

# **Competitiveness and Modernisation of Public Finances: Selecting an Action Scenario in Hungary following EU Accession**

by  
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*The most important strategic tasks of Hungarian economic policy are to complete the process of European integration, to build up the appropriate institutional and social capacities and to harmonise real and nominal convergence. This article discusses a theoretical framework for modernisation and how it could be adapted to the Hungarian public sector. Several action scenarios are discussed, but any reforms should aim to rethink the role of the state and improve competitiveness while maintaining social cohesion.*

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**H**ungary faces historical challenges as a new member State of the European Union. As a consequence of globalisation, the key criterion of the sustainable development of each country, but especially of those small countries on a medium level of development with open economies which are similar to Hungary, is to hold on in global competition. This challenge has not been softened by our EU membership either, since it is publicly known that the Union itself is searching for new ways of faster development. Nevertheless, our EU membership creates a historically unique opportunity for integration and for achieving real convergence. However, by joining the EU, Hungary has committed itself to join the euro area and therefore to fulfil the criteria of convergence, i.e. achieve nominal convergence.

The timing of accession and the costs and benefits of introducing the common currency are the subject of debates in Hungary, as well as in each new EU member State. The most important strategic task of Hungarian economic policy is to complete the process of Europeanisation of the country, to build up the appropriate institutional and social capacities<sup>1</sup> and to harmonise real and nominal convergence according to an appropriate schedule. The public sector is the most critical area of economic policy that the government can influence. Thus, it is not simply a question of fulfilling the fiscal criteria of nominal convergence (see Table 1), although that in itself is a significant task to accomplish (Government of the Republic of Hungary, 2006).

These are the reasons why I aim to discuss the required changes which support the development of appropriate responses to these challenges from a strategic point of view. I am doing so because it can be observed all over the world that supreme audit institutions, by relying on the experiences that they have accumulated in the course of their activities, continuously assess the risks of the public sector and, by their advisory activity, contribute to the modernisation of the economic policy decisions that impact on the public sector and to the modernisation of regulation. I would like to commence by introducing a suitable theoretical framework and its adaptation to the Hungarian situation. I am then going to highlight some issues of the required modernisation and reforms that I find important. Finally, I will touch upon the changed and upgraded role of auditing. However, before discussing my actual subject, I would like to give you a very brief overview of the Hungarian public sector.

Table 1. **Criteria of convergence relevant to fiscal policy and inflation**

As a percentage of GDP

	2004 (actual)	2005 (preliminary actual)	2006 (preliminary performance)	2007 (forecast)	2008 (forecast)	2009 (forecast)
Budget deficit	6.6	7.5	10.1	6.8	4.3	3.2
Gross public debt	60.2	62.3	68.5	71.3	72.3	70.4
Consumer price index (Harmonised Index of Consumer Prices)	6.8	3.6	3.5	6.2	3.3	3.0

Source: Convergence Programme of Hungary (September 2006).

## 1. Some features of the operation of the Hungarian system related to public funds

The Hungarian public finance system can be divided into two levels and four sub-systems. The major player at the level of the central government is the central budget. Furthermore, the two social security funds (the Health Insurance Fund and the Pension Insurance Fund) and the separated state funds belong here as well. The second level is the sector of local governments. The current system of performing community tasks, the legal and state organisation system that represents a democratic constitutional state, as well as the operational framework of the real economy are **politically** based on those social compromises that are to be reconsidered in a number of respects nowadays, since the foundation of the political and social changes in 1989. The values which defend the integrity of society defined in the Hungarian Constitution – such as civil and entrepreneurial rights, the right to health, education and civil representation (and the operation of the central and local administrative systems defined as a result) – should be mentioned here, along with those which were manifested in various legal regulations which can mostly be amended by the qualified majority of the National Assembly. These factors define the professional frameworks, requirements of the state task performance, and the financial magnitude of the so-called social transfers reflected in the budget.

Within the framework of public finances, rules of financial management and the clearance of accounts are provided for in the Act on Public Finance introduced some fifteen years ago and the related decrees of the government and the Minister of Finance. However, this legislation underwent significant changes in the past few years, and in many respects it went out of date. The situation is ripe for the re-regulation of financial management relevant to public finances.

The central budget plays a critical role in the public finance system in every country. Defined in financial legal terms, this means that the role of the

main budget is fulfilled by this sub-system. The revenues associated with state sovereignty are presented at this level, and this is also the level which is entitled to relinquish some of the economic privileges associated with sovereignty in favour of the other levels of the public finance system or the private sector players.

The bases of Hungary's current taxation system were established by the tax reform introduced in 1988. The Hungarian taxation system centralises 38-39% of annual GDP. The majority of revenues come from central taxes; the weight of local taxes is around 1.5% of GDP. The major problem of the Hungarian taxation system lies in the fact that, due to the presence of the grey and black economies, the distribution of tax burdens is highly uneven, the proportion of property-type taxes is low, and tax administration is not as efficient as it should be.

Table 2. **Tax and contribution revenues**

As a percentage of GDP

	2004 (actual)	2005 (preliminary actual)	2006 (preliminary performance)	2007 (forecast)	2008 (forecast)	2009 (forecast)
Taxes	25.5	24.9	24.1	25.3	25.5	25.2
<i>Of which:</i>						
Taxes on production and imports	16.2	15.6	14.6	14.8	14.7	14.4
Current taxes on income and wealth	9.2	9.2	9.4	10.4	10.7	10.7
Capital taxes	0.1	0.1	0.1	0.1	0.1	0.1
Social contributions	12.5	12.8	12.8	13.5	13.5	13.4
Total tax and contribution revenues	38.0	37.7	36.9	38.8	39.0	38.6

Source: Convergence Programme of Hungary (September 2006).

