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# Reforming fiscal rules and institutions in Hungary – aspects and proposals

*The statement that Hungary's central budget is struggling with dire problems has now become a cliché. In spite of considerable austerity measures, the country's deficit in 2007 is expected to be in the range between 6 and 7 per cent in terms of GDP, which would be a substantial improvement from 9 to 10 per cent recorded in 2006, but cannot be considered acceptable by any other standards, not even in the short term. Adjustment plans do not stop here of course, targeting a gap of less than 3 per cent in terms of GDP[1]. But, aside from statements uttered by politicians emphasising their personal commitment, taxpayers have relatively few guarantees to be assured that failures of past attempts at cutting back budget deficits will not recur this time. Hungary has a track record of producing deficits of around 8 or 10 per cent, but since all previous records-of a rather questionable nature-were broken in 2006, the time has come to ask the question: What guarantees are there to prevent it from happening again in four or eight years' time?*

Some structural reforms have been started; a very important achievement, good news indeed, but unfortunately each and every reform has to be successful for the announced budget path to be attainable. Safety reserves of the convergence program are not contained in additional unannounced reforms but in conservative estimates for the results of the first years. This involves serious dangers. If the budget situation turns out to be somewhat better than expected and it leads to a waning reform enthusiasm or even triggers a step-up in the government's inclination to increase the deficit, then any plans for deficit reduction of future years will go out the window, too.

According to international experience, this is typically the moment in the schedule of economic policy adjustments and reforms when the system of rules and institutions of fiscal discipline should be renovated.

A great number of studies have been made in regard to the central budget's system of rules and institutions. *Von Hagen* (1992) and *Gleich* (2003) attempt to quantify and compare system characteristics of European Union member states by using composite indices. Hungary was definitely a poor performer in the 2003 comparison (managing to outstrip Romania only).

The Hungarian budget regime was reviewed by the OECD in the spring of 2006, establishing

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that, in light of international practice, Hungary's budget-making process includes some features that particularly increase susceptibility to overspending and revenue overtargeting.

All this originates from the fact that in spite of regular adjustment campaigns-including the adjustment and reform program of 1995, popularly dubbed the "Bokros package"-institutional reforms across the entire budgetary system have never been made in Hungary. This study aims to provide viewpoints and suggestions in three areas to this cancelled yet long-needed reform.

Fiscal rules can be interpreted in a narrow and a wide sense. According to a definition formulated by *Kopits* and *Symansky* (1998), fiscal rules are constant criteria referring to the development of certain aggregate budget indicators (such as deficit, public debt, expenditures). These indicators can be calculated in nominal or real value, or in terms of GDP, and the criteria may be of legal status (defined in the Constitution or the statute for public finance), or may manifest themselves as part of a coalition agreement, or in the form of an unwritten rule (provided the parties involved will observe them). The mutual objective *of fiscal policy rules* is to rein the outcome expected from the execution of the Budget Act.

Fiscal rules, as interpreted in a wider sense, include the rules of how the budget is made and implemented. These *procedural rules* may relate to the work of the administration; the finance minister's special licences; the rights of MPs and parliamentary committees in plenary debates; public access and control of information, et cetera.

Solutions promoting the transparency of budgetary processes are to be highlighted among procedural rules. These include mandatory content of data, forecasts and analyses including the way they are released; and the establishment and operation of a budget office or a macro-economic analysis institution, both of which should be independent of parties and the government. The mutual objective of *rules that ensure transparency* is to provide the professional and general public with an accurate and easily digestible image of the current financial position and outlooks of public finance with as short a delay as possible in order to enable the public to exercise real control over the cabinet's activities.[2]

Considering of all the above-and not on the level of generalities but specifically in relation to the current situation in Hungary-this study aims to describe suggestions that take long-term considerations into account[3] but are executable in the short term in all three areas in order to further fiscal discipline.

For reasons of length, this study does not address possible ways of transforming these suggestions into laws; this should be done after professional debates of the concepts have been made. It should also be noted here that a performance-oriented transformation of the central budget is not addressed here. Introduction of performance monitoring and a new type of management in the public sector requires the budget presentation to be transformed into one of program-orientation, but this is a problem entirely different from budget discipline and transparency.

## TRANSPARENCY

Even though an increase in transparency seems only to be a derivative component in the system of fiscal institutions, in fact no well-operating system can be conceived without it. A system of rules cannot be based on anything else but existing, public, reliable, and realistic information. Therefore, the line of suggestions to be made by this study shall be started with the recommendations that ensure transparency.

Of the international literature addressing the transparency of budget systems, studies by Kopits and *Craig* (1998) as well as OECD

(2001) should be underlined by all means. The majority of statements in a comprehensive study of transparency made by *P. Kiss* (1998) have unfortunately not lost their actuality, because a 2003 law, popularly dubbed the Glass Pocket Act[4], has introduced rules to improve transparency in the scope of cash-flow management and subsequent control only, failing to bring progress in budget data and planning. Some of the topics covered there (such as public procurement, public employment) are not addressed by this study as it intends to focus decidedly on the budget regime.

## Some possible reasons for rules to improve transparency

### *Credibility*

Risk premia, incorporated in the expected yields of forint-denominated government securities, increase the interest payment obligations of the budget considerably. Projected to the forint-denominated public debt of HUF 11,000 billion, it currently amounts to 3 to 3.5 percentage points over euro yields[5], causing HUF 350 to 400 billion, mostly unnecessary, excess annual expenditure (corresponding to 1.5 to 1.7 per cent of GDP). Risk premia actually reflect investors' uncertainties. Investors want to be certain not only of a disciplined budget policy but they also want to be sure that no such information is hidden from them that could be essential from their point of view.

When a budget policy gains credibility with market players, this risk premium could drop substantially, which, in addition to freeing budget inputs, reduces medium- and long-term interest rates that are relevant for market players (such as the rates of mortgages and corporate investment loans). This, in turn, could increase economic activity, accelerate economic growth, thus increase tax revenues and reduce the deficit further.

### *Limitation of a race in unsubstantiated promises*

When the data that give a true reflection of the budget's position and outlooks are disclosed to the general public, opportunities will diminish for the opposition of the time to utter unsubstantiated promises with no risks as to implementation and thus force the governing party of the time to come up with similarly unrealistic pledges-in which case there is a risk of implementation.

### *Constant improvement in the quality of planning*

It is essential for the constant improvement of the budget system that it should be given constant incentives in the form of professional debates and independent analyses in order to improve the quality of data output and to develop methodology.

## Proposed set of rules to improve transparency

### *Classifying budget items*

Documents of the Hungarian budget currently available actually make only one distinction between various revenue and expenditure appropriations: The actual figures of revenue items and some expenditure items may depart at any extent during the year from the extent set forth by the law (commonly referred to as automatically overshooting or open [uncapped] appropriations), while the (numerical) majority of expenditure appropriations cannot exceed the extent defined by the law (closed [capped] appropriations). When the legal limitation of closed appropriations are reached, the treasury simply effects no more payments from this scope. Open expenditure appropriations are, by definition, based either on legal eligibility (such as pensions, family benefits, per capita subsidy in education, etc.) or on civil law agreements

that bind the government (such as interest payments of public debt, redemption of state guarantees, payments originating from litigation).

To file a bill which, say, aims to give families HUF 4 billion more subsidies, to be financed from higher VAT revenues resulting from this measure, is nothing but the illusion of control.[6] It should be underlined that the documents of the budget proposals and the process of approving the relevant bill should be able to differentiate between various items, but at the same time it is not obvious where and upon what principles the border should be drawn. Making distinctions between items will be significant primarily from the aspect of fiscal rules, because they will clarify what items the government will be able to influence in the short term, and, subsequently, what the government is legally accountable for.[7]

Items that in fact cannot be decided by the parliamentary vote of the budget bill because they are included in other bills (tax laws, pension laws, etc.) or possibly defined by macro-economic or demographic variables (outside the control of the Parliament) are defined by U.S. terminology as mandatory. Non-mandatory items that depend on the free will of legislation are defined by U.S. terminology as “discretional”.

The controllability of a budget item could be assessed from at least three aspects:

- institutional level of decisions (parliament, cabinet, institution),
- type of risk factors (business cycles, demographic trends, exchange rates, etc.),
- minimum time required to eliminate the item.

Items ultimately decided by institutions are not regarded really controllable, because this method makes it hard to check whether the rule based on them is observed.

Items whose total depends mostly on business cycles (tax revenues primarily) are of particular significance from the aspect of economic policy, because they could act as automatic stabilisers. If automatic stabilisers are to exert their impacts at a maximum rate, they should not be managed in the same scope as the items defined by the annual budget process are. Fortunately, control over the majority of items sensitive to the business cycle are borne by the Parliament.

A large number of budget items can only be terminated on paper, because the government's task provision obligations do not allow the actual elimination of these spending items. Theoretically, the budget act could set forth zero forint for education subsidies, but obviously this would not be a solution to the problem. Long-term agreements bound by civil law could considerably reduce the manoeuvring space of budget policy in the short term, but a proliferation of such contracts should not be regarded as “an external factor” that is independent from the government. Instead, suitable decision-making mechanisms should be put in place and implemented in order to establish appropriate control.

We recommend that primary items that are approved by the Parliament in substantive laws and whose annual total are not influenced directly either by the Budget Act or the cabinet should be classified as mandatory budget items. All other items should be regarded as discretional items, including, in line with this definition, tax revenues (including tax allowances), pensions and other related benefits, compensation life annuities, payments to the European Union, the wage of the President of the Republic and the Members of Parliament). Very inflexible they may be, but obligations originating from PPP agreements with terms between 20 and 25 years should not be regarded as mandatory items, because these amounts are not stipulated by substantive laws. Neither should an investment project spanning years be regarded as mandatory spending, because the government does have the opportunity to fine-tune spending in any given year by modifying invest-

ment schedules. With time, the Parliament will obviously be under considerable pressure to put in law the amount of items preferred by some interest groups, removing them from the annual budget bargaining. It is of utmost importance for the government and the Parliament to stop narrowing their own room for manoeuvring.

Additional classification is needed in the scope of discretional items, because the parliament often makes decisions regarding obligations that span several years or authorises the government to take on long-term obligations (in case of investment projects that last years, for example). When a civil law contract has been made on the basis of such authorisation, the government may not modify it unilaterally even by a law. Consequently, distinction should be made between old and new budget items, in line with U.K. terminology. Defined by mandatory items and old budgets, discretional items are already determined when the bill for the year is addressed, therefore "free items"-items outside this scope-are the only ones to be put to the vote. Accordingly, budget documents shall clearly separate various item categories. The parliamentary vote should be applied to new, discretional-free-items (this is why they are also referred to as vote items), and the balance, which includes items determined previously, is merely acknowledged by the Parliament.

The table below summarises various appropriation types, focusing on the fact whether the distinction is made from the fiscal policy rule's or the procedural rule's point of view:

| Fiscal rule | Item type | Parliamentary vote |
|---|---|---|
| Mandatory items | Tax revenues and eligibilities/ authorisations | Determined items |
| Discretional items | Inherited items | |
| | Voting items | Free items |

If the law can make distinctions between discretional expenditures "inherited" from new and old budgets, there is no obstacle before the Parliament to approve multi-annual programs at their totals, unlike the current practice when approvals are given implicitly-with rare exceptions-via the inclusion of the first year's outlay in next year's budget. (Pursuant to the Public Finance Act, institutions have the right to take on obligations beyond the current year within certain limitations, but this will not make the total of the actual obligation visible).

