

Fiscal responsibility framework: Comments on the Finance Ministry proposal

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Background

In Hungary, the deficit bias has been a problem over the past decade and a half. Since the post-socialist transition, fiscal developments have been determined mainly by political cycles as compared with many other countries where the budget balance broadly reflects the impact of economic cycles.¹ The deficit bias becomes particularly pronounced during election campaigns. From this perspective, Hungary is virtually a textbook example: the fiscal imbalance is rooted simultaneously in time inconsistency and the common-pool problem.² After the election, each government emphasises its commitment to fiscal discipline, but then, in the run-up to the next election, unable to resist various interest group pressures, it embarks on a spending spree, ignoring the ultimate budget constraint.³

As a result, public debt (adjusted for the effects of privatisation) is on an unsustainable path. During the 2006 election campaign the deficit bias had reached a new peak: the general government deficit stood at nearly 10 percent of GDP, with public debt rising well above 60 percent of GDP. The fiscal measures taken by the government to boost its re-election prospects and the promises made by nearly all political parties only aggravated the problem.

Recognising that the unsustainable fiscal policy stance could easily push the country into a financial crisis, in May 2006, the National Bank of Hungary and the State Audit Office organised a conference on fiscal responsibility, attended by foreign and local experts as well as leading politicians involved in fiscal matters. Most participants agreed that Hungary would greatly benefit from the introduction of a rules-based fiscal responsibility framework (FRF).⁴

Key elements of the FRF introduced by a number of countries are: fiscal policy rules (e.g., balanced budget, expenditure ceilings), fiscal procedural rules (e.g., medium-term budget planning, pay-go requirement), and transparency standards (e.g., accrual-based accounting, reporting system). In addition, a surveillance mechanism under the authority of an independent institution was established to ensure transparency and compliance with the rules.⁵

Prior to the conference, some opposition party leaders called for greater fiscal responsibility, and in particular for the creation of an independent Fiscal Council, to be entrusted with oversight in the conduct of fiscal policy. Recently, Mihály Varga, chair of the Budget Committee of Parliament, clarified that the Council should be similar to the Convergence Council – appointed temporarily by the Government to assess the Convergence Programme submitted to the EU authorities in September 2006. The Council would consist of three members: the President of the State Audit Office, the Governor of the National Bank of Hungary and a member delegated by

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the President of the Republic. In addition, he favored primary expenditure limits at the central government level and segregation of local development and operational expenditures to contain the indebtedness of local governments.⁶

Legislative proposal

In April 2007, at yet another conference organised the Finance Ministry and the National Bank of Hungary, the prime minister announced the introduction of a rules-based framework, in light of last year's poor fiscal performance and of the government's low credibility.⁷ In June, the Finance Ministry issued a legislative proposal on fiscal responsibility and on the creation of a Parliamentary Budget Office.

The proposal, posted on the Ministry's website, outlines a rules-based FRF.⁸ As regards the central government, it prescribes that (1) gross public debt may not grow at a faster pace than inflation; (2) the nominal primary budget balance must be consistent with this objective and may not be negative in any event; furthermore, (3) the discretionary budgetary items (which can be modified in the annual budget law), subject to direct government control, may not net a worse balance than the constraint imposed by the nominal primary balance (after deducting mandatory revenue less expenditure). These fiscal policy rules are underpinned by procedural rules, namely, the pay-go principle⁹ and medium-term budget planning. The proposal also contains a version of the golden rule at the local government level that allows municipalities to borrow in proportion to development expenditures, though taking into account own resources requirements of EU funding. In order to increase transparency, the law would stipulate at all government levels that accounting rules should be revised in conformity with best international practice, and would introduce rather stringent reporting rules. In addition, the law would establish the Parliamentary Budget Office (*Országgyűlés Költségvetési Hivatala* - OKH), an independent, politically neutral, well-informed institution, modelled after the U.S. Congressional Budget Office.

