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Credibility and Flexibility

Changes in the Framework of Hungarian Public Finances

Summary: This paper presents the three most important institutional steps that Hungary took in 2010 and 2011 to promote the responsible management of public funds. It provides a detailed analysis of the strict provisions of the new Constitution regarding public finances, the strengthened mandates of the Fiscal Council and the renewed audit instruments of the State Audit Office of Hungary. The transformation of the institutional system and the regulatory environment was necessary because the significant increase in debt indicated that the earlier, more permissive regulation failed to attain its target. Experience confirmed that without strict rules and reinforced institutions it is not possible to regain the credibility of fiscal policy and to ensure the economical and responsible financial management of the public sector. The paper explains that Hungary's new fiscal rules represent an unprecedented fiscal commitment even at international level, and that the constitutional powers of the Fiscal Council and the resulting rigour are unique in the world.[1]

Keywords: budget, fiscal policy, public finances, fiscal council, budgetary institutions
JEL codes: H60, H61, H63, L38, P48

It is no longer questionable that the earlier breaking loose of fiscal expenditures and the resulting increase in government debt represent a very serious economic policy problem in Hungary. Over the past year, the Government and the National Assembly have taken several decisions to promote responsible financial management and address the debt problem in an efficient manner: the new Constitution contains a public finances chapter, the Fiscal Council has received strengthened mandates, and the Act on the State Audit Office of Hungary (SAO) has been recodified by the National Assembly.

These are new times that require new solutions, and this is especially true for public finances. The change was necessary, new rules had to be laid down and new institutions had to be set up because neither the SAO, nor other independent institutions had been able to prevent the chronic public overspending and the drastic increase in government debt in earlier years *(see Chart 1)*.

No doubt, the economic crisis and the disorderly public finances of Hungary warrant savings measures. Consequently, the same or increasing amount of tasks has to be performed using the same amount of or even less resources than earlier. Therefore, renewal does not mean the expansion of the institutional system, but the widening of powers, the increasing of transparency and making sanctioning possible.

One of the preconditions for economic recovery and breaking free from the debt trap is strict saving, responsible management of public funds and national assets, which, first of all, means keeping public finances on a short leash.

Consequently, it is a fundamental national

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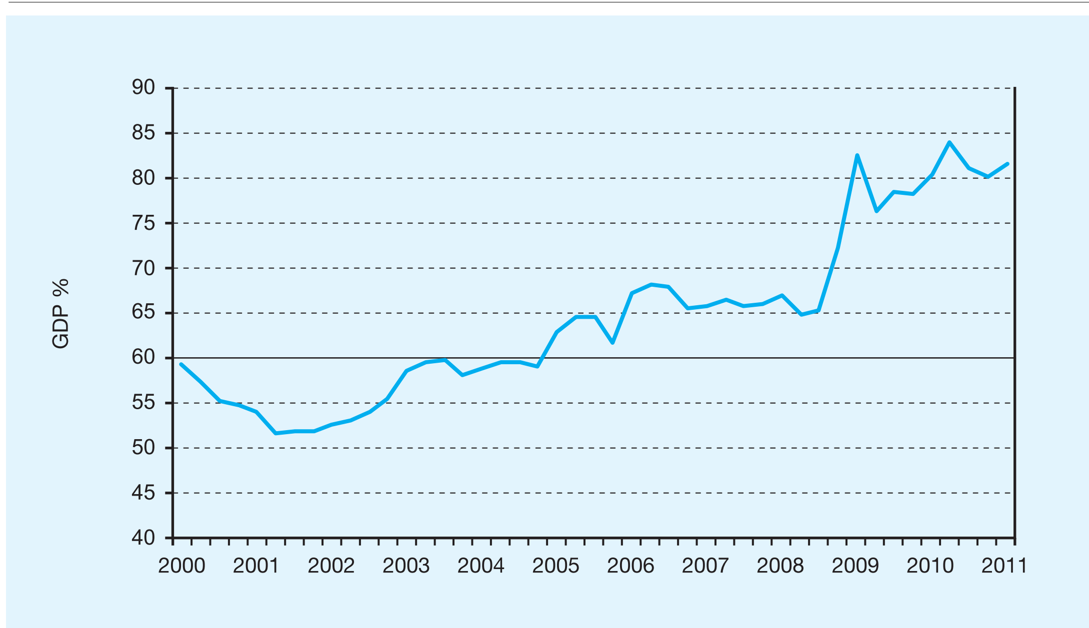
Chart 1

