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Budgeting in Hungary

OECD study

INTRODUCTION

This paper presents the main findings of the budget review of Hungary that was carried out by the Secretariat of the Organisation for Economic Cooperation and Development (OECD) in May 2006 as part of the working programme of the Working Party of Senior Budget Officials. The Working Party is the committee of the Budget Directors of the OECD countries. It meets annually and discusses the budget reviews which are carried out by the OECD Secretariat.

While preparing the review the OECD Secretariat has made a mission to Budapest during which it met with officials of the Ministry of Finance, the State Treasury, the Ministry of Education and the Prime minister's Office. The Secretariat also met with the President of the State Audit Office, the Deputy Chairman of the Budget Committee of Parliament and a member of the Monetary Council of the Central Bank. All Hungarian officials and authorities have provided the OECD Secretariat generously with information and have frankly exchanged their views with the Secretariat. This review has made ample use of this information and these exchanges.

The Hungarian budget review has been presented at the Ministry of Finance of Hungary on 29 and 30 May 2006. At that occasion the OECD Secretariat had an opportunity to discuss its findings with all Hungarian officials and authorities who contributed information and views during the Secretariat's mission to Budapest. These discussions have led to some further adjustment of the review.

This paper summarizes particularly the part of the review that is concerned with the budget formulation process in Hungary. The OECD Secretariat feels that this process suffers in Hungary from some shortcomings that hamper financial planning and that are partly responsible for the deficit overruns in recent years.

In response to updates of the Convergence Programme 2005-2008 the EC committee has in two subsequent years decided that Hungary needs to clarify its budgetary strategy and take additional structural measures which are fully consistent with its medium term adjustment path. Lacking such clarifications and additional structural measures Hungary does not comply with its obligation to reduce its excessive deficit under the Growth and Stability Pact by 2008. This would put at risk the introduction of the euro in Hungary by 2010 as presently envisaged by the government.

The paper will firstly present some fundamental characteristics of the present budgetary situation in Hungary (section 2). Then it will shortly resume the development of budgetary policy in the last few years (section 3). Subsequently it will treat some key characteristics of the budget formulation process in Hungary, namely the focus on the actual (not cyclically adjusted) deficit (section 4), the focus on the budget year rather than the medium term (section 5), the lack of rules of budgetary discipline (section 6) and the lack of transparency concerning forecasts and outcomes (section 7). The final section contains conclusions (section 8).

FUNDAMENTAL CHARACTERISTICS

Hungary's long-term growth record is good. After the transition upheavals of the beginning nineteen nineties, GDP growth accelerated and averaged 4% per year in the period 1997–2002, around 2% percentage points above the EU average. If maintained, such a difference would lead to a gradual convergence with the EU average per capita GDP in some 25 years (according to Eurostat figures, Hungarian GDP per capita reaches 63% of the EU average in 2005). The main driver behind growth has been the development of Hungary's role as a production platform principally for supply chains to European markets. The rapid growth of production capacities in electrical and transport goods has been particularly important. The financing of this exporting activity has mainly come from foreign direct investment and later on the reinvesting of earnings along with injections of new foreign capital. On a per capita basis Hungary has received since the early nineteen nineties among the highest net inflows of foreign direct investment inflows among OECD countries (surpassed only by Ireland, New Zealand, the Czech Republic and Sweden). In 2002 and 2003 export growth slowed down, but strong domestic demand and public spending has partly compensated for that. In 2004 there was a welcome move back to export and investment led growth and projections suggest that this healthier composition of growth will continue in the near future *(Table 1)*. For the period 2005–2008 the estimates of European Commission (EC) are shown in addition to the estimates by the Hungarian Government in the Convergence Programme (CP).

Strong growth has allowed Hungary to expand government expenditures while simultaneously reducing the tax burden. However, in the period since 2000, the Hungarian authorities systematically overestimated the room for expenditure initiatives and tax relief or even approved such initiatives or tax measures without room. The picture of expenditure and revenue development since 2000 is complicated considerably by continuous revisions of estimates. These revisions are due on the one hand to outcomes

Table 1

GROWTH IN REAL GDP

(Per cent change on previous year[1])

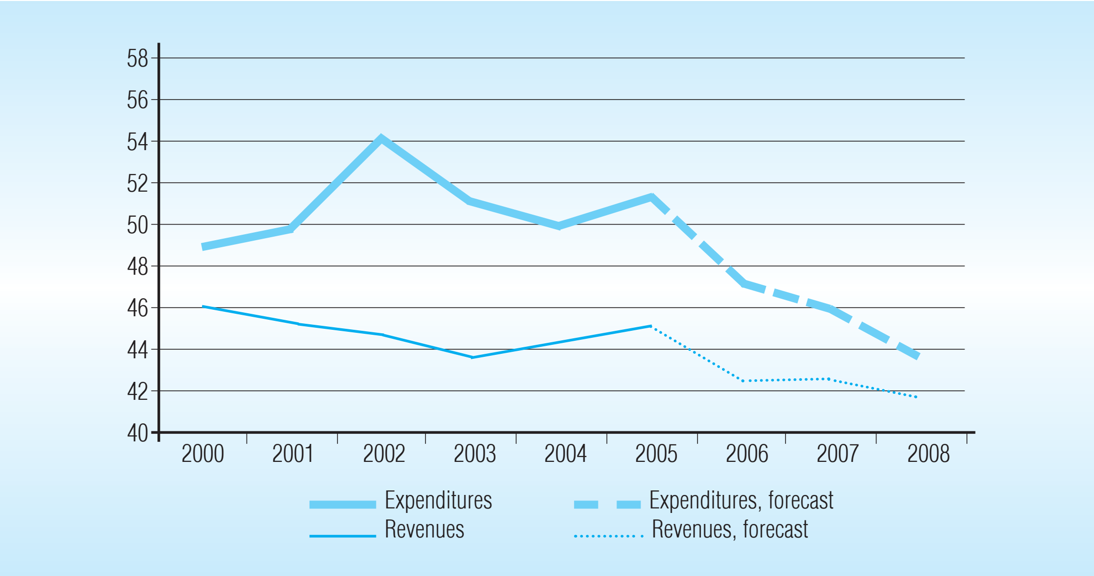
	2000	2001	2002	2003	2004	2005	2006	2007	2008
EU 15	3.8	1.9	1.1	1.1	2.3	1.4	2.0	2.2	n.a.
Hungary CP	5.2	3.8	3.5	3.0	4.2	4.0	4.1	4.0	4.0
Hungary EC	5.2	3.8	3.5	3.0	n.a.	3.7	3.9	3.9	n.a.

Sources: EU 15: Eurostat. 2005–2007 forecast. Hungary 2000-2003: IMF (2005). Hungary CP 2004–2008: Government of the Republic of Hungary (2005). Hungary EC 2005–2008: European Commission (2005).

Figure 1

GENERAL GOVERNMENT EXPENDITURES AND REVENUES (ESA95)*

(per cent of gdp)



* Excluding the consequences of pension reform, the purchase of military Gripen aircraft and quasi-fiscal activities of public enterprises and including investment expenditures of road construction PPP´s.

Sources: 2000–2003: IMF (2005), 2004-2008: Government of the Republic of Hungary (2005).

that deviate from estimates (so that budget estimates are not reliable) and on the other hand to revision of accounting methods, imposed on Hungary by international organisations, in particular the European Union. Taking these revisions into account the general picture that arises is that of a widening gap between expenditures and revenues from 2000 to 2002, which has only partially been redressed since then. Whereas expenditures have increased from 48.8% in 2000 to 51.2% in 2005, revenues have decreased from 46.0% of GDP in 2000 to 44.4% of GDP in 2005 (on accruals basis, ESA95). *Figure 1* illustrates this development. The development after 2005 is indicated in Figure 1 in accordance with the latest update of the EU Convergence Programme (December 2005).

