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Possible ways to improve competitiveness – as seen by the State Audit Office of Hungary

The State Audit Office (SAO) has not explicitly audit competitiveness, but hundreds of its reports on the operation of public finances discussed many areas related to the improvement of competitiveness and the underlying conditions. In addition, while performing research activities, the staff members of the SAO and of the Research Institute of the SAO have also frequently analysed the subject of competitiveness. Building on this vast array, the following is a brief summary of recommendations for the improvement of Hungary's competitiveness, in reference to the problems of competitiveness identified on the basis of international comparative analyses, i.e.

- *the condition of public finances,*
- *taxation,*
- *education and training,*
- *research development, and*
- *political and governmental activities.*

REINFORCEMENT OF THE SUSTAINABILITY OF PUBLIC FINANCES

Major problems of the operation of public finances and the possible ways out

Although the financial and financing abilities of the operation of public finances reciprocally influence the values and objectives of the state and of the governance, changes in financing are rather the subordinated "what and why" consequences of these systems of objectives, and the concomitant tasks. In the past 20 years the operation and path of public finances have been shaped by the duality of *external* (environment, adaptation requirements and patterns, orientation) and *internal* (mobilisable real economic and institutional foundations, willingness for social adaptation) *conditions*. In the transitional economies and societies, like in Hungary, consolidation and recovery depend more on the purposive harmonisation of interests and on value generating responsibility than in the more developed European countries. In Hungary the external and internal determinants affecting the safe operation of the state organisation and the modernisation possibilities of services have developed in a controversial manner as the change of the political regime has become more distant in time, and their joint effect is rather constraining in nature. This had an adverse impact on the stability of the regulation of public finances, the predictability of financing, the prospect of organising social transfers on the basis of normative support or need, and even on the possible paths of competitiveness that may trigger real economic growth. The periods of overspending have been followed by consolidation

– or rather "forced stabilisation" inconsistently, only with long delays and only for short periods of time. Modernisation attempts have yielded only partial results. Until recently the rigid system of public finances, which came into being already before the change of the regime, and which could be maintained with deteriorating efficiency despite the external funds involved, practically remained unchanged. Although Hungary did achieve results in the more regulated economic management system, there remained unutilised potentials in the "business administration" solutions, and *the system was unable to operate efficiently.* The financing problems of the public finance system and deficient performances are nothing but consequences.

Here we must mention the adaptation potential of the Hungarian society. The practical limitations (e.g. timely implementation, reception by the society, marked conflicts of interests) faced during the creation of the shorter and longer term harmony among the various real economic, public finance and financial concepts occur, and the necessary modernisation programmes and reform steps must be implemented under the real, and not under the modelled conditions. In addition to the crisis of values and the political polarisation that can be traced back to the general opinion on "personal pliancy" common in the period lasting until 1989, the society is burdened with several very serious conflicts of interests that the Hungarian public policy has been unable to resolve for years. In fact, the conflicts that have become even deeper as a result, and endanger the foundations of harmonious and expedient actions include: the conflict between the entirely different objectives and interests of the active and inactive groups of the society; the conflict between people facing marginalisation, and people who have already marginalised; the conflict between employers and employees; the conflict between people working in the public sector and in the real economy; as well as the conflict between "poorer and richer" people. These fault-lines and gaps are getting deeper due to the distribution of the burdens of the crisis. Taking into consideration the fundamental thoughts[1] of the studies written by *László Bogár, György Jenei, László Laki, István Stumpf* and others we note that the social reality that significantly confines all actions taken with a view to implementing changes is determined by those aspects and attitudes (that often offset or hamper one another, and overwrite rationality) that have developed on purely emotional grounds, or naturally, on the basis of the burdens of bad experiences or mistakes.

Today's distrustful, and in many aspects rightly disillusioned general public, the contraposition of the dogmatised liberal, conservative and social values can very adversely influence the feasibility of actions that could be relatively easily harmonised under different circumstances. The fractured social structure and political dividedness imply further obstacles to changes. For example, the fact that values that are regarded as (or sometimes just believed to be) social achievements, and the related financing obligations enjoy special protection in the Constitution and in the so called "two-thirds" acts irrespective of whether or not there exist socially more equitable, technically and organisationally more modern or more fundable solutions than the solution regulated in a given act. Despite the transitional period of 20 years the Hungarian society is very reluctant to consciously accept that market power becomes administrative power, and that political and administrative power can also be transformed into economic power. All this constitutes a dual obstacle to action. It represents the reality of a rejecting host society for all those people who would like to act either as politicians or as financial or economic experts.

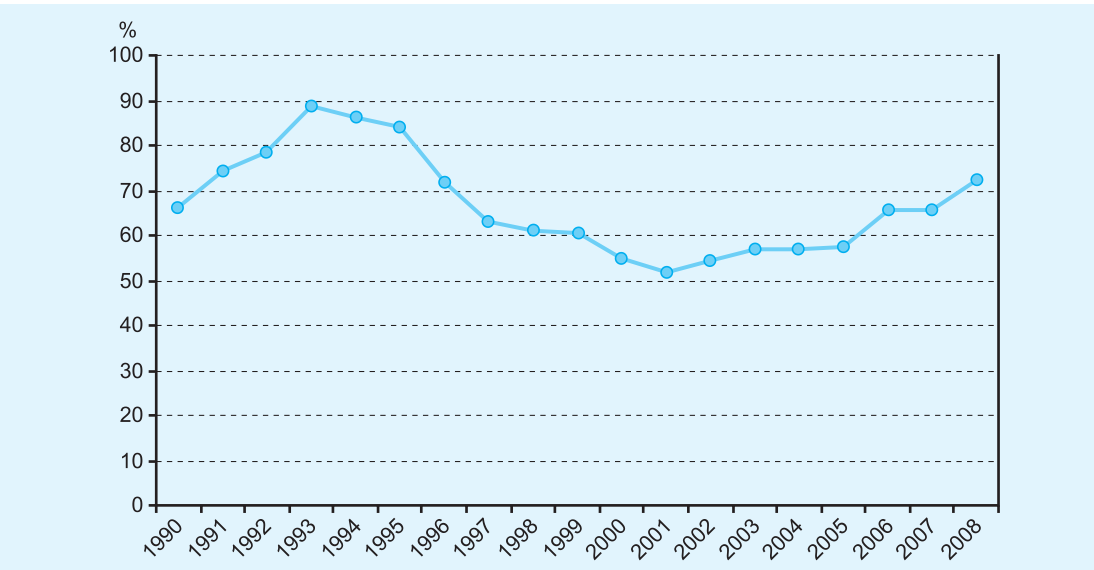
Due to the contradictory nature of public policy the state is unable to act proactively, its behaviour has been at best reactive only, adjusting to and following the needs of the EU or the different bearers of social interest. *The abandonment of the path that Hungary was forced to take requires changes in* (mutually interacting) *social expenditures and transfers* that cannot be implemented without the reconsideration of the fundamental constitutional rights (pension, healthcare, education and other tasks assumed by the state), without reaching new social and political compromises (regional administration, local governmental sector, reformulation of the role of the state, "rebuilding" of the state). Today the absence *of public consensus* hinders the development of stable and long-term programmes, while it is obvious that spending more than we earn cannot be maintained, since the large community and social supply systems have already reached their performance limits. Changing this practice and the underlying causes requires a *new approach and real public consensus,* on the basis of which public finances can foster and not hinder the performance of the real economy.

