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OVERVIEW



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Summary

Hungary's economy faces severe headwinds. The global economic slowdown and heightened financial market stress have pushed an already fragile and highly indebted economy towards recession. But, controversial domestic policies have also contributed to uncertainty thereby hurting consumer, business and market confidence. Stabilising the economy is the first most pressing priority. Strengthening the credibility and predictability of domestic policies is essential to develop an environment which is conducive to growth and rising incomes. An agreement with multilateral organisations would help restore confidence and support needed fiscal consolidation. In doing so, it would lower the debt burden in foreign currency by stabilising the exchange rate. The second challenge is to put growth on a sound footing to allow a durable recovery. This requires reductions in households' debt without damaging banks to avoid a credit crunch. Finally, raising potential growth is of utmost importance: boosting labour force participation and health outcomes are two promising avenues.

Credible fiscal consolidation and support for labour demand will help stabilise the economy. Despite a relatively favourable fiscal position, a recent deterioration in the underlying balance calls for renewed efforts on top of measures adopted for 2012. A sustained fiscal consolidation should rely more on durably curbing spending by implementing permanent measures and structural reforms to boost growth, such as those outlined in the Széll Kálmán plan, and, if needed, by raising the least distortive taxes. As recent changes in the tax and benefit system have been highly regressive, minimising negative distributional impacts of consolidation is essential to ensure public acceptance and, thus, political sustainability. The credibility of the consolidation programme would be bolstered by providing the fiscal council with adequate resources to perform fiscal surveillance; by contrast, its excessive power to veto the budget should be removed as it could potentially lead to a fall of government. Avoiding cyclical unemployment becoming structural requires an overhaul of labour market policies with a stronger focus on active measures including high-quality training, but also better targeting of employment subsidies and correction over time of the very large increases in the minimum wage.

Making the economy more robust to shocks and promoting a business-friendly environment will put growth on a sounder footing. Hungary is excessively exposed to shifts in investors' confidence through its high foreign currency indebtedness. This applies to public debt, which should rely more on domestic financing in forints, and especially to households. Programmes to support household debt reduction should focus on distressed households, and ensure burden sharing between lenders, borrowers and the government. The mid-December 2011 agreement with banks is a welcome step in the right direction, but is not sufficiently targeted to distressed borrowers. To forestall deeper credit rationing, bank recapitalisation, if necessary, should be done by raising the level of capital so as not to downsize loan portfolios, and the bank levy should be reduced and redesigned. More checks and balances would also lead to a more predictable and thus business-friendly environment. In particular, the full powers of the Constitutional Court in economic matters should not be conditional on the level of the debt-to-GDP ratio, and effective independence of the central bank should be guaranteed, in line with Hungary's international obligations.

Raising labour force participation and improving health can boost growth. Structural measures are needed to increase labour supply of under-represented groups. Participation of women would benefit from developing flexible work arrangements and making it easier to combine work and families. Better attuning the education system to labour market needs would ease the integration of youth and the Roma. Finally, reforming early retirement and lifelong learning would raise incentives to work at older ages. The limited effectiveness of the health system creates opportunities to improve health outcomes without straining public finances. This could be achieved by reallocating resources from inpatient services to outpatient services, prevention and health promotion programmes, and long-term care, and by enhancing health workforce management. Access to health care would be enhanced by discouraging informal payments.

Assessment and recommendations

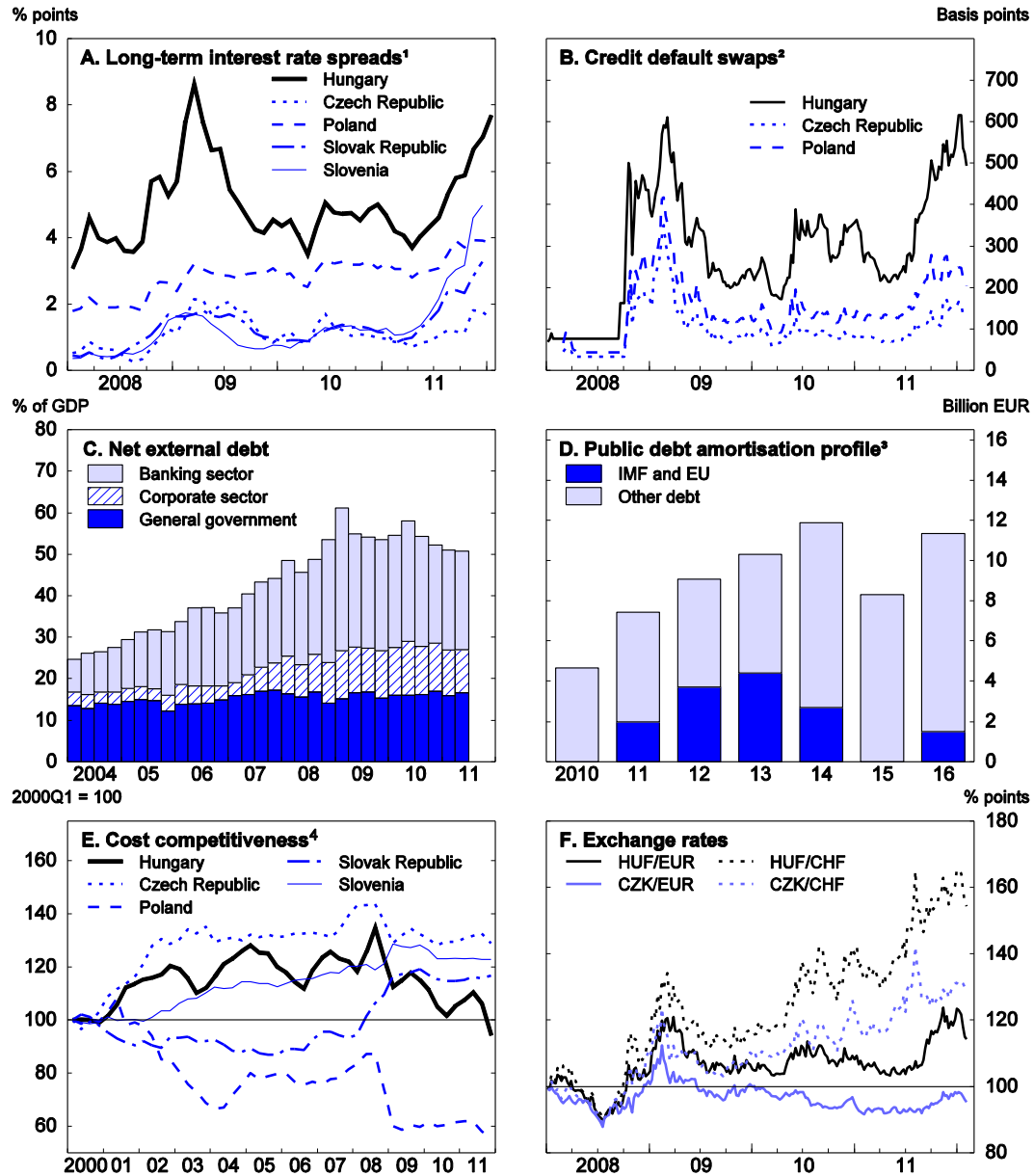
Hungary's economy is facing renewed market stress

Hungary is confronted with heightened tensions in financial markets. Long-term interest and credit default swap rates on public debt have risen significantly since spring 2011 (Figure 1, Panels A and B). The sovereign rating was downgraded to non-investment grade and several debt auctions failed or partially failed in late 2011, which creates high uncertainty ahead of significant public debt rollover needs in 2012 and 2013 (Figure 1, Panel D). In addition, the currency has depreciated sharply, increasing the debt burden in foreign currency (Figure 1, Panels F and C). To help stabilise the markets, the government requested financial precautionary assistance from the European Union (EU) and International Monetary Fund (IMF), and the central bank raised its policy rate by 50 basis points twice in November and December 2011 to 7%.

The combination of global economic slowdown and heightened market stress is hitting an already fragile economy. Solid cost competitiveness (Figure 1, Panel E) and contained relative export prices have been behind large gains in market shares and Hungary's current account surplus, but have not prevented a steep slowdown in export growth. Private-sector reduction of debt is depressing domestic demand. The introduction and design of the flat tax in 2011 increased average net incomes, but other direct tax measures led to a loss in the incomes of households at the lower-end of the wage distribution, who are those with the highest propensity to consume and therefore also those most affected by the increased value added tax (VAT) in 2012. Despite cuts in the corporate income tax for small and medium-sized enterprises and some flagship projects in the automobile industry which boosted manufacturing investment, overall investment has remained subdued. This reflects in part depressed construction activity as well as economic uncertainty, compounded by the levy of "crisis taxes" imposed on various sectors. The introduction of a sizeable bank tax contributed to some credit rationing. Also, to compensate households who lost income following the removal of the employment tax credit, the government raised minimum wages and gave incentives to firms to increase wages by excluding from public tenders and subsidies those failing to comply with the tripartite agreement on wage increases.

