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Rule-Based Budgeting: The Road to Budget Stability[1]

The Hungarian Solution

Summary
Starting from the macro-economic processes of public finance, this article examines the road to reaching financial stability and sustainable economic growth. It outlines the role played by rule-based budgeting in this process. It introduces the regulatory and institutional solutions and explains how, as a logical consequence of being part of a framework, this service can become a useful aspect of financial policy by implementing the respective regulations of the system and of annual budgetary practice. It reaches the conclusion that "elevating" the major stipulations of the rule-based budget framework and the operational rules of the institution safeguarding the implementation into the Fundamental Law of Hungary in 2001 was unavoidable from the aspect of strengthening fiscal responsibility. The article deals with the linkages of the Stability Act, the major characteristics of the work done by the Fiscal Council and the body's recommendations made in the last few years. Finally, it illustrates with some data the improvement of fiscal (public finance) stability supported by rule-based budgeting.

Journal of Economic Literature (JEL) code: B15, E62, H15, H61, H63, L38, P48
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Introduction – The essence of rule-based budgeting

It is common knowledge that in the course of implementation of the goals of fiscal policy in order to reach a lasting position of near budgetary (public finance) balance position and the financial viability of social services, it is of decisive importance to maintain the measure of state redistribution at the level required to reaching these goals. The maintenance of state redistribution at the required level is also a primary condition for the regional and global competitiveness of the entire national economy, both from the aspect of the long-term decrease of government debt and also, ultimately, in terms of the sustainability of socioeconomic development.

Lack of financial stability paralyses, or can paralyse, the social-economic functioning of a country within a few years. That is why regaining and maintaining this stability has become a strategic issue across the globe and has required new solutions, rules and institutions. The so-called *rule-based fiscal policy* framework that was first applied in the economic crisis-ridden states of Latin America and then, from the 1980s onward worldwide, and thus also in Europe, fits this target system (Kutasi, 2012).

The so-called "rule-based fiscal policy" means more than the regulatory compliance[2] of the preparation and implementation of budgeting, as this dictates the fiscal responsibility framework via the rules of budgetary policy, procedural-transparency regulations and – additionally – via the institutional mechanisms that represent the guarantee of observing these rules (Kutasi, 2012). The system used in practice is made up from these regulations and mechanisms – in harmony with the specific features of the given country (Ódor, 2014).

From the middle of the 2000s it became obvious in Hungary too that in order to prevent expenditure overruns that diverged from economic performance it was not enough simply to be more disciplined when it came to the implementation of the current budget. Regaining and maintaining financial stability became a strategic issue that required new constitutional stipulations that uniformly regulate public money matters and high level legal norms that rely on these new stipulations. The Hungarian efforts to put the finances of the country on a solid basis from the second half of the past decade, together with the cessation of expenditure overruns, successfully served this purpose when, five years ago, these goals were incorporated in the Fundamental Law of Hungary[3] and institutionalised in the Stability Act[4].

This article focuses on introducing these regulations and is then followed by a detailed analysis of the road to regaining fiscal stability.

Sketchy international outlook

Reasons for introduction and principles of rule-based budgetary practice as a therapy

Expenditure overruns have occurred in a long line of emerging and developed countries in the past few decades and, as a consequence, the problem of sustainability and growing debt has been accompanied by bank crises[5] (Antal, 2004; Bod, 2013; Győrffy, 2009; Muraközy, 2010).

Governments of several countries chose to introduce rule-based budgeting in the hope that it could help to confine balance-related tensions and *create lasting finance-ability,* growth and sustainable development. To this end, they incorporated into constitutional stipulations the proportions of the expenditure and revenue sides of the budget as well as the acceptable degree of indebtedness – in the form of numerical regulations, planned alongside a set rule of procedures and institutionally controlling the budget (Kopits, 2007; 2013).

In practice this meant that they:

– are employing fiscal policy regulations (for example, identifying expenditure ceilings to maintain a balanced budget),

– introduced fiscal-procedural regulations (for example, medium-term budget planning, and the obligatory compensation of expenditures),

– validated transparency norms (for example, accrual approach accounting, and reporting systems),

– established institutional guarantees to promote transparency and the observance of regulations and their macro- and micro-economic "supervision" (for example alongside the Supreme Audit Institution of the given country or – possibly within this institution – the operation of a parliamentary organisation and/or fiscal council that gives an opinion on the budget and that is independent from the government).

International experiences of applying this system have shown that its consistent operation could reverse the trend that throughout the last decades has been manifested in a long line of emerging and developed countries in the form of budgetary over-spending, the unsustainability of the budget and the growing government debt (Oblath–Szapáry, 2006).

Solutions in international practice

Some countries had already introduced rule-based budgeting *before the 2008 crisis* and they established independent fiscal institutions (see Table 1).[6]

It is apparent that they were using elements of the rule-based method in very different ways (Jankovics, 2012). Most frequently, however, the general balance requirements emerge and we can also find more concrete stipulations, such as setting a limit (ceiling) concerning indebtedness and calling for medium-range planning (Kopits, 2013). The method of calling for an independent institution can be different as well: in most cases it occurred with a simple law or political guideline (agreement), but in the case of Poland, for example, it was through the constitution. The countries of the euro area fixed the requirements in an agreement.[7]

A diverse picture has also enfolded in the EU Member States *in the period following the 2008 crisis.* From the "picture taken" on 1 January 2016, we have separately examined the individual countries belonging to the groups that accessed the EU before 2004 (see Table 2a and 2b) and those that accessed the EU from 2004 onwards (see Table 3a and 3b) (Adema, 2008). As a consequence of the crisis, the number of countries that have introduced the stipulations of rule-based budgeting has also increased among *the countries that had accessed the EU earlier.*[8]

Table 1: Functions and responsibilities of independent fiscal institutions guarding the observance of rule-based budgeting in the EU Member States prior to the 2008 financial crisis

	Country	**DK**	**BE**	**LV**	**SE**	**BG**	**EE**	**PL**	**UK**
	Date of the introduction of fiscal rule	**1962**	**1989**	**1990**	**1997–98, 2007**	**1998**	**1998**	**1998**	**1998**
Fiscal political rule	Deficit limit					X			
	Structural surplus or deficit		X		X				
	Expenditure limit		X		X				
	Current balance								X
	General balance	X	X	X			X		
	Efficacy studies								
	Medium-term planning	X							X
	Debt limit							X	X
	Stabilisation fund					X	X		
Authority	Public finance level	X	X	X	X	X	X	X	X
	National (central, federal)		X						
	Sub-national governments		X					X	
Basis of establishment	Constitution							X	
	Law	X	X	X	X				
	International agreement								
	Political guideline, agreement				X	X	X		X
Public law rating	Independent or parliamentary organisation	X	X	X	X	X	X		X
	Belonging to the executive branch							X	
Sanctions IFIs can use	Veto right								
	Loss of reputation	X	X	X	X	X	X	X	X
	Legal							X	
	Financial								

Abbreviations of the listed countries: DK – Denmark, BE – Belgium, LV – Latvia, SE – Sweden, BG – Bulgaria, EE – Estonia PL – Poland, UK – United Kingdom

Source: DG-ECFIN/IFI websites/Kopits, 2007; 2013/the author's compilation

Table 2a: Functions and responsibilities of independent fiscal institutions safeguarding the observance of budgeting on 1 January 2016 in the EU-15 country group