Among the professional guarantees the *framework system for budget responsibility* can be of great significance, i.e. the consistent enforcement of the rule-based fiscal policy and the *gradual introduction and subsequent wide-scale application of modern programme budgeting.* Supporting the renewal and operation of the budgetary system would open up a new horizon and opportunities for financial *audits*, too. These changes would definitely help overcome and "overwrite" those constraints that can be attributed to the lack of trust and the professional mistakes made in the past nearly 20 years and that are now characteristic of the forced-pace preparation and control of the budget and the final accounts.

Hungary was hit by the crisis in the midst of a budget stabilisation programme following a period of endless overspending. The *serious public finance deficit* that emerged in the years of 2002–2006, and the resulting repeatedly high level of *government debts and debt servicing (see Figures 1 and 2)* do not make it possible to carry on with the anti-cyclical economic policy.

Chart 1

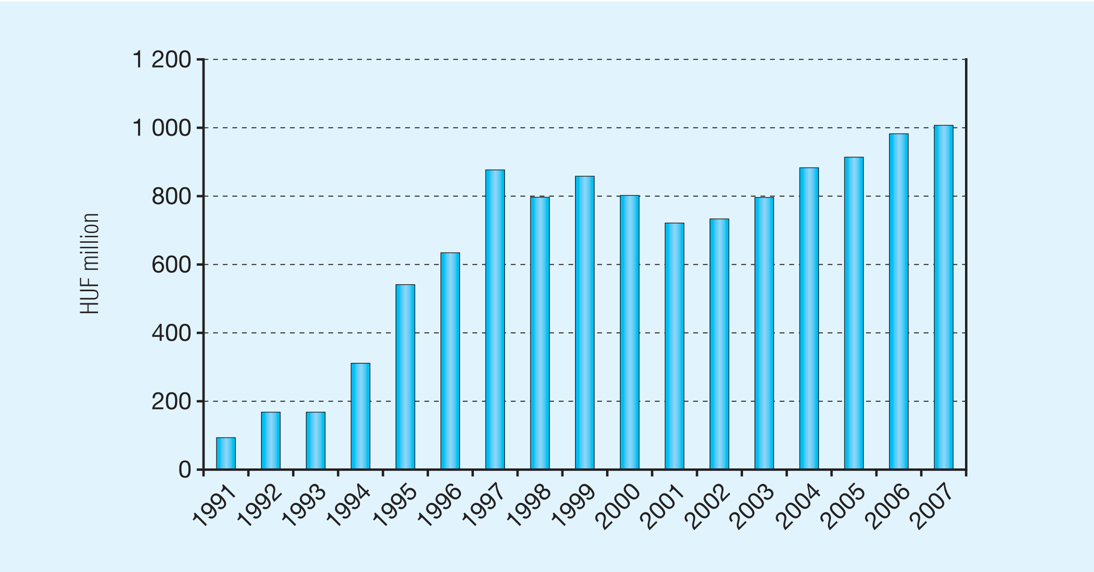
THE GROSS DEBT OF THE CENTRAL BUDGET AS A PERCENTAGE OF THE GDP



Source: Ministry of Finance

Chart 2

DEBT SERVICING EXPENSES



Source: Ministry of Finance

In the short run budgetary expenditures must be adjusted to the dramatically falling revenues, after which economic growth can be promoted by the implementation of structural reforms. Both tasks require the reconsideration of the role of state expenditures, state institutions, and even that of the state. The fundamental question of the future is how we will be able to unfold the structural reforms (that affect the position of the budget), especially the modernisation of the large community supply systems, i.e. the pension, healthcare and education systems, and to accelerate developments that are designed to improve competitiveness using EU funds, in harmony with the reform-scale modernisation of the system of public administration (including the local governmental system) and of the regions. Sustainable development and financeable growth requires fundamental, no longer postponable changes and adaptation that comply with the fundamental principles of the social market economy, and at the same time undertake financeable social subsidisation, while fostering real economic performances. The public policy, economic performance, and last but not least the financing related causes of the emerged situation are also their own consequences. Under such circumstances the *Hungarian economic policy must cope with several* – often conflicting – *priorities and fundamental tasks.* The consequences of the financial tensions and recession must be managed by means of an *effective crisis management method* while preserving the results that have been achieved in the framework of the recent stabilisation and consolidation process, by preventing a further financial and currency crisis, and concurrently by curbing the acceleration of unemployment, and by improving the liquidity and creditworthiness of the economic players. Furthermore, the possibilities for finding a way out, the conditions and opportunities of sustainable and financeable growth and development should be created as soon as possible (should have been created much earlier) by means of *structural reforms.*

