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# *The Macroeconomic and Institutional Context of the 2012 Budget*

**SUMMARY:** In my paper, I look at the 2012 budget from two distinct points of view. Approaching from the perspective of the economic environment, I describe the most important lessons and relevant empirical experiences of budgetary adjustments as well as the topical macroeconomic and budgetary processes providing the foundation for next year's budget. The second half of the paper discusses the institutional environment of the adoption of the budget. The paper presents the tasks related to the preparation and adoption of the 2012 budget, providing assistance for the legislative work of Parliament adopted by the Fiscal Council and which also follow from the new Constitution adopted in April. In addition, I shall also give an overview of the analyses provided by the Hungarian National Bank (MNB) to be used by the Fiscal Council in its relevant work.

**KEYWORDS:** budgetary consolidation, macroeconomic path, Fiscal Council

**JEL-CODES:** G31, H6, E2

## THE MACROECONOMIC ENVIRONMENT OF THE 2012 BUDGET

### Basic Economic Processes

First, I would like to explore the issue of the possible effects of budgetary consolidation on growth outlooks. Several empirical studies have dealt with the same issue (e.g. McDermott and Wescott, 1996; Alesina and Perotti, 1995; Alesina and Ardagna, 1998; Giavazzi, Jappelli and Pagano, 2000; Von Hagen, Hughes Hallett and Strauch, 2001; Ardagna, 2004; Giudice, Turrini, int't Veld, 2007; Alesina, 2010). These studies generally arrived at the conclusion that fiscal consolidation tended to hold back growth in the short term. Although there are some exceptions to this; for instance, the consolidation implemented in Ireland and Denmark in the 1980s. Several factors influ-

ence the speed with which the impact of the fiscal consolidation, after the initial decline, turns into growth. The cited studies have shown that growth outlooks are more favourable, if the consolidation takes place in a positive international environment, if it is mostly based on measures on the expenditure side, if the output gap is negative at the outset, and if the CDS spreads were high before the consolidation was launched. Successful consolidation also tends to hinge on structural measures. On the other hand, consolidation tended to be less successful when preceded by a financial crisis. In light of the above, it is a question as to what kind of an opinion one should form about Hungary. What should be done to ensure that these so-called non-Keynesian growth incentive effects come into play in Hungary as soon as possible?

On the one hand, Hungary's CDS spreads need to be reduced as quickly as possible, which would have a positive effect on growth vis-à-vis the reduction of long-term interest

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rates. Unfortunately, currently the reduction of CDS spreads is held back by the growing concerns about the European debt crisis and the fact that regardless of how significant the reduction of the current external financing need of the Hungarian economy has been, shedding the accumulated large amounts of debt is going to be a slow process, which will continue to leave the Hungarian economy vulnerable in the long term. On the other hand, the government has set ambitious goals, which are laudable, however the announced measures carry significant implementation risks.

Investments, employment – and through that – growth would be encouraged by long term positive change in the revenue outlooks of the players of the economy prompted by budgetary consolidation. For example, if companies feel that no additional taxes will be imposed on them, that has a positive effect on their investment activities and general level of activity. This, however, is contradicted by the still fragile global recovery, by the fact that our neighbouring export markets are also undergoing fiscal consolidation and that Hungary is now being subject to a major balance-sheet adjustment. The population is grappling with an enormous debt burden, which is likely to hold back consumption in the medium term as well. Investment activity has been low in certain sectors in the long-term (in the construction industry as well as in the area of market services), which is further enhanced by the uncertainty of the regulatory and tax environments.

Thirdly, growth could also be kick started, if the banking sector would aid recovery through lending. Unfortunately, in reality we can see that Hungary is not in a very good position in this regard either. Lending has been on the rise in virtually all the countries in the region with the exception of Hungary.

In summary, it is reasonable to ascertain that although budgetary consolidation is underway, it should not be expected that the non-

Keynesian effects can substantially contribute to the mitigation of the direct demand shrinking effect of the measures.

