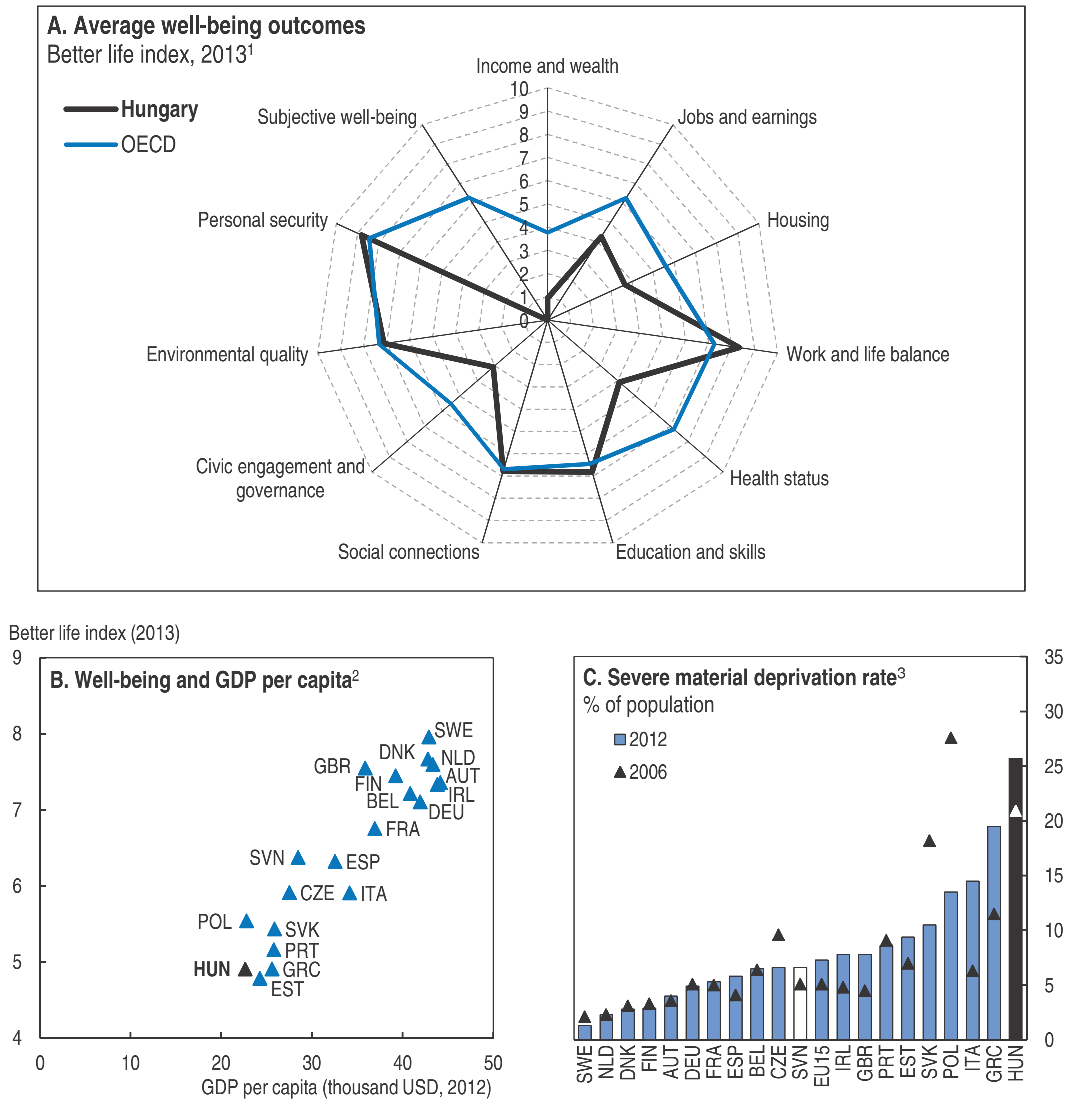
due to improved labour market participation, which nonetheless remains low. As discussed below, a more competitive and better regulated business environment is essential to foster investment and productivity growth, while tackling labour mismatches will contribute to increasing the employment rate among low-participation groups and also benefit productivity.

Hungary ranks low among OECD countries on some well-being indicators, which can be related to a low level of income and therefore a high incidence of material deprivation (Figure 4). Poorer Hungarians suffer from relatively poor health and housing conditions, the latter mainly affecting younger generations. They also have few chances to climb the social

Figure 4. **Social indicators**



1. Each well-being dimension is measured by one to three indicators from the OECD Better Life indicator set. Normalised indicators are averaged with equal weights so they range between 10 (best OECD country) and 0 (worst).
2. The overall Better Life Index is calculated with equal weights on the 11 dimensions. GDP per capita in US dollars at current prices and purchasing power parities.
3. Severely materially deprived are characterised as persons unable to pay for at least four of nine material deprivation items (e.g. rent, mortgage or utility bills; a washing machine or a car). 2011 instead of 2012 for Ireland.

Source: OECD (2013), *OECD National Accounts Statistics* (database), December and *OECD Better Life Index*; Eurostat (2013), "Income and Living Conditions", *Eurostat Database*, December.

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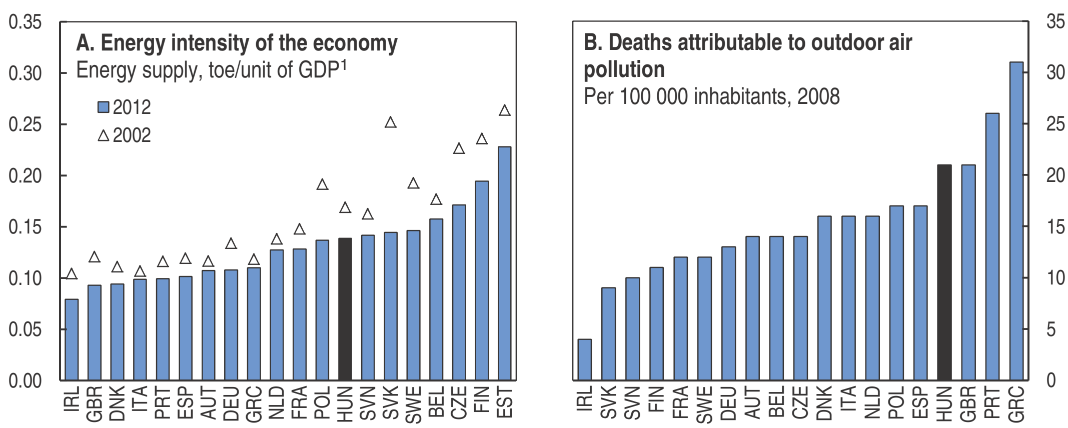
ladder as education outcomes – although relatively good on average – depend more on social background than in most other countries (OECD, 2010a; OECD, 2012a). Poverty is concentrated in rural areas in Eastern and Southern Hungary and among the Roma minority. Income inequalities were slightly lower than the OECD average in 2009, but both inequalities and poverty have increased substantially over 2009-12 as a result of rising unemployment during the economic crisis, as well as cuts in social benefits, the shorter duration of unemployment benefits and the introduction of a flat rate income tax in 2011

(TÁRKI, 2013). The low ranking on well-being also results from a very low level of subjective satisfaction and a relatively poor performance in civic engagement and governance, which reflects a lack of trust in public institutions and weighs on the business environment.

Over the past decade, progress has been made in reducing energy intensity and greenhouse gas emissions (Figure 5, Panel A). Nevertheless, much scope remains to increase energy efficiency, particularly in transport and housing. Investment in energy-efficient housing is deterred by artificially low energy prices for households, as a result of low excise taxation (OECD, 2013a) and administrative price cuts. Emissions from the transport sector are higher than a decade ago and transport contributes to substantial local air pollution in Budapest, with adverse effects on health (Figure 5, Panel B). Use of public transport is relatively high, but pollution from private vehicles could be reduced by better reflecting their environmental performance in annual vehicle taxes and, as envisaged by the authorities, further increasing the relative taxation of diesel (OECD, 2008).

Figure 5. **Environmental indicators**



1. Total primary energy supply (estimated for 2012) in tonnes of oil equivalent (toe) per thousand USD. GDP in constant prices and purchasing power parities.

Source: IEA (2013), *Energy Balances of OECD Countries 2013*, International Energy Agency and WHO (2013), Global Health Observatory Data Repository.

StatLink http://dx.doi.org/10.1787/888932982901

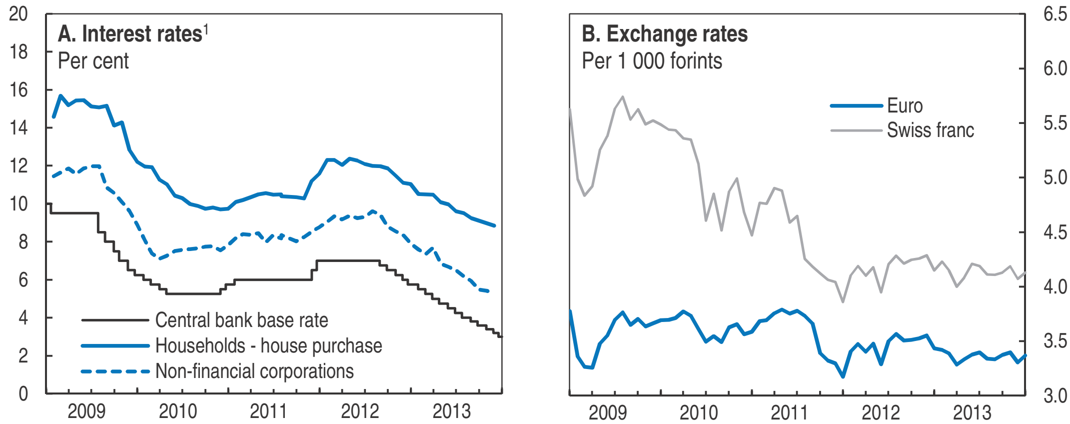
Improving water quality is another important challenge, as the use of nitrogen and pesticides has increased and wastewater treatment could be further developed. To improve water quality, the authorities have been pursuing the National Drinking Water Quality Improvement Programme since the early 2000s, whereas sizeable EU funding has been devoted to wastewater collection and treatment. Nonetheless, around a quarter of the population is still not connected to a sewage network. Water management fees were cut administratively by 10% in 2013. Further cuts could hamper needed infrastructure investment, as there is indication that the cost coverage of water supply and sanitation services is relatively low (OECD, 2010b).

Monetary policy and financial stability

Monetary easing should help stimulate lending

The Central Bank of Hungary (Magyar Nemzeti Bank, MNB) has cut its policy rate steadily since August 2012 to support demand and credit growth, bringing it to historical lows. These cuts were largely transmitted to interest rates on new lending (Figure 6,

Figure 6. **Monetary and financial indicators**



1. For households and non-financial corporations, loans in forints weighted by the amount of new business. Loans extended under the Funding for Growth Scheme are generally excluded.

Source: MNB (2013), "Money and Capital Markets", *Statistical Time Series*, Magyar Nemzeti Bank, December and Datastream.

StatLink http://dx.doi.org/10.1787/888932982920

Panel A), and helped the economy exit recession. Due to declining inflation and a still weak cyclical position, a standard Taylor rule would suggest some further scope for rate cuts. However, volatile external conditions together with the fact that domestic demand is picking up in any case call for extreme caution as regards continuing the easing cycle. Further rate cuts could increase the risk of a forint depreciation, which has been avoided over the past two years (Figure 6, Panel B). Given the still high indebtedness denominated in foreign currency, a depreciation could prove damaging to balance sheets of households, firms and the government. If depreciation pressures materialise or as the output gap closes, the central bank should stand ready to raise rates.

The central bank launched a Funding for Growth Scheme (FGS) in June 2013 to ease credit conditions for SMEs and reduce vulnerabilities associated with foreign currency indebtedness, which is a positive initiative. It has provided banks with HUF 750 billion (2.6% of GDP) of zero per cent financing to lend to SMEs at a maximal interest rate of 2.5%. Over 90% of this sum has been disbursed, making corporate loans outstanding rise in the third quarter of 2013. In September 2013 the central bank decided to continue the FGS until end-2014, with more emphasis on new lending (as opposed to rolling over existing SME loans), by adding a further HUF 500 billion refinancing, which may be gradually lifted to HUF 2 000 billion (almost 7% of GDP) depending on the assessment of macroeconomic, financial and credit conditions.

However, the scheme entails a number of risks. As its total possible amount (HUF 2 000 billion) is close to 60% of total SME loans outstanding at end-2012, it is unclear whether SMEs can absorb such a large sum. Further, it may induce capital misallocation through below-market interest rates or excessive risk-taking by banks, and hamper the monetary transmission mechanism. It also entails fiscal costs, to the extent that central bank dividends to the Treasury will decrease as the refinancing rate, at zero, is lower than the policy rate. The central bank argues that the limited interest rate margin curbs excessive risk-taking, capital misallocation risks should be weighed against existing market failures (as regards SME access to financing) and increased economic activity will help offset the scheme's fiscal costs. On balance, and before further extension of the scheme, the central bank should carefully monitor the above risks and assess whether the FGS is creating new activity, as opposed to displacing credit extended outside the scheme (*inter alia* by bringing forward some lending). Adjustments to the scheme could also be considered, such as linking the refinancing rate to the policy rate or, to the extent that conditions in the banking sector allow it, linking the quantity and price of funds available to participating banks to changes in their net lending to SMEs, as in the UK Funding for Lending Scheme. The banks' allowed interest rate margin, which is currently below market values, could also be reassessed.

Restoring financial intermediation remains a key challenge

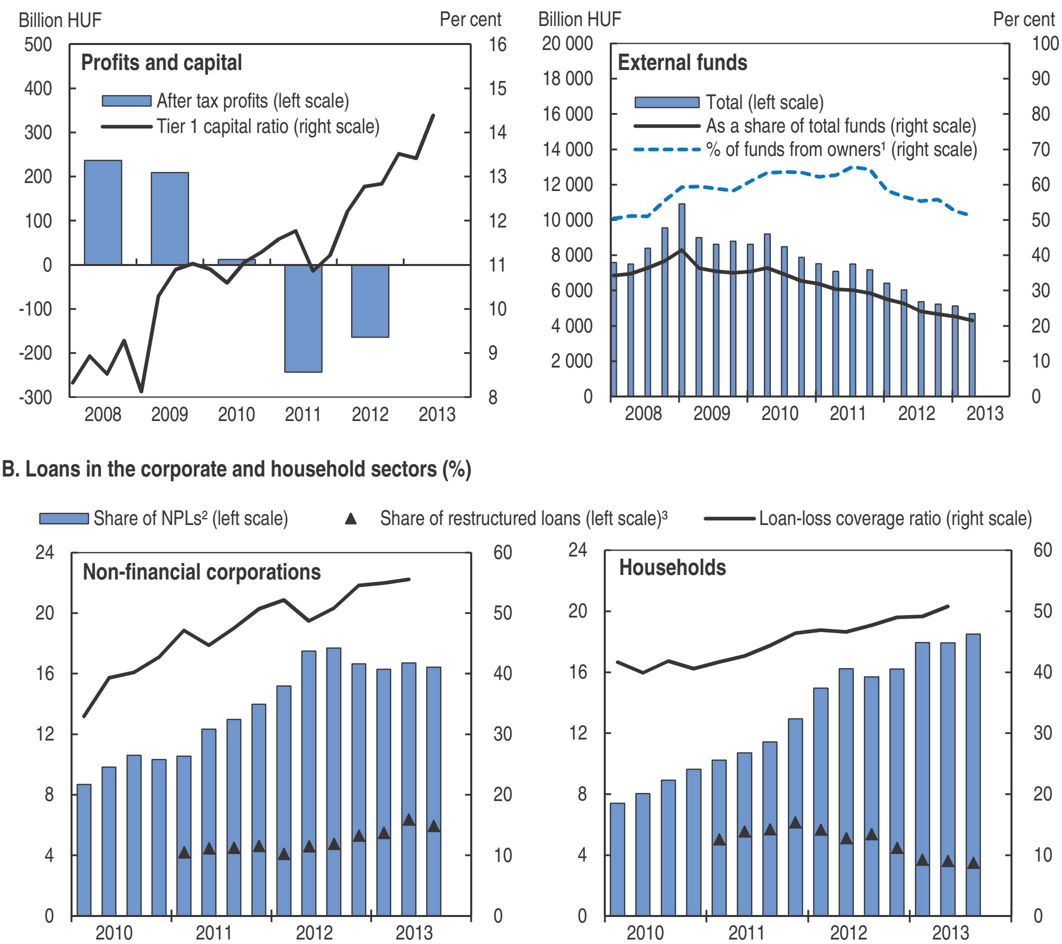
Restoring credit growth will require improving banks' profitability, providing a more stable operating environment and cleaning up their loan portfolios. Profitability has become negative, affected by high tax burdens (mainly the levy on financial institutions, a tax of up to 0.53% on assets created in 2010), non-performing loans (NPLs) and relief to foreign currency borrowers, discussed below (Figure 7, Panel A). While foreign parent banks have provided large-scale recapitalisation (Hungarian banks' capital is 90% foreign-held), they have nonetheless curtailed funding (through deposits, loans and securities) to their affiliates, which has accompanied and to some extent worsened credit contraction in Hungary (MNB, 2013). As discussed in the financial stability chapter of the 2012 *OECD Economic Survey* of Hungary (OECD, 2012b), the authorities should reduce tax burdens while improving tax design. A levy on balance sheets can help improve incentives for a better funding structure, so as to reduce risks. In this vein, the base of the levy on financial institutions could be adjusted so as to exclude capital and deposits (the most stable sources of funding), and deductibility of losses from portfolio cleaning allowed.

Rising NPLs exert a significant negative impact on credit (IMF, 2013b; Figure 7, Panel B). Further, restructured loans not overdue, which are also sizeable, often hide "evergreening" (successive credit extension to a borrower otherwise unable to service debt), which hampers credit reallocation towards growing companies. There has been some recent regulatory improvement, especially to ensure up-to-date collateral assessments. Still, reporting and provisioning requirements should be tightened for restructured loans (especially if renegotiated more than once) and credit to sectors with high NPLs, such as construction and real estate (MNB, 2012). Establishing a personal insolvency framework may ease negotiations between banks and debtors. A costly and ineffective judicial liquidation process, which in the end sometimes yields values below collateral appraisals, makes banks reluctant to repossess and sell properties. The authorities should streamline judicial procedures and ensure that the National Asset Management Agency, set up to buy properties from socially vulnerable borrowers (and then let to them), meets its targets (25 000 property purchases until 2015, the proceeds being used to fully reimburse loans at a substantial haircut). They could also require banks to gradually reduce the value of repossessed but still unsold homes on their books, as was done in Spain (OECD, 2012c).

In recent years the authorities have launched a number of relief schemes for foreign currency (FX) mortgage debtors. Efforts to reduce vulnerabilities from FX indebtedness are welcome. The early repayment scheme (2011), allowing mostly well-off borrowers to pay off their FX mortgages at a preferential exchange rate, cost banks an estimated 0.9% of GDP. The exchange rate cap scheme, which remains open, enables eligible borrowers to service their mortgages at a preferential exchange rate during five years, the difference to the actual market rate being repaid afterwards as a forint loan (with an element of partial debt

Figure 7. **Banking sector indicators**

A. Bank profitability, capital adequacy and funding



1. Share of funds from owners to total external funds.
2. Non-performing loans (NPLs) are loans overdue for more than 90 days.
3. Non-overdue restructured loans; for households these exclude loans under the exchange rate cap scheme.

Source: Magyar Nemzeti Bank.

StatLink http://dx.doi.org/10.1787/888932982939

forgiveness which is shouldered by banks and the government). By end-July 2013 participation had reached 50% of the eligible credit stock (more than half of total household FX loans). While this major scheme should slow down portfolio deterioration, it excluded until November 2013 all NPLs, where those debtors facing the greatest difficulties are likely to be found. In that month, eligibility was enlarged to all FX mortgage debtors, and will only be lost after joining if instalments under the scheme become more than 180 days overdue (previously, 90 days). While this is a positive step, there is room to better target distressed borrowers based on objective criteria such as high repayment-to-income ratios or negative equity, as discussed in the financial stability chapter of the 2012 *Survey* (OECD, 2012b; Havrylchyk, 2012). The authorities' stated intention to decide on further relief to FX debtors provides an opportunity for doing so, and this should be realised through negotiations with banks to ensure balanced burden-sharing. Greater certainty about the legality of disputed clauses of foreign currency loan contracts has ensued from recent Supreme Court decision, which is welcome.

Strengthening institutional arrangements

In October 2013, the financial regulator (Hungarian Financial Supervisory Authority, HFSA) was integrated into the central bank. Making the central bank responsible for banking supervision is now quite common in Europe and may better integrate micro and macro-prudential analysis and regulation. To maximise benefits from the merger it is important to ensure, in line with current arrangements, separate decision-making processes within the central bank for monetary policy and financial stability. The same holds for consumer protection, for which the central bank has also become responsible (OECD, 2011a). The enlarged remit of the central bank makes it even more important that it is consulted in a timely way on any draft legislation with implications for the financial system.

Box 1. **Main recommendations on monetary policy and financial stability**

Key recommendations

- 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 small and medium-sized enterprises. 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.

Other recommendations

- Unless the economy slows significantly, consider any further cuts in the central bank policy rate with extreme caution.
- Improve targeting of foreign currency mortgage relief on those debtors most in need.

Fiscal policy

Substantial fiscal consolidation was achieved, but risks remain sizeable

The authorities implemented substantial underlying fiscal consolidation in 2012 (Table 2). Large revenue increases, mainly from VAT but also from other indirect and direct taxes, were accompanied by restraint in major expenditure items, such as wages and social transfers. In 2013, the authorities introduced two additional fiscal packages, one cutting spending and the other mainly raising and redesigning sector-specific taxes. Overall, the deficit is likely to have remained somewhat below 3% of GDP, with a small loosening in the underlying stance relative to 2012. Official plans suggest a further underlying fiscal expansion of ¾ per cent of GDP for 2014, leading in the OECD projections to a slight increase in the headline deficit amidst a recovery in activity, and a broadly neutral fiscal stance in 2015-16.

Maintaining fiscal discipline will be important to preserve market access – Hungary was out of international bond markets for almost two years until early 2013 – and reduce public debt. Projected at 79% of GDP by end-2013, public debt is below the European Union (EU) average, but high in a regional perspective. After some decline in population ageing costs until 2030, the related public spending is projected to increase by more than 4% of

Table 2. **Fiscal indicators**

Per cent of GDP

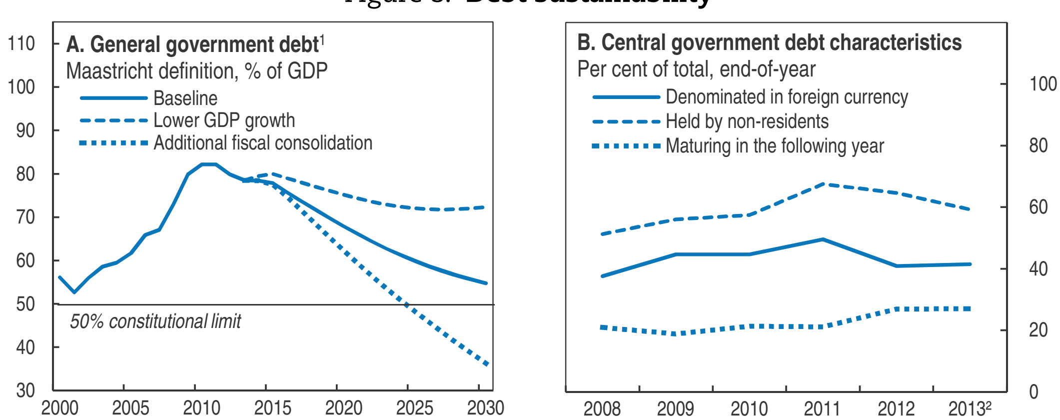
	2000	2005	2010	2011[1]	2012	2013[2]	2014[2]	2015[2]
Spending and revenue								
Total revenue	44.7	42.2	45.6	54.3	46.6	45.9	45.6	44.8
Total expenditure	47.8	50.1	50.0	50.0	48.7	48.7	48.6	47.7
Net interest payments	4.8	3.9	3.9	3.8	4.0	4.1	4.1	4.0
Budget balance								
Fiscal balance	-3.1	-7.9	-4.4	4.2	-2.1	-2.7	-2.9	-2.9
Cyclically adjusted fiscal balance[3]	-2.2	-9.3	-2.9	4.9	-0.8	-1.6	-2.4	-2.6
Underlying fiscal balance[3]	-2.2	-9.5	-3.9	-4.1	-1.6	-2.0	-2.8	-2.6
Underlying primary fiscal balance[3]	2.6	-5.6	-0.1	-0.4	2.3	2.0	1.3	1.4
Public debt								
Gross debt (Maastricht definition)	56.1	61.7	82.2	82.1	79.8	78.5	78.4	77.8
Net debt	33.3	46.4	61.8	53.3	61.2	61.3	61.6	61.6

1. The budget balance (total revenue, fiscal balance and cyclically adjusted fiscal balance) is distorted by huge one-off revenues reflecting the liquidation of the second pillar of the pension system.
2. Projections.
3. Per cent of potential GDP. The underlying balances are adjusted for the cycle and for one-offs. For more details, see *OECD Economic Outlook* Sources and Methods.

Source: OECD (2013), *OECD Economic Outlook: Statistics and Projections* (database), November.

GDP over 2030-60 (European Commission, 2012), adding to the need to reduce public debt to pre-finance these costs. Under the favourable assumption of a significant pick-up in potential GDP growth to 3% per year, which implicitly assumes broad further structural reforms, the fiscal stance envisaged by the authorities would result in a gradual decline in the public debt ratio to the 50% of GDP constitutional limit, by around 2030 (Figure 8, Panel A, baseline scenario). However, in the absence of growth pick-up, the decline in the public debt ratio would be very slow (Figure 8, Panel A, lower growth scenario). An additional consolidation by 1¼ per cent of GDP would ensure more rapid debt reduction

Figure 8. **Debt sustainability**



1. The baseline consists of the preliminary projections for the *Economic Outlook* No. 94 until 2015, prolonged with the OECD long-term baseline scenario (potential GDP growth would average 3% per year over the projection period) and assuming a neutral fiscal stance (constant structural primary budget balance) from 2016 onwards. The "lower GDP growth" scenario assumes lower real GDP growth by 1.5 percentage point per year over the period. The "additional fiscal consolidation" scenario is identical to the baseline and assumes an additional 1¼ per cent of GDP fiscal consolidation spread over 2015-17 to comply with the Hungarian public debt rule.
2. Estimate based on latest data available.

Source: ÁKK (2013), *Statistics*, Government Debt Management Agency, December, *www.akk.hu*; OECD (2013), *OECD Economic Outlook*, No. 94 (database) and OECD calculations.

StatLink http://dx.doi.org/10.1787/888932982958

(Figure 8, Panel A, additional consolidation scenario) and would comply with the pace of debt decline prescribed by Hungarian law (see below).

Overall, the envisaged fiscal expansion for 2014, although limited, appears unnecessary given the projected recovery in activity. Budget reserves set aside for unforeseen expenditures have been more than halved to 0.7% of GDP in 2014. As 2014 is an election year, budget slippages would signal the return of an electoral cycle in fiscal policy, which should be avoided as in 2010. Overall, the authorities should make sure that the fiscal expansion in 2014 remains moderate and take gradual consolidation steps over the medium term to put public debt on a firmly declining path.

The share of foreign currency in public debt has been brought to a lower level, notably via the repayment of International Monetary Fund (IMF) loans, but it remains substantial (Figure 8, Panel B). In addition, reliance on short-term forint securities rose in 2011-12 and so did the share of non-residents among forint debt holders, both of which increase roll-over risks. The authorities should aim to increase debt maturity and continue to reduce the exposure to foreign currency instruments.

Towards more growth-friendly fiscal instruments

The composition of public spending and revenues could be adjusted to better support growth. In recent years, the government has introduced and increased a number of special taxes on specific sectors (Table 3). While these taxes have contributed to fiscal consolidation and helped avoid a higher tax burden on labour, they have also reduced the predictability and simplicity of the tax system, and the levy on financial institutions has contributed to depress credit by reducing bank profitability and adding to uncertainty. Greater stability is planned for 2014, which is welcome. In the longer term, the authorities should scale down special taxes and replace them with more growth-friendly fiscal instruments, while also taking into account social and environmental concerns and reinforcing the fight against tax evasion. Increasing inheritance taxes and municipal recurrent taxes on immovable property would raise revenues with a relatively small effect on growth. Increasing currently low taxation on energy use would benefit the environment by encouraging investments in energy efficiency. Child-related benefits for children aged

Table 3. **Recent special taxes on specific sectors**[1]

Billion HUF

	2008	2009	2010	2011	2012	2013[2]
Finance[3]	12.6	12.6	192.3	195.9	94.6	373.9
of which: Levy on financial institutions	. .	. .	182.3	186.5	84.9	139.1
Energy	. .	24.2	81.2	115.9	87.2	98.9
Telecommunications	. .	. .	58.6	51.3	62.9	61.7
Retail	. .	. .	28.9	21.6	33.3	2.2
Total	**12.6**	**36.8**	**361.0**	**384.7**	**278.0**	**536.7**
In % of GDP	*0.0*	*0.1*	*1.4*	*1.4*	*1.0*	*1.8*

1. Includes levy on financial institutions, extra tax on selected financial institutions, financial transaction tax (excluding transactions by the Treasury), insurance tax, income tax on energy service providers, surtaxes payable by certain economic sectors, tax on wires and pipelines, and telecommunications tax.
2. Preliminary budgetary data.
3. The amounts for 2013 exclude the technical adjustments introduced in the extra tax on selected financial institutions to ensure equal burden-sharing between banks and the state as regards debt forgiven under the exchange rate cap scheme.

Source: State Treasury, Ministry for National Economy.

under three are the most generous in the OECD and are not means-tested (OECD, 2012b; Kierzenkowski, 2012). International evidence suggests that a combination of shorter maternity leave and more developed formal childcare provision would more efficiently support fertility and female labour participation (OECD, 2011b). Subsidies to public transport companies should be reduced while pushing for efficiency gains. There may also be scope to rationalise the workforce of local governments.

EU structural and cohesion funds are an important fiscal resource, amounting to about 3½ per cent of GDP per year on average. After starting slowly, EU fund absorption has accelerated, although the full absorption of 2007-13 funds before the 2015 deadline still poses challenges, as illustrated by the European Commission temporarily freezing certain funds in 2013 because of irregularities in control procedures. However, the main issue is to ensure that funds are spent efficiently. For 2014-20, about 20% less funds will be available (in nominal euro terms). The authorities plan to shift funds from infrastructure projects towards financial support to SMEs, innovation and active labour market policies. This choice is commendable in the current economic situation, but it entails challenges in terms of adapting governance processes. In particular, the efficiency of SME support programmes and training for the unemployed should be carefully monitored and financing for innovation should be better targeted to innovative firms (for example, hotels can currently benefit from venture capital). Ensuring a good co-ordination between EU-financed and other government policies is also important. The planned decentralisation of operational programme management to line ministries may facilitate co-ordination, although certain ministries may still lack sufficient administrative capacity.

Public procurement accounts for a quarter of public spending, close to the OECD average (OECD, 2013b). A 2011 law simplified legal practices in procedures below a certain threshold and encouraged participation of SMEs, with the side effect of restricting participation by foreign-owned companies, harming competition. A new law introduced in mid-2013 to tackle corruption requires contractors to disclose procurement-related data on a common public database, such as the list of bidders, the highest and lowest bids, procurement contracts and some information on their execution. This is a step in the right direction, but the effectiveness of the measure remains highly uncertain, as disclosure requirements on the implementation of contracts and negotiated single-bidder procedures seemed insufficient based on an analysis of the draft law (Transparency International, 2013). Developing electronic procurement, which is used less than in many other OECD countries, would contribute to both transparency and competition (OECD, 2009).

Strengthening the fiscal framework

The Constitution provides a fiscal anchor by stipulating that public debt, which is projected at 79% of GDP by end-2013, should eventually not exceed 50% of GDP. Until it comes down to this level, the debt-to-GDP ratio is to decline every year, subject to a broad escape clause for "special cases and long-term recessions". The law defining the pace of decline after 2016 stipulates that nominal public debt can increase only by expected inflation minus half of expected real GDP growth. This will generally encourage counter-cyclical fiscal policy, although it could turn out to be pro-cyclical in some instances (e.g. above-trend growth but a negative output gap), as pointed out in the 2012 *Survey* (OECD, 2012b). As discussed above, additional fiscal efforts will be needed over coming years to comply with the rule, and the authorities should prefer structural budget adjustment to one-off budget measures and asset sales.

