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## *The main characteristics of the operation of the Hungarian state and the directions of necessary changes*

**I**n April 2007, the State Audit Office (SAO) presented to Parliament a document entitled “Theses on the Regulation of Public Finances<sup>1</sup>”, which the Parliament discussed, asking the government to use the theses during the “reregulation of public finances”. The renewal of regulations on public finances has begun, as a result of which important laws have been passed. These laws have, however, failed to establish, as a system, a modern framework for public finance management; a revision of the volume of public finances has failed to take place and there has also been a failure to incorporate into a system the public duties to be financed by the Hungarian state now and in the future. In September 2009, the Research Institute of the State Audit Office continued the work begun by working out the theses by elaborating a study entitled “An expedient economic role for the state in the global economy of the early 21st century”. The study sketches the logical chain related to the role of the state, reviews international trends as well as the main experience of the operation of the Hungarian state in the past 20 years, outlining what changes are necessary in the assumption of economic roles by the state. Attached to the study, the Appendix includes the theoretical-methodological system of aspects that may serve as a starting basis for the evaluation of the public political ideas and policies aimed at the reform of the public sector.

*In this article, based on the study, we summarise the main characteristics of the operation of the Hungarian state and the directions of necessary changes. The aspectual framework of the study is determined by the following principles.*

▶ *In the mixed economy formed in the twentieth century, the state assumed a role of a different quality compared to before. The traditional (public authority) functions of the government were complemented with social (social political) as well as economic tasks, the latter aimed at mitigating the effects of economic cycle fluctuations.*

▶ *The activity of the state is not simply task-solving of an organisational-technical nature but is at the same time an effort made to serve the public good.*

▶ *The need to keep up in today's global competition means new challenges for the state. One of these is the market perfecting function, comprising three tasks: easing information asymmetries, strengthening control, creating competition conditions and, if necessary, forcing out competition.*

▶ *The current crisis has made the challenges clear in its own dramatic way. The global crisis is the consequence of the fact that a distancing of an irrational extent has developed between the real sphere and the speculative financial space. The global crisis and the search for economic courses leading out of it cast a new light upon the role of the state.*

## THE MAIN CHARACTERISTICS OF THE OPERATION OF THE HUNGARIAN STATE

The relevant acts in Hungary regulate the operational order of state institutions instead of elaborating a detailed state model. The main reason for this is that *at the time of the political change, there was no consensus between political players on the issue of a state model to be established*. For the same reason, there was no comprehensive amendment made to the constitution.

A detailed analysis of the overall operational mechanism of the Hungarian state or even of individual subsystems of public finances would be far beyond the scope of this article. Our starting point is that the state implementing a market-making, privatisation centred economic policy and urging the influx of foreign operating capital would have been consistent (and, as a result of a consistent policy, successful) if it had transformed the government sector and its institutions according to the requirements of the market economy and the required economic catch-up, contributed to creating the conditions necessary for a dynamic development and mitigated the inequalities caused by market mechanisms. The analysis is therefore carried out along three main strategic action directions:

- creative destruction,
- creating the conditions required for catch-up and for sustainable development later on and
- serving the public good.

Creative destruction means the activities that have been related partly, beginning with the political change, to creating the operational conditions of the state necessary for the establishment of the market economy and partly to renewing the outdated operational conditions, within the framework of reforms. The creation of the conditions required for dynamic development and catch-up focuses on the activities

that are needed from the side of the state for the achievement of this goal. The service of the public good means the totality of the activities through which the principle of harmonising individual and community interests is implemented.

### Creative destruction: the semi-reforms of the government sector or the reforms that have failed to take place

The *public finance reforms* related to the political change were decisively aimed at downsizing the state socialist system, withdrawing the state from the economy and democratizing and decentralising<sup>2</sup> the system of public finances, while the need to establish mechanisms serving the efficiency and transparency of the public sector was ignored. The Act on Public Finances passed in 1992 did not take it fully into account in which direction the public sector would develop and according to what old and new rules in would operate in the developed world. Thus, compared to the regulations on other fields of the financial system (e.g. accounting, credit institutions, the capital market, bankruptcy procedures, etc.) public finances have been lagging behind almost since the very beginning.

The political, economic and social transformation has been characterised by an institution building serving the establishment of a middle class system and an economic political manoeuvring serving the maintenance of the external and internal financial balance. This dichotomy has characterised the transition processes of the public sector as well. On the one hand, the important institutions of the public finances of modern market economies have been established: a new system of taxation has been introduced, a subnational government level independent from the point of view of public law, as well as a State Audit Office have

been established (before the political change already). In 1990, the source regulation system of councils/local governments changed. In the same year, the social security fund was separated from the central budget. By dismantling state property, the privatisation of the entrepreneurial property of the state began and local governments as well as social security authorities were assigned property.

It was another important element of the public finance reform process that, adjusting to the international trends of globalisation, the financing of deficit was gradually put on a capital market basis. Partly related to this, the Bank of Issue Act passed in 1991 established the independent bank of issue. By the foundation of the Hungarian State Treasury in 1996, the modernisation of the fund management system of public finances began. The treasury system produced significant savings; through the opportunity of ex ante control, the financial discipline of economic entities supervised by the Treasury improved. State-debt related transactions were gradually transferred from the bank of issue to the State Debt Management Centre (Treasury), which was part of the treasury system. The beneficial use of the opportunities granted by the treasury system and the strengthening of public finance discipline are, however, significantly hindered by the facts that the Treasury information system is outdated on the one hand, while, on the other hand, a considerable part of state duties have been withdrawn from public finances and assigned to various corporate and non-profit organisational forms. In its report<sup>3</sup> published in July 2009, the State Audit Office establishes the following:

*“It has impeded the operational efficiency of the information system and, through this, of the Treasury, that, lacking strategic establishment or coordination, the system has been supported by subsystems with activities developed at various*

*platforms, requiring parallel data input but being unable to directly communicate with one another, which were mostly characterised by outdated technology furthermore, making only weak inner and managerial control possible. The system supporting budget planning and the compilation of the report, based on a 15 year old technology, involves high risk and cannot be further developed at this platform. The demands of the accounting system introduced over 10 years ago have also changed considerably, as a consequence of which the system as well as its development application perform on the verge of their capacity.” Related to the former, it would also be needful to combine the technological modernisation currently supported from EU funds with the substantive modernisation of the information and budget presentation system”.*

Concurrently with the introduction of the treasury system, the way of financing of local governments changed (gross financing was replaced by net financing), a law was passed on the procedure to be applied in the case of local government insolvency and articles of the Local Government Act concerning financial management were amended in several places. In 1997, the establishment and operation of local government associations was regulated by law. It would be advisable to consider extending central financial management to the local level of public finances, without violating the constitutional independence of local governments.

Apart from the above, *the political forces implementing the political change* – beyond the understandably different natures of the values they represented, also due to economic political constraints – *were unable to reach a consensus on the target model of the state “of after public finance reforms”.* “For the policy makers of the country in transition as well as for its wide social strata, the direct examples, the wish to develop the welfare services assumed and operated by the state to approach the level of these

examples and the particularities involved therein were determined by European integration and the social-economic value and interest system of the “social market economy” representing it. This obligatory adjustment meant the adoption of the system of rules and institutions, i.e. in practice of the EU legal order (*acquis communautaire*) in force. Yet there has been no consistent following of the European example. Neither as regards social services (social policy, health care and pension services), nor as regards the society and economy organisational (administrative, conducting and managing) roles of the state. Since, for a segment of the political-economic elite influential in decision-making, the so-called »mainstream« patterns from overseas, advocating the efficiency of a »night-guard state«, the advantages of privatising social services and the self-reliance of citizens, were formulated, almost dogmatically, as the keys to joining the mainstream.”<sup>4</sup>

It can be explained by the uncertainty about choosing the model that some of the newly established public finance systems and institutions have operated with serious inner contradictions. A typical example for this is that social security funds were transferred to local authority supervision in 1993 but were renationalised in mid 1998. The most important sign of the lack of a consistent target model is the Hungarian local government system, which has been assigned a constitutional independence of an unusual extent in international comparison as well as a wide and, despite the scattered settlement structure, a homogeneous scope of duties and authority. Due to a misinterpretation of the principles of fiscal decentralisation, the public legal institution of *obligatory association*, which would ensure an economies-of-scale and efficient task performance at the local level, has failed to be introduced until today. The decentralisation of tasks also meant the decentralisation of conflicts at the same time. This eased the pain of the eco-

nomie transition in the short run but generated several instances of tension in the longer run. In the local government sector, serious lack of funds and, even today and especially in the case of the capital and of cities with county rights, wasting, have been concurrent phenomena. The situation is made more serious by the untransparent operation of local-government owned business organisations performing local government tasks.<sup>5</sup>

*In relation with the above, it is established in an Audit Office report<sup>6</sup> published in 2009 that every year, a significant proportion of the local governments audited, in the years 2005–2007, some 80 per cent of them and in the year 2008, 70 per cent, failed to ensure the balance of the planned budget revenues and expenditures, i.e. their budget revenues failed to provide coverage for their budget expenditures. For the financing of the planned budget expenditures, ensuring liquidity for the year and helping the budget balance, some two thirds of them planned to take up a short-term liquid loan in 2005–2008. In 2007–2008, one quarter of the audited local authorities issued bonds, most of which (74 per cent) were foreign currency based bonds with a variable interest rate. Bond issuing meant a gradual indebtedness of local governments; as the proposals of the bodies of representatives reveal, the commitments generated were to be covered from operating budget revenues. Considering the exchange rate changes of the currencies concerned as well as the variable interest condition, bond issuing involves risks for local governments. In the long run, indebtedness has an adverse effect on the financial situation of local governments. Local governments, supported by the irresponsible credit policy of banks, involve an increasing risk for the public finances balance, fragile as it is.*

The decision making affecting public finance systems has been generally characterised by the avoidance of conflicts involved in conscious

structural transformation or in the closing of superfluous institutions. Instead, it has tried to encourage institutions or their maintainers to increase the efficiency of financial management by reducing central funding. A good example for this is primary education where a fall in the number of school children and the growth in the rate of church-run and non-profit run schools were not followed by a proportionate downsizing of the local government institutional system.

