Content

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The purpose of this journal is to present an authentic picture of the domestic financial system in Hungary, to show the major features of operating the public sector and the national economy – as reflected by the principal financial interactions –, the efforts aimed at convergence and at building a future, as well as presenting the related professional debates.

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István Hetényi is 80 years old

The life and work of a finance minister is anything but balanced, calm, free from daily excitements and unpredicted situations anywhere in the world. This is especially so in Hungary, where this position would probably rank high on a scale of stress-loaded jobs. It can partly be attributed to this fact that in the past 16 years at least two, but more often three persons headed the Ministry of Finance within each election cycle.

Finance ministers come and go, however there is someone who represents permanence, continuity, someone, who was a finance minister for a relatively long period, for six years, and whose advice, experience, gravity, calmness, rationality and sense of reality have been utilised by most ministers ever since. This person is István Hetényi, who is described rather laconically in reference books – he did not disclose much about himself to the reference book writers –, but is regarded as an eternal finance minister, or rather "The Finance Minister" in professional circles.

His career has been very rich. The field of tax theory is readily associated with his name not only at academic level, but also in the dissemination of taxation related information. A significant part of his publications are on taxation. He also addresses the practical problems of the current tax systems. In his writings he covers the fundamental questions of economic policy, and apart from the general tasks of economic policy and national economy planning he extensively writes about one of the most monumental tasks of the past decade, i.e. the reform of the public finance system.

Rationality and reality. This is what every finance minister needs in his hectic daily work schedule to be able to thoroughly review the decisions, reveal the correlations, adequately analyse the events, i.e. foresee the future.

István Hetényi represents rationality and reality. Rationality that is supported by profound professional knowledge and preparedness that is available only to the fortunate few. On the other hand, reality is nothing but keeping in mind how much daily reality differs from theory and pure science. Such sense of reality can be possessed only by someone who has spent a very long time in public administration, in a planning office, in the Ministry of Finance, and who started to build the fundamental elements of the market economy at a time when the political turnaround was not even in the air.

Naturally, the systems about which brainstorming began while Mr. Hetényi was holding the post of finance minister have been built, implemented and put into operation by now. The market economy was created, Hungary underwent great changes in the past three decades, and in many aspects the Hungary of the 1980s is incomparable to the current Hungary. However, a considerable similarity is that reforms have again been put on the agenda.

Action is needed in the field of public finance. Time is pressing, tasks are plentiful and such decisions must be made within a relatively short timeframe that will significantly determine the country's life in the next decades. The road we have embarked on is not always paved and it is undeniable that there are plenty unnecessary detours, too. Of course, this does not mean that we should be afraid of the changes, slow down or give up some of the objectives. It is important to maintain consistence, courage, perseverance, rationality and the sense of reality. It is important to maintain what István Hetényi represents with eighty years of experience, with the energy of forty-year-olds and with the fresh-mindedness of reformers. It is important to keep the reforms going, because interests are violated. The reforms must be continued despite the strong resistance of the different interest groups, despite the fact that many people object to the changes while they themselves want changes, and despite the fact that in the short run political popularity with the voters can hardly be won with reforms.

However, reforms pay off in the long run, although not always for the reformers, but definitely for the economy and the country. Professionally well-founded, well implemented reforms bring the country to the front-line of development, accelerate the process of gap reduction, and create new opportunities for the population to manage or improve their lives.

The precondition is professional well-foundedness, i.e. everything that is present in István Hetényi's writings, work, orally presented thoughts, and comments which he offers to each finance minister in office without hoping that his advice would be accepted as is. He knows that many other factors need to be taken into account. Yet, myself and my colleagues have occasionally realised subsequently that those comments would have deserved more careful consideration.

Happy birthday István Hetényi!

János Veres
Minister of Finance

Daniel Bergvall–Ian Hawkesworth–Dirk-Jan Kraan–
Philipp Krause

Budgeting in Hungary

OECD study

INTRODUCTION

This paper presents the main findings of the budget review of Hungary that was carried out by the Secretariat of the Organisation for Economic Cooperation and Development (OECD) in May 2006 as part of the working programme of the Working Party of Senior Budget Officials. The Working Party is the committee of the Budget Directors of the OECD countries. It meets annually and discusses the budget reviews which are carried out by the OECD Secretariat.

While preparing the review the OECD Secretariat has made a mission to Budapest during which it met with officials of the Ministry of Finance, the State Treasury, the Ministry of Education and the Prime minister's Office. The Secretariat also met with the President of the State Audit Office, the Deputy Chairman of the Budget Committee of Parliament and a member of the Monetary Council of the Central Bank. All Hungarian officials and authorities have provided the OECD Secretariat generously with information and have frankly exchanged their views with the Secretariat. This review has made ample use of this information and these exchanges.

The Hungarian budget review has been presented at the Ministry of Finance of Hungary on 29 and 30 May 2006. At that occasion the OECD Secretariat had an opportunity to discuss its findings with all Hungarian officials and authorities who contributed information and views during the Secretariat's mission to Budapest. These discussions have led to some further adjustment of the review.

This paper summarizes particularly the part of the review that is concerned with the budget formulation process in Hungary. The OECD Secretariat feels that this process suffers in Hungary from some shortcomings that hamper financial planning and that are partly responsible for the deficit overruns in recent years.

In response to updates of the Convergence Programme 2005-2008 the EC committee has in two subsequent years decided that Hungary needs to clarify its budgetary strategy and take additional structural measures which are fully consistent with its medium term adjustment path. Lacking such clarifications and additional structural measures Hungary does not comply with its obligation to reduce its excessive deficit under the Growth and Stability Pact by 2008. This would put at risk the introduction of the euro in Hungary by 2010 as presently envisaged by the government.

The paper will firstly present some fundamental characteristics of the present budgetary situation in Hungary (section 2). Then it will shortly resume the development of budgetary policy in the last few years (section 3). Subsequently it will treat some key characteristics of the budget formulation process in Hungary, namely the focus on the actual (not cyclically adjusted) deficit (section 4), the focus on the budget year rather than the medium term (section 5), the lack of rules of budgetary discipline (section 6) and the lack of transparency concerning forecasts and outcomes (section 7). The final section contains conclusions (section 8).

FUNDAMENTAL CHARACTERISTICS

Hungary's long-term growth record is good. After the transition upheavals of the beginning nineteen nineties, GDP growth accelerated and averaged 4% per year in the period 1997–2002, around 2% percentage points above the EU average. If maintained, such a difference would lead to a gradual convergence with the EU average per capita GDP in some 25 years (according to Eurostat figures, Hungarian GDP per capita reaches 63% of the EU average in 2005). The main driver behind growth has been the development of Hungary's role as a production platform principally for supply chains to European markets. The rapid growth of production capacities in electrical and transport goods has been particularly important. The financing of this exporting activity has mainly come from foreign direct investment and later on the reinvesting of earnings along with injections of new foreign capital. On a per capita basis Hungary has received since the early nineteen nineties among the highest net inflows of foreign direct investment inflows among OECD countries (surpassed only by Ireland, New Zealand, the Czech Republic and Sweden). In 2002 and 2003 export growth slowed down, but strong domestic demand and public spending has partly compensated for that. In 2004 there was a welcome move back to export and investment led growth and projections suggest that this healthier composition of growth will continue in the near future *(Table 1)*. For the period 2005–2008 the estimates of European Commission (EC) are shown in addition to the estimates by the Hungarian Government in the Convergence Programme (CP).

Strong growth has allowed Hungary to expand government expenditures while simultaneously reducing the tax burden. However, in the period since 2000, the Hungarian authorities systematically overestimated the room for expenditure initiatives and tax relief or even approved such initiatives or tax measures without room. The picture of expenditure and revenue development since 2000 is complicated considerably by continuous revisions of estimates. These revisions are due on the one hand to outcomes

Table 1

GROWTH IN REAL GDP

(Per cent change on previous year[1])

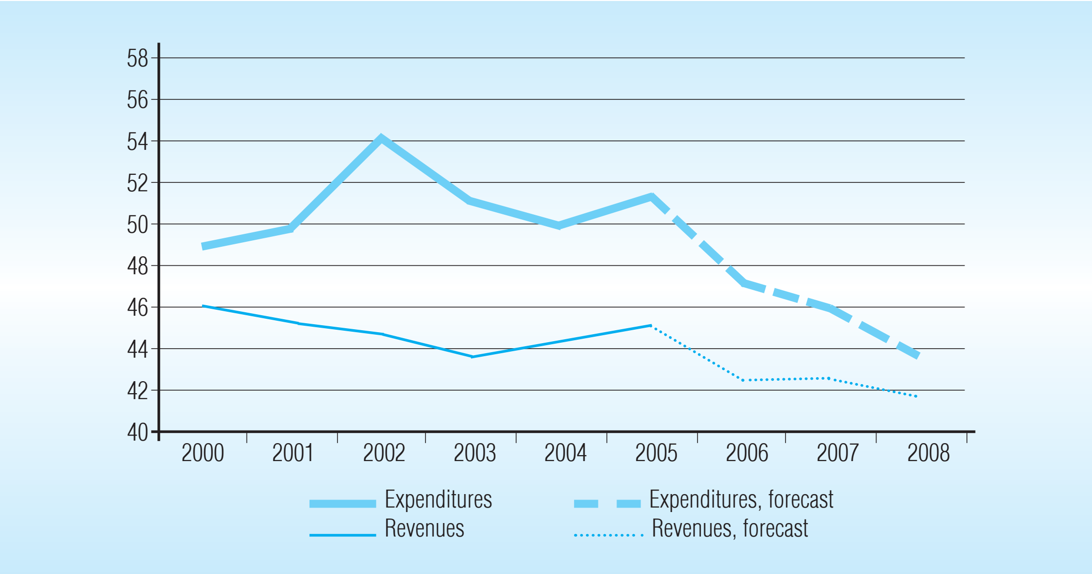
	2000	2001	2002	2003	2004	2005	2006	2007	2008
EU 15	3.8	1.9	1.1	1.1	2.3	1.4	2.0	2.2	n.a.
Hungary CP	5.2	3.8	3.5	3.0	4.2	4.0	4.1	4.0	4.0
Hungary EC	5.2	3.8	3.5	3.0	n.a.	3.7	3.9	3.9	n.a.

Sources: EU 15: Eurostat. 2005–2007 forecast. Hungary 2000-2003: IMF (2005). Hungary CP 2004–2008: Government of the Republic of Hungary (2005). Hungary EC 2005–2008: European Commission (2005).

Figure 1

GENERAL GOVERNMENT EXPENDITURES AND REVENUES (ESA95)*

(per cent of gdp)



* Excluding the consequences of pension reform, the purchase of military Gripen aircraft and quasi-fiscal activities of public enterprises and including investment expenditures of road construction PPP´s.

Sources: 2000–2003: IMF (2005), 2004-2008: Government of the Republic of Hungary (2005).

that deviate from estimates (so that budget estimates are not reliable) and on the other hand to revision of accounting methods, imposed on Hungary by international organisations, in particular the European Union. Taking these revisions into account the general picture that arises is that of a widening gap between expenditures and revenues from 2000 to 2002, which has only partially been redressed since then. Whereas expenditures have increased from 48.8% in 2000 to 51.2% in 2005, revenues have decreased from 46.0% of GDP in 2000 to 44.4% of GDP in 2005 (on accruals basis, ESA95). *Figure 1* illustrates this development. The development after 2005 is indicated in Figure 1 in accordance with the latest update of the EU Convergence Programme (December 2005).

After the peak deficit election year 2002 the new centre-left coalition has tried to bring the general government deficit under control. This effort was strongly underscored by the political goal, agreed by the Hungarian Central Bank, to enter the euro area in 2008. However, subsequent attempts to set out and maintain a deficit reduction path that would bring the deficit back to the Maastricht benchmark of 3% have failed. According to the most recent estimates agreed by the EC the general government deficit on ESA 95 basis in 2005 has been 6.1% of GDP *(Table 2)*.

The public debt ratio in Hungary is slightly below the 60% GDP benchmark of the Stability and Growth Pact. After the declining trend in the debt ratio reversed in 2002 with the ratio rising from 53.5% of GDP in 2001 to 57.6% of GDP in 2004, the Updated Convergence Programme of the Hungarian Government foresees a return to declining ratio's from 2006 onwards, triggered by the continuous decrease of the general government deficit and the declining interest burden

Table 2

GENERAL GOVERNMENT DEFICIT (ON ESA95 BASIS)*

(Per cent of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
EU 15	1.0	-1.2	-2.2	-2.9	-2.6	n.a.	n.a.	n.a.	n.a.
Hungary	-2.8	-4.5	-9.4	-7.2	-5.4	-6.1	-4.7	-3.3	-1.9

*Excluding the consequences of pension reform from 2004. the purchase of military Gripen aircraft and quasi-fiscal activities of public enterprises and including the investment expenditures of road construction PPP´s. Including the impact of pension reform. the general government balance according to the updated CP would be 6.5% GDP in 2004. 7.4% GDP in 2005. 6.1% in 2006. 4.7% GDP in 2007 and 3.4% GDP in 2008.

Sources: EU 15: Eurostat. Hungary 2000-2003: IMF (2005), Hungary 2004-2008: European Commission (2006)

on the debt stock due to falling interest rates *(Figure 2)*. However, this does not take into account the impact on the debt ratio of the classification of the second-pillar funded pension scheme outside the general government which has to be implemented as from 2007. Including this impact the debt ratio will rise above the 60% Maastricht benchmark as of 2007 (the impact rises gradually from 3% of GDP in 2004 to 6% of GDP in 2008).

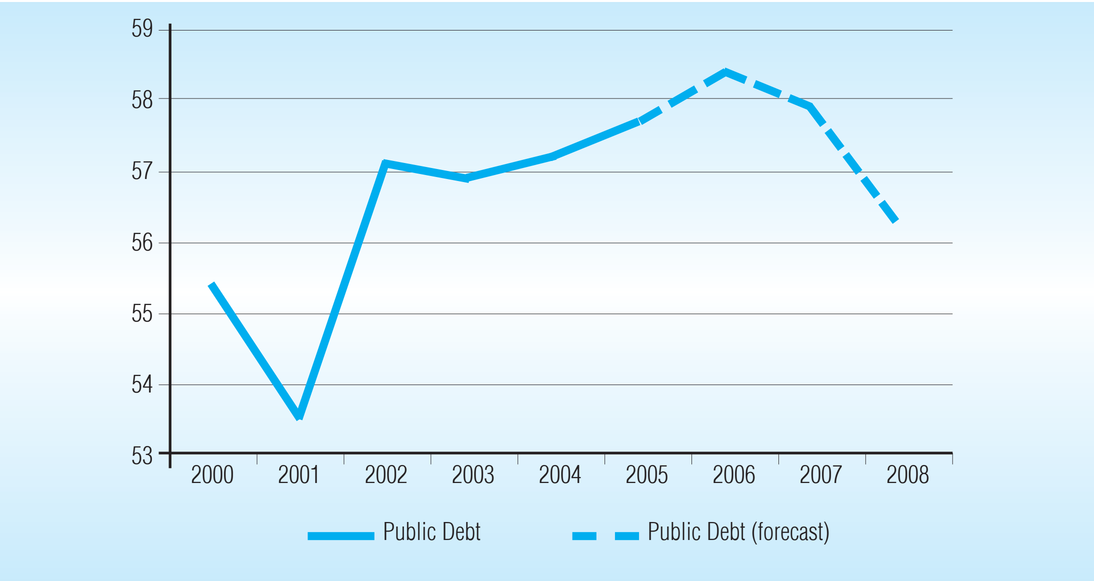
BUDGETARY POLICY IN THE RECENT PAST

There has been a strong tendency in Hungary for spending commitments to be ramped up in the run-up to elections[2]. The general elections of May 2002 were no exception in this regard. The deficit of 2002 overshot the target by 1.8 percentage points of GDP (excluding one-off measures) and represented a fiscal loosening of 3.4 percentage points on 2001. A large share of

Figure 2

PUBLIC DEBT

(Per cent of GDP)



Sources: 2000-2003: IMF (2005), 2004-2008: Government of the Republic of Hungary (2005) the increase in spending in 2002 was due to a series of large wage hikes starting in 2001 and culminating in a 55% salary increase for army officers in January 2002 and a 50% wage increase for all public servants in September 2002. Public sector employment was increased in 2002 by 1.5%. These measures increased the government wage bill by nearly 23% in 2002. Other sizable increases in 2002 took place in social security benefits (18% in 2001), other current transfers (27% on 2001), subsidies (30% on 2001) and investment (44% on 2001, mainly at the local level). The general government deficit on ESA95 basis reached 9.4% of GDP (OECD 2004).

The new centre-left government has made significant efforts in 2003 to reverse the fiscal easing of 2002. Simultaneously it embarked on a tax reform aimed at a more favourable business environment[3]. The deficit target for 2003 was set at 4.5% of GDP on ESA95 basis. In October 2003 the Pre-Accession Economic Programme Update announced a slippage of 0.3 percentage points of this target. At the revenue side shortfalls due to rebates on 2002 tax allowances and windfalls due to higher than expected VAT and wage related revenues were supposed to even out, whereas at the expenditure side there was greater than expected spending on housing subsidies, transfers to local government for social assistance and education, subsidies for prescribed drugs, subsidies for firms employing disabled workers, interest, child care and compensation to victims of the communist regime, in total 0.3% of GDP. In the autumn of 2003 however, further setbacks at the revenue side due to changing economic conditions relating to tensions in the forint market and the current balance of payment account, implied additional slippage, leading to an ESA95 deficit over 2003 of 7.2% of GDP (OECD 2004).

In the summer of 2003 the Government and the Central Bank announced in a joint press conference the intention to join the euro area in 2008. This was based on the recommendations of a committee of experts from the Ministry of Finance and the Central Bank set up in 2002 with a view to define a strategy for euro entry. A key issue for discussion in the committee was whether a precise date or a target period should be announced. In the event, the first option was chosen on the ground that that it would provided a clearer signal to the markets about the Government commitment to fiscal adjustment. As to the precise target date, the committee agreed that the earlier the entry date, the shorter the period of exposure to possible sudden reversals of capital flows. Reflecting this, the Government chose 2008 as the entry year (OECD 2005a).

The 2004 budget (submitted to Parliament in September 2003) repeated the commitment to the medium term expenditure plan announced in the Pre-accession Economic Programme Update. Although it expected to reach the medium term deficit target mainly through autonomous increases at the revenue side, it contained some bold policy measures both at the revenue and the expenditure side. The key measures at the revenue side were changes in the VAT[4], the personal income tax[5] and the social security contributions[6]. In combination these measures were expected to account for 40% of the nominal revenue increase (the VAT and social security contribution revenue gains being much larger than the personal income tax relief whereas the customs and import duties due to EU-accession were lost). At the demand side one of the key measures was the reduction of public employment. The planned cuts involved 7000 jobs out of the 93000 employees in central public administration (including the social security funds). Furthermore it was planned that central government transfers to local government in 2004 would include only a small part of the planned 6% increase in the wage bill for local government, which would prompt staff reductions among the approximately 520000 local government employees. In spite of these measures the 2004 draft budget's consolidated general government expenditures as a share of GDP exceeded those in the 2003 initial budget. This was partly due to EU accession expenditures. The revenue estimates were also influenced by EU accession. Notably, there were cuts in rates and extension of brackets in personal income tax, decrease of profit tax rate from 18 to 16 per cent as well as elimination of many tax allowances and credits. The ESA95 target for 2004 was set at 3.8% of GDP[7] (OECD 2005a).

Commitment to the deficit target for 2004 was demonstrated in December 2003 when, in response to changing economic conditions and the slippage of the 2003 revenue estimates the Government announced a number of measures, including steps to curtail spending in addition to those in the budget submission of September 2003. These measures included further tightening of the housing-loan subsidy scheme, suspension of a mechanism that tied educational spending to previous year's spending, cutting back or suspending the use of carried over budget residues from the previous year and the imposition of a "budgetary blockage" on central government spending. In addition a review of the tax system was scheduled for the spring of 2004 (OECD 2004).

After Hungary had entered the EU in May 2004, the Convergence Programme 2005–2008 was prepared as successor of the Pre Accession Economic Programme (PEP) 2002–2006. The programme was decided in May 2004 and aimed at an ESA95 deficit target for 2004 of 4.6% GDP, a slippage of 0.8% percentage points since the budget 2004 mainly necessitated by worse than expected revenue outcomes for 2003. Furthermore the programme sought to reduce the deficit by 0.5 percentage point annually until it had reached 3.1% in 2007, after which the medium term target of 2.7% in 2008 was in reach (European Commission 2006).

The Convergence Programme also deferred the euro entry target date to 2010. The Convergence Programme stated however that "if conditions turn out to be more favourable, and inflation falls more rapidly, the adoption of the euro can take place already in 2009 under the base line scenario". Later on the reference to the economic developments has been ignored as the deficit outturn for 2004 was revised upwards. Accordingly, the updated Convergence Programme of December 2004 announced that "the criteria for joining the euro area can be satisfied by 2008 and the introduction of the euro is possible in 2010" (OECD 2005a).

In July 2004 the European Council decided that Hungary was in excessive deficit and issued a recommendation for its correction under art. 104(7) of the European Stability and Growth Pact. Following a decision of non-compliance in January 2005, the Council issued new recommendations under art. 104(7) in March 2005 reiterating that the excessive deficit had to be corrected by 2008, the target year for euro entry set by the Hungarian authorities in the Convergence Programme of May 2004 and confirmed in its December 2004 update. In particular, the Council recommended to the Hungarian authorities to take effective action in order to achieve the deficit target for 2005 and to make the timing and implementation of any tax cuts conditional upon achievement of the deficit targets for 2005 to 2008 (European Commission 2005).

The general government ESA95 deficit in 2004 came in at 5.4% of GDP a further slippage of 0.8 percentage points since May 2004 (excluding the costs of pension reform). The actual real GDP growth outturn for 2004 was close to a half percentage point higher than the 3.5% originally projected in the budget. However, having been fuelled by robust growth in exports and investments, rather than consumption, stronger than expected macroeconomic conditions did not support the revenue side of the budget. The main reasons for the slippage were excessively optimistic VAT revenue expectations, which failed to materialize partly owing to introducing self-declaration for VAT on third-country imports as an additional measure, macroeconomic factors and unexpected reactions of the business climate to changes in administration (1.1% of GDP), misreading of housing grants (0.4% of GDP), non-wage expenditures by line ministries (0.9%) and social security spending (0.4% of GDP, evenly split between health care and pensions) and interest (0.6% of GDP, largely caused by erroneous estimation and extraordinary and unforeseen events on money market rather than by increase of public debt). The large upward revisions of the 2003 deficit and the setbacks during 2004 were partly compensated by new measures of fiscal restraint adopted throughout 2004. These measures included cash controls in the health sector, tightening of conditions for the use of unspent appropriations from previous years, cash controls on local governments and extra budgetary funds, one-off measures to collect dividend from public enterprises and tight control of VAT refunds in connection with EU trade (OECD 2005a).

The 2005 budget, approved by Parliament in December 2004 set a deficit target of 3.6% of GDP in 2005 (excluding the costs of pension reform). In line with the updated Convergence Programme of December 2004, the budget assumes a 4% real output growth. It comprises a decline in tax revenue equivalent to 1.4% of GDP, a decline in primary spending of 1.7% and a decline in interest payments as a consequence of falling rates equivalent to 0.2% of GDP. In order to help the budget stay on track a special reserve fund was created which aimed at covering unexpected revenue shortfalls of 0.5% of GDP. The tax package in the budget 2005 consisted primarily of the simplification of the personal income tax (reduction of the marginal rate brackets from three to two, dropping the middle bracket and raising the bottom bracket from HUF 0.8 million to HUF 1.5 million), a greater tax exemption on the local business tax to stimulate employment accompanied by cuts in social security contributions by employers and an increase in the 25% tax reduction of the local business tax from the corporate income tax base to 50%. This package, causing a revenue shortfall of 0.5% was only partially offset by revenue enhancing measures[8]. Key measures at the expenditure side included the planned freeze of carried over appropriations from 2004 to 2005 and the use of PPP's in road construction projects. The latter measure was supposed to save 1.4% of GDP. Half of this improvement was one-off, reflecting the revenues accruing from the sale of existing motorway assets. Furthermore a quarter of the planned 6% nominal increase in the public sector wage bill was supposed to be covered using unspecified economies generated at the level of line ministries.

In view of the slippage of 2004 and in reaction to the recommendations of the European Council of March 2005, the Hungarian authorities took additional corrective measures in order to ensure meeting the 2005 deficit target. This was done in two steps. The first set of measure was announced shortly after the adoption of the Council recommendations in March 2005. This package consisted of the increase of the reserve fund created in the 2005 budget from 0.5% to 0.7% of GDP as well as some across the board cuts, in total 0.8% of GDP. The second set of measures was taken in June 2005, after the Hungarian authorities had acknowledged that several revenue and expenditure estimates were considerably optimistic and had to be corrected. This package consisted of saving measures in the sphere of pharmaceutical subsidies, the freezing of unspent appropriations carried over from the previous year, broadening of the social security contribution base, increase of the tax on slot machines, tighter control on the import of tobacco products, the partial restoration of the previous regime of levying of VAT on imports[9] and extension of the use of PPP arrangements in motorway construction (European Commission 2006).

In September 2005 Eurostat decided that the motorway construction financing arrangement included in the budget 2005 and extended in the June package could not be recorded outside the government sector. In the same month the Hungarian authorities submitted a revised Excessive Deficit Procedure (EDP) notification announcing a 2005 deficit of 6.1% of GDP in 2005 (in contrast to the targeted 3.6% in the 2005 budget). This revised notification took into account (1) that the planned sale of existing motorways to the state owned motorway company, including those under construction until the end of 2005 as part of a PPP arrangement could not be considered as a deficit reducing measure, and (2) that the payment of 13th month salaries to public employees should be recorded in the year to which it pertains also if actual cash disbursements take place at the beginning of the following year. These revisions increased the ESA95 deficit with 2% of GDP (1.9% for the recording of PPP´s in the government sector and 0.1% for the shift in the recording of 13th month salaries). The notification also contained an additional slippage of 0.5% GDP due in equal measure to VAT revenue shortfalls and expenditure overruns. Against this background and in view of further slippages regarding the 2006 deficit, the European Commission recommended and the European Council decided in November 2005 for the second time that Hungary did not comply with a Council recommendation under the EDP procedure (European Commission 2006).

The draft budget 2006 was approved by Parliament in December 2005. It targets a general government ESA95 deficit of 4.7% of GDP in 2006 (up from 2.9% in the December 2004 update of the Convergence Programme). The deficit estimate excludes one-offs, in particular the purchase of the Gripen military fighter planes adding 0.3 percentage points in both 2006 and 2007. On the revenue side, the budget calculates with the revenue-reducing effects amounting to about 1% of GDP resulting from the implementation of the comprehensive five-year tax cut package adopted in 2005. The compensation of the lower revenue and the increased social security expenditures (family benefits and pensions), as well as the planned deficit reduction from 6.1% of GDP in 2005 to 4.7% of GDP in 2006 is expected to be achieved by expenditure cuts amounting to 4% of GDP. The main measures are a 1.0 percentage point reduction in total government consumption expenditure, a 0.5 percentage point decline in interest burden and a decline of more than 1.0 percentage point in other expenditures, including decreased capital transfers to companies for projects not co-financed by the EU. Furthermore, 1 percentage point expenditure reduction is expected to be achieved by a new attempt for substitution of motorway investment by PPP projects (European Commission 2006).

In December 2005 the Hungarian government submitted to the European Commission the second update of the Convergence Programme 2005–2008. This update was in accordance with the Budget 2006 approved by the Parliament in the same month. The budget continues to target the ending of the excessive deficit in 2008. The foreseen reduction path is 6.1% of GDP in 2005, 4.7% of GDP in 2006, 3.2% of GDP in 2007 and 1.9% of GDP in 2008, representing a yearly cut of 1.4 percentage points. In addition to the purchase of Gripen fighter planes, the projections exclude the Eurostat decision of March 2004 on the classification of funded pension schemes ranging from 1.0 to 1.5 percentage points of GDP, which will have to be taken into account by the time of the spring 2007 EDP notification. The strong decline in revenues of some 3.5% of GDP, mainly as the result of the newly introduced five year tax cut strategy, is projected to be overcompensated by a reduction of expenditures by some 7.5% of GDP between 2005 and 2008 (European Commission 2006).

In the Assessment of the updated Convergence Programme of December 2005, issued in January 2006, the European Commission noted that the structural measures outlined in the programme lack the necessary quantifications to judge their short- and medium term effects. Furthermore, according to the Commission the tightening of expenditure by 4 percentage points in 2006 compared to the 2005 budget is not based on clearly defined and quantified measures. In outer years, the shift of motorways investment to PPP´s may again be subject to accounting problems. The projected decline in interest rates may not materialise and there is uncertainty regarding the effects of tax reform, possibly resulting in lower revenues. The Commission concludes that, taking into account the risk assessment, the budgetary strategy in the programme needs to be substantiated to ensure consistency with the correction of the excessive deficit by 2008. For that purpose Hungary the Commission deems it appropriate for Hungary to present by 1 September 2006 at the latest a revised Convergence Programme update that identifies concrete and structural measures that are fully consistent with its medium term adjustment path (European Commission 2006).

The general picture arising from the conduct of fiscal policy in the last few years is that of too much reliance on one-off measures and unspecified savings and too little emphasis on structural reform at the expenditure side. In combination with the subsequent implementation of sizeable packages of tax relief, this has led to a pattern of over optimism about future developments which has been refuted by the facts year after year. This development is illustrated in *figure 3* (taken over from European Commission 2006).

FOCUS ON THE ACTUAL DEFICIT

Hungary has no fiscal rule in the sense of a long-term constraint on fiscal policy[10]. Instead it has committed itself to a reduction path of the factual deficit in the EU convergence programme. As long as the actual deficit is above the Maastricht reference value of 3% of GDP, a reduction of the deficit in the medium term is stated as the first priority.

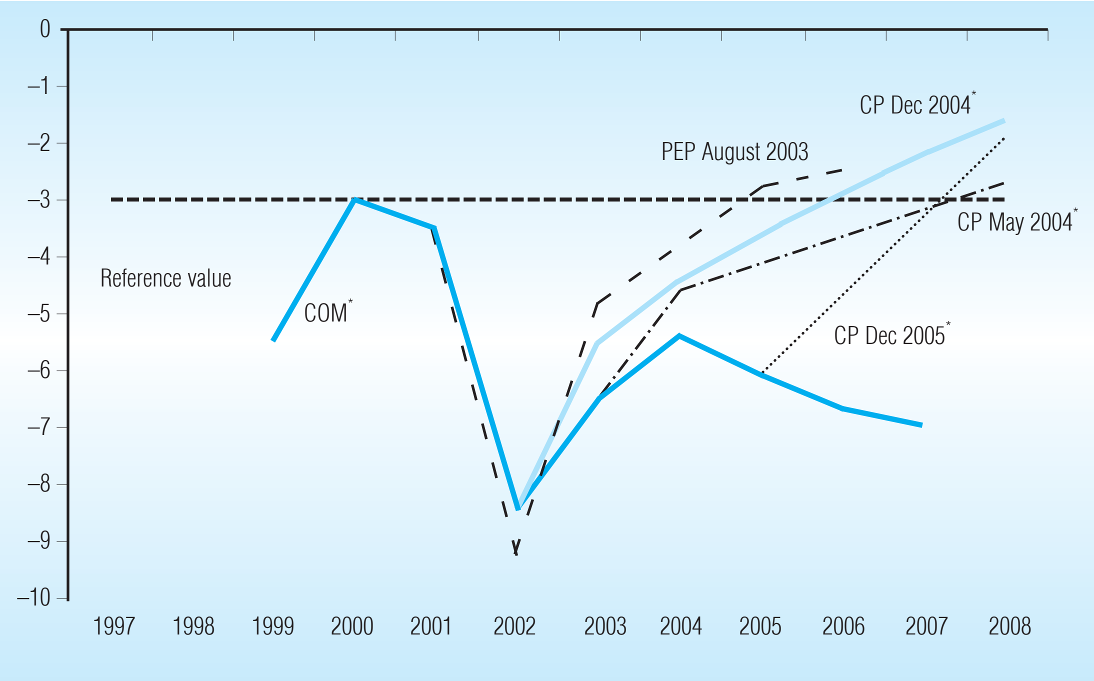
Reduction of the deficit in the medium term does not necessarily mean that budget policy should focus on the actual deficit. This focus has two major disadvantages: (1) it hampers an orderly decision-making process; (2) it hampers automatic stabilization.

The actual deficit is determined by both the expenditure and the revenue side of the budget. The revenue side is almost entirely determined by substantive legislation, namely tax legislation, and the expenditure side is partly determined by substantive legislation, in particular social security and health legislation (entitlements). This implies that forecasts for the factual deficit are permanently moving, not only during the formulation phase of the budget process, but also during the execution phase. Focus on the actual deficit requires therefore that the budget has to be amended often during both phases of the budget process to react on the latest predictions. This hampers an orderly decision-making process and tranquillity in the budget numbers. Moreover, it leads to a volatile fiscal stance that changes from month to month in the light of the latest forecasts.

Figure 3

GENERAL GOVERNMENT DEFICIT FORECASTS IN SUCCESSIVE CONVERGENCE PROGRAMMES

(Per cent of GDP)



CP: Convergence Programme . **PEP**: Pre-Accesion Economic Programme. **COM**: Estimate of the European Commission of the ESA95 deficit.

** Excluding the impact of the 2004 Eurostat decision on the classification of funded pension schemes, which needs to be implemented by spring 2007.*

Source: EC (2006)

Budgetary adjustments motivated by short-term macro-economic fluctuations bring a pro-cyclical element in budgetary policy and hamper the stabilizing effect of the budget. This can be avoided by, for example, using a fiscal rule based on annually appropriated expenditures[11]. Alternatively a cyclically adjusted deficit constraint can be used. However a disadvantage of a cyclically adjusted deficit constraint is that there are arbitrary elements in the calculation of the output gap on which the cyclically adjusted deficit is based. Moreover, the concept of the cyclically adjusted deficit is not always transparent to politicians and the public. Steering exclusively on the expenditure side is more transparent and possibly less susceptible to manipulation[12].

In OECD countries that steer exclusively on the expenditure side, different approaches can be distinguished concerning mandatory spending (on the basis of entitlement laws) at the expenditure side.

In the UK and the US at the time of the *Budget Enforcement Act* (expired in 2002) mandatory spending is exempted from the expenditures ceilings. These ceilings refer exclusively to discretionary spending. This has been motivated by the fact that much of social security spending is determined by macro-economic fluctuations. Exclusion of mandatory spending from the expenditure ceilings can thus contribute to automatic stabilization. In the Netherlands and Sweden on the other hand, mandatory spending programmes are covered by the expenditure ceilings. The main argument for inclusion in these countries is that many entitlement programmes have little to do with macro-economic fluctuations (health, education, disability pensions) and that a ceiling is more effective to the extent that it encompasses a larger part of total expenditures. Including entitlements and other mandatory expenditures under the ceiling forces the government to make policy decisions and prioritise with strict limits for total expenditures. However, it is clear that the latter approach is only viable if budget formulation is focused on the medium term rather than on the upcoming budget year since adjustment of entitlement programmes can only affect expenditures in the medium term.

FOCUS ON THE BUDGET YEAR

Budget formulation in Hungary is focused on the upcoming budget year rather than on the medium term. In accordance with the Act on Public Finance of 1992 multi-annual expenditure estimates at the line item level for three years following the budget year are published, but they do not play a role during budget formulation. Multi-annual expenditure ceilings for the general government budget or its sub sectors (central government, local government, social security funds) are lacking.

International organisations have often recommended to the Hungarian authorities to develop a multi-annual expenditure framework[13]. Although Hungary has never formally announced a medium term expenditure framework in the budget or in policy documents, in fact the EU Convergence Programme, to which the Hungarian Government has committed itself, can be seen as such a framework. The term multi-annual expenditure framework may be used in different ways and it is important to be precise about the practical consequences to be attached to the adoption of an expenditure framework.

Almost all OECD countries presently work with a multi-annual expenditure framework. Most of them adjust the framework from year to year in the light of outcomes of the previous year, new estimates of the consequences of current policies and new political priorities. This can be called a flexible framework. The major advantage of a flexible framework in comparison to no framework is that at the time of budget formulation the multi-annual consequences of all changes (setbacks and windfalls at the revenue and expenditure sides and new priorities) can be traded off against each other and against the adjustment of medium term targets for expenditures, revenues or the deficit.

A few countries, notably Sweden, the UK and the Netherlands have a multi-annual expenditure framework that is not adjusted from year to year. This can be called a fixed framework. It has also been called a fiscal rule for expenditures. A fixed expenditure framework can be rolling like in Sweden and the UK, or it can be periodical like in the Netherlands. In a rolling framework an additional year is added at the end of the sequence of annual ceilings every year (for instance in Sweden in the budget bill for 2007 a ceiling for 2009 is added to the existing ceilings for 2006–2008). In a periodical framework a new sequence of ceilings is drawn up at periodic intervals, for instance at the beginning of every new cabinet period (for instance in the Netherlands a new framework for 2004–2008 was drawn up in 2004 at the beginning of the cabinet period and remains in place throughout the cabinet period). It is characteristic for a fixed expenditure framework that the multi-annual overall ceilings for the general government or for a combination of its sub-sectors (for instance central government and social security funds) can not be changed from year to year. This implies that during budget formulation all line item budget numbers and all line item multi-year estimates have to be squeezed in the overall ceiling over the entire term of the framework. The first major advantage of a fixed expenditure framework in comparison to no framework is identical to that of a flexible framework: all trade offs have to be considered. A second major advantage, also over a flexible framework, is that it is (more) effective in realizing multi-year expenditure targets. Precisely because the overall ceiling can not be changed from year to year, the target is automatically realized as long as the framework is maintained.

Multi-annual expenditure frameworks usually contain not only overall ceilings or broad sectoral ceilings for central government, local government or the social security funds, but also ceilings at the level of ministries or expenditure areas. Ministerial ceilings are important because, once established, they impose a certain discipline on ministers and help to prevent overspending. In the case of a flexible framework the disciplinary effect on ministerial request behaviour is less pronounced than in the case of a fixed framework, but usually not entirely absent because last year's ceiling for the upcoming budget constitutes in any way a clear base line which the Minister of Finance can invoke in budgetary negotiations. In a fixed framework the disciplinary effect is clearly larger, but not so much because ministerial ceilings are not alterable as is sometimes thought. In countries that employ fixed frameworks ministerial ceilings are often changed during budget formulation and sometimes even during budget execution and this is not seen as a loss of discipline. Rather ministerial ceilings are more effective in fixed frameworks because the overall ceiling is not alterable, so that every increase in a ministerial ceiling has to be compensated either in another ministerial ceiling or in another sub sector. Because not many countries have experience with fixed frameworks, this is not always well understood. Indeed, what marks the difference between fixed and flexible frameworks is that under a fixed framework the flexibility that every budget process needs to accommodate setbacks or new priorities is found exclusively in reallocation or in use of a reserve[14], whereas under a flexible framework it can also be found in adjustment of the overall ceiling, possibly in connection with adjustments at the revenue side.

For Hungary the EU Convergence Programme has in previous years functioned more or less as a flexible expenditure framework that is adjusted from budget year to budget year and even during the budget years at the occasion of EDP notifications. However, a crucial element is lacking, namely the adjustment of multi-year estimates at the line item level. It is the lack of this element which is at the root of the volatility and sometimes hectic character of the Hungarian budget process. Policy measures require time to phase in. This is true for new spending programmes as well as for savings measures. In the case of saving measures gradual implementation is often particularly important in view of accompanying measures like social plans, reorganisations or adjustments of entitlement laws. If during budget formulation attention is mainly focused on the upcoming budget year, expenditure programmes tend to be approved and saving measures to be dismissed too easily because their budgetary effects arise only in later years. The main advantage of a multi-annual expenditure framework, whether flexible or fixed, is lost if budget formulation does not focus on the multi-annual line item estimates instead of on line item estimates of the upcoming budget. Government spending programmes in OECD countries have reached levels of size and complexity that it is frequently difficult to make policy changes in the current year that substantially affects next year's budget. *Budget formulation therefore ought to focus entirely on the multi-year estimates, rather than on the upcoming budget. The central task of budget formulation is the harmonisation of multi-year estimates* *at the line item level with the expenditure framework.* Budget formulation focusing on next year's budget will necessarily lead to expenditure plans that are too grandiose (have large consequences after the budget year) and saving measures that are too simple (affect only the upcoming budget year) and hamper transparency: stop gap measures such as cash limits, across the board cuts and accounting gimmicks. This has been typical of the Hungarian budget process over the previous years.

Expenditure frameworks bring discipline to the expenditure side of the budget, but not to the revenue side. In particular they tend to favour new tax expenditures (tax exemptions and tax credits) which are not affected by the multi-annual ceilings and which can often substitute for subsidies. Even if it is acknowledged that tax expenditures are a policy instrument in their own right[15] and that under special circumstances they may be preferable to subsidies, it is important that they be subjected to budgetary discipline. There are two approaches to budgetary discipline at the revenue side: coordination with expenditure ceilings and revenue floors. Many OECD countries have made progress with the first approach, few with the second. Both approaches are not mutually exclusive but may strengthen each other.

The idea of coordination with expenditure ceilings is that certain policy changes with respect to revenues are brought under the expenditure ceilings. The most straightforward application of this idea is the inclusion of non-tax revenues under the expenditure ceilings. The ceilings are then defined in terms of net expenditure, namely gross expenditure minus non-tax revenue. This is practiced in many OECD countries that use multi-annual frameworks. Net expenditure ceilings open the possibility for ministries to off-set expenditure measures with non-tax revenue measures. This makes it easier to comply with the ceilings and extends budgetary discipline to the non-tax revenue receipts. It requires however a careful demarcation of tax and non-tax revenues, because burdens on the private sector that do not create claims to concrete public services on the part of citizens should not be counted as non-tax revenues (cases of doubt mainly occur in the area of environmental levies/fees).

Recently most OECD countries have also started to publish lists of tax expenditure estimates in their annual budget documents with a view of coordinating these estimates with expenditure estimates. Some countries have also wholly or partly moved the oversight of tax expenditures from the tax policy division of the Ministry of Finance to the expenditure division (the Netherlands, Sweden, the US). However, the countries that subsume entitlement legislation under the ceilings (the Netherlands and Sweden), have so far not brought tax expenditures (which are also entitlements) under the ceilings. Since most tax expenditures are more sensitive to macro-economic fluctuations than most expenditure entitlements, it can be argued that excluding tax expenditures from the ceilings makes sense from the perspective of stabilization. This is no to say that tax expenditures should not be estimated and published in the budget. Estimation of tax expenditures contributes to transparency and helps to prevent inefficient or inappropriate use of this policy instrument even if the estimates are not brought under the ceilings.

The second approach to budgetary discipline at the revenue side is revenue floors. This involves the annual publication of multi-annual estimates for tax estimates on the basis of current legislative tax policy[16] and the introduction of a compensation requirement on all legislated changes. This existed in the US under the *Budget Enforcement Act* (until 2002) and presently in the Netherlands. From budget year to budget year, every change in the tax estimates over the medium term that originates in change in the tax laws is subject to a compensation requirement (in the US within the entire sector of entitlement legislation including the expenditure side, which was exempted from the expenditure ceilings). Autonomous changes in the estimates flowing from macroeconomic fluctuations do not need to be compensated. In this way tax floors bring budgetary discipline to the revenue side of the budget without impairing automatic stabilization and tranquillity in the budget process.

Ministerial expenditure ceilings should annually be corrected for inflation. For this purpose ceilings have to be defined in real terms and to be inflated from year to year with the general GDP deflator[17].

Multi-annual expenditure frameworks, whether fixed or flexible, can only be effective if care is taken in the definition of the coverage of the ceilings. This is particularly true for EU countries where the framework also serves the purpose of keeping the budget within the limits of the EU Stability and Growth Pact. The EU prescribes the application of ESA95 bookkeeping rules for the purpose of calculating the deficit (the "Maastricht deficit"). Most EU countries authorize the budget in cash terms, often making use of the bookkeeping rules of the General Financial Statistics (GFS86). However, in practical terms there are only a few differences between both systems and these can relatively easily be taken into account.

On the expenditure side the main differences between ESA95 and GFS86 are cash shifts, interest expenditures and long term contracts. Cash shifts (postponement of payment or advance payment) are to be avoided in any case and should not be allowed by the Ministry of Finance even if the expenditure ceilings are defined in cash terms[18]. Corrections for interest and long term contracts (for instance purchase of aircraft or ships) regard only a few line items and can be presented to the Parliament in an extra-budgetary account if the government prefers to stick to cash ceilings. This requires of course that the cash expenditure ceilings are set up in such a way that the corrections do not endanger the deficit constraint on the ESA95 deficit. However, in view of the confusion that an extra budgetary correction account might create, there is much to say for the idea to define the ceilings in ESA95 terms to begin with, or, which amounts to the same, to define only the expenditures for interest and long term contracts[19] in ESA95 terms, whereas the rest can remain in cash terms (since for that part GFS86 and ESA95 terms are equal). It might seem that formulating ceilings (and estimates) partly in cash terms and partly in ESA95 terms is not entirely consistent, but in view of the fact that the ESA parts of ceilings and estimates are typically only a small part of the budget and that cash is generally better understood than ESA95, it might still be practical to proceed in this way.