Overall, the economy is projected to be in recession in early 2012, with a weak recovery starting in the latter half of the year as confidence returns somewhat and global financial and economic conditions improve (Table 1). The unemployment rate is projected to increase due to the economic slowdown, compounded by a large hike by 19% in the minimum wage in 2012, while labour force supply may increase along with cuts in the generosity of social benefits. This projection is consistent with a "muddling through" on the global stage, but has significant downside risks with a substantial possibility of materialising. In the medium term, prospects remain bleak without new policies to boost potential growth. A decrease by 25% in gross fixed investment since mid-2008 is reducing potential output from close to 3% in the pre-crisis period to below 1%. While labour productivity is projected to increase somewhat, rapid demographic ageing will hold growth to an estimated 1-1.5% in the coming years.

Figure 1. Key indicators



1. Ten-year government bond spreads relative to the German rate.
2. Five year rates; mid-rate spread between the entity and the relevant benchmark curve.
3. Based on *IMF Country Report* No. 11/137 of June 2011.
4. Effective exchange rate based on relative unit labour costs in the manufacturing sector.

Source: OECD (2012), *OECD Economic Outlook: Statistics and Projections* (database), January; Datastream, Magyar Nemzeti Bank and International Monetary Fund.

Table 1. Short-term outlook

	Current prices (billion HUF) 2008	Percentage change, volume 2005 prices ¹				
		2009	2010	2011	2012	2013
Real gross domestic product	26 589	-6.6	1.2	1.5	-0.6	1.1
Private consumption	14 380	-6.2	-2.2	-0.7	-2.0	-0.2
Government consumption	5 801	-0.7	-2.1	-0.3	-1.3	-0.2
Gross fixed capital formation	5 760	-11.0	-9.7	-6.7	-3.9	-0.2
Final domestic demand	25 940	-6.1	-3.7	-1.8	-2.2	-0.2
Stockbuilding ²	528	-4.6	3.2	0.5	-0.1	0.0
Total domestic demand	26 468	-10.5	-0.5	-1.3	-2.4	-0.2
Exports of goods and services	21 677	-10.2	14.3	9.4	4.8	6.4
Imports of goods and services	21 557	-14.8	12.8	6.8	3.3	5.5
Net exports ²	121	3.6	1.8	2.7	1.7	1.3
<i>Memorandum items</i>						
GDP deflator	..	3.9	3.0	2.0	4.0	2.4
Consumer price index	..	4.2	4.9	3.9	4.9	2.9
Private consumption deflator	..	3.7	4.2	3.4	4.6	2.7
Unemployment rate (% of labour force)	..	10.1	11.2	11.0	11.9	11.8
General government financial balance ³	..	-4.5	-4.3	4.0	-3.4	-3.3
Gross government debt (Maastricht definition) ³	..	79.2	80.9	84.2	85.1	85.9
Current account balance ³	..	-0.2	1.1	1.9	1.4	1.2

1. Projections from 2011 onwards from OECD (2011), *OECD Economic Outlook*, No. 90.

2. Contribution to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

3. As a percentage of GDP.

Source: OECD (2012), *OECD Economic Outlook: Statistics and Projections* (database), January.

Stabilising the economy and boosting potential growth

With heightened financial market pressures and activity falling, the first challenge is to stabilise the economy. Rapidly reaching an agreement with multilateral organisations for new financial assistance is a key first step to help restore investor confidence, stabilise the exchange rate and relieve some pressure on households, who are heavily indebted in foreign currency. By insuring against rollover risks and providing a stable market access, such an agreement would provide an environment allowing needed fiscal consolidation. Well designed structural consolidation measures that minimise economic costs and adverse distributional impacts are necessary. Credible fiscal adjustment will eventually open the way for a loosening of monetary policy.

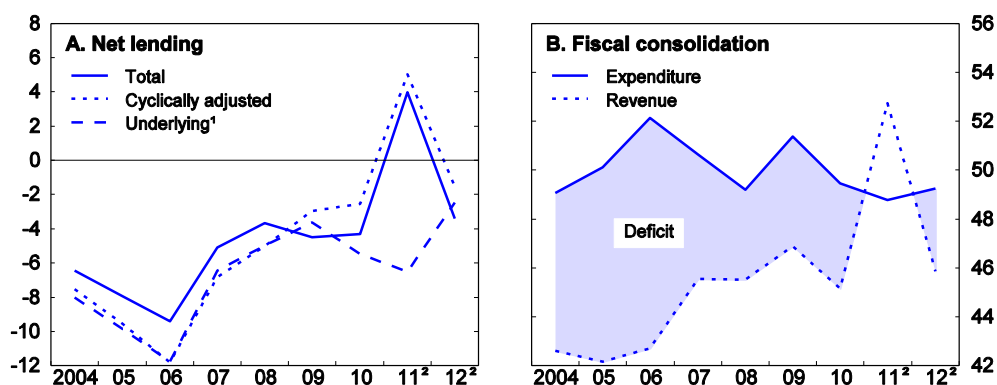
The second main challenge is to restore growth through further structural reforms. In the short-term, a precondition for any durable recovery is reducing household exposure to foreign currency. As the excessive borrowing in foreign currency was a shared responsibility of lenders, borrowers and regulators, the burden of adjustment should fall on banks, households and the government. The mid-December 2011 agreement between the government and the banking sector was a welcome step towards fair burden sharing, but is not sufficiently targeted to distressed borrowers. In the medium term, raising potential growth will be fostered by a business-friendly environment with a level playing field and strong checks and balances to avoid unpredictable policies and uncertainty of contracts. This should stimulate investment and labour productivity but boosting drivers of potential employment growth, notably the growth in trend labour force participation, will be necessary as well. Reforming labour market and health policies could contribute significantly to this objective. The main assessment and recommendations on these issues are summarised below and analysed in more detail in the chapters of the survey.

Short-term policies to restore confidence and head off the risk of a prolonged downturn

Resuming fiscal consolidation

After three years of sizeable fiscal consolidation from 2006 to 2009, some adjustment fatigue resurfaced as the underlying fiscal balance deteriorated in both 2010 and 2011, reversing earlier gains (Figure 2, Panel A). Cuts in labour and capital income taxes resulted in significant revenue losses that were initially offset through one-off measures, notably the assumption of second-pillar pension assets which led to a large, but one-off, budget surplus in 2011 (Figure 2, Panel B). The government subsequently announced an ambitious programme of structural reforms in spring 2011, the Széll Kálmán plan, which was, together with additional measures laid out in the Convergence programme, rightly focused on curbing public expenditure. These measures, to be implemented mainly from 2012 onwards, have since been supplemented with mostly revenue-increasing measures as faltering growth prospects and, also, expected partial implementation of the earlier measures called for additional consolidation efforts. These notably include hikes in employees' social security contributions, various excise taxes and the VAT rate (from 25% to 27%, from January 2012). However, spending measures have been less well defined (for instance the review and more efficient management of public tasks and duties) or their gains may prove to be difficult to sustain (for example the freeze in public wages or indexation of family benefits and other social transfers).

Figure 2. Net lending and fiscal consolidation
General government, per cent of GDP or potential GDP



1. Cyclically adjusted less one-offs.
2. Projections.

Source: OECD (2011), *OECD Economic Outlook: Statistics and Projections* (database), December.

Curbing expenditure growth

With a high level of public expenditure (close to 50% of GDP), especially given Hungary's level of per capita income, additional consolidation measures should focus on the spending rather than the revenue side. Low public sector efficiency provides an opportunity to restrain spending without unduly reducing public services. General government employment, which is close to 20% of total employment, could be reduced, especially at the local level. The government took measures in that direction at end-2011. Cutting the wage bill by reducing headcounts, rather than by cutting wages, would provide more flexibility and prevent the public sector from becoming increasingly uncompetitive in the labour market. Indeed, public sector wages already compare unfavourably with wages in the private sector (OECD, 2010a). To maximise the benefits of public-service reform, redundancies should be governed by staff performance assessments and a review of public policy priorities.

