Stability Pact for Hungary?
Rise of the Third Generation Reforms

István Benczes
Department of World Economy, BUESPA

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Abstract

Accession to the European Union is the clearest symbol of globalisation for a country in transition. The integration process does not represent purely regional values, but globalised ones as well, which are widely shared in the developed or globalising part of the world. In order to be fully integrated into the EU, the initiation of the so-called third generation reforms is required. On this basis the study argues that a Stability Pact can be an effective means to constrain deviant behaviour and to enforce fiscal discipline not just within a monetary union but also within a transitional country as well, by blocking the consequences of rash judgements stemming from cyclical changes in politics.

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1 István Benczes is a Ph.D. student and an assistant lecturer in International Economics at the Department of World Economy, Budapest University of Economic Sciences and Public Administration and was a visiting Ph.D. researcher at Heriot-Watt University, CERT, Edinburgh. The author would like to thank Paul Hare and László Csaba for their many helpful comments and advice. However, the usual disclaimer remains. Financial assistances from the Jean Monnet Project and from the Department of World Economy, BUESPA are gratefully acknowledged, with special thanks to András Blahó.

2 Budapest University of Economic Sciences and Public Administration Fővám tér 8, 1093 – Budapest, Hungary, istvan.benczes@vg.bke.hu
I. Introduction

With the launching of the third phase of the EMU the monetary policies of the participant countries are under the control of a supranational institution. The twelve cannot devalue their currencies, and are not allowed to print money which inflates debt. However, fiscal policy is still regulated autonomously by national governments.

The stability of the EMU depends largely on the readiness of the governments to adhere to the rules laid down especially in the Treaty on European Union and in the Pact for Stability and Growth. A close investigation is needed to evaluate whether these disciplining forces in the Community legislation are able to guide and rule national governments so as not to endanger the stability of the European Economic and Monetary Union. The paper lists ten plus one rationales for the Stability Pact while at the same time five counter-arguments are evaluated critically focusing on the role and performance of fiscal policy, the need for a golden rule and an adequate policy mix, the strength of market versus legal forces and the lack of structural reforms. It tries to identify the weaknesses of the counter-arguments and show the superiority of the Stability Pact in the EMU.

Accession to the European Union is the clearest symbol of globalisation for a country in transition. The integration process does not represent purely regional values, but globalised ones as well, which are widely shared in the developed (or globalising) part of the world. After the successful implementation of the so-called first and second-generation reforms the initiation of the third generation reforms is required in order to be fully integrated into the EU in the medium run. The newest generation of reforms differs significantly in its objectives, principles and tasks from the earlier ones as it aims at a given set of norms. On this basis the study argues that a Stability Pact can be an effective means to constrain deviant behaviour and to enforce fiscal discipline not just within a monetary union but also within a country in transition as well, by blocking the consequences of rash judgements stemming from the cyclical changes in politics.

Section I introduces the topic. Section II analyses the framework set by the Treaty on EU and the Stability Pact for national fiscal policies. Section III is devoted to the idea of the adaptation of a Stability Pact in Hungary due to the need to launch third generation reforms. The newly designed Pact is evaluated from different angles. Section IV concludes.
II. Disciplining forces in the Community legislation

The Maastricht Treaty

The Economic and Monetary Union is a further step along the process of European integration. Although experts emphasise the economic gains of the EMU, it is a means to bind Europeans more closely together as well as to revive the spirit of supranationalism. The foundation of an economic and monetary union in Europe is not just a goal but a tool, as it serves a fundamental condition in fulfilling further objectives, namely the establishment of a political union. Title VI of the Maastricht Treaty on European Union (MT) laid down the following rules within the scope of economic policy:

(a) countries conduct their economic policies according to the objectives and principles of the Community and take them as a matter of common concern (Article 102a and 103(1));

(b) member states co-ordinate their activities according to the broad economic policy guidelines and ensure closer co-ordination of their economic policies (103(3));

(c) pressurising the European Central Bank (ECB) and privileged access to financial institutions is prohibited (104(1), 104a, 107);

(d) agents are solely responsible for their own liabilities and obligations due to the no-bailout clause (104b(1)); and

(e) member states avoid excessive government deficit (104c(1)).

Without questioning the relevance and credibility of the rules it is clear that the Treaty in Maastricht made the following overt: it supports an economic environment with stability and non-inflationary, sustainable growth. Member states are expected to respect these aims in such circumstances where the monetary policies of the participant countries are under the control of a supranational institution and fiscal policy is still regulated autonomously by national governments. However, the founding fathers (the Germans, to be precise) wished to further strengthen the target of sustainability. They did not have much trust in the national autonomous fiscal policies. It was generally believed that the monetary policy could only be successful and the EMU viable, if it was backed up by consistent national fiscal policies. The Stability and Growth Pact (SGP) was created for this reason, further specifying and developing the MT.

3 The reference values for the government deficit and debt are 3 per cent and 60 per cent of the GDP, respectively. If an excessive deficit exists and the country fails to correct it, the Commission can be the initiator of restrictions, which come into force only by a qualified majority vote in the Ecofin. However, the excessive deficit procedure will not be launched if (1) the deficit to GDP ratio declines substantially and continuously and reaches a level close to 3 per cent or/and the debt to GDP ratio is sufficiently dropping and approaching the reference value at a satisfactory pace; or (2) the government deficit occurs due to public investment expenditure or (3) exceptional circumstances arise.
The Stability and Growth Pact

In December 1996 the European Council reached an agreement in Dublin to set up a Stability and Growth Pact which was adopted in Amsterdam half a year later. The European Council’s resolutions and two other Council regulations on the Stability and Growth Pact were enacted in order to provide both for prevention with the strengthening of the multilateral surveillance of budgetary positions and co-ordination of economic policies and for deterrence with speeding up and clarification of the excessive deficit procedure. In accordance with the above, the SGP defines a concrete target: sound government finances aiming at a close to balance or in surplus position in the medium run. The aims not only point beyond those in the MT, but it is more clearly and precisely given. It calls for a framework, which not only ensures sound public finances but also supports macroeconomic stability, a strong, sustainable growth and increasing employment. Procedures were introduced to put the objectives into practice - in this way the implementation of the national economic policy does not remain ambiguous, instead it is in the public eye:

(i) speeding up and clarifying the provisions of the excessive deficit procedure;
(ii) by urging a stronger surveillance of medium-term fiscal positions, an early warning signal is introduced in the shape of so-called minimal benchmarks;
(iii) clarifying the conditions under which participants will be allowed to exceed the 3 per cent ceiling without punishment along with what the terms "exceptional" and "temporary" mean;
(iv) outlining the process and the amount of the punishment;
(v) setting up a strict time limit for the whole procedure.

