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Enforcing budget discipline in Hungary and abroad

In October 2007, the Hungarian government submitted to parliament a bill on a fiscal responsibility framework. In this article, the concept and inner logic of the bill as well as some social and future political issues related to the bill but pointing further ahead are to be considered. Within the framework of the above, the European practice as well as a few months earlier concept of the Ministry of Finance on a similar issue, are to be examined. The article is meant to be part of the discourse on the bill. Two problems are to be considered:

- *the first question to be examined is whether the bill submitted can be regarded as the best possible proposal considering narrower professional criteria and*
- *the other question is if there is a consensus on the broader institutional and social political consequences of the bill, if once passed.*

As intended by the proposers of the bill, Parliament is to make a decision on the issue only after a comprehensive professional and parliamentary debate sometime in spring 2008. At the time of writing this article[1]*, we are thus at a relatively early stage of legislation. Both the professional content of the bill and the political support for it are still fluid. The approach outlined above is thus, in my opinion, still justified.*

PROFESSIONAL AND INTERNATIONAL REVIEW

This chapter is to provide guidelines for the first question, considering examples from the European Union primarily, justified by Hungary's intention to join the euro zone and the compulsion for adjustment to the EMU stability requirements. It is the quality of the suggested changes that should be made clear first. Let us suppose that the changes are implemented at the proposed pace by 2010. Could we then maintain that the budget has been reformed?

Reform or system correction only?

The bill is intended to establish a *new framework system for budget discipline*[2] in two ways basically:

- through numerical and procedural rules, on the one hand, which 'hamstring' the preparation and approval of the budget as it were, and
- through a new, independent institution to monitor the enforcement of the rules, i.e. through imposing institutional control on the budget.

The new framework system for budget discipline would be a firm response to the budget fiasco that peaked in 2006: it would mean more than the firefighting measures taken in 2006 but, in international comparison, it would be less than a real reform. There are two reasons why the proposed disciplinary framework system cannot be regarded a real reform.

◗ The disadvantages of 'hamstringing', i.e. strict regulation, are well known: rigidity as well as unwanted side effects apparent in other success indicators. Although these disadvantages can be mitigated by refining the rules, they cannot be abolished completely.[3]

◗ The international experience of the real budget reform, *program budgeting,* is also well-known, at the same time. Unlike the disciplinary framework system, this is not a 'necessary evil'-type change but a novelty grasping the essence of the public sector: its weaknesses and strengths compared to the competition sector. There is ample information in the literature on both international solutions and Hungarian experiments.[4]

The main reason for the need to enforce budget discipline is budget *deficit bias.* International experience shows two main reasons for long-term deficit bias: excessive welfare commitments and the ageing of the population. Another shorter-term political reason characteristic under Hungarian conditions may be the efforts of political parties to gain advantage at the elections and consequently an inclination towards excessive distribution, burdening future generations.

The two main pillars of the framework system used in the international practice are numerical *fiscal rules* on the one hand, which impose permanent fiscal constraints expressed in some summarising fiscal performance indicator, and *independent institutions* of fiscal functions on the other hand. The latter are typically financed by public money and participate in budget related activities functionally independent from the government.[5] Keeping the Hungarian bill in mind, the following two subchapters examine the European Union experiences on the two pillars.

The two basic subtypes of refining budget rules[6]

A detailed description of the rules used in the international practice is beyond the scope of this article and can be avoided also because it is not the types of indicators suggested for Hungary, only the threshold values of these indicators specified in the rules that are questioned in later parts of this article. At the same time, two notes drawn as a conclusion from the international practice may be illuminating for the Hungarian regulation.

◗ The format of the rules is acts or, more frequently, directives or agreements. Considering country experiences it can be established that *there is no correlation between the format and the efficiency of rules;* efficiency rather depends on other country specific factors. In addition to the rates laid down in the rules, the consequence of non-performance is also an important circumstance.

◗ Through due attention and by avoiding the negative international experience, Hungary may possibly use the advantage of countries with developmental delay. In the European Union, there has been an intensified debate on the rigidity and harmful side effects of the fiscal rules in the Stability and Growth Pact, like the increasing fluctuation of issuing or the distortions in the structure of expenditures, as well as on two possible alternatives for rule refinement.

