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Gergely Baksay and Gábor P. Kiss: Act one, act first – the law on fiscal responsibility*

The Law on Fiscal Responsibility adopted late 2008 is a new element in Hungarian fiscal policy, although not without precedent. Under the law, the Parliament and the Government limit themselves to prevent high fiscal deficits and a further increase in public indebtedness, experienced in recent years. Budget planning turns into a three-year process, hardening over time. As a first step, the targeted primary (non-interest) budget balance is subject to the requirement that the stock of government debt cannot rise in real terms. However, ex post, the law allows for deviations in fiscal performance-including those reflecting the effect of so-called automatic stabilizers-attributable to factors beyond the control of the authorities. This means that the actual deficit is not necessarily equal to the deficit path consistent with the real debt limit, but it may fluctuate around this trend over the medium term. In addition, the law prescribes observance of the pay-go principle. Finally, it provides for the establishment of an independent Fiscal Council entrusted with monitoring compliance with the rules and with transparency standards. We evaluated the law according to the Kopits–Symansky criteria applied in the international literature. In most aspects, the law exhibits favourable properties, consistent with the criteria, although inevitably at the expense of simplicity. The assessment suggests that the law would benefit from extending coverage of the rules to local governments. Moreover, enforceability of the rules would be strengthened if the law were adopted by a qualified legislative majority.

INTRODUCTION

The Act on Fiscal Responsibility and the Fiscal Council was adopted by Parliament at the end of 2008 (Act LXXV of 2008). Our article first describes the operation of the new fiscal framework and then briefly evaluates the new rules on the basis of the Kopits–Symansky criteria.

In a general sense, the fiscal rules can be interpreted as a regulation containing a permanent, numerical constraint on the decision-makers of fiscal policy. Before the adoption of the aforementioned act there were two fiscal rules in Hungary.

The more comprehensive rule is the fiscal framework of the European Union, which has applied to Hungary as well since its accession in 2004. Its basic element is the ceiling of 3 per cent for the deficit and 60 per cent for the debt-to-GDP ratio of the government sector, as stipulated in the Maastricht Treaty, which serves as a basis for the European Union. The other, complementary element is a preventive/disciplinary fiscal framework, put into effect by the Stability and Growth Pact for the adequate functioning of the Economic and Monetary Union (EMU). The aim of the preventive regulations is to prevent the development of an excessive fiscal deficit. As a first step, a minimum benchmark value of deficit was determined for each country. If this benchmark is complied with, the 3 per cent deficit ceiling is not jeopardised during the usual fluctuation of the economic cycle. In the second step, a medium-term objective (MTO) – stricter than the minimum benchmark value – can be set, which has to be attained gradually by the member countries which joined EMU and the states participating in ERM II, which is considered to be the 'waiting room' before the adoption of the euro.[1]

The internal rule limiting local governments' indebtedness has been in force for a longer period of time. Act LXV of 1990 on Local Governments has determined the maximum degree of local governments' annual debt service since 1997. Based on the rule, the theoretical debt limit is the perpetuity value of 70% of own revenues reduced by short-term liabilities. On the one hand, this value exceeds the tolerance level which is in conformity with responsible financial management, and on the other hand, it does not restrain the path of reaching the limit (in the event of a low starting level, it can allow a significant deficit and indebtedness in a given year).

The act adopted in December 2008 was preceded by a similar bill. The public finances package drafted in the summer of 2007 consisted of three bills, but in the end it was not debated in

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[1] The MTO values – cyclically adjusted and excluding one-off measures – approved by country range between a deficit of 1 per cent of GDP (low debt/high growth potential) and a balanced equilibrium or surplus (high debt/low growth potential).

Parliament. (For its evaluation, see Kopits, 2007; for the background, see the articles of the 2007/2 issue of the Public Finance Quarterly.) Within this package, the first proposal can be considered as the antecedent of the act which is entering into force now, because it contained the ideas regarding the state budget rule and the establishment of a Fiscal Office. The difference between these proposals and the one adopted is that the former did not include an expenditure ceiling. The proposal regarding the Office is also different to some extent from the Fiscal Council which is being established. One of the differences is that the existence and functions of the Office would have been laid down in the Constitution. In addition, the amendment to the Constitution would have made the law regulating the operation and transparency of the general government a two-thirds (qualified) act. The third part would have replaced the act on local governments with a regulation similar to the 'golden rule', which would have permitted indebtedness only as a proportion of local government investment.