Public procurement is another area where important savings could be made. In 2008, general government and state-owned utilities' procurement represented 20% of GDP, three percentage points above the OECD average. A new simplified law on public procurement favouring the participation of small and medium-sized enterprises was adopted in mid-2011. Yet a greater opening of national procurement markets to foreign suppliers coupled with a stronger reliance on information and communication technologies would reduce costs by boosting competition, enhancing transparency and cutting administrative burdens (OECD, 2011a).

There are significant potential efficiency gains as the organisation of public transport (bus, railway and airline companies) is generating losses and requiring regular bailouts and recapitalisations from the state. Despite cuts in price subsidies, expected savings from restructuring have not been achieved so far and, instead, the government has had to increase its support. Any further bailouts have to go in tandem with a hardening of the budget constraint and, as needed, rationalisation of overall service provision. Moreover, public ownership in the potentially competitive segments of network industries should be phased out to reduce pressure on public expenditure and improve governance and efficiency.

Increasing property and environmental taxes

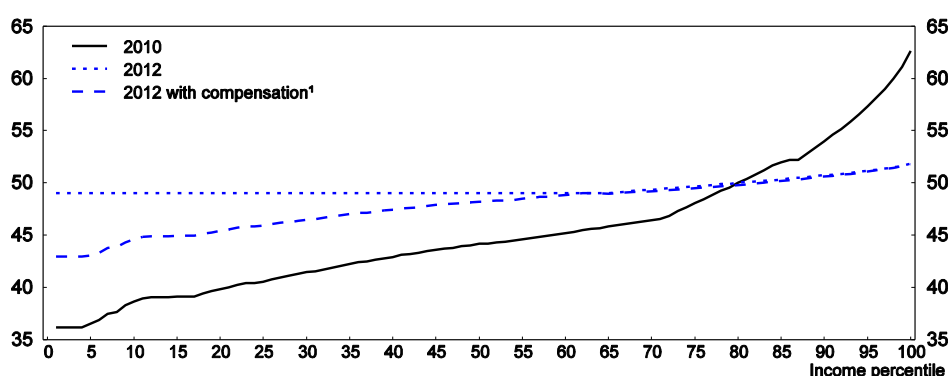
If the authorities need to resort to taxation to achieve consolidation, they should raise the least distortive taxes. The recent increase in VAT is favourable in this respect but the "crisis taxes", in particular the bank tax (see below), are highly distortive. They should be removed no later than the end of 2012 or 2013 (bank tax) as planned. Environmental taxes could be raised further as effective taxes on energy are among the lowest in Europe. Property taxes (notably on immovable property, net wealth, inheritances and legal transactions) are still low in Hungary, raising just around 1% of GDP in 2008, compared with an OECD average of nearly 2% of GDP. A residential property tax that was to be raised at the central level was cancelled by the Constitutional Court in 2010, even though such taxes are among the least damaging to growth (Arnold et al., 2011).

Another efficient way to raise taxation is to strengthen tax collection. Two tax authorities were merged into a single institution in January 2011, and its powers and procedures enhanced in January 2012, which ought to create conditions for a more efficient fight against widespread tax avoidance. Beyond this, tax controls should be reinforced at the top and the bottom of the income distribution and supported by better inter-agency data sharing, stronger penalties and financial sanctions.

Ensuring fair sharing of consolidation efforts

Successful fiscal consolidation requires fair sharing of adjustment efforts between the rich and the poor to foster public acceptance and ensure the sustainability of tax reforms. Notwithstanding the government's motivation to improve economic efficiency through tax reforms, this issue is all the more pressing in Hungary because recent fiscal reforms have shifted the tax burden towards low-income earners. On the revenue side, across-the-board hikes in social security contributions and the removal of the employment tax credit significantly increased the tax wedge on households at the low-end of the income distribution, especially for those without children (Figure 3). The rise in the standard VAT rate (the reduced rates have remained unchanged), while limiting economic distortions, tends to affect low-income earners more as they spend relatively more of their income on consumption. On the expenditure side, a freeze in social benefits has been more detrimental to the poorer. Tax expenditures granted to families with children rise with the level of income.

Figure 3. Average tax wedge for different income percentiles
For a household with no children, per cent



1. Any increase in private sector wages beyond 5% is refunded to firms through cuts in employers' social security contributions.

Source: OECD estimates based on OECD Tax/Benefit models and Ministry for National Economy data.

There are options to adjust burden sharing while retaining the efficiency aspects of the recent reforms, but all such measures would need to be carefully considered in the light of the need to reduce the fiscal deficit and ensure longer-term fiscal sustainability. Reinstating the recently removed employment tax credit would both provide income to low-income earners and enhance work incentives. The fiscal cost could be lowered by phasing it out from a lower income level than was previously the case. A tax-free allowance in the personal income tax system would provide relief at the low end while maintaining the overall flatness of the tax structure. Cancelling current plans to lower the effective income tax rate to 16% for those earning above the average wage would be another option to preserve progressivity. Linking child-related benefits to income rather than, as now, only the number of children would steer more money to the needy. Raising the least distortive property taxes on affluent individuals could be an option to create fiscal space for the restructuring of foreign currency loans of distressed borrowers (see below).

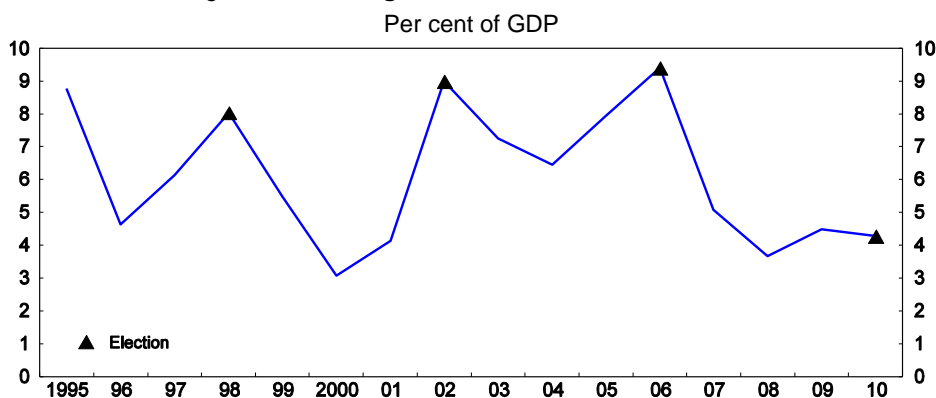
Strengthening the fiscal framework to bolster the credibility of fiscal consolidation

Historically, the Hungarian budget has had a marked political cycle, but not in the 2010 elections (Figure 4). This sharp change could have reflected the adoption of the fiscal responsibility law, which established fiscal rules and a high-profile independent fiscal council in 2008, and the government commitment to stick to the deficit target. However, this framework was weakened with the replacement of the former council by a new one with much less resources (three members and no budget). It does, however, have the power to veto fiscal laws, but as this could potentially lead to a fall of a government - the President of the Republic can dissolve the Parliament if a new law is not adopted by end-March - it is unclear how such an option could be constructively deployed. A debt ceiling has been introduced in the Constitution, stipulating that gross public debt should be cut below 50% of GDP at some point in the future. According to the economic stability law adopted in December 2011, this ceiling is backed by a debt rule that stipulates that the public debt can increase only by expected inflation minus half of expected real GDP growth, as long as the debt-to-GDP ratio is above 50%. It also stipulates that the debt rule will come into force only in 2016, while the targets of the Convergence program of 2011 will apply in the meantime.

The new fiscal framework could be improved. Increased flexibility would reduce its pro-cyclical bias. The escape clause dealing with economic contingencies ("significant and enduring national recession") may be too restrictive since the rule could turn out pro-cyclical in some instances: for example, this could happen when economic growth is positive but the output gap still negative. Fiscal policy would be strengthened if it were set in the context of a multi-year budgeting approach, with medium-term deficit targets supported by realistic growth projections and detailed measures to achieve the targets. The new act on economic stability subjects changes of some regulations of the tax system (e.g., the flat-rate taxation of personal income), pension system and budget management to a two-thirds majority in Parliament. This risks unduly restricting needed flexibility in the future.

Although the definition of the public debt is close to the Maastricht definition, making it strictly identical would increase transparency. More broadly, public acceptance of the debt rule should be bolstered by removing the stipulation that most of the prerogatives of the Constitutional Court in economic matters are suspended as long as the debt ratio is above 50% of GDP. This would be one measure to restore a better functioning of checks and balances. Finally, the analytical capability of the fiscal council should be strengthened by stepping up the staffing and the budget; however, its excessive power to veto the budget should be removed as it could potentially lead to a fall of a government. Also, the fact that one member of the fiscal council can only be replaced if a two-thirds majority in the Parliament can agree on a new candidate, risks further undermining its political acceptance in case of a political gridlock.

