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Ludovit Odor and Gábor P. Kiss[1]: The exception proves the rule? Fiscal rules in the Visegrád countries*

This article gives an overview of the national fiscal rules in force or recommended for introduction in the Visegrád countries. In the article, we review the various potential elements of the regulation framework, in particular the debt rule as a limit, the balance target, the expenditure rule as an instrument and the fiscal council as a supporting entity for the entire framework. We establish on the one hand that the more a rule covers the scope of fiscal policy, the more effective it becomes. On the other hand, it is highlighted that filtering out the effect of exogenous factors – such as the economic cycle – is also important in ensuring that the rules restrict fiscal policy in such a way as to simultaneously prevent procyclical measures. The difficulty resides in the fact that the effects of exogenous factors and fiscal policy are difficult to distinguish. Resolving this issue may be one of the tasks of the fiscal council.

INTRODUCTION

Adequate fiscal institutions, such as fiscal rules, fiscal councils and procedural rules can significantly contribute to the success of national fiscal policies. Fiscal rules encompass the quantitative requirements for debt, deficit or expenditures that apply to certain parts or the entire general government. Defining a fiscal council is a more difficult task, as this may fulfil several functions.[2] Procedural budgetary rules govern the preparation, approval and execution of the budget act. This article primarily deals with the former two topics.

These topics are all the more relevant now as the budgetary frameworks of the Member States have come under particular scrutiny in the European Union's package of economic governance legislative proposals. The package of reforms stresses, in particular, the importance of surveillance, and thus the role of independent analysis carried out by bodies endowed with functional autonomy and the role of cash-flow data. It recommends the preparation of projections for each major expenditure and revenue item for the budget year and beyond based on unchanged policies. The operation of general government bodies and funds which do not form part of the regular budgets should be given particular consideration, because public finances should be comprehensively covered by the budgetary frameworks. At the same time, it calls for a solution that would prevent a procyclical fiscal policy. This means that ideal fiscal rule would be able to distinguish between the deficit-increasing impacts of exogenous factors (economic downturn) and those of fiscal loosening. No corrective measures would be required in the former case, while consoslidation efforts would be needed in the latter case. It recommends that consequences in the event of non-compliance should be applied, which, in practice, could mean the automatic application of deficit-reducing measures.

The first section of this article presents the characteristics of the Visegrád countries and their fiscal rules. We then continue with the issue of the debt limit. Subsequently, we examine the annual balance targets, followed by the requirements setting the growth rate of expenditures, which could be an instrument for achieving the balance targets. Finally, we review the possible functions of a fiscal council. In closing, we draw our conclusions.

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* The views expressed in this article are those of the author(s) and do not necessarily reflect the offical view ot the Magyar Nemzeti Bank.

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[2] A literary review of the role of independent fiscal agencies can be found in the Debrun et al. (2009). For a discussion of the possible roles of fiscal councils, see Calmfors and Wren-Lewis (2011).

CHARACTERISTICS OF THE VISEGRÁD COUNTRIES

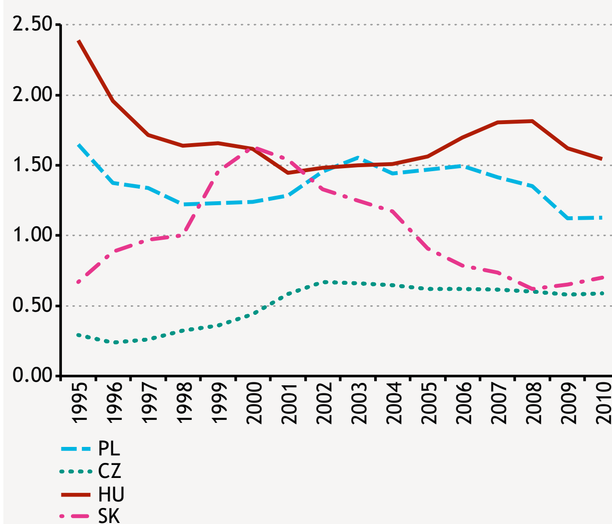
The Videgrád countries – the Czech Republic, Hungary, Poland and Slovakia – have several interrelated common features (for more information, see Odor, 2011).

- Higher macroeconomic volatility compared to more developed countries, i.e. higher GDP fluctuation.
- This is partly the result of "stop-go" cycles of fiscal policy, which lead to stronger fluctuations in the deficit in comparison to developed countries.
- Substantial current account deficits and greater dependence on inflows of foreign direct investment (FDI).
- Lower tax potential, caused, in addition to the openness of the economy, by higher tax evasion.
- Public expenditure pressures are also higher, stemming from lower fixed capital levels, labour market problems and the constant lack of resources for certain state functions.
- Widespread corruption and less effective enforcement of compliance with laws.

One apparently common feature is the low level of public debt and higher growth potential. From the perspective of our subject, it is worth examining whether the above apply to all four countries.

- Debt as a percentage of GDP is close to the EU average only in the case of Hungary and is significantly lower in the other three countries.
- The situation is somewhat different, however, if we take into account differences in development levels. These differences must be taken into consideration as the level of debt that foreign investors are willing to finance is higher in more developed countries.[3] If we adjust the level of debt in the Visegrád countries by the size of gap in GDP compared to the EU average measured at purchasing power parity (Chart 2), the debt of Hungary and Poland soars above the average (Chart 1).[4] Hungary's debt – adjusted by its level of development – has been elevated in a regional comparison ever since the regime change. By contrast, Slovakia's initial level of debt was significantly lower. During the economic transformation, hidden debts (such as public companies and financial institutions) appeared on the one part, but were offset by revenues from the privatisation of state assets. The debt dynamics of the past decade, however, have primarily been determined by the "stop-go" cycles of fiscal policy.