Apparently, the objectives reflect the conviction of the eighties that the importance of deficit criterion is to ensure price stability or in other words: deficit causes inflation. A hierarchy can be perceived between monetary and fiscal policy and therefore probably among authorities and institutions as well (or even a clash between supranationalism and national policies). In this sense, fiscal discipline is required because the main priority is price stability. On the basis of the hierarchy-principle, fiscal policy is punished if it endangers price stability.

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4 See references.
5 If an excessive deficit exists, the member state is expected to undergo the sufficient and appropriate adjustments. If the country fails to do so, then financial sanctions are imposed. The deposits (between 0.2 per cent and 0.5 per cent of the GDP) become real fines after two years if corrective action has still not been taken. However, the SGP also offers a few routes for escape. If the decrease in the GDP reaches at least 0.75 per cent, there is a possibility to avoid punishment. If the decrease is at least 2 per cent, then the punishment is automatically swept aside.
Debating the Pact

Ten plus one rationales for the Stability Pact. The shaping of fiscal policy is naturally a product of political will. The Stability Pact is also a consequence of political decisions, just like any other measures concerning the process of integration. However, there are a number of economic rationales for launching the Pact. Based on the academic discussions about the advantages and disadvantages of the SGP, a discrete selection has been made here identifying ten plus one. The pact (1) creates the conditions for price stability; (2) increases budgetary discipline; (3) reduces the danger of an inflationary public sector bail-out; (4) maintains the sound operation of the banking system; (5) alleviates the ECB from the pressure of monetising debt, preserving its credibility; (6) establishes accountability and responsibility through monitoring the stability and convergence programmes; (7) restricts the use of political preferences in resource allocation; (8) calls for a structural adjustment in both sides of the general budget; (9) creates room for manoeuvre in the case of cyclical induced downturns; (10) promotes co-operation in the process of multilateral surveillance of economic policies and encourages policy co-ordination among member states; (plus 1) deepens integration, opening up a road towards fiscal federalism and political union.

Five counterarguments

However, why do so many criticise the Pact if it is dedicated to the above rationales? Are they right to maintain that: fiscal discipline can be achieved only at the cost of limited budgetary flexibility; the fiscal rules of the Maastricht Treaty and those of the Stability and Growth Pact can in fact be seen as excessively binding constraints on the properly designed and implemented counter-cyclical policy; the ‘close to balance or in surplus’ position of the general budget does impede capital accumulation and economic growth, causing slowdown or possibly recession; or that governments should concentrate on more relevant problems hampering the functioning of EMU, *i.e.* the structural rigidity of the labour market which is completely neglected in the case of a total adherence to the provisions of the Pact; etc.? The following five points will be examined critically.

1. Procyclicism

Criticism: *The balanced budget requirement forces governments to follow a procyclical fiscal policy, as governments are forced to raise taxes and cut spending in downturns to satisfy the preconditions of the SGP. Thus it punishes those who need help the most.*

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6 The paper gives only an enumeration of the arguments for launching the SGP. For a critical survey on them see Eichengreen and Wyplosz (1998), Schuberth and Wehinger (1998), Arestis *et al* (1999). However, the
Indeed, it is highly probable that some will be in trouble while others perform well. It has been proven that the EMU is not an optimal currency area. Asymmetric shocks may arise and these might force states to respond and counteract appropriately by not hurting others’ (the Union’s) interests. A country in trouble cannot depreciate the common currency, cannot ask for the help of the central bank or other financial institution, thus fiscal policy would remain the only helping hand.

In a neo-classical world, the deficit would be eliminated over the cycle. The usual argument is that under such circumstances: (a) a definitely negative correlation exists between the deficit and the output gap, (b) the debt to GDP ratio remains constant in the long run because the accumulated debt of recession is offset by the surpluses of the recovery, (c) politicians are not inclined to cheat (surprises do not exist), instead they behave according to the Barro-Ricardo equivalence.

However, empirical studies show that industrialised countries have ended up in a rather different situation, violating the points above: ad (a) the deficit financing of recession was not followed by fiscal tightening in the period of positive output gaps, ad (b) the debt to GDP ratio has grown constantly, ad (c) politicians did not refrain from accumulating debt and running a huge deficit.

It can be argued that EU members practised a procyclical fiscal policy during the seventies and eighties, that is even in the case of positive output gaps governments did not allow automatic stabilisers to work and give the debt-to-GDP ratio a declining trend. Countries, therefore, could not use fiscal policy for stabilisation. Nevertheless, the European Commission (2000) differentiates between high debt and low debt countries. While the former pursued a procyclical fiscal policy along the last two decades the same does not hold unequivocally for low debt countries which behaved as if the strict rules of the SGP were already in place.

The need to measure both structural and actual positions is highly recommended because the former refers to a situation where economic cyclical fluctuations do not exist, economic activity is at its trend level and the effects of economic growth conditions are removed. The Pact targets a ‘close to balance or in surplus’ position in the structural balance and not in the actual. At the time of attaining a balanced fiscal stance the member will be able to pursue a more flexible fiscal policy, allowing automatic stabilisers to work properly. In fact, fiscal policy can work as a stabiliser (in the obvious
counterarguments are considered from a critical perspective later on.
8 For instance Buti and Sapir (1998).
absence of exchange rate adjustment) only if fiscal consolidation has been completed fully and a balanced budget position is maintained, otherwise there would not be enough room for manoeuvre. Sound public finances are a quasi pre-condition for an effective fiscal policy.

Nevertheless, a conflict between discipline and flexibility may occur in the transition period aiming at a position of close to balance. To the extent that the declared medium term goal of balanced budget position is not fully reached, discipline must overcome flexibility. Consequently, the transition period should be overcome as soon as possible.

2. Need for a golden rule

Criticism: There is a definite possibility of diminishing capital accumulation made by the public sector due to the strict requirements of the Treaty and the SGP. Corollary: public spending on capital accumulation should not be taken into account when an excessive deficit procedure is set up because capital accumulation serves the future generations’ interests.