Figure 4. **General government deficit and elections**



Source: OECD (2011), *OECD Economic Outlook: Statistics and Projections* (database), December.

Credible fiscal policy should help monetary policy easing

In 2011, headline inflation rose above the central bank's medium-term inflation target of 3% driven by higher food and energy prices, weakly anchored inflation expectations and recent currency weakness. As a result, the policy rate was raised by 75 basis points to 6% in early 2011 and to 7% at end-2011, despite a large degree of slack in the economy. The exchange rate is a key inflation transmission channel owing to the large trade openness of the economy, while the pass-through of monetary policy through the interest rate channel is weakened in the presence of high foreign currency indebtedness. Moreover, given a large external debt, in periods of heightened tensions in financial markets the monetary authorities' scope to reduce interest rates is constrained by rising risk premiums. In this context, price pressures are likely to intensify temporarily in 2012 in the wake of currency weakness and substantial increases in indirect taxes. A credible fiscal retrenchment would create conditions for monetary policy accommodation.

Several important amendments to the law on the central bank have been introduced, affecting the institutional framework of monetary policy. A new procedure was established to select the external members of the Monetary Policy Council (MPC) by a parliamentary committee and four new members were appointed this way in early 2011. Further amendments subject to a two-thirds majority were introduced at the end of 2011. The power of the governor to nominate his two deputies, also members of the MPC, was repealed and transferred to the prime minister, while the maximum number of MPC members was raised from seven to nine and that of deputy governors from two to three. Although such appointment procedures exist in many OECD countries, they represent a clear departure from best practices (Cukierman et al., 1992; European Commission, 2006). Undertaken against the backdrop of frequent government criticism of the central bank decisions and its governor, multiple previous changes to the law (which have already significantly cut the remuneration of the governor and his deputies), these changes could undermine central bank independence, especially if implemented before the end of the mandate of the current governor. The European Central Bank and European Commission have expressed significant concerns about central bank independence on several occasions. The authorities have announced their readiness to resolve these issues. Furthermore a transitional provision of the new constitution allows for a merger of the central bank with the Hungarian Financial Supervisory Authority (HFSA) into a new institution. Although the government

indicated that such merger will not happen until the end of the current governor's mandate, the fact that the central bank governor would become deputy of the new institution is incompatible with the provisions of the Treaty on the Functioning of the European Union, as well as the Statute of the European System of Central Banks.

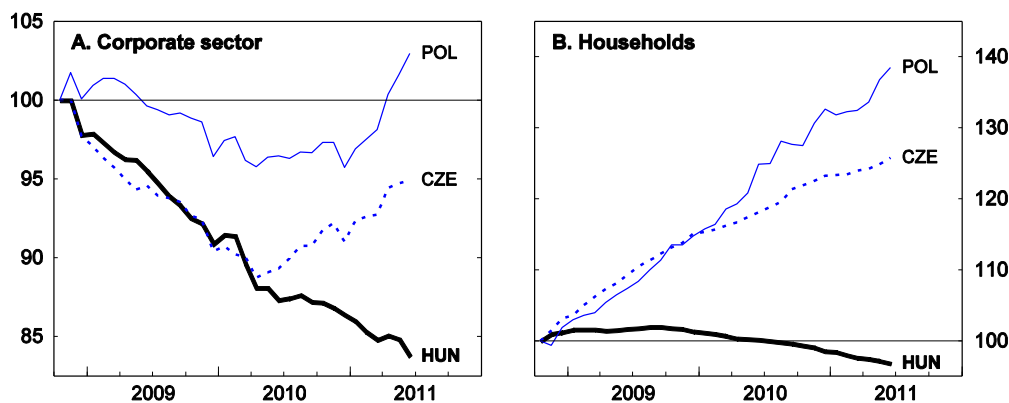
Facilitating household deleveraging without hurting banks is the key to putting growth on a sound footing

Actions taken so far have put a high burden on the banking sector, risking credit rationing

Recent research of the central bank shows that two-thirds of the fall in corporate credit is attributed to supply factors (Sóvágó, 2011) and there is increasing evidence of credit rationing and no recovery in lending (Figure 5). Moreover, high unemployment and households' large exposure to foreign currency induced a sharp increase in overdue and renegotiated loans. Restoring a proper functioning of financial intermediation requires both cleaning up banks' balance sheets and helping households to deleverage. These two objectives could conflict with each other, and also with fiscal consolidation. In practice, the authorities have imposed most of the burden on the banking sector. An exceptional bank levy was introduced in 2010 to help fiscal consolidation. This levy is very high by international comparison and even currently unprofitable institutions are subject to it, as its base is the historical value of the stock of assets. A law promulgated in September 2011 allowed households to repay their foreign currency loans unilaterally in a single instalment at favourable exchange rates. This law mostly benefited non-liquidity constrained individuals; and to increase the take-up rate tax reliefs have been granted to employers in return for a lump sum support to employees taking part in the scheme. The early repayment measure is expected to have been widely used with at least 20% of performing loans repaid through this scheme. Following additional provisioning efforts related effective losses for banks amounted to one third of the accumulated loan-loss provisions. Overall, as some of the above policies undermine creditors' rights and interfere with private contracts, there is a risk that foreign banks may withdraw from the Hungarian market; some have already announced either a freeze or a downsizing of their network in Hungary because of these policies.

Figure 5. Corporate and household lending

Exchange rate adjusted, October 2008 = 100



Source: MNB (2011), *Report on Financial Stability*, Magyar Nemzeti Bank, November.

New measures should focus on financially constrained households and a rapid clean-up of banks' balance sheets

The burden of restructuring overdue loans should take into account the fiscal space of the government, the repayment ability of borrowers and the stability of the financial sector. An efficient restructuring programme should target only those borrowers who are distressed; who have high repayment-to-income ratios and negative equity. To provide the right incentives, the program should be voluntary for both banks and borrowers and should be designed in consultation with the central

bank and the financial supervisor. To induce banks to participate in loan restructuring, the government should not rely on forbearance (such as allowing banks not to put aside provisions for restructured loans without overdue payments), but could rather offer incentives such as partial tax credits for restructured loans.

The mid-December 2011 agreement between the government and the banking association is a significant improvement compared to earlier schemes. The non-performing foreign currency mortgages would be converted into domestic currency and 25% of the debt would be forgiven for mortgages delinquent for more than 90 days, if the payment default was due to a verifiable and substantial deterioration in the financial standing of the debtor, with the government providing interest rate subsidies. Moreover, an earlier scheme fixing the exchange rate and accumulating the difference with market rates on a separate account has been amended as well. The total repayment (principal and interest) of the accumulated difference will be delayed and the interest part of the latter will be equally shared between banks and the government, which delays the impact on banks' balance sheets. In both cases, the authorities should create an appropriate fiscal space, while ensuring a fair sharing of efforts as mentioned previously. In their turn, banks will be able to deduct 30% of the losses resulting from the early foreign currency mortgage repayment scheme and the programme of debt forgiveness of non-performing loans from the bank levy in 2011 and 2012, respectively. While the December agreement has the potential to create the right incentives for loan restructuring, the process of conversion of non-performing loans still fails to apply objective criteria to target truly distressed borrowers, such as repayment-to-income ratios and negative equity. Such targeting is essential to avoid moral hazard problems, which might be significant, because the government has created an atmosphere of bail-out expectations in the previous few months and some borrowers could have stopped paying their instalments. If banks need to raise their capital ratios to absorb losses, they should be encouraged to do so by raising the level of capital (by refraining from distributing dividends or issuing new equity) so as not to downsize their loan portfolio. Finally, in order to help clean up banks' balance sheets, a National Asset Management company will purchase 25 000 residential properties by 2014, focusing on delinquent borrowers who have one or more children and are in the most social need.

To strengthen banks' balance sheets and ease credit rationing, the existing financial levy should be replaced by a less distortive tax, such as one based on a proxy of banks' value-added. Since financial institutions are exempted from value added tax, such a tax on financial activities might be desirable to create a level playing field between financial services and other sectors. In addition, financial taxation could serve as an important complement to regulation in addressing macro-prudential concerns. If the Hungarian authorities opt for a "Pigouvian" tax, its base should offer in-built incentives for financial institutions to accumulate capital and raise deposits, reducing reliance on more volatile cross-border funding in foreign currencies. The mid-December agreement with banks confirmed earlier plans to halve the bank levy in 2013. As from 2014 the bank levy will be adjusted to the prevailing relevant legal framework of the European Union, or the practice in effect in member states.

