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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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Elemér Terták[1]

About the Financial Perspective of the European Union for the years 2007–2013

The future should not be foreseen, but made possible.
Antoine de Saint-Exupéry[2]

The development of the budget policy of the European Union have been characterised by recurrent fierce debates and disagreements in the past few decades. The rows about the distribution of powers between the Council and the Parliament were accompanied by the often deep dissention about the equitable distribution of the burden among the member states. Based on the experience gained from these debates, the players developed rules and procedures that could not prevent the debates, however maintained the financial capacity of the EU. At the same time, however, the system has become incomprehensibly complex for outsiders. The enlargement carried out in May 2004 and the further, already decided enlargement of the EU pose new challenges for the community budget. The additional costs incurred due to the integration of less developed countries accentuate the distribution related debates among the member states and interest groups of the European Union. The situation is aggravated by the fact that keeping indebtedness under control has become more difficult even for wealthier member states due to the sluggish economic growth and the ageing population, wherefore the increase of community contributions seems to be an unbearable load. An agreement on Agenda 2007, i.e. the financial perspective for the period 2007–2013 must be reached amongst such conditions.

In my article I intend to present the rough road leading to the approval of the new financial perspective, and at the same time I wish to contribute to reducing the general lack of information about the community budget. According to the Eurobarometer survey conducted last autumn, the Hungarian respondents named the administrative and personal costs as the area that receives the largest share from the EU budget. In reality, the biggest chunk of the EU's budgetary expenditures is steered into the farming sector. The administrative costs were considerably overestimated by the respondents, since they only account for six per cent of the budget.

And at last but not least, the article intends to find a reply to the question as per what should be inevitably avoided, and where should much greater forces be focused in order that Hungary could maintain, or, possibly increase its role in the region, which itself undergoes great changes. It seems sure: the next wave of the EU enlargement, and the accession of the Balkans with a population of 15 million sooner or later will definitely change our position in the EU. Hungary must make the best of the coming seven-year period in order to win a stable position in the European Union based on thoroughly elaborated strategies and development concepts. In addition, I provide a review about issues on which we must take a stand during the preparation of the next financial perspective.

ON THE BUDGET OF THE EUROPEAN UNION

One of the basic objectives of the Treaty of Rome is the establishment of an economic and political union among the nations of Europe. For this purpose, the member states must gradually delegate certain tasks and activities and the related powers to the EU. For the implementation of the common objectives common policies must be developed and the related costs must be shared. Similarly to the national budgets, funding of the community budget also means the regrouping of incomes, in this case from the national to the supranational level.

The possibility of having direct (own) sources of income was already incorporated into the budget of the European Coal and Steel Community, at an early stage of the history of European integration. However, up until 1970, expenses were only paid from contributions made by the member states. The Community increasingly sought to generate own resources bypassing the national budgets of the member states, and thus increase its autonomy. Naturally, the term "own revenue" is a euphemism, since the European Union cannot raise autonomous revenue based on the right to levy taxes.

In the beginning, the direct sources of revenue of the European Economic Community were customs revenues from trading with third-party countries and agricultural levies. However, since the 1970s own revenues have not been sufficient to cover the expenses of the community, wherefore the so called VAT-based contribution was introduced. As a result of the further growth of expenses, in 1988 a decision was passed about the introduction of a fourth type of resource, which is the so called gross national income (GNI[3])based resource.

Resources

For the time being, the common budget of the EU can rely on four types of own resources:

❶ agricultural levies (i.e. the difference between the prices of agricultural products on the world market and the subsidised prices within the Community, which is a sort of "mobile" customs duty),

❷ customs duties on goods imported from countries outside the Community,

❸ a certain percentage of the value added tax (VAT) base, and

❹ the fourth resource, which supplements the former three resources, is the contribution paid by the member states proportionately to their gross national incomes (GNI).

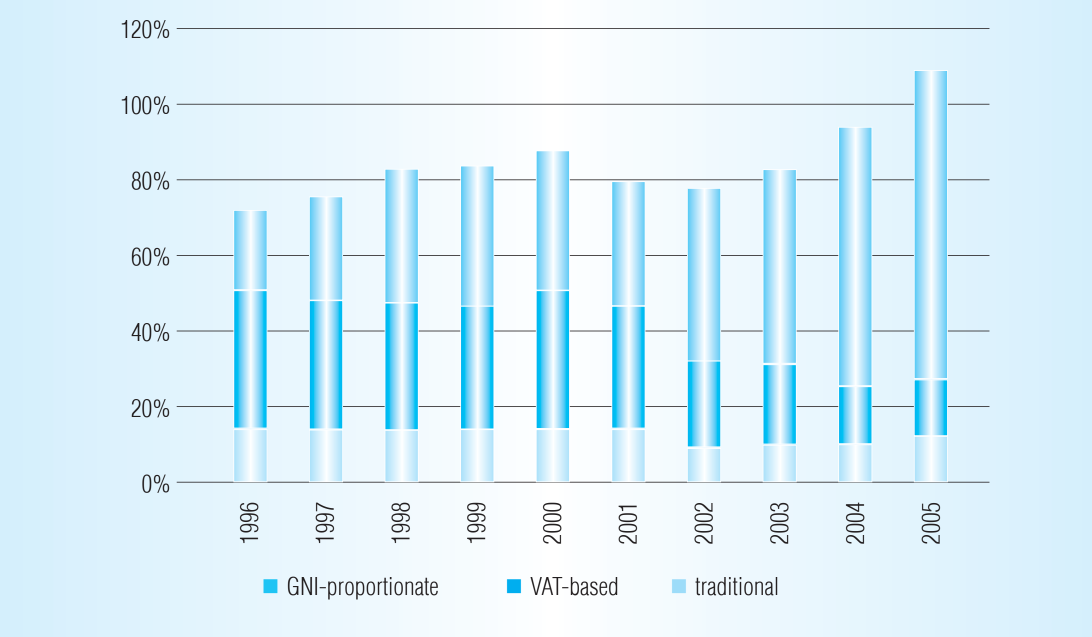
The member states must pay maximum 1.27 per cent of their GNI to the EU collectively under the four legal titles.

Apart from the above mentioned sources, revenues are raised from a few less significant resources, too: from the tax payments of EU officials, from the corporate fines levied by the European Commission and from surpluses carried forward from the previous year. *(See Figure 1)*

From time to time the idea of introducing an independent European tax is raised as an alternative for the above mentioned funding resources. The proponents expect that this would enhance the financial independence of the EU, and the transparency of expenses related to the activities of the EU. However, the opponents fear that if the EU would acquire the right to impose taxes, the already high tax burden would further increase, and they point out: the political debates erupt primarily in connection with the expenditure side of the budget, i.e. a new source of revenue would not halt them. However, since the realisation of such a reform requires unanimous approval by the member states, one can hardly expect the introduction of a European tax in the foreseeable future.

Figure 1

THE STRUCTURE OF REVENUE RESOURCES IN THE EU BETWEEN 1996 AND 2005



The decision passed in year 2000 about own resources resulted in a few minor reforms. The modification of the rate of VAT based resources in 2004 reduced the significance of this resource by half, or to 0.5%. As far as the traditional resources are concerned, cost reimbursement for collection grew from the former 10% to 25%. (However, this does not mean a large concession for the member states due to the reduction of the customs tariffs). The system of British rebate[4] also underwent minor changes: certain technical corrections prevented the United Kingdom from capitalising on the enlargement through the former practice of automatism. On the other hand, the four largest net contributors (Germany, the Netherlands, Sweden and Austria) were granted some concessions in funding the British rebate versus the other member states. In 2001, the gross sum of the common budget totalled EUR 92.6 billion on the expenditure side, which accounted for 1.08% of the Community's GNI.

In 2001, each citizen of the EU paid on average EUR 214 to the budget. The highest amount was paid by the citizens of Luxembourg (EUR 583 per capita), while Greece and Portugal contributed EUR 126 and 128, respectively per head. The biggest portion of budgetary revenues came from the fourth, the GNI based resource (37.5%). The share of VAT-based revenues was similar (33%), while agricultural and sugar levies accounted for merely 2.1%, and the customs duties imposed on imports from third countries equalled nearly 15%.

The introduction of the financial perspective

The tool of financial perspective (outlook) was introduced in 1988. The precedent was that the Council asked *Jacques Delors*[5], the then president of the Commission to submit a report on the financial standing of the EU at the London meeting to be held in December 1986. The admission of Spain and Portugal at the beginning of that year led to significant additional spending from the structural funds, and the prices for agricultural products on the world market threatened that the maintenance of the common agricultural policy in the original form would trigger payments without coverage in 1987.

Delors hoped that unless the member states wanted to make rich regions even richer and the poor ones even poorer, his proposals would be evaluated based on the realised need for increased solidarity (cohesion). In addition, he took into account the fact that the Single European Act, which was approved in 1986, earmarked that the community should assume greater responsibility in certain fields, such as research, which evidently requires more funds from the budget. In his proposal he initiated the doubling of the structural funds in five years, the increase of the research appropriations, measures to handle superfluous agricultural products, as well as the elaboration of a new framework for establishing the EU budget that determines the sum and ratio of the major expenditure items for five years ahead ("financial perspective").

The proposals were received rather differently by the member states. The German government was not pleased by the potential increase of net payments, which resulted from the enlargement of the structural funds, while *Margaret Thatcher's* government called for a tighter control over CAP spendings and all expenditures in general. No agreement was reached by the end of 1987, wherefore an extraordinary Council meeting had to be convened in February 1988.

At the extraordinary Council Meeting in Brussels the crisis was avoided by extending the deadline for the doubling of the structural funds from five to six years, by creating a new own resource based on GNI-proportionate payments, a Directive designed to restrict of the growth of expenditures under the common agricultural policy[6], and in that the volume of the budget would not exceed 1.2% of the GNI by 1992. Finally, the proposal regarding the medium-term budgetary planning was approved and it was agreed that the financial perspective would be reviewed in 1992.

The community expenditures are approved by establishing the annual budgets, in which the expenditures of the different policies are earmarked. The preparation of a medium term perspective is important since the implementation of many policies takes several years, wherefore framework conditions consistent with the programs must be created for the budgets of subsequent years. The financial perspective is a sort of a planning aid, for the elaboration of the annual budgets within the period. On one hand, the financial perspective sets the ceiling for expenditures, and the structure of the expenditures by determining the appropriations of the individual legal titles on the other. Within the framework of an Interinstitutional Agreement of May 6, 1999 between the Commission, the Parliament and the Council on budgetary discipline and improvement of the budgetary procedure the Commission, the Parliament and the Council universally undertook to abide by the approved limits in the period of the perspective. The establishment of the limit mandatory for all three institutions has proved to be very useful in the past 18 years: it contributed to the prevention of crises that formerly routinely reoccurred during the establishment of the annual budgets. These crises primarily erupted due to the debates on powers between the Council and the Parliament: since 1975, the right to establish the budget has been divided between the two institutions: in relation to the so called mandatory expenditures (expenses incurred for the completion of tasks arising from the Treaty or secondary legislation derived therefrom) the decision is in the hands of the Council. In contrast with this, the final decision lies with the Parliament in the case of non-mandatory tasks. While the common agricultural policy is a mandatory task, structural and regional policies are regarded as non-mandatory tasks. Since the division of the tasks into these two groups is rather arbitrary, the decision-making competence is evidently a source of fierce debates.

The tension is further aggravated by the Parliament's regularly manifested intention to use its budgetary rights in connection with non-mandatory tasks to achieve a greater influence on community policies. Although the above-mentioned fault-lines did not disappear upon the introduction of the financial perspective instrument, the dissents considerably diminished during the establishment of the annual budget.

This means that the appropriations of the financial perspective determine the weight of the individual legal titles of expenditure. Due to its weight, the most significant one is the agricultural policy. Nearly 43% of the expenditure is channelled into this area. This is followed by the structural policy with 34%. Internal policies (including the most significant area. i.e. research) have a share of 7.4%, while 9% is allocated for external policies and equalisation for the new member states. As much as 0.4% is spent on reserve formation and 6% on administrative tasks.

The Commission's ideas related to the financial perspective for years 2000 to 2006 were published in a document titled Agenda 2000 in July 1997. The material concluded that the inevitable reform of a few community policies could be implemented and the additional costs arising from the first wave of enlargement could be covered without increasing the 1.27% budget ceiling. The more detailed calculations that were published in 1998 envisaged an annual growth of 2.5% in the EU-15 and a 4% growth in the new member states. The frameworks of Agenda 2000 were agreed upon at the Council Meeting held in Berlin in March 1999. The agreement was based on the fact that in the first wave of enlargement six new member states would join the EU, and the budget would be increased by 18.6% by 2006 in order to cover the additional costs arising from the enlargement (pre-accession resources, growing agricultural and structural fund spending). The resources earmarked for the enlargement were “frozen”, i.e. they were made inaccessible for the 15 member states.

As we could see, the bitterest arguments in the European Union have always been about money. That is partly because the budget is inherently a zero-sum game: more for one country means less for others. But it is also because, although the budget is small (just over 1 per cent of EU GNI, equivalent to 2 per cent of EU-wide public spending), the gross sum is still significant compared to the budgets of the individual member states.

THE BIRTH OF THE NEW FINANCIAL PERSPECTIVE

The fourth financial perspective of the community, which comes after Delors I (1988–1992), Delors II (1993–1999), as well as Agenda 2000 (2000–2006) spans the period from 2007 to 2013, and is called Agenda 2007. As time went by, it became increasingly urgent to reach an agreement on the financial framework conditions of the next period, especially because it could be foreseen that firm negotiations would have to be conducted in order to reach an agreement.

The difficulties that had to be bridged stemmed from several sources. In the past years the European Union assumed many new tasks in the fields of the preservation and enhancement of internal security – such as the control of the external borders, certain subfields of asylum and migration matters –, as well as foreign policy. On the other hand, the accession of ten countries in 2004, and the planned admission of Bulgaria and Romania in 2007 posed new challenges in the field of the traditional policies: the conservation of the former subsidy policies would have entailed a rapid growth of the budget of the common agricultural policy and that of the structural and regional policies. But tensions appeared

Table 1

NET PAYERS, NET BENEFICIARIES AND THE LIVING STANDARDS (2003)

	Total net position (EUR million)	Net posítion as a percentage of the GDP	Per capita GDP at purchasing power parity (EU–15 = 100)
Luxembourg	–56.2	–0.28	196.7
Ireland	1564.6	1.40	121.3
Denmark	–213.7	–0.11	112.4
Austria	–336.2	–0.15	112.0
Nethelands	–1956.1	–0.43	110.8
United Kingdom	–2763.3	–0.16	108.6
Belgium	–775.1	–0.28	107.9
Sweden	–950.4	–0.36	105.5
Finland	–20.7	–0.01	103.5
France	–1910.9	–0.12	101.6
Germany	–7651.8	–0.36	99.0
Italy	–793.6	–0.06	97.9
Spain	8733.2	1.21	89.6
Greece	3368.2	2.22	74.1
Portugal	3482.0	2.66	68.1

Source: European Commission, Eurostat

between the old member states, too. Germany, the Netherlands and Sweden believed that they bore an unproportionately large share of community financing, while the beneficiary countries strove to continue the financial policy which was beneficial for them. The debate focused on the concept of the net position. The net position is the balance of payments made to the community and received from the EU in the form of subsidies. Although the net position shows some methodological weaknesses in terms of establishing the level of the beneficiary status, it more or less indicates the distribution of burden among the member states. The member states carrying the bulk of the burden had all the right to object to the fact that similarly developed (or sometimes even more developed) countries had a smaller share of the burden of redistribution to the benefit of less developed countries. *(See Table 1)*

The table lists the old member states in a decreasing order of per capita GDP. It presents the net position in terms of absolute sums as well as in comparison to the national GDP. As it can be seen, the Netherlands, Germany and Sweden contribute to the community revenues with the largest GDP proportionate amounts. This ratio can hardly be derived from the achieved high living standards, since certain wealthier member states contribute less to community expenses proportionately to their GDP. What is more, Ireland even obtains net revenues. The significant differences mostly stem from the Union's structure of expenditure: those countries get into a less advantageous position that enjoy the benefits of support-intensive agricultural and structural policies to a smaller extent due to their endowments. What is more, several member states in this latter group struggle for the consolidation of their own budgets, wherefore they understandably made all efforts to curb or cut back their expenses, including their contributions to the community budget.

Battle lines

For the above reason the battle lines over the budget were drawn even before the European Commission made its own proposal for the next financial perspective. In December 2003, the six biggest net contributors to the budget (Germany, Great Britain, France, the Netherlands, Sweden and Austria) demanded that the budget be held below one per cent of the EU GNI, despite the imminent arrival of ten new member states – including Hungary –, and the likely accession of two other countries at the beginning of the new "financial perspective" period. The joint initiative of the six countries was hardly sufficient to conceal the major clashes of interests that existed even among these six countries. For example, Great Britain has a vested interest in retaining the current rebate, and France insists on maintaining the current system of agricultural subsidies due to the importance of the agricultural sector in its national economy. The net contributors' ability to enforce their interests is further weakened by the fact that conflicts of interests arise even within certain countries. For instance, at federal level Germany would be interested in curbing regional subsidies, however the east German provinces are striving for maintaining the current intensity of support.

In its proposal submitted in 2004 the Commission called for the increase of the budget, claiming that the upper limits of commitments and contributions should be set at least at 1.24% of the GNI and 1.14% of the GNI, respectively, i.e. at EUR 929 billion. The Commission claimed that a credible program facing the new challenges of the EU can be developed only with that budget. On similar grounds, the Parliament believed that a gross sum of EUR 975 billion, i.e. 5% more than that proposed by the Commission would be necessary for the seven-year period beginning in 2007.

The proposal submitted by the outgoing Commission under *Romano Prodi* on February 10, 2004 largely ignored the recommendations of its own expert group chaired by the Belgian economics professor André Sapir. The Sapir Group had concluded that in its current form the EU budget was an "historical relic" that did little for Europe's economic growth". This is why it recommended that a reformed budget should be divided into a fund for economic growth (including research and development), a convergence fund, which would include all current regional aid, and would be concentrated in the new, relatively poor member states, and a restructuring fund that would help industries, including the farm sector, to adjust. It also recommended that the EU should reduce the portion of the budget it spends on agricultural support to just 15 per cent from the then effective 40 per cent.

The Commission's proposal was much more conservative than Sapir's suggestions, and initiated only rather prudent changes, which was partly related to the recognition of political realities. For instance, the agreement about agricultural subsidies signed by the President of France *Chirac* and Chancellor of Germany *Schröder* in October 2002 was regarded to have been cast in stone. In addition, the proposal – rather than steering regional aid to the new member states – would have allocated over half of the structural fund spending to the 15 old ones – even though all but two had incomes per head above the EU average. The only essential new element in the Commission's proposal was the increase in spending on policies for growth and competitiveness, however agricultural subsidies and the structural funds would have still accounted for the lion's share of the budget, namely 33 per cent and 36 per cent of the total, respectively, over the 2007 to 2013 period. Apart from this, the Commission proposed that the first financial perspective after the year 2006 should again span seven years, but then 5-year planning periods should follow one another.

Hungary's standpoint

Hungary found the Commission's proposal as a good starting point, since it was close to Hungary's standpoint in that the financial perspective after 2006 should credibly ensure the further funding of the old community policies and the funding of new tasks. From among the community policies the cohesion and the agricultural policies were especially significant for Hungary; and among the new challenges before the Union supporting research and development for the enhancement of competitiveness, as well as the protection of the common external borders and the new neighbourhood policy were of special importance.

Hungary urged that the expenditure structure of the new financial perspectives should ensure the implementation of the theory of community solidarity through the maintenance of the cohesion policy. It did so because a considerable portion of the population of the new member states live in regions where community support can directly contribute to the elimination of social, economic and regional disparities. EU subsidies create jobs, support the development of the local and national infrastructure, help enterprises become stronger, and contribute to environmental protection. According to the Hungarian standpoint, the regions of the new member states must receive funding comparable to the supports granted to the beneficiary regions of the old member states. According to the EU regulations, such supports cannot exceed 4% of the gross national income of a country[7]. In addition, Hungary believes that the agreement reached in October 2002 on the annual nominal increase of market-based and direct payments to the member states by 1% by 2013 is an endowment influencing budgetary planning. In Hungary's view, the EU can hold its ground in the global competition only if more investments are made in the field of research, development and innovation, as well as in human resources.

Since according to Hungary it is necessary to simultaneously maintain the community policies that have played a crucial role so far, satisfy the funding needs arising from the enlargement and comply with the new tasks, it supported that proposal of the Commission according to which the ceiling of the expenditures of the new financial perspective should not be lower than the current one. Furthermore, Hungary found it important that the upper limit of commitments should be set at 1.24% of the aggregate gross national income of the Community. In addition, in response to the efforts of the largest net contributors, Hungary did not agree with rebate systems that earmarked refunds based on the net position.

A compromise in the wake of heated debates

The difference between the effort of the six large net contributors and the Commission's proposal was rather considerable: it amounted to EUR 215 million annually, or EUR 1.5 billion for the entire seven-year period. The Parliamentary report published on June 8, 2005 tried to bring the two standpoints closer to each other, and proposed to set the budget ceiling for payments at 1.07 per cent. In the run-up to the June 2005 summit, some of the net contributors indicated that they might accept a somewhat bigger budget, but only with conditions. For the sake of an agreement, the rotating Luxembourg presidency proposed a compromise that was more beneficial for the large payers. However, at the Council's meeting the Prime Minister of Britain submitted a radical proposal demanding structural changes, and at the same time he insisted on maintaining the British rebate. Therefore, despite the efforts of the Prime Minister of Luxembourg, no agreement was reached at the June summit.

Despite the failure of the Brussels summit, new intensive negotiations commenced between the member states during the British Presidency, which started on July 1, 2005. As a result, a near-agreement was reached by December last year. The increase of the commitments equalling 1.03% of the GNI could have been accepted by the majority of the net contributors, however Sweden called for further savings. On the other hand, Poland and Hungary did not approve the budget that had been curtailed by 3% compared to the proposal of Luxembourg, due to the significant reduction of cohesion fund spending allocated to the new member states (minus 8 per cent), and because of the increasing funding needs of the enlarged Union. The lower budget was found to be inadequate by the three Baltic states, too. The size of the budget was significantly determined by the announcement made by the largest contributor, Germany, according to which it could accept a ceiling of 1.04–1.05 per cent of the GNI. As a result, the 1.045% ceiling of the third British perspective was accepted by the member states (EUR 862 billion in commitments and EUR 821 billion in payment appropriations).

In the debate conducted at the working dinner of the summit four large net contributors, as well as Belgium and Luxembourg were for allocating larger subsidies to the new member states. At the same time, four of the new member states accepted the reduced cohesion funds partly due to the proposed individual discounts, and partly due to the cancellation of the planned restriction of the rules of use, or the alleviation thereof. In relation to the rules of use it was paramount to maintain the eligibility of non-refundable VAT, the increase of the maximum rate of EU co-financing to 85%, the accountability of the costs of projects financed in conjunction by the public and the private sectors (PPP projects), as well as the creation of the possibility to grant subsidies to improve the living conditions. The new member states unanimously objected to the introduction of the automatic decommitment rule (n+2–rule[8]) under the Cohesion Fund. Therefore, the final agreement stipulated that for the first four years of the period the n+3 rule would be introduced.

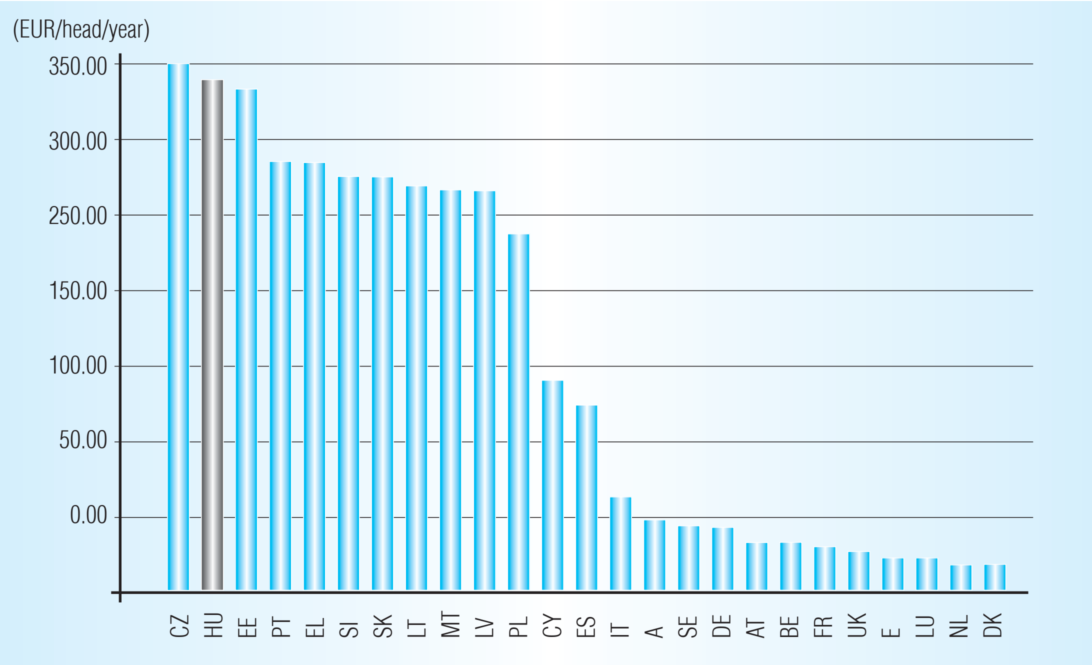
The reduction of the British rebate by EUR 8 billion was considered insufficient by the overwhelming majority of the member states for the equitable distribution of the costs of enlargement. In line with the expectations, the rebate was criticised by several member states. The deal, which means that the costs allocated for the new member states will be gradually taken out from the amounts earmarked for the British rebate, was finally struck based on the compromise between the Prime Minister of Britain, the Chancellor of Germany and the President of France. In pursuance of the agreement, the calculation of the British rebate will gradually change from 2009 onwards. The costs allocated to the new member states will progressively be taken out of the calculation formula from 2009 onwards, and in full from 2011, with the exception of CAP. This is to prevent the growth of the British rebate proportionately to the costs of enlargement. At the same time, the agreement maximizes the increase in contribution paid by Britain in the years 2007–2013 – arising from the reduction of the rebate – at EUR 10.5 billion.

In return for the individual discounts and more flexible rules of use under the cohesion policy, most member states could have accepted the reduced gross sum contained in the second British proposal. Partly out of principle, and partly because of the small size of the discounts, Hungary and six other – mainly new – member states did not find the discounts sufficient. Their demands could be mostly tackled by the third British proposal, and a consensus could be reached. *(See Figure 2)*

In the other pivotal issue of the British and French debate a low-key text of compromise was accepted despite the former harsh announcements. In pursuance of the elaborated

Figure 2

PER CAPITA SUPPORT FROM THE COHESION FUND BETWEEN 2007 AND 2013 IN THE EU-25 COUNTRIES



formula, in the years 2008 and 2009 the Commission will submit a comprehensive review material covering all elements of the budget, such as the community policies – including CAP – however it does not contain any provision that would create and obligation or automatic mechanism before 2013 or after 2014. The approved Council proposal for the budget was EUR 113 billion (11.6%) less than the amount the Parliament had originally found necessary, and EUR 60 billion (6.5%) less than the initial proposal of the Commission.

The agreement bargained by the heads of state and government can enter into force only upon being approved by the Parliament. However, the Parliament found the amount of the compromise too low, wherefore it demanded that the budget would be expanded by at least EUR 12 billion, and demanded a bigger say in the discussions of 2008–2009 designed to review the system of the EU budgets. The Budget Committee of the Parliament determined: if the member states do not table a more favourable proposal, it would rather back out from the trilateral agreement on the budget signed in 1999 and then partially modified in 2002. For the lack of an agreement, the institutional framework in which the medium-term financial plans may exist would disappear, and we should return to the system of annual budget-bargaining. The termination of the agreement may seem threatening in the first instance, however experts believe that it is actually a dual weapon. It is a matter of interpretation to what extent the threatening should be regarded fatal, since the current agreement will cease to have effect anyway, and a new one would be needed from 2007 on. Threatening with termination is weightless as long as it is not accompanied by the announcement according to which the Parliament does not wish to sign any new agreement in the future. However, this was not the case. What's more, the Parliament showed willingness in continuing the negotiations in case the Austrian presidency would receive an "actual mandate" for this.

Rapporteur *Reimer Böge* justified his standpoint expressed in the draft he complied with the fact that the financial perspective reached by the member states "does not guarantee an EU budget enhancing prosperity, solidarity and security". This is why the Parliament – in line with its standpoint – found it necessary to increase the total budget by at least EUR 13 billion, or 1.5%. According to the draft report, the compromise reached by the member states in December focuses on the traditional policies "rather than putting emphasis on policies enabling the European Union to face new challenges and develop added value for citizens". Furthermore, the draft deplored that the member states fought to preserve their national interests rather than foster the European dimension. Finally, the Parliament objected to the Council's agreement because it did not provide for a detailed flexibility mechanism, or a clear role for the Parliament in the review.

The intense negotiations between the Council's Permanent Representatives Committee (COREPER) and the Parliament outlined a new compromise by early April, which already seemed acceptable for both sides. As a result, on April 5, in the fourth round of the trilateral talks, after a session of more than seven hours, the delegation of the Parliament agreed with the Austrian Presidency about the EU budget for the years 2007–2013. The seven-year community budget will be EUR 4 billion larger than that established at the December summit of the heads of state and government of the EU member (EUR 862.3 billion). *(See Table 2)*

Although the Parliament demanded a sum three times bigger than the achieved surplus, it still succeeded in ensuring that significantly greater funds be spent on programs facilitating the Lisbon strategy, such as research, develop-

Table 2

THE INTERINSTITUTIONAL AGREEMENT IN FIGURES

	Growth compared to the Council Agreement of December (EUR million, at 2004 prices)	
Subheading 1.a – Competitiveness for growth and employment		2 100
Trans-European networks	500	
Lifelong learning (Erasmus and Leonardo)	800	
7. Research framework program	300	
Competitiveness and development	400	
Social policy agenda (Progress)	100	
Subheading 1.b – Cohesion for growth and employment		300
Structural Funds (regional cooperation)	300	
Heading 2 – Preservation and management of natural resources		100
Provision for action plans (Life+ és Natura 2000)	100	
Subheading 3.b – Citizenship		500
Healthcare and consumer protection	200	
European culture and citizenship (culture, youth, European citizens)	300	
Heading 4 – The EU as a global partner		1000
European neighbourhood and partnership instrument	200	
Common foreign and security policy	800	
Total:		4000

ment, trans-European networks, supports to small and medium-sized enterprises, and education. Furthermore, the budget of the Union's foreign policy was also raised significantly (by EUR 1 billion).

From the surplus of EUR 4 billion, 2 billion comes from the modification of the computational rules pertaining to the traditional revenue resources of the Union, and the other 2 billion comes from the emergency fund and the solidarity instrument. In addition, the guarantee fund of the European Investment Bank was raised by EUR 2.5 billion. As a result, EIB can contribute EUR 1 billion more to development and SME supporting programs each, and EUR 0.5 billion more can be spent on the development of trans-European networks, too.

The Parliament and the representatives of the member states also agreed to evaluate the experiences of the budget and the interinstitutional agreement at the end of 2009, and to involve in this process the European Parliament to be re-elected in that year. The agreement also calls for the enhancement of the quality of the use of community funds by the member states, as well as the execution of the programs and the budget, and also for parliamentary control over the external activities of the Union. The flexibility related provisions also improved by the establishment of a fund designed to offset the unfavourable effects of globalisation, as well as by maintaining the European Solidarity Fund, the immediate assistance reserve and the flexibility mechanism.

The interinstitutional agreement staved off the threat of the need to approve the Union's short-term budget annually for the lack of an agreement. The agreement will become final after the deputies approve the medium-term financial perspective at the plenary meeting of the Parliament – presumably on one of the session days between May 15 and 18 – in an official format, too. By that time the text of the agreements will be made more accurate both legally and professionally. As for the Council, it will confirm the agreement at the next meeting among the items to be approved without debate.

After the agreement was reached, President of the European Parliament *Joseph Borrell* announced that during the negotiations the Parliament had fought not only for more resources, but also for a better budgetary structure. From among the achievements he pointed out that the Erasmus program, lifelong learning, developments and small and medium-size enterprises would receive greater subsidies. The Parliament's budget rapporteur Reimer Böge stated that although he was not satisfied with the agreement, but a compromise still acceptable under the current circumstances had been reached. He considered it as a positive achievement that 40,000 more students would be able to participate in the European exchange programs.

President of the Commission J*osé Manuel Barroso* believes that the compromise based deal is definitely more favourable than the December agreement of the Council. He believed that the EU now has those resources at its disposal with which the objectives of the next seven years can be implemented.

Soon afterwards the Foreign Policy Committee of the Parliament accepted *István Szent-Iványi's* report on the Instrument for Preaccession Assistance (IPA) planned for the period of the new financial perspective. According to the committee's proposal, IPA would replace the large number of pre-accession instruments (PHARE, ISPA, SAPARD, CARDS, TAIEX, etc.). The new scheme would partly apply to candidate countries (Turkey, Croatia, Macedonia), and partly to the other countries of the West Balkan, (Bosnia Herzegovina, Serbia and Montenegro, Albania), as potential candidate countries. The European Parliament will be able to call the Commission to suspend or restore supports should it be justified by the behaviour of the beneficiary state.

