

Gyula Pulay

The necessity of reforming the role the state plays in economy

Essential experience gained from ÁSZKUT research

T*The efficiency of public finances, and in a wider envelope the efficacy of the operation of the public sector, is one of the most significant research areas of Állami Számvevőszék Kutatóintézete [State Audit Office Research Institute] (hereon referred to as the Institute).¹ Thus, we need to ask the question time after time in the course of our research projects: How much can the state and the entire public sector contribute to improving the competitiveness of the economic sector and, ultimately, the entire country? In this opening study I would like to present the results gained from nearly 10 years of work of the institution that has been seeking answers to that question.*

First, I want to mention *our multidisciplinary research project carried out in collaboration with Budapesti Corvinus Egyetem Versenyképesség Kutató Központja [Corvinus University of Budapest, Research Centre for Competitiveness]* which set out to explore connections between the competitiveness of public sector and private sector. Started in 2005, the results of the research were detailed in the studies published in 2007 and May 2010, respectively.² Complemented with the results of similar researches carried out by the Institute, this research delivered important

lessons is respect of further development of public policies.³

Perhaps the ultimate lesson: Based on multi-lateral analyses – which were also diversified in terms of research methodology – including comparative assessment of international competitiveness rankings; polls by questionnaire at corporations, municipalities and NGOs; in-depth interviews; comparative analyses based on statistical data; evaluation of Audit Office reports, very similar conclusions were reached: *Analyses carried out with different approaches led to conclusions that reinforced one another in many respects.* To display that, areas regarded the most problematic by the responders in the corporate questionnaire poll (*see Table 1*), as well as indicators where Hungary has in recent years been awarded the lowest points in international competitiveness rankings (*see Tables 2 and 3*) were pitted against one another. The similarities are glaring.

Based on the three “blacklists”, some areas can be pinpointed where the most urgent and deepest changes are necessary. *Table 4* displays the areas, blending them a bit, that are in one of the Top 10 spots in at least two of the three negative rankings with similar names.

Table 1

**AREAS REGARDED BY POLLED CORPORATIONS AS MOST PROBLEMATIC
IN TERMS OF THEIR COMPETITIVENESS**

Ranking	Areas	Average
1.	Tax regulation (extent, structure, transparency)	6.48
2.	Corruption	6.27
3.	Efficiency of educational system	6.25
4.	Impacts of government economic policy	6.22
5.	Black (illegal) economy	6.19
6.	Extent of public taxes and contributions	6.17
7.	Public administration, ethical standards of public institutions	6.05
8.	Extent of R&D expenditures	5.92

Table 2

**MOST UNFAVOURABLE INDICATORS OF GOVERNMENT ACTIVITIES
IN 2005 THROUGH 2008 AS PER IMD COMPETITIVENESS RANKING⁴**

Ranking	Indicators	Place in average of four years
1.	Personal Income Tax rate	54th
2.	Budget deficit	51st
3.	Size of budget expenditures	51st
4.	Size of social security contribution to be paid by employers	50th
5.	Impact of National Bank of Hungary policy on development	46th
6.	Transparency	45th
7.	External debt of government	43rd
8.	Risk of political instability	43rd
9.	Black (illegal) economy	42nd
10.	Corruption	35th
11.	Consistency of government policy	30th

Table 3

**TEN MOST UNFAVOURABLE INDICATORS REGARDING GOVERNMENT ACTIVITY IN 2008
ACCORDING TO WORLD ECONOMIC FORUM GCI RANKING⁵**

Ranking	Indicators	Place in 2008
1.	Extent and impact of taxes	133rd
2.	Budget deficit	123rd
3.	Transparency of government decision-making	117th
4.	Public procurement of technologically up-to-date products	116th
5.	Public debt	110th
6.	Full tax rate	105th
7.	Training of employees	101st
8.	Public confidence in politicians	94th
9.	Quality of education system	87th
10.	Corporate R&D spending	83rd

Table 4

AREAS TO BE IMPROVED MOST URGENTLY TO BOLSTER HUNGARY'S COMPETITIVENESS

Ranking	Areas
1.	Extent and structure of public taxes and contributions; transparency and stability of regulations
2.	Extent of public finance deficit and government debt
3.	Transparency and consistency of political (governmental) decision-making process
4.	Efficiency of education system
5.	Corruption, black (illegal) economy
6.	Extent and structure of R&D spending

IMPROVEMENT OF BUSINESS LANDSCAPE

In addition to carrying out a diagnosis, the research outlined a proper method for therapy and some of its components, as well, affirming the well-known theory that *what enterprises need most to improve their competitiveness is a stable business environment and access – free of major obstacles – to resources they need for progress.* Within this scope, we have bundled our recommendations to two target areas :

- human capital, development and exploitation of human resources;
- fostering the diffusion of scientific results and technology.

In the target area 'human capital, development and exploitation of human resources', the corporate survey indicates that access to specialised skills is greatly hampered by the fact that the systemic operation of three components of education – vocational training, higher education, and business training – have become disrupted, the quality of education and training has declined, hence market demands have been met incompletely, if at all.