Chart 1
Relative indebtedness adjusted by relative development
(EU average = 1)



Source: calculations on the basis of Eurostat data.

- Compared to the EU average, GDP trends measured at purchasing power parity were also quite divergent among the Visegrád countries (Chart 2). In the second half of the 1990s, the privatisation of state assets and the inflow of FDI were determining factors, while in the 2000s Hungary was also characterised by "stop-go" cycles. Moreover, the role of labour market and financing conditions (the credit boom and its reversal) also became key factors. Since the crisis, the growth potential of certain countries compared to their more developed peers has become less obvious. Although an overall trend of convergence characterises relatively homogenous economic areas[5] (faster growth in less developed countries), this trend is not automatic (see the case of Greece) and depends on economic policy. Economic convergence may represent a key factor in curbing the public debt-to-GDP ratio (for example Slovakia in the 2000s).

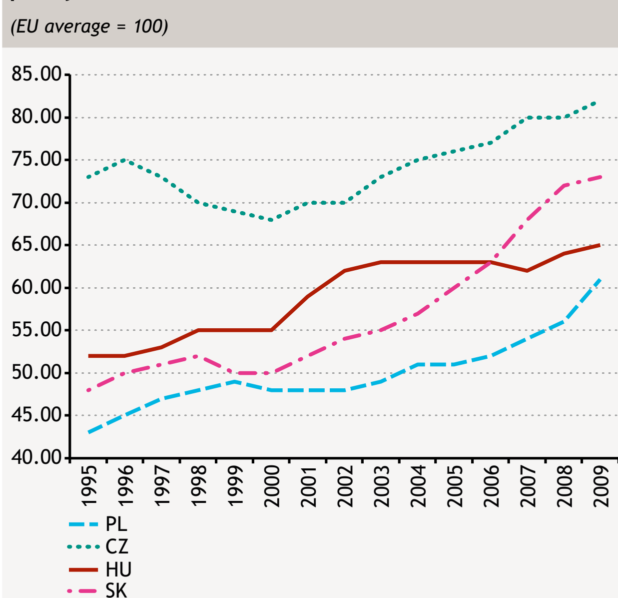
[3] Efficiently used resources (such as infrastructure investments) can in principle affect the level of development, so this represents a possible correlation between debt and development.

[4] To calculate relative indebtedness, we divided the debt compared to the EU average by GDP compared to the EU average, measured at purchasing power parity.

[5] For a summary, see Acemoglu (2008) for instance.

Chart 2
Relative development compared to the EU average expressed in GDP calculated at purchasing power parity

(EU average = 100)



Source: Eurostat.

It is an interesting contradiction that while the Visegrád region is broadly characterised by relatively high levels of deficit, at the same time voters and companies alike consider public debt to be a serious issue.[6] This may be due to the low fiscal transparency that allows deficits to increase prior to elections. Fiscal loosening is not reflected in the increase of budget appropriations in certain cases, rendered possible by the optimistic planning of revenues, while in other cases, expenditures can be temporarily concealed by creative accounting. An example of the latter is temporarily cutting back subsidies to public companies, and after elections assuming the debt which simultaneously increases the deficit. Poor transparency thus often leads to wrong motives (Horvath and Odor, 2009). The other factor behind concerns about public debt and tolerance for high deficits maybe the heterogeneity of voters. Although voters may be aware of the fact that an unsustainably high deficit may require adjustment, they may be hoping that other social groups will bear the burden thereof.[7]

Just like voters, debt-funding financial markets are also ineffective in disciplining fiscal policy in time. As a result, this may take place too late and so radically that it may give rise to a liquidity crisis, jeopardising the renewal of maturing debt.[8]

In principle, fiscal policy may also be regulated by international organisations. The EU's supervisory role is somewhat stronger within the euro area than in member states not included in the monetary union. However, as the EU's set of regulations focuses primarily on current years, it fails to adequately regulate forms of creative accounting that push the costs generated by government decisions (public private partnership investments) forward in time, or retroactively deteriorate the previous period's budget. International organisations (such as the International Monetary Fund or the new European Stability Mechanism [ESM] within the euro area) could in principle exercise much greater control if they would grant credit subject to certain criteria. If necessary, they could even define fiscal criteria in a way that would effectively counteract creative accounting. The problem, however, is that these could only be enforced at a late stage, when borrowing has already become critical, due to lack of confidence on the market.

FISCAL RULES AND FISCAL COUNCILS IN THE VISEGRÁD REGION

Due to deficits that are characterised by peaks from time to time, fiscal rules have been or are currently being introduced in several countries in the region, representing a form of fiscal self-restraint. On a similar note, fiscal councils have also been set up or will be set up in the future, which may bolster the efficiency and credibility of self-restraint. In the following section, we take a look at the Visegrád countries one by one.

In **Poland,** the fiscal regulation governing debt – incorporated in the constitution – has been in place since 1997, restricting the debt calculated on the basis of the national methodology at 60% of GDP.[9] The act on public finances complemented this with several provisions. For one, it introduced protective

[6] According to KPMG's (2010) survey, 75% of Czech and Slovakian senior corporate decision-makers were deeply or exceptionally concerned by the level of public debt, the highest rate among the 26 countries examined. Poland ranks eleventh on this list, while Hungary ranks eighteenth. In the Czech Republic and Hungary, 90% of citizens considered public debt to be the greatest threat (Nézőpont Intézet, 2011; Ipsos Tambor, 2010). In Poland, less than 50% of voters would support an increase of the constitutional debt limit (GfK Polonia, commissioned by Rzeczpospolitej, 2010).

[7] Although a different indicator, agreeing with the statement "People can only get rich at the expense of others" suggests a similar mentality. Compared to the average of a sample of 50 countries, people in Poland ranked average whereas Hungarians scored far above average (World Values Survey Association, 2009).