The medium term objective of ‘close to balance or in surplus’ financial stance assumes a significant change in the financing of capital investments. According to the Maastricht rules and the SGP’s requirements, deficit financing should be suspended sooner or later and public investments would be covered by current revenues instead. The opportunity to have a choice between tax and debt financing will be eliminated, burdening only the current generations and liberating the future generations from the interest burden of capital investments which were made in the present. However, an overt conflict may arise: while future generations can enjoy the benefits of public investments, it is the current generation who has to pay a much larger bill, including both the costs of current investments and the interest burden of earlier debt-financed projects. Balassone and Franco (1999) use the analogy of a pension system stating that concerning public investments EMU countries are in a transition from the pay-as-you-go system to a funded one. Yet, it is worth differentiating between the two periods of 1997 and 2002/3 (the transition stage) and after the period of fiscal consolidation (post-transition stage) - that is expected to be implemented until 2002/3 – because in the latter case a new equilibrium is expected to be reached. Accordingly, only the period of fiscal consolidation goes along with significant sacrifices in the shape of restrictions in investment spending, while the post-transition stage creates the possibility of wealth accumulation once again in a more investment friendly macroeconomic environment.
But can the adoption of a golden rule be seen as the proper solution for ensuring the steady ratio of capital accumulation by the public sector? On the one hand the Maastricht Treaty already implied a quasi-golden rule in its excessive deficit procedure by emphasising the need for taking into account government investment expenditures exceeding government deficit (Article 104c(3)). On the other hand several counterarguments arise: first, a revision or any additional amendment of fiscal rules (incorporating an explicit golden rule in the Treaty) may threaten the credibility of the EMU as a whole. Second, it would require the launching of dual budgeting, excluding investment expenditures from the operating budget. However, domestic and euro-zone wide monitoring would become much more problematic, not mentioning the difficulties of proper accounting and data collecting. Besides, an increase of moral hazard (due to creative accounting) may threaten the EMU, resulting in a considerable loss of credibility in a period when gaining strength and credit is a top priority. Third, adopting a golden rule may serve as an excuse for states to implement constantly discretionary fiscal measures which hamper the proper work of automatic stabilisers. Fourth, although it is easy to find rationales for a golden rule (e.g. Poterba, 1995), it has been adopted mainly in federal countries where local and central budgets can be distinguished easily. However, among EMU countries there are many small economies and the federal (EU level) budget is still insignificant compared to the US for instance. Fifth, cohesion countries could preserve their relatively high investment ratios even in times of consolidation in public finances without a golden rule as well, thanks to the EU funds. So those in need still have the chance (and source) to finance their capital projects. Sixth, aiming at strengthening the private provision, a crowding-in effect can occur in the longer run. What is really needed from governments is good structural and competition policy both on national and EU supranational level because these measures can support the proper function of the single market.

3. Market discipline is perfectly sufficient

Criticism: the Pact is superfluous due to the accelerating competition of the financial market and the TEU is already a well-functioning legal disciplinary force.

Parties are prone to go towards two extremes: they are either for legal forces exclusively, such as the Pact, or for market forces only. In the former case, proponents overemphasise market deficiency, e.g. shocks. According to the latter point of view the legal restrictions just block the efficiency of the market, resulting in adverse selection, asymmetric information, etc.

9 According to Balassone and Franco (2000) alternatives to a golden rule which ensures public capital accumulation are tax cutting, deficit reducing and investment in human capital. It is worth emphasising that expenditures on education or health care belong to current outlays. In the case of a dual budget these investments could be disregarded although their
Lemmen (1998), for instance, states that security markets and financial regulators can discipline the governments, since it is unimaginable that such highly developed countries would ever go bankrupt. His view on the subject is that all the EMU needs is a prudent government bond market. Contrary to him, others prefer the legal forces to work. For them a credible no-bailout clause (strengthened by the SGP), hand in hand with deterring penalties makes it possible for market participants to evaluate precisely each government's default risk, establishing the right level of risk premia. In a union-wide competition among member states' governments, the sources become relatively more expensive for those that are not willing to carry out plausible reforms. While lowering the costs of borrowing, the adjustment also avoids the need for being bailed out.

It is hard to pass a judgement between the opposing parties but it is clear that the launch of the EMU was mainly supported because it was thought to deepen the achievements of the Single Market, including financial markets. The attempt can best be supported by strengthening both the market and the legal forces. If this is the case there is a chance that the securities market is becoming simpler, the conditions of bank loans are becoming more transparent, the competition is getting fiercer: the disciplinary force of the market is growing considerably. The EMU has speeded up already the process of the financial market’s integration, which resulted in a more intensive competition among issuers. Both Germany and France would like to become the benchmark. France effectively modernised its bond market through standardisation. Germany has shifted from issuing debt through syndication to auctions where domestic and foreign investors are welcome. The Italians cannot possibly compete for the position of being the benchmark. Nevertheless, they pursued a successful transformation in the maturity of their bonds, as well as Spain. (Corsetti and Pesenti, 1999)

10 European banks purchase bonds in large amounts. A country’s default may threaten other countries through the banking system indirectly. Italy's stock of debt equals one-third of the Union's total debt and Italian bonds have been purchased by, e.g., foreign pension funds. If the Italian government were to face insolvency, then it can probably force open-market operations on the common central bank. Government debt diversification could be a possible solution to reduce the risk of causing damage to the banks. Yet diversification is not a solution to all the problems, a systemic default risk cannot be handled. The restriction of 25 per cent of own capital for loan for one client does not hold for governments. If the strict limit were to apply to Italy, the country could finance only an eighth of its total debt (Gros and Thygesen, 1998).
4. Lack of structural reforms

Criticism: the Pact does not offer a remedy for the most significant problem of the European Union, the breaking up of structural rigidities. Actually, it does just the opposite: its fiscal tightening hampers the required adjustments on the real side of the economy.

In a world-wide competition the EU’s most problematic issue is the structural rigidity of its economy. Although several attempts have been worked out to eliminate these, in practice little has been achieved. It is rather doubtful whether, at a time of fiscal consolidation, there would be room for adjustments in the real economy as well.

ECB (1999:59) stresses that the submitted stability programmes are "minimalist" in nature, lacking the spirit of the Pact. According to the spirit of the SGP, the balanced budget requirement should not only be fulfilled by tax raising (reflecting who pays the bill of a nation’s wealth) or particularly the cutting of expenditures (showing what the government supports). The picture is more complex. The countries should start preparing for the future challenges stemming from such changing trends as the ageing of the population. Without a significant change in the current structure of the general budgets this fact will burden the whole society. The often-cited labour market rigidities also require some sort of remedy. Apparently, while a strict fiscal policy is being implemented, it does not particularly mean a more effective resource allocation. However, SGP aims at a long recovery through the stabilisation of the macroeconomic basics. The ultimate goal of economic policy is to achieve real and nominal convergence at the same time.

