

## Budgeting in Hungary

by

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*This review of the Hungarian budget process was carried out in May 2006. The review covers budget formulation, budget execution, parliamentary approval, accounting and auditing, and sub-national financing. Hungary has modernised its budget process over the last ten years, first as part of the pre-accession programme and then, since EU accession in 2004, in connection with the Convergence Programme 2005-08. Nevertheless, there remain some shortcomings which include the focus on the actual (non-cyclically adjusted) deficit, the focus on the budget year rather than the medium term, the lack of rules of budgetary discipline, and the lack of transparency concerning forecasts and outcomes. Hungary's long-term growth record and general economic outlook are good, but institutional reform to correct these shortcomings is important for fiscal consolidation and macroeconomic stability.*

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## 1. Introduction

### 1.1. General characteristics

Hungary is one of the central European states that evolved from the Soviet-dominated part of Europe in the 1980s. It has rapidly developed democratic institutions. During the 1990s Hungary successfully privatised a large part of its public sector and has maintained a high rate of economic growth throughout the 1990s and up until now. Hungary joined the OECD in May 1996 and the European Union in May 2004, and intends to enter the euro area in 2010.

Hungary is a medium-sized European country with a population of 10.1 million, of which around 1 million consists of ethnic minorities, mostly Roma. According to the constitution Hungary has a unicameral Parliament of 386 seats. There are four main parties of which the centre-right Fidesz Party and the Hungarian Socialist Party (MSZP, evolved from the former communist party) are the largest. From 1998 to 2002 the Fidesz party formed the government with the smaller conservative MDF and the smallholders' FKGP parties. Since 2002 the Socialist Party has governed in coalition with the left liberal Alliance of Free Democrats (SZDSZ). In the elections of April 2006 the coalition of the MSZP and SZDSZ maintained its majority. Since the first free election in 1990, this was the first time that an incumbent government won an election and it has formed a new government.

After the privatisation drives of the 1990s, the expenditures of the general government sector of Hungary are now comparable to those of the EU countries at 49.6% of GDP (2003). This is somewhat smaller than the Nordic countries (Denmark 55.2%, Finland 50.8%, Sweden 58.2%, however Norway 48.4%) and somewhat larger than most west European countries (Germany 48.4%, Italy 49.4%, Netherlands 47.1%, Spain 38.3%, United Kingdom 43.2%, however France 53.6%). In comparison with the central European countries, Hungary's general government sector is somewhat smaller than that of the Czech Republic (53.5%) and somewhat larger than those of Poland (44.5%), the Slovak Republic (39.7%) and Slovenia (47.9%).

Hungary's long-term growth record is good. After the transition upheavals of the early 1990s, GDP growth accelerated and averaged 4% per year in the period 1997-2002, around two 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 reached 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 from the reinvesting of earnings along with injections of new foreign capital. On a per capita basis Hungary has received since the early 1990s among the highest net inflows of foreign direct investment among OECD countries (surpassed only by the Czech Republic, Ireland, New Zealand and Sweden). In 2002 and 2003 export growth slowed down, but has been partly compensated by strong domestic demand and public spending. 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 2005-08, the estimates of the European Commission (EC) are shown in addition to the estimates by the Hungarian government in the Convergence Programme (CP).

Table 1. **Growth in real GDP<sup>1</sup>**  
Per cent change on previous year

	2000	2001	2002	2003	2004	2005	2006	2007	2008
EU15	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.

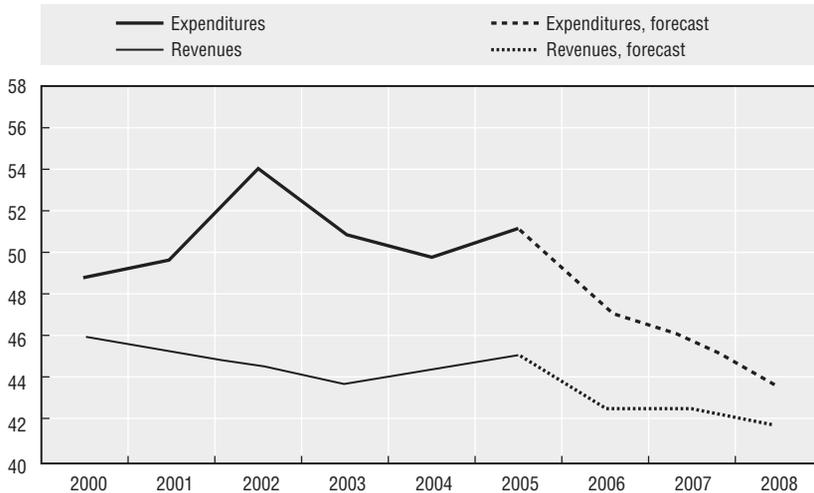
1. Excluding FISIM allocation. In October 2005, the Hungarian Central Statistical Office published for the first time revised national accounts figures including the sectoral allocation of financial intermediation services indirectly measured (FISIM). This change consists in breaking down interest paid to banks and other financial intermediaries by each sector into "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 GDP series is slightly revised upwards, similarly as in other countries. For 2004, the real GDP growth was 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. Table 1 uses the EU numbers of December 2005 that do not yet include the FISIM allocation for Hungary.

Sources: EU15: Eurostat (2006); Hungary (CP and EC) 2000-03: IMF (2005); Hungary (CP) 2004-08: Government of the Republic of Hungary (2005); Hungary (EC) 2005-08: European Commission (2005).

Strong growth has allowed Hungary to expand government expenditures while simultaneously reducing the tax burden. However, in the period since 2000 the Hungarian authorities have 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 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 (see Box 1). 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 an accruals basis, ESA95). Figure 1 illustrates this development; the development after 2005 is indicated in accordance with the latest update of the Convergence Programme (December 2005).

Figure 1. **General government expenditures and revenues (ESA95)<sup>1</sup>**  
Per cent of GDP



1. 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 PPPs.

Sources: 2000-03: IMF (2005); 2004-08: Government of the Republic of Hungary (2005).

After the peak deficit election year 2002, the new centre-left coalition tried to bring the general government deficit under control. This effort was strongly underscored by the political goal, agreed by the Hungarian Central Bank, of entering 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 an ESA95 basis in 2005 was 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 ratios from 2006 onwards, triggered by the continuous decrease of the general government deficit and the declining interest burden

## Box 1. Accounting revisions

### Types of accounts

The Hungarian authorities have two sets of budget accounts: public budget data and general government national accounts statistics. The Act on Public Finance prescribes public budget accounting on a cash basis. For that purpose the methodology of the IMF Government Finance Statistics (GFS86) has been chosen as the conceptual framework. The so-called GFS account is used in the legislated budget and its corresponding deficit is presented to Parliament. More recently, an accrual-based set of accounts using the guidelines of the European Commission European System of Integrated Economic Accounts (ESA95) has been compiled. This is the set of accounts used for the official government deficit (the so-called Maastricht deficit). The Hungarian Statistical Office compiles ESA statistics and the Ministry of Finance makes ESA95 forecasts for the current year and for the future.

The underlying bookkeeping system of the budgetary institutions and funds serves both purposes. Whereas the recording of revenues and expenditures is on a cash basis, full balance sheet accounts record all changes in assets and liabilities and produce information to make adjustments for ESA95.<sup>1</sup>

Aside from the GFS86 and ESA95 accounts, the Hungarian Central Bank produces a set of accrual-adjusted data for the general government based on augmented SNA accounting methodology. The principal difference between the accrual-based accounts of the government and those of the Central Bank is the inclusion in the latter of the quasi-fiscal activities of the Hungarian Development Bank, the National Motorway Company and the State Railway Company.

### Pension reform

A Eurostat decision of September 2004 ruled that the consequences of Hungarian pension reform have to be taken into account in the calculation of the deficit as of 2007. This reform implied that old age and disability pensions will gradually be taken over by funded private pension funds with compulsory contributions. The compulsory contributions to the so-called “second pillar” of the pension system amount to 8% of the gross wage bill and are due for all employees who entered the labour market after 1997. For employees who entered the labour market at an earlier date, participation in the funds is possible on a voluntary basis. The ruling of September 2004 allows Hungary – along with few other EU Member States – to reclassify defined contribution funded second-pillar pension funds as government units until 2006 in reporting statistics.<sup>2</sup>

**Box 1. Accounting revisions (cont.)**

A recent ECOFIN ruling introduced as part of the reform of the Stability and Growth Pact established that, when deciding about the abrogation of an excessive deficit, the Council of the EU shall also take into account on a declining basis the pension reform burden of compulsory pensions, if the deficit has declined substantially and continuously and if it has reached a level that comes close to the reference value of 3% of GDP. The new decision applies with regards to a period of five years, during which the full amount of the deficit consequences of the reform will be taken into account at the abrogation decision in 2005, followed by 80% in 2006, 60% in 2007, 40% in 2008 and finally 20% in 2009.

**Financial lease of Gripen fighter planes**

According to a decision of Eurostat in March 2006 on the treatment of the acquisition of military assets, the acquisition of Gripen fighter planes increases the ESA95 expenditures in 2006 and 2007 by 0.3% of GDP as compared to the figures envisaged by the Hungarian government, irrespective of the arrangement and timing of actual payments. In view of the nature of the arrangement (a ten-year lease of the aircrafts with an open future decision on purchase at the end of the lease period), this adjustment has not been adopted in the updated Convergence Programme of December 2005.

**Road construction public-private partnerships**

Investment expenditure is generally recorded in national accounts as construction progresses. Investments through PPPs are counted as corporate investments or general government investments depending on whether the risk associated with the project is transferred to the private partner. The risks in transport projects are usually divided into construction risk, demand risk and availability risk. In general, Eurostat requires that at least two of these risk modalities have to be transferred to the private partner for a PPP project to be accepted as a corporate investment. In the case of the Hungarian road construction projects, the Hungarian authorities have stated that construction risk and availability risk are transferred to the private partner (the demand risk stays with the government, as revenues are collected through a vignette system and the private partner is paid a fixed availability fee independent of traffic). However, in a decision in 2005, Eurostat did not accept the exclusion from the general government accounts of investment expenditures after the transfer of completed road sections to a public corporation as PPP partner, because the risk transfer was applied retrospectively.<sup>3</sup> The Hungarian Central Bank, using augmented SNA methods, had not accepted the exclusion of the motorway construction PPP from the beginning.

### Box 1. Accounting revisions (cont.)

1. A business accounting style bookkeeping system was already introduced in Hungary in 1968 for budgetary institutions. This was replaced by cash accounting in 1992 and is now essentially restored. Note, however, that ESA95 is not a full accrual accounting system, since it does not require amortisation of investments. The underlying bookkeeping systems of the budgetary institutions may serve various purposes (such as the improvement of cost information) but the compilation of ESA95 accounts need not be dependent on them (see Section 2.3 below).
2. Since that ruling, two subsets of accounts have been maintained: with and without corrections due to pension funds.
3. According to consultation with Eurostat, choosing a government-owned public enterprise as PPP partner does not preclude the recording of investment expenditures as corporate expenditure if the other risk transfer criteria are met.

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).

Table 2. **General government deficit (on an ESA95 basis)**<sup>1</sup>  
Per cent of GDP

	2000	2001	2002	2003	2004	2005	2006	2007	2008
EU15	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

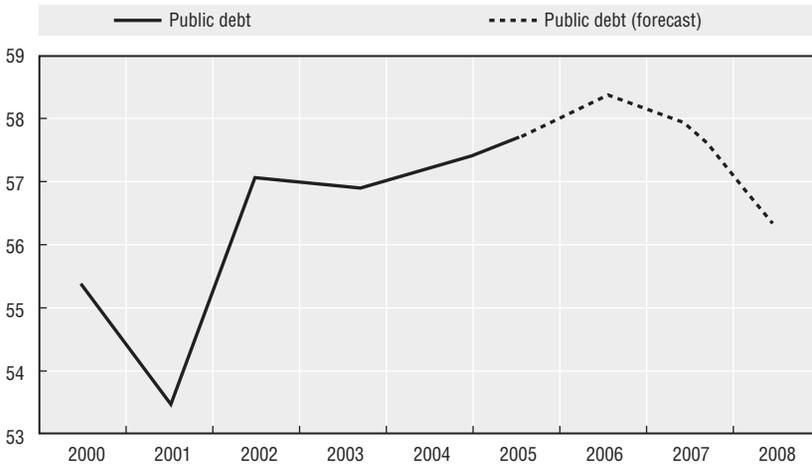
1. Excluding the consequences of pension reform, the purchase of military Gripen aircraft and quasi-fiscal activities of public enterprises, and including the investment expenditures of road construction PPPs. But including the impact of pension reform, the general government balance according to the updated Convergence Programme would be 6.5% in 2004, 7.4% in 2005, 6.1% in 2006, 4.7% in 2007 and 3.4% in 2008.