[8] Hauner and Kumar (2006), and Balassone et al. (2006) demonstrated that interest rates and credit ratings generally represented low costs for governments.

[9] The National Road Fund, for instance, forming part of the general government according to the National Accounts, falls outside of its scope. This presented a loophole in the rule.

bands of 50% and 55%. There is no escape clause in the event that the ceiling is breached.

If debt exceeds the 50% ceiling (which occurred in 2003 and 2010), a budgetary act ensuring that the revenue level of the subsequent second year's budget will not decrease must be adopted in the following year.

Breaching the 55% debt ceiling triggers significantly more severe measures:

- A budgetary act ensuring that the subsequent second year's budget will be a zero-deficit budget must be adopted in the following year.

- Expenditures of budgetary units may only exceed revenues if they are EU-funded expenditures.

- Public wages are frozen, pensions are only indexed to inflation (instead of 20% of real wage indexation), and budgetary lending is entirely prohibited.

- The government reviews expenditure programmes implemented through foreign credit, and prepares long-term programmes and consolidation programmes.

Breach of the 60% constitutional limit imposes a restriction on budgetary units, the expenditures of which may not exceed their revenues, and public sector guarantees are prohibited. In this case, the government must prepare a consolidation programme with measures aimed at bringing the debt below the 60% ceiling.

Separate rules set out in the act on public finances apply to local governments. First, their debt may not exceed 60% of their revenues, and second, their debt service expenditures (interest plus instalments) may not exceed 15% of their revenues. As there is no protective band for these limits, the restrictions only take effect if the values are breached, allowing ample leeway until then, just like in 2009 and 2010.

The public finances act also introduced a rule governing expenditure in 2011, which will remain in force as long as Poland is included in the EU's excessive deficit procedure (EDP). This rule only allows discretionary budgetary expenditures (approx. 5% of GDP) to amount to 1% of real annual growth. Interest expenditure, EU payments, road construction and maintenance, long-term projects, EU-funded projects and defence expenditures are all classified as non-discretionary items.

Hungary incorporated a rule into its act on local governments in 1996, setting adjusted own revenues as the ceiling for its annual commitments generating local government debt (loans and contributions, bond issues, guarantees and leases). Adjusted own revenues are 70% of planned annual own revenues minus the amount of short-term liabilities (capital and interest repayment, lease fees) due that year. Similarly to the Polish rule, there is no protective band, and thus it only becomes effective once the limit is breached, leaving ample leeway until that point.[10] A major advantage of the rule is that it restricts not only credit-type expenditures, but also the guaranties substituting them (such as for the debt of local government companies) and lease fees (and thus public private partnerships as well).

Regarding the central budget, the act on fiscal responsibility was adopted in 2008 (for an assessment of the act, see Baksay and P. Kiss, 2009) restricting the expansion of debt by deducing deficit targets in a forward-looking manner from real debt. The above were complemented with expenditure and procedural rules (compulsory compensation, PAYGO). Transparency was improved by including public private partnerships and public companies into the applied deficit indicator. (The latter was removed from the scope of the act in 2010, before it entered into force.) A three-member fiscal council was set up, the first in the region, assisted by forty economists. In 2011, the council was radically restructured. The President of the State Audit Office of Hungary and the Governor of the Magyar Nemzeti Bank became members, and the head of the council was appointed by the President of the Republic. The team of experts assigned to the council was dissolved; members now rely on their own institutions for support.

The constitution adopted in 2011 defined a 50% limit on the central budget's debt. As the debt currently stands much higher than this, the constitution declares that until the target is reached, the Parliament may only adopt a central budget act that prescribes the reduction of public debt measured in proportion to total GDP. In order to ensure compliance with the above, the preliminary approval of the fiscal council is required for the adoption of the central budget act, essentially granting it a right of veto. Divergences from the debt rule are only permitted in the event of an exceptional legal order, only to the extent required to mitigate the circumstances having triggered it, or to the extent required to restore balance in the event of a prolonged and substantial downturn in the national economy. The constitution aims to restrict local government indebtedness by requiring approval by the government for

[10] Following the debt wave of 2007, debt could increase by another 2-2.5 fold according to estimates (Homolya and Szigel, 2008).

those financial obligations of local governments which exceed a limit stipulated by law.

In **Slovakia,** expenditures within the central budget may only increase by 1% (nominally), if revenues exceed the appropriation. The main objective of this rule is to enforce adjustment during times of economic expansion. A sort of golden rule applies to local governments, only allowing them to become indebted up to the extent of investments. Over and above this amount, local government debt may not exceed 60% of the previous year's current revenues, and debt service may not exceed 25% of current revenues. There is no fiscal council; there is, however, a committee in charge of issuing macroeconomic forecasts and another one responsible for issuing tax forecasts, made up of independent experts and analysts, in order to define the foundations for the budget's tax revenues. It is their task to form and officially assess the forecasts made by the Ministry of Finance.

Slovakia is currently preparing to adopt an act on fiscal responsibility. The concept places emphasis on net worth and plans to introduce several types of fiscal rules.[11] The new fiscal framework would be supervised by an independent fiscal council funded by the central bank. Its responsibilities would primarily include the evaluation of compliance with fiscal rules, the preparation of long-term generational accounting and assessing the impacts of draft legislation.