In a welcome step, the authorities are introducing a medium-term budgeting framework to comply with EU requirements. Under this framework all levels of government are to project their revenues and expenditures for the three years after the current budget year and have to explain any deviation from their expenditure path. In implementing the framework, the authorities should bear in mind potential loopholes (e.g. government-owned companies, payment arrears, implicit debt from public-private partnerships) and include clear correction mechanisms in case of slippage. Further, the authorities should seize this opportunity to put more emphasis on the medium-term fiscal strategy, taking into consideration potential spending pressures and the need to reduce public debt.

The analytical capacity of the fiscal council has been reinforced, as recommended in the 2012 *Survey* (OECD, 2012b), by recruiting staff and developing an expert network. The council has kept its veto right over budget laws, which is a safeguard of last resort for fiscal discipline. However, this right potentially gives the council – an unelected body – too much power over fiscal decisions. By consistently rejecting a budget bill, the council could prevent the Parliament from passing a budget on time, opening the possibility that the President dissolve the Parliament (OECD, 2012b; IMF, 2013c). The council has the right to comment on any fiscal issue, but its compulsory mandate is too narrow, as it is focussed on *ex ante* compliance with public debt rules. It should be broadened, including to the discussion of medium-term fiscal plans. To be effective, the council needs to be, and seen to be, independent from the government if it is to build up credibility.

Financial relationships between central and local government have been substantially reformed over recent years. Responsibilities have been recentralised in education and healthcare while the financing of other responsibilities, such as pre-school provision and local infrastructure, has been reformed to introduce a so-called task-based financing system. As these changes may have large effects on the budgets of certain municipalities, the authorities should stand ready to compensate losers, at least temporarily and especially in disadvantaged areas. An envelope of 0.1% of GDP was set aside for this purpose. A number of municipalities have accumulated unsustainable debts over the past decade, some of them in foreign currency, ultimately leading the central government to take them over. To avoid moral hazard, municipalities now need prior authorisation by the central government before contracting new debts.

Box 2. **Main recommendations on fiscal policy**

Key recommendation

- 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.

Other recommendations

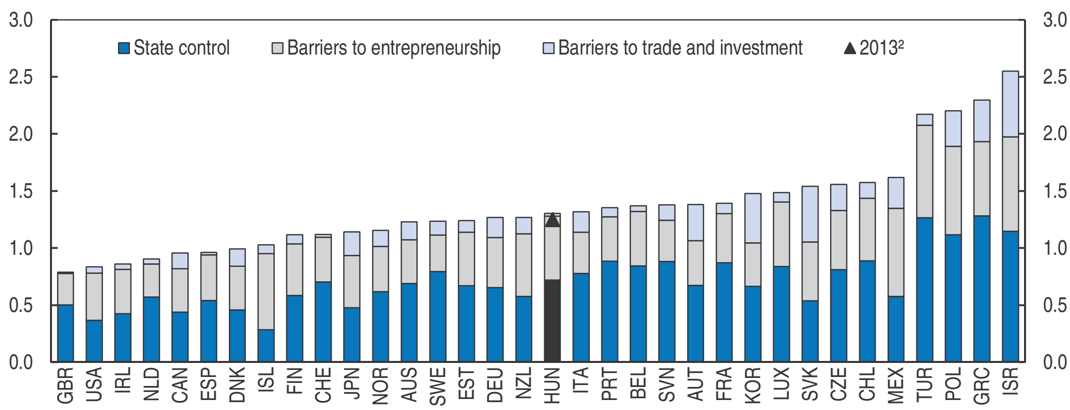
- Ensure that the planned fiscal expansion in 2014 remains moderate. Take gradual consolidation steps over the medium term to put public debt on a firmly declining path, in accordance with the fiscal rule.
- Broaden the mandate of the fiscal council to medium-term issues, but reconsider its veto power over budget laws.

Enhancing competition and the business environment

Overall product market regulation in Hungary continues to reflect the substantial pro-competitive reforms started in the 1990s and is characterised in particular by very high openness to trade and foreign investment (Figure 9). However, the business environment is still burdened by high administrative costs and limited competition in major non-tradable sectors. In recent years, it has also been further weakened by regulatory volatility and difficulties in access to finance (especially for SMEs). These factors deter investment and harm productivity, according to evidence available at aggregate, industry and firm levels (Arnold et al., 2011). Productivity growth is penalised both within firms (e.g. through weak incentives to innovate) and between firms by hampering labour and capital reallocation towards the most efficient companies in a sector, an area where Hungary performs below par (Andrews and Cingano, 2012; Andrews and Criscuolo, 2013). The birth and subsequent growth of innovative SMEs which might be able to challenge larger competitors then becomes more difficult. In retail, professional services, energy and telecommunications, the effects of insufficient competition (mainly due to barriers to entry) extend to countless downstream industries, where the scope and incentives for productivity improvements can be reduced.

Figure 9. **Product market regulation indicator**[1]

Index scale of 0-6 from least to most restrictive, 2008



1. The integrated product market regulation indicator measures the degree to which policies promote or inhibit competition in areas of the product market where competition is viable and covers formal regulations in the three areas shown (equal weights).
2. Preliminary data calculated on the basis of the 2008 methodology for purposes of comparability. For more details, see Koske et al. (2014) which provides the 2013 indicators with a revised methodology.

Source: OECD (2013), *OECD Product Market Regulation Statistics* (database), July and I. Koske, I. Wanner, R. Bitetti and O. Barbiero (2014), "The 2013 Update of the OECD Product Market Regulation Indicators: Policy Insights for OECD and non-OECD Countries", *OECD Economics Department Working Papers*, forthcoming.

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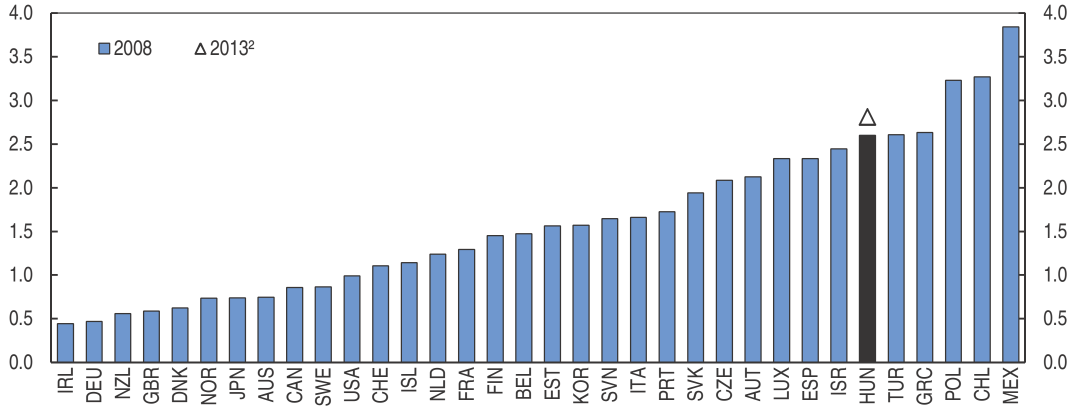
Regulatory burdens and instability are high

Administrative burdens, compounded by regulatory instability and uncertainty, are high in Hungary (Figure 10). Taxation is a case in point; the time spent by SMEs complying with obligations is 50% above the OECD average (World Bank and IFC, 2013). Recent simplification efforts (like the Magyary and the Cutting Red Tape programmes) have streamlined the existing stock of administrative burdens, as part of an overall government strategy to improve the business environment. These efforts have included steps addressed to small firms, such as new simplified corporate tax schemes. However, a high flow of new regulation has created new burdens. The authorities should aim at fewer but

Figure 10. **Administrative burdens are high**[1]

Index scale of 0-6 from least to most restrictive



1. The product market regulation indicator for administrative burdens is composed of the following three elements (equal weights): administrative burdens for corporations, administrative burdens for sole proprietor firms and sector specific administrative burdens (road transport and retail distribution).
2. Preliminary data calculated on the basis of the 2008 methodology for purposes of comparability. For more details, see Koske et al. (2014) which provides the 2013 indicators with a revised methodology.

Source: OECD (2013), *OECD Product Market Regulation Statistics* (database), July and I. Koske, I. Wanner, R. Bitetti and O. Barbiero (2014), "The 2013 Update of the OECD Product Market Regulation Indicators: Policy Insights for OECD and non-OECD Countries", *OECD Economics Department Working Papers*, forthcoming.

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better prepared regulation. For government-initiated legislation, this requires persevering with efforts towards high-quality Regulatory Impact Assessment (RIA), covering economic, social and environmental impacts, for which further capacity building in the administration is needed. For bills initiated in parliament, which account for a growing share of total adopted legislation, mandatory consultations with experts and stakeholders should be introduced. RIA outputs and opinions delivered in consultations should be made public, and secondary legislation detailing and implementing primary legislation should be timely and transparent. As repeated information reporting is a major source of burden on firms and citizens, ongoing efforts to ease information-sharing and co-ordination among different public agencies should continue and be given high priority, without neglecting appropriate safeguards for data privacy and security.

Since 2010, the proliferation of successively amended special taxes vividly illustrates abundant and unstable new regulation, and is at odds with simplification steps in other areas of taxation, such as the flat personal income tax. Investment is deterred by uncertainty, and has fallen more steeply in the sectors hit hardest, such as energy (-39% in 2012, also due to a relatively high basis in 2011) and telecoms (over -20% per year in 2010-11), than in the economy as a whole. Adverse growth effects may also stem from a sharp deterioration in profitability, as in banking, or from distortions in competition when tax design penalises some firms more than others, as has been the case in retail and telecoms.

Institutional quality has room for improvement

A stable and efficient legal framework, grounded on the principles of separation of powers and judicial independence, is widely seen as growth-enhancing (North, 1990; Rodrik et al., 2004). In Hungary, the perceived quality and effectiveness of legal and political institutions is weak. As mentioned previously, Hungary performs poorly on the indicator of civic engagement and governance (Figure 4, Panel A) and observers have voiced concerns about constitutional changes and legislative practices in the past three years (Venice

Commission, 2013; European Parliament, 2013). Hungary ranks 84th among 148 countries in the institutional component of the Global Competitiveness Index (World Economic Forum, 2013), and has lost places in recent years. Besides administrative burdens, trust and transparency in policymaking and the efficiency of the legal framework in enabling firms to challenge government regulations are seen as particularly problematic.

While inevitably subjective, perceptions help shape investor sentiment, with implications ranging from exchange rate stability to fixed capital formation. Well communicated steps towards stronger checks and balances, as discussed in the 2012 *Survey* (OECD, 2012b), are therefore important. Although not unprecedented in Europe, it may be problematic that regulations by some independent bodies, such as those overseeing energy or the media, can only be appealed to the Constitutional Court, instead of ordinary courts. Reputation and credibility would also benefit from giving priority to people widely regarded as non-affiliated to political parties in future appointments to boards of independent agencies (Thatcher, 2005; Gilardi and Maggetti, 2010).

The Hungarian Competition Authority (GVH) has lost influence in a number of ways, which potentially affects competition promotion and enforcement. The long-standing lack of systematic and timely consultation with the GVH on relevant draft legislation has, if anything, got worse. Loss of influence has also stemmed from a partial exemption of agricultural products from competition rules (2012) and from legislation empowering the government to bypass the GVH in allowing mergers under special circumstances (2013). The authorities should expand rather than restrict the scope of application of competition law and systematically consult the GVH in relevant matters. Enforcement by the GVH could also be usefully strengthened. Merger control decisions have recently become much faster, but the opposite has taken place with cartel investigation (Global Competition Review, 2013).

Fostering SME growth and entrepreneurship

The creation and growth of innovative, high-productivity start-ups requires access to finance, which, despite some recent improvement, is still identified by 17% of Hungarian SMEs (against 15% in the EU average) as their most pressing problem (European Commission, 2013). As discussed above, the authorities intend to channel a larger share of EU funds towards financial support to SMEs, including financial instruments such as credit guarantee schemes, and the Funding for Growth Scheme aims to ease credit conditions for these firms. A recent capital injection in the co-operative credit institutions' sector may also lead to increased lending capacity to SMEs, though the effective nationalisation of the sector has strongly weakened the autonomy and property rights of individual institutions.

However, more should be done. Besides speeding up portfolio cleaning, the authorities can foster loan financing to SMEs by taking further steps to improve transparency, on both bank and SME sides, and deepen credit information. The latter helps both banks to credit-score their clients and clients to switch banks, whereas lack of transparency often discourages SMEs from even applying for credit (Brown et al., 2011; Ministry for National Economy, 2012). In this vein, rules to curb unilateral contract modification by banks (now essentially confined to household mortgage loans concluded after April 2012) should be extended to all types of loans, and credit information from non-bank sources (such as retailers or utilities) included in credit bureaus.

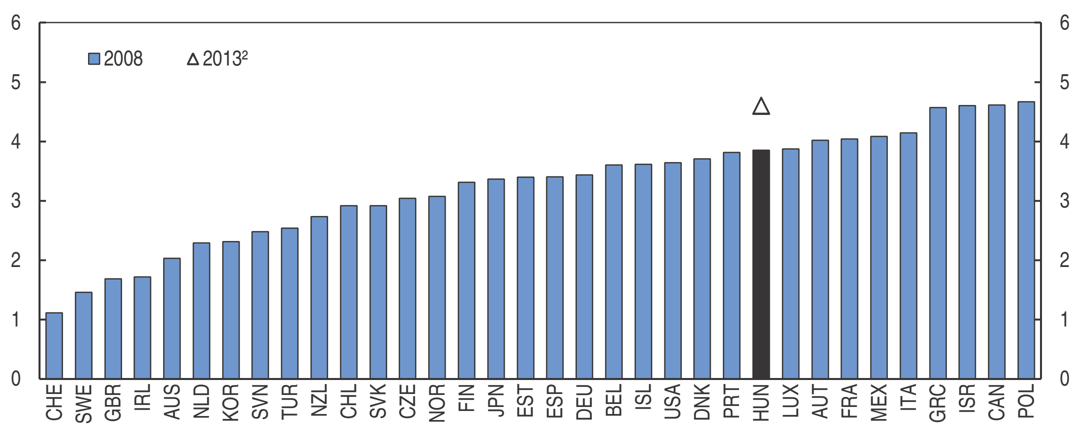
Corporate insolvency procedures in Hungary are lengthy and, largely as a consequence, lead to low recovery rates (38% against 68% across the OECD, according to World Bank and IFC, 2013). This penalises creditors, thus harms credit availability and hampers resource reallocation (Andrews and Criscuolo, 2013). The authorities should therefore take steps to shorten the duration of corporate insolvency procedures, for instance by introducing out-of-court settlements and simplified procedures for micro and small firms. As for private individuals, legislating a personal insolvency framework may reduce the time needed for debt discharge, and therefore favour entrepreneurship and risk-taking.

Barriers to entry in services are high

Barriers to competition in services, especially those restricting entry, are high and have recently worsened (Figure 11). Since 2012 and until end-2014, new commercial buildings exceeding 300 square metres, a low threshold, require government permission, which has been denied in almost half of the requests so far. In the case of pharmacies, pharmacists are to become majority owners by 2017 and geography and demography-based entry barriers were reinstated. These restrictions should be removed, and the large outlet threshold substantially raised. Competition should be further enhanced by reducing retail-specific administrative burdens, such as those pertaining to other permits and licences. In professional services, there is also a need to alleviate restrictive entry barriers (especially internationally high education requirements and extensive exclusive rights for service provision) and to remove anti-competitive price and fee regulations, such as the right of many professional chambers to set recommended prices, which in practice often become binding.

Figure 11. **Barriers to entry in services**[1]

Index scale of 0-6 from least to most restrictive



1. Barriers to entry in retail trade and professional services covering licensing, education requirements, commercial permits, specific regulation for large outlets and protection of existing firms.
2. Preliminary data calculated on the basis of the 2008 methodology for purposes of comparability. For more details, see Koske et al. (2014) which provides the 2013 indicators with a revised methodology.

Source: OECD (2013), *OECD Product Market Regulation Statistics* (database), July and I. Koske, I. Wanner, R. Bitetti and O. Barbiero (2014), "The 2013 Update of the OECD Product Market Regulation Indicators: Policy Insights for OECD and non-OECD Countries", *OECD Economics Department Working Papers*, forthcoming.

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Price controls in energy hurt competition, competitiveness and the environment

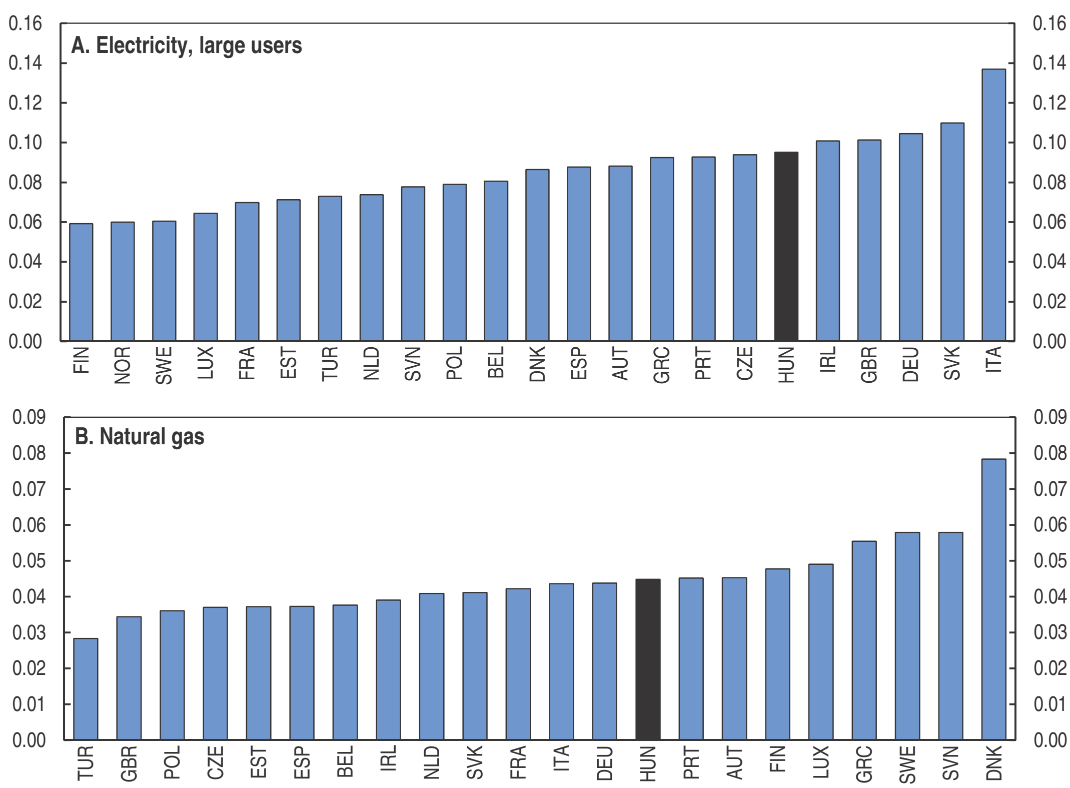
Energy markets are often highly concentrated, providing monopolistic or oligopolistic market positions to several players. In wholesale, the electricity incumbent, state-owned MVM, has recently purchased a leading position in gas import and storage. Gas consumption is covered mainly from imports delivered only via two pipelines and largely takes place under a single long-term contract. In electricity and gas retail, regulated-price and liberalised markets coexist, with eligibility for the former restricted since 2008-09 to small consumers (mainly households). Concentration is also high, as the few firms servicing the regulated-price segments, generally part of vertically integrated groups, also have prominent positions among traders in the liberalised segment.

Stronger competition in wholesale markets will benefit from the ongoing progress in cross-border interconnections and market integration and from continued regulatory support for market development, including by preventing abuse of dominant position. In energy retail, however, government-decided cuts in regulated prices totalling 20% in 2013, on top of previous temporary freezes, risk having anti-competitive effects. Lower profitability and regulatory uncertainty deter investment and market entry (IEA, 2011). Further, as eligible consumers will tend to remain under (or return to) regulated prices, liberalised retail markets may not grow and smaller traders in these markets, likely less able to withstand a temporary profitability squeeze than vertically-integrated groups (REKK, 2010), may be forced out.

Further, industrial users are cross-subsidising households in electricity, where costs from network use fees and support to renewables, *inter alia*, have been shifted to the liberalised segment. To the extent that gas firms pass burdens from regulated price cuts onto the free market, industrial users can also be affected. While for households this blunts price incentives for energy efficiency, for industrial users international competitiveness is hurt, especially as energy prices for industry are on the high side for gas consumers and for large electricity users (Figure 12). The authorities should move towards

Figure 12. **Energy prices for industrial users**

Prices excluding value added tax, euro per kilowatt/hour, 2012[1]



1. Average of data for the two semesters of 2012. Electricity covers the consumption band 20 000-70 000 megawatt/hours and natural gas is an average of all consumption bands.

Source: Eurostat (2013), "Energy Statistics – Prices", *Eurostat Database*, December.

StatLink http://dx.doi.org/10.1787/888932983034

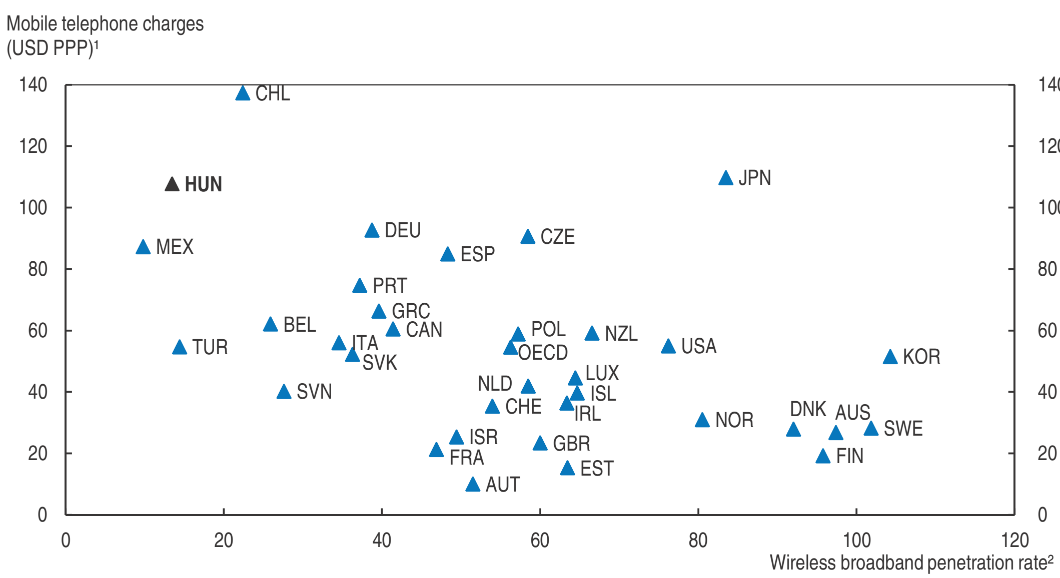
cost-reflective, market-based pricing in electricity and gas by vesting the right to set regulated prices in the sectoral regulator. In the longer term, strengthened competition in the free market may allow gradually phasing out regulated prices. Given such developments, adequate safety nets need to be in place to shield the living standards of poorer households, which may require higher transfers to vulnerable consumers.

There is room to increase competition in mobile communications

High market concentration also prevails in mobile communications, which contributes to expensive voice and smartphone-based data traffic and to low wireless broadband penetration (Figure 13). This hampers the economy's potential for innovation. There are only three mobile network operators (MNOs). Often associated with large retailers, mobile virtual network operators (MVNOs) have only about 1% of total market share, enjoy little or no technical autonomy from the respective host network (the spectrum owner), and thus do little to enhance competition.

Figure 13. **Telecommunications**

2012



1. For 300 calls and 1 GB mobile basket in August. The OECD basket of mobile telephone charges includes fixed and usage charges per month (including value-added tax) and is shown in US dollars at purchasing power parities (PPP). Charges are distributed between peak and off-peak hours and are based on an average call duration. The number of calls includes 225 SMS messages.
2. Subscriptions per 100 inhabitants in June.

Source: OECD (2013), *OECD Communications Outlook 2013*.

StatLink http://dx.doi.org/10.1787/888932983053

Market entry by new players, either MNOs or MVNOs, could stimulate competition and lower prices, as the recent experiences of France or Israel illustrate (OECD, 2013c). The regulator should ensure that potential MVNO entrants can buy full wholesale access to the existing physical networks under regulated, competition-enabling conditions. So far, the absence of regulatory intervention may have prevented entry by full (technically autonomous) MVNOs that could dent the market power of the existing MNOs. Further, the operation of more than three MNOs can be viable even in small markets (examples include Denmark, Israel and Slovenia). A spectrum auction held in 2011, which would have allowed entry by a fourth such operator, was later annulled by court decision. To enable entry, the regulator should therefore launch a new auction, building on consultations started in November 2013.

Box 3. **Main recommendations to enhance 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.

Improving the efficiency and inclusiveness of the labour market

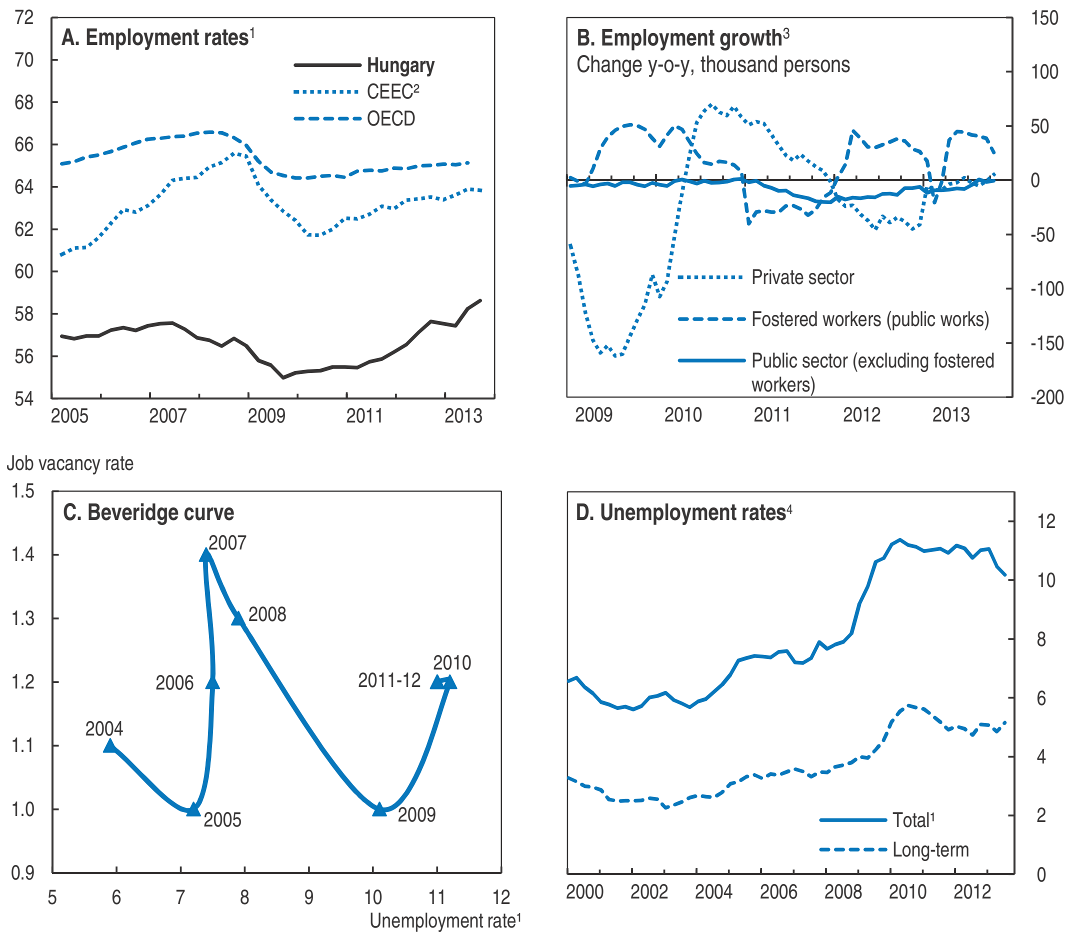
Despite significant increases over recent years, the employment rate remains well below the OECD average (Figure 14, Panel A), reflecting low employment by the low-skilled, youth, the elderly, women of childbearing age, the disabled and Roma. Since 2010, labour force participation has increased by around 2.5 percentage points, notably on the back of new tax/benefit policies aiming to make work pay. However, labour demand remains weak and heavily dependent on the public works programme, which largely fails to reintegrate participants into the open labour market (Figure 14, Panel B). Greater efforts are needed to boost employment, an area in which active labour market policies have a major role, especially as the low birth rate means that the working-age population will shrink by 5% over the next decade and more rapidly afterwards (European Commission, 2012).

As discussed in the 2012 *Survey* (OECD, 2012b), a number of steps would stimulate participation, such as more employment-friendly family policies, measures against Roma segregation and better activation of disabled people. In the latter area, recent reforms of rehabilitation services and new wage subsidies are positive steps. Also, parents returning to work after one year (instead of two years before the measure) can cumulate their parental benefit with their wage. Promoting employment also requires tackling the relatively high skills and geographic mismatches on the labour market, which would also enhance productivity by better allocating labour resources.

Rising structural unemployment and an outward shift in the Beveridge curve suggest that labour mismatches have increased over the past decade (Figure 14, Panels C and D). The main mismatch, amplified by the economic crisis and technological progress, is an oversupply of low-skilled workers, as reflected in their very low employment rate (Figure 15). In contrast, high-skilled labour supply is somewhat tight in certain fields, mainly medical professions, which have suffered from rising emigration. The reallocation of labour across economic sectors has slowed since the mid-1990s (Harasztosi, 2011).

Figure 14. **Labour market indicators**

Per cent



1. Age 15-64.
2. Unweighted average of other Central and Eastern European countries (Czech Republic, Estonia, Poland, Slovak Republic and Slovenia).
3. Number of employees, change over the same period of the previous year. The private sector covers firms with more than five employees and includes non-profit institutions. Data adjusted for the reclassification of 19 000 workers in the health sector from the non-profit to the public sector in April 2013.
4. Long-term covers unemployment duration of twelve months or over.

Source: Eurostat (2013), "Labour Market", *Eurostat Database*, December; OECD (2013), *OECD Main Economic Indicators* (database), December; HCSO (2012-13), "Average Gross Earnings", *First Release*, various editions, Hungarian Central Statistical Office.

StatLink http://dx.doi.org/10.1787/888932983072

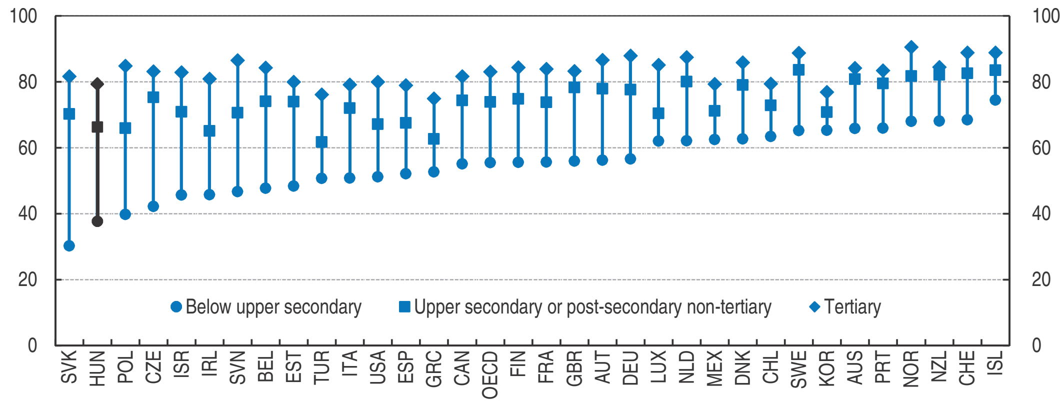
Geographic mobility is low, resulting in persistently large regional discrepancies in the unemployment rate (Figure 16). Certain mismatches originate in the rapid changes in labour demand during the transition to a market economy, but younger generations exiting the education system are also poorly matching labour market needs, as illustrated by a youth unemployment rate that was already high before the crisis and has increased further.