5. Co-operation and policy mix

Criticism: Maintaining a high degree of sustainability in the EMU requires a shift from the numerical criteria of MT (regarding overall deficits and debts), and a new focus on the quality of fiscal adjustments and of the institutions governing public finances in the Member States.

The criticism given here is watertight, it is hard to question its relevance. However, there are great variations among the ideas for implementing such a shift. In fiscal adjustment there is a widely shared consensus that cutting expenditure can serve better than tax raising. Yet, tax raising is much easier to implement and its short-term effects are more plausible. Nevertheless, if long term

11 While price stability is necessary in a monetary union, it is not sufficient alone for grasping all the advantages of the EMU (Duisenberg, 1999).
sustainability is considered, permanent adjustment can be achieved particularly by cutting down on public spending, especially current spending, because this is inclined to grow automatically (Alesina and Perotti, 1996).

Others in the relevant literature underline the quality of the institutions in public finances, emphasising the role of budget processes that may influence significantly the success of a fiscal adjustment (von Hagen, 1992; von Hagen and Harden, 1994). EU-level institution design concerning fiscal policy is still rather weak. Although there are a few hints on the expected means of co-ordination, it can be suspected that the main role of the MT and SGP is mainly to make the following clear: the task of fiscal policies is not to threaten monetary policy. Accordingly, at the supranational level negative co-ordination is preferred to positive, where the former means the enforcement of budgetary discipline through an explicit possibility of punishment. Nevertheless, it can still be seen as a relatively tight form of co-ordination as it ensures the commitment of each member and minimises the risk of moral hazard. Positive co-ordination refers to multilateral surveillance and broad economic policy guidelines which are relatively weak in force as they might target a political union in the long run that is not in the current interest of the members.

Sustainability and the overall economic performance are definitely among the top priorities of the European Union (see Article 2). In a monetary union price stability is up to the common central bank. However, economic stability depends on other agents as well, which calls for some kind of co-operation.

As far as the monetary side is concerned, theoretically the central bank cannot become a lender of last resort, it should concentrate on its number one mission: ensuring price stability (Article 105). The situation is complicated, however, because the monetary authority is comprised of two institutions with one target. The European System of Central Banks consists of 15 delegates of the EU member states, thus giving a forum for expressing national interests. That is why De Grauwe

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12 According to the European Commission’s report (1999a:13) albeit cutting in government spending is important, the effective use of resources and the channelling of sources into more effective programmes should be the cornerstone of reforms in fiscal consolidation. Accordingly, European Commission, (1999b:11) writes that the Council warns the members that “attention will shift to the structure of government revenue and expenditure”.

13 The deepest form of fiscal policy co-operation is fiscal federalism. The Pact is attacked by many because it asks for a balanced budget in such a union where the level of community transfers is extremely low. The common budget is not more than a maximum of 1.27 per cent of the total GDP of the EU (far from constructing federalism in practice), and this figure is not expected to be raised. This contrasts with the US where even though balanced budget requirement does exist for the member states, the federal "helping hand" is working as well. See Eichengreen and von Hagen (1995), Bayoumi and Masson (1997), Beetsma and Bovenberg (1997) and Kletzer and von Hagen (2000).

14 On the conflict of the ESCB and the ECB Wyplosz (1999:49) writes: "The need for an ear to national public opinions calls for a role of the Governing Council of the ESCB while effectiveness calls for centralisation and delegation of powers to the narrower Executive Board of the ECB".
et al (1998) believe that a weak, politically susceptible ECB (or ESCB) does not support the operation of the EMU, instead the former European Monetary System should be preferred in this case. Beetsma and Uhlig (1997) point out that without a monetary union governments are sensitive to the consequences of their debt accumulation on inflation. However, in the EMU a highly indebted government does not have to internalise fully the inflationary consequences of its debt policy. The defaulting country hopes to get transfers from the other member states, being bailed out and creating moral hazard. Therefore, in order to hamper such an unfriendly behaviour within a monetary union, members are ready to adopt a severe pact which introduces elements of punishment. They claim that: “an appropriately designed stability pact will be strictly preferred to autonomy” (op. cit., p.23.).

When fiscal policy also comes onto the scene the picture becomes more complex. Analysing the relevant data in the Communities the European Commission (2000) states that during the seventies and eighties the laxity of fiscal policy forced the tightening of monetary policy. Therefore, weak economic performance can be traced back to the following policies: the weak credibility of public finances and the high real interest rates. However, supply side weaknesses had a role as well in the unsustainable economic policy environment: the generous welfare state preserved the structural rigidities of labour and product markets. Summarising, an inappropriate policy mix might have resulted in a slower rise in both the actual and potential output and a stagnation of employment.

The nineties showed a rather different situation in which the role of policies changed significantly. From 1994 fiscal policies of member states have become tighter, while monetary policy can be seen as relatively expansionary. Monetary policy supported fiscal policy throughout the nineties, the consolidation period, a phenomenon dubbed as “substitutability of policy mix” by Wyplosz (1999). It is worth underlining that in pursuing an adequate policy mix, stability and convergence programmes have a significant role. The programmes after 2002 (reaching a ‘close to balance or in surplus’ stance) should focus already on structural problems, giving birth to (a cautious) tax cutting.
III. Stability Pact for Hungary?

*Rise of the third generation reforms.*

Accession to the European Union is the clearest symbol of globalisation for a country in transition. The integration process does not represent purely regional values, but globalised ones as well, which are widely shared in the developed (or globalising) part of the world. It points further ahead of simply stating the supremacy of the market, since it also re-evaluates the normative role of the state. In fact, it goes far beyond even that, as the ultimate goal of the European integration is the establishment of a political union, in which the role of national autonomy will be subjugated to supranationalism.

Transition economies have already responded to the challenges posed by global values. First generation reforms ensured the deconstruction of the previous system of planned economy and one-party rule, opening up the road towards a (free) market economy and democracy. The first years of transformation passed with the implementation of the so-called SLIP, that is stabilisation, liberalisation and privatisation, with the fairly clear target of releasing the market forces and constraining the state in all possible segments. However, the processes of marketisation and de-statistation had not proved sufficient to sustain a long term, healthy recovery. Thus, second generation reforms have been initiated with the task of “getting the basics right” and have urged steady changes stressing quality, aiming at a sustainable growth. With newly erected institutions and mechanisms the objective has shifted to creation and not destruction. The state is not a manifestation of evil any more but an important agent which produces public goods or guarantees the rules, etc. It has become evident that the state should act for the benefit of the public and its transparent performance is the base for the rule of law.