Today it is especially difficult to make this choice against the daily interests of the extremely divided Hungarian society, which has lost confidence as a result of unfeasible welfare promises, and which is reluctant to accept anything new. *The subject of the debate is the rate of restrictive measures,* since earlier not only contradictory promises, but also marked, concrete measures could be seen in the world of taxation, social security contributions, pensions and wages. In the given situation it is natural that the measures taken (and not yet taken) within the framework of a scenario which was launched without sufficient financial resources, which contained conflicting intentions, which provided subsidies without linking them to performance, and which did nothing but promise the transformation of the obsolete supply systems "backfire" *in the first, most sensitive period of the transition to the new path. At the same time these measures bring about tensions – often in the form of public distrust – that would otherwise belong to one of the dominant choices of values.*

Renewal of the system of public finances as a possible way out

The SAO audits have been repeatedly compelled to state that the urgently needed structural reforms, as well as the renewal of the tax system and of the large community supply systems have been postponed, and have been replaced with more or less successful austerity and restrictive measures. This issue has been raised by the international organisations and the competent bodies of the EU, too. Following the review of the Hungarian budgetary system, the experts of the OECD and other international organisations have also pointed out that Hungary has no clear rules pertaining to budgetary discipline, and that expenditures are not maximised in the budget. In relation to the underlying causes, including the Hungarian society's above mentioned reluctance to adopt anything new – *its adaptation potential representing internal determinants* – it is worth discussing the *external determinants, too.*[2]

If we start out from the fact that in theory the conditions of the operation of public finances are determined by the size of tasks assumed by the state, and the money that can be spent for this purpose – the performance of the economy – then the external determinants to be highlighted should first of all include the external, real economic determinants triggered by the transition from the plan economy to the market economy, especially by the major components of privatisation, as well as Hungary's adaptation targets related to its accession to the European Union, the consequences of accession, and finally the effects of globalisation.

In the major segments of public finances *adaptation to the European Union was a beneficial constraint*. As a result, and last but not least due to regional-level thinking and attitude shaping, significant modernisation changes have taken place in several areas, including development projects, the audit culture, the possibilities of applications for funding and fund acquisition. The balance is positive even if in some areas – such as applications, public procurement, allocation and direction of developments – actions were sluggish and occasionally counterproductive (instead of constructing much needed facilities at the right places those facilities were realised for which funding could be obtained).

It cannot be denied that in addition to these (on the whole *beneficial*) effects the new – *European and overseas* – partners did not share the same way of thinking, and the solutions they followed differed in relation to the interpretation of state tasks, and the role of the state in controlling the economy. This caused orientation disturbances and uncertainties for the unprepared Hungarian policy makers (who were in short of adaptation abilities, yet full of *"honour student"* ambitions) in setting the modernisation objectives, as well as in *selecting the model to follow* already before the change of the political regime, and since the millennium the number of these disturbances an uncertainties has increased even more.

For both the policy shapers and wide social layers of the democratic Hungary the *direct models*, the need for the *approximation of welfare services* assumed and operated by the state, and the subsequent determinants were provided by the European integration and *the value and interest system of the "social market economy"*[3] it represented. In practice, this was implemented through the mandatory system of adaptation rules and institutions (acquis communautaire), the support system of the EU (pre-accession, cohesion and convergence funds), and the development policy that was influenced in this manner, too. As a consequence, an increasing external – beneficial – financial determinant emerged in the planning and utilisation of public finance development funds, including the tax and support policies. At the same time, in the field of social services (primarily social policy, healthcare and pensions) such a clear model-following could not be observed. This can in part be attributed to the fact that the major driving force of the increasingly unifying and unipolar world, the USA, abandoned the Keynesian path at around this time. The so called "mainstream" models transmitted from the US, which emphasised the efficiency of the *"night-watch state", the advantages of the marketisation of social services, and self-support by the citizens* for a public policy shaping segment of the political and economic elite, became the key, central dogmas to joining the mainstream. Consequently, these two imported, only partially conform adaptation models, as well as the uncertainties about following the European or the Anglo-Saxon path caused zigzags, or rather inaction in relation to task performance by the state, the intentions to modernise community services, and thus the allocation of funds. All this fluctuated not only during the political economic cycles, but also due to the open or hidden shifts in the focal points of the governments or government coalitions. It excluded the implementation of service reforms, and even the modernisation of business administration, since in general it was not stipulated what community services the Hungarian state was ready to assume, and what action scenario it wanted to choose for the sake of development.

Furthermore, the *models transmitted by trade and later financial investors during the process of privatisation and greenfield developments* had a strong impact, too. These investors' requirements, corporate cultures, increasing economic weight, as well as system of interests and conditions[4] more and more increasingly revealed the slow and uncertain adaptation of the institutional system financed from public finance sources, as well as the weaknesses of economic organisation, legislation and the enforcement of willpower. The modernisation of public finances and the implied risks affect financial audits, too. They set new requirements, and lead to the fact that by today serving and strengthening of the safety of public financing have become a basic content and objective of the SAO audits. The enrichment in the content and increase in the value of SAI audits all over the world can be attributed especially to this requirement, as well as to the related professional commitment and responsibility.

Driven by such principles and objectives, the SAO – in conjunction with its own Research Institute – compiled its recommendations for the renewal of the regulation of public finances, *which it submitted to the National Assembly under the title Theses on the Regulation of Public Finances in April 2007.* The theses have fulfilled their designated purposes. In relation to the approval of the 2006 Activity Report of the SAO a resolution of the National Assembly called for the comprehensive renewal of the regulation of public finances, and stated that the government should prepare this on the basis of the theses prepared by the SAO.

During the elaboration of the theses the SAO took into consideration that the anomalies of the budgetary system are not at all special Hungarian phenomena. In the past decades they have come to the surface in a range of emerging and developed countries, too. And each country has made conclusions and acted – in line with the local endowments – understanding that fiscal discipline and macroeconomic stabilisation can provide an adequate basis for financeable economic growth and sustainable development while mutually strengthening each other. The theses were also prepared on the basis of this starting point, and in line with the comprehensive approach they provide suggestions not only on the application of rules-based and programme-based budgeting, but also on the fact that *the budgetary system must preferably be renewed in a comprehensive and complex manner,* and that the possibilities and tasks of the state in the operation of public finances must be clarified taking public finances as a whole, and with consideration to the social impacts. The SAO believes that an expedient tool to aid recovery and the abandonment of the old path is raising the most important pillars and regulators of public finances to constitutional level.