GROSS GOVERNMENT DEBT OF HUNGARY



Source: MNB

interest to have a transparent, efficient and accountable Budget Act, which deals with public revenues and expenditures. The various institutions should assist the National Assembly in drawing up a realistic and feasible budget, and encourage the Government to implement it. If the budget is built on too optimistic macroeconomic forecasts, it jeopardises the feasibility of the budget appropriation bill. Therefore, it needs to be examined whether the macroeconomic projection of the Government is well-founded. Public finances need to be put on a sustainable path, i.e. deficit and debt should be prevented from soaring.

The public finances chapter of the new Constitution, the strengthening of the Fiscal Council and the recodification of the SAO Act were the consequences of the realisation that greater emphasis needs to be put on public finances than earlier, and that the institutional system that existed until then had been unable to ensure sustainability.

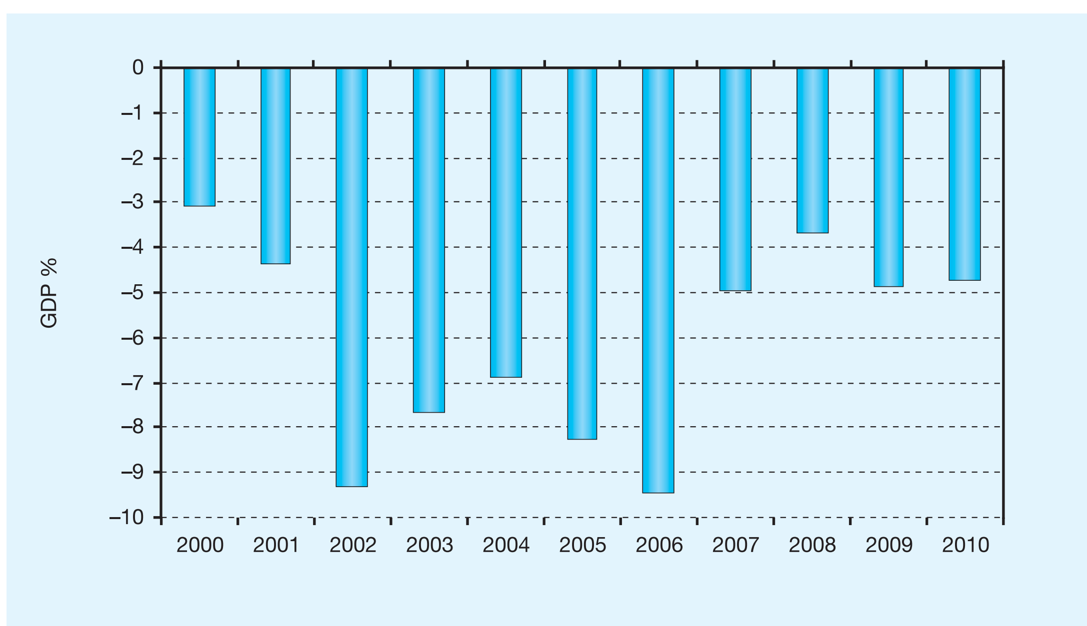
CONSTITUTION AND PUBLIC FINANCES – WITH A NEW APPROACH AGAINST DEBT

In financial circles, Hungary was an example of the vulnerability of state budget for years, which is not surprising in view of deficits exceeding the budgeted amounts by far in each year following the turn of the millennium *(see Chart 2)*.[2] It also discredited the country that within the European Union Hungary was the first state (as early as in 2008) that needed to ask for a life-belt from international organisations. The Hungarian budget showed an extremely high deficit, and the increase in government debt accelerated in an unprecedented manner: in early 2011 the debt ratio exceeded 80 per cent of annual economic performance.

Considering the developments, it is not surprising that emphasis was laid on the responsible management of public funds in the new Constitution as well, which enters into force in January 2012. This is a major change compared to the Constitution currently in effect, which,

Chart 2

FINANCING CAPACITY OF THE GENERAL GOVERNMENT[3]



Source: MNB

at best, deals with issues of public finances only indirectly.