Nevertheless, practising second generation reforms does not mean following a clear target and adopting a concrete model of the western world. Countries in transformation may have a chance to choose among different ways of catching up (while it is evident that the framework is given by the capitalist system). There is one exception, however. Countries which applied to the EU have to be capable of meeting the challenges demanded by the organisation. The European Union offers a

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15 The launching of the 1995 austerity package meant a significant change in the process of economic transformation. With its heterodox policy it managed to perform an in-depth and successful shift in the economy and also changed the way citizens thought. Main features of the package: the devaluation of HUF by 9 per cent, introduction of a preannounced crawling peg system, - of import surcharge, - of convertible HUF, cuts in budgetary spending and reduction in real wages.

16 On the first and second-generation reforms see Csaba (2000a) and Tanzi and Tsibouris (2000).
clear path to follow, a clear path to catching up. Its consequence is that there exists a final “destination” (although it is being tuned day by day). The method of trial and error has come to an end with its existence and the search among several alternatives – called a constructivist experiment by Gedeon (1997), has been brought to a close. When both the target and the method are changing, a new phase is born evidently which requires a new terminology introducing the third generation reforms. Table 1 shows the evolution of transition reforms, identifying and comparing their aims, methods and approaches, principles, tasks and the perceptions of the market and state.

Table 1: The evolution of transition reforms

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<th>1st generation reforms</th>
<th>2nd generation reforms</th>
<th>3rd generation reforms</th>
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<tbody>
<tr>
<td><strong>Aims</strong></td>
<td>macroeconomic stabilization</td>
<td>sustainable, long run growth</td>
<td>harmonious and balanced development of economic activities along with sustainable and non-inflationary growth</td>
</tr>
<tr>
<td><strong>Method</strong></td>
<td>orthodoxy</td>
<td>trial and error</td>
<td>supranational and subsidiary</td>
</tr>
<tr>
<td><strong>Approach</strong></td>
<td>top-down (gradualism or shock therapy), concentrating on quantity variables</td>
<td>top-down and bottom-up, concentrating on quality variables</td>
<td>(union wide) coordinated policies and cooperative actions</td>
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<tr>
<td><strong>Principles/Tasks</strong></td>
<td>restoring internal and external balance, tight monetary policy with fixed exchange rate, control of inflation, liberalization of prices, interest rates, and trade, privatization, creating and strengthening private property, removal of subsidies and protection, setting up financial institutions</td>
<td>getting the basics right, institution building and adoption, consolidation of norms and values, appropriate balance of policy mix, transparent and accountable fiscal policy, investment friendly tax reforms, adequately regulated and prudent financial sector, deregulation and competition policy</td>
<td>high degree of convergence of economic performances, economic and social cohesion, high level of employment and social protection, raising the standard of living and quality of life, solidarity among member states, respecting the environment</td>
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<tr>
<td><strong>Perception of the market</strong></td>
<td>free market</td>
<td>regulated market forces, inevitable market failures</td>
<td>single-internal market, economic and monetary union</td>
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<td><strong>Perception of the state</strong></td>
<td>state failures overemphasized, neglecting the importance of state provisions</td>
<td>good governance (state as regulator, provider and guarantee)</td>
<td>pre-political union (delegation of power to supranational bodies) sensitiveness to the commonly shared aims of the Community</td>
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Partial surrender of national sovereignty, the delegation of power in certain areas to supranational forces poses new requirements for candidate countries. After ten years of transition, countries are in a rather schizophrenic situation, they have to find out now what the state should look like. First, it was the destruction of the whole hostile state apparatus, secondly, it has been the creation of a
reliable and transparent but at the same time autonomous state and in the current third phase supranational institutions should be empowered on the account of national autonomy and at the same time made the organs of state bureaucracy capable of influencing union-wide decision-making processes. While second generation reforms opened up the road towards the possibility of EU accession (so their importance in widening the Union is unquestionable), third generation reforms have been proven to be inevitable in playing a role in the process of European integration.

Adaptation of a pact

The new members cannot undertake less than those already stipulated in the Union since the latter do not wish to pay a too high price. Therefore, as a member, Hungary will have to adopt almost every single word of the *acquis communautaire*, including the respective sections of the Stability and Growth Pact. The country does not have to adhere to the *acquis* years before the accession. However, it is good to know what it will have to conform to. This is where the EU norms come in, more precisely, the adaptation of a Stability Pact.

Why does Hungary need a Stability Pact? The public choice paradigm stresses that policymakers follow short-term objectives. Gaining additional votes means not just the realisation of their political programmes but rather the purchase of their own wealth. In Central and Eastern Europe (CEE) there is a new elite forming, while the national assets are redistributed as well. Thus it does make a difference for politicians who is in charge of redistribution (e.g. the process of privatisation). The consolidation of democracy and the escalating party competition comes together with selfish political myopia, which does not care about long-term sacrifices. The rent-seeking politician engages easily, bails out those in need if it is in his interest. However, he neglects the consequences of the promises and bailing out because the burdens will be carried by his successor, who will need to pay the bill for earlier populist practices.

Thus the time has come to bind the hands of the policymakers in order to strengthen the rule of law, and consolidate politics in a western style. The Stability Pact, the targets of which have been widely discussed earlier in the paper, *can be an effective means to constrain deviant behaviour and to enforce fiscal discipline* not just within the (European) monetary union. It can be effective within

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17 Membership means not just the adaptation of the *acquis communautaire* but the ability to use it, to implement common policies and to participate in formal or informal decisions: “The European Parliament will give its consent to each and every admission to the EU based on factors including whether the institutional reforms undertaken by candidate countries are sustainable and of sufficient quality.” (PMF, 2000:3)
18 Of course, transitory derogations will be applied in several fields (see for instance Mayhew, 2000).
a country as well, by blocking the consequences of rash judgements stemming from the cyclical changes in politics. Fiscal policy in an independent country depends on those in the government. If stability is one of its top priorities (in fact it should be) then fiscal policy needs to be regulated with concrete rules and procedures. Only a stable economy governed by responsible policymakers can be the basis for sustainable growth.