One method of rule refinement that may come into question is target determination for the cyclically corrected budget *(= refinement along the time dimension)* following the example of Chile[7], for instance, where the target is a structural balance excess of GDP 1 per cent.

Within this, the fluctuation of annual balances is tolerated.

The other type of rule refinement is *along the structural dimension.* Under this, different rules would apply for the various budget components of a different nature. There are European examples and expert recommendations for excluding investment from fiscal constraints. This is what is referred to as the *golden rule*, the strongest argument for which is the avoidance of unfair generational redistribution. Under the latter, a margin should be set between items of expenditure favourable for the present generation only and items with advantages spread over time, favourable for both present and future generations. For the protection of the present generation, borrowing is justified to the extent of net investment while, with regard to the future generation, net investment should be increased to the extent of borrowing.

Independent budget institutions in Europe

The part of the bill deserving the most attention and generating the most disputes refers to the establishment of a Legislative Budget Bureau independent of the government, considering which the international experiences on independent budget institutions may be especially important. Before a summary on this, it is advisable, however, to make a short detour and compare monetary and fiscal policies with respect to function independence.

Can an institution implementing fiscal policy be made independent?

For fiscal policy, monetary policy which, in order to meet the inflation target, relies on the independence of the bank of issue basically, rather than on an intermediary target variable like the amount of money, may be an example to follow *in principle.* Based on the analogy of the monetary policy and the bank of issue, implementing fiscal policy could be, *in theory*, possible through an institution independent from the government, certainly excluding redistribution issues of a political nature from the delegated authorities. Despite the theoretical possibility, there are not any examples for this really. Although the danger of distortion caused by politics speaks for independence, there are other aspects speaking against it.

◗ First of all, there should be a consensus on what a healthy fiscal policy is all about, but the stabilisation and sustainability requirement to be determined need political consideration, on the other hand, for which an independent institution is unsuitable.

◗ Making the fiscal function independent may not cause any coordination disturbance with other, unindependent functions of governing like the labour market, for example. This is a requirement that fiscal policy, due to its effects more direct than those of monetary policy, is hardly able to meet.

Although it seems that the fiscal function itself cannot be made independent, some of its sub-functions can. For practical considerations, there have existed independent institutions with important fiscal sub-functions for a relatively long time.

Observations about independent budget institutions in Europe

There is special attention given to independent budget institutions by international and Hungarian literature as well as by the European Union. The following observations are based on an EU survey summarised in a study.[8]

There are independent budget institutions (IBI's) operating in 15 member states of the EU. From the point of view of this survey, the type of IBI, i.e. whether it is *an audit office or another type of institution,* is an important aspect. In seven member states, audit offices have independent budget functions beyond their basic functions, while there are ten countries where institutions of a different type but with a similar function exist. There is little overlap between these two sets; moreover, in the two countries where there is, the non-audit office IBI has a scope of specialised duties.

OBSERVATION ❶: *in EU countries, it is either exclusively audit offices or institutions of another kind that have independent budget functions; parallel responsibilities in this respect are untypical.*

The second major aspect for analysis and grouping is whether the IBI concerned contributes to the budget in a normative way (through qualifying observations and recommendations) or in a constructive, positive way (typically through macroeconomic prognoses). The typical functions of audit offices, sometimes with independent budget functions, are normative observations and recommendations, and it also holds for other IBI's that the two above types of activity are typically mutually exclusive within the same institution.

OBSERVATION ❷: *institutions making prognoses serving as a basis for budgets or conducting other activities that are incorporated into budgets, do not usually make qualifications or observations.*

Another important aspect is whether the IBI concerned exercises its independent budget function during the process of planning and/or execution (ex post). Regarding this aspect, the distribution of audit offices functioning also as IBI's is about the same in both groups, while other IBI's are mostly involved in the foundation and planning phase of budgets.