Sources: EU 15: Eurostat (2006); Hungary 2000-03: IMF (2005); Hungary 2004-08: Government of the Republic of Hungary (2005).

## 1.2. Fiscal and institutional policy in the recent past

OECD budget reviews look specifically at the budget process. This comprises the budget institutions (the rules of decision making) and the way they function. In the recent past, in the context of economic reviews, the OECD already paid attention to the institutional side of the budget process, with a view to improving fiscal outcomes. Other international organisations such as the IMF and the EU have also made recommendations to the Hungarian authorities for institutional reform (for instance, OECD, 2002; OECD, 2004a; OECD, 2005a; IMF, 2004). Until now, many of these recommendations have not been fully implemented. In this review a fresh look will be cast upon the most urgent reforms to be recommended to the new cabinet that came into office after the elections of April 2006.

Figure 2. **Public debt**  
Per cent of GDP



Sources: 2000-03: IMF (2005); 2004-08: Government of the Republic of Hungary (2005).

However, to put these recommendations into perspective it is useful to pay attention to the development of fiscal policy in the past few years.

There has been a strong tendency in Hungary for spending commitments to be ramped up in the run-up to elections.<sup>1</sup> 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 in 2001. A large share of 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% in 2001), subsidies (30% in 2001) and investment (44% in 2001, mainly at the local level). The general government deficit on an ESA95 basis reached 9.4% of GDP (OECD, 2004a).

The centre-left government 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.<sup>2</sup> The deficit target for 2003 was set at 4.5% of GDP on an ESA95 basis. In October 2003 the Pre-accession Economic Programme Update announced a slippage of 0.3 percentage points for this target. On 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 on 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 on 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, 2004a).

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 provide 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 on the revenue side, the 2004 budget contained some bold policy measures on both the revenue and the expenditure side. The key measures on the revenue side were changes in the VAT,<sup>3</sup> the personal income tax<sup>4</sup> and the social security contributions.<sup>5</sup> 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). On the demand side, one of the key measures was the reduction of public employment. The planned cuts involved 7 000 jobs out of the 93 000 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 520 000 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, a decrease of the profit tax rate from 18% to 16% as well as the elimination of many tax allowances and credits. The ESA95 target for 2004 was set at 3.8% of GDP<sup>6</sup> (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 the 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, 2004a).

After Hungary entered the EU in May 2004, the Convergence Programme 2005-08 was prepared as a successor to the Pre-accession Economic Programme (PEP) 2002-06. The new programme was decided in May 2004 and aimed at an ESA95 deficit target for 2004 of 4.6% of GDP, a slippage of 0.8 percentage points since the 2004 budget, mainly necessitated by worse than expected revenue outcomes for 2003. Furthermore the programme sought to reduce the deficit by 0.5 percentage points annually until it reached 3.1% in 2007, after which the medium-term target of 2.7% in 2008 would be within 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 baseline scenario". Later the reference to the economic developments was 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 Article 104(7) of the European Stability and Growth Pact. Following a decision of non-compliance in January 2005, the Council issued new recommendations in March 2005 under Article 104(7) 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 that the Hungarian authorities 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, see Box 1). 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 materialise partly owing to the introduction of self-declaration for VAT on third-country imports, macroeconomic factors and unexpected reactions of the business climate to changes in administration (1.1% of GDP); a misreading of housing grants (0.4% of GDP); larger than expected non-wage expenditures by line ministries (0.9%); and overspending on social security (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 markets rather than by an 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 extrabudgetary funds, one-off measures to collect dividends 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, see Box 1). 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 2005 budget 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 tax exemption on the local business tax from 25% to 50% of the tax base. This package caused a revenue shortfall of 0.5% that was only partially offset by revenue-enhancing measures.<sup>7</sup> Key measures on the expenditure side included the planned freeze of carried-

over appropriations from 2004 to 2005 and the use of PPPs 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 (OECD, 2005a).

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 meet the 2005 deficit target. This was done in two steps. The first set of measures was announced shortly after the adoption of the Council recommendations in March 2005. This package consisted of an 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 introduced 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, freezing unspent appropriations carried over from the previous year, broadening the social security contribution base, increasing the tax on slot machines, tightening control on the import of tobacco products, partially restoring the previous regime of levying VAT on imports<sup>8</sup> and extending 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 2005 budget 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 that: 1) 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) the payment of 13th month salaries to public employees should be recorded in the year to which it pertains, even if actual cash disbursements take place at the beginning of the following year. These revisions increased the ESA95 deficit by 2% of GDP (1.9% for the recording of PPPs 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 for 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 includes 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. Both 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, are expected to be achieved by expenditure cuts amounting to 4% of GDP. The main measures are a one percentage point reduction in total government consumption expenditure, a 0.5 percentage point decline in interest burden and a decline of more than one percentage point in other expenditures, including decreased capital transfers to companies for projects not co-financed by the EU. Furthermore, a one 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 2005-08. This update was in accordance with the 2006 budget approved by 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 (see Box 1). 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 compensated by a reduction of expenditures by some 7.5% of GDP between 2005 and 2008 (European Commission, 2006).

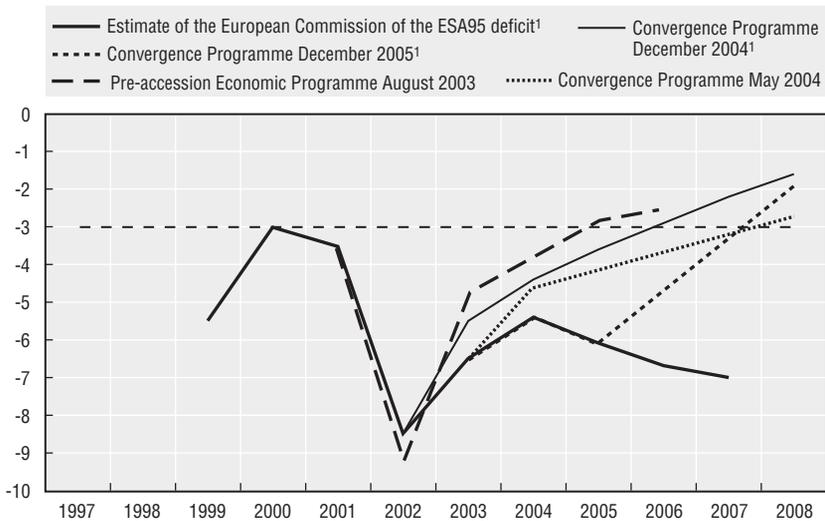
In the assessment of the updated Convergence Programme of December 2005, issued in January 2006, the European Commission noted that the structural measures outlined in the programme lack the necessary quantifications to judge their short-term and medium-term effects. Furthermore, according to the Commission the tightening of expenditure by four 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 PPPs 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, 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 on 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.

Figure 3. **General government deficit forecasts in successive Convergence Programmes**

Per cent of GDP (reference value = - 3)



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

Source: European Commission (2006).

## 2. Budget formulation

### 2.1. Key characteristics

It should be mentioned at the outset that, in the light of OECD best practice, the Hungarian budget formulation process has some features that

make it particularly vulnerable to overspending and revenue shortfalls. These features are:

- focus on the actual (non-cyclically adjusted) deficit;
- focus on the budget year;
- no clear rules of budgetary discipline.

The resulting problems are confounded by a lack of transparency concerning forecasts and outcomes.

## **2.2. Focus on the actual deficit**

Hungary has no fiscal rule in the sense of a long-term constraint on fiscal policy.<sup>9</sup> 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 stabilisation.

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 actual 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 be amended often during both phases of the budget process to react to 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.

Budgetary adjustments motivated by short-term macroeconomic fluctuations bring a pro-cyclical element into budgetary policy and hamper the stabilising effect of the budget. This can be avoided by, for example, using a fiscal rule that puts a ceiling on expenditures.<sup>10</sup> 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 (Anderson and Minarik, 2006).

In OECD countries that steer exclusively on the expenditure side, different approaches can be distinguished concerning mandatory spending (on the basis of entitlement laws). In the United Kingdom, and in the United States at the time of the Budget Enforcement Act (expired in 2002), mandatory spending is exempted from the expenditure ceilings. These ceilings refer exclusively to discretionary spending. This has been motivated by the fact that much of social security spending is determined by macroeconomic fluctuations. Exclusion of mandatory spending from the expenditure ceilings can thus contribute to automatic stabilisation. 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 macroeconomic 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.

### **2.3. 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 are lacking for the general government budget or its sub-sectors (central government, local government, social security funds).

International organisations have often recommended that the Hungarian authorities develop a multi-annual expenditure framework (for instance, OECD, 2002; IMF, 2004; OECD, 2005a). 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 the previous year's outcomes, 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 on 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 the Netherlands, Sweden and the United Kingdom) 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 United Kingdom, 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 (in Sweden, in the budget bill for 2007, a ceiling for 2009 is added to the existing ceilings for 2006-08). 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 (in the Netherlands, a new framework for 2004-08 was drawn up in 2004 at the beginning of the cabinet period and remains in place throughout that 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) cannot 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 under 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 realising multi-year expenditure targets. Precisely because the overall ceiling cannot be changed from year to year, the target is automatically realised 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 behaviour regarding requests 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 anyway a clear baseline 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<sup>11</sup> whereas under a flexible framework flexibility can also be found in adjustment of the overall ceiling, possibly in connection with adjustments on the revenue side.

For Hungary, the EU Convergence Programme has functioned in previous years more or less as a flexible expenditure framework that is adjusted from budget year to budget year, and even during the budget years on 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 saving measures. For the latter, 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 such levels of size and complexity that it is frequently difficult to make policy changes in the current year that substantially affect 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 (having large consequences after the budget year) and to saving measures that are too simple (affecting only the upcoming budget year) and hamper transparency: stop-gap measures such as cash limits, across-the-board cuts and accounting gimmicks. These phenomena have 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<sup>12</sup> 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 on the revenue side: co-ordination 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 co-ordination 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 practice is used 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. However, it requires 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 to co-ordinating 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 United States). 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 macroeconomic fluctuations than most expenditure entitlements, it can be argued that excluding tax expenditures from the ceilings makes sense from the perspective of stabilisation. This is not 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 on the revenue side is **revenue floors**. This involves the annual publication of multi-annual tax estimates on the basis of current legislative tax policy<sup>13</sup> and the introduction of a compensation requirement on all legislated changes. This existed in the United States under the Budget Enforcement Act (until 2002) and exists

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 United States 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 revenue floors bring budgetary discipline to the revenue side of the budget without impairing automatic stabilisation 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 be inflated from year to year with the general GDP deflator.<sup>14</sup>

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 authorise the budget in cash terms, often making use of the bookkeeping rules of the Government Finance Statistics (GFS86). However, in practical terms there are only a few differences between both systems and these can be taken into account relatively easily.

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.<sup>15</sup> Corrections for interest expenditures and long-term contracts (for instance, purchase of aircraft or ships) regard only a few line items and can be presented to Parliament in an extrabudgetary 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 extrabudgetary correction account might create, there is much to say for the idea of defining the ceilings in ESA95 terms to begin with or, which amounts to the same thing, of defining only the interest expenditures and long-term contracts<sup>16</sup> in ESA95 terms, whereas the rest can remain in cash terms (since for the remaining part GFS86 and ESA95 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 ESA95 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).

Regarding **tax revenues**, the European Commission 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 Commission 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 an extrabudgetary account or define the floors themselves in ESA95 terms or, which amounts to the same thing, define only the VAT, sales and excise receipts in ESA95 terms whereas the rest can remain in cash terms (since for the remaining part GFS86 and ESA95 are equal). It should be recalled that revenue floors only constrain legislated tax changes (not revenue shortfalls due to macroeconomic 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).