Based on our corporate questionnaire survey, it is also apparent that *competitive operation of economic entities is hindered most by the system of vocational training.* Urgent reforms are needed in this scope. Higher education received a good grade, but primary and secondary education got mediocre grades. Data gained from the survey

indicate that deficiencies in these scopes have not yet weakened corporate competitiveness directly.

Feedback given on the quality of business training, however, gives food for thought. The average grade (3.89 on a scale of 5) reflects positive judgement. However, satisfaction with the quality of business training is in direct correlation with corporate size. Apparently, it's hard for micro businesses to acquire employees that have received business training that meets their demands, and it's hard for their employees to access business training that can be utilised in the small-business scope. *Lack of up-to-date business knowledge, however, could be one of the reasons why Hungarian micro businesses and small enterprises fail to develop with proper dynamics.* Market supply is able to meet the demands of large and medium corporates for business training, but government measures are needed for micro businesses and small enterprises to access business training of their needs at affordable prices. Programs implemented with support from the European Union provide an appropriate frame to that goal.

Critical areas are very well identified in responses regarding the availability of trained workforce. The case is worst regarding skilled labour, but corporations are not satisfied with highly educated specialists, either. Interestingly, enterprises whose majority are held by foreign entities are more satisfied with the standards of higher education and degree-holders and the

quality of education in general than other corporate entities are. All this might suggest their ability to attract the most skilled recruits by being able to offer them higher wages. *Consequently, small businesses are hit hardest by recruits' deficiency in skills, because they are less competitive in the labour market (because they offer lower salaries and benefits).* Therefore, they face mounting disadvantages.

With regard to assessment of labour market regulations, the fact the economic entities are less satisfied with the benefit system for the unemployed than with the rules of employment has to be underlined. Laws and regulations relevant to recruiting and dismissal of employees as well as the official minimum wage etc. are not regarded by enterprises as a hindrance to business activities an average (at 3.32 points on average). However, small and medium enterprises perceive serious problems in the unemployment benefit system (giving 2.78 points on average). It is also assumed here that lower wages to be earned at smaller companies are not attractive enough for the unemployed, thus it's not worth "giving up" their job-searching benefit.

A related research was carried out by the Institute to identify the macroeconomic risks of the budget for the year 2009.⁶ The study established that a large-scale decline in the standards of employment of young demographics between 2003 and 2007 – besides an increase in demand for schooling – had been the result of deteriorating chances for young people to find jobs. Due to dropping out of the public education system and/or their inaptitude for higher education, *an increasing number of youths enter the labour market without usable skills or competencies required for employment.* Lacking appropriate bases, it is very hard to provide them with access to jobs even via employment policy tools. The number of unemployed startup job-seekers with secondary education has also risen considerably. *The employment shock due to the global financial cri-*

sis has made young workforce's weak competitiveness in the labour market even more obvious: Hungary's 7.7-percent jobless rate in Q3 2008 increased to 10.5 per cent by Q4 2009, and the unemployment rate of young demographics (between age 15 and 24) surged to 27.7 per cent from 6.9 per cent in the same period.⁷

Our study underlined a seldom analysed phenomenon that approximately one-third of youths admitted to higher education will never obtain a degree, entering the labour market with secondary education. Data suggest that *the increase in the jobless rate of youth is at a great extent owing to their inappropriate vocational skills.*

Against this backdrop it would be of particular importance that active tools of employment policy⁸ help the unemployed to find permanent jobs. Active tools, however, fulfil this role quite partially. In 2006, 46.6 per cent of new entrants to various employment-support programs were involved in public-use service only, which represented temporary employment only. Those employed in public and community service, also temporary jobs, are not included in that figure. By launching the program *Út a munkához* [Road to Work], the number of permanently unemployed who get some jobs every now and then via subsidised temporary employment has increased further (66,403 were involved in public-use employment in 2006, while the number of those participating in public-use and public-purpose works was 123,854 in 2009)⁹

Jobless individuals with a lower level of education and consequently worse positions in the labour market are underrepresented among unemployed supported by active employment tools that really foster employment, and overrepresented in the scope of public-purpose work that offers temporary jobs only. A large percentage of the unemployed have a very low level of employability, in other words they are unable to be gain a permanent place in the open labour

market due to their low level of education, inappropriate skills, poor mobility factor, health or life management problems. *In order to offer a short-term remedy to the problem, Hungarian employment policy spends outstanding amounts in international comparison on supporting various temporary public employment designs. These projects operate with extremely low efficiency in terms of permanent employment of those involved,¹⁰ at the same time deny funds from financing active employment tools that ensure better efficiency.*

In the scope of intra-corporation development of human capital and human resources – as a supplement to what is mentioned above with regard to access to specialised skills – the biggest challenge state-run economic organising activity is facing these days is to create a better alignment of education and labour market. *The conditions of obtaining information, developing skills and abilities, as well as knowledge conversion should be ensured in a forward-thinking way on the basis of competence to achieve this goal.*

In order to enhance economic competitiveness, *further expansion of the frames of complex development in lifelong learning is also seen as a large-scale state-run task* to provide a higher standard of knowledge and skills. The findings of a relevant study¹¹ by the Institute underline that

- merely 3.1 per cent of the Hungarian demographics between the ages 25 and 64 get involved in lifelong learning, a sharp contrast to a 9.6-percent average in the EU 25;
- disadvantaged individuals – those that would need to develop their competencies most – are underrepresented in training. The ratio of individuals with up to eight grades in primary school (completion of primary school) is 25 per cent in labour market training, while their percentage among job seekers is 42 per cent;
- vocational training and vocational further training are decisive in adult training. In practice, there are few “general-purpose” trainings for adults, although these formats

could fill in the gaps left by basic training which would be a prerequisite to reduce social disadvantages;

- supply of training not flexible enough in adjusting to changes in demand.

