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PUBLIC FINANCE QUARTERLY

Journal of Public Finance
Published Quarterly

Founder and Owner: Ministry of Finance, Hungary, since May 1954
State Audit Office, Hungary, since July 2005

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.

Public Finance Quarterly publishes articles proofread by editorial committee members holding scientific degrees.

PUBLIC FINANCE QUARTERLY – Journal of Public Finance ■ Editorial Office: 1052 Budapest, Bécsi u. 5., Phone: 484-9104, 235-4075, e-mail address: hingljn@asz.hu ■ Translation: L.C. Bt. ■ Publishing House of Hungarian Official Gazettes, 1085 Budapest, Somogyi Béla u. 6., Phone: 266-9290 ■ Responsible Publisher: dr. László Kodela, Chief Executive Officer of the Publishing House of Hungarian Official Gazettes. ■ Printed by: The printing House of the Publishing House of Hungarian Official Gazettes; Responsible Executive Norbert Burján, Deputy Chief Executive Officer. ■ HU ISSN 0031-496-X. 06.2076

Price per copy: HUF5000

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First anniversary of the renewed Public Finance Quarterly

The bilingual (Hungarian-English) public finance professional journal of Hungary, the Public Finance Quarterly – renewed in contents, structure and design alike – was first published in the autumn of 2005. During the one year that has passed since then, after publishing the consolidated issue of 2005, we have come out with the journal on a quarterly basis in accordance with our commitment. We hereby present this year's fourth issue to our respected readers.

We have completed our professional programme with the help of the Editorial Committee. In line with our objective published in the imprint, too, we have consciously focused our attention on the major correlations of the operation of the national economy and public finances, the future-shaping efforts and the related professional discussions.

In the light of this, the journal has centred on the national economic and corporate aspects of competitiveness, innovative strategy, the maturity of Hungary's economy for integration, and such novel ambitions as the development of economic cooperation between the public and private sectors. We have paid special attention to the vision of the European Union and the financial framework plan for the years 2007–2013. In the meantime we have not ignored special problems – also of an international scale – such as the change of paradigm in the fight against money laundering.

In addition, the thematically colourful Public Finance Quarterly has focused on the review, evaluation and analysis of the operation of the Hungarian domestic public finances, the modernisation of the budgetary system, as well as the underlying background correlations and influencing factors.

We hereby recommend our respected readers this year's last issue, which mostly contains studies reviewing the convergence programme, and the basic, convergence linked questions of the operation of public finances and the monetary sector.

With the holiday season drawing near, on behalf of the Editorial Committee and the Editor Staff I wish our respected readers and authors a peaceful and merry Christmas, and much success in the new year.

Pál Csapodi
Editor-in-Chief

Árpád Kovács*

Observations about the convergence programme

The activity of supreme audit institutions is no longer limited to the preparation of reports on audits – conducted in accordance with international standards – but supports the work of legislators and the (financial) government in (national) economic issues with advice based on the synthesis of audit experiences. The evaluation of the economic or fiscal policies, or the professional correlations thereof is beyond the competence and authorisation of such institutions. Advice is given and opinion is formed usually via the publication of audit experience analyses and recommendations that can be utilised in the implementation of a certain task or programme.

The provision of advice may thus extend to the assessment and evaluation of the well-foundedness of certain economic policy objectives and measures, the preparation fostering the sustainability of processes leading to the realisation of such objectives and measures, the quality of preliminary analyses, as well as the implied risks, and as such it is in full accordance with the legal requirements and authorisations pertaining to the supreme audit institution of the state. The State Audit Office of Hungary (SAO) feels and assumes responsibility to publish on the basis of its audit experience – and even beyond – the conclusions it has reached, the risks it has revealed and the corrective measures it finds necessary. This is also the main strategic objective of the SAO.

Upon the Prime Minister's request, the State Audit Office evaluated the convergence programme especially with this goal in mind.[1]

When compiling the opinion, instead of the stabilisation measures we focused our attention on the evaluation of the well-foundedness of institutional reorganisation and structural reforms accepting the stabilisation measures as facts, as a realistic foundation of programme launching. In addition, we focused on aspects on the basis of which we can contribute to the better transparency of the utilisation of public funds, the improvement of the operational efficiency of the state and public finances through evaluating (the working material of) the convergence programme, too.[2]

THE MAIN DIRECTION OF THE PROGRAMME – GENERAL OBSERVATIONS

Similarly to the written opinion of the National Bank of Hungary (NBH) and the Convergence

* The author thanks his colleagues *Gusztáv Báger, Erika Horváth Menyhárt* and *László Kékesi* for their involvement in compiling the SAO opinion on the convergence programme of Hungary. Their and other colleagues' work, too, contributed to the publication of these observations.

Council about the convergence programme, we also found that the series of measures presented in the programme can be regarded professionally well-elaborated along a definite concept and strategy. We found it positive that both the approach and the concrete measures explicitly talk about the roles and responsibilities of the individuals and the state in burden sharing. Professional well-foundedness and elaborateness is maintained basically until the end of the programme, i.e. 2009. However, in the subsequent period the contours of the programme become vaguer due to natural uncertainties arising from the long time horizon, and also to a great extent from the lack of elaborateness of further measures required for sustainability.

The programme makes it clear that it intends to promote the creation of an economy that strives and is able to continuously renew in terms of structure, technology, level of organisation and quality of management.

Having compared the figures of the document with the available information, including direct audit figures, we concluded that *the initial parameters and forecasts of the macroeconomic path are realistic,* or rather somewhat pessimistic and prudent. Therefore, in this aspect the programme carries no risks, on the contrary, it has some reserves. The chances of implementing the path outlined in the programme are also specifically improved by the fact that the Government reports to Ecofin (Economic and Financial Council) semi-annually, and it must also ensure the implementation of corrective measures should such become necessary.

We find it important that the programme describes alternative paths, too. However, we believe that it would have been (it would be) necessary to develop and analyse a version for the undesirable case when all conditions and influencing factors considered during the development of the balance path are less favourable than expected and calculated. This worst case scenario must not be ignored either. It would be reasonable to figure out how a situation like this would influence the Government's room for manoeuvre, or the main direction of the programme, the chances of implementation of the underlying sub-measures, as well as compliance with the original deadlines. It can and must be analysed especially in this correlation how the possible return to the old regime could be prevented in the worst case scenario.

The annex to the document contains the most important measures. This helps in following and controlling the events.

The authors of the programme believe that the tensions in balance can be relieved and the economy can be put on a sustainable growth path via comprehensive reforms.[3]

In professional circles there has been full agreement about the fact that the prerequisite of the progression of the reforms is immediate consolidation, the stalling of processes unfavourable for the balance, and the consistent implementation of the underlying fiscal measures.

Central bank analysts and others, too, have drawn attention to the vulnerability and fragility of the Hungarian economy, and the need for fiscal consolidation. According to the central bank, due to the balance problems, the Hungarian economy is very vulnerable to capital-market shocks. If the funding needs of public finances do decrease in the wake of consolidation, this process will automatically entail the improvement of the external balance according to NBH.[4]

In other words: the vulnerability of a country may be caused by the impacts of several factors of capital movements. A balanced budget policy and a sustainable stock of debts are fundamental requirements to offset such impacts.[5]

Another study argues for the need for turnaround from the aspect of macroeconomic balance and economic growth. According to the authors of the programme, the two major steps promoting the aforesaid are the definite, expenditure-based reduction of the budget deficit and the growth in employment. They also cite international experience, according to which deficit cuts "pay off" anyway. They confirm that countries with nearly balanced budgets managed to catch up to a greater extent in the past decade, and could better retain their edge in terms of income. They point out that economic growth and deficit cuts are factors that mutually strengthen each other. Not only deficit cuts could influence economic growth, but equally, the latter can contribute to the reduction of deficit.[6]

For the achievement of goals specified in the programme, and the enforcement of the main direction it is positive that *the medium term objectives and measures aiming at the reduction of public sector expenditures could be formulated with uniform logic.* Real progress, catching up and a sustainable growth path *inevitably require that the structural reforms be completed as soon as possible,* i.e. there is work to be done to develop the contents and schedules of steps and measures coordinated with one another that lead to reform-scale changes, as well as to develop the guarantees underlying implementation. This is equally true for public finance reform in the narrower sense, the modernisation of public administration, the careful definition of the group and content of public services, and the solutions of related funding. This is all the more important since full agreement has not been reached in the case of short-term, "industry level" expenditure cutting measures built on mature decisions either.

The (working material of the) convergence programme stays within the frameworks of public finances. It tries to outline a realistic economic growth path, however it fails to sufficiently count with how the measures may hamper economic growth or what social impacts they may induce. Therefore, during the practical implementation of the programme the line that shows how the measures will lead to real reforms would definitely have to be made more marked. One of the basic preconditions for laying the foundations for and successfully implementing this objective is – what the SAO emphasises at every possible forum – the full-scale reconsideration of the role of the state, and on this basis the clarification of the contents of state liabilities and tasks, which also requires new compromises, and then the regulation thereof in a manner that allows monitoring in practice, and the distribution of the workload among the various actors involved in implementation that are not necessarily and exclusively state players.

On the basis of the audits, our reports have repeatedly emphasised the lack of harmony between state tasks, organisational frameworks and budgetary resources, and focused in particular on the evaluation of the operation of the large provision systems from the critical perspective. Our recommendations for the elimination of contradictions have been only partially utilised.

The audit findings warn that the social and economic processes, tasks and determining conditions are too complicated for us to claim that the central aim and objective of the state reform should be clearly the creation of "a smaller and less expensive state". *It is advisable to consider gradually "building" a modern state that provides for closing the gap, development and services in line with the requirements of our age.*[7]

This state (concept) is forward-looking, and is very much different from the existing one in terms of basic features. It is worth highlighting in this context (too) that the interpretation and reconsideration of the tasks of the state – which recur in this writing of mine, too – i.e. one of the key issues of the public finance reform is inevitable, since the task structure of the modernised and europenised state of the future will definitely differ from the currently funded "task package".

The public finance reform is indispensable for state reform, and in fact, public administration can and must be restructured, europenised and modernised on the same basis, simultaneously. The warnings that come from several sides (Hungarian expert writers, international financial institutions and several SAO reports) that find it urgent and important that the reliability of budget planning be enhanced by the methodological development of macroeconomic forecasts, by strengthening the forward-looking nature of finance policy, and that fiscal and development policies be consistently coordinated, practically recommend and require the revival of the (system of) institutionalised national economy planning and the operation thereof in accordance with the requirements of our age. However, all this (reforms and modern planning) can be implemented only in line with strategic principles based on professional consensus and supported with in-depth impact assessment studies. Implementation is paramount, since we definitely need to find a way out of the situation, according to which today the need for the development and reinforcement of the (aspect and practice of the) individual's responsibility for burden-sharing and self-support exists side by side with the need for the introduction of strong austerity measures serving consolidation.

This is one of the fundamental contradictions of progression, especially for the day-to-day life and short-term perspective of the population, the citizens. The contradiction requires control and solution at such level of development in Hungary – medium-level by international comparison – which represents a specific "danger zone" in the world economy. The population's needs have almost reached the level of developed countries, which is also fostered by the demonstrative effects of those countries. However, the performance and competitiveness of the Hungarian national economy is not yet sufficient to allow most citizens to satisfy these needs from labour income.[8]

Catching up and a sustainable balance path would be fostered if analyses quantifying the expected impacts of the measures outlined in the convergence programme were disclosed and were publicly available. Such analyses would not only support economic assessment and the better understanding of the programme, but would surely help develop expedient governmental behaviour and action as per how the society could be prepared to adopt the impacts of the measures underlying the realisation of the programme, with regard to the fact that initially these impacts will be detrimental for most income earners, i.e. a large part of the population. I am deeply convinced that this is a task of invaluable importance that cannot be put off. *The society* (which is of course far from being homogeneous and uniform, and is characterised by many layer-specific features) *must be regarded as a partner, and it must be won over to the cause of reforms* that go with difficulties due to the austerity measures, but *serve future generations, too!*

One of the most important manifestations of our activities serving the National Assembly, which facilitates the work of the members of Parliament is that – in line with the legal requirements – each year we audit the budget bill for well-foundedness, feasibility and internal consistence. We submit an audit report, which is officially called opinion, to the National Assembly, which is also a precondition for parliamentary debate. We first of all draw attention to the major risks implied in the budget bill, as well as its positive features that foster progress.[9]

The approval of the convergence programme by the EU has practically set off the development of the necessary turnaround. The budget for 2007 must be also determined so that the process could continue. The budget basically relies on, or adjusts to the convergence programme. This partly explains why it contains lower level and smaller risks than the budgets of the previous years.

It is beneficial that in general, the expected tax revenues also carry lower risks than before. It is positive that most of the revenues planned to be realised from state property is well-founded. It affects the expenditure side that by observing the convergence criteria, appropriations that can be exceeded without the need for budget modification could be realistically planned, and their ratio has not increased compared to the 2006 level. Within this the most significant family, social, normative and housing subsidies can be regarded well-founded, which is very important for social justice and cohesion. The revenues of the social security funds are also well-founded. The benefit budget of the Pension Insurance Fund is realistic. It is uncertain whether the Health Insurance Fund appropriation can be realised. The risks can be reduced by the enforcement of measures and regulations adjusted to the convergence programme, which reduce expenditures, make the distribution of the contribution burden more equitable, and create long-term sustainability.

I must add that *the budget bill fails to present* (is unable to present) *the quantified impacts of the planned* or already realised measures *to the same extent as we missed the presentation of the quantified impacts of the reform measures from the convergence programme.*

How can we evaluate the relationship or harmony of the budget bill with the convergence programme? The public finance deficit figures contained in the bill correspond to the deficit appropriations set in the programme. The inflation path outlined in the programme and the forecast thereof for 2007 are in line with the macro-path indicators of the utilisation of the GDP.

The main uncertainty factor is the expected behaviour of the various income owners. It is difficult to assess in advance how investments will change in the competitive sector, and what impacts expenditure cutting and tax avoiding efforts will have. Furthermore, another major risk factor in the budget calculations, which greatly rely on private consumption, is how the population will react to the fiscal measures? The impacts of increasing living costs, job uncertainties, changes in private consumption and the presumably more prudent saving and borrowing attitudes can only be estimated and assumed. At any rate, the population's reactions deserve special attention even in relation to the social acceptance of changes.

Naturally, it must be acknowledged that in the case of such a broad economic and budget policy turnaround as we currently witness, the quantification and analysis of multi-year budgetary impacts is an especially demanding and complex task. However, it is undoubtedly important that the documents that shape and determine the vision of the society and the economy should contain as much relevant information as possible. In addition to the enhancement of the performance of the national economy, the improvement of competitiveness and the restoration of the balance, the availability of the most complete and substantive financial information ensuring transparency and accountability is extremely important, because as a specific reflection of the credibility of public finance management they themselves are eminent factors in the restoration of the confidence of the money markets and investors, which is indispensable for the success of the convergence programme.

On the road leading to the closure of the gap and the creation of the new balance it is a crucial step to eliminate the not sufficiently well-thought after, often squandering utilisation of public funds and the underlying causes. *However, the curtailment of expenditures is not an end, but a means.* The reduction of expenditures is one of the *preconditions for the recon-*

sideration of the contents, extent, arrangement and organisational frameworks of state tasks, and equally the determination of the requirements of task performance, as well as that of the renewable conditions for access to services provided within this framework.

We can only agree with the Speaker of the National Assembly, who formulated the following clear requirement, which has been several times published in the written and electronic media: it is inevitable for any progression to determine those minimum tasks that the state should undertake constitutionally in the interests of its citizens.

The success of the convergence programme also requires that we should focus more than before on the requirements, and equally on the favourable opportunities arising from our EU membership. Apart from anything else, Hungary's active participation in the European Union requires the immediate reconsideration of the roles of the central government and the local governments, and the development of a state that provides for catching up, development and services.

All this falls together with the economic policy message of the latest, 44th Economic Convention, which was submitted to the Government by the chairman of the Hungarian Society of Economics. Apart from other things the document says that: "Increased tax rates, reduced expenditure, or structural transformation remaining in the scope of business administration are not sufficient for the implementation of the Convergence Programme and for stepping on the course of modernisation. Social spending and social transfers should be transformed to such an extent which are inconceivable without the reconsideration of the basic constitutional rights (pension, healthcare, 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 programmes today. Wide professional and social partnership is needed for the reaching of public agreement, i.e. the reforms should not be implemented by way of stealthy legislation."[10]

QUESTIONS AND COMMENTS – COMMENTS ON THE DETAILS OF THE PROGRAMME

Reduction of public sector expenditures

The restraint, curtailment of expenditures is based on three pillars: headcount reduction, wage management and real expenditure cuts. As an aggregate impact, the public sector's GDP relative operational expenditures will drop from the current 18.4% to 15.2% by 2009. Therefore, this part of the programme contains the probable quantified impact or yield of the planned measures. On the other hand, the headcount reduction idea relies neither on performance requirements (the convergence programme only promises the elaboration of such requirements), nor on more extensive function and task analyses, as well as the concrete harmonisation of tasks and resources.

Our audit experience shows that recent restructuring projects – carried out mostly within the ministries – were not preceded by similar analyses and calculations either. However, the reduction of government staff without the expedient reorganisation of tasks cannot be regarded as an assuring solution. We drew the National Assembly's attention to this problem in our opinion on the 2007 budget, too.

I believe that for the time being we cannot determine for sure whether the cost cuts arising from the reduction of headcount (also because its implementation will temporarily entail additional costs in 2007) can be sufficient by itself to achieve the expected result in relation to the modernisation of the public sector, or further measures may become necessary, which may force the comprehensive review of the set of rules that determine the entire social and financial prestige of the public sector.

To the best of our knowledge no feasibility study has been prepared about that and the possible consequences thereof. The convergence programme does not deal with this side of the problem. However, this would also be necessary, since public administration should not be made uncertain when the public finance and public administration reform itself should be assigned to the experts working especially in public finances and public administration. In the absence of the preliminary assessment and evaluation of behavioural motivations and the various impacts, as job and work security diminishes, when life becomes unpredictable, we can count with an uncertain and bad-tempered staff of administrators and public service providers, although they have done nothing to deserve such a change in their situation and perspective. This increases the risks of the implementation and social acceptance of the reforms.

Sustainability of public finances

The programme devotes a separate section to the problem of sustainability of public finances. Within this section it deals with the pension and healthcare systems, and although it looks beyond the time horizon of the programme, it does not describe longer-term solutions.

Healthcare

One of the specifically sensitive areas of the convergence programme is healthcare, and the presentation of the reform ideas aiming to restructure healthcare. The restructuring that affects both institutional funding and responsibility relations promises “better care and more health”. However, its pillars cannot be clearly judged since the presentation and evaluation of the impact mechanism of the listed measures are completely missing from the programme. For the lack of a published computational background no opinion can be formed about the well-foundedness of “resource strengthening”.

The programme does not highlight the model of enforcement of the accessible for all principle. The enforcement of a constitutional right does not only assume public power will (guarantees, including financial guarantees), but also the involvement (responsibility) of the individual, which is clearly expressed by the document. This is why it is completely justified that apart from the state the individual should also be given a role (proper encouragement) in ensuring access to healthcare services. With the regulation currently in force, coverage for services is provided by the state budget – by the taxpayers – for several groups of significant size. The current solution – which, by the way, draws resources away from other, equally important tasks – cannot be undertaken in the long run. If the material does not outline concepts for the reduction of such state responsibilities, then the system continues to be burdened by an unsolved matter, which will continue to curb community expenditures (reduce development funds) as a rule.

Let me cite a few SAO audit experiences from the healthcare system to illustrate the typical problems.

No fundamental changes have been carried out in the field of healthcare. The preparation of the National Health Development Programme was several years behind schedule. The National Assembly decided about launching the Decade of Health Béla Johan National Health Program in 2003. Only part of the resources required for the completion of the sectoral tasks was available. The consistent realisation of long-term programmes was hindered by the fact that the Government had no approved concept. The long-term programme launched for the renewal of the stock of instruments/equipment of institutions was shortened to one year. Deficit became permanent, which was caused by the changing social and economic environment, the professionally weak planning and the growth of contribution debts.

The financial standing and operational conditions of local government owned hospitals were improved by the recent central measures (raising the basic fees, 50% wage hike, consolidation programme), but the systemic and complex review of tension inducing factors, the comprehensive handling and resolution of problems have not taken place. Shortage and wastefulness still exist side by side in the healthcare system. Shortage is characterised by the bad state of repair of the buildings, the obsolete instruments, the employees' income level and the inadequate level of hotel services, while wastefulness is triggered by maintaining an inefficient structure and the shift in the provision of care towards the more expensive in-patient care. Healthcare in Hungary is still hospital-centred. The continuous growth of performances in out-patient and active in-patient specialised care is induced not by changes in the population's needs, but rather by the need of the institutions to increase revenues. The funding entity could not provide comprehensive and continuous professional control for the actual content of performance settlements, the institutions tried to increase their revenues by enhancing their performances at any price.

We must agree with the effort to increase resources for public financing, since there is no other possibility. In the case of in kind benefits the key to changes is the development of an insurance system/insurance systems, of a funding solution/funding solutions for the use of services, and the changes of the systems of subsidies (primarily that of pharmaceutical subsidies). It must also be considered how the institution of disability pension could be realistically handled – by eliminating the potential risks of corruption – and how the practice, according to which there are currently nearly 800,000 people who do not pay contribution, could be ended.

Education

The reform objectives defined in this circle give priority to the promotion of the enhancement of competitiveness, and the utilisation of the opportunities inherent in innovation for growth, which is appropriate. However, it can be criticised that the measures first of all focus on secondary and higher education and neglect primary education, where the economy-of-scale problems are well known according to the convergence programme, too. For the lack of a forward-looking educational policy, and partially due to a shortage of funds, in the past fifteen years the higher education institutions turned out more graduates than needed and not in line with the necessary employment structure. The programme does not sufficiently deal with this problem. Therefore, it does not (cannot) tell what to do with young professionals that can no longer or not yet be employed in the economy.

Another tension is caused by the drop in the turnout of secondary level vocational training, which will gradually form an obstacle to competition, since soon we will witness a “shortage” of well-trained skilled workers. Therefore, it is not enough to merely speak about the need for a vocational training system that is more adjusted to the market requirements. A new secondary level vocational training strategy must be developed that corresponds to the current conditions and the needs of the foreseeable future alike. It can and must be achieved with the necessary changes to curb significant unemployment among college graduates and prevent Hungary from becoming a pool of disadvantaged unskilled workers on the labour market of the EU in a few years' time.

The SAO audits have also revealed that the integration of higher education institutions did not yield the expected cost reduction, it did not have a synergic effect, and the training structure of integrated institutions did not show any significant change or development. Research resources have not been concentrated in an expedient way, management and organisational fragmentation, and consequently, inadequate efficiency still prevails. Research and development subsidies allocated from the central budget are not adjusted to the importance of the task, and the award of state subsidies is not linked to a modern, performance oriented set of requirements. Normative funding developed in higher education could not be made an efficient budgetary tool. The institutions have not become interested in optimising the training costs.

The pension system

The convergence programme makes it clear that one of the main reasons of the existing imbalance, which will soon assume menacing proportions, is the pension system. Yet, it does not pay sufficient attention to the more comprehensive, long-term reforming of the pension system, which could also guarantee sustainability. Whereas the system, which is inequitable already in its elements from several aspects, and cannot be sustained in the long run, has been ripe for such a change for a long time.

The current problems include that the regulatory system contains a lot of disproportions and contradictions, and long-established privileges that can hardly be justified today, while the relatively low retirement "age centre" can only be partially supported with the population's state of health. The programme defines contradictory objectives. While it shows strong social policy commitment to the increase of pensions and pension-like benefits, it also promises the completion of the corrective programme undertaken last year. However, the series of recommendations hardly moves towards the creation of real fundability. The increased retirement age, and the more stringent conditions for retiring do not yield assessable impacts in the short run. In fact, they hardly do more than "heat" the social policy surface of the issue.

In the period of consolidation, in the conditions compelling the restoration of the balance, the possibilities to relieve the tensions of the pension system are rather limited. On the revenue side, the increase in contributions is inseparable from the question of the distribution of public burdens, while on the expenditure side the determining factors are extremely strong, as it is well known. The possibility of measures planned to be taken in the next two to three years seems especially critical. It must also be considered whether in the transitional period of balance creation all commitments undertaken at the expense of the budget (including for instance pensions for the 13th month) can be fully met? It must not be ignored either that the immediate modification of the retirement conditions announced a decade ago (retirement age, incomes considered during the calculation of pension benefits, employment while receiving pension benefits, etc.) to the detriment of those affected will only entail relatively modest savings. In addition, these measures are expected to be unfavourably received by the non-affected age groups of the society, too.

In effect, it is indisputable that the convergence programme highlights the real problems of the pension system, and tries to prevent the aggravation of these problems with rapid and firm measures. The situation is made more complicated by the fact that the earlier fulfilment of the election promises of the successive governments created the social illusion that the satisfaction of most demands aimed to improve living standards is nothing but a question of determination and goodwill on the government's side.

Yet, the future and the renewal of the pension system that will become unsustainable in the foreseeable future is a key issue.

There is no doubt that the unfavourable demographic structure and grim forecast of demographic processes, as well as the characteristic features of employment, and first of all the problems of fundraising due to the strong budgetary constraints make it extremely difficult to explore possible solutions that would be accompanied by the least possible shocks, and adequate in terms of future impacts.[11] However, the programme fails to outline the measures that may serve progression in the period after the turn of the decade.

Local governmental system

Compared to the national and international expectations about the reform of the system, and especially to the required modernisation corresponding to the new European needs, the measures envisaged by the document are modest. As far as we know, there are much more concrete modernisation plans on the desks of the competent authorities both for the situation arising if the acts requiring affirmative votes from two thirds of the Parliament are amended, and for the manoeuvring room provided by acts that can be amended without such a majority. In the light of this, two scenarios should have been followed.

In the case of changes requiring support from two thirds of the Parliament, apart from regional restructuring and the related simultaneous task re-centralisation (from the settlements to the regions) and decentralisation (from the central level to the regions) new opportunities may open up through prescribing the fulfilment of certain tasks by mandatory associations, and through the "tightening" of the budgets of the local governments: liquidation of the standard local governmental monetary fund, requirement of a balanced current budget and surplus, reconsideration of the rule pertaining to the maximum credit line.

In the case of acts requiring support from half of the Parliament, significant results could be achieved by creating regulatory, framework-type acts, by simplifying the system of resource regulation (including the radical reduction of eligibilities for support and the confinement of such eligibilities to a certain period of time), as well as by transforming the system of local taxes. For example, completed preparatory steps and planned measures for property taxation should have been presented in a more pronounced manner. Local tax administration should be centralised and the number of local tax types should be reduced in order to streamline the system of local taxation and make it less expensive.

The success of the initial steps of the progression may be fostered by the fact that the budget bill for 2007 is based on priorities well chosen by the local governments. In line with the convergence programme and the macroeconomic requirements solutions that foster the utilisation of EU development funds in a practical manner, as well as developments boosting the reduction of regional disparities, and changes showing in the direction of the modernisation of financing and administration, have come to the foreground.

In the local governmental sector the Government promotes that development programmes should be increasingly implemented under the aegis of the EU. It raises the related budgetary appropriation, and rationalises the eligibility conditions. It is also in accordance with the convergence objectives that the role of the regions is strengthening in closing the gap between disadvantaged and more developed small regions. It is a forward-looking feature of next year's budget that task performance by multifunctional small regional associations, and regional cooperation will be intensely encouraged with fiscal means. However, these modifications cannot lead to the required turnaround in local governmental financial management. That requires system-scale changes that extend to – among other things – the definition of the content of public tasks, the rearrangement of the resource structure of supply, all the more since the debts of the local governments are growing.

Price subsidies

By curbing supplements provided through price subsidies the programme subordinates everything to the actual pressure of restoring the balance. It basically relies on transitional, temporary solutions. The causes that called for and maintained the extensive subsidies should also be considered systemically. The programme practically ignores such causes, and also whether the current system can be sustained in the longer run, or a real change will be put on the agenda in the near future. In case "purchase power with insufficient income" is required to be supported in the longer run, the reconsideration of income distribution (linked with the issues of employment and income policy) is inevitable. In addition, it must also be examined whether the expenditure envisaged for this purpose is commensurate with the expected outcome. It cannot be ignored that the volume of the corporate income tax has been practically constant for years. Meanwhile, a significant gap has occurred between the state subsidies and the tax paid on the basis of profits.

Revenue increasing measures

Within the programme these measures mostly contain changes that are indispensable for quick balance improvement. However, the statement, according to which apart from the property tax planned to be introduced in 2008, no other significant tax/contribution measures are needed, is considered to be risky. Apparently, this standpoint does not count with the fact that should the continuous expenditure cuts slow down or come to a halt, the resources that become available due to the measures earmarked so far are probably not able to fulfil the co-financing needs, especially if – which must also be taken into account – in contrast with the forecasts, the external market conditions may also change to the detriment of Hungary.

Since the programme is about a series of short-term and tense budgetary measures, the future of withdrawals requires a more prudent approach. This is all the more so because the listed modifications (or impacts thereof) are not quantified either. There are no planned revenue figures, or revenue sums expected to be collected with the given fluctuating rate of law-abidance in Hungary. This also increases the number of uncertainties that come to the surface in connection with the professional well-foundedness of the convergence programme.[12]

The convergence programme sheds a new light on more equitable public burden sharing. I would like to stress in this context (too) that tax policy is not and end, but a means of economic process regulation. Tax squeeze by itself cannot yield long-term and favourable results. It cannot replace a harmonised, more forward-looking tax reform adjusted to the macroeconomic processes, which assumes the development of a comprehensive economic strategy, which extends not only to the tax policy, but also to the entire income policy.

Within the list of urgently needed practical steps, the entire withdrawal structure should be stripped from the privileges, and the cost accounting rules that allow taxes to flow away must also be reviewed. Nearly two fifths of the taxpayers obtain supplementary income from the obsolete income tax exemption and accounting technique related rules. There have never existed so many companies that account all of their revenues as expenses. Similarly, the current practice of invoice issuance is a tacitly accepted social deviancy, which can only slightly be combated by audits, the number of which should definitely be increased. The document says nothing about such measures, and nor does it contain measures aimed at the modernisation and reinforcement of the technical and IT elements of the enforcing organisations, although these are also important conditions to enhance revenue discipline, and eventually to bring the Hungarian tax morale to the European level.

It goes without saying that next year's budget will definitely play an important part in the implementation of the convergence programme. Based on the SAO analysis of that budget we had to conclude that the significant changes in taxation specified both in the convergence programme and the 2007 budget do not show in the direction of tax reform. The system is too complex, its simplification is imperative. On the other hand, it is favourable that broadening of the tax basis will be started in accordance with the convergence programme. The chances of firmly containing tax avoidance may be enhanced by the strengthening of audits and the improvement of the underlying conditions. Tax and contribution hikes by themselves – and not as part of a comprehensive tax reform – in the short run will not foster efforts aimed at the reduction of the grey economy, and neither will they foster the fight against and reduction of corruption.[13]

Privatisation

The convergence programme mentions the role of privatisation in the modernisation of the economy in relation to productivity and employment. It lists a few major companies to be privatised. I believe that the main task is not the selection of companies to be sold. Rather, in the first step a comprehensive analysis should be drawn up about the existing state assets, and it should be assessed on this basis why and what percentage of those assets could be privatised. This percentage is very low, and selling those assets could mean no more than certain security reserves.

Partnership of the public and private sectors

The convergence document emphasises that this cooperation should be made more efficient, and that the private sector should be more involved in investment projects designed to develop public services. The need for "transition" between the two sectors, partnership based development projects and the supply of services are indisputable.[14]

However, not only the possibility of cooperation must be strongly emphasised, but also the need for applying schemes that provide institutional security for public money and public property, as well as the need for full-scale and realistic accountability. The relevant legal regulations must be worked out.[15]

In the past two years several decisions have been made about certain projects to be implemented in the PPP scheme (construction of student residence halls, prisons and motorways). In the light of the audits the experience is clearly unfavourable: private capital has practically not been involved at all, what's more, in certain cases the share undertaken by the private sector has been funded by the budget or the social security system. At this stage we finally got to the point that we cannot decide what the dominant objective is: sparing of budget resources, modernisation of services, or the creation of a new risk-free market – and a new type of subsidy in the special Hungarian form of the scheme – to private investors. Harmonisation of the objectives is a task to be solved. This scheme is rewarding for the public sector and the country only if it involves real capital investments, and is accompanied by quality performance guarantees.

The regulatory and institutional conditions of fiscal discipline

Although the convergence programme cannot endeavour to discuss in detail the professional questions and technical features, since this is not the objective of the document, it is striking how little the document deals with the various methodological, regulatory and institutional conditions of the enforcement of fiscal discipline.[16]

If said conditions were described in more detail, we would be more aware of what budget planning, institutional, regulatory and methodological solutions and changes may induce the attainment and preservation of the targeted results of the adjustments for a longer term, the restructuring of the expenditure side of the budget in greater harmony with the needs and the possibilities, i.e. the enhancement of the quality of the budget. In the current situation these are the tools and tokens of budgetary security, too, and shall be developed and strengthened as much as possible for economic and social considerations alike. In addition to the professional aspects, these are also important since they provide guarantees against any potential voluntarism of political character that may – intentionally or not – come to the surface.

