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Magic weapon in fiscal policy?

Thoughts on the budget rules applicable to the local governments

It is a welcome development that budgetary sustainability and transparency have become the focus of domestic professional discussions[1]. The debates that have livened up in the wake of the international conference organised by the State Audit Office and the National Bank of Hungary on rule based budgeting in the spring of 2006[2] and the public finance theses of the SAO published in the spring of 2007[3] indicate that thinking has turned towards institutional solutions. Being a loyal chronicler of these processes, the Public Finance Quarterly dedicated its second issue of 2007 to this subject. One of the most important suggestions found in international literature and practice is the application of budgetary rules as an institutional solution for the sustainability of the budget.

THE RULES OF BORROWING MUST BE MODIFIED

The only quantified rule in the Hungarian system of public finances is the credit limit stipulated in § 88 of the act on local governments. When introduced, this rule was supplemented with the so called local governmental bankruptcy act requiring 50 per cent plus one affirmative votes. This act clearly stipulated the financial responsibility of the local governments. The limitation of credits taken by the local governments – which was "cast in stone" within the framework of the infamous Bokros package in an act requiring two thirds of the votes – needs to be modified for three reasons.

First of all, there are several arguments claiming that this rule was deficient already at its *inception*. The rule cites liquidity credit as an exception, however, it fails to define it. Limitation applies to 70 per cent of the adjusted own current revenue, however this value was devised in an ad hoc manner. What is more, own revenue items can be freely modified under other rules of law. Such a rule would have been the revocation of the local business tax, the decision about which was first adopted and then repealed. Furthermore, changes in the rules of sharing personal income tax revenues (for example, differentiation between the share left at the disposal of the local governments, and the share built into the normative subsidies) resulted in the unpredictability of the application of this rule, just like the annual changes in the fund regulation system. Although the rule counted with risk assumptions that do not appear in the budget (by considering surety and guarantee as debt elements), this rule can only be enforced in a "lightning-like manner", since the public finance information system presents redeemed

guarantees only. The provisions of the accounting regulations, according to which unredeemed guarantees must be presented in the supplementary annex to the report, are observed only by a few entities in practice. This problem is aggravating, because in addition to the local governmental businesses – most of which belong to big cities – legislation also allows multifunctional small regional associations set up since 2004 to take credits. However, in the absence of other credit coverage and security, such associations may take credits only with surety provided by the member settlements. In this case, the pending liability may appear in the financially vulnerable local governmental sector.

Secondly: as time has gone by, the growth in the funding needs of the sector has been accompanied by the spreading of "financial innovations" offered by credit institutions, which have provided an increasing legal loophole in relation to the application of the rule. The first possibility to abuse the rule is given by the liquidity credit category specified in the rule. Credit institutions are fond of capitalising on the exemption provided by this rule. Practically, this makes it possible for the local governments to use credits to finance their budget deficits, too. The other serious possibility is implied in the application of instruments and techniques not listed in the rule item by item, e.g. bond issuance, or PPP schemes that appear as hidden credits.

Thirdly: quantitative rules – in an ideal case – enforce fiscal policy rules, too. It cannot be argued that the fiscal policies of 2005–2006 and 2008–2009 face radically different challenges. In the current situation, I think, the basic dilemma is about the alignment of the requirements of nominal convergence (meeting the criteria for joining the euro zone) and real convergence (closing the gap between Hungary and most advanced countries), including the proper selection of the objectives of the supporting fiscal policy.

ACCELERATING INDEBTEDNESS OF LOCAL GOVERNMENTS, INCREASING RISKS

The indebtedness of the local governmental sector has accelerated in the recent years. It is not surprising for experts, however it may concern politicians and the general public that different data sources communicate significantly different figures. The final accounts bill of the Republic of Hungary estimates that state debts totalled HUF 463.5 billion at the end of 2006. Based on the statistics of financial accounts disclosed by the NBH, credits amount to HUF 497.6 billion, including HUF 27.4 billion in bonds debts, liabilities towards domestic credit institutions equal HUF 347.3 billion, and foreign bank loans total HUF 122.9 billion. *Table 14* shows a few indicators of the indebtedness of the local governmental sector. The debt stock consists of three components: borrowings from domestic banks (denominated either in forint or foreign currency), foreign currency credits taken from foreign banks, and bond issuance by the local governments, which is gaining momentum again.

