András Vigvári

A possible path to implement public finance reforms[1]

REFORMS AND THEIR SOCIAL ENVIRONMENT

The foremost question to clarify is what is meant by reforms or reform-equivalent changes. The authors of this study agree with the concepts that say it is the changes in the operation methods of a reformed system and the difference in the approach of entities participating in the system. An improvement in the performance of the system is the essence of the changes. The study intentionally avoids using the term "state finance reforms", the phrase "public finance reforms" is used instead. That the former has been fairly jaded over the years is not the main reason, nor the fact that the international terminology uses the second phrase. The decisive factor in our decision has been the fact that in the Hungarian practice budget reforms are tied to the political and economic transformation, and the term means one of the methods of denationalisation (streamlining the state's roles and capacities) [Hetényi, (1996), page 7]. Conclusion of the political transformation, accession to the European Union, and ensuring global competitiveness[2] result in new functions for the government sector[3], and the transformation of these functions into government roles presumes new capacities (capacity building) and new organisation, thus new institutions.

Restructuring public sectors is on the agenda in each of the medium-developed and developed countries. At the end of the 20th century and the beginning of the 21st, politics in these countries face two severe challenges. One is the fiscal problem that increasing demands for resources stemming from an expansion in the achievements of the public sector and also the demands and expectations from the public sector can no longer be ensured in the old way. This tension has created several reasons that intensify one another. Without establishing a priority order, the unsustainability of mandatory pension systems generated by employment and demographic reasons, the productivity and performance problems of the public sector, the impacts on competition and adverse affects of tax war created by the mobility of capital shall be more than ample reference.

The other problem is the legitimacy of the civic democratic political system, and voters' judgement on it. There's no denying it, common belief in resolving various social problems by political measures has been constantly eroding for many reasons other than fiscal tensions. The operation of the political market, and also the cycles adjusting to it, is in ever sharpening contrast with new features of the government's roles, the enforceability of strategic approach[4] and the funding possibilities of the public sector.

For widely known economic reasons, the state and the public finance system in Hungary has also served since the early 1980's the withdrawal of funds to ensure external debt servicing and an improvement of the country's balance of payments. Since this period, operation methods and reflexes-“vegetative processes” in the words of *Kornai*-have developed that, if left unchanged, do not allow the country to progress. No other example shall be given than the budget institutions' unbridled drive to increase their own revenues or the funding control that urge local municipalities to live off their assets. Budget laxity intended to compensate for the intensifying under-financed nature of the sector. The idea of state councils, and later the unified municipality cash funds and self-financing municipalities actually served the withdrawal of funds. No transparency or accountability can be demanded from such a system. On the contrary. It is in the basic interest of regulators to maintain an information asymmetry, the method of obscuring the nature of processes as much as possible in order to avoid political conflicts. In this operating method the cynical camaraderie of 'I won't pay your costs of providing services and in return I don't care how you raise the money to survive' has prevailed.

Implemented as a result of the political transformation, the unavoidable liberalisation, deregulation and privatisation have reduced, disarmed and emptied the traditional state. It is the paradox of public sector reforms in Hungary that the bulk of public finances has remained sizeable compared with the state's diminishing role and a decrease in its performance and efficiency. It has three core reasons. The first, efficient benefit-hunting[5] activities of various economic lobby groups, that is, corporations operating in Hungary (including foreign-owned ones as well) live off government expenditures at a large extent. Thus, the high level of public spending is generated by the private sector. Secondly, the Hungarian political elite is struggling with growing problems of legitimacy, trying to mitigate it by giving away funds to various voting strata. Apart from the aforementioned system of housing subsidies, blatant examples of it are the pension bid neglecting the achievement of the pension reforms of 1997, which does not lack mistakes, and also the postponement of the implementation of institutional reforms and tuition fees in higher education. The third reason is the political parties' lack of cooperation abilities. Altering courses in the public sector in the wake of government changes, including multigeneration investment programs, are factors that boost the sector's “overhead”. Thus weakened, the state has become an obstacle to economic progress ensuring convergence, indicated by a number of signs. The most glaring of them is a further deterioration of legal security, generated by the state not only as a legislator but also as a law enforcement authority and at times even as a market player. The situation of corruption[6] seems to be deteriorating, instead of improving. On the one hand, this incorporates dangers because, by sapping away a large bulk of funds, it causes an indirect damage to economic expansion. On the other, foreign market players have apparently adapted to the local conditions, and it has impacts on the scope and behaviour of foreign entities investing in Hungary in the future. Downsized and having ever-decreasing powers of action, the state has to be modernised and reinforced to be able to perform its new roles.

The complexity of this task is reflected well by a coincidence of the need to establish a modern state and the pressure of establishing budget stabilisation. In many cases pressure finds its way easier than long-term interests do. Budget stabilisation is a must primarily due to risks stemming from the country's small size. The Hungarian forint is likely to become a target of currency speculations again, which may lead to a currency crisis whose social costs and impacts on modernisation processes are immeasurable. The country's high exposure to financial markets, however, increases the significance of various symbolic reforms and other government measures that can be communicated well, as large financial investors do not really base their decisions on in-depth knowledge of a country but on various standard information sources. *Table 1* demonstrates Hungary's performance regarding fiscal convergence criteria and the composition of state debt. The table reveals a significant increase in debt generated by the deficits of the health care insurance fund and pension insurance fund. It's a warning sign that the ratio of the municipality sectors is growing within the consolidated debt. A contraction in the portfolio of government securities within public finances reflects municipalities' thinning cash reserves. *Table 2* demonstrates changes in economic sectors' net financing abilities. The table indicates that the funding demand of the public sector has been constantly growing since 2000. At the beginning of the period, the population was the most significant domestic provider of funds, but the corporate sector also recorded a huge debt ratio. By the end of the period, however, retail savings had diminished (to nearly zero by 2003), and the financing demand of the corporate circles also decreased. The erosion of retail savings occurred primarily on the back of the housing subsidy system and to a lesser extent other consumer loans. Therefore, the housing boom, fuelled by interest rate subsidies, acted as a particular twin-deficit factor. The table demonstrates the development of twin deficit well; the public sector gap is mostly financed by foreign funds. The vulnerability of the Hungarian economy is further increased by the fact that the proportion of items denominated in foreign currencies are higher and higher within debt-generating external funding, meaning domestic market players are increasingly burdened by exchange rate risks. The exposure cannot be simplified as the size of debts denominated in foreign currencies. Purchased by foreigners, the portfolio of forint-denominated government securities is also a risk factor, as trading with forint-denominated government securities has impacts on the forint's exchange rate as well. The bulk of government securities held by foreign entities is estimated by the National Bank of Hungary to be HUF 2,500 billion. This sum equals EUR 10 billion roughly. Just for the sake of comparison, the amount of foreign exchange reserves held by NBH is around 15 billion euros.