Assessment of the proposed rules

An internationally accepted set of criteria (the so-called Kopits-Symansky criteria) allows for the evaluation of the rules contained in the proposal.¹⁰ As none of the existing FRFs can meet fully all the eight criteria, every country has to make a strategic choice, taking into account its own circumstances and objectives. This explains why there is no single universally applicable model FRF. From an application of the criteria we can draw the following observations as regards the rules proposed by the Finance Ministry:

1. Definition: are the performance indicators, time-frame and institutional coverage sufficiently well specified? The proposed rules stipulate clear and unambiguous conditions, the spectrum of institutions covered by the fiscal indicators is broad and well-defined (including in principle the quasi-fiscal activities of state enterprises) for the central government, while local governments are covered by a separate set of rules. The time-frame (three years) of the indicator which underlies the fiscal policy rule is also clearly defined.

2. Transparency: is there scope for creative accounting and forecasting, and can compliance with the rules be monitored in real time? Generally speaking, the proposal contains transparent norms of accounting and forecasting, on the basis of clear regulatory responsibilities. However, at the local government level, the golden rule would be applied on less than transparent intergovernmental arrangements.
3. Adequacy: are the rules likely to achieve their objective? The application of the proposal would significantly improve the medium- and long-term debt sustainability by containing the rise in the real public debt burden per capita (given a stagnant population size); as a corollary, the debt/GDP ratio will decline for any positive GDP growth rate.
4. Consistency: is there consistency among fiscal policy rules on the one hand, and between these rules and other economic policy instruments on the other? In the proposed rules, the discretionary balance constraint derived from the real debt target ensures internal consistency. At the same time, compliance with the rules reduces fiscal dominance,¹¹ and thereby expands the room for monetary policy and enhances external consistency. In addition, the rules are compatible with, and are more stringent than, the Maastricht criteria.
5. Simplicity: are the rules easy to understand by politicians, citizens and investors? Communication and explanation of the relatively complex set of rules contained in the proposal requires a major outreach effort.
6. Flexibility: can the rules accommodate business cycles and various exogenous shocks, or do they aggravate their macro-economic impact? The proposed rules permit ex-post deviations from the ex-ante forecasts of mandatory budgetary items (that is, they allow for the operation of automatic stabilisers), as long as they are attributable to unforeseen deviations from the initial underlying macroeconomic projection. Therefore, the proposed rules imply a neutral fiscal stance, while passively cushioning the impact of the cycle¹². In addition, the rules can be suspended in the case of emergency (natural disasters, financial crises, etc.).
7. Enforceability: are the rules enforceable in practice? The proposal provides the government in office with direct control over the nominal discretionary balance, with the support of useful procedural rules (particularly the pay-go principle). If the rules are breached, the sanction consists primarily of a significant reputational loss, instead of pecuniary or legal penalties. Given the exceptionally low level of government credibility, at present this is an important deterrent for non-compliance.
8. Efficiency: can compliance with the rules cause distortions in resource allocation? At the outset, in principle, the rules can be applied efficiently, but over time, in the absence of reform in the tax system and the major redistribution schemes -- with reduced scope for discretionary measures -- the government will need to rely increasingly on stop-go or across-the-board measures to comply with the primary balance rule, and thus, with the real debt rule. This should encourage the government and the parliamentary majority to alleviate structural rigidities in the budget and, if necessary, to implement in-depth reforms for this purpose. The distinction between mandatory and discretionary items

provides some protection for investment expenditure classified as discretionary items, which is the intent of the golden rule (as in the case of Germany and the United Kingdom).

On balance, when assessed against these eight criteria, the draft proposal meets the internationally accepted standards of a well-designed FRF. As in many other countries, trade-offs always exist among these criteria in Hungary as well: it is not easy to improve the design under a particular criterion without sacrificing another criterion.¹³ At the same time, it can be said that the proposal provides a realistic solution and takes Hungary's circumstances into account.

However, in light of the above evaluation, three problem areas can be identified, with a view to strengthening simplicity, transparency, enforceability, and efficiency. First, a major challenge for the government is the dissemination and explanation of the proposal both internally and abroad; this should help promote acceptance of the rules. Second, in order to apply the golden rule to local governments, the assignment of expenditure tasks and revenue sources between the central and local governments should be stable and transparent. Third, a requirement for efficient compliance with the rules is the implementation of a critical mass of reform measures in the tax and social security systems.