Boosting demand for low-skilled labour, especially in disadvantaged regions

Lowering the relatively high labour costs on low salaries is a priority to boost demand for low-skilled labour. In 2013, the Job Protection Act halved employer contributions (from

Figure 15. **Employment rate by educational attainment**

Employed persons aged 25-54 in per cent of population in the same age group, 2011

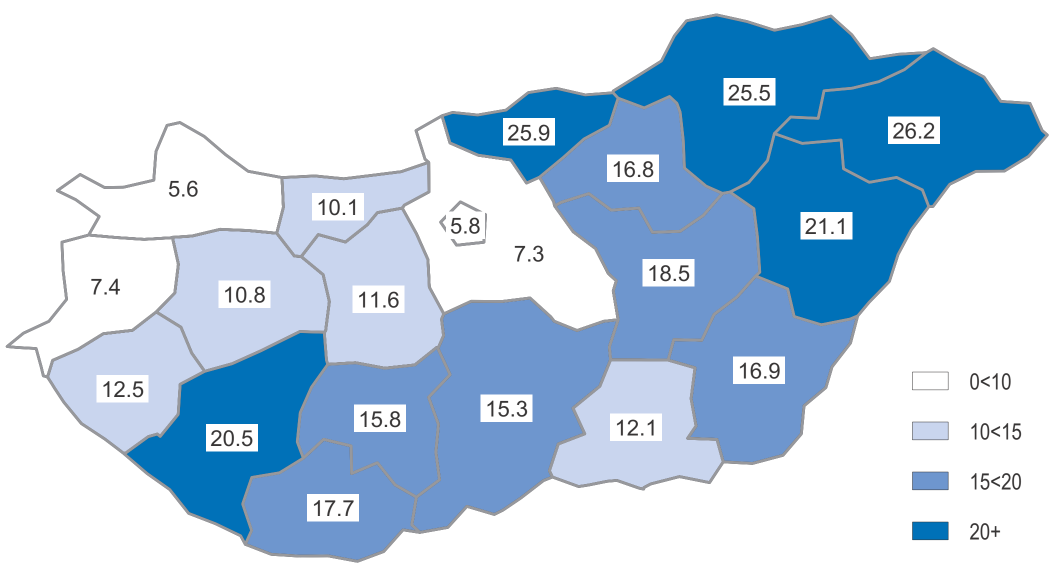


Source: OECD (2013), *Education at a Glance 2013: OECD Indicators.*

StatLink http://dx.doi.org/10.1787/888932983091

Figure 16. **Unemployment rate by county**

Registered unemployment rates, per cent, 2012[1]



1. Registered jobseekers in per cent of economically active population aged 15-64.

Source: HCSO (2013), “Regional Statistics: Labour Market”, *STADAT Tables*, Hungarian Central Statistical Office, December.

StatLink http://dx.doi.org/10.1787/888932983110

a 28.5% standard rate to 14%) on the first HUF 100 000 of wage for younger, older and unskilled workers, and suppressed them for two years for career starters, long-term unemployed and returning mothers. This is welcome, but there is scope for better targeting, as 14% of the target group earns more than the average wage. Even after these measures, the average tax wedge on low salaries remains substantially above the OECD average. This is to some extent a consequence of the 16% flat rate income tax introduced in 2011, which along with the abrogation of the employment tax credit has increased the wedge on low wages and reduced it on higher ones.

The minimum wage is set by the government after consultation of social partners. It was increased nominally by 19% in 2012, 5% in 2013 and 3.6% in 2014, and is now slightly above the OECD average relative to the median wage. Past experience suggests that large minimum wage increases can affect low-skilled employment, especially in disadvantaged regions (Kertesi and Köllő, 2003). To preserve demand for low-skilled labour and competitiveness, the authorities should refrain from increasing the minimum wage by more than warranted by inflation and productivity developments, and consider even freezing it for some time. Introducing a formula-based benchmark for minimum wage increases could help in this respect.

To stimulate activity in disadvantaged regions, the authorities have created low-tax ("free-enterprise") zones. They should also consider moving progressively towards a lower minimum wage in disadvantaged regions, where the low-skilled oversupply is more acute. This is permitted by the new labour code introduced in 2011 and could be achieved gradually through differentiated indexation.

Enhancing active labour market policies

Over recent years, the authorities scaled up public works programmes for the non-employed and EU-co-financed active labour market programmes for vulnerable groups. At the same time, Public Employment Service (PES) staffing was reduced and the duration of unemployment benefits shortened from nine to three months. Only 5% to 10% of the participants in public works subsequently find regular jobs. As participants are mostly low-skilled, the authorities intend to enhance the training component in the programme, as recommended in the 2012 *Survey* (OECD, 2012b). To maximise targeting and efficiency, this new training should be evaluated carefully to ensure it leads to greater job placement. The transition to regular employment could be also facilitated by enhancing co-operation at the local level between municipalities (which manage most public works programmes), the PES network, private companies and non-governmental organisations (NGOs). To encourage municipalities to actively contribute to reintegration, they could be given a financial bonus linked to the medium-term labour market outcome of participants.

International evidence suggests that assistance co-ordinated by the PES is generally a more efficient activating tool than public works (Card et al., 2010). In this respect, PES staff per unemployed is relatively low (less than half the level in Austria, Czech Republic or Germany), calling for increased staffing and seeking efficiency gains by developing a statistical profiling system and rationalising the PES network. The short duration of unemployment benefits may leave the unemployed insufficient time to retrain and look for the most suitable job and reduces their incentives to maintain contact with the PES. Along with upscaling PES capacity, the authorities should consider lengthening unemployment insurance somewhat, even though this could reduce incentives to accept work. Job search requirements and obligations to accept employment offers should be strongly enforced. Lifelong learning is relatively underdeveloped and of uneven quality. Better evaluating training should be a priority – some recent steps were taken in this direction.

Better education to match labour market needs

In the long term, tackling labour mismatches requires enhancing education outcomes. Although secondary education attainment is relatively good, the social background of children disproportionately influences their education outcomes and employment prospects. This notably reflects the greater social segregation of schools in Hungary than in other OECD countries (Jenkins et al., 2008). To tackle inequalities, pupils in some small rural schools could be sent to more diverse schools in larger towns, even though it may imply a loss of proximity. Targeting more resources to disadvantaged schools would help to attract more qualified and experienced teachers and directors. In 2013, the relatively low teachers' wages were increased by more than 30% in exchange for longer working hours, a welcome step although still larger increases in disadvantaged areas would have been warranted. In addition, responsibilities for education were recentralised, which may give disadvantaged schools more resources for infrastructure maintenance, as poorer municipalities lacked funds to finance it. However, it also risks hampering school organisational autonomy in adapting to the local context.

Enhancing the quality of vocational education and training (VET), which was considered relatively low in the recent past, would support low-skilled employment. VET was reformed in 2013 to better match labour market needs, mainly by increasing the share of practical training and involving companies more. To facilitate labour market transition, the focus should be on training in companies, as the authorities envisage, rather than school-based workshops. The reform also shortened the vocational curriculum from four to three years, which risks weakening students' general skills and thus their ability to retrain to adapt to future labour market needs. To strengthen general skills and reduce education inequalities, the tracking into general or vocational studies – at age 14, against 15-16 in most OECD countries – should be delayed. In the shorter term, increasing opportunities to change track and further merging vocational secondary schools and (more practical) training schools would also mitigate the negative consequences of such early tracking. In addition, more attention should be devoted to labour market outcomes of VET students to improve the quality of training and student guidance.

Tertiary education attainment of young adults reached 30% in 2012, in line with EU 2020 targets, but is still 10 percentage points behind the OECD average. Despite the good employment and wage prospects of graduates, university enrolment has declined since the mid-2000s and the drop-out rate remains high. New admissions fell further in recent years, reflecting in large part a sharp cut in the number of "state-financed" (no tuition fees) positions in 2012. A new obligation to reimburse half of the state financing if studies are not completed within a reasonable time also discouraged applications, but this measure may help to avoid subsequent drop-out. Aiming to meet a perceived lack of engineering and natural science graduates, the authorities most drastically reduced state-financed access to law, economics, humanities and social sciences, although new admissions in science fields also declined in 2012-13. A recently introduced system to monitor labour market outcomes of students could be used more intensively to better calibrate such policies. It suggests a relative oversupply of graduates in social sciences and possibly humanities, but not clearly so in law and economics.

New, more subsidised, student loans were introduced in 2012, with an income contingent reimbursement schedule. This may support participation by disadvantaged students. There is also a positive discrimination element in the admission procedure, which favours students from disadvantaged background. If this does not suffice to raise participation, especially in fields with few state-financed positions, a further step could be to extend the state financing of studies to all disadvantaged students meeting admission criteria. This could be financed by extending tuition fees, currently paid by about 40% of students, to more of the better-off students.

Financing was reformed to give universities incentives to attract students and to close courses with very few students. This should help to rationalise the supply of courses, but public universities may lack flexibility to adapt as the reform also substantially reduced their organisational and academic autonomy. Expanding autonomy again, as the authorities plan for 2014, while ensuring accountability and preserving the right for the authorities to intervene in problematic cases, would be preferable.

Attracting high-skilled immigration

Emigration has increased from a relatively low base, prompting fears of a brain drain, although so far it has materialised only in the medical professions. To avoid potential skill shortages, improving the general socio-economic situation and business environment would help, along with targeted measures such as further wage increases for doctors and nurses. The impact of a new requirement that state-financed university students work in Hungary for as many years as they studied over their first 20 years of career is uncertain, as potential sanctions can be implemented only in 20 years. Attracting high-skilled immigration, including by returning Hungarians emigrants, could help to prevent skill shortages and enable skills accumulated abroad to spill into the economy. In this respect, schemes combining easier visa and work permit requirements (for non-EU citizens), language courses and support for administrative procedures would help. Targeted tax breaks in potential skill shortage domains, similar to the recently introduced social contribution exemption for researchers with a doctoral degree in science, could also be considered.

Tackling geographic mismatches

Internal migration from job-poor to job-richer areas has been too slow to reduce large regional differences in unemployment. The recent introduction of relocation subsidies for around 500 selected workers will help at the margin, but broader reforms of housing and transport are needed. Housing mobility is low, reflecting the very high homeownership rate inherited from the transition to a market economy and encouraged by a favourable tax treatment. To stimulate the emergence of a (formal) rental market, the choice between homeownership and renting should be made more tax and subsidy-neutral by increasing recurrent municipal property taxes (or introducing a national one) and gradually phasing out mortgage interest subsidies. The proceeds could serve to reduce the 4% housing transaction tax. The regulatory environment should also be improved by simplifying and shortening eviction procedures in case of unpaid rents.

Commuting by public transport is widespread, but efficiency gains would support labour mobility. A 30 km monthly train or bus ticket costs about EUR 70, 20-70% more than in other Visegrád countries. Companies are required to finance 86% of their workers' commuting costs by train or inter-city bus, but probably reflect it in lower wages. Commuting workers also indirectly pay for the high public transport discounts enjoyed by certain groups (entirely free for the elderly, 90% discount for large families, etc.), which should be reassessed.

The substantial subsidies to public transport companies (1.2% of GDP in 2012) have often taken the form of one-off transfers or debt takeover. Setting subsidies in advance and in return for a given level of service, with the possibility of corrective action if needed, would be a better model – the new medium-term budgeting system for train and bus companies goes in this direction. Subsidies could be gradually reduced over the coming years to put pressure on companies to reap long-awaited efficiency gains.

In railways, there may be scope to replace underused lines, which are expensive to maintain, by cheaper bus services. To rationalise intercity bus supply, the authorities are merging the 24 small public providers into 7 regional entities. The medium-term plan to open the market to competition will require a robust procurement framework for public service obligations that could be inspired from the new governance structure of Budapest public transport, which instituted tenders for the attribution of bus lines.

Box 4. **Main recommendations to enhance labour market participation 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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ANNEX

Progress in main structural reforms

This annex reviews action taken on recommendations from previous Surveys. They cover the following areas: fiscal policy, financial sector policies, labour market policies, education (including lifelong learning) and health policies. Each recommendation is followed by a note of actions taken since the March 2012 Survey. Recommendations that are new in this Survey are listed in the relevant chapter.

This annex presents under each theme:

- Past recommendations
  - ❖ ***Actions taken and current assessment***

A. Fiscal policy

- Ensure a balanced distributional impact of fiscal consolidation by means testing child-related benefits, reinstating the employment tax credit, adopting a tax-free allowance in the personal income tax system, cancelling plans to cut the effective personal income tax rate for above-average earners, and raising property taxes on affluent individuals.
  - ❖ ***In 2013 the ceiling on employee pension contributions was abolished and targeted social security contribution cuts were introduced among others for low-skilled workers. From 2014, family tax allowances can be deducted from social security contributions, benefiting the generally low income families that could not fully take advantage of the deductibility from income tax.***
- Make all pension benefits liable to income tax.
  - ❖ ***No action taken.***
- Reduce public debt exposure to foreign currency loans and increase debt maturity. To smooth issuance in forint, increase the pool of subscribers by developing the third pension pillar.
  - ❖ ***The share of foreign currency debt in central government debt was reduced from 49.5% by end-2011 to 41.4% in November 2013.***
- Allocate higher staff and budget resources to the Fiscal Council. Remove its power to veto fiscal laws.
  - ❖ ***The capacity of the Fiscal Council has been reinforced by recruiting staff and developing an expert network.***
- Adopt a multi-year budgeting approach, with deficit targets supported by realistic growth projections and detailed measures to achieve the targets.
  - ❖ ***A medium-term budgeting framework was adopted at the end of 2013, where all levels of government project revenues and expenditures for three years after the budget year.***
- Cancel the principle linking the powers of the Constitutional Court to the level of the debt ratio.
  - ❖ ***No action taken.***

B. Financial sector policies

- Target debt restructuring programmes to distressed borrowers based on repayment-to-income ratios and/or negative equity.
  - ❖ ***No action taken.***
- Replace the exceptional bank levy by a less distortive tax.
  - ❖ ***The bank levy was made permanent. As of 2013 the levy on insurance companies was replaced by an indirect tax on insurance premiums except life insurance (insurance tax).***

- To avoid unilateral contract modification by banks, extend transparent rules on setting fixed or varying interest rates to all loans.
  - ❖ ***A law on transparent interest rate setting came into force in April 2012, but essentially only applies to mortgage loans concluded thereafter.***
- Strengthen the financial independence of the Financial Supervisory Authority by increasing the level of supervisory fees.
  - ❖ ***The Financial Supervisory Authority was integrated into the central bank in October 2013.***
- Increase loan loss provisioning on restructured loans (even with no payment arrears).
  - ❖ ***Banks have increased provisions on performing restructured loans in the corporate segment, but – due to collateralisation – much less so in the household segment.***
- Make the credit information registry comprehensive by forbidding borrowers with positive debt history to opt out and lengthening its memory.
  - ❖ ***The credit registry coverage was considerably expanded in April 2012 with the inclusion of individuals with positive debt history, who nonetheless can opt out after loan termination. No further action taken.***

C. Labour market policies

- Restructure the public works programme to provide significantly scaled-up training and skill-upgrading services.
  - ❖ ***New EU-financed training programmes for agricultural and basic professional skills were launched and extended to about 30% of public works participants by early 2014.***
- Allow employers fewer grounds to refuse part-time work and grant a right to automatically revert to full-time employment.
  - ❖ ***The new Labour Code forces employers to accept part-time work for mothers of children aged under three or returning after maternity leave. Part-time and flexible work arrangements will be supported by EU-financed subsidies.***
- Design a comprehensive activation strategy based on extended training, skills upgrading and pre-employment support for disability pensioners losing eligibility.
  - ❖ ***EU-financed unified rehabilitation services were created, integrating medical, occupational, training and social aspects. Employers can benefit from social security contribution exemptions and wage subsidies.***
- Reduce the length of post-maternity parental leave.
  - ❖ ***Parents returning to work after one year (instead of two in the past) will cumulate parental benefits.***

D. Education (including lifelong learning)

- Alternate study and on-the-job training through apprenticeship programmes and compulsory internships.
  - ❖ ***In vocational training, more time will be devoted to occupational skills, notably in companies. HUF 8.5 billion of EU funds were made available to subsidise apprenticeships.***

- Promote the development of lifelong learning by creating individual learning accounts and participation of low-skilled workers through public subsidies.
  - ❖ ***EU-funded trainings were launched for mainly low-skilled adults in foreign languages and information technology skills. Over the year to September 2013, 70 000 adults participated, half of whom completed the programme.***
- Develop high-quality early childhood education and care services for children aged under three. Increase the participation of Roma in high-quality pre-school.
  - ❖ ***Pre-school will be compulsory for children aged over three in 2015. EU-funded programmes were launched to expand childcare and pre-school facilities.***
- Provide learning support for children lagging behind.
  - ❖ ***A "Bridge" programme was created to offer specific training to lagging pupils. An EU-funded grant and mentoring programme for disadvantaged pupils between grade 7 and first year of university and an after-school support programme (TANODA) were introduced.***
- Encourage the mixing of Roma and non-Roma pupils across and within schools.
  - ❖ ***Since 2012, the ratio of disadvantaged students per school shall not exceed the average in the settlement plus 15 percentage points.***
- Merge vocational training schools with vocational secondary schools.
  - ❖ ***Over the past five years, 85% of vocational training schools were merged with secondary schools for administrative matters. Transition between vocational training school and tertiary education was shortened from three to two years.***

E. Health policies

- Set adequate remuneration levels to retain health care professionals in the system.
  - ❖ ***Wages of health professionals were increased by around 10% to 15% in 2012.***
- Unify the financing of providers for recurrent and capital costs.
  - ❖ ***No action taken.***
- Ensure that the restructuring of inpatient institutions facilitates the reallocation of resources to outpatient and long-term care.
  - ❖ ***Part of the resources made available could be reallocated to financing outpatient care.***
- Strongly discourage informal payments by seeking legal sanctions.
  - ❖ ***The scope for prosecution for accepting informal payments was widened, but they remain legal if allowed by employer.***
- Facilitate the purchase of practice rights and in the longer term abolish practice rights to ease the entry of young general practitioners (GPs) into the system.
  - ❖ ***An envelope was allocated to supporting young GPs purchasing a practice and medical equipment (67 GPs benefitted in 2012).***
- Encourage group practice in primary care.
  - ❖ ***No action taken.***

- Scrutinise and monitor the prescribing and dispensing of drugs through the centralised electronic records.
  - ❖ ***No action taken.***
- Increase the share and training of lower-skilled health care workers to take over mundane tasks performed by doctors.
  - ❖ ***As part of the vocational training reform, the training of certain professionals (e.g. psychiatric specialist nurses) was broadened.***

Thematic chapters

Chapter 1

Enhancing competition and the business environment

Over the past decade, the growth potential of the Hungarian economy has declined substantially. Trend productivity has ceased to increase, and investment has fallen to historically low levels. To an important extent, the explanation lies in a business environment characterised by high administrative burdens, regulatory volatility, barriers to growth of small and medium-sized enterprises (SMEs) and entrepreneurship, and limited competition in major non-tradable sectors, problems which have sometimes become worse in recent years. Under these conditions, many SMEs find it hard to leave semi-informality and grow. Large multinational firms operating in manufacturing often have supplier networks weakly anchored in Hungary, while those in the non-tradable sectors sometimes face little competitive pressure; in both cases, positive spillovers to the domestic economy remain limited.

Steps should be taken both at the economy-wide level and in specific sectors to increase investment and restore productivity growth. Such measures must include fostering greater regulatory stability, inter alia by reducing the flow of new regulation and improving its quality, not least in taxation. Investor confidence would benefit from promoting trust and transparency in public institutions. Apart from vigorous competition enforcement across the economy, it is essential to remove sector-specific obstacles to competition, such as barriers to entry of different types, lock-in effects and distortive regulated prices, in retail, professional services, energy, and telecommunications.

The growth potential has markedly declined

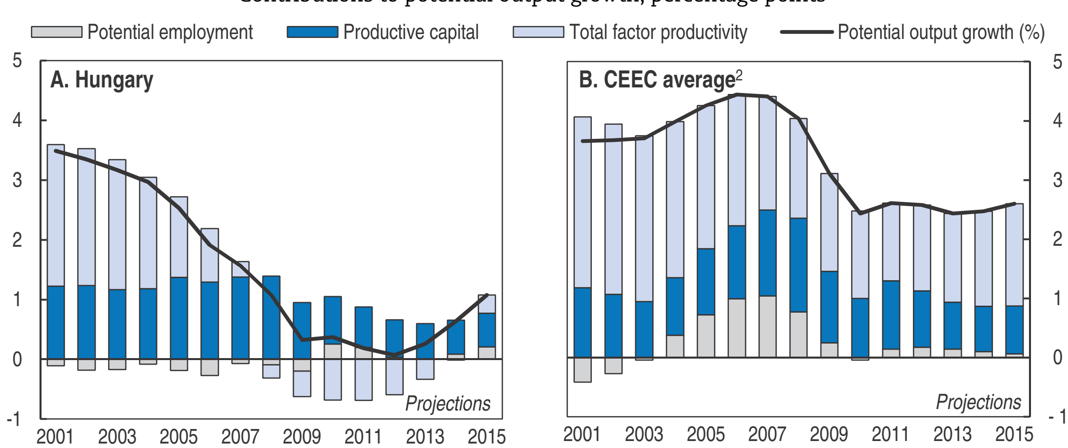
Over the past decade, the Hungarian economy has been falling behind its regional peers. Potential growth declined throughout the past decade, mainly reflecting adverse developments in total factor productivity (Figure 1.1). More recently, amidst widespread investment weakness, especially in Europe, potential output has also been hampered by a substantial slowdown in the pace of capital accumulation. The latter has been widespread but more pronounced in residential construction and in those sectors mainly dependent on the domestic market, such as energy and services, in sharp contrast to developments in the more outward-oriented manufacturing (Figure 1.2 and Martonosi, 2013). This overall disappointing economic performance permeates both strands of the largely dualistic Hungarian economy: large multinationals and domestic SMEs.

Spillovers from multinationals are limited

Foreign direct investment (FDI) is a driver of dynamism and in the 1990s Hungary was among the first countries in the region to attract large FDI inflows, partly due to a faster privatisation process. As a result, multinationals came to dominate the main export-oriented manufacturing sectors, such as transport and electronic equipment, and sectors servicing the domestic market, such as energy, telecommunications and banking. However, international competition for FDI has become fiercer. Leading car manufacturers have expanded capacity in Hungary, but some prominent electronics multinationals have done the opposite, pointing to the risk of less FDI in the future.

Figure 1.1. **Potential growth**

Contributions to potential output growth, percentage points[1]



1. Contributions to growth are calculated using a weight of 0.67 for potential employment and 0.33 for productive capital; total factor productivity is calculated as a residual. Productive capital excludes investment in housing, while potential employment abstracts from cyclical variations in the labour force and unemployment.
2. Unweighted average of other Central and Eastern European countries (Czech Republic, Poland and Slovak Republic).

Source: OECD (2013), *OECD Economic Outlook: Statistics and Projections* (database), December.

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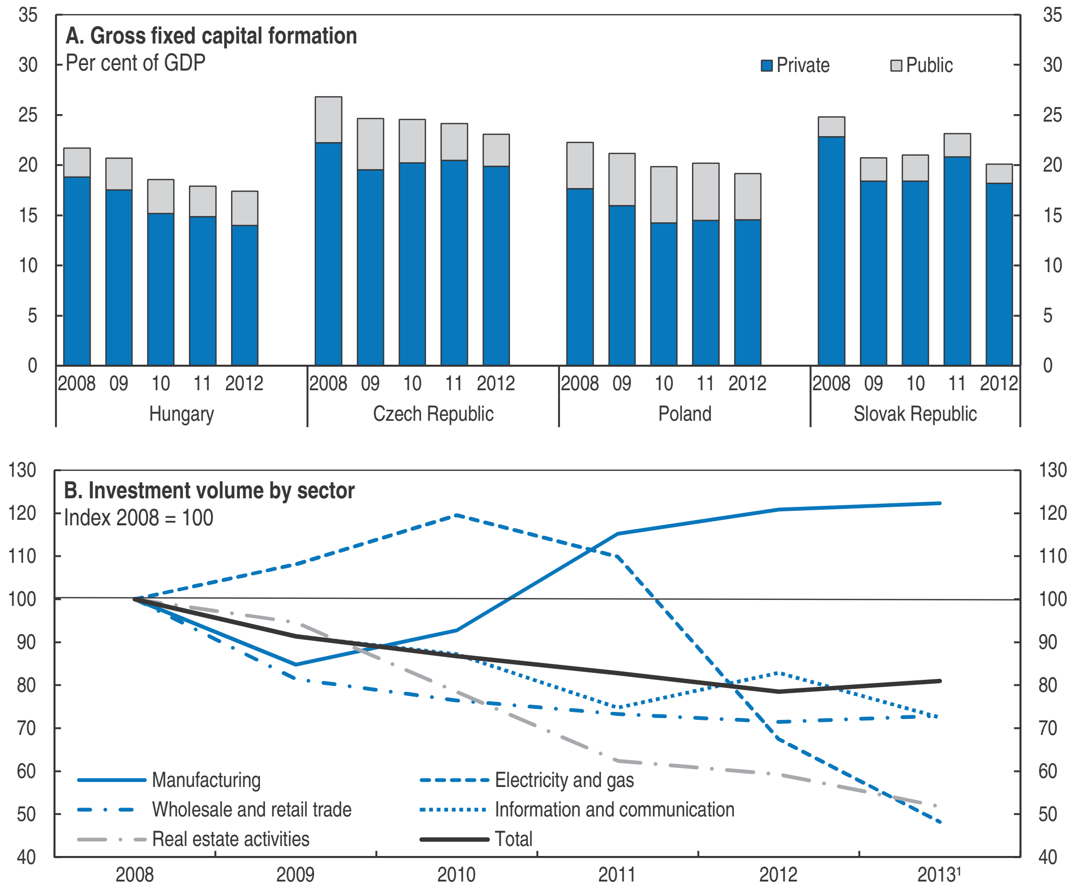
Figure 1.2. **Investment**



1. Estimate based on quarterly data available.

Source: OECD (2013), *OECD National Accounts Statistics* (database), December and HCSO (2013), "Business Units and Nonprofit Organisations", *STADAT Tables*, Hungarian Central Statistical Office, December.

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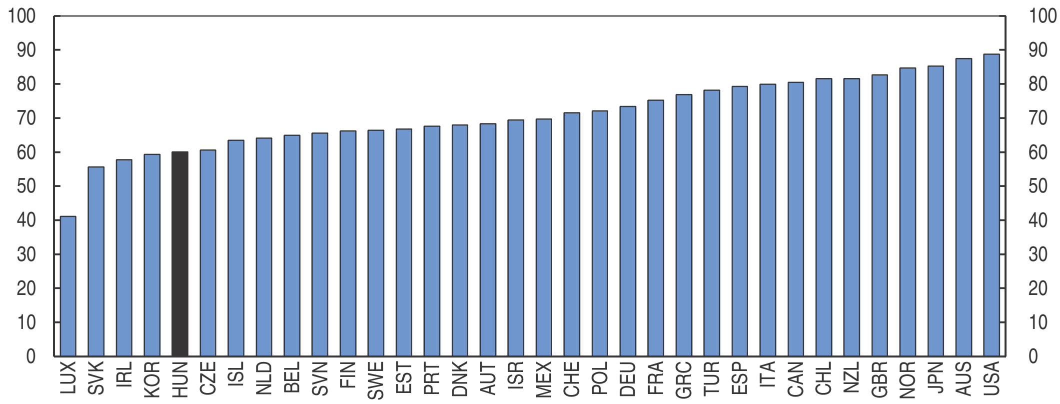
Surprisingly, and worryingly, FDI in Hungary has often brought only limited benefits to economy-wide productivity. While manufacturing foreign affiliates account for most business enterprise research and development (R&D) expenditure (0.75% of GDP in 2011), multinationals' R&D involvement in non-tradable sectors like energy or telecommunications is low by international standards. In addition, the domestic value added content of gross exports is low in international comparison (Figure 1.3), especially in the manufacturing of transport and electronic equipment. This suggests that the supplier networks of multinationals in manufacturing are weakly anchored in Hungary (OECD and WTO, 2013; Tóth, 2013) and may explain why higher productivity in multinational firms did not percolate to the rest of the economy.

SMEs are relatively abundant relative to the population, but generally of very small size and low productivity (Figure 1.4, Panels A and B). Further, they are weakly inserted in international trade (or in the supply chains of larger firms) and seldom engage in R&D or innovation (Figure 1.4, Panels C and D), though on the latter count recent years have witnessed some progress. Weaknesses in SMEs help explain their difficulty in liaising to multinationals and are accompanied, and to some extent induced, by a large informal sector (Figure 1.5), which tends to be associated with low productivity and slower firm growth (World Bank and IFC, 2013).

Figure 1.3. **Domestic value added content of gross exports**[1]

Per cent, 2009



1. This reflects the total domestic value-added embodied in exports as a per cent of gross exports, illustrating how much value-added is generated throughout the economy for a given unit of exports. The lower the ratio the higher the foreign content and so the higher the importance of imports to exports.

Source: OECD/WTO (2013), *OECD-WTO: Statistics on Trade in Value Added* (database), May.

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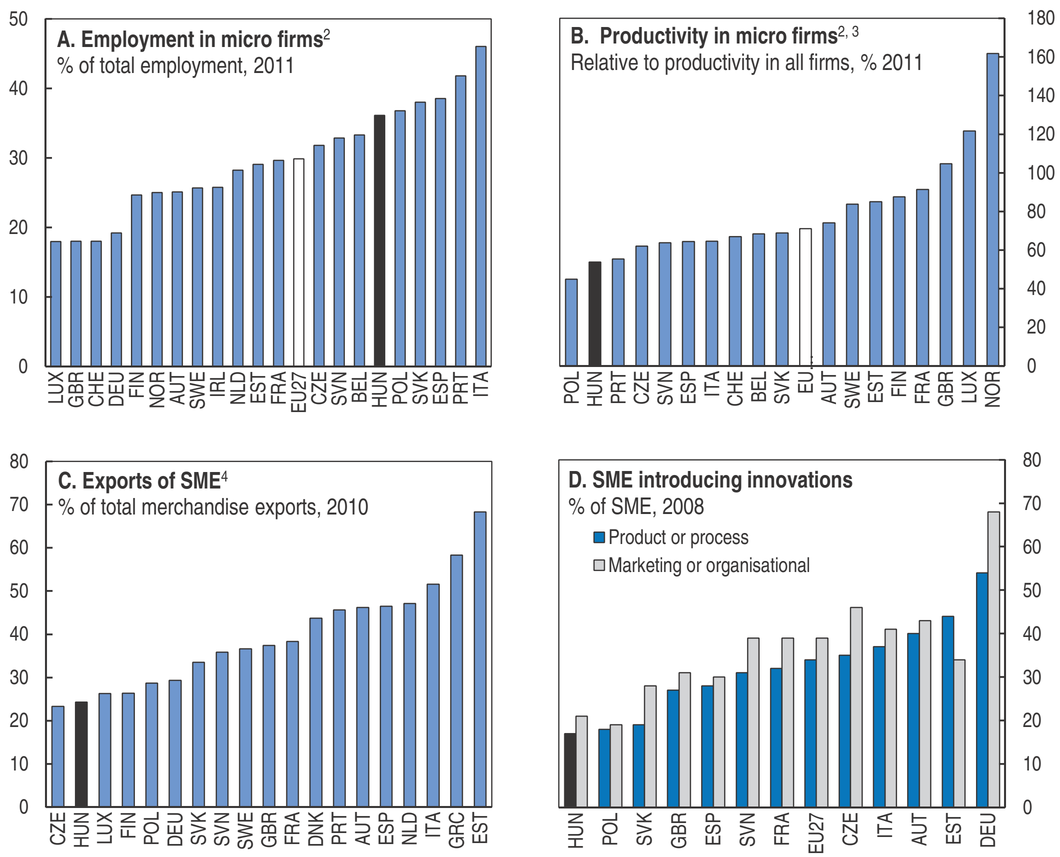
Weaknesses in the business environment

Weaknesses in the business environment and problems of insufficient competition (some of which, though long-standing, have worsened in recent years) are key to explaining the above shortcomings. Regulatory instability, not least in taxation, deters investment. So do barriers to entry (Alesina et al., 2005), either sector-specific (see below) or of a cross-cutting nature, such as high administrative burdens. These dimensions of restrictive product market regulation also harm productivity, according to evidence available at aggregate, industry and firm levels (Arnold et al., 2011). Productivity growth is reduced both within firms (e.g. through less incentives to innovate) and between firms by penalising allocative efficiency (i.e. resource reallocation towards the most efficient companies in a sector), an area where Hungary performs below par (see Figure 1.6 and Andrews and Criscuolo, 2013). Difficult access to finance and cumbersome insolvency procedures also hamper resource reallocation. More generally, the perceived quality and effectiveness of legal and political institutions is modest and has tended to decline in the recent past.