Table 3

THE SIZE OF THE EXPENDITURE HEADINGS

(EUR million at 2004 prices)

Commitment appropriations	2007	2008	2009	2010	2011	2012	2013	2007–2013 Total
1. Sustainable growth	51 267	52 415	53 616	54 294	55 368	56 876	58 303	382 139
1a. Competitiveness for growth and employment	8 404	9 097	9 754	10 434	11 295	12 153	12 961	74 098
1b. Cohesion for growth and employment	42 863	43 318	43 862	43 860	44 073	44 723	45 342	308 041
2. Preservation and management of natural resources	54 985	54 332	53 666	53 035	52 400	51 775	51 161	371 344
including: market related measures and direct payments	43 120	42 697	42 279	41 864	41 453	41 047	40 645	293 105
3. Citizenship, freedom. security and justice	1 199	1 258	1 380	1 503	1 645	1 797	1 988	10 770
3a. Freedom. security and justice	600	690	790	910	1 050	1 200	1 390	6 630
3b. Citizenship	599	568	590	593	595	597	598	4 140
4. The EU as a global partner	6 199	6 469	6 739	7 009	7 339	7 679	8 029	49 463
5. Administration*	6 633	6 818	6 973	7 111	7 255	7 400	7 610	49 800
6. Compensation	419	191	190					800
TOTAL COMMITMENT APPROPRIATIONS	120 702	121 473	122 564	122 952	124 007	125 527	127 091	864 316
as a percentage of the GNI	1.10	1.08	1.07	1.04	1.03	1.02	1.01	1.048
TOTAL PAYMENT APPROPRIATIONS	116 650	119 620	111 990	118 280	115 860	119 410	118 970	820 780
as a percentage of the GNI	1.06	1.06	0.97	1.00	0.96	0.97	0.94	1.00
Available room for manoeuvre (as a percentage)	0.18	0.18	0.27	0.24	0.28	0.27	0.30	0.24
Upper limit of own resources as a percentage of the GNI	1.24	1.24	1.24	1.24	1.24	1.24	1.24	1.24

* The pension expenditures subject to the upper limit of this heading do not include the personnel contributions paid to the affected system, and were calculated for the years 2007–2013 based on the available EUR 500 million limit calculated at 2004 prices.

SUMMARY AND EVALUATION OF THE AGREEMENT FROM THE HUNGARIAN PERSPECTIVE

The commitment appropriations of the budget for the years 2007–2013 will equal 1.05% of the gross national income of the EU, or EUR 866.4 billion. (For the expenditure headings see *Table 3*, and for the grouping of expenditures see *Table 4*)

SUBHEADING 1A., COMPETITIVENESS: the gross sum of the heading has not changed since the proposal of Luxembourg was put forward. However, a modification was made in favour of the R+D expenditures; R+D supports allocated from the common budget will exceed the 2006 level by 75%. Special attention will be given to the development of trans-European networks. The European Commission and the European Development Bank were asked to work out a credit scheme of EUR 10 billion to support the R+D investments of the private sector.

SUBSECTION 1B., COHESION: an agreement about the gross sum of this heading was reached in the period between the last Luxembourg and the second British proposals. The cap on cohesion support to the new member states grew by 0.1143–0.1263 percentage point of their GNI. The other component of the growth of the cohesion support is made up

Table 4

GROUPING OF EXPENDITURES

HEADING 1	**Sustainable growth**	
1A.	Competitiveness for growth and employment	NME*
1B.	Cohesion for growth and employment	NME
HEADING 2	**Preservation and management of natural resources**	**NME**
	Exceptions:	
	• *the expenses of the common agricultural policy that affect market measures and direct subsidies, including fisheries related market measures and fishery agreements with third parties*	ME**
HEADING 3	**Citizenship, freedom, security and justice**	**NME**
3A.	Freedom, security and justice	NME
3B.	Citizenship	NME
HEADING 4	**The EU as a global partner**	**NME**
	Exceptions:	
	• *expenditures under the EU's international agreements with third parties*	ME
	• *contributions to international organisations and institutions*	ME
	• *contributions to the credit guarantee fund*	ME
HEADING 5	**Administration**	**NME**
	Exceptions:	
	• *pensions and severance pays*	ME
	• *benefits and other allowances paid upon the termination of service*	ME
	• *legal expenses*	ME
	• *reimbursements*	ME
HEADING 6	**Compensations**	**ME**

* NME = Non-mandatory expenditures
** ME = Mandatory expenditures

of individual discounts above the support. *(See Figure 3)*

Hungary's cohesion support equals 3.524% of the country's GNI, or EUR 22.5 billion. On top of this amount (i.e. above the ceiling of supports) the Central Hungarian region will receive an additional support of EUR 140 million in the years 2007–2013. The development projects to be implemented in the region will be subject to the same favourable rules of implementation as those realised in the poorest regions. As a result, the total amount of cohesion support was EUR 1 billion more than the first British proposal offered.

HEADING 2, NATURAL RESOURCES, AGRICULTURE: the frameworks of the common agricultural policy will basically be maintained for the years 2007–2013. The Brussels agreement reached in October 2002, which determined market based and direct payments to the producers until 2013, was respected with the supplementary provision that payments made to Romania and Bulgaria would also form part of the agreement of 2002. In the case of the old member states, regrouping from direct payments for rural development purposes may grow to 20% through voluntary modulation.

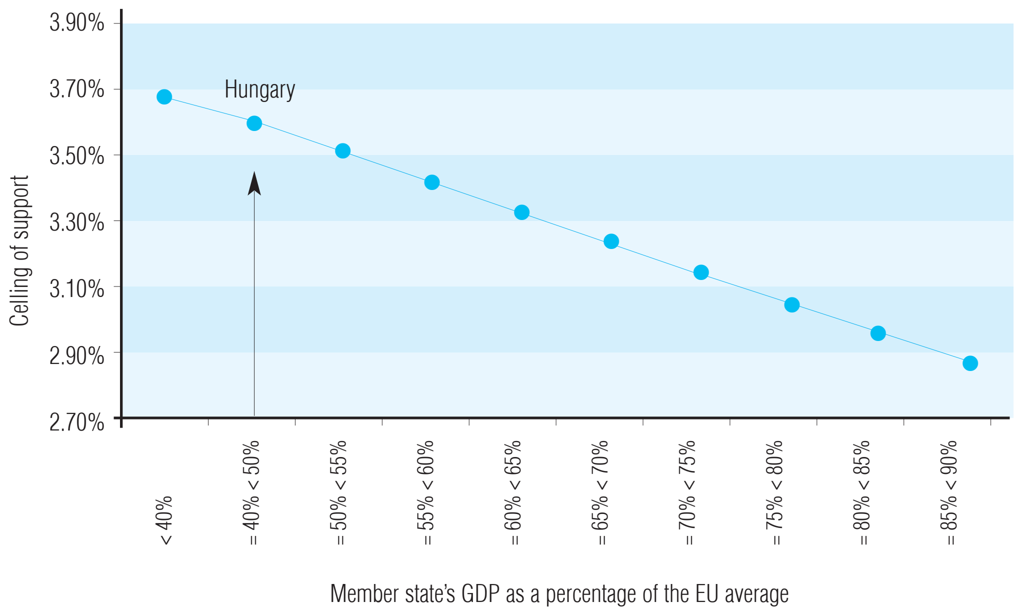
The direct support to producers and market based subsidies will be disbursed to Hungary in compliance with the provisions of the Accession Treaty. Hungary will receive EUR 3 billion as rural development subsidies throughout the seven years.

HEADING 3, *subheading 3a, freedom, security and justice* will continue to receive special attention.

The size *of subheading 3b (culture, youth, audiovisual matters)* was determined at a slightly lower level than envisaged by the Luxembourg proposal.

Figure 3

CAP ON COHESION SUPPORT



HEADING 4, EXTERNAL ACTIONS: the budget of this heading equals the budget proposed during the Luxembourg negotiations. No change has been made to the system of instruments applied in external actions compared to the Luxembourg proposal. The European Development Fund (EDF) remains outside the common budget, however the budget of the common foreign and security policy (CFSP) may increase.

HEADING 5, ADMINISTRATION: the budget of the heading is identical with the one contained in the Luxembourg proposal, however there are differences in the yearly breakdown.

Compensation: Romania and Bulgaria will receive budgetary compensation in the period between 2007 and 2009 so that their net position would be favourable in the first years of their EU membership. (This compensation is similar to what the countries that became members in 2004 receive in the first three years of membership.)

RULES PERTAINING TO THE USE OF SUPPORT

Non-refundable VAT will continue to be eligible costs. This is of paramount importance for both the local governments and the central budget.

At the Structural Funds the maximum rate of co-financing was raised to 85%. This is a significant step forward compared to the period of 2000–2006.

The agreement does not extend the Lisbon cap on cohesion supports to the new member states, which creates a greater room for manoeuvre in the development of local infrastructure.

An agreement was reached about the introduction of the n+3 rule already mentioned under the Cohesion Fund and the Structural Funds for the years 2007–2010.

The costs of projects financed from public and private resources alike will become eligible for support. This is especially important in the case of PPP projects, since it increases the possible rate of co-financing by the EU by expand-

Table 5

HUNGARY'S TOTAL SUBSIDIES AND CONTRIBUTIONS IN THE YEARS 2007–2013
(at 2004 prices, EUR billion, total for 7 years)

AVAILABLE SUBSIDIES (level of commitment appropriations)	
1a. Competitiveness (TEN, R+D, lifelong learning, etc.)	1.0
1b. Cohesion policy	22.6
2. Natural resources	9.2
direct agricultural support	6.1
rural development	3.0
other (fisheries, environmental protection)	0.1
3. Area of freedom, security and justice (media, culture, migration, etc.)	0.1
4. EU as a global partner (support to third countries)	0.0
5. Administration	0.1
6. Compensation (only to Romania and Bulgaria)	0.0
Total:	33.0
EU BUDGETARY REVENUES	
Traditional own resources (customs duties, sugar levies)	1.9
Contributions (VAT- and GNI-based)	5.8
VAT-based contribution	0.9
GNI-based contribution	4.9
Financing the British correction	0.6
Total:	8.3
BALANCE OF COMMITMENTS AND PAYMENTS	24.7

ing the group of eligible costs. Furthermore, it becomes possible to subsidise housing projects.

REDUCTION OF THE EXCESSIVE NET POSITIONS

In pursuance of the agreement, the calculation of the British rebate will gradually change from 2009 onwards. The costs allocated to the new member states will progressively be taken out of the calculation formula from 2009 onwards, and in full from 2011, with the exception of CAP. This is to prevent the growth of the British rebate proportionately to the costs of enlargement. At the same time, the agreement maximizes the increase in contribution paid by Britain in the years 2007–2013 – arising from the reduction of the rebate – at EUR 10.5 billion.

In the system of own resources four member states are given preferential treatment in order to reduce the extreme imbalance of their net positions.

REVIEW CLAUSE

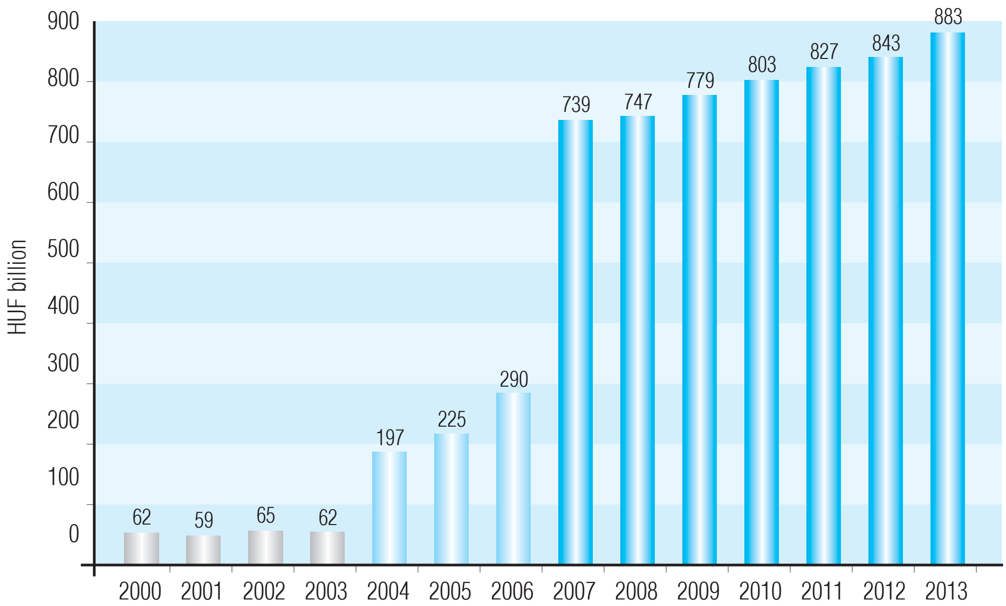
The clause on the review of the financial perspective did not turn out to be very ambitious. The Council invites the Commission to review the expenditure and revenue sides of the budget in the report to be published in 2008–2009. The conclusions of the report can be taken into account during the preparation of the next financial perspective for the period after 2013.

As it can be seen from *Table 5*, Hungary may receive a total of EUR 24.7 billion in development resources, which equals 4% of

Figure 4

COHESION SUPPORT GRANTED TO HUNGARY IN THE YEARS 2000–2013

(Phare, ISPA, SAPARD, Structural and Cohesion Funds)



its GDP, in the years 2007 through 2013 under the cohesion policy of the EU. *(See Figure 4)* The precondition for drawing the resources down is the existence of the National Strategic Reference Framework (National Development Plan[9]) and the relevant operative programs.

This document shall establish the system of objectives and tools related to the use of funds.

According to the Government's concepts, counting with a realistic, annual economic growth of 4 to 5%, the Hungarian budget will contribute to the community resources nearly HUF 90 billion in 2007 and nearly HUF 200 billion in 2013 in the framework of co-financing.

This year, community funds assist the implementation of 20% of Hungarian development projects, and this ratio will grow to 60% by 2013. In 2006, community resources worth HUF 316 billion will come to Hungary through the Hungarian budget, which is expected to grow to HUF 1,060 billion by 2013.

In line with the EU's priorities, the main pillar of the National Development Plan effective in the period of the new financial perspective is about the enhancement of competitiveness, the promotion of economic growth, the expansion of employment and the enhancement of justice, as well as the establishment of security. The target oriented and regionally efficient use of EU funds that would expand considerably compared to the current period can significantly accelerate the pace of economic development and the alleviation of social tensions.

In the next seven years, the Hungarian citizens, entrepreneurs, local governments and regions can be actively and fully involved in the implementation of community programs that cover almost all areas of the economic and social life of EU citizens. These programs include the LIFE+ environmental program to be launched at the beginning of the new financial perspective, the Competitiveness and Innovation Framework Program (CIP), the Seventh Framework Program for Research and Technological Development (FP7), MEDIA 2007, the Integrated Action Plan for Lifelong Learning, as well as the Culture 2007 and Youth in Action programs.

FURTHER TASKS[10]

The sizeable supports that will be available during the seven-year period starting in 2007 will offer promising perspectives for Hungary in the next two election terms. However, the next wave of enlargement, and the envisaged accession of the Balkans with a population of 15 million will definitely change our position in the EU, and the amount of subsidies that could be used under the next financial perspectives will be necessarily curtailed. This is why we must make the best of the next seven-year period to win a stable position in the community based on well-developed strategies and development concepts. Completion of the task is made difficult by the fact that the disorderly budget must be urgently remedied, and the budgetary deficit, which by far exceeds the Maastricht criteria, must be reduced. In addition, towards the end of the period Hungary will have to face increasing budgetary burdens in relation to the pension system due to the unfavourable demographic processes. In the imminent period Hungary must streamline its central public administration system, and develop a smaller and more efficient system of self-governance based on decentralisation. In addition, the reform of the large provision systems, especially that of healthcare is inevitable, and the comprehensive review of the pension system cannot be evaded either. The Government must submit to the Commission already in September the convergence program containing the authentic program for the completion of all these tasks, and must set to implement it without delay. The failure of implementation would not only trigger the serious consequence of the money markets' shattered confidence in Hungary, but also the freezing and partial loss of the expected supports. Under the given circumstances, the special significant of the available EU supports is given by the fact that in spite of the naturally painful reduction of budgetary expenditures they make it possible to avoid or (at least endure) the streamlining of infrastructural, cultural and educational developments taken in the broad sense of the word. This is especially important in terms of laying the foundations for the country's future. Since budgetary developments can no longer be financed at the expense of aggravating indebtedness, we must make the best of the resources available through Hungary's EU membership. It is impermissible to lose even the smallest subsidy due to planning or implementation errors, delayed implementation, or due to the inefficient use of funds.

PREPARATION FOR THE DEVELOPMENT OF THE NEXT FINANCIAL PERSPECTIVE

In the medium run, the future of the Union – including the opportunities to be exploited by Hungary – will be largely determined by the preparation of the Commission's report on the expenditures and own revenues of the common budget scheduled for 2008–2009, and the debates to be conducted based on the report. In the course of those debates we will again face the question as per what consensus can be reached about the existing community policies, especially about the future of the common agricultural policy. It may seem early to ponder about this question, however it is not useless to prepare for this review well in advance. It is important to prepare for this presumably fierce debate thoroughly and free of any pre-concepts. The call for review does not necessarily mean that the common agricultural policy is a completely obsolete, wasteful mechanism, in relation to which the only question is how to get rid of it as soon as possible. But it cannot be regarded as an eternal rule either that resources allocated to the common agricultural policy can be used in the old structure and method. In the light of the often radical changes that occurred in the social and economic structures of the member states, in the framework conditions of world politics and trade in the past four decades, as well as in the light of the global climate change and the energy balance of the world one must thoroughly think over to what extent the original objectives of the common agricultural policy should be modified, and how the objectives to be pursued in the future could be most efficiently achieved. However, no matter how good the strategy is if the farm sector is not restructured, and adjustment is only forced by the new rules retroactively, and therefore with delay.

The community must make progress in the issue of own resources, too. The member states are not likely to agree on the introduction of an independent European tax, however, anomalies that led to different contributions paid by similarly developed countries must obviously be eliminated. For instance, Belgian Prime Minister *Guy Verhofstadt* proposed the introduction of a guarantee rule that would put a cap on per capita contributions paid by the wealthier member states as a percentage of the average GNI in the EU. Such a move would definitely limit the amounts that could be allocated for poorer countries so that they could catch up with the wealthier ones.

The other big issue that will determine the future of the EU – and consequently, the frameworks of its budget – in the medium run is the development of its enlargement policy. The EU must maintain its openness towards those European countries that have expressly indicated their intention to join the Union, and which are ready and able to meet the accession criteria. This is indispensable for the Union to radiate stability towards its environment, and is equally important for those European countries for which accession to the EU is the direction of development. Due to its recent accession to the EU, as well because of its geopolitical situation, Hungary must promote openness within the Union. However, while maintaining openness, it is equally important for the EU to consistently stand by its own principles, and require all candidate countries to fully comply with the so called Copenhagen criteria[11]. It is no surprise that Hungary – a country that tread along this road itself – expects that these criteria be met in the future, too. This is also the key to restoring the confidence of the general public in that the enlarged Union can provide the same or even better conditions than pre-enlargement Europe. The consistent enforcement of the principles can convince the candidate countries that the decision about their admission is not made on the basis of the sum of sympathies and antipathies, but exclusively depending on whether or not they will be ready and able to meet the political, legal and administrative conditions of accession. However, since further enlargement of the EU would practically mean the accession of countries that are less developed than Hungary[12], we must be aware of the fact that the specific weight of subsidies available for Hungary will decrease. Consequently, the further process of enlargement will be beneficial for the country if the domestic companies are able to exploit the opportunities offered by the increased market.

Another big question will be – obviously in relation to the aforesaid – whether the tendencies within the Union strengthen or not upon which after the establishment of the euro zone and the Schengen area internal homogeneous groupings of member states will emerge in more and more regions, and whether the current “outsiders” can join or catch up with these internal groupings within the shortest possible time. There is no doubt that this issue will be crucial for Hungary's future position in the European Union, and also for the direction in which the entire EU will open up. There is no doubt that we are primarily interested in a Europe which manifests as much homogeneity, togetherness and solidarity as possible, in which we become involved as soon as possible in the long-standing and reinforced cooperation, but where the main point is not in having more and more smaller groups. The precondition for all this is that at our own fault we must neither halt nor hinder tighter integration, which requires successful economic policy efforts.

At last but not least we must find the answer to the question that will determine the future of the Union in the short, medium and long run alike: how can the trust in the European institutions and European integration be restored and strengthened? Although this question is not directly related to the community finances, real progress in the common matters – including the common budget – is hardly possible without finding a good answer to it. Partly due to the volumetric limits of this article, I will not endeavour to take into account all factors of the reinforcement of confidence, however I must definitely point out the general opinion about the European Union and globalisation. The analysis of the rejection of the European constitution in the French and Dutch referendums clearly shows that the fears of the general public about the consequences of the competition that goes with globalisation are projected to the European Union, and especially to the enlargement related expectations. However, such fears can be encountered not only in the societies of the founding member states: according to the Eurobarometer survey cited above, 55% of the Hungarian respondents thought that the EU membership adversely affected employment. In relation to the fears related to EU membership, as much as 75% of the Hungarian respondents indicated the loss of jobs, or the transfer thereof into other countries. All this indicates that people must be convinced with facts and arguments about the fact that the European Union is not the cause of the needs to adjust, but on the contrary: it provides tools and opportunities enabling the individuals, communities and member states to successfully face the challenges inherent in globalisation. It would be worth reminding ourselves, too, of the fact that after the political turnaround Hungary could successfully join the group of market economies and meet the challenge of competitiveness that was dreaded by so many people, and the impacts of which could not be fully predicted. Similarly, the first two years of Hungary's EU membership on the whole proved to be successful, and the worries and fears turned out to be unjustified. The only effective remedy against the parlous fear from the future is the one to which the motto of my writing calls attention: the future should not be foreseen, but made possible.

Notes

[1] This article contains the author's views and does not necessarily reflect the official standpoint of the European Commission.

[2] This thought of the famous French pilot, writer and moralist (1900–1944) was the motto of the Commission's proposal tabled in February 2004 on the financial perspective for the years 2007–2013. The quotation is from the author's book of essays titled "The Citadel" which was translated into Hungarian by László Pödör under the title Citadella (Lazi Publishing House, Szeged, 2002)

[3] The Gross National Income (formerly Gross National Product – GNP) is the sum of the gross domestic product (GDP), and the capital incomes

received from abroad and paid abroad. According to the preliminary data of the HCSO, in 2004 the gross national income (GNI) in Hungary totalled HUF 19,273 billion at current prices, while the gross domestic product (GDP) equalled HUF 20,413 billion.

[4] Since it joined the European Community in 1973, it has been a major intention of the United Kingdom to adjust the amount it pays as contribution to the community. The theoretical basis for this was given by the fact that the agricultural sector does not play a crucial role in the national economy of the United Kingdom, wherefore it can expect only minor subsidies under CAP. In addition, due to joining the Community, it was no longer eligible for the favourable imports from the British Commonwealth, which lead to deteriorating terms of trade. For this reason, it was decided at the Council's Fountainbleau Summit in 1984 that Britain would receive a rebate in relation to the VAT-based contributions. This rebate system has been modified several times since then, as a result of which the rules pertaining to own revenues have by now become extremely complex, which triggers much criticism.

[5] The French Jacques Delors, who was born in 1925, was the president of the European Commission between January 1985 and January 1995.

[6] CAP reform: the common agricultural policy (CAP) was first introduced in 1960 to provide secure food supplies for Europe at reasonable prices. However, the common agricultural policy has become the victim of its own success, since it accumulated undesirable surpluses from certain products, such as beef, barley, milk and wine. In addition, the subsidies paid to the European farmers distorted global trade. Therefore, in 1999 the Commission set to review CAP. In 2003, the EU agreed on further reforms, placing and especially big emphasis on quality agricultural production, and animal friendly husbandry, which protects the environment and preserves the values of the countryside. The EU intends to reduce direct subsidies to farmers in order to restore the balance between the agricultural markets of the EU and the developing countries.

[7] The ceiling set at 4% of the GDP is disadvantageous for the less developed EU member states because of the difference between the market and purchasing power of the exchange rate of the euro. However, since this restriction will not be in force due to the level of development Hungary has achieved, this remark is significant in theory only.

[8] In pursuance of Article 31.2 of Regulation 1260/1999/EC (June 21, 1999) laying down general provisions on Structural Funds, in respect of assistance to be carried out over a period of two or more years the Commission shall automatically decommit any part of a commitment which has not been settled by the payment on account or for which it has not received an acceptable payment application. This rule would have been extended to the Cohesion Funds, too.

[9] A National Development Plan must be prepared by every member state whose per capita GDP is below 75% of the EU average. Hungary and all the other nine countries that joined the EU on May 1, 2004 belong to this category. The National Development Plan must include all those development concepts and objectives for the implementation of which the member state concerned wants to use support from the Structural and the Cohesion Funds.

[10] When writing this section of the article I considerably relied on Péter Gottfried's study titled “How to go further after the agreement on the financial perspective” published in Európai Tükör Jubileumi Évkönyv (European Mirror Jubilee Yearbook – 2006).

[11] The Copenhagen criteria: in June 1993, the Council meeting held in Copenhagen set three criteria that the candidate countries had to meet before their accession to the EU. First of all, they must have achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities, and the existence of a functioning market economy. Furthermore, they must have taken over the acquis in full and must support the various objectives of the European Union. In addition, the candidate countries must have a system of public administration that is able to apply and manage the EU legislation in practice. The EU reserves the right to decide when a candidate country meets these criteria, and when the EU would be ready to accept new members.

[12] Iceland, Liechtenstein, Norway and Switzerland, which are all more developed than Hungary and are the member states of EFTA, do not wish to join the EU in the foreseeable future, albeit for different reasons.

Literature

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Klára Vicze–Gábor Braun–Attila Bencze

Insight into the own resources system of the EU through the spectacle of the Hungarian VAT based payment[1]

The article firstly gives a short summary concerning the own resources system financing the budget of the EU and the state of the VAT based resource within this system. Afterwards, with the help of the Hungarian VAT base statement, it specifies the methodology of the calculation of the harmonised VAT base and the own resource itself. Finally it presents an overview of the reform concepts for the future of the own resources system.

THE ORIGINS OF THE OWN RESOURCES SYSTEM AND ITS SUCCESSIVE REFORMS

The own resources system of the European Coal and Steel Community (ECSC) was ensured as soon as the Treaty of Paris entered into force in 1952. Signed in 1957, the Treaties of Rome provided for the two Communities (European Economic Community, Euratom) set up by the Treaty to be financed by contributions from the Member States for a transitional period before changing over to a system of own resources. Contrary to the contributions of the Member States in the case of own resources there is no need for any subsequent decision by the national authorities for calling in, thereby own resources provide financial autonomy for the Community. The "natural" own resources could be derived from Community policies (the customs union and the common agricultural policy). As a result of that, the own resources decision of 21 April 1970 replaced national contributions by a system of own resources comprising agricultural levies, customs duties and a budget-balancing resource calculated by applying a maximum rate of 1 per cent to the VAT base. However, because of delays in harmonising the base, the VAT resource was not generally applied until 1980. The system was subsequently modified by successive new own resources decisions.

The Decision of 7 May 1985 (following the Fontainebleau European Council) introduced a correction mechanism for budgetary imbalances, the so-called UK rebate, amounting to 66 per cent of the UK's net contribution. The cost of financing the UK rebate was shared between the other Member States according to their shares of VAT payments (except for Germany whose share was reduced by a third). Furthermore, the increase of the maximum VAT call-in rate to 1.4 per cent was also decided to coincide with the accession of Spain and Portugal. This increase was designed to meet the costs of enlargement.

The reform of the Community's finances in 1988 altered and broadened the composition of the Community's own resources by the creation of a new budget-balancing category of revenue, based on Member States' gross national product (GNP) and derived from the application of a percentage rate to the sum of the GNPs of all the Member States. The Third Decision of 24 June 1988 (following the Brussels European Council) set an overall ceiling of the budget rising to 1.20 per cent of total Community GNP in 1992. Pending a new Decision on new resources, the 1.20 per cent ceiling remained applicable in 1993 and 1994.

As agreed at the 1992 Edinburgh European Council, a new Decision on the system of own resources was adopted on 31 October 1994. This Decision raised the own resources ceiling to 1.21 per cent of GNP in 1995, and, in stages, up to 1.27 per cent of GNP in 1999. The maximum VAT call-in rate was gradually reduced from 1.4 per cent to 1 per cent in 1999 and the VAT base to be taken into account for own resources purposes was reduced ('capped') in stages, at 50 per cent of GNP instead of 55 per cent previously. The Member States eligible for assistance under the Cohesion Fund had their VAT base capped at 50 per cent of GNP already in 1995. The reasons for these measures were the regressive aspects of the VAT based own resource for the least prosperous Member States.

The possibility of replacing the 1994 (fourth) own resources decision by a new one for the Financial Perspective 2000–2006 did not become concrete until the date of the March 1999 Berlin European Council approached. The Berlin European Council of 24–25 March 1999 reached a political agreement on the new financial perspective for 2000–2006 and on the revision of the EU's financing system. The Council's conclusions were the basis of the new own resources decision (2000/597/EC, Euratom) adopted on 29 September 2000, which, after ratification by all the national parliaments, entered into force on 1 March 2002 with retroactive effect from 1 January 2002.

The UK rebate and the own resources ceiling of 1.27 per cent of GNP was confirmed. The 2000 own resources decision provides for an increase, as from 1 January 2001, in the percentage of traditional own resources retained by Member States to cover their collection costs, which increased from 10 to 25 per cent. The maximum call-in rate for the VAT resource was reduced to 0.75 per cent in 2002 and 2003 and to 0.50 per cent as from 2004. New rules regarding the financing of the UK correction were also established. Firstly, the share of Austria, Germany, the Netherlands and Sweden is reduced to 25 per cent of its normal value. Secondly, the so-called windfall gains for the UK caused by the increase in the percentage of traditional own resources retained by Member States are neutralised and an amount of so-called enlargement windfall gains is, furthermore, deducted from the rebate.

Finally, the current own resources decision extends the application of the 1995 European system of accounts (ESA 95) to the area of the EU budget. In ESA 95 the concept of gross national product (GNP) has been replaced by gross national income (GNI). In the new own resources decision GNP is therefore defined as being equal to GNI for the purposes of own resources. However, in order to maintain unchanged the amount of financial resources put at the disposal of the Communities, the ceiling of own resources as a percentage of EU GNI had to be adapted[2]. The new ceiling equals 1.24 per cent of the GNI of the EU.

The current own resources can be divided into the following categories (the figures below refer to the 2006 budget amounts to about 112.6 billion EUR adopted in December 2005):

- *Traditional own resources (TOR)* consist of customs duties, agricultural duties and sugar levies. These own resources are levied on economic operators and collected by Member States on behalf of the EU. However, Member States keep 25 per cent as a compensation for their collection costs. Customs duties and agricultural duties are levied on imports of products coming from third countries, at rates based on the Common Customs Tariff. Sugar levies are paid by sugar producers to finance the export refunds for sugar. TOR account for around 12.7 per cent of total EU revenue.

- *The own resource based on value added tax (VAT)* is levied on Member States' VAT bases, which are harmonised for the purpose of equal treatment in accordance with Community rules. The so-called uniform[3] rate is levied on the harmonised base of each Member State. However, the VAT base to take into account is capped at 50 per cent of each Member State's GNI. This rule is intended to avoid that the less prosperous Member States pay out of proportion to their contributive capacity, since consumption and hence VAT tend to account for a higher percentage of a country's national income at relatively lower levels of prosperity. The VAT-based resource accounts for around 14.1 per cent of total EU revenue.
- *The resource based on gross national income (GNI)* is used to balance budget revenue and expenditure, i.e. to finance the part of the budget not covered by any other sources of revenue. The same percentage rate is levied on each Member States' GNI, which is established in accordance with Community rules. The GNI-based resource accounts for around 72.1 per cent of total EU revenue.
- A specific mechanism for correcting the budgetary imbalance of the United Kingdom (the *UK rebate*) is also part of the own resources system. The current UK rebate mechanism was introduced in 1985 to correct the imbalance between the United Kingdom's share in payments to the Community budget and its share in Community expenditure allocated to the Member States. This mechanism has been modified on several occasions to compensate for changes in the system of EU budget financing, but the basic principles remain the same. This imbalance is calculated as the difference between the percentage share of the UK in EU expenditure paid in the Member States ("allocated expenditure") and the UK share in total VAT-based and GNI-based own resources payments. The difference in percentage points is multiplied by the total amount of EU expenditure allocated to the Member States. The UK is reimbursed by 66 per cent of this budgetary imbalance. The cost of the correction is borne by the other 24 Member States. The distribution of the financing is calculated on the basis of each country's share in total EU GNI. The financing share of Germany, the Netherlands, Austria and Sweden is, however, restricted to one fourth of its normal value. This cost is redistributed across the remaining 20 Member States. (According to a Council proposal, the amount of the rebate would be gradually reduced from 2009 by some expenditures oriented towards new members who joined since 2004.)

THE ANNUAL STATEMENT ON THE VAT-BASED OWN RESOURCE

The VAT-based resource relies in the first place on calculations made by Member States' authorities in conformity, in particular, with Council Regulation (EEC, EURATOM) N°1553/89 on the definitive uniform arrangements for the collection of own resources accruing from value added tax. This Regulation has to be applied together with the rules of the Council Directive No. 77/388/EEC (so-called

6th Directive) by the Member States. For the year concerning the VAT base statement, the rules of the operative national Act on VAT have to be compared with the rules of the Directive in the calculations.