As regards the **expense structure** of the central budget, no major changes have occurred in recent years, which shows the faltering progress of real convergence. Although comparative statistical figures for the most recent period are not available in each field, it is apparent from Table 3 that the extent of government involvement and the weight of the individual functions are different in each country being at a different level of development and having a different social setup. The roles and weights of the individual functions change over time as well. The level of redistribution of government expenditures (the ratio of consolidated expenditures of the public finance system as compared to GDP) on average for the oldest EU member States (EU-15) grew slightly from 2000 to 2003; it is currently around 48%. This growth is typical in the area of welfare operations, more precisely in the areas of health and social security. The redistribution level of the new member States is a bit lower, i.e. 46.2%. The

proportions of the individual areas are similar: the proportion of welfare expenditures (especially health expenditures) is somewhat lower, and Hungary spends more on economic flows and other functions.

While the extent of redistribution in Hungary only slightly exceeds the European average, the proportion of the individual functions shows major differences. The weight of expenditures of government operations, which include public debt transactions as well, was 14% in 2000, whereas the same rate for EU member States was 10%. There was significant backlog in the area of welfare expenditures, specifically in the areas of health, social security, culture, and housing. However, similarly to the average of the ten new member States (NM-10), the proportion of education expenditures was higher. By 2003, the expense structure approached that of the EU member States although the expenditures related to economic flows continued to be high, especially in 2002, the year of completing the construction and inauguration of highways. As regards 2004 and most probably 2005 as well, the weight of health expenditures has again decreased after the 2003 peak of 5.6%, the proportion of education expenditures still exceeds the EU average, while the level of expenditures for supporting government operations fell, approaching the average of EU member States. The share of expenditures for supporting economic flows is still high and will continue to be an additional component in the structure of public expenditures for quite a long time, as a result of the justified state task of infrastructural development and the ever increasing utilisation of EU financial resources for development purposes.

In an international comparison, **health and social protection** are under-represented in the Hungarian budgetary expense structure, while government operations and the state's role in supporting the economy and, what is more, even the weight of education expenditures compared to several other countries are over-represented. The social security funds, which play a critical role in fulfilling the health and social protection functions, are unable to finance health services from the collected contributions; an increased reliance on the resources of the central budget will be required, and this is not even sufficient. Fifty per cent of the very high budget deficit, which is 10% of the GDP projected for 2006, is due to the expenditures of the social security system<sup>2</sup> (the other 50% is due to the increasingly difficult debt management). This draws attention to the contradictions of the social security system, which can be explained by the lack of self-sustainability, the lack of a defined content of mandatory health insurance, and the structural problems of the supply system.

The second level of the Hungarian public finance system is the sector of **local governments**. The sector, which is highly fragmented as compared to the size of the country (there is a total of 3 200 county, city, and community local governments, along with the relevant structure of administration and service organisation), struggles with a wide range of services, even in international

Table 3. **Functional classification of government expenditure in individual EU member States and in Hungary**

As a percentage of GDP

	Government operations <sup>1</sup>	<i>Of which:</i>			Welfare operations	<i>Of which:</i>					Economic flows <sup>2</sup>	Total
		General public services <sup>1</sup>	Defense	Public order and safety		Education	Health	Housing	Culture	Social protection (social security and welfare)		
<b>EU15</b>												
2000	9.9	6.5	1.8	1.6	31.4	5.0	5.9	1.0	0.9	18.6	4.3	45.6
2001	10.3	6.9	1.7	1.7	31.7	5.1	6.1	1.0	0.9	18.6	4.6	46.6
2002	10.2	6.8	1.7	1.7	32.3	5.3	6.3	0.9	1.0	18.8	4.6	47.1
2003	10.1	6.7	1.7	1.7	33.1	5.4	6.5	1.0	1.0	19.2	4.6	47.8
<b>EU25</b>												
2003	10.1	6.7	1.7	1.7	32.9	5.4	6.4	1.0	1.0	19.1	4.8	47.8
<b>Selected individual countries 2004</b>												
Czech Republic	8.3	4.8	1.3	2.2	27.5	5.0	6.3	0.7	1.3	14.2	8.6	44.3
France	10.4	7.1	2.2	1.1	39.0	6.4	7.3	1.9	1.5	21.9	4.0	53.4
Germany	8.7	6.0	1.1	1.6	34.0	4.0	6.1	1.1	0.7	22.1	4.1	46.9
Greece	13.9	9.8	2.8	1.3	28.5	3.5	4.9	0.5	0.4	19.2	7.6	49.8
Poland	8.2	5.6	1.0	1.6	30.2	6.0	4.3	1.4	0.9	17.6	3.8	42.2
Portugal	9.5	6.2	1.4	1.9	31.2	7.4	6.6	0.8	1.2	15.2	5.5	46.1
Slovak Republic	7.3	5.0	1.0	1.3	26.1	3.7	4.2	1.2	1.2	15.8	7.1	40.6
Slovenia	11.2	7.9	1.4	1.9	32.2	5.8	6.6	0.2	0.9	18.7	4.0	47.4
Spain	7.8	4.9	1.1	1.8	25.3	4.4	5.5	1.0	1.4	13.0	5.8	38.8
United Kingdom	10.0	4.8	2.6	2.6	30.2	5.8	7.0	0.7	0.5	16.2	3.6	43.7

Table 3. **Functional classification of government expenditure in individual EU member States and in Hungary (cont.)**  
As a percentage of GDP

Government operations <sup>1</sup>	Of which:			Welfare operations	Of which:					Economic flows <sup>2</sup>	Total	
	General public services <sup>1</sup>	Defense	Public order and safety		Education	Health	Housing	Culture	Social protection (social security and welfare)			
<b>Hungary</b>												
2001	13.6	10.2	1.3	2.1	28.0	5.9	4.6	1.4	1.5	14.6	7.1	48.7
2002	12.3	8.8	1.4	2.1	29.2	6.1	4.8	1.3	1.5	15.5	11.4	52.9
2003	11.4	8.1	1.3	2.0	31.7	6.0	5.6	1.1	2.2	16.8	6.4	49.6
2004	12.7	9.3	1.3	2.1	30.3	5.8	5.4	0.8	1.8	16.5	6.6	49.7
2005	12.4	9.1	1.2	2.1	31.0	5.8	5.6	1.0	1.6	17.0	7.3	50.7

1. Including public debt transactions.

2. Including environmental protection.

Sources: Eurostat database; Hungary 2001-02: *Government Finance Statistics Yearbook* (IMF); Hungary 2003-04: Eurostat database; Hungary 2005: estimate.

terms. At the same time, a two-thirds majority of the National Assembly is required to make any step forward relevant to the essential setup of the system.