Competitive pressures are limited in some mostly non-tradable sectors, such as retail, professional services, energy and telecommunications. This is mainly due to high barriers to entry and, in energy, distortive price regulation. While empirical evidence on mark-ups in Hungary is scarce, especially in the non-manufacturing sectors, Bottini and Molnár (2010) report an internationally high value in retail trade. In telecommunications and energy, Hungarian price levels are often comparatively high, pointing to potentially high mark-ups. Negative impacts are substantial. Some evidence suggests that within service sectors anti-competitive regulation has a strong detrimental impact on allocative efficiency and therefore on productivity growth (Andrews and Cingano, 2012). Further, the effects extend to countless downstream industries, where the scope and incentives for productivity improvements can be reduced. For instance, restrictive regulation of professional business services slows down the growth of patenting firms across the economy (Andrews et al., 2013).

Figure 1.4. **Small and medium-sized enterprise (SME)[1] indicators**



1. Enterprise size classes are based on the number of persons employed: a SME employs 0-249 persons and a micro firm employs 0-9 persons.
2. The sector covered is the total business economy (including repair of computers, personal and household goods; excluding financial and insurance activities). Data for 2010 for Germany, Switzerland and the European Union aggregate.
3. Productivity is defined as value added at factor cost (in euros) per person employed.
4. Exports in US dollars for the total economy.

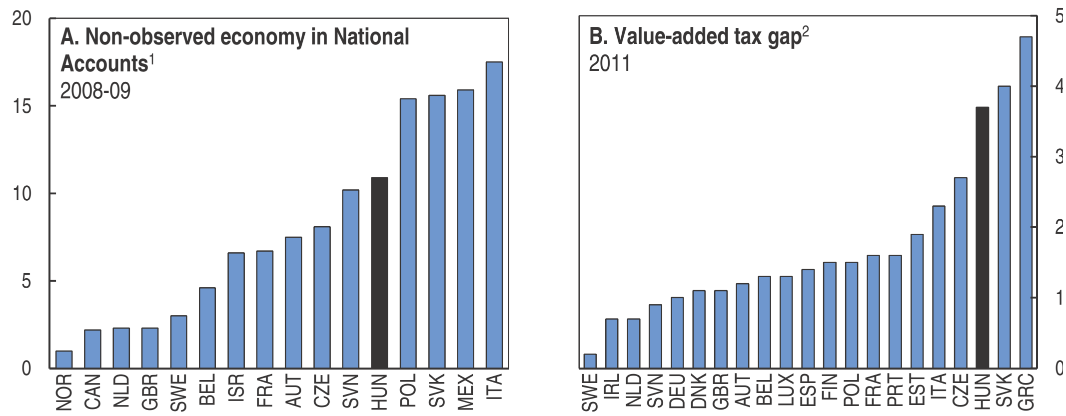
Source: Eurostat (2013), "Structural business statistics – Industry trade and services", *Eurostat Database*, December; OECD (2013), *Entrepreneurship at a Glance 2013* and European Commission (2013), "SBA Fact Sheets 2013" for each country, DG Enterprise and Industry.

StatLink http://dx.doi.org/10.1787/888932983167

SMEs are disproportionately affected by administrative burdens and thus often choose to slide into semi-informality, which thwarts their growth and makes it harder to change banks or suppliers of professional services (Balás et al., 2010; World Bank and IFC, 2013). SMEs are also hit hardest by financing constraints, which compounds the barriers to their growth and therefore to their ability to challenge larger competitors. Hampered resource reallocation towards dynamic young firms likely decreases the incentives to innovate in the first place (Andrews and Criscuolo, 2013). In turn, low-innovation firms generally have a weaker export performance (Halpern and Muraközy, 2012). As in other countries with a strong presence of foreign firms and low domestic value added content of gross exports, like Ireland, supporting the development of innovative SMEs would also help foster spillovers from multinationals, *inter alia* through joint R&D efforts or high-skilled labour mobility between the two sets of firms (OECD, 2013a).

Figure 1.5. **The informal economy is large**

Estimates in per cent of GDP



1. Numerical estimates of the non-observed economy (NOE) adjustments made to National Accounts based on responses to an OECD Survey carried out in 2012. The reference year of the responses varies from 2005 to 2009 with the large majority falling in 2008 or 2009. For details see the OECD document cited in the source.
2. The value-added tax (VAT) gap is the difference between the expected VAT revenues (account taken of reduced rates and exemptions) and VAT actually collected by national authorities. While non-compliance is certainly an important contributor to this revenue shortfall, the VAT gap is not only due to fraud. Unpaid VAT also results from bankruptcies and insolvencies, statistical errors, delayed payments and legal avoidance amongst other things.

Source: OECD (2012), "Summary of the OECD Survey on Measuring the Non-Observed Economy", Working Party on National Accounts, Committee on Statistics, Statistics Directorate, STD/CSTAT/WPNA(2012)21 and European Commission (2013), "Study to Quantify and Analyse the VAT Gap in the EU-27 Member States – Final Report", TAXUD/2012/DE/316, July.

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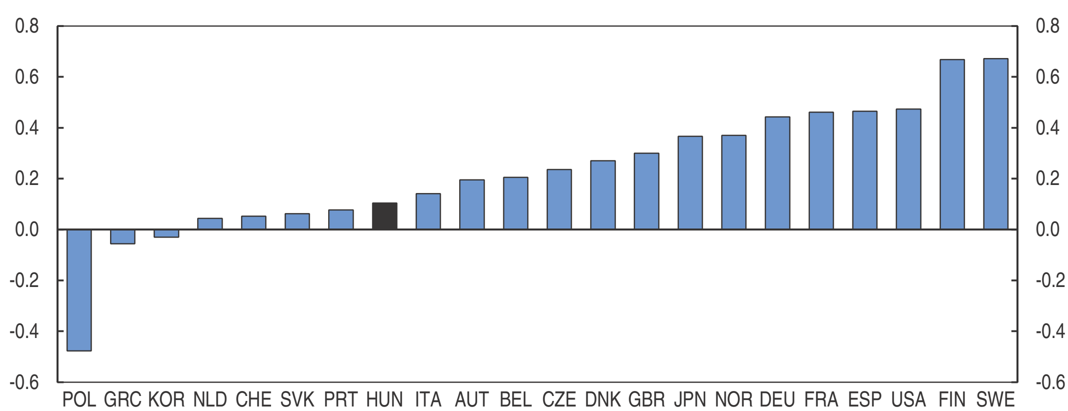
Figure 1.6. **Contribution of allocation of employment across firms to manufacturing labour productivity**[1]

In selected OECD countries, log points, 2005



1. The estimates show the extent to which the firms with higher than average labour productivity have larger employment shares in the manufacturing sector. In most countries, the covariance between productivity and employment share is positive, suggesting that the actual allocation of employment boosts manufacturing labour productivity (e.g. by around 50% in the United States), compared to a situation where resources were allocated randomly across firms (this metric would equal zero if labour was allocated randomly). See source publication for further details.

Source: D. Andrews and F. Cingano (2012), "Public Policy and Resource Allocation: Evidence from Firms in OECD Countries", *OECD Economics Department Working Papers*, No. 996.

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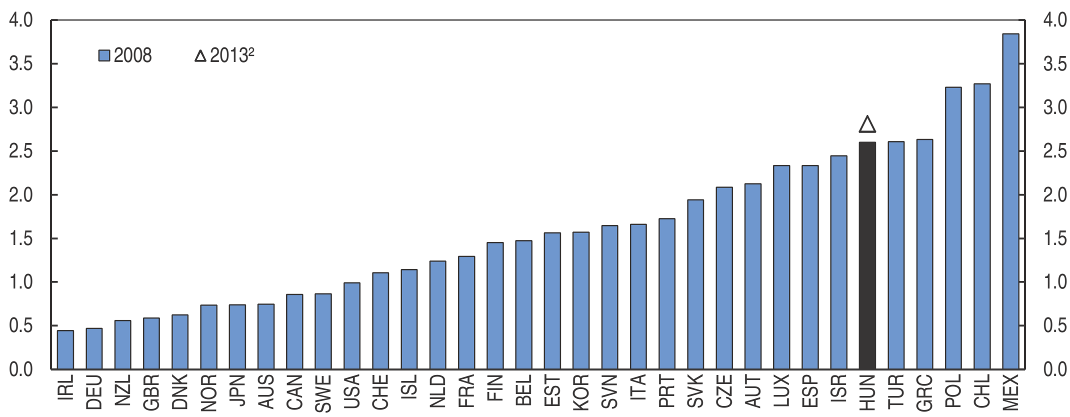
This chapter proposes reforms to improve product market regulation and thus foster investment and productivity growth in the Hungarian economy, discussing first problems felt across the economy and then addressing barriers to competition in specific service and utilities sectors.

Reducing administrative burdens and regulatory instability

There is abundant evidence of high administrative burdens in Hungary, both from indicators based on a cross-country comparison of prevailing regulations and from surveys based on business perceptions (Figure 1.7). An example of the latter is the Global Competitiveness Report (World Economic Forum, 2013), where in 2012 Hungary ranked 140th among 148 countries as regards the perceived burden of government regulation. Burdens are generally compounded by regulatory instability and uncertainty, which, if anything, have worsened in recent years, with executives often singling out policy instability, together with hard access to financing, as the most problematic factor for doing business (World Economic Forum, 2012 and 2013).

Figure 1.7. **Administrative burdens are high**[1]

Index scale of 0-6 from least to most restrictive



1. The product market regulation indicator for administrative burdens is composed of the following three elements (equal weights): administrative burdens for corporations, administrative burdens for sole proprietor firms and sector specific administrative burdens (road transport and retail distribution).
2. Preliminary data calculated on the basis of the 2008 methodology for purposes of comparability. For more details, see Koske et al. (2014) which provides the 2013 indicators with a revised methodology.

Source: OECD (2013), *OECD Product Market Regulation Statistics* (database), July and I. Koske, I. Wanner, R. Bitetti and O. Barbiero (2014), "The 2013 Update of the OECD Product Market Regulation Indicators: Policy Insights for OECD and non-OECD Countries", *OECD Economics Department Working Papers*, forthcoming.

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The authorities have long been aware of these problems and have made several attempts over the years to tackle them. In 2011, as part of an overall government strategy to improve the business environment, two ambitious administrative simplification programmes were launched, one addressed at citizens (the Magyary Programme, led by the Ministry of Public Administration and Justice) and the other at firms (the Cutting Red Tape Programme, led by the Ministry for National Economy). Wide-ranging in nature, these programmes have made important strides in streamlining existing regulations (Box 1.1). However, further progress requires reducing the flow of new regulation while improving its quality, persevering with efforts at greater co-ordination among different agencies (not

Box 1.1. **Recent administrative simplification programmes in Hungary**

The Magyary Programme, which has benefitted from a strategic assessment and capacity development advice from the OECD,* aims at both administrative simplification for citizens and public administration reform. Under the former strand, 228 procedures were simplified, in areas as diverse as family matters, taxation, employment and social assistance, with stronger reliance on interactions with the administration through electronic means (e-administration). While the Programme still awaits a formal evaluation, its goal was to decrease administrative burdens on citizens by more than 25%. Additionally, the authorities have been developing a network of one-stop-shops, which in July 2013 had reached 29 offices able to deal with 150 administrative procedures. Plans to expand the network to 300 shops handling around 2 500 procedures by end-2013 have been revised and rescheduled for 2014. As regards public administration reform, the Magyary Programme comprises actions to promote capacity building among civil servants, for instance through training in *ex ante* regulatory impact assessment, as well as efforts to fight corruption.

As regards simplification steps addressed to firms, 93 out of the 114 measures initially envisaged under the Cutting Red Tape Programme had been implemented by the end of 2013. Official estimates based on the standard cost model suggest that the administrative burden of businesses decreased by around HUF 210 billion per year (0.7% of GDP). Over 40% of this reduction has been achieved in taxation and accounting, identified as the most burdensome areas, *inter alia* by extending e-administration, decreasing the number of payments to the tax authority by allowing the merger of various payments into one single money transfer and streamlining public health insurance administration. Simpler procedures when applying for European Union funds and building permits are also noteworthy, as is the reduction from 30 to 21 days in the general deadline for a public authority to finish a procedure. Further, implemented measures extended to the areas of transportation, environmental protection, agriculture and legal protection. Measures still pending are mostly connected to e-government (e.g. interoperability of databases and extension of electronic data provision), which has a large potential for further improvement. Based on the encouraging results obtained so far, the government is planning to launch a second phase of the Cutting Red Tape Programme.

* OECD (2012), *OECD-Hungary Strategic Partnership for Public Administration Reform. Compendium of Analysis and Activities*, internal working document.

least in information-sharing), and promoting greater transparency and stakeholder involvement in programme monitoring.

While the stock of pre-existing burdens has been curtailed, new regulation, sometimes poorly prepared, has relentlessly kept flowing. The requirements for and the extent of Regulatory Impact Assessment (RIA) processes in Hungary have traditionally been below-average (OECD, 2009). In 2011 RIA was made compulsory for government-originated legislation, and technical capacity for that purpose started to be built at the two ministries that are leading the administrative simplification effort. However, ensuring high-quality RIA which is able to cover economic, social and environmental impacts is still challenging, for reasons as diverse as insufficient staff training, the lack of an evaluation culture or shortcomings in information systems (such as the need to know, for instance, how many firms will be affected by a new regulatory requirement). The authorities should thus continue ongoing efforts to tackle these problems, and regularly publish RIA outputs.

The situation is worse as regards parliament-initiated bills, which account for a growing share in total legislation (around 36% of all laws adopted between the 2010 elections and September 2013, up from 19% in the 2006-10 legislature). They are not subject to RIA, with even consultation of affected parties being left at the discretion of parliamentarians. Mandatory consultations with experts and stakeholders should be introduced, and the opinions delivered in those consultations made public. Further, secondary legislation detailing and implementing primary legislation should be timely and transparent.

Successful administrative simplification requires strong intra-government co-ordination, which is still challenging in some areas. Though the two simplification programmes were initially assigned to different ministries, with limited exploitation of the synergies between measures for citizens and for firms (OECD, 2012a), co-ordination improved with the later creation of a high-level Task Force (led by the Ministry of Public Administration and Justice) to monitor both programmes in May 2012. However, the need for increased co-ordination remains particularly pressing as regards information sharing and database integration, as the large burdens from information obligations (Deloitte, 2009) are partly induced by repeated reporting to different agencies. The authorities are currently preparing the legal conditions for the interoperability of state-owned databases, with full implementation expected to extend beyond 2014 (Government of Hungary, 2013). These efforts should be continued with a high priority, without neglecting appropriate safeguards for data privacy and security.

Finally, the authorities should further promote systematic stakeholder involvement in programme monitoring, the results of which should be made public. So far, monitoring has essentially taken the form of internal government reports, and interactions with stakeholders have been insufficient for programme steering, though stakeholders were initially involved in programme design. However, regular interactions help to make agencies more aware of firms' and citizens' needs, nurture mutual trust and provide valuable feedback on implementation, enabling corrective interventions if a gradual approach is taken. On this latter count, earlier plans for an extremely rapid expansion of one-stop-shops in 2013 (see Box 1.1) provide a counter-example. Publicly-available reports on progress in implementation foster transparency and raise the political profile of simplification efforts, thus reinforcing the momentum for reform.

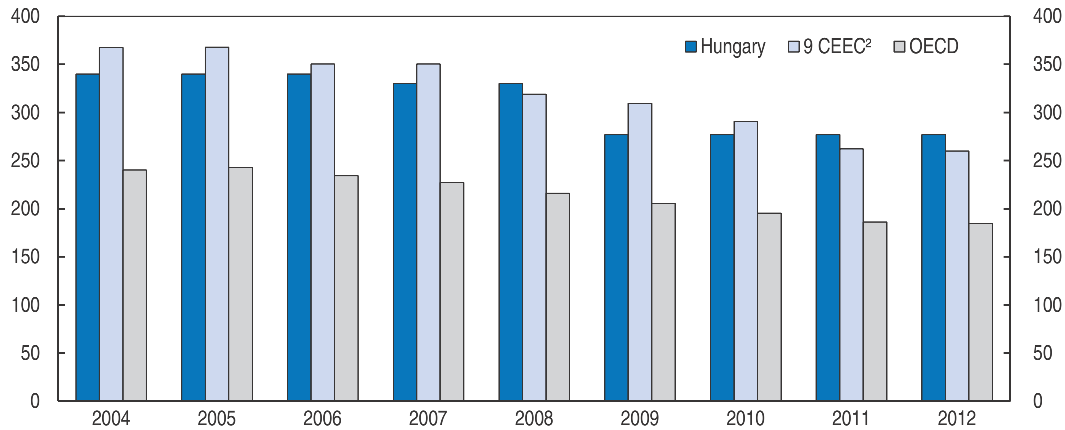
Burdens and instability are prominent in taxation

Taxation is a major area where economic agents face burdensome and unstable rules, accounting in some studies for over 40% of total administrative burdens from information obligations (Deloitte, 2009). According to *Paying Taxes 2014* (World Bank et al., 2013), a Hungarian SME spends 277 hours per year complying with tax obligations, 50% more than the OECD average, although not much different from other Central and Eastern European countries (Figure 1.8). The administrative costs of tax collection, either relative to GDP or to tax revenue, are also high in international comparison (OECD, 2013b). Explanations include a high number of different taxes as well as complex and unstable tax laws, partly due to sizeable tax expenditures (amounting to almost 4% of GDP in 2013 according to official estimates).

In recent years, the proliferation of successively amended special taxes (not included in the above estimate of the time needed for compliance) has compounded instability and uncertainty (Box 1.2). While these taxes have contributed to fiscal consolidation and

Figure 1.8. **Paying taxes**

Time taken to prepare, file and pay taxes, hours per year[1]



1. Corporate income tax, value added or sales tax, and labour taxes (including payroll taxes and social security contributions). Zone aggregates are unweighted averages.
2. Central and eastern European EU member countries: Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Poland, Romania, Slovak Republic and Slovenia.

Source: World Bank (2013), *World Development Indicators*, *World DataBank* (database), November and *www.doingbusiness.org.*

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helped avoid a higher tax burden on labour, the associated regulatory volatility has deterred investment. Some of these taxes have also had further adverse impacts on investment, such as those stemming from the sharp deterioration in the profitability of banks and therefore in their ability to extend credit (the levy on financial institutions (Box 1.2) being particularly harmful on this count), or may distort competition when tax design penalises some firms more than others (as discussed below in the context of telecommunications). The authorities should gradually scale down these special taxes and improve the design of the most distortive ones. An analysis of how to improve bank taxation can be found in the financial stability chapter of the 2012 *OECD Economic Survey* of Hungary (OECD, 2012b) and in Havrylchyk (2012).

The authorities have taken some welcome steps to reduce burdens in taxation, but there is still much room for improvement. Substantial progress has been made over the past decade in electronic tax filing by firms (OECD, 2013b). More recently, some minor taxes were abolished, and in 2013 tax payments were streamlined (Box 1.1) and two simplified corporate tax schemes addressed at micro enterprises (KATA, a lump-sum tax) and at small firms (KIVA, a cash-flow-based one) were introduced, though take-up has been more gradual than anticipated and previous preferential schemes for SMEs have remained in force. The merger of tax and customs operations into the National Tax and Customs Administration (2011) has the potential to reduce compliance costs (as the integration of social contributions collection into the tax agency gradually did in the past) as well as to enable a more effective fight against tax fraud and evasion. In pursuing the latter, however, the authorities should avoid creating excessive information burdens on complying taxpayers, as it could be the case with the recent requirement to detail VAT returns on a per invoice basis.

Consolidating several related taxes into fewer and broader ones is an important avenue for simplification. For instance, the five different types of social contributions (all falling on the gross wage, but nonetheless with some divergence in rules) could be unified,

Box 1.2. **The expansion of special taxes in Hungary**

Since 2010 there has been a steep increase in revenue from taxes with statutory incidence on a limited number of sectors, namely finance, energy, telecommunications and retail (Table 1.1). Existing taxes have been modified and new ones introduced, often with several subsequent revisions, as summarised below.

Table 1.1. **Selected sector-specific taxes**

Billion HUF

	2008	2009	2010	2011	2012	2013[1]
Finance	12.6	12.6	192.3	195.9	94.6	373.9
Levy on financial institutions	..	..	182.3	186.5	84.9	139.1
Extra tax on selected financial institutions[2]	12.6	12.6	10.0	9.4	9.7	8.1
Financial transaction tax (excluding Treasury)	..	..	..	..	..	200.5
Insurance tax	..	..	..	..	..	26.2
Energy	..	24.2	81.2	115.9	87.2	98.9
Income tax on energy service providers	..	24.2	17.0	16.9	5.6	54.1
Surtaxes payable by certain economic sectors	..	..	64.2	99.0	81.6	3.9
Tax on wires and pipelines	..	..	..	..	..	40.9
Telecommunications	..	..	58.6	51.3	62.9	61.7
Surtaxes payable by certain economic sectors	..	..	58.6	51.3	50.7	3.7
Tax on wires and pipelines	..	..	..	..	..	14.0
Telecommunications tax	..	..	..	..	12.2	44.0
Retail	..	..	28.9	21.6	33.3	2.2
Surtaxes payable by certain economic sectors	..	..	28.9	21.6	33.3	2.2
Total	**12.6**	**36.8**	**361.0**	**384.7**	**278.0**	**536.7**
In % of GDP	*0.0*	*0.1*	*1.4*	*1.4*	*1.0*	*1.8*

1. Preliminary budgetary data.
2. The amounts for 2013 exclude the technical adjustments introduced to ensure equal burden-sharing between banks and the state as regards debt forgiven under the exchange rate cap scheme (a foreign exchange mortgage relief scheme).

Source: State Treasury, Ministry for National Economy.

Since 2007 credit institutions have had to pay a special tax (the **extra tax on selected financial institutions**) on interest income from state-subsidised loans. This tax replaced the extraordinary tax on financial institutions, introduced in 2005.

In 2010 taxes on the financial sector were expanded with the introduction of the **levy on financial institutions**, falling on the adjusted balance sheet amount at end-2009. A 0.15% rate is applied up to HUF 50 billion, beyond which the marginal rate rises to 0.53%. In 2012, some losses from the foreign exchange mortgage early repayment scheme (which allowed debtors to pay off their mortgages at a concessionary exchange rate) and from debts overdue more than 90 days could be deducted, the same holding for the increase in the credit portfolio towards SMEs (which has remained deductible to date). According to April 2012 Convergence Programme plans, this tax would have been halved in 2013 and further reduced in 2014. In October 2012, however, the authorities decided to postpone halving to 2014, and one month later to retain the tax indefinitely and in full. Insurance companies have been exempted from this tax since 2013 and a consumption-type **insurance tax** was introduced instead, falling on insurance premia (except for life insurance).

Box 1.2. **The expansion of special taxes in Hungary** *(cont.)*

The **financial transaction tax** (FTT), in force since 2013, is levied on most transactions of financial institutions and the Treasury, including money transfers, cash withdrawals and amortisation of loans, among others. The FTT was initially supposed to replace the levy on financial institutions, and the law creating it (July 2012) set a rate of 0.1%. In the autumn, however, the general rate was increased to 0.2%, with a higher rate (0.3%) charged on cash withdrawals. A ceiling of HUF 6 000 per transaction generally applied. Because of large revenue shortfalls, the authorities increased rates again to 0.3% (0.6% on cash withdrawals), effective from August 2013, and abolished the ceiling for cash withdrawals. Further, banks were required to make a one-off payment of HUF 75 billion in the autumn. Banks, nonetheless, have generally succeeded in shifting the FTT to their clients through increased service fees (MNB, 2013).* A November 2013 amendment attempts to limit this pass-through by making individuals entitled to two free cash withdrawals per month (on which banks still have to pay FTT) up to a total HUF 150 000 from February 2014 onwards.

Turnover-based **surtaxes payable by certain economic sectors** (energy, telecommunications and retail) were introduced in December 2010, retroactively covering 2010, and phased out, as planned, at end-2012, leaving retail special-tax-free. Each sector concerned had its own schedule of progressive tax rates.

The **income tax on energy service providers** (nicknamed the Robin Hood tax) was introduced in 2009 as a temporary tax to last for two years (2009-10). It fell on pre-tax profit at a rate of 8%. The tax has stayed on after 2010 and the April 2012 Convergence Programme envisaged to double it to 16% in 2013. The planned 2013 rate was later revised downward to 11% and finally raised to 31% in November 2012 (with an up to 50% deduction for certain types of job creating investments). Since 2013, the range of companies liable to pay this tax has also been broadened with the inclusion of electricity and natural gas distribution system operators and universal service providers.

A **tax on wires and pipelines**, falling on the owners of utility networks, came into force in January 2013, set at a rate of HUF 125 per meter of ducts providing for electricity, natural gas, heating, water and wastewater services. For telecommunications, the marginal rate is progressive on the length of the network, ranging from HUF 25 to the standard HUF 125 per meter. The legislation was proposed and passed within only five days in November 2012. According to plans made one month earlier the tax would have been local and optional. State and municipality owned enterprises are exempt.

A **telecommunications tax** on fixed and mobile voice calls and mobile SMS/MMS services has been effective from July 2012, set at HUF 2 per minute of calls and per SMS/MMS, with monthly caps per calling number of HUF 400 for private individuals and HUF 1 400 for other subscribers. These caps were increased to HUF 700 and HUF 2 500, respectively, at the beginning of 2013. In August 2013 the tax for other subscribers was increased to HUF 3 per minute or message with a monthly ceiling of HUF 5 000.

* MNB (2013), *Report on Payment Systems*, Magyar Nemzeti Bank.

and older forms of preferential corporate income taxation for SMEs reconsidered as new schemes are introduced. Also, the authorities should aim at greater stability of tax rules, notably by rolling back tax expenditures and other special provisions (reduced rates of value-added tax [VAT], which go well beyond essential food staples, being a case in point) and significantly reducing the flow of new ones. By reducing uncertainty and compliance costs, simpler and more stable tax rules would also pave the way for greater trust and transparency in the relationship between firms and the tax administration (Balás et al., 2010).

Strengthening institutional quality

Legal institutions need to be strong

A stable and efficient legal framework, grounded on the principles of separation of powers and judicial independence, is widely seen as growth-enhancing (North, 1990; Rodrik et al., 2004). Furthermore, transparency and trust decrease transaction costs and help foster a level playing field for business. In Hungary, however, the perceived quality and effectiveness of legal and political institutions is weak. While inevitably subjective, perceptions help shape investor sentiment, with implications ranging from exchange rate stability to fixed capital formation. Hungary performs poorly on an indicator of civic engagement and governance (OECD, 2013c), and ranks 84th among 148 countries in the institutional component of the Global Competitiveness Index (World Economic Forum, 2013). In the latter, besides administrative burdens, trust and transparency in policymaking and the efficiency of the legal framework in enabling firms to challenge government regulations are seen as particularly problematic. Over the past few years, Hungary has gone down in the rankings in most of these areas. Citizens' perceptions of corruption have also worsened (Transparency International, 2013).

Some recent developments have not helped to foster transparency and trust in public institutions. Constitutional changes have proved controversial (Venice Commission, 2013; European Parliament, 2013). Legislation has reinforced the statutory independence of sectoral regulators, a welcome goal, but has also limited the possibilities of appeal. Energy or media firms, for instance, can only challenge the general regulations by the respective sectoral agencies at the Constitutional Court, instead of ordinary courts – arrangements which, while not unprecedented in Europe, may be problematic. Further, the decisions of the media regulator in individual cases, which may include hefty fines, are to be immediately enforced regardless of any subsequent appeal to courts. In the context of tobacco monopolisation (see below), important legal amendments (namely raising the profit margin and enlarging the range of other products licensed retailers are allowed to sell) took place after the closing date for applications for retail licences. Well communicated steps towards stronger checks and balances, as discussed in the 2012 *OECD Economic Survey* of Hungary (OECD, 2012b), are therefore important. Reputation and credibility would also benefit from giving priority to people widely regarded as non-affiliated to political parties in future appointments to boards of independent agencies, either those with macroeconomic or sectoral roles (Thatcher, 2005; Gilardi and Maggetti, 2010).

Preserving a broad and efficient competition enforcement

Recent developments have limited the ability of the Hungarian Competition Authority (GVH) to enforce and promote competition. According to competition law, any draft bills or regulations which may affect competitive conditions or the operation of markets must be submitted to the GVH for an opinion. However, both parliamentarians and the government have long been reluctant to do so, and the problem is arguably getting worse (the number of yearly submissions declined from around 500 in 2007 to 115 in 2012), making it harder for the GVH to exert a pro-competitive influence in law-making. Non-submission is due either to decisions of the legislation proponents or to the general exemption of consultation obligations for parliament-initiated bills. The authorities should systematically consult the GVH in relevant matters, as well as any sectoral regulators concerned. Further, enough time should be allowed for the delivery of an informed opinion, any departures from which the authorities should be asked to publicly justify.

Also of concern are recent developments curtailing the scope of competition law. A legal amendment in force since November 2012 exempts, under certain conditions, agricultural products from competition rules on cartels. Conditions give considerable leeway for interpretation (for instance, whether the anti-competitive effects of a cartel agreement exceed what is necessary to ensure a fair income to producers) and are assessed by the Minister of Rural Development, whom the GVH must consult in any proceeding involving those products. While so far the only exemption has been granted to watermelon producers and retailers, halting the investigation of an alleged cartel which the GVH had started before the legal amendment, the new rules have the potential to severely restrict competition in retailing. Further, 2013 legislation empowers the government to bypass the GVH in authorising mergers considered to be of national interest. Again, the criteria to be fulfilled – such as the need to protect jobs or to ensure secure supply – leave substantial room for interpretation. To reverse these trends, the authorities should expand rather than restrict the scope of application of competition law.

The GVH continues to foster capacity building in the region through the dedicated operation of the OECD-GVH Regional Centre for Competition in Budapest, and has achieved major efficiency gains in merger control through more systematic pre-notification contacts with interested parties, the creation of a dedicated merger section and streamlined procedures for non-problematic deals. Though internal restructuring has also taken place in antitrust, the enforcement record in this area has so far won less praise (Global Competition Review, 2013). In 2011-12, the average length of cartel investigation substantially increased, leading to fewer decisions. Advocacy work has also likely decreased, as it has mainly consisted in reacting to a decreasing number of draft bills submissions (though the GVH took on some occasions the initiative of sending comments directly to the legislation proponents), with less use of active advocacy tools, such as sectoral inquiries (the recent investigation into the market of online room reservations in the tourism sector, launched in July 2013, was the first such new inquiry since 2010). Drawing on the efficiency gains achieved in mergers, the GVH should step up work in antitrust enforcement and further active competition advocacy.

SME growth and entrepreneurship need to be fostered

Despite some recent improvement, access to finance is still identified as the most pressing problem by 17% of Hungarian SMEs, against 15% in the European Union (EU) average (European Commission, 2013a). In a similar vein, lack of capital is seen as the main obstacle to self-employment and entrepreneurship (OECD, 2013d). Repairing bank balance sheets by recognising losses from non-performing loans and avoiding "evergreening" (successive credit extension to borrowers otherwise unable to service debt) is probably the single most important way to ease SME financing (Darvas, 2013). SMEs are also benefitting from targeted central bank lending through the Funding for Growth Scheme, which provides banks with zero per cent interest funding to lend to SMEs in forints or to convert outstanding SME foreign currency loans into forints at a maximum 2.5% interest rate. Further, to give SMEs easier and cheaper access to finance, credit guarantee schemes were bolstered in 2013 with a 75 basis point budget subvention to reduce guarantee fees for a wide range of loan types. However, as discussed below, more should be done, on both debt and equity finance fronts. Since late and non-payments are a major problem in Hungary (Intrum Justitia, 2013), a further way to reduce firms' liquidity and financing strains is to cut payment delays in the public sector, building on recent progress in this area.

Greater reliance on bank financing, more informational asymmetries and less bargaining power make SMEs more vulnerable than large firms to competition problems in the banking sector, discussed in the financial stability chapter of the 2012 *OECD Economic Survey* of Hungary (OECD, 2012b; Havrylchyk, 2012). One important dimension is transparency about credit eligibility and conditions, the lack of which often discourages SMEs from even applying for credit (Brown et al., 2011; Ministry for National Economy, 2012). In this vein, rules to curb unilateral contract modification by banks, now essentially confined to household mortgage loans concluded after April 2012, should be extended to all types of loans. As discussed above, fewer administrative burdens, as envisaged by the authorities, would foster less informality and hence more transparency on the SME side.

