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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.

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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, Executive Officer. ■ HU ISSN 0031-496-X., www.hknyomda.hu

Price: HUF 5,775

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The European Court of Auditors and the cooperation with the Supreme Audit Institutions in the European Union

Building a network based on accountability, transparency and confidence

Independent auditors, both in the private and public sectors, attach great importance to promoting accountability and transparency. These are fundamental democratic values that are essential to ensuring trust and confidence not only in markets but also in government. In the public sector, they are essential to ensuring that public funds are soundly managed on behalf of citizens and taxpayers.

Accountability and transparency are particularly important in the context of an EU of 27 Member States and in the face of global challenges, such as dealing with the current financial and economical crisis, creating jobs and growth, combating climate change and achieving sustainability. These challenges are putting pressure on public finances everywhere, and EU citizens and taxpayers expect and trust that EU funds will be spend wisely.

The cooperation between the European Court of Auditors (ECA) and the Supreme Audit Institutions (SAIs) in the European Union (EU) is becoming increasingly important in the context of the external audit of the EU funds. This article outlines the role of the ECA within this context, the impact of its audit work and opin-

ions, and the reinforcement of the cooperation between the Court and the SAIs towards the building of a network based on accountability, transparency and confidence.

THE ROLE OF THE EUROPEAN COURT OF AUDITORS IN THE EU

The European Court of Auditors performs its audits within a legal framework laid down mainly by the EC Treaty¹, Articles 268 to 280 of which contain financial provisions governing the Community's income and expenditure, and the Financial Regulation² applicable to the general budget of the European Communities (EU budget).

The Court is the EU Institution established by the EC Treaty to carry out the audit of EU finances. As the EU's external auditor, its mission is to contribute to improving EU financial management and acts as the independent guardian of the financial interests of the citizens of the Union, promoting accountability and transparency.

Under the constitutional systems of modern

States the external audit function is generally considered to be one of the main elements for ensuring accountability, alongside Parliamentary scrutiny. Appropriate arrangements for ensuring external auditing are an essential part of public-sector financial management, required for Member States' accession to the EU³.

The setting-up of the European Court of Auditors followed this same reasoning and coincided with two particularly important events, firstly, the extension of the European Parliament's powers in the area of EU budgetary control and, secondly, the full financing of the EU budget by own resources.

In view of these changes and the increase in the European Parliament's powers in the area of the implementation of the budget, it was essential for the European Communities to make a qualitative change in the external auditing of the budget.

Thus, the European Court of Auditors was established by the Treaty of Brussels (1975), and started operating in 1977, with its headquarters in Luxembourg.

The Court was promoted to the rank of an institution with the entry into force of the Maastricht Treaty (1993), thus enhancing its independence and authority as one among equals. Since then the Court has been required to publish a Statement of Assurance (DAS – from the French term “Déclaration d'assurance”) as to the reliability of the EU accounts and the legality and reliability of the transactions underlying those accounts.

ECA's role was confirmed and strengthened by the Treaty of Amsterdam (1999), which empowered the Court to carry out sound financial management audits, emphasised its intervention in the fight against fraud and allowed it to have recourse to the Court of Justice in order to protect its prerogatives with regard to the other EU institutions.

The Treaty of Nice (2003), which is still in

force, confirmed the principle that there should be one Member from each Member State and that the Court should continue to take decisions as collectively, as a College. However, the Treaty allowed the Court the option of being organised in chambers. It also highlighted the importance of the Court's cooperation with the Supreme Audit Institutions in a joint declaration to the Treaty:

“The Conference invites the Court of Auditors and the national audit institutions to improve the framework and conditions for cooperation between them, while maintaining the autonomy of each (...)”⁴.

The Court does not have judicial powers and thus neither its audit reports nor its opinions are legally binding. However, the Court's work is used to improve financial management by those responsible for legislation, managing and controlling EU programmes and finances.

Indeed, the Court promotes accountability and transparency not only by auditing EU funds, but also by providing independent advice to other EU institutions/bodies to help them shape and scrutinise legislative and budgetary proposals as well as subjects with financial impact.

The Court's current institutional status, its composition, powers and mandate are confirmed in the Lisbon Treaty⁵, which is yet to be ratified.

EU BUDGET: INCOME AND EXPENDITURE

The Decision on the System of Own Resources establishes a ceiling for the annual appropriations between 1.24% (for payment appropriations) and 1.31% (for commitment appropriations) of the sum of all the EU Member States' gross national income (GNIs).⁶

For instance, the 2009 EU budget is approximately 130 billion euro, less than 1% of the

GNI of its 27 Member States⁷. Compared to national budgets this is a small share although for some Member States funds from the EU play an important role in financing public activities.

The Own Resources are transferred from Member States based mostly on national gross national income as well as customs duties and value-added tax (VAT) based resource. According to the principle of subsidiarity established by the EC Treaty⁸, the EU budget cannot replace the national budgets, partly due to differences in their respective functions. For example, the Union is not responsible for social security systems, usually a large part of national spending.

The expenditure side of the EU Budget has evolved over time, agriculture and cohesion policies now being its major components representing around 80%.

Since the 1960's agricultural spending, typically through payments to farmers across the Union, has been the largest part of the budget although its share is now decreasing. In 2009 45.3% of the budget is aimed at preservation and management of natural resources, mainly agriculture and rural development.

Ever since the 1980's a major part of spending has been directed towards cohesion – i.e. regional and social development – co-financing a wide range of projects related, for example, to infrastructure construction and professional training. In 2009 spending on sustainable growth, of which the lion's share is for cohesion, is planned at 39.6% of the budget. This heading also includes a significant part of the EU funds directed to research.

In addition, the EU spends significant amounts on development and humanitarian aid as well as support to countries close to the Union or candidates to join it (7.2%). Lastly, 6.7% of the budget is needed for financing the administration of the Community institutions.

LIFE CYCLE OF EU BUDGET

The life cycle of EU budget comprises the following stages: the establishment, the implementation, the audit and the discharge of the EU budget.

It is decided annually (within the context of seven-year financial frameworks) by the directly elected European Parliament and the Council, following a proposal of the European Commission. As set out by the EC Treaty, the Commission is responsible for the EU Budget implementation on its own responsibility, and the Member States shall cooperate with it to ensure that the appropriations are used in accordance with the principles of sound financial management⁹.

Depending on the spending schemes, national administrations may be responsible for setting spending strategies, selecting projects and making payments to beneficiaries. A specific feature of Community expenditure is the high percentage of payments based on claims submitted by the beneficiaries themselves, be they farmers or project managers throughout the Union.

The external audit of the EU Budget is the exclusive prerogative of the European Court of Auditors. In the areas of the budget where management is shared, Member States cooperate with the Commission in setting up supervisory and control systems – internal control – to ensure that funds are spent properly and in accordance with the rules. Internal control thus has a European as well as a National dimension. In addition to the work done by the Court, many Member States' SAIs audit EU funds that are spent, managed and controlled by national administrations.

The SAIs provides a picture from an independent national viewpoint of the use of the part of the EU funds spent in that Member State by the national authorities. The Court, on the other hand, audits EU policies not Member

States and it does so from the EU level all the way down to the final beneficiary of EU funds within the Member State.

Finally, the European Parliament, based on a recommendation from the Council, is responsible for giving discharge to the Commission for the execution of EU budget. To this end, the European Parliament and the Council examine the Annual Report, the Statement of Assurance (DAS) and the relevant Special reports of the Court of Auditors¹⁰.

ECA'S AUDIT WORK ON EU BUDGET

The starting point of the Court's audit work is the EU Budget that is presented by policy area¹¹. The Court does not have the capacity to audit each area in detail every year. It therefore selects its audit tasks in order to make the most effective use of its resources. A number of factors are taken into consideration when selecting tasks, including the risks to performance or compliance for the expenditure, the level of spending involved, the time since any previous audit, forthcoming developments in the regulatory or operational frameworks, and political or public interest.

The Court carries out its work, in accordance with the international auditing standards, through different types of audits: financial, compliance and performance audit. These address the three following questions.

- ▶ Do the accounts present fairly, in all material respects, the financial position, results and cash flow for the year, in accordance with the applicable financial reporting framework? (Financial audits)

- ▶ Are activities, financial transactions and information, in all material respects, in compliance with the legal and regulatory frameworks which govern them? (Compliance audits)

- ▶ Is the financial management sound? i.e. are the funds used kept to a minimum (economy),

are the results achieved with the least possible resources (efficiency) and have objectives been met (effectiveness)? (Performance audits)

In order to provide assurance as to whether the payments comply with legal and regulatory frameworks, the Court draws on the results both of its examination of supervisory and control systems, intended to prevent or detect and correct errors of legality and regularity, and of a sample of the transactions (payments) themselves. When systems are tested and found to be reliable, then fewer transactions can be audited by the Court in order to come to a valid conclusion on their legality and regularity. Other sources, such as the work of other auditors, are also used to support the Court's conclusions.

In performance audit, the Court uses a variety of audit methodologies to assess management and monitoring systems and information on performance against criteria derived from legislation and the principles of sound financial management. When selecting which performance audits to carry out, the Court aims to identify audit subjects which are likely to yield high impact in terms of identifying potential improvements in the economy, efficiency and effectiveness of EU spending.

The Court publishes the results of its audit work in three main types of report.

- Firstly, the Court produces an Annual Report containing its observations on the execution of the EU Budget for each financial year, including a Statement of Assurance (DAS) on the reliability of the EU accounts for that year, and the legality and regularity of the underlying transactions. The primary aim of the DAS is to provide stakeholders – notably the European Parliament and the Council, but also all EU citizens – with an audit opinion as to whether EU income and expenditure are completely and accurately recorded in the accounts, and have been raised or spent in accordance with the applicable legislation and contractual provisions.

■ Secondly, the Court produces an Annual Specific Report on the results of its financial audits for each of the Communities agencies and bodies established in the different Member States to accomplish specific technical, scientific and managerial tasks.

■ The third type of reports the Court produces are known as Special Reports – 12 were published in 2008 – that present the results of selected performance and compliance audits, covering a wide range of areas: from the cross-compliance policy under the new Common Agricultural Policy (CAP)¹²; the Intelligent Energy for Europe Programme 2003–2006¹³; to the European Commission Rehabilitation Aid following the Tsunami and Hurricane Hitch¹⁴.

The ECA's audit reports provide an important basis for the annual discharge procedure mentioned above.

CURRENT STATE OF THE EU FINANCIAL MANAGEMENT FROM ECA'S PERSPECTIVE

In its most recent Annual Report¹⁵, the Court gave, for the first time, a clean opinion on the reliability of the EU accounts. This comes three years after the introduction of accruals accounting by the Commission and represents significant progress towards improving transparency and accountability.

However, as regards the legality and regularity of underlying transactions the Court concluded that the situation was similar to previous years as areas making up the majority of expenditure continue to be affected by material levels of errors of legality and regularity although to different degrees.

The areas under shared management were among the areas found to be materially affected by error. These areas are mostly made up of spending on agriculture and cohesion which is spent through national budgets.

Material levels of errors of legality and regular-

ity persist because there is a high level of inherent risk associated with many areas of EU spending and weaknesses related to supervision and control.

Much of the EU budget, including in the areas under shared management, is disbursed to millions of beneficiaries across the Union, often under complex rules and regulations based on the self-declarations of those who receive the funds. These inherently risky circumstances lead to errors in all Member States by final beneficiaries and by those paying out the funds.

As most errors occur at the level of the final beneficiary they can often only be detected reliably by detailed controls carried out on-the-spot. Such checking is costly and so usually only a small proportion of individual claims are checked.

IMPACT OF EUROPEAN COURT OF AUDITORS' WORK

Through its professional, relevant and timing audit reports and opinions on legislative/budgetary proposals as well as financial management issues,¹⁶ the Court contributes to improving EU financial management and acts as the independent guardian of the financial interests of the citizens of the Union.

Short and medium term impact

Public auditing is a key component in ensuring accountability, and a useful contribution to public debate. It also plays a key role in helping modern democracies run efficiently. Through audit activities the ultimate stakeholders, in this case citizens of Europe, are being informed about whether their money is being spent in a correct and useful way.

The Court's audits provide information directly to decision-makers in the institutions concerned – in the EU context, primarily the Commission, the Parliament, the Council and

the Member States. They can take action on this information in order to improve the management of the EU Budget.

One example of immediate impact is given by the ECA's report on cross compliance already mentioned, which publication (November 2008) coincided with the adoption of the health check of the PAC. Due to the importance of cross compliance and its central role in the CAP and due to the timing publication, the report was intensively discussed in the Parliament, which has included almost all of the Court's recommendations in its 2007 Discharge Report recently adopted¹⁷: simplification, clarification and a hierarchy of applicable rules.

Other observations and recommendations of the Court were taken seriously by the Parliament in its 2007 Discharge Report. For instance, it is noted that, owing to disparities in presentation and to a lack of added value, the ECA considers that the annual summaries do not yet constitute a reliable appraisal of the operation and effectiveness of the control system and, consequently, calls on the Commission to analyse the summaries received in 2009 with the aim of optimising their added value in terms of the assurance they provide regarding the operation of the internal control systems employed by the Member States.

This was clearly inspired by the Court's opinion on the "Annual summaries of Member States, national declarations of Member States, and audit work on EU funds of national audit bodies"¹⁸ according to which the annual summaries can in time stimulate improved management and control of EU funds. However, the Court emphasized that these elements could only give added value and be used by the ECA if they are of adequate and comparable scope, approach and timing, following the requirements of international auditing standards. According to 2007 Annual Report they did not provide a complete assessment of the functioning and effectiveness of the systems.

Furthermore, the measures taken by the Commission in 2008 following the 2006 Parliament's discharge report – based mainly on Court's recommendations¹⁹ – also testify the influence of the Court's reports. In Agriculture, new guidelines were issued for certification bodies. In Cohesion, there has been simplification of the rules and eligibility criteria for the 2007–2013 period. In the area of Internal Policies, there is now better information for beneficiaries, improved audit arrangements, and simplification of cost eligibility. In external actions joint EC-UN visibility guidelines were issued, the information systems for projects have been improved, and the framework governing the verification of expenditure at the level of project implementing organisations has been strengthened.

Long-term impact

But there has also been a positive response to Court's recommendations of a more long term nature, which is the case of the Court's opinion that proposed a "Community internal control framework" for EU funds²⁰.

The Court acknowledged in its audit reports the significant efforts made by the Commission and Member States over the past few years, to address weaknesses in supervision and control and, consequently, to reinforce accountability and transparency.

However, the Court identified scope for improving existing management and control procedures, notably in the areas of the EU Budget under shared management. As the Court has repeatedly stated in its annual reports, the key to improvement is through sufficient, appropriate internal control systems operated at European and National level.

Furthermore, both the European Parliament and the Council expressed on several occasions concerns about a lack of coordination of the

various controls and checks at the different administrative levels. It is generally recognised that the resources applied to the control and audit of EU finances should be organised more coherently and cost effectively.

The Court considers in its opinion that the success of a “Community internal control framework” would depend on three important elements: first, the simplification of the legislation in force; second, the definition of a tolerable risk of error, having regard to the inherent risk per policy area and the costs of controlling and, finally, the establishment within the Commission and the Member States of a coherent and effective chain of internal controls based on common standards.

The Commission's “Action Plan towards an integrated internal control framework”²¹ is an example of a positive way forward which was inspired by the Court's opinions. The last report on the Action Plan's impact was recently presented by the Commission²².

Since the publication of the above mentioned opinion, both the Council and the European Parliament have followed-up this subject, in particular in what concerned the trade-off between the costs and benefits of controls. In its 2007 Annual report, the Court encouraged the Commission to proceed with “its analysis on the cost of controls and on the different levels of risk inherent in the spending areas”. The Commission's communication “Towards a common understanding of the concept of tolerable risk of error”²³ – which also provides a useful focus on the effectiveness of controls and their costs – was, therefore, welcomed by the Court, although it considers that there are a number of aspects which need to be reflected upon in the future²⁴.

The Commission has noted in the communication that any decision on a tolerable risk of error should be based, among other things, on the potential for further simplification. The Court similarly underlines the importance and benefits

of further simplification and its potential impact on the reduction of errors/irregularities.

The Court is of the view that analysis of the costs and benefits of expenditure programmes could inform not just discussions about tolerable risk but also a review of the regulatory regime and management structure for the programmes concerned. In this context, the pertinent question might not be whether there is a tolerable risk of error but whether the risk of error is so great that the particular scheme or programme in question should be discontinued or substantially changed. Indeed, the concept of tolerable risk should also be given specific consideration when designing expenditure (and income) schemes or programmes.

Furthermore, it would be useful if expenditure programmes, at the time of adoption, also gave sufficient information on the risks associated with such programmes and the costs of the intended controls designed to reduce these risks to a tolerable level. In this way, political decisions would be taken in a more informed manner, explicitly considering the risks, the costs as well as benefits involved.

The EU budget review exercise might provide an opportunity to reflect further on this topic, as suggested by the Court in its response to the Commission's communication “Reforming the Budget, Changing Europe”²⁵.

FURTHER DEVELOPMENTS TO IMPROVE EU PUBLIC FINANCES

Further developments to improve the management and control of EU public finances will depend largely on the success of the budget review exercise, launched by the European Commission in 2007²⁶. The public discussion closed in June 2008, and its results were presented later in November 2008 in a Conference on the Future of the EU budget, organised by the Commission²⁷.

Another instrument that might influence the future of the EU finances is the forthcoming review of the Financial Regulation applicable to the EU Budget that will take place during this year to enter into force in 2010²⁸.

The Court's contribution to the ongoing exercise of reforming the EU budget focused on one of the main questions put by the Commission in its Communication: "How could the effectiveness and efficiency of budget delivery be improved?"

It is important to recall first that, with the exception of payments under the Agriculture Schemes, the EU budget part finances the activities of private and public agents rather than providing goods and services to EU citizens directly. And secondly, implementing the budget requires multi-level governance arrangements involving EU institutions and governments (national and regional) of Member States and, in some cases, third countries and international organisations.

From the Court's point of view, to answer the mentioned question it is needed to begin by acknowledging that efficient and effective use of EU funds is unlikely to have been achieved unless the benefits for EU citizens are clear and visible and there is good reason to suppose that the best way to have achieved those benefits was by action at the EU level. In other words "EU value added" is probably the appropriate basis on which to judge the efficiency and effectiveness of the use of EU funds.

At the level of expenditure programmes, the Court suggests that the key to achieving efficiency and effectiveness lies in the design of expenditure programmes. Close attention needs to be paid, in particular, to: first, the terms on which EU spending is made available to budgetary recipients (the eligibility criteria); secondly, the responsibility for managing the budget (accountability and governance); and, thirdly, the cost-effectiveness of management arrangements.

In devising the eligibility, governance, and management arrangements for expenditure programmes the Court recommends decision makers follow a number of "principles".

▶ *Clarity of objectives* – "Be clear about what is to be achieved": maxime, in Rural Development and Cohesion.

▶ *Simplification* – "Don't make things any more complicated than they need to be": complex rules on eligibility conditions lead to errors and can increase the cost of controls.

▶ *Realism* – "Don't set conditions that can't be checked": difficult legality conditions in Agriculture and Research cannot be checked efficiently.

▶ *Transparency and Accountability* – "Make sure responsibilities are clear": for decision-makers to be accountable there needs to be clear and transparent information and reporting as well as clear responsibilities for managing and controlling funds.

Beyond these "principles", the Court also suggests giving consideration, for instance, to recasting expenditure programmes in terms of acceptable outputs rather than eligible inputs ("payment by results") and defining control systems in terms of their outputs rather than their inputs, i.e. setting a "tolerable" level of risk to be achieved rather a level of checks to be carried out.

In this context, budget delivery could be improved by political authorities in three main ways: first, by clarifying the principle of European added value in EU legislation and applying it while choosing expenditure priorities. Second, when it comes to designing the expenditure programmes to meet those priorities by giving due attention to ensuring eligibility, governance and management arrangements are as clear, simple, realistic and transparent as possible. And finally, by considering whether expenditure programmes and control systems could be more "output" rather than "input" focussed, with payments made on a more sim-

ple basis and with, perhaps, more discretion below EU level in managing some expenditure.

BUILDING A NETWORK BETWEEN ECA AND SAIs

Different forms of cooperation

As mentioned above, most EU expenditure is in areas under shared management, which means that it passes through the national budgets of Member States and is executed by Member State authorities at either national, regional or local level. This also means that most EU expenditure falls within the audit mandates of both the ECA and the SAIs of the Member States.

This brings us to the importance of cooperation between ECA and the SAIs of the Member States of the EU that has been continually reinforced for more than 30 years.

The EC Treaty foresees that the European Court of Auditors and Supreme Audit Institutions shall “cooperate in a spirit of trust whilst maintaining their independence”²⁹. Maintaining the independence of each is essential to their abilities to carry out their distinct but complementary roles with respect to the audit of EU funds.

The SAIs have a national perspective and provide recommendations to improve financial management within Member States; the European Court of Auditors, as explained above, provides an EU level perspective by policy area. This EU level perspective enables the Court to contribute to improving financial management at EU level and to the sharing of best practice between Member States.

This cooperation takes a number of forms. First, there is a direct role played by SAIs to facilitate the audit missions of the Court in their Member State. Work programmes and reports are exchanged and the Court sends copies of all

correspondence with national authorities to the Member State's SAI. Furthermore, the Court is willing to rely on the work of other auditors and it is open to the possibility of carrying out joint audits with interested SAIs which will provide audit evidence that is not only relevant to the opinions of national audit bodies on national accounts but also to the Court's audit work, notably the DAS³⁰.

Secondly, there is the work done together in the Contact Committee of the President of the ECA and the Heads of the Supreme Audit Institutions of the EU, which provides a forum for multilateral and bilateral cooperation, such as sharing experiences, developing common approaches as regards the audit of EU funds and using each others work, carrying out joint or parallel audits. Day to day contacts are maintained through Liaison Officers appointed by each SAI.

The Contact Committee has also established over the years various Working Groups to help develop common positions and practices. One example is the working group on Common Auditing Standards, chaired by the Court, which aims to develop common auditing standards and comparable audit criteria based on internationally recognised auditing standards tailored for the EU areas. With effect from December 2008, the Court took over the (rotating) chair of the working group in the field of VAT, and the Agricultural Experts Network was re-launched under the chairmanship of a Member of the ECA.

The third form of cooperation is developed through INTOSAI and its regional organisations like EUROSAI, which bring together audit institutions from the European Union and beyond, to address common audit challenges according to the motto “*Experientia Mutua Omnibus Prodest*” (Mutual Experience benefits all).

As a full member of INTOSAI, the Court has actively contributed to the work of the Performance Standards Committee through its participation in the Subcommittees on

Financial Audit, Compliance Audit, and Performance Audit Guidelines.

Since 2008 the Court has been chairing the working group on accountability for and audit of disaster-related aid (which succeeded the INTOSAI Tsunami task force). The main objective is to develop guidance for accountability and audit in this area, addressing all parties involved through their respective standard setting bodies. Chairmanship of this working group also implies that the Court is represented in Governing Board meetings of INTOSAI.

At the VII EUROSAI Congress in Krakow in 2008, the Court contributed with a paper on “The role of leadership” within the working group which reported on the theme “Establishing an Audit Quality Management System in a Supreme Audit Institution”, chaired by the State Audit Office (SAO) of Hungary.

In the context of the EUROSAI, the Court has been also actively involved in the IT Working Group that aims to share expertise and implement joint activities in the field of information technology, and in the Environmental Working Group whose main strategic goals are to facilitate concurrent or coordinated environmental audits, to encourage audits within the area of climate change, and to develop methodology and governance practices concerning environmental auditing.

The Court has been appointed by the VII EUROSAI Congress, together with the National Audit Office of the Republic of Slovakia, as EUROSAI auditors for the 2009–2011 period.

Reinforced cooperation due to the crisis context

The Contact Committee has a crucial role to play in the crisis context. At its meeting held in December 2008, in Luxembourg, under the

Court's chairmanship, the EU budget reform and the revised 2008–2011 Lisbon Strategy were discussed and, last February, a workshop was held at the Court on the Role of the EU SAIs in the current economic and financial crisis.

The workshop's participants agreed on the need for swift and timely action, for transparency and trust, and for international cooperation. In fact, transparency is an absolute value, and the proper functioning of the financial system relies on confidence and trust, which can only be achieved through transparency.

In order to prepare this workshop, the German Federal Court of Auditors, in cooperation with the SAI of the Netherlands and the ECA, developed a questionnaire designed to provide key information concerning the role of the SAIs in the context of the global crisis. The results of the questionnaire show that all Member States have taken action to respond to the crisis. In spite of the wide variety of measures adopted, in a majority of cases, the measures take the form of State Guarantees and refinancing. The questionnaire also showed that all SAIs have a mandate to audit government financial management, and that they are authorised, in principle, to look into government action taken in response to the financial crisis. However, only 70% of the SAI's have a specific mandate for auditing the rescue packages. Central questions were the audit of the beneficiary institutions, especially the banks, the adviser role of the SAIs and the presentation of the audit observations.

It was agreed to establish voluntary networks with the aim of providing a platform for the exchange of experiences and audit information concerning the implementation of the revised Lisbon Strategy and EU crisis management that are closely connected. A kick-off meeting for such voluntary networks took place in May 2009.

The influence of the current crisis in the cooperation's reinforcement was also dis-

cussed at the second conference EUROSAI-ARABOSAI held in Paris (April 2009), on the subject of “The role of the SAIs in the Development of the Performance of the State Institutions”. According to its conclusions, the role of the SAIs should assume three different perspectives: firstly, a reinforced warning role in the context of the financial, economical and social crisis; secondly, a proposal making role which implies an adaptation of the SAIs methodologies, notably through a more strategic planning, a focus on the management's risks and opportunities, and a more proactive relationship with the managers and; finally, a role of assistance and support vis-a-vis the national Parliaments and Governments, without prejudice to their respective independence.

Strengthening cooperation as outlined above reflects the values of accountability, transparency and confidence. Those responsible need to be accountable and SAIs have a role to play to ensure transparency, which in turn will contribute to provide confidence to EU citizens and taxpayers. This subject will be developed further in the next Contact Committee meeting to be held in Budapest in December 2009 under the chairmanship of *Dr. Kovacs, Árpád* President of the SAO of Hungary.

Court's Peer Review

The mutual participation in peer review processes aimed at assessing one another best practice also clearly demonstrates auditors' commitment to transparency and accountability.

The International Peer Review Report on the European Court of Auditors, published in December 2008³¹, represents a major milestone in the Court's reform process. The peer review was undertaken by a team of experienced financial and performance auditors from the SAIs of Canada, Norway, Austria and Portugal.

The peer review team concluded that the “audit framework established by the Court is suitably designed in accordance with the international auditing standards and good practices of Supreme Audit Institutions”. The team also observed that “the Court conducts its work with independence and objectivity”; and that “the stakeholders have a high level of confidence in the Court's reports and generally considered them to be fair, factual and objective”.

The Court welcomed the observations and constructive recommendations of the peer review team, which identified the main challenges and opportunities that will allow its own improvement as a single audit institution.

CONCLUSIONS

The role of the European Court of Auditors – as the EU external audit institution – is to contribute to a better management and control of EU public finances. Through its audit reports and opinions, recognised for their quality and impact, the Court influences in a proactive way the changes that are likely to improve the supervisory and control systems over EU funds and, consequently, to have a positive impact on their ability to limit the risk of irregular expenditure. Aiming to be at the forefront of developments in public audit, the ECA's work must bring added value to the EU management, playing a major role within the construction of the European Union and being closer to the European citizens.

However, further developments are needed. In the context of an integrated internal control framework, proposed by the Court in its Opinion No 2/2004, the publication in December 2008 of the Commission's communication “Towards a common understanding of the concept of tolerable risk of error” is an important step forward. This is an idea with the potential to radically change the way EU funds are

managed and audited. The Court has been quick to react and will closely monitor developments.

The Court is well aware of the external developments and changing audit environment that imply, in particular, *the reinforcement of its international cooperation activities*, maxime with the SAIs of the European Union.

The financial, economical and social crisis, and other global challenges such as climate change, jobs and growth, sustainability, are putting pressure on public finances everywhere and crisis management measures have led to increasing State intervention in the economy which has had consequences for accountability and regulation and the role of public sector auditors. It is against this background that the Court hosted the annual Contact Committee meeting in December 2008, mainly focused on the reform of the EU budget and the revised 2008–2011 Lisbon Strategy. The following workshop held in 2009 on the role of the EU

SAIs in the context of the crisis resulted in a network being set up to promote cooperation on audits related to the Lisbon Strategy and EU crisis management measures.

In order to better meet its Treaty obligations and fulfil its mission, in a professional manner that stands comparison with other Supreme Audit Institutions around the world, the Court has recognised that it should adapt to a changing audit environment and reform itself. After the peer review process, it is ready to face new challenges in the forthcoming years, not only by doing more, but also by doing it better. At the same time, the Court will cooperate actively with fellow SAIs aiming to contribute to improve the management of EU public finances by sharing our experiences and developing common approaches. There is a unique momentum for them to contribute to building a network based on accountability, transparency and confidence.

NOTES

¹ Treaty establishing the European Community as amended by the Treaty of Nice (EC Treaty), OJ C 325 of 24.12.2002

² Regulation (CE, Euratom) No 1605/2002 of 25.6.2002. OJ L 248 of 16.9.2002

³ Article 6, no 1, and Article 49, of EC Treaty

⁴ Joint Declaration to the Treaty of Nice No 18 concerning the European Court of Auditors. OJ C 80 of 10.3.2001

⁵ Treaty of Lisbon signed in 13.12.2007. OJ C 306 of 17.12.2007

⁶ Council decision 2007/436/EC, Euratom of 7.6.2007 on the system of the European Communities' own resources. OJ L 163 of 23.6.2007

⁷ General Budget of the European Union for the financial year 2009. OJ L 69 of 13.3.2009

⁸ Article 5 of EC Treaty

⁹ Article 274 of EC Treaty

¹⁰ Article 276 of EC Treaty

¹¹ The EU Budget is Activity Based (ABB), which means that it presents information on what policies are pursued and, within them, what activities make up the policies and what financial and human resources are spent on each activity.

¹² Special Report 8/2008 available at ECA's website: <http://eca.europa.eu/portal/pls/portal/docs/1/2246310.pdf>

¹³ Special Report 7/2008 available at ECA's website: <http://eca.europa.eu/portal/pls/portal/docs/1/1555539.pdf>

¹⁴ Special Report 6/2008 available at ECA's website: <http://eca.europa.eu/portal/pls/portal/docs/1/1357526.pdf>

¹⁵ Annual Report of the Court of Auditors concerning the financial year 2007. OJ C 286 of 10.11.2008.

¹⁶ Article 248 of EC Treaty; Articles 143–144 of Financial Regulation

- ¹⁷ Report on 2007 Discharge – Section III Commission, adopted by the European Parliament's Plenary on 23.4.2009
- ¹⁸ Opinion 6/2007 on the Annual summaries of Member States, national declarations of Member States, and audit work on EU funds of national audit bodies. OJ C 216 of 14.9.2007
- ¹⁹ Annual Report of the Court of Auditors concerning the financial year 2006. OJ C 273 of 15.11.2007
- ²⁰ Opinion 2/2004 on the “Single audit” model (and a proposal for a Community internal control framework). OJ C 107 of 30.4.2004
- ²¹ Action Plan towards an Integrated Internal Control Framework. COM (2006) 9 final of 17.1.2006
- ²² Impact Report on the Commission's Action Plan towards an Integrated Internal Control Framework. COM (2009) 43 of 4.2.2009
- ²³ Commission's communication towards a common understanding of the concept of tolerable risk of error. COM (2008) 866 of 16.12.2008
- ²⁴ Reflections by the ECA on the Commission's communication “Towards a common understanding of the concept of tolerable risk of error” are available at its website: <http://eca.europa.eu/portal/pls/portal/docs/1/2410290.pdf>
- ²⁵ Response by the European Court of Auditors to the Commission's communication “Reforming the Budget, Changing Europe”, available at ECA's website: <http://eca.europa.eu/portal/pls/portal/docs/1/1481518.pdf>
- ²⁶ Commission's communication “Reforming the Budget, Changing Europe, a public consultation paper in view of the 2008/2009 budget review”. SEC (2007) 1188 final of 12.9.2007
- ²⁷ The contributions and the results of the Conference are available at: <http://ec.europa.eu/budget/reform>
- ²⁸ The last review of the Financial Regulation was made in December 2006, applicable with effect from 1.5.2007: Council Regulation (EC; Euratom) 1995/2006 OJ L 390 of 30.12.2006. Article 279 of EC Treaty and Article 184 of Financial Regulation provide for the review of the Financial Regulation every 3 years.
- ²⁹ Article 248 of EC Treaty
- ³⁰ Opinion 6/2007, points XIV to XVII
- ³¹ Available at ECA's website: <http://eca.europa.eu/portal/pls/portal/docs/1/1843517.pdf>

Péter Paczolay

The position of the State Audit Office in the branches of power

During the twenty years of the State Audit Office's (SAO) existence, a number of studies have been drawn up to position it, based on its activity, in the system of organisations that exercise public power. Still, in the light of decisions passed by the Constitutional Court in the past few years, it is worth examining the relation of the SAO to each of the branches of power as defined in the Constitution, as well as the role of its reports based on its auditing activity.

The initial question was actually raised in full depth only in the most recent Decision passed by the *Constitutional Court*¹, No. 42/2008. (IV. 17.), which also affected the State Audit Office. The background is that, in 2005 and 2006, the SAO carried out audits concerning financial aids used by local governments for investments in public utility development works, and summarised the findings in two reports. Both reports examined regularity of applying subsidies provided from public finances in relation to local public utility development works, and explored the utilisation of multiple different subsidies in respect of one another, and their respective impacts. The reports revealed the liability of the local governments using the investment system called “ÖKOTÁM 2000” and similar financing solutions in terms of unlawfully reclaimed subsidies for public utility development. The SAO duly

left the legal method of such revocation and settlement to be devised by the government and its members; however, in its other recommendations, it initiated issuance of or amendment to the relevant decree, and even amendment of to the law – identifying the use of a specific legal instrument. Based on the contents of the SAO's report, the National Assembly ordered in the Act on final accounts that the deficit generated in such way be repaid by the local governments, and granted authorisation for the payment obligation to be regulated in decrees.

The abovementioned decision, however, annulled the relevant provision of the Act on Final Accounts and the decrees, with reference to the fact that the obligation imposed on local governments to repay the development subsidies pursuant to the SAO's findings was laid down by the National Assembly in a normative form, which deprived the local governments of judicial legal defence. The Constitutional Court pointed out that their decision did not address whether the ÖKOTÁM system was legal, or whether the SAO's reports were substantiated, but whether the established repayment method was constitutional.

Beyond the specific examination of the potential consequences of unlawful utilisation of subsidies granted to local governments in

terms of constitutional law, however, the decision also had other implications; the case indirectly raised the issue of how to use the SAO's reports in the right or in the wrong way, and, through that, the general relationship in terms of constitutional law between the SAO and the branches of power. The Constitutional Court was held back by its limitations of competence from seeking comprehensive answers to these theoretical questions in the decision, but the twentieth anniversary is a good opportunity for further consideration of these questions.

HISTORICAL PRELIMINARIES OF THE SAO

“The past of state audit offices is rooted in the institutions that have been established in the various states since as early as the 11th century in order to audit asset management and to provide accountancy services”². According to a book written by the Head of Council of the Hungarian Royal Supreme Audit Institution³, university professor *Ferenc Teghze-Gerber*, the *Exchequer* in England was in place as early as in the 11th century, and its scope of authority included examination of accounts and recalling of accountants. The accountants (including, in particular, county sheriffs) were required to attend the meetings of the *Exchequer*, and were sworn prior to reporting; which is a most ancient act of administrative jurisdiction in the functioning of these offices. In England, revenue has been managed by a separate audit office since 1314. In France, records have mentioned accountants (*magistri computorium*) since 1256, but an accounting chamber is only referenced in 1304. Established in Belgium in 1386, the *Ratskammer* did not only function as a court but also as an audit office. Similar institutions are also found in the history of other states, under similar names: *Court of*

Exchequer, *Cour des comptes*, *Camera computorium*, *Ratskammer*, *Rechenkammer*, *Hofkammer*, *Rechnungshof* – these can be designated in the most general sense as audit chambers or audit offices. The function of these chambers was not only to audit accounts but also to administer legal actions of accounting against accountants; consequently, their organisations also resemble those of courts; being collegial organisations passing judgements on accountants at council meetings, exempting or condemning them. With the development of public finances, however, the first-instance examination and the review of accounts have been split in most states, and the function of audit chambers consists only of reviewing accounts and passing judgements on accountants. Their independence of executive organs is was ensured by their direct subordination to the monarch. Although a constitutional central budget laid down by legislation was missing, and no connection existed between audits by the audit office and the feudal national assembly, *the scopes of authority of audit offices to perform audits in today's sense evolved by the end of the 18th century*.

The first printed budget was published in 1781 in France under finance minister *Necker*, which was followed in 1789 by the first complete and constitutional budget.

A fundamental document of the French revolution, the Declaration of the Rights of Man and of the Citizen, adopted by the National Constituent Assembly as the first step towards producing a constitution on 26 August 1789, declared:

“XIII. A common contribution is essential for the maintenance of the public forces and for the cost of administration. This should be equitably distributed among all the citizens in proportion to their means.

XIV. All the citizens have a right to decide, either personally or by their representatives, as to the necessity of the public contribution; to

grant this freely; to know to what uses it is put; and to fix the proportion, the mode of assessment and of collection and the duration of the taxes.

XV. Society has the right to require of every public agent an account of his administration.

XVI. A society in which the observance of the law is not assured, nor the separation of powers defined, has no constitution at all.”⁴

The 19th century began a new era in auditing, when constitutional transformation in each state lead to recognition of their respective national assembly's budgeting right. As a consequence of this, legislative bodies extended their scopes of audit to the entire financial management of the government. It was obvious to transfer the function of auditing the budget to a relevant institution – the audit offices established in the absolute states, which were most suited to the task – instead of establishing new ones. The new audit offices typically retained the scope of authority of the old audit chambers, together with the names, generally in most cases.

In Hungary, state accountancy and the official organisation dedicated to it was historically based on a decree issued by supreme resolution on 21 November 1866⁵. This decree is materially supplemented by Article XVIII of 1870 “on the establishment and scope of authority of state audit offices”⁶ and Act LXVI of 1880 “on the state audit office's internal organisation, administration and scope of authority to audit state debts”⁷, which were used on organising the state audit office. The function of the SAO was to audit the state's entire accountancy, with a scope of authority independent of the ministry of finance. It was headed by a president, aided by vice presidents and audit advisors, department advisors, secretaries, auditors, as well as auxiliary and administrative staff in the necessary numbers. The president was commissioned by the king for life service, initiated by the House of

Representatives, chosen from three individuals nominated by the National Assembly, as proposed by the Prime Minister. The vice president, the audit office advisors, the departmental advisors and secretaries were commissioned by the king, proposed by the president and countersigned by the prime minister. The president's rank and salary equalled those of the minister. In the event of his unlawful action or default, the House of Representatives declared indictment of the president, and the court authorised to act in cases of indicting ministers passed judgement, pursuant to Article III of 1848.

The institution was discontinued in 1949. Instead of the National Assembly, the control and organisation of state audit was transferred to the government's scope of competence for roughly 40 years (State Audit Centre, Ministry for State Audit, Central People's Control Committee).⁸ An amendment to the constitution made on 23 October 1989 re-established the State Audit Office as a key element of the democratic system of institutions, with legal status, duties, scope of competence and organisation regulated in detail by Act XXXVIII of 1989; the general licence to audit laid down in the SAO Act is detailed in another approximately 30 acts. The National Assembly elected *István Hagelmayer*⁹ as the first president of the SAO on 31 October 1989, who remained in office until 1 July 1996; since 9 December 1997, the organisation has been headed by *Árpád Kovács*.¹⁰

On assessing the position of the Hungarian SAO in the system of powers in Hungary, and even more on evaluating the consequences of SAO reports, it must be taken into account that the Hungarian solution does not follow the judicial court type (*Cour des comptes, Corte dei Conti*) structure in terms of organisation and competence, but is more like the German model, similarly unauthorised to administer legal actions of accounting.

BRANCHES OF POWER AND THE SAO

If we accept that the theories of the classic model of power distribution as drawn up by Montesquieu can also be applied to the structure of today's establishment, the SAO is to be positioned with the legislative branch of power¹¹ – considering that it is the financial and economic auditory body of the National Assembly. It is important to emphasize this theoretical issue because positioning a constitutional institution in terms of powers influences the nature and competences of the respective institution.

It was reinforced by *Decision 3/2004. (II. 17.) of the Constitutional Court*, which stated that the SAO was an organ subordinated to the National Assembly. “Subordination” certainly does not imply that the SAO would not be an independent constitutional organisation;¹² the possessive form referred to in Paragraph (1) of Article 32/C of the Constitution (*an organ of the National Assembly*) only denotes that the SAO performs its duties for the National Assembly, as instructed by it, independently from the executive power.

The decision discussed whether the Prosecutor General could be interpellated, but it also examined the issue of responsibility of public dignitaries elected by the National Assembly, in a broader context. In the Constitutional Court's opinion, the fact alone that the National Assembly elects someone in a political dignitary position does not automatically mean that the person fulfilling a public office is politically accountable to the National Assembly in the sense defined in constitutional law. The Constitutional Court distinguished the following groups.

Certain politically exposed persons and heads of organisations – although elected by the National Assembly – do not even have an obligation to report to the National Assembly (such as the President of the Republic, or the

President of the Supreme Court). Others (such as the President of the National Radio and Television Commission) are required to report on the activity of the organisation they manage on an annual basis, and acceptance of such reports is decided by the National Assembly, however, non-acceptance has no consequences. The third group consists of managers with a reporting obligation to the National Assembly, and to whom the Members of Parliament are authorised to pose questions (such as the Parliamentary Commissioner for Civil Rights). The Chief Prosecutor belongs to a fourth group on the grounds that he has a reporting obligation, and can be questioned and interpellated; however, he bears no political liability to the National Assembly in terms of constitutional law. Finally, the fifth group comprises the Government and its members, who are required to report to the National Assembly on a regular basis, can be questioned and interpellated; moreover, in the event political confidence declines, there is a facility – with the use of an independent constitutional institution, a motion of no confidence – to revoke the mandates of the Prime Minister (and the whole government).

An obligation to report to the National Assembly alone does not mean a restriction concerning the independence of the obligor and, accordingly, the organisation headed by them (such as the Prosecutor General and the Prosecutor General's Office). The reporting obligation is only a means of general audit and of gathering information about the activity of the particular organisation. Such a reporting obligation is required in the Constitution for the Parliamentary Commissioner [*Paragraph (6) of Article 32/B*], the Governor of the Central Bank of Hungary [*Paragraph (3) of Article 32/D*] and certainly the Government and its members [*Paragraphs (1) and (2) of Article 39*]. In addition, a number of acts lay down obligations to report to the National

Assembly or any of its committees; along these lines, the President of the National Radio and Television Committee, the President of the Hungarian News Agency, the Director General of the Hungarian Atomic Energy Authority and the President of the Hungarian Competition Authority are required to report to the National Assembly on an annual basis.

“A similar obligation is imposed by Paragraph (2) of Article 32/C of the Constitution on the State Audit Office: it is required to inform the National Assembly in writing of the audits it has performed, submission of which is ensured by the President of the State Audit Office. Although the State Audit Office is an organ subordinated to the National Assembly, and may be instructed to perform specific audits, it is only subject to the law on carrying out such audits, and cannot be instructed to pass or modify specified decisions.”¹³

The SAO itself does not exercise executive power; it does not apply general rules of conduct (laws) to everyday life as an authority does, nor is directly responsible for enforcing provisions of law, as is characteristic of the executive power. The SAO's measures – with few exceptions – are indirect in nature, it typically reports to the National Assembly, or initiates proceedings to be performed by other organs. *It follows not only from the Act on the SAO, nor from Article 32/C of the Constitution, but from the structure of the establishment as laid down in the Constitution.* It would be incompatible with a licence of the SAO to assign a licence to the SAO for imposing fines or other scopes of authority executive in nature.¹⁴ It is similarly not permitted by the SAO's constitutional status to act as an authority in order to enforce proper financial management of budgetary funds. All these would entail breaching the constitutional principle of the distribution of power.¹⁵

Pursuant to the Constitution, auditing is the fundamental duty of the SAO; instead of resolu-

tion, it entails exploration of adverse situations emerged. This function, however, is comprehensive: the SAO “[is authorised to examine] utilisation of public funds and operation of public property in terms of the whole public finances and all actions of the executive power in its entirety, independently of the latter”.¹⁶

In this context, it is worth examining the provisions of *Decision 766/B/2004 of the Constitutional Court*¹⁷ on the interpretation of the rule stipulated in the Constitution concerning the SAO, and concerning pre-audits and post-audits.

Prior to explaining the arising constitutional issue, the standpoint of the International Organisation of Supreme Audit Institutions (INTOSAI) concerning the abovementioned duties of audit institutions must be discussed. INTOSAI comprises the audit offices of states that are also members of the United Nations or any of its Specialised Agencies. INTOSAI was founded in 1953 in Havana, and since then the number of member institutions have risen from the original 34 to over 180. The chief duty of the organisation is to develop and control cooperation among audit institutions. These institutions have a major role in auditing the accounts and operations of governments, and facilitate their reliable financial control and accountability. In 1977, INTOSAI adopted the Lima Declaration¹⁸ of audit principles, which is considered as the Magna Charta of government auditing.¹⁹

Section 2 of the Declaration addresses pre-audit and post-audit issues. Pre-audit represents a before the fact type of review of administrative or financial activities; post-audit is audit after the fact. Subsections 2, 3 and 4 of Section 2 state: “Effective pre-audit is indispensable for the sound management of public funds entrusted to the state. It may be carried out by a Supreme Audit Institution or by other audit institutions. Pre-audit by a Supreme Audit Institution has the advantage of being

able to prevent damage before it occurs, but has the disadvantage of creating an excessive amount of work and of blurring responsibilities under public law. Post-audit by a Supreme Audit Institution highlights the responsibility of those accountable; it may lead to compensation for the damage caused and may prevent breaches from recurring. The legal situation and the conditions and requirements of each country determine whether a Supreme Audit Institution carries out pre-audit. Post-audit is an indispensable task of every Supreme Audit Institution regardless of whether or not it also carries out pre-audits”.²⁰

In Decision 766/B/2004 of the Constitutional Court²¹, a question was raised concerning the statutory duties of the SAO pursuant to the effective provisions of the Constitution, without any amendment to the Constitution. The specific question was whether, pursuant to Paragraph (1) of Article 32/C of the Constitution, pre-audits belong to the SAO's scope of duties and competence irrevocable by law. Paragraph (1) of Article 32/C of the Constitution lays down that the SAO “oversees in advance the legality of the utilisation of central budgetary funds”.

The Act on the SAO originally stated that “[the SAO] audits the financial management of public finances, including substantiation of the central budget proposal (supplementary budget proposal, possibility of compliance with the revenue appropriations, legality, necessity and expediency of utilisation, borrowings of the central budget, their utilisation and repayment. *The [SAO] ascertains that none of the items of spending in the central budget are exceeded or transferred without authorisation from the National Assembly.*

It audits the final accounts produced on execution of the central budget” [Paragraph (1) of Article 2 – *my italics*].

As of 27 June 2004, however, this list was modified: it is no longer a statutory duty of the State Audit Office to ascertain that “none of

the items of spending in the central budget are exceeded or transferred without authorisation from the National Assembly”. According to a motion submitted, with this modification, which restricts the statutory duties of the SAO, the act has been made contrary to the Constitution, although the prevailing standpoint in the field considers pre-audits to be a duty of the fiscal governance.

The majority decision followed an interpretation of Paragraph (1) of Article 32/C of the Constitution that stated that the National Assembly held a broad freedom of decision concerning the SAO's regulation in terms of the specific scopes of duty and competence transferred to the audit office for complying with its financial and economic auditing tasks, with respect to the latter's constitutional legal status.

According to the Constitutional Court, the National Assembly is bound by the requirement concerning pre-audits of the utilisation of the central budget laid down in Paragraph (1) of Article 32/C of the Constitution to an extent that forces it to regulate the SAO's scope of authority in a way that it is able to comply with this constitutional duty within its scope of authority.