The public finance system as a whole is characterised by what we call the incremental planning and budgetary procedure. The operation of the sector has a few relevant budgetary rules (credit limits of municipalities, the general and specific reserve system of the central budget). The experience of the State Audit Office shows that the **current practice of budgetary planning and approval is unsuitable** for enforcing the required structural changes, and that the applied reporting system (basically cash-flow based) is inappropriate for presenting the real costs and performances as well as the pecuniary position. Modernisation is needed in order to contribute to increasing competitiveness and the resulting sustainable development on well-founded strategic bases.

## 2. Theoretical and methodological framework for building up a public sector that supports competitiveness

Before I start discussing the achievements and problems relevant to the modernisation and development of the Hungarian economy in the fifteen years following the political and economic changes, I find it worthwhile to make a few theoretical and methodological remarks.

According to the familiar and generally used definition, the major task of the state is to **create conditions** in both the human and the material, real infrastructure. In this sense, the state appears, in the light of the complex security interests of the functioning of society, as a **regulator** of the economy, as an **owner** and as the **articulator** of society's goals, and also as the **implementer** and **organiser** of the tasks to be performed in order to achieve these goals. By adapting a Dutch method published in 1997, we can say that institutions "in a society are equal to the accepted rules of the game [...] these are the limits set by the people, which shape the human relationships" (Central Planning Bureau, 1997). There are four different mechanisms in this framework; these may become capable of co-ordinating the behaviour of the players in a market economy. Such mechanisms are:

- **competition** among economic players, the indispensable institutional aspects of which are prices (except for rents, transportation and community services), the liberalisation of foreign trade, privatisation, and an efficient financial intermediary system;
- **shared values and norms**, namely the shared preferences of a specific group of economic players which fundamentally influence human behaviour;<sup>3</sup>
- **co-operative transactions**, executed based on bargaining as a result of the co-operation of economic players. Such transactions include, for instance,

trilateral co-operation between the government, the employers and the employees, which is a significant institutional factor and the basis for social partnership;

- **government administration**, namely the ability to enforce the state will that influences decisions, *e.g.* through government regulation, which presumes that public administration of a high standard complements the newly established role of the government, that legal security is guaranteed for the private sector, and furthermore that there is efficient management in the public sector.<sup>4</sup>

In this article, I will only briefly touch upon the first three elements of the method of analysis described above, *i.e.* competition, shared values and norms, and co-operative transactions.<sup>5</sup> However, I will go into more detail regarding government administration, to which I will add a few ideas regarding the main elements of **change theory** that is part of the thinking on strategic management. In the world of institutional changes, it makes sense to pay special attention to the generative role of the so-called change agents which can also be regarded as interest groups. These change agent organisations include domestic and international entities which are gaining increased significance, and the latter also have global and European examples. If you want to build contacts with international change agents, this will mean that, in exchange for the advantages of integration, certain government functions will rise above the level of the nation-state. This includes the process as a result of which large companies and concern-type groups of companies as well as the cross-border multinational empires<sup>6</sup> have gained increased significance in providing public services in the past decade. All this has led to a new chapter in the development of the co-operative state, unprecedented in Hungary to date.

The considerations described above are suitable tools for establishing the **reference frame** for the areas of institutional changes and the evolution of economic performances, which will also include the requirements presented by globalisation. In Table 4, qualifying factors (global and European change agents jointly) that function for each change agent are allocated to the relevant change-generating mechanism, and the required organisational characteristics are connected to the mechanisms.

The well-known requirement that the efficiency of government activity in a broader sense is a critical factor in any scenarios relevant to the role of the state is almost a cliché. However, opinions differ concerning the importance of each of the elements of the state's role. As a comprehensive goal at the centre of modernising the mechanism of government administration, we always see the achievement of public management and public administration compliant with the changed role of the state, which is consciously controlled and operated,

as well as applicable for generating changes. This key area cannot go untouched by the new forms of society. Besides the measures taken to increase efficiency which follow the traditional solutions (organisation sociology and/or public administration rationalisation), let us say measures of the “business administration” approach, Hungary is experiencing an increasing emergence of philosophically new solutions, which make public administration open and imply a kind of environment-conscious approach. In the government administration of today’s Hungary – although with a high level of distrust and inconsistency – the major direction of change is the complete development of the management approach where, however, experts have to (should) be aware of the costs of activity on a daily basis, as profit-oriented management cannot replace the current system without this knowledge. According to the latest SAO reports, for the time being there are deficiencies in this area.<sup>7</sup> We find it difficult to accept that the classic principle according to which public administration “stays where it is” and thus provides stability and predictability has become relative in Hungary as well. “Open system” public administration (or rather management) encourages representatives of the private sector to undertake public positions<sup>8</sup> but a basic issue here is that these players should be able to think and act in line with the interests of the entire society.