During the elaboration of the theses not only the regulatory solutions had to be considered, but also the fact that the budget deficit and government debt related provisions of the Maastricht Treaty and the Stability and Growth Pact set strict requirements for the modern structure of the budget.

With regard to the outlined correlations, the "theses" find that the key issue is the modern regulation of public finances, the solution of which must be based on internationally accepted principles confirmed by domestic political consensus. The cornerstone of regulation is the accurate specification of public duties. The required regulation must cover all entities using public funds and the entire management system of public finances; it must distinguish the central and local levels of public finances; it must ensure that the National Assembly can exercise its budgetary right, as well as the responsibility of the executive branch of government; and it must ensure sustainability and balance. The new modern regulation must support the transparency of the collection and utilisation of public funds, the dominance of the "value for money" principle. Within the frameworks of the new regulation management and financial control, as well as (financial) audits will "take their deserved place".

The SAO theses divided the areas to be regulated into *five blocks:*

- regulation of balance-related issues of the budget, the system of budgetary responsibility;
- budgeting and final accounts;
- information management and public finance management;
- so called status issues;
- economic management of public assets.

The theses indicated that these issues can be catered for concurrently, in a complex law, however, since the number of problems awaiting solution is high, and their economic and legal elaborateness is not yet complete, separate regulation for each block can be implemented, too.

The government chose the latter option. First it renewed the regulation of economic management of public assets which was then approved by the National Assembly in the autumn of 2007. At the same time, elaboration of the so called Status Act on the legal status and financial management of budgetary organisations was started. The Act took effect on 1 January 2009.[5]

Following the "fiscal alcoholism" of the periods of overspending and consolidation, selfrestraining fiscal rules were formulated in 2008. *Act LXXV of 2008 on economical public spending policy and fiscal responsibility* (the so called Budget Ceiling Act) contains all those elements – with less common technical solutions – that have been already successfully applied by other countries. The legal regulation introduces certain so called "ceiling rules" to constrain expenditures, and intends to achieve – through detailed calculation provisions (and the Fiscal Council) – institutional guarantees that budget bills, and other bills affecting the budget should be put up for discussion and should be adopted only after the preparation of analyses, forecasts and impact assessment studies.

The SAO theses indicated: it would be reasonable if regulation as a whole would not only become more modern, but would also become more transparent. However, this has not fully come true, since the subject blocks listed above – as well as the Property Act and the so called Status Act – *leave the Public Finance Act as a background or auxiliary regulation,* as a result of which the need remains for the concurrent application of several acts in relation to the individual issues.

The act stipulates the content and legal nature of the final accounts, and specifies principles for their preparation, similar to those applied in budgeting. However, one of the major regulatory deficiencies can be revealed here. On the revenue side of the budget the regulation of responsibility relations has been created in an obvious manner, arising from the nature of things. Natural persons and legal entities that fail to comply with their obligations to pay public dues, or comply with such obligations inaccurately or beyond the deadlines, are subject to various punishments. However, the management of the expenditure side, *exceeding the budgetary expenditure appropriations* is a fact different in nature and content, the confinement of which could and should be implemented not only by constraints applied during budgeting – this goal is served by the rules-based budgetary system –, but it would be necessary to allocate the legal consequences to unexplainable, significant overspending in a much more differentiated manner than before. This is how the content of the act could be harmonised with its title: the regulation of fiscal responsibility.

Furthermore, the SAO proposed that the new public finance regulation should distinguish two levels of public finances – instead of the four subsystems defined by the current regulation of public finances (central budget, social security funds, off-budget funds, local governmental budgets). The content of the adopted act basically complies with the proposals formulated in the theses, however it provides detailed regulation only for the central level. The act also fails to settle the financial relationships between the two levels.

In summary it can be stated that the approved act contains a lot of values, it enforces most of the criteria laid down in the SAO theses. *However, apart from eliminating the above mentioned deficiencies, public finance regulation must cover more extensively the modernisation tasks of budgeting, including those related to the introduction of programme-based budgeting, information management, and public finance management, too.*

THE RATE OF TAXATION AND METHODS OF TAX AVOIDANCE

One of the major issues influencing competitiveness is what types and rates of taxes and contributions constitute public dues, and how these taxes and contributions burden the different layers and groups of society. In theory, a well designed tax system must reflect the income relationships of the society, and must distribute the burdens accordingly – "in an equitable manner" – and must establish proportions that provide an incentive for social development.

The debates conducted about the rates, proportions and types of taxes year after year do not only imply what revenues can possibly be counted on – with smaller or greater risks – in the following year during the allocation of the budgetary resources. They also provide a platform for the confrontation of standpoints representing the interests of various layers of the society, societal management, action and scenario selection aspects, social problems and competitiveness objectives. *For the improvement of the competitiveness of the Hungarian economy, for the promotion of crisis management and growth the main important thing is to implement a change in the taxation system that may lay the foundations for a more favourable path for subsequent years.*

In financial politics it is already agreed that Hungary's current tax system is ready for review. The question pertains to the method, rate and scheduling of such a review. The problem is that there is no financial and political consensus for fast and effective action, and only short-term "half-way measures" are taken. The only concept that seems rational is the one that *intends to review public dues in parallel with the modernisation of public finances.* As far as revenues are concerned, it is justified to widen the tax base – by reducing allowances and exemptions –, and to reduce the tax rates in parallel with that. This requires the critical review of nearly fifty taxes or tax-like instruments that can no longer be maintained due to their inevitable bureaucracy, and ultimately counter-productive effect. The review is also necessitated by the deceleration of revenue growth, which can be attributed to the central taxes exaggerated both in number and weight, as well as the recession of the economy. At the same time the local governments of the settlements keep local taxation within the rational boundaries, and they not at all intend to "maximise" local revenue generation.

