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Highlights in this issue:

- **Hungary's recent serious public finance imbalances were linked to weak fiscal governance**
- **If adopted, the Government's planned reform is an important step towards ensuring the durability of the fiscal adjustment**
- **Achieving a political consensus is essential to restore the credibility of fiscal policy**

Public finance reform in Hungary: light at the end of the tunnel?

*By László Jankovics**

Summary

The dominance of electoral considerations in determining budgetary outcomes has been evident in Hungary over the last 15 years, with government deficits reaching their highest levels in election years (1994, 1998, 2002 and 2006). This deterioration of public finances has largely been possible due to the weakness of fiscal governance. In the current decade, fiscal laxity was particularly strong until mid-2006; the country was even said to be suffering from a form of "fiscal alcoholism". At the same time, economic activity was hampered by serious budgetary imbalances through various channels, which also slowed down catching-up vis-à-vis the EU average. In this Country Focus it is argued that the recently unveiled comprehensive proposal to reform Hungarian public finances is an important step towards curing these institutional weaknesses, even though there is still room for improvement. It is crucial that the reform is based on a broad political consensus so as to ensure its credibility and durability.

Fiscal governance: the evolution of the present system

No major reform in fiscal governance since the early 1990s…

Essentially, no major changes have been made to the way in which the annual Hungarian budget is planned, formulated and implemented since the adoption of the Public Finance Act in 1992. The Parliament's role is traditionally confined to a limited reshuffling of budgetary appropriations between the line ministries, without substantively modifying the headline figures or correcting unrealistic estimates of revenue and expenditure. The budget bill is usually approved by the legislature in the week before Christmas, after which local governments start discussing their budgets until end-March (i.e. three months into the actual budget year).

As regards institutional arrangements, the State Audit Office (SAO), which is the State's independent financial monitoring institution, was established in 1989. The SAO assesses the draft budget in the course of the Parliamentary debate (*Annual report on the budget proposal*), carries out ex-post monitoring of the implementation of the budget law (*Annual report on the final accounts*), and regularly highlights the risks in relation to optimistic projections for revenue and expenditure items. The SAO also issues recommendations based on the findings of its audit reports. However, the Government is not obliged to take the SAO's recommendations on board and is free to use its own macroeconomic assumptions and fiscal projections in preparing the budget. Overall, the SAO's support for fiscal responsibility over the last 18 years has proved to be rather limited, which is in part due to the fact that the SAO was basically unable to foster effective public scrutiny of the budgetary process.

*** Directorate for the Economies of the Member States.**

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Although technical improvements have been made in the budgetary framework (e.g. the establishment of the State Treasury and the Government Debt Management Agency as separate organisations in 1995-96, or the introduction of a numerical debt rule for local governments in 1996[1]), the process also suffered setbacks. Most notably, in 2002, the Public Finance Act was amended to give the Government significantly more room for manoeuvre when budgetary outcomes deviate from plans (for example, the Government is required to submit a fully-fledged supplementary budget only if the deviation from the target exceeds 5% of total budgeted expenditure).