Table 4. **System of inter-relations relevant to changes**

A reference frame

Qualifying factors	Change-generating mechanisms							
	Competition		Government administration		Values and norms		Co-operative transactions	
	Domestic	Inter-national	Domestic	Inter-national	Domestic	Inter-national	Domestic	Inter-national
Purpose consciousness	A <sub>11</sub>		A <sub>12</sub>		A <sub>13</sub>		A <sub>14</sub>	
Method consciousness	A <sub>21</sub>		A <sub>22</sub>		A <sub>23</sub>		A <sub>24</sub>	
Skill consciousness	A <sub>31</sub>		A <sub>32</sub>		A <sub>33</sub>		A <sub>34</sub>	
Source consciousness	A <sub>41</sub>		A <sub>42</sub>		A <sub>43</sub>		A <sub>44</sub>	
Environment consciousness	A <sub>51</sub>		A <sub>52</sub>		A <sub>53</sub>		A <sub>54</sub>	

The central government and the local governments have to develop the content and forms of competence sharing and potential co-operation with their new partners. This includes the development of unified rules of procedure containing norms and guiding principles, i.e. guidelines for the concerned acting state and local government bodies as well as the audit of financial processes relying on this system.<sup>9</sup> In other words, the responses to

the challenges should reflect conscious, long-term **harmony** in regulation, the institutional system, the management methodology, and implementation. Multidimensional government consciousness also means that the following is acknowledged: the structure, setup, tasks, and even the personal and qualification requirements of the staff in public administration and public services are set by the state tasks and how well they are defined, i.e. the Hungarian legal system.

Starting from the above, and on the basis of national audit institutions' experience regarding the current situation, in line with the goals set in the action plans of Hungarian change agents (connection point A<sub>12</sub> in Table 4) the government administration in a broader sense should ensure internally consistent regulation compliant with the selected scenario, as well as such budgetary planning of which the top priority is the sustainability of the budget, and state presence and intervention should be limited and the methods thereof should be changed. In Hungary, all this basically coincides with the accomplishment of tasks relevant to accession to the euro area as stated in the Convergence Programme.

The clear definition of tasks, transparent planning, and a budget approved on the basis of functional and performance requirements renders performances more measurable, as a result of which the conditions of accountability, analysis and assessment, adjustment and – last but not least – auditing will (may) improve. Government operations will become more transparent for the “public” as well, a consequence of which will be a more stable government coupled with the strengthening of political confidence. A longer-term budget, as well as budgetary planning that takes perspectives into account, presume and require the operation of an extensively developed macroeconomic financial planning system adjusted to the nature of the current market economy.

As a result of reducing the redistribution of high proportion, and the accompanying high taxes and contributions, state presence and intervention can be limited:

- defining and narrowing the scope of the tasks to be financed by the state;
- encouraging changes in the proportions of financed objectives that give priority to the developmental, educational and environmental protection requirements of international competitiveness, rather than the direct costs of production.

The limitation of state presence and intervention presumes the reconsideration of state involvement and, accordingly, the clarification of the state tasks, which require new social and political compromises: the future tasks of the state cannot be identified by the current financing.

### 3. Events and options in the Hungarian scenarios

There are two dominant approaches to the content of the socio-economic changes taking place these days. It is publicly known that one approach considers the critical factor to be **economic growth** well definable by quantitative characteristics, while the other approach focuses on the qualitative features of **sustainable development** which are more difficult to parameterize. Both growth and development involve and presume that a certain economy, country or even social model is **competitive**. Whether or not is this explicitly declared, competitiveness in Hungary today is defined according to the latter approach<sup>10</sup> – i.e. in line with the sociological understanding that, even by sacrificing growth, we wish to achieve and maintain a dynamic balance between the production of the economy and social cohesion.

Hungarian experience also shows that the competitiveness bases of sustainable economic development are composed not only of restrictive or permissive so-called stabilisation actions increasing or decreasing economic burdens and economic rationalisation in the narrow sense, but also of reforms or simply the much less quantifiable factors of preparation, decision making and adaptation relevant to the adjustment to the changes, which are of critical importance for the success of convergence. Thus, the process of convergence – in Hungary especially – is influenced by the most diverse conditions of capacities, skills, social identification and public confidence, and all of these are reflected in the evolution of competitiveness.<sup>11</sup>

As to the long-term chances of Hungarian modernisation, development and integration, there are two publicly known challenges and action scenarios providing responses to these challenges (which are put in contrast for didactic reasons):<sup>12</sup>

- consolidating the bases of sustainable development by improving competitiveness; and
- preserving and strengthening social cohesion.

The environment for selecting the scenario is provided partially by internal factors (social support, traditions, political-administrative institutional system, the level of economic development, indebtedness, financial reserves, etc.) and partially by external conditions (EU and globalisation-related adjustment constraints, NATO and other international commitments, available EU resources, conditions of the global economy, etc.). These factors provide the scope for action of decisions.

The selection of a scenario where the improvement of **competitiveness** is placed at the centre of socio-economic action is aimed at reaching maximum social and financial responsibility of the individual, while at the same time minimising or at least substantially decreasing the number of state interventions.

Direct responsibility for state services, as well as the services provided technically via its own organisational system, is reduced; furthermore, the bureaucratic administrative commitments are also narrowed down. The dynamics of general government expenditures are diminishing, except for educational expenses; and besides (in spite of) decreased taxes imposed on entrepreneurs and consumption, more funds can be utilised for development and innovation subsidies. As a consequence, the concentration of income may become more moderate, and the expected economic consciousness and flexibility will enhance efficiency and will become a tool in the fight against wasting funds. It is required for the long-term success of anti-inflation measures to produce, as quickly as possible, significant results in increasing productivity and reducing the budget deficit, since the achievement of growth without inflation is our objective and at the same time a requirement of competitiveness.