OPERATION OF THE FISCAL FRAMEWORK

The aim of this set of rules is *to maintain the level of the real value of government debt* (central government debt).[2] Accordingly, every year the nominal value of debt may grow only to the same extent as inflation. With real GDP growth, this would mean a gradual decline in government debt measured as a ratio of GDP. The law determines not only the objective, but also the means of attaining it, which is practically the reform of fiscal planning. Fiscal planning will be a rolling three-year process, in each year of which the debt level to be attained three years later must be set. At the end of the period, the actual debt can be different from the one envisaged, because the budget act does not have to react to the cyclical fluctuations of the economy or the interest rate level. Over the longer term, if the economic forecast is realistic, and does not contain any systematic error, the total effect of economic cycles is neutral, so the expected value of debt will really be the designated debt path. As a result of the three-year planning cycle, 2012 is the first year for which a budget can be prepared in line with the law. In the period until then, transitional provisions limiting the increase in fiscal expenditures apply.

The act also provides for the establishment of a new institution, the Fiscal Council. The Fiscal Council consists of three persons; its work is aided by a secretariat consisting of permanent staff. This body prepares macroeconomic forecasts and a baseline projection for budget figures as well as methodological recommendations relating to fiscal planning. Based on its own forecast and calculations, it also comments on the budget and supplementary budget bills and on all provisions of law which may have an impact on the budget. Preparation of the baseline projection is very important, because this is the economic forecast based on which the level of fiscal debt is determined three years in advance. The as-precise-as-possible, but at least undistorted[3] baseline forecast (see box text) is a pre-condition for the proper functioning of the law. The Council's powers extend to forming an opinion, but it does not have any legal means if the submitted bill is not in conformity with the provisions of the act. The Council and the secretariat will expand their scope of duties gradually until reaching the complete range stipulated by law. The Council will prepare macroeconomic forecasts starting from 1 July 2009, will give its opinion on the budget act starting from 1 July 2010, and will perform all of its tasks required by law from 1 January 2011 onwards.

Pursuant to the transitional provisions, *in 2010 and 2011,* at real value, the consolidated adjusted primary expenditure of the state budget may increase by one-half of the real GDP growth rate at most. With the expected low economic growth this would practically mean keeping the level of the real value of expenditures in 2010 and a slight increase in 2011.

The fiscal rule determined in the law applies to the budgets starting from 2012. It requires keeping constant the level of the real value of fiscal debt and a limited growth rate of expenditures (expenditure ceiling). Fiscal rolling planning becomes a three-year process, in which new pieces of information and forecasts overwrite earlier plans to a certain extent. As time passes, the decision-maker's room for manoeuvre steadily narrows.

- Pursuant to the rule, the level of government debt to be attained by the end of year t must be determined three years in advance *(in year t-3)* on the basis of the inflation forecast, and the primary balance necessary for achieving this as well as the expenditure ceiling as a way of attaining the primary balance must be fixed.[4] The envisaged primary balance may not have a deficit.

[2] The debt rule does not apply to local governments. Central government consists of the central budget, the social security funds and the decentralised funds. Of the three subsectors only the central budget has debts. The act calls the consolidated gross debt of the three subsectors 'government debt'; the difference between the latter and the 'general government debt' is mainly the debt of local governments.

[3] In this case, undistorted forecast means that factual data will be somewhat below or above the forecast with the same probability, i.e. the projection is not systematically too optimistic or pessimistic.

[4] A given objective (reduction of deficit) can be attained through various combinations of increasing revenues and reducing expenditures. The degree of expenditure cut is determined by the expenditure ceiling. Therefore, theoretically it is also possible to adopt a restrained ceiling, which also allows for tax reduction, in parallel with a given objective (deficit reduction).

– For two years in advance *(in year t-2)* the balance of the so-called discretionary items, which can be changed by government decision, must be fixed in a way to be in line with the primary balance envisaged one year earlier. This requires knowledge of mandatory items (see box text), stemming from the baseline projection prepared by the Council.