The decision points out that no constitutional requirement derives from the legal state clause to stipulate that all the duties of a constitutional organ as laid down in the Constitution must be repeated in an act regulating the legal status, scopes of duties and competence thereof.

This standpoint explained in the decision is built on a restrictive and limiting interpretation of the Constitution; the use of an expansive and broader, more “activist” method of interpretation would have yielded a different result.

The majority decision states that it cannot be considered as unconstitutional if a regulation does not assign distinct scopes of authority identified as expedient for compliance with the

duties defined in the Constitution for any of the duties specified for the State Audit Office in the Constitution, but it defines the SAO's scope of authority in a way that, on exercising it, the SAO can, directly pursuant to the Constitution, comply with its function regulated in Paragraph (1) of Article 32/C of the Constitution.

The reason set forth in the decision argues that the provisions of law invariably refer legality audits of the budget proposal, the final accounts and the chapters within the structure of the central budget, financial management of social security funds and separated funds to the competence of the State Audit Office; on such audits, a legality audit includes examining whether in their financial management the audited organs have complied with the budget appropriations laid down in the central budget, and ascertaining that the budget appropriations are not exceeded or transferred without the National Assembly's authorisation. In the opinion of the Constitutional Court, nullification of the provision of the SAO Act referenced by the abovementioned motion has not left the State Audit Office devoid of means in terms of auditing the legality of utilisation of the budget appropriations laid down by the National Assembly in the Budget Act and complying with its duties defined in Paragraph (1) of Article 32/C of the Constitution. The reason admits at the same time that the Act does not *expressis verbis* require the SAO to use its *ex ante* audit licences on auditing the utilisation of budget appropriations; however, the Act on the SAO and other acts specify further broad scopes of competence for the SAO, exercising which the SAO performs its functions specified in Paragraph (1) of Article 32/C of the Constitution.

The final conclusion of the decision is as follows: “The provision of the Constitution concerning *ex-ante* legality auditing of the utilisation of the central budget – with respect to the

fact that the utilisation of the central budget is a process implemented through numerous specific financial decisions of numerous state-operated organs – cannot be considered as a rule applicable to the scope of competence, and does not give rise to an obligation either for the audit office to set up an '*ex ante*' audit system, or for the act regulating the audit office's scope of competence to define an identified scope of competence that entails *ex-ante* legality auditing of decisions concerning utilisation of the central budget.”²²

A dissenting opinion²³ enclosed to the decision states that the interpretation of the Constitution is not an appropriate means of settling disputes²⁴ concerning justification of *ex-ante* audits; the majority decision also accepts that the Constitution contains some kind of pre-audit (*ex ante* or *a priori* audit) concerning the legality of utilisation of the central budget (at least in the form of a task); at the same time, it is indisputable that neither the legal regulation of the public finances, nor the Act on the SAO recognise such scope of competence for the audit office – not even such scope of duty. The dissenting opinion disagrees with the conclusion drawn by the majority, stating that the wording the SAO “oversees in advance” set forth in Paragraph (1) of Article 32/C of the Constitution is a norm applicable to the duty and not to the competence; consequently, it is the legislator that decides the norms concerning competence to be assigned for implementing the task. According to the dissenting opinion, it would have justified *ex-officio* establishment of omission.

The other dissenting opinion²⁵ points out that on amending the Act on the SAO – as a consequence of Parliamentary Resolution 35/2003. (IV. 9.) – “outdated, non-performable provisions were removed”. Compared to the system envisaged in 1989, designated in the Constitution, and regulated accordingly in detail in the following few years, Act XXXVIII of

1992 on public finances, as well as Act CV of 1995 on amending certain associated provisions of law induced changes. Unlike the previous ones, this new system also re-formulated the role of the SAO differently from the earlier ones. As a result of increased transferring and auditing activities of the government, the rules related to pre-audit by the SAO were not retained: – Pursuant to Article 39 of the Public Finances Act, the State Audit Office was required to be informed of the government's transfer decisions performed within a small circle within 8 days, and this notification obligation was removed by the amendment of 1995; the reason set forth in the amending bill stated that “public disclosure of modifications to the appropriations implemented within the Government's scope of competence also entails notification of the SAO.” – Pursuant to Paragraph (1) of Article 42 of the Public Finances Act, the Government was required to notify the SAO of a decision passed on assuming guarantee; as opposed to that, the amended Paragraph (1) of Article 42 of the Public Finances Act states that the Government passes a public resolution on individual guarantees assumed on account of the central budget, and pursuant to the new Paragraph (3), the guarantee contracts are signed by the Minister of Finance, and sent to the State Audit Office on a monthly basis. No countersignature by the President of the SAO is referenced here. Moreover, the reason given by the minister in the bill identified “a treasury to be set up in order to perform financial tasks related to the functioning of public finances in a centralised way” as a fundamental cause of amending the Public Finances Act. According to Paragraph (1) of the new Article 18/A of the Public Finances Act, the Hungarian State Treasury financially administers execution of the budgets of public finance subsystems and Paragraph (1) of the new Article 18/B assigned audit functions to the State Treasury. After 1995, the

Public Finances Act was repeatedly amended, but the abovementioned provisions were not changed in essence.

This legislative objective set forth in the parliamentary resolution referred – among others – to a portion of the SAO's tasks listed in Paragraph (1) of Article 32/C of the Constitution. Without amendments to the Constitution, the duties and scope of competence defined in the Constitution for the SAO, which functions as the financial and economic auditing organ of the National Assembly, cannot be reduced by law. On creating an amendment to the law, Article 32/C of the Constitution was not amended. According to the dissenting opinion, as a consequence of the amendment only performed at the level of the law, the rule attacked by the motion is partly contrary to Paragraph (1) of Article 32/C of the Constitution.

However, the issue of ex ante audit examined in the resolution can also be analysed in the context whether it shakes the SAO out of its role as a helper of the legislative power, and whether it pushes it towards the executive power.

CONCLUSION: THE ROLE OF THE SAO'S REPORTING

Designation of the SAO's constitutional position provides help with exploring the nature of its reports in terms of constitutional law.

This question was addressed in detail by Decision 1251/E/1995 of the Constitutional Court²⁶, where the initiating local government raised an objection stating that it does not have a legal remedy that complies with Paragraph (5) of Article 57 of the Constitution against the SAO's report – which was adverse to them. In its decision, the Constitutional Court also focused on the constitutional position of the SAO. It was an argument of the Constitutional

Court that the SAO does not act as an authority, and, as a general rule, does not pass a decision that is mandatory for the audited organisation, in terms of neither contents, nor format. From this starting point did the decision arrive at the pivotal standpoint that *in terms of the fundamental right to legal remedy, the SAO's report is not an authority act containing a decision, but it is an opinion*. And, certainly, if the report is only an “opinion formulated on the financial management of the audited organisation”, in that case, no material legal remedy is necessary to be provided against it.

There are two recipients of this opinion. The National Assembly, on the one hand, as the legislative power, intended to “utilise” the report. On the other hand, however, the public is also a recipient, as pursuant to Paragraph (1) of Article 18 of the SAO Act, the SAO's reports must be disclosed to the public. This rule validates the right of access to data of public interest; subjects can access the data on financial management of public funds – with little restriction.

Discussing the ÖKOTÁM case, an answer can be found to the question concerning the purpose of the SAO' report addressed to the National Assembly. The case may lead to the conclusion that notification of the National Assembly about the audit result facilitates legal and political accountability, instead of legislation, directly. The National Assembly – as seen in the ÖKOTÁM case – cannot automatically incorporate the result of the SAO's report in law, because it would infringe constitutional rights of the audited organisation. It is a different question that an indirect result of the findings presented in the SAO's report may be an amendment to the law, if that serves the purpose of excluding future occurrences of abuse.

The ÖKOTÁM case pointed out that the *system of legal steps resulting from the audit*

office's reports is unclear. In systems built on legal actions concerning accounting, exercising the judicial function puts an end to the case through the statutory decision. In the Hungarian solution, it is courts of record that need to draw the conclusions, in addition to sanctioning and eliminating the situation criticised by the SAO. A possible and most evident way of doing so is through a legal action initiated by the State Treasury. Although consequences of legislation cannot and should not be excluded with absolute validity, the government's response to the ÖKOTÁM case was law-making. What is more, not only at the level of law-making (the Final Accounts Act listed indebted local governments), but also through government decrees. According to our standpoint, the appropriate government response would have been an individual government measure, instead of normative law-making.

In parliamentary states, however, it is also a duty of the legislative power to exercise control over the executive power. The SAO is an organ of control; the audit office's report helps the National Assembly's role of a controller against the government.²⁷

This is because the government is accountable for the financial management of the budget, which is a kind of “financial liability”, denoting responsibility for the state's financial activity in line with the principles of legality, economy and expediency.²⁸ Accountability and its means are defined by the National Assembly – on a parliamentary basis. The SAO's responsibility is limited to revealing anomalies in its reports and reporting on these to the National Assembly, thus providing it with adequate ammunition for financially auditing the government.

The rest does not depend on the State Audit Office...

NOTES

- ¹ Decisions of the Constitutional Court (hereinafter referred to as ABH) 2008, 417.
- ² Ferenc Teghze-Gerber: *State Accountancy*, vol. I, General Accountancy, Second revised and extended issue, Budapest, 1941, p. 34
- ³ The name of the State Audit Office established in 1870 under the leadership of Salamon Gajzágó was changed in 1914 (Act IV of 1914) to Hungarian Royal Supreme State Audit Office. http://hu.wikipedia.org/wiki/Állami_Számvevőszék
- ⁴ <http://mek.oszk.hu/00000/00056/html/228.htm>, Hungarian translation by Sándor Mika
- ⁵ In civil states, distinction must be made between royal decrees issued with ministerial countersignature and ministerial decrees issued at the king's resolution.
- ⁶ <http://www.1000ev.hu/index.php?a=3¶m=5424>
- ⁷ <http://www.1000ev.hu/index.php?a=3¶m=5957>
- ⁸ <http://www.magyarorszag.hu/kozigazgatas/intezmenyek/egyszerv/allszam>
- ⁹ Parliamentary Resolution 28/1989. (XI. 10.)
- ¹⁰ Parliamentary Resolution 111/1997. (XII. 10.)
- ¹¹ Representing the SAO as an independent branch of power is not unheard of in the legal literature. (László Nyikos: Conceptual issues of audits performed by the audit office, *Public Finance Quarterly* 1994, Issue No. 3, pp. 159 and on.) However, I agree with András Holló that defining the SAO as an independent branch of power is disputable not only in respect of the Hungarian constitutional structure but also in general (see András Holló: A few remarks on the constitutional position of the SAO, *Public Finance Quarterly*, 1994, Issue No. 6, p. 474.).
- ¹² In this respect, I share the critical observations made by Attila Vincze. Attila Vincze: *the State Audit Office*, In: András Jakab (editor): *Commentaries to the Constitution*, Századvég, Budapest, 2009. (being published) [27]
- ¹³ Decision of the Constitutional Court 3/2004. (II. 17.), ABH 2004, 48, 56.
- ¹⁴ With a different approach, Holló arrives at the same conclusion, i. m.
- ¹⁵ In more detail, see the parallel explanation given by judge of the Constitutional Court Péter Schmidt to Decision 1251/E/1995 of the Constitutional Court
- ¹⁶ Árpád Kovács: *Fifteen years in the life of the State Audit Office*, *Magyar Közigazgatás*, 2004/Issue No. 10, p. 610
- ¹⁷ ABH 2006, 1631.
- ¹⁸ [http://www.asz.hu/ASZ/modszert.nsf/0/966A55C26B060B85C1257322003EB2D3/\\$File/issai_1.pdf](http://www.asz.hu/ASZ/modszert.nsf/0/966A55C26B060B85C1257322003EB2D3/$File/issai_1.pdf)
- ¹⁹ Hungary has been a member of the International Organisation of Supreme Audit Institutions (INTOSAI) since 1968. In recognition of the active participation in the international organisation, the State Audit Office of Hungary was invited to organise the XVIII INCOSAI meeting of the organisation in 2004; concurrently, SAO President Dr Árpád Kovács took over the chair of the Governing Board (2004-2007). <http://www.asz.hu/ASZ/www.nsf/intosai.html>
- ²⁰ Hungarian translation by Irén Malatinszkyne Lovas and Zoltán Giday
- ²¹ ABH 2006, 1631.
- ²² ABH 2006, 1631, 1634.
- ²³ A dissenting opinion of András Bragyova, shared by Mihály Bihari.
- ²⁴ The motion was submitted by an expert working on specific questions of financial audits.
- ²⁵ Attila Harmathy's dissenting opinion, shared by Elemér Balogh and Árpád Erdei.
- ²⁶ ABH 1996, 572.
- ²⁷ Árpád Kovács quotes a conference presentation by Franz Fiedler in November 2001 in Limassol. Kovács, i.m. p. 610
- ²⁸ Schambeck, Herbert: *Government and Parliament, Thoughts about parliamentary auditing in the wake of Austria's example*, *Magyar Közigazgatás*, Issue No. 11/1994, p. 649

Péter Galbács*

Estimation of the structural balance based on the OECD approach

Theoretical considerations and empirical experiences

Correlations between the performance of the real economy and the budget position of the general government have been a key area of methodological research for decades. The related concepts focus on the recognition that the same budget may equally result in a surplus or a deficit depending on what happens on the national income side (Mackenzie, 1983). “All” we need to do in order to identify the underlying processes behind the budgetary position is to “remove” the impact of cyclical changes in the real economy. An improvement of the fiscal position can be a reflection of improvement in the real economy while a turnaround in fiscal developments is to be counted on once macroeconomic conditions deteriorate. Under these circumstances, fiscal policy cannot be claimed to be on the right track even if the related indicators suggest an improvement. No wonder that in the context of Hungary's convergence program, both the Ministry of Finance and the European Commission focus on assessing Hungary's budget from this viewpoint. The

Research and Development Institute of the State Audit Office of Hungary (SAO RDI, hereinafter RDI) issued an evaluating study both in 2007 and 2008, highlighting to the National Assembly of Hungary the risks associated with the macroeconomic viability of the budget bill. The 2008 macroeconomic study of the RDI already contained calculations on the trends of the structural balance (RDI 2008). Although the budgeting process for 2009 took place under extraordinary circumstances which forced both the Ministry of Finance and the State Audit Office to depart from their usual work procedure (for further details refer to Báger – Pula, 2008b), this third macroeconomic study of the RDI made a cautious attempt to forecast the structural balance for 2009 based on the budget bill figures.

Here we review the arguments supporting the estimation of the cyclically adjusted budget balance first. Then we move on to discuss the method recommended by the OECD for the quantification of the structural deficit and the related results. We will not strive for either presenting the methodology in full or highlighting the potential errors therein. Both of these are discussed extensively in technical literature. What we go for is to apply the method as consistently and possible and to present the results generated this way.

* The author wishes to express his gratitude to Gusztáv Báger (SAO RDI) and András Vígári (SAO RDI) for their critical remarks on the former versions of this study. Special thanks to Gábor Pula (ECB) for his indispensable guidance on the estimation of the domestic capital stock. Any potential errors herein are the sole responsibility of the author.

CYCLICAL ADJUSTMENT AND POTENTIAL GDP

It already became clear to economists from the mid 1940's that the traditional interpretation of deficit (i.e. the balance of general government revenues and expenditures or that of a subsection of these broad categories) is not suitable for describing the budget position adequately. A part of the criticisms related to the fact that the growth (change) of the deficit may stem from multiple sources; this way, the macroeconomic impact of a specific deficit figure can vary significantly depending on whether the source of the deficit growth is the drop of revenues or the rise of government expenditures. However, the attempts to define and calculate balance indicators which eliminate the effect of economic cycles were built on another experience. As several elements of government revenues (and some expenditure items) are sensitive to the performance of the real economy, the view that any budget deficit is actually identical to the required fiscal corrections may become overly simplifying (Tanzi, 1993). In other words: *the same budget act may lead to diverse balances depending on the actual trend of the real economy – deceleration or boom*. As someone put it quite descriptively, we cannot really set the level of tax revenues in the budgetary planning process. We can only specify the set of tax laws – revenues will depend somehow on national income (or e.g. consumption expenditures) (Solomon, 1964), thus tax policy is only partially decisive. Therefore, if we wish to judge the extent of the deficit, it is indispensable to ensure that the balance indicator we examine reflects solely the position of the budget and that the big picture is not distorted by factors which do impact the budget position but the changes of which the financial government cannot be held liable for. This way, the cyclical adjustment of the general government balance enables a clear view [even if the cycli-

cally adjusted deficit only provides an adequate answer to a limited range of questions about the functioning of the general government (Blanchard, 1990). Probably the most suitable use of the cyclical balance is for finding an answer to the initial question which generated this approach in the first place: what would be the balance of the central budget like if the real economy were in equilibrium?], since prosperity may suggest that the improvement of the general government balance is a result of fiscal policy accomplishments albeit it stems purely from cyclical sources while these processes may turn into an opposite direction once the real economy slips onto a downward curve. As a result of this approach, in some cases the cyclically adjusted balance becomes the an indicator of the sustainability of the budget. *If we clean the budget balance from the cyclical effects, we reveal the fiscal rearrangements which can be considered the results of discretionary political steps*¹ (P. Kiss – Vadas, 2005). While in the period after 1962, this recognition drew special attention to the concept of *full-employment budget surplus*, today we talk about a *structural deficit*² (cyclically adjusted general government deficit). The former concept refers to the budget balance that would take shape under the tax regime in effect if the economy were in the state of full employment – later we will see that the notion of structural deficit quantified in accordance with OECD recommendations is very close to this former term (in our opinion, this approximation of terms occurs in each case when the structural balance is defined on the basis of a production function that starts out from a labour market equilibrium).³ Thus if we reject the simplifying view, a (partially theoretical, partially methodological) problem crops up immediately. It is about the development of the right balance category that excludes the effect of real economy fluctuations. It is sufficient to refer briefly to the fact that while focusing on the diverse effects of deficit-gener-

ating fiscal policy steps and the concept of a structural balance originate in different approaches regarding financial management by the general government, these issues are not independent of each other. In order to gain a comprehensive view, both (what is more, as many as possible) aggregate indicators must be examined. Regarding the impact on aggregate demand, even numerically equal structural balances reflect some differences, since changes of the traditional and thus structural deficit may be fuelled by different shifts in revenues and expenditures.

A diverse set of methodologies are applied to the quantification of the structural balance and there is no consensus regarding the most adequate approach. The task is always a twofold one: the first step is to assess the cyclical position of the national economy concerned and then the resulting data must be used as a basis for quantifying the deficit. The two phases are linked by information that describes the sensitivity of specific government revenues and expenditures to the performance of the real economy. The approaches differ in the method used for measuring the cycle (Donders – Kollau, 2002), but the measuring of the cyclical impact on general government revenues and expenditures (and the assumptions in this respect) are more significant. The most widely used indicator to describe the cyclical position is the output gap. Thus the description of the cyclical position is equal to the task of defining the potential GDP. For long, the potential GDP trend was identified with the trend described by GDP time series. Consequently, the use of the HP filter or other trend estimation methods proved to be sufficient for generating the necessary time series; accordingly, GDP-smoothing was the suggested method in EU and OECD recommendations over a long time (P. Kiss, 1998, page 51). However, it is an undeniable drawback of these methods that all of them are purely mechanical thus the underlying infor-

mation specific to the national economy under review has no role in the analysis at all.⁴ At the same time, it is also true that estimates which rely on the production function unavoidably approximate the concept of full-employment budget deficit.

Thus the method preferred by the OECD (and the European Union) since the mid-1990's quantifies the potential output based on a Cobb-Douglas production function⁵ which uses substantially more data. Consequently, expert estimates and judgements on specific national economies play an incomparably bigger role in this approach than before. The main advantage of the production function-based approach is not that it yields more reliable results than the trend filtering approach; the real step forward is the lavish amount of information used. In this approach, the potential output of the real economy will equal a GDP level where the utilisation of capacities and labour is in equilibrium. At that point, the relatedness to full-employment budget balance may become clear, since the equilibrium utilisation of labour can be approximated with operational terms like the natural or equilibrium rate of unemployment⁶. This way, the result will rely on a more solid foundation although it will be more disputable, too. The alternative estimates that are based on different assumptions must become part of discussions on economic policy and methodologies.

BRIEF DESCRIPTION OF METHODOLOGY AND SUPPLEMENTARY RESULTS

The methodology applied by the OECD is presented in *Giorno et al.* (1995), using the accomplishments of *Torres et al.* (1989) and *Torres – Martin* (1990). According to the recommendations, the coefficients (α and $1-\alpha$) of capital and labour inputs in the private sector must be estimated with the standard two-

factor Cobb–Douglas production function and the same applies to factor productivity which appears as a residual variable. Error member values generated in the first regression and smoothed with a HP filter produce factor productivity (e^*) which contribute to the generation of the potential GDP line of the non-governmental sector at the actual level of applied capital (k) and potential (equilibrium) labour (n^*)

$$y^* = \alpha + \alpha^* + (1 - \alpha)k + e^*, \quad (1)$$

(trend smoothing remains an element of the toolset although its role is reduced to the subsequent correction of econometric estimates). The potential output of the entire national economy must be completed with the real income generated by the government sector. According to the recommended methodology, the labour input (n^*) of the private sector can be calculated as follows:

$$N^* = LFS(1 - NAWRU_{HPTREND}) - EG \quad (2)$$

Where

LFS is the smoothed number of people who are active in economic terms (working age

population multiplied by activity rate data smoothed by the HP filter),

$NAWRU$ is the unemployment rate that does not inflate wages, and

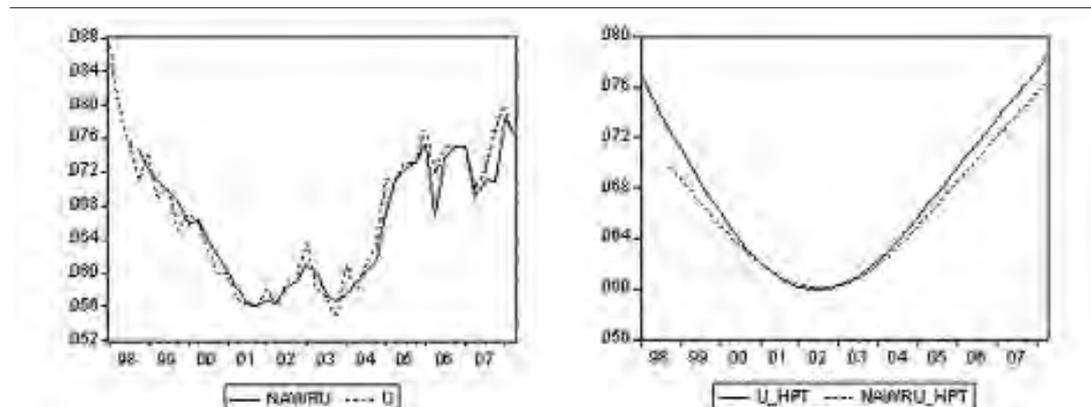
EG is the number of people employed in the government sector.

The estimation of $NAWRU$ -based production functions can be considered general (see e.g. Slevin, 2001 with further examples), but the equilibrium unemployment is sometimes taken as identical to the HP trend of unemployment rate [the quarterly forecast model of the Magyar Nemzeti Bank belongs to this category of methodologies (Jakab et al., 2004, page 4). Without ranking the approaches,⁷ we must point out that the two methodologies (naturally) do not lead to equivalent time series – at least the estimates generated upon the quantification of the structural balance suggest so. (See Chart 1)

The unemployment rate at equilibrium employment is apparently changing over time, although the very first explanations of the natural rate would predict differently. The first estimates of the natural rate of unemployment were prepared by *Samuelson* and *Solow* (1960). Subsequent estimates were showing the stability of equilibrium unemployment for a long time (see Gravelis, 2007).

Chart 1

NAWRU AND UNEMPLOYMENT AND THE HP TREND OF VARIABLES ($\lambda=1600$), HUNGARY, QUARTER 1, 1998 - QUARTER 2, 2008



Source: HCSO

Later a theoretical explanation was developed regarding the variability of the natural unemployment rate (e.g. Ball – Mankiw, 2002): It suggested that the changes of this rate were also impacted by the improving expiry structure of frictional unemployment, i.e. more efficient operation of the labour market, higher productivity and changes in the structure of labour. There are more obvious reasons of course: as the *NAWRU* follows closely the fluctuations in actual unemployment, its curve is affected by all the factors which are decisive for actual unemployment as well, e.g. demand and supply shocks.⁸ *Camarero et al.* (2005) found that the unemployment curve in Hungary is not unique within the newest European Union member states. Unemployment in these countries decreased from the mid-1990's then began to increase again. In the unemployment trends of the EU10, several breaking points were identified which suggest that structural changes induced by transition and convergence (also) influence the functioning of the labour market, in particular its equilibrium [in the period after 2000, the unemployment trend was determined by intensifying international competition and the resulting second restructuring process (see more in Laky, 2005, page 90)]

The quantification of the *NAWRU* time series requires more information. The related methodologies (among others Elmeskov – MacFarlan, 1993; based on Elmeskov, 1993) rely on the assumption that wages inflation (and the changes thereof) are in linear correlation with the gap between actual unemployment and the *NAWRU* (due to the fact that the *NAWRU* represents a level of unemployment where wages inflation is constant). Accepting the fact that the *NAWRU* value changes only gradually over time, the observations on inflation and actual unemployment may be used for originating the *NAWRU* time series.

Therefore,

$$D^2 \ln W = -\alpha(U - \text{NAWRU}) \quad (3)$$

where D is the difference operator (i.e. $D^2 \ln W_t = D \ln W_t - D \ln W_{t-1}$), which is the change of the wages growth rate,

W stands for wages, and

U represents unemployment.⁹

The equation for estimating the *NAWRU* is as follows:

$$\text{NAWRU} = U - \left(\frac{DU}{D^2 \log W} \right) D^2 \log W \quad (4)$$

The resulting *NAWRU* line must be smoothed using the HP filter in order to eliminate erratic fluctuations. The n^* data derived from this smoothed time series will be used in the production function. After that we can get the total added value generated by the economy by summing up the added value actually created by the government sector with the estimate for the private sector (i.e. the private sector's potential added value) or we can calculate the potential output level for this sector, too (the third option is to quantify the production function for the entire national economy – this was our preferred approach during the calculations¹⁰).

Prior to presenting the calculation methodology of the structural balance and the resulting estimates, we must mention briefly the data sets of capital inputs (capital stock). Several time series are available on the capital stock used by the private sector. The Hungarian Central Statistical Office (HCSO) regularly carries out questionnaire-based surveys and in recent years they have been using estimates that rely on complex methodologies (which use the time series of investments); Similar initiatives were launched at the Magyar Nemzeti Bank, too. What is a major problem though is the considerable gap between the estimated net capital figures that result from the two methodologies. Net capital assets are affected by a number of

factors which corporations do not monitor and therefore the questionnaire-based survey is not reliable (Pula, 2003). Both the HCSO and the MNB applied the PIM (Perpetual Inventory Method) approach¹¹ when generating estimates. Yet the HCSO's algorithm was specified for annual figures only while the MNB also calculates quarterly (but not yet public) data [there is nothing in the way of generating quarterly figures at the HCSO either as model input data are available on a quarterly basis (Becksei, 2003)]. The variable that describes the trend of capital inputs is expressed in the formula

$$C_t = C_{t-1} \times (1 - D) + INV_t \quad (5)$$

which calculates the total capital stock of the national economy where

C_t is quarterly real capital,

D is the average depreciation rate,

INV_t represents total investments in the national economy at a constant price.¹²

The quantification of the structural deficit (interpreted in some way) is based on the potential output calculated as described above. In the course of the calculation, we split actually realized government revenues and actual expenditures into cyclical and structural components. In other words, we attempt to quantify the would-be balance of revenues and expenditures upon the assumed equality of actual GDP and potential GDP. The structural balance must be determined based on actual revenues and expenditures. In this process, we adjust the components of the equation to potential and actual output ratios as follows:

$$\frac{T_i^*}{T_i} = \left[\frac{Y^*}{Y} \right]^{\alpha_i} \quad \text{és} \quad \frac{G^*}{G} = \left[\frac{Y^*}{Y} \right]^{\beta} \quad (6)$$

where

T_i^* stands for (cycle sensitive) revenues actually realized from tax i ,

T_i^{sc} represents structural revenues realized from tax i (to be estimated),

G is actual government expenditures cleaned from capital expenditures,

Y is actual output,

Y^* is potential output,

α_i is tax category i ,

β represents the output elasticity of government expenditures.

Some sources consider expenditures based on unemployment and thus talk about the elasticity of expenditures in comparison to unemployment (Girouard – André, 2005). This distinction, however, is insignificant concerning our calculations: the only expenditure regarded by the OECD methodology as elastic to real economic cycles is unemployment benefit (Girouard – André, 2005, page 4). These items are outside the budget balance as per our definition which means that expenditures can be shown with their actual values (actual expenditures and structural expenditures can be considered identical). Similarly, we can disregard social security contributions which constitute revenues for the respective funds and thus are outside the scope of this examination. Naturally, the central budget is related to both social security and separated state funds; this relationship is regulated by the individual acts on the budget but it also keeps the incomes of these funds separated from central budget revenues. Furthermore, when quantifying the structural balance, we took revenues from simplified entrepreneur tax as an external factor (i.e. independent of the effect of cycles). Revenues from this tax type have been collected since January 2003 and their amount reflects an upward trend. According to the tax subject statistics of the Hungarian Tax and Financial Control Administration (APEH), the number of subjects that chose to pay taxes in the simplified entrepreneur tax (Hungarian acronym: EVA) scheme has been growing constantly. As

a consequence, the examination of the related impacts would not yield comparable results due to the expanding group of taxpayers involved. Among expenditures, the unemployment contribution (job seeking allowance) examined by the OECD and other unemployment benefits are financed in part from the Labour Market Fund – thus supports to the unemployed do not show up directly on the expenditure side of the central budget. Using these congruencies, the structural balance can also be expressed as follows:

$$B^* = \sum_{i=1}^4 T_i \left[\frac{Y^*}{Y} \right]^{\alpha_i} + T_{NS} - G \left[\frac{Y^*}{Y} \right]^{\beta} - G_{NS}, \quad (7)$$

where $\alpha_i > 0$ and $\beta < 0$. This equation also takes into consideration the fact that the methodology classifies cycle-sensitive taxes into four groups as follows: corporate tax, income tax, social security contribution and indirect taxes. We considered all taxes which do not fit into any of these four groups at their actual value (T_{NS}) as their course is independent from the cyclical fluctuations of the real economy. Based on the considerations outlined above, cycle-sensitive expenditures can be disregarded as we accepted to use total expenditures as structural expenditures in our estimations. We took the elasticity coefficients required for the definition of the structural balance (α_i) from the OECD's presentation (Girouard – André, 2005, page 19).¹³ Accordingly, we used the following elasticity figures: $\alpha_{i=1,44}$ for corporate tax; $\alpha_2=1,70$ for personal income tax and $\alpha_3=1,0$ for consumption taxes.

OUTPUT GAP AND STRUCTURAL BALANCE

When reviewing the methodology above, we could already get a brief insight into some important partial results, so now we can focus on the estimates of the output gap and the

structural balance. We considered the structural balance a complete balance of the central budget; this was necessary to enable the comparison of the related figures as the convergence program only quantifies the structural balance for this balance category (Ministry of Finance, 2007). Naturally, we aggregated the monthly figures to (calendar) quarterly level.

Based on the estimation of the production function with limitations, we got to the following equation:

$$\hat{Y} = 0,287294 \times N^{0,36251} \times K^{0,63749}. \quad (8)$$

where the potential output of the real economy can be calculated using the methodology after factor productivity has been smoothed. The resulting output gap in percent of the GDP is showed in *Chart 2*; We compared the difference between the real GDP adjusted for seasonality and the potential GDP to the potential GDP in the quarter under review.

For control purposes, we also present the estimation prepared with the HP filter (as recommended in the methodology, $\gamma=1600$). (See *Chart 3*)

It is apparent that the estimation generated with the production function shows more intense fluctuations, but the plus or minus sign of the output gap is sufficiently close in the case of both methods (which is quite important for the reliability of estimations). In order to adjust for the fluctuations, we may consider smoothing the output gap (or perhaps the potential GDP time series) with a sufficiently low λ . For the period in question, the Magyar Nemzeti Bank published the following estimates (see *Chart 4*).

In the light of international experiences, it is no surprise that the output gaps generated with different methods are different. When the OECD began to prefer the production function-based approach over trend smoothing in

Chart 2

OUTPUT GAP IN PERCENT OF POTENTIAL GDP BASED ON THE COBB-DOUGLAS PRODUCTION FUNCTION, Q1 2000 – Q4 2007

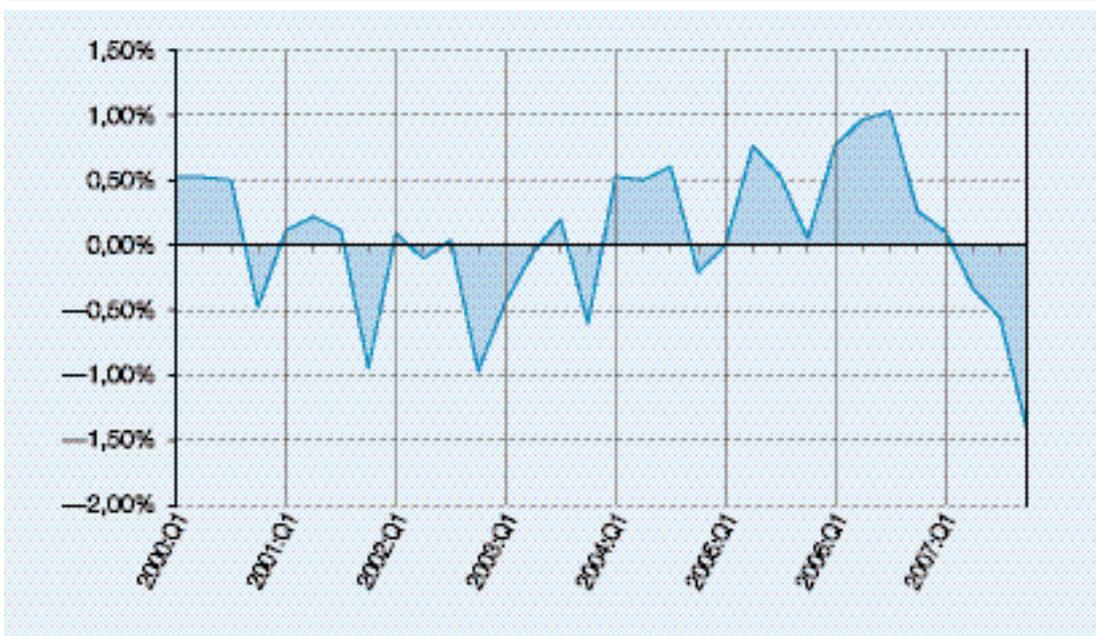


Chart 3

OUTPUT GAP IN PERCENT OF POTENTIAL GDP BASED ON THE HP FILTER, Q1 2000 – Q4 2007



**OUTPUT GAP IN PERCENT OF POTENTIAL GDP,
Q1 2000 – Q4 2007**



Source: MNB (2008)

the mid 1990's, Giorno et al. (1995) carried out a thorough comparison of the various approaches. An analysis of data from between 1971 and 1995 revealed several national economies where the estimates prepared with different approaches did not only differ in terms of the output gap but sometimes in respect of its prefix, too (the examples included Spain, Sweden, Greece and Australia). Another remarkable finding was that the growth rate of the potential output showed bigger year-on-year fluctuations in the case of production function-based estimates than with the smoothing methods. According to an analysis of 1996–2005 data, e.g. the Central Bank of Brazil (they also use inflation targeting) came to similar results when comparing the HP filter and the Cobb–Douglas production function (BCdB, 2005, page 94). It has to be noted though that there is still no consensus about which of these methods is more reliable. Naturally we cannot strive for deciding this matter or taking a clear stand. Although the produc-

tion function-based approach undoubtedly uses information of a higher order, its application may be objectionable in some cases. There is extensive reasoning in technical literature about why the standard Cobb–Douglas production functions must be estimated with special care in the case of Hungary (e.g. Benk et al., 2005, pp. 10–13; P. Kiss – Vadas, 2004, page 6; 2005, pp. 111–112). Therefore, some specialists recommend complex methods that eliminate these difficulties; These methods partly break away from the approach of production functions and use the toolset of time series modelling instead (e.g. Darvas – Vadas, 2003), while some of them strive for eliminating certain deficiencies while retaining the production function (P. Kiss – Vadas, 2004).

Now it is time to turn our attention to the structural balances derived from the three different types of output gaps. The significance of difficulties with the various methodologies described above is mostly eliminated because

the balance estimates show very little difference (see charts 5, 6 and 7).

The estimates of the structural balance seem to be stable and show no sensitivity to the specific method applied for determining the output gap. Table 1 provides a review of annual balances generated from estimates developed along different methods (the annual balances were prepared by adding up the quarterly balances of the respective years).

As expected, the annual structural balances calculated with the three output gaps show very little difference. What is remarkable however is that the structural balance calculated in accordance with OECD recommendations differ from the values published by the Ministry of Finance for both 2006 and 2007 (although the deviations point to different directions) and both figures suggest favourable fiscal developments (we do not investigate the obvious methodology-related reasons of the difference here).

What should be pointed out regarding the analysis of data instead is that the structural balance followed closely the actual deficit in the years that had an unfavourable annual balance (2002 and 2006 but also 2004 and 2007). What it suggests is that unfavourable fiscal processes can hardly be blamed on actual prosperity or downturn trends. Furthermore, we must conclude that the growth performance of the Hungarian economy did not help the formation of a budget balance (Báger – Pulay, 2008a). In its audit report on the implementation of the act on the budget, the State Audit Office already highlighted the trends indicated by the extraordinary deficit in 2002 (SAO 2003; Kovács 2003). Items which are often qualified as unforeseeable in the final accounts obviously played a role in the sudden growth of the deficit. Most of these items were *budgeting errors* (SAO, 2003, page 18). These budgeting errors are not simply *mistakes*: the fulfilment of budget objec-

Chart 5

**STRUCTURAL BALANCE (THE COMPLETE STRUCTURAL BALANCE OF THE CENTRAL BUDGET)
IN PERCENT OF CURRENT-PRICE GDP BASED ON THE PRODUCTION FUNCTION,
Q1 2000–Q4 2007**

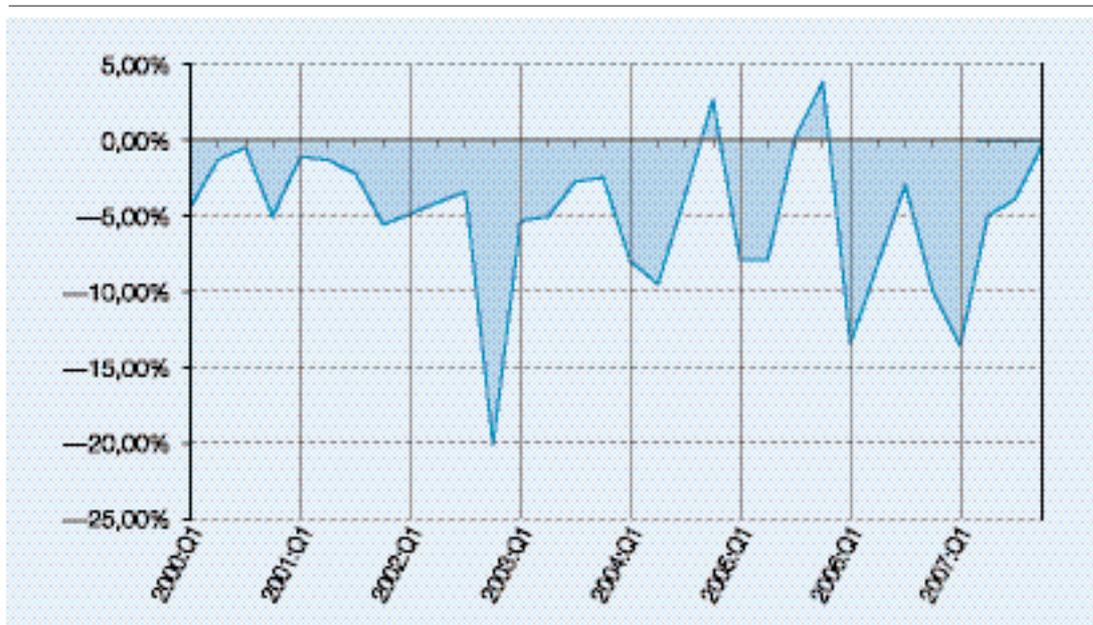


Chart 6

**STRUCTURAL BALANCE (THE COMPLETE STRUCTURAL BALANCE OF THE CENTRAL BUDGET)
IN PERCENT OF CURRENT-PRICE GDP BASED ON THE HP FILTER,
Q1 2000–Q4 2007**

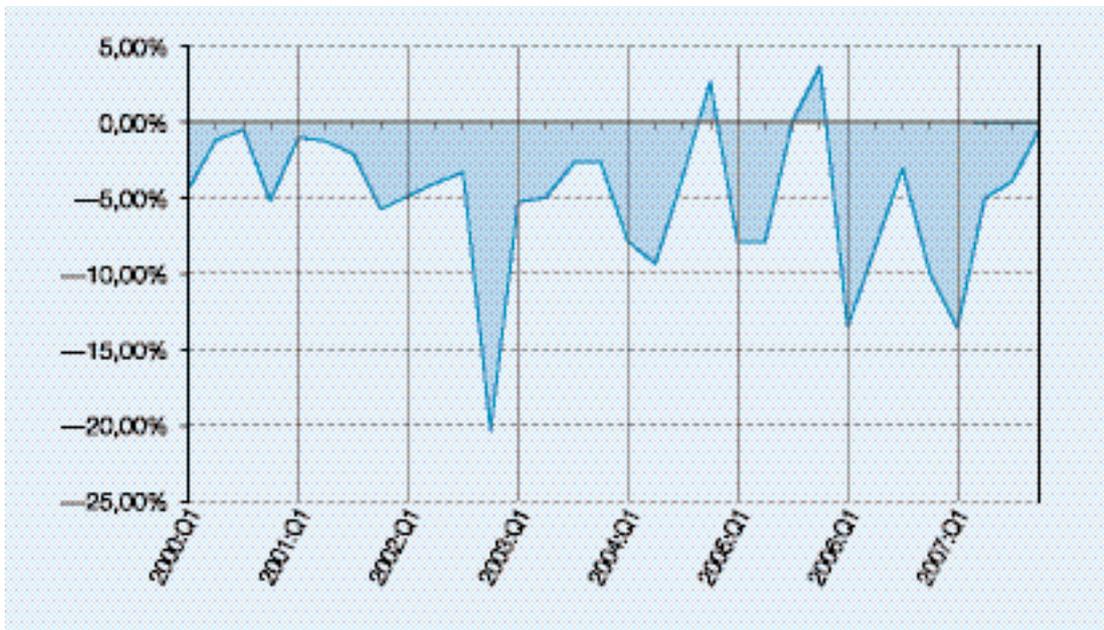


Chart 7

**STRUCTURAL BALANCE (THE COMPLETE STRUCTURAL BALANCE OF THE CENTRAL BUDGET)
IN PERCENT OF CURRENT-PRICE GDP BASED ON THE OUTPUT GAP ESTIMATED BY THE
MAGYAR NEMZETI BANK, Q1 2000–Q4 2007**

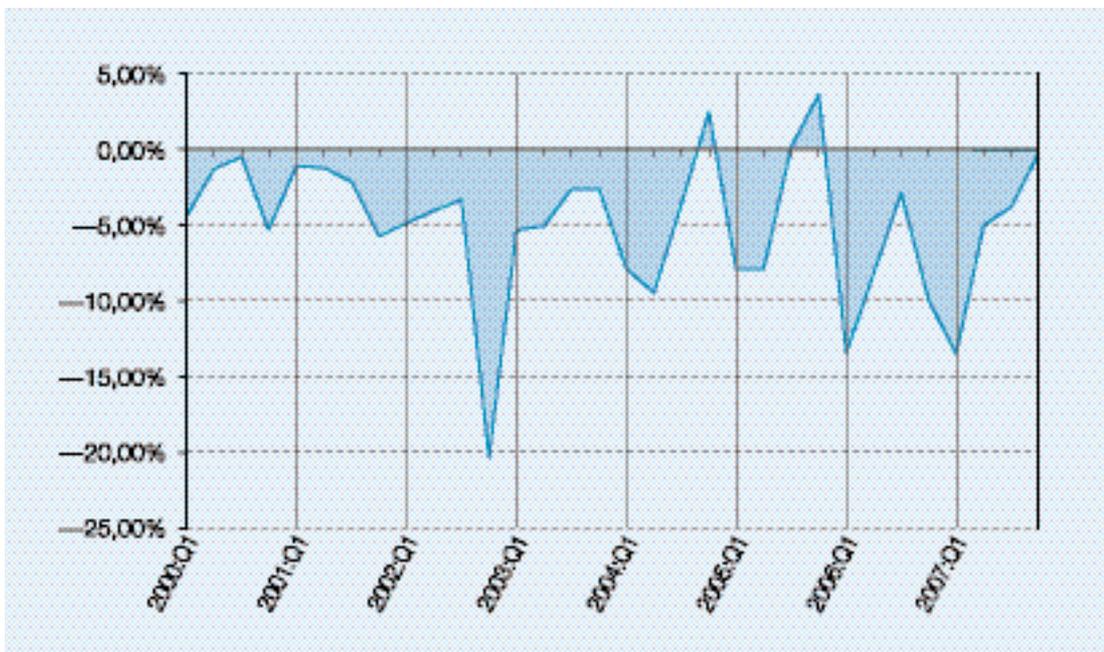


Table 1

**ANNUAL BALANCE AND ANNUAL STRUCTURAL BALANCE IN PERCENT
OF CURRENT-PRICE GDP, 2000–2007**

Year	Structural balance for the year based on production function	Structural balance for the year based on the HP filter	Structural balance for the year based on MNB's output gap	Annual balance	Structural balance as per the convergence program (Ministry of Finance, 2007)
2000	-2.78	-2.78	-2.82	-2.73	
2001	-2.66	-2.64	-2.65	-2.71	
2002	-8.51	-8.49	-8.51	-8.58	
2003	-3.78	-3.74	-3.77	-3.84	
2004	-4.35	-4.34	-4.38	-4.29	
2005	-2.54	-2.59	-2.59	-2.47	
2006	-8.39	-8.48	-8.43	-8.23	-8.8
2007	-5.32	-5.36	-5.28	-5.47	-4.9

tives is burdened by a number of risks and uncertainties, including the incalculability of the macroeconomic environment and the resulting risk. The risk deriving from the functioning of the economic-social environment is inherently present: the improvement of forecasting methods would not provide a solution to the matter, since due to the stochastic nature of reality the future cannot be predicted with full certainty. Thus mistakes that occur during budgeting (provided budgeting is based on careful forecasts) are not necessarily budgeting errors. The latter would include intentional underbudgeting or overbudgeting (and potential technical mistakes) (Báger – Pulay, 2008a, pp. 387–388). Naturally, one-off items do disturb a clear view (P. Kiss, 1998, page 45). Although we more or less disregarded the impact of cycles, the balance still includes items that cannot be considered structural although they are not caused (or eliminated) by cyclical fluctuations. An in-depth analysis identified several one-off items for the period before 2007: e.g. the way motorway construction was accounted for which increased the budget deficit with HUF 250 billion in 2002 and 2006 respectively (amounts charged to this titled were

around 200 billion in 2004 and 2005 as well). The budget balance for 2006 was further deteriorated by outstanding items related to the purchase of Gripen jet fighters. All that has been topped by the “additionality” requirement in relation to EU accession since 2004. Without attempting to analyse item by item the budget of each year mentioned here, we must emphasize that although one-off items and those deriving from EU accession had a negative impact on the budget, the deterioration of the budget position were mainly of structural origin and the unfavourable effects did not centre around any specific subset of budget revenues or expenditures (Ohnsorge-Szabó – Romhányi, 2007). As a result of these unfavourable processes, both sovereign debt and the budget deficit reached extraordinary levels by 2006 and unplanned items (or inappropriately budgeted items – meaning purposefully underbudgeted or overbudgeted ones) did play a role in that (Kovács, 2007). We are obviously more or less correct if we identify the *deficit inclination* of the budget with the structural nature of the deficit (applying the terminology used so far). Hungary's engagement in a definitely unhealthy competition with other new EU-10

countries obviously did not help these trends – what is more, they had an explicitly negative effect. In this rivalry, the lack of sustainability and a short-term approach may become economic policy “values” (Csaba, 2008). Talking about the new type of populism that is based on textbook examples, perhaps the way out could be the consideration of high theorems. For the related authors warned decades ago that the axiom of utility maximization is not a postulate without a time dimension. This economic theory and economic policy school (which also originated from the theorems of *Edmund S. Phelps*) firmly argued that attempts to exploit short term benefits clearly deteriorate the future opportunities of any economic policy as amidst unleashed expectations it takes bigger sacrifices in the real economy to redirect any macroeconomic system to the balanced (sustainable) track. Thus the costs of the short-term loosening of fiscal and monetary policy only appear on the medium and long run which may be enticing for the motivations and actions of fiscal government that is (also) driven by political considerations and, at the same time, has a destructive impact on annual planning and implementation of the budget.