	Country	**SE**	**UK**	**FR**	**DE**	**IE**	**PT**
	Date of the introduction of fiscal rule	**1997–98, 2007**	**1998, 2010**	**2013**	**2010**	**2011**	**2012**
Fiscal political rule	Deficit limit				X	X	X
	Structural surplus or deficit	X					
	Primary expenditure limit	X					
	Current balance		X				
	General balance			X	X	X	X
	Efficacy studies						
	Medium-term planning		X				
	Debt limit		X	X			
	Sustainability						
Authority	Public finance level	X	X	X	X	X	X
	National (central, federal)	X	X	X	X	X	X
	Sub-national governments				X		X
Basis of establishment	Constitution				X		
	Law	X		X		X	X
	International agreement						
	Political guideline, agreement	X	X				
Public law rating	Independent or parliamentary organisation	X	X	X	X	X	X
	Belonging to the executive branch						
Sanctions IFIs can use	Veto right						
	Loss of reputation	X	X	X	X	X	X
	Legal				X		
	Financial						

Abbreviations of the individual countries: SE – Sweden, UK – United Kingdom, FR – France, DE – Germany, IE – Ireland, PT – Portugal – fiscal rules recommended by the EU for the countries of the euro area
Source: DG-ECFIN/IFI websites/Kopits 2007; 2013/the author's compilation

Table 2b: Functions and responsibilities of independent fiscal institutions safeguarding the observance of budgeting on 1 January 2016 in the EU-15 country group

	Country	**FI**	**DK**	**BE**	**AT***	**NL**	**EZ**
	Date of the introduction of fiscal rule	**2010**	**1962, 2010**	**1989**	**2012**	**1945**	**2015**
Fiscal political rule	Deficit limit						X
	Structural surplus or deficit						
	Primary expenditure limit						
	Current balance						
	General balance	X	X	X	X	X	X
	Efficacy studies					X	
	Medium-term planning		X			X	
	Debt limit				X		X
	Sustainability				X		
Authority	Public finance level	X	X	X	X	X	X
	National (central, federal)	X	X	X	X	X	X
	Sub-national governments			X	X	X	
Basis of establishment	Constitution						
	Law	X	X	X	X	X	
	International agreement						X
	Political guideline, agreement						
Public law rating	Independent or parliamentary organisation	X	X	X	X	X	X
	Belonging to the executive branch						
Sanctions IFIs can use	Veto right						
	Loss of reputation	X	X	X	X	X	
	Legal						
	Financial						X

Abbreviations of the individual countries: FI – Finland, DK – Denmark, BE – Belgium, AT – Austria, NL – The Netherlands, IT – Italy, EZ – fiscal rules recommended by the EU for the countries of the euro area
Source: DG-ECFIN/IFI websites/Kopits 2007; 2013/the author's compilation
**In Austria there are two institutions operating, one is Fiskalrat (Fiscal Council) functioning on the technological background of the Central Bank of Austria, the other is Budgetdienst (the Fiscal Council of the Parliament)*

We have to note that in October 2015 the European Commission established the *Independent Fiscal Institution of the Union,* the European Fiscal Board[9], as an opinion-giving body that plays an advisory role. Its activities, mandates and examinations were limited to the countries of the euro area. According to the resolution, the new body will work independently from the national and European institutions, but in cooperation with them.[10]

Table 3a: Functions and responsibilities of independent fiscal institutions safeguarding the observance of budgeting on 1 January 2016 in the countries of the EU-13 country group (encompassing the countries that accessed the EU in the period of enlargement, 2004–2013)

	Country	**BG**	**EE**	**CY**	**PL***	**LV**	**LT**
	Date of the introduction of fiscal rule	**1998**	**1998**	**2014**	**1998**	**1990**	**2014**
Fiscal political rule	Deficit limit	X					
	Stabilisation fund	X	X				
	Primary expenditure limit	X					
	General balance		X	X	X	X	X
	Debt limit				X		
	Sustainability			X			X
Authority	Public finance level	X	X	X	X	X	X
	National (central, federal)	X	X	X	X	X	X
	Sub-national governments				X		
Basis of establishment	Constitution				X		X
	Law			X		X	X
	Political, agreement	X	X				
Public law rating	Independent or parliamentary organisation	X	X	X		X	X
	Belonging to the executive branch				X		
Sanctions IFIs can use	Veto power						
	Loss of reputation	X	X	X	X	X	X
	Legal				X	X	

**The IFI of Poland that is functioning as a governmental organisation has been "accepted" by the OECD as part of the group of such organisations by inviting them to their meetings. However, the EU does not regard it as an independent fiscal institution and the Poles do not get invitations to the so-called ECFIN meetings*

Source: DG-ECFIN/IFI websites, Kopits 2007; 2013/the author's compilation

Twelve of the 13 countries *that accessed the EU in 2004 or later,* operate rule-based fiscal regulatory mechanisms, together with the independent institutional guarantees ensuring the observance of these rules. The system was already set up prior to the outbreak of the 2008 crisis in four countries while in another five – among them in Hungary – it was introduced in the period 2009–2012.[11]

The picture is mixed with respect to the utilisation of the elements of rule-based budgeting as well as the functions and responsibilities of the individual fiscal institutions.[12] One "novelty", however, stands out and this concerns us. This is the application of the veto right (we will deal with this in more detail later).

Table 3b: Functions and responsibilities of independent fiscal institutions safeguarding the observance of budgeting on 1 January 2016 in the countries of the EU-13 country group (encompassing the countries that accessed the EU in the period of enlargement, 2004–2013)

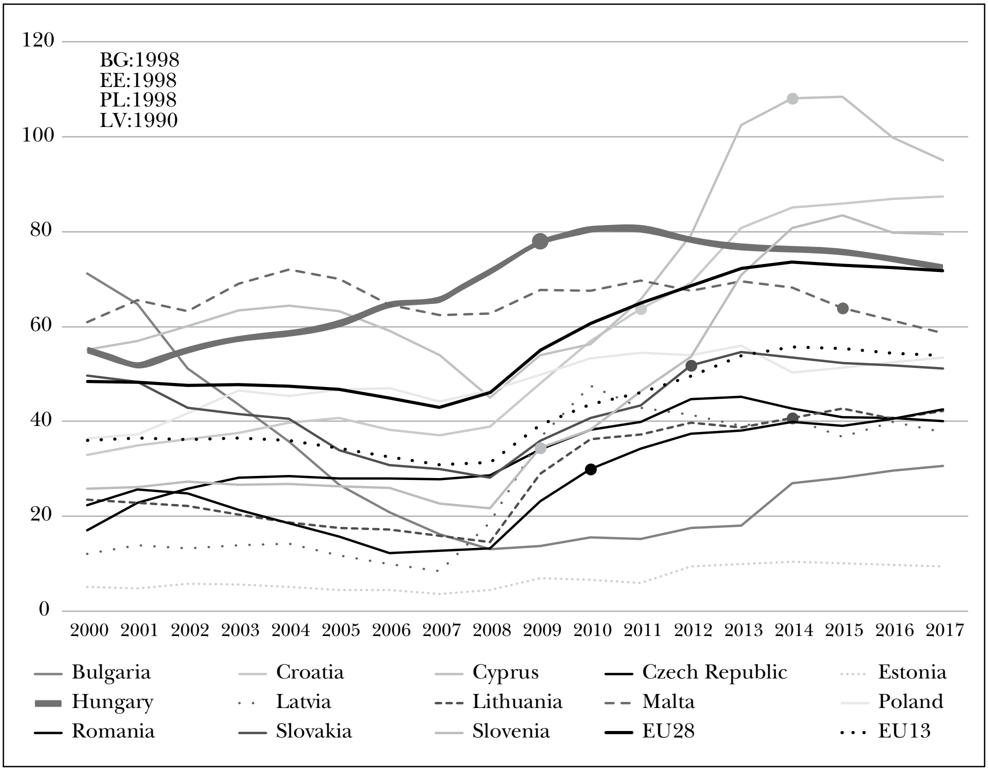
	Country	**HU**	**HR**	**MT**	**RO**	**SK**	**SL**
	Date of the introduction of fiscal rule	**2009**	**2011**	**2015**	**2010**	**2012**	**2009**
Fiscal political rule	Deficit limit						
	Stabilisation fund						
	Primary expenditure limit						
	General balance		X	X	X	X	X
	Debt limit	X	X		X	X	X
	Sustainability			X			X
Authority	Public finance level	X	X	X	X	X	X
	National (central, federal)	X	X	X	X	X	X
	Sub-national governments						
Basis of establishment	Constitution	X				X	
	Law	X		X	X		X
	Political, agreement		X				
Public law rating	Independent or parliamentary organisation	X	X	X	X	X	X
	Belonging to the executive branch						
Sanctions IFIs can use	Veto power	X					
	Loss of reputation	X	X	X	X	X	X
	Legal	X					