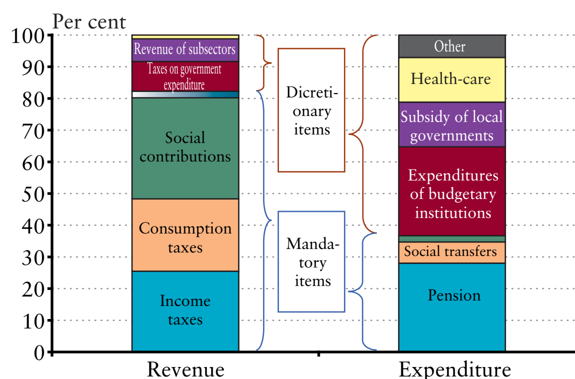
– In the course of planning the detailed budget act *(in year t-1),* the government cannot deviate from the value of the discretionary items given this way even if in the meantime the expected balance of the mandatory, exogenous items changes. This means that the law does not require reacting to short-term shocks; it allows the functioning of automatic stabilisers. All this means that if the change in macroeconomic parameters alters the expected balance of mandatory items, no reaction in the balance of the discretionary items is required. Consequently, the expected primary balance will deviate from the envisaged one. The Council's baseline projection represents a fundamental reference value during the budget debate as well, because in the balance of the proposed changes neither the deficit nor the balance of mandatory items can be changed. This compulsory offsetting ensures the observance of the rule.

Box 1: The difference between mandatory-discretionary items and the baseline projection

Baseline projection and the separation of the so-called discretionary and mandatory items are important new concepts in the law. The *baseline projection* is a forecast of fiscal data for several years, which presumes unchanged fiscal policy. In this respect, a distinction can be made between discretionary items, which are those revenues and expenditures that the budget act can influence, and mandatory items, which are influenced by macroeconomic and demographic developments or regulated by other provisions of law, independently of the budget act. For example, tax revenues which are determined partly by the tax laws and partly by economic developments belong to exogenous items. Consequently, most revenues are mandatory items, except for the tax burden of public wages as well as goods and services purchases of the general government, which follows the changes in expenditures automatically. However, most of the expenditures are discretionary items, except for pensions, payments to the EU and some other items (interest expenditure).

Chart 1

Separation of consolidated primary discretional and mandatory items as interpreted by the MNB on the basis of the 2009 budget act

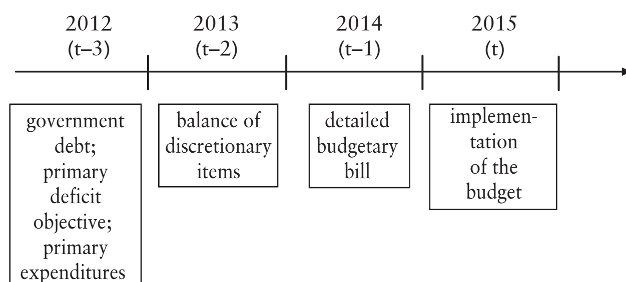


Accordingly, based on the rule, unchanged real debt functions as a several-year anchor, but the detailed budget bill for year t submitted to Parliament does not have to contain a year-end debt which equals the objective determined earlier. In addition, fiscal developments in a given year may also result in a departure from the objective. Consequently, fiscal debt will be exactly identical with the envisaged value only in exceptional cases, i.e. 'by chance'. Trend-like deviation from the targeted debt path may be prevented by two brakes. On the one hand, this can be safeguarded by the baseline projection prepared by the Fiscal Council, which is in principle undistorted. On the other hand, this can be avoided by the rule stipulating that the real value of the debt determined for the given year in year t-3 must equal either the debt level of year t-1 or of year t-4, whichever is the lower at real value. The latter ensures that possible overshooting in debt does not result in a change in the trend, but the debt returns to the path which excludes the outlier.

The example below shows how the multiyear planning would take place *for 2015.* The primary budget balance target in billion forints for 2015 must be determined as early as *in 2012* in such a manner that the value of the end-2015 government debt exceeds the lower of either the debt expected for end-2014 or the year 2011 fiscal debt by the rate of inflation at most. In addition, it must be determined to what extent expenditures are permitted to increase at real value in 2015 compared to the 2014 level. *In 2013,* new economic and fiscal forecasts will have to be prepared for 2015. Based on the baseline projection, the balance of mandatory items expected for 2015 must be estimated in billion forints as precisely as possible, then the balance requirement of discretionary items for 2015 – expressed in billion forints – must be determined in a way that the expected primary balance equals the one set in the previous year. The detailed fiscal plan for 2015 must be drafted *in 2014.* On the one hand, the balance of discretionary items in it must meet the balance requirement defined a year earlier,

