László Parragh

Why is it Important to Modernize Public Finances and Public Services?

The need to reform public finances is a topic of discussion for decades. Recently, the demand to upgrade government management and public administration, in other words, public services, had been added to this discussion.

With *execution of a tax and public finance reform,* competitiveness would have the chance to improve spectacularly and over the long term. There are multiple resources available to recoup budget revenues that would be lost to tax-cuts and mandatory contributions. Reforming public finances and the public sector would trigger growth, while the service providing state would significantly cut the overhead costs of public administration. Lower tax rates would also improve the willingness to pay, all of which would increase revenues.

However, this appears to be *an idyllic state of affairs that is far away*, as even reform initiation is being postponed. The longer these reforms are postponed, the less chance remains to somewhat rapidly close the economic gap, and establish a state of equilibrium.

COMPETITIVENESS

A question we often hear is whether Hungary and the Hungarian economy are competitive. Politicians tend to oversimplify the issue, – as they usually do – and they respond at the two extremes of the scale. They claim *either that all is lost and gone forever or* that the Hungarian economy is *the tiger of Pannonia.* We cannot accept either response, since we are seeing combinations of warning and promising signs at the same time.

Hungary, or more correctly, *the Hungarian economy should be in a steady state of competitiveness.* It should dynamically maintain competitiveness and improve it by moving forward in conjunction with changes in market conditions; considering that, the market environment itself is in a constant state of accelerated change.

We can approach competitiveness trends from a number of angles. We can approach it from the perspective of our immediate neighbors, or as being part of the European Union, or looking outwards at the world at large. We might analyze competitiveness based on the sizes and compositions of our businesses, along the lines of the various industries or of concrete sectors of the economy.

At this point, we offer a few major indicators as a comparison with our neighbors and the EU-15, while focusing on the role of Hungarian public finances and public services to illustrate the necessity of the earliest possible modernization. (The countries used for comparison were chosen for the various reasons. The Visegrád Four (V4) nations – Slovakia, Czech Republic, Poland in addition to Hungary – are important political and economic partners. Romania is increasingly becoming a competitor. We also need to consider Austria, Portugal and the rest of the EU-15, since Portugal is similar in size, and Austria is our immediate neighbor).

Competitiveness Rankings

Looking at the various rankings of competitiveness,* let us see how others perceive us.

- According to one OECD ranking, as of January 2005, Hungary was in the lower section of midfield.

* *Sources of competitiveness ranking: IMD, OECD, ICEG, EBRD, Eurostat*

The list prepared by the EBRD of the 2004 transformation shows Hungary in the top slot. According to the ICEG survey published by the daily economics paper, called *Világgazdaság,* Hungary was in the sixth place among the eight Eastern and Central European countries in economic gap reduction.

Based on growth and business competitiveness, the World Economic Forum placed Hungary three places back in 2004. The Economist Intelligence Unit (EIU) brought Hungary forward by two places in its investment attractiveness survey, while Romania moved ahead by eight places and Slovakia by three. The IMD competitiveness ranking brought Hungary forward from 42nd place to 37th. At the same time, in the international price competitiveness category, Hungary was in the top slot of the negative field.

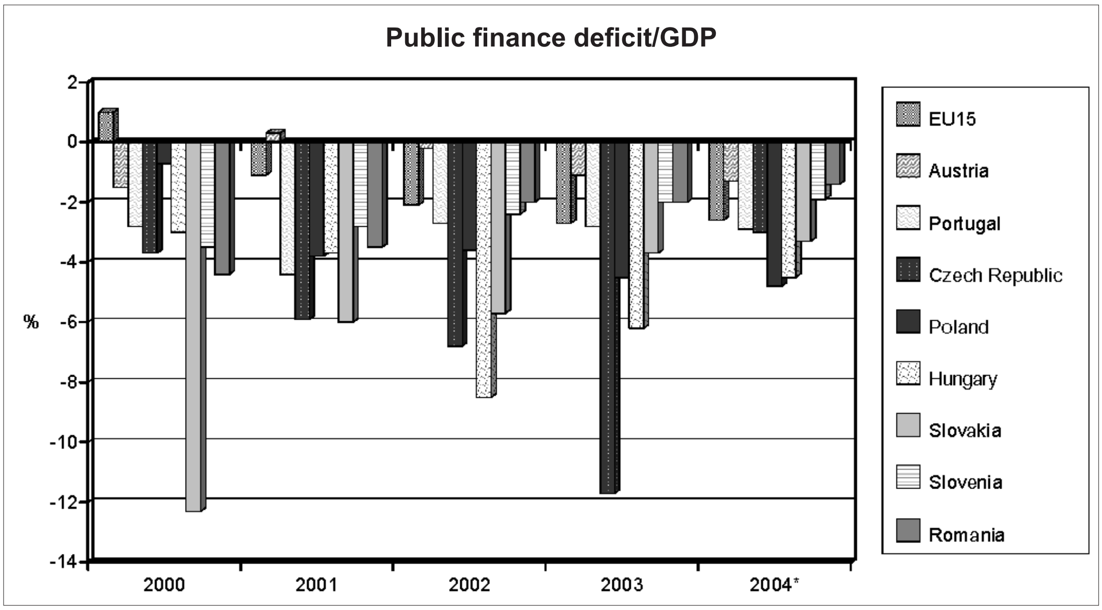
In 2004, Hungary's total productivity index (GDP per economically active person at purchasing power parity, USD), a comprehensive measure of competitiveness, placed Hungary at 52.5 percent of the EU15 index. This shows the same level as Slovakia. As far as the other competitors in its "weight category" are concerned, Slovenia is well ahead (with 76.2 percent), the Czech Republic is slightly ahead (with 56.0 percent), Poland is behind Hungary (with 43.2 percent), and Romania is well behind the pack (with 31.7 percent).