Table 1

SOME FIGURES RELATED TO FISCAL CONVERGENCE CRITERIA

(in percentage of GDP)

Item	2000	2001	2002	2003	2004
Primary balance*	1.5	1.0	–6.3	–2.5	–0.5
Government sector deficit*	–3.0	–3.5	–8.5	–6.5	–5.4
Government sector expenditures on investments and subsidies*	3.2	3.8	4.9	3.4	3.5
Consolidated state debt*	55.4	52.2	55.5	57.4	57.6
Government securities held within public sector	0.7	0.8	0.5	0.3	0.4
Pension fund deficit	– 0.13	0.01	– 0.08	– 0.21	– 0.39
Health care fund deficit	– 0.48	– 0.20	– 0.51	– 1.61	– 1.68
Debts of local municipalities sector	0.8	0.8	1.1	1.2	1.3

Source: Ministry of Finance data
*In accordance with ESA 95

Table 2

ECONOMIC SECTORS' FINANCING POSITIONS IN TERMS OF GDP

(per cent)

	1999	2000	2001	2002	2003	2004
Public sector	–5.9	–4.2	–5.2	–8.8	–8.4	–8.3
Households	7.0	5.9	5.4	2.7	0.2	2.0
Corporations	–8.9	–9.8	–5.8	–0.7	–0.4	–2.2
Foreign	–7.8	–8.1	–5.6	–6.8	–8.7	–8.5
Current account balance	–7.8	–8.7	–6.3	–7.1	–8.7	–8.8
Private sector	–1.9	–3.9	–0.4	2.0	–0.3	–0.2

Source: NBH

This is the reason why it is in Hungary's eminent interest to adopt the European common currency at the earliest date possible-but at least along with Poland and the Czech Republic. This, and the requirements of euro adoption (nominal convergence) cause real conflicts in the steps leading to convergence (real convergence). Increasing absorption capacities and public sector reforms shall be implemented in sync with budget stabilisation. Of course, the contradiction between these goals is not irreconcilable, because the solution in both cases is delivered by structural reforms. The conflict stems from a time lapse in the impacts of structural reforms. Nevertheless, adjustments should be made in the short term, causing further erosion in absorption capacities because of inadequate tools and in lack of structural measures and thus hindering real convergence. The conflict between real convergence and nominal convergence is present in the area of institute development as well. Reinforcing the mid-level of municipality scope and bolstering the revenues of local municipalities make the implementation of fiscal stability even harder. Fiscal stability shall be regarded as a public property incorporating public interests, whose advantages are enjoyed by all, but their consent needs to be coerced. General experience indicates [for example Kopits (ed.), (2004), and Daflon (ed.), (2002)] that sub-national administrations with adequate financial independence tend to take free rides. It means decentralisation should be supplemented by stability institutes that do not impair the advantages of decentralisation.

REFORM OF THE PUBLIC FINANCE SYSTEM

As in the other areas of reforms, the two-stage approach shall be applied in public finance reforms (Ágh, 2006). In the first cycle-spanning between 2006 and 2010-the financing and institutional conditions of public finance reform and public administration reform shall be created by taking the criteria of euro adoption into consideration. Care should be taken so as stabilisation measures will not arrest future reforms. In this scope, steps in institution development and legislation can be made, which-with a pinch of salt-do not cost any money. In the second stage-the government term between 2010 and 2014-the achievements of public sector reforms shall be stabilised, and corrections made wherever necessary.

In the present situation it would be a mistake to confuse budget stabilisation with necessary reforms. Restructuring the public finance system in a reform-equivalent way is a time-consuming process, whereas stabilisation should be done in the short term. Albeit successful, the stabilisation program of 1995 should be mentioned, as it has failed to alter substantially the operation method of the public sector despite its objectives and partially implemented measures. Hungary's economy is in a special position, therefore in the area of institution development, special solutions are needed that cannot be copied from elsewhere.

The success and systematic approach of reforms are ensured by two factors:

- consistency of the contents of restructuring processes implemented in various subsystems of the public sector,
- adequate timing for various steps.

Reforms, however, are not carried out in a vacuum, thus the art of the politics of the time is to enforce these aspects to achieve a near-optimum status. The role of experts is to define frames for political manoeuvring that keep processes within the boundaries of reform-equivalent changes. In the 10 years ahead, the focal points, or, so to say, strategic objectives of public finance reforms are as follows:

- increasing accountability and transparency by improving the conditions of control and information,
- bolstering the performance and operational efficiency of the central government,
- increasing the performance and absorption capacities of the local municipality system,
- improving state asset management,
- ensuring budget stability,
- improving the quality of national economic planning by leaps and bounds,
- restructuring the system of public burdens.