After the peak deficit election year 2002 the new centre-left coalition has tried to bring the general government deficit under control. This effort was strongly underscored by the political goal, agreed by the Hungarian Central Bank, to enter the euro area in 2008. However, subsequent attempts to set out and maintain a deficit reduction path that would bring the deficit back to the Maastricht benchmark of 3% have failed. According to the most recent estimates agreed by the EC the general government deficit on ESA 95 basis in 2005 has been 6.1% of GDP *(Table 2)*.

The public debt ratio in Hungary is slightly below the 60% GDP benchmark of the Stability and Growth Pact. After the declining trend in the debt ratio reversed in 2002 with the ratio rising from 53.5% of GDP in 2001 to 57.6% of GDP in 2004, the Updated Convergence Programme of the Hungarian Government foresees a return to declining ratio's from 2006 onwards, triggered by the continuous decrease of the general government deficit and the declining interest burden

Table 2

GENERAL GOVERNMENT DEFICIT (ON ESA95 BASIS)*

(Per cent of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
EU 15	1.0	-1.2	-2.2	-2.9	-2.6	n.a.	n.a.	n.a.	n.a.
Hungary	-2.8	-4.5	-9.4	-7.2	-5.4	-6.1	-4.7	-3.3	-1.9

*Excluding the consequences of pension reform from 2004. the purchase of military Gripen aircraft and quasi-fiscal activities of public enterprises and including the investment expenditures of road construction PPP´s. Including the impact of pension reform. the general government balance according to the updated CP would be 6.5% GDP in 2004. 7.4% GDP in 2005. 6.1% in 2006. 4.7% GDP in 2007 and 3.4% GDP in 2008.

Sources: EU 15: Eurostat. Hungary 2000-2003: IMF (2005), Hungary 2004-2008: European Commission (2006)

on the debt stock due to falling interest rates *(Figure 2)*. However, this does not take into account the impact on the debt ratio of the classification of the second-pillar funded pension scheme outside the general government which has to be implemented as from 2007. Including this impact the debt ratio will rise above the 60% Maastricht benchmark as of 2007 (the impact rises gradually from 3% of GDP in 2004 to 6% of GDP in 2008).

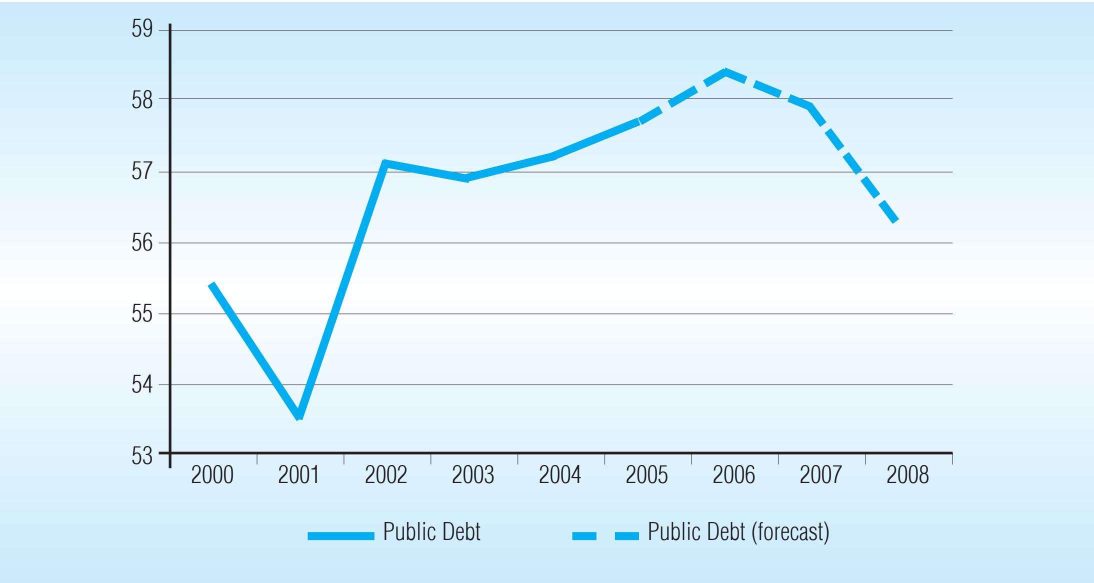
BUDGETARY POLICY IN THE RECENT PAST

There has been a strong tendency in Hungary for spending commitments to be ramped up in the run-up to elections[2]. The general elections of May 2002 were no exception in this regard. The deficit of 2002 overshot the target by 1.8 percentage points of GDP (excluding one-off measures) and represented a fiscal loosening of 3.4 percentage points on 2001. A large share of

Figure 2

PUBLIC DEBT

(Per cent of GDP)



Sources: 2000-2003: IMF (2005), 2004-2008: Government of the Republic of Hungary (2005) the increase in spending in 2002 was due to a series of large wage hikes starting in 2001 and culminating in a 55% salary increase for army officers in January 2002 and a 50% wage increase for all public servants in September 2002. Public sector employment was increased in 2002 by 1.5%. These measures increased the government wage bill by nearly 23% in 2002. Other sizable increases in 2002 took place in social security benefits (18% in 2001), other current transfers (27% on 2001), subsidies (30% on 2001) and investment (44% on 2001, mainly at the local level). The general government deficit on ESA95 basis reached 9.4% of GDP (OECD 2004).

The new centre-left government has made significant efforts in 2003 to reverse the fiscal easing of 2002. Simultaneously it embarked on a tax reform aimed at a more favourable business environment[3]. The deficit target for 2003 was set at 4.5% of GDP on ESA95 basis. In October 2003 the Pre-Accession Economic Programme Update announced a slippage of 0.3 percentage points of this target. At the revenue side shortfalls due to rebates on 2002 tax allowances and windfalls due to higher than expected VAT and wage related revenues were supposed to even out, whereas at the expenditure side there was greater than expected spending on housing subsidies, transfers to local government for social assistance and education, subsidies for prescribed drugs, subsidies for firms employing disabled workers, interest, child care and compensation to victims of the communist regime, in total 0.3% of GDP. In the autumn of 2003 however, further setbacks at the revenue side due to changing economic conditions relating to tensions in the forint market and the current balance of payment account, implied additional slippage, leading to an ESA95 deficit over 2003 of 7.2% of GDP (OECD 2004).

In the summer of 2003 the Government and the Central Bank announced in a joint press conference the intention to join the euro area in 2008. This was based on the recommendations of a committee of experts from the Ministry of Finance and the Central Bank set up in 2002 with a view to define a strategy for euro entry. A key issue for discussion in the committee was whether a precise date or a target period should be announced. In the event, the first option was chosen on the ground that that it would provided a clearer signal to the markets about the Government commitment to fiscal adjustment. As to the precise target date, the committee agreed that the earlier the entry date, the shorter the period of exposure to possible sudden reversals of capital flows. Reflecting this, the Government chose 2008 as the entry year (OECD 2005a).