Revenue risks can be equally attributed to technical causes (such as the clarity of regulation, the level of preparation of the Hungarian Tax and Finance Administration, the absence of authentic records, etc.), as well as to economic and social conditions (e.g. social resistance against regulation, the economy is not capable of the performance that would correspond to the given revenues).

In general, but also in terms of competitiveness the Hungarian public finance system operates with an extremely high rate of income centralisation, and redistribution. Nearly one half of the performance produced domestically (GDP) is withdrawn in the form of taxes and contributions.

▸ *At the level of public finances income centralisation was in the range of 42 to 48 per cent in the 1995–2008 years.* The around 48 per cent income centralisation at the beginning of the period dropped to 42 per cent by the middle of the period, and then, following minor fluctuations, it rose to a level of 45–47 per cent. The change was influenced by the tax reductions and tax hikes (decrease and increase of the VAT rate, reclassification, raising the brackets in personal income taxation, reduction of the number of tax rates, introduction and elimination of tax allowances), introduced by the subsequent governments, as well as related to *Hungary's accession to the European Union and the convergence programme,* and the weaker performance of the economy – especially in the last years of the period under review in relation to the global economic crisis.

▸ As far as the *VAT* is concerned, during the term of the first government after the change of the regime (year 1993) the preferential VAT rate grew from 6 per cent to 12 per cent, and then to 15 per cent in 2003. At the beginning of 2006 the normal VAT rate decreased from 25 per cent to 20 per cent.

- As far as the *corporate income tax* is concerned, the tax rate was reduced in the early 1990s, and significant tax allowances were introduced to attract foreign direct capital. Before the EU accession, the transformation of the system of allowances was a significant step, which included, first of all, the introduction of the tax allowance on development projects, and the transposition of the relevant EU provisions into the Hungarian legal regulations. It can be regarded as a major move that the dividend tax obligation on incomes taken abroad was abolished in 2006. The 4 per cent *solidarity tax* introduced at the end of the period was designed to improve the public finance balance.
- As far as the *personal income* tax is concerned, the number of tax rates dropped from five in the early 1990s to two, and the tax bracket boundaries often changed. The highest rate at the beginning of the period under review was around 50 per cent, which dropped to 36 per cent by 2006. However, at the end of the period a 4 per cent *solidarity tax* was introduced.
- The introduction of the *simplified entrepreneurial tax* in 2003 served the elimination of the underground economy in relation to all tax revenues. However, it must not be forgotten that the measure led to a reduction in VAT and PIT revenues. Raising the tax rate from 15 per cent to 25 per cent at the end of the period under review reduced the number of such taxpayers and constrained the growth of revenues from this tax type.
- *Social security contributions* decreased by nearly 2 percentage points relative to the GDP in the period of 1998-2006. Although the contribution rates increased as a result of the measures taken in 2007 and 2008, they did not reach the 1998 level.
- In 2010 a new tax, the much disputed *property tax* was introduced. Its proclaimed objective was to increase the fairness of taxation, and to make better off groups of the society pay more public dues. Without going into detail about the societal and social risks of introduction, we must raise doubts about the reliability of the property registers, the feasibility of control, as well as due to the limitations of value assessment, which serves as the tax base.

With these tax rates *tax centralisation* in Hungary – although it is close to the EU average – is significantly (by 40 per cent) higher than the rates applied in competing countries. The level of public dues levied on employment is one of the highest in the European Union. This competitive disadvantage is somewhat mitigated by the recent reduction of the social security contribution for a small group of low-income people. At the same time, this change contributes to the "whitening" of the informal economy, but the containment of the informal economy requires broader, more efficient steps – affecting 20 to 25 per cent of the GDP. The success of these steps will lead to a more proportionate and equitable distribution of public burdens, and consequently the reduction of effects distorting competition, and the increase of resources available for economic development. Furthermore, apart from the steps already taken, in the longer run it is inevitable to significantly reduce taxes and contributions by the major restructuring of the tax system.

EDUCATION AND TRAINING

The educational system and standards that have evolved in Hungary in the past two decades can only partially meet the needs of the economic sectors. What is more, this deficiency appears at a time – today and even more in the future – when human capital and knowledge have become, and are becoming extremely important preconditions for the improvement of competitiveness, and *the knowledge-based economy* is no longer a theoretical, but also a practical issue.

Taking all this into account, the *Research Institute of the SAO published a study*[6] to summarise the dual concept of the knowledge-based economy and society, the system of indices elaborated for the evaluation thereof, as well as the status and tasks of the knowledge-based economy and society in Hungary. The topics of the study put special focus on education and human resource training.

In this respect one of the greatest challenges today is the creation of the harmony between *education and the labour market,* the provision of job opportunities for young professionals after their study years. It is important to emphasise that knowledge investment is more than just adaptation to the structure of the labour market. In fact, it implies much more than that: it is to ensure the conditions for knowledge and information acquisition, as well as knowledge conversion in a foresighted manner.

The most important task is the comprehensive development of *public education* both in terms of quantity and quality. The 20th century results of the Hungarian primary and secondary education are well known. However, all these are gone by now. Literacy and numeracy deficiencies are now much more frequent than at any time in the history of the modern Hungarian educational system. The number of people who do not finish primary school, or do not go beyond the lower primary stage is on the rise again. We may say that one of the most fundamental conditions for Hungary's convergence is the quantity of "educated minds", but this requires that the country's public education system be able to fulfil its traditional functions, and at the same time meet the new challenges of the 21st century.

Another fundamental issue is the exploration of *the correlations between higher education and the labour market,* as well as the clarification of the related theoretical questions, but first and foremost the qualification of the "output" values (results) of the education system on the labour market.

From this point of view a radical turn is initiated by the target markets. The opinion and judgement by the output, i.e. graduates and the *corporate sector* employing them, get stronger. It is increasingly demanded on both sides that the opinion of companies employing graduates should be fed back to the higher education institutions, and they would thus assist in adjusting the content and quality of education to the needs of the business sector as much as possible.