BASIC FEATURES OF PUBLIC FINANCE REFORMS

In this section, one of the segments-of course a key component-of public sector reforms, the restructuring of the public finance system is addressed. As a starting point, the functions of the system are outlined. The overview shows that it takes a complex system to enforce these functions. Actual solutions ensuring enforcement of functions depend on a number of factors, including economic development, the country's size, the public administration system, etc.

A well-operating public finance system has to ensure

- implementation of strategic, political and policy objectives;
- resources required by the government to operate, and to achieve its objectives;
- distribution of resources among various government levels and areas in proportion to their tasks;
- resources and distribution methods of narrowing income gaps between various social groups, as well as regions, settlements, and industries in line with public policy goals;
- appropriate incentives for and control of entities that execute the policies;
- management for the financial risks of government activities.

The public finance system presently operating is unsuitable to support government actions that ensure convergence for the country, as it fulfils its functions with low efficiency and giving decidedly harmful incentives at some points. Today's spendthrift state should be replaced with the Hungarian model of a developing state (Ágh, 2006), one that is able to absorb the available EU funds appropriately and ensure the necessary conditions of foreign direct investments. This developing state is considerably different from developing state models that emerged in the last third of the last century and reaped successes in industrialisation in many aspects. Completely different social traditions, international embedment, and economic structure characterise Hungary in the 21st century than Far Eastern economies that industrialised in the last third of the 20th century. The Hungarian developing state does not aim to ensure capital accumulation by government measures but to develop and operate institutions that work to absorb the funds available to the country and use them in such a way that furthers modernisation. The role of the Hungarian developing state is to enhance physical infrastructure and human resources to improve the country's competitiveness, as well as to reinforce social cohesion, and also to ensure an economic progress sustainable from the aspect of environment protection and environment impact. This requires institutional capacities and operation methods that ensure an undisturbed absorption of EU funds, including own resources, warranting from these funds the development of projects that are important from the aspect of economic convergence and financially sustainable in the long run.

Characteristics of changes, or their strategic features so to say, are described by the following core principles.

❶ ACCOUNTABILITY AND TRANSPARENCY

This principle describes the concept where decision-makers use public funds in a responsible manner, and the costs, benefits, and achievements of the operation and restructuring of the public sector are clear-cut.

Theoretically, the implementation of this concept would cost least; it is only a matter of willpower-with a bit of an exaggeration. Due to various economic and political reasons, in the history of the Hungarian public sector far less has been done to date than would have been necessary or possible. Applied budget planning processes have been of rather low quality, and decision planners have not always put politicians in a position of making decisions. Budget accounting has not reflected the costs of public services, or changes in the value of public sector assets. Administrative classification is prevalent among international budget accounting standards; economic and functional statements are not adequately reliable. Statements for consolidated state debt, other obligations, and the government sector's receivables fail to meet a desirable quality. Currently there are no certified data for simple issues such as economic entities active in the public sector (budget entities, NGOs, public benefit companies). The statement is to be ventured that any reform initiative could only be taken seriously when steps are taken in this area as well.

❷ STABILITY AND PREDICTABILITY

The means and techniques employed in the implementation of reforms shall convey the message that the government is aware of where it wants to go from where, and also that the government means the objectives it has set.

The crawling-peg exchange rate regime also contributed to the success of the economic stabilisation of 1995, ensuring for the corporate sector an appropriate level of predictability. Similar predictability should be implied to economic interest groups within or in connection with the public sector. Stability and predictability could be supported by enhancing budget planning methods, adequate financial techniques (plan contracts, fixing, performance indicators), and a budget stability act, codified after the fashion of a similar law adopted in Spain.

❸ FAIRER AND MORE EQUITABLE PUBLIC BURDENS

The Hungarian economy's global tax burdens-average in EU terms but higher than average compared with newly accessed countries-cannot be realistically reduced in the period surveyed, as this would contradict the aforementioned objectives of stability and absorption. What cannot be avoided, however, is summarised as follows.

The tax base should be expanded primarily by asset taxes, reducing the possibility of tax evasion for hidden incomes. Thus enlarged, the public burden system will, without any decline in tax revenues, allow for a reduction in the burdens of live labour, one of the major factors in competitiveness nowadays. Taxation should further job creation as well. The tax system should be aligned with the restructuring in the provision of public tasks, increase the role of local taxes, and reconsider tax distribution among various government levels.

❹ OPEN-MINDED AND FLEXIBLE APPROACH IN IMPLEMENTATION

Public sector restructuring could be the result of a longer process, as reorganisation cannot be executed by a full-out attack on the system. There will arise numerous unforeseen factors in the process of restructuring, and ample room should be ensured for the government to manoeuvre. Consequent process levels should be structured in such a way that new solutions introduced in earlier phases will not force subsequent stages to alter any of their core characteristics, if possible. This is an especially important principle because of the need for delegating tasks between the central and local municipality level.

❺ SUBSIDIARITY AND REGIONAL APPROACH OF TASK ALLOCATION

Task sharing among government levels, and also the related financing techniques, presently fail completely or partially to incorporate the principle of subsidiarity. Its fulfilment requires simultaneous decentralisation and centralisation of resources. Implementing the principle requires primarily an appropriate mid-level in the municipality system which, by having a potential to earn autonomous revenues, is able to ensure subsidiarity, as well as economical and efficient task fulfilment locally in the system of local municipality associations. It is important to underline that enforcing the requirement of economies of scale is not an end in itself on the one hand, and on the other various public services have various economical sizes. Local taxes, divided upward, provide associations of local municipalities with revenue potential. Like it or not, subsidiarity and economies of scale are conflicting demands, therefore compromises will have to be made. Centralisation of some municipality tasks could generate conflicts between local municipalities, which are best avoided. The Hungarian public finance system pursues a sector approach in respect to both the system of financing local municipalities and the elaboration and implementation of the national development plan. Aspects of public policy sectors should be transmitted by the laws of the relevant professions and national development plans in the future. Meeting challenges the country faces, addressing spontaneous polarisation stemming from Hungary's accession to the EU, stopping large social strata from sliding down further and turning this process around require a basically different logic of areas and regions.