### A POSSIBLE WAY OF TREATING INHERITED BUDGET ITEMS

The problem of treating inherited items is to a large extent similar to that of unspent appropriations in the current system. By showing "revenues", "expenditures", and "central subsidies", the current presentation implicitly assumes that the stock of unspent appropriations at the end of the year will be the same as it was at the beginning of the year. This is the very reason why the stock of unspent appropriations can jeopardise the deficit target: Based on previous year's decisions, ministries and institutions have authorisation for spending amounts not allowed for in the current year's budget. It would be advisable to plan explicitly the change in the stock of unspent appropriations in the current budgeting system as well, not in a binding way of course, but only as additional information. It is easy to treat inherited items if the parliamentary presentation of the budget is supplemented by two further columns, expected stock of unspent appropriations at the beginning and at the end of the year (hereon referred to as "residual"). Multi-annum programs can be budgeted at full cost in the first year as central subsidy, while expected outlay in the first year is shown in the column "expenditures" , and the rest is put in the last column "expected residual at the end of the year".

In the second and subsequent years, the Parliament does not have to take decisions (at least not in the course of the budget debate unless the project is to be granted additional subsidies), only a part of the initial stock of unspent appropriations can be shifted to the column "expenditures", while the rest is left in

the column for "expected residual at the end of the year". The Parliament is given all the relevant information as before (or even more); the difference is that the decision has to be made about variables only, which, however, can be influenced.

A register of contractual and legal commitments is a precondition for the presentational form proposed above, but "fortunately" this is an essential and indispensable part of any disciplined medium-term fiscal policy, too.

there is no need for much change compared to the current system, since residuals (except for a few, usually unjustified, cases) can only be accumulated on capped appropriations (discretionary items mostly) as a rule of thumb, but not always (e.g. there cannot be any residuals on wage expenditures).

According to the recommendations outlined by this study, the scope of uncapped appropriations could only include those that are subject to macro-economic or demographic factors. This way, no items that are independent of such factors could be classified as uncapped items because of technical uncertainties.[8] Likewise, today's uncapped items, and also mandatory items, as defined by the new terminology, should be identical in the case of expenditures, provided the principles of uncapped systematisation are employed consistently. Revenues including items (income from selling state assets, for example) that are currently under the uncapped heading, however, should be classified as discretionary items in reference to their content. If these are not forecast with proper accuracy for the benefit of market risks, then expenditures that will certainly be effected shall not be charged against these revenues.

### *Alignment of accounting rules to best international practice*

One of the major sources of transparency problems (and sometimes the basis of abuses) present in Hungary's current budgeting system is the fact that the parliamentary documents are prepared on the basis of accounting rules spelled out in Hungary's Public Finance Act, whereas the country's budget policy in the medium term is defined by convergence programmes[9] that are based on the European Union's ESA'95 rules. It would be prudent to align the Hungarian rules to ESA'95[10] as close as possible in order for monthly cash-flow data recorded in the Hungarian accounting system to provide as much information as possible about the likelihood of medium-term targets to be attained.

Although the implementation of an ESA-compliant, modified accrual-based accounting system[11] to replace the current Hungarian system of modified cash-flow based accounts[12] is not recommended by this study, some items that represent replacements for financial instruments (such as return of accounts receivables, loan provision) should be eliminated from the balance, and the scope of legal public finance should be extended to an ESA-compliant, wider governmental sector. The introduction of a sub-category "budget corporates" is also conceivable for state-owned corporations that fulfil public tasks and are financed publicly, for which corporations the state shall, for various reasons and at least implicitly, take responsibility[13]. Obviously, creditors of the National Motorways Co. Ltd. or the Hungarian Television Co. Ltd. will not be left out in the cold even if these corporations lose all their equity, because the state is going to repay credits (based on universal liability, for example).[14] The scope of public finance entities defined by the current Budget Act cannot be interpreted from the aspect of economics because it does not include these corporations. If public finance is regarded as a legal and not a presentation category, then the consolidated balance of the central budget and budget-financed corporates should not be voted by the Parliament, and it would be meaningless, too. However,

pursuant to the Public Finance Act, the debts of these corporations could well be limited by law (and it would ensure for the government to substantially increase its control over the Maastricht criteria on public debt).[15]

The best international practice recommends other techniques in addition to the ones mentioned above in order to be able to provide as transparent and realistic an image of budget processes as possible. According to the principle of gross accounting, transactions shall be accounted and the data presented not in terms of net cash flow but economic content. In the case of certain budget items it could be beneficial to depart from the general cash-flow based approach of the parliamentary presentation and apply an accrual-based accounting, because otherwise the image of the budget could emerge seriously distorted. The comparison of cost/benefit analyses requires related costs and benefits to be recorded and accounted under the same headings, if possible. Although not included among the general principles of accounting, this method could be called the principle of "activity-based costing" for the sake of simplicity, for it says that each budget expenditure shall be accounted at the very same item for which they are created. Consistent application of these principles are important not only for transparency but for allocative efficiency, as well.

### GROSS ACCOUNTING, MODIFIED CASH-FLOW APPROACH, ACTIVITY-BASED COSTING

The way state assets are managed by Hungarian Privatisation and State Holding Co. is one example of disregarding the principle of gross accounting, as the asset management agency spends a substantial proportion of income realised from utilising and selling assets in a way that these are recorded neither in the revenues nor the expenditures side of the budget (for example, the entirety of privatisation reserves are included in this scope).

Modifying the cash-flow approach has been done in respect of a number of items (for example, debt write-offs shall be accounted as expenditure appropriations, increasing the deficit), but it would beneficial if the year-end total of various pending items were divided appropriately and re-accounted to their appropriate headings for the year that has just ended. A new accounting method for PPP projects would be another possibility of modifying the cash-flow approach to be considered. According to ESA 95 methodology, availability fees of proper PPP projects are to be accounted in the deficit, the investments themselves are not charged against the budget if the invoices are paid. It is obvious, however, that availability fees do include the price of investments in addition to the current costs of services and financing. Accordingly, in Sweden for example, the price of investments of PPP projects at the moment of finishing are shown in the parliamentary presentation of the central budget, which of course does not impact the content of the contracts but does improve transparency.

Activity-based costing is also violated in the scope of state cash-flow management, because state-owned institutions do not pay interest on the state funds they use (for example, when using up budget appropriations quicker than scheduled), nor is any interest given when an organisation manages to pay as late as possible (in line with its contracts, not defaulting of course). Total costs of undisciplined fund management are currently accounted among the interest payments of public debts, which, in turn, means that these burdens are borne by disciplined organisations as well, thus undisciplined ones are in no way incentivised to alter their conduct. Applying an internal interest rate would mean an "overgrossed figure", because it increases both the revenue side (Treasury) and the expenditure side (institutions), but this item is (not expected to be) as high as to distort the full picture, and, on the other hand, a legislative solution would be easy to find to adjust totals appropriately (for example, interest payments should be reduced by the amount institutions have refunded to the Treasury).

An example of the combination of gross balance and performance-oriented method is the way earnings realised by state-owned corporations are accounted. According to present regulations, withdrawn dividends shall reduce the deficit, and an equity raise increases it. The way balance of payment statistics

handle the earnings of foreign-owned corporations is a more transparent solution. Here, total earnings impact current accounts, and if foreign owners withdraw only part of their earnings as dividend, then the difference is accounted in the capital balance as reinvested capital. Likewise, in the case of state-owned corporations the total earnings in terms of the state's shareholdings (be it profit or loss) should be accounted in the deficit, and if financial transactions show any discrepancy, then it should be regarded as a financing item. This accounting method would render various, and often confusing, solutions (or even manipulations) related to financing state-owned corporations unnecessary and pointless, because the budget balance is affected similarly if the corporation in question receives subsidies from the budget in advance or it borrows instead and the debt is assumed by the budget subsequently (motorway construction, for example).

Managing various tax allowances (employee tax credits, charity payments, certain R&D expenses, etc.) is an example of applying gross balance and cost bearer's burden in a combination. Current presentations do not list them as gross figures, instead, the revenue appropriations originating from the tax type in question are merely reduced (an orientation table is usually included in the final accounts). This practice decreases transparency for two reasons. One, neither decision-makers nor the general public is aware of the budget impacts of decisions and, therefore, these expenditures in fact do not compete explicitly displayed expenditures, even though they likewise act as the means of accomplishing certain objectives in economic or social policy. Also, the fact that no appropriate and public estimates are made of the budget impact of these measures ex ante, there is opportunity for ex post controlling of either the success of the decision or the quality of the ex ante estimates, which, however, would be essential to a learning process. It is of utmost importance that the current practice should be altered as soon as possible to record tax allowances in the expenditures side of the accounts.

Sureties and guarantees pledged by the state are also an example of applying gross balance and activity-based costing combined. It happens all too often that the state, considering the obliged party's financial standing, waives payment of guarantee fees. State guarantees may be an optimum solution from the aspect of the national economy, but it should be noted that the obliged party has in fact received a subsidy. It is no coincidence that the European Union has this “subsidy content” accounted, for it could distort competition in the case of market players. According to the most recent amendment to the Public Finance Act, the principle of gross accounting has been implemented in that the legal maximum of guarantee fees shall be accounted as revenue in the case of all guarantees (because, according to market logic, the actuarial value of a guarantee is usually incalculable), and if the obliged party should pay less than that, then the difference shall be accounted as expenditure (subsidy). It would be a progress in the presentation in this scope if the waived parts of the guarantee fees were accounted by the budget at their relevant headings (for example, a free guarantee represents a valuable subsidy for cultural entities and it is not meant to display the finance minister's extravagant spending).

Giving away real estates owned by the central government to municipalities, foundations, etc. free of charge is a third important example. When the gross balance approach is used, cash subsidies should be accounted first for the beneficiary then the beneficiary would use this sum to purchase the real estate on paper. Considering the fact that real estates, being a tangible assets, shall be accounted when sold as revenue in the current system, the budget balance would not change even in the gross balance system, but the value of the real estate would become transparent as a subsidy granted to the beneficiary sector.

The combined lack of applying these three approaches is demonstrated best by the usage of state-owned real estates. Currently, state institutions do not pay any rent for using state-owned real estates, but rent shall indeed be paid when private sector players use state-owned real estates or when state-financed institutions rent real estates from market players. The budget's balance in the case of state-owned real estates deteriorates at the moment when investment/purchase or renovation is made, while the rent of market real estate includes depreciation. Renovation costs of state-owned real estates are often accounted among the expenditures of the Treasury Property Directorate, an organisation representing the owner, while market-based rents are accounted in the individual ledgers of actual tenants. As a result, on the one hand, the state's various task fulfilment methods cannot be compared, and, on the other hand, certain institutions feel a strong urge to retain useless real estates because it will not produce extra costs but “excellent revenues” can be had by them in times of austerity (provided the finance minister authorises such an action).

### *Making data, forecasts, and methodologies public*

Although the current practice falls very short of a desirable standard, it is obvious for all that neither professional nor public circuits can hold high-quality debates about budget policy when public data of appropriate quality are not available. It would be a significant step forward in this respect if the detailed actual data reported to va-rious international organisations-the European Union, primarily-were available to all, and organised in the form of time series.[16] Time series would ensure the opportunity for members of the professional public to analyse and produce substantiated estimates and forecasts. In lack of them, it cannot be decided whether a piece of new data is surprising or not, which strongly questions the foundation of political debates on budgetary issues. The professional quality of such debates may be improved if the explanation of budget bills (and final accounts) included analytical sections which could direct attention to deeper and farer-reaching issues of budget policy, and would base the explanation of individual items on macro-fiscal effects wherever possible, and not on an incrementalist approach comparing everything to the previous year's data.

In the case of items with particular importance (such as main tax revenues and major entitlement expenditures), it would be advisable to conduct detailed impact analyses in the explanatory part of budget bills to display the impacts of changes in various presumptions on budget expenditures and revenues (for example, the impact an unexpected one-percentage-point drop in inflation would make on VAT revenues).[17] In order to improve the quality of impact analyses, it is necessary for the budget reports to show (even on a quarterly basis) not only the extent at which appropriations have been fulfilled, but they should provide numerical analyses of the factors that have impacted them, particularly the effects of unexpected developments in macro-economic and other factors.