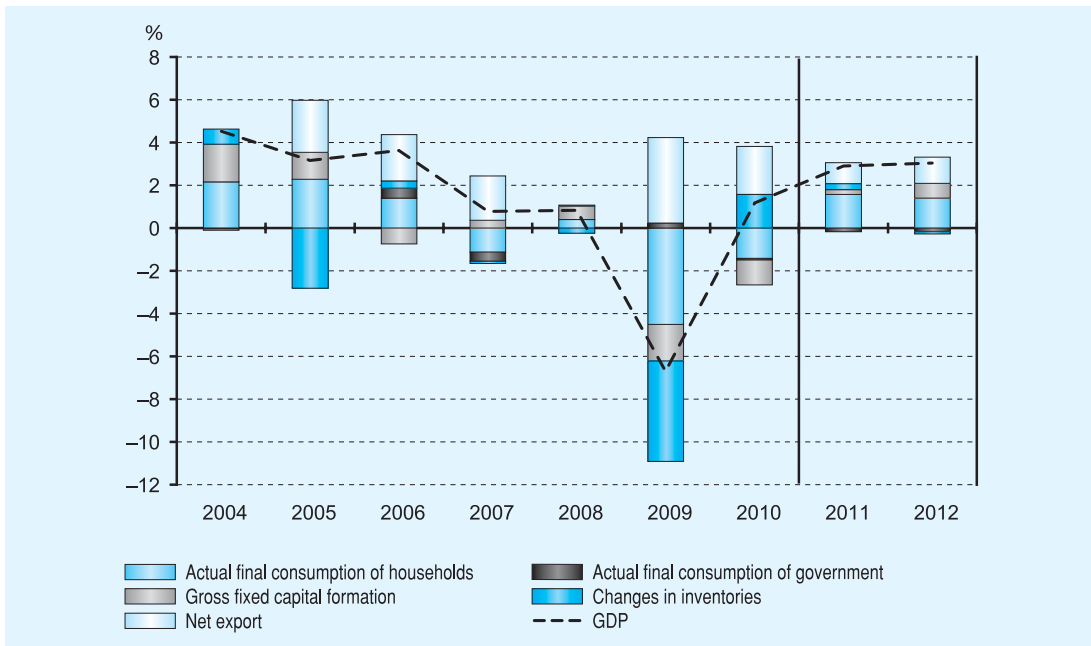
Let us now take a look at how the MNB views the macroeconomic outlooks of Hungary. I would like to cite the latest inflation report of the MNB from March. Based on the forecasts published in the report, growth of around 3 percent expected this year as well as next year. In contrast to previous forecasts, this growth and these changes already include the stimulating effect of consumption and investments in addition to the beneficial effect of net exports. (*See Chart 1*)

Internal demand is slow to pick up despite the fiscal incentives. As mentioned above, internal demand is particularly hard-hit by the restrained lending on the part of the banks. As seen in Chart 1, the domestic loan portfolio of the corporate and retail sectors dropped off steadily until the end of 2010, and the unfavourable tendencies have continued this year as well. Several analyses have been drawn up in MNB about the reasons thereof. In our opinion, when the crisis hit there were strong supply effects in place, whereas later on lower demand was the most important reason behind the reduction of the overall loan portfolio. Over the last few months, however, supply constraints have once again taken effect. That is to say that it is not loan demand that is holding back growth – although it is quite weak – but loan supply. (*See Chart 2*)

As mentioned earlier, the fact that outlooks are uncertain for the whole of Europe leaves its mark on employment and the development of internal demand. This, in turn, holds back the expansion of employment. *Chart 3* shows changes in GDP and employment during the years of the crisis and since the recovery. Ostensibly, in 2008-2009 during the recession, employment and GDP decreased proportionately in most countries. In contrast, since the start of the recovery, between the end of 2009 and