Feasibility of a Pact. Naturally, the Hungarian-designed Stability Pact cannot be the same as that in the EU. Table 2 lists the main features of the original Stability and Growth Pact, focusing on its newly established or clarified procedures. More plus signs (the maximum is three) in column 2 denote a more feasible alternative for a country in transition.

| Limits (a)                      | +     | +     |
| Deficit (3 per cent of GDP)    | +++   |
| Debt (60 per cent of GDP)      | +++   |
| Excessive deficit procedure (b)| ++    |
| Budgetary surveillance (c)     | ++    |
| Co-ordination of economic policies (d)| +    |
| Public information (e)         | ++    |
| Sanctions (f)                  | ?     |
| Programme-preparing (g)        | +++   |

Notes: The points below explain the potential role of the Pact’s procedures.
(a) acting as upper limits, taking into account the medium term objective which is to achieve a close to balance or in surplus (structural) budgetary position in order to ensure room for manoeuvre in case of normal cyclical downturns;
(b) ensures that the deficit and debt limits and the reduction in quasi fiscal spending is respected, yet no (or even a vague) possibility for direct sanctions (see below);
(c) ensures the operation of an early warning system indicating the divergence from the undertaken objectives if excessive deficit procedure holds; its multilaterality can be achieved by guaranteeing a monitoring task for either domestic (the parliament, specified committees, local research institutions) or foreign actors (EU bodies through National Programme for Adapting the Acquis, European Treaties on Accession, Country Report, etc.);
(d) non-EU members cannot practice it directly but participation in the Accession Council is given;
(e) ensures transparency, Council recommendations make no sense however;
(f) self-punishment makes no sense, yet moral persuasion persists (see footnote 30);
(g) launching convergence programme.

The SGP in the EU induces a deficit reduction in order to enforce price stability. In the transitional countries there is a technical and a more fundamental problem, however. Particularly in Hungary,

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19 This is not about corruption but the strengthening of the democratic institutions.
inflation has a significant impact on the deficit. The Maastricht deficit-criterion is a nominal and not a real value. However, in CEE there is a huge difference between the two due to inflation. Hungary has a significant interest payment obligation, a part of which is inflationary compensation, and only a smaller half of it is real interest rates. From a more fundamental viewpoint it is still not clear whether Hungary’s primary task is to get inflation down.

The introduction of caps on overall and discretionary spending could discipline public finances. For each newly approved expenditure the source would have to be specified automatically without a time lag. Nevertheless, the 3 and 60 per cent ceilings are incorporated into the *acquis communautaire*, so not taking them into account would mean a violation of EU rules after accession. The limits ensure a significant room for manoeuvre if a balanced position is targeted in the medium run. The automatic stabilisers could be put in service, leaving room for manoeuvre and ensuring flexibility. In transitional economies such leeways are required because:

1. many uncertainties arise in a transformation (e.g. internal shocks), without having real confidence in the final “direction”;
2. institutional challenges are ahead, e.g. reform of the general budget;
3. modernisation of the micro sphere, structural adjustment, development of the export sector, deregulation, liquidation of monopolies and freedom of competition are all needed;
4. being a small, emerging market economy, external shocks may threaten the stability not only of the financial system but of the whole economy, the danger of contagion is significant;
5. public investments are needed in infrastructure, R and D and education.

Direct punishment will not play a role at all in a Hungarian Pact unless parties in the parliament agree on an amendment of the constitution. Accordingly, fines cannot be imposed on the government itself. However, violation of deficit limits or caps would raise questions of irresponsibility that could result in the fall of the government in a subsequent election. For surveillance there is the parliament and its committees and the public, of course, which warns the fiscal authority as soon as it diverges from the standards. By identifying a significant divergence of the budgetary position from the objectives laid down in the programme, an early warning system draws attention to the required adjustment and prevents the occurrence of an excessive deficit. Without sanctions the Pact is still able to establish transparency and fiscal discipline throughout its

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20 Oblath, (1999), Barabás *et al* (1998) suggest an introduction of operational deficit as a reference value. However, Hungary is not in the position to assess the Maastricht criteria (Csaba, 2000b).
21 On arguments for caps on nominal limits, see OECD (1999).
procedures and would make all the information public. To achieve these aims, the introduction of a convergence programme is required first of all as the first step to introduce the Stability Pact itself.

The convergence programme (Article 9, 1466/97, SGP) in the EU shall present the following information in particular on variables related to convergence:

(a) medium term objective for the budgetary position of close to balance or in surplus, the converging paths towards the undertaken objective, the expected path for the general government debt ratio, the medium term monetary policy objectives, the relationship of the objectives to price and exchange rate stability;
(b) the main assumptions about expected economic developments and important economic variables, such as government investment expenditure, real GDP growth, employment and inflation;
(c) description of budgetary and other economic policy measures being taken to achieve the objectives, an assessment of the main budgetary measures’ quantitative effects on the budget;
(d) analysis of how changes in the main economic assumptions would affect the budgetary and debt position.

Information on (a) and (b) cover the current, the preceding and the following three years. Preparing the programmes requires not just the publication of major macro indicators but a detailed and clearly argued adjustment path towards the goals as well, indicating the direction and the main consequences of reforms in institutions and procedures in a comparative perspective.

Current Hungarian legislation in a comparative perspective

The Hungarian Law on General Budget (LGB) requires the preparation of a three-year prognosis. The “brochure” is attached to the central budget chapters and delivered to the Parliament to inform the legislative body. According to Article 36c, LGB, the prognosis describes the Estimates completely for the two years following the budgetary year. Estimates are based on: (1) pervading effects and processes of the budgetary year, (2) the planned reforms and changes in institutions,

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22 Article 109j(1) MT expects sustainable convergence from the member states.
23 The Council consequently investigates whether the programmes handed-in: (a) are consistent with the targets laid down in the broad economic policy guidelines, (b) contain realistic assumptions on the future path of the economy, especially the rate of growth, (c) undertook such objectives that could be fulfilled in the medium term, i.e. the described adjustment path towards a close to balance or in surplus budgetary position is feasible, (d) the consistency between monetary and fiscal policy (in the case of convergence programmes only). (European Commission, 1999b)
organisations and task-management and (3) economic assumptions. Besides, in accordance with Article 36d, the prognosis should indicate the most relevant and important social and economic consequences of the budget.