Source: DG-ECFIN/IFI websites, Kopits 2007; 2013/the author's compilation

Let us end the rather sketchy international outlook with the question of whether *financial management has become more disciplined* in the budget sector with the entry of the fiscal rules and institutions (fiscal councils). It is a fact that in the majority of the countries, following the introduction of a stricter system, the rate of government debt began to decrease (see Figure 1), and economic growth also started, more powerfully in the group of the Visegrád countries. Although the financial system of some Southern European states can, from time to time, be operated with the help of their own "forced solidarity", the practise of rule-based budgeting has brought certain results here too.

Accordingly, we can clearly reach the conclusion that the strengthening effect on discipline of favourable, problem-solving financial management can be demonstrated. This can be directly experienced mainly in the gradual relief of the burden of indebtedness. We should note, however, that the degree of the contribution of rule-based budgeting to the strengthening of fiscal stability strongly depends on the ability

Figure 1: Government debt to GDP of certain member states of the European Union and the date of creation of their independent fiscal institutions



Source: EUROSTAT, 2014–2016: Forecasts based on the National Convergence Programmes

of society and the political leadership to recognise the capacity, socio-economic will and, naturally, the authorisations in constitutional law of the institutions safeguarding the observance of this set of rules.[13]

Domestic fiscal policy in the past decade and a half

Problems in managing public finance and the human factor

First of all, let us see why and how we reached the recognition in the middle of the 2000s that, in order to establish stability in fiscal (budgetary) policy in Hungary it was unavoidable to introduce stricter regulations and the consequent control of their functioning.

After the turn of the millennium it was not only Hungary that was facing more and more unmanageable public finances, overspending and, as a consequence, deepening problems of indebtedness that led to the undermining of the financial stability of the country. However, the situation was different for us in that the overlap of the political and economic cycles and the processes through which they strengthened or weakened each other – the effort to maximise votes – have resulted in expenditure overruns and the ensuing indebtedness, and most likely they played a larger role than in other countries with similar fates[14] (Karsai, 2007). Therefore, before we deal with the introduction of rule-based budgeting to Hungary, it is worth briefly looking beyond our borders.

It is obvious that in the system of relations of financial policy outlined in the introduction, reaching the desired goals depends not only on establishing the appropriate rules, but also on their disciplined observation and enforcement. But in this process the *human factor and the ability of society to recognise its interests and its will to follow these rules* play important roles without which the financial stability of a country can scarcely be realised (Kovács, 2016a).

Following the transition to democracy in Hungary, the fiscal policies followed by subsequent governments were characterised by bargaining mechanisms, with a planning and financial management procedure that was built on political promises and dogmas. This presented an obstacle for public finance stability and sustainable development (Antal, 2004; Csaba, 2007; Karsai, 2007; Lentner, 2008; Matolcsy, 2008; Muraközy, 2010 and others).

Consequences measurable by financial indicators

From time to time (mostly in years close to the elections) the *public finance deficit* has "skyrocketed"; in 2002 and in 2006 it was close to 10 per cent of the gross domestic product (GDP) (see Figure 2).

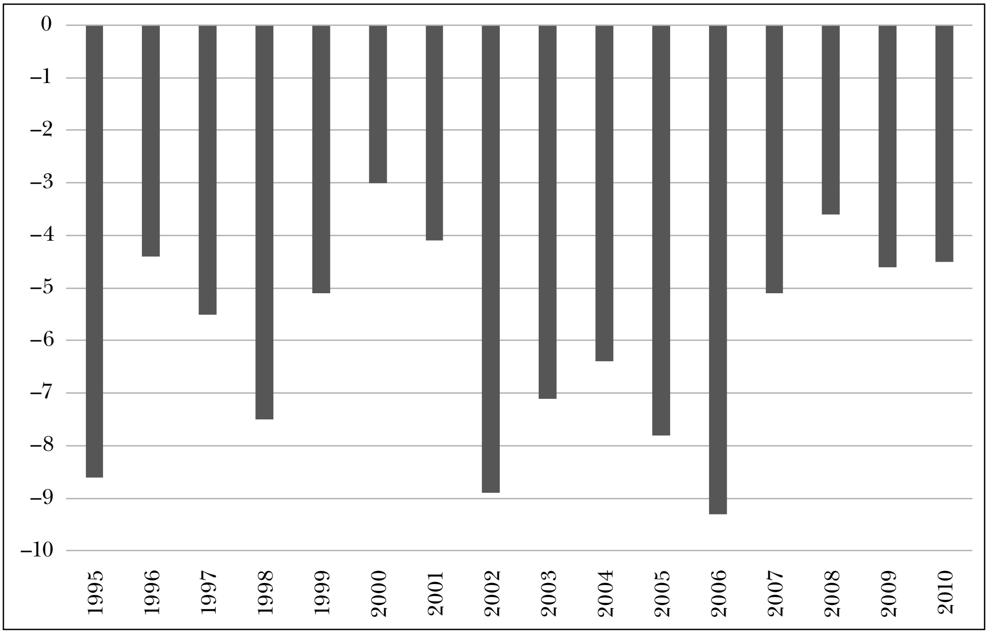
The continuous increase of the *measure of government debt expressed as a proportion of GDP (government debt rate)* up to the introduction of the rule-based fiscal policy in 2010 was a direct consequence of the high deficit level (see Figure 3).

In the first half of the 1990s and then, following a temporary decrease, in the 2000s, the country was heavily burdened not only with the paying back of the soaring *government debt* but also the very expensive *financing* of the debt (debt service, i.e. the interest rate). "In the period of 1993–1999 in Hungary the expenditure on interest exceeded the expenditure on education, culture and health care" (György–Veres, 2016). To this we can add that, even in the years following 2010, servicing the debt tied up the same amount – i.e. 8-9 per cent – as that used for financing health care and was scarcely less than the 10–11 percent dedicated to education.