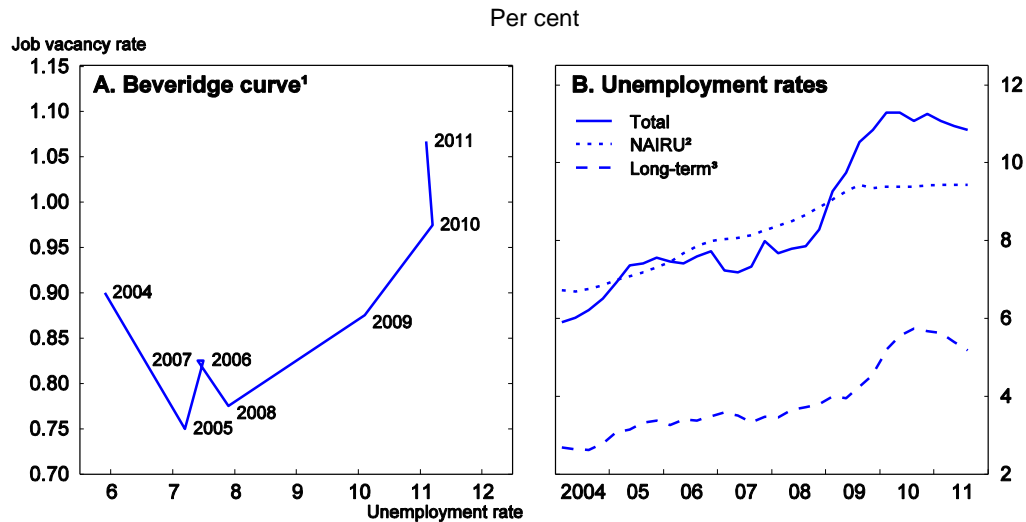
Appropriate measures to support the labour market and prevent an increase in structural joblessness

At 47% in 2010, the ratio of the minimum to the median wage was close to the OECD average, though it was 2-3 percentage points higher than in regional peers (Poland and the Slovak Republic) and more than 10 percentage points higher than in the Czech Republic. On 1 January 2012, the authorities raised the standard minimum wage by 19% and the minimum wage for skilled workers by 15%. Despite a complex system of some partial and temporary financial offsets offered to firms as of January 2012, such increases will hinder employment growth and reduce cost competitiveness in the medium term. In this context, the government should ensure that further increases do not exceed consumer price inflation for a prolonged period, so as to reduce the level of the minimum wage relative to the median wage over time.

Hungary has strong regional disparities in unemployment rates and low internal labour mobility, which contribute to a high incidence of long-term unemployment (close to 50%) and poor matching in the labour market (Figure 6). A recent cancellation of the job search benefit for youth and prime age workers will worsen worker mobility. Moreover, the duration of unemployment benefits has been reduced to only three months and capped at the level of the minimum wage, which, with a weak

labour market risks aggravating mismatch problems. These can lead to an inefficient allocation of labour and turn cyclical unemployment into structural, which would call for an extension of the duration of unemployment benefits. On the other hand, a recent amendment of the labour code has created a welcome possibility to differentiate the minimum wage. This creates an opportunity to introduce such differentiation on a regional basis. Labour demand could be supported by reducing the minimum wage in regions where productivity, living costs and reservation wages are low.

Figure 6. Beveridge curve, long-term unemployment and NAIUR



1. Average of quarterly data for job vacancies. Data for 2011 show the average of the first three quarters.
2. Non-accelerating inflation rate of unemployment.
3. Twelve months or over.

Source: Eurostat (2012), "Labour Market", *Eurostat database*, January and OECD (2012), *OECD Economic Outlook: Statistics and Projections* (database), January.

The authorities have put a strong emphasis on a new public works programme to raise labour demand. The aim is to create financial incentives to resume work by providing a higher income than social assistance, but lower than the minimum wage. Yet, the experience of OECD countries suggests that subsidised public sector employment programmes may create strong lock-in effects (OECD, 2010b). Empirical evidence indicates they are the least effective form of active labour market policies, whereas training programmes are associated with positive medium-term impacts (Card et al., 2010). Evidence for Hungary also shows that various public works schemes in the past failed to improve the employability of participants or provide a foothold in the labour market (Fleck and Messing, 2010; Budapest Institute, 2011). Therefore, the effectiveness of the public works programme should be fostered by providing significantly scaled up training and skill-upgrading services for participants so as to ease their transition to the primary labour market.

Employer social security contributions are high and should be reduced in a deficit-neutral way. A new scheme permanently reducing employers' payroll taxes for workers in elementary occupations will be available in 2013. Temporary and targeted reductions in labour costs may also support job creation in the early stages of recovery and overall increases in labour demand (OECD, 2010c; 2011b). With this as a background, the authorities could continue the programme of marginal employment subsidies for net job creations ("SME + programme") while ensuring low compliance costs to increase the take-up rate. Temporary gross hiring subsidies for career-starters ("Start programme") could be also useful in supporting labour demand, conditional on an improved targeting. Instead, programmes for parents returning to work after parental leave ("Start plus") and for older, low-skilled or long-term unemployed ("Start extra") appear to be well targeted on disadvantaged groups. Both programmes were replaced with a new programme ("Start bonus") in 2012.

Box 1. Core recommendations on short-term policy priorities

Ensuring economic stabilisation through credible fiscal consolidation

- Conclude an agreement with multilateral organisations to bolster confidence.
- Effective independence of the central bank should be guaranteed.
- Ensure that fiscal consolidation is sustained by curbing spending, improving revenue collection and, if needed, raising only the least distortive taxes.
- 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 the least distortive property taxes on affluent individuals.
- Raise the effectiveness of the fiscal council by allocating it higher staff and budget resources to accomplish its tasks. Remove its power to veto fiscal laws.

Dealing with households' indebtedness while avoiding credit rationing

- Target debt restructuring programmes to distressed borrowers based on repayment-to-income ratios and/or negative equity.
- When the exceptional bank levy expires in 2013, replace it by a less distortive tax. Ensure recapitalisation of banks if needed by recommending banks to retain earnings and raise high-quality new equity.

Avoiding structural unemployment

- Ease transition to the primary labour market by restructuring the public works programme to provide significantly scaled up training and skill-upgrading services.
- Ensure that further increases in the minimum wage do not exceed consumer price inflation to reduce the minimum-to-median wage ratio.

Medium-term structural policies to foster potential output growth

Making debt sustainability less sensitive to macroeconomic shocks

The debt-to-GDP ratio is sensitive to fluctuations in exchange rates because half of the public debt has been issued in foreign currency (about 38% excluding EU/IMF loans) and 50% of marketable debt is held by non-residents. The steep depreciation of the currency at end-2011 was sufficient to wipe out all debt reduction efforts achieved by using part of the second-pillar pension assets in mid-2011. In addition, the share of Hungarian debt with shorter maturity has increased since the outset of the financial crisis, raising rollover risks. To reduce such risks, the authorities should start reducing the share of public debt in foreign currency and lengthen its maturity as soon as possible, and adjust the portfolio strategy by taking into account lessons from the current crisis. To facilitate debt issuance in forint and make up for a reduced role of the second-pillar pension funds following the assumption of most of their assets, the government should encourage the development of the third (voluntary) pension pillar (see below). This could help maintain a significant share of resident subscribers in domestic currency.

Long-term fiscal sustainability needs to be fostered by further reforming the pension system

Hungary's long term fiscal sustainability significantly improved between 2006 and 2009 in the wake of parametric reforms of the pension system and improvements in the fiscal position. As a result, sustainability gap indicators, as estimated by the European Commission in 2009, were closed accordingly. However, fiscal sustainability is likely to have worsened, as the underlying fiscal position deteriorated in both 2010 and 2011 (Figure 2, Panel A). Moreover, as the financial and economic crisis has significantly dented potential output and growth prospects, fiscal sustainability has been

negatively affected as well. Finally, the dissolution of the second pillar of the pension system in 2011 worsened fiscal sustainability as the transfer of implicit pension liabilities to the state pillar was not fully offset by the use of pension assets to cut the public debt as part was used to finance current expenditure.