The Hungarian legislature partly coincides with the points of the convergence programme, mainly in point (a), but point (b) or (c) are affected as well. However, it is not even nearly so all encompassing as the convergence programme. Firstly, the Hungarian prognosis does not aim at a clear target in the medium term as the programmes in the Union do, namely in a ‘close to balance or in surplus’ position. Secondly, stemming from the first point, it is not able to define an adequate path towards the given goal. Thirdly, it does not list the main macro indicators that should be involved in the prognosis. Fourthly, in their convergence programmes the outs (those outside the EMU but members of the EU) have to pay significant attention to the explanations and underpinnings of their economic assumptions but the Hungarian “version” does not even say a word about it. Consequently, the fifth point stresses that no sensitivity studies and scenarios are required as obligatory complements, thus point (d) of the convergence programme is totally missing.

The Hungarian legislation concentrates mainly on the present budget year’s effects of commitments in the longer run and the enumeration of quantitative effects of reforms that have been decided now, not incorporating (the possibility of) changes within a few years. Nevertheless, despite the magnanimity of the law, the Hungarian government in its three year prognosis has tried to go further and deeper than it is required to (see Ministry of Finance, 1999). It has undertaken clear goals that can be seen as first-line targets in a transitional economy aiming at joining the EU. The main points are: increasing competitiveness (responding to the Copenhagen criteria), maintaining the achieved macroeconomic stability (as one of the most important results of the first and second-generation reforms) and improving the economic and social cohesion (parallel with MT and the third generation reforms). Principles complement the targets, giving priorities to actions in the sphere of the health service, local governments, tax and allowance system, higher education, pension system and focusing on improving efficiency of the public management and work of the general budget itself. Properly speaking, though the problems are identified, the weakness of the prognosis is that it fails to elaborate on the necessary adjustment mechanisms.

24 The remarks in brackets are the author’s.
25 It is worth mentioning, that the Union’s Maastricht and SGP rules concentrate on macro indicators (the ‘close to balance or in surplus’ position particularly) and structural reforms are believed to happen indirectly (a top-down policy is prevailing, directed supranationally and managed nationally). In the Hungarian case structural reform are the top priority and deficit reduction is hoped to be fulfilled via micro adjustment (a bottom-up approach).
The Hungarian government and the Economic and Financial DG of the Union have jointly prepared an assessment of the Hungarian mid-term priorities (Government of the Hungarian Republic and European Commission, 2000). On the whole, it overlaps with the above-described prognosis. There is some difference in emphasis: the joint assessment underlines the need for the continuing transformation and the preparedness for joining the European Union. In line with the latter it aims at the raising of the standard of living and quality of life in order to achieve greater economic and social cohesion, showing the need for the introduction of third generation reforms. Table 3 compares the two documents reflecting the main priorities, principles and tasks, emphasising structural reforms and changes in public administration, excluding monetary policy.
### Table 3: Comparison of preferences in different official documents

<table>
<thead>
<tr>
<th></th>
<th>3 Year Prognosis</th>
<th>Joint Assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Top priorities</strong></td>
<td>increasing competitiveness, maintaining macroeconomic stability and economic and social cohesion</td>
<td>continuing transformation, preparedness for joining the EU</td>
</tr>
<tr>
<td><strong>Second line priorities</strong></td>
<td>maintaining fast and harmonious economic growth, forcing market competition, improving self-care and socio-economic adaptivity, increasing investments, forcing appropriate income policy, raising the standard of living involving job creation (active policies), social solidarity and respect for the environment</td>
<td>maintaining macroeconomic stability and fast but balanced economic growth, continuing the integration to EU, increasing competitiveness, increasing investments, stabilising the level of external debt, raising the standard of living through the involvement of increase in employment, carrying an appropriate income policy and social solidarity</td>
</tr>
<tr>
<td><strong>Fiscal consolidation</strong></td>
<td>deficit = 2-3%, debt = 55%, primary balance = +2%, redistribution = 38-39%</td>
<td>deficit &lt; 3%, debt &lt; 60%, primary balance = +1.5 or +2%, redistribution = &lt; 40%</td>
</tr>
<tr>
<td><strong>Public management</strong></td>
<td>transparency and a more effective monitoring</td>
<td>reducing its weight, concentration and economic role, privatisation of market-oriented activities, transparent accounting, modernising the process of budgetary planning (a shift from source to function principle)</td>
</tr>
<tr>
<td><strong>Structural reforms</strong></td>
<td>health service, local governments, regional developments, higher education, pension system, tax system</td>
<td>health service, local governments, regional developments, Hungarian Railways, pension system, tax system</td>
</tr>
</tbody>
</table>

**Note:** The categories have been defined by the author. The sequence within a box reflects an order. Ratios are in GDP.

Targets and principles are given clearly in both the prognosis and the joint assessment. However, neither the former, nor the latter contain a precisely given schedule in which task, source and time are matched. Additionally, there is a big difference between the convergence (or stability) programmes and the Hungarian documents: no procedures are involved in them, thus the targets and principles are only informative but not compulsory. Certain limits on the deficit or debt are missing, excessive deficit procedure or budgetary surveillance are not incorporated, and sanctions make no sense. Because neither the prognosis nor the joint assessment contains accountable (possibly punishable) elements, thus even the markets are not willing to evaluate the country’s performance in comparison with these.
The political economy of public finances

The feature and success of fiscal consolidation is strongly determined by the institutions involved in public finances, and the budgeting process in particular (von Hagen, 1992, Alesina and Perotti, 1996, Perotti et al 1999 and Poterba and von Hagen, 1999). Perotti et al (1999) emphasise that there is a strong positive correlation between the level of fragmentation of the budgetary process and the extent of overspending. As a corollary, the success of fiscal consolidation largely depends on the power structure of the government, the relative strength of the individual ministers. The tendency towards an excessive deficit is the result of a kind of co-ordination failure within the government. The solution can be the suspension of fragmentation via the implementation of centralisation. In that event, it becomes possible to internalise the budgetary externalities that prevailed earlier in the system. However, the form and method of centralisation remains to be determined, and experience in more developed economies suggest two possible approaches:

(a) the delegation form; and
(b) the contracting form.

In case (a) the finance minister has the right to oversee the whole process of budgeting from the agenda-setting up to the closing and evaluation. The spending ministers are under his own control, a definite hierarchy is on stage. Countries which practice such an approach are mainly those where one party can form the government.