Considering all, these competitiveness rankings support the argument that Hungary's good/intermediate competitiveness rating has weakened as an outcome of deterioration in its macro-level equilibrium. Moreover, the relative weakening appears more pronounced since other countries became stronger. Most criteria indicate that the former "head of the pack" country is still performing well, or at least not poorly.

ECONOMIC INDICATORS

From the major economic indicators, it is apparent that when compared to the other countries chosen as a frame of reference, *Hungary's performance is weaker* in the sphere of government intervention *where the state has a powerful influence on economic flows,* and stronger in the market sphere where the economy tends to operate on its own.

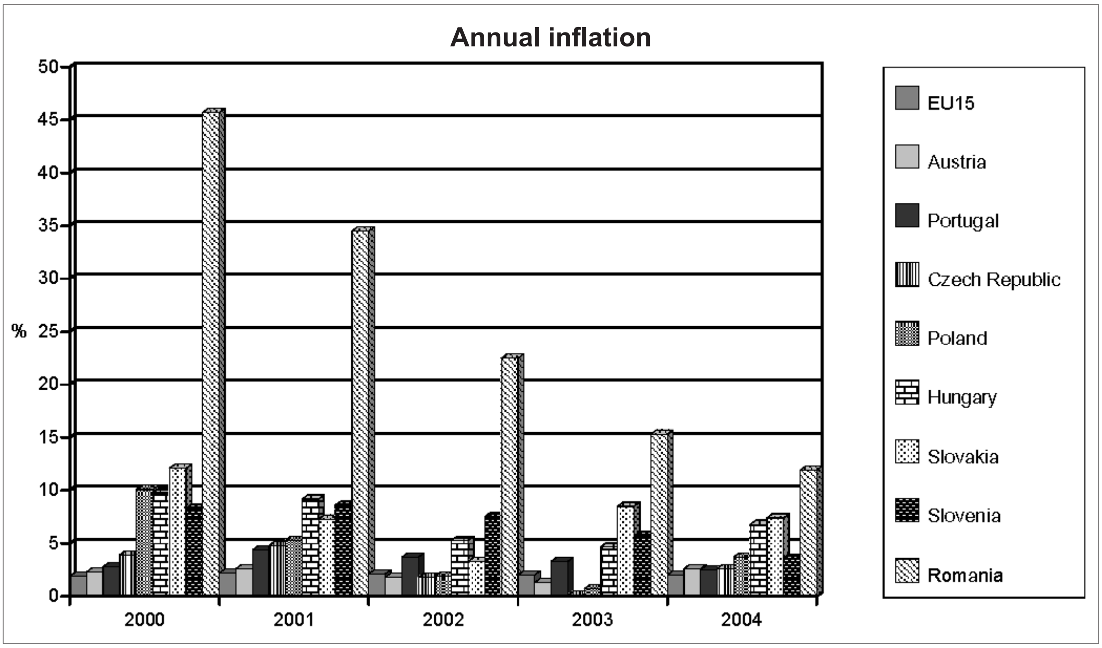
Differences in the size of the public finance deficit as a percentage of GDP are not dramatic within the countries. However, it should serve as a warning, and is actually a worrisome sign that Hungary is also at the top of the negative list in the area of pension correction.