By joining the *European Union,* Hungary became a member of a large, multilingual community that has a very complex structure, encompasses many nations, nurtures a variety of traditions, possesses a colourful and multilevel economic background, and is regulated by a complicated legal system. As a result, the Hungarian higher education system directly entered the international education market. Students in Hungary must be supplied with knowledge that can be immediately utilised in any EU member state. In the field of regulating higher education Hungary must adopt the rules applied in the European Union. It must prepare for *competition* not only on the international higher education market, but also – sooner or later – on the domestic market with the competing European universities and colleges, as well as with the professional workforce of the other European countries.

Unique tasks must be completed in the *vocational training system.* The former results and outstanding traditions of the Hungarian vocational system are well known. However, the efficiency of the system considerably deteriorated after the change of the regime, important trades have disappeared from the curriculum of vocational training, and the quality of training has been strongly influenced by the fact that vocational training has been mostly chosen by students who are not able for higher education. Several efforts have been made in this field, too, to stop and reverse the unfavourable processes. The task is to achieve a quality breakthrough in this field, utilising the possibilities provided by life-long learning, training and further training, too. According to the statistical figures, two million of Hungary's citizens fit to work have no qualifications at all, while the demand side of the labour market is increasingly looking for professionals, and preferably people with multiple professions. According to the estimates, by eliminating or minimising this "blot" employment could rise by 5 to 7 per cent, since the building and processing industries are experiencing an obvious shortage of properly qualified workforce. Naturally, this assumes the intensification of adult education and further training, and the radical improvement of its quality. This is in line with the Lisbon Strategy of the EU – and now of Hungary – renewed for this decade, which focuses on the increase of employment and the improvement of economic competitiveness, and which defines the paradigm of *life-long learning* as the framework for the complex development of human resources.

Naturally, finding solutions to these problems is not exclusively a state task. However, the role of the state is determining, since it extends to vocational training, retraining, the creation of public benefit jobs, and labour market regulation alike.

INNOVATION, RESEARCH AND DEVELOPMENT

The other weakness in the improvement of competitiveness is the operation of the *national innovation system,* which is closely related to education, primarily higher education. In relation to the system, in a *former report*[7] the SAO made several statements that refer to the unsatisfactory operation of the system.

- It is necessary to elaborate an innovation policy, to review the R+D activity in a comprehensive manner, including the review of the financing mechanism.
- The state management and coordination of the Hungarian research and development sector was divided among the Ministry of Education, the Hungarian Academy of Sciences and the sectoral ministries.
- In the R+D activity budgetary research places involved in basic and applied research played a dominant role (large share of state resources compared to entrepreneurial resources), and the entrepreneurial sector was relatively subordinate.
- The figures supplied by the Hungarian Central Statistical Office on R+D activities significantly differ from the aggregate data obtained from the budget and the final account on the budget.

These findings chime with the findings of a later study prepared by the *Research Institute of the SAO.*[8] According to the evaluation of the study, Hungary needs a significant breakthrough both in terms of quality and quantity in an important field of the knowledge-based economy and society, namely in research and development, as well as innovation. There is no doubt that important measures have been taken in legal regulation, institution development and the improvement of the relevant conditions. However, the implied conceptual change of paradigm was only partially followed in practice. In addition to the measures taken so far, further significant steps are needed to enable Hungary to get on the path to convergence and progress. Using the results of research conducted in the field of knowledge-based economy and society too, *the following provides a general and comprehensive framework of actions for the areas that we find the most important.*

- The increase in the risk-bearing and growth abilities, as well as the innovative activity of businesses requires a predictable economic policy that serves long-term efficiency, competitiveness and modernisation. It also requires the enforcement of a monetary policy that takes into account both the competitiveness of the economy and the stability of the financial system. Furthermore, it requires the reduction of the large-scale centralisation of original incomes and large-scale redistribution by the state, as well as the promotion of long-term savings and capital investments.

▸ It is indispensable to elaborate a coordinated scientific, technological and innovation policy at government level, the precondition of which is the harmonisation of the different policies. The situation of the Hungarian scientific schools must be analysed in comparative studies, with special regard to the EU's system of preferences.

▸ The increase of R+D expenditures proportionate to the GDP must be linked to institutional reforms that show beyond the Hungarian R+D sector and improve the efficiency of the knowledge industry, as well as the enforcement of the selection system of state financing based on scientific and technology policy priorities. (We cannot be competitive in every field, but following the methodology of the market niche policy we may rise to be among the best.)

▸ State financing for the R+D sector is a strategic issue for the country's long-term competitiveness. Therefore, there is a need to modify the practice, in which state financing for R+D has become a residual element of the budgets. The system and time horizon of state financing must adjust to the nature of the R+D activity, which spans calendar years, and must also indicate the social and economic objectives of utilisation. The government must examine the impacts of the existing taxation, accounting, legal, etc. regulations on the flow of knowledge, as well as innovation. Those forms of state support that have turned out to be ineffective must be eliminated.

▸ In the R+D sector the possibilities provided by laws must be used to create situations that on the one hand stimulate the competition for state resources, and on the other hand encourage cooperation among higher education research places, research institutes and enterprises.

▸ The evaluation of higher education institutions and research institutions should considerably be based on their R+D achievements utilisable in the innovation process, their patent activity, and cooperation in cluster(s) and/or spin-off enterprises. The share of the private sector in the financing of research places (especially in the field of life, natural and technical sciences) shall be an evaluation criterion in order to decrease excessive dependence on the state, too.

▸ In the R+D sector the strongly discipline- and institution-oriented financing must be replaced with a financing and support system that focuses on multi-disciplinary objectives (projects) and that promotes the development of the innovation net. To this end preference must be given to the financing of consortium projects led by enterprises directly interested in the utilisation of the research results.

▸ The Government's small company strategy must include innovation as a competitiveness factor, and state financing shall not be a capital replacement tool, but a factor promoting innovation activity and encouraging corporate R+D and innovation expenditures. Steps must be taken to enforce the provision of the Act on the Innovation Fund for Research and Technology, according to which the resources of the Fund must be spent on research and development implemented indirectly or directly by the economic companies.

▸ The enhancement of mobility on the market of the scientific workforce is also a precondition for the success of knowledge creation ("knowledge production") and knowledge flow. To this end one must utilise the opportunity opened up by the Innovation Act, according to which researchers may take up temporary employment in the business sector (at home or abroad) without losing their original jobs.

