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Principles of a regulated public finance system

Stabilisation, economic growth, public finance reform—these have long been the call words of Hungary's economic policy. None of them is a new-found expression, but they have become timely on a wider scale just recently.

Some of the most powerful manifestations of the Hungarian economy's non-equilibrium have been the balance of public finances and current account, and the size of public debts. When detailing the system of correlations of these factors, one cannot avoid explaining why the funding needs of public finances have to be curtailed, the increase of net external debts stopped, inflation reduced, and why it is necessary to keep public finances deficit at a low level.

Differing opinions have surfaced in respect of budget policy. There are conflicting views about the factual extent of equilibrium loss and the judgement on various indicators that reflect budget deficit among not only economists engaged in studying the central budget or public finances but also among researches and researchers that supply the basis for economic policy.

The concept of public sector reform generally includes education, health care, pensions, and the number of public employees. The agenda herein includes not these items but the budget system itself and its mechanisms.

Usually, this topic has no direct impact on average citizens, thus they are not interested in it, but it is now inevitable for professional circles engaged in budget policy. OECD for example has addressed this topic for decades, but IMF and EU have also taken a liking to it in the past one or two years.

Of course, it's not to say that an adequate budget mechanism would be a substitute for political willpower (see today's budget policy in the United States of America), but international experience suggests that even an appropriate political resolve could prove lacking if institutions and mechanisms are inefficient.

The question of what the government's tasks are is never answered by the executives of the system or the institutions, but it will always be the subject of political consideration.

INITIATIVES, BACKGROUND, AND CREDIBILITY

Nowadays, public finances and the central budget operates, develops, and progresses on the principle of what tasks the current political administration thinks should be covered, what should be financed by the central budget, what the relation is between the state and the society, and how the relation between public inter-

est and public power develops. Task fulfilment has two basic principles today. One says the state undertakes tasks on behalf, or in the interest, of the public or a group of the public, while the other theory argues that the possibility of public authority-or “pressure”, even-is always present in the operation of the state.

In theory, the operation of the state is based on an invisible agreement with the society in which, for the sake of fulfilment of government tasks, members and institutions of the society waive part of their economic independence and accept the consequences that stem from the existence of the state.

Everybody knows that an agreement is good when all the parties to it are satisfied with the contents. Hence, it is a basic interest of the government of the time to establish a system which will suit the widest scope of the society.

Social and economic processes of recent years, and the system of modern societies-having become more complex than ever-inevitably require the state's economy-influencing and task-managing role.

From the aspect of the state, the most substantial problem is the basis it picks its tasks upon. The focal point of debates in respect of public finance reforms has always been the definition of state tasks. The answer is only seemingly easy, because the following factors always present problems.

■ Various strata and groups within the society have different degrees of interest enforcement abilities, and they represent different interests against the state. The preferences of the society are not unambiguous, the profits of various tasks are “hard to translate into numbers”, and are incomparable.

■ The objectives of the society cannot be aggregated clearly. Various target vectors assume different task fulfilment and redistribution systems.

■ Measuring the performance of the state is a tough job, bordering on the impossible in cer-

tain cases; for example what should the annual deficit measure, and how should the budget's quality be translated into numbers?

■ Non-measurable factors that do not make their impact through the budget directly should also be taken into account (e.g. multiplication effect).

In light of the aforementioned facts, one of the core rules of public finances can be described as follows: There are no everlasting solutions, and the system of public finances will always be defined by the movements of social, economic, and political factors. Yet why have the demands that urge regulated and transparent mechanisms at an increasing extent become pressing, saying a system of fiscal regulations should be established?