* Forecast

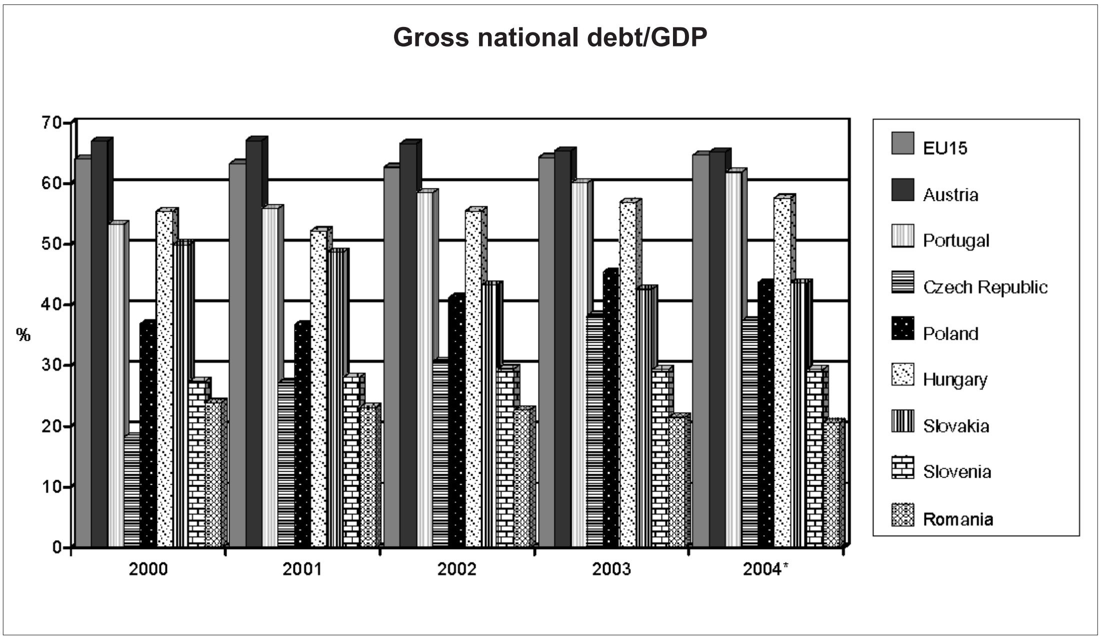
Source: Eurostat

The inflation rate remained on a high level for many years, but by today, a downward trend is clear.



Source: Hungarian Central Statistics Office (KSH), Eurostat 2004

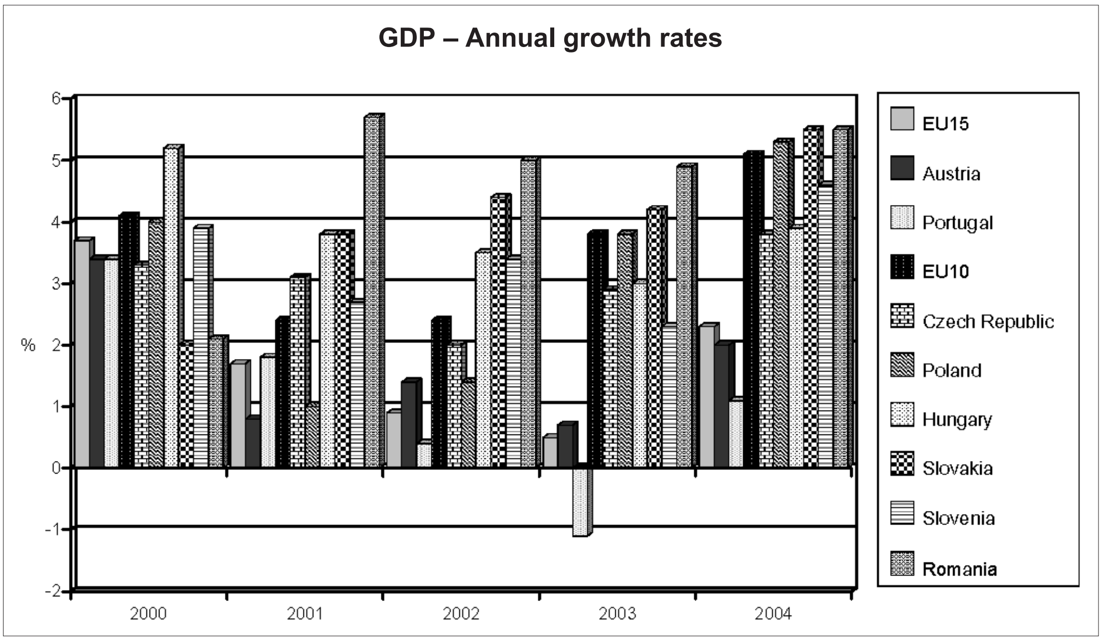
Hungary's gross national debt as a portion of GDP "is fast approaching" that of the EU15, Austria, and Portugal. Meanwhile, our infrastructural development level is low and improving it requires enormous government spending, which in turn further increases the debt.