BACK TO BASICS

The operation methods and vegetative processes of the public sector are largely determined by the basic rules of the sector. As it has been made clear by sections above, the legal control over the Hungarian public sector presently fails to meet the requirements of modern public sector management and European standards alike. Without clear-cut legislation, neither accountability nor transparency[7] of public funds can be achieved. The Constitution regulates issues related to the use of public funds and community assets in quite a lenient manner. The Constitution should lay out the principles of public burdens and the execution of budget rights in a stricter way than they are set forth now. Constitutional guarantees are needed to ensure harmony between tasks and distribution of resources. Additionally, without an adequate information system, the management reforms required to improve the operational efficiency and success ratio of the public sector would be built on unstable ground. An appropriate information system for accounting, reporting and control should be developed in a consistent, yet well-separated, platform.

Legislation defining the operation of the public sector can be arranged in groups as follows:

- statutes on revenues,
- statutes on industries or sectors,
- statutes regulating task sharing between government levels and the conditions thereof,
- statutes defining the rules regarding various aspects of the financial management of the central budget and use of public funds,
- statutes on annual budget reporting and final accounting.

Currently, substantial inconsistency is present between these statute types. It is urgent to eliminate this, and its reappearance could be prevented by the obligation of preparing impact studies on regulations. Regulatory impact studies should be first applied to ensure a basis for relatively fast amendment of professional laws.

The first tasks of the new government include the re-codification of the act on public sector finance currently in force. The new legislation on public finance should address the following issues. The financial information system of the public sector should be developed in accordance with European and international standards. Today's modified cash-flow accounting should be replaced with accruals-based accounting. Information that provide bases for budget decisions and reporting should be represented in consistent economic and functional classification as well, in addition to the current policy of largely administrative classification. For entities exercising their rights under the budget act, aggregates (voting units) should be established where substantive decisions could be made. [Kassó, 2006]. The budget act currently in force gives the government too little and at the same time too great an independence. In respect of accounting budget items, processes of asset changes in the public sector (especially in public finance) could be tracked on the basis of accrual-based accounting. Asset changes emerge as the aggregate of, in addition to processes affecting the budget cash-flow, material asset components, state debt components, various government levels' claims, and off-statement obligations of traditional state debts. The legal foundations of applying program budgets should be established. The traditional planning approach of employing basis-comparisons (incremental planning) is not suitable to orchestrate the necessary structural changes appropriately.

The legal positions of potential organisations that fulfil public tasks, and also the regulations for their financial management, should be regulated in a separate act, or in a differentiated way within the act on public finance. The internal control system of the budget's financial management, and the independent internal control should be regulated in accordance with international standards, for the regulation currently in force act as an obstacle to both resource absorption and enforcement of accountability. An up-to-date internal control system incorporates management procedures without which, success, high performance, or cost efficiency in the public sector cannot prevail. A great deal has to be done in this regard especially in the scope of local municipalities.

To be implemented in the medium term, a prerequisite of transparency and well-founded operation is a radical renewal of the institutional conditions of economic planning. This requires partly the elaboration and approval of a bill on planning, and partly a restructuring of government organisations engaged in planning, and that the division of tasks be put on a new basis.

THE WEAKEST LINK

Regarding the issue of absorbing EU funds and of competitiveness, the system of local municipalities represent the weakest link, thus immediate measures are necessary here. In the past fifteen years, central governments have used this sector as a "conflict container"[8] for unresolved problems. Basically stripped of their functions and thus operating without gravity, local municipalities have been unable to enforce a regional approach in development projects and services organisation. The lack of a strong medium level has had even more severe impact in regional development. In spite of substantial subsidies for regional development, inequalities among regions have intensified. Echoing the reflexes of the indirect "plan economy" of the Communist regime, the lack of a mid-level caused resources control on a sectoral level, which re-centralised the system that was supposed to be resources-oriented, therefore their resources were planned on the "principle of remainders". A collective irresponsibility has prevailed in the relationship of the central administration and the sector. This means that in return for inadequate resources, local municipalities are regulated by financial management regulations that are regarded liberal even in international standards. This has allowed them to live off their assets and conduct negligent financial management that at times was even squandering-without any sanctions. Since 1994, central administrations have constantly increased the tasks of local municipalities, but withdrawn substantial resources from this sector. This is also proven by *Table 3,* demonstrating the real value of the expenses of the municipality sector deflated by consumer price index. The sector has been able to manage it by selling assets to finance their operational deficit, shown in *Table 4.* The sector is simultaneously characterised by squandering and deficit. A large part of overspending

Table 3

LOCAL MUNICIPALITY SECTOR EXPENDITURES (1990–2004)

Year	GFS-basis expenditures of local municipalities (HUF billion)	Nominal cheange of expenditures (%)	Consumer price index* (%)	Change in real value (%)
1990	315	–	–	–
1991	374	118.5	135.0	87.8
1992	489	133.3	123.0	108.4
1993	599	120.4	122.5	98.3
1994	750	125.2	118.8	105.4
1995	800	106.7	128.2	83.2
1996	913	114.1	123.6	92.4
1997	1,135	124.3	118.3	105.1
1998	1,348	118.8	114.3	103.9
1999	1,476	109.5	110.0	99.5
2000	1,651	111.9	109.8	101.9
2001	1,902	115.2	109.2	105.5
2002	2,286	120.2	105.3	114.1
2003	2,533	110.8	104.7	105.8
2004	2,689	106.0	106.8	99.0
2004/1990	–	854.0	804.0	106.0

Source: Ministry of Finance

* Consumer price index is not the best indicator to measure changes in the price level of local public services. In our estimation, a "municipality price index" is higher due to the sector's special consumer basket.