If ceilings are defined in terms of net expenditure, one-off financial transactions, which generate revenue or lower expenditure by alienation of government assets, should be kept out of the ceilings. This applies to privatisation proceeds, sale of stock in public enterprises, sale of land or real estate and financial lease. One off revenues of this nature should not be balanced with expenditures or should lead to one-off reduction of the ceilings (for instance if purchase is replaced by financial lease, leading to postponement of the acquisition of property rights).

As to tax revenues the European authorities are generally satisfied with very simple measures to turn cash into ESA95 estimates. For instance, a one month backward shift of cash estimates for VAT, sales and excise tax revenues will do. The European authorities accept cash estimates for the income tax, the succession tax, the corporate tax and the dividend tax as ESA95 estimates. This implies that if a country wishes to work with tax revenue floors, again both approaches are possible: either define the floors in cash terms and account for the corrections in a extra budgetary account or define the floors themselves in ESA95 terms or, which amounts to the same, define only the VAT, sales and excise receipts in ESA95 terms whereas the rest can remain in cash terms (since for that part GFS86 and ESA95 terms are equal). Recall that revenue floors only constrain legislated tax changes (not revenue shortfalls due to macro-economic conditions) and that using floors partly in cash terms and partly in ESA95 terms may be practical for domestic purposes (while the estimates are accepted by the EU as ESA95 estimates).

NO CLEAR RULES OF BUDGETARY DISCIPLINE

A multi-annual expenditure framework, whether flexible or fixed, can only function effectively if it is accompanied by clear rules of budgetary discipline. These rules require that all setbacks or new spending initiatives that violate the ceilings are compensated. In Hungary, clear rules of budgetary discipline are presently lacking.

Budgetary discipline requires that the multi-annual overall ceilings are maintained. In particular the overall ceilings (for year t to t+*n*) of a *flexible framework* have to be maintained from the moment they have been adjusted or confirmed during budget formulation (in year t–1) until they come up for adjustment or confirmation during budget formulation in the next year (t) and the overall ceilings of a *fixed framework* have to be maintained from the moment they have been established, usually during budget formulation (in a year previous to t–1) until the end of the budget year to which they apply. Furthermore, working on the basis of a multi-annual expenditure framework means that during budget formulation first decisions have to be taken on the multi-annual (overall and) ministerial ceilings and that subsequently the decisions on budgetary and multi-annual line item estimates have to comply with the ceilings (top-down budgeting). Ministerial requests can play a role in the determination of the (overall and) ministerial ceilings, but after the ceilings have been decided, they have to be maintained rigorously.

Rules of budgetary discipline ought to be precise about the treatment of mandatory spending (spending required by entitlement laws). If (some forms of) mandatory spending are subsumed under the ceilings, the general principle can be that setbacks have to be compensated and windfalls are available for new spending initiatives. However, it is recommendable to specify that windfalls can only be used for new spending initiatives with approval of the Government or the Minister of Finance, so that they can possibly be used to compensate for setbacks in other budget chapters (leading to reallocation of ministerial ceilings under the overall ceiling).

In the stage of budget formulation, rules of budgetary discipline ought to apply not only to decisions about the budget in a strict sense, but to all decisions of Ministers or the Government with budgetary consequences. Policies are decided throughout the year and mostly disconnected from the budget process. This is the case in all OECD countries and there is nothing wrong with that. What is important though, is that the budgetary consequences of these decisions are compatible with budgetary policy. For that purpose it is essential that each policy proposal with budgetary consequences submitted to the Government at any time of the year is accompanied by information, preferably in a standard form, describing how the budgetary consequences of the proposal are reconciled with the multi-annual ministerial expenditure ceilings either through reallocation under the ceiling or through use of windfalls under the ceiling. In addition it is essential that ministerial policy decisions that do not need the approval of the Government, but that nevertheless have budgetary consequences are brought to the attention of the Minister of Finance, accompanied by information on reconciliation with the ministerial expenditure ceiling, before they are implemented.

Rules of budgetary discipline ought to apply also to the stage of budget execution. Policy decisions of ministers or of the Government that affect budgetary estimates during the execution year ought to be accompanied by information about the reconciliation with the ministerial ceiling in a similar way as during budget formulation. This requirement is not a duplication of the normal controls by the Ministry of Finance and the Treasury on spending during budget execution as regulated by the budget system law. Indeed, in Hungary the Act on Public Finance leaves more leeway to overspending than rules of budgetary discipline ought to do. The role of rules of budgetary discipline during budget execution is not to stiffen the budget or to hamper flexibility, but rather to spell out more precisely the compensation requirements. Indeed to the extent that the rules of budgetary discipline are more effective, the legal requirements of the Act on Public Finance could eventually be loosened somewhat. This would lead to more, rather than less flexibility during the execution year.

Information on the budgetary consequences of policy decisions during budget formulation and budget execution enables the Minister of Finance to update the budget and multi-annual estimates permanently throughout the budget cycle. In this way the policy making process becomes better integrated with the budget process and the annual budget formulation decisions in the proper sense become more focused on the small part of the budget where trade-offs have to be considered. This typically impacts only a very small part of the budget.

If Hungary would decide to move towards a multi-annual expenditure framework, it is recommended that the rules of budgetary discipline are clearly specified and explicitly endorsed by the Government in connection with the framework itself. It is also recommended that the rules of budgetary discipline are published, widely dispersed and brought to the attention of the Parliament.

Budgetary discipline is also important for Parliament. In some countries Parliament has issued standing orders that require compensation on all amendments to budgetary or other bills that have budgetary consequences. If, or as long as, such parliamentary compensation requirements are lacking, it is recommended that ministers are made responsible for the compensation of the budgetary consequences of parliamentary amendments to bills in their portfolio.

Rules of budgetary discipline can only be effective if they are scrupulously maintained and enforced by the minister of Finance and the Prime minister. In the case of Hungary the most natural division of tasks may be that the minister of Finance is made responsible for the formulation of the rules and the permanent updating of the budgetary and multi-annual line item estimates in accordance with the rules. In cases of non-compliance that can not be solved at the level of bilateral contacts between ministries, the minister of Finance should contact his colleague or ultimately bring the matter to the attention of the Prime minister. Ultimately, rules of budgetary discipline and, by implication, multi-annual expenditure frameworks can only be effective if the Prime minister is committed.

LACK OF TRANSPARENCY CONCERNING FORECASTS AND OUTCOMES

In the beginning of the year, the Ministry of Finance makes macroeconomic forecasts and tax revenue estimates for a three year period.

There are no fixed procedures in which external partners are involved. Consultation takes place on a case by case basis. In practise however, the publication of the forecasts enables various external think tanks to comment. The Ministry compares its forecasts with those of national and international banks. There are also consultations with the Hungarian Central Bank about the forecasts. The estimates are updated quarterly and when there are major changes in assumptions. Thus revisions are made when the national accounts are finalised, when more detailed assumptions about entitlement programmes are submitted by line ministries, and when major policy changes take place. The Ministry of Finance uses an economic model, but there is a lack of long and stable time series on which to estimate the basic relations, as in many formerly communist countries.

The Central Bank has for a number of years also published its forecasts for the coming year and the effects of the general government budget. Differences with the government forecasts can partly be explained by the fact that the detailed assumptions for calculating government expenditure are not published by the Ministry of Finance, making it hard for outsiders to identify the crucial factors and questionable assumptions. For instance, the detailed assumptions concerning consequences of new initiatives such as improved tax collection are not made public. An effort to increase transparency would contribute to meaningful public discussion about the forecasts. Further sensitivity analysis and transparency about uncertainty margins might also contribute to the quality of the forecasts.

In general there have been quite substantial forecasting errors in Hungary in the past few years. These occurred mostly at the revenue side of the budget and were a major cause of deficit overshooting. Improvement of transparency concerning assumptions and methodologies ought to be a first priority in this respect, since forecasting methods can only evolve if they are openly discussed in the public domain. Another top priority should be to publish separate forecasts for the various tax expenditures. In general tax expenditures forecast require separate methodologies as their determining factors are different from those of tax revenues in general.

In order to strengthen economic forecasting and public debate it might be useful to establish an independent organization for this purpose, as seen in Slovenia, Sweden, the Netherlands and the US, and is being considered in Canada and other OECD countries. Although financed by the Government, these organizations have generally been able to withstand political pressure. They operate in a strong academic environment and generate public interest in the matter. Alternatively a standard procedure for consultation with external partners and private sector institutions could be worked out. Both alternatives have to be accompanied by a more detailed disclosure of assumptions and methodologies.

The State Audit Office publishes its own analysis of the macroeconomic assumptions and forecasts, and criticises concrete estimates of expenditure if they are not deemed realistic. The State Audit Office does not, however, calculate alternative macroeconomic forecasts. There is a continual debate between the State Audit Office and the Ministry of Finance concerning these issues in the time leading up to the presentation of the budget to the Parliament.

The Hungarian budget has a strong and detailed input-focus, as in many other countries. Plans are being developed for a new framework for the state budget that is more output oriented and that will allow more use of performance information. It should be noted, that most OECD countries have opted for a pragmatic and gradual approach to the use of output information. Output-oriented account reclassification is a first step that does not require the abolition of all input controls. Reclassification would have to result in a substantial reduction of the number of line items. Presently the number of budget titles in Hungary is already 2100 and the number of line items could be a multiple of that number. Output-oriented reclassification could reduce the number of line items to less than 30 per chapter.[20] Such a reform would not only contribute to a more output oriented budget process but also to the transparency of forecasts and outcome data. Output-oriented account reclassification provides benefits for focus on results and for financial planning within the ministry and government at large, but does not necessarily require performance measurement. Experience shows that political interest in performance information proceeds at a measured pace.

CONCLUSIONS

In the light of international best practice the Hungarian budget formulation process has some features that make it particularly vulnerable to overspending and revenue shortfalls. These features are (1) the focus on the actual (non-cyclically adjusted) deficit, (2) the focus on the budget year, and (3) the absence of clear rules of budgetary discipline. The resulting problems are confounded by a lack of transparency concerning forecasts and outcomes.

Focus on the actual deficit hampers an orderly decision-making process and hampers automatic stabilization. For medium term deficit reduction it is not necessary that short term macro-economic fluctuations lead to budgetary adjustments. Alternative approaches are to use a cyclically adjusted deficit or to control the expenditure side of the budget exclusively. Focusing on the expenditure side is more transparent and possibly less susceptible to manipulation. In OECD countries that control the expenditure side different approaches can be distinguished as to whether mandatory spending (based on entitlement laws) is wholly or partly subsumed under the expenditure ceilings. It is clear however, that mandatory spending can only be subsumed under the ceilings if budget formulation is focused on the medium term, rather than on the upcoming budget.

Focus on the budget year implies that during budget formulation attention is diverted from structural policy measures with effects in later years. Although Hungary tries to adhere to a multi-annual deficit reduction path as specified in the European Convergence Programme, the main advantage of a medium term approach is lost if budget formulation does not focus on the multi-annual line item estimates instead of on line item estimates of the upcoming budget. Government spending programmes in OECD countries have reached levels of size and complexity that it is frequently difficult to make policy changes in the current year that substantially affects next year's budget. Budget formulation therefore ought to focus entirely on the multi-year estimates, rather than on the upcoming budget. In countries that use a multi-annual expenditure framework, the central task of budget formulation is seen as the harmonization of the multi-annual line item estimates with the multi-annual ceilings of the expenditure framework. Budget formulation focusing on next year's budget will necessarily lead to expenditure plans that are too grandiose (have large consequences after the budget year) and saving measures that are too simple (affect only the upcoming budget year: stop gap measures such as cash limits, across the board cuts and accounting gimmicks). A medium term orientation of budget formulation can further be enhanced by bringing non-tax revenues under the multi-annual expenditure ceilings and by the use of tax revenue floors.

Rules of budgetary discipline require that all setbacks or new spending initiatives that violate expenditure ceilings or revenue floors are compensated. Rules of budgetary discipline ought to be precise about the treatment of mandatory spending (spending required by entitlement laws). If (some forms of) mandatory spending are subsumed under the ceilings, the general principle can be that setbacks have to be compensated and windfalls are available for new spending initiatives. In the stage of budget formulation, rules of budgetary discipline ought to apply not only to decisions about the budget in a strict sense, but to all decisions of Ministers or the Government with budgetary consequences, regardless when they are taken. Rules of budgetary discipline ought to apply also to the stage of budget execution. If Hungary would decide to move towards a multi-annual expenditure framework, it is recommendable that the rules of budgetary discipline are clearly specified and explicitly endorsed by the Government in connection with the framework itself. It is also recommendable that the rules of budgetary discipline are published, widely dispersed and brought to the attention of the Parliament.

In general there have been quite substantial forecasting errors in Hungary in the past few years. These occurred mostly at the revenue side of the budget and were a major cause of deficit overshooting. Improvement of transparency concerning assumptions and methodologies ought to be a first priority in this respect, since forecasting methods can only evolve if they are openly discussed in the public domain. Another top priority would be to publish separate forecasts for the various tax expenditures. In general tax expenditures forecast require separate methodologies as their determining factors are different from those of tax revenues in general.

The Hungarian budget has a strong and detailed input-focus, as in many other countries. Plans are being developed for a new framework for the state budget that is more output oriented. Output-oriented account reclassification could be a first step that does not yet require the abolition of all input controls. Output oriented reclassification could reduce the number of line items to about 30 per chapter.

Notes

[1] Excluding FISIM allocation. In October 2005 the Hungarian Central Statistical Office published for the first time revised national accounts figures including the sectoral allocation of financial intermediation services indirectly measured (FISIM). This change consists in breaking down interest paid to banks and other financial intermediaries by each sector in 'pure' interest and the implicit price of financial intermediation. From then on the latter is registered as consumption of services. This is in accordance with new ESA accounting guidelines. As a result the, the GDP series is slightly revised upwards, similarly as in other states. For 2004 the real GDP growth has been revised from 4.2% to 4.6%. For 2005 to 2008 the sectoral allocation of FISIM is expected to increase the real growth rates by 0.1 to 0.2 points per year. The present table uses the EU numbers of December 2005 that do not yet include the FISIM allocation for Hungary.

[2] The year 2002 was an election year. Research by the IMF has shown that the pattern of strong deficit increases in election years has existed in Hungary since the beginning nineteen nineties, with peaks of more than 10% and more than 7% in previous election years 1994 and 1998, partly due to one-off measures, debt assumptions, etc. (IMF 2005).

[3] The tax package included: tax-free provision for development and accelerated depreciation, reduced health care contributions, simplified entrepreneur-

ial tax for small enterprises, tax-free threshold for self-employed, tax exemption up to minimum wage, tax bracket increases, tax benefits on adult education, computer equipment and internet connection, increase in the private pension fund membership fee, increase in the insurance tax credit, abolition of tax liability on exchange markets, preferential taxation for those in an approved "Employee Securities Benefit Programme".

[4] All zero rated goods and services were moved to a 5% rate, the 12% rate increased to 15%, the rate on books lowered to 5%.

[5] Marginal rates were reduced from a schedule of 20%, 30% and 40% to a schedule of 18%, 26% and 38% and bracket ceilings were increased in excess of household income increases.

[6] Health care contributions of employees were increased by one percentage point, the tax credit on pension employee contributions was abolished, the 40% tax deduction on mortgage payments was reduced, the tax credit on investment was abolished.

[7] There is a large difference between the ESA95 and GFS86 deficits in the 2004 budget due to a changeover in the method of collecting VAT on imported goods. From May 2004 onward the system of VAT collection by the Customs Authority using case-by-case assessment methods was replaced by a monthly self-declaration and payment system run by the Tax Office. This system resulted in a shift of about one and a half month in cash collections and a revenue shortfall in cash terms estimated at HUF (Hungarian Forint) 220 billion. Under ESA95 this revenue shortfall is not registered.

[8] A temporary surtax on the profit of financial institutions, some measure in the VAT on telephony purchases, an increase in the tax on car registration, a cap on tax allowances for households.

[9] See note 13. Although under ESA95 the cash shift in VAT payments is not registered, it was supposed that the measure would still improve the ESA95 deficit because of "tighter tax-declaration discipline".

[10] See the definition of a fiscal rule proposed by Kopits and Symanski (1998) which states that a fiscal rule is "a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance".

[11] Allowing deficit fluctuations originating in tax revenues (and entitlement programmes) makes the budget acyclical rather than anticyclical. Attempts at anticyclical (Keynesian) budgetary policy have generally been given up by OECD countries since the nineteen eighties.

[12] Anderson, Minarik, (2006)

[13] For instance in: OECD (2002); IMF (2004), OECD (2005a)

[14] Sweden has a reserve under the overall ceiling which is used to accommodate new developments. This reserve can be used instead of reallocation between ministries.

[15] Tax expenditures are often seen by budget officials as a form of undesirable "back-door" spending. However, in a 2004 report for the OECD Working Party Senior Budget Officials it has been argued that a tax expenditure is sometimes preferable to a subsidy. Tax expenditures can be seen as policy instruments in their own right, which ought to be subjected to disciplinary discipline rather that to attempts at abatement (Kraan, 2005).

[16] Current legislative tax policy is current tax law plus changes in tax law decided but not yet implemented.

[17] Inflation with the GDP deflator leads to some automatic redistribution between programme sectors because price and wage deflators differ per programme sector. An alternative approach would be to inflate the ceilings from year to year with sector specific deflators. However, these deflators can to some extent be influenced by policy and would adversely affect the incentive for wage and purchase price restraint. For this reason the Netherlands follows the approach to inflate the ceilings with the expected sector specific deflators at the moment they are established, deflate them back to ceilings in real terms and subsequently inflate them again from year to year with the GDP deflator. This procedure limits the automatic redistribution from year to year to the difference between the expected and real programme deflators which is negligible.

[18] An example in Hungary was the treatment cash payment of the 13 month salary to civil servants

in January which in one year was attributed to December and in the next year to January, so that in the year in between there was no 13 month payment.

[19] According to ESA95 payments for long term contracts have to be booked at transaction time, which is the time of delivery (not the time of the contract). In most long term contracts payment has also to start at the time of delivery, so that even for long term contracts there is not much difference between GFS86 and ESA95.

[20] In the Netherlands a major output-oriented reclassification exercise has reduced the number of line items per chapter to less than 30.

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Program budgeting

Characteristic features and practical experiences

Incremental budgeting, i.e. the chapter based budgeting mechanism that groups expenditure items mostly according to the administrative classification – and is also used in Hungary – is suitable for the detailed planning of expenditures and the itemised control of their implementation. However, it is not suitable to measure the quantity and quality of products and services that were generated through the expenses, or the absolute and relative costs involved. In its reports the State Audit Office of Hungary has several times called for the application of modern budgeting techniques in the Hungarian system of public finances. One of these techniques is the so called program budgeting. Based on the available international experience and the presented case studies, the main purpose of this article is to promote the comprehensive application of program budgeting in Hungary. However, we cannot omit mentioning the theoretical background of some of the correlations.

THEORETICAL BACKGROUND

It has been increasingly demanded that the state should give up – as much as possible – its substantial active economic role typical for welfare mixed economies and should return to its original functions. This is all the more necessary because in many countries the priority of the redistribution function and the expansion of the economic ventures of the state have many times interfered with the fulfilment of the traditional functions (the so called core functions). This is why the allocative function of the state is given more and more emphasis. This function of the state intervenes into the allocation of resources in a manner different from the one used by the market, with a view to generate collective goods more efficiently than with the market method.

This means that the allocative function is designed to deter market losses, wherefore it is gaining importance not only in the developed, but also in the emerging countries.

According to *Tanzi*[1], in less developed societies economic inequalities are determined by the mainstream social norms and the possession of real assets in contrast with the modern, developed societies, where the key role is that of human capital, and where the main source of income is work rather than property. As a result, the emphasis must be placed – in less developed countries, too – on the production of collective or semi-collective goods (on education in the first place), i.e. on the allocative function of the state. It must be understood that the concept of collective goods (which apart from purely collective goods includes other groups of goods, such as goods subject to fee payment, goods of common stock and meritoric goods, too[2]) covers a group that keeps changing both in space and time. In these countries excessive state intervention is also contra-indicated by the fact that the tax revenues are much smaller because of the smaller per capita GDP, wherefore a large state structure would fulfil its function *a priori* less efficiently.

Judging from the theoretical background of the method, the planning/reporting technique and institution financing method called program budgeting was devised to fulfil the allocative function of the state, and is basically supported by two, primarily microeconomic concepts: Firstly, state institutions also generate goods (collective goods), i.e. their operation must be developed keeping this in mind. Secondly, it has been recognised that the inadequate efficiency of state institutions is usually due to the principal-agent type system of relations. Consequently, the starting point for program budgeting is the identification of the collective goods to be generated and/or the related tasks and outputs. On the other hand, it tries to establish a system of responsibilities that is able to reduce the inefficiency arising from the principal-agent phenomenon.

PRINCIPLES

Program budgeting is a performance (output) based budget planning, executing and auditing system, or rather process, which directly links the funding of the budgetary organisation to the results achieved by said organisation, the generated "products" and services.[3] In this system the budgetary needs of an organisation include not only the resources planned to be received, but also those "products" (outputs) and results (outcomes) that are expected to be generated from the resource allocated to that organisation. The decision-maker sets performance objectives for the outcomes and outputs, and determines the size of the funds to be allocated for the task based on the costs of production, and transfers such funds to the selected organisation. This can happen in the form of the purchase of the produced outputs and results (outcomes) by the decision-maker from the organisation or (another entity).

This means that funding is linked to performance. The customer, in this case the government, sets performance objectives, and decides about the extent of funding in the light of the required costs. In contrast with this, the traditional budgeting system is only capable of planning and of inspecting implemented expenditures. *Figure 1* shows the difference in the logic of the two planning systems.

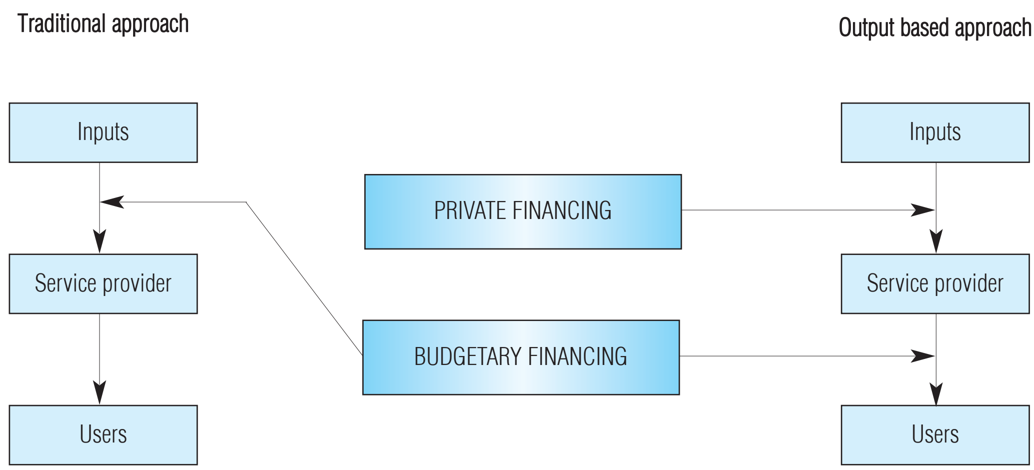
Three stages can (must) be distinguished in the modern program budgeting technique.

❶Planning: comprehensive, strategic, long-term objectives must be set. The social policy objectives must be thoroughly worked out and quantified, because they cannot be interpreted by themselves for program budgeting (e.g.: instead of "the quality of healthcare must be improved!" we should say "the mortality rate or the number of days spent on sick leave must be reduced"). It must also be determined what social groups are covered by the different objectives, and what alternatives can be used to attain these objectives. Briefly: what and how the government wants to achieve?

❷Programming: the objectives of the planning stage must be classified under programs, which are then decided about by the competent decision-making authority. As far as possible the most ideal one must be selected. This process is best suited by the cost and profit assessment. The program categories (broad priorities) are usually selected by the government, while the priorities can be optimised by the competent ministries. A good decision requires an adequate information system. In many

Figure 1

THE DERIVATION LOGIC OF THE TRADITIONAL AND PROGRAM BUDGETING SYSTEMS



places the PPBS method was forced to be given up for the lack of such a system.

❸Budgeting: the program appropriations are broken down annually by organisational units and the responsibilities pertaining to the individual programs. This is actually the most difficult task, since the concrete duties for the given budget year must be determined on the basis of multi-year programs. In this stage it might pose a problem if one program is supervised by more than one entity, if the persons in charge of the program form another responsibility organisation, too, apart from the organisational structure. The two structures may conflict each other, causing information disturbances or the clash of organisational interests. To forestall this problem, efforts are made to unify the two systems of responsibility.

Program budgeting must be integrated into a broader model of budget management, i.e. governmental services must be redefined in a much more outcome oriented manner. Based on the pioneering experience of a few developed countries, the most efficient approach for this is the thorough consideration and enforcement of responsibility (accountability) relations within the public sector:

- performance itself, the content, qualitative and quantitative characteristics thereof and the conditions for service supply must be determined in a manner so that they can be applicable by the organisational leaders in charge of budget management;
- instead of the stringent regulation of inputs, budgetary organisations must be given greater managerial autonomy and freedom, so that they could decide how the set objectives can be most efficiently achieved;
- the system of incentives and sanctions applied to the organisational leaders must be modified.

In many countries reorientation from the old concept towards the new, top-down one entailed profound consequences, since the precise definition of the collective goods and governmental activities to be provided triggered a major reduction of the public sector, and certain public finance reforms in many cases. The consequences included the restructuring of the relationship between the government and the private sector, which meant – among other things – that the government's role has been significantly curtailed in the regulation of certain private sector activities.

On top of all that, the government increasingly borrowed private sector techniques to plan and provide governmental services. One of these techniques is strategic planning, which is not identical with the traditional method used for the preparation of the state's development plant. The consistent example of strategic planning is the solution applied in New Zealand, i.e. a three-stage process implemented top-down.

❶First of all the sustainable level of state activity must be determined. Sustainability must be considered for the long run (too), albeit strategic planning must be implemented at least for a medium-term timeframe.

❷In the next step the most important tasks to be performed must be determined (strategic result areas). Keeping in mind the requirement of long-term sustainability, too, these areas of strategic importance mostly focus on the generation of collective goods (education and further training, national defence, etc.).

❸In the third stage of planning these major activities must be translated into action plans for all organisational units.

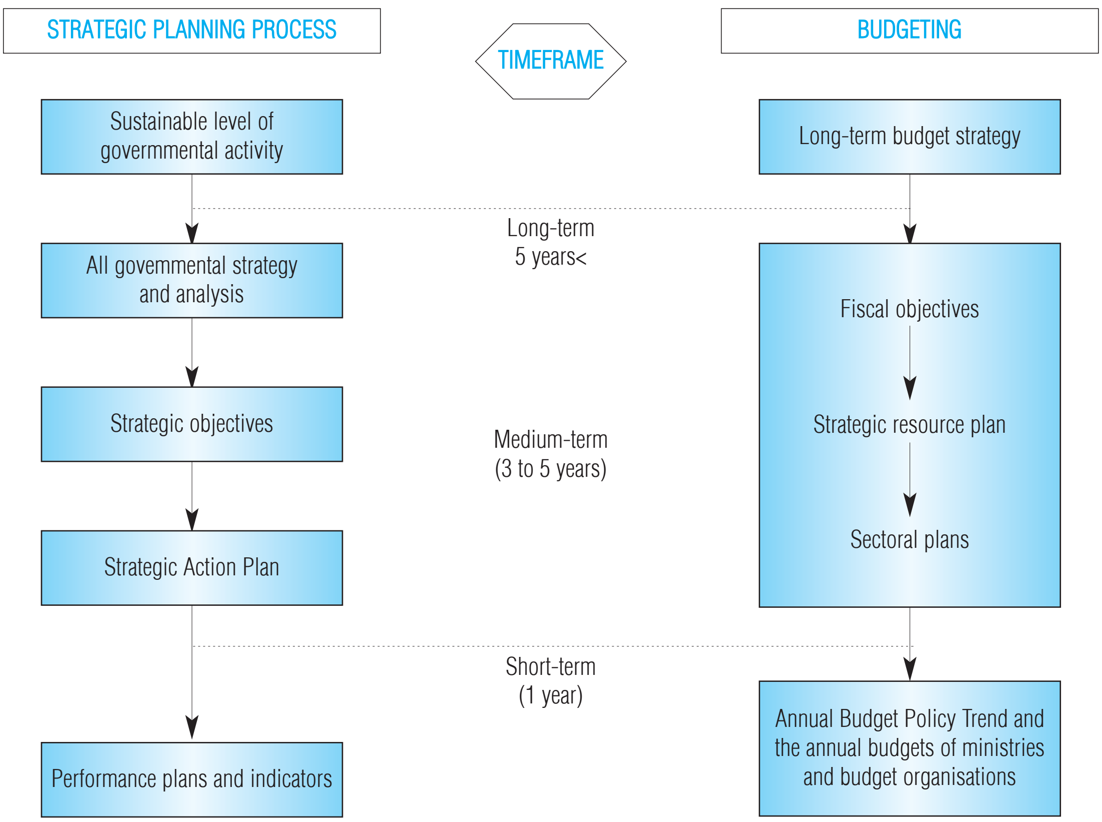
Figure 2 illustrates the relationship between strategic planning and top-down budgeting.

INTERNATIONAL EXPERIENCES

The pioneers of performance oriented budgeting techniques were overseas Anglo-Saxon countries, however such techniques were later

Figure 2

THE RELATIONSHIP BETWEEN STRATEGIC PLANNING AND TOP-DOWN BUDGETING



incorporated into the European practice, too. Without giving a comprehensive description of this process, which was characterised by advances and setbacks, we first review in detail the major characteristic features of the public finance reforms in New Zealand, and then more concisely those of the Spanish and French public finance reforms. Finally, we provide a summary of a few general experiences, and then discuss the Slovak experience in a little more detail.

The public finance reform in New Zealand

The reform in New Zealand crystallised in the decision-makers along a chain of ideas similar to those described at the beginning of this article[4]. In line with this: in relation to the state functions the emphasis should be shifted to the old "core function" and the allocative function, and the generation of public goods. The production of all goods that are closer to the private goods on the public goods-private goods scale[5] must be preferably left to the private market. Public goods production by the state also needs to be reformed due to the special conditions pertaining to the supply of and demand for collective goods. The reform in New Zealand focused on increasing the efficiency of the supply side. It did so for a good reason, since the demand for collective goods can hardly be revealed. Yet, an effort was made to improve efficiency on this side, too: the 1993 reform of the election law. As a result, the Anglo-Saxon electoral system, which consisted of single-seat, "first past the post" constituencies was replaced by a mixed system – similar to the Hungarian one – consisting of multi-seat, party list constituencies. In this system the chances are much slimmer for the majority to become over-represented in the House of Representatives, wherefore it often happens that a government can only be established through coalition. This means that a wider consensus is required for decision-making in important issues, which yields voting results closer to the Pareto optimum.

Naturally, the reform of the supply side was much more elaborate, accentuated and comprehensive. The methods applied here are sometimes referred to as state functions coupled with market conditions. From the theoretical point of view this is nothing more than the development of such efficient principal-agent sample agreements, i.e. the application of such efficient incentive mechanisms that create market-like relationship between the participants.

The Government of New Zealand faced serious macroeconomic problems in the first half of the 1980s: inflation jumped to 15% in 1982 from the 10% measured two years before. As a consequence, the Government froze all prices and incomes in the economy by law. This measure reduced inflation in the short run, but distorted relative prices, caused hidden inflation, and made it even more difficult to plan and implement fiscal and monetary policies. Governmental expenditures grew from 28% (1970s) to 41% of the GDP, while the budget deficit grew from 1% (early 1970s) to 9% of the GDP by 1984. Gross state debts reached 64% of the GDP, and a further rise could be anticipated due to the large fiscal deficit. Unemployment grew from a negligible level in the 1960s to 7% by 1983, while 31% of the employees worked in the state sector. During 1984, increasing speculation could be witnessed against the national currency, and the defeat of the governing National Party at the general elections held in July caused a currency crisis. The country's credit rating deteriorated from AAA to AA.

Naturally, stabilisation efforts were made earlier, too, however they did not yield long-term success. Since two thirds of the deficit composed of structural deficit, the decision-makers realised that the permanent success of adjustment could only be guaranteed if structural (micro) reforms were implemented, too. It was proposed that the state's role in the economy and society should be redefined. This meant that the need for efficient market coordination was recognised again. It was realised that market conditions should be extended to as many functions as possible, i.e. the state should be redirected to fulfil its core functions and allocative functions.

The reform was implemented from 1984 through the mid 1990s, throughout four election cycles[6]. First of all, the majority of rules and restrictions hindering free market processes were gradually demolished. On an imaginary scale the officials involved in the reform tried to determine to what extent the goods and services provided by the state were public goods.[7] Institutions that provided services deemed to represent private or semi-private goods were spun off from the central government and were transformed into companies operating according to market principles, and as many of such companies were privatised as possible. The production of only those collective goods was left to the central government that could not be marketised at all, or could have been done so only at the expense of great market losses. Based on the experiences and theoretical relations – after the low efficiency of bureaucratic institutions and the success of corporatised companies was realised – the management and funding of the government was restructured in the late 1980s.

Prior to the reform of the central government, the country was run by an input-financing bureaucratic system that regulated everything centrally to the tiniest detail. In the middle of the 1980s the following problems were thought to be the most urgent ones:

- the designation and objectives of the departments and ministries were not clearly defined;
- the responsibilities of the politicians and public officials, including the accountability relations, were not unambiguous;
- the ministers managed everything to the tiniest detail, they made concrete decisions regarding the internal management of the departments although they hade neither sufficient information, nor adequate incentive mechanisms;
- there were no adequate tools to sanction low performances.

During the elaboration of the new operational structure the following happened from the theoretical point of view: the roles in the politician-public official (principal-agent) relationship, as well as the objectives and tasks of the participants were clearly defined, the asymmetry of information, which made the principal-agent relationship problematic, was reduced to the minimum, and assignment contracts containing efficient terms and conditions (incentives, sanctions) were formulated.

In reality, the fiscal bureaucrats implementing the reform believed that that the major sources of the problems in the community sector included annuity-hunting, and the capture of the department by itself or by external entities. This is why it was thought that assignment contracts should be made efficient by applying market conditions and political decision-making should be separated from implementation, i.e. production (input-output separation). As a result, political decision-makers can act as consumers who sign contracts with departments and ministries producing public or semi-public goods, and which must compete with other suppliers. The emerging customer-seller relationship and the competition will create market-like conditions. However, this functions well only when supported by an efficient controlling mechanism, and the underlying social publicity and openness. This is why, after presenting the steps of market creation, the controlling and reporting requirements designed to maintain the operation of the market must also be briefly described.

The precise definition of the roles first of all required the clear definition of who sells what in the principal-agent relationship, and who uses what for his activity. The main issue was that public institutions had to shift from input financing to output financing. This necessitated the unambiguous definition and differentiation of the concepts of input, output and result (outcome).

Input means those resources (capital, workforce, information, time, etc.) that are used for the production of goods. Therefore, the salary of a public official or the purchase of a fire engine is considered as input.

Output means goods or services that the minister purchases[8] from community or private producers. These can include political consultation, the enforcement of rules and many other services. The departments (ministries) must define their outputs as well as the volume, quality, delivery deadline and costs thereof.

The different outputs are grouped under various output classes. The Parliament authorises the ministries to purchase output classes. Outputs grouped in the same output class must be homogeneous, they should provide information, according to the ranking criteria, to the Government for decision-making and to the Parliament for controlling.

There are two main outputs: the departmental outputs that are produced by governmental departments, and the nondepartmental outputs that the minister purchases not from a governmental department, but rather from voluntary groups, public benefit private foundations and (most often) from Crown Entities.[9]

The result (or outcome) is the impact of one or more outputs on the community. It is up to the Government's political decision what community impacts or outcomes it wants to achieve by spending public funds. These decisions can be predicted from the strategic areas[10] related to the long-term community objectives of the Government. Such areas must be determined through the coordination of the Prime Minister's Office and the Cabinet. Strategic Result Areas in the mid 1990s included:

- the maintenance and possible improvement of economic growth,
- the maintenance of external relations,
- education and further training,
- public safety,
- social welfare,
- healthcare,
- environmental protection.

It is decided by the Government and the ministers what outputs they want to purchase to reach a certain outcome. Outputs can be purchased from several suppliers to reach a given outcome. For example, to attain the "reduce the number of crimes" outcome the Government may purchase outputs from the police, the Ministry of Justice, the Ministry of Social Welfare, Crown entities producing educational services and other entities. Low performance forces the government to purchase the given output from another place if possible.

As an output purchaser, the Government is interested in the acquisition of the same information as a customer requires in a private sector purchase and sale agreement: the price, the quantity, the quality, the place and time of delivery. This is why the departments must define these characteristics of their outputs, as I have mentioned above.

As the owner of public departments, the Government wants to make sure that the assets in its possession are utilised efficiently, and that a department maintains its efficiency in the long run, too. As an owner it needs a financial report prepared according to the result oriented procedure used in the private sector (accrual accounting) so that efficiency could be compared with that of private companies.

The dual interest of the government (owner-customer) can be revealed in the distinction between "vote" and "responsible" ministers.[11]

The vote minister requests authorisation from the Parliament for the purchase of outputs, i.e. he represents the government's interests as a customer. Output financing is voted by the Parliament by categories.[12] In general, one ministerial portfolio belongs to one ministry (department), which requires one parliamentary approval. (In other words: one approval – one minister – one ministry.) However, if a ministerial portfolio belongs to several ministries, or a ministry produces outputs for more than one minister, more approvals are needed. Public money can be spent only for the purpose specified by the given parliamentary approval.

Each ministry has a responsible minister representing the interests of the owner (the Government and the people of New Zealand) of the capital invested in the department. The responsible minister and the vote minister are often the same person. Naturally, the ministers are not involved in the day-to-day management of the ministries. That is the responsibility of the directors general heading the ministries, however the ministries must report to the Parliament about the general performance of the ministries. The ministries are first of all responsible for the delivery of outputs stipulated in the contracts signed with their respective ministers.

Apart from funding outputs, public money can be paid under two other legal titles: capital allocations (which are also voted by the Parliament case by case) and transfer payments. Obviously, in case of the ministry performing the transfer payment, the transfer has nothing to do with the departmental costs: the transfer payment is the ministry's output.

Table 1 presents immigration related outcomes and output classes as an example.

Table 1

IMMIGRATION RELATED OUTCOME AND OUTPUT CLASSES

THE OUTPUT CLASSES PROPOSED FOR ADOPTION BY THE MINISTER OF IMMIGRATION (VOTE MINISTER) AND THE RELATED OUTCOMES FOR THE 1999/2000 BUDGET YEAR:

Vote minister: Minister of Immigration

Ministry producing the output: Ministry of Labour

Responsible minister: Minister of Trade

Related governmental outcomes:

The general objective is to make immigration contribute to the powerful growth of the economy. This is why the Government aims to:

- spur economic growth through increasing New Zealand's human capital and expanding its international relations;
- contribute to social cohesion through well adjusted immigrants;
- protect the interests of legal aliens in New Zealand through ensuring the integrity of licensing criteria;
- fulfil the international humanitarian commitments of New Zealand.

Output classes:

- political consultation on immigration;
- management of the movement of immigrants and visitors;
- investigation of the violations of immigration laws;
- completion of the necessary deportations;
- ensuring border surveillance;
- supporting the services of immigration organisations;
- evaluation of asylum requests and management of the refugee quota program;
- ensuring programs and research projects that facilitate the settlement of immigrants.

Source: Department of Labour, 1999

The directors general of the ministries are hired with a performance contract for a definite term of usually three to five years. The performance contract is a key document between the responsible minister of the department and the director general. The career advancement and remuneration of the director general depends on how well he can meet the output requirements laid out in the (purchase) contract. In return, he is given a free hand to utilise the inputs, including human resource decisions.

The purchase contracts are signed by the director general and the vote minister. The contracts stipulate the above features of the outputs, in which the minister is interested as a customer. These are:

- the terms and conditions of the contracts,
- the description of the outputs,
- the costs of the outputs,
- the method of performance evaluation,
- the reporting requirements,
- the possible sanctions and
- the contract amendment procedure.

The ministers may choose from among the outputs, and have the possibility to replace a given quality level with a larger quantity, lower costs, or vice versa. (In other words, trade-off is possible.) The ministers may determine the content and format of the report they require, on the basis of which they can evaluate the completion of the purchase contract, or may even modify it. If modification requires additional resources, a new authorisation is needed from the Parliament.

Some of the ministers may conclude purchase contracts with nongovernmental organisations, too. In such cases the contract is signed by a ministry represented by a minister.

The director general must exercise versatile control over the output costs not only to have adequate information to modify the input combinations should the input prices change, but also – among other things – because output pricing is based on this output cost, too. Naturally, other methods are also used for this purpose, i.e. private and community producers are invited to submit competitive bids.

The objective is to make ministries as efficient as private companies. To this end, the minister seeks several output producers and calls them to compete.

The directors general and managers need accurate and up-to-date information to efficiently run the departments. On the other hand, the Government and the general public demand regular reports on the departments' performance. For this reason the community sector began to use an accounting system that is also used in the private sector. Formerly only cash flow was registered; the government knew how much money it spent in a given fiscal year, however it had no information about the output volume, the costs of output production, or about the value of assets in its possession. The new accounting system[13] accounts each transaction after it is completed, irrespective of the fact that it is carried out in cash or kind. The system also takes into account changes in the value of assets. The departments account to cost places and cost bearers. Although these concepts seem to be self-evident, New Zealand is the only country where the entire public sector follows this accounting principle, which makes it possible to compare the effectiveness of the public and the private sectors.

This method allows the Public Finance Act to mandate the departments to prepare a general statement of funds flow. Based on these statements, the Crown (the State) can produce reports reflecting the actual financial and property position. The three most important statements are:

- Statement of Financial Performance, i.e. of revenues and expenditures;
- Statement of Financial Position: a balance sheet containing the net asset value of the Crown;
- and the Statement of Cash Flows.

Control and transparency is also ensured by the fact that public funds can be kept only on two types of accounts held by commercial banks.

- The first is the bank account of the Crown, which is managed by the Treasury. Prior to the reform this account was kept by the central bank, which made it extremely difficult for the Treasury to manage the economy's short-term liquidity. As a result of the reform, the central bank turned into a public department the only output of which is to keep the annual rate of inflation below 2%. Pursuant to the relevant purchase contract, the president of the central bank is responsible only for this output.
- The other type of account is the so called departmental (ministerial) bank account. These accounts can only be used for keeping money transferred by the Treasury or yielded from the sale of departmental assets. All other public funds must be deposited on the Treasury account.

As far as the macroeconomic results of the reform are concerned, it is beyond any doubt that the position of the budget largely improved by the end of the reform period. Although improvement was significantly assisted by the reform of the central government, it is difficult to distinguish its impact from the impacts of other fundamental reforms and measures, such as the liberalisation of international trade or capital movements, the deregulation of the financial markets, or the introduction of the monitoring of inflationary objectives.[14] In addition, the development cycles also paid an important role: the budget deficit hardly decreased until 1990, and a balanced budget could be achieved only in 1994, after a boom in 1993. It seems that the comprehensive reforms contributed to the rise in tax revenues and the drop in expenditures. Despite the reform, expenditures initially grew to 42% of the GDP by the years 1990–1991, but then – under various impacts – they fell back to 35% by 1995. Such impacts were generated by the reduction of social expenditures, the alleviation of unemployment from 11% to around 6%, as well as cost savings and enhanced efficiency achieved through the structural reforms.

New budgetary system in France

The 1959 decree of constitutional force *(Ordonnance)*, which governed the French budgetary system – and which, due to its function, was a basic law serving as a foundation for the budget laws[15] – was replaced by a new regulation in 2002. The new decree of constitutional force launched a considerable public finance reform, a major element of which was the introduction of program budgeting. This technique was and is still expected to enable the ministries (departments) to set the achievable objectives, to prepare substantial performance reports on their activities, and consequently to reach greater independence and accountability.

According to the decree, program budgeting should be introduced by 2006. This deadline has been met: two major blocks of it – the compilation of program budgeting itself and the issuance of the audit opinions by the Supreme Audit Institute of France *(Cour des Comptes)* – have already been applied during the development of the 2006 budget.[16]

Strategic and prospective budgeting was implemented at three levels.[17] The most comprehensive objectives (missions) were defined in the form of 45 public policies.

In the course of this work 149 strategic program directors were responsible for connecting the strategic objectives derived from the public policies with the operative results. In line with this, 149 programs were presented to the Parliament for approval instead of the former, nearly 800 line items. The programs are linked to performance indicators that help the preparation of the annual reports.