The process of calculation of the harmonised VAT base is briefly the following:

The annual VAT revenue on cash basis has to be adjusted by corrections regulated in the 6th Directive. Calculating the intermediate VAT base the above-mentioned corrected VAT revenue (so-called net VAT revenue) will be the "numerator". The denominator is the weighted average rate of VAT (WAR), which has to be calculated with four-figure accuracy. Determining the final harmonised VAT base, the intermediate VAT base is required to be adjusted by compensation items in order that the possible differences (e.g. tax exemptions) between the national VAT regulations and the rules of the 6th Directive do not affect the base of the VAT based own resource. If the final harmonised VAT base exceeds 50 per cent of the Member State's GNI, the VAT-based own resource must be paid to the budget of the EU on the basis of 50 per cent of GNI.

The Commission verifies the annual statements of the VAT bases submitted by Member States in order to fix the amounts that each Member State must pay to the budget. In this work the Commission is guided by three principles:

- *Transparency:* it must be clear how the VAT base has been determined;
- *Uniformity:* so far as possible Member States must use identical methods and draw on the same sources of information;
- *Equity:* each Member State must be treated the same.

Each Member State sends an annual statement showing the total VAT tax-base, including adjustments to take account of variations in national VAT practices, to the Commission by 31 July of the year following the year concerned. The statement contains not only the figures but also information about data, sources, methods and formulae used to establish and adjust the base. After preliminary checks to verify the credibility and plausibility of the figures, the Commission's control unit sends the data to the unit that manages budget receipts.

Subsequently, each statement is the subject of an on-the-spot control visit in the Member State concerned. It is now usual to control 2 or (increasingly) 3 years at one time. The control is carried out by officials of the Budget Directorate-General, usually supported by officials from the Taxation Directorate-General and the Statistical Office of the European Communities (Eurostat).

Within 3 month following a control, the controllers draw up a Control Report presenting their findings and indicating in particular any reservations concerning the figures or problems of sources or methodology, as well as cases where it appears that Community law has been disregarded. The Member State then sends its Observations on the Control Report within 3 months, during which it either accepts the Commission's findings and makes appropriate changes or contests the findings. After an analysis of these Observations, the Commission's controllers draw up a Summary Report within 3 months, which presents the resulting state of affairs and lists any reservations that remain. These may be the subject of continuing bilateral discussions and/or will be re-examined during the following control mission. If there is no agreement regarding the debated point, the Commission may initiate infringement proceedings against the Member State and if no agreement is reached the case may go before the European Court of Justice.

The Control Report, the Member State's Observations and the Summary Report are jointly discussed at the next available meeting of the Advisory Committee on Own Resources

Figure 1

SUMMARY ACCOUNT FOR CALCULATING THE AMOUNT OF THE VAT ASSESSMENT BASE

1. Gross collected VAT revenues
2. Fines and interest payments for delays to be deducted from revenues
3. Collection costs to be added to revenues
4. Correction (negative) for small enterprises with an annual turnover not exceeding EUR 10 000
5. Other corrections
6. Taxes not collected due to graduated tax relief
7. Correction (positive) for flat-rate farmers
8. Net VAT revenue
9. Weighted average rate (with 4 decimals)
10. Intermediate VAT base
$\frac{\text{net VAT (8.) x 100}}{\text{weighted average rate (9.)}}$
11. Compensations related to exemptions
11.1. Compensation (positive) for small enterprises with turnover exceeding EUR 10 000
11.2. Compensation (positive) for simplified entreprenurial tax (EVA)
12. Compensations related to Annexes E, F, G of Council Directive No 77/388/EEC
12.1 Compensation (positive) related to the domestic leg of international passenger transport
13. Compensation resulting from the restriction of the right to deduct VAT
13.1. Compensations for passenger cars
13.1.1. Negative compensation related to passenger car purchases
13.1.2. Positive compensation related to the sale of second-hand cars
13.1.3. Negative compensation related to the purchase of second-hand cars
13.1.4. Negative compensation related to closed-end leasing
13.1.5. Negative compensation related to fuel and diesel oil used by passenger cars
13.1.6. Negative compensation for repair and maintenance costs of passenger cars
13.2. Compensation based on Article 17. Section (7) of Council Directive No 77/388/EEC
Total compensations
14. Final (harmonized) VAT base
(intermediate VAT base + positive compensations - negative compensations)
15. GNI
16. Final (harmonized) VAT base capped in 50% of GNI

(ACOR) in Brussels, where representatives of every Member State have an opportunity to examine and discuss the treatment of other Member States. This is how respect for Community law and also the principles of transparency, uniformity and equity are ensured.

In 2006, control visits will be carried out in 9 Member States. This is more than usual and results from the fact that the Commission at first time will also examine the annual VAT statements of five New Member States for 2004.

Gross collected VAT revenues

According to Council Regulation No. 1553/89/EEC gross VAT revenue means the amount of VAT actually collected by the budget on cash basis (which is called net VAT revenue in Hungarian terminology, that is, VAT payments reduced by refunds). The Treasury provides figures constituting the base for VAT based own resources. Gross tax revenue represents the total of the cash balances of three VAT accounts, which is included in the central budget in the line "Value Added Tax". The contents and typical features of the three VAT accounts are summarised below.

- *General value added tax account:* The account is managed by the Tax and Financial Control Authority (TFCA). It contains net VAT revenues originating from payments made on the basis of domestic sales and VAT refunded on domestic purchases (including products imported appearing in the first domestic phase of sales) until 30 April, whereas since 1 May it includes net VAT revenues resulting from payments made on the basis of domestic sales, imports and intra-community purchases and VAT refunded in connection with them. Due to the introduction on 1 May 2004 of the system based on self-declaration of VAT on imports and intra-community purchases registered on this account instead of levying by the Hungarian Customs and Finance Guard (HC&FG), the positive balance of the account is considerably higher compared with previous years. This latter effect was to a lesser extent moderated by the reintroduction of levying of VAT by HC&FG concerning a limited range of importers as of 1 July 2005.
- *VAT account for imported products:* This account contains payments of VAT on imports and refunds related to customs procedures collected, managed and recorded by HC&FG.
- *The VAT account for tobacco products* is also managed by the customs authority. Besides the excise duty, the tax seal also contains the VAT on tobacco products, and so collected by HC&FG. The general functioning of this account has not been affected by the administrative changes resulting from Hungary's accession to the EU.

In order to ensure the integrity of accounts between the Treasury, the tax authority as well as the customs authority, the balances of the accounts between Treasury and TFCA, and Treasury and HC&FG are recorded in an official document each year.

Fines and interest payments for delays to be deducted from revenues

In the Hungarian budget, these items are managed separately, and are recorded on a different account, and therefore they do not influence gross VAT revenues.

Collection costs to be added to revenues

In Hungary the VAT accounts do not contain collection costs, and therefore the collected VAT revenues do not need to be adjusted with this item.

Correction for small enterprises with turnover not exceeding EUR 10 000

In accordance with EU regulations, Member States can choose to leave out the transactions of taxable persons whose annual turnover specified on the basis of Article 24 Section (4) of the 6th Directive on VAT does not exceed EUR 10 000. Regarding the 2-million-forint limit of eligibility for exemption, Hungarian legislation has changed: since 1 January 2004, the above limit was increased to HUF 4 million. Since HUF 4 million exceeds EUR 10 000, there is no more need to calculate correction for this item.

Other corrections

Other corrections include VAT refunds, which are shown separately in accounting; some of the VAT amount is reported under different accounting categories; revenues shown in accounting as a result of the application of Hungarian VAT regulations concerning areas not governed by measures applicable to own resources; special VAT refund options provided in the Hungarian Act on VAT. The correction items may increase revenues, or they have to be deducted from revenues:

- Some of the amounts received in the foreclosure deposit account of the tax authority (TFCA), typically the ones that are paid in during the last two weeks of the year, are not allocated on 31 December. VAT revenues must be increased with the amount in the deposit account on 31 December of year *n*[4] to be allocated in year n+1. On the other hand, revenues must be reduced with the amount on the closing balance of the deposit account for the year *n*–1 to be allocated in year n.
- Since 1 May 2004 the customs deposit account kept by HC&FG functions in the same manner as the deposit account of TFCA. The positive correction of revenues relating to the account consists of three parts: the remaining amount from previous years' customs security accounts to be accounted for and concerning year n; the remaining amount from previous years accounted for year n+1, but concerning year n; and execution deposit payments in year *n*–1 accounted for year n+1, but concerning year n.
- VAT on regional HC&FG accounts must be added to gross VAT revenues.
- VAT items not paid into VAT accounts must be added to gross revenues, whereas non-VAT amounts paid into VAT accounts must be deducted from revenues.
- Amounts written off at HC&FG and TFCA for equity considerations entail a positive correction of revenues with the amounts concerned.

As noted by the DG Budget of the European Commission, further positive corrections should also be made, because the community regulations do not allow the application of certain provisions included in the Hungarian Act on VAT. The following items belong to this category:

- Gross VAT revenues are to be increased with the amount of VAT refunds concerning projects subsidised from PHARE and ISPA funds preceding EU accession. PHARE/ISPA contracts have not been concluded any more after the EU accession, therefore after the realization of projects financed through contracts made prior to the date of our accession there will not be new ones.
- The refund in certain cases of VAT on costs financed with foreign aid entails a positive correction of gross VAT revenues.
- Refund of non-deductible VAT to social organisations, churches and foundations must be added to gross VAT revenues.

Tax not collected due to graduated tax relief

Hungary does not apply the graduated tax relief system, therefore VAT revenues do not need to be adjusted with this item.

VAT not collected from flat-rate farmers

In accordance with Hungarian VAT regulations, taxpayers engaged in agricultural activities determined in the Act on VAT are not obliged to pay tax with regard to such activities except for product import and certain transactions being free of charge, but they cannot deduct the tax either. In transactions the buyer is obliged to pay a compensation premium to the taxpayer engaged in agricultural activities (12 per cent for plant products, 7 for livestock and animal products and for agricultural services), in addition to the purchase price, but included in the price. The buyers are entitled to account the compensation premium as 'pre-charged tax' (deductible VAT).

Calculations give an estimate of how much the compensation premium covers irrecoverable VAT on inputs of flat-rate farmers. In the case of over-compensation gross VAT revenues must be increased with the surplus (which means VAT shortfall) and vice versa. The calculation method is the following:

a) determination of the ratio between VAT deducted and the tax base from data provided by TFCA (VAT returns);
b) estimate of the intermediate consumption (IC) of flat-rate farmers;
c) calculation of VAT on IC;
d) estimate of gross fixed capital formation (GFCF) of flat-rate farmers;
e) calculation of VAT on GFCF;
f) estimate of production of flat-rate farmers;
g) ratio between irrecoverable VAT on inputs and production of flat-rate farmers = (c+e)/f;
h) the difference between the ratio of VAT deducted to the tax base and the ratio of irrecoverable VAT on input to production (a-g), multiplied by the tax base = correction (positive).

Since Hungarian Central Statistical Office (HCSO) does not have direct data with regard to flat-rate farmers, the necessary data had to be estimated on a residual basis. The basis for the calculations carried out by the Hungarian Central Statistical Office are the so called "product balance sheets" (PBS) which are compiled at commodity level from pure statistical data collections. The product balance sheets are compiled separately for institutional sectors (households and non-financial enterprises). PBS of households includes private entrepreneurs with tax number and households of natural persons producing for the market and/or own consumption. We have information on the sales of private entrepreneurs from the VAT statements broken by crop- and animal production, as well as agricultural services. By deducting the data of private entrepreneurs from the households sector data, we get the data of those households which are flat-rate farmers or produce solely for own consumption. Figures for IC and production of year n are estimated from the Economic Accounts for Agriculture of year *n*–1 with the estimated index of flat-rate farmers. In the case of GFCF there is no need for indexation, because fact figures for year n are available at the time of drafting the report.

When calculating VAT on IC and on GFCF the relevant tax rate is assigned to each category of products and services within the main categories of plant products, livestock & animal products and agricultural services. Detailed data for private producers from the Farm Accountancy Data Network (FADN)[5] system were used for weighting where the categories covered several items with different VAT rates.

When calculating production, from total production PBS item of intermediate production had to be deducted to avoid redundancy. Production figure of flat-rate farmers includes production for own consumption, at the same time – for the sake of consistency – purchased IC of production for own consumption is included in purchased IC of flat-rate farmers. Sales data for agricultural entrepreneurs are available from the VAT returns. It is assumed, that the structure (for example, the proportion of direct sales to the total sales value) of PBS of entrepreneurs is similar to that of agricultural enterprises. Thus, by using the weights (structure) of enterprises, the missing details of PBS of entrepreneurs are calculated.

Net VAT revenues

Applying the positive and negative correction items specified above to gross VAT revenues we get net VAT revenues.

Weighted Average Rate of VAT (WAR)

The statistical offices of the Member States carry out the calculation of the weighted average rate with four-figure accuracy according to the regulations. The HCSO calculates the WAR for the Hungarian VAT base statement.

In order to calculate the weighted average rate of VAT for year n, the basic data are taken from the National Accounts (NAs) for year *n*–2 in accordance with Article 4 of Council Regulation No. 1553/89. These data and the provisions of the VAT Act are used for identifying the transactions subject to non-deductible VAT and classifying them by the VAT rates applicable for year n.

The Council Regulation No. 1553/89 allows the application of data prior to year *n*–2 only in very justifiable cases. However, for the purpose of breaking down these transactions by VAT rates, the structure of the Supply and Use Tables (SUT) (CPA 60 by NACE[6] 60) for year *n*–3 is applied. The EU did not make objection to this, since the Use Table is applied only for the structural breakdown of figures, which are available in National Accounts on macro level. The National Accounts have been compiled in accordance with the ESA'95 (European System of Accounts) accounting system. In the WAR calculation the breakdown of transactions by statistical category is based on the data taken from the NAs. As the NAs do not contain a breakdown according to VAT rates, supplementary data sources are used, e.g. the Household budget survey for getting more detailed manner of household final consumption expenditure and the Use Table for estimating the intermediate consumption-structure.

The weights used in the average VAT rate are calculated on the basis of NAs for year *n*–2, and the VAT rates applicable in year n are weighted with the taxable base net of VAT. From year *n*–2 to year n changes of the VAT rates and goods or services shifted from a VAT rate to another have to be taken into consideration as well. Since in both above-mentioned cases there is a delay between the entry into force of VAT rate and its effect on the VAT revenues corrections, approximately 1-month time lag has to be applied.

Accordingly, for the final household consumption, the intermediate consumption of the general government and non-profit institutions serving the households sector (NPISHs) and for the other sectors 1/12 of the purchases net of VAT was attributed to the "former" rates in force in year *n*–1 and the remaining 11/12 to current rates of year n. There was no need for time lag adjustment in cases when the rates changed already during the year.

In accordance with the Council Regulation No 1553/89/EEC, the following categories are identified for the calculation of WAR:

- Household final consumption expenditure (including also agricultural on-farm consumption and direct sales by flat-rate farmers to final consumers);
- Social transfers in kind to households purchased by government from market producers;
- Intermediate consumption of the general government sector;
- Intermediate consumption of the non-profit institutions serving households sector (NPISHs);
- Intermediate consumption of the other sectors liable to non-deductible VAT;
- Gross fixed capital formation (GFCF) of the general government sector and the NPISHs sector;
- Gross fixed capital formation of the other sectors liable to non-deductible VAT with housing investments;
- Expenditure in respect of the restriction on the right to deduct for business cars.

Methodology for the calculation of the final household consumption

In the calculation of the weighted average VAT rate, the household final consumption expenditure in domestic terms needs to be taken into account. In the WAR calculation the data of household consumption come from the National Accounts for year *n*–2. The expenditures are classified on the COICOP codes and on basis of the VAT rates specified either in the VAT Act for year *n*–2 or for year n. The expenditures net of VAT for year *n*–2 are reclassified by VAT rates for year n and applied as weights in the calculation.

In those cases, where more detailed breakdown needs to be used, the household budget survey and various special statistics, which serve as a basis for the NAs (e.g. cultural statistics, telecommunications statistics, etc.), are applied. The household final consumption expenditure includes the owner-occupied housing services as an imputed item. The purchases related to this imputed item (repair and maintenance) are classified under the imputed rentals of owner-occupiers heading under the standard rate in the detailed table for household final consumption.

The WAR calculation includes an adjustment in accordance with the compensation calculation for small exempt firms with turnover above EUR 10,000 and for the enterprises applying the simplified taxation scheme ('EVA'). The supplies to final household consumption of the above-mentioned firms are presented in a separate row in the category of the household final consumption expenditure.

The household final consumption includes the on-farm consumption and direct sales to final consumers by flat-rate farmers. These data are taken from the flat rate farmers calculation carried out for the year *n*–2. The input rate used in the calculation for on-farm agricultural consumption and direct sales by flat-rate farmers is taken directly from the calculation of the correction part of statement for year *n*.

The social transfer in kind from government is also included in the WAR calculation. In the NAs the social transfer in kind from government consists of individual goods and services provided as transfers in kind to individual households by government units, whether purchased on the market or produced as non-market output by government units. In this part of the WAR calculation only the taxable social transfers in kind to households purchased by government from market producers are involved. The figures for social transfers in kind to households purchased by government from market producers are calculated from the budget statistics. These items are the following: pharmaceutical products and other medical instruments, public transport. The social transfers in kind from NPISHs consist only of non-market output of the NPISHs.

Intermediate consumption of the general government sector

Institutions belonging to the public sector are primarily engaged in tax exempt activities, but they have some output on which they can reclaim the VAT. In order to identify the expenditure subject to non-deductible VAT accounted in the intermediate consumption of the general government sector, the pro-rata method is applied. For this method the data (gross output and intermediate consumption) are taken from the National Accounts for year *n*–2 (by activity, NACE in two-digit level). At first, the ratio of activities that have the right to VAT refund to the gross output is identified. The calculation of pro-rata of taxable activities is based on the sector account data (gross output is divided into social transfers in kind from non-market output, collective consumption and sales) and from this the sales were further examined by types and activities.

In the next step, the intermediate consumption related to government output that have the right to reclaim the VAT is extracted by means of pro-rata of deductibility. The intermediate consumption of government sector by activities is taken from the production account of general government sector for year *n*–2. After taking out the intermediate consumption belonging to the output subject to VAT, the breakdown by products and services on the basis of Use Table (at two-digit level) is made. Those product and service groups that were not homogeneous according to the VAT rates, were subdivided on the basis of the detailed table of current purchases from the annual budget report. Afterwards the net intermediate consumption can be identified with help of the net of VAT expenditures for year *n*–2 reclassified and summed up by the VAT rates for year. It is noted, that the tax-exempt items are not included in the calculation of the weighted average VAT rate.

CALCULATION SCHEME OF THE INTERMEDIATE CONSUMPTION FOR THE GOVERNMENT SECTOR LIABLE TO NON-DEDUCTIBLE VAT:

1. Identification of the taxable activity-share of gross output, which are subject to deductible VAT (pro-rata of deductibility). It is done by type of activities.
2. Taking out the intermediate consumption belonging to the output, which are subject to VAT refund by means of the pro-rata of deductibility.
3. Breakdown of intermediate consumption belonging to the activities liable to non-deductible VAT by VAT rates on the basis of the structure in the Use Table.
4. Further breakdown of the intermediate consumption structure by means of supplementary information.
5. Deduction of the VAT according to the VAT rates for 2002 from the intermediate consumption at purchasers' prices.
6. Regrouping the taxable intermediate consumption (excluding VAT) by VAT rates for 2004 (generation of eights), taking into consideration the time lag, as well.
7. Calculation of the weighted average VAT rate for this category.

Intermediate consumption of non-profit institutions serving the households sector (NPISHs)

In the National Accounts the non-profit institutions are mainly classified into the NPISHs sector, but some of them are reclassified into the general government, financial and non-financial corporations sectors in accordance with ESA'95 rules. The data of non-profit institutions classified into other sectors than NPISHs are included in the calculations for those sectors. On the basis of the VAT statistics, for this category it is possible to estimate the ratio of activities subject to VAT within the gross output, by type of activities, which is calculated alike the above-mentioned (pro-rata) method.

Intermediate consumption of the other sectors liable to non-deductible VAT

The most significant part of this item is the intermediate consumption of the financial corporations sector and other financial activity accounted in the households sector. Financial services and supplementary financial services are tax exempt activities with the exception of safe services and financial leasing. For the NACE 65 (Financial intermediation, except for insurance and pension funding) the part of output related to the financial leasing can be derived directly form the sector account. The NACE 66 (Insurance, except compulsory social insurance) activity is completely exempt. For the NACE 67 (Financial supplementary activities) the 'pro-rata' of the output is calculated on the basis of the VAT statistics both for the financial sector and the households sector. The calculation scheme is the same as for the general government sector and for the NPISHs sector.

Besides the financial services the following activities belong to the 'other exempted' category: dental technicians, national postal services, real estate services (partly), education (except non-accredited education), human health care services and social services classified into the non-financial corporations and household sector (sole proprietors), other membership organization services reclassified into the non-financial corporations sector, public service radio and TV programming, gambling services.

There were several changes concerning the deduction of VAT charged on local and long-distance telephone services, and mobile telephone services, and on Internet-protocol-based voice transmission according to the VAT Act. Currently 50 per cent of the tax charged on these services cannot be deducted but this deduction restriction should not be applied to taxable persons who re-invoice at least 50 per cent of these services. As the deduction restriction also extends to the business sector estimation should be carried out for calculating the expenditures in respect of the partial restriction on the right to deduct for telephone in the business sector.

The WAR calculation includes an adjustment in accordance with the compensation calculation for small exempt firms exceeding EUR 10,000 and for the enterprises applying the simplified taxation scheme ('EVA').

Gross fixed capital formation (GFCF) of the general government sector and non-profit institutions serving the households sector

The data on GFCF of the general government sector and the NPISHs sector are taken from the NAs for year *n*–2. The data on GFCF of the NACE K 'Real estate, renting and business activities' in the government sector have a negative item because of the privatization of the housing by local government. In order to make the calculation accurate the data on the privatization of the housing was removed from the proxy. In accordance with the principle of transparency, for the GFCF of the general government sector and the NPISHs the same 'pro-rata method' is used as for their intermediate consumption. GFCF of the general government sector and the NPISHs sector that have right to VAT refund are taken out by applying the pro-rata of the taxable activities described above.

GFCF for other sectors liable to non-deductible VAT

GFCF for other sectors liable to non-deductible VAT, excluding housing investments

The calculation of GFCF for other sectors liable to non-deductible VAT is also based on the 'pro-rata method'. For the calculation of the non-deductible VAT of GFCF and the intermediate consumption of the other sectors, the above-mentioned unified method was applied. The standard rate is applied to all capital goods taken into account in the calculation.

Housing investment by households

In the scope of the Capital Accounts, within the National Accounts, the dwelling investment of households was revised and in the frame of this improvement, a detailed calculation was carried out concerning the non-deductible VAT content of housing investment. For the purpose of the WAR this calculation was applied directly.

Taxable base in respect of the restrictions on the right to deduct for business cars

On the basis of the restrictive provisions of the VAT Act, business enterprises cannot deduct

VAT for their passenger car purchases. Similar restriction is applied for the purchase of the fuel and the repair and maintenance services in connection with passenger cars. The taxable base for this category should be taken from the car compensation calculation of the VAT base statement for year *n*–2.

Transactions related to gold

The consideration of transactions related to gold as a weight was taken out of effect in a regulation before the accession (Council Directive No 98/80/EEC), therefore there is no need to calculate with this item.

Intermediate VAT base

Using net VAT revenues and WAR, the formula for calculating the intermediate VAT base is the following:

$$\frac{(\text{net VAT revenues x } 100)}{\text{WAR}} = \text{intermediate VAT base}$$

Compensations related to VAT exemptions

Small exempt enterprises with an annual turnover exceeding EUR 10 000

According to the legislation of the European Union small enterprises with a turnover not exceeding EUR 10 000 are eligible for exemption. In Hungary, in the case of private entrepreneurs and companies the limit for exemption is HUF 4 million, whereas for family estate farmers (belonging to the category of small enterprises according to Article 24 of the 6th Directive) and for flat-rate farmers HUF 6 million. Since these amounts are higher than the limit of the European Union, for entrepreneurs with annual revenues between HUF 4 or 6 million and the HUF equivalent of EUR 10 000 a positive compensation needs to be made for their sales revenues, and a negative compensation must be calculated for the net value of their inputs.

In the calculation, the proposal of the Committee is taken into account, according to which the ratio of sales to final consumers is generally higher than the average in the economy, so the proposed ratio of 75 per cent is applied. Calculations contain data separately for companies. Since Hungarian authorities do not have fact data for year n regarding this category at the time of drafting the report, estimation had to be made using input/output data of year *n*–1 and the appropriate indexes. The method of calculation is the following:

a) determination of total annual revenues of enterprises concerned through tax returns and indexes;
b) application of the 75 per cent ratio to revenues as proposed by the Commission, thereby we get revenues concerning final consumption;
c) calculation of inputs falling under VAT through tax returns and indexes;
d) net revenues concerning final consumption *(b/1+WAR) (positive compensation);*
e) net value of inputs *(c/1+WAR) (negative compensation);*
f) balance of compensations *(d–e) (positive).*

Enterprises paying simplified entrepreneurial tax ('EVA') with a turnover exceeding EUR 10 000

Since 1 January 2003 private entrepreneurs and companies operating in certain fields of activity have the right to apply the simplified taxation scheme, hereinafter referred to as 'EVA'.

EVA base shall be the total revenue including VAT received by an eligible taxpayer in a tax year, subject to some modifications. EVA rate is 15 per cent of the tax base. Since those under this scheme are exempted from – among others – VAT, a compensation of the VAT base needs to be calculated for this item. The procedure examining compliance of EVA with the 6th Directive has not been finished yet. The upper eligibility limit of EUR 100 000 for EVA exceeds the limit of EUR 35 000 set for exemption during the accession negotiations of Hungary. Until further decision, the Commission proposed that compensation for EVA should be presented as a type of VAT exemption.

Regarding the fact that the EVA is a separate tax, compensation for the VAT base in respect of the EVA scheme can only be calculated indirectly, with approximation. EVA base of private entrepreneurs and companies are determined from the tax returns for year n, which is then cleared from VAT. During further steps of the calculation only subjects with a net base above EUR 10 000 are taken into account.

As a starting method, the ratio of output vested on final consumption was determined using VAT returns. The amount of purchases of VAT subjects from EVA subjects (presented in VAT returns as indicative data) divided by sales of EVA subjects gave the ratio of output not directed to final consumption, whereby we got to the ratio of final consumption. Regarding the fact that it cannot be determined from VAT returns whether purchases were made from EVA subjects under or above the 10 000 EUR limit, for the calculation of the ratio the total output of EVA subjects was taken with the total purchases from EVA subjects presented in VAT returns.

Since EVA returns do not contain any data on inputs (purchases subject to VAT), as a starting method, they were determined as a ratio of output using a cost ratio gained from the tax returns of enterprises not subject to EVA in year n or *n*–1, under similar activity sector identification numbers with revenues between EUR 10 000 and the upper eligibility limit for EVA. In the case of private entrepreneurs under the Act on Personal Income Tax, the returns for year n were used, whereas for companies under the Act on Corporate Tax, the return for year *n*–1 had to be used (the difference is due to the differing deadlines for returns). The amount of compensation is the difference between output adjusted with the final consumption ratio and inputs calculated above, both cleared from VAT.

Taking into consideration the fact that – due to its unique nature – for EVA there is not any agreed compensation methodology in the EU, the Hungarian authorities are developing the above calculation method working together with the Commission. In order to improve estimates, for example, the possibility of using data from sectoral input-output tables and national accounts instead of indicative tax-return data for calculation of the ratio of outputs vested on final consumption, as well as data from former VAT returns of EVA subjects for estimation of the input ratio have been considered as future development.

Compensation related to transactions identified in annexes E, F and G of the 6th Directive

Article 6 Section (3) of the 6th Directive gives an opportunity to Member States either not to take into account differences originating from transactions listed in Annexes E, F and G of the Directive, or to use estimates during the calculation of the VAT own resources base.

Annex F of the Sixth Directive contains transactions which are subject to VAT in EU regulations, but in individual Member States they may be exempted from tax for a temporary period (which is five years on the basis of Article 28 Section 4 of the 6th Directive) or permanently (on the basis of Article 28 Section 3.b of the 6th Directive). If there is such a difference, the hypothetic VAT base of the Member State concerned must be increased with the net value of the transaction (positive compensation). However, at the same time, we need to take into account that providing that the given transaction is exempt from VAT on the basis of the provisions of the 6th Directive, the party conducting the transaction cannot deduct VAT on inputs. On the contrary, in the Member State concerned the input VAT can be deducted, and thus the hypothetic VAT base must be reduced with the same amount (negative compensation).

In recent years, Hungarian VAT regulations have been modified to have the highest possible level of harmonisation with the 6th Directive concerning tax exemptions. As for Annex E, all the necessary modifications of the Act on VAT have been carried out in 2004, therefore there is no more need to calculate compensation regarding this part. In the case of Annex F only one item remains for which compensation needs to be made (domestic leg of international passenger transport). There are not any items in Annex G for which compensation must be calculated. Following the recommendation of the Commission, for items phased out, a one-month time-lag adjustment was calculated.

Compensation related to the domestic leg of international passenger transport (F 17)

According to the Hungarian VAT regulation the international passenger transport is taxable with zero rate. By the Council Directive No. 77/388/EEC Article 28. 3.b) Paragraph Hungary can maintain the received derogation (with the right of tax deduction) regarding international passenger transport after the accession. However a compensation item related to the domestic leg of international passenger transport should be calculated, which increases the harmonised VAT assessment base.

The calculation of this item is based on the revenue of the transportation companies for year n. In the case of air transport revenue, domestic leg of international transport has no sense in Hungary, because flights cannot be used for travelling inland. Therefore the revenue on the domestic leg of international railway and road transport is needed for the calculation, which is provided by the Hungarian transport companies.

Taking into consideration that no statistical data is available on the revenue deriving from the domestic leg of international transport, Hungarian authorities need to apply estimation. Therefore Hungary, like other new Member States, made an application for authorisation to the Commission. This application was accepted by the Commission at the meeting of the Advisory Committee on Own Resources (ACOR-VAT) on 13–14th October 2005. An authorisation will, however, not exempt the Member States from increasing permanently the accuracy of the calculation. From the point of view of Hungary the problem is that up to the present no information is available about the revenue of foreign bus companies deriving from the Hungarian leg of international transport. Therefore this component of the compensation fails from the Hungarian VAT base statement, which was pointed out by the Commission as well.

■ *Railway transport*

In respect of railway transport the Hungarian State Railways (HSR) gets revenue only from performance on the domestic leg of international passenger transport. Namely the HSR transfers only that part of its revenue to other railway companies which was taken from the use of foreign lines and in contrary, HSR gets that part of the revenues of other railway companies as transfer which accrued from the use of Hungarian lines. As a result of that, in case of railway transport the revenue from transportation on the domestic leg is equal to the HSR's total revenue from the international passenger transport and this amount is the railway component of the compensation as well.

■ *Road transport*

In case of international transport the main Hungarian bus companies (Volán companies) adopt two schemes for accounting with their foreign partners. Except for the Eurolines routes, Volán bus companies apply individual accounting, which means, that company is entitled to get the total amount of the revenue, which operates the coach service. Therefore the total revenue deriving from tickets sold abroad is also transferred to the operator company. If a Volán company operates coach service, according to the individual accounting it gets the total revenue for the total distance, thus revenue of Volán companies contains revenue deriving from the foreign leg of the international passenger transport too. To detach this effect, the revenue of the Volán bus companies was adjusted in the calculation of the compensation on the basis of domestic performance of the operators in terms of passenger kilometres in international passengers.

Regarding the long and busy Eurolines destinations of Volánbusz Plc. pooling accounting is applied, where one pool for a destination has 2–3 or more member companies. In this scheme costs are deducted from the total sales revenue of the pool and then net income is allocated equally to the members of the pool. After that this allocation is further adjusted by taking performances of members (passenger kilometres driven) into consideration. Therefore the amount of the proportional adjusted revenue of Volánbusz Plc. is to be calculated for the compensation.

The Association of Volán bus companies presents the total revenue from international passenger transport, incorporating regular (scheduled), non-regular (contracted, special) service as well. Taking into consideration that the members of the Association of Volán bus companies are only the greatest operators, therefore performance data (in terms of passenger kilometre) of international passenger transport published by HCSO is used for extrapolation. Therefore the total revenue of the Hungarian bus companies derived from the performance provided on the domestic leg of international transport can be calculated with help of extrapolation of the Volán companies' market share.

Consequently the compensation related to the domestic leg of international passenger transport is calculated by the sum of the total revenue of railway and road transport derived from the domestic leg, where the latter can be estimated by an extrapolation of the revenue of the Volán companies.