Chart 2

The process of planning the budget for 2015



and on the other hand, the real growth rate of primary expenditures compared to 2014 must comply with the conditions fixed in 2012. However, mandatory items may deviate from what was envisaged in the previous year, because they depend on economic developments, and the economic path expected for 2015 may change. As a result of mandatory items, the balance in the detailed budget act may be different from the one determined earlier. The government must submit a supplementary budget if, based on the baseline projection, it turns out during the year that the balance of the current year will be worse than the planned balance by more than 0.2 per cent of planned GDP, and this is not attributable to macroeconomic or demographic effects.

By keeping constant the level of the real value of government debt, the debt-to-GDP ratio declines from year to year if real GDP increases. If real debt really remains at an unchanged level, the debt-to-GDP ratio practically does not depend on any other factor but economic growth. The underlying reason is that inflation raises debt and the gross domestic product at the same rate.[5] Although the value of government debt is also affected by exchange rate developments through the revaluation of the foreign currency denominated debt, the law does not specify how this is to be taken into account. Over the long term, we may even ignore the revaluation effect, because with the adoption of the euro it will evidently cease to exist. However, we must emphasise that in the case of a long-term projection like this demographic effects also have to be reckoned with. For the compliance with the real debt rule, the increasing pressure on the budget owing to the aging of society requires structural reforms or significant cuts in expenditures in other areas. As a result of the high degree of uncertainty of parameters, the debt paths shown in Table 1 can only be considered as estimates, although they roughly illustrate what debt ratio can be attained over the longer horizon by obeying the law. They also demonstrate that obeying the rule will allow a reduction of the gross debt-to-GDP ratio below 60 per cent over the medium term against the background of an average 5 per cent GDP growth between 2010 and 2015. As even in the best case growth of not more than 4 per cent can be presumed for these five years, if debt has to be reduced below 60 per cent at a faster pace in accordance with the EU's requirements, a somewhat stricter fiscal policy than the rule may be needed in these years.[6]

Table 1

Changes in gross government debt as a percentage of GDP under various annual average economic growth scenarios*

		1%	2%	3%	4%
2008	fact	69%	69%	69%	69%
2010	forecast	77%	77%	77%	77%
2015	simulation	73%	70%	66%	63%
2020		70%	63%	57%	52%
2025		66%	57%	49%	43%
2030		63%	52%	43%	35%
2035		60%	47%	37%	29%
2040		57%	42%	32%	24%
2045		54%	38%	27%	20%
2050		52%	35%	24%	16%

* *For 2010, the table shows the debt forecast based on the background calculations of the February issue of the Quarterly Report on Inflation. This forecast may change, depending on the developments in deficit, exchange rate and GDP. The impact of the coming into force of the debt rule will be felt after 2011.*

[5] For calculating the increase in volume from the change in the nominal level of GDP instead of inflation normally we use the GDP deflator, but now, for the sake of simplicity, we consider it equal to the consumer price index on the average of the longer period.

[6] Gross debt can certainly be repaid to some extent by reducing the holdings of financial assets (deposits, state ownership) as well.

Chart 3

Interpretation of the operational balance

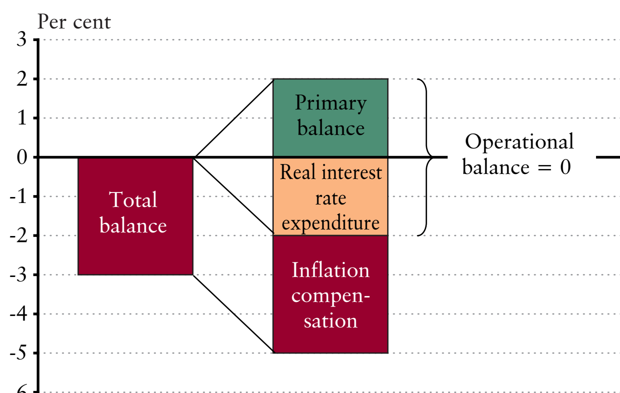
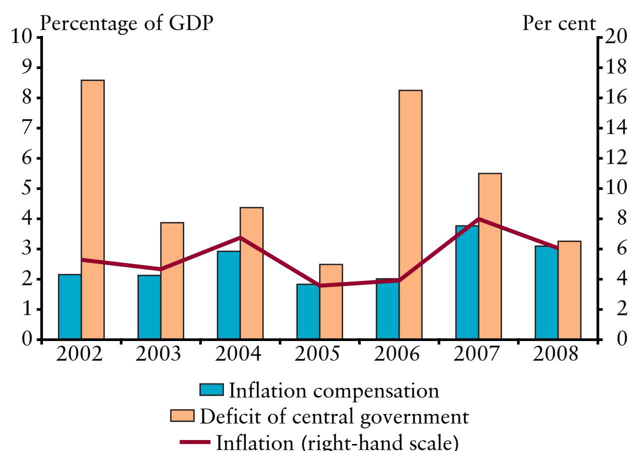