*An Audit Office report published in 2008<sup>7</sup> establishes the following on the above: “In the period of 2004–2006, the number of children and students in public education, as a consequence of the national demographical situation, fell by 2.8 per cent and, within this, the fall was 4.5 per cent in state (i.e. local government) run schools. The fall in the number of children/students was not followed by a proportionate downsizing in the number of teachers. In the same period, the number of teachers in public education fell by 0.6 per cent overall and by 2.6 per cent at state (local government) run institutions. The coverage per child/student was (at state/local government run institutions) HUF 471.6 thousand in 2004 and HUF 550.2 thousand in 2006, which meant a 16.7 per cent rise. The coverage per child in kindergartens rose by 13.2 per cent, while the specific coverage per student at primary and secondary schools rose by 17.4 per cent. The rise in the specific coverage was partly due to an increase in the payments to personnel, and partly due to a fall in the number of children/students. Yet, the fall in the student/teacher ratio and the rise in the specific coverage were not followed by an improvement in students' performance, i.e. by a strengthening of efficiency in public education. Comparing expenditure to efficiency it can be established that, in Hungarian public education, the resources available have been used at low efficiency.”*

*Several instruments of the financial system of public finances have served the withdrawal of*

*funds. It is sufficient to refer to the endless own income interest of local governments or of the council and later local government fund regulation system encouraging the depletion of assets. The loosening of budget management was meant to compensate for the growing underfinancing of the sector. Transparency or accountability could not be demanded of such a system. What we had here was a cynical practice of 'accomplices': “I will not give you enough funds to cover your duties” but, in return, “I do not care where you get the money for survival”. Consequently, the reducing of funding by avoiding a conscious restructuring has led, in many cases, to the depletion of assets, or the performance of excessive state/local government duties at a low standard. At the central level of public finances, it is due to an imprecise planning of the own revenues of central budget organs as well as the low efficiency control of the public moneys used here that operation is characterised by low efficiency.*

*In economic transition processes, liberalisation, deregulation and privatisation<sup>8</sup> took place simultaneously, which weakened the state, since privatisation and liberalisation would have required a significantly stronger regulatory role by the state than the one established. The main reason for this was that privatisation was extended also to public utility companies operating as natural monopolies.*

### Creating the conditions for sustainable development

*The performance of duties by the state may be undisturbed, continuous and safe if the state is able to create the conditions for sustainable development (growth). In today's globalised world, state involvement is a general requirement of a state for the sake of such development. This is well illustrated by the fact that, among the mil-*



lennium targets of the United Nations, sustainable development is number one.

The content-theoretical formulation of the requirement of sustainable development can vary considerably, however. In the monetarist mainstream trend it is used to describe a state of economic growth which proceeds without inflation. For environmentalists, it means an economic growth sustainable in the long run by the use of renewable resources, without causing significant environment pollution. In what follows, the various approaches are to be presented by using the formulations of the National Sustainable Development Strategy.<sup>9</sup>

For economic policy, sustainable development means a development implemented in a way creating a balance between economic, environmental and societal-social targets not only in the short but also in the long run. Thus, sustainable development serves a broadly interpreted improvement of the quality of life, because of which the sustainable management of natural resources must couple with an economic development fostering the achievement and preservation of welfare and with social justice.

With reference to natural resources this means that the realistic needs of society can be only met through the sustaining capacity of the natural environment, but the sustaining capacity of the natural environment also restricts the meeting of demands at the same time.

In a society that follows the principles of sustainability, social justice is implemented, the basis of which is guaranteeing equal chances in the access to opportunities and the sharing of social burden, alongside with an effort to continuously improve the quality of life. The currently ongoing social-economic processes and their effects often significantly contradict these environmental and social requirements.

*In this article, it is the financial aspects of sustainability that are to be dealt with in detail.* In the first approach, we must meet the require-

ments of the European Stability and Growth Pact and gradually perform the criteria of joining the Euro zone. In the second approach, we must further improve the public finance balance and conquer surface as well as deeper structural problems.

Surface structural problems include the lack of budget discipline on the expenditure side of the budget, an insufficiently sound financial basis for government decisions as well as ungrounded political promises. The revenues side, on the other hand, is endangered by a weak taxation discipline.

*The sustainability of financial balance is endangered by a deeper structural disproportionateness behind the surface phenomena. The major supply systems* (health care, pension, social care, education) are overdeveloped compared to the economic potential of the country: there are too many institutions and too broad entitlements, while these systems *operate with low efficiency*. At the same time, these supply systems are also strained by demography problems, by what were believed to be one-time losses of the political change (e.g. the closing of 1.5 million work places) and by the major differences that have occurred and remained in regional development. Public finance revenues, on the other hand, have failed to grow sufficiently due to the lacking competitiveness of Hungarian enterprises. Small and medium enterprises are unable to either pay the high tax and contribution burden or to significantly widen employment. Their innovation activities are also much restricted.

In the situation given, the creation of a sustainable financial balance requires both the further reduction of state expenditure and the increase of revenues by widening the circle of taxpayers, as well as the preparation of measures aiming at the rationalisation of the major supply system. Through these steps, in just a few years' time there will be savings attainable that can be partly spent on increasing the com-

petitiveness of enterprises. The growing competitiveness of small and medium enterprises in turn may mean rising employment. A significantly rising employment level may contribute to increasing budget revenues, reducing social expenditure and improving the active/inactive ratio. Thereby it may ensure an improving financial balance and the sustainability thereof in the medium run.

Correlations are certainly not as simple as this as *Hungary must face, even in the long run*, most adverse effects of the international economic and financial crisis as well as *serious challenges* following from the ageing of the population, the global transformation of the world economy and environmental changes.

Considering economic growth, Hungary was characterised by stagnation at the point of reaching the political change: in 1988, there was a slight decline in GDP, while in 1989, there was only 0.7 per cent growth compared to the previous year. After the change, in the period referred to as transformation, there was a significant fall in GDP, reflecting the overall gross performance of the Hungarian economy: compared to 1989, GDP was 18 per cent lower in 1993. *The political change involved significant structural changes:*

- through the privatisation process, ownership structure was transformed,
- the number of market players grew,
- the weights of the state sector, the big corporations- and the small and medium company sector changed,
- the rate of foreign ownership rose significantly,
- there were changes in the structure of production and in the geographical and product structure of foreign trade.

Without discussing economic growth, external effects or the actual economic political responses to these, let us just note that *there was a failure to establish the conditions necessary for sustainable development. In the beginning of*

*the period, after the one-time serious transformational fall, the policy based on foreign operating capital import proved unsuccessful.* As can be seen today already, this process not only established a dual economic structure but, due to the global economic rearrangements, catchup would require a conscious economic structural change. In this, the state with a developing function, with the necessary institutions and operational mechanisms, and last but not least, with the modernisation of the system of national economic planning, should have a significant role.

### Serving the public good: an attempt to construct a social market economy

For the practical implementation of serving the public good through state involvement, the system of conditions to start from comprises what are referred to as the fundamental laws (the Constitution primarily), the international agreements and the internal and external endowments and circumstances limiting the scope of development. In relation with the Hungarian Constitution, it is necessary to underline that *it is declared in two places in the Constitution that the economic system of Hungary is market economy, while a certain market economy model with specified contents is not identified.* The Constitution is neutral from an economic political point of view, so it gives no guidelines on the extent or intensity of state intervention, and there are certainly no hints on a ban on state intervention. *The Constitution Preamble, however, talks of a social market economy specifically, which does involve obligations.* Considering, furthermore, that the sustainment and protection of market economy are constant constitutional responsibilities of the state, it is justified to view the model of social market economy as authoritative in the state involvement in serving the public good. It

should also be seen that, lacking adequate public finance regulations, the necessary restraints and counterweights are missing with regard to both the sharing of tax burden and state obligations.