#### **2.4. 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 decisions have to be taken first 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 advisable 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 organic budget law. Indeed, in Hungary the Act on Public Finance leaves more leeway for 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 decides to move towards a multi-annual expenditure framework, it is advisable that the rules of budgetary discipline be clearly specified and explicitly endorsed by the government in connection with the framework itself. It is also advisable that the rules of budgetary discipline be published, widely dispersed and brought to the attention of 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 cannot be solved at the level of bilateral contacts between ministries, the Minister of Finance should contact his/her 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.

## **2.5. Annual budget process**

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 practice, 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.

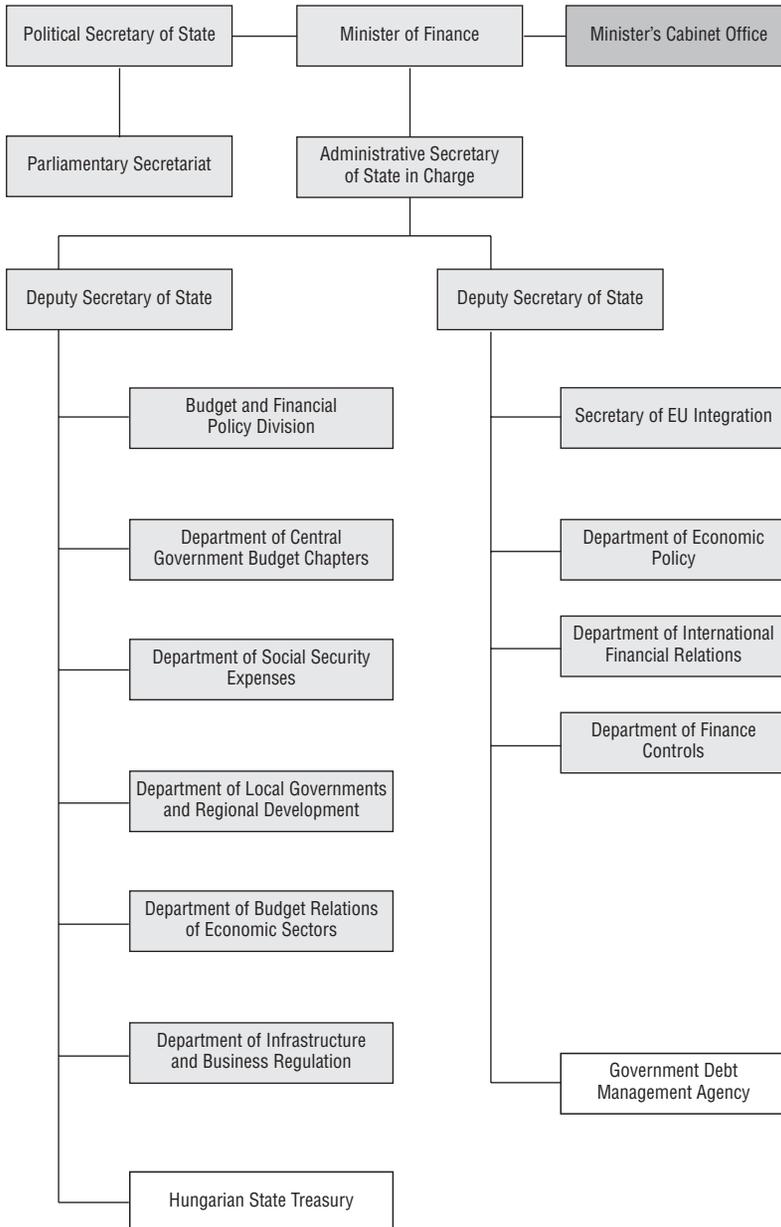
**Table 3. Timetable for budget formulation**

The fiscal year in Hungary is the calendar year

Due dates	Activity
January-April	Ministry of Finance develops macroeconomic assumptions and estimates, finalised in the Economic Guidelines document.
15 April	Economic Guidelines are submitted by the Ministry of Finance to the government for approval and sent out to line ministries.
Early June	The Budget Circular, based on the Economic Guidelines, is sent to line ministries. It contains purely technical assumptions for budgeting, such as GDP growth, employment, inflation, etc., as well as deadlines for submission. Envelopes are distributed by the Prime Minister containing nominal spending limits for the budget chapters.
July-August	Development of the draft budget by line ministries, and discussions with the Ministry of Finance about expenditures for existing activities and suggestions for new appropriations.
31 August	The draft budget bill compiled by the Ministry of Finance is submitted to the government.
September	Finalisation of the budget bill and discussions with external partners such as the State Audit Office.
30 September	Budget bill proposal submitted to Parliament.

The Hungarian 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 on the revenue side of the budget and were a major cause of deficit overshooting. Improvement of transparency

Figure 4. **Organigramme of the Ministry of Finance (budgetary activities)**

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, forecasting tax expenditures requires 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 organisation for this purpose, as seen in the Netherlands, Slovenia, Sweden and the United States, and being considered in Canada and other OECD countries. Although financed by the government, these organisations 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 Hungarian 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 Parliament.

In the Ministry of Finance, the macroeconomic and fiscal forecasts are developed by the Department of Economic Policy. There are 32 staff, of which 12 are directly involved in forecasting. The budget preparation is co-ordinated in the Budget and Financial Policy Division with 42 staff under a Deputy Secretary of State, supported by the Department of Central Government Budget Chapters (32 staff), the Department of Social Security Expenses (34 staff), the Department of Local Governments and Regional Development (28 staff), the Department of Budget Relations of Economic Sectors (13 staff), and the Department of Infrastructure and Business Regulation (15 staff).

## **2.6. Account structure**

The budget bill contains budgets for the state, the extrabudgetary funds<sup>17</sup> and the social security funds.<sup>18</sup> The different budgets are debated and voted on concurrently.

In accordance with the Act on Public Finance (Articles 19-20), the central budget is composed of chapters. The chapters are funds that for the purpose of budget planning, implementation and reporting are independently supervised and managed, typically by a minister. The 2006 central budget contains 31 chapters.

Seven of these relate to the state and judicial entities including Parliament, the President, the courts of law and the State Audit Office. Eighteen chapters cover the government area, namely the ministries and transfers to local government; and four chapters cover the autonomous organs.<sup>19</sup> Finally there are two technical chapters concerning the main tax revenues and the public debt service.

Under the chapters, the state budget is divided into titles, mainly as one of the following types: 1) budgetary institutions; 2) chapter-managed appropriations for sectoral programmes and other programmes under the discretion of the chapter head (minister); 3) EU projects managed by the chapter; 4) centrally managed appropriations, mainly entitlement programmes, transfers to the extrabudgetary funds, to the social security funds and to local government, special larger investment projects and interest payments; and 5) central revenues, including tax and non-tax revenues. Titles are sub-divided as indicated in Figure 5.

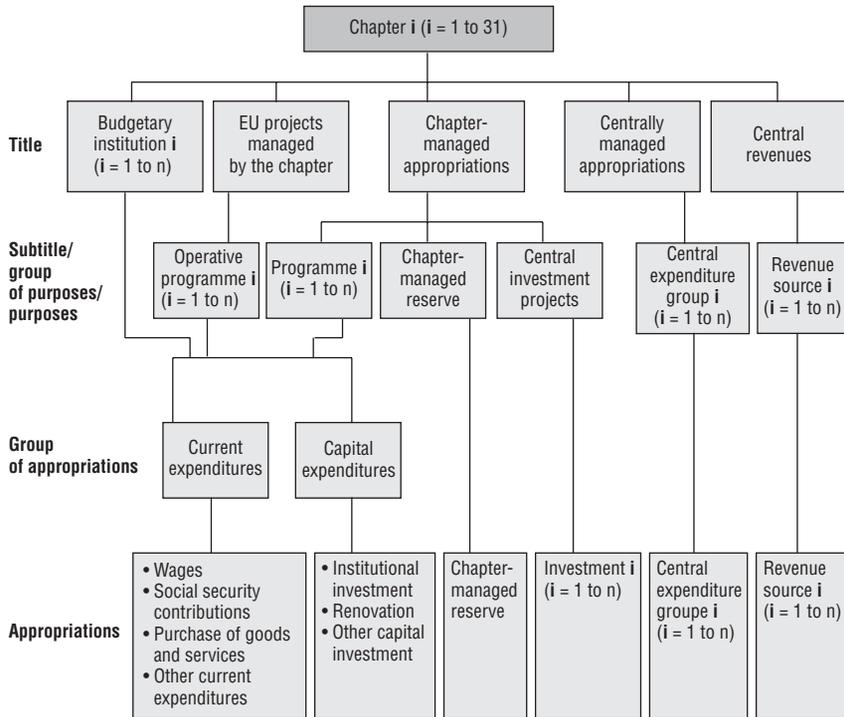
In the 2006 budget there are 36 budgetary institutions under the state and judicial chapters, 675 budgetary institutions under the government chapters, 68 budgetary institutions under the autonomous organ chapters and 43 budgetary institutions under the extrabudgetary funds – in total 822 budgetary institutions. In addition the budget contains some 1 242 chapter-managed and centrally managed appropriations. In total there are around 2 100 expenditure items at title level which Parliament authorises in the budget bill.

## **2.7. The Economic Guidelines and the Budget Circular**

On the basis of the macroeconomic forecast of the Ministry of Finance, the Economic Guidelines for the budget year are drafted. This follows from the 1992 Act on Public Finance that stipulates that, by 15 April, the Minister of Finance must prepare and lay before the government the main directions of budgetary policy based on his economic policy ideas for the next three years, as well as the budgetary principles determining the overall framework of budgetary planning. The Economic Guidelines include expected economic growth, inflation, tax revenues, total general government expenditures and the resulting expected general government deficit and debt. In addition, the guidelines set out in general terms the policy areas to which the government will give priority in the upcoming budget. This document thus sets the direction for the following internal budget process. In recent years it has been a brief document about 15 pages long, of which two were devoted to medium-term fiscal planning.

Two weeks after the government has approved the guidelines, the Ministry of Finance issues the Budget Circular. The circular is a technical document regarding budgetary planning and contains all the relevant information which the manager of a policy area (chapter) needs to take into account during the

Figure 5. Account structure of the Hungarian budget



planning procedure, e.g. the basic assumptions concerning unemployment, inflation, budgeting principles, procedures and deadlines. It is a purely technical document and does not contain any spending limits for the ministries.

On the basis of the projected revenue, each minister receives an envelope from the Prime Minister containing the nominal spending limits for the chapters in the relevant ministers' portfolio for the coming year.<sup>20</sup> This is based on the previous year's spending and the Prime Minister's priorities for the budget. This procedure is not regulated in legislation, but is the way that ministers get an indication of what they can expect to receive.

In 2004, the Ministry of Finance launched a new initiative called "programme planning" for the 2005 budget cycle. According to the methodology used, the total expenditure calculated in conformity with the macroeconomic framework was divided into two parts: on the one hand the planning procedures for the operating and investment expenditure of government entities remained based on the annual allocation of departmental envelopes, and on the other hand line ministries had to compete for funds and assemble a "tender" for their programme activities in the area of transfers, subsidies and grants. The

### Box 2. Budget formulation in line ministries

In March/April, the line ministries are asked to provide inputs to the Economic Guidelines document by the end of March in the form of estimates of mandatory spending. Since the guidelines also identify general areas that are to be prioritised, the ministries are also asked for input on this.

The more substantial work begins after the line ministries receive the envelope and the circular in April/June, the former containing spending limits at chapter level, the latter indicating the procedures and deadlines for submission of the ministry's draft budget. When the line ministry has received the circular, it sends guidelines to its budgetary institutions with technical assumptions and information regarding the budget process within the line ministry and chapter. All agencies and other budgetary institutions are invited to submit their spending requirements for the current level of activity, as well as suggestions for funding of new activities. For instance, under the Ministry of Education there are about 35 budgetary institutions.

On the basis of this input, the minister makes an internal prioritisation of the baseline budget and the new wishes. The baseline budget is based on a continuation of last year's activity level. Some reallocation takes place with regards to programme appropriations – as high as 10-15% of the total programme budget – but only a minimal amount of reallocation regards salaries and other operating expenditures of budgetary institutions. The ministry generally does not use multi-year estimates in the budgeting process.