The figures broken down in the table indicate several processes and phenomena, of which I hereby highlight a few. One important thing is that the gross savings of the sector (surplus of the current budget) are decreasing proportionately to GFS revenues. It is also noteworthy that the growth of debts is not automatically followed by the growth of interest expenditure. This is caused by the fact, among others, that the ratio of foreign currency borrowings has grown, which implies less direct funding costs, but at the same time increases the significance of a new type of risk. The modest rise in interest expenditures is probably due to the growing role of bond financing, as well as the rise in the rate of foreign currency liabilities within domestic bor-

Table 1

A FEW INDICES OF LOCAL GOVERNMENTAL BUDGETING AND INDEBTEDNESS

	2002	2003	2004	2005	2006
Balance of current revenues and expenditures, HUF billion	79.6	110.5	144.4	107.6	66.4
Balance of current revenues and expenditures as a percentage of GFS revenues, %	3.75	4.42	5.40	3.72	2.06
Balance of cumulative revenues and expenditures, HUF billion	–184.5	–142.1	–160.9	–189.0	–222.9
Interest expenditures, HUF billion	10.0	12.6	17.8	15.2	20.1
GFS balance excluding privatisation revenues, HUF billion	–199.5	–40.7	–119.2	–202.6	–172.0
GFS balance as a percentage of the GDP, %	1.16	0.2	0.5	0.9	0.7
GFS balance minus privatisation revenues, HUF billion	–104.9	–31.6	–16.5	–81.4	–156.5
Increment in debts towards the domestic banking system, HUF billion	28.3	28.9	59.1	51.5	52.7
Increment of total debts*	95.8	16.3	90.7	46.7	151.4
Total debts, HUF billion	186.5	212.1	272.6	346.2	497.6
Debts as a percentage of the GDP, %	1.08	1.10	1.30	1.56	2.20

*These figures also include borrowings through bond issuance and credits taken from foreign banks.

Source: own calculations based on figures provided by the NBH and the Ministry of Finance

rowings, and the increase in foreign borrowings. An important development is the growing contribution to the state debts, which shows an even more unfavourable picture based on the ESA indicator.[5]

The special features of these bonds include private issuance, a relatively long maturity, deferred amortisation, which implies not only advantages, but also risks of concealing the real load-bearing capacity. Repayment of bonds issued in 2007 to date has to be started after the next local governmental elections. Another feature of bond financing is that the assessment of risks – especially in the case of private bonds – is much more superficial than debtor and credit rating. There are no public figures about the rating of local governmental credits extended by domestic banks, however, on the basis of concrete experiences it can be stated that the rate of classified claims is growing in this segment, too.

These figures are not able to present the following impacts. PPP schemes, the use of which is spreading, primarily in large cities, can be regarded as hidden credits, which in certain cases imply liabilities similar to those of direct borrowings based on the calculated present value.[6] Nor do these figures indicate that the repayment of credits starts after a grace period, which may make repayment liabilities due in the critical years. Nor do the figures reflect sureties provided by the local governments – typically on credits taken by public utility companies that are owned by the local governments and perform mandatory tasks – or the impacts of the redemption of such sureties. It is also obvious that the aggregate values conceal the special situation of the individual local governments or types of local governments. In other words, behind the averages there can be significant or even extreme indebtedness at certain players of the sector.

Year 2007 shows that contrary to the former behavioural pattern of the sector, the indebtedness of the local governments grew even after the elections. According to the financial statistics of the NBH, in the first half of 2007 the bond debts of the local governments grew by HUF 17.8 billion, borrowings from the domestic bank sector increased by HUF 24 billion, credits taken from foreign banks rose by HUF 4.7 billion, and total borrowings grew by HUF 46.5 billion. This phenomenon can be partially explained by the correlation with the influx of

EU funds. In addition, bond debts denominated in foreign currencies and borrowings taken by the local governments from foreign credit institutions amount to several tens of billion forints.