Chart 1

**THE STRUCTURE OF ANNUAL GDP CHANGES**



Source: MNB

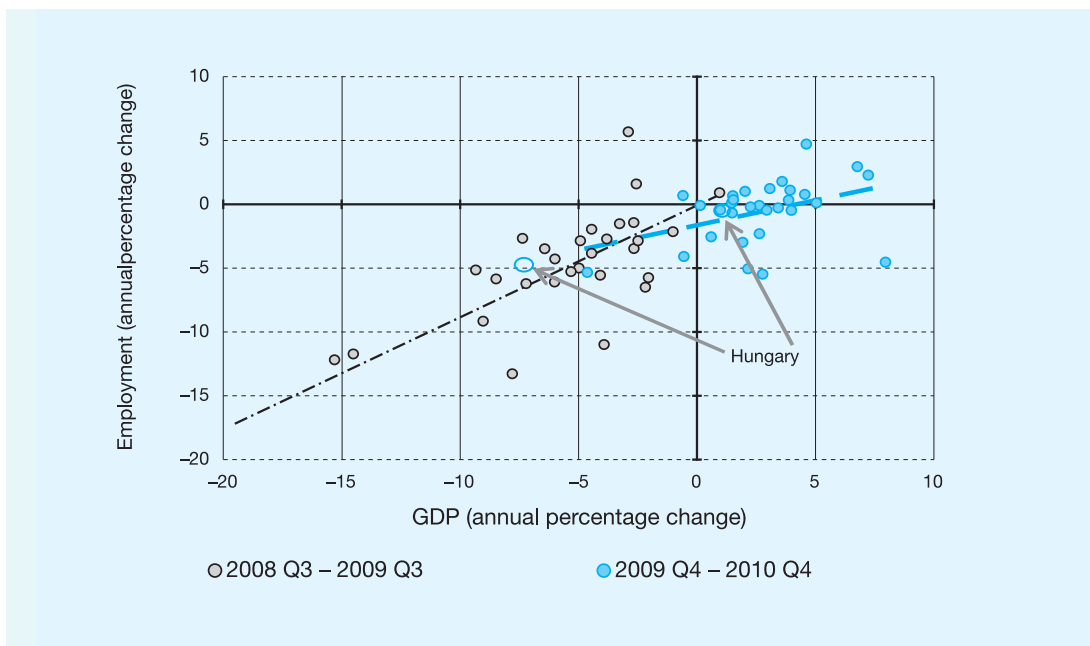
Chart 2

**CHANGES IN THE DOMESTIC LOAN PORTFOLIO OF THE CORPORATE AND RETAIL SECTORS – EXCHANGE RATE ADJUSTED**



Source: MNB

**CHANGES IN EMPLOYMENT AND GDP IN THE FIRST AND SECOND PHASES OF THE CRISIS**



Source: MNB

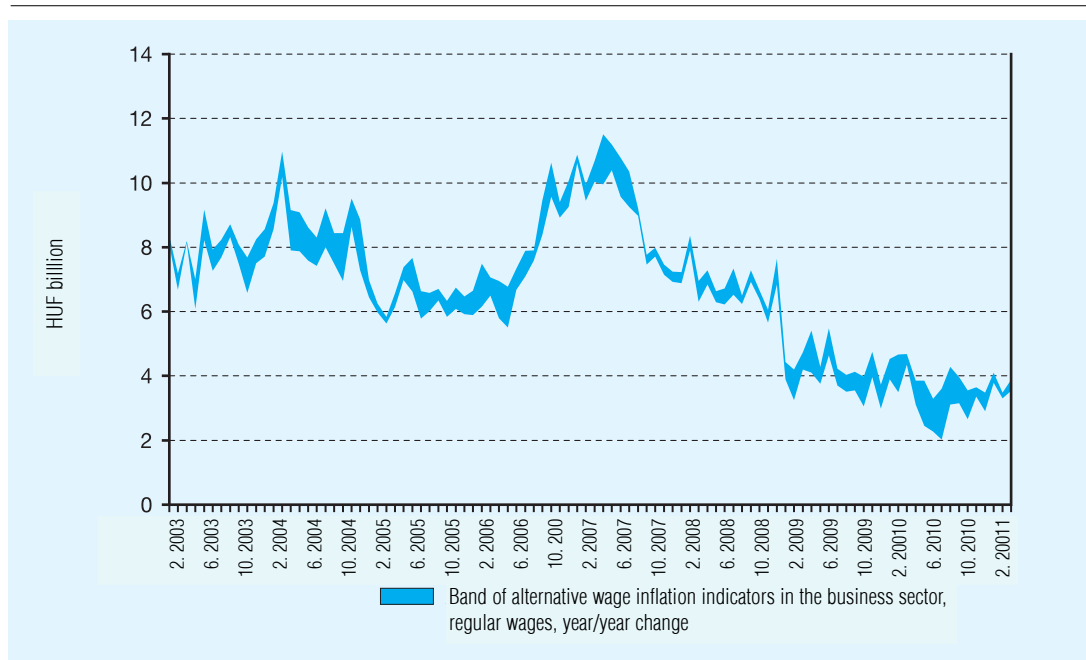
2010 – shown by the green dots here – although output has already started to expand, employment has not followed suit. This is what characterises the majority of countries, including Hungary. In our opinion, this might partly be due to the uncertainty of long-term outlooks.

That is to say that employment lags behind recovery, which creates a loose labour market in Hungary. In our opinion, unemployment will remain above 10 percent in the next two years in Hungary, as a result of which wage growth is expected to be extremely modest. In addition to a loose labour market, this could also be influenced by the possibility of increasing net wages with unchanging gross wages as a result of the PIT cut. Overall, it is our opinion that until the end of our forecast time horizon real wage growth may fall short of the expected growth in productivity. This could improve the competitiveness of the country and mitigate the inflationary pressure on the economy. (See Chart 4)

Generally speaking, inflationary processes are characterised by duality. On the one hand, the economy has been hit by significant cost shocks, which keep inflation high, especially items not included under core inflation. That is to say that there is an outside inflationary pressure that is essentially external in nature. At the same time, the internal inflationary pressure originating from the real economy is rather low, as is core inflation, which moderates ripple effects. According to our forecasts, the effects of the cost shocks will level out on the monetary policy horizon, and the 3 percent inflation target will be within reach by the end of 2012. However, there are significant two-way risks standing in the way of achieving this target. There is great uncertainty with regard to the future path of the cost shocks. In addition, the measures taken by the government – here I would like to mention the various measures taken by the government aimed at reducing demand, the elimination of price subsidies, the