At the second level of the new budget system approximately 1,200 operative budget program directors were assigned operative objectives, who also became accountable through the performance indicators. The implementation of the concrete tasks (actions) is the responsibility of the directors of the operative units.

The programs are audited by an interministerial committee headed by the chief auditor of the Ministry of Finance. On one hand the committee is responsible for ensuring that the programs are implemented in compliance with the quality requirements laid out in the budget law submitted to the Parliament. The other task of the committee is to evaluate the annual performance audits prepared about the programs.

Thus, budget planning spans several three-year-long periods, and – since the 2002 decree of constitutional force was adopted – this, as well as the transfer of the appropriation for the next year is permitted for all operational and investment appropriations, except for wage-like expenditures. The latter are restricted with an upper limit, and can be regrouped for other purposes (however, regrouping in the other direction is not possible).

The Parliament approves the programs, as well as the related multi-year commitments and annual payment limits. As we have already mentioned above, the commitments can be taken forward to the next year without any restrictions.

As far as the reports on the programs are concerned, they are prepared on the basis of partial, outcome oriented statements, while the budget is developed and approved with the cash flow approach. The third component of the new accounting system is a managerial information system capable of monitoring program costs and outcomes.

The budget and accounting system outlined above seems suitable to enable the public administration system of France to measure the costs of public policies and evaluate the underlying assets.

The public administration reform in Spain

Although the national economy of Spain is much bigger, it is also much less open than that of Hungary. Yet, the development path taken by the Spanish Kingdom in the past decades may also present many lessons for the economy of Hungary. Spain's accession to the EU was preceded by the reform of the public sector. In the period 1982–1986 the socialist Government's major efforts were needed not only because of the large budget deficit, but also because the deteriorating efficiency of the utilisation of budgetary funds. One of the main direct objectives of the reform was the adoption and application of modern budgeting techniques, and the final indirect objective was the transformation of the budget into a tool capable of improving public services. Within the framework of the report, budget expenditures were linked to programs. The development of the practice of program budgeting took several years. It is important to point out that program budgeting is applied not for the entire, but for the larger part of public expenditures in the case of which this is justified by the nature of the expenditure objective.

Similarly to Ireland and Greece, the momentum of GDP growth slowed down in Spain, too after the EU accession, and even a setback could be witnessed in 1987. Based on the available data we can determine however that consumption relative to the GDP increased (which means that the growth of real consumption decelerated to a smaller extent than it would have been justified by the setback in the GDP). On the other hand, gross savings measured as a percentage of the GDP almost remained the same.

The economic slow-down experienced by Spain in 1995–1996 was followed by a 3.4% GDP growth in 1997 due to increasing exports, investments and consumption. The quickening of the economy was facilitated by the drop in interest rates.

Eventually, after joining the euro zone, the objective became increased employment combined with price stability. Unemployment was never as low as it has been now, and the Spanish companies are powerful participants in the global markets.

The topical objectives of the economic policy are the gradual increase of real wages and employment, the economic prosperity of the regions, the development of less developed regions, as well as the prevention and handling of problems arising from the ageing of the population.

From the above mentioned objectives we highlight compliance with the Maastricht nominal convergence criteria and the issues of absorption capacity building in relation to the Structural and Cohesion Funds of the EU. This is given special actuality by the fact that in the two years preceding its accession to the European Monetary System, Spain's public finance deficit was well above the fiscal convergence criteria in Spain.

Another important feature is that the Spanish state structure is regionalised, the statutes of the autonomous provinces provide great independence, and the local governmental system is fractured. In other aspects the Spanish state structure serves as a model for the public administration reform proposals tabled by Hungarian experts, since the two countries have faced similar issues in the funding, task performance, as well as the external and internal control of the local governments.

The Spanish experience is noteworthy for budget stabilisation. The deficit that emerged after Spain's accession to the EU (in the second half of the 1980s) was addressed by the gradual introduction of program budgeting. Accession to the eurozone was ensured by means of a system of social and economic agreements, which also served the curtailment of budget expenditures. With a view to observe the Stability and Growth Pact, the Budget Stability Act was adopted, which contains mandatory and predictable requirements (objectives and tasks) for all levels of the public finance system. The first budget subject to the Budget Stability Act was prepared in 2003. The permanent budget framework was introduced for the autonomous communities, healthcare services were fully decentralised and the new financial system was introduced for the local authorities. These novelties are supplemented with close monitoring and transparency. The reform of the personal income tax – going beyond the mere reduction of the tax rates – has been put on the agenda. The country pursues a labour market supply oriented policy that encourages women to enter the labour market, and promotes geographical mobility on the labour market. The amendment of this act is under way. A considerable lesson of the Spanish budget reforms is that Spain could harness the budget processes despite significant fiscal decentralisation, which is largely attributed to the application of program budgeting.

The general experience of the developed OECD countries

Apart from the three countries mentioned above, in the early 1950s and 1960s – after many successful and even more unsuccessful efforts – several other countries tried to introduce a new, more mature performance based approach. According to an OECD survey performed in 2001[18], seventy percent of the member states used performance related information in their budgets.

Based on the general experience gained from the program budgeting efforts of the developed

OECD countries, it is recommended to consider the following for the success of the reforms:

- a reform can be successful only if it is the result of organic development, a certain evolution;
- the need for reform must be generally accepted;
- the reform must play a central role in the political directives of the government;
- the state and the public must have adequate possibility and ability to control the fiscal processes (in the current Hungarian practice this conditions is very weak, since the fiscal management cannot or can hardly resist the pressure on the expenditure side, and this cannot substantially be changed by posterior audits);
- it is very important that the greater room for manoeuvre available for the heads of institutions, the certainty of budget financing (multi-year budget planning must be implemented at lower governmental levels, too) and the performance requirements set for the managers must exist simultaneously, since if any of the three is missing, the aim of program budgeting cannot be attained. What is more, the risk of overspending or reduced operational efficiency emerges;
- since the situation differs from country to country, the reform process must be planned with engineering accuracy, starting from the elaboration of the reform plan through the strategy of introduction to the orchestration of the new processes.

The experiences of the transitional countries based on the public finance reform in Slovakia

The problems that the public finance system of Slovakia had to face at the turn of the millennium were similar to the current Hungarian problems in many aspects: the pressure on the expenditure side of the budget triggered overspending again and again, and the problems of the Slovak and Hungarian large social supply systems (the pension and healthcare systems) practically shared the same roots.

Naturally, it holds true for Slovakia, too that the fulfilment of the Maastricht criteria, and compliance with the co-financing requirements linked to the EU transfers – mostly to subsidies from the structural and cohesion funds – produce conflicting effects on the position of the public finance system, and thus encourages the reform of the public finance system from the outside. After the measures taken in 1999 and 2000 to curb the budget deficit, the Slovak Government launched a comprehensive public finance reform following the general elections of 2002. This reform affects many elements of the public sector and induces structural changes, too. The governing parties' commitment to the reform was indicated by the fact that in 2003 they relatively easily adopted those acts and legal regulations that regulate the tax and pension reform, the reform of social benefits, as well as the reform of the labour market, the partial reform of the public administration system, the reform of the healthcare, education and judicial systems.

The Ministry of Finance initiated the introduction of program budgeting already in the late 1990s. In 2000, US experts were invited to assist the implementation of the program. This budgeting technique was first applied in the framework of a pilot project in 2001, then in four budget chapters (Ministry of Education, Constitutional Court, Supreme Court and the Academy of Sciences of Slovakia) in 2002. In the 2003 budget, program budgeting was applied for further five chapters: the Ministry of Health, the Ministry of Transport, Posts and Telecommunications, the Ministry of Agriculture, Ministry of Defence and Ministry of Interior.

In June 2003, the World Bank extended a USD 5 million loan to the Slovak Ministry of Finance to foster the implementation of the budgetary reform, including the extension of program budgeting to all budget chapters from 2004 on.[19] The long-term objective is to create a prospective budgeting system, in which the annual budget is always only the first part. Despite this fact, the program based budgets of the years 2002–2004 were exclusively elaborated for the given years only. Comprehensive program budgeting as a planning and accounting system that covers all budget chapters and means programming for several years ahead have been used only since 2005.

Based on the experience gained so far, the Slovak Ministry of Finance believes that the following positive developments are worth highlighting during the application of the program budgeting technique.

- The senior managers of the ministries have the political will to apply the method to all budget chapters.
- The budget chapters are developed by the affected organisations themselves, in close cooperation with the Ministry of Finance. The Ministry of Finance set up a so called Budget Committee comprising of the representatives of organisations under six important budget chapters.
- The Ministry of Finance was restructured with a view to strengthen the implementation of the budgetary reforms: within the so called public finance division of the ministry the Department of Budget Analysis was set up. The main task of this unit is to review the program based budgets developed by the individual chapters.
- Utilising the experience of the past three years a schematic new budgeting methodology and the underlying macro-level planning framework were developed, and the budget is submitted to the Parliament based on programs. The Budgetary Information System[20] was developed to ensure the preparation, implementation, monitoring and standard IT management of program budgeting. Entities in charge of the preparation of the individual chapters can enter information about their own budgets into this system. The system is capable of presenting the expenditures for each program, or by economic or functional categories.
- The above-mentioned macro-level planning method can forecast the expected changes in the GDP, as well as in the revenues and expenditures of the public finance system and the budget for four or five years. It is also able to provide an estimate for the economic classification of expenditures.
- It is a very important element that the budgetary funds are not fully allocated to the chapters in the first stage of budgeting. Instead, the so called priority money is kept on a stand-by bank account, from which it is drawn during the budgeting process. The recipient and size of the allocated funds is decided by the cabinet on a purely political basis, as a result of which it becomes possible for appropriations depending on political priorities to be based on the program budgeting concept.

At the same time however, the mistakes committed during the first years and requiring correction, as well as the lack of a few elements of program budgeting are also noteworthy. In most cases these phenomena can be considered as the natural concomitants of the reform process, since it takes a longer time to successfully introduce the method and particularly to establish the required attitude. The problems, some of which were partially solved by the Budgeting Rules Act adopted in 2004, are the following:

- the relationship between the direction of the Government's strategy and the programs is not always obvious;
- although the 2005 budget was planned on the basis of multi-year experience, the resources that would be available in the future were often neglected;

- due to macro-level planning, there is a ceiling projected for the aggregate of public finance expenditures for one or more years, however such limit is missing at chapter level, which makes program budgeting more difficult[21] ;
- the traditional and program budgeting approaches are still mixed: although the chapters are required to develop their programs, certain economic classification restrictions exist in relation to certain expenditures (e.g. wages), which are calculated on the basis of the expenditures of the previous year(s)[22];
- the figures for the given year and the projected figures to be submitted to the Government are prepared by two separate organisational units, using different methodologies (e.g. the figures are consolidated with different methodologies), as a result of which the current data are not consistent with the projected ones. On top of that, the projected ceilings for years $n+1$ and $n+2$ are not formally integrated into the budget planning and implementation process. Therefore, when year $n+1$ or $n+2$ becomes the current year, the former projections shall not mandatorily be applied during the compilation of the budget for the given year.

Similarly to the Ministry of Finance, other experts also concluded on the basis of experience gained in 2002 (and partially in 2003) that the definition of program objectives and the programming tasks arising from the new technique remained formal, and they meant nothing but extra tasks for the budget departments of the ministries. The introduction of the method was typically limited to the budget departments without the involvement of the senior officials of other professional departments. What is more, the issue was not addressed at the level of ministers representing the political management either. In order to make the experiment successful, the ministry level political management should have directly participated in the application of the method, since this is the only level where the governmental priorities can be translated into actions and identifiable, measurable results or outputs. This problem is well illustrated by the expert conclusions reached at the Ministry of Transport, Posts and Telecommunications. This ministry developed the following main programs (consisting of several subprograms) for the years 2005–2007:

- Program No. 053 – Public Road Infrastructure
- Program No. 055 – Air Transport and Infrastructure
- Program No. 07S – Rail Transport
- Program No. 07T – Strategy building and application

Although this ministry has been involved in program budgeting for several years, it still cannot be claimed that the management of the ministry considers the program budgeting method as a tool capable of cost-effectively connecting the available resources with the desired strategy (objective, objectives). As a result, this method is not emphasised in the budgeting process. What is more, although program budgeting is a top-down process by its very nature, it seems to take place in the other direction within the ministry.

As we have already stated, program budgeting can be really effective if it is used in the entire governmental sector. The Slovak Ministry of Finance is well aware of this fact, and has also realised that in case program budgeting is used successfully, it becomes clearer where and how tax money is spent by the Government. And a budget that is transparent for the general public, too, strengthens the confidence in democracy, the long-term political benefit of which is beyond all doubts.

This is why – and of course learning from the negative experience – the Slovak Ministry of

Finance applied program budgeting as the main method of resource allocation already during the preparation of the 2005 budget. Within the programs, the Ministry gave a free hand to use resources except for a few mandatory items (e.g. wages). In addition, the Ministry also made it possible to take unused funds forward to the following years within the program.

Although on the whole program budgeting was introduced smoothly – taking into consideration the relatively short timeframe available for introduction – we would like to highlight two major aspects that must be given more attention if we want to make the public finance reform successful in Slovakia, and elsewhere:

❶ preferably all political parties should accept the reform strategy and harmonise it with the formulation of their political goals;

❷ the performance evaluation methods must be defined and applied much more specifically than today.

HUNGARIAN EXPERIENCES AND A PILOT APPLICATION

Local governmental experiences

With support from USAID, a complex program was implemented in the period between 1994 and 1999 under the title "The Modernisation of the Financial Management of Local Governments", which aimed at the spreading of the program budgeting technique in Hungary. The program was executed by the New York based Urban Institute and the Hungarian Városkutatás Kft. Several US and Hungarian experts contributed to the program as advisors. The Hungarian advisors were responsible for adapting the US know-how to the conditions of the Hungarian reality. The participants of the program included Hungarian local governments, as well as the leaders and financial officials thereof.

In the first part of the program concrete expertise required for budget programming was transferred and taken over. This happened in the framework of systematically structured training sessions. In the preparatory phase not only the mastering of the "common language" and the transfer of knowledge was important, but it was the time when it was decided which of the participating local governments would start a partial or complete model experiment for the development of local program budgeting practices. The following towns participated in the model experiment: Szolnok, Szentes, Püspökladány, Hajdúszoboszló, Orosháza, Nagykanizsa and Tatabánya.

The most mature results were obtained in Szolnok, a town with county rank, and in the town of Szentes. For specific reasons, the experiment in Szolnok started in 1994, practically simultaneously with the start of the USAID program in Hungary. Preparation and the development of the IT conditions required three years. Experience showed that compared to the former planning methods, program budgeting enabled the town to slash its budgetary expenditures by 5% annually. However, this "saving" was "taken back" by the central resource regulation system, which sort of justified the local critics of the introduction of this method.

In the town of Szentes the experiment was a "greenfield investment" project, with no contentual background. Despite the fact that Szentes is a much smaller town, the process required a similar timeframe as the Szolnok experiment.

The experience of the Hungarian local governments *confirmed* the international experience. It was proven that it is easier to launch changes at the lower governmental levels, which can be explained by several factors. On one hand, at lower governmental levels there are considerable fewer tasks than at the central level, wherefore it is much easier to define the introduction related tasks than at the level of the central government. On the other hand, interest can be raised much easier at local governmental level, and it is much easier to overcome conflicting interests. The Hungarian fiscal policy regularly ignored the local governmental sector, wherefore the financial managers at this level were forced to more intensely look for reserves. However, the Hungarian developments confirmed that the introduction of program budgeting is not irreversible. Not only were the processes of the Hungarian local governmental system unfavourable for the adoption of positive examples, but they even created conflicting interests therein and eroded the existing results.

Which were the *counter-acting* factors? We believe that they included the following:

- frequent changes in the tasks and the underlying legal conditions (professional regulations);
- unpredictability of the central resource regulation system;
- strengthening of the discretionary elements of financing;
- conflicting interests of the dominant political elite.

All these factors reversed the positive impetuses, and *generated conflicting interests* in relation to the practice of program budgeting.

Application of the program budgeting technique at the State Audit Office of Hungary

The utilisation of the audit capacity of the State Audit Office of Hungary (SAO) is mostly determined by the legal regulations. Each year a major task of the SAO is the completion of audit tasks at regular intervals as required by the legal regulations, such as: commenting on and auditing of the bill on the state budget and the final accounts, auditing of the utilisation and accounting of subsidies allocated to the local governments from the central budget, auditing of the national news agency and the political parties. These legally prescribed, regular tasks absorb nearly 60% of the annual audit capacity – considering the average of several years.

However, apart from the regularity and comprehensive audits prescribed by the law – taking into account the limited capacities – the SAO performs more and more performance audits focussing on cost-effectiveness, efficiency and effectiveness. The SAO audits the implementation of tasks that are important and topical in the public finance subsystems and in the utilisation of treasury property for enhanced competitiveness, the more efficient operation of the public sector and the improved life quality of the population. Based on the figures of several years, these audits that are performed on the basis of the decision of the SAO's president absorb around 40% of the audit capacity.

Within the relevant legal frameworks and relying on its own strategy, in many cases the SAO itself can determine the subject, extent and methods of its audits, and may decide about the timing and nature of the audits; It is in the position to identify the outputs and outcomes of the work itself. As far as the evaluation of the outcomes is concerned, each audit is in a special situation, since the real outcome is "normal" operation. Hence, the outcomes can be predicted based on the quantification of expected losses and unutilised capacities. The outputs are the interim audit reports (auditor's reports) and the SAO reports that are the summaries of the auditors' reports. The content and formal requirements pertaining to such reports are defined in the SAO's internal regulations. In the case of reports that are prepared at regular intervals (pursuant to legal requirements), the performance indicators are determined without any major problem. The outcomes of reports prepared pursuant to legal requirements depend less on the State Audit Office.

When compiling the annual audit plan, the free capacities to be allocated by the president of the SAO are also distributed. Based on the current legal requirements, performance audits are ordered by the president of the SAO within his own scope of power. The problem of the definition of the outcomes (to be more precise, the definition of the expected outcomes) is the most striking in this group of audits. In the case of the allocation of these capacities it is important to forecast the expected outcome. This can be well approached using the method of risk-based planning. The major financial risks of a time period can be revealed by means of appropriate background analyses. An example for this could be the absorption of EU funds at the proper level, or the potential sources of loss due to the involvement of the private sector (PPP) in the completion of public tasks.

In the course of compiling the budget by means of the program budgeting technique, the expenditures and various resources must also be identified in addition to the above elements. This task is not very difficult for the SAO. The direct costs linked to the outputs (reports) can be measured with the audit days, as well as with real costs linked to the preparation of the reports (paper, press, vehicle usage, etc.). The problem is caused by the spreading of indirect costs. If we narrow the mission of the SAO to the preparation of SAO reports, the solution may be the even distribution of these costs. However, this cannot be recommended for several reasons, some of which are presented below:

- as we could see, the SAO is mandated by law to perform routine tasks, while the audits ordered by the president of SAO require innovative approaches (see the performance audits, for example). This is why the mechanical projection of costs would underestimate the resource needs of reports falling in the latter category;
- the consciously undertaken advisory role of the SAO is an independent output and result, wherefore several costs – that are regarded as indirect costs from the aspect of the audit – can be projected onto this activity as direct cost;
- furthermore, the mission of the SAO arising from its position is the improvement of the financial culture, in relation to which direct cost needs and related direct outputs can be defined;
- last, but not least, the maintenance of international relations can also be defined as a separate cost bearer.

When shifting to program budgeting within the State Audit Office of Hungary it must also be taken into account that the earmarked funds must fit into the system of budget chapters, and at the same time financing must be actually scheduled on the basis of performances and outcomes. For this purpose, it must be determined – in line with the so called top-down approach of strategic planning – what results should be achieved in order to implement the long-term strategy of the State Audit Office, and what outputs should be ensured for this purpose. One of the most difficult tasks is the definition of these outputs, since the defined outputs must be sufficiently concrete, they should preferably be measured with quantitative indicators, and in case their evaluation inevitably requires the use of qualitative indicators, such indicators be exact and comparable.

Once the outputs are available, it must be clearly and unambiguously determined which organisational unit is responsible for the implementation of the different outputs. This definitely requires the restructuring of responsibilities, if not the transformation of the organisational structure, since the responsibility for the generation of the outputs must go together with the responsibility for financial management. The aim behind this is to make the head of the unit responsible for the generation of the output motivated in the optimum use pf inputs required for the generation of the output, i.e. in the most cost-saving performance.

FEW SUMMARY COMMENTS AND PROPOSALS

If a government (or local government) decides to restructure its budgeting and introduce program and performance budgeting, it is inevitable that the government (local government) be aware of the theoretical background of the system, primarily building on microeconomic considerations. The system can be based on this, as well as on the decades-long experiences of many countries by paying utmost attention to the possible obstacles and the avoidance thereof.

Naturally, the question arises who might be interested in this shift and who might have conflicting interests. Since the effects are definitely positive at community level and in the long run, the success of the reform can be regarded as public interest. Just like in the case of any public interest, the question is raised how to articulate it in a way to make the decision-makers realise that they should at least try the introduction thereof. In order to answer this question it is worth analysing the current social situation, the concrete political arena, and approaching the issue by way of a game theory analysis, for instance.

Experience shows that the possibility of introduction arises when and where the economic problems arising from inefficient public administration (among other things) become tangible. When things are coming together, budgetary discipline is much more likely to become lax than stringent and rationalised. Of course, this will produce a counter-effect, which will then create favourable conditions for the political consensus required for introduction.

The lesson is that there is no universal recipe, each country and each local government must tailor the structure – which is in general adequate for the model – to their own needs and conditions.

A structure that exactly corresponds to the theory (model) can be developed only in exceptional cases (such was more or less the public finance reform in New Zealand), and generally when the negative effects arising from poor efficiency are too big and perceptible. Even then, special conditions must exist (e.g. small country, not too complex public administration and state administration, etc.)

The methods applied in reality are mixed methods from the theoretical point of view. This is not a problem, since especially thereby, through the rational consideration of reality and the possibilities will they be viable and able to induce positive effects.

We find it desirable to apply this method in the Hungarian budgeting practice[23]. The underlying reasons are manifold. They include the condition of the entire public finance system, the constraints arising from nominal convergence, as well as the adequate absorption of EU funds (especially those of the regional development and cohesion funds).

We do not believe that these efforts are free from conflicts and setbacks. However, it is important to make sure that the experiments are started in the appropriate public finance segments. Therefore, this system is first of all recommended to be introduced at chapters having great independence and well defined, predictable tasks in the field of the state budget, like the State Audit Office.

The shift to program budgeting can be an important and reform-scale step. However, one must not believe that this budgeting technique is a wonder drug that cures all budgeting problems. Effective state reform also requires the reconsideration of state tasks, the observance of constitutional guarantees, and the review of acts on the large supply systems. However, in strengthening the budgetary discipline an important role could be attributed to program budgeting. In order to achieve the set objectives and minimise setbacks known from the international experience[24], certain conditions must be met.

The most important is that the current public finance act should be replaced with modern and constitutional regulation. The description of the content of this act is beyond the frameworks of this article, wherefore we only refer to the fact that the new act should definitely integrate public finance information questions – some of which are currently regulated only in government decrees –, and the entire budgeting and final accounting schedule must be revised. A sensitive point of this technique is the creation of the necessary information basis and its opposition to the current interest relations. Below is the SWOT matrix of the system's introduction, which gives a good estimate about the expected costs and benefits. *(See Figure 3)*

It is equally important, and the strength of threats described in the T = threats field of the SWOT matrix can be reduced if the society's low tax consciousness is improved and the fiscal illusions are dispelled. The political discourse is fundamentally affected by the fact how much or how little the general public knows about the actual costs of the various public services. If by dispelling the fiscal illusions we manage to make the society accept the need for a public finance reform, and within that, the use of the program budgeting method, a multilateral consensus is reached almost automatically, since the consensus of the general

Figure 3

SWOT MATRIX OF THE INTRODUCTION OF PROGRAM BUDGETING

S = **Strengths**	O = Opportunities
• elimination of the baseline budgeting principle, • clear establishment of priorities, • considerable reduction of the possibility of political voluntarism, while the conditions could improve for exercising the budgetary rights substantially, • supporting the radical restructuring of expenditures, • improvement of the conditions for the successful provision of public tasks, • improvement of the conditions for making politicians and civil servants accountable.	• development of real cost consciousness in the public sector, • creation of the harmony between public policy priorities and budgetary expenditures, • elaborate and scheduled introduction, • better public services even in case of decreasing budgetary centralisation in the medium and longer run.
W = Weaknesses	**T = Threats**
• there are no immediate savings, • additional costs are incurred in the initial phase, • it is not suitable to be applied in all fields of public service.	• political resistance, first of all by supporting the so called “annuity hunting” lobbies, • resistance by the civil servants in order to maintain the asymmetry of information, which is so beneficial for them, • failure of introduction without adequate legal and information foundations, • rush introduction may discredit the technique.

public would practically force the political players to reach an agreement in this issue. The elimination of fiscal illusions would also eliminate the possibility to generate political capital by building on such illusions.

In support of the above written I hereby cite the following quotation: "… reforms that have been most brilliantly designed and prepared from the professional aspect can fail, too, if the reformers and responsible decision-makers do not communicate with the citizens during the introduction of the reform. We believe that only those proposals can be successful that offer clear, custom-made options to the citizens supported with a cost-profit analysis understandable at the level of the individuals, too."[25]

In summary: careful and gradual introduction is the precondition for successful reforms. Introduction may start with pilot programs that could be implemented in conjunction by the Ministry of Finance and the SAO, and the latter could continuously analyse the experiences.

Notes

[1] Tanzi, V. (1997): The Changing Role of the State in the Economy: A Historical Perspective. *IMF Working Paper;* Tanzi, V. (1998): Fundamental Determinants of Inequality and the Role of Government. *IMF Working Paper;* Tanzi, V. (2000): The Role of the State and the Quality of the Public Sector. *IMF Working Paper*

[2] For more details see Vigvári (2002): Közpénzügyek, önkormányzati pénzügyek, *KJK-Kerszöv* (Public finances, local governmental finances)

[3] The literature on the topic includes the following fundamental works: Wildavszky, A. (1975): Budgeting. A Comparative Theory of Budgetary Processes. *Little and Company, Boston-Toronto;* Wildavszky, A.–Caiden, N. (2001): The New Politics of the Budgetary Process. Fourth Edition. *Addison Weskey Longman, New York;* Diamond, J. (2003): Performance Budgeting: Managing the Reform Process, *IMF Working Paper, Fiscal Affairs Department, Washington, D.C.*

[4] Cangiano, M. (1996): Accountability and Transparency in the Public Sector: the New Zealand Experience, *IMF Working Paper;* The Treasury (Ed. Bí: Horn, M., 1996): Putting it Together, *Wellington: Government Printer;* Somogyi-CS. Á. (2000): Piaci viszonyok az állami bürokráciában – Avagy az új-zélandi államháztartási reform esete. *Szakdolgozat, Budapesti Közgazdaságtudományi Egyetem* (Market conditions in state bureaucracy or the reform of the public finance system in New Zealand. *Thesis, University of Economics, Budapest)*

[5] In other words, which are more characterised by possible exclusion and rivalry.

[6] In New Zealand an election term is only three years long.

[7] This was not explicitly stated like this. Instead it was said that the state should refrain from trading activities, and should rather create competitive markets, and should efficiently and carefully manage the remaining state functions.

[8] And the emphasis here is on purchase, since it indicates that it involves output financing instead of input financing.

[9] Crown entities are organisations that are controlled by the government (most often as the owner), but are not state companies. Crown entities include such diverse organisations like central research institutions, hospitals, the National Film Committee, the New Zealand Tourism Board, the New Symphonic Orchestra, the Human Rights Committee, etc.

[10] Strategic Result Areas

[11] Vote Ministers – Responsible Ministers

[12] This is called Vote. This means that (one or more) Votes are owned by healthcare, national defence, Maori issues, immigration, etc.

[13] Accrual Accounting (This method is called Generally Accepted Accounting Practice in New Zealand)

[14] It must be noted that New Zealand was the first country in the world to introduce the method of inflationary objective (in 1989).

[15] The Basic (Organic) Act on budget laws more or less corresponds to the Hungarian act on public finances.

[16] The transformation of the system of internal audits – which is of high importance – has not been fully completed.

[17] Mordacq, P. (2005): Financial Management and Audit Practices. The French Ongoing Reform. Presentation to the World Bank Seminar, *Dead See Hotel, Jordan, 20–23 June, 2005*

[18] In 2004, one of OECD's working committees put the topic of performance information on the agenda again. See Mrs. László Hamza's and Etelka Bécsi's report on the conference summarising the results and lessons of the investigation in this issue of the *Public Finance Quarterly*

[19] This loan can first of all be used for institutional development, technical assistance, as well as for budget planning and governmental financial management training. The project supported by the loan is titled: Public Finance Management Reform Project (PFMRP).

[20] Budgetary Information System (BIS)

[21] This would be important because the ceiling of the individual chapters and partial budgets cannot be determined by the organisations belonging to the respective chapters, since the number of applications for funds is theoretically unlimited. However, the partial ceilings that are determined by the Ministry of Finance with regard to the macro-level limit should be forwarded to each budgetary organisation.

[22] The problem with this is that if expenditures are planned independent of the programs, the performance based approach fully disappears, since there is no relationship between the used inputs and the objectives targeted by the program, which should be the main reason for the application of the method. Of course, the budgetary expenditures can also be presented by economic and functional categories, but only after they are planned with the program budgeting technique.

[23] The State Audit Office of Hungary has called for the need for changes in several of its reports. See for example: ÁSZ (2005): Report on the activities of the State Audit Office of Hungary in 2004, page 14, pp 80–81. The Research and Development Institute of the SAO has also processed the literature of this field, the experiences related to its application in detail, and published it on the SAO's website for professional debate. See Báger G.–Vigvári A. (2005.): A programköltségvetés elméleti alapjai és alkalmazásának nemzetközi tapasztalatai. (The theoretical basis and international experience of the application of program budgeting)

[24] In the United States budgetary reform efforts have been made three times (at the beginning of the 1950s, 1960s and 2000s). All three efforts were followed by the restoration of the former order.

[25] Csontos L. – Kornai J. – Tóth I. Gy. (1999): Adótudatosság, fiskális illúziók és az egészségbiztosítás reformjával kapcsolatos vélemények, *Tárki, Budapest, http:/www.tarki.hu/adatbankh/kutjel/ pdf/a195.pdf)* (Tax consciousness, fiscal illusions and opinions on the reform of the healthcare system)

Tibor Palánkai

Theoretical relevances of our integration maturity

Integration theories generally analyse five major dimensions of the process, namely, the following:

- the contents (essence) of integration processes;
- fundamental organisational forms and institutions of integration;
- integration policies (regulation), issues of governance;
- benefits and drawbacks of integration;
- integration maturity (integration capacities).

For a long time, the literature of integration assigned key importance to the forms of integration and the cost-benefit analysis for practical reasons. With the progress and completion of the integration process, however, issues of governance also assumed a growing need for a solution. With regard to the development of the single market and the economic union, as well as the eastern enlargement, the issue of integration maturity has also been added to the agenda starting from the 1990s.

Earlier, it was possible to ignore preparedness for integration (at the level of free trade agreements, the customs union and the single market) for a number of reasons. Particularly in the first period, the economic development and structure of countries entering the integration were basically similar, and all were deemed to be mature for integration. For the enlargement performed in the 1980s, political considerations were clearly dominant. What is more, the Copenhagen criteria are also the fruit of a political bargain, considering that at the time the associated eastern countries endeavoured to achieve acceptance of a possible membership in 1992 with the EU member states, it was precisely the criteria they raised in an attempt to reach a compromise.

The programme of the economic and monetary union made it clear, however, that at this level integration maturity could no more be ignored on political grounds. A significant new circumstance for the economic union was the fact that member countries were not automatically allowed to participate; they were required to meet certain criteria. The consequences of market liberalisation were mostly unilateral and unidirectional (less developed or weaker partners had more to lose), and the responses to wealthier and stronger member countries were not directly experienced. The situation with the single market and particularly with the economic union was different: interactions were amplified and became direct. Economic difficulties of a partner (budgetary deficit or regional imbalances) affect the economies of the others, and may destabilize them (for example by generating inflation). Participation in the economic union also has an effect on the institutional and political structure of the respective national economy. In this context, readiness and preparedness for integration need deliberation.

On the other hand, integration maturity was raised in connection with the different development levels of member states, and new applicants in particular, and it was especially marked on adding eastern enlargements to the agenda.

It is natural that each integration organisation may specify certain conditions for membership to the participants. These are mostly obvious (resulting from geographical closeness or political orientation), or are general enough not to be exclusionary in nature. The Treaty of Rome only stipulated for participation in the European Communities that the country in question be European and democratic. Although it left some uncertainties in terms of geographical definition (for Turkey, for example), it was general enough to open up a possibility of accession as wide as possible. In other cases, the social and political orientation of countries was decisive (for instance, the Council of Mutual Economic Assistance). The necessity of formalizing accession criteria became obvious in the context of eastern enlargements.

From 1948 (foundation of GATT) until 2000, 214 regional trade agreements were concluded among the countries of the world. Out of these, only 134 were still in effect by the beginning of the 2000s. The majority failed: they either terminated activity or were cancelled. This is particularly true for agreements concluded in the first wave of regionalism, which mostly disappeared after the great political and economic changes of the past decades (the economic crisis of 1970s, or the collapse of the Soviet block). The second wave starting from 1990s appears to be much more successful, when the creation of new organisations were urged by increasing international economic interdependence and the progress in communication (Jones, R. A. 2001, p. 28) As many as 90 such new regional trade agreements were concluded between 1995 and 2000 only – from the free trade zone to the common market.

It is obvious that this high "casualty rate" was an outcome of numerous specific economic and political factors. This large number may also suggest more general and fundamental reasons, but it also raises the question of how well general conditions were provided, and how prepared the specific countries were to apply the particular forms of regional integration. In other words: the question is how mature these countries or regions were for integration.

We started dealing with integration maturity under multiple research programmes at the Global Economics department of Budapest Corvinus University (Budapest University of Economics (Közgazdaságtudományi Egyetem) at that time) in the early 1990s. During the research, it became apparent that distinctions must be made between meeting accession or membership criteria and integration maturity due to the complexity of preparation for and participation in regional integrations.

Accession or membership criteria, in a broad sense, define the conditions and requirements of participation in an organisation of integration, both formally and officially. Accession criteria are narrower; they refer to a specific integration organisation or form, and specify no more than the conditions of becoming a member. Accession criteria must be met previously, from the outside. Non-compliance can simply be sanctioned by delayed admission.

Membership criteria are applicable to the requirements for behaviours and actions within the integration zone, they are met from the inside, and non-compliance is sanctioned (court enforcement of compliance with the rules of the single market; procedures stipulated for non-compliance with the Growth and Stability Pact or meeting democratic principles, or sections 6 and 7 of the Treaties of Amsterdam and Nice).

Broadly speaking, adoption of and compliance with the entire *acquis communautaire* is a membership criterion in the European Union.

Accession criteria are dependent on the level of integration the given organisation has reached by the time of accession. When Greece or Portugal acceded, they entered a common market structure. New members now accede the single market and the economic and monetary union. They are required to meet some of the membership criteria still before accession, while some gradually, from the inside.

Integration maturity can be defined as a capability to exploit the benefits of the given form of integration to the maximum, while the costs and drawbacks can be minimised. Integration maturity can be measured by comparing costs and benefits. A country is mature for integration if membership on the whole is advantageous for it.

An analysis of integration maturity does not primarily focus on compliance with conditions and requirements, but much more on the consequences and successfulness of the process. These two are certainly closely related, considering that membership criteria endeavour to express integration maturity. Accession and membership criteria specify a minimum of requirements instead, which may allow accession on compliance, while the issue of maturity goes far beyond that, and generally examines the conditions of successful and efficient integration in their entirety.

In the EC/EU, specific accession criteria were defined first in 1991, pertaining to the transition to the economic and monetary union. The so-called Maastricht convergence criteria grab an important requirement of the monetary integration when requiring member countries to meet specific indicators of monetary and fiscal stability as a condition to participate in the EMU.

- Member countries need to achieve a high level of price stability. Inflation as measured by the consumer price index cannot vary more than 1.5 percentage points from a standard set by the three member states achieving the best inflation results in the examined one-year period.
- Government financial positions need to be stable, specifically:
  - budgetary deficit should not exceed 3 per cent of the GDP, and
  - state debt should be under 60 per cent of the GDP.
- Convergence in terms of interest rates is construed for the average nominal interest rate of long-term government bonds not to vary more than 2 per cent from the results measured in the three countries with the best results in price stability in the examined years.
- The member country's currency should participate in the EMU's exchange rate mechanism, and within two years be stable to an extent not to have to be devaluated against any country's currency.

Accession criteria related to eastern enlargements have been defined for new admittees. The so-called Copenhagen criteria were accepted in June 1993, then further specified and completed. These conditions are as follows:

- stability of democracy, of legitimity and of institutions that guarantee human and minority rights;
- a market economy that is operational and able to withstand the pressure of the acute competition typical of the EU and of market forces;
- compliance with obligations pertaining to membership, and acceptance of the goal of the political, economic and monetary union;
- availability of the EU's absorption capacity.

Parameters of compliance with accession/membership criteria are in some cases precisely elaborated and explicit (for example, the Maastricht convergence criteria). In other cases, parameters needed for analysis and assessment are rough, inconsistent, highly disputable or simply missing. No material guidelines are available for the Copenhagen criteria, for instance. This is often traced back to insufficient elaboration of analysis methods, while at other times it is also a sign of deliberation, which provides a facility either to manage conditions in a flexible way, or to accelerate or delay and hinder the integration process.

The maturity and preparedness of acceding countries for membership were examined by the European Commission and other EU organisations (for example, the European Parliament) on a regular basis, fundamentally from the aspect of meeting the accession criteria, of course. These provide no serious theoretical and methodological foundation for the assessment of integration maturity. Their system of criteria and methods of analysis are unclear, and provide but a loose framework for assessment on political grounds.

It is not only on accession that the examination of integration maturity is necessary and timely, given that the maintenance of integration capabilities constantly remains a condition of reaping the benefits subsequently. The case with accession criteria is slightly different. Examination of these loses significance after the accession, as member countries are never excluded, not even on non-compliance. Countries are called to account for compliance with the accession criteria (for example, based on the Stability and Growth Pact) on a continuous basis; what is more, non-compliance is (or may be) sanctioned.

Integration maturity can be analysed in terms of four main dimensions: compliance with

- economic,
- social,
- political and
- institutional aspects and criteria.

A particularity of the Copenhagen accession criteria is that they equally stipulate political, economic and institutional conditions for new members. However, a characteristic of the Maastricht decisions is that they are narrowed down to budgetary and monetary criteria within economic ones pertaining to accession, although institutional requirements are also stipulated as a membership criterion. Beyond the Stability and Growth Pact, regulation of the independence of national central banks and the European Central Bank also refers to this. (Social implications of integration maturity are not addressed here.)

ECONOMIC CRITERIA FOR ACCESSION AND MEMBERSHIP, AND INTEGRATION MATURITY

Basic criteria of integration maturity concerning the economics of integration are as follows:

- operational market economy;
- competitiveness (structural and development requirements);
- macroeconomic stabilisation/stability;
- convergence;
- capability of being financed and providing financing.

The parameters of integration maturity are more complex than the ones generally used for accession and membership criteria. These criteria constitute the general frameworks for normal operation of the given form of integration; these form the conditions of successful integration. It is expedient to analyse economic criteria as broadly as possible, given that the profitability of this enlargement, as well as the maximum utilisation of the benefits in terms of efficiency and well-being fundamentally depends on the compliance with these.

On the market economic criteria of integration

In Copenhagen, establishment of an operational economy that is able to withstand the pressure of the acute competition typical of the

EU and of market forces was set as a condition for accession. Normal operation of the market economy is a starting condition for all forms of integration. The whole theoretical and analytical system of the economics of integration is based on assuming these. Liberalization eliminates precisely the obstacles to these in terms of trade or economic policy. The advantages of internal free trade can only be utilised alongside properly operating market mechanisms. The issue of an operational market economy was only added to the agenda as an official membership criterion pertaining to the accession of Central and Eastern European countries; however, it does not mean that it had no relevance earlier. At the same time, it is obvious that this issue is assigned various emphases at the various levels of integration, and cannot be avoided in case of closer forms of integration (EMU), not even for the most developed countries. It is a different question that the requirement of an operating market economy (flexible factor markets and factor prices) was not set as a membership criterion for the EMU, either, but was only analysed in informal theoretical debates.

The six founding countries of the European Economic Community, as developed market economies met this requirement, and material doubts of this type did not arise even for Mediterranean enlargements. (As opposed to eastern enlargements, Greece, Portugal and Spain only acceded the common market.) They were compliant, at least practically, if we consider that no market economy operates perfectly. It must be added that this compliance was not full or automatic at all. It is no accident that the customs union and the common market have been coupled with powerful competition control and regulation at a community level right from the beginning, to which broad legal harmonisation ensuring unhindered trade has been added subsequently. A number of measures facilitate becoming an operational market economy. For the members of the EC, it was sufficient to perform it after being admitted as members.

Similarly, member countries have adapted themselves to the single market from the inside and subsequently since the early 1990s. Formally, the single market is a step forward compared to the common market, i.e. a more developed grade of integration. At the same time, in terms of contents, it is no other than the actual implementation of the common market. The common market also identifies the four freedoms as an objective, but it mostly focuses on eliminating the limitations to it. The programme of the single market tries to break down all the limitations to the four freedoms systematically, thus ultimately creating the conditions of an operational market economy.

Applying a theoretical approach, certain similarities may be revealed between an optimal currency zone and the Copenhagen membership criteria. The optimal currency zone also raises the requirement of an operational market economy, even if applicable mostly to the factor markets, specifically. Given that the single market is a starting condition to the economic and monetary union, an operational market economy in this case still covers a much broader criterion. "In economic terms, the EU maturity of a country can ultimately be also conceived as a capability of seamless adaptation to the single market." (Rácz, M. 2000, p. 812) We could also say that an operational market economy is the most general criterion of integration, and an important condition for properly exploiting the benefits of integration.

On the eastern enlargement, the issue of integration maturity emerged as a novelty. Central and Eastern European countries in the early 1990s were still in the middle of the transition, and what was formulated in June 1993 in Copenhagen as an accession criterion was practically no other than the completion of transition from a centrally planned economy to a market economy. Concerning central and eastern Europe, adoption of the requirement of an operational market economy set a certain desired minimum of transition on the one hand, and bore a reference to the requirements of participating in the single market, on the other hand.

From the aspect of accession and membership maturity, an important issue is the proper construal, identification and, in certain cases, measuring of the operability of a market economy. It was obvious: the mere legal establishment of the institutions of a market economy was in fact insufficient for the candidate countries to meet the requirement for maturity.

Operability of the market economy is a natural expectation at any level of the economy. Operability assumes a free movement of market participants and prices without any artificial constraints. Participants of the economy respond appropriately and rationally to market impacts in the given economic and economic policy environment. Company surplus becomes a profit in the actual sense of the word, which can be used to measure the contribution of the company to the profitability of the entire economy. Implementation of a market economy requires the application of policies, institutions and means of economic policy that are in harmony with the operation of the market, and attempt to harmonise broader social interests taking these into account (market-conform state institutions). Under the circumstances of globalisation – particularly in smaller economies – an important condition is for the economy to (be) open to external institutions.

Transition reports (for example, EBRD Transition Reports) in combination with the EU's Regular Reports on countries provided an assessment stating that the candidate Central and Eastern European countries – with Hungary among them – met the requirement of an operational market economy by the late 1990s. In Hungary, privatisation was mostly over (and involved corporate reorganisations unparalleled in the region), the major elements of the market economy came in line with the parameters typical of developed countries:

- approximately 97 per cent of prices are liberalized,
- entry to the free market is ensured,
- the majority of foreign trade (approximately 80 per cent) has become free,
- the forint has been convertible in terms of the current balance of payments since 1996 (and fully so since 2001),
- interest and exchange rates reflect market conditions.

Money and capital markets are rapidly expanding, with their services and infrastructure upgraded. The two main pillars of the market-conform tax system, the sales taxation in the form of value added tax adopted in 1988 and the progressive income taxation have been reinforced, and the Hungarian economy has performed successful modernisation since the mid-1990s. In the other countries, the value added tax was only adopted as of the 1990s. Economic legislation approached the EU standards, and has reached them in most areas. Similar developments have taken place in the Baltic states; however, Bulgaria and Romania have been unable to overcome their handicaps. The other countries in the region (the former Soviet and Yugoslavian republics) are lagging even more behind, although Croatia, for instance, may rapidly catch up.

We may have practical experience on integration maturity only a couple of years after achieving membership. However, the impacts of European Agreements implementing the free trade association have previously suggested that these countries are capable of exploiting the benefits of market integration. Full membership (full incorporation in the single market) did not pose a dramatically new situation in terms of opening the market (the market of industrial products had already been liberalized), and opening in additional areas (the agrarian sector, services) may also result in a positive balance of benefits and drawbacks. Integration maturity at the same time also needs to be extended to the economic and monetary union, considering that the new members wish to accede to these after a relatively new transitional period (3 to 6 years).