Among the planned fiscal rules, the new debt limit, expenditure rules and the amendment of the rules governing local governments deserve mention. The debt limit would apply to the debt defined in the gross statistical sense and would be paired with protective bands. The protective bands would become activated 10 percentage points below the ceiling, and would trigger stricter measures for every 2-3 percentage points. The expenditure rule would include the entire public sector (including public companies), with the exception of local governments, and would take into account tax expenditures. It would not apply, however, to European Union funds, interest expenditures and fluctuations stemming from the economic cycle. The value of the expenditure ceilings would be derived from the trajectory of the sustainability indicator planned by the government for the upcoming four years. As a result, the rule would treat long-term structural measures (such as pension reforms) and immediate balance adjustments identically. Local government rules, however, would be amended by the addition of protective bands under the debt limits, the broadening of the definition of debt (public private partnerships), and making bankruptcy proceedings more stringent.

The **Czech Republic** introduced its local government rule in 1998, according to which debt service expenditures (repayment and interest) may not exceed 30% of current revenues. However, there is no fiscal rule or fiscal council regulating the central budget, with only some general concepts regarding their formation.

The above illustrates the diversity of the fiscal frameworks among the Visegrád countries. The various elements, however, may be correlated, as reflected by the EU's most recent recommendations. In addition to the function of a debt limit, the budget balance may fulfil the role of an operational target. The expenditure rule can in turn act as an instrument for achieving the target, and the fiscal council may support the entire regulatory framework. The remaining part of this article discusses these four elements (debt, the budget balance, the expenditure rule and the fiscal council).

DEBT AS A LIMIT

The debt rule applies to the level of debt. In this sense, it can be regarded as a limit, because a fiscal trajectory – as an operational target – cannot be deduced from it.[12] The scope of debt included under the debt rule bears primary importance from the perspective of the rule's efficiency. One of the dimensions of this aspect is the coverage of entities falling within the scope of the rule.

- The EU's debt criteria[13] applies to the government sector defined in the statistical sense, comprised of the central government (budget, social security), local governments and part of the public companies included in the government sector.

[11] The concept of net value, or net worth, examines the state balance sheet. The state has its own specific assets and liabilities, so it is often the case that estimates can only be made regarding changes therein, rather than their volume. Examples of such assets are real assets, natural and environmental assets or taxation potential. Examples of such liabilities are contingent liabilities or the net present value of future public social expenditures. (For details, see for instance Buiter, 1993; Odor, 2011).

[12] The Hungarian real debt rule only resembles other debt rules in name, as, contrary to these, it does not define the level of debt, but can instead be used for determining deficit targets. As an ex ante rule, it is based on the notion that debt, taken at real value, should not increase, which essentially means that a deficit target ensuring an inflation-adjusted (operational) balance of zero must be defined. In other words, the deficit target must correspond to the expected level of inflationary compensation included in interest (Baksay and P.Kiss, 2009).

[13] The EU's new economic governance package also formulates a recommendation for the pace of debt reduction. The new rule, however, treats the debt criteria as a target approached from above, which is a weakness of the recommendation in our view.

- Rules adopted on a national level apply to the subsectors defined in a legal sense, rather than a statistical one. Local governments are generally governed by a different set of rules.[14] The central government applies to the entities included under the scope of the annual budget act. From this perspective, the inclusion of public companies can have a significant impact, as the effect of quasi-fiscal expenditures not covered by revenue appears automatically, irrespective of whether they are continuously covered by the budget or whether it assumes corporate debt subsequently (e.g. the United Kingdom).

The other dimension of the rule's scope is how it defines debt categories.

- The EU's criterion applies to gross debt, i.e. liabilities based on a creditor/debtor relationship. The current debt rules in the Visegrád countries also apply this definition.

- Certain national rules (e.g. in the United Kingdom) apply to the net debt, that is the balance of financial liabilities and assets (such as deposits) based on a creditor/debtor relationship. This presents the advantage of the effect of deposit accumulation or utilisation remaining neutral from the perspective of compliance with the rule.

- National rules may also diverge from the financial items based on a creditor/debtor relationship. One possibility is that the national rule covers all financial liabilities and assets. The obstacle, however, is that state-owned assets are often unmarketable, and thus their valuation is unreliable. The other possibility is that it instead includes the items over and above financial liabilities, which bear greater significance from the perspective of creative accounting, such as the liabilities stemming from fixed assets generated with the inclusion of private capital (public private partnerships). These liabilities, by outsourcing public investments, temporarily improve both debt levels and the balance, and this effect is only reversed after an extended period. The inclusion of public private partnerships in debt eliminates the initial debt-improving effect.

Debt is a stock indicator reflecting the cumulated impact of past deficits. Its advantages and drawbacks both stem from its nature of reflecting stocks.

- Its advantage is that it contains the costs of creative accounting, albeit with a delay, i.e. it is less prone to distortion than the annual budget balance. If, for example, losses made by the railway company are not covered for several years and are subsequently recognised in one lump-sum capital transfer, this expenditure will only deteriorate a single year and then phase out. By contrast, the expenditure has a permanent effect on the level of debt; consequently, in the case of a debt rule, creative accounting will have a consequence, even if it is delayed. The immediate (real time) effect of creative accounting would be captured if the definition of debt would also be extended to public companies and public private partnership debts. The advantage of real time recognition of debt would be that the debt rule could thus restrain the fluctuations of the "stop-go" cycle, as it would not allow expenditures to be pushed forward in time until after elections.

- Its drawback is that it is far more sensitive to fluctuations in the economic cycle than the balance. On the one hand, the cyclical impact affecting annual fiscal balances appears in a cumulated form in the nominal debt. On the other hand, the economic cycle also exerts an effect through the denominator (GDP), which increases in function of the debt-to-GDP ratio.