Chart 4

## WAGE INFLATION INDICATORS



Source: MNB

treatment of the price moratorium and the measures designed to increase activity – pose significant uncertainty with regard to inflation. (See Chart 5)

### The public finances forecast of MNB for March

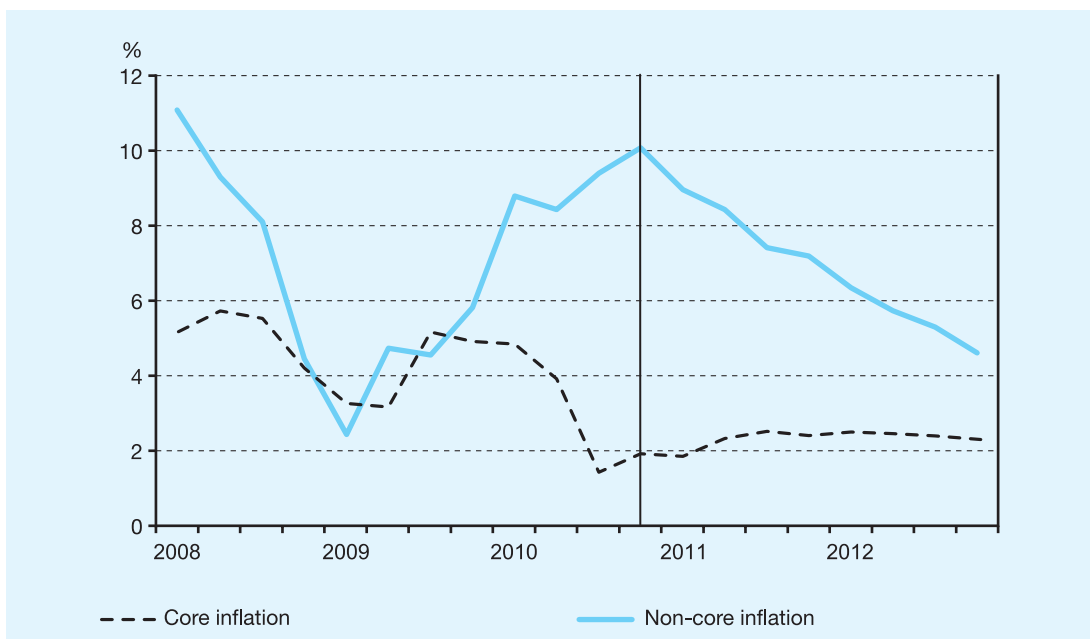
The March 2011 forecast of the MNB showed an accrual budget surplus of 2.5 percent of GDP for 2011. This figure was reached taking into account the transfer of private pension fund assets and the debt consolidation of MÁV (Hungarian State Railway Company), but did not include the information derived from the April EDP report of the government (i.e. the assumption of the debt of the Budapest Transport Company and the repurchasing of the PPP investment projects). The latter one-off items bring down the forecasted 2011 budget surplus by roughly 1 percent of GDP.

Because the details were unavailable, MNB was only able to take into consideration a fraction of the impact of the previously announced stability reserve as a rule.

In its 2012 forecast, MNB revealed two distinct fiscal paths.<sup>1</sup> In our rule-based forecast, due to the lack of detail, we were only able to take into consideration less than gross HUF 100 billion of the gross HUF 550 billion effect of the Széll Kálmán plan (Hungary's Structural Reform Programme) anticipated by the government (mainly the continued levying of the bank tax and the measures aimed at the restructuring of sick pay). Relative to 2011, this growth path showed a deteriorating balance and a current budget deficit of 4.6 percent of the GDP for 2012.

Considering that the government seemed to be committed to fiscal adjustment achieved through the reduction of government expenditure, in March of 2011 in addition to our usual rule-based forecast, we also presented an alter-

**ANNUAL PRICE CHANGE OF CORE INFLATION AND ITEMS NOT INCLUDED UNDER CORE INFLATION**



Source: MNB

native fiscal path, which was based on a normative approach. In this alternative scenario we took into consideration the entire, targeted balance improving effect of the Széll Kálmán Plan, but – pursuant to an expert estimate – we reduced the gross effect with indirect taxes, after which this netted effect was further reduced by the so-called “second-wave” effects originating from changes in the macroeconomic path. As a result, the expected 1.8 percent savings of the Széll Kálmán Plan for 2012 improved the balance of the budget by 1.2 percent of GDP. Ultimately, our alternative path predicted a budget deficit of 3.6 percent of GDP for 2012. Based on this it was already clear in March that the government’s 2012 deficit target of under 3 percent (2.5 percent of GDP) was unachievable even if the Széll Kálmán Plan was successfully implemented in its entirety.