Successful adjustment, which focuses on the strengthening of competitiveness, will result in permanent and accelerated economic growth and, in its final impact, social modernisation and development. However, social insecurity, tensions and the lack of equilibrium will probably grow as a consequence of the changes; unequal opportunities will become stronger, the impact of which can only partially be compensated by the increasing performance of the private sector. All this will act against assuming a higher risk in respect of economic policy. This means that the questions are to what extent the planned action will be limited by the short-term interests of the system of political shift (and social groups that use the services), and to what extent the chances of consensus-based solutions that go beyond the election cycles will decrease. Thus, if the external support associated with the cyclical world economy can be regarded as constant, then it is a fundamental criterion of implementation that faster domestic growth should be able to compensate for the unfavourable effects of the restrictions of public finances on the population and institutions on a shorter term, and no such situation may occur where the social reactions result in diverting the implementation of this scenario. This is an especially significant risk in those countries where a change of political system took place and which later joined the European Union. The credibility of the political institutional system, social confidence and a higher level of tolerance in the hope of future integration are of critical importance in moderating this situation and keeping it within tolerable limits. As regards the chances, a favourable perspective is provided by the historical opportunity called the “integration advantage” (Lawrence, 1997) as it was shown by the example of numerous successful OECD countries in the development process that followed the Second World War.

Others regard the so-called action scenario **based on the strengthening of social cohesion** as a suitable solution, as opposed to the idea described

above. This line of thinking suggests that the relative lack of social conflicts is an economic driving force that improves competitiveness and supports adjustment. This scenario builds on the operation of a social model in which, besides improving the role of the state as a service provider and service organiser and enhancing the operational efficiency of the supply system itself, public institutions with unchanged significance will function and provide fundamental social and innovative services, while the private sector will gain increasing significance in the organisation and the technical implementation of service provision, by being given a service provider market.

Many regard this scenario as a simple “warming up”<sup>13</sup> of the concept of the so-called welfare state, a kind of drifting on the waves of social needs, although it means more and something different if implemented in reality. If we do not simply refer to the slogans, but in fact undertake to implement this scenario, then our goal is to make the social supply system more efficient, starting from the idea that the more efficient utilisation of social and welfare expenses will bring about better social results. In order to reach this goal, it is unavoidable to modernise the service-organising institutions at the regional, community, and territorial levels, which involves a lot of tensions, as well as to eliminate the old systems and develop new ones that have significant cost implications. In countries joining the European Union, this option may be preferable first of all in order to create a chance for integration<sup>14</sup> where again those states are better off where there is consensus in selecting the values which survive the individual government terms, and/or where the shared success of the nation which has a cathartic effect (such as the newly attained sovereignty of a state) provides social support.

It can be stated that such a scenario will almost definitely be well liked by wide strata of society; this is why it is easier to implement. However, this is only so at the moment of announcing such a programme, since a solid and secure functioning of society involves cohesion between the active and inactive social groups, or the employers and the employees as well, along with the enforcement of the basic principle that no single generation is entitled to “live better” than its successors to the detriment of the latter by accumulating debts. This principle is becoming more and more difficult to enforce, as the proportion of the elderly population that is especially sensitive to the issue of social and health services is increasing. Thus, the risks of implementation are not only related to the self-evolvement of the competitive sector of the national economy in question, the success of the entrepreneurs' aspirations to unilaterally enforce their interests, errors in projecting the perspectives of the global economy, and perhaps unexpected “force majeure” effects incurred in the material bases of the nation (such as flood or earthquake disasters) but, paradoxically, to a gap between social expectations and the ability to finance these. In the set of goals aiming to improve social cohesion, it may easily occur

that the constraint of the system of political shift “to maximise the number of votes” and the need to comply with the “expectations of electors”<sup>15</sup> turn the model into a drifting system which utilises disproportionately significant amounts for social expenses, even though the required economic capacity may be lacking. From this point, it is only possible to attempt to return to the growth track of sustainable development at the cost of restrictions causing major social crises and shattering society’s perspectives. The enforcement of the required remarkable financial restrictions and the introduction of an “economic policy dictatorship” will increase the chances of the appearance of a government that functions in a longer term as a narrow centre of power and/or an autocratic institution, as an alternative, or rather, an “ultima ratio”. This setup stands significant chances of occurring in post-communist countries.

As opposed to the theoretical approaches described above, it is obvious that in reality the so-called experimental scenarios gain ground, often resulting in perceptibly different development trends. The environment for choosing the scenario is provided by the above-mentioned internal factors and external conditions. Often there are exaggerated illusions attached to the size of this scope for action and to the power of interactions, while the impact of other factors is underestimated. In Hungary, for instance, no such hope has stood the test of reality that the improvement of economic competitiveness and thus the strengthening of growth potentials may quickly result in the solution of social problems, and – as social security is in itself an important driving force – this already has a favourable impact on growth in the short run. Similarly, we have not duly considered the demographic trend<sup>16</sup> which is one of the most important components of the socio-political factor mentioned among the factors influencing competitiveness and largely defining the selection of values.

Two questions arise here. Can this choice be fully objective? Furthermore, are these scenarios equivalent to each other? Both responses are clearly negative.

The selection of goals and values is not entirely objective even if it is scientifically and consciously well-founded and the environmental conditions, the available resources and the expected evolution of social support are precisely known. In selecting values, an important role is also played by factors ranging from political compromises and bargaining mechanisms to elements of social theory and ideology, as well as socio-psychological and human motivations. On the question of whether the scenarios that can be selected are equivalent, the answer again is no. Since the goal can only be to achieve social cohesion, the safe operation and the strengthening of society, it is a paradox that this cannot be reached without appropriate economic and financial bases and it can only be created by strengthening competitiveness; thus the related steps have to be taken if we want success.

The question still remains whether it is possible at all to talk about a typical scenario by combining the elements related to the selection of values. My answer is yes, on the basis of a precise definition of position, an “equilibrium” action course including compromises which do not go beyond the main objectives and reflecting a consistent selection of values, the starting point of which is that a democratic state creating opportunities is needed, which implies a co-ordinated economy with social balancing mechanisms in order to have international competitiveness.

Any action scenario means a continuous selection of values, and if it is enforced in the long run, it can be interpreted in the context of development – more precisely, as part of the correlation between the political and social ideas regarding the content of development. At the same time, this means that for a value-based choice in the longer term it is unavoidable to have a socially accepted and politically articulated vision, which can be best defined in the case of Hungary (with major simplification) as reaching the level of the more developed countries of the European Union and becoming successful by taking the advantages provided by the “*acquis communautaire*” while at the same time preserving our identity. However, it is generally not sufficient to accept a model which reflects a more or less equivalent selection of values in its main principles of social distribution, but the **adaptation** of the related modernisation objectives and the system of tools serving the implementation of these in specific steps is a must.