The peaking – especially when compared to the neighbouring countries and also to the OECD average – of *state redistribution* at close to 50 per cent of GDP, was the direct consequence of our fiscal policy (Figure 4).

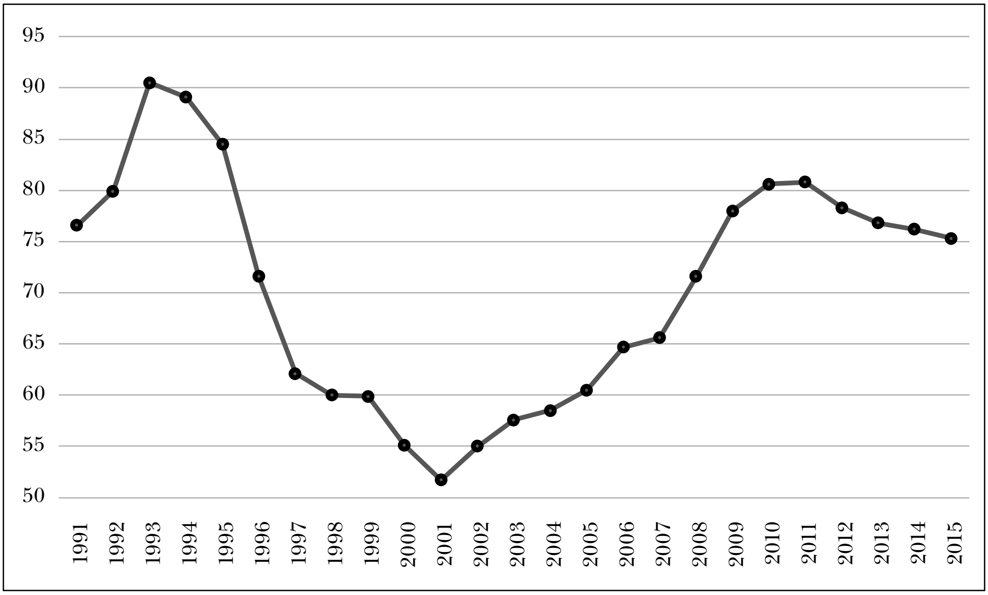
It was inevitable that the huge amount of *withdrawn income* (and more specifically, the high degree of tax centralisation) that was necessary for state redistribution, encouraged tax evasion that, as a consequence, led to a reduction in the number of taxpayers, the erosion of the tax base and even to higher tax rates. As a result, *private sector investments* have shrunk. Companies being forced out of the credit market also contributed to this trend.

Figure 2: Hungarian public finance deficit from 1995 to 2010 calculated according to EU methodology (percentage of GDP)



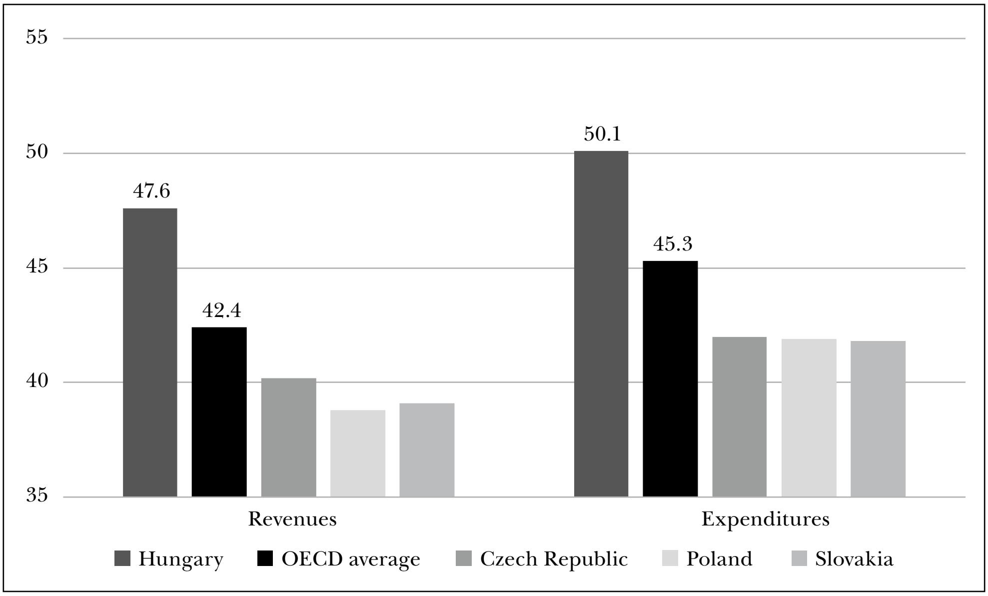
Source: Eurostat, Edited by the FC Secretariat

Figure 3: Government debt to GDP from 1991 to 2015



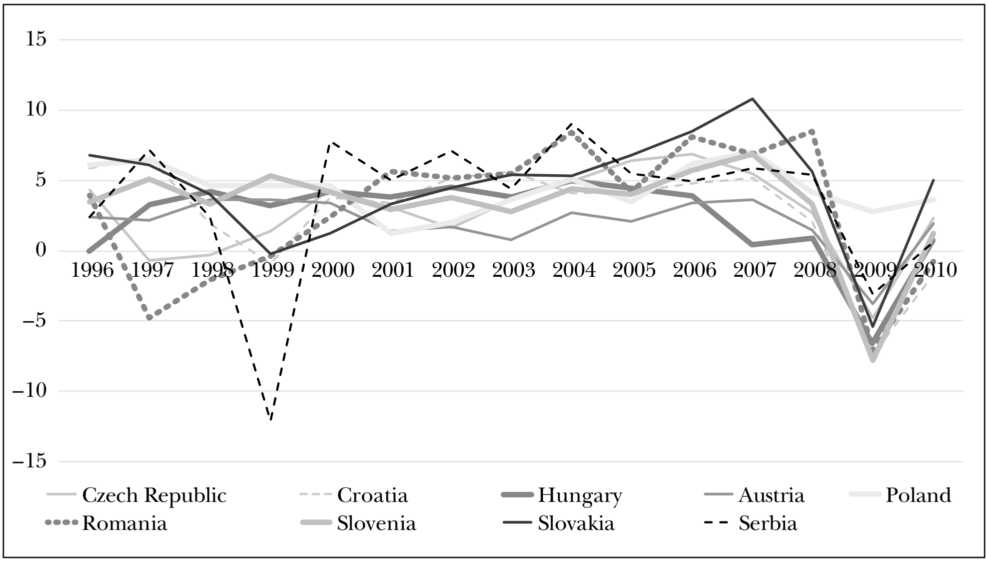
Source: Eurostat, edited by the FC Secretariat

Figure 4: The degree of the revenue centralisation and redistribution of public finance in the Visegrád countries (2014) and the OECD average (Consolidated revenues and expenditures to GDP)



Source: OECD, on the basis of Zoltán Cséfalvay, partially edited by the FC Secretariat

Figure 5: Economic growth of Hungary and the neighbouring countries in the period 1996–2010 (change compared to the previous year, per cent)



Source: Eurostat, European Commission, edited by the FC Secretariat

The aforementioned reasons appearing in Hungary together with a number of other factors, like ever-decreasing productivity, led to a *more moderate growth, and occasionally even to recession,* compared to the neighbouring countries, and the level of growth could only be maintained by the continued involvement of external sources i.e. indebtedness (see Figure 5).