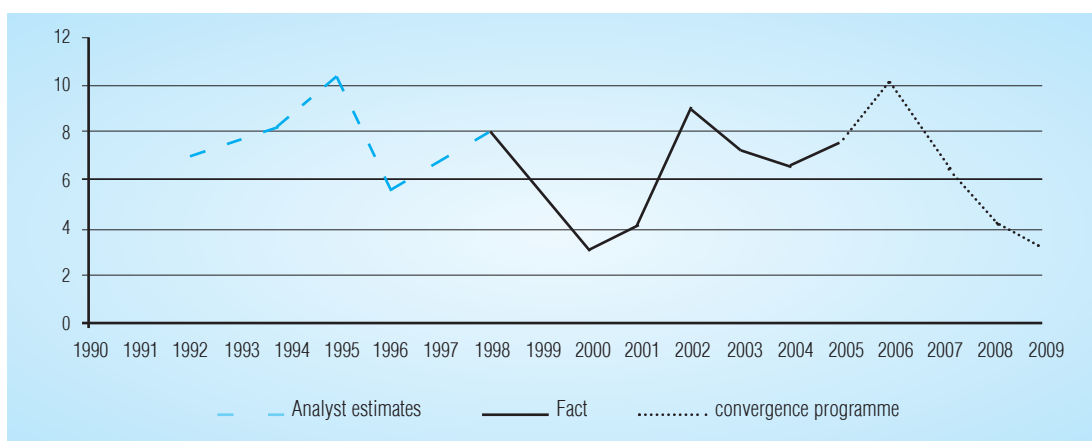
The last major budget adjustment in Hungary occurred in 1995, but ten years later similar problems returned as budget processes had veered to the border of a non-manageable position. The convergence programme has set a path of fast and clear-cut adjustments, but even now the question arises: What will prevent the current situation from returning five or ten years later? It's not enough to get to a sustainable path, you need to stay on it, too.

Without any further comment, *Chart 1* is seen below, displaying the changes and cyclical fluctuation of the deficit from the 1990s to 2010. Particular regard should be given to the years 1994, 1998, 2002, and 2006.

Deficits generated in the public sector are to be financed via money markets, and it does matter what terms and conditions apply.

Hungarian money market processes are substantially influenced by international market developments, particularly in the short term, but if economic players believe that troubles (overspending) will not return, then longer-term interest rates could drop. Restoring credibility takes some time, of course, but developing a mechanism to support sustainability could speed up this process substantially.

PUBLIC SECTOR DEFICIT IN TEMS OF GDP



A major part of restructuring of the budget system and budget mechanisms could be implemented without laws that require two-thirds majority votes in Parliament, but they would only have real power when based on the consensus of all political parties because it is important for new mechanisms and institutions to function in the long run, spanning several government terms. (This should also be some kind of a “social” contract).

LEGISLATIVE RULES TO BE CREATED

Main indicators for the central budget are defined in the convergence programme. Targets for deficit, primary balance, and gross public debt have been defined. These indicators are featured in *Table 1* below.

Result rule

The table above shows that the deficit change between 2007 and 2011 is planned to amount to 4.6 per cent of GDP, and the decrease in public debt accounts for 4.3 per cent of GDP. This could and have to be set as an objective for the economy of the time to achieve.

The essence of this rule is as follows: A target is set that the debt ratio shall decrease by 4 percentage points in the next four years. This solution will smooth over the impacts of boom cycles to some extent, at the same time it allows no delays for finding solutions for structural problems.

If the debt ratio fails to drop on the basis of technical projections, adequate measures are to be made. Of course, the result rule is to be observed by regulated annual budgets, and when troubles start to emerge they should be corrected in a regulated way in the following year.

An example when “nothing is being done” expect being credible, yet expenditures are dropping steeply.

According to EU estimates, also included in the convergence programme, expenditures related to old age will increase in Hungary by 4 percentage points in terms of GDP between 2010 and 2050. In 2010, Hungary's debt will amount to nearly HUF 20,000 billion, or 68.5 per cent of GDP, and the related interest expense will be HUF 1,070 billion, no less than 3.6 per cent of GDP. If the central budget's spending on interest dropped by as low as 0.5 percentage point of GDP as a result of restoring credibility (when the market believes that the country is able to stay on the designated path), it would still mean a huge amount of savings. Thus, these amounts could be spent on financing expenditures related to old age.

Table 1

TARGETS FOR BUDGET INDICATORS

	2007	2008	2009	2010	2011	Change: 2007–2010
Deficit	6.8	4.3	3.2	2.7	2.2	4.6
Primary balance	-2.4	-0.2	0.8	1.0	1.5	3.9
Gross public debt	71.3	72.3	70.4	69.0	67.0	4.3

Procedure rules

The essence of the “pay-go” rule is as follows: When the Parliament decides about an entry with impact on the central budget in the form of a law (for example new regulations are created within the Higher Education Act), then the very same law should address funding for such extra appropriations.