The correlation is specific: said fiscal rules are necessary, but not sufficient conditions for structural reforms. These rules can fulfil their functions (and in this respect they belong to the tool portfolio of budgetary security – *inclusion by the author*) if there exists political willpower to enforce them and have them enforced.[17]

It is (also) emphasised in relation to reform-scale changes and the success of the convergence programme that "…budget planning that »thinks« over longer horizons must be provided …", which "…makes budget decisions and their effects transparent and easy to follow for Parliament, which exercises regulatory authority over the budget…", and "…creates an opportunity for increased security in planning long-term development concepts, and understanding the costs associated with their implementation."[18]

The OECD study analysing the Hungarian budgetary system argues similarly when it cites excess focus on the budget year and actual deficit, as well as the lack of clear rules of budgetary discipline as the main causes of the vulnerability of the Hungarian budget.[19]

EXPLANATIONS TO OUR PROBLEMS – A FEW CONCLUSIONS

The causes as well as the consequences of financial tensions, structural problems and usually economic difficulties are manifold and often interconnected. I believe that the common cause of the majority of these problems is ultimately rooted in the imbroglio of globalisation, the unsettled relationship between the global world economy and Hungary's national economy, and (also) in the lag of coordination and adjustment. No proper method and schedule have been worked out yet for the optimum adjustment of the national economy. The various balance and debt problems, as well as the difficulties in meeting the Maastricht convergence criteria mean and present only partially the problems of sustainable economic growth and balanced development.

There is currently fierce innovative competition and desperate fight in the world for new markets. At the same time, Hungary is retreating from the major markets. The world is currently dominated by a trend of accelerating buy-outs and mergers, while Hungary has been still excessively preoccupied with the distribution of resources (just think about the taxation rules of 2006). While the world is ridden by a more and more threatening "energy war", we are unable to decide about the energy supply strategy of the country (e.g. renewal of production capacities, clarification of the possible funding techniques of the rising energy prices, etc.).

There is no doubt that it is justified to agree with the conclusions – which has recently been more markedly present in the articles of *Zoltán Pitti*[20] from among the Hungarian opinion formers – that the biggest problem is not the budget deficit, but the lack of a theoretically mature economic strategy that relies on professional and political consensus, and can also be enforced in practice.

Therefore, it is wrong to follow the one-sided approach, according to which malfunctioning exists only in the state structure, because then we address the symptoms only. The competitive sector also plays a major role in strengthening the performance and competitiveness of Hungary's national economy, and in improving the balance. In agreement with Zoltán Pitti and others I believe that the closure of the existing gap, progression and evidently the realisation of the convergence programme require that *performance halting phenomena that can be revealed in the competitive sector, and the underlying causes should be offset.*

With certain simplifications these phenomena and causes can be summarised as follows.

- Structural changes in the economy, as a result of which nearly half of the GDP is now produced in the service sector due to the strong flow of resources (enterprise, capital, labour) from the productive sectors to the service sector; however, this sector has no export ability, wherefore it practically depends on the slowly growing domestic effective demand.
- The differentiation of the economic players represents a multidirectional problem, such as insufficient profitability and capital accumulation ability, and the negligence of economy-of-scale aspects.
- The domestic added value indicator relative to the gross output is continuously deteriorating, which can first of all be attributed to the shift of resources to industries producing lower added value.
- The relatively low knowledge performance of Hungary is the consequence of the curtailment or at best stagnation of R&D and innovative activities, which is also due to the fact that the entrepreneurial willingness of the competitive sector is low in this area[21].
- In certain sectors of the national economy, business forms or regions investments are lower than the reduction in assets. In these places we witness the limitation of expanded reproduction.
- The invisible, hidden economy permanently booms, we cannot cut corruption and the avoidance of the payment of public dues, and for the time being we are also unable to eliminate the underlying causes and social embeddedness.
- The capital supply is insufficient, and loan capital required for continuous economic activities is unrealistically expensive.
- The disparities in and contradictions between the level of qualification of the work-

force and the trade structure and employers' needs, as well as the "incapacity" of the vocational training system are gaining ground. Furthermore, the quality of public education is also deteriorating.

The operational and development possibilities of our national economy, the implementation of the convergence programme are influenced by many macro- and microeconomic correlations, the domestic and external markets, as well as social and human policy factors. This is why the questions of the future can be answered very diversely. And depending on the contents of such answers, we can presume several development paths.

It is true that without adequate motivation and encouragement even the best and more expedient programme may run into difficulties in the implementation phase, or may even go the way of incapacitation. Therefore, we must widen the horizon of our way of thinking and actions. Hungarian public administration and system of state institutions should not modernised in line with the current needs, i.e. in a static state. It would be more reasonable to create a vision and a state building concept that could adjust public administration to the functionality of Hungary in 15 to 20 years' time. We are talking about different things, yet the correlation is obvious: according to some opinions, the expenditure and revenue paths of the budgets of the next 10 to 20 years should be reviewed on a professional basis, and this should be the most important step in preparing the reforms.[22]

The models that so far have been mostly based on a static approach and restrictions should be replaced with dynamic models, since *we are facing a completely new challenge of adaptation.* We need to count with a range of specific factors of economic and social development (such as cooperation, new partnerships, the performance of the state organisational system, consistence in the application of law, the security of state task performance and the budget). These issues also affect social questions and correlations, and cannot, or can only hardly be expressed with the help of parameters. However, as a general effect they will settle into shape and may represent either a marked, boosting force that foster progress, or a counteracting, braking force.

Notes

1 Opinion was formed about the draft, working material of the 2005–2009 convergence programme of the Republic of Hungary updated as of September 2006. The State Audit Office formulated its opinion on the working material received on 25 August 2006 by 28 August. This opinion was taken into account by the competent parties when compiling the final document, i.e. the *Convergence Programme of Hungary 2005–2009, Budapest, September 2006.*

2 My study is also based on this approach. The gist of my opinion was outlined at the symposium of the Hungarian Society of Economics held in Kossuth Club, Budapest on 19 October 2006, where academician *Tibor Erdős* also gave a talk in the same subject.

3 According to the programme, the Government's most important objective is to create the prerequisites of growth based on long-term equilibrium, thereby facilitating the lasting and accelerating catching-up in economic output and living standards to the EU average. Real convergence requires a growth and development oriented economic policy relying on the long-term equilibrium of the general government. The achievement of the general government equilibrium requires not only adjustments with short-term effects but also substantive reforms of the operation of the state. *Convergence Programme of Hungary 2005–2009, Budapest, September 2006, page 3*

4 Report on the convergence processes, *National Bank of Hungary, Budapest, 2005, page 6*

5 Dóra Győrffy: Eurócsatlakozás és fiskális konszolidáció Magyarországon, tanulságok a globális tőkepiacok történetéből, *Külgazdaság, 2005.3, pp. 79–80* (Adoption of the euro and fiscal consolidation in Hungary, lessons from the history of global capital markets)

6 Makro egyensúly és gazdasági növekedés, *Central European Management Intelligence, Budapest, April 2006, pp. 27–28* (Macro balance and economic growth)

7 The Hungary 2015 strategic research project integrates and summarises the work of the nearly 100 researchers. According to one of the summary studies of the research: "…we do not accept the neoliberal approach of a small and inexpensive state, but we rather start out from the concept of a strong and effective state that provides for development and services. Due to the permanent underperformance of the public sector, a *de facto* "state phobia" has emerged in Hungary, and demagogical statements about the drastic streamlining of the state are also often times heard of. Similarly, the institutions themselves have suffered an enormous loss of prestige in the past decade due to their low effectiveness, low efficiency and poor social impacts. Therefore such proposals have dominated the public opinion, according to which the radical downsizing of the institutions and the resulting savings will considerably improve competitiveness. In fact, the opposite is true, since the most important precondition and factor of international competitiveness is a high capacity state – or usually institutional – sector. The state shall not be downsized, but rather expanded – through radical reforms and its organic connection with the social capacity." *See: Attila Ágh: Az intézményi reformok – 2015, Az alapvető változások 2006 és 2015 között, White Paper, joint project of the Hungarian Academy of Sciences and the Prime Minister's Office, Hungarian Academy of Sciences, Sociology Research Institute, 2006, Budapest, pp. 242–243* (Institutional reforms – 2015, The basic changes between 2006 and 2015)

8 Attention to this specific correlation is drawn by academician *Mihály Simai* in his writing titled *The world economy and Europe in the early 21st century* (A világgazdaság és Európa a XXI. század elején). *See: Fejlesztés és Finanszírozás, 2006.1, pp. 7–8*

9 We have recently published our latest material: Opinion on the 2007 budget bill of the Republic of Hungary, *SAO report No. 0641, November 2006, National Assembly No.: T/1145/1.* In the following we will refer to this document several times without indicating the page numbers, since the findings are contained in different sections of the report.

10 Conclusions regarding economic policy made at the 44th Economic Convention – Information for the Government (Document), *Public Finance Quarterly, 2006.3, pp. 405–406*

11 The population of Hungary is continuously decreasing, and will drop to 9.85 million by 2021. Currently every fifth citizen is, and in 2021 every fourth citizen will be 60 years old or more. *See: Katalin Tausz: Társadalmi kohézió – 2015, White Paper, i.m. page 116* (Social Cohesion – 2015 White Paper) It must be mentioned here that "in 2005 there were 3,902,000 employed, and 304,000 unemployed people in Hungary. The economically inactive population totalled 3,517,000 people, 55% of whom were pensioners, 21% were full-time students, 17% were other dependents and 7% received childcare benefits. According to the analysis of the Hungarian Central Statistic Office (HCSO), the remaining 2.5 million people are not simply actively unconnected to the economy or the world of labour, but a significant portion of them is unable or unwilling to enter into employment." *See: Hungary 2005, HCSO, Budapest, 2006, page 19*

12 A prudent comment on the income policy: it would also be necessary to consider to what extent the limitation of effective demand will deteriorate the chances of survival of mostly service supply companies that almost exclusively rely on the internal market. It must also be considered that – due to the slow change in effective demand, and the restriction thereof – the freezing of incomes will at best slow down, or in a worse case scenario may even incapacitate the marketisation of the public service system.

13 After all this, it is just a supplementary note that the solidarity tax imposed on taxpayers over a specific amount (HUF 6.67 million per year) is more of a symbolic value than a measure designed to markedly increase revenues, while progress in the affected group is far from being uniform, and – from this aspect – this measure does not actually take income differences into account.

14 "…market mechanisms appear in various forms in the performance of public functions. … We can establish that the cooperation described

above (i.e. PPP schemes – *inclusion by the author*), its potential usefulness, or even necessity cannot be questioned." *Gusztáv Báger: Public-private partnerships and audits, Public Finance Quarterly 2006.1, page 76*

15 "Hungary has no legally distinct PPP category. Legislators only refer to it…" *Mihály Varga: PPPs in Hungary – Do They Hurt Us or Help Us? Public Finance Quarterly, 2005 Consolidated Issue, page 62.* Furthermore: "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 …creating national regulation is a truly urgent task." *János Fónagy: PPP regulation is lacking, Public Finance Quarterly, 2006.3, page 367*

16 Functional and programme budgeting can also be mentioned here, since its specific disciplinary impact requires planning for a programme period usually spanning several years, which also counts with the influencing factors, and programme implementation also requires a specific impetus and compulsory path. The major characteristics, international and national experiences are well described by *Gusztáv Báger's* paper titled *Program budgeting-characteristic features and practical experiences, See: Public Finance Quarterly, 2006.3, pp. 284–305*

Among the guarantees, even more direct and targeted solution is provided by the tools of rule based fiscal policy interpreted in the narrower sense. The major elements of the relevant rule of law can be: budget policy rules (numerical limits on deficit, expenditure and debt), budget procedural rules (pertaining to medium-term budget planning or accrual accounting), transparency standards (reports on the financial standing of the state), and a monitoring and enforcing mechanism (possibly by an independent authority). *See: György Kopits: Conference on fiscal responsibility, Public Finance Quarterly, 2006.1, page 125*

Apart from the balanced budget and deficit requirements, the literature includes borrowing rules, reserve formation rules and the exchange rate system in fiscal policy rules interpreted in the broader sense. *See: István Benczes: Fiskális szabályok használata a Gazdasági és Monetáris Unióban, Külgazdaság, 2004.11, page 26* (The use of fiscal rules in the Economic and Monetary Union)

The major lessons of the conference on budgetary responsibility, including the authoritative international experiences of the responsibility framework of rule based budgeting is systematised in the paper compiled by *Gábor P. Kiss* and *László Kékesi. Conference on fiscal responsibility, Public Finance Quarterly, 2006.3, pp. 383–398*

17 Miklós Losoncz: Válasz a körkérdésre, *Külgazdaság, 2006.3, page 34 (Answers to the poll)*

18 Árpád Kovács: Competitiveness and Public Finances, *Public Finance Quarterly, 2005 Consolidated Issue, pp. 39–40*

19 Daniel Bergvall – Ian Hawkesworth – Dirk-Jan Kraan – Philipp Krause: Budgeting in Hungary, OECD study, *Public Finance Quarterly, 2006.3, pages 263–283.* The study 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 official report prepared about the review, which is much more sizeable than the cited study, also emphasises the anomalies indicated above: *see Budgeting in Hungary (GOV/PGC/SBO/2006/8), OECD, 2006, pp. 28–29.*

20 Zoltán Pitti honoured the author by providing a brief summary of his thoughts.

21 The latter is highlighted by Gábor Papanek in his book titled Tudásáramlás, jogbiztonság, együttműködés (Knowledge flow, legal certainty and cooperation), which maps the invisible resources of the development of the Hungarian economy, when he argues for the need to strengthen the economic role of knowledge. On pages 169 and 170 of his book he also points out that the basic tool for Hungary's progress is technology transfer in the broad sense of the word, and in particular the acceleration of the knowledge flow in every single field. The author presumes that this would allow for an annual growth rate 0.5–1% higher than that developed countries usually realise.

22 András Simonovits: Válasz a körkérdésre, *Külgazdaság, 2006.3, page 49 (Answers to the poll)*

László Akar

The economic policy turnaround and the new convergence programme

The Government that took office after the elections had to face an inescapable economic policy turnaround, which, by its very nature, had consequences in internal politics, too. At last, politics was required to frankly and profoundly consider the dramatic imbalance of the budget, which turned out to be even graver than the typical external expectations. This situation would have emerged after any election result, the only difference could have been witnessed in the presentation of the measures in internal politics, or maybe in the details of the chosen measures, however by that time the room for manoeuvre had narrowed down.

The economic policy shift was reflected in a general form in the Government's programme, but even more in the package of adjustment measures announced in June (and mostly specified in laws in July), and then in a more comprehensive and forward-looking manner in the new convergence programme, which was finalized by 1 September. The latter is true even if the analysis of longer-term reform steps in this document reflects uneven, not yet fully developed and rather general concepts in several fields due to the need for urgent programme development (apparently from the aspect of the current level of elaboration).

However all this clearly indicates that the Government opted for an economic turnaround, which has already been actually set off.

ECONOMIC POLICY LESSON – CRISIS OF THE EXTERNAL BALANCE OR THAT OF THE BUDGET?

Despite all possible analogies, the economic policy lesson that took shape by mid 2006 fundamentally differs from the situation characteristic for the turning point of 1994 and 1995. In contrast with the situation over a decade ago, neither the external balance, nor growth performance and inflation can be regarded as real problems. Yet, analogy does exist in the sense that due to the considerably disturbed balance of public finances massive and so called “front-loaded” adjustment (which yields significant results early on) became inevitable in both cases. (Interestingly enough, during the current adjustment cycle the primary balance of public finances should show exactly the same improvement as we could witness between 1994 and 1996.)

As far as the external balance is concerned, there circulate apparently different opinions. Apart from the methodology in force, the most comprehensive indicator of the external balance is the total of the current balance of payments and the balance of capital. The GDP proportionate value of this indicator dropped from 8.3% in 2004 to 6% by 2005 (according to the latest calculations), and is expected to be similar in 2006 (relative to the GDP calculated with the weak Hungarian currency). There is no doubt that the current level may also seem extremely high at first sight. At the same time however, according to the new methodology introduced a few years ago, the calculation of this deficit indicator also contains the not yet withdrawn profit of foreign owned companies (which is a natural feature of usual business operations), which means the automatic financing of part of the reported deficit. Reflecting this as well, in 2006 the use of non-debt generating resources is expected to exceed 60% in deficit financing. In addition, the foreign currency denominated debts of domestic companies and individuals will largely cover the funding of explicit indebtedness.

The realistic evaluation of the situation also requires noting that the external trade balance of goods and services (which are contained in the balance calculations of the GDP) is more or less in equilibrium, i.e. the deficit of the current balance of payments and balance of capital mostly arise from the natural demand for income realization from foreign direct investments, which have reached enormous proportions (obviously beneficially if the overall impacts are considered). On the other hand, the rapid growth of EU subsidies is expected to more and more favourably influence changes in this balance.

The relative acceptability of the external imbalance is suggested by the fact that the NBH has huge foreign currency reserves, and the interest margins of foreign exchange loans funding the state do not give rise to major concerns despite the deteriorating ratings.

All this shows that although the problem with the external balance is considerable, it shall not be considered as threatening for the time being. (Rather, it has the potential to turn into a serious problem, especially if the balance of public finances cannot be significantly improved).

As far as growth performance is concerned, the Hungarian economy can maintain the growth rate equalling the average growth of the EU-15 +2 percent. Obviously, the expected growth rate of around 4% does not reflect a crisis situation (especially if we take into account that more developed countries usually grow at a slower pace). Of course, an even more dynamic growth would be better, but the main problem of the current economic policy is not the lack of growth performance.

From among the balance indicators, inflation is undoubtedly low compared to the trend of the 1990s. If we look at core inflation, which reflects one-off impacts to a smaller extent, the inflation rate is still very favourable.

The public finance deficit has hit (negative) records in Europe since 2005, and the nearly 10% GDP relative level expected in 2006 is already alarming. This means that if we use rounded figures, the Hungarian state spends HUF 120 from each revenue unit of HUF 100, which is obviously unsustainable. The public finance debt, which is growing because of the large current public finance deficit, is getting more and more dangerous, since it puts an increasing burden on the current budget due to rising interest expenses, too.

If we cannot radically change this situation already in the short run, the so far tolerant external assessment of Hungary's external imbalance may be reconsidered.

The EU convergence rules explicitly aim at preventing excessive deficits, they want to make the member states comply with the below 3% limit. Experience shows that member states may get away with smaller deviations, but the current Hungarian deficit is far greater than the commonly seen discrepancy. Going upstream against the EU rules may turn off the EU money taps in a few years, which would deprive Hungary from huge development opportunities.

If convergence becomes unrealistic, the danger of negative market reactions would grow, a major foreign currency crisis may emerge, or even a general balance crisis may unfold.

On this basis, today's main economic policy problem is the high public finance deficit, the curbing of which must be in the focus even at the expense of temporary growth sacrifices. It is now not an end in itself to adjust the consumption/accumulation ratio by the reduction of consumption, or the regrouping of incomes to companies for the same purpose, or the significant increase of the incomes of exporting companies, or making imports considerably more expensive.

However, with a view to improve the balance of public finances, it is a goal to cut the end-user expenses of public finances, to change the sharing ratios between public finances and the other income earners, which will obviously restrain consumptions and corporate investments, too. However this can be regarded as a bearable side-effect of the treatment (in particular in the light of the preceding events).

IN SUMMARY: the new economic policy, which focuses on the consolidation of public finances, influences the other economic policy goals, too, therefore it entails, among other things, the relative narrowing of internal consumption, growth setback, rising inflation and the improvement of the external balance.

In the current situation it is justified to improve the public finance balance by relying on tools different from those used in 1995, when the general external and internal imbalance had to be treated with drastic measures.

The need for significantly improving the public finance balance coincides with the comprehensive problems of the operation of the state, and the similarly justified need for the implementation of the state reform. This condition also considerably influences what methods should be reasonably used in the current adjustment strategy.

THE ROAD LEADING TO THE DISRUPTION OF THE BUDGET BALANCE

Evaluation of the shift in the budget policy is not possible without examining what public finance processes have led to the high public finance deficit. According to the official forecast, from the GDP relative public finance deficit of around 3% in 2000, by 2006 Hungary has managed to inflate this deficit to 11.5% without the measures or 10% if the one-off impacts are deducted.

There are not sufficient comparative public data available for the exact analysis of the balance sheets per economic classification, which could probably describe the processes the best. What is more, the planned figures for 206 cannot be used for the huge discrepancies either. Yet, the major underlying factors can bee seen from the comparison of the final account cash flow expenditures grouped according to the economic classification of 2000 and 2005.

If we take into account the expected value of the five-year cumulative consumer price index (133.2%), the growth figures of real expenditures can also be calculated for the purpose of analysis. According to these calculations, between 2000 and 2005:

- transfers and subsidies considerably ran up, within which the growth of household subsidies was the largest, including the growth of pension expenses, which was the biggest item. (In addition, gas price subsidies, which evolved from scratch, also played a role.) If we ignore the inflationary impact, the real growth in household subsidies equals HUF 1,027 billion;
- due to the wage increase of civil servants and public employees, and the unrealized

reforms, the total gross personnel costs of the system of public finances almost doubled. This means an additional gross expenditure of HUF 867 billion on top of the inflationary compensation. If we deduct the public dues payable on wages, which are automatically re-channelled to this group, the net real growth in expenditure is still estimated to be around HUF 350 billion;

- the real costs of public services also grew by almost 50%, reflecting the expansion of the institutional system. This represents a real growth of HUF 122 billion.

From this we can conclude that – despite the common belief – the run-up of public finance expenditures is not primarily the direct consequence of the wage hike in the public sector, although this also played an important role. The growth in expenditure was first of all caused by the quick rise in household subsidies. One factor of this is the gas price subsidy scheme, but the main cause is the dynamic growth of pension expenditures. Through the rule of indexation, pensioners were favourably affected by the wage hike of the public sector and the reductions of the personal income tax, which were beefed up with the introduction of the 13th month pension and the augmentation of survivors' pensions. (In the case of pensions no automatic state revenue is generated like from the public dues on wages in the case of wage increases in the public sector; the only favourable budget consequence can be seen in the case of VAT revenues.) In addition, the change in the composition of retiring people also drives pension expenditures up.

The growth in expenditures was also triggered by the increase in the real costs of public services, and obviously by the boom of motorway construction (which cannot be quantified by cash flow figures, yet were partially compensated by restraining other development expenditures).

However, the other factor explaining the disruption of the balance was the implementation of tax cuts that were obviously oversized for the given expenditure policies.

THE SIZE AND TIMING OF THE NEED FOR ADJUSTMENT

According to the latest official calculations, without any measures the GDP relative public finance deficit would have totalled 11.6% this year, which would mean a primary deficit of 7.8%. Of course, the measures include one-off items to reach the 2009 goal, including, beyond any doubt, the GRIPEN purchases, the cancellation of the Iraqi debt, flood protection related expenses, the usual extra deficit of the local governments in the election years, and the utilisation of reserves from the previous year, which together equal around 1.8% of the GDP. Taking all this into account, if Hungary wants to achieve the desirable target in 2009, the primary balance must be adjusted by nearly 7%. This entirely corresponds to the improvement of the primary balance that was achieved between 1994 and 1996 as a result of the Bokros package. The current situation is more favourable in that we have 3.5 years, economic growth is higher than it was then, and the very high level of motorway investments considered in the baseline calculations may drop (partly due to the lessening development needs, and partly because of the expansion of real PPP projects). It is true, however, that the co-financing of EU programmes may require increasing expenditures.

In the emerging situation the regaining of the confidence of the market and the EU (with regard to the global money market processes, too) required that a strategy demonstrating significant progress in the adjustment as early as in mid 2006 should be followed. Therefore, it obviously became necessary to choose methods than can yield quick results, too.

POSSIBLE METHODS OF BUDGETARY ADJUSTMENT

Experience shows that the strategic methods of adjusting the primary balance may theoretically be standardized (of course, we can argue about the classification of the methods, and the individual cases are not fully isolated, either). Decision-makers that face such a task need to consider the following possibilities.

a *The use of surplus revenues from economic growth (and in particular from the rise in consumption and wages) for balance improvement,* if the budgets would put a freeze on the real value of expenditures (or on the nominal value in the stricter versions, or combine the two approaches). A specific case of this is when somehow economic growth can be accelerated and the economy and employment (in particular the legal economy and employment) can also be expanded.

b *Enforcement of balance improvement by inflation (preferably by surprise inflation)* Higher inflation a priori generates surplus revenues that improve the balance, if the nominal value of the expenditure items do not need to be increased (this is temporarily not possible in the case of debt associated interest expenditures denominated in Forint). A particularly interesting balance scenario is when price rises occur through the increase of consumption type taxes or the attachment of "price tags" to budgetary subsides. (We can also mention here the policy where inflation is underplanned on purpose, and the expenditure levels are linked to this inflation, and then surplus revenue is realized due to higher inflation, which can be used for the improvement of the balance.)

c *Intervention into the distribution of incomes* in the system of sharing public dues, increasing taxes and contributions directly affecting incomes. This can happen by reducing exceptions and exemptions, by imposing taxes on tax avoiders and/or by increasing the general taxes and contributions on incomes.

d *Reduction of transfers and subsidies,* which may mean the curtailment of payments primarily to the population, part of which are protected by the Constitution, therefore cannot or can only slightly be curbed.

e *Reduction of the expenditures (personnel and real expenditures) of public services.*

f *Reduction of cumulative expenditures* funded by the system of public finances.

FEASIBILITY OF THE POSSIBLE STRATEGIES IN THE COURSE OF THE CURRENT ADJUSTMENT

In Hungary all of the above mentioned methods have been tried in the recurrent restrictive cycles, and the various options have been often used in combination. Any time a serious imbalance occurred, for decades the first reaction was the immediate augmentation of the tax content of the prices of alcohol, cigarettes and petrol. Budgets that experimented with restraining investment expenditures were also a common sight.

The most renowned adjustment package, the so called Bokros package relied mainly on the so called surprise inflation, the devaluation of the Forint, the introduction of the customs surcharge, and the curbing of public finance expenditures. This programme also included both expenditure cuts and massive tax hikes, however, the main method of the latter was the introduction of the above mentioned customs surcharge, which set off inflation (the personal income tax was also increased).

It is worth reviewing the feasibility of each potential strategy that may be followed in the adjustment of the public finance system, which has become necessary and has been started lately. It is equally worth examining how such strategies have appeared in the decisions that have been adopted so far.

a *The strategy that builds on the impacts of growth* is the most gentle, most easily acceptable option, especially if it only requires the freezing of the real value of expenditures. However, this strategy cannot be used in certain areas (pension indexation, due to the increasing EU co-financing costs), and its stronger form can obviously be used only for a few years. What is more, with this method results can only be achieved later on (not at all in 2006, and at the earliest within the framework of the 2007 budget). Due to the aforesaid and the size of the public finance deficit, there is no way to use this strategy initially or by itself, although it could be applied later on. And this intention is indeed reflected in the convergence programme. The intentions that basically mean the freezing of nominal spending can be revealed especially in all public sector operational expenditures, but also in other expenditure items.

It must be examined separately, how the public finance balance can be improved by accelerating economic growth and by expanding employment (in particular legal employment), as well as by the reduction of social security contributions to this end. In the short run, the reduction of the public dues on employment would certainly entail revenue losses only, and (to a smaller extent) this phenomenon would probably prevail in the longer run, too. The expansion of employment is restrained by the market (especially by external markets in Hungary's case), and the larger scale reduction of the grey economy can hardly be expected from the realistically presumable general improvement of the so called wage wedge (the share of public dues from all wage costs).

The advocates of balance improvement by tax cuts emphasize, among other things, the success of the reduction of corporate income tax by 50% at the beginning of 1995. However, the real value of tax revenues did not actually increase at that time either. The relatively strong tax-paying discipline was mainly caused by other impacts, including especially the dynamic growth of corporate profits from an unbelievably low level due to the massive reduction of real wages. We must add though that in those days the corporate income tax played a rather insignificant role in public finance revenue. In contrast, public dues on wages currently represent the main sources of revenues, and their reduction by 50% (or even 25%) could hardly be undertaken even in a more stable budget situation due to the risk of an enormous loss of revenues.

b *The inflation based adjustment strategy* can only moderately applied in the current situation, compared to 1995. In principle, it is easy to turn inflation up, but then it is difficult to bring it down. Having the objective of adopting the euro, Hungary can hardly undertake significant (say 10%) inflation acceleration, since then it would take a long time to reach price stability. Furthermore, with the current legal role of NBH, such an economic policy shift would be against the price stability objective of NBH, which could trigger astronomical interest rates due to the different target functions (temporarily increasing the budgetary burdens, too). Seemingly it is easier to choose an inflation based adjustment policy (the direct losers of the measures remain invisible versus in the case of tax rises and subsidy cuts), but its practical implementation would be rather difficult today, since the Government cannot decide about the exchange rate, and the room of manoeuvre of officially fixed prices (tax content increase) is also limited (and conflict-ridden).

At the same time, the preceding events put the partial application of this strategy on a "forced orbit". The half-finished VAT reform had to be completed, and gas price rises are inevitable due to the current world market prices. Meanwhile, the devaluation of the Forint, which was triggered by several causes (including causes influenced by the Government and the NBH) – albeit to a smaller extent – induces inflation. Therefore, inflation does have a role in adjustment, but it cannot be regarded as the number one player.

c *The strategy modifying the distribution of incomes* is supported first of all by the fact that it can be quickly implemented, and according to the analysis of the previous years, tax reduction is no longer an option, what is more, without any measures the net real wage rise in 2006 would have exceeded 5%, which is far from the level that could be justified by economic performance (if the growth performance and the deterioration of the terms of trade are taken into account). Obviously, it is easier to undertake the increase of burdens by curbing tax allowances and reducing tax avoidance. The raising of the general tax rates (especially those on live labour) is more problematic. The first stage of adjustment greatly relied on such measures. Several measures are designed to reduce tax avoidance (contribution payment on the basis of twice the minimum wage, etc.) while the increase of the individual contributions, the two types of solidarity tax and the tax on income from interest gains will modify the proportions of income distribution for a longer time.

d Within the framework of the *strategy based on the reduction of transfers*, one can hardly argue – from the economic point of view – about the need for the significant curtailment of household gas price subsidies (to pass on the considerable growth in import prices) and the transformation of the remaining subsidies into means tested social subsidies. The restraint of the growth in pharmaceutical subsidies is also long overdue. The interest subsidies associated with housing loans are based on set conditions, while new loans are drawn in foreign currencies (without subsidies). Pensions are protected by constitutional provisions, wherefore the only options include the modification of the rules of annual pension rises, and in theory, the reform of the 13th month's pension, and the restructuring of the system of disability pensions, which has been postponed for a long time.

It seems that restraining the transfers is difficult because of the social consequences. Certain partial reforms may yield some savings, but naturally, this cannot be the main strategy of adjustment. The already adopted governmental decisions include the transformation and narrowing of the gas price subsidy scheme, and the convergence programme earmarks the rationalization and transformation of the system of disability pensions into a separate system. The convergence programme also outlines the need for further corrections in the pension system, albeit only in rather general terms.

e *The strategy restraining the expenditures of public services provided by the state* can be made accepted relatively most easily, and it is expected to trigger resistance by the affected (but influential) minority "only". This strategy can be regarded justified based on the processes of the past years and also due to the need for the state reform. Furthermore, the need for following this strategy is also supported by the current status of public services as a whole, the low level of realization of economies of scale, the over-inflated organizational structure and the quality of operations. At the same time though, in this case the financial impact of the measures is delayed, and the preparation of the decisions is also time-consuming (especially in the local governmental sector). Therefore, this strategy can only be used as part of a strategy mix, but it will play an important role in the implementation of the adjustment according to the convergence programme.

The ideas pertaining to the rationalization of the central public administration are relatively clear-cut and mature in terms of direction in the convergence programme. Yet, most of the expenditures are linked to the local governmental sector, where the road could not yet been opened to the introduction of mandatory small regional cooperation and regional administration with laws requiring the support of two thirds of the members of Parliament. Hopefully, a consensus will be reached in this matter after the local governmental elections. If the consensus falls through (and also, until a consensus is reached), in principle the local governmental system can be significantly rationalized by the adequate modification of the financial funding rules and the relevant laws. However, it is not yet clear from the convergence programme, what methods will be used for this purpose.

f *The strategy aiming at restricting investments* seems to be only partially applicable given the ongoing road construction projects and the needs for EU co-financing. Yet, the channelling of development needs into EU programmes and the very high level of investments in 2006 (and the prevalence of the PPP scheme in new developments) do provide some possibilities in this area, too.

IN SUMMARY: it seems that due to the magnitude of the required adjustments and the need for significant results early on, the realistic way could only be a strategy mix, and this approach is reflected in the decisions and programmes adopted so far.

The Government expects quick results primarily from strategy *c)*, which affects income distribution, and strategy *b)*, which is a more moderate, inflation based strategy primarily building on a direct budgetary impact. This expectation is well-founded.

On the other hand, in later stages of the adjustment (according to the convergence programme, the adoption of which in the budget for 2007 is still to come) preference will be given to strategy *e)* (rationalization of public services) and strategy *a)* (building on growth and the freezing of expenditures), but strategy *f)* (restraining investment expenditures from own resources, re-channelling tasks into EU programmes) may also be applicable. Strategy *d)* (reduction of transfers) can probably contribute to balance improvement to a larger extent only in certain specific areas. (Apparently, this strategy will take over as a main strategy only after all other options have been exhausted.)

PUBLIC FINANCE ADJUSTMENT PATH FOR THE 2006-2009 PERIOD

According to the convergence programme, although public dues will increase by 4% of the GDP due to the measures adopted in the summer of 2006 (compared to the situation which would have emerged without the measures, and without considering the cancelled tax cuts scheduled to be implemented later on), but approximately 2 percentage points of this will automatically decentralize later on due to the characteristics of the economic policy path (low level of consumption and wage hikes). Therefore, the increase in public dues will ultimately contribute to the improvement of the balance only by around 2% of the GDP.

The convergence programme plans to reduce the operational expenditures of the public sector by 3.2%, i.e. from 18.4% to 15.2%. Assuming a nominal GDP growth of 23% this means that in three years the total nominal value of these expenditures can increase only by 1.5 to 2%, i.e. they must practically be stagnant.

In relation to investment projects and other government programmes implemented exclusively from domestic resources, the convergence programme counts with savings of nearly 2%.

In addition, the liquidation of the gas price subsidy scheme can be started and several other balance improving measures can be taken. Nonetheless, it is true that the non-recurrence of one-off expenditures technically appears as saving in the programme.

IN SUMMARY: with the planned measures we have all right to hope that the primary balance can be adjusted by 7%, in particular if we take into account the reserves arising from revenues as well as from the not fully quantified potential measurements.

