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SOME CONNECTIONS BETWEEN DISCIPLINE OF STATE BUDGET AND GROWTH IN THE EU

PH.D. THESIS

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1. Introduction

At the beginning of the 1980-s, the substantial budgetary deficit and the growing indebtedness of the government in proportion to the GDP made fiscal sustainability the most pressing question of the economy of the country. It became extremely important both for economists and politicians to determine whether the fiscal policy is sustainable or not. It is not without any reason that a host of expert economists are dealing with this issue even in our days.

In my essay, I analyse this topic in detail and reveal the relevant factors by presenting first the relevant ways of development and main characteristics of the Hungarian, the Austrian and the Dutch economic system (economic status after the Second World War, changes and roles of the three countries' social partnerships, today's Netherland's, Austria and Hungary from the point of view of the sustainable balanced budget, focusing on the financial circumstances of the state) and budget system. After that, I analyse the fiscal regulatory practice applied in each country. Finally, I try to prove that fiscal consolidation does not necessarily mean the end of the welfare state.

When comparing the Hungarian, the Austrian and the Dutch budget, the major differences seen are not the ones naturally arising from the differing forms of state (as these may rather be perceived as interesting features) but the consequences of the difference in the degree of establishment and stability of democracy. Of course, the difference between the different (the Hungarian republican, the Austrian federal and the Dutch (parliamentary) constitutional monarchical) forms of state basically predestines the state system, but the exercise of power by the Parliament is a common feature in all of them. The parliamentary system and the responsibility of the head of government result in similarities and parallel features in the budgets of the compared countries as well. It may be taken as a starting point that institutions aimed at the efficient and controllable management of public funds are of constitutional significance in each of the three budget systems, while the extent of their significance also reflects the concept on the role of the state.

As a result of the revolution of 1848, the budget of the Hungarian Kingdom was placed under parliamentary control ahead of the Austrian imperial (which it was necessarily closely linked to) and the Dutch royal court budgets. Article 37. of Act No. III. of 1848 declared that the lower house of the Parliament should have the right to approve and review the state budget. During the era of absolutism, the Austrian and the Hungarian budgets were prepared jointly by the Austrian government. Following the conciliation, Act No. XXVIII. of 1868 enabled again the preparation of an independent budget under the control of the

Hungarian Parliament already for the year 1869. It was at this time that a customary system of norms pertaining to budgeting began to evolve, which was to be made effective by Act No. XX. of 1897 (Földes 2000:64).

The common development of the Austrian and the Hungarian budgeting was broken by the change of the regime after the World War II. The budgetary development following the political changes almost 50 years later was characterised already by building on a wider basis of experience, as well as momentary political limitations in opportunities. A major achievement of the dissimilar Austrian development is that from 1948 on the financial relations of the state (the federal state and the individual member states) were (and still are) managed by a separate Financial Constitution (*Finanz-Verfassungsgesetz*) alongside the Austrian Federal Constitution (*Bundes-Verfassungsgesetz*). The constitutional level regulation of financial relations is nailed down in the conventional acts on public finance, on the municipalities etc., and thus, with a system of norms allowing more frequent and easier modifications, it constitutes a solid basis for the financial system of the state. A particularity of the system is that these regulations of the Financial Constitution are fixed at all times by the regulations of the Financial Equalisation Act (*Finanzausgleichgesetz*), which is effective for several years. In fact, the Financial Equalisation Act is to be understood as a pact between the federal state, the individual member states, and the associations of municipalities (Bundesministerium für Finanzen 1).

During the period that has passed since the democratic change, the Hungarian economic and legal regulations have more or less made up for the lag accumulated in the state party system. Therefore, the development of the Hungarian and Austrian budgeting, which have common roots, may be similar again in the future. What is more, in view of the political events of these days, the Hungarian regulatory system may even surpass the Austrian one.

However, the development of the Dutch budgeting ran a completely different course. It has no common roots either with the Austrian or with the Hungarian system. But while the Hungarian and the Austrian systems ran on parallel courses at the beginning of their development, the Dutch and the Austrian systems show similarities in the later phases of their development (apart from fundamental differences). Now, each of these three EU Member States prepare their budgets subject to EU regulations and based on their respective experience gathered in the course of their previous development. Despite similar opportunities for development in Austria and the Netherlands, the Austrian budget system shows much more similarities with the Hungarian than with the Dutch system, which may be explained by its geographical location, its heritage and mentality or its earlier concept of state.