The credibility of analyses and forecasts is a much more complicated matter: Constant feedback is needed in order to improve permanently the quality of forecasts. One form is to make the methodology of budget bill forecasts public, and an even more preferable case is when external experts are able to fully reproduce the forecasts.

Should the macro-paths, predicted on the basis of the latest actual figures, as well as consequent forecasts of mandatory items be submitted to the Parliament several times a year (say, quarterly), then decision-makers could prepare for modifications and measures required in the following year in a timely manner (to avoid gung-ho cutbacks, popularly dubbed the “Lawnmower Principle”). The system of making quarterly assessments of the budget's position would be in full compliance with a new legal approach[18] according to which entities in charge of individual budget chapters shall report to the government each quarter whether the expenditures of their chapters (including automatically overspending, uncapped appropriations too!) would overshoot the levels set forth by the annual budget act.

In order to make the impacts of various alternative bills and other possible measures comparable, a long-term base-line projection about the budget is required, against which the quantified impacts of each alternative can be measured. This base-line projection can be prepared in several ways.

According to the method used in the United States, only the letter of laws and effective agreements is what matters (legal determination): Whatever is not written in them does not represent a determining factor. Of course, such a scenario does not lead to realistic forecasts, nor is it its duty, but only to

provide a basis against which various proposals are considered.

An assumption can be made, for example, that neither laws and agreements in force nor political preferences change. As one of the possible formulations, the real value[19] or ratio of legally undetermined items do not change in terms of GDP. Since macro-paths change much less in this base-line projection, a market consensus derived from calculations made by research institutions and analysts may be regarded as an acceptable macro-path. This version may be called a no-policy-change scenario (hereafter, NPC), because, in a sense, it answers the question: What's going to happen if nothing new is decided? As it has been suggested above, public reports on the budget's position and expected path should be made each quarter, it is recommended likewise that the NPC scenario for the current year and two subsequent years should also be updated quarterly and made public.

The Act on Legislation prescribes[20] that the impacts of laws shall be analysed before they are adopted. Although the law does not state it, the budget impact is obviously one of the most significant economic effects, but hardly any examples are to be found in practice where these impacts are demonstrated.[21] If the Parliament really demanded that the explanations of bills and amendment proposals should contain impact studies on the budget in appropriate quality (taking the most direct effects into account, for example), then fewer proposals would be created and the decisions on them would be more substantiated.

All this is important not only for the required learning process to start and the quality of databases and forecast methodology to improve substantially as a result of feedbacks, but also because government plans and programs defined for various terms cannot be aligned without them. Currently there is nothing to ensure harmony between the National Development Plan, submitted to the EU and having a time frame of seven years, and the Convergence Programme, spanning three years, and annual budget acts, thus, in turn, nothing guarantees that targets made in the planning centres of various sectors (and, consequently, special bills submitted to the Parliament, such as the Motorways Act, passed in 2001) could fit with any sustainable macro-fiscal frames.

## *Independent budget institution*

One of the most powerful tools to ensure budget transparency would be the establishment of a nonpartisan and well-informed budget institution. Such an organisation, named perhaps Parliamentary Budget Office (hereon referred to as PBO), would be able to act as an appropriate democratic counter-weight and prevent abuses of the information advantage of the executive power. The most prominent example is the United States Congressional Budget Office, but independent budget institutions play an eminent role in some European countries as well (including the Central Planning Bureau in the Netherlands, and the Federal Planning Bureau in Belgium). In the Hungarian landscape the State Audit Office fulfils PBO tasks, in that it provides preliminary opinion of the government's budget bills and prepares reports to the Parliament whether the appropriations and other estimates are to be considered sufficiently substantiated. According to a strict interpretation of the law, the State Audit Office has no authority to recommend alternative figures to replace faulty calculations, although there are no legal obstacles to present its own calculations in order to support its opinion.

### *Competence alternatives*

The possible tasks of independent budget institutions may be divided into two main groups: positive and normative[22] tasks.

### CONGRESSIONAL BUDGET OFFICE

The U.S. budgeting system is based on the balance between the legislative and the executive power at a decisive rate. Nowhere in the world has the legislation such great a power as in the United States. The institutional guarantees of the traditionally existing balance of power between the president and the Congress were motivated by President Nixon's abuse of power in the early '70s.

As a result of budget reforms implemented in 1974, the president has been obliged to submit his/her budget proposal to the Congress each year, but the Congress is able to create a full budget on its own. Practice has indicated that sometimes the Congress hardly scans the president's proposal, immediately starting to work on its own version. The Congressional Budget Office (hereon referred to as CBO), the most important institution of the congressional process, was established within the framework of the aforementioned reform. The CBO is a nonpartisan and well-informed organisation, which fulfils a number of important tasks in respect of the budget, including:

regularly calculating base-line projections for a 10-year horizon, based on current legislation and macro-economic forecasts. The basis for the parameters required for a macro-path projection (GDP growth, inflation, interest rates, etc.) is provided by the average of the projections made by the best independent forecasting institutions. These averages are modified by the CBO slightly, partly because merely making averages may result in a mathematically inconsistent macro-path, and partly because this represents the independence of the institution;

"re-pricing" the president's budget proposal each year based on its own macro-economic forecasts and technical projections, actually calculating real budget impacts of proposed decisions on a ten-year horizon, continuously informing the Congress of how earlier targets (the deficit predominantly) are developing during the budget debate;

calculating the budget impacts of each congressional bill or amendment proposal (including amendment proposals for the budget bills), which has been found by at least one congressional committee suitable for debate;

calculating the expected impacts of bills in respect of the federal budget, the sub-national governments (federal states and local municipalities) and also for the private sector. This role is particularly important in the case of bills whose impacts are not evident at first sight. Even though these calculations do not play an eminent role in congressional debates, they have in recent decades influenced the mindset of congressmen and congresswomen in tabling their proposals;

preparing economic forecasts (the impacts ageing, for example) for a very long horizon (spanning as long as 125 years with 50 years in retrospect and 75 years ahead);

scrutinising actual issues, tabling decision alternatives-of course, upon request by any committee or member of the Congress without any political assessment;

preparing news bulletins for the Congress of current economic situation and processes.

In the course of decades, a rivalling cooperation has evolved between the CBO and the Office of Management and Budget (the presidential budget office). Initially, there were huge discrepancies, ranging between 20 and 30 per cent, between the forecasts of the two institutions. By now, however, the gap has narrowed to less than one per cent. Many from the staff of both institutions have worked at both organisations, and they are proud of it. OMB expert find support against political pressure in the fact that the government will find itself in a very unpleasant situation (bordering on ridicule) if OMB predictions deviates too much from CBO's forecasts.

Positive tasks include:

- maintaining a public database,
- preparing macro-economic forecasts,
- preparing base-line projections,
- assessing calculation methods,
- preparing budget impact analyses, including
  - verification of the substantiation of the entire budget proposal,
  - impact studies on amendment proposals during budget debates,
  - impact studies for each parliamentary proposal (bills and amendment proposals.

Borderline cases:
- analysing the expected impacts of party programmes[23],
- drawing attention to problems by preparing projections for very long terms.

Normative tasks:
- elaborating economic policy alternatives,
- making recommendations for economic policy measures.

Obviously, the more a budget office is engaged in normative tasks and the more it is reduced to merely issuing recommendations, the more likely political parties will attempt to influence its activities by political pressure. Accordingly, the PBO of the current practice in Hungary shall decidedly avoid normative tasks (including, for the time being, borderline cases as well), but shall exercise its delegated powers in the positive tasks in as wide a scope as possible.

The weight of PBO could be based on the power of publicity when the assessments and opinions of PBO bear no direct consequences (such is the case with Hungary's SAO), but opinions can be given legal status, as in the United States for example, where the CBO's estimates are usually used automatically in budget debates by the Congress when the figures differ from the numbers contained in the president's proposal. The Dutch government is obliged to apply CPB's macro-economic forecasts, and the Belgian government has to state the reasons for deviating from FPB's macroeconomic forecasts. In the current Hungarian environment two solutions are conceivable:

If SAO/PBO continues to not produce its own alternative calculations, it could be prescribed by the House Rules that budget bills submitted by the government cannot be debated as long as the SAO reports find any of the forecasts for mandatory items insufficiently substantiated.[24]

If SAO/PBO does produce alternative calculations, these could be submitted automatically by the budget committee as amendment proposals, and the Parliament could decide between the government's calculations and those made by SAO (who was right will be seen when final accounts are made).

Evidently, PBO does not replace independent market analysts but supplements them. Market players have the advantage of being privy to market information, but PBO can access information from within the state. PBO may safely use market analysts' predictions on macro-path and financial indicators (prime rate, exchange rates), and market analysts could rely on PBO's superior analytic capacity in processing and assessing budget data.

### *Alternative organisational structure*

An independent budget office could, theoretically, be set up in a number of organisational forms.

A separate directorate and office could be established within SAO, which would fulfil the tasks of PBO without the authority to conduct subsequent assessment of the budget. As an advantage, this solution would utilise SAO's existing credibility capital and would not require extensive amendments in terms of legislation. Some say, however, that this design has a disadvantage in that it would cause a conflict of interests within SAO, because both *ex ante* and *ex post* control would be conducted by the very same organisation.

It is the same organisation indeed, but the features of these two control types differ, since *ex ante* control requires competence in economics, whereas for *ex post* control legal knowledge and approach is needed. Accordingly, should SAO pledge the extended tasks of *ex ante* control, it is very likely that it will have to scale up its capacity (which, of course, does not represent as high a relative extra cost as though a brand new organisation would be created). Given the fact that a sufficient number of experts with appropriate expertise for this task are not available in

Hungary at the moment, it would be prudent to expand the scope of tasks gradually.

Obviously, the purest solution would be to establish a new organisation under the Parliament's control, but a significant disadvantage would be the fact that the new organisation would take several years at best (and some battles won) to prove its professional credibility and independence from political parties, which are essential to accomplish its objectives and mission as described initially. If internal conflicts of interest prove to be more severe after a few years' time than predicted and therefore warrant the establishment of a new organisation, it is still a lesser problem in our view than an initial lack of public confidence in the organisation's politically unbiased approach.

Finally, it should be mentioned that some experts believe a body consisting of independent experts-a budget council, not unlike the Convergence Council which operated in Hungary in the summer of 2006-should be set up. The council could consult other experts informally, but would not operate a large staff. The practice in Germany could be mentioned, where the "Five Wise Men" release their report and forecast of the economic development each year. This design has the advantage of being communicated well, and a wide scope of voters could see "credible faces". This could absolutely not be the solution in Hungary's current situation because all that a small number of experts could do is examine macroeconomic projections because a more detailed scrutiny of the budget would require much larger staff. The United States Congressional Budget Office operates with a staff of more than 200, out of whom 30 work on macro-economic analyses, 18 on taxation, 76 on budget expenditures, 21 on micro-economic analyses, 31 on issues of healthcare and human capital, and 17 on defence spending. Subordinated to the six-strong management, a staff of 35 provide back-office services, such as preparation of publications, IT, etc. Most of the latter could be spared if the Hungarian PBO were to be established within SAO. Taking CBO as an example, the staff of even a penny-pincher Hungarian version would count closer to a hundred than to fifty.

*Summarising* the above, we believe that an office, to be headed by a separate vice chairman, could be established within SAO, which would expand its activities gradually, first with a low staffing (to be increased later), and would, if possible and needed, go independent in a few years' time. This gradual progress is in line with the assumption that it will take time to develop the required two expert communities (one at the Ministry of Finance and the other at PBO), but it is our assumption that a rivalling co-operation to develop between the two institutions would speed up the process.

## FISCAL POLICY RULES

Fiscal policy rules that restrict budgeting are in place in a large number of countries across the globe, but the majority of these rules (including the golden rule) are historical heritage in a sense. In the early 1990s, the need arose that the fiscal rules to be implemented should comply with some kind of theoretical expectations. Regarding international literature, *Anderson* and *Minarik* (2006), as well as Kopits (eds.) (2004) address these issues. In Hungarian, Antal (2004) discussed the matters related to sustainable fiscal policy, particularly the convergence processes of the new members of the European Union.