Naturally, the rise in the interest level (temporarily over the level assumed in the programme) will influence the current status of the entire public finance balance. Yet, in the course of a longer-term adjustment the most important factor is the primary balance, since as convergence progresses, domestic interests will adapt to the system of euro interests. As far as the current public finance deficit is concerned, the ultimate impact of the temporarily less favourable interest balance becomes visible only through the additional interest burdens of the higher state debts. However, this is not an extremely huge amount, and should state debts reach this amount, it can be offset with privatization proceeds. (What is more, the annual target balances that are planned with some reserves are able to tolerate minor interest growths.)

CONCLUSIONS

The analysis shows that the decisions adopted so far and the convergence programme more or less follow a rational and expedient practice in relation to the strategic methods for the adjustment of public finances and in relation to the order of the application of the selected strategies. In the first stage of the adjustment controlled inflation rise and intervention into income distribution dominate, and then the rationalization of public services gains ground. At the same time, a few other strategies are also applied. The exact proportions of use may obviously change later on, since the revenue side has been forecast with a pessimistic approach. (The faster than assumed growth of wages in the business sector, the non-occurrence of the anticipated decline in consumption may clearly improve the budget balance.)

All this does not necessarily mean that the selected strategy mix has been and will be followed with the optimum tools during the enforcement of the individual strategies. The greatest risk is implied especially in the fact that the reform concepts have not reached full maturity. Therefore, from this point of view the convergence programme cannot be fully evaluated yet.

Since the Government expects that nearly half of real adjustments would come from the rationalization of public services, it is worth pointing out the related dilemmas. The curtailment of expenditures can in theory be implemented by almost retaining the existing structures, through the reduction of real wages while maintaining the current level of employment. This would not yield a permanent solution, and would sooner or later regenerate the public finance imbalance (the large-scale wage corrections of 2001 and 2002 also reflected the cumulative, ten-year backlog of the public sector.) At the same time, adjustment may also be carried out through the real rationalization of the public sector, the growing realization of economies of scale, by cutting back excess capacities (and employment), and by the reconsideration of processes. Keeping to such a path would yield permanent savings.

Therefore, the real issue is now a dual question. The first question is whether the plans outlined in the convergence programme are followed by consistent implementation, and the other is to what extent implementation can be both professionally and socially acceptable especially on the expenditure side, i.e. to put it more simply: are there across-the-board cuts and unstable improvement, or real reforms and permanent solutions?

The – hopefully positive – answers (or the majority of the answers) to these questions will be given by the budget for 2007 and the reform acts to be passed in 2007.

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Economic policy reflections in view of the 2006 convergence programme

Member states that have not yet adopted the euro submit convergence programmes to the competent organisations of the EU, the Council and the Commission each year. It is common knowledge that the Council requested that the Hungarian programme submitted in 2005 should be revised for the known reasons. This updated programme states already on the first page that "…the new Government, which took office in June 2006, presents in the programme the medium term objectives of its economic policy, in particular the way to consolidate the high deficit." (Convergence Programme of Hungary, 2005–2009)

We find it important to state early on that the title of this article was initiated – among other things – by the aforementioned. It is obvious that the publication of the programme were long awaited not only by the citizens, but also and in particular by the professional circles of the country. From our point of view the most important question was whether the economic policy would finally be properly outlined after so many years. (Veress, 2006) Since in the last years macroeconomic parameters have shown a worrisome downward trend, especially for the lack of a marked economic policy, it was expected that the convergence programme would include crisis management elements, i.e. there would be a pool of assessable economic policy measures even in the absence of a specific philosophy.

According to the programme "…the New Hungary Development Plan (NHDP) and the National Action Programme (NAP) are being prepared simultaneously with the convergence programme. The NHDP outlines the main trends of development policy of the 2007-2013 period." (Convergence Programme of Hungary, 2005–2009) We need to add that the elaboration of the New Hungary Rural Development Strategic Plan (2007–2013) is also under way. We possess the available versions of said materials, however since these documents have not yet been fully elaborated, we will not include them in our analysis. Nonetheless, we draw attention to the fact that the convergence programme, which is explicitly regarded as a collection of economic policy ideas by its authors, does not contain such development policy benchmarks that could set the trend for the New Hungary plans. This is either a mistake, or lack of concept (lack of strategy), or a conscious (economic) policy premise. This can partly be judged by time, and partly by one's own specific economic philosophy.

The convergence programme outlines Hungary's medium term path and naturally, the underlying measures that will lead to the fulfilment of the Maastricht criteria. However, the requirements pertaining to the means used to achieve the objectives are seldom heard of. The convergence programme must fit into the general social and economic development concepts – if such exist at all – to the greatest possible extent.

In this paper our aim is not to examine whether the measures earmarked by the updated convergence programme will lead to the desired quantitative improvement in relation to the public finance deficit. Competent expert opinions are explicitly positive in this field, and it is undoubtedly true that the outlined macroeconomic path *(see Annex)* is (more) realistic this time. However, we find that the evolution of certain indicators in time is not well-founded. (We will discuss such indicators later on.) The main objective is to scrutinise how the tool portfolio of the programme suits the topical problems of the Hungarian society and economy, as well as the development trends that we have all right to expect therefrom. Due to the chronic internal and external imbalance, and the grasp of the international monetary market, the convergence programme necessarily contains emergency restrictive fiscal policy elements, the natural consequence of which is the short-term decline in growth and welfare. However, it does matter a lot how we structure the package of economic policy measures we intend to use. If we significantly deviate from the necessary minimum setback, the short-term negative impacts may sustain in the medium and long run, too.

Yet, the evaluation of the convergence programme from the aspect of the Hungarian economy and society is only one – albeit the most important – aspects. We also examine to what extent the programme fits into the frameworks of neoliberal mainstream economic policy, particularly into the directives formulated in the Washington Consensus.

ECONOMIC AND SOCIAL REVIEW

Internal and external imbalance: facts and background

The GDP proportionate deficit of public finances has been extremely high since 2002. Incessant overspending can also be felt in the growth of state debts, which will reach nearly 70% of the GDP this year according to the forecasts. In addition to the need for evading the debt trap and all the negative economic and social impacts thereof the increasing loss of confidence by the international money markets also call for immediate adjustment.

The chronic external imbalance of the coun-

Table 1

INDICES OF THE INTERNAL IMBALANCE

	2000	2001	2002	2003	2004	2005	2006*
Public finance deficit (GDP %)[1]	3.6	3	9.1	7.3	6.6	7.5	10.1
Gross state debts (GDP %)[2]	54.4	51.5	56.6	58.9	60.2	62.3	68.5

Source: www.p-m.hu

1 2000–2001: GFS without revenues from privatisation, 2002-2006: ESA95 figures
2 2000–2001: gross debt of the central budget, 2002-2006: consolidated state debt according to ESA95

* forecast

try is also growing at a worrisome pace. The total deficit of the current balance of payments and capital, which determines the country's need for external funding, has been around 6.5 to 9 percent of the GDP in all years but one since 1998. So far the different forms of foreign investments have usually covered the economy's excessive need for resources, but it is evident that this cannot be maintained in the long run. With such external funding the GDP proportionate net external debt[1] of the national economy and the outflowing incomes will continuously rise.

Unfortunately, the structural trends of the current balance of payments convey an unambiguous message: the country is being in an external debt trap. The need for external financing exceeds the growth rate of the GDP, and the problem has been augmented by the outflow of incomes yielded from foreign investments at a rate of 7 to 8% of the GDP since 1996. This means that the restoration of the external balance is very urgent. *(See Tables 1 and 2)*

However, the chronic external imbalance actually stems from the fatal economic policy "blunders", which, together with the export demand related consequences of the dissolution of COMECOM led to the collapse of the Hungarian corporate sector in the years following the political turnaround: the straightforward introduction of the accounting and bankruptcy laws, as well as the drastic liberalisation of imports. The place of companies that went out of business because of chain debts and competitive disadvantage compared to western companies was taken over by imported goods and multinational companies that settled in Hungary to satisfy internal demand. The deterioration of the foreign trade balance caused by increased imports could be alleviated by the exports of multinational companies at a much smaller extent than it could have been done by the exports of domestic companies, since these multinational companies have not yet fully integrated into the Hungarian economy, as a result of which they work with a high import ratio. The income produced by foreign direct investments

Table 2

SIZE OF THE EXTERNAL IMBALANCE AND THE MAJOR FACTORS THEREOF*

(as a percentage of the GDP)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Balance of goods and services	–0.3	0.5	1	–1.5	–2.7	–3.8	–1.4	–2.3	–4.5	–2.9	–1.3
Balance of incomes	–3.8	–4.4	–5.9	–6.3	–6	–5.5	–5.5	–5.5	–5	–6	–6.3
Outflow of income from direct capital portfolio and other investments[1]	5.7	7.1	9.1	8.8	7.7	7.8	7.8	7.3	6.5	7.8	n.a.
Income yielded from foreign direct investments	0.4	2	4.1	4.5	4.5	4.3	4.5	4.8	4.3	5.4	n.a.
Current balance of payments +balance of capital (need for external funding)	–3.5	–3.6	–4.2	–6.8	–7.8	–7.9	–5.5	–6.8	–8.7	–8.3	–6.6
Balance of payments (changes in internal reserves)	10.2	–3.2	–0.3	1.8	0.5	2.3	–0.1	–2.8	0.7	1.9	4.4

Source: National Bank of Hungary. HCSO

* rounded values, relevant items of the balance of payments

[1] outflow of income yielded from (foreign) direct capital, portfolio and other investments

also deteriorates the current balance of payments and increase the need for external funding (by 4 to 5 percentage points in the past ten years)[2]. The domestic corporate sector has not been able to regain sufficient strength to occupy its former position on the domestic markets, or to act as a significant exporter or investor on the external markets. This is also reflected in the inequilibrium of the balance of goods and services and that of incomes. Therefore, the dual real economy still plays a major role in the external imbalance, which is augmented by the traditional twin deficit problem.

The reasons behind internal imbalance include the protracted reform of public administration and the large provision systems, but we can state that dual economy may also have a role here (Lóránt, 2006).

Therefore, if we aim at providing a proper remedy rather than merely treating the symptoms of the twin deficit, we must give up the lopsided traditional therapy: by restraining government and private consumption we must focus on the conscious strengthening of the domestic corporate sector, too (Lóránt, 2006). The solidification of the Hungarian companies would increase budgetary revenues, improve the foreign trade balance, and reduce the GDP proportionate outflow of incomes generated by the multinational companies. Thus, the external balance would be achieved by relying on internal resources, which would ensure long-term sustainability and foster the balance of public finances. However, the latter inevitably requires the rationalisation of public administration and the large provision systems.

This means that cure is available, however the patient's condition is already too critical. This is why the current economic policy management is in real trouble. The need for alleviating economic imbalances already in the short run leads to such revenue increasing and expense curbing measures that are necessarily somewhat inconsistent with the creation of sustainable balance (the strengthening of the Hungarian economic sector). Despite this fact the convergence programme cannot go without measures showing towards the latter aim, or at least the concepts for the period following the temporary consolidation of the imbalance.

Labour market

The neuralgic point of the Hungarian labour market is the economic activity and employment rate of the population. The two indicators pertaining to the "economic activity" of the working age population is low even by international standards. Although a slow improvement has started since the mid 1990s, Hungary is very much lagging behind the EU average. *(See Table 3)*

The low employment rate puts excessive burden on those maintaining the society. It is inevitable to increase the economic activity rate of the population if we want to handle more

Table 3

RATE OF ECONOMIC ACTIVITY OF THE POPULATION AGED 15–74

	1998	1999	2000	2001	2002	2003	2004	2005
Activity rate[1]	51.4	52.6	53	52.8	52.9	53.8	53.8	54.5
Employment rate[2]	47.4	48.9	49.6	49.8	49.9	50.6	50.5	50.5

Source: HCSO

[1] (employees + the unemployed)/population in the 15–74 age group

[2] employees/population in the15–74 age group

easily the challenges arising from the demographic processes in the coming 50 years. Therefore, the primary task of the economic policy is not only to create jobs, but also to increase the willingness to be employed.

Income polarisation and poverty in the Hungarian society

According to OECD's poverty and income polarisation statistics for 2000, Hungary is not lagging behind in this respect by international standards. The GINI index more or less corresponds to the OECD average, while the applied relative poverty index[3] shows a below average value. However, poverty cannot be observed in a relative manner, since subsistence is an absolute category.

The income polarisation of the Hungarian society has slightly grown in the past ten years, however, the deterioration is considerable compared to the level immediately preceding the year of the political turnaround. While in 1987 the average income in the upper income percentile was 4.6 times higher than the income in the lowest percentile, the same ratio was 7.6 in 2004 (HCSO, 2006a).

Despite the fact that there exists a multitude of relative poverty indicators, one can obtain an objective picture about poverty only on the basis of subsistence level calculations – provided we accept the relevant methodology developed by the statistical offices. According to the HCSO figures, the subsistence level in Hungary was HUF 56,408 in 2005 per consumption unit[4]. We have no information as per how many households may live below the subsistence level computed based on the composition of the households. At the same time, using the subsistence amounts calculated by HCSO for different family types *(See Table 4)* and the average incomes we can picture the load-bearing capacity of a demographically sound, average Hungarian family. In 2005, the average income of households with one earner was HUF 103,149[5], or twice as much (HUF 206,298) in case of two earners. If we compare these amounts with the subsistence levels calculated for demographically sound Hungarian households (1 or 2 adults with at least two children) we can see that one-earner families cannot bear any additional burden, and two-earner families can only hardly do so.

EVALUATION OF THE TOOL PORTFOLIO

It is required from any economic and social policy programme that its tools should fit as much as possible to the neuralgic points of the economy and the society, and the development trends that can be derived therefrom. In the first part of the study we briefly reviewed some of the issues that are important for Hungary. Here we are trying to find out how the measures – already adopted or planned – laid down in the convergence programme will help

Table 4

SUBSISTENCE LEVEL OF HOUSEHOLDS

(2005)

HUF/month	1 adult	1 adult, 1 child	1 adult, 2 children	2 adults	2 adults, 1 child	2 adults, 2 children	2 adults, 3 children
subsistence level	56.408	93.073	121.277	98.714	135.379	163.583	186.146

Source: HCSO (2006b)

resolve or deepen these problems. We pay special attention to the evaluation of structural reforms – stipulated in the programme – vital for the long-term balance of public finances in the fields of central and regional public administration, healthcare, the pension system, higher education and public education. The tool portfolio of the convergence programme is contained in the Annex broken down according to the subjects of evaluation. Where preliminary calculations were available, we also indicated the amounts of the expected income growth and expense cuts in order to illustrate the relative weight of the individual measures.

Impact on the economic activity of the working age

Apart from making the conditions for unemployment benefits more stringent, the economic policy can increase the willingness of the working age population to be employed by reducing the rate of taxes and contributions payable after employee earned incomes. The measures earmarked by the convergence programme show in the opposite direction. Apart from the extension of the personal income tax brackets, the changes planned to be implemented by the end of 2007 will all decrease net incomes, and thus offset incentives such as the transformation of the unemployment benefit into job seekers' benefit at the end of 2005, or the system of pension premium[6]. It is only the solidarity tax affecting higher income earners that is not expected to significantly affect the willingness to enter into employment.

It is true that the tax and contribution rises affecting employee earnings include measures that are reasonable from the social or economic point of view, such as the rise in the health insurance contribution – in the light of the funding difficulties of the healthcare system – or the introduction of the solidarity tax, or the inclusion of pension in the consolidated tax base. However, this does not change the fact that the measures counteract the aim of increasing the activity rate of the working age population, which should be a top economic policy priority given the expected drastic rise in the rate of dependents/potential supporters (people above the retirement age/working age population)[7] if the current demographic trends continue. Naturally, income centralisation is expected to reduce as the balance of public finances improves, however the programme does not elaborate on which tax and contribution elements will be concretely affected.

Impact on poverty and the polarisation of the living standards

We have already concluded in relation to the complex economic and social review that a demographically sound average Hungarian family (1 or 2 adults with at least 2 children) cannot or can only hardly bear further burdens, since they either live below the subsistence level, or their income is only 10 to 25% higher than that. This also means that these families spend the overwhelming majority of their income on consumption, and their savings are not significant. As a result, taxes on consumption or the rise in public utility and public service fees will immediately affect their living standards, while taxes on savings will affect their ability to accumulate (and thus indirectly they also slightly deteriorate their future living standards). These taxes and prices also increase the subsistence level, and consequently poverty, even if this is not necessarily reflected in income polarisation. Therefore, the immediate effect of the augmentation of public utility and public service fees, as well as that of consumption related taxes will be the polarisation of living standards.

The programme's measures pertaining to the taxes on consumption and savings, as well as to public service and public utility fees temporarily project the increase of poverty and the further polarisation of living standards, the time horizon of which depends on the dynamics of per capita real income. It is uncertain whether households will be able to live through this period without any "permanent scars".

Apart from the immediate need for increasing revenues and decreasing expenditures the only measure that shows the signs of long-term thinking about sustainable public finance balance is the review and reduction of consumer price subsidies.

Impact from the aspect of the dual real economy

When examining the tool portfolio of the convergence programme in this respect, we intend to learn whether the measures affecting the entrepreneurial/corporate[8] sector differentiate between the domestic and foreign companies in terms of the burden sharing. It is well known that the competition regulation of the European Union prohibits negative discrimination against companies based on the country of origin, however, discrimination is possible in the case of large companies versus SMEs[9] when setting the tax and contribution rates. Due to the duality feature of the Hungarian real economy this would also mean hidden differentiation between the foreign and domestic corporate sectors, since the activity/economic power of foreign companies is much more concentrated in the group of large companies.[10] Furthermore, the structural differences between large companies and SMEs (average turnover, pre-tax profit, import/export ratio, work productivity, etc.) offer various techniques of giving preference to domestic companies on a silver plate.

From among the measures affecting the enterprise sector, the minimum contribution base, the expected tax and the petty cash tax serve the bleaching of the economy. Since the grey economy is mostly typical for the SME sector, (it is easier for the tax authority to control large companies for the quantity of such companies), therefore these measures affect the domestic entrepreneurial/corporate sector to a larger extent. It would be difficult to argue that the declaration of minimum wage for tax or contribution avoidance, or the accounting of revenues as expenditures with bogus invoices, or keeping high amounts of cash in hand in order to escape income tax payments are mostly typical for self-employed people and small enterprises.

Raising the rate of the simplified entrepreneurial tax is also a change that primarily affects Hungarian owned enterprises, since the requirements pertaining to the business form and income ceiling[11] of taxpayers *de facto* narrows the group of eligible entities to the SME sector.

The SME and the large corporate sectors – and therefore foreign and domestic companies alike – are affected to the same extent by the revocation of the plans to reduce employers' contributions, the local business tax and the healthcare contribution, and by the extra tax of 4% payable by corporations/enterprises.

The annuity payable by credit institutions on interest income from loans associated with state subsidies is a reasonable step, and based on the ownership structure of the Hungarian market of financial institutions we can state that in contrast with all the other measures, this measure primarily increases the burden on foreigners[12].

All in all it can be said that all major measures affecting the entrepreneurial sector but one are more detrimental to or equally affect Hungarian and foreign companies. The effort made to bleach the economy is justified and welcome. Furthermore, considering the parameters of the petty cash tax, the minimum contribution base and the expected tax, they will not threaten the functioning of SMEs operating outside the grey economy. Despite this fact, knowing the structural problems of the real economy, it would have been absolutely advisable to increase the tax rate affecting multinational companies instead of raising the rate of the simplified entrepreneurial tax, and to differentiate between measures that now affect the two corporate sectors without differentiation (for example the elimination of the local business tax only for SMEs), especially in the light of the fact that there are huge differences between SMEs and large companies in terms of the average size of tax allowances (payable tax/computed tax), favouring the latter group[13]. Therefore, the relevant measures of the convergence programme do not move in the direction of the liquidation of the dual real economy and unsoundly structured growth. What is more, the wording of the programme suggests that the authors were not aware of one of the most neuralgic points of the Hungarian economy.

Public administration reform

Elements in which the size of savings can be projected relatively well can mostly be found in public sector related measures; expenditures will be cut by 3.2% of the GDP by 2009.

The first step that will have an impact already in the short run is staff reduction in the central public administration. The downsizing of 20% effectuated earlier, and that of 10% to be implemented by the end of the year will save HUF 35 billion in the short run, but its cost reducing effect will linger on for a longer term. At the same time, laid off people will increase social costs (unemployment benefit), and on the other hand – if we would like to redirect them to other segments of the labour market – state support provided for their retraining is also a cost increasing factor. Finally, social security revenues will also decline due to the loss of contributions paid by the redundant employees. These aspects may also emerge as long-term impacts.

The concept of changing the current local governmental system is another important element that is planned to be solved on the funding side. In the past 16 years local governmental resources have continuously dropped, they have been reallocated by each government to their own benefit, just to later be redistributed on the basis of various directives. According to the programme, the operation of the fully fragmented Hungarian local governmental system must be rationalised, regional and small regional associations must be set up to fulfil jointly implementable tasks (for example education). Although the idea seems to be worth supporting, it can cause too many problems that the Government intends to "encourage" the establishment of associations from above, which in reality means the significant curtailment of the number of normative supports, i.e. there is nothing new in this approach. Although it would be more reasonable if forms of cooperation were set up bottom up, using more local resources – based on the local interests and endowments – such cooperation is nothing but utopia under the current conditions. Obviously, the withdrawal of funds can be easily implemented, the Government expects to reduce the costs by over HUF 49 billion, however the impact and implementability of the measures are questionable because of the local resistance.

Performance evaluation and the general use of performance related wages are introduced in the public sector. This idea can be supported at theoretical level, if a definitely exact measurement method is elaborated. However, in most public sector fields but a few it is very much doubtful on the basis of what standards bad or good performance could be identified. On one hand, too many subjective elements in the algorithm may deteriorate workplace morale, while on the other hand wage costs can be occasionally retained, which can be used as a tool to reduce the deficit of organisations working inefficiently due to bad management, and may reduce budgetary expenditures if this becomes a general practice in the entire public sector.

The elimination of parallel functional fields, the winding-up of institutions and the spreading of electronic public administration are elements that would decrease the costs by HUF 22 billion, (real estate related expenditures, drop in material and wage costs), and at the same time they also correspond to the centralisation of institutions and the need for smaller staff. However, the elaboration and development of the new system, and the training of operators[14] temporarily require higher expenditure.

The reform of the pension system

The demographic processes continue to be unfavourable, and increase the deficit of the system despite the envisaged long-term adjustments. Real improvement in the ratio of supporters/dependents would be achieved by making the inactive working age population economically active. However, there is a "simpler solution": changing (raising) the working age category, but basically this is just an emergency measure, the postponement of the problem. Measures that aim to reduce the amount of pension benefits for early retirees and at the same time ban wage-earning activities in such a status, also serve the rapid solution of the problem by making people less interested in leaving the labour market.

The charges payable by employed pensioners will also rise, their income will be untaxed benefits (which will generate revenues of HUF 32 billion in 2007), and employed pensioners will be required to pay a 4% in-kind healthcare contribution (HUF 8 billion in revenues in 2006). The latter raises an interesting question in relation to the planned restrictions of the use of healthcare services: what services will an employed pensioner be eligible for in the doctor's office if he does not pay contribution? Will he be eligible for all services if he "introduces himself" as a pensioner, or only for basic care services if he "introduces himself" as an employee?

The elimination of the anomalies of pension calculation (valorisation), and the 13th month pension also represent long-term expenditure growth. The fact that the 13th month pension has not been abolished, contradicts the principle that says that a shift must be made from the exceptions towards the general rule, and it has not been a good decision for the improvement of the balance either.

Disability pension becomes a separate service branch, with better control to combat abuses and rehabilitation activities. This measure is completely justified since budget expenditures entailed by the enormous number of abuses are huge. Abuses trigger losses not only through the unjustified payment of benefits, but also through those state subsidies that were provided for the employment of people with reduced working abilities, who thus indirectly "reduced" the employment opportunities of "normal" job seekers, since in certain jobs companies preferred the employment of people with reduced working abilities. Therefore, the measure can only be comprehensive if stricter control is extended not only to the new cases, but also to all people on disability pension retroactively. In case an abuse is proven without any doubt, adequate criminal and civil law actions should be initiated.

Sustainability is designed to be temporarily improved by shifting the proportions within the 29% social security contribution payable by employers, i.e. reducing the healthcare contribution from 11 to 8% and raising the pension contribution from 18 to 21%.

Despite the measures already in place the pension system will require growing budgetary support in the future. The payments to be gradually made by private pension funds will not keep pace with the increment in the total pension spending in relation to the GDP, which will trigger an increase in the expenditures of the first pillar[15]. Knowing the demographic processes, the revenues of the Pension Insurance Fund will not be sufficient to fill that void. The question is raised: if anything else is ignored, how can we meet the Maastricht requirement pertaining to the public finance balance, if the deficit of the Pension Insurance Fund calculated with net pension expenditures will reach 3.9% of the GDP in 2050 according to the projection of the convergence programme? Of course, by then this requirement will probably be a thing of the past.

Healthcare reform

The deficit of the Health Insurance Fund totalled around 1.6 to 1.8% of the GDP in the past years. The deficit is considerable and well exceeds the level witnessed in the second half of the 1990s. Expenditures have also increased in terms of real value.

The "distortions" influencing the Health Insurance Fund can be summarized as follows:

Revenue side

- Unrealized contributions:
  - "social security cheaters": people who would not be eligible for healthcare services other than basic services (accident, emergency treatment, etc.) available on the basis of citizenship. The number of such people is estimated to be 500,000;
  - a group of persons that pay contribution on the basis of the minimum wage presumably earn more than the minimum wage.

Expenditure side:

- Increasing and high pharmaceutical subsidies: between 1998 and 2005, the turnover of subsidised drugs nearly tripled, while we now spend nearly 20% more on inpatient care than on pharmaceutical subsidies. The reason behind this is the small share of lower-cost generic products from the turnover (around 25%), and partly the excessive use of drugs.
- The number of direct "physician-patient contacts" is outstandingly high even by European standards.
- There are under-utilised hospital beds, disproportionate distribution of capacity, fragmented hospital departments.
- Hospital-oriented care as opposed to outpatient-oriented care: some patients treated in active hospital care could be efficiently treated in the less expensive outpatient care. (Active inpatient treatment is the most expensive form of treatment: the maintenance of a single hospital bed costs about HUF 5.5 million a year.) It reveals a lot that in the Netherlands and Great Britain seven and 17 times more one-day surgeries are performed, respectively, than in Hungary (Green Paper on Healthcare). The streamlining of unjustified inpatient care would yield a significant drop in expenditure, since this item accounts for more than 25% of the Health Insurance Fund.
- The "blurring" of curative and nursing services: part of the care provided on active hospital beds is of a social (nursing) character rather than curative after which the health insurance fund pays a normative support available to the considerably more expensive curative activities. Nursing is becoming a more and more serious problem in our aging society. However, for the lack of adequate infrastructure, nursing is mostly an unsolved problem – except for in the fee-paying private institutions – wherefore, in the absence of other alternatives, people in need often end up on hospital beds.

The measures that were mostly just outlined in the convergence programme, but have more or less been finalized since then, affect the distortions of both the revenue and expenditure sides. During the discussion of such measures, we will evaluate the operative decisions if such already exist.

In order to screen "social security cheaters", the control of the payment of social security contributions is planned to be made more stringent, and the introduction of the minimum contribution wage is designed to combat the evasion of contribution payment. Eligibility packages based on non-insurance, insurance and supplementary insurance have started to be worked out. In the light of the equitable and just distribution of public charges and dues these measures seem to be justified. (It is too early to jump to conclusions, however, if only a few persons undertake to have it proven that they have no other source of income than the minimum wage, we must ask ourselves: who does the minimum wage protect? Does it protect the employee from starving to death, or the employer from contribution payment or the distribution of equitable wages?)

The rise in the price of drugs that were formerly subsidised at 100% to HUF 300 is more of a symbolic and psychological measure than a measure practically contributing to the reduction of the public finance deficit. The same can be said about the co-payment and the daily fee payable for hospital stays, from which the Government expects that the number of direct physician-patient contacts – which is outstandingly high even by European standards, and is also unjustified according to us – will drop and tip money will be eradicated. At the same time, while the Government estimates the amount of tips to be nearly HUF 100 billion, it expects to yield HUF 30 to 35 billion from the co-payments and the daily hospital fees. The psychology behind the introduction of these measures is understandable, however the circumstances of introduction are inequitable from several aspects. On one hand, in order to justify these measures and combat the institution of tips a campaign was launched that undeservingly bemired medical doctors in general. The impact on social and human relationships is inestimable. On the other hand, the social groups enjoying exemptions or allowances are too large (approximately 4 million people). It is only the icing on the cake that the difference is reimbursed by the state after the beneficiaries, not to mention the additional administrative costs.

As far as the expenditure side is concerned, the measures are more diverse. The increasing and high pharmaceutical subsidies are planned to be curbed by the revision of the system of pharmaceutical subsidies, by the increased control of prescription habits and eligibilities, as well as by giving preference to the generic drug programme[16]. The other main pillar of expenditure cuts is the rationalisation of curative and preventive care: the elimination of the unjustified disproportionate capacity distribution, the liquidation of under-utilised capacities, the reduction of the predominance of inpatient care over outpatient care, as well as the establishment of "centralized" regional hospitals in lieu of scattered hospital buildings.

In theory one cannot question the raison d'etrê of the Health Insurance Supervision controlling spending by the National Health Insurance Fund. In practice, there is a risk of aggravating the "too-many-chiefs" syndrome by adding even more chiefs. The convergence programme does not reveal exactly what will ensure the transparent operation of the Health Insurance Supervision.

In connection with the liberalization of the health insurance market we need to wait until the end of the year, however, in relation to the liberalization of pharmacies, it is worth hearing some pharmacists' panting cries for help. It is difficult to explain why a market of three thousand pharmacies, which is otherwise regulated by the authorities in terms of margin, needs further liberalization. It is acceptable that certain products should be sold without assistance, however the price setting habits and the margin related regulations do not justify the liberalization of the rules for the foundation of pharmacies. There is tangible pressure by the global actors. What would notary publics say if any law students were authorized to issue certified copies of documents?

Education[17]

The programme does not go into details about the changes planned to be implemented in higher and public education. It is only in the annex that a few measures are named originating from the amendment of the public education and higher education acts in July 2006.

Let us examine higher education first. We cannot or can only hardly argue with the proper recognition of the symptoms (parallelisms in higher education, student headcount that does not meet the needs of the labour market, reduced student activity). However, the solutions give rise to doubts at a few points. According to the preliminary calculations, the development contribution, i.e. the tuition fee, which will unfold completely by 2011–2012, will yield only HUF 13 billion for the university sector, and maximum half, but at least one third of it must be spent on scholarships. The remaining sum available for development would thus fluctuate in the HUF 6.5 and HUF 9 billion range. Said amount can be regarded significant neither for the public finance deficit, nor for the budget of higher education[18]. In contrast with this, the side-effects, the discounts and scholarships that can be granted on the basis of academic achievement and social standing put significant burdens on higher education administration. We must also mention another proposal, the subsequent training contribution (“subsequent tuition fee”), which would have improved the finances of the universities and colleges to a larger extent, albeit only at a later stage. (According to the preliminary calculations, by HUF 120 billion by 2030.) According to the proposal, degree holders would have been required to pay their training costs subsequently, proportionately to their income.

The outlines of the measures affecting normative funding in a move to transform public education seem to be efficient and reasonable. At the same time we must add that based on the measures outlined in the convergence programme it is not possible to assess their actual impacts. The question is raised about the future of laid-off teachers in areas with an already high unemployment rate. The unemployment benefit and the costs of retraining deteriorate the balance manicured by teachers that have been excluded from normative funding.

ABOUT THE MACROECONOMIC PATH

As we have indicated among the introductory thoughts, according to the competent expert opinions, the macroeconomic path outlined in the programme is much more realistic than the former versions, and on the whole it is accomplishable, however there are significant risk factors. Below we will focus on momentums that we regard most risky and unjustified for the sustainability of the macroeconomic path.

Risks of the GDP growth path

According to the programme, the drop in the dynamics of the internal demand resulting from the restrictive fiscal measures will significantly withhold the GDP growth rate, which will then return to the presumably sustainable rate of 4 to 4.5% from 2009 on. The drop in the growth rate of internal end use affects all three large internal income groups: the real value of household and community consumption will drop in 2007, while the growth of gross fixed assets accumulation will decline by 4.5% partly due to the aforesaid, and partly due to the increasing charges payable by businesses. The measures will not significantly affect external demand, because they do not deteriorate the competitiveness of multinational companies that account for the bulk of exports. The reaction of internal demand to the restrictions outlines a realistic tendency.

Inconsistence in the growth path occurs in relation to the upturn and the background thereof. If we observe the growth components it seems clear that the slow increase in the GDP growth in 2008, and the faster development thereof in 2009 is based on the dynamic growth of investment projects and household consumption expenses. Per capita real income will resume growth in 2009, wherefore the consolidated value of the latter is acceptable. The presumed strong growth of the annual dynamics of investments (5% in two years) is much more problematic, since it is supported neither by the measures outlined in the convergence programme, nor by the other components of demand. On one hand, the restrictive measures against enterprises are not planned to be lifted, and on the other the upturn in household and community expenses is very modest. The investment incentives[19] outlined vaguely and only in general in the programme reflect the characteristic features of supply-side economics and neoliberal economic policy dogmas. Consequently, it is highly doubtful whether they are able to adequately offset the negative demand shock generated by the restrictive measures. Naturally, the positive expectations of businesses can bring about the indicated growth of investments despite the fundamental factors. However, the expectations cannot be predicted in advance, and it would be a mistake to use them as a foundation for the investment path.