*The government of the political change established in May 1990 announced the policy of establishing a market economy according to this model. But the practical implementation of the principles of the model was hindered by the above mentioned decline in economic performance and the deterioration of the budget balance. Even in 1996, household consumption was still some 13 per cent lower than in the year 1990, which means an annual fall of 2.3 per cent.*

*Throughout the whole period examined, economic transition had an adverse effect on social cohesion. One of the major problems was a growing income inequality: the ratio of the incomes of the top 10 per cent to the bottom 10 per cent was 6.1:1 in 1990, rising to 7.3:1 in 1995. It can also be established that qualifications had a growing role in the development of income differences. Even today, the living conditions of social groups falling behind, especially the situation of the Roma population, continues to deteriorate.*

*The macroeconomic correction in 1995 worsened the chances for the very much needed strengthening of social cohesion most suddenly and to a great extent. The slowdown of economic growth in 1995 and 1996 and the reallocation of incomes to the benefit of the corporate sector, with the aim to increase competitiveness, caused a sensitive decrease in the sources available for welfare functions within public finance expenditures, including the real value of the funds for the Health Insurance Fund and the Pension Fund, in both years.*

In the first two government cycles, the most significant laws regulating welfare systems were passed. The welfare services appropriated in these, generally without detailed effects cal-

culations, could not be fully guaranteed by the state, lacking the necessary financial or other resources. Therefore, the laws had to be frequently amended on the one hand and, on the other hand, those in need did not have equal access to social, health care or other welfare services. From the beginning of the new millennium, the incorporation of the *acquis communautaire* of the European Union into the Hungarian legal system began. This consolidated the basis of social market economy but, at the same time, further increased the difference between declared rights and actually attainable opportunities.

From 1997 on, the acceleration of economic growth to 4–4.5 per cent made it possible to improve the position of public finances and reduce unemployment. In salary outflow, there was a conscious withholding for some time, which gradually eased thereafter. Social and social security expenditure similarly rose. *The ambitious measures raising salaries and pensions, taken within the framework of a welfare catchup but without realistically considering the resources available, caused a deterioration in the fiscal position to an extent that, from the middle of this decade, the stabilisation of public finances became the primary task. The global crisis in 2008 made it even more evident that a comprehensive modernisation of the welfare systems was inevitable.*

## THE SIZE OF PUBLIC FINANCES IN HUNGARY: THE PARADOX OF A LARGE BUT WEAK STATE

Is the size of public finances in Hungary really too large? This question is easiest to answer by an international comparison. In Hungary, in the socialist system, the extent of state redistribution well exceeded the corresponding extent in capitalist welfare states. As a consequence, after the political change, Hungarian public



finance expenditures expressed in GDP percentage were above 60 per cent, which was 10–15 per cent higher than the extent characteristic of European welfare states at the time. *Chart 1* compares the major ratios of Hungarian public finances of the year 1992 to the corresponding data of Germany and the United Kingdom. The chart very well reveals that the inherited socialist system of redistribution may even be regarded a newborn welfare system: besides the debt management expenditure included in the operational expenditures of the state, it was welfare expenditure expressed as GDP percentage that significantly surpassed the corresponding GDP-proportionate expenditures in Germany and the UK.

It is worth comparing the situation with the one that developed by 2007 (see *Chart 2*).

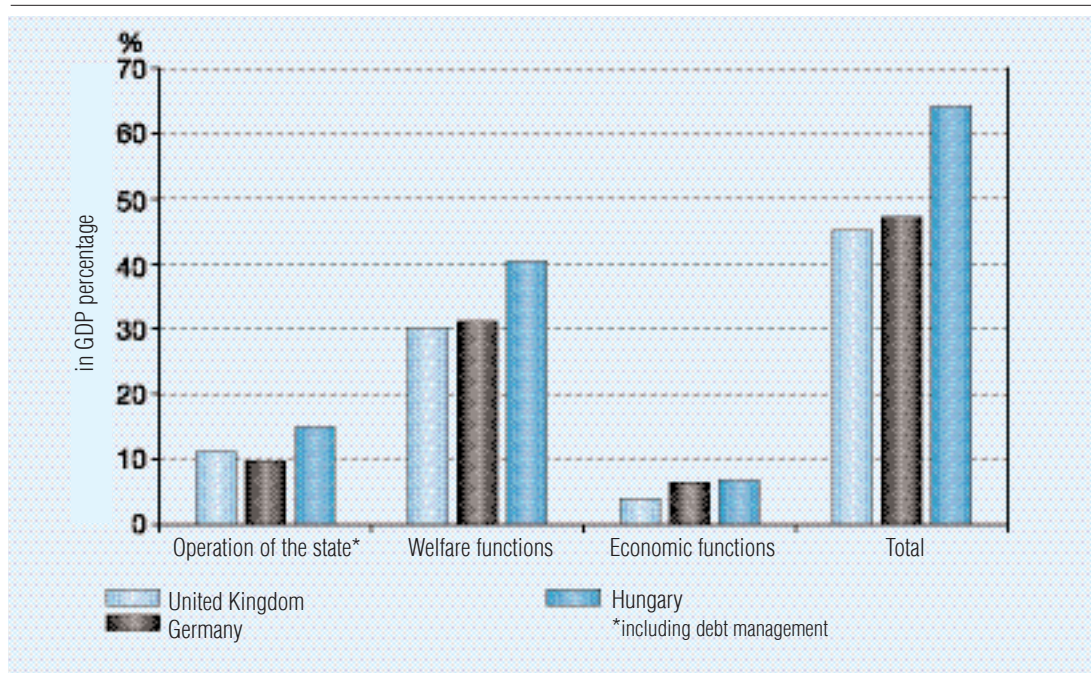
The chart clearly shows that Hungary, GDP proportionately, spent as much on welfare functions as Germany and the UK. Hungary

proportionately spent more than the other two countries on the operation of the state, the main reason of which was that the public debt interest expenditure had to be taken into account here. It is economic functions on which Hungary spends in fact more, GDP proportionately, than the two developed market economies.

After the two “snapshots” in Charts 1 and 2, *Chart 3* presents changes in the functional structure of government expenditures in Hungary in the percentage of GDP, from the political change until today. The chart very well shows that in 1995–1996, through a drastic reduction of welfare expenditures primarily, the size of Hungarian public finances shrank to approximately the average of European welfare states and essentially stayed at that level until 2001. From 2001, government expenditure expressed in GDP percentage started to rise once more, exceeding the carrying capacity of

*Chart 1*

**PUBLIC FINANCE EXPENDITURES – MAJOR FUNCTIONS (1992)**



Source: EUROSTAT data base

Chart 2

**PUBLIC FINANCE EXPENDITURES – MAJOR FUNCTIONS (2007)**

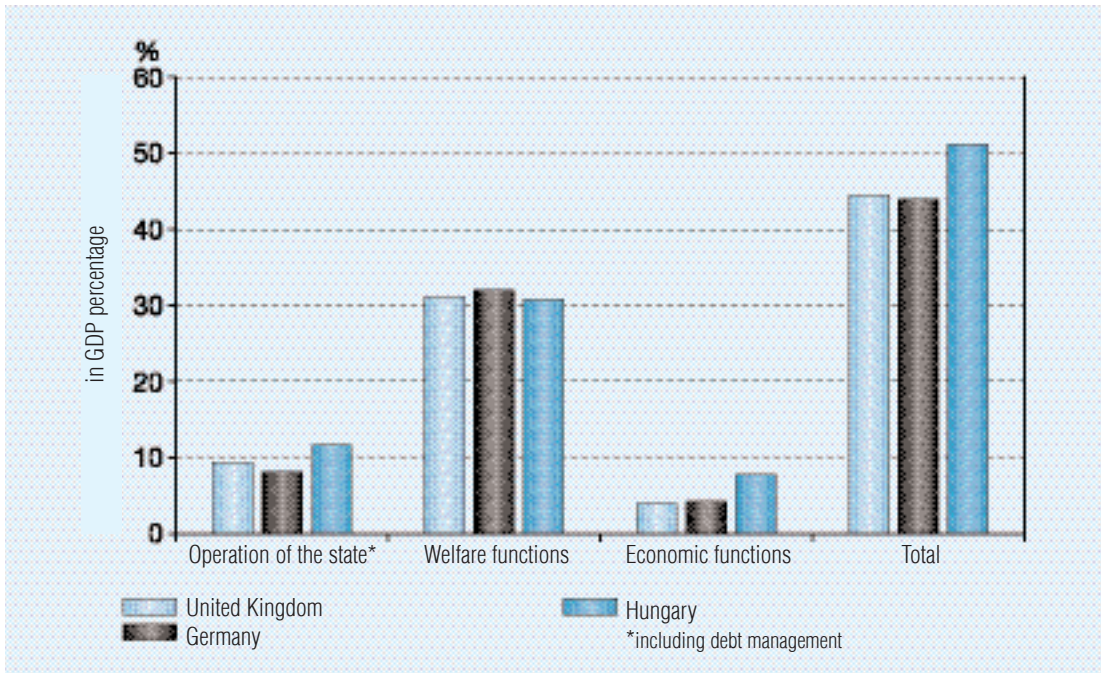
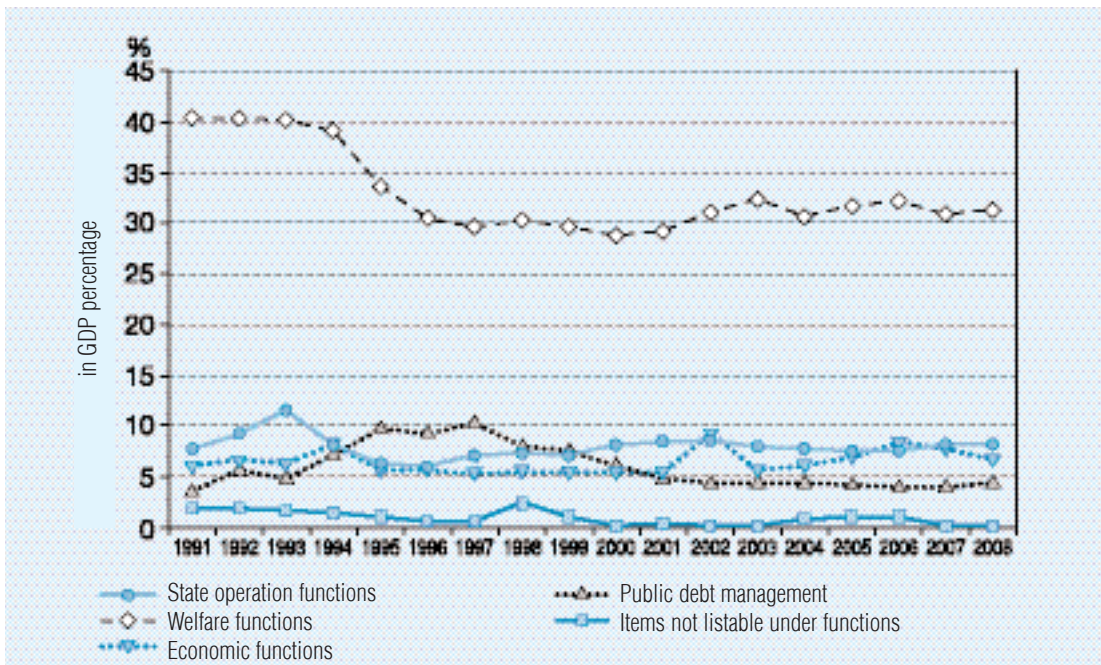