Compensations in respect of the restriction of the right to deduct

Compensation for passenger cars

Regarding compensations for passenger cars, Article 17 Section (6) of the Council Directive No 77/388/EEC provides guidelines in the legal practices of the European Union. On the basis of the provisions of this Directive, no VAT can be deducted for inputs, which are not strictly related to business purposes. The Directive set a four-year deadline for the exact definition of strictly business-type expenses, in the case of which the restriction of the right to deduct can be applied. Since the Commission did not do it, in theory the right to deduct can be applied to the entire range of business expenses. With regard to expenses related to passenger cars, the Hungarian Act on VAT does not allow VAT to be deducted (based on

Article 33 Sections *1/c* and *2/b* of Act on VAT). Therefore the intermediate VAT base must be adjusted accordingly [see Council Regulation No 1553/89/EEC, Article 6 Section (4)]. Compensation can only be applied to passenger car and fuel purchases for business purposes, passenger car leasing and repair and maintenance expenses.

Compensation related to new passenger car purchases

On the basis of the provisions of Article 33 Section *2/c* of the VAT Act, no VAT can be deducted in the case of passenger car purchase if the purchase is not made for re-sale. Only purchases for business purposes need to be taken into account, because this is the area where the Hungarian Act on VAT is different from the EU regulations.

The estimation of new motor-car acquisitions by sectors is basically based upon direct data collections of HCSO. Investment data collected contained the values of the acquisitions of new and second-hand passenger cars, and the value of passenger cars obtained in the framework of financial leasing. This widened range of collected figures on passenger car acquisitions provided the possibility to base our calculations on direct data of year *n*–1. Data collection on the quarterly product structure of retail trade (NSSP 1646), administrative data on the number of passenger cars put into operation for the first time from the database of the Ministry of Interior and experts' estimation on the non-surveyed part of the economy (corporations and sole proprietors employing less than 5 employees) were taken into account in the estimation process of industrial and sectoral breakdown of new passenger car acquisitions apart from the investment data.

The urge on harmonizing these statistical calculations with the preliminary estimations of National Accounts, especially with the consumption of households by function within this area is possible now with the wider range of applicable statistical sources. The basis of the estimation of total acquisition value of passenger cars, and its sector breakdown is the value calculated as the number of new cars sold multiplied by the estimated average price that adds up from the consumption of households and the investment of production units. The average price of a passenger car is calculated by taking into account the relevant retail trade figures from the retail trade statistics and the number of cars registered in the administrative database of Ministry of Interior. The number of cars of import origin was estimated from the information of the Hungarian Car Sellers' Association. The result of the above-described estimations is the breakdown of the value and volume of the new passenger car purchases by legal and natural persons.

The industrial and sector breakdowns of car investments were calculated from the final figures of the investment questionnaire for year *n*–1. The data collection covered the purchases of cars and the value of cars acquired via financial leasing constructions for corporations and sole proprietors working with more than 20 persons, and for all budgetary units. For units working with 5–20 employees there was a sample survey carried out, and the grossed-up results were available to support our estimations. The whole investment value of motorcars estimated for year n follows the sector structure of the final data for year *n*–1 when the total figure for year n is allocated to budgetary units, financial and non-financial corporations. Estimation procedure is solely applied for small units to distribute passenger car investments. The investment value for corporations and sole proprietors working with 5 or less employees for year n was estimated from their assumed Capital Stock values and replacement patterns. In case of sole proprietors, the whole investment value of transport equipment is determined by experts' estimations. The pattern applied to cut off the share of motor-cars is identical to the share of motor-cars/all vehicles observed on corporations.

According to that the value of the new passenger cars purchased by legal persons can be broken down to non-financial corporation, financial corporation and governmental sectors. Taking into consideration that data also include the value of cars acquired in the framework of financial leasing constructions and the compensation related to closed-end leasing is calculated further on separately in the VAT base statement, therefore data of new passenger car purchases must be decreased by the value of financial leasing purchases. For the value of financial leasing purchases the Hungarian Leasing Association provides data from its member companies, therefore with help of extrapolation the total value of the financial leasing purchases is available. Besides that data of new passenger car purchases must be reduced also by VAT exempt purchases for calculating the compensation. According to the Act on VAT deduction of VAT with regard to expenses related to passenger cars is not allowed except for some special cases. According to Hungarian authorities expenses of entities with the right of VAT deduction are insignificant. The calculation of the compensation item is the following:

New passenger car compensation = – (net VAT base of new passenger car purchases for business purposes – net VAT base of car purchases within the frame of financial leasing – net VAT base of passenger car purchases by exempt entities) x ratio of car use for business purposes

For increasing the accuracy of calculation the Commission requested the Hungarian authorities to decrease the amount of the compensation by the net VAT base of new car purchases by those sectors that have a right to deduct (e.g. taxi) as well. The examination of the database is in process.

Positive compensation related to the sale of second-hand cars

According to the provisions of Article 39 Section *3/a* of the VAT Act, a proportionate amount of the undeducted VAT on the passenger car sold by a taxpayer can be deducted within 5 years from the purchase. During the calculation of compensation for passenger cars, this was not taken into account, and therefore the intermediate VAT base needs to be increased with this amount (positive compensation).

Second-hand car sales of taxable persons are taxed according to the Hungarian VAT regulation. Yet correction is possible during the monitoring period of the VAT for tangible assets (Article 20(3) of the 6th Directive, 3rd indent of the Article 39(3) of VAT Law). Through this there is an opportunity of additional tax deduction but only in the ratio of using the car by a person other than the taxpayer. The re-sale of a second-hand car is a new taxable transaction, which is carried out by the taxpayer as such. It is also expressed by the value of the transaction, by the tax base. Since there is a tax devolution, a tax is to be paid, even if there is no longer any correction of the deductible tax, in case of a sale after the five-year monitoring period.

The estimated value of sales of second-hand cars registered for the first time in Hungary in year n comes from the multiplication of two matrices. The first matrix includes the volume broken down by years respectively by legal form of operators (natural persons, legal entities, total), the second matrix includes the appropriate values of depreciation function composed by the Institute for Transport Sciences (KTI) calculated by using the prices of new cars. The volume data are based on the register of Central Data-Processing, Registration and Electoral Office of the Ministry of Interior and price data are based on the car price list of Auto2 specialist journal. The problem is that the register of the Ministry of Interior does not allow further breakdown of operators (by private entrepreneur, sectors etc.) and there is also a difference between the vehicle merchants and the HCSO how to define new cars. Furthermore, the vehicles fleet registered for the first time in Hungary reflects a fixed temporary state and there is no follow-up of car owners afterwards.

Positive compensation for second-hand passengers cars (1) =

$$\sum_{i=n-4}^{n-1}$$

(compensation for new passenger cars x ratio of second-hand passenger cars x proportion of the value of second-hand passenger $cars_i$ x average deduction $ratio_i$ x price change for second-hand passenger $cars_i$), where "i" signs the given year.

The price changes, the average deduction ratio in the current year, the estimated breakdown of second-hand vehicles and their turnover ratio compared to new passenger cars need to be taken into account in the calculation. The number of passenger cars licensed for traffic by non-financial companies was estimated in the following way: the ratio of the second-hand passenger car purchases of non-financial companies and legal persons was multiplied by the number of new passenger cars licensed for traffic by legal persons. In case of passenger cars licensed for traffic more than one year ago it was assumed that all the cars were licensed by non-financial companies, since purchases of second-hand cars are not typical by financial companies and by the governmental sector at all. In that way the share of the second-hand cars can be estimated from the compensation for new passenger cars.

The Commission recommended simplifying the calculation of the positive compensation for second-hand cars. The improvement of the calculation is expected to be carried out in that way.

Negative compensation related to the purchase of second-hand cars

Some of the second-hand cars are purchased by enterprises, which cannot deduct VAT on these purchases. Thus negative compensation occurs in such cases again.

Negative compensation for second-hand passenger car = – (Compensation for new passenger car purchases x ratio of second-hand passenger cars x average value of second-hand passenger cars compared to new passenger cars)

Estimates are needed again for not having direct data, taking into account the ratio of second-hand passenger cars, and their average value compared to new cars. The ratio of second-hand passenger cars compared to the new passenger cars was estimated by the following way: net value of passenger cars licensed for traffic by non-financial companies divided by the number of second-hand passenger cars multiplied by the number of passenger cars licensed for traffic by non-financial companies divided by the net value of new passenger cars. In case of passenger cars licensed for traffic more than one year ago it was assumed again that all the cars were licensed by non-financial companies, since purchases of second-hand cars are not typical by financial companies and by the governmental sector at all.

According to the Act on VAT deduction of VAT with regard to expenses related to passenger cars is not allowed except for some special cases. According to Hungarian authorities expenses of entities with the right of VAT deduction are insignificant.

The Commission criticized using estimation, instead of that more reliable direct statistical data would be required. Moreover, this negative compensation item should concern second-hand car purchases by companies, instead, the data used in the calculation concern supplies, therefore this estimation is also a concern for the Commission. Because of the lack of direct statistical data and improvement of the methodology, the Commission recommends eliminating this compensation item from the calculation; otherwise the Commission expects to place a reservation. If there is no agreement after making a reservation on this item, the question could be brought before the European Court of Justice.

Compensation related to closed-end leasing

Leasing firms can deduct VAT if on the basis of the lease contracts they pass on the ownership title of the passenger car to the lessee at the end of the term (this is the closed-end leasing which, for the purpose of change of ownership, is different from financial lease in a way that in the case of financial leasing a purchase option can also be agreed on at the end of the term). However, in the case of closed-end leasing the lessee cannot reclaim the VAT and the lease fee (in fact this is a sales transaction). In the case of an open-end lease (classified as a service) the leasing firm cannot deduct the VAT on the passenger car for the purpose of the VAT Act the lease contract is practically a rental contract, without re-sale. In addition, we should also take into account that the tax exempt group indicated above (for example financial service providers) cannot deduct VAT on purchased passenger cars irrespective of the restrictions on the right to deduct indicated above, and therefore compensation cannot apply to such amounts. Similarly, amounts belonging to companies (for example taxi companies), which can deduct VAT on passenger cars in certain cases, should also be deducted.

In the case of closed-end leasing, the leasing firm can reclaim VAT on the passenger car. However, in such cases the VAT on the lease fee cannot be deducted (VAT Act Article 6 Section 2). In the case of business-type use, this could be deducted, and therefore negative compensation occurs. The calculation of this compensation item is based on the financed value of passenger cars put on financial leasing, which is provided by the survey of the Hungarian Leasing Association among its members. The Hungarian Leasing Association also presents expert estimations concerning the share of that stock belonging to business companies having the right to deduct, share of closed-end leasing total stock of financial leasing related to passenger cars and the market share of the member companies of the Hungarian Leasing Association. Consequently there is an extrapolation in the calculation as well.

Compensation for closed-end leasing = – (net VAT base of the annual stock of financial leasing related to passenger cars – ratio of private use – tax exempt entities and entities with the right to deduct) x (ratio of close-end leasing within the financial leasing) x (ratio of car use for business purposes)

A survey was conducted within the framework of National Statistical Survey Programme (NSSP) by HCSO for closed-end leasing. After data processing, the harmonisation of data provided by the Hungarian Leasing Association and NSSP together with the elaboration of a more accurate methodology is currently proceeding. The Commission also prefers calculations based on statistical data.

Compensation related to fuel and diesel oil used by passenger cars

Pursuant to the provisions of Article 33 Section *1/c* of the VAT Act, no VAT can be reclaimed for fuel, providing it relates to the operation of passenger cars. In this case, there is a need for further negative compensation, because on the basis of the Council Directive No. 77/388/EEC, VAT for business consumption could be deducted. The negative compensation amount can be calculated with the following formula:

> **Compensation for fuel** = – (net value of fuel consumption of passenger cars owned by enterprises – tax exempt entities and entities with a right to deduct VAT) x (ratio of use for business purposes) – net value of diesel consumption of passenger cars owned by enterprises – tax exempt entities and entities with a right to deduct VAT) x (ratio of use for business purposes)

- *Fuel*

On the one hand, in the case of fuels, the restriction of the right to deduct applies not only to passenger cars, but also to total consumption according to Article 33 Section *2/a* of the Act on VAT. For the calculation the volume data concerning fuel use for business purposes are provided by the Energy Centre Non-profit Company, the fuel average prices are provided by HCSO. The volume data are reduced by the fuel consumption of flat-rate farmers, as there is a particular correction item for them. Fuel consumption not related to passenger cars is considered insignificant.

- *Diesel*

For estimating the consumption of passenger cars running on diesel, the passenger car statistics of HCSO can be used with an assumption, namely the average mileage of passenger cars used for business purposes is independent from the consumed fuel. Data on the breakdown of petrol and diesel operated passenger car and diesel average price data are provided by HCSO.

Compensation for repair and maintenance costs of passenger cars

On the basis of Article 33 Section *1/a* of the VAT Act, VAT cannot be deducted if the expense does not relate to the economic activities of the taxpayer. The net VAT base of car maintenance was calculated on the basis of the relevant data of the National Accounts for the purchased consumption of households (using the ratio of expenses for fuel and repair and maintenance) and assuming that the proportions were also the same for car use for business purposes. In the VAT statement for 2004 the HCSO turned to the quarterly estimation of household consumption on the group level of four digits. It means, that from 2004 the (estimated) data of the appropriate COICOP groups are available for the calculation of this negative compensation.

> **Repair, maintenance compensation** = – (absolute figure of total fuel compensation) x (value of repair, maintenance and vehicle components according to household statistics)/(fuel-consumption according to household statistics)

Compensations applied on the basis of Article 17 Section 7 of Council Directive No. 77/388/EEC

The right of VAT deduction is not restricted on the basis of Article 17 Section 7 of Council Directive No. 77/388/EEC in Hungary.

Final (harmonised) VAT assessment base for year n.

The final single (harmonised) VAT base is calculated by adding positive compensations to and deducting negative compensations from the intermediate VAT base. On the basis of the provisions of Article 2 Section (c) of No. 2000/597/EC Euratom Council Regulation, the harmonised VAT assessment base of the member states, which is the basis of the VAT-based contribution, cannot exceed 50 per cent of the GNI of the member state concerned. If the harmonised VAT base exceeds 50 per cent of the GNI, the VAT-based own resource must be paid to the general budget of the EU on the basis of 50 per cent of GNI.

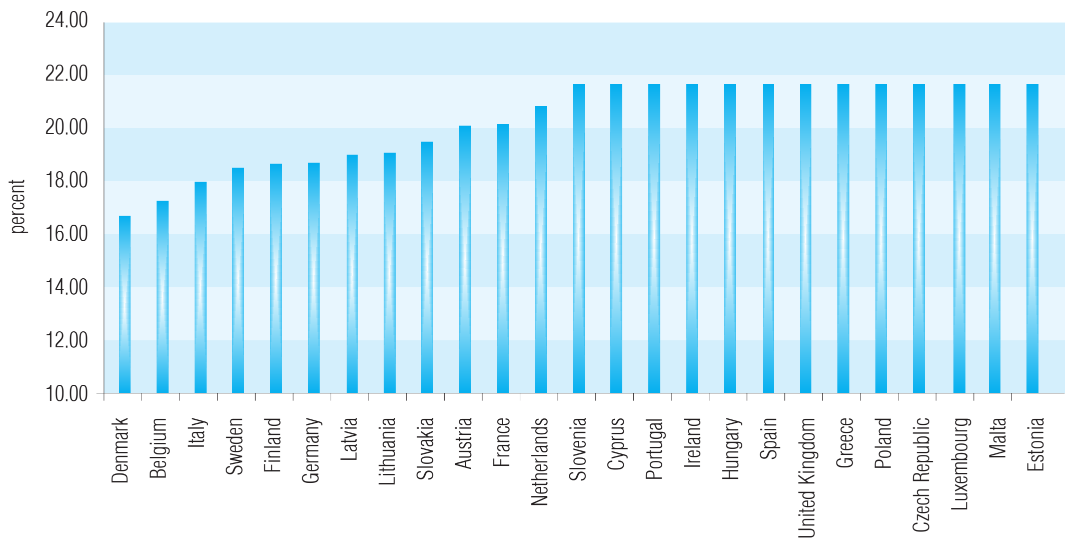
PAYMENT OF THE VAT OWN RESOURCE, QUESTIONS ABOUT THE FUTURE

Calculation of the VAT based payment maximized in 50 per cent of GNI (capped VAT base) is the following. Determination of the frozen rate taking into account the UK rebate constitutes the most important part of the method: the theoretical contribution of Germany, Austria, the Netherlands and Sweden (net contributors) to the financing of the UK rebate is deducted from the sum of the UK rebate, the figure is then divided by the aggregate capped VAT bases of the remaining member states. Deducting this rate from the maximum call-in rate fixed at 0.5 percent we get the uniform rate with which the capped VAT base of a given member state is multiplied, thus giving the amount of the VAT own resource payment to be effected by the given member state. The above method shall change from 2007 concerning the uniform rate which will be fixed at 0.3 per cent (except 0.225 per cent in Austria, 0.15 in Germany and 0.1 per cent in Sweden and the Netherlands).

Regarding the amount of VAT own resource payments set for 2005, the biggest contributor is Germany, followed by the UK, France, Italy and Spain. The order of countries is the same as far as GNI based contributions are concerned. It is useful though to examine the structure of countries' payments, showing which countries pay relatively more and which pay relatively less VAT resource. The following diagram shows the proportion of VAT based and GNI based payments.

Figure 2

VAT-BASED PAYMENTS / GNI-BASED PAYMENTS



Source: payment appropriations for the budget in 2005

According to the above data, Denmark pays proportionately the least VAT own resource (less than 17 per cent), it is followed by Belgium and Italy. As can be seen in the diagram, in the payment of most new members states the weight of the VAT based part is relatively higher than in older member states, reaching 21–22 per cent. Due to the capping of the VAT base (in 50 per cent of GNI) the rate does not increase beyond a certain limit, it never reaches 22 per cent. The difference of the above rates between countries can be explained by the following factors.

- Differing rates of consumption and savings measured in proportion to national income: countries with a lower propensity to save pay relatively more VAT own resource.
- Difference between the effectiveness of tax administrations: ineffective systems produce less VAT revenues.
- Significant discrepancies between cash-based and accruals-based VAT revenues for a given year. As the report on the harmonized VAT base takes a cash-based approach, revenues carried forward between years affect yearly VAT based contributions to the EU, too.
- Reliability of estimates used for corrections and compensations: different countries may have different databases and methods for calculations of adjustments necessitated by the difference within certain limits between VAT regulations of the member states, it is up to the Commission's judgment whether a methodology is accepted or not. It happens that lacking the requisite data, a member state is not permitted to calculate a negative compensation of the VAT base for a certain item.

In theory, the difference of VAT rates between member states – ceteris paribus – does not affect the amount of the national VAT based payment, since for the calculation of the intermediate VAT base the weighted average VAT rate is applied. However, taking a dynamic approach – depending on price elasticities and tax incidence – high VAT rates discourage (registered legal) consumption, resulting in a more moderate VAT base. The influence of VAT exemptions of certain entrepreneurs permitted within certain limits is supposed to be neutralized by compensations of the intermediate VAT base, consequently, these exemptions differing from one country to another do not influence the final (harmonized) VAT bases in a static approach. However, differences in exemption of certain products and services can have an effect on the harmonized VAT base.

Regarding the future of own resources, in the short term (until the end of the next EU budget cycle) the three present sources (GNI based, VAT based and traditional own resources) will continue to assure the financing of the common budget. Although the present system ensures the stability of revenues for the EU, it makes the common budget increasingly dependent on transfers from national treasuries. On preparing and evaluating its study on own resources, the Commission proposed the reform of the current system to the Council. In assessing the system of own resources[7], the Commission applied the following criteria:

- transparency and simplicity,
- financial autonomy,
- efficient allocation of resources,
- sufficiency,
- cost-effectiveness,
- stability,
- equity.

The conclusion is that though the present system of own resources ensures the stability and sufficiency of resources, the system has a low level of transparency, does not ensure the efficient allocation of resources, furthermore, it restrains the financial autonomy of the EU.

The Commission put forward three alternatives for financing the EU budget in the future (all would retain traditional own resources).

1. maintaining the present financing system unchanged;
2. adopting a purely GNI-based financing system;
3. adopting a financing system based on fiscal own resources.

The Commission does not approve the 1st version, because the system in its present form does not assure a direct link between the EU and its citizens who tend to judge EU policies and initiatives exclusively in terms of their national allocation.

According to the Commission, the 2nd version is simple and easy to understand but does not reflect the status of the EU, which is more than an international organization. It would imply an idea of the Union in which citizens would be only indirectly represented by their Member State, something that is unacceptable to the Commission.

The 3rd version means that part of the present GNI based resource and the statistical VAT resource would be replaced by a fiscal own resource (or fiscal own resources). This could increase the financial autonomy of the EU and introduce a direct link to citizens. The participation of citizens and economic operators in the EU budget would go hand in hand with a reduction in the level of contributions by Member States and ensure higher visibility and increased political accountability for expenditure decisions. However, a fully tax-based system does not appear appropriate to the Commission because of the threat to balanced budgets. Therefore, the retention of a limited GNI resource together with an increase in the share (maybe to 50 per cent) of taxed-based resources seems preferable. A prerequisite for the functioning of the system would be the harmonization of tax bases. The increase of tax-based own resources does not call for any new taxes because the EU share could be levied as part of the national rate paid by taxpayers. The Commission put forward three options:

- Fiscal resources related to energy consumption: Under the new directive on energy taxation, most energy products are subject to Community taxation. However, the Commission proposes limiting the Community levy to the tax base related to motor fuel used for road transport, which is already harmonized at a Community level. It could be supplemented with a levy on aviation fuel or the related emissions. This option could be implemented within a short period of time (around 3 to 6 years);
- A fiscal VAT resource: In place of the present statistical VAT resource, the EU rate would be levied as part of the national VAT rate paid by taxpayers, together with the national rate on the same taxable base. Citizens would not have to bear an additional tax burden as the EU rate would be offset by an equivalent decrease in the national VAT rate. The main stumbling block to this measure is the incomplete harmonization of member states' VAT systems. Technically, the introduction of this option would be possible within a period of up to 6 years;
- A resource based on corporate income. This option would require a prior definition of a common consolidated tax base, thereby boosting cross-border economic activity, which is hampered by 25 national tax systems and a myriad of laws. This option would imply setting a minimum tax rate for the harmonized tax base and would be the longest to implement.

The proposals have been discussed in the Own Resources Working Groups of the Council on several occasions. Instead of arriving at political decisions, the object of the working groups was to discuss the technical details of the proposals and the positions of member states with regard to them. The negotiations will continue during next presidential cycles.

Changing of the financing system of the EU requires unanimous decision of the Council (i.e governments of the member states). In order to reach a political consensus, coordination of the divergent interests of the member states and elaboration of a compromised proposal are indispensable. As discussed at the beginning of the article, the development of the own resources system was, in itself, the result of a long, multi-staged process, therefore the introduction of a new element is possible at the earliest in the framework of the financial perspective beginning 2014. It is certain that until that time the current statistical VAT own resource will remain, at the maximum some methodological changes are possible pending mutual agreement of the member states.

Notes

[1] Thanking for those colleagues, who contribute to elaborate the VAT base statement: dr. Csák Ligeti, dr. Pál Pozsonyi, dr. Katalin Gábriel, dr. Mária Forgon, Katalin Fazekasné Kovács, Zsuzsanna Szőkéné Boross, Éva Süveges, Szilárd Pál, Józsefné Horváth, Gábor Valkó (Central Statistical Office), Péter Szilágyi (Tax and Financial Control Authority), László Nyerges, Pál Antall (Hungarian Leasing Association), dr. József Molnár (Association of Volán bus companies), István Kabai (Volánbusz Plc), Valéria Gajdica (Hungarian State Railways), Lajosné Richter (Energy Centre Non-profit Company), András Drexler (Hungarian Customs and Finance Guard), Istvánné Mehlhoffer (Treasury). The following colleagues forward our work with their helpful advices: Henrietta Lucz, Péter Zólyomi, Balázs Tibor Kováts, dr. Katalin Haraszti, Annamária Márkus, Endre Gács, István Molnár (Ministry of Finance).

[2] See COM (2001) 801 final of 28.12.2001

[3] The uniform rate is equal to the difference between the maximum call-in rate and the frozen rate. The frozen rate is equivalent to the ratio between the gross amount of the UK correction (estimated at about 180 per cent of the UK correction) and the sum of the Member States' capped VAT bases.

[4] Year n stands for the year discussed in the report.

[5] A representative information system managed by the Institute of Agricultural Research and Informatics providing data on the performance and profitability of different groups of agricultural enterprises on a regional and state level.

[6] NACE = Nomenclature statistique des Activités économiques dans la Communauté Européenne

[7] Report from the Commission "Financing the European Union": Commission report on the operation of the own resources system (11752/04 FIN 364 RESPR 5 CADREFIN 29 + ADD 1 (COM(2004) 505 final))

Sources

Main data sources applied for the calculations:
- Statistics of Hungarian Central Statistical Office
- Data of Hungarian State Railways
- Data of Volán bus companies
- Data of the Hungarian Leasing Association
- Data of Energy Centre Non-profit Company

Ministry of Finance of Hungary: Statement of the VAT Own Resources Base (July 2005)
Homepage of the European Commission (http://europa.eu.int/comm)

Rules of the EU:

- Council Regulation No. 1553/89 (EEC, EURATOM)
- Council Directive No. 77/388/EEC (6th Directive)
- Adaptation of the ceiling of own resources and of the ceiling for appropriations for commitments following the entry into force of Decision 2000/597/EC, Euratom COM (2001) 801 (2001.12.28)

Károly Fazekas[1]

Employment prospects in Hungary – present and future[2]

For years the Hungarian labour market has been unable to get out from its imbalanced state accompanied by an extremely low level of employment. In spite of the continuously expanding productivity, the growth in employment practically stopped in 2000. This low employment rate is backed by a high rate of inactivity and not of unemployment, and it is mainly due to the very low job seeking activity of the those out of work. This study analyses four questions. What are the special characteristics of the Hungarian employment situation? What are the reasons for the extremely high inactivity? What are the reasons for the increasing unemployment rate among young people in Hungary? What shall be done in order to increase the employment rate and reduce the inactivity rate at the same time, along with reducing the social and regional differences that contribute to the inactivity? This study can be summarised in the following four sentences: the most serious problems exacerbating the Hungarian employment situation are the high inactivity of people with low levels of education, the concentration and the regeneration of the those with such educational background in certain sections of the society and in certain regions. It is imperative to concentrate more on these problems, even if other, equally important problems get less funding or attention. Better and real coordination is needed between government institutions for the implementation of the required measures. The success of the employment policy measures lies in the systematic analysis of their effects, based on appropriate databases, expertise and institutional support.

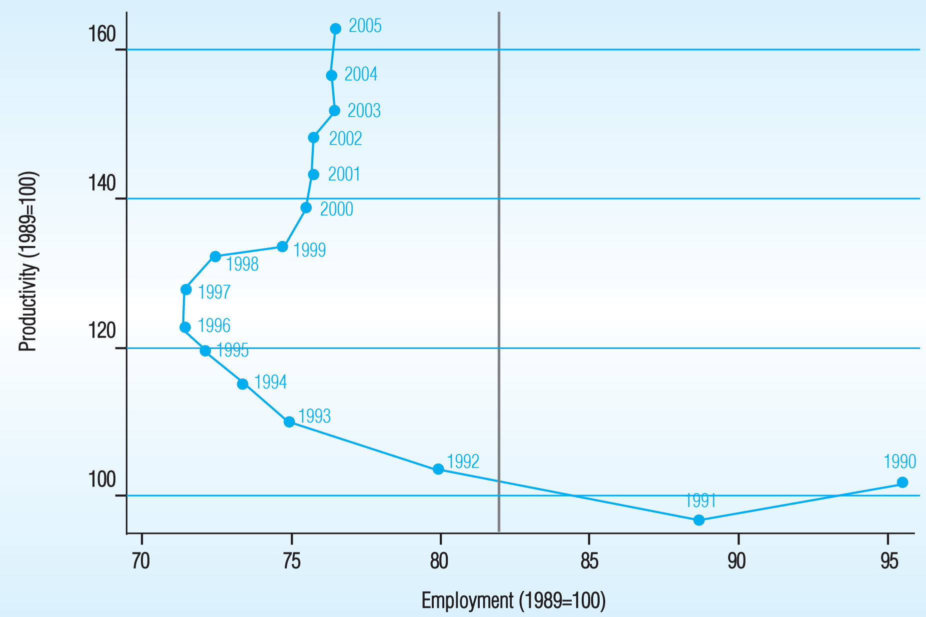
INTRODUCTION

Following the critical years of transition to market economy, Hungary is now functionally integrated into the European Union's economic, political and social system, with an economic growth rate constantly higher than the EU average. With an objective assessment of facts, it can be clearly established that through determined and appropriate governmental measures Hungary can meet the convergence requirements set by the Economic and Monetary Union. Recent events and future prospects, however, are not so much reassuring, if we take into account the state of the employment in our study.

Figure 1 demonstrates well that the Hungarian labour market does not show any improvement; it has been stuck in a steady, unfavourable state for long years, while the level of employment is extremely low. Despite the fact that the economic productivity has been continuously growing since the end of the

Figure 1

EVOLUTION OF EMPLOYMENT AND PRODUCTIVITY (1989–2005)



Source: database of KSH (Hungarian Central Statistical Office), calculations of *János Köllő*

transformation crisis, the promising growth in employment figures, which started in 1997, practically reached a dead-end in 2000. During the period of 2000–2005, the number of Hungarian people employed rose only by 45 thousand (i.e. 1.2 percent). The thick black vertical line in the figure indicates the average employment level in the European Union. To reach this level, the number of those employed should increase by six hundred thousand, and by nine hundred thousand to achieve the Lisbon objectives[3] of the European Union. Apparently, the government measures taken during the past years turned out to be inadequate to solve this problem. No substantial change can be achieved in the labour market by further reparation of the existing support schemes, active and passive labour market measures.

Besides the important and inevitably necessary small-scale measures, we have to determine what fundamental changes should be brought about in the social and economic institutions to reach a significant rise in the employment level.

FOUR QUESTIONS ON EMPLOYMENT

❶ What are the special characteristics of the Hungarian employment situation?

No substantial change has occurred as far as employment is concerned in Hungary during the past five years. The increase of the employment rate, which started in 1997, lost momentum in 2001, and since the end of the millennium there has been no real change. As regards the key indicators of the labour market, in particular the rate of activity, Hungary could not break out of the circle of the EU member states lagging behind. Unfortunately, it is a Hungarian characteristic that low employment level is not coupled by a high level of unemployment; instead, it is comes with a high rate of inactivity. The low employment level is mainly due to the very low job seeking activity of the unemployed[4]. *Figure 2* shows that the decrease in the unemployment rate in the nineties was almost entirely due to the fall of the job seeking activity. Similarly, the increase in the unemployment rate during the past two years has been almost entirely due to an increase in the job seeking activity. The underlying problem, however, is not the low unemployment level and the rate of inactivity, but rather that employment difficulties are concentrated in certain layers of the society and certain regions of Hungary. The inactivity rate is especially high among men aged 25 to 54, and first of all among the undereducated living in backward, rural regions of the country.

Compared to the OECD countries, the rate of inactivity of the middle-aged men is two times higher and the inactivity of those with low levels of education is two and a half times higher in Hungary. At the same time, the employment rate of secondary school graduates and higher education graduates is equal to, or only marginally below the respective rates of the OECD countries. *(Figure 3)* The ratio of the undereducated population excluded from the labour market is so high, that this layer, the proportion of which is relatively small, is almost entirely responsible for Hungary's lag in the aggregate employment level compared to the OECD or EU averages.

❷ What is the reason for the extremely high inactivity rate?

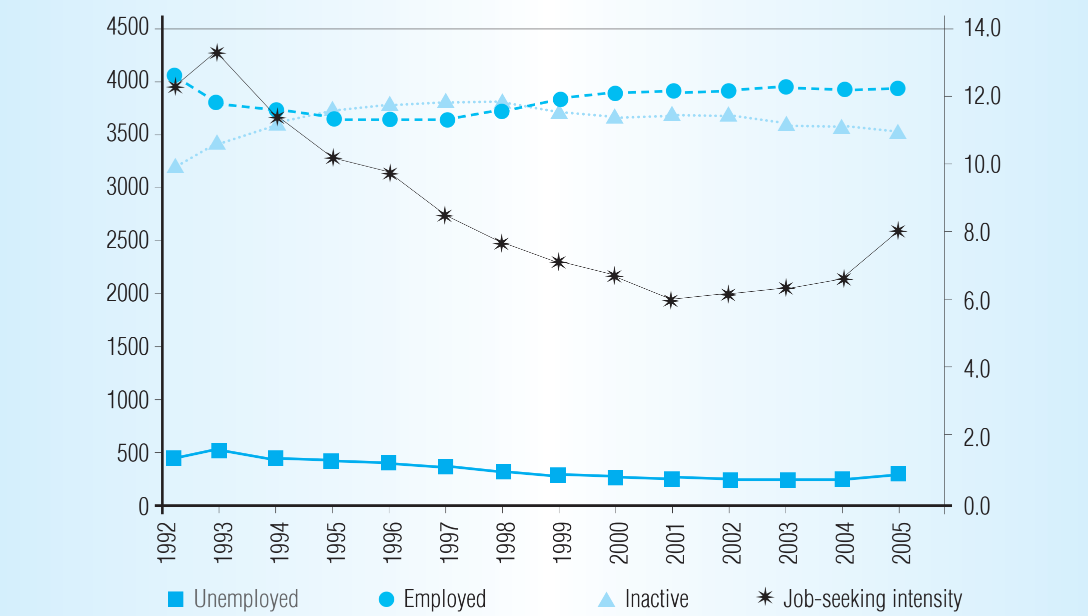
The high inactivity rate has got many reasons of different significance. Some special factors characteristic of Hungary will be highlighted here.