Deepening credit information would help both banks to credit-score their clients and clients to switch banks. For this purpose, credit information from non-bank sources (such as retailers or utilities) should be included in credit bureaus, which is not yet the case with BISZ, the main credit bureau in Hungary. Better information on individuals is also relevant for SME lending, as entrepreneurs, even when not personally liable for their business, are often required to provide personal guarantees when seeking a loan. BISZ used to collect both positive and negative information on firms, but only negative data on individuals. Legislation passed in October 2011 requiring BISZ to also provide positive information on individuals has had limited effect so far, since only about 20% of the borrowers with positive debt history have given the needed consent for such information to be disclosed and kept after the respective loan is terminated. Though consent is often also required abroad (Rothemund and Gerhardt, 2011), in the light of low financial literacy in Hungary the authorities should go further and impose mandatory disclosure and storage of positive information, without giving borrowers the right to opt out.

Equity finance is especially important for young innovative firms, which are often unable to borrow due to lack of collateral and track record. Venture capital investments have substantially increased in Hungary, which among EU countries leapt from one of lowest values as a share of GDP in 2009 to the highest (0.065%) in 2012. This largely reflects EU-funded public programmes, and most prominently the New Széchenyi Venture Capital Programme, endowed with over HUF 30 billion (0.1% of GDP) in 2009-13, which makes investments in mostly high-technology young firms with private sector co-financing. In contrast, another EU-funded vehicle, the HUF 14 billion Széchenyi Fund for Capital investments (SZTA), relays venture capital to a wide variety of economic sectors, including low-technology activities like hospitality and furniture production. To maximise impacts on productivity and growth, public venture capital programmes should be better targeted to innovative firms and undergo systematic evaluation.

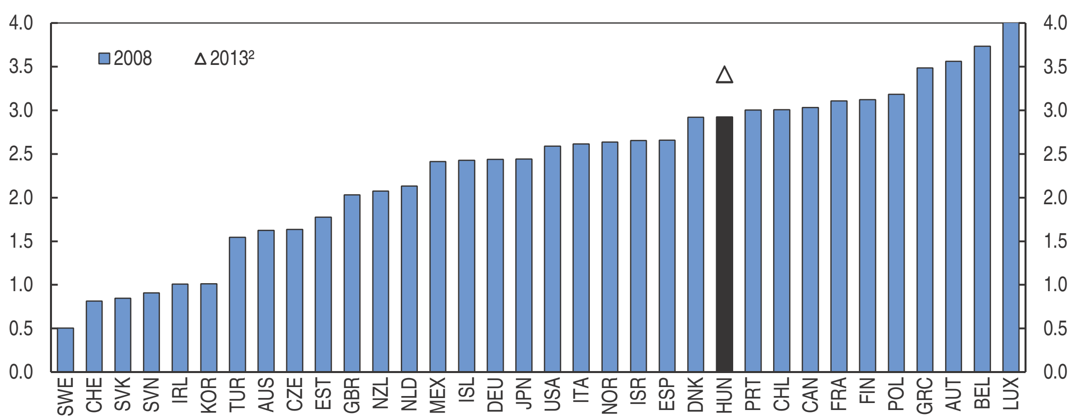
Reforms in bankruptcy laws are also needed to support innovative SMEs and entrepreneurship. Conversely to the ability to rapidly scale up production when innovation proves successful, swift exit in case of failure is essential to maximise salvage value and give entrepreneurs a second chance. Corporate insolvency procedures in Hungary are lengthy and, largely as a consequence, lead to an internationally low recovery rate (38% against 68% across the OECD, according to World Bank and IFC, 2013). This penalises creditors (and thus harms credit availability) and hampers resource reallocation (Andrews and Criscuolo, 2013). The authorities should therefore take steps to shorten the duration of corporate insolvency procedures, for instance by introducing out-of-court settlements and simplified procedures for micro and small firms. As for private individuals, introducing a personal insolvency framework may reduce the time needed for debt discharge and therefore favour entrepreneurship and risk-taking.

Barriers to entry are high in retail and professional services

There is ample scope to spur competition and productivity growth in retail, where restrictive regulations, already significant in 2008, have recently tightened (Figure 1.9). The share of small shops, generally of low productivity (only 64% of the sector average in 2010), is high (Figure 1.10, Panel A) and the fall in their numbers has noticeably slowed down since the mid-2000s. This may help explain an upward trend in the relative price of food (Figure 1.10, Panel B), in contrast with developments in the first half of the decade, when rapid expansion of modern retailers, often owned by international chains, moderated food inflation (Igan and Suzuki, 2012).

Figure 1.9. **Product market regulation in the retail sector**[1]

Index scale of 0-6 from least to most restrictive



1. Barriers to entry in retail trade covering licences or permits needed to engage in commercial activity, specific regulation for large outlets and protection of existing firms.
2. Preliminary data calculated on the basis of the 2008 methodology for purposes of comparability. For more details, see Koske et al. (2014) which provides the 2013 indicators with a revised methodology.

Source: OECD (2013), *OECD Product Market Regulation Statistics* (database), July and I. Koske, I. Wanner, R. Bitetti and O. Barbiero (2014), "The 2013 Update of the OECD Product Market Regulation Indicators: Policy Insights for OECD and non-OECD Countries", *OECD Economics Department Working Papers*, forthcoming.

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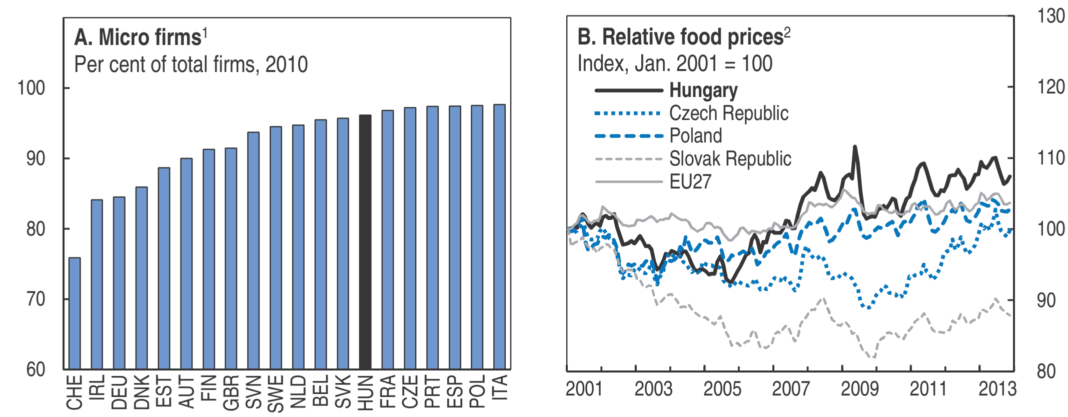
A major barrier to entry was added in 2012 by requiring government permission for new commercial buildings exceeding 300 square metres, a provision to stay in force until end-2014. The low threshold will bind virtually all modern-format retailers, such as hypermarkets, supermarkets and discounters (Igan and Suzuki, 2012). Further, the ministerial committee which assesses requests has denied permission in almost half of the cases so far. It has ample room for discretion, as legal provisions give no clear guidelines on the environmental and urban planning criteria to be taken into account. Retailers wishing to expand have often opted for purchasing existing stores rather than trying to build new ones, which helps explain a high number of mergers in the food retail

Figure 1.10. **Indicators on retail firms and prices**



1. Firms with less than ten employees in the retail trade (excluding motor vehicles and motorcycles).
2. Prices of food and non-alcoholic beverages relative to all consumer prices (harmonised indices of consumer prices).

Source: OECD (2013), *Structural and Demographic Business Statistics* (database), December and Eurostat (2013) "Economy and Finance – Prices", *Eurostat Database*, December.

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market in 2012-13 (GVH, 2013). Higher market concentration ensues. The authorities should substantially raise the large outlet threshold and set out clear criteria for deciding on requests. Competition should be further enhanced by reducing retail-specific administrative burdens, such as those pertaining to other permits and licences.

Restrictive regulation for specific products has also been introduced. To make tobacco less accessible, especially for the youth, tobacco retail was monopolised from July 2013. Licensed retailers, selected through tenders and expected to reach around 5 000 nationwide, are around nine times less numerous than tobacco vendors before, and also enjoy a higher profit margin (10%). Post-monopolisation data shows a marked increase in tobacco prices (12% in June-November 2013), while expected tobacco excise revenues in 2013 were slightly revised downwards, and are forecast to decline further in 2014, in contrast with strong increases in 2011-13 on the back of excise hikes.

Monopolisation may thus be leading to higher profits for the few licensed retailers to the detriment of the public purse. A related concern is black market growth, as the geographical distribution of retailers is uneven, with only gradual improvement in the coverage of small settlements. The authorities should consider further rising tobacco excises as an alternative to monopolisation. Part of the increased revenues could finance strict enforcement of the current ban on sales to minors across a wider network of points of sale.

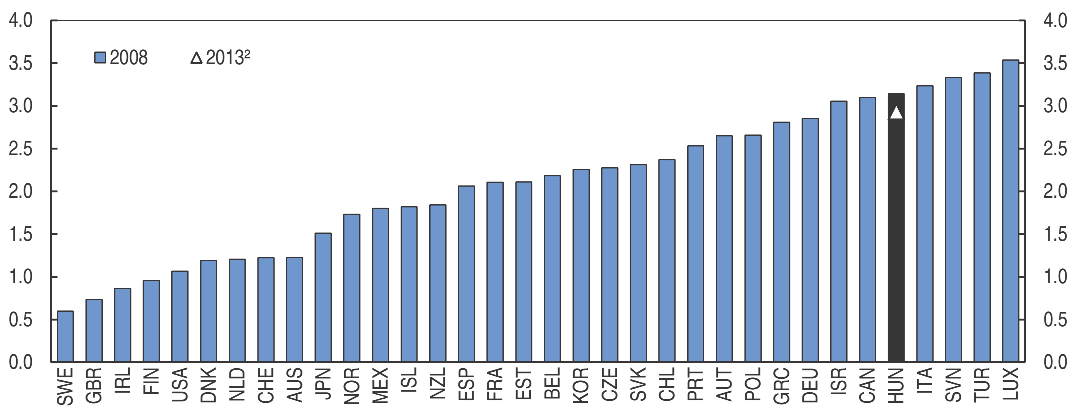
Barriers to entry have also been raised in the pharmacy sector. After substantial liberalisation in 2006, which made the number of pharmacies increase by around 20%, 2010 legislation reinstated geography and demography-based entry barriers (minimum thresholds for residents per pharmacy and distance between pharmacies) as well as ownership constraints. Pharmacists must own a majority stake by January 2017, a requirement which is currently not met by around one third of all pharmacies. Further, one pharmacist can own only four pharmacies (existing larger chains will not be disintegrated and will have a transition period to move to majority control by a pharmacist). Some evidence suggests that restrictions of this kind lower productivity and allocative efficiency without offsetting gains in service quality (ECORYS, 2007).

The worthy aim of protecting public health may be attained in less restrictive ways. For instance, professional oversight and counselling may be ensured by requiring a pharmacist's presence, rather than ownership. Restrictive practices stemming from wholesaler ownership – which were in any case not detected in 2006-10 – may be tackled under competition law. The authorities should therefore roll back the restrictions introduced in 2010. They should also expand the range of over-the-counter medicines that can be sold outside pharmacies.

Impediments to competition in professional services are internationally high (Figure 1.11), both as regards conduct regulations (see below) and barriers to entry. The latter mainly stem from lengthy training requirements, both in higher education and as compulsory practice, and extensive exclusive rights for service provision. Accounting and legal services, needed by the vast majority of firms, are among those most tightly regulated. If sustained, the recent sharp decrease in admissions to certain tertiary education programmes, including economics and law, partly induced by an even sharper fall in the number of state-financed (i.e. tuition fee-exempt) positions available (Chapter 2), will in the medium term also restrict entry in the corresponding professional services.

Figure 1.11. **Barriers to competition in professional services**[1]

Index scale of 0-6 from least to most restrictive



1. This indicator covers entry and conduct regulation in the legal, accounting, engineering, and architectural professions.
2. Preliminary data calculated on the basis of the 2008 methodology for purposes of comparability. For more details, see Koske et al. (2014) which provides the 2013 indicators with a revised methodology.

Source: OECD (2013), *OECD Product Market Regulation Statistics* (database), July and I. Koske, I. Wanner, R. Bitetti and O. Barbiero (2014), "The 2013 Update of the OECD Product Market Regulation Indicators: Policy Insights for OECD and non-OECD Countries", *OECD Economics Department Working Papers*, forthcoming.

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Anti-competitive price and fee regulations are common. As an exemption from competition law, many professional chambers, including those for architects, engineers and auditors, are entitled to set recommended prices for certain services. Though not legally enforceable, in practice those prices often become the standard. Competition is also limited by the fact that, due to their high degree of informality, many SMEs find it hard to change lawyers or accountants (locking-in effects). The authorities should curb the right to make price recommendations. They should also review training requirements and exclusive rights and aim at reducing them, as international comparisons suggest that current restrictions go beyond what is needed for adequate consumer protection.

Cuts in regulated energy prices harm competition, competitiveness and the environment

Energy markets often remain highly concentrated. In wholesale, the electricity incumbent, state-owned MVM, has also recently purchased a leading position in gas import and storage. Gas consumption is covered mainly from imports delivered only via two pipelines and largely takes place under a single long-term contract. In electricity and gas retail, regulated-price and liberalised markets coexist, with access to the former restricted since 2008-09 to small consumers (mainly households). Concentration is also high, as the few firms servicing the regulated-price segments (universal service providers, USPs), generally part of vertically-integrated groups, also have prominent positions among free market suppliers (traders). District heating service provision is not competitive, as each provider (around 100 in total, mostly owned by municipalities) operates in its own supply area.

Further progress in cross-border interconnections and regional market integration will enhance competition in wholesale markets and security of supply. In electricity, market coupling with the Czech Republic and Slovak Republic since September 2012 has reduced Hungarian wholesale prices, although interconnection bottlenecks still hinder full price convergence. In gas, where wholesale prices are less transparent, the expiration in 2015 of the dominant wholesaler contract for imports from Russia and ongoing progress in international connections (most prominently a pipeline with the Slovak Republic, with completion due in 2015) offer increased possibilities of stronger wholesale competition. The authorities should continue to promote regional energy market integration.

Other policy interventions have been less benign for market development. Since 2010, when a temporary price freeze was imposed, the authorities have increased their influence over regulated price setting, to the detriment of the sectoral regulator. In 2013, they cut regulated energy prices by a total of 20% (Box 1.3). Anti-competitive effects might result. As eligible consumers will tend to remain under (or return to) regulated prices, liberalised retail markets may not grow and smaller traders in these markets, likely less able to withstand a temporary profitability squeeze than vertically-integrated groups (REKK, 2010), may choose to exit. Further, the energy sector has been penalised with hefty taxes (Box 1.2), under which the effective corporate income tax rate can reach up to 50%. Deteriorating profitability and regulatory uncertainty deter market entry and investment (IEA, 2011). Also due to a relatively high starting point, the energy sector stands out by its sharp fall in capital formation in the recent past (Figure 1.2), which, if sustained, would threaten secure energy supply in the long run, as acknowledged by the authorities (Ministry for National Development, 2012).

Interventions in regulated prices have also worsened price distortions. In electricity, the implementation of the price cuts contains significant cross-subsidisation from industrial to residential users (Box 1.3). To the extent that gas firms pass burdens from regulated price cuts and subsidisation of district heating onto the free market, industrial users can also be affected. This hurts international competitiveness, especially as energy prices for industry are on the high side for gas and, for large users, electricity (Figure 1.12). Further, below-market prices for households, together with low excise taxation on energy use (see below), fail to provide incentives for energy efficiency. The authorities should

Box 1.3. **The implementation of the 2013 energy price cuts**

The 2013 20% total cut in regulated energy prices (achieved in two equal steps, the first in January and the second in November) was implemented in different ways, reflecting the diverse price formation arrangements in electricity, natural gas and district heating.

In electricity, the regulated price paid by final consumers used to have four components: the price of electricity as a product (itself containing a universal service fee and the universal service providers [USPs] margin), the system usage charge, other financial tools (a component reflecting the cost of several support schemes, examples of which are given below) and value-added tax (VAT). The 20% cut was achieved through changes in the first three parts. The product price component was reduced, *inter alia* by some compression of the USPs margin. Further, USPs were released from the obligation to purchase their share of the more expensive electricity produced from renewables under feed-in tariffs, all of which must now be bought by free market traders and end-users importing electricity or buying it directly from generators. Cross-subsidisation was also present in the changes made to the second and third components of final prices. System usage charges were decreased for regulated-price consumers and increased for those in the free market, whereas other financial tools were fully shifted to the latter group of electricity users. According to preliminary estimates pertaining to the January price cut alone (REKK, 2013),* the total transfer to regulated-price consumers in 2013 reached HUF 48 billion, with cross-subsidisation from the free market amounting to HUF 27 billion, the income of USPs and distributors decreasing by HUF 11 billion, and VAT revenues falling by HUF 10 billion. The full-year benefit to regulated-price consumers from the 20% total cut should therefore near HUF 100 billion (over 0.3% of GDP).

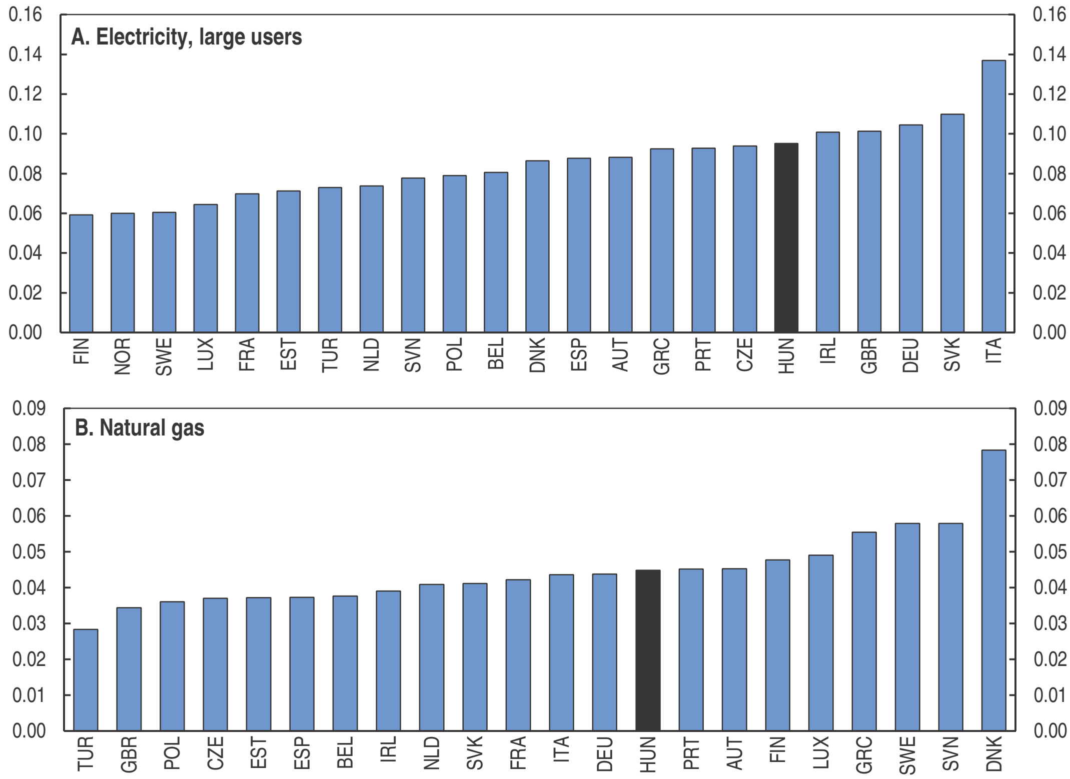
Before the price cuts, the regulated price of gas included a product fee, a base fee, a security storage fee and VAT. The base fee and the product fee cover the wholesale price, the margin of wholesalers, the costs of transport and storage, the distribution fee and the margin of USPs. The 20% reduction was achieved by eliminating the security storage fee and by decreasing both the base and the product fees. The total full-year transfer to regulated-price consumers is estimated by the authorities at around HUF 90 billion, with effects spread along the supply chain as well as lower VAT revenues. Around two-thirds of the pre-VAT burden are put on the domestic gas producer and on distributors.

In district heating there was a direct 20% total cut in the final end user prices charged by utilities. In 2011 heat producers, which supply those utilities, ceased to receive feed-in tariffs for electricity produced by cogeneration. To avoid that more expensive heat translated into higher prices for households, district heating utilities started to receive support from the compensation fund of district heating, itself financed from a new fee initially imposed on all electricity customers under the so-called other financial tools. Steps to finance the further losses of utilities due to the 2013 price cuts have included a reallocation within other financial tools and the introduction of cross-subsidisation from the gas market, as a similar fee was imposed on the domestic gas producer.

* REKK (2013), "Vihar a rezsiben: A REKK elemzése a 2013. januári rezsicsökkentésről" (Storm in overhead costs: Analysis of the overhead reduction of January 2013 by REKK), *Working Paper*, No. 1, Regional Centre for Energy Policy Research, Corvinus University of Budapest.

Figure 1.12. **Energy prices for industrial users**

Prices excluding value added tax, euro per kilowatt/hour, 2012[1]



1. Average of data for the two semesters of 2012. Electricity covers the consumption band 20 000-70 000 megawatt/hours and natural gas is an average of all consumption bands.

Source: Eurostat (2013), "Energy Statistics – Prices", *Eurostat Database*, December.

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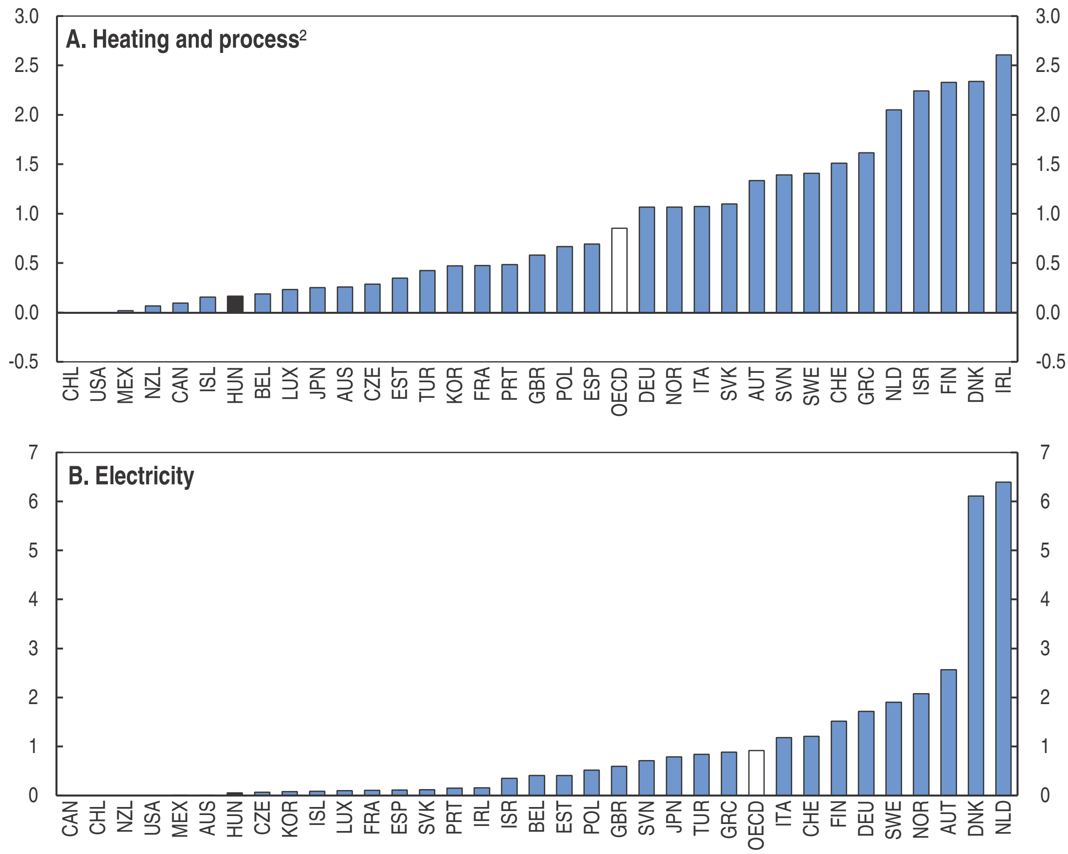
move towards cost-reflective, market-based pricing in electricity and gas by vesting the right to set regulated prices in the sectoral regulator. In the longer term, strengthened competition in the liberalised market may allow gradually phasing out regulated prices. There will be a need to ensure that adequate safety nets are in place to shield the living standards of poorer households, which may require higher transfers to vulnerable consumers.

There is significant scope to increase energy efficiency, especially as regards residential uses. Buildings account for 40% of all energy consumption (Ministry for National Development, 2012), a very high figure. Inefficiency problems are most acute in district heated homes, which house around 20% of the population. The authorities have long emphasised subsidies for energy efficiency projects, which remains a priority area in the National Energy Strategy (Ministry for National Development, 2012) and in the forthcoming EU funds programming period. Price incentives for energy efficiency are nonetheless blurred by the reduced 5% VAT rate on district heating (since 2010) and very low energy excises (Figure 1.13). Energy use taxation should be increased, in tandem with stepped up efforts at individual metering and consumption control in district heated flats (where often they are still not possible) and the provision of consumer information about the benefits of energy-saving investments (such as insulation).

Figure 1.13. **Low energy taxation for heating and electricity**

Effective tax rate for all fuel use, euros per gigajoule[1]



1. Tax rates are as of 1 April 2012 (1 July for Australia); energy use data is for 2009. Figures for Canada and United States only cover federal taxes. The OECD aggregate is an unweighted average.
2. Use of energy for space heating and in production processes. For Chile the negative amount reflects the credit provided by the Petroleum Price Stabilisation Fund for domestic kerosene.

Source: OECD (2013), *Taxing Energy Use: A Graphical Analysis*.

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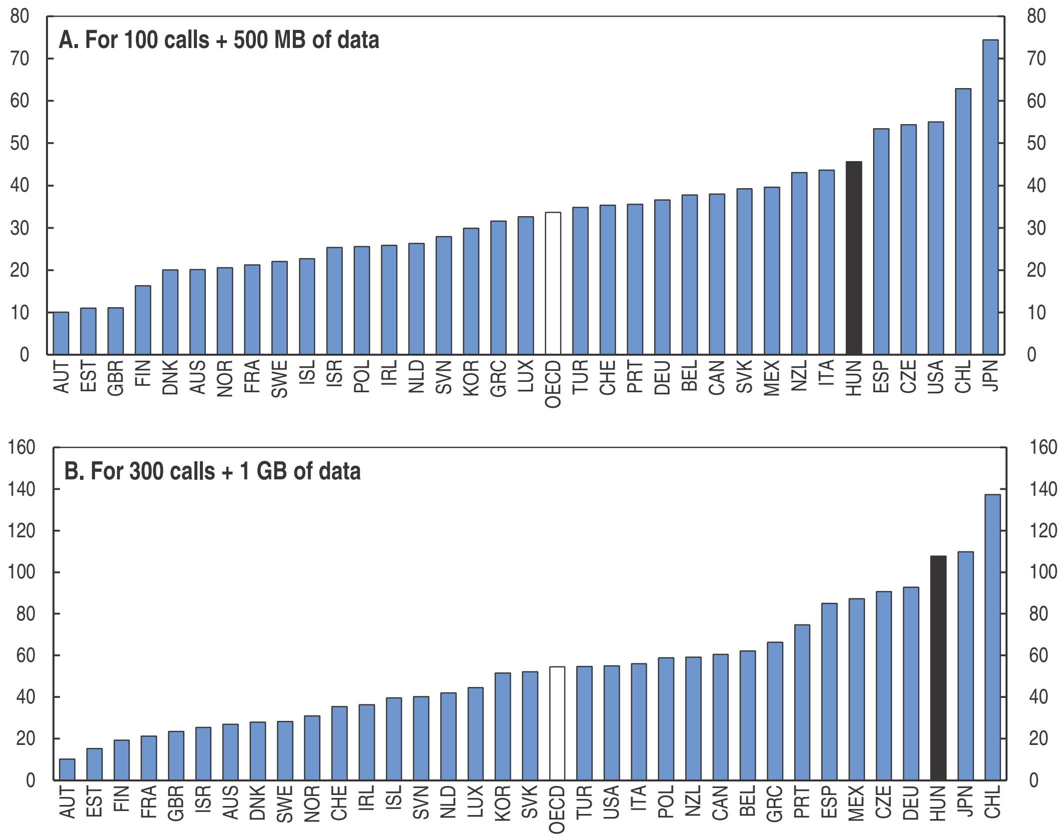
There is scope to increase competition in mobile communications

Expensive mobile telecommunications and low broadband penetration burden consumers and firms and hamper the economy's potential for innovation. Unlike fixed line calls and fixed broadband, mobile voice and smartphone-based data traffic is expensive in international comparison, especially in PPP-adjusted terms (Figure 1.14) but often also at unadjusted exchange rates (OECD 2013e; Rewheel, 2013). High prices are particularly penalising given the large share of mobile networks in total voice traffic (78% in 2011) and the growing delivery of bundled communications services on mobile phones. Fixed broadband penetration, at 22 subscriptions per 100 inhabitants, is somewhat below the OECD average (26 subscriptions, December 2012 data), though above regional peers. Wireless broadband penetration is very low (Figure 1.15), which high prices help to explain. This weakens the communications infrastructure with repercussions in many areas, such as innovation capabilities or the delivery of e-government services.

The same three mobile network operators (MNOs, all belonging to multinational groups) have been in place since 1999, and the two largest operators had a joint share of 77% of subscribers in October 2012 (against 66% in the EU on average). The authorities have

Figure 1.14. **Price of mobile communications**

OECD mobile baskets including VAT, August 2012 (USD PPP)[1]



1. The OECD basket of mobile telephone charges includes fixed and usage charges per month (including value-added tax [VAT]) and is shown in US dollars at purchasing power parities (PPP). Charges are distributed between peak and off-peak hours and are based on an average call duration. The number of calls includes SMS messages: 140 SMS for 100 calls or 225 SMS for 300 calls.

Source: OECD (2013), *OECD Communications Outlook 2013*.

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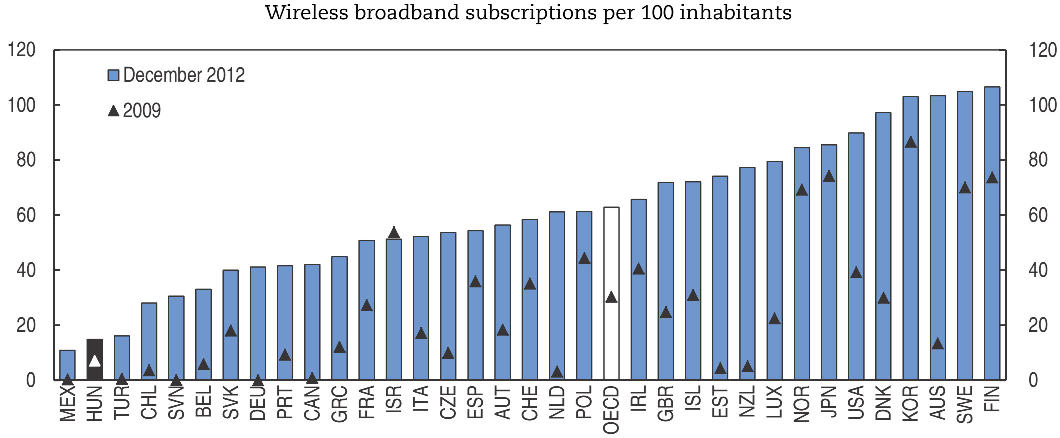
Figure 1.15. **Wireless broadband penetration**

Wireless broadband subscriptions per 100 inhabitants



Source: OECD (2013), *OECD Communications Outlook 2013* and OECD Broadband Statistics, *www.oecd.org/sti/ict/broadband*.

StatLink http://dx.doi.org/10.1787/888932983338

recently taken some pro-competitive steps, such as a decrease from eight to two in the working days needed to change operator while keeping the same number (from October 2012 onwards), but more needs to be done.

The potential of mobile virtual network operators (MVNOs) to enhance competition in mobile communications has so far failed to materialise. The two initial MVNOs providing voice services, each associated to a major retailer, started operations in 2012 and are estimated to have a joint share of around 1% of total subscriber identity module (SIM) cards, while in some countries with publicly available MVNO data the corresponding figure exceeds 10% (European Commission, 2013b). Further, they are partial (and not full) MVNOs, as they have little or no technical autonomy from the respective host MNO, and mainly provide sales and marketing expertise targeted at low-end consumers. A third MVNO, also drawing on an existing network of shops (petrol stations, in this case) and operating along similar lines, was launched in 2013. The National Media and Infocommunications Authority (NMHH) has so far not intervened in the conditions of access to the host network (e.g. origination fees), and the current MVNOs were freely negotiated between the parties. However, it is doubtful that any of the MNOs would give access to a full MVNO under conditions enabling the latter to exert strong competitive pressure. The regulator should therefore ensure that potential entrants can buy full wholesale access to the existing physical networks on competition-enabling conditions.