Therefore, the actual development of investments is a risk factor in terms of the sustainability of the GDP dynamics and the public finance balance path. *(See Table 5)*

THE INTERNAL RISK OF THE PUBLIC FINANCE BALANCE

The greatest risk in the public finance deficit is caused by the estimated, nearly 6% drop in

Table 5

GDP GROWTH AND ITS COMPONENTS
(change in percentage, at prices valid in 2000)

	2005	2006	2007	2008	2009
GDP	4.1	4.1	2.2	2.6	4.1
Growth components:					
Household consumption expenditures	1.7	3	–0.7	0.6	1.5
Community consumption expenditures	–0.4	1.7	–1.8	–3.8	1.4
Gross fixed-assets accumulation	6.6	6.6	2.1	3.7	7.0
Changes in stock accumulation (as a percentage of the GDP)	–2.3	–3.9	–3.8	–3.8	–3.6
Product and service exports	10.8	12	10.9	9.9	9.4
Product and service imports	6.5	9.5	8.5	8	8.8

Source: Convergence Programme

primary expenditures in the period 2006–2009. The growth in revenues can be calculated based on the measures that have already been introduced, as well as tax and contribution related measures to be introduced during 2007, and therefore serve as a foundation thereof. In contrast with this, structural reforms fostering expenditure cuts in public administration and the public sector, as well as in the pension system, mostly exist as concepts only, wherefore they make the expected savings uncertain. Although the programme outlines the portfolio in which it intends to reach the 5.8% drop in primary expenditures,[20] however, the well-foundedness thereof is as uncertain as the changes in expenditures. *(See Table 6)*

Risks of the external balance path

Naturally, the programme deals with the circumstances of restoration of the external trade balance. It earmarks that exports, which are regarded as a stable growth factor, will grow by around 10% annually, and counts with reduced import dynamics until 2008. According to this forecast, the funding need of the balance of goods and services, which equals 1.2% of the GDP in 2006, will grow to 2.8% by 2009, which would considerably improve Hungary's external positions. In addition, it counts with the inflow of EU funds, which accounted for three quarters of the capital balance in 2005, and will account for 95% in 2009. Therefore, a significant improvement is expected also in terms of capital balance (0.8% in 2005, 2.2% in 2009 compared to the GDP). These two, presumably improving tendencies are put against the constantly negative, over 6%, GDP proportionate deficit of the balance of primary incomes and transfers arising from the dual structure of the economy (dominance of foreign owned companies, increased profit repatriation).

The assumptions can be questioned at several points. The assumption about lower import dynamics is based on the fact that the restrictive measures reduce the disposable income of resident companies, which will also lead to a drop in demand for imports. The introduction of the stabilization package in 1995, the 8% customs surcharge and the one-off 9% devaluation of the Hungarian currency, the sliding devaluation and the 12% drop in real wages were not sufficient to improve the foreign trade balance to the extent which is earmarked by the convergence programme with considerably smaller intervention.

The other realistic threat may be posed by the excessive deficit procedure applied in relation to EU funds. It has been raised in Brussels several times that the excessive public finance deficit of Hungary should be followed by sanctions, which would also mean the withholding of funds from the Cohesion Fund. Since practically the entire capital balance is ensured by the EU transfers, the consequences

Table 6

PUBLIC FINANCES

(as a percentage of the GDP)

	2005	2006	2007	2008	2009
Revenues without EU transfers	42.2	40.9	42.6	42.7	42.2
Primary expenditures without EU transfers	45.6	47.2	45	42.9	41.4

Source: Convergence Programme

of their loss are unpredictable in the current situation. *(See Table 7)*

Should the said external positions develop in a way other than predicted by the programme, a radically different path would emerge, since if the process of indebtedness continues, the planned improvement of the positions of public finances becomes impossible, too. In what correlation can this happen?

If Hungary's external positions do not improve – among other things, due to the aforesaid – a new crisis of confidence may emerge with another deterioration of the country's rating: the expected risk premium of state securities will either stabilize or grow. Since a considerable portion of state securities (28% in the first quarter of 2006) is kept by non-residents, the price of external financing will continue to grow due to the increase in the expected interest rate. This is a factor that directly strengthens external imbalance. At the same time, there is also an indirect impact. A dominant part of state securities is held by financial companies (56% in the first quarter of 2006 without NBH). These companies are almost exclusively owned by foreigners. They realize greater revenues from the increasing interests of state securities, which also means a greater outflow of income if we count with the given rate of profit repatriation, and this also deteriorates the external balance position. The situation is aggravated by the fact that due to the postponement of Hungary's integration into the euro zone, the Forint has become more volatile and its exchange rate has become weaker. This latter largely contributed to the fact that within the gross debt of the central budget, debts denominated in foreign currencies have continued to grow both in absolute and relative terms (25.3% in January 2005, 30.3% in August 2006).

Meanwhile, the threat of the repeated growth of inflation is realistic, if the imbalance remains for a longer period, but also, paradoxically, if the economic players believe that the immediate restoration of the balance of public finances has been given priority. How can it be? The economic actors are well aware of the fact that the upturn of inflation or the achievement of a certain surprise inflation rise is in the interest of public finances. Therefore, the central bank can offset the integration of any motives to the inflationary expectations only with greater basic rate rises. However, in this case, since the Hungarian state predominantly funds itself from Forint securities with relatively short remaining maturity (approximately 70%; 3.49 years in the first quarter of 2006), the rise in the interest level will increase the interest burden of the budget already in the medium run. Therefore, the restoration of the balance of public finances can be jeopardized by many “quasi-exogenic” factors, too.

Table 7

FUNDING POSITIONS

(as a percentage of the GDP)

	2004	2005	2006	2007	2008	2009
Net external funding ability (+)/demand (–)	–8.3	–6.6	–7.1	–4.2	–2.2	–1.4
including:						
– balance of goods and services	–2.9	–1.3	–1.2	0.6	2.2	2.8
– balance of primary incomes and transfers	–5.7	–6.1	–6.7	–6.5	–6.5	–6.4
– capital balance	0.3	0.8	0.8	1.7	2.2	2.2

Source: Convergence Programme

This means that the correction of the public finance imbalance is neither possible nor independent of the proper development of the external position. And the external position, which becomes less and less sustainable, reveals the fundamental structural problems of the Hungarian economy. External debts, i.e. foreigners' investments, and the country's external debts will remain in place for a long time, since as Hungary catches up (as the profit gap narrows) the volume of new investments will decrease, and profit repatriation (which is currently 50%) will increase.

The Hungarian economy balanced on a knife's edge in the past decade, too, it had no internal mechanism for the automatic elimination of imbalances. If resident companies would contribute with a much greater share to the GDP, the structure of Hungary's real economy would be able to handle damage caused by the too loose budget policy at any time with a smaller shock, since in relation to stabilization – with some exaggeration – the restoration of the internal balance processes would not depend on so many other uncertain factors. An economy that is exclusively based on foreign capital (debt) will regenerate external imbalance again and again, and paradoxically, this problem becomes more and more acute as the catching-up process gains momentum. In this situation budgetary indiscipline generates much graver situations.

MAINSTREAM ECONOMICS AND THE HUNGARIAN CONVERGENCE PROGRAMME (WASHINGTON CONSENSUS)

The Brady Plan[21] (March 1989) which was developed to escape the debt trap was "legitimised" within the framework of a conference series. The term "Washington Consensus" was first used in *Williamson's* (1990) introductory speech at one of these conferences. The word consensus refers to a certain synthesis of views of the World Bank, the Federal Reserve Bank and the Congress of the United States, i.e. of those standing in the centre of these organisations. This also means that 30 to 50% of the members of these organisations do not support the outlined concepts, yet sort of "advanced", ab ovo, the global expansion of these centrist views. Concerns were raised already at the conference, since the proposals were basically made for remedying the problems of one region, i.e. South America, and others feared that the originally novel proposals would turn into dogmas. As it later turned out, these fears were well justified. Later Williamson acknowledged, too, that it would have been more appropriate to use the term "general convergence". These events then developed the "recipe like", universal recommendations, which primarily aimed at the restoration of the balance, the launch and/or acceleration of growth on a new basis. *Kuczynski-Williamson* (2003) emphasise the difference between the original meaning of consensus and the current interpretation thereof, according to which when it was first drafted, the consensus dealt with a much broader spectrum of problems. After being reworded, growth and the question of justice were named as equally important aspects.

The ultimate goals – as Williamson himself put it: growth, low inflation, acceptable balance of payments, equitable income distribution – can really be regarded as centrist views if taken by themselves.

The authenticity of the document is greatly weakened by the fact that the recommendations it contains are often neglected especially in the birthplace of the concept itself. In the United States corruption, the budget policy, the exchange rate policy and the trading policy are often outside the range of vision of the above requirements.

The following 10 points were reworded in 2003
(Williamson, 2003; Szakolczai, 2005)

1. *Budget deficit:* fundability without an inflation tax.
2. *Ranking of public spending:* redirection of resources from unjustified areas toward neglected areas with great yields (which could improve income distribution), such as elementary education, public healthcare, infrastructure.
3. *Tax reform:* increasing the number of taxpayers and lowering the marginal tax rates.
4. *Interest rates:* financial liberalization, where the ultimate goal is an interest rate determined by the market players.
5. Foreign exchange rate: in line with the medium-term macroeconomic objectives (fast growth of exports, fundability of the current balance of payments).
6. Trade policy: replacing quantitative trade restrictions with customs duties, and then gradually decreasing such duties to a flat 10 to 20% rate.
7. Foreign direct investments: removal of obstacles to foreign direct investments.
8. Privatization: privatization of state-owned companies.
9. Deregulation: abolition of regulations that impede market entry or restrict competition.
10. Property rights: providing security for property rights.

Basically, there are two major doubts about the Washington Consensus. The first is empirical in nature, while the other is more of a theoretical dispute of beliefs. Experience showed (e.g. in Mexico) that nothing guarantees that growth would actually set off after adequate stabilization. The Consensus is incomplete at this point and can be criticized with many well-grounded facts, and in fact, this is the most often criticized part of the document. It practically said nothing about the restart of growth; it was considered evident, which was a mistake, as it is shown by practical examples, especially in South America. The other criticism targeted at the theoretical justification (lack of justification?). The measures entirely rest on the views of classical (mainstream) economics, and reject the utilization of the scientific results of growth theory schools.

The latter is the most difficult intellectual challenge in relation to the new stabilization process in Hungary, too. Even if we assume the success of stabilization, it is a question how the Government will create the favourable environment required for the development of the efficient private economy. Investments are indispensable for economic boom, and they are clearly unable to grow in an unstable macroeconomic environment. Therefore, the restoration of the macroeconomic environment is the number one task. Then there are basically two paths to choose from, provided we take into account historical experiences, too.

The first is a neoliberal approach, in which the Government creates the adequate incentives, trends, it acts in a consistent manner, and steps aside after setting the rules of the game hoping that growth will set off. Sometimes this may work and does work in countries with adequate institutional conditions (e.g. Great Britain).

The other path, the approach taken in Eastern Asia assumes a more active and initiative role of the state. Experience shows that a small government apparatus, a consistent economic policy, undervalued currency, conscious export development and the strictly temporary protection against imports, as well as highly qualified and disciplined workforce accompanied by entrepreneurial skills lead to strong growth.

However, a very strong precondition for the success of active industrial policy is that the government should have adequate skills in strategy development. This is not a universal endowment, not even international organizations can give such advice, however, in the absence of such skills it is very difficult to forecast with great certainty, which industries will be long-term winners in the future. Therefore, any inconsistent intervention can do more harm than inaction.

The crises of the past decade all confirmed that universal recommendations to economies of different levels, with different endowments and economic cycles are neither necessarily viable, nor can be forcefully implemented.

Despite the said anomalies, by accepting the Maastrich convergence criteria and the Stability and Growth Pact, the EU practically committed itself to the economic policy trend recommended by the Washington Consensus. In contrast with the rest of the world, the EU is interested in the explicit maintenance of a strong and stable currency, this is what it strives for, since the basic prerequisite for the attraction of direct investments is security and predictability. A stable currency is less vulnerable, however we must pay a price for that. The EU requires a strict budget policy from all member states, consistently with the monetary conditions. This restriction narrows the range of economic incentives (e.g. export incentives), which is detrimental for the EU in international competition.

Naturally, the picture is much more varied than that. The European Union is much less strong vis-a-vis the international financial organizations than its economic potential would justify, since there is practically no united action by the member states. The fundamental reason behind this is the political fragmentation, the declared "union"-type structure, which is actually a confederation, and the frequently differing interests of the individual member states. There are countries that could meet the requirements set for the common currency (Denmark, Sweden, Great Britain), but they do not do so because they do not need the common currency. On the other hand, there are several member states that have nominally committed themselves, but in fact do not meet the mandatory requirements (e.g. Germany, Italy), because they can run their social systems – which are completely unsustainable financially in the long run – only with major deficits already today. These countries go upstream against the Washington Consensus, but of course, not explicitly, since no member state of the de facto confederate Europe would undertake this financial policy before the World Bank or the IMF. The new member states, including Hungary, ab ovo fully committed themselves to the achievement of the prescribed parameters, i.e. they have adopted the paradigms of the Washington Consensus.

Since Hungary would also like to become an organic part of the integration, it strives to meet the requirements for the introduction of the common currency. The new convergence plan is in full agreement with the original interpretation of the Washington Consensus, but it also tries to take over a few elements from its reinterpreted version, namely the emphasis on more equitable burden sharing.

In order to examine the concepts behind the plan it is worth dividing it into two parts, which is also justified by the structure of the measures. The first period (2006 to 2009) is the period of stabilization of the macro-parameters. The restrictive measures aim to restore the drastically poor fundability of public finances, as well as the external balance (current balance of payments), or as the plan puts it: the structural adjustments create the conditions for sustainable growth. According to the GDP growth related calculations, in this period growth will drop below the potential output, to a mere 2 or 3% (negative output gap), the real income of households will decline, and the trend is expected to change only at the end of the period. According to the Washington Consensus, the growth sacrifice is not necessarily a negative thing, if a new boom may unfold in the wake of successful stabilization. At the same time, however, it is worth remembering the plenty of empirical examples that show that a successful stabilization does not guarantee the take-off of growth. The assumptions behind the long-term projections of the programme contain quite a lot of uncertainties, wherefore it is not impossible, but is greatly uncertain that they will actually come true.

The assumptions of the second stage of 2009–2011 are exactly the weak pillars of the Washington Consensus. As the plan puts it: "Productivity growth is promoted by the increase of the capital stock. Economic policy may affect investment growth primarily indirectly, by enhancing economic stability, adopting a balanced income and fiscal policy, improving the quality of public services, deregulating the administrative burdens of businesses, strengthening the business and innovation environment or improving the physical and human infrastructure, though certain co-financing programmes and tax benefits may also play a role".[22] Observing the experiences of the short history of the Hungarian market economy it can be stated, albeit with strong reservations, that the drastic correction of the macro-parameters may create a certain condition for growth. But what guarantees that the planned structural changes would create a really viable economic environment, and even if rapid growth takes off, "would it not hit against the ceiling again"? The public administration, social security, education and public finance reforms are badly needed, but probably not sufficient conditions for real convergence.

In the first reading the new convergence plan seems to be in conformity with the policy of the Washington Consensus, but more in terms of its intentions than measures. The reason behind this is the trap generated by the unbelievably shaky status of public finances. The programme earmarks measures that contradict the future conditions for growth (e.g. rise of contributions on labour, which will presumably decrease and not increase the rate of economic activity). Despite its declared intentions the programme contains a long list of exceptions and beneficiaries again (e.g. in the case of the co-payment the members of those target group became beneficiaries /pensioners, i.e. the main users of healthcare services, among others/), whose healthcare service using habits the programme intended to change). The state forces itself upon the economy again by increasing tax incidence, by increasing redistribution and dependence, which do not foster the change in attitude demonstrated by the economic players and the population either. It is equally probable that the tax on savings will not increase the internal resource accumulation. However, as the programme says, there is no growth without investment, and as it can be clearly seen already, investments cannot be financed from foreign sources only; the implied risk is a highly vulnerably economy exposed to events in the global economy.

Annex

THE PATHS OF MAJOR MACROECONOMIC AND PUBLIC FINANCE FIGURES

	2004	2005	2006	2007	2008	2009
change in GDP (at prices valid in 2000) %	5.2	4.1	4.1	2.2	2.6	4.1
HICP	6.8	3.6	3.5	6.2	3.3	3.0
Unemployment rate %	6.1	7.2	7.3	7.5	7.4	7.3
Net external funding ability (+)/need (-) (as a percentage of the GDP)	–8.3	–6.6	–7.1	–4.2	–2.2	–1.4
Gross state debts (as a percentage of the GDP)	60.2	62.3	68.5	71.3	72.3	70.4
Public finance deficit (as a percentage of the GDP)	6.6	7.5	10.1	6.8	4.3	3.2

Source: Convergence Programme

MAJOR MEASURES DERIVED FROM THE CONVERGENCE PROGRAMME (2006–2009)*

Tax rises that directly affect consumption and saving, changes/introduction of public utility and public service fees (poverty and polarization of the population by living standards)	Employment related taxes and contributions (activity of the working age population)	Measures affecting the corporate sector (dual economy)
Gas price compensation will be replaced by means-tested social subsidies to those in need (2007) Modification of the system of public transport subsidies Changes in the system of pharmaceutical price subsidies ((30) 1st measure: medicaments that were fully subsidized earlier would cost HUF 300) **(30)** HUF 300 co-payment and daily hospital care fee (2007) **(170)** The preferential VAT rate grows from 15% to 20% (2006) **(6)** Excise duties will increase: by 5.7% on cigarette, by 7% on alcohol (2006); further increase of the excise duty on cigarette by 2.7% two times (2007) **(26)** The rate of tax on income from interest and stock exchange deals will grow from 0% to 20% (2006) Abolishment of certain tax allowances, or occasionally the lowering of the income ceiling for eligibility (2007) Changes in vehicle taxation (2007) **(10<)** Introduction of the real property tax (2008) Tuition fee in higher education (2007–2008 academic year)	**(220)** Raising the individual contributions of employees (health insurance contribution in two stages from 4% – to 7%, 2006-2007; employees' contribution will grow from 1% to 1.5%, 2006) **(20)** The tax payable on in-kind benefits will grow from 44% to 54% (2006) The bracket of the two-rate personal income tax will be raised from HUF 1.55 million to 1.7 million (2007) **(8)** Employed pensioners must also pay a 4% in-kind health insurance contribution (2006) **(32)** Pensions will become non-taxed emoluments (2007) **(24)** Private individuals will have to pay a 4% special tax on the portion of their consolidated income above the upper limit of the individual pension contribution (so called solidarity tax, 2007) The health insurance contribution payable by private individuals after certain separately taxed incomes will rise from 4% to 15%. The upper limit of such payments will grow from HUF 400,000 to HUF 450,000 per year.	**(53)** The rate of the simplified enterprise tax is increased from 15% to 20% (2006) **(170)** Corporate businesses must pay a special tax of 4% on their adjusted, pre-tax profits (2006) Introduction of the minimum contribution base (HUF 125,000 per month in 2006; HUF 131,000 per month in 2007). Exemption can be granted upon request and an immediate tax inspection. (Retired) self-employed people and members of corporate businesses who pursue auxiliary activities must pay a 10% healthcare contribution instead of the former 5% accident contribution (2006), the rate will be raised to 16% (2007) **(88)** The healthcare contribution of HUF 1950 per head will not be revoked (2006) **(55)** Minimum tax levied on self-employed people and members of corporate businesses (2% of the total revenues realized in the tax year minus the revenues of foreign sites and the purchasing price of goods sold) (2007) Changes in vehicle taxation (2007) **(50)** Credit institutions must pay a 20% annuity on interest income from loans associated with state subsidies. (2007) **(10)** Introduction of a 20% tax on excessive cash in hand held by corporate businesses (2007) **(210)** The planned reduction of employers' contribution will not be realized (3% in 2007; 2% in 2009) In contrast with the plans, the local business tax will not be abolished (2008)

* In brackets in front of the measures – where such calculations were available – the amount of the revenue growth or expenditure cut expected by the Government due to the measures in HUF billion. Certain items may be shown more than once in the table. The Government expects to yield HUF 9 billion from the changes in vehicle taxation, the distribution of which between companies and private individuals is not yet known. After the measures, either the date of introduction or the date of the relevant bill is indicated.

MAJOR MEASURES DERIVED FROM THE CONVERGENCE PROGRAMME (2006–2009)*

Central and regional public administration (internal balance)	Higher and public education (internal balance)	Pension system (internal balance)	Healthcare** (internal balance)
Central administration: **(20)** A 20% downsizing in the organizations of central administration (implemented) **(15)** A 10% downsizing in the central administration and its regional agencies (by 1 December 2006) **(10)** Centralization of parallel functional areas operating in the same scope (2007) Spreading of electronic public administration (from 2007) **(12)** Liquidation of certain institutions *Local governments:* **(49<)** Task fulfilment within city, small regional or regional associations to eliminate the dominance of county level task performance (public administration, public education, etc.), and the development of the corresponding funding structure (2006 bill) Introduction of performance based wages in public administration (from 2007)	*Public education:* It is optional in 2006, and mandatory in 2007 to increase the number of mandatory classroom hours by two units per week (2006) Transformation of the normative funding of public education: funding on the basis of the number of computed teacher jobs (2006 bill) Task performance in association with other institutions (2006 bill) *Higher education:* Introduction of the tuition fee in the 2007-2008 academic year (approved) Reduction of parallel training courses, and the number of higher education institutions (2007 bill) The structure of state funded education will change and the number of state funded students will drop (Government Decree, 1 October 2006)	Raising the early old-age retirement age by one year Adjustment of the benefit disbursed to early retirees as justified by actuarial calculations (2006 Act No income earning activity can be pursued if pension is disbursed below the retirement age **(8)** Employed pensioners must pay a 4% in-kind health insurance contribution (2006) **(32)** Pension benefits will increase the aggregate tax base (2007) The anomalies of the pension award rules will be eliminated (valorisation, netting).(2006 bill) Disability benefits will become an independent benefit category, and they will be removed both from the healthcare and pension systems (2007 bill) Category III disability pension will be replaced with a temporary benefit and will be supplemented with appropriate rehabilitation required to encourage the return to the labour market. Elimination of abuses when determining the abilities of people with reduced working capacities, review of the eligibility of current disability pensioners (2007 bill)	A decision will be passed about the liberalization of the health insurance market by the end of the year Restructuring of the healthcare system (elimination of regional disparities in capacity distribution, elimination of unused capacities, reduction of the predominance of inpatient care over outpatient care, centralization of active hospital care in "regional central" hospitals) (from October 2006) Drug thrift act for the rationalization of expenses related to pharmaceutical subsidies (Autumn 2006) Pharmacy liberalization **(30)** HUF 300 co-payment and daily hospital fee (2007) The Health Insurance Supervision will be established. Apart from other tasks it will follow spending by the National Health Insurance Fund (OEP) (2007) Medicines that were formerly subsidizes at 100%, will cost HUF 300 (2007) More stringent control of the payment of social security contributions; development of eligibility packages based on non-insurance, insurance and supplementary insurance (from 2007) Primary agricultural producers will also become insured (2007)

* In brackets in front of the measures – where such calculations were available – the amount of the revenue growth or expenditure cut expected by the Government due to the measures in HUF billion. Certain items may be shown more than once in the table. The Government expects to yield HUF 9 billion from the changes in vehicle taxation, the distribution of which between companies and private individuals is not yet known. After the measures, either the date of introduction or the date of the relevant bill is indicated.

** Healthcare measures were formulated with regard to the operative decisions passed at the Government meeting held on 31 August and 1 September 2006

Notes

1 Net external dept = balance of the net external debts of the state, companies and households + direct capital investments

2 This part of the need for external funding generates its own resource proportionately to the rate of reinvestment. However, this alleviates the burdens only temporarily, since reinvested income will sooner or later generate additional outflowing income for the owner.

3 The publication titled Society at a Glance: OECD Social Indicators 2005 used the ratio of the population earning less than 50 of the average wage as a relative poverty index.

4 consumption unit = a single adult

5 The monthly net wage of employees in 2005. Here we do not count with the extra income generated from the social transfers.

6 Since 2004, on each month spent in employment after the retirement age has increased the old age pension by 0.5%.

7 According to the 2005 OECD publication titled Society at a Glance: OECD Social Indicators, the demographic dependency rate (population above 65 years /the 15–64 age group) will grow from 21% in 2000 to 50% by 2050.

8 In this section the words enterprise and company are used as synonyms.

9 SME = small and medium-sized companies

10 In 2003 as much as 61.1% of the registered capital of foreign owned companies concentrated in large companies, while the same ratio was only 36.9% in the case of companies owned by Hungarian companies, and only 3.7% in the case of companies owned by Hungarian private individuals (Kállay – Kőhegyi – Mrs. Kiss Kovács – Maszlag, 2005)

11 Companies limited by shares cannot opt for the simplified enterprise tax, and the revenue ceiling of enterprises and corporations is HUF 25 million.

12 Nonetheless, this has few positive results for the dual economy, since it originates in the production sector instead of the service sector.

13 For instance, in 2003 this indicator (payable tax/computed tax) was 97.2% at SMEs, and only 46.8% at large companies! These ratios were not more favourable in the years before 2003 either. (Kállay – Kőhegyi – Mrs. Kiss Kovács – Maszlag, 2005)

14 Such additional expenses are also taken into account by the Convergence Programme (page 35).

15 Expenditures of the first pillar: 9.3% of the GDP in 2000; 13.5% of the GDP in 2050 according to the forecast of the convergence programme.

16 The share of generic drugs from turnover is low by international standards, too (25%), which can be attributed to the drug prescription and consumption habits.

17 The amounts shown here are the background calculations of the Ministry of Education and Culture.

18 Pursuant to Act CLIII of 2005 on the 2006 budget of the Republic of Hungary, the operational budget of universities and colleges equals HUF 347 billion this year.

19 The following measures are mentioned in the convergence programme as the planned tools to encourage investments: favourable investment environment (expanding physical infrastructure, investment encouraging programmes, simplification of administration, quality state services, vocational training adjusted to the market needs), economic stability, balanced income and budget policy, favourable business and innovation environment, large-scale investments between 2009 and 2011in order to turn Hungary into a logistics centre, as well as in relation to agricultural energy policy and renewable sources of energy.

20 Slightly more than 50% of the 5.8% drop in primary expenditures arises from the reduction of wage and other current costs of the public sector, slightly over 10% is caused by the cuts in in-kind allowances, and slightly over 30% is caused by the curbing of state investments and other government programmes.

21 Debt conversion programme hallmarked by US Secretary of Treasury Nicholas Brady (March 1989).

22 The Convergence Programme of Hungary 2005–2009, page 14

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Green Paper on Healthcare
(2006)

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Principles of a regulated public finance system

Stabilisation, economic growth, public finance reform-these have long been the call words of Hungary's economic policy. None of them is a new-found expression, but they have become timely on a wider scale just recently.

Some of the most powerful manifestations of the Hungarian economy's non-equilibrium have been the balance of public finances and current account, and the size of public debts. When detailing the system of correlations of these factors, one cannot avoid explaining why the funding needs of public finances have to be curtailed, the increase of net external debts stopped, inflation reduced, and why it is necessary to keep public finances deficit at a low level.

Differing opinions have surfaced in respect of budget policy. There are conflicting views about the factual extent of equilibrium loss and the judgement on various indicators that reflect budget deficit among not only economists engaged in studying the central budget or public finances but also among researches and researchers that supply the basis for economic policy.

The concept of public sector reform generally includes education, health care, pensions, and the number of public employees. The agenda herein includes not these items but the budget system itself and its mechanisms.

Usually, this topic has no direct impact on average citizens, thus they are not interested in it, but it is now inevitable for professional circles engaged in budget policy. OECD for example has addressed this topic for decades, but IMF and EU have also taken a liking to it in the past one or two years.

Of course, it's not to say that an adequate budget mechanism would be a substitute for political willpower (see today's budget policy in the United States of America), but international experience suggests that even an appropriate political resolve could prove lacking if institutions and mechanisms are inefficient.

The question of what the government's tasks are is never answered by the executives of the system or the institutions, but it will always be the subject of political consideration.

INITIATIVES, BACKGROUND, AND CREDIBILITY

Nowadays, public finances and the central budget operates, develops, and progresses on the principle of what tasks the current political administration thinks should be covered, what should be financed by the central budget, what the relation is between the state and the society, and how the relation between public interest and public power develops. Task fulfilment has two basic principles today. One says the state undertakes tasks on behalf, or in the interest, of the public or a group of the public, while the other theory argues that the possibility of public authority-or "pressure", even-is always present in the operation of the state.

In theory, the operation of the state is based on an invisible agreement with the society in which, for the sake of fulfilment of government tasks, members and institutions of the society waive part of their economic independence and accept the consequences that stem from the existence of the state.

Everybody knows that an agreement is good when all the parties to it are satisfied with the contents. Hence, it is a basic interest of the government of the time to establish a system which will suit the widest scope of the society.

Social and economic processes of recent years, and the system of modern societies-having become more complex than ever-inevitably require the state's economy-influencing and task-managing role.

From the aspect of the state, the most substantial problem is the basis it picks its tasks upon. The focal point of debates in respect of public finance reforms has always been the definition of state tasks. The answer is only seemingly easy, because the following factors always present problems.

- Various strata and groups within the society have different degrees of interest enforcement abilities, and they represent different interests against the state. The preferences of the society are not unambiguous, the profits of various tasks are "hard to translate into numbers", and are incomparable.
- The objectives of the society cannot be aggregated clearly. Various target vectors assume different task fulfilment and redistribution systems.
- Measuring the performance of the state is a tough job, bordering on the impossible in certain cases; for example what should the annual deficit measure, and how should the budget's quality be translated into numbers?
- Non-measurable factors that do not make their impact through the budget directly should also be taken into account (e.g. multiplication effect).

In light of the aforementioned facts, one of the core rules of public finances can be described as follows: There are no everlasting solutions, and the system of public finances will always be defined by the movements of social, economic, and political factors. Yet why have the demands that urge regulated and transparent mechanisms at an increasing extent become pressing, saying a system of fiscal regulations should be established?

The last major budget adjustment in Hungary occurred in 1995, but ten years later similar problems returned as budget processes had veered to the border of a non-manageable position. The convergence programme has set a path of fast and clear-cut adjustments, but even now the question arises: What will prevent the current situation from returning five or ten years later? It's not enough to get to a sustainable path, you need to stay on it, too.

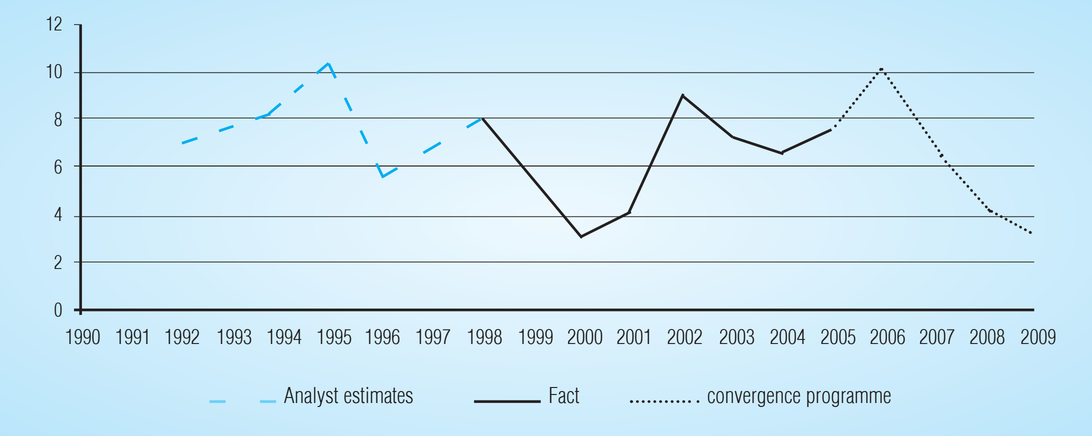
Without any further comment, *Chart 1* is seen below, displaying the changes and cyclical fluctuation of the deficit from the 1990s to 2010. Particular regard should be given to the years 1994, 1998, 2002, and 2006.

Deficits generated in the public sector are to be financed via money markets, and it does matter what terms and conditions apply.

Hungarian money market processes are substantially influenced by international market developments, particularly in the short term, but if economic players believe that troubles (overspending) will not return, then longer-term interest rates could drop. Restoring credibility takes some time, of course, but developing a mechanism to support sustainability could speed up this process substantially.

Chart 1

PUBLIC SECTOR DEFICIT IN TEMS OF GDP



A major part of restructuring of the budget system and budget mechanisms could be implemented without laws that require two-thirds majority votes in Parliament, but they would only have real power when based on the consensus of all political parties because it is important for new mechanisms and institutions to function in the long run, spanning several government terms. (This should also be some kind of a "social" contract).

An example when "nothing is being done" expect being credible, yet expenditures are dropping steeply.
According to EU estimates, also included in the convergence programme, expenditures related to old age will increase in Hungary by 4 percentage points in terms of GDP between 2010 and 2050. In 2010, Hungary's debt will amount to nearly HUF 20,000 billion, or 68.5 per cent of GDP, and the related interest expense will be HUF 1,070 billion, no less than 3.6 per cent of GDP. If the central budget's spending on interest dropped by as low as 0.5 percentage point of GDP as a result of restoring credibility (when the market believes that the country is able to stay on the designated path), it would still mean a huge amount of savings. Thus, these amounts could be spent on financing expenditures related to old age.

LEGISLATIVE RULES TO BE CREATED

Main indicators for the central budget are defined in the convergence programme. Targets for deficit, primary balance, and gross public debt have been defined. These indicators are featured in *Table 1* below.

Result rule

The table above shows that the deficit change between 2007 and 2011 is planned to amount to 4.6 per cent of GDP, and the decrease in public debt accounts for 4.3 per cent of GDP. This could and have to be set as an objective for the economy of the time to achieve.

The essence of this rule is as follows: A target is set that the debt ratio shall decrease by 4 percentage points in the next four years. This solution will smooth over the impacts of boom cycles to some extent, at the same time it allows no delays for finding solutions for structural problems.

If the debt ratio fails to drop on the basis of technical projections, adequate measures are to be made. Of course, the result rule is to be observed by regulated annual budgets, and when troubles start to emerge they should be corrected in a regulated way in the following year.