SUMMARY

The structural balance indicator is not a miraculous, cure-all tool. It does not answer all the questions about the functioning of fiscal policy. Its application is only appropriate if we employ the widest possible range of tools for judging the position and direction of fiscal policy. It seems that the former debate on the proper interpretation of cyclically adjusted balance and its usefulness has settled by now and excess expectations concerning the indicator have become moderate.

We think that the selection of one item from the diverse set of approaches available for the quantification of the structural balance and the implementation of recommendations as consistently as possible may help clarify the questions about the usability of this methodology. Our study was intended to serve this very purpose. The results we got were consistent with the structural balances gained with alternative methods or based on output gaps, i.e. the method does not seem to be sensitive to the method selected for the determination of the output gap – assuming the methodology is correct and produces an output that is theoretically defensible.

NOTES

¹ Interestingly, technical literature was evidently too demanding in respect of the cyclically adjusted budget balance indicator. E.g. Muller and Price (1984) argued that the sustainability of the budget can be assessed correctly based on the structural balance indicator since cyclical correction separates the effects of booms/downturns and discretionary fiscal policy measures; in their view, the structural balance is a good indicator of the aggregate demand-regulating activities of fiscal policy. Later the clarification of misunderstandings around the proper use of the structural balance and the right question became just as important an issue as establishing the right methodology (see more about this in Blanchard, 1990).

² Due to the conceptual relation to the core inflation indicator, the structural balance indicator is often referred to in technical literature as the core balance (see e.g. Ize, 1983).

³ The accurate definition of the structural balance highlights the same feature, defining the balance as the difference between budget expenditures and revenues which we would have in case the real economy were steadily and lastingly growing at its full potential (Muller – Price, 1984).

⁴ Naturally, the analyst must make decisions when applying this methodology, too. These decisions, however, are hardly related to the quality of data

used and the structural characteristics of the national economy concerned. E.g. when using the HP filter, one must arbitrarily select a parameter that defines the robustness of smoothing. Although the original methodology does provide recommendations on this (Hodrick – Prescott, 1997, page 4), technical literature mostly rejects this approach and researchers are divided over the principles to follow during the analysis. E.g. the parameter in question can be chosen in a way that the resulting smoothed time series produces cycles which are consistent with former expert opinions of the cycles of the national economy. The heart of the problem is that researchers must make an arbitrary judgement on the smoothness of potential GDP changes (see more in OECD, 2001, pp. 41–42). Another thing to pay attention to with the HP filter is to have the start date and end date of the analyzed period in the same section of the cycle or else the resulting trend will be distorted. One solution of this problem is to provide an expert estimate of future GDP, i.e. the extension of the sample period.

⁵ This conceptual change is not independent of how we interpret potential output. If potential output is a trend around which actual output fluctuates and forms cycles, it can be described well with trend filtering approaches. If we definitely link potential output to the supply side, potential output will be equal to an output level that would emerge upon the optimal use of capacities (labour, capital assets, human capital). In these cases, quantification calls for a production function (see all this in more detail in Benk et al., 2005). The difference between these two approaches also highlights the key difference between the methodologies used for estimating the potential GDP.

⁶ If we were to review the historic evolution of labour market equilibrium categories, we would run into an interesting theoretical problem. Without outlining this topic in any detail, we just refer briefly to the fact that the groundbreakers in this area were Milton Friedman and Edmund S. Phelps. Despite the similarities on the surface, they established fundamentally different concepts. For Friedman, the natural rate of unemployment was an unemployment level at which inflation could be increased in a sustainable manner and at which all people can be employed who are willing to seek a job (Friedman, 1986, pp. 228–229; Begg, 1982, pp. 132–133). Thus supply and demand on the labour market are equal here.

In Phelps' interpretation, the equilibrium rate of unemployment refers to an unemployment level where ex-ante and ex-post inflation are identical – forced unemployment can be present though (Phelps, 2006), i.e. we cannot talk about the equilibrium of the labour market here. It seems highly obvious that estimates prepared with the production function will differ depending on the equilibrium concept selected for describing the position of the labour market.

⁷ Another reason for not doing so is that with the N.E.M., the explanation of HP filtering is not savings but the fact that equilibrium unemployment is affected by a number of variables which are exogenous factors in the model and their relation to labour supply is difficult to clarify according to the supporters of these arguments (Benk et al., 2005, page 11).

⁸ After more thorough consideration, we cannot think that the variability of NAWRU over time is proving the mainstream theory wrong. In this context, Ball and Mankiw (2002) argues that the fluctuations of the natural unemployment rate prove that monetary policy, at least on the short run, is able to affect the level of aggregate demand thus trigger changes in inflation and unemployment.

⁹ In the analyses herein we took unemployment for the 15–74 age groups based on HCSO figures. *W* represents quarterly gross wages of full time employees.

¹⁰ The application of this approach is not unprecedented in Hungary (see e.g. P. Kiss – Vadas, 2004; furthermore, this method is used in the MNB's quarterly forecast model; see Jakab et al., 2004). What is more, the OECD methodology leaves room for this simplification by allowing the estimation of the potential output of the government sector. Although the methodology recommends the splitting of the real output of the national economy by governmental and non-governmental sector (Torres – Jarrett – Suyker, 1989, page 5), it would only be feasible with the introduction of a number of assumptions which would erode the validity of estimation results.

¹¹ The point of this concept is that the net capital stock of any *t* point of time can be determined using three figures (net capital stock in the *t*–1 period, gross investment in the *t* period and depreciation in the *t* period).

¹² Based on expert opinions, we assume a depreciation rate of rate of $D=0,016$ (i.e. 1.6 per cent) in the calculations. Relying on Pula (2003), we took the year-end capital stock of 1994 as the starting value; For Q1 1995, we already applied estimates as per (5), using figures published by the HCSO

(we converted both the 1994 capital stock and investments to year 2000 prices).

¹³ That study did not examine the elasticity of simplified entrepreneur tax which was another reason to take the related tax revenues as a given factor.

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György Csáki

The International Monetary Fund and the global economic crisis, 2008–2009¹

Thanks to transmission mechanisms, the severe financial crisis that broke out in the United States in 2007–2008 became global almost immediately. As the disappearance of immense amounts of virtual money dried out international financial markets, the global liquidity crisis promptly turned into a global credit crunch, triggering an immediate recession in sectors like the construction and the auto industries where products are mainly (or almost exclusively) purchased on credit. In combination with the credit crisis, the severe setback in specific industries first pushed the US economy into crisis and then dragged the vast majority of the global economy into recession.²

This current crisis is the first truly global crisis of the world economy. Considering the circumstances of its outbreak and its anticipated impact, it is obviously comparable to no other turmoil but the great Depression of 1929–1933. The world, however, has learnt the lessons of the 1929 crisis. Back then, the collapse of the New York stock exchange and the financial crisis in the USA could only become a global crisis (the most devastating one in known history) because the protagonists of the world economy responded to it with a wave of restrictive measures and a devaluation contest evolved among them. The architecture of the international economy in the post World War II era was based on those very experi-

ences.³ Now it seems that the main lessons of 1929–1933 learnt in the past sixty years by collective historic memory are as follows: First, in a time of recession, consumption must be stimulated instead of pursuing a restrictive economic policy; second, the crisis can only be avoided through cooperation and, if it still breaks out, cooperation is the only way out of it. Consequently, the institutional frameworks of multilateral international cooperation on economic policy matters are becoming increasingly valuable in the current crisis, too. More than thirty years after the dissolution of the Bretton Woods system, its institutions are in the limelight again. Regulatory weaknesses that led to the crisis can only be eliminated through the global coordination of financial regulation. (Garten, 2008) Global imbalances threaten the survival of liberal trade now. (Wolf, 2008) Obviously, global problems call for global answers – actually a coherent entirety of global answers. A well-known columnist of the *Financial Times* writes straightforwardly (albeit with some irony of course) about the need for world government. (Rachman, 2008)

The new situation makes old answers irrelevant but new answers only evolve from debates – and international organizations do engage in debates. The subtitle of the December 2008 report of UNCTAD asks: “We will never learn?” The introduction of the policy brief ends with the fol-

lowing firm statement: “The current IMF approach asking for pro-cyclical policies in crisis countries is inadequate. UNCTAD has long argued that multilateral coordination is the only viable solution.” (UNCTAD, 2008, issue 1) According to the analysis, “Unless there is a fundamental rethinking of the exchange rate mechanism and the cost involved in the traditional “solution” of assistance packages without symmetrical intervention, the negative spill-over of the financial crisis into the real economy will be much higher than needed.”⁴ (UNCTAD, 2008, issue 2)

Hereinafter this paper reviews what and how the International Monetary Fund⁵ has done since the outbreak of the crisis to overcome it as quickly as possible and to foster the balanced and sustainable development of the world economy in the post-crisis era.

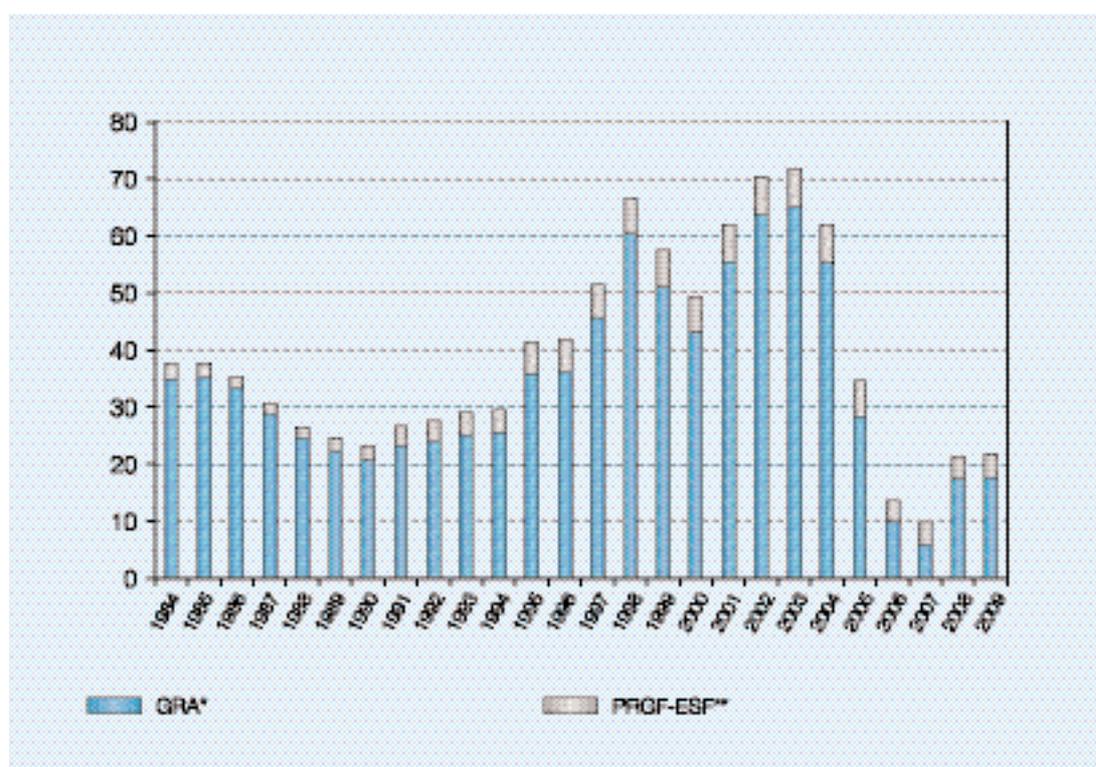
THE IMF IS A BENEFICIARY OF THE CRISIS!

Strangely enough, the crisis brought about the revival of the IMF – the International Monetary Fund has found a central role in the global economy in organizing and orientating international cooperation on economic and economic policy matters.

The IMF completely lost significance by 2005–2006 after its biggest debtors (Argentina, Brazil, Mexico and Turkey in the late autumn of 2005 then Indonesia in early 2006) all repaid their loans before the expiry date. It seemed that demand only existed for the “softest” types of IMF loans that are considered quasi-aids. While the total value of loans provided by the IMF exceeded 70 billion SDR (i.e. USD 100 billion) in 2002–2003, it dropped to 10 (!) billion SDR by 2007. (See Chart 1)

Chart 1

IMF LOANS PROVIDED, 1984–2009
(SDR billion)



The indispensable reform of the organization came to a halt after 2006 as the rearrangement of voting rights failed. The largest creditors to the world economy, Japan, China and India, are dissatisfied with their quotas held in the IMF (i.e. with their vote percents) since e.g. China has a smaller vote than the Benelux states...⁶

By early 2006 it was obvious that this situation could not be sustained any longer. *The governor of the Bank of England* (who by tradition is also the IMF governor of his country) “proposed radical reform of the IMF, warning that without it the institution would slide into obscurity”. In order to avoid this, *Mervyn King* suggested that “day-to day duties should be removed from the IMF managing director and Board of directors who should monitor and criticize the member countries' economic policies” instead. The representation of member countries in the IMF must be reduced. There is no need for a resident board in Washington. A non-resident board with six or eight meetings a year would be sufficient. (Gilles – Balls, 2006) The IMF's role as a “last resort” creditor decreased dramatically and only had an effect in the poorest countries. The *Financial Times* editorial on the same day put it even more sharply: “For long, the IMF has not been the supervisor of the Bretton Woods system anymore.” Europe is overrepresented in the IMF (France and Great Britain possess 4.95–4.95 percent of total votes while China has 2.94 percent only). What is the IMF's role in today's globalized financial system? (...) The IMF is the relic of an era when global communication was not available yet.” (The Financial Times, 2006)

Leading Financial Times columnist on world economy matters *Martin Wolf* used rather tough words: “Let us be brutal: the IMF is on the brink not just of “obscurity”, as Mr King suggests, but of irrelevance. ... If the International Monetary Fund did not exist, we

would not re-invent it!” (Wolf, 2006] Wolf says three questions need to be addressed: First, how has the world changed since the 1944 conference at Bretton Woods? Second, what (if anything) is its contemporary role? Third, what changes are needed if it is to play it? Possible new roles are as follows: The IMF could function as an advisor, albeit not providing loans; it would be a mistake if the IMF did not address insolvency and liquidity deficit issues; the IMF could direct international reserve-pooling.⁷ According to Wolf, the true mission of the IMF would be to act as a firmly thinking, independent organization providing truly independent global supervision in today's international financial system. However, “this is what the largest shareholders want the least” added Wolf sceptically.

In the time of the current crisis, however, the IMF is more and more frequently referred to as being the only financial organization with global reach that could coordinate the provision of required resources. Ted Truman, senior associate of the respected *Peterson Institute for International Economics* put it simply: (Truman, 2009) “When the leaders of the G-20 countries gather in London on April 2, they will have one policy instrument immediately available to address the global economic and financial crisis cooperatively, concretely and credibly.” They could undertake a “commitment to an immediate, one-time allocation of \$250 billion in special drawing rights (SDR) by the International Monetary Fund (IMF) to its member countries”⁸

The IMF can make an impact amidst the global economic crisis in three ways:

- ① By preparing global, regional and country-specific studies, i.e. by revealing the global economic situation in a thorough and professional manner and by providing explicit advice;
- ② Like central banks, the IMF is also able to exercise “verbal intervention”: orientate the key players of the world economy through the

speeches, statements, presentations of its executives;

③ Loan granting – as a quick response to the 2008 crisis, the IMF significantly reformed its loan granting policy by revamping loan arrangements and disbursement practices and by elaborating new loan schemes.

IMF ANALYSES REGARDING THE CRISIS

It was the June 2008 issue of *Finance & Development*, the joint quarterly of the IMF and the World Bank that first mentioned a crisis in express terms, actually in more than one articles: “The current crisis is the worst to hit mature financial markets in decades, and it is not yet over”. (Kodres, 2008, page 9) In Kodres' approach, the road to the crisis was characterized by low nominal interest rates, excess liquidity, low volatility on financial markets and large investor risk appetite which evolved from overall self contentedness. As favourable circumstances appeared to be lasting, many money market players began to believe a new paradigm of financial markets. Investment in riskier assets became the norm, often with little understanding on the part of investors of the underlying risks and insufficient capital to support them. “Despite repeated warnings from the official sector that financial stability could be compromised by the intense »search for yield,« private sector incentives continued to encourage further risk taking. By the spring of 2007, even top managers in some of the largest financial institutions began to express public concern, particularly about structured credit securities backed by subprime mortgages and the leniency of the loan covenants and conditions backing leveraged buyout activity. But, given still-low interest rates and ample liquidity, demand for structured credit products carrying the AAA rating and earning higher-than-normal yields continued unimpeded until mid-

2007. Supervisors had insufficient information and clout to halt the proliferation of overpriced securities.” (op. cit. page 9) “Like former credit crunches, this crisis also stemmed from the softening of lending standards. The crisis which evolved in the subprime mortgage market spread on quickly: the complexity and lack of transparency of structured credit instruments concealed their real dimensions and the leverage of positions taken, often before the financial institutions themselves. The quick escalation of the crisis surprised and intimidated many investors. Solving the problems will not be easy because the incentives that underpinned the crisis are deeply ingrained in private sector behaviour and, in some cases, are even encouraged by regulation. But the problems deserve serious attention because the effects of the crisis are set to reach a broad swathe of average citizens in many countries” (op. cit. pp. 9–10)

An article by *Randal Dodd* and *Paul Mills* (Dodd – Mills, 2008) analysed the starting point of the problem, pointing out that “any of the myriad problems in the U.S. mortgage market could have been contained, but together they caused a crisis that spread across the globe.” The US mortgage market could break loose and high-risk lending could become “systemic” because property prices rose sharply in the US and never decreased since 1929. “What have we learned from this contagion? First, securitization has moved some credit risks from the banking system, but not as much as anticipated and at the expense of transparency. It is taking a long time to discover where the losses have accumulated. Second, over-the-counter markets are not necessarily liquid when under stress. The disruption to interbank markets has been more profound and long lasting than anyone anticipated before August 2007, meaning that institutions must be able to survive considerable periods on their own resources. Third, risk management at individual banks has focused on protecting the institution

while largely ignoring systemic risks. As a result, individually rational actions to ensure survival have resulted in collectively irrational outcomes. And, finally, crisis resolution has become extremely complex in a world of dispersed risks and derivatives. Central banks have been required to innovate rapidly to contain the outbreak, and yet the crisis has persisted. Fighting this epidemic has proved far harder than the doctors imagined.” (op. cit. page 18)

In the same issue of *Finance & Development*, an article by *Jaime Caruana* and *Adyta Narain* discussed the new requirements for banking supervision. (Caruana – Narain, 2008) The article concludes that “we must remember that Basel II is not an overall guide to how banks should run their businesses. Capital requirements cannot prevent banks from making mistakes – or substitute for banks' own responsibilities for assessing risk and managing it appropriately. Capital requirements can, and should, help create the right incentives for risk taking and support good risk management generally. Other elements of a bank's operating environment, such as accounting rules and market incentives, can also play an important role in shaping risks. Achieving consistency between these various competing influences – accounting, risk management, and regulation – will continue to be an open challenge for policymakers.” (op. cit. page 28)

The December 2008 issue of *Finance & Development* was devoted entirely to the crisis, viewing it in a historic perspective and on a historic benchmark but also addressing several elements which are relevant in the current crisis.⁹ The introductory study was written by IMF chief economist *Olivier Blanchard*. The first sentence in the article sets the tone for the entire issue: “The global economy is facing its worst crisis in 60 years. In the first half of the 2000s, a benign environment led investors, firms, and consumers to expect a permanently bright future and to underestimate risk.

Housing and other asset prices shot up, risky assets were created and sold as being nearly riskless, and leverage increased. So when housing prices turned around, and subprime mortgages and the securities based on them turned sour, the stage was set for the crisis. In the context of rapid global integration and deep and complex interconnections between financial institutions, the crisis quickly moved across assets, markets, and economies. The rest is history, or, more precisely, history in the making.” (Blanchard, 2008)

As for *Olivier Blanchard*, the short term action plan is clear though not easy: “Governments must attack the crisis on two fronts. They must implement and refine the policies adopted in the past few months to deal with the financial crisis. And they must take strong measures to sustain demand, limit the fall in output, and restore confidence and private spending.”¹⁰ In this difficult situation “Changes in policy and ambiguities about future policy are in some cases making things worse rather than better. Until the programs are clarified, and rules of the game more clearly established, private investors are unlikely to be enthused, worsening the crisis and delaying the adjustment in the financial system.” (op. cit.) The IMF's chief economist thinks that governments will have to face dramatically worse budgetary positions after the crisis and that the financial environment will change dramatically, too.¹¹ “Governments will face a number of questions about how to manage their presence in the financial sector. The goal here should be to maintain a level playing field with privately owned institutions, and to steadily allow the return of the financial sector to private hands. Experience from many past banking crises provides a useful guide on how best to do this.” (op. cit. page 10)

In order to avoid the repetition of the current crisis, better regulation is needed. “The crisis has shown the limits of the current regu-

latory and supervisory frameworks at both the domestic and international levels. The challenge is, therefore, to design new rules and institutions that reduce systemic risks, without imposing unnecessary burdens and stifling innovation. Implementation will take time; the design has already started, and will be further explored by the working groups created at the G-20 meetings. The contours of reform are however already clear.” (op. cit. page 10) Blanchard underlines two elements of these “contours”: *Measuring systemic risk will require better, more accurate information; New and better national rules will be necessary, both at the individual institution and at the macroeconomic level.*

In a quite remarkable study, Noel Sacasa, senior financial expert at the IMF's Monetary and Capital Markets Department summarizes the main question raised by the crisis along with the possible prompt responses. The article identifies the main actions to take: “The financial crisis has exposed weaknesses in the current regulatory and supervisory frameworks. The recent developments have made it clear that action is needed in at least four areas to reduce the risk of crises and address them when they occur. These are (a) finding a better way to assess systemic risk and prevent its buildup in good times; (b) improving transparency and disclosure of risks being taken by various market participants; (c) expanding the cross-institutional and cross-border scope of regulation while safeguarding constructive diversity; and (d) putting in place mechanisms for more effective, coordinated actions” (Sacasa, 2008, page 11)

This is necessary because there are at least three areas which did not receive sufficient attention in the past decades and therefore they could contribute significantly to the formation of systemic risks:

① global macroeconomic imbalances resulted in lower interest rates during the past

decade, inducing more risk-taking and contributing to the creation of asset price bubbles worldwide;

② changes in financial sector structure and the failure of risk management to keep up with financial innovation during the past two decades rendered the system more prone to instability;

③ leveraged financial institutions have inherent incentives to take on excessive risks without internalizing systemic risk, which is the main reason they need to be regulated.

Sacasa summarised the desirable priorities of regulatory reform as follows: *1. Due to systemic risk and procyclical risk-taking, both capital requirements and macroeconomic policy must be made more countercyclical. 2. Mark-to-market accounting must be reassessed. 3. Securitization must be made more compatible with incentives. 4. Liquidity management must be strengthened. 5. Risk management models and systems must be reassessed.* (op. cit. pp. 13–14)

The study¹² that probably received the most attention discussed the severity of the crisis and the probability that it lingers on. It sharply contradicted with the forecasts in the October 2008 *IMF World Economic Outlook* and the 6 November Update. The title of the article by Stijn Claessens – M. Ayhan Kose – Marco Terrones speaks for itself and so does the editorial highlight: “*When crises collide. Recessions accompanied by credit crunches or asset price busts are deeper and longer lasting.*”¹³ (Claessens – Kose – Terrones, 2008) The authors examined 122 recessions that broke out between 1960 and 2007. The average duration of these downturns was 4 years (with the shortest and longest lasting for 2 and 13 quarters respectively), their amplitude (i.e. the extent of the setback) was 2 per cent at an average. 28 credit crises, 28 real estate market crises and 58 securities market crises were identified by the authors who also found that the duration of credit and real estate market crises exceeded the average. Credit

crises usually lasted for two and a half years and entailed a 20 per cent decrease of borrowings in the private sector. Real estate market crises took even longer – four and a half years at an average, with the real prices of property falling 30 per cent. Recessions and/or crises often break out in more than one country simultaneously: we have had four global recessions in the past four decades: in the mid 70s, the early eighties,¹⁴ the early nineties and in 2001. The authors came to the following final conclusion: “The global economy has been experiencing a financial storm of historic proportions. The lessons from the earlier episodes of recessions, crunches, and busts are sobering, suggesting that recessions following this storm may be more costly, because they are likely to take place alongside simultaneous credit crunches and asset price busts. Furthermore, although the effects of the current crisis have already been felt gradually around the world, past evidence suggests that its global dimensions are likely to intensify in the coming months. Nevertheless, the nature of a recession in a particular country can be shaped by many factors – including the financial health of its firms, banks, and households prior to the recession, and the policy measures that authorities employ to mitigate its adverse effects. Continued decisive policy actions at both the national and global levels could help meet the evolving challenges of the crisis.”¹⁵ (Op. cit. page 28)

Naturally, the March 2009 issue of Finance & Development also kept the crisis in the limelight through the articles in “The World in Crisis” section¹⁶. The study of *Jean Pisani-Ferry* and *Indhira Santos* analyse the more general consequences of the crisis, in particular its impact on globalization (Pisani-Ferry – Santos, 2009) It is also obvious that a lot of crisis management experiences have been compiled in the past decades but there is no memory of a truly global financial crisis in people's

minds. Globalisation was criticised before the crisis already as not everyone had access to the benefits of global free trade and movement of capital and jobs. “Although economists, corporations, and some politicians were supportive, critics argued that globalization favoured capital rather than labour and the wealthy rather than the poor.” (Op. cit. page 8) The authors are of the opinion that globalisation in the form as it unfolded and operated in the past two decades was a cause of this crisis in many ways. Although microeconomic failures were real and represented a starting point, “their effect would have been much more contained absent the insatiable appetite for AAA-rated U.S. assets. It was the combination of strong international demand for such assets, largely in connection with the accumulation of current account surpluses in emerging and oil-rich economies, and an environment of perverse economic incentives and poor regulation that proved to be explosive. (...) Discussion at the international level was further complicated by political overtones: (...) the United States has insisted that the key macroeconomic problem in the world economy was not its current account deficit, but rather China's high propensity to save.” (Op. cit. page 9) As another mistake, “it was hoped, until autumn 2008, that economies immune from the direct fallout of the subprime crisis would sail through the storm with sufficient strength to pull along the entire world economy. (...) But it is now apparent that growth is declining sharply in all regions of the world.” (Op. cit. page 10) Pisani-Ferry and Santos also believe that while unregulated globalization undoubtedly played a role in the outbreak of the crisis, the crisis also imposes a backlash on globalization, bringing it to a halt at least temporarily. “The drivers of the recent globalization wave – open markets, the global supply chain, globally integrated companies, and private ownership – are being undermined”¹⁷ (Op. cit. page 10) It is obvious

that once the world economy emerges from the crisis, the global economic environment and governance will change. “The main test remains fostering international cooperation at a time when there is a big temptation to look for solutions at home. It is in deeper multilateralism, rather than in nationalism, that many of the answers to the current challenges lie. But what exactly should global actors and national governments do?” (Op. cit. page 11)

“VERBAL INTERVENTIONS” BY THE IMF

The IMF's “verbal interventions” mainly consisted of lectures, articles and statements by IMF managing director *Dominique Strauss-Kahn*, first deputy managing director *John Lipsky* and chief economist *Olivier Blanchard*.

Welcoming the Washington summit of G-20 countries, Strauss-Kahn said on 15 November 2008 (IMF, 2008/a) that “A new world economic order is developing that is more dynamic and more inclusive than any we have yet seen¹⁸”. Naturally, the managing director was pleased to acknowledge that the G-20 intended to assign a key role to the IMF in managing the crisis. Strauss-Kahn explained: “I welcome the emphasis on fiscal stimulus, which I believe is now essential to restore global growth. Each country's fiscal stimulus can be twice as effective in raising domestic output growth if its major trading partners also have a stimulus package.”

Also reflecting to the G-20 summit at a lecture presented at the John Hopkins university on 17 November 2008, first deputy managing director of the IMF *John Lipsky* outlined his views on the main short-term crisis management tasks and also on what needs to be done in the long run after the crisis. In the introduction he said that “*In several important ways, the coming months will represent both a test and a turning point for the global economy, for interna-*

tional financial markets and for global governance. While the efforts agreed last weekend may fall short of something that could be given as grandiose a label as a new international financial architecture, nonetheless their scope and importance shouldn't be underestimated.” Lipsky welcomed the G 20's endeavours regarding the future of the world economy, underlining that proposed reforms “*will only be successful if grounded in a commitment to free market principles*, including the rule of law, respect for private property, open trade and investment, competitive markets and efficient, effectively regulated financial systems.” Lipsky also expressed his pleasure that the G-20 Leaders pledged to initiate a new push to reach agreement on the Doha Round of multilateral trade negotiations before the end 2009 but he also added as a cutting remark that we should not be “ignoring the widespread scepticism that a deal would or could be reached in the foreseeable future.”

Lipsky emphasised that as the global inflationary pressure eases, many developed and emerging countries may further loosen up their monetary policies. “It is appropriate, therefore, that fiscal expansion will play a central role in helping to sustain domestic demand.” Lipsky pointed out that “*the Liquidity Shock must be prevented from becoming a solvency crisis. In emerging economies, the focus must be dealing with immediate liquidity and exchange rate pressures. As these emerging economies likely will remain under pressure for some time from global financial deleveraging. As a result, liquidity provision will continue to be critical to emerging economies' ability to weather this storm.*”

Thinking on a longer timeline that extends beyond the current crisis, Lipsky underlined three important issues regarding the future of the global financial architecture: *the global financial system must be improved; systemic risks must be evaluated more accurately; far more efficient and harmonised crisis manage-*

ment mechanisms are needed to manage potential future crises.

In a lecture on the IMF's future given in Madrid on 15 December 2008, Strauss-Kahn summarised the IMF's short-term proposals and outlined a financial architecture that could lay the foundations for the more balanced and more stable development of the world economy. (IMF, 2008/c) The IMF's managing director highlighted the following action items as top priorities for the near future: – Restoring stability to financial markets; – Supporting aggregate demand; – Providing financial support to crisis-hit countries. Strauss-Kahn provided a summary of long-term action items under the title “Policies to Avoid a Future Crisis”, emphasizing that changes must be introduced in the regulation of financial markets, both at the national level and in terms of international coordination; the effectiveness of international financial institutions (The Financial Stability Forum, the International Organization of Securities Commissions, the Basel Committee on Banking Supervision) must be improved and the IMF can play a pivotal role in this effort. Regarding the future of the regulatory system, Strauss-Kahn underlined the significance of early warning for threats and the ability to take firm action in emergencies.

Olivier Blanchard, chief economist of the IMF rendered a rather meaningful title to a guest article he authored (Blanchard, 2009/a): “(Nearly) *nothing to fear but fear itself*”. Blanchard principally warns that in times like today when fear from the “unknown unknowns”¹⁹ dominate, and the economic environment is so complex as to appear nearly incomprehensible, the result is extreme prudence, if not outright paralysis, on the part of investors, consumers and firms. And this behaviour, in turn, feeds the crisis.” Therefore, policymakers must first reduce uncertainties. Financial resources must be channelled back to

riskier businesses which the private sector must fund. Therefore, once the crisis begins to fade away, governments must recycle their portfolio accumulated during the crisis into the private sector. Consequently, they must separate more clearly the role of fiscal and monetary policy, but, in the current state of play, “this is a minor wrinkle”, added Blanchard with a pinch of French humour. The third element of his proposal looks familiar from the writings of Strauss-Kahn and Lipsky quoted above: “Third, [government should] undo the effects of the wait-and-see attitudes of consumers and firms on the demand side. Get them to spend more, and have the state do some of the spending itself. Offer incentives to buy now rather than later; for example, temporary subsidies to consumers who turn in a clunker and buy a new car, a measure adopted in France. Increase spending on public infrastructure (...). If tailored and communicated well, these programmes can not only stimulate and replace private demand, but also convince consumers and firms that they are not in for another Depression.”

Strange but *true: even in the heydays of Keynesism, the International Monetary Fund was not as Keynesian as these days*: in today's global financial and economic crisis, which is the most severe since 1929 and broke out in the world's largest and most developed financial market, *the most frequently applied expression and economic policy advice in the IMF's communication is “fiscal stimulus”*.²⁰ *It is indeed difficult not to think of Keynes who wished happy new year to president Roosevelt in a still famous and remembered open letter in 1933, saying: “Mr. President: spend, spend, spend!”* (Keynes, 1933)

Of course, the IMF also warns for the related long-term dangers: although economic policies must continue to focus on triggering an upturn, now “we must step over the crisis and look for an exit strategy.” (Lipsky, 2009) In this

context, “exit” refers to the ending of fiscal stimulus and the long-term management of state money pumped into the economies. What this calls for above all is the limitation of medium-term risks, the handling of inflationary threats and the minimizing of economic policy distortions (i.e. excess intervention by governments). These actions will be rather difficult to see through as the problem on the medium and short run is not simply the neutralisation of today's excess budget expenditures: “Market confidence in the sustainability of budget positions would be helped by formulating medium-term fiscal frameworks and by announcing an outline of measures that will be used to tackle rising health care and retirement costs.” (Op. cit.) However, the one and only way to execute these immense tasks is through cooperation among the key players of the world economy and the harmonisation of economic policies, ultimately through *the fixing of today's global financial imbalances*. Today even the first deputy managing director of the IMF emphasises that “The fiscal consolidation that will be required after the crisis and the inevitable rise in private saving in advanced economies – reflecting the steep decline in financial and housing wealth and tighter credit availability – will need to be matched by an increase in emerging market domestic demand. In turn, this would be facilitated by stronger social safety nets that would reduce the need for precautionary savings, by developing more effective financial systems, and by more flexible currency management that would support more fluid rebalancing of global supply and demand.” (Op. cit.)

* * *

The global analyses and outlooks of the IMF provide a starting point for generating local prosperity forecasts all around the world. In this respect, the single most important IMF publication is the *World Economic Outlook* (hereinafter: WEO).²¹

As it turned out very soon, the title of the October 2008 outlook, *Financial Stress, Downturns, and Recoveries* was way too optimistic. (WEO, 2008/a) The executive summary kicked off with these statements: “The world economy is entering a major downturn in the face of the most dangerous financial shock in mature financial markets since the 1930s. Global growth is projected to slow substantially in 2008, and a modest recovery would only begin later in 2009. Inflation is high, driven by a surge in commodity prices, but is expected to moderate. The situation is exceptionally uncertain and subject to considerable downside risks. The immediate policy challenge is to stabilize financial conditions, while nursing economies through a period of slow activity and keeping inflation under control.” (WEO 2008/a: xv.) The title of the next sub-chapter suggested considerable optimism as well: “*Recovery is not yet in sight and likely to be gradual when it comes*”. (Op. cit.) In October 2008²², IMF experts were of the opinion that a gradual recovery in 2009 is likely because of three reasons: Commodity prices are projected to stabilize, although at high levels. The US housing sector is expected to reach the bottom in 2009, ending the negative drag on growth and significantly relieving the housing sector's pressure on the financial market. Emerging economies will have a stabilizing effect on the global economy, although “the longer the financial crisis lasts, the more they are likely to be affected.” (Op. cit. xvi) Accordingly, the WEO projected a 3.9 percent global growth rate for 2008 and 3.0 percent for 2009 (0.2 and 0.9 lower than the respective figures in the July 2008 forecast) and predicted that global trade would expand at 4.9 percent in 2008 and at 4.1 percent in 2009. In consistence with this optimism, the IMF anticipated a 50.8 percent rise in oil prices in 2008 and a –6.3 percent unwind in 2009.

While there have been precedents in the past decades that the IMF issued an interim analysis

between the April and October issues of the WEO, it has never happened before that an IMF forecast had to be updated in less than six weeks. The title of the update issued on 6 November 2008 (WEO, 2008/b) reflected well the deteriorating prospects: *Rapidly Weakening Prospects Call for New Policy Stimulus*. The analysis is based on the observation that “Prospects for global growth have deteriorated over the past month, as financial sector deleveraging has continued and producer and consumer confidence have fallen.” (Op. cit. page 1) The paper points out that for the first time (!) in the post world-war era, global output will decrease in 2009 and recovery can only start at the end of the year. Consequently, the decrease of product prices became predictable. The IMF's analysis was especially firm in reevaluating the financial crisis and underlined that “The financial crisis remains virulent. Markets have entered a vicious cycle of asset deleveraging, price declines, and investor redemptions” (Op. cit. page 2) The paper highlights the pressure on emerging markets which is far above the average and stresses the need for strengthening the financial sector: Financial policies have responded strongly. However, they could be reinforced, clarified, and better coordinated and thereby foster a more rapid recovery of lending and demand. Depending on how much prospects worsen, the scale of current recapitalization efforts may need to be broadened.” (Op. cit. page 4)

Another WEO update was issued on 28 January 2009 (WEO, 2009/a), titled *Global Economic Slump Challenges Policies*. The introduction of the study pointed out that “World growth is projected to fall to 0.5 percent in 2009, its lowest rate since World War II. Despite wide-ranging policy actions, financial strains remain acute, pulling down the real economy. A sustained economic recovery will not be possible until the financial sector's functionality is restored and credit markets are

unclogged. For this purpose, new policy initiatives are needed to produce credible loan loss recognition; sort financial companies according to their medium-run viability; and provide public support to viable institutions by injecting capital and carving out bad assets. Monetary and fiscal policies need to become even more supportive of aggregate demand and sustain this stance over the foreseeable future, while developing strategies to ensure long-term fiscal sustainability. Moreover, international cooperation will be critical in designing and implementing these policies.” (WEO, 2009/a, page 1)

These sentences not only reflect a fast and dramatically worsening situation but also highlight the IMF's firm departure (as described in detail above) from neoliberal orthodoxy which it used to follow. This is also proved in the closing section of the analysis which points out that besides the stabilization steps taken to date (liquidity support, deposit insurance and recapitalization schemes), there is also a need to manage long-term uncertainties about the solvency of financial institutions e.g. by establishing state institutions to manage bad loans. “In current circumstances, the timely implementation of fiscal stimulus across a broad range of advanced and emerging economies must provide a key support to world growth. Given that the current projections are predicated on strong and coordinated policy actions, any delays will likely worsen growth prospects. Countries that have policy room should make a firm commitment to do more if the situation deteriorates further. Fiscal stimulus packages should rely primarily on temporary measures and be formulated within medium-term fiscal frameworks that ensure that the envisaged buildup in fiscal deficits can be reversed as economies recover and that fiscal sustainability can be attained in the face of demographic pressure. Countries that have more limited fiscal space should focus their efforts on supporting the financial sector and credit flows, while

ensuring that budgets adjust to less favourable external conditions.” (WEO, 2009/a, page 5)

Analysing the new phenomena, the next issue of WEO published late April 2009 (WEO, 2009/b) further adjusted forecasts. The publication's title (*Crisis and Recovery*) already described actual world economy trends as a crisis, predicted a severe setback for the whole of 2009 and assumed that recovery (which was “deferred” to 2010) would be rather modest. “*Global economy is in a severe recession inflicted by a massive financial crisis and acute loss of confidence. Wide-ranging and often unorthodox policy responses have made limited progress in stabilizing financial markets and containing the downturn in output, failing to arrest corrosive feedback between weakening activity and intense financial strains.* While the rate of contraction should moderate from the second quarter onward, world output is projected to decline by 1.3 percent in 2009 as a whole and to recover only gradually in 2010, growing by 1.9 percent. Achieving this turnaround will depend on stepping up efforts to heal the financial sector, while continuing to support demand with monetary and fiscal easing.” (WEO, 2009/b, page 1) The unparalleled severity of the situation and the continuous deterioration of the world economy since September 2008 are highlighted by the fact that “global activity is now projected to decline 1.3 percent in 2009, an 11 percentage point downward revision from the January estimate. By any measure, this downturn represents by far the deepest global recession since the Great Depression. Moreover, all corners of the globe are being affected: output per capita is projected to decline in countries representing three-quarters of the global economy, and growth in virtually all countries has decelerated sharply from rates observed in 2003–2007.” (WEO, 2009/b, page 9)

When comparing the October 2008 forecast of the World Economic Outlook to the two

subsequent updates and the April 2009 outlook (see Table 1), it is apparent that the IMF had to apply a series of downward revisions to its global forecasts between September 2008 and early April 2009. Parallel to that, the IMF had to use more and more serious categories in their evaluation of the world economy's situation.²³

Table 1 shows that the IMF lowered its global output forecast for 2009 by 3.7 percentage points and the forecast for 2010 issued in April 2009 was 2.7 percentage points more pessimistic than the related figure released seven months earlier. The macroeconomic outlook for the USA practically moved downwards parallel to that of the entire world economy, while the outlook for Japan and Russia worsened above the average (the latter obviously due to the dramatic fall of commodity prices on the world market) and anticipations decreased below the average in several important developing and emerging economies, principally in China and India. Inflationary expectations dropped significantly in each group of countries. With a view to already low former inflation rates, they may even give some ground for deflationary fears.²⁴ Interest rates that were not high before were pushed further down by the crisis and today we can hardly speak about positive real interest rates. (This is dangerous as it deprives governments from any elbow room in monetary policy.)

As forecasts worsened and were further adjusted downwards, the predicted start of recovery moved further and further into the future: while in September–October 2008 the IMF believed that recovery would begin in late 2009 (emphasising the anticipated low dynamics thereof), in April 2009 they forecasted it for Q4 2010. However, in June 2010, IMF first deputy managing director John Lipsky predicted that growth outlooks for 2010 would be improved slightly. (Lipsky, 2009) Lipsky's optimism was not based purely on empirical analyses. He emphasised that

Table 1.

SUMMARY OF WEO FORECASTS, OCTOBER 2008 – APRIL 2009

				Change 1.		Change 2.		Change 3.		Total change	
	2008	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010
World output	3.2	-1.3	1.9	-0.2	-0.8	-1.7	-0.8	-1.8	-1.1	-3.7	-2.7
Advanced economies	0.9	-3.8	0	-0.1	-0.8	-1.7	-0.5	-1.8	-1.1	-3.6	-2.4
USA	1.1	-2.8	0	-0.1	-0.8	-0.9	0.1	-1.2	-1.6	-2.2	-2.4
Euro area	0.9	-4.2	-0.4	-0.1	-0.7	-1.5	-0.7	-2.2	-0.6	-3.8	-2
Japan	-0.6	-6.2	0.5	-0.2	-0.7	-2.4	-0.5	-3.6	-0.1	-6.2	-1.3
Russia	5.6	-6	0.5	-0.2	-2	-4.2	-3.2	-5.3	-0.8	-9.7	-6
China	9	6.5	7.5	-0.1	-0.8	-1.8	-1.5	-0.2	-0.5	-2.1	-2.8
India	7.3	4.5	5.6	-0.1	-0.6	-1.2	-0.3	-0.6	-0.9	-1.9	-1.8
Brazil	5.1	-1.3	2.2	..	-0.5	-1.2	-1	-3.1	-1.3	-4.3	-2.8
Mexico	1.3	-3.7	1	-0.1	-0.9	-1.2	-1.4	-3.4	-1.1	-4.7	-3.4
Global trade	3.3	-11	0.6	-0.3	-2	-4.8	-2.5	-8.2	-2.6	-13.3	-7.1
Commodity prices (USD)											
Oil	36.4	-46.4	20.2	-10.6	-25.5	-17.6	9.7	2.1	0.2	-26.1	-15.6
Consumer prices											
Advanced economies	3.4	-0.2	0.3	..	-0.6	-1.1	-0.8	-0.5	-0.5	-1.6	-1.9
Emerging and developing economies	9.3	5.7	4.7	-0.2	-0.7	-1.3	-0.5	-0.1	-0.3	-1.6	-1.5
LIBOR											
USD	3	1.5	1.4	-0.2	-1.1	-0.7	-1.4	-0.2	-1.5	-1.7	...
Euro	4.6	1.6	2	-0.3	-1.2	-0.8	-0.8	-0.6	-0.7	-2.6	...
Yen	1	1	0.5	..	-0.2	..	-0.3	0	0.1	-0.2	...

Change 1 = 1 October – 6 November 2008
 Change 2 = 6 November 2008 – 28 January 2009
 Change 3 = 28 January – April 2009

Source: WEO 1 October 2008; WEO update – 6 November 2008; WEO update – 6 January 2009 and WEO April 2009. compiled by the author

“While the latest data point to a slowing of the global contraction, the timing and pace of the global economic recovery remains uncertain. Moreover, it is clear that whatever comes next will not simply be a return to the status quo ante. Rather, if a new global expansion is to be sustained, it will have to be based on rebalanced sources of growth across countries and regions. Moreover, the current crisis has made it abundantly clear that a substantial strengthening is needed regarding international collaboration in the design and implementation of economic and financial sector policies.” (Op. cit.)

“CRISIS LENDING” BY THE IMF²⁵

The IMF's “Emergency Financing Mechanism” was set up to manage the Southeast Asian crisis that broke out in 1997. Back then, loans were provided to the Philippines, Thailand, Indonesia and South Korea through this special lending mechanism.²⁶

The purpose of the emergency financing mechanism is to provide financial resources much faster than usual²⁷ in crisis situations to member countries that need it. This mechanism can be applied when a member state slides into an extraordinary financial position

where its financial stability is at risk and a quick response is required to eliminate the threats to that country or to the international financial system. The management of the IMF obtains information on needs for activating the mechanisms and a short written report is circulated among management members; as quickly as possible, an agreement is to be reached with the government of the member country concerned, then management can start negotiations within 48–72 hours. Under the emergency financing mechanism, the final decision on lending loan can be made extremely quickly.

In the global financial crisis that broke out in 2008, the following countries applied for an IMF loan until 21 May 2009: *Armenia, Belarus, Costa Rica, Salvador, Georgia, Guatemala, Hungary, Iceland, Latvia, Mongolia, Pakistan, Romania, Serbia, the Seychelles and Ukraine*. Although the loans were awarded and disbursed extremely quickly under the emergency financing mechanism, they were provided as stand-by loans through the IMF's first and still fundamental trademark facility, the stand-by lending arrangement. As of 21 May 2009, the IMF had 16 stand-by lending arrangements in effect²⁸ with an aggregate value of SDR 48.038 billion (USD 74.211 billion), of which SDR 27.012 billion (USD 41.729 billion) was disbursed to date.²⁹ In the form of stand-by lending arrangements approved under the emergency financing mechanism since early November 2008, SDR 11.443 billion has been disbursed to Romania (USD 17.676 billion), SDR 11 billion to the Ukraine (USD 16.993 billion), SDR 10.538 billion to Hungary (USD 16.279 billion), SDR 5.169 billion to Pakistan (USD 7.985 billion) and SDR 1.522 billion to Latvia (USD 2.351 billion)³⁰ among others (See Table 2).

Under the pressure of the crisis, the IMF significantly overhauled its lending framework. This reform was implemented at a speed

unprecedented in the IMF's history³¹ and basically encompassed six areas (IMF, 2009/c):

- *modernizing IMF conditionality for all borrowers,*
- *introduction of new, flexible credit line (FCL),*
- *enhancing the flexibility of the Fund's traditional stand-by arrangement,*
- *doubling access limits (credit lines),*
- *simplifying cost and maturity structures of lending, adapting them to the aforementioned changes,*
- *eliminating certain seldom-used facilities.*

The *modernization of conditionality* involves two areas. In the future, the IMF will not rely exclusively on traditional (ex post) conditionality as the basis for awarding and disbursing Fund resources but also on pre-set qualification criteria (ex-ante conditionality). This principle is embodied in the newly introduced *flexible credit line*.