In Hungary, a major step forward is needed in order to foster the diffusion of scientific results and technology, also confirmed by three studies in the book of analyses. According to international comparison in competitiveness, “the extent of corporate R&D spending” is among the ten most unfavourable indicators of government activities in Hungary (*see Table 2*). State-run R&D is classified by the corporate survey as a problem area but also a scope whose development is demanded most (*see Table 1*). Comparison analyses of international statistics point out that *a deep gap is indicated not only by low R&D spending, but also by a low ratio of companies in the services sector that introduce innovation as well as low level of innovation spending by small and medium enterprises.*

The Institution has analysed the situation of R&D in two studies.¹² Our publication *A tudásalapú gazdaság és társadalom [Knowledge-based economy and society]* gives a detailed report of indicators used to identify knowledge economy and the country rankings on the basis of such indicators. In these pages all we can highlight is how Hungarian performance is pitted against the EU average as analysed alongside some major factors (*see Tables 5 and 6*).

Comparing the data of the two charts reflects clearly that *dual characteristics of economy is also present in the scope of innovation in Hungary*. Capacities created by foreign direct investments represent high-tech at a large percentage, like export goods manufactured by those capacities. Consequently, the ratio of workforce employed at those workplaces and the weight of high-tech in exports are better than in the EU-25. As a contrast, innovation activities of small and medium enterprises that have been established by Hungarian capital are

Table 5

INDICATORS OF APPLYING INNOVATION IN THE EUROPEAN UNION AND HUNGARY (2006)

APPLICATION	EU-25	HU
Employment in state-of-the-art technology services (as a percentage of total workforce)	3.26	3.37
Employees in medium-, high-, and state-of-the-art technology industries (as a percentage of total workforce)	6.63	8.41
Ratio of high-tech within total exports	16.7	20.2

Source: European Innovation Scoreboard, 2007. Published in A tudásalapú gazdaság és társadalom [Knowledge-based Economy and Society], FEMI [State Audit Office, Research and Development Institute], 2008, page 144

Table 6

INDICATORS OF ENTERPRISES' INNOVATION ACTIVITIES IN THE EUROPEAN UNION AND HUNGARY (2006)

INNOVATION AND ENTERPRISING	EU- 25	HU
Ratio of entities active in innovation within the scope of small and medium enterprises (%)	21.6	9.3
Ratio of entities cooperating in innovation within the scope of small and medium enterprises (%)	9.1	6.6

Source: European Innovation Scoreboard, 2007. Published in A tudásalapú gazdaság és társadalom [Knowledge-based Economy and Society], FEMI [State Audit Office, Research and Development Institute], 2008, page 144

Table 7

INDICATORS OF FINANCING INNOVATION IN THE EUROPEAN UNION AND HUNGARY (2006)

KNOWLEDGE CREATION	EU-25	HU
Government R&D expenditures as a percentage of GDP	0.65	0.50
Business R&D spending as a percentage of GDP	1.17	0.41
Ratio of medium-, high-, and state-of-the-art technology R&D spending against total R&D spending in industry	85.2	90.9
Ratio of companies granted public funds for innovation	9.0	5.7

Source: European Innovation Scoreboard, 2007. Published in A tudásalapú gazdaság és társadalom [Knowledge-based Economy and Society], FEMI [State Audit Office, Research and Development Institute], 2008, page 144

less than half the EU average. The picture isn't much better regarding the ratio of SMEs participating in innovation. Among other reasons, this dividedness of the private sector is one of the reasons why Hungarian companies spend so little on R&D in comparison to Europe. In terms of state-funded R&D expenditures, however, the country is somewhat less behind (see Table 7). Line 3 of the chart should be noted, because it shows the Hungarian government spends a major portion of R&D expenditures on public sector finance, leaving just a little to support corporate innovation.

Numerous recommendations have been outlined in our studies, and some of them have been implemented. In the scope of innovation, significant measures in legislation and institute development have been implemented, but actual results are far from satisfactory.

ECONOMIC ROLE OF GOVERNMENT

Corporate experts say the competitiveness of their respective economic entities is seriously hindered by fiscal and monetary environment

both. It is particularly true for taxation where the responses underline an unacceptable state of affairs – vis-a-vis the entire taxation regime. Survey show small and medium enterprises are overall the most dissatisfied with the performance of public sector, as they suffer most from high taxes, unpredictability of the economic environment, a public administration sector which is less of a service-providing kind, and inappropriate quality of public services. *Competitiveness of enterprises would be increased by much if the public sector operated more efficiently.*

Knowing these problems, the Institute set out to explore the processes in the two decades since the economic and political transition that have led to a loss of balance in the Hungarian economy. The findings of our study on the matter¹³ are best explained by two paradoxes:

- *the integration of the Hungarian economy to global markets has occurred without convergence of the entire domestic economy;*
- *making the state weaker and postponing the reform of public finance have collectively caused a state to emerge that is large in size but poor in efficiency.*

The latter paradox has been addressed in detail in an essay published in Issue 2, 2010 of *Pénzügyi Szemle [Finance Quarterly]*.¹⁴ Hence, in these pages we would like to present some trends that support the first paradox only.