On the market of scientific workforce the precondition for creating equal competitive conditions is the modification of the employment regulations in force in the state sector. In the state institutions of scientific, technological and innovation policies larger integration and stability must be ensured.

- It is required to eliminate red tape linked to the application and support system, which is not only costly, but also distorts institutional and entrepreneurial attitudes. Furthermore, administration focusing on the implementation of the development and innovation objective must be developed. Deregulation must be carried out after the revision of the legal regulations in force (Public Finance Act, as well as government and ministerial decrees).

- The country must create a social environment and economic conditions in which the possible failure of an innovative enterprise established for knowledge "production" and utilisation does not imply stigmatisation, exclusion or the prevention of a new start.

POLITICAL-GOVERNMENTAL ACTIVITY AND PUBLIC TRUST

Transparency and accountability

Public finance decision-making and management can fulfil its role if public policy sets a direction, clear and transparent concepts motivating for action, and the senior and junior staff members of the public finance organisational system can identify themselves with the major objectives set by the parliamentary majority and the Government, and have the possibility to contribute professionally to their implementation within their scope. The other precondition for successful operation is that the society must have a good knowledge about and must accept those financial possibilities and constraints that must be taken into account when organising and planning life. Since the society, too, *understands* that the state can spend only what citizens – entrepreneurs, officials, workers – pay in the form of taxes and contributions, it has all rights to expect a *fair and audited account* of the use and utilisation of their contributions.

These are nothing but additions to indicate how much public discipline and trust contribute to successful finances. As an example we note that for this reason all budgets must meet the criteria that serve the transparency and accountability of economic management. Naturally, these objectives appear in accounting and auditing, too, for instance through the principle of clarity and detail.

The transparency of public finances and the accountability of those bearing economic responsibility is a governance tool of an efficient society (efficient societies) living in a risk community, since it is obvious both for the globalised world and the individuals that we belong to a risk community (financially, too). Therefore, transparency and accountability represent the legal principles of the operation of public finances.

The former means that – at various levels – the financial information system of public finances is public, and the latter means that any person who uses public funds must be ready to have his/her activities be audited on behalf of the general public, and must give an account on how he/she complies with the rules, and how effectively, efficiently and economically he/she uses the available resources. (In the international terminology this is called the principle of the three Es: *efficiency, economy, effectiveness).*

Evaluating the practice of *budget planning and execution* on the basis of these requirements and principles it can be stated that *we cannot be content with the transparency thereof.* Its absence is also a competitive disadvantage deteriorating trust indices as indicated by a range of SAO audits.

The situation that has evolved must be changed through multidirectional actions, too. As a main course of action *the order of budgeting,* process scheduling and regulation *must be modernised.* Furthermore, information required for the completion of public finance tasks, issues related to the statistical and accounting system of public finances, as well as the issues related to the regulation of the entrepreneurial and treasury assets of the state, and the assets of the local governments must be clarified. Similarly, the tasks related to the modernisation of the financial audit system of public finances must be reconsidered.

Starting out from this fact, and taking into consideration the theses of the new public finance regulation, within the second course of action the hardly transparent *Public Finance Act,* which is still in force, but is amended on a continuous basis due to the so called Status Act, must be developed on new, modern foundations to ensure greater transparency and accountability.

The third course of action aimed to improve transparency implies the changing of the rather frequent practice when *macroeconomic forecasts* based on unrealistic assumptions lead the fiscal policy astray. In the name of objectivity both over- and underplanning must be avoided in the Hungarian practice, including the wrong practice deliberately followed due to political considerations. NGOs participating in forecasting must also be given access to all data and parameters used.

As far as the *budget process ensuring integrity* is concerned, a further course of action for the enhancement of transparency includes the determination and practical enforcement of the budgetary procedure, the full-scale practising of budgetary rights by the National Assembly and the local governments, as well as social publicity and comprehensive control.

The new public finance regulation to be created must enable the National Assembly to ensure that the deputies should make decisions only in substantiated cases, and for definite purposes. This requires that the so called voting units, i.e. tasks and appropriations on which the deputies must actually decide, be appropriately defined in the budgetary documents. Politics should decide about aggregates that adequately ensure the enforcement of political preferences and that make the implementation of these preferences accountable, but do not hinder efficient implementation.

The integrity of the budgeting process would also be strengthened by the introduction of the practice according to which *the Government should prepare a report every four years before the general elections.* The report would not only provide information about the commitments for the coming years, but would be an important tool in the confinement of "over-politisation" affecting the budget by restricting the competition of groundless election promises.

Corruption

Transparency and accountability are not only the strongly correlated fundamental principles of the operation of the state organisation, but also factors that influence and determine corruption risks. Since these two legal principles of public finances represent the norm for the activities of the SAO, too, in the past decade the institution paid utmost attention to the *fight against corruption, which represents a significant social problem.* In addition to this, in the spring of 2008 Section 2./c of Resolution No. 72/2008. (VI. 10.) issued by the National Assembly specified for the SAO as a professional task "to pay increased attention to the typical causes and fields of corruption, and to highlight deficiencies in the application of the law".

The SAO is involved in the fight against corruption *in three ways:*

- during the SAO audits it pays utmost attention to the identification and detection of corruption risks;
- prepares summary studies that explore and analyse the causes, risks and tendencies of corruption;
- in justified cases it initiates sanctions against the crimes committed on the basis of the SAO Act.

Similarly to the former anti-corruption governmental bodies, the SAO was actively involved in the work of the Anti-Corruption Coordination Body established in 2007. The body was the first to prepare an anti-corruption strategy on the basis of corruption phenomena in Hungary, paying special attention to the analysis of corruption risks, and defined the preparation of corruption risk maps as a separate special objective.

At the same time, in the spring of 2008 the Dutch-Hungarian twinning project completed in the Research Institute of the SAO indicated the possibility for adopting and applying an integrity approach based methodology, which corresponds to the development priority of the State Reform Operational Programme designed to improve the "culture of public administration".