…although a number of positive steps have been taken since mid-2006

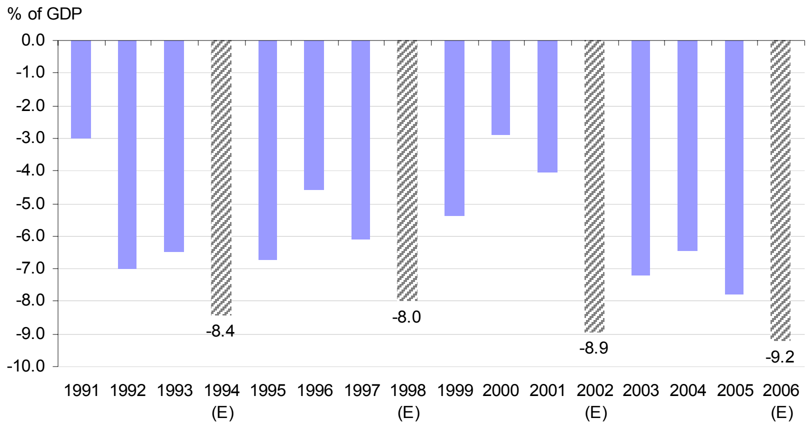
On a positive note, starting from the summer of 2006, the Government has taken a number of steps to reinforce the budgetary framework. Budgetary accounting has become more transparent due to the explicit inclusion of quasi-fiscal activities (e.g. PPP motorway projects) in the government accounts. The authorities also committed themselves in September 2006 to report on budgetary developments to the Council and the Commission twice a year until the abrogation of the excessive deficit procedure. Furthermore, the Government introduced a new control mechanism, which allows the conditional release to ministries of the chapter balance reserves (specified for each budgetary chapter in the budget bill, and totalling around 0.3% of GDP in both 2007 and 2008) after the ministries have submitted their quarterly report on budgetary execution. However, the timing and the amounts to be released are still decided on an ad hoc basis. A further amendment required that the draft budget should be consistent with a non-negative primary balance. However, given the magnitude of the debt service in the coming years, which is projected at around 4% of GDP, compliance with this provision *per se* would not lead to the correction of Hungary's excessive deficit. There is, therefore, a clear need to enact stricter fiscal rules in Hungary.

The institutional and procedural weaknesses in Hungary

Public finances were fully exposed to the electoral cycle

The budgetary framework has some characteristics which make it vulnerable to fiscal slippages and leave it fully exposed to the electoral cycle (see Chart 1). This peculiar pattern was aptly described as "fiscal alcoholism" by György Kopits.

Chart 1: Electoral cycle in Hungary: budget deficit over the last 15 years



Note: 1991-1995: cash flow figures, 1996-2006: ESA figures (in 1998 and 2002, some sizeable one-off operations were also incorporated into the deficit). (E) stands for election year.
Source: Commission services

Lack of a genuine multi-annual budgetary framework…

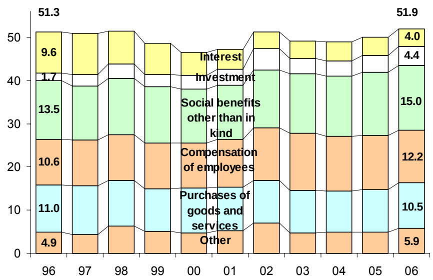
First, formulation of the budget focuses too narrowly on the forthcoming budget year, without genuinely embedding the planned fiscal variables in a multi-annual deficit reduction path (Kraan et al. 2007). Although the pre-accession economic programmes, and subsequently the successive convergence programme updates, continued to put forward increasingly ambitious multi-year adjustment paths, these plans did not effectively constrain budgetary policy. Linked to this, the authorities have been more inclined to cut expenditure using short-term measures (budgetary freezes, unspecified across-the-board savings, fiscal gimmickry, "one-off" deficit reducing measures) rather than structural ones, if they thought it necessary; often this eventually resulted in a rebound in expenditure. The lack of an effective multiannual fiscal framework was therefore not conducive to achieving a sustained reduction in the expenditure-to-GDP ratio (see Chart 2).

Second, until recently there were no effective mechanisms in place to ensure budgetary discipline within a given year. In particular, there were no rules on how to compensate for an emerging expenditure overrun or a revenue shortfall that appeared during the year. Likewise, there were no clearly specified procedures about the treatment of windfall revenues or possible expenditure savings within a particular chapter of the budget; hence, line ministries were able to use these revenues for new spending initiatives. Furthermore, within the year, decisions on new policies were for the most part disconnected from the budgetary process, to the extent that there was no standard method of calculating the budgetary impact of the adopted changes. And even in cases where the budgetary calculation was provided, it did not include any reconciliation of the costs with the Government's multi-year budgetary targets.

