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Fiscal Risks and the Quality of Fiscal Adjustment in Hungary

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Hungary's government has made great progress toward revealing the true fiscal cost of its budgetary and off-budget programs, containing the financial risks of its policies, and improving the management of public expenditures and contingent liabilities. Although far from complete, fiscal adjustment in Hungary has been successful not only in cutting the budget deficit but also in reducing less visible aspects of fiscal vulnerability.

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Summary findings

The government of Hungary has contained the main fiscal risks of the transition to a market economy. It has paid off and resolved most problems in the banking and enterprise sectors. Since 1995 it has implemented fiscal adjustment with the objective of long-term fiscal stability rather than an immediate deficit target. The main result has been pension reform, which has raised temporary deficits but reduced the long-term public liability. Only the health sector awaits the reform needed for long-term fiscal stability.

Levels of government spending, budget deficits, and public service remain high, but the government has made great progress toward rationalizing public spending and improving the management of budget and off-budget fiscal risks.

In the transition, the government has taken on new fiscal risks — mainly state guarantees and growing programs of credit and guarantee agencies (operating on behalf of government) organized after privatization to support, first, industries and, later, exporters. The government has dealt with these new programs of contingent government support prudently and transparently, with reasonable ceilings on (and reporting of) risks.

Hungary is likely to face pressure for additional spending. Priorities in fiscal policy should include reforming health financing, establishing checks on hidden subsidies in guarantee programs, and determining the government's optimal exposure to risk.

In terms of institutions, the government should aim to create a more flexible, responsive budget process and greater capacity to analyze medium-term fiscal risks, to build a more results-oriented budget management system, and to improve mechanisms for sharing risk between the public and private sectors under government programs.

This paper — a product of the Poverty Reduction and Economic Management Sector Unit, Europe and Central Asia Region — is part of a larger effort in the region to enhance the quality of fiscal adjustment in countries preparing for accession to the European Union. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Alison Panton, room H4-296, telephone 202-458-5433, fax 202-522-2751 (Internet address apanton@worldbank.org). Policy Research Working Papers are also posted on the Web at http://www.worldbank.org/html/dec/Publications/Workpapers/home.html. The authors may be contacted at hpolackova@worldbank.org or apapp@worldbank.org. September 1999. (50 pages)

FISCAL RISKS AND THE QUALITY OF FISCAL ADJUSTMENT IN HUNGARY

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1. CONSIDERING FISCAL RISKS: PRINCIPLES AND FUTURE CHALLENGES

Introduction

In transitional countries, fiscal adjustment sprawls across all sectors of the economy. Adjustment entails liquidating failing enterprises, privatizing sound ones, and creating the conditions under which new firms can enter the market and old ones can expand; restoring financial health to banks by injecting new capital, resolving bad debts, and strengthening bank supervision; regulating the issuance of new guarantees and providing adequate financing for old ones; recognizing the accrued liabilities of the pension system and containing the buildup of new liabilities; and more.

Fiscal adjustment has not been easy in Hungary, nor has it been without risk to the country's future economic stability. The transformation to a market-driven economy has impelled the government to deal with a stockpile of inherited, long-buried obligations and liabilities, while taking on new commitments to promote development and stabilize social conditions. For the most part, the government has dealt with old and new fiscal risks in a prudent, disciplined manner—liquidating many accrued liabilities, making remaining ones more transparent, and taking on new fiscal commitments within the fiscal aggregates set by the budget. To the extent it has acted in this manner, Hungary's fiscal adjustment has been real, not illusory, and the burden of past and ongoing risks on future budgets has been diminished. But the adjustment has not yet been completed, and Hungary needs to take additional steps to bolster its fiscal prospects.

Until late 1980s, similarly to the other former socialist economies, Hungary hid its true fiscal condition in a maze of administered deceptions. Taxes were embedded in prices, enterprise losses were hidden by subsidies, financial institutions concealed insolvency by overstating the value of assets, social insurance schemes were supplied cash to cover current payments but little provision was made for long-term commitments, health (and other public services) were financed through normative grants that veiled the relative cost and quality of services.

As a result, enormous unrecognized costs and liabilities accumulated to surface only later, during the transition. First, in the early 1990s, this trend contributed to the large fiscal deficits and debt increases. As true fiscal adjustment and structural reforms had been postponed, in the late 1994 the fiscal outlook lost sustainability. The 1995 massive reform package for fiscal adjustment started with budgetary cuts (wages, public employment, sick pay, family allowances, education). The government also launched efforts to develop institutions, particularly the treasury function in budget implementation, to support aggregate fiscal control. Consequently, the public expenditure/GDP ratio declined by 11 percent during 1994-97.

Whether to recognize and pay for the liabilities accumulated in the past has been a key issue faced by Hungary and other transitional countries. Some governments have sought to postpone the day of reckoning in the hope that economic improvement will make adjustment less painful in the future, only to find that the expected growth has not been forthcoming or not as robust as hoped for. Some have been slow or half-hearted in removing subsidies or in privatizing state enterprises, only to find that the losses and liabilities have continued to pile up, and that rather than recovering, the economy has languished.

With some notable exceptions, Hungary generally has taken a different track, making the implicit liabilities accumulated in the past and the costs of adjustment explicit, and paying these costs in current budgets, as well as establishing institutions which would ensure transparency and fiscal discipline in the future. It has reformed the pension system, consolidated the banking sector and privatized most banks and enterprises, resolved the risks of inter-government finances, detached public spending and debt from the books of the National Bank of Hungary, and modernized its budget management and tax systems. These measures have brought public finances on a path sustainable in the long term. In effect, Hungary has cut most of its past losses, enabling both the government and entrepreneurs to build new economic institutions that bode well for the country's future.

But in transitioning to an open, market-driven economy, the government has taken on new risks to stimulate development, rebuild the country's deteriorated infrastructure, stabilize financial institutions, and encourage capital inflows. Directly or through various intermediaries, the government of Hungary has guaranteed loans to private enterprises, it has provided guarantees to various institutions such as reserve and guarantee funds and it has ensured participants in the new pension scheme a minimum return. Moreover, the government has not liquidated all past risks, for it still maintains a portfolio of state-owned enterprises, retains an ownership interest in several banks, and has failed to create cost-saving incentives in the health system while providing an open-ended guarantee to deliver the best available health care to all Hungarians according to their needs.

As Hungary's economic condition has improved, some disquieting signs have emerged of the government's greater willingness to take risks that were avoided during the early transitional period. While these do not yet threaten its overall fiscal sturdiness, they bear close watch. One disturbing sign is the use of state financial institutions to assist troubled enterprises; another is the increased volume of high-risk guarantees to protect or expand export markets; as third is the evolution of APVrt, the privatization agency, from an institution whose overriding responsibility was to dispose of state-owned assets into one that maintains a portfolio of such assets and uses its cash flow (at the behest of the government) to provide off-budget guarantees or assistance; a fourth is pressure on the government to accept financial responsibility for a number of implicit guarantees or expectations. These may turn out to be transitory problems, but they do indicate how difficult it can be to complete the transition from a state-controlled to a market-based economy.

Principles

In liquidating old obligations and undertaking new ones, the government has been guided by two principles: explicit risks should be identified, and to the extent feasible, its exposure should be assessed; and risk should be reduced and contained within the approved fiscal framework. The first principle is transparency, the second is containment.

Transparency is expressed in a number of policies and actions: the risks and costs of past policies should be explicit, and, where appropriate, funds should be set aside to pay for them. For example, the commitments embedded in social security benefits should be measured and financed in the budget. Moreover, when the government takes on new risks, prospective costs should be estimated. While laudable, transparency may entail political costs, for it reveals to citizens costs and problems which have long been concealed. Transparency is difficult to fully implement because, first, many commitments are implicit and based on expectations rather than legal obligations, and second, it is hard to estimate the downstream costs of contingent liabilities. Transparency is easiest to enforce when the obligations are direct and explicit, and hardest when they are implicit and contingent (see Part 2).

At time the government has paid a heavy price for deviating from the transparency rule. For various reasons, the government of Hungary was reluctant to address the deteriorating fiscal condition of Postabank, an institution which was almost entirely privately-owned at the start of transition, but over the course of the decade has become almost wholly state owned. The lesson from this costly episode is simple but important: while transparency may be difficult to uphold, violating this principles often makes matters worse.

In upholding transparency, the government of Hungary boosted independence of the National Bank of Hungary, releasing the central bank from its earlier responsibilities for financing of fiscal deficits and parts of the (unreported) public debt. Sometimes the government has appeared to be taking on new risks when all it has done has been to set aside resources to finance previously hidden commitments. For example, bank consolidation was paid from the budget and sovereign debt issues; and in reforming the pension system, the government has budgeted resources to cover unfunded "accrued" obligations of workers who switch to the new partly privatized system.

Containment It is not sufficient for a government to disclose risks; it also must manage them, that is, limit its financial exposure and take on new risks within its approved budget framework. In Hungary, the government has contained many old risks by liquidating them. In privatizing enterprises and financial institutions, the government has had to disclose losses and liabilities and either pay these off or transfer the obligation to the new owners. Subsequently, bank privatization and tight bank regulation and supervision have enabled the government to contain major contingent fiscal risks of the banking sector. To prepare for possible fiscal risks, the government has created multiple

reserve funds, such as a deposit insurance reserve fund, a guarantee fund for pension funds, and a state guarantee fund in the state budget which adequacy is supervised by the State Audit Office.

Containment also applies to new risks taken by the government during the transitional period. The national government also has contained the potential spill-overs of obligations from subnational governments by making them subject to strict bankruptcy law, legal borrowing limits and, in case of the sizeable[1] subnational governments, to regular state audit. The pension reform has reduced the accrued benefits in the public pension system and the total size of government pension liabilities in the medium and long term. The Public Finance Act requires that guarantees be set forth in the budget which limits the amounts that may be tendered during the financial year and also provides for the costs of existing guarantees that may be called during the year.

Future Challenges

The true test of fiscal risk comes when the economy is faltering, not when growth is robust, things appear to be going right and confidence is high. Promises of contingent support appear inexpensive as long as the economy is functioning well, however, they will generate, sudden pressures on the budget if the economy weakens. There is no such thing as risk-free development. The process of building a country, developing its infrastructure, and improving public services entails the taking of risks by both entrepreneurs and government. Even if the latter were to refrain from guaranteeing private transactions, it would likely be compelled to intervene if the country's economic future was jeopardized by failing enterprises and weak financial institutions.

Despite the largely successful adjustment, the government of Hungary still faces some fiscal risks, far greater than those typically encountered in developed countries. The elevated risk is partly due to the thinness and fragility of its capital markets, its dependence on capital inflows, and vulnerability to sudden outflows. In taking on new risks and holding on to old ones, government leaders are betting that economic management and the positive impact of the EU accession process will sustain growth and investor confidence for the next 5-7 years. But 5-7 years is a long stretch, and Hungary may not have as much time to complete its fiscal adjustment as it needs and expects. Further weakening of emerging market economies would spur more calls on state guarantees. Even though the total amount of calls was low in the past, this expectation signals that any significant weakening of the economy may leave the government with commitments made in good times that are difficult to cover when adversity strikes.

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[1] According to the Act on Local Government (1990/65) only governments of the counties, cities with county rights, the capital city and district of the capital city are obliged to have an audited annual balance sheet. In addition, local governments which annual expenditure is above HUF 100mn and have an accumulated debt stock or are about to borrow need to call an official auditor.

Beyond macroeconomic performance, three types of risks warrant concern. One is that fiscal adjustment still is far from complete. With public expenditures near 50 percent of GDP and the budget deficit hovering near 4 percent of GDP, Hungary may face greater risk than some neighbors which have smaller public sectors and smaller deficits. Hungary has made significant progress in right sizing the public sector and in aligning revenues and expenditures, but much remains to be done.

Second, the government of Hungary has not liquidated all inherited risks; it still retains some state enterprises, maintains an ownership interest in some weak banks, and is burdened by a health care system whose services are regarded as inadequate and whose revenue increasingly fails to cover growing expenditures.

Third, the government has taken on a portfolio of new risks. To some extent, the government has replaced the old system of enterprise subsidies, by promises of contingent support. State guarantees have supported selected enterprises, banks and farmers. More recently, specialized credit and guarantee agencies, for which the government has assumed limited obligation, have been expanding particularly to promote exports. New risks also include the normative pension guarantee in the new pension system and macroeconomic uncertainties arising from fiscal decentralization.