■ *Low retirement age, early retirement*

The retirement age in Hungary is still below the international standards, and the proportion of those who take early retirement is high. This decreases the employment and the unemployment rate, too. The low retirement age obviously reduces the willingness to work, which is expressed by the labour force participation rate. Early retirement reduces unemployment

Figure 2

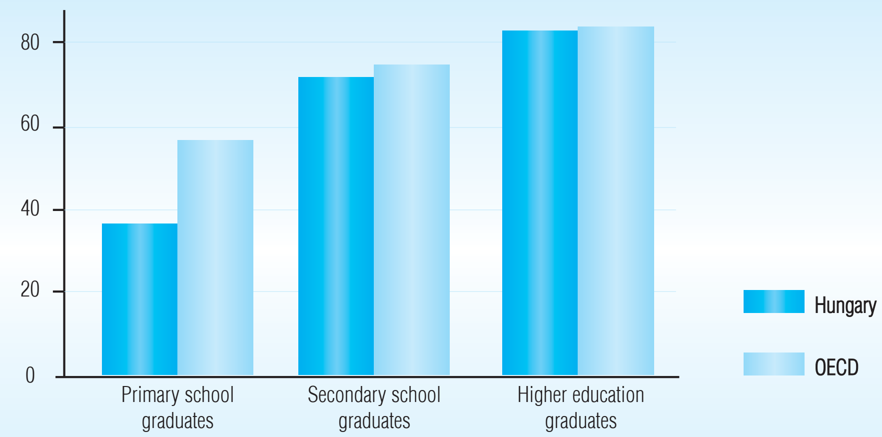
EVOLUTION OF LABOUR MARKET ACTIVITY IN HUNGARY (1991–2005)



Source: KSH Recruitement

Figure 3

PROPORTION OF EMPLOYED PERSONS IN THE 25–64 YEAR OLD POPULATION SEGMENT (2002)



Source: OECD Employment Outlook

rate because it is a means of escape for many people from unemployment, especially from long-term unemployment.

■ *High number of hopeless non-workers*

Among the Hungarian non-workers, the proportion of hopeless non-workers is high. Due to the drastic decrease in labour demand and the radical transformation of the occupational, professional and regional structures resulting from the change in the political regime, many became excluded from the labour market, and were qualified economically inactive after giving up efforts to find a job. This group is still made up of hundreds of thousands of people, but the number of the hopeless non-workers will automatically decrease as the members of this generation gradually reach the age of retirement. (Köllő, 2004).

■ *High number of hidden job-seekers*

In Hungary, there is no substantial difference between the unemployment rate of the active job-seekers and those willing to work, but not seeking a job. This specific layer of inactive persons has been formed gradually during the past ten years in Hungary. During this process, the job seeking activity of the non-working population has dropped to half of the initial number, while the significance of the jobseeker's allowances decreased radically in the income of the non-workers.

■ *High proportion of unregistered employees*

Compared to the average numbers in the older Member States, a bigger segment of the working-age population is employed on an unregistered basis, which may contribute to the low employment and unemployment rates in Hungary. It is probable, indeed, that only a part of these people reveal in the labour force surveys that they work in the black/grey economy, which qualifies them economically active. It is also probable, that only a part of them declare that they are unemployed.

■ *Regional concentration of the inactive population*

In Hungary, similarly to other countries of Middle and Eastern Europe, there are significant regional differences in the ratio of employed to unemployed persons. The strong concentration of the inactive population in the disadvantaged areas with low employment rate is a typical Hungarian phenomenon. The polarisation of the Hungarian labour market and the extreme and permanent territorial differences result from the low territorial mobility of the labour force and low capital mobility. The low intensity of the labour market induced migration could be explained by the fact that the possible wage increase obtainable this way is low as well as by economic and partially cultural, traditional factors. The movement of capital, therefore the migration of workplaces, to regions with high unemployment rate is hindered by the agglomeration effects (Fazekas, 2005, 2005a). In recent years, the territorial differences in labour costs adjusted by variances in productivity have dropped significantly in Hungary. Therefore the lower wages in the higher unemployment rate regions still cannot compensate the newcomer enterprises for the loss of the positive external effects offered by the developed, urbanised areas.

■ *Employment status of the Roma population*

The employment rate of the Roma population in the years following the political transition drastically dropped. According to the results of the 1993 and 2003 representative surveys on the recruitment of the Roma population in Hungary, the employment status of the Roma population during the period under review – instead of showing improvement – settled at a level comparable to that of the third world countries. The basic characteristic of this new state, which seems to be permanent by now, is that the extremely low employment rate (30–35 percent) is accompanied by extremely high turnover rates of entering and quitting jobs. We may conclude that the social exclusion of the Roma population has reached a dramatically high level, since these employment-related characteristics are not typical of the similarly undereducated segment of the total population with maximum eight years in primary education. The employment rate of the low education level group is almost two times higher than the Roma employment rate, and their employment instability remains significantly below, by over 50 percent, the instability level of the Roma population.

The exclusion of the Roma workforce from the labour market is mainly due to discrimination, their low levels of education and their unfavourable territorial distribution. In addition, the active labour market programmes, which concern mainly the Roma population – communal work etc. – further contribute to the preservation of the temporary and unstable forms of employment, and do not increase the chance of the Roma for permanent employment. (Kertesi, 2005).

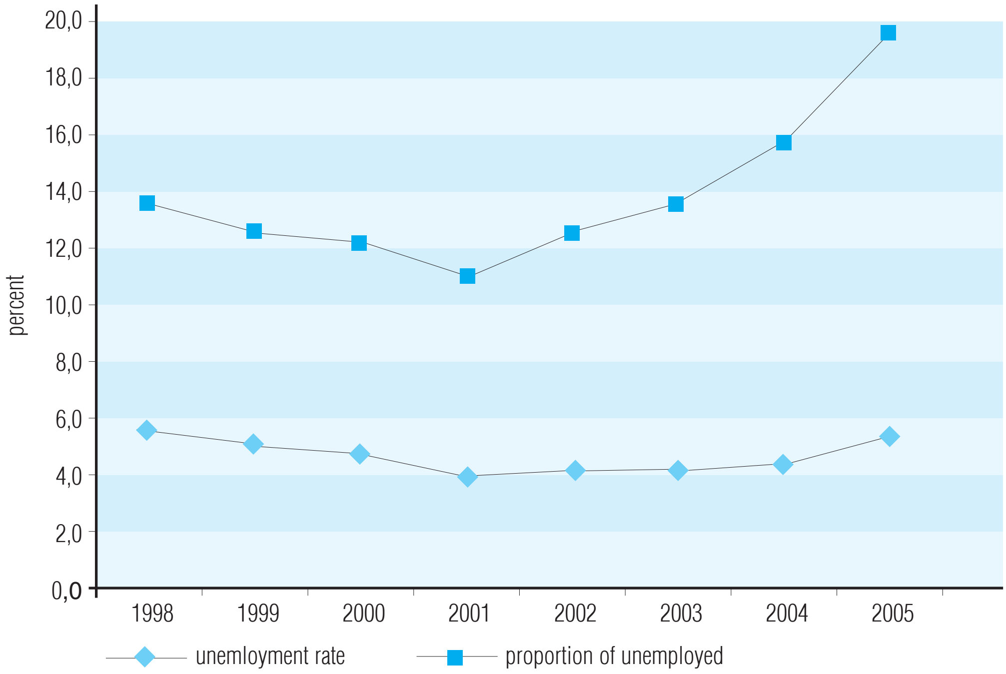
❸ What are the reasons for the increasing unemployment rate of young people in Hungary?

Between 2001 and 2005, the unemployment rate increased from 10.8 percent to 19.4 percent in the age group of 15–24. Before studying the reasons for this situation, which is definitely getting worse, we have to point out that the unemployment rate of this age-group cannot be compared to any other age groups. The reason for this is that in this group the proportion of students is very high, therefore the number of active persons is very low. A higher proportion of students among young people increases the unemployment rate, even if the number of the unemployed persons is not increasing, or, on the contrary, it is decreasing. *Figure 4* shows that between 2001 and 2005 the unemployment rate of those between 15–24 increased by almost 10 percentiles, while the proportion of the unemployed people increased only by 1.4 percentiles.

It can also be seen that during the past years the unemployment rate of young people grew only among those with low levels of education. The employment rate of the population with higher education is above 70% in the age group of 15–24. Among those with primary education only, this figure is just 7.2 percent. There is a popular belief, which cannot be possibly justified, that the employment prospects of young

Figure 4

EVOLUTION IN THE PROPORTION OF THE UNEMPLOYED AND EVOLUTION OF THE UNEMPLOYMENT RATE IN THE AGE GROUP OF 15–24



Source: KSH (Hungarian Central Statistical Office) database, Recruitement

people have dramatically worsened because of the overproduction of graduates in higher education. The calculations made by Kertesi and Köllő show clearly that during the past few years, besides a marked decrease in the wage premium of the higher education graduates, which is still very high on an international scale, the chances of employment of the higher education graduates are much better compared to those without vocational skills or with only secondary education.

❹ WHAT SHALL BE DONE IN ORDER TO INCREASE THE EMPLOYMENT RATE AND TO REDUCE THE RATE OF INACTIVITY AT THE SAME TIME, ALONG WITH REDUCING THE SOCIAL AND REGIONAL DIFFERENCES THAT CONTRIBUTE TO THE INACTIVITY?

A basic prerequisite of the elaboration of an employment scheme is the assessment of the national characteristics, their reasons and their consequences. However, in reality, more needs to be done in order to define objectives and priorities. To find the right answer, further questions shall be asked. With well-targeted questions, we can avoid analysing evident facts, automatically accepting popular, but unjustified beliefs and failing to notice the really important, but less obvious connections. Let's just go back to the foundations and ask three basic questions which are believed to be answered for a long time, therefore these have been neglected.

▪ *Is it really necessary to increase the rate of employment in Hungary, and if so, at what cost?*

The connections between a low employment rate and the other factors presented above justify that the main objective in Hungary cannot be "to raise the employment rate by this or that percent during the forthcoming years", since the main problem is not only the very low employment rate, but the extreme differences in the inactivity rate, which seem to be permanent, among the various segments of the society and certain regions. This difficult situation creates social problems that go far beyond the labour market, and they result in, for example, the uneven regional and demographic distribution of households with children and without wage-earners, living in extreme poverty.

Therefore, the rate of employment is to be increased, however, the existing differences among the regions and social strata should be decreased at the same time. On the other hand, a higher employment rate would not automatically reduce the public financing needs related to measures aiming to reduce social disparities, but it could even increase them, for example due to the changes in the wage-earner/dependent family member ratio.

Hereby, we should highlight certain often neglected fact.

◈If the increase of the employment rate results only in the fact that people move from the single income family model to the multiple income model, we have to take into consideration the undesirable motivation-related consequences of this change. The increasing popularity of the multiple income family model increases the economically desirable wage differences by weakening the links between the wages of the individual employees and the earnings per capita in the households. Thus, with the prevailing multiple income model, the relative differences in wages become less motivating. The increasing spread of the multiple income family model decreases the socially possible wage differences, because at a higher earner/dependent ratio the average income per capita in a household is higher, compared to the average wages. This is one of the factors determining the minimal wages.

◈We also have to take into consideration that there is a contradiction between the adjustment of the wages to those of the more developed European Union member states and the increase of the employment rate. There is a short-term and a long-term exchange relationship between the increase of the employment rate and the increase of the productivity, even if the guidelines of the European Union suggest the opposite. In the long run, however, the evolution of the real wage level is mainly determined by the trends of the productivity. Consequently, when the economic growth is an outcome of the increased productivity, rather than an increasing employment rate, the wage adjustment will occur faster. And vice versa: it is easier to catch up as far as employment is concerned, if the wages are adjusted to the average wages of the European Union at a slower pace.

◈We also have to see that the economic growth that results from a higher rate of employment is somewhat illusory, because a higher rate of employment generally means only that certain unregistered activities carried out in the household sector become official market or communal activities.

Employment rate increasing measures have got a number of other, shorter- and longer-term micro- and macroeconomic effects, which cannot be possibly listed here. With the above-mentioned examples we only intend to suggest that we always have to consider the advantages and the disadvantages of such measures, when we assess the desirable changes of the employment.

■ *To what extent do high wage related tax and contribution rates hinder the growth of employment*

Contrarily to common beliefs, there is no correlation between the rate of the tax burden and the labour cost per production unit as employers gradually pass on the burdens represented by the higher taxes to the employees in the form of lower net wages. We have to take into consideration that the labour cost reducing effect of an eventual burden moderation, aiming to increase the number of employees, can be neutralised by the subsequent labour cost increasing effect of the higher net wages.

We also have to take into account that the labour cost flexibility of the labour demand of the Hungarian enterprises is about –0.3. This means for example, that a significant, 10 percent tax and contribution moderation, which would reduce gross labour costs by approximately three percent, would raise labour demand by 1 percent at most. General tax moderation, therefore, would have only very modest results.

It must be also mentioned that Hungary, contrarily to popular beliefs, has got a relatively moderate rate of wage related labour taxes and contributions on an international scale. However, taking into account the total tax burden rate on net wages (contributions, income tax, VAT) Hungary is in the upper third of the OECD countries with the heaviest tax burdens. The tax burdens on gross wages (labour costs), which contain the non-cash benefits as well, have a greater influence on the labour costs than the tax burdens on the net wages. However, if we take into account the non-cash benefits and exclude VAT, a single income Hungarian family with two children in 2003 has got a tax burden rate of 30.3 percent on the gross labour cost, which is only 3.5 percentiles higher than the OECD average, and lower than the tax burden rates calculated in the same way in many other European Union member states.

■ *In what way does the flexibility of the labour market hinder the growth of the employment rate?*

Contrarily to popular beliefs, the Hungarian labour market is considered to be very flexible, if the assessment is based on the legal and institutional factors regulating the workforce recruitment and dismissal and work related rules. The flexible adaptation to the changing labour demand is mainly limited by geographic mobility factors. We would like to draw the attention to the two main forms of geographic mobility. The first form is daily commuting. Its possible range and accessibility are mostly determined by the rate of development of the interurban public transport (network density, journey time etc.) and transport costs. The second form is the change of domicile, which becomes more widespread, when flat lease is preferred to private home ownership. This means that geographic mobility represents the biggest difficulty for groups who live in hardly accessible, remote places, and have low levels of education.

The most important factor that determines the occupational mobility is the level of education: the more educated people can change occupation much easier. The possible intensity of the workplace mobility depends on two main mutually dependant factors: how much the different occupations have in common concerning vocational skills, and whether the vocational skills taught by the vocational training institutes are adapted to the needs of the market.

After listing the most important mobility factors, it becomes clear that the promotion of workers' mobility, although it is crucial, cannot promise spectacular or magical results. Obviously, the improvement of the work force mobility could not change alone, not even in the long run, the permanent regional differences in the employment and unemployment rates, and discriminative, unequal opportunities of employment.

OBJECTIVES AND PRIORITIES

The 32-page National Development Action Programme adopted by the Hungarian Government in 2004 describes the employment objectives quantified by the Employment Action Programme and the objectives to be achieved by 2005 and 2010 respectively as defined by the European Union. The Lisbon Action Programme for Growth and Employment adopted in October 2005, groups the priorities of the employment objectives for the next years under 12 headings, in accordance with the relevant Community directives. It is obvious by now that neither the European, nor the

Hungarian objectives can be accomplished. We have to set realistic, attainable goals which take into account the characteristics of the Hungarian labour market.

We have to know, where and at what costs is it possible to increase the rate of employment, what the most serious problems are and what the priorities are defined by the government in the possible fields of activity and for the possible measures. Much improvement is needed in a number of fields and various instruments have to be applied in order to reach the employment objectives. At the same time, resources shall be concentrated to the fields defined by the priorities.

There is no doubt that the government, during the elaboration of the Hungarian employment policy objectives, shall take into consideration the directives adopted by the European Union. In order to reduce Hungary's lag behind the overseas OECD countries, these priorities aim to raise the employment rate and to improve the low labour market flexibility, considered to be the main reason for the low employment level. The priorities emphasize the need for the continuous accumulation of human capital, too.

However, during the definition of the Hungarian priorities, we have to take into account first of all the Hungarian characteristics, which are only partially common with those of the acceding Member States of Central and Eastern Europe. The characteristics considered to be the most important in the definition of the priorities are the following:

- exclusion of people with low levels of education from the labour market,
- nearly complete exclusion of the Roma from the labour market,
- the rate and permanence of regional differences.

The phenomena such as the regeneration and the high inactivity of the population with low educational levels, the exclusion of the Roma from the labour market and the continuously increasing lag of the disadvantaged municipalities are connected to each other and they cumulate a number of disadvantages on the labour market. The accumulation of the educational, ethnic and regional disadvantages is such an extremely serious problem of the Hungarian society, unknown in the OECD countries, or in the recent past of the European Union, before Hungary's accession. We believe that the resolution of this problem will be the main priority of the next decades in Hungary, even if resources have to be reallocated for this purpose from other high-priority fields of the European Employment Policy, like the equality between men and women or the creation of the necessary conditions for life-long learning.

WORK HAS TO BE DONE ACCORDING TO THE PRIORITIES

We think that the answers given to the following three answers forecast the success or failure of the government's employment policy in the years to come.

- Is the government able to concentrate resources to the high priority fields?
- Is it capable coordinating efficiently the key government units?
- Is it able to evaluate the effects of the employment policy measures systematically, and carry out the necessary modifications according to the impact assessments?

❶ Focus resources on the measures reducing educational, ethnical, and regional disadvantages

■ *Measures reducing educational disadvantages*

Current instruments are evidently not sufficient to reach the objective of reducing the rate of the people with low education levels.

This segment consists of groups who did not finish primary school or have not acquired the basic skills, or they dropped out from secondary education, therefore, they have very little chance to get into the adult education and acquire vocational skills. The Ministry of Education and the other ministries concerned should elaborate programmes to follow those who drop out of school early and return them to the educational system. It would be worthwhile to consider restarting the education of the working adults and initiate similar programmes that develop the skills of those, who dropped out of secondary education, in order to enable them to start vocational training later.

Obviously, the necessary measures extend far beyond the competencies of the employment policy or the Ministry of Education. Just to reveal the complexity and diversity of the tasks, we are going to list some of the measures that were defined by a research programme[5] focused on the exploration of the correlations between the educational system and the labour market, prepared in 2005 at the Institute of Economics.

◈ First of all, we have to focus on the primary schools (schools in small municipalities, schools of single school municipalities, suburban schools etc.) in the proximity of which disadvantaged students are living and where they learn. More precisely, the objective is to equilibrate major qualitative differences in the primary education services between regions, municipalities and residential areas.

◈ Essentially, this means that as far as educational opportunities are concerned, a general primary school rehabilitation programme would be necessary especially for the disadvantaged children. This programme would concentrate on the complex development of the institutions frequented by these pupils (including facilities, staff, educational programmes, social support etc).

◈ A central scholarship programme, as an indispensable part of this programme, financed by the Ministry of Education would offer the opportunity for young teachers to study abroad for a number of years in the colleges and universities of the Scandinavian countries, the Netherlands, the United Kingdom for example, which have got a long tradition of the competent education of disadvantaged children. A programme like this has to be prepared accompanied by a rehabilitation programme for the disadvantaged schools, because the major obstacle of the rehabilitation is the lack of well-trained teachers. It can hardly be expected from the current, rigid and obsolete training system to train teachers with the necessary modern views. A well-planned international scholarship programme involving a high number of teachers would help to overcome this obstacle. Young teachers participating in this program would sign a contract for at least 5 years and they would engage themselves to work for at least 5 years after the programme in one of the disadvantaged schools.

◈Commuting aid should be allocated to poor families, whose children (intend to) go to school in a different municipality. Many children raised in poor families cannot go to a better school, if it is located outside the family's residential area due to the commuting costs. Furthermore, the accessibility of underdeveloped, small-size municipalities should be improved. In many cases, there are no local bus lines or their time-tables are not adjusted to the school time-tables, which constrain the children of the poor families to go to the local "ghetto" schools. Middle-class parents take their children by car from these places to the better schools in their proximity. If we do not improve these conditions, we will deprive a large number of children of the poor families from the advantages of the free selection of schools, already before the application.

■ *Measures to improve the labour market conditions of the Roma population*

The Roma population, which have been long excluded from the labour market, and live far from the urban labour markets, unable to finance the commuting costs and having low levels of education, are rather employed through welfare employment, which, however, does not help to find a way to the long-term employment. The wide application of socially integrating projects would be necessary, which, if operated well, could offer a real chance to acquire the skills and knowledge needed for the employment. Such solutions could be provided on one hand by the programs managed by competent non-profit organisations who could promote the economic self-organisation of the Roma. On the other hand, rehabilitation programs in the fields of economy, transports, education, health care and the social institutions could be a solution for the densely populated, depressed rural regions where Roma people live. It would not be a perfect solution, but a much better one compared to the existing scheme, to establish a system of aid and support functioning according to uniform principles in a uniform way, on the basis of the network of the local employment centres. It is also very important to follow up the situation of the Roma population by means of statistical analysis conducted on sufficiently large-scale, representative samples. It is unacceptable that there are not even plans on about the possible surveys on the situation of the Roma population in Hungary: their way, their frequency, the resources and the data collecting organisations have to be specified.

■ *Measures to reduce regional disparities*

The harmonisation of employment policies with other policies, such as housing, transport and education etc., and a closer cooperation between the ministries responsible for the employment policy and regional development would be a significant step towards the economic catching up of the depressed areas. Obviously, financial support of the regional development cannot compensate alone the negative effects of the agglomeration effect which reproduces infrastructural, logistic and educational inequalities, however, they affect territorial mobility and the distribution of human capital, too. A better support of schools in the disadvantaged regions would have a major achievement in the elimination of these regional disadvantages. The most urging task of the Ministry of Education is the complex evaluation of the effects of the instruments which serve the regional compensation of the employment differences, aiming to improve the territorial distribution of the population. Without this, the principle to finance measures which serve the best the aimed objectives, considering regional characteristics as well, cannot be implemented.

Discussion is needed as soon as possible between the Ministry of Economic Affairs and Transport and the Ministry of Education in order to prepare the governmental decisions on the development of the transport infrastructure, falling under the authority of the Ministry of Economic Affairs and Transport. We have to change to the current approach and the practice, which stresses only the beneficial employment effects that will be brought about by 2015, following the construction of the Hungarian Helsinki corridors and the other highways, which solves the problem of the strongly centralised road network. On the other hand, the development of local road networks does not receive enough attention, and the timing of the construction of the express roads serves only transport politics and transport organisation interests. We believe that in the construction of the highways, priority should be given to those stretches that reach the most disadvantaged areas. The construction and modernisation of the secondary and auxiliary road networks should receive more attention in order to facilitate commuting between villages and local labour market centres, along with the financing of public transport lines, which are not economical, but they are vital for the affected villages.

❷ Improve the coordination between institutions playing a key role in the elaboration of the employment aims and priorities and in the implementation of measures

According to the employment principles of the European Union, "The governments of the Member States shall seek to ensure the development and the execution of the action plans that enable the citizens to take care of themselves and of their families, of their health of their old age security and to contribute at the same time to the functioning of a knowledge-based, competitive economy".

Last year, with my colleagues who work at the Institute of Economics of the Hungarian Academy of Sciences (HAS), we participated in the evaluation of the National Development Programme related documents, of the National Development Action Programme of 2004, and of the Lisbon Programme for Growth and Employment. Based on our experience, the Hungarian institutional conditions of governmental action do not favour the elaboration and the execution of an overall employment strategy that could consistently control the objectives.

In the field of the employment policy, the preparation and the responsible execution of the action plans – in theory – are carried out in collaboration with all the ministries and high authorities, which are coordinated by the Ministry of Education. In practice, however, the contribution of the different governmental organisations is generally restricted to the supply of data and to the expression of the opinion, and there is not much initiative to collaborate in the analysis of the conditions and effects needed to the elaboration of a coherent programme. This situation has different reasons. On one hand, there has not been any agreement between the governing parties following each other about the basic questions of the employment policy, and we lack the stable organisational and personal framework and the continuity to execute the necessary measures. On the other hand, there are no authorised, competent institutions to manage the collaboration.

The directives of the European Union require that the government has to conduct a substantial debate with the social partners. There is no doubt that during the past years the Ministry of Education responsible for the preparation of the employment policy concepts has made efforts to debate the programmes with the various non-governmental partners, for example with the representatives of the employers' and workers' organisations. Typically, none of the intervening parties presented professionally founded propositions, specifying employers' or employees' needs that would differ from the existing action plan. The propositions were restricted to certain fields, employees urged adjustment of the wages to the European wages (unrealistic compared to the Hungarian economy's productivity) and urged to respect the obsolete Labour Code rules. The elaboration of propositions to increase the chances of employment of the unemployed persons remain still outside the sphere of interest of both employers' and employees' organisations.

❸ The effects of the measures shall be continuously evaluated and the institutions and procedures have to be continuously updated and developed according to the evaluations

Employment policy measures cover a number of fields, for example the curtailing of support, the increase of minimum wages, which have been analysed during the last years. Professional impact assessments were prepared, and fact-finding studies were conducted on several additional, restricted fields like education and labour market, working-age inactivity rate, unemployment benefit regime, gender-equality, the situation of the Roma, the problems in the employment of disabled persons and the hidden economy. These data can be useful for the evaluation of the measures. In certain areas, indeed, no results are available, sometimes not even raw data can be found, to be able to assess the impacts of the measures. This is the case, for example, in the collection of representative data about the situation of the Roma population, or in the creation of databases that allow the follow-up of the effects of the different income transfers on the labour supply and on the labour demand.

However, it is not sufficient to envisage the necessary surveys, analyses and impact studies. Appropriate personal, legal and institutional conditions have to be created in order to connect the existing statistical and administrative public administration databases on an individual level and to carry out evaluations. Without these prerequisites, it is not possible to follow up the effects of the employment policy measures. It is not by chance that we emphasise the need for systematic work. During the recent years a number of programmes have been in operation, which revealed information of basic importance regarding certain periods, like the analysis of the sectorial and regional wage differences adjusted for the compound effects; the impact study of the minimum wage increase; and the impact study of the public work. Researchers work in these fields occasionally and prepare these studies in the framework of independent research projects. However, employment policy decisions continuously require such information. The supply of information cannot be guaranteed by programmes within the framework of short-term projects. Appropriate conditions are needed for that the public institutions could prepare the necessary reports and calculations on a regular basis.

Notes

[1] This study was prepared on the request of the Economic and Social Council, and it relies substantially on the labour market researches carried out by the Institute of Economics of the Hungarian Academy of Sciences (HAS), with particular regard to the National Research and Development Programme entitled “Knowledge-based society and labour market in the 21st century”, a research programme prepared by the Institute of Economics (IE) for the Ministry of Labour, entitled “A comprehensive evaluation of the Hungarian employment policy of the past five years, within the context of the European Employment” and the HAS-MEH (Hungarian Academy of Sciences – Prime Minister's Office) strategic research programme entitled "Hungary 2015".

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[3] At the Lisbon European Council held in March 2000, Heads of State and Government of the Member States made a commitment to raise the employment rate of the 15–64 year old population to 70%, female employment rate to 60% by 2010.

[4] Job seeking activity is the ratio of the unemployed to the not employed population.

[5] “Knowledge-based society and labour market in the 21st century”, research No. 5/180/2001. The results of the research were published in Munkaerőpiaci Tükör 2004 (Labour Market Bulletin) in the thematic section entitled Education and Labour Market, and in the book series of IE under the title of “Education and Labour Market”.

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Zoltán Bara

Competition and the Hungarian competition policy

Tendencies in the changes of the competition status quo of the Hungarian economy from the point of view of the legislative regulation of competition

My paper is the result of inner motivation. Having spent almost half a decade in the Competition Supervisory Board of the Hungarian Competition Authority I have felt an increasingly frequent and strong urge to answer the questions: what is the tangible result of the legislative regulation of competition, does it have specific bearing on the formation of competition situations, and has it contributed/is it contributing to the creation, or, indeed, the development of the competitive sector of the economy? I therefore request the Reader to regard my paper as a stage in my process of thinking. The author will try to summarise how far he has come in answering the original question. Meanwhile – naturally – he realised that he may not be seeking the answers to his original problems but has come upon some other, more important one in the course of his reflections.[1]

SOME BASIC PRINCIPLES

I cannot undertake to include in my investigations all areas of the economy important from the point of view of competition. I will therefore concentrate in my study on those sectors only that the Hungarian Competition Authority (GVH) has most frequently dealt with during its mission of regulating competition. That does not mean that in other markets and other areas our competition landscape should be free of problems, and not even that I will expand on each area where there are major competition related difficulties.

Let us stop for a second over the meaning of the term: competition related difficulties. What does it refer to in conjunction with economic sectors, or individual markets? There are two major threats to competition: the state, and the competitors themselves. There are some branches in which no competition can come about or no competitors may enter by way of a natural process. That is called monopoly by technical literature. Such markets are (for various reasons) closed to competitors, and so there is one single undertaking to reap all the benefits of the monopolistic situation. For a long period we thought landline telephony, rail transport, gas, electricity, basic public utilities (water, sewage, waste collection, lighting of public areas, etc.), postal services, cable television services – to name only the most important ones – were such areas. In these areas competition related problems result from the closed nature of the market, i.e. the fact that unless the state acts upon it (institutes regulation), no undertaking other than the incumbent[2] ones protected by monopoly can find their way to the consumers. That also has a simple technical reason: the incumbent firm owns some of the indispensable equipment (primarily the network) access to which is instrumental for competition to be present. Without such access there is no competition, thus competition related problems are similarly disabled.

Competition begins when these markets open, i.e. when appropriate legal regulation and action by a public administrative body create the conditions of access to such indispensable equipment. That is usually a complex regulatory challenge in which the general aspects of the competition must materialise in the specific context of the branch. Which are these aspects, and how are they realised in the given branch? What, how, and when to regulate (or not to regulate)? Such questions constitute the set of competition issues related to opening the market. When preparing, developing, and implementing market opening, the GVH may first come up against the state (and legislators) if the latter do not or do not appropriately take account of the general aspects of competition, and so market opening fails to result in effective[3] competition in the given sector.

The other set of competition related problems could be labelled traditional, classic issues of competition. It is about sectors without natural monopoly, without indispensable equipment, and, consequently, without naturally created problems of access to be resolved by either the state or some other regulatory authority. One could even phrase it as follows: in such cases the conditions of competition are or could be present. Of course, organisations already in the market would like to alter these to their benefit or to the detriment of their actual or potential competitors. Market actors are able to hamper, distort or eliminate competition in any market because competition cannot defend itself. However, competition as an institution must be defended rather than just individual competitors.

The following are the traditional groups of competition related problems:

- use of unfair competition techniques by competitors against each other
- deception of consumers, abuse of dominant economic power, and finally the gravest one:
- collusion of market actors, i.e. the cartel.

The present study aims to investigate whether the efforts of the GVH have had any influence on modifying the overall situation of competition, and if so, what way such influence surfaces. In the following chapters we wish to answer the following major questions:

❶ Which were the more significant economic sectors or markets in which competition related difficulties emerged following the political changes? What intervention and with what frequency was instituted?

❷ Can any tendency be observed after an analysis of the nature and the frequency of these instances of intervention from which assumptions could be made concerning the status of the competition in the given economic sector/market?

❸ Which were the economic sectors whose competition related problems were given extra attention?

During the approximately 15 years that passed since the political changes there were two processes of change of fundamental significance in the legislative standards of competition regulation. Act LXXXVI of 1990 on the Prohibition of unfair market behaviour (PUMB) was replaced by Act LVII of 1996 on the Prohibition of Unfair and Restrictive Market Practices (PURMP), effective 1 January 1997, a piece of legislation considerably more up-to-date, and closer to EC legal standards. It brought about changes of even more significance following 1 May 2004 whereafter the domestic bodies of competition regulation (GVH, courts of law) can, and, in certain cases are even obliged to apply the EC's provisions concerning competition law.

While the two dates referred to above fail to coincide with the segmentation of the transition process as recognised by several sources, they are not far apart from each other, either. As regards that segmentation, I can most easily identify with the views of *László Csaba,* who claims that the Hungarian economy mostly resolved its tasks in conjunction with the first phase of the restructuring (transition) process by 1996–97[4]. Most experts relate the second phase – at least in the East-Central European region – with the preparation process to EU accession. This is why the two dates in question essentially overlap with the early (first) and later (second) phase of the economic transition process. Another question I seek an answer to is what major differences emerge as one compares the two phases in terms of the appearance and the handling of competition related problems. As part of that discussion I will try to answer briefly what one may expect on the basis of experience so far regarding the appearance and handling of competition related problems following our EU accession, and, based on the same, what is the present competition landscape, and what expectations are justified concerning its future.[5]

I would like to discuss briefly the way in which competition regulation correlates with the status of economic competition labelled either competition landscape/status of competition or competition climate. The first and perhaps most important statement is that competition regulation cannot establish competition where the requisite conditions are not in place. If in a particular market an undertaking is in a natural monopoly, then – due to the given technical, economic, and regulatory conditions – that single undertaking can more cheaply manufacture a product that does not have a close replacement product than any combination of two or more companies.[6] That well-known thesis of economics holds true to the present day, but technical conditions in numerous sectors – previously thought to be natural monopolies – have changed so that an artificial change in the market's competitive conditions became possible (branch level regulation). Thus my first thesis is that competition regulation does not create or bring about competition in the market.