There are flexible and inflexible, or regular and extraordinary, appropriations in the budget, also called by some economic literature constant or variable items.

▶ Short-term inflexible (“regular”) entries include various allowances, normatives, wages (social security, family welfare, social and educational normatives, etc.) and tax revenues because these are stipulated (previously!) by specialised laws and not by the law on central budget.

▶ Short-term flexible (“extraordinary”) items include application funds, operational expenditures for appropriations that are managed by budgetary chapters, etc. If a decision is made to amend specialised laws that define regular entries, it could be offset in the scope of extraordinary items, which means spending defined by specialised laws should be offset elsewhere. Thus, funding is immediately found for any extra expenditure.

Expenditure cap rule

The essence of the expenditure cap rule—according to which chapter-based subsidy appropriations are defined for n+3 years—is

that each ministry will receive advance plans of their subsidies for the period. Ministers and executives responsible for budgetary chapters have decision-making authority to define priorities within these allocations. The government will review the caps each year and may rearrange them in certain cases, such as the occurrence of residual funds, new tasks, or extraordinary events. Obligatory rearrangement is to be executed when indicators defined by the result rule are jeopardised.

Guarantee rule (budget planning on the basis of cautious macroeconomic predictions)

Various guarantees should be built in the medium-term program in the course of planning. According to a possible concept, the “half-percent rule” could be applied. This means that the government will create, together with players on the domestic and international markets, a consensual extent for budget-defining parameters (macroeconomic indicators), for example that GDP will grow steadily at an annual rate of 4 per cent in the years to come, or that inflation will be around 3 per cent. In the course of subsequent planning, figures half a per cent worse than the consensual path will be taken into account.

Half-percent rule in practice (four macroeconomic indicators)

▶ Real GDP grows 0.5 per cent slower than market consensus says it will, therefore the former figure should be taken into account.

▶ Retail real consumption shall be accounted at a figure 0.5 per cent slimmer than market consensus.

▶ In the course of planning, inflation should be 0.5 per cent lower than market consensus.

▶ When planning interest expenditures, interest rates shall be 0.5 per cent higher than predicted by market consensus.

When planning authorities base their initial calculations on the guarantee rule, substantial reserves will be created automatically, allowing compensation for occasional overruns. The guarantee rule does not mean wilful underplanning, for it must not be applied in the case of indexed appropriations (for example, the extent of increase in pension expenditures).

This rule decreases public finance risks stemming from changes in the status of the economy, creating guarantees for observing main indicators and the result rule.

Equilibrium rule

In 2006, an equilibrium rule was built in the Public Finance Act in connection with the amendment of said act. The rule dictates that ministries shall prepare quarterly reports, and at these presentations they are to state whether they will go over their appropriations or create a surplus at the end of the year

The very same amendment to the Public Finance Act stipulates that appropriations shall be designated that could only be used when a ministry in question will not overrun its annual budget (equilibrium reserve).

Act XXXVIII. of 1992 on Public Finance

Article 49, Paragraph q)

“Unless the law prescribes otherwise, the executive of the authority in charge of the chapter in question shall submit reports to the Government in every quarter in respect of chapter revenues

and expenditures and also of their expected development for the year in question”.

Article 36, Paragraph f)

“Upon submitting the bill on central budget, the Government shall make recommendations in the chapters defined for ministries for appropriations that shall only be allowed by the Government to be utilised when, based on the quarterly report of the ministry chapter in question, expected developments in the budget of said ministry permit such utilisation of funds”.

HOW AND WHY DOES TRANSPARENCY HELP CREATE EQUILIBRIUM?

Transparency of finances starts with submitting the bill on budget to the Parliament and ends with paying the invoices of public institutions. Therefore, it must be ensured that the overall route of public funds be tracked.

Initially, it should be demonstrated in the case of each new bill how the balance of the budget will be impacted if the bill in question is approved. In addition, the validity of the arguments should be verified. Verification could be done by the State Audit Office, private research institutions, international analysts or by an institution established specifically for that purpose.