The 2004 budget (submitted to Parliament in September 2003) repeated the commitment to the medium term expenditure plan announced in the Pre-accession Economic Programme Update. Although it expected to reach the medium term deficit target mainly through autonomous increases at the revenue side, it contained some bold policy measures both at the revenue and the expenditure side. The key measures at the revenue side were changes in the VAT[4], the personal income tax[5] and the social security contributions[6]. In combination these measures were expected to account for 40% of the nominal revenue increase (the VAT and social security contribution revenue gains being much larger than the personal income tax relief whereas the customs and import duties due to EU-accession were lost). At the demand side one of the key measures was the reduction of public employment. The planned cuts involved 7000 jobs out of the 93000 employees in central public administration (including the social security funds). Furthermore it was planned that central government transfers to local government in 2004 would include only a small part of the planned 6% increase in the wage bill for local government, which would prompt staff reductions among the approximately 520000 local government employees. In spite of these measures the 2004 draft budget's consolidated general government expenditures as a share of GDP exceeded those in the 2003 initial budget. This was partly due to EU accession expenditures. The revenue estimates were also influenced by EU accession. Notably, there were cuts in rates and extension of brackets in personal income tax, decrease of profit tax rate from 18 to 16 per cent as well as elimination of many tax allowances and credits. The ESA95 target for 2004 was set at 3.8% of GDP[7] (OECD 2005a).

Commitment to the deficit target for 2004 was demonstrated in December 2003 when, in response to changing economic conditions and the slippage of the 2003 revenue estimates the Government announced a number of measures, including steps to curtail spending in addition to those in the budget submission of September 2003. These measures included further tightening of the housing-loan subsidy scheme, suspension of a mechanism that tied educational spending to previous year's spending, cutting back or suspending the use of carried over budget residues from the previous year and the imposition of a "budgetary blockage" on central government spending. In addition a review of the tax system was scheduled for the spring of 2004 (OECD 2004).

After Hungary had entered the EU in May 2004, the Convergence Programme 2005–2008 was prepared as successor of the Pre Accession Economic Programme (PEP) 2002–2006. The programme was decided in May 2004 and aimed at an ESA95 deficit target for 2004 of 4.6% GDP, a slippage of 0.8% percentage points since the budget 2004 mainly necessitated by worse than expected revenue outcomes for 2003. Furthermore the programme sought to reduce the deficit by 0.5 percentage point annually until it had reached 3.1% in 2007, after which the medium term target of 2.7% in 2008 was in reach (European Commission 2006).

The Convergence Programme also deferred the euro entry target date to 2010. The Convergence Programme stated however that "if conditions turn out to be more favourable, and inflation falls more rapidly, the adoption of the euro can take place already in 2009 under the base line scenario". Later on the reference to the economic developments has been ignored as the deficit outturn for 2004 was revised upwards. Accordingly, the updated Convergence Programme of December 2004 announced that "the criteria for joining the euro area can be satisfied by 2008 and the introduction of the euro is possible in 2010" (OECD 2005a).

In July 2004 the European Council decided that Hungary was in excessive deficit and issued a recommendation for its correction under art. 104(7) of the European Stability and Growth Pact. Following a decision of non-compliance in January 2005, the Council issued new recommendations under art. 104(7) in March 2005 reiterating that the excessive deficit had to be corrected by 2008, the target year for euro entry set by the Hungarian authorities in the Convergence Programme of May 2004 and confirmed in its December 2004 update. In particular, the Council recommended to the Hungarian authorities to take effective action in order to achieve the deficit target for 2005 and to make the timing and implementation of any tax cuts conditional upon achievement of the deficit targets for 2005 to 2008 (European Commission 2005).

The general government ESA95 deficit in 2004 came in at 5.4% of GDP a further slippage of 0.8 percentage points since May 2004 (excluding the costs of pension reform). The actual real GDP growth outturn for 2004 was close to a half percentage point higher than the 3.5% originally projected in the budget. However, having been fuelled by robust growth in exports and investments, rather than consumption, stronger than expected macroeconomic conditions did not support the revenue side of the budget. The main reasons for the slippage were excessively optimistic VAT revenue expectations, which failed to materialize partly owing to introducing self-declaration for VAT on third-country imports as an additional measure, macroeconomic factors and unexpected reactions of the business climate to changes in administration (1.1% of GDP), misreading of housing grants (0.4% of GDP), non-wage expenditures by line ministries (0.9%) and social security spending (0.4% of GDP, evenly split between health care and pensions) and interest (0.6% of GDP, largely caused by erroneous estimation and extraordinary and unforeseen events on money market rather than by increase of public debt). The large upward revisions of the 2003 deficit and the setbacks during 2004 were partly compensated by new measures of fiscal restraint adopted throughout 2004. These measures included cash controls in the health sector, tightening of conditions for the use of unspent appropriations from previous years, cash controls on local governments and extra budgetary funds, one-off measures to collect dividend from public enterprises and tight control of VAT refunds in connection with EU trade (OECD 2005a).

The 2005 budget, approved by Parliament in December 2004 set a deficit target of 3.6% of GDP in 2005 (excluding the costs of pension reform). In line with the updated Convergence Programme of December 2004, the budget assumes a 4% real output growth. It comprises a decline in tax revenue equivalent to 1.4% of GDP, a decline in primary spending of 1.7% and a decline in interest payments as a consequence of falling rates equivalent to 0.2% of GDP. In order to help the budget stay on track a special reserve fund was created which aimed at covering unexpected revenue shortfalls of 0.5% of GDP. The tax package in the budget 2005 consisted primarily of the simplification of the personal income tax (reduction of the marginal rate brackets from three to two, dropping the middle bracket and raising the bottom bracket from HUF 0.8 million to HUF 1.5 million), a greater tax exemption on the local business tax to stimulate employment accompanied by cuts in social security contributions by employers and an increase in the 25% tax reduction of the local business tax from the corporate income tax base to 50%. This package, causing a revenue shortfall of 0.5% was only partially offset by revenue enhancing measures[8]. Key measures at the expenditure side included the planned freeze of carried over appropriations from 2004 to 2005 and the use of PPP's in road construction projects. The latter measure was supposed to save 1.4% of GDP. Half of this improvement was one-off, reflecting the revenues accruing from the sale of existing motorway assets. Furthermore a quarter of the planned 6% nominal increase in the public sector wage bill was supposed to be covered using unspecified economies generated at the level of line ministries.

In view of the slippage of 2004 and in reaction to the recommendations of the European Council of March 2005, the Hungarian authorities took additional corrective measures in order to ensure meeting the 2005 deficit target. This was done in two steps. The first set of measure was announced shortly after the adoption of the Council recommendations in March 2005. This package consisted of the increase of the reserve fund created in the 2005 budget from 0.5% to 0.7% of GDP as well as some across the board cuts, in total 0.8% of GDP. The second set of measures was taken in June 2005, after the Hungarian authorities had acknowledged that several revenue and expenditure estimates were considerably optimistic and had to be corrected. This package consisted of saving measures in the sphere of pharmaceutical subsidies, the freezing of unspent appropriations carried over from the previous year, broadening of the social security contribution base, increase of the tax on slot machines, tighter control on the import of tobacco products, the partial restoration of the previous regime of levying of VAT on imports[9] and extension of the use of PPP arrangements in motorway construction (European Commission 2006).

In September 2005 Eurostat decided that the motorway construction financing arrangement included in the budget 2005 and extended in the June package could not be recorded outside the government sector. In the same month the Hungarian authorities submitted a revised Excessive Deficit Procedure (EDP) notification announcing a 2005 deficit of 6.1% of GDP in 2005 (in contrast to the targeted 3.6% in the 2005 budget). This revised notification took into account (1) that the planned sale of existing motorways to the state owned motorway company, including those under construction until the end of 2005 as part of a PPP arrangement could not be considered as a deficit reducing measure, and (2) that the payment of 13th month salaries to public employees should be recorded in the year to which it pertains also if actual cash disbursements take place at the beginning of the following year. These revisions increased the ESA95 deficit with 2% of GDP (1.9% for the recording of PPP´s in the government sector and 0.1% for the shift in the recording of 13th month salaries). The notification also contained an additional slippage of 0.5% GDP due in equal measure to VAT revenue shortfalls and expenditure overruns. Against this background and in view of further slippages regarding the 2006 deficit, the European Commission recommended and the European Council decided in November 2005 for the second time that Hungary did not comply with a Council recommendation under the EDP procedure (European Commission 2006).