### Possible reasons for fiscal policy rules

#### *Budget impacts of ageing*

In the majority of developed countries the average age of the population and the dependency ratio have grown constantly. As a result, budget expenditures related to ageing (pen-

sions, healthcare, and long-term care) will grow substantially in the next twenty to forty years compared to their current level. According to current estimates, Hungary's gross excess spending for this purpose will amount to 6 to 7 per cent of GDP by 2050, but will even be 3 percentage points higher even as early as 2030.

Therefore, reforming the country's pension and healthcare system is unavoidable; however, the pressure can be reduced considerably by decreasing the weight of certain other expenditures. Most prominent among them is interest expenditures which-by definition-is the product of debt rate and its implicit interest rate. By reducing the debt rate and the risk premium incorporated in interest rates, budget expenditures could be cut back by percentage points.[25]

Reducing interest expenditures may be interpreted as pre-savings. In order not to have to increase taxes in line with growing pressure on the budget originating from the ageing of the society (which would perhaps reduce workforce supply which would be at a low level anyway), the assets whose yields will cover extra expenditures would have to be accumulated now. Since the Hungarian state has a huge amount of public debt, one of the convenient ways of asset accumulation is to reduce debt.

### *Intergenerational equality*

The budget redistributes incomes, not only among various income groups, geographical regions, and industries, but among generations. Typically, generations in inactive age groups will receive net transfers from the central budget, while active age groups are net donors. If, as a result of a set of rules effective at a given moment, inactive age groups are given a higher average of net transfers than the average paid to the budget by active age groups, then the budget has to increase its debts. In this case it may be said that it burdens this disequilibrium on future generations because they will have to repay these accumulated debts.[26]

According to one possible interpretation of historical fairness[27], no generation has the right to force later generations into any worse situation than his own. If economic activities have a positive net yield in the long term[28], in other words the concept of economic growth is a reality, then each generation has the right to realise this yield in their own savings, thus demanding a little higher net transfer on the whole than the total they paid to the budget when they were in the active age group.

It's not obvious whether there exists a positive real yield that could be guaranteed on an infinite time scale. Therefore, as a conservative estimate, it is estimated that no generation has the right to bequeath debt to future generations unless granting them assets of identical value that produce yields. Unfortunately, the system of national accounts, applied almost exclusively, never accounts for the exhaustion of non-renewable natural resources, thus it is very likely that the growth rate expected for an extremely long term will fall short of a statistically demonstrated potential expansion rate of one to two per cent.[29]

The question remains: What will happen to debts that have been accumulated in spite of the above principle? Obviously, the next generation cannot be expected to pay them back alone, because it will unfairly put them in an adverse situation. On the basis of historical fairness, these burdens can be distributed among an infinite number of future generations, which means that each generation will have to pay back an infinitely small ratio. This solution is only ensured if none of the future generations accumulates further net debt.

In this respect, special attention is to be directed to the golden rule, which states that the reason for a budget deficit can be nothing but investment expenditures. At first glance, this is equivalent to the condition that a growing debt should be offset by an increase in the portfolio of yield-producing assets, but unfor-

tunately the situation is not as simple as that. A significant practical problem is that the majority of the government's fixed investments cannot be proven to produce substantially higher overall yields (calculated at current prices) that would exceed the historic costs of such investments; and hence they should in fact be accounted as consumption. However, it seems likely that the ratio of return on expenditures spent on human capital investments and R&D is substantially higher, but statistics (on which the golden rule is usually based in practice) account them not as investment expenditures but as current spending. Currently, there are no official and well-defined indicators for investment expenditures, as regarded from an economic aspect according to which investments in fact increase the value of future consumption opportunities at an extent higher than the historic cost of the investment itself.

### *Avoiding socially expensive financial crises*

According to international experience, the typical time for strengthening a system of fiscal institutions is the year subsequent to the first major adjustment measures after a serious crisis, because institutional solutions by themselves cannot save the budget, but, when appropriate political will is mustered[30], could contribute greatly to retain the results of the accomplished stabilisation and to prevent the crisis-which would cause substantial economic and social costs-from recurring. For example, this path was taken by New Zealand in the mid-1980s, and also by Sweden and Canada in the middle of the 1990s. To date, there have been very few historical examples of a country reforming its own budget regime and implementing fiscal rules of its own accord, without any internal crises or external legal pressure, as if voluntarily. One of the few examples is Chile where-seeing the crises of neighbouring South-American countries-a rule for the cyclically adjusted primary balance was introduced in 1998 as a preventive measure. This example should be followed, because learning lessons from a crisis is a very expensive process. Estimates given by international literature differ widely, but calculations made by *Barro* (2001) indicate that financial crises reduce the economic growth of involved countries by 2 percentage points on average for five years. Accordingly, it may be said that five years after the crisis the GDP of these countries will be 16 per cent less than without crisis. Translated into Hungary's case, this would mean more than HUF 3,500 billion.

### *Monetary union*

In a monetary union it is necessary to restrict fiscal policies that remain under national control, as it would be beneficial for individual member states to opt for a strategy of succumbing to deficit-making at the expense of the others. The most obvious connection between national budget policies of a monetary union is represented by interest expenditures originating from public debt. Should one of the countries turn undisciplined, interest rates will rise in financial markets, because the “no bail-out” threat vis-á-vis the other freeriders is seldom credible. The Maastricht rules have been in force in the European Union since 1992, designed to manage such problems (and the Stability and Growth Pact of 1997 has even fortified its system of institutions). However, recently it has become evident that in a significant part of the member states ownership of the rules controlled by the central institutions of the EU is lacking both among politicians and the general public, and most members states are willing to violate them openly or surreptitiously if they feel their interests make such an action acceptable or necessary. Therefore, the European Commission has in recent years increasingly encouraged member states to strengthen their fiscal rules and institutions within their national competence.

### *Increasing transparency*

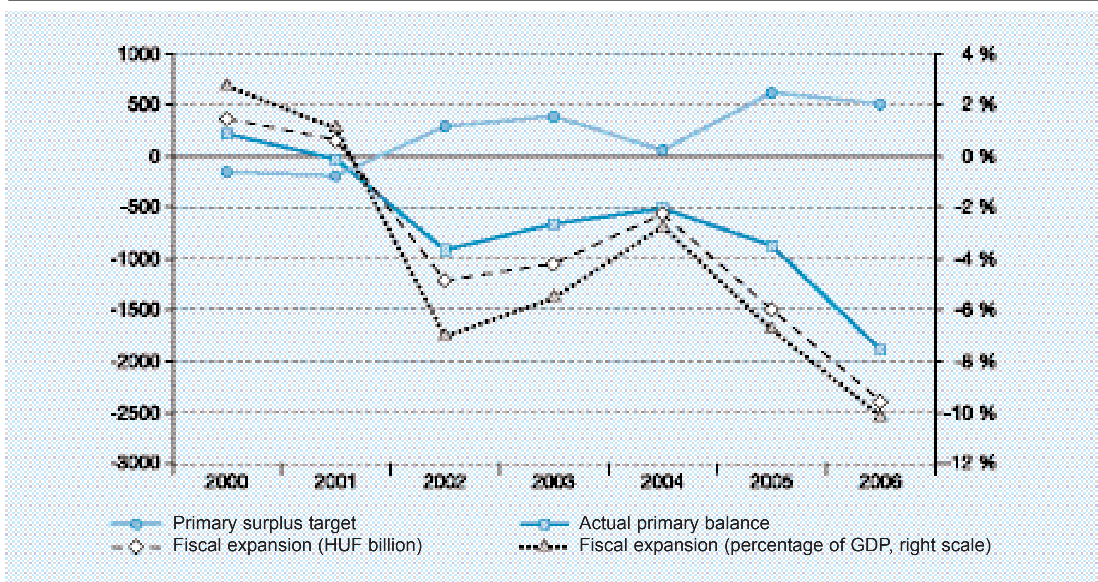
Fiscal policy rules that are binding only ex ante may be considered rules that ensure transparency, because, when being violated, they signal, as an early warning system, that the budget policy has taken a turn in the wrong direction. One of the examples is the public debt ratio employed in the EU, which cannot exceed 60 per cent of the GDP of a member state in accordance with the Maastricht Treaty. The sixty-percent value itself bears no particular significance from the aspect of economics, but when this limitation is regarded as an indicator of a government's budget policy performance (provided the debt ratio has started from a lower level), then the violation of this rule is equivalent to a confession by the government of not being able to fully control the situation and that processes are not headed in the right direction. If the general public is sensitive to this kind of information (because of not wanting to face another serious crisis again), political decision-makers will do their best to observe the rule even when no legal sanctions are imposed. This concept naturally leads to the conclusion that fiscal rules are to be created in a way that does not facilitate institutional arbitrage, in other words it allows no creative accounting and doctoring (or just a little and involving some very hard work at that).

## The proposed system of fiscal policy rules

The essence of the proposed system of budget fiscal rules is that the Parliament shall record increasingly accurate details each year as the budget year draws to a close, which details will then have to be observed in budgeting. Four years prior to budgeting, the Parliament can see what is to be expected with no policy changes. Three years prior, it records the primary balance target, and two years before budgeting the upper limit of the net value of discretional expenditures is set. And in the year preceding the budgeting process, all the budget bill debate will be about is the detailed allocation of free items. The value of the primary balance to be targeted is recommended to be derived from the formal fis-

*Figure 1*

**POSSIBLE DEVELOPMENT OF PRIMARY BALANCE**



cal rule which says that the real value of the government debt cannot increase; however, this rule is binding in the planning phase only. For the purpose of demonstration, a chart was prepared to show how the primary balance would have developed in the past ten years if this rule had been in force *(See Figure 1)*.

In the course of implementation, nothing but discretional spending caps are legally binding, for they are the only scope that ensures real control and accountability. The basic logic behind the operation of the system is as follows:

❶ *Debt rule:* Fiscal plans must not imply any increase in the real stock of public debt[31] (in the medium and long term).

❷ Based on the debt rule above-and taking medium-term macro-economic (primarily inflation-oriented) forecasts into account-the path of the nominal value of public debt may be defined three years in advance.

❸ Based on the path of nominal debt-and taking medium-term macro-economic forecasts (related primarily to the development of interest rates) into account-the balance of interest revenues and expenditures may be defined three years in advance.

❹ *Primary balance targeting:* The target value of the primary balance is created on the basis of estimates for nominal public debt and net interest expenditures.

❺ Based on the macro-economic path, a forecast for the balance of mandatory items is developed. If the Parliament does not reach new decisions in the future that would affect the balance of mandatory items, the expected path of discretional items would be developing on the basis of the debt rule. If the Parliament or the government decides that the room of manoeuvring available to either of them is inappropriate (believing it to be too narrow, for example), then the Parliament shall-upon recommendation by the cabinet-decide how to adjust these two sub-balances.

❻ Based on the Parliament's decision, the government will elaborate proposals and reach decisions (reforms) which ensure that the balance of mandatory items, as expected by the Parliament's decision, are met. Subsequently, neither the Parliament nor the government can make a decision to alter the balance of mandatory items.

❼ *Net discretional expenditure ceiling:* After the Parliament has reached the decision of what balance of mandatory items is to be targeted, the discretional balance, as based on the debt rule, shall be set forth in the law. The government shall adhere to it by all means, as this will provide the basis of accountability when the final accounts have been made.

❽ The government will submit the budget bill for the year $t+1$ in the autumn, which will have to address only the expected balance of discretional items as defined in the autumn of year $t–1$ and also the items inherited from previous years. The difference between the two shall represent the balance of voting items, or the manoeuvring space in other words.