Finally, implicit commitments, or pressure on the government to assist individuals or entities who have not succeeded in the market, emerge from time to time. In the late 1990s, these have included for example demands that the government indemnify workers who lost their jobs after the state enterprise in which they worked was privatized. Furthermore, there was pressure on the government to assist enterprises which borrowed to build privately financed infrastructure (such as highways) when revenues do not suffice to cover debt service. In addition, depositors in government-sponsored savings schemes have demanded restitution when actual returns have not been as high as they expected. The common element in these examples is that the government does not have an explicit commitment, but may nevertheless face fiscal risks.

All countries come face to face with implicit risks that were previously ignored or unknown. The tendency may be greater in transition countries because of the inclination of enterprises and individuals to look to government for assistance. There may be no permanent remedy for implicit risks, but the more government accepts the moral obligation, the more it will be obligated in the future. The best course, therefore, may be for government to wean firms and citizens from the expectation that it will rescue them by refusing to do so.

To ensure continued fiscal stability as required in the EU accession, the government needs to continue to reduce its exposure to fiscal risks. For this it will need to build new capacities to deal with risk. In its choices whether to finance particular outputs or guarantee that the private sector would attain desired outcomes, the government should continue to favor transparency and predictability of future public financing requirements.

This paper explores fiscal risks that have remained or emerged during the 1995-97 fiscal adjustment in Hungary. It details how the government has handled risks of transition and explains the different the attributes of these risks.[2] The next section summarizes the fiscal risks and their main sources faced by the government in Hungary. On a sector-by-sector basis the third section concentrates on the channels through which the 1995-97 fiscal adjustment dealt with fiscal risks. The fourth section looks at the developments in public finance management system in Hungary and the treatment of fiscal risks in this system. The final section summarizes the potential claims on the budget that are likely to emerge from the existing fiscal risks in the near future and offers an agenda for the future.

2. THE FISCAL RISKS MATRIX

This section identifies, classifies and compares the largest sources of future potential fiscal risk in Hungary. In this framework, developed by Polackova (1998), governments face four types of fiscal risk, each of which is a broadly defined liability that combines two of the following characteristics: explicit versus implicit and direct versus contingent.[3]

- *Explicit liabilities* are specific obligations of the government established by a particular law or contract. The government is legally mandated to settle the obligation when it comes due. Common examples are the repayment of sovereign debt and repayment of nonperforming loans the state has guaranteed.
- *Implicit liabilities* involve a moral obligation or expected responsibility of the government that is established not by law but by public expectations and political pressures. Examples of implicit liabilities are future public pension benefits that are not specified by law, disaster relief for uninsured victims, and default of a large bank on nonguaranteed obligations.
- *Direct liabilities* are obligations that will arise in any event and are therefore certain. They are predictable based on some specific underlying factors; they do not depend (are not contingent) on any discrete event. For example, future public pensions are a

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2 See Annex I for a questionnaire that has served to evaluate the problem of government fiscal risks and risk management.

3 The international accounting standards for governments proposed by the International Federation of Accountants define a liability as a present obligation of the government that entails a form of economic benefits and that arises from past events whose settlement is expected to result in an outflow of government resources (International Federation of Accountants 1998).

direct liability whose size reflects the expected amount of the benefit, eligibility factors, and future demographic and economic developments.

- *Contingent liabilities* are obligations triggered by a discrete event that may or may not occur.[4] The probability of the contingency occurring and the magnitude of the government outlay required to settle the ensuing obligation may be difficult to forecast. Relative to government policies, they are exogenous (a natural disaster or capital flight) and endogenous (the design of government programs or the quality of regulations, which both have implications on moral hazard in the markets).

The fiscal risk matrix in Table 2.1 provides a typology of the sources of the potential financial requirements that are faced by the government of Hungary. There are four categories of fiscal risks in the matrix, which are defined as a combination of the above characteristics. For each category, the matrix lists government activities and promises that may create significant future fiscal pressures.

[4] International accounting standards define a contingency as a condition or situation whose ultimate outcome is determined only by the occurrence, or nonoccurrence, of one or more future events (International Accounting Standards Committee 1997).

Table 2.1 Possible sources of future financing pressures on the central government

Liabilities	*Direct* (certain)	*Contingent* (if a particular event occurs)
Explicit Government liability is recognized by law or contract	• future health care financing (Health Fund deficits) • future public pension benefits under the new pay-as-you-go scheme (post-reform transitional deficits) • future social safety net • future salaries and benefits of public employees • sovereign borrowing (loans contracted and securities issued by the central government)	• obligations of the state-guaranteed agencies, such as State Development Bank, EXIM Bank, Export-Import Insurance Company, Pension Reserve Fund to cover pension guarantees, Deposit Insurance Fund, Credit Guarantee Fund, Rural Credit Guarantee Foundation, and Office of Agricultural Market Regime • environment guarantees and other obligations of the Privatization Agency (APV Rt) • pension guarantee to the new fully-funded pension scheme • state guarantees issued to public and private sector entities and local governments • guarantees on private investments (concessions)
Implicit A "moral" obligation of the government that mainly reflects public expectations and pressures by interest groups	• the cost of policies to meet the EU requirements • military financing requirement of the NATO membership	• obligations of large and politically influential banks (Postabank) and enterprises (Railways) • municipal obligations to provide critical services • indemnification of workers for lost work places in former state owned enterprises • financial rescue to concessions if revenues do not suffice to cover debt service • development support in depressed regions (support to large enterprises) • debt relief and future investment needs under the housing support programs • defense of the crawling peg by the National Bank of Hungary

[a] The liabilities listed in the table refer to the fiscal authorities and not directly to the central bank.

Direct explicit liabilities in Hungary mainly comprise of the large public debt, increasing spending requirement on health care, and transitional benefits under the pay-as you-go pillar of the new pension system. The 1995-97 fiscal adjustment helped to stabilize the sovereign debt, temporarily suppressed health spending, and significantly reduced the long-term public pension liability. But the government still faces the challenge of reforming the health system in order to maintain health spending under check in the long term.

Direct implicit liabilities of the government arise as presumed, rather than as legal or contractual, obligations of the state are primarily established by Hungary's commitment to take on expenditures needed to meet the EU and NATO requirements in various sectors. The government has launched a detailed sector-by-sector analysis to quantify these implicit obligations.

Contingent explicit liabilities, as legal obligations of the government to make a payment if a particular event occurs, are still relatively moderate in Hungary. The main source of explicit contingent fiscal risk to the government have been state guarantees and guarantees and credits issued by various agencies on behalf of the state. After privatization, these programs have increasingly supported Hungarian exports rather than industries. As the government has been cautious in designing these programs and the economy has performed well, the hidden subsidy embedded in these programs has not fully materialized. The risk and potential budgetary cost of these programs, however, have increased with regard to the possible consequences of international financial crises for Hungarian banks and enterprises.

Contingent implicit liabilities, which are hidden until *after* a failure occurs, are no longer large in Hungary. The largest contingent implicit liability, the banking sector, had mostly been paid off and brought under control. During 1995-97 Hungary further reduced its contingent implicit liabilities by implementing sound macroeconomic framework, good regulatory and supervisory systems, information disclosure in the markets, and inter-government finance reform. Hungary's macroeconomic framework has also reduced risks that are potentially associated with international private capital flows (such as assets overvaluation and overgrowing). The remaining contingent implicit risks are primarily associated with banks and enterprises that have remained under state control.

3. ANALYZING SELECTED AREAS OF RISKS

THE EFFECT OF THE PENSION REFORM ON CONTINGENT GOVERNMENT LIABILITIES[5]

The aggregate fiscal objective

The pension reform constitutes one of the most critical element of fiscal adjustment in Hungary. The reform introduced in 1997 has sought to restore the long-term viability of and to encourage private responsibility for the provision for retirement. The reform aimed at reducing the prospective cost of the mandatory social security pillar and at creating a set of privately managed, fully funded, defined contribution funds. As a result of the reform two pension systems will exist parallel for the next four decades: the inherited public pay-as-you-go (PAYG) system, modernized to offer lower benefits and to require higher retirement age and stricter rules for eligibility; and the new multi-pillar system, which complements the PAYG scheme with the smaller, fully funded, privately

[5] This section benefited primarily from the contribution of Csaba Fehér, Private Pensions Guarantee Fund, Hungary, and Robert Palacios and Judit Spat, World Bank.

managed second pillar and a voluntary, fully funded third pillar.[6] Participation in the new multi-pillar system is mandatory for new entrants in the labor force and optional for individuals already active in the labor force.

The risk of high transitional deficits under the public PAYG scheme

Even though the pension reform reduces both the long-term pension liability and fills the initial gap between assets and liabilities of the government under the PAYG scheme, the fiscal effects of the pension reform look unfavorable in the conventional, flow-based analysis of fiscal adjustment in the medium term. That is because, in the early years after the reform, the transition to the new system generates deficits in the reformed PAYG. The transition deficits result from the government offering all participants in the old system an option to switch to the new, multi-pillar system, and taking three quarters of their contribution to a private pension fund.[7] This option makes part of the initially hidden pension liability visible. The size of the visible share of the pension liability and thus the transition deficits in the PAYG scheme grow with the numbers of individuals switching from the old to the new system, increasing thus pressure for further fiscal adjustment in state budget. Nevertheless, this is a temporary pressure only as later on the modernized PAYG system overcompensates the losses.

New, contingent pension liabilities

The pension reform, while reducing its long-term direct pension liability, also generated new contingent liabilities in the form of explicit and implicit government guarantees. The government introduced these guarantees to cover risks of individuals under the second, mandatory pillar. The introduction of the guarantees was necessitated by the fears expressed by the Hungarian public about the market risks of private pension funds. To build political support to the partial privatization of the pension system the question was not whether to issue guarantees and thus create new (contingent) public liabilities, but rather how to protect individuals against risks without creating excessive moral hazard in the new system and without exposing the government to excessive risks. Institutional (such as strict conditions for licensing and management of pension funds, State Pension Fund Supervision, portfolio regulations, rate of return requirement) and contingent guarantees (so called normative guarantee and budget guarantee behind Private Pensions Guarantee Fund[8]) were legislated to reduce the risks of the new pension system for individuals and the government:

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6 For a detailed description of the new system please see Bokros and Dethier, 1998.

7 The drop of public saving will be offset by an increase in private saving through the second, mandatory saving pillar.

8 The Guarantee Fund is financed through mandatory membership fees levied on the pension funds. Its function is, inter alia, to supplement fund member account balances in case these fall short of the capital required to meet the *normative funding* requirement at retirement or the *normative annuity* at any time following the retirement, make temporary payments to fund member accounts in case of *short or long term liquidity problems* of a pension fund.

The ***normative guarantee*** promises individuals contributing to the second pillar for at least 180 months an annuity of not less than 25 percent of the value of the PAYG pension benefit (normative annuity), a benefit that equals about 93% of the benefit that the fund member would have obtained had he not switched to the new system. For a fund member the Private Pensions Guarantee Fund would top up his fund account should the benefit payment at any time after his retirement fall below the normative annuity calculated at the time of his retirement, or should the balance of his account at retirement fall short of the normative funding need to provide the normative annuity.

The risk of the normative guarantee being called and thus the risk exposure of the Private Pensions Guarantee Fund depends on three factors: the pension funds' investment performance, the benefit level in the PAYG and the age and income distribution of the pension fund members. There is a high risk that the guarantee is called with respect to those who opted for the second pillar above the age 45. In their case, pension fund returns shall reach at least real wage growth plus 1.8 percent[9] on average for the guarantee not to be called. At the same time, as even a rather conservative estimate of future pension fund returns averages around 1.5 percent above the expected real wage growth, the fund performance in the long term should not generate risk of the guarantee being called on a large scale.

With respect to the age of fund member, the risk is higher for individuals who have switched to the new system at a higher age, since they may not have sufficient time to accumulate the required resources to meet the normative annuity and funding. Those who switched to the new system at the age of 47 or higher will not meet the guarantee eligibility criteria. Thus the largest risk is posed by individuals who have switched at age 41 to 47 years. To reduce the risk, government public awareness campaign has focused on explaining the negative implications of switching to the new pension system at an older age. The age distribution of fund members will not be know until the end of the transition period (end of year 2000). The first almost one million fund members, however, shows a fairly reassuring picture: almost three fourth of the switchers is 35 or younger, around 15 percent is 36 to 40 years and approximately 10 percent is 41 to 47 years.