INTEGRATION WITHOUT CONVERGENCE¹⁵

Following the political and economic transition, the Hungarian government strived to create as soon as possible the institutions and property relations that were typical of a market economy. Therefore, *the system of regulations were established in a way that it led to an extremely fast-paced privatisation.* Designated as one of the ultimate objectives of the political and economic transformation, privatisation would not have

been possible within a short time in terms of historic periods without the involvement of foreign direct investments. To that end, government economic policy created an enticing set of conditions with tax allowances, state subsidies, general and individual benefits to promote foreign market players – particularly large corporates – to acquire market.¹⁶

Continuous maintenance and bolstering of the level of foreign direct investments has become the ultimate indicator for the success of the government's economic policy. In this economic policy mindset, competitiveness measured by the size of foreign direct investment deployed in the country has become the general objective of competitiveness improvement. As a result of large-scale FDI influx of a decade and a half, the total of foreign capital in Hungary exceeded 60 per cent of GDP at the end of 2007. In line with economic policy objectives, foreign capital has played a deceive role in economic growth and in particular in a dynamic expansion of exports. At the end of 2007, companies under foreign ownership were producing nearly 50 per cent of corporate total gross added value¹⁷ and over 75 per cent of Hungarian exports. *As a result of such a strong involvement by foreign capital, the other economic policy objective – export-driven economic growth – has also been met.*

The growth of Hungarian exports outstripped that of the economy at an increasing rate and has become the engine of economy, according to the views of economists and the government's economic policy. This was true at a certain time and at a certain extent. However, the trend of Hungarian exports decoupled from the path of Hungarian economy, and at a much larger extent than in the scope of developed economies in general¹⁸ (*see Chart 1*).

Important facts lie beneath the difference of the two growth paths. On the one hand, import content of Hungarian exports has remained high while domestic added value attached to exports have stayed low. On the

DIFFERING TRENDS IN THE ANNUAL GROWTH PACE OF HUNGARY'S GDP AND EXPORTS BETWEEN 2001 AND 2008

(changes as a percentage of the preceding year)



Source: KSH

other hand, in the present structure of Hungarian economy, appropriate economic growth cannot be achieved without a significant boost in exports. However, some of the proceeds from Hungary's foreign trade have been used outside the Hungarian economy, its global results have only partially integrated into domestic economy.

Apart from being very open and having a weak domestic market, Hungary's economy is also vulnerable to external economic boom. This gives a partial explanation as to why the downturn of Hungarian economy exceeded the European Union average in 2009 (registering 6.9 per cent versus 4.5 per cent in the EU). At the same time a high import content of exports and low domestic added-value is reflected by the fact that GDP declined by 6.9 per cent "only" while exports plunged 10.1 per cent and imports fell even deeper by 16.1 per cent.¹⁹

Employment is greatly dependent upon exports and domestic production of transnational corporations. Compared to their overall

weight in Hungary's economy, however, foreign companies have a relatively low share in employment. While the foreign (and decisively multinational) companies have a share of a little over 50 per cent in terms of gross added value in Hungarian economy and 75 to 80 per cent in exports, only one-fourth of all employees are working at foreign-owned companies. *Hungarian exports managed to reach and then exceed 70 per cent of GDP in a way that added value produced in Hungary, and consequently related employment, has been very low.*

The European Commission has released an important survey of the internal structure of export.²⁰ The analysis distinguishes between four groups of export goods in terms of factor intensity. The factors are raw materials, labour, capital, and R&D.

Table 8 underpins the concept that Hungary's export structure is basically different from other groups and countries shown in the table in terms of factor intensity. R&D intensity of exports, a scope dominated by

Table 8

EXPORTS IN TERMS OF FACTOR INTENSITY
(in 2006, export with given intensity as a percentage of total exports)

	Materials-intensive	Labour-intensive	Capital-intensive	R&D-intensive
Old EU 15 member states	15	15	23	47
10 new accessions	14	20	25	41
Hungary	9	10	16	65
Poland	16	22	27	35
Czech Republic	8	18	29	45
Slovakia	12	16	36	36
Slovenia	6	22	32	39

Note: 10 new member states accessed in 2004 and 2007, excluding Malta and Cyprus.