The *Enhanced Stand-by Arrangement* was created to *increase the flexibility of the traditional stand-by arrangement (SBA)* the IMF's most widely used lending instrument since 1946. It can be disbursed for crisis prevention purposes to countries not entitled to flexible credit lines. The new SBA framework enables high-access on a precautionary basis and provide increased flexibility by allowing frontloading of access and reducing the frequency of reviews and purchases where warranted by the strength of the country's policies and the nature of the balance of payments problem faced by the country.

Non-concessional loan access limits for countries has been doubled – with the new annual and cumulative access limits for Fund resources being 200 and 600 percent of quota, respectively.³² Through the *Exceptional Access procedures*, higher loans will be available subject to case-by-case evaluation. The evaluation mechanism has been clarified and simplified.

Table 2

STAND-BY ARRANGEMENTS OF THE IMF AS OF 18 JUNE 2009

(SDR million*)

Beneficiary	Effective date	Expiration date	Amount agreed	Drawn to date	Available
Armenia	06. 03. 2009	05. 07. 2011	368	206	162
Belarus	12. 01. 2009	11. 04. 2010	1 618	1 100	518
Costa Rica	11. 04. 2009	10. 07. 2010	492	492	0
El Salvador	16. 01. 2009	10. 03. 2010	514	514	0
Gabon	07. 05. 2007	06. 05. 2010	77	77	0
Georgia	15. 09. 2008	14. 03. 2010	477	189	288
Guatemala	22. 04. 2009	21. 10. 2010	631	631	0
Hungary	06. 11. 2008	05. 04. 2010	10,538	4,215	6,323
Iceland	19. 11. 2008	18. 11. 2010	1,400	840	560
Latvia	13. 12. 2008	22. 03. 2011	1,522	986	535
Mongolia	01. 04. 2009	01. 10. 2010	153	153	0
Pakistan	24. 11. 2008	23. 10. 2010	5,169	2,533	2,639
Romania	04. 05. 2009	03. 05. 2011	11,443	7,073	4,370
Serbia, Republic of	16. 01. 2009	05. 04. 2010	351	351	0
Seychelles	14. 11. 2008	13. 11. 2010	18	11	6
Ukraine	05. 11. 2008	04. 11. 2010	11,000	8,000	3,039
Total:			48,038	27,012	21,059

* 1 USD = 0,647508 SDR, 1 SDR = 1,539473 USD (22 June 2009 exchange rates), SDR interest rate: 0.42%.

Source: IMF Financial Activities - Update June 18, 2009. <http://www.imf.org/external/np/tre/activity/2009/061809.htm> tabl2a

USE OF THE IMF'S FLEXIBLE CREDIT LINE AS OF 18 JUNE, 2009

(SDR million)

Beneficiary	Effective date	Expiration date	Amount agreed	Drawn to date	Available
Columbia	11. 09. 2009	05. 10. 2010	6,966	6,966	...
Mexico	17. 04. 2009	26. 04. 2010	31,526	31,526	...
Poland	06. 05. 2009	05. 05. 2010	13,690	13,690	...
Total			52,184	52,184	...

Source: IMF Financial Activities - Update June 18, 2009. <http://www.imf.org/external/np/tre/activity/2009/061809.htm> tabl2a.

An especially important or should we say the “most important” element of the IMF's lending framework reform is the introduction of the *flexible credit line (FCL)*.³³ The FCL is for countries with very strong fundamentals, policies, and track records of policy implementation which need this facility for crisis prevention. Access under the FCL would be determined on a case-by-case basis. Disbur-

sements under the FCL would not be phased or conditioned to policy understandings as is the case under a traditional Fund-supported program.³⁴ The IMF keeps emphasising that access to this facility is limited to countries with exceptional performance and very strong track records regarding all former IMF-supported programs.

The flexibility of this arrangement is princi-

pally manifested in the following (IMF, 2009/c) features:

- *Large and upfront access to Fund resources* – with no ongoing (ex post) conditions, enabling proactive action in managing economic problems;
- *Renewable credit line* – renewable at the borrower's discretion after six or twelve months;
- *Longer, 31/4 – 5 years repayment period*;
- *No hard cap on IMF credit line* and
- *Flexibility to draw at any time on the credit line* – treating it as a precautionary instrument.

In the course of qualification, the IMF expresses its confidence in the qualifying member's policies and ability to take corrective measures in economic policy when needed. The qualification process is intended to ascertain that the member has very strong economic fundamentals and institutional policy frameworks; it is implementing – and has a sustained track record of implementing – very strong policies; and remains committed to maintaining such policies in the future. The criteria for gaining access to flexible credit line resources are as follows (IMF, 2009/c):

- sustainable external positions;
- a capital account position dominated by private flows;
- a track record of steady sovereign access to international capital markets at favourable terms;
- a reserve position that is relatively comfortable when the FCL is requested on a precautionary basis;
- sound public finances, including a sustainable public debt position;
- low and stable inflation, in the context of a sound monetary and exchange rate policy framework;
- the absence of bank solvency problems that pose an immediate threat of a systemic banking crisis;

- effective financial sector supervision;
- data transparency and integrity.

Compliance with these criteria does not necessarily mean unconditional loan disbursement. When deciding on a potential FCL arrangement, the IMF takes into consideration all ongoing corrective actions in the country's economic policy. Between 17 April and May 11, 2009, the IMF disbursed three significant loans from the flexible credit line facility (IMF, 2009/d): Mexico received an FCL of SDR 31.528 billion (USD 48.705 billion), then Poland was granted a loan of SDR 13.690 billion (USD 21.149 billion). The third FCL loan was disbursed to Columbia in an amount of SDR 6.966 billion (USD 10.761 billion). Practically, all three countries used up the entire credit line almost immediately. This also proves the flexibility of the credit line facility since immediate drawdown is not possible with any other major IMF arrangement.³⁵

The *simplification of maturity structures and costs* also represents a full overhaul. The modernization of loan repayment resulted in a longer grace period and simpler repayment schedules. Repayment along a pre-defined schedule may reduce the burden on borrowers and mitigate the IMF's credit risks without discouraging early access to IMF resources.

The *reform of facilities for low-income country members* strengthens the IMF's ability to provide short-term and emergency financing to low income countries.

Under the *simplification of the lending toolkit*, the IMF terminated some lending facilities that have not been recently used.³⁶

The purpose of the *emergency financing mechanism* is to provide financial resources much faster than usual³⁷ in crisis situations to member countries that need it. (IMF, 2009/a) This mechanism can be applied when a member state slides into an extraordinary financial position where its financial stability is at risk and a quick response is required to eliminate the

threats to that country or to the international financial system. The management of the IMF obtains information on needs for activating the mechanisms and a short written report is circulated among management members; as quickly as possible, an agreement is to be reached with the government of the member country concerned, then management can start negotiations within 48–72 hours. Under the emergency financing mechanism, the final decision on lending can be made extremely quickly.

It was the *emergency financing mechanism* that enabled the 13 aforementioned member countries to access the stand-by arrangement much faster than usual³⁸. Furthermore, *draw-down was made flexible. The combination of these two elements constitutes a fundamental reform of the IMF's oldest and key loan arrangement.*

By all means, quickly disbursed loans are of fundamental importance for the countries that received it but there is a mutual interest here: *the IMF is the sole real beneficiary of the crisis as the financial turmoil allowed it to regain its former importance in the international financial and currency system, i.e. in the global economy!* This was obviously a surprise for the IMF itself, too. The US Treasury Secretary urged the significant increase of the IMF's financial resources and the “comprehensive reform of the global financial architecture”. (Beattie, 2009) G-20 finance ministers and central bank leaders have already agreed to boost the IMF's credit lines with USD 250 billion. (The Financial Times, 2009/a) While the European members of the G-20 do not support US plans for a “global stimulus package” that would try to render impetus to the world economy with contributions equalling 2 percent of the GDP of participating countries, “Mr. Geithner proposed a dramatic expansion of the International Monetary Fund's resources. European finance ministers, who live in fear of a contagious financial crisis in Eastern Europe, should welcome it even if it means they

get less influence over the fund. (The Financial Times, 2009/b) There are lots of ways to increase the IMF's resources, but raising money quickly may require the help of some donors – notably China – who would demand a greater say in the running of the fund. Europe's weight would be cut back. This is desirable in any case, and it would be a small price for the continent to pay in order to prevent a catastrophe on its eastern frontier.”

Pursuant to the agreement reached at the G-20 London summit (G-20, 2009), the IMF passed a resolution at its Spring 2009 session whereby member countries would immediately raise (i.e. double) IMF credit lines by USD 250 billion and expand from various resources the funds of the New Arrangements to Borrow (NAB) by USD 500 billion. (IMFC, 2009) Credit lines will be expanded through a raise of quotas while NUB funds that are intended to finance special lending arrangements will be provided from individual and voluntary contributions from member countries. The two largest contributions to date have been disbursed by Japan and the USA, each providing the equivalent of USD 100 billion.

SUMMARY AND OPEN QUESTIONS

The International Monetary Fund which was unable to make progress with its announced institutional, decision-making and lending reform since October 2005, *responded very quickly and effectively to the crisis that broke out in the autumn of 2008* (or rather which broke out in 2007 and became tougher than ever with the bankruptcy of Lehmann Brothers in September 2008 *and evolved into a global financial crisis at unbelievable speed*). An institution that used to be accused for decades of being slow, rigid and unable to change (on valid reasons), demonstrated unprecedented quickness, flexibility and efficiency!

The IMF gave up (probably put aside or suspended) its former neoliberal orthodoxy at breathtaking speed and began supporting and encouraging the plain Keynesian practice of “fiscal stimulus”. The recent publications of senior IMF staff members (Lipsky, 2009; Blanchard, 2009/b) suggest that the IMF has accepted the inevitable need for eliminating global financial imbalances.³⁹

It is strange though that the World Economic Outlook, a basic source and starting point of short-term growth predictions all around the world had to reassess its forecasts within six weeks after the October 2008 analysis. Then the update was further adjusted (downward in all key elements) ten weeks later and the forecasts in the May 2009 WEO were gloomier than ever (and thus more pessimistic than January predictions). This way, *while demonstrating spectacular improvement in the flexibility of lending and publishing several in-depth and critical (mostly self critical) analyses, the IMF was unable to orientate world economy players adequately through its single most important global analysis and forecast.*

However, some key questions about the IMF's future have remained open.

It is surprising somewhat that under the framework of “crisis lending”, the IMF provides *stand-by loans on simplified and shortened credit rating* and (rather unusually in IMF procedures) on *soft conditionality*. It is unclear though whether this will be a *lasting change* in the IMF's disbursement philosophy and practice.

Since October 2005, there has not been any significant progress in the IMF's institutional reform, in the rearrangement of voting proportions, decision-making mechanisms and the IMF organization. The crisis made it even clearer that the IMF cannot function efficiently while the current voting ratios are in place. While the operability of the international financial system

cannot be sustained without the active participation of China and while China can and must be a key source for expanding the IMF's resources, its quota and voting power in the General Meeting and the Board is smaller than that of the Benelux countries (as mentioned earlier)! This is obviously unsustainable. The increased role of G-20 countries and the fact that the G-20 summits in Washington (November 2008) and London (April 2009) were of decisive importance regarding the IMF's future highlighted the same trend.⁴⁰ The G-20, however, is an informal organisation with no own staff and secretariat (actually the IMF staff substitutes for the G-20 staff!) and it may easily take the place of the G-7/G-8. Still, the obvious increase in the importance of its global role cannot substitute for the long overdue restructuring and institutional reform of the IMF.

The success of plans to *increase the resources of the New Arrangements to Borrow by USD 500 billion is also questionable, along with the list of donor countries and the size of their contributions.* Between the G-20 decision on 2 April and early July, only the USD 100 million contributions of Japan and the USA could be regarded secured, with a USD 50 billion contribution from Saudi Arabia seeming likely. Plans to raise the remaining USD 250 billion through bond issuance still carry a number of uncertainties: neither the term nor the interest rates and the range of subscribers have been clarified. China seemed willing to buy long-term IMF bonds for USD 50 billion but India has some other preconditions, too. A potential failure to clarify the conditions of bond issuance and to make the necessary commitments until the October 2009 Annual Meeting of the IMF would not only put limitations to liquidity expansion but it would also mean a severe loss of face for the organisation.

NOTES

- ¹ For this study, I used a part of a manuscript titled “International economic organizations and the global economy crisis, 2008–2009” which I wrote for a research program of the Institute for World Economics of the Hungarian Academy of Sciences. The research program is named “Strategies for Hungary’s social and economic breakout: Challenges in a globalized world and on a historic crossroad affected by EU integration.”
- ² In some dynamically emerging economies, primarily in China, India and some other Southeast Asian countries, the term “crisis” did not (yet?) apply in April 2009. They were not even in a recession, only experienced a slowdown of growth. This group of countries is the very reason that global output is not decreasing significantly even though both IMF and OECD forecasts predict a GDP decline in developed countries in 2009. At the same time, the setback in developed economies and the shrinking of markets will obviously trigger a recession in the majority of developing countries. Still, as of the Spring of 2009, there is still a visible chance that some dynamically emerging economies with a large internal market (principally Brazil, India and China) may avoid the crisis.
- ³ With a view to the topic of this study, here we disregard the other historic lesson that the Bretton Woods system rested on: After WWII, the defeated countries were not excluded from Bretton Woods in order to avoid repeating the destroying effect of the peace treaties after WWI.
- ⁴ Op. cit. page 2
- ⁵ We closed the collection of materials with the documents of the IMF’s Spring meeting held 25–26 April, 2009.
- ⁶ About the loss of significance of the IMF and the reform plans outlined in 2005–2006 see Csáki, 2006
- ⁷ The term “Reserve-pooling” comes from the original text.
- ⁸ Naturally, many people thought so earlier as well. In August 2006, the *Le Monde* published an extensive set of articles about the perspectives for the IMF. Michel Camdessus (former IMF managing director over three cycles) was not the only one who represented the opinion that “there has never been this big an imbalance between debtor and creditor economies. The USA has never accumulated so large deficits and China has never accumulated this large surpluses. Add the geopolitical crises and the energy crisis to that and we can easily understand that in a world like this the risks of a financial crisis cannot be considered distant threats. If the IMF was to be wound up, it would have to be re-established immediately. In a time when immense opportunities co-exist with similarly immense risks, the world needs an institution that is able to bring countries to the same table.” A critic of the IMF, Barry Eichengreen would like to see the IMF function as a “marriage consultant” that is able to convince the “vicious couple” to take reasonable action, i.e. persuade the USA to raise taxes and China to spend more on education, public health and infrastructure. (...) the IMF remains the most suitable forum for that.” [Faujas, 2006]
- ⁹ Collins, Charles (2008): *The Crisis through the Lens of History*. The current financial crisis is ferocious, but history shows the way to avoid another Great Depression.; El-Erian, Mohammed A. (2008): *A Crisis to Remember*. The case for modernizing the multilateral framework; Ingves, Stephan – Lind, Göran (2008): *Stockholm Solutions*. A crucial lesson from the Nordic experience is the need for prominent state involvement in crisis resolution; Kang, Kenneth – Syed, Murtaza (2008): *The Road to Recovery*. A View from Japan. Strategy for addressing both liquidity and solvency issues is needed. In: *Finance & Development*, Volume 45, Number 4. December.
- ¹⁰ Op. cit. page 9
- ¹¹ “The financial landscape will look dramatically different.”
- ¹² There is no better proof of attention than the fact that Samuel Brittan, the doyen of the economic policy writers of the *Financial Times* devoted an extensive article to present the key findings of these three authors. [Brittan, 2009]
- ¹³ Pp. 26–28. The article summarizes the main findings of an extensive study published under the title *IMF Working Papers 08/274*.
- ¹⁴ As it is well known, these two recessions in 1974–1976 and 1979–1982 were preceded by oil price explosions.
- ¹⁵ Op. cit. page 28

- ¹⁶ Besides the study to be discussed herein: Finance & Development (2009): Deep Impact. Four countries confront the harsh and disruptive effect of the global economic downturn. Volume 46, Number 1. March.; Cottarelli, Carlo (2009): Paying the Piper. The role of medium-term fiscal policy in rebounding from the crisis; Kodres, Laura – Narain, Adyta (2009): What is to be done. The scope of financial regulation needs to be revamped and the provision of liquidity improved. Here's how; Milesi-Ferretti, Gian Maria (2009): Changing Fortunes. Finance & Development, Volume 46, Number 1. March
- ¹⁷ Op. cit.
- ¹⁸ In this specific context, the word “inclusive” refers to the fact that new players have entered the group of countries that define the power relations in the world economy. The reference is obviously about the BRIC countries.
- ¹⁹ I.e. fear from the not objectively unknown.
- ²⁰ The Bretton Woods system was obviously the manifestation of a kind of “collective Keynesianism”. Each of its three principles and the statutes of all three basic institutions were inspired by Keynesianism. The “only” exception was that instead of the artificial currency proposed by Keynes, the US dollar became the key currency of the Bretton Woods financial system...
- ²¹ The World Economic Outlook (commonly abbreviated as WEO) is published twice a year: for the spring and annual meetings of the IMF and it is freely downloadable from the IMF home page. (Currently the issues published since 1998 to date are available for downloading. See: <http://www.imf.org/external/ns/cs.aspx?id=29>. The WEO database can be accessed separately and includes all tables published in WEO issues since April 1999. See: <http://www.imf.org/external/ns/cs.aspx?id=28>.
- ²² The 1 October 2008 issue of WEO was available on 22 September already at the IMF's home page, thus it is likely to have been prepared prior to the 15 September collapse of Lehmann Brothers and therefore it actually reflected opinions and conditions as of early September 2008.
- ²³ As mentioned before, the terminology applied in IMF analyses progressed from setback through recession to crisis.
- ²⁴ Deflationary fears are fuelled extensively by experiences with Japanese recession and stagnation in the nineties.
- ²⁵ The term “crisis lending” represents IMF parlance
- ²⁶ “Emergency Financing Mechanism” (IMF, 2009)
- ²⁷ “At short notice” in IMF parlance.
- ²⁸ Beside the 8 countries listed, Salvador, Gabon, Honduras, Iraq and the Seychelles were in a stand-by borrowing agreement as at the end of 2008.
- ²⁹ See IMF, 2009/b.
- ³⁰ Five additional countries were granted stand-by loans of USD 1.36 billion in total as at the end of 2008: with a view to this figure, we could rightfully call the IMF's position “insignificant” as in the autumn of 2008.
- ³¹ This unprecedentedly quick change in the more than six decades of the IMF's history probably reflects the fact that IMF management has graded the crisis since October 2008 as an extremely severe global crisis that is only comparable to the Great Depression of 1929–33. While even the IMF's institutional reform (the transformation of quotas, voting rights and management bodies) made hardly any progress since 2005, under the squeeze of the crisis the IMF was able to overhaul its entire lending mechanism within a few weeks!
- ³² These are stand-by loans disbursed from the “regular lending arrangements” of the IMF, extended stand-by loans and loans provided from the extended credit facility. Concessional loans are arrangements provided to the poorest countries on especially favourable conditions and in response to one-off circumstances like natural disasters, sudden fall of export revenues, etc.
- ³³ The IMF considers the Flexible Credit Line an element of the modernization of conditionality. It is perfectly reasonable from the standpoint that the access mechanism reflects a significant simplification and improved flexibility of conditionality. At the same time, the FCL's declared purpose of “crisis prevention” represents a significant departure from the traditional goal of stand-by loans, the management of short term current imbalances.
- ³⁴ The FCL replaces the former short-term liquidity facility (SLF) thus its flexibility is usually measured against that of the SLF.

- ³⁵ This shows well that the flexible credit line is not only flexible in terms of conditionality but also in terms of phasing.
- ³⁶ Two credit arrangements were eliminated: the supplemental reserve facility, created in the wake of the Southeast Asian crisis of 1997 and available for financing extraordinary current account deficits triggered by sudden and extensive loss of market confidence. This arrangement was made unnecessary by the overhaul of crisis lending. The compensatory financing facility used to provide low amounts up to 20 and 10 percent of quotas to finance lost export revenues and the increasing costs of grain imports. Due to the insignificance of accessible amounts, there was hardly any demand for this facility.
- ³⁷ "At short notice" in IMF parlance.
- ³⁸ Formerly the awarding of stand-by loans was preceded by at least six months of negotiations, multiple iterations between the IMF and the potential borrower and finally by multi-step and lengthy decision preparation. The emergency financing mechanism was used during the Asian crisis in 1997, providing stand-by loans to the Philippines, Thailand, Indonesia and South Korea and then to Turkey in 2001.
- ³⁹ The IMF's first deputy managing director and chief economist explained on the same day that long-term recovery cannot happen unless internal consumption decreases and private savings increase in the USA while the opposite happens in China. So many have said for a long time that the constant and growing increase of the US current balance deficit is unsustainable (just like the mirror image of this phenomenon, the growing current balance surplus in China) that it is a cliché now. However, as undoubtedly the USA has been the engine of the world economy since 1990, it is an open question whether a significant decrease of (import) demand in the US would hinder global recovery and upswing amidst the current worldwide crisis.
- ⁴⁰ The unexpected growth in the significance of G-20 countries, their fundamentally changed role in the world economy deserves a separate study. Discussing it herein would stretch the scope of this paper beyond reasonable limits.

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The relationship between the Lisbon Strategy and tax policy in the context of the economic crisis

Ten years after the collapse of the East Central European planned economic systems, the European Council set out a ten-year economic modernization agenda at its March 2000 session in Lisbon. The aim of the ambitious concept called Lisbon Strategy, is to make the European Union “the most dynamic and competitive knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment by 2010” (European Council, 2000). The Lisbon Strategy rests on the following three pillars:

① *Economic pillar*: it aims at establishing a competitive, dynamic knowledge-based economy, putting emphasis mainly on research and development (R&D).

② *Social pillar*: it aims at forming an information society that can be characterized by investing into human resources and avoiding social exclusion.

③ *Environmental pillar*: its essence is to make economic growth sustainable and based on natural resources.

This strategy provides for the adaptation and strengthening of the earlier Luxembourg process for employment, the Cardiff process for the improved functioning of the internal market and the Cologne process supporting the macroeconomic dialogue. The implementation

of the Lisbon Strategy, at the same time, covers economic policy areas which fall overwhelmingly within the exclusive competence of the Member States. Therefore, the Lisbon Program has strengthened the existing coordination mechanisms and introduced a political innovation called Open Method of Coordination (OMC), which is based on the mutual information and monitoring of the Member States.

Open Method of Coordination

As part of the Lisbon Strategy, the open method of coordination provides a new framework for cooperation between the Member States to reconcile their national policies towards certain common objectives. This intergovernmental method is applied in areas which fall within the competence of the Member States, such as employment, social policy, education and training. The method is principally based on jointly defined objectives adopted by the Council, jointly established measuring instruments (statistics, indicators, guidelines), on the comparison of the Member States' performance monitored by the Commission and the exchange of best practices.

Depending on the areas concerned, the OMC also includes “soft law” measures that are compulsory for the Member States in varying degrees but which do not take the form of directives, regulations or decisions. Thus, Member States have to prepare national reform plans, for example, which are submitted to the Commission. (SCADPlus)

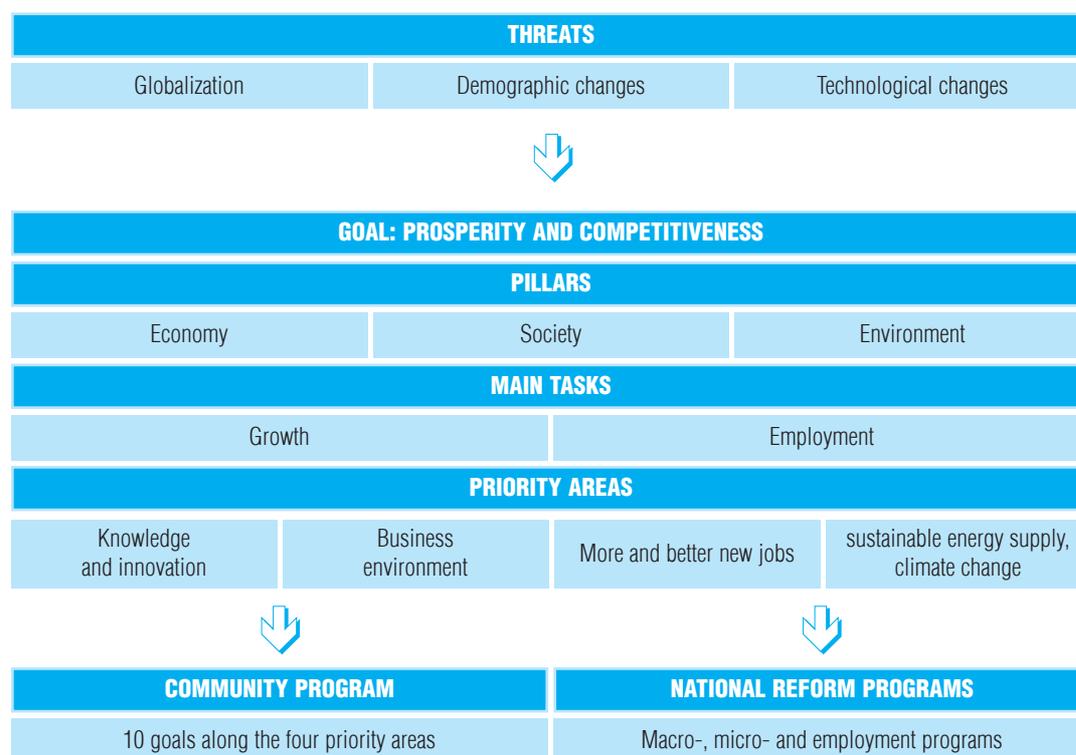
THE DEVELOPMENT OF THE LISBON STRATEGY IN A NUTSHELL

Five years after the start, the repeatedly reviewed and expanded strategy reached its half-time but was still only at its first steps concerning the achievement of its goal (Sapir et al., 2003; European Community, 2004). For this reason the program was relaunched in 2005 after a necessary simplification and renewal, with a focus on employment and economic growth (European Commission, 2005a). In the spring of 2005 the program still contained more than 100 goals and numerous detailed guidelines, which led to a mix-up in the National Programs and an implementation deficit in the realization of the goals, especially with respect to national structural modernization. In order to give new impulse to the implementation of the strategic goals, the targets were rationalized and the actions of the Union were made more focused.

The restarted strategy is based on European and national partnership; its success depends on the determination of the Member States to undertake reforms. National actions for reform are now complemented by actions implemented or coordinated at the Community level, which provide for important added value through the Community Lisbon Program. Planning occurs in three-year cycles; the Commission presents a Community Lisbon program and the Member States develop national reform programs and annual reports on their progress. In 2006 the European Council defined four priority areas to focus the Lisbon Strategy: investing in knowledge and innovation, providing a more favourable business environment, creating more and better jobs and adapting to the challenges of energy and climate changes. (See Chart 1)

The former economic and employment policy guidelines have been henceforth presented

Chart 1



jointly in integrated guidelines, which contain 24 intermediate targets altogether for macroeconomic, microeconomic and employment policies (European Commission, 2005c; European Commission, 2007). The greatest task for Member States is to designate the instruments for implementing the renewed strategy according to national characteristics (Kovács, 2007).

There have been numerous debates, both at the national and Community level, on the future of the Lisbon Strategy, which is currently in its second and thus, according to the agenda, last three-year cycle (Cohen-Tanugi, 2008; Austrian Federal Ministry of Economy and Employment, 2008). The evolving economic and financial crisis has, on many occasions, led to taking contradictory measures and intensified the discourse.

CONCEPTUAL FUNDAMENTALS

The Lisbon Program is in fact the European Union's supranational economic policy answer to the accelerating globalization, the consequently intensifying economic competition as well as the worsening demographic situation of the Union caused by the ageing of the population and the shrinking of working-age population. While trying to make the EU more than the sum of its parts, meaning the Member States, the strategy builds on synergy effects to enable it to keep pace with the growth and the productivity of the USA and Far Eastern countries.

The concept is led by the macroeconomic recognition that increasing prosperity can be accomplished through raising productivity and employment, which can be achieved by improving competitiveness. In the globalizing world, economic systems with different structures and policies compete with one another. Individual regions and their decision makers experience the com-

petition in different ways, still, almost everywhere, action is taken in the direction of improving competitiveness. There are different policy areas and strategies that can lead to a more favourable relative competitive position, which can have either a positive or a damaging impact on all competitors as well as on the competition itself (“systems' competition”).

The national economic policy of states can be aimed, for example, at the public takeover of activities where the market failed. The subsequent introduction of a market in the form of a competition among states can lead to failure once again, however (“selection principle”: Sinn, 2003), which can be regulated only jointly or at a higher level. Tax policies or tax competition in an effort to underbid one another in order to encourage settling in companies can result in a so-called “race to the bottom” phenomenon, in the underfinancing of public goods and the overtaxation of less mobile factors, especially labour. Tax harmonization aiming at avoiding tax competition can on the other hand lead to an oversupply of public goods, in particular of infrastructure. The competition of regulators – the relatively slacking financial regulations in the United Kingdom or Ireland, for example – can, however, lead to insufficient regulation and the socialization of business risks.

Though the European Union has no single social model, solidarity as a value is shared by all Member States, but is realized through extremely different tax burdens and national tax systems in the 27 countries (European Policy Centre, 2004; Sapir, 2006). *André Sapir*, for example, divides the social models of the EU Member States into four categories according to efficiency and equity: Continental, Mediterranean, Anglo-Saxon and Nordic. *Social models become unsustainable mainly because of the lack of efficiency, which can make the Lisbon Process unfeasible and deteriorates the competitiveness of the EU.* The current social

inequalities between and within the Member States can hinder the efficient functioning of the internal market (Sapir, 2005).

Tax policy holds a lateral, cross sectional function within the national and also the supranational economic systems. Let us just think of the three pillars (economic, social, and environmental), which are all affected by tax policy, or of the reform of the social and economic models. The Lisbon Program does not attempt to harmonize tax rates but strives to accomplish an appropriate tax coordination, which can contribute to making the benefits of tax competition available to the widest possible circle of market participants. With the progress of the Lisbon Concept, there has been growing emphasis on taxation. The current crisis did not break this trend; it has just made it more complex.

THE CONTRIBUTION OF THE TAX POLICY TO THE LISBON PROGRAM

The Lisbon Strategy renewed in 2005 attempts to make Europe an attractive place to invest and work, in order to encourage growth and employment. Therefore, the EU forms and coordinates the various policies in a way to stimulate economic growth and ease job creation for enterprises. (European Commission, 2005a)

It is obvious that tax policy can play a significant role in the attainment of these objectives, since it can notably contribute to raising the efficiency of the economy, increasing competitiveness as well as to giving incentives to trade and innovation. Broadening the circle of taxable persons, for example, is an effective way to raise legal employment and tax revenues without increasing tax rates. Restructuring the tax system (decreasing labour taxes and increasing the tax burden on consumption and pollution) could also help to raise employment. The rela-

tive high tax burden on labour, however, hinders the creation of new jobs, especially in case of low skilled workforce. These correlations have certainly been recognized by Member States well, which has resulted in an intensified tax competition among Member States as well as a growing number of tax reforms. (European Commission, 2005b) The costs of the tax system are the deadweight loss related to the substitution effect on the one hand as well as the administrative burdens and the compliance costs of the taxpayers and the tax administration on the other hand. It is no wonder therefore that the main elements of the *tax reforms* are *low marginal tax rates, flat taxes and tax simplification*.

Code of Conduct

Already in the nineties, the EU and the OECD were faced with the dilemma that, while fair and limited tax competition could have favourable economic effects, unlimited and harmful tax competition was to be fought, however. The conclusions of the Council of Economic and Finance Ministers (ECOFIN) of 1 December 1997 included the so-called Code of Conduct for *company taxation*. By the adoption of this legally not obligatory but politically significant instrument, the Member States have undertaken to roll back existing tax measures that induce harmful tax competition and refrain from introducing any such regulation in the future ("standstill").

For the purpose of filtering out harmful measures, the Code sets out various criteria. Taking the advantages of fair competition into consideration, the Code of Conduct focuses especially on detecting tax measures (legislative, regulatory, administrative) that are targeted at non-resident companies exclusively, providing them with a more favourable tax treatment than is general in the Member State concerned. These Member States unduly influence the location of business activity within the Community.

The criteria for harmful measures are the following:

- the actual level of taxation is significantly lower than the general level of taxation in the Member State concerned,

- tax benefits granted to non-resident companies,
- tax incentives for activities that are isolated from the domestic market and have therefore no impact on the national tax base,
- granting tax benefits even in the absence of real economic activity,
- the profit calculation of a member of a multinational company group diverts from internationally accepted rules, in particular from those approved by the OECD,
- lack of transparency.

On 9 March 1998 the EU's Finance Ministers established the Code of Conduct Group, which assesses the corporate taxation measures of the Member States falling within the scope of the Code. In November 1999 the Group identified 66 tax measures as troublesome; the Member States concerned have begun their revision or replacement accordingly.

On the basis of a grandfathering clause devised for the beneficiaries of such measures of before 2000, tax benefits are to be granted by 31 December 2005 at the latest, whether or not they were to be granted for a fixed period originally. However, there has been an agreement to extend some of the benefits for defined periods beyond 2005 as well. Since then, the Group has regularly reported on the measures of the Member States to the Council.

Within the framework of the Code of Conduct, the Commission has also committed itself to publishing guidelines on the application of state aid rules relating to direct corporate taxation. Moreover, the Commission urges more transparency and information exchange in the field of corporate taxation and wishes to implement coherent EU policies concerning offshore financial centres.

In 1998, the OECD also established a special forum in order to abolish harmful tax practices. The forum aimed at involving tax havens and non-OECD economies as well and it worked out a tax agreement model on the exchange of tax information. (Website of DG Taxud)

The main objective of the tax system is, however, to provide the necessary financial resource for public redistribution in the most efficient way possible (Stiglitz, 2000). Therefore tax policy falls basically within the

competence of the Member States, while, at the EU level, a unanimous decision by the Member States is required in tax issues. Nevertheless, the common single market based on the four rights of freedom, namely the free movement of goods, services, capital and persons, and the tax policies of the Member States also affect one another. Consequently, there is a need for coordination at the EU level regarding tax policy issues in order to ensure that the measures of Member States should, by fostering one another, serve the implementation of the Lisbon strategy.

The diversity of the national tax systems in fact involves considerable administrative burden in terms of compliance cost. Double taxation, tax-based cost planning and the differences in the tax rules of Member States hinder the effective functioning of the competitive single market. The removal of the Community's tax barriers could create new opportunities for market entrants, investment and innovation. As a result of that, the competitiveness of the EU would improve, which would in turn foster both economic growth and the creation of new jobs (European Commission, 2005b).

As a consequence of globalization, cross-border activities have intensified and their importance has substantially increased. Internal market integration has accelerated, its role has grown, while, at the same time, the demolition of tax barriers could often not keep pace with this progress. Accordingly, taxation obstacles increasingly obviously prevent the advantages of the single market from being fully exploited.

THE TAX POLICY INSTRUMENTS OF THE RENEWED LISBON STRATEGY

In its Communication of 25 October 2005 (European Commission, 2005b), the Commission proposed the implementation of tax measures

that could help to attain the objectives of the renewed Lisbon strategy. The two main goals of the Lisbon Program are to provide more attractive investment and work conditions in the Community and to boost economic growth through the promotion of knowledge and innovation. The tax measures concern the fields of company income tax (CIT) and VAT primarily. While the legislation of VAT, as it is one of the main resources of the EU's budget, is already harmonized at the Community level within the framework of the 2006/112/EC directive, in the case of CIT, the creation of new Community legislation would be necessary, however.

THE AIMS OF THE TAX MEASURES PROMOTING INVESTMENT AND MARKET INTEGRATION are to extend and deepen the internal market, create open and competitive markets inside and outside the EU as well as improve the European and national regulatory environment.

① Since there is no obligation to harmonize CIT rules at the EU level, there are most diverse CIT systems functioning simultaneously in the various Member States. The co-existence of various national tax systems hinders the deepening of the internal market, however. This involves compliance costs for transnational companies on one hand and provides an excellent opportunity for tax avoidance on the other hand. Corporate tax rules treat cross-border activities within the Community differently from domestic activities, which may encourage firms to rather act and invest domestically. In 2001, the Commission proposed to introduce a *Common Consolidated Corporate Tax Base (CCCTB)* in order to deepen the integration of the internal market. This means that companies operating in the internal market would calculate their tax bases according to same rules in different Member States. Besides increasing transparency, CCCTB would solve the cross-border off-setting of losses and numerous tax problems

linked to cross-border activities. Nonetheless, the Commission has always emphasized that it had no intention to make a proposal for a harmonised CIT rate, i.e. each Member State could apply its own tax rate to the CCCTB.

② The Commission, depending on the realization of the CCCTB, has proposed other targeted measures in the field of company income tax in order to *eliminate cross-border tax obstacles*.

▶ Most Member States allow the *relief for cross-border losses* only within one firm, but there are a few countries that allow the setting-off of such losses within a corporate group. This practice distorts internal market competition since it gives tax incentives to companies to invest domestically.

▶ One instrument available for companies to optimise their CIT payable is the application of *transfer prices*. Therefore, transfer price management is part of the compliance costs involved in the diverse company tax systems of the Member States. In 2002, the Commission established the EU Joint Transfer Pricing Forum and made a proposal for working out a Code of Conduct concerning the documentation of transfer pricing.

▶ Some Member States apply *capital duty* in line with the Council Directive 66/335/EEC. This is disadvantageous for EU companies that start a business, restructure operations or increase their capital. In order to encourage investments and support the development of EU companies, the Commission urges cutting back the capital duty.

③ It is mainly transnational companies that are present at the single market and the Common Consolidated Corporate Tax Base would benefit these companies principally. At the same time, *simplifying the tax environment and creating a level playing field* are also among the objectives of the Commission which has, accordingly, tabled a package of measures that would foster the trade of primarily small and medium enterprises (SMEs) at the internal

market. SMEs in fact face, especially in the field of VAT, relatively higher compliance costs than large companies. To facilitate the entry of SMEs to the single market, the Commission has come forward with the following five proposals:

- ▶ Concerning company income tax, the Commission urges the introduction of *Home State Taxation for SMEs as a pilot-scheme for five years*. The point of this concept is that qualifying companies would apply the corporate tax rules of their residence state to subsidiaries and permanent establishments in other Member States. This would require the mutual recognition of the corporate tax treatment of SMEs, while tax rates would continue to be set by each Member State individually.

- ▶ The Commission would simplify the cross-border VAT compliance obligations. One of the main elements of the proposal is the introduction of the *one-stop shop system*, which would allow enterprises to use a single VAT number for all transactions within the EU and to prepare a single global VAT declaration which could be submitted through an electronic portal. The one-stop shop system would then submit the tax return automatically to Member States where the trader has had taxable activities.

- ▶ The spreading of cross-border *international services* (e.g. broadcasting, telecommunication, e-commerce) is a serious challenge for the EU. VAT legislation, with respect to the places of services, has to be coordinated in order to ensure equal treatment for operators both from EU and third countries also in the case of long distance services. Furthermore, VAT revenues have to be guaranteed for all Member States where the services concerned are used. The Commission would amend legislation on the place of supply for both services between taxable persons (B2B) and those supplied to end consumers (B2C) in order to eliminate the additional VAT registration requirements and costly refund procedures for service providers.

- ▶ The general exemption of *financial services* is based on a VAT legislation of more than 30 years. This means that VAT paid by financial institutions on their inputs is not deductible and it thus becomes a cost factor for them. They can pass on these costs incorporated in the price of the financial services to their business clients, who are similarly unable to apply the right of deduction because the service is VAT exempted. This cost factor deteriorates the efficiency of the financial market because of which the Commission is to revise the legislation of financial services, involving those concerned.

- ▶ Similar to the financial services, the VAT rules on *services of public interest* also need to be revised since public administration organs are currently out of the scope of VAT. Taking into account that, in certain areas, there are private organisations, too, participating in supplying public services beyond public administration organs, the Commission intends to amend the current legislation with the aim of guaranteeing equal treatment.

- ④ *A simpler and more transparent legislative background* also helps lift the anomalies of the internal market and intensify competition. Considering that there is substantial EU legislation on indirect taxes, the Commission focuses on the *more uniform application of the VAT system* primarily. Since 2007, the 6th VAT directive has been replaced by the 2006/112/EC directive, which has made the Community VAT legislation more transparent. Moreover, a more uniform application and implementation of the VAT rules is necessary, as taxpayers and tax authorities often interpret the EU VAT law differently. A typical consequence of the divergent interpretations of the law is double taxation or even non-taxation. The adoption of binding secondary VAT legislation (regulations) could remedy that, since it is increasingly difficult to find orientation among the numerous judgements of the European Court of Justice.

⑤ *Forcing back tax fraud* is a common interest of the EU, Member States and lawful enterprises. On the one hand, both the EU budget and the Member States suffer losses of revenue through fraudulent action, because of which the latter may even be compelled to increase taxes. On the other hand, enterprises committing tax fraud gain unfair competitive advantage over lawfully operating firms since the former realize higher profits while keeping “tax costs” lower and are not affected by tax increase, either. Although the operation of tax systems falls within the competence of Member States, a coordinated Community approach may improve the efficiency of the fight against tax fraud. Accordingly, in its 2006 communication, the Commission outlined the main elements of the anti-fraud tax policy at the EU level, which concern the field of VAT as well as of cooperation and information exchange among Member States primarily.

⑥ One of the reasons for the fragmentation of the European car market and for the limited cross-border car trade is the considerable difference in registration tax among Member States. In order to exploit the advantages (competition, economies of scale) of the single market in a more efficient way, the Commission calls for the *gradual abolition of car registration taxes* in Member States or their replacement by annual circulation taxes or by other innovative taxes. With the help of the gradual abolition of registration taxes, the car market would become more transparent, bureaucracy and the existing great differences in car prices would decrease in the Member States.

TAX MEASURES SUPPORTING KNOWLEDGE AND INNOVATION are aimed at fostering investment in research and development (R&D) in order to boost economic growth, and at facilitating the sustainable use of resources. The reason for giving incentives to company R&D investments is that it has positive external spillover effects, however, due to the high-level

investment demand of R&D and the long pay-back period, without state intervention, the level of business research and development would generally remain below the socially optimal level. The sustainable use of resources can be relatively easily influenced by indirect taxes (e.g. excise duties, energy and car taxes). With the help of taxes, negative externalities can be internalised (the so-called Pigou-tax), while price increase may encourage innovation and the change of consumption patterns. In the case of both instruments, coordination at the EU level is desirable in order to tackle internal market distortions.

① The purpose of *R&D tax incentives* is to boost R&D investments by reducing their costs. At the EU level, this can be accomplished by improving legal security, applying coordinated approaches (e.g. spreading best practices) as well as by combining private and public sources. The Commission does not intend to introduce mandatory regulation beyond the coordination. Nonetheless, Member States have to bear in mind that the EU strictly regulates the framework of state aid in order to avoid competition distortions.

② So as to encourage the *sustainable use of resources*, the Commission is to review the Energy Tax Directive and draft more ambitious environmental targets. Furthermore, it wishes to introduce an environmental (CO₂-emission sensitive) element into car taxation. In the case of excise duties, the Commission aims at raising minimum tax levels and, so as to eliminate competition distortions at the haulage market, it urges convergence in the levels of excise duties on diesel.

Considering the above measures, it can be easily established that, except for the Common Consolidated Corporate Tax Base, these EU level tax policy instruments serve the improvement of the efficiency of the current system. It is also obvious, however, that taking the competence of the Member States and the unani-

mous decision making procedure in the Council in field of taxation into consideration, the Commission did not table as ambitious tax policy proposals as would follow from the Lisbon strategy. In the following, we shall briefly demonstrate the low-key character of the tax measures so far implemented within the framework of the Lisbon strategy, through the example of Hungary.

As a result of the renewed Lisbon strategy, Hungary has taken steps in four different fields of tax policy (Republic of Hungary, 2008). The recodified Act 127 of 2007 on VAT, which closely follows the structure and logic of the 2006/112/EC directive, is meant to foster the uniform interpretation of the legislation.

The main task of the program called “Fine-tuned to Businesses” was to reduce administrative burden. The aims of the program, launched at the end of 2006, are to simplify company and tax administration, strengthen legal certainty for enterprises, improve financial operating conditions and make competition fairer and more transparent. In 2007, as a result of this program, enterprise start-up became simpler and faster in Hungary, the number of the various tax declarations was reduced by about fifty percent and it was made possible to use the same forms for tax declaration and self-revision. Furthermore, the use of fill-in guides and check programmes has become more widespread. In order to widen the scope of e-administration, since 2008, taxpayers performing their tax declaration obligations electronically have been able to obtain their „zero„ tax certificates and make queries concerning their current tax account balance through electronic means. Moreover, the electronic company registration procedure has become mandatory and payment by credit card has been ensured at branches of the Revenue Office.

With the aim of limiting tax fraud, the rules on invoicing and on suspending tax registration numbers have been tightened. Tax and contri-

bution bases have been broadened (since 2006, contributions have had to be paid on the basis of at least twice the minimum wage) so as to narrow the possibilities of tax avoidance and reduce the black economy. The review of fictitious employment contracts, stricter labour surveillance as well the reinforcement of the organisations of the Hungarian Customs and Finance Guard, the Revenue Office and the Consumer Protection Authority, the broadening of their competence and the coordination of their activities have also facilitated the fight against fiscal fraud. Strengthening the social insurance character of health insurance contribution payment has, by confirming the connection between the insurance and its utilization, contributed to increasing the efficiency of the supply system (Republic of Hungary, 2007).

In 2007–2008, excise duty rates were differentiated according to the composition of biofuels. Through the lower tax burden, both the production of biofuels and the sustainable use of resources are encouraged. Moreover, in 2009, the scope of Act 88 of 2003 on energy tax was widened to cover coal as well. In case of registration tax, tax rates are dependent both on the environmental classification and the cylinder capacity of the engine. At the same time, registration tax revenues have been decreasing as a result of the tax competition with Slovakia and the worsening crisis in the car industry.

PERSPECTIVES AGAINST THE BACKGROUND OF THE CRISIS

There is a worldwide consensus that the current financial and economic crisis calls for immediate government intervention. In many cases, the action urges the use of the instruments of traditional business cycle policy like enhancing demand or the government's assuming financial risks. Demand-oriented economic

policy follows a different philosophy from that of the Lisbon Strategy, which is based on structural reforms and is often categorized simply as a supply-side economic policy. Owing to these differing views, the strategy has been repeatedly under attack; as a consequence of the crisis, it has been called outdated or invalid.

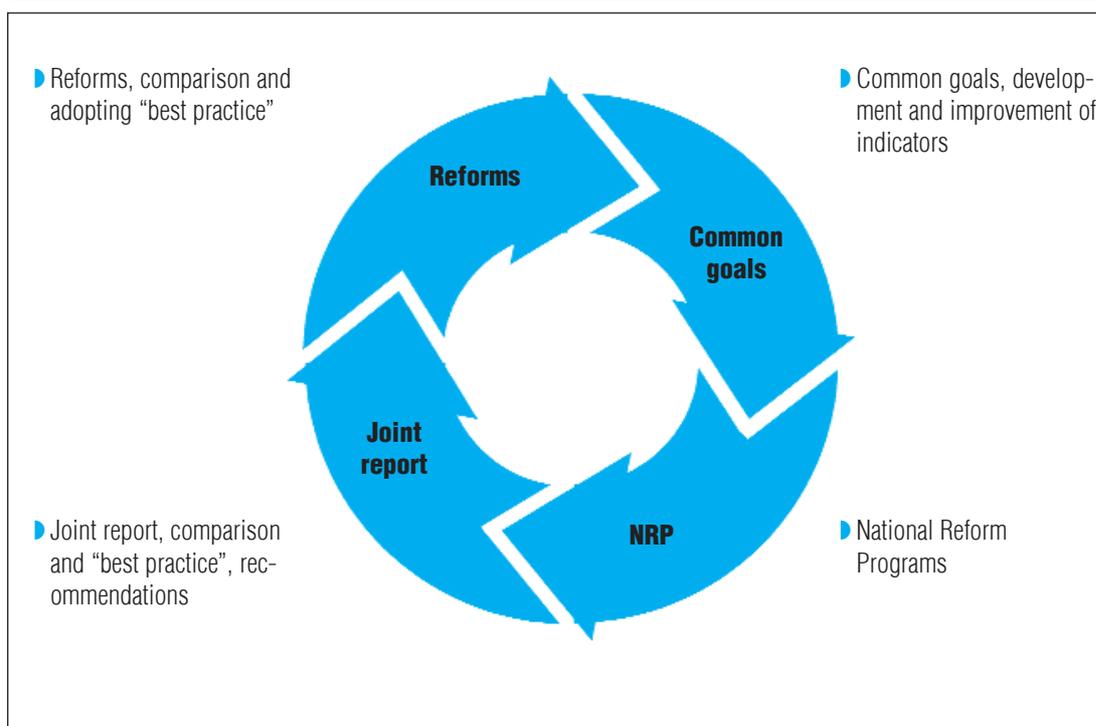
The Lisbon Strategy is a comprehensive dynamic learning process, which addresses the challenges of the diversity of the European Union and of changes simultaneously. Its development so far should be interpreted also in this context rather than solely in an actual-target comparison. The open coordination method serves as the integration and change management instrument of the strategy. There are supranational forums and actors complementing the formerly exclusively national economic policy. The exchange of experiences and learning take place through the formulation of short, medium, and long-term European guide-

lines and deadlines, quantitative and qualitative indicators, benchmarks showing best practices, the transfer of guidelines into national policies, regular monitoring and mutual peer-review (see *Chart 2*).