Market entry by an additional MNO could also stimulate competition and bring about a significant drop in prices, as has recently been the case in countries like France or Israel (OECD, 2013e). Denmark, Israel, Slovenia and other countries show that more than three MNOs can be viable, even in small markets. An additional MNO may also ease MVNO entry, since a full MVNO can be a strong challenger to all operators with a physical network, but is at the same time a large customer of the host MNO. More competition among players with frequencies may therefore improve the bargaining position of prospective MVNOs. A spectrum auction held in 2011, which would have allowed the entry of a state-owned fourth mobile player, was later annulled by court decision, as two mutually contradictory decrees on frequency allocation were in force at the time. To enable entry, the regulator should therefore launch a new auction, building on consultations started in November 2013.

Recent special taxes are also likely to hamper competition and infrastructure development. Telecommunication investment fell by 27% in 2010 and by another 22% in 2011 (European Commission, 2013b), which could also be partly due to the aftermath of the 2009 recession. Besides running counter to government efforts to foster broadband expansion, such as the backhaul optical network development project, the new tax on wires and pipelines may well have anti-competitive effects: progressive rates (Box 1.2) are likely more than undone by the fact that incumbents are able to spread the tax liability from a given length of cables among their large client base, while smaller expanding firms are not.

Box 1.4. Main recommendations to enhance competition and the business environment

Reducing administrative burdens and regulatory instability

- 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 (RIA) of government-initiated legislation. Ensure timely and transparent related implementing regulations. RIA outputs and opinions delivered in consultations should be made public.
- To promote simplification and stability in taxation, curb tax expenditures and other special provisions, and consolidate several related taxes into fewer and broader ones.
- Promote greater co-ordination among government agencies. Fully implement the inter-operability of databases, while ensuring appropriate safeguards for data privacy and security.
- Foster systematic stakeholder involvement in the monitoring of administrative simplification programmes, the results of which should be made public.

Strengthening institutional quality and competition enforcement

- Do not restrict the scope of competition law and ensure vigorous antitrust enforcement.
- Systematically consult the Competition Authority, as well as relevant sectoral regulators, in draft legislation concerning their areas of competence.

Fostering growth of small and medium-sized enterprises and entrepreneurship

- Extend to all loans, both new and outstanding, rules to curb unilateral contract modification by banks.
- Further deepen information in credit bureaus, by including data from non-bank sources and imposing mandatory disclosure and storage of positive credit information on individuals.
- Increase the targeting of public venture capital programmes to innovative firms.
- To ease market exit in case of failure and foster entrepreneurship, shorten the duration of corporate insolvency procedures and introduce a personal insolvency framework.

Promoting competition in retail and professional services

- Decrease barriers to entry in retail through administrative simplification and by substantially raising the surface threshold for the regulation of large outlets (currently at 300 square meters).
- Reconsider training requirements and exclusive rights in professional services with a view to reducing them. Curb the right of professional chambers to make price recommendations.
- Liberalise the pharmacy sector by abolishing geography and demography-based entry barriers as well as ownership requirements by pharmacists.

Promoting competition in energy and telecommunications

- Move towards market-based pricing in electricity and gas by vesting the right to set regulated prices in the sectoral regulator.
- Continue to promote regional energy market integration through further progress in cross-border interconnections and market coupling.
- Increase energy use taxation, together with stepped up efforts at individual metering and consumption control in district heated flats and the provision of consumer information about the benefits of energy-saving investments.
- In mobile telecommunications, ensure that mobile virtual network operators can buy full wholesale access to the existing physical networks on competition-enabling conditions.
- Launch a new spectrum auction to enable market entry by an additional mobile network operator.

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Chapter 2

Tackling labour mismatches and promoting mobility

Significant labour market mismatches and insufficient mobility penalise employment and productivity. Mismatches have above all a skills dimension, with an excess of low-skilled workers and a possible lack of skilled workers in certain domains. Reducing the high tax wedge on low salaries and avoiding excessive minimum wage increases would support demand for low-skilled labour. In the longer term, upgrading the labour supply requires improving educational outcomes, especially of disadvantaged students, and making the school-to-work transition less abrupt. To facilitate good matching and enhance sectoral mobility, a somewhat longer duration of unemployment benefits and an upscaled Public Employment Service would be of value, as well as greater focus on reintegration in the public works programme and more efficient and developed lifelong learning. Besides skills mismatches, important geographic mismatches are illustrated by high and persistent regional disparities in the unemployment rate. Mobility is hampered by the underdevelopment of the rental housing market, while there is room to enhance the efficiency of public transport to further support commuting.

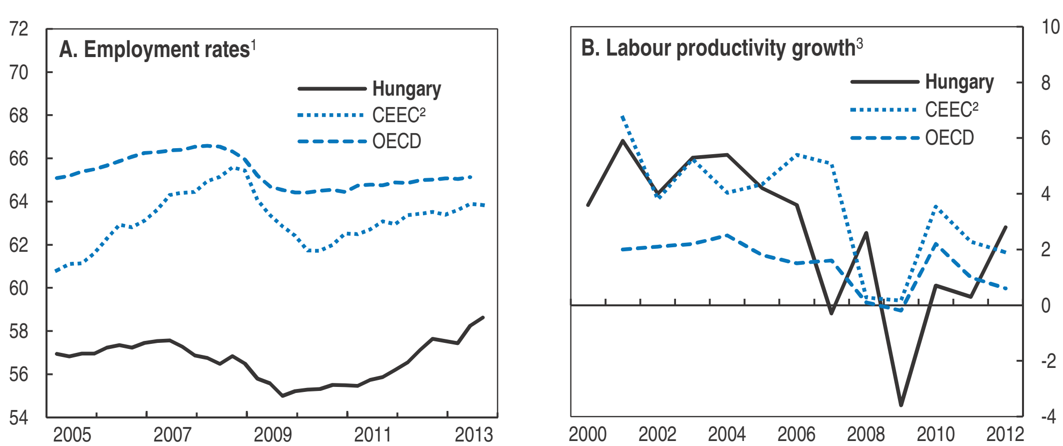
Substantial labour mismatches weigh on economic performance

Labour mismatches contribute to low employment and weak productivity (Figure 2.1). Broadly speaking, mismatches can be defined as imbalances between labour supply and demand across geographic regions, sectors, occupations and skills. In Hungary, the main mismatch is a large structural excess of low-skilled labour supply, resulting in a very low employment rate among this group (Figure 2.2, Panel A; Fazekas and Scharle, 2012). In contrast, high-skilled labour is in somewhat tight supply in certain fields, such as medical professions, and more companies report skill shortages than the European Union (EU) average (European Commission, 2013a). Among employed workers, under or over-qualification appears less common than in most OECD countries (Figure 2.2, Panel B; OECD and Statistics Canada, 2011; Randstad, 2012; in contrast, Quintini, 2011, suggests frequent under-qualification of workers), but many people occupy a position not directly related to their field of study, a common pattern across Eastern European countries (Figure 2.2, Panel C). Mobility of workers is essential to good matching. Although job-to-job mobility is about average, the reallocation of labour across economic sectors has slowed since the mid-1990s (Harasztosi, 2011) and geographic mobility is low, resulting in persistently large regional discrepancies in the unemployment rate (Figure 2.3).

Certain labour mismatches originate in the 1990s transition to a market economy. As the sectoral composition of the economy changed rapidly and workers moved from state-guaranteed employment to the open labour market, an important group of workers with low or ill-adapted skills could not find jobs. However, mismatches have apparently worsened

Figure 2.1. **Employment and labour productivity growth have been low**

Per cent



1. Age 15-64.
2. Unweighted average of other Central and Eastern European countries (Czech Republic, Estonia, Poland, Slovak Republic and Slovenia).
3. GDP in constant prices per hour worked, total economy.

Source: OECD (2013), *OECD Main Economic Indicators* and *OECD Productivity Statistics* (databases), December.

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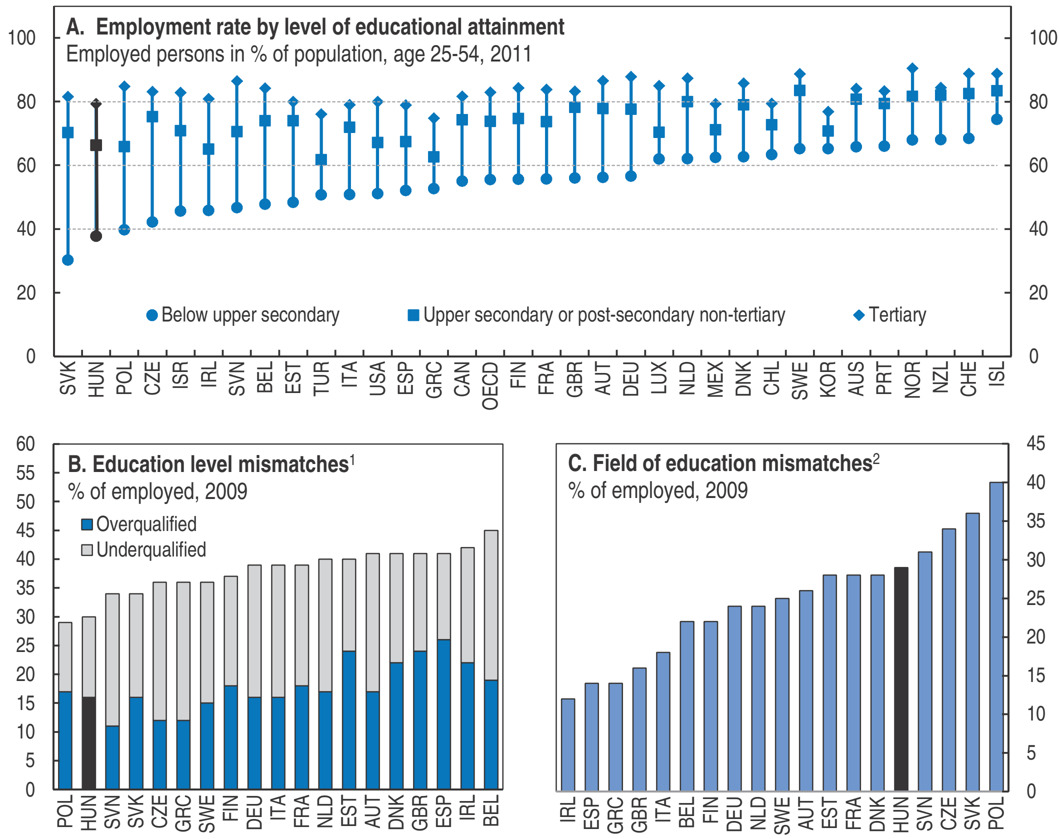
Figure 2.2. **Skills mismatches**



1. To assess education level mismatches, jobs and qualification levels were classified using the International Standard Classification of Occupation (ISCO) developed by the International Labour Organisation (ILO).
2. Field of education mismatches take place when the level of education matches job requirements but the type of education (e.g. field of study) is inappropriate for the current job.

Source: OECD (2013), *Education at a Glance 2013: OECD Indicators* and Randstat (2012), "Into the Gap: Exploring Skills and Mismatches", *SEO Report*, No. 2011-56, SEO Economic Research.

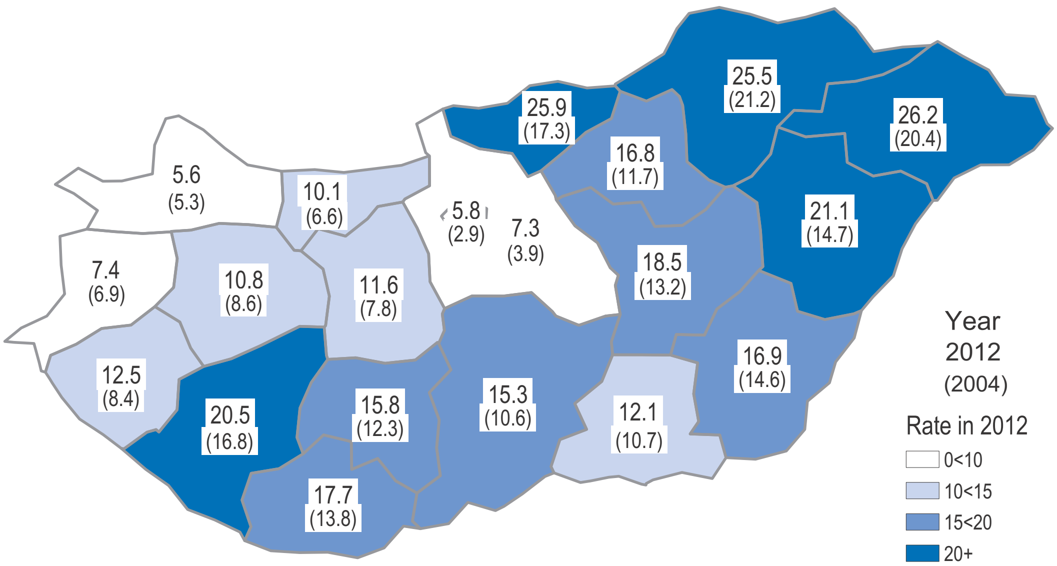
StatLink http://dx.doi.org/10.1787/888932983376

over the past decade, as illustrated by rising long-term unemployment and an outward shift in the Beveridge curve (Figure 2.4). This reflects limited progress made in reintegrating these workers and, more worryingly, that the skills of younger generations exiting the education system have been poorly matching labour market needs. Indeed, youth unemployment is high and only partly cyclical. Looking ahead, two factors may aggravate labour mismatches. *First*, technological progress tends to reduce demand for low to medium-skilled labour and increase demand for high-skilled labour. *Second*, young high-skilled emigration appears to have increased over recent years, although from a relatively low base.

Tackling labour mismatches could yield large benefits in terms of employment and productivity by improving the allocation of labour resources. In the short term, lower labour costs would foster demand for low-skilled labour. In the longer term, labour supply should be upgraded by raising education outcomes and ameliorating the school-to-work transition. The mobility of workers across occupations and sectors is supported by the relatively low employment protection legislation (EPL) and the decentralised wage negotiation settings, but should be further propped up by enhanced activation policies and more focus on lifelong learning. To address geographic mismatches, the authorities have

Figure 2.3. **Evolution of the unemployment rate by county**

Registered jobseekers in per cent of economically active population aged 15-64 in 2012[1]



1. Data for 2004 is shown in parentheses for comparison.

Source: HCSO (2013), "Regional Statistics: Labour Market", *STADAT Tables*, Hungarian Central Statistical Office, December.

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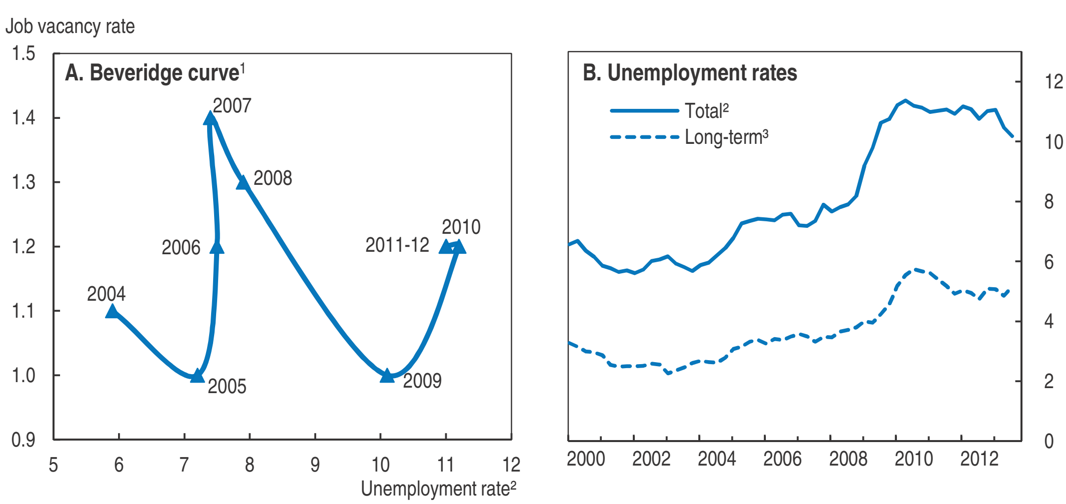
Figure 2.4. **Unemployment and job vacancy rates**

Per cent



1. Break in series in 2009 due to a change in industry classification.
2. Age 15-64.
3. Long-term covers unemployment duration of twelve months or over.

Source: Eurostat (2013), "Labour Market", *Eurostat Database*, December and OECD (2013), *OECD Main Economic Indicators* (database), December.

StatLink http://dx.doi.org/10.1787/888932983414

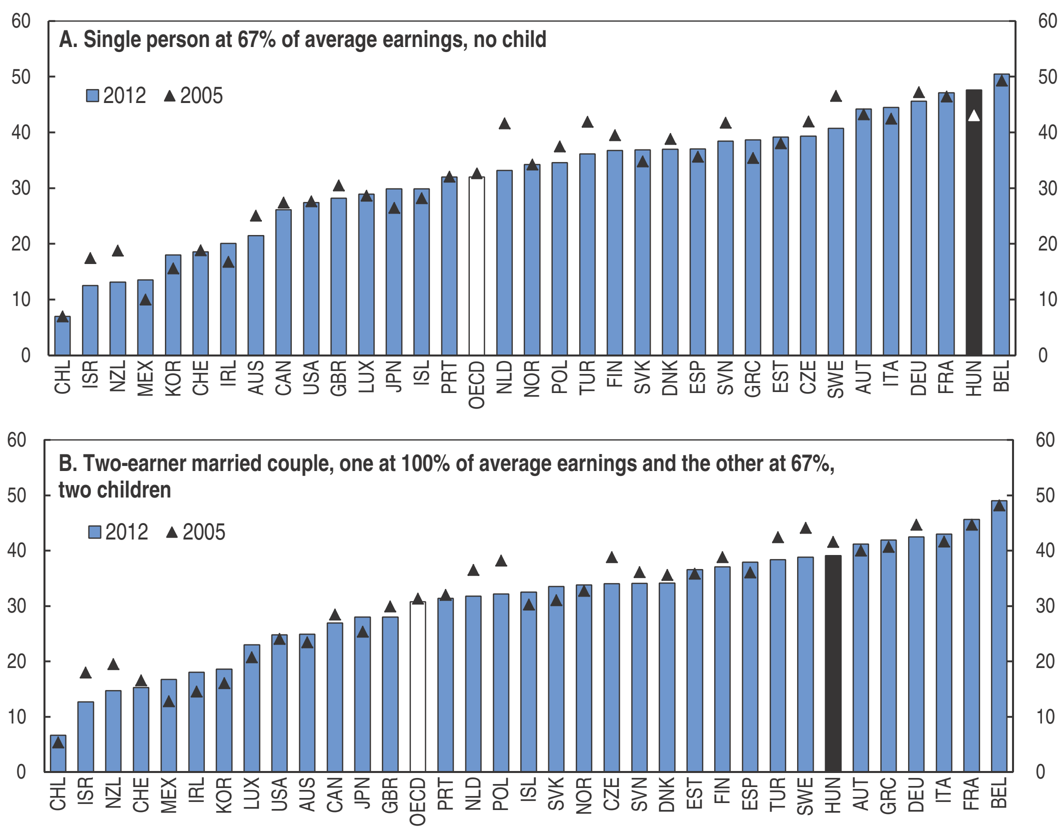
recently taken limited steps to encourage jobs moving to job-poor areas (through the creation of low-tax zones) and workers moving to job-rich areas (through relocation subsidies), but broader reforms of housing and transport are needed to reduce relocation and commuting costs.

Enhancing demand for low-skilled labour

Less than 40% of people with at most lower-secondary education are in employment (Figure 2.2). A number of them are employed in the public works programme with limited prospects of regular employment. This reflects both a lack of skills and employability, as some workers have been out of employment for a long time, and the relatively high cost of low-skilled labour. The main reason is a high tax wedge on low salaries. The minimum wage, by contrast, is only slightly above the OECD average relative to the median wage (Figures 2.5 and 2.6).

Figure 2.5. **Average tax wedge on low to average wages**[1]

Per cent of labour costs



1. Taxes are the sum of personal income tax and employee plus employer social security contributions together with any payroll tax less cash transfers.

Source: OECD (2013), "Taxing Wages: Comparative tables", *OECD Tax Statistics* (database), December.

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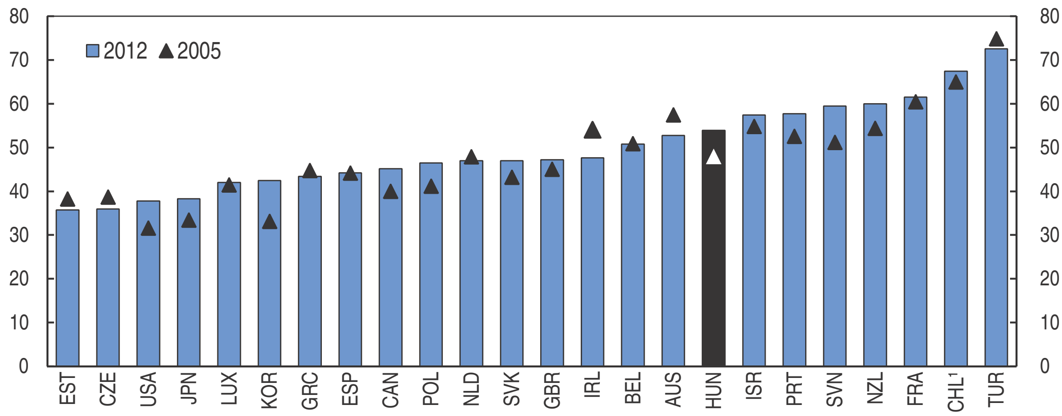
Reducing the tax wedge on low salaries

The tax wedge on low salaries reflects high social security contributions and the 16% flat income tax rate (Ladányi and Kierzenkowski, 2012). The flat tax applies from the first forint of income and there is no deduction for employment since the abolition of the employment tax credit in 2012. In 2013, the Job Protection Act reduced the tax wedge for certain groups. On the first HUF 100 000 of wages (about the level of the minimum wage), the rate of employer social security contributions was lowered from 28.5% to 14% for younger (below age 25), older (above age 55) and unskilled (i.e. occupying a position

Figure 2.6. **Minimum wage**

Gross minimum wage as a per cent of median wages of a full-time worker



1. Data for 2011 and 2006.

Source: OECD (2013), *OECD Employment and Labour Market Statistics* (database), December.

StatLink http://dx.doi.org/10.1787/888932983452

requiring no qualification) workers. In addition, it was lowered to zero for two years for young career starters, long-term unemployed and returning mothers. This second component replaced the Start programme, which used to offer support for one year, but on wage costs up to 150% of the minimum wage.

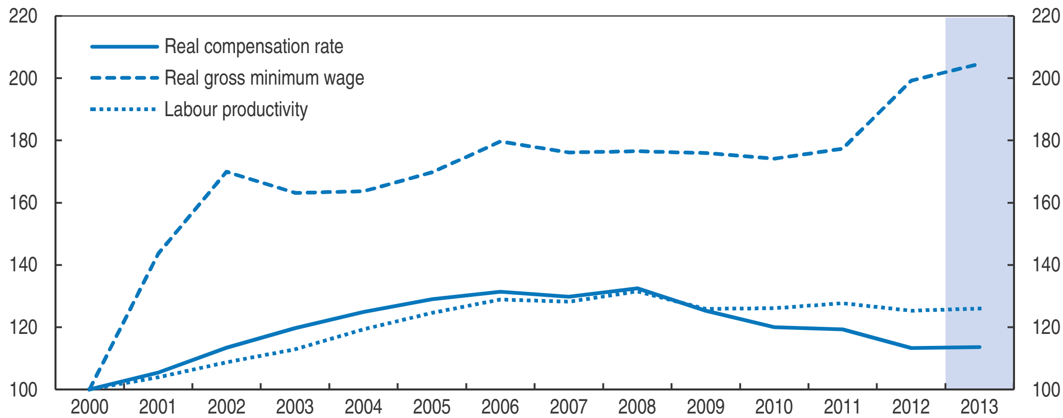
The Job Protection Act was a step in the right direction of reducing the tax wedge on low salaries, which nevertheless remains substantially higher than the OECD average. A micro-simulation exercise suggests that the programme could boost employment by about 1% (Benedek et al., 2013a). However, cuts in social contributions could have been better targeted, as many high income earners benefit – 14% of the target group earns more than the average wage – while some low-wage middle-aged workers do not. To improve targeting, the cuts should be phased out above a certain wage level (progressively to avoid spikes in marginal tax rates), such as at the average wage. The proceeds could serve to further reduce the tax wedge on low salaries, for example by contributing to the costs of introducing an employment tax credit that progressively declines with the wage level.

Avoiding excessive minimum wage increases

The minimum wage is set by the government after consultation of the social partners within the National Economic and Social Council. Since 2000, the minimum wage was increased faster than the average wage and labour productivity (Figure 2.7). In 2012, it was raised by 19% in order to counter the negative effect of higher taxes on the purchasing power of recipients. It was raised by another 5% in 2013, which turned out to be higher than inflation, and by 3.6% in 2014. Rapid increases in the minimum wage have supported the income of the employed low-skilled, but they have also led, at least in the early 2000s, to important job losses, especially in small companies and disadvantaged areas (Kertesi and Köllő, 2003). Now that the minimum wage is slightly above the OECD average relative to the median wage (Figure 2.6), the authorities should refrain from increasing it more than suggested by inflation and productivity developments, and consider even freezing it for some time. Introducing a formula-based benchmark for minimum wage increases, as a way to inform decisions by the authorities, could help in this respect.

Figure 2.7. **Compensation and productivity**[1]

Index, 2000 = 100



1. Real compensation rate and labour productivity of the total economy. Projections for 2013.

Source: OECD (2013), *OECD Economic Outlook: Statistics and Projections* (database), December.

StatLink http://dx.doi.org/10.1787/888932983471

The authorities should consider moving progressively towards a lower minimum wage in disadvantaged regions, where the oversupply of low-skilled workers is more acute. The 2011 reform of the labour code offers this possibility. According to Scharle and Váradi (2009), a 30% decrease in the minimum wage in well targeted sub-regions could boost unskilled employment rate by 6-12% within two or three years. The potential impact on income inequalities is ambiguous, as lower wages would increase inequalities but higher employment would reduce them.

In the current context of high youth unemployment, a lower minimum wage for the youth could also be envisaged, as a way to facilitate the school-to-work transition. Youth minimum wages are in place in eight OECD countries, such as the Netherlands, and have been found in some cases to have a positive, albeit small, effect on employment (OECD, 2010a). In the case of Hungary however, these benefits should be balanced against the associated risks in terms of increased tax evasion through wage underreporting and of segmenting the labour market by generalising low-paid jobs among the youth.

The minimum wage debate is closely related to tax evasion issues, as wage underreporting remains widespread. The average rate of wage underreporting is estimated to be at least 9-13%, with higher rates in the lowest and highest income groups (Benedek et al., 2013b). Wage underreporting generates substantial fiscal losses, poses fairness issues and tends to be regressive. To mitigate the issue, a 17% higher minimum wage is applied to jobs requiring at least secondary school or vocational education, but this is not ideal because of the potential adverse effects on employment. Reinforcing direct measures against tax evasion would be preferable. Sanctions for wage underreporting range between 50% and 200% of the unpaid tax (depending on whether tax evasion is judged deliberate), but the probability of being caught is not sufficient to deter underreporting. Enhancing this probability requires strengthening qualitatively the capacity of the tax administration, better using the information available to target individuals and companies for tax inspections, and putting in place a strong framework to prevent corruption of tax officials. Regarding the latter, recent initiatives to reinforce whistle-blower protection go in the right direction.

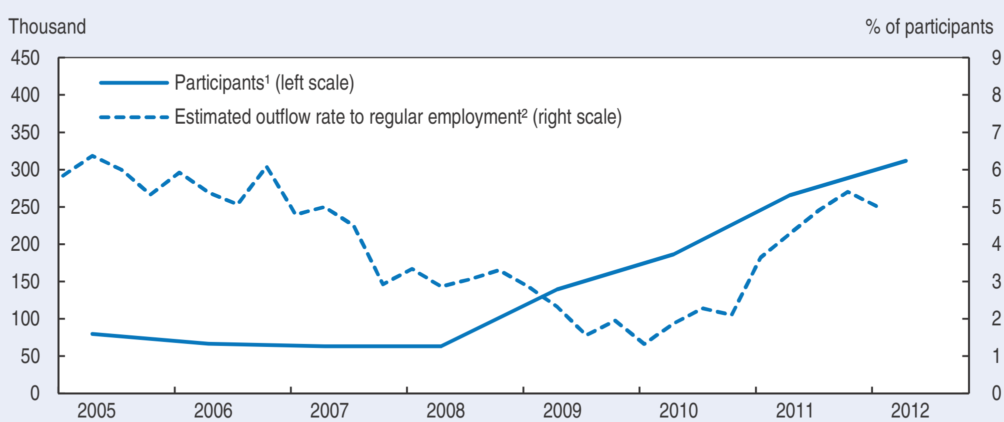
Enhanced activation policies and lifelong learning

In combination with lower labour costs, enhanced activation policies are needed to enable low-skilled workers to find a suitable job, possibly after training. In recent years, more resources have been directed to the public works programme and EU-cofinanced active labour market programmes for vulnerable groups have been scaled up. At the same time, the duration of unemployment benefits has been drastically shortened and the administrative capacity of the Public Employment Service (PES) reduced. The ability of public works to promote reintegration to the regular labour market remains very low (Box 2.1).

Box 2.1. **The public works programme**

Public works programmes have been in place under different forms since the early 2000s and have been massively scaled up since 2009 (Figure 2.8). They typically consist of low value-added jobs in sectors like agriculture or road maintenance. Employment can be either full or part-time and, in 2012, lasted on average eight months. The programme is organised by the Ministry of Interior and participants are mostly employed by municipalities and government-owned companies, although their wages are paid by the central government. Participation is compulsory in the sense that refusing a suitable offer to participate renders one ineligible for unemployment benefits and social assistance. The salary for full-time employment is about three quarters of the minimum wage and three times the level of social assistance. Most participants have low to very low skills – about half of participants have not gone beyond primary school – and largely come from the Roma minority.

Figure 2.8. **Participation in public works programmes**



1. Number of individuals having participated in public works, even for a short time, during the year.
2. Share of public works participants that find non-fostered employment in the following quarter. Calculations by Cseres-Gergely et al. (2013) are based on micro data from the Labour Force Survey. Fostered work includes public works but also other kinds of publicly supported jobs.

Source: NFSZ, *A foglalkoztatáspolitikai eszközök működése*, Nemzeti Foglalkoztatási Szolgálat (National Employment Service), various editions and Z. Cseres-Gergely, G. Kátay and B. Szörfi (2013), "The Hungarian Labour Market in 2011-2012", in K. Fazekas et al. (eds.) (2013), *The Hungarian Labour Market, 2013*, Centre for Economic and Regional Studies, Hungarian Academy of Sciences and National Employment Non-Profit Public Company Ltd.

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Reintegration of participants to regular employment appears to have increased since 2009, but remains very low, especially in municipality-organised programmes. In 2012, the share of public workers finding a regular job just after public works was only 5% (Figure 2.8), although the rate after half a year was 9%.

Reintegrating public works programme participants

Public employment programmes are generally considered to be among the least effective activation instruments (Card et al., 2010). Past experience in Hungary has been no exception (Budapest Institute, 2011). Thus, public works should remain a transitional instrument, as envisaged by the authorities. They should only be targeted to low-skilled people who have been out of work for a long period of time. For other groups, traditional activation procedures via the PES – generally among the most efficient activation instruments internationally – are likely to be more efficient, provided there is sufficient PES capacity (see below). Given their low skills, lack of recent work experience and the potential discrimination against the Roma, activating public works programme participants is very difficult and requires a determined and broad-based approach, combining training and support in the transition to the regular labour market.

Following a recommendation of the 2012 *OECD Economic Survey* of Hungary (OECD, 2012a), the authorities intend to put more focus on training public works participants. The share of participants receiving training was only about 5% in 2012. The authorities aim to use EU funds to train 30% of the participants in the winter 2014 programme that started in November 2013. Training focuses on agricultural and basic general and professional skills. Given the large uncertainty about which training programmes may work for which groups of participants, the efficiency of the different programmes should be carefully monitored to improve quality and targeting over time. More focus on services could also be considered, as they may offer more employment perspectives than agriculture in the long term. Training will be organised exclusively by the public Türr István Institute in charge of adult vocational training. This centralisation may facilitate organisation, but there is a risk of duplication of roles and lack of co-ordination with the PES, which already provides activation for the unemployed, notably by subcontracting training to a network of (mostly private) providers. Greater co-ordination and integration between the two would make activation more effective, while involving some private providers in the training of public works participants should be considered.