Source: Krisztina Vida (2009), page 16

Table 9

ADDED VALUE PER CAPITA AND HEADCOUNT IN 2008*

	Added value per capita (HUF thousand)	Headcount (1,000 staff)
Total of enterprises in national economy	5,635.3	2,229.2
of that: 100-percent domestic ownership	3,752.8	1,630.0
100-percent foreign ownership	10,002.1	391.2
foreign ownership over 50 per cent	13,162.1	146.9
Foreign ownership (100% and 50%)	10,864.8	538.1
Foreign / National economy	193 per cent	24 per cent

* Enterprises with double-entry bookkeeping system

Source: Calculations made by the Ministry of Finance on the basis of APEH [Hungarian Tax and Financial Control Administration]: Flash report on the data submitted by enterprises obliged to file corporate tax returns on 31 May 2009

transnational corporations, is highest in Hungary among new EU recruits, but Hungary's level exceeds the corresponding indicators of the EU 15 (developed Europe). A large percentage of export-oriented investments effected by foreign capital has been implemented at extremely high technological standards and this is why their employment-expanding impact has been relatively low. It is also true in general terms that the productivity of live labour at enterprises under majority foreign ownership boasts nearly twice as high as the national economy average (See Table 9). As a result of high productivity, however, their demand for labour is relatively low, employing just 24 per cent of the national headcount to produce 50 per cent of gross added value.

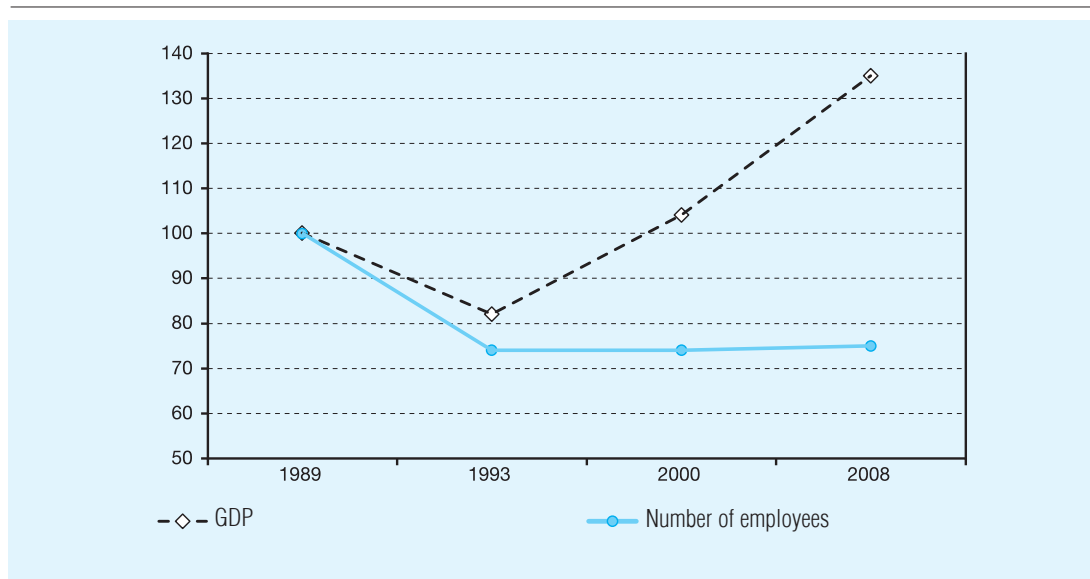
The relationship between economic growth and employment should be examined separately. On the back of transformational changes, the bond between employment and economic growth has changed. This connection is well reflected in Chart 2 below.

It is a natural phenomenon that medium and large companies that generally employ more up-to-date technology – which makes them more productive, too – contribute more to the GDP of a country than they do to employment. European comparison, however, indicates this correlation is stronger in Hungary (see Table 10).

It is to be underlined among the data in the table that the weight of micro businesses in employment is much larger in Hungary than the EU average. However, the contribution

Chart 2

DEVELOPMENT OF A GAP BETWEEN GDP AND EMPLOYMENT IN THE TWO DECADES SINCE THE POLITICAL AND ECONOMIC TRANSFORMATION (1989 = 100)



Source: Values calculated from various volumes of KSH Magyar Statisztikai Évkönyv [Hungarian Statistical Office, Hungarian Statistical Year-book]

Table 10

CORPORATE PERCENTAGE IN EMPLOYMENT AND GDP PRODUCTION IN TERMS OF CORPORATE SIZE CLASSES IN HUNGARY AND THE EU

Company size	Ratio of employees		Ratio of added value	
	Hungary	EU average	Hungary	EU average
Micro businesses	35.8	29.5	15.8	21.1
Small enterprises	18.9	20.6	16.3	19.9
Medium-sized companies	16.2	16.9	18.1	17.9
Large corporates	29.0	32.9	49.7	41.1
Total	100.0	100.0	100.0	100.0

Source: SBA Fact Sheet Hungary, 2009. Quoted in: A kis- és középvállalatok és a vállalkozás helyzete [Status Quo of Small and Medium Enterprises and Enterprising] (Statisztikai Tükör) [(Statistical Mirror)], KSH [Hungarian Statistical Office], August 2009, page 1

from them to GDP falls below the European average. As an additional problem, a large percentage of micro businesses do not want to step outside the scope of self-employment and become employers. This way, however, employment cannot expand.

The level of employment in Hungary is very low even in European comparison. The coun-

try's employment rate was 56.7 per cent in 2008 versus a EU average of 65.9 per cent. Poland is the only country among EU member states in Central and Eastern Europe with a lower employment rate than in Hungary. Low economic activity is the root of a number of social problems and makes financing public services harder.