Altogether, it can be stated based on the above facts, too that the fiscal risks of the national economy are increasingly concentrating in the local governmental sector. This is indicated inadequately by the figures (deficit, indebtedness) of the budget reports and financial statistics. Debts that do not appear in the balance sheet (surety, PPPs), as well as the debts of business organisations in majority or exclusive local governmental ownership that perform mandatory local governmental tasks and/or utilise EU funds are significant and growing, just like the foreign exchange risk, which is partly due to the denomination of the debts, and partly to the disbursement of development funds in euro.

In relation to the growing deficit and debts we must add that in the absence of adequate strategic planning both at national economy and local levels, it is highly probable that the investment boom hoped to be started by the EU funds will result in unnecessary and/or financially unsustainable capacities, while developments required for compliance with several EU provisions[7] and for satisfying the needs of the local economy will be cancelled. Inadequate planning may also result in the repayment of EU funds. Due to the given rules (own share and ex-post financing of the subsidies), the absorption of EU subsidies by this sector prognosticates considerable liquidity problems. According to our current knowledge, there can be seen two critical years: 2008 may be such a year due to the finish of the 1st National Development Plan, and the New Hungary Development Plan gaining momentum. Furthermore, 2011 can be such a year due to the fact that the $n+3$ rule changes to $n+2$ rule.

IT IS BEST TO ELABORATE BUDGET REGULATIONS IN A SYSTEMIC MANNER

Having outlined the situation, let me return to the presentation of the fiscal rules. In the issue of the Public Finance Quarterly mentioned above one can read the excellent articles by *Gábor P. Kiss* (2007) and *Balázs Romhányi* (2007), among others. These two articles are characterised by significant differences in emphasis.[8] Both writings contain proposals for the modernisation of the budgetary institutional system, including the institutional solutions pertaining to the local governmental system. Despite their radically different viewpoints in other institutional issues, both authors stand up for the enforcement of the golden rule of budgeting, in accordance with several other domestic suggestions. In general, this rule calls for a balanced current budget, or surplus in the current budget, allows a deficit in the cumulative budget, and the funding of investments from credits. However, as we all know, the devil is in the details. The enforcement of the golden rule means different things in different fiscal regulatory environments. In the following I will argue with the two outstanding authors focusing on this issue.

Balázs Romhányi suggests – a bit inaccurately though – the introduction of “a golden rule that is more stringent than the current one”. (Romhányi, 2007; page 352) We know that this rule is used in more advanced regions of Europe, too.[9] However, it is more important to ask why the institution of the standard council and then local governmental monetary fund established in the mid 1980s, i.e. the negligence of the golden rule, did not take into account the international practice.[10] Well, we must look for the underlying reason in the given economic situation and the operation of the resource regulation system. Due to the lax boundaries between the current and the cumulative budgets, it is possible to offset insufficient central contribu-

tions to the mandatory tasks not only from the current own revenues, but also from revenues yielded from the sale of assets. This has resulted in a situation in which the Hungarian local governments fund their current budget deficits from cumulative revenues. The "standard local governmental monetary fund" scheme ab ovo prevents the enforcement of the golden rule.

We welcome the proposal put forward by Gábor P. Kiss, according to which the stabilisation burdens of the local governmental sector must be made proportionate to public finances as a whole, but – in my opinion – this cannot be achieved exclusively with financial instruments.

Apart from specifying the local governmental minimum[11] and the minimum level of mandatory task provision, fund regulation should also be simplified. The simplification of resource regulation should go together with a radical change in the current status of mandatory task performance by the local governments. This in part would mean the "deregulation" of the sectoral laws in relation to the current mandatory tasks, the replacement of the unreasonable and unfundable professional standards by a "local governmental minimum", which would result in the better accountability of local governmental executives instead of the current collective irresponsibility[12]. At the same time, it would make it possible to decide about the minimum mandatory service locally.

It would be worth reviewing this issue after the indepth survey of public service companies owned by the local governments – in conjunction with the survey of the financial management regulation, which is being elaborated for the entire system of pubic finances. The review of task performance should also focus on long-term aspects. By this I first of all mean the review of the financial consequences of the recently started reconsideration of task sharing and task differentiation between the different types of settlements and regional local governments. For the time being, in the current political constellation, this review can only be carried out in the form of a mental experiment[13], yet it would not be useless examining and modelling the possibilities and impacts of task centralisation and decentralisation to be implemented after the reinforcement of the regional local governments.