Courage was missing from the public finance reforms – consolidation attempts – announced by the governments of the period in the aftermath of the transition to democracy. Lack of social acceptance and support played a role in their failures or – at best – half-successes, as well as the lack of adjustment to the economic viability (tax-paying ability) of the country when it came to a powerful structural transformation and the tasks undertaken by the state. Furthermore, they did not set requirements to promote the more efficient utilisation of public funds.

The above-mentioned oversized public finance and the subsequent "greed" and inefficient system of operation exerted a negative effect on the national economy and this also contributed to the declining *competitiveness* of the country.[15]

Despite the excessive weight of public finance people experienced a continuous worsening of the level of public services and thus their quality of life, i.e. their expectations have not been met despite the promises given in the election campaigns (Kovács, 2016a). In addition, the economic crisis of 2008 that started in the money markets and expanded to a general crisis further weakened our position thanks to the already weak situation of the Hungarian economy.

Introducing rule-based budgeting in Hungary – Antecedents and institutional solutions

By 2006, following the deepening problems of Hungarian public finance that were endangering its sustainable financing and damaging the competitiveness of the real economy, it had become obvious that the budgetary practice followed ever since the transition to democracy had excluded the possibility of stepping on of the path towards sustainable development. The change could not be deferred any longer; a genuine change was needed in fiscal policy. However, the question was what should be the contents of such a change.

Balancing on the edge of fiscal unsustainability led to the recognition that in order to maintain the long-term sustainability of public finance, the direction of government had to insure, already in the short term, a regulation that was consistent and appropriate for the selected scenario as well as fiscal planning in the financial system that was "thinking" in the longer term, and independent control overseeing the observance of the regulations.

Dual search for a solution (2006–2007)

Experts were seeking solutions in two directions regarding the character of the regulations required for fiscal sustainability, as well as the institutional guarantees of their observance.

The *theses on modernising public finances* elaborated by the State Audit Office of Hungary assumed that in order to have significant change, the whole management of public funds would have to be regulated and made transparent and accountable. However, the agreement concerning the necessity and usefulness of comprehensive redefinition proved to be insufficient, owing to political divisions and the circumstances of a coalition government burdened with internal debates.

The other professional initiative focused on the most significant cause – the prevention of expenditure overruns – and regarded the adoption of the elements of *rule-based budgeting, which were* already successful in international practice, as appropriate for solving domestic problems too.

Accordingly, the development of the framework for *rule-based budgeting* was launched on the initiative of the State Audit Office of Hungary and the Central Bank of Hungary.

By the end of year 2008, and in the shadow of the threat of state bankruptcy and the pressure of borrowing from the IMF–EU, the *Act on Cost-Efficient State Management and Fiscal Responsibility* was born. Owing to its conception as an intervention mechanism that set limits on expenditure, this act was also referred to as the "Ceiling Act". The act limited the grand total of budget expenditure for the following year (the plan for the year 2009 had to be equal to the provision for 2008, but later it could be increased by half of the expected rise in the real value of GDP). Besides this, they established complicated rules concerning the plannable balance of the budget and the envisaged extent of government debt.[16]

There were also two different plans for the *Fiscal Council and its organisation.* Although there was agreement on the idea that the chairman of the body should be an authority representing the head of state, there were different ideas concerning who should be the members of the body. One plan held that the members should be the incumbent presidents of the two financial institutions, i.e. the State Audit Office of Hungary and the Central Bank of Hungary, both institutions being independent from the government. According to this plan a secretariat with a small staff would take care of the general and organisational tasks, as professional support for the decisions made by the Council would be ensured by the SAO, which would check the foundations of fiscal planning at both the macro- and micro-economic levels as it could rely on its independent research staff, and the Central Bank with its existing, and traditionally high-level, capacity for macro-economic analysis.[17]

The other solution was significantly different from the above plan. In this second concept, apart from the authority representing the head of state, members of the body would be selected from experts nominated by the heads of the SAO and the Central Bank of Hungary. The secretariat would consist of a large number of staff, be financed by an independent budget and have significant expertise in macro-economic analysis.

In the end, the second plan was included in the "Ceiling Act" and this prevailed until the end of 2010 (Török, 2011). Then, from 2011, there was a return to the first plan, with the conditions of the transition being regulated by the 2011 Budget Act.[18]

Following the 2010 general elections, the new Government – enjoying a two-third majority in the Parliament – undertook the tasks of reviewing the whole of the legal system, and within this public finance, and setting up a new legal framework. This solution opened a new chapter, appropriate to the importance of the issue, with regards to the regulation of the rule-based budgeting system.

The Fundamental Law of Hungary and the Stability Act on rule-based budgeting

The *Fundamental Law of Hungary,* which was passed on 18th April 2011, dedicated a separate chapter to public finance. This chapter lays down the budget-making role of the National Assembly. Additionally, it states that the management of public finance shall be done in a transparent and accountable way, by keeping in mind the requirements of legality, expediency and efficiency. It also sets up a barrier for indebtedness, not only with regard to overall public finance but also, separately within it, to local authorities.

The Fundamental Law also defined the annually plannable extent of government debt when it created the *government debt rule.*[19] According to this rule the National Assembly cannot pass a central budget act which would result in government debt exceeding half of GDP. As long as government debt exceeds half of GDP, the National Assembly can pass only a central budget act that contains the requirement to decrease government debt to GDP.

The Stability Act established a government debt rule *not only regarding the planning and passing of the budget but also concerning its implementation.* It states that as long as government debt rule exceeds half of GDP – with specific exceptions – no borrowing can take place in the course of the central budget implementation and no such financial obligations can be made as a result of which the proportion of government debt to total gross domestic product would increase compared to the previous year.

The Fundamental Law of Hungary elevated the Fiscal Council (in short: the Council or FC), which oversees the observance of fiscal stability, to become one of the conditions of the functioning of the Constitution. The Council is a body supporting the legislative work of the National Assembly and carries out its duties and tasks subordinated to the Fundamental Law and other laws. Among these tasks the FC participates in the preparation of the central budget bill; as an organisation supporting the legislative work of the National Assembly, on the one hand *it examines – gives an opinion on – the foundations of the central budget,* while on the other hand it *gives its preliminary consent to the passing of the central budget bill* in the interest of the observance of the government debt rule. The Council was granted a role as an independent fiscal institution with the above-mentioned duties and sphere of authority – i.e. the so-called *right to veto – together with the accompanying responsibility.*

This solution exceeds the practice of the majority of EU countries where – as we explained above – the work has mainly an awareness–raising and advisory character, not involving direct responsibility and tends towards a macro-economic analysis and technical forecasting with various reporting rights (that, in a limited way, might be strengthened by the relationship of the given institution to the SAO or the Parliament) (Domokos, 2012; 2015).