The Hungarian shift in scenarios can be described by the development of a so-called “social market economy” in the early 1990s, while the period between the spring of 1995 and the summer of 2000 showed that action was defined by a scenario focusing on the development of competitiveness. In the period between 1995 and 2000, Hungary was in such a favourable situation that the increased growth and the control of the budget deficit could go hand in hand with decreasing unemployment rates. This action scenario, which has proven to be successful, prevailed during a relatively longer period. In order to create an equilibrium in the social system and in the outflow of wages, conscious restrictions (sometimes explicitly expressed, at other times concealed) were introduced in this scenario; but the break with a social and economic policy balancing and drifting on the edge of a crisis (which developed as a result of the shocks brought about by the change of the political system) was the result of the constraint to avoid a crisis situation rather than a conscious selection of values for a longer term.

The selected economic policy scenario has gradually changed from 2000 onwards as the results were overvalued; but it seemed to be the case even in 2002 that, after the corrections, we could realistically count on future economic development at an accelerated pace, since the system of interest relevant to competitiveness would be returned to the centre of action. However,

this did not happen. Instead, an experiment was undertaken to execute both scenarios at the same time. The action programme that at last strived to enjoy the fruits of the changed political system, which promised a “change of social systems” and tried to improve competitiveness and to achieve “European integration” at the same time, has proved to be unfeasible. The fiasco is due not only to the fundamental lack of financial resources but to the selection of mutually exclusive values and the inconsistency of the timing and setup of the measures already taken. Insecure leadership and the raising of welfare hopes that exceeded the realistic opportunities caused a situation where simultaneous efforts were taken to reduce the taxes and contributions on employment (with a view to increasing the rate of employment and activity) on the one hand, and to increase the old-age and pension-type benefits on the other hand. In the given structure of the social supply systems, the growing number of elderly people and the health condition of the population required increasing expenses even with a decreasing standard of these services. Questions partly related to public confidence remained unanswered or were given highly biased answers: who in fact will reap the benefits of economic growth; via what kind of transfers and by what time will these results reach the entire society; will they reach the entire society at all. This is partly the reason why the matter of executable action scenarios has become the subject of daily political conflicts. The measures relevant to wages that were taken in 2002 and 2003 as a result of yielding to social pressure had a rather modest impact on increasing the level of social satisfaction.<sup>17</sup> This can be partly associated with improper scheduling and the disregard for performance requirements, and partly with unrealistic expectations. As a result, the steps taken without resulting in any increase in efficiency and productivity turned out to be detrimental for the economy, and they brought about a serious and enduring loss of equilibrium of public finances.<sup>18</sup>

We were wrong to think that state involvement can be defined by the consecutive zigzags of the specific measures that affect the selection of the values “competitiveness” versus “improvement of social cohesion”. The starting point was also erroneous: we thought that the financing of the modernisation needs of the state organisation may be provided by financing technical modernisation and the campaign-like streamlining of the institutional system rather than a task-adjusted planning of resources. The so-called yo-yo effect was a natural consequence: after the “slimming diet”, the undisciplined “patient” (the Hungarian public finance system) continuously put on even more weight, a rapidly growing burden which was made even worse due to the countless promises disregarding the real position of public finances during the election campaign of 2006, and the postponement of the required measures until after the elections.<sup>19</sup> These processes and the consequences which are traceable in deteriorating chances of integration are well known in Europe

and the OECD countries. We should consider natural the back listing in the competitiveness, investor, and credit ratings and, not least, the rejection in late 2005 of the Convergence Programme for joining the euro area which had been submitted to the EU earlier.

In order to avoid lagging behind, currently there is an agreement that besides the immediate restrictive measures taken in the summer of 2006 with the aim of stabilising the public finance system and improving its equilibrium, further steps need to be taken starting from a position that is worse than the one two to three years before. This should be done on the basis of a scenario which places the improvement of competitiveness at the centre and undertakes the fast transformation of the social supply systems but, at the same time, does not jeopardise the equilibrium of the public finance system. This process is illustrated by the new Convergence Programme for joining the euro area approved by the government in late August 2006.

No target date is set in the document for joining the euro area. However, there is a need for a growth-oriented and development-oriented economic policy relying on the long-term equilibrium of public finances and leading to the introduction of the single European currency in Hungary in the foreseeable future. According to the idea of the programme, the achievement of the equilibrium of public finances requires not only adjustments with short-term effect (such as increasing taxes, contributions and consumer and entrepreneurial charges, as well as decreasing government expenditures) but also substantive reforms of the state operation. The intention is that overspending by the government will be systematically prevented, just as regular imbalances of public finances and a balance of payments hindering the convergence process must be avoided. Accordingly, the latest medium-term economic policy (action scenario) of the Hungarian government can be divided into two well defined phases:

- **2006-09: stabilisation in a sustainable way with the least possible sacrifice in growth.** In order to accomplish this goal, the intention is the major reduction of the general government deficit with stabilisation measures and the launch of reforms to stop and then reduce the growth of public debt. The programme takes into account that economic growth is expected to temporarily decline to 2-3% in 2007-08 and to resume the earlier rate of 4% in 2009. The real income of households will decline in 2007, remain on the same level in 2008, and finally increase in 2009.
- **2009-11: the beginning of a process of lasting economic growth and improvement of living standards on the basis of the established equilibrium.** As the reforms unfold, tasks that will be accomplished will relate to: the reinforcement of the equilibrium and the further reduction of the general government deficit and the public debt; the manifestation of the

ever strengthening stimulating effects of the growing development funds; the resumption of a fast and sustainable growth path; and a noticeable start of growth of employment and income.