After the line ministry submits the draft budget to the Ministry of Finance, there are a number of discussions concerning technical matters and clarifications about the wishes for additional funds. These discussions can reach ministerial level, but seldom lead to the resolution of disagreements about additional spending. In practice the ministry submits two budgets: one that adheres to the envelope's spending limits and one that is in line with the ministry's suggestions for additional funding.

The resolution of the ministry's budget happens during negotiations involving the Prime Minister, the Minister of Finance and line ministers. By 31 August the draft budget bill is submitted to the government, so most of the issues have to be resolved at that time. There can however be adjustments up until the moment when the budget is submitted to Parliament, by 30 September.

assessment of the various tenders was based on several factors, of which the efficiency, the co-financing from EU funds and the harmony with government priorities were the most important. The ministries had to include output and outcome indicators for each programme, where available. Despite some

inevitable problems with the new initiative, it is considered to be a promising project to develop further in the future.<sup>21</sup>

From around late May until August, the line ministries have technical discussions with the Ministry of Finance. Issues of disagreement are first discussed between officials of the line ministry and of the Ministry of Finance and then between the line minister and the Minister of Finance. Few substantial disagreements are resolved in this process. Instead, technical difficulties are discussed, such as assumptions for mandatory spending, and requests for funding of new activities are clarified. Thus the overwhelming majority of disagreements between the Ministry of Finance and the line ministries are only resolved at the level of the Prime Minister. Line ministers request funds from the central basket when they submit their draft budget to the Ministry of Finance.

During the same period, the detailed budget bill is drafted by the budgetary institutions and subsequently aggregated by the central financial directorate in the line ministries. According to the Act on Public Finance, the Minister of Finance shall by 31 August (15 October in election years) submit the draft budget bill to the government. The following month is used to finalise the budget.

The decision regarding a minister's final appropriations takes place in a three-way negotiation between the relevant minister, the Minister of Finance and the Prime Minister. In these negotiations the central "basket" is distributed. Before these meetings take place, the Ministry of Finance prepares a unified document of the budget proposal for each ministry and the government as a whole. This document is discussed by all permanent secretaries before final decisions are made. On 30 September the draft bill is submitted to Parliament.

If Hungary were to move to a procedure that is more oriented towards the medium term, this would have consequences for the annual timetable. In particular it would be essential that ministerial requests that would lead to a change of ministerial ceilings as decided in the previous year be brought to the attention of the Ministry of Finance and the Prime Minister in the first stage of the annual process. Subsequently, final decisions would have to be made by the government about the ministerial ceilings before the Budget Circular is sent out. The Budget Circular would have to contain the definitive ceilings, and the Minister of Finance and the Prime Minister would have to see to it that the ceilings are maintained throughout the subsequent phases of the process. This would bring a strong top-down element into the process, which is essential for budgetary discipline.

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 2 100 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.<sup>22</sup> Output-oriented account reclassification provides benefits for strategic planning and focus on results 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.

## 2.8. 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 stabilisation. For medium-term deficit reduction it is not necessary that short-term macroeconomic 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 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 such levels of size and complexity that it is frequently difficult to make policy changes in the current year that substantially affect 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 harmonisation 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 (having large consequences after the budget year) and to saving measures that are too simple (affecting 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 be made 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 of when they are taken. Rules of budgetary discipline ought to apply also to the stage of budget execution. If Hungary decides to move towards a multi-annual expenditure framework, it is advisable that the rules of budgetary discipline be clearly specified and explicitly endorsed by the government in connection with the framework itself. It is also advisable that the rules of budgetary discipline be published, widely dispersed and brought to the attention of Parliament.

In general there have been quite substantial forecasting errors in Hungary in the past few years. These occurred mostly on 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, forecasting tax expenditures requires 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.

### 3. Parliamentary approval

#### Box 3. Parliament

The Hungarian National Assembly is a unicameral Parliament called Országgyűlés, with 386 seats. Members of Parliament are elected by popular vote under a system of proportional and direct representation to serve four-year terms. The President is elected by the National Assembly for a five-year term. To be elected, the President must win two-thirds of the legislative votes in the first two rounds or a simple majority in the third round. The Prime Minister is elected by the National Assembly on the recommendation of the President. The Hungarian Constitution was originally enacted on 18 August 1949 and effective from 20 August 1949. It was revised on 19 April 1972 and more importantly again on 18 October 1989, when basic legal rights for individuals and constitutional checks on the authority of the Prime Minister were established. Since then the principle of ministerial responsibility is assured. Accordingly, the government and individual ministers are dependent on the confidence of a parliamentary majority. In 1997 an amendment streamlined the judicial system.

Source: Central Intelligence Agency, 2006.

#### 3.1. Legal framework

Parliament's role and proceedings are governed by the Act on Public Finance of 1992 and the Standing Orders of Parliament of 1994. By 30 September (31 October in election years) the budget bill has to be presented. Detailed tables concerning individual chapters and their explanatory texts shall be submitted to Parliament by 15 October (15 November in election years). The first debate on the budget has to be completed by 30 November and the state budget act has to be passed before the end of the year.

If Parliament fails to pass an annual budget law by 1 January, it may adopt an act of temporary economic management, which authorises the government to continue collecting revenue and to make expenditures according to the law. If the temporary act is not passed, or has expired, the government is entitled to collect revenues in accordance with the legal regulations in force and to make expenditures on a *pro rata* basis of the annual expenditures of the previous year or, in the case of social security funds, as benefit payments are due.

#### 3.2. The parliamentary Budget Committee

Pursuant to Standing Order No. 28, Parliament has to set up the committee dealing with the national budget. The Budget Committee can make recommendations and propose amendments regarding any part of the budget

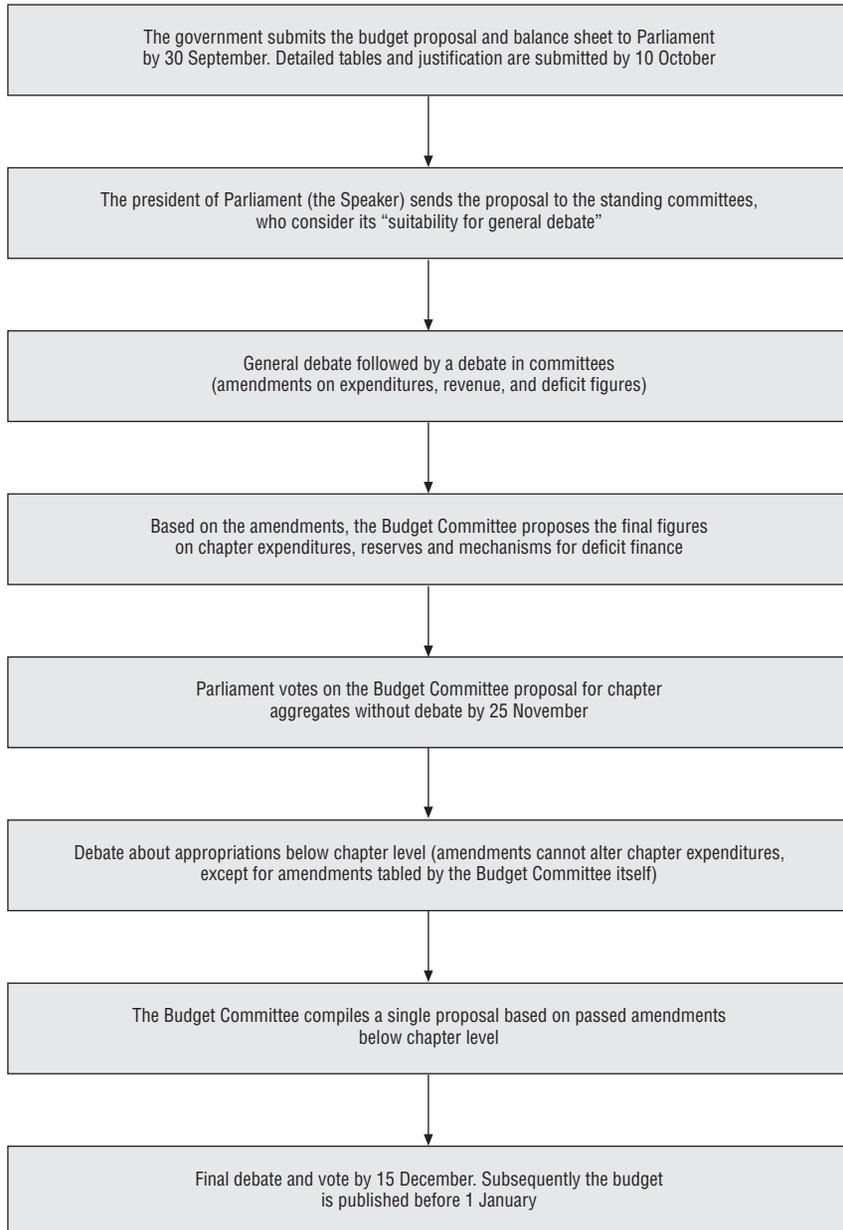
bill. In addition it can make recommendations regarding any other bill, proposed resolution and proposed amendments that have significance for the budget. The committee has a central role with regards to the budget bill's passage through Parliament, in that the committee assesses whether the amendments conform to the rules relating to the budget and how the proposals can be implemented.

The Budget Committee co-ordinates the debates on the government's budget bill. Each standing committee can put forward amendments to the budget, within their competence, but the Budget Committee has to consider the amendment. In addition, the Budget Committee can table its own amendments, in any areas, to the budget bill. Also, the Budget Committee makes a final recommendation concerning the overall figures and compiles the results of the voting on specific amendments in the first and second debates, which summarise the decisions that have taken place as a consequence of the voting. Beyond its role in co-ordination, the Budget Committee does not have a veto or other special right compared to other committees.

### **3.3. Parliamentary process**

The government submits the budget proposal together with the general government balance sheet to Parliament by 30 September. The president of Parliament (the Speaker) then passes the proposal to the standing committees. Each standing committee debates the budget concerning its area and decides about the amendments that are to be submitted to the plenary (general) parliamentary debate. For an amendment to be tabled, at least a third of at least one committee has to vote in favour of the amendment. The amendments are collected and presented to Parliament by the Budget Committee. The debate on the "suitability for general debate" is a full round of committee debates, where first the representative of the government explains the main features of the bill, the representative of the State Audit Office presents its main findings and views, and the Members of Parliament have a general (usually rather political) debate. Finally Parliament votes on the bill's "suitability for general debate". So far it has never occurred that the bill was found unsuitable.

The parliamentary procedure on the annual budget is fundamentally divided into two parts: a debate about the spending for each chapter, aggregate expenditure and revenue; and a debate concerning appropriations within each chapter. The first debate begins with a general debate on the budget. After this, Parliament moves to debating the amendments put forward. Although the amendments often refer to specific titles, subtitles and appropriations (see Figure 5), the vote is only on changes at chapter level or above. The debate therefore centres on an aggregate level concerning the separate chapters and the budget implications for revenue, expenditure and deficit. After the debate, a vote is held on each amendment. In recent years, approximately

Figure 6. **Overview of the budget bill's process through Parliament**

2 000 amendments<sup>23</sup> have been tabled on average and about 100 of these have been accepted, amounting to a budget deficit increase of about 0.2% of GDP (less than 0.5% of total expenditures in the budget).<sup>24</sup> Out of the 2 000 amendments, 1 500 are tabled in the first round.

On the basis of the passed amendments, the Budget Committee prepares a summary bill about the overall figures including revenue, expenditure, general reserves, deficit and financing of the deficit. This summary bill is submitted to Parliament for a confirming vote without debate. If this is passed, it is the basis of the following detailed debate about the budget.

The second round is about allocating funds within chapters. Amendments introduced into the debate of the budget bill may alter neither the amount of the surplus or deficit nor the revenue and expenditure totals for the chapters. Thus any proposed increase must be matched by a proposed decrease within the particular chapter. The procedure is the same as in the first debate. There have in recent years also been about 500 amendments in this round of debate, affecting approximately 10% of the appropriations to a larger or lesser extent. On the basis of the passed amendments, the Budget Committee once again prepares a summary bill, which is voted on and forms the basis for the final vote on the budget bill.

Parliament could consider adopting a standing order requiring the compensation of amendments resulting in expenditure increases or revenue decreases. This would shift the responsibility for compensation from the government to Parliament, which is appropriate if the amendments derive from Parliament.