Since the level of the normative annuity is linked to the pension benefit offered in the first pillar of the pension system, the risk of the normative guarantee being called also depends on the developments under the PAYG scheme. Changes affecting the benefit level under the first pillar will directly affect the level at which the normative guarantee

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[9] For reference see The World Bank: Hungary Country Economic Memorandum 1999; Fiscal Chapter. The calculation is based on the assumption that average real wage growth equals 3 percent, the average return of pension funds is above real wage growth by 1.5 percent, administrative cost of pension funds is 0.15 percent of the contribution collected. For income, the average individual wage profile was used based on historical data available at the Hungarian social security funds.

will be called. Members may also pay lesser attention to monitoring and comparing the performance of the pension funds before deciding to invest, which may have a negative impact on the behavior of pension funds. The fact that the normative guarantee can not be called upon within the next 15 years allows the Private Pensions Guarantee Fund to accumulate reserves and policy makers to further strengthen the guarantee framework.

The most significant risk to the Private Pensions Guarantee Fund emerges from its obligations under the normative guarantee procedure. To deal with fund short-term liquidity problems, the Guarantee Fund will be lending to the troubled pension funds, charging an administrative fee and penalty. Through this mechanism the Guarantee Fund can set the cost of "borrowing" at above market level and thus ensure that it is only used as a financier of last resource. Regulations need to be further elaborated particularly to deal with the potential fund problem of long-term liquidity and fund reserve insufficiency during the beneficiary annuity period.

The system of guarantees was not based on cost-benefit analyses or any work aimed at sticking a price-tag on the system as a whole and its components. Uncertainty surrounds the expected size, time-structure and likelihood of the possible contingent pension liabilities to be called. Table 3.1 summarises the types of financial obligations, the determinants and reasons of uncertainty in forecasting it. The year in italic is the earliest time when (under current legislation) the Fund may have to make payments.

Table 3.1 Contingent risks of the pension system

Reason of Obligation	*Major determinants of its size and timing*	*Unknown and undefined variables*
Frozen assets at a pension fund - short-term liquidity problem *immediate*	Size and concentration of the market, access to liquidity, relative cost of borrowing,	Short-term growth of the market
Frozen assets at a fund facing long-term liquidity problems *immediate*	Effectiveness of supervision, long-term absolute and relative of funds, size of the market	Asset valuation rules, bankruptcy and liquidation rules, indemnification rules
Normative annuity shortfall *2013*	Relative age/income structure and earned entitlements of switchers	Age/income/entitlement structure of switchers, PAYG pension formula, variability of the actuarial calculation of the annuity
Shortfall of the separate benefit reserves during beneficiary period *2013*	Flexibility of actuarial revaluation rules, structure and nature of the annuity market	Actuarial guidelines, annuity market

There is an ***explicit state guarantee*** behind the Private Pensions Guarantee Fund that ensures that the Fund will fulfil its financial obligations even if it has insufficient reserves. It provides financial backing to the second pillar of the pension system. This guarantee is the core of the mechanism explicitly transmitting the risks of the new

pension system to the state budget. The technical aspects of the guarantee are yet to be clearly defined in law.

To summarise, in the next 10-15 years, the main fiscal pressure will arise from the transition deficits under the PAYG scheme rather than from the pension funds. At present around three-fourths of the pension funds participating under the second pillar are concentrated in 5 big and several medium-sized funds, sponsored by well-known, mostly international financial groups that, presumably, will vindicate their pension funds. The government may need to withhold some political pressure when due to shocks to the Hungarian stock market, several bigger pension funds may fail to meet the minimum return criteria, and similarly, in cases of fraud and unforeseen shocks.

IMPLICIT CONTINGENT LIABILITY OF THE BANKING SYSTEM

In most countries, the financial system represents the most serious contingent liability of the government. International experiences have indicated that markets expect the government to help financially if stability of the financial system is at risk. In such cases, governments are compelled to intervene financially far beyond their legal obligation either to secure some critical functions of the financial system, or to protect depositors and specific market agents beyond the limits of any state insurance schemes. However, such practices further exacerbate the moral hazard problem in the financial and corporate sectors.

Hungary had successfully restructured most of the banking sector by the late 1990s. However, resolving the banking crisis has not been easy or straightforward, for though most financial institutions are privately owned and have strong capital/asset ratios, Hungary's first efforts to shore up its banking system did not entail privatization. Although faced with a rising volume of non-performing loans and falling capital/adequacy ratios, the large banks (in which the state held most of the equity) were continued in operation by weak accounting practices or by infusions of public funds.

Privatization as a remedy was applied only after the government spent vast subsidies on acquiring debt held by state-owned banks. To the extent privatization has occurred, fiscal risk has largely been shifted to the new owners, some of which are strong multinational banks. But where privatization has not occurred or is incomplete, the government still holds significant fiscal risks, some of which have burdened recent budgets.

Reform of the banking sector unfolded in three stages, corresponding to the types of instruments used, the degree of fiscal risk, and the transparency of public assistance. The first, high-risk, stage began in the early 1990s, with the liberalization of the economy and the deterioration in enterprise performance. During this stage, the government assumed most of the risk of inability of firms to service their bank debt. The second, medium-risk, stage spanned the 1993-95 period, during which bank consolidation was

emphasized and the capital position of banks was improved. The most recent stage has been characterized by a substantial reduction in government's exposure to adverse changes in the financial condition of Hungarian banks.

High risk: loan acquisitions

In the early 1990s, the crisis in the banking sector mirrored the crisis in the economy. Thousands of enterprises were unable to service their debt, Hungarian banks had a rising volume of non-performing loans and a deteriorating capital adequacy ratio. The banks needed an infusion of capital, which given economic conditions and the structure of the banking industry[10] had to come from the government. During this period, the government enacted a far reaching bankruptcy law, which sought to force insolvent enterprises into bankruptcy or liquidation, and to resolve their outstanding debt. Thousands of bankruptcies were filed and thousands of firms were liquidated, but the banks were not active participants in the process. Most of the liquidations were of small firms, while most of the bank debt was owed by large enterprises. In many cases, the banks rolled over maturing loans of these enterprises, in the expectation that the government would bail out the affected companies. But rather than injecting capital and requiring banks to clean up their loan portfolios, the government elected to acquire a substantial portion of the bad debt.

The effect was to transfer the risk from the banks to the government which ended up with significant losses on these transactions. Financial risk was heightened by the manner in which the loan acquisitions were made and financed. First, although loans were purchased at a discount, the purchase price typically was a fixed percent of face value; it was not based on assessment of the quality of loans in bank portfolios. Second, with the state taking over their bad debts, the banks had no incentive to work out restructuring or payment terms with affected enterprises. Third, while a portion of the purchased debt was sold by tender or restructured, most was sold to the Hungarian Investment and Development Bank, transferred to state property agencies, or written off.

Medium risk: bank consolidation

Despite its high cost, the loan acquisition strategy did not resolve the banking crisis. By the end of 1993, almost one third of the loan portfolios of Hungarian banks were qualified, and an independent audit found that three of the five largest banks were technically insolvent and that without new measures, their condition would continue to deteriorate. The government realized that simply buying loans would not induce banks to actively clean up their portfolios, improve lending and collection practices, or work out bad debts. The fiscal risk had to be shared with the banks, but doing so required that their financial position be strengthened through an infusion of capital.

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[10] Most of the large institutions were predominantly state-owned.

The new program had two main elements: consolidation agreements between each assisted bank and the Ministry of Finance spelling out the measures the former would take to assess its financial condition, and developing work out units to resolve qualified loans. In addition, preparation of plans for remedial action, as well as operational improvement were required. The Ministry of Finance established a Bank Control Unit to oversee the financial institutions and monitor compliance with the consolidation agreements. The bank consolidation scheme was mainly financed by HUF165 billion in 20-year bonds; it succeeded in raising the capital adequacy ratio of the assisted banks from 0 percent at the end of 1993 to 8 percent a year later. Bank consolidation was implemented in tandem with a Debtor Consolidation Program intended to accelerate the resolution of enterprise debts, but the program had only limited success by the time it expired in 1995.

Low risk: the privatization strategy

Early appraisals of the bank consolidation program generally were favorable. Bank supervision by State agencies tended to be weak, accounting standards were lax, and the banks were slow to take up their new responsibilities. In retrospect, it is evident that these startup problems were overcome as the government and the banks gained experience in handling their new responsibilities. The direct fiscal cost of solving the banking sector problems is shown in Table 3.2. The government has financed bank consolidation also indirectly, through agencies such as the State Development Bank. However, compared to the direct fiscal cost, the amounts of the indirect financing have been small.

Between December 1993 and December 1996, qualified loans declined from 29 percent to 11 percent of bank portfolios. With improved balance sheets, satisfactory capital adequacy ratios, and a stronger regulatory regime, it was feasible to privatize the banks and to thereby shift virtually all explicit risk from the state to the new owners. Most bank privatization occurred during the 1994-1996 period, as state ownership fell from 67 percent to 5 percent. In some cases, the state retained a substantial minority stake, but most of these were subsequently reduced or sold off.

Privatization has been accompanied by development of deposit insurance funds, with premiums paid by banks held in reserve to indemnify depositors against loss. The buildup in the deposit reserve funds should suffice to cover losses if small banks fail, but the state may still be at risk if a large bank were to get in trouble.

Table 3.2 Fiscal cost of the banking problems 1991-98

	1991	1992	1993	1994	1995	1996	1997	1998
Bank Consolidation Bonds (changes in stock) (HUF, bn)	0.0	0.0	285.6	47.0	6.0	9.0	-85.9	182.0
Guarantees issued (HUF, bn)	10.4	0.0	0.0	0.0	0.0	16.5	27.8	44.0
Amortized Bank Consolidation Bonds (HUF bn)	0.0	0.0	0.0	0.0	0.0	0.0	85.9	0.0
Interest Paid on Bank Consolidation Bonds (HUF bn)	0.0	0.0	0.0	54.5	96.6	102.7	86.5	50.5
Guarantees called (HUF, bn)	0.0	2.3	0.4	0.0	6.8	2.9	11.8	6.2
Guarantees recovered (HUF, bn)	0.0	0.0	0.0	0.0	0.2	0.1	0.0	1.1
Total direct fiscal cost (HUF bn)	0.0	2.3	0.4	54.5	103.6	105.7	184.2	57.8
Total direct fiscal cost % of GDP	**0.00**	**0.08**	**0.01**	**1.25**	**1.85**	**1.53**	**2.16**	**0.60**

Source: The Ministry of Finance, Debt Management Agency

Note: The bank consolidation cost was largely financed by new debt issues not through the budget and thus did not affect the deficit figures. Total fiscal cost is calculated as the cost of the bank consolidation program (amortized bonds + interest payments) plus the amount of guarantees called minus guarantees recovered.

The 1993 bank consolidation expenditure of over 8 percent of GDP partly also includes debtor (enterprise) consolidation.

Postabank

Privatization has been the most effective bulwark against the fiscal risk of bank failure. Nevertheless, to the extent that privatization has not been completed, the government still is burdened by the need to assist troubled institutions. Postabank offers the best contrast between containment of risk through privatization and risk through state control (not necessarily ownership).

This bank was established in 1990 with capital contributed by the State Property Agency. Unlike the other large banks, Postabank has not been majority state-owned in the strict sense nor has it has been completely privatized[11]. The state's share in Postabank was relatively small, only 16 percent, although large shareholders have included, quasi state agencies such as the state-owned Hungarian Post and the public Health and Pension Funds. Postabank has been controlled by the state indirectly, via government influence on the bank management. The main explanation offered by MOF officials for controlling it is that Postabank has had a large retail base. Apparently, the government has not wanted to control of this institution transferred to foreign hands.

[11] The average state ownership was of more than 70 percent for the five other large banks.