❾ In the final accounts adherence to the directives related to the balance of discretional items shall be scrutinised, as well as the reasons why the balance of mandatory items developed the way they did.

❿ Should the public debt overshoot the limit set by the targeted path, there are three years available for correction. This condition could be secured by making the primary balance requirement aligned not only with the stock of debt of the previous year but with the condition that the real value of the debt cannot exceed the level recorded four years earlier.

Providing more detailed time frames and explanatory notes, the timetable is contained in the *Appendix* along with the logic design of how the fiscal policy rules work.

An important problem from the aspect of operating the rule in practice is that the GDP deflator-which defines the target value of the

primary budget balance through the implicit interest rate of the public debt-cannot be measured or predicted accurately or timely. Therefore, some kind of a proximate price index is to be selected. The most convenient design is the Harmonised Index of Consumer Prices used by the European Union, but it should be noted that it differs from the deflator at several significant points. Firstly, it includes the effects of changes in consumer price subsidies-which, however, does not impact the GDP deflator. And one of the most important trends in transitional economies of Central and Eastern Europe is to cut back these subsidies gradually, as a result of which the measured rate of inflation has increased by one percentage point on average in the past 16 years. Secondly, it does not include any price rise of usage of owner-occupied dwellings, regarded as imputed personal consumption; and, thirdly, it does not account any price increase in other GDP components outside the scope of personal consumption (primarily public consumption, investments, and net exports). It is the latter items that cause great uncertainties and delays in measuring the GDP deflator. A solution may be the requirement of using a value 0.5 per cent lower than the market estimate on the harmonised consumer price index when the budget is being planned. This, on the one hand, would facilitate cautious planning in respect of some inflation-dependant items (VAT mostly), and, on the other hand, would mean an approximation to the GDP deflator from the aspect of the fiscal rule.

All this would be applied to the central budget, as well as the budget of separated government funds and social security, whereas a golden rule more stringent than the presently applied one[32] should be implemented for municipalities, stipulating an equilibrium between their current revenues and expenditures, which means their total deficit cannot exceed their gross investment expenditures (their fixed-asset investments predominantly). A relatively simple way of practical implementation of this rule would be to restrict municipalities to use medium- and long-term loans to finance investments only. The portfolio of short-term loans taken out for liquidity management purposes should be limited in terms of their own income, because funds from the central budget to finance current spending will be transferred, by definition, in line with task schedules.

To choose between various systems of rules, it should be scrutinised what impacts they have on the significant economic variables under different conditions. The problem is somewhat analogous to the dilemma one faces when browsing the test results of various models before buying a car. There is a more or less established system for vehicle testing (including acceleration, braking distance, fuel consumption, frontal crash, low-speed crash, the "reindeer test", probability of malfunction, etc), but to our knowledge no such test criteria exist for fiscal rules. A "test course" of "driving situations" is discussed in the Appendix, which in our view provides an appropriate scrutiny into whether or not a given fiscal rule can be applied in Hungary's current situation.

## PROCEDURAL RULES

Of procedural rules addressed in international literature, the country analyses made by von Hagen (1992) and Gleich (2003), as well as by OECD's periodical *Journal on Budgeting* should be underlined primarily.

### Some possible reasons for procedural rules

#### *Conscious shaping of budget structure*

*Wierts* (2005) scrutinised structural changes in the budgets of EU member states between

1998 and 2003. In the years around the euro introduction of 1999, the debt service expenditures of most member countries decreased in terms of GDP, because the risk premiums of interest rates gradually vanished in terms of the common currency, re-pricing public debts gradually (with respect to longer-term bonds). Savings facilitated by some member states (Greece, for example) were close to 10 per cent of their respective GDPs, but the others also recorded figures around 5 per cent. The question arises: What did they use their increased room of manoeuvring for? Experience indicates that member states operating sophisticated systems of budget institutions used part of the savings to reduce their deficits, spending the rest on future-oriented, growth-enhancing expenditures (such as investment, R&D, etc.). In countries that were less developed in this sense most of the savings was consumed by an increase in social transfers. This example illustrates the concept especially well that an appropriate system of fiscal institutions is important not only for the short-term control over deficit but it is essential to shape the budget structure relevant to long-term sustainability in a well-considered way.

According to international experience, one of the typical problems is that fiscal adjustments are procrastinated until there is very little time left to avoid a crisis, thus expenditure items that can be reduced easily and quickly will fall victim first. Among them future-oriented expenditures, probably because they are in nobody's vested interest. Making a general trend, various interest groups strive to have their budget allowances legislated as mandatory items, making it hard or even impossible to reclaim these items from them in times of adjustments. It is to be expected of a good system of procedural rules to safeguard the quality of the budget and prevent mandatory items from proliferating.

### *"Breathing technique"*

According to one of the most important findings of the Pebereau Report on the analysis of the dire situation of the French budget in 2005, a general practice had emerged in France in the past decades where the government was expected to resolve each and every significant economic and social problem, with the most typical, and sometimes the only, method being the budget's readiness to give money-often fast and without any efficiency considerations. It seems this phenomenon is not entirely alien to the Hungarian practice, either. Given the fact that problems will always exists-and always the current problems will seem to be the most significant-the only way to respect fiscal constraints is to install appropriate procedural rules to curb overly careless and irresponsible increase of budget expenditures. The phenomenon is somewhat similar to the situation of a long-distance runner: The body always needs large amounts of oxygen, but it almost certainly leads to failure when the runner gasps for air haphazardly, instead of taking controlled breaths.

### *Ex ante credibility*

#### ■ *External credibility*

The issue of credibility, as one of the most important reasons for implementing rules that ensure transparency, has been addressed above, but there it was only said that economic players, especially investors, want to be as certain as possible that no information relevant to their positions is hidden from them. Procedural rules help credibility by decreasing the negative ramifications of collective decision-making and time inconsistencies. Risks are reduced substantially if the government and the Parliament tie their hands in advance by procedural rules as well. Not only has the government to pursue a disciplined budget policy, but also has to convince financial markets in advance, otherwise a deficit reduction due to risk premiums will not

happen, increasing the social costs of the adjustments.

### *Internal credibility*

Situations where the implementation of the budget needs adjustments within the fiscal year should be avoided as much as possible, because in practice this almost always means across-the-board cutbacks on expenditures that can legally be reduced (multi-annual investments, for example). Across-the-board cutbacks destroy the government's internal credibility because even disciplined entities are penalised. To avoid the necessity of implementing interim adjustments, an appropriate system of reserves should be installed in the planning system which has been assessed *ex ante* by the professionally accepted and independent expert institution. When the budget policy lacks credibility and it is foreseen that adjustment will be needed with time, then this prophecy will almost certainly fulfil itself, because fears of adjustments trigger a strong urge for fast over-spending.

**BLOCKING APPROPRIATIONS WITHIN THE FISCAL YEAR; REASONS AND METHODS TO AVOID THIS PRACTICE**

Blocking appropriations within the fiscal year has in recent years become regular in Hungary. The practice of across-the-board cutbacks ruins the government's internal credibility, because blocked items that are supposed to offset faulty planning (due to lack of information, carelessness, or wilful wrongdoing, for example), will damage ministries and institutions that have had nothing to do with arising mistakes or a deficit overrun in a universal manner. As a consequence, some ministries and institutions cease to be interested in a disciplined, savings-oriented approach, and the urge even intensifies to create reserves (superfluous activities and institutions) which can be sacrificed without having to endure large losses when the cutbacks emerge "on time, as expected". The proliferation of reserves (with deficit targets "carved in stone") will of course just put additional tension on the budget and increase the necessity of cutbacks. As an additional adverse effect, interventions within the fiscal year necessarily distort the budget structure, because, on the one hand, there is not enough time and information to develop an optimum action plan, and on the other hand, a large number of expenditure items (which "deserve" to be reduced) are inflexible in the short term because of civil law agreements clinched earlier. All these provide foundation for the expectation that interventions within the fiscal year should never be necessary in a well-operated system.

In order to establish this principle as a general rule, let's take a look at some of the cases when the necessity of intervention within the fiscal year may arise at all, and what phenomena could cause budget figures for the current fiscal year to deviate from targets:

1. noise (for example, a large amount slips over to the next budget period; litigations have unexpected outcomes; weather; etc.),
2. changes in seasonality (due to legal modification of in-payment deadlines, for example),
3. unexpected events in the business cycle,
4. structural breaks in trends,
5. wrong forecasting model,
6. wilfully wrong planning.

In cases 1 and 2, economic policy must not react at all. In case 3, the automatic stabilisers have to be allowed to do the job. If forecasting models are based on time series spanning several years, then in cases 4 and 5 at least one year is necessary to detect any breaks in the structure or any fault in the model, thus no reaction shall be made before the next budget. The only case when the action should not be delayed until the next budget is when planning was faulty from the start. The necessity of making a substantial adjustment within the fiscal year can only be excluded if and only if intentionally erroneous planning is precluded. Planning errors can be ruled out safely when the process is professional and transparent, meaning:

1. appropriate database and forecasting methodology are in place,
2. the database and the methodology are public, and can be assessed by the professional community,

❸ a nonpartisan and well-informed institution is operational with the task of scrutinising the substantiation of plans and targets.

It can be established overall that involuntary interventions within the fiscal year can be eliminated by reducing planning mistakes to a minimum. Minor planning faults and other uncertainties that emerge in spite of these precautions may be managed by installing appropriate budget reserves (general provisions, for example).

### *Prevention is more efficient than penalties even in political decisions*

In parliamentary democracies, elected politicians bear political responsibility for their political decision, where the main indicator of political responsibility is the chance of losing the election. Since elections are held every four years only, the outcome reflects the combined effects of a huge number of decisions, therefore an election result cannot be regarded as a direct consequence, or either a reward or a punishment for any specific political decision. There is no other way outside the elections to assess political decisions in a legally binding manner, nor there is a way to sanction political decisions or their consequences. If for some reason it is deemed important to avoid an excessive public debt, then it's no use promising sanctions for such an event (because these threats in themselves are not too credible), but any chances of excessive debt should be excluded by installing appropriate procedural rules (the observation of which, however, is not classified as a political decision). If the cabinet and the governing parties are really sincere about budget discipline, then they will undertake these rules voluntarily, and it will not be in the interest of the opposition in the first place to inherit a debt-ridden country one day.

### *Increasing transparency*

If political decisions cannot be sanctioned appropriately by legal measures and the shaping of the budget is necessarily a subject of political decision[33], the only solution left is the transparent measurement and assessment of the extent to which promises have been kept. Through forming public opinion, this will lead to political consequences (voluntary resignation, for example). This requires that promises be quantified if possible, measured timely, and that their implementation should actually (and mostly) depend on the performance of decision-makers. Otherwise nothing is to be expected but never-ending political exchanges and the smearing of responsibilities that cannot be exposed objectively.

## Recommended system of procedural rules

### *Budget cycle, decision competence*

The procedure for setting various target values and limits have already been explained in the section addressing the recommended system for fiscal policy rules, thus it will not be repeated here. However, it should be noted that the Parliament's explicit decision in respect to mandatory and discretionary items is supposed to help safeguard the quality of the budget.

One of the most important tools of retaining fiscal discipline is to give neither the government nor the MPs the chance to increase the deficit by submitting amendment proposals to either the Budget Act or other specialised law (in excess of the set of fiscal rules). Dubbed PAYGO rule[34] by U.S. terminology, this rule has already been effective in the House Rules of the Hungarian Parliament[35], but, surprisingly, there is a single exception from its applicability-none other than the first round of the budget bill debate.[36]

In order to make the rule of restriction on deficit increase observed, the expected budget impacts of each bill and budget amendment proposal shall be calculated (estimated). In

order to make the various alternatives comparable, a common point of reference is needed, and this is exactly what the aforementioned base-line projections ensure. Therefore, it seems expedient to prepare base-line projections regularly, each quarter for example.