The new Constitution contains several very strict regulations to ensure responsible financial management. For example, the National Assembly must not adopt a budget that would result in government debt above one half of the gross domestic product.[4] Moreover, while government debt exceeds this value, the National Assembly may only adopt budgets that provide for the reduction of government debt. Deviation from these rules is allowed only in very exceptional cases, which clearly shows that debt reduction has become the highest priority of economic policy in Hungary.

The inclusion of the debt ceiling in the Constitution means that in connection with fiscal disciplining Hungary, according to the categorisation by *Wyplosz* (2005), opted for the rule-based solution as opposed to the institutional one, which is explained by the fact that the credibility of Hungarian economic policy became significantly eroded after 2002. The strength of the Fiscal Council is also primarily attributable to the Constitution; the task of the Council is exactly to enforce the constitutional rule so that it is more than written word.

Another important new feature of the Constitution is that the Fiscal Council was included among the organs that have a constitutional legal status, i.e. it received equal status with the SAO and the National Bank of Hungary (MNB, Magyar Nemzeti Bank). In order to reduce the outstanding debt, the Constitution also grants the organisation a general right of returning. This means that the Hungarian National Assembly undertook self-restraint that is outstanding even at international level, as it will be possible to adopt the budget only with the consent of the Council. The primary aim of the mandate granted to the Council is to forward the best, most reliable and best-founded draft budget possible to the National Assembly. It is the members of the National Assembly who will have to vote and assume responsibility.

The Constitution has been strongly criticised by some politicians and analysts because it reduces government controls and brakes. However, the truth is that the public finance regulations of the new Constitution, and the provisions concerning debt and the strengthened Fiscal Council in particular, will mean unprecedented control from the aspect of the budget.

RENEWED AND STRENGTHENED FISCAL COUNCIL

The Fiscal Council is an organ that supports the legislative activity of the National Assembly and examines the grounding of the central budget.[5] The new Constitution has granted very strong mandates to the Fiscal Council, not only compared to the previous Council, but also compared to similar institutions of other countries.

■ *How is the new Fiscal Council different, what additional mandates does it have?*

In Hungary, the idea of establishing a Fiscal Council was first brought up in 2006, when government debt was soaring, and in 2009 a council was set up, which had a staff of its own, and was therefore a costly organisation. However, without real powers, it was relatively weak. According to *Kopits – Romhányi* (2010), when the Council was established, the issue of determining the maximum levels of government debt, budget deficit and general government expenditures arose, and it was also discussed whether the Council should be granted coercive powers. Finally, the ceilings, which would have imposed serious limitations on the Government, were not introduced, and an institution was established that did not have any "direct legal means to comply with the rules and requirements", i.e. it could "use the means of convincing rather than those of coercion". The task of the Fiscal Council would have been to prepare economic forecasts, impact assessments and estimates for each bill that affects the budget, but the Council did not receive any decision-making powers.

In 2011, this Council was replaced by the new, smaller and cheaper Fiscal Council, which, at the same time, has more mandates. It consists of the Governor of the MNB, the President of the SAO, and a Chairperson appointed by the President of the Republic. This body is comprised of only three members, and it does not have an office of its own, which is possible because the Council relies on the professional staff of the MNB and of the SAO as well as on the analyses of acknowledged workshops of Hungarian scientific life. The change in 2011 was significant, because the new Council does not receive any state subsidy and can return the draft budget to the Government, whereas only in this year HUF 835.5 million should have been spent on the old Council according to the draft budget, while it only had a right to give an opinion.

One of the reasons for the transformation in 2011 was that although the Council would have been granted some kind of veto right in budget matters according to the original idea, finally it did not materialise, and thus the Council became a "toothless lion". In 2011, the law changed in a way that before submission to the National Assembly, the Council can return its opinion on the draft budget to the Government, and compel the Government to prepare a new draft, which means much greater authority than the right to give an opinion. The right of the Council is limited to the extent that although it can return the draft once, it cannot return the second draft; the law only allows the publication of the opinion of the Council on the website of the National Assembly.

This right was enhanced by the new Constitution, which stipulates that as of 2012, it will not be possible to adopt the budget with-

out the consent of the Council, i.e. returning the draft budget will not be a single opportunity. The Council has to judge whether the constitutional requirement regarding government debt is met (i.e. if debt reduction or at least the maintenance of the debt level is ensured); if not, the Government has to prepare a new draft budget. The mandate of the Council is further strengthened by the provision of the Constitution that if the country does not have an adopted budget by 31 March, the President of the Republic may dissolve the National Assembly, and may call new elections.