- Its drawback is that debt is not only affected by the budget balance, but also by the effect of financing (privatisation revenues and deposit accumulation or utilisation in the case of gross debt), by unexpected fluctuations in inflation through the denominator (GDP deflator) and by the revaluation of FX debt.[15]

The level of public debt is therefore more resistant to intentional distortion (creative accounting); nevertheless, it can be improved by financing transactions (privatisation). The effect of exogenous factors, however, is substantial, as both the economic cycle and changes in the exchange rate can affect the debt-to-GDP ratio substantially. As the discretionary effects of fiscal policy cannot be distinguished from those of exogenous factors, the entire fiscal rule should not be linked to a single defined debt level. Two types of solutions, or their combination, seem viable. Firstly, the rule can be rendered more flexible with the help of an escape clause (such as the one in the Hungarian

[14] The golden rule applied to local governments is not a debt rule, as it does not limit the volume of debt, only its annual growth, restricting indebtedness beyond the accumulation of fixed assets.

[15] It is also a sign of the economy's vulnerability if revaluations of FX debt exert a substantial impact on debt. Unexpected spikes in inflation can also decrease debt measured as a percentage of GDP, due to higher nominal GDP. However, as yields also adapt to this, nominal debt also gradually increases as debt is renewed, and *ceteris paribus,* the debt-to-GDP ratio returns to its initial value in the medium term. Of course, other expenditures and tax revenues would also change due to unexpected inflation, besides interest expenditure, but the effect is smaller in the balance (P. Kiss, 2007a).

constitution), and secondly, the Polish and the planned Slovakian solution complement the debt limit with protection bands, which, if breached, triggers a series of increasingly strict measures as the debt increases.

The escape clause can only function effectively if the criterion allowing suspension of the rule are clearly defined. The usual definition, however, which allows exemption from the rule in the case of a certain percentage of decrease in GDP, lacks accuracy in and of itself. Any decision on the escape clause should therefore be made by an independent institution, the fiscal council, where the following issues can be adequately analysed.

- A negative cyclical position does not mean an absolute decline (a fall in real GDP), but rather a deviation compared to potential (or trend) growth (negative output gap). This, however, cannot be measured, but only estimated, and such estimates must be updated from time to time – the current crisis has revealed how actual figures can radically alter the picture formed of the trend.

- Changes in public revenues do not depend on the output gap, but on the "gaps" of wages and consumption. Changes in GDP may differ from changes in wages and consumption, which define revenues. They may diverge not only in time and order of magnitude, but also in their sign. Therefore, an estimation method that can simultaneously perform estimates for several gaps is required (Reppa and P. Kiss, 2010).

- Finally, the exchange rate effect must also be taken into account, as depreciation can substantially inflate debt depending on the weight of FX debt. This effect is obviously mitigated by the fact that depreciation also decreases the debt-to-GDP ratio, because GDP as a denominator increases. However, this is only gradual, and may be of smaller magnitude. For example, if the FX debt ratio in Hungary is around 40% and the inflationary effect of a unit of change in the HUF/EUR exchange rate exerted over a three-year period is only 25%, the depreciation can still exert a significant effect on the level of debt over a three-year period.

The protective bands paired with debt limits originally served the purpose of preventing the debt rule from entering into force too late, in other words, it allows the restriction of loosening at lower levels. If, however, the effect of exogenous factors (output gap, exchange rate) cannot be filtered out (see escape clause), bands of ample width are required, otherwise (procyclical) tightening may be triggered in cases that should not covered by the original objective. The Hungarian situation is unique in the Visegrád region in that the debt level defined in the rule must first be approached from above. There are two options for this. On the one hand, the real debt rule can be sustained until the 50% level is attained, which defines the trajectory for debt reduction.[16] On the other hand, some protective bands above the 50% level can be implied, which could require gradually less serious corrective measures in case of convergence toward the 50% level, thereby rewarding continuous debt reduction.[17]

The protective band's optimal width is determined so that is does not leave too much leeway for fiscal loosening on the one hand, while being wide enough to accommodate the effects of exogenous factors, only breaching the protective band in extreme cases.

Poland set protective bands at increments of 5% below the constitutional debt limit. This band may be too wide if deterioration is caused by deficit-increasing measures, as the jump between bands would represent a deficit higher than 5% within one year. The band is also too wide from the perspective of exogenous factors. A 6% slow-down in GDP growth, for instance, could push debt-to-GDP ratio up from 50% to 53%, and generating an approximately 2 percentage point tax loss would increase the debt rate from 53% to 55%.[18] A downturn of this extent, however, did not occur in the current crisis. As the ratio of FX debt is around 27%, an exchange rate depreciation of 30% would be needed to breach the 5% protective band, which is much higher than the actual exchange rate fluctuations.

The Slovakian solution includes protective band increments of 2-3 percentage points. This is sufficiently narrow to mitigate the threat of measures that would substantially increase the deficit. The question is whether it is wide

[16] Real debt rule to some extent "looks beyond" the effect of cyclical fluctuations and depreciation. If the decrease is such that economic growth is not expected to resume its trend over a two-year forecast horizon, it may lead to slighter procyclical tightening in two years. Only one-third of depreciation distorts the rule, as two-thirds of the 1% depreciation affecting the 40% FX ratio are neutralised in the calculation by the fact that inflation calculated in three years is 0.25% higher.

[17] The section on the expenditure rule presents how this can, for example, be the increasingly less restrained growth rate of budgetary expenditures. Between 70% and 65%, for instance, there could be no increase in nominal expenditure, there could be a 2% annual increase between 65% and 60%, etc.

[18] If the slowdown lasts three years, for instance, a slowdown in GDP of 3.5% would be needed to breach the band, as this would increase the debt/GDP ratio from 50% to 51.75%, and annual tax loss would exceed 1%, which would push the debt rate up by 3% over a span of three years.

enough not to be "activated" by the effect of exogenous factors. As Slovakia is a euro area country, no exchange rate effect comes into play. At the same time, fluctuations in GDP may strengthen. A slowdown of 3.5% is sufficient to breach a 2.5% band, which would increase debt-to-GDP ratio from 40% to almost 41.5%, supplemented by the effect of a higher than 1% cyclical tax loss. In the event of a slowdown enduring for a period of three years, a 2% slow-down in growth is enough to push the debt rate over the 2.5% band by the end of the third year.

