

MINISTRY
FOR NATIONAL ECONOMY

DR. GYÖRGY MATOLCSY
Minister

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Mr. László Andor
Commissioner for Employment, Social Affairs and Inclusion
European Commission

Mr. Olli Rehn
Commissioner for Economic and Financial Affairs
European Commission

B-1049 Brussels
Belgium

Budapest, 9 June 2011

Dear Commissioners,

I write to you to express my serious concerns regarding the course of action the Commission took during the European Semester and especially some key elements of its assessment on the Hungarian programme.

As you know, Hungary was among the few Member States which submitted the two relevant documents (Convergence Programme and National Reform Programme) according to the preferred deadline, i.e. on April 15. At the same time, well before the finalisation of the Commission's assessment on the programmes, we had provided the opportunity to the Commission Services to have an open and frank dialogue regarding the details of the programmes in terms of economic policy objectives and the adopted or planned measures aimed at reaching the policy goals. Unfortunately, the Commission Services did not grasp this opportunity. The Commission's assessments of the programmes and the draft recommendations were only published on 7 June, leaving insufficient time for the experts and policy makers of the Member States to prepare for a meaningful discussion of these documents before the European Council session in June. This approach undermines the credibility of the whole procedure.

As far as the draft Council Recommendation regarding the assessment of Hungary's 2011 National Reform Programme and the 2011-2015 Convergence Programme are concerned, let me underline that our opinion differs substantially, from several aspects, about the assessment of the current situation and the proposals you made.

Let me start with a general comment. While recognising the need of sustained debt reduction, the economic policy of the Hungarian government does not aim to achieve some simple short-term fiscal adjustment, but we intend to remedy the economy's inherited structural problems (weak competitiveness, low employment ratio, deteriorating demographic trends). To this

end, we have reformed the pension and taxation systems and started growth-oriented structural reforms, having also put in place the right incentives for increased labour market participation.

Therefore, I find the reference of the Commission document about the abolishment of the mandatory private pension pillar absolutely misleading. In contrast to the text suggesting that the aim was to generate budget revenues, the pension system has been reformed in order to avoid further accumulation of the negative effects of the mandatory private pension pillar and to improve the sustainability of public finances as a whole. The reforms reduce the explicit public debt in the short, medium and also in the long term, and at the same time they address the problem of increasing implicit public debt in the long term. The positive impacts of the complex long-term measures aimed at tackling the demographic and employment challenges will gradually unfold and contribute to the sustainability of the system.

As far as the 2010 budget balance and the measures to reach it are concerned, the extra taxes and the abolishment of the private pension pillar are mentioned as steps we took to limit fiscal deterioration. However, there is no reference to the long-term cost cutting measures at the ministries which had been implemented parallel to the measures boosting revenues. These were described in the first action plan of the new government and carried out at the end of last year. In my view, such a reference is indispensable to get the full picture on public finances.

As I reiterated in my letters of February and March 2011, the structural reform programme (Széll Kálmán Plan) will unfold in full size in 2012 and 2013: a great majority of the measures come into effect already in 2012 and the whole programme is to be accomplished by the end of 2013. Both the Convergence Programme and the Commission forecast that the structural reform programme will have its greatest impact (reaching more than 1% of GDP) on the structural balance in 2012, in the first whole year of the programme. This is expected to be followed in 2013 by an additional adjustment of almost 1% of GDP. Furthermore, steps of a permanent nature were taken to secure the 2011 budget balance target: the stability reserve (approximately 1% of GDP) has been cancelled and this change has been integrated into the basis of the 2012 budget planning (the relevant government decisions have already been adopted). Consequently, the fiscal consolidation path is far from being „back-loaded“. Therefore, the reference to a “back-loaded” consolidation strategy gives the wrong impression.

As for the macroeconomic scenario, the Convergence Programme is based on a conservative macroeconomic path that takes both upside and downside risks regarding domestic demand into consideration. The fact that the development of domestic demand is viewed slightly more favourable by the Convergence Programme than by the Commission can be attributed to a number of aspects which the Commission's Forecast of Spring 2011 failed to consider. In connection with private consumption, several factors point toward more robust upward trends. First, the measures aimed at assisting distressed foreign currency borrowers would increase the disposable income of the households involved. These households, as their liquidity is limited, will presumably spend a large part of this extra income. Furthermore, we expect that general consumption propensity will gradually recover in the forthcoming years (from the historically low levels during the crisis), therefore the previously delayed consumption could partly materialise in 2011-2012. Finally, regarding the payment of pension fund returns, evidence suggests that the majority of households opted for cash payouts (signalling preference of spending) instead of investing it into the third pension pillar -- despite the tax incentives on such investments. As far as investment growth is concerned, one needs to consider a possible decrease in risk premiums (following the government action plan to decrease public debt), which will ultimately improve credit conditions. Last but not least,

banks' propensity to lend is expected to improve significantly because of the impact on their portfolio after lifting the foreclosure/eviction moratorium.

Regarding the reference to the deficit projection of 3.3% of GDP for 2012 in the Commission's Forecast of Spring 2011, it should be noted that this forecast explicitly states that the 2012 deficit is "to come out just below 3% of GDP" "if all measures were taken at face value". Hungary is committed to a strict implementation of the announced structural reform plan, and we have demonstrated this commitment by the speedy and timely adoption of the announced measures. A strict timetable was attached to the structural reform programme on the basis of which all detailed measures of medium-term fiscal consolidation will have to be elaborated by the end of this year.

Concerning the new flat-rate personal income tax system, I consider it important to add that in our view the reform was necessary as, relative to our regional peers, tax wedge had been too high for each income category, especially on above-average incomes. Therefore, the reduction of the average tax wedge was particularly needed in order to tackle employment and competitiveness problems. In 2010, the tax wedge for taxpayers earning 3-4-times the average income was 15-25 percentage points above the average of our regional peers. In 2011 this difference was reduced to 10 percentage points and below. Furthermore, the presently poor demographic prospects necessitated the recognition of the costs of raising children.

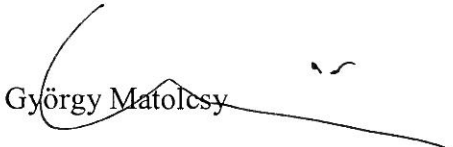
With respect to the recommendation to improve the fiscal governance system, I have to call the attention to the ongoing work to operationalise the debt brake rule enshrined in the Constitution, as well as to enhanced power of the Fiscal Council. Furthermore, it should be noted that the Fiscal Council can rely on the expertise of the professional staff of the State Audit Office and the central bank.

Given the above-mentioned shortcomings in the assessment of the Hungarian programmes, the review of all country assessments may be deemed necessary. We are thoroughly analysing the assessment of the Hungarian programmes and we are ready to share our findings with the Commission services.

Finally let me emphasise that we consider extremely important that the risks to the credibility of the European Semester arising from the current practice of the Commission in terms of both process and substance be eliminated as soon as possible.

As in the past, I am ready to discuss the issues further should you find it necessary.

Yours sincerely,


György Matolcsy