Table 1

TARGETS FOR BUDGET INDICATORS

	2007	2008	2009	2010	2011	Change: 2007–2010
Deficit	6.8	4.3	3.2	2.7	2.2	4.6
Primary balance	–2.4	–0.2	0.8	1.0	1.5	3.9
Gross public debt	71.3	72.3	70.4	69.0	67.0	4.3

Procedure rules

The essence of the "pay-go" rule is as follows: When the Parliament decides about an entry with impact on the central budget in the form of a law (for example new regulations are created within the Higher Education Act), then the very same law should address funding for such extra appropriations.

There are flexible and inflexible, or regular and extraordinary, appropriations in the budget, also called by some economic literature constant or variable items.

- Short-term inflexible ("regular") entries include various allowances, normatives, wages (social security, family welfare, social and educational normatives, etc.) and tax revenues because these are stipulated (previously!) by specialised laws and not by the law on central budget.
- Short-term flexible ("extraordinary") items include application funds, operational expenditures for appropriations that are managed by budgetary chapters, etc. If a decision is made to amend specialised laws that define regular entries, it could be offset in the scope of extraordinary items, which means spending defined by specialised laws should be offset elsewhere. Thus, funding is immediately found for any extra expenditure.

Expenditure cap rule

The essence of the expenditure cap rule-according to which chapter-based subsidy appropriations are defined for n+3 years-is that each ministry will receive advance plans of their subsidies for the period. Ministers and executives responsible for budgetary chapters have decision-making authority to define priorities within these allocations. The government will review the caps each year and may rearrange them in certain cases, such as the occurrence of residual funds, new tasks, or extraordinary events. Obligatory rearrangement is to be executed when indicators defined by the result rule are jeopardised.

Guarantee rule (budget planning on the basis of cautious macroeconomic predictions)

Various guarantees should be built in the medium-term program in the course of planning. According to a possible concept, the "half-percent rule" could be applied. This means that the government will create, together with players on the domestic and international markets, a consensual extent for budget-defining parameters (macroeconomic indicators), for example that GDP will grow steadily at an annual rate of 4 per cent in the years to come, or that inflation will be around 3 per cent. In the course of subsequent planning, figures half a per cent worse than the consensual path will be taken into account.

Half-percent rule in practice (four macroeconomic indicators)

- Real GDP grows 0.5 per cent slower than market consensus says it will, therefore the former figure should be taken into account.

◗ Retail real consumption shall be accounted at a figure 0.5 per cent slimmer than market consensus.

◗ In the course of planning, inflation should be 0.5 per cent lower than market consensus.

◗ When planning interest expenditures, interest rates shall be 0.5 per cent higher than predicted by market consensus.

When planning authorities base their initial calculations on the guarantee rule, substantial reserves will be created automatically, allowing compensation for occasional overruns. The guarantee rule does not mean wilful underplanning, for it must not be applied in the case of indexed appropriations (for example, the extent of increase in pension expenditures).

This rule decreases public finance risks stemming from changes in the status of the economy, creating guarantees for observing main indicators and the result rule.

Equilibrium rule

In 2006, an equilibrium rule was built in the Public Finance Act in connection with the amendment of said act. The rule dictates that ministries shall prepare quarterly reports, and at these presentations they are to state whether they will go over their appropriations or create a surplus at the end of the year

The very same amendment to the Public Finance Act stipulates that appropriations shall be designated that could only be used when a ministry in question will not overrun its annual budget (equilibrium reserve).

> *Act XXXVIII. of 1992 on Public Finance*
> *Article 49, Paragraph q)*
> *"Unless the law prescribes otherwise, the executive of the authority in charge of the chapter in question shall submit reports to the Government in every quarter in respect of chapter revenues and expenditures and also of their expected development for the year in question".*
> *Article 36, Paragraph f)*
> *"Upon submitting the bill on central budget, the Government shall make recommendations in the chapters defined for ministries for appropriations that shall only be allowed by the Government to be utilised when, based on the quarterly report of the ministry chapter in question, expected developments in the budget of said ministry permit such utilisation of funds".*

HOW AND WHY DOES TRANSPARENCY HELP CREATE EQUILIBRIUM?

Transparency of finances starts with submitting the bill on budget to the Parliament and ends with paying the invoices of public institutions. Therefore, it must be ensured that the overall route of public funds be tracked.

Initially, it should be demonstrated in the case of each new bill how the balance of the budget will be impacted if the bill in question is approved. In addition, the validity of the arguments should be verified. Verification could be done by the State Audit Office, private research institutions, international analysts or by an institution established specifically for that purpose.

Transparency is to be applied also as a general practice in the case of forecasts and budget policy commitments. Here, the verification of government prognoses is to be done by market players, or an institution independent from the government and reporting to the Parliament can also form opinions just like the Convergence Council does.

Preparing consistent time series and making them publicly available is a prerequisite to objective analysis. Aside from those few macroindicators that are usually released, the number of intermediate assumptions to derive budgetary figures from reaches into the hundreds.

The State Audit Office is already making an enormous work in commenting draft budgets, but it does not disclose alternative calculations-partially due to lack of legal authorisations and of necessary capacities.

A relatively extreme example for comparison is the United States where the calculations of the Congressional Budget Office automatically replace the budget submitted by the President if the former is materially different from the latter.

In Hungary, the relevant parliamentary committee could have the right to decide by vote whether the calculations of the government or the State Audit Office should be considered as relevant when judging the expected future impact of a specific measure. This would make the job of the government more difficult at first glance; however, it would result in more accurate and transparent calculations. It would also help approve the bills on final accounts if the State Audit Office already made these calculations in the budget planning phase. Running mutual risks would help achieve the objectives more efficiently.

PROGRAM-BASED BUDGET

What has been described above can be achieved if steps are taken to establish what is called a programme-based budget[1].

Draft budgets today consist of approximately 5,000 pages in ten volumes. Generally, 3,000 amendment proposals are submitted by MPs, mostly aiming to achieve local objectives such as the construction of by-pass roads or other local subsidies and other financing in their own constituencies. But there are no real debates about the macroeconomic path, or expenditure possibilities and priorities defined by the economic environment.

Consequently, after the tax laws and the macroeconomic path defined in the budget bill have been approved by the Parliament, MPs should not be debating VAT, nor could they submit amendment proposals to repay less interest the following year and spend the money on other objectives instead.

Therefore, the decision-making process is to be restructured to establish new emphases. The

Table 2

PROGRAMME BASED BUDGET – MODEL

	Main program	Program	Sub-program
Subject	Function	Objective	Measures
Decision	Parliament	Parliament	Government
Responsibility	Head of Portfolio or Representative	Undersecretary of State or Representative	Head of Institution or Representative
Number	40–50	200–300	1500–2000
Example 1.	Environmental protection	Concept for waste water treatment	Construction of waste water treatment plant Increase in penalties
Example 2.	Housing construction	Program for housing blocks made of prefabricated concrete	System of interest subsidies Elaborating the role of municipalities

only way to achieve it is to introduce program-based budgeting.

Fewer numbers should be presented and more issues that impact the life of the citizenry are to be discussed.

Program-based budgeting would mean that the Parliament would approve the financing of specific projects, and the government would report to the Parliament on the implementation of these programs. This is a model where state responsibilities are classified by tasks and functions, and these tasks and functions would appear as appropriations in budget presentations. *(See Table 2.)*

Reporting is made biannualy to the government or the head of a portfolio in a report prepared by the person in charge for the program. Supervision of annual implementation and control of program indicators are to be submitted to the Parliament. Program-based budgeting will, or at least is likely to, resolve the issue of performance indicators. There has been a long-standing need for measuring the performance of public institutions and state organisations. International experience varies, implementation is unlikely to be quick and inexpensive, yet it is an essential part of reforms, for there is no better practical, or even theoretical, alternative. Performance indicators used in programs should be in line with performance requirements.

* * *

The author believes to have managed to convince you, dear reader, that the management of public finances is to be reconsidered. This is not the interest of the financial government alone. The parliamentary opposition of the time, the State Audit Office, and the relevant ministries are also partners to it, for their activities do not focus on preparing new budgets solely, they also want to achieve good results in their own professional areas. The betterment of the economy is in the interest of all political and non-political entities.

NOTE

[1] A relevant article has been published by these pages this year. See: Gusztáv Báger: Program-based budget - typical features, practical experience, *Pénzügyi Szemle [Public Finance Quarterly], 2006.3., pages 281–301 (Editor)*

György Szapáry*

Experience with inflation targeting in Hungary

I would like to recall to start with some of the basic principles regarding to the purpose and conduct of monetary policy which, while fully accepted by the profession, are perhaps less familiar to the general public.

The Magyar Nemzeti Bank (MNB) – just like the central bank of any developed country – is obliged by law to ensure and maintain price stability. It is fairly easy to see the reason for this obligation: inflation hinders the healthy development of the economy, i.e. it is a harmful phenomenon. The most harmful element of high inflation is that it causes an unintentional redistribution of incomes: it typically erodes the savings and incomes of those who live on salaries and pensions, and thus has a particularly adverse effect on the elderly population. High inflation also involves higher price volatility, which increases uncertainty. The volatility of inflation interferes with the information content of prices which forms the basis of any properly functioning market economy. This distorts the assessment of demand and supply conditions, preventing the efficient utilisation of resources. High inflation rate goes hand in hand with high nominal interest rates, as a result of which borrowers' nominal cost of debt repayment will increase as a proportion of their disposable income. This results in shorter maturities of loan agreements and consequently reduces the depth of financial intermediation. Another problem is that the uncertainty generated by inflation means that economic relationships (such as business contracts) tend to become shorter, which is unfavourable for economic activity.

Although the fact that inflation results in significant social costs is now generally accepted in the economic profession, the commitment to low inflation continues to be a great challenge for economic policy. The reason for this is a problem that we refer to as 'time inconsistency'. Time inconsistency stems from the assumption that the central bank is capable of surprising economic agents with higher-than-expected inflation. Since this surprise inflation is able to increase output and decrease unemployment *temporarily* (by redistributing income to corporate earnings away from those whose livelihood comes from salaries and pensions), there is sometimes a politically-motivated inclination to oblige the central bank to boost inflation. Since economic agents are aware that

* I would like to express my gratitude to *Máté Barnabás Tóth* for his contribution to this article, as well as to *István Hamecz, Zoltán Jakab M.* and *Mrs. Kaderják, née Ágnes Csermely* for their useful comments. This essay served as the basis for the author's article that was published in the October 10, 2006 issue of the daily *Népszabadság*.

political interests may be behind the generation of surprise inflation, they adjust their expectations from the very start, resulting in inflation rates which exceed the social optimum while leaving the level of output unchanged. This conflict is especially intense during periods of disinflation, since disinflation may involve temporary costs in the short run, while the advantages arising from low inflation only materialize over the longer term.

The key to solving the time inconsistency problem and the occasional inclination of decision-makers to generate inflation is credible commitment. In both the economic literature and in actual policy thinking it is a generally accepted view that the political cycles typical in democracies, and the main goal of politicians to get elected, make it difficult to build a credible commitment to price stability and to maintain such stability. This is why monetary policy decision-making has been placed in the hands of an independent body (the central bank council), the members of which are thinking in longer time horizons without regard to political cycles when making decisions about maintaining price stability. The independence of the central bank is the guarantee for avoiding conflicts between commitment to price stability and other goals. This is why it is important that society entrust responsibility for monetary policy to decision-makers who think in terms of a longer time horizon, rather than short-term economic or political interests.

It is a generally accepted view both in the economic profession and in central banking practice that monetary policy can best contribute to long-term economic growth by maintaining price stability. Long-term economic growth is determined by the evolution of potential output which is determined by factors exogenous to monetary policy (such as technological development, accumulation of human capital or demographic trends). This means that monetary policy is not able to raise output in a sustained manner above its potential or natural level. Nor is monetary policy able to offset market deficiencies restraining potential growth which are rooted basically in the real economy or are of a structural nature (such as labour market rigidities, distortionary taxes, budgetary inefficiencies). Moreover, monetary policy is not able for maintaining a country's external balance over the long term if it is undermined by excessive government spending. A depreciation of the exchange rate may halt the deterioration in the balance of payments in the short term, but if there is no real adjustment in fiscal policy, price and wage inflation will soon adjust to the depreciation, eroding the beneficial effect of depreciation on the external balance.

POSSIBLE MONETARY STRATEGIES

It is a fundamental premise and a general expectation that monetary policy should provide a nominal anchor that guides the expectations of economic agents and serves as of point of reference for making economic calculations. In the 1970s and 1980s, several developed countries implemented policy regimes that targeted monetary aggregates, which assumed a stable correlation between money supply and inflation. International experience, however, has shown that this correlation is rather weak and can change over time. Despite this, the German Bundesbank operated such a regime for a long period of time prior to the introduction of the euro. Although the targets for the monetary aggregate were frequently missed, the Bundesbank was able to maintain a permanently low inflationary environment. One explanation for this apparent contradiction may be that the expectations of economic agents were guided by the Bundesbank's anti-inflation reputation rather than the monetary aggregate targets. As the old saying went, '*Not* *all Germans believe in God, but all Germans believe in the Bundesbank*'. Due to the loose and unpredictable correlation between money supply and inflation, most developed countries eventually abandoned the policy regimes targeting monetary aggregates.

Another possible strategy is a system based on exchange rate targeting, when the central bank explicitly commits itself to an exchange rate level or an exchange rate band *vis-a-vis* a strong international currency. This commitment must be very strong to provide a stable anchor for expectations. The strongest version of such a commitment is a currency board stipulated by law (or perhaps even by the country's constitution). But having a fixed exchange rate as a nominal anchor can cause several problems. First, the monetary policy 'imported' with a fixed exchange rate is not necessarily the optimum solution for the country which applies the fixed exchange rate, especially if there are considerable differences in economic structures, or if country-specific cost or supply shocks occur. Fluctuations in the markets' risk assessment may also represent a significant challenge for a country that fixes its exchange rate. Second, in such a system, adjustment to external shocks affecting the real economy is only possible through changes in relative prices and wages. If prices and/or wages are 'sticky', this will be a lengthier and more painful process than adjustment through the nominal exchange rate. This phenomenon is well illustrated by the example of Lithuania, where the rising world oil prices resulted in inflationary pressure within the framework of the currency board system that prevented the country's accession to the euro area. Finally, lack of support from fiscal policy may undermine the credibility of the fixed exchange rate to such a degree that the system can no longer be maintained and it collapses. In such cases, credibility can only be restored at considerable cost (see the case of Argentina).

Due to the aforementioned deficiencies of the regimes based on targeting monetary aggregates or the exchange rate, more and more countries have been switching over to using the system of inflation targeting. In an inflation targeting system, the central bank has no 'indirect targets' in the classical sense, such as the exchange rate or a monetary aggregate; instead, a direct, quantitative inflation target is set by the monetary authority. The inflation forecast can, however, be regarded as interim targets, in the sense that monetary policy influences the inflation rate expected in the future (within 1–2 years) by using the tools available to the central bank (the policy interest rate in most countries) in an attempt to keep inflation close to the target. In a somewhat simplified terms, an inflation targeting central bank's decision-making rule is that if the forecast exceeds the inflation target, monetary conditions are tightened, whereas if the forecast is below the target, then conditions are eased. The inflation forecast is prepared taking into account a wide range of leading economic indicators. This is also an aspect which distinguishes the inflation targeting system from the other regimes discussed above, since those regimes focus on a primary indicator, the evolution of which serves as the basis for the central bank to make its decisions. The system of inflation targeting is thus more flexible and allows more room for discretion by taking into account all of relevant economic developments.

In a successful inflation targeting system, the inflation target is able to anchor inflation expectations. As a result, pricing becomes increasingly forward-looking, and economic agents can prepare for long-term price stability. Because expectations play a key role in the operation of the system, and the measures taken by the central bank do not have a direct and immediate effect on inflation (as they work only with a certain lag and a certain degree of uncertainty), the role of communication and transparency is of greater importance compared to the other regimes. This includes both verbal communication and written documents, such as inflation reports, through which the general public can learn how the central bank views the development of the economy. By relying on these reports, economic agents are able to formulate expectations about the future actions of the central bank. Using these documents, the monetary authorities can provide information to serve as the basis for their decisions, which is vital for strengthening the credibility of the central bank.

Another advantage of inflation targeting is that the central bank does not explicitly need to make a commitment to an economic variable (monetary aggregates, exchange rate), over which it only has indirect and limited influence. Thus, it does not continuously have to risk its credibility. Instead, a medium-term goal is defined, from which temporary deviations are accepted. This can be significant if the inflationary process is affected by shocks that, due to the 1 to 2-year lag in the impact of monetary policy actions, the monetary policy is not able to and does not necessarily intend to fully offset (such as increases in oil prices or VAT rates). This allows the monetary policy to be more flexible, and there is more time for it to recognise and evaluate changes in economic developments. Furthermore, potential monetary policy errors will not automatically lead to a loss of credibility of the system. Despite this seemingly 'soft' commitment, the regime still addresses the problem of time inconsistency, since the inflation targeter central bank's only goal is price stability, and this target is transparent and accountable.

THE EXPERIENCE OF INFLATION TARGETING IN HUNGARY

In Hungary, the inflation targeting regime began operating in June 2001, after the previous crawling-peg devaluation system proved

Figure 1

EVOLUTION OF THE CONSUMER PRICE INDEX AND CORE INFLATION IN HUNGARY

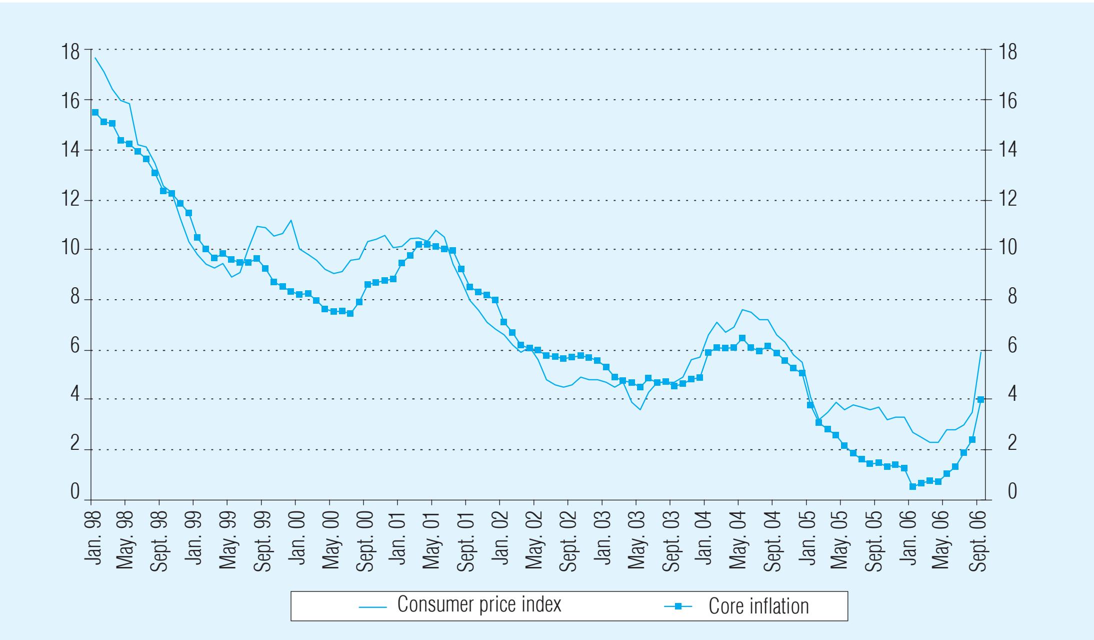
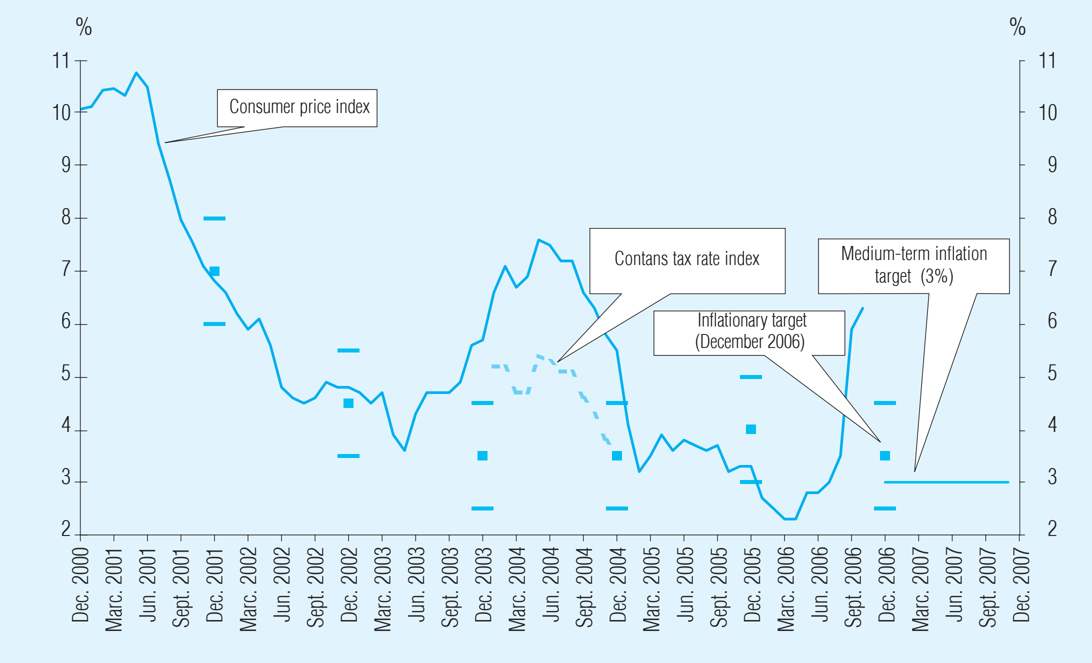


Figure 2

INFLATION TARGETS AND THEIR EVOLUTION



unsuitable for further reducing inflation that had become stuck at around 10 per cent. When the new regime was introduced, inflation targets of 7 per cent and 4.5 per cent were set by the MNB for December 2001 and 2002, respectively. Afterwards, annual inflation rates for at least two years in advance were defined each year until the end of 2006. Once inflation has dropped to around 3 per cent, the MNB will switch over to using continuous inflation targets from 2007 onwards. The mid-term goal, which is 3 per cent, was jointly set by the MNB and the Government in August 2005.

Following introduction of the inflation targeting regime, the inflation rate, which had previously stagnated at a high level, began to decline *(see Figure 1)*. Due to the stricter monetary conditions, but also to the favourable development of external factors, inflation dropped by 4 percentage points by the end of 2001 compared to the peak rate registered in May, and approached the target value of 6.8 per cent. By late 2002, inflation had further decreased to 4.8 per cent, closely approaching the target *(see Figure 2)*. Achievement of the 2001 year-end target cannot entirely be regarded as the result of inflation targeting, since the end of 2001 was outside of the time horizon of monetary policy effectiveness and there was also a fall in the price of pork. Nonetheless, the initial credibility of the new regime was enhanced by the fact that the target was achieved and, in this respect, the timing of the introduction of this system proved to be favourable.

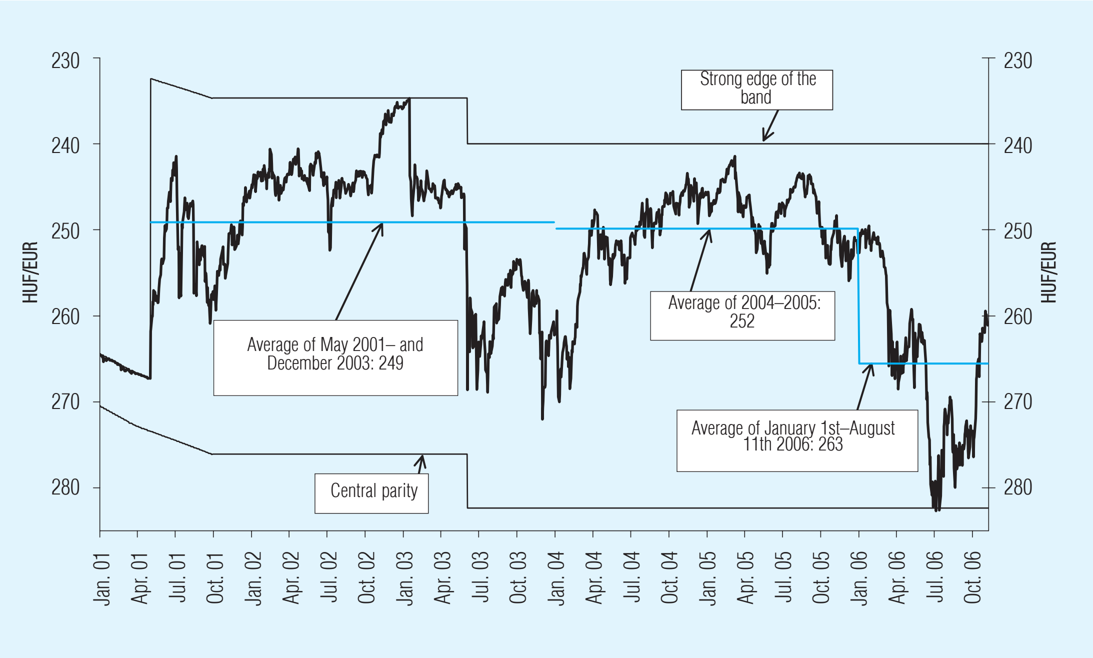
As the Hungarian economy is very open, the exchange rate plays a major role in the impact of monetary policy on the real economy and on inflation. Following the widening of the Hungarian forint's fluctuation band, the exchange rate appreciated by some 11.6 per cent from May 2001 to December 2002, as significant amounts of capital flew into the country despite a lowering of domestic interest rates. On the basis of unit labour costs, the appreciation was somewhat higher, amounting to 14 per cent. The MNB was criticised on several occasions during that period for allowing such a large degree of exchange rate appreciation. Critics were worried about the adverse impact of the appreciation on exports and the external balance of the economy. The disinflationary effect of a stronger exchange rate was highly uncertain at that time. Many disputed the effect of a stronger exchange rate on inflation, or believed that the sacrifice of the real economy required for disinflation achieved in this manner was excessive. Accurate assessment of the impact of appreciation on the real economy was rendered even more difficult by the fact that, as a result of the convergence process, the Hungarian economy is moving on a long-term equilibrium path of real appreciation. In such an environment, a possible overvaluation of the real exchange rate can only be assessed in comparison to an equilibrium appreciation path – which cannot be directly observed – rather than in comparison to an earlier level. However, it is important to note that the effect of the sustained nominal appreciation on exports was, as expected, mitigated by the rapid growth in domestic productivity, helping the corporate sector to adjust relatively flexibly to the stronger forint. Nevertheless, it cannot be proven and will remain an open issue whether a slower appreciation and disinflation could have anchored inflation expectations so quickly, and whether it would have involved less real cost for the economy over the medium term.

A considerable relaxation in fiscal policy occurred in 2002, and this was not followed by a genuine adjustment in the post-election period. This fiscal loosening affected inflation through the channels of both demand and supply. The most important demand factor was the increase in household consumption resulting from salary increases and the introduction of tax-free minimum wages, in conjunction with the state-subsidised housing loan system. As a supply factor, we should mention the tension in the labour market caused by an increase in public sector employment. This fiscal loosening did not yet affect the achievement of the inflation target for end-2002, but as a result of the above measures, considerable upside risks emerged in relation to the 2003 target, which was set at 3.5±1 per cent back in late 2001. The loosening of fiscal discipline also involved a deteriorating and fluctuating risk assessment of the Hungarian economy. The exchange rate of the forint depreciated temporarily in the summer of 2002, and could only be stabilised by an increase in central bank interest rates and the Government's promises to reduce the budget deficit. As a result of these fiscal policy shocks and, to a lesser extent, rising oil prices, meeting the 2003 year-end inflation target required a strict monetary policy, and the exchange rate approached the strong edge of the fluctuation band *(see Figure 3).* Stronger capital inflows and the associated strengthening of the forint during that period can partly be ascribed to market optimism boosted by the positive results of the referendum on EU expansion held in Ireland.

In response to this contradictory situation, a significant amount of speculative capital flew into Hungary in January 2003, with a view to forcing a shift in or an abandonment of the strong edge of the exchange rate band in the hope of realizing a high profit. Abandonment of the strong edge of the band appeared to be a possibility to speculators because in the new situation brought about by the loosening of fiscal constraints, the scope of action for monetary policy seemed to be restricted. At that time, the anti-inflation credibility of monetary policy had been strong in the eyes of market participants, so that the thought that the MNB would be willing to modify, or even give up the fluctuation band of the forint – in order to achieve the

Figure 3

EVOLUTION OF THE EUR/HUF EXCHANGE RATE



inflation target set for 2003 – might have seemed plausible to many players. This belief may have been strengthened by the MNB's communication, as it emphasised the importance of the exchange rate in pursuing the inflation target. However, these beliefs proved to be wrong in several respects: first, in early 2003, the inflation target for December 2003 was already outside the horizon relevant for monetary policy and second, market participants disregarded the fact that the exchange rate system could only be changed with the Government's approval. It was known that the Government was opposed to any steps which could have increased the risk of further appreciation. That said, it can be assumed that the intensity of speculation could have been reduced had the conditions required for modifying the band been communicated more clearly.

The central bank's response to the influx of speculative capital was to considerably reduce the base rate, as well as to widen the overnight interest rate corridor, as a result of which pressure on the exchange rate was alleviated: some of the capital speculating on an appreciation exited Hungary, as a consequence of which the exchange rate of the forint weakened by 4 per cent and then stabilised. In June 2003, the MNB agreed to the modification of the exchange rate band requested by the Government which meant a slight – 2.26 per cent – devaluation of the forint's central parity. This difficult to understand action was probably urged by the Government in order to moderate the risk of a potential appreciation. This small, but unexpected measure shook the market's confidence in monetary policy, leading to a capital outflow, as consequence of which the exchange rate of the forint depreciated significantly. The risk premium required by investors increased considerably, indicating that the uncertainties related to the future evolution of the exchange rate had risen. In response, the central bank increased the base rate by a total of 3 percentage points in two consecutive steps in June.

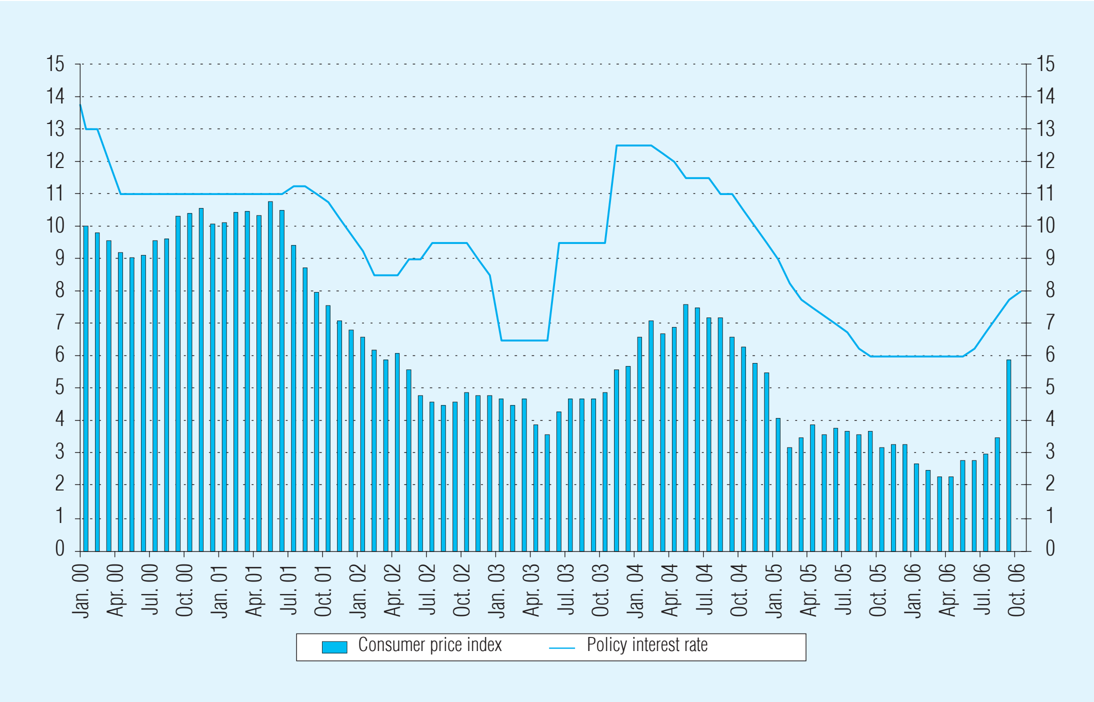
After the consolidation that followed this turbulent period, as the end of 2003 approached, the market's attention increasingly focused on the unfavourable equilibrium position. The promised fiscal tightening measures were only realised to a symbolic extent, and the fiscal expansion and increased consumer spending was reflected in a strongly negative current account position. The long-term prospects of nominal convergence deteriorated and the date of adopting the euro in Hungary was accordingly delayed. As a result, the exchange rate grew considerably weaker in late November and yields rose, indicating that the risk premium of forint investments had worsened. The Monetary Council increased the policy rate by 3 percentage points at the end of November, with a view to offsetting the increase in the risk premium and preventing further weakening of the forint which would have jeopardised meeting the inflation target. Despite these efforts, monetary policy was unable to maintain the exchange rate within the range consistent with the inflation target and this allowed the inflation-generating impact of the earlier shocks to have a greater effect. Consequently, in mid-2003, the process of disinflation stalled, and the consumer price index increased by 5.7 per cent by the end of the year, considerably surpassing the 3.5 per cent ± 1 per cent target for December. The fact that in October 2003 the Government and the MNB defined an inflation target of 4 per cent ±1 per cent for 2005, compared to the 3.5 per cent ±1 per cent for 2004, also shows that the process of disinflation had lost momentum by this time.