My second thesis: it is not a requirement against competition regulation to determine the conditions of competition in a given sector, how large the competing companies should be, what factors (price, quality, etc.) should form the subject of competition, what the desirable (competitive) price should be, etc. And that thesis is far less self-evident, sometimes not even for economists. There is no thesis of economics to suggest that the more companies in the market, the more intense, and the more effective the competition. The competitive conditions of a sector, or of a market may be best modified by economic policy. Provided that these changes take place within the frameworks of applicable legislation, the GVH is entitled to add its observations to draft laws, but it fails to have the right of veto even in a case where the legislative provision to be passed is obviously of an anti-competition nature.[7]

What is then the duty of competition regulation in conjunction with the competition landscape? The primary role of the GVH in the functioning of a market economy, and the freedom of competition is to give effect to the provisions of the Competition Act to the benefit of the public, in a way which increases social welfare and competitiveness, and to help bring about a situation in which there is branch-level legislation[8] creating the conditions of competition even in areas where competition is not possible.

The operation of the GVH, and thus the implementation of competition policy principles followed by it rest on two pillars, namely on competition supervisory procedures, and on efforts encouraging competition. Competition supervisory procedures stand for the implementation of the financial and legal provisions of the Competition Act in accordance with established processes. As for the encouragement of competition, it means the activity of the GVH whereby it tries to influence decisions by the state so as to protect competition.

TENDENCIES OF COMPETITION IN THE PERIOD 1991–1996

Competition legislation was developed in the late 80s, prior to branch level legislation. Our model in the course of legislative efforts was the German competition law, and we likewise took into account the provisions concerning competition law of the Treaty of Rome, i.e. the EC model. That decision was justified partly by historical antecedents, and partly by traditions. The law was drafted in 1989 by the parties of the Opposition Round Table, experts, and renowned scholars of the subject. Although there was no consensus concerning the content of the Act[9], yet the newly formed Parliament passed it in 1990. The creation of laws on branch-level competition began long after that.

The application of the first competition law began under very tight, and tense conditions from both economic and political points of view. Following a period of 40 years of the state's overweight the law was very restrictive concerning the manoeuvring space of the GVH. The GVH was faced with a double task: on the one hand it had to protect competition as an institution from direct state interference, and, on the other, it had to protect competition, then unfolding, from the restrictive moves of market actors. These tasks had to be implemented in a rigid market structure formed several decades before, and controlled decisively by monopoly organisations. Another objective of the 1990 PUMB included breaking state monopolies, and the opening up to competition and the private sector some branches previously controlled by the state.

In the first years of the transition there was an immediacy to re-engineer the laws created for regulated markets for a market economy context. So the GVH concentrated its competition encouragement efforts especially on separating authority functions from entrepreneurial functions, and on creating the accounting, transparency, and institutional conditions of regulation suitable to enforce efficiency.

Experience of the first six years of competition regulation

Upon assessing the first Hungarian competition law one has to emphasise that competition legislation is a new area in law, and a new legal institution that is mostly capable of producing its ful effect in a context of a set of standards of a relatively developed market economy[10]. In that sense the PUMB law may be characterised as a premature birth. It was forced to develop, and prove its operability and viability simultaneously to the transition of the economy, while it could not – and, in fact, was not in a position to – work a significant influence on the process of economic transition, especially on privatisation. It is due to that relative 'immaturity' that the GVH sometimes had basic values such as the protection of the interests of the public, of the competitors, and the consumers intermingled in its operation.

The Competition Act is essentially a sector and branch neutral set of standards applicable to any actor of the market regardless of economic policy priorities. The principle of sector neutrality may cause confusion of roles to the GVH especially if some branch level regulation derivable from the principle of the public interest is not available or is deficient. In such cases economic actors frequently expect (up to the present day) the GVH to fill in the legislative vacuum. That, however, is not a justified expectation because if a certain branch requires specific regulations, then those logically cannot apply to other branches; thus competition regulation cannot assume that role. During the first six years of the transition the creation of sectoral regulations only just started.

The PUMB embraced two bodies of legislation: one about fighting unfair competition that served the integrity of competition, and the body of legislation to counter restrictions of competition that protects the freedom of competition. Part of the legislation to counter unfair competition are the so-called classic acts of competition including denigration, breach of business secret, instructions to boycott, servile simulation, and integrity of tendering as well as the prohibition to deceive consumers. One may state post facto in conjunction with the latter that the competition law must also play a role of making up for missing legislation because nearly 8 years had to elapse before Act CLV of 1997 on Consumer protection was enacted.

New enterprises entering the market in large numbers with deficient or plainly lacking knowledge of standards of market behaviour brought with them a long series of cases of deceiving consumers. Suffice it to mention the pyramid scheme type of games, lottery games or mail-order firms. Entrepreneurs trying to profit almost exclusively from deceiving consumers caused significant social damage to Hungarian consumers by abusing the latter's inexperience. Regarding that group of cases the primary duty of the GVH is the protection of the public interest associated to the integrity of competition, i.e. remedying the distortion of competition and the market that concerns most consumers. However, complaints by individual consumers are not the competency of the Office as sanctioning these is specifically the task of consumer protection agencies, although one has to admit that these did not exist at the time. That circumstance also contributed to the problem that even with a large number of cases processed, many complaints remained unremedied.

The number of so-called *consumer protection* cases grew steadily in the first ten years. With that number growing the number of actionable cases (i.e. where the fact of infringement was established) also grew. Among infringement cases consumer protection cases (even today) amount to about triple the cases of abuse of dominant power, and are one magnitude more than cartel cases.

Consumer protection cases in the first years began at the request of the competitor. Most cases related to misleading advertisement or concealing an unfavourable quality of the product. Condemnatory decrees were issued most frequently in conjunction with mail-order services, lotteries, or the illegitimate use of the adjectives 'best', 'cheapest', or 'fastest'. 1994 saw the appearance of advertisements by multinationals, followed by pyramid schemes. A similar case gave rise to the sum by far the highest to be paid in fines by MIKROKER Kft. sentenced to pay a penalty of 400 million HUF. And in 1995, cases of time sharing holiday arrangements began.

Another decisive body of legislation concerning competition is the one against restricting competition, and these together are named antitrust legislation[11]. The provisions of these apply to cartels, abuse of dominant economic power, associations created by entrepreneurs, i.e. areas of a weight where defence may no longer be left to handle by the parties of such infringements. The assessment of the individual cases, and the decisions require complex investigations of an economic and legal nature, and the institutional defence in these cases must be the tasks of the Hungarian Competition Authority.

So-called horizontal agreements aimed at restricting competition were regulated by the provision on the prohibition of cartel in chapter III of the PUMB. The law gave individual names to the cartels depending on whether the underlying agreement concerns price or the market, and among vertical agreements the law handled specifically the re-sale price. So-called *bagatelle agreements* or agreements with little significance were taken off the blacklist; such agreements are ones where the parties involved have a market share below ten percent. Similarly off the blacklist were cartels aimed at preventing the formation of dominant economic power. The price and market cartel transactions of the last 6 years in which gross infringement was established, some of which reached legal effect included the meat cartel (Vj–49/1991), the sugar cartel (Vj–224/1992), and the coffee cartel (Vj–185/1994).

The so-called meat cartel started when 20 state owned meat processing companies founded the Budapest Meat Wholesale Joint Venture (BHKV) with the purpose of securing meeting meat and meat product needs of the capital city in the framework of the then customary economic management practices. The board of managers of the BHKV decided that in 1991 only the BHKV was allowed to sell pork and beef in Budapest. Simultaneously to that it discontinued the Budapest sales by the manufacturing companies in a direct manner in a period of general oversupply in the market. Companies involved in the sugar cartel announced identical producers' prices which they raised at identical rates four times in 1991, and in the summer of 1992 they continued to raise their prices at almost identical amounts mostly on identical dates despite significant unsold stocks accumulating by then. The coffee cartel involved three price raises on identical dates by the five major trading houses controlling a decisive part of the market, a move affecting the consumer prices of roasted coffee on the domestic market between 15 June and 1 October 1994.

As regards the situation of dominant economic power chapter IV of the Competition Act does not object to its development or its existence, only its abuse. The objective of the legislation is to control the activities of companies of an exploitative nature, restricting competition, and distorting the market. In the first six years there were 52 condemnatory judgements in economic dominance cases by the Competition Supervisory Board. Most of these were representative of the rocky road that leads to a market of competition. Service providers in a monopoly situation and companies rendering local public services were for instance regular actors of that type of case. Controlling the activities of natural monopolies would have been particularly important in the early stages of the transition period. It is partly the merit of exactly the Hungarian Competition Authority that regulatory issues of gas distribution and electric utility, and telecommunications companies attracted public attention along with some other companies that had exclusive ownership of essential facilities or services indispensable in a particular branch[12]. However, let us see other examples as well:

The overwhelming majority of the cases starting in 1991 involved buying up of agricultural produce (cereals, sugar-beet, milk) as a result of the distortion of power relations resulting from sales difficulties. In 1992 one of the major dilemmas was the coexistence of 'market/non-market'. In 1994 e.g. it gave rise to 6 condemnatory decrees, even though each involving low fines, for unjustified refusal to contract.

One of the most important cases of 1995 was conducted against ELMÜ (Electric Works, Vj–38/1995). The reason was that the company charged disproportionately high fees for reconnecting customers disconnected for payment arrears, and failed to notify the consumer in advance of that fact. In the HÍRKER Rt. case the infringement was hindering the entry of the competitor in the market (Vj–135/1995).

In 1996 another OTP bank affair ruffled many feathers. The bank unilaterally raised the administrative charges on housing loans retrospectively (Vj–12/1996). OTP infringed the law by notifying its customers too late, only in November 1995 of the raising of administrative charges taking effect on 1 September 1995. There were three other proceedings against OTP, all involving housing loans. From 1996 so-called cable television cases came increasingly frequently most usually involving excessive increases of charges or the unilateral changes of the programme packages.

Control of organisational association of entrepreneurs (control of mergers) was regulated by chapter V of the Competition Act. There were few interpenetrations (69 cases) until the mid 90s as *Table 1* indicates. The reason – other than the organisational decentralisation process referred to earlier – was the narrow specification of territorial scope. Thus from among the interpenetrations investigated there was only a single case in which the licence application was refused, namely when the Gastrolánc Kft. of French interest wanted to buy up Junior Vendéglátó Rt. (Vj–172/1994). Due to the two firms' high share in the Budapest student catering market the GVH saw no proof that the quoted advantages of concentration (e.g. improvement of quality, cutting down on costs, etc.) could materialise in practice.

The activity of GVH to foster competition in the first six years of transition

As early as the first moves of its operation, the competition authority had market analyses prepared to identify the sectors that it found particularly sensitive from the point of view of competition. However, the institution of sectoral analysis was still missing from the PUMB This is why findings based on the studies mentioned above to be taken seriously by market actors were available much later, in the framework of the Competition Supervisory Board process following the 2000 amendment of the PURMP law. The GVH initiated 12 such investigations during that period. That series of investigations, even though it was not a priority at the time, could be after all interpreted as a preparatory stage of later proceedings. This is e.g. how the cement industry, the construction industry or the car repair sector was investigated, along with all other areas where former state monopolies or state owned trusts were characteristic, and so competition did not have its institutional barriers stemming from the economic system. The role of the investigations was partly exactly to encourage companies to shift from their habitual automatisms to a competitive attitude.

Table 1

CONTROLLING ORGANISATIONAL ASSOCIATIONS

Case type	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Deceit of consumers	6	24	29	50	53	56	74	72	65	86	59
Agreement restricting competition	21	5	3	1	5	9	5	15	15	18	10
Abuse of superior power	28	32	26	28	46	52	45	44	35	56	33
Controlling interpenetratic	5	8	3	4	24	25	30	49	46	70	81
Other	17	31	39	36	29	22	16	–	–	–	–
Total	77	100	100	119	157	164	170	180	161	230	183

A further basic element of the reforms implemented in the course of the transition process was the de-composition of state property. The privatisation process required the transformation of large state owned companies into some other legal form, in some cases even prior to the privatisation. That required only few companies to be broken (further) up for competition policy considerations. The privatisation of state assets was virtually fully completed in industry, in services, and in agriculture. The share of state owned assets sank below 30% by 1996, at which time about 85% of the GDP was generated in the private sector.

From 1991 to 1997 the competition authority as a permanent guest at the meetings of the privatisation decision making body had consultant status in the majority of acquisitions completed in the course of the privatisation process[13]. It was a conscious decision by GVH management at the time to choose the role of consultant[14] instead of requiring veto rights or even just voting rights in privatisation matters. The reasonability of that decision was questioned by many later on. That decision then served the purpose of helping the political consensus supporting competition policy to solidify. They therefore wanted to avoid controversial situations in which competition policy would most certainly have lost numerous battles. As a result of the privatisation process the GVH eventually had 11 merger cases on its desks, and refused the license only in one single case.

■ However, privatisation did not always deliver the results associated to it. In the sugar industry and in road construction the post-privatisation market became excessively concentrated. Meanwhile privatisation in the retail sector – during which geographically arranged networks were broken up to individual shops (assuming that these would reorganise into much more effective and competitive groups later) – resulted in an excessively fragmented structure. Multinational companies set up immediately big-size retail firms through their investments while their Hungarian counterparts could continue their operations mostly as the small actors of the market. And in some sub-sectors of the food-industry such as the dairy industry privatisation failed to fend off surplus capacities, which, due to the governmental subsidy on milk resulted in and stabilised overproduction. Privatisation in some sectors even re-instituted excessively fierce power struggles e.g. in the vegetable oil or the cable manufacturing sectors. In the food industry some privatising firms closed down the local plants with the sole purpose of replacing the supplies to Hungary by some alternative source. Yet, the problem of concentration of market power was successfully avoided in both the tobacco and the refrigeration industry as the members of earlier groups were split up prior to the privatisation process. The companies that remained in state ownership, however, even in the otherwise privatised branches, could remain in a position which could perhaps bring competition related problems into play. Such a situation evolved in the poultry sector, in schoolbook publication (where the only state owned company, the National Schoolbook Publishing House privatised as late as 2004 held 50% of the market), and in pharmaceuticals wholesale (where the only major state owned company, Hungaropharma privatised in 2002 had to compete with a dozen privatised but smaller firms)

■ In the energy, telecommunications, and transportation sectors the shift toward open, competitive market structures was not even beginning. Businesses that were to be statutorily operated by the state, or a local authority, or a public benefit association or through a concession tender included pharmaceutical supply, postal services, telecommunication, management of broadcasting frequencies, the railway, mining, gas distribution, and electricity supply.

The term of the concession could range from 5 to 35 years, and even individual pricing regulations were sometimes applied to it. That time privatisation related considerations were much more powerful than competition related ones. The best example here is the 8 year telecommunications concession monopoly granted to MATÁV in 1993 in an attempt to attract investment.

▫ In the agricultural sector the system of specifying guideline prices was based on the activity of the National Product Board, a body consisting of producers, processing plants, and sales organisations. Changes in prices, and other terms required the consensus of the parties interested. The agrarian market regulations[15] provided that the prices stated, and restrictions of quantity adopted by the Product Board could be exempted from under its provisions prohibiting agreements restricting competition. Exemption depended/depends on whether the Minister of Agriculture was/is of the opinion that the economic advantages of guideline prices, and quantity restrictions exceeded the disadvantages resulting from restricting competition. While the Minister had to observe the provisions of the competition Act, the standard applied by the Minister of Agriculture turned out to be much more general than the essential exempting criteria provided by the Competition Act. Due to more relaxed assessment, the result could differ from what the GVH would most probably have decided.

▫ In the banking sector the branch supervision authority was responsible for enforcing competition policy until 1994. (That duty is today under the GVH fortunately). That change was necessary as noteworthy competition related problems emerged in the sector already in 1994. Part of them concerned the OTP whose dominant power was still evident at the time. It was a source of concern in the banking sector in this period that the price of banking services was higher than would have been justified in a real competitive market. In case Vj–188/1994 e.g. it qualified as abuse of dominant power that the OTP required a public notary statement before it granted the so-called Start-loan.

▫ In the early 1990s the insurance sector worked practically as a duopoly of the Hungária and the Állami Biztosító insurance companies as the two market actors enjoyed exclusive rights in certain insurance sub-sectors. When these markets were privatised, the market opened to other enterprises as well, and new insurance sub-sectors, and with them new insurance arrangements could be introduced. Numerous foreign insurance companies entered the market, so the members of the former duopoly lost to them some of their market share.

▫ The privatisation of pharmacies is largely over, yet, that market is not essentially characterised by competition. Following 1990 the number of pharmacies grew by 50%, and soon there were 74 wholesalers instead of a single one until then. Retail prices still remained fixed and uniform, even though they were not subject to the VAT Act. The wholesale price of pharmaceuticals was technically free, but the Ministry of Health decided on the statutory amount of subsidy on some pharmaceuticals. The Ministry, and the National Health Insurance Fund (OEP) conducted annual negotiations with the sector's representatives on wholesale prices to identify the proportions of budgetary expenditure, and the subsidy. There was a statutory maximum to the aggregate margin between wholesale and retail prices. In practice the customers came across uniform and fixed prices. On one occasion the GVH recommended the relaxation of the restrictions on the products sold so that the pharmacies could generate profit from selling other products as well, and to have the other restrictions – apparently applied with the aim of ensuring profits, and the provision of the minimum statutory service – also eased. That recommendation was not accepted.

■ In the Hungarian domestic bus transport market both entry and the charge of the services are regulated, but in international transportation there was competition. The earlier monopoly of Volán was broken up into regional companies in 1989, and market entry from 1989 to 1991 was free. When the state owned firms went bust, some jobless bus drivers decided to go it alone. The competition thus launched was found clearly excessive by some, so in 1991 they reinstated the regulation whereby the service may be provided in the framework of a concession or directly by local governments. Maximum prices were thenceforward set by the government. In the stead of the concession system, the GVH recommended a license-based system, but the ministry failed to approve it. The GVH presented similar arguments for international personal transportation as well, and was successful this time. This is how in the international arena there are private firms providing scheduled transport services.

Long-distance haulage services were essentially liberalised meanwhile, and there are numerous small companies in the market even at the present moment. The former national haulage firm, Hungarocamion was privatised. The domestic market, however, was still dominated by state owned, and subsidised haulage firms.

■ Since August 1994 the electricity sector has been under the direction of the Hungarian Energy Agency (Magyar Energia Hivatal, MEH), itself under the umbrella of the Ministry of Economic Affairs. The GVH argued for placing the sector in the hands of an independent body rather than a ministry, and Parliament was in favour of the argument. The MEH had its obligations as well as its rights in areas important from a competition point of view including entry, behaviour, and exit, and even in the area of consumer protection. The Ministry has, however, insisted on its discretion of deciding on issues of pricing and entry. The law enabled direct retail trade with regard to the individual large consumers. Industrial power stations, however, which generated the power for their own functioning could feed their surplus back in the grid same as the public thermal plants could do. To serve this purpose, the law enabled – but not obliged – the owners to grant also other companies access to its assets. Although prices had to be set keeping competition considerations in mind, the Minister held full authority, and so the Competition Act could not be enforced. The branch level law applicable at the time – Act XLVIII on Generating, transmitting, and distributing electric energy – specified transmission and distribution as natural monopolies requiring state regulation that grants exclusive rights, and imposes the obligation of distribution.

Despite that sectoral regulation the Competition Act could be applied in the electricity sector as long as it was not indirectly/implicitly substituted by other legislation. The GVH investigated and approved four mergers on that basis that concerned power stations, and a mine. With mergers concerning electricity, distance heating, and gas two licences were required, i.e. both the GVH, and the MEH could halt the process. There were no cases during the period in which the sector supervisory section GVH and the MEH should not have agreed. In one of the mergers the GVH was perhaps excessively lenient as they gave the green light on a share transaction (Vj–241/1995) that resulted in the intertwining of various rights of direction among regional distributors, and which the MEH had previously permitted. One of the investors, the Electricité de France directed two distribution businesses ÉDÁSZ, and DÉMÁSZ. The other investor, Bayernwerk AG, in turn, directed a third one, DÉDÁSZ. They therefore agreed to divide ownership in ÉDÁSZ so as to end up with identical stakes, and would jointly manage ÉDÁSZ. The GVH found that just because due to the concessions the areas were too far away from each other geographically, the distribution companies were not competing with each other. So the competition generated by the new investments was probably too limited to influence the decisions. Further, both distribution companies were dependent on the monopoly of the national transmission company. The Competition Supervisory Board failed to take account of the fact that upon liberalising the market these companies could become the likeliest new entrants in each other's markets. And joint management guaranteed exactly that this threat should not materialise. The Competition Supervisory Board was of the view that the prospects of retail level competition were not readily apparent in the sector at the time. One has difficulties understanding, however, that the GVH, based on the same logic, prevented a similar acquisition in telecommunication because the liberalisation programme was more detailed in that case, and the new competitors were truly about to enter.

THE COMPETITION LANDSCAPE FOLLOWING THE CONCLUSION OF THE FIRST STAGE OF THE TRANSITION PROCESS TO A MARKET ECONOMY (1997–2005)

The second generation Competition Act – Act LVII of 1996 on the Prohibition of Unfair and Restrictive Market Practices (PURMP) – extended the application of the scope of the law from 1 January 1997 onward to Hungarian acquisitions of foreign businesses. The number of corporate interpenetrations grew steadily between 1995 and 1998, when the GVH had to process just below 100 license applications. Nearly one third of the interpenetrations granted were associated to privatisation. Such privatisation cases were sped up by a technical cooperation agreement concluded by the managers of ÁPV Rt. (State Privatisation and Holding Company), and the GVH in October 1997. That agreement enabled an accelerated the decision making process by GVH in merger cases relating to privatisation thereby ensuring a rapid conclusion of the individual cases.

In accordance with the merger provisions of the Competition Act the GVH could rubber-stamp the transaction as soon as its advantages outweighed the disadvantages resulting from restricting competition. As an added feature, the law contained failing-firm-defense provisions. That meant that the GVH could okay mergers of otherwise anti-competition effect against proof by the parties that without merging, the continued operation of one of them could come under threat.

Privatisation related duties shrank by 1998 in spite of the fact that privatisation was put off in some areas. Such deals included the still unsold companies related to cultural assets, broadcasting, postal services, and transportation of persons on public roads. An increasing role was given within ÁPV Rt. to asset management, and reorganisation as part of that function. Such reorganisation concerned partly the set of privatisable companies that required to be kept eligible for privatisation, and companies remaining in long-term state ownership where the reinforcement of companies was justified by national economic considerations as well as the improvement of the sectoral policy positions. The ÁPV Rt. as owner was charged with the double duty of selling the decreasing entrepreneurial assets to private owners, and to safeguard, utilise long-term state owned assets, and maintain, and improve their operating potential. In 1998 ÁPV Rt. did more inspections, control, and holding services. It was a new phenomenon that – for the first time since the political changes – the amount of state property was again on the increase. Thus Postabank, BÁV, and Malév were returned to state ownership, and the re-nationalisation of the gas business line of Mol Rt. was again under consideration.

Mergers

While privatisation opportunities and duties reduced significantly by 1998, mergers reflect an opposite trend. The Competition Supervisory Board responded to 49 applications in 1998, 46 in 1999, and 42 until 31 July 2000. As elsewhere in the world, we also witnessed the continued process whereby companies tried to reinforce their market positions by mergers. In 2000 most of the mergers took place in the telecommunications sector with 13 applications coming in from various market actors. The Competition Supervisory Board approved most mergers except for the one whereby Matáv wanted to acquire the Tata cable television network as there were three other well capitalised firms applying for the cable television network, and the competition by the three companies was expected to effect beneficially future consumer prices.

The Competition Supervisory Board set conditions, and specified obligations before it consented to the mergers. One exception was the Matáv/Westel deal. The Competition Supervisory Board saw no reason to ban the merger, but required guarantees to ensure effective competition through non-discriminatory treatment of other mobile telephone service providers.

Industrial mergers in 2000 numbered 17 including 6 from the energy sector. In addition to telecommunication there were four in the food industry, three in both pharmaceutical trade, and financial services, and one in newspaper publishing allowed by the Competition Supervisory Board.

Unfair influencing of consumers' decisions

In unfair influencing of consumers' decisions the experience of earlier years continued. Infringing the freedom of consumers' decisions continued to be a priority case type in terms of both number and importance. Misleading information in the medical aids market, deficiencies in the course of sales campaigns of trade networks, and unjustified use of adjectives in the superlative were all recurring phenomena.

■ The financial services market emerged separately as a threatened market. The increasing complexity of financial products, the appearance of new products (e.g. the bank insurance product group) would have required advertisement and promotion providing even better information on the significant features of the given product so as to achieve freedom of consumers' choice. At the same time the advertisement and promotion of financial products were often not aiming at facilitating comparison of the product to others, or communicating or highlighting its most important features even after the purchase. Significant deficiencies continue to abound in consumer information media other than advertisements. Although most of these problems appear in GVH procedures, they were only partly possible to handle within the framework of the Competition Act as some had to be remedied by the financial regulatory authority.

In its proceedings against the OTP Rt. (Vj–181/1999) the Competition Supervisory Board established that in banking services possible future changes deriving directly from the contractual relationship for an unspecified period cannot be left out of consideration. Similarly recurring is the problem caused by credit interest information published by banks. Some banks publish fixed or changing interest for their loans, advertising them as an especially advantageous deal, and list it as a potential benefit for consumers. In its promotion material on changing interest personal loans, Citibank Rt. (Vj–68/2000) failed to publish essential information on the product. Then the bank made the performance of its contractual obligations conditional upon an undisclosed criterion such as the profitability of the arrangement, and transferred all exposure from changing interest exclusively on the consumer.

▫ That time enterprises organising so-called customer groups also appeared in Hungary. Customers' groups are voluntary, temporary purchase arrangements that are based on the association of persons united by a common interest. That common interest is that they acquire certain goods at small instalments, and a relatively long maturity period. That is achieved by members of the groups committing themselves to save up, i.e. paying the specified instalment for a longer or shorter period prior to collecting the item in question. They stage draws at regular intervals to select the member who will receive the given item on the given date. Credit Center 2000 Kft. (Vj–61/2001), an enterprise organising customer groups advertised its services as if it was rendering banking services, keeping the substance of the service completely undisclosed. The advertisement highlighted the feature of 'hire-purchase without banking interest' available to customers, but failed to refer to the fact that the enterprise itself did no more than arranging and managing customers' groups. The customer could only learn that fact when contacting the enterprise. It is regrettable that the government decree regulating the arrangement of customer groups was first delayed, and was subsequently taken off the agenda, while it could have helped a great deal in enforcing consumers' rights had it regulated the compulsory content of customer information material, and rescission by the consumer in due course.

▫ The infocommunication market is likewise a threatened area. Ever since the mobile phone providers entered the market, there has been fierce competition to increase market share, which is done by winning over customers by promotion/advertising. Here, too, ads began to appear comparing a provider's product to that of the competition in numerical terms along with promotion concealing one or more essential features of the product or service. Simultaneously to the opening of the telecommunications market competition is setting in more and more powerfully in the land-line telecommunication segment as well, moreover, a characteristic feature is that land-line and mobile networks may under certain conditions be in a limited competition with each other. In case Vj–67/2001 the Competition Supervisory Board established infringement on the side of MATÁV Rt. for having withheld the essential barriers, conditions of the Ritmus service package in its information leaflets, promotions, and the business regulations. It failed to communicate that those choosing the package cannot change packages within one year without detrimental payment consequences. Companies of the telecommunication sector forced to compete often introduce new services available at complicated terms. In that situation it is a particularly important requirement that the consumer should be able to have all the necessary information available before choosing the service of one competitor.

▫ The subject of a larger group of cases concerns infringement by trading networks. The large number of such infringements is explained by the fact that commerce has undergone a major change in Hungary over the last 10 years. Large, and increasingly powerful retail chains enter the market with growing popularity and turnover. Saturation in the market brings about cut-throat competition, which requires the analysis of the behaviour of competitors, and integrating such information in the companies' strategies for growing market share. However, such behaviour only qualifies as unlawful in accordance with the Competition Act if they are unfair, and/or could give rise to unfair influencing of consumers' decisions. There were a relatively large number of cases involving temporary sales campaigns of retail chains. Auchan and Tesco were fighting a price war resulting in condemnatory decrees with reference to both companies. Both of them advertised unjustified and inaccurate comparisons of the prices of the other's products, and used adjectives in the superlative to suggest particularly advantageous purchases.

In the course of an investigation (Vj–88/2002) against Tesco Global Áruházak Rt. (Tesco Global Supermarkets Ltd.) it was established that Tesco staged a sales campaign in an unfair manner by claiming a higher rate of discount in the price of a microwave oven than the actual figure, and one of the houses in the chain had a particularly low level of stocks on launch day having sold out almost all items on the previous day. As an instrument to boost demand, the sales campaign may increase demand not only for the discounted product, but may have a beneficial influence also on other products in the store as it builds on the temporariness of the discount, and the limited stocks of the product in question thereby encouraging an urgent decision on the side of consumers. That boosts demand for other products as well. The principle of staging fair sales campaigns requires that the product being discounted should be available in appropriate amounts, and should not generate consumer demand impossible to satisfy anyway.

■ In both of its decrees concerning financial services – (Vj–149/2002) regarding product loans available in the Hungarian houses of the Auchan Magyarország Kft. (Auchan Hungary Ltd.) chain granted by Magyar Cetelem Bank Rt. (Hungarian Cetelem Bank Ltd.), and (Vj–131/2003) regarding the change in the interest rate of a bridging loan placed by Fundamenta Lakáskassza Lakástakarékpénztár Rt. (Fundamenta Savings Fund for Housing Purposes) – the Competition Supervisory Board established that providing accurate, and appropriate information to consumers is particularly important in contracts concluded for a financial service where mutual trust between the parties is of outstanding significance in the light of the features of the product, and because the consumer has limited if any judgment as to whether some of the components of the service rendered by the company comply with the promises made by such company prior to the conclusion of the legal relationship. Deficient knowledge of consumers concerning financial services, and trust – with hands tied – toward the proficiency of financial organisations, and the potential of information on financial services to influence consumers' choices raises the importance of companies' competition law responsibility in informing consumers.

■ In the banking sector, competition became more powerful in retail banking services by applying new market tactics, and new market expansion schemes. OTP continues to have the strongest position, but its earlier dominant position is beginning to thaw away as strong competitors (Posta Bank, Budapest Bank, and most recently ABN AMRO Bank) are gaining ground, and increasing their market share. Another tendency likewise related to the banking sector is that banks are gradually entering each market segment related to financial services (banking services, insurance, pension funds) as major actors. That phenomenon will bring about a situation where consumers will sooner or later meet the same actors in almost all areas of financial services market. A clear progress toward universality is taking shape partly even preceding relevant legislative regulation.

■ Economic regulation is missing also in the area of cable television services in spite of the fact that even here one sees many instances of natural monopolies. That shortage is reflected in the competition supervision board procedures of the GVH. There are numerous competition related problems generated almost on a continuous basis that could be eliminated through appropriate regulation. Today, however, the only remedy of consumers in the present regulatory vacuum is turning to the GVH as competition law fails to offer solutions suitable to the nature of these problems.

Agreements restricting competition

The number of proceedings associated to agreements restricting competition has increased significantly (tripling up from 1997 to 1998) compared to previous years. Part of the increase is ascribable to the fact that the PURMP imposes more wide-ranging prohibitions to agreements restricting competition than the PUMB (and thus deregulation could become necessary in vertical restrictions, while earlier that was not the case because general ban did not extend to these). It is pointless to refer to tendencies due to the relatively low number of cases, yet it is worthwhile mentioning that in many cases it was in fact not or not only the companies that restricted competition, rather the state arranged some competition restricting agreement or created a situation with the same effect [tax form (Vj–48/1998), Dialysis (Vj–100/1998)]. In these cases, the GVH contacted the state agencies concerned in an attempt to resolve the problems.

■ Case Vj–61/1998 was related to specifying the base price, i.e. one of the factors in the buy-up price of sugar beet. An interesting feature of the case was that pricing in agriculture takes place in a setting where harmonising prices is not unusual as even the state provides assistance to that process through regulating the sector. A guideline price may be given e.g. for the buy-up price of sugar beet by the Sugar Board making a recommendation to the Minister. So the Sugar Board conducts a harmonisation talk on prices where an important characteristic distinguishing it from price cartels is that both sellers (sugar beet producers), and buyers (sugar factories) participate. There are an increasing number of cases in the course of which product boards of various agricultural sectors or some committees thereof reach agreement on and published guideline prices or minimum prices without the authorisation of the Minister which thereby became unlawful.

■ The Competition Supervisory Board found the stipulation of the joint agreement – concluded by METRO and SPAR on the one hand and the meat processing companies (Délhús and others) (Vj–64/2000) on the other – to be against the law whereby the meat processing companies committed themselves to sell to all other traders at a price minimum 5% higher than the sales prices at which they sold to METRO and SPAR as established in their agreement. So that agreement was basically a *vertical* type of agreement by trading organisations with a large market share and many production firms of large market share. Its major effect was the restriction of the competition among trading companies as the price clause objected to resulted for other trading companies in a competitive disadvantage. At the same time it had its horizontal elements as the agreement contained also an agreement on the recommended suppliers' prices, which, functioning as a centre price restricted competition among meat processing companies.