Unlike in many other countries, the Hungarian tax law is typically presented and approved by Parliament before the budget is approved. This is due to the fact that the 1992 Act on Public Finance stipulates that tax laws have to be passed at least 45 days before taking effect. Hence any changes in the tax laws have to be approved by Parliament before 15 November, some 15 days before the final parliamentary vote on the grand total of the budget.

### **3.4. Conclusions**

The principle of first conducting a general debate concerning the big picture is very sound. However, the vast number of amendments in the first round seems to suggest that, in spite of this principle, various specific items at the chapter level receive more attention than the main features of the budget. A possible solution to this problem could be the splitting of the debate in the first round between a session on main features, to be conducted on the basis of a memorandum to be put up by the Budget Committee, and a session on line items and reallocation.

Parliament could consider adopting a standing order requiring the compensation of amendments resulting in expenditure increases or revenue decreases.

## 4. Budget execution

### 4.1. The organisation of budget execution

According to the Act on Public Finance, financial implementation of the central government budget is the responsibility of the Hungarian State Treasury and debt management is the responsibility of the Government Debt Management Agency. Budgetary institutions send commitment notifications and payment orders to the Treasury. Payments are made through the single treasury account. The budget directorates of line ministries and the budget staff of the Ministry of Finance monitor these commitment notifications and payment orders to make sure that budgetary institutions behave in accordance with the Act on Public Finance and the annual budget law. There are thus two controllers: the line minister and the Treasury (on behalf of the Minister of Finance). The Treasury is a budgetary institution with independent legal personality and it operates under the responsibility of the Minister of Finance.

The Treasury function was separated from the Ministry of Finance in 1996. At the same time the single treasury account was set up in the Hungarian Central Bank. When it was set up in 1996, the Hungarian single treasury account system was one of the first of such systems in Central and Eastern Europe. Before the establishment of the single treasury account, budgetary institutions kept accounts in commercial banks. When the Treasury was set up, it employed 900 staff. As a consequence of the enlargement of its functions, today it employs 4 000 staff in its Budapest headquarters and 20 regional offices.

The Hungarian State Treasury is a large organisation handling many tasks for the government, including:<sup>25</sup>

- execution of the central government budget (mainly registration of commitments and registration and execution of payments and revenue collection);
- cash management (cash flow forecasts and management of the single treasury account);
- financial services (bookkeeping of the government accounts, administration of loans and guarantees, provision of statistical information);
- calculating and paying family and other social benefits;
- managing the central remuneration system for central government employees;
- fulfilling various controlling functions.

The Treasury prepares reports for the Ministry of Finance and relevant line ministries regarding cash flows and commitments. These reports are made daily, weekly, monthly, quarterly and yearly.

The Treasury has an electronic system to manage the information flows. This system is only accessible for the Treasury. Information to and from other ministries and budgetary institutions cannot be transferred automatically but instead has to be transferred in other ways, in some cases by sending paper documents to either the Treasury headquarters or one of its regional offices.

#### **4.2. Reserve funds**

According to the Act on Public Finance, the central government budget shall include a general contingency reserve. This reserve shall be established to meet unforeseen expenditures or to compensate for unexpected revenue shortfalls (some budgetary institutions have own revenue). The general reserve appropriation shall be between 0.5% and 2.0% of total expenditures in the central budget. The fund can be used discretionally by the government, under the proviso that not more than 40% of the reserve fund can be committed during the first six months of the budget year without the approval of Parliament. Unused funds from the reserve, without commitment, shall be handed back and cannot be saved by budgetary institutions in following years. If there is commitment, the payment must happen before June of the following year.

There are also two other types of reserves. The special reserve is an appropriation that is often added to the chapters of the annual budget law (see the account structure in Figure 5). It can be used for any purpose by decision of the government (*e.g.* if there is a plan for reducing the number of employees, then the special reserve may be used for a social plan for the people laid off). In the 2006 budget, the total size of the special reserves amounted to 0.02% of GDP.

The safety reserve was introduced in the 2005 budget (see Section 1.2). Some types of funds allocated to budgetary institutions can be blocked by the government at the beginning of budget year and subsequently used only under strict conditions. The blockage can be cancelled during the execution year if the reasons for its imposition have lapsed. In the 2006 budget, the safety reserve amounted to 0.35% of GDP.

#### **4.3. Budget flexibility and reallocation**

After approval by Parliament, the Hungarian budget is rather rigid and leaves only limited room for reallocation. The general rule is that reallocation between separate appropriations (line items) and separate groups of appropriations is possible, but reallocation between headings above the level of groups of appropriations, such as subtitle, title and chapter, is only possible in

particular cases specified in the Act on Public Finance (see the account structure in Figure 5). An exception to this general rule is that appropriations for wages cannot be increased.

Apart from allocations from the budget reserve, budgetary institutions generally cannot overspend their appropriations. However, overspending is allowed on centrally managed appropriations and, with approval of the government or the Ministry of Finance and depending on the budgetary institution, on chapter-managed appropriations. Appropriations for entitlement programmes generally belong to the centrally managed appropriations (see the account structure in Figure 5). There are 56 of these line items, of which 19 belong to the support of municipalities.

Special rules also apply for the social security system (mainly health care and pensions). The social security system is based on entitlement laws. The monthly forecasts for this system are monitored by the Treasury. The Minister of Finance can authorise expenditure overruns of 5% for healing/preventive treatment and 10% for medicines and instruments. Overruns higher than these limits have to be approved by the government (OECD, 2004b).

If the aggregate balance of the budget, including social security and extrabudgetary funds, deviates by more than 2.5% of total expenditure in the budget, the government has to lay a bill before Parliament amending the annual budget law. If the aggregate balance deviates by more than 5.0%, the government has to lay a supplementary budget bill before Parliament.<sup>26</sup>

If the balance of the budget develops less favourably than estimated in the annual budget law, the government also has the possibility of decreasing appropriations discretionally. If measures taken by the government decrease an appropriation by more than 10%, and by more than 0.1% of total expenditures in the budget, the government must notify Parliament within 30 days. As expected deficits have been higher than planned for several years, the government has used this possibility and decreased certain appropriations regularly.

The Act on Public Finance allows budgetary institutions to save unspent appropriations from one year to another with the approval of the Ministry of Finance. Due to budgetary problems, the normal case at present is that appropriated funds that are still not paid out (in cash) at the end of June in the year after the budget year are withdrawn. Furthermore, cash carryovers can only be allowed by the Minister of Finance if commitments are made during the year they were appropriated, i.e. cash carryovers without commitments are not allowed. Countries with little end-year flexibility in spending usually experience hikes in spending or incurrence of commitments late in the budget year when budgetary institutions spend all available funds for fear of losing them (“December fever”). This is typically also the case in Hungary, and it can

lead to inefficient spending. A possible solution is to enable budgetary institutions to save a certain proportion of their appropriations for coming years.

To meet unforeseen developments, a budget needs some flexibility. At the same time the flexibility must not jeopardise budget discipline and sound fiscal behaviour. At present the Act on Public Finance offers limited scope for overspending and reallocation. These provisions are paradoxically both too constraining and too lax. They are too constraining because more flexibility might be required, exactly to counter overspending through reallocation. They are too lax because they do not require compensation in every case. If the introduction of rules of budgetary discipline, along the lines exposed in Section 2 above, takes away the danger of overspending, the constraints on overspending and reallocation in the Act on Public Finance could gradually be relaxed to a certain extent.

#### **4.4. Cash and debt management**

The aim of cash and liquidity management is to make sure that cash balances do not lie idle in the treasury accounts and that cash needs can be satisfied by cost-efficient debt management.

The planning process for cash management starts after the approval of the budget. Cash management is the responsibility of the Treasury. The single treasury account has over 4 000 sub-accounts belonging to approximately 2 000 budgetary institutions such as ministries, agencies and public foundations, including budgetary institutions outside central government. The Treasury has a foreign exchange account in the Hungarian Central Bank which is used for depositing EU resources in foreign currency. Payments can be made in both domestic and foreign currency from this foreign exchange account. Budgetary institutions may have own foreign exchange accounts to manage their own revenues in foreign exchange (tuition, resources won through international applications, etc.). These accounts are kept by commercial banks. Payments from these accounts can be executed only through the Treasury. Budgetary institutions report on these transactions once a year in the framework of their annual reporting.

Sub-national governments are not part of the Treasury system. They hold accounts with commercial banks. The Treasury has a network of offices at county level that are responsible for cash flows between central and local government. These local offices also monitor the lawful use of grants by local governments.

Before 28 February, the responsible official of a chapter shall submit a utilisation plan (cash plan) of the chapter's appropriated funds to the Ministry of Finance and the Treasury for each of the quarters of the budget year. These plans are made up of the cash plans of the budgetary institutions in the

#### Box 4. Systems of cash management

There are basically three models of cash management in central governments.

In the decentralised model (in place in Hungary before the introduction of the single treasury account), all budgetary institutions have their own account with the commercial banks. These accounts are funded by periodical cash advances supplied by the Treasury on the basis of cash flow estimates and cash allotment decisions. Budgetary institutions make payment orders by drawing on their own accounts.

In the centralised model (now in place in Hungary), budgetary institutions are not allowed to have their own accounts with commercial banks. There is only a single account (with sub-accounts), usually kept at the Central Bank, which belongs to the Treasury. Since the Treasury is not allowed to borrow from the Central Bank, the Treasury handles short-term borrowing by auctioning securities among the commercial banks. All budgetary institutions have to send payment orders to the Treasury in order to draw upon their sub-accounts.

In the hybrid model, budgetary institutions are allowed to have their own bank accounts with a single commercial bank, but any positive balances on these accounts are daily transferred to the Treasury account with the Central Bank and bank accounts are daily supplied with cash advances. The contract with the commercial bank is usually auctioned. Similarly, short-term borrowing is centralised at the Treasury. Budgetary institutions make payments by drawing on their own account with the commercial bank.

Both the centralised and the hybrid model realise efficiency gains through consolidation of balances and centralisation of short-term debt management at the Treasury.

chapter. At the same time, the Treasury makes its own cash forecasts on a monthly and a daily basis. According to the Treasury, its own aggregate forecasts are more accurate than the forecasts provided by the budgetary institutions. The normal distribution of cash allotments is 1/12th of the annual appropriation for each month. Budgetary institutions may, with the approval of the Treasury, deviate from this standard. The cash plans can be modified during the budget year, but no later than the 20th day of the month preceding the quarter concerned.

During the budget year, budgetary institutions send new cash forecasts every quarter before the 20th day of the month preceding a new quarter, updating their earlier forecasts with respect to funds already used. Budgetary institutions can incur commitments without the approval of the Treasury and

send information on commitments to the Treasury. For larger projects, such as large investment, the contract has to be sent to the Treasury.

When payments are due, budgetary institutions send bulk notifications to the Treasury which then makes funds available in the budgetary institutions' sub-accounts. From these accounts, the budgetary institutions pay the suppliers. Payments cannot be made if the commitment has not previously been entered. However, entering a commitment is still not always obligatory in cases of small payments or wage payments. In these cases there is only a preliminary check to see if the account balance is sufficient for the particular disbursement.

In cases when budgetary institutions receive non-tax revenues, these funds have to be paid into the single treasury account. The central government makes some payments on behalf of local governments. These amounts are then subtracted from central government grants. In the annual budget, grants are appropriated on a gross basis.

If budgetary institutions repeatedly spend in excess of their cash plans, the Treasury can send special supervisors to the budgetary institutions. These advisors then have to approve all new commitments for the budgetary institution. These cases are reviewed in *ad hoc* Treasury committees; in practice there are six to eight cases per year.