Assessment of the OKH proposal

The proposed Parliamentary Budget Office (OKH) has generated considerable debate and deserves a bit more attention. The OKH would have the characteristics of a credible supervisory authority, if endowed with an independent and well-qualified staff and with sufficient material resources to fulfil its mandate.

In principle, an alternative institutional arrangement may be equally plausible – given adequate human resources with expertise in macroeconomic and fiscal policy areas – if transparency and access for the public are guaranteed. However, since the institution would need to have its own autonomous profile, it should not be merged with other existing public entities, such as the National Bank of Hungary or the State Audit Office.

Although in Hungary the central bank is the only institution with adequate macroeconomic and fiscal analytical capacity and with sufficient independence, incorporating the fiscal surveillance authority into the central bank would not be advisable because this does not belong in the latter's core functions. (Currently, as an exception, Peru is the only country with such an institutional arrangement.)

The State Audit Office currently lacks the necessary expertise to undertake macroeconomic and fiscal policy analysis, and its institutional profile (control and legal audit) has not developed in line with this objective. It is no coincidence that recently only the fiscal analyses and evaluation by the National Bank of Hungary have attracted domestic and international attention in cases where information released by the government regarding the actual fiscal situation would have misled the financial markets.¹⁴ By contrast, the State Audit Office does not usually conduct comprehensive fiscal analyses or forecasts and it does not assume an independent surveillance

function, even when legally it might be authorised to do so. From this perspective, the State Audit Office is even less suited than the Bank to discharging the above-mentioned function.

Therefore, a possible solution could be the establishment of a "State Audit Office 2" with its own profile. But the activities of this institution would have to be clearly delineated and it would need to be provided with adequate resources, much like the proposed independent Parliamentary Budget Office. Along these lines, the establishment of the Council as proposed by Mihály Varga would be a feasible option as well.

What can we expect from a FRF in Hungary?

Inspired by New Zealand's Fiscal Responsibility Act of 1994, an increasing number of developed and emerging market economies have already introduced a FRF.¹⁵ Among these, at least a dozen countries have implemented a well-designed framework (for longer than a full political cycle), successfully eliminated the deficit bias and reduced public debt relative to GDP. As a result of regaining debt sustainability, investor confidence has been restored and interest rates dropped significantly. In these countries, growth rates are higher and volatility lower than in comparable countries in their respective region.

From this perspective, the only major exception among countries with such a framework is Brazil, where the growth rate has remained low, primarily due to the slow pace of structural reforms, which underscores a problem area mentioned in the context of Hungary. In spite of the relatively weak growth performance, arguably, the FRF has helped Brazil to avert a potential financial crisis.¹⁶

A FRF is usually grounded in a broad social and political consensus -- especially if its introduction was prompted by the onset of a financial crisis¹⁷-- and in some countries the framework is enshrined in a high-level agreement or legislation. In Brazil, for example, the fiscal responsibility statute was actively supported by major political forces, and enacted as a so-called organic law with a two-thirds majority. This ensures survival of the legislation over several political cycles.

In view of Hungary's legislative tradition and the current situation, the introduction of the FRF can only be credible if it takes place in one step through the adoption of a law supported by two-thirds of MPs. The key features of the proposed legislation are closely interrelated: without transparent, verified data and forecasts, the enforceability of the rules cannot be guaranteed, and in the absence of rules, transparency alone does not guarantee sustainability and predictability. For all these reasons, therefore, submitting the Finance Ministry proposal to a multiparty consultation process, launched with the support of the President of the Republic, was most welcome.

With the support of a broad political consensus, adoption of the FRF could have similar results in Hungary as it did in other countries. In these countries, after a few years, the FRF contributed to a major cultural change toward de-politicising fiscal policy, partly comparable to the earlier de-politicisation of monetary policy. This, of course, only applies to the fiscal policy envelope (i.e., in terms of the overall budgetary outcome), but not, for example, to the composition of

expenditure or the progressivity of tax rates, which should always remain open to legislative debate. In Brazil, Bulgaria, Chile or Sweden, politicians do not question – not even during election campaigns – the necessity of bringing fiscal expenditure proposals in line with the FRF.