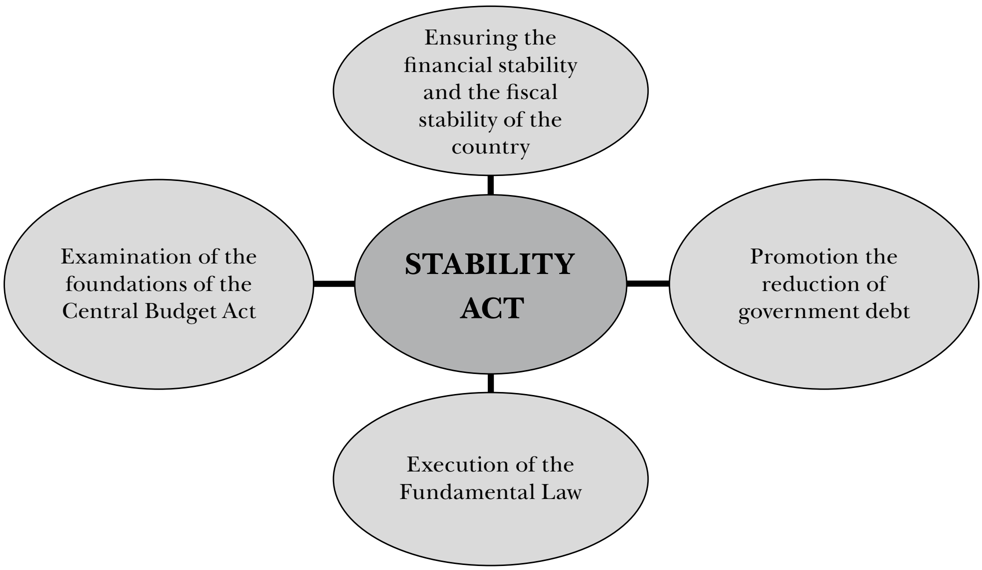
The framework for the Council's duties defined by the Fundamental Law was further detailed by the Stability Act (see Figure 6).

It is the Stability Act that sets forth in detail the rules of procedure for the implementation of the *mandatory duties* of the Fiscal Council, including the duties of the Government, first and foremost by focusing on the process for enacting the budget bill. Thus, if in the course of formulating its opinion on the budget bill the FC expresses its lack of consent, then the Government shall have to confer again and reach agreement with the Council. The procedural rule concerning the provisional consent of the Council with regard to the bill's accordance with the government debt rule is even tougher: if the Council resorts to using its veto right and rejects giving its provisional consent then the final voting shall have to be postponed and the procedure be continued until the Council gives its consent.

In addition to the above, the main duties of the Council are to express an opinion every six months on the implementation of the central budget act and the expected trend of government debt.

The FC monitors the macro economy and the implementation of the budget in the context of longer term macro-economic processes. For this purpose – just as when expressing an opinion on the budget – the Council relies on the analysis capabilities of the SAO and the MNB, and also on the work of research institutes, external experts, professional forums and advisory bodies.

Figure 6: Tasks of the Fiscal Council according to the Stability Act



Source: www.kormanyhivatal.hu/download/3/de/20000/6 Stabilitási törv.pdf

With regard to the *other, non-mandatory duties* of the Fiscal Council, the Stability Act states that it can give its opinion on any issues that are related to the planning and implementation of the budget, the utilisation of public funds, and the state of public finances. From a broader perspective, satisfying social and professional/media interests fits within these duties, as well as asking for the opinion of economists, and responding to information requests from international organisations, cooperating with the independent fiscal institutions of other countries, and, likewise, the promotion of the stability of public finances using the tools of publicity (the Council's resolutions, annual work plan, other documents, and research used for the FC's work are available on its website).

Activities of the Fiscal Council and the balancing of public finances

The activities of the FC and the tools at its disposal – not least the body's strong authority for promoting fiscal discipline, but also the guarantee of its presence –, *have contributed to the balance-oriented budgetary policy*, as a result of which the excessive deficit procedure (EDP) against Hungary was terminated in 2013, and the benchmarking parameters of public finance management have been realised, on the basis of which it became possible, in 2016, for international credit rating organisations to return Hungary to investment-grade status.

Some decisive resolutions of the Fiscal Council can be linked to this process:

– In 2012, the FC objected to the macro-economic trajectory and the targeted deficit in the 2013 central budget bill. As a consequence, a new proposal was made that amended the macro-economic background, the targeted deficit and included additional revenue (thus concerning the tax system) and expenditure-affecting measures.

– In 2013, in its opinion on the 2014 central budget bill, the FC identified risks both on the revenue and expenditure sides. Thus it considered it justified that strict financial management is followed at all levels of public finances to ensure that balance requirements are met.

– In 2014, in the case of the 2015 central budget bill, the FC focused its attention on the necessity of "fending off" those external conditions that threatened the implementation of the macro-economic trajectory.

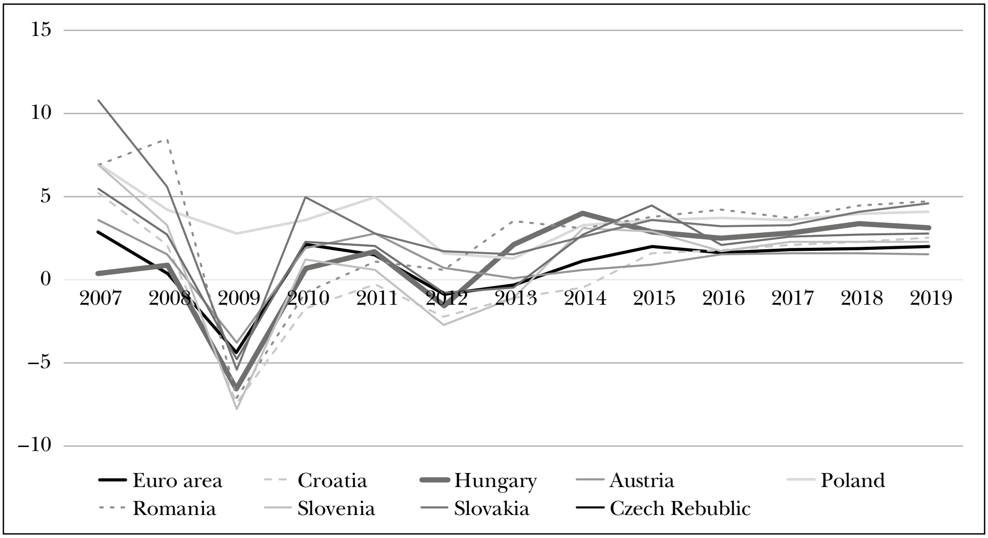
– In 2015, with regard to the 2016 central budget bill, the Council pointed out that the observance of the government debt rule (the debt formula stipulated by the Stability Act) was facing challenges (as a result of these challenges both the balance and the growth of public finances were in danger) and recommended the amendment of the formula. The National Assembly adopted a new government debt rule, also as a consequence of the FC proposal.

– In 2016, the Council gave a positive evaluation of the 2017 central budget bill thanks to the step taken towards a balanced budget (the separation and deficit of the operational and accumulation budgets was shown only in case of the latter). At the same time the FC called the attention to the fact that the requirement regarding the so-called structural deficit had not been met.

The stability of Hungarian finances as the basis of growth

Growth determining the stability of the country and public finances has been present since 2013. It should be stressed that "the years of 2014 and 2015 were the first two years, ever since the early 1990s, when the Hungarian economy was able to grow without being followed by the growth of government debt and the external debt of the economy" (György–Veres, 2016:380). It is auspicious that economic activity has strengthened and that economic growth in the region exceeds the average of the euro area (see Figure 7).