The pivotal act on the Fiscal Council has not been prepared yet,[6] and for the time being practical experience concerning operations is not available either, so it is uncertain what the general right of returning granted to the Council will actually mean. Based on the text of the Constitution, it will formally have a right of veto, as, according to the general justification, the Council "will be strengthened by being granted a right of veto against the act on the central budget if the latter does not comply with the provisions of the Constitution regarding the extent of government debt". The same is included in the detailed justification as well, which says that "the body is also granted a right of veto regarding the Act on the Central Budget". However, one must not forget that eventually it is the Hungarian National Assembly that is responsible for the budget, as the National Assembly is the only competent body authorised by the voters to decide on the budget. This also means that the primary responsibility of the Fiscal Council is to ensure submission of a well-founded draft budget to the National Assembly.

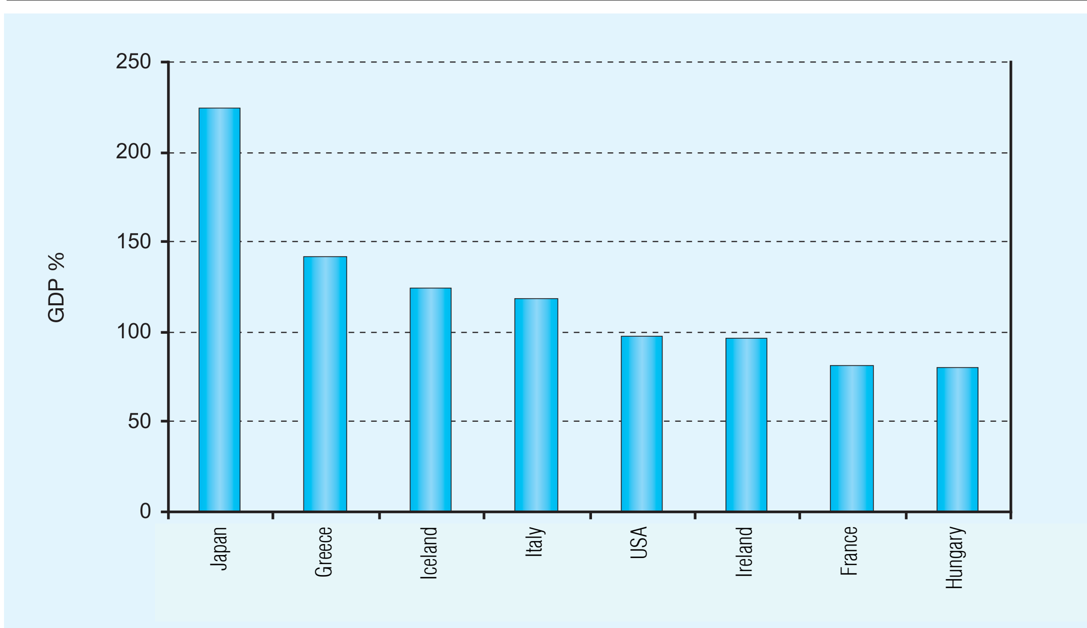
■ *What is the difference between the Hungarian Fiscal Council and similar bodies of other countries?* Fiscal councils operate in many countries of the western world. The comparative study by *Calmfors – Wren-Lewis* (2011) lists 11 operating councils (in addition, professional discussions have started about the eventual introduction of fiscal councils in another three countries: Slovakia, Ireland and Portugal). There are councils the legal predecessors of which were established decades ago: for example, institutions that today may be considered fiscal councils were set up in the Netherlands in 1945, in Denmark in 1962 and in the United States in 1974. In the last two to three years, as a result of debt problems coming to the surface, several states that had not had fiscal councils earlier established their respective organisations, including, inter alia, the United Kingdom, Sweden, and Hungary.

According to Calmfors (2011), in each case the councils were brought into being by the same phenomenon, i.e. the chronic overspending by the governments and the increase in government debt. Wren-Lewis (2011) adds that although there are differences between the two institutions, monetary councils, which have a proven track record in central bank policy, served as models in setting up the fiscal councils. Due to the current crisis, several Western European states and OECD member countries simultaneously had to face the fact that their general government deficit was swelling and government debt was increasing to unprecedented levels. *Reinhart – Rogoff* (2011) expressly state that due to the high and increasing government debts and the similar problems of the private sector, the period between 2008 and 2017 will be called the decade of debt in the developed world.