This multilevel and multilateral change management aims at creating a new economic structure that is flexible and which stimulates and stabilizes at the same time. Accordingly, the Lisbon Program, although it is based on a future vision, is retrospective; it adapts to the environment, the resources and the goals and combines competitive advantages with opportunities. In this dynamic process that is based on regular feedback, the Union assumes the leading and coordinating role, while execution and the creation of a favourable economic environment are the tasks of the Member States, who can also learn from the parallel political innovation experiments of one another. The EU's diversity and parallelism are

Chart 2

LEARNING CYCLE IN OPEN METHOD OF COORDINATION



advantages in this concept: the process is thus faster, more efficient, and it can lead to higher quality results than in an exclusively hierarchical system.

Government intervention aiming only at correcting the effects of the economic cycle does not meet global structural challenges. Such unique and provisional measures may be taken at the expense of trust, predictability and plannability. This is especially true for tax policy, since the tax systems in the European Union require modernization from a structural aspect as well.

Trends

- ▶ The Lisbon process and economic policy will be influenced by economic cycles, crises and favourable effects in future as well:
 - Both the earlier and the forthcoming reviews of the strategy have been and are to be characterized by an economic crisis environment; the good results in between were enhanced partly by economic prosperity.
- ▶ The Lisbon Strategy will continue and develop and is to support crisis management:
 - Structural reforms cannot be substituted with business cycle policy.
 - The three big challenges (globalization, demography, technology) call for structural changes.
 - There will be internal and external dimensions, too.
- ▶ Through new iterations, open coordination as a recursive steering instrument will become
 - more efficient,
 - more transparent, simple, democratic and
 - more effective.
- ▶ The role of tax policy is to grow, strengthen and accelerate within the strategy:
 - Policies to improve efficiency.
 - Other changes in the tax structure, like the spreading of tax policies that promote decreasing taxes on labour, the internalisation of external costs and the sustainable use of resources
 - Tax policies promoting growth, like encouraging R&D

With the exception of the CCCTB, Community level tax measures, initiated within the framework of the Lisbon strategy, support improving the efficiency of the tax system since they facilitate the deepening of the internal market integration. Experience shows, however, that decision-making in the Council is a result of a rather lengthy dealing procedure. Taxation issues fall principally within the scope of national competence and, due to the unanimous decision-making, the measures adopted at the EU level are not so spectacular. Nevertheless, Member States have to adapt themselves to the changing economical circumstances and have to meet global challenges, which also enforces the alteration of the tax structure. Decreasing tax burden on labour and income, accompanied by increasing consumption and energy taxes, is a general tendency nowadays. Through the price effect, the latter influences consumers' behaviour, it internalises external costs and as a second round effect it can encourage innovation as well. Furthermore, Member States may apply various tax policy instruments also in order to boost economic growth (investment R&D). It can be established overall that tax policy is expected to play an increasingly important role as far as the implementation of the Lisbon strategy is concerned.

Tax competition in the Union has led to a tendency of decreasing corporate tax rates, while, in spite of this, state revenues as a whole have increased. In this environment, with little room for action, it is especially difficult for new Member States to increase welfare or achieve real convergence; to ensure the sustainability of their social systems or the level of infrastructure. Under the pressure for change, old Member States, too, increasingly become transformational economies.

Tax policy plays a significant role in the implementation of the Lisbon Strategy, both in the fields of social models and of other necessary structural reforms like improving the

functioning of the internal market or modernizing economic models (Vágvölgyi, 2009). Already in the beginning, the modernization of social models was mentioned by the Commission as a potential basis for economic impulse (European Commission, 2000). The efficient internal market, through its size and the unfolding competition, can create a uniquely differentiated division of labour, innovation, and productivity. The less tax policy distorts or slows down the development of these areas and the more it is able to stimulate the realization of the goals specified in the Lisbon Strategy, the more chance the European Union will have to enhance its competitiveness.

The results of the Lisbon Strategy have been influenced by economic cycles since the beginning. In the current period of crisis, the Commission considers the strategy and the

structural reforms all the more necessary; short term stimulus measures either are or can be made compatible with the former. The guidelines adopted in 2008 may be an instrument helping to immediately face the challenges of the crisis, like growing unemployment or social exclusion. At its March 2009 summit, the European Council urged maintaining the Lisbon Strategy even amidst the current economic circumstances and called for accelerating structural reforms (European Commission, 2009). Discussions about the future of the program were postponed to the end of this year. The preparation of a new program is required for the period following the last planning cycle in 2010, while the current objectives and results are also to be reviewed, which will partly be the responsibility of the Hungarian Presidency to assume office in the first half of 2011.

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Alessandro Goglio*

Encouraging sub-national government efficiency in Hungary

Hungarian sub-national governments are facing difficult challenges. Many of the cost-cutting structural reforms to public services being initiated by central government involve the municipal and county governments through their responsibilities in providing services. In addition, these governments face ongoing investment challenges in raising the quality of local infrastructures to address social and economic issues. There are wide regional disparities in GDP per capita across Hungary, reflecting an uneven pace of economic development. Local governments in poorer areas in particular need to be successful in accessing EU-funds aimed at narrowing gaps in development through infrastructure investment.

This paper looks at how meeting these challenges can be helped by changes to budgeting systems,

financing arrangements and spending responsibilities in the municipal and county governments.

THE SUB-NATIONAL GOVERNMENT SYSTEM

Hungary, a unitary state, has three layers of elected governments – central government, counties and municipalities. There are 3,167 municipalities, 19 counties and 20 city-counties (including Budapest) which have a special dual status as a municipality and a county (*Table 1, left column*). Elections to the respective assemblies are held every four years and always (at least so far) in the same year as the general elections. Established in 1990, this structure replaced a centrally controlled system comprising three levels: communities, districts and counties.¹

Unlike under the previous system, which granted significant powers on spending rights and funding allocations to the counties, the municipalities today benefit from a considerable degree of autonomy. Municipal governments are no longer subordinated to county governments; notably, a county cannot overrule the decisions of a municipality. The institutional foundations of the present framework are the Constitution and the 1990 Act on Local Governments. Both legal instruments have

* This paper was originally prepared for the OECD's 2007 *Economic Survey of Hungary*. At the time of writing, Alessandro Goglio was an economist in the OECD's Economics Department. The author is grateful to the experts from the Hungarian government and non-government bodies who provided information and comments, as well as to OECD colleagues for their suggestions, in particular Val Koromzay, Andrew Dean, Andreas Wörgötter, Philip Hemmings, and Roland Natran (now at the Hungarian Ministry of Finance). Thanks are also due to Margaret Morgan for technical assistance and to Sylvie Ricordeau and Josiane Gutierrez for assistance in preparing the document.

organic law status, meaning that they can only be amended by a qualified parliamentary majority of two-thirds, rather than a simple majority.

Understandably, the qualified majority requirement is intended as a safeguard against the risk of excessively frequent and possibly disruptive changes. As in other countries, however, it may occasionally generate tensions and even hold back opportunities to introduce changes with a potential to raise the effectiveness of service delivery. This is particularly the case in Hungary at present, where following the recent local elections the opposition has a majority in most local governments.

Many local activities, particularly in infrastructure development, education and healthcare, are initiated and co-ordinated via a system of local Councils and micro-regions (*Table 1, right column*). A National Development Council and 19 County Development Councils were created in 1996, along with seven Regional Development Councils for the 'NUTS II' regions which pro-

vide the interface with the EU's regional funding mechanism. However, the regions not only play a policymaking role in development but also other areas of spending. For example, there are Regional Healthcare Councils that include representatives from counties and municipalities.

Since 2004, there are also 166 "NUTS IV" micro-regions, comprising groups of municipalities that plan and implement various local activities, mainly with an aim to expand the provision of joint services. Most changes at the regional and micro-regional levels were initiated as part of Hungary's process towards joining the European Union (Temesi, 2000).

BUDGETING ISSUES

There are several mechanisms that aim to make local governments deliver balanced budgets and these include the requirement for balanced budget submission and a "deficit grant". By law

Table 1

THE STRUCTURE OF PUBLIC ADMINISTRATION IN HUNGARY

Elected bodies	Appointed Councils, notably on development, education and health
Parliament	<p><i>Councils in the national and regional level.</i></p> <p><i>There are three National Councils covering Development, Education and Healthcare, respectively. Most of their members are appointed by the central government. For example, the Development Council includes representatives from 9 Ministries, the presidents of the Regional Development Councils (see below) and the Mayor of Budapest.</i></p> <p><i>There are also 7 Regional Development Councils (NUTS II regions) and 7 Regional Healthcare Councils. Most of their members are appointed by the central government.</i></p>
19 County governments	<p><i>19 County Development Councils. These Councils include members appointed by the central government and county governments.</i></p>
3167 Municipalities plus 20 cities with county status (including Budapest)	<p><i>Development Councils of micro-regions (166 in total) and other forms of local government associations. These Councils are appointed by the municipalities.</i></p>

Source: OECD, based on M. Kopányi and D. Wetzel (2004)

sub-national governments have to submit a balanced budget. In addition, there is a “deficit grant”, that provides immediate relief to municipalities experiencing temporary financial pressures because of unforeseeable developments.

Moreover, there are strict regulations limiting the amount of debt sub-national governments can carry. Annual debt service is limited to “corrected own revenues”, namely 70% of own source revenues (defined to exclude revenue sharing) after subtracting the amount of short-term liabilities. The legal framework imposes limitations on the assets and revenue sources that can be used as collaterals and loan guarantees. The government has proposed to modify regulations of local governments' debt. Vígvári discusses the proposal and debates on financial rules for sub national governments (2007).

Municipal bankruptcy is subject to special legislation under which the creditor or the local government can initiate a bankruptcy proceeding each time a debt is 60 or more days overdue (World Bank, 2006). Cases are examined by a court which can:

- Order the start of debt settlement procedures and designate a financial trustee; or alternatively,
- Determine that the local government can meet its obligations from existing cash

flows and assets and establish the conditions for the reimbursement.

The legislation mainly works as a deterrent and has been used relatively sparingly so far. Since the end of the 1990s, there have been eleven municipal bankruptcy cases approved by court decision. Nine cases resulted in a voluntary debt settlement agreement between the parties. In two cases the court followed the recommendation of the trustee and ordered the liquidation of the assets. Interestingly, procedures have never been initiated by the creditors. All were launched by the local governments themselves, most of which were small municipalities with a population below 5000 inhabitants.

As a result, the combined budget of sub-national governments has typically been close to balance or even in a slight surplus. Also, Hungary's local governments have not accumulated much debt (*see Table 2*).

However, it is hard to draw a firm conclusion about the quality of financial management from this. Given the strong reliance of the local system on central government transfers, these positive budgetary outcomes could reflect a tendency for central government to respond to local budgetary slippages with increased funding. The following sections look in more depth at various aspects of budgetary management.

Table 2

GROSS PUBLIC DEBT END OF YEAR PER CENT OF GDP								
	2000	2001	2002	2003	2004	2005	2006	2007
Central government	54.3	52.0	55.0	57.1	58.4	60.3	65.0	64.3
Social security funds	0.9	0.4	0.8	2.0	2.1	2.2	0.6	0.0
Local governments' gross debt	1.0	1.1	1.5	1.5	1.6	1.9	2.4	3.1
<i>Consolidation within general government</i>	<i>1.9</i>	<i>1.4</i>	<i>1.6</i>	<i>2.7</i>	<i>2.8</i>	<i>2.7</i>	<i>1.2</i>	<i>0.0</i>
<i>General government consolidated gross debt</i>	<i>54.2</i>	<i>52.1</i>	<i>55.6</i>	<i>58.0</i>	<i>59.4</i>	<i>61.7</i>	<i>66.8</i>	<i>67.4</i>

Source: National Bank of Hungary

Making use of stronger budgeting rules

Strategic prioritisation in sub-national government budgeting is rather weak. Indeed, local governments focus almost exclusively on ensuring that the budget meets legal and procedural obligations, and medium- and long-term policy goals tend to take a back seat. Most municipalities only fulfil minimum presentation requirements which just require classification by spending units (salaries, goods and services, capital expenses). Only a few municipalities specify their spending objectives by services or programmes (education, child care, water, garbage collection and so on). The basic objectives of public spending are therefore not transparent in most municipalities' accounts. Various steps could be taken to rectify this:

- ▶ Specification of separate budget balance rules for current and capital items.² Local governments must present budget proposals that differentiate between capital and operating items, but there is only one budget balance requirement (which applies to the aggregate budget). The city of Budapest has taken a welcome lead with a self-imposed rule that any surplus on current spending can only be used to finance infrastructure investment.³

- ▶ Introduction of multi-year budgeting at the local level, in parallel with developments in central-government practice (*see OECD, 2007, Chapter 2*). Several OECD countries (including Finland, Norway and Spain) have introduced multi-annual budgeting to both central and local government either simultaneously or following a defined timetable, rather than targeting the central budget alone.

A need to widen the coverage of budgets

Several OECD countries (Austria, some Canadian provinces, Poland and Spain) have

recently made local governments move “off-budget” items into their accounts and Hungary could follow this example. The financial flows associated with certain important activities are not fully reflected in local-government accounts. The accounts of local public utility holdings (notably in transport) and non-profit foundations created to run housing and welfare assistance services are off-budget. In addition, the motivation for outsourcing some activities is questionable as this also can take accounts off-budget. Off-budget status makes it difficult to find out the amount being spent in these areas and obscures the true status of local-government debt given the likelihood of implicit guarantees. Both local holdings and non-profit foundations are governed by commercial law and are therefore free to finance themselves in the capital market. In addition, off-budget accounts widen the scope for circumventing fiscal rules through accountancy gimmickry. Reportedly, more than one third of the non-profit organisations receiving local financial support do not report the full extent of financial assistance (State Audit Office, 2006).

Better monitoring during the budget year is required

Municipalities must submit annual and semi-annual budget updates to the Ministry of Finance but there are problems in the format of the reports. According to the State Audit Office (SAO), more than two thirds of the local governments implement registration systems that are unsuited to allowing precise assessment of liabilities (State Audit Office, 2006). Efforts should therefore be made to improve the quality of reporting, for example by regulations requiring local governments to re-submit when reports fail to meet standards.

In addition, the sanctions against municipalities that break budget rules are rather soft. At present the Ministry of Finance can only send out signals or make recommendations when it sees that a sub-central government is in breach of fiscal rules. One way of giving more teeth to sanctions would be to introduce provisions that require local governments to provide an explanation for breaching the budget rules and to submit a plan describing the measures to rectify the situation.

At the same time, in some respects too much budgetary information is demanded and a review of the budgetary information that municipalities have to provide to the central government should be carried out. A frequent complaint of municipal officers is that a great amount of unnecessary information must be attached to the budget documentation. Several hundreds of expenditure and revenue variables are collected annually by the central government. The level of detail is such that the Ministry of Finance lacks enough means to scrutinise that such expenditures cater effectively to their objectives. Not surprisingly, much of the information sent is incomplete or unreliable and is kept confidential at the national level.

The deficit grant is unsuited to deal with cyclical pressures

The deficit grant aims to provide relief to municipalities due to unforeseeable financial developments. In 2007 the eligibility criteria of the deficit grant have been tightened. However, improving local budget management would probably require abolishing it. This grant has to date amounted to about three quarters of a percentage point of GDP per year and it has adverse incentive effects for local governments.

The introduction of multi-year budgeting at

the local level, as suggested above, could be used as a vehicle for removing the deficit grant. Specifically, a municipality in difficulty could be allowed a temporary deficit as long as its multi-year budget remains in balance. In the Netherlands, where a similar mechanism is in place, if a municipality is unable to show a balance budget over the official multi-year budgetary period of three years it has to submit the budget to the higher level of government for approval.

Enhancing the effectiveness of the auditing system

The auditing system was reformed in 2003 and included a requirement that over each parliamentary cycle the SAO must audit each local government at least once. Though the new auditing framework also included changes intended to raise the visibility of the link between the budget and the quality of service delivery, little progress on this front has been achieved so far. Reportedly, this reflects the problem that many of the municipalities surveyed by the SAO have yet to implement internal audit systems or, when in place, the internal auditors are not independent of the local governments.

Spending assignment issues

Decentralisation of spending responsibilities to the municipalities and the counties in the early 1990s was significant. The municipalities were made responsible for several core services, most prominently primary education, water supply and various areas of healthcare including general practices, non-specialist hospitals and ambulatory services. The counties are notably responsible for secondary education, research hospitals and other specialised healthcare services. All in all, 20 key tasks are allocat-

ed to sub-national governments (see Table 3), a fairly large number in the OECD context. Indeed, Hungary's municipalities perform broadly the same range of tasks as in the European Nordic countries, even though local systems are much less dispersed in these countries, based on the overall number of municipalities.⁴ In terms of the share of total public spending, Hungary's sub-national governments are not exceptional. The counties and municipalities combined account for about a quarter of general government spending, a similar level to Poland, the Czech Republic and the UK (see Chart 1).

The devolution of responsibilities for public services has been a broadly positive step but has also generated some challenges. The following sections look at problems in co-ordination, challenges in overcoming economies of scale and issues in wage setting for public-sector workers.

Costly co-ordination failures

Getting the “middle level” of government right: counties or regions?

The middle level of government and administration (i.e. the level between the municipalities and the central government) has become rather complicated. Entry to the EU required the formation of the regions based on Eurostat NUTS II criteria as an administrative tool in EU funding. As mentioned above, the resulting system of seven regions has been used by central government to set up regional councils, which are made up of representatives from the counties and municipalities and which cover issues in development, health and education. This has further narrowed the role of the counties which, as noted, was already significantly reduced by decentralisation in 1990.⁵

The co-existence of decision-making bodies at the regional level via the councils with coun-

ty and municipal governments has generated overlapping responsibilities, especially between the councils and the large urban municipalities which also have county status. This is slowing decision making considerably, particularly in infrastructure development where it is difficult to agree upon the boundaries of a given project (e.g. road projects, water services and energy supply).

Co-ordination failures between central government and sub-national government

Hungary's constitutional law provides a large degree of autonomy to municipalities, but freedom in policymaking is affected by several other factors. A key role is played by the provision regulations laid down in sector specific laws, on which line ministries have strong influence. These laws have come under increasing criticism for going beyond the core mission of enforcing or supporting nationwide standards and priorities.⁶ Compared with local government laws, sector-specific laws can be passed relatively quickly, namely by means of a simple parliamentary majority.

The Act on Public Education, for example, imposes overly restrictive rules on closing, or modifying the use of education facilities that restrain the room for adjusting the provision of services to local conditions. In particular, the Act confers special veto power to both providers and users of the service on any proposal to dissolve a public education institution.⁷ The impact of the mechanisms encouraging joint provision in education (see below) is likely to be weakened in these circumstances.

In healthcare, most hospital workers are public-sector employees and have to be paid using central funding.⁸ This framework considerably limits the scope for introducing performance management and performance-based compensation in the hospitals. Also, it exacerbates the problem of so called “gratitude

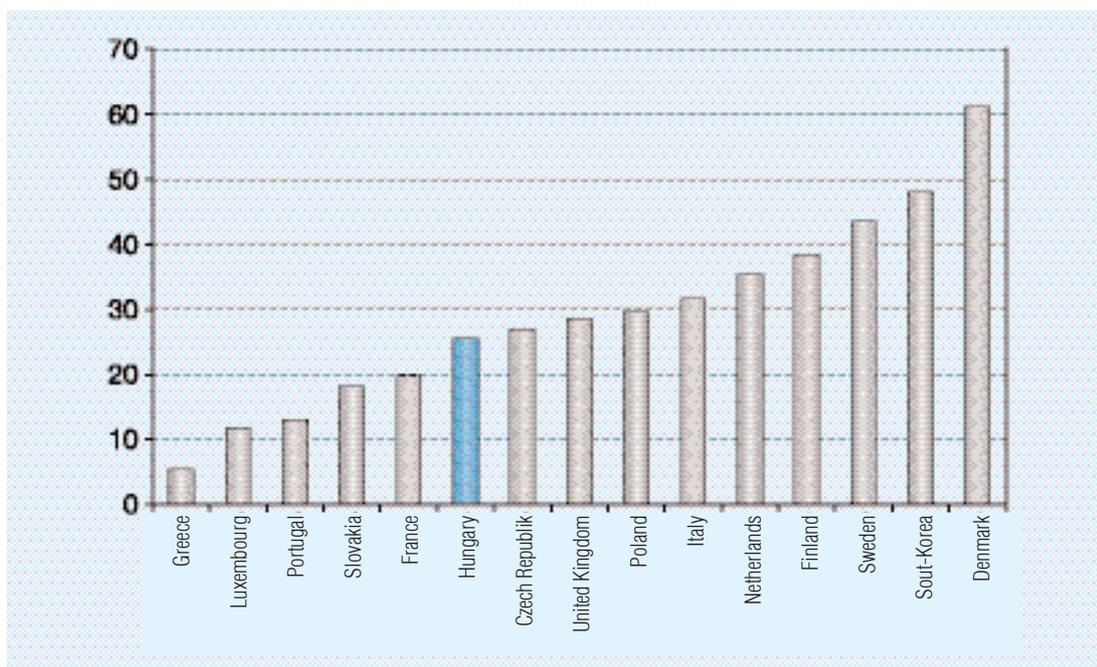
Table 3

THE ASSIGNMENT OF COMPETENCES TO THE LOCAL GOVERNMENTS

Fuctions	Municipalities	Counties/Urban governments	Local administrative units of the central state
<i>Education</i>			
Pre school and primary	X		
Secondary		X	
<i>Social welfare</i>			
Nurseries, kindergartens and welfare homes	X		
Social care services (elderly, disabled, special services for homeless and families in crisis)	X		
Social housing		X	
<i>Healthcare</i>			
Primary healthcare	X		
General hospitals		X	
Preventive care			X
<i>Leisure</i>			
Culture, leisure and sport		X	
Parks and cultural centres	X		
<i>Water and energy</i>			
Water supply and waste water treatment	X		
Gas supply and heating			X
Electricity supply			X
<i>Environment and public sanitation</i>			
Refuse collection and disposal	X		
Street cleaning		X	
Cemeteries	X		
Environmental protection	X		
<i>Roads and transports</i>			
Local roads and public lighting	X		
Secondary and national roads			X
Public transport services		X	X
<i>Urban planning and development</i>			
Town planning	X		
Regional planning		X	
Local economic development	X	X	
Tourism	X		X
<i>Administration and emergency services</i>			
Licences and administrative services	X		X
Law enforcement and emergency services (police, fire brigades, etc.)	X		X
Consumer protection			X

Source: OECD, Temesi (2003)

LOCAL GOVERNMENTS' SHARES IN GENERAL GOVERNMENT EXPENDITURE⁹



Source: OECD, National Accounts Database

money” (under-the-table compensation payments), which is widespread, though illegal. Other aspects of the legislation are also overly prescriptive on issues which should be at the discretion of local decision makers. For example, the sector-specific act in healthcare states that patients must be able to access hospitals using regular public transport.

Reconsideration of central and sector specific laws is needed to cut back on regulations that hamper, rather than encourage improvements in public services by sub-national governments. Over-regulation generates inefficiencies in the sector they apply. It also creates a more general problem of weak incentives in local governments to initiate reform because they feel they are merely the executors of central-government policy, tightly bound by the provision rules and detailed formula-based grants (so called “normative subsidies”).

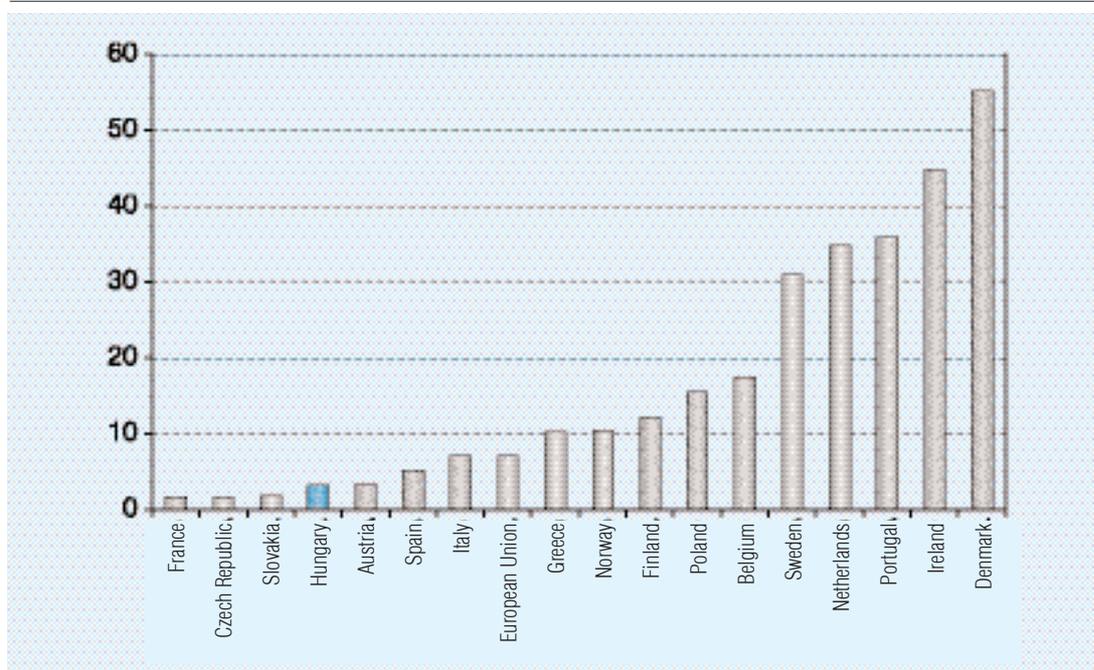
Economies of scale

The average size of Hungarian municipalities is one of the lowest of the European Union (see Chart 2). The small size of many municipalities, especially given the wide range of responsibilities they have to cover, raises the question as to whether the scale of operation in administrative overheads and public services is efficient.

Though a precise picture of the relationship between size and efficiency in local government is difficult to establish, it seems that many Hungarian municipalities are relatively inefficient reflecting the small scale of their administrative capacities and client populations. Empirical studies broadly agree that efficiency begins to drop off significantly below 5 000 inhabitants.¹⁰ Among them, *Solé-Ollé* and *Bosch* (2003) estimate that spending needs

INTERNATIONAL COMPARISON OF THE AVERAGE NUMBER OF INHABITANTS PER MUNICIPALITY

(thousands)



Source: Denmark, Ministry of the Interior and Health website; Dexia Bank

per head in Spain's municipalities with 1,000 inhabitants are 23% higher than in municipalities with 5,000 inhabitants. Research on small local governments in Swiss cantons (a system often held up as a case where small-scale government works well) suggests that costs and quality are severely compromised below a population of 500 (Ladner and Steiner, 2003). Evaluated against these benchmarks, the number of municipalities below critical minimum sizes in terms of efficiency is relatively large in Hungary (see Table 4).¹¹

The most obvious solution to the Hungarian problem of economies of scale would be through mergers. However, this is easier said than done. Many argue that mergers will never get political support because the setting up of local democracy is one of the main achievements of transition.¹² Local democracy is

indeed strongly protected; the constitution prohibits the central government from decreeing the merger of municipalities. Given this, policy has to work more indirectly so that joint provision is encouraged through persuasion and incentive mechanisms.

A good feature of the local-government system is that it allows municipalities to transfer their service responsibilities to the county level on the grounds that they are unable to meet the related operating costs.¹³ While this helps avoid costly duplications of specialised services, some regulatory fine tuning is required. At present, the ownership of the asset is not transferred along with the transfer of the utilisation rights. Transfer of ownership requires approval by the municipality following a request from the recipient county but this is rarely carried out. The municipalities are often reluctant to

THE SIZE DISTRIBUTION OF MUNICIPALITIES

Population range	Number of municipalities	Number of municipalities (cumulative)	Percentage of total municipalities (cumulative)	Total population	Total population (cumulative)	Percentage of total population (cumulative)
Below 200	312	312	9,9	38,030	38,030	0,4
201–499	705	1,017	32,1	241,942	279,972	2,7
500–999	682	1,699	53,6	497,662	777,634	7,6
1 000–4 999	1,157	2,856	90,2	2,445,773	3,223,407	31,6
5 000–10 000	146	3,002	94,8	1,012,533	4,235,940	41,6
Above 10 000	165	3,167	100,0	5,957,446	10,193,386	100,0

Source: Ministry of Finance

introduce changes in the use of their infrastructures and this limits the counties room for manoeuvre in reform. The regulations on passing over responsibility for services would be more effective if municipalities were prevented from imposing rules on how the county uses the infrastructure.

In addition, the joint provision of services by municipalities is common.¹⁴ There exist various legally recognised forms of associations. These allow for the joint delivery of services, the delivery of services by one of the member municipalities and the formation of joint administrative districts (e.g. covering local tax offices and internal audit).

The system of 166 “micro-regions” (based on Eurostat's NUTS IV criteria) set up in 2004 has been used to bring more structured joint provision in key areas of public spending, including development projects. Central government is encouraging municipalities to use the micro-regions as a basis for joint provision. The broad aim is to encourage co-operation between small villages and larger settlements, something the former have often been reluctant to accept for fear of losing autonomy. Several incentive mechanisms have been introduced.

PROGRESSIVELY INCREASING GRANTS Grants for some services are progressively increased

with the population coverage of the associations of municipalities. For example, for sewage networks serving between 2,000 and 15,000 residents, the central-government grant covers 40% of total costs, this is increased to 50% if population exceeds 15,000.

THRESHOLD REQUIREMENTS IN INVESTMENT GRANTS Access to special investment grants is sometimes contingent upon meeting a minimum population or consumption threshold.

ONE-OFF AND FORMULA BASED COMPENSATIONS These are provided when associations are formed and later on to help cover operating and development costs. This compensation represents only about 2% of total central-government transfers to municipalities but the experience so far suggests that even this modest compensation can be enough to motivate small settlements to co-operate.

DETERRENTS From 2007 some penalties have been introduced. For example, the “deficit grant” will no longer be available to those municipalities that are not in an association for the joint provision of education services.

There is welcome flexibility in the micro-region system. Borders can be altered through legislation that allows municipalities to switch to an adjacent micro-region.¹⁵ In addition, central government is taking a flexible approach in

its application of the incentive mechanisms described above. Associations do not have to comprise all municipalities in a micro-region to be eligible for the incentives and the joint provision of public services can even span the boundaries of the micro-regions.

The general perception is that these mechanisms are indeed encouraging a more efficient scale of operations. Virtually all the micro-regions are now being used for joint provision and are running at least three services. The most common joint provision is in education (see Table 5).

Though the micro-region system seems to be running well, there is some scope for improving governance. The micro-regions are typically run by the association councils comprising only the mayors from the participating municipalities. Reportedly, in some instances this is leading to excessive marginalisation of the municipal assemblies. The law allows the establishment of a separate organisation – a joint municipal authority – to oversee joint services. However, very few have been created because their powers are vaguely defined. Oversight of the association councils could be strengthened by provisions allowing for com-

ment on preliminary council decisions from all stakeholders. This however would also require allowing local stakeholders access to the relevant details of the councils' work.

Additional mechanisms for encouraging joint provision should be explored. Adjustment of tax allocation formula is one candidate. For example, the Czech Republic is considering adjustment of its tax allocation formula to reward joint provision (OECD, 2006c). However, the returns to both existing and new schemes need to be carefully evaluated. It can prove tricky to ensure that co-operation agreements result in concrete economies in service provision and not just superficial organisational changes to fulfil eligibility criteria. Also, the returns from a fiscal perspective may be limited if efficiency gains emerge in improved service quality rather than cost savings.

FUNDING ARRANGEMENTS FOR LOCAL GOVERNMENTS

Aside from the structure of spending assignments, *de facto* levels of self-determination in the municipalities and the counties are influ-

Table 5

DISTRIBUTION OF MICRO-REGIONS BY TYPE OF ACTIVITY END OF 2007

Purposes	Number of micro-regions with joint provisions
Educational	164
Social institutional	33
Social basic service	128
Children-protection service	3
Children-welfare basic service	145
Moving library	85
Inner audit	154
Total number of micro regions with joint provision subsidised by central government	164
Total number of micro regions with joint provision	173

Source: Ministry of Finance.

enced by the system of intergovernmental financing. Most sub-national government funding goes to the municipalities, reflecting the much wider range of responsibilities compared with the counties. The key features of the system are as follows (see Chart 3):

GRANTS FROM CENTRAL GOVERNMENT

Grants are by far the most important source of revenues for sub-national governments. These are the sole source of revenue for counties and account for a large share of municipal funding. Grants account for roughly 45% of the aggregate revenues of municipalities, equivalent to about 6% of GDP.

TAX SHARING About 40% of revenues from personal income tax (PIT) are distributed to the municipalities. These account for 15% of total sub-national government revenues (some 2% of GDP).

LOCAL TAXES Local taxes make for roughly another 15% of total revenues, though there is

considerable variation across sub-national governments. Particularly important is a tax on business turnover which totals approximately 80% of overall local tax revenues at the sub-national level (this is discussed further below).

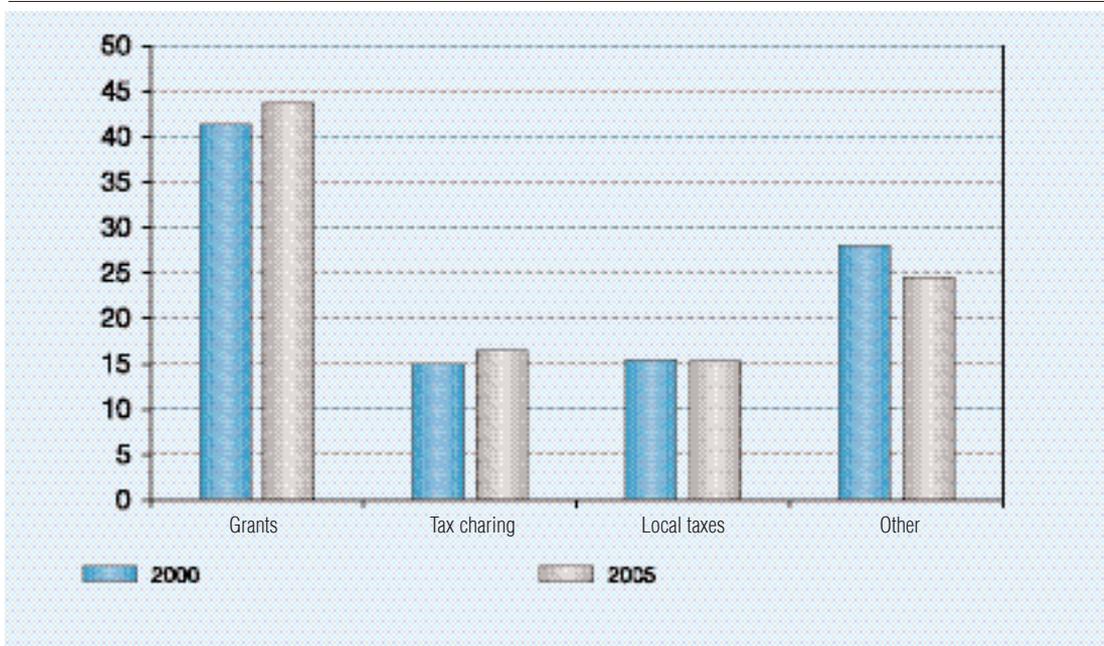
OTHER REVENUE SOURCES The remainder (roughly 25% of total revenue) comes from various items, in particular asset sales, revenues from local fees and fines, and the reimbursement of value added taxes (for instance that those paid on the purchase of inputs used for services).¹⁶

In broad terms, the system of financing is overly complex. This problem has been recognised by the government, particularly regarding the grant system (see, for example, Government of Hungary, 2006b). This is discussed in detail below along with the use of performance indicators in financing, the PIT tax allocation, local business taxes and the funding of investment.

Chart 3

REVENUES OF LOCAL GOVERNMENTS BY TYPE

(% of total revenue)



Source: Ministry of Finance

An administratively costly grant system

The largest grant transfers are so-called normative subsidies, i.e. they are formula based grants. Around 40% of these transfers are for primary education. A large share of grants are not-earmarked (i.e. they go into general sub-national government revenues). Recent OECD work (Blöchliger and King, 2006) calculates that 43% of total grant transfers are non-earmarked, a share roughly in line with the OECD countries' average (45%).

Some important grants are however earmarked (i.e. the local authority must spend the allocation on the designated activity) and stipulate matching funding (i.e. the local authority has to make a contribution to the funding of the activity). The largest earmarked grant is the social security transfer for healthcare which is paid directly to the healthcare institutions. Supplementary funding allotted to education (e.g. special programmes for Roma children) and grants for large infrastructure projects are also earmarked. This is the case, at present, with the Budapest's fourth Metro line.

A major source of concern in the grant system is with the large number of detailed financial normatives applied. It is usual for grant systems to be complex because of the need to tailor the grants to suit the services being funded. However, excessive complexity and administrative costs are added to the Hungarian system due to the large number of specific characteristics and sector requirements. This is exemplified by the numerous formula based grants, of which there are over 200.¹⁷ The education grant alone results from the aggregation of some 30 normatives, each one associated to a mandatory service.

The government is taking some steps to cut back on the number of formula based grants. The Convergence Programme of Hungary (Government of Hungary, 2006b), contains a commitment to reforms, beginning with edu-

cation. From September 2007 (the beginning of the school year), kindergartens and primary schools will be financed using a single normative subsidy instead of the ten normatives used to date. Unlike the present system, where the normative is calculated on a per-child basis, the new formula will be based on organisational parameters with the objective of increasing the number of classes taught per-teacher and the number of pupils per class. The government expects that, once fully implemented, the uniform grant will replace 70% of all state grants in public education.

Further to these measures, the current OECD assessment of good practices with grant management (Bergvall et al., 2006) suggests that other options should be considered.

► Further reducing the number of earmarked grants as part of a broad re-assessment of the structure of the “basic package” of services covered by these grants. Switzerland, for instance, has had some success in removing perverse incentives by replacing earmarked grants with non-earmarked general purpose grants. In the Netherlands a more selective approach has been taken: switches from earmarked to non-earmarked grants are only made in areas where municipalities are unlikely to cut back services drastically.

► Simplifying the system of obligations and minimum standards. Reducing the number of normative subsidies can be facilitated if detailed and superfluous standard requirements are eliminated. It also facilitates the calculation of the aggregate non-earmarked grant.

The need for more performance-based funding

Progress in introducing measures of output in funding formulae has been modest so far. Indeed, the largest subsidies put a very strong emphasis on the *per capita* component and

items reflecting outcomes or quality carry little, or no, weight. For example, grants for secondary education remain largely based on the number of students in the classroom with no penalties or rewards based, for example, on student performance in national tests or on the number of successful students who have access to higher education. In addition, central government authorities like the Ministry of Finance or the Ministry of the Local Governments do not verify outcomes. As a result, quality standards are not enforceable, even when they are set in the sector-specific laws.

The government sees the fiscal adjustment programme as providing opportunity to make grant transfers more conditional on performance. For example, since 2007 funding of local social welfare services has made half of the grant dependent on the fulfilment of provision standards. Similar quality-focussed incentives have been introduced in education, notably affecting the numerous secondary art schools.

The ongoing efforts to increase the role of quality and output in determining funding for mandatory services are welcome. This is a positive feature because these are services that contribute to established central government objectives. However, the use of quality indicators remains limited and more work is needed to widen this approach.

Fine tuning the allocation of personal income tax

The share of PIT revenues allocated to the municipalities has declined and is now roughly 40% of total PIT revenue. The allocation mechanism is complex. The calculation is based on total PIT revenue collected two years previously and has several components:

OWN-BASED COMPONENT The “cessation level”, i.e. the share allocated according to the

PIT collected within the municipality (own-based revenues), will equal 8% of overall PIT revenues in 2008.

EQUALISATION COMPONENT Another part of PIT is spent on an equalisation mechanism. In this process, the annual state budget law sets averages of per capita tax revenues according to several size-classes of municipality (the calculations factor in revenues from PIT as well as the local business tax). Municipalities with per capita revenues below the average for their size-class receive a supplement that fully covers the shortfall. Those with per capita revenues above the average have to contribute to the equalisation scheme according to a schedule in which the share of the difference with the average that is retained increases with the size of the gap. For 2008, the equalisation will cost the equivalent of 8.3% of total PIT revenue.

FORMULA BASED (NORMATIVE) COMPONENT The remainder of the municipalities' share of the PIT is used to fully fund a range of administrative services and to top-up funding in some other areas (e.g. welfare services). The allocation uses formulae similar to those used in the grant system. This component is relatively important; for the 2008 budget it will amount to 23.7% of total PIT revenues and for the past fifteen years it has never been below 20%.

The formula based component of the PIT allocation should be reconsidered. First, the link between the funding of a range of services to PIT revenue runs against the principles of efficiency and flexibility in financing and should be severed. For instance, the link to PIT means strong exposure in funding for these activities to fluctuations that are unlikely to relate to cost or output variation. One way forward would be to drop this indirect allocation of PIT to municipalities and to fund these services from general government revenues (as is the case for other formula based funding for municipalities). Another approach would be to re-direct the allocation into the own-based and

equalisation components and to drop the specific funding for these activities. The need for simplification in this area of municipality financing is echoed in a recent World Bank report on local-government financing in Central and Eastern Europe (World Bank, 2006).¹⁸ Indeed, of the eight countries surveyed, only Hungary has a two-tier system in which revenue redistribution on an origin basis and general purpose grant transfers are combined together.

Second, if formula based funding is retained for those areas currently funded (at least partly) by the PIT allocation, a review of the formulae should be conducted because at least some of them appear to run counter to encouraging the joint provision of services. For example, under the 2007 budget each municipality with less than 500 inhabitants is entitled to receive a PIT-related normative for “administrative, communal, and sport-related tasks” that is twice the value of larger municipalities, which weakens

the objective of municipal co-operation. Similar adverse signalling mechanisms are contained in the grants allocated for the issuance of official documents (passports, identity cards, car plates, birth certificates, etc.).¹⁹

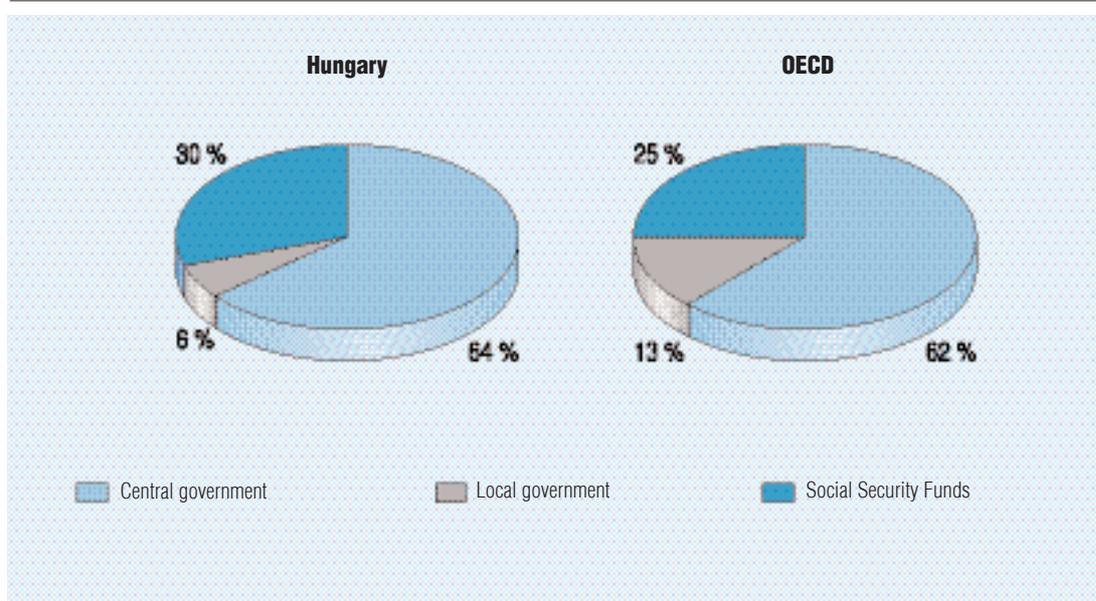
Problems with local tax-raising capacity

Local government own tax revenues are well below the average of the sample of unitary OECD countries (see Chart 4). In addition, the most important local tax is a local business tax, rather than a property tax (see Table 6). Hungary has a local property tax, based on the size of plots or buildings, but its contribution is negligible, as is the case with the tourist tax. Under the current legal framework the local authorities have a relatively wide margin of discretion about how to shape their local taxes.²⁰

There are a number of problems with the business tax:

Chart 4

TAXES BY LEVEL OF GOVERNMENTS % OF TOTAL TAX REVENUE²¹



Source: OECD (2006), Revenue Statistics, 1965–2005

LOCAL TAXES AS OF 2007

Type of tax	Number of municipalities levying the tax	Number of municipalities levying the tax as a percentage of total number of municipalities levying at least one tax	Amount of revenues reised as a percentage of total local revenues
Building tax	743	23.8	10.1
Land tax	422	13.5	1.4
Communal tax for private individuals	2233	71.6	2.5
Communal tax for business	700	22.4	0.2
Tourism tax	717	23.0	1.3
Local business tax	2676	85.8	84.5
Total number of municipalities having at least one tax	3119	100.0	100.0

Source: Ministry of Finance

It erodes the local tax base as it is imposed on mobile assets and increases pressure on tax competition. This is visible in the trend increase in the number of local municipalities that choose to set the level of the local business tax rate below the statutory maximum ceiling of 2%.

Since it applies to business operations that can last for short periods – such as construction – the basis of the tax is subject to variability.

To the extent that the regional disparity in the local business tax basis broadly matches that of wealth, the strong reliance on local business taxation aggravates regional income disparities. At present Budapest and surrounding municipalities collect most of the local business tax and, Budapest alone account for 30% of total business tax revenues.

The base is questionable. Because the tax is based on turnover it runs counter to the principle of taxing incomes or profits.

Acknowledging these problems, the government announced in 2005 that firms would be able to fully deduct the local business tax in the calculation of corporate income tax.

A system more focussed on the local property tax would ultimately be better. Property

taxes have low avoidance and relatively stable and predictable revenues. In addition, the “benefit principle” is more strongly adhered to since the local property tax is imposed directly on the local taxpayers and is difficult to avoid. A broadening of property taxation is under discussion as part of reform on the local revenue system. The reform should also include removal of the local business tax. The following issues should be considered in the proposals.

Development of up-to-date local “value maps” to ensure that the new property tax is levied on values that reflect market developments. At present, properties are valued using arbitrary point values, such as per square metre and location in the case of land, or in the case of buildings, per square metre and according to use (whether office or residential). Such values were deliberately set low in the early 1990s when Hungary lacked a properly functioning property market and have never been re-evaluated since.

Broaden the tax to include home owners. A broader tax base would more closely align the tax with the local electorate, thus bringing it more in accordance with the benefit principle.

It would entail corresponding widening of valuation to include residential premises. Much of the framework necessary to do this is already in place. The cadastral mapping and the legal property registry are unified and all land and real estate properties in the country have been registered. One source of possible problems is that while the information technology systems in the land offices are operational, the national network of registries is yet to be connected. An ongoing programme to produce digital cadastral maps is expected to be finalised by 2008, though putting digital maps in a fully harmonised format should take longer.