In the Netherlands the expression "budget" labelled the budget of the Royal Family for a long time, which was not accessible to the average Dutch citizen. The change occurred in the year 1849, but for a completely different reason than in the history of Hungary. It was in this year that King William II. died bestowing a substantial amount of debt behind, which exceeded the assets of the Royal Family (Dutch Royal House). The Royal Family was in need of internal and external support, which obviously resulted in the loss of their privileges and the surrendering of every controlling role. In essence, from this time on the monarch resorted to the support of the state. Although the private wealth of the Royal Family has increased in the meantime, they still receive regular allowance so that they can comply with their obligations arising from their royal duties, based on a separate act. By now the role of the Queen in the fiscal policy and in the procedure of the adoption of the budget has been limited to her speech delivered on the so-called "*Prinsjesdag*", i.e. the 3rd Tuesday of September in each year, in which she outlines the budget for the next year, as well as the budgetary memorandum containing the guidelines of the government on the budget of the subsequent year (Dutch Ministry of Finance 1). EU membership brought for the Netherlands, among others, a long-term and pre-planning approach to budgeting and a fiscal policy complying with EU requirements.

The direct consequence of the parliamentary system in each of the three countries is that the budget must be adopted by the Parliament. But while this is obvious in the case of the Hungarian unicameral Parliament, in Austria only the National Council (*Nationalrat*) has this right, and in the Netherlands the budget must be voted for by both houses to take effect.

2. The fiscal rules

Economic literature has two main arguments to support the necessity of fiscal restrictions. One of them is to insure fiscal sustainability, the other one is to optimally equilibrate monetary and fiscal policy (Fatás – Mihov 2003). Numerical fiscal rules determinated by law, rules of procedures referring fiscal decision-making and general budgetary principles can be distinguished. Fiscal rules of the first group can take different forms, such as restrictions of deficit-financing, determination of upper expense limit, numerical aims in reference to the balance, rules of borrowing and restraints in connection with the rate of debts. In the second group, rules of procedures are in connection with the instruments and enforcement of fiscal policy each. As to the third group, it contains general principles.

In the economy-specialized literature some stand up for rules of procedure and some for fiscal rules. According to practical experiences simple numerical rules are mainly preferred, maybe due to the fact that neither politicians, nor the society are convinced that procedural reforms can create the same degree of discipline as simple numerical targets. Setting numerical targets is thought to be more credible than a simple government announcement about its commitment to reduce deficit (Drazen 2004). Others emphasize the significance of the institutions instead of the rules of procedure or the numerical and fiscal politics rules (Schick 2004). The main point of their reasoning is that fiscal problems are rooted in the deficiencies of the institutions. Related theories are based on the point that fiscal rules can only partially solve fiscal problems, as fiscal institutions have a stronger effect on budget expenditures. These findings inspired international organizations and national governments to seek solutions to the problem of strengthening the budgetary discipline and attaining fiscal sustainability.

3. The effect of the fiscal consolidation on the welfare state

The roots of the institution of welfare state, which redefined civil rights and completed them with the rights to welfare services, date back to the end of 19th century. Welfare states in Western Europe created social peace and reached significant results in the field of health-care, education and employment. They managed to repress malnutrition and several diseases, literacy became general, and life expectancy increased. Welfare states basically tried to decrease social inequality with high taxation and the redistribution of incomes. The level of public expenditure increased parallel to the increasing number of laws and economic rules. It cannot be denied, however, that the welfare state also put burdens on the citizens, such as high taxes.

So, welfare states after the World War II. were thought to be responsible for the citizens' well-being. This idea led to an increased amount of responsibility, functions and tasks on the part of the public sector until the beginning of 70's. From the beginning of 70's (not only due to decreasing financial sources but also due to the appearance of the welfare state's significant disadvantages) the disputes about the government's basic tasks and liabilities urged changes in the field of public sector's tasks. On the other hand, the expectation of the citizens and the whole society have not decreased at the same rate. Consequently, the aim of the government is not only to complete more tasks with less expenditure, but solutions have to be found to complete the public tasks on a higher level with less expenditure. We cannot speak therefore of the crisis of the welfare state in general, just only of new problems, which draw attention to the necessity of reforms of welfare expenditures. The changes of the past decades in the field of the economy and the society require the reconsideration and reform of several elements of the welfare institutions, but it does not mean that welfare institutions are inflexible or are not viable. Welfare states in the 21st century are characterised by restructuring. The aim is, among other things, to stop the rise of the rate of public expenditures compared to the GDP or perhaps to cut them.