Transparency is to be applied also as a general practice in the case of forecasts and budget policy commitments. Here, the verification of government prognoses is to be done by market players, or an institution independent from the government and reporting to the Parliament can also form opinions just like the Convergence Council does.

Preparing consistent time series and making them publicly available is a prerequisite to objective analysis. Aside from those few macro-indicators that are usually released, the number of intermediate assumptions to derive budgetary figures from reaches into the hundreds.

PROGRAM-BASED BUDGET

The State Audit Office is already making an enormous work in commenting draft budgets, but it does not disclose alternative calculations—partially due to lack of legal authorisations and of necessary capacities.

A relatively extreme example for comparison is the United States where the calculations of the Congressional Budget Office automatically replace the budget submitted by the President if the former is materially different from the latter.

In Hungary, the relevant parliamentary committee could have the right to decide by vote whether the calculations of the government or the State Audit Office should be considered as relevant when judging the expected future impact of a specific measure. This would make the job of the government more difficult at first glance; however, it would result in more accurate and transparent calculations. It would also help approve the bills on final accounts if the State Audit Office already made these calculations in the budget planning phase. Running mutual risks would help achieve the objectives more efficiently.

What has been described above can be achieved if steps are taken to establish what is called a programme-based budget¹.

Draft budgets today consist of approximately 5,000 pages in ten volumes. Generally, 3,000 amendment proposals are submitted by MPs, mostly aiming to achieve local objectives such as the construction of by-pass roads or other local subsidies and other financing in their own constituencies. But there are no real debates about the macroeconomic path, or expenditure possibilities and priorities defined by the economic environment.

Consequently, after the tax laws and the macroeconomic path defined in the budget bill have been approved by the Parliament, MPs should not be debating VAT, nor could they submit amendment proposals to repay less interest the following year and spend the money on other objectives instead.

Therefore, the decision-making process is to be restructured to establish new emphases. The

Table 2

PROGRAMME BASED BUDGET – MODEL

	Main program	Program	Sub-program
<i>Subject</i>	Function	Objective	Measures
<i>Decision</i>	Parliament	Parliament	Government
<i>Responsibility</i>	Head of Portfolio or Representative	Undersecretary of State or Representative	Head of Institution or Representative
<i>Number</i>	40–50	200–300	1500–2000
<i>Example 1.</i>	Environmental protection	Concept for waste water treatment	Construction of waste water treatment plant Increase in penalties
<i>Example 2.</i>	Housing construction	Program for housing blocks made of prefabricated concrete	System of interest subsidies Elaborating the role of municipalities

only way to achieve it is to introduce program-based budgeting.

Fewer numbers should be presented and more issues that impact the life of the citizenry are to be discussed.

Program-based budgeting would mean that the Parliament would approve the financing of specific projects, and the government would report to the Parliament on the implementation of these programs. This is a model where state responsibilities are classified by tasks and functions, and these tasks and functions would appear as appropriations in budget presentations. (See Table 2.)

Reporting is made biannually to the government or the head of a portfolio in a report prepared by the person in charge for the program. Supervision of annual implementation and control of program indicators are to be submitted to the Parliament. Program-based budgeting will, or at least is likely to, resolve the issue of performance indicators. There has been a long-standing need for measuring the performance

of public institutions and state organisations. International experience varies, implementation is unlikely to be quick and inexpensive, yet it is an essential part of reforms, for there is no better practical, or even theoretical, alternative. Performance indicators used in programs should be in line with performance requirements.

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The author believes to have managed to convince you, dear reader, that the management of public finances is to be reconsidered. This is not the interest of the financial government alone. The parliamentary opposition of the time, the State Audit Office, and the relevant ministries are also partners to it, for their activities do not focus on preparing new budgets solely, they also want to achieve good results in their own professional areas. The betterment of the economy is in the interest of all political and non-political entities.

NOTE

¹ A relevant article has been published by these pages this year. See: Gusztáv Báger: Program-based budget - typical features, practical experience, *Pénzügyi Szemle [Public Finance Quarterly]*, 2006.3., pages 281–301 (Editor)