Describing the processes between 1990 and 2008 quite well, the data shown above reflect truly that Hungary could not have integrated to developed Western economies that fast if not for an efficient commitment from foreign direct investments. Yet, even though two decades have passed since the political and economic transformation, the trend graphs of exports, GDP, and employment show a gap between them. *In spite of a large-scale channel-in to market economies, there still are areas in the Hungarian economy that have failed to converge so far.* In Hungary, corporates established by foreign capital and using high-tech as well as domestic-owned micro business that are working with a low efficiency as well as throngs of jobless individuals and those without access to the labour market are present simultaneously.

As a result of a fast-paced restructuring in foreign trade, capital market, and property relations, Hungary's domestic market has become international, and changes, developments, progress-supporting impacts of global economy but also its downturn-causing disruptions and crises have affected the entire Hungarian economy in a direct way.

The trends of some economic processes selected from the past 20 years reflect that basically interconnected paths have decoupled from one another in Hungary: A dynamic expansion of exports have given economic growth a small boost only, and the advantages of economic expansion have failed to be translated into growing employment. These trends give fair evidence that Hungary's successful integration to global markets has failed to couple with the rise of the entire economy and society.

In Hungary, it's not financial balance alone that has been upset, but also the balance of internal economic and social structures as well as social security systems. In our view, the disturbance of balance has been caused by mis-

takes committed in the course of market opening and privatisation or by obsessive and badly structured overspending in public finance at a partial extent only. *We believe the main problem lies in the government's inability to have established an economic environment that allows Hungarian enterprises to progress rapidly also by connecting to new industries created by foreign capital and utilise an expansion in domestic demand.* Often-modified regulations and high level of taxes and contributions have prompted capital-hungry Hungarian enterprises²¹ mainly to survive rather than grow and expand employment.

SUSTAINABLE DEVELOPMENT, AFFORDABLE STATE – SUSTAINABLE STATE, AFFORDABLE PROGRESS

As this analysis is centred around two paradoxes, the direction towards a solution is also described by a paradox. It is a cliché nowadays that every (European) country should identify sustainable development as their objective, which comprises three dimensions: sustainability of economy, society and environment. Sustainability of the budget is one of the crucial components of economic sustainability. For Hungary, this means fulfilment of the Maastricht criteria and implementation of the convergence program leading there. In order to maintain fiscal balance, however, a hulking but weak state of the past two decades should be replaced by a smaller but more efficient state. *In first approach, public sector should be as big as a publicly funded system may be financed by the private sector. However, another approach is also needed, one that does not regard public sector a burden to finance, but an efficient public service organisation that contributes to increase the competitiveness of economy.* Our theoretic and empiric researches have addressed both sides of this system of connections.

Sustainable development requires a state that makes developments but at least maintains standards and creates favourable conditions for the operation of the economy by providing high-standard public services, crating a stable economic environment, safeguarding fairness in competition, and using taxpayer money efficiently. An economy replenished this way with resources – for instance, healthy, skilled labour – will perform better, and thus be able to finance a larger public sector (better pension regime, and a social security system that offers real security). This way both sides of the paradox come true.

But what is the right order of steps? Many say you have to shrink the state to an affordable size first before you can make it suitable to increase competitiveness. *In our view, the right order is not that, because both tasks have to be carried simultaneously.* The analysis reflecting the most significant results of our research shows that Hungary not only has to restore public finance balance amid the financial crisis, but to create balance within the frames of the global world that ensures sustainable development. *New drivers of progress should be identified aside from economic growth fuelled by exports based on the import of foreign direct investments.* The economy could be stimulated and employment bolstered primarily by creating a more favourable and more stable economic environment for Hungarian small and medium enterprises. Increasing employment level and improving ratio of dependants/wage earners could create the conditions to remedy social problems.

Sustainable development requires a change in values and deep structural changes that are not simply a new structure of production and financial sectors, but embrace the entire relation system in economy, redistribution, and society. The boundaries and functions of the state should be defined for that purpose. And this includes modernisation of the system of

regulations, creation of a competition market, as well the relation of the state to economic entities, including large corporates, small and medium enterprises, as well as the civil sector.

The institute has neither the mandate nor the capacity to develop a program for such a grand modernisation project. It is obvious, however, from corporate surveys, ÁSZ [State Audit Office] reviews, and our own research that *it's not haphazard changes that's needed but the creation of long-term harmony in public taxes and contributions that can be collected without crippling state-pledged public tasks or the economy.* As for the content of that harmony, it is created by a series of decisions (in social policy and economic policy, etc.). *Their internal consistency can only be assured by a further development of the regulations for public finance that clearly defines the boundaries of a sustainable budget and makes them impenetrable.* Sustainable development can only be achieved when these limits are observed. Of course, there are complex interactions between various components of sustainable development (such as “inclusive labour market” and “green economy”). As a result, the real art in governance is to prevent these impacts from diminishing each other and to ensure they give mutual support, creating a positive spiral of development.

SUMMARY OF PUBLIC POLICY RECOMMENDATIONS

Our research has identified *six areas* where the state (the public sector) could contribute most to improving corporate competitiveness by providing them with better regulation and operation.