The draft budget 2006 was approved by Parliament in December 2005. It targets a general government ESA95 deficit of 4.7% of GDP in 2006 (up from 2.9% in the December 2004 update of the Convergence Programme). The deficit estimate excludes one-offs, in particular the purchase of the Gripen military fighter planes adding 0.3 percentage points in both 2006 and 2007. On the revenue side, the budget calculates with the revenue-reducing effects amounting to about 1% of GDP resulting from the implementation of the comprehensive five-year tax cut package adopted in 2005. The compensation of the lower revenue and the increased social security expenditures (family benefits and pensions), as well as the planned deficit reduction from 6.1% of GDP in 2005 to 4.7% of GDP in 2006 is expected to be achieved by expenditure cuts amounting to 4% of GDP. The main measures are a 1.0 percentage point reduction in total government consumption expenditure, a 0.5 percentage point decline in interest burden and a decline of more than 1.0 percentage point in other expenditures, including decreased capital transfers to companies for projects not co-financed by the EU. Furthermore, 1 percentage point expenditure reduction is expected to be achieved by a new attempt for substitution of motorway investment by PPP projects (European Commission 2006).

In December 2005 the Hungarian government submitted to the European Commission the second update of the Convergence Programme 2005–2008. This update was in accordance with the Budget 2006 approved by the Parliament in the same month. The budget continues to target the ending of the excessive deficit in 2008. The foreseen reduction path is 6.1% of GDP in 2005, 4.7% of GDP in 2006, 3.2% of GDP in 2007 and 1.9% of GDP in 2008, representing a yearly cut of 1.4 percentage points. In addition to the purchase of Gripen fighter planes, the projections exclude the Eurostat decision of March 2004 on the classification of funded pension schemes ranging from 1.0 to 1.5 percentage points of GDP, which will have to be taken into account by the time of the spring 2007 EDP notification. The strong decline in revenues of some 3.5% of GDP, mainly as the result of the newly introduced five year tax cut strategy, is projected to be overcompensated by a reduction of expenditures by some 7.5% of GDP between 2005 and 2008 (European Commission 2006).

In the Assessment of the updated Convergence Programme of December 2005, issued in January 2006, the European Commission noted that the structural measures outlined in the programme lack the necessary quantifications to judge their short- and medium term effects. Furthermore, according to the Commission the tightening of expenditure by 4 percentage points in 2006 compared to the 2005 budget is not based on clearly defined and quantified measures. In outer years, the shift of motorways investment to PPP´s may again be subject to accounting problems. The projected decline in interest rates may not materialise and there is uncertainty regarding the effects of tax reform, possibly resulting in lower revenues. The Commission concludes that, taking into account the risk assessment, the budgetary strategy in the programme needs to be substantiated to ensure consistency with the correction of the excessive deficit by 2008. For that purpose Hungary the Commission deems it appropriate for Hungary to present by 1 September 2006 at the latest a revised Convergence Programme update that identifies concrete and structural measures that are fully consistent with its medium term adjustment path (European Commission 2006).

The general picture arising from the conduct of fiscal policy in the last few years is that of too much reliance on one-off measures and unspecified savings and too little emphasis on structural reform at the expenditure side. In combination with the subsequent implementation of sizeable packages of tax relief, this has led to a pattern of over optimism about future developments which has been refuted by the facts year after year. This development is illustrated in *figure 3* (taken over from European Commission 2006).

FOCUS ON THE ACTUAL DEFICIT

Hungary has no fiscal rule in the sense of a long-term constraint on fiscal policy[10]. Instead it has committed itself to a reduction path of the factual deficit in the EU convergence programme. As long as the actual deficit is above the Maastricht reference value of 3% of GDP, a reduction of the deficit in the medium term is stated as the first priority.

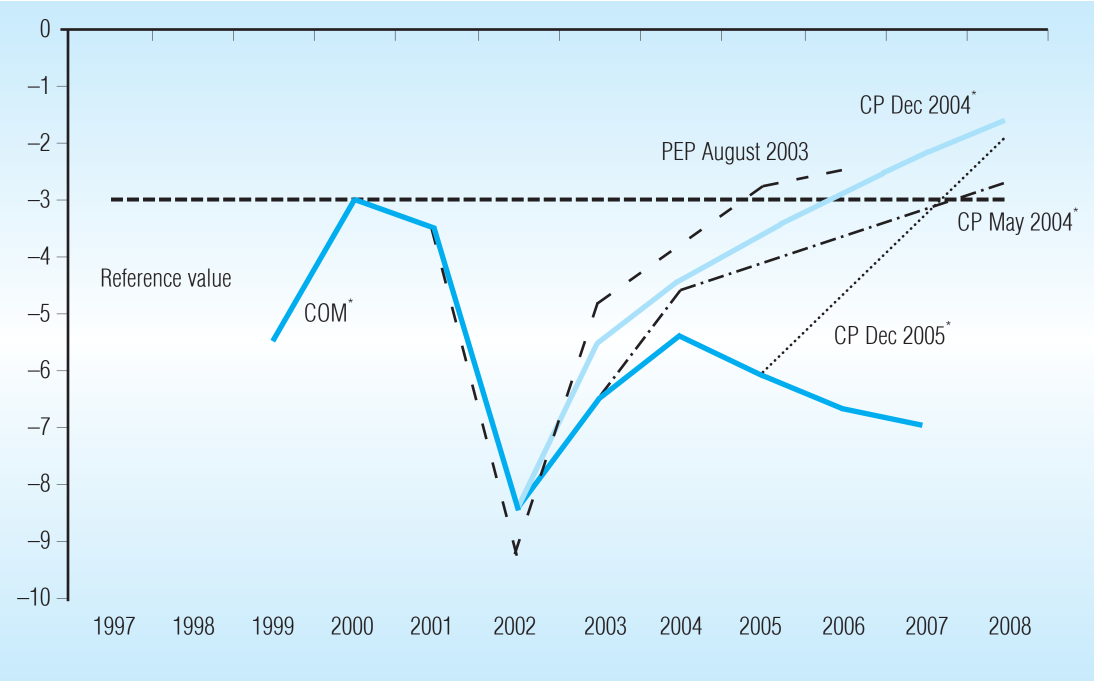
Reduction of the deficit in the medium term does not necessarily mean that budget policy should focus on the actual deficit. This focus has two major disadvantages: (1) it hampers an orderly decision-making process; (2) it hampers automatic stabilization.

The actual deficit is determined by both the expenditure and the revenue side of the budget. The revenue side is almost entirely determined by substantive legislation, namely tax legislation, and the expenditure side is partly determined by substantive legislation, in particular social security and health legislation (entitlements). This implies that forecasts for the factual deficit are permanently moving, not only during the formulation phase of the budget process, but also during the execution phase. Focus on the actual deficit requires therefore that the budget has to be amended often during both phases of the budget process to react on the latest predictions. This hampers an orderly decision-making process and tranquillity in the budget numbers. Moreover, it leads to a volatile fiscal stance that changes from month to month in the light of the latest forecasts.

Figure 3

GENERAL GOVERNMENT DEFICIT FORECASTS IN SUCCESSIVE CONVERGENCE PROGRAMMES

(Per cent of GDP)



CP: Convergence Programme . **PEP**: Pre-Accesion Economic Programme. **COM**: Estimate of the European Commission of the ESA95 deficit.