Despite the continuing severe economic imbalances in Hungary, the period that commenced at the beginning of 2004 was characterised by stable monetary conditions and significant progress in disinflation. With the interest rate hikes carried out in late 2003, as well as the ensuing gradual but cautious cycle of interest rate cuts, the central bank clearly indicated to the financial markets that it was committed to achieving price stability. In this period, the exchange rate of the forint was relatively stable, and the strong appetite for risk-taking in the global financial markets allowed for a gradual lowering of the domestic interest rate level, despite the lack of improvement in budgetary prospects. However, the MNB was criticised for being overcautious in reducing the base rate. The increased degree of caution in the monetary policy course taken was also necessary because the VAT rate was increased by the Government with effect from January 2004, which exerted a direct, one-off influence on price levels, and there was a risk that this one-off higher inflation would be incorporated into expectations, causing an increase in inflation over the long run. The central bank did not wish to neutralise the direct price level impact of the VAT tax increase, so it simply "saw through" it. At the same time, however, it indicated that the second round effects represented an upward risk for achieving the inflation target. It is worthwhile to note that the base rate was reduced by the MNB in 2004 prior to the inflation hitting its peak, as soon as it became clear that inflation expectations had not increased *(see Figure 4)*.

In my opinion, the cautious easing cycle helped to anchor expectations and, as a result, no second round effects of the one-off increase in price levels materialized in the inflation. While it is true that the 5.5 per cent rate of price increase at the end of 2004 exceeded the upper end of the 3.5±1 per cent target, the price index with unchanged tax content, which did not take into account the impact of the VAT rate increase, coincided with the 3.5 per cent target. This showed that monetary policy was able to keep the econo-

Figure 4

EVOLUTION OF INFLATION AND THE CENTRAL BANK POLICY RATE



my on a stable nominal course even in the midst of unfavourable shocks and to successfully anchor inflation expectations. This was increasingly apparent in the wage-setting processes as well. Despite the significant fluctuations in the gross average salaries of the public sector, the growth rate of average wages in the whole economy has tended to decrease ever since the regime of inflation targeting was introduced *(see Figure 5)*. In the course of 2004–2005, due to Hungary's accession to the European Union, competition in the retail sector, together with the slower growth in consumer spending and the adjustment of wages to a lower level of inflation, lead to a consolidation of the downward trend in inflation. By the end of 2005, inflation approximated the 3 per cent level, regarded as price stability for the Hungarian economy. Inflation decreased to 3.3 per cent by December 2005, remaining within the tolerance band, but slightly undershooting the 4 per cent inflationary target set for the end of the year. In the first six months of 2006, the inflation rate was consistently below 3 per cent, primarily as a result of the VAT rate reduction which took effect on 1 January. However, the price moderating effect of the VAT cut proved to be less than expected and the inflation figure of July 2006 (3 per cent) suggests that inflation may again follow an upward trend.

CONCLUSION

Having reviewed the experience with inflation targeting, we may ask whether the monetary policy of the past five years has been successful. The success of monetary policy can best be measured against two benchmarks:

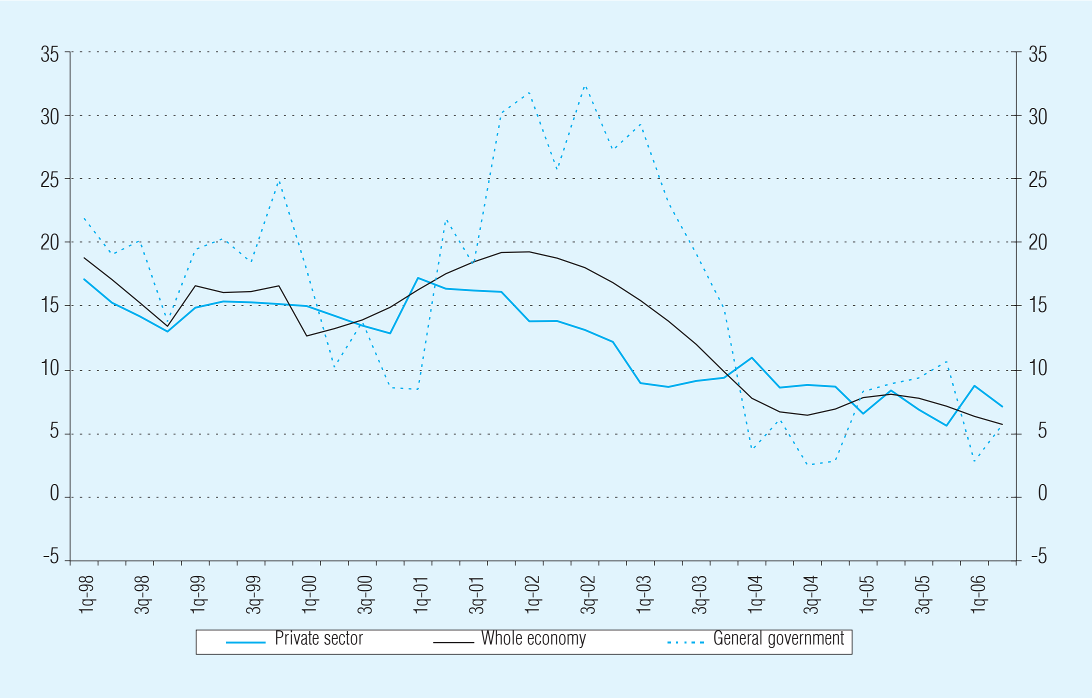
1. At what real economic cost has low inflation been achieved?

and

Figure 5

ANNUAL GROWTH OF GROSS AVERAGE SALARIES

(seasonally adjusted data)



❷ Can low inflation be maintained in the long term?

It can be regarded as a success for monetary policy that over the last five years – despite the significant cost and demand shocks that have affected the Hungarian economy – price stability was gradually achieved and inflation expectations were reduced to a moderate level. All of this occurred in conjunction with economic growth which was not significantly lower than the potential value, i.e. without considerable costs in terms of growth. It is true that the demand-generating effect of the budget also contributed to sustaining growth, but the structure of this growth improved and exports became the driving force. The strict monetary policy was precisely made necessary by the lax fiscal policy. It should be noted that the role of monetary policy has not been the only factor behind in the favourable developments in inflation; other factors also played a role. Among these one should note the global disinflationary tends seen in recent years, the favourable external interest rate and liquidity environment, as well as the rather strong risk appetite for emerging market assets. The rapid growth in productivity in the domestic economy has been another contributing factor, as it has allowed to keep the prices of traded goods at a low level, thus maintaining competitiveness. The economically not well justified practice of keeping certain regulated prices artificially low has also been a factor contributing to the moderate inflation.

The above results were achieved under conditions of significant imbalances that carries considerable risks of sustainability in the long run. The massive twin deficit of the government budget and the current account renders the country vulnerable to external shocks. Not only do external shocks slow down the growth of the economy, they may also have an adverse effect on the inflation process and expectations. This means that the achievement of low inflation and relatively balanced growth can only be maintained over the long run if the central bank's commitment to low inflation is also supported by fiscal policy. From the second half of 2003, the Hungarian economy functioned in a particularly favourable global environment, which was characterised by low long-term yields on the global markets, the strengthening of investors' risk appetite and the related historically low risk premium on emerging market instruments. Hungary did not, however, take advantage of this 'grace period' to improve its budget position. On the contrary, highly favourable external financing conditions were accompanied with a strongly expansionary fiscal policy. As the largest central banks started increasing their interest rates in 2005-2006 and the risk appetite began to weaken, the negative demand effects of the fiscal consolidation efforts commenced in 2006 will reach their peak in a much less favourable international environment. If fiscal policy had not previously been so expansionary, and if the measures aimed at reducing the deficit had been taken earlier, the required adjustment would have been smaller and could have been carried out in a significantly more favourable financing environment. This would have resulted in a lower decrease in aggregate demand and lower sacrifice.

Consequently, the Hungarian monetary policy now faces new challenges. The large fiscal and external imbalances and the significant but in its structure unexpected fiscal adjustment, together with the global cycle of interest rate increases and declining risk appetite, have lead to a weakening exchange rate and higher domestic interest rates. Thus, the announcement of the budgetary adjustment measures taken by the new Government has not rendered monetary policy any easier over the short run. The measures aimed at improving the budget balance are mostly focussed on the revenue side of the budget and have a significant inflationary effect (such as the increase of VAT rates and gas prices), while the long-term sustainability of the announced measures on the expenditure side is uncertain. Average *annual* inflation will probably be well over the 3 per cent target in 2007, and will exceed it to a lesser degree in 2008. It is also difficult to judge how this second jump in inflation in such a short period of time will influence inflationary expectations which seemed to have been successfully anchored at a low level. But is it sustainable when fiscal policy repeatedly pushes inflation higher?

In conclusion, this brings up an important question, namely what is the correct (optimum) reaction for monetary policy when strong fiscal overspending causes a large current account deficit. If the central bank attempts to support the consolidation of the government budget by keeping interest rates low and tolerating a significant weakening of the exchange rate of the forint which jeopardises the fulfilment of the inflation target, the current situation would probably deteriorate further. Such behaviour by the central bank would allow the economy to drift into another inflationary spiral, with all of the concomitant disadvantages discussed earlier. This would be exacerbated by the fact that every new inflationary episode makes it more costly to anchor expectations and to bring inflation down again. This would result in a loss of credibility in the eyes of the foreign investors which finance the current account deficit and, to a large extent, the budget deficit as well, and would trigger a steep increase in long-term yields and decreased capital flows into the country. The interest burden of the budget would go up rather than down as a consequence, while the state debt denominated in foreign currency would suffer a significant exchange rate loss.

Since the monetary policy has no tools at its disposal with which budgetary developments can be effectively influenced, the central bank can best support fiscal policy by endeavouring to preserve its own credibility and achieve its inflationary target. Beyond this, the monetary policy can only try to use persuation through consistent communication, calling attention to the unsustainability of excessive deficits and the expected costs of the unavoidable adjustments that will be forced upon by the markets. Credible communication also means that the central bank, in order to ensure transparency, should always strive to present a realistic picture of the budgetary position, even if this is not always greeted with enthusiasm on the part of governments.

Miklós Losoncz

EU tax harmonisation and tax competition – lessons to Hungary

This study explains the correspondence between tax harmonisation and tax competition, focussing its arguments around the notions of competition and competitiveness. The development of the European integration, the particular forms of integration and the particularities of the common budget give rise to the necessity of developing and operating a common tax policy and a system of taxation, with the harmonisation of national tax policies and systems of taxation as a minimum requirement. With deepening globalisation and a gradual phase-out of discriminative tax allowances incompatible with market economies, however, it is not only countries or their companies and sectors that compete but also their tax policies and systems of taxation – primarily in reducing their tax rates. As a consequence of this, however, a requirement follows for Member State tax policies and systems of taxation to compete and be tendered in competition.

An overview of a few general issues of tax harmonisation places corporate taxation in a broader context; such an overview is the focus of this study. Our purpose is to analyse what factors influence EU harmonisation and tax competition, whether harmonisation or competition will be the decisive factor, and how the expected trends will affect the competitiveness of Hungary and the local corporate taxation.

What makes this subject topical is, among others, that the latest enlargement added countries to the European Union where the corporate income tax (hereinafter referred to as corporate tax in short) rate was low, what is more, some of the acceding countries even reduced this rate before accession. Such a step was conceived by old Member States as tax competition, or directly as “tax dumping”.

SOME GENERAL ISSUES OF TAX HARMONISATION

According to a generally accepted definition, tax is a recurring liability of the various participants of the economy, and revenue gained from it is used to cover public expenses. Tax liability is incurred by a unilateral will of the public authority, involves no direct consideration, and is enforceable on non-performance (Vigvári, 2002, page 144). In addition to covering public expenses, tax is also an essential macro-economic regulator and a means of orientation. Tax-rises curb economic growth, while exemption from taxes, or tax allowances may induce growth both in certain parts or the whole economy. Taxation also affects the distribution of income among the participants of the economy (business sector, households) and the utilisation of production factors (workforce, capital).

Accordingly, tax policy and the tax system need to pursue two contradictory objectives simultaneously: the income necessary to perform government duties must be catered for, while economic activities and an efficient utilisation of production factors should not be restrained, but possibly promoted, and competitiveness should be improved.

In the European Union, the issues of tax policy and the tax system are met at the level of integration on the one hand, and at the level of Member States on the other hand. The budget of the European Community differs from the budgets of both the individual states and of international organisations. The EU budget reallocates a much smaller portion of the GDP (a maximum of 1.045 percent in the period between 2007 and 2013) compared to the Member States (40–55 percent); at the same time, the EU budget is much higher than that of international organisations, and much lower than of all Member States. The common budget contains restrictions that are inconceivable in a country. Accordingly, no taxes are levied at the community level, and the expenses of the common budget are covered from Member State taxes and contributions collected. The Community has no organ dedicated to taxes, Member State contributions are limited, budget deficits cannot be funded from loans, and a seven-year statutory financial budget limit planning precedes the production and acceptance of the budget. The expense side of the common budget has more limited functions of allocation compared to individual states. The conflicted targets of ensuring revenues and encouraging economic activities at the same time are not applicable to the common budget.

From the viewpoint of the European Community, the tax policy and the tax system of Member States are a material component of the economic environment, which is inseparable from the free movement of goods, servoices and production factors (capital and workforce) among Member States. Indirect taxes are levied to product and service sales, and, consequently, they directly affect the operation of the customs union and the single market including the customs union. Direct taxes are applicable to the income of natural persons and legal entities, accordingly, are linked to a smaller extent and directly to the movement of goods and services among Member States, however, they may affect the movement of production factors (workforce and capital) among Member States, i.e. the operation of the common market and the included single market.

The treaties of the European Union consider competition as an engine to economic development, consequently, aim at breaking down all factors hindering competition, which also affect trade among Member States. The differences between tax policies and tax systems of various Member States undoubtedly distort competitive conditions among Member States. The significance of this distorting effect increases with transition to new forms of regional economic association (free trade zone, customs union, common market, single market, economic and monetary union). As a consequence of this, a requirement to unify the tax policies and tax systems of Member States, and even to develop a common tax policy and a tax system. At the same time, the tax systems of individual countries also compete each other in the integration, which may have positive effects on economic growth, and – in a broader context – on economic development and competitiveness.

The harmonisation of tax laws aims at eliminating differences between tax conditions in Member States, which also caters for the convergence of tax provisions. Harmonisation can be complete, for instance, if a uniform adoption of a European corporate tax is set as an objective. For partial tax harmonisation, the tax rates of individual Member States are intended to be adjusted to one another. In case of positive tax harmonisation, community legislation is applied to converge tax-related provisions. Negative tax harmonisation means seeking to avoid arbitrary discrimination or protectionism that would be caused by differences in the tax legislation in individual countries, while the differences themselves persist. Finally, in case of the weakest form of legal harmonisation, relying on the principle of subsidiarity[1], national tax laws primarily use Member State legislation to reach compatibility among national tax provisions. In such cases, direct community legislation becomes unnecessary (Deák, 2001, page 166).

Negative legal harmonisation appeared as early as in the Treaty of Rome with a view to preventing taxes generating protectionism from influencing trade among Member States (Fazekas, 2002, page 52). Under Article 90 of the currently effective EC Treaty "no Member State shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed on similar domestic products. In addition, no Member State forbids the imposition on imported products of any form of taxation of such a nature as to afford indirect protection to other products." Under Article 91, "where products are exported to the territory of any Member State, any repayment of internal taxation shall not exceed the internal taxation imposed on them whether directly or indirectly."

Article 92 stipulates that "in the case of charges other than turnover taxes, excise duties and other forms of indirect taxation, remissions and repayments in respect of exports to other Member States may not be granted and countervailing charges in respect of imports from Member States may not be imposed unless the measures contemplated have been previously approved for a limited period by the Council acting by a qualified majority on a proposal from the Commission."

Finally, under Article 93, "the Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market within the time limit laid down in Article 14" (Fazekas, 2002, page 52).

The direction, contents and pace of legal harmonisation within the Community are directly related to the four freedoms (general turnover tax: free movement of goods and services; profit tax: establishment of enterprises and movement of capital; personal income tax: free movement of labour, i.e. what eligibility can be obtained in another country against public dues paid in one country).

In terms of regulating taxation, two contradicting views are distinguished in the European Union. One concept aims at unity and unification, which is directed at eliminating differences among the tax policies and tax systems in Member States, and at unifying tax types and tax rates. The other concept considers also the interests of Member States, and, accordingly, recommends a differentiated approach, and settles for cooperation among Member States in terms of tax policy. Followers of this concept attribute positive growth and efficiency effects to competition among various tax types. They emphasize that taxes should be paid or collected in a Member State subject to the location of the respective taxable activity. Considering that the location of economic activity can be freely selected, governments are forced to compete for tax revenues. In a single market, the conditions of competition requires no harmonisation of Member State tax policies; coordination of tax policies is sufficient. The latter refers to eliminating withholding taxes on money and revenue transfers (interest and royalty payments) between associated enterprises, and to coordination in terms of regulation concerning pricing and cost settlement, among others.

The harmonisation of tax law in the European Union has been implemented in various forms of compromise between these two concepts. The main reason for this lies in the fact that the specific forms of tax harmonisation affect the volume of tax revenues, and, through them, public finances and the current balance of payments, while in the case of indirect taxes, the redistribution of revenues generated by the common budget among Member States is affected. The most advanced state of legal harmonisation is seen in the field of direct taxation (taxes on the exchange of goods and services: general turnover tax, excise duties) (positive harmonisation), which is related to the fact that the first to be implemented was customs union. Due to converging market conditions, the operability of the common budget and the registration system, the current agenda item for the general turnover tax has been a transition from the principle of the country of destination to the principle of the country of origin – for over fifteen years now. In terms of corporation tax, negative harmonisation addresses the elimination of tax evasion and harmful tax competition, and positive harmonisation aims at the convergence of conditions of corporate taxation (tax bases, tax rates, conditions of allowances and exemption, a uniform taxation of capital revenues). For the taxation of personal income, negative harmonisation is focused on prohibiting discrimination. In the distant future, the systems of personal income tax and contributions may converge. The differences present in the systems of personal income tax have the least impact on trade between Member States. Despite a relatively slow progress, the acquis communautire concerning taxation has grown to comprise over 140 provisions. Henceforth, this study focuses on the corporate tax, and only addresses other tax types inasmuch as those are related to it.

COMMUNITY HARMONISATION EFFORTS IN CORPORATE TAXATION

According to a widely used – and substantiated – concept, the role of tax systems, in general, is secondary when making investment decisions. Companies make investment decisions considering a number of other aspects influencing the return on investment (market size, availability of workforce of sufficient quality and quantity, volume of labour costs, development of infrastructure, etc.). Competitiveness does not primarily depend on taxation, while taxation, and, in a broader sense, the system of public dues, affects the competitiveness of companies and national economies though a number of mechanisms (Akar, 2006, page 101). Various experts assess the role and significance of these mechanisms in different ways.

Differences in taxes levied on corporate profits by country are brought to the foreground in investment decisions (and become factors of competitiveness) when all other conditions provided by the countries are nearly identical. Rules of profit taxation may advance to play a crucial role and be a competitiveness factor, in particular cases, in an intensifying competition for foreign working capital investments. The tax competition has other implications, too: a non-negligible branch is to supplement the narrow domestic tax base with the broad foreign tax base and the realisation of any associated profits.

Arguments among those against the harmonisation of direct taxes, and, accordingly, the profit tax equally include ones of economic and political nature. A political argument is that community institutions – except for the European Parliament – have no democratic legitimation, given that the members are not directly elected. To be able to levy Community taxes, representation would be necessary. (This argument may be easily refuted by referencing the particularities of the Community's system of institutions.) A more significant fact is that the redistribution preferences of Member States are different. The burdens of stabilisation policies are also left to the public finances of individual Member States: it would generate great difficulties to establish a community stabilisation fund; however, slight is Member State interest in developing public policies that require high expenses (Nicodeme, 2006, page 6). Underlying to these arguments is probably the fact that tax policy is a crucial symbol of financial sovereignty, which (in combination with financing public expenses and redistribution) individual Member States do not wish to give up. After all, the right of levying taxes is an exclusive right of states, while other participants of the economy (including supranational institutions) are not authorised to do so.

A key argument of those in favour of community tax harmonisation is that economic integration and the mobility of production factors may induce a situation where Member States develop a “harmful” strategy to attract and retain the most mobile production factor, i.e. capital, while tax burdens are imposed unilaterally on a less mobile production factor, i.e. workforce. The avoidance of such factors also necessitates coordination at the community level. Various tax-related obstacles prevent completing internal market unification. These can only be eliminated at the level of the community, and not within Member States. This comes from the fact that taxes have certain impacts that are easier to handle at the community level than within individual Member States. Despite all limitations of the role of the community in stabilisation and redistribution, Member States may retain more resources to finance their policies through cooperation at the level of the integration. Finally, a common monetary policy also necessitates monitoring impacts on production and stability (Nicodeme, 2006, pages 6–7).

Application of the principle of subsidiarity alone, as specified in the EC Treaty, to taxation restricts influence at the community level. For community decisions on taxation, unanimity i.e. agreement by all countries is required in the Council to accept community provisions. Previously, the United Kingdom and Ireland prevented tax harmonisation in terms of corporate tax.

Tax harmonisation necessarily violates the national sovereignty of individual states; consequently, community intervention may only take place in duly justified cases. Tax competition, however, is also a breach of Member State sovereignty. Irrespective of all these, the Treaty allows for intensified community action in the case of indirect taxes and state subsidies, ensuring the principle of no discrimination, eliminating the obstacles to unifying the internal market, multilateral supervision of economic policy and certain specific actions.

The harmonisation of profit taxes was first proposed in 1962 in the so-called Neumark report. This report was used to develop a draft directive in 1975, which was, however, withdrawn in 1990. Any subsequent legal harmonisation has had rather modest aims since. Three principles are applicable to the harmonisation of profit tax systems. The principle of mergers eliminated tax-related disadvantages to cross-border organisational changes and reorganisations. The principle of parent companies and subsidiaries aims at abolishing double taxation on profit paid to the parent company (dividends) in cases where the parent company and the subsidiary are seated in different countries. Finally, the principle of interest and royalties has eliminated taxation on interest and royalty payments for associated enterprises in the EU Member States where these payments originated.

The code of conduct adopted in 1997 on profit taxation is seen as a particular "weak" form of legal harmonisation, which is deemed to be a non-binding recommendation (Joumard, 2001, pages 48–49). The underlying legal base is Articles 90-93 of the EC Treaty. By adopting it, Member States assume a unilateral obligation to comply with the standards of conduct defined in the code. With certain exceptions, no sanctions can be imposed on the violation of standards of conduct set forth in the code. The exceptions are related to the fact that a number of non-compliant practices of taxation are applicable to state subsidies under the competence of the EC Treaty, which belongs to the European Commission to sanction.

It must be noted that in 1998 OECD issued guidelines with similar contents to those of the community code of conduct, which are applicable to 30 states in the organisation. Beyond a different geographical scope, the main difference between the two documents is that while the code addresses business activity in general, the OECD guidelines focus on financial and other services (OECD, 1998).

The countries signing the code of conduct have assumed an obligation to provide one another with information on their existing or proposed tax-related provisions and procedures governed by the code, under the notion of transparency. No tax-related measures that prejudice the Community will be adopted, and any such measures in effect would be eliminated until the end of 2003. The code considers taxation in a broad context (laws, other provisions, practice of taxation, etc.). It is applicable to enterprise-related taxes that have a significant impact on the location of business activities.

Under the code, all activities that result in lower actual taxes compared to the rate customary in the given Member State are deemed non-compliant: reducing the tax base by way of, for example, special depreciation write-offs or accumulation of tax-free provisions, full or partial reduction of the tax rate, deferral of or exemption from tax payment obligations in cases where the allowance was provided from state resources (Erdős – Földes – Őry – Véghelyi, 1999, pages 137–138). A subsequent examination identified 66 non-compliant tax provisions and practices that encouraged business activities to be pursued in one EU Member State to the disadvantage of another one.

However, non-compliance is not applicable to allowances that do not affect the trade among Member States and that may be used by any enterprise under equal conditions (accrual of loss, allowances related to R&D, etc.).

The intensive competition in the field of profit taxation is not contrary to the letter and spirit of the code of conduct and the OECD guidelines. An increasing number of countries wish to achieve an international competitive advantage by reducing their corporate tax rates. If a low rate of corporate tax is applicable to all enterprises registered in the given Member State, it is in line with the provisions of the code of conduct, considering that a tax burden lower than the customary rate imposed on some participants of the economy is not the case. What could be questionable here is how significantly a reduced corporate tax rate affects the location of business activities.

A review of community proposals on profit taxation would go beyond the scope of this study (European Commission, 2001). (For a summary of such proposals, see Mintz, 2002). In the light of community decision-making, no decision is expected within a short time. The ministers of finance of Member States agreed on a tax harmonisation package in June 2003, which contains an obligation not to use corporate tax as a means of unfair competition.

SOME THEORETICAL CORRELATIONS OF TAX COMPETITION

According to some followers of an approach to this concept, capital is the most mobile production factor that moves into countries that apply the lowest rate of corporate tax – especially in circumstances where there is a strong global competition for investments of foreign working capital. Related to this is the fact that large transnational corporations also use various methods (management fees, transfer prices, ownership loans, etc.) to regroup their profits to countries with low tax burdens. All these encourage governments to reduce corporate tax rates and, in a broader context, taxes on capital revenues on a continuous basis, which may result in a race to the bottom (or even to zero) (Wilson, 1999). As a consequence, the centre of gravity for tax burdens is transferred to immobile production factors, and within those to workforce, as this may balance public finance revenues lost due to lower capital taxes. Harmful effects may be avoided by tax harmonisation or coordination of economic policy.

The paradoxical nature of this situation is indicated by the fact that raising taxes imposed on companies is, from a political aspect, an apparently easier and more grateful duty than raising personal income taxes. Company owners are fewer in number compared to the employees, whose votes represent a greater part on elections. According to the economic theory, it is not companies but ultimately persons that pay taxes, namely, company owners, and, in a broader sense, capital owners. It is only one side of the coin that increased corporate taxes impose more burden on the rich than on the poor because it is primarily them that hold shares and other forms of capital ownership (the core deposits of limited liability companies in Hungary, for instance).

There are more details to the effects than mentioned so far. On the one hand, in developed countries, and particularly in the Anglo-American states, share ownership has spread at a high pace wide across the society. In the USA, over half the population holds shares directly or indirectly (in investment funds, pension funds, etc.), although share ownership itself is fairly concentrated. Despite, rises in corporate taxes affect an extending ownership group.

On the other hand, a response given by companies to raised corporate taxes may be to increase the prices of goods and services, or to freeze or reduce employee wages (the latter, at least nominally, is quite a difficult case, as wages are known to be rigid downwards). Raised corporate taxes already afflict "common people", i.e. – put in a more sophisticated way – a portion of taxes imposed on companies is paid by employees and consumers (Stiglitz, 2000, page 576).

According to the relevant theories, raising corporate taxes does not encourage savings, as higher tax rates make savings and investments less attractive. Lower investments mean lower capital stock, less capital per employee, and, consequently, lower wages. Many studies have established a negative correlation between investments and corporate tax rate: the higher the corporate tax rate in a country, the fewer the investments.

Globalisation further intensifies these effects. In such circumstances, capital is quickly transferred from countries with high corporate tax rates to those with low ones. As a result, in countries with high corporate tax rates, fewer investments are implemented, and real wages are lower. Winners of this process are employees in countries with lower corporate tax rates.

Disregarding other conditions, in small and open economies the impact of low corporate tax rates on wages and investments is more significant than in less open, large countries. In small countries, productivity improves at a fast pace with direct foreign capital investments. As a general rule: according to a generally accepted model of tax competition, it is the size of the country that counts from the aspect of tax competition – and, normally, the winners are small countries. At the same time, not even small national economies are able to stand the pressure of the tax competition, but they have much more to win. They have a low domestic tax base, but a high foreign tax base. Gains from a considerable foreign tax base may neutralise their losses resulting from a reduced corporate tax rate on the domestic tax base (Ganghof – Genschel, 2006, page 103).

It is probably related to this that the highest corporate tax rates are found, of all developed market economies, in Japan and the USA. When tax rates were reduced in the USA (e.g. under the presidencies of *Ronald Reagan* and *George Bush*, Sr.), it was never the corporate tax but the personal income tax that was decreased. Due to higher corporate tax rates, large masses of companies are unable to leave the USA and Japan – it is not possible because of the size and the geographical position of the country. Germany is also a country with large economic dimensions, but there, expatriation of various sectors and corporate activities to countries with lower cost levels and tax rates has reached such an extent that the government decided to reduce the corporate tax rate of nearly 40 percent deemed to be the highest in Europe to 30 percent. Corporate tax rates in smaller countries are generally lower than those in large ones. Based on experience gained in the past two decades, the correlation between the country size (dimensions of national economy) and the corporate tax rate is strong. The smaller a country, the lower the corporate tax rate.

Certain theoretical approaches deny the necessity of tax harmonisation. Considering the impacts of geographical distance, the intensifying competition in applying lower and lower tax rates is not indispensable, and tax harmonisation is outright harmful to all countries. According to the economic geographical theory, the factors that form the decisions on selecting business premises in companies are centrifugal and centripetal forces. High transportation costs, for example, force companies to recede from the centre, while a large selection of workforce, favourable infrastructure available in the centre and synergies resulting from the presence of a high number of companies attract economic organisations. The latter provides a facility for countries in a central position to keep high tax rates compared to those on the periphery. Low corporate tax rates in peripheral countries are not aimed at obtaining competitive advantages, but at eliminating competitive disadvantages. Peripheral countries do not encourage central countries to reduce their tax rates; the latter ones may raise their corporate tax rates without detrimental consequences. On these grounds, it is no accident that the tax rates of large countries are generally higher compared to small peripheral ones.

This line of thought appears convincing at first glance. It is rather difficult to support it with empirical data, though. This argument does not address the relation between dimensions of national economy, or the level of economic development and the corporate tax rate. In addition to the relation between the centre and the periphery, these factors also affect the rate of corporate tax.

As for an empirical testing of theories, a high number of analyses have been conducted on the correspondence between changes in the effective tax burden (actual burden, i.e. considering allowances) and capital influx. According to a study prepared in 1999, a 1-percentage point rise in the corporate tax rate in the USA is coupled with a 0.5 to 0.6-percentage point drop in working capital investments (Hines, 1999).

Relatively little empirical research was administered to quantify correspondence between corporate tax rates and wages. One such investigation carried out by the staff of the American Enterprise Institute tried to find correspondence between the corporate tax rates and the wages of employees in the processing industry in 72 countries, considering data relevant to 22 years (Hassett – Mathur, 2006). The purpose of the investigation was to test a logical conclusion whether differences in corporate tax rates have affected wages, certainly also considering the other factors forming wages (productivity, negotiating force of trade unions, etc.). The research results revealed that a 1-percentage point rise in the corporate tax rate was coupled with a 0.8-percent reduction of wages in the next five years in the countries considered in the examination. This correspondence was stronger in small countries than in large ones. International tax competition was also important: a 1-percentage point reduction in corporate tax rates in the neighbouring countries resulted in a 0.5-percentage point reduction in wages at home.

The specific figures representing the described analysis may be exaggerated. Despite – like it or not –, it seems confirmed that the rate of corporate tax, as well as the direction and rate of any change to it play an important role in the dynamics of wages. Raising the corporate tax rate does not result in a proportionate increase in corporate tax burdens, because an increasing portion of burdens is gradually shifted to the workforce. At the time of globalisation, the main propelling force is the movement of working capital; companies invest in countries with low corporate tax rates, and transfer an increasing portion of their production and service activities there.

CAUSES AND CONSEQUENCES

The average corporate tax rate in the European Union of 15 decreased from 50 to 30.4 percent between 1984 and 2005. One group of experts attributes a key role to tax competition in the process, facilitated by the community harmonisation of tax law (including the code of conduct). With the unification of the internal market, a reduction in the transaction charges of cross-border tax arbitrage also had a hand in that. According to the other approach, the reason why governments reduced the corporate tax rates was not international tax competition, but because experience gained from the recessions in the 1970s and 1980s shed light on the disadvantages of a system based on a combination of high tax rates and allowances. This system encouraged harmful domestic tax arbitrage (Ganghof-Genschel, 2006, page 102). A tax rate reduction coupled with the elimination of discriminative allowances added transparency to the system of corporate tax rate. (See Table 1)

The harmonisation of tax provisions and the code of conduct have established an appropriate framework for Member States to reduce their corporate tax rates, while the transparency of tax systems in Member States has also been improved by eliminating a significant portion of discriminative allowances (non-compliant tax-related measures). Consequently, community regulation is in harmony with both lines of thought, and can be used to confirm both. The second line of thought, however, is only valid for the period up to the mid-1990s, and, certainly, not exclusively even for that. Subsequently, the effect of tax competition seen among Member States and globally was dominant, however, certainly, not alone but combined with other factors.

At the same time, it is important to emphasize that a corporate tax rate defined by law is just a component in international tax competition; it does not show the position and the role of a country in the international ranking order, or only to a limited extent. A considerable modifying factor is an often complicated system of tax allowances, as well as the calculation of the tax base. The definition of the tax base has been different in each individual Member

Table 1

STATUTORY CORPORATE TAX RATES IN THE EU MEMBER STATES

	1980	1990	1995	2000	2005
Austria	55	39	34	34	25
Belgium	48	41	40.17	40.17	33.99
Cyprus	n.a.	42.5	25	29	10
Czech Republic	n.a.	n.a.	41	31	26
Denmark	n.a.	40	34	32	30
Estonia	n.a.	n.a.	26	26	24
Finland	59	41	25	29	26
France	50	37	36.67	36.67	34.93
Federal Rep. of Germany	52.8	57.7	56.8	51.63	38.29
Greece	43.4	46.0	40.0	40.0	35.0
Hungary	n.a.	50	19.64	19.64	17.68
Ireland	45	43	40	24	12.5
Italy	36.3	41.8	52.2	41.25	37.25
Latvia	n.a.	n.a.	25	25	15
Lithuania	n.a.	35	29	24	15
Luxemburg	n.a.	39.4	40.9	37.45	30.28
Malta	n.a.	32.5	35	35	35
Holland	48	35	35	35	31.5
Poland	n.a.	40	40	30	19
Portugal	n.a.	36.5	39.6	35.2	27.5
Slovakia	n.a.	n.a.	40	29	19
Slovenia	n.a.	n.a.	25	25	25
Spain	33	35	35	35	35
Sweden	n.a.	40	28	28	28
United Kingdom	52	34	33	30	30
Average of EU-15	n.a.	40.4	38.0	35.3	30.4
Average of new Member States	n.a.	n.a.	30.6	24.8	18.2

Source: Nicodeme, 2006, page 18

Note: For some countries, adjusted with local corporate (business) tax

State. Considering tax allowances and the tax base, the business sector's actual tax burden may vary from what is suggested by the nominal tax rates specified in law.