OBSERVATION ❸: *EU countries typically do not see a conflict of interest between preliminary and ex-post independent fiscal institutional contribution and control – not even in the case of audit offices.*

It is also an important question to what extent the independent budget function is taken seriously. Among audit offices, there are no examples for the independent institutional 'input' to be formally obligatory, and these are rare also among non-audit office institutions. Remarkably, there are some countries, however, where it is *not absolutely optional* to follow the recommendations; in some cases, for instance, recommendations are partially obligatory to follow or are always followed in practice, or in other cases the rejection of recommendations requires public justification.

Considering the 'seriousness' of implementing the recommendations, the *British* audit office is interesting from a professional point of view: it is obligatory for the treasury to consult the audit office on the conditions serving as the basis for planning and, in practice, it always follows the recommendations of the office despite the lack of legal obligation.

In the EU, there are unique combinations of the aspects examined. In *Belgium*, the government is obliged to use the macroeconomic prognoses made by independent institutions, and fiscal target recommendations by the Belgian Supreme Financial Council are similarly obligatory to follow.

In the Hungarian budget renewal concept, the rule enforcement control of the budget plan is an important IBI-function, for which there are relatively few examples in the European Union. (There is a Dutch, a Danish and a Swedish institution with similar functions.)

OBSERVATION ❹: *The quasi obligatory authority of the proposed independent budget institution in Hungary is not unique in the EU environment, its planned function, however – i.e. the rule enforcement control of the budget plan – would be rather unique.*

Finally, the current pre-audit function of the *Hungarian* audit office should be mentioned as a solution professionally appreciated in the EU; in this case, it depends on the government if the recommendations are used. Irrespective of the unique circumstances of the establishment of this function and its disputedness by the auditing profession[9], international trends imply that pre-audit functions are not alien to audit offices. A similar example is the above mentioned function of the British audit office, which has a narrower scope than its Hungarian counterpart but its observations are quasi obligatory to follow.

SOME THOUGHTS ABOUT THE PLANNED FISCAL RESPONSIBILITY FRAMEWORK IN HUNGARY[10]

General observations

The bill proposes the introduction of numerical and procedural rules and the establishment of an independent budget institution, the Legislative Budget Bureau (Bureau). International experience shows that fiscal rules and independent institutions can complement each other well. Numerical rules – including procedural rules – may be inflexible, while independent institutions – depending on their mandates – may flexibly adjust to circumstances.

The rule system proposed is extremely complicated: it includes correlations and feedback embracing a period of several years, independent and decision variables, mediatory and target variables, which make it a manful algorithmic challenge for non-mathematicians.[11] My general opinion on the rules in the bill is that – although they fit into a persuasive-looking closed model – they are abstract and rigid. In the rule system, there is little opportunity for adjustment and feedback to the political dilemmas of the present and the uncertainty factors of the future.

The rigidity of the rule system would be no problem if the planned Bureau introduced sufficient flexibility into the system. But it does not because it is not given an independent fiscal political role. On the basis of the bill it seems that the officials involved in preparing legislation, to be employed at the Bureau, would practically be an assistant capacity of economic analyses of the parliament committee in authority, which, considering the complicated rules, is certainly a function well needed. The scope of service duties determined in the proposal, at the same time, does not enable the Bureau or the framework system to be established together with it, to flexibly react to already known and to unforeseeable economic, financial and political challenges.

Below, an analysis of the bill is to follow provision by provision, which also matches a logical order more or less. During the analysis, the question of the Bureau is to be discussed once again, but it is some notes regarding the rules that are to come first.

Rules in the bill

The structure and logic of the rules

The bill would, rightly, introduce *multi-year planning* as a basic system element: from the year of planning, three years should be planned ahead and, with respect to one benchmark, there should be a review of one year. The closer the year planned, the more operatively realisable *type of indicator* is prescribed for the year concerned (N = year of planning):

$N+1$: appropriations	$N+2$: balance	$N+3$: debt

As the second basic principle, the closer the year planned, the easier it *is to influence* the indicator to be used within the framework of budget planning. So as to foster this – mapping reality – the bill differentiates items that are influenceable within the framework of budget making ('inner') and others that are not influenceable (not influenceable any longer or not influenceable at all, 'outer') items. In the following demonstration, the arrow pointing downwards indicates logical correlation:

(inner item-balance planned in year *N*–2. ↓)	(primary balance planned in year *N*–1 ↓) balance of inner items	(debt target↓) primary balance
appropriations (bill)	appropriations (government order)	appropriations (government order)
Planning for year *N* +1	for *N* +2	for *N* +3

Rule refinements

The system proposed by the bill does not contain, as a general system element, any refinements for cyclical fluctuation or the management of investments, but some detail rules do. The proposal contains two refining corrections in the case of the central budget and one in the case of the local budget.