** Excluding the impact of the 2004 Eurostat decision on the classification of funded pension schemes, which needs to be implemented by spring 2007.*

Source: EC (2006)

Budgetary adjustments motivated by short-term macro-economic fluctuations bring a pro-cyclical element in budgetary policy and hamper the stabilizing effect of the budget. This can be avoided by, for example, using a fiscal rule based on annually appropriated expenditures[11]. Alternatively a cyclically adjusted deficit constraint can be used. However a disadvantage of a cyclically adjusted deficit constraint is that there are arbitrary elements in the calculation of the output gap on which the cyclically adjusted deficit is based. Moreover, the concept of the cyclically adjusted deficit is not always transparent to politicians and the public. Steering exclusively on the expenditure side is more transparent and possibly less susceptible to manipulation[12].

In OECD countries that steer exclusively on the expenditure side, different approaches can be distinguished concerning mandatory spending (on the basis of entitlement laws) at the expenditure side.

In the UK and the US at the time of the *Budget Enforcement Act* (expired in 2002) mandatory spending is exempted from the expenditures ceilings. These ceilings refer exclusively to discretionary spending. This has been motivated by the fact that much of social security spending is determined by macro-economic fluctuations. Exclusion of mandatory spending from the expenditure ceilings can thus contribute to automatic stabilization. In the Netherlands and Sweden on the other hand, mandatory spending programmes are covered by the expenditure ceilings. The main argument for inclusion in these countries is that many entitlement programmes have little to do with macro-economic fluctuations (health, education, disability pensions) and that a ceiling is more effective to the extent that it encompasses a larger part of total expenditures. Including entitlements and other mandatory expenditures under the ceiling forces the government to make policy decisions and prioritise with strict limits for total expenditures. However, it is clear that the latter approach is only viable if budget formulation is focused on the medium term rather than on the upcoming budget year since adjustment of entitlement programmes can only affect expenditures in the medium term.

FOCUS ON THE BUDGET YEAR

Budget formulation in Hungary is focused on the upcoming budget year rather than on the medium term. In accordance with the Act on Public Finance of 1992 multi-annual expenditure estimates at the line item level for three years following the budget year are published, but they do not play a role during budget formulation. Multi-annual expenditure ceilings for the general government budget or its sub sectors (central government, local government, social security funds) are lacking.

International organisations have often recommended to the Hungarian authorities to develop a multi-annual expenditure framework[13]. Although Hungary has never formally announced a medium term expenditure framework in the budget or in policy documents, in fact the EU Convergence Programme, to which the Hungarian Government has committed itself, can be seen as such a framework. The term multi-annual expenditure framework may be used in different ways and it is important to be precise about the practical consequences to be attached to the adoption of an expenditure framework.

Almost all OECD countries presently work with a multi-annual expenditure framework. Most of them adjust the framework from year to year in the light of outcomes of the previous year, new estimates of the consequences of current policies and new political priorities. This can be called a flexible framework. The major advantage of a flexible framework in comparison to no framework is that at the time of budget formulation the multi-annual consequences of all changes (setbacks and windfalls at the revenue and expenditure sides and new priorities) can be traded off against each other and against the adjustment of medium term targets for expenditures, revenues or the deficit.

A few countries, notably Sweden, the UK and the Netherlands have a multi-annual expenditure framework that is not adjusted from year to year. This can be called a fixed framework. It has also been called a fiscal rule for expenditures. A fixed expenditure framework can be rolling like in Sweden and the UK, or it can be periodical like in the Netherlands. In a rolling framework an additional year is added at the end of the sequence of annual ceilings every year (for instance in Sweden in the budget bill for 2007 a ceiling for 2009 is added to the existing ceilings for 2006–2008). In a periodical framework a new sequence of ceilings is drawn up at periodic intervals, for instance at the beginning of every new cabinet period (for instance in the Netherlands a new framework for 2004–2008 was drawn up in 2004 at the beginning of the cabinet period and remains in place throughout the cabinet period). It is characteristic for a fixed expenditure framework that the multi-annual overall ceilings for the general government or for a combination of its sub-sectors (for instance central government and social security funds) can not be changed from year to year. This implies that during budget formulation all line item budget numbers and all line item multi-year estimates have to be squeezed in the overall ceiling over the entire term of the framework. The first major advantage of a fixed expenditure framework in comparison to no framework is identical to that of a flexible framework: all trade offs have to be considered. A second major advantage, also over a flexible framework, is that it is (more) effective in realizing multi-year expenditure targets. Precisely because the overall ceiling can not be changed from year to year, the target is automatically realized as long as the framework is maintained.

Multi-annual expenditure frameworks usually contain not only overall ceilings or broad sectoral ceilings for central government, local government or the social security funds, but also ceilings at the level of ministries or expenditure areas. Ministerial ceilings are important because, once established, they impose a certain discipline on ministers and help to prevent overspending. In the case of a flexible framework the disciplinary effect on ministerial request behaviour is less pronounced than in the case of a fixed framework, but usually not entirely absent because last year's ceiling for the upcoming budget constitutes in any way a clear base line which the Minister of Finance can invoke in budgetary negotiations. In a fixed framework the disciplinary effect is clearly larger, but not so much because ministerial ceilings are not alterable as is sometimes thought. In countries that employ fixed frameworks ministerial ceilings are often changed during budget formulation and sometimes even during budget execution and this is not seen as a loss of discipline. Rather ministerial ceilings are more effective in fixed frameworks because the overall ceiling is not alterable, so that every increase in a ministerial ceiling has to be compensated either in another ministerial ceiling or in another sub sector. Because not many countries have experience with fixed frameworks, this is not always well understood. Indeed, what marks the difference between fixed and flexible frameworks is that under a fixed framework the flexibility that every budget process needs to accommodate setbacks or new priorities is found exclusively in reallocation or in use of a reserve[14], whereas under a flexible framework it can also be found in adjustment of the overall ceiling, possibly in connection with adjustments at the revenue side.

For Hungary the EU Convergence Programme has in previous years functioned more or less as a flexible expenditure framework that is adjusted from budget year to budget year and even during the budget years at the occasion of EDP notifications. However, a crucial element is lacking, namely the adjustment of multi-year estimates at the line item level. It is the lack of this element which is at the root of the volatility and sometimes hectic character of the Hungarian budget process. Policy measures require time to phase in. This is true for new spending programmes as well as for savings measures. In the case of saving measures gradual implementation is often particularly important in view of accompanying measures like social plans, reorganisations or adjustments of entitlement laws. If during budget formulation attention is mainly focused on the upcoming budget year, expenditure programmes tend to be approved and saving measures to be dismissed too easily because their budgetary effects arise only in later years. The main advantage of a multi-annual expenditure framework, whether flexible or fixed, is lost if budget formulation does not focus on the multi-annual line item estimates instead of on line item estimates of the upcoming budget. Government spending programmes in OECD countries have reached levels of size and complexity that it is frequently difficult to make policy changes in the current year that substantially affects next year's budget. *Budget formulation therefore ought to focus entirely on the multi-year estimates, rather than on the upcoming budget. The central task of budget formulation is the harmonisation of multi-year estimates* *at the line item level with the expenditure framework.* Budget formulation focusing on next year's budget will necessarily lead to expenditure plans that are too grandiose (have large consequences after the budget year) and saving measures that are too simple (affect only the upcoming budget year) and hamper transparency: stop gap measures such as cash limits, across the board cuts and accounting gimmicks. This has been typical of the Hungarian budget process over the previous years.

Expenditure frameworks bring discipline to the expenditure side of the budget, but not to the revenue side. In particular they tend to favour new tax expenditures (tax exemptions and tax credits) which are not affected by the multi-annual ceilings and which can often substitute for subsidies. Even if it is acknowledged that tax expenditures are a policy instrument in their own right[15] and that under special circumstances they may be preferable to subsidies, it is important that they be subjected to budgetary discipline. There are two approaches to budgetary discipline at the revenue side: coordination with expenditure ceilings and revenue floors. Many OECD countries have made progress with the first approach, few with the second. Both approaches are not mutually exclusive but may strengthen each other.