In summary, several observations can be made. First, the operation of the debt rule is more efficient the closer its definition is to the debt category determined by the fiscal policy, for example whether it includes public companies and public private partnership liabilities, but excludes deposits. The escape clause suspending the rule can only be efficient if it is capable of identifying the debt-increasing effect of exogenous factors. As the effect of fiscal loosening and exogenous factors is difficult to distinguish, the width of protective bands surrounding the debt limit must be adequately sized to restrain substantial loosening, but to allow sufficient leeway to avoid frequent "false alarms" due to the debt-increasing effect of exogenous factors.

THE BUDGET BALANCE AS A TARGET

In respect of the balance target, the focus is on specific years, but there is also a need to include them in a medium-term time framework. These frameworks enable fulfilment of the medium-term balance target and an adequate rate of debt reduction. The Hungarian real debt rule, which deduces deficit targets from keeping debt unchanged in real terms, is an example of the combination of these two aspects. A medium-term balance trajectory is necessary even in the case of an expenditure rule, as the growth rate of expenditures can be defined and fixed for several years on the basis thereof.

Similarly to debt, the coverage of the rule is of primary importance from the perspective of the balance target's efficiency. One of the dimensions of this aspect is the set of entities falling under the scope of the rule.

- The EU's balance targets apply to the government sector defined in the statistical sense, comprised of the central government (budget, social security), local governments and some public companies included in the government sector. (The latter generally includes only a smaller portion of public companies, and loss-making companies are only included under special circumstances.)

- Rules adopted on a national level apply to the subsectors defined in a legal sense, rather than a statistical one. The so-called golden rule is characteristic of the local government sector, stating that the current balance must be balanced, and deficit may only be generated up to the extent of investment expenditures.[19] The central government applies to the entities included under the scope of the annual budget act. In countries where all public companies are included in this group (the United Kingdom, for example), the under-financing of quasi-fiscal corporate expenditure or extra payments from companies do not improve the consolidated balance, even temporarily.

Besides the affected institutional group, another important factor is how the rule defines revenues and expenditures.

- EU rules primarily define the balance based on the statistics of national accounts. On the one hand, this entails the reclassification of a portion of public companies into the government sector (which nevertheless does not mean that there remains no debt related to quasi-fiscal activities, such as PPP investments). On the other hand, they remove certain revenues or expenditures from the deficit as financing transactions (such as privatisation revenues). Finally, most of the revenues and expenditures are recorded on an accrual basis, rather than at the time of payment. This presents the advantage of allowing less option for influencing the balance by timing expenditures.[20] It incurs the cost of a completely different type of data collection replacing cash-flow data for certain items, and this data collection is only available at a later date. This additional time and retroactive statistical adjustments make the application of the rule more difficult.

- National rules generally define the balance based on a cash-flow based approach. The advantage here is that this

[19] As EU funds account for an increasingly high share of investment funding, indebtedness should be allowed up to the extent of net investment expenditure (P. Kiss, 2007b). When applying netting, the revenues stemming from the sales of real assets (negative investments) should also be deducted, in addition to EU funds.

[20] The balance can nevertheless still be influenced, even if applying this methodology. On the one hand, a part of transfers remain subject to the cash-flow approach. On the other hand, the simplest form of accrual accounting *(time-adjusted cash)* only represents a shift of 1-2 months in cash flow, resulting in the equivalent distortion in the accrual approach balance.

approach is fully in line with changes in debt, the data are almost immediately available and it offers the best control during the year. Its drawback is that this control can lend itself to abuse, allowing the fine-tuning of the balance by shifting payments between years. In the event of underfinancing, the fulfilment of public tasks is not even reflected as expenditure – only appearing in the form of debt assumptions at a later stage – if public companies are not included in the coverage of the rule. Moreover, not all government-type investments are recognised at the time of implementation, as the costs of public private partnerships are paid spread out over time.

- In Hungary, the Expert Body on Budgetary Accounting (Költségvetési Elszámolások Szakértői Testülete, KESZT), operating in 2010, put forward a recommendation for cash-flow based recognition modified in the context of national rules (see KESZT, 2010). The objective was to preserve the advantages of the cash-flow based approach, while making adjustments to eliminate its drawbacks.[21] The adjustments would aim to create comparable data on the level of "regular" cash-flow based accounting that cannot be distorted by the underfinancing of public tasks, the outsourcing of government-type investments in the form of public private partnerships, the late settlement of invoices, the unrecognised "subsidy content" of guaranties and lending programmes initiated by the government, and certain capital revenues (such as the payments made by persons returning to the state pillar from private pension funds).[22]

- In Slovakia an analytical indicator is recommended which would complement official accounting instead of replacing that, revealing any loopholes in the rules, and enabling the preparation of sustainability calculations. Within the stock-type indicator approach, this is similar to the category of the net worth, albeit taken in the broadest possible sense. It is comprised of generational accounting, natural resources, the state of the natural environment and the net worth of public companies, as well as contingent liabilities (guaranties) and public private partnership debt. Theoretically, more information can be derived about fiscal policy from changes in net worth as opposed to focusing solely on the balance. This latter flow-type indicator partially overlaps with the KESZT recommendation outlined in the previous point.

The balance is a flow-type indicator, and consequently, presents different advantages and drawbacks compared to the debt indicator.

- Its advantage is that the balance is immune to the revaluation of FX debt and privatisation revenue.