■ The Competition Supervisory Board made a total of 18 peremptory decrees in 2002 concerning agreements restricting competition, and in 10 out of these the GVH had to intervene. In the proceedings undertaken at the request of an outside party the GVH issued an exemption in three cases for a specified period, of which in one case it set conditions to the exemption. In the 13 cases undertaken out of official duty the GVH established infringement in seven cases, and imposed a fine in three cases, stipulated a condition to exemption, revoked the earlier decree of exemption in one case, and in two cases it instructed the parties to refrain from the behaviour in question.

■ The case generating the greatest interest was the so-called cement cartel where the parties participating in the agreement were found in breach by the Competition Supervisory Board because they used an IT system whereby they could agree on a planned market behaviour. Also worthwhile mentioning is the unlawful agreement between the BKV, the Budapest Transport Company and several newspaper publishers in which significant fines were imposed. Major agreements temporarily exempted by the Competition Supervisory Board include the multipoint card cooperation of OTP, MOL, and MATÁV, and the goods procurement contract of the members of the CBA retail chain.

■ In 2003 there were 20 peremptory decrees in Competition Supervisory Board proceedings conducted in conjunction with agreements restricting competition. In certain markets the lack of demand, and surplus supply seemed for competitors to magnify the value potentially inherent in an agreement (75–80% of condemnatory decrees involved companies in such market positions), while in other cases the easily available large monopolist profit was the major attraction. In 2003 the case most in the limelight was called mobile cartel, in which mobile service providers were stated to distort the market by keeping the termination charges of calls from land lines to mobile phones artificially high (Vj–22/2002).

■ The group of cases of greatest significance in 2004 involved collusion among bidders in the construction and building industry in a public procurement process. There were seven cases fully processed by the Competition Supervisory Board in which various kinds of unlawful cooperation were identified prior to bid submission. One could highlight one of the largest investment projects in Budapest of the last years involving the renovation of Bartók Béla út, and other related traffic nodes. Eight competing companies submitted bids to the individual calls for tenders, but in fact there was no real competition in terms of either price or performance. As a result of their agreements the bidders virtually eliminated all possible risk from the race, could quote higher prices helping them share the benefits of the assignments, and the extra profits. The public procurement processes to build motorways took place in the spring, the summer, and the autumn of 2002. The investigation by the Competition Supervisory Board established that the bidding companies had agreed to divide among themselves the motorway construction subprojects worth a total of 110 billion HUF.

■ From a competition point of view the banking sector offers the most difficulties. A good benchmark is *Éva Várhegyi's* study prepared at the request of the GVH. The study was seeking an answer to the specific features on the basis of which competition may be interpreted in the banking sector, how the situation in the Hungarian banking market may be evaluated, and whether the beneficial effects of competition are any different in this sector than in others. To answer this question she investigated the relationship of stability of competition and financial stability, the applicability of various generally known models, and international examples.

She set about assessing the competition in the Hungarian banking sector by looking at market structure, and analysing the usual concentration indices, and came to the conclusion that in the 90s the degree of concentration palpably reduced in the Hungarian banking sector. From the point of view of the equalisation of the structural balance in the banking market, and the strengthening of competition the major thrust came from the large number and early entry of foreign banks. The mitigation of concentration was much more intensive in the retail market than in the entire sector.

The structural transformation of the banking market created the preliminary condition to competition, i.e. exposure to offensive by competitors. Investigations indicated that the flexibility of interest rates in the corporate banking sector is suggestive of satisfactory competition, i.e. banks are compelled to adjust their interest rates to their marginal costs and yields, while in the retail segment the relationship between interest rates and the money market environment is much less direct, i.e. the market structure still holds the possibility of realising monopoly contribution.

The pricing behaviour of banks is characterised by downward flexibility. The corporate loan market is more balanced than the retail market where the conditions for competition are set, and the majority of banks into corporate lending have interest policies that respond sensitively to changes in both limit cost or interest of the competitors.

Banks' pricing behaviour greatly affects their profitability. Hungarian interest margin and operating costs are double the EU average. The Hungarian banking system achieves relatively high profitability at low ROA as it generates extra levels of interest and commission even in a climate of limited competition. In international comparison the effectiveness of the Hungarian banking system is still quite weak while its profitability is relatively high due to the monopolistic nature of the individual subsegments of the market.

The GVH undertook a sectoral investigation in the housing mortgage market as from 9 July 2004 against the following background: banking interest characterising the market, and greatly increasing profits, interest margins were much higher than the EU average indicating that the features of effective competition situations do not present themselves to the required extent. Besides, several reports as well as the transcript by the Parliamentary Ombudsman of Citizen's Rights claimed an investigation into the housing loan market by the GVH.

The sectoral investigation by the GVH covered the period between January 2002 and July 2004, and involved 41 lending institutions. Based on the assessable answers from 25 lending institutions, the GVH examined the conditions of 250 products, grouped by type. With its findings in hand the GVH did not feel justified to instigate a competition supervisory process against any of the market actors, but decided to continue to monitor and analyse the processes in the housing loan market in the light of the feature of large housing loans whereby they – firstly – tend to tie the debtor to the creditor bank on a long term which could exceed 20 years, and – secondly – that the history of the sector is too short to make more reliable predictions concerning the behaviour of the market actors, thus one cannot preclude later patterns of behaviour by market actors with regard to contracted consumers that will necessitate further investigations by the competition authority.

The investigation has also identified problems impossible to handle through the Competition Act. In the period covered by the sectoral investigation into housing loans banks' pricing (and thus profitability of individual products) was not primarily determined by market conditions but – due to the absolute dominance of loans of subsidised interest – by changes in state regulations, and subsidy policy. That fact is well reflected by the 7–9% margin having been reduced to a band of 3.4–5.4% following the change in regulations effective as from summer 2003, ensuring excessive banking profits, and available at the level of the banking system in the first five years following disbursement and refinancing. Besides, the various forms, and amounts of subsidy result in different competitive positions for not only the products, but also for market actors (commercial banks, lending associations, mortgage banks, housing saving funds).

Housing loans are subject to a series of costs on top of just interest and administrative charges that come under a long list of types and names. A main shared feature of these added costs is that – unlike administrative charges – they are not payable during the full period of the transaction, but some of them are charged several times. Another basic feature is that they are specified sometimes in percentages, sometimes as an absolute figure, and sometimes as a combination of the two, thus their comparability is rather doubtful. In addition, one is bound to believe that the consumer ends up paying multiple times for the actual banking services related to the loan. That intransparence of the situation partly hampers effective competition, and partly it may result in welfare loss to the consumers[16].

Opening the market

The GVH published its views multiple times whereby agencies enforcing legislation related to market opening must be granted a significant degree of deliberation so that they should be able to apply legislative provisions drafted necessarily in a general way to individual specific situations. In the course of applying regulations, supervisory agencies make decisions based purely on professional considerations, and in perfect disregard of current political and economic policy aspects, free from any influence whatsoever of the companies being regulated, which requires a high level of autonomy on their side.

Hungary embarked on the liberalisation of its railway system quite early, but at one point the process got stuck. There was legislation to ensure separate accounting treatment to network rail and freight rail operators, and then a ministerial decree separated one from the other, and established all non-essential functions into separate companies to be privatised later on. Access to the track had to be granted in theory to each domestic freight railway company. On the basis of international agreement or some mutual arrangement the same applies to access by non-domestic freight railway companies as well. Freight railway may be subject to concession tendering. Scheduled local and long-distance personal transport has been specified as a public service. Fares are regulated through maximum prices. Liberalising freight charges began in 1998.

Despite promising framework regulations hardly anything was done in the entire branch at the time to institute competition. The only investment in infrastructure took place on the Vienna-Budapest line. They failed to close the loss making branch lines. The supervisory authority responsible for distributing track capacity was set up in 2002 (VPSZ). The GVH actively participates in creating ministerial regulation.

The GVH likewise contributed to the creation of plans concerning the liberalisation of the energy sector. Complying with the request of Parliament's Economic Committee, it prepared a report in 1997 on natural monopolies and exclusive rights. The recommendations of the report included an in-depth revision of the sectoral policy, and increased reliance on competition (and on more powerful regulation where appropriate). The GVH participated in the ministry's energy task force that prepared a draft on the way in which Hungary should ideally come in line with EU directives applicable to the sector. The GVH argued for splitting off the signalling, and the high voltage network, and monopoly must be discontinued at a wholesale level, and (gradually, if necessary) local third-party access enabled. The GVH was of the view that in the long run transmission and distribution must be separated from each other, but electricity generation should not as yet be separated from transmission and distribution.

Natural gas is still a monopoly, and competition is not likely to set in. MOL is the only producer, importer, and wholesaler, and it owns and operates the only high-pressure pipe, and the storage capacities. It also sells to large consumers at a retail level. The six local supply companies were privatised in 1996. As licenses tied consumers to the companies (including MOL), there is no competition among the haulage companies to win over the consumers taken over upon entry in the market. There is some limited competition for new consumers, and previously unconnected local governments. But competition requires physical connection as MOL or the haulage company is not required to allow third parties access to the pipeline. (MOL is in fact required to allow third parties access if such access is for the purposes of distributing gas produced in Hungary other than what MOL produces, but no one has so far found natural gas in Hungary.) Charges are directly determined by the government. The scope of application of the Competition Act is quite narrow.

Adoption of the Electric Energy Act (vet.) in 2003 eliminated the most important administrative obstacles from before the creation of a competitive market of electric energy generation and commerce. That encourages old and new market actors to effect capital intensive investments aiming at improving their operational standards, and effectiveness. However, before real competition could begin sometime in the future several problems must be remedied. Alternative fuel use of generators lead to pricing tensions in 2001 as costs thus increasing were not covered by authority-set prices in several power stations.

In 1 January 2003 the amendment of the Electric Energy Act enabled companies consuming over 6.5 GWh per annum to satisfy their electric energy needs from a source of their choice, and so they are under no obligation to purchase from MVM Rt. in the public utility market at prices set by the Minister of Economic Affairs. 20% of the full yearly amount of power consumption moved over to the free market as a result of that partial market opening. Market opening, however, was suddenly halted soon after, even some degree of backtracking was observable. Certain signs indicated that neither enough supply nor enough demand made its way to the free market, a fact that motivated the GVH to launch a branch level investigation in 2004 aimed at better understanding the functioning of the electricity market, the slow pace of the opening process, and the reasons of the halting as well as mapping obstacles to competition.

Prices of services rendered on the basis of the concession contracts (essentially all retail and wholesale charges) qualified as authority-set prices on the basis of the Act on Telecommunication[17]. Concessions regulated entry in public switched telecom services, public mobile services, and national public pager services and in broadcasting. The majority of the public telecom network is operated by MATÁV owning concession rights in 36 out of the 54 districts in local services, and has exclusive rights concerning domestic and international long-distance calls. These exclusive rights were in effect until 2002. The supervisory authority in the branch is the Telecommunication Supervisory Board (HIF) with its own organisation and budget, operating under the Ministry. HIF approved the services such as satellite broadcasting that did not belong under the effect of the Concession Act.

The GVH failed to approve of the merger of MATÁV and Jásztel in 1999. On the basis of the concessionary agreements and legislation concerning the telecom sector the Minister may allow the transaction in the light of financial and branch-specific considerations. The Minister did not, however, take action against acquiring management rights. The GVH eventually prohibited the merger in order to ensure the possibility of competition for the period when the market will be liberalised.

Following the opening of the telecom market[18] the GVH actively participated in drafting a uniform telecommunications law. The GVH considered it a regulatory objective to facilitate competition among service providers following the liberalisation (this is why ensuring access to the network, and opening the local loop constitute a key element of regulation), but it should materialise under conditions that do not disable later infrastructure development, i.e. the creation of competition among networks. A paradoxical feature of liberalising the telecom sector is that during the transition period until real competition sets in more complicated operating rules must be prescribed for service providers with significant market power than at the time exclusive rights were in effect. Detailed, asymmetric temporary regulation is necessary partly in order to prevent abusive behaviour by market actors toward new entrants, and partly to provide preferential conditions to new entrants so as to accelerate the establishment of the desired market structure. It is particularly important in that transitional period that the telecom authority should have the highest level of independence, discretional titles in its decisions, and authority for effective enforcement of course with the support of the required legal remedy system. Dynamic development in the sector, and changes in EU legislation brought about the necessity of the review, still in 2002, of the freshly created system in the light of market opening and competition policy objectives, a plan established in a government decree. Such a review could create an opportunity for re-considering the GVH's previously rejected recommendations.

The Telecommunications Act[19] is the fundamental piece of legislation of the liberalisation process so important in the development of the infocommunication sector. Although the opening process of the telecommunication sector did not begin – or conclude – by passing the Telecommunications Act yet it counts as a significant milestone from the point of view of creating an environment placing emphasis on competition. The law contains legal institutions specifically meant to boost competition. In grouping these provisions mention should be made of those whose objective is helping challenging actors gain foothold in the market, thereby accelerating the previous monopolised market structure, and those that aim at facilitating the choice made by consumers. The former group contains provisions related to network contracts, while the latter requirements such as the choice of the service provider and number portability.

The Act on Radio and Television[20] provided sector specific regulations concerning mergers of programme providers, and other media-sources and similar associations. Controlling stakes between programme providers of national coverage is prohibited, and ownership of regional and local programme providers is subject to limitations. For example, no programme provider is allowed to control more than twelve local programme providers. The law prohibits controlling stakes between programme providers of national coverage and daily papers of national circulation, and limits ownership between programme providers and other daily or weekly papers. It further prohibits crossovers between non-profit and profit oriented programme providers. The principal objective is promoting the freedom of and protecting the printed press. The law in fact creates an irrefutable assumption in conjunction with market definition and dominance of power. The law is enforced by the National Radio and Television Agency. Transactions continue to be reportable as required by the Competition Act as soon as they exceed statutory limits. However, the GVH must not approve the deal if it would infringe the structural regulations of the Act on Programme provision.

MAJOR TENDENCIES, AND CHANGES IN THE COMPETITION LANDSCAPE

In the early stages of the transition period the inherited corporate structure took a long time to move toward effective market competition despite the relatively fast transformation of ownership conditions. Competition regulation measures failed to affect the more significant sectors of the economy, in which abuse of dominant power was the default situation. Instruments of merger control were either not applied in conjunction with privatisation processes or did not promote appropriately the creation of more effective market structures.

The creation of fundamental market conditions was essentially completed in the second phase (1997–2005). The number of market actors dropped in certain significant sectors under the effect of transition related setbacks as a side effect of economic restructuring. That fact and the increasingly strong presence of multinationals generated growing competitive pressures in many economic sectors. Corporate behaviour restricting competition became more and more frequent as a result of strengthening competition bringing with them more interventions on the side of the Competition Supervisory Board.

Both phases were characterised by so-called consumer protection related cases if for basically different reasons. The typical cases in the first phase were gross deceptions capitalising on inexperienced consumers in the hope of fast profit (pyramid schemes, mail-order services, etc.). In the second phase, deceiving consumers was committed as a result of even more fierce competition, and with the aim of winning over consumers from competitors, i.e. it could be interpreted as a sign of intensifying competition.

Cases involving abuse of dominant power tended to be more of the so-called exploitative type in the first phase, while in the second restriction of competition prevailed. This is partly the result of the fact that in the first phase – largely because market opening did not yet take place – companies in dominant power positions were not exposed to competitive pressures by potential entrants, so they tried to take advantage of their situation by generating unfair profit to the detriment of their consumers. More and more markets become vulnerable to competitors, against which the incumbent company has to defend itself.

The increasing number and significance of cartel cases is likewise indicative of increased competitive pressure. In most economically significant branches the earlier power patterns essentially survived into the first phase with the only difference that state monopolies changed into private monopolies. Under these conditions companies are not compelled to collude in order to achieve extra profit. New actors appearing later in the Hungarian market, often with significant international weight are able to generate major competitive pressure that is bound to replace the cooperative pressure among market actors.

Increasing problems in the agrarian sector and the food industry are probably related to the changed subsidy system, involving the revocation pricing license of Product Boards, and/or refusal to issue new ones. Overproduction, or oversupply under such conditions motivated the Product Boards more and more frequently to handle the situation themselves (determine and publish minimum prices or guideline prices), whereby they transgressed the borderline between lawful and unlawful behaviour.

Market openings clearly reflect the improvement of the competitive landscape even if the process did not proceed in each branch discussed above at the required pace. At the same time the mere appearance of the possibility of competition stimulates defence by incumbent companies, including behaviour to prevent new entries through unlawful methods, and rendering new entrants' stay in the market more difficult.

Our previous discussion of the banking sector have referred to the fact that EU accession did not in itself directly affect the competitive landscape. No quick solution of competition related problems present for some time in Hungary may be expected from our membership, and in fact no tangible signs are apparent yet. However, competition regulation took on another dimension following accession through the network (ECN) created by the member states' competition authorities and European Commission. Effectiveness of action against behaviour targeted at restricting competition affecting even trade among member states is hoped to increase with the help of the ECN.

Notes

[1] In my present effort of writing this paper, and especially in collecting the background material I have received significant assistance from *Ágnes Tóth,* inspector of the GVH, who has been working for the Office for much longer than myself.

[2] Incumbent company: technical literature uses that name to refer to companies that are already in the market, enjoying monopoly earlier on, but who have to face competition from other companies willing to enter the same market.

[3] Hungarian *hatásos* is sometimes used to translate the English word *effective* in English language technical literature.

[4] Some date the end of the first phase of the transition process from the completion of the so-called SLIP tasks (stabilisation, liberalisation, institutional restructuring, and privatisation), while others from the fulfilment date of the EC's three Copenhagen criteria of 1993.

[5] In preparing my study I have relied on the reports by the GVH delivered in Parliament, the market studies by the GVH research staff and by outside experts as well as the experience of GVH branch level surveys.

[6] This is the so-called *subaddivity* condition.

[7] A recent example is Act CLXIV of 2005 on Commerce with numerous provisions labelled anticompetitive by the GVH following its assessment. Nevertheless, Parliament passed the law, which will come into effect on 1 June 2006.

[8] All I mean here by branch-level legislation is that the conditions of competition - replacing the earlier circumstances of natural monopoly - are created by state regulations in a given branch as competition regulation is unable to accomplish it by its own legislative means.

[9] Primarily concerning the issue of whether there should be a German or an American type anti-trust law.

[10] It is no contradiction to that statement to say that in Anglo-Saxon countries the first competition laws were passed quite a long time ago. In most European countries competition laws were enacted only after WW2, i.e. in a developed period of the market economy.

[11] The two laws together are named anti-trust legislation.

[12] Essential facilities: a technical term in competition theory referring to indispensable assets and services. In these branches/industries the given undertaking has exclusive ownership of a production tool without access to which the competitors are unable to satisfy customer demand.

[13] From 1997 onward the scope of the provisions of the competition Act applicable to mergers was extended to all privatisation transactions as well.

[14] That was enabled by the narrow interpretation of *undertaking* in the law as in that version its scope failed to cover foreign undertakings not having acquired property in Hungary before.

[15] Act VI of 1993 on Agrarian market regulations

[16] The sectoral report is available on the GVH's website (www.gvh.hu).

[17] Act LXXII of 1992

[18] Act XL of 2001 (hkt.)

[19] Act C of 2003 replacing the kht. (eht.)

[20] Act I of 1996

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András Vigvári

Our Public Finance

KJK–KERSZÖV Legal and Business Publisher Ltd.,
Budapest, 2005

Money is the most serious issue in modern societies. Moreover, in democratic societies there is an even more serious issue: public funds. A decision made on the appropriation of public funds – let it be either on the national or local level – is always the test of practicing democracy at the same time. As a logical outcome of these truths, very many different publications regarding information or views on public funds are made either orally or in written forms. Similarly, we often come across the term 'public finance'.

But in the first place: what is public finance? If we had to give a quick answer, we may become embarrassed. We don't have any problems as long as we have to cite the practice of public finance established over a long period of time. Experience has proven that a democratic society can only evolve in a mixed economy, in which the public sector operates as the necessary supplement to the market, therefore public finance must be in place in such economies. The difficulty lies in the precise, scientific definition of public finance, but at present we do not have an undebated definition of it. Even today many of us have different concepts of public finance. The statement attributable to *John Stuart Mill* is possibly true in this case as well, that the definition of a science has almost invariably not preceded, but followed, the creation of the science itself. If someone today wants to write about public finance, he cannot rely on the exact definition of public finance, but based on some guidelines, normally deals with one particular public finance system that is already operating in practice.

However, the different views are quite close to each other regarding that it is still important sometimes to deal with public finance by using a practical approach. The importance of public finance for us has been further increased by our membership in the EU. Namely, a special situation has been created within the framework of EU operation, that while monetary policy was escalated to the EU level, fiscal policy remained at the national level, it remained the most important arena for governments for maneuvers to make economic political decisions.

András Vigvári made a major undertaking when he summarized our public finance according to his own logic in a book. The book deals with the operational issues of community financial system, it tries to depict the operation system. The approach is based on practical motivations. Emphasizing the operational aspects of the systems helps to make a clear-cut distinction from other areas like the economy of public sector or public policy.

Although the scope is well-defined, it is still not an easy undertaking to write a good book on public finance. This issue has a considerably extensive literature, ranging from works that build on axioms and are excessively theoretic to those on the other extreme that are too practical. Objections against the first approach involve claims that there is no connection with practice, while the problem with the second approach is usually that practice is quite "liable to deterioration", therefore it is difficult to write a book for long-term use.

András Vigvári has selected a very good framework of thoughts for summarizing our public finance, since describing the issues with a system approach facilitates for us to have a better overview of the system of public finance, where describing the macro-and micro economic issues, presenting the tasks, financing needs and methods are all included. In addition to this, the author can claim to be lucky to have been able to rely on the experiences of his two former books written in this subject, thus 'Our Public Finance' can be considered as an already boiled-down, didactically systematized summary of a diverse system covering several areas. Apart from the system approach description the author's intention to make the book more colorful by incorporating some autobiographical elements should be also highlighted, and made his views more well-founded by emphasizing the chronological aspect that nowadays is often missing from our professional books. The inclusion of charts supporting the understanding of correlations and the 'What costs how much' subchapters at the end of the chapter proved to be a good solution. The latter is especially important because it is hardly possible to discuss economy and finances without measurement and analysis.

◘ Chapters 1, 2 and 3 can be considered as *the first part* of the book based on the conceptual unity. By using the facilities offered by system approach, in this part the author describes the types of state roles and the government sector, somehow thus giving the reader a general idea of what public funds are utilized for. The book is started with the budget debate of the local government's management of an imaginary town in the first chapter. Starting with a description of the practice is helpful for inexpert readers to grasp the significance of terms and correlations discussed later in the book. The description of the economics aspects of the state's financial role in the second chapter is started with an analysis of the government's regulative, allocative, redistributive and stabilizing functions. He introduces the structure and operation of the institutional system that facilitates the practical implementation of the different functions. By describing the historical theoretical background regarding the state's economic role, the author lays the foundation of a detailed understanding of how the public finance sector of a modern, mixed economy operates, which is discussed in later chapters.

(Unfortunately the Hungarian economics and education often pay little attention to introducing the history of this science, therefore the initiative is especially welcome.) The third chapter that deals with the micro economy of the public sector, provides the basis for an understanding of the „micro economics" of state's role regarding public finance and thus discusses the state's functions with a new market economy approach. The further interesting feature of chapter 1, 2 and 3 is that the changes in public sector role is also analyzed in relation with the tertiating of the economy, namely the dynamic headway of the service sector.

■ Chapter 4, which can be considered *the second part* from a thematical point of view, may be the most original part of the whole book. This is where the author discusses the functions and factors of public finance. Apart from the fund-raising, and allocating, incentive, management and control functions, the author sets out the elements of the public finance system, then comes the detailed description of the structure encompassing these elements. What should be separately mentioned in the elements is the thorough description of stakeholders and roles and the systematic demonstration of the different financing instruments. The presentment of the basic structural elements of the public sector can be also successfully used for resolving different practical problems. This chapter well lays the groundwork for the later chapters of the book. Just to mentions an example: he defines and organizes the types of risks inherent in public sector.

■ *The third part* includes chapters 5 and 6. Chapter five explores the impact of public finance sector on other subsystems and stakeholders of the economy, what affect the tax system on the revenue side and the budget on the expenditure side has on economic processes. Then he reviews the problem of deficit arising from the variance between revenues and expenditures, its recognition options, indicators, the established practice for government debt financing and its economic consequences.

The particular items of budgeting are just as well present in the individual managing organizations like in the broader systems. In chapter six we can get acquainted with the principles of this, focusing on the budget, asset management, funds management, capital market operations and information management. Given the financial orientation of the book, labor management is only briefly mentioned, and the control and reporting functions are detailed in later chapters. One of the most important view-shaping conclusion may be the author's remark regarding that although the majority of principles is related to the appropriation of public funds, the term management represents a much broader concept than the simple appropriation of public funds!

■ Chapters 7, 8 and 9 constitute *the fourth part* of the book. The levels and subsystems of the state budget are described in chapter 7 in a not too detailed manner, but instead giving an overview of the function and operation of major areas. Certain previously mentioned subjects also recur with regard to analyzing the correlation between the state budget and the Hungarian conditions. Tax system, treasury system, government administration, social insurance funds, appropriation funds, local governments, the basic units of state budget management and state budget assets are the main subjects mentioned in this chapter. At the end of the chapter the reader finds the appropriate sources to gain more knowledge about this subject. Chapter eight discusses the budget of the European Union. It reviews its development, by which the present system has been shaped. It introduces the directives and principles, within the framework of which planning is made, the procedures for budget planning as well as the function of different institutions within it. Meanwhile, the author concentrates on those alterations and special features, which are different from the national and sub national budgets. The chapter is concluded with an outlook to the possible future of the EU community budget.

Chapter nine on the toolkit of regional and settlement development on the one hand continues the description of the European Union subject matter by describing the regional development system. This is specially justified because after having acquired the EU membership, our country's toolkit of regional and establishment development accommodates to the EU structural and cohesion political framework. Also true to this chapter, that it does not strive to describe all the partial rules, it does not show the individual "trees", but it shows the "woods". By describing support intensity, a less known term in professional literature, a comprehensive picture is depicted of this professional area, too.

■ Finally *the last two chapters* as an independent unity of thoughts guides the reader – contrary to customary approaches – to areas of increasing importance but which are less discussed. Chapter 10 deals with one of the key areas of public sector. We can have an insight into how this important management tool is applied, we can get a general view of accounting. We can get acquainted with the differences between cash flow and profit-oriented approaches, as well as through examples with the motivations and difficulties of the transition to the profit-oriented approach. The chapter also explores the problem of cost-and performance measurement, and emphasizes the differences from market players. The basic features of cost-benefit analysis are also included at the end of the chapter.

Chapter 11 gives a concise, straightforward summary of public funds control and those basis concepts and correlations appear, without the knowledge of which the philosophy of modern financial control cannot be understood.

■ As I already mentioned, another book by the author on a similar subject has been published, so he would have had the chance to make a corrected, extended version of this previous issue. However, in good cooperation with the publisher, the author decided on adaptation. The outcome justifies the correctness of the decision. A new book has been born, which overwrites the former one in many respects. It is good that the approach hasn't changed basically, the system approach type of description remained. At the same time it is apparent that the author has utilized his educational experiences and by relying on them the book has become more didactic, systematic and expressive than the former one.

Possibly the experiences gained from teaching gave rise to the idea of applying solutions that are unusual in professional books but are very useful. Such are the similar questions at the end of the chapters, including Internet knowledge base for further increasing the understanding that can be gained from the book.

The high degree of openness of the approach revealed in the book reserves separate mentioning. The author does not review the discussed subjects as completed sciences, but always refers to other possible interpretations, too. This approach must be appreciated because it gives evidence that issues discussed under the title 'public finance' cannot be molded into a homogenous mass, since these issues are exactly the ones for which perpetual professional debates represent the status quo. In other words this means that in case someone expects undebated, all-time correct conclusions on any of the public sector issues, he is strayed.

Whom can this book be offered to? Those days are gone when books were targeted to a well-defined group of the public. It is difficult to tell whether a given book serves as a university textbook, a professional or educational book. It is not shameful if a scientific book is an educational book at the same time. Certainly this makes the author's task more difficult but András Vigvári managed to well adjust himself to this requirement. Accordingly, his book discussing our public finance may well support university education, the needs of professionals working on a public finance area, but it can be also read by non-specialists with interest in this subject. In this age of lifetime learning even those participating in adult training can use it. If we consider that today even at the highest level of government administration the issue of public sector reform is dealt with daily, then the publication of the book appears to be specifically timely, since the applied system approach is adequate for handling this complex process.

Finally let me conclude this review by highlighting the good cooperation between the publisher and the author. The publisher assisted to convey the author's ideas to the readers in the appropriate form with high-standard editing and design. In the competition to get into the readers' good graces such cooperation has great significance, especially if its fruit is a nice book both in contents and appearance.

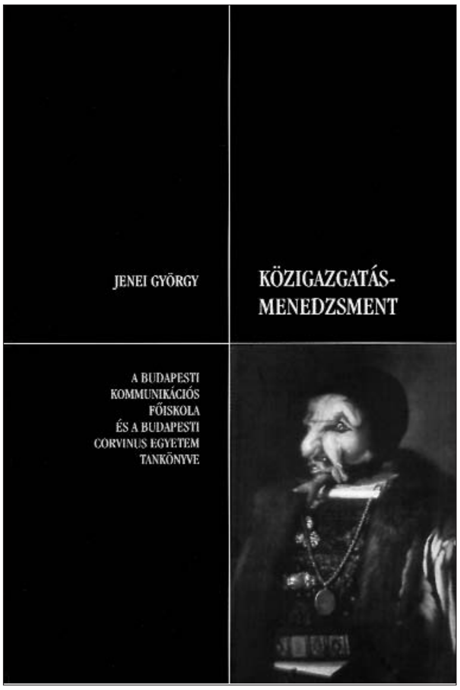
József Sivák

Notes

[1] Középénzügyek, önkormányzati pénzügyek (KJK-KERSZÖV, 2002) és Pénzügy(rendszer)tan (KJK-KERSZÖV, 2004)

György Jenei

Public Administration Management



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Public administration reform endeavours date back much further than we would think in the first instance. Reading *György Jenei*'s new (course) book, formerly sceptic readers – who label the nowadays frequently mentioned reforms as a new fashion – can also realise that the concept of a (more) rationally structured system of public administration, or that of the quality assurance of public services are not the results of the past few months.

■ Public administration management. Any reader having at least some knowledge about the topic will surely toss his head since the title itself may give rise to a debate. Several terms are beginning to circulate in the Hungarian and international literature; however it is rather disturbing that they are far from having the same meaning. Let's take for example the term public service management, in which the 'public service' attribute is used differently in legal and economic circles. Without joining the debate on terminology I would like to note: the author probably succeeded in finding the two most neutral terms that suit the nature of his writing best, i.e. public administration and public institution management (as a matter of fact, the title of the book is broader in meaning).

György Jenei assumed a great task when setting to write his book. This statement is true even if we take into account that the author possesses sizeable professional experience. The difficulty of the task itself would of course not be sufficient to draw the readers' attention. Why is it worth reading the book then? The first benefit can be realised almost immediately: the considerable logical framework, which can be of great help for newcomers to the subject. In addition to the introduction, the book is made up of four parts and altogether 14 chapters. The review of the symptoms, approaches and development paths of the reforms in public administration is followed by the presentation of the theoretical background. Then the reader may study the usual historical typology related to the topic, and finally the components of the introduction strategies of the reforms, which contribute to the essence and better understanding of public administration management.

In my opinion one of the most positive things in the book is the introduction (Switching paradigms in the public sector). On one hand it sets the tone for the book, and on the other it outlines the economic and social context in which the author elaborates in the rest of the book. The "crisis symptom ridden period" and dual expansive force that the public institutions had to face were especially interesting factors that triggered a switch in paradigm. Both are thought-provoking: the subject of the welfare state is *ab ovo* ridden with controversies, and the dual expansive force – namely stagnant (or falling economic resources) and the increasing social demand for the quality and standard of public services – is characteristic for today's world, too.

■ PART ONE starts with a useful distinction: the public institution management reforms affected the organisational structure of public administration and the public services differently, and were more accentuated in the case of the latter. Naturally, these two areas cannot be hermetically sealed from each other, all the more since institutions that belong to the organisational framework of public administration (also) provide public services. This is why the author remarks that a clean-cut shift can be perceived in both areas towards the application of market type mechanisms.

One of the interesting features of this part is that it lists the symptoms of the management reforms, such as the transformation of the public service systems and organisations in a way that can increase efficiency, effectiveness, adaptability, and creates special conditions for competition. Or I could mention customer orientation as an exciting symptom, according to which public administration management considers citizens as critical consumers. However, the strength of the subchapter is less in "mechanically" bringing the symptoms together, and more in the fact that Jenei speaks about both the opponents and advocates of the management reforms. As he puts it, the advocates support the establishment of business-type public service organisations "even if that requires the novel interpretation of the legal legitimacy of the political system". According to the opponents, however, the dominance of the business-like approach in the public sector would shake the foundations of the modern welfare state. The author continues the description of the symptoms by analysing the essence of the management reforms from different aspects. As a conclusion of this part, he presents the development paths of the management reforms of public institutions along a similar concept, and in relation to this he remarks (presumably) correctly that these elements are present in reality in various combinations rather than in isolation, and can rather be regarded as an ideal.