The gross government debt of the United States, the leading economic power of the world, already exceeds USD 14,300 billion, and the debt ratio equals more than 100 per cent of the US gross domestic product (GDP). In the United Kingdom, where the debt ratio amounted to 30 per cent some years ago, this ratio has grown to almost 60 per cent by now, while it is 94 per cent in Ireland, a country

Chart 3

GOVERNMENT DEBT IN THE WORLD AND IN HUNGARY, FIRST HALF OF 2011



Source: IMF[7]

where debt was a mere 25 per cent in 2007 and which is on the verge of national bankruptcy at present. Government debt in Japan, which was hit by natural disasters this last spring, increased to more than 200 per cent of GDP. This by itself already means serious indebtedness, and the expectedly huge reconstruction costs will only add to it *(see Chart 3)*.

At present, the debt-to-GDP ratio in Hungary is somewhat below 80 per cent,[8] which is lower than the values listed above, but the developments in Hungary are alarming from two aspects. In less than a decade, the government debt of Hungary increased by almost 30 percentage points, and as a result of the chronic overspending in recent years, Hungary has lost the confidence of investors as well, which reduced the level of sustainable debt.

The seriousness of the situation in Hungary also contributed to the fact that upon the renewal of the Constitution the new Hungarian Fiscal Council was granted a decision-making right, which is considerable even by international standards. In international practice, Hungary is an exception, as such institutions elsewhere only have a right to give an opinion. Many of the councils are typically independent organs that prepare studies regarding the budget and economic policy decisions, and formulate recommendations for the sustainability of fiscal policy. However, they do not have decision-making competence.

According to Wyplosz (2008), based on their competences, fiscal councils can be classified into three main groups. It is typical of the councils with the weakest mandates that their opinion fits in the process of preparing the budget, i.e. they can be considered as some kind of advisory institutions of the government and the national assembly, which prepare forecasts, but do not even come up with recommendations. This type of "wise men's council" can be found in Germany, South Korea, Mexico and Japan.

A great majority of the councils have some-

what wider powers than that, since they operate as advisory organisations that are independent of the legislature and the executive. Typically, their role and task is to submit recommendations every year for the budget of the given year; these recommendations are made public. Of course, it is the national assembly that decides on the budget. These councils have an effect on fiscal developments if they prove to be more influential and stronger than the interest groups whose interest is the increasing of fiscal expenditures and the reduction of taxes. Consequently, the strength of these councils lies in their credibility, and require other interest groups to be driven back, that is, good governance. Fiscal councils like that operate, for example, in Belgium, Denmark, the Netherlands and Chile. The council has a somewhat more important role in Sweden, where its mandate covers not only forecasting, but also the examination of the consequences of economic policy decisions.

However, the above models are not viable in highly indebted countries that have not followed a credible economic policy for years.[9] In such states, progress can only be brought by fiscal councils that also have decision-making rights, as the hands of governments inclined to overspend have to be tied. In theoretical works dealing with fiscal councils, this decision-making right is supposed to mean that the fiscal council is entitled to determine the size of the fiscal balance (typically of the budget deficit), but without having any influence on the magnitude or composition of the budget, which clearly constitute the tasks of the legislators. The strength of the decisions of the council is increased if they are mandatory for the government and the national assembly, i.e. the elected bodies (primarily the national assembly) have room for manoeuvre within the limits determined by the council.