Chart 4

The relationship of inflation, inflation compensation and fiscal balance in the central government



If the nominal value of government debt increases from year to year only by the rate of inflation, this means that the fiscal deficit cannot exceed the product of the previous year's debt and inflation of the given year. Using technical terms, it *postulates a balanced operational position.* Namely, the traditional (nominal) fiscal balance – among other methods – can be broken down into the public interest expenditures and the primary balance, which does not contain interest expenditures. Interest expenditure, in turn, can further be broken down into expenditure compensating the state's creditors because of inflation and the interest expenditure to be paid on the basis of the real interest rate. The operational balance is the sum of the primary balance and the interest expenditure on the real interest rate.[7] In order to prevent the deficit of the total balance from being higher than the interest expenditure paid as inflation compensation, the operational balance must not show a deficit. Consequently, the surplus of the primary balance must be at least equal to the expenditure to be paid on the basis of the real interest rates.

Against this background it is possible to quantify the potential size of fiscal deficit in each year without an increase in the real value of government debt. In addition to the value of government debt, the long-term projection of domestic and foreign inflation rates is also needed for the calculation of inflation compensation. The result greatly depends on the inflation forecast. Assuming an average 3 per cent inflation in the coming decade and an average debt of 66 per cent (year 2015 value at a 3 per cent economic growth, see Table 1), multiplying this 66 per cent with the 3 per cent inflation rate we see that an average 2 per cent fiscal deficit must be attained in order to avoid an increase in the real value of government debt. The value of inflation compensation as a ratio of GDP, i.e. the potential deficit consistent with real debt rule, closely followed inflation trends in the recent period. The budget deficit exceeded the magnitude of inflation compensation every year, which resulted in a rapid increase in total debt. The time series of the inflation compensation as a ratio of GDP also shows how high the budget deficit would have been in recent years if the operational deficit had been balanced (see Chart 4).

EVALUATION OF THE FISCAL FRAMEWORK

The properties of the newly adopted set of rules are examined below on the basis of an internationally accepted set of criteria (Kopits–Symansky criteria). This analytical framework allows a concrete rule to be described on the basis of eight criterion types.

1. The first criterion which can be examined is **whether the rules are sufficiently well defined.** Namely, whether the indicator to which it pertains or the coverage of institutions to which it applies is well defined, and if there is any escape clause. The clause may specify under what conditions fiscal policy may be exempted from complying with the rule. The Kopits–Symansky criteria mention the traditional (nominal) deficit indicator and the broadest coverage of institutions as positive examples. Owing to their measurement difficulties and evadable character, the current balance excluding investments and the exclusion of the so-called quasi-fiscal activities, which are recorded outside general government, are cited as negative examples. In the Hungarian fiscal framework, primary balance is closer to the positive, while separation into mandatory and discretionary items is closer to the negative example. At the same time, its definite

[7] The MNB prepares quarterly statistics using one of the methods of calculating operational balance, excluding inflation. See: http://www.mnb.hu/Resource.aspx?ResourceID=mnbfile&resourcename=ahtadatok2_hu.

strength is the inclusion of public-purpose investments made by the private sector (PPP) under the scope of the rule, and recording the balance of state-owned companies. Due to the latter, with the exception of their investments the effect of quasi-fiscal activities appears in the deficit. Since the rule applies to local governments only to the extent of their central subsidies, for wider coverage it would be important to expand the scope of the regulation in some form to local governments as well.[8] The primary balance and the balance of discretionary items by themselves represent a narrower category than total deficit. However, the primary balance is rather well definable, while the balance of discretionary items can be less accurately defined (due to the borderline cases between them and mandatory items). The terms used in the rule are precisely defined in the law.[9] On the whole, the definition of the rule can be considered as rather favourable.