…coupled with inadequate budgetary discipline and the lack of institutional checks and balances…

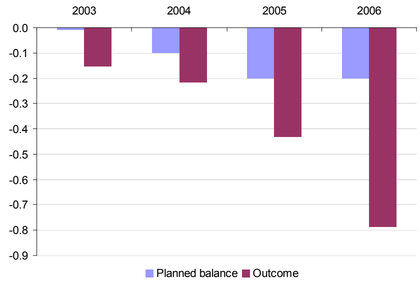
Third, there was always a danger of a higher-than-expected deficit at the sub-national level (see Chart 3). This could be explained by the central authorities' limited supervision over the formation of the local budgets and the fact that, although the debt rule was able to limit the accumulation of debt in the long run, it could not prevent slippages in the annual local budget. The situation has become even worse in recent years as the budgetary transfers to the sub-national sector were a primary target of the Government's across-the-board expenditure cuts, which eventually led to an accumulation of liabilities in the local government accounts.

Chart 2: The evolution and structure of government expenditure, % of GDP



Note: "Other" includes subsidies and other current and capital transfer;
Source: Commission services

Chart 3: Deficit projections for local governments and outcomes, % of GDP



Source: Pre-Accession Economic Programmes; successive Convergence Programme updates; Commission services

Finally, another shortcoming was that the official macroeconomic and financial assumptions were not exposed to public scrutiny, and therefore turned out again and again to be overly optimistic, which led to fiscal slippages (Kiss 2007). Moreover, the budget document provided no sensitivity analysis of fiscal outcomes to possible domestic and global economic shocks. The lack of independent scrutiny over the budgetary process also damaged transparency, as exemplified by the repeated plans – which Eurostat did not accept – to record the investment in new motorways built by public-private partnerships off-budget.

…led to poor fiscal governance and hampered economic growth.

Overall, it is not surprising that a comparison of the different features of fiscal governance in the newly acceded Central and Eastern European countries showed Hungary to have the second weakest budgetary framework after Romania (Gleich 2003). Very similar results emerged from the analysis of the 2007 Public Finance report on the quality of the budgetary procedure, which put Hungary in 15th place out of the sample of 18 EU Member States. Hungary's ranking was particularly low in the categories "using top-down budgeting techniques", "centralising the budgetary process" and "applying performance-budgeting methods" (European Commission 2007). Linked to this, the frequent changes of direction in Hungarian economic policy have also created uncertainty for economic agents. Moreover, empirical evidence suggests that the high budgetary deficit had a negative impact on private investment (Lendvai 2007). The growth-hindering impact of high budget deficits, especially when coupled with a high debt stock as in the case of Hungary, is well-documented in the empirical literature (see for example Adam and Bevan, 2005).

The comprehensive reform proposal

In recent years, the Council and the Commission have repeatedly recommended to Hungary to back the medium-term deficit reduction path by a strengthened national budgetary framework. After the positive but insufficient steps taken in the second half of 2006 to reform public finances, multi-party negotiations started in June 2007 on the basis of a complete blueprint (Ministry of Finance 2007). In November 2007, the Government adopted a package of laws based on this blueprint, which was subsequently submitted to Parliament. The main goal of the planned reform is to prevent a future recurrence of the electoral cycle. The proposed elements form a comprehensive and interlinked system (see Table 1 for key aspects), which is similar to a so-called Fiscal Responsibility Framework that Kopits (2007) advocated for Hungary, based on positive international experience.

The Government puts forward a proposal for a new comprehensive and interlinked arrangement…

Table 1: Overview of the key elements of the reform package

Category	Description of the feature	Effective as of:	Quorum
Constitutional embedding	Fiscal sustainability is defined as a new constitutional principle	2008	Qualified
Medium-term budgetary framework	Three-year nominal expenditure ceilings for budgetary chapters defined by the Government	2008-2010 period	Simple
Numerical rule for central government	Unprecedented "no increase in real terms" rule for the gross central government debt, from which primary balance targets are derived	New calculation for primary balance: 2011	Simple
Numerical rule for local government	“Golden rule”-type limit on local government borrowings for investment purposes	2008	Qualified
Institutional changes	Establishment of the Legislative Budget Office (LBO) for independent macro-economic and budgetary projections	Operation: 2008, full competencies: end-2010	Qualified
Procedural guarantees	Introduction of the rule of mandatory offsetting	2008	Simple
Transparency	Semi-annual government report on budgetary execution, publication of a detailed set of budgetary reports before national elections	2008	Simple

Note: The Government intends to secure the adoption of the entire package by qualified majority. The last column defines the legal minimum form of majority for the enactment of certain elements.