Figure 7: Economic growth in the countries of Central Eastern Europe and of the euro area

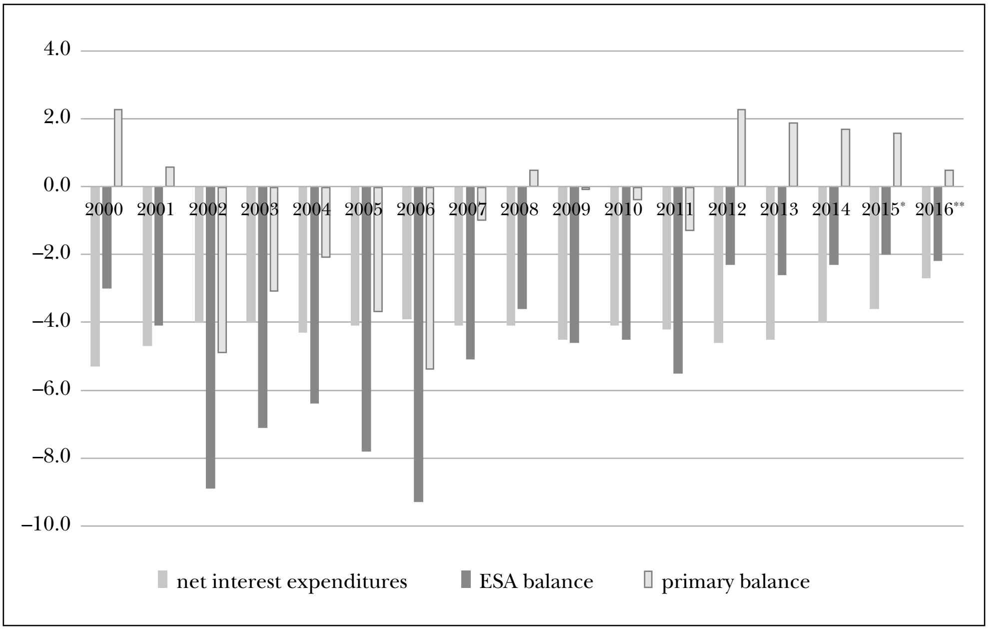


Source: 2016 spring forecast of the European Commission

The improvement of the government debt balance at the same time stimulates growth both in Hungary and in the neighbouring countries. It is the success of our rule-based budgetary policy that it is manifested not only in the decreasing trend in the public finance deficit but also in the fact that ever since 2012 our primary balance has been continuously positive, in contrast to the previous years when we were able to produce such a favourable result only for a year (Figure 8).

As a result of the marked improvement in the effectiveness of revenue collection, the adequate control of expenditures and the subsequent improving of the deficit indicators, after 2010 the government debt rate has been improved every year (as show in Figure 3). With the improving balance, the costs of financing the budget decrease. Cheaper financing then liberates resources for the economy and for society and thus represents a factor for growth. From the aspect of the "vulnerability" of the country, the spectacular fall of the ration of foreign currency within government debt is especially favourable (see Figure 9).

Figure 8: Hungary's budget deficit, net interest expenditures, and primary balance to GDP

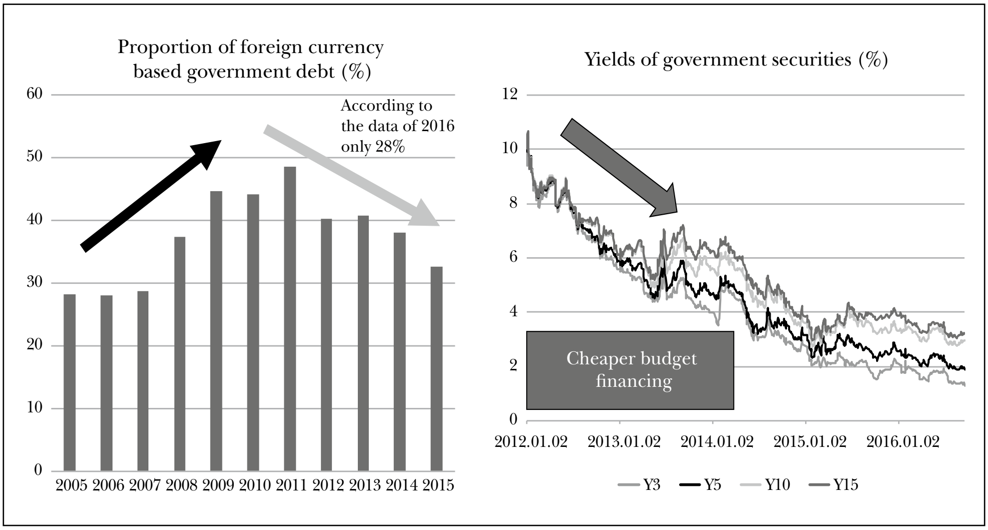


** The previously expected -1, 6% deficit is even more favourable*

***Expected data for year 2016*

Source: MNB, on the basis of Eurostat, edited by the FC Secretariat

Figure 9: Hungarian government debt denominated in foreign currency and the yields of government securities



Source: ÁKK

Instead of a summary

The characteristic of the "Hungarian model" that was renewed in 2011 is that, in order to prevent the earlier fiscal indiscipline, the FC was granted constitutional authority (right to veto) on the acceptance of the budgets (and their respective amendments). Apart from this it is also a characteristic feature of the Council that thanks to is budget-related constitutional authority, the body primarily deals with the stability risks of the current and the following year, utilises medium-term outlook and forecast data t, and does not bring them to the level of a corporate decision.

Generally speaking, the Hungarian system can successfully function not only because of its strict regulations, simple and transparent principles for fighting government debt and overseeing the observance of these regulations, but also because of its solutions, its effect on mitigating expenditure overruns, its awareness raising and confidence-building strength and its durability. In this way, it can contribute to the stabilisation of the country, to its sustainable development, the improvement of the country's economic competitiveness and, ultimately, the advancement of the nation and the citizens of the country (Kovács, 2016b).

By the application of the elements of rule-based budgeting and the operation of the Fiscal Council, and also owing to the confirmation of the related requirements in the Fundamental Law and the Stability Act that made the regulations more transparent and consistent, the balance of public finances in the years following 2011 has clearly improved with respect to the deficit and debt indicators. Fiscal stability makes it possible for public finances to increasingly contribute to economic development. Competitiveness indicators[20] even today lag behind those of the Visegrád group of countries. Among a series of weaknesses, however, those related to the low effectiveness, excessive consumption and lack of financial stability of Hungarian public finances are no longer present today. These serious and determinant factors were responsible for the withdrawal of resources necessary for the economy and the dramatic fall of competitiveness in the 2004–2010 period.

The improvement of our balance situation affects our national competitiveness in a positive way. Further continuing the idea of linking competitiveness to the material and intellectual progress of our citizens, one must agree with a definition from Magdolna Csath that: "the economy is competitive when the abilities of the nation are useful and in the longer run keep gaining strength continuously, and when companies produce high added value, and as a consequence of these factors the standard of living and quality of life of the individuals keep improving" (Csath, 2016:5–6.).

Concerns the answer to the question "how to proceed" let me invoke once again the thoughts of László György and József Veress: "After having fended off direct dangers we can start developing those efficiency-improving and innovative factors that are able to set a solid foundation for competitiveness and economic growth […] first of all developing the following fields: vocational training, adult education, higher education, innovation, optimisation of the coordinating mechanisms of the economy and decreasing of the bureaucratic and administrative burdens of market operators" (György–Veress, 2016: 380).