Postabank grew rapidly during its early years, building up a strong retail business, but in 1994 it still was relatively small, holding only about 5 percent of bank deposits and 7 percent of loans. Postabank had an aggressive growth strategy which made it Hungary's second largest bank by 1998. However, this scheme involved risky practices that weakened its financial position. The growth in its loan portfolio has not been matched by increases in its capital and in 1997, Postabank suffered HUF3.8 billion in losses and, following rumored bankruptcy, the withdrawal of HUF24 billion in deposits. To protect the bank and depositors, the government has provided equity capital through the State Privatization and Holding Company and the Hungarian Development Bank. The government also has pledged HUF12 billion in guarantees to bolster depositor confidence in 1997.

The true financial condition of Postabank was hidden from auditors, and possibly from the government as well, by selling non-performing loans to a separate entity, established with a loan from Postabank. The loan was recorded on Postabank's books as an asset, while the non-performing assets were removed from its books. This enabled Postabank to report that it was in sound condition, thereby postponing and making worse the adjustment that would have to be made. The equity capital was provided at face value or higher, far above the true value of Postbank's shares would have been if its real condition had been made public. Moreover, APVrt and the Hungarian Development Bank supplied capital at the direction of the government; they had no discretion in the matter. By using these institutions, the government was able to provide assistance outside the budget.

This assistance could not, however, rescue Postabank, and in late 1998, the government in effect recapitalized Postabank by injecting approximately HUF 150 billion. It did so in the 1999 budget (adopted in December 1998) but recorded this as a 1998 expenditure. The effect was to make the 1999 budget look better in comparison with the previous year. The Postabank rescue package was also complemented with a compensation package in an amount of HUF 40 bn for the State Development Bank for its losses on the share capital provided earlier that year to Postabank.

Postabank illustrates how state control over bank management adds to fiscal risk. With state guarantee, be it implicit or explicit, to a bank, first, political considerations and moral hazard in the bank's decisions increase; second, risk is concentrated in the government and not diversified through a network of multinational banks; third, the bank is more likely to suffer from lax management than those in which private owners hold the risk; fourth, the cost to government is veiled by relying on various indirect financing mechanisms through other state-controlled entities. The strong probability is that Postabank would be in sturdier condition today if the state had released it from political networks and exposed it fully to market risk.

Assessment

In the medium term, we do not expect the fiscal authorities to spend on the banking sector. Some state entities (principally the State Privatization and Asset Management Agency and the Hungarian Development Bank) still have an interest in some banks, but not to a degree that would pose a fiscal risk. The cost of restructuring the banking system in the 1990s has been high: approximately 12 percent of GDP. But the benefits also have been high: reduced fiscal pressure on the state, a sounder relationship between banks and enterprises, growing confidence in the banking sector, and more prudent accounting and regulatory practices. At the present time Standard & Poor's estimates the overall implicit contingent government liability of the banking sector in Hungary at a favorable level of less than 7 percent of GDP.[12]

PRIVATIZATION OF STATE ENTERPRISES AND CONTINGENT FISCAL RISKS

Privatization to contain fiscal risks

During the 1990s, the Hungarian economy has been transformed from state ownership and control to one predominantly in private hands. Early in the decade, state property agencies managed approximately 2000 enterprises, by the end, almost 90 percent of their holdings had been liquidated or sold. At the onset of transition, the state or entities controlled by it held approximately two thirds of domestic wealth, including more than 80 percent of productive assets. By the end, well over half of Hungarian assets were privately owned, moreover, three quarters of productive assets were in private hands.

However, as occurred in the banking sector, privatization of state enterprises started slowly and had to surmount various difficulties before it was implemented wholeheartedly. Table 3.3 reports year-by-year revenues from privatization; it indicates that half of the revenues were obtained in 1995-96. Before these years, privatization was slow and halting. In fact, the government obtained more cash from privatization sales in 1995 than it had in the previous five years.

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[12] For comparison, the contingent fiscal cost of the domestic banking system is presently estimated by Standard & Poor's at levels under 10 percent of GDP in Argentina, Italy, Poland, and Sweden, about 10 to 20 percent of GDP in Greece, Philippines, Singapore, Slovakia, U.K., and U.S. and over 30 percent of GDP in China, Czech Republic, Hong Kong, Japan, Korea, Malaysia, Thailand and Taiwan.

Table 3.3 Privatization revenues during 1990-98 (HUF bn at current prices)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Cash	0.7	31.4	77.2	169.9	139.8	481.0	176.1	301.7	99.2
Liquidation	17.7	39.8	31.7	32.1	29.0	12.6	5.0	15.5	0.0
Asset Transfers/Other	154.0	0.0	17.5	41.1	19.6	91.2	20.0	26.8	0.0
Divestiture Total	172.4	71.1	126.4	243.5	188.5	584.9	201.1	344.0	99.2
Divestiture Total, % of GDP	**8.3**	**3.1**	**4.3**	**6.9**	**4.3**	**10.4**	**2.9**	**4.1**	**1.0**

Source: The APV Rt. and MOF.

Note: The cash amounts are not adjusted for devaluations which occurred during this period.

1990-94: Slow Privatization. Privatization began largely as a "spontaneous" process, with thousands of companies started by spinning off viable parts of state enterprises into new entities. Spontaneous privatization was swift, but it was not transparent, nor did it always safeguard the state's interest. There were widespread charges of abuse and favoritism, and whether warranted or not, they led to a slowdown in the transfer of state assets to private owners. Although many enterprises were liquidated (often by being transferred to new owners) during this period, most were small or medium-size firms; the biggest enterprises (in energy, communications, and transport) which accounted for the bulk of state assets, still were publicly owned. By the end of 1994, the state property agencies had divested only about 35 percent of their initial state equity holdings.

In divesting enterprises, the government took several strategic decisions which may have slowed the process but enhanced adjustment to a market economy. Privatization was to be case by case, not wholesale, as in other transitional countries. Moreover, the government opted for cash sales, rather than vouchers and other non-cash transactions. Each enterprise had to be evaluated and managed, and a tender prepared for each. To stabilize state enterprise and enhance their sales value, the property agencies spent time and money restructuring viable entities. In the preparation for privatization, the property agencies contributed capital, or offered guarantees. Even when assets were privatized, the state often continued to be implicated in the enterprises. In some cases, the government policy required the state to retain an ownership share; in others, the state held or guaranteed enterprise debt; in a few cases, the property agency took back the company when the new owners were unable to make it a going concern.

1995-96: Accelerated Privatization. As Table 3.4 indicates, 1995 was the turnaround year in Hungary's privatization strategy. The government decided to move ahead with divestiture of some of its largest holdings. To spur the process, it enacted a new law that consolidated responsibility for divesting and managing state assets in a single agency[13], made the process more transparent, required the agency to provide written explanations of its decisions, and generally reduced the state's residual share in privatized firms.

[13] Privatization was entrusted in 1990 to a new state property agency; subsequently, a second agency, holding many of the largest companies, was established.

More than 80 percent of the revenue earned from privatization in 1995-96 were in cash (or cash-like) transactions. A portion of the money went to pay the expenses of privatization, but most was used to repay foreign debt. Around HUF100 bn of it has been used to supplement the budget each years (see Table 3.4).

Table 3.4 The use of privatization revenues 1990-98 (HUF bn at current prices)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Budget support and debt repayment	0.5	22.4	51.5	57.5	151.7	368.4	122.9	254.8	39.0
Transfers to Municipalities	0.0	2.3	4.8	3.4	6.0	6.1	21.6	26.4	0.0
Direct privatization costs	0.0	1.1	6.2	7.6	25.3	33.6	33.0	36.1	46.3
Reorganization expenditures	0.0	0.0	8.7	49.5	8.0	9.8	16.8	12.1	13.5
Guarantees	0.0	0.0	5.8	7.8	7.0	3.7	33.2	16.0	51.6
The use total	0.5	25.8	77.0	125.8	198.0	421.6	227.5	345.4	150.4
The use total, % of GDP	**0.02**	**1.12**	**2.62**	**3.55**	**4.54**	**7.51**	**3.32**	**4.1**	**1.5**

Source: The APV Rt. and MOF.

Note: Out of the amounts on budget support and debt repayment, HUF150 bn and HUF100 bn in 1995 and 1996, respectively, were used to support the budget.

Continuing obligations and contingencies

Current government policy is that to the extent feasible, divestiture should be a clean transaction, with no remaining state obligations. Thus, the state property agency does not warrant the future performance or financial condition of privatized entities, nor does it indemnify the new owners for the cost of meeting rising environmental standards. Nevertheless, the state property agency does have a number of ongoing commitments and risks either predating privatization or arising out of the sale of assets. The agency maintains reserve funds to cover various contingencies and is confident that these will suffice to protect the government against any call on the budget.

In describing the ongoing risk held by the privatization property agency, it is useful to distinguish between those which are independent of the privatization process and those which are directly linked to the divestiture of assets. The former includes assets still owned by the state, asset management guarantees and bank and enterprise equity.

State Owned Assets. By early 1999, the state property agency has held approximately 250 companies with estimated total equity value of HUF560 billion. It expects to divest approximately HUF200 billion through future privatizations, but anticipates that the remaining assets will remain under state control. The state will continue to be at risk for the performance of these companies, and with all of them managed by a single agency, the risk of cross subsidization is substantial.

Asset management guarantees have been issued by the current state property agency or its predecessors in cases where the enterprise has not been able to borrow on its own account. These loans have been used to finance restructuring of state enterprises prior to privatization; they generally have been fully collateralized. This type of guarantee was much more common prior to 1995, and they rarely have been called.

Equity. Although it has guaranteed enterprise debt, the state property agencies generally have not lent money to cover enterprise losses. But they have purchased shares in banks (such a Postabank) and in some instances, enterprises in need of additional capital. While these equity infusions obviously increase financial risk, they also enable the state to benefit from improvements in the performance of the assisted enterprises. Of course, if the condition of the enterprises deteriorates, or if their performance is weaker than might occur if the enterprise were in private hands, the government and the economy will bear the costs.

Commitments Contracted Pursuant to Privatization

In privatizing assets, the government divests the risks associated with their performance. But in order to consummate the transfer of assets, the state property agency often has to provide various assurances (see Box 1.) concerning the commitments or condition of the assets. The state property agency maintains a reserve fund (HUF38.8 billion in 1997 and HUF44 billion in 1998) to cover the various guarantees. The fund is financed by privatization revenues. The principal risks covered by the reserves are environmental guarantees (HUF15 billion) and due diligence (HUF10 billion). The agency believes that the reserves have been based on conservative assumptions and that there is little likelihood that the state will have to make good on any of its guarantees. For example, the reserve for environmental liabilities assumes that half of the property agency's guarantees will be called.

Box 1: Privatization Guarantees Contracted by the State Privatization Agencies

Ownership. The state property agency warrants that it is the owner and has legal authority to sell the property on behalf of the state. These generally are low-risk guarantees.

Due diligence. The state property agency guarantees that it has accurately stated the financial condition and pre-existing obligations of the entity. In view of the due diligence exercised in the course of privatization, these also have been low risk.

Financial status quo. Most privatizations are time consuming transactions that take as much as half a year or more from audit of the company until closing. In some cases, the property agency, usually at the behest of the buyer, conducts a second audit at closing and indemnifies the buyer for material deterioration of condition. This type of guarantee has become quite rare.

Undisclosed environmental liabilities. The state property agency warranties that the property to be sold is of a certain environmental quality. It agrees to pay for any environmental damage that was not stipulated or revealed at the time of sale. The warranty does not cover the accumulated costs of past environmental damage or the cost of meeting higher future standards. The guarantee is either for a fixed amount or for an agreed percentage of the contract's value. The total stock of outstanding environmental guarantees was HUF20 billion in 1998.

Evaluation

In addition to generating revenues and limiting risk, privatization has contributed to fiscal adjustment in several ways. It has spurred the government to broaden the tax base and improve tax collection; it has permitted reductions in state subsidies; and it has enabled the government to repay a substantial portion of its foreign debt. Privatization is now limited to the dwindling stock of enterprises still owned by the state.

Although the privatization process has nearly been completed, the state still is at risk with respect to the performance and financial condition of certain enterprises, in some cases because it is still the owner, in others because it has retained a minority interest, and in some because it has guaranteed various elements of the privatization process. The State Privatization and Asset Management Agency will retain and manage various assets, including institutions in which government has a financial interest. In this capacity, it will retain income from cash flow and privatization, and possibly use some of this money to finance some risks off-budget. While this development is in its infancy and might not mature into routine practice, it bears close observation.