Issues in investment funding

Hungary's sub-national governments initiate a lot of investments and local development is one of the main pillars of the new government strategy to use EU funding. Assessments by the government and the World Bank conclude however that the system is highly fragmented and somewhat un-coordinated (Government of Hungary, 2006a; World Bank, 2000). While the allocation process stimulates competition among municipalities, engaging in local investment funding requires substantial administrative costs and local priorities are not always well identified.

In response to these issues, the latest Development Plan of Hungary (Government of Hungary, 2006a) sets out clearer local objectives and brings in new approaches to manage funding. Investment activities will not only focus on traditional “hard” infrastructures (e.g. roads and railways), but also on boosting local human resources and skills (e.g. education and training). In transport, there is the intention to widen the scope beyond motorways and to invest more in local roads, the expectation being that, by helping local labour mobility, this will support employability. Local policy-

makers will have to submit development strategies that involve more co-operation and close ties between local governments, the business community and local institutions, such as universities. According to the Development Plan, several large municipalities will act as “hubs” for development.²²

To improve co-ordination, the allocation of EU funding will become more centralised. So far, programmes have been divided up between line Ministries. Under the new approach, the Ministries' role will be more that of intermediary bodies, both during the planning stage and as executors of programmes. Otherwise, any funding decisions will be taken centrally.

CONCLUSION AND POLICY RECOMMENDATIONS FOR LOCAL GOVERNMENT REFORMS

Budgeting issues

- ◆ The authorities should consider reinforcing budgetary rules: separate budget balance rules for current and capital items should be specified and, in parallel with developments in central-government practice, multi-year budgeting at the local level should be introduced.
- ◆ Hungary could follow the example of several OECD countries (Austria, some Canadian provinces, Poland and Spain) which have recently made local governments move “off-budget” items into their accounts.
- ◆ On budgetary transparency, efforts should be made to improve the quality of reporting, for example by regulations requiring local governments to re-submit when reports fail to meet standards. One way of giving more teeth to sanctions would be via provisions requiring local governments to provide an explanation for breaching

the budget rules and to submit a plan describing the measures they intend to implement in order to rectify the situation.

- ◆ The deficit grant is unfitted to deal with cyclical pressures. A good opportunity to remove it appears to be offered by the ongoing shift to the multi-year budgeting framework in central government. Specifically, a municipality in difficulty could be allowed a temporary deficit as long as its multi-year budget remains in balance.

Spending assignment issues

- ◆ Efforts to find consensus on the issue of replacing the county-level of government with elected assemblies in the seven NUTS II Regions should continue. The replacement would help overcome problems of overlapping responsibilities and allow for savings in administrative overheads.
- ◆ Reconsideration of central and sector specific laws is needed to cut back on regulations that hamper rather than encourage improvements in public services by sub-national governments.
- ◆ The regulations on passing over responsibilities for services from municipalities to counties would be more effective if municipalities were prevented from imposing rules on how the county uses the infrastructure. Support from the municipalities for joint provision *via* the system of “micro-regions” would be helped by stronger mechanisms for public comment on the decisions taken by the councils of mayors that run these services.
- ◆ On benchmarking, much faster progress is required in the development of comparable

cost, output and performance indicators.

- ◆ Sub-national governments should be given more leeway in designing the work contracts of their employees and in setting wage levels so as to reflect local conditions better.

Funding arrangements for local governments

- ◆ The number of formula based earmarked grants should be further reduced as part of a broad re-assessment of the structure of the “basic package” of services covered by these grants.
- ◆ Steps are needed to eliminate problems in the PIT allocation. First, the link between the funding of a range of services to PIT revenue runs against the principles of efficiency and flexibility in financing and should be severed. Second, if formula-based funding is retained for those areas currently funded (at least partly) by the PIT allocation, a review of the formulae should be conducted because at least some of them appear to run counter to encouraging the joint provision of services.
- ◆ Ongoing efforts to increase the role of service quality in funding represent good progress. However, the use of quality indicators remains limited and more work is needed to widen this approach.
- ◆ A broadening of property taxation is under discussion as part of reform on the local revenue system. The reform should also include removal of the local business tax. Local “value maps” ought to be developed to ensure that the new property tax is levied on values that reflect market developments. The tax base should be broadened to include home owners.

NOTES

- ¹ For earlier discussions of Hungary's structure of governance see Wetzels and Papp (2003), OECD (2001a), OECD (2001b) and World Bank (2000).
- ² Sutherland et al. (2005). Drawing mainly on questionnaire responses, this paper gives a detailed picture of fiscal rules for sub-central governments in a number of OECD countries.
- ³ The City of Budapest's self-imposed rule on use of the current surplus has been in place since 1995 and surpluses on current spending have been recorded since then. For 2006, Budapest's gap between current revenue income and spending was 13%, with the plan being to widen the gap further to 20% before 2010.
- ⁴ In Finland, for example, a system of grants has provoked some mergers. In Denmark, the number of municipalities was cut quite dramatically from January 2007 from 271 to 98, with an average population of 55,000 compared with 20,000 previously. The 14 counties have been merged to five regions responsible for healthcare (OECD, 2006a). It should be noted, however, that compared with Hungary municipalities enjoy much less constitutional protection in Denmark.
- ⁵ For further discussion about the role of counties, Vigvari (2006), Fekete, et al. (2002) and Pálné Kovács (2005)
- ⁶ The issue was originally raised in World Bank (2000). Peteri (2006) suggests that the power of line ministries may have led to less "objective" local grants, basically reflecting strong ministries' control of sector laws.
- ⁷ For example, the dissolution of a public education institution is conditional upon a consultation involving the staff of the institution, the school board, the parents and the school's student council, with all these players having veto rights.
- ⁸ The law allows local governments to contract out the operations of their hospitals but this does not happen very often. In this case, the hospital becomes a private company and the healthcare workers are no longer public employees.
- ⁹ Secretariat estimates based on the latest available national accounts figures (2005 for most countries) and excluding the transfers paid to other levels of government.
- ¹⁰ These estimates should be considered with caution, since larger municipalities tend to offer more services, resulting in higher average spending per capita. For recent surveys of economies of scale issues, see Fox and Gurley (2006) and Lotz (2006).
- ¹¹ Excluding Budapest and the largest cities, Hungary's municipalities average only 1 258 inhabitants. There are 1 020 municipalities with populations of less than 500 and 1 700 of less than 1 000. A number of papers have argued that although mergers and joint provision may allow scale economies to be exploited, such solutions are not without drawbacks. In France, for example, where joint provision is very common, concerns have been raised that they could lead to a failure of democratic control because joint bodies are not elected by the population and are often perceived as lacking transparency (Le Saout, 1998). Citizens may therefore be left with little influence over local services. However, these views apply only weakly to countries, such as Hungary, where citizens from small municipalities do not exert a strong voice with regard to local affairs (see below).
- ¹² Before the transition there were 1,500 municipalities and Budapest, which counts as many as 23 districts, was considerably more centralised than at present.
- ¹³ The municipalities can only transfer duties that were passed on to them in 1990 as part of decentralisation. Over the past fifteen years many secondary schools as well as a number of hospitals were transferred from the municipalities to the counties by this means. Also, municipal governments have the right to take over the control of any county service as long as it can be proved that over at least the previous four years it has been mostly used by local residents.
- ¹⁴ Joint provision is covered by Act on Local Governments which permits the establishment of inter-communal partnerships on a voluntary basis. Adherence to a joint association requires approval by a qualified majority of the local council and the law does not impose any specific requirement with regard to the sectors the association is going to cover.

- ¹⁵ Notably, boundaries can be adjusted with a four year frequency, within 6 months from the general local government elections. During this period, local governments can opt to join an adjacent micro-region if this is seen as leading to better public services for their inhabitants.
- ¹⁶ These VAT revenues are to be initially paid to the State Tax Authority, implying that also the expenditure-side of the sub-national government balance sheet contains this item.
- ¹⁷ “Only” 50 normatives are presented in a special annex attached to the draft budget. See Fox (2004) for more details on this issue.
- ¹⁸ Notably the World Bank report concludes that Hungary has the most complex system among the eight countries surveyed (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia). Lithuania, for example, which has the simplest system in the region according to the World Bank study, targets a fixed level of equalisation using a single parameter. Specifically, the PIT is distributed entirely on an origin basis, with the richer jurisdictions then being required to share part of their revenues with the poorer ones. See World Bank (2006, p. 68)
- ¹⁹ In this case, the 2007 budget law states that the grant is evaluated at 513 HUF per document processed (roughly equivalent to 2 euros), but at the same time it requires that the total grant value cannot be less than HUF 6 million which implies funding for processing 12 000 documents. It seems unlikely that municipalities with only a few hundred inhabitants require processing on this scale.
- ²⁰ The institutional setting is defined by the Act on Local Taxes under which the central government defines the ceiling but not the floor of local taxes. As a result, the local governments have the right but not the obligation to introduce certain taxes (OECD, 2006e).
- ²¹ Estimates for 2004. Central government includes supranational taxes (attribution less than 0.5%) collected on behalf of the European Union by its member states. OECD is an unweighted average of unitary countries. The figures do not take into account the transfer of revenue from central to local government which in Hungary's case is partly derived from the local government's tax base.
- ²² For example, Győr and its surroundings, which make for the automotive centre of Hungary, will focus on the engineering industry and renewable energies. Miskolc, where many chemical companies are already located, will act as an R&D pole in the area of nano-technologies and alternative energies.

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Richárd Adorján

Governmental experiment for the introduction of zero-base budgeting

Presentation and criticism of the programme proposal system of 2004, suggestions for moving forward

In 2004, during the preparation of the budget for the following year, the budget chapter managers¹ were required to submit claims for chapter managed appropriations and other development funds broken down by programmes, and the government decided about the distribution of public funds on the basis of these claims with a view to implement the government's programme, social and development policies, to establish a more cost-efficient state, as well as to curtail absolute and relative squandering. The experiment was unique, since as it is now known such professionally developed techniques were used by the government neither before, nor after that year. This study explores the usefulness and the possible future of this initiative.²

In the past years dozens of plans and proposals have been developed in various scientific and other professional workshops³, as well as within the government⁴ for the possible introduction of task, performance or programme based budgeting in Hungary.⁵ International organisations, especially the OECD, have also shown interest in this topic and have made recommendations to the countries of Central and Eastern Europe.⁶ These initiatives contain the most diverse professional contents, but despite the major differences they share common ele-

ments such as the need to move away from the classical base approach and institution financing, greater focus on the completed task and performance in budgeting, or on the whole: the modernisation of the system, shaking it up from its “sleeping beauty's dream”. A serious counterpoint to, and at the same time justification for this professional desire was formulated in the general explanation of the act on the legal status and financial management of budgetary organisations⁷ at the end of 2008: “For the lack of mandatorily required content and practice, the basic budget and the related documents cannot be considered to contain the annual (real) expectations of the taxpayers towards the budgetary organisations, and cannot be considered to guarantee enforceability and accountability, because they fulfil mere fiscal functions, and only cover and neglect the management of real processes. *Budgetary discussions* that contain such contents, too, and moreover, put the emphasis on such contents, *have become almost non-existent in the past decade.*”

The government's recent attempt, which forms subject of this study, and has entered the professional consciousness⁸ under the name *programme proposal*⁹ is regarded as a refreshing

exception. In many aspects the procedure was characterised by the specific features of the classical zero-base budgeting method, however only in relation to a small group of central budgetary appropriations (see later). Expenditures under other legal titles did not need to be justified – using the base approach¹⁰ – and the provision of funds for such expenditures was left in the competence of the chapter managers. In the central budget in the case of institutional budgets proposals had to be submitted for increments, the base was acknowledged at the time of the construction of the budget.

This study does not aim to present the theoretical background of zero-base budgeting, or to compare it with other methods and theories aiming at the renewal of budgeting. Finally, this study does not aim to meticulously compare the theoretical premises with the implemented practice. Instead, it presents the causes, objectives and processes of the *applied* budgeting procedure, the roles and activities of those involved in this procedure, the decisions and the end results of the procedure, and eventually formulates a professional evaluation and criticism thereof, while taking into account the tasks aimed at the development of the method. It must be pointed out that the application of the zero-base procedure, i.e. the procedure that questions the task assumption and resource allocation of the former years, is itself *forward-looking and value generating*, and may serve as a good foundation for the elaboration and introduction of a budgeting methodology or procedure that puts a greater emphasis on professional and social preferences than the current procedure.

This study demonstrates no scientific rigour in that it formulates subjective opinions, too, as well as statements that have not been tested scientifically. This is justified by the fact that the more varied approach obtainable in this manner – as the author hopes – gives much

more significant added value than is taken out by subjectivity.

BACKGROUND

Governmental decision related to the programme proposal

During the planning of the annual budget for 2005, the implementation of the government's programme, social and development policy, the creation of a more cost-efficient state, as well as the curbing of absolute and relative squandering required the chapter managers to apply for the so called chapter managed appropriations¹¹ (and later for other funds, as can be seen later) *in the form of proposals, broken down by programmes*. The size and structure of the programmes could be decided by the ministries. Optimum task performance was intended to ensure transparency on the one hand, and the differentiated manageability of claims on the other. The breakdown of the programmes made it possible to evaluate the state's responsibility in the completion of each task. The proposals not only had to present the individual programmes, but they also had to contain *the real prioritisation* thereof.

The *objectives* of the proposal system were as follows.

- For the consideration of budgetary needs abandonment of *base budgeting*, and thereby
 - ensuring the selection of *professionally justified programmes* that yield significant synergic effects and *meet political priorities* on the one hand, and programmes *that cannot be undertaken* in the given circumstances; as well as *relieving the tension* between the accumulated new needs and the possibilities on the other,
 - making it mandatory to prove the social necessity of the programmes, as well as elaborate and *efficient implementation*,

- enforcing the *review* of all chapter managed appropriations and programmes by the ministries,
- *encouragement* of the use of modern budgeting, financing and evaluating techniques in the utilisation of public funds.

■ Ensuring that allocation related issues requiring a political decision *should really be decided at political level*, which can also contribute to the enforcement of government priorities in the construction of the state budget.

The proposal system was an internal government procedure for the selection of programmes to be financed, the objective of which was – as described above – *not* preplanned resource *withdrawal*, but rather *the encouragement of chapter level inspections*, as well as the *submission* of programmes for *consideration at the level of the government* – and not the Ministry of Finance.

During this procedure the *raison d'etre* of not all legal titles or claims was questioned. On the contrary: claims having a *raison d'etre* had to be selected (the attainment of this objective was fostered by the set evaluation priorities and criteria). At the same time the government declared that the *various legal and other norms were not unchangeable* due to the fact that these modifications had to be implemented after the evaluation of the proposals, but before the adoption of the Budget Act.

The proposal forms were contained in the issued planning circular. On the basis of the circular, the proposals had to be submitted for the following claims:

- *objectives fundable from chapter managed appropriations* (including subsidies to the local governments¹²): professional programmes or investment projects,
- enlargement of the *professional capacity* of existing institutions,
- operational budget of potentially *new institutions*,
- additional funding needs of the *Health*

Insurance Fund for curative and preventive services and for subsidies to medical devices.

The role of the competent ministries¹³, the Ministry of Finance and the government in the distribution of public funds

Although theoretical considerations deliberately have a peripheral role in this study, at this point we need to declare that by keeping the public interest in sight, the distribution of funds to be spent in the respective institutional systems and in other ways *cannot be fully trusted to the ministries*.¹⁴ This problem, the details of which are investigated by the sub-disciplines of economics (first of all by those studying community decisions and game theory) is especially topical due to the fact that in the budgeting procedures of the last few years after the determination of the budgets for the ministries, the ministries *were given extremely significant independence* in the allocation of the funds assigned to them. This means that there was no need for “open fights” with the competing ministries for the shrinking funds, however this was of little comfort since all ministries had to distribute diminishing funds – albeit the rate of reduction varied – while the structure of tasks remained practically unchanged.¹⁵

Competent ministries have a double identity. During the distribution of state funds they act as claimants, while during the distribution of “awarded” funds within the chapter they act as allocators. Their decision-making mechanism – in both roles – is naturally at the mercy of the current interests, power relations, the fights for power, since the ministries are live organisations.

Even the distribution of state funds requires an allocator, an external organisation, the employees and decision-makers of which are

quite unlikely to be biased to certain programmes or ministries, and whose considerations are not likely to be significantly influenced by their own subjective sympathies. Furthermore, the allocator must possess sufficient professional knowledge required for deliberation. In 2004 this role was assigned to the Ministry of Finance.¹⁶

The Hungarian reality provides an excellent general example for the fact that claimants apply to the allocator for extra budgetary funds not always in full compliance with the public interest and the requirements of professional task performance. Knowing the most general statistical correlations, it can be easily seen even without proof that *at least sometimes*, in a few cases and in relation to small amounts, it should happen that the claimant *proposes the reduction of the amount allocated* for some of its own tasks, or institutions. The reason behind this could be increased efficiency, reduced social demand for the given activity, or the impact of changes in the legal regulations, which circumstances often occur. It can be stated that such a suggestion is never made in the process of budgetary negotiations, and the phenomenon that *Csaba László* named “hunger for appropriations” holds perfectly true (*László*, 1994, pages 125–126). The existence of this phenomenon proves that *in the capacity of claimants* the ministries cannot necessarily be considered as the representatives of public interests, wherefore it is likely that *we cannot make this assumption even in their capacity as allocators*, which is supported by the emergence of the problem of claimants (organisations, organisational units, interest groups, “strong” people, etc.), and consequently of allocators and claimants.

Finally: when compiling the budget of a state not only the different needs of a sector must be forced to compete, but also the sectors themselves, or rather all claims of all sectors, which evidently requires the existence of a decision-

making and selection mechanism that stands above the sectors (chapter managers, ministries), the existence of an organisation in charge of the decision-making and selection mechanism, as well as the actual decision-making process and a decision-maker. In a democratic country the latter role must be assumed by the government, while the former one can usually be best fulfilled by the ministry of finance (or by any other organisation responsible for the preparation of the budget and vested with similar rights). At the same time it poses a serious problem here that the members of the government are in fact the claimant ministers and the minister of finance, and it is not realistic to assume that once these person form a body they will immediately undertake a new role. The key to the solution can be the *prime minister himself*, who is not formally linked to any ministry, and is constitutionally the most important member of the government, the first among the non-equals.

EVALUATION OF THE PROPOSALS

Evaluation criteria

Coming back to the preparation of the budget for 2004: in order to evaluate the programmes the ministries had to prioritise their own proposals according to a pre-defined system. When drawing up this priority list, the following *determination* (points A to C) and *other priority* (points D to F) categories were established.

A Processes to be financed in any case (e.g. provision of normative subsidies, operation of new institutions that come into play as a result of investment projects).

B Unamendable legal regulatory conditions.¹⁷

C Commitments burdening year 2005 (in case non-compliance with the private law or

international commitments or final resolutions is impermissible).

D Government programmes, other political preferences (government decrees stipulating such programmes or preferences), including:

- Social policy priorities:
 - ♦ promotion of employment, job creation (training related to large investment projects, job creation in small and medium-sized enterprises, contract work, export, job retention, public work and public purpose employment programmes),
 - ♦ subsidisation of low-income families with children, improvement of the condition of disadvantaged groups of the population (people with disabilities, people with low education and income, people living in distressed regions),
 - ♦ facilitation of the situation of career starters and young families (discounts, subsidisation of first-home buyers, etc.).
- Development policy priorities:
 - ♦ ensuring co-financing required for the reception of EU funds,
 - ♦ development of express road network,
 - ♦ increasing performance oriented R & D grants.

E Decentralised programme organisation.

F Efficient task performance, synergy.

In addition to these priorities, decision-making about allocation was fostered by other material information that could be determined on the basis of the proposal form.¹⁸

Furthermore, special evaluation/inspection criteria were determined:

- in the case of programmes co-financed by the EU the share of national resources should not be higher than the required minimum,
- programmes the objectives of which are identical with the objectives of programmes co-financed from EU funds should not be approved,

- “parallel” claims (programmes with identical objectives) must be rejected,
- only such programmes should be approved the funding needs of which indicated for the forthcoming years can be satisfied irrespective of the sum indicated in the proposals.

During the procedure the *draft* of the proposal system was supplemented with the following.

■ During the elaboration of the budget bill *guarantee elements* must be incorporated so that

- the budget bill would include precisely the *funds* required for the programmes to be approved by the government,
- chapter managed appropriations approved in the Budget Act could not be used for purposes other than the programmes approved by the government.

■ A *separate budget* shall be ensured for small-scale projects that the ministries find important.

■ The legal and other conditions of task performance, and of the abandonment of the task shall be elaborated.

■ During the evaluation process it should be a basic principle that in the case of supported programmes the *funds to be required in the forthcoming years* should also be ensured by the approval of the budget bill for 2005, and these funds are not necessarily identical with the amount indicated in the proposal. In other words, one must take into account the simple correlation that a not yet determined programme, which can be subjected to consideration, will – if accepted – generate an expenditure determination in the coming years.

The planned four stages of the evaluation process

① The submitted proposals are examined by the Ministry of Finance, primarily in order to determine

- whether prioritisation by the chapter managers is acceptable (from two aspects: to determine whether the Ministry of Finance is of a different professional opinion, and whether the ministry concerned uses “trickery” to gain advantage¹⁹),
- whether the amounts required for the individual programmes are justified (whether under- or overplanning can be detected).

After the evaluation of the claims – and after clarifications with the chapter managers – the Ministry of Finance prepares a document for the preparation of further decision-making.

② The *interministerial work groups* review the claims, examine the social, economic, political and legal consequences thereof, classify and – on the basis of the examination – quantify the determinations.

③ The evaluated claims – including determinations and optional programmes, as well as their budgetary impacts – are discussed by *the governmental forums* (Economic Cabinet, Social Policy Cabinet).

④ The *government* discusses the claims modified pursuant to the criteria established during the previous stages. The government decides about the programmes to be supported, the size of subsidies as well as about the required programme modifications (restructuring, reconsideration of programmes developed in detail on the basis of government decisions made during the process, etc.).

Process of selection of programmes to be funded

After the receipt of the nearly 1,000 proposals (almost 35% of which were new programmes) it immediately became evident that the total of the required subsidies (equalling nearly HUF 2,250 billion together with the claims of the local governments and the social security funds over their preset budgets) significantly exceeds

the available budgetary funds. These latter funds could not be precisely determined since the major figures at the level of the budget proper were being determined at that time, and within this the “proposal budget” was in fact the flexible and adjustable element; its planned amount totalled approximately HUF 700–900 billion.

Due to the substantially excessive claims, the number one task of the staff of the Ministry of Finance was to determine – in cooperation with the ministries and on the basis of information provided by the ministries – *the amount that needed to be ensured in any case*. On the basis of the first negotiations and calculations this amount totalled HUF 1,051 billion, broken down as follows according to the types of determinations.

A Processes to be funded in any case

HUF 489 billion

B Unamendable legal regulatory conditions

HUF 345 billion

C Commitments that were undertaken in the previous year(s) but will burden the budget of 2005 *HUF 217 billion*

[in case non-compliance is impossible due to international (subcategory C1) or private law (subcategory C2) commitments or final resolutions.²⁰]

In addition to the above determinations a list of so called “inevitably necessary” programmes was also drawn up, which included programmes that did not qualify as determinations on the basis of legal title and/or amount, yet required implementation in any case for professional or political reasons. The implementation of such programmes required a total of HUF 189 billion.

This means that together with the determinations a total of HUF 1,240 billion was required from the government's proposal budget, much more than the size of this budget. The total claim for funding, which is nearly three times greater than the available budget,

but not alarming in itself, *in fact implied an extraordinary tension*, since even with the use of additional resources only determinations interpreted in the narrow sense could be supported. Therefore, the task appeared to be the further reduction of the number of determinations, the implementation of measures and regulatory amendments, and on the other hand, the selection of the “inevitably necessary” claims. In the remaining phase of budgeting *practically this double task was implemented*, in part mechanically. Only limited attention was paid to discussions and bargaining about the size, justification and social benefits of the individual claims.

The proposal budget ultimately approved by the planner²¹ was developed in the following manner. Determinations related to the individual programmes were put into one of categories A, B, C1, C2 or C3. In the case of category A the planner considered 75% of the set determination as the so called “reduced determination”. This ratio was 65% in category B, and 55% in category C. Without affecting the total amount of chapter managed appropriations, the claimants had the possibility to modify the amounts of the reduced determinations in each programme, i.e. reallocate the approved reduced determination budget among the individual appropriations already in the preparatory phase of the individual programmes and the budget bill. Apart from the reduced determinations programmes belonging to the “inevitably necessary” category were also approved. (An iteration process was carried out in relation to the set of programmes classified as such, and in relation to determining the required funds. During the process this set and the size of the appropriations significantly shrunk.) Obviously, once approved, these sums could not be reallocated by the claimant. The reallocated reduced determination amounts and the “inevitably necessary” sums made up the proposal budget approved by the planner.

Eventually, the iteration process brought the allocated proposal budget close to the level of *the original funding claims for determinations*, and *not to the manoeuvring room* that was initially roughly calculated. The budget figures that appeared in the budget bill included nearly HUF 1,200 billion as appropriations won through a proposal process.²² (Out of this sum HUF 1,073 billion was determined and approved in the framework of expert level procedure, while the remaining resources were determined and approved as a result of subsequent discussions carried out at ministerial, prime ministerial and government level.)

EVALUATION OF THE METHOD AND THE PROCEDURE²³

Fundamental findings

Before a more detailed evaluation and criticism is made, the most important statements – about which consensus has been reached – can be put down.

■ From the aspect of efficient public fund allocation the application of the method *can altogether be considered as forward-looking*, which can and should be further developed. However, it was debated within the ministry, too, whether the application of this method is adequate if budgeting is first of all about the reduction of resources. In other words it is the deficit rather than the surplus that must be divided. In my opinion it is especially the *zero base that provides a possibility for withdrawal* from state tasks and programmes that lack financing resources, as well from the evaluation of the consequences of reduced funding.

■ *At the same time* it cannot be definitely stated that the concrete application of the method *was altogether useful*. This is in part explained by the fact that no major savings could be achieved with this method, and partly

by the fact that the introduction of the programme based approach could not be enforced.

■ All in all the method got a mixed reception (which was more negative or more positive depending on which side of the process the evaluator was, and how he weighted the advantages and disadvantages he observed).

■ The *public finance system* (required information system, standard definitions, procedures, protocols and adequate legal regulatory environment) and the *public administration apparatus* (professional knowledge, division of work processes between the professional and financial apparatuses, motivation) were not prepared for successful application. It was primarily due to these two factors that the applied method and the concrete procedure suffered from obvious problems and hiatuses:

- the most significant fact is that the key task was not completed: the “usefulness” of the programmes was not really determined, *the need for the programmes of the ministries was not prioritised* (an important reason behind which was that the determined claims appeared as a bottleneck, in other words: no real room for manoeuvring was left for non-determined claims),
- *in the technical sense it did not form a unified system*; disconnected tables that cannot be incorporated in one system were distributed, forwarded, supplemented, summarised, etc., which implied the risk of data loss and distortion, potential misinterpretation and interpretation without context from the beginning,
- it was built on a *scattered and uncontrollable* (but at least uncontrolled) *information base*,
- the interpretation and management of the *definitions*, and consequently the *data contents* were not standard,
- the professional and political *evaluation* of the different programmes was not or not

systemically performed at government level (e.g. in the Cabinets),

- for the lack of a pre-determined system of rules *the method of determining the amounts to be approved and supported* at the ministries and at the individual programmes of the ministries *was not standardised*,
- the programmes and the related appropriated funds *were not managed consistently* during the entire budgeting process (up to the adoption of the Budget Act),
- no *follow-up* was conducted in connection with the programmes after the end of the budgeting process.

It must be considered which is *the right order of priority*: application of the method without the existence of 100% of the conditions (public finance system and public administration apparatus prepared as described above), during the gradual development of such conditions, or the creation of all conditions before the introduction of the method. In my opinion the former way is more favourable, since in the latter case it is feared that real progress will be postponed to the *unforeseeable future*.

Detailed evaluation

Since the mere attempt of programme based budgeting represents a definite progress compared to the traditional base approach and method, it is reasonable to describe the positive points first. The positive features and relative advantages summarised below did not appear in each programme of each ministry, but were altogether characteristic of the applied method.

■ It helped the Ministry of Finance and the other ministries realise (and it confirmed) that the compilation of the macro-budget(s) is a *fiscal and professional task*, the public finance processes can be managed with the budget breakdown method neither in the short, nor in

the long run. The acceptance and awareness of this method generates a range of tasks.

■ The application of the method provided *the Ministry of Finance and the competent ministries with a significant amount of additional information* about the utilisation of public funds, concrete programmes and appropriations.²⁴

■ The completion of the data forms required the formulation and elaboration of such programme parameters – irrespective of future utilisation – (e.g. objective, social impact, output, the indexes thereof, personal and material conditions), which otherwise were not necessarily formulated and elaborated, or were formulated and elaborated not in the budgeting process. The planning of the utilisation of public funds, i.e. budgeting itself became an increasingly conscious process at the level of both the ministries and the Ministry of Finance.²⁵

■ The claims *became more transparent*, i.e. the probability of efficient decision-making grew. The real funding requirements of the different tasks and programmes could be more successfully determined.

■ The procedure supported and laid the foundations for a *multi-year outlook*, however there is no doubt that it was not able to considerably fulfil this objective.

■ *No response was received about any extreme budgeting error* that would have occurred due to the application of the method, which definitely supports its *raison d'etre*. (At the same time, outstandingly positive examples were not reported either.)

The number and range of problems related to the method and the applied procedure *by far outweigh the positive features*. This can only partially be explained by the fact that the recognition and identification of the problems is more useful (but not more important!) for progress than the identification of the positive experiences. Furthermore, it must be stated that the

applied method and the concrete procedure *implied all those (teething) troubles with which the entire budgeting system has – unfortunately – been struggling ever since*.

■ The gravest, most far-reaching experiences²⁶ are the following.

▶ *The base approach budgeting was abandoned* neither by the Ministry of Finance, nor by the decision-makers. Most proposals were *not about classical “programmes”*, but contained *budget requirements in the system of the former years*. This is in part understandable, since the “alteration” of the system – if this will be attempted at all – may take years.

Some of the ministries and applicants *did not consider themselves responsible* for the task, they considered it as a mandatory bad thing, the “independent show” of the Ministry of Finance, unnecessary extra work. A smaller part of the ministries and applicants did not understand the objective of the programme proposal, and a significant group of them altogether found the application of the new method unuseful.

▶ In many cases *not even the ministry had information about its own proposal*. This can be attributed to the bitter experience that the ministries manage the system trusted to them *not in the right manner or not to the right extent* (which is assumed to be an important factor in the system of the budget). The proposal was often elaborated by an organisation under control, which significantly hampered further discussions about the merit – even in technical terms.

▶ Apart from other reasons, for the lack of accurate task descriptions known to all players, as well as for the lack of an evaluation and decision preparation process, the *decision-makers did not have the possibility* (energy or time) for the *thorough evaluation of the programmes* (although this was clearly made possible by the method), and they almost exclusively relied on preparations made by experts.

This is a problem for several reasons. On the one hand, the knowledge of experts within the Ministry of Finance about other ministries is limited, and due to the bureaucratic hierarchy they typically carry out instructions (instead of solving problems). On the other hand, as civil servants they cannot represent political priorities.

Therefore, aspects that are not or cannot be considered by experts could articulate only to a very limited extent in decision-making, while aspects that are or can be considered, could be enforced irrespective of the budgeting system, or the principles and results of such system, in the form of the usual bargaining mechanisms.

■ The applied procedure *violated the principles of zero-base budgeting* at several points:

▶ By creating the “inevitably necessary” category the government practically declared that that are programmes that are *more important* than or are equal in importance with accurately deduced *determinations*. This is a serious contradiction, a sort of criticism of the government's work, since especially the most important programmes should be made determined in the form of appropriately elaborated frameworks (legal regulations, calculations, etc.). If a programme is ranked higher than the determined expenditures, it will necessarily lead to a situation – especially in the case of a shortage of funds – that some of the preset determinations will not be financed, which will generate unwanted, but deliberately non-prevented defects in the operation of the public finance system. However, this is a simple arithmetic exercise: consideration of the programmes can be started only if the amount of the determination is smaller than the room for manoeuvring. Otherwise the size of the determination must be modified with appropriate measures.

In 2004, the *determination amounts were curtailed* basically in two ways. To a smaller extent by the careful re-examination, debate and evaluation of the claims, and to a larger extent with

a *differentiated, yet “across-the-board” method*, in which the planner accepted different percentages of the amounts associated with the individual determinations as “new determination amounts”. This was a point at which a merely fiscal, but theoretically unjustifiable mechanical element was incorporated into the professionally sophisticated system.²⁷

So what is the issue here? Either the government's apparatus is unable to correctly define the size of the determination, (or the government is unable to encourage it to do so), wherefore the government can *presume* (but cannot *know about*) the overplanned nature thereof (see the section on the claimants' “trickeries”), wherefore it can reduce the accepted rates associated with the legal titles. In this situation the government practically does not know what financial burdens the state must bear year after year, and nor does it know the consequences of the reduction of funds under the different legal titles in relation to the provision of the given tasks.

The other possibility is that the size of the determination is defined more or less well, however in this case by rejecting a significant portion of the determinations the government “programmes” non-compliances with the legal regulations and the unenforceability of the signed contracts.

▶ The applicants also *had the right to modify the amount* of the approved programmes, i.e. *re-distribute* the approved reduced determination budget among the individual programmes, or among the different appropriations in the preparatory phase of the budget bill. This also questions the fact, or at least the level of determination.

■ A significant part of the problems arose from the *insufficient development* and non-observance of the procedure, the shortness of the available time, the lack of the required know-how, in general from the insufficiency of human resources in possession of modern

methodologies, i.e. *from the non-existence of the required boundary conditions*:

▶ By According to the plans, before government level decision-making the working groups (the ministries separately, the Ministry of Justice, the Ministry of Finance) and the different governmental forums (first of all the cabinets) would have discussed the claims. This practically did not happen, programme level discussions and evaluations *were carried out exclusively on bilateral expert level*, between the Ministry of Finance and the ministerial staffs.

▶ Irrespective of the relationship to the proposal system, the quality of form completion, and consequently the evaluability of the data extremely varied. This led to *unintended differentiated treatment*. (Naturally, this factor must be taken into account in the case of any budgeting method.)

▶ The decision-makers typically conducted discussions about the *chapter budgets* that were developed after the expert-level inspection of the programmes (at the same time it was a positive development compared to the practice of the former years that programme-level consideration was also introduced), however *decisions were made not about strictly observable legal titles and budgets*, which would be mandatory in the case of zero-base budgeting.

▶ At the level of decision-making there was *no real transfer among the programmes of the different ministries*.

▶ In part due to the novel nature of the system, the *staff of the Ministry of Finance was also unable to handle the proposals in a standard manner*. This caused problems especially in defining the determination rates, at the approval of the amounts specified by the ministries, and led to unintended differentiated treatment. The possibility to control the data and judge the level of substantiation was not ensured.

▶ Efficiency and social impact (in the positive and negative sense), as well as the measure-

ment and control thereof appeared *as a real selection criterion only to a very limited extent*. However, due to the experimental nature of the programme such an expectation was not and could not be excessive.

▶ The *structure of the proposals* and the *structure of presentation* were not in harmony, wherefore follow-up, checking and feed-back were *a priori* impossible.

■ Other problems and criticisms that were characteristic of the process, or that came to the surface:

▶ In case the ministries detect (possibly on the basis of multi-year experience) that the claim presented as a determination enjoys priority, *they may be interested in undertaking excessive commitments already before the end of the budgeting period*.²⁸ In the best case scenario legislation and the government are impervious about preventing this, but in many cases the ministries continue this practice on purpose.

▶ There was excessive preliminary expectation (at least at the level of declaration) in that the ministries can and must be “forced” to observe the programmes and amounts approved in the proposal system during finalisation and then during implementation with *legal tools*. It is more reasonable to achieve this objective with governmental *management tools*.

▶ The achievements of the budgeting method *suffered a blow* during the *parliamentary stage* of legislation.

▶ Until the completion of the budgeting process only part of *the commitments* pertaining to the next year are assumed, other commitments emerge only at a later stage. Naturally, some of the “potential commitments” that emerge after the completion of the budgeting process can be prevented, however others cannot (e.g. a public procurement procedure launched in an orderly manner in January often reaches the stage of commitment assumption only in November). Accurate and standard handling in this respect is crucial for

defining the determinations, however no such practice was established.

▶ Finally: a major cause of most of the above problems was *the shortness of time*²⁹ available for the completion and evaluation of the proposals, as well as for decision-making.

SUGGESTIONS FOR FURTHER DEVELOPMENT³⁰

The fundamental finding of the study is that although the experiment cannot be considered successful, it showed enough positive signs and results that justifies efforts for further development. It is a crucial, but not yet answerable question whether *in the medium run* the Hungarian budgeting system (including its major players: the competent ministries and the Ministry of Finance, the technical background, and above all, the way of thinking about public funds and the culture of utilising public funds) can be prepared for the *introduction of a new budgeting regime of this type*, or of any other system focusing on the social rate of return? This chapter describes what preparations are inevitable on the basis of the lessons of the experiment.

Preliminary works

■ *Claims, programmes to be launched or continued, as well as resources* for which proposals must or can be submitted shall be defined as accurately as possible. (I.e. there should be no “grey zone” left in relation to any forint of the budget from the aspect of the applied budgeting method.) It should continue to basically focus on the chapter managed appropriations, but it is worth considering what other group should be involved in the proposal system.

■ Since apart from the fiscal and other boundary conditions the issue of *determina-*

tions is of crucial importance, this element of the method requires very precise and careful elaboration:

- defining the *types* of the determinations, and communication thereof to the ministries;
- exact formulation of the *definitions* of the different types of determinations, so that *the determination nature could* be verified, or at least presentable, and the meaning should be unanimous for everyone in each category;
- ensuring the possibility for the *establishment of clear priorities* among the different types of determinations (It is possible that a given claim is considered as a determination under several legal titles. For example, the payment of EU subsidies is most often based on private law contracts. In case the prioritisation of the types of determinations can be ensured, a given claim is treated adequately if ranked as the highest among the existing types of determinations.³¹);
- *separation* or possibility of separation of the *claim related to the programme and the size of the determination therein*; raising awareness of ensuring the presentability of “importance” and “necessity”;
- ensuring the presentability and evaluability of the consequences and tools of cancellation, reduction, postponement, etc.;
- ensuring the exact formulation and documentation of the definition of “commitment assumption”, with special regard to the time of commitment assumption (before or after budgeting);
- specifying the amount of the determination after multiple discussions with the Ministry of Finance.

■ It must be precisely determined *what can be regarded as a programme*. Since this is the basic unit of evaluation, the different level of aggregation (contentual and not financial aggregation) makes comparison impossible.³²

■ A solution must be found to detect *same-purpose programmes* on the one hand, and *programmes that can be implemented with EU co-financing too* on the other.

■ The *prioritisation of the submitted programmes* cannot be fully trusted to the applicants (the ministries). Instead, the programmes should be submitted according to the predefined categories, and thus the use of “trickeries” can be prevented. In this respect firm government instructions are needed.

■ It can be proposed that *the maximum number of proposals* to be submitted by the ministries *should be determined in advance*. However, this upper limit shall not guarantee the subsequent acceptance of the proposals.³³ This is the application of a so called “double ceiling”, where the first screening should be performed by the claimants themselves, and only the viable proposals should be considered at government level.

■ The *development* – and naturally the thorough and plastic presentation of the consequences – *of the method of withdrawal from the task* must be an accentuated task.

■ For the lack of a standard public finance information system *the IT background of the method must also be developed*: efficient IT support must be provided

- to simplify the data transfer, data recording and data management system;
- to facilitate systemisation, classification and summarisation according to various aspects;
- if possible, the decision-making mechanism should include objective and comparable factors (ones for which algorithms can be written).

■ The *presentation system* of public finances, including that of the central budget must be restructured so that it would ensure adequate identifiability and flexibility. This also creates the possibility for *reporting* according to programmes/tasks.

Suggestions fostering adequate application

During the evaluation of the programme proposal system detailed suggestions were formulated. In accordance with the critical remarks described above, during the evaluation of the programme proposal system detailed suggestions were given regarding the measures to be taken by the government for successful implementation. It must be emphasised that this is about the improvement of the applied method. The introduction of a programme, performance or task based budgeting system that would affect the entire budgeting process *was not and has not been on the agenda ever since*. The suggestions are important, often perspective, but here it is no longer reasonable to deal with this level of operativity. Based on the most important suggestions the following findings were made.

■ *Fundamental* suggestions:

▶ In case of the excessive rate of claims that appear as determinations funding should not be reduced proportionately (across the board), but rather *omittable determinations should be selected and then the necessary measures should be taken*. Without this the method will lose its theoretical base, since the essence of the determinations is especially that both political and fiscal consideration can be excluded in connection with them, and that if the circumstances remain the same, funding for such purposes must be ensured in any case.

▶ *Motivating and sanctioning* elements must be introduced to prevent the use of “trickeries” by the applicants in order to gain benefits (additional funding). On the contrary: such conduct must have well perceivable professional, financial and political (and possibly personal) risk.

▶ After an agreement and decision are made about the determinations within each programme, the ministries *shall not be allowed to reallocate the budget so established*. On the con-

trary: separate guarantee elements must be enforced in the conciliatory process so that the approved amounts be included in the budget bill. (Deviation shall only be permitted for especially important reasons, in cases approved by the government.)

▶ A *follow-up* method and system must be developed for the *programmes*. Actual performance (both professional and financial) must be compared with the planned performance. Feedback information (on the concrete programmes, the adequacy of budgeting at the individual ministries, as well as on the programme proposal budgeting system) must be utilised in the next budgeting period.

▶ It must be ensured, at least on the procedural side, that *the boundary* between the approved and rejected programmes and claims at the individual ministries should be drawn *in a standard manner*. This boundary must be drawn at claims having the same margin of profitableness at each ministry.³⁴

■ Suggestions related to *the nature of the procedure*:

▶ *Sufficient time must be provided for completion* for two reasons: to improve the quality of elaboratedness, to prevent the generation of legal title on the basis of inaccurate, incomplete or inadequate (for other reasons) form completion. Time is needed for preparation and decision-making within the chapter, it must be ensured for the applicant ministry and the institution working out the proposal to cooperate.

▶ *Sufficient time must be provided for the evaluation of the proposals and for decision-making*.

▶ The ministries must agree in advance on which ministry will apply for which programme (this is an important task in the case of programmes co-financed by the EU). The Ministry of Finance must provide assistance in *detecting overlaps and inconsistencies*.

▶ It must be determined whether a programme has revenue and expenditure connec-

tions in more than one ministry, and the *standard treatment* thereof must be ensured. (For example, it should not happen that one “leg” appears as an important determination, while the other is ranked as a subordinated programme.)

■ *Further practical conditions* of appropriate application:

▶ It must be achieved that all ministries should be able to *produce proposals of the same quality*. The allocation of public funds shall not depend on the fact that an apparatus is more prepared for this task than the other. The low level of preparedness of ministry employees shall not lead to the inadequate selection of public tasks or to the provision of inadequate funding.

The *applicants must be better prepared* in another sense, too: communication of the objectives and the procedure in due time, request for opinions, etc. Identification with the method – to a certain extent – and the reduction of aversion is also an objective. This significantly affects the success of the method.

▶ The procedure used for the evaluation of the proposals and for decision-making *shall be determined in advance*, including the exact tasks of the entities involved (this is of special importance in the case of the Ministry of Finance and the different government forums).

Although the exact course and manner of the evaluation of the proposals had been developed, the actual process was adjusted to it only partially. A problem may arise in case this deviation is not the result of a deliberate political/upper managerial decision, but that of external factors which are irrelevant from this aspect.³⁵ Therefore a greater emphasis must be put on reaching a *preliminary agreement* on and continuous *compliance* with the process of evaluation (by allowing deviation only upon government level approval).

▶ The ministries must have such a profound knowledge of all of their proposals that would allow them to conduct negotiations about them.

▶ *Firm governmental support must be ensured to the Ministry of Finance* professionally and politically alike. The competence of the Ministry of Finance cannot be questioned in relation to the coordination of budgeting, in relation to its right to access (or rather to submit to the government) the budgeting requirements derived from the fiscal framework conditions. *This does not mean the delegation of issues requiring government level decision to the Ministry of Finance*, which can trigger the ministries' repugnance threatening all-governmental interests, "empoisoning" budgeting, usually without real foundations.

However, the apparatus of the Ministry of Finance must be left on the "objective" budgeting side (by terminating its bondage to the ministries) and by ensuring responsibility and accountability.

▶ Finally: there are serious requirements against the entire government: the government must be *committed* and *must demonstrate commitment*. "Tricky" proposals should carry perceptible professional, financial and political risks at the ministries. The proposals must be brought to the level of *referrable* budgeting documents. It must be achieved that *the professional and financial apparatuses of the ministries should really cooperate* both in the preparatory and the conciliatory phase.

Conditions to be created in the longer perspective

In relation to certain programmes and appropriations the successful application of programme based budgeting requires that all those changes be made in the long run that usually emerge in relation to a "public finance reform", and the *resolution of which was and has been attempted in the past years*, sometimes unquestionably successfully. Therefore, here it is not worth going into details about this. The neces-

sary conditions include but are not limited to the following (the list does not reflect the optimum prioritisation of implementation):

- *general review and reconsideration of the tasks and roles of the state*, because a strategic way of thinking and budgeting cannot be substituted with any annual budgeting technique;³⁶
- elaboration of *sectoral strategic programmes*, in harmony with medium term (3 to 5 years) outlooks the major figures of which pertain to a longer period (e.g. 10 years), in harmony with the macroeconomic path to be followed, as well as with the current national development plan;
- development of a *public finance information and monitoring system* that can handle professional, financial and financial management contents in a usable manner;³⁷
- *development of a legal regulatory environment*, which would foster or "force out" the standard use of terms, as well as the enforcement of the principle of efficiency and performance;³⁸
- in order to ensure the *mobilisation* of professional programmes, they must be planned and financed independently from the operation of institutions;
- *controllability* of data provided by the ministries, in the longer run *auditing* of the provided data.³⁹ This is important especially in establishing the actual rate of determination;
- ministerial apparatuses having appropriate professional, budgetary and economic knowledge, as well as the ability to apply such knowledge.⁴⁰

CONCLUSION

As a conclusion of the article I attempt to answer a simple question: what can be the cause behind the fact that despite the success of the

experiment – albeit limited – the government still refrains from using this budgeting method?

Before answering this question I find that two topics are worth being highlighted. On the one hand it must be mentioned that at the end of 2006 the government decided on a programme with impressive objectives, i.e. the general review of public tasks.⁴¹ In parallel with the “assumption of excessive tasks by the state” the citizens are – in general justifiably – dissatisfied with the offered services and the functioning of the state. This makes it evident that in addition to reducing the size of the organisation, further reform steps are urgently needed to improve operational efficiency and for the significant enhancement of the prioritisation of the assumed tasks. The review of public tasks intends to serve this latter issue, on the basis of which we intend to achieve that the state should undertake fewer but better services and tasks.” (The review of public tasks 2007, page 3) This means that the government has openly and directly undertaken to start off with a “clean slate” and the *raison d’être*, the optimum manner of performance and the size of all tasks assumed by the state (and by the local governments) should be inspected, and should eventually be reduced and adjusted to the citizens’ preferences and the load-bearing capacity of the country. Today we can already see that this latter objective has not been attained, the tasks of the state and the local governments have not decreased in number, and nor have they been substantively prioritised. It is not my intention to address the underlying causes, in fact they can be the topic of an independent study.

Secondly: it must be pointed out that although the programme proposal initiative was welcome and promising, *it is far from meeting the requirements of classical zero-base budgeting*. Many people share the opinion according to which “with some simplification, the objective of the experiment was to investigate the

well-foundedness of chapter managed appropriations, and to reduce or terminate the funding of programmes that have been found unsubstantiated” (Sebők, 2007a, page 25). The *raison d’être* and forward-looking nature of the initiative is not questioned, wherefore it is not justified to cancel any advancement or steps in other directions.

Exploring the causes behind the question asked it seems that one of the most important causes is – contrary to common belief – not only 2006 which is a watershed year in many aspects, or the general crisis that erupted in 2008, but rather the decreasing room for budget manoeuvring – witnessed for years – in the sense that the amount of non-allocated expenditures that can be spent “freely” is practically zero if not negative. As it was said before, negotiations in 2004 were held practically about the “distribution of the deficit” rather than about the distribution of the surplus. Since then the situation has become even worse. Under such circumstances the government and the minister of finance presumably do not find the shift justified and timely.