- Its drawback is that without separate methodological adjustments (see KESZT recommendation), the balance for a specific year can be temporarily influenced by creative accounting. This could exacerbate "stop-go" cycles, taking the form, for instance, of "savings" generated by leaving the losses incurred by the railway company unrecognised prior to elections and channelling them into social transfers, subsequently recognising the accumulated corporate losses in a lump-sum payment following the elections.

- Its advantage compared to debt is that it is less sensitive to the fluctuations of the economic cycle.

- Its weakness compared to the expenditure rule is that the cycle's effect cannot be ignored (a 1% output gap – assuming similar wage and consumption gaps – alters the deficit-to-GDP ratio by approximately 0.3%). This is significant in that fiscal policy and the impact of exogenous factors are once again difficult to distinguish; for instance, it is difficult to subsequently assess the reason(s) behind missing a target. One possible solution could be the allocation of provisions for unforeseeable negative surprises for the upcoming one year, or incorporating an escape clause that would be triggered in the event of an unexpected deviation, exceeding a certain value.

In summary, the efficiency of such a balance depends on the proximity of its definition to the expenditures and revenues influenced by fiscal policy. In practice, this means it should include, for example, public companies and public private partnerships. As the effect of exogenous factors is difficult to filter out, provisions should be allocated to unforeseeable surprises or an escape clause should be incorporated for extreme cases. To ensure transparency, the target could be also evaluated on the basis of a sustainability analysis (net worth).

[21] The recommendation resembles the modified cash-flow indicators used by the Congressional Budget Office in the United States, and the central bank in New Zealand and Hungary. The statutory recognition used in the United Kingdom resembles it from the perspective that instead of the general government, and recommends the public sector category, comprising public companies.

[22] The recognition of PPP projects as budgetary items is prescribed by the official method of accounting effective as of 2010. The act originally included the recognition of the accounting profit or loss of companies in majority state ownership as budgetary items in the year the balance sheet is compiled. This corporate category, including current profit or loss and depreciation, however, was inconsistent with the budgetary indicator reflecting current balance and investment expenditures, so the amendment was revoked before its entry into force. As a solution, the KESZT proposed the consolidation of the same budgetary and corporate category, the cash-flow based financing requirement.

THE EXPENDITURE RULE AS AN INSTRUMENT

The expenditure rule restricts the growth rate of budgetary expenditures and can thus contribute to achieving the balance target, consistently with medium-term frameworks. Similarly to debt and balance, the scope of entities covered by the rule is an essential issue, as is the group of expenditures that it applies to; moreover, a distinction between certain subgroups of expenditure may also be useful.

- As a part of its new fiscal framework, in the future the EU will monitor the growth rate of government spending. In the context of assessing convergence towards the medium-term objective (MTO), both the structural deficit and the expenditure trajectory adjusted by the effect of revenue measures are examined. As long as a country falls short of the medium-term objective, the growth rate of adjusted expenditures cannot exceed the economy's potential growth rate.[23] The potential growth rate, thus representing the ceiling for expenditure growth, is defined based on a common methodology. As investment spending may fluctuate due to a major project in smaller member states, this will also be taken into account.

- National rules generally cover the consolidated cash-flow based expenditures of the budget, according to the legal definition. If the legal definition includes them, public companies and public private partnerships can be classified in this group. Consolidation is required because intrabudgetary transfers fall outside of the rule's scope, which only covers the final expenditure actually made. According to the current Slovakian and earlier KESZT recommendations, tax expenditures should also be recognised as spending. The gross treatment of this item is justified by the fact that from several aspects, they could be interchangeable with expenditures, creating a loophole in the rule. From the perspective of efficiency, it is essential to have the broadest possible range of expenditures included under the scope of the rule. Expenditures that are defined by acts (exogenous or mandatory items according to the Hungarian definition) other than the budget act (discretionary items according to the Hungarian definition) (see Polish solution) should therefore not be excluded.

- Within the budget expenditure rule, budgetary transfers to local governments should be examined separately (P. Kiss, 2007b). Such transfers should be defined along with tax sharing with the budget, allowing all resources assigned to local governments to be recognised jointly. Separate treatment of local governments is justified, as it prevents a disproportionately high or low portion of the total growth in budgetary spending from appearing as local government revenues. If tasks and resources are adequately distributed among the central government and local governments, there is no reason, for example, for a disproportionately high portion of fiscal adjustment to be assigned to local governments.

- In addition to spending, there are forms of state guaranties that partly represent a subsidy. If this can be determined (KESZT recommendation), it can be included in the spending and the balance. If, however, the amount of support cannot be determined, expenditure ceilings may have to be extended to guaranties as well (P. Kiss, 2007b). In this case, the expenditure ceiling cannot be circumvented through the expansion of support in the form of guarantee. The creation of groups for guarantees, however, is important, according to their probability of being called (low, medium or high), with a different ceiling assigned to each group.

The expenditure rule has different advantages and drawbacks in comparison to the balance and debt rule.

- Its advantage is that, similarly to the balance, it is not affected by the revaluation of FX debt and privatisation revenues.

- It presents the advantage of having small cyclical effects on expenditure. Although spending co-varies with the cycle due to its indexing to real indicators (such as the Swiss indexing of pensions), this is mostly offset by the opposite movements in spending stemming from unemployment. Accordingly, fiscal policy is clearly responsible for the trends in spending, as opposed to exogenous factors. This is also the reason why the EU's fiscal framework will monitor spending separately.

- Its drawback is that without separate methodological adjustments (see KESZT recommendation), the spending for a specific year can be temporarily influenced by creative accounting. This could exacerbate "stop-go" cycles, for instance, by increasing social transfers at the costs of underfinancing the railway company, subsequently recognising the accumulated corporate losses in a lump-sum capital transfer following elections.

[23] Expenditures must be adjusted by revenue measures in order to allow both the implementation of higher expenditure growth offset by tax increases and tax cuts offset by spending cuts.