In general, measured against the overall structure and condition of the Hungarian economy, these risks generally seem to be prudent and well managed, and it is not expected that the government will incur any significant expenditure due to unexpected problems in the enterprise sector.

CONTINGENT EXPLICIT RISK OF STATE GUARANTEES AND STATE-GUARANTEED AGENCIES

During transition, Hungary has removed enterprise subsidies and direct state interventions in the markets, replacing them to some extent by state guarantees and other indirect, off-budget, market-stimulative programs. For this purpose, as in many other countries around the world, in addition to issuing individual state guarantees, Hungary established several specialized credit and guarantee agencies to support development and investment programs by providing credits and guarantees. These institutions largely rely on their own financing but also are guaranteed by the state and supported from the budget. Annual additions to the amounts of outstanding state guarantees and of liabilities and outstanding guarantees of the credit and guarantee agencies are in most instances subject to ceilings specified in the annual budget law.

Hungary's government has been relatively prudent in issuing guarantees and allowing for state-guaranteed institutions. It has implemented several simple measures to reflect contingent explicit liabilities in fiscal analysis and expenditure planning. The government consolidates the full list and calculates the total face value of state guarantees, requires sectoral analysis of risks prior to issuing a guarantee, and applies ceilings on the amounts of guarantees issued. To mitigate moral hazard in the market and better control fiscal risks, the government however has to recognize the importance of risk sharing, and good surveillance under its programs of contingent support. For example, so far the government has guaranteed the full value of an asset subject to a state guarantee against all risks, without any risk-sharing mechanisms under the guarantee contract. Box 2 summarizes the legal provisions for dealing with guarantees.

Box 2: Dealing with Government Guarantees: The Public Finance Act, 1992

The Government may extend individual guarantee for purposes specified in, and on the expense of the annual budget law. It is entitled to guarantee loans of international financial institutions, as well as to guarantee and to reinsure guarantees of specific legal entities.

The amount of individual guarantees issued for specific purposes (such as, supporting reorganization of certain industries, guaranteeing deposits established before 1993) within a fiscal year is limited as a ratio of total budgeted state revenues. Guarantees may be undertaken also in excess of this percentage limit for strategic activities (such as filling energy reserves) with Parliamentary approval defining the amount of guarantee issue. In case of guarantees to cover loans of international financial institutions, the individual contracts set the limits for the guarantee. Guarantees and reinsurance to entities whose activities are prioritized by economic policy (such as promotion of export, small and medium size enterprises, investments in agriculture) are restricted up to a measure specified in the annual budget law as a lump sum. The following institutions are eligible for state reinsurance: the Hungarian Export-Import Bank Co., Hungarian Export Credit Insurance Co., Credit Guarantee Co., Rural Credit Guarantee Foundation Co. and the Hungarian Development Bank Co.

The issuance of guarantees shall be reported to the State Audit Office. Its size, amount, conditions, type, and the justification for it as well as information on the lender and borrower shall be made public in a Government resolution. The economic actor to whom the guarantee is issued is responsible for presenting an unbiased justification for the issue and assessment of the probability of default, of the chances of recovery. The supporting sector Minister, together with the Minister of Finance, submits to the Government its request for guarantee in a form of a draft Government resolution.

After the respective sectoral ministry and the sectoral department in the Ministry of Finance has assessed the expected defaults, guarantee is issued, the issue is outlined in government resolution, and this resolution becomes part of the next year's budget law. For each explicit contingent liability the annual budget is required to show the probabilities of default and the expected payments due. In the final account, the government is required to report any payments related to calls on contingent government liabilities.

The MOF, assisted by the State Debt Management Office, is responsible for monitoring the government's risk exposure vis-a-vis state guarantees and reinsurance programs for credit and guarantee agencies. As a rule, state guarantees cover all risks and the entire value of the underlying asset. This appears to be a result of creditor pressure on the government. Most credit and guarantee agencies extend partial credit guarantees, thus covering only a share of the underlying asset. The government covers the risk of the credit and guarantee agencies by partial state re-reinsurance up to 70 percent on average.

State guarantees and credit and guarantee agencies do not presently pose a threat to fiscal stability. On the policy front, enterprise privatization has alleviated the pressure on the government to guarantee credit issued by former state-owned enterprises. On the institutional front, the government's practice to budget for a provision for state guarantees and for credit and guarantee agencies generates an ex-ante estimate of their overall implicit subsidy makes it visible in the budget and thus positively affects the incentives of policymakers in dealing with nonbudgetary support programs. Together with the low ceilings on newly guaranteed amounts of state guarantees and on obligations of credit and guarantee agencies, if sustained, this practice will prevent guarantees and these agencies from seriously threatening fiscal stability in the future.

The use of guarantees in Hungary, however, is problematic in the allocative and operational sense. While some guarantee programs pursue justifiable development objectives, others merely conceal the true nature of state involvement. A positive example of revealing the true nature of guarantees relates to one of the individual guarantees. The Hungarian State Railways have been known for their repeated reliance on state-guaranteed loans of an annual average of HUF 20bn taken for operational purposes in the period of 1992-1995. The Railways have partially defaulted on their borrowings in 1994 and 1995 requiring thus more budgetary resources than the government considered allocating to the Railways on the basis of the strategic priorities. Moreover, the government had to take over the Railways obligations to commercial banks that had been subject to worse terms than the sovereign debt. The government has recognized that the cost of supporting the Railways had been higher than envisaged and that a subsidy would deliver the objective at a lower cost than a state guarantee, hence when it took over the Railways debt stock, it closed a contract specifying ex ante the size and forms of further state support .

The performance of government guarantees and credit and guarantee agencies has been affected by the crises in Asia and Russia. The actual fiscal cost related to state guarantees and state-guaranteed institutions remained under the budgeted figures throughout most of the 1990-97 period both in terms of guarantees issued and guarantees called. There have been two exceptions. During 1991, the government increased the ceiling for new guaranteed issues from 0,5 percent to 3 percent of budgeted state revenues. And, in 1992 the actual issues exceeded the ceiling of 2 percent of state revenues by 1 percentage point. Turmoil in the international financial markets in 1998 has

not resulted in calls on state guarantees to an extent higher than expected. Moreover, while the MOF has slightly increased the 1999 appropriation for potential calls on guarantees in order to prepare for the emerging losses due to the Russian crisis, it has left the ceiling for the issue of new state guarantees at its 1 percent (of revenues) level in the 1999 budgeted.

Guarantees with annual limits

Individual guarantees. The ceiling on the total face value of newly issued individual guarantees has been defined by the Annual Budget Laws in the range of one to three percent of budgetary revenues in the past nine years. Higher ceilings characterized years 1990-1994. In this period, state guarantees were directed particularly to support specific industries. Privatization has reduced the demand for and redirected state guarantees. State guarantees have increasingly covered several troubled banks (Postabank), enterprises and small farmers, while specialized credit and guarantee agencies have expanded primarily to support exporters and small and medium enterprises. The amounts of new guarantees issued dropped to one percent of budgeted state revenues in 1997. Each year until 1998, individual guarantees have required the largest government outlays out of all the types of contingent government liabilities called. These incorporated payments for loans of companies in coal, steel, machine and agricultural branches as well as providing support to cleaning portfolio of certain commercial banks. The sharp increases up to HUF13.5bn in 1997 and a budgeted 24.7bn in 1998 are mainly a consequence of government's decision to cover part of the losses of a Postabank.

Strategic reserves. Beyond the ceiling, individual guarantees are issued rarely. Such rare cases mainly relate to purchases of strategic reserves and unique legal cases such as loans of an enterprise established by a central budgetary agency. Their maximum amount is usually determined by the Parliament.

Guarantees to the public. These state guarantees cover bonds issued by the former local councils and council companies prior to 1987, as well as deposit guarantees for deposits placed in domestic financial institutions prior to the creation of the National Deposit Insurance Fund in 1993. While there have been regular calls on these types of guarantees, their amounts have been low (an average HUF 0.3bn per annum in the 1991-97 period), dropping in real terms, and recoverable (almost HUF 0,1bn per year). The amounts still outstanding are low and diminishing. Also, privatization of the former council companies that had been issuing bonds prior to transition reduced fiscal risks. Meanwhile the National Deposit Insurance Fund has built own reserves for potential threats to deposits, and has obtained state-guaranteed access to loans from the central bank and other financial institutions.

Credit and guarantee agencies

Eximbank. For Eximbank, the state provides a guarantee up to an outstanding stock of HUF 75bn in 1998. The state is also the owner. Eximbank extends long-term loans and issues guarantees on behalf of the state with the objective to support Hungarian export activities. Until 1998, the state guarantee was called once, in 1996, in the amount of HUF1bn. Audited balance sheets imply that Eximbank is a fast-growing and financially sound institution. In 1997, Eximbank assets reached HUF 36bn, up from HUF13.6bn in 1996. The exposure of Eximbank to Russia, approximately HUF 3bn, may somewhat deteriorate its performance and increase its calls on the state budget in 1998-99. While only 5 percent of Hungary's exports go to Russia, 20 percent of Eximbank's portfolio is in Russian guarantees. The Eximbank's practice is to mark loans to market, so that its portfolio is revalued each year to reflect changing market conditions. Eximbank expects to draw HUF 1.5 bn from the 1999 budget.

Export-Import Insurance Company (MEHIB) MEHIB operates as a market-based credit and investment insurer covering either political or commercial risk.[14] The government is the owner of MEHIB and reinsures exclusively against political risks taken by MEHIB. There is an annual ceiling the amount of MEHIB-insured assets that are covered by the state reinsurance. The ceiling has been rapidly increasing since the establishment of MEHIB, reaching HUF 185bn in 1998. Similarly, MEHIB has increasingly utilized this ceiling from 36 percent use in 1995 to 66 percent in 1997.[15] The limit has been raised to HUF250 bn for 1999, with a 44 percent utilization rate.

In its audited balance sheets MEHIB has reported slight profits. The recent explosive increase in new insurance issued by MEHIB may, however, raise its future costs. MEHIB's credit insurance goes to relatively high-risk transitional countries, as part of government policy to support trade with these countries. In its geographical distribution, MEHIB is exposed 45 percent to CIS countries (around HUF 22bn to Russia), which may negatively influence MEHIB's performance in 1998-99. MEHIB suggests a provision of HUF 5.6bn for its possible 1999 claim on the state budget.

Credit Guarantee Co. The state reinsures 70 percent of the obligations that emerge from guarantees issued by the Credit Guarantee Co., up to 70 percent of the company's reserves. The legal ceiling on guarantees outstanding is HUF 55bn in 1998. Shareholders of the Credit Guarantee Co. include mainly commercial banks and saving cooperatives. Guarantees issued by the Credit Guarantee Co. partially cover credits mainly to small and medium sized enterprises. The state budget paid relatively modest HUF 326m on guarantees triggered in 1997. In 1999 however, there are expectations of a total call of HUF 1.8bn due to the budget re-insuring a wider range of business activities of the company (risk capital investments) than before.

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14 MEHIB is also insuring Eximbank's guarantees.

15 Turnover data show a significantly smaller involvement in insuring against political risks. Use of the statutory limit is measured in terms of negotiated deals rather than actually closed contracts.

Rural Credit Guarantee Foundation. The state reinsures 70 percent of the obligations that emerge from guarantees issued by the Rural Credit Guarantee Foundation, up to 70 percent of the Foundation's reserves. The legal ceiling on guarantees outstanding is HUF33bn in 1998. The Foundation is under the supervision of the Ministry of Agriculture. The guarantees cover 50-80 percent of the underlying credit of an average 5-year maturity. The value of guarantees triggered was HUF172mn in 1997. There are expectation of a total call of HUF 600mn in 1999, as the types of businesses reinsured by the state budget increases.

State Development Bank (MFB) A state guarantee to MFB applies to foreign loans and bond issues and has a ceiling of HUF80bn in 1998. The owner of the MFB is the state. MFB concentrates on domestic long-term lending and investment banking activities. Since 1992, MFB has participated in the consolidation of Hungary's banking sector and carries a small amount of bad assets payable to the Ministry of Finance. Assets reached HUF92 and 160 billion in 1996 and 1997 respectively, partially as MFB was directed to inject money into Postabank, even though this did not comport with its ostensible mission. As a consequence, the government was compelled to recapitalize MFB by the end of 1998.