* Forecast

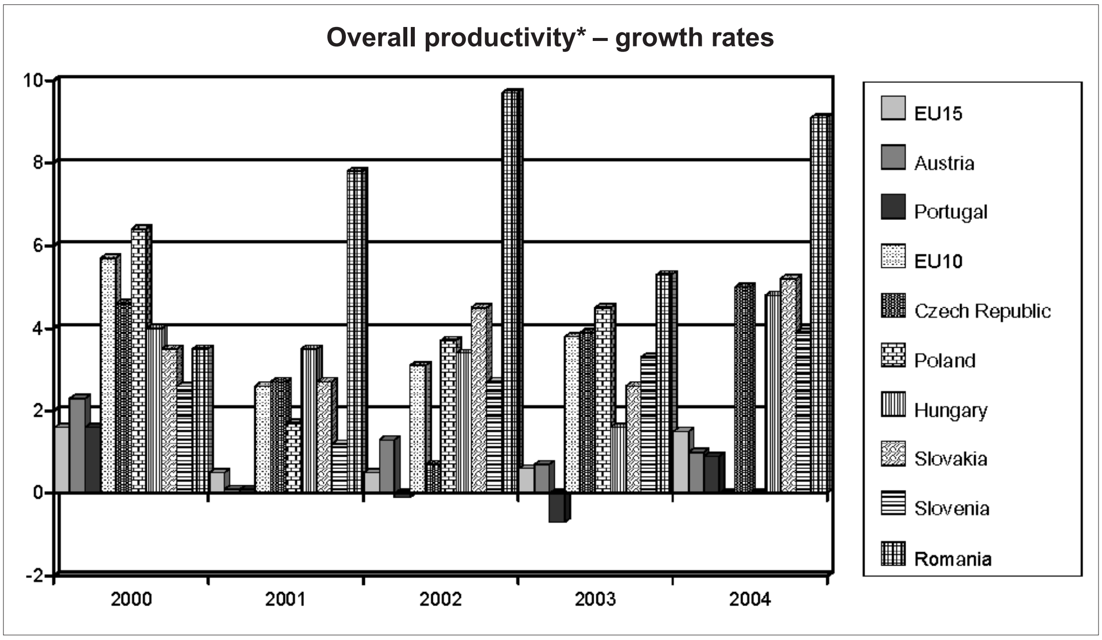
Source: Eurostat

As far as the 2004 GDP growth is concerned in our region, the Czech Republic was the only country that performed worse than Hungary.



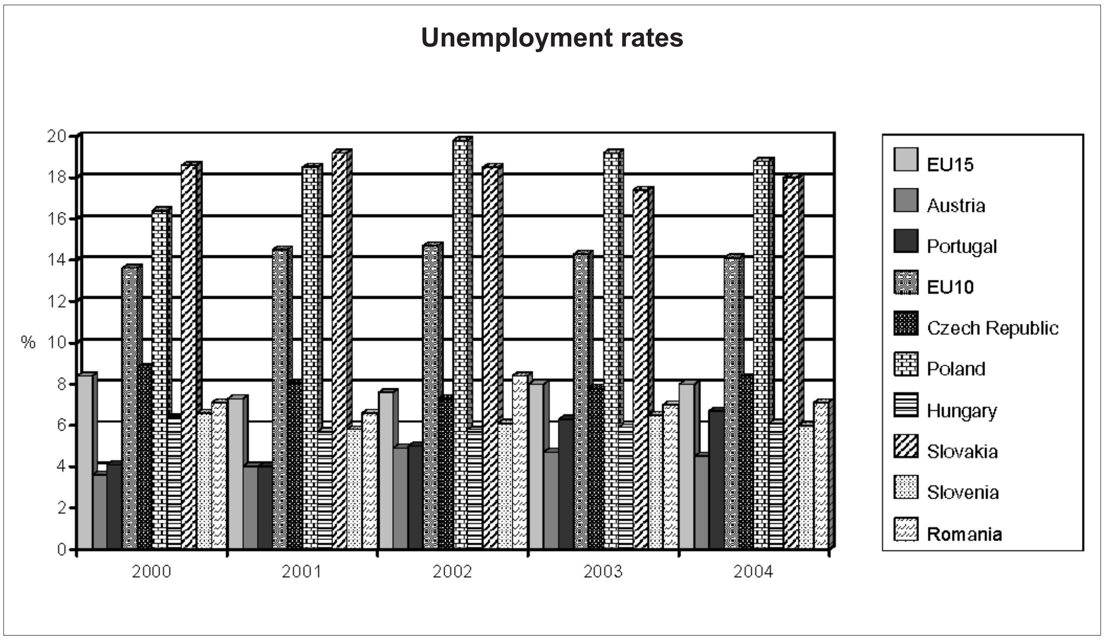
Source: KSH, Eurostat, UN Economic Commission for Europe

As far as the overall growth of productivity is concerned, the countries of the region have performed quite similarly. The growth-rate of the EU15 was, of course, slower.



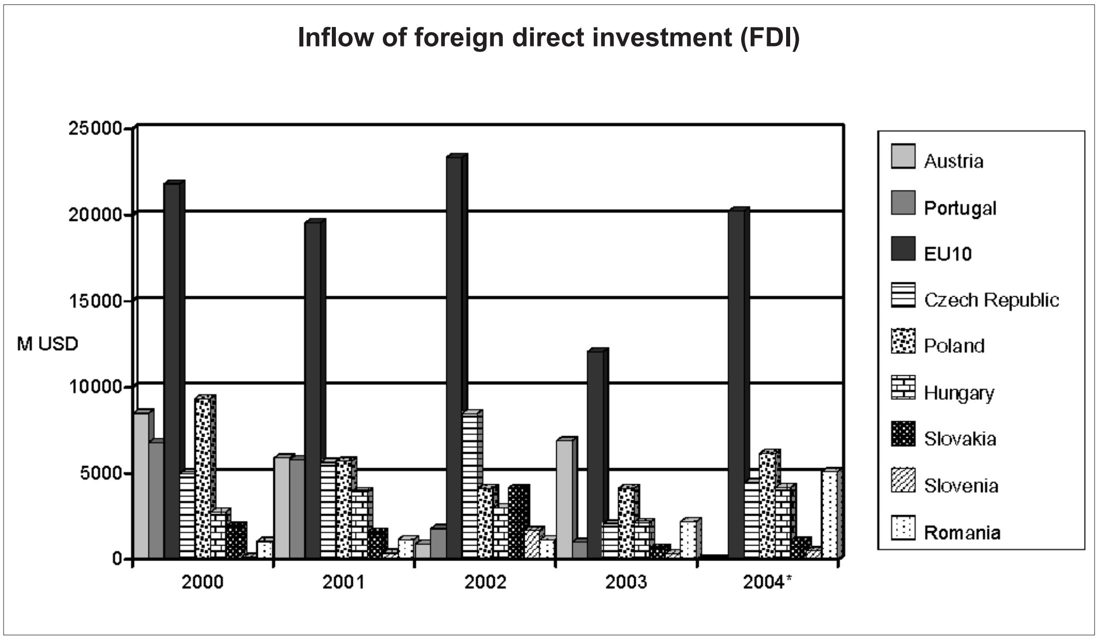
* *GDP/economically active person at purchasing power parity*
Source: Eurostat, UN Economic Commission for Europe