Chart 3

**PUBLIC FINANCE EXPENDITURES ACCORDING TO FUNCTIONS**



Source: Ministry of Finance data base, 2008: End of year accounts bill

the economy. This can be illustrated with the rise of the state debt compared to GDP from 2002 onwards (see Table 1).

High public debt involves significant financial burden due to the lacking authenticity of the economic policy and especially of financial policy within this, as well as the obvious lack of accordance between the monetary and fiscal policies. Considering the close correlation between public debt financing and the stability of the Hungarian currency, sustaining the recently attained improvement in authenticity and joining the Euro zone as soon as possible are issues of cardinal importance.

*Paradoxically, high public debt expenditures co-occur with a deteriorating quality of public services, a rise in social conflicts and a general lack of confidence.* All these phenomena demand that up-to-date budget planning methods and public funds management simultaneously serve the exploration of the reserves hidden in the “micro structure” of public finance expenditures and the improvement of public confidence.

### The main problems in the activity of the public sphere from the point of view of competitiveness

The state can make various contributions to the improvement of economic competitiveness. Ideally, it establishes and sustains the legal, social, political and institutional media and system of norms necessary for the activity of the competition sphere serving society, i.e. it creates a suitable business environment. In addition, it establishes the infrastructural con-

ditions that are essential for the competitive operation of the private sector and which the competition sphere is reluctant to establish due to the lack of market returns involved. In the age of knowledge-based societies, major areas of state contribution to competitiveness are education and R&D.

None of the competitiveness improving activities of the public sphere give reason for satisfaction at the moment. This is clearly reflected in a World Bank survey on business environments, according to which, in 2008:

- the Hungarian economy, relative to its level of development, is surpassed by 23 per cent of the countries;
- compared to Hungarian public institutions and local governments, it is in 46 per cent of the countries where the operation of the there public institutional system is a lesser burden for the business sphere;
- the backlog of Hungary is especially significant in the fields of authority procedures, the protection of investors, the certification of lawfully acquired property and the management of tax payment.

From the beginning of this decade, *Hungary* – as international comparisons, e.g. the IMD World Competitiveness Yearbook reveal – *has fallen increasingly behind in the country ranking in competitiveness.*

*In the ranking according to the summarised indicator of competitiveness, Hungary occupied only the 45<sup>th</sup> place in the year 2009, in contrast to the 27<sup>th</sup> place in 2000. Considering direct rivals, the country group comprising the Czech Republic, the Slovak Republic and Poland had the 34<sup>th</sup>*

Table 1

#### LEVEL OF PUBLIC DEBT EXPRESSED IN GDP PERCENTAGE

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Level of Debt	54.3	52.1	55.8	58.1	59.4	61.7	65.6	65.8	73.0	78.7

Source: Ministry of Finance

place in 2008, while it was still 39<sup>th</sup> in the year 2000. Another country group (Bulgaria and Romania) also improved its position in competitiveness: from the 45<sup>th</sup>, it advanced to the 42<sup>nd</sup> in 2008. It was an improvement in several of the sub-indicators of competitiveness that made it possible to overtake Hungary. In the case of Hungary, government efficiency deteriorated to a great extent, while Bulgaria and Romania strengthened their positions in this respect and the Czech Republic, the Slovak Republic and Poland were able to keep their earlier positions in the ranking. As regards the sub-indicator of business efficiency, Hungary once again worsened its position in this respect, too, while the other two country groups maintained their earlier positions. Regarding the sub-indicator expressing economic performance, Hungary's position deteriorated considerably, while Bulgaria and Romania sustained and the Czech Republic, the Slovak Republic and Poland improved their competitiveness status to some extent. Considering all indicators, it was only the field of infrastructure where Hungary was able to maintain its relative earlier position, similar to the country group comprising the Czech Republic, the Slovak Republic and Poland, while Bulgaria and Romania both improved their positions compared to previous years in 2008.

### The influence of party politics on public policies and the proliferation of rent seeking

Behind the weaknesses like the outlined non-occurrence of public finance reforms, the accumulation of high public finance deficit, of a decisive significance, and the insufficient public service and regulation activities of the public sphere, there were *political obstacles of various natures playing a significant role. These were partly of politics-nature and partly of policy-nature.*

Obstacles of politics nature include an extreme opposition of political forces and the lack of a consensus between the political elites, as a result of which the reforms launched by one government were tried to be annulled by the next government.<sup>10</sup> Another serious obstacle of politics-nature was the attitude of political parties governed by short-term goals like popularity hunting and the collection of votes. Maximising votes is a natural objective of political parties. At the same time, the initiatives of political parties in Hungary often failed to provide advantages to the targeted group of voters sustainable in the long run, instead, they led to measures easy to communicate and high sounding, which failed to produce permanent improvement in the living conditions of target groups, however. These anomalies were pointed out in several reports of the Audit Office as well as in the study of this research institute.<sup>11</sup>

Government measures with short-term effects and which therefore mutually destroyed the effects of one another are well illustrated by the changes in the salaries of the public sphere in the past 15 years. *Chart 4* presents the development of gross salaries compared to inflation in the competition and public spheres.

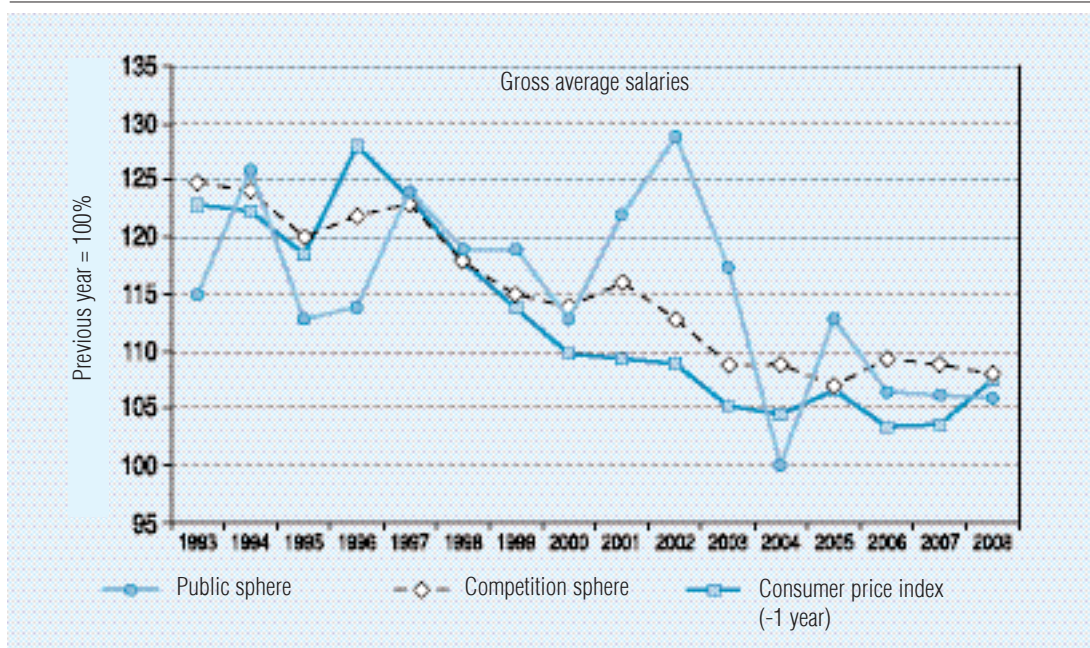
In a study analysing the macroeconomic risks of the 2008 budget<sup>12</sup> we highlighted upon an easy to follow tendency in salary development in the competition sphere: the rise in gross salaries was mostly adjusted to the inflation to the previous year.