Early retirement options in the general pension regime were eliminated, except for women with 40 years of contributions, which is expected to improve fiscal sustainability. Restricting access into different other early retirement pathways would boost the employment rate of older workers and reduce spending. In mid-2011, a constitutional amendment to that aim was adopted by Parliament, stating that any pension granted before the legal retirement age may be reduced (by subjecting it to personal income tax), transformed into a social benefit, or even, for beneficiaries finding employment, terminated. From 2012, the level of new and existing retirement benefits of special pension regimes (up to the statutory retirement age) will be reduced by an amount equivalent to the income tax, although eligibility conditions for all early retirement options will be left unchanged. Beyond this, aligning early retirement privileges of different special regimes (law enforcement officers, miners, chemists or artists) with the general pension system should remain a priority. More generally, to reduce replacement rates, all pension benefits (and not only new ones from 2013) should be made liable to the personal income tax, which would share consolidation efforts between current and future pensioners.

Ensuring stable and affordable financing of the economy while minimising financial risks

Lower financing cost can be fostered by increasing transparency

The costs of banking intermediation are high in Hungary, reflecting mainly weak competition, as indicated by high market power and operating costs. Competition needs to be strengthened, in particular in the segment of household lending. Until recently, banks were allowed to change their lending rates in a unilateral manner in many cases, which was hindering the comparability of loan products and inducing lock-in effects for customers. Progress has been made with a recent law which imposes transparent rules for the setting of interest rates on mortgages. To put an end to unilateral contract modifications, this legislation should be fully implemented and a similar law created to cover all types of loans. The credit information system remains underdeveloped, leading to potential adverse selection problems and higher costs for borrowers. The recent creation of a legal framework for mandatory sharing of positive and negative information regarding individual loans is an important step forward, but it should make information sharing between banks binding for all borrowers. The disciplining role of credit information sharing should be enhanced by lengthening its memory of defaults to ten years and if debt is recovered to three years, which is advisable in a country with a relatively poor credit culture. The central bank or the financial supervisor should be allowed to retain the information for a longer time for supervisory purposes, without an unnecessary duplication of databases.

Encouraging the development of a voluntary third pillar

The development of capital markets and other financial intermediaries is also important to provide funding to the economy. In particular, pension funds accumulate savings with long maturities that can be productively invested long term. To provide a strong incentive to invest in third-pillar pension funds, individuals need to enjoy sufficient returns. Yet, mandatory Hungarian pension funds achieved an average annual real net yield of only 1.65% over the period 1998-2010, which is very low by international comparison. Creating conditions for sound competition is necessary to boost performance, notably through more transparency. Transparency could be enhanced if pension fund members were to receive information not only about pension fund returns, but also about fees and commissions.

Bolstering macro-prudential regulation

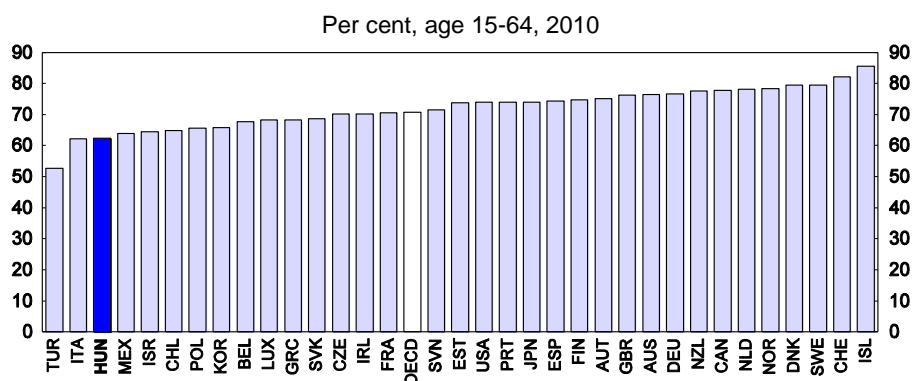
As shown in the 2010 OECD Economic Survey of Hungary (OECD, 2010a), inadequate financial regulation and supervision has been one of the sources of banking difficulties in Hungary. Until recently, the responsibilities for macro-prudential policy have been very fragmented between the financial supervisor (HFSA), the central bank (Magyar Nemzeti Bank, MNB) and the Ministry for National Economy. A new law on the central bank passed on 30 December 2011 equips the MNB with

the mandate for macro-prudential regulation backed by regulatory independence to choose its instruments. This is a welcome development because it ensures a more transparent and efficient legal framework for the allocation of responsibilities and the MNB appears to have the necessary expertise to fulfil this new role. The role of the micro-prudential supervisor, HFSA, was also strengthened by equipping it with some regulatory powers. However, its financial autonomy should be enhanced through an increase in the level of supervisory fees. A transparent and clear distribution of responsibilities should exist to ensure accountability of each agency. An effective cooperation between the micro and macro-prudential supervisor is essential in order to use the macro-prudential toolkit effectively. It remains to be seen how the new system is implemented in practice and the Financial Stability Board (FSB) should ensure coordination of these three agencies.

Living standards can be boosted by lifting one of the lowest participation rates in the OECD

Sustainable fiscal policy and a sound financial system are preconditions for durable growth, but structural reforms are also needed to better exploit existing resources and raise one of the lowest activity rates in the OECD (Figure 7). Rapid population ageing is compounding this challenge. Exclusion from the labour market is a primary cause of inequality and social problems. Hence, efforts are needed to foster the inclusiveness of the labour market for various under-represented groups, in particular low skilled, youth, elderly, women of childbearing age, disabled and the Roma.

Figure 7. Labour force participation rates in OECD countries



Source: OECD (2011), *OECD Labour Force Statistics* (database), December.

Preserving work incentives when lowering the tax wedge

Changes in the Hungarian tax system in relation to the adoption of a flat-rate personal income tax at 16% have increased an already high average tax wedge on low-income earners and reduced it on high-income earners (Figure 3). Employees' social security contributions were hiked and the employment tax credit eliminated. In this context, there is a risk that the low-skilled could drop out of employment or shift to the informal sector. The employment tax credit should thus be re-introduced. Moreover, despite the indication of significant positive effects of taxation on the taxable income of high-income earners in Hungary (Bakos *et al.*, 2008; Kiss and Mosberger, 2011) and OECD countries (Meghir and Phillips, 2010), it is less certain to what extent such effects may occur through an increase in hours worked or, instead, through lower tax evasion and enhanced effort or creativity. The overall net impact of the flat tax on labour supply might therefore be low, all the more once the fiscal measures needed to offset the sizeable budget cost are taken into account.

Remedying youth non-employment

At close to 18%, Hungary had the lowest employment rate of youth aged 15-24 in the OECD in 2010. At the same time, more than half of all workers possess fewer qualifications than required by their job, the highest ratio in the OECD (OECD, 2011c). In this context, Hungary lowered the age of compulsory education from 18 to 16, starting from September 2012. Lifting the overall level of educational attainment is important to increase employment prospects and wages. Furthermore, to reduce the risk of qualification mismatches, the education system has to be made more attuned to

labour market needs by raising the quality of vocational education and training and better steering student inflows into tertiary education. More generally, the transition from school to work should be made less abrupt in Hungary. The experience of OECD countries shows that combining study and work is an effective pathway to enter the labour market (OECD, 2010d). With this as a background, the authorities should have refrained from lowering the age of compulsory education and, instead, continued to raise educational attainment and diversify educational pathways by alternating study and on-the-job training through apprenticeship programmes and compulsory internships.

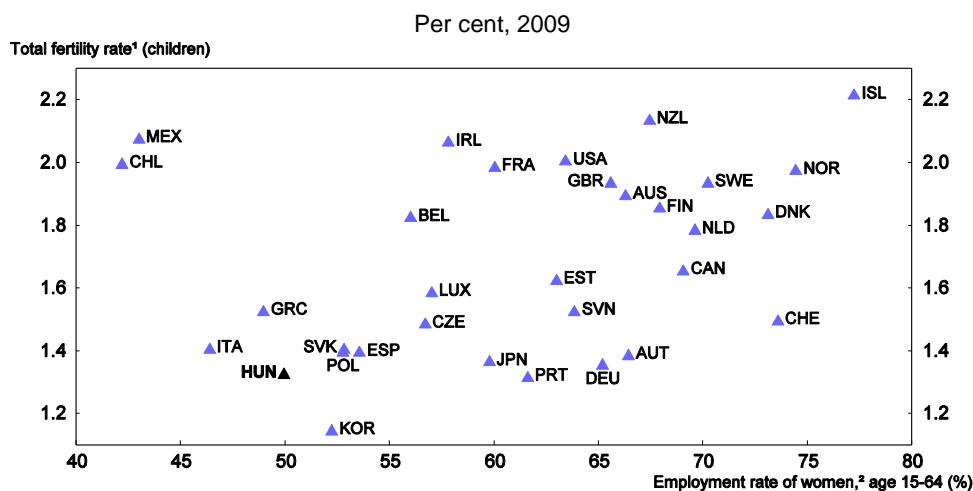
Promoting the participation of the elderly

At slightly below 35%, Hungary had the third lowest employment rate of workers aged 55 to 64 in the OECD in 2010. Past and future parametric reforms of the first pillar of the pension system (as discussed above) should favour longer activity. At the same time, promoting lifelong learning starting at mid-career would support the productivity of older workers and, by preventing the risk of a growing misalignment with their wages, their employment. The persistence of lifelong learning could be encouraged by creating individual learning accounts. Moreover, public subsidies supporting adult learning of low-skilled and low-educated workers through vouchers and individual allowances could enhance their take-up incentives.