As far as unemployment was concerned, Hungary was in a distinctly favorable position with a low rate. However, a slow – and hopefully transitional – deterioration began in 2005.



Source: KSH, Eurostat

The inflow of foreign direct investment (FDI) climbed significantly in 2004. A significant relationship is assumed between EU-membership and the FDI indicators.

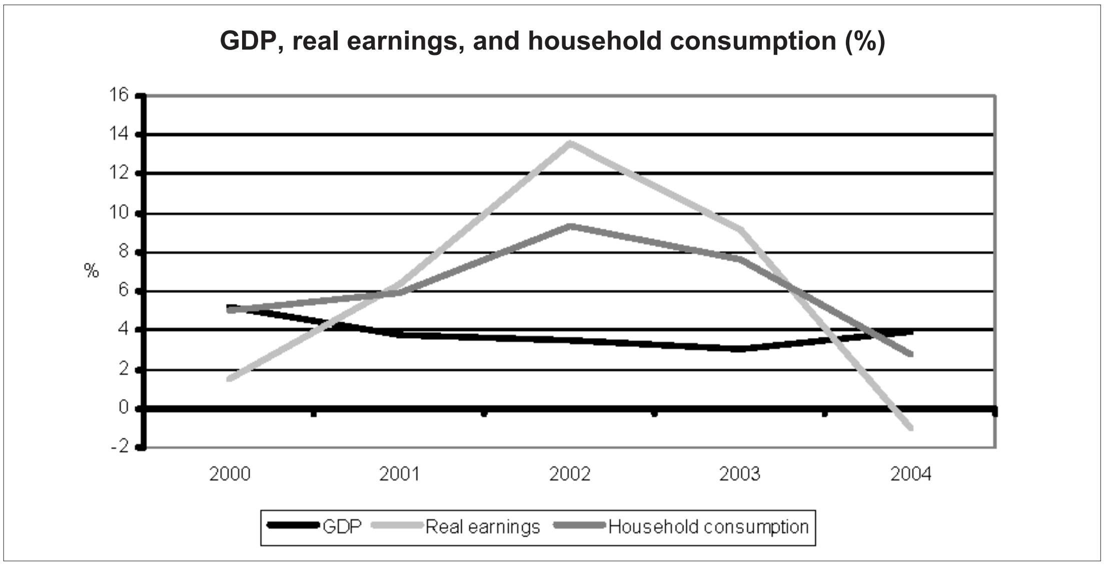


* Forecast

Source: UN Economic Commission for Europe

For quite some time, the high prime interest rate was a serious obstacle to the competitiveness of the Hungarian economy. Hungary had the highest central bank prime rate in the region – except for Romania – however, it dropped significantly in 2005, in line with other economic shifts.

Real earnings and household consumption rose significantly. Their growth-rate exceeded that of the GDP in the past four years. From 2005 this phenomenon favorably turned around, when the GDP began to grow more rapidly.



Source: KSH

THE GOVERNMENT AND COMPETITIVENESS

One factor *influencing the country's competitiveness is the performance of public services.*

There are one or two examples of this from public administration. Most recently, the state has taken (been forced to take) a role in business. For instance, according to current plans a series of tourism-promotion bureaus, called Tourinforms, will also operate as travel agencies. These offices, financed from business taxes, will appear as competitors in the travel industry.

It often happens that the state does not even keep to its own rules. One blatant example was the auditing of all reimbursement requests for the 2004 value-added-taxes, which delayed payments for months. Another example is the non-payment of winning bids for funding. In some cases the government still owes money that was due back in 2003.

Inefficiencies in Public Administration and Local Government Operations

The efficiency-levels of public administration and local governments are poor. *While the headcount size might be disputable in these areas, the inefficiencies are undeniable.* For instance, the major distribution systems operate with low efficiency levels. Neighboring countries are taking much more courageous steps to address these issues; and although some of their actions are forced on them, their results are just as commendable.

The public administration reform is underway. So far three recommendations were made – one on the organization of government, one on the bodies supported by the budget, and one on government assets. There is a fourth under development regarding the structure of government and – it is said – it should be ready by autumn. The basic principle of the reform – quite correctly – is that *"affordable government" cannot be bigger than required by doing its job, and cannot spend money hand over fist,* meaning that an institution should not be spending more on itself than the amount allocated to manage the tasks it has been charged with.