- Another drawback is that the expenditure rule does not fully ensure achievement of the balance target. This is required to ensure the reliability of estimates of the envisaged tax measures and macroeconomic forecasts on the revenue side.

Another important question regarding the expenditure rule is how and for what time horizon the growth rate should be determined. The growth rate generally applies to the nominal, rather than the real index (on its advantages, see: P. Kiss, 2007b). If the time horizon over which the growth rate of spending is determined reaches the average length of the economic cycle, budgetary expenditures can fulfil the role of automatic stabilisers, as their growth remains constant throughout the cycle. The minimal requirement could be that the time span be equal to those of medium-term planning frameworks, thereby contributing to achievement of the balance trajectory defined therein. The selection of the level of expenditures and revenue, however, is a matter of social preferences; nominally fixed spending, for instance, can contribute to the gradual attainment of a low expenditure level. This may change or even reverse depending on the political cycle.

One general problem is that although adjustment can be obtained by applying debt, balance and expenditure rules, ensuring its sustainability by structural measures is less viable. The relative advantage of the expenditure rule is that it may in principle promote structural measures on the expenditure side. However, as structural measures may also incur costs, which are disregarded by the rules, they may represent a form of counter-incentive. Slovakia's proposal, whereby the broadest possible context is taken into consideration when determining the growth rate of expenditure, was formed in response to this issue. This is the aforementioned concept of net worth, which resolves the inconsistency between the long-term benefits, which are often impossible to demonstrate, and short-term costs, which may restrict fiscal policy.

In summary, the expenditure rule can better help determine the extent of the responsibility of fiscal policy. This, on the one hand, assumes that every expenditure-like item determined by government decisions (quasi-fiscal spending, tax rebates, guaranties) is included within the rule's scope. On the other hand, the inspection of revenues remains necessary, although in this case, the effect of the fiscal policy and the cycle are difficult to distinguish. Finally, the adequate distribution of central and local government tasks and resources is also required, without which the local government sector can be disproportionately burdened within the general government's adjustment requirement. Compliance with the expenditure rule does not mean that it is underpinned by structural measures, but if such measures are in fact taken, the long-term benefits and short-term costs can be recognised when setting the growth rate of spending.

THE FISCAL COUNCIL AS A SUPPORTING ENTITY

The fiscal framework represents the self-restraint of fiscal policy. This can only be achieved in a credible way if there is sufficient transparency. The required level of transparency fundamentally depends on the nature of the framework, in particular from the perspective of simplicity and enforceability. Greater transparency is required for those fiscal frameworks which are more complex and have severe sanctions. The institution of a fiscal council can be a key tool for ensuring transparency.

The role and tasks of fiscal councils can be very diverse, depending on the nature of the framework and the other players participating in its operation. Accordingly, fiscal councils may fulfil the following roles.

- Supervision of the fiscal framework's operation. This bears particular importance if rules are complex and cannot be directly evaluated by public opinion. This also applies to the fulfilment of certain procedural rules, such as compulsory compensation (PAYGO). In some countries, this task may also be performed by another independent organisation, such as the State Audit Office.

- Macroeconomic projection. Preparing reliable forecasts is fundamental to making targets achievable and to triggering the escape clause. Regarding their legal status, forecasts can be either recommendations or compulsory, to be taken into account in budgetary planning and in making the decision on the escape clause. Organisations other than the fiscal council may prepare the macroeconomic forecast; in Slovakia, the forecast is instituted by a committee, also comprising private analysts. Independent market forecasts cannot be made use of automatically, as the fiscal council prepares rule-based projections, according to which – contrary to private forecasts – special assumptions are made regarding future fiscal policy.

- Assessment of the impact of budgetary measures on revenues or expenditures. In many cases, fiscal policy only defines one parameter (such as the tax rate), changes in which have uncertain effects on the budget. The effect depends on the reactions of certain macroeconomic indicators, for which estimates must be prepared. This task may also be performed by some other

body; Slovakia has a separate committee assigned to this role, comprising private analysts.

- Activation of the escape clause. Breach of the rules may occasionally be attributed to exogenous factors, and thus the application of potential sanctions may be restricted by the escape clause. A complex, albeit important task is the distinction of exogenous effects from the effects stemming from fiscal policy, as any error could allow discretionary loosening authorised by the escape clause. This task could also be performed by an independent organisation, which has competence in the domain of macroeconomic forecasting and analysis.

- Input for determining the fiscal framework's parameters. According to the Slovakian recommendation, the fiscal council may take the responsibility of reviewing the growth rate specified under the expenditure rule. The net worth concept would present a solution to the contradiction between the long-term and the short-term impacts of structural measures. Setting the growth rate of expenditures, however, is essentially the government's role, as it represents a question of social preferences.

- Forecasting local government revenues and expenditures. The local government rule (if effective) and the resources channelled from the central budget may fundamentally determine the room for manoeuvre for local governments. Nevertheless, local governments retain their independence, which is why their financial management should be scrutinised. In addition to the local election cycle, indebtedness may also divert the local government balance from the level assumed by the central government; accordingly, commitments made to the EU may also be jeopardised.

- Right of veto. The weight of the fiscal council's operation is fundamentally determined by its capability to block the adoption process of the budget act if it disagrees with any point thereof. This may mean that the government could be required to resubmit the draft legislation, but a second blocking of the process may not be allowed. It may also mean that the right of veto can be exercised any number of times. In the event that no budget act has been adopted, a country has several legal options to choose from. One of them is a provisory budget that is based on the previous year. The other could be the failure of the government or Parliament. The more severe the consequence of the veto, the more important it is for the fiscal council to operate in a transparent manner.

- Fiscal analyses. The fiscal council may also prepare analyses if the results thereof have no