2. Another criterion to be looked at is how **transparent** the operation of general government is. This includes the assessment of accounting rules, the forecast and institutional solutions. Negative examples are the obscure objectives of fiscal policy, the practice of creative accounting as well as the deliberate misinterpretation of the size and timing of future fiscal liabilities. The functioning of the fiscal rules of New Zealand can be mentioned as a positive example. These contain both cash- and accrual-based accounting, and strive to take into account the full scope of liabilities. The Hungarian fiscal framework is a modified cash basis, i.e. different from the modified accrual-based accounting of the statistical definition of the Maastricht criteria (ESA). The advantage of the cash-based approach is that it makes verification easier and it is more quickly available. Moreover, debt is also of a cash-based approach, and according to New Zealand experiences it complements the accruals approach very well in economic analysis too. The Hungarian rule also takes into account a significant part of future fiscal liabilities in a way that PPP investments are recorded as early as at the date of the activation, instead of spreading it over time. Most of quasi-fiscal losses also appear due to the fact that the losses of state-owned companies must be recorded (with a delay of one year) when their balance sheet is prepared. The Fiscal Council plays an important role in ensuring transparency. By preparing macroeconomic forecasts and baseline projections, this independent institution provides the basis for the impact analysis of external factors on the one hand, and of the measures on the other hand. This way it can ensure the effectiveness of transparency in the preparatory and adoption phases of the budget act. Overall, in terms of fulfilling the transparency criterion the set of rules can again receive a favourable evaluation.

3. The evaluation of the **adequacy** criterion of the rule seeks to answer whether the rule attains the set target. In the literal sense, the rule aims at keeping the debt constant at real value, which results in a reduction of the government debt-to-GDP ratio if economic growth is positive. The condition that the GDP growth rate should be positive will most probably be met. On the other hand, the rule does not apply to local governments; therefore, its success also depends on whether the current or a new fiscal rule limits the increase in local governments' debt in an adequate manner. Considering the current local government rule, this may take place over the medium term at best. The fiscal framework may on the whole be suitable for achieving the target set.

4. A criterion close to the adequacy aspect is the matter of **consistency**. Based on this, it can be examined whether the individual elements of the fiscal framework and other means of economic policy are in harmony with one another. The consistency of the Maastricht deficit and debt criteria can be given as an example. The change in deficit is consistent with the changes in net financial assets, but not with the change in gross debt. However, this inconsistency may limit certain forms of creative accounting.[10] At the same time, the deficit ceiling of 3 per cent of GDP and the gross debt ceiling of 60 per cent are numerically in conformity with one another if certain parameters are met. The methodology of the Hungarian fiscal framework is different from the statistical definition of the Maastricht criteria (ESA). On the one hand, instead of the accrual basis it is built on a modified cash basis, because the cash deficit is consistent with the change in debt. On the other hand, as opposed to the ESA, the fiscal framework does not contain local governments. By contrast, it includes the losses of state-owned companies and PPP investments, which restricts creative accounting. The total effect of these methodological differences may amount to 1/2 per cent of GDP, i.e. on annual average, the deficit measured with the methodology of the Hungarian rule may exceed the ESA deficit by this much. Accordingly, the set of rules can numerically be in line with the ESA deficit, because if it is obeyed, an ESA deficit below 3 per cent can be expected. It is also in accordance with the 60 per cent gross government debt and the 1.6 per cent minimum benchmark,

[8] In terms of the maximum level of indebtedness, the current regulation regarding local governments' indebtedness is not strict enough, and it does not limit the deficit path leading to indebtedness either. In other words, until the debt ceiling is reached, extreme deficits are also possible in some years.

[9] The only deficiency is that the management of foreign currency debt (e.g. revaluation) is missing from the establishment of real debt.