In combination with training, the transition of public workers to regular jobs should be facilitated. At the local level, more co-ordination is needed between municipalities, job centres in the PES network, non-governmental organisations (NGOs) and private companies. For example, this could take the form of municipalities being allowed and having incentives to "lend" public workers, preferably after or in combination with training, to NGOs and private companies in a simple administrative framework (however, an existing scheme has generated almost no demand because of limited scope, administrative complexity and lack of incentives for municipalities). Although this may displace other low wage workers (but in its current form, the public works programme may already displace some), such a scheme would probably increase employment overall, displace some informal work and facilitate the reintegration of public workers. More generally, the incentives of municipalities to focus on activation should be enhanced, for example by offering them a financial bonus linked to the medium-term labour market outcome of participants.

As pilot projects have shown, empowering public works participants to create micro-enterprises could also be part of the solution. Promoting such entrepreneurship requires further reducing administrative burdens and developing specific training and mentoring as well as micro-financing.

Strengthening assistance for jobseekers

PES staffing appears low in an international perspective, although the different remit of PES across countries makes comparisons difficult (Table 2.1). Since the mid-2000s, the number of jobseekers per PES staff has increased by a half. A modernisation of PES infrastructures may have raised efficiency, but the earmarking of some resources for tasks such as rehabilitation for the disabled has also left fewer staff for standard activation policies. The consequence is that contacts with the unemployed are often limited to

Table 2.1. **Average caseload in the public employment service**

	Year	Registered job seekers (thousand)	Public employment service (PES) staff (thousand)[1]	Job seekers per PES staff member
In Hungary				
	2000	390.5	4.2	94
	2005	410.6	4.4	94
	2006	403.4	4.3	94
	2007	445.0	3.9	113
	2008	477.4	4.0	119
	2009	604.6	4.3	139
	2010	591.3	4.6	130
	2011	552.3	4.3	129
	2012	569.3	3.9 (4.2)[2]	145 (135)[2]
	2013	..	4.2 (4.4)[2]	..
In European comparison[3] (the remit of the PES varies across countries)	**2011**			
Austria		258.6	4.9	53
Belgium		547.4	10.0	54
Czech Republic		509.2	7.3	70
Denmark		207.7	5.8	36
Estonia		53.2	0.5	108
Finland		470.4	3.9	120
Germany		5 207.6	110.0	47
Greece		576.6	3.4	169
Ireland		444.9	0.6	778
Netherlands		625.6	5.0	125
Poland		2 011.2	23.8	84
Portugal		639.7	3.6	177
Slovak Republic		401.5	2.3	172
Slovenia		110.7	1.0	112
Spain		5 745.3	9.4	613
Sweden		679.0	10.8	63
United Kingdom		1 473.0	72.9	20

1. For Hungary, this includes persons employed within the EU programmes financed by the European Social Fund. Break in series in 2012.
2. Figures in parentheses include staff of the Hungarian Labour Inspectorate and National Institute for Vocational and Adult Training which were merged with the National Employment Office. The number for 2013 is an estimate.
3. 2010 for job seekers for Greece and United Kingdom. The PES data shows the latest data available from the country fiches of the European Commission website, 2010 or 2011 in most cases. The remit of the PES varies across countries in terms of groups covered (e.g. disabled, employed jobseekers) and services provided (e.g. career guidance, in-house training). For more details see the "PES Business Models" study by Mobility Lab available from the European Commission website (link below).

Source: For Hungary – K. Fazekas and Á. Scharle (eds.) (2012), *From Pensions to Public Works: Hungarian Employment Policy from 1990 to 2010*; Hungarian Central Statistical Office and National Employment Office. For other European countries – Registered job seekers from Eurostat (2013), "Labour Market Policy", *Eurostat Database*, September and PES staff numbers from European Commission, Employment, Social Affairs and Inclusion, Public Employment Services, *http://ec.europa.eu/social/main.jsp?catId=105&langId=en*, accessed September 2013.

compulsory administrative checks, leaving little room for individualised assistance. To counter this, the authorities are implementing a partly EU-financed programme for 2011-15 to provide more complex assistance to disadvantaged groups, such as the young, low-skilled or disabled job seekers. This is welcome, as such personalised support may increase employment perspectives of beneficiaries (Budapest Institute, 2013). However, it should come with a broader increase in the capacity of the PES to ensure that all jobseekers receive sufficient job search assistance. In addition, further use of the available data through the development of a statistical profiling system would enhance the targeting and efficiency of activation. Rationalising the network of job centres could also be considered, as many local centres, although offering the benefit of proximity, are too small to provide complex assistance services (Fazekas and Scharle, 2012).

In complement to other instruments, a "First Job Guarantee" programme was launched in 2012 and extended in 2013 to facilitate the labour market integration of young people. In the programme, PES centres select first-time jobseekers and place them into selected companies. Their wages are fully government financed for six months up to 150% of the minimum wage, with since 2013 an obligation of further employment for at least three months. Of the more than 7 000 participants in 2012, around half were still employed after the end of the wage subsidy. The personalised support for first-time jobseekers is welcome, although by mobilising scarce PES resources it may come at the expense of other jobseekers if the capacity of the PES is not increased. As deadweight costs of such schemes can be important, good targeting is essential, but also difficult. Higher-skilled people may not need such high wage subsidies and some lower-skilled ones may need to train first before working, or to combine the two. Extending the scheme to vocational apprenticeships could be interesting in this respect. In any case, the full government financing seems excessive as it gives job centres the power to offer free labour to selected companies (with only a short obligation for further employment). Reducing the amount of wage subsidy would mitigate this issue, while also lowering the fiscal cost of the scheme, as well as perhaps giving companies greater incentives to invest into participants.

Increasing the duration of unemployment benefits

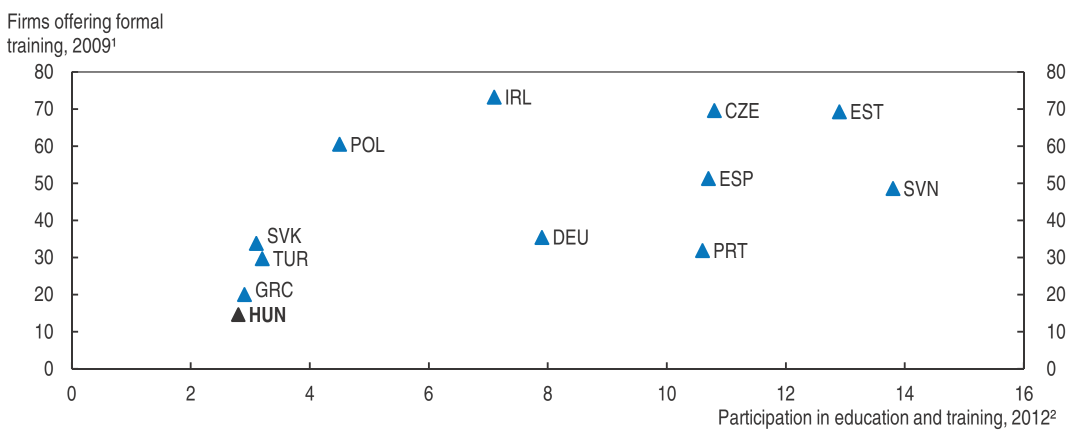
In 2012, the duration of unemployment benefits was reduced from nine to three months for workers aged below 55 (against an OECD average of 15 months in 2010). The measure may stimulate labour supply, but could have a high cost in terms of poverty and labour misallocation, especially given the current economic slack. Indeed, it leaves little time for jobseekers to find the most suitable job and may also deter them from engaging in training or geographic mobility, hampering the reallocation of workers across sectors and regions. Empirical evidence suggests that shorter periods of benefit are associated with lower job reallocation and thus lower productivity (Boeri and Macis, 2010). Another indirect consequence is to reduce the leverage of the PES over jobseekers. After the measure, less than 10% of jobseekers still receive unemployment benefits and incentives to maintain contact with the PES have weakened. This leaves almost no scope for a system of gradual sanctions to promote active job search. Overall, the duration of unemployment benefits should be increased somewhat. Longer unemployment benefits should be accompanied by adequate monitoring and enforcement of job search requirements. Also, benefits could decline over time to further encourage active job search.

Encouraging lifelong learning and enhancing its quality

Lifelong learning can play an important role in fostering mobility across occupations and sectors, but it is poorly developed in Hungary (Figure 2.9; OECD, 2012b). In 2011, only 14% of the unemployed were in training. Incentives for companies to train their staff were reduced in 2012, as the possibility of fully deducting training costs from the vocational training contribution (a 1.5% employer contribution on wages) was eliminated, except for apprentices. Additional EU funds have more than replaced this subsidy in 2012-13, although they may also involve more administrative costs. Reinstating a subsidy for training costs could be considered, in which case it should preferably be kept partial to reduce deadweight costs and potential misuse. The significant size of the informal economy may also hamper lifelong learning, as informal employers have less incentive to train workers.

Figure 2.9. **Adults in education and training**

Per cent



1. Firms offering formal training programmes to their permanent, full-time employees. Data for 2008 for Turkey; 2005 for Germany, Greece, Ireland, Portugal and Spain.
2. Participation in formal and non-formal education and training by 25-64 year-olds. Per cent of population in same age group.

Source: Eurostat (2013), "Population and Social Conditions: Lifelong Learning – LFS data", *Eurostat Database*, December and World Bank (2013), *Enterprise Surveys*, *www.enterprisesurveys.org*.

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An alternative (or complementary) approach could be to place the subsidy with individuals rather than companies, for example by creating a system of individual learning accounts. Such systems exist under different forms in a number of OECD countries, such as France, United Kingdom and United States (Cedefop, 2009; Gautié and Perez, 2012). Such a shift could support mobility, as workers would be more likely than companies to choose training which allows them to subsequently change sector. On the downside, individual learning accounts can be administratively complex and have difficulties to reach the low skilled.

Steps are needed to improve the quality of training, especially for jobseekers. The sector is very fragmented, as local PES centres contract out training to more than 1 000 private institutions and for a smaller part to the (public) Türr István Institute. Although some tools have long been in place to evaluate the efficiency of the main labour activation policies (in the form of annual monitoring by the National Employment Office and occasional reports by independent researchers), little is known about the efficiency of individual training providers. Anecdotal evidence suggests uneven quality and even some cases of corruption, and a high drop-out rate. Where evaluations are in place, generally in the form of questionnaires to participants about their labour market situation after a few months, they are of little use because of high non-response rates.

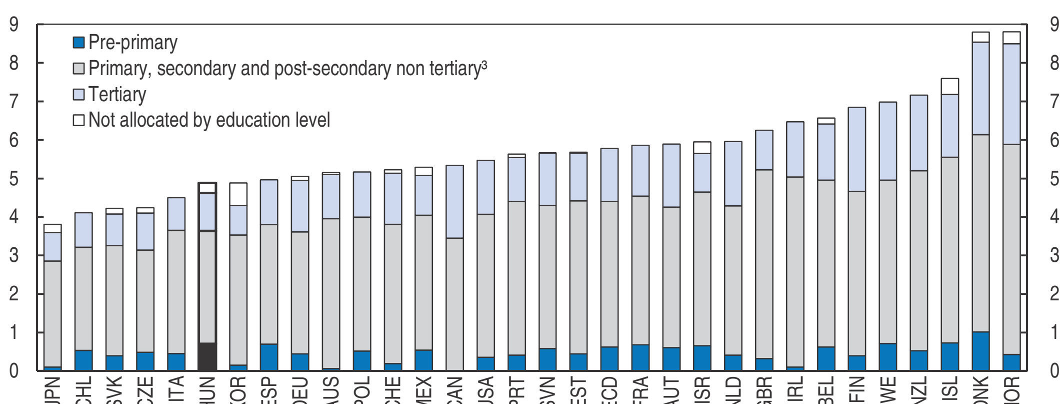
To augment the labour market relevance of training, the authorities have focused it more on vocational, language and information technology (IT) skills – in the latter two fields, already 70 000 adults received EU-funded training in the year to September 2013, half of whom have completed it successfully (the programme is ongoing). More generally, enhancing efficiency requires improving the quality of evaluation, for example by giving participants a financial incentive to answer questionnaires. In a welcome step, a recent law introduced a requirement for the authorities to evaluate every other year the quality of training institutions. These evaluations should be made public and jobseekers be more involved in the choice of their training provider, as a way to push providers to compete on quality. Such increased transparency would also reveal what type of training best fits jobseekers' abilities and labour market needs, allowing more effective orientation of jobseekers.

Improving initial education to match labour market needs

In the longer term, reducing labour mismatches requires enhancing education outcomes and skills to better match labour market needs. Certain education outcomes are relatively good, especially given the relatively low spending (Figure 2.10). Secondary education attainment is relatively high among the younger generations and average PISA scores (Programme for international student assessment) are broadly in line with the OECD average (OECD, 2013a; OECD, 2010b). However, the number of early school leavers remains high, the quality of vocational training is low and participation in tertiary education still lags the OECD average. In addition, despite the relatively high pre-school attendance, the background of children influences their performance more than in most OECD countries (Figure 2.11). In

Figure 2.10. **Public spending by level of education**[1]

Per cent of GDP, 2010[2]



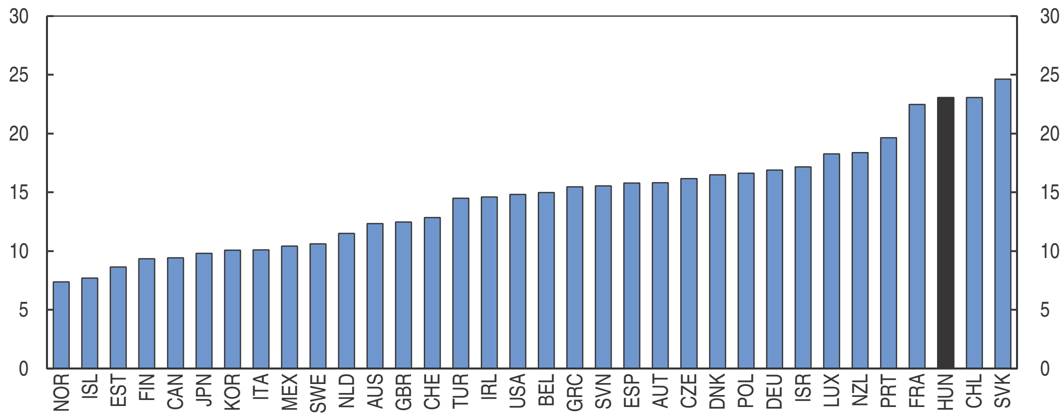
1. Direct public expenditure on educational institutions plus public subsidies to households (for living costs such as scholarships and grants to students/households and student loans) and other private entities.
2. 2009 for Canada and Germany.
3. Includes pre-primary for Canada.

Source: OECD (2013), *Education at a Glance 2013: OECD Indicators*.

StatLink http://dx.doi.org/10.1787/888932983528

Figure 2.11. **Inequalities in education**

Impact of socio-economic background on education outcomes, per cent, 2012[1]



1. Percentage of variance in student performance explained by the Programme for International Student Assessment (PISA) index of economic, social and cultural status (ESCS). R-squared × 100.

Source: OECD (2013), *PISA 2012 Results: Excellence through Equity (Volume II)*.

StatLink http://dx.doi.org/10.1787/888932983547

turn, educational attainment has a strong impact on employment and wage prospects relative to other countries (Figure 2.2; OECD, 2012c). The government is carrying out vast reforms at all levels of the education system, which are presented in boxes below.

Tackling inequalities in primary and secondary education

Hungary has the highest rate in the OECD of social segregation in schools, measured on the basis of parental occupation (Jenkins et al., 2008). As a result, there are large variations in the performance of pupils across schools and only relatively low within-school variation. In particular, schools in small settlements (below 3 000 inhabitants) have much poorer performance than others (OECD, 2010c). Segregation reflects both social inequalities across the country, including an overrepresentation of the poor and the Roma in rural areas, and the relatively widespread practice of schools to select pupils on the basis of their academic record. Selection can start at the entry to primary school and 90% of pupils are in schools which are in a position to select students (Havas, 2009; OECD, 2012d). Segregation may have increased over the past decade, as the number of schools with Roma majority among pupils has increased (European Commission, 2013b).

Reducing segregation would give better chances to disadvantaged children, as segregation is generally considered to weaken their performance. Substantial negative effects may only materialise above a certain share of disadvantaged students in the classroom (30% to 70%, depending on school characteristics), meaning that greater diversity could enhance the results of disadvantaged students without greatly affecting the results of more well-off ones (Karsten, 2010). To tackle segregation, notably of Roma children, certain schools in small rural settlements could be closed – despite political pressure to keep all schools open – and their pupils sent to schools offering more socio-economic diversity in larger settlements, even though this would entail a loss of proximity and higher transport costs (which should be covered by the government to prevent school drop-out). A large scale programme to close small rural schools in Portugal in the second half of the 2000s had generally positive results in terms of efficiency and integration of disadvantaged pupils (Box 5.2 in OECD, 2013b).

Other measures could also be considered to tackle segregation, such as creating financial incentives for high-quality schools to attract disadvantaged students, or reducing to some extent the ability of schools to choose students by making it conditional on certain rules on school diversity (OECD, 2012d). A 2012 law stipulates that the ratio of disadvantaged students in each school shall not exceed the average ratio of disadvantaged people in the settlement by more than 15 percentage points. However, the effect is likely to be limited because of the existing geographic segregation.

To further improve the prospects of disadvantaged students, more resources should be targeted to schools where they are overrepresented. The 2013 recentralisation of responsibilities may help in this respect as poorer municipalities often lacked resources to finance school infrastructures, while the central government may provide more funds (Box 2.2). The general increase in teachers' wages may also help in recruiting and retaining more highly qualified teachers. Still, more should be done to attract the most qualified and experienced teachers and school directors to the most difficult schools, which is a key to enhancing performance (OECD, 2012d). Teachers in disadvantaged areas receive a bonus, but it only amounts to about 10% of the wage and is relatively less for more experienced teachers. To attract and retain better teachers in difficult areas, this bonus should be increased and, more generally, working conditions should be improved, including through

Box 2.2. **Recent reforms in primary and secondary education**

In 2013, the responsibility for primary and secondary education was transferred from municipalities to the central government. Only school maintenance in larger municipalities (over 3 000 inhabitants) remains a municipal responsibility. The central government took over the financing of schools, which no longer have independent budgets, as well as certain responsibilities that were traditionally devoted to school directors, such as hiring and firing teachers. To manage these new responsibilities, a new administrative layer, the Klebelsberg Institute, was created, with a network of around 200 local branches.

Teachers' wages in primary and secondary education were increased by an average 34% in September 2013. Further increases of about 10% per year are envisaged for the three coming years. In exchange, teachers' low working time is to be increased. The measure, which follows a recommendation in the 2010 *Survey*,* should help the recruitment and retention of better teachers as, after many years of wage freezes, teachers' wages had become very low *vis-à-vis* other occupations at the same qualification level.

A number of largely EU-financed measures aim to increase the chances of disadvantaged students. Pre-school will be made compulsory for children over three years-old in 2015 (94% are already attending), which is a positive step given that enrolment generally enhances education outcomes of children with poor backgrounds. A so-called Sure Start programme aims to support young children in disadvantaged areas by providing pedagogic and social support in dedicated centres and promoting parental involvement. To reduce school dropout, Bridge programmes were launched in 2013 to help pupils performing poorly in elementary education to acquire basic skills and a partial vocational qualification, and an after-school support programme (TANODA) was launched. A "For the Road" programme provides support to disadvantaged pupils (at least half of them Roma) from 7th grade to the first year of university, in the form of a monthly scholarship (of an amount depending on academic results) and mentoring.

* OECD (2010), *OECD Economic Surveys: Hungary 2010*,

further use of EU funds for education projects. In addition, novice teachers in disadvantaged areas should be better prepared for the specificities of their environment through specific training and mentoring. Parental engagement should also be fostered, for example by establishing home-school liaison co-ordinators to facilitate contacts between teachers, families and communities (OECD, 2010d).

Preserving an adequate level of school autonomy is important to allow schools to adapt to the local context, especially in disadvantaged areas. Empirical evidence suggests that decentralised education systems tend to perform better if autonomy comes with accountability (OECD, 2010e; Blöchliger et al., 2013). School autonomy was traditionally high in Hungary, but the 2013 centralising reform substantially reduced it, at least in theory. In practice, a lot will depend on how the reform is implemented and how relationships evolve between schools and the newly created Klebelsberg Institute that will manage the recentralised responsibilities for the central government. In this context, the authorities should ensure that organisational and some pedagogical autonomy remains with schools, including the management of human resources, and focus the Klebelsberg Institute on benchmarking school performance to enhance accountability of school directors, providing logistical support and taking initiatives to support disadvantaged students.

Making the best of vocational training reform

Enhancing the quality of vocational education and training (VET) is essential to improve employment prospects of the lower skilled. The quality and image of VET have gradually deteriorated after the transition to a market economy, as it failed to adapt to large changes in labour demand (OECD, 2008a; OECD, 2010f; European Commission, 2011). An important reform took effect in 2013, which aims to bring students' skills closer to labour market needs by increasing the practical component of training and involving private companies more (Box 2.3). The latter is positive as it may facilitate skills matching and the transition from school to work. To enhance effectiveness, it should be ensured

Box 2.3. **Vocational training reform**

An important reform of vocational education and training (VET) entered into force in 2013. The curriculum in vocational training schools was shortened from four to three years and the focus on practical training increased, both in vocational training schools and in (less practical) vocational secondary schools. On average, the share of practical training should reach about 70% in vocational training schools, from about 50% before the reform. Practical training will also start earlier, in the first year of vocational school (9th grade), instead of respectively 10th grade in vocational training schools and 12th-13th grade in vocational secondary schools.

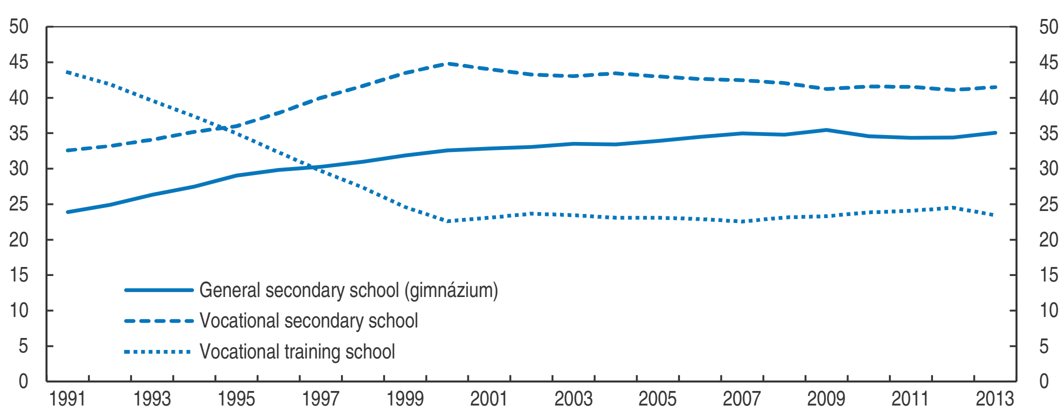
The reform also increases involvement of private companies in VET. It gives a bigger role to chambers of commerce to influence the content of training with the aim to better attune it to labour market needs. It also aims to expand the elements of dual training (apprenticeship systems), notably through additional EU financing. New professional and examination requirements aim to follow labour market needs more closely. To promote studies in potential skill shortage areas, vocational students in lists of "shortage occupations" (defined at the county level on the basis of job vacancies and surveys among companies) can be offered scholarship grants.

that, as intended, the additional practical training takes place in companies (e.g. in the form of apprenticeships) rather than in school-based workshops or in the network of regional training centres (TISZKs) developed in the late 2000s, which have had mixed performance (Cseres-Gergely, 2010). This may require additional incentives for companies to train apprentices.

The downside of the reform is a strong risk that the shorter curriculum and the lower share of general classes will reduce general skills. A lack of general skills, in particular literacy and numeracy, can be an issue for employability in the longer term as it makes it more difficult to retrain to adapt to changing labour market needs. Delaying the tracking of students would contribute to tackle this lack of general skills. Tracking into general, vocational secondary and vocational training schools (the latter giving the most emphasis to practical skills and regrouping a quarter of students, Figure 2.12) currently takes place at age 14, as against 15-16 in most OECD countries. In general, early tracking is considered to have a negative impact on students assigned to lower tracks without raising average performance (OECD, 2012d). In Hungary, it also contributes to perpetuating the high existing socio-economic inequalities (Csapó 2009; OECD, 2010f). In addition to delaying tracking, its negative consequences should be mitigated in the shorter term by increasing opportunities to change tracks and putting in place flexible settings where children are grouped by ability only for certain subjects. This would be greatly facilitated by further merging vocational secondary schools and vocational training schools, most of which now operate under the same management but not always in the same premises. In addition, more resources should be devoted to enhancing the quality of general teaching in vocational training schools, which is generally low (Liskó, 2009).

Figure 2.12. **Students in secondary education**

Per cent of students in full-time education[1]



1. Vocational training school is more practical than vocational secondary school.

Source: HCSO (2013), "Education", *STADAT Tables*, Hungarian Central Statistical Office, December.

StatLink http://dx.doi.org/10.1787/888932983566

The greater involvement of the private sector in defining the content of VET is welcome. To further improve the matching of training to labour market needs, a bigger role should be given to evaluation. Labour market outcomes of VET students should be collected and published on a school and programme basis, as recommended in OECD (2008a). This would enable more informed student choices, especially if it were combined with more systematic career guidance. It would also contribute to defining the so-called "shortage occupations", for which vocational students are entitled to special grants, in a more transparent and evidence-based manner. More generally, given the traditionally strong links between VET and manufacturing industry, the authorities should ensure that the interests of the service sector are also fully taken into account, as this sector may offer better long-term employment prospects.

Enhancing participation in tertiary education and its quality

After rising rapidly up to the mid-2000s, participation in the (mostly public) tertiary education has declined somewhat. Compounded by a high drop-out rate, this results in graduation rates still lagging the OECD average (European Commission, 2012; OECD, 2013a). Labour market prospects of graduates are rather good as they generally find a job rapidly and enjoy a relatively high wage premium (Strauss and de la Maisonneuve, 2007). Nevertheless, the quality of higher education is uneven, reflecting *inter alia* declining spending per student over the past decades, and outcomes may not always match labour market needs. Companies frequently complain about a lack of new engineers (GVI, 2012), although the wages of white-collar workers in industry have not over performed relative to other sectors in recent years, thus giving no clear indication of a shortage. The two-tier system, where a majority of students (state financed) – selected mainly on the basis of high-school results – pay no tuition fees, while the others (self-financed) pay some, tends to be regressive, despite an element of positive discrimination in the admissions procedure. Indeed, most students benefitting from state financing have a relatively privileged background and the self-financing option may be less accessible to disadvantaged students, who are more sensitive to financing costs and the risks associated with student loans (Semjén, 2013).

The number of applicants to tertiary education has declined by around 30% over 2011-13 and the number of admitted students by more than 25%, in contrast with the stated aim to promote participation (Government of the Republic of Hungary, 2013). This reflected to some extent demographic factors, but also much lower quotas of state financed positions in 2012 and uncertainty around the important reforms taking effect in 2013 (Table 2.2; Box 2.4). A new obligation for students to reimburse half of the state financing if studies are not completed within a reasonable time has also discouraged applications, although it may

Table 2.2. **Applications and admissions to tertiary education**

General admission procedure, thousand persons[1]

		2001	2004	2007	2008	2009	2010	2011	2012	2013
Total	Number of applicants	148.9	167.4	108.9	97.0	127.3	140.3	141.0	110.6	95.4
	Number admitted	98.0	109.9	81.6	81.1	94.7	98.2	98.2	80.1	72.7
	State financed	50.8	59.9	48.8	52.8	65.7	68.6	67.0	51.3	54.2
	Self-financed	47.2	50.0	32.8	28.3	29.0	29.6	31.2	28.8	18.5
	Share of state financed (%)	51.8	54.5	59.8	65.1	69.4	69.9	68.2	64.0	74.6
16 subjects in law, economics, social sciences and humanities	Number admitted	..	..	25.2	25.0	25.2	23.1	22.4	16.3	13.5
	Share of state financed (%)	..	..	36.3	39.7	39.0	37.9	33.0	6.3	8.2
Other subjects	Number admitted	..	..	56.4	56.1	69.5	75.1	75.8	63.8	59.2
	Share of state financed (%)	..	..	70.3	76.4	80.4	79.7	78.6	78.3	89.7

1. From 2007 onwards numbers include students applying and admitted to master programmes in the Bologna system, which were developed gradually. From less than 1 000 in 2007, the number of applicants to master programmes rose to about 24 000 in 2010, of which about 16 000 were admitted.

Source: Hungarian authorities, *www.felvi.hu*.

Box 2.4. **The 2012 tertiary education reform**

The reform modified the distribution of state-financed (no tuition fees) positions across institutions, introduced new contractual obligations for state-financed students, created new loans to support self-financed students, streamlined the financing of institutions and changed their governance.

The cornerstone of the admission procedure remains a ranking of applicants on a 500 point scale, reflecting mainly their previous academic results, with a 40 point bonus for applicants from disadvantaged backgrounds. This ranking determines access to university and awarding of state-financed positions. Until 2013, the government defined the number of state-financed positions by setting quotas per field of study and university. With the aim to improve the matching of students and universities, these quotas have been replaced by minimum score requirements per study programmes and capacity constraints at the level of universities. In 16 study programmes in law, economics, social sciences and humanities, score requirements to receive state financing were set much higher (between 410 and 465 points) than in the other fields (240 points, to be raised by 20 points in 2014 and again in 2015), confirming the 2012 decision to toughen drastically state-financed access to these programmes (Table 2.2).

If their studies are not completed within 1.5 times the normal length, students will have to reimburse half of the state financing received. Another new requirement for state financed students is to work in Hungary for a time period equal to the length of their study within 20 years of their graduation or to reimburse tuition costs if they do not.

In order to support the self-financed students, the government has complemented the existing student loan system with additional – more subsidised – loans to cover tuition fees. The interest rate is a fixed 2%, against a higher and variable rate (8% in 2012) in the existing scheme. In both schemes, the repayment schedule is wage-contingent, but the total amount to be reimbursed is not.

Budgets of institutions will be based on their actual, rather than potential, number of state-financed students. This gives universities greater incentive to attract students. It will also put important financial pressure on less prestigious universities, generally smaller and outside Budapest, which are less likely to fill their capacity. These universities have seen the largest declines in the number of students. Over 2011-13, admissions declined by 22% in the 10 largest universities and 33% in the other 39 universities.

Several governance reforms have increased government influence. Heads of public tertiary education institutions will no longer be directly elected by the assemblies (senates) representing university stakeholders (e.g. university staff, teachers, students), but picked by the government from a list established by the senate. Internal auditors and economic directors will also be appointed by the government. Government influence over the committee giving accreditation to academic programmes was also reinforced. In addition, the capacity limits of detailed study programmes will be subject to government approval.

reduce drop-out rates. The authorities plan to tighten minimum admission criteria over the two coming years, which may further reduce student numbers, but again also reduce drop-out rates.

A monitoring system was introduced in 2009 to collect and publish information about the labour market outcomes of university graduates. As foreseen in the 2011 law on higher education, this information should be used more intensively by the authorities in decisions to favour certain fields of study over others. For example, state-financed access to

16 programmes in law, economics, social sciences and humanities was sharply restricted in 2012 in an attempt to steer potential students towards engineering and natural sciences (although the number of students in these specialties also declined in 2012-13). The array of available indicators indeed suggests a relative oversupply of graduates in social sciences and possibly humanities, but not clearly so in law and economics, although graduate prospects have been deteriorating in the latter (Table 2.3; Varga, 2013). Further, promoting scientific careers would also require strengthening scientific studies in primary and secondary schools.

Table 2.3. **Tertiary education: labour market prospects per field of study**

Better (+) or worse (-) student prospects than in the average of fields (2010 graduates)

	Employment rate	Unemployment rate	Time to find first job[1]	Earnings	Matching of job with degree subject
Agriculture	+	-	n.d.	-	-
Economics	+	+	-	+	+
Humanities	-	-	=	+	-
Information technology	+	+	+	-	+
Law and administration	+	-	+	+	+
Medical and health sciences	-	+	=	-	+
Natural sciences	-	+	=	=	-
Social sciences	-	-	=	-	-
Technology (engineering)	+	+	=	-	+

1. Unweighted average of bachelor and master level.

Source: J. Varga (2013), "Labour Market Success of Hungarian Higher Education Graduates in 2011", in *Hungarian Graduates 2011*, Educatio Public Services, Ministry for Human Resources.