Table 4

GFS-BASIS BUDGET POSITION OF THE HUNGARIAN MUNICIPALITY SECTOR, INCLUDING AND EXCLUDING PRIVATISATION REVENUES

Year	GFS balance of budget, privatisation revenues included (HUF billion)	GFS balance of budget, privatisation revenues excluded (HUF billion)
1994	–45.5	–
1995	8.5	–
1996	47.9	–
1997	65.2	–
1998	–8.7	–
1999	22.9	–122.3
2000	4.9	–108.1
2001	1.2	–91.4
2002	–104.9	–199.5
2003	–31.6	–40.7

Source: Ministry of Finance

stems from central control itself, which transmits wrong messages to local authorities. Changing the rules frequently makes the operation of the system more expensive, and urges short-term financial management. There is no contradiction with the fact that the municipality lobby, active in Parliament, is strong but these lobbyists could always enforce only their immediate interests, real or imaginary, but never their comprehensive long-term interests. Also, the positions of interest enforcement have been influenced by coalition constellations as well. Figures included in *Table 5* reflect changes in the financial positions of the municipality scope within the public sector.

Within the scope of restructuring the municipality sector, financing issues cannot be picked out from the entire operation of the sector. Reforms of the municipality system should be scrutinised in four dimensions.

■ In the first dimension, tasks related to municipalities' constitutional status and public administration system should be scrutinised. This package primarily contains issues such as the medium level of the municipality system (elected regional or grand-county municipalities), the future of the micro-region level, and introduction of the execution of rights attached to self-governance and implementation of the institutional system of mandatory municipality associations. There is a consensus that the medium level of the municipality system should be reinforced. This could be made by merging current counties into grand counties on the basis of the seven officially existing development regions, but even a three-region model is conceivable. Each option has its pros and cons, the decision will be influenced, apart from narrower professional aspects, by political perspectives of feasibility. There is one thing to underline. Namely, there's no point in any regionalisation without decentralising central tasks and competencies[9]. There is a debate about exercising municipality rights. Here a reference should be made that rights attached to self-governance shall not be confused with the reasonable scale of task fulfilment. There are suggestions that self-governance rights should be deployed on a micro-region level. We believe there's no point doing that. However, it

Table 5

SOME FIGURES OF CENTRAL BUDGET AND MUNICIPALITIES*

	1991	1993	1995	1997	1999	2001	2002	2003	2004
Central budget expenditures in terms of GDP	33.2	35.0	35.4	25.9	31.3	28.3	35	31	31
Thereof: ratio of total transferred to municipalities (central budget=100)	24.6	25.43	21.03	19.45	19.55	19	17	13	14
Ratio of municipalities' GFS-basis expenditures in terms of GDP	15.2	17.2	14.6	13.3	13.0	12.3	12.8	11.9	13
Ratio of local taxes in municipality revenues (%)	2.5	5	6	9.3	12.7	13.4	12.8	12.7	

Source: Own calculations based on Ministry of Finance data
*No election years included except for 2002

would be necessary to define a minimum size of municipality units on the basis of the number of local population. A severe internal contradiction is present in existing associations of multi-purpose micro-regions, namely that they have tried to pack the tasks of public administration, public services fulfilment, as well as village and region development into a single frame. Multi-purpose associations are regarded herein as an optimum framework for regional development and certain tasks but not as the basic unit of self-governance.

▪ The second dimension is task deployment to municipalities. Here, three questions arise. First, is it necessary, and by what legal techniques, to deploy tasks and competences in a differentiated way between local municipalities (villages, towns, cities) and regional levels (micro-regions, agglomerations, regions). Second, in what scope should the decentralisation of tasks from the central level and the re-centralisation from local levels be executed? Re-centralisation-redeployment from local level to regions-is necessary in public education and health care; decentralisation in road management, environment protection and water management, and in certain areas of interlocal transport. Last but not least, another important issue is the characteristics of mandatory associations. Should mandatory regulations refer to a certain scope of local municipalities and/or economy-of-scale task delivery and/or certain territorial units? We believe that in primary education and health care the basis for mandatory association should be task delivery on economy-of-scales basis. For example, a primary school should be operated for 600 to 800 students. Following marginal corrections and making discriminations in the regulations for urban and rural small-regions, existing small regions represent adequate units in the scope of administration-type tasks and regional development (NUTS 4).

▪ The third dimension comprises issues of service organisation. In this scope, the dominance of budget institutions will probably have to be reduced, and the matter of off-budget task delivery units should be reconsidered. The decrease of institution-orientation should be accompanied by intensifying control over public funds used at off-budget organisations and also over community assets.

▪ The fourth dimension is the financing system. Within this scope, the ratio of own funds;

dilemmas of tax or fee financing; central allocation mechanisms of transfers for operation, equalisation and development; and municipalities' financial architecture, to be designed later, should be scrutinised. Regarding financing, the first task is the sector's financial consolidation. In the current position of the budget, this could only be made by terminating part of the mandatory tasks[10], because it's not a realistic scenario that the sector would be getting more funds in real value in 2007. The next urgent step is to recreate the system of local taxes and central resource control. The discontinuation of local business tax from 2008 will deprive municipalities of considerable own revenues, as this tax accounts for nearly 11 per cent of their income. However, the termination of this tax is justified. Not because of compliance with EU regulations, but because it ensures revenues for only a narrow scope of municipalities. However, "floating" this income adversely affects municipalities' creditworthiness. On the other hand, predictability dictates that the rules for a new system of local taxes be known before the end of 2006. In the case of reforms for the local tax system, the following aspects are recommended for consideration:

- compared with the current practice, local tax burdens of businesses should be reduced and those of households increased. The current 10/90 per cent ratio between households and businesses should be replaced by a far more equalised tax burden in such a way that the weight of local taxes in municipality revenues increase from current 10 per cent by at least twofold;
- in order to eliminate a tax race and negative effects from economic booms, asset taxes should be given a larger role. Value-based property tax imposed on entrepreneurs and a value-based vehicle tax are recommendable solutions. Many raise the issue of introducing value-based real estate tax for the population. In our view this could only be implemented in a longer term, partly due to careful creation of the necessary law on appraisal, and partly because of income policy reasons;
- in order to bleach the economy, taxation and grant-provision techniques are to be employed that, being a closed system, increasingly eliminate illegal employment. Such a tool could be the transformation of personal income tax into regional tax, which at the same time could provide the basis for equalisation between villages in the region. That said, the efficiency of local tax control should be intensified, even by mandatory associations;
- that regional municipalities have appropriate own revenues should be taken into consideration when selecting new local taxes. Apart from splitting central taxes with the municipalities, the opportunity of transfer-

Table 6

DISFUNCTIONS OF CENTRAL RESOURCE CONTROL

	1993	1998	1999	2000	2001	2002	2003
Transferred PIT in percentage of total revenues	8.8	12.8	13	14.2	14.4	14.4	15.7
PIT used locally. in percentage of total revenues	8.8	6.4	4.9	1.8	1.8	1.8	3.9
Sum of ÖNHIKI* benefit (HUF billion)	0.9	7.7	12.2	12.4	13.6	16.7	15.5
Number of subsidised municipalities	165	994	1,362	1,169	1,208	1,423	1,238

Source: Sándor Varga (2004a)

*Municipalities that have become near-insolvent through no fault of their own.

ring some of the revenues from local, village-level, taxes upward (to municipality associations) should also be addressed.

An additional task that cannot be postponed any longer is the simplification of central resource control, and enforcement of it in accordance with its initial logic. Symptoms of the system's disfunctional operation are demonstrated in *Table 6.* Here, two scenarios are outlined. For the event when the act on municipalities is amended, our recommendation is to discontinue the institution of municipality cash fund in such a way that different rules should be applied for operational budget and development budget. Currently employed in Hungary, the concept of unified cash fund is not a widespread idea in the international scope. This step would result in stricter limitations for municipalities' budget, and would ensure a better control for municipality borrowing. In case the unified cash fund is terminated, requirements for equilibrium or surplus in the operational budget of municipalities would make special grants for fund-thirsty municipalities needless, including the ÖNHIKI subsidy for municipalities that have become near-insolvent through no fault of their own-a phenomenon none too rare these days. Thus, it will be easier to keep a firm grip on the sector's financial position. The following steps should and will have to be taken even if laws that require a two-thirds majority in the Parliament are not amended: by amending professional laws, reducing the scope of mandatory tasks, municipalities' manoeuvring space should be enlarged[11]. The number of titles of normative subsidies should be reduced to no more than five, and transparent methods should be implemented for equalisation, an unavoidable task. The existing sector-based equalisation should be replaced with a two-stage solution. On the one hand, income equalisation between regions with different fiscal capabilities should be ensured. It will be all the more necessary because, based on earlier experience, Hungary is also expected to see an increase in regional inequalities on the back of EU grants (Ágh-Rózsás-Zongor). On the other hand, equalisation between municipalities with different functions within the regions is necessary so that service provision minimums are ensured. Consideration should be given to establishing a municipality risk fund, managed by the parties involved (central government, representatives of regional assemblies, and interest enforcement associations of municipalities), to manage special situations. Predictability of grants for municipalities should be ensured for a longer term, say the EU's medium-term plan cycle. For it is the prerequisite for a responsible and accountable medium-term planning for the municipality sector, which also acts as a basis for success in EU applications. The solution would be to employ some kind of a fixing method, to be included in a later budget stabilisation act. Thus, annual budget acts would be exempt from a detailed regulation for resource control.

Municipalities' financial management culture has to be enhanced substantially to ensure a guarantee for a more efficient and successful operation and also for a reduction of financial risks. In general, it requires the conditions of education and further training to be created and organised. There are proven methods for this in EU member states. In an interest alliance system of municipalities, which is more unified than it is today, these institutions would be the natural trustees for these tasks. Further training of municipality public servants and involved public employees should be carried out in a far more purpose-oriented further training system designed for public servants. In the area of enhancement of financial management culture, there is a concrete task of establishing the institutional and personnel conditions of medium-term financial planning, internal control mechanisms, as well as those of the operation of internal control and owners' control.

INSTITUTIONAL CONDITIONS OF SUSTAINABLE FISCAL SYSTEM

In order to secure the fiscal objectives of nominal convergence and also to ensure stability objectives for the period after joining the eurozone, our recommendation for the government is to start elaborating a budget stability act and have it passed by the Parliament as soon as possible. Two institutional prerequisites are required to achieve budget stability.

- On the one hand, the basis-oriented approach of the budget (incrementalism) should be eliminated. If the argument saying the structure of expenditures should be radically restructured is true, then it is also obvious that the program budget method should be applied for suitable public policy areas when planning public expenditures. Its implementation is a process whose basis will be created by the aforementioned new public finance act.