The reduction of corporate tax rates in the EU Member States has not yielded reduced revenues of corporate tax rates, either as an absolute value, or in proportion to the GDP, and has not eroded the welfare state. (If it took place in certain countries, it was not caused by the tax competition.) Stagnating or increasing tax rates – at least for small countries – allow for a conclusion that the loss incurred by a reduced tax rate on the domestic tax base was offset by gains related to an increased foreign tax base. As for large countries, tax revenues increased as a result of eliminating allowances were able to offset the impacts of reduced tax rates. The tax competition and the decreasing rate of corporate tax also promote reforms to the expense side of the budget. The tax competition may contribute to reinforced financial discipline, and to an improved balance of tax burdens and state services (Hetényi, 2006, page 89). At the same time, tax evasion is still possible by way of a proper selection of the location of economic activities, and by representing profit in a country with a more favourable tax rate (Nicodeme, 2006, page 36).

With the enlargement of 2004, tax competition, or the debate on the subject has gained new impetus in the European Union. This has been substantiated on the fact that the average corporate tax rate in 2004 was approximately 10-percentage point lower in new EU Member States compared to the old ones. The difference between old and new Member States between 1995 and 2004 grew from 7.3 to 10.8 percentage points, i.e. corporate tax rates were reduced to a greater extent in the new Member States than in the old ones. The majority of new Member States have used the last moment before accession to the EU to reduce their corporate tax rates; accordingly, as of 1 January 2004, the rate was reduced from 27 to 19 percent on Poland, from 31 to 28 percent in the Czech Republic, from 19 to 15 percent in Lithuania, and from 25 to 19 percent in Slovakia. It is worth noting that Rumania, which is to become a member of the EU as of 2007, decreased its corporate tax rate from the earlier 25 to 16 percent in 2005. The eastern European tax dumping voiced in the western media and occasionally in the literature is not a comprehensible notion. Dumping is referenced if a company sells goods abroad below the production costs, and causes a disturbance to the market. No such dumping is present in profit taxation.

Also in the course of enlargement, the correlation between the dimensions of national economies and the rates of corporate tax was confirmed. On an EU scale, small countries acceded, where, compared to the large countries of the EU, the corporate tax rates are low.

The rate of corporate tax is closely related to the highest of personal income tax rates. If the reduction of the corporate tax rate is not followed by a reduction of at least the highest rate of personal income tax, a facility of tax arbitrage is available, which is harmful at the level of the national economy, because it leads to tax evasion. This means that private individuals transfer themselves to the business sector in increasing numbers, and convert their wage revenues into profit revenues, thus saving tax. This process is curbed by the fact that entrepreneurs do not only have the personal income tax rate to consider, but also public dues on wages, which makes tax arbitrage less attractive.

On reducing the corporate income tax rate, either the highest rate of the personal income tax needs to be reduced, or harmful tax arbitrage needs to be considered, i.e. the fact that taxable revenues flow from personal income taxation to corporate taxation. In both cases, the tax revenue potential and/or the progressivity of the personal income tax system is decreased, which affects the whole tax system, and, hereby, may also influence the competitiveness of the national economy (Ganghof – Genschel, 2006, page 110). An intention of avoiding harmful tax arbitrage may also have had a hand in the propagation of single-key tax systems in various forms. An analysis of this would exceed the scope of this study both in terms of contents and extent.

In order to restrict harmful tax competition, the necessity of adopting a common minimum corporate tax rate emerged in the European Union. On the one hand, the common minimum tax rate would set a lower limit for tax competition among EU Member States, while it would not completely eliminate tax competition. On the other hand, a minimum tax rate increases the space available to Member States for movement towards developing competitive tax rates. Member States with high tax rates may reduce their rates, while they need not be afraid of uncontrollable tax competition beyond a certain limit. Countries with a low tax rate may carry on using their corporate tax to involve foreign working capital, or may compensate their peripheral position with a lower tax rate (Ganghof – Genschel, 2006, page 111).

In tax cases under Article 94 and section (2) of Article 95 of the EC Treaty, Member States pass unanimous decisions. This makes the adoption of a common corporate tax rate minimum more difficult but not impossible. The time requirement of such a process is unforeseeable for the time being.

The efforts of the European Commission for legal harmonisation have recently been directed at harmonising the corporate tax base (an optimised common consolidated corporate tax base for enterprises conducting business in Europe) (European Commission, 2001, 2005, 2006). The proposals produced so far do not affect the corporate tax rate, consequently, leave tax competition unchanged. The Member State support of harmonising the corporate tax base is higher than that of harmonising rates, or of adopting a common minimum rate, although the former efforts also leave important issues open (such as the distribution of the tax base). Depending on the support from Member States, draft legislation is expected to be produced before the end of 2008.

RECENT TENDENCIES IN THE HUNGARIAN TAXATION POLICY

Hungary harmonised most of its tax provisions prior to the accession to the EU. The burdens of tax-related and other provisions enacted based on the New Balance programme announced in June 2006 are distributed among the participants of the economy: employees, or, in a broader sense, households or consumers, the business sector and public finances. The Government expects the adoption of the solidarity tax as of 1 September 2006 on the one hand, and the so-called expected tax, on the other hand, to be a contribution of the business sector towards the reduction of the public finance deficit. Further revenues are expected from the tax levied on the cash-on-hand kept by enterprises, which is applicable to higher amounts of cash held by enterprises compared to what is justified by their course of business. Finally, and parallel to tax increases, the Government annulled its multiannual programme adopted in 2005 to reduce taxes, including the earlier provision of law whereby the local business tax, which had an outstanding deteriorating effect on the competitiveness of enterprises – and whose compliance with community provisions was also debated – would be eliminated in 2008.

The solidarity tax base is the pre-tax profit of an enterprise, which cannot be reduced by allowances. The tax rate equals 4 percent of the tax base. In terms of contents and function, the solidarity tax is, at first glance, similar to the corporate tax, i.e. its introduction could, in theory, have been replaced by a 4 percentage point increase in the 16 percent corporate tax for medium-sized and large enterprises. Adoption of the new tax type was justified by the fact that the first time the corporate tax rate can be changed is 1 January, while a new tax type, such as the solidarity tax, can also be enacted during the year (i.e. on 1 September).

Parallel to the solidarity tax, the Government also raised the highest rate of the personal income tax by 4 percentage points, which is also termed a solidarity tax. It eliminated any possibility of harmful tax arbitrage, although the space for the participants of the economy is rather limited in this respect in Hungary, due to the high rates of contributions payable on wages.

At the same time, the bases of the solidarity tax and the corporate tax are different. The solidarity tax base is not the corporate tax but the pre-tax profit of the company not considering any allowances. This is not in harmony the government's effort to make the state encourage research & development and investments by way of tax allowances. The adoption of the solidarity tax may also result in some foreign corporations that brought their financial, research & development and service centres to Hungary because of corporate tax allowances, or received allowances under other titles, considering withdrawal. This affects approximately one hundred companies, each with significant lobby power.

At the same time, the solidarity tax base does not include income from foreign premises and dividends received. This slightly eases the tax burdens of companies that possess foreign premises, or receive dividends. Finally, the negative impacts of adopting the solidarity tax are also somewhat reduced by changes anticipated in terms of development tax allowances.

The so-called expected tax is a flat-rate corporate tax. The Government justified the adoption on the grounds that a significant portion of enterprises appear to generate deficit for years, and do not pay profit taxes. As of 1 September 2006, all taxpayers subject to corporate tax must pay a corporate tax amount expected as a minimum to persist in the economy. This new tax type is primarily aimed at remedying tax evasion of small and medium-sized enterprises. The sector of large corporations that determines the competitiveness of the Hungarian economy may suffer a disadvantage of eliminating accrual of loss, because a tax must be paid on 2 percent of the revenue even if the company generates a deficit. This may primarily be a disadvantage to new corporations appearing in Hungary, and may discourage efforts of this nature, implementing new, large-scale greenfield projects. It is easily possible that these corporations will generate deficit in the first one or two years due to high amortisation. In this respect, it should be considered that the construal of this provision of law is ambiguous on the one hand, and the government may take measures to offset this disadvantageous effect, on the other hand.

The Hungarian government, as it appears, has contradicted the conclusions of economic theory and the trends in a globalising world economy when – probably attentive to short-term political aspects – did not reduce but increased the tax burdens of the corporate sector. This is not a fortunate message to potential foreign investors and the ones already settled in Hungary (neither to domestic companies). The 4-percent solidarity tax applicable to the company profit has also significantly reduced the earlier tax advantage of Hungary in general, and has eliminated it when compared to some countries competing for foreign investments, and, what is more, has turned advantage into disadvantage. Earlier, the Hungarian corporate tax rate of 16 percent was – behind Ireland – the second lowest in the European Union. (Currently, the 10-percent rate of Cyprus is the lowest.) In the wake of introducing the solidarity tax, however, Hungary has been pushed back in the international ranking order chiefly in comparison with the new EU Member States in a way that the increase of burdens have not been offset by other tax-related measures (accelerated amortisation, etc.).

SOME COMMENTS AND CONCLUSIONS IN SUMMARY

In issues of taxation in the European Union, the principle of subsidiarity is used, scopes of competence are concentrated in the Member States, community-level decisions are passed by the Member States unanimously, there are no community institutions competent in tax issues, and the Community has no licence to levy and collect taxes. Individual tax types correspond to one of the four freedoms: the general turnover tax and the excise duty to the free movement of goods and services; the corporate tax and other taxes on companies and capital to the free movement of capital; the personal income tax to the free movement of labour. The harmonisation of tax provisions has been closely related to the development of integration, most strikingly in the case of turnover tax types, as these taxes have the most effect on the trade among Member States.

The harmonisation of profit tax, a key element of which are a legally non-binding recommendation issued in the form of a code of conduct, a flexible framework for Member States, and a compromise solution between the theoretical and practical concepts emphasizing the importance of benefits related to tax competition and also to the elimination of obstacles persisting in the internal market and distorting the conditions of competition among Member States. The code of conduct has eliminated a significant part of discriminative components that restricted the competition (non-compliant tax-related measures) from the tax system of Member States, although has not fully eliminated tax evasion. At the same time, no limits have been set to the tax competition among Member States as represented in the reduction of corporate tax rate. Tax competition has become more transparent, and shifted the centre of gravity of the competition from various allowances to a changed rate of corporate tax.

The tax policies and tax systems of individual countries face a particular conflict of targets. Considering that capital is the most mobile one of the production factors, in addition, in the current development phase of the world economy, capital – as a resource for growth – is appreciating in value for a number of reasons not detailed here, economic rationality requires capital, and within it, the business sector, to be taxed to a smaller extent compared to the other production factor, workforce. At the same time, it is not companies but individuals that vote on parliamentary elections, consequently, using requirements of political rationality results in a higher tax burden of the business sector. The conflict of targets is a lot more visible in small countries open to the world economy and more in need of foreign working capital investments than in large national economies. What is more, the increment in the tax burdens of the business sector, or a part of it is ultimately paid by the workforce or the consumers.

With globalisation propagating, this conflict of targets has been deepened by the international tax competition intensifying parallel to the competition for foreign capital investments. An increasing number of countries intended to improve their international competitiveness and, within that, their ability to attract capital by reducing their corporate tax rates. As a result of that, the corporate tax rate has decreased in the past 20–25 years in the Member States of the European Union, although the race to the bottom has not yielded a zero tax rate in any of these. Tax competition within the European Union has further intensified with the enlargement; most of the new members reduced their tax rates prior to acceding to the EU. A drop in the corporate tax rate may also necessitate a decrease in the highest rate of the personal income tax, or else a facility of harmful tax arbitrage would be available, which may involve loss of turnover tax revenue at the level of national economies.

In the European Union, cutting back on corporate tax rates has not yielded a drop in tax revenue in the period after 1980. Small countries benefited from offsetting the disadvantages derived from decreasing corporate tax rates by advantages resulting from the extended international tax base.

In order to stop the tax competition rampaging in the European Union, a necessity to establish and adopt a common corporate tax rate minimum has emerged. This would not eliminate tax competition among Member States, but would set a lower limit to reducing the corporate tax rate, and would provide sufficient space to countries with both high and low tax rates. As for the rate of the common minimum tax floor, experts have not taken up positions yet. Adoption of a common tax rate is doubtful because of the principle of subsidiarity applied within the Community for issues of taxation. More probable is the development and adoption within a foreseeable time of a legal provision for an optimal common consolidated corporate tax base.

For the Hungarian tax policy and tax system, the community regulation is satisfactory; it provides sufficient space to enforce the strategic national interests. Irrespective of this, the tax-related measures adopted in 2006 in Hungary under the New Balance programme impose increased tax burdens on the business sector, and are inconsistent with the conclusions of economic theory drawn particularly for small countries, contradict the international tendencies, and, consequently, weaken Hungary's international competitiveness.

Hungary is interested in adopting a common corporate tax rate minimum, which would set a lower limit to tax competition among Member States smaller and/or less developed than Hungary. For added transparency, Hungary is also interested in establishing a common consolidated corporate tax base.

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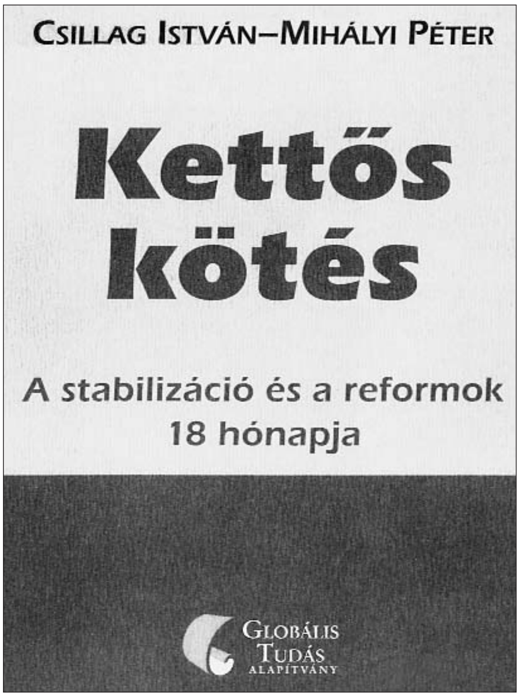
István Csillag – Péter Mihályi

Double bind

the eighteen months of stabilisation and reforms



GLOBAL KNOWLEDGE FOUNDATION (GLOBÁLIS TUDÁS ALAPÍTVÁNY), 2006

Hardly can a book be more topical than this small-format, 144-page booklet written by *István Csillag* and *Péter Mihályi.* The proposals which are outlined in the book are very similar to the ones tabled by the government and caused a great political stir throughout the country. This cannot be a coincidence. The ideas described in the book and the authors themselves must have had a considerable effect on the government's proposals, or in fact on its measures, and thus on the political events that followed. This book must necessarily be reviewed by bearing in mind the above.

There is a reference to this obvious relationship even in the Preface. We can read there that the book is a "triple mixture". The authors make the following statement in the Preface: "On the one hand…we have tried to meet the requirements of thoroughness and objectivity that can be expected from a scientific essay. On the other hand, we have aspired to explain our proposals in the simplest possible way in order that…they are convincing even for those whose only source of information is newspapers. Our book is also meant for politicians. After all, we would like the political elite and the government to take our proposals to heart." (Page 10) There cannot be a more specific reference to the fact that the book serves direct economic policy purposes, or even political purposes.

The underlying, theoretical principles of the book are set out in the sentence before the title page written as an epigraph instead of recommendations and they are also presented in the Preface. This epigraph-like sentence reads "This book has been written in the interest of our children and our grandchildren." In technical terms, it means that the book basically addresses the issues of income distribution between generations. At the same time, we can read right at the beginning of the

Preface, in the second paragraph and directly after it that the considerably inflated and substantially increased general government deficit leads to the risk of currency crises. “Due to the inflated condition of public finances (weighing more and more heavily on the economy) even the business sector whose performance is good even today is under threat now.” (Page 8) Twin deficit “has arisen due to the excessive size of general government and to the implementation of good political intentions using the taxpayers' money. ...The processes giving rise to the formation of twin deficit are nurtured by the survival of the Kádár-era redistribution.” (ibidem) There is no need to explain this in technical terms. This view implies that the principal problem lies in the general government deficit, which generates the current balance of payments deficit and all the other problems. Furthermore, it means that the solution is to decrease public expenditures and redistribution, thus substantially cutting back the welfare state or at least partially eliminating it.

Based on the aforesaid, the present writer finds it necessary to make it clear at the very outset of this review that it is impossible to write a review on this book without formulating a standpoint and challenging the views expressed in it. Therefore, I must state here and then that I fully agree with the first of the two fundamental principles quoted. This country manages its economy to the detriment of the generations to come and consumes the future, which is intolerable in my view as well as according to the teachings of economic science and based on common sense. I must also state that I consider it unfounded, or in fact a hasty judgement that “the considerably inflated and substantially increased general government deficit” (page 7) is the cause of every problem and that is why “the risk of currency crises” has also emerged (ibidem). I hold the same about the statement that “due to the inflated condition of public finances…” (page 8) “even the business sector whose performance is good even today” is under threat (ibidem). I consider the view, which is closely related to the above subject, particularly unfounded, according to which “the twin deficit as it is called in specialised literature, i.e. the parallel deficit of external and internal balances -” (ibidem) “has arisen due to the excessive size of public finances and the implementation of good political intentions using the taxpayers' money” (ibidem). So I think that the statement, according to which all problems are attributable to only one reason or to only one main reason, i.e. “the inflated condition of public finances” (ibidem), leads not only to unfounded but wrong economic recommendations. Therefore, I regard it as unfounded and in fact a hasty judgement that the solution lies in reducing redistribution and substantially curtailing the welfare state. There is empirical evidence that the external imbalance is mostly an independent problem and its solution may not come from the reduction of redistribution. At the same time, the answer to the question of maintaining or reducing the welfare state depends mainly on value judgements, thus it is a political issue, which needs to be addressed by taking account of considerations that go beyond the area of economic science.

Despite what has been written above, the present writer fully agrees with the authors' other ideas outlined in the Preface. It is true that the reduction of contributions and/or taxes cannot be a good point of departure (page 9). Instead – although it is not stated by the authors here – it is necessary to raise taxes and it has actually been carried through. I also completely agree with the remark that “the national and local political elites, as well as other public opinion shaper groups – media, circles around the political parties – further fuel tensions" (page 12), and that this has to end. We cannot agree more with what has been written about the question of the individual, voluntary savings falling short. (Page 14)

At the same time, I am strongly against the conclusion drawn in the Preface: "We look upon agreement, consensus as a result of action rather than a prerequisite." (Page 13) This is the declaration of the anti-democratic or even unrealisable principle that reforms should be carried out without consensus and without or in fact against the support of the general public, namely people are to be made happy against their will. This invokes the spirit of a failed experiment. This principle is impracticable, because even the best reforms may fail or, to put in more harshly, cannot be pushed through without consensus or at least a minimum consensus. Finally, this principle is also unacceptable in scientific terms. The reform concerns the interests and conflicting interests, the value judgements and differences in value judgements among various groups of the society. In such questions there is not only one single undisputed scientific truth that is to be asserted without achieving consensus or even by force. Instead, the solution can be worked out in the course of democratic political processes. According to modern social science, the solution is path dependent: it depends on the historical background and the ensuing public opinion, or actually on mentality. Some countries function fairly well with a smaller scope of redistribution, others with a larger scope of redistribution, and they cannot be made adopt the institutional conditions of the other. I think therefore that the basic concept, which prevails throughout the whole book, is unacceptable, i.e. there is only one optimum solution that applies to all countries and that is to be applied under any circumstances. It is therefore indispensable to attempt to achieve the largest possible consensus, and where there is no chance for wide consensus, the solution may be reached through democratic decision-making processes and with the support of public opinion.

As I have made such pronounced critical remarks as early as in the introduction, I should here and then mention the merits of the book, too. The authors undertake to do something that – as far as I know – no-one has so far ventured to do in Hungary: they put forward specific and consistent proposals for the range of problems as a whole. Moreover, although the basic concept, which I have already described and criticised above, prevails throughout all those proposals, the actual details are often concrete and less ideological than the Preface. So I highly recommend, already at this point, that this book should be read.

Let us now turn our attention to reviewing the book; I shall make my additional remarks after the review.

■ *Chapter I is entitled 'Detailed Diagnosis'*, however, some proposals are presented as early as here. It starts from the principle that there are ten-year cycles in Hungary and there is a need for overhauling the system and for reforms in every ten years. The chapter sets forth the cause of the problems, i.e. the political elite's struggle for obtaining the votes, and it identifies the most important elements of the problems: budget deficit and current balance of payments deficit and the insufficient level of household savings. It is emphasised in the sub-title that "There is no alternative to equilibrium". (Page 19) It is also stressed that "the stabilisation and the change must be firm and concentrated on a relatively small period of time, but it must also be effective even in this phase..." (page 24). Then, based on the figures of the Central and Eastern European countries, the authors maintain that "the lower the levels of distribution and deficit, the higher the rate of growth." (Page 25)

The remaining section of Chapter I is clearly challenging the present system of public burden-sharing and the social security system. It lays down the fundamental principle forthwith: "It takes several insurers to make it work..." (page 27), consequently, social security must be transformed into a system built on the competition of several insurance companies. This is inescapable for "more and more throw off … the yoke of forced solidarity,…for this reason, the financial balance of funding has by now toppled to such an extent that it threatens public finances as a whole." (Page 28) This is followed by a long description of "how public burden-sharing can be evaded in 2006" (page 31). Then an analysis of the effects of demographic changes is given (page 33) with the conclusion that "the pension reform was not able to create the institutional guarantee for the long-term balance of the state pension system." (Page 37)

The next sections that discuss the issues of education, unemployment and demographic policy contain specific proposals. "The present situation is absurd..." and "...it can be changed by regrouping the majority of state subsidies from higher education into elementary and secondary education." (Page 38) A direct consequence of this is the abolishment of the gratuitousness of higher education, for the present situation leads to the deterioration of the quality of education, and thus "the time when the first child is born is inevitably delayed, which will eventually result in the decline of the average number of births." (Page 39) As regards the development of social imbalances, the authors state: "An overwhelming majority of the Hungarian general public found the imbalances excessive as far back as in the mid-90s. What is more, prominent representatives of the political elite talked about the political divide of the country back in 1989." (Page 40) Yet, they continue as follows: "We assume that the income and financial differentials are going to rise for some time in the country." (Page 40) All this is inevitable because "the state economic policy is not sovereign." (Page 42) Chapter I is concluded with a lengthy argumentation in favour of diminishing the role of the state.

■ *Chapter II entitled 'What Should Be Done'* carries on with these arguments. It prints in a frame a famous quotation from Ronald Reagan's first inaugural address of January 20, 1981 that reads: "the government is not the solution to out problem." (Page 51) Although I want to stick to reviewing the book in the next paragraphs just as before, I cannot resist the temptation to voice my basic criticism here. The *Thatcherite-Reaganite* insistence on the rigidly anti-state free-market fundamentalism was a subject of ridicule even at the time of *Bush* Senior, and it became a definite laughing-stock during the *Clinton* Presidency, and remained so in the 2000s. According to the modern development theory, the government has a decisive role in a society's adaptability to the challenges of today's global economic changes. Going bankrupt is caused primarily by the bankrupt government in the Soviet successor states, in the Western Balkan countries and in sub-Saharan Africa and elsewhere, like in several Latin-American countries. The excessive anti-state position and its justification by the 1981 quotation from Reagan is therefore an old-fashioned standpoint. The book under review also cites – quite rightly – the introductory words to the quotation: "In this present crisis..." (ibidem). Consequently, even Reagan did not say that the problem is always the government.

The first part of Chapter II, we have just discussed, deals with general economic issues, while the second part dwells upon the large social distribution systems. The authors gave a questionable title to the introduction to the first half of the chapter: 'Smaller Debt, More Investments', and – again questionably – they write that "people …. must save more." (Page

49) In the authors' view "the programme of the change, consolidation and reforms (should be implemented) during the first 18 months of the government which comes into office after the general elections..." (page 53), because after that the government should turn its attention to preparing for the next elections. The book specifies the major tasks to be carried out during that period of time. The authors think it necessary to establish the Budgetary Council in order to solve budgetary problems. (Page 52) "The Budgetary Council consists of seven members. Its members include the Minister of Finance and prominent professional experts appointed by the Prime Minister …Members of the Budgetary Council – except the Minister of Finance – are not obliged to accept instructions from anybody." (Page 58) "No proposal can be put forward to government …without the prior opinion of approval of the Budgetary Council." (Page 57) The important or even principal goal of the change, consolidation and reforms is accession to the euro zone. A condition of this is to lessen the centralisation of revenues in the hands of the state by almost 1.5–2 per cent in the coming four years, and to reduce state redistribution by nearly 5 percentage points." (Page 59)

Then, quoting *Kornai* in the first place, the authors describe in detail their views on sector-neutral taxation. I am probably not mistaken to think that the gist of the proposal is that "the uniform rate of the personal income tax, VAT and enterprise profit tax should be established somewhere within the bracket of 20–23%, and it would be desirable if the rate of social security contributions were not substantially different from that." (Page 64) The authors emphasise that "sector-neutral taxation does not mean the application of only one tax rate, the introduction of a one-tier system even in the area of income taxation" (page 65), furthermore they stress that the intention is to complete this system with strongly progressive inheritance taxes. Proposals relating to the local government reform and to PPP-financing complement this analysis.

This is followed by the second half of Chapter II, which addresses the reform of the pension system and the health-care system. The starting point is that "the pay-as-you-go….system leads to irresponsible promises and over-distribution" (page 72), and that "there are also great risks in the health insurance fund and pension fund solution which is generally applied in the United States." (Page 73) Consequently, "only the systems that are independent both of the government and enterprises, and that are operated by insurers based on individual accounts and capital accumulation are capable of making people adopt reasonable and long-term strategies." (Page 73) The authors add that "a combination of self-provision and state support is implemented everywhere. It is clearly desirable that in the wake of redistribution, greater subsidies are provided to those in need in proportion of their social needs, while smaller or no subsidies to the well-to-do." (Page 74) This proposal is explained by stating that "contributions are not public funds, the individual can select the pension fund and health insurance fund, …the monies paid in by him are kept on an account under his name, and he has free disposal over that account within certain limits." (Pages 74–75) It continues: "Health-care and pension are the two areas where the relationship between payments and benefits are relatively easy to understand for all adults. …So let it be a pensioner or farmer – all labour incomes should be fully subject to personal income tax and social security contribution liabilities." (Page 75)

Then the details pertaining to pensions and the health-care are discussed. Technically speaking, the essence of the proposal is that, for the sake of clarity, all incomes are to be grossed up, and contribution is to be paid after and documented for each income on individual accounts. Quasi-contributions of less importance are to be abolished. "The 'health ticket' – today called as health contribution (abbreviated as eho in Hungarian) – (which gives entitlement to use basic health-care services) is an expense to be paid by all across the board." (Page 77) "The statutory retirement age has to be raised from 62 years to at least 65 years." (Page 79) The calculation of pensions must be adjusted to the income earned throughout one's career, i.e. to the payments made, rather than the so-called last earned income calculated with some sort of formula. "…we need stringent rules to access any forms of early retirement. …Those who can continue working, should not enter the pension system!" (Page 80) At the same time, the health insurance service package will have to be broken down into three parts. Pillar No. I, the group of services, falling under the so-called state pillar, does not constitute a part of the health insurance system. …Pillar No. II or the basic pillar would include frequent, generally accepted procedures and interventions. …Finally, a third, so-called risk pillar would be created to include health-care services that are exceptionally expensive." (Page 81) This paper cannot go into the further details of this subject.

A quotation from *Lajos Bokros* serves as the motto of the section dwelling upon employment, which – similarly to the Reagan quotation – is highlighted in a frame: "If higher education is gratuitous to those who receive its blessings, then this investment with a considerable probability of return has to be financed from the budget into which taxes are paid by also those who will never benefit from it." (Page 86) It is followed by the authors' comments emphasising the excessive proportion of higher education. They state that the basic problem is not the situation of higher education, but rather the problem is that "20 per cent of the current population is entrapped in the low educational level." (ibidem) Therefore, "the fundamental goal is to make sure that the possible largest proportion of younger generations receives a school-leaving certificate, because without that they cannot even be employed at large enterprises on the production line!" (Page 87)

This chapter is closed by the section entitled 'The Interaction of Fiscal and Monetary Policies', which is to some extent an introduction to the calculations presented in the Annex. Here, the authors explain that there is a chance for the emergence of currency crisis attributable to the fact that "confidence vested in the Hungarian economy collapses in the form of a shock," which "inevitably induces the escalation of inflation." (Page 88) The only comments the authors make here is that as a result of the above "it is possible that…spontaneous euroisation gathers further impetus when households and enterprises, in large numbers, transfer their assets from Hungarian Forints into Euros as a resort." (Page 90)

■ *Chapter III headed 'Social Impacts'*, which is cut rather short, does not primarily deal with the issues referred to in the title. Instead, it repeats more firmly the authors' views regarding social consensus. "Have we got *the so-called* necessary political and professional consensus?" (Page 91, italics mine, Gy. Sz.) – they pose the question. And they give the answer right away: "There is, as a matter of fact, *no* such *consensus, and there is not going to be.*" (ibidem, italics in the original.) "The situation is similar to that when new scientific theories gain ground against the old ones. "A new scientific truth does not triumph by convincing its opponents and making them see the light – writes *Max Planck* in his Scientific Autobiography – but rather because its opponents eventually die and a new generation grows up that is familiar with it." The task of the then government is to take – having parliamentary majority –

the decisions deemed necessary by its own apparatus and its own advisors." (ibidem) "There is no reason to be afraid of public opinion either. …the pension reform prepared in 1996–1997 and formulated in 18 months almost as quickly as a coup had not a jot affected the 1998 general elections. …The reform process, the government action itself …have the power of achieving consensus. …If there is a reform, then its political marketing can also be worked out…" (page 92) Thus, the authors are convinced that their set of proposals is a scientific truth, and that the government, having parliamentary majority, has to implement the proposals without being afraid of public opinion. These are dangerous views, and we are going to come back to their assessment.

The substance of the book ends with this, and a personal epilogue and two annexes follow the three chapters treated so far.

■ In the *Personal Epilogue* István Csillag essentially offers an explanation to why he failed to carry out the ideas outlined in this book at the time when he was a member of government, quite an influential one. According to the personal epilogue, there are two reasons for that. The first is "...the greatest ills are the elimination of democracy and the prevention of a populist dictatorship..." (Page 95) The second is that: "The smaller coalition party has no other means than withdrawal from the coalition, or any hint to such blackmailing..." (pages 95–96), which was not advisable to do under the given circumstances. This means that in his judgement the dominant coalition partner was responsible for the failure of the necessary reforms. Annex I refutes the false assumptions and wish-dreams, and one can generally agree with what has been stated there.

■ *The second Annex is entitled 'Detailed Calculations*', but it does not give account of these detailed calculations; it only sets out their results or perhaps the basic assumptions behind them in a tabular form. The textual part gives an overview of the steps that are necessary to restore the budgetary equilibrium, and then it provides a comparison of the "reform path" and the "collapse path". The first is the scenario without the evolution of currency crisis; the second assumes the occurrence of currency crisis. Hoping that the currency crisis can be prevented, we are going to concentrate on the reform path in the following.

The author's conception and its consequences can perhaps be best illustrated by the tables showing numerical values. Accordingly, in case of the reform path, the rate of GDP growth will decline by 2.5 per cent in 2007, at unchanged price, due to the disincentive effect of the restriction, and it will stabilise at 3 per cent in 2011. This rate differs very little from the expected growth rate of the EU-15, and it is likely to fall behind that of the EU-25. This means that based on the authors' assumption, no real convergence is to be expected until 2011. They also assume that in the total absence of real convergence the negative balance of the main items of public finances will diminish steeply, and then the balance will become positive exactly in the year before the general elections, in 2009. This positive balance will continue to increase in 2010, in the year of the general elections and in the year after, and in 2011, the positive balance will attain 16.8 per cent of the central budget revenues and 9.3 per cent of the revenues of the whole government sector. This writer have not yet heard nor have presumably others heard about the revenue surplus amounting to 9.3 per cent of the budget of the whole government sector and 16.8 per cent of the central budget. Nor did he hear about the possibility of turning the present central budget deficit of 20.5 per cent, expressed as percentage of revenues, into a surplus of 16.8 per cent in five years – from 2006 to 2011. In the case of the total budget of the government sector, this presumed change would entail transforming the 11.4 per cent deficit of 2006 to a surplus of 9.3 per cent by 2011. These figures cannot be regarded as realistic, nor can they be taken for the starting point of any realistic analysis.

Continuing with the analysis of the figures disclosed in the book and with the above train of thoughts, we cannot hold it to be realistic that in 2011 the total budget of the government sector spends 10.1 per cent of its revenues and the central budget 18.2 per cent of its revenues on debt repayment when, according to the 2006 adjusted figures shown in the authors' table, the growth of debt stock amounts to 18.5 per cent of the revenues of the total budget and to 10.4 per cent of the central budget revenues. Additionally, in this case the figures of the central budget are to be taken into account since the debt stock of local governments and social security funds is negligible. The present writer has no knowledge of any precedent anywhere or any time in which 18.2 per cent of the central budget revenues would have been spent on debt repayment rather than debt servicing, a figure which is to be supplemented by interest payments, which are also considerable in size, but which are not quantified by the authors. It is totally inconceivable that according to the adjusted figures, the debt stock growth amounting to 18.5 per cent of the central budget revenues in 2006 could in five years be converted into a debt stock reduction amounting to 18.2 per cent of the revenues by 2011. These numbers are unrealistic, and if this is so, then consequently, the following row of figures is also necessarily unrealistic: according to which figures the gross debt of the central budget, expressed as percentage of GDP, will drop from the adjusted value of 61.3 in 2006 to 40.4 per cent in 2011. These numbers are out of touch with reality, there is no historical precedent to prove that changes of such magnitude can be accomplished within such a short time.