In its fiscal forecasts, MNB uses the *cyclically adjusted augmented SNA balance* as the

indicator to describe the medium-term position of public finances assuming no further general government measures. Compared to the accrual based ESA balance, this indicator filters out the so-called quasi fiscal effects and the effects of “creative accounting”, spreads out the capital revenue derived from the withdrawals from the private pension fund scheme on a past horizon and adjusts the current balance for the fiscal effect of the economic cycle, which produces a result that better reflects the processes affecting the budget in the long-term.

The fiscal adjustments that took place after 2006 have continuously improved the medium-term position of public finances. Between 2006 and 2012 the structural balance improved from –9.3 percent to –1.3 percent of GDP. (See Chart 6) As a result of this adjustment process that lasted for several years, the medium-term position of public finances reached its best value to-date in 2010.<sup>2</sup> In 2011, as a result of the tax cuts

### HISTORIC CHANGES IN THE MEDIUM-TERM POSITION OF PUBLIC FINANCES AND THE MARCH FORECAST OF MNB



Source: MNB

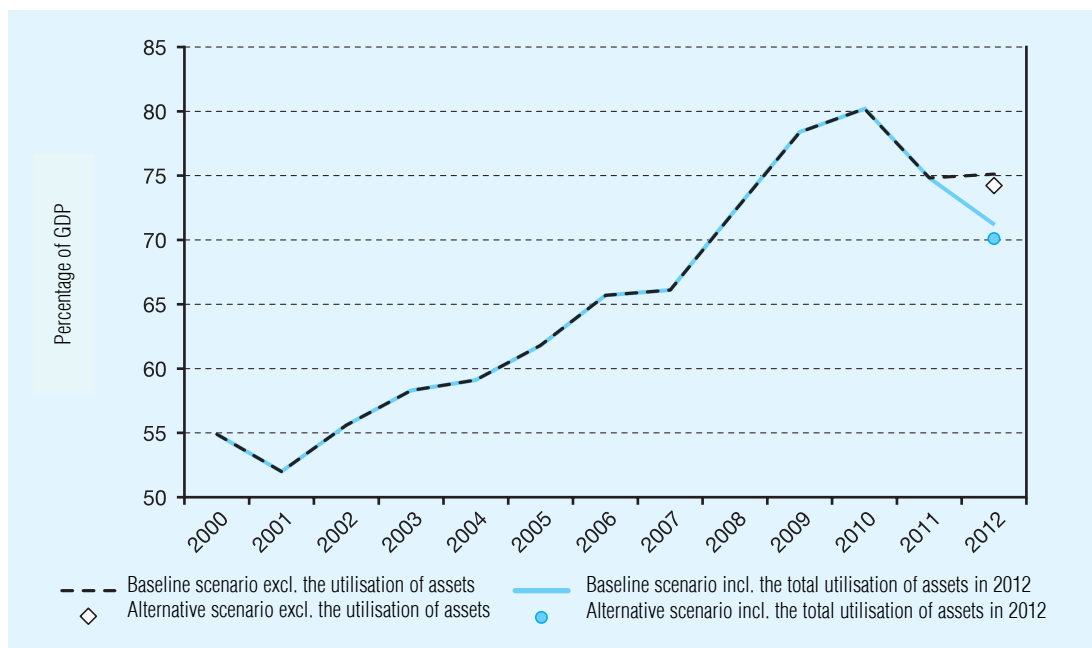
and the real yield payouts of private pension funds, the medium-term forecast is once again dropping off sharply (to -5.1 percent of GDP). Based on our rule-based Inflation Report of March, inflation is only going to improve slightly in 2012 (-4.0 percent), but given the alternative scenario – which assumes that the Széll Kálmán Plan will be implemented fully – into consideration, the rate of inflation ends up below 3 percent (-2.6 percent).

Since 2002, high levels of general government deficit have caused a rapid increase in public debt. (See Chart 7) In 2008 and 2009 the drawing of IMF/EU loans accelerated the growth of the gross debt ratio, but a part thereof was allocated in deposit form. The Hungarian Government drew a total of EUR 12.8 billion, of which it used EUR 9.5 billion until March to finance the general budget. Based on our March forecast, in 2011 the debt ratio will be reduced by 5 percent of GDP.

Although fiscal processes and debt assumption – without the long-term blocking of the stability reserve – have slightly elevated debt levels, this was offset by the one-off revenue item generated from private pension fund savings.