Unless reforms are completed and consensus is reached, the counties (and the districts) are "condemned to live." Even if every single political force agreed that they need to be transformed/eliminated, which they do not, interests opposed to closing them down (power, status, jobs) would still be so strong that all repeated efforts would most likely fail. So far, the only move forward has been the establishment of the micro-regional system. As of 2005, this system allows local governments to combine forces and manage certain high-level tasks related to education and administration at a lower cost.

These reforms would not necessarily result in staff reductions. If a regional structure is established, central authorities would be transferred. Thus, the jobs would not be lost, only their location would change.

Cutting staff using the lawn mower principle has nothing to do with reform, so no results should be expected from this type of move. Moreover, constant job insecurity will chase away the highly qualified professionals who have the ability to adapt. In some areas, the additional work resulting from EU membership will require even more staff. Consequently, headcount reduction connected to annual budgets will not speed up administration or make it more efficient.

All attempts to reduce staffing appear to be doomed to failure, since "the system is programmed to grow," and experience to date has shown that the status quo ante is guaranteed to return in some manner. The most often used method to address this challenge is outsourcing. However, outsourcing tends to increase costs, complicate coordination, and limit accountability and oversight functions.

In the current administration system, an institution is considered more important if it has a bigger staff, its management has "bigger desks," and if it receives more funding from the budget. On the other hand, their operational efficiency – which cannot be measured without *the introduction of performance principles* – is ignored. Overblown, monstrously complex, and vague parallel authorities have already damaged the country's competitiveness. To cite one example, the trade development programs for 2005 (International Trade and Development – Hungary – ITD-H) were made public in June. There was no organized project at all during the first half of the year, and ITD-H underwent one of its habitual reorganizations. There was absolutely no purpose to the operation of the organization, which annually costs about HUF 5 billion (about EUR 20 million).

We need to clean up the jungle of participating organizations and the outsourcing of tasks. Outsourcing agreements will have to include not only the specifications of the tasks that are being outsourced and the fees for handling them, but also the responsibility of contractors and sanctions for under par results.

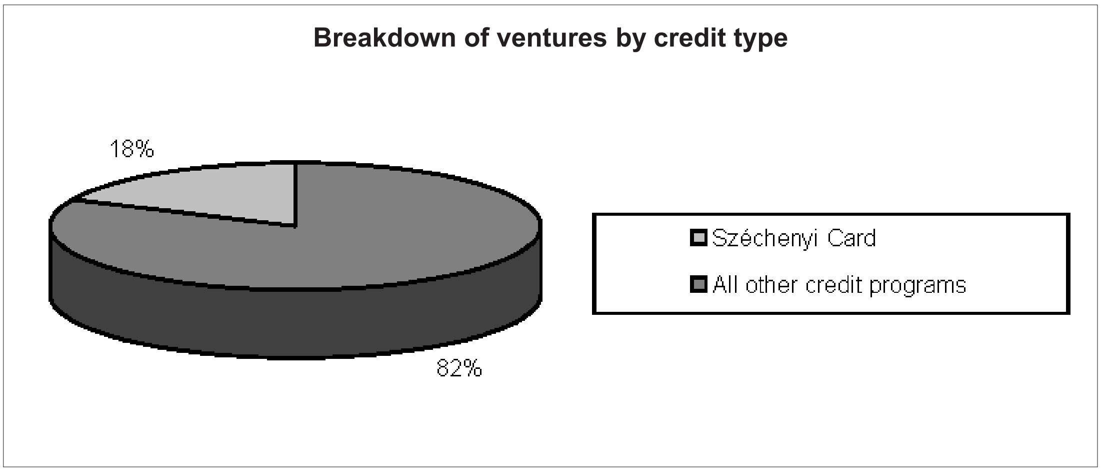
The introduction of electronic administration keeps running into obstacles; Hungary is behind even the Central and East European region when it comes to building e-public-administration. We should consider following Estonian practices, where tax authorities refund taxes within 24 hours of receiving an electronically submitted refund request. Meanwhile, in Hungary, members of the business sector are forced to waste months, for instance, even on obtaining investment permits.

Inefficient administration also increases the costs of the economy when managing official business. Another reason why it would be imperative to accelerate e-administration urgently is that including the performance principle might even force the entire administration scheme to change. Distinct boundaries between tasks and responsibilities, regular analysis, performance targets, and continuous evaluation of whether targets are being met are all essential factors to e-processes. Both domestic and foreign investors are alarmed by slow and disorganized administration, and by the low level of cooperation and information exchange between authorities.