- 1 Regulation of public burdens:
 - reducing their extent,
 - restructuring them in a way to hamper employment and competitiveness of Hungarian companies at a lesser extent,

- increasing transparency and stability of regulations.
- ② Reduce public finance deficit and sovereign debt to Maastricht criteria levels.
- ③ Increase transparency and consistence of political processes (government decision-making).
- ④ Improve education system, including the frames of lifelong learning; increase efficiency.
- ⑤ Reduce corruption.
- ⑥ Increase R&D expenditures, primarily by encouraging corporates to spend in this area. Items fostering innovation and subsequent market entry should be given a greater weight in the structure of expenditures.

A comprehensive package of measures are required for each of the six areas. Recommendations for individual components have been laid out by numerous workshops; we want to add a few viewpoints to the work.

► Based on experience gained from our researches and ÁSZ [State Audit Office] reviews, it is to be underlined that social and economic objectives for the country should be defined prior to deciding on individual measures, outlining a vision that represents a harmonised cluster of correlations, values, and goals of public politics and specialised policy.

► Next step is to design a development strategy that focuses on country objectives and the requirements of sustainable development. It should not be a case of “creating papers” but a planning system in national economy should also be established that is designed to ensure foundations, maintenance, and implementation of the strategy.²²

► In possession of country objectives and strategies, it is advisable to reconsider the content of state tasks, update their definitions, and specify performance requirements they are to meet. This step will allow, among others,

- to establish clear and well-defined budget frames whose funding needs are transparent;

- to define performance indicators, improving the opportunities of control and accountability;
- to clarify state tasks (define them unambiguously), improving the conditions of separating authority and responsibilities of the central government and local municipalities;
- to make the operation of the state more transparent for the public, increasing confidence in politics.

► Our researches into macroeconomic risks of the budget have underlined that a drastic reduction in some spending appropriations in the central budget in itself will not result in an improvement in public finance balance. If budget institutions and enterprises to be financed by such appropriations are unable to adapt to scarcer funds, then the deficit remains in the system in a more hidden way (e.g. accrued losses or deferred payments), and budget consolidation will be required sooner or later to eliminate them. *Permanent reduction of public finance deficit, therefore, requires a budgeting system with steadier foundations and a more up-to-date approach. The opportunity to create a better balance between tasks and funds is inherent in a forward-looking budget and a program finance based on it.* This will make not only the issue of “smaller or bigger public finance” decipherable in the context of selecting an action plan, but also supports to dissolve today's transparency and accountability problems in budgeting and budget management.

► With regard to making the education system more successful, we want to primarily underline the problem that a large percentage of youth leave or drop out of the education system without skills or competencies that they could use in the labour market enter the labour. In this case it's not only a problem of employability but also of trainability, because they do not even possess competencies that

would allow them to obtain specialised skills in vocational training in their adulthood. In spite of that, *Hungary's adult education system focuses on providing vocational training and does not direct too much attention to make it possible for disadvantaged individuals to earn competencies required for trainability and employability.* A major change in the direction is needed in this area.

► Based on our researches, we recommend that a comprehensive action program designed to update R&D regulations include the following measures:

- develop aligned policies in technology and research;
- increase government R&D expenditures;
- ratings given to higher-education institutions and research institutes should reflect their results in R&D and achievement to be utilised in innovation process;
- to enhance mobility in the market of scientific labour in order to improve the success rate of knowledge creation and flow;
- to eliminate expensive bureaucracy related to the system of applications and subsidy, which is distorts the attitude of institutions and enterprises, and to establish efficient administration instead.

► Integrity-oriented approach is the tool that fosters a change in attitude in public administration and the society in the fight against corruption. Public employees are characterised by integrity when they honour the values and standards of good public administration. According to the integrity-

oriented approach, public employees should strive to use the responsibilities allocated to them as well as the power, information and resources vested in them to the good of the people and to observe the interest of the public and act honourably toward co-workers and third parties alike. *Countries pioneering in the fight against corruption, the Netherlands for example, enhance integrity to diminish corruption.* In order to receive some of this experience, the Institute cooperated with experts from the Dutch audit office and developed a method to *map corruption risks in the public sector.*²³ In order to continue this work and implement it in practice, ÁSZ [State Audit Office] has launched an integrity-oriented anti-corruption project²⁴ financed by EU funds. It would be expedient if *a process of paradigm change started* in Hungary's public administration, focusing on enhancing the positive values of public service.

► *In the course of deciding on any measure, great attention should be directed at any and all impacts the measure might have on micro businesses, as well as small and medium enterprises.* Our researches have provided ample evidence that the pace of development in the SME sector is not defined by the availability of subsidies earmarked for the companies of the sector but by the fact whether the regulatory environment in general and individual directives in particular observe special demands of micro businesses as well as small and medium enterprises, and also whether the entire business landscape of the country is enterprise-friendly or not.

NOTES

¹ The name of the Institution was ÁSZ Fejlesztési és Módszertani Intézet (FEMI) [State Audit Office, Research and Development Institute] between 2001 and 2008.