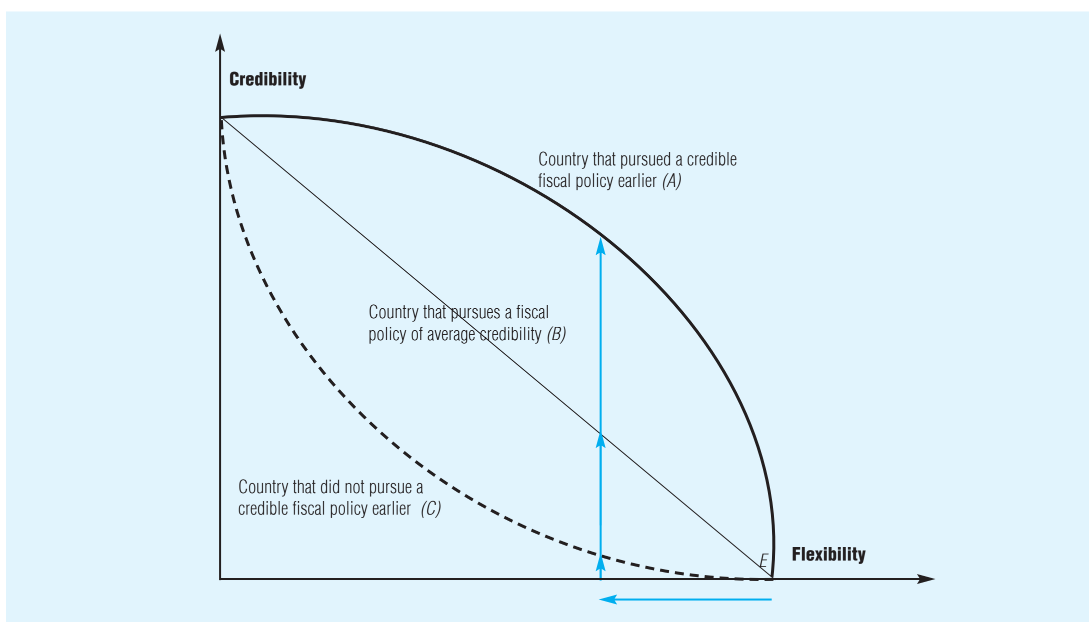
Although the Hungarian Fiscal Council cannot influence the absolute size and structure of the budget, pursuant to the Constitution it is obliged to prevent the budget from adding to government debt. The transformation of the Hungarian council in 2011 and the adoption of the new Constitution may serve as an example even at international level, because no other council has such strong decision-making rights anywhere else. The data and analyses of Calmfors (2011) and Wyplosz (2008) also suggest that Hungary is the only country to take the reduction of government debt so seriously that it has tied even its own hands in this respect.

In regulating the spending of public funds, the choice between credibility and flexibility as well as finding the right ratio always require consideration, as flexibility allows deviation from the norm and the promise, thus reducing credibility. The choice is largely determined by the past, experiences and institutional-cultural environment of the given country. Indeed, it matters whether or not a given country is credible on the basis of earlier experience: if a government is less credible, flexibility needs to be more limited in order to regain credibility, whereas increased flexibility entails only a smaller loss of credibility in the case of states that have been pursuing a reliable fiscal policy than in the case of a state that is not credible.

The possibility of a trade-off between credibility and flexibility and the differences in opportunities across states with various histories of credibility are illustrated in *Chart 4*.[10] In a given institutional environment it is not possible to achieve simultaneous improvements in the credibility and flexibility of the fiscal policy framework, i.e. a choice has to be made between the two "positive" factors. However, the opportunities vary across countries, depending primarily on the extent of their earlier credibility. Chart 4 shows the case of three countries: the credibility of country *A* has been above average, country *B* has had average cred-

Chart 4

CREDIBILITY AND FLEXIBILITY IN LIGHT OF THE CREDIBILITY OF EARLIER PERIODS



Source: own editing

ibility, while the credibility of country *C* has been below average in the past period.

Country *A* can significantly increase its credibility by having to make a smaller flexibility sacrifice (limitation) in exchange;

- To attain the same objective, country *C* has to give up most of or the whole of its possibility to pursue a flexible fiscal policy;
- The position of country *B* can be designated between countries *A* and *C*.

From 2002 on, Hungary was steadily losing its fiscal and economic policy credibility (in graphical terms, the curve expressing the possibilities was increasingly pressed towards the origin), which entailed that for a "unit" of improvement in credibility it had to give up an increasing share of the flexibility of the system. By 2010, the decline in credibility reached such a level that Hungary could not do anything else but set up the Fiscal Council and radically renew it in 2010; the Government had to tie its own hands for the sake of the credibility of the promise of deficit and debt reduction. The debt ceiling had to be set in the Constitution for the same reason; this also considerably reduces flexibility, that is, rapid adjustment to changes,[11] but because of the extent of the loss of credibility of the Hungarian economic policy, the country had to endure this as well in order to regain confidence. For years, economic literature has been debating whether credibility should be restored by so-called rule-based measures or through an institutional-organisational system that also allows flexible reactions. However, as a result of the chronic overspending in recent years, Hungary had no choice: the application of flexibility and soft solutions threatened with such a considerable loss of credibility that the country could not afford. Therefore, the only possible solution was to apply the rule-based system, which has to be operated by a Fiscal Council that is vested with strong authority.