The analysis of the operation of the multifunctional small regional associations to date can also yield several lessons. However, this would require such financial and financial management information that is not available in the current public finance accounting system, or that cannot be or can only hardly be produced from the elementary financial statements. The modification of the budget procedures and the introduction of rules by themselves do not provide the conditions for the answer to the seemingly simple question of "what how many?".

Therefore, during the development of budgetary regulations it is worth thinking and acting in a systemic manner, which in this case means – in addition to the above written – that the current situation, i.e. the underfundedness of mandatory tasks must be changed (including not only the operational costs, but also the fact that state contributions do not expressly include the amortisation of tools that are worn down during the performance of such tasks). In theory, we can achieve this by two ways. We either increase the central state contributions[14] and/or reduce the group of mandatory tasks, and/or simplify the relevant professional standards. Those who know the Hungarian fiscal relations are well aware of the fact that the local governments receive relatively less and less funding from the central budget for the performance of their legally mandated tasks.

The practice of tax sharing also contradicts the principles of local governance stipulated in the Constitution. The number of legal titles under which central support can be requested (which fluctuates between 150 and 200 depending – in part – on the interest representation

ability of the different policy sectors and local government lobbies) causes continuous uncertainties and orientation problems for local planning. It is difficult to imagine compliance with the "golden rule of budgeting", i.e. with the minimum balanced budget, without radically reducing the number of support legal titles (most of which allow the free utilisation of funds, but some of which are labelled for certain regional tasks), as well as without tax sharing serving adequate equalisation.[15] The fixation of state contributions with a proper technique is indispensable for changing the double-dealing attitude towards local taxes, for the utilisation of local reserves and the development of the local economy.

In the current situation, most of the local governments – at least quantitatively – can comply with the proposed golden rule with three types of supplementary state support, two of which are central budget appropriations that are exceeded on a regular basis. For example, the HUF 12 billion appropriation for ÖNHIKIs (subsidies for local governments with financial problems through no fault of their own) in 2006 eventually equalled HUF 29 billion.[16] Funds spent on the appropriation titled 'temporary support to ÖNHIKIs and local governments with long-lasting solvency problems' in 2006 was in total 136.3 per cent higher than planned, and exceeded the actual figure for 2005 by 52.6 per cent.[17]

A special problem in the enforcement of the proposed rule is caused by the interpretation and management of liquidity credits in the case of the budget rules applicable for local governments. Balázs Romhányi's related proposal, according to which this should be restricted proportionately to own revenues, is impossible to interpret due to the logic of the fund regulation system, and the previously mentioned problems of EU funding. After all, the liquidity credits of the local governments serve the purpose of advancing central subsidies allocated for mandatory state tasks – and probably this is why legislators exempted liquidity credits from credit restrictions – just like the liquidity credits before the reception of the EU funds.

I think that the problem of liquidity credits can only be managed if regulation provides for audits, or if necessary, sanctioning, by the bank supervisory authority. The reason for this is that today the use of this legal loophole is the common moral hazard of the local governments and the banks.

In addition to being unsuitable for exploring the cost relations of services, the current status of the public finance information system is the source of several other problems.[18] To put it sharply, the information system of the local governments (but in general that of public finances) is not suitable for the presentation of the actual financial situation and risks. It is not possible to learn from the public finance reporting system the conditional commitments of the local governments (sureties, guarantees), or their gross budget relations with public utility companies they own. The asset and liability statements do not present the value of real properties mortgaged as collaterals, which value is accordingly reduced. Pursuant to the accounting act, such information should be disclosed in the supplementary annex to the statement, however such public finance information is omitted even if the local government has such an annex attached to its financial statement. According to the interpretation of the above mentioned local governmental tax rule, 70 per cent of the adjusted own revenues include guarantees redeemed in the given year, as well as the debt service. If a local government undertakes surety – let us say, as a member of a small regional association for a proportionate part of the credit taken by the association, or for an overdraft loan as the owner of a public utility company –, this conditional commitment is not subject to the fiscal rule. The same applies to bonds issued with a grace peri-

od for repayment, or credits taken under similar conditions. Naturally, public finance accounting should be radically modernised for several reasons, but one thing is sure: it does not support compliance with the fiscal rules.