It is recommended that the Parliament should debate the budget bill and tax bills jointly in order to ensure consistent transfer of tax law amendments into budget forecasts. Following the first round of the debate when key figures are defined-and respecting the 45-day preparation period as stipulated by the law to be passed between announcing tax laws and putting them into force-the tax laws can be announced. Then, the second round of the debate starts, now concentrating purely on budget issues, with voting items being the only scope that may be changed within their individual chapters.

The schedule of preparing and addressing the final accounts is recommended to be modified. According to current practice, the government delivers the draft to the SAO by 30 June after the fiscal year, and then the Parliament will receive the final version at the end of August. It means that the SAO has roughly two months to check the draft. It is recommended instead that the first draft-which contains numeric data predominantly-should be prepared by the end of March but the Parliament should not start debating it before next spring. This setup would yield four benefits:

- the basic data could be used in next year's budget planning as early as April;
- the SAO would be given substantially more time (about a year) to conduct the audit;
- explanation of the final accounts could analyse various factors that have impacted the budget; presently it cannot be done because macro-economic data for the preceding year released by the Hungarian Central Statistical Office are usually unavailable before August;
- documents of final accounts could be given much greater attention by the Parliament than today, as currently they are overshadowed by the budget debate in the autumn.

In the present system of the Hungarian budget (and legislation, in general) the finance minister and the Parliament's Budget Committee have eminent roles in a relatively few aspects. It is to be considered that the Parliament should not address proposals (either bills or motions for amendment) that have been found by the budget committee unsuitable for debate.[37] The finance minister's role of making a preliminary screening would be advisable to be extended by the solution-already used in some areas, such as guarantees-that motions are to be submitted to the cabinet jointly by the finance minister and the minister of the relevant portfolio.

### *Content of budget documents*

The legal part of the budget documents would comprise three basic accounting components:

1. detailed appropriations of voting items for the upcoming year,
2. mandatory lower limit for the balance of discretionary items for the second subsequent year,
3. required changes in the balance of mandatory items for the third year and subsequent years after the current years. (See also: Item 5 in sub-section *Recommended system of budget policy rules* above)

The explanatory part would comprise the following components:

1. macro forecast for the next three years,
2. forecast of all budget revenues and expenditures (including mandatory items) in the three subsequent years where the estimates for the third year are based on the assumption of no policy change.

Seemingly, there is a contradiction between the legal and the explanatory part, because esti-

mates for the third year in the explanatory part are made on the assumption of no policy change, which most likely does not comply with the requirement defined by the fiscal rule. The contradiction is only seeming because the Parliament has to decide how much of the gap should be eliminated by modifying mandatory items and how much by modifying discretionary items. When in the following year the government tables its proposals to the Parliament by which the balance of mandatory items will improve at the desired extent, the balance of discretionary items can be defined and aligned on the basis of the new current macro-forecast.

### *Reserves system; amending the Budget Act; supplementary budget*

As it has been indicated above, appropriate reserves are to be built into the budget in order to eliminate any violation of budget policy rules as well as necessarily non-optimal interventions with as high a probability as possible. Since mandatory and discretional items are both exposed to various risks, reserves need to be created on the basis of different principles. It is recommended by this study that the sustainability of the balance of mandatory items should be "cushioned" with conservative assumptions. One of the relevant examples is the solution applied in Canada between 1994 and 1998, which took market consensus as the basis for macro forecasts and transferred the impacts of an assumption along the entire path (growth, inflation, etc.) that interest rates would be one percentage point above the market consensus. As a technically easier solution, growth and inflation predictions can be directly modified in the direction unfavourable for the budget.[38]

In the scope of discretionary items the concept of general reserves should still be in place in order to cover really unexpected expenditures, but additional reserves are also conceivable. These could include special provisions (to manage in-process litigation), or equilibrium reserves, such as the system of equilibrium reserves for chapters in the Budget Act of 2007, perhaps with the addition to ensure the Parliament's control over the utilisation of reserves (for example, the Parliament could define in advance what to spend the equilibrium reserve on if the deficit develops as planned).

To replace the current and inapplicable regulations of "amendments to the Budget Act" and the "supplementary budget" the following two designs are recommended.

*Amendments to the Budget Act*:

- one-round procedure,
- no more than 5 discretionary items can be modified,
- updated macro-fiscal forecast is to be attached,
- applicable no more than twice a year,
- can be consolidated with the debate of other laws only if they directly relate to the items to be modified.

*Supplementary budget:*

- a procedure equivalent to the usual two-round address of the Budget Act,
- cannot be consolidated with other bills,
- updated macro-fiscal forecast is to be attached.

If it becomes clear during the year that the planning of some discretionary items have been faulty, a way shall be found to correct the mistake, but the sequestration should be avoided by all means. The recommendation of a compromise that no more than 5 discretionary items can be modified aims to achieve this objective.

## SUMMARY

From every professional aspect, the situation in Hungary has matured to implement comprehensive reforms to ensure budget discipline and transparency. In a relatively short time frame, changes could be made that may serve

for decades as a suitable foundation to a sustainable fiscal policy. This study recommends that the transparency of the budget system be substantially improved first, and then, as technical conditions are being developed, fine-tuned and perfected continuously. Having secured the methodologies of data and forecasts and the credibility thereof, the opportunity arises to implement a very simple fiscal rule: The real value of government debt must not increase. The target value of the primary balance of the budget can be derived from this rule, and then, in turn, the expected balance of discretionary items-which the government could control in the short term as well-could be deduced. The latter should be subjected to accountability, because it allows personal/organisational responsibility to be established. Excessive debt accumulation by municipalities could be prevented by the golden rule; and in the case of state-owned corporations, the gross accounting of their earnings in the budget could make the efficiency of their finances transparent.

If and when policy-makers are willing to tie their own hands with rules that have proven worthwhile in other economies and to regard and manage credible information related to the operation, situation, outlooks and intentions of the sate as data of public interest, then the private economy will reward the creation of a new and more predictable environment with intensified economic activity. The state too would profit from it.

## Appendix

## TESTING FISCAL POLICY RULES

### Main requirements from a system of fiscal policy rules

Before choosing among different possible fiscal policy rules we have to define the theoretical and practical requirements that an optimum system has to meet. Unfortunately, these requirements are partly contradicting each other, hence there is no single optimum rule for all possible circumstances. This is a real choice, for which we consider the following incomplete list of aspects important in the current Hungarian situation: the optimum rule shall

- ensure long term sustainability
  - guarantee the reduction of the debt ratio over the next 20 to 40 years required by the expected increase in age-related expenditures
  - leave enough fiscal room of maneuvering for the subsequent governments and years
  - provide the mechanisms necessary to safeguard the quality of public finances
- support economic stabilization
  - let automatic stabilizers work
  - be compatible with an inflation-targeting or Taylor-rule based monetary policy regime
  - not enforce excessive reaction to temporary effects
- be robust
  - achieve its goal even if policy-makers always want to meet the minimum requirements
  - not use complex and arbitrary calculation methods (e.g. shall not be based on cyclically adjusted indicators)
  - not be subject to circumvention via creative fake solutions (e.g. institutional arbitrage, privatization, re-valuation, etc.)
  - stabilize the optimum long term path, i.e. economic policy shall be redirected to the original path when the rules are violated
- be politically feasible
  - be easily comprehensible, measurable and verifiable

- be compatible with EU-obligations such as the Stability and Growth Pact
- make every decision-maker liable for what they can sufficiently control
- leave enough time to prepare structural reforms when necessary
- not lead to unnecessary tightening, shall not disproportionately favour future generations

## Mathematical formulation of the real debt rule

The rule, stating that the real value of public debt must not increase, can be defined in a mathematical formula as follows:

$$\text{(1)}\quad \frac{D_{t+1}}{1+\pi_{t+1}} \le D_t$$

where $D$ represents the stock of nominal debt, and $\Pi$ is the GDP deflator.

When the rule is observed accurately, the debt ratio will be decreasing subject to the growth rate of real GDP, because:

$$\text{(2)}\quad \frac{D_{t+1}}{Y_{t+1}} = \frac{D_t(1+\pi_{t+1})}{Y_t(1+\pi_{t+1})(1+\rho_{t+1})} = \frac{1}{1+\rho_{t+1}}\frac{D_t}{Y_t}$$

where $Y$ is the level of nominal GDP, and $\rho$ represents the growth rate of real GDP.

In absence of financial transactions and revaluation effects the change in the stock of nominal debt equals the total deficit. If the impact of interest expenditures is deducted from it, then there emerges a relatively simple approximate formula for the primary balance:

$$\text{(3)}\quad \frac{b_{t+1}}{Y_{t+1}} = \frac{i_t D_t - (D_{t+1} - D_t)}{Y_{t+1}} = \frac{i_t D_t - \pi_{t+1} D_t}{Y_{t+1}} = \\ = \frac{i_t - \pi_{t+1}}{(1+\pi_{t+1})(1+\rho_t)}\frac{D_t}{Y_t} \approx (i_t - \pi_{t+1})\frac{D_t}{Y_t} = r_t \frac{D_t}{Y_t}$$

where $b$ is the nominal value of the primary balance, $i$ represents the implicit nominal interest rate of public debt, and $r$ is the (ex ante) real interest rate thereof.

As another possible interpretation of the rule, the total deficit may not exceed the extent of inflation compensation paid on the public debt.

$$\text{(4)}\quad \frac{D_{t+1} - D_t}{Y_{t+1}} \le \pi_{t+1}\frac{D_t}{Y_{t+1}} = \frac{\pi_{t+1}}{1+\pi_{t+1}}\frac{D_{t+1}}{Y_{t+1}} \approx \pi_{t+1}\frac{D_{t+1}}{Y_{t+1}}$$

Assuming in accordance with economic theory that holders of government bonds do not regard this part of the interest income as income because spending it would reduce the real value of their assets, then, obviously, this deficit cannot implicate any additional demand on aggregate level, or, in other words it cannot generate inflation. (Antal, 2004, page 219).

## Comparison with alternative fiscal policy rules

Hereunder the recommended system will be compared with three frequently mentioned alternatives. The first of these is a strict interpretation of the "close-to-balance or in surplus" requirement for the fiscal policy set forth in the Stability and Growth Pact, which means that the total balance has to be in constant equilibrium, perhaps with minor cyclical fluctuations. The second one is again a strict interpretation, this time of the Maastricht criteria, which stipulates that the entire deficit cannot exceed 3 per cent of GDP and the debt ratio must not exceed the 60-percent threshold, also relative to GDP.[39] Considering that the 60-per-cent debt ratio can be stabilised by the 3-per-cent GDP-related deficit only if the growth rate of nominal GDP reaches 5 per cent in the long term, but in line with current outlooks it is not to be expected in developed European countries, therefore, out of the two rules the one limiting the debt ratio would probably be effective in the long run. The third one is a primary balance rule, included in the Public

*Table 1*

**REQUIRED PRIMARY BALANCE**

| | Nominal debt | Debt/GDP ratio | Primary balance |
|---|---|---|---|
| Stability and Growth Pact | $D_{t+1} = D_t$ | $\frac{D_{t+1}}{Y_{t+1}} = \frac{1}{(1+\pi_{t+1})(1+\rho_{t+1})}\frac{D_t}{Y_t}$ | $\frac{b_{t+1}}{Y_{t+1}} \approx (r_t + \pi_{t+1})\frac{D_t}{Y_t}$ |
| Real debt anchor (recommended) | $D_{t+1} = (1+\pi_{t+1})D_t$ | $\frac{D_{t+1}}{Y_{t+1}} = \frac{1}{1+\rho_{t+1}}\frac{D_t}{Y_t}$ | $\frac{b_{t+1}}{Y_{t+1}} \approx r_t \frac{D_t}{Y_t}$ |
| Maastricht Treaty | $D_{t+1} = (1+\pi_{t+1})(1+\rho_{t+1})D_t$ | $\frac{D_{t+1}}{Y_{t+1}} = \frac{D_t}{Y_t}$ | $\frac{b_{t+1}}{Y_{t+1}} \approx (r_t - \rho_{t+1})\frac{D_t}{Y_t}$ |
| Primary balance/GDP anchor | $D_{t+1} = (1+i_t)D_t - \kappa Y_{t+1}$ | $\frac{D_{t+1}}{Y_{t+1}} = \frac{1+r_t}{1+\rho_{t+1}}\frac{D_t}{Y_t} - \kappa$ | $\frac{b_{t+1}}{Y_{t+1}} = \kappa$ |

Finance Act as amended at the end of 2006, according to which the primary balance should record a surplus.[40] In this study, the rule shall be described slightly more generally: the primary balance has to reach $\kappa$ per cent of GDP. *(See Table 1)*

If the stringency of fiscal rules is measured on the basis of the required primary balance, it is obvious that the real debt rule is some kind of a midway solution between the strict interpretation of the Maastricht Treaty and the Stability and Growth Pact. The last column of the table indicates that all three rules define the required primary balance against a debt ratio, where the SGP-anchoring the nominal debt level-defines the nominal interest rate as the multiplier; the real debt rule sets the real interest rate as the multiplier; and the Maastricht debt ratio rule defines the multiplier as the difference between the real prime rate and the real growth rate. Anchoring the GDP-related primary balance is problematic for it is an unstable system, because in case of external impacts on the single equilibrium points the debt and the debt ratio both will increase or decrease to infinity (even into the negative territory).