Summary of contingent liabilities outstanding

One measure that may improve the performance of projects under state guarantees would be to strengthen the mechanism for sharing risk between the government and parties in guarantee contracts. Moral hazard and the probability of default in projects under a guarantee are high if the guarantor insures the whole rather than a part of the obligation, and all risks rather than selected political and/or commercial risks.

For state guarantees and the credit and guarantee agencies, Table 3.5 estimates the contingent government liability outstanding in 1998 and the value at risk. The estimates reflect the existing ceilings, the nature of risks associated with the guaranteed programs and the expected economic developments. We estimate the total contingent liability related to state guarantees and credit and guarantee agencies in the neighborhood of HUF 400bn in 1998. On flow basis, we expect that the 1999-2001 budgets may be called to cover approximately HUF 50-60 bn annually on these programs.

Table 3.5 Contingent government liability outstanding, value and risk by 1998

Type	Name	Liability Ceiling (bn HUF)	Liability outstanding (estimates, bn HUF)	Risk (estimates, percent)	Value at risk (bn HUF)
Individual Guarantees					
	Individual Guarantees (within % limit)	25*	120	30	40
	Individual Guarantees (beyond % limit)	64**	37	5	1.8
Guarantees to Activities of Specific Institutions					
	State Development Bank	80	50	5	2.5
	Eximbank	75	50	7	3.5
	MEHIB - Export-Import Insurance Company	185	110	8	8.8
	Credit Guarantee Co.	39	20	5	1.0
	Rural Credit Guarantee Foundation	23	10	5	0.5
TOTAL		**n.a.**	**397**	**n.a.**	**58.1**

Notes: The table excludes guaranteed loans from international financial institutions.
* The 1998 ceiling on the issue of new guarantees.
** Total amount of individual guarantees beyond the percentage limit.

CONTINGENT IMPLICIT RISK OF LOCAL GOVERNMENT OBLIGATIONS

As a result of the political liberalization process in Hungary, every settlement is entitled to establish its own governing body. Consequently, almost every municipality in Hungary has its own local assembly: there were 3200 local governments in the country by mid-1998, with an average number of 3000 inhabitants. The Hungarian Constitution entrusts all local governments with freedom from political and economic interference by the central government. Nevertheless, the local governments' economic freedom was implemented in a way that suppressed the principle of transparency in the use of public moneys and the fact that the central government remains ultimately responsible for many local government obligations. This issue was addressed by the Parliament enacting two precautionary standards: a cap on local government borrowing and municipal bankruptcy law.

Since 1990, nine local governments have gone bankrupt, mainly because they overestimated their financial capacity to repay loans. Local governments had taken these loans mostly to accomplish public utility investments and to undertake special

entrepreneurial activities. As a general rule, these municipalities have not been bailed out from central budgetary resources. In 1996 the government passed an act on municipal bankruptcy. This act did not so much change but formalized bankruptcy procedures and explicitly limited the exposure of the central government to local government fiscal risks. The law declares that the priority in dealing with local government financial problems is continuous service delivery. It forbids collaterization of core local government assets and central budgetary transfers for local government loan repayment. Under the bankruptcy procedure, a local government is require to repay its debt from own revenues (including asset sales). Until 1998, only one of the local governments under bankruptcy has had outstanding liabilities larger than assets.

Risks related to service delivery arrangements

Local governments in Hungary, independently of their size, are made responsible by law for a wide range of services. They are responsible for the provision of kindergarten care, primary education, public health services, social assistance, drinking water, public lighting, and for the maintenance of public roads and cemeteries. As the mandated services are diverse and the size of the serviced areas is often very small, the provision of services is fragmented and costly, without realizing economies of scale. In addition, local governments commonly offer a number of other, non-compulsory services, such as sewage system, public transportation, housing, public cleansing, contribution to energy supply, participation in local employment. Local politicians only rarely undertake the political pain of reducing the non-compulsory services.

Local governments in Hungary extensively depend on central government resources: the proportion of budgetary transfers (current and capital) is around 70% of the total revenues. Local taxes represented a small part of total revenues in the early 90s (5% in 1993), though they gained importance as a result of squeezed budgetary resources after 1995 (10% by 1997), but the ratio of total own revenues, such as institutional revenues and various fees has remained constant over time. Once resources are transferred from the central budget, however, local governments are independent from the central government in spending according to their own priorities. The lack of earmarking of budgetary transfers to specific activities reflects the high level of political and economic independence of local governments granted by Constitution.

Several symptoms show that there is a built-in systemic inconsistency in the current inter-government finance structure and responsibility assignment. Local governments can obtain a 'deficit grant' to deal with financial difficulty that is not caused by their own fault. The number of local governments applying for this additional grant during the budgetary year has increased significantly over time, and was almost 25% of municipalities by 1997. The total amount of the deficit grants remained about HUF 6 and 7bn respectively in 1996 and 1997. However, the number of instances shows that the local government structure is inadequate to supply all the compulsory services because of inefficiencies in service provision. (The roots of these inefficiencies will be discussed in the institutional section below.) Another problem relates to the amortization of assets,

which has not been properly incorporated in local spending decisions, and to the renewal of assets, which has been repeatedly postponed on a common basis. For example, in the health sector where a majority of hospitals is owned by local governments, the stock of the deferred renovation of buildings and replacement was estimated to be around HUF 140 bn by the end of 1997.

To ensure more efficient operations, the central government has established financial incentives in several areas: 10% more central government resources are obtainable by municipalities for schooling or public utility services in case of joint service delivery. Although these incentives have had a modest impact on rationalizing service delivery, the process of establishing joint arrangements is rather slow. The central government has abstained from using major administrative force with the objective to let the system evolve. While this approach is justified on political grounds, the evolution of a more efficient system could be lengthy, and hence, also costly for the central government. Meanwhile, local governments may cover current operations through increasing their dependence on the central budget either explicitly (by increasing their applications for the deficit grant) or implicitly (by accumulating arrears, neglecting maintenance and depleting assets).

Risks related to investment financing at the local level

A majority of local government investments is financed through state transfers for investment purpose (addressed and targeted subsidies) with matching own financial resources of local governments. Until 1994 local governments covered their own financial share primarily by borrowing from the bank sector (without sovereign guarantee of the central government) and bond issues. Local government had obtained assets in the privatization process.[16] From 1995 onwards, as the central government introduced a cap on local borrowing, local governments have replaced borrowing by asset sales. Local governments have also used the proceeds from asset sales for debt repayment.

In the longer run, the combined effect of the borrowing cap and of the gradual depletion of marketable assets will inevitably limit local investment activities. Unless local governments increase their own revenues and deliver efficiency gains in their operations, their infrastructure development may extensively depend on the central budget. Local investments with high priority (e.g. sewage systems due to the EU accession requirements) may need to be taken over or by the central government, and unfinished high-priority investments will need to be completed from the central budget. Moreover, a shortage of own resources and the lack of ability to co-finance investments would disqualify many local governments from applying for the EU structural funds. The government has estimated that, following its EU accession, Hungary may be eligible for structural funds in the amount of approximately 2 percent of GDP annually. As the lowest

[16] Their assets have included the housing stock initially owned by the state and former local councils, companies established by the former local councils as well as state companies utilizing the land in the territory of municipalities.

co-financing requirement is around 20%, local governments will need to contribute about 0.5 percent of GDP for projects to utilize the structural funds.

The question that Hungary should resolve in the inter-government finance thus has several levels. First the central government needs to reconsider incentives, particularly with respect to the mechanism of budgetary transfers to local governments. Second, the central government needs to improve the mechanism for allocating investment funds to local governments. Third, the central government needs to improve its monitoring of financial management (including asset management) of local governments. And finally, after these steps are completed, the central government should reconsider how to regulate the access of local governments to the financial markets and possibly increase the local government borrowing cap. While any obligations of local governments increase the fiscal risk vis-à-vis the central government, too low a cap on local government borrowing may produce sub-optimal results as well, particularly in during the EU accession process.

THE HEALTH FINANCING LIABILITY

An open-ended state guarantee

As many other European countries, Hungary provides an unlimited state guarantee that all citizens have access to adequate health care. The central government explicitly guarantees that health services are provided even if revenues of the health fund fall behind the planned amount.[17] Data in table 3.6 indicate that in every year since 1992 actual expenditures and the deficit have been above budgeted levels. The guarantee, however, generates moral hazard in the health system, reduces incentives toward cost-reduction and efficiency, and is a source of persistent financial imbalance in the health system.

This problem arises particularly because the shift from tax-based to health insurance-based financing has not been completed, the mechanism for health investment decisions is not transparent, and many structural problems in the health system remain unresolved. Moreover, health care cost is expected to increase rapidly with the political pressure to apply state-of-the-art technology and new medications, and, similarly to pensions, with population aging in the next fifty years. The benefit package guaranteed by the state appears increasingly non-affordable. Coupled with budgetary constraints, financial tensions appear both at the macro and the micro level.

The national Health Fund has continuously run higher-than-expected deficits since its establishment in 1992 and has year after year drawn on additional budgetary resources. On a regular basis, revenues have been falling short of and, more significantly, expenditures have been surpassing the planned amounts. The expenditures of the Health Fund have been mainly driven by higher than expected disability and sick pay

[17] Act 80/1997 on Eligibility of Social Security Services and Private Pension, and Their Financing

expenditures in the first half of the 90s, by increasing pharmaceutical expenses, and by extra wage increases of health sector employees.[18] The continued increase on these fronts has not been off-set by any observable productivity gains, and thus indicates that the current institutional and incentive structures of the health care system are flawed. Table 3.6 shows the budgeted balance and actual deficits of the Health Fund for 1992-97. In addition, hospitals have accumulated a large debt in the past few years, rolled on from one year to another.[19]

Table 3.6 Deficits of the Health Fund 1992-1998

Health Finances	1992		1993		1994		1995		1996		1997		1998	
	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual
Revenues HUF bn	238	235	271	280	336	380	436	423	490	465	521	481	573	574
Expenditures HUF bn	238	257	287	306	336	398	436	445	491	509	525	537	595	621
Deficit HUF bn	0	-22	-17	-26	0	-18	0	-22	-1	-44	-4	-56	-22	-47
Deficit % of GDP	0	0.7	0.0	0.7	0	0.4	0	0.4	0	0.6	0	0.7	0.2	0.5

Source: Ministry of Finance

Policy, institutional and demographic risks

The increasing deficits and arrears in the system can be expected to continue. In absence of any major reform, the present system is not sustainable for three main reasons. First, related to policy, the benefit package is large if at all limited, pharmaceutical expenditures are rapidly increasing, salaries of doctors and other health employees are lower than sustainable while the number of doctors remains very high, and eventually, amortization of health infrastructure will need to be covered. Second, on the institutional front, the responsibility and accountability of the Health Fund are not well defined in operational spending nor are local government obligations clearly articulated in

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[18] According to the national wage agreements, part of the wage increases should be financed through a downward adjustment of the number of employees in the sector. The wage appropriations for the laid-off personnel could be used for wage increase of others. This arrangement has had a limited success for the past few years, hence wage increases resulted in increasing deficits.

[19] With the exception of 1992-93 when the Health Fund deficits have been financed from a special bond issue by the central government and written off by end of each fiscal year. The deficits of the Health Fund have been particularly meaningful since 1997. Until 1997 the social security system employed an opaque cross-financing mechanism. For example, the Health Fund paid for pension contributions of people on child care leave while the pension fund financed health care for disabled under retirement age. Moreover, until 1998, the Health and Pension Funds reported directly to the Parliament and State Audit Office, bypassing the government oversight.

At the end of 1996, the government launched a hospital debt consolidation program. This program required HUF4 bn from the state budget in 1997. Despite the effort to reconcile systemic difficulties at the hospital levels, however, the Final Account for year 1997 indicates that hospitals have accumulated new debt during the same year. The 1998 budget made separate appropriations to cover hospital debt, which can hardly be seen as a one-for-all rescue program.

investment spending. The third problem is demographic. The cost of health care for an individual increases sharply with age. As the share of elderly in the population in Hungary is increasing, the overall health cost will also continue to rise for the foreseeable future.