The idea of coordination with expenditure ceilings is that certain policy changes with respect to revenues are brought under the expenditure ceilings. The most straightforward application of this idea is the inclusion of non-tax revenues under the expenditure ceilings. The ceilings are then defined in terms of net expenditure, namely gross expenditure minus non-tax revenue. This is practiced in many OECD countries that use multi-annual frameworks. Net expenditure ceilings open the possibility for ministries to off-set expenditure measures with non-tax revenue measures. This makes it easier to comply with the ceilings and extends budgetary discipline to the non-tax revenue receipts. It requires however a careful demarcation of tax and non-tax revenues, because burdens on the private sector that do not create claims to concrete public services on the part of citizens should not be counted as non-tax revenues (cases of doubt mainly occur in the area of environmental levies/fees).

Recently most OECD countries have also started to publish lists of tax expenditure estimates in their annual budget documents with a view of coordinating these estimates with expenditure estimates. Some countries have also wholly or partly moved the oversight of tax expenditures from the tax policy division of the Ministry of Finance to the expenditure division (the Netherlands, Sweden, the US). However, the countries that subsume entitlement legislation under the ceilings (the Netherlands and Sweden), have so far not brought tax expenditures (which are also entitlements) under the ceilings. Since most tax expenditures are more sensitive to macro-economic fluctuations than most expenditure entitlements, it can be argued that excluding tax expenditures from the ceilings makes sense from the perspective of stabilization. This is no to say that tax expenditures should not be estimated and published in the budget. Estimation of tax expenditures contributes to transparency and helps to prevent inefficient or inappropriate use of this policy instrument even if the estimates are not brought under the ceilings.

The second approach to budgetary discipline at the revenue side is revenue floors. This involves the annual publication of multi-annual estimates for tax estimates on the basis of current legislative tax policy[16] and the introduction of a compensation requirement on all legislated changes. This existed in the US under the *Budget Enforcement Act* (until 2002) and presently in the Netherlands. From budget year to budget year, every change in the tax estimates over the medium term that originates in change in the tax laws is subject to a compensation requirement (in the US within the entire sector of entitlement legislation including the expenditure side, which was exempted from the expenditure ceilings). Autonomous changes in the estimates flowing from macroeconomic fluctuations do not need to be compensated. In this way tax floors bring budgetary discipline to the revenue side of the budget without impairing automatic stabilization and tranquillity in the budget process.

Ministerial expenditure ceilings should annually be corrected for inflation. For this purpose ceilings have to be defined in real terms and to be inflated from year to year with the general GDP deflator[17].

Multi-annual expenditure frameworks, whether fixed or flexible, can only be effective if care is taken in the definition of the coverage of the ceilings. This is particularly true for EU countries where the framework also serves the purpose of keeping the budget within the limits of the EU Stability and Growth Pact. The EU prescribes the application of ESA95 bookkeeping rules for the purpose of calculating the deficit (the "Maastricht deficit"). Most EU countries authorize the budget in cash terms, often making use of the bookkeeping rules of the General Financial Statistics (GFS86). However, in practical terms there are only a few differences between both systems and these can relatively easily be taken into account.

On the expenditure side the main differences between ESA95 and GFS86 are cash shifts, interest expenditures and long term contracts. Cash shifts (postponement of payment or advance payment) are to be avoided in any case and should not be allowed by the Ministry of Finance even if the expenditure ceilings are defined in cash terms[18]. Corrections for interest and long term contracts (for instance purchase of aircraft or ships) regard only a few line items and can be presented to the Parliament in an extra-budgetary account if the government prefers to stick to cash ceilings. This requires of course that the cash expenditure ceilings are set up in such a way that the corrections do not endanger the deficit constraint on the ESA95 deficit. However, in view of the confusion that an extra budgetary correction account might create, there is much to say for the idea to define the ceilings in ESA95 terms to begin with, or, which amounts to the same, to define only the expenditures for interest and long term contracts[19] in ESA95 terms, whereas the rest can remain in cash terms (since for that part GFS86 and ESA95 terms are equal). It might seem that formulating ceilings (and estimates) partly in cash terms and partly in ESA95 terms is not entirely consistent, but in view of the fact that the ESA parts of ceilings and estimates are typically only a small part of the budget and that cash is generally better understood than ESA95, it might still be practical to proceed in this way.

If ceilings are defined in terms of net expenditure, one-off financial transactions, which generate revenue or lower expenditure by alienation of government assets, should be kept out of the ceilings. This applies to privatisation proceeds, sale of stock in public enterprises, sale of land or real estate and financial lease. One off revenues of this nature should not be balanced with expenditures or should lead to one-off reduction of the ceilings (for instance if purchase is replaced by financial lease, leading to postponement of the acquisition of property rights).

As to tax revenues the European authorities are generally satisfied with very simple measures to turn cash into ESA95 estimates. For instance, a one month backward shift of cash estimates for VAT, sales and excise tax revenues will do. The European authorities accept cash estimates for the income tax, the succession tax, the corporate tax and the dividend tax as ESA95 estimates. This implies that if a country wishes to work with tax revenue floors, again both approaches are possible: either define the floors in cash terms and account for the corrections in a extra budgetary account or define the floors themselves in ESA95 terms or, which amounts to the same, define only the VAT, sales and excise receipts in ESA95 terms whereas the rest can remain in cash terms (since for that part GFS86 and ESA95 terms are equal). Recall that revenue floors only constrain legislated tax changes (not revenue shortfalls due to macro-economic conditions) and that using floors partly in cash terms and partly in ESA95 terms may be practical for domestic purposes (while the estimates are accepted by the EU as ESA95 estimates).

NO CLEAR RULES OF BUDGETARY DISCIPLINE

A multi-annual expenditure framework, whether flexible or fixed, can only function effectively if it is accompanied by clear rules of budgetary discipline. These rules require that all setbacks or new spending initiatives that violate the ceilings are compensated. In Hungary, clear rules of budgetary discipline are presently lacking.

Budgetary discipline requires that the multi-annual overall ceilings are maintained. In particular the overall ceilings (for year t to t+n) of a *flexible framework* have to be maintained from the moment they have been adjusted or confirmed during budget formulation (in year t–1) until they come up for adjustment or confirmation during budget formulation in the next year (t) and the overall ceilings of a *fixed framework* have to be maintained from the moment they have been established, usually during budget formulation (in a year previous to t–1) until the end of the budget year to which they apply. Furthermore, working on the basis of a multi-annual expenditure framework means that during budget formulation first decisions have to be taken on the multi-annual (overall and) ministerial ceilings and that subsequently the decisions on budgetary and multi-annual line item estimates have to comply with the ceilings (top-down budgeting). Ministerial requests can play a role in the determination of the (overall and) ministerial ceilings, but after the ceilings have been decided, they have to be maintained rigorously.

Rules of budgetary discipline ought to be precise about the treatment of mandatory spending (spending required by entitlement laws). If (some forms of) mandatory spending are subsumed under the ceilings, the general principle can be that setbacks have to be compensated and windfalls are available for new spending initiatives. However, it is recommendable to specify that windfalls can only be used for new spending initiatives with approval of the Government or the Minister of Finance, so that they can possibly be used to compensate for setbacks in other budget chapters (leading to reallocation of ministerial ceilings under the overall ceiling).