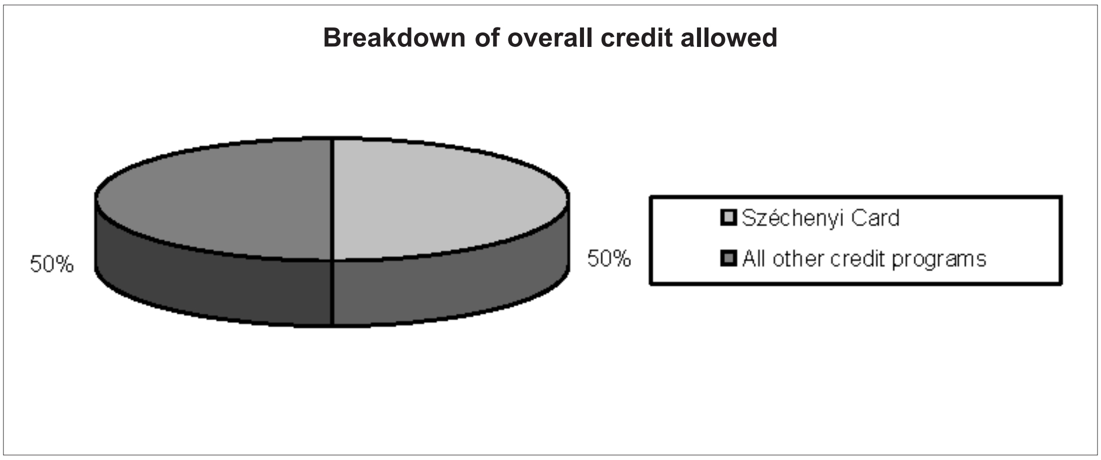
The Government's Contribution

By turning the regulatory and economic environment into a pro-business one, the government *would contribute* to improving the competitiveness of the private sector. We already see signs of movement in this direction, but the actual cases, where real action has been taken, are still isolated.

Hungarian businesses are still undercapitalized, so it would be very important for them to *attract low-cost capital.* There are various initiatives, but despite their efforts, *they are not sufficiently coordinated within our systems of conditions and targets*. Configurations are changed often, though sometimes only in name. No one is surprised that the *Széchenyi Card,* a simple and quick way of obtaining capital, has been the most *"popular"* alternative. The various professional chambers, National Association of Entrepreneurs, and Employers (VOSZ) are the most vocal advocates of this card, which again, is not surprising. In 2003, eighty-two percent of the state supported projects assigned to be implemented by the Hungarian private sector (including the Hungarian Development Bank (MFB), various developmental and other state-owned corporations, and the Széchenyi Card) were done with Széchenyi Cards. One-half of these funds were distributed *through the organizational efforts of the Hungarian Chamber of Commerce and Industry, the regional chambers, and offices of the National Association of Entrepreneurs and Employers (VOSZ).*

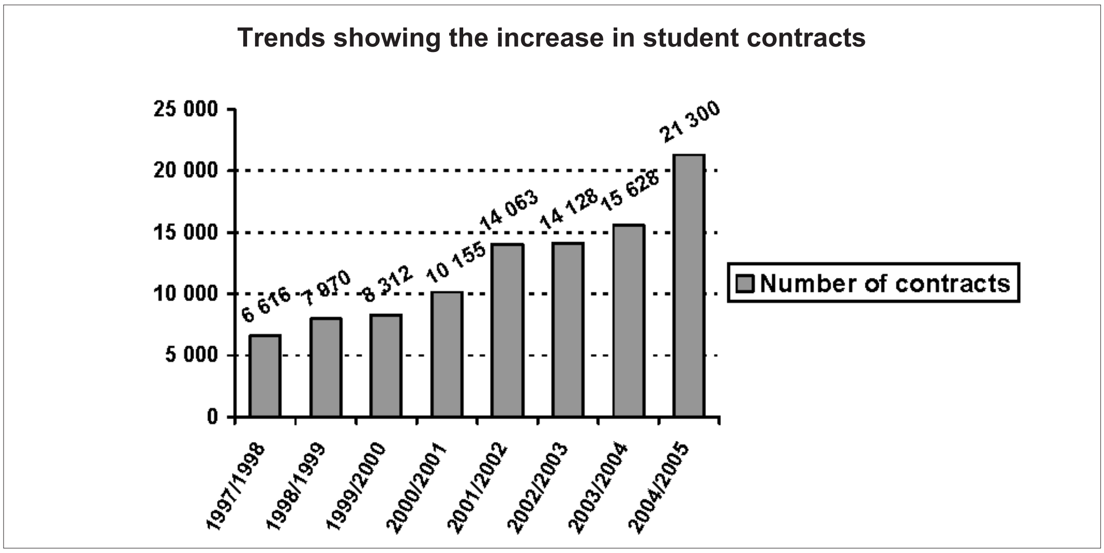


Source: Calculations based on data provided by the Ministry of Economics and Transport



Source: Calculations based on data provided by the Ministry of Economics and Transport

The guarantee of a bright future is *a well-trained workforce with diverse skills, which is ready and able to upgrade and update its knowledge.* However, a look at the education system reflects a growing number of problems. We are seeing a rise in functional illiteracy, very poor language skills, and a deterioration of quality in higher education as the number of students increases. The initiatives submitted by the education profession for improvements are dismissed one after the other. Instead, hurried and haphazard measures are taken, while the prestige of the teaching profession is heading steadily downhill. A problem of *vocational training and adult education,* that very slowly being resolved, is that they do not support the needs of the economy. *Representatives of the real sector have begun to participate in vocational training efforts, and this has been turning them in a positive direction.* At the same time, adult education appears to be entirely isolated from economic reality. The state plays a dominant role in these areas, in foreign language education, as well as in the dissemination of computer skills. The *Chamber* took on the job of managing *student contracts* in 2000 to help promote vocational training. Today 21,300 students are included in this initiative and their number continues to grow. Within two years, their number should be reaching the maximum, which is about 30,000 (estimate based on the number of children in the country).