Requirements for competitiveness (development and structure)

Requirements and criteria for competitiveness, development and structure already became the focus of attention related to the free trade zone as the loosest and simplest form of market integration (particularly in connection with the integration attempts of emerging countries), and the situation is all the more so with more developed basic forms.

Compared to earlier enlargements, the problem of differences in development and structure emerged particularly strongly on eastern enlargements. In some of the candidate countries, the weight of agriculture is still significant, and the competitiveness of multiple sectors is low. The requirement of withstanding the pressure of competition was the manifestation of a very realistic concern. It expressed the fear – justified to some extent in 1993 – that membership may also have serious, what is more, disastrous effects on the economies of the candidates, which was not the interest of either party.

The EU did not detail the parameters of withstanding the pressure of competition, which left it wide open to interpretation. We believe that the EU only defined competitiveness as a membership criterion indirectly and with a narrowed meaning (for example, exchange rate stability). At the same time, competitiveness must be considered an important indicator (probably one of the most important ones) of integration maturity. No doubt, the candidate countries are unable to exploit the benefits of integration unless they have companies and products capable of withstanding market competition. Otherwise, competition may eliminate the companies of acceding countries from the market in large numbers.

Competitiveness, however, is not a clear-cut concept (and even less measurable). Although some believe that it can only be understood at the level of products and companies (cost level, product quality, etc.), and cannot be interpreted at the macro level, competitiveness needs to be analysed in a complex way. Micro and macro approaches are both relevant, but it is not simply a case of adding up producers' and companies' competitiveness at a national or international level, they have independent factors and effect mechanisms.

Countries do not only compete by their structures of production, technical and economic management (products, technologies, innovations, corporate governance) or the development of their infrastructure, but also by their social, economic and institutional systems. And, in a given situation, the latter may be more important. It is well known, for example, that the processing industry of the most developed EU member states has no material disadvantage compared to their global rivals in terms of production and technological competitiveness. Their structural problems are mostly related to social and institutional factors (overregulation of economies by the state, lower efficiency of the state sector, high taxes, the crisis of the European welfare state, inflexibility of factor markets, etc.). Reinforcement of the EU's competitiveness is much more dependent on implementing structural reforms than on product or technological development in a traditional sense.

In terms of integration maturity, the technical/structural, performance, infrastructural, institutional and political, as well as the subjective dimensions of competitiveness are the most important ones.

Various analyses clearly suggest that the competitiveness of new members in terms of accession and integration maturity has significantly improved in the past decade. Central and Eastern European countries have made material progress in competitiveness rankings, and have fought their way up to the mid-field of global world economy. In terms of the general competitiveness index of the World Economic Forum, Hungary ranked 26th in 2001 (32nd in 2000), and first in the region. These analyses indicate that new Central European members may stand a good chance of catching up with the developed centre of the EU in 15 to 20 years.

Unfortunately, the positions of Hungary have gradually deteriorated in the past years, according to the World Economic Forum's ranking, and, based on 2004 data, have gone back to the 39th position (and stayed there also in 2005 and 2006). Considering that three new countries were added to the study in the meantime, Hungary went down in ranking 10 positions only. This weakening position can basically be traced back to the macroeconomic performance (particularly to the record deficit of the central budget).

The main source of competitiveness of the Central and Eastern European economies lies in a rapid improvement in their productivity, as well as the high quality and inexpensiveness of their human capital. The competitiveness of Hungarian goods is principally rooted in these. As established by ITDH's study entitled Competitiveness 2000, productivity calculated using the production per employee in the processing industry between 1991 and 2000 grew to 2.2 times the rate. As opposed to this, real wages increased moderately, by approximately 20 per cent in total, with certain fluctuations. Considering this, the competitiveness of the Hungarian industry rose significantly, and wage cost advantages increased. The transformation crisis went hand in hand with a material cut in real wages, which only started rising in the second half of the 1990s. Between 1997 and 2000, real wages in Hungary grew by 3.1 per cent per year, with a 4.7 per cent annual increase in productivity – i.e. wage cost advantages carried on improving. (*Napi Világgazdaság [Daily World Economy], 27 July 2001)* Some data reveal that while Hungary's general productivity level is 58 per cent of the EU average, the wages are only around 40 per cent of the same. (*Consulting 2002 – Világgazdaság [World Economy], 15 February 2002)* The fact that real wages grew by nearly 40 per cent – a rate far above the growth rate of competitiveness – between 2001 and 2006 has weakened the country's competitiveness.

As a result of market liberalisation, energy prices in Hungary are practically in line with the world economy averages. For electricity and gas service, the state has kept retail prices lower, but industrial consumption prices are close to the level of those in other EU member states. The expensiveness of telecommunications, however, represents a competitive disadvantage. Calculated at purchasing power parity, the business sector phone costs are 30–40 per cent higher compared to the developed countries. Costs of Internet access are 2 to 3 times of the EU rate. Although real evaluation of the national currencies in the majority of Central and Eastern European countries has kept a curb on improving competitiveness, but it caused no problems in the long run, considering that productivity grew faster.

Despite the relatively good quality of labour force, the new members are still far from establishing a knowledge-based society. In the majority of countries, and also in Hungary, the main losers in the transition crisis were R & D expenses, their share in the GDP decreased to 0.5 per cent from the 2 per cent measured in the early 1990s. Although convergence has started in this area, too, the Hungarian rate of approx. 1 per cent is still behind the EU's 1.8 per cent rate. The entire EU is also lagging behind its global competitors. (The same rate in the USA is 2.8 per cent, and 2.9 per cent in Japan.)

The rapid growth of productivity is still of key importance, and much difference is made by how fast and successfully these countries can enter the knowledge-based society. An encouraging sign is that transnational companies in Central and Eastern Europe have made increasing investments in the R & D sector. As calculated by the OECD, the processing industry and one quarter of services output originate from knowledge-based sectors in Hungary, and it is a higher rate than in numerous leading countries (Germany, France or Austria). In this respect, the Czech Republic and Poland precede Portugal. *(Financial Times, 28 October 2001).* Transnational corporate structures represent the basis of the country's competitiveness. At the same time, the structure of the Hungarian economy is of dual character. The competitiveness of domestic small and medium-sized enterprises is far from satisfactory.

The competitiveness of the region is weakened by a relatively high level of social redistribution. Although the tax rate of 39 per cent as a percentage of GDP in Hungary is below the 42 per cent EU average (this number in the USA was 30 per cent, and 27 per cent in Japan), but comparison with countries like Portugal (34 per cent) or Ireland (31 per cent) is more justified, considering its relative development. In 2000, the respective data for the Czech Republic was also 39 per cent, while 36 per cent for Slovakia and 34 per cent for Poland. "To be able to stand its ground in the expected stronger competition on the European Union's extensive market, Hungary should have reduced its level of tax burden by a minimum of 4–5 percentage points back before the accession, performed in a single step, which – depending on the future steps of the other countries in the same group – should be followed up by further adjustments in certain cases." (Szabó, 2004, p. 39)

Macroeconomic stabilization and stability

Stability of an economy is no doubt an important factor in integration maturity. This is valid for both normal market operation and the utilisation of market integration benefits. Certainly, macroeconomic stability and successful integration are mutually dependent on each other: stability may be a prerequisite to integration, on the one hand, and an indicator of its success, on the other hand.

We have a number of possibilities to measure stabilisation, and selection among these is possible considering, for instance, the priorities set in the stabilization process. Generally, it would be difficult to find measures or parameters that are valid in an absolute sense, and which could be used reliably to characterise the stability of a country's economy or the optimal nature of its stabilization process. Reference points are mostly relative, and express stability comparative to specified considerations. Based on such indicators, an attempt can be made to calculate stability indices or forecast crisis situations on the basis of unfavourable processes.

■ "Optimal or favourable macroeconomic performance, which is based on an ideal configuration of economic growth, inflation, employment or the budget balance. This is of course a very uncertain and relative approach. Presumably, the question can be best assessed on a case-by-case basis. Economic performance, and consequently, stability depend on a number of factors (level of development, innovation capacities or positions in world economy, etc.). For economic growth, output gap can be examined, which is the difference of growth potentials and actual growth." *(OECD*

Economic Outlook, November 2001, No. 70.) Economic growth can also be compared to the trend line of development (a theory of *Jánossy, Ferenc)*, which means that a 3 per cent growth for a certain country can be insufficient, while in another case a 2 per cent growth can be optimal and fairly satisfactory. Unemployment can be compared to its natural rate, which may show large differences by country, in terms of various factors. Inflation is considered satisfactory if the desirable inflation is within a 2–3.5 per cent band defined internationally. Generally, equilibrium between the central budget and the balance of payments is considered desirable, but this requirement cannot be absolutised, either. For countries that are rapidly modernising and changing their structures, a deficit in the budget and the balance of payments can probably be significant; still, it would not be expedient to consider it a sign of instability. Consequently, the indicators of good performance and economic stability need prudent and specific analysis. In certain cases, absolute performances should be used as the starting point, in other cases, an improving tendency of processes that at other times are sufficient for stability.

■ Ensuring sustainable growth (which should not be mistaken for sustainable development, which strives for harmonising economic prosperity with sustaining, or what is more, improving the condition of the environment). This issue is particularly important for Hungary, which has been struggling in a particular stop-go cycle since the 1970s, resulting in over 20 years of economic stagnation. From time to time, economic growth has proved inconsistent with the balance of the economy, which has never allowed for growth rates over 1–2 per cent. Higher growth rates regularly and immediately lead to crashing the budget and the balance of payments, which resulted in a significant and unacceptable increase in debt stock. This is what happened in 1987 when a growth rate barely over 3 per cent lead to a doubled debt stock, but the case in 1993 was also similar. Restrictions made in favour of the balance regularly kept development back. The Hungarian economy was only able to break out of this ill-conceived cycle after 1997, owing to drastic stabilization measures in 1995 (the Bokros package) and successful modernisation of the economic structure. The Hungarian economy took to a sustainable growth path after 1997, and a relatively rapid economic growth (around 4–5 per cent) seemed sustainable in the longer term without causing external or internal imbalance. The economy gradually slipped off this path after 2001, and has not been able to return to it – at least in terms of budgetary balance. Sustainability of growth is also a manifestation of the structural state of the economy: so-called structural problems show a slow growth rate as a major symptom. A number of other countries (Bulgaria or the Czech Republic, for that matter) have also struggled with similar problems.

■ Performance characteristics of economies, compared to the EU:

- choosing the economic performance of EU member states as a benchmark, what is more, using the indicators from the golden era (1957–1973) of economic development.
- comparison with the average performance of EU member states.
- the best performing EU countries can be used as the benchmark.
- EU member states at an almost similar level of development can be used as the basis of comparison.
- the Maastricht criteria can be used as a starting point, which can be topped off with compliance with the Stability and Growth Pact.

After the planned economies crashed, Central and Eastern European countries experienced a grave transformation crisis: they were forced to modernise their economic structure in a radical way, while their economic output was deteriorating apace starting from the late 1980s. The depth, scale and consequences of the crisis were comparable to nothing but the Great Depression of 1929–33 in the 20th century. Between 1989 and 1994, the GDP in Hungary decreased by approximately 20 per cent, while unemployment and inflation peaked at 12.4 per cent in 1992 and 38 per cent in 1991, respectively. Hungary, as well as all countries except for the Czech Republic and Slovakia (the Czechslovakian peak of inflation was 58 per cent in 1991) faced hyper-inflation – at around 1000 per cent – by the early 1990s, while unemployment peaks in most of these countries (Slovakia, Poland, Slovenia, Bulgaria, Romania) reached 15–17 per cent.

The transition crisis affected Central and Eastern European countries less than the rest of the former socialist countries, and they started emerging from it as early as after 1993/94. The upsurge was rooted in an external economic opening, the extension of trade with chiefly EU member states, and the influx of foreign working capital, which, in most countries, was coupled with a structural reorganisation of the economy. These countries reached their production level of 1989/90 around 2000, and then gradually entered a period of convergence. The decline of other countries or regions (the Balkans, the Baltic states, the CIS, etc.) was larger in scale, and it was also a longer time until a boom set in.

The GDP in Hungary reached the level of 1989 in 2000, and even exceeded it by 31 per cent by 2006. Economic growth caused a stronger upswing starting from 1996, and the annual growth between 1997 and 2001 reached 4.5 per cent. In 2002/2003, growth slowed down to 3.6 per cent, and then, the average of the years 2004 to 2006 rose again to approx. 4.2 per cent. Global recession has moderately affected the economy, and the extra growth compared to the EU has remained a permanent 2.5 per cent since 2001 (i.e. slow-down in the EU was more intensive). The growth structure deteriorated between 2001 and 2003: while investments were declining, consumption grew intensely. The unemployment rate in Hungary (7 per cent in 2005) is relatively favourable in the region; however, the employment rate stays behind the level of 1990. (It was 4.9 million in 1990, and reached its low point at 3.6 million in 1997, but even in 2005, it was only 3.9 million.) The activity rate is around 55 per cent, which falls behind the 62 per cent average of the EU. Particularly after 1995, inflation decreased gradually, but it only broke through the 10 per cent rate – from above – as of 1999. Inflation decreased to 3.6 per cent in 2005, but the stabilization measures of 2006 may induce another acceleration, and the planned 2.5 per cent does not seem feasible.

Despite its relatively good general stabilization performance and integration maturity, Hungary shows a significant lag in terms of compliance with the Maastricht criteria, what is more, occupies the penultimate position among the new member states. Particularly unfortunate is the budgetary deficit. The record amount of budgetary deficit in 1995 (8.1 per cent) decreased to 3 per cent by 2000, and then deteriorated intensively (in 2002, and it broke another record of 8.4 per cent). Efforts made to improve the balance brought but moderate results, and by mid-year, the 4.7 per cent deficit projected for 2006 turned out to be unfeasible, and potentially to reach a rate of 9.6 per cent in the absence of stabilization measures. State debt in 1993 equalled 91 per cent of the GDP, but it decreased to 52 per cent until 2001, and rose above 58 per cent by 2005. In 2006, it may reach 62 per cent, which would cause Hungary (the only one of the new member states) to exceed the Maastricht ceiling.

As the Commission established in Agenda 2000, convergence criteria will be key benchmarks from the aspect of assessing stabilisation-oriented macroeconomic policies, and when the time comes, the new member states will have to be in permanent compliance with these. (Agenda 2000, The opinion of European Commission on Hungary's Application for EU Membership. *Integration Secretariat of Foreign Ministry of Hungary, 1997, p. 41)* As the macro performance of the new members has been relatively favourable in the past years, shortcomings of stabilisation have not hindered accession. (The performance of the old leading member states has also deteriorated to such an extent that they could not have used Hungary's lag as a reference.) A separate issue is accession to the Euro zone, or the permanent macroeconomic stability that constitutes a prerequisite to it. This in the next years will depend on consistent implementation of structural reforms, successful structural modernisation and sustainable growth ensured. As of 2007, Slovenia may join the Euro zone, and soon after that the Baltic states may follow. Officially, the Visegrad countries hope to adopt the Euro starting from 2009 (Slovakia) and 2010. Based on current performances, an adoption in 2011 seems more realistic for Hungary.

Real economic and financial convergence

Convergence may be examined from both real economy and monetary aspects, and in a certain respect, is a necessary prerequisite to efficient and successful integration. Variance in development standards and integration maturity are only very loosely connected. Balanced development cannot be considered a prerequisite, but benefits may be distributed very unevenly in case of major differences. The ideal case is an almost identical level of development, but this only characterised the European integration back in the fist period. The majority of integration programmes identify levelled development as a desirable and official target, and the EU strives to facilitate achievement of this using common policies.

In case of extreme differences, it is very probable that the balance of benefits and drawbacks is negative for a less developed country, i.e. the country in question is not mature for integration, and for this reason, integration is not recommended for it. For larger differences of development, looser forms of integration (free trade associations) are recommended, and it is expedient to link these to certain forms of compensation. Compensation may take place through asymmetric trade liberalization, financial aids or technical and other types of assistance. These may offset one-sided benefits, may adjust relationship and structural distortions, and may render conclusion of such contracts mutually acceptable. Later, as convergence progresses, compensations may be eliminated.

When the six countries signed the Treaty of Rome, their level of development and economic structures were very similar, with differences limited to certain regions only (southern Italy). Later, with consecutive enlargements – especially with the accession of Mediterranean countries – differences of development grew. The development level of these countries was 40–45 per cent lower than the Community average. Their accession – although with varying success – accelerated their economic development, and they achieved a remarkable level of convergence with more developed member states in less than two decades.

With eastern enlargements, a radically new situation evolved. The average difference of development standards has been increasing to a great extent (from an average of 20–30 per cent to 60–70 per cent), and the order of magnitude of the differences between the two extremes (Latvia or Lithuania and Denmark) reaches four-fold (and five-fold for Bulgaria). In the meantime, the development level of the most developed new member countries and less developed old ones is practically identical. Accordingly, new members constitute a rather heterogeneous group, not only in terms of economic and social development, but also historical and cultural traditions. With the eastern enlargement, the ratio of population holding an income lower than the EU average grew by 77 per cent.

For the economic and monetary union, convergence is a more sensitive issue. Stronger integration may deepen economic and social differences (mainly regionally), and for this reason, budgetary transfers may be necessary under the issue of cohesion. Compliance with the monetary and budgetary convergence (the Maastricht criteria) is a prerequisite of a stable monetary union, particularly in terms of achieving price stability.

The extended structural, then transition crisis of central planned economies had a significant impact on their convergence. Hungary's GDP per capita in the 1960s is estimated to have been around 60 per cent of the European average, which at that time corresponded to the Spanish or Irish standard, and was well above the Greek and the Portuguese development. The world economic crisis after 1973 affected the countries of the continent to different degrees. The convergence of Ireland, Spain, Portugal and Greece accelerated particularly from the 1980s – as a result of the EU membership, among others. For the Central and Eastern European region, lost decades followed starting in the 1970s, when their relative situation deteriorated significantly. The twist for Hungary began after 1996, and in 10 years the country produced a remarkable performance in terms of convergence. Compared to the GDP per capita of the 25 (at purchasing power parity) the Hungarian indicator rose from 48.5 per cent to 61.5 per cent, and it may be ascertained that it reached a relative level of the 1970s. At the same time, it remained behind that of the Mediterranean partners, not to mention Ireland. If the country is able to keep the current extra growth of 2–2.5 per cent, our convergence with the EU average may be completed in 15–20 years.

In the past years, a number of institutions and banks have commenced publishing convergence indicators. Deutsche Bank Research publishes its convergence report for all new member states and acceding states once every six months. The convergence matrix is compiled from five indicator group, which is based on a summary of 16 variables. These indicators embrace

- real economy (GDP per capita, employment, the proportion of private economy in the GDP production, the weight of agriculture and industry),
- growth dynamics (growth of GDP and productivity),
- legal, institutional and regulatory elements (legal system, liberalisation index, banking systems, harmonisation of rates and policies),
- external factors (current balance of payments, influx of foreign capital, the proportion of trade with other EU member states in their foreign trade), as well as
- the situation of finances and the budget (inflation, budgetary balance and state debt).

Taking the 15 earlier EU members states as 100, the first group of new members is situated around the level of 75 (Slovenia, the Czech Republic, Hungary, Estonia), the second level approaches the two-third level (Latvia, Slovakia, Lithuania and Poland), while the two Balkan candidates (Bulgaria and Romania) are below 60 per cent.

The indicators of Spain and Portugal similarly around 75 per cent evidence that less developed earlier members and the most developed new members are practically at the same level and in the same category. (Ranking within the groups makes almost no sense, considering the differences are as low as 1–2 per cent as shown by specific data, consequently far below the fault limit.)

On examining convergence, differences in incomes per capita are often focussed on. A major merit of convergence indicators is that they evaluate the convergence process on a comprehensive and all-round basis – and precisely for this reason, they sometimes yield radically different results than simple income details. In respect of real GDP per capita (even at purchasing power parity) Hungary has only got as far as 61.5 per cent of the EU average, far below the Portuguese level. However, compared to complex convergence indicators, Hungary reaches 75 per cent of the EU average, and is level with Portugal.

Attention must be called in particular to the structural convergence of the Hungarian economy. Although the transition crisis, as mentioned previously, was combined with a strong recession in production, the structure of economy has radically changed in the meantime, and was approaching the economic structure of developed EU counties.

Between 1989 and 2004 in Hungary, the proportion of agriculture in producing the GDP decreased from 16 per cent to approximately 4 per cent, i.e. to one quarter. As opposed to that, the ratio of services grew from 42 to 67.5 per cent, which is over a time and a half. Similar tendencies have characterised other Central and Eastern European countries, too. The contribution of agriculture to the GDP in the new member states fell to 3–4 per cent by the early 2000s, which is still roughly twice the 2 per cent level of the fifteen EU countries, but the difference is more quantitative than qualitative. In the EU, services constitute three quarters of the GDP. Some new member states have reached or approached this level, but for the majority, this ratio is still around two thirds. Again, differences are rather quantitative than qualitative.

The ratios of trade between new member states and the EU suggest a high level of structural convergence, as does the strong similarity of their import and export structures, the rapid expansion of intra-sector trade and the shares of foreign capital. As for the ratios, material variances are only shown by the data of Bulgaria and Romania. Averages may cover large differences in our case, as well. The convergence of fine structures takes a longer time.

Providing financing and the capability of being financed

Convergence in terms of the development levels and structures of the economy necessitates serious developments, which requires significant resources. Similarly, the issue of compensation provided to the weak and the losers is raised, due to an uneven distribution of trade benefits. Tensions and confusions generated from growing differences is not in the interest of more developed partners, either; consequently, some form of solidarity and compensation has been on the agenda right from the beginning in the various integrated communities, what is more, the majority of integration organisations have assumed political obligations to equalise these.

Although no material differences in structure and development were present among the six founding countries of the EEC, they even made efforts to diminish the existing ones. What else could have been the purpose of introducing a common agrarian policy as of the 1960s than a compensation of the more agrarian France and Italy against a more industrialised Germany?

It is another question that the financing criteria for greater differences in development may be put on the agenda even related to the free trade agreements or the customs union. Later, as a consequence of enlargements, this is precisely what happened when the issue of regional supports came into focus with the growth of differences in development. Such supports had been primarily targeted at Southern Italy previously, but with the enlargements, supports had to be extended to additional regions. One reason for establishing the European Regional Development Fund (1974) was the Irish and English accession, as these countries (have) had a number of underdeveloped regions. With the Mediterranean enlargement, the problem has become more marked. The single market followed by the economic and monetary union has even more reinforced the necessity of a regional equalisation.

With the accession of the Central and Eastern European countries, differences in terms of economic development and structure have significantly intensified in the European Union; accordingly, the issue of providing financing and the capability of being financed are among the critical issues of enlargement. The capability of being financed is basically in issue of integration maturity, and an important indicator of it.

- Availability of domestic capital resources. How capable is the economy in question of producing the resources of its own development? This, among others, points out the relation between national capital accumulation and efficiency. With an obsolete economic structure and deficit-producing sectors, the options of internal savings also become restricted.
- The existence of operating capital markets, which are able to mobilise internal and external resources, and allocate resources reasonably. The economy's ability to minimise capital losses (devaluation of savings due to high inflation, freezing resources by way of thesauration, prestige consumption, transferring capital abroad).
- The state of budgets in the acceding countries, the ability of governments to reach or maintain a budgetary balance, and to fund the costs related to accession.
- The ability of a particular country to absorb capital, both in terms of external investments of private capital and the intake of budgetary transfers.

On the EU's part, at the same time, financing capability appears more as a membership criterion, which was also specified in the Copenhagen criteria, not explicitly, but indirectly. This means that it is not a question of whether the EU is able to finance the eastern enlargement, but whether the governments, and particularly, taxpayers are politically prepared for it. In Agenda 2000, the budgetary transfers defined as 1.0–1.5 per mill of the GDP were of a negligible order of magnitude, especially when considering that a significant part of these got back to the donor countries – in the form of orders. Still, the enlargement crisis of the past few years appeared primarily as a financing crisis (debates on the budget for 2007–2013, primarily on contributions by the member states).

Financing may equally serve the purposes of convergence and economic stability. As for external resources, convergence of Central and Eastern European countries certainly can also be basically implemented using foreign investments of private capital. For this reason, it may be assumed that integration entails an improving resource allocation this time, too.

In order to reach integration maturity and to implement a successful integration, the new member states need considerable resources for various reasons.

- A starting condition is to improve and maintain the competitiveness of their respective economies. The modernisation and structural reorganisation of the economies of new members have relied on foreign investments of private capital; consequently, their stimulation is of great importance. (Of course, the role of local private capital should not be neglected, either.)
- Development of the region's infrastructure. In this area, new members may rely on more significant EU funds – the majority of development costs, however, is left for the specific countries to pay (programmes implemented through co-financing or purely from the member state's resources).

- Improving the condition of the environment. Compliance with environmental requirements and expectations in the new member states would necessitate thousands of billions of Euros.
- Building institutions, harmonising legislation and policies.
- Compensating for losses. No doubt, adaptation to membership criteria involves costs, and certain sectors incur losses. This is a natural process, a part of the structural reorganisation related to integration. This, for instance, is expected in agriculture.
- Payment obligations to the European Union must be complied with.

Financing or being capable of receiving financing is a key issue of integration maturity and membership adaptation. Difficulties begin with the underdevelopment of capital markets and credit rating, which for a number of countries raise the expenses of involving external resources. In the worst case, rating may as well avert all kinds of reasonable investments, as it has occurred to a number of countries in the past 10–15 years. Still, a major limitation of eastern enlargements was budgets. It equally applies to the budgets of old and new members, as well as that of the European Union. Despite the restricted nature of the EU's financing capability, approximately HUF 1,000–1,100 billion is expected between 2007 and 2013 as annual supports. It is up to the country's ability to absorb supports and the reasonable application of funds how these resources are actually utilised.

POLITICAL AND INSTITUTIONAL CRITERIA OF ACCESSION AND MEMBERSHIP

In the political and institutional dimensions, compliance with membership criteria and integration maturity cannot be strictly separated. As for institutional compliance, it is more accurately the specific membership (accession) maturity that can be addressed. The questions of democracy can certainly be analysed in general theoretical contexts, too, and the general political state of integration may lead to conclusions to integration maturity.

Political criteria are related to political integration in a wider context, and it is particularly so if the integration community commits itself to a political union. Practically, this is only true for the EU alone out of the approximately 130 regional integration organisations in the world. For looser forms of integration, mostly no tighter political criteria are stipulated. At the same time, political expectations and conditions arise in connection with the free trade zone or the customs union, although these are restricted, and mostly of a legal and institutional nature.

This does not mean that political integration maturity is unconstruable. On the contrary: the general political contexts of this can be formulated very well in a number of respects. Political criteria can be important for looser forms of market integration. For instance, anti-market or anti-democratic political systems seriously endanger market operation (efficiency, interest, consumers' choice) or the freedom of enterprise, for that matter (the danger of nationalisation); as a consequence, no closer integration is possible with these. Occasionally, political conditionality, the specification of political criteria (for associations, for example) means no more than forcing behaviour compliant with international standards.

For political integration (political union), it is obviously more. On the one hand, these formulating communities are organised along the lines of a specified system of political, economic and social values, and all participants are expected to accept it. On the other hand, the specific integration organisation runs common policies and institutions on an increasing scale, and the democratic nature and efficiency of these is a community interest. Antidemocratic behaviour and development of a community member may endanger the whole community, its safety, well-being and stability. Political and social pursuits and value systems at the same time may not be detached from the respective communities; they are dependent on their historical and cultural traditions, development level, economic and social relations, and the diversity of their compositions.

The Treaty of Rome had stipulated certain political criteria for potential members (democracy, belonging to Europe), but the first formal political criteria for accession were specified for the Central and Eastern European candidates in 1993 in Copenhagen (democracy, legitimacy, stability of institutions that guarantee human and minority rights), which was complemented subsequently in 1995 in Madrid (operational institutions of democracy). Later, in the Treaty of Amsterdam, political membership criteria were implemented against member countries. It was no accident that the political conditions related to the eastern enlargement were extended, although a more specific definition has still not been provided. Accordingly, the candidate countries were required to meet the following major criteria:

❶General enforcement of democracy (Treaty of Rome, 1957). In this context, the major principles are formulated as early as in the agreements on association. As a membership criterion, Central and Eastern European countries are practically required to implement political transformation consistently and fully: commitment to plural democracy, rule of law, enforcement of human rights, fundamental political, economic and cultural liberties, minority rights, multi-party system, free and democratic elections, freedom of the media, market economy and social justice. Similar expectations were expressed for other associations, too.

❷Stability of democracy and institutions (Copenhagen, 1993). It must be no accident that the stability of democracy is emphasized in the Copenhagen criteria. The eastern European transition is precisely a proof that it is insufficient to establish the formal democratic frameworks, and stable democracies are far from having developed in all countries. The EU has not specifically defined the parameters of stability, they were only possible to be concluded from the problems voiced in the regular reports. The stability of democracy is also addressed in the literature of politology. The stability of democracy and its institutions is associated with the settlement of political debates and problems in parliamentary and democratic circumstances; with the balance of power relations among the political parties; with the parliamentary consensus allowing for the governability of the country; as well as with the maintenance of legal security and public safety.

❸Operation of democratic institutions (Madrid, 1995). Efficient operation of democratic institutions is applicable to the operation of the legislative, executive and judicial branches of power – to a degree that is in line with the principles of democracy –, to the adoption and practical application of legal harmonisation, to anti-corruption action, as well as to the development of legal security and public safety, and, finally, to the implementation of social and economic processes that serve the country's growth.

❹It is a new development in the history of European integration that political membership criteria have become a part of the community law, and member states are also called to account for compliance with these (Amsterdam, 1997; Nice, 2000). The first attempt is made in the Treaties of Amsterdam and Nice to handle extreme populist forces gaining power in EU member states, which deny European democratic values. By this, compliance with the principles of democracy has practically become an internal membership criterion.

Contrary to the Council of Europe, the EU holds no possibility to exclude a member state. At the same time, articles 6 and 7 of the Treaty of Amsterdam are the first to allow for sanctions against member states violating the European democratic standards (as was implemented against Austria).

When the situation of new member states was examined prior to 2004, it was clear that the requirements for accession and integration maturity were met in a political respect. Still, multiple countries showed discrepancies in terms of enforcing minority rights, anti-corruption action or the operation of certain institutions. The past years have proved that Hungary is among the most stable democracies in the region.

Institutional implications are attached great significance from the aspect of integration maturity. Institutional frameworks provide the forms of implementing the integration process, and considerably determine the efficiency of integration policies and measures. With the integration deepening and especially the progress of the economic and monetary union, the significance of institutional conditions and criteria is growing.

It has been voiced multiple times that compliance with the institutional membership criteria will be handled as a key aspect on selecting acceding countries on closing membership negotiations. Ultimately, this was not what happened in practice, and the issue was decided on political grounds. The Europeanization of the domestic system of institutions is a post-accession task, and is expected to take a long time.

Related to enlargement, the Copenhagen criteria stipulated the necessity of adaptation also for old members states (capability of the EU to accept new members). These were not specified to detail, but the main courses and areas of the necessary reforms were mostly identifiable and accepted. Agreement was apparent on the following measures in particular: making the system of institutions suitable to accept new members, a reform of the common agrarian policy, a budgetary reform and successful implementation of the EMU programme. The issue of absorption capacity is particularly acute in terms of future enlargements (primarily for Turkey).

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Péter Steiner

Change of paradigm in fighting money laundering

A global anti-crime system in operation

(The new European Union directive on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing)

"Money laundering and terrorist financing are international problems and the effort to combat them should be global."
(Directive 2005/60/EC of the European Parliament and the European Commission)

After years of preparation the Parliament of the European Union adopted the new directive 2005/60/EC on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (hereinafter referred to as the directive) relatively quickly, on 26 October 2005, which replaced the first and the second 'anti money laundering directives' bringing back the relevant legislation of the EU to the forefront. The member states are required to adjust their legislation by 15 December 2007 the latest.

One might ask whether it is not an exaggeration to speak about a global system of instruments in connection with the regulation of such a special field. In this essay I would like to highlight changes that have contributed to this instrument, which initially served as a tool in the prevention of drug-trafficking, to become a global instrument in anti-crime efforts.

GENERAL CHARACTERISTICS

The international legislation fighting money laundering is specific in a number of ways.

- The system of global regulation is based on a group of experts, whose authority is unquestionable, operating on a club like basis (which means that it is an exclusive organisation with strict admission rules where admission is to be consented by the members), established in 1989 as an ad hoc working committee, the form of which is still retained. This organisation is authorised to create rules, monitor and assess compliance and sanction non-compliant behaviour.
- The legal and other rules related to money laundering – unlike elsewhere in the world – require uniform procedures from a uniform group of those obliged based on uniform principles with uniform content using uniform concepts. Being an element of the system of rules, the international cooperation, the uniform regulation in these countries and the institutions based on these form a global system.
- A stable mechanism serves as a basis of the constant development and functioning of such uniform regulations on a global level.
- The basic principle of the operation of this system is the procedure initiated based on the

principle of the emergence of a suspicion. In the first place the key role players – who become quasi law enforcement entities – are financial institutions, lawyers, traders etc., often referred (unofficially) to as the 'guardians of the gates'.

■ Due to its success to date the system has been charged with the prevention of financing terrorism as a global commitment in addition to their existing tasks, and assigned a significant role in the fight against global corruption (by a new rule on the control of the so-called politically exposed persons, i.e. political elite in the world).

ESTABLISHMENT OF THE INSTITUTIONAL BASIS FOR COMMON STANDARDS

The FATF Group

In 1989, the leaders of the G7 countries decided to set up a task force for a defined period of time to lay down the principles for the elimination of money laundering practices witnessed in the financial sector. Presumably it did not occur to any of the founders at that time that they launched one of the most influential international organisations in the world. Indeed, the abbreviated name of the Financial Action Task Force (FATF) soon became a 'trademark'. Its success may be due to the fact that the experts worded their forty recommendations in a simple and easily understandable form in line with everyday practical moral standards. The documents known as the Forty Recommendations not only became an international standard, its title became a symbol, too. The number of the new recommendations adopted in 2003 is 40 again with various new parts categorised under subtitles, supposedly in order to keep the original title, which became so familiar. Since its establishment, the assignment of FATF has been renewed a number of times, and it seems that this will continue in the future.

After 11 September 2001, in addition to the Forty Recommendations, the Eight Special Recommendations on Terrorist Financing were adopted. (Further nine were added, that's why these are addressed as the 40+9 Recommendations).

As a result of the fairly restrictive admission policy of the FATF, which is still operating on a club-like basis, and its evaluation system based on mutual evaluations carried out regularly, it became necessary to set up regional, FATF-type organisations for non-FATF member countries. (Hungary, for example, is a member of Moneyval, a FATF-type organisation established in the framework of the European Council.) The region is made up of European countries other than the EU-15. These organisations are engaged in the monitoring of compliance with the FATF recommendations; however, they have no right to prepare recommendations. There is a pyramid-like hierarchy evolving, with FATF on the top authorised to create rules, monitor adherence and sanction shortcomings and regional organisations at the base, which follow up and evaluate the compliance with the rules in accordance with the methodology of the FATF.

The new 40+9 Recommendations published in June 2003 is different from the former ones essentially in that the short, easy to understand, but necessarily simplified rules were replaced by new regulations that make often quite different options possible, thus taking into account the mechanisms of the economy and financial transactions. In addition it was the service provider's responsibility to determine to which extent the stipulated measures were to be applied based on an assessment of risks. Practice will reveal whether the system may remain uniform when those liable take advantage of these options. These FATF recommendations are addressed primarily to the member states and legislative organisations and the content of these recommendations should be transposed in the national laws. Each EU member state transposes the recommendations in its national legislation. The EU member states – and thus Hungary – are directly subject to the adoption of the Forty Recommendations effective since June 2003. However, most member states will consider the Forty Recommendations filtered through the new EU directive as a basis of their national legal acts to be created by 15 December 2007.

In order to establish and prevent a single internal market the EU believes that Community level regulation should be adopted which contains the minimum requirements and is uniform as far as the key issues are concerned. In the EU the free movement of goods in the internal market and the free provision of financial services in all EU member states require the management of the resulting risks specifically.

Cooperation of FATF and other international organisations

Jointly, the International Monetary Fund and the World Bank (IMF/WB) have long been keeping guard over the balance of the world's international finances. In this framework 'country reports' are prepared on a regular basis on the state of a given country's financial system (Financial Sector Assessment Program: FSAP). Recognising the significance of the fight against money laundering as far as a given country's financial state is concerned, adopting the FATF recommendations and their assessment aspects, a uniform IMF/WB assessment methodology was elaborated as part of the FSAP, which is compatible with the methodologies of FATF and FATF type organisations. The cooperation of these organisations is well illustrated by Hungary's country report of last year. In this framework the third round of the Moneyval assessment of the member states' measures against money laundering and terrorist financing ('mutual assessment') was carried out by the experts of the IMF/WB commissioned by and with the participation of Moneyval. The results discussed and partly revised by the general meeting of Moneyval was integrated (without any modification) in the FSAP report of the IMF/WB due in the same year.

The Basel Committee on Banking Supervision, which provides a forum for authorities supervising central banks and financial institutions, has created standards for various aspects of bank security. This is how it became a creator of a number of recommendations on measures against issues endangering the renown of banks, such as money laundering. FATF considers these highly important and so it refers to them directly in its new Forty Recommendations. Furthermore, it stipulates their application in other financial service areas, wherever possible. It means that the two regulatory systems, formed taking different aspects into consideration, are connected. The connection was made in the intersection of the protection of financial institutions, their customers, owners and the financial markets and the protection against criminal activities, serving both purposes. The international bodies of other financial services (insurance, securities trading etc.) have also prepared their own recommendations on the fight against money laundering in line with the Forty Recommendations. This is how the hierarchic system of compatible recommendations has been established.

THE EVOLUTION OF THE BASIC ELEMENTS OF THE SYSTEM

Extension of the definition of money laundering

The fight against money laundering evolved from measures against drug-trafficking. For a relatively lengthy period money laundering meant cleaning dirty money obtained through drug-trafficking especially as international agreements covered only this field. However, with the emergence of FATF and the issuance of the Forty Recommendations the international background facilitated the extension of the definition of money laundering to financial and other instruments obtained from other criminal acts, too. For a while money laundering was defined as the concealment of instruments derived from serious criminal acts. The 'all crimes approach', as a final solution covers all criminal acts where the origin of the instrument is concealed. The new EU directive has actually introduced this latter principle. It also means that money laundering activities are globally on the rise partly as an increasing number of criminal acts are included in the definition of money laundering. A very important achievement is that those under obligation should report suspicions of money laundering acts. Should any other criminal acts be behind the suspicious proceeds or transaction, they all may be considered as reportable transactions. It means, however, that regulations against money laundering have turned into an instrument against all crimes instead of an instrument against a single crime.

Extension of the reporting obligation

Initially, when the primary objective was to prevent laundering money obtained from the sale of drugs, the relevant regulations referred only to institutions capable of entering money into bank accounts, i.e. financial institutions.

The most important elements of the regulations are well known. Their short summary is as follows:

- it is obligatory to record and keep the customers' data;
- suspicious transactions should be reported to an authority set up for this very purpose and the transaction should be stopped, if it is possible and suitable;
- money laundering is a crime, which may be punished even by detention for years;
- the reporting entity is not responsible for the customer's loss arising in connection of such reporting.

However, as the money laundering techniques are becoming more refined, and anti-money laundering measures are in place in financial institutions, criminals try to make their proceeds legal through newer and newer transactions. Recognising this, the obligatory application of anti-money laundering measures was extended in 2000 in the European Union, years before the similar steps taken by FATF. From this date this covers various professions other than financial services such as lawyers, car dealers, jewellers or real estate agents. Consequently, the following step in the procedure was that for all purchases exceeding a relatively high limit (which is currently 15 thousand euros) the anti-money laundering rules apply to all traders within the territory of the EU with special regard to recording the customer's data and reporting suspicious transactions.

This means that the obligation related to anti-money laundering (and terrorist financing) regulations, which originally applied only to banks, now potentially affects all traders. Therefore the number of those who should understand the various rules is measured in millions. They are also required to prepare internal regulations, train their staff on a regular basis, set up records, check black lists etc. The implementation and compliance should always be controlled (or validated) by an authority (which could be a professional local government). Such extension is a great burden not only on those under obligation but also on the public administration, chambers and other similar self-governing bodies. (There is no ready solution for these tasks in any EU member states.)

Such development incurs a number of problems for the investigating authorities, too. Due to the continuous and significant rise in the number of those obliged the number of reports has multiplied. For the law enforcement agencies the system offers a great advantage in that from now on not only the financial service providers, but also a significant portion of the non-financial service providers are treated as the "guardians of the gates".

In case law enforcement is carried out thoroughly, a further extension of the group of those obliged could have a great impact, i.e. when the anti-money laundering regulations are extended to all natural and legal persons who and which – due to their positions – act on behalf of the actual owner concealing the owner's identity. (I will go into details later, when listing the new instruments, however let me point out that the core of the system's development in the field of anti-corruption measures is already present in this regulation.)

Spatial extension of the application of the Forty Recommendations

It ensues from the characteristics of the FATF group that initially, its members took on the obligation to introduce the anti-money laundering measures themselves. Soon however, the OECD, which, apart from its own tasks, performs secretarial tasks for the FATF, included the implementation of the Forty Recommendations among the conditions of OECD membership. Among other things, the recommendations state that *it is* necessary to consider breaking off relations with countries and institutions that have inappropriate anti-money laundering regulations. The next step taken in this direction was the FATF action called *blacklisting*, within the framework of which the FATF selected the countries whose legislation they did not deem appropriate – and made their names public. This practically obliged each country in the world to have legislation that complied with the Forty Recommendations, unless it wished to intentionally risk breaking off its settlement, and (through that) economic relations with other countries.

Blacklisting proved extremely successful: the states in the list made every possible effort to be taken off the list, and the others also enhanced their efforts to further improve their legislation. The totally public nature of the repeatedly held mutual assessments, and their results' being made public supplemented the effect of blacklisting – partly even taking its place. Today, in the third round of mutual assessments, it is not the existence of the legislation that is scrutinised any more – as, essentially, it can already be taken for granted in every country, but the observation of the actual regulations. Today, regulations already require both the authorities and those obliged to comply to implement them. One effective tool of a quick survey of the implementation will be the obligatory collection and publication of statistical data on reporting, investigations, judicial proceedings, verdicts, and seized assets.

Geographically, the circle of corporations obliged to comply that follow appropriate procedures has further expanded. The reason is that now a company registered in any Member State is obliged to observe the anti-money laundering and terrorist financing regulations and procedures of its parent country in all its branches in countries outside the EU, and even in its subsidiaries. Should that prove impossible in a given country, immediate reporting is obligatory.

Establishing comprehensive customer monitoring

It has long been one of the cornerstones of the prudential regulations concerning financial institutions to require circumspect customer management and appropriate monitoring. Thus, the "Know Your Customer!" rule has quickly become one of the tools in the fight against money laundering.

However, the new legislation reformulated the unchanged provision, now as a comprehensive requirement. When establishing a business relationship, the service provider is obliged to become familiar with the purpose of the customer's business activity, the origin of the assets serving to achieve it, and, in the case of companies, the identity of beneficial owners. On establishing that relationship, the service provider shall conduct ongoing monitoring to find out whether the transactions between the customers and their business partners correspond to the originally established customer profile. Therefore, it is necessary to monitor all the customers and all their transactions during the whole course of the business relationship, and it is also necessary to assess whether a transaction that can be deemed suspicious on any account has been made – continuously, within a realistically set interval.

Extension of the indictability of the activities relating to money laundering

In Hungary today, the law differentiates between two types of money laundering, i.e. between the intentional and negligent commission of the offence. According to the definition of the new EU Directive, if the suspicion of either money laundering or terrorist financing arises, it is being committed intentionally that decides whether it is possible to consider it a criminal offence. In this respect, the Directive is milder than the current domestic legislation. However, in another section, the EU Directive imposes the requirement that it be possible for those having leading positions within legal persons to be held liable on the basis of their function at the company – depending on the decision of the given country, but at least in the framework of a surveillance procedure, even if they have had no part in the money laundering itself at all, but

- one of their employees has committed the infringement for the benefit of the given institution, or
- they have failed to conduct the controlling activity which is their task, thus making the commission of the infringement possible.

However, essentially, these latter facts – limited to leaders – correspond to the concept of responsibility for negligent commission, while they also fit into the new legislative trend which intends to establish the greater personal legal responsibility of leaders of legal persons.

It promises to be a new provision of great practical impact that legal persons shall be indictable – with effective, proportionate and dissuasive penalties -, at least within a surveillance procedure. (It is true that the possibility of legal persons' being held criminally liable had been part of the legal system of the EU, and since our accession, that of Hungary as well.)