One may raise the question as per whether the critic has a concept or not. I have had the chance to be involved in works during which we developed several proposals with local governmental financial professionals and other experts working in public administration, for local governments, or for the State Audit Office. I am convinced that there is no single best solution. As I indicated at the beginning of my article, budgetary rules depend on the fiscal policy. First the strategic questions related to the local governmental sector must be decided, and it is worth deciding on the basis of impact studies only in the next step. In relation to rules that do not affect the amendment of the act on local governments, yet are critical in relation to rules applicable to local governments – the fiscal policy related to the asset structure of the local governments is critical, including the issues of own revenues (local taxes and usage fees), the concrete local tax system, the sharing of central taxes, as well as the issues of the allocation mechanisms of state contributions. I am convinced that it is possible, but definitely not worth drafting budgetary rules without thinking over these issues and deciding on a direction.

THE REFORM: A COMPLEX PROBLEM

In summary, using the example of the local governments I wanted to express my opinion, according to which the implementation of the Hungarian budget reform is more complex than creating budgetary rules and organisations. The institutional system implies the rules of task performance, the planning issues, as well as the issues of the public finance information system. In my opinion, without changing the latter, and by the unilateral enforcement of the budget rules, we will do nothing but cast in stone the practice of incremental budgeting, despite all our intentions. Furthermore, it must also be considered to what extent the stipulation of rules independent of the concrete fiscal and economic situation in acts requiring two thirds of the votes is suitable for the operation of a government sector promoting competitiveness.[19] At last, but not least, a rule is worth something only if it is observed. In its report published in 2006, the State Audit Office wrote that as much as 92 per cent of the 83 local governments audited in 2005 assessed the impact on the debt limit while taking a credit, and 13 per cent of the audited local governments took loans violating the statutory provision.[20] It is obvious that it is difficult to assess the effectiveness of any budgetary rule without potential sanctions.

NOTES

[1] Some people cite this as a key issue for the competitiveness of the Hungarian economy. See: Kovács (2006)

[2] Public Finance Quarterly reported on this conference. Gábor P. Kiss – László Kékesi: Conference on fiscal responsibility, Public Finance Quarterly Issue 3 of 2006

[3] State Audit Office: Theses on the regulation of public finances, and Pál Csapodi: The key messages of the theses on the regulation of public finances, in: Public Finance Quarterly Issue 2 of 2007

[4] I find it unnecessary to present elementary data, since they are easy to access, however, the derivative figures may lead to interesting conclusions.

[5] The ESA consolidated state debt indicator also shows the ratio of state securities in the portfolio of local governments. According to the NBH's fig-

ures, this amount dropped from HUF 76 billion to HUF 42 billion.

[6] See Hegedűs' and Tönkő's study in Vigvári's collection of studies (2007)

[7] The most significant of these is the imminent expiration of the derogation for waste water drainage and treatment.

[8] I do not go into details about them, since these articles are obviously known to a wide group of professionals.

[9] See Dafflon (2002) and Kopányi - Vigvári (2003)

[10] For more details see The weakest link in: Vigvári, 2006a

[11] See Zongor (2006)

[12] The mutual finger pointing by the local governmental executives and the Government implies the blurring of responsibility for service supply.

[13] Both the presenters and the opponents of the proposal would know what they are talking about.

[14] It is not from the devil either if certain items (e.g. teachers' pay) are fully funded centrally as a way of task financing.

[15] Vigvári's collection of studies (2005) contains relevant suggestions by several authors.

[16] See the general explanation of the final accounts

[17] See at the same place

[18] These problems are analysed in detail in two studies by Zsuzsa Kassó. See Vigvári (2006a and 2006b)

[19] The limitation of borrowing by local governments in an act requiring two thirds of the votes may serve as a lesson.

[20] SAO (2006) and Lóránt (2007)

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