How to read this table: Economics graduates have a higher employment rate and a lower unemployment rate than the average of graduates. They take on average more time to find a first job, but have higher average earnings and their job more often matches with their field of study than the average of graduates.

An obstacle to participation in tertiary education may be that disadvantaged students are too risk-averse to finance their tuition with student loans, even though the loan reimbursement schedule is income contingent. The creation in 2012 of additional loans, with a greater degree of subsidy, to cover tuition costs may help in this respect (Box 2.4). If they do not succeed in raising participation of disadvantaged students, especially in programmes with few state-financed positions, a further step should be to extend the state financing of studies to all disadvantaged students meeting admission criteria. This could be financed by extending tuition fees (coupled with student loans) to more of the better-off students, which would be unlikely to deter them from enrolling given the high wage premium on university studies.

To enhance the quality of tertiary education, there is room to further rationalise supply. Many institutions operate at a small scale, cover too many topics and may offer education of relatively low quality (OECD, 2010f). The reform of university financing was a positive step as it reduced the potential for courses with very few students, contributing to reduce sharply the number of programmes offered by universities, to still more than 500 in 2013. The logical continuation would be to close certain small institutions or merge them with larger ones. As these institutions are mainly in smaller towns or cities outside Budapest, care should be taken to not restrict participation of local students, especially with a disadvantaged background. To this end, scholarships could be put in place to facilitate their studying in larger cities. There may also be room to develop short-cycle "type B" tertiary programmes focusing on practical, technical and occupational skills, which can provide good employment outcomes and are less developed than in many OECD countries (OECD, 2012a). New two-year vocational programmes (*felsőoktatási szakképzés*) were launched with this purpose in 2013.

The 2012 reform has markedly reduced the autonomy of tertiary education institutions (Box 2.4). Although greater accountability in terms of educational and financial results was needed – including the right to intervene directly in problematic cases – a certain level of autonomy can stimulate dynamism and creativity (OECD, 2008b). Autonomy can also help develop partnerships with private companies, which can facilitate the labour market transition of students. In this specific case, the reduced autonomy may also hamper the flexibility of universities to adapt to the new financing rules that give them more incentives to attract students. As these new rules mean that institutions will be under more pressure from student choices – the authorities emphasise the importance of market-like mechanisms in this area – there should rather be less need for direct government control. In a welcome step, the authorities intend to restore a greater degree of autonomy in 2014, by reducing government influence in the nomination of university directors.

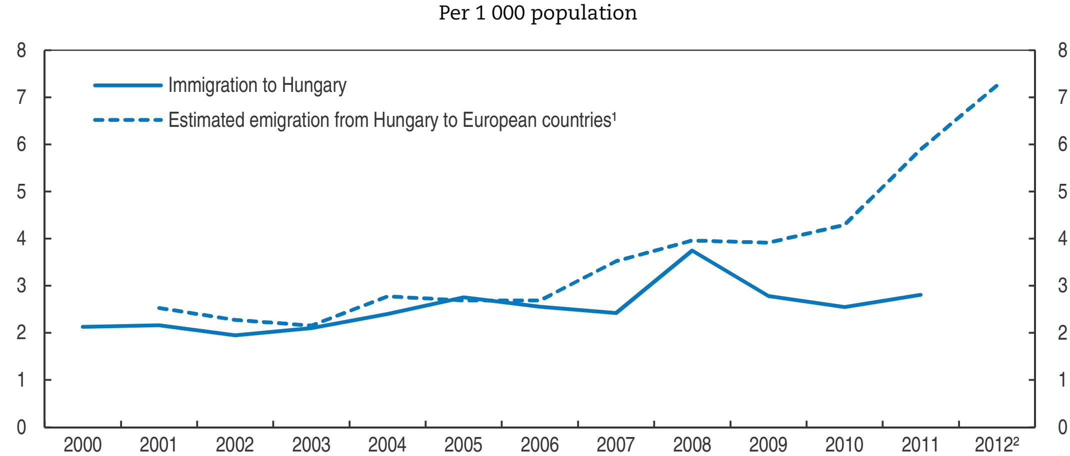
International migration and the global competition for skills

Rising emigration prompts fears of skill shortages

Hungary is traditionally a relatively low migration country (Hárs, 2009). Over recent years, emigration has sharply increased – while remaining lower than in some other eastern European countries – reflecting weaker economic prospects at home and the gradual opening of EU labour markets to Hungarian citizens (Figure 2.13; note that emigration flows are likely to be underestimated by certain migrants still declaring residence in Hungary). Germany, Austria and more recently the United Kingdom are the main destinations. Looking ahead, surveys suggest an increasing willingness to emigrate, especially among young adults, and high-skilled emigration may increase further as the

Figure 2.13. **Migratory trends**

Per 1 000 population



1. Based on "mirror" statistics, that is the number of Hungarian citizens registered as immigrants in the host countries.
2. Estimate.

Source: Eurostat (2013), "Population and Social Conditions", *Eurostat Database*, December and SEEMIG (2013), "South East Europe and Hungary – Migratory Trends", South East Europe Transnational Cooperation Programme.

StatLink http://dx.doi.org/10.1787/888932983585

global competition for skills intensifies. Rising emigration is prompting fears of skill shortages. For now, these have materialised only in healthcare. Roughly one sixth of doctors may have left the country since the mid-2000s, a trend which, if continued, could rapidly lead to deficiencies in care supply (OECD, 2012a). On the other hand, emigration can also bring economic benefits in the form of remittances (1.8% of GDP in 2012), trade networks and skills. Skills accumulated abroad can spill into the domestic economy and bring productivity gains if migrants return after some time. An illustration is that returning migrants command a wage premium of around 30% in Hungary (Martin and Radu, 2012).

Rising emigration can signal the need to improve the socio-economic situation and the business environment, as discussed in Chapter 1. In areas of potential skill shortages, especially healthcare, where the job vacancy rate is more than double the economy-wide average, targeted measures are needed to ensure sufficient labour supply. As recommended in the health chapter of the 2012 *Survey* (OECD, 2012a; Eris, 2012), wages of health professionals were increased substantially, by around 10% to 15% in 2012 depending on the data source (with larger increases for doctors), and about 7% in the first 10 months of 2013 according to the Central Statistical Office. However, they remain low in a European perspective. As emigration of health professionals has only stabilised, at a high rate, in 2012, further substantial wage increases and improvements in working conditions for doctors and nurses will be needed to bring down emigration rates and maintain adequate supply. A more specific issue is the system of "practice rights" (*praxisjog*), which complicates the entry of young family doctors into the system and thus encourages them to emigrate. As recommended in the 2012 *Survey*, this system should be phased out (OECD, 2012a).

As a way to moderate high-skilled emigration, or at least to make emigrants contribute more to their education costs, higher education students benefitting from state-financed tuition are now required to work in Hungary for a period equal to the duration of their studies over their first 20 years of career (Box 2.4). The effect of the measure on emigration may remain limited, as the implementation of potential sanctions (the reimbursement of tuition costs) is uncertain and will only start in 20 years, making it conditional on the scheme remaining in place over the period. An unintended consequence, not necessarily negative, is also that some students may decide to study abroad to remain free from any future geographic constraints.

Attracting high-skilled immigration, including by returning migrants

There may be scope to attract more high-skilled immigration, including by Hungarians returning after a few years, to offset potential skill shortages and enhance the potential of the economy. The share of returning migrants, although difficult to observe, may have declined over recent years (SEEMIG, 2013). Immigration is relatively low, and largely comes from ethnic Hungarians in neighbouring countries – a tendency that the 2011 law may reinforce as it gave them easier access to Hungarian nationality, with about 100 000 people benefitting. The low immigration reflects the language barrier, but also until 2013 the lack of a national immigration strategy and possibly a relatively high incidence of xenophobia (Hárs and Sík, 2008; Hárs, 2009). More recently, the deterioration of the socio-economic situation and certain measures affecting more heavily foreign-owned companies, such as some special taxes on specific sectors, may also have weighed on high-skilled immigration.

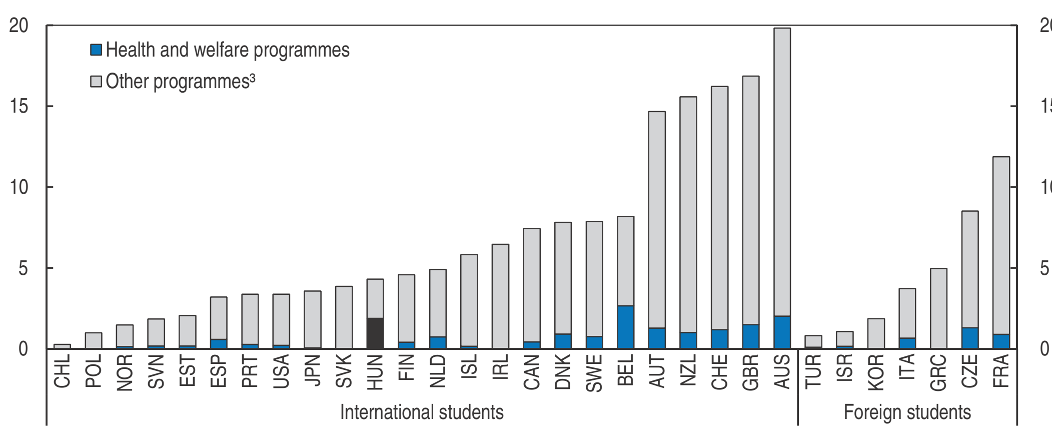
Targeted schemes combining easier visa requirements, language courses, support for administrative procedures and possibly tax incentives could be introduced to attract migrants in potential areas of skill shortage. However, potential negative consequences on the labour force of origin countries, especially in the healthcare sector, should be taken into account, potentially requiring co-operation with these countries. For non-EU citizens, visa and working permit requirements can still represent a substantial barrier. In particular, potential employers have to prove that no Hungarian jobseeker is suitable for the job and working permits last for a maximum of only two years. The introduction of the EU blue card (a work permit for high-skilled non-EU citizens) has not helped in this respect, as Hungary has set very high minimum wage requirements for such immigrants (120-150% of the average wage of the sector), resulting in almost no take up (Busch et al., 2013). More recent efforts include steps to simplify administrative processes, including joint application to visa and work permit for non EU citizens, and an information package for immigrants in the health sector.

Tax privileges for immigrants, including returning emigrants, exist in many OECD countries (Dumont and Lemaître, 2005). For example, the Netherlands offers high-skilled expatriates in the country a 30% income tax break and Israel has recently broadened tax privileges of immigrants and extended them to returning migrants. In Hungary, the relatively low income tax rate on high incomes represents a form of tax incentive, although relatively high social security contributions mean that the tax wedge on high incomes is above the OECD average. Also, researchers with a PhD in science are eligible to tax relief.

Further attracting foreign students could also contribute to high-skilled immigration. Depending on the country, it is estimated that 15% to 30% of them stay after their studies (OECD, 2011a). The number of foreign students in Hungarian universities has nearly doubled since 2000, although it remains below the OECD average (Figure 2.14). However, an important share of them are medical students, who sometimes come to avoid student quotas in their countries and generally have little interest in staying in Hungary afterwards. Growth in the number of foreign students was supported by the transition to the Bologna qualification system, the development of the Erasmus programme, the introduction of the Campus Hungary programme and the increasing availability of courses

Figure 2.14. **International and foreign students**[1]

Per cent of all tertiary enrolment, 2011[2]



1. International students are students who have crossed borders expressly to study. Foreign students are non-citizens of the country for which the data are collected. These two sets of data are not comparable and therefore are presented separately. For further details of data coverage see Tables C4.1 and C4.2 of the source publication.
2. 2010 for Canada.
3. All programmes for countries where no health and welfare breakdown is available.

Source: OECD (2013), *Education at a Glance 2013: OECD Indicators*.

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in English. The fact that foreign students can benefit from state-financed tuition – a third of them did in 2011 – also helps. The authorities should further push to attract foreign students, and are designing a new strategy with this purpose.

A more flexible housing market would facilitate the relocation of workers

Internal migration is taking place from job-poor areas in the south and east of the country, to job-richer ones around Budapest and near the Austrian border. However, the pace of migration over the past decade has been insufficient to reduce the large regional differences in unemployment. Increasing the mobility of workers, both in terms of relocating and commuting, has significant potential to increase employment. A risk is that workers leaving job-poor areas may further depress activity there, adding to geographic inequalities. Efforts to relocate activity to disadvantaged areas, such as the recent creation of "free enterprise" low-tax zones, can help mitigate this risk. Take-up to these new zones has started slowly – the authorities assess that 400 jobs were created (or shifted) in the first half of 2013 – and further measures may be necessary to encourage activity to relocate, such as, as discussed above, moving towards a lower minimum wage in disadvantaged areas.

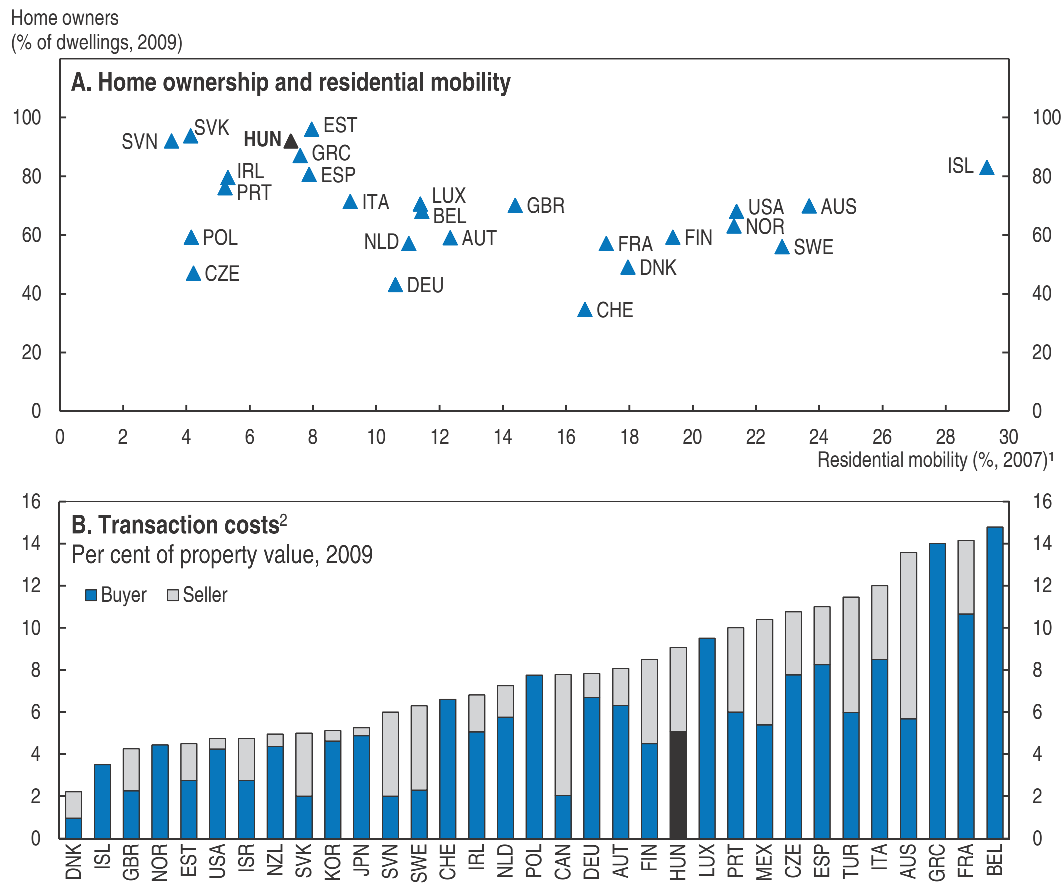
The high homeownership rate is an obstacle to mobility

Housing mobility is very low in Hungary, reflecting the underdevelopment of the rental market, substantial transaction costs and, more recently, high mortgage indebtedness of certain households (Figure 2.15; Andrews et al., 2011). The lack of a rental market is particularly detrimental to relocating workers as house prices are much higher in job-rich areas, particularly Budapest. In this respect, a relocation subsidy launched in 2012 for 500 selected workers may help, but only at the margin. The homeownership rate has been extremely high since the transition to a market economy, when dwellings were sold to tenants at a large discount. Younger generations, who have not benefitted, have much poorer housing conditions and often need parental support to buy a house (Giday, 2011). Since the transition, the development of a rental market was never really encouraged. Homeownership was always strongly tax- and subsidy-favoured and the social rental market is almost non-existent. The informal rental market is generally estimated to represent roughly two thirds of the total rental market. Tax avoidance is the main reason for informality, even though net rental income is subject only to the 16% personal income tax. Informality (and the associated tax evasion) poses fairness issues, creates risks for both landlords and tenants by reducing scope for legal action in case of dispute and can deprive tenants of an official address.

Encouraging the development of a formal rental market

The development of the formal rental market should be encouraged by reducing the bias towards homeownership induced by taxation and mortgage interest subsidies. The current combination of low recurrent property taxes (0.3% of GDP in 2010, against an OECD average of 1.0% of GDP) and generous mortgage interest subsidies on loans in forint (50-70% of the interest is paid by the government in the first five years of contract) is very favourable for homeowners. In general, mortgage interest subsidies do not strongly expand housing opportunities, because they partly translate into higher prices, but tend to be costly, regressive and favour excessive leverage (Andrews et al., 2011).

Figure 2.15. **Housing market**



1. Percentage of households that changed residence within the last two years. The low mobility rate in some Eastern European countries may reflect problems with the underlying data. However, this is difficult to verify as there is no alternative data source.
2. Average costs including notary fees, typical real estate agent fees, legal fee, registration fees and transfer taxes (e.g. stamp duties).

Source: D. Andrews, A. Caldera Sánchez and Å. Johansson (2011), "Housing Markets and Structural Policies in OECD Countries", *OECD Economics Department Working Papers*, No. 836.

StatLink http://dx.doi.org/10.1787/888932983623

In theory, the best solution to make housing taxes and subsidies neutral *vis-à-vis* other investments would be to tax homeowners on their imputed rents, while allowing them to deduct mortgage interest from their income tax (OECD, 2011b). In practice, only a few countries tax imputed rents and those that do substantially underestimate rental values. A more practical solution would be to gradually raise recurrent property taxes (as a substitute for taxing imputed rents) and phase out mortgage interest subsidies. The proceeds could serve, among others, to reduce the 4% housing transaction tax. Regarding the phasing out of interest subsidies, an exception could be made in the short run for the purchase of new dwellings to avoid further depressing the construction sector. In 2003, sharp cuts in subsidies for forint-denominated mortgages contributed to a wave of excessive borrowing in foreign currency (Banai et al., 2011). However, such an outcome would be much less likely this time, thanks to much stronger regulation of foreign currency borrowing.

Recurrent property taxes are generally considered among the least harmful for economic growth, but often pose political issues (Cournède et al., 2013; Norregaard, 2013). In Hungary, several property taxes are levied at the municipal level. The most important is the residential building tax, which only less than 20% of municipalities have opted to levy. The tax rate is set by municipalities, with a maximum of HUF 1 722 per square meter or 1.8% of the assessed market value of the property. A national tax on properties worth more than HUF 30 million was briefly introduced in 2010 and abandoned after its design was judged unconstitutional. To enhance political adhesion to higher property taxes, and taking into account the very high homeownership rate, care should be taken in assessing the impact on poverty and in offering solutions to the asset-rich but income-poor (mostly elderly) people who would be most affected, for example life-annuity property sales, where the buyer pays a regular sum to the seller and receives the property when the seller dies.

Informal renting is currently widely tolerated. Improving the regulatory environment to reduce uncertainties for potential landlords would encourage formality and should be combined with more effective tax controls to discourage informality. Eviction of a tenant who has ceased to pay rents can be difficult and lengthy. It involves a court trial and a procedure that can take up to two years in Budapest. This should be simplified and greatly shortened for cases with cause, such as non-payment of rent. Reducing the scope for conflict around utility bills would also help. Bills are often paid by tenants, but utility contracts are generally in the name of the landlord, who is ultimately responsible in case of unpaid bills. Contracts should rather be transferred to tenants, or provisions for utility bills should be included in the rents.

Enhancing the quality of housing conditions

The quality of housing is relatively poor (Hegedüs et al., 2009). Overcrowded dwellings are much more common than in most EU countries, especially among younger generations, which may contribute to the low birth rate. Many buildings, notably those built during the communist era, lack maintenance and have poor insulation. Renovation work has slowed as many homeowners struggle with high indebtedness (Giday, 2011). Increasing taxation of energy use and generalising individual meters would give greater incentive to enhance energy efficiency (Chapter 1; Energiaklub, 2011). It would also bring funds that could be used, along with already existing EU funds, to further support such renovation works. To improve the housing conditions of the poorest, developing social housing should also be considered. The starting point for a national social housing system could be the National Asset Management Agency (NAMA), which in 2012 started buying properties from (and then letting to) socially vulnerable borrowers with excessive indebtedness.

Improving the efficiency of transport to reduce commuting costs

Commuting by public transport is more common in Hungary than in neighbouring countries (Paci et al., 2007), but there is room to develop it further by making transport more efficient. This would facilitate labour market matching and stimulate employment in rural areas, which strongly depends on commuting costs (Bartus, 2012). A 30 kilometre monthly train or bus ticket costs about EUR 70, 20-70% more than in other Visegrád countries. Still, many workers commute by public transport, reflecting a lower car ownership than in most OECD countries and a very dense public transport network, although the network would benefit from better integration between transport modes. The road network has been expanded over recent years with new EU-cofinanced highways, but it can be very congested during peak hours in Budapest. Low investment in maintenance has resulted in deteriorating road and rail infrastructures, forcing trains to reduce speed on some lines (Persson and Song, 2010; State Audit Office, 2012a and 2012b).

Workers and jobseekers can benefit from transport subsidies. Companies are required to finance 86% of their workers' commuting costs if they commute by train or intercity bus. However, the effect on employment is unclear and may even be negative, as this represents an additional labour cost for companies.

There is significant scope for efficiency gains in public transport provision

Until 2012, the public transport sector ran persistent operating losses and accumulated debts, which were periodically taken over by the central government. In 2012, an operational surplus was achieved, but this reflected higher government subsidies (1.2% of GDP in 2012, mainly to the railway company) more than efficiency gains, as there has been considerable delay in the implementation of efficiency-enhancing measures in the Szell-Kalman plan (European Commission, 2013b). In general, subsidising public transport can be economically justified as it generates positive externalities relative to travelling by car. However, it is important that subsidies be transparently set in advance in return for an agreed level of service and that the government take rapid corrective action if that contract is not fulfilled (OECD, 2011c). The new medium-term budgeting system for train and intercity bus companies introduced in 2012 goes in this direction. In such an arrangement, subsidies could be gradually reduced over coming years to push the public transport companies to achieve efficiency gains.

A very dense railway network was inherited from the communist era and traffic on certain train lines is low. Some lines could probably be replaced efficiently by bus services (GKI, 2012). A few lines were closed in the late 2000s, but some were reopened in 2010. In recent years, train circulation was reduced on many lines, while some timetable and tariff modifications have aimed at attracting more passengers. The costs and benefits of keeping low-traffic lines open should be assessed and the results made public. Closing some low-traffic lines would allow better targeting of the scarce maintenance funds, could bring environmental benefits, especially as certain lines are not electrified, and could allow reduced staffing, as it is generally considered ample. In addition, there may be room to renegotiate working conditions of employees to bring them closer to equivalent private sector occupations. For example, train and intercity bus drivers are among the very few occupations that can still retire early, as they have to contribute 20% less time than other workers to receive the same pension. The governance structure of the railway company (MÁV) should also be reviewed, as envisaged by the authorities, as the division into several sub-entities a few years ago increased the number of management positions, and thus costs, without a clear effect on efficiency (State Audit Office, 2012a).

The very dense network of government-owned intercity buses (Volán) connects poorer people in remote areas to services and potential employment in larger towns. However, efficiency could be enhanced as the size of buses is not always adapted to the traffic load and the company is fragmented into 24 small independent entities operating at the local level (GKI, 2012). The authorities intend to merge these into seven regional providers, which should help rationalise supply, bring economies of scale and facilitate co-ordination. In the medium run, there are plans to privatise these providers and open the market to new entrants to comply with EU requirements, which may enhance competition and efficiency. To preserve coverage of remote areas, a transparent procurement framework should be put in place where companies compete for public service obligation subsidies.

Progress has been made in rationalising the Budapest public transport system. A holding company (BKK) was created in 2010 that represents the municipality and subcontracts transport provision mainly to BKV (the historical provider, which BKK supervises). The operation of about 20% of bus lines has been delegated to a private operator (VT Transman) and the intercity bus company (Volán). This new governance structure may bring efficiency gains as companies regularly have to compete in open tenders for the attribution of the different bus lines, although participation has remained limited so far. Also in 2010, working contracts have been renegotiated in BKV (for instance lunch break time is no longer paid), contributing to 5% savings. Nevertheless, there remains scope for further efficiency gains, as envisaged, by introducing electronic metro gates and integrated electronic ticketing.

Towards fairer and greener transport

The important government-financed discounts for specific groups in public transport contribute indirectly to higher costs for other passengers, such as commuting workers (Table 2.4). In trains, there are more than 40 different discounts and only 40% of passengers pay the full price. Certain discounts, such as those for large families and elderly people, appear very high internationally. This calls for reassessing the socio-economic justification of the different discounts and, as a minimum, means-testing them to target only poorer households. The associated savings could be used to reduce prices for other passengers and improve the fiscal position.

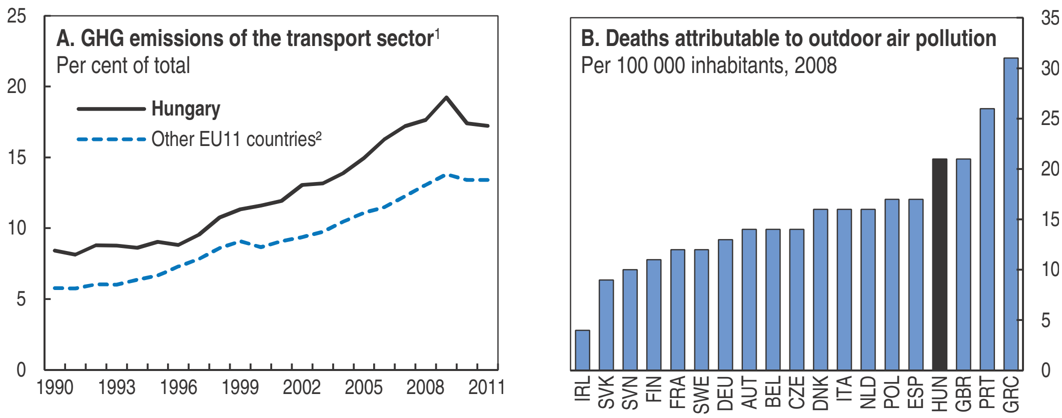
Table 2.4. **Main discounts in public transport**

	Railways (MÁV)	Intercity buses (Volán)	Budapest public transport (BKK)
Elderly people (over 65)	100%	100%	100%
Pensioners (below 65)	90% on 2 trips per year, 50% on 16 trips per year	90% on 2 trips per year, 50% on 16 trips per year	65%[1]
Children (below 6)	100%	100%	100%
Children (aged 6-14)	50%	50%	..
Students	90% between school and home, 50% otherwise	90% between school and home, 50% otherwise	63%[1]
Young people (below 26)	33% between Friday and Sunday	..	..
Disabled people and accompanier	90%	90%	100%
Large families (travelling with at least 3 children)	90%	90%	..
Adult accompanying at least one child below 18	33%	..	..
Civil servants	50% on 12 round trips per year	50% on 12 round trips per year	..

1. Only for passes of a duration of at least one month.
Source: MÁV, Volán and BKK websites, June 2013.

Greenhouse gas emissions from the transport sector are higher than a decade ago, although they have declined during the economic crisis, and local air pollution in Budapest is harmful for health (Figure 2.16). In an environmental perspective, the relatively high reliance on public transport is positive. However, the relatively old age of the rolling stock – both in public and private transport – is contributing to pollution. In Budapest, 20% of the public bus fleet is being renewed.

Figure 2.16. **Transport and the environment**



1. Net greenhouse gas (GHG) emissions/removals, excluding land use, land-use change and forestry (LULUCF).
2. EU11 is a weighted average of other Central and East European countries that are members of the European Union (Bulgaria, Czech Republic, Croatia, Estonia, Latvia, Lithuania, Poland, Romania, Slovak Republic and Slovenia).

Source: UNFCCC (2013), "GHG Data – UNFCCC", United Nations Framework Convention on Climate Change and WHO (2013), *Global Health Observatory Data Repository*.

StatLink http://dx.doi.org/10.1787/888932983642

More should be done to internalise the negative externalities of private transport in terms of pollution and congestion. Vehicle registration taxes take into account environmental performance, but annual vehicle taxes do not fully do so, as they decline with vehicle age, which can slow fleet renewal and contribute to pollution (OECD, 2008c). The average age of the vehicle fleet is relatively high – 12½ years in 2012, up by two years since 2008 (HCSO, 2013). Diesel cars represented 54% of first time car registrations in 2012, more than twice the share ten years ago. Taxation of diesel should be further increased relative to gasoline (though the difference is already lower than in many OECD countries), as envisaged, to reflect that diesel engines, despite being more fuel-efficient, emit more particulate matter that is harmful for health. On the positive side, an electronic toll system for trucks on main roads was launched in 2013, which will contribute to internalise their negative externalities in terms of wear-and-tear and pollution. A road pricing scheme for private vehicles in Budapest, on the model of London, was considered in 2010 but abandoned. Such a scheme would help reducing congestion – especially if user charges are higher at peak hours – and pollution, although it would require additional investments in public transport to accommodate shifting demand.

Box 2.5. **Main recommendations to tackle labour market mismatches and promote mobility**

Stimulate demand for low-skilled labour

- Further reduce the tax wedge on low salaries to stimulate low-skilled employment. Target existing cuts in social security contributions (Job Protection Act) exclusively on low salaries.
- Refrain from increasing the minimum wage by more than warranted by inflation and productivity developments, and consider even freezing it for some time. Consider moving progressively towards a lower minimum wage in disadvantaged regions.

Box 2.5. **Main recommendations to tackle labour market mismatches and promote mobility** *(cont.)*

Upgrade workers' skills through enhanced active labour market policies and lifelong learning

- Enhance reintegration of public workers through carefully evaluated training, local co-operation between municipalities, job centres, non-governmental organisations and private firms, and further support to micro-entrepreneurship. Give municipalities medium-term financial incentives to reintegrate participants to the labour market.
- Scale up the capacity of the Public Employment Service in terms of staffing and efficiency. Increase somewhat the duration of unemployment benefits. Ensure monitoring and enforcement of job search requirements.
- Evaluate the efficiency of training programmes for the unemployed, publish the results, and involve the unemployed more in the choice of their training provider.

Reform education to reduce inequalities and better meet labour market needs

Primary and secondary education

- Tackle school segregation by sending pupils in small rural schools to more socially diverse schools in larger towns. Target more resources to disadvantaged schools and give teachers more financial incentives to work in disadvantaged areas.
- Preserve the functional and pedagogic autonomy of schools, but reinforce benchmarking to enhance accountability.
- Postpone tracking to enhance the general skills of pupils and their future adaptability to change jobs.

Tertiary education

- Encourage participation of disadvantaged students by extending the state financing of studies to all disadvantaged students meeting admission criteria.
- Use the information collected on labour market outcomes of students more intensively in the allocation of state-financed (no tuition fees) positions across fields of study.

Attract high skilled migration to prevent skill shortages

- Combine easier visa requirements, language courses, support for administrative procedures and possibly tax incentives to attract high-skilled immigrants in potential skill shortage domains.

Enhance the flexibility of the housing market to facilitate the relocation of workers

- Encourage the development of the rental market by gradually phasing out mortgage interest subsidies and increasing recurrent municipal property taxes.
- Improve the regulatory environment of rental contracts by simplifying and shortening eviction procedures.

Improve efficiency in the transport sector to reduce commuting costs

- Finance the public transport companies transparently with pre-determined annual subsidies in exchange for an agreed level of service. Gradually reduce subsidies over the coming years to push for efficiency gains.
- Assess the costs and benefits of keeping low-traffic train lines open and publish the results. Where justified, replace them by bus services, which would be cheaper.
- Reassess public transport discounts to specific groups, so as to reduce transport costs for other travellers.

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