However, according to the definition, hiding funds and other assets derived from crimes committed by themselves – expressively termed as "self-laundering" –, disguising their origin, etc. are considered to be money laundering, in spite of the fact that several legal experts in Hungary regard this as double punishment. (Influenced by previous notions originating from the EU, this concept was incorporated into the Hungarian legislation years ago.)

In summary, the new legislation exerts direct pressure on senior management, and creates owners' interest in the compliance with the provisions at the same time.

Extension of the monitoring and reporting obligations

The world-wide institutional system established to prevent money laundering has numerous features that also enable it to cut off terrorist funds.

■ Primarily, the peculiar feature that reporting is obligatory even if only based on mere suspicion. This makes very early initiation of inspection and detection possible.

■ The thoroughly outlined legal background – the chain from reporting obligation, through prohibition to inform the customer, to exemption from responsibility for incidentally caused damage – can be immediately applied essentially unchanged; so it is not necessary to take years to newly develop an international system.

■ Technologically, it is essential that the automated monitoring programs, embedded in the computerised settlement and clearing systems, developed for anti-money laundering systems, which also recognise transaction types, together with the elaborate and well-proven reporting systems, which are operated by all those obliged to comply, can be rendered suitable to quickly select transactions and persons of different types, and to inform the authorities of them – promptly and with relatively few additions.

The UN, the EU and certain governments publish the names and other known data of the persons for whom or which no service whatsoever shall be provided owing to their participation in terrorist activities, whose availing of any funds or assets shall be hindered, and whose funds and other assets shall be frozen in different international lists. The EU publishes its own lists and the relating freezing measures in the form of regulations having direct effect in all Member States, while requiring the use of other lists necessitates issuing domestic legislation. (In Hungary, that requires legislative authorisation considering that it constitutes limitation of a fundamental right. However, Act No LXXXIII of 2001 empowers the government to publish its own limiting and prohibitive lists – for a limited period of time.)

Regulation (EC) No 2580/2001 – as an exceptional measure, corresponding to a particularly significant problem –, proceeding in a manner that to a certain extent evokes ancient Roman proscriptio, i.e. exclusion from all protection under law, obliges everybody (i.e. natural and legal persons as well as organisations) to freeze all movable and immovable properties of the persons and organisations in the list, which is essentially the equivalent of seizure of property in the everyday sense. The authorities in the Member States have had three tasks. One was to create adequate internal legislation. Pursuant that, those who do not implement what is required by the regulation are adequately punished, and reporting the freezing to the national authority designated for this purpose (usually the ministry of finance) is made mandatory. The second step: the national authority shall also immediately inform the EU Commission of the freezing. The third task: for reasons of equity, or to provide their owners a way to make a living, the designated national authority may again give access to the frozen assets to their owners in justified cases. In a rather one-sided fashion, the legislation deriving from this regulation rendered it the task of private individuals and enterprises to deprive terrorists of their assets – based on their own assessment and decisions, relying on the names and possible other identification data in the list –, without even mentioning the procedural tasks of law enforcement bodies. By comparison, the significance of the new Directive is that now the full and well-proven set of instruments of protection against money laundering may and shall also be applied as soon as the suspicion of terrorist financing arises. Practically, it means that if e.g. a person whose name seems familiar to service providers from the list appears among their customers, providers are not left to their own resources during the procedure because, on their informing the police, the whole well-proven mechanism is supposed to be set in motion.

However, the Directive did not take the opportunity to connect the instruments serving the same purpose: it does not refer to the still obligatory monitoring and use of the terrorist lists pursuant Regulation (EC) No 2580/2001. The reason for this presumably lies in the rigid legal separation of the tools belonging to the three different pillars of the EU. Thus the seemingly logical step, i.e. the EU anti-terrorism Directive's requiring the automatic application of the appropriate provisions against the persons in the EU terrorist list failed to be taken. (The Directive on the specific details of the implementation of Directive 2005/60/EC is expected to contain at least one reference to the still obligatory application of Regulation (EC) No 2580/2001 and its amendments.)

According to the present definition, terrorist financing – similarly to money laundering – is only considered a criminal offence if committed intentionally. Concerning specific cases, this will obviously render the taking of evidence more difficult. Consequently, the efficiency of the legislation will crucially depend on the judicial practice to be established in the course of handling such cases.

NEW (FUTURE) INSTRUMENTS OF THE DIRECTIVE

Risk-based approach

The so-called risk-based approach has long been used in several fields of process control – such as the supervision of financial institutions. Briefly, it means concentrating limited resources on the areas and institutions constituting the largest potential danger and damage. At several points, the new Directive empowers the Member States and certain institutions obliged to comply to introduce provisions or internal procedures milder than recommended, or even ignore the application of the given rule altogether if it is found permissible in the course of risk assessment. However, this permissive rule implies – not in the domain of state decisions, but in that of corporate decisions – that if something goes wrong, then it is the company that shall prove before the supervisory body: the measures applied have corresponded to the extent of the risk. By comparison to the previous system, the simple but rigid system that required identical procedures against everything and everybody ceases to function. The professional skills and experience of those obliged to comply may have a part in the choice of necessary procedures, which, on the other hand, has its price: the persons authorised to make decisions will have to assume the responsibility of their choice and the risk involved.

This constitutes a huge risk for the management of individual institutions: naturally, the application of simplified procedures may be advantageous for profit maximising, however, in such cases the possibility that their supervisory body will not approve of their procedures in retrospect and they will have to bear the personal consequences described above will lurk above them continuously. This makes it probable that many of them will endeavour to make the supervisory body approve of deeming the given type of situation one of low risk in advance. However, this would hardly be in harmony with the aim of the Directive: the risk of the application of the risk-based approach is to be taken by the accountable managers of service providers, which is to force them to examine all still bearable risks regularly, on a case by case basis.

Simplified and enhanced customer monitoring, prohibitions

It is perhaps in this field that the Directive presents really ample opportunity to the Member States to outline country-specific variations of the legislation, taking domestic characteristics into consideration. After describing the different steps of customer monitoring, the Directive describes cases and situations when enhanced or simplified procedures shall or may be applied, as opposed to the default procedures, in two chapters. In the majority of the cases encompassed in the Directive, the Member States can decide to introduce the milder procedures themselves; however, they are obliged to introduce the considerably tightened procedures.

Some simplified procedures grant actual, total exemption from customer management provisions. (The Directive, probably unintentionally, does not differentiate between identification procedures and transaction monitoring, and when authorising simplified procedures, basically, it remits both. However, the Implementing Directive will in all probability establish that filtering transactions shall constitute a fundamental obligation, not to be neglected under any circumstances.)

With regard to the second group of simplified procedures, the Directive renders possible the simplified execution of the required inspections in the case of transactions of small individual value relating to certain services provided on occasions, or to an insignificant extent.

A number of key institutions – e.g. credit institutions, insurers, investment funds, etc. – are under strict (official) state supervision as managers of other people's money, and so are players of the financial and capital markets to protect the operation of the market. As part of the state administration or as a state property (e.g. state-owned companies), several customers (e.g. municipalities) are under direct or indirect state supervision of some form. In view of this supervision, and also taking the differences in the nature of the supervision into account, the Directive requires and permits both obligatory and optional simplified procedures.

The Directive grants obligatory exemption from customer management provisions to credit institutions and financial institutions[1], which means that the legislation of a Member State cannot impose obligations on them in this respect.

As for the other institutions listed in the Directive and its Implementing Directive, the exemption is optional; consequently, national legislation may provide exemption, but not obligatorily.

Enhanced, or tightened customer monitoring shall always be required of those obliged to comply, by national legislation, if

- customer identification has been carried out without the physical presence of the customer,
- a correspondent banking relationship has been established with a credit institution of a non-EU country or a country to be deemed identically,
- they establish or maintain business relationships with customers classified as politically exposed persons, or
- they deal with products or transactions that favour anonymity.

Apart from financial organisations' exemption from the identification obligation, only two definitive prohibitions are found throughout the Directive: one prohibits establishing relationships with so-called shell banks, i.e. phantom banks registered somewhere without actual business presence, while the other prohibits establishing or maintaining relationships with unidentifiable customers. As far as the latter is concerned, it is worth noting that with regard to small-amount anonymous accounts, diminishing, but at a very slow pace after the campaigns aiming to identify the owners of savings both in Hungary and in certain other Member States, the Directive permitted maintaining these accounts as a separate rule, on condition that the owners might not use their deposits in any manner prior to the registration of all their identification data (which condition had been taken over from the Hungarian Anti-Money Laundering Act).

Divulging the beneficial owner's identity

The previous EU Directive had already required that apart from the identity of the customer, service providers also know that of the natural person known as the beneficial owner, who – in contrast to the customer – was the ultimate owner or beneficiary of the given funds and other assets. A beneficial owner may only be a natural person. Theoretically, this means that independently of the number of legal persons (ltd's, plc's, foundations, etc.) through which someone's proprietary right is established, the service providers obliged to comply shall continue searching until they reach the living, flesh and blood human being. The customer's obligation to divulge the beneficial owner's identity and the service provider's obligation to trace the real owner serve the same purpose: to extend the effect of the Directive to the real owners. (Among those specifically referred to in the Directive, the terms "trust and company service provider" and "trustee" refer to professions whose names do not even have established Hungarian translations yet, and the legislation concerning them has solidified to an even smaller extent. At the same time, it is highly probable that the representative and trust activities relating to them are wide-spread in Hungary albeit without their being recognised as professions.) Consequently, demanding that the actual market players be identified reaches much further than the fight against money laundering and terrorism: in the long run it may serve as a basis to create general money and capital market transparency.

However, when the legislation was being drafted, it quickly became obvious that these ideas in their pure form could not be put into practice at present. The reasons include the following:

- there exist millions of small owners without any influence on the business activity of the company co-owned by them, thus it is unnecessary to identify them as beneficial owners;
- the owners of public limited companies may change several times or significantly even during one day, which, naturally, authorities have to trace for the transparency of market processes and in order to prevent fraud. Still, it is not necessarily expedient for the different service providers (e.g. their banks or investment consultants) to continuously register these temporary changes;
- the ultimate beneficiaries of the activities of foundations and charity associations are not (and cannot) be known in advance.

Also, it is impossible to put these ideas into practice in a perfect form because the large public registration systems established throughout the world over the centuries – such as company registers of company registrars, land registers, etc. – have not been developed to allow establishing the identity of beneficial owners; thus they are not suited to serve as background tools of an automated query system.

The above reasons have led to a significant shrinkage of the theoretically rather ambitious scheme to identify beneficial owners – partly out of rationality, partly out of necessity. However, the basic principle has remained unaltered, and will probably prevail in the long run.

The most important exceptions and simplifications concerning beneficial owners contained in the Directive are the following:

■ It is not obligatory to apply most of the tools of customer monitoring in relation to credit institutions and financial institutions registered in EU Member States or in certain third countries at all. Especially in the case of their own-account transactions, it is possible to waive the obligation of identification. (Naturally, this does not concern the dealings of intermediaries of customer transactions.)

- The Member States may waive the obligation of identification regarding owners of public companies, owners of amounts on lawyers' and notaries' clients' pooled accounts, and domestic authorities.
- In the case of limited companies, owners who own a minimum of 25 per cent of the shares, or have control over the managing of the company in any other way are to be regarded as beneficial owners. (This percentage was established through heated debates and may even be decreased in the long run.) Consequently, if there is not at least one person with such an ownership ratio, or an owner having similar influence on company decisions in any other manner (e.g. there are five co-owners with equal rights), the enterprise – at least with regard to anti-money laundering provisions – does not have a beneficial owner. According to the unofficial opinion of an EU expert, for this reason it is unnecessary to search any further to find one. This greatly eases the task of those obliged to comply, moreover, it creates a simple opportunity to evade the application of the provision (e.g. through a 24.9% ownership), and as such, it is likely to be utilised widely in the future.

The Directive left open the question whether those obliged to comply should obtain customers' and beneficial owners' data from

- registers also available for the public,
- customers' statements, or
- other sources.

This latter instance suggests that utilising any data collection not expressly prohibited by law for this purpose will be acceptable in the future.

Fulfilling the reporting obligation

In the early 1990's, what anti-money laundering experts emphasised was the importance of the largest possible pressure to be put on the clerk who had direct contact with the customer in order to ensure the fulfilment of the reporting obligation. At that stage, the sole obligation of the company or enterprise concerned was not to hinder reporting, but rather help it by appointing the person responsible for it.

Today companies and employers are the general addressees and executors of the legislation to be prepared based on the recommendations – and more importantly, on the Directive. It is their duty to make sure that they both operate appropriate systems and have appropriate employees who conform to regulations. Reporting has also become the duty of companies primarily, as it is unambiguously stated: "shall require the institutions (…) covered by this Directive, and where applicable, their directors and employees, to cooperate fully by promptly furnishing (...) information".

Focussing on the company with regard to that obligation shows that the treatment of the topic as such – due partly to the modernisation of the professional procedures, and partly to the transformation of the objectives – has become industrialised. It has been recognised that there is a higher interest in putting the whole enterprise – especially its top management – in the service of detecting and preventing money laundering than in maximising the pressure on a few employees who have direct contact with customers. Besides, the large majority of suspicious transactions and persons are now singled out, and the information on them is automatically sent to analysers by the fully automated checking and recognising software embedded in the clearing processes. Thus, suspicion often arises in the minds of machines and not people. Traditionally, or legally speaking, in such cases it is not even possible, or at least it is difficult to speak about the recogniser's suspicion…

Eventually, in the majority of cases, after the examination has been carried out in compliance with several internal rules, utilising a series of software, and involving further experts, reporting is done by an analyst whose official range of duties includes detecting money launderers and terrorists. It is easy to accept that functionally, this person in charge of reporting is rather different from clerks who expressed their suspicion based on their own personal impressions on each occasion, and on whom the system was once built. Accordingly, the Directive no longer deals with the clerk in charge of reporting at all. Moreover, regulations concerning the person within the company traditionally reporting to the financial intelligence unit (FIU), and the reporting route up to the person in charge are only indirectly tackled. The reason is that it is required that those obliged to comply (i.e. the companies) "promptly inform (...) the FIU, (...), where the institution or person covered by this Directive knows, suspects or has reasonable grounds to suspect that money laundering or terrorist financing is being or has been committed". The prohibition of filtering – retaining reports that have been prepared, or refusing to forward them – has also only been formulated concerning forwarders of reports in certain countries, e.g. public prosecutors, thus emphasising that it is now companies that are primarily responsible for fulfilling the reporting obligation.

Restrictions concerning the use of cash

Since the beginning of anti-money laundering activities, cash transactions have been considered the most suitable method for money laundering. For this reason, a separate system of regulations has been outlined to treat them and restrict them to the greatest possible extent.

Despite the example of setting an upper limit for (permitted) cash payments in a Member State, the EU has not introduced this very drastic, prohibitive solution (even though there is reference to it in the Directive). Instead, it is required that in the case of cash transactions in an amount over EUR 15,000, even retailers who would otherwise not be covered by this legislation apply the rules of customer monitoring and other anti-money laundering measures. The provision is expected to have a restrictive but by far not prohibitive effect on cash payments in almost the whole of Europe. The introduction of the provision will probably cause problems in daily business activities, primarily in the new member states, which rely on cash to a significantly larger extent than the EU-average. Still, it is important to emphasise that this may be the first all-EU legislation which openly disfavours – even if only indirectly – the use of the notes issued by the central banks of the Member States as legal tenders as official and permitted means of payment. In the future, the process thus initiated is expected to continue: further restrictions are expected to be introduced in order to further reduce flow of money that is impossible to monitor.

Introduction of regulations concerning PEP's

The introduction of the term "politically exposed person" (PEP), and the provisions relating to procedures concerning such persons is the element the most fully representing the universal law enforcement function in the new legislation. The theme originated from the habit of many 20th century dictators and their henchmen, who, anticipating a possible downfall, placed a significant part of the huge fortune which they had obtained from individuals and the state budget unlawfully during their reign in foreign banks. Obviously, making these amounts appear to be the property of those unlawfully possessing them is one form of money laundering. Also, it has been experienced that certain amounts moved through foreign accounts have served to finance further serious crimes such as arms smuggling and terrorism. Assuming that it is the possession of high-ranking state, military, political, etc. posts that creates an opportunity to commit such crimes, the Directive required that all people entrusted with prominent public functions, as well as their immediate family members and colleagues be classified as politically exposed persons, and also as high risk persons. The Directive also refers to the threat to the reputation of enterprises that maintain business relations with such persons and participate in their illegal transactions – and thus, eventually the threat to the trust in the financial system, one of the cornerstones of the economic system. [Again, at this point, the provision of the EU-Directive, (also) serving to protect good reputation, shows connections and overlap between the requirements set down in the Basel Core Principles on bank security and the FATF Recommendations concerning the fight against money laundering, thus verifying the existence of the global connecting process of regulations of different objectives, which, however, concern identical processes.]

However, the system, based on a deduction accepted as logical, will also have rather specific and unusual consequences. Declaring all world leaders to be high risk customers, and especially ones that require to be under close surveillance – at their banks, insurers, pension funds, and when purchasing cars, property, jewellery, etc. – will result in a sort of inverted "Big Brother is Watching You" situation. From now on, it is not the leader that will keep the ones led under constant surveillance, but – by service providers obliged to comply being inserted in the system – the relationship is becoming oddly reversed. We are witnesses to the unfolding of a global surveillance system mounted against the misuse of political power and state-level corruption, based on a thorough consideration of anti-money laundering principles, extending them to the utmost limits.

Therefore, in the PEP regulations, beside the double task to act against money-laundering and terrorist financing, we can recognise the introduction of a third use of the system, i.e. to act against corruption. (If we regard the obligatory tracing of the identity of beneficial owners as a separate task to be carried out even if there is no suspicion concerning either money laundering or terrorist financing, then together with the ones previously mentioned, we can distinguish four essential tasks of the system, out of which only two are openly declared.)

Deciding whom to classify as a PEP exceeded the possibilities of those outlining the Directive. The European Commission has been assigned the by no means simple task to define the term PEP within the framework of the decrees on the implementation with exactitude, seeking the opinions of the experts representing the Member States in the Committee to Prevent Money Laundering and Terrorist Financing. Outlining detailed rules, e.g. how long a former PEP can justly be regarded as a PEP, what the criteria of "outstandingly high rank" are, what "local state administration leader" means, what standards are to be used for the classification "of a large city", how wide "the circle of immediate colleagues" is to be extended, etc. has resulted in numerous debates and a heavy workload. All the basic principles and details are still far from being completely outlined.

With regard to the usual element of committing the crime in question, i.e. transporting something abroad, the task is further aggravated by the fact that each PEP is only to be treated as a PEP in the foreign Member States. Thus, it is not domestic but foreign PEP's that are to be recognised in each Member State. (However, the FATF has suggested that the PEP regulations be also extended to domestic PEP's, and some Member States will presumably take account of this recommendation.) This poses a practical obstacle – e.g. who outside Brazil can tell the name of, say, the governor of Mato Grosso State? –, which will obviously make consulting outside professional aids necessary.

However, the preparation and application of lists containing names and other data of PEP's had not halted to wait for the EU basic principles to be outlined. The reason is that the new FATF Forty Recommendations became effective in June 2003, while the already effective EU Directive only makes compliance with this provision (and the ones relating to it) obligatory in the Member States as of 2008. However, it is rather uncertain whether reference to the transitory period will provide full protection against any criticism to be expressed in the course of accreditations provided by the FATF or similar organisations.

There is also a list compiling industry, which has developed based on the very generally formulated FATF Recommendations. Its leading companies have already compiled lists containing hundreds of thousands of names and created the programs necessary to apply them for their clients. There already exist world-wide compilations on PEP's on sale, based on information deriving from the news, Who's Who-like publications, different authorities' search programs or blacklists, and perhaps their compilers' own research. However, as yet, their scope and data content does not necessarily correspond to the EU-criteria, which is being laid down in an autonomous manner.

As soon as such details as whether e.g. the EU wishes to classify mayors of large cities as well as the leaders of the Catalan Generalidad, the German Länder, etc. as PEP's have ultimately been decided, professional compilers of lists (also) working for the European market will probably comply quickly by developing a variation satisfying the European PEP regulations.

Within this process, naturally, it will also be essential to know to what extent and how the service providers obliged to comply will be held responsible for the mistakes and for the updating of the lists either compiled by themselves or purchased, rented, leased, etc. under national legislation. As yet, this question has not arisen; still, it is conceivable that a certain kind of regulation or supervision will have to be extended to compilers of lists themselves in the future.

A further question to be answered is what kind of provisions ought to be applied concerning small and medium sized enterprises, which account for the vast majority of those obliged to comply. The purchase of pricey lists and their regular maintenance would represent too big a burden for them, and, at the same time, it would not be expedient to require that of those enterprises due to the size, composition, etc. of their clienteles. It is mostly the copyrights and the business policies of the compilers of the lists that are expected to constitute the limitations of the development of the probably multifarious national legislation, as it is to be decided based on these whether e.g. it is possible to check if a new customer is a PEP over the phone, or whether several users may purchase a single PEP-database for common use, etc.

In the future, as a first step within the PEP procedure, service providers are expected to request all their customers to declare whether or not they classify themselves as PEP's based on criteria provided for them.

Customer identification by agent

Acting on the Forty Recommendations, the new Directive has accepted the consequences of a globalised world economy and the development of telecommunications equipment: international investments have become large-scale without the vast majority of investors ever appearing in the country where they have purchased interests and, indispensably, financial and other services. For the legislation to require that these investors or other persons in similar circumstances – such as foreign royalty owners and heirs – be physically present at the service provider's office in the target country in order to identify themselves would indeed be incompatible with the actual functioning of the world economy. The Forty Recommendations – and the Directive presented based on them – have offered two routes towards the solution of the problem.

One: identification without the customer's being physically present. E.g. executing a contract through the internet demands increased diligence of providers: it is their task to verify the new customer's (or beneficial owner's) identity through the use of additional documents and by applying special identification techniques.

There is another possible solution, which is significantly more similar to identification in the physical presence of the customer than the previously mentioned method, and is mutually more advantageous for parties acting in good faith: involving a new, so-called third participant, called introducer in the terminology used in Anglo-Saxon countries, to carry out the identification on behalf of the service provider. The term was introduced by FATF's New Forty Recommendations in a manner that allows its members – representing different and sometimes mutually exclusive views on this topic – to follow their own ways. Essentially, legislators were entrusted to decide who or what might be an introducer in a given country or group of countries. Fitting the activity of introducers into the framework of a definable profession – and introducing it in one form or another throughout the world – apparently serves to somehow eliminate the contradiction that has emerged between the theoretical requirement of the type of "Know Your Customer!" and the actual functioning of the world economy.

The EU was driven by a similar intention when outlining its own detailed regulations, which allow for several options. Pursuant the main rule, a country may decide not to allow identification without the customer's being physically present at all. However, if it permits introducer's activities to be carried out by its residents and companies in any manner, then it will have to permit it to be carried out by introducers from all other Member States, belonging to the same categories.

Another general rule is that if the identification procedure applied by introducers satisfies their own Member State identification criteria, its result is to be accepted in another Member State even if different identification criteria are established there. It is apparent that both rules serve the consolidation of the internal market to the largest possible extent.

With regard to who is allowed to carry out identification for whom, the structure of the meticulously balanced regulatory system can be likened to a pyramid.

The top of the pyramid is constituted by credit institutions, insurers, investment firms, and (with the exception of currency exchange offices and money transmission or remittance offices) financial corporations. They are authorised to carry out customer identification on behalf of both each other and service providers belonging to all the other categories. It is apparent that when granting them these rights, legislators were not influenced by size, but the following common characteristic of theirs: these financial organisations need to be licensed to start and maintain their activities in all Member States in any case, and for this reason they are under strict supervision of an equally high standard in each EU Member State, as it is legislatively declared. Still, it seems dubious whether e.g. a financial corporation with a few million Hungarian forint registered capital will always be able to carry out a customer identification procedure of a standard identical to that of a bank with a registered capital of several billion Hungarian Forints, or whether it will be able to have the result accepted as one of identical value to that of the latter's.

The second level of the pyramid is constituted by representatives of the two types of service providers excluded from the previous group, currency exchange offices and money transmission or remittance offices. These service providers may only carry out customer identification for each another.

Among the other financial service providers to be covered by the legislation serving to prevent money laundering and terrorist financing pursuant the Directive – e.g. auditors, external accountants, tax advisors, notaries, etc. – only real estate agencies, casinos and traders may not act as introducers, while the others may carry out such verification activities for all members of their own group. (However, the exclusion of notaries from among universal introducers will probably cause major problems as, traditionally, it is exactly the representatives of this profession who most often authenticate copies of identification documents throughout the world.)

In summary, it is apparent that the picture of a large-scale, world-wide identification system is starting to be outlined in which, – maybe in several possible combinations, but based on transparent rules – specific customer information may now flow among determined participants on a global scale. We are to witness data flow of an even larger scale if we also consider the new rule that makes it possible – in sharp contrast with the total prohibition earlier – to communicate suspicion concerning a given customer within a group of corporations, and, on certain conditions, often outside it as well.

Authorising the EU Commission to outline and modify certain details of regulations

It is widely known that EU Directives usually follow the international recommendations serving as their basis with great delay. The primary reason for this is the demand for and the practice of continuously comparing views, both rooted in the basic principles underlying the creation of the EU. Consequently, big changes cannot be expected in this area in the future, either. On recognising and admitting this, authorisations granted to the EU Commission have started to appear in the EU Directives more and more frequently. Pursuant these, the EU Commission is both granted the right to and is obliged to adjust the technical details of the given legislation to fit the circumstances changing with time, and to outline and – applying strict control mechanisms – revise the parts that are expected to change frequently within the period determined by the given legislation. Thus, among other things, Directive 2005/60/EC has instructed the EU Commission to compile and maintain a list of third (i.e. non-EU) countries which both have and execute legislation of a standard at least equal to that of the Directive to Prevent Money Laundering and Terrorist Financing, as the Directive allows a number of simplifications –

identical to those prevailing in the consolidated internal market of the EU – for the Member States concerning clearing, settlement, correspondent banking relationships and other important financial relationships maintained with the countries in this list. Consequently, the internal EU regulations concerning the European countries that constitute half of the FATF membership have already become or may become one measure of the international relations of the EU. This is expected to contribute to the further unification of the international criteria and requirements, and to their further development as a global system also influencing countries outside the European Union.

NOTE

[1] Identically to the usage of the Directive discussed here, the term *financial institution* is to be utilised as a broad term encompassing financial and investment corporations as well as insurers and insurance intermediaries.

Sir John Bourn

The external auditor's role in regulation

An insight into the advisory activity of the National Audit Office of the United Kingdom

There has been considerable growth in recent years of government regulations over a whole range of activities and businesses. Regulation is a product of the way in which society perceives and responds to risk. In devising regulations, there must be a proper consideration of where the risks lie and how to balance the need for protection against the need to foster a society where people accept and share responsibility for managing life's risks. Good, effective regulation requires proper risk analysis, a thorough assessment of cost versus benefits and an independent approach – all skills that can be well deployed by the external auditor. In the UK, the National Audit Office has been working with the Better Regulation Commission to reduce regulatory burdens without endangering regulatory outcomes. The Better Regulation Commission (www.brc.gov.uk) is an independent body which is responsible for advising and challenging the Government on regulatory reform, and scrutinising the Government's plans for regulatory simplification. Its focus on reducing burdens has the benefit of releasing resources for higher value activities, increasing voluntary compliance and improving legitimacy. This paper concludes that regulatory reform is an important issue for Supreme Audit Institutions.

Supreme Audit Institutions (SAIs) have increasingly supplemented a core focus on the financial statements of government entities with an interest in auditing performance, value for money and policy effectiveness. Performance audit has a broader focus than the audit of financial statements, and can encompass not only the classic tax-and-spend role of the state, but also its regulatory functions. This paper sets out the background to the audit of regulation, and then describes the work of the UK's National Audit Office on what has come to be known as the Better Regulation agenda.

There has been a considerable growth in recent years of government over a whole range of activities and businesses. The main driver of this growth has been risk, since regulation is a product of the way in which society perceives and responds to risk. Three risks in particular have underlain the growth in regulation:

❶THE RISK OF MARKET ABUSE BY DOMINANT COMPANIES. As countries have privatised formerly state-owned enterprises, they have often tended to transfer public monopolies to the private sector. Realising that private sector monopolies may have a greater incentive to charge excessive prices, countries have sought to create independent regulators to constrain this form of abuse. In the UK, for example, the privatisation of water companies as a series of regional monopolies was accompanied by the creation of Ofwat[1] as water regulator, with responsibility for controlling the price and quality of service offered by private sector water companies. Auditing the work of such regulators has been the subject of discussion in, and Guidelines from, the International Organisation of Supreme Audit Institutions (INTOSAI) Working Group on the Audit of Privatisation.[2]

❷THE RISK OF WIDER MARKET FAILURE. Economists and policy makers have recognised that, while markets may be efficient in the technical sense of matching resources to demand, they may ignore or even create wider external problems (known as 'externalities'). Such externalities arise typically in the environmental sector (where an efficient market may nevertheless degrade some element of the environment, such as air quality) or the employment market (where an efficient market may not protect workers against some risks, such as discrimination on the basis of ethnicity or gender). The typical policy response is to create regulations and regulators designed to prevent and prohibit the market failure.

❸THE RISK OF UNCOMPETITIVE BEHAVIOUR. Even competitive markets can from time to time suffer a tendency to relapse into anticompetitive arrangements. This can often manifest itself as the creation of cartels or other restrictions that harm consumers because they deny them the benefits of a choice between competing suppliers. In the UK, for example a recent case identified price-fixing between manufacturers and retailers of the England football shirt. After the UK's competition regulator, the Office of Fair Trading (OFT), intervened to break the price fixing agreement, prices of England shirts fell by around 35 per cent.[3]

While each individual regulatory response may be justified in the light of some defined risk, the cumulative effect can be pernicious. This is because an overly protective regime, which seeks to minimise and remove any residual risk to consumers, employees and citizens, can reduce the incentive on individuals to manage their own interests. In devising regulations, therefore, there must be a proper consideration of where the risks lie; and of how to balance the need for protection against the need to foster a society where people accept and share responsibility for managing life's risks.

Government have also found that it is generally easier to create regulations – in response to some newly perceived risk – than it is to remove them. There are several factors behind this inertia, or what is often called regulatory creep:

- *Vested interests* – there is a complex and equivocal relationship between business/government and regulation. There are many who benefit from regulatory regimes. For example, in the UK, the Financial Services Authority (FSA)[4] has been criticised for several years for imposing too-stringent requirements on investment banks operating in the City of London. When the FSA recently announced its plan to remove training requirements however, most banks complained that they in fact valued these requirements since the common basis they provided made it easier to recruit staff with well-understood credentials.
- *Zero tolerance* – the desire for a proportionate and risk based approach to regulation runs up against the public demand for zero tolerance. To take another UK-based example: in 2004 a group of illegal immigrant workers drowned while collecting shellfish in coastal waters. The ensuing public concern about the protection of such workers led to the creation of a new agency, the Gangmaster Licensing Authority, which has issued new regulations about the supply of workers to agricultural enterprises.[5]
- *Regulation as source of comfort* – there is an enjoyment of the reassurance that detailed reg-

ulation provides. This was described beautifully by the Chair of the UK's Better Regulation Commission, *Rick Haythornthwaite*, when he compared society's guilty attachment to regulation to an adult's continuing love for a teddy bear that he or she knows is a vestige of childhood.[6] We do not want to admit our love for regulation, Mr Haythornthwaite argues, and we must first recognise it before we can start to wean ourselves off it.

THE ROLE OF THE AUDITOR

What then is the role of the Supreme Audit Institution in this regulatory debate? An SAI needs to evaluate the effectiveness of cross-cutting Government agendas, including Better Regulation and public sector reform. On reform, the auditor is well placed to provide independent challenge to government initiatives to improve efficiency. For example, the UK Government is aiming to secure L21.5 billion of ongoing efficiencies and headcount reductions of more than 80,000 by 2008. Each government department has been set a public target to deliver. Efficiencies are being targeted across a wide range of activities, from better procurement to more cost-effective funding and regulation of public bodies.

The UK National Audit Office is contributing to the efficiency programme in two ways. First, the NAO assesses the robustness of efficiency savings reported to date. In its February 2006 report, *Progress in improving government efficiency*[7], the NAO outlined good practice principles departments should follow to demonstrate the validity of reported savings. Savings should only be claimed if they are supported by credible baseline data, methodologies which include monitoring of service quality, and adequate data assurance processes.

More widely, through its work on the value for money of the UK public sector, the NAO provides guidance to departments on where efficiencies could be secured. NAO reports, on topics ranging from the operation of the criminal justice system to the running of major defence procurement projects, analyse performance of government departments and recommend where improvements could be made.

The benefits of the external auditor scrutinising existing operations can similarly be seen in the context of regulation. It is clear that good, effective regulation requires proper risk analysis, a thorough assessment of cost versus benefits and an independent approach. These are all skills that can are exemplified in, and well deployed by, the external auditor.

In the UK, the NAO has been working with the Better Regulation Commission.[8] Better Regulation is concerned with improving the way government as a whole regulates business, voluntary organisations and the public sector itself. It sees poorly designed regulation as burdensome and costly, and aims to improve productivity by releasing resources from regulatory functions in companies, so that they can focus more on their core activities. The Better Regulation Task Force's report Less is More estimated that reducing unnecessary regulatory burdens could produce “potentially greater than a 1 per cent improvement in GDP”.[9]

The main tools of Better Regulation have been:

- Regulatory Impact Assessments, which seek to ensure that the flow of new regulation is properly evaluated and assessed;
- Administrative Burden Reduction, which seeks to address the stock of existing regulation by reducing unnecessary information requests made on companies and voluntary organisations;
- A review of inspection and enforcement, known as the Hampton Review, leading to recommendations for consolidation of the existing “fragmented” regulatory structure into a more streamlined system of thematic bodies.[10]

In response to the challenges of our age, the UK National Audit Office (NAO), one of the world's leading financial audit organisations, contributes to the operational efficiency of the public sector not only through its regularity audits, but also through the provision of economic evaluations and advice. The strategy of the State Audit Office of Hungary (SAO) – presented below – reflects a similar approach and aims.

The British partner institution supported the SAO's institution development project complying with the European standards within the framework of a twinning partnership program funded from EU sources. As a continuation of this program, a strategic partnership was launched between the two organisations pursuant to an agreement signed in 2001, which has since been renewed several times. This partnership primarily implies continuous professional and methodological cooperation, within the framework of which NAO will assist the SAO audits to be performed in relation to the modernisation of the Hungarian public administration system, and will also be involved in the joint research project of Corvinus University of Budapest and the Institute of Development and Methodology at the State Audit Office on public finances as a specific factor of competitiveness. Furthermore, cooperation manifests itself in agreed actions at INTOSAI events, and in joint actions for the modernisation of other supreme audit institutions. *Sir John Bourn,* Comptroller and Auditor General of the United Kingdom and *Árpád Kovács,* president of the State Audit Office of Hungary have already agreed to renew the relevant agreement, which will expire in the middle of 2007.

The advisory activity to the National Assembly and Government of Hungary – which is lively described by the basic principle of NAO "helping the nation spend wisely" – corresponds to the INTOSAI recommendations just like the mission and vision of the State Audit Office of Hungary that serve as an arranging principle for the SAO's strategy.

The NAO has reported extensively on Regulatory Impact Assessments (RIAs).[11] RIAs are intended to consider the costs and benefits of new regulations and legislation. They include formal competition tests and are intended to assess whether the benefits of a proposed regulation outweigh the costs. The good RIA will challenge the case for command-and-control regulation and always consider alternatives, including voluntary codes and Doing Nothing – though our reports found that the consideration of costs and benefits rarely in practice undertake this analysis. In fact, the NAO has identified three types of approach to the RIA within government departments:

- Pro-Forma RIAs, which are started late, have little analysis and have little influence on regulation;
- Informative RIAs, which are technically competent and communicate the decisions well, but do not really influence them; and
- Integrated RIAs, which are started early, well-resourced, robust and influence decision making.

The NAO will also report on the UK government's Administrative Burden Reduction programme. This programme, which adopts the Standard Cost approach first introduced in the Netherlands, involves an extensive cross-Government measurement programme to establish a baseline estimate of the total cost of administrative obligations under UK law and regulations. Government departments will then be expected to deliver cuts against the baseline. While it is important that the NAO examines the content of the baseline and departmental actions to reduce it, we will devote most of our efforts to evaluating the outcomes of this programme. We will consider whether it really is achieving the improved business environment that it is expect to deliver.

On the consolidation of the regulatory structure, the NAO is currently undertaking a study entitled “Improving Public Sector mergers”. The target audience for this report will be those responsible for designing and carrying out future mergers of regulators. By focusing on the experience of a largely successful and complete merger (the creation of the communications regulator, Ofcom, in 2003-04, from the combination of 5 separate broadcasting and telecoms regulators), the NAO will identify the key success factors in delivering this kind of change and how the cost-benefit framework underlying a merger decision can be tracked.

The aim of this work has been to identify ways of reducing regulatory burdens without endangering regulatory outcomes. By 'outcomes' we mean the array of benefits that individuals and society as a whole derive from regulations.

It is important to emphasise that this is not simply a crude “cutting red tape” objective. Indeed, less burdensome and detailed regulation may actually be “better” regulation. Why? Firstly, a lower level of administrative burden and inspection may well release resources to higher value activities. This is true not only for businesses, who can concentrate on more productive things, but also for regulators and government, who may need to spend less time processing information returns from, and undertaking routine inspections into, regulated industries. The experience of the UK's new Pension Regulator is perhaps starting to bear this out, with an approach far more focused on meaningful risks to pension scheme members and less on trivial breaches of pension legislation.[12]

Secondly, one of the big disincentives to individuals and businesses to complying is the cost imposed; the burden taken on by complying. By lowering the burden, we may actually increase voluntary compliance – and hence secure better outcomes.

Thirdly, a less burdensome regulatory regime more focused on where the risks lie might in fact increase its legitimacy in the eyes of the regulated. The UK Maritime and Coastguard Agency, which inspects all UK-flagged ships, provides a fantastic example of this. Over the last 5 years, in response to an NAO report, the Agency has focused more of its work where there is the greatest risk.[13] This more intelligent regulatory regime has made the Agency more business-like and helped to attract more merchant ships to the UK flag – the number of registered vessels has increased dramatically, from 379 in 1999 to 600 in 2005, reversing a long-term decline due to world-wide competition and the costs of meeting UK maritime legislation requirements.

CLOSING REMARKS

This paper has set out some general analysis of the growth of regulation in modern, liberal societies. It has also explained the role taken by the UK's National Audit Office in helping the UK government improve the effectiveness of regulation in the UK. The NAO's work on regulation is not merely of local UK interest, but of general importance across the SAI community.

This is because there is a growing demand for regulation in many societies, on the one hand, and increasingly powerful critiques of regulation on the other. It is therefore an issue on which societies might legitimately expect an SAI to contribute; and one on which SAIs, with their independence, technical rigour, and risk-based approach, are perhaps uniquely qualified to comment.

NOTES

[1] Ofwat's full name is the Office of Water Services. It is responsible for ensuring that licensed water companies fulfil their duties and meet the needs of consumers of water. It sets both prices and quality of service targets for licensed water companies.

[2] The full title of these Guidelines is Guidelines on Best Practice for the Audit of Economic Regulation. They can be found at http://www.nao.org.uk/intosai/wgap/ecregguidelines.htm

[3] This case, and the Office of Fair Trading's work enforcing the Competition Act more generally, has been covered more extensively by the National Audit Office's report Enforcing Competition in Markets, HC 593, 2005–06.

[4] The Financial Services Authority regulates the financial services industry in the UK. It covers both wholesale and retail financial services and has a wide range of rule-making, investigatory and enforcement powers. Its overall aim is to promote efficient, orderly and fair markets and to help retail consumers achieve a fair deal.

[5] The Gangmasters (Licensing) Act 2004 provided for the establishment of a licensing scheme and the creation of a register for gangmasters operating in agriculture, horticulture and shellfish gathering together with the initial processing and packing of agricultural and fish produce. The Act received Royal assent on 8 July 2004. The Gangmasters Licensing Authority (GLA) was established on 1 April 2005 and will introduce the detailed licensing arrangements. It is anticipated that the GLA will start issuing licenses in Spring 2006 with the principal offences established by the Act coming into force during in Autumn 2006.

[6] Rick Haythornthwaite, Britain's secret shame: we just love red tape, *Financial Times, 9 February 2006*

[7] The NAO's first report on the Government's efficiency programme, Progress in improving government efficiency, can be found on the efficiency pages of the NAO website alongside other NAO material relevant to public sector efficiency. The pages can be found at www.nao.org.uk/efficiency

[8] The Better Regulation Commission is an independent advisory body. It provides independent advice to government, from the perspective of business and other external stakeholders, about new regulatory proposals and about the Government's overall regulatory performance. The Commission continues the challenge role carried out by the Better Regulation Task Force, as well as taking on new responsibilities following the announcements in Budget 2005, including vetting departmental plans for simplification and administrative burden reduction. It replaced the Better Regulation Task Force which had a similar remit. Its reports are available on its website at www.brc.gov.uk.

[9] Better Regulation Task Force, Less is More, A BRTF Report to the Prime Minister, page 3

[10] Reducing administrative burdens: effective inspection and enforcement, Philip Hampton, March 2005. Philip Hampton is Chairman of Sainsbury's plc, the leading supermarket group.

[11] The NAO has published two annual evaluations of the quality of regulatory impact assessments, in 2004 and 2005. Evaluation of Regulatory Impact Assessments Compendium Report 2004–05 (HC 341 2004–2005); and Evaluation of Regulatory Impact Assessments Compendium Report 2003–04 (HC 358 2003–2004)

[12] The Pension Regulator was established by the Pension Act 2005, partly in response to the recommendations of an NAO report on its predecessor, the Occupational Pensions Regulatory Authority (Opra: Tackling the risks to pension scheme members, HC 1262 2001–2002).

[13] Dealing with pollution from ships, HC 879 2001–2002

The strategy of the State Audit Office of Hungary 2006–2010

Document

INTRODUCTION

The State Audit Office of Hungary – the financial and economic audit organisation of the National Assembly – has been publishing its strategy for the third time since 1998, aiming at responding challenges under the unity of continuity and adaptation to a changing environment, weighting duties to be able to fulfil its social and constitutional mission in a reliable and successful way by efficiently utilising its resources on complying with its legal obligations.

Basic objectives set in the earlier strategy of the State Audit Office of Hungary (2002–2006) included developing a methodology complying with international standards and requirements of the European Union, making audits qualifying the reliability of the final account more complete, modernising audits of local governments, developing a comprehensive advisory activity evaluating the utilisation of public funds and public property.

By implementing its strategy, the State Audit Office of Hungary has established the conditions for performing its broadening audit tasks by applying a methodology that is in line with both the international standards and the best international practices. Basic rules of auditing at the State Audit Office of Hungary (of which main elements are the Code of Ethics, Audit Principles and Standards, and the Audit Manual) have been developed, and a closely related quality management system of audits carried out by the State Audit Office of Hungary has been set up. The audits qualifying the reliability of final accounts have become more complete, and the amounts of budgetary revenue and expenditure covered in this way have significantly grown. Regular and comprehensive audits of local governments managing considerable funds and properties have been performed, meaning that the State Audit Office of Hungary has audited each local government in the past four years. A number of studies – also addressed by the agendas of parliamentary committees – have analysed the major problems of public finances.

Under the agenda of continuity, the organisation carries on with and strengthens the main trends of actions taken in the past four years. In addition, the State Audit Office of Hungary has also considered the changes in the external environment when developing its strategic objectives, first of all the fact that making the best of the benefits of the EU membership and compliance with the European requirements pose unavoidable challenges for public finances.

Besides complying with the Maastricht convergence criteria, developments indispensable for an improved competitiveness and social problems related to demographic changes also need to be *addressed, and essential changes to the participation of the state also require a reform-scale reorganisation. Emphasis has been placed on the modernisation of the central public administration and the system of local governments, on regionality, as well as on the utilisation of EU resources. This undoubtedly requires a genuine economic and budgetary policy, the reform of the financial system, and all combined with the predictability, transparency and accountability of public finances and processes related to public funds.*

In the circumstances indicated above, a fundamental strategic ambition of the supreme organ of state auditing is to provide even more assistance to a regular, efficient and balanced operation of the public sector and public finances through its audits, analyses and proposals, and to initiate the essential processes of reorganisation as much as possible. The role of the State Audit Office of Hungary is to call attention to the sensitive areas in the utilisation of public funds; however, any progress is dependent on the decisions of the National Assembly and the government organisations.

In the strategy for the years 2006-2010, the State Audit Office of Hungary defines the major principles and values underlying its activity, arranging the medium-term objectives in three main groups, with the indication of associated tasks to be performed in order to achieve them, as well as development trends of supporting activities (human resources policy, communication, methodology and information technology).

MISSION AND VISION

The mission of the State Audit Office of Hungary (SAO) is to serve the secure, balanced and efficient operation of public finances, to support development, to strengthen the transparency of processes related to public funds, and the accountability of managing public funds and public property.