In 2012, it will only be possible to reduce debt levels, without resorting to the reserves, if the government consistently implements its plans to cut the deficit. In the beginning of 2012, there could be significant amounts (4–5 percent of GDP) at the government's disposal from the Pension Scheme Reform, the Debt Reduction Fund, as well as the deposit that was made from the IMF/EU loans. Therefore, changes in the debt ratio will significantly depend on the government's decision regarding what proportion of the reserve to use to finance the general government. Using the entire reserves to reduce the national debt could cut the year-end debt portfolio by up to 4 percent of GDP.

**HISTORIC CHANGES IN PUBLIC DEBT AND THE MARCH FORECAST OF MNB**



Source: MNB

The GDP redistribution ratio calculated from consolidated general government expenditure has remained virtually the same since 2006. In 2007, its value dropped from 56 percent calculated for 2006 (up primarily because of one-off items) to 50 percent, then fluctuated between 50 and 49 percent in 2008–2010. The effect of the adjustments is recognisable mainly in that despite the substantial shrinking of the denominator – i.e. GDP – during the crisis, the redistribution ratio did not increase considerably. Based on our March forecast, despite more accelerated economic growth, the redistribution ratio will even rise somewhat in 2011, from 48.9 percent last year to 49.2 percent this year.

The redistribution ratio forecasted by us will, however, drop in 2012. Under the alternative March Inflation Report scenario – which takes all the effects of the Széll Kálmán Plan into account – the same value is 1 percentage point lower (45.8 percent) as compared to the

calculations relying on the so-called rule-based path (46.7 percent). In the standard case scenario, expenditures expressed as a percentage of GDP are reduced by the one-off effect of the MÁV consolidation, decreasing interest costs, dwindling municipal investment projects and the fact that the most important expenditure aggregates (personnel and non-personnel expenses and transfers) are growing at a slower rate than the nominal growth rate of GDP.

**The Convergence Programme**

The convergence programme released by the government in April is a significant step forward in terms of revealing the details of the Széll Kálmán Plan as well as the fiscal policy of the next few years. As a result, the programme increases the credibility of economic policy and contributes to enhancing investors’ perception of Hungary.



The convergence programme presents concrete and quantifiable measures aimed at achieving the savings targets announced in the Széll Kálmán Plan. Moreover, the fact that the government has undertaken measures to reach the balance targets in addition to those stipulated by the Széll Kálmán Plan is commendable. That is because, as I have mentioned earlier, according to MNB's calculations the Széll Kálmán Plan in itself would not have been sufficient to meet the 2012 deficit target. According to the current preliminary calculations of MNB, the accrual-based 2012 deficit can only drop below 3 percent of GDP, if every measure of the convergence programme were implemented with the effect elaborated in the programme.

One of the highest risks in terms of the feasibility of the 2012 deficit target is in relation to the HUF 250 billion stability reserve generated in February of 2011. That is because according to the convergence program, this reserve would be cancelled this year and included in the planning basis next year. Due to the fact, however, that the details are as yet unknown, it is not possible to gauge the extent to which the implementation of the cancellation is supported by savings measures promising to be long-term, or by the simple shifting of this year's palpable expenditure tensions to next year. That is why it is imperative for the government to publish the cancellation of appropriations in a transparent manner and in sufficient detail.

As I have mentioned earlier, significant progress has been made in terms of the level of detail available on the Széll Kálmán Plan, but some of the implementation risks continue to persist. The outlined planned labour market and pension scheme measures of the government as well as the significant drop in the number of beneficiaries may lead to grave social tensions. If the government does not provide the necessary additional funds to promote the entry to the labour market of the groups

adversely affected by its measures, the resulting social consequences may run the risk of these planned measures becoming unsustainable. It is also worth noting that the government is planning to consolidate the debt of MÁV in 2011. Afterwards, in the next 2–3 years, theoretically the subsidisation of public transport can be reduced (in excess of the assumed interests) in a manner that is not underpinned by cutting operating costs, or real improvement in the efficiency of the public transport company. In this case, however, MÁV would once again face another round of indebtedness and the structural balance would not improve significantly.