■ PART TWO analyses the theoretical background of public administration management. I must note here – mildly saying – that it is hard work to collect the theoretical tendencies influencing this topic, which is considered as a boundary area from several aspects, and typically requires a multi- and interdisciplinary approach. However, since the objectives of the book include the presentation of the multiple impact, obviously the author could not disregard it. The public institution reforms bring together the legal, public policy, management and economic aspects – i.e. the author has all the right to use the *complex* attribute. He is wise to point out in several passages that subjects based on a heterogeneous group of theories like this one inevitably lead to fierce debates and mutual tensions. This is true even if the experts of the different fields try to take one another's viewpoints into account. It is sufficient to mention that no consensus has been reached on the fundamental terminology of public administration management – or as the author puts it: the meanings of the words are "obscure and varying".

This part may arouse sympathy even in the most sceptical readers: the presentation of the essence of the different groups of theories is accompanied by the description of the critical approaches and the explanatory force of the different theories. For example, in relation to the community elections the author remarks that they definitely present the operation of one part of the public sector, but they cannot be regarded as an exclusive explanatory theory. When explaining neoinstitutionalism he points out that a further complementary theory must be taken into account, one that is able to reveal the social, cultural, moral and legal relations, too. Then during the description of the public service orientation model he proves that differences in value can be revealed between the private and public sectors, and although certain entrepreneurial ideas can be used in the public sector, it is impossible to adapt the entire model thereto.

The last chapter of Part Two looks at the connection points of organisational science and the organisational system of public institutions, primarily through performance promotion and the motivation of civil servants. Starting from scientific management through *Weber's* theory to the participative management systems (engaging subordinates that demand a share of power and decision-making influence in various management processes). In Jenei's words: the early homo oeconomicus human image of economic management considerably shifted towards the social and communicative human image that demands a share of power and involvement in the decision-making process. The author notes that the combination of performance promotion systems can be a fortunate one in Central and Eastern Europe (including Hungary), since in these areas it is practically impossible to "wait for" the organic development of the subsequent processes, or to follow a path similar to the one performance promotion followed in countries that are considered as developed countries.

■ PART THREE presents the traditional historic typology of the public institution reforms. It first describes the characteristic features of the British reform process, then the German modernisation, and finally New Zealand and France. All four typologies are justified: the British, German and French examples are regarded classic since they involve three marked public administration models that are often cited as typical solutions. The inclusion of New Zealand in the study is exciting because of the extreme nature of its reforms: there the new public institution management dominated in a rather strong and extreme manner. The four typologies have different features, however Jenei remarks, too that "one can move in the same direction on different paths". The author does not intend to provide a comprehensive presentation about the country-specific reforms. Part Three rather aims to help the Hungarian reform processes unfold by giving a historical background.

■ PART FOUR is of special importance since it plays a certain synthesising role, and is also a weighty section of the book due to its length. It contains a discourse about the managerial, public policy and legal components of the introduction strategy of management reforms.

It may be worth citing the conclusions summarised at the beginning of this part for those who are still indecisive about reading the book. According to the author, it is a general point that the introduction of the reforms requires cooperation between the politicians and civil servants; it is indispensable to confront and combine the professional and political aspects.

It is an equally important conclusion that an adequate strategic approach is a must during the implementation of the reforms – however this does not mean that detailed plans are needed. There is no generally applicable recipe; continuous adaptation is required during implementation. From among the conclusions we must also note that the changes show beyond public administration – they also appear in the day-to-day political and social life. Or, in Jenei's words: they have become public matters.

■ AS A SUMMARY: György Jenei's book – which demonstrates macro approach on the analogy of economics – may give a good foundation for both the newcomers to this subject and the more experienced readers. However, it is far from being an easy for one afternoon. Although it is hard work to go through the chapters of Public Administration Management, it is definitely worth the effort and time. On one hand because of its integrating force, which can bring together theories and concepts that have been considered to be distant, even if every strand of this imaginary braid has been always criticized. On the other hand, the book contains a lot of Hungarian references: when presenting the international examples the author returns – from time to time – to the question: what lesson can be drawn for the new EU member states, including Hungary?

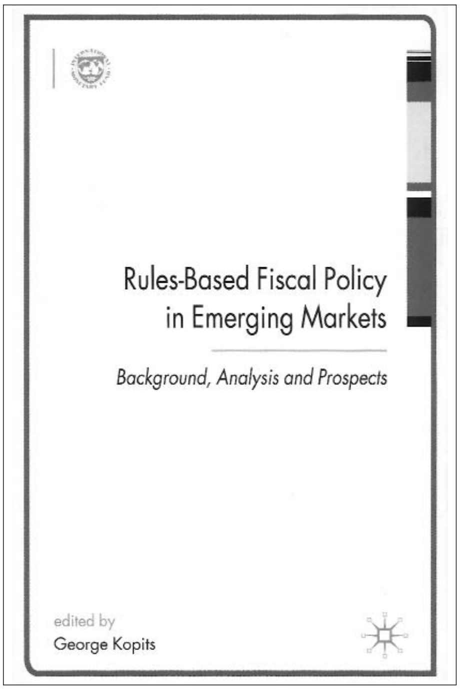
And what brings the book close to the reader and makes it, or rather the author's thoughts impressive, is its questioning, thought-provoking spirit that presents the complexity of the subject well. This means that it is actually mandatory literature for those who have considered the healthy operation of public administration a public matter, or to put it more emphatically, a matter close to their heart.

Enikő Szilágyi

George Kopits (ed.)

Rules-Based Fiscal Policy in Emerging Markets

Background, Analysis and Prospects



PALGRAVE MACMILLAN, 2004

The necessity of short-term economic stabilisation and a structural reform affecting longer-term expectations has clearly set the topic for common talk in the past few months in Hungary. While an animated discussion has been continued on the order of magnitude of an adjustment and the desirable course of a reform, professional debates are still short of a line that would link the formation of fiscal policy to rules, and thus would attempt to accomplish policy credibility. This book edited by *George Kopits* (National Bank of Hungary) may contribute to this approach gaining ground in Hungary, too, in view of the fact, if not for a different reason, that compliance with fiscal rules (and principally using the derived benefits) for Hungary as a member of the European Union is (would be) not only an option but also an obligation.

The reviewed book is an edited and completed collection of materials prepared for a conference held and organised by the Mexican government, the IMF and the World Bank in cooperation. Systematic research into the application of fiscal policy rules is certainly not a recent development. The editor of this book, George Kopits himself has, for instance, popularised this vehicle of depoliticising fiscal policy in a number of publications (see in particular Kopits and Symansky, 1998, and Kopits, 2001). However, earlier articles on this issue concentrated on economically developed and stable democratic countries almost without an exception, and particularly on the Euro-zone. A decisive feature of this recent book in the literature of political economy may precisely be the fact that it construes the use of the fiscal policy rules specifically in the context of emerging economies. Certainly, in this globalised world, distinctions between developed and emerging countries stop making sense in many aspects, even if some believe this is exactly when differences begin to show clearly. The editor himself, similarly to the author of the foreword, *Agustín Carstens* (IMF), makes a number of references to the fact that emerging countries are incessantly exposed to the value judgement of international markets due to the liberalisation of capital mobility. An inappropriate economic policy considerably intensifies the vulnerability of these countries. Not infrequently, an overspending government policy leads to a crisis, which then adversely affects broad social strata. Another serious problem for emerging markets is a high degree of macroeconomic volatility (measured in output or the employment rate), a phenomenon that bears hardly or at least to a lower extent on so-called developed countries. All these in combination require (and at the same time justify) a radical change in the course of fiscal policy accustomed to before the eighties and the nineties: accomplishing a balanced budget, which holds – as the message of this book goes – a powerful but still not almighty instrument in the form of fiscal policy rules.

While the topic is specific, it is worth stating in advance that the volume is highly readable and – without exaggerations – constitutes an exciting piece of literature on the new political economy. The book is organised in three major parts.

■ *In the first part,* authors collected theoretical explanations of and general experience with the use of fiscal policy rules. Readers less familiar with the field of fiscal policy rules can also easily orient themselves to the topic, given that the first part serves as a kind of general review and an introduction. Specifically: following Chapter 1 that both trails and summarises the topic, Chapter 2 describes different interpretations of dissaving tendencies from a political economy perspective, pointing out the options and limitations of rules-based fiscal policy. Chapters 3 to 6 analyse the features non-specific to countries, which draw on emerging countries in general, such as public debt structure and debt rating (Chapter 3), macroeconomic volatility (Chapter 4), the impacts and strengthening of capital mobility (Chapter 5), as well as the issue of political will and credibility (Chapter 6).

The first part that provides a thorough orientation to the reader even for studying the second and third parts, which present the fiscal policy practices of a number of mostly emerging countries in the form of case studies. The second unit of this book focuses on regulation at a national level, discussing countries such as Brazil (Chapter 8), Mexico (Chapter 9), or Central and East Europe (Chapter 10), as well as Venezuela and Norway (Chapters 11). The third part enhances literature with a level of analysis for application of fiscal policy rules, i.e. the regional or provincial levels, which is scarcely investigated but is all the more relevant to emerging market economies. The difficulties of harmonising interests within a country are summarised in a simple game theoretic model in Chapter 12, then longer presentations are given on India (Chapter 13), Argentina, Colombia and Mexico (Chapter 15). Two chapters (Chapters 7 and 14) address the analysis of the EU's fiscal rules with a clear intention to be used as a moral to emerging countries.

Although Kopits mentions in the starting chapter of this book that it would be too early to give a comprehensive evaluation of the application of fiscal policy rules in emerging countries, as emerging (transitory) economies have recently replaced earlier discretion-based policy with rules-based fiscal policy commencing in the late nineties (page 1), the reader may draw a number of useful conclusions recommended for consideration in Hungary. A principal message of this book is that the existence of fiscal rules in itself does not guarantee a reduced vulnerability of emerging countries, even if the application of these rules in Latin America has become widespread as a result of bitter experience from the past and with apparently permanent crises. "…There is nearly unanimous agreement that fiscal policy rules are not a magic wand that somehow will immunize the economy against macroeconomic volatility or financial crises and will sustain high economy growth. Clearly, the timing, design, circumstances and overall institutional basis are critical for the success of rule-based approach" – Kopits writes (page 8). It is certainly not insignificant for success whether the use of rules is widely supported by a social consensus, whether they are formulated amidst debates facilitating public understanding, and whether they represent broad empowerment and an imperative force. Anyway, experience shows that it is mostly not the countries laying down their fiscal rules in their constitutions that are successful indeed in macroeconomic stabilisation, but it is the ones using them as some kind of guidelines or recommendations, such as Chile or Estonia (page 9).

A remarkable statement is that rules alone, without an appropriate arrangement of institutions/procedures of fiscal policy rarely yield any results. On successful application of rules high values are attached to the procedural requirements that focus on the transparency of planning of, decision making on and implementation of fiscal policy, and reinforce the role of audit – be it any level of public finance. In emerging economies, institutional development and the capacity and expertise of the state are attributed particular significance (page 9).

In his review, *Allen Drazen* (Tel-Aviv University) considers it worth emphasising, among others, that fiscal policy rules are no other than a useful commitment technique, and, as such, are essentially an instrument to achieve credibility of government policy – especially in countries where the problem of time-inconsistency is crucial. Another important conclusion: it is more correct to construe rules as a potential means of imposing burdens on policy-makers – instead of hoping for actual benefits derived from them –, in the sense that deviation is given publicity. (This, at the same time, also represents the strongest and most authentic punishment, as opposed to the sanctions that lose credibility precisely by being too harsh on the government or its employees. It is hard to imagine, for instance, that any of the EU countries would actually pay into the common budget an amount up to as much as half a percent of its GDP.)

Another statement by the author also gives food for thought: paradoxically, the practice of creative accounting gaining ground in the countries applying fiscal policy rules is evidence of the efficiency of rules, as politicians rely on creative accounting techniques precisely because they are afraid of the consequences (costs) of incompliance with the rules.

In his exciting study, *Ricardo Hausmann* (Harvard) calls attention to the fact that the poor credit rating of emerging economies is not simply attributable to high public debts and, accordingly, an improper, irresponsible and wasteful economic policy, but much more to a relatively unfavourable debt structure. The majority of debt securities of emerging market economies are not issued in the domestic currency, and neither for long term or at a fixed yield. As a consequence, the high volatility of exchange rate risk and interest movements causes low credit rating of countries with relatively small amounts of public debts. As he points out, "from a policy perspective, managing the debt structure may reduce risk premia and allow rapid fiscal consolidation through a self-reinforcing reduction in interest rates. This implies that governments should be concerned not only with the debt stock but also with its riskiness." (page 34). Accordingly, the author proposes use of a fiscal rule that would set up a limit for the debt stock weighted by risk (page 50).

The principal aim of using fiscal rules in emerging economies is the long-term sustainability of public finance, which often desensitizes the users of rules to economic cycles – *Guillermo Perry* (World Bank) states. Now the price of procyclical policy may be unreasonably high, especially in an emerging economy. If countries fail to produce more at times of prosperity, governments will be forced by money markets to trim down deficit by reducing expenses at the times of recession, slowing down the growth rate of the economy (page 53 and pages 55 to 56). In addition, the growth restraining effect of procyclical policy affects mostly the poor, among others by forcing the government to reduce social expenses – precisely at a time when the poor lack revenues anyway (page 62). Examples of Latin American countries show that none of the countries in the region, except for Chile, have succeeded in achieving a closing surplus at times of prosperity. Crises in Colombia and Argentina are partly explained by dissavings in periods of recession, deemed unsustainable by lenders (page 57).

With reference to crises seen in emerging economies, Kopits adds that a permanent concealment of implicit commitments of the public sector has considerably contributed to the crises in Argentina, Mexico, Indonesia, Korea, Russia and Thailand. As he writes: "in an open economy, a weak and opaque fiscal policy can undermine credibility and thus contribute to a speculative attack. Conversely, public finances underpinned by transparency and strong institutional infrastructure can foster credibility. Accrual-based accounting, economic and functional classification of expenditures, wide institutional coverage and an explicit medium-term macroeconomic framework enhance the clarity of public finances." (page 75). At the same time, Kopits also challenges Perry by stating that countries gain more by the rules reinstating the credibility of the government than the cost of losing the flexibility of fiscal policy (such a cost is for instance the implementation of procyclical policy – page 76). Perry from the World Bank does not renounce rules himself, what is more, similarly to the authors of Norwegian and Venezuelan country studies, *Olav Bjerkholt* and *Irene Niculescu* (see later), he also recommends stabilisation and savings funds in combination with the rule fixing the structural deficit to avoid crises (page 59).

Allen Schick (Brookings Institute) discusses in detail an opinion stating that rules can only ensure substantial lessening of the vulnerability of emerging economies in combination with political commitment, which recurs throughout the book. In his analysis, he points out an obvious contradiction whereby supporting institutions that play an indispensable role in the success of rules – for example comprehensive and transparent budget planning – "are most likely to be present in countries that need targets the least, and least likely to be present in countries that need them the most." (page 92). Drazen in Chapter 2 argued similarly when he construed the rule as an indication (expressing commitment), and, as such, considered it a vehicle of achieving reputation and not an alternative to it. It is important to emphasise Drazen's idea separately because the issue is mostly raised in the literature stating that either the rule or reputation constitute a vehicle that ensures credibility in the everyday practice of fiscal policy (page 25).

▪ *In the second part of this book, Ilan Goldfajn* (Central Bank of Brazil) and *Eduardo Refinetti Guardia* (Sao Paolo state) have made the presentation of Brazilian fiscal policy particularly interesting to Hungarian readers by linking the issue of using fiscal rules to the problem of sustainability of the Brazilian public debts stock. The task assigned to Brazilian governments in the late nineties was complex: stabilise the public debt stock, efficiently control spending at the level of member states and local governments, eliminate bailout policy at all levels of the state, rationalise the budget process, introduce a medium-term macroeconomic budgetary framework and create transparency (page 121). Surveying the reforms implemented in terms of public funds in the nineties, the authors arrived at the conclusion that numerical rules alone would have proved insufficient to eliminate the bailout policy and a resulting further indebtedness also condemned by Kopits. However, fiscal rules have been successfully amalgamated by Brazil with various procedural requirements circumvallating the budget process, and rules reinforcing transparency, which in combination have been able to eliminate structural imbalances, and significantly improve the quality of controlling macroeconomy (pages 127 to 128). Let us remember that previously Hausmann (in Chapter 3 of this book) also argued in general for the idea that the problem of emerging economies is in fact that they are only able to fund their public spending from the market at a considerably higher risk premium even in case of equal debt stocks. For this reason, a debt reducing policy credible also to them is a question of life and death. For him also, quality improvement in public finance represented a solution.

Unfortunately, the Central and Eastern European region has not been assigned too much space in this book. A refreshing exception is a writing by *Fabrizio Coricelli* and *Valerio Ercolani* (University of Siena), in which the authors, having examined Hungary, Poland, Slovenia and Romania, state that the budgetary deficits of newly acceded countries are basically of structural origin, procyclical in nature, and the proportion of their public investment projects is high above those of old EU members. These three factors are described as particular features of countries where a change of regimes has taken place. Consequently, the authors advocate changes to the fiscal rules set up by the Stability Pact considered by them to be strict and rigid. They suggest that the European Commission and the Council of Ministers should focus on the structural balances of countries in the continuation, and that adoption of the British fiscal rules could present a solution, namely, by applying the golden rule (current expenses are not permitted to be funded from a deficit) and by aiming at a sustainable debt stock. It is interesting, by the way, that on reviewing the European regulation, two excellent analysts of the European Commission, *Marco Buti* and *Gabriele Giudice* – besides being front-line fighters for the preservation of the Stability and Growth Pact in the European Union – in Chapter 7 clearly take sides stating that the rules for debts and deficit laid down in the Pact would not be suitable in Latin America, and they would require emerging economies to generate a surplus in the primary structural balance instead of keeping up a deficit (page 107). Hungarian readers may draw two considerably different conclusions from this:

- countries of Central and Eastern Europe cannot be considered emerging market economies, what is more, by finding themselves in the club of the most developed countries as EU members, the states in our region do not need such flexible interpretation of rules any more, or
- the authors consider maintenance of the status quo more important in the EU at any price (and this is why they also mention Central and Eastern Europe in addition to Latin America) than engaging in a debate that may easily prove to be Pandora's box.[1]

An interesting study is presented by Olav Bjerkholt (University of Oslo) and Irene Niculescu (Central University of Venezuela) on rules applied in countries rich in non-renewable resources (particularly oil). In their comparative study, they showed that rigid rules that merely provide for deficits cannot be applied in these countries, because the price of raw material depends on external factors, and the income side of the budget is exposed to considerable volatility. Instead, a more flexible form of fiscal rules is recommended to them (such as an indicator of structural deficit considering cyclical effects), which is reasonable to be combined with funds used as instruments of stabilisation on the one hand, and also generates savings that can be applied for education, health care and infrastructure on the other hand (pages 169 and 178). This dual system complemented by transparency requirements may be capable of depoliticising the application of assets generated from exploiting resources once and for all (see, for instance, the case of Ecuador).

It is not a recent recognition in Mexico, either that rich oil resources may be a nuisance, when combined with weak fiscal discipline and the procrastination of structural reforms. *Andrés Conesa* and co-authors (from the Mexican Ministry of Finance) say about the application of fiscal rules adopted in the country in the second half of the nineties that they are far from being perfect as yet, but a combination of improving control on expenses and efficiency of tax collection reduced the public sector's credit requirement from 6.3% (of the GDP) of 1998 to 2.7% by 2002 (page 135). The authors provide an exhaustive documentation of other requirements adopted in the country to support the numerical rules, especially in terms of planning, approving and implementing the budget, in order to achieve predictability and credibility of fiscal policy. In this way, if income is behind the budgeted amount, for example, the government must cover the discrepancy from a stabilisation fund, and if the sufficient funds are not available (because it was not topped up in time), then public expenses must be reduced. The surplus income generated in good periods can only make up for a part of a current budgetary deficit. A quarter of income surplus is used to top up the reserve fund, while one half is statutorily applied to public investment projects (pages 133 to 134).

■ *The third part of the* book presents the options of applying fiscal rules at the level of member states and provinces. *Miguel Braun* and *Mariano Tommasi* (University of San Andrés) in their game theoretical model warn that no permanent fiscal discipline is conceivable without coordination between the various levels. Responsible spending by the central government is all in vain if it is not combined with self-restraint on the part of provinces and states – typically with high levels of autonomy. This proposition is backed by *Kalpana Kochhar* and *Catriona Purfield* (IMF) using the example of India. (Purfield's name may be familiar to Hungarian readers: her study published by IMF in 2003 under the title 'Fiscal adjustment in transition countries: evidence from the 1990s' gives an exhaustive and duly objective presentation of the challenges and faults in fiscal policy in the nineties.) The authors provide a thorough and comprehensive overview of the status of Indian public funds, emphasising that despite a robust growth and a recent opening, the country has still a lot to do in terms of macroeconomic management. Since the end of the nineties, India has generated a 10 percent annual deficit, or more, which resulted in its debt stock reaching 80 percent by 2002 (page 200). The fact that the country has had nothing to fear from a crisis is a result of a domestic money market system still relatively closed (state-owned banks), high amounts of (forced) savings, denomination of the debt in domestic currency, and relatively long maturity ranges (pages 201 to 205). Nevertheless, fiscal laxing has involved considerable costs of growth, which – similarly to other emerging economies – mostly affected the poorer layers of the population (page 198). Although the authors welcome the efforts of the central government primarily hallmarked by the Act on fiscal responsibility and budget planning in effect since 2003, still, parallel to that, they also voice their doubts stating that a down-to-top approach in the fiscal policy is still dominant in India, ensuring a great deal of autonomy to each state, which duly use (or misuse) it – accumulating considerable deficits from year to year. The authors propose a solution whereby stronger central fiscal budgeting controlled from above is implemented in India in the not too distant future, similarly to Brazil.

Although not rare, self-restraining requirements implemented in the member states are still an exception. On the other hand, as presented in a study by *Fabrizio Balassone, Daniele Franco* and *Stefania Zotteri* (National Bank of Italy) addressing the Euro-zone, a number of member countries adopted internal stability pacts embedded in their national laws that obviously aim at forcing their governments (and even heads of provinces) to implement discipline in fiscal policy. This endeavour is particularly successful in Spain, Austria and Belgium, and attempts at regional regulation have also been made in Italy and Germany, although these latter two have not had any convincing results.

The last chapter in the book, authored by *Christian Y. Gonzalez* (University of Georgetown), *David Rosenblatt* and *Steven B. Webb* (World Bank), can also be construed as practical implementation of the game theoretical model detailed initially in the third part. Examining three Latin American countries, the authors have shown that inappropriate delegation of responsibility between levels of government necessarily generates conflicts. Analysing the transfers between the government and the member states/provinces in Argentina (for a long time), as well as in Colombia and Mexico (for a short time), they found that a full central guarantee for provincial transfer payments significantly increases the emergence and embedding of moral risk at lower levels. Guaranteed payments not only lull the politicians of member countries but also prompt them to coordinate their activity with the central government as little as possible. The three authors reasonably see the issues of reinforcing coordination and distribution of responsibility as the solution, a specific form of which would be manifest in a fiscal policy rule endorsing the distribution of risks among the different levels of government, matching the particularities of each country.

In summary, it can be stated that this book can be a useful and enjoyable reading for anyone who views the delay in the adoption of Euro in Hungary with concern, and would finally like to find some aid to achieve depoliticising fiscal policy, ensuring public finance sustainable in the long run in Hungary. The book offers a number of general and practical guidelines richly illustrated by country studies on this topic. Especially appealing is the authors' approach that they do not promote fiscal rules disregarding the circumstances. Instead, they agree to point out where and on what conditions fiscal policy rules can or could become a token of success. One thing is surely seen: this solution is gaining ground to achieve credibility not only in the developed part of the world but also among emerging market economies. As for myself, I am waiting for a sequel – which perhaps will also have a chapter on Hungarian success.

Benczes István

Notes

[1] For more details of this dilemma, see Buti et al. (2003)

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New focuses in the relationship of the World Bank and the supreme audit institutions

Lessons learned from a World Bank seminar

The World Bank and the audit offices, as well as INTOSAI, the international organisation comprising the latter, have been converging for years. This convergence has been based on the sense of responsibility shown by both systems of institutions in the proper and efficient application of public funds, good financial direction, effective accomplishment of public administration activities, and supplying information to the state control authorities and the general public through objective reports.

For the World Bank and the donor countries, this cooperation is made directly valuable by the fact that the activity of audit offices may significantly facilitate the application of subsidies towards the goals. This has also motivated the World Bank to develop a strategy: to see how it is capable of supporting and reinforcing the activity of audit offices.

The importance of implementing these efforts and the Millennium Development Goals was suggested by the World Bank's Vice-President *James Adams* in his opening address at the seminar entitled 'Developing the capacity of state audit offices: opportunities and challenges'[1] to the participants from the World Bank and a few experts invited to give lectures. The Vice President also mentioned on a critical note that the World Bank had spent millions of US dollars in the past ten years on developing direction systems for public funds in developing countries – primarily in Africa –, but the desired results had not been achieved.

On behalf of the World Bank, the principal goals of the seminar were summarised by the Bank's chief expert of financial direction, *Rafika Chaouali* in four points:

- it is a fundamental part and manifestation of cooperation pursued with the audit office;
- it is an opportunity for the World Bank staff to familiarise themselves with the audit offices' progressive experience with reforms;
- an exchange of experience is to be carried out on the challenges involving public funds direction systems, and
- to understand where and what cooperation can be expected by the World Bank, and from whom, under an efficient partnership.

A REVIEW OF THE REGIONS

For meeting these goals, good starting points were provided by the World Bank's experts in their presentations giving a diagnosis of World Bank regions. As in almost every respect, regions show a great deal of diversity also in terms of audit office features. This report will only allow for mentioning but a few.

In the *African region*, the performance capacities of audit offices differ widely, and development programs are in many case in the planning phase only. Implementation is hindered almost everywhere by a shortage of resources and experts. Another problem is that the relationship between the audit offices and the parliaments is insufficient both in terms of quality and intensity. This is also related to an undesirable phenomenon whereby new audit organisations are often established, weakening the role of existing audit offices.

In a number of countries in the *European and Central Asian region,* the establishment of legal and institutional frameworks necessary for audits, independence of operation and the improvement of relations with legislators still pose a challenge. Within this region, the best audit office performance is produced by the EU8 countries. Among these – according to the expert requested to organise this seminar, former chief auditor of the French audit office and the president of OECD's External Audit Committee, *Patrick Mordacq* – Hungary and Poland lead the way.

The countries of *Latin America and the Caribbean region* have achieved significant development in improving the legal and independence statuses of audit offices; however, independence in terms of finance and operations, as well as the size of actually available financial resources are still not sufficient for efficient external auditing. Another general problem is that the opinions and recommendations made by audit offices are utilised to a small extent.

The auditing practice of the *Middle Eastern and North African region* is characterised by a high degree of diversity: supervision over court and common law audit offices ranges from the government through the head of state to the parliament. Capacity development is highly required, however, the relation maintained by some countries with donor countries is unsatisfactory. Audit offices do not audit World Bank projects.

In the *South Asian region,* auditing culture has considerable traditions. Difficulties are caused by low levels of administrative independence, and the associated frequent interventions by the ministry of finance. Unsatisfactory are the facilities of familiarisation with audit results, and it is also typical here to have a low level of accepting and enforcing audit office opinions and suggestions. The audit offices also audit most World Bank projects.

Within the *East Asian region,* in China, audit also extends to subsidised projects, in addition to the ones with domestic funding. Mongolia focuses on adopting international standards, while Vietnam and Cambodia on developing internal audit. In Indonesia, enhancement of auditing capacity is emphasized.

TRENDS IN AUDITING

Based on this diagnosis – illustrated with examples – and the experience presented by the invited experts of developed countries, some statements can be made on the courses of development typical of the activities of state audit offices.

■ Experience shows that the legal operating environments of audit offices and the direction features of public funds systems vary. However, there was an agreement in the seminar that an obstacle to assisting public funds reforms more efficiently was – while a slow progress was seen – that the independence of the audit office was not enforced properly. Out of the five elements influencing it, – legal, operational, financial, management/administrative independence and free information –, it is most frequently financial independence and the election of the management for political considerations that hinder the enforcement of management/administrative independence most. In addition to this, as pointed out by Canada's chief auditor *Sheila Fraser*, the most critical point – even in developed countries – was to achieve financial independence.[2] The importance (severity!) of this issue is indicated by the fact that in Canada a Charta is being produced on independence.

■ Another major obstacle to the activity of audit offices is – as seen with the regions – the shortage of audit capacities. This is primarily manifest in the low standards of auditors' professional competence. More efficient auditing is also hindered by the fact that information obtained by auditors is restricted, for example, important budgetary expense items are considered to be beyond their mandates, and the establishment of efficient working relations with the ministries of finance, other ministries and government organisations are impeded. For this reason, development of audit capacities is a high priority task with resolution especially urging in the emerging countries. Denmark's chief auditor, *Henrik Otbo* highly appreciated the World Bank's initiative to have directed attention to this important area with this seminar. In this context, the chief auditor of the United States of America, *David Walker* emphasised that the quality standard of audits needed to be raised, and the closest possible international cooperation was indispensable to achieve this – highlighting the role of the World Bank. Both pointed out that audit offices deserved confidence. The chief auditor of the US also supported it with personal experience, stating that – at more developed levels of activity – the professional standard of state audit offices does not fall behind that of private audit/consultancy companies.

■ In the world – experts unanimously stated – familiarity with and utilisation of audits performed by audit offices are unsatisfactory. Experience gained through auditing is not widely known to citizens, and this restricts their control over the process of modernising the public funds system, and also plays a role in the fact that audit offices do not, or hardly use the method of risk analysis in their activity. An obstacle is, for instance, that decision-making governments often fail to show sufficient will to implement the recommendations of audit offices, and the working relationship between parliaments (the committees) and the audit offices is inappropriate. This shortcoming has been termed by Patrick Mordacq as an "expectation gap" towards audit offices. For emerging countries and countries in transition, he raised the issue that auditors often set up a narrow scope of activity for themselves, and in this way they are merely "auditors" instead of "helpers" of financial reforms. This is the transformation that should be facilitated by reinforcing the capacity of audit offices – through more thorough training, a better level of organisation, application of more recent methodologies, elimination of the formality of audits, etc. –, as well as a bolder attitude to taking on any potential errors (risks) of forward-looking consultancy.

Out of the methods aiming at unfolding this latter activity, considerable attention has been directed to the Canadian and Hungarian practises. In Canada, an organisation working as an independent and neutral forum, the Canadian Comprehensive Auditing Foundation, provides assistance in improving the efficiency of the audit office's activity by serving auditors, government managers and elected MPs, as well as by cooperating with them as a partner. This service embraces activities, starting from reinforcing accountability through research to training. Under research activities – for example – principles have been developed for reports on the performance of the public sector, by conducting diverse consultations with the representatives of the abovementioned three target groups of partnership. Another example: the Foundation summarises the major recommendations of the auditors in publications for the parliamentary committees.

A similar activity characterises the Hungarian practice. The Institute for Development and Methodology of the State Audit Office, in addition to presenting best international practises and experience, issues summarising and analysing studies to assess the development tendencies related to public finance, and pays particular attention to presenting the reasonable courses of reforms necessary in the public finance system.

However, development of forward-looking consultancy of audit offices cannot be considered a boundless process. By multiple considerations of each country's capabilities, – as the chief auditor of the US, David Walker put it – one can palpate the limit that ought not be crossed.

Today, perceivable convergence is being implemented in the public funds direction systems. This globalisation-related change also has an impact on financial auditing activity.

Based on the presentations and discussions of this seminar – with some courage – an attempt can be made at briefly reviewing the changes and trends perceived in financial auditing.

- Financial/compliance audits are indispensable but insufficient to achieve a sustainable fiscal position. Performance audits need to be placed in the foreground, to be used as the principal value in the audit office's activity.
- With the extending role of performance audits, the decentralised nature of audits is intensified, which requires different auditor capabilities and information. (Decentralisation is progressing also in internal audits.) The progressive practice of programme budgets also needs to reinforce decentralisation – even if with a new attitude.
- Also related to some extent to the increasing role of performance audits ex post audits gain increasing significance as opposed to ex ante audits.
- For good governance, transparency and accountability are becoming increasingly important requirements. A prerequisite to accountability is transparency; consequently, these two criteria are inseparable.
- In financial auditing, the functions and tasks of internal control mechanisms and independent internal audits are reasonably established in harmony with each other, using approaches and methods typically used in audit office audits and methods.
- The supply models of public services are changing to include a growing role of background institutions, outsourcing, and projects implemented with public private partnership (PPP). The capacity enhancement of state audit offices needs to be implemented in a way that provides them with the ability to meet challenges concomitant with these changes.

The work performed in this seminar has also proved: state audit offices are not island-like, standalone institutions, but important parts of the public funds direction system. For this reason, the World Bank's expert staff intend to maintain even closer and more efficient cooperation with state audit offices in the future. A strategic cooperation between the World Bank and the audit offices provides powerful support to INTOSAI's strategic and renewal plan for the years 2005–2010, and facilitates implementation of the first two of the four major objectives laid down in the strategy, namely, enforcement of professional standards and accountability, as well as institutional capacity development. In summary of the above, it can be stated that the seminar met its objective in all respects.

Gusztáv Báger

Notes

1 This seminar was held on 3rd and 4th May 2006 in Washington. The World Bank invited lecturers for panel discussions in recognition of their performance at audit offices, i.e. representatives of the respective audit offices in Australia, France, Denmark, Canada, Poland, Hungary, Great Britain and the United States of America were present.

2 In Hungary, the SAO's financial independence has particularly been enforced since 2004, considering that it has submitted its draft budget directly to Parliament.