The activity of the SAO contributes to set compliance with the rules as a general standard, to make the management of public funds and public property more effective and efficient.

PRINCIPLES AND VALUES

By virtue of its position in a constitutional state, its statutory obligations and authorities, the main duty of the State Audit Office of Hungary is to facilitate the National Assembly exercise its budgetary right, and fulfil its legislative and control function. This is accomplished relying on the following principles and values.

The State Audit Office of Hungary,

- based on the fundamental values of its activity performed for over fifteen years, as well as the stability, unity and professional potential of the organisation, is ready for an ongoing revival, consciously adapts to the changes of the social, economic, and auditing environment;
- conducts audits, makes proposals and carries out advisory activities with the intention to help, and aims at preventing errors, deficiencies and irregularities with its audit results, encouraging the reform of the operation of public finances;
- is a committed supporter of quality-oriented management and operation, which is consistently enforced in each area of its operation;
- enforces the same requirements of efficiency and transparency in its operation as it requires when carrying out audits;
- actively participates in developing the audit culture and the public auditing system, utilising its audit experiences and the results of its scientific research.

Guarantee conditions for enforcing the principles and values are as follows: the constitutional legal status of the State Audit Office of Hungary; its complete independence from politics; the publicity of and free access to its reports; the professional reliability; and the commitment of the management and the staff.

STRATEGIC TRENDS, OBJECTIVES AND TASKS

The fundamental principle underlying the activities of the State Audit Office of Hungary is to put an emphasis on recommendations developed with intent of improvement, based on findings and conclusions. In this way, it primarily focuses on activities and conduct supporting management and decisions, instead of finding errors and persons accountable or imposing sanctions. Aiming at a balanced and secure operation of public finances, SAO audits should ultimately influence the financial management of the state, the major monetary processes and the underlying real processes.

A fundamental value of modern auditing is the competence related to procedures, methodology and information technology. However, the effectiveness of the SAO's activity depends on the relationship with each particular audit field and subject, and the areas of utilising experiences, while technical, organisational and human resources capacities and opportunities also have an impact on auditing.

Considering all these, the SAO defines the main development trends of auditing, as well as the objectives concerning the development of organisational management, professional work and public relations in a way that ensures compliance with its special role as a guarantor, in line with the challenges of the new millennium.

Strategic trends are as follows:

- supporting the transparent and regular operation of public finances, the reinforcement of budgetary responsibility, and initiating necessary changes;
- facilitating the efficient accomplishment of state-related tasks;
- taking further efforts to modernise its organisational management and internal division of labour;
- implementing a quality-oriented development of its professional regulation system;
- modernising communication activity;
- contributing to improving the standard of audit culture.

DEVELOPING THE AUDIT ACTIVITY

THE STATE AUDIT OFFICE OF HUNGARY SUPPORTS THE TRANSPARENT, REGULAR AND ACCOUNTABLE OPERATION OF PUBLIC FINANCES WITHIN THE PUBLIC SECTOR, AS WELL AS THE REINFORCEMENT OF BUDGETARY SECURITY AND RESPONSIBILITY.

A comprehensive audit opinion is given on the reliability of final accounts of the central budget, provided that the internal audit units of the budgetary chapters have accomplished their assigned tasks. It provides professional and methodological assistance to budgetary chapters in qualifying the statement of accounts of their institutions.

It develops the comprehensive audit of budgetary chapters into a modern system audit, which is used to facilitate developing the operation of internal control systems.

It further develops the audits of the financial management of local governments:

- it renews the comprehensive audit of local governments having considerable budgets and property (in counties, towns with county ranks, towns, the capital, and districts of the capital), supplemented by performance audit elements, and the assessment of rules followed in case of applying for and utilising EU funds;

- by way of its audits of final accounts of the central budget, it facilitates renewing the regulation system of local governments.

It initiates and supports the renewal of the procedures applicable to the operation, planning, accounting and control of public finances, and, linked to it, the elaboration of a full and consistent (re)regulation of the financial management of public property.

It strengthens its advisory function in providing an opinion on budget planning, with special attention to the security and feasibility of the budget.

It assists the operation of the internal and external audit systems of public finances to rely on each other, with a unified system of professional requirements in order to utilise auditing resources in an efficient way.

It detects the risk factors in the relations and recent investment and development cooperation of public finances and the private economy, it assesses the degree of regulation for projects being implemented and the efficiency of the applied financial arrangements.

It investigates the reasons for corruption, as well as areas and processes representing increased risk.

It increasingly conducts audits of implementing the supported targets, also including final beneficiaries.

THE STATE AUDIT OFFICE OF HUNGARY FACILITATES THE EFFICIENT AND EFFECTIVE ACCOMPLISHMENT OF STATE-RELATED TASKS, PAYING SPECIAL ATTENTION TO THE BALANCE-RELATED CRITERIA OF PUBLIC FINANCES AND THE MODERNISATION OF LARGE COMMUNITY SUPPLY SYSTEMS.

It audits the efficiency and effectiveness of the accomplishment of state-related tasks within and out of public finances, reveals parallel courses and areas of the public sector where a restructuring of the system of tasks is urgent. The SAO evaluates the professional support of and progress in the reorganisation and reform of public finances.

It also encourages to carry out performance audits that facilitate more efficient operation of large supply systems, as well as to prepare comprehensive analyses and assessments relying on these.

For the purposes of fully utilising and making a proper use of EU funds, and protecting EU financial interests,

- it audits the institutional, planning, financial and economic relations of regional and settlement development and of regionality, with special attention to micro-regions;
- it examines the utilisation of resources serving the purpose of enforcing EU cohesion policy, evaluates the implementation of national development programmes and the related (sub) tasks, and the utilisation of financial aids;
- it prepares an annual information report and assessment (trend report) on the utilisation of EU funds, the work of national control organisations and the audit results for the National Assembly and the European Court of Auditors.

It audits and analyses budgetary revenues, the system of allowances, exemptions, and revenue assignments affecting budgetary revenues, as well as the impacts of these.

It develops its advisory services, intensifies the analysis and assessment work directed at certain key areas and neuralgic points of public finances.

ORGANISATIONAL MANAGEMENT AND DEVELOPING PROFESSIONAL WORK

THE STATE AUDIT OFFICE OF HUNGARY TAKES FURTHER EFFORTS TO MODERNISE ITS ORGANISATIONAL MANAGEMENT SYSTEM AND INTERNAL DIVISION OF LABOUR.

It boosts cooperation between management levels and organisational units by a system-driven development of internal information and coordination.

It harmonises and builds thematically related audits on each other in order to increase the efficiency of audit activity. It increases the use of work organisation solutions beyond the limits of organisational units within the framework of its audit and other tasks.

It ensures the protection of the most important professional value of the State Audit Office of Hungary, i.e. professional knowledge. For this purpose

- it motivates innovative conduct of the staff, and supports ongoing development of their professional competence, with a view to any qualification requirements related to joint work carried out on request from international audit organisations;
- it develops its activity aimed at replacement, recruitment and training.

Through continuous and reasonable IT development, it supports the efficient operation of the institution, also coordinated with the competent government institutions.

THE STATE AUDIT OFFICE OF HUNGARY IMPLEMENTS A CONTINUOUS AND QUALITY-ORIENTED DEVELOPMENT OF ITS PROFESSIONAL REGULATION SYSTEM.

On a contonuous basis, it develops the professional regulation system of audits carried out by the institution, considering experiences gained through application, and taking into account international developments and the best practices.

It carries out further development of audit planning methods, audit procedures and the format of displaying audit results, including the selection of subjects based on conscious and up-to-date analysis methods, a computer assisted and standardised documenting system for performing audits, as well as the modernisation of the internal structure of audit reports.

With a view to a constant good quality and reliability of audit activity and the resulting reports, it ensures complete implementation, proper operation, continuous maintenance and development of the integrated quality management system.

DEVELOPING PUBLIC RELATIONS

THE STATE AUDIT OFFICE OF HUNGARY FURTHER DEVELOPS ITS COMMUNICATION CONTACTS, AND USES THE FACILITIES AND THE POWER OF PUBLICITY.

With the additional application of recent technical equipment, it systematically develops communication, in line with the specific requirements and expectations of the National Assembly, the government, the citizens and other targeted user groups.

Relying on the results achieved, it completes a uniform institutional image that represents the fundamental values of the organisation.

BY ITS EXPERIENCE GAINED THROUGH AN ACTIVE PARTICIPATION IN THE DOMESTIC AND INTERNATIONAL ARENA OF THE AUDIT PROFESSION, THE STATE AUDIT OFFICE OF HUNGARY CONTRIBUTES TO IMPROVE THE STANDARD OF AUDIT CULTURE.

It participates in the professional activity of international audit organisations and in the cooperation of partner institutions under extensive, bilateral and multilateral conditions.

It follows the changes of content and methodology in the professional activities carried out by international audit organisations and by national audit offices. The SAO examines and analyses the way and the extent of reasonable adaptation to these changes, and the ways of participating in disseminating up-to-date professional knowledge within international framework.

In order to train future economic experts and influence their attitude, it develops its relations with universities and colleges, also reinforced by cooperation agreements. Compared to earlier times, it assumes an increased role in teaching auditing.

It participates in the activities of social associations and societies addressing economic, financial and auditing issues. It seeks to utilise its audit experiences and the results of its assessment activity – with special regard to the preventive role of auditing – also by way of its professional contacts.

Under its advisory activity, the SAO is the editor of the professional journal of public finance published in Hungarian and English.

May 2006

Dr. Árpád Kovács,
President

Pál Belyó–István Molnár

Use of microsimulation models for political decesion making

ABSTRACT

Socioeconomic systems are complex, extremely sensitive and of great social and economic importance. Microsimulation is a method able to handle complex socioeconomic systems by creating and studying a model that makes intensive use of the statistical data of the observed objects. These objects are the so-called micro units of the socioeconomic system; the person, the family or the household. Microsimulation models use simulation techniques in order to study the behavior of micro level units in time.

Microsimulation is generally accepted by decision-makers and widely used in Australia, Canada, Europe and the USA to prepare political decisions. In the European Union, more and more signs indicate an increasing demand for instruments of microeconomic analysis and prediction, coupled with a tendency of more willingness to budgetary spending for microsimulation. However, not only highly developed economies, but economies in transition also face many problems, especially in demography, pension systems, health care and taxation, for which microsimulation could be a very useful tool by doing a model-based study of related problems and possible solutions.

In this contribution first a short overview about the basic terms and recent microsimulation model developments is presented. Next, the feasibility of introducing capital income taxation in Hungary will be analyzed and discussed based on a microsimulation model. The current economic environment and the specific Hungarian economic characteristics are shortly described, followed by the economic justifications, the basic data collection and analysis, the microsimulation model, the model results and validation. Finally, the impact of different taxation policies on various social layers of the population and the macroeconomic consequences will be discussed and briefly analyzed.

Keywords:

- Socioeconomic modeling,
- Microsimulation,
- Capital income taxation,
- Taxation policy in Hungary.

Simulation models are models of real or hypothetical systems, which are developed in order to gain new information about system characteristics or behavior. The models reflect all important features of the system studied and all relevant relationships of the system with its environment. Because of the complexity of both the system and the model, digital computers are used to calculate the requested results.

A general *simulation model* can be described as follows *(see Figure 1)*

For the current purposes a few working definitions are introduced as follows. A *system* is given as a potential source of data. An *experiment* in this sense is the process of extracting data from a system by forcing it through its input to provide some output. Experimenting with the system might be impossible, dangerous or costly; therefore experiments are processed on models rather than the system itself. A *model* for a system and experiment(s) are used to answer questions about the system. *Modeling* means the process of acquiring and organizing knowledge about a given system, while *simulation* is an experiment performed on a computer model.

System elements are represented as *entities* or objects in the simulation model. They have distinguished properties or characteristics, which are also called *attributes or state variables.* The set of state variables determines the *state of a system* at a specific point in time. While time is passing by, the value of the state variables (sometimes even the set of state variables) are changing. Events are activities that change the state of the system (the value of particular state variables). *System behavior (trajectory)* is the changing of system states over time. *Simulation* in this sense is the numerical computation of system behavior.

Modeling and numerical computation of simulation results are loaded with errors. *Validation* checks the modeling process and the final result of it, the conceptual model, whether it is able to represent the system under investigation in a satisfactory way. *Verification* checks the computer model, especially whether the computer model is executed and the results calculated correctly. The model is never a perfect representation of the system and the numerical computation might also consist of rounding and/or method dependent errors. It is the responsibility of the modeler to make a final decision about the model and the acceptance/rejection of the model results.

Figure 1

SIMULATION MODEL

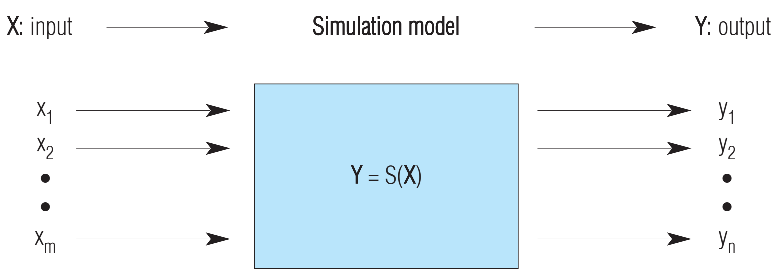
$$\boxed{Y = S(\mathbf{X}), \qquad (1)}$$

where

$\mathbf{X} = (x_1, x_2, \ldots, x_m,)$ denotes m input variables,

$\mathbf{Y} = (y_1, y_2, \ldots, y_n,)$ denotes n output variables, and

S = denotes the transformation made by the simulation model.



MICROSIMULATION

Socioeconomic systems are complex, extremely sensitive to changes and of great importance. Politics is the set of complex relations of (groups of) individuals living in a society and is also understood as the art and science of government. Governments are concerned with creating and/or maintaining governmental policy. Governmental *policy* is not just the prudence and wisdom in the management of society's affairs, but also the finding of a definite course and method of action selected from alternatives under given conditions in order to make appropriate *decisions*. It is a basic requirement of the society that these educated and smart governmental decisions be based rather on a scientific approach than on a blind experiment with the population, therefore modeling and simulation of socioeconomic systems is not just a technical opportunity but also a moral "must". Study of socioeconomic systems is a demanding challenge; simplified scientific approaches do not have the necessary accuracy and hence result in misjudgment and decisions with long-term negative effects and fatal consequences for the society.

Socioeconomic models can be used to study the effects of governmental policy changes; to study costs and (re)distributional aspects, to identify "winners" and "losers", without endangering the welfare of the society. Mathematical modeling and computer simulation are appropriate scientific approaches to analyze and help to solve socioeconomic problems; *micro-analytic simulation models,* also called microsimulation models, can be developed and studied instead of experimenting with the society.

Microsimulation is a method able to handle the high complexity of the socioeconomic problems by creating and studying a model that makes intensive use of the statistical data of the observed objects. These objects are the so-called micro-units of the socioeconomic system; the *person*, the *family* or the *household*. The microsimulation models use simulation techniques in order to study the behavior of micro level units (see also Orcutt et al. 1961).

Microsimulation models have the following main elements: simulation data, simulation model, simulation parameters and simulation results. The *initial model data, intermediate and/or final simulation result data,* are stored for further analysis. The *simulation model* consists of algorithms, which describe the *behavior of micro-units* and represent their environment. Simulating the micro-units' state and behavior (the changes of state over time) and the change of micro-units as a result of policy changes is often called "aging the data". *Static aging* refers to the adjustment by re-weighting the used sample based on some aggregate control variable (e.g., the composition of the sample by gender), while dynamic aging refers to adjusting each micro-unit attributes (e.g., income) by recalculating them at each time period, one period at a time. Special care is taken to do the data analysis and the estimation of simulation *model parameters,* which are stored together with the simulation model *(See Figure 2)*.

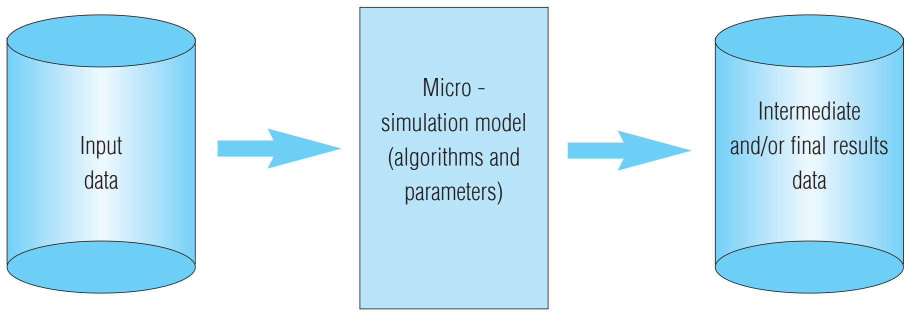
Given the model responses of micro-units at unit level, the microsimulation models can estimate aggregate effects and aggregate changes by grouping, creating distributions, tabulating or summing up unit-level individual model results in order to make statements about the various characteristics of the population as a whole.

The microsimulation model is working in an *experimental framework* in order to study the effects of policy changes on all micro-units, on the microsimulation model behavior itself. The model calculations are executed by a digital computer.

Initial data of microsimulation models are collected from *cross-sectional surveys, and/or longitudinal surveys.* Cross-sectional surveys

Figure 2

MICROSIMULATION MODEL



collect data about a sample population for a single period of time (e.g., a survey of tourists' expenditures), while longitudinal surveys collect data about the same sample population (also called panel) for several periods of time (e.g., a household statistical survey). Microsimulation models could also use a *time-series of cross-sectional surveys,* which collect data at periodic intervals (e.g., micro-census). Special techniques have been developed to improve data quality and use additional data sources available (e.g., imputing, merging, synthetic data). Model verification and validation also use different sophisticated statistical methods and techniques (see e.g., Rubin 2004, or Little and Rubin 2002, or Schofield and Polette 1998, or O'Donoghue 2001).

Microsimulation models are a subset of socioeconomic models and have specific characteristics. They are typically:

- *Large:* based on large samples and related detailed datasets.
- *Quantitative:* based on mathematical and statistical models and constructs in contrast to qualitative models, which are based on normative approaches.
- *Static:* not having the intention to model a time sequence of changes, but rather the immediate (or short term) effects of policy changes ("the morning after") in contrast to dynamic models, where all micro-unit attributes are recalculated at each time interval over a longer period of time in order to describe the dynamic transitions.
- *Non-behavioral:* not allowing any changes of micro-units' behavior in response to policy changes (in the absence of data related to behavioral pattern and pattern changes) in contrast to behavioral, which allow the models to reflect micro-units' behavioral patterns and policy change impacts on behavioral patterns.
- *Deterministic:* or rule-based, not allowing conditional probabilities, in contrast to stochastic, which allow modeling of events based on conditional probabilities.
- *Non-spatial:* just modeling the impacts and the effected population in contrast to a spatial approach that also takes into consideration the geographical/regional aspects of the impacts.

As a result of recent efforts, new models are emerging, which are stochastic, have behavioral elements, and use a regional model view.

Generally, two major microsimulation model classes were developed in order to build realistic models: *data-driven models and agent-based (behavior-driven) models.* Despite the different modeling approaches, both model classes handle model data and methods in a similar way; in both cases, significant amount of data must be analyzed and processed.

One of the most important technical problems of microsimulation model implementation is the integration and usage of different data sources available for microsimulation models. Historically, three different approaches were developed:

- File processing approach (e.g., Heike et al. 1994)
- Database-oriented approach (e.g., Sauerbier 2002)
- Agent-oriented approach (e.g., Pryor et al. 1996)

These approaches use mainframe or PC technology and as such, are not portable and architecture neutral. In the 90-ies, new network-oriented technologies were developed in order to support applications (like model-based analysis) using heterogeneous hardware and/or software platforms. Nowadays, the development of networked multi-platform microsimulation applications is not just necessary but also technically possible (see Molnar 2005).

Modeling and simulation of socioeconomic systems is a challenging task because of the complexity and non-technical nature of socioeconomic systems studied, and because of the fact that the modeling of such systems is highly influenced by the social positions or expectations of individuals' (and the modelers), eventually also by their financial or political interest. Difficulties in interpreting, understanding and accepting model results are also related to the reasons listed as modeling difficulties. It is imperative also to emphasize the importance of the data quality of microsimulation models, because it also determines to a great extent the quality of the model results, and even the quality of the model itself. Both, modeler and user must respect the limitation and enjoy the benefits of these models and the underlining methodology.

The advantages and disadvantages of microsimulation models can be summarized as follows:

Advantages:

- Micro-unit based behavioral analysis provides a more detailed and flexible model.
- Detailed data provides more possibilities for data analysis.
- Detailed model and detailed data provides detailed computational results; distributional analysis, aggregations at different levels retaining the opportunity to analyze the important interactions is possible, which the aggregated methodologies tend to hide.
- A rich variety of data, different model scenarios can be processed, providing both short term and longitudinal analysis of the impacts of policy changes.

Disadvantages:

- While describing and analyzing micro-units (like household, family or individuals), models do handle firms and government as “environment”, the behavior of which is not included and described in the models.
- Microsimulation models represent “one side” of the economy, therefore might not necessarily deliver correct macroeconomic results.
- The dependence on micro-data results in large data bases, expensive data analysis, high computational costs, and long development time. This inflexibility in development of the models might result in rapid outdating of model and results.

Microsimulation is generally accepted by decision makers and widely used in Australia, Canada, Europe and the USA to prepare political decisions (see O'Donoghue 2001). Not just highly developed economies, but economies in transition also face many problems especially in demography, pension systems, health care, and taxation. Microsimulation can be a very useful tool to a model-based study of related problems and possible solutions. Unfortunately, while the current immediate impacts of political decisions are routinely analyzed using microsimulation models, future long-term impacts, structural changes and behavioral response to policy changes are not yet analyzed as widely with these models by policy makers.

Exploiting the basic approach of microsimulation, the method can be applied also for transportation problems. Transportation, especially urban transportation problems have been studied in the past few years more frequently by using the activity-based approach (McNally 1999), which takes into account that individuals' travel behavior is a complex socioeconomic phenomenon. Time-dependent and also often space-dependent (geographical) analysis and modeling of this phenomenon can contribute to a better understanding of the overall problem. Models built upon this approach often use agent-oriented techniques to realize the simulation model (e.g., Rindt et al. 2002).

MICROSIMULATION MODELS FOR TAX SIMULATION: EUROMOD

They are several approaches to the microsimulation of tax systems or tax policies published recently. *Haan and Steiner* 2004 and also *Creedy* and *Kalb* 2005 analyze existing tax systems. Some of the publications listed aim to simulate fiscal reform policies (e.g., Burman 2005, Trautman 1999) or the tax system simplification impacts (e.g., Gale and Rohaly 2002, or Shaviro 2004, or Edwards 2005), others investigate political programs (e.g., Gale at al. 2004, Beach at al. 2004).

From our point of view, the most important publications are closely related to the *Targeted Socio-Economic Research (TSER)* program of the European Commission (CT97-3060), the aim of which was to build *EUROMOD*, a tax-benefit microsimulation model covering all 15 then-member states of the European Union (see Sutherland 2001). The program runs currently in FP6 Research Infrastructures Action as a Design Study. The main aim of the project is to expand EUROMOD to include the 10 new member states and make it easier to use.

EUROMOD uses micro-data at individual level; the main source of which has been determined by each member country. Different types of data sources are used, starting with national panel studies to the more unified European Community Household Panel (ECHP). Even though EUROMOD does not consider itself responsible for data quality, it contributes to data quality improvement by giving professional advice regarding definitions, determination of common variables used, exclusion from samples, non-response biases, furthermore uses imputing to include household expenditure and an indicator for risk of social exclusion into the database.

The model design and implementation of EUROMOD focuses on common structural characteristics and data requirements, therefore the tax-benefit system has been conceptualized and operationalized as follows: the tax-benefit system is made up of individual policies, which are collections of tax-benefit instruments. There is a *policy spine,* which determines the list of policies and their execution order. Calculations are performed by the tax-benefit *modules*. The implementation has been focusing on stand-alone PC configuration using C/C++, MS Excel and Access. Output statistics are standardized but tools are provided to create different, flexible and parameterized user defined outputs (e.g., tabulations, summary statistics).

Because of the main output of EUROMOD is a measure of Household Disposable Income (HDI), several components for output calculations must be distinguished based on availability and importance. Some data elements are covered by the model and therefore can be used for calculations, some might be modified (in part simulated), and some are fully simulated. The calculation scheme of the main output is as follows: wage and salary income + self-employment income + property income + other cash market income and occupational pension income + cash benefit payments - direct taxes and social insurance contribution.

Based on available documentation, the following tax-benefit instruments are *simulated* in all countries:

- Income taxes (both, national and local),
- Social insurance contributions (paid by employees, employers and the self-employed),
- Family benefits,
- Housing benefits,
- Social assistance benefits and other income-related benefits.

The following instruments are *not simulated* in all countries; however, there is a possibility to include them into the national models:

- Capital and property taxes,
- Real estate taxes,
- Pensions and survivor benefits,
- Contributory benefits,
- Disability benefits.

EUROMOD has been intensively tested and validated. For validation a baseline validation exercise (e.g., ranking countries in terms of poverty and inequality), among others, has been successfully executed. EUROMOD has been used intensively in the past years and several microsimulation applications were developed (see Sutherland 2001).

EUROMOD is a great tool and can be used for analysis and planning tax-benefit systems and policies. Unfortunately, at the current level of development a few major disadvantages could be observed, which limit the use of the tool:

- As the authors also mention, the static model does not incorporate the effects of behavioral changes or the long-term effect of changes.
- The model can use only those variables that are present in the underlying database.
- Accessing and updating databases seems to be difficult; there are no network-oriented software solutions, there is no version concept applied and there is no concept to regulate the data granularity problems.
- Because the database differs from country to country, the comparability of results is not without difficulties.

CAPITAL INCOME AND ITS TAXATION IN HUNGARY

Based on increasing efforts to harmonize the economy with the other member states of the EU and to exploit the positive effect of tax system changes, the possible results of capital income taxation have been investigated using microsimulation. This research extends the EUROMOD project aims and provides new, promising directions for the Hungarian researchers working in this field (Belyo and Molnar 2005).

In Hungary, the introduction of a uniform capital income tax rate would be desirable, but taking into account the complexity of the present taxation and the difficulties of income and revenue estimations, the task is challenging. The possible effects of a capital income tax could differ significantly with different consumption patterns. Thus, it is important to first understand the savings and consumption patterns and their dynamics and to base the new tax in the framework of the presently functioning system.

The forms of private savings of the population based on National Bank of Hungary (NBH) statistics are as follows *(see Table 1)*.

Comparing the major characteristics of the economic environment and private savings

Table 1

GROSS SAVINGS STATISTICS BETWEEN 2002 AND 2004

Saving forms	2002 billion HUF	2002 (%)	2003 billion HUF	2003 (%)	2004 billion HUF	2004 (%)	Compositions (%)
1. Cash and bank deposits	5 177	110	5 921	114	6 451	109	41
2. Securities (excl. #4)	1 002	107	1 104	110	1 302	118	9
3. Credits and loans	0.5	167	N/A		N/At		N/A
4. Stocks, shares	4 391	115	4 871	111	5 437	112	34
5. Insurance	1 498	129	1 924	128	2 519	131	14
6. Other claims	166	125	207	125	283	137	2

Source: MNB

behavior, the following salient features can be observed:

❶ The growth of savings related to capital income (mainly forms 1–4) during the last four years was close to exponential. At the end of 2004, the net savings of the population related to capital income have been estimated as HUF 11,888.5 billion. Insurance related net savings (5) were estimated at HUF 2,394 billion. 50–60% of the savings is related to forms 1 and 5.

❷ During the past 5 years, the ratio of consumption in the GDP has been growing continuously, while the society has been undergoing radical restructuring and a significant part of the population has been unable to generate savings, rather incurred debts. The trend of increasing consumption is in contrast with the "old" EU member states, where during the past 15 years the household consumption ratio, as a sign of well balanced economic development, has remained basically unchanged.

❸ Because a significant part of the population was unable to save, a lion's share of the savings originated in high income households. Generally, with increasing age, people use more frequently cash and bank deposits (savings form 1); so do members of lower middle class families. Members of the upper middle class and people between 50 and 65 find forms 2 and 4 more favorable. Savings forms, related to title 5 are popular for blue collar workers, people with lower than average income and recent graduates. The behavioral patterns related to the savings dynamics are based on an ECOSTAT survey: half of the people are actively changing their portfolios; well educated individuals under 50 years of age are especially committed.

❹ Major parts of savings consist of cash and bank savings, in contrast to most EU member states, where stocks and shares have a far greater proportion. At the same time, people are migrating towards real estate and other portfolio investments with greater returns or profit rates. However, some savings forms cannot be fully estimated, because no specific information is available for them (this is the case for deposits or real estate investments held abroad).

❺ The dynamics of savings do not depend strongly on the interest rate (negative correlation) or the income of the population, but can be partially explained by the inflation rate (preemptive spending). This indifference to interest rates has happened in spite of the emergence in the past 5 years of a competitive financial system resulting in relatively higher interest rates than could have otherwise been expected (the average interest rates in 2004 are presented in *Table 2*).

❻ A widely accepted international practice is to tax capital income indirectly, by using different forms of asset/property taxes. The current Hungarian income taxation system levies a tax on real estate rental fees and on realized profits from increased stock exchange investments. According to the Hungarian State Tax and Financial Control Office (APEH), in 2003 an estimated 421,000 individuals paid HUF 90 billion tax, of which 20% has been paid as individual entrepreneurship tax, 10% stock/bonds value increase-related tax, 29% share-related revenue tax, and 20% real estate rental fee related revenue tax.

CAPITAL INCOME TAXATION SIMULATION

Data preparation

The microsimulation model of capital income taxation in Hungary has been developed as a static simulation model, which is based on corrected statistical data of 2002.

The basic data were selected using the Household Statistical Survey (HSS) of 2002. The survey consisted of household budget data of 10,000 households. The sample was random, representative, layered by type of settlement, and country-wide. However, the income and spending data of the HSS2002 are not able to fully reproduce (match) the macro level statistical data. Because of the central role of the HSS2002 survey in calculations of other economic data, e.g., income elasticity, this data set was selected for further corrections. These corrections aimed to accomplish two series of changes:

❶ Changes of income related data: Asset and capital related data were corrected by 1,358 billion HUF, 48% of which were salary based and 59% were entrepreneurial income. The changes were based on the 2002 individuals' "tariffs survey" (TS), which has been conducted by the Hungarian Central Statistical Office (HCSO). Data corrections on HSS2002 were determined based on the TS data using the statistical matching method. After the corrections, the net income increased by 23.6% and as a consequence of the changes, the original data set matched the relevant macro data.

❷ Changes of consumption related data: 75% of the generated income data was imputed as consumption, the remaining 25% was imputed as savings. The number of changes has been marginal (13 corrections), but their statistical importance significant.

The corrected data of 2002 of HSS2002 (C2002HSS) has been aged and aggregated as a second step of data preparation. The aging aimed to produce an initial synthetic data set for 2005 using published macro data (e.g., salary data, pension data) and certain statistics

Table 2

AVERAGE INTEREST RATES OF DIFFERENT SAVINGS FORMS IN 2004

Saving forms		Profit (%)
1.	Cash and bank deposits	8,5
2.	Securities (excl. #4)	12,2
3.	Credits and loans	N/A
4a.	Stocks,	54
4b.	Share,	10,8
5.	Insurance	10,2
6.	Other claims	N/A

provided by the HCSO and the NBH (e.g., the distribution of incomes and assets). The aggregation aimed to generate household level data using the individual data of C2002HSS. As a result of this step, a synthetic data set for the capital income taxation microsimulation model has been created. Different cross sections and comparisons with macro level data of years 2003–2005 show that the resulting synthetic data are satisfying for further use in the microsimulation study.

The process of data preparation is showed on *Figure 3*, below.

Microsimulation model

The static microsimulation model executes the simulation for the year 2006, which can be considered as a one year aging on the synthetic statistical data set of 2005. The simulation model uses the same type of macro data as the aging procedure (e.g., salary, inflation, and pension). Starting with the households of the synthetic data set, the model generates the savings and calculates the appropriate taxes. For generating savings, further studies of ECOSTAT and TARKI about savings behavior (e.g., household portfolio management) were taken in consideration. Data used for portfolio composition is presented in *Table 3.*

For validation of the simulation model and the quality check of synthetic data, tax revenue calculations were used for the time period between 2003 and 2005. The results demonstrated the ability of the model to calculate tax revenues in an acceptable range compared to the measured and/or predicted government tax data.

Microsimulation model experiments

Based on the ECOSTAT survey and to study the expected impacts of capital income taxation, different scenarios and cases were created and analyzed. Two scenarios, each of them with two cases were analyzed. The data of basic scenarios are presented in *Table 4*, the cases differed only in the behavior of the first and second quintile; there is no behavior change. Experiments were made based on the following different capital income tax rates: 5%, 10%, 15%, 20%, and 25%.

The experiments aimed at giving a clear picture about the range of revenue generated by

Figure 3

MICRO-DATA PREPARATION

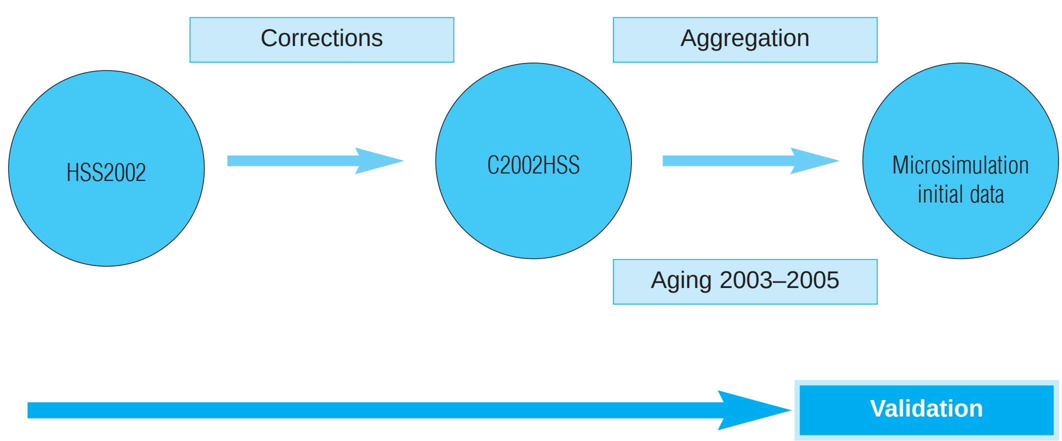


Table 3

PORTFOLIO COMPOSITION AND SAVINGS CHARACTERISTICS PRESENTED BY INCOME QUINTILE

Income quintiles	Bank deposits (%)	Stock and goverment securities (%)	Insurance (%)	Share (%)	Ratio of savers in the quintile (%)	Savings in the quintile(%)
1. quintile	70	0	20	10	20.4	1.2
2. quintile	65	5	20	10	22.5	3.5
3. quintile	65	5	10	20	39.1	9.4
4. quintile	53	7	15	25	50.4	20.3
5. quintile	33	12	15	40	69.4	65.6

the capital income taxation and the impact of the new taxes on the population at different income levels. It has also been a goal to recognize tax avoidance problems and their economic impacts (e.g., changing the portfolio may increase the pressure on the real estate market).

Results of the microsimulation model study

The most important results of the microsimulation study:

❶ Because of the complexity of the current tax system and the difficulties in forecasting, the expected revenue generated by uniform capital income taxation may vary significantly. The tax revenue generated by the capital income taxation is calculated between 23.1 and 86.8 billion HUF. In the best case scenario, the capital income taxation revenue will amount to 0.4% of the GDP.

❷ The introduction of capital income taxation would not affect the population dramatically: the income decreases less than 1% in each quintile. People with higher income would pay more taxes, but the most impact is to be expected for the oldest and the youngest. The retired and inactive population would be more affected. Looking at the families, the most impact is to be expected in families without children.

❸ Based on the static microsimulation model, the long-term behavioral changes cannot be studied. Nevertheless, in case of radical behavior changes of the population, the negative effects could be significant. Cash savings and bank deposits could decrease considerably, while the demand for government securities and stocks would decrease. The danger of a radically increasing consumption and the "exports of savings" cannot be excluded.

CONCLUSIONS AND FINAL REMARKS

Microsimulation is a popular and valuable instrument for governments to study the social impact of their decisions, especially impacts that cannot be observed using other methods. It provides the tools for detailed study of impacts of political decisions; tax policy changes can be also studied before introduced. There is a clear need to support governmental decision processes with this methodology, consequently there is a significant demand to make the methodology and related technology more available and user friendly. In Hungary, there is a need to develop a methodology, which reflects the changed international position of the country and the influence of globalization

Table 4

DATA OF MICROSIMULATION MODEL EXPERIMENTS

First scenario
10% ignorant
12% more spending
25% starting a business
53% changing portfolio to:
• 75% real estate
• 10% valuables and insurance
• 15% looking for higher revenue

Second scenario
10% ignorants
12% more spending
25% starting a business
53% changing portfolio to:
• 75% real estate
• 7% insurance
• 3% valuables
• 15% looking for higher revenue

TAX SENSIBILITY THRESHOLD	
Capital income tax	% of changes
5	29
10	59
15	84
20	91
25	100

on the political decisions. EUROMOD and other EU-conform decision support tools can contribute to a better decision making. A series of our future efforts will aim to improve the quality of statistical data (starting with the data collection phase) and the technical support of data analysis and model validation. We believe that further methodological and technological improvements can eliminate the basic disadvantages of the currently used static microsimulation models. We will concentrate our future efforts on the development of dynamic microsimulation models for tax policy related decision making in Hungary.

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PPP regulation is lacking

Public Private Partnership, or PPP for short, and the necessity, possibilities, and the content of its application has been a popular subject in public economy discourse recently. This characteristically third way method (the concept was suggested by *Anthony Giddens* in his book (The Third Way) is considered by some as the miracle tool while others think of it as the incarnation of irresponsibility relaxing fiscal regulations, and bringing long-term misery.

European experience has favourable and unfavourable examples alike, although one should note that PPP arrangements presently underway have only reached implementation phase at best, and one cannot predict the outcome of the decade-long projects. Some have good experience, and diversify their PPP portfolio, while in other cases modifications or lowering of profile results.

The rate of domestic interest is explained by the supposed or actual circumstances of PPP arrangements to date (cf. the adventurous history of the M5 motorway), i.e. the contradictions between the urge to launch development projects fuelled by high-flying political ambitions, and the present state of the central budget. Interest is reflected by an increasing number of papers published on the subject including the writings of former Minister of Finance *Mihály Varga* in *Pénzügyi Szemle* (Public Finance Quarterly) in 2005 and *Gusztáv Báger,* Director General of the Institute of Development and Methodology at the State Audit Office, in 2006. The former investigated the issue from the point of view of social and economy utility, the latter from the point of view of transparency, accountability, and controllability.

In my present contribution I would like to deal with two issues touched upon in both papers but not elaborated in detail: the legal framework of the Hungarian 'nameless' arrangement (translator's note: the author refers to the fact that PPP has no Hungarian translation yet), and the necessity of creating domestic legislative standards.

The essence of Public Private Partnership funding arrangements first seen in Anglo-Saxon countries is that capital intensive investments of the public sector are realised by involving the private sector. The extent, the method, and the consequences of such cooperation are essentially associated – at least to my best judgement – to the level of development and strength of a given society and its economy, stability in political and common law terms of the country in question, and the role that the government of that country attributes to the state in both theory and practice.

Motorway construction projects in certain southern European EU countries are implemented in a PPP arrangement in which one third of the funding comes from the state budget, one third is granted by the EU (they sat it out), and one third private investment. The last third – i.e. one third of the full expenditure – is supposed to be recouped from toll revenues, and in some cases revenues from related services that constitute the actual risk for the investor. In Hungary the full return on the investment – blown up significantly by the banking costs of private investment funded from loans – is guaranteed by commitment cost paid from the central budget, involving no real exposure.

In the light of the above: we need national legislation, too, which takes account of the limits of financial load that the central budget can cope with, and also of EU legislation as far as public finance requirements are concerned, but one which is based on Hungarian features in regulating the possibilities, and limitations of PPP projects, their preparation, launching, implementation, and audit.

Independent, dedicated regulation has been so far presumably delayed by the fact that Hungarian law, even today, does not actually prohibit the application of that method. Act XXXVIII of 1992 on the State budget, and Act LXV of 1990 on Local governments enable various entities under the public finance system to become participants of such arrangements. Independent regulation on concession, and standards applicable to financial leasing sometimes enable distinction between the two, however, these cases are unpredictable, relative, and jeopardise both enforcement, and judicial practice by allowing uncertainty.

That is why creating national regulation is a truly urgent task.

This is the reason why in debates on PPP in recent years some ministries placed the creation of independent regulation on their agenda and made even promises to that end. However, none of these have so far been delivered. Guessing possible reasons for that delay would be largely based on imagination, would exceed the dimensions available for my contribution, and encroach upon the reader's perseverance.

I will therefore suggest arguments for independent legal regulation.

The World Bank's summary states that in 9 out of the 11 countries where PPP is being applied there is either established, properly formulated legislation or a draft is under preparation. Out of the six new EU countries that apply PPP to any extent in some way national regulatory work has been undertaken or is currently underway in four. (The summary report classifies Hungary as 'work commenced'). Among candidate countries Bulgaria and Romania apply the arrangement in question, and have begun relevant legislative work. It is to be noted that Turkey, member of the same group, does have dedicated national level regulation, but does not use PPP.

When preparing PPP legislation, the following must be borne in mind based on international and national experience, in addition to the usual regulatory objectives:

- Social needs assessment and accurate economy computations to serve as a basis for the preparatory work to applying the arrangement
- Medium-term and long-term implications of the arrangement
- Social and economy limitations of its application (how much of the services now in public competence are planned to be handed over and in what manner, limitation of the financial load and earmarking on all times' state budget, the effect it has on the costs of implementation and operation, etc.)

It might seem obvious, but I recommend integrating the 2.5 thousand year-old category of exposure in the regulation, and taking it into account all along with special regard to the fact that unburdening the state budget, and the viability of PPP require a real private partner, and a real private partner requires taking actual risk.

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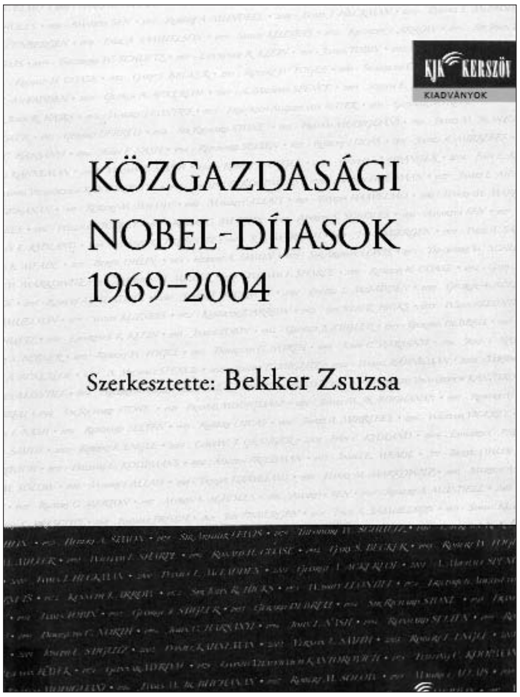
European Commission: Guidelines for successful Public Private Partnerships, 2003

PPPUE/Capacity 2015: PPP training, *26 January 2006*

Nobel prize laureates in economics 1969–2004

Edited by Zsuzsa Bekker



KJK-KERSZÖV, BUDAPEST, 2005

Zsuzsa Bekker, professor of the Corvinus University of Budapest, has accomplished a significant enterprise with this book. Although countless information, analyses and reviews are published about the life-work of the economists who win the Nobel Memorial Prize as early as on the day of announcing the award in Stockholm, it is nevertheless – or for that very reason – extremely difficult to briefly summarise in a reference book the career path, achievement and influence of a scientist or the controversies over his work. For this book is a rather hefty volume. Of course, few will read it as the reviewer who has read it as a saga from cover to cover. Of course, it is not a novel; a reference book should not be read as a story. I presume those who read the book, do it with a specific aim: to learn – for instance – about a scientific school or the path-breaking and conceptual life-work of a great personality. The book offers a lot even in this respect, since after presenting the biography and intellectual achievements of the prize-winners, the essayists of the book – in addition to listing the major works of a scholar- enumerate a dozen or more of the most important reviews and specialist literature written about him.

It also makes sense, however, to read it linearly. But not exactly like in *Karinthy*'s sketch in which the professor's wife read a mathematical dissertation as a romance. Although she could not understand all the complexities, she concluded with satisfaction that at the end of the novel X and Y did meet after all, all be it in infinity. When reaching the last page of the records covering 35 years we know, as a matter of course, that it is not the end of the story. But it is not the only reason why it is hard to tell where the plot is going to wind up in the history of economics. For the authors of this book write stories about characters that have been selected by others. So this is a serial whose characters are chosen by the Nobel Committee. This prize was awarded to 55 male scientists (yes, only to men) until 2004 as a result of a not entirely transparent procedure. On the basis of such a period of time and number of people, certain trends could be established in respect of the chosen subject, work method, personality and scientific-social bonds of the most prominent economists, although, according to the very rules of our discipline, we must proceed with caution in analysing this multitude of limited representation.