In the transitional countries of Central Europe the first generation tasks (stabilisation, liberalisation, institutional reform, privatisation) were necessary conditions for the market economy to come into existence. In these countries this period ended by the middle of the 90's. By now, in the second generation period, the most important question is how the state can speed up welfare and administration reforms, i.e. how the state can redefine its own role in the economy. However, social consensus and a favourable public opinion are required for performing these tasks of transformation, because citizens might easily dismiss or obstruct reforms. The fundamental purpose of this second period (both for developing and developed countries) was to bring a sustainable welfare system to fruition (Csaba 2006:114-122 and 189-197). The necessary arrangements in this case are more difficult to execute than in the case of SLIP tasks, as political mechanisms had to be put in practice in order to start decisions. Additionally, the questions are diversified and are dependent upon cultural values, and there is no uniform cure. Reforms may change the status quo in fields where relations have been consolidated for decades, so the general public may question the inevitability of the modifications, the necessity of which seems evident for experts.

The second generation tasks include the reform of public finances primarily, i.e. to make public finances sustainable. For the time being some elementary conditions of fiscal sustainability are not being observed in countries that joined the EU in 2004 (the Ten), where mass parties and coalitions have a temptation to spend more and the discretionary fashion is on the increase. For that very reason, the economic role of the state needs to be constrained in the constitution to restrain the discretionary overspending and over-taxation.

The reform of public finances is, however, hard to implement without a reform of the public administration. It would be difficult to find a general cookbook to use everywhere, because the potential solutions are determined by different historical and cultural factors. The size of public sector in the Ten is very far from the optimum[1].

The following component of reforms to be implemented is the restructuring of welfare services. This element of the reforms is the same both for the old and the new EU Member States, because they are in the same situation with respect to falling birth rates, low labour market activity and the increasing number of senior citizens. Moreover, second generation tasks include the development of rural areas, the enhancement of social cohesion as well, as without shared values the institutions of democracy can hardly function effectively.

Second generation reforms have been launched, but the pace of their implementation was set back in the period between 1997 and 2005 in all emerging European economies[2]. Pension reforms were slowed down, or occasionally reversed. The privatisation of utility and other network industries were started but not finished anywhere. But the completion of these tasks is indispensable to achieve higher economic growth and to establish fiscal sustainability (Csaba 2006:189-197).

An important element of the reforms in Hungary was the renewing of the pension scheme in 1997, which allowed the establishment of the private retirement insurance pillar. Obviously, the reform has not yet led to the significant improvement of the budget balance, because significant extra resources (2% of GDP) from the general budget are needed over the paid up pension contribution to cover the pension expenditure. Another area of reforms is the reorganisation of the government's activities, which could decrease the expenditure of the government. To this end, the numbers in the public sector were reduced from 2004 on, however, the institution system has not been tightened, so as a result the extent of public expenditure has not changed considerably. But among the 2nd generation tasks it is just the public administration reform that could yield the greatest amount of savings corresponding to 2-3% of the GDP. In 2006 the government set itself the goal of restructuring the health-care fund, and the implementation of the reform could allow a deficit decrease of 1,5%. Another objective of the present government is the restructuring of the education system. The abolition of the free higher education system is estimated to result in a gradual improvement of the public finance balance by nearly 1%. The aforementioned reforms could collectively lead to a 5-7% improvement in the budgetary balance (Erdős 2006).

[1] The reform of the territorial administration overlaps only in part with the government reform. The fundamental aim of this reform is to provide equal opportunities for people living at long distances from the capital cities and major centres.

[2] Except Slovakia and Estonia.