◗ The rule on the real value of state debt specifies two base years (the years one year and four years prior to the year planned), whereby the regulation covers five years altogether, expected to neutralise the election cycle.

◗ From the bases of the above rule, the earlier base is an adjusted factual figure (in fact the target figure), which is meant to filter extraordinary, one-off effects (like catastrophes, compensation commitments) and random after-effects.

◗ Under the bill, local governments could basically run up long term-debts for development purposes only.

Potential and foreseeable problems in case the proposed system is introduced

◘ In modelling in general and especially in an extremely algorithmised model like this, 'redundantly' overdetermined (through more than necessary factors) operation may cause problems. Under the bill, both primary balance and real debt are doubly determined. Uncertainty in codification is the lesser problem (a suggested complementation is that always the stricter rule should be applicable); a bigger problem in future could be potential tension triggered by the enforcement of the act, caused by two distant benchmark years, for instance, which could be difficult to cope with. The unfortunate recurrence of extraordinary expenditures, for instance, could make the gap between the earlier and later debt bases unbridgeable.

◘ In the Finance Ministry concept prior to the bill (May 2007), within the inner items[12] there was a further differentiation between inherited items and items for voting, i.e. the regulation of *determination*. In the current bill, there are soft rules on determination: for the time of submitting the budget bill, only publishing information on the commitments and, after the budget has been passed, issuing the relevant government order are prescribed, two years ahead. It is no use that the rule on debt spans a complete election cycle once determination is softly regulated. The proposed system may give room, in the form of a balance determined by commitments, to the 'electional budget' meant to be expelled from the system and the political distortion following therefrom.

◘ Several provisions of the bill rule on the categorisation of appropriations under 'inner' and 'outer' items, which would mean a tough priority ranking for 1–2 years ahead during the preparation of the budget bill. The addressees of 'outer' expenditures would not have to worry with respect to 1–2 years after the planning because, under the rules, the budget balance requirement would then be forced out to the detriment of the balance of inner items unilaterally. Under the proposal, individual entitlements determined by other acts would be regarded as outer items. If the bill is passed, there will surely be competition for the status of 'outer item of expenditure' in future.

This latter is already a *political issue* indeed. Why is it that the pension increment of old-age pensioners, determined by the pension act and demography, enjoys preferential treatment to the increment of the specific medical costs of patients determined by the state of national health, demography and medical techniques, for example? Only because medical services are services in kind rather than cash vouchers incorporating individual entitlement?[13]

Target variable, intermediary targets and political content

We have now reached political dilemmas. The target variable of the system enshrined in the bill is *the real value of state debt;* the value of the target variable is the constancy of its amount. Why exactly this? What is the content of the chosen target value? These questions are to be discussed below.

In connection with the first question it is to be noted that the chosen target variable value is insufficiently justified compared to the precise elaboration on the algorithm of implementation. However, the target variable is the basis of the whole construction and the solidity of a building, too, depends mostly on the foundation. The essence of the chosen target variable value is freezing debts and gradually 'growing out of them'.

The central element of the bill is the effects analysis. It would be expedient to extend this to the target variable value along the logic of the following questions.[14]

◗ What could a 'technical projection'- to have been carried out before the generous pay rises in 2002 – have resulted in with reference to the 21st century generational redistribution in Hungary?

◗ How much distortion has been caused in this by the new sharp deterioration of the state balance?

◗ What shift could be triggered here by the chosen target variable, considering the gloomy demographic and employment perspectives of the nation and the uncertainty of economic growth?