Reforming family policies to enhance women's labour market participation

In Hungary, family policies are geared to increasing the fertility rate through high public spending on family benefits and prolonged duration of post-maternity parental leave. Nevertheless, the fertility rate, at 1.33 children per woman in 2009, is the third lowest in the OECD. Moreover, labour market participation of women with young children is low in Hungary. Nowadays affluent OECD countries with high employment rates of women also tend to have high fertility rates (Figure 8). Policies that favour the reconciliation of work and care responsibilities would have a positive effect on fertility patterns, though the structure of family policies also plays an important role (OECD, 2011d). Best-performing countries in terms of employment outcomes have short post-maternity parental leave and low cash benefits and tax breaks per child. At the same time, they also have high enrolment rates in childcare services for children under three. Hungarian family policies should be overhauled in that direction. In particular, spending on cash benefits and tax expenditures should be re-oriented towards the development of high-quality early childhood education and care services for children aged under three.

Figure 8. Employment rates of women and total fertility rates



1. Number of children that would be born to a woman over her lifetime. See indicator SF 2.1 of the *OECD Family Database* for further information. Israel has a rate of 3 and is excluded from this figure as an outlier.
2. Turkey has a rate of 24% and is excluded from this figure as an outlier.

Source: OECD (2011), *OECD Family Database* (www.oecd.org/els/social/family/database) and *Employment and Labour Market Statistics* (database), July.

Improving labour market integration of the disabled

At around 10% of the working age population in 2010, the share of disability benefit recipients in Hungary is the second highest in the OECD, and only around a quarter of beneficiaries work at all. In 2011, the government announced a large-scale review of disability rights with the objective to bring 110 000 of 220 000 disability pensioners under the age of 57 back into the labour market. Retesting beneficiaries according to new assessment criteria is an unprecedented and welcome step. Despite initial plans for a swift implementation, the authorities have decided to spread it over several years, which can be justified by weak labour market conditions at present. Disabled people who remain out of the labour force over an extended period lack relevant labour market qualifications and recent work experience. Their integration could be fostered through comprehensive re-employment services contracted out to the private sector and supported by an outcome-based funding mechanism (OECD, 2010e). The measure could be financed by re-allocating expenditure away from wage subsidies for sheltered firms failing to place a certain share of disabled workers in the regular job market. At the same time, targeted tax incentives, such as a recent introduction of employers' tax allowances, may promote labour demand for disabled workers.

Tackling the problem of labour market exclusion of the Roma

In Hungary, the Roma represent around 7% of the population. They enjoyed high labour market participation during the period of planned economy, but took the brunt of the transformation shock with the decline in demand for unskilled labour in the early 1990s. As a result, the employment rate of the Roma became 40 percentage points lower than that of the non-Roma and remained persistent, mainly driven by lower educational attainment (Kertesi, 2010; Kertesi and Kézdi, 2011). Roma parents should be encouraged to send their children to pre-school before the compulsory age, which is key to prevent the initial learning gaps that increase educational segregation. Inequities are also reinforced by early tracking and a free school choice adopted in 1993, which led to a strong sorting by income and ethnicity between schools (Kertesi and Kézdi, 2010). In this context, it is extremely important to encourage the integration of Roma and non-Roma pupils across schools. Merging vocational training and vocational secondary schools would also foster access of Roma to quality education as almost two-thirds of Roma children in post-primary education attend only the former type of school, conducive to high dropout rates (OECD, 2010a).

Improving health outcomes and the system

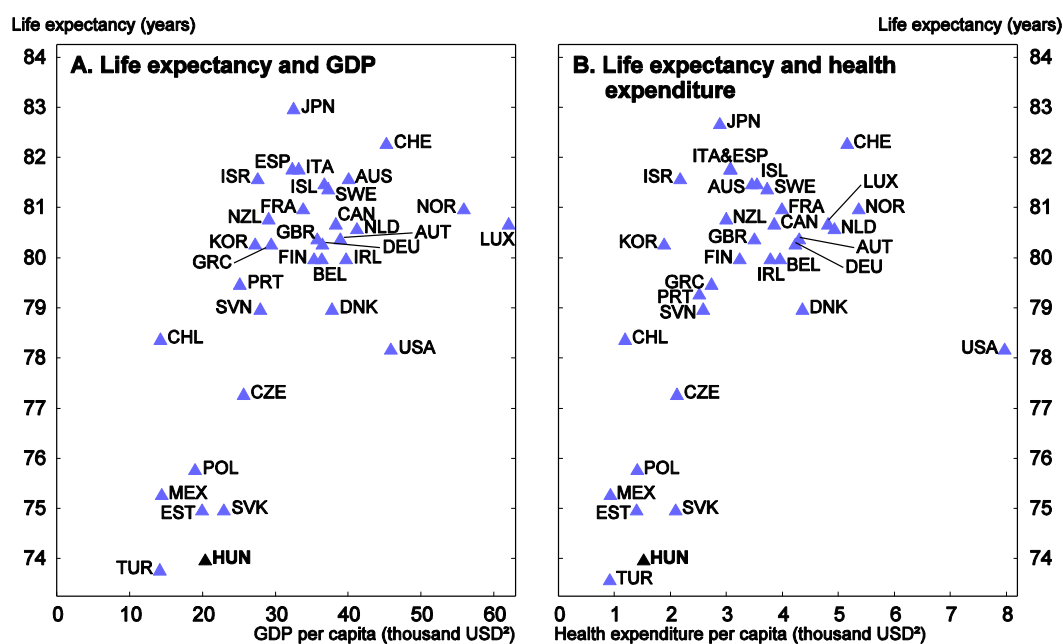
Comparatively poor health outcomes negatively impact growth

Besides being an important determinant of well-being, health outcomes are linked to economic outcomes. Healthy individuals are likely to enjoy longer and more productive lives, and to invest in their human capital, boosting growth. In return, higher levels of GDP per capita allow additional spending on health, which is an important issue in view of long term pressures stemming from population ageing and cost pressures in health care.

According to the latest available data up to 2009, the health status of the Hungarian population was among the poorest in the OECD and excess mortality among the working-age population has been a drag on growth. While these outcomes have been driven by the economic development and lifestyle risks, they also reflect the limited effectiveness of the health care system in improving health outcomes (Joumard et al., 2010), despite generating high health care outputs, such as a high number of doctors' consultations and hospital discharges. Health outcomes are behind levels that are consistent with Hungary's level of development or the level of fiscal expenditure on health, although gains in life expectancy have been broadly in line with those in other OECD countries (Figure 9). Limited fiscal space has heightened the urgency of health care reforms to improve cost effectiveness and better reallocate resources to areas where the needs are the most pressing.

Figure 9. Life expectancy at birth relative to national income and health expenditure

2009¹



1. In Panel A 2007 for Canada and 2008 for Italy. In Panel B 2007 for Greece, 2008 for Australia, Italy, Japan, Portugal and Turkey.
2. In US dollars at current purchasing power parities.

Source: OECD (2011), *Health at a Glance 2011*.

Better allocating public funds

Health care providers in Hungary are funded by the National Health Insurance Fund Administration (NHIFA) for recurrent costs and out of general revenues for capital costs, effectively separating investment decisions from the utilisation of health care services. This in turn has negative repercussions for service delivery and quality. For instance, there is evidence of the use of less effective or older technologies, inappropriate care and provision of unnecessary services. In the absence of adequate returns on private capital, including the coverage of depreciation costs, private sector involvement in the health care sector has also remained limited. In addition, this practice has placed a substantial burden on local governments with a maintenance obligation as the owners of providers. One potential way to rectify this problem is to incorporate the price of capital into health care provider payment systems, which would: i) make providers realise that capital is a costly input; ii) induce providers to ensure an appropriate mix of capital and labour; and iii) improve the comparability of costs across different health care providers.