## Operation of the system of rules with alternative scenarios

### *Long-term sustainability*

If excessive debt accumulation of municipalities is prevented by the golden rule and the earnings of state-owned corporations are included in the budget balance, as dictated by the gross accounting principle addressed above, then excessive debt of the governmental sector-as defined by the ESA'95 statistical methodology of the European Union-and an increase in the Maastricht debt ratio could be prevented by limiting the central government debt.

If there is no real growth-as perhaps presumed for the long run when external factors are taken into consideration-the debt ratio stabilises. If the growth is fast, the debt ratio will decrease quickly but will not disappear entirely, hence there should be no concerns over the liquidity of the government securities market (as it was repeatedly the case at the end of the 1990s when the public debt of the United States started dropping at a very brisk pace).

In a scenario with roughly an initial 70-percent debt ratio and a real growth rate of around 4 per cent, the debt ratio will drop by nearly 3 per cent annually, far steeper than the 0.5-percentage-point reduction required by the Stability and Growth Pact, but not as much as if the total balance would be around 0, as required again by the SGP as well. Should Hungary be able to maintain an average growth rate of around 4 per cent, the debt ratio would decrease to 47 per cent within ten years. And if the average rate of growth is 3 per cent in the subsequent ten years, then the debt ratio by the end of the 20th year will have dropped to 35 per cent, half of today's ratio.

If Hungary's growth within the European Union-the real convergence-is slower, the debt ratio will also decrease at a lesser pace. This could be interpreted as a concept where the current generation has no right to live off the benefits of a fast convergence to the EU alone, and where the real convergence creates the opportunity for Hungary to relatively quickly reduce the debt accumulated by previous generations.

An unexpectedly high inflation rate during the convergence process-because, for example, the Balassa-Samuelson effect is stronger-allows a higher nominal deficit, but this will not affect the declining path of the debt ratio because of a higher nominal GDP.

From two aspects it is important to underline that formula (2) describing the development of the debt ratio contains the rate of real growth, whereas the approximating formula (3) of primary balance calculates with a real interest rate.

One of the aspects: Following the euro adoption, the implicit interest rate of the Hungarian public debt will likely be identical to the government securities yield of the other euro economies, which in turn will probably induce a lower implicit real prime rate. As a result, the primary balance targeted in line with the debt rule will decrease. If Hungary enters the euro zone with a 60-percent debt ratio, then-with a 5-percent nominal interest rate for the euro and a 3-percent (!) Hungarian inflation (GDP deflator)-the target for the primary balance will be 1.2 per cent, and dropping gradually further as the debt ratio decreases.

The other aspect: When the fiscal rule is observed, the primary balance is subject to the real prime rate, and the debt ratio will depend on real growth. Both major trends are to be expected to emerge in the Hungarian economy in the decades to come, but ageing and a decelerating economic growth both will deteriorate the budget balance. There is an element of luck, though; a period of relatively fast growth is ahead for Hungary before the impacts of ageing kick in at full force. This period has to be utilised to get prepared. If the current debt ratio of around 70 per cent is maintained and in 30 year's time the expansion drops to near zero, as predicted by a worse-case scenario, then a 1.4-percent primary balance with a real prime rate of around 2 percentage points will be able to prevent the debt from taking off. If, using this period of "pre-funding" prudently, the debt ratio is reduced to 35 per cent, then even a 0.7-percentage-point lower primary balance would be sufficient with unchanged conditions to maintain the budget policy in the long term (even infinitely). This means that a 0.7-percentage-point part from the burdens of ageing, indicated to be between 3 and 4 percentage points, will be offset by a decrease in interest expenditures. A similar advantage is not available to Italy and Belgium for example, because they have accumulated even higher debts and cannot expect to see a considerable extra growth in the decades to come.

### *Economic stabilisation*

The required balance of discretionary items shall be fixed by the Parliament in the second year before the current fiscal year on the basis

of estimates of macro-economic indicators and the derived balance of mandatory items for the current year available at the time. When the Parliament approves the budget in the autumn of the (first) year preceding the current fiscal year, expectations for macro-economic variables and mandatory items might differ largely from the forecasts of one year previously, but anchoring the balance of discretionary items is important exactly because of the operation of automatic stabilisers; the balance of mandatory items may change-but strictly due to changes in macro-economic variables, and not as a consequence of additional parliamentary decisions.

Formula (3) gives a good reflection of an appropriate coordination with monetary policy, because fiscal policy also needs to become more stringent as monetary policy gets tighter (rising real prime rate), as measured by an increase in the primary balance. If automatic stabilisers are working in the budget, the price shock will produce the necessary improvement in the primary balance by itself (through increasing VAT revenues, for example), without government intervention.

If, in line with a Taylor rule, the central bank makes a 0.5-percent hike in the expected prime rate to compensate for a one-percentage-point rise in inflation, then the primary balance should improve by 0.3 percentage point with a 60-percent debt ratio. This will only happen automatically, if the budget balance has an inflation sensitivity of around 0.3. The weight of directly inflation-sensitive items is far lower than that in the current Hungarian budget, but when the inflation sensitivity of private sector wages is also taken into account, its impact through tax revenues induces a considerable stabilisation effect. It is therefore important from this aspect that the parliament should finalise the balance of mandatory items not one but two years previously, so macro-economic shifts in the year preceding the current year could make their impact.

The higher the debt ratio, the more sensitively the budget has to react to economic cycles. A primary deficit can only be allowed if the expected prime rate stays negative for an appropriately long period of time (in other words, a recession period of several years is recognised by the monetary policy and the equity market alike), or if the state assumes a creditor position.

Should an unexpected price shock (fuelled by oil prices, for example) hit the economy, causing inflation to rise temporarily, monetary policy will most likely get a little tighter (lest the price increase affect expectations), which, in turn, will cause expected nominal interest rates to increase slightly. The implicit nominal interest rate of the public debt will climb even less, because longer bonds are re-priced gradually. Should the impact of the shock prove to be long-lasting-and thus the central bank keeps the prime rate high or even increases it-then this will gradually transpire into an increase in the required primary balance. Hence, the budget need not respond immediately or drastically (which would be especially imprudent when the shock is indeed a temporary affair), nor should concerns arise that the necessary adjustments would be delayed till the end of time.

If growth makes an unexpected one-off boost and reduces the debt even by one forint more than planned, the required primary balance will decrease the very next year, allowing the government to spend a little more, but the yield of the surprise expansion is shared between the current and all future generations.

## *Robustness and political reality*

In the event that the debt exceeds the limit set by the targeted path (it can be lower, but higher it must not be), the initial level should be reverted to. It's not a good thing if the rule can be breached without any consequences and even repercussions, even though a legal, *ex post,* obligation is applicable to the balance of discre-

tionary items only (and perhaps to expenditure ceilings). Prudently, three years should always be available for correction when the debt requirement has been violated.

No full and immediate adjustment is to be prescribed, for it may lead to unconsidered and possibly unsustainable decisions. At the same time, the system should not be allowed to react too late to certain structural problems, interpreting the budget overshoot as a bad economic situation. As an additional advantage, the three-year time frame compels the very same government to right the mistakes that were made in the first year of its term (it's not beneficial to top the predecessor's apparent tab in the first year of the term).

Of course, as mentioned above, the core objective is to never break the rule, which goal could be secured more firmly by the system of budgeting reserves (see below). However, it is important to have a rule for the event when the rule is indeed broken, otherwise the chance of an ex lex state will destabilise the entire system.

As much as the objective is not to allow any chances for deviating from the path required by the rule without any “punishment”, so should it be avoided for the rule to prescribe an unreasonably stringent fiscal policy, for the ensuing political tension obviously could only lead to the “death” of the rule (either by de *iure* elimination or *de facto* disregard). Also avoidable is policy-makers' impression that the fiscal stringency of the present will finance years of lax fiscal policy in the future. Such a historical unfairness would indeed make the rule harder to be accepted by decision-makers of the present.

Since the proposed rule refers to the debt and not to some net asset category, the question arises: Can the rule be deceived by selling assets or by privatisation? In other words, can necessary measures be delayed? The debt rule cannot be sidestepped directly by planning revenues from selling stocks in state-owned corporations, because such an evasive action would require these revenues to be planned consciously three years ahead. The balance of discretionary items is impacted by the selling of tangible assets only (according to the current regulations), the selling of financial assets is not considered as revenues (in line with the methodology of the Maastricht deficit indicator). Planning a one-off revenue from asset sell-off is compliant with the PAYGO rule only if it offsets a one-off expenditure item. A problem arises only when the one-off expenditure item does not represent an increase in state assets, hence it is not an investment. In other words, the recommended system does not provide protection from the state's intention to ensure funding-of one-off welfare payments, for example-by selling tangible assets that are in the realm of state-owned assets.