Besides the National Bank of Hungary and the economic experts involved (the *ad hoc* “convergence board”), the State Audit Office of Hungary also gave an opinion on the programme. The expert opinions were rather similar to each other. According to these opinions, the starting points of the programme (as opposed to the previously submitted ideas) reflect the realities of the economy and public finances; according to the information available to the persons giving an opinion, the starting parameters, effects and forecasts assumed for the macroeconomic correlations of the adjustment course are realistic and the programme contains endeavours to clarify the borderlines between the government sector and the economic players.

The intention of the government to execute comprehensive reforms in order to ensure the sustainability of the budget cannot be disputed either, nor can it be questioned that the government regards a substantive, internal long-term change in the community supply systems as necessary. However, there were doubts concerning the feasibility of these programmes and the implementation of the planned practical steps. The government answer states that the missing links – i.e. the steps related to the specific modernisation ideas that contribute to longer-term sustainability of the programme, which are to be taken after 2008-09 – will be developed by the end of the year. I believe that the SAO comment was justified even in this context as well. According to this comment, when drawing up the alternative courses of action, security and a guarantee of keeping on track would have been provided if the document had contained what should be done if the external (cyclical) and internal (aspects of social support and the ability to introduce reforms) conditions taken into account in the development of the equilibrium course evolve less favourably than expected.

I regard the internal risks as more significant from the aspect of programme implementation. It is very difficult to make progress against the daily interests of a divided Hungarian society having lost its confidence as a result of welfare promises which are impossible to fulfil and with very limited openness to something new. In this situation it is natural that the backlash of the previous years – without the appropriate financial resources, carrying endeavours that mutually exclude each other, providing benefits which are not associated with performance, those which did nothing but promised to transform the obsolete supply systems – appears in the very first, most sensitive phase of switching to a new course of action. They simultaneously strengthen all those tensions, many times manifested in the loss of public confidence, which otherwise would belong to one or the other dominant value.

#### 4. Further issues related to the reform of public finances in Hungary and auditing

With the implementation of the Convergence Programme, the chances of staying on the track of necessary modernisation raise the question that for a change in the course of action it is not enough to increase taxes, cut costs and implement structural changes solely within the scope of business administration. A break from this forced course of action also requires change in the inter-related social expenditures (social transfers), which cannot be resolved without rethinking constitutional rights (primary and secondary education, health care, care for elderly and disabled persons, etc.) and reformulating socio-political compromises (regional administration, the system of local governments, reformulating the role of the state and restructuring the state), nor without reforms based on these new fundamentals.

The first question to be clarified is as follows: what do we mean by reforms or changes of reform value? There is no consensus in this regard in Hungarian professional public opinion. We share the belief that this would require a changed method of operation of the system and a change in the behaviour of the actors of the system. The substance of the changes within the public sector is the **improvement of system performance**. The absorption of EU funds, the system related to public funds which promotes improvement of competitiveness and the institutional capacities for budget sustainability have to be built up simultaneously (Vigvári, 2006).

The **rethinking of the content of state tasks** and a more precise **definition of their scope** are fundamental questions of competitiveness and modernisation in Hungary today.<sup>20</sup> A clear definition of tasks, authorities and responsibilities presumes the clarification of the borders between the public sector and other economic actors the operation of “understandable” mechanisms serving the management and co-ordination of government activities, and a clear and expedient allocation of responsibilities within the government and, last but not least, within the legislative, executive and jurisdiction branches of power. On the basis of these foundations, the method of financing tasks can be defined; then, by adapting to, reflecting and implementing these methods, a way opens for the separation of government tasks and authorities and for the clarification of the reporting system and content.

The objective of auditing as regards content is to serve and strengthen the security of public financing. Audits give assurance of security and induce intervention if security is missing or at risk. Extending and upgrading the content and the role of audits carried out by national audit institutions is a global phenomenon of our time. Today, globalisation-driven convergence can be observed in the operation of systems related to public funds. This also has an impact on audit activities. The internal control system of the public sector

and, within this, the operation of independent internal audit are regulated by international standards.

An important value of supreme audit institutions is **independence**. This also means that their tasks do not include the qualification of the economic and fiscal policy of the ruling government. However, independence does not mean indifference. In its own way, the SAO is responsible for the sustainability of the budget, as well as the effective, regular and efficient utilisation of public funds. It is the responsibility of a supreme audit institution – on the basis of, but also beyond, the scope of direct audit experiences – to define its conclusions, the risks it identifies and the corrections it considers necessary, and thereby to advise and suggest means for analysing the state of affairs and for decisions relevant to changing the course of action. Observations of a national audit institution always reflect the past and present; however, they are about the future and for the future.

## Notes

1. See, for example, Ágh, 2005.
2. The financing system of Hungarian social security was established in the context of the reforms of public finances after 1990. From the early 1990s, these two systems operated as funds independent from the central budget. The revenues of the funds come from the contributions paid by employees and employers. The contributions are collected by the central tax authority. In the case of the Pension Insurance Fund, the excess of expenditure is fundamentally related to the increased pensions and the political promises (such as the 13th month pension) where the amount of the expenses can be exceeded without an obligation to modify the appropriations, according to the relevant law. In the case of the Health Insurance Fund, the earmarked expenses are regularly exceeded by the spending on medicine.
3. By supporting the self-sustaining process of the rules, these play an important role in making the economic transactions easier. The self-sustaining process based on mutual understanding and good will is a very important qualitative factor, which is often manifested in lower costs as well. Confidence in the third partner, i.e. civil society, is further strengthened through the state by shared values and norms; and the members of this society try to find answers to problems that can be resolved by community decision, through co-operation.
4. Public sector auditing plays an important role in its implementation, especially in Central and Eastern Europe, where it is rather difficult to enforce the existing legal regulations. This is why it is justified that this function should not only be seen within the context of government administration but also as an independent mechanism, which works side by side with the government and is closely related to it.
5. A major research project was launched by the Research and Development Institute of the State Audit Office of Hungary and the Competitiveness Research Centre of the Budapest Corvinus University on the subject of the correlations between competitiveness and the public sector, by taking into consideration OECD recommendations at government level meant to encourage corporate