Although in most countries the FRF was introduced after a financial crisis, there are some exceptions where preventing a crisis was a good enough argument for politicians to hammer out the necessary political consensus. The main question is which group Hungary will opt to join. Hopefully, it will be the latter.

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¹ See the analysis of the political business cycle by Nordhaus [1975] and the empirical application by Alesina and Roubini [1990].

² See the comprehensive analysis by Persson and Tabellini [2000].

³ See the fiscal practices in Hungary by Kopits [2006, 2007].

⁴ The Conference on Fiscal Responsibility (May 19, 2006) was summarised by Kiss and Kékesi [2006].

⁵ See Kopits [2000, 2007] on the rationale and international overview of the FRF.

⁶ For example, Mihály Varga, “*Kiigazítás és reformok – az eddigi ‘eredmények’*” (“Adjustment and reforms – the ‘results’ so far”) 45th conference of the Hungarian Society of Economists, Debrecen, September 20, 2007.

⁷ Introduction at the “On the Road to the Euro: Good Governance and Effective Partnership” conference, 19 April 2007.

⁸ See www.p-m.hu. See the background analysis by Romhányi [2007].

⁹ According to this principle, each proposal to reduce taxes or to increase expenditure has to be offset with a saving measure of the same magnitude. This principle was successfully applied, for example, in the United States in the 1990s (Budget Enforcement Act of 1990), and after being suspended for several years in this decade, it was reintroduced this year.

¹⁰ See Kopits and Symansky [1998]. Initially, the criteria were discussed and approved by the IMF Executive Board. For an application of the criteria to the EU Stability and Growth Pact, see Buti and Giudice [2002], and to the UK Code of Fiscal Stability, see Kell [2001].

¹¹ Fiscal vs. monetary dominance can be interpreted according to Walsh [2003]. In this sense, for Hungary, fiscal dominance means that the long-term intertemporal fiscal constraint (i.e., non-negative aggregate present value of current and future budget balances) is guaranteed by monetary policy, either with a high base interest rate or a high rate of inflation. By contrast, monetary dominance obtains when the rules-based fiscal policy essentially adjusts to monetary policy.

¹² In the initial period, the current fiscal adjustment contained in the Convergence Programme is pro-cyclical, followed by the FRF that would only enter into force upon completion of the Programme in 2010. If the fiscal forecast is based on a neutral macroeconomic path (based on potential GDP growth and the inflation target of the National Bank of Hungary), and fiscal policy does not react actively to actual macroeconomic fluctuations (when actual output differs from the potential output, or actual inflation diverges from the inflation target), then the rule is in fact counter-cyclical, assuming that within the budget the weight of items endogenous to macroeconomic variables is sufficiently large. Hence, the structure of the rules is in line with the proposal of Coricelli and Ercolani [2004].

¹³ For example, it would be much simpler to prescribe a continuous overall budget balance (to be met every year), but at a significant loss in terms of transparency and flexibility.

¹⁴ However, not even the National Bank was capable of influencing fiscal policy substantially, therefore, a crucial issue is that the impartial (albeit not infallible) calculations of the budgetary office to be established should have the largest possible weight in parliamentary decision-making when fiscal sustainability is at risk.

¹⁵ Countries with successful FRFs are, for example, New Zealand, Brazil (at all government levels), Canada (at the provincial level), Bulgaria, Chile, Estonia, Norway, Peru, Sweden and several countries in the euro area (Finland, Ireland, Luxembourg). See Kopits [2007].

¹⁶ After the sudden peak of the sovereign risk premium during the 2002 presidential election campaign, the premium fell significantly as soon as investors were satisfied that the new center-left government would abide by the FRF. In terms of the EMBIG index, the market assessment of Brazil improved significantly during this period. In spring 2002, the sovereign spread for Brazil jumped to more than 2000 basis points from some 600 basis points. Since then, the spread has gradually narrowed to its current level of about 200 basis points.

¹⁷ Of course, the EU Stability and Growth Pact is an exception because its objective is to prevent free-rider behaviour by member states.