So, who can win the Nobel Prize? In her introductory essay Zsuzsa Bekker refers to *Friedman*, according to whom a candidate stands a better chance if he is a man, an American and a graduate from the University of Chicago. Certainly, two-thirds of the recipients are American nationals or have become one in the course of time. There were seven British, five Scandinavian scientists, and the rest of the world shared the remaining five places. A man had a far better chance to win if, beyond his position as Harvard or Columbia university professor, he was an associate of the American Cowles Commission, or if he worked for the American National Bureau for Economic Research (NBER).

This is the final result although we have not even unfolded the plot. If we do read this textbook chronologically, we often feel that we have found a thread, but we often lose it in the next chapter. The prize, established in 1968, was first awarded to pioneer scholars and undisputed giants in pursuing high theory. Since – unlike in natural sciences and literature – this was a new award presented in the field of economics, at the outset there were obviously too many outstanding intellectual contributions to be rewarded. It was perhaps in the mid-1980s that beyond the deserving scholars whose award was long overdue, the awards committee had an opportunity to reward outstanding accomplishments in the study fields of economics outside the strictly defined mainstream. When reading works of the prize-winners in the past ten years, we can often obtain an insight into the achievements of a sub-branch of the discipline or a fringe movement.

Arriving at the present time, the reader may conclude that he has no firsthand experience of reading any publications of some of the new Nobel Laureates. This is not entirely attributable to a gross negligence on the reader's side, because while from the 1970s onwards the Nobel prize was given to living classics in economics, it is now – as customary in other classical disciplines – given as a recognition of outstanding contributions made in a specialised branch of science in the years preceding the decision rather than as a reward for life-work.

When reading this book as a novel, other threads of the story are unravelled (then disappear). At the beginning, the award was mainly granted to those who have strengthened and fine-tuned conceptual and mathematical clarity within economics, we could almost say to those who have turned economics into a 'science'. In any case, it is certain that strong mathematical competence and considerable methodological groundwork are always evident in the work of the winners. This trend, however, becomes less important, because despite finance, economic-mathematical modelling and econometrics, i.e. several “tough” areas of economics, continue to dominate the subjects chosen by the winners, subjects of institutional economics also appear as it were to prove that economics, contrary to all rumours, is a social science. This is how Adam Smith's great work was conceived at the time when he studied the economy of nations, and found that the division of labour and co-operation among people emerged above all the other possible explanations for prosperity.

The editor – sparing no effort – has won over the most prominent representatives of Hungarian economics to review the 35 years. Most of these expository and analytical papers are genuine essays. I hope I will not offend those by this qualification who consider their study published in this book a part of their professional work. An essay is no less, rather, it is more than a well-written professional article, since the essayist attempts to (this is why the name of this genre originates from the French word 'essai') discuss a complex and far-reaching subject relatively briefly and, as far as possible, clearly for all. For precisely this was needed for the simultaneous presentation of a scientist's scientific and public profile and the summary of the evolution in a field of research.

There were some among the 49 authors who accepted the genre of the essay and even enriched it with some personal aspects. For instance, *János Kornai* who, talking about the life-work of *Kenneth Arrow*, instead of focusing on the most well-known and most often analysed achievements of the scientist, has summarised his contributions that are especially interesting for an essayist today (and apparently less known by the majority of Hungarian readers). In Arrow's case, it is related to his work on the economics of healthcare and, in particular, to his statement about the transition following socialism. The essayist's personal attitude is not as evident in the writing of *Aladár Madarász,* but his two essays assessing the work of *Hayek* and *Myrdal* respectively are more than a mere study and summary – they refer briefly to issues of international and Hungarian perception, to the possible disputes and considerations behind the shared prize given to two scholars of very different schools of thought.

While Aladár Madarász is a "full-time" historian of theory, others have approached the scholar they had to write about (or chose) from their own field of research rather than the history of theory. In such cases, an in-depth analysis and summary are given about the field of research under review in addition to presenting the Nobel recipient. My opinion is of course subjective, but I have found *János Vincze's* paper on the 1988 prize-winner French scientist, *Maurice Allais* especially educational. We know little about Allais's life-work, and, it may sound strange but language barriers play a part in it, in so far as today English has predominance over all European and non-European languages. The chapter about Lucas (written by *Júlia Király*), as well as the one presenting *Ronald Coase's* career (by *Pál Valentiny*) are also gratifying reading. It would be hard to pick even a few of the many interesting and profound studies. For the reviewer those have been particularly interesting which have dealt appropriately with a scientist's reception in Hungary.

Although it is not a tendency, it is nonetheless worthy of attention that several of the winners of recent years have researched the operation of financial markets and the micro-economic (financial) links of the macro-theory. *Modigliani's* far-reaching pursuit received distinction in 1985, *Merton Miller* in 1990, together with two other scientists: *Harry Markowitz* and *William Sharpe* who have come into prominence by elaborating financial subjects. The above-mentioned Lucas has also enhanced monetary theory (as well as the theory of economic policy). *Robert Merton* and *Myron Scholes* (1997 winners) are living classics of modern financial theory. At the same time, the award given to *Amartya Sen* for his contributions to welfare economics, and to two economic historians, *Douglass North* and *Robert Fogel,* puts a halt to our urge to form trends. It seems that the awards committee has recently not only recognised formalised and “hard” economics but at times also the interrelated and adjoining areas of economics.

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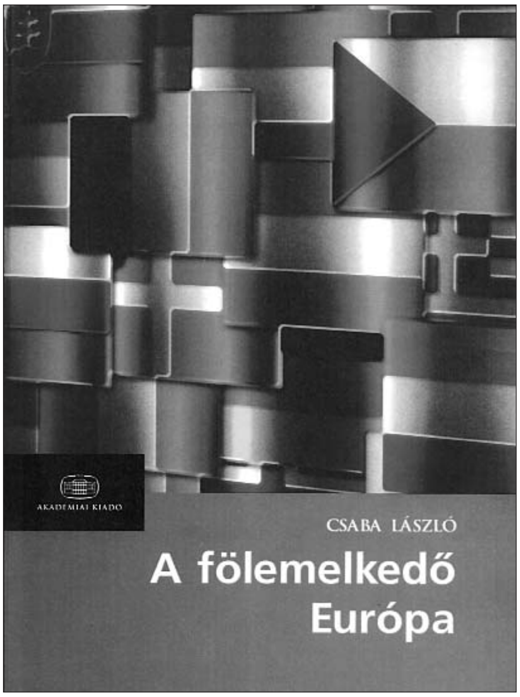
The editor of the book has won over prominent personalities of Hungarian economics to write the essays. Beyond the doyens of the profession, among the authors are representatives of the middle generation and a number of young people. It must have been a challenging task to fit the chosen subject into the limited size of an essay. It is to the editor's merit that the reviewer could hardly find any fault in the large volume. I recommend this book to professors, university students and to all who wish to become familiar with the recognised achievements of an important social science.

Péter Ákos Bod

A LIBERAL CREDO?

László Csaba

The rising Europe



AKADÉMIAI PUBLISHING HOUSE, 2006

Readers of *László Csaba*'s voluminous book will find it a particularly meaningful and exciting review of world economy. The author presents a huge set of facts, an unusually large variety of literary references, features an inclination to discuss views different from his own, builds theory, and endeavours to verify these theories most consistently. These qualities deserve respect, or better, appreciation.

The author calls *rising Europe* the countries of central Europe having completed their process of political change with more or less success, and investigates the regularities of their transition. In that process he brings new countries and groups of countries into his increasingly widening spectrum, and as he rises higher and higher he recognises correlations of greater and more general application.

Even though his main tool is economic analysis, he confidently draws on the knowledge of other sciences and disciplines, involving the results of these in his investigations. This renders his analyses more finely shaded, richer, and at certain points positively exciting.

Reviews written about the English edition of the book, whose most important observations the author shares with the readers of the Hungarian edition at the appropriate point in his line of thought (footnotes on pp. 15, 214, 355, 386, and 402) highlight his consistent analytical framework concerning the groups of countries, developments, and correlations investigated as perhaps László Csaba's major merit.

We may regard this all the more a virtue as The rising Europe is the summary of at least four books in a single volume, so in spite of the author's repeated statement this is a multi-subject rather than a single-subject treatise.

■ The first analysis is about the transformation and the performance of the transition countries, and has the main message that the (East) Central European countries having joined the EU in 2004 (plus Croatia) should not be equated to Eastern European countries (member countries of the Commonwealth of Independent States), with countries of South-East Europe, and Central Asia. László Csaba calls the countries in the first group the rising Europe, and that is why it is strange, moreover, even somewhat misleading that the cover of a book with this title displays the flags also of the states of the so-called old Europe (e.g. France, Belgium, Germany). The mere name of rising Europe is contradictory since '*... the rift of development between the transition countries and the West has widened on the whole and in general over the last one decade and a half.* That means that the difference, measured in dollars, has increased rather than reduced.'[1] (page 39) Moreover: '*There isn't the slightest trace of the so frequently mentioned convergence:* while some EU countries converge with other member states, others lag behind, and while there is no sign of the richest ones beginning to slow down (in a way that others can catch up), while the economy of some of the poor countries continues to grow slowly.' (page 40)

This part of the book is the richest in statistics (and additional information). The author apparently presents, and explains UN statistics, while the numbers are only needed as an excuse: László Csaba has such in-depth knowledge of the economy, and the development of former socialist countries, and their leaders – sometimes taking their positions in rapid succession, – and the reviewer (who, as the majority of Hungarian economists would feel embarrassed having to put e.g. Turkmenistan on a blind map) can only bow in respect seeing this amount of knowledge.

Professor Csaba argues with great emphasis that the common socialist past is an increasingly weak explanation for the development curve, and the economic and social performance of the transition countries. Their development diverges because they allowed to varying degrees the open market to strike root, and the level of sophistication, stability, and effectiveness of their economic institutions is also different.

In fact one cannot be satisfied with the performance of central-European countries either: 'despite external capital market funding gaining ground and the increasing presence of operating capital' the system of resource allocation is not effective (p. 53), and the maintenance of general access to welfare systems inevitably results in high levels of public contributions, and that in turn leads to low employment rates. (p 56) In both cases the problem is a regulatory (governmental) rather than market failure!

■ The second major conceptual unit is the part dealing with the European Union. The EU, which seemed an example to follow in the first chapters even for leading transition countries is suddenly unmasked if looked at from a short distance: serious structural and equilibrium problems, reluctance to face up difficulties, the economies and the societies of member countries are sometimes distorted by opportunistic/corporativistic deals. The EU is mistaken also as an institution: e.g. by maintaining the common agricultural policy it partly wastes (and passes on to the richer producers) its scarce common budgetary resources, and partly conserves the uncompetitiveness of the sector leaving it to its own devices. However, the EU has at least one success story (i.e. one in addition to the creation of the single market), namely the Euro. Under that heading the author primarily discusses institutional/regulatory correlations. He submerges into detailed discussions concerning the importance and the virtues of the EU Stability and Growth Pact, and reprimands the member states that do not comply with their commitments undertaken in that Pact.

■ The next conceptual unit presents the recent development in Russia and China. The author has selected these two countries as he regards them good control groups to evaluate the performance of the East-Central European states. László Csaba's most important message in conjunction with the former is apparently that Russia does not stick out of the group of the transition countries. It is true that it embarked later on its process of political changes, but even the transformation crisis did not last significantly longer and was not any deeper than generally east of the Elbe, and the same basic regularities may be recognised there as anywhere else in this group of countries. The introductory part of the chapter presenting China has a weighty message: the author summarizes/repeats the innate problems of the failed Soviet type development model, and the main ingredients of its unsustainable character. László Csaba does not question China's practically unique economic performance, but labels it unsustainable and – what the writer of the present review finds much more important in our case – unrepeatable. He ascribes this latter – among others – to Chinese traditions, claiming that – let us put it that way – *business thinking* could never be eliminated from these traditions. He attributes a similarly important role to the high level of independence of Chinese regions, and to the intermediate forms of ownership characteristic of China.

■ The last two chapters of the book, i.e. the fourth conceptual unit repeats, and generalises the significance of regulation and of the institutions. The author formulates recommendations much to the liking of the reviewer:

- Regulation must serve the public good, thus it is preferable that the state rather than the Mafia or multinationals pay public officials and judges;
- Some duties cannot be outsourced from state administration as they can fall prey to partial interests;
- As many as possible self-regulating mechanisms and bodies are necessary that can play their roles with much lower transaction costs (lawyers' fees) than traditional institutions including courts of justice.

When approaching László Csaba's latest book from the economic theory point of view, one can state that he enriches the liberalism represented by him for a long period by the elements of new institutional economics. The author brings an abundance of examples from recent history to illustrate that the market only operates properly if there are stable, effective, and reliable institutions to ensure that the public good should assert itself. The recipe of economic policy resulting from that is also to be considered by all transition countries, even though such consideration may be embarrassing: compliance requires the discipline of all actors of the economy. Of course it primarily requires it from the state, which is traditionally most inclined to give priority to momentary interest (including even crazy ideas) against economic regularities or the long-term public good. That kind of voluntarism was not only characteristic of former socialism in the transition countries, but may be experienced on a daily basis in mature market economies as examples that illustrate the feebleness of governments. That lesson is worthwhile learning in a country where the government (and occasionally even the parliamentary majority) 'was/is angry' at institutions or heads of institutions such as the national bank, the prosecutor's office or the financial supervisory agency…

However, good institutions impose discipline not only on states but also on market actors: they can put an end to the abuse of economic power, and prevent some groups (mainly trade unions and NGOs) from imposing their interests on the majority as an instance of corporativism.

It follows from the above that public administration should by far not be relegated to the background: on the contrary, it should be equipped with more effective tools.

It is true at the same time that its authority should be curtailed. '… in transition countries, similarly to most emerging markets, central administration should be strengthened rather than minimised. That is the only way in which *case-processing administration, day-to-day mentoring, supplementary actions/activism can be repressed, moreover, in a systemic fashion.* Reducing the economic role of the state, then, requires the strengthening of public administration […] more effective market coordination may be the basis of the improved quality of bureaucratic regulation, and those mutually strengthening processes are exactly the key to the success of the leading-edge economies.' (p. 135)

In agreement with the majority of the profession László Csaba represents the view that restoring economic equilibrium is the primary task of economic policy: '*… we see no single case where growth returned prior to or – let alone – without stabilisation.*' However, he is also clear about the fact that it is a necessary but not sufficient condition: '… stabilisation itself will not generate lasting growth, especially not one faster than that of developed states.' (p. 43)

It is a particularly important lesson for the readers of the Public Finance Quarterly that the '… "great rift" among the transition countries mostly coincides with the line of the success or failure of their financial system.' (p. 112). That is because '… the benefit of an inherited banking relation' may survive for some time in a process of transition into a market economy, which, of course, works against economic effectiveness. It is therefore not at all by chance that '… *the more resolutely* a transition country *cut the umbilical cord connecting state administration to enterprises, the more successful it could become later.*' (p 134)

László Csaba argues that the state should establish the system of institutions and the set of regulations to guarantee the healthy representation of market forces, and should then operate the former, and ensure the unbroken compliance with the latter. The responsibility of economic policy meanwhile is to secure equilibrium. Moreover, the author, formulating recommendations from the EU's Stability and Growth Pact goes as far as not entrusting this to economic policy, but prefers to integrate it straight in the Constitution so that '… the Ministry of Finance should have the duty of levelling off public finance over the full cabinet term.' (footnote to p. 257) Agreeing that that would '… fuel the slowing down of self-destructing populism' (p. 257), which would be a truly commendable outcome, we would be worried not about the requirement itself, but about never-ending professional debates expected to break out in conjunction with the assessment of compliance with the regulation.

By ensuring the *ordo-liberal* structure, and equilibrium I find that the economic responsibilities of the state have not yet ended, especially not in a country now emerging or still in transition. In disagreement with professor Csaba I reckon that there is a third field – possibly called economic strategy – between the two where there is really no need for 'hustle-bustle' by the state (p. 336), while there is a need to determine the main directions of development and the required resources. If there were a country that could afford leaving its enterprises to their own devices – apart from complying with the above regulations – it would be the most developed market economy. The writer of the present review has experienced several times over a short period spent in public administration that the heads of state and the diplomats of these countries never shrink back from a little bit of hustle-bustle if the interests of an 'important' company in their country so requires. Any minister of finance of any government after the political changes could, of course, quote a long list of such cases. But even international press including the liberal *Economist* mentions names like *Halliburton* or *Bechtel* in the same context…

There are numerous other examples questioning the necessity of narrowing down the role of the state, stated by László Csaba as follows (among others): 'A civilised market economy is where the normal operation of the market is controlled and protected on a constitutional basis, while the state is the *regulator and the arbitrator, but by no means the administrator,* it is not a manufacturing entity, nor the representative of partial interests, nor the doctor of individual heartaches.' (p. 121) Well, not many countries fit that description, even if we ignore other cases like Alitalia, or Crédit Lyonnais, quoted elsewhere by the author. Let us just think of regional policy in general, or of the agricultural policy of many countries and the EU, or the support granted to the so-called social economy. In other words, economic policy representing purely the public good void of the influence of any partial interests could sooner be a theoretical fiction than the practical test of whether a market economy is civilised.

The writer of the present lines regards it more as the measure of the civilisation level of the market economy the extent to which that market economy is able to represent various interests, and harmonise them/find the common aliquot. That is why we cannot categorically reject the practice of countries relying heavily on reconciling interests, bargaining, as the aggregate performance of these is not necessarily any worse than of those where little or no such interest reconciliation exists. It is worthwhile looking at the competitiveness rankings of countries to see that Scandinavian countries, topping the interest reconciliation list, do not perform badly at all…

I am of course aware of the fact that for small countries with open economies there is no alternative to integrating as fully as possible into the international division of labour, and trying to attract operating capital. Surely, authors quoted by László Csaba are right in claiming that '…the more powerfully a country manages to hand its financial sector in foreign hands' the likelier it is that '…the favourable effects of trans-nationalisation will ripple on.' (p. 134, footnote). And how much profit trans-nationalisation will bring, and how wide a circle of the economy it will reach, and how much profit it generates in the host country (and how much of it will remain there), how lasting it will be are issues in which economic strategy, and economic management may have a role to play.

From among the many kinds of valuable lines of thought in the chapters on the European Union we find worthwhile highlighting the one – due to its relevance to economic strategy – that encourages that Hungary should aim at more than simply the optimum position in a given situation when bargaining with the EU. László Csaba quotes Attila Ágh in agreement, when the latter thinks that the countries of the rising Europe 'should reasonably support the reform camp because their real national interests are not net transfers equalling some tenth of a % of the GDP, but primarily *the sustenance, and improvement of the operability of the EU, and better representation of interests through joint action.*' (p. 230) In other words, Hungarian politicians should rise to the 'founding fathers' of European integration, and '… work on creating the European community formed by long-term goals, and value-based aspects.' (p. 230)

In all his scientific functions (university professor, leader of doctoral schools, chairman or member of editorial boards of magazines/papers, main character or simply the opponent of economists at their defence of the title Academy Doctor) László Csaba always does his work meticulously honouring the people he meets on such occasions with a detailed critique. The reviewer cannot deny the same gesture from professor Csaba, and must direct attention to some specific errors, or mistakes of the book (the genre being review, the following can merely be a selection).

■ The author writes the following concerning the exception whereby the decision on the introduction of the Euro is left with the member state (the so-called *opt-out*): '…several of the old ones – Denmark, Ireland, Great Britain, and Sweden – take advantage of it.' (p. 168) The option of staying out is only granted in the protocols attached to the Maastricht Treaty to the United Kingdom, and Denmark, and no one else. Sweden, as is commonly known purposefully fails to meet the Maastricht convergence criteria in order to postpone accession. Ireland was happy to introduce the Euro in 1999 together with the majority of the then member states. We must note also that – unlike it is stated on page 237 – not the two richest countries of the EU remain outside the Euro zone. Neither was Spain a late joiner to the Euro zone. (p. 40)

■ 'The role of the EP continues to be one of deliberation, and approval, but following the Amsterdam and the Nice Treaty its authority of co-decision has increased, *particularly as regards personal and financial issues.* (p. 184) It may be subject to dispute just how genuine the EP's role is in EU decision making, or if it continues to be primarily a deliberative and approving role; one thing is certain, however, that the jurisdictions of the EP have broadened in strict monotony in the history of EU integration so far. An important fact, however, is that the EP has no right of co-decision in either personal, or financial (fiscal) issues. Co-decision is a procedure specified in § 251 of the Treaty Establishing the European Community, which has, by today, become the most frequently applied form of creating EU legislation. In personal issues the EP has the right of approval, and in budgetary questions a characteristic procedure is used.

■ The book intermingles the concept of stability and convergence. On p. 282, in footnote 9 it refers to the German convergence programme submitted in 2004. As a member of the Economic and Monetary Union (EMU) Germany had to prepare not a *convergence* but a *stability* programme. The former is the regular 'homework' for member countries intending to enter the EMU.

■ 'The transforming agricultural policy of the EU is coming increasingly in overlap with the environmental objectives. It is commonly known that no community resources are allocated to the latter …' (p. 195) Well, even though environmental policy unlike agricultural policy belongs not under *common*, but under *community* policy, quite significant funds are earmarked annually for such purposes. Half of the whole Cohesion Fund finances environmental investments, moreover, other resources (e.g. the so-called structural funds) are likewise available for that area.

■ Readers dealing with the EU will certainly be puzzled to learn that László Csaba uses the word Council to refer to the European Council rather than the body of ministers (first on p. 14), or that he mixes up directives and guidelines (e.g. on p. 242). The Stability and Growth Pact is not the attachment to the Nice Treaty (treaties, as it happens, have protocols and declarations rather than attachments attached to them – p. 238), and not even the attachment to the EU Treaty (pp. 248, 280, 283), however, they are nevertheless binding documents. In Nice the list of majority decisions was not shortened, instead, it was further extended. (p. 252). What they organised in Laeken was a *summit* not an *intergovernmental conference* (p. 213).

■ 'When awarding the 2004 Nobel Prize for economics the Stockholm Riskbank could not and perhaps did not even intend, even this time, to distance itself from the apparently most important challenges of the age.' a statement on page 273. Well, the prize was indeed established by the Riksbank (the Swedish national bank), but they are not the awarding organisation because they managed to 'distance themselves' to the extent where they actually transferred that right to the Swedish Royal Academy of Sciences.

■ It is not fortunate to use the definition given in the book for the GDP, a fundamental category of economics. It says: The GDP includes '… all activities that have a price'. (p. 42) Work in the household as mentioned by the author is really not part of the GDP, but there are many types of work that do not have a price, and yet are part of the GDP. Examples include public administration, or education. And perhaps one does not even need a definition for the GDP in a technical book on economics. Instead, a definition of 'Dutch disease' would have been good to provide, mentioned six times throughout the book.

Much more disturbing than mistakes are the contradictions that would have been much less possible to weed out by a conscientious proof-reader or editor.

László Csaba enters the battlefield as the crusader of a religion bringing 'salvation': liberalism (even though he has new coats of arms on his shield: that of new institutional economics, moreover, new political economy). It is commonly known that such religions are inpatient because they regard themselves the only true faith. The reviewer observes the world from a position much more tolerant than that, so he respects the author's 'faith', and only refers to a few among the instances where the author has clearly or implicitly come in contradiction with himself.

■ In the introductory chapter the author discourages the use of the term *transition economy* saying that '… it means no less than having limited duration' (p. 29). If the reviewer has the liberty of looking around for a good argument, than he can say that of course the word does not have that meaning just as the existence of the transition coat [Hungarian compound word for coats worn in spring and autumn] is not anymore limited in time than that of a winter coat… (of course a transition economy, unlike the coat is temporary (transitional) in its very character, i.e. it will probably sooner or later become a real market economy.) Our problem is simply that after this point the author goes on to use that phrase with full confidence, and makes frequent allusions to the 'science of transition'.

■ 'In overlap with the literature on growth and development, our analysis also highlighted the *central role of savings by private individuals,* as a kind of fixed point of departure' one reads on page 455. Five pages onward, still in the same chapter we see the whole issue in a different perspective: 'The more seriously we take the recognition of the new paradigm of development economy, i.e. that the primary fuel to growth is not capital accumulation, instead, growth is brought about by a good number of policies and institutions *together*… (p. 460)

■ 'In Hungary the political class has until most recent times resisted to the concept of the ministry of European affairs, last emerging in 1994. In 2004 a solution was found as a result of personal arrangements/combinations that I considered as approaching the right direction, where both the allocation of funds and representation of EU interests were partly controlled by the same hand, functionally moving beyond the non-EU-minded, traditional division of sector-based cabinet structure.' (footnote on page 229) One only needs to turn one page, and on page 231 in a section arguing for the importance of de-centralisation the reader sees the following: '*That is exactly the opposite of the practice of the previous decade and a half, when a handful of experts handled EU affairs working in close working relationship either with a Minister in a super ministry or the prime Minister.*'

■ Similarly to the author, the reviewer is not a subscriber of mathematical economics, and can also accept if someone is a little sceptical about the results of this 'ancillary science'.

What the reviewer finds difficult to tolerate is only that if the findings of modelling corroborate our statement, then the given discipline must be taken seriously, but when it does not, we should simply ridicule it. An example for the former: 'However, by comprehensive model-analysis it may be proved …' (p. 277), and the example for the latter: That question may, of course, be modelled infinitesimally, and the result may be anything depending on the definition of the result and hypothesis.' (p. 246.)

■ The author, requiring with unswerving rigour governments, central administration systems to create good institutions, to comply with laws, and regulations, turns a blind eye with amazing generosity to the features of the Russian developments, unacceptable by European standards. 'Reference to the "theft of the century", i.e. the shady privatisation deals of the 90s is probably a feeble argument if one only thinks of the 18-19th century history of the United States. That was namely the birth of the rule saying that it was not polite to inquire about the origin of the first million dollars. The stories of gold diggers, and robbers, merciless slave owners, and barons were sung by literature, and sociology, and yet private property became part of the establishment in America.' (p. 329) I do not think that we may accept 18-19th century standards at the turn of the 20 and 21st century. Let us just imagine what grading Hungary would have deserved in the late 1980s from the Unites States if the latter had applied the American human rights standards of the 1940s or the 1960s in conjunction with the minorities… Interestingly, the author is not so tolerant with China, and applies to them the standards of present day America: 'While a large number of the legislative loop-holes enabling abuse in the wake of the initiatives of the Sarabanes-Oaxley- [correctly: Sarbanes-Oxley-] committee were closed, and those responsible were held accountable in court, in China creative accounting is still daily practice.' (p. 379) Once we mentioned the historicity of things let us refer to the example of *chaebols* and *keiretsus.* These South-Korean, and Japanese corporate empires come up in the book as negative examples through the crisis that they exemplify, while perhaps they do not deserve that one-sided reference, forgetting the role they played in the industrialisation, and rapid progress in world economy of their respective countries. Their crisis related to these formations may justify the view that they are unsustainable, in which case one would deny them the potential for development, and adaptability. The same approach would justify qualifying the institution of the market economy an unsustainable formation, whereas it is just its openness to change, and adaptability that ensures its lasting existence.

■ Perhaps the greatest theoretical and economic policy dilemma discussed in the book is how much countries resemble each other, and to what extent, and under what circumstances solutions elaborated in one country/group of countries may be applied in another. On the one hand we read in László Csaba's book that '… whatever holds for OECD countries should hold for poor countries as well' (p. 117), but – very correctly – the author suggests that this is only one side of the coin. The author recognises, and we may appreciate that as a significant move forward in the light of his classic liberal mentality, that *one-size-fits-all* does not exist: 'For example a formal legal solution that operates perfectly in one country may simply prove to be irrelevant in a different cultural setting. Similarly, differences in social values may result in hardly any demand for leading edge solutions.' (p.221) Or: 'If solutions without appropriate foundations were forced to apply, they usually failed' (footnote to p. 161) Further: 'The above seems to corroborate the argument already supported from several sides that common objectives may be achieved presumably by *different methods* in different countries. In the labour market dominated by cultural and social traditions that plausibly cannot be any different, as the group achieving the best results includes Austria known for its corporative traditions with an unemployment rate of 4.6% as the flagship of the free-market solutions, and Ireland (4.2%).' (p. 228) And the conclusion: '…it is not possible to create a policy or institution system valid for every age and every country, i.e. one that is *interpreted as the optimum at the level of economic theory.*' (p. 446) The ideas quoted above justify for us the question mark in the title of our review.

■ It is likewise clear that the converging countries must not seek individualistic solutions, at least this is what experiences of recent history suggests to the author. 'Foreign banks gaining ground, trans-nationalisation of companies, the acceptance of the pace-maker role of operating capital, *active role* in the new order of global and trans-national regulation (and taking over existing solutions instead of criticising them), taking over global standards ultimately form one logical chain. That is why it is not by chance, rather, it is a necessity just as *diverse groups formed along the same fault among emerging markets.*' (p. 159 the underlining is mine – T. H.). Follow-up countries are reprimanded sometimes just because of imitating others: 'The often unenlightened, market-protecting or simply ineffective solutions of the older EU member countries as e.g. tertiary education producing mass unemployment found followers easily.' (p. 202) Some countries do not simply imitate, but clearly ape others ahead of them: 'That feeds a hope that the spontaneous liberalisation of the labour market will bring better results than the aping of the Western-European solutions…' (p. 60) The only remaining question is who decides which institutions to take over, and which should be kept out of reach of converging countries.

There is hardly an author in the Hungarian economic profession to corroborate arguments with more references than László Csaba. At the same time we are somewhat surprised at the small number of original documents in the literature list apart from statistics. The author often relies on second-hand information, and sources, even though one should be fair to add that such information and sources are ones of high standards. The same deficiency is quite striking with EU subjects: László Csaba e.g. analyses and evaluates in several chapters the Stability and Growth Pact without referencing it a single time. The large number of references also appropriately reflects that the author likes to elaborate his ideas in a reflective (not infrequently self-reflective) manner, and clash is his life blood. Of course we do not object the fact that László Csaba disagrees with many (after all that is a basic feature of scientific learning), but often he does not argue with them, but grades them briefly and categorically.

László Csaba's sizeable volume of over 43 printed sheets is a piece of writing of particularly high standards: it comprises a remarkably rich pool of facts, and excellent argumentation to support theoretical conclusions. There are certainly economists who cannot identify with his every statement, or proposition, however, one thing is for certain: everyone can learn a great deal from it. And the hypothetical state, which in accordance with the reviewer is the main message of the book, namely that the states of the rising Europe will become countries where stable institutions, predictable rules ensure stability, where well trained, top standard officials serve the public good (rather than the interests of individual groups), where the latter do not spoil market mechanisms by hustling and bustling, but take care of those in disadvantaged positions, well, that state is an attractive perspective for all economists. The book will certainly convince those opponents of liberalism of the invalidity of their views who criticise this regime just because it ensures the fastest sustainable growth…

Some years ago Béla Csikós-Nagy, a decisive figure of class IX of the Hungarian Academy of Sciences, the honorary former chairman of the Hungarian Society of Economists told the writer of the present review that after the last election of academics he ran into László Csaba in a restaurant, and told him only this: 'You will be next'. We are convinced the book titled The rising Europe greatly contributes to the realisation of Béla Csikós-Nagy's prediction (just as his predictions materialised many times before).

❖ ❖ ❖

And finally a remark: it is not clear why prestigious publishing houses fail to have their publications checked by a proof-reader. That should not be allowed even if the author is a leading teacher or researcher. Even the most famous opera singers are not ashamed to work with a music director, and precaution – as the present volume proves – is not unnecessary with anyone. The music director may call to mind the proof-reader, and the proof-reader may remind us of spelling. It is strange that Akadémia Publishing House has difficulty printing a simple small letter (namely ä), and that it consistently divides the Hungarian conjunction 'vagyis' as 'va-gyis' ('that is')! We could mention by the same token the fact that the system called 'beszolgáltatás' (a kind of in-kind tax) occurring in several eras of Hungarian history is not the same as 'beszállítás' (supply). (p. 374) The names of F. Mitterrand former French president of the republic and *Gyula Zsivótzky*, former olimpic champion and even the name of *Frits Bolkenstein*, who was among others chairman of the Liberal International. The name of *Ferenc Jánossy* comes up once correctly, once as Jánosy in the same footnote. The examples quoted above suggest that privatisation – at least in the world of science – is not necessarily always an advantage…

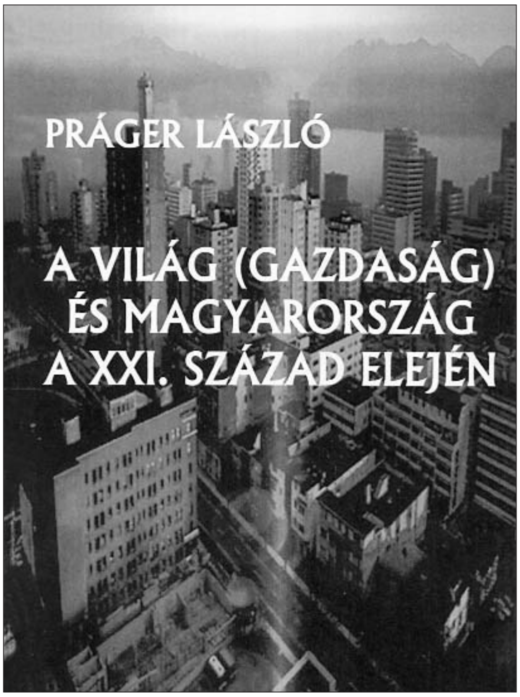
Tamás Halm

Note

[1] In this quotation and in the following ones – unless otherwise indicated – highlighting follows the original. (editor)

László Práger

The world (economy) and Hungary at the beginning of the 21th century



UNIÓ PUBLISHING HOUSE, BUDAPEST, 2003

László Práger's book offers a novel approach to Hungarian society and the professional public bound to judge the development of the world by looking simply at Western Europe. In his book, the author aims at presenting real global political, economic, social, and ecological processes at work on our planet, and assesses Hungary's situation, and possibilities in the context of these global *fields of force*[1]. And he does it by moving beyond the usual political-economic approach, and laying extra emphasis on the social, and ecologicalal consequences and contradictions associated to development and power concentration processes. 'But man suddenly realises that he is not just an actor of the economy: equilibrium in life means not only balances of payment, balances of trade, but also that of the forces of society, and the external environment.' (page 12). The author chooses the turn of the millennium as his period of investigating global political, economic processes, and assessing the general situation, making it clear that whatever we experience in a given period is the outcome of a long process, which may be only truly understood and appreciated in the light of development tendencies. In an attempt to evaluate the situation, therefore, we must reach back to WWII, and in many cases even further.

The book consists of two main parts: part I investigates the special features of the political, economic, and power reshuffle taking place in the period between WWII and the turn of the millennium, while part II, the shorter one, tries to provide an assessment of the situation crystallising by the turn of the millennium.

The major global characteristics of the last 50 years may be summarised as follows:

■ POWER RELATIONS

◗ The world has become unipolar: not only the military, but also the economic power of the US is of a magnitude (controlling 30% of the world's GDP, i.e. 9,000 bn out of 30,000 bn USD) that diminishes both the European Union and East Asia to the role of a challenger. In the bipolar world of the post-WWII period the Soviet Union with its increased military power assumed the role of the counter-pole, until the moment that its relatively weak economic potential managed to support that role.

◗ A typical feature of this period is the formation and strengthening of economic and political integrations (e.g. the EU)

◘ Economic development

◗ Over the last 50 years (1950–2000) the world's GDP has grown sixfold (30,000 bn USD), and its foreign trade 18-fold (6,000 bn USD)

◗ Foreign trade has outgrown the pace of development of production, and the changes in the flow rate of operating capital have over the last two decades exceeded multiple times the pace of growth of international trade, which meant that the international movement of goods has been increasingly yielding to the international movement of companies (or capital).

◗ The total volume of operating capital investment reached 1,300 bn USD by 2000, and the value of capital operating abroad amounted to 6,000 bn USD by the turn of the millennium, a sum equal to the full amount of the world's foreign trade. The free flow of capital has given an astonishing impetus to business mobility.

◗ Supranational corporate empires have formed controlling a level of capital exceeding the economic power of small and medium size countries; and transnational companies were born, whose foreign-based subsidiaries had direct sales amounting to 15,860 bn USD, a level 2.5 times greater than the annual value of world trade at 6,000 bn USD.

◗ The really powerful growth of the world economy, however, did not manage to level off the performance of individual countries, but, instead, resulted in further differentiation.

◘ Factors outside the realm of the economy

◗ A process of extreme differentiation of revenues characterises the whole world, and each region and each country, bringing with it an increased number and ratio of poverty, and more specifically the phenomenon of so-called abject poverty as well as a detachment of the medium layers of society. In 2000 as many as 1.2 bn out of the total population of 6 bn lived on less than 1 USD/day meaning that an average citizen of the developed world consumes as much in a day as a poor citizen of the developing world in a whole year. In the US, in the period 1970–2000 the revenue of the poorest 20% dropped by 10 percent, while the revenue of the top 10% doubled up.

◗ There was a continuous deterioration of the natural environment, and of the state of the different elements of nature, and the exhaustion of natural resources necessary for man's subsistence became a real threat.

◗ A general characteristic of the era was that the general pace of life speeded up, and uncertainty, and unpredictability grew in every respect.

Power relations and networks of interest at present may only be represented in a complex matrix. László Práger divides the multi-tier structure of global power of great complexity into three *worlds*. He thus distinguishes the *world of countries*, the *world of corporations*, and the *world of owners and managers*, and categorises the global processes of the post-WWII situation on that basis. The political and economic system was arranged under the control and according to the interests of the United States of America, emerging from the war victorious, and economically strengthened. 'The designers and the creators of the new world order have clearly strived to establish – in addition to the two decisive factors of stability and development – a *field of force* of world politics that could ensure the existence, strengthening, and expansion of their sphere of power.' (page 43) The United States, having a crucial influence on that process was interested for its own further development to bring up the countries victim to the destruction of war to a certain level of economic performance. 'It is a unique science of politics and history to strengthen and upgrade the environment of a leading power to a degree which enables that power to further increase its power, involve and cut new resources, but ultimately allow growth only to an extent where it can ensure that the countries recipient to that help and support do not grow to become competitors.' (page 42). The fact that the political and economic superiority of the US is so obviously felt at the turn of the millennium is ascribable to its own economic potential, the expansion and growth of its corporate sector, and, even more significantly, to the international economic and political institutions established under its control (UN, OEEC, IMF, BRD, NATO) whereby it managed to cover for decades

- the whole of international politics,
- world trade,
- economic policy
- the financial world
- military policy, and military power. (page 45)

The socialist world resisting that superiority, and existing largely by virtue of the peace deal concluding WWII could find no better defence than seclusion, and based the operation of its economy on sales contingents controlling production in the framework of the COMECON, bilateral agreements, artificial currency, and a whole artificial economic world, which was uncompetitive clearly and predictably from day one.

No country (other than China perhaps sometime in the future)can compete with the weight that the US represents in world power, except economic, political integrations of countries. That explains the creation and enlargement of the EU. The author stresses the point that a significant condition to acquiring functions of economic, political power is the size of the available space and population. That is what one witnesses when keeping track of the EU's enlargement process. The EU's GDP generating capacity comes near the level of the US (at the turn of the millennium the EU generated 8,500 bn USD, and the US 9,200), but lags behind the latter in terms of organisational level and economic competitiveness. '…besides the competition of countries, and the world of countries the corporate world took shape as a new circle of the activities, relationships, and power of trans-national companies.' (page 24). That was enabled by (apart from the enormous internal market) politics of power and of economy which, through its liberal economic policy imposed upon the world, removed the obstacles from the way of capital. 'Presently the capital represented by the most valuable companies of the world amount to several hundred bn USD each on the basis of so-called market capitalisation: General Electric is worth 520, Intell 417, Cisco Systems 395, Microsoft 323 bn USD.' (page 24) All that may be properly appreciated in the light of Hungary's GDP at 50 bn USD (or 100 bn, counted at purchasing power parity). A fact indicative of the US' superiority in the corporate world is that in 2002 out of the 500 most valuable companies of the world 238 were American, 50 Japanese, 41 British, 28 French, and 21 German (cf. page 25).

Liberal economic policy enabled the remarkable increase of wealth and influence of not only companies, but also of owners, and managers behind or at the head of such companies. They could create their own universe by meeting the important requirement of access to information, and managing their network capital. This is how e.g. *Bill Gates* built up a personal fortune of 58.7 bn USD, and *Warren Buffet* 32.3. Another fact reflecting the US' economic superiority is the fact that 8 out of the 10 richest persons in the world are Americans. The world power of the second *(corporations)* and the third type *(owners, managers)* is derived power, representing the result of the successful power policy, and liberal economic policy of the country. 'Even an apparently independent person can occupy the greatest apparent or actual financial or political posts only if he is member of particular centres of power and intellect.' (page 25)

The processes taking place in world economy are the outcome of liberal economic policy intending to achieve economic growth and the resulting welfare through free competition, markets, and economic and power positions achieved. Contrarily to spectacular economic indicators, the economic lag, impoverishment, and the state of the environment seen and experienced in some parts of the world (north-south), in some countries, and huge social groups tend to prove otherwise. The author makes an interesting statement concerning capital placement. 'On the surface it is always the recipient countries' economic performance (GDP) that benefits, while in fact it is the countries exporting operating capital whose economic and political power increases, and extends from their own land to other countries, eventually to the whole of the (globalised) world.' (page 140). The breaking up of social cohesion, the increase of international tensions resulting from poverty, the critical ecological situation of the world suggest the necessity of the limitation of liberal economic policy, 'the necessity of some central control' (page 154) as the process might be leading to an evolutionary dead-end. Taking account of social and ecological aspects is itself a step closer to the European set of values as represented by the Rhine school endeavouring to realise the more effective harmonisation of the set of economic and social aspects. Práger's principle is: '… competition must be created, ensured and allowed wherever possible, and (if so required) central, state regulation instituted where necessary.' (page 158)

Following the examination of international processes the author evaluates the progress made by Hungary, of which the period after the political changes deserves particular attention. He writes the following about that period: '…virtually uncontrolled privatisation resulted in a narrow Hungarian, and a much broader, foreign social layer that managed to lay hands on significant financial and the resulting political power, while at the other end social detachment got underway, and began to accelerate.' (page 195) 'Even after 1989/90, the change of régime, Hungary remained in many respects outside the economic, political system of the West' (page 170), which came as a severe economic disadvantage. An oversized foreign ownership ratio was created in the financial and corporate sector (e.g. 52.7% of gross added value, 82% of exports) which never became integrated in the entire economy. The redistribution of revenues, however, took place to the detriment of 80% of the Hungarian society, moving toward the top 10%: '… internal Hungarian space, social and economic, became international while the country was never able to maintain the national *lines of force* even for a single (historical) moment...' (page 166) Therefore the author finds it indispensably important to strengthen the group of large companies, and the small and medium sized enterprises and urges the convergence of social groups now in the process of detachment. Hungary's area constitutes 0.07% of the world's entire surface, and its population equals 0.17% of the world's total population, its export is 0.5% of the world's export, and has a 0.2% share of the world's GDP. That small country has to find its place in a global and

European *field of force* With its European Union membership Hungary has become member of a regional alliance, but whether it will reap the benefits of cooperation and globalism depends on how consciously we will endeavour to represent our national interests, how successfully we manage to harmonise with the European Union, and the global community, and what priority we attach to our social and ecologicalal problems while handling them.

With his book László Práger is not trying to look in the crystal ball. The author, who has a long track record of research, attempts to objectively present, and evaluate the tendencies of development over the last 50 years, and the resulting global situation from as many angles as possible (economic, power-based, political, social, ecologicalal). The author makes a noteworthy observation a number of times whereby the first decade after the political changes required economic and social sacrifice unjustified in many respects. Yet it qualifies as an achievement that the Hungarian economy of the turn of the millennium is no longer the same as before as our country can be made capable of successfully joining the international economic competition. He supports each of his statements with credible facts and figures. A particularly rich set of information presented in tabulated form, supplemented with diagrams suggest conclusions that may serve as important source of knowledge for researchers, economic experts, and those with an interest in tertiary education. The author's easily readable style, and the abundant illustrations of the book make it an exciting reading experience for all those interested in the political-economic processes unfolding in the world and in Hungary in particular.

Attila Buday-Sántha

Note

1 It is just the novelty of László Práger's book and the complexity of its approach that justifies writing in 2006 a synopsis of a book first published in 2003. We likewise regard it our objective in the future to direct our readers' attention to books published some time before but proving to be of lasting value. (the editor)

Conference on fiscal responsibility

Organized by the State Audit Office and the National Bank of Hungary with assistance from the Ministry of Finance on May 19 2006, the conference on a Fiscal Responsibility Framework (FRF) responded to the topical issue of the lasting grievances and the continuous deterioration of the transparency of budget processes as well as the strengthening social demand (rather than pressure) for change. The participants of the conference included high-ranking foreign experts and recognized professionals from domestic financial and scientific circles. An overview of Hungary's fiscal problems with international experts was expected to provide useful contribution to avoiding the onset of a crisis and to determining possible courses of action.