The correlation is well illustrated by the chart. Even more obvious are the ups-and-downs in the development of salaries in the public sphere.<sup>13</sup> Here it was namely not economic regularities but the “logic” of politics that was implemented: in the years when the government in office strove to win the favour of public employees, significant salary rises were implemented, but at times when expenditures could be reduced with the least political



Chart 4

**THE ADJUSTMENT OF AVERAGE SALARIES TO INFLATION IN THE COMPETITION AND THE PUBLIC SPHERES 1993–2008, FULL-TIME EMPLOYEES, PREVIOUS YEAR = 100%**



Source: Central Statistical Office - Employment and salary ratios, institutional employment statistics

resistance by a decrease in the same salaries, public employees suffered a real salary cut.

*It was also characteristic of the shaping of public policies that individual policy branches were shaped by an excessive rivalling of the opinion forming and interest groups of the branches concerned, which, too, had several ties to party political influencing. A frequent consequence of this was, as was also pointed out by a growing number of Audit Office reports, that the professional goals or expected results of the policies were not formulated, while the professional, social, financial and budgetary effects were not sufficiently explored. Laws forced through with political motivation proved contradictory, unfinanceable and unimplementable in practice.*

The harmful political influencing experienced in the public sphere has been especially apparent in the following areas recently:

- in political cycle changes (in the changes apparent in macroeconomic processes in election years, the excessive public finance deficits in election years and in the contradictory development of investments spanning over government cycles);
- in the allocation mechanisms of state development subsidies and the operation of the cronyist systems being parts of these mechanisms, as well as in the existence of a significant level of corruption;
- in the financial dependence of local governments from the central government and
- in the strong party political affiliation of the majority of the civil sphere, in their ideological dividedness, the cohesive function of their own financial interest instead of the interests of the groups “represented” and in the lack of their so much needed genuine independence.

A direct consequence of party political influ-



ence, the weakened state (public administration) and the lack of a genuine civil control is the proliferation of *rent seeking*. Rent seeking denotes the forms of behaviour of economic players targeted at the creation, attainment or maintenance of rents in the economics sense. Rents in the economics sense (i.e. extra profit) are made when the owner of a resource, through a certain activity (or attitude) attains extras that would be impossible to attain by other uses of that resource, under genuine competition conditions. Rents produce higher yields for the owner of the resource concerned than the opportunity cost of the resource.

Rents (extra profit) are also attainable at the market, by getting into a monopoly position. Rent seeking occurs when market players try to attain rents by utilising for them favourable conditions of state rules or orders, or by influencing these conditions. The presentation of the operational mechanisms of rent hunting got into the focus of attention through the theory of community decision making.<sup>14</sup> Rent hunters strive to influence legislative, governmental or administrative measures that are aimed at changing the life situation of individual voters and some production, employment or consumer interest groups thereof, or have such effects as unintentional side effects of the measures. Accordingly, rents can be produced in two different ways:

- state decision makers intentionally favour some groups,
- rents are produced due to the deficiency of state decisions.

In the former case, the politicians elected, so as to increase their re-election chances, or the appointed bureaucrats, civil servants or administrators, so as to increase the resources at their disposal, grant monopoly rights in a certain circle of public goods, welfare or income transfers, to the producer or service groups producing these or to the groups of employees or consumers using them. It is important to empha-

size that this is a case of the bad operation of a political mechanism, i.e. it is about the imperfections of the government; it is not about corruption, but lawfully passed state measures. They pass a law, for example, that grants a special premium to a group of employees, or there is a ministry that makes too strict licensing requirements. The latter makes it necessary to recruit more employees to the department responsible for licensing while, at the same time, market entry is made more difficult: accordingly, those who do get a licence, acquire a rent.

According to the literature, the social costs of rent hunting at the political markets well exceed the total sum of the individual profits acquired by participation in it; this kind of rivalry should be regarded as clearly unproductive.<sup>15</sup> The realisations formulating the presence of rent hunting and the necessity of investigating into it were born based on the findings of empirical surveys on the operation of state regulation and it is the same findings that serve as a basis for estimations on the costs of rent hunting. While it should be kept in mind that the data are difficult to compare – calculations refer to various time periods and estimation procedures are different, too – empirical analyses suggest very high numerical values in rent hunting.<sup>16</sup>

*According to the findings of calculations made using data of India of the year 1968, the costs of rent hunting generated by regulation restrictions in state investment, foreign trade, product control, interest restrictions and railway services, amounted to 7.3 per cent of the national income. Another survey using data of Turkey also of the year 1968 found that foreign trade restrictions implemented by customs duties, taxes and other fees made the value of import licences incorporating the stake of rent hunting so high that it amounted to GNP 15 per cent. Analyses examining the effects of foreign trade restrictions on*

*the basis of data from 1980 estimated the costs of rent hunting to have reached GDP 38 per cent in Kenya and GNP 25–40 per cent in India. A survey published in 1975, using data of the United States, reveals that total social losses involved in rent hunting amounted to 3.3 per cent of the GNP. Estimations published in 1978 taking corporate production values as a reference basis show that social losses involved in rent hunting consume 7–13 per cent of the corporate production value in the United States and 4–7 per cent in the United Kingdom. According to the conclusions of an analysis investigating into the costs of rent hunting for welfare and income transfers, published in 1992, 10 per cent of the total value of government transfers in the United States are lost in the form of rent hunting costs.*

The mechanisms of rent hunting are also active in the Hungarian economy and society. This is indicated by the fact that in public finance expenditures, the weight of so-called economic expenditures can be considered high in international comparison (see Charts 1 and 2). Hungarian analyses examining the manifestations of the above present that various acts of state regulation, from foreign trade regulation to the subsidisation systems of agriculture and crisis branches, the utilisation of EU funds and public procurement procedures, are all marked by the signs of successful rent hunting as is shown by the examples of other countries.<sup>17</sup>

The social costs of rent hunting can be very high also in the Hungarian economy. A recent analysis in which numerical estimations, too, were made presents, for example, how and to what extent the significant public finance funds used for the implementation of a package of government measures aimed to foster the purchase of informatics instruments through tax credits were “tapped” by the mechanisms of rent hunting operating within the public pro-

urement rule system. Only 58 per cent of the “profit” of the state subsidy granted in the form of tax credits reached the consumer groups that were to have been the original beneficiaries, while 42 per cent of the state subsidy disappeared in the pockets of the distributors taking part in the project. During the implementation of the project, distributors earned rents worth an estimated amount of almost HUF 11bn.<sup>18</sup>

The destructive processes of rent hunting do not stop at the border of fiscal processes: the increasingly swirling vortices of “disorder”, “chaos” and anomie sooner or later carry along the whole state operation and the whole society with them.<sup>19</sup>

### The paradox of a large and inefficient government sector

It was through the processes described in the previous subchapters that the paradox of Hungarian public finance reforms developed, *i.e. that despite the hollowing of the state and the decrease in its performance, its size has stayed significant*. There are four fundamental reasons for the latter.

Public opinion believes *the number one reason* is the “overdeveloped” welfare system. On the basis of the above international comparison and the investigations of the Audit Office, the number one fundamental reason is that the economic sphere is given (back) too large sums from the central budget. Companies in Hungary (including those in foreign ownership) live, to a significant extent, on state expenditures (funds) and, considering this, the net tax burden rate of the entrepreneurial sphere is also significantly lower than the gross. The state subsidies granted to the economic sphere are unharmonised and wasteful; the cost level of state orders (public procurement) is unduly high.

*For the illustration of the above, let us quote a report of the Audit Office published in August 2009<sup>20</sup>: “In the investments audited, aspects of economic efficiency have not been given priority. The economic efficiency requirements of state investments or the requirements of state investors are not laid down in law and such requirements have not been set by the ministry exercising the ownership rights (Ministry of Economy and Transport, Ministry of Transport, Telecommunications and Energy Affairs), either. There have been no complex comparative calculations or analyses made to estimate the cost effects to be generated by relieving the road network around the motorways to be built (shorter travel times, lower environmental burden, lower fuel consumption, etc.). During our audits year by year, we have repeatedly found that, prior to motorway construction, there are no preliminary cost estimations or price calculations made based on a detailed unit price analysis. The engineer’s costs that NIF Zrt. (National Infrastructure Development Ltd.) had assessed for the implementation of the investments were based on earlier contractor’s costs, which also included the risk surcharges of the contractors. The estimation based on the former did not reveal the realistic costs of the respective motorway sections. The “lowest quotation on the whole” formulated in the public procurement act does not mean in itself the best quotation from the national economic point of view.”*

The *second* reason is that the political elite suffer from growing legitimacy problems, which they try to mitigate by granting financial favours to various groups of electors. As a consequence, instead of a comprehensive modernisation of the welfare systems, there have been newer and newer, on the whole unsustainable, elements appearing in the social security and social services system.