Source: Hungarian Chamber of Commerce and Industry

When building a knowledge society, the most important thing is to catch up to the international knowledge level, raise the general qualification and knowledge of society (one part of which is to eliminate functional illiteracy), improve the value of knowledge, and to restore the social prestige of teachers and other educators of children.

The main pillars of a knowledge-based economy are adjustment of the content and structure of education and training to market demands by establishing regional centers for knowledge (research and innovation centers), and increasing lifelong learning opportunities.

The economic players themselves must be included in the decisions on the content and requirements of education that offers competitive knowledge.

The *state* needs to participate in improving competitiveness, mainly by adjusting the competitive environment, but *direct development* is also necessary. Government efforts should be focused on building and maintaining a *basic infrastructure*, implementing long- term *research projects that are not focused on the immediate market and profits,* and on reducing *regional disadvantages* as financial resources allow it.

A key issue to reducing regional gaps is *to build the network of necessary institutions.* Decentralization and regionalism need to be reinforced. Clarifying the status of the regions (counties) and micro-regions is an urgent task. It would be important to conduct a rational transfer of central government tasks to the regions and micro-regions (decentralization), and to disseminate electronic administration and simplify laws.

Representatives of the business world need to be drawn into all levels of institutional development *as equal right partners, and serve on regional councils* discussing regional improvements. Without them, the job cannot be done successfully. However, for many years, successful governments have refused to consider doing this, which is understandable from their perspectives. When political forces take development decisions, they prefer to make their choices based on political and popularity considerations (sometimes not even on these), and the last thing they want is the "disturbing" presence of professional business organizations.

Lower mandatory contributions and taxes are key elements of competitiveness. However, it would be a mistake to attempt to improve competitiveness and foreign economic equilibrium primarily through tax cuts. *Government expenditure would just increase the deficit if taxes were cut, unless the structural reasons for its overspending are eliminated.*

Effective incentives for investment and an appropriate network of institutions to rely on require the operation of *trade promotion systems that rest on regional chambers of commerce and industry.*

Public finances and government administration also have to utilize *quality assurance* systems and procedural protocols.

When modernizing the network of institutions, we need to rely *on the existing networks* and build on them. If we establish a new organization to handle every new task, all we are doing is increasing the number of parallelisms. It would be a major move forward to introduce the concept of signing planning contracts on various tasks management, and financing these by the local governments and the regions.

In summary, *the time is here for a second regime change.* When the first one took place, many areas were left untouched, including public finances and its distribution systems, the administrative systems, etc. They remain in place as fossilized structures and unless they are changed, our competitiveness cannot be increased.

Second Regime Change: Public Finances – Competitiveness

The services included in public finances are the entire social and economic environment, and the budget and financial systems (inclusive of planning, methodology, accounting, and monitoring areas). For that reason, it is extremely difficult to move forward. It is not enough to agree on financial and economic issues, but it is necessary to have social and political consensus.

This demand *throws a new light on the concept* and practice *of partnerships,* which can no longer be limited to seeking opinions. The principles and practices of partnerships need to be revamped according to EU practices. They need to operate as integrated institutional systems and not as lax forms of cooperation or dialogue.

This "second regime change" would be vital to public finances where we have lost our view of the interactions. The private sector has given up its one-time social and welfare institutions. These either have been terminated or continue to exist as service organizations, but financing now comes from social insurance, weighing down central and local government budgets. *The number of "public service providers," and the public expenditure itself have increased, which can be only financed by increasing public debt.*

This also illustrates the close relationship between public finances and the competitiveness of the business sector.

The first thing we need to clarify is *exactly what tasks the state has to meet,* and what resources (staff, miscellaneous expenditure, fixed assets, etc.) must be available to maintain a cost conscious, but efficiently operating public finance and public administration system. Then, *the reduction in expenditure will not be a goal, but rather an achievement,* because tax monies only will be used to finance necessary public tasks. This is the only way to attain a long-term expenditure cut, which could also result in *budget balance improvement.* This will allow for *increasing resources to boost competitiveness* on one hand, and to cut high taxes that are hindering competitiveness on the other.

There is no *planning or financing norm* connected to the handling of government tasks. When the budget is prepared, analysis is not performed to determine the actual need for the funding categories. This "good practice" is also used at closing. Therefore, there is a large margin of error when trying to judge the effectiveness of public financing, delegation of tasks, and necessity of parallel institutions. These tasks might be considered components of reform preparation, but they also could be addressed on their own.

As far as recommendations resulting from oversight, we can say in advance that *more government tasks* should be *delegated* – but not in the "usual way." *The overhead and support that need to be reduced should not be outsourced* to various businesses. Instead, spending conscious standards need to be established. Then, numerous current central government tasks, with the resources to manage them, should be turned over to local governments and public bodies of chambers of commerce that have their own nationwide networks and infrastructures to handle them.

Competitiveness is the concern of the entire national economy and the Hungarian society as a whole. It can be improved only through a complex approach, where every sector of the national economy has its own assigned tasks, and when execution is under public control. Today, Hungary is still competitive, but unless it manages to improve the state-run economic environment within the near future, not only will its neighbors catch up, but it will have to deal with the social consequences of falling behind as well.