We consider the announced labour market measures to be questionable in terms of their ability to live up to the expectations attached to them. In our opinion, the steps designed to reintegrate disabled pensioners into the labour market will only be able to improve employment figures to a marginal extent. The majority of disabled pensioners have a low level of education; more than 40 percent of them have only completed primary school. The employment chances of this layer of society are minimal. According to our calculations, in Hungary between 2004 and 2008 due to the already stringent disability pension regulations and practices, the number of disabled pensioners with a low level of qualifications has increased substantially. At the same time, the employment rate of this group remained the same. In contrast, disabled pensioners with a higher level of qualifications were successful in their attempts to return to the labour market. The ratio of successful job seekers in this group is equal to the ratio of non-disabled people in the same age group. The employment chances of people with low level qualifications have worsened further as a result of the crisis; this was the group hit hardest by increasing levels of unemployment. That is why, in our opinion, increasing the employment of disabled retirees will also require the establishment of active

labour market programmes, and these programmes will, in turn, require additional budgetary funds. (See Chart 8)

### The tasks of the Fiscal Council related to the 2012 Budget and planned MNB analyses to support the work of the Council

The new Constitution is going to enter into force on January 1, 2012. Therefore, until then the operation of the Fiscal Council (FC) will be governed by provisional rules currently stipulated by Act LXXV of 2008 on Cost-efficient State Management and Fiscal Responsibility. Although the Fiscal Responsibility Act only stipulates one responsibility of the FC (providing an opinion on the Act on the Budget before its submission for debate), in its spirit it is no different from the Constitution in that a legislative desire to establish an FC with more overarching responsibilities is apparent from the wording of the Act.

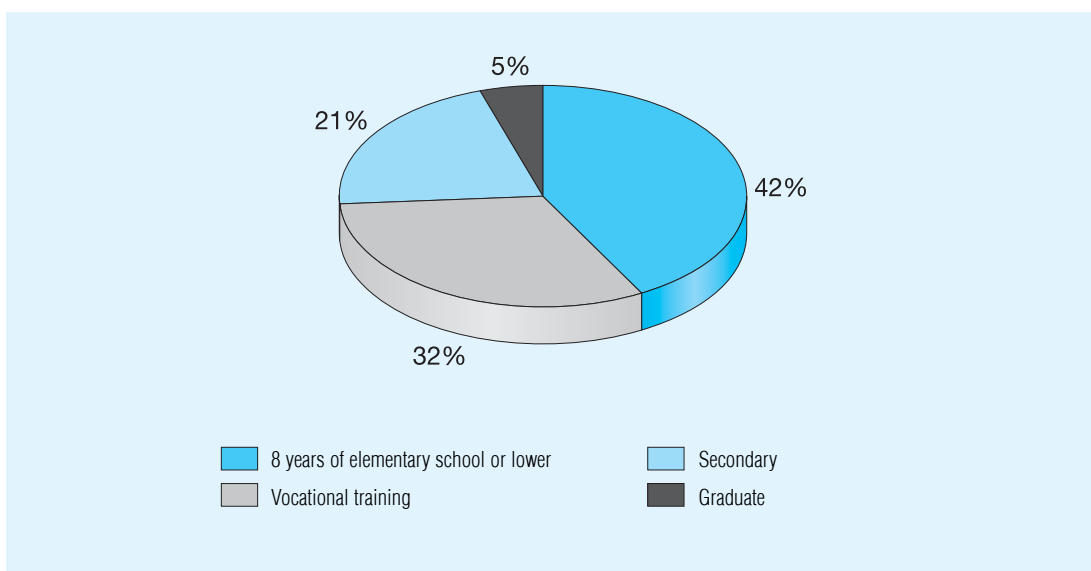
The Constitution determines the fundamental provisions with respect to the FC<sup>3</sup> as well as the fundamental rules pertaining to the central budget<sup>4</sup>, which the FC must take into consideration during its work. The Constitution bestowed the following strong powers onto the Fiscal Council:

- ❶ The Fiscal Council is an organ that supports the legislative activity of the National Assembly and examines the substantiation of the central budget.
- ❷ The Fiscal Council contributes to the preparation of the Central Budget Act in the manner specified by law.
- ❸ The prior approval of the Fiscal Council is required for the adoption of the Central Budget Act – in order to comply with Paragraphs (4) and (5) of Article 36 of the Constitution.

These strong powers in independent, democratic countries where the rule of law predominates such as Hungary entail certain obligations. That is because one of the tenets of the rule of law is legal security, which is essentially condi-

Chart 8

#### DISABLED PENSIONERS ACCORDING TO LEVEL OF EDUCATION IN 2010



Source: MNB

tional upon the predictable behaviour of law enforcers – for instance on how the FC exercises its powers. It follows from the requirements of the rule of law and legal security that the draft legislation must clearly delineate the framework and criteria under which the FC can exercise its powers. The Council must live up to its strong mandate, namely through independent, transparent and expedient operation as well as the provision of professionally sound opinions. Without an objective framework, independence and transparency the operation of the Fiscal Council would be unpredictable and subjective as a result of which its decisions would become questionable.