The *third* reason is the lack of a cooperation ability between political parties, as a result of which changes or developments started by one government, including investment projects to

serve several generations, have always been neglected by the next government in office.

The *fourth* reason is that, partly due to the lack of political consensus, even the reforms actually launched were discontinued or got stuck at the surface, not getting beyond various amendments made to financing regulations or the formal transformation of the organisations concerned.

*An Audit Office report<sup>21</sup> established the following on the basis of a recent investigation into the higher education reform, for example: “Under the Higher Education Act, the financing of higher education has been implemented in a multi-channel system (per capita support, tenders, agreements). The per capita support to be allocated is, however, not determined on the basis of the coverage required for the training or of performance requirements but is practically rendered as baseline funding, depending mostly (for 80 per cent) on the number of state funded students and to a lesser extent on the number of tutors/employees. Thus, institutions have a stake in increasing and maintaining student intake. The number of state funded students at the respective higher education institutions is determined, besides the number of applying students, by the annually changing ministry decisions. The current system of granting state funding, despite the competition for students of higher education institutions, has not contributed to the qualitative selection of the institutions. State funding is independent of the value judgement of the labour market and the students.” Understandably, the “semi reforms” launched in various fields of the public sphere every 3-4 years, which were then discontinued, have not led to a more efficient operation of the sphere.*

It should be mentioned as the number *five* reason that the efficiency of the utilisation of public moneys is rather low. The application of up-to-date planning and management methods is missing; alongside the above mentioned fre-

quent changes in financial conditions, ensuring survival until tomorrow has become a permanent goal in the lack of a strategic attitude; those in charge of public funds have developed adverse interest.

The state allowing rent hunting and postponing consistent reforms has become an obstacle to economic development ensuring catchup, which has been manifested in several ways. The most apparent of these has been the *deterioration of legal security*, which the state has triggered not only as a legislator but also as a law enforcer and, sometimes, even as a market player. There has been no improvement in the corruption situation. This is dangerous because, on the one hand, it causes direct growth losses through effectuating the leaking away of a significant part of the funds. It is estimated that, among countries of OECD, following Turkey, it is Hungary where the tax losses, caused by corruption and the interaction of tax rates with the high corruption,<sup>22</sup> are the highest (GDP 9.1 per cent). On the other hand, it is easy to see that foreign economic players have well adapted to the situation in Hungary, which will influence the circle and attitude of future foreign investors in Hungary.

### THE DIRECTIONS OF NECESSARY CHANGES IN THE OPERATION OF THE STATE

Just as the existence of market failures and market economic imperfections is a reason for state involvement, government failures are the natural consequences thereof. Government failures are corrected through various public sector reforms. In developed countries, there have developed various reform trends (strategies). These have included efforts to introduce different modern budgetary methods and to employ managements based on performance criteria. Under Hungary's specific conditions,

the state should not only guarantee the general conditions of competitiveness but, as has been pointed out several times, it should serve catchup as well. Therefore, what is required under the reform of the government sector is pragmatic solutions, a suitable mixture of various public reform strategies (*reform mix*).

*In the past period, the need to meet global requirements*, especially EU legal harmonisation and the performance of economic political and financial tasks following from the cooperation with international financial institutions, *has been a considerable adjustment pressure for the operation of the Hungarian state*. The latter were especially determinative in the 1990's. While this pressure has eased in the past few years, it is to get significantly stronger, temporarily, once again, as a consequence of the international financial and economic crisis and another case of large-scale foreign indebtedness. In spite of the latter, a strong dominance typical for the 1990's should not be expected to return, one reason for which is that, under the current conditions, even international organisations have surpassed the practice of the rigid implementation of the strict principles of the Washington Consensus. Accordingly, the consideration of national characteristics can be given more room in the practice of state operation.

*The expedient way and extent of state involvement can be determined starting from the paradox of "sustainable development – maintainable state"*. The most important task of the Hungarian state is to put the country on a new development track sustainable from economic, social as well as ecological aspects. In order to achieve this, it is especially important to overcome two difficulties. One is that, following from the transitional, catch-up character of Hungary, *economic growth is much less even than in developed countries*: it is a process broken by standstills and backslides. This phenomenon is caused by great external shock effects, macroeconomic volatility and income

differences as factors shortening growth periods. *Another factor* making the transition to a new track difficult is *the serious recession following as a consequence of the global financial and economic crisis and the drawn out stagnation involved* as well as the risk that markets will lose confidence in that the solvency of the state can be maintained.

As the first step to make in order to overcome these difficulties, supported by the experts of IMF, it is *essential to work out a strategy ensuring the maintenance of solvency*, one of the main pillars of which is to place the economic stimulation policy into a mid-term framework based on clear economic political principles, goals and an institutional system supporting these, and the other is to launch wide-scale genuine structural reforms in order to foster growth.

Related to these pillars, *there is a new task involved in the implementation of a development-oriented economic management recommended by the OECD and the World Bank*, the logical-contentual steps of which are: mutually established goals and strategies, the application of a performance or policy based budget, the operation of a decision-making system based on professional evidence as well as public accountability. For the operation of such an economic management system *it is essential to establish a multi-year national economic planning system*, including a mid-term budget framework and mid-term expenditure frameworks, which would remedy the state operational deficiency that the political, macroeconomic planning and budget making processes are not adequately harmonised. The establishment of the system would make it possible to prepare economic and social development alternatives for the society and the government that would offer genuine choice opportunities and at the same time help to prevent that the budget policy put too high a burden on the future generations but ensure that this policy

should be sufficiently flexible and adjustable in the medium and long run. The successful and smooth operation of the system certainly requires raising the operational standard of the government, keeping the law, employing a well trained and experienced civil service apparatus as well as the participation of civil society.

On the basis of the above it is obvious that the implementation of this major task requires the performance of a multitude of subtasks by the state. At the same time, *a major obstacle to sustainable development is exactly the fact that the competition sphere has to sustain a public sector of low efficiency compared to its size*. The only way to solve this contradiction is to improve the efficiency of Hungarian state operation. In what follows we shall list the most important fields where we believe that the Hungarian state operation should be significantly improved.

### Defining the contents of state functions and tasks and laying them down in regulations

Reducing state commitments and increasing the efficiency of task performance have usually appeared as goals in the policies of consecutive governments but their implementation has failed. The reform of the public sphere namely does not simply mean a need to reduce the size of the state or economise public expenditure. A higher standard of state services should be achieved by making the operation of the state more efficient. In order to achieve this, it is a *fundamental requirement to reconsider the contents of state tasks, define them in more detail and set related performance requirements*. Through this

- it is possible to create a clear framework for the budget, with transparent resource needs;
- in the knowledge of the tasks assumed and assumable by the state, more specific goals and performance indicators can be set,



whereby the opportunities of control and accountability improve;

- policies that fail to meet the expected requirements can be cancelled;
- the clear identification (determination) of state tasks improves the conditions of separating the authorities and ranges of duty between the central and local governments;
- there are better conditions to decide what and to what extent the state wishes to support by public funds in the civil sphere;
- the operation of the state becomes more transparent also for the “public”, which will strengthen political confidence, making a more stable governing possible, even the more so because a budget designed this way and the financing based thereon involve a better harmonisation of tasks and funds.

### Defining a future vision

Under the conditions of the globalised world, it is an unpostponable task for the state to design a social and economic “country target”, i.e. a politically formulated and professionally well grounded future vision, achievable and to be achieved, which is supported by the majority of society. *The “country target”, the future vision is basically a harmonised set of public political and professional political correlations, values and targets.*<sup>23</sup>

From this statement it also follows that *without a clearly formulated future vision it does not make much sense to talk about development policy or competitiveness* and the debates, scientific research or political statements in the issue of “the most competitive public sphere” also become very shaky. It is a basic message thus that this comprehensive target identification cannot be avoided in any way; without this, any shaping of an efficient public sphere is doubtful, its implementation shaky and its end result unpredictable.

### Establishing a national economy planning system

Designing a future vision and keeping it continuously “in condition”, harmonising state tasks, require the establishment of a national economic planning system and its construction as soon as possible.

*The system to be established must guarantee, as a most important characteristic feature, the institutional harmonisation of real development* (national development concept and plan, regional development, settlement development, economy development, the development of the social and cultural spheres) *and financial planning* (the convergence policy and the annual budget at both the central and local levels). Another requirement of this system is that, keeping the requirements of the *development policy and economic competitiveness in view*, it must incorporate structural reforms into the development plans.

Two policies of the New Hungary Development Plan (the State Reform and the Electronic Administration Operative Policies) may provide direct funds for the purpose of designing a planning system serving the establishment of a modern state with a developing function.