In the stage of budget formulation, rules of budgetary discipline ought to apply not only to decisions about the budget in a strict sense, but to all decisions of Ministers or the Government with budgetary consequences. Policies are decided throughout the year and mostly disconnected from the budget process. This is the case in all OECD countries and there is nothing wrong with that. What is important though, is that the budgetary consequences of these decisions are compatible with budgetary policy. For that purpose it is essential that each policy proposal with budgetary consequences submitted to the Government at any time of the year is accompanied by information, preferably in a standard form, describing how the budgetary consequences of the proposal are reconciled with the multi-annual ministerial expenditure ceilings either through reallocation under the ceiling or through use of windfalls under the ceiling. In addition it is essential that ministerial policy decisions that do not need the approval of the Government, but that nevertheless have budgetary consequences are brought to the attention of the Minister of Finance, accompanied by information on reconciliation with the ministerial expenditure ceiling, before they are implemented.

Rules of budgetary discipline ought to apply also to the stage of budget execution. Policy decisions of ministers or of the Government that affect budgetary estimates during the execution year ought to be accompanied by information about the reconciliation with the ministerial ceiling in a similar way as during budget formulation. This requirement is not a duplication of the normal controls by the Ministry of Finance and the Treasury on spending during budget execution as regulated by the budget system law. Indeed, in Hungary the Act on Public Finance leaves more leeway to overspending than rules of budgetary discipline ought to do. The role of rules of budgetary discipline during budget execution is not to stiffen the budget or to hamper flexibility, but rather to spell out more precisely the compensation requirements. Indeed to the extent that the rules of budgetary discipline are more effective, the legal requirements of the Act on Public Finance could eventually be loosened somewhat. This would lead to more, rather than less flexibility during the execution year.

Information on the budgetary consequences of policy decisions during budget formulation and budget execution enables the Minister of Finance to update the budget and multi-annual estimates permanently throughout the budget cycle. In this way the policy making process becomes better integrated with the budget process and the annual budget formulation decisions in the proper sense become more focused on the small part of the budget where trade-offs have to be considered. This typically impacts only a very small part of the budget.

If Hungary would decide to move towards a multi-annual expenditure framework, it is recommended that the rules of budgetary discipline are clearly specified and explicitly endorsed by the Government in connection with the framework itself. It is also recommended that the rules of budgetary discipline are published, widely dispersed and brought to the attention of the Parliament.

Budgetary discipline is also important for Parliament. In some countries Parliament has issued standing orders that require compensation on all amendments to budgetary or other bills that have budgetary consequences. If, or as long as, such parliamentary compensation requirements are lacking, it is recommended that ministers are made responsible for the compensation of the budgetary consequences of parliamentary amendments to bills in their portfolio.

Rules of budgetary discipline can only be effective if they are scrupulously maintained and enforced by the minister of Finance and the Prime minister. In the case of Hungary the most natural division of tasks may be that the minister of Finance is made responsible for the formulation of the rules and the permanent updating of the budgetary and multi-annual line item estimates in accordance with the rules. In cases of non-compliance that can not be solved at the level of bilateral contacts between ministries, the minister of Finance should contact his colleague or ultimately bring the matter to the attention of the Prime minister. Ultimately, rules of budgetary discipline and, by implication, multi-annual expenditure frameworks can only be effective if the Prime minister is committed.

LACK OF TRANSPARENCY CONCERNING FORECASTS AND OUTCOMES

In the beginning of the year, the Ministry of Finance makes macroeconomic forecasts and tax revenue estimates for a three year period.

There are no fixed procedures in which external partners are involved. Consultation takes place on a case by case basis. In practise however, the publication of the forecasts enables various external think tanks to comment. The Ministry compares its forecasts with those of national and international banks. There are also consultations with the Hungarian Central Bank about the forecasts. The estimates are updated quarterly and when there are major changes in assumptions. Thus revisions are made when the national accounts are finalised, when more detailed assumptions about entitlement programmes are submitted by line ministries, and when major policy changes take place. The Ministry of Finance uses an economic model, but there is a lack of long and stable time series on which to estimate the basic relations, as in many formerly communist countries.

The Central Bank has for a number of years also published its forecasts for the coming year and the effects of the general government budget. Differences with the government forecasts can partly be explained by the fact that the detailed assumptions for calculating government expenditure are not published by the Ministry of Finance, making it hard for outsiders to identify the crucial factors and questionable assumptions. For instance, the detailed assumptions concerning consequences of new initiatives such as improved tax collection are not made public. An effort to increase transparency would contribute to meaningful public discussion about the forecasts. Further sensitivity analysis and transparency about uncertainty margins might also contribute to the quality of the forecasts.

In general there have been quite substantial forecasting errors in Hungary in the past few years. These occurred mostly at the revenue side of the budget and were a major cause of deficit overshooting. Improvement of transparency concerning assumptions and methodologies ought to be a first priority in this respect, since forecasting methods can only evolve if they are openly discussed in the public domain. Another top priority should be to publish separate forecasts for the various tax expenditures. In general tax expenditures forecast require separate methodologies as their determining factors are different from those of tax revenues in general.

In order to strengthen economic forecasting and public debate it might be useful to establish an independent organization for this purpose, as seen in Slovenia, Sweden, the Netherlands and the US, and is being considered in Canada and other OECD countries. Although financed by the Government, these organizations have generally been able to withstand political pressure. They operate in a strong academic environment and generate public interest in the matter. Alternatively a standard procedure for consultation with external partners and private sector institutions could be worked out. Both alternatives have to be accompanied by a more detailed disclosure of assumptions and methodologies.

The State Audit Office publishes its own analysis of the macroeconomic assumptions and forecasts, and criticises concrete estimates of expenditure if they are not deemed realistic. The State Audit Office does not, however, calculate alternative macroeconomic forecasts. There is a continual debate between the State Audit Office and the Ministry of Finance concerning these issues in the time leading up to the presentation of the budget to the Parliament.

The Hungarian budget has a strong and detailed input-focus, as in many other countries. Plans are being developed for a new framework for the state budget that is more output oriented and that will allow more use of performance information. It should be noted, that most OECD countries have opted for a pragmatic and gradual approach to the use of output information. Output-oriented account reclassification is a first step that does not require the abolition of all input controls. Reclassification would have to result in a substantial reduction of the number of line items. Presently the number of budget titles in Hungary is already 2100 and the number of line items could be a multiple of that number. Output-oriented reclassification could reduce the number of line items to less than 30 per chapter.[20] Such a reform would not only contribute to a more output oriented budget process but also to the transparency of forecasts and outcome data. Output-oriented account reclassification provides benefits for focus on results and for financial planning within the ministry and government at large, but does not necessarily require performance measurement. Experience shows that political interest in performance information proceeds at a measured pace.

CONCLUSIONS

In the light of international best practice the Hungarian budget formulation process has some features that make it particularly vulnerable to overspending and revenue shortfalls. These features are (1) the focus on the actual (non-cyclically adjusted) deficit, (2) the focus on the budget year, and (3) the absence of clear rules of budgetary discipline. The resulting problems are confounded by a lack of transparency concerning forecasts and outcomes.

Focus on the actual deficit hampers an orderly decision-making process and hampers automatic stabilization. For medium term deficit reduction it is not necessary that short term macro-economic fluctuations lead to budgetary adjustments. Alternative approaches are to use a cyclically adjusted deficit or to control the expenditure side of the budget exclusively. Focusing on the expenditure side is more transparent and possibly less susceptible to manipulation. In OECD countries that control the expenditure side different approaches can be distinguished as to whether mandatory spending (based on entitlement laws) is wholly or partly subsumed under the expenditure ceilings. It is clear however, that mandatory spending can only be subsumed under the ceilings if budget formulation is focused on the medium term, rather than on the upcoming budget.