◗ And finally, is the selected adjustment course fair enough for the future generation or could an alternative course with balance requirements still bearable for the generations of the present and the near future be outlined against it?

To the second question raised with reference to the target variable (What is the content of the chosen target value?), the annex of the above quoted preliminary Finance Ministry concept gives the answer: according to the other formulation of the target value, for foreseeable time, the debt ratio must fall by the extent of real growth, and the current annual primary balance excess must cover the real interest.

The chosen target variable value may trigger *problems* needing serious consideration if the system is introduced.

▣ Following from the target value, the budget must, for foreseeable time, squeeze out of society and the economy the interest price of the earlier pay rises, i.e. the further growth of burden on the future generation must be prevented at least in real value. Although this is a modest expectation regarding the future, it is a serious one regarding the society of today, especially considering that the earlier pay rises did not result in any social satisfaction or confidence reserves. A requirement like this should not be treated as a question of fiscal discipline and responsibility only. Unless the government promotes social consensus by straight rhetoric, the lack of agreement will be apparent in all salary and social dialogues, which even a precisely formulated act on fiscal discipline will be unable to tackle.

▣ Unfavourable external growth, a bad economic policy and a lack of interest caused by stagnating real-utilisation may, in turn, cause permanent economic stagnation (or even decline in a worse case), as a consequence of which the debt ratio would not decrease on the basis of the proposed target variable value. The question is if the future state debt creditors would tolerate this. If they would not, the rising cost of loans would demand an even greater sacrifice from the country, in the form of further balance improvement, which would further decrease the chance for an upswing. The question is if the country could avoid sinking into a financial and domestic political bankruptcy along a negative spiral.

■ The other side of the debt rule proposed by the bill is that – in contrast to real growth – it would allow debt increase by the extent of the planned inflation. This form of leniency raises concerns. Decreasing inflation is a goal of the same importance as debt reduction. It is not expedient, with reference to one of the goals – i.e. the debt rule – to open a valve for counterpressure that may set free forces adversely affecting another important goal, fighting inflation. If the longer-term goal of budget policy is formulated as the freezing of debts, it should be considered – following the Stability and Growth Pact, which is stricter than the bill – *to nominally* freeze debts and ease the rigidity of the system in another way.

About the planned Bureau

We are now back to the rigidity of the system, easing which the Bureau, within the framework of its planned mandate, will not be suitable for, as mentioned above.

The bill grants an undisputed advance in the framework system for budget discipline. The bill extends control not only *in time* (medium-term planning), but also *in subject,* in the following way:

- effects analysis and budget filter with reference not only to the contents of the budget bill but to all acts affecting the budget;
- an offset commitment in the case of any bill or draft amendment involving budget expenditure.

It is also undisputable that, for implementing the above controls, the scope of duties of the Bureau enacted in the bill, but not necessarily the Bureau itself, is required. International examples, including those in the EU, show that, in the case of independent budget institutions, the conflict of interest is between *normative* (qualifying, evaluating) and *positive* (macroeconomic predictions to be used as an obligatory input, for instance) functions. Positive functions are typically not proposed by the bill, however, considering which the implementation of the institutional solution may be an open question from a professional point of view. EU examples show no conflict of interest between preliminary control and ex-post activities of audit offices. Considering this, the State Audit Office itself may come into question as an alternative.

The situation would be different and really only an independent institutional alternative would come into question if, on the basis of the arguments mentioned in the previous subchapter, the Bureau was assigned fiscal political functions as well. The current bill makes this possible only indirectly, through the president of the republic and the constitutional court, however.

What belongs to the issue of budget discipline, beyond the bill

The principle of the golden rule

In an earlier part of this article, the structural refinement of fiscal rules was discussed, i.e. that rule enforcement may differ with respect to the various components of the budget of a different nature (through the application of the golden rule, for example).