Public social expenditure/GDP ratios are often used for the international comparison of welfare states. However, the comparison of budgetary allocations with a social purpose does not provide a full picture of social efforts, because this information does not capture private social arrangement to which the population subscribes on a compulsory or voluntary basis. We should emphasize that public and private social expenditure may widely vary. Between 1960 and 1980, public social expenditure doubled in nearly all OECD countries, since then, however, the level of public social expenditure has been fluctuating in line with the economic cycles. Private social spending trends are different, as private spending has increased since 1980 in nearly every OECD country.

In most European countries there were slight increases, except in the Netherlands and the United States. In most countries, the share of public social expenditure in the total social expenditure is around 90%, while this proportion is around 80% in the Netherlands and the United Kingdom. The gross public social expenditure indicator reveals that the public social expenditure in the Northern countries (30%) and in Europe in general (28%) is much higher than in non-European OECD countries (18%) (Adema – Ladaigue 2005 and OECD 2007).

Public social expenditure increased from 16% to 21% between in 1980 and 2003 in OECD countries, but the rate of growth is different in each country. In the Netherlands, where fiscal consolidation has been successfully accomplished, public social expenditure decreased only by several percentages in the period of 1980 – 2004. Now its rate is around 20% of the GDP, but, at the same time, the rate of compulsory and voluntary private expenditure has also been steadily growing.

4. Thesis

The European Union tries to generate the balance of budget by using fiscal rules, which has become a key political mean of observing and enforcing the financial discipline.

Thesis (1): fiscal rules are needed but not sufficient for generating balanced and maintainable state budget, as democracy has a tendency to do overdistribution.

I unequivocally disprove the “expectations of a miracle” related to using merely fiscal rules. By the help of these rules balanced and maintainable state budget is attainable, but in this relation they can only be regarded as the basic conditions of reaching a higher aim. Thus I do not agree with the opinions accentuating the application of fiscal rules alone can be the solution for everything.

Thesis (2): the European Union did not provide the observing and enforcing of its fiscal rules, so we can speak about the crisis of enforcement regarding the period between 2001 and 2007. But, according to the experiences, those who broke the rules had to sacrifice their growth.

Thesis (3): in the transition countries the transformation-specific reasons and overtaking cannot be the explanation for the higher deficit and level of debt.

My previous statement also suggests that referring to transformation-specific reasons is only an attempt of an unsuccessful economic policy to find a scapegoat. Alluding to a general reason which is easily comprehensible for the wider groups of society is simpler than facing the mistakes and find the real reasons of the problems.

After comparing the three small countries in the present dissertation we can make the conspicuous conclusion that a consensus based on social conversation is requisite. In my point of view it is harder getting the reforms through society than introducing fiscal rules. That is why I think that separate application of fiscal rules can be effective only in dictatorial countries, but it is not enough in democracies.

Thesis (4): enforcing the economic laws has political and cultural conditions (keeping the rules, confidence), that cannot be derived from economic theories, but the latter is a precondition.

The key of success is in the ability of changing, the proper evaluation and adaptation of the local circumstances, such as in the suitable customization of the fiscal rules.

Thesis (5): introducing fiscal rules does not interfere with the interests and purpose of a traditional welfare state. Financial consolidation does not make an end to the welfare state, it merely converts that.

Actually my statement is a reply for those who see fiscal consolidation as restraint and restrictive measures for society. Proper application of fiscal rules can be a complementary idea, a guarantee for the welfare state, it can lead to a different quality.

Thesis (6): the conditions of the balanced and maintainable state budget can be generated between democratic bounds, but they do not come into being by themselves, because neither globalization nor the EU of its own is enough for this.

From the studied connections clearly follows – which can solve the puzzle made at the beginning of the present dissertation – that the institutions, the internal power relations, the political set-up, such as the culture of financial stability form the financial performance together. This is the reason of the so different results of the restrictive strength of the global monetary market and the European Union's common, regulated fiscal policy in the three examined, equally little and open countries, in same periods. In my opinion that is why no deterministic, model-like examination can give realistic answers. Financial result is formed by internal and external effects intensifying (in the Netherlands) or deteriorating (in Hungary) each other. We can lay down again that fiscal policy is a necessary but not sufficient condition of effectuating the balanced, maintainable state budget.

Continuing my inquiries we could find out how the social and political conditions of financial consolidation can be created, how democracy can operate more efficiently, such as what the European Union needs to be able to make its own rules executed and kept.

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