In case (b), however, a multi-party government is in power where the finance minister himself is a delegated member of one party. Spending ministers and the finance minister are in a rather horizontal relation with one another. However, if economic stability and fiscal consolidation are still a top priority for the elected government, the executive body will attempt to establish a contract among the parties involved in the governing coalition. Such a contract might even include fiscal targets within the framework of a multi-annual programme. Then any threat to the contract would also risk breaking up the coalition, providing a strong incentive to respect the agreement.

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26 The externality occurs due to the misperception of real social costs and benefits of projects provided by the state. The costs are covered by the tax-fund paid by the whole society while benefits are channelled to a given target-group. According to political economic theory, in such a situation there is a tendency to overspending resulting in huge deficits.

27 It is not exceptional for scholars to ask for such a programme. Braga de Macedo (1998) argues that the successful consolidation of Italy and Portugal was due to the launching of a multi-annual fiscal adjustment strategy in their transition towards the EMU.
In a country in transition the institutional aspect of public finances should be emphasised more strongly because the quality of transition itself, and the success of accession to the EU, largely depend on remedying the externality problem.\(^{28}\) As far as Hungary is concerned, between 1994 and 1998 the larger coalition-party had an absolute majority. The introduction of the 1995 austerity package could only have occurred under conditions where the finance minister had a strong support.\(^{29}\)

After the subsequent election, a three-party coalition was formed, in which none of the parties has an absolute majority. Hungary then had to move towards the contracting approach. In the new coalition, the finance ministry is relatively weak, while the spending ministries and parliament gained in influence. The largest coalition party tried to ensure for itself as much room for manoeuvre as possible through the coalition agreement, the weakening of parliament and local authorities. It also enforced and adopted a two-year budget. However, while neighbouring Austria has introduced its multi-annual budgeting process in order to put in place the framework for fiscal consolidation required by the Maastricht rules (an economic rationale), the Hungarian leading party in the coalition has tried to restrain its coalition partners, gaining additional strength for the elections in 2002 (a political rationale).

Therefore, a clear goal should be to eliminate the dominant political rationale in Hungarian economic policy design, notably by strengthening the economic rationale. A practical definition of the latter is: aiming at sustainability along with a disaggregated view of the budget and a close scrutiny of institutions. The precise enumeration of revenues and expenditures is required, which points to the deficiencies of institutions. The Stability and Growth Pact, throughout the mandatory preparation of convergence (or stability) programmes and particularly by setting up obligatory mechanisms and procedures, offers just this. By comparing the planned and actual performance, the government’s activity becomes easier to monitor on the one hand and by implementing disciplinary legal authority, members have to behave according to these on the other hand. The benefits of a Hungarian-designed Pact would be the reduction of discretionary measures, the disciplining of policy-makers and obliging them to take the long run consequences of their decisions into account. The distribution of public expenditures based on political preferences can be scrutinised, public finances become transparent.\(^{30}\)

\(^{28}\) About the importance of institutional changes in a transition economy see Hare (2001) who gives a theoretical and methodological overview on the topic.

\(^{29}\) Interestingly, the smaller party in the coalition supported the finance minister even stronger, so a 2/3 majority – which is required to amend the constitution in the country- was ensured for the decisions taken by Lajos Bokros, the Hungarian finance minister.

\(^{30}\) Government spending often increases because the relevant expenditures are tied to entitlements or indexed to economic variables outside the direct control of government. After the introduction of a Stability Pact it is in the government's own interest to stop such self-restrictive actions in order to give room for manoeuvre under cyclical fluctuations.
The political rationale in such a new environment would be (at least) counter-balanced by the economic rationale.

What is really essential is that deviant behaviour is made public. The message sent to the markets is straightforward: take notice of the violator who does not abide by the rules laid down in the contracts. In actual fact it is not the community-imposed fine of 0.2 per cent or 0.5 per cent which really counts, but the market's punishment and disciplinary actions which impose further, heavy expenses on the troubled economy and consequently on the government as well.\footnote{In Table 2, a question mark is given for sanctions. The reason behind it is that while officially it is not likely that sanctions will be imposed on governments, market forces still have the chance to express a negative evaluation. However, the question is how much and especially in what quality the information will be provided.}

Additionally, bailing out is a serious problem that concerns the EU. However, in the process of transformation this has become almost fully acceptable in order to maintain social consensus and to sustain political power.\footnote{According to Kornai (1996), the two main preferences of the Hungarian leaders until 1995 were the avoidance of conflict and the maximisation of the current consumption as the legacy of the past.} The problem is that if bailing out becomes permanent then who will practice self-restraint? Risks will be under-estimated by entrepreneurs, returns going to the brave while the state hopefully pays for any losses. One of the trials of transforming into a market economy is the hardening of budget constraints. Nevertheless, a soft budget constraint cannot persist any longer if the Pact – through its ability to stop bailouts – could reorient expectations. It could change the behaviour of economic agents by acting as a quasi-law. Thus its role in the erection of institutions in the consolidating transformation would be outstanding. Going back to the third counter-argument of SGP it could be claimed that the legal (e.g. the SGP itself) and market forces develop together in a transitional country, creating both democracy and market economy.
IV. Conclusion

The Economic and Monetary Union is a further step along the process of European integration. It is a means to bind Europeans more closely together as well as to set up a framework for stable and sustainable public finances. The Stability and Growth Pact strengthens the faith that sound government finances, aiming at a ‘close-to-balance or in-surplus’ position in the medium run, ensure support for stability-oriented monetary policy and for strong sustainable growth. The Pact, as has been discussed, strengthens both budgetary discipline and fiscal flexibility, reduces the danger of an inflationary public sector bail-out, limits the enforcement of political preferences in resource allocation, calls for structural adjustment in the longer run and deepens integration, opening up a road towards fiscal federalism and political union.

Joining the EU and the EMU strengthens the convergence of economic policies in the transforming economies but at the same time poses new challenges that require the introduction of the so-called third generation reforms. In the third phase of the transitional reforms the state partly delegates its power to supranational bodies and is sensitive to the commonly shared aims of the Community but is also able to influence Union-wide decision-making processes.

Thus, even before accession it would be worth thinking about the adaptation of a Stability Pact. The main targets of a Hungarian-designed Pact would be to reduce discretion in fiscal policy, to discipline policy-makers and to make them take into account the long run consequences of their decisions. The soft budget constraint could be hardened and the distribution of the public expenditures based on political preferences could be scrutinised, thus guiding public finances towards transparency. Sustainability has become a determining factor of economic integration. This needs to be understood by a country in transition, waiting for EU accession in a globalised world. The early adaptation and adoption of a Stability Pact could contribute to this.
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