### Mapping out national development strategies

It is a widely recognised and recommended fact related to the practical implementation of sustainable development that states (governments) should work out national development strategies that present requirements in an integrated way. In order to help mapping out such strategies, *the United Nations and OECD have worked out guidelines to follow*, the most important elements of which are the integration of policies, the frameworks connecting genera-

tions, coordination and institutional relations, the harmonisation of local and regional management as well as monitoring and evaluation. In the case of Hungary, these guidelines were used by the government when working out a document on the national sustainable development strategy.

*A remarkable attempt has been made for outlining a development strategy with view to the requirements of sustainable development also on the part of the Audit Office.*<sup>24</sup> The study referred analyses the arguments for and against the application of two alternative development scenarios: a scenario creating the basis for sustainable development by improving competitiveness and the other one putting the emphasis on sustaining and strengthening social cohesion, coming to the conclusion that, for Hungary, at this stage of development, the most expedient solution would be the conscious utilisation of some of the elements of both scenarios more or less simultaneously, in a harmonised way.

For development strategies constructed from such bases, *it is a major challenge to treat the pressure caused by the effects of the international economic and financial crisis in serving the public good and social cohesion.* It is necessary to fairly distribute in society the longer-term adverse effects and burdens of the crisis in a way that all members of society and not only or excessively social strata who are poor or have weak interest representation abilities should have a share. On the other hand, it is important to consider that, as a consequence of the crisis and other development factors, economic growth has been slowing down and there is less income to distribute, while social costs have been increasing due to the ageing of the population, among others.

Even though the tasks of the state are of special importance from the point of view of serving the public good and social cohesion, in this activity it is essential not only to use the achievements of the well-established, usual

social dialogue but, in the spirit of the EU guidelines, also to construct and introduce a wider scale civil dialogue. *The creation of the basis of sustainable development can thus best be fostered by working out a national development strategy in which strengthening economic competitiveness and increasing the public good, social cohesion and the role civil society are interconnected.*

In the implementation of the requirements of sustainable development, high level state or civil (independent) committees which, on the one hand, help work out and continuously update the strategies and, on the other hand, control the government's implementation of the strategy partly considering the aspect if the professional documents are prepared in accordance with the strategy on sustainable development, also play an important role. In Hungary, the National Sustainable Development Council has been established and started operation with the latter authority.

### Improving competitiveness

As has been reported above, Hungary, since the beginning of this decade, has increasingly fallen behind in the country ranking regarding competitiveness. The state, too, has a significant role in the attempts to change the situation. From the supply factors of competitiveness, the role of the state is apparent in two fields primarily: in economic policy and economic regulation. With reference to the latter, it is necessary that the state pay attention to the business environment, taxation, infrastructure, education, research and development as well as human resources. The direct subsidies applied in the case of some of these factors often lead to the distortion of market competition, because of which it is advisable to replace the majority of them, in the field of innovation, for example, by indirect, market oriented subsidies. As regards

infrastructure, the implementation of e-administration seems especially important. A third important area of state involvement is the tasks of reforming education, especially higher education, based on definitive qualitative criteria, and of narrowing the excessively decentralised institutional system.

*The situation that companies regard the public sphere as a serious obstacle factor for the expeditious operation of the economy must be changed urgently.* This requires the following major changes:

- reducing the tax burden, ensuring a more even taxation, increasing the service nature of tax administration, simplifying regulations on the various taxes and contributions;
- creating a stable business regulatory environment;
- reducing administrative burden, improving the quality of administration and raising the ethical level of state institutions;
- developing line infrastructure and human infrastructure;
- consolidating the situation of the small and medium enterprise sector, working out policies fostering its development and applying subsidies, with regard to the facts that this sector has generated considerable economic growth in the past years but has been hard hit by the current economic and financial crisis;
- curtailing the black economy and corruption as soon as possible;
- fostering a more even regional development.

### Public institutional reforms

*For the state to be able to perform an efficient activity in increasing competitiveness, it is essential to launch major, EU conform public institutional reforms in Hungary. The public finance regulation theses of the Audit Office as well as the reform trends in EU and OECD countries may serve as good starting points for this:*

- instead of the concept of transparency, the attention is focused on meeting the requirement of openness which, in addition to transparency, includes citizens' accessibility to information as well as the demand of fast response;
- the raising of the service standard of public institutions, with special attention to a new and genuine performance orientedness in public services;
- the transformation of institutional organisational conditions by decentralisation and by meeting global challenges;
- the considerate application of various forms of market-type mechanisms.<sup>25</sup>

### Strengthening the role of civil society

The organisations of civil society may play an important role in improving competitiveness.

A prerequisite for fostering the above is the performance of the following major activities:

- increasing investment in human capital with the aims of an institutional development improving the educational, health and social situation of the population and a value-oriented community building;
- involving civil organisations in the formation of the government's social and economic policies;
- maintaining an interest harmonisation based on a regular dialogue for civil organisations;
- establishing flexible partnership and financial relations on the part of government institutions;
- harmonising the activities of nonprofit enterprise supporting organisations and making them thus more efficient.

It is important that the performance of these tasks couple with a fundamental change of attitudes that meets the requirement of "governance" type governing, i.e. that the civil sphere,

in addition to the state administration and the business private sphere, should be a recognised and acknowledged third player, an equal partner, in the management of state operation.

### Reducing the volume of redistribution and improving its purposefulness

The scope of redistribution is determined by EU expectations, social-economic changes, the related interest and power relations as well as historical traditions. Within this framework, there are *four factors of determinative significance for state involvement: fostering economic growth and employment, improving competitiveness, stabilising economic cycles and strengthening social cohesion*. Among these, on the basis of international and Hungarian experience, the first two factors can typically be served by low redistribution and the third and fourth factors by higher redistribution.

The demand for higher redistribution is primarily important for strengthening social cohesion so that the state could mitigate market imperfections related to income distribution as much as possible. Considering the current large-scale economic decline, the rather high redistribution rate and even its rise in the past few years, in the case of Hungary it is a state task considerable from several aspects to reduce the volume of redistribution and change its structure, including the purposeful amendment of tax rates and budget expenditures, in a way fostering economic growth and helping the improvement of competitiveness. The latter could be made possible by income reallocation to the fields of research and education.

### Strengthening state (financial) control

*An important condition for the institutional responses to the new challenges is the effort to*

*strive for good governance*, meeting the requirements of good governance like accountability, transparency and openness. Transparency makes it possible for those concerned to oversee the tasks of the government, its political intentions, etc. A prerequisite for this is that those in authority could be held accountable and called to account for their decisions. The component of control, as a part of transparency, is inevitably reevaluated and put into the foreground, both in the public and private spheres.

One reason why the role of the Audit Office changes in order to foster good governance is that, in its activities, the emphasis is shifted to counselling, for the Parliament primarily, since improving the quality of state and government activities is a most important goal. *The Audit Office as an organ with auditing and counselling functions may contribute to establishing efficient government control to a great extent*. It is important, at the same time, that the Office retain its independence and avoid direct involvement in determining government policy since the latter is in the authority of the legislation and government organs.

Also as a consequence of the social transformation involved in globalisation, the auditing authority of the Audit Office has been widening fast. A new area of Audit Office auditing posing a major challenge is sustainable development auditing. These audits usually comprise comparisons by which the actual situation is compared to the desired development. The basis for these is the requirements (standards) on which the auditors and the audited institutions agree upon. The standards may be taken from international agreements or laws, national laws, policy targets and commitments, the operational requirements endorsed by the organisations concerned or the procedures frequently used in the international practice, meeting the requirement of best practices. *Beyond strategic goals, the audit of sustainable*

*development must cover the implementation of these goals, the measuring of the process, the reporting on the implementation as well as accountability.*

The wider auditing authority is also reflected in the aspect that, *instead of the auditing of short term financial management, longer-term performance oriented evaluation is put into the foreground.* The government, too, increasingly prefers long-term control. Therefore, changing the approach of auditing helps the government to become more performance oriented.

### Strengthening social cohesion

Alongside the above illustrated political will striving to mitigate great societal income differences, it is a task of special importance for serving the public good to strengthen social cohesion by improving the situation of declining social groups and underdeveloped regions. Considering declining social groups (a considerable part of the Roma population, the untrained youth in villages and small towns as well as untrained immigrants), it is fostering the catchup of the Roma population in an increasingly serious situation that should be in the focus of state policy.<sup>26</sup>

### Modernising public finance management

The basis for the necessary modernisation of public policy fields and the condition of the long-term sustainability of the budget is a much improved operation of public finance management. *Any type of reform in the government sector demands the comprehensive modernisation of the public finance system.* The reason for this is the role of finances as fine tuning mechanisms. Society, including the government sector, is a living, organic, constantly

changing system in which, we believe, it is impossible to introduce ultimate ideal solutions. Paradigmatic, reform-level changes take place with a frequency of once in several decades. The corrections that seem to be necessary on the basis of the operational experience of paradigmatic changes can be most flexibly performed exactly by financial stimulators and curbs. Certainly, *the financial situation is at the same time the indicator of the health or illness of the system. This is also obvious from our earlier diagnosis about the paradox of a large and inefficient state.*

The renewal of public finance regulation serves a double goal. Its immediate goal is to set rules, establish institutions and find technical solutions that make the management of public finances more transparent, predictable and efficient both at the level of the national economy and local governments and at the level of institutions. The ultimate goal is, however, that, through the better operation of the public finance system, the improvement of public finance equilibrium and the growth of confidence in the former, the external and internal conditions of competitiveness and sustainable development should improve. In what follows, we shall determine in more detail some of the tasks involved in the renewal of public finance regulation.