- The other aspect of institutionalised stability is an institutionalised interest reconciliation forum within the budget process. Implementation of a rule-based budget process and enforcement of the principle of partnership requires the establishment of a Budget Commission, organised on corporate basis. The body would comprise representatives of the central administration, governing and opposition parties, and sub-national governments, and also those of the interest-enforcement bodies of employers, entrepreneurs and local municipalities. Upon right of consultation, the chairman or a delegate of the State Audit Office may also participate in the work of the body. Establishing the institutions of budget stability also represents a significant condition of partnership. Voters and enterprises demand lower taxes, at the same time they expect their constituencies to progress, or their companies to be given government orders. This negotiation design may diminish differences in the bipolar system. Conducting discussions within the appropriate frames, the body's task is to reach agreements on the criteria that define the medium-term progress of public finances, and the financial positions (deficit and debts) of certain public sector sub-systems (central budget, social security funds, municipalities sector). Before the Parliament votes in such issues, the body makes a statement on key figures, defined by the bill on annual budget, that reflect the position of the consolidated public finance, the positions of government and consolidated municipality cash funds, the necessary corrections, and also the use of any unplanned surplus. This would ensure the transformation of the current government practice that is based on the logic of power into a new type of interest-based governance. This institution would put the content of exercising budget rights into a new dimension. The sovereignty of political bodies would decreased as to how much they could spend, but their responsibility would increase as to how, for what purposes and in what structure, they could spend the public funds available to them. The stability act and the related institutions could reinforce the Parliament in exercising its budget rights. In the past 15 years, the Hungarian legislation has exercised this right in a quite limited manner. Further work is needed to clarify constitutional issues regarding the establishment of the budget body and its scopes of tasks and competences.

Some eurozone member countries have installed such laws to ensure the implementation of the objectives of the Growth and Stability Pact. Highly regionalised, Italy, Spain and Belgium have established their own procedures and their legal background. Two countries operating in federal systems, Austria and Germany have introduced similar procedures. Recently, Poland has also installed a law in order to ensure budget stability.

The budget stability act would be applicable to all sub-systems and basic units of the public finance system with the aim of having a grip on spending. It would define the positions of the consolidated public sector, in particular those of various sub-systems, for a period spanning several years, and would secure coordination between them by implementing adequate methods. The budget act would limit the amount of the consolidated public sector's expenditures and the debt portfolio of municipalities. Also, it would define procedures for excessive deficits and also for use of budget surpluses. At the same strike it could define the main features of municipalities' central resource control, and the fixing to be applied in the given period.

In respect of maintaining budget stability and controlling state debt, the significance of processes occurring, the municipality sector will grow. The ratio of own income will be higher in the revenues of medium-level and local municipalities, and in the event of decentralisation the ratio of public funds concentrated in this scope may grow from 25 per cent of the annual consolidated public sector budget to as high as 50 per cent, depending on the extent of decentralisation. On the back of reinforcing the financial independence of municipalities, in addition to the funds used by the sector the assets dedicated to task delivery will also grow, increasing the financial management risks of the budget. Risks, on the one hand, are related to high-volume investment activities and, on the other, to a laxity in budget discipline. It should be ensured that investments serve to meet actual local and regional demands and to improve competitiveness, and that the implemented projects be sustainable financially. On the one hand, this could be ensured by an institutionalised financial planning for the medium term (adjusted to EU planning cycles). As recommended above, the act on planning would insert it to the system of national economy planning, whereas this obligation would replace that of economic program creation in the municipality act. The professional standards of municipality plans would be included in the acts on public finances and planning.

We believe there are three ways of reducing risks mentioned in respect of sub-national governments:

- First, a rule-based budget shall be prescribed. In this scope, as mentioned above, the institution of a unified cash fund for municipalities should be terminated, any deficit of the operating budget prohibited, and, beyond the limitation referred to above, it should be prescribed that no other loans but liquidity loans should be raised regarding operation. The size of development loans, to be taken out for supplementing the investments budget, should be limited subject to financial capabilities.
- Second, a municipality debt registry[12] should be implemented, with functions to monitor the financial positions of the municipality sector, in particular making up-to-date records of its budget positions and debt portfolio. In addition to the central government, local municipalities would, via their interest enforcement associations, also participate in the management of the organisation. Information provided by the organisation could be used by a wide scope from EU executive and control authorities to central government to municipalities' interest alliances and business circles alike; and this organisation would be responsible for providing the information bases for the Budget Commission's decisions regarding municipalities. This organisation is all the more important because the constitutional independence of municipalities, which would not be amended by the new Constitution, is not represented at a desirable extent in the sector's budget processes.
- Third, the independent external control by the State Audit Office shall be intensified substantially[13], for which several models exist internationally. In the United Kingdom, municipalities are audited by an organisation,

the Audit Commission, operating independently of the sate audit office but bearing similar rights. In Spain's autonomous provinces, control chambers with state audit rights are operated.

THE PUBLIC SECTOR MANAGEMENT BEING RENEWED

The long-term objectives of the reforms are to ensure the efficacy, effectiveness, efficiency and productivity of the public sector. For this, the accomplishment of two tasks is considered imperative. On the one hand, the principle of preparing feasibility studies must be enforced in legislation, including the budgetary consequences of new legislation, which was required as early as in the act of 1987 on legislation, but not actually applied since. The preparation of a feasibility study is not an end in itself but a fundamental condition to attaining responsible public policy. A feasibility study must be required to be attached to the documentation of each substantial government decision and bill. Professional substantiation of feasibility studies prepared by the relevant fields of competence should be examined by the Prime Minister's Office (MEH). On the other hand, continuous and systematic monitoring of the impacts of government activity must be ensured, and the activity adjusted if necessary. A reasonable solution would be to assign these two tasks to a central unit linked to MEH, such as a division assessing government performance (controlling centre). A task of a controlling centre would be to develop performance indicators for the various political areas (sectors). These performance indicators form the basis of substantiated budget planning and of evaluating the performance of various organisations and areas of public policy. For this activity, the controlling centre would rely on the experience and analyses of the various sectors and local governments. The performance indicators must be applied when planning the central budget (programme budget), while for the system of local governments, the central controlling of resources conveys performance requirements. In addition to these, the organisation uses various procedures to evaluate the performance of central administration organisations and the related service provider units on a continuous basis. A direct user of evaluations is the Prime Minister. The information obtained in this way can be used to assess the effectiveness of government activity, and the efficiency and efficacy of each department and area of public policy. This provides a basis for further government activity, legislation and personnel decisions. Performance indicators and evaluations serve as an information base also for substantiation assessments of the indispensable feasibility studies prior to tabling new bills. This function should not be mistaken for auditing. The controlling unit may play a significant role in creating the professional conditions of the programme budget; at the same time, adoption of the programme budget will be a prerequisite to completing this function. The organisation would not assume the responsibility of the Ministry of Finance (PM) in terms of implementing and planning the budget, or the preliminary auditing function of the Hungarian State Treasury (MÁK), but could still represent an appropriate counterweight to PM in terms of policy. Controlling indeed is an integrated management tool, which focuses on feedback based on systematic performance monitoring of processes and government areas.