Having realised this, the State Audit Office undertook to contribute to the establishment of the methodological foundations of systemic state measures against corruption by launching a large-scale project and by implementing it in the next two years. The *aim of the project* is to explore, map and classify the corruption risks of public administration, better substantiate the audit plans, as well as to comply with a more uniform audit practice and with the publicity, legal and ethical norms. For the professional sustainment of the achieved results a proposal is being prepared for the Government on the project's experiences, and the amendments to the legal regulations required for the large-scale introduction of the method.

We expect and hope that we will be able to achieve *the three main results of the project:*

- a certain area of the domestic administration system is going to be mapped for corruption mainly on the basis of a self-assessment based survey; the database will be accessible by the public on the internet;
- by utilising the results of the risk analyses, better substantiation of future audit plans, and consideration of previously assessed corruption risk characteristics for the given field in the course of planning; and
- at societal level, for the prevention of corruption situations the corruption risks burdening the individual social and economic systems become identifiable, which will promote the expedient management thereof.

SUMMARY CONCLUSIONS

1 In the first half of the decade Hungary was successful in terms of export competitiveness. This was significantly due to the multinational companies that came to Hungary, and the major source of success was the rise in productivity. Cost competitiveness also contributed to this outstanding export performance. On the basis of labour costs per working hour Hungary was in the mid-range among EU member states. However, this situation has changed since 2006–2007: Hungary's ranking has perceivably deteriorated in terms of international competitiveness, and in 2007–2008 among the regional competitors Hungary was preceded by the Czech Republic, Slovakia and Poland, as well as by Portugal, Spain and Slovenia as country groups.

2 According to the sub-factors that make up the overall competitiveness scoreboard of IMD, Hungary is especially lagging behind in

the field of business and government efficiency. The setback could be witnessed in all of the sub-factors that determine government efficiency (public finances, fiscal policy, institutional framework, business legislation and social framework).

3 For actions designed to improve the competitiveness of the government an important orientation may also be obtained by getting to know *the 10 most unfavourable indicators of government activities* on the basis of the international competitiveness rankings. However, there are three difficulties that hamper practical utilisation in this field. One difficulty is that during the compilation of international rankings subjectivity may play a strong role, for instance when experts involved in the surveys may "mark down" a country or a region because of the prevailing general economic and political situation. In the study we wanted to counterbalance this effect by taking into consideration both internationally acknowledged methods (the IMD and GCI indices), and on the basis of comparison we could conclude that *regarding the problems of competitiveness, both methods lead to similar results.*

The other problem of practical usability is caused by the fact that the group of the ten most unfavourable indices changes year after year, different indices are used because of the two methods, and by the resulting increase in the number of indices. This difficulty can be eliminated by creating *competitiveness problem groups* from the large number of individual indices.

The third problem comes from the following question: For practical reasons should we count with all of the critical indices – including those that reflect the effects of the global crisis – or only with those in connection with which domestic actions can be taken? With our opinion we support this latter procedure, therefore we may ignore indicators that reflect changes (rise) in capital costs, the expected level of recession, or the impact of the policy of the National Bank of Hungary on development – just to mention a few.

4 By taking into account these considerations, for the improvement of competitiveness the *following three problem groups are regarded as the most important ones that require urgent solution:*

- *for the creation and strengthening of the sustainable position of public finances (balanced budget, government debt)* renewal of the public finance system, and in harmony with that the reduction of high public dues (taxes and contributions), income centralisation and redistribution;
- *improvement of the quality of education and training, elaboration of an innovation policy promoting research and development,* improvement of the efficiency of state control, as well as the creation of the strategic nature of state financing for R+D;
- *improvement of the quality of political and government activities,* for building public trust, for the improvement of the negative opinion formed about political decision-makers, for reduction of corruption, for the improvement of the consistence of government policies and the transparency of governmental decision-making.

While in the first two groups finding a solution to these problems is equally important for both the domestic and foreign economic actors, in the third group the improvement of competitiveness is currently of utmost importance for foreign political circles and investors.

In connection with the different groups of indices we hereby note that the time during which causes leading to deterioration occur, and the time that is presumably needed for the elimination (repair, mitigation) thereof are not symmetrical, and differ from indicator to indicator. Furthermore, they include indices, like trust in the political institutional system, which greatly depend on emotional factors and attitudes, too. Therefore it can be seen that material changes can be expected to happen only in the medium and longer run, even in case of consistent and fundamentally efficient actions.

5 After, or maybe concurrently with progress achieved in the first three priority areas

- we find it necessary to create strategic foundations that would provide a long-term orientation for the improvement of competitiveness; furthermore, for the strengthening of governmental decision-making we find it necessary *to elaborate a national economic planning system that would allow for the well-founded development of modernisation paths based on the selection of strategic values;*
- as a supplement to the former task it is reasonable to accelerate *the process of renewing the budgeting process,* with special regard to the broadest possible application of the programme-based budgeting system, as well as to create the culture of "objective setting – measurement – evaluation – feedback" in governmental activities, and
- through these modernisation processes and other organisational restructuring in public administration *the quality of the completion of public tasks, and that of the legal and institutional frameworks must be enhanced.*

6 As it can be seen, the brief programme outlined above for the improvement of competitiveness is in agreement with the audit, analysis and research results and recommendations that were presented on the basis of the activity of the State Audit Office.

Notes

1 See László Bogár (2009), György Jenei (2008), László Laki (2008), István Stumpf (2006), László Trócsányi ed. (2006)

2 See Árpád Kovács (2009)

3 The member states of the European Union define themselves as social market economies, which was formulated in the Hungarian Constitution, too, in 1989.

4 See the relevant SAO reports on privatisation, as well as on the budgetary resources used for supporting the economy, and on innovation.

5 See Zsolt Aradi (2009)

6 See Gusztáv Báger – Tibor Bogyó – István Goldperger – Ágnes Hegedűs – Daisy Kiss – László Őrlős – Gyula Pulay – József Roóz – Sándor Szorcsik – András Vigvári (2008)

7 Report (2004)

8 See Gusztáv Báger – István Goldperger – György Varga (2005)

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