Focus on the budget year implies that during budget formulation attention is diverted from structural policy measures with effects in later years. Although Hungary tries to adhere to a multi-annual deficit reduction path as specified in the European Convergence Programme, the main advantage of a medium term approach is lost if budget formulation does not focus on the multi-annual line item estimates instead of on line item estimates of the upcoming budget. Government spending programmes in OECD countries have reached levels of size and complexity that it is frequently difficult to make policy changes in the current year that substantially affects next year's budget. Budget formulation therefore ought to focus entirely on the multi-year estimates, rather than on the upcoming budget. In countries that use a multi-annual expenditure framework, the central task of budget formulation is seen as the harmonization of the multi-annual line item estimates with the multi-annual ceilings of the expenditure framework. Budget formulation focusing on next year's budget will necessarily lead to expenditure plans that are too grandiose (have large consequences after the budget year) and saving measures that are too simple (affect only the upcoming budget year: stop gap measures such as cash limits, across the board cuts and accounting gimmicks). A medium term orientation of budget formulation can further be enhanced by bringing non-tax revenues under the multi-annual expenditure ceilings and by the use of tax revenue floors.

Rules of budgetary discipline require that all setbacks or new spending initiatives that violate expenditure ceilings or revenue floors are compensated. Rules of budgetary discipline ought to be precise about the treatment of mandatory spending (spending required by entitlement laws). If (some forms of) mandatory spending are subsumed under the ceilings, the general principle can be that setbacks have to be compensated and windfalls are available for new spending initiatives. In the stage of budget formulation, rules of budgetary discipline ought to apply not only to decisions about the budget in a strict sense, but to all decisions of Ministers or the Government with budgetary consequences, regardless when they are taken. Rules of budgetary discipline ought to apply also to the stage of budget execution. If Hungary would decide to move towards a multi-annual expenditure framework, it is recommendable that the rules of budgetary discipline are clearly specified and explicitly endorsed by the Government in connection with the framework itself. It is also recommendable that the rules of budgetary discipline are published, widely dispersed and brought to the attention of the Parliament.

In general there have been quite substantial forecasting errors in Hungary in the past few years. These occurred mostly at the revenue side of the budget and were a major cause of deficit overshooting. Improvement of transparency concerning assumptions and methodologies ought to be a first priority in this respect, since forecasting methods can only evolve if they are openly discussed in the public domain. Another top priority would be to publish separate forecasts for the various tax expenditures. In general tax expenditures forecast require separate methodologies as their determining factors are different from those of tax revenues in general.

The Hungarian budget has a strong and detailed input-focus, as in many other countries. Plans are being developed for a new framework for the state budget that is more output oriented. Output-oriented account reclassification could be a first step that does not yet require the abolition of all input controls. Output oriented reclassification could reduce the number of line items to about 30 per chapter.

NOTES

[1] Excluding FISIM allocation. In October 2005 the Hungarian Central Statistical Office published for the first time revised national accounts figures including the sectoral allocation of financial intermediation services indirectly measured (FISIM). This change consists in breaking down interest paid to banks and other financial intermediaries by each sector in 'pure' interest and the implicit price of financial intermediation. From then on the latter is registered as consumption of services. This is in accordance with new ESA accounting guidelines. As a result the, the GDP series is slightly revised upwards, similarly as in other states. For 2004 the real GDP growth has been revised from 4.2% to 4.6%. For 2005 to 2008 the sectoral allocation of FISIM is expected to increase the real growth rates by 0.1 to 0.2 points per year. The present table uses the EU numbers of December 2005 that do not yet include the FISIM allocation for Hungary.

[2] The year 2002 was an election year. Research by the IMF has shown that the pattern of strong deficit increases in election years has existed in Hungary since the beginning nineteen nineties, with peaks of more than 10% and more than 7% in previous election years 1994 and 1998, partly due to one-off measures, debt assumptions, etc. (IMF 2005).

[3] The tax package included: tax-free provision for development and accelerated depreciation, reduced health care contributions, simplified entrepreneur-

ial tax for small enterprises, tax-free threshold for self-employed, tax exemption up to minimum wage, tax bracket increases, tax benefits on adult education, computer equipment and internet connection, increase in the private pension fund membership fee, increase in the insurance tax credit, abolition of tax liability on exchange markets, preferential taxation for those in an approved "Employee Securities Benefit Programme".

[4] All zero rated goods and services were moved to a 5% rate, the 12% rate increased to 15%, the rate on books lowered to 5%.

[5] Marginal rates were reduced from a schedule of 20%, 30% and 40% to a schedule of 18%, 26% and 38% and bracket ceilings were increased in excess of household income increases.

[6] Health care contributions of employees were increased by one percentage point, the tax credit on pension employee contributions was abolished, the 40% tax deduction on mortgage payments was reduced, the tax credit on investment was abolished.

[7] There is a large difference between the ESA95 and GFS86 deficits in the 2004 budget due to a changeover in the method of collecting VAT on imported goods. From May 2004 onward the system of VAT collection by the Customs Authority using case-by-case assessment methods was replaced by a monthly self-declaration and payment system run by the Tax Office. This system resulted in a shift of about one and a half month in cash collections and a revenue shortfall in cash terms estimated at HUF (Hungarian Forint) 220 billion. Under ESA95 this revenue shortfall is not registered.

[8] A temporary surtax on the profit of financial institutions, some measure in the VAT on telephony purchases, an increase in the tax on car registration, a cap on tax allowances for households.

[9] See note 13. Although under ESA95 the cash shift in VAT payments is not registered, it was supposed that the measure would still improve the ESA95 deficit because of "tighter tax-declaration discipline".

[10] See the definition of a fiscal rule proposed by Kopits and Symanski (1998) which states that a fiscal rule is "a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance".

[11] Allowing deficit fluctuations originating in tax revenues (and entitlement programmes) makes the budget acyclical rather than anticyclical. Attempts at anticyclical (Keynesian) budgetary policy have generally been given up by OECD countries since the nineteen eighties.

[12] Anderson, Minarik, (2006)

[13] For instance in: OECD (2002); IMF (2004), OECD (2005a)

[14] Sweden has a reserve under the overall ceiling which is used to accommodate new developments. This reserve can be used instead of reallocation between ministries.

[15] Tax expenditures are often seen by budget officials as a form of undesirable "back-door" spending. However, in a 2004 report for the OECD Working Party Senior Budget Officials it has been argued that a tax expenditure is sometimes preferable to a subsidy. Tax expenditures can be seen as policy instruments in their own right, which ought to be subjected to disciplinary discipline rather that to attempts at abatement (Kraan, 2005).

[16] Current legislative tax policy is current tax law plus changes in tax law decided but not yet implemented.

[17] Inflation with the GDP deflator leads to some automatic redistribution between programme sectors because price and wage deflators differ per programme sector. An alternative approach would be to inflate the ceilings from year to year with sector specific deflators. However, these deflators can to some extent be influenced by policy and would adversely affect the incentive for wage and purchase price restraint. For this reason the Netherlands follows the approach to inflate the ceilings with the expected sector specific deflators at the moment they are established, deflate them back to ceilings in real terms and subsequently inflate them again from year to year with the GDP deflator. This procedure limits the automatic redistribution from year to year to the difference between the expected and real programme deflators which is negligible.

[18] An example in Hungary was the treatment cash payment of the 13 month salary to civil servants

in January which in one year was attributed to December and in the next year to January, so that in the year in between there was no 13 month payment.

[19] According to ESA95 payments for long term contracts have to be booked at transaction time, which is the time of delivery (not the time of the contract). In most long term contracts payment has also to start at the time of delivery, so that even for long term contracts there is not much difference between GFS86 and ESA95.

[20] In the Netherlands a major output-oriented reclassification exercise has reduced the number of line items per chapter to less than 30.

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