It would be worth considering the golden rule, if not the rule itself but its conceptual content at least, for the regulatory framework of the central budget, too (and not only in the case of local governments). The bill only makes a unilateral, quantitative proposal for the adjustment of distorted generational redistribution (freezing and 'growing out of' debts), while, with respect to the central budget, it ignores the structural side of adjustment. It should be examined at least if the proposal possibly contains structural elements affecting the fairness of the generational distribution of burden and advantages, especially regarding the priority of the so-called outer items of expenditure to inner items.

An argument against the general application of the golden rule, extending it to public finances as a whole, is that it grasps only some of the items important for the future generation – namely investments – disregarding the current expenditure on education and family subsidisation, for example. The golden rule nevertheless highlights an important aspect of public politics, the obligation to preserve and expand public property for the future, which is to be shortly discussed in the following, last chapter of this article.

The preservation of public property

A well-known development after the political change was the inversion of the extreme rates of public and private property to the detriment of public property. The usual concerns – to what extent privatisation could be termed as irresponsibly scattering, using up or simply wasting public property – are not to be discussed here, but a question of a more general nature is of relevance. To what extent is the present generation entitled to reduce the public property available for the future? Should not a narrower scope of privatisation have been agreed upon by consensus?

In my opinion, the present generation is not entitled to further reduce public property, with regard to the future generation. Such a restriction would not contradict privatisation but would save public property from being illegally transferred to the private sphere at 'special', sacrifice prices. Something else to be avoided is using privatisation income as an offset against past or present overconsumption in the form of debt repayment or balance improvement. This is namely an unfair example for generational redistribution to the detriment of the future generation, against which there should be guarantee granted by other acts if it does not comply with the nature of this bill. Within the framework of this guarantee, it should be considered binding privatisation to an offset rule the way budget expenditure is bound by the budget bill. The sale of public property or any other transaction reducing it should only be allowed offset by another transaction increasing public property (by investment or purchase) of (at least) a similar value. There should be independent institutional guarantees for the veto of unfair privatisation transactions of public property (like sale at sacrifice prices) at both the central and local levels.

Notes

[1] The article was written in December 2007 and closed in February 2008.

[2] The concept is used based on a lecture by George Kopits (Conference on Fiscal Responsibility, May 19, 2006).

[3] See the study by Antonio Fatás entitled: Is there a case for sophisticated balanced-budget rules? (OECD, December 2005)

[4] The experiences of New-Zealand, France, Slovakia and – in the experimental phase – of Hungary in program budgeting are presented in a study of the Research and Development Institute of the State Audit Office (SAO RDI) of 2005; the examples of the United Kingdom, Sweden and Denmark are included in an OECD-survey of 2006. Commissioned by SAO RDI, the author of this article also wrote an analysis of the issue (December 2006).

[5] The EU publication entitled Public finances in EMU 2006 includes a detailed survey and analysis on the fiscal rules applied by member states of the Union and the independent fiscal institutions operated.

[6] The primary source of this topic was the study by Antonio Fatás (OECD working material; December 2005).

[7] The source of the information on the Chilian system was the Conference on Fiscal Responsibility organised under the auspices of the State Audit Office (May 19, 2006).

[8] The main source of this chapter was the EU publication entitled Public finances in EMU 2006. In addition, I reviewed the compilation of the British audit office on the audit offices of the European Union as well as some institutional homepages, but these did not provide additional information on the issue compared to the main source. Further sources are listed under the References.

[9] See the articles by László Nyikos in Számvitel és Könyvvizsgálat 1991/12 and in the Economic Review, May 1992.

[10] The observations on the bill refer to the state of the bill at the date of submitting it, i.e. November 2007.

[11] The SAO RDI study evaluating the well-groundedness of the budget bill for 2008 includes an effects analysis on the proposed real debt-rule. Within the framework of this article, I examined the rule system from the aspect of logics only, without testing it with numbers.

[12] In the Finance Ministry concept of May 2007: discretional items

[13] By this critical remark, it is certainly not the usefulness of the automatic stabilisation effect outlined in the economic effects analysis related to the bill that is questioned.

[14] The starting point of the effects analysis on the target variable may be the recently published analysis by László Ohnsorge-Szabó and Balázs Romhányi. (How did we get here: Hungarian budget 2000–2006; Public Finance Quarterly 2007/2)

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