[10] Non-market government lending may evade the deficit measured by the ESA statistics (at least until the date of cancelling the loan), but cannot circumvent gross debt.

which protects the ESA deficit ceiling and represents a safety margin, and it gradually approaches these levels (see Table 1 and Chart 4). Unchanged real debt postulates a balanced operational position, and the difference between the latter and the traditional (nominal) deficit is the inflation compensation included in the interest payments. Therefore, if the half per cent methodological difference is taken as a basis, a 1.6 per cent ESA deficit equals a 2.1 per cent inflation compensation, which means, let us say, that the minimum benchmark can be attained if inflation and debt amount to 3 per cent and 70 per cent, respectively.[11] All of this means that for the sake of faster debt and deficit reduction a surplus could be envisaged instead of the balanced operational deficit. This can be achieved in line with the rule, as the balanced operational position is indicated as an upper limit, and a better balance can be envisioned at any time. To sum it up, the Hungarian fiscal framework and its methodology do not harmonise perfectly with the fiscal framework of the EU. The disadvantage of the methodological difference is the lack of local governments, while its advantage is the limitation of creative accounting. Otherwise the set of rules is consistent by itself and with other means of economic policy.

5. The criterion of **simplicity** means how easily understandable a rule for politicians, voters and investors is. The requirement of a balanced budget is mentioned as a positive example in the Kopits-Symansky study. In terms of simplicity, the earlier rule of the Netherlands is an unfavourable example, where the structural deficit was targeted, as the cyclical adjustment of deficit represents serious methodological difficulties, and it is hard to present it in a simple manner. From the aspect of simplicity, the Hungarian fiscal framework cannot receive a favourable evaluation. On the one hand, it consists of several interrelated elements; it contains the objectives and the means at the same time. On the other hand, it is not simple methodologically either; in addition to the separation of mandatory and discretionary items, it also postulates the exclusion of revaluation.

6. The criterion of **flexibility** requires the rule to allow for flexible adjustment in the event of unexpected external shocks. For example, a budget which is balanced in every year does not let automatic stabilisers function in the period of an unexpected economic downturn, because missing tax revenues have to be offset immediately (even during the year) by restrictions on the expenditure side (or by tax increase). By contrast, the cyclically adjusted (or structural) deficit or the fiscal balance attained over the medium term makes it possible that fiscal policy does not have to react to the downturn. The Hungarian fiscal framework is highly flexible because it does not force an immediate reaction of fiscal policy to unexpected external shocks (economic cycle, inflation, etc.). Instead, it provides a deadline for correction of 3 years. By reason of economic policy considerations it is of course possible that certain shocks still have to be reacted to faster.

Box 2: Budgetary effects of automatic stabilisers

The *automatic stabiliser* effect means that the tax revenues of the general government follow the fluctuations of the economic cycle, while its expenditures change independent of private economic activity, and they are relatively stable without extraordinary measures. Accordingly, fiscal balance improves in times of economic upswing, while in times of downswing it deteriorates without the government having to take any measures. As the movement of the net demand generated by the government is exactly the opposite of the private sector, it is smoothing the fluctuations of the private sector. Expenditure rules which are not related to current economic developments have a fluctuation reducing effect like this. Pursuant to the act, the growth rate of expenditures has to be determined three years in advance, which connects the growth rate of expenditures to the trend in economic growth, rather than to the actual growth rate. The escape clause that the government does not have to react to unexpected developments in external factors (economic cycle) neither when preparing, nor when implementing the budget has a similar effect.

7. The criterion of **enforceability** refers to the extent up to which the effectiveness of the set of rules is guaranteed by law, and what safeguards are assigned to it. The penalty (which can be of financial, judicial or reputational sanctions) imposed in the case of non-compliance with the rule can be mentioned as an example. Another means can be an independent institution, which is responsible for overseeing the compliance, methodological requirements

[11] It is even more difficult to predict compliance with the medium-term objective (MTO). Hungary can start approaching the MTO after joining the ERM II. At present, the accepted value of the MTO in Hungary is a 0.5 per cent structural deficit, which corresponds to 1 per cent inflation compensation. On the one hand, however, the value of the MTO can be reviewed from time to time, for example a higher medium-term deficit may be allowed if debt becomes lower in a country. On the other hand, the calculation of structural deficit is also affected by the methodology of calculating the economic cycle, for which, in addition to the methodology currently applied by the EU, there are several international methods which give different results.

and procedural rules of the regulation. In the Hungarian fiscal framework, the consequence of the departure from the rule may be the loss of good reputation, which may entail financial consequences as well if market confidence is shaken. It would be essential also for voters to consider the compliance with the rule important, because in the case of non-compliance would have political consequences as well. In the course of budget planning and the adoption of the budget act the Fiscal Council can control the functioning of the rule to a certain extent. Subsequent and comprehensive audits can be performed by the State Audit Office. However, in terms of enforceability it is disadvantageous that the act on the fiscal framework was adopted by Parliament by a simple majority. With regard to the current situation it may indicate that the rule does not enjoy full support, while concerning the future it makes the whole rule simply revisable or terminable. A law adopted by qualified – two-thirds – majority and especially the amendment of the Constitution proposed in the package of public finances acts would have reinforced the rule, and would have made it more credible so that it would be respected. Overall, in terms of enforceability the assessment of the set of these rules is not so favourable.