The passages below present the gist of the lectures, contributions and the discussion (as captured by *Gábor P. Kiss,* a principal economist of the National Bank of Hungary) and the major conclusions of and the lessons learnt from the conference (as summarized by *László Kékesi,* deputy secretary general of the State Audit Office):

LECTURES, CONTRIBUTIONS, DISCUSSION…

■ In his opening address, *Árpád Kovács* (President of the State Audit Office) underscored the importance of a framework of government interventions in terms of substance and technical aspects. That is not simply a question of adaptation, it is a vital issue from the point of view of competitiveness in Hungary. In addition to the steps designed to achieve stability and modernization, it is necessary to develop a controllable system of fiscal planning and execution.

In the past fifteen years, the margin of "planning error" between plans and execution has kept widening, and it would be oversimplification to attribute that to lack of discipline. There are too many governmental tasks and priorities. Public finance suffers from lack of transparency. Rules of administration and procedure would help moderate the public finance deficit and indebtedness and would also reduce the scope of economic policy interference and require political will for compliance.

Expressing an opinion on the draft legislation on the budget and assisting members of Parliament do their job have become one of the most important roles for the State Audit Office. Performing those roles would, however, require at least one month allowed for analyzing the proposed budget act. Moreover, a decision would be needed on the five-to-six fundamental terms about which the analysis has to make black-and-white statements.

Finally, there is a need for a database which contains actual figures.

Fiscal rules should not be looked upon as panacea, but they are a suitable means of ensuring fiscal discipline. The success of the rules hinges first and foremost on whether or not the government in office has the political intent to abide by them.

■ A speech by *György Kopits* (Member of the Monetary Council, National Bank of Hungary) offered a comprehensive overview of the international experience of the past decade. Set against an increasingly integrated international backdrop, several countries with emerging markets and many of their developed peers have been hit by financial crises as a result of their chronic propensity to run into fiscal deficits and the resulting unsustainable trend of indebtedness. Several countries have introduced a rule based Fiscal Responsibility Framework (FRF) as a remedy for the propensity to incur deficits and for managing (or preferably avoiding) the related crises. Most of the solutions were modeled first of all after an Act (Fiscal Responsibility Act) New Zealand introduced in 1994.

Essentially, rule based FRF contains four key components:

❶ Fiscal policy rules: limit values set mainly for the balance (total, primary or structural definition), expenditure (primary if possible, i.e. net of interest expenditure) or for debt;

❷ Rules of fiscal procedure (fiscal planning, debate, execution) including medium term fiscal planning;

❸ Transparency standards, including inter alia regular, factual and timely reports that are easy to access and are complemented with result oriented data reporting and careful forecasts based on macro-fiscal assumptions regarding the sector of government finance as a whole;

❹ A control and enforcement mechanism operated if possible by an independent government organization.

Over and above the aforementioned common components, FRF shows a variety of institutional features country by country. The FRF is set forth in a charter (constitution, act or international treaty) or simply in a government decree or directive, whichever is suitable for the purpose in a specific country. The effect of the rule, the time horizon and the size of the scope of applicability are more important. Enforcement is also an important aspect: is there an exemption clause or a sanction applicable upon a failure to perform (i.e. an adjustment obligation, pecuniary fine or loss of reputation). It is just as important to identify a control organization (state audit office, panel of experts, court of law or central bank) and its role accurately (normally supervision, control).

The experiences of the countries applying FRF are positive in general, but final evaluation will have to wait at least until the end of a full economic and political cycle. The majority of these countries conform to the rules, but there are examples of non-compliance and also of mixed experiences. Wherever fiscal rules were adhered to, investments and growth reached above average and stable rates, real interest was modest and inflation was relatively low. Yet, there is mixed experience with external balance, which is not surprising, because the balance on the current account of the balance of payments is also influenced by the savings behavior of the private as well as the public sector. Wherever FRF is complied with, there are no signs of creative bookkeeping, but there have been a few cases when one-off stop gap measures were taken to comply with the fiscal policy rule and the necessary structural reforms were postponed.

To summarize the experiences of about 20 countries: FRF is not a magic wand, it is rather a useful framework, it operates as a signaling system (as a 'third wheel') to help achieve fiscal discipline. In that sense, its helps fortify commitment (commitment technology). However, to achieve that, continuous adjustments, reforms are constant vigilance are needed.

Over the past decade and a half, Hungary has shown a gradually growing and large appetite for fiscal deficit. Hungary has shown clearly discernable signs of the lack of a culture of stability, which we can call also 'fiscal alcoholism' and which has well-known attitudes and symptoms (denial, postponed withdrawal treatment, blaming others, etc.). The introduction of the FRF needs to be underpinned by political commitment and social consensus. Its technical conditions precedent include transparency, strengthening rules of procedure (including medium term fiscal planning) and the launch of comprehensive reform steps (particularly the reform of large distribution systems). As far as the structure and operation of the FRF are concerned, there are several potential solutions, but one cannot do without limiting primary expenditure supported by a system of careful macro-fiscal forecasting and by ensuring control by an independent authority (e.g. by the State Audit Office).

One thing is certain: Hungary's fiscal processes are unsustainable. The question is whether we have reached the tipping point (see 'tipping point' in *M. Gladwell*), which will trigger radical changes and hence the strict application of FRF or we need to wait first for a financial crisis to hit.

▣ Next, *Mario Marcel* (Director, Ministry of Finance, Chile) summarized the experiences Chile accumulated over decades. Drawing the lessons from past financial crises and macroeconomic volatility, Chile aspired to achieve fiscal and monetary discipline starting the late eighties. The left wing government elected after the Asian crisis in 2000 introduced a rules-based FRF without enacting it. The framework was built upon four guiding principles: macroeconomic efficiency, efficient allocation, efficiency in the use of budget resources and lastly the principle of transparency. The main practical elements of FRF included a rule requiring a budget surplus, the copper stabilization fund coupled with strengthening and focusing the procedures of budgeting.

By adopting a fiscal policy rule, the government obliges itself to achieve a structural surplus of the budget at 1 percent of GDP. To calculate the structural balance, it is necessary to filter the impact of the cyclical swings of the economy on the budget. Filtering the effect of the cycle is simple through applying well-known and internationally accepted (IMF, OECD) methodology, but the price volatility of copper, the most important export commodity, must also be managed. In practice, a 14-strong panel of independent professionals is in charge of controlling the application of this methodology (including the filtering of the cycle by lengthening trends) and adherence to the rule.

In addition to the above, the occasional profit (or loss) realized due to the fluctuation of the price of copper is invested into (subtracted or compensated from) a stabilization fund. Forecasting the price of copper and determining the trigger price for the fund depends on a prognosis made by 12 independent experts. So far, the obligation to maintain a structural surplus has been met while the actual balance expressed as a percentage of the GDP moved between –1.5 and 4 percent in response to the cycle and the fluctuation of the price of copper. The justification for the structural surplus of 1 percent of GDP is the need for pre-funding central bank losses reaching 1 percent and other future liabilities, including the coverage of PPP programs, guaranteed minimum pensions, the guarantee of bank deposits and the compensation of non-renewable income from copper exports.

The rules of fiscal procedure introduced as of the late nineties increased governmental control over the legislative process such as by granting the right to veto. The authority of

Congress was limited to reducing expenditure. Theoretically, solutions based on hierarchical fiscal institutions may facilitate better fiscal performance, but in that case fiscal discipline could not be guaranteed either due to discretional decisions.

Moreover, 1600 performance indicators were introduced in response to the improved fiscal principles, 60 percent of the expenditures are appropriately evaluated and the remuneration of public sector employees depends on performance. Application of the GFS 2001 standard in accounting is another safeguard for transparency, and an independent committee verifies the foundations for the major macroeconomic assumptions of the surplus rule.

Mario Marcel emphasized that the Chile experience suggests (on the basis of a comparison of the impact of the external shock of 1982–1983 with that of 2001–2002) that the fiscal rule has reduced the exposure of the economy to cyclical fluctuations and set it on a higher level, lasting growth curve. The increasing level of efficiency and competence set a strengthening 'angelic circle' into motion, which supported macroeconomic stability and higher growth. That result drew heavily on a high level of transparency, congressional support (abandoning discretional measures) and accountability. Interestingly, the FRF introduced by the left-wing government is also supported in full by the opposition.

■ Speaking about the fiscal rules of Sweden *Yngve Lindh* (Chief Counsel, Ministry of Finance, Sweden) explained that the FRF introduced in the mid nineties was justified by both the catastrophic status of public finances and the lack of transparency in procedures comparable only to Greece within the EU. That statement received wide publicity and shocked the community of experts. Swedish fiscal policy responded to the adverse changes in the international environment by running up demand, but eventually the country could not avoid a financial crisis in 1991–1993. The fixed exchange rate had to be abandoned and the Swedish Crown depreciated. GDP growth diminished for three years. Rising unemployment and the support required by shaken banks drove the rate of the deficit to 12% of GDP and national debt, expressed as a percentage of the GDP was up 35 percentage points in a few years.

In 1992, a new left wing government took office and several measures were taken thereafter. A consolidation program started. A system of inflation targeting was introduced and forecasting the inflation target and productivity created a new platform for wage bargaining. The pension system was reformed. The country joined the EU and market deregulation became comprehensive.

■ In the second part of the presentation, *Ake Hjalmarsson* (Director, Ministry of Finance, Sweden) reviewed the operation of the FRF. The reform of procedural rules was prepared in 1992–1994 and the new arrangements were used first in 1996 for the budget act of 1997. Among other measures, the new system reversed the former 'bottom up' approach, which started from the details, and began the budgeting procedure from the level of aggregate figures (i.e. 'top down'). Fiscal policy being integrated into a rolling medium term perspective or framework is an essential element of the reform. The government monitors the execution of the budget carefully. An organic public finance act was adopted, including provisions about the new steps of the procedure.

Starting the second half of the nineties, a left wing government adopted and committed to three fiscal policy rules. After completing the program of fiscal adjustment, the government introduced a nominal primary expenditure limit, which is projected for three years as part of medium term planning. Two years later, the government committed itself to a structural surplus of 2 percent of the GDP (without a formal act). The actual size of the surplus was calculated in proportion to the needs of an aging society, or more accurately by factoring in the profits of the newly established private pension funds. (If Eurostat disapproves of calculating the balance of the budget this way, the surplus rule will in all likelihood be replaced by a structural balance rule.) Moreover, local governments must maintain a balance on current account (known as the golden rule).

There are three de facto independent governmental institutions cooperating in responsible manner during the supervision of compliance with the rule: the National Debt Bureau, the National Finance Bureau, and the National Research Institute. These have clearly defined roles in macroeconomic and fiscal analysis as well as in both short and medium term forecasting. Their core principles demand professionalism and publicity.

Swedish fiscal rules have functioned well and the expenditure rule was always respected in the period between 1997 and 2005. The top down approach to budgeting was also successful. On average, fiscal surplus reached 1.9 percent of the GDP in 2000–2005, that is to say the rule was successful and government debt dropped to 50 percent of GDP. Local governments also respected the golden rule and reached equilibrium in their balances on average in 2000–2005.

Ake Hjalmarsson drew the lesson to be learnt by saying political decision making circles learnt from the crisis and accepted the paradigm shift. However, technical and legal solutions alone are insufficient. The heart of the matter lies in the values prevailing in government financial affairs and living up to political commitments. An alleged disadvantage of the rule involves on the one hand the restricted room for discretional decisions. On the other hand, it may reduce capital expenditure in theory. To avoid that eventuality, funds were set aside for a 20 year infrastructure program while the strict expenditure rule was in effect, and a golden rule exempting capital expenditure was introduced at the municipalities. Thirdly, attempts to evade the system could be seen as a disadvantage. To circumvent that a rule more stringent than those set forth under ESA95 was adopted and PPP capital expenditure was charged as cost in each case. A slight degree of evading the expenditure rule was observed only in connection with granting tax concessions.

▪ The paper presented by *Jacques de Larosiere* (Councilor, BNP) discussed international experiences keeping EU member states in focus. Introducing rule-based fiscal policies is an option worth considering for countries that have a propensity to run up budget deficits and to submerge into debt. Wherever slippage into deficit is more and more frequent and lasting, applying a medium term framework of limits is necessary. All the more so, because the time horizon of political decision making is frequently determined by the date of the upcoming elections and reducing expenditures which had been programmed for a number of years is problematic in policy terms and sometimes even technically. Analyzed from this perspective, certain successful countries have resorted to nationally applicable rules (for instance, the Netherlands and Sweden in the EU). These adopt a medium term view and seek to avoid structural imbalance and pro-cyclic fiscal policy by combining numerical expenditure limits with structural efficiency targets. Hungary could draw lessons from the Stability and Growth Pact (SGP), which seems to be a truly prudent system, but its practical success is limited by five factors:

The system:

- fails to allow automatic stabilizers work in both directions, i.e. fails to prevent spending the extra income realized in a positive boom cycle;
- failed to set the reduction or elimination of structural deficit as a requirement for the initial stage;

- failed to better adapt the equilibrium rule to the specificities of individual countries (e.g. stricter application in highly indebted countries);
- failed to capture the fiscal impact of longer term demographic processes; and
- the fiscal debates conducted at Commission and Council level should be devoid of political considerations, and member states should not interpret the rules as exerting external pressure.

The softening up of the SGP introduced last year does not guarantee improved efficiency, although it has become more realistic and more flexible by taking the differences between countries into account. The problem is that 'other relevant factors' can also be considered when evaluating compliance with the fiscal deficit limit of 3 percent of the GDP. Also, the deadline for adjustment was expanded from one year to two years. The symmetric application of the SGP continues to be unresolved.

Jacques de Larosiere said politicians must look upon substantial deficit and debt and a major national issue as the costs of delay are immense. That is why the introduction of a rules-based medium term framework at national level is so important within the Pact (recognizing that the Pact itself is not efficient enough).

Finally, the speaker underscored that the creation of a national FRF is almost inconceivable without a wide consensus between political powers and the public. He made reference to the most recent experience of France, where an independent committee appointed by the Minister of Finance plays a key role, as (chaired by *Michel Pébereau* with members representing a wide political spectrum) the committee submitted consensus based recommendations to the government among others about reaching fiscal balance in the next four years by adopting a nominal expenditure limit and about reducing national debt from the current 53 percent to 45 percent of the GDP in ten years.

▫ During the round-table discussion, *János Veres* (Minister of Finance) stressed in his keynote speech that it was not capturing in the constitution or an act that ensures giving effect to a rule. Current fiscal procedures would allow the enforcement of predetermined limits. However, the situation in Hungary is special in that there was no consensus among the parties neither on the need for nor on the direction of reducing the deficit. The prevailing trend has so far been stretching existing limits, but now reforms would be needed, some of which include the amendment of acts by a two-third majority (e.g. on the legal status of representatives, municipality system, elections, emoluments). Regulating these areas requires amendments.

Some of the international experience can be put to good use. The expenditure target may not be modified in Hungary after the first reading of the budget act. There may be a need for specifying rules-based macro frameworks. Three areas (public administration, local governments and the health system) require changes in merit. Also, the control over government revenues should be improved, along with the appropriate monitoring of expenditures. There will be a uniform system for registering commitments in the future. Divided into 27 parts, the fixed system of Swedish expenditure targets is an appealing solution, which János Veres would support, because it would be more favourable for the country as well as the Ministry of Finance. Setting up a new organization (a fiscal council) seems unnecessary, though, as it would not bring additional control over and above that exercised by the State Audit Office. It could only have an advisory role without decision making powers. An independent body should not be involved in performing other activities; hence the participation of the central bank in such a council is unacceptable.

▫ *Mihály Varga* (Chairman of the Parliamentary Fiscal, Financial and State Audit Committee) thinks it is a false dilemma to contemplate how to balance out public finance as the level of redistribution is also important. There are two models, one of a low and one of a high level of redistribution, but both can be successful. Stabilization can be achieved in conjunction with reducing the level of redistribution, and it is easier to get support for that.

The visible increase of the margin of error in planning is not a mere coincidence. The level of transparency has deteriorated and control has become a formality as the State Audit Office had a single day for expressing an opinion on the budget last year. It was his impression that staff was working under pressure.

Asserting his view that it is illusionary to wait for an external force (EU, capital markets), Mihály Varga recommended drafting a new law on public finance, which would be based on a cost-benefit analysis, as the present act has become vacant and imposes no sanctions. There is a need for independent actors who will press for responsibility and help restore credibility. Legislation should be enacted about PPP programs. The presence of PPP is not a problem, but the lack of statutory control is a grievance, which is why parliamentary authorization would be necessary. Members of Parliament could be assisted in their work by an office, which would be independent of the government and would be similar to the Congressional Budget Office operating in the United States. It is necessary to rethink the mechanism of the National Development Plan along with the strengthening of cooperation and transparency. The introduction of personal liability in addition to institutional liability is also recommended and could take the form of pecuniary or financial sanctions.

▪ *László Csaba* (professor, Central European University, Hungary) quoted the statement that whenever policy falls victim to interest groups, it culminates in the decline of the nation. He also quoted Buchanan, who said voters were short-sighted and failed to recognize that present expenditures trigger future tax hikes and needed protection therefore. On the other hand, Kydland and Prescott suggest that only rules can protect public figures from repeated errors due to temporal inconsistency.

Deficit tends to reduce GDP through crowding out. There have been no or only transitional growth sacrifices of adjustment in the past 25 years. Adjustment will not give rise to mass unemployment, which is more likely to occur in circumstances where problems are treated by running up deficits. Fiscal stimuli fail and large-scale government CAPEX projects also tend to increase corruption. Conversely, the fiscal rule increases GDP.

In practice, several decision making powers have been granted to trade agencies but remained under control. The delegation of certain powers by Parliament does not mean the end of democracy.

Speaking about changes in Hungary, László Csaba stressed the lack of fiscal transparency and the lack of reliable reporting methods. Figures are important or at least should appear to be so that we can measure up against something. A top down approach to fiscal planning could be beneficial. The role of independent forecasting is an important institutional aspect, including, for instance, the preliminary verification role of the State Audit Office and publicity, both of which can help a lot.

▪ *István Csillag* (Chairman of the Board, Eximbank Zrt., Hungary) began his speech by asking two questions. First, is a paradigm shift possible without a crisis? Second, can fiscal responsibility be strengthened by setting up institutions?

We should learn from the mistakes made by others. We should examine what is considered to be normal and acceptable nowadays and how it would be possible to introduce something new so as to avoid repeating past mistakes in the future. At present taxpayer money is spent without restraint or control and the only limit is set by the balance of payments. Hungary cannot remain isolated and should pursue fiscal and monetary policies with a view to international capital markets. The twin deficit may force changes upon us, but adjustments are insufficient, internal controls should be enforced. An internal rule should be set up in support of the internal limit. It is a question whether or not domestic circles will be willing to accept that. Also, the most important component is a question.

István Csillag would borrow five internationally tested components. Cyclically adjusted deficit should balance out. On the other hand, demographic phenomena render fiscal problems more severe and the revamp of the social security system could prevent the annual recurrence of deficit overshoots. The Danish or the UK model of reducing government debt should be made mandatory and deficit should be reduced simultaneously with redistribution. The rate of redistribution should be reconsidered due to international competition. The power of publicity is weak as regards the consequences of political promises. The statistical accuracy of data should be increased. The budget should not be based on official forecasts, rather on those by professional institutions. Setting up a Fiscal Council with a single mandate of 18 months, which Mr. Csillag himself had recommended earlier, does not substitute an internal limit and the control of behaviour. He disagreed with the option that the State Audit Office or the Central Bank should delegate members to such a council.

■ *László Nyikos* (Research Advisor, Institute of Development and Methodology, State Audit Office, Hungary) remarked that he sensed some scepticism concerning the relevance of legislation in János Veres' speech. The constitution does not address the issue of public funds and how taxpayer money is used. At present, there are three laws in effect about those matters: first of all, the act on public finance, which has slowly become incomprehensible. There are two improvements to be made: first, it should require the presentation of time series and second, it should define the principles of budgeting, e.g. the principle of detail. The second law is the government decree on government accounting, which used to be an act between 1897 and 1950. The accounting regulations should adopt international standards. The third law is the act on the State Audit Office, which provides no more than the State Audit Office's obligation to express an opinion about the budget.

Tamás Mészáros (Rector, Corvinus University, Budapest; Chairman of the Board, State Privatization and Holding Zrt., Hungary) highlighted that the profession itself should reach a consensus before recommending that politicians should come to one. Failing that, politicians will have the discretion to select whichever expert they please depending on what the experts are saying at the time. International institutions and independent credit rating agencies try to be objective, the latter do so because they want to see their loans repaid.

■ *György Szapáry* (Deputy Governor, National Bank of Hungary) quoted Rogoff's maxim, which suggests that each brilliant idea goes through three stages. First it seems ridiculous, then possible to implement and finally self-evident. 80 years ago the idea of central bank independence was in the first stage; nowadays the idea of a Fiscal Council has reached the second stage. The question is not who will sit on the council, but what licenses the council will hold. It could have the power to decide whether or not reaching a convergence trajectory was likely, whether or not income and expenditure targets were realistic, and if the answer is in the negative, it could return the budget to Parliament.

■ *György Kopits* mentioned that it was the role of the Council that mattered. The literature frequently referred to it as a decision making body, but that was a foredoomed idea. Fiscal policy decisions cannot be outsourced as monetary policy is outsourced to the central bank, i.e. the Monetary Council under a clear-cut principal-agent relationship. The only country that is planning to introduce a Fiscal Council with decision making powers is Nigeria. But they have a special reason for that (federal fiscal system with regional states enjoying a high degree of sovereignty). In Hungary it would seem more practical to strengthen the control function of the State Audit Office than to set up a new institution called a Council.

■ Closing the event, *Zsigmond Járai* (Governor, National Bank of Hungary) said the goal of the conference was to bring together economists and decision makers to create a dialogue about whether or not a rules-based fiscal responsibility framework was worth introducing, and if the answer was in the affirmative, then how should we go about it. That is only one step out of one hundred steps towards fiscal discipline. Summarizing the proceedings, Mr. Járai detected a consensus about the need for a steady balance showing a surplus, reaching a 3 percent deficit is insufficient. Complying with the Maastricht criterion is not enough, the requirements of the SGP should be met. As Mario Marcel suggested in his speech, savings on interest rather than debt may be used to increase social support. But it is very difficult to give up fiscal alcoholism. The question is whether or not a financial crisis is needed to have things fall in place. Elsewhere such a crisis was required. The lesson to be learnt from history is that no one ever learns from the past. It is likely that there is consensus among the parties about the critical state of the budget and that after the elections one can see that the emperor is naked. Ten out of eleven speakers stressed the importance of the rules and the person that represented a slightly alternative position was János Veres, who put more emphasis on the role of determination without questioning the need for rules. Several of the speakers mentioned the level of redistribution. István Csillag stressed the importance of true measures, so that this does not end up being a balloon. Regarding the matter of a Fiscal Council, the majority would want something to happen, but there is no consensus on what it should be. Presumably, independent control enjoys supremacy over setting up a council. We ignored discussion corruption and the lack of transparency, only László Csaba made mention of them. We have come closer to discussing fiscal discipline. Is there a consensus in the profession on deficit? Politicians are not convinced that deficits are necessarily bad. The public should be convinced that international experience proves that deficit harms a country.

…AND THE MAJOR CONCLUSIONS AND LESSONS

❶ A consensus seems to have been reached suggesting that although there are significant differences between individual countries in terms of government mechanisms, capacities and economic frameworks, politicians and governments share the tendency to promise a lot in the run up to an election and tend to fulfill their promises once they are voted into office, disregarding forecasts and the capability of the economy to perform. Consequently, to avoid major disasters (crises)

- the way politicians approach fiscal issues must (or should) be changed, and
- the public must (or should) be convinced of the essence and effects of the various adjustment measures, and
- guarantees (framework rules) should be created to help implement decisions.

In 2000, Chile implemented serious measures that also affected the election system and the influence and accountability of the executive power for the sake of reaching fiscal discipline. The measures were sufficient to reach 1 percent structural growth, GDP growth and both politicians and the public felt the tangible benefits and utility of the strict fiscal framework.

❷The loosening of the fiscal framework culminates in fiscal alcoholism (with graduated withdrawal and weakening distributions), to borrow the figure of speech used by György Kopits. There is not a single country whose fiscal and political systems does not present symptoms of the potential or the actual lack of such discipline. Country experiences naturally strengthen the temptation, but it is common knowledge that the budget never fails to be the focal point of political conflicts.

❸Past international experience suggests that measures designed to strengthen fiscal discipline have been taken under the pressure of crises, but the effects (consequences) of the latter dictate that it would be worth avoiding crises by timely action. Hence the universal truth that political parties should reach consensus on major issues (for instance on the future of laws requiring qualified majority in Hungary, by abandoning the recent tactical arsenal of tools that were mostly targeted at blocking) and should agree on improvement measures based on rational rather than political considerations.

❹The efficient operation of the fiscal process can receive support from the creation of a fiscal responsibility framework, which is frequently said to realign lines of responsibility and to curb the appetite for investments, etc. The Chilean and Swedish presenters showed that the above general statement is not true on its own because the operation of certain limits (a fiscal framework) will

- accelerate (or at least set on) growth,
- keep inflation low,
- increase investor confidence.

Practical experience from Sweden demonstrated the need for iron hands in developing the rules and tight control over observing them. Sweden set expenditure limits for 27 items, each of which were strictly applied. As a result, employment increased (to 77.5 percent), government debt dropped (50.5 percent), and all in all the structural reforms brought a surplus of 2.5-2.6 percent. Politicians (also) understood that the condition precedent to sustainable development is a sustainable budget (in surplus).

❺To reach the goal, complying with the Maastricht criteria is not enough; fiscal balance with a surplus is needed to set the budget (the management of finances) straight, and the balance of the budget must be planned for economic cycles. Simply put: a structural surplus is needed.

A structural surplus – as the example from Chile demonstrates – can be spent on the risks of the budget or on managing the backlog of severe social tensions. (Since 2000, Chile has had the opportunity to double her social spending without threatening economic development and progress.) Restoring fiscal discipline produced a favorable cycle.

❻It is necessary to rethink the mechanisms of redistribution radically; expenditures should be matched to the capacity of the economy to perform, and true expenditure cuts are also required: reforms are inevitable (including tax hikes).

❼Naturally, there is no universal panacea for treating these maladies, but the solution must be started definitively without ado. Each country makes its own decision, but facts from the countries that have done so prove the utility of fiscal austerity. The fiscal responsibility framework is a complex system, and the associated tools (rules, figures and other requirements) must be captured in legislation – the conference agreed unanimously. The necessary steps include:

- strong governmental commitment to change the direction of processes (and obtaining the required support for the purpose),
- a review of the softened fiscal mechanism, fiscal hierarchy (and competencies),
- modernization of the provisions of the parliamentary House Rules about the discussion of public finance related issues, sectioning the process of discussion,
- setting straight the issues of liability for the decision,
- defining consolidated fiscal ratios and medium term expenditure limits (unemployment benefits, sick pay, pensions, etc.) for a whole economic cycle, developing tighter procedures (of planning and coherence testing) than those applied currently,
- strengthening control mechanisms (State Audit Office, NGOs, publicity), guaranteed terms for the necessary reviews and modernizing the methods and procedures of control,
- developing a tight monitoring system to drive back corruption,
- setting rules that set the mainstream of political debate and directions for planning,
- convincing politicians and the public with the media playing an appropriate role.

8 The conference considered the role of a fiscal (or budgetary) council from several perspectives: János Veres suggested that operating such a council would narrow the powers of the National Assembly and the State Audit Office; others (including László Csaba and Gyögy Kopits) did not think such a council would violate the principles of parliamentary democracy, Mihály Varga, former Minister of Finance and chairman of the Parliamentary Budget Committee referred to the budget office working for the US Congress as an example worth copying. Everyone agreed, however, that the question is of a caliber that it is necessary to rethink once again the issue of fiscal control, which could in turn lead to additional strengthening of the role of the State Audit Office or to devising the terms of another form of control or oversight.

And to conclude, a maxim from Cicero quoted by Mr. Kopits: “*The budget should be balanced; the treasury should be refilled; public debt should be reduced.*”

Gábor P. Kiss – László Kékesi

Use of performance information in budgeting and management processes

Lessons of an OECD conference[1]

A The budget is one of the most important economic policy documents of the governments, in which the coordination and implementation of political objectives is translated into concrete actions and concrete budgetary allocations. Transparency – i.e. openness in the formulation and implementation of economic and political intentions – is a key element of good governance. The OECD countries are in the lead in terms of budgetary transparency: they are seeking forms of conciliation with which they can win the society and the economic players over to the budgetary targets as much as possible. However, the key element continues to be the agreement between the legislative and executive powers, and the conditions and real content of this agreement. To monitor the development of the budgetary system, each year OECD selects one or two topics for detailed examination based on the responses given to the questionnaire.

All over the world, citizens claim more and more from their governments, demand more transparent spending, decision-making, more and better quality services for the taxes they pay. They would like if the performance of the public sector became tangible for them, too.

In order to research this topic, the following question must be asked: what do we understand by public sector performance, and how can it be measured?

An essential part of public sector reform all over the world is the integration of performance information into the process of budget planning and execution, and institution operation. In 2004, the Public Governance Committee of the Directorate for Public Governance and Territorial Development, OECD, included the topic in its agenda within the framework of the Performance and Outcomes working group. At the first meeting dedicated to the topic – which was held in April 2004 – many matters of dispute were brought up. It was concluded that the use of such information is costly and requires fundamental changes that go on for years, i.e. they can be best implemented within the framework of a wider reform of budget planning and execution. Many countries had doubts whether the performance information could be successfully integrated into their management and budget systems.

The topic of discussion of the conference is closely related to the launch of state reform related works in Hungary, as well as to the modernisation of budget planning, execution and reporting within the competence of the State Audit Office (SAO) and the Ministry of Finance of Hungary.

In line with its strategic objective, the SAO carries out performance audits in an increasing number of fields, which assumes the measurement of the effectiveness and efficiency of public spending. This work would significantly improve if performance information was more extensively integrated into the process of budget planning, decision-making, execution and reporting. No wonder that in many countries the performance indicators are applied and refined upon the initiation of the supreme audit institutions.

The Ministry of Finance works on the restructuring of budgetary institutions and their procedures within the legal frameworks based on the international practice, expectations, as well as audit findings and recommendations in order to fully ensure transparency, authenticity and reliable accountability of public spending.

The aim of the OECD conference was to give an overview – based on the experiences of the member states – of the status of the use of performance indicators, the manner performance information is used by the different countries in the budgetary and management processes; as well as of the counter-effect it has on budgetary, management and political decision-making, and governmental performance itself.

The use of the indicators assumes the elaboration of a new, performance based budget (performance budgeting)[2], which focuses on outputs (production, services, value) and outcomes (results) rather than on inputs.

The use of the indicators is often determined by performance based agreements, where the number one task is to define – for ministers and institution heads responsible for implementation – the objectives to be attained. For this purpose governmental services must be re-defined in a more result oriented manner, and budgetary needs must be supported with information on performance and program costs. At the same time, in most countries an important part of this public sector modernisation process is the shift to accrual accounting[3].

Concrete topics of the conference:

- Description of the budgetary performance systems of the different countries, discussion of the experiences, development of the use of performance information in budgetary and management processes.
- Performance measurement and result evaluation: types, problems and bottlenecks of information development, directions of the refinement of output and outcome indicators.
- Integration of the performance indicators into the entire process of budgeting and management, the connection thereof with the budgetary decisions.
- Dissemination of the main lessons as best practice.

In 2005, the Secretariat of the OECD performed a questionnaire survey[4] among the member states about what performance indicators they use in their budgeting processes. The findings of the survey – which included the following questions among others – were also disclosed at the conference.

- Since when have the countries been using performance measurement and indicators in the field of public finances?
- When do you plan to introduce performance budgeting, budget execution or accounting? (Hungary did not give a definite answer.)
- When was output measurement first initiated? Which institutions are responsible for this?

Based on the reports and the survey it can be concluded that most countries use some performance measurement and performance indicators in the budget process. However, such practices differ from country to country, they are of different weight, representing mostly supplementary information, and in reality they are not organically integrated into the budget planning, decision-making, execution and auditing processes.

As far as Hungary is concerned, according to the responses, output and outcome information and indicators and measurements in Hungary are related to the funding of primary education and prisons. Direct performance budgeting is used in the case of higher education programs, while high quality output measurement is used in the budgeting of the healthcare system, education and the tax authority.

Based on the experiences of the different OECD countries it can be concluded that most countries used very general wording and addressed the process of practical implementation only briefly.

Excerpts from the usable elements of the Danish case study[5] *for the definition of output and outcome targets.*

- *It was set for the Danish Competition Authority that the productivity of the agencies in service provision should improve by 2% compared to the previous year.*
- *It was prescribed for the Danish Chamber of Medical Doctors that the approval procedure of drugs and vaccines with new ingredients should be 210 days long in 95% of the cases.*
- *The Danish Statistical Office must achieve that the level of satisfaction with the statistical services be 4.3 on a scale of 1 to 5.*

According to the country reports presented at the conference, former efforts pertained to the value of products and services delivered by the government (output), to which it was very difficult to attribute performance information. Currently, the emphasis has shifted towards results and benefits (outcomes) yielded by the outputs, to which it is much easier to attribute performance indicators. The following conclusions were drawn from the experience gained so far:

- it is useful if performance information is linked to a wider reform of the public sector;
- the most important objectives and tasks must be defined in a systemised manner; it is important to keep the number of objectives and programs low. (Each country had to narrow the originally set system of objectives and indicators to make it manageable.);
- the automatic application of performance information must be avoided.

All in all, the reports show that although most OECD member states rely on performance information, such information is used in different ways and in different forms in the governments' activities:

- medium-term budget figures and balance indicators are usually made with the accrual approach;
- the medium-term budget frameworks are filled with programs, i.e. social and economic objectives, actions to be performed for the sake of implementation and the results appear in the budget;
- in the course of budget execution the expectations and results are determined in the framework of agreements between the hierarchical levels, wherefore accountability improves at all levels;
- governmental actions are monitored on the basis of various professional reports and – a reasonable number of – quantified indicators;
- apart from the measurable products increasing significance is attributed to the evaluation of the impacts, usefulness of these products, as well as to how much they contribute to the achievement of social and economic goals, and to the analysis of the overall social and economic impacts;
- the financial report contains a complex account about the property, income and financial standing.

The OECD meeting was especially useful for Hungary, since it offered several solutions and lessons for the reform of public finance, budget formulation, execution and reporting institutions and processes, as well as for preparation for this reform. The theoretical and practical questions or issues are the following:

- transparency, publicity, predictability and accountability must exist in all stages of budgeting; this can be fostered by the system of performance information;
- it can be seen in several countries that the major budget policy measures are taken and implemented on the basis of a national consensus;
- the performance information system has enhanced the independence of the ministries in that they can determine the priority professional fields within their budgetary means, and in line with the national priorities;
- in several countries program implementation is reviewed by a separate committee at intervals of two or more years;
- the correlation between performance budgeting and improved efficiency is confirmed, for instance, by the case of the budget of the Netherlands: the preparation of the annual budget report for the Parliament has accelerated (the report is now submitted in May as opposed to the former submission date of September);
- the structure of the budget has become more transparent, partly due to the succinct policy justification (15 pages instead of the former 60 pages).

Further challenges were formulated:

- Australia uses the indicators primarily in reporting. The weakness of the system is that the integration of the performance indicators into the budget procedure involves several problems, and there is no adequate relationship between the performance indicators and budgetary decision-making;
- the greatest threat is that the application of the indicators becomes automatic;
- it is important to ensure the reliability of data, to integrate the central and local levels of governance in the decision-making process, as well as to separate the decision-making and executive powers.

OECD is preparing a summary report on this topic that will serve as a certain guideline for the countries in the field of the elaboration, application, evaluation, modernisation, etc. of performance information.

Mrs. László Hamza–Etelka Bécsy

Notes

[1] Public Governance Committee of the Directorate for Public Governance and Territorial Development, OECD, Paris, 2–3 May 2006

[2] Performance budgeting is used as a synonym of program budgeting.

[3] Accrual accounting, and partial accrual budgeting have been introduced in many member states in the most varied forms. Some countries have fully switched over to accrual accounting and budgeting, while others use accrual accounting only in their reporting systems. There are also some countries that enforce certain accrual elements while retaining the cash flow system, or utilise accrual background information, like Hungary.

[4] Performance Information in the Budget Process: Results of the OECD 2005 Questionnaire (by Teresa Curristine), *OECD Journal on Budgeting, Volume 5, No. 2. OECD, 2005*

[5] Experiences of Utilising Performance Information in Budgeting and Management Processes, Draft Case Study – Denmark, *OECD, Paris, 2–3 May 2006*

Conclusions regarding economic[1] policy made at the 44th Economic Convention

(Information for the Government) Document

Nearly one hundred presentations and comments were made on various subjects at the itinerary congress. No closing declaration has been agreed on by the participants, neither did the organizers endeavor to develop a single position regarding the presented ideas. This explains why the following opinions, proposals and recommendations are so diverse.

1 The participants of the itinerary congress agreed on the necessity of the adjustment efforts that commenced well into 2006, and, what is more, *they regarded the strict measures aimed at improving the equilibrium as unavoidable.* In their opinion, the steps defined in the Convergence Program will probably push the development of the Hungarian economy into the right direction. However, doubts were expressed as to whether these measures will prove to be sufficient to put the Hungarian economy onto the course which leads to reaching a sustainable balance.

2 It can be considered majority opinion that increasing the tax burdens of employment and savings goes contrary to the announced economic policy objectives and the integration strategy. *The higher tax rates should have been imposed on consumption,* and the widening of the tax basis should have been started consistently. However, the increased tax rates in the given structure – even with their projected positive effects on the equilibrium both in the short- and mid-term – will push the Hungarian economy off the course which leads to European integration.

3 The *coherence between* the three *strategic documents,* i.e. the government program, the 2nd National Development Plan, and the Convergence Program, prepared by the government in the summer of 2006, *is weak,* and difficult to recognize.

4 The professionalism of the last two plans is also questionable: not even the profession is aware of those *impact analyses* without which no such documents can be prepared, or at least such cannot be approved.

5 The *professional element has been pushed into the background* even more than before in public administration, which is the area responsible for developing and executing these programs – however, the political factors have received priority. This again questions the professionalism of the programs, and reduces their credibility in public opinion.

6 One of the most important tasks of the government is related to this very *credibility:* its credibility has eroded both in Hungary and abroad. Certain members of the government (others than the ones taking part in the itinerary congress) give statements on the need to regain credibility in such a way as if they had not played the main role in losing it.

7 The chances for the social acceptance of professional *action built on economic rationality* are not good, since the political decision-makers made large groups of the population and small entrepreneurs believe that all benefits, absorptions, taxes only depend on the goodwill, or will of the government. Consequently, politics and state leadership have lost their creditability.

8 In the Hungarian economy's current phase of development, the weakening of the state is not the right solution: the tasks of domestic and external economy, as well as social policy require that the state's standards and the *apparatus* that operates the state *be strengthened*, and their standards be improved. It is unjustifiable, even unacceptable to make the position of the public administration apparatus uncertain, especially in the midst of deep-going reform efforts – execution is the responsibility of the members of this very body.

9 The experience accumulated by the Anglo-Saxon countries offer only one possible way to develop the institutional system. The public administration of Scandinavian (and other European) countries, which are similarly successful both in competitiveness and the quality of life, relies on pretty much fewer *solutions adapted from business.* This means that the latter cannot be presented in such a light as if they had been the only possible method of modernizing the functioning of public administration. This approach raises concerns regarding the democratic nature of its operation as well.

10 The assessment of *the efficiency of the budgetary sector,* as well as the evaluation of performances in this area require a different approach than the one applied in the competitive sector, since the former always has to take into account the set of values required for preserving and strengthening social cohesion.

11 International comparisons have shown, on the basis of numerous series of data, that, by taking into account the new EU member states, and even the two further states to join the EU in 2007, Hungary has in fact been relatively falling behind since the early 2000's: *the process of integration is the slowest in Hungary from among the countries of the region.* What is even worse, various calculations also suggest that Hungary has the region's flattest potential GDP growth cycle, and the development expected by the government for the period following 2009 will not speed up growth spectacularly in the anticipated economic policy environment.

12 The uncertainty about the date of introducing the *euro* preserves country risk factors. It questions the full-fledged utilization of the opportunities arising for Hungary from the EU's enlargement into the Balkans.

13 *Increasing the rate of employment* – rightly – is one of the principal objectives of the 2nd National Development Plan. However, the major tool of implementation is not employment policy as such, but *education*, as well as *the child support system.* Contrary to public beliefs, at the current level of wages, there is no deficiency in skilled workers in the Hungarian economy today. The market appreciates general rather than specialized knowledge.

14 The Convergence Program has an adverse effect on employment, since – wrongly – it increases *the burdens imposed on active work.*

15 The external orientation of economic development has to be strengthened but the regions outside the EU member states should not be disregarded either. Since some of these regions mean markets with higher risks, *institutions aimed at supporting exports* are badly needed. It is not the right practice that these (EXIMBANK and the Hungarian Export Credit Insurance Ltd.) are subordinated to the Hungarian Development Bank, as the latter endeavors to make maximum profits, while the former aim to increase exports. If there is a more favorable exchange rate, our exports could grow by as much as USD 10–20 bn.

16 *The willingness* of the Hungarian population *to start businesses* is by far behind that experienced in the leading states, where university students, for example, make up an important group of entrepreneurs. It is imperative to teach business studies on a wider scale.

17 The problems of funding the public finance system are only a consequence of that *the state has been incapable of proactive action until recently*, their behavior is reactive at most, and it drifts with the requirements of the EU or the various social interest groups (such as entrepreneurs, pensioners, university lecturers, physicians, etc.).

18 There was agreement on that a fairer distribution of public dues is necessary. This, however, does not only require the introduction of new/modified tax rates (new tax types) in practice but the rendering of the *complex, over-administrated taxation system transparent*, and the clearance of the overall absorption structure of "privileges", and the review of the cost settlement rules that allow the "outflow" of the tax amounts. The technical and IT areas of the executive bodies should also be updated and strengthened.

19 The economic role of the state – whether it is a regulatory, ownership or even organizational function – is represented by organizational structures and institutions, which cannot be managed by the *"bargaining" techniques* applied for small and medium enterprises.

20 The pension system cannot be sustained in its current form, it is necessary to *increase the retirement age.* In order to achieve this goal, jobs should be created; and the duality according to which people are forced to retire, while it is obvious that they should continue to be employed, cannot be maintained. The problems of the health care system are in very close connection with the contradictions of the pension system.

21 It is by far not certain that the model of several insurance entities will bring about genuine competition *in the health care system,* while competition in these markets is a tool rather than a goal in itself.

22 In late August 2006, the Hungarian daily press started to discuss the reasons for the strange fluctuations in the costs of highway constructions, and in the discussions on this topic at the congress, it also came up that a genuinely consistent restoration of the budget requires *a thorough transformation of the system of party funding,* and it should be made truly transparent as well. A wide-ranging social campaign should be launched for *the elimination of corruption* as well, as a result of which hundreds of billions could be saved.

23 One of the basic requirements for integration is to create an *information* economy and society. However, this makes it necessary to implement infrastructural developments of such high volume which not even the Western-European giant companies are able to carry out- this means that state involvement is indispensable here.

24 The number and roles of the regions should be reconsidered in development policy. According to regional studies, Hungary has *five natural regions.* The idea of regionalism continues to be underrepresented in both the economic policy and the development plans.

25 The Hungarian companies' willingness to innovate is weak, which is public knowledge. In an international comparison, there is an especially *low rate of innovation in the sector of small and medium businesses,* where this makes the losing of the domestic markets a real threat. Besides, the funds aimed at supporting corporate innovation (such as the Ányos Jedlik tender) are used for financing musical and theater historical research, or in 2006, one related to Joyce's literary activity.

26 Increased tax rates, reduced expenditure, or structural transformation remaining in the scope of business administration are not sufficient for the implementation of the Convergence

Program and for stepping on the course of modernization. Social spending and social transfers should be transformed to such an extent which are inconceivable without the reconsideration of the basic constitutional rights (pension, health care, education and other tasks undertaken by the state), and the agreement on new social-political compromises (regional administration, the issue of municipalities, the redefinition of the state's role, the rebuilding of the state). It is the lack of public agreement that prevents the creation of stable and long-term programs today. *Wide professional and social partnership is needed for the reaching of public agreement, i.e. the reforms should not be implemented by stealthy legislation.*

Note

[1] Nyíregyháza, August 31 – September 2, 2006 – Appr. 350 economists took part in the itinerary congress. A large number of the government's experts (such as the Finance Minister or the Government's State Reform Commissioner) made presentations –this summary of course does not reflect what they presented at the congress.