The Hungarian council is in a special situation also because it does not have a staff of its own, i.e. it consists of only three members.

Independent council staff was dispensed with because the Council has two members (the Governor of the Central Bank and the President of the SAO) who direct independent institutions with a serious background of analysts, i.e. nothing justifies not to use the existing staff to prepare the impact studies and the analyses about the substantiation of the budget. Thus the Hungarian Fiscal Council is the smallest in the world, and as its members do not receive any remuneration, it is also certainly one of the most economical councils. This is extremely important in the current fiscal situation, both from the aspect of the budget and in terms of the social support necessary for the often painful transformations. Similar institutions of other countries employ at least a dozen staff; indeed, Calmfors – Wren-Lewis (2011) cite one with over 250, which would rightfully seem lavish in today's Hungary.

THE ROLE OF THE SAO IN ENSURING SUSTAINABLE PUBLIC FINANCES

The State Audit Office of Hungary (SAO) plays a prominent role in controlling the budget. As provided for in the Constitution, "the State Audit Office of Hungary is the financial and economic audit organisation of the National Assembly." The tasks of the SAO include, inter alia, a review of the financial management of the general government, and of the substantiation of the budget appropriation bill. The Fiscal Council works complementing the work of the SAO, but vested with other mandates; the close relationship between the two institutions is shown by the fact that the President of the SAO is one of the members of the Council.

The new SAO Act is also an important element of the renewal of the Hungarian public finance system.[12] The significance of the Act is shown by the fact that it was the first pivotal bill submitted to National Assembly following the adoption of the new Constitution. The SAO also participated in the preparation of the bill;[13] the Act was drafted relying on the SAO's more than twenty years of experience. This legal regulation, which entered into force on 1 July 2011, promises considerable renewal in three areas; namely, in the fields of the mandates of the SAO, independence guarantees, and transparency.

Sanctions for more efficient operations

Under the new Act, the SAO is vested with discernibly stronger powers than earlier in order to make sure audits will not remain without consequences. Although the Act retains the SAO's nature as an agency, it makes, unlike before, cooperation with it mandatory and sanctions failure to do so. In contrast with the permissive rules of the previous SAO Act, the new law includes provisions prescribing specific actions with deadlines attached.

The Act provides that the audited organisations must supply all the information and make available all the documentation required for the planning and conduct of audits. This is a significant step forward in that the previous legislation did not sanction refusal to cooperate, even though such refusal could have thwarted the audit. For the cases of squandering public funds, the President of the SAO has also been granted the right to initiate the freezing of funds or even the suspension of the disbursement of state subsidies. Pursuant to the new Act, the head of the audited organisation is obliged to draw up an action plan in response to the findings of the audit report and send it to the President of the SAO by a set deadline, while this provision was not included in the previous regulation.

The powers of the SAO are considerably bolstered by the prospect of up to three years

imprisonment for dishonouring the obligations related to SAO audits. In cases of minor violations of the law or wasteful practices, the Act also allows the President of the State Audit Office to remind the head of the audited organisation in a letter, who in this case is obliged to take the necessary measures and inform the President of the SAO thereof.

Strengthened independence of the SAO

The new SAO Act provides safeguards of independence as the backbone of the SAO's operations both financially and at the institutional and organisational levels. To that end, it is ensured that the SAO's budget is not reduced in nominal terms from one year to the next and it is assigned additional statutory responsibilities only if the necessary funds are also provided. Financial independence is also guaranteed by decoupling auditors' base remuneration from civil servants' pay as the act links auditors' earnings, which are subject to strict conflict of interest provisions, to the level of average national economy monthly gross earnings. Thus, changes in the base remuneration have become automatic, and hence the Government is prevented from influencing them.

As a safeguard of institutional and organisational independence, the SAO continues to report only to the National Assembly and the findings and conclusions of its reports may not be contested before courts or other authorities. The SAO works out the professional guidelines of audits and its methods on its own. The Act allows the President of the SAO considerable leeway in shaping the SAO's organisation, which enables the SAO to respond flexibly to new challenges. It remains a guarantee of independence that nominations for the SAO's President excludes candidates who have been members of the Government or acted as elected leaders in any party's central or national organ in the preceding four years. Another guarantee is the provision that requires the engagement of the President of the SAO in drafting any and all legislation on the SAO's work and the general government.