8. The criterion of **efficiency** examines whether the functioning of the fiscal framework contributes to the sustainable expenditure-revenue structure. The Kopits-Symansky study mentions that feature of the EU's fiscal framework as a negative example that some member countries managed to achieve the 3 per cent reference value of the deficit-to-GDP ratio only through recourse to one-off measures. Moreover, rules based on balance-type indicators may be achieved by various combinations of revenue-increasing and expenditure-reducing measures. Accordingly, a deficit criterion can also be met through a tax increase which cannot be sustained over the medium term. It is also true for the structural deficit, where the one-off measures in principle have to be excluded, but there is no obstacle to tax increases or temporary restrictions on investments. Compliance with an expenditure rule requires measures on the expenditure side, but it is not guaranteed here either that permanent, and not temporary, steps are taken. Generally, it is true that the various rules represent some kind of an aggregate limitation, and compliance with the rule by itself does not mean that it is done in a sustainable expenditure-revenue structure. Efficiency is guaranteed the least in the case of balance-type rules, while structural deficit or expenditure rules are more favourable in terms of efficiency. In the course of setting the targets, the Hungarian fiscal framework starts from a balance-type indicator on the one hand and from an expenditure rule on the other hand. However, as time passes, the possible scope of measures becomes narrowed to the expenditure side or the discretionary items which can freely be changed by the decision-makers. In addition, the scope of one-off measures is limited by the methodology which brings quasi-fiscal corporate losses and public-purpose investments implemented in the form of the PPP model under the effect of the rule.

The Kopits–Symansky study, which set up this set of criteria, emphasises that no set of rules is able to meet all the criteria simultaneously, and a trade-off between simplicity and efficiency or between flexibility and enforceability may evolve. In deciding which criteria should be given preference, it is always what is more important in terms of the needs of the given country that is decisive. Based on our above assessment, the Hungarian fiscal framework is essentially well-defined and transparent, it may be adequate for attaining its objective, it is generally consistent, and has an average efficiency, although all this is realised at the expense of simplicity. At the same time, its limited enforceability is not related to its high flexibility, but rather to the fact that it is not supported by an act adopted by qualified majority.

CONCLUSION

The new Hungarian fiscal rules constitute an essentially well-defined and transparent system, which can achieve its set objective. In setting the medium-term objective, it envisages unchanged real debt, i.e. a minimum zero operational balance. Owing to methodological differences, consistency with the EU's fiscal framework is difficult to judge. The set of rules is clearly in line with the provisions of the Maastricht Treaty; application of the rules allows compliance with the 3 per cent deficit ceiling, and debt may also be reduced below 60 per cent gradually. At the same time, as for the recommendations of the preventive arm of the EU's fiscal framework the balanced operational position may still prove to be insufficient in the coming years. However, the rule allows that if it is expedient for fiscal policy, an operational surplus of such size can be envisaged which ensures a faster reduction of deficit and debt. The rule is flexible, as the actual annual deficits can fluctuate around the path targeted on the basis of the real debt rule, because over the short term the rule 'ignores' the effect of the fluctuation of the interest expenditure or the cycle. Systematic deviation from the targeted debt path may be prevented by two factors. On the one hand, this can be safeguarded by the baseline projection prepared by the Fiscal Council, which is in principle undistorted. On the other hand, the rule that possible overshooting in debt cannot result in a change of the trend, but adjustment to the path excluding the outlier has to be carried out when setting the debt target. However, the inevitable cost of these favourable properties is that the rule

cannot be considered simple. As we have seen, one of the pillars of the successful functioning of the rule is the work of the Fiscal Council. Another factor enhancing the credibility of the fiscal framework may be the demonstration of political support. One of its elements would be the creation of an adequate rule applying to local governments as well as a statutory reinforcement of the enforceability of the current rule (for example by adopting a law which requires qualified majority).

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