- competitiveness (“Summary Report: Micro-policies for Growth and Productivity”, OECD, 2004). The findings will be published in the first half of 2007.
6. Although rather high hopes were invested in the economic force of the small and medium-sized enterprises for a long time, the opening up of the so-called dual structure of the Hungarian economy has continued in the past three years, i.e. larger companies have gained strength, while the market weight of small and medium-sized enterprises decreased. See Bod, 2005, Appendix.
  7. Failures included: the impact and cost analyses of the individual measures were regularly not prepared, decisions on headcount reductions were made earlier than the definition of the tasks of the concerned organisations, etc. See the SAO report on the 2005 final accounts, as well as the reports on the Ministry of the Environment and the Prime Minister’s Office, at *www.asz.hu*. In 2007, the efficiency of the central public administration reform will be reviewed by the SAO with the professional participation of the United Kingdom National Audit Office, based on the partnership between the two organisations. Until this review takes place, in the context of the methodological solution described in this article, the experience of this review and the related proposals, broken down into various topics, will be made available to the government commissioner in charge of programme implementation.
  8. No strict dividing line can be drawn – in government areas or in local governments representing local politics – between who is a manager living on his/her salary as a (senior) official in the public administration in Hungary today, and who discharges public functions in a business capacity (as a “businessman”). The idea is that government functions better and more efficiently if management is done by self-made individuals rather than by intermediaries, career bureaucrats or those politicians whose only source of livelihood is their political activity.
  9. Auditing is not only the “built-in stabiliser” for the functioning of the system of budgetary institutions but, more recently, it has also become the guarantee for ensuring the regular and efficient co-operation of the public sector and the private enterprises influenced (also) by the business relationships generated by the public sector. It is not a one-sided or exaggerated statement that, if these institutions function properly, they can be regarded as special guarantee and security elements of the state organisation.
  10. The concept of the competitiveness of the national economy was introduced into economics in the United States as a result of the challenges of the world economy in the 1980s. The content of this concept has been the subject of lively debates ever since. Competitiveness can be characterised from both the supply approach and the demand approach. Various and often complex synthetic indicators exist, and sometimes even areas covered by the descriptions and explanations related to these indicators are also used in this regard. Examples for such indicators include natural/environmental, geopolitical resources, the level of qualifications, the development level of technology and IT, the performance of the economy and the “competition” sector and the innovative capacity thereof, the power of the banking system, the standard of the infrastructure, as well as the development level of the community supply systems, etc.
  11. Such conditions include historical and tradition-related features, the strength of social cohesion determined by the former factors as well, the general openness of society to new ideas as such, “tolerance capability”, sensitivity to adjustment and to the preservation of values, politico-cultural and leadership efficiency/co-operation (the professional conditions of public administration and government with regard to the institutional system), as well as global competition,

the world economy, the operation of international organisations, the effect of integration.

12. The selection of values can be regarded as one dimension of economic policy decisions, where the choice is not made on the basis of optimisation or by ranking with regard to efficiency as opposed to the definitions of the scope for action of the economic policy (resource allocation, macro-level demand, legislation). See Antal, 2004, p. 183 and p. 185.
13. For example Hungarian economist Szamuely (2004), p. 948 and pp. 967-969.
14. Such solutions may become necessary especially because of social groups that need to be supported due to structural changes (for instance in the area of agriculture). Innovation services, such as R&D support, helping small and medium-sized enterprises in the market, etc., contribute to the strengthening of competitiveness, as well as standing firm in the global market and in the single internal EU market.
15. In the countries affected by the fall of the Berlin Wall, the erosion of social security associated with the benefits provided by the paternalistic state caused an especially painful social disillusionment because none of the countries in our region had welfare services of a high standard in the modern sense (so there was nothing left to reduce); on the contrary, the society hoped (is hoping) for the development of a social market economy to be brought about by the very reform of the economic system (Báger and Kovács, 2004).
16. The unfavourable evolution of the age composition of the population is not a Hungary-specific problem, but causes serious and increasing trouble for nearly every EU Member State as well as a number of OECD countries. The real problem lies not only in the decreasing population but also in its aging. The consequences are evident not only in the chances for innovation, the problems in the labour market, the proportion of active and inactive groups and other similar effects, but also in the political decision-making mechanism. It is not only the socio-political division of the population that deteriorates the chances of rethinking the state tasks on the basis of consensus, but the increasingly unfavourable demographic situation also means a forced course of action. The short-term system of interests related to social services to be provided to the aging population creates rather harsh constraints. We should even face the fact that the worsening proportion of the active *versus* the inactive population in Hungary not only slows down further economic development but may even become an obstacle, since an increasingly higher proportion of the national income has to be used for supporting the elderly population which is becoming inactive.
17. The salaries of public employees and civil servants grew by 30-50%.
18. The budget deficit grew to 9.1% of GDP in 2002 and it remained high (i.e. 7.3%) in 2003 as well.
19. In spite of several warnings by the competent EU commissioner, a law in which tax reductions were planned was pushed through by the government, while the opposition campaigned by promising even more significant reductions of tax and contribution amounts than those defined in this law.
20. Hungary is not the only country where the tasks of the state are not defined in detail either in laws or in other legal documents regulating the operation of public finances. What are the limits to governmental tasks, why does public financing extend to specific tasks and services, and why to that specific extent? There are a number of countries (Israel, the United Kingdom) that operate excellently without

detailed rules of operation of the state organisation. For us, such a change would mark a new era also in the sense that it would eliminate the forced planning approach under which the decision is enough: the decision “makes” money, i.e. the tasks of the state are determined by a 50%+1 vote of the National Assembly.

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