Detailed development of proposals and an adequate choice between alternatives require appropriate modelling and an IT background. Steps must be taken to ensure compatibility, and, where necessary, uniformity and publicity of various databases supporting government activity. However, the significance of information technology goes far beyond the narrow area mentioned above. Public finance reforms must also provide the conditions of wide-ranged and safe use of information technology in public administration. Today, legislation does not consider the requirements of and processing performed by information technology. In Hungary, the development of information systems in line with the legislation verges on the impossible. Day-to-day changes in the legislation are permanently on the agenda due to a lack of preparation and adoption of ad-hoc ideas. As a result of this, information technology is applied in both public administration and the business sphere with lower efficiency than possible and necessary.

Due to continuous changes in legislation, permanent updating is costly, which leads to controversial situations for data protection and the protection of privacy under these legislative circumstances. Solutions operational in the whole world are prohibited for public administration, which would facilitate the collection of taxes using efficient methods, and the catching of fraudsters or persons taking advantage of chaos. Public administration is working for the introduction of e-governments, whereas not even the prerequisites of paper-based administration are available. The majority of the public administration staff lack basic IT skills. Auditing-both internal and external, as well as audits of accounts in the business sector-has not even recognised that the operation of IT systems and the data generated can and must be audited using specific methods, and certainly cannot learn and apply the necessary skills. Our suggestions therefore aim at creating a system of conditions necessary to apply information technology extensively in the public sector. Accomplishment of the prerequisites of e-government is possible until 2010, while a full implementation belongs under the Hungary 2015 programme-mostly using EU funds.

INSTEAD OF AN EPILOGUE

We do not believe that the outlined solutions represent the only possible way. What is considered important, however, is whether substantial professional discussion should take place instead of the bluffing competition for its own sake. In terms of reform plans, verbal and symbolic reforms, we must be in the international vanguard. It is to be seen that our proposals contain a pragmatic mix of reform strategy. We do not believe in any doctrinaire solution; neither that the one and only solution comes from marketising and competition, nor that audits and severity are omnipotent. Instead, we believe that the appropriate institutions can substantially change the method of public sector operation; for this reason a key issue of reforms is seen in the reduction of causes resulting in the well-known imperfections of the government. Practitioners of budgetary law, elected politicians, must be faced with actual situations of decision, and clear and accountable performance requirements need to be defined for the operators of the public sector.

In the short term, creating the legal conditions necessary for management reforms is deemed to be the most important. In the medium term, defining public duties accurately-in recent terms[14], setting up a task cadastre-and partially rearranging them between levels of government is considered unavoidable. Concurrently, we intend changes to financial institutions implementing a system that enforces competitiveness of bearing pubic duties and equitability to a greater extent, and produces a situation better than today in terms of funding public duties. The moral of successful reforms carried out in developed countries[15] is that a strategic attitude, a consistent concept and political determination are necessary. The critical points must be found in changing the situation, the involved participants must be assigned appropriate independence and responsibility, and last-but not least-the necessary changes must be properly communicated. In the period to come, the breakthrough point is the creation of conditions for transparency and accountability, as well as the local government reform and the institutions of budgetary stability, because these steps provide the required independence and accountability. The wide-ranging communication required for a successful reform must ensure domestic social consent on the one hand, and regaining foreign confidence-EU institutions, in particular the European Commission and the European Central Bank, as well as money markets, on the other hand.

Notes

[1] This study is a compilation of researches into public finances reforms conducted within the strategic research project "Hungary 2015". Research achievements of IDEA program have also been used. A detailed list of studies used as reference is attached. What has been described herein reflects the author's personal opinion.

[2] The content of this concept is not addressed herein. See also Kovács, Á. (2005B).

[3] See also Báger, G. (2006a)

[4] See also a study by Kovács, Á. (2005b)

[5] Benefit hunting, as described by international literature, is the efforts made by market players to ensure their income positions by securing state subsidies rather than by market performance.

[6] On issues of accountability and transparency see Kovács, Á. (2003) and Kovács, Á. (2005a).

[7] A term coined by Attila Ágh

[8] On connections between decentralisation and regionalisation see: Horváth, G. (Ed.) (2004).

[9] A study prepared by Ferenc Dudás, Undersecretary of State for Public Administration at the Interior Ministry, also raises this issue. Németh (ed.) (2006), page 16

[10] See: a study by Ferenc Dudás, in: Németh, J. (ed.) (2006), pages 13–18

[11] A feasibility study has already been prepared by Károly Nagy and his team of experts. Economy Development Bulletins, Issue 2

[12] A book by Árpád Kovács provides excellent insight (2003).

[13] Árpád Kovács urges this in a number of publications. See: Kovács, Á. (2005a)

[14] The Spanish regionalisation and the related fiscal model, the Finnish example or the recent Danish reform are considered as examples.

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