Despite several major attempts to limit them, the number of hospital beds in Hungary remains above the OECD average, reflecting a bias towards inpatient care in the delivery of health care services. Local governments own a great majority of hospital beds and health care investments are guided by local economic interests, leading to poor coordination and a wasteful supply of equipment. The authorities should ensure that the restructuring of inpatient institutions facilitates the reallocation of resources from inpatient to outpatient and long-term care, consistent with health care needs of the population and efficiency considerations. The takeover of the Budapest area and county hospitals effective 1 January 2012 could be an important opportunity to better organise the inpatient institutions and allocate funds.

Strengthening the quality and delivery of health care services

Even though measures strengthening the quality and delivery of health care services may raise public expenditure, they should boost the efficiency of the health system and create conditions for a better allocation of resources. In particular, primary care has a major role in the delivery of health services in the majority of health systems, but Hungary, as most other OECD countries, spends little on primary care. The number of general practitioners (GPs) relative to specialists is among the lowest in the OECD. An important step in strengthening primary care is to attract a greater number of doctors. A quota system was introduced in 2000, giving “practice rights” (praxisjog) to each family doctor with a territorial supply obligation in that year. It has become a major obstacle to the entry of young family doctors into the system. The purchase of practice rights should be facilitated in the short term and steps should be taken to abolish them in the long term to ease the entry of young GPs into the primary care system. Remuneration should also be improved to attract a greater number of GPs.

A better alignment of the capacity of providers to the needs of patients has been a stated goal of successive governments since 2002. In 2006, the government explicitly recognised that the structure of the health care delivery system (the ratio of acute, chronic, and nursing care capacities) in relation to morbidity and mortality patterns was distorted. Furthermore, it was argued that the geographical distribution of the capacities was unequal, resulting in unfair disparities in access to care. The authorities need to perform systematic health planning, needs assessments and performance measurements, and utilise them in the purchasing decisions of the NHIFA.

Addressing informal payments and insufficient pay

Informal payments are deeply rooted in the Hungarian health care system. Such payments not only influence the efficiency of the health care system and possibly undermine policy objectives, but also are a highly regressive way of funding health care (Szende and Culyer, 2006). Thus they should be strongly discouraged by being considered as a corrupt practice subject to sanctions. Fighting corruption and retaining health care professionals could also be enhanced by setting adequate remuneration: an increasing number of health care professionals have been leaving the country, with a low level of salaries reportedly being the main push factor. Despite some recent targeted increases, the average salary of health care workers across all categories has stood at a relatively low level, significantly below the economy-wide average (87% in 2010), and by international standards.

Box 2. Core recommendations on medium-term policy priorities

Ensuring long-term fiscal sustainability

- 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.
- Continue to reform the first pillar of the pension system by making all pension benefits liable to income tax and effectively closing pathways into early retirement schemes (including for special pension regimes).

Ensuring sustainable and least costly financial intermediation

- Reduce borrowing cost by extending transparent rules on setting fixed or varying interest rates to all loans.
- Strengthen the financial independence of the Financial Supervisory Authority by increasing the level of supervisory fees.

Raising labour force participation

- Raise educational attainment and diversify educational pathways by alternating study and on-the-job training through apprenticeship programmes and compulsory internships.
- Promote the development of lifelong learning starting at mid-career and ensure its persistence by creating individual learning accounts and participation of low-skilled workers through public subsidies.

- Reduce the length of post-maternity parental leave and re-orient public spending from cash benefits and tax expenditures towards high-quality early childhood education and care services for children under three.

Improving health policies

- Set adequate remuneration levels to retain health care professionals in the system.
- Unify the financing of providers for recurrent and capital costs.
- Ensure that the restructuring of inpatient institutions facilitates the reallocation of resources from inpatient to outpatient and long-term care.
- Strongly discourage informal payments to improve access to health care services.

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Chapter summaries

Chapter 1. Ensuring debt sustainability amid strong economic uncertainty

Despite a deep recession in 2009 and weak growth in subsequent years, Hungary's fiscal position compares favourably with many other OECD countries. Nonetheless, the underlying fiscal balance started deteriorating in 2010 and 2011. Recognising this, Hungary's government launched an ambitious set of fiscal consolidation measures in spring 2011, the Széll Kálmán plan, which is rightly focused on curbing public expenditure. This plan, together with subsequent significant revenue-increasing measures, should help restore fiscal adjustment in 2012 and 2013. However, ensuring the sustainability of Hungarian public debt remains challenging in the context of the persistence of the sovereign debt crisis in many European economies since shifts in market sentiment could lead to unsustainable debt servicing costs. In this context, increasing the credibility of fiscal consolidation requires using several policy levers. First, the cost/risk assessment of the debt management strategy should be reassessed by taking into account lessons from the current crisis: the share of government borrowing in foreign currency will likely need to be drastically reduced. Second, additional consolidation efforts should focus more strongly on the spending side and avoid raising distortive taxes. Third, the fiscal framework should be improved by making fiscal rules less pro-cyclical and by raising the profile and political acceptance of the fiscal council through better analytical support and an enlarged mandate, while removing its power to veto the budget.

Chapter 2. Ensuring financial stability and efficiency

Loan creation has not recovered after the crisis owing to a combination of demand and supply factors. Although the banking sector is sufficiently capitalised in the short term, banks are deleveraging by cutting down their dependence on cross-border financing. The ability of the financial sector to supply credit has been further stifled by a high financial levy, a de facto ban on foreign currency lending for mortgages, future uncertainties about parent banks' funding and undermined creditors' rights. Up to recently, new measures to restructure household loans did not help borrowers with real repayment difficulties while weakening banks' solvency. The mid-December 2011 agreement between the government and the banking sector was a welcome step towards fair burden sharing. Bank recapitalisation, if necessary, should be done by raising the level of capital so as not to downsize loan portfolios. In the long term, the demand for credit is hampered by large price-cost margins, which call for stiffer competition. The development of the financial markets has also been adversely affected by the de facto nationalisation of mandatory pension funds, which played a crucial role in the accumulation of long-term savings. The regulation of mandatory and voluntary pension funds requires harmonisation and transparency to increase their cost-efficiency. An effective cooperation between micro and macro-prudential regulation should be ensured in practice and the financial independence of the financial supervisor strengthened. Co-operation between host and home regulatory authorities should be enhanced in a manner that accounts for systemic risks in Hungary. Finally, an effective independence of the central bank has to be guaranteed.

Chapter 3. Towards a more inclusive labour market

A rapid decrease in unemployment is a short-term priority to limit social problems and reduce the risk of rising structural unemployment. To this end, strengthening labour market policies to sustain labour demand is key. The public works programme should remain temporary and become more focused on training. The authorities should also refrain from further raising the minimum wage. Fundamental structural reforms are needed in the medium term to raise one of the lowest participation rates in the OECD. This challenge is acute in the context of a rapidly ageing population. The authorities have started restructuring the tax/benefit system to make work pay and increase labour supply, yet additional efforts are needed to foster the inclusiveness of the labour market. Groups which are significantly under-represented in the labour market include the low-skilled, youth, the elderly, women of childbearing age, the disabled and the Roma. Structural measures are needed to develop part-time and other flexible forms of employment, reform family policies, ease the integration of people with disability into the labour market, better attune the education system to labour market needs, enhance the level of qualifications and skills at different ages, diminish disincentives to work at older ages and break the segregation of the Roma.

Chapter 4. Improving health outcomes and system

Based on the latest available data up to 2009, the health status of the Hungarian population is among the poorest in the OECD, including countries with a similar level of income per capita. While this outcome has been driven by the socioeconomic status of the population and lifestyle risks, it also reflects the relatively limited effectiveness of the health care system, for which relatively low levels of resources have been available: total health spending amounted to 7.4% of GDP in 2009, lower than in other OECD countries with similar levels of income per capita. Although the health care system is generating significant health care outputs, such as doctor's consultations and hospital discharges, problems with the quality of health services and the need to reallocate resources where they would contribute most to health outcomes suggest a need for reforms. Reforms are needed to address immediate challenges to stem the outflow of health care workers, reorganise care capacities, align incentives faced by providers and patients, and improve access to health care services. The medium-term challenge for the health care system is to increase available resources to significantly enhance health outcomes. As there are relatively weak mechanisms to regulate quality and prevent unnecessary care, further improving efficiency is also of key importance.

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 25 January 2012. 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 January 2012.

The Secretariat's draft report was prepared for the Committee by Rafał Kierzenkowski and Mehmet Eris under the supervision of Pierre Beynet. Statistical assistance was provided by Desney Erb. The survey also benefited from external consultancy work.

The previous Survey of Hungary was issued in July 2009.

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