Disciplined fiscal policy and making the work of public finance supply system more effective and efficient must contribute continuously to the future success of our national economy. There are plenty of tasks still to do for the Fiscal Council by contributing to the strengthening of fiscal responsibility.

Notes

[1] The author thanks László Kékesi and Sándor Varga, advisors to the Chairman of the Fiscal Council, for their contributions to writing this article.

[2] We can also regard the Maastricht criteria as obligatory and uniformly used "numerical and procedural rules". Let's think about the stipulated 3 per cent deficit limit or the goal of keeping government debt at 60 per cent of GDP, the obligatory decrease of the part of the deficit leading to it or that of the part above the limit by 1/20th annually and the independent fiscal institution of the EU Commission, the European Fiscal Board established as an advisory body of the EU zone countries. Members of this body were appointed in October 2016, a year after its establishment, by the EU Commission and it started working in practice following this.

[3] Paragraph (1) of Article N of the Foundation of our Fundamental law ("Hungary shall observe the principle of balanced, transparent and sustainable budget management.") and Articles 36, 37 and 44 of the chapter The State.

[4] Act CXCIV of 2011 on Hungary's Economic Stability.

[5] The introduction and application of rule-based budgeting has a wide range theoretical literature. Additionally the European Commission, and lately the cooperation forum of the independent fiscal institutions of the EU countries have also published documents. This chapter was prepared using these materials.

[6] Rule-based budgeting and financing based on it carries the better harmony of tasks and resources and undoubtedly mitigates the cyclic nature of the budget (Kopits, 2013). The lessons of the crisis complemented this "classic function" by proving that the introduction of rule based budgeting can be one of the tools of crisis management (Reinhart–Rogoff, 2010; Kovács, Á., 2013).

[7] As regards the constitutional rating of institutions overseeing the observance of relevant rules, independence from the government is a generally prevailing requirement, although we see Poland as the "odd one out" where the institution was established as part of the executive power. A well-known consequence is loss of reputation/credibility as a sanction applied by fiscal institutions. In the case of Poland we can see the option of legal sanctions (for example the renegotiation of the budget), while financial sanctions (for example, the suspension of EU resources) can be used in the countries of the euro area (Franco, 2011).

[8] Stricter fiscal rules were applied after 2008 and institutions were dedicated to overseeing the observance of such rules in Germany, Ireland, Portugal, Finland, Austria and Italy. The system was further enhanced in the countries that already had such institutions (in Sweden in 2007, in Denmark and the United Kingdom in 2010).

[9] By its Resolution No. 8000 issued on 21 October 2015 the European Commission decided to establish the institution, while a decision on its member was made only a year later, in October 2016.

[10] Due to the short time that had passed since its establishment, naturally we don't yet have evaluable experiences regarding its operation and the perception of the body about its mission. The cooperation and consultation forum of the independent fiscal institutions of the EU countries that was created about one and a half years ago as a self-contracting and professional-consultation forum is looking for opportunities to establish a mutual exchange of experiences with the European Fiscal Boards as soon as possible to share best practices.

[11] The Czech Republic does not use any elements of the rule-based fiscal framework. The fact that, for political reasons, the former Czechoslovakia never received external resources and the transition to democracy took place in a country that had a relatively developed economy, low living standards but minimal level of indebtedness all played an important part is this. The situation is somewhat similar in Poland, where they had been successfully using the fiscal policy and procedural regulations prior to the crisis and they do not see the need to establish an IFI.

[12] As regards the concepts of the professional backgrounds of independent fiscal institutions, their constitutional status has no international (European) "best practice". What is important is the capability of institutions to maintain rules, which can be realised in the various countries by lining up constitutional instruments of differencing strengths, by different values of trust and credibility (prestige), by relying on professional support of different organisational backgrounds, and by various constitutional and institutional tools. The guarantees to keep the budget deficit in control and to prevent expenditure overruns, and the rules created with the aim of limiting investment expenditures, (Benczes–Váradi, 2011) can be interpreted together with the state organisation and fiscal system of the given country (Török, 2011). There are a number of examples in international practice in which analyses serving as the foundation of the body's decisions are provided by experts from the business sector or other, independent organisations – SAI, central bank, etc. Among the countries of the European Union France, Finland, Lithuania, Latvia and Italy rely on their respective SAIs while the Slovakian and Austrian IFIs chose their Central Banks as a background. In the case of the latter, however, we also have to note that in Austria there is an additional institute with a parliamentary background that oversees rule-based budgeting.

[13] Such can be, for example, when the IFI prepares the macro-economic forecast that serves as the basis of the budget bill, gives its opinion on the budget bills and the defined parameters (government debt to GDP, deficit ceiling, etc.).

[14] In 2006 Gábor Karsai wrote: "The amplitude of domestic political cycles in Hungary appears to be more powerful than what is usual in the older member-states of the EU. Very likely part of this is the consequence of the greater tensions caused by the transformation process. The other reason is the consequence of more modest democratic traditions. […] As regards the Hungarian economic and privatization policy we clearly have to differentiate between the declared principles and practice expressed in the election campaigns, and the government programme and the laws. This has two important elements. On the one hand, the processes often went on without parliamentary regulations." (Karsai, 2006:510)

[15] Naturally the problem is manifested in a far wider context however, discussion of this – especially the impact assessment of the factors of production efficiency – exceeds the frame of the present article).

[16] Act LXXV of 2008.

[17] In order to ensure the technical conditions for the operation of the secretariat with a small staff it can be attached either to the SAO or the Central Bank of Hungary, although it can be also expedient if the Office of the National Assembly supplies the technical background for the operation. There are examples of each solution in international practice.

[18] The changing concepts of institutional building and grasp of mission exceed the frame of the present article. A more detailed explanation can be found in the following document: "The Fiscal Council in the Hungarian Fundamental Law, Draft of Institutional Development and the European Practice" (Kovács, 2016b).

[19] Paragraphs (4) and (5) Article 36 of the Fundamental Law. In Hungary government debt was concretised by the Stability Act. According to the original wording that came into law in 2015 and was used for the first time for the 2016 central budget, the planned amount of government debt by the end of the following year was able to grow by the amount of half of the difference between the growth rate of inflation and real GDP. However, this was unenforceable and thus this requirement was amended (the movement of economic growth and inflation in opposite directions would have resulted in a restraint on growth). As a result of the 2015 amendments this rule is valid only in cases of an inflation target exceeding 3 per cent and, at the same time, economic growth predicted above 3 per cent. In any other case, the goal is set at reaching at least a 0.1 per cent decrease in the debt indicator. At the same time, the decrease in the debt indicator can be even larger by reaching the goal set by the public finance law, i.e. by reaching

the targeted budget deficit in the medium term. Diversions from the above requirements are allowed only in cases of the introduction of a special law, to the extent of mitigating the consequences of the factors calling for the introduction of such law, or, in the case of a lasting and significant recession of the national economy, and only to the extent necessary to restore normal conditions.

[20] Attila Chikán wrote: "Quite a strong correlation exists between productivity and competitiveness. It is rather unlikely to be wrong when we say that one of the important factors of Hungary's significant falling behind is that in the rank of 33 OECD countries merely five countries are behind us and our country's indicator does not reach half the level of the data for the USA data and 60 per cent of the OECD average. A general lagging behind is inevitable with such real outputs. It is an especially regretful fact that the productivity growth rate of productivity is also showing a downward tendency" (Chikán, 2014).

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