Source: Draft laws submitted to the Hungarian National Assembly

The purpose of adding fiscal sustainability to the main principles of the Hungarian Constitution provides the possibility for a legal challenge to be brought before the Constitutional Court if the budget law does not meet this condition. As to numerical rules, when adopting the budget, Parliament would at the same time approve the primary balance targets for the first two years following the budget year, and these targets must all be in line with the requirement of preventing an increase in the central government's debt in real terms. There is also a stipulation that consistency with the requirements of the Stability and Growth Pact should also be preserved when the Parliament decides on the primary balance targets. The Government's plan to specify medium-term expenditure ceilings in a separate decree would provide a further orientation for budgetary institutions as to their budgetary “elbow-room” in the medium term. The proposal distinguishes between mandatory items (e.g. spending required by entitlement regulation, direct and indirect taxes) and discretionary budgetary appropriations; only the latter items would be discussed in the debate on the budget. To complement the regulation presented above, a "golden rule" would be introduced for local governments, with a view to moderating the risk of accumulating large deficits at sub-national level.

…including unique numerical rules, improved procedures and the establishment of an independent fiscal institution.

Compliance with the envisaged multi-annual adjustment path would also be supported by the introduction of mandatory offsetting. This means that the Parliament cannot approve any amendments that would reduce the primary budget surplus in the coming years without providing appropriate compensation. The offsetting requirement is related not only to the budgetary debate, but also to the adoption of specific bills (e.g. regulation on social benefits, employment legislation). This offsetting procedure would be made technically possible by the obligation to append a budgetary impact assessment to every new draft bill and also for any type of legislative amendment.

As regards fiscal institutions, an important change is the plan to establish an independent budgetary authority, reporting to Parliament (the President of the LBO would be appointed for a renewable 12-year term). The new institution would be entrusted with safeguarding the transparency of the budgetary process by taking on a number of tasks. It would provide publicly available independent macroeconomic and budgetary forecasts. It would also carry out a plausibility check and validate the fiscal impact assessments of the legislative proposals. If it disagrees with the calculations provided, Parliament must use those prepared by the LBO. It would also assume the task of providing an ex-ante evaluation of the draft budget proposal from the State Audit Office, whose role is foreseen to be limited to carrying out the ex-post financial and performance audit on public activities.

A tentative assessment and issues for further consideration

An important and consistent concept to remedy the present weaknesses, which could be strengthened by…

The proposed reform is undoubtedly an important step to prevent recurring electoral cycles, as a coherent rules-based system would be able to remedy the above-mentioned shortcomings. The introduction of the planned set of numerical fiscal rules could be instrumental in generating a truly multi-annual budgetary framework and improving budgetary control. Through the circumscription of mandatory items in the budgetary planning, the proposed new-set up allows for the operation of automatic stabilisers to a large extent, thereby compliance with the rules does not seem to lead to pro-cyclical fiscal policy. The establishment of the LBO and the regular publication of budgetary reports could increase the transparency of budgetary accounting and fiscal developments. Once it has fully assumed its responsibilities, the new fiscal office could serve as an institutional counterbalance to the Government through the entire budgetary process. The risk of expenditure overruns at local government level could be mitigated by the introduction of a "golden rule" type of fiscal regime. The planned overhaul would contribute greatly to the success of the Government's ongoing fiscal consolidation programme, the first results of which were felt in 2007, with a deficit reduction from over 9% of GDP to possibly below 6% of GDP.[2]

…designing an adequate mechanism for positive budgetary surprises, giving autonomous profile to the new fiscal body and ensuring that well-defined enforcement mechanisms are put in place.