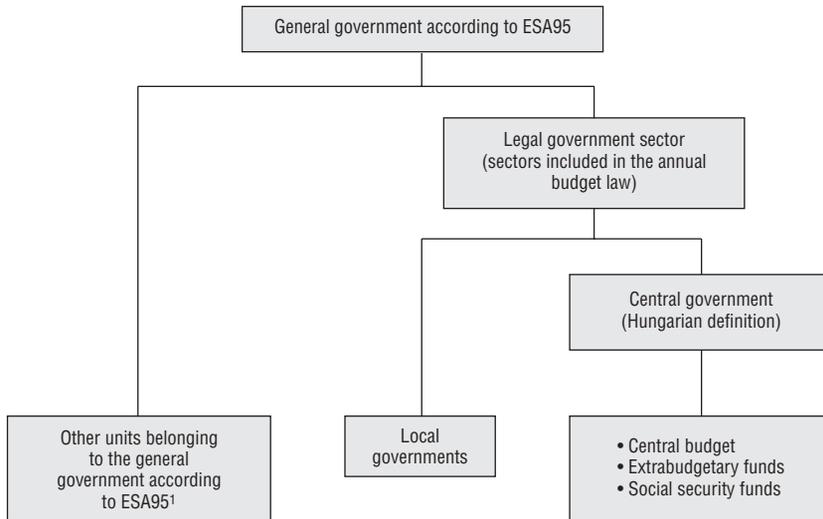
Debt management is the responsibility of the Government Debt Management Agency. Like the Treasury, this agency is a corporation with independent legal personality and it operates under the responsibility of the Minister of Finance. It performs its tasks independently, within the framework of relevant legal regulations and instructions from the Ministry of Finance. The Government Debt Management Agency is responsible for both short-term and long-term borrowing. On the basis of the Treasury's cash forecasts, it makes borrowing plans for the coming three months. These plans are updated weekly to make sure that funds will be available to meet expenditures through the single treasury account.

#### **4.5. Service delivery**

In Hungary the "legal government sector" consists of four parts: the central budget, extrabudgetary funds, social security funds, and local governments (see Figure 7). The first three parts belong to the central government (Hungarian definition). The general government according to ESA95 differs to some extent and includes also a number of entities controlled by the central government, such as the State Privatisation and Property Management Company, the National Road Construction Company, the Government Debt Management Agency and some 120 non-profit units and public companies. Most of these entities belong to the sub-sector of the central government sector in ESA95.

The annual budget law covers the legal government sector (including grants to local government). Expenditures of entities outside the legal government sector but inside the ESA95 government sector (usually financed by credit, equity or fees) are not included in the annual budget law (although the transfers to these organisations appear in the budget). All in all, about 3-5% of total general government expenditure according to ESA95 is not included in the Hungarian legal government sector.

Figure 7. **Organisation of the government sector in Hungary**



1. These include the State Privatisation and Property Management Company, the National Road Construction Company, the Government Debt Management Agency and some 120 non-profit units and public companies not included in the Hungarian central government budget, but classified in the general government sector according to ESA95.

The central budget consists of 675 budgetary institutions, including ministries, agencies and other organisations executing the budget. The central government also has regional offices, for example the Treasury's 20 regional offices that, among other things, oversee the use of grants by local governments. Apart from the central government, there are more than 3 000 municipalities and 19 counties (to be discussed in Section 6 below).

The number of **extrabudgetary funds** in Hungary has dropped significantly since the mid 1990s, when 35 extrabudgetary funds existed outside the Hungarian government budget. These funds sought financing through earmarked revenues outside the state budget or through fees and other means and had a certain independence from the central government. On the basis of recommendations from the State Audit Office, all but two<sup>27</sup> of these funds were brought into the regular budget process during the period 1995-98. Two

new extrabudgetary funds were created in 2004 and one in 2006, bringing the total number to five.<sup>28</sup> Except those five, the extrabudgetary funds are included in the annual budget law. At present, the share of the “on budget” extrabudgetary funds is approximately 3% of GDP.

Expenditures in the different sectors are roughly:

- 50% central government budget;
- 25% social security funds;
- 3% extrabudgetary funds;
- 22% local governments.

The social security system and the sub-national level of government are to some extent funded by transfers from the central government budget. Grants cover approximately 10-11% of the expenditures of the social security funds and 31-32% of the expenditures of the sub-national level of government (OECD, 2004b).

The government is currently planning to modernise the civil service. This work started in 2002 when the present government took office. The Prime Minister's Office has the lead in this effort. The main objective is to improve the performance of the public administration. A complete overhaul of the organisation of government was seen as too complicated. Instead the focus was put on human resource issues and on programme review.

In the area of human resource issues, the aim is not to reduce staff, but to use them in a better way. Part of the present plan for 2007-10 is to improve the assessment of civil servants' performance with measurable targets and evaluation of performance against these targets. There is also a plan to introduce a civil service exam as a prerequisite for recruitment. Hungarian officials indicated that there was a certain tendency towards “politicisation” of staff, particularly in senior levels. This may negatively affect the objectivity of their advice.

At present the government is also working on a procedure for programme review. This work is still at an early stage, but in the educational area a new measurement and evaluation system for the performance of schools and pupils has been introduced (OECD, 2005a). According to present plans, the Ministry of Finance and the Prime Minister's Office are supposed to play a strong supervising role in the review procedure, while participation of external experts is envisaged as a guarantee for objectivity. Procedures of this kind exist in many OECD countries to achieve concrete saving targets, sometimes *ad hoc*, sometimes more permanent and formalised.<sup>29</sup> For effectiveness it is important that the programme reviews are not “captured” by the line ministries but remain under the control of the central ministries.

OECD countries that have traditionally separated the policy development and policy execution organisations (the Nordic countries) or that in recent

### Box 5. Procurement

The Public Procurement Office is the Hungarian body overseeing procurement. It has a staff of approximately 80 employees. It is placed under the Hungarian Parliament and reports to the Budget Committee. The tasks of the Public Procurement Office are supervising compliance with the Act on Public Procurement, policy making, information and arbitration.

The Act on Public Procurement states three threshold levels for procurement. In descending value order the levels are: EU level, national level and a low-value level for tenders with a simplified procedure. Tenders above the EU level have to be published in the entire European Union; the second two types of tenders have to be published nationally if the value is above half the threshold for the national level. All these levels have different thresholds for construction and for other goods and services. Public procurement above the national level threshold amounts to approximately 6% of GDP.

The policy-making role of the Office consists of commenting on draft legislation and government decrees relevant to its area of competence. The Office also has an important role in the dissemination of information regarding procurement in general. It publishes tenders in its official journal three times a week.

The Act on Public Procurement regulates procurement for all parts of the public sector, private companies considered to be monopolies and private companies in the public utilities area.

Of the approximately 4 000 procurement contracts per year (with a value over the national level), about 1 000 are brought to the Office for arbitration. Each case is assigned to an arbitration committee of three officials of the Office, and the committee's decision is legally binding. If the complainants are not satisfied with the decision of the arbitration committee, they may start a civil procedure. About one-third of the 1 000 cases that go to arbitration go on to the general court system.

Public procurement has been regulated in legislation since 1995. The present procurement law dates from 2003. It complies with EU legislation and is very detailed. The level of detail might have had an adverse effect on smaller companies. Circa 60-70% of the tenders are made by small and medium-sized enterprises, compared to 80% in the EU15.

years have moved in that direction (the Netherlands, the United Kingdom) have generally attempted to realise two benefits from this split:

- more freedom for executive agencies concerning the production process and the input mix in order to enhance efficiency; and,
- better information about cost prices of outputs.

Both benefits are not fully realised in the Hungarian central and decentralised agencies. First, the split between policy making and execution has not gone far enough. Second, budgets of budgetary institutions generally remain largely on a detailed input basis which impedes the autonomy of the budgetary institutions concerning the production process and the input mix. Third, outputs are not well defined and monitoring procedures on outputs in the central ministries are feeble. Under these conditions, the separation can even have adverse effects in so far as it allows budgetary institutions to hide resources from oversight. Hungary would be able to reap more benefits from the split between policy making and service delivery if it took further steps to define outputs and improve and institutionalise its oversight procedures. The fulfilment of the roles of owner and principal by core ministries *vis-à-vis* the budgetary institutions must still largely be developed.

Public procurement is regulated in the Act on Public Procurement of 2003.<sup>30</sup> It regulates in detail all aspects of procurement such as thresholds for procurement, how to make tenders, how bidders make complaints, etc. The Public Procurement Office oversees all areas of procurement and hears complaints from affected parties (see Box 5). In addition to the Public Procurement Office, there is a Central Services Directorate in the Prime Minister's Office which co-ordinates procurement for government institutions. This office signs general framework contracts with suppliers that budgetary institutions can then use by a simple procedure. Some 1 000 central government budgetary institutions are obliged to purchase through this office. Sub-national governments may use the services of the Central Services Directorate on a voluntary basis.

#### **4.6. Conclusions**

If the introduction of rules of budgetary discipline, along the lines exposed in Section 2 above, takes away the danger of overspending, the constraints on overspending and reallocation in the Act on Public Finance could gradually be relaxed to a certain extent.

Budgetary institutions have to send commitment notifications and payment orders to the Treasury. At present, the Treasury registration system is only available inside the Treasury. A more automated registration system available to line ministries and budgetary institutions would save time and resources for both the budgetary institutions and the Treasury.

According to present legislation, some end-year flexibility exists in Hungary. But in recent years, budgetary institution savings have been withheld by the Ministry of Finance. In the short run this has led to some savings, but in the longer run it removes the incentives for efficient spending and restores end-of-year spending sprees. It is advisable to return to adequate provision for carryover of unspent appropriations.

The remaining extrabudgetary funds should be integrated into the budget.

The plans for the modernisation of human resource management are important and should be continued with urgency. Special attention should be given to merit-based recruitment and promotion practices and the prevention of politicisation among the senior staff.

The plan for a procedure of programme review is worthwhile and deserves to be implemented soon. For effectiveness it is important that the programme reviews are not “captured” by the line ministries but remain under the control of the central ministries.

## **5. Accounting and auditing**

### **5.1. End-of-year reporting**

The legal foundation for public accounting is given in the Act on Public Finance of 1992 and the Act on Accounting of 2000, which is further elaborated in a number of decrees and regulations. All government units with legal personality and autonomous financial management (including budgetary institutions, extrabudgetary and social security funds, and local government units) are accounting and reporting units. They are obliged to conduct their own double-entry bookkeeping. Accounting is not centralised, meaning that each budgetary institution carries out its own accounting. However, in some areas accounting is centralised (Ministry of Defence, police, some local governments). Each budgetary institution has to comply with the government’s unitary Chart of Accounts. Accounting of revenues and expenditures is done on a cash basis, but an advanced double-entry bookkeeping system produces sets of balance sheet items and supplementary information on accruals for each budgetary institution. In addition to the accounts of the budgetary institutions, the Treasury keeps records of all transactions it carries out during the budget year.

The legal basis for the end-of-year reporting is found in the Act on Accounting for budgetary institutions *vis-à-vis* their supervisory authorities, and the Act on Public Finance for the government *vis-à-vis* Parliament (the final accounts). Given that each budgetary institution manages its own bookkeeping, end-of-year accounts are first prepared at that level. After the end of the budget year, usually in January, the Treasury sends drafts of the final accounts to each budgetary institution. Data from the central Treasury accounts and the budgetary institution’s accounts are then reconciled and returned to the Treasury. The Treasury publishes its statement on the execution of the budget (the State Treasury Report) by mid February.

Each budgetary institution forwards its final accounts to the head of its chapter, where all unit accounts are compiled into the final chapter accounts which in turn are forwarded to the Ministry of Finance. The Ministry compiles

the inputs from all chapters and prepares the final accounts for the central government. These are then handed over to the State Audit Office for auditing around the end of June. The final accounts have to be presented to Parliament before the end of August.

The final accounts are presented to Parliament in the form of a draft law. The documentation includes final data reported by local governments consolidated with the budgetary institutions under their supervision, as well as final data reported by the government covering the legal government sector as specified by the Act on Public Finance. Final accounts are always accompanied by the State Audit Office's report and observations on the final accounts. The draft law is tabled first in the Finance Committee. Other specialised committees prepare reports on the accounts of their respective chapters and forward them to the Finance Committee, which is in charge of putting together the final version of the draft law. This law is then presented to the whole assembly. Deliberations over the law usually take place in October and the law is passed in November. It has been pointed out by observers that this process unfortunately overlaps with the deliberations over the new budget for the following year, diverting the lawmakers' attention from the important task of discussing the final accounts. In past years, the law on the final accounts was always passed by Parliament.