Another important cause is that the method would require the state (more precisely the Parliament, the government and the ministries responsible for task performance) to back out from tasks related to the “rejected” claims. The example of the review of public tasks demonstrates that in today’s Hungary decision-makers find it professionally and/or politically impossible to undertake, and therefore they fail to take this step even if this would be in the public interest, and despite the fact that maintaining the task may cause serious financial disturbances.

We must not forget about the fact that in addition to the Status Act, at the end of 2008 the National Assembly adopted another act that affects the foundations of the Hungarian budgetary and public finance system, about cost-efficient financial management by the state and about fiscal responsibility. On the

basis of this act in a few years' time it will be unavoidable for the ministries to create the necessary conditions outlined in the article (conditions that will basically create the possibility to harmonise public task performance with the necessary budgetary resources). This will be the only way to determine and meet the objective of maintaining the primary balance.

Finally, it must be acknowledged that in mid 2009 *Elemér Hankiss* had all the right to write that “the lack of competence in Hungary is unbelievable both in politics and public admin-

istration” (*Hankiss, 2009*). In the field of human resources significant, seemingly almost impossible development is needed to create at least the basic conditions for the expansion of the use of the modern budgeting techniques. This means that the enhancement of the efficiency of the state apparatus requires us not to maintain performance, or the output by using the continuously decreasing capacity and input, but rather to increase the output, and eventually the outcome, i.e. social benefit by using an input almost identical with the current one.

NOTES

¹ Officially: chapter managing organisations the detailed list of which can be found in the definitions of Government Decree 217/1998 (XII. 30.) on the rules of operation of public finances. In the following, for the sake of simplicity, I often use the term ministry.

² The article exclusively reflects my personal views which are not necessarily identical with the official position of the Ministry of Finance or other government agencies.

³ An important basis for the preparation of the study was the internal evaluation carried out with the involvement of the staff members of the affected Finance Ministry departments a few months after the conduct of the program proposal system. Furthermore, I am indebted to Zsolt Aradi, László Balogh, Péter Banai, Balázs Romhányi and Zsolt Tavaszi, who contributed to this article with many valuable thoughts and suggestions.

⁴ See for example Sebők (2007a, 2007b)

⁵ See for example New budgeting system (draft) (2006)

⁶ A good overview of this is given by the thematic publications of the State Audit Office, e.g. SAO (2007)

⁷ See for example OECD (2007), Hemming et al. (2007)

⁸ Act CV of 2008 on the legal status and financial management of budgetary organisations, known as the “Status Act” or “Legal Status Act” in the professional jargon, which is misleading content-wise.

⁹ The name of the procedure speaks for itself: the ministries had to submit proposals for state subsidies, and they could participate in this procedure with governmental and sectoral programs.

¹⁰ According to Miklós Sebők, the proposal system of 2004 was by far the most outstanding from among the larger-scale attempts affecting all ministries (Sebők, 2007a, page 19).

¹¹ It must be noted here that the use of the base approach in budgeting is not an a priori bad or less valuable method than zero-based budgeting, since it starts out of the often fully relevant assumption that public task performance in the plan-year and the required resources show discrepancies from the subject year only at well-definable points, wherefore it is economically and professionally justified to consider the discrepancies only, and that these discrepancies should serve as a basis for budget bargaining and consideration by the allocators. This is especially true if the state/local government performs public tasks through maintaining institutions. It is another issue that even in this case from time to time it is worth questioning the legitimacy of the legal title and size of all cost elements, although it is not reasonable to perform such an inspection every year.

¹² The central budget basically contains four types of expenditure allocations: expenditures of the central budgetary organisations, appropriations that are managed by the different chapters, but cannot be allocated to any budgetary organisations (at least not in the budgeting period) (chapter managed appropriations), and the so called centrally managed

appropriations within which it is reasonable to differentiate subsidies given to the other subsystem of public finances, and the other expenses (individual and normative subsidies, transfers to households and other transfers, consumer price subsidies, debt service, interest subsidies, payments to the EU, etc.). The share of these expenditure groups naturally varies from year to year; the expenditures of the central budgetary organisations accounted for 28.0% of the total central budgetary expenditure of HUF 8,498.1 billion in 2007 (compared to 29.1% of HUF 7,004.4 billion in 2005), while the expenditures of chapter managed appropriations accounted for 21.8% (versus 18.5 in 2005), subsidies to the other subsystems totalled HUF 19.6% (versus 18.9% in 2005), and the other central expenditures totalled 30.6% (compared to 33.5% in 2005).

¹³ Under the current legal framework, program based budgeting cannot be applied in planning the financing of the local governmental subsystem. It can exclusively be applied in the case of chapter managed appropriations that affect local governments, too. The specific extension of this budgeting method to this subsystem can be explored within the framework of a reform aiming at the transformation of the local governmental system.

¹⁴ By competent ministries I mean the ministries responsible for various sectors (healthcare, education, defence, etc.). For the sake of simplicity in the following I will use the word ministry.

¹⁵ The problem described here is explained in an excellent and detailed manner by László (1994, pages 125-135), by describing the claimant's and the allocator's behaviour, and the causes and objectives of such behaviour. These terms are used throughout the study in this sense.

¹⁶ For the relevance and failure of the public task review that aimed at changing the task structure see Section 6.

¹⁷ This "casting" is generally accepted in the international arena, however, in the period of 1998-2002 the Hungarian Government intended to assign a similar position to the Prime Minister's Office with the system of offices then developed.

¹⁸ It must be asked what the difference is between amendable and unamendable legal regulatory conditions, since in theory the National Assembly can amend any act, the government may amend any of its decrees, etc. "Unamendable" legal regulatory

conditions mean those conditions within the procedure the amendment of which was practically impossible (e.g. it would have surely been rejected a two-third support, wherefore proposing the amendment did not make any sense), or the public interest in a given condition was so strong that amendment was out of question (e.g. elimination of the law enforcement tasks of the police):

1. the transparency and elaboratedness of tasks, projects and the implementation thereof during the program,
2. ensuring implementation in accordance with the objective,
3. expected consequences of the abandonment or termination of the program,
4. availability of personal and material conditions,
5. harmony between the required additional personal and material conditions, and resources, and task performance,
6. relationship between subsidy resources and implementation,
7. correlation with other chapter managed appropriations/programs,
8. the output and social impact (outcome) of the program, elaboratedness and quantifiability thereof,
9. program inputs, determination and quantifiability of such inputs and the size of the related expenses,
10. elaboratedness and substantiation of the program's cost analysis, as well as that of the expenditure needs broken down by tasks and projects,
11. the relationship between the requirement for 2005 and the expected utilisation in 2004,
12. elaboratedness of the financial schedule of the entire program,
13. acceptability of the financial needs of further years,
14. availability of the professional and financial control of the program,
15. experiences and ratings of the former professional and financial audits.

¹⁹ In the following I will use this not too elegant expression for the behaviour when the claimant does not inform the allocator about the real priorities known to him, or about the really needed amounts, but deliberately modifies (mis-states) the information or forwards erroneous or ambiguous data so that in the budgeting process, or later during the execution of the budget it would receive a greater amount than the one allocated upon an optimum resource allocation decision. Such "trickeries" may include the following:

- a) indication of appropriations with no upper limit

at a smaller sum, underplanning of such appropriations with a view to leave a room for manoeuvring for other programs during budgeting (the consequence of which is overspending in the implementation stage);

b) indicating a higher than real sum for, or overplanning of determinations (in case of approval a room for manoeuvring is created during the year);

c) deliberate subordination of a task that must be performed in any case. This creates a chance for the approval of program that would not be approved if ranked properly, however during the implementation stage claims are put forward for the subordinated – yet required – task performance.

²⁰ During the negotiations a third (C3) subcategory was also determined when drawing up this category of determinations. This subcategory had to include those programs and granted amounts that did not fit into the above determination categories, but were co-financed from EU funds, and in the case of which the unavailability of national resources would have meant losing the EU co-funding, since after 2005 those funds cannot be drawn down.

²¹ The “planner” indicated several times in the description first of all means the Ministry of Finance, and in many places – for the sake of simplicity – this is how I refer to it. Yet, it is worth separating the two, since during the budgeting process discussions with the ministries were carried out in several iterations (e.g. in relation to the categorisation of the determinations), and several budgeting issues were forwarded to government level. Therefore, the complete identification of the planner with the Ministry of Finance would be misleading. On the other hand, when I use the term “Ministry of Finance”, under the changing circumstances it does not necessarily mean the current ministry of finance, but rather the government member and his work organisation coordinating the budgeting process both professionally and numerically.

²² Since the set of proposal programs did not fully overlap with the set of chapter managed appropriations contained in the budget bill, this value cannot be learnt from the bill itself. The amounts of the approved proposals were often incorporated into the appropriations of institution titles, in other cases they were merged, restructured, etc.

²³ The evaluation is firstly based on the completed documents, secondly on subjective experiences and oral discussions, and thirdly, on a non-representative survey conducted a few months after the end of

the budgeting process among the staff members of the ministry of finance that were involved in the process.

²⁴ Several responses were received according to which even the supervising organisation obtained information on certain processes within its institutional system, and about the future plans through the forms. (This is of course not a favourable fact since it reflects the supervisory and management problems that are experienced at every step.)

²⁵ The obtained knowledge was utilised during the elaboration of Act CV of 2008 on the legal status and financial management of budgetary organisations.

²⁶ Naturally, these statements are based not only on this experiment, but also on multi-year experiences.

²⁷ It is another issue that in the given situation this was the best solution, since the rate of determination could not be managed without this “cut”. The economically justified solution, i.e. the careful examination of the claims in order to establish the “real determination” was impossible to implement both in theory and practice in the given circumstances.

²⁸ This type of conduct does not belong to the category of “trickeries”, since it is not about giving a false picture about reality, but about changing reality.

²⁹ Hardly two weeks were available for the preparation of the proposals (for getting to know the government's intention, for internal discussions, for defining the necessary tasks and the submission thereof to the appropriate level, for concrete data collection, for consideration, form completion, decision-making, etc.). In the case of the concrete person in charge of form completion this probably requires a deadline of one or two days. Three weeks were left for evaluation and decision-making (physical processing, requesting new data, conciliatory talks, consideration and the repetition of these stages several times). An important role was attributed to the special and atypical circumstance that a government crisis occurred in August 2004, and a change of government took place at the end of the month.

³⁰ The suggestions show many similarities with other writings prepared on the topic of budgeting, yet with completely different objectives. See for example Sántha–Vigvári, 2006

- ³¹ For example, the existence of a private law contract in this case is a higher level determination than the fact that it represents the national co-financed part of an EU subsidy, wherefore decision can be made on the basis of the former determination.
- ³² Two extremities: the National Development Fund divided its funding need of HUF 225 billion into 5 programs, of which the program titled “Implementation of EU subsidy programs” totalled HUF 174 billion, and the program titled “Preparation of EU large projects” equalled HUF 50 billion. In contrast with this, the Ministry of Justice presented its claim for HUF 10 billion broken down into 42 programs.
- ³³ The advantage of this is that the ministries would be a priori forced to thoroughly consider and pre-select the claims (consequently, only “serious” claims should be processed). The disadvantage, on the other hand, is that – especially due to the zero-based nature – no adequate methodology can be assigned for the determination of the budgets of the individual ministries. Therefore, it is reasonable to define these budgets as a percentage of the planned figures for the previous year, however this would reinstate the base approach in the method.
- ³⁴ Therefore it cannot happen that Ministry *A* approves a program whose margin of profitability, i.e. whose social profit from the last spent tax forint is smaller than the social profit from the first spent tax forint of a program rejected at Ministry *B*. Naturally, the pure theoretical formula cannot be used in itself, however comparison must be carried out at the level of political and professional consideration.
- ³⁵ The dominant cause cannot be determined subsequently and at professional level.
- ³⁶ The strategy requires that the planner (here: the ministries) should carefully consider the state tasks and programs to be implemented in the medium run, as well as their adjustment to the room for financial manoeuvring, and this must be enforced by the macroeconomic situation and the pressing modernisation of public finances. However, it is a different issue what technique the government chooses to budget the funds required for the claims emerging in a given year. The budgeting technique should not “wait” until after the actual implementation of strategic budgeting, and nor should it wait until after the itemised review and reconsideration of state tasks and roles. Both would mean the unsubstantiated postponement of program based budgeting to the uncertain future. It must be noted here that the review of public tasks was carried out in 2006 and 2007 (see Section 6), however since the review yielded only partial success, this task cannot be regarded as completed.
- ³⁷ The Budgetary Management System (BMS) under construction is in part designed to serve this objective, although it represents a great step forward more in terms of IT solutions than in laying the professional foundation of budgeting and financial management.
- ³⁸ This task was more or less completed by the adoption of Act CV of 2008 on the legal status and financial management of budgetary organisations, but the intended implementation may take years in several aspects.
- ³⁹ Ideally, auditing should be performed by external experts (persons, companies) since this would ensure objectivity and competence to the greatest possible extent. There is no doubt that for the time being the practical implementation of this does not seem possible. It is another question whether auditing should take place already during the elaboration of the proposal (before its submission), or in relation to accepted claims, in the period before deciding on the proposal and the compilation of the budget act. The latter is supported by the fact that in this case only a smaller group of claims would need to be audited.
- ⁴⁰ During the evaluation of the article it was raised that the Hungarian ministries lack a group of 5 to 10 politically uncommitted people who would form the “general base”, a so called professional “tail” of governmental work, and who could serve as a foundation for the successful implementation of the so called all-governmental projects through collaboration, sharing the same language, using the same terms, and building on more or less similar knowledge. A similar governmental objective was formulated during the elaboration of the legal regulation on the all-governmental project – or the elaboration of the theoretical foundation thereof – in 2006 and 2007, however implementation is still to come.
- ⁴¹ For the description of the government's objectives and the applied tools see The review of public tasks (2007). Government Decision 2229/2006 (XII. 20.) on the review of public tasks.

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Pál Csapodi – György Sántha

New trends in the international professional regulations pertaining to external audit organisations

Incessant global changes and the subsequent competitiveness challenges force audit institutions assume newer and newer tasks on a regular basis. As a result of ever-widening international cooperation financial audits cross the national borders, wherefore – corresponding to the globalisation process – a gradual standardisation process has started in this field too, which is universal in terms of the basic principles, yet preserves the values of the national practices.

An important precondition for standardisation is that the activities of the audit organisations should be harmonisable and linkable with one another. This goal is served by the coordination of the audit techniques, methods and procedures, the establishment of international standards, as well as the application and further development thereof. Said process is coordinated and encouraged by the International Organisation of Supreme Audit Institutions (INTOSAI), which integrates the supreme national or state audit organisations, and coordinates the professional development thereof – today increasingly in conjunction with the International Federation of Accountants (IFAC).

The new expectations to be set against the new situations are primarily mediated by the regulatory systems, within which – in addition to legal regulations – the periodic renewal of professional regulations comes up as a key issue. The legal reg-

ulations primarily answer the questions “what?” or “why?”, which are necessary but not sufficient preconditions. In contrast with this, the professional regulations also deal with the problems of “how, with what methods?”, with standard solutions – methodologies – in the centre.

Within the professional regulatory system the professional standards of auditing are currently linked to fundamental terms such as materiality, risk, sampling, assurance, etc., which appear as the main threads of quality in this respect. The standards are not legal regulations, since they are based on the principle of voluntary adherence, however, they clearly indicate the expected quality level. Apart from this, during the audits the professional standards are used as a benchmark, or measurement tool, wherefore they must be considered as indispensable elements in the audit quality management systems, too. Apart from the general standards, the guarantee values of the national economy and public finances, such as the transparency and accountability of the utilisation of public funds, the enforcement of which requires the consistently good quality of the audit activity, have by today become key factors. It results from all this that it is impossible to develop and operate the quality management systems of external audit organisations without the continuous modernisation of the professional (methodological) regulation of audits.

The following is an attempt to identify the global professional processes that have been increasingly taking shape in the past years, as well as to identify the possible directions of development, with special regard to the professional regulatory tasks that can currently be set for the State Audit Office, the external audit institution of Hungary. However, when keeping track of the international trends it is unavoidable to systemically review the professional audit documents produced in the past years, which are continuously accessible on INTOSAI's website and which form the number one subject of this study.

THE PROFESSIONAL REGULATORY ACTIVITY OF INTERNATIONAL ORGANISATIONS

From among the international organisations engaged in activities of the audit profession reference is made to seven institutions the professional methodological activities of which must inevitably be inspected for the development of the internal regulations of the supreme audit institutions (SAIs). These institutions are the following:

- the International Organisation of Supreme Audit Institutions (INTOSAI),
- the International Federation of Accountants (IFAC),
- the Institute of Internal Auditors (IIA),
- the European Association of Supreme Audit Institutions (EUROSAI),
- the European Court of Auditors (ECA),
- the Internal Audit Service (IAS) of the European Commission, and
- the European Organisation of Regional External Public Finance Audit Institutions (EURORAI).

From among the above mentioned organisations, the most relevant for the State Audit Office of Hungary (SAO), the supreme audit

institution of Hungary, is the professional regulatory activity of INTOSAI founded in 1953 as a consultative body of the Economic and Social Council of the UN.

The INTOSAI

The objective of the international professional organisation, which operates within the cooperation system of the UN with 189 full members, is to support the operation and professional development of the member institutions and the harmonisation of their professional activities.

One of the most often cited basic INTOSAI documents is the Lima Declaration adopted at the Congress of INTOSAI in October 1977. The experiences gained to date from the application of the professional regulatory system, which is based on the aforementioned document (also cited as the constitution of SAI audits) also verify that it is both necessary and possible to formulate audit principles and rules crossing the boundaries of various traditions, cultures and political regimes. Another important stage of development after the Lima Congress was the INTOSAI congress held in Washington in 1992, at which the member states approved the INTOSAI Auditing Standards.¹

Since then the world organisation has continuously shaped and modernised the system of international audit standards at each of its subsequent congresses. For example, the XVIII Congress held in Budapest in 2004 adopted the Strategic Plan 2005–2010 serving the modernisation of INTOSAI, the number one goal of which is to foster accountability and the adoption of adequate and successful professional standards. Within the framework of the strategy, the three standards committees (*accounting, audit, and internal control standards committees*), which had been functioning since 1984,

were reviewed and reorganised. By today these committees have developed several policies and guidelines.

Activities aiming at the development of professional rules and standards meeting the requirements of our age have accelerated since the Budapest Congress held in 2004. Thus, for example, the XIX Congress held in Mexico City in 2007 approved the novel structure of the audit regulations (audit standards) modified in accordance with the Strategic Plan. Furthermore, the participants specified the tasks required for the renewal of the system – including those that support the implementation of the so called “good governance”.

Professional work within INTOSAI is carried out in *committees*, as well as *working groups or task forces*. In important issues that affect the supreme audit institutions of all member states – such as the development of audit standards, or the issuance of directives – INTOSAI usually sets up “committees”. For special issues – such as privatisation or environmental audits – “working groups” are established. In addition, the results of the standard-setting work are reviewed at congresses (International Congress of Supreme Audit Institutions – INCOSAI) organised every three years and attended by all member states.

Pursuant to INTOSAI's Strategic Plan 2005-2010, the Professional Standards Committee incorporated all of the existing and new INTOSAI standards and guidelines in a new, standard framework, under the title ISSAI (International Standards of Supreme Audit Institutions). In parallel with this, the Professional Standards Committee prepared a plan for the period until 2010 for the further development of the INTOSAI Audit Standards. This plan extensively enforces the requirements of the International Standards of Auditing (ISA), too, which can be applied among the conditions for SAI audits.

In the hierarchically structured ISSAI system the number of approved and planned standards and guidelines currently exceeds eighty. These standards and guidelines include all those documents that the INTOSAI congresses have approved as guidelines in relation to the most important professional standards of the supreme audit institutions, such as the basic principles related to the legal, organisational and professional preconditions, as well as guidelines on the performance of audits and other tasks. Where appropriate, the ISSAI documents (may) also describe the applied good practices. Both the approved and draft standards and guidelines can be accessed on the www.issai.org website – organised according to standard classification principles. Apart from this, the website contains the working titles of all documents planned to be elaborated until 2010.

The professional regulatory system of INTOSAI currently contains documents on 4+2 levels, ranging from the Lima Declaration specified on the first regulatory level (ISSAI 1) to the more specific implementation guidelines for IT, environmental, privatisation and state debt management audits identified as the fourth regulatory level. The so called “good governance” guidelines pertaining to the audited institutions, as well as other supplementary documents with no separate ISSAI numbers (forewords, explanations, annexes, attachments, notes) represent a supplementary regulatory level.

The professional regulatory levels of the ISSAI system are described in the following narrative table.

In connection with the regulatory system of INTOSAI described above we find it important to lay down that the Level 1 through 4 documents contain the external normative provisions pertaining to SAI audits. Consequently, they can be regarded as the “international rules for SAI audits”, while the

<p>REGULATORY LEVEL 1 Founding Principles</p>	<p>Level 1 contains <i>the Lima Declaration</i> (ISSAI 1, 1977), which formulates the founding principles of INTOSAI.</p>
<p>REGULATORY LEVEL 2 Prerequisites for the Functioning of Supreme Audit Institutions</p>	<p>Level 2 develops further the founding principles as prerequisites for the proper functioning of SAIs. This level contains</p> <ul style="list-style-type: none"> – the Mexican Declaration on SAI Independence (ISSAI 10, 2007) and independence related guidelines and good practices (ISSAI 11, 2007), – the basic principles on transparency and accountability (ISSAI 20, completed draft), as well as the related good practices (ISSAI 21, completed draft), – INTOSAI’s Code of Conduct (ISSAI 30, 1998).
<p>REGULATORY LEVEL 3 FUNDAMENTAL AUDITING PRINCIPLES</p>	<p>Level 3 is based on the documents of Level 1 and Level 2, and contains the general standards for auditing public entities:</p> <ol style="list-style-type: none"> 1. <i>The basic principles of SAI audits</i> (ISSAI 100, 2001) 2. <i>The general standards of SAI audits</i>: they contain requirements related to qualifications, independence, incompatibility, professional competence, diligence, etc. (ISSAI 200, 2001) 3. <i>The field standards in government auditing</i>: they contain more detailed guidelines related to planning, to audit evidences, report analysis and internal control (ISSAI 300, 2001) 4. <i>Reporting standards</i>: they contain standards on financial audit reporting (auditor’s opinion), opinion-forming on regularity and performance audits, and reporting (ISSAI 400, 2001)
<p>REGULATORY LEVEL 4 Auditing Guidelines</p>	<p>Level 4 documents present the fundamental auditing principles (Level 3) in more detail - to support implementation – broken down into two groups:</p> <ol style="list-style-type: none"> 1. <i>Implementation guidelines</i>: <ul style="list-style-type: none"> – on financial audits, (ISSAI 1000, draft)² – on performance audits, (ISSAI 3000, 2004)³ – on compliance audits; (ISSAI 4000, draft)⁴ 2. <i>Specific (theme-specific) guidelines</i>: <ul style="list-style-type: none"> – on auditing international organisations (ISSAI 5000) – on environmental audits (ISSAI 5110) – on privatisation audits (ISSAI 5210) – on IT audits (ISSAI 5310) – on the audit of public debt (ISSAI 5410) – on the audit of disaster-related aid (ISSAI 5500)
<p>Guidance for “good governance”</p>	<p>Compared to the four-level norm system of INTOSAI, guideline-type INTOSAI documents pertaining to the administrative audit of the public sector represent a separate – quasi 5th level. Their place, numbering and titles in the current system differ from the other documents of the ISSAI system, however their significance is expected to grow in the future:</p> <ul style="list-style-type: none"> – Guidelines for internal control standards for the public sector (ISSAI GOV 9100), – Guidelines for the accounting standards (ISSAI GOV 9200, 2004.).
<p>Other documents <i>(Appendices, notes and forewords)</i></p>	<p>These materials clearly represent documents outside the INTOSAI standards, wherefore they do not have separate reference numbers. However, they are closely related to normative documents, since they are classified according to INTOSAI numbers:</p> <ul style="list-style-type: none"> – appendices – forewords, – notes.

other INTOSAI documents (such as the guidance on “good governance” and other documents) facilitate the day-to-day application of the provisions contained in the former documents, and as such they mostly contain practical, supplementary guidelines and good practices.

The audit standards of INTOSAI form a system that is being shaped and developed on a continuous basis, and to which the supreme audit institutions of the member states must continuously adjust. The most intensely developing INTOSAI standards include *financial audit* standards that are increasingly approaching the International Standards on Auditing applied by IFAC.

The IFAC

The International Federation of Accountants (IFAC) founded in 1977 is a global organisation for the accountancy profession. It has 158 member institutions in 122 countries, including the Hungarian Chamber of Accountants. IFAC has developed major international standards related to auditing, professional training on auditing, ethics, as well as financial reporting in the public sector, with which it provides continuous support to the audit profession.

The organisation of IFAC consists of boards and committees. A few years ago the International Auditing and Assurance Standards Board (IAASB) of IFAC developed International Standards of Auditing (ISA).⁵ Another internal body of IFAC, the International Public Sector Accounting Standards Board has developed the International Public Sector Accounting Standards (IPSASs), which deal with the audit and the inspection of the financial statements of the governments, local governments and government agencies.

In the past years cooperation between INTOSAI and IFAC has strengthened, especially in relation to the clarification of the criteria of “good governance” and accountability, as well as the formulation and development of audit standards. Standards on financial audits are still developed jointly by the audit standards committee of INTOSAI and the independent standards board of IFAC.

The IIA

The Institute of Internal Auditors (IIA) was established in the United States in 1941, and currently comprises of 165 member states. The IIA promotes the further development of the internal audit profession by issuing standards, guidelines, professional practical guidances, as well by comprehensive professional training. It plays an important role in spreading and publicising the best international practice of internal audits, as well as in the further training of internal auditors.

In relation to the standardisation process of the profession it is a major development that IIA has set up an international examination system that measures the knowledge of the applicants on the basis of general internal audit criteria. The name of the achievable accredited qualification is Certified Internal Auditor (CIA). Apart from this, IIA also provides for a special certification for the internal auditors of the public sector, in which case the name of the accredited qualification is Certified Government Auditing Professional (CGAP).

In order to support the day-to-day task performance of internal auditors IIA has issued its own standards for internal audit practices in the past years (International Standards for the Professional Practice of Internal Auditing – ISPPA). In addition, many references are made to the Code of Ethics of the organisation, which out-

lines those forms of behaviour and conduct that internal auditors must observe in the course of their work.

IIA comprises of national organisations that form regional units. Its Hungarian member organisation is the public benefit organisation called Institute of Internal Auditors, Hungary.

According to IIA's Strategic Plan 2008–2013, the main objective of the institution for 2013 is to make the internal audit profession acknowledged worldwide, to define the professional principles, and to make such principles easy to use worldwide. IIA is engaged in internationally acknowledged professional research projects and analyses in the field of internal audits, the objective of which is to make the professional requirements known to and observed by as many internal auditors as possible. It is important to note that strong cooperation has been established lately between INTOSAI and IIA.

The EUROSAI

The European Organisation of Supreme Audit Institutions (EUROSAI), which was founded in 1990, is the European regional organisation of INTOSAI, wherefore professional and technical cooperation among the member states of INTOSAI is ensured at regional level, too, with the involvement of EUROSAI. The main objective of the organisation is to foster professional cooperation among the member states, promote the exchange of experience, and to deepen the knowledge about auditing in the public sector.

EUROSAI has set up a separate committee (EUROSAI Training Committee) for the fulfilment of professional training tasks, but it also runs several other professional working groups, such as the working group on environmental auditing, the IT working group, or the

working group promoting the good practices of quality management, which is led by the State Audit Office of Hungary. As a result of their work, the professional working groups issue recommendations, guidelines⁶ and practical guidances, they collect the best international practices and make them available for the SAIs.

The European Court of Auditors (ECA)

The European of Court of Auditors (ECA) is one of the EU's independent institutions, which has performed its audit activities in accordance with the Treaty of Rome – which established the European Union and has been amended several times since then – and with the IFAC and INTOSAI International Auditing Standards and Codes of Ethics, in so far as these are applicable in the European Community context. Pursuant to the Founding Treaty in force, the European Court of Auditors must examine all community revenues and expenditures, and must publish its opinion annually. To this end the ECA issues a statement of assurance, generally known as DAS⁷.

The Founding Treaty requires the ECA to examine whether the financial management of the European Community has been sound and whether the activities have been performed in an economic, effective and efficient manner. The related Performance Audit Manual is also accessible on the ECA's website.

In addition to the above written, the auditors of the European Court of Auditors must perform their work in compliance with the audit policy and standards of the organisation, the Audit Manual of the European Court of Auditors, as well as the audit procedures approved by the organisations. In connection with this it is important to note that in 1998

INTOSAI issued – upon the initiative of the European Court of Auditors – its European Implementing Guidelines for the INTOSAI Auditing Standards to facilitate the application of the INTOSAI standards.

In connection with the relationship between the EU member states and the European Court of Auditors it is of utmost importance that the Nice Treaty of 2001 commissioned the European Court of Auditors to establish the so called Contact Committee.⁸ The objective of the Committee, which meets once a year, is to deepen and further develop cooperation among the SAIs – with special regard to the transfer of professional knowledge related to the audit of the EU Funds, and the related exchange of professional experiences. The Committee is headed by the president of the European Court of Auditors, while the members are the heads of the SAIs of the member states. The Contact Committee cooperates with INTOSAI and EUROSAI, and thus contributes to the further development of the financial management of the EU from the aspect of “good governance”. The Contact Committee will hold its annual meeting in Budapest at the end of 2009.

The Internal Audit Services (IAS) of the European Commission

The European Commission consists of Directorates General (DGs), which include internal audit units – often in combination with the internal control units (*directorates*). The Directorates General continuously evaluate and audit the implementation of community policies and objectives, before, during and after implementation. In relation to the management of EU Funds, responsibility is divided between the member states and the Commission. The Commission checks whether the management and control system set up by the member states comply with the legal requirements of the EU.

In addition, the European Commission issues guidelines for the member states on how to conduct the audits, as well as issues manuals, methodological guidelines and other guidances that it regularly publishes on its website.

The Internal Audit Service (IAS), which is one of the internal services of the European Commission, has been functioning as an independent Directorate General since 2001. Its task is to provide an independent audit opinion about the operation and quality of operation of the internal management and internal control system of the EU Commission, as well as to make recommendations for the efficient and effective achievement of the community objectives. IAS performs its activities in accordance with the professional standards and the code of conduct of IIA. Within this framework it conducts risk analysis based horizontal audits, and so called thematic audits in the European Commission. The audit findings are then discussed with the audited entities.

IAS concludes its own audits with recommendations, wherefore its activity helps the Directorates General of the EU Commission better identify control risks and pay a greater attention on the observance of the rules. In addition, IAS organises high level international conferences that provide opportunities for the internal auditors of the public and private sectors to regularly exchange their experiences.

The EURORAI

The European Organisation of Regional External Public Finance Audit Institutions (EURORAI) was established in 1992 with a view to harmonise the various audit methods of the participating countries. Its activity includes the further development of the local governmental and regional audit activities, the promotion of the exchange of experiences and the flow of information among the member states,

the organisation of training sessions and the harmonisation of the audit terminology. Apart from organising meetings, seminars and conferences, the organisation performs its tasks by issuing joint publications,⁹ as well as by fostering expert level meetings.

NEW INTERNATIONAL TRENDS IN PROFESSIONAL REGULATION

Within the processes of international professional organisations utmost significance is attributed to the professional regulatory process at INTOSAI, which accelerated in 2005, and as a result of which the professional regulatory framework called ISSAI will be practically completed by 2010 with documents containing professional guidelines. In accordance with the schedule of INTOSA's development strategy 2005–2010, the implementing guidelines that contain the universally applicable, common professional minimum requirements broken down by the major audit types (financial audit, performance audit, compliance audit) have been available since the summer of 2009.

The requirements stipulated in the documents will not be mandatory in the future either, and have not been prepared with the intention of exerting force either. Yet they provide a standard and transparent picture of the common concepts, interpretation and methodology, on the basis of which the SAIs of the individual countries are advised to formulate their own audit standards, as well as their systems of consistent terminology and internal professional regulation (methodology), transposed into their national languages.

However, the obvious objective of the large-scale international standardisation process, which respects the national characteristics at all times, is to allow for the comparison, approximation and harmonisation of the audit prac-

tices of institutions established in different parts of the world on the basis of different historical and cultural endowments. This is what made joint participation in the international audit programmes possible in the past years, in relation to which in the case of Hungary we can emphasise professional cooperation with the EU member states (e.g. joint or parallel audits) and the establishment of adequate relationships with the EU institutions. In addition to the above written it is reasonable to mention the audit of certain international organisations as a professional challenge that would be practically unsolvable without reference to the common professional standards.

Having examined the standard-setting practice of INTOSAI it can be stated that a real trend seems to be taking shape in that

- after the accentuation of the importance of performance audits, emphasis is (again) placed on financial audits in the standard-setting work,
- the INTOSAI and IFAC standards are being increasingly approximated,
- compliance audits emerge as a quasi independent audit type,
- the importance of “good governance” type guidances grows.

Financial audits gain emphasis again in the standard-setting work

The significance of audit types is in that they determine the rules and methods of audits within their scope. From this aspect it is an interesting fact that at INTOSAI level no professional implementing guidelines with reference numbers have been elaborated on financial audits to date. Historically it happened so that in the professional regulatory system of INTOSAI the general standards related to the fundamental principles and framework conditions of SAI audits were developed first in the

past years, and they were followed by theoretical guidelines pertaining to audit types other than financial audits (performance audits, compliance audits).

After the elaboration and large-scale dissemination of the standard methodology for performance audit in the past decades, which appeared to be a newer and more modern audit approach compared to the traditional financial audit, attention will again be focused on financial audits in the forthcoming years.¹⁰ On the one hand because within the system of SAI standards financial audits represent the greatest, professionally coherent area, and on the other hand because these professional rules (guidelines, practice notes) that are considered to be the most significant in the system of INTOSAI standards are to be completed shortly, but by 2010 at the latest.

As it was referred to above, in the hierarchical system of ISSAI documents pertaining to financial audits the implementing guideline on financial audits – planned to be issued under number ISSAI 1000 – ranks the highest, to which further 36 documents can be assigned.¹¹ Although these (currently) 37 professional documents of different levels, contentual weight and length make up nearly half of the current ISSAI system, their degree of completeness is rather low: while nine documents were approved in 2007, 25 professional materials are still only in the draft stage. At the same time however all of these materials but one have already been offered for public commenting, and the comments of the member states on nine of these materials can already be read on the website of INTOSAI.

Despite the different sizes of the tasks and the different operation of the individual working groups, a strange situation has arisen in that the working groups dealing with the detailed professional rules completed their tasks sooner than the standard-setting bodies formulating the general guidelines of the given audit type.

The material referred to above as an exception is exactly the ISSAI 1000 implementation guideline on financial audit, the provisions of which should in theory be used as a basis for all the other ISSAI documents beginning with one thousand. However, for the lack of this document it is difficult to imagine how the subsequent standard-setting tasks and tasks related to the practical implementation of the completed documents could be carried out.

One of the possible reasons behind the quasi reversed order of task performance in the standardisation of financial audits compared to the elaboration of other professional rules can be that in the standard-setting work financial audit represents the largest field, in relation to which the work of extremely many international working groups must be coordinated throughout many years. The other reason behind this time-intensiveness is that these professional standards must be adequately justified, professionally unquestionable, and practically applicable even when compared to other INTOSAI documents. Especially for these reasons the financial audit standards of INTOSAI are being developed with consideration of the existing or renewing audit standards of IFAC and IIA, with special regard to the different audit criteria (compared to the standards mentioned above) to be enforced during practical application.

Approximation of the INTOSAI and IFAC standards

As it was indicated above, contrary to the methodology development practice of the former years, which focused on performance audits, in the forthcoming period the INTOSAI member states will conduct intense professional discussions primarily about the further development of financial audits. Within the framework of this activity special emphasis will

be placed on the creation of increased harmony with the International Standards on Auditing (ISAs) issued by IFAC. In this respect preparations have already been started for several documents that can be classified under the following three document types (in connection with financial audits):

- implementation guideline, ISSAI 1000, preliminary draft),
- general consideration, ISSAI 1001, 1002, not accessible),
- practice notes, 17 documents).

It is not yet known which types the other 18 documents currently under preparation belong to, however it is probable that they will also be completed as practice notes. Practice notes play an extremely important role in the harmonisation of INTOSAI standards on SAI audits and the IFAC audit standards.

In relation to the approximation of SAI audit standards and standards on auditing we cite the following example: at the beginning of 2009 the Swedish National Audit Office heading the Financial Audit Guidelines Subcommittee of INTOSAI forwarded to the INTOSAI member states the INTOSAI practice notes prepared for ISA standards No. 200, 210, 240, 250, 500, 550, 560, 570 and 580 issued by IFAC for commenting. The numbering of said practice notes is adjusted to the numbering used by IFAC with the difference that the INTOSAI numbers are four-digit numbers due to inserting a thousand digit before the original numbers. Consequently, the ISA 200 standard issued by IFAC on the principles of auditing financial statements was assigned the ISSAI 1200 number in the INTOSAI system.

In the introductory parts of the individual practice notes INTOSAI lays down in every case that the notes shall be interpreted in conjunction with the general consideration No. ISSAI 1002 prepared for the implementation guidelines on financial audits. However, this latter document is expected

to be completed only in 2010, and the first draft is expected to be available no sooner than 2009.

The individual practice notes are developed by expert groups consisting of the representatives of INTOSAI member states. The documents, taken as a whole, contain the IFAC standards (ISAs), as well as those supplements and notes formulated by INTOSAI that must be taken into account during the application of IFAC standards for SAI audits (differences, exceptions, etc.).¹²

Staying with the former example, during public sector audits the ISA 200 auditing standard of IFAC must be used together with practice note No. ISSAI 1200 issued by INTOSAI, and these two documents provide guidance for the auditors during the audit of financial statements inseparably from each other. The differences between the public and the private sectors are formulated by the practice notes themselves. Hence, for example, the contents of the financial statements prepared in the public sector may differ from the contents generally accepted in the private sector. In the latter audit environment the financial statement may contain information not only about the financial situation, financial performance, accumulation or loss of assets, but also about performance, as well as about the utilisation of the budgetary appropriation.

It comes from the above – far-reaching – rule that the auditors of the public sector will by all probability also apply the IFAC standards – similarly to the auditors of the private sector – however they will also be required to take into consideration the comments/supplements formulated in the practice notes issued by INTOSAI. It may also have longer term consequences that if an audit is conducted on the basis of all INTOSAI practice notes pertaining to the public sector, the term audit may refer – even literally – to the application of IFAC standards according to the rule. Finally, reference is

made to the application framework – established consciously in collaboration by INTOSAI and IFAC – according to which the effective dates of the INTOSAI practice notes and the auditing standards of IFAC (ISAs) are identical, i.e. if all goes to plan, both standard types will in theory be applicable from the same date.¹³

From INTOSAI's perspective the SAI audit of financial statements can also be part of a larger financial audit task. For instance, depending on the legal mandates of the SAIs, the financial audit may include the audit of financial statements, the issuance of an opinion (certificate) on the financial accounts (final accounts) of the government, and last but not least the evaluation of internal controls and internal audit functions. In the future the related work of the auditors of the public sector will be aided by INTOSAI's implementation guidelines on financial audits (ISSAI 1000), as well as the system of practice notes linked to these guidelines and to the IFAC standards. And when the SAIs are required to undertake an even greater financial audit task – in compliance with their legal mandates – the application of other professional INTOSAI rules (e.g. the guideline on compliance audit – ISSAI 4000) may become justified.

The wide-scale use of compliance audits:

In relation to the audit types the ISSAI system was formerly characterised by a certain dual structure, which in essence meant that all INTOSAI documents could in theory be classified under two main audit types – financial audit and performance audit.

Yet, at the end of 2008 the Norwegian National Audit Office chairing the Compliance Audit Subcommittee of INTOSAI issued three new draft

guidelines – beginning with number 4000 – to the member states for commenting:

- the General Introduction to Guidelines on Compliance Audit No. ISSAI 4000,*
- the Compliance Audit Guidelines for Audits Performed Separately from the Audits of Financial Statements under No. ISSAI 4100, and*
- the draft of Compliance Audit Guidelines Related to the Audit of Financial Statements under No. ISSAI 4200.*

Having reviewed the documents it can be stated that on one hand compliance audit can be linked to the audit of financial statements, or can be part thereof, when the compliance audit guidelines supplement INTOSAI's Implementation Guidelines on Financial Audit (ISSAI 1000), and in this case compliance audit is also a financial regularity audit (ISSAI 4200). On the other hand, compliance audit can be conducted separately from the audit of financial statements – as a separate audit task or linked to a concrete performance audit (ISSAI 4100).¹⁴

Compliance audits do not necessarily imply regularity audits. During compliance audits the SAIs audit to what extent the activities and operations of the audited entities comply with certain criteria. Naturally, such criteria can be legal regulations (acts, decrees), as well as other rules, guidelines, standards, practical guidances, terms of contracts or agreements, objectives, or even ethical norms. Compliance criteria can be determined even by the auditors, however in this case these criteria must be very precisely and clearly identified in advance.

In the case of compliance audits the subjects of the audits can be both general or specific, or can be *quantitative* factors allowing greater objectivity (e.g. changes in institutional vacancies), or *qualitative* factors (e.g. the audit of ethical conduct) that are more subjective. In addition, compliance audits can also be conducted at the central or local levels of public

finances, just like at institutions – not necessarily budgetary institutions – that use public funds in any form.

In practice, SAI reports drawn up about compliance audits state to which extent the audited entities comply with the pre-determined criteria.

The meaning itself may take various shapes depending on the user's needs. On this basis the following types of reports can be drawn up:

- separate compliance audit report (short or long);
- report containing the compliance opinion as part of the financial audit report;
- report that lists those activities and cases that did not meet the compliance criteria; or report that simply declares that during the audit the auditor obtained no knowledge about activities and cases that failed to meet the compliance criteria;
- opinion on whether the transactions that were examined during the audit complied with the rules (criteria) or not.

The numbering beginning with 4000, as well as the place of the drafts in the system among the implementation guidelines on financial audit (ISSAI 1000–2999) and performance audit (ISSAI 3000–3999) indicate a main audit type. In addition, documents No. ISSAI 4000, 4100 and 4200 describe compliance audit as a separate audit type. INTOSAI itself does not exclude the possibility of developing a new audit type from this audit approach later on, however a relevant decision is expected to be preceded by several professional debates in the INTOSAI committees and working groups.

Just like the activity of every SAI is determined by its own constitutional status and national legal regulatory environment, the application of the future guidelines on compliance audits will not be mandatory for the member states either. The individual SAIs will

decide to what extent the compliance audit approach can be approximated with their audit authorisations and scopes.

As it is mentioned in the general introduction to the draft guidelines – for certain transparency and accountability reasons – SAIs require a wide scope to audit public funds, which thus requires the implementation of more comprehensive audit objectives compared to the auditing inspections. Yet, according to our standpoint, the draft guidelines on compliance audit can be well incorporated into the current audit mandate of the State Audit Office of Hungary, and can be approximated with the legal regulatory environment of the SAO. According to all probability, opinion forming on the bill and the audit of the financial management and operation of the parties can be an area in which the new, compliance audit type professional (methodological) approach of INTOSAI can be used successfully.

The increasing role of “good governance” type guidances

The term *good governance*, which grew out of the foundations of *new public management*, and basically represents a neoliberal economic approach itself, appeared in the documents of the World Bank more than twenty years ago, and has been widely used ever since to define that form of governance that utilises the economic and social resources in an undiscriminatory and transparent manner.¹⁵ Along this concept, in relation to the public sector legal security, transparency and accountability, and last but not least the fight against corruption should be defined as fundamental requirements.¹⁶

The modern concept of the state, which has spread in the past few decades, has left a mark on the professional regulatory activity of

INTOSAI, too since the millennium. The XIX congress, which was held in Mexico City in 2007, approved not only the new system of the international audit standards (ISSAI), but also the first group of documents (5) belonging to the “good governance” guidances. The current places, numbering and names of these documents within the system differ from those of the other documents of the ISSAI system.¹⁷

The professional documents that represent a separate – quasi 5th level – compared to the four-level norm system of INTOSAI include guidelines (ISSAI GOV 9100), guidances (ISSAI GOV 9110, 9120, 9220) and framework systems (ISSAI GOV 9130). Their characteristic feature is that they focus on the administrative audit of the public sector, wherefore their content is primarily related to the internal control standards of the public sector, and the recommended cooperation with the internal auditors. Consequently, compared to the other professional rules of INTOSAI the major difference is that the “good governance” guidances formulate basic principles to be followed not for the external audit organisations, but for organisations they audit. Naturally, these expectations are not binding for the affected organisations, yet they represent a professional minimum that the external audit organisations may take into consideration during their audits.

The “good governance” documents that can be regarded as the latest results of the standardisation work performed within the framework of INTOSAI for the time being occupy a special place in the document system of INTOSAI. However, their importance is expected to grow since there is increasing need for external professional support to the government agencies in almost every country (advisory function). One of the consequences can be that the internal audit standards (IIAs) and INTOSAI's general professional stan-

dards pertaining to external audit organisations (ISSAI) will be significantly approximated.

However, according to a more developed interpretation of “good governance”, the state undertakes an active role not only in creating the conditions for governance, but also in the fulfilment of certain public tasks.¹⁸ In this new approach “good government” plays a proactive and exemplary role in the creation of social solidarity, justice and equity, as well as a value based public administration culture (integrity).

The development of the “good governance” term is also reflected by the professional documents – representing a higher hierarchical level, i.e. not ISSAI GOV type documents – that were forwarded for commenting by the French National Audit Office chairing the Transparency and Accountability Working Group of INTOSAI at the beginning of 2009. The document titled “Principles of transparency and accountability” (ISSAI 20) and the draft “Principles and good practices” (ISSAI 21) prepared for the former document are linked to the second INTOSAI regulatory level that determine the operational principles of the SAIs. This level contains important documents such as the Mexican Declaration on SAI Independence or the Code of Conduct of INTOSAI. The importance of these documents is also augmented by the fact that these INTOSAI audit standards must be used in conjunction with the above mentioned principles.

The professional drafts that have been published together with the opinions of the member states specify the requirements of transparency and accountability in close correlation. Consequently, accountability pertains to the legal frameworks of the organisations – to the organisational structure, the strategy and the activity performed by the organisation –

according to which the operation of a SAI must always be harmonised with the audit mandates, as well as the relevant legal and internal rules.¹⁹ This includes that apart from the preparation of the SAI reports the organisations themselves report on their activities and financial management, evaluate their own performance, and that the managers and staff members of the SAIs do their work responsibly. At the same time transparency means that the SAIs regularly issue information on their mandates, status, strategies, activities, financial management, operation and performance. Furthermore, the SAIs are required to publish their audit findings and recommendations.²⁰

HUNGARIAN CHALLENGES RELATED TO THE CHANGING INTERNATIONAL TRENDS

Due to the above external trends Hungary should also determine – as soon as possible – a common professional standpoint that would take the international changes into consideration, and on the basis of which the people in charge of the institutions of the external and internal audit systems could specify the tasks of the near future in coordination with one another.

According to our standpoint, on the part of the State Audit Office of Hungary the following responsive steps can be taken:

- making the certified Hungarian translations of the international professional documents available as soon as possible,
- further improvement of the harmony between the internal professional regulations of the SAO and the international audit professional standards,
- the further development of the quality management system to ensure better compliance with the transparency and accountability principles deduced from the “good governance” requirement.

Making the translations of the international professional documents available

In the case of the State Audit Office of Hungary one of the first and foremost tasks is to make the professional requirements clear-cut, and known to the staff members. Since the audit related external and internal requirements form a – theoretically logical and consistent – hierarchical system (system of audit requirements), when defining the professional rules it must be ensured that all significant international standards applicable in Hungary are translated into Hungarian, the translations are proof-read from the professional perspective, and that the proofread translations are made available on a continuous basis to all parties concerned.