## BUDGET CYCLE (1)

| Relativ date (months) | Absolute date to year 2011 | Work process | Content of the decision | Comments |
|---|---|---|---|---|
| *t*–44 | 30 June 2007 | The government submits its macro-forecast and the pre-determined items through t+12 to the PBO (Parliamentary Budget Office). | | |
| *t*–42 | 31 August 2007 | The PBO submits its assessment on the macro-forecast and the predetermined items. | | |
| *t*–40 | 30 September 2007 | Submission of a macro-fiscal baseline forecast to the Parliament.<br>*The government develops an action plan.* | | The Parliament faces potential problems for the year 2011 for the first time (Convergence Programme in November refers to the years 2008-2010). |
| *t*–32 | 30 June 2008 | Submission of the macro-forecast and the predetermined items through *t+24* to the PBO. | | EThese forecasts already assume the Parliament's approval for measures developed in the preceding 8 months. |
| *t*–30 | 31 August 2008 | AThe PBO submits its assessment on the macro-forecast and predetermined items. | | The PBO calculates an independent cost estimate of the action plan. |
| *t*–28 | 30 November 2008 | | | The Convergence Programme for 2011 contains the government's plans only, but already with approval from the PBO. |
| *t*–25 | December 2008 | The Parliament may order, in the form of a resolution, additional action plans from the government.<br>*The government develops additional measures.* | Based on the medium-term plan, the Parliament defines the minimum primary balance to be targeted for 2011 (in HUF billion, and not as a percentage relative to the GDP). | Even though exchange rate changes, privatisation or other financial transactions may impact the debt ratio to be expected for end-2010, these will not affect the primary balance target. |
| *t*–20 | 30 June 2009 | Submission of the macro-forecast and the predetermined items through t+36 to the PBO. | | These forecasts already assume the Parliament's approval for measures developed in the preceding 5 months. |

## BUDGET CYCLE (2)

| Relativ date (months) | Absolute date to year 2011 | Work process | Decision of the content | Comments |
|---|---|---|---|---|
| *t*–18 | 31 August 2009 | The PBO submits its assessment on the macro-forecasts and the determined items. | | The PBO also prices the new action plans. |
| *t*–16 | 30 September 2009 | The government proposes a minimum balance of mandatory items (in HUF billion, and not as a percentage relative to the GDP).<br><br>Addressing amendments to substantive laws (including tax laws) | | The balance of mandatory items would be derived from this and the target value of primary balance (defined earlier), but it cannot be fixed because macro-variables may change later.<br><br>These amendments can modify the balance of mandatory items in either direction, also affecting the room of for discretionary items, because the primary balance is already anchored. |
| *t*–13 | December 2009 | | The Parliament defines and fixes a minimum balance for the discretionary items. | The (yet undefined) balance of mandatory items cannot be deteriorated subsequently, but automatic stabilisers may work. |
| *t*–8 | 30 April 2010 | Negotiations between the line ministries and the Ministry of Finance. | | Budget circular about the distribution of free items among chapters. |
| *t*–6 | 30 June 2010 | Submission of the macro-forecast and of the predetermined items through t+48 to the PBO. | | |
| *t*–4 | 31 August 2010 | The PBO submits its assessment on the macro-forecast and the predetermined items.<br><br>*Debate on voting items within the government.* | | |
| *t*–3 | 30 September 2010 | Submission of the budget proposal to the Parliament.<br><br>Debate about the budget law and the tax laws jointly (round 1) | | The explanation includes the forecast for the mandatory items, as updated in line with the most recent macro-forecast, and also contains the predetermined discretionary items.<br>Tax laws may only be amended with zero net effect on the deficit (unless these measures come into force in later years). |

## BUDGET CYCLE (3)

| Relativ date (months) | Absolute date to year 2011 | Work process | Decision of the content | Comments |
|---|---|---|---|---|
| *t*–2 | | The PBO submits its report on checking the calculations related to the voting items. | | The costs of individual tasks need not be known in the first round of the debate, because the decision is about defining the total of major functions (for example, health-care expenditures). |
| *t*–1,5 | 15 November 2010 | Voting on aggregate figures, announcing tax laws<br><br>Debate about allocation of voting items within individual chapters (round 2) | Anchoring aggregate figures | No subsequent re-allocation between chapters (“functions”) is allowed. |
| *t* | 1 January 2011 | Start of the fiscal year | Detailed budget | |
| *t*+12 | December 2011 | End of the fiscal year | The final accounts are prepared by the Ministry of Finance | |
| *t*+15 | March 2012 | The numeric part of the final accounts are received by the SAO. | The final accounts are audited by the SAO. | |
| *t*+27 | March 2013 | Submission of the final accounts to the Parliament. | | The impact study as to the development of macro-economic factors is now included in the explanation. |

## NOTES

1 Which of course is also a bit high considering the fact that the Convergence Programme does no calculate with a substantial output margin for 2010.

2 The analyst of the institution says what's surprising is not the fact that there have been politicians in Hungary who have not spoken and written truthfully of the positions and outlooks of the central budget, but the way they have been allowed to do so for so many years. This fact alone is an evidence of serious problems regarding the transparency of the central budget system.

3 Accordingly, the euro adoption in Hungary or its date plays no role in this study.

4 Act XXIV. (IV. 25.) of 2003 on the amendments to various Acts regarding usage of public funds, the increase of publicity and transparency of and control over the usage of public assets.

5 What the premium prices predominantly is not the risk of default (for a country can never run out of its own currency, but it can wilfully refuse payment, like Russia did in 1998; and on the other hand the premium of Hungarian government securities denominated in foreign exchanges is no more than 20 to 40 basis points), but the risk of falling bond prices that occur on the back of currency depreciation at a larger extent and prime rate hikes at a smaller extent. The risk of non-payment is measured by the rate premium of forex-denominated government securities, which, however, is no more than half a per cent.

6 Unless the macro-path, serving as basis for the budget, or the derived estimates on VAT revenues are challenged, or an amendment to the VAT Act is submitted to increase VAT levels. None of these was the case on 23 November 2005 when the above amendment proposal (T/17700/932) was submitted by the Parliament's Budget Committee itself, and eventually approved by the Parliament. Of course, it was not the only reason why the VAT revenues of 2006, initially targeted to be HUF 1,791 billion, recorded HUF 1,831 billion only despite the 15-percent rate having been increased by 5 percentage points in September.

7 Theoretically, the Parliament could influence some of these items when an amendment is approved when the budget bill is being debated (for example, to modify the indexation of pensions), but it is assumed not to be, thus measures aiming to modify mandatory expenditures are to be submitted not later than the budget bill. Of course, civil law agreements already signed cannot be modified even in this design.

8 For example, the timetable of an investment to be implemented outdoors is subject to weather.

9 Before 2004, Pre-accession Economic Programmes – PEP

10 There are three material differences between the two accounting methods. The Hungarian presentation contains data only for public finance in a modified cash-flow approach, and accounts some transactions as revenues or expenditures, as the case may be, which represents the exchange of financial assets only. As a contrast, the methodology of ESA'95 covers a somewhat wider scope of organisations, including some state-owned corporations and a number of NGOs as well, contains modified performance-oriented data and never accounts the exchange of financial assets.

11 It may be regarded as modified accrual-based approach because it accounts some items not in a performance-oriented but a cash-flow based approach. The most significant example is that investments instead of depreciation are accounted as expenditures.

12 It may be considered modified cash-flow because some items that do not actually generate a cash flow, such as return of accounts receivables, do influence the balance.

13 Of course, "budget corporates" is not a category in corporate law but in public finance only, which would represent enhancements to the presentation and ownership control. These corporations would continue operation in line with the Corporate Act, just like limited companies, limited liability companies, etc. do.

14 This is exactly the economic reason why these corporations are included in the ESA concept of the general governmental sector.

15 Based on this very consideration and upon recommendation by the State Audit Office of Hungary, the Budget Act of 2007 has transferred the authori-

sation for the two motorway companies to borrow to the jurisdiction of the cabinet.

16 According to information available, the Hungarian Central Statistical Office has been working on producing a time series of current revenues and expenditures of the government sector, but progress has been relatively slow due to capacity problems. Financial accounts of the government sector have been prepared and published by the National Bank of Hungary until 1991 in retrospect.

17 The European Union usually prescribes that convergence programmes to be submitted shall contain calculations as to the sensitivity of budget balance.

18 Articles 36 and 49 have been amended by Article 3 of Act LXV. of 2006.

19 Maintaining the real value at level presumes that, for example, the level of public services are not changing when the scope of service user is not changing, either. This approach would be a good reference point because it represents a mild incentive to reduce the level of budget expenditures in terms of GDP to the level of real GDP growth on the one hand, and to pursue a counter-cyclic budget policy on the other hand, provided that the approach of "greater boom means more spending" is disposed of.

20 Section (1), Article 18. Prior to creating a law, analysis shall be made, based on scientific results, in respect of the scope to be regulated as to the social and economic relations, the effectiveness of civic rights and obligations, the opportunities of dissolving conflicts in interests, and the expected impact of the regulations as well as the conditions of implementation thereof shall be scrutinised. Legislators shall be notified thereof.

21 Of course, what should be regarded here primarily is not the Budget Act but substantive laws which regularly introduce regulations whose expected impact on the budget is not known.

22 The concept of positive/normative is used in a sense of establishing facts and qualities as widely used in sciences.

23 In the Netherlands, for example, the Central Planning Bureau prices the election promises of the parties before each general election. Not that it is required by law to do so, but it has such a huge reputation that the general public does not consider a party a serious political force which does not request CPB voluntarily (!) to price its political programme.

24 Of course, this would necessitate to extend and modify the schedule of negotiations in a way that the government should be notified of SAO's assessment before official tabling, as in the case of final accounts, to enable the cabinet to make modifications in the proposal accordingly.

25 If the debt ratio falls from its current level of around 70 per cent to half of it and the implicit interest rate drops from around 6 to 7 per cent to 4 to 5 per cent, the usual rate in the euro zone, then interest expenditures could be reduced from current 4.5 per cent in terms of GDP to 1.5 to 2 per cent. (Unfortunately, it is not evident that the current 4 to 5 per cent euro interest rates will be sustained in the long run).

26 The concept of disequilibrium used herein is simpler than the indicator applied in the theory of generational accounting, because it does not contain the current value of future annual deficits.

27 One of the most accepted approaches of the concept of social fairness says that because no one knows before his or her birth into which social stratum, what geographic location he or she will be born, a social redistribution system should be created which ensures the highest possible welfare in the largest possible number of life situations. As an analogy to this reasoning, we have no way of knowing in which era we will be born, therefore a redistribution system should be developed across generations that ensures equal chances for welfare in all historical eras. One of the implications of this reasoning is that each generation has the right to the same return on their savings.

28 Yield, of course, should be interpreted in the widest possible sense here, taking into consideration the combined changes in the value of human capital, fixed assets, natural resources, technological skills, net financial assets, etc.

29 Of course, the potential growth of 1 to 2 per cent refers to the period after the real convergence process in the EU.

30 For example, the Parliament passed a law (Article 1, Budget Act of 2004) in autumn 2003, upon recommendation from the government, that the

Maastricht deficit figure in the years 2004 to 2006 cannot exceed 3.8, 2.8, and 2.5 per cent of GDP, respectively. As a sharp contrast, the government submitted a budget bill in which the deficit planned for 2005 exceeded the legal maximum, still in force at the time, by 1.9 percentage points. In spite of this, the opposition made no address in the Parliament to demand the targeted deficit to be reduced to the legal level.

31 Pursuant to the definition of the Public Finance Act, the debts of municipalities are not included in the public debt.

32 The law currently restricts not municipalities' debt portfolios or debt increase but their annual debt service expenditures, thus municipalities have the theoretic right to take on a payment obligation for perpetuity. The limit is subject to the total of corrected own income.

33 This study does not subscribe to the view that a body of nonpartisan experts, independent from political parties, should decide the desired level of budget deficit in an analogy to the fact that the short-term interest rate is decided by the Monetary Council of the central bank.

34 Pay As You Go, referring to the similarities between shopping and budgeting. When you buy something in a shop, you have to pay immediately; likewise, when budget expenditures are being approved, funding for them shall be dedicated immediately. The very same objective can be achieved without amending the House Rules: The budget statute may prescribe for the government to compensate for a balance deterioration caused by amendment proposals approved in the first round of the budget debate by employing cutbacks in voting items.

35 Section (5), Article 94 of Parliamentary Resolution 46/1994. (IX. 30.) on the House Rules of the Parliament of the Republic of Hungary. In spite of being in force, this rule is in fact not enforced in practice due to lack of substantiated fiscal cost estimates.

36 Section (4), Article 120 of same

37 Pursuant to current rules, an amendment proposal is suitable for plenary debate when supported by at least one-third of the members of at least one parliamentary committee who are present. In the case of a 12-strong committee, this means four votes, but two MPs (with four hands between them) are sufficient when they represent two others as well.

38 Unfortunately, it is to be expected in both cases that on the back of consistent implementation, credibility will again be jeopardised-this time in the opposite direction.

39 Of course, the Maastricht Treaty basically refers to sustainable fiscal policy and equilibrium, defining these values not as targets but as extremes. Experience of recent years, however, indicates (primarily in respect to applying sanctions) that a number of countries have in fact interpreted the criteria as targets.

40 This is analogous to the design applied by Sweden, Chile, and Brazil, where the primary balance is to indicate a surplus of 1 and 2 per cent, respectively. In Chile, the stipulation pertains to the primary balance as adjusted for cycles, but Brazil has not implemented this approach.

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