Assuming that the present policies will continue without increases in pharmaceutical expenditures, wages and investments, we can realistically estimate the annual deficits of the Health Fund to stabilize around 0.7 percent of GDP until 2010. However, if the likely increases on the three accounts (pharmaceuticals, wage and investment) realize, the deficits may be expected around 2.1 percent of GDP by 2010[20]. In this scenario, the net present value of the Health Fund net deficits until 2010 is around 20 percent of the 1997 GDP. [21] For the entire health system, also considering health care revenues other than those collected by the Health Fund, this scenario would imply that deficits will be gradually increasing from about 0.7 percent of GDP in 1997 to 1.9 percent of GDP in 2010.

The Health Fund is mainly in charge of financing the existing arrangements. The Health Fund does not play a significant role either in defining services that are needed and affordable or in selecting efficient providers. This limited role forestalls efficiency of the entire health system. Unlike the Pension Fund, which is just transferring pension benefits of a pre-determined level, the Health Fund could, if it were a real purchaser of services, significantly affect the cost of health care in Hungary.

Indirectly, given its overall health care guarantee, the government also bears the risk that local governments will fail to adequately maintain health facilities they own. While the ownership of health facilities has been with local governments, local governments have to compete for investment funds from the central budget. The allocation of resources for investment, however, does not fully reflect the investment needs. This may cause investment needs to accumulate and health facilities to fail in some localities.

Even though institutional reform in the health system would produce efficiency gains, the demographically and policy-related increases of future health care costs, will inevitably produce increasing government liabilities in the future. Thus, the government needs to incorporate its increasing health liabilities into its medium-term fiscal analysis and consider policy reforms to improve the purchasing function of the Health Fund, harden the budget constraint in health sector, to some extent at least limit the universal benefit package, and enhance the incentives of the public and private agents acting in the health system.

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[20] Depending on the GDP growth rate chosen, the Health Fund's deficit might vary between 2.1-2.5% of GDP by 2010. For reference see Hollo,I. Long,M Papp,A.; Health Care Financing in Hungary (Background paper for Health Financing Conference October 16-17,1998 (Manuscript)

[21] Depending on the discount factor chosen the result varies between 20-23% of the 1997 GDP.

4. MANAGING THE BUDGET AND FISCAL RISKS

During the socialist era, public resources generally were allocated on the basis of multiyear economic plans rather than annual budgets. The principal function of the budget was to implement approved plans[22], not to establish government policies and priorities. During the transformation of the Hungarian economy, central planning has been de-emphasized and budget decisions have become more prominent. During the first years of transition, the budget management system failed to secure aggregate fiscal control and even to provide information about the ways public moneys were spent.

Since 1996-1997 the government had strengthened the role and competence of the Ministry of Finance in economic and public management and established a modern Treasury equipped with advanced information and control systems. Since then the MOF has effectively taken the lead role in fiscal adjustment and the management of the central budget and off-budget government obligations; leading the process of annual budget allocation in coherence with macroeconomic forecasts, overall policy priorities and basic principles of fiscal prudence. The State Treasury has became responsible for budget execution, making all government payments from a single account, controlling ex-ante any such payment against budget appropriations, and recording them in the general ledger. Extrabudgetary funds (other than the social security funds) have been restored to the budget. These steps have limited the scope for overspending and misuse of government funds and—by keeping the cash centrally available at the single account and, thus, reducing public borrowing needs,—have improved the efficiency of government cash management.[23]

Ahead of many European countries, Hungary has been expanding its budget management system to address contingent government liabilities. State budget proposal makes provisions for the main sources of potential financing pressure on the central government (such as individual guarantees or reinsurance extended to various agencies operating on behalf of government). The official 3-year fiscal forecast includes expected outlays on contingent government liabilities. State Debt Management Office reports the full list of state guarantees from a comprehensive database of public liabilities, and reviews the terms of new guarantee contracts. MOF submits to the Parliament reports on the potential cost of both newly considered and existing programs of contingent government support, and audited balance sheets of state-guaranteed agencies. The State Audit Office is authorized to review government activities under both direct spending and contingent support programs, the adequacy of budgetary provisions and reserve funds with respect to risk exposure, and the management of contingent as well as direct explicit liabilities. National Bank of Hungary has expanded its monitoring of potential fiscal risks in the private sector. In inter-government finance and the banking sector, regulatory and

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[22] To a somewhat lesser extent than in other central European countries, but much more than in the OECD community.

[23] For detailed discussion on budget management reforms see Bokros and Dethier, 1998.

enforcement mechanisms have been strengthened to minimize any residual fiscal risks. These measures have effectively limited the government's use of contingent support programs and thus also the government's exposure to off-budget risks.

Initially, it was primarily a political decision to finance the cost of transition, including bank consolidation programs, through the budget and direct public debt, rather than through any special purpose vehicles outside the budgetary system, and to manage government obligations transparently. For the future, it is mainly the principles of transparency and budgetary provisioning for contingent government liabilities in the public finance management system in Hungary, which reduce the likelihood that policymakers would indulge in pursuing partial interests through hidden forms of government support, such as contingent government liabilities and expose the government to major hidden fiscal risks.

An adequate institutional system requires that the government treat any non-cash program involving a contingent fiscal risk like another budgetary or debt item. Most importantly, the system has to make the potential fiscal cost of off-budget programs visible ex ante. Accrual-based budgeting and accounting systems help fiscal discipline but are neither sufficient nor necessary in their entirety. Disclosure of full fiscal information is most critical. Disclosure of face values of contingent government liabilities, also, enables the markets to analyze and measure the fiscal risks and thus, indirectly, assist the government in its risk assessment. Rules on the use of state guarantees and insurance programs, and on the behavior of state-guaranteed and public agencies and subnational governments, are critical.

Fiscal Discipline

In striving for accession to the European Union, the government must be mindful of the impact of current spending commitments on future deficits. MOF has taken an important step by compiling the legal and other commitments that may entail additional expenditure over the next three years. The list is quite detailed and explicit, though yet to be published. It includes the cost of fulfilling pension obligations under pension reform, recent legislation, and the expenditures that may result from political commitments. For policymakers to identify, classify, and understand the full range of fiscal risks is the first condition for fiscal stability.

In 1999, to strengthen future fiscal discipline, the government formalized its medium-term strategy by establishing a fiscal framework for each of the next three years, and included contingent government liabilities in fiscal analysis. The three-year fiscal framework is now required to show more clearly what are the medium-term fiscal implications of government decisions that either involve public expenditures or create a contingent government liability. If done correctly, fiscal analysis thus factors in the cost of implicit subsidies provided by contingent support programs, including the potential future claims on public resources from arrears and other obligations of state- guaranteed and owned institutions.

To minimize future outlays on contingent government liabilities, the government needs to further elaborate its tools, procedures and capacities in analyzing and dealing with risks on program-by-program basis. The existing rules for guarantees, government-guaranteed agencies and other off-budget obligations are effective in limiting the total face value of contingent government liabilities. But the system is weak to minimize the likelihood of contingent government liabilities being called and the size of public outlays required when they are called. Specifically, before the government adopts a program of contingent support, it needs to analyze the attributes of the underlying risks, factors influencing the size of these risks, and the incentive mechanisms of the parties under the program.

On the basis of such analysis, the government can design the program that would still deliver the desired outcomes but minimize the government's risk exposure. The objective would be particularly to expose the government only to those risks that are beyond control of the parties under the program and that would spread the potential cost of the program between the government and the beneficiaries. Under a state guarantee, for instance, the government would identify and cover in the guarantee contract only selected risks and a part rather than whole of the underlying asset. With respect to the autonomous agencies, such as the State Development Bank or Export Import Insurance Company MEHIB, the government should strengthen the financial and managerial accountability of their staffs by remunerating sound risk analysis and early warning signals rather than short-term profits of these agencies.

Strategic Allocations

Much of the budget is allocated on the basis of normative standards that purport to measure service needs. Approximately one quarter of central government expenditure are in the form of grants to local governments, and more than 75 percent of these grants are formula-based. Thus, a community's population strongly influences the number of hospital beds budgeted for it, the number of beds determine staffing levels, staff size determines the amounts granted by the central government to localities. Normative allocations have several advantages: they simplify formulation and implementation of the budget; they reduce the need for information on program impacts and service needs. When budget shares are decided by formula rather than through political negotiation, conflict is abated and decisions can be taken expeditiously.

But normative rules rigidify budget allocations, weaken the capacity of the government to allocate on the basis of its strategic objectives and priorities, and complicate the task of fiscal adjustment. The normative rules have the effect of creating entitlements, propping up spending and employment levels, generating diseconomies of scale, and reducing the government's ability and willingness to reallocate across sectors or local governments in accord with its assessment of need and on the basis of evidence on program effectiveness. Normative allocations tend to rigidify over time, as beneficiaries mobilize to protect their budget shares. The formulas devised for one set of

governmental conditions still are used when needs and priorities change. Reallocation, which is hard to do under normal budget conditions can be virtually impossible when the funds are parceled out under old formulas. In Hungary, the government compensates for normative grants by distributing supplemental funds to local governments on the basis of its priorities rather than preset rules.

Inasmuch as budget allocations also the programs of contingent government support in Hungary tend to reflect bottom-up norms and pressures rather than clearly relate to policy priorities and specific results. A guarantee extended on credit taken by Postabank or the State Railways, for instance, tends to be a result of "emergency" and eminent political pressure rather than a strategic decision to support certain outcomes at a given price and to expose these institutions to hard budget constraint. Particularly when programs of contingent support are discussed separately from the budget process, the government may end up pursuing objectives of lower priority through potentially expensive guarantees, after it had made cuts that endanger delivery of services and outcomes of a higher priority in the budget.

The government has made initial steps toward linking its expenditure decisions with the cost of delivering specific services and accomplishing specific policy objectives. This is the direction of institutional development, which has been implemented in the EU countries and, also, which would facilitate Hungary's spending choices in the EU accession process. In an improved system, the Cabinet and Parliament would define the inter-sectoral priorities, the Ministry of Finance would set sectoral ceilings on budget allocations and contingent support programs to reflect the priorities, and line ministries would receive more control to determine the spending and contingent support programs in their sectors. To truly compare the expected cost of government support across sectors with the inter-sectoral priorities, the ceilings on spending and guarantees and other contingent support program would be added up for each sector.

Ideally each sector would be subject to a single ceiling that would include both budgetary expenditures and the expected outlays on guarantees and other contingent support programs in the sector. The ceiling would thus apply to the expected cost of all government activities in the sector. For guarantees and other contingent government liabilities, the ceiling would have to reflect the net present value of their future expected cost. The sector ministry could decide on the mix of direct and contingent support programs. The contingent support programs, however, would be subject to risk assessment and approval by the Ministry of Finance and the Debt Management Office. When approved, guarantees and other contingent support programs would still be issued through the Ministry of Finance. The net value of the expected future cost would be deducted from the sector ministry's budget allocation and transferred to a central contingency reserve fund, which would exclusively serve to cover government obligations ensuing from the approved and reported contingent government liabilities.

Such budgeting mechanism creates disincentive to use forms of contingent government support excessively. Contingent government liabilities create uncertainty in

the future public financing requirement, which has a negative value particularly if the government of Hungary cannot yet fully rely on unlimited favorable access to borrowing and good risk management capacities, and if it has low risk preference.[24] The Treasury would be best placed to manage the contingency reserve funds. In the medium-term framework, the annual ceilings, mix of direct and contingent support programs and the reserve funds would be set for 3 years ahead.

To improve financial and managerial accountability, financial information on inputs (wages and material cost) available through the Treasury would be complemented by information on cost and results of government programs. Improved accountability would, in turn, allow the introduction of performance-based contracts in the civil service and managerial freedom in delivery of government services. To further enhance the quality of information needed for public finance performance management, the government would gradually accept accrual accounting standards and produce balance sheet including commitments, fiscal risks, assets and liabilities, and contingent liabilities in its reports. A well-developed budget system, with procedures for establishing programs, bidding for resources, and assessing results will be a necessary condition for switching from normative grants to discretionary allocations.

Operational Efficiency

Not only do normative rules impede reallocations, they also diminish the incentive of central government agencies, funds and local governments to be efficient in their activities, and make it more difficult to rationalize the provision of government services and reduce the size of public employment. Hungary's very large public work force strongly indicates the embedded inefficiency of public services. One out of every four workers is employed in the public sector, particularly in education and health sectors, in which the normative rules tend to stiffen overstaffing and underpayment. It appears that the government has been more willing to restrain pay than to take the hard decisions on shrinking the public services. This and similar dilemmas would be mitigated by the intended move toward a more performance-oriented public management system, in which allocations are based on relative costs and the recipient's results.