² A közzsféra és a gazdaság versenyképessége [Competitiveness of public and private sector], ÁSZ

FEMI [State Audit Office, Research and Development Institute], Budapest, 2007 A közzsféra és a gazdaság versenyképessége – empirikus eredmények és tanulságok [Competitiveness of public and private sector – Empirical results and lessons], ÁSZKUT [State Audit Office Research Institute], 2010

- ³ See in detail: G. Báger – Gy. Pulay: Közpolitikai javaslatok [Recommendations for public policy], In: A közszféra és a gazdaság versenyképessége – empirikus eredmények és tanulságok [Competitiveness of public and private sector – Empirical results and lessons], ÁSZKUT [State Audit Office Research Institute], 2010, pp 154 through 167.
- ⁴ Competitiveness Centre of International Management Development analyses and ranks the competitiveness performance of 55 developing and developed countries by using 331 competitiveness indicators; their number has increased to 57 since 2009.
- ⁵ The ranking of GCI Global Competitiveness Index is based on standard macroeconomic and social statistics, as well as the data of a survey made by an identical methodology in every country involved.
- ⁶ A 2009. évi költségvetés makrogazdasági kockázatainak elemzése [Analysis into the macroeconomic risks of Budget 2009], FEMI [State Audit Office, Research and Development Institute], 2008
- ⁷ Source: A Válság hatása a munkaerőpiacra, [Impacts of crisis on labour market], KSH [Hungarian Statistical Office], 2010, page 13
- ⁸ Various subsidies, services, programs available to promote employment.
- ⁹ Source: A Válság hatása a munkaerőpiacra [Impacts of crisis on labour market], KSH [Hungarian Statistical Office], 2010, page 27
- ¹⁰ Experience indicates that employers involved in these employment forms are able to finance less than one per cent of participants permanently after the employment subsidy has been withdrawn.
- ¹¹ A felnőttképzési rendszerek hatékonysága nemzetközi összehasonlításban [Efficiency of adult training systems in international comparison], ÁSZKUT [State Audit Office Research Institute], 2009
- ¹² A kutatástól az innovációig – a K+F-tevékenység helyzete, néhány hatékonysági, finanszírozási összefüggése Magyarországon [From research to innovation – R&D in Hungary with some connections in efficiency and funding highlighted], FEMI [State Audit Office, Research and Development Institute], 2005, and A tudásalapú gazdaság és társadalom [Knowledge-based economy and society], FEMI [State Audit Office, Research and Development Institute], 2008
- ¹³ Az állam célszerű gazdasági szerepvállalása a XXI. század elejének globális gazdaságában [Prudent economic role of the state in the global economy at the beginning of the 21st century], ÁSZKUT [State Audit Office, Research Institute], 2009
- ¹⁴ G. Báger -Gy. Pulay -A. Vigvári: A magyar állam-működés főbb jellemzői és szükséges változtatásának irányai [Main characteristics of the operation of the Hungarian state and direction of necessary changes], Pénzügyi Szemle [Finance Quarterly], 2010/2, pp 217 through 243
- ¹⁵ This section of the study mentioned is described in detail in our essay authored with dr. Gusztáv Báger: Világpiaci integrálódás hazai felzárkózás nélkül [Integration to global markets without domestic convergence], Polgári Szemle [Civil Review], 2010/1, pp 6 through 21
- ¹⁶ In 2008, enterprises fully owned by Hungarian entities used HUF 3,800 tax allowance per employee, a sharp contrast to HUF 88,700 per employee granted to companies under at least 50-percent foreign ownership. Source: Calculations made by the Ministry of Finance on the basis of data supplied by companies that were to submit corporate tax returns on 31 May 2009.
- ¹⁷ According to own calculation based on data published on page 68 in KSH's [Hungarian Statistical Office] publication Magyarország nemzeti számlái 2006–2007 [Hungary's national accounts in 2006 and 2007], 46.7 per cent of gross added value produced by the corporate sector in 2007 was generated by companies under foreign ownership.
- ¹⁸ In the past 150 years, an increase in openness in foreign trade has been a decisive factor in global economy. In 1870, exports against GDP was 4.6 per cent in terms of the entire world. At the end of the 20th century, the world's combined export/GDP ratio was 17.2 per cent. In the period from the end of the 20th century until the global crisis of 2008 the historic trend shown here continued.
- ¹⁹ Source: KSH [Hungarian Statistical Office], Makrogazdaság [Macroeconomy], 2008–2009
- ²⁰ European Commission. Five years of an enlarged EU-Economic achievements and challenges, European Economy. 2009/1., quoted by Krisztina Vida (2009)

²¹ High taxes and contributions affect domestic-owned enterprises more adversely. Calculations by the Ministry of Finance indicate that Hungarian-owned companies paid the budget 36 per cent of added value produced in 2008, whereas the same ratio was 29 per cent in the scope of companies under majority foreign ownership.

²² See in detail: Gusztáv Báger's essay in the present issue of Pénzügyi Szemle [Finance Quarterly]

²³ Korrupciós kockázatok feltérképezése a magyar közszférában [Mapping corruption risks in the Hungarian public sector], ÁSZ Fejlesztési és Módszertani Intézet [State Audit Office, Research and Development Institute], Budapest, 2008. (authors: Gusztáv Báger, Andrea Korbul, Gyula Pulay)

²⁴ Titled Korrupciós kockázatok feltérképezése – integritás alapú közigazgatási kultúra elterjesztése [Mapping corruption risks in the Hungarian public sector – Promoting integrity-based public administration culture]

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