Independence not only means independence from other government bodies, but also independence of Council members from one another. This is not the case today, as the SAO audits the MNB and the president of the Council is the president of the Supervisory Board of the central bank, who thus also audits the central bank. In addition, the SAO is also entitled to audit the Supervisory Board of the MNB. This is not in line with international best practices, but that does not mean that the body cannot function properly. Professional credibility, however, hinges on the FC's ability to adequately support its decisions and make them available to all interested, disclose any dissenting opinions, make analyses publicly available and ensure that the analytical methodologies used are controllable. One of the most important common reasons why fiscal councils are established around the world is to increase transparency for legislators as well as for the general public, the tax payers of the country. This task, however, can only be implemented, if the institutions themselves operate transparently.

MNB wishes to contribute to the professional grounds on which the FC makes its decisions through several analyses, the planned content and the publication schedule of which

I will now present in brief. The analyses prepared for the FC are no different from the other publications of the MNB in terms of their sophistication, but their focus tends to be somewhat different in that they evaluate the fiscal processes, the deliverability of balance targets and fiscal sustainability as opposed to the effects of fiscal policy on the macroeconomy and financial stability. The themes and the time horizon of the analyses were determined with a view to what is relevant for the ministries working on the preparation of the Act on the Budget, the MPs that will vote on the bill and also to ensure that it related to the budget planning cycle. Naturally, in addition to the analyses of MNB the FC is also going to take other background materials into account in order to be able to fully perform its task.

The fundamental objective of the *medium-term outlook* based on the already adopted budget to be first published in 2012 is to provide a strategic foundation and support for the next budget. On the one hand, this analysis would contain the medium-term (4–5 year) impact study of the Act on the Budget and other relevant pieces of legislation, with particular regard to the constitutional debt rule and the enforcement of the requirements stemming from EU membership. On the other hand, the analysis would also assist in gauging what kind of amendments are necessary to relevant legislation in the medium term. To this end it would shed light on the delayed, long-term effects of the demographic, employment trends and relevant acts of legislation.

Our analysis of the *planning frameworks*, which we plan to publish as early as this summer, is aligned with the start of the preparation of the current budget appropriation bill. The purpose of the analysis is to present the planning basis that determines the budgetary elbow room available next year and to expand the relevant information pool available especially to legislators. The publication would evaluate the relevant

budgetary processes of the current year, give a forecast on expected compliance with the budget balance and the core lines of the budget, and would also take the risks that need to be considered during planning into account.

Providing a preliminary opinion on *the budget appropriation bill of the government* is linked to the closure of the preparatory phase, the main purpose of which is to call the attention of the government and the legislature to the planning problems that need to be resolved before the bill is submitted for debate. Therefore, it would assess the draft bill on the basis of the following considerations:

- the substantiation of the macroeconomic forecast;
- the extent to which revenues and expenditure are in line with the most likely macroeconomic path and the related legislation (acts and decrees);
- the extent to which the deficit arising therefrom is in line with the debt rule stipulated by the Constitution;
- whether the proposal complies with the provisions of the Acts on Budgetary Responsibility and Public Finances with regard to transparency and reasonable level of required detail;
- the evaluation of the structural position of the budget;
- whether the budget is consistent with the requirements arising from EU membership,
- taking account of the most significant risks affecting the budget.

The analysis containing a *repeated opinion on the budget appropriation bill* would be drawn up in time for the vote on the key figures of the budget (presumably in November). The purpose of this analysis would be to assess what steps have been taken in terms of the budget balance as a result of the relevant new acts of legislation and motions for the amendment of legislation submitted since the first opinion on the budget appropriation bill. The importance of providing an opinion on the bill will be enhanced by the fact that in the future the budget can only be adopted with the prior approval of the FC. The decision of the FC in this regard must not come as a surprise to Parliament, the government or the public. That is why the Council must inform the stakeholders about its position while the Act on the Budget is being worked out, in order to enable them to eliminate the circumstances that stand in the way of the FC's consent.

The aspects of the second report would match those applicable to the opinion to be provided prior to the submission of the draft bill, but in the second round, it would rely on a more extensive base of information. Based on our experience, several key pieces of information providing a basis for the budget are only revealed after the bill has already been submitted. These include the detailed macroeconomic path assumed by the government, the three-year budget outlook, or the detailed justification of the appropriations under the various chapters.

## NOTES

<sup>1</sup> At the time the article was submitted (10 June 2011), MNB's forecast for June was not yet available.

<sup>2</sup> This is partly due to the revenues generated from extraordinary taxes, which represent 1.3 percent of GDP, for which this particular structural indicator

does not filter, and also to the fact that the value of the cyclical component calculated by us – -2.4 of the GDP – was at its worst in 2010.

<sup>3</sup> Article 44 of the Constitution

<sup>4</sup> Articles 36-37 of the Constitution

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