However, there are also several other issues that may warrant further consideration. First, there is no mechanism planned to ensure that revenue windfalls (e.g. in case of a positive growth surprise) or unexpected savings (e.g. lower-than-projected interest expenditures) are allocated to accelerate deficit reduction. As was also shown by the budgetary execution in 2007, there is a clear temptation not to make full use of the extra manoeuvring room for a more rapid consolidation. Although the planned delineation between mandatory and discretionary items would help to discipline the implementation of the budget, it would still be possible to use savings or windfall revenues for extra spending or tax cuts within the same category of budgetary items. It might be appropriate, therefore, especially with an eye to the coming years for which the deficit targets are still relatively high, to build in a procedure that ensures the accelerated reduction of deficits and debts whenever there are positive surprises.

Second, a possible reservation about the plan to attach the LBO to the legislature power is that as a prospective unit of the Parliamentary Office, the new body might not be fully insulated from political interference. From this angle, there are valid arguments for establishing the new office independently of already existing institutions also in view of the need to rapidly build a positive reputation for the LBO. Another alternative would be to create the new body within the State Audit Office, thereby to some extent inheriting the professional reputation of the SAO. However, this solution would also raise some concerns, since it may be best to separate positive tasks (e.g. financial audit) from normative assessments of the budgetary estimates (which will be among the new office's tasks) as the latter might be publicly criticised by political actors, and this could eventually damage the reputation of the institution. Moreover, there is a built-in conflict of interest if both the ex-ante and the ex-post analysis of the public accounts are carried out by the same institution, as it would be tempted to raise the same problems ex-post that were already highlighted ex-ante (see also European Commission 2006).

Third, as international experience has shown, the design of the enforcement mechanisms is an important factor in ensuring the successful operation of fiscal rules. Actions (corrective measures or sanctions) to be taken in the event of non-compliance should always be defined ex ante and preferably be implemented by a non-partisan institution, so as to make the rule credible. The option to appeal to the Constitutional Court may not ensure efficient and rapid enforcement, one of the reasons being the time needed for such a complex decision. Therefore, the proposed system relies primarily on the assumption that the Hungarian authorities would do their best to adhere to the rules, thereby avoiding possible further damage to their reputation. However, also in view of the major fiscal slippages in the past and given the complex design of the proposed system, it might be better to spell out the appropriate legal instruments (e.g. strengthening the competencies of the LBO) to ensure the observance of the planned complex set of numerical rules.

Conclusions and prospects

With some possible corrections, the proposed draft laws form a consistent system and should be conducive to improving the transparency and sustainability of public finances. Hence, the new framework could help achieve the planned fiscal consolidation over the coming years as outlined in the country's latest convergence programme. Regarding political feasibility, the Government intends to seek a two-thirds majority in Parliament for the whole package. All political forces have already expressed their commitment to strengthening fiscal governance; however, disagreements on a number of issues still remain. Although a more limited version of the reform package could be enacted without the support of the opposition, this could lead to the current weaknesses being only partially remedied, thereby creating inconsistencies within the new set-up (e.g. the introduction of numerical rules without supervision by an independent fiscal body). Whatever the precise features of the new fiscal system, it is important that it is based on a broad political consensus so as to ensure its consistency and credibility.

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[1] The Local Government Act sets a ceiling on the debt stock of sub-national governments, which is specified at 70% of the "annual own revenue capacity" (calculated as receipts from local taxes and other revenues minus interest payments). It should be noted, however, that this provision does not cover short-term liquidity loans. Furthermore, more recently, local governments started to increasingly circumvent the regulation e.g. by accumulating debt in the books of local government-owned public companies instead of their own accounts.

[2] For details see the Commission services' assessment of Hungary's most recent convergence programme (European Commission 2008), which presented an earlier version of the findings of this Country Focus.

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