## **5.2. External audit**

The supreme audit institution in Hungary is the State Audit Office (SAO). It was established in the course of the constitutional transition in 1989. Despite its relatively recent foundation, the SAO sees itself in the tradition of an earlier, eponymous audit institution that dates back to 1870 and was dissolved only in 1949. The SAO commands considerable respect and fulfils its mandate with commitment and confidence. The current Constitution enshrines the separation of the SAO from the government; it is an independent body that answers directly to Parliament. It is subject only to Parliament and the law. The mandate and setup of the SAO generally resemble the Anglo-Saxon model of supreme audit institutions with a strong head of the organisation and a close relationship to Parliament. This approach to external audit favours an open and independent audit function, as the SAO has its own constitutional position and its head cannot easily be removed from office by other constitutional bodies.

Apart from the Constitution itself, there are several laws that delineate the mandate of the SAO, namely the Law on the State Audit Office of 1989 and the Act on Public Finance of 1992, which stipulates in Article 120/A that the external audit of the government shall be performed only by the State Audit Office. Its president and vice-presidents are selected with a two-thirds majority by the legislature, for terms of twelve years. They can be re-elected. The length of their mandate grants the State Audit Office's leadership considerable independence from day-to-day politics. In the budget for the central government,

the SAO is financed through an independent chapter. Its accounts are audited separately from the central government by an independent auditor chosen by the Speaker of Parliament.

The independence of the SAO appears solid both in theory and in practice. The SAO itself prepares the draft of its own budget bill based on its expenditure estimates for the coming year. The SAO, usually in the person of the president or one of his/her deputies, holds regular meetings with all factions represented in Parliament. In these consultations, the draft is discussed with the representatives. Once the draft budget bill is tabled formally, Parliament usually follows the recommendation of the SAO and approves the chapter for the SAO without making any changes.

Overall, the State Audit Office employs 618 staff, of which about 70% are involved in the actual audit work. Officials are divided between the central office in the capital and 19 regional offices around the country. The SAO has to cover a very broad mandate. Apart from the annual financial audit of the central government budget, which is composed of about 900 budgetary units, the SAO is also charged with auditing the local governments (around 3 200). Each year only a sample can be audited, but even this takes up more than 50% of the SAO auditing capacity in most years, according to the SAO's own figures (State Audit Office, 2002).

In addition, the government sends the audited final accounts of the social security budget to the SAO, which includes it in its annual report to the legislature. Also, the Act on Public Finance stipulates that the auditor of extrabudgetary funds is recommended by the president of the SAO (Article 57 of the Act on Public Finance). The SAO oversees the Government Debt Management Agency and the State Privatisation and Property Management Company. All public spending is theoretically subject to auditing by the SAO. This includes private companies if they receive subsidies or contributions (other than payments for goods or services delivered) from the government. Finally, the SAO has to prepare an *ex ante* audit report on the coming year's budget. In its report to the National Assembly, the SAO shall particularly give its opinion on the planned deficit and the state debt. This report is forwarded to Parliament by November and deliberated before the budget bill is passed into law.

In general, it is the right of the State Audit Office to initiate an audit. Parliament can request the SAO to carry out a particular audit by formally passing a decree to that effect. According to SAO officials, however, that procedure is not being used in practice. Instead, in any given year, the SAO prepares an annual work plan that outlines the audits it plans to undertake. The first draft of the audit plan is produced in June for the following budget year. It is passed together with the SAO's budget in November. One part of the audit plan, including the annual financial audit of the central government

budget, is determined by law. Other audits are carried out according to sample procedures or on the SAO's own initiative. In pursuing its audit plan, the SAO can follow any hints or requests it deems important, many of which it would receive through informal channels.

Each year, the SAO carries out around 3 000 separate audits on all levels of government and publishes about 60-70 full audit reports. Some of these reports, for example in the case of local governments, are based on a large number of separate audits. Of these, about 60% are financial audits. Among the rest are performance audits and value-for-money audits, as stipulated by the SAO's legal mandate. All reports and findings, in addition to being forwarded to the government, the legislature and the audited body, are made available to the public. These include the report on the final central government accounts. Reports can be downloaded from the SAO website ([www.asz.gov.hu](http://www.asz.gov.hu)). The SAO also sends its reports to research institutions and the media and gives interviews and press conferences to publicise its findings.

The SAO has broad rights of access to people and documents in the pursuit of its audits. After an audit is completed, the head of the audited body can be requested to respond to the audit findings. If that is the case, the official is given a deadline to respond in writing. According to officials from the SAO, recommendations from its financial audits are usually followed up, sometimes quietly and sometimes after extensive public coverage. Officials see the impact of their performance audits more sceptically and note that their advice in those reports is rarely followed. The same applies to the *ex ante* budget report (see Section 2.5).

In Parliament, audit reports are received throughout the year as they are forwarded by the State Audit Office. Only in the case of the central government final accounts is the calendar fixed by law. The SAO has to receive the comprehensive final accounts two months before they are presented in Parliament by the end of August. The SAO audits the comprehensive statements and the accounts of each chapter of the budget except its own. However, it does not audit the accounts of each and every one of the 822 budgetary institutions and therefore cannot give complete assurance on the regularity of all government spending. Its report contains detailed recommendations on how to improve public spending, and in principle it can be accompanied by a recommendation on whether Parliament should pass the draft law on the central government final accounts. In practice a negative opinion has never been given in the past. In the legislature, audit findings are discussed both by the Audit Committee and the specialised committee for the chapter in question. According to officials, the more detailed and meaningful deliberations would take place in the specialised committees, while the Audit Committee debates the state of public finances in more broad and general terms. It is not known if or how parliamentarians follow up on the detailed recommendations made by the

SAO in its reports to the National Assembly. According to one Member of Parliament, their decision making is indeed affected, but it would be difficult to specify exactly how that takes place.

### **5.3. Internal audit**

The Hungarian public administration, which in many ways is still influenced by the continental German administrative tradition, has a traditionally strong internal control system. These internal controls used to focus on ensuring compliance by lower-level administrative units. EU accession in 2004 brought profound changes in the internal control system, as the government orients its internal audit system towards modern, performance-oriented processes, and will continue to shape the agenda for some years to come. Although the strictest legal requirements for internal controls would only apply directly to the expenditure of EU funds by the Hungarian government, it was decided early on that it would not be sensible to allow two parallel control systems to exist in the public sector. It was therefore decided to substantially adopt the EU control requirements throughout the central government sector and make the necessary changes in the legal framework in time for the accession date in May 2004.

The legal basis for the public internal financial control system is given in the Act on Public Finance (Chapter XIII). The main responsibility for internal audit (as separate from both external audit and regular financial management control) rests with the head of each budgetary institution. The manager is responsible for the establishment of a proper internal audit system in his/her organisation. The internal audit is defined as an “independent, objective assurance and consulting activity” which shall evaluate “the effectiveness of risk management, control and governance processes” (Article 121/A, §1 of the Act on Public Finance). The internal auditor reports directly to the head of each budgetary institution. The move from the traditional internal control system, which focuses strongly on compliance, towards a modern system of internal audit is clearly visible in the newly amended law. The scope of the internal audit shall now encompass compliance/regularity, systems-based audits and performance audits. The expertise of the SAO shall be employed in the development of the appropriate methodology.

The internal audit of the central budget, special funds, social security budget, chapter-managed expenditures and EU funds is carried out by a central internal audit body, the Government Control Office (GCO). Hierarchically, it is part of the Prime Minister’s Office. It has about 100 staff to carry out its tasks. The Ministry of Finance is responsible for the central co-ordination of the public internal financial control (PIFC) system (financial management control and internal audit) and the harmonisation of rules, procedures and methodology. This is done by the Central Harmonisation Unit (CHU) with a staff of about 13, of

which 4-5 work on the development of common methodologies and the training of internal audit staff across government. The CHU is also responsible for the operation of an interministerial committee for PIFC (with sub-committees for financial management control and internal audit) that takes system-wide decisions on internal control and audit rules and procedures.

The CHU carries out its mandate with considerable commitment and seems to have achieved substantial changes in a very short period of time. It managed to create considerable momentum towards a modern internal audit system across government, initiated by the push towards EU accession. The necessary legislation was duly passed in time by 2004. In 2005, the work of the CHU focused on training the trainers with a view to implementing the changes. In 2006, according to CHU staff, all the necessary changes should be in place to allow the new system to properly function. It is estimated by staff at the Ministry that about 15% of all internal audits would be performance audits; the majority would still be compliance audits.

Due to the many changes of recent years, there seems to be some confusion in the field of financial audit relating to the closure of accounts about the exact division of labour between the internal and external audit. However, officials on both sides remarked that the working relationship is very good and no serious conflict between the organisations has become evident.

It is quite clear that the central ministries are aiming for a substantial change in the role of the internal audit. Evidence from other countries suggests that it takes years to establish a “performance culture” in a public administration, but the commitment of internal audit staff at the central ministries to bring about such a change is not in doubt at present. However, it is difficult to assess how far exactly the establishment of internal audit units in each budgetary institution has in fact progressed, in terms of both staffing and procedural changes.

#### **5.4. Conclusions**

Hungary has a complex and well-developed system of audit and control institutions. The Hungarian public administration can look back on a long tradition and has well developed roles for both internal control and an independent external audit institution. The successful State Audit Office can be seen as a continuation of this tradition. It carries out its mandate independently and effectively. At the same time, the process of EU accession prompted the government to initiate many changes in its control system, particularly with the internal audit system. While successful advances are already visible, some unresolved issues remain. These relate particularly to the exact division of responsibilities between the internal and external audit functions in the field of financial audit relating to the closure of accounts.

There is a case to be made for easing the burden of the SAO and enabling it to work more strongly on *ex ante* advice on the central government budget. However, it has been pointed out by officials and external observers that the *ex post* audit of last year's accounts and the *ex ante* audit of next year's budget run in parallel during the budget calendar. This is unfortunate because it binds the same capacities at the SAO at a crucial time of the year and then diverts the attention of legislators who have to discuss both reports at roughly the same time in the fall. This coincidence is unnecessary and could impair the quality and impact of both audits. If the processes could be de-coupled, for instance by presenting the audited final accounts earlier in the year, both Parliament and the SAO would be served well.

## 6. Financial relations between levels of government

### 6.1. Legal foundation

The basic legislative foundations for the sub-national level of government in Hungary are laid down in the Act on Local Self-government of 1990, the Act on Public Finance of 1992 and the Government Decree on the Regime of the Operation of the Legal Government Sector of 1998. The Act on Local Self-government regulates the organisation of local government and the responsibilities of its political and administrative organs. This act is an organic law that can only be changed by a qualified majority of two-thirds of cast votes in Parliament.

### 6.2. Decentralisation

The Hungarian system acknowledges only one tier of local governments. This tier consists of municipal governments (further distinguished in village, town, "county right" town, the capital city and its districts) and county governments.<sup>31</sup> However, municipalities are not subordinated to counties. This means that even the smallest municipal governments maintain direct financial relations with the central government. The local governments have local representative assemblies elected by popular vote every four years.

Approximately 1 700 municipalities have less than 1 000 inhabitants, and of these over 300 have less than 200 inhabitants, making them in many cases too small for the efficient provision of certain public services. However, the merger of municipalities can only be carried through by law, with a two-third majority, and is often hard to achieve for political reasons. To overcome this problem, the government has taken the initiative for the formation of micro-regions (see Box 6).

Counties are mainly responsible for secondary education, special care, larger hospitals, nursing homes and spatial development. Municipalities are mainly responsible for public utilities (water, sewerage, local roads, etc.),

Table 4. **Breakdown of local government by type**  
Number of units

<b>Municipal level of government</b>	
<b>Villages</b>	<b>2 889</b>
Less than 200 inhabitants	302
200-499 inhabitants	700
500-999 inhabitants	691
1 000-4 999 inhabitants	1 131
5 000-10 000 inhabitants	58
More than 10 000 inhabitants	7
<b>Towns</b>	<b>233</b>
1 000-4 999 inhabitants	38
5 000-10 000 inhabitants	82
More than 10 000 inhabitants	113
<b>"County right" towns</b>	<b>22</b>
More than 10 000 inhabitants	22
<b>Budapest (with its districts)</b>	<b>24</b>
More than 10 000 inhabitants	24
<b>County level of government</b>	
<b>Counties</b>	<b>19</b>
<b>Total</b>	<b>3 187</b>

pre-school, local public transportation, primary education, primary health care, basic social benefits and fire protection. Both counties and municipalities may also engage in other activities for the benefit of their inhabitants, if they have the financial means to do so.