The move toward a performance-oriented public management system that would link budget allocations with government results would create incentives in government agencies to improve their operational efficiency and thus most likely produce savings in the amount of government employment and in the total wage bill. Improved incentives can, however, deliver better efficiency only if the government strengthen managerial skills in departments, introduce systems of internal control, and identify and measure outputs well. In view of the importance of local governments in delivering services, it is important that managerial improvements extend to them as well. Although fiscal

[24] Reserve funds partly reduce the potential harm when contingent liabilities fall due, but raise other problems. Therefore, volatility in the financing requirement and impact on the overall government risk exposure should be considered in the design of government programs.

decentralization and the prominence of normative grants have weakened the central government's capacity to dictate local management, the central government should use its leverage as the main source of local revenues to prod them to improve efficiency, prune employment levels, and budget on the basis of performance.

Aside from the rules, it is above all the capacities required particularly on the side of the Ministry of Finance, State Treasury, State Audit Office and, also, line ministries to identify, analyze, manage and prevent risks. The government must be able compare the cost of a subsidy with the expected cost of a guarantee or other form of government support in order to choose the most efficient program to deliver the desired policy support. For example, ad hoc credit guarantees are not likely to be the most efficient form of government support to a permanently loss-making enterprise like the State Railways. In addition, programs of contingent government support, such as guarantees, to deliver the desired outcomes while minimizing its future fiscal cost, require the expertise and skills of risk analysts and financial managers rather than civil servants to be prepared and administered well. For instance, the guarantee contract has to emerge from a good qualitative and quantitative analysis of the underlying risks and outline an efficient mechanism for risk sharing between the government and the covered parties.

Summary of Measures To Reduce Fiscal Risks

Table 4.1 lists ***systemic measures*** to promote understanding of fiscal risks by policymakers, the public and markets. Table 4.2 summarizes specific ***steps to control fiscal risks on a program by program basis.***

Table 4.1 Systemic measures

Fiscal Policy	Public Finance Institutions
• consider full fiscal performance beyond the budget and debt • identify, classify and analyze all fiscal risks in a single portfolio • determine the government's optimal risk exposure and reserve policy according to its risk preference and risk management capacity	• cover the sources of all potential public outlays • apply a joint ceiling on the expected cost of contingent and direct programs in each sector • disclose the full fiscal picture, beyond the budget and debt • monitor, regulate and enforce disclosure of risks in the public and private sectors

Table 4.2 Measures for individual programs

Fiscal Policy	Public Finance Institutions
Before accepting • assess how the fit with policies • consider financial risks • announce the program limits so to minimize moral hazard	***Before accepting*** • evaluate the risks, estimate the potential fiscal cost, and set additional reserve requirement • design the program well to minimize government risk • design hedging strategy
When accepted • stick to the pre-set limits	***When accepted*** • budget, account and disclose the risk • transfer additional funds to the reserve fund • monitor the risk factors and reserve adequacy • regularly adjust hedging strategy
When to be executed • execute within the pre-set limits • if implicit, assess the fit with policy priorities and desired market behaviors	***When to be executed*** • compare and report the actual fiscal cost versus the estimates, evaluate performance and punish for failures

5. SUMMARY OF FISCAL PRESSURES AND NEXT STEPS

The Government of Hungary has contained the major fiscal risks of transition. Particularly, it paid-off and resolved most problems in the banking and enterprise sectors. Clearly, since 1995 the Government has implemented fiscal adjustment with the objective of long-term fiscal stability rather than immediate deficit target. The pension reform has been the main result of this approach, raising temporary deficits but reducing the long-term public pension liability. A single sector awaiting for reform in order to protect future fiscal stability is the health sector. Although the levels of government spending, budget deficits, and public service have remained high, the government has made significant progress in rationalizing public expenditures and improving the management of budget and off-budget fiscal risks.

In the process of transition, the government has been taking on new fiscal risks. These mainly include state guarantees, and growing programs of credit and guarantee agencies operating on government behalf to support industries first and exporters more recently, following privatization. The government has dealt with these new programs of contingent government support in a prudent and transparent manner. Ceilings on and reporting of the risks have been reasonable. Similarly, the normative pension guarantee

applied in the process of the pension reform is unlikely to pose major threat to future fiscal stability.

In the years ahead, however, Hungary is likely to face pressure for additional spending, as the implications of the recent turmoils in the financial markets surface, pressure grows to improve various services and as population ages. Table 5.1 offers estimates of the main fiscal pressures in the medium-favorable scenario.

Table 5.1 Estimating pressures on state budget (% of GDP)

	1999	2000	2001
Health deficit	0.7	0.7	0.7
Pension PAYG deficit	0.3	0.3	0.3
EU requirements*	1.7	1.7	1.7
Local government claims	0.05	0.05	0.05
State guarantees	0.3	0.25	0.25
MEHIB	0.08	0.03	0.02
Eximbank	0.03	0.02	0.01
State Development Bank	0.02	0.02	0.02
Credit Guarantee Fund	0.01	0.03	0.01
Rural Credit Guar. Fund	0.01	0.01	0.01
Total	**3.2**	**3.1**	**3.1**

* Conservative estimate for annual additional investment requirement to meet EU environmental standards in a 20 year period.

The objective of EU accession makes future fiscal stability rather than temporary deficit reduction increasingly important. Thus, in establishing its agenda for the future, the government should concentrate on reducing the remaining fiscal risks of its policies and on building institutional capacities to deal with risks in the future. On the policy front, health financing reform, continued check on hidden subsidies provided through guarantee programs, and determining the government's optimal risk exposure are the priorities.

On the institutional front, the aim should be for a more flexible and responsive budget process, in which the government has enhanced capacity to maintain fiscal discipline outside as well as within the budget, prioritize allocations of public resources and risk, and promote efficiency in central and local government operations. Particularly, the government may wish to build its capacities to analyze fiscal risks in the medium-term fiscal framework, build a more result oriented budget management system, and enhance the mechanisms of sharing risk between the public and private sectors under government programs.

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7. ANNEX

PUBLIC LIABILITIES: HOW BIG A PROBLEM IN HUNGARY?

A Set of Questions

The whole picture: coverage

1. What are the major risks to future fiscal stability? Fill the table below with specific items.
   These include direct borrowing, guarantees, institutions that are covered by some type of government guarantee, state insurance programs, and all government commitments to spend or intervene financially in the future. In the classification think of direct liabilities (which are considered an obligation of the government in any event) and contingent liabilities (which will be considered an obligation of the government if a particular event occurs), each of which can be either explicit (defined by a law or contracts) or implicit (broadly pre-determined by public expectations and pressures by interest groups).

Liabilities	***Direct*** (obligation in any event)	***Contingent*** (obligation if a particular event occurs)
Explicit Government liability as recognized by a law or contract	• foreign and domestic sovereign borrowing (loans contracted and securities issued by central government) • expenditures by budget law • budget expenditures legally binding in the long-term (civil service salaries, civil service pensions)	• state guarantees for non-sovereign borrowing and obligations issued to subnational governments and public and private sector entities (development banks) • umbrella state guarantees for various types of loans (mortgage loans, student loans, agriculture loans, small business loans) • trade and exchange rate guarantees issued by the state • guarantees on borrowing by a foreign sovereign state • state guarantees on private investments • state insurance schemes (deposit insurance, minimum returns from private pension funds, crop insurance, flood insurance, war-risk insurance)
Implicit A "moral" obligation of Government which mainly reflects public expectations and pressures by interest groups	• future recurrent cost of public investment projects • future public pensions (as opposed to civil service pensions) if not required by law • social security schemes if not required by law • future health care financing if not specified by law	• default of a subnational government, and public or private entity on non-guaranteed debt and other liabilities • liability clean-up in entities under privatization • banking failure (support beyond state insurance) • investment failure of a non-guaranteed pension fund, employment fund, or social security fund (social protection of small investors) • default of central bank on its obligations (foreign exchange contracts, currency defense, balance of payment stability) • bail-outs following a reversal in private capital flows • residual environmental damage, disaster relief, military financing, ...

The liabilities listed above refer to the fiscal authorities, not the central bank.

2. Is there a precise legal delineation of the public sector (for example in the form of a full list of public sector agencies) and government responsibilities?
If yes, note the definition and/or reference to appropriate legal documents.

Selected risks

1. State-guaranteed institutions and directed credit

   - List all institutions that fulfill orders of government to extend financing to enterprises, banks, agencies of any kind, or households. Provide their balance sheets and statements of contingent liabilities.

   - What type of government support do these institutions receive? (for example, privatization revenues, cheap financing via central bank, state guarantee on borrowings)
     Try to draw a diagram showing the institutions involved in directed credit and the financial and cross-supporting flows.

2. Guarantees

   - List all government guarantees, their issuer (the MOF versus another government agency) beneficiaries, creditors, face values, the type of risks and their shares covered, currency of denomination, risk estimates if any.

3. State-owned enterprises and banks

   - List all large state-owned enterprises and provide their audited balance sheets and statements of contingent liabilities.

   - List all large state owned banks and provide their audited balance sheets, statements of contingent liabilities, and risk-assessment of assets.

Recording and reporting: transparency

1. For each type of direct and contingent liabilities you identified in the table above, register the institutions responsible for final approval, recording, monitoring, and data consolidation.

2. Which institutions can instantaneously retrieve from their databases up-to-date figures of the items listed below. Which documents report such figures? What is the time lag in reporting?

   - sovereign debt portfolio (breakdown according to maturities, currencies and interest-rate types)
   - debt service profile for the next months and years
   - guarantee portfolio (breakdown according to guaranteed institutions, sectors, currencies)
   - the total face value of all state guarantees

- the total sizes of state insurance schemes
- the total sizes of reserve funds associated with guarantees and state insurance schemes
- private foreign and domestic borrowing
- sector allocation of foreign credit

3. Which sources of fiscal risks are, according to your view, *not* reported to:
   - Ministry of Finance
   - Cabinet
   - central bank
   - Parliament
   - foreign investors
   - public

Institutional arrangements: accountability

1. Are there any legal requirements on the government to estimate, account and report the *future* fiscal costs associated with its budgetary policies and off-budget promises (such as guarantees and other contingent liabilities)?

   No

   Yes - in the budget process
   when the government is called to pay
   when cash is transferred
   other:

2. Which of the liabilities that you identified in the table are *not* regulated by any law and depend fully on ad hoc government decisions?

3. Describe or provide references for:

   - state guarantees: the requirements for their design (the type of risks allowed to be covered, the extent of required risk-sharing), issuance (only the MOF is authorized?), government control mechanism (required reports from the creditor and beneficiary, audit and valuation requirements), and realization mechanism if they fall due.

   - subnational governments, public sector agencies and enterprises, and state-guaranteed institutions: the financial management and reporting requirements and government control mechanism.

   - demands on government to extend an ad hoc, previously unforeseen financial support: the legal requirements and practice for the deliberation process in government decision making.

4. Is the government legally required to explain the amounts of public liabilities?

No

Yes - to the Parliament
to the public
other:

Policy: practice

1. When considering alternative policy choices and forms of government support (such as direct provision and financing versus guarantees), do the Ministry of Finance, Cabinet, central bank or Parliament:
   - quantify the future fiscal cost of alternative options in a single medium-term fiscal framework?
   - describe the risks of alternative options?

2. As it appears, in which areas and under what circumstances is the government expected by the public or by interest groups to provide financial support beyond the budget?

3. List examples when government withstood political pressure and did *not* provide financial support above the budgeted figures? (For example, when the government refused to solicit financial support for a failed enterprise or bank.)

4. Are public enterprises and banks, state-guaranteed institutions, and creditors/beneficiaries under state guarantees "rewarded" and "punished" according to their management of risks?
   Provide examples.

Risk management: capacities

1. Describe the capacities of the MOF, other government agencies, public sector institutions and enterprises, and state-guaranteed institution to evaluate and control the risks of government programs and contingent liabilities.

2. Describe the process of designing a state guarantee or state insurance program.

3. How is the required size of the government reserve fund pre-determined?

4. What steps does the MOF and other agencies undertake to *prevent* fiscal risks arising from the public and private sectors? (For example, are any actions taken if enterprise debt or central bank obligations appear to high?)

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