So where does this really horrendous surplus in expenditure come from, and what is the source of expenditure designated for debt repayment? In the authors' view, they can be generated by the radical reduction in the expenditure items of the general government. Based on the authors' assumptions, the major expenditure items of the general government, expressed as percentage of GDP, will be down from 61.6 per cent in 2006 to 46.9 in 2011. The gross sum of the expenditure side will drop from 32.3 per cent to 22.9 per cent in the central budget, from 12.5 per cent to 11 per cent in local governments, from 6.5 per cent to 4.4 per cent in the health fund and from 8.8 per cent to 7.7 per cent in the pension fund. It is quite inconceivable to implement such a transformation especially without the presumed real convergence. The authors fail to specify the reduction of which expenditure items of the central budget is assumed to produce such a steep decline in total expenditure. Taking account of the present status of health-care, a reduction of such magnitude in health fund expenditures would result in the total collapse of health-care. In the light of the demographic trends, the reduction of the pension fund could only be accomplished by curtailing the level of benefits, which is politically unthinkable, because the government relies on the votes of the pensioners.

The consequence of the above figures would not be limited to the collapse or at least to the totally radical transformation of the welfare state, including the health-care system, the pension system and presumably even the educational system, whose figures are hidden in the central budget and not quantified. The consequence of the above figures may actually lead to the collapse of society, public order and the collapse of the state. No society can be made to accept the collapse or such a drastic transformation of the traditional welfare system or in fact state institutional systems. No society can be made to accept such a fast pace transformation from the concept of solidarity to the concept of extreme individualism. Even if such a transformation were unquestionably proper, no society can tolerate such fundamental changes within such a short time, whereas in reality, as I am going to elaborate below, these changes cannot be considered unquestionable proper. It is true that every society must adjust to changes, and the more adaptable a society, the more successful it is. But an adaptation of such fast pace is impossible – even if it is agreed that the direction of changes is the correct one. This proposal is out of touch with reality.

Now we have arrived at the two basic assumptions of the authors and at the predicted schedule of the implementation of the reform.

■ One of the basic assumptions is that this conception is scientifically proven correct. In reality, this is not the case. There are ideas that can be proven scientifically or that are actually proven, others are scientifically disputable or disputed, and there are some ideas where even scientific provability is doubtful. It can be proven scientifically that the present conditions are not maintainable, and it is not possible to cope for long with such a budget deficit and current balance of payments deficit and with such insufficiency of internal private savings. The optimum date for the introduction of the euro, the permissible level or optimum degree of budget deficit and even the best method of measuring budget deficit are scientifically debated. There are strong scientific arguments supporting the idea that countries, such as Hungary, that are catching up will have to overcome a substantial backwardness in environment protection and infrastructure, even in health-care, education, science and culture. In addition to this, they have to overcome general social backwardness and one that affects, in particular, certain social groups. It cannot be accomplished without the utilisation of external resources which serve productive purposes. In other words, it is argued whether it is proper to apply the Maastricht deficit criterion of 3 per cent to these countries in an unchanged form, which percentage has been calculated without regard to the above consideration. There are sound arguments against it, which suggest that the development needs of these countries have to be born in mind. We can now return to the items that can be proved scientifically. It can be considered scientifically proven that the level of the withdrawal of revenues the authors expect to take place in the last years of the period under review cannot be tolerated and that it would stir up economic, social and even political crises in the country.

Let us continue with the arguments and proceed to the questions that are beyond scientific provability: questions linked to value judgements. The present writer attributes paramount importance to social solidarity and equal opportunities, while the authors of the reviewed book obviously give preference to the individual's freedom of choice against solidarity and equal opportunities. Furthermore, these are only differences in degree, and the reviewer is also in favour of personal freedom and the individual's possible greatest freedom of opportunities of choice. Even the authors of the reviewed work may not oppose the possible greatest equal opportunities and they promote the idea of solidarity as a complementary aspect. This writer, however, does not treat his preferences as scientifically proven even if there are emphatic scientific arguments behind them, and he must ask the authors to accept that.

It directly results from the above that there is no clear-cut and scientifically founded answer to the question of what the extent of the budget, the welfare state and redistribution should be. Even a basic economic textbook, such as the work of *Samuelson – Nordhaus,* which is probably known to the readers of this review, teaches that the budget, the welfare state and state redistribution, and in fact the state as a whole have inevitably a lesser role in the colonial states, such as the United States, and a larger role in societies where traditions have a stronger part to play, like in Continental Europe. In addition, as I have already stated in one of the introductory paragraphs, the institutional system is path dependant, a function of the historical background. Hence, there is no point for the authors to thunder against Kádárism – a political regime, with which the reviewer demonstrably never identified himself with and never made a compromise with – because it is an element of the development course Hungarian society had taken, and its effects are felt even today. Consequently, Hungarian society today clearly insists on the stronger role of the welfare state, state redistribution and the state, in general. No matter how much the two authors of the reviewed book disapprove this mentality, this mentality prevails and it can by no means be changed in five years, it can be changed, at the very most, slowly.

▫ This argument cuts the ground from the authors' second basic assumption, i.e. the reforms can be carried out without consensus, and having parliamentary majority, the government must carry them out regardless of the opposition against it. This is not true, since even proposals that are scientifically proven correct, such as the reduction in the budget deficit and current balance of payments deficit can be accomplished if there is at least a certain degree of consensus. Consensus is achievable, because everyone can be convinced that no one can spend more in the long run than he earns. On the other hand, in case of value judgements, such as the degree of social solidarity and the size of the welfare state, decisions can be taken only through the democratic decision-making process and with the ongoing involvement of society as a whole and its institutions, rather than merely voting in every four years. Pursuant to the provisions of the Constitution, the parliamentary majority may – de jure – pass its decisions, but the parliamentary majority is short-witted if it – de facto – ignores public opinion and the views of civil organisations.

This is the point where we have to touch upon the questions of scheduling. According to the authors, 18 months are available for carrying out the reforms. Their view is supported by two arguments. On the one hand, international experience shows that the adjustment measures, or consolidation as the authors refer to it, have to be implemented really quickly; a requirement which may perhaps be qualified as a scientifically proven truth. On the other hand, the authors hold that this scheduling follows directly from the four-year election cycle and from the time required for getting ready for the subsequent elections. However, I wrote this paper on 26 October 2006, six months after the parliamentary elections when one-third of the 18 months has already elapsed, and it is not very likely that the planned reforms can be realised within 18 months. The events of these six months unquestionably prove that there is a need to create consensus.

In my judgement, in terms of the proposed scheduling, the authors make the mistake of not differentiating between measures that can be or need to be carried out in a concentrated manner and the ones that require much longer time for implementation. It is quite true that the measures aimed at setting off the budget deficit reduction have to be taken or even implemented quickly. As I have mentioned before, there is a chance for creating consensus in that regard, and therefore even their implementation would meet with no difficulties.

However, creating the proper size of a welfare state that is economically and socially acceptable is a task for which the designated time limit of 18 months for implementation is plainly inconceivable. The authors' approach in which they fail to differentiate between measures that are to be carried out instantly and inevitably and the ones that are to be implemented slowly or not even necessarily is clearly counterproductive, because the efforts aimed at incorporating in the 18-month timetable questions that cannot be resolved within such a short time actually represent obstacles to accomplishing the very measures that indeed belong among the tasks of this 18-month period.

With this, we have come to the end of the review and the most important part of the critique. Our sole task remains to be to make brief comments on the ideas described in Chapters I and II of the book which have only been reviewed so far. However, it is difficult to perform this task properly within the given framework. The authors outline detailed proposals with special regard to the tax system, health-care, pension system and education, implicitly suggesting that the adjustment and the stabilisation cannot be accomplished without a radical reform of these institutional systems and without reducing the budget from 60 per cent of GDP to 45 per cent of GDP within a period of five years. I have already pointed out in the foregoing that this conception is fundamentally mistaken. The task is to start reducing the deficit by creating social consensus behind it, – this is to be accomplished, first of all, by means of increasing revenues and curtailing expenditures which are beyond doubt unnecessary, and by introducing general austerity measures which are inevitable and necessary – however, without the immediate and radical diminishing of the size of the state and without reducing the scope of redistribution, and by so doing to create the possibility of introducing further reforms prudently and on the basis of a wide consensus. The authors thus treat the above two tasks together, but I think they should be definitely separated.

As a direct consequence of this, I cannot undertake to make paragraph-long comments on the authors' views on taxation and the reform of the large social distribution systems described in a few pages in respect of each group of questions, because each group of questions would need to be tackled at least in an independent article. I obviously agree with several proposals, and hold others as worth considering, and again others as rejectable. We must inevitably agree with the radical elimination of the legalised possibilities of tax evasion, with the simplification of the tax system and with the broadening of the tax base, the success of which alone would very likely or undoubtedly solve the budgetary problems. On the other hand, it is difficult to accept the proposal, according to which the Budgetary Council, that is an advisory body, has a right of veto even concerning recommendations. It is worth considering the priorities of the educational system. Although it is true that the greatest problem of the country is the unemployment of an ever increasing group of underprivileged people with multiple social handicaps due to lack of education, however, if this problem were resolved at the expense of higher education it would hamper the long-term development of the country. There is no denying that there is a need for the concept of self-provision to play a bigger role in the health-care system and pension system, furthermore, the above systems will have to be used to encourage private savings. However, if the aspect of solidarity were to be neglected such institutions would be deprived of their very basis of existence, as a result of which those falling behind may face even grimmer prospects. Finally, I am of the opinion that we must definitely reject the views which hold it inevitable or even desirable to further increase social inequalities. Moreover, these views are in contradiction with a number of specific proposals presented in the book.

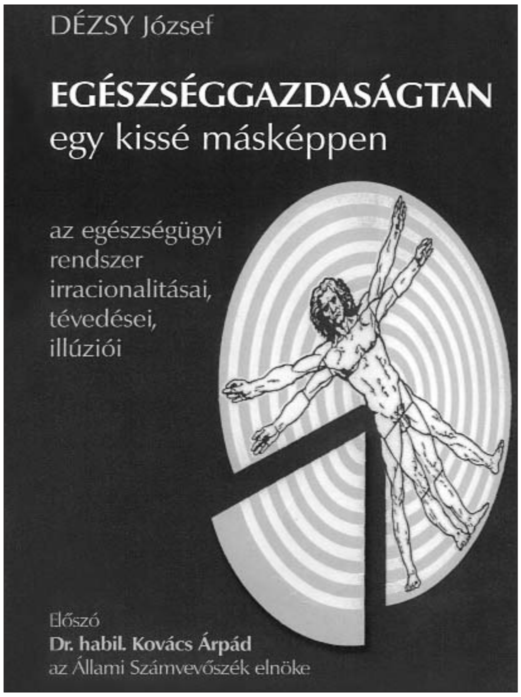
In summary: I certainly recommend that this book should be read. Its great merit is that it tries to give an answer to a complex set of questions based on a uniform conception, thus practically provoking a debate about it. It cannot be expected from a work of this size and especially from two authors to offer final answers to the questions raised and, above all, to all aspects of the questions. I hope that with the review and the critique of the book I will contribute to initiating and conducting a debate which descends even to particulars, and to finding solution based on wide consensus.

György Szakolczai

József Dézsy

Health economics with a small difference

the irrationalities, mistakes and illusions of the health system



SPRINGMED PUBLISHING HOUSE, 2006

To our present knowledge the competitiveness of a country greatly depends on the state of its human resources, the ratio, and the health status of the active population. That correlation also works the other way around: the economic performance, and level of welfare of the given country affects the health of the individuals inhabiting it. An applied science within economics, health economics seeks an answer to how the distribution of resources available to the health sector, scarce at all times and in every country, could be improved in order to help that improvement ripple on to the general health status of the people. We are witnessing the rapid growth of a sub-discipline that has an increasing number of adequate methods, and is capable of makeing an increasingly successful contribution to better economic decisions in the health sector that also have an influence on the health of people.

THE LITERATURE OF HEALTH ECONOMICS

The attention of traditional economics began to turn gradually to the health sector in the 60s. The turning point was *Kenneth Arrow*'s trend-setting article written in 1963 with the title 'Uncertainty and the welfare economics of medical care'. Since then the development of health economics – simultaneously to the strengthening of the economic and social pressures on developed countries – has been ever more dynamic. The two-volume manual on the same discipline was published in 2000 by Elsevier publishing house, and edited by *Anthony Culyer* and *Joseph Newhouse.* From the 90s onward even in Hungary we have seen the appearance of more and more high standard investigations on the issue. The foundations were laid by the works of *Éva Orosz, Péter Mihályi, László Gulácsi, Gyula Kincses* and *János Kornai.* (see under Literature)

The book by *József Dézsi,* professor of economics of Hungarian descent working in Austria is a new item in our collection, representing a new approach in a certain sense. Dézsy investigates the 'behaviour' of people's health, and the functioning of their healthcare systems from an aspect new both in structural and linguistic terms. He does not relate new information, rather, he explains it in a novel way, and thereby tries to satisfy the common need of his multi-faceted readership: let us find the common language, let us try to understand each other!

LANGUAGE Domestic authors on the subject suffer from a confusion of identity in the good sense of the word up to the present day. Who should technical treatises on health economics be written for? The target group is quite diverse. There are too many and too few Eskimos at the same time. Everyone thinks they know how to reform the health sector, but there are few people whose vision extends behind the scenes. In an environment like that the writer would have difficulty narrowing down the target audience too much, and would probably make a mistake doing so. It would not be worthwhile scaring away self-appointed health economists and enthusiastic amateurs with rudely technical language. An added complication is that everyone has a little different angle looking at the issue: the doctor and the patient view things from underneath, from the 'working floor' of the system, the health politician from above, the economist sometimes from outside, sometimes from inside, while the man in the street through their own attitude depending on their age, sex, and health status. Moreover, one had better address such a heterogeneous readership of such varied professional provenance extremely tactfully. Every word of criticism counts multiple in writing as health sector staff often feel that they are under the permanent pressure of deciding on life or death, and those concerned always regard the problems of health economics as their personal difficulty that is hard for them to understand.

It may be partly due to that fact that any author writing on health economics is inclined to even swap roles temporarily. Economists write to doctors using the latter's language, and medical people try to familiarise with economic terminology. Everyone tries to give effect to their concepts from their own point of view. For the time being, all that tends to work a beneficial effect on this rapidly growing technical area, and promotes the development of a common language.

József Dézsy's book also seeks that common path, that common language with a little difference. Gulácsi and Orosz use exclusively the language of health economics, understood by relatively few people up to the present day. Mihályi tries to convey his messages through examples (often away from the realm of health economics). Kincses applies health policy discourse, Kornai is the economist integrating this sub-discipline into economics as a whole. Dézsy chooses a new way: he tells a tale, illustrates phenomena, comments on himself, and even uses the odd gag. That is indeed a rather direct way of winning over new subscribers to this young discipline.

NOT A TEXTBOOK The book speaks to all those who are in any way concerned by the health sector: managers, doctors, nurses, health politicians or just interested laymen. Everyone will find sentences of their liking, thought provoking similes, and real-life references. It is not a textbook, however. Please nobody expect a manual with a section of definitions. Dézsy touches upon numerous issues of health economics, but never pushes his own views, while he certainly suggests some solutions he would find viable. For instance we find out about the author that he is a committed believer in case management, that he finds the system of closed health funds a primitive but reasonable solution, and supports the opening of health funds, and considers the “gatekeeper” role of the family doctor an indispensable element, and regards the base package of health insurance not much good. We do not have to agree with him by all means, but he places a number of hackneyed concepts in a new perspective through his observations.

In health care, too, there are three 'controls' to adjust its operation: price, quality, and quantity says Dézsy, and re-tells the frequently quoted stories of health economists with a small difference. 'The re-setting of one control changes the setting of the others, too, to some extent' (p 92) The author concentrates in each chapter on the tight-rope dance that the health sector dances together with its own players. He illustrates the irrational behaviour of the homo economicus through the fact that people 'buy' the improvement of their health rather than cars, bread or travels.

STRUCTURING OF SUBJECTS, AND CLARITY

The book has a logical line of thought, is easily readable, but does not follow the traditional build-up of technical books. The 19 chapters do not constitute a firm structure and are not characteised by all-inclusive cohesion. The chapters discuss issues interesting in themselves, and follow a set of loosely intertwined lines of argumentation. Dézsy rarely or never brings his own judgement, instead he argues for and against, and lets the reader ruminate over the problems. He seeks justice, and occasionally marvels at the small number of easily resolvable issues in the health sector. The author clearly has a weighty professional background against which he quietly sits back in his easy chair making his sometimes stinging remarks. The title of his book was initially going to be 'The comics of health economics' Gesundheitsökonokomik) adequately indicative of the author's self-reflecting intention. Dézsy often squints at the reader as if saying: Yes, I am an economist, and of course in theory I know the answer to the problem, but that does not seem to be true in each case.

His remarks, and words directly addressed to his readers frequently hit the target, but not always. The reason is that the translation is not completely flawless as it is indeed quite difficult to find the Hungarian phrase for some German concept that hardly exists in Hungary. English technical terms also rarely have an established equivalent. That is a challenge for many authors and translators. On the other hand, examples mostly come from the Austrian health system based on compulsory but strict insurance principles competitive in many respects. Thus the Hungarian reader may enjoy several snapshots of the Austrian healthcare system at the cost of not always getting the exact message. Problems in this federally structures health insurance market based on sickness insurance contribution understands it, and partly the po-licy holder's own risk are different from a system such as the Hungarian resembling a quasi-social insurance arrangement but being essentially a national health service. There is little explanation in the text, which could grow double if the author had to all explain all of his witty examples. That would mean that the most important attraction of the book, i.e. readability would be lost.

Dézsy's language is fortunately very readable. The author avoids technical jargon as much as possible, and does not force the use of technical terms easily understood by health economists but causing difficulty for laymen, and prefers to paraphrase them, analyse them, and 'recite' them. That has two benefits. On the one hand everybody understands it, and, on the other, many times the economist knowing his area well by professional standards awakens to the importance of the human factor in every behavioural pattern related to healthcare. He discusses one by one the well known phenomena such as moral risk, information asymmetry, harmful selection, agent theory, co-payment, supply-induced demand. He does it in a way that the reader gradually realises how much these concepts interrelate. The reader is made to marvel at the notions proposed, which is really useful.

Dézsy consciously rejects using accurate literary quotations in this book. We may well agree with him, this is not the genre where that counts. The emphasis is on the 'story' and less on meticulously documented facts. But that, at the same time, gives rise to inaccuracies. At some points simplification costs quality. E.g. saying that 'managed care means that we do everything that a patient needs, but possibly in a cost-saving manner.' (p. 53) is a rude over-simplification of a method of patient care and insurance-arrangement, even if there are so many such methods that they are difficult to define with a single sentence. Clearly, the author himself did not mean it himself.

The effect of the Austrian and the German school is reflected all along the book. Dézsy taps into his experience of several decades, and brings numerous examples from German speaking geography. At the same time he indulges in quoting the founding fathers of economics including *Adam Smith, Jean Baptiste Say, David Ricardo,* together with the great figures of health economics such as Uwe Richard, Kenneth Arrow, Peter Zweifel thereby lending authority to his message.

CLOSING NOTE The greatest virtue of the book is the highlighting of the human factor. 'It is not the Minister of Health or the insurance company, not even the health fund or the doctor who are at the top of health policy, but the patient.' says Dézsy (p. 144). That is one of the most important messages of the book, and that message comes from a health economist. That is what we think makes this book a little different from its predecessors. It is a piece of 'European' writing that puts man at its centre, one that not only teaches us but also talks to us personally. One of the last chapters discusses specifically the human factor, summarising the relationship of health economics and ethics, which is a really novel hue in Hungarian technical literature. Dézsy's work is an ideal first reading for students and health workers, useful extra reading for students of health economics, and a valuable reference volume for professional health economists, and lecturers.

Balázs Nagy

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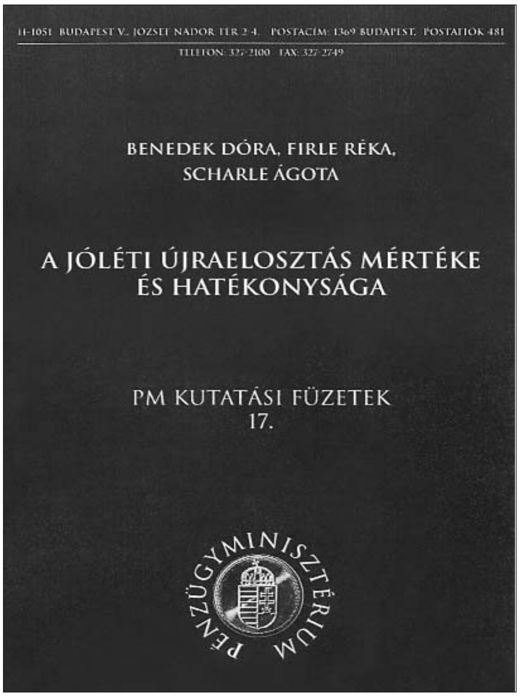
Results of an outstanding workshop

Ministry of Finance Research Working Papers



In this novel introduction to specialised literature, I wish to present a series of studies which constitutes a fundamental part of research conducted in the subject area of finance in Hungary. In reviewing 17 different working papers, the only aim can be awakening interest – which in my view is a very important one.

The editors and, in most cases, the authors of the working papers are researchers of the Ministry of Finance. By operating its Economic Research Division (the former Strategic Analysis Division) and by publishing this series, the Ministry fulfils a significant mission. The task of the Division is defined in the series of studies as follows: "it aims to support evidence-based policy-making in priority areas of financial policy." It is then added: "The Working Paper series serves to disseminate the results of research carried out or commissioned by the Ministry of Finance."

By going well beyond its task of promoting policy-making, the series of studies makes a substantial contribution to the accomplishments of local economic research. Five of the 17 working papers published so far are produced by the small research team operating within the Ministry of Finance. These studies are rated among the best, so we can say that the Ministry staff members play a central role not only in organising the work done in the workshop, but also in contributing to its success. A wide range of external experts is involved with excellent results. However, the most valuable of all is the distinctly outlined concept and the closely interlinked thematic structure of the researches which facilitate diverse approach to and identification of the major problems in the Hungarian economy. There is an apparent aspiration for a uniform internal structure in the researches, i.e. the presentation of the theoretical background, summary of the results of empirical research as well as frequent references to international comparisons depending on the nature of the subjects under review. Besides providing a successful summary, it also enriches science with several new research results and provides good foundations to economic policy which are useful in many respects.

The subject matters of the research projects tackled by the working papers can be divided into two major groups. The first seven studies in the series clearly elaborate one main subject area – systematically and thoroughly: competitiveness, the foundation stone of every economy's success. The working papers published within this subject area in 2003 and 2004 are products of the research carried out by the Ministry of Finance team with the contribution of external experts. In her introduction, research project leader *Orsolya Lelkes* describes the structure of her study on competitiveness, according to which the analysis of the factors influencing competitiveness is centred around three main themes as listed below (we add in brackets reference to the study issued in the series).

I. Resources
Infrastructure (*Fleischer,* Working Paper No. 2, August 2003)
Labour market (*Scharle,* Working Paper No. 4, October 2003)
Direct foreign investment (*Sass,* Working Paper No. 3, September 2003)

II. Operation of the market, regulatory environment
Innovation, research and development (*Borsi,* Working Paper No. 6, February 2004)
Enterprise environment (*Kállay, Kissné Kovács, Kőhegyi,* Working Paper No. 1, August 2003)

III. External effects
Environment protection (*Pataki, Bela, Kohlheb,* December 2003)
Social cohesion (*Lelkes,* March 2004)

A lot of papers are published on competitiveness, and because of the varied approaches, it is necessary to give the definition of the concept. This is already briefly and clearly outlined in the introduction to the review of the research results: competitiveness is interpreted as a growth potential, which – both at the level of national economy and that of a company – depends on the adaptability of the economic unit. An appropriate macro-economic, political, social and legal environment will create the potential for competitiveness, but efficiency depends, ultimately, on the improvement of the micro-economic capabilities of the economy, along with the quality of local competition.

This interpretation explains the significance of the theme of the study first published (Kállay, Kissné Kovács, Kőhegyi, 2003). Market environment, regulation and support for small enterprises – which is the very title of the working paper – are areas where the state exerts its influence. The authors state that (according to a survey carried out in 1997–1999), high public taxation and unpredictable regulations were key obstacles to the growth of small and medium-sized enterprises. They point out that contrary to international practice, where the emphasis has been shifted from subsidized services to legal regulation and to programmes that in the medium term can be operated without support, in Hungary the tools applied were limited to the provision of relatively inexpensive funds to small groups of recipients, and thus they made their impact alongside with the distortion of competition. We should mention that EU accession probably asserted a positive change in this respect.

The study appearing as Working Paper No. 2 deals with the relationship between infrastructure networks and competitiveness. The author, *Tamás Fleischer,* rightly lays special emphasis on the role of info-communication. It is often apparent to the reader that he does not share the great expectations about motorway development, underlining that in order for regions to enjoy the positive impacts of investments they must have other prerequisites which are essential for the absorption capacity, e.g. local network linkage systems.

In Working Paper No. 3, which focuses on the function of direct foreign investment, *Magdolna Sass* highlights that in order to halt the lag of an otherwise smaller extent in the capital inflow Hungary has shown since 1999 compared to its competitors, and to improve the country's capacity to attract capital, it is necessary to eliminate macro-economic imbalances and to develop the infrastructure as well as education and training. She calls our attention to the institutional changes that had to be made to investment promotion in order to meet the requirements of EU-accession, highlighting within this the co-financed forms of assistance and compliance with the aid ceilings.

Working Paper No. 4, the work of *Ágota Scharle,* addresses the relationship between the labour market and competitiveness. The author considers the high inactivity rate as the key impediment to competitiveness, and seeks, first of all, to find an explanation for that in her study backed up by abundant statistics. In the course of systematically reviewing the factors determining the labour market, she examines a number of important and highly current issues. Talking about government transfers, the author refers to the possible effects of increasing the retirement age, and raises the issue of the employment of disability pensioners and disabled persons. In the absence of sufficient empirical analysis, Scharle does not take a view on how the changing of taxes, tax increases or tax cuts would influence labour demand and supply. She dwells upon the effects of the minimum wage rise and the low level of labour mobility. With respect to training, she makes a noteworthy statement: the ratio of enterprises organising professional further training is low in comparison to EU Member States and to other countries of the region.

The study published in Working Paper No. 5 was prepared by *György Pataki, Györgyi Bela* and *Norbert Kohlheb,* staff members of Szent István University, Institute of Environmental Management. In relation to the other studies, this paper elaborates at greater length and details upon theoretical foundation and reviews international practice and empirical evidence. It can be considered fully justified if we think of how unacknowledged environment management aspects are in the country compared to their real and great significance, and how undeservedly they are pushed into the background in society as well as in economic decision-making. It is a pity that in the absence of substantial empirical survey, the presentation of the rather disappointing local circumstances is falling short.

In research paper No. 6 *Balázs Borsi,* member of the Heller Farkas Innovation Research Team of the Budapest University of Technology and Economics deals with the subject area of technological modernisation, innovations, and research and development. After the introductory chapter defining the main terms based on the concept of the National Innovation System (NIS), the specific features of the Hungarian innovation system are outlined. Macro-economic statistics reveals, among other things, that the more developed a country is the higher the proportion of researchers will be who, out of the total number of researchers, are involved in the private sector. In this respect, Hungarian figures are among the worst within the OECD countries. The analysis of the micro-level is based on a business survey which demonstrates, inter alia, that almost two-thirds of the enterprises introduced new technology in the previous years. Chapter III, which is aimed at formulating possible economic policy steps, highlights the significance of a systemised approach.

The problem of social cohesion plays a special part in competitiveness, which is the topic Orsolya Lelkes addresses in the last paper (No. 7) within the first large subject area. Improving social cohesion and taking efficient action against social exclusion, unemployment and extreme income differences enhance economic growth potentials. The author stresses that the real question is how the state finances the welfare systems rather than how much it spends on them. Her statement is very topical, i.e. the relevant issues are the various forms of benefits, their eligibility criteria and the impact of such benefits on business behaviour. The quality of welfare services is measured by the extent they promote social integration, including in particular, participation in the labour market. The low employment rate of the Roma population is linked to social exclusion. The author underlines that it is related to the low education level characterising this social group. With respect to the income position, she establishes that regarding the indicators of relative poverty, Hungary has a relatively favourable position compared with other EU countries.

Orsolya Lelkes's study leads on to the other large group of researches which falls within the subject area of consumer income, social redistribution and welfare systems. The Ministry of Finance research team has carried out the major part of the research, but a few invited external experts have also made some contribution.

Working Paper No. 12, prepared by researchers of the Ministry of Finance, deals with the analysis of the minimum wage increases between 2001 and 2006, a subject related to the analysis of primary incomes. The study, which also reviews theoretical results and foreign empirical researches, focuses on the effect of minimum wage rises on two areas: income disparities and, in particular, employment. The researchers make a detailed study of the real and expected impact of minimum wage rises in 2001–2002, and in 2006 respectively. In the first case, they conclude that there was no substantial decline in employment in the national economy as a whole, but employment dropped in certain sectors and other economic spheres, which affected smaller enterprises, unskilled and old employees and regions with high unemployment rate. The same effects are foreseen in respect of the latest minimum wage increase.

The issue of social redistribution is the central theme of the series. Working Paper No. 9 serves as a starting point with its analysis of empirical evidence. It provides a broad overview of the structure of general government expenditures and revenues in the period between 1991 and 2002 in Hungary. The authors make a consistent use of international comparison.

I presume we can all agree that in the present times when reforms are unavoidable, one of the most important issues to be addressed in Hungary is the extent and manner of the state's role in the welfare systems. The author of Working Paper No. 8 on this subject is a foreign professor, *John Hills,* from the London School of Economics, who held a lecture in Budapest at the invitation of the research team. I recommend this study to all readers, especially because it illustrates the British experience. We should bear in mind the distinction Professor Hills makes and uses as the framework of his lecture: in connection with the role of the state and the private sector he differentiates the following categories: provision (i.e. whether the service provider is a public or a private institution); financing (who pays for the service); and the decision (whether the private individual can select the service provider and the price payable). It is noteworthy that the 18-year privatisation process during the Thatcher and Major governments had hardly any effect on the composition of services in the welfare sector: the share of the public sector remained almost unchanged (dropping from 52 per cent to 49 per cent).

Also comprehensive in its theme, Working Paper No. 17, which addresses the degree and efficiency of welfare redistribution and is focused on the selection of redistribution models and the means of redistribution. The authors – researchers of the Ministry of Finance – give an overview of the system of

Hungarian redistribution supported with ample factual data, and arrive at the conclusion that the domestic welfare system is equitable, but operates with low efficiency, consequently, in its present form it is unsustainable in the long run. They consider the targeting of benefits as acceptable, while that of the price subsidies as poor. The authors take a clear stand in favour of abolishing tax allowances which offer advantages to the well-to-do groups.

Study No. 10 in the series assesses income redistribution in Hungary using a micro-simulation model. Within this framework, the authors show the effect of tax and subsidy systems applied in the period between 2002–2004 on society as a whole and on different groups of society formed according to various considerations. Based on their examination conducted from the perspective of households and individuals, the authors draw the same conclusion that tax allowances tend to benefit medium-income groups, while their abolishment and the increased role of central support are favourable for the most needy, including in particular, families with children.

The high number of inactive people represents an acute problem in the Hungarian economy. We are not only talking about aging and a longer period of life spent in education, nor is it related to unemployment which would affect a large percentage of job seekers. It is instrumental in inactivity that compared to other countries, a large proportion of the working-age population is absent from the labour market, for not at all unequivocal reasons. *Zsombor Cseres-Gergely's* study addresses this vital question (Working Paper No. 13), placing special emphasis on the group of inactive middle-aged people and households. In his study, which is based on analysing a survey of the Central Statistical Office published in the Annex, the author tries to explore the reasons for early retirement and analyses its conditions and impact. Working Paper No. 14 is also connected to the pension scheme. It provides a long-term overview of the changes in generational accounts, covering the period between 1992-2001, in the study produced by *Róbert Iván Gál, Árpád Törzsök, Márton Medgyesi* and *Tamás Révész.*

The analysis of the savings incentive scheme, more precisely the incentives built into the taxation system, is linked with the review of consumer incomes, which is the subject matter of Working Paper No. 15 prepared by Anna Vidor. The author starts from the fact that such incentives can only be effective if they, at least partly, encourage new savings rather than resulting in shifting savings from other type of assets. She establishes that in Hungary pension fund savings coupled with tax allowances produce the above described effect.

As we have seen, it is apparent from this series that the key theme of the researches has been the analysis of the financial implications of competitiveness as well as consumer incomes and social redistribution from different angles.

There are two exceptions: Working Papers No. 11 and 12 which address a particular subject. *Mária Lesi* and *Gabriella Pál* introduce to the readers the theoretical foundations and EU regulation of carbon-dioxide emission trading, and discuss in detail its expected impact on the Hungarian electricity market.

In summary, we may conclude that this significant series has become an indispensable part of financial research in view of the importance of the issues raised by it and the success of the research work. Thus, it is an essential resource for economic decision-making as well as for further research and education, and it also provides a useful source for promoting general knowledge and informing the press on these often discussed issues. We hope and expect that the research workshop of the Ministry of Finance will continue its efforts and this invaluable series to the benefit of us all.

Iván Schweitzer

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