### ■ *Implementing the principles of good governance in public finance regulation*

Some principles of public finance regulation follow from the democratic state order. In the formulation of other principles, the documents of several international organisations may be taken as a basis since, in the past 10-15 years, these organisations have declared several principles of good governance, contrasting these with the practices of certain countries (cf. the box below). It is important that the new regulation, in its spirit, reflect international standards. These are, in the field of statistics, the



GFS and ESA95; in accounting, the IFAC Public Sector and IPSAS- standards; in external control, the guidelines and standards of INTO-SAI, as well as the COSO and COBIT standards laying down the principles of internal control systems, and the internal control standards of IIA.

Under today's public conditions, transparency is a value that must be represented at several parts of the legislation on public finance management as an important objective to achieve. Transparency is a justified expectation of all players having to do with public finances. According to the relevant document of the International Monetary Fund, the implementation of transparency is ensured by the following factors:

- the straightforward determination of tasks and authorities,
- wide access to the accumulated information,
- the publicity of budget making, implementation and reporting,
- fair management.

■ **Renewing budget planning**

*The practice of budget planning in Hungary must be renewed paradigmatically.* The current institution-oriented baseline planning is unsuitable both for the implementation of performance requirements and for creating a basis for the necessary structural changes. The current practice of residue planning conveys unilateral, fiscal aspects to sector players who, applying the adequate techniques, are able to adjust to these constraints. There is no alternative to following the goals of financial equilibrium but, without these changes, the recreation of equilibrium problems comes as a rule. From the countries ahead of us, many have proved that the performance requirements of the public sector as a whole, its branches and the individual players produce welfare excess.

At the planning of appropriations, the goal of the proposed expenditure, the way to achieve

the goal, as well as the justification of the suggested resources and of the amount of expenditure must be presented. For the identification and accountability of the goals, performance indicators are to be widely used. In the case of appropriation changes, the same requirement must be implemented. Performance-orientedness is guaranteed by introducing the practice of program-based budgeting to fields of expenditure where performance can be measured or the conditions for it can be created and the monitoring of budget implementation as well as the institutionalisation of performance control are possible.

**THE PRINCIPLES  
OF GOOD GOVERNANCE**

Under the conditions of globalisation, there are uniformisation tendencies experienced in the operation of the state as well as the performance of public tasks. Some of these processes are due to nation states' following good examples and adopting good international practices. Some of the international organisations are catalysts to the uniformisation process. Within the framework of this, they formulate rules obligatory to follow as well as various guidelines for their member states. OECD, for instance, has worked out an efficient system of regulatory principles for the trade and investment policies to be followed by the states, which has set both procedural and conceptual values, as follows:

- the transparency and openness of decision making processes,
- the lack of discrimination,
- the avoidance of unnecessary trade restrictions,
- the application of internationally harmonised measures,
- the acceptance of valid regulatory measures applied in other countries,
- the application of the principles of economic competition.

The White Book of the European Commission on the European Governance names the following principles as the criteria of good governance:

- openness,
- participation,
- accountability,
- efficiency,
- coherence.

The logic of the application of program budgeting and performance indicators is that resource (input) needs are calculated on the basis of the results and the expected output. The quality and volume of outputs must be justified just like the volume and composition of the necessary inputs. This planning procedure “guards” the purposeful spending of public moneys: the procedure of accepting expenditure targets and resource needs does not only produce savings but, to a significant extent, automatically filters out the possibilities of illegal spending and overinvoicing.

So as to foster this reform-level changes, the following tasks must be performed:

- summarising international experience,
- on the basis of the international experience, identifying the areas of application of program budgeting in Hungary and working out an application methodology meeting Hungarian conditions,
- during budget planning, selecting the pilot fields to apply the methodology. Potential fields include: environment protection, health care, higher education and economy development as well as local governments. In the case of the central budget, one of the starting aspects in the selection may be the rate of what are referred to as chapter managed appropriations within chapter expenditures, the other is the rate of EU subsidised projects within chapter managed appropriations.

If the suggested changes are implemented,

the planning of the expenditure side should be made in two main clusters. Some of the expenditures are to be planned with the method of program budgeting. This method is to be applied where significant structural changes are required and/or there are explorable resource reserves. In another segment, planning should continue to follow in an institution-centred way, starting from the resource needs of the sustained level of the capacities that seem necessary. This principle typically holds for public authority organisations, i.e. to state authority, administrative, justice, defence and law enforcement fields. Here it is exceptional if the performance of tasks is assigned to an organ outside the budget order. In this case, the voting unit is the institution. In the case of institutions, some natural and fundamentally typical input data (the size of the staff, office area, number of equipment, etc.) can also serve as the basis for appropriations. The budget decision here refers to the approval of the justified character of the planned resources. The planning of these capacities does not necessarily mean baseline planning. It is possible that, through different screenings, the given capacity can be guaranteed by a different combination of resources or that, in the case of a new task, the item of expenditure is produced by zero-based planning.

#### ■ *Modernising the public finance information system*

An information system (be that statistics or accounting) is always to be established according to certain decision aspects. A modern practice is unimaginable without a well constructed and organised information system. Macro and mezzo level information meet the interest of those outside the circle of executors in the public sector, primarily of taxpayers, the political bodies representing them, international organisations, creditors, investors, etc.

The first field of information management is

accounting. This includes the rules of book keeping, the reporting system, the accounting policy (e.g. the evaluation principles of instruments and sources, consolidation methods, etc.). Despite efforts, state accounting, as regards its specificities, does not by far dispose of internationally accepted principles either in book keeping, or in the reporting system or in accounting policy. Regulation has a wide scope of action. What should be reasonably kept in mind is that the new practice should not contradict international expectations, it should adequately support the implementation of the principles laid down in the legislation and should avoid causing extra costs.

At the level of economic entities, the partial accrual approach of book keeping should be followed. During the transition to this, all aspects must be treated carefully, with special attention devoted to the management of amortisation. In the international practice, there are considerable differences in the latter field.

Transition to any type of an accrual approach takes 4–5 years at the minimum. It also involves significant personnel and transaction costs. Before the actual decision making, a cost-profit analysis must be made. There are also examples for a gradual transition and the introduction of the new practice to various public finance segments in various ways.

We believe that, without the solution of this multitude of subtasks, it is impossible to give the right answers to either the challenges caused by the current global crisis or those following from the dead-end nature of the economic policy of the Hungarian political change followed after 1990, despite the frequent attempts to find a way out. It is therefore imperative to prepare the modernisation of the operation of the state as fast as possible and ensure its possibly soonest implementation.

## NOTES

<sup>1</sup> For a summary of the research serving as the basis for the theses, see Báger – Vigvári (2007)

<sup>2</sup> For an analysis on the operation of the Hungarian local government system, see Vigvári (2009)

<sup>3</sup> Report on the Control of the Operation of the Treasury System (0918)

<sup>4</sup> Kovács Á. (2009)

<sup>5</sup> This similarly holds for state-owned business organisations certainly.

<sup>6</sup> Report on the audit on the financial management system of local governments in the year 2008 (0927)

<sup>7</sup> Report at the chapter on the Ministry of Education and Culture on the utilisation of financial means spent on the financing of public educational tasks (0807)

<sup>8</sup> For the effects of privatisation, see Báger – Kovács, (2004)

<sup>9</sup> The referred version of the strategy was passed by the government on June 29, 2007 and was published on the homepage of the National Development Agency.

<sup>10</sup> This process is well illustrated by a study of the Research and Development Institute on a section of health care reforms (in-patient care), published in 2003. SAO RDI (2003).

<sup>11</sup> SAO RDI (2007) pp. 49–88

<sup>12</sup> SAO RDI (2008a) and Báger – Pulay (2008)

<sup>13</sup> The fluctuations were made stronger by the fact that 13th month salary payment was shifted to and fro between respective years.

- <sup>14</sup> Csontos (1997)
- <sup>15</sup> Lőrincz (2007)
- <sup>16</sup> Lőrincz (2007)
- <sup>17</sup> Csontos (1996), Nemes (2005), Borkó – Oszlay (2007)
- <sup>18</sup> Édes (2007)
- <sup>19</sup> Sajó (2008).
- <sup>20</sup> Report on the audit of motorway investments to be completed in 2008 (0926)
- <sup>21</sup> Report on the audit on the implementation of the Higher Education Act (0915)
- <sup>22</sup> (2009), p. 54
- <sup>23</sup> This line of thought is elaborated on in more detail by Pulay (2009)
- <sup>24</sup> See Kovács Á. (2005)
- <sup>25</sup> For details on these reform trends, see Jenei (2008)
- <sup>26</sup> For more details, cf. SAO-RDI (2008b) and Benkő – Pulay (2009)

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