The competences and responsibilities conferred upon municipalities may differ according to population size. This reflects the administrative capability of the municipal administration. In addition, the services that in general are provided by the counties may in some cases be transferred to the municipalities if they are large enough to perform the tasks efficiently.

Counties receive no tax revenue but are instead financed through fees, levies and grants from the central government. In general, approximately 30% of local government revenue derives from own sources (fees, charges and local taxes) and the remaining 70% derives from central government sources (grants and tax-sharing arrangements).

In general, local borrowing is not guaranteed by the central government but exceptions, based on specific government decisions, are possible. The Act on Local Self-government sets a ceiling on sub-national debt, roughly proportional to annual own revenue capacity (70% of own revenue capacity<sup>32</sup>). Local governments borrow from commercial banks. Loans are covered by special legal provisions for local government bankruptcy. If a sub-national government becomes insolvent, the central government steps in, not to clear

### Box 6. Micro-regions

The creation of micro-regions is a central government initiative to promote municipalities to co-operate in service delivery, without changing the actual structure of municipalities, with an aim of making public service delivery more efficient.

Micro-regions are groupings of municipalities that on a voluntary basis co-operate in the provision of services in one or more areas. For example, municipalities can share a hospital or a school. To promote this kind of co-operation, financial incentives have been introduced, such as financial support to buy a school bus if schools are shared.

It is the government that decides which municipalities shall belong to a certain micro-region, and a municipality can only belong to one micro-region; that is, the government divides the municipalities into micro-regions, but then the municipalities are free to choose in what areas they want to co-operate. As of today, there are 168 micro-regions including approximately 2 000 municipalities. Of these micro-regions, 120 are up and running and the other 48 have been formed on paper but are not yet fully operational.

The most common areas of co-operation so far have been in the core areas of local government responsibility: education, health care and social affairs. About 70-80% of the co-operation in the current micro-regions is in these three areas.

Table 5. **Sub-national government revenue and expenditure**

Billion forints

	2000	2001	2002	2003	2004	2005 preliminary
<b>Revenue</b>	<b>1 656.1</b>	<b>1 903.7</b>	<b>2 181.0</b>	<b>2 501.7</b>	<b>2 673.5</b>	<b>2 865.1</b>
Taxes	478.9	569.6	646.9	759.5	869.2	885.0
<i>Of which: own taxes</i>	221.8	266.7	296.8	322.6	367.2	396.0
<i>Of which: shared taxes</i>	257.1	302.9	350.1	436.9	502.0	489.0
Grants <sup>1</sup>	772.3	871.1	1 066.2	1 261.5	1 280.9	1 409.9
Other	404.9	463.1	467.9	480.7	523.4	570.1
<b>Expenditure</b>	<b>1 651.1</b>	<b>1 902.4</b>	<b>2 285.9</b>	<b>2 533.4</b>	<b>2 690.0</b>	<b>2 923.5</b>
Current expenditure	1 330.5	1 516.8	1 804.8	2 106.2	2 241.2	2 379.0
Capital expenditure	320.6	385.6	481.1	427.1	448.7	544.5
<b>GFS86 cash flow balance</b>	<b>5.0</b>	<b>1.3</b>	<b>- 105.0</b>	<b>- 31.7</b>	<b>- 16.5</b>	<b>- 58.4</b>

1. Grants include intergovernmental revenues and EU transfers.

Source: Hungarian Ministry of Finance.

the debt, but to co-ordinate the bankruptcy process (selling assets, rescheduling debt, etc.) and to make sure that the provision of basic public services continues. There have been 14 cases of bankruptcy under these provisions. Overall, the debt held by local government is quite limited, amounting in 2004 to approximately 1.5% of GDP (OECD, 2005a), of which 42% belongs to the capital city.

### **6.3. Tax revenue**

Tax revenue comes both from own taxation and from a tax-sharing system, with a somewhat larger part from shared taxes. Municipalities receive a 40% share of the personal income tax collected by the central government. The tax share transferred to municipalities has some equalising features:

- One-quarter of the tax share is transferred directly to the municipality where the tax was collected.
- One-quarter of the tax share is transferred through an equalising formula to compensate for low business tax capacity.
- The remaining 50% of the tax share is task-based, taking account of the number of children in primary education, etc.

The profit-based business tax is the main local tax. Municipalities are free to set their own rates, with a maximum rate of 2%. The government intends to overhaul the local tax system in the period 2006-08. The first step in this reform was the introduction on 1 January 2006 of a local property tax on real estate with a value of more than HUF 100 million. The plan is to replace the local business tax with a general property tax in 2008. A review will be conducted to decide whether the tax base will be levied on companies only, or also on residents. Municipalities also have own tax revenue from vehicle tax and tourism tax, but revenue from these taxes is small compared to the business tax.

Tax capacity differs considerably between municipalities. For the personal income tax, the variation between the smallest and largest tax capacity is 1 to 4, and for the business tax it is 1 to 8.

### **6.4. Grants**

Grants are in many countries a very important source of revenue for the sub-national levels of government. Grants can take different forms and are usually divided into earmarked and non-earmarked, and general purpose and special purpose. Different varieties of grants can have different effects on the behaviour of the grantee. In general, non-earmarked grants are more efficient for the purpose of providing resources for local service delivery. If the purpose is to subsidise the provision of a certain service, for example in the case of positive external effects, an earmarked transfer might be efficient as well (Bergvall, Charbit, Kraan and Merk, 2006).

Grants are an important source of revenue for the local government sector in Hungary. Almost 40% of total revenues comes from grants, both earmarked and non-earmarked:

- Approximately 70% of the grants are non-earmarked. These grants are meant to finance local services and are distributed according to needs criteria, using up to 100 different variables such as the number of school children, population size, etc.<sup>33</sup>
- Approximately 30% of the grants are earmarked, divided equally between financing grants distributed according to needs criteria and special purpose grants for which local governments have to apply.

### **6.5. Equalisation**

The tax capacity and needs of local governments differ, and without an equalisation mechanism many counties and municipalities would face difficulties in delivering local services at a proper minimum standard. The equalisation system in Hungary is based on equalisation of both tax capacity and needs (including cost differences) and works through both the tax-sharing system and grants.

In addition to equalising features of the personal income tax sharing system and the distribution formulas of grants, the Act on Local Self-government includes a general provision (§ 6b) stating that “the local authorities that are considered underprivileged through no fault of their own are entitled to additional state support”.

### **6.6. Conclusions**

Many countries struggle with finding an “optimal” size of sub-national level of government. This is not an easy task, as sub-national governments usually provide a wide range of services, and the “optimal” size differs from service to service. Furthermore, democratic control of sub-national service delivery is a value *per se* which codetermines the optimal size of jurisdictions. In Hungary, many municipalities are too small to handle responsibilities which larger municipalities can assume. The creation of voluntary micro-regions presently pursued by the central government offers a solution to this problem, but it is too early to judge whether this will be sufficient.

Earmarked grants are often used in Hungary for the financing of local service delivery rather than for the compensation of external effects, such as spillovers from urban centre municipalities to suburban municipalities. For efficiency reasons, it is generally preferable to finance local service delivery from non-earmarked grants.

## Notes

1. 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 early 1990s, with peaks of more than 10% and more than 7% in the election years 1994 and 1998, partly due to one-off measures, debt assumptions, etc. (IMF, 2005).
2. The tax package included: tax-free provision for development and accelerated depreciation; reduced health care contributions; simplified entrepreneurial tax for small enterprises; a tax-free threshold for the self-employed; tax exemption up to the minimum wage; tax bracket increases; tax benefits on adult education, computer equipment and Internet connections; an increase in the private pension fund membership fee; an increase in the insurance tax credit; abolition of tax liability on exchange markets; and preferential taxation for those in an approved "employee securities benefit programme".
3. All zero-rated goods and services were moved to a 5% rate, the 12% rate was increased to 15%, and the rate on books was lowered to 5%.
4. 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.
5. 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, and the tax credit on investment was abolished.
6. There is a large difference between the ESA95 and the 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 months in cash collections and a revenue shortfall in cash terms estimated at HUF 220 billion. Under ESA95 this revenue shortfall is not registered.
7. These measures included a temporary surtax on the profit of financial institutions, a measure regarding the VAT on telephone purchases and telecommunications services, an increase in the tax on car registration, and a cap on tax allowances for households.
8. See note 7. 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".
9. 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".
10. 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 abandoned by OECD countries since the 1980s.
11. 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.
12. Tax expenditures are often seen by budget officials as a form of undesirable "back-door" spending. However, in a report for the OECD Working Party of Senior Budget

Officials, it was argued that a tax expenditure is sometimes preferable to a subsidy (Kraan, 2004). Tax expenditures can be seen as policy instruments in their own right which ought to be subjected to budgetary discipline rather than to attempts at abatement.

13. Current legislative tax policy is current tax law plus changes in tax law decided but not yet implemented.
14. 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 of inflating the ceilings with the expected sector-specific deflators at the moment they are established, deflating them back to ceilings in real terms and subsequently inflating 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.
15. An example in Hungary was the cash payment of the 13th 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 13th month payment.
16. 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 also has to start at the time of delivery, so that even for long-term contracts there is not much difference between GFS86 and ESA95.
17. The extrabudgetary funds are established in law which determines their function, revenue sources (such as targeted taxes, contributions, fines, etc.) and eligible expenditures as well as the responsible minister. In Hungary, the term "extrabudgetary funds" is a bit misleading, as the funds are comprised in the budget law (except a few, see Section 4.5). Expenditures by extrabudgetary funds are approximately 3% of GDP. They currently consist of the Labour Market Fund, the Central Nuclear Fund, the Research and Technological Innovation Fund, the Homeland Fund and the Cultural Fund.
18. The Hungarian system of social security that constitutes part of the public finances is a risk-sharing compulsory social insurance system that functions according to the principles of insurance and solidarity.
19. These four autonomous organs are the Economic Competition Office, the Central Statistical Office, the Hungarian Academy of Science, and the National Research and Technology Office.
20. This excludes entitlements mandated in law other than the annual budget law, as these funds are not under the discretion of the minister.
21. As one of the ministries explained, in the 2006 budget cycle, funds for new programme initiatives were withheld from ministerial envelopes and placed in a central "basket". The basket funds were distributed by the Prime Minister on the basis of the line ministers' requests for additional funds in the final stages of the budget process. These funds related in principle only to new programmes in the sphere of transfers, subsidies and grants and not to operational and investment expenditures.

22. In the Netherlands, a major output-oriented reclassification exercise has reduced the number of line items per chapter to less than 30.
23. The amendments tabled in the years 2002-05 totalled 1 688, 2 902, 2 084 and 1 219 respectively.
24. Almost every year in the second round of the parliamentary debate, when only “zero-sum” amendments can be submitted, some amendments are tabled which propose spending measures at the expense of higher tax revenues (e.g. VAT or personal income tax) but without changing the relevant tax laws. In the debate in autumn 2005, this amounted to 0.15% of GDP.
25. For more details, see Article 18B of the Act on Public Finance.
26. In Hungary a supplementary budget bill is a large exercise producing a complete new budget bill. This is a very rare situation in Hungary; it happened last in 1995. An amendment on the other hand is a more simple exercise, only covering the appropriations that have to be changed. The annual budget law is usually amended once a year.
27. The two funds are the Labour Market Fund and the Central Nuclear Fund.
28. The two recently created extrabudgetary funds are the Research and Technological Innovation Fund and the Homeland Fund. The first is funded by a tax (0.2%) levied on company profits; it will finance, on application, research and development projects of universities and other institutions. The latter is funded by voluntary contributions; it has a state guarantee and can pay compensation for damages that are not covered by insurance (OECD, 2004b).
29. Examples of permanent and formalised procedures are the United Kingdom spending reviews and the Dutch interdepartmental policy reviews (see OECD, 2005b, pp. 121-125).
30. The first version of this act dates back to 1995.
31. Counties differ from municipalities in that they do not have own revenues.
32. Short-term liquidity loans are not covered by the borrowing rule.
33. According to legislation, the criteria for calculating grants shall be normative. Actual cost observations are used in practice to some extent, mainly in the decision on how large total grants in the area shall be.

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