The application of the INTOSAI standards is first of all the sovereign decision of the supreme audit institution of a given state. This becomes important especially in relation to much more numerous and lengthy materials on the fourth regulatory level of INTOSAI (implementation guidelines). However, if a SAI decides on the use of the INTOSAI standards, it has two options: it must either use the original documents drawn up in the official languages of INTOSAI (English, Arabic, Spanish, French and German), or must prepare certified translations. Otherwise in theory no reference can be made to the ISSAI numbers or the individual sections of the standards.

Due to the above written, INTOSAI formulated recommendations for the translations, too,²¹ with the following elements:

- specifying and conducting a translation process that allows for the production of certified translations – except for the translators' notes – without omissions and supplements
- translation of the key terminology/concepts and maintenance of the key terminology – use of a glossary or a terminology dictionary – by mak-

- ing it clear that for the avoidance of mistranslations the translators wish to understand the intentions of the authors of the original documents;*
- the consistent and standard use of key terminology/concepts during the preparation of subsequent translations with the condition that it can be noted in a footnote if the common meaning of a given expression is different in the given country;*
- the translation of the entire texts of all guidelines within a given category of guidelines;*
- during the translations application of the principle on the basis of which the draft was prepared;*
- use of professional translators in the first place, in close consultation with the organisation ordering the translations;*
- considering – especially in the case of materials on financial audits – whether it is justified to translate the texts (key terminology) of the relevant IFAC standards;*
- establishment of a translation working group – preferably with the involvement of members having a native level of English, and adequate experience in the application of INTOSAI and IFAC standards; after that, the review of the materials of the professional translator by the working group;*
- use of the English terminology in case of translation disputes.*

Improvement of the harmony between the internal professional regulations and the international standards

In the second step it is a serious professional challenge to determine the audit types that are in full compliance with the system of INTOSAI's professional standards, as well as the consistent practical application of these audit types – both during the planning of audit tasks and the quality assurance of the individual

audits. Otherwise it is extremely difficult to compare the SAO's audit practice with the audit activities of other audit systems, countries or international organisations (e.g. EU, OECD, NATO, etc.).

From the perspective of the professional development of the SAO in the past two decades the Audit Manual containing the professional rules of SAO audits, which was issued in 2004 for the first time, and was revised in 2008, can be regarded as a major milestone. The Manual, the application of which was ordered by instruction No. 9/2008 issued by the President of the SAO²², is at the peak of the hierarchical system of the internal professional regulations of the SAO, and is already in full compliance with the renewing professional regulatory system of INTOSAI. As a result of the intense methodological developments of the past years it can be stated that the requirements of the Audit Principles and Standards²³ laid down in the Audit Manual to specify the principles of the work of the SAO fully correspond to the INTOSAI standards.

The major types of SAO audits are specified by the Audit Principles and Standards²⁴. Thanks to the methodological development carried out in the past years, there are currently three major audit types: *regularity audit*, *performance audit* and *comprehensive audit*. In addition to the above written, the Audit Manual specifies *financial regularity audit* as a subtype of regularity audit. The Manual derives the audit types from the INTOSAI standards (the basic principles in government auditing, ISSAI 100).

In relation to the audit types another future challenge can be the further specification of the role and place of the so called comprehensive audits – which play a major role in the audit practice of the SAO – in the professional regulatory system of the SAO. The reason behind this is that the ISSAI 100 document, which describes the major audit types and contains

the basic principles of the auditing of public entities, does not contain direct reference to comprehensive audits focusing on the internal management, regulatory and control system designed to ensure the operation of the individual organisations and the implementation of activities and other tasks within the organisations. However, taking into consideration that in relation to the audit of the operation of the individual budgetary institutions/chapters the external and internal audit systems in Hungary are not always standard coherent, for the time being the methodological approach of comprehensive audits cannot be excluded from the current audit practice of the SAO.

Having examined the current internal professional rules that determine the method of the implementation of the audits it can be stated that the increase of the role of the so called *system audit*²⁵, as a special audit approach within the main audit type of performance audit, is another task to be solved in the near future.

However, in addition to the correlations of the individual documents it will also have to be examined how the internal professional rules on methodology affect the auditors' day-to-day work from the perspective of the quality centred operation of the SAO. The latter makes it possible to approach the professional audit activity in a systemic manner, since in this case the coherent system of methodological documents that comply with the international requirements forms only a single element of a process during which the progressive methods and techniques are incorporated into the everyday practice continuously and efficiently.²⁶

The further development of the quality management system of the SAO

Another challenging issue related to the internal professional regulation is the exploration of the correlations between the performance of

professional regulatory (methodological) tasks, and the coordinated development of these two systems. In connection with this it is still a major starting point that the fulfilment of methodological regulatory tasks forms part of the quality management system.

With regard to the constitutional status – professional, organisational and financial independence – of the SAO, it is of utmost importance to maintain mutual trust among the SAO, the National Assembly approving the individual audit results, as well as the general public. With a view to ensure this trust, and considering the transparency and accountability practice that is gaining acceptance in the supreme audit institutions, the establishment, operation and conscious development of an independent quality management system would be an appropriate response.

The fundamental objective of the quality management system that was established within the SAO in 2005²⁷ – and which can be regarded as an extremely significant result in relation to organisational development, is to ensure the continuous high quality of the SAO reports that can be identified as the end-products of the audit work, as well as that of the individual audit findings, conclusions and recommendations. The concept of quality includes – in addition to compliance with the pre-determined expectations – compatibility with the public interests and the public good as a content element specified for the public sector. Consequently, the SAO shall continue to focus on compliance with the needs of the National Assembly and the citizens in the future, too.

The terms used in the current quality regulations of the SAO have the same contents as defined in the international standards²⁸. Therefore, a distinction can now be made between “quality control”, which is incorporated into the auditing process, and “quality assurance”, which is performed subsequently. In fact, quality within the SAO is “assured” by these

two procedures jointly. However, in relation to the operation and development of the current quality management system quality must play an important role in two areas at the same time: in the institutional operation of the SAO on the one hand (*process side*), and in relation to the process of production of the outputs of the audit activity (reports, opinions) (*output side*).

In the past years the system of internal regulations has been expanded, and these regulations have been consistently applied in the audit practice, too. Therefore, progress can rather be made in the direction of total quality manage-

ment systems, which assign certain quality requirements to each function of an organisation – including the fulfilment of functional, operation-related tasks such as the operation of IT, educational or other external expert systems designed to support professional work. In public administration such total quality management systems have come into being on the basis of the methodological foundations of the Common Assessment Framework (CAF) – which has been gradually gaining space since 2001 – the applicability of which by the SAO is another issue to be investigated in the future.

NOTES

¹ A significant milestone in methodological development was the Washington Accords adopted at the XIV Congress of INTOSAI in 1992. This document emphasised that contrary to the former practice, audits should preferably stop providing a merely narrative, observing control. Instead they should foster improvement, be supportive, strive to influence the financial management of the states, and should not only detect errors, but should also recommend solutions. This meant that in addition to the regularity audits, performance audits have been given increasing attention since the early 1990s.

² The first draft of the INTOSAI's financial audit guideline has been prepared, however it has not yet been offered to the SAIs for comment. Its content is based on IFAC standards (ISAs), as well as on the so called Practice Notes made by INTOSAI to these standards. It highlights those practical aspects that must be taken into account when auditing public entities.

³ The implementation guideline for performance auditing was approved by the INTOSAI Congress held in Hungary in 2004. The Performance Audit Subcommittee of the Professional Standards Committee is currently – until 2010 – developing guidelines that describe the methods of applying certain qualitative and quantitative aspects during performance audits.

⁴ In 2007, at the XIX Congress of INTOSAI, the Professional Standards Committee proposed the development of guidelines for compliance audits,

too. These guidelines were elaborated by the Compliance Audit Subcommittee of the Professional Standards Committee. The draft document was completed in October 2008, and was offered to the SAIs for comment by 1 February 2009. It is expected to be published in 2009.

⁵ The latter shall be taken into consideration in relation to the “Guidelines on financial audit” to be elaborated by the Financial Audit Guidelines Subcommittee functioning within the framework of the Professional Standards Committee (PSC) of INTOSAI. The new ISSAI number will also contain a unanimous reference to the number of the relevant ISA standard.

⁶ For example the Guidelines for VAT Audit

⁷ The DAS (acronym for the French Déclaration d'Assurance) is the formal opinion of the European Court of Auditors on the reliability of the EU accounts, and on the legality and regularity of the underlying transactions. The methodology of DAS is accessible on the website of the European Court of Auditors.

⁸ Before that the heads of the SAIs of the member states had met since 1960. The European Court of Auditors first attended the meeting of the member states' SAIs independently in 1978.

⁹ Here we can mention the comparative study about the audit of European local governments, or the four-language (English, French, German, Spanish)

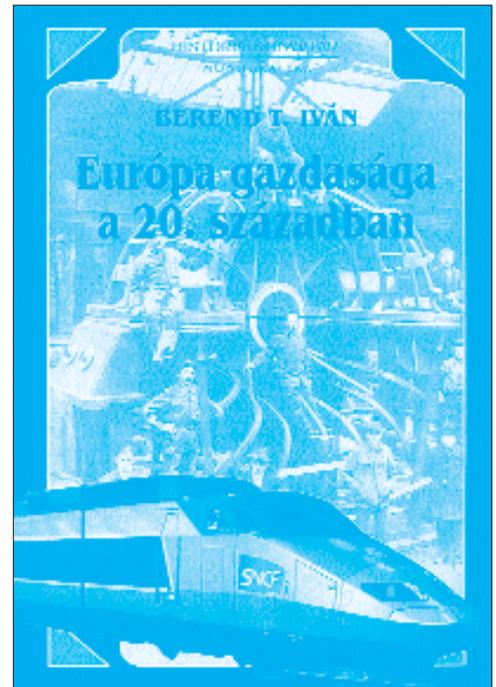
glossary, which contains expressions related to the audit of the public sector.

- ¹⁰ The significance of performance audit is not expected to decline in the forthcoming years, however it can be regarded as a routine, generally known audit method, compared to which increasingly specialised forms are expected to gain space. Consequently, it is reasonable to allocate resources for the methodological support of (performance) audits related to IT systems, state debt, as well as cost-intensive environmental and transportation infrastructure investment projects.
- ¹¹ The theoretical starting point of INTOSAI is that the system will be expandable and supplementable on a continuous basis. The website of the organisation contains the schedule of the preparation of another 36 documents in contrast with the list specified in Annex 1 to the preliminary draft of the ISSAI 1000 document, which envisages the preparation of two more – total of 38 – documents in the field of financial audits. The difference comes from the ISSAI 1001 document titled “Bridge between INTOSAI Auditing Standards and International Standards of Auditing (ISAs)” and the ISSAI 1002 document titled “General Considerations when Applying International Standards of Auditing (ISAs) in the Public Sector”, while the latter are not yet presented on the website as scheduled tasks.
- ¹² Upon authorisation by IFAC, INTOSAI has published – together with the draft practice notes – the texts of the IFAC standards (ISAs) planned to be issued in the future, however no comments can be made on the latter.
- ¹³ IFAC is currently revising its standard in this topic. The revised standards will take effect in 2010.
- ¹⁴ The SAIs may be assigned separate audit tasks – depending on their respective legal authorisation and mandate – by the national parliaments, and the SAIs (or their presidents) may decide themselves about the performance of separate audit tasks.
- ¹⁵ See Gábor G. Fodor – István Stumpf: The two meanings of “good governance” – or the programmes and conditions of democratic governance, *Nemzeti Érdek*, 2007/3., Századvég Kiadó, pages 76–95
- ¹⁶ See Gusztáv Báger – Árpád Kovács: A few aspects of the relationship between the political and economic sectors – the foundations of minimum consensus (manuscript), 2007
- ¹⁷ The numbering of good governance documents differs from the other ISSAI documents in that the acronym “GOV” must also be used when referring to such documents (ISSAI GOV). In addition, their numbering starts with 9000 (9100 through 9299), in a distinguishable manner from the other audit types.
- ¹⁸ See Gábor G. Fodor – István Stumpf: A neoweberian állam és a jó kormányzás (The neo-Weberian state and good governance), *Nemzeti Érdek*, 3/2008, Századvég Kiadó, pages 5–26
- ¹⁹ The fundamental questions of accountability are “who?”, “about what?”, “to whom?”. See: the lecture held by Dr. Árpád Kovács under the title “The transparency and accountability of public finances”, at the annual conference of ICGFM (International Consortium for Governmental Financial Management) (USA, Miami, 3 May 2005)
- ²⁰ The fundamental questions of transparency: clear definition of tasks and scopes, wide-scale accessibility of information, publicity of the preparation and execution of the budget, as well as of the report on the execution of the budget, ensuring management integrity. See Dr. Árpád Kovács: “The transparency and accountability of public finances”, ICGFM, USA, Miami, 3 May 2005
- ²¹ See Annex 3 to the Implementation Guidelines on Financial Audit – Introduction, expected to be published under number ISSAI 1000 in 2009, for the Translation Recommendations
- ²² Presidential Instruction No. 9/2008 about the Audit Manual of the State Audit Office of Hungary, effective since 4 September 2008
- ²³ See Volume 4 of the Audit Manual
- ²⁴ Volume 4 of the Audit Manual, Chapter I/3 (page 7)
- ²⁵ Instruction No. 10/2008 of the President of the SAO about the methodology of system audits, effective since 22 September 2008
- ²⁶ The major documents of the audit profession (methodological documents) used by the SAO are available on the SAO's website (www.asz.hu)
- ²⁷ Before that an independent Quality Assurance Department was set up within the organisation in 1998.
- ²⁸ See the European Guidelines on the Implementation of INTOSAI Auditing Standards, Article 51, Quality Assurance

Iván T. Berend

An economic history of twentieth-century Europe

INSTITUTE OF HISTORY OF THE HUNGARIAN
ACADEMY OF SCIENCES – HISTÓRIA BOOKS/MONOGRAPHS,
ISSUE 25, 2008



História, the monthly of *Ferenc Glatz*, the former President of the Hungarian Academy of Sciences also functions as a label for a publishing house. They publish chronologies, bibliographies, lecture transcriptions, atlases, document collections and monographs both in Hungarian and in English. For a venture of this profile, the release of a summary volume in Hungary (already published in England) by a scientist who refers to himself as an American Hungarian¹ is an apt choice. We are way too familiar with the gap that has become permanent by now between international book prices and the means of domestic collections (even the seemingly richest ones). This gap has made the regular procurement of latest international technical literature an unaffordable luxury² and it is probably further aggravated by the avarice of textbook authors and reviewers and by overall frugality which hits higher education more than before thanks to the Bologna process. On

top of all that, a new education approach is gaining ground which focuses on single textbooks and concise reading materials available on the internet. In this approach, the education of professionals with a genuine intellectual mindset is no longer part of the mission (respect to exceptions). In this state of crisis, special appreciation should go to the publisher who released this lastingly valuable and in many ways direction-setting piece of work in a high-quality translation.

Iván T. Berend's career consists of sharply distinct phases, starting from meticulous research in archives, continued with the comparative analysis of economic policies and then the third phase dominated by large summary volumes. The reader is informed right at the beginning (page 10) that the book offers a *long-term comparison of economic systems along specific criteria* instead of providing a thoroughly documented review of economic growth,

policies or economic structures. In the forefront of the analysis are the presentation of failed convergence attempts and the investigation of underlying causes. The author openly admits his bias in terms of values when describing the universal welfare state as “...probably the biggest accomplishment of mankind” on pages 15–17. At the same time, he mostly rejects but does not challenge the economic doubts raised about the *sustainability* of this model, either here or in the closing chapter of the book. While this approach is not unusual in summaries that rely on similar considerations (in domestic technical literature, Béla Tomka's work³ is a recent example), it should not be regarded as an obvious one either.

The book reviews the period between 1870 and 2000 in six chapters. All the way through, the approach follows the school which compares old and new globalization. In the English original, it is expressed with the title “from free market to globalization”. The key viewpoint of this approach is that government control over the economy in the form that evolved after 1914 and remained dominant until 1990 is the mainstream system and more competition-oriented and market-driven alternatives from before and after that period were deviations. There is nothing wrong with representing this viewpoint (many do so in literature) but it is definitely not the majority view in economics.

■ Chapter 1 reviews the 1780–1918 period and considers the first of these centuries as a kind of a prelude. The author comes to three fundamental conclusions:

① Contrary to the widely shared views of *Dickens* and *Marx*, the long 19th century was not a period of mass poverty but that of unprecedented development of mankind, not only in terms of income but also in respect of each human development index (HDI).⁴

② The convergence of Scandinavia gained impetus between 1870 and 1913, i.e. the development of the welfare state should definitely

be regarded as a *premise and not as a consequence*.

③ While the monarchy of Austria–Hungary did not converge in the sense that *Lenin* described as “catch up with and surpass”, the benchmark for its development was Germany, the most powerfully developing economic hub at the time. Therefore, contemporary thinkers had good reasons to call the era the “happy golden years of peace” (page 44) as it was more dynamic as preceding and subsequent periods. In the meantime, other regions, in particular the Balkans, Italy and Russia tailed off somewhat and Iberia fell behind, too.

■ Chapter 2 discusses the 1914–1933 period as an era with uniform characteristics. Taking on the opinion of *Keynes* from 1924 (and contrary to mainstream economic opinion about the era), it views the expansion of government intervention as *normality instead of deviation or a temporary loss of direction* (page 45). Consequently, the author views the war economy of WWI (pp. 51–59) as a herald of the future while economists of the time considered it an exceptional state. This way, despite the obvious accomplishments, the return to the market in the “roaring twenties” (sung by so many and not only in literature) may have seemed like an illusion. Economic nationalism which evolved at a different pace and to a different extent in small countries (described on page 60 plainly as the “thirty-year war”) became the norm as outlined by *E. H. Carr*, although obviously not in the best and desirable sense but as the “average”, using the term introduced by *Kuznets* (page 64). From this viewpoint, 1929–1933 was not a derailment caused by major economic policy mistakes as one would think based on the now classic analysis by *Friedman* and *Schwartz*⁵ and the book of (later FED chairman) Ben Bernanke half a century later (2005)⁶ but a necessary outcome of economic policy and theory development in former periods. Many authors at the time (e.g.

Ákos Navratil⁷) and later (Abay-Neubeuer⁸) considered government interference and its generalization by Keynes a wrong approach that amplifies problems.

At the same time, Iván T. Berend aptly underlines (page 67) that the increasing adaptation of market protection itself became a reason of the escalation and evolution of the crisis into a worldwide turmoil. Taking these observations further, on pp. 75–77 the author describes controlled economies as examples of a *matured theoretical model* and not as improvised solutions. In fact, Keynesian teachings were considered “esoteric” at the time and were only adopted as elements of good manners in economic policy much later, during the fifties and the sixties. On page 83, war economies are cited as role models too, what is more, as the hotbed of *every* economic policy experiment of the 20th century. This is certainly not valid for the period after 1989 and, in my opinion, it is not valid either for the original German version of social market economy in the 1940s which was characterized by relatively moderate income redistribution, powerful competition policy, intensifying international trade and price stability, not to mention the United States variant.⁹ For *Walter Eucken, Wilhelm Röpké* and their followers created their solutions just as confronting alternatives to controlling economies. Furthermore, America always built on free competition which the prosperity policy of the New Deal only dampened but never eliminated. But the author mainly means his statements for the “short twentieth century” of 1920–1989, in particular to Europe. Besides, although no conclusions are drawn in the summary, the author aptly points out that Europe's *backlog in the global economy* became irreversible *just in the heydays of these experiments* i.e. between 1914 and 1944 (pp. 83, 89, 92–93, 97).

■ The subject of chapter 3 is dirigisme. The common feature of the related models is

wartime mobilisation, welfare populism, direction by a leader figure and a closed economy which professor Berend interprets as a kind of a development dictatorship (page 96). He points out some nice and exciting similarities between Southern European and German solutions, underlining the spiritual leadership and initiative role of Italians (which of course was not supported by economic power, while in Germany it was just the other way around). What is painfully missing from this comparison is the solution that proved to be the most lasting one, created by *Mustafa Kemal Atatürk*. The characteristic feature of the Italian model is the merger of the state and the governing party (page 101), self supply, the combination of welfare, a leader figure and a series of solutions which later generations got to know in a very different context, from the heroic mother through the breaking of virgin lands to free, centrally organized and cultured pastime activities for the masses. The author rightly points out (page 111) that average annual growth in Europe hardly reached 1 per cent at the time of this model.

■ Chapter 4 presents the “planned economy” system. The author highlights (pp. 132–137) that this model was the offspring of the German war economy during WWI and principally served modernisation subordinated for war purposes (page 146). The thorough explanations presented in this chapter fail to highlight sufficiently that Marxian daydreams merely had a fig leaf role after they were implemented in Lenin-style revolution and the rebuilding of the empire by Stalin that started in 1922. Professor Berend rightly points out (page 135) that the Marxian vision could only become a society-shaping force after it was fundamentally reinterpreted in the German social-democratic movement (completely independently from its scientific value which was disputed right from the beginning). Quoting the author, in the wake of the Kronstadt rebel-

lion¹⁰, *Lenin* became a “pragmatic politician” (page 140). In other words, after making a series of 180-degree turns, he no longer relied on Marxian teachings and neither did his successor, *Stalin*. The “socialism in one country” approach represented a fundamental change of strategy: world revolution was replaced by imperial nationalism (page 144). We should add that the three pillars of czarism, populism, autocracy and the state religion of a single true faith (*pravoslavije*) was restored by 1922–1924 at the latest.

Then the author outlines the development of the next period, 1922–1940. Unfortunately, however, he mostly relies on the well-known statistics from the era instead of the recalculations by *Abram Bergson*¹¹ or *Bernhard Heitger*¹² which provide a more realistic overview. Had he used these latter sources, he would hardly have written about “nearly miraculous growth” (page 148 and the subsequent pages) neither here nor in the context of other periods.

On pages 148–154, the author describes the evolution of the two-pole world with the development of blocks on both sides but refers to this process as a predestined and inevitable one. However, the analyses of the second Paris peace treaty (Fülöp and Sipos¹³, Romsics¹⁴) suggest that the idealism and constructivism embodied in the United Nations structure, the *chance* for a new world order that is built on cooperation was not zero at all between 1943 and 1947, no matter how many times we all learned so from the endless flow of works generated under the compelling force of subsequent self-justification. Block policy on an international scale gained dominance because “realistic policy” overcame other approaches, because the world slumped back into 19th century practices of imperial counterbalancing and because former war allies turned against each other in an unforgiving and uncompromising manner. Without these factors, the combina-

tion of “Finlandisation” on a broader scale, a neutral and disarmed Germany, communist participation in the governments of France and Italy and a Russia-supporting Iran would have served better the interests of the soviet empire than the arms race that started in 1946 and was obviously unwinnable¹⁵ for them right from the start.

Iván T. Berend already provided critical analyses of the “planned economy” approach in many of his former books. In this work he objectively points out (page 158) that in this political system which presented itself as the engineer of the future to justify oppression, *the real compelling force* from the very beginning to the very end *was the operational plan* i.e. the set of action plans for 10, 30 or maximum 90 days. While the “welfare package” of the system showed astonishing resemblance to similar solutions elaborated by the nazis, its core scheme of low and equalizing wages and fringe benefits was and remained quite popular even subsequently (page 163).

When providing a final evaluation of the entire system, professor Berend comes to disappointing conclusions (pp. 169–174): *despite* four decades of intense industrialization, qualitative and structural *weaknesses* that reproduced *underdevelopment* remained in place. Why did the very reforms that could have eliminated this outcome fail? As for the author, there would have been a chance for such reforms but real action was scarce (page 177). The combination of backward steps and the loss of perspective sealed the fate of endeavours launched in the late 80s (page 181) which was then followed by free market experiments (page 182 and subsequent pages). Obviously the latter was not a cause but a consequence of the foregoing.

■ The subject of chapter 5 is mixed economy and welfare state in Western Europe in 1945–1980. In this chapter, sharing the opinion of the late *Béla Csikós-Nagy*, the author

describes the period as a veritable *golden age* (pp. 185–186). In this period, new approaches were developed based on former solutions i.e. based on directed economies. The point of the new synthesis was that government regulation was paired up with neo-corporatism, free trade and regulation under the EEC/EC (pp. 186–190). The author discusses in detail the creation of the EEC and the reasons for its establishment. One question remains open though: what could have been the quantitative contribution to aggregate economic performance in that golden era of a system that hardly redistributed 1 per cent of the total GNI?

This chapter reviews the wave of nationalisation from France to Austria, rightly pointing out that state companies in Western Europe, after all, remained market players and their finances were never integrated into central government finances (page 215). The planning approach introduced at the time was indicative and not dictatorial in nature.

The author thoroughly reviews how the universal welfare state gained ground throughout Western Europe. No mention is made, however, of the regular and significant draining of state money which is unavoidable in general redistribution (which the author describes in the words of *N. Barr* as government “piggy bank”), of the related low efficiency, the lack of sustainability both in theory and practice and of the abhorring costs and alienating effect of bureaucracy conveyed by the system (which was perceivable for all of us in Hungary during the experiments with our healthcare system in 2006–2009).

Analysing the interconnections of economic growth and structural change, the author presents the transformations caused by productivity, consumption, mechanization also at households, declining agriculture, servicing society and mass tourism. Unfortunately, no mention is made of the three aspects of sustainability here either: the *natural* (Club of Rome, Gore

panel) element, the *financial* element (old and new Bretton Woods) which has become so timely by today and finally of the *social* element (the conservative revolution triggered by the stagflation experience in the 1973–1979 period). Without examining these elements, however, we can never know whether the label “golden age” for the 1945–1980 era (i.e. up to the second oil price explosion) only has nostalgic value or if it also relies on a scientific foundation. Following the opinion of the late *József Bognár*¹⁶ most economists would assign the 1973–1979 years to the change of eras in the world economy and consider it a time when everything turned upside down instead of linking them to the 1950–1973 period.

■ Chapter 6 discusses globalization as the revival of free market endeavours. The author rightly points out that what we see is the *aggregation* of commercial, financial, technological, organizing, ownership transformation and intellectual processes which mutually strengthen each other (pp. 252–262). The criticism of free market ideologies that follows is hardly comprehensible without direct *memories and mass experience* of stagflation and the collapse of the soviet empire and other “non-capitalist development paths”. We should note that *Hayek* and *Friedman*, the two economists cited by the author definitely did not belong to *mainstream* economic thinking of the era which was manifested in the 70s and 80s in Samuelson's synthesis, i.e. in the reconciliation of neo-Keynesian and neo-classical schools on a methodological basis. The impact of the two great thinkers was more tangible on intellectual life than on applied economic policies.

In the chapter titled Globalization and Europe, professor Berend aptly points out that the shocks in 1973 and 1979 only *amplified* the crisis symptoms observed and described in earlier eras (268 and subsequent pages). The way out of “eurosclerosis” was the transformation of knowledge-based society from slogan to

reality (page 274) in countries (mainly Scandinavian states) where this transformation actually happened. What deserves special attention (especially for believers of historical determinedness) is the fact that former semi-peripheral countries (e.g. Ireland, Finland, Spain and Portugal) converged to the centre in a little more than a quarter of a century between 1973 and 2000.

Examining the connectedness of a mixed economy and the welfare state, the author finds that it is impossible to get away with per-capita welfare expenditures that are the double of similar expenditures in the United States and Japan. For despite all the neoliberal slogans, welfare and social spend (especially pensions) had a *growing proportion* in Western Europe in the period concerned (page 289).

In his evaluation of the entire process, professor Berend points out that globalization does not have a *general* impact as it comes to existence as a function of human capital and the nature of economic policy answers (page 294), further refined by geographical and institutional factors.

Beyond doubt, Europe emerged in the last twenty five years of the millennium as an *economic superpower* (page 304). Its GDP and population reached and exceeded that of the US respectively. Per-hour productivity is the same, but work time is much shorter in Europe. Partly because of this “leisure time society”, the symptoms of falling behind are visible in Europe now. The way of the future is shown by the rise of Asia, where not less than

37 per cent of total global income was generated in 2000 (page 309).

* * *

Perhaps it speaks for itself that the book does not have a closing summary chapter that would directly present the author's view on learnings and future perspectives. Principally targeting American readers, the book has been written in excellent, almost literary language. The stylistic quality of the excellent Hungarian translation is a merit of *Vera Gáthy*. The book undoubtedly serves the cause of raising benevolent interest towards Europe. It is a valuable piece of work which conveys the specific features of summaries. The presentation of interesting stories (from the history of NOKIA to that of the Agnellis) in separate boxes is great and so is the presentation of many illustrative tables and reader-friendly diagrams. Insistence to the global viewpoint throughout the book is a definite strength along with the comparative approach and the openly confessed, traditional social-democratic values of the author which did not wobble with the changes of the past decades. Perhaps a more intense integration of the past two decades' economic literature, the presentation of original data which characterized the former works of the author and more frequent challenging of different viewpoints could have made this book an even more powerful piece of work. Naturally, even in its current form the book is a must-read that fills a gap on the market.

László Csaba

NOTES

¹ Iván T. Berend (2009): *My Life in Three Eras*. New York–Budapest, CEU Press

² While younger generations use the Internet extensively, important books are rarely available online and the use of preliminary versions makes laxity the norm.

³ Béla Tomka (2009): *The history of society in Europe in the 20th century* (Európa társadalomtörténete a 20. században), Budapest, Osiris

⁴ HDI is often (mis)interpreted as an indicator of the level of human development. This is rather funny if we look at humanity in the context of e.g. the car-

bon-dioxide emission of vehicles or waste water treatment. This is the reason for the “neologism” which we apply here. Some take incomparable dimensions and combine them into composite indicators that have no unit of measure, as if the lack of fresh air could be traded in for longer education, at least among women.

- ⁵ Friedman, M. – Schwartz, A. J. (1963/2009): *The Great Contraction, 1929–1933*, Princeton, N. J.: Princeton University Press
- ⁶ Bernanke, B. (2005): *Essays on the Great Depression*. Princeton, N. J., Princeton University Press
- ⁷ Navratil, Á. (1934/2008): *How economic crises end? (Hogyan szűnik meg a gazdasági válság?)* In: Navratil, Ákos: *Old truths and new theories in economics (Régi igazságok és új elméletek a közgazdaságtanban)*, edited and foreword by Márta Hild, Budapest, Aula Publishing House, pp. 259–283
- ⁸ Abay-Neubauer, Gy. (1958/1999): *Oeconomica Aeterna*, University of Pécs books, pp. 304–307, 312–318 and 354–357
- ⁹ Regarding the latter, the war industry should be handled separately as its key role was well-known at the time already, along with the ratio of redistribution and direct governance forms which it directly determined and which impacted the entire national economy.
- ¹⁰ For younger readers: Russian marines who carried out the coup-d'état in October 1917 and were stationed near St. Petersburg turned against the Bolsheviks in 1921 in a hunger riot. “Naturally”, the Bolsheviks violently oppressed the uprising. Yet as a result, they gave up wartime communism and embarked on a more allowing policy (resembled by current Chinese politics) in the so-called NEP-era (1921–1929).
- ¹¹ Bergson, A. (1997): *How big was the Soviet GNP? Comparative Economic Studies*, year 39, volume 1, pp. 1–14.
- ¹² Heitger, B. (1992): *Economic growth in the East and the West (1950–1990) (Gazdasági növekedés Keleten és Nyugaton)*, *Külgazdaság journal*, year 35, volume 2
- ¹³ Fülöp, M. – Sipos, P. (1998): *Hungary's foreign policy in the 20th century: Magyarország külpolitikája a XX. században*, Budapest, Aula Publishing House
- ¹⁴ Romsics, I. (2006): *The Paris peace treaty of 1947 (Az 1947. évi párizsi békeszerződés)*, Budapest, Osiris Publishing House
- ¹⁵ There is no precedent that a country could lastingly maintain a war potential that exceeds the multiple of its economic power (the Huns could do it for a couple of decades and the Soviets, too, for approximately 60 years).
- ¹⁶ Bognár, József (1975): *A change of eras in the global economy (Világgazdasági korszakváltás)*, Budapest, Gondolat Publishing House

Pál Belyó

Properties of hidden economy

SALDO KIADÓ, 2009



As the author himself underlines in the preface, *hidden economy* is one of the most thrilling scopes of economic research currently under way in Hungary, for the size of this economy is big and growing all over the world, but a fitting method to measure it, the social roles it plays, its effects of central budget, and its management in economic policy are all under controversy, and answering the questions raised by this issue is hindered by a number of problems in content and methodology. Therefore, the topic of the book has been selected cleverly. Publication of the book could foster additional research into the subject and better understanding of actual problems, and also the development of the right social assessment of this slice of economy.

■ Chapter One aims to clarify the notion of hidden economy. Readers unacquainted with the topic may even be surprised to see a definition. In the explanation, however, it becomes

clear that neither the activities connected to hidden economy, nor the terminology used in analyses are standardised. For instance, a wider 'statistical' view in the analysis comprises (specific) activities that are *not measured in statistics* on one hand, and to-be-measured but *unreported* activities on the other hand.

▶ The group of *unmeasured* activities are not uniform, either; some of them, including household work and favours, are entirely legal, but most criminal activities are also listed in this group.

▶ The hidden percentage of activities that should be measured in statistics is most often called *underground* economy. This group consists of illegal production activities, such as the making of and trafficking in drugs on the one hand, and

▶ *black* economy on the other hand (previously called secondary economy in the Hungarian terminology), comprising work

done by unregistered 'entrepreneurs' (companies under the radar of various authorities, as well as individuals working without being registered employees), and non-reported activities conducted by registered companies.

Widespread in Hungarian public opinion and also used in some chapters of the book, the terminology most often uses the above described definition of 'black economy' for hidden economy. At times, however, some components of non-measured activities are also included here, for instance community house-building (page 23), and the barrier between legal and illegal activities in case of sexual services is also undecided. Leaving statistical aspects out of consideration, an interpretation based on ethics, limiting this scope to activities that are harmful to the society, is not rare, either. Since this topic is closely related to the concept of public taxes – and the lack of registration in the scope of 'black' activities most often stems from tax evasion – uncertainties in terminology may have implications in practice.

■ Nearly all chapters of the book attempts to give some clues to estimate the full scale of the hidden economy in Hungary (which is inherently a very tough task). The focus of these efforts is centered around defining the weight of unregistered – and thus tax-evading – black activities, resulting in a 'fork' of two values. Right on the first pages there is a statement that 'unreported and unpaid taxes and social contributions are currently estimated to amount to nearly HUF 1,000 billion' in the Hungarian economy (page 25). Based on the results of calculations that include certain unmeasured components, it is also stated in the book that 'the size of hidden economy in Hungary dropped to nearly 25 per cent by 1998 in terms of GDP from the 33-percent peak measured in 1993, and has been decreasing ever since' (page 79). According to the chart using this latter calculation, the annual value of the output realised in hidden economy amounts to

HUF 5,000 billion at current prices, a multiple of unpaid taxes and contributions (page 80). The reviewer, however, who believes these figures are underestimated and is also doubtful about the slow retirement of hidden economy, is sorry to see no attempts from the author to list the most significant totals at least.

It is hard to decide whether the aforementioned percentage – which is high in international comparison – should be regarded acceptable or an exaggeration considering the local environment. Accounting for roughly two-thirds of the book, the analyses explain the ECOSTAT surveys that attempted to give an answer to this question. The surveys were conducted in the corporate and household scope in 2000 and 2005.

The surveys conducted in the *corporate* scope focused on the reasons and methods for legal and illegal tax reduction, and also to possibilities in curbing the latter. Both surveys stated that company managers assessed Hungary's taxation system mostly negatively (pages 84, 111), regarding taxes too high and contributions strongly excessive, and sharply criticised the bureaucratic approach of the system. No surprise, they reckoned that approximately half the companies were likely to be involved in hidden economy (pages 93, 117), and estimated the size of hidden economy relatively high at a quarter of economic activities on average (pages 90, 199). They reckoned construction industry was the most infected.

Most company managers in the survey were familiar with a very broad array of illegal tax evasion methods, and indicated these were employed in a more or less extensive scope, according to their experience. Both surveys depicted various perks employed for the purpose of tax savings as a wide-spread legal technique; in 2005 the scope of 'legal methods' was increased further by the employment of experts with cost-cutting purposes and also by lobbying activities aimed at securing orders –

with the average remuneration being nearly 20 (!) per cent of the price invoiced for the orders. In the company of illegal techniques, unreported employment and no-tax-payment claimed the top of the list, and responders reckoned that perhaps 40 per cent of companies had slush funds to finance these practices. Company managers estimated non-invoiced sales at 25 per cent of total sales on national level. At the same, rejection of these practices were almost typical.

Experiences gained in the *household* survey complement the corporate results nicely. Back in 2000, already more than one-third of responders stated they knew at least one person among their acquaintances that had been doing unregistered works regularly in the preceding six months; roughly half of them had heard of instances when work was done in return for unreported benefits, and more than half were familiar with the practice when employers registered employees at the official minimum wage and paid the taxed amount out of a slush fund (pages 154–155). A slight improvement showed by 2005, as only 16 per cent of responders were aware of unregistered employment, 40 per cent had heard of work paid for in a no-tax scheme, and a smaller percentage in both groups were aware of employees having been registered unreasonably at minimum wage (page 181). In both scopes, there was a high percentage of responders that considered sales without invoice or underbilling a regular practice, and many had information about invoice collection for other entities and sale of fictitious invoices. Matching popular opinion, tips proved wide-spread in specific sectors, but one-third of responses in 2000 and one-quarter in 2005 mentioned unpaid work made for the personal purposes of their superiors. (pages 170, 196).

■ When the Hungarian morale of tax payment, or rather non-payment, is to be assessed, one cannot disregard the fact that, based on

other probes into the matter, the status quo outlined by *Pál Belyó* may be regarded as relatively gentle. For instance, the study *A fekete-munka elleni küzdelem [Fight against unreported labour]*¹ authored by *Károly Horváth* reports not only of regular black work made by individuals regularly, but also of organisations specialised in intermediating and trading black (i.e. unregistered) workers and also of a wide scale of bureaucratic obstacles that hamper the fight against these entities, and also of indications of organised crime in this scope. The article *Az adócsalás gazdaságpszichológiai megközelítése [Economic-psychological Approach of Tax Evasion]*² authored by *Ms. Erzsébet Papanek*, however, indicates that in a minor (and anonymous) survey conducted with the participation of psychological majors nearly all small-business managers and employees “admitted” to employing some – today regarded minor-league – tax-evasion methods. And let's not mention the implications of the author being 'understanding' toward the recent tax-evasion acts of the wealthy. For the book makes almost no mention of amounts siphoned off to tax havens via off-shore companies, estimated by some to total many hundreds of billions of forints, which has only increased in recent years.³ And few words are spent on corruption, too, including “payola schemes” related to construction projects of motorways, bridges, and underground lines, which are also estimated at many hundreds of billions of forint and counting.⁴

The analyses offer a clear answer to the question that probes into the size of hidden economy in Hungary, making the author's opinion clear repeatedly that this extents should be reduced, and also his efforts of looking into the possibilities (methods that could make the reduction possible). He assesses government efforts that have been made in this direction in recent years as positive, the undoubted curbing of frauds in the scope of excise tax (most

notably the shady businesses that developed in the early 1990s in fuel trade); stricter and more efficient control of the scope eligible for social security; developments in the IT landscape of the tax authorities, but he believes additional steps are necessary. His recommendations, based on international comparison, urge stricter control in labour issues; more transparent tax legislation and lower tax burdens; simpler economic regulations; better communication; and “orientation” for the Hungarian society which is prone to be generous about a number of tax evasion methods.

■ In every study it's easy to list topics the author should have elaborated more. Nevertheless, the reviewer does not find it unjustified to mention his wish to read more about economic policy related to hidden economy. He is convinced, for instance, it is important to differentiate objectives and concentrate efforts in this scope. He believes community work, which fosters social relations and the idea of “giving a helping hand” – for instance grape harvests made by family and friends – should not be restricted but supported; and decidedly illegal conduct, such as organised crime, cannot be curbed by taxation methods but by law enforcement actions only. Imposing and collecting taxes is harmful where costs are

equal or even higher than the available income (although some surveys indicate there are several of these taxes in force).⁵ An analysis into the correlation between the tax burden and tax evasion in Hungary (the Laffer Curve) would have been a welcome sight, and also a survey to show what effect the tax extent in Hungary has on the expansion of unregistered labour – on output retention wide-spread in a number of economic segments but unmentioned in the book, and also on relocating production facilities to neighbouring countries with lower tax burdens. But a warning would be equally important that tax payment morale is enhanced when tax payments serve the achievement of objectives (even local ones) that are deemed important by the society. Since the centrally-imposed administrative burdens in terms of GDP is a multiple the international average⁶, it would have been useful to describe some proposals to reduce tax bureaucracy. Had economic policy conducted all these analyses a decade ago, there would have been chances for Hungary's economy to get closer than it is now to the situation depicted on pages 228 and 229, namely a 3-percent GDP growth and also 3-percent budget deficit in terms of GDP.

Gábor Papanek

NOTES

¹ In: Papanek, G. (Ed.): *Jogbiztonság a magyar gazdasági életben* [Legal Security in Hungarian Economy], Filum Kiadó [Filum Publishing], 1999

² In: Hunyadi, Gy. – Székely, M. (Ed.): *Gazdaságpszichológia* [Economic Psychology], Osiris, 2003

³ BDO Könyvvizsgáló Kft. [BDO Audit LLC] In: *Keresik a kimentett vagyont* [Rescued Wealth Sought], Magyar Nemzet, 25 April 2009

⁴ See, for example, Varga, Sz.: *A korrupció és a védekezés lehetőségei* [Corruption and the

Possibilities of Fighting It], *Vezetéstudomány* [Management Science], Issue 3, 2009

⁵ See, for example, Szirmai, P. – Szerb, L. – Madarassy, T. – Petheő, A. I.: *Közvéleményre hangolva* [Tuned to Public Opinion], manuscript, Corvinus – PTK, 2008

⁶ See, for example, Mester, Z.: *Kormányzati programok a versenyképes üzleti környezetért* [Government Programs for a Competitive Business Environment] In: *A gazdasági környezet és a vállalati stratégiák* [Economic Landscape and Corporate Strategies], MTA IVB, 2008

Think global, act local

Ilona Kovács Pálné

Local governments in Hungary

DIALÓG CAMPUS KIADÓ, 2008



The idea of local government reforms has again come to the foreground of Hungarian professional discussions. This may even be good news if the various reform ideas rested on objective analyses and the lessons distilled from the professional disputes but unfortunately, this is not the case. The dominant opinions (at least in the media) are based on presumptions and prejudices rather than on knowledge, although scholars do what they are supposed to do, their results could be built upon.¹ An example for this is a monograph that was recently published, which we can call the “black book” of the Hungarian local government system in the sense that it ruthlessly does away with all the illusions that have led to the development of today's system. The author, who is an honored senior researcher of the narrow professional circles, has summed up her several-decade research on the subject in her latest book. The book is a scholarly piece of work in the widest

and most positive sense of the word but as we have already suggested, it is also much more than that. While it meets all the criteria of scientific analysis and monographic elaboration (use of the relevant literature, synthesis of theoretical and practical knowledge), it describes the international trends and correlations of the analyzed area, it also ruthlessly explores the operational mechanisms of the subject and takes a clear standpoint on further development, on the basis of firmly stated values. The author does not make it a secret either that she is “for” local governments but she looks at the “Hungarian model” of the local government system with the criticism of a clever parent and not with a kind of “doting attitude”. She confronts the public and the researchers of the area (including herself) with those illusions and prejudices as a result of which (too) the Hungarian system of local governments is in its current status. As regards its genre, the “black

book” may even be green. By this, I do not mean to qualify the maturity of the conclusions contained therein but I mean that the decision-makers of the local government reforms could boldly use the book as a source. Of course, the politicians of any time are not obliged to take over, or copy the warnings and guidance of science as such. The observer sitting in the crow's nest² is not in the same position as those serving on the captain's bridge. He does not see the same things, he is not the one to steer the boat. Treacherous reefs may escape the attention of the observer but the land is probably better seen from up the deck.

The author starts the book by describing the theoretical framework of the topic, presenting and systematizing the knowledge accumulated by economics and political science. The second part deals with local and regional policies, avoiding all kinds of mystification and flourish but at the same time, clearly describing the most important feature of this complex, if you wish, highly specific public policy area. It is indicated by some provoking subtitles (Does local power exist?, Who governs?) that the book aims to bring up, and if possible, to resolve problems rather than to gloss over them. Theoretical foundation is followed by the narrative description of the evolution of Hungarian state administration through several chapters. This is followed by the detailed and many-sided description of the structural and public policy features and operation of local government. The monograph is closed by presenting some scenarios for solving today's unsustainable situation, which statement is also proven by the book. If one only gets their information from the table of contents, they may be missing the obligatory chapter on “international outlook”. Well, thanks to God, this is missing from the book, as we are talking about a book that discusses the international trends and the domestic processes (be they theories, public policy, or organizational solu-

tions) *as an organic whole*. We hereby do not undertake the (impossible) mission of introducing all the relevant ideas of the book. Instead, the reviewer highlights those messages of the book which are especially attractive to him and which may encourage the readers of this review to read the book themselves.

From the book, you will learn about those strong tendencies in the development of the global economy that result in permanent changes in the role of the state, as well as the transformation of the spatial structure of the economy. The presented periodical processes, which should also be reckoned with by those who devise domestic reform ideas, tend to fundamentally reshuffle not only the contents of the state tasks but also the distribution thereof between the individual government levels. It shows how, besides and instead of regionalization, the global networks of cities affect the spatial relationships of the economy and what challenges they pose to the state organization.

In the author's analysis, *system approach* and *historical view* jointly represent themselves. These virtues may teach important lessons to the “radical” reformers. The art of reforms is the art of distinguishing between something *to be changed* and something that *can be used*, between things that *can be changed* and things that *cannot be changed* momentarily. It is an art, as politicians always act in a specific field of force. Science can help politics in that it shows the opportunities and constraints of its action. The book's merits are both in the presentation of the things determined by the past and the continuities, as well as in its making the reader feel that society and its various subsystems make up an organic whole. Each intervention modifies the internal balance of this organic whole at any time. The application of these approaches makes the book enjoyable reading for both those interested in the widest professional spectrum of social sciences and the actual players of the local government system.

These approaches are also suitable for getting a sophisticated picture of the syndrome “from front-runner to straggler”, which idea dominates Hungarian public speech. It is obvious from the book that this approach is rather narrow-minded. When the Berlin wall came down, the Hungarian politicians and professionals of this field used to have a libertarian view of the market and of democracy, which was actually an idea about a social structure that had never existed anywhere. The use of the past tense is by far not justified in the light of the reform ideas of today, as the prejudices of the recent past haunt us even today.

This had several kinds of consequences. On the one hand, planning-based coordination disappeared from the Hungarian set of concepts, depriving itself from an efficient tool of solving several problems. The West used to “suggest” strong decentralization to the countries in the process of changing their political systems, *in spite of* the obvious integration tendencies of the Central-European countries, with good reasons. A “small” and weak state is less able to resist the economic advocacy groups and the external political lobbies. The latter is very conspicuous in the case of the disintegrated post-Yugoslavian states but the story is also about other countries.

Dr. Ilona Pál-Kovács shows it from many aspects that the Hungarian model of local governments has realized decentralization without subsidiarity and collective irresponsibility, while the constitutional frames and the economic realities got increasingly distant from

each other, and the model became a “dump-site” for the unsolved conflicts of the political shift.

In her proposals, the author diverts at several points from today's fads in political science and state administration in Hungary. She has a determined counter-opinion against the municipality regions and de-concentrated organizations installed on the NUTS2 level. This opinion of hers, however, is not emotionally biased and not the result of a “consistency” in a negative sense but the application of the outcome of the research activities which provide the background of the book and which continued after the completion thereof³.

It would be good to act but it does make a difference how. Political action is always specific, or local, if you like. The local feature, however, is not the synonym of provincialism. The reforms are not for themselves but for the better operation of the areas to be changed. The ambitious reformers of the local government system had better pay attention to such analyses as the book written by Dr. Ilona Pál-Kovács. I am sure that the monograph will become the Bible of students of political science and PhD students dealing with the subject. I am less sure, however, whether those who make the political decisions will also utilize this treasury of knowledge. Thus, I recommend this book written in extraordinarily good style to both reformers and those who are simply interested in the topic.

András Vigvári

NOTES

¹ The literature provided here is intended to be a kind of obligatory and extendable list of sources for those interested in the local government reform.

² Metaphor used by Bálint Csátári

³ See also Mrs. Pál, 2008

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