Transparent operations and the power of publicity

The Act attaches particular importance to the issue of transparency, which is considered a key principle (for more details, see Domokos, 2010), and requires that all SAO reports should be public. This is to ensure audit findings are made known to the public and thus contribute to the responsible management of public funds and national assets. It is the interest of operational transparency that, even though it is within the SAO's responsibility and competence to determine its audit methodologies, the Act places the SAO under an obligation to disclose the methods and professional guidelines which it follows in conducting audits.

Pursuant to the new Act, audits on the spending of public funds and the management of national assets have to be made available to the public. First, this improves the efficiency of the SAO's work and the utilisation of the reports. Namely, the SAO is neither a court, nor an authority; its power largely stems from publicity. Second, it complies with the democratic expectation of the society that tax-paying citizens want to know what happens to their money.

The Act also expresses the intention that the SAO's reports need to be considered an acknowledged and sought after source of information. Accordingly, the SAO, also taking the opportunities offered by the world wide web, conducts active and proactive communication, and ensures that socially relevant information reaches the public in an easy-to-understand form and through accessible channels.

Jegyzetek

[1] This article is an edited, supplemented and updated version of the presentation held at the Faculty of Economics of the University of Miskolc on 19 May 2011. Pál Péter Kolozsi, PhD also contributed to the compilation of this study.

[2] A considerable deterioration in public finances started in 2002. The (two-year) Budget Act concerning that year originally provided for a deficit of HUF 505 billion, which was raised by the 2001 Act on the Final Accounts to HUF 565 billion. The deficit was raised to HUF 1,249 billion in the 2003 Budget Act, but the actual deficit already exceeded HUF 1,570 billion, which was more than triple the original deficit.

[3] A negative net financing capacity means a net borrowing requirement. This is the amount that the state has to obtain through debt issues in order to maintain the solvency of the budget, not including debt repayments. General government deficit accounts for most of it.

[4] Although it is not a widespread solution, the Hungarian Constitution is not the only one that contains provisions for the magnitude of government debt: for example, in the Polish Constitution, which is considered one of the models of the Hungarian Constitution, its maximum extent is 55 per cent.

[5] The examination of **grounding** is one of the most important tasks of fiscal councils throughout the world, as this may significantly improve the credibility of fiscal policy.

[6] The Fiscal Council was established by Act LXXV of 2008 on Cost-efficient State Management and Fiscal Responsibility, and for the time being this is the act that regulates the operation of this body. However, the Constitution stipulates that the National Assembly has to enact a pivotal law on the Council.

[7] In the case of the United States of America, the total government deficit is included in the chart, i.e. not only the debt of the federal state.

[8] As a result of taking over the assets of the private pension funds, government debt declined by more than 5 percentage points in the summer of 2011.

[9] There are several developed states where fiscal councils with an advisory role have been working for decades, but government debt is growing. One of them is the United States: when the Congressional Budget Office was set up, government debt amounted to some 40 per cent; now it is nearly 100 per cent.

[10] As a result, moving in the direction of the origin from point *E*, representing maximum flexibility and zero credibility 10, Calmfors (2011) describes this trade-off phenomenon with a curve that is similar to the production possibility curve known from microeconomy. This is also the starting point of the schematic model presented in this study.

[11] As opposed to the rule-based solution, an institution-based solution also exists, which is much more flexible, as the authorised organisation always takes individual decisions. This only leads to the optimum (1) if there are consequences of the decisions of the institution that supervises fiscal policy, and (2) if the system is highly credible. Neither of these conditions was met in Hungary in the case of the original Fiscal Council.

[12] The Economic and IT Committee of the National Assembly decided on the submission of the Bill on the State Audit Office at its meeting on 9 May 2011. The Bill was passed by the National Assembly on 20 June 2011.

[13] The preparations for a possible transformation of the organisation started at the SAO in 2010, which

is well indicated by the fact that the Research Institute of the SAO organised a scientific conference entitled "Public policy challenges in the new decade" in May 2010. The edited versions of the presentations were published in Volume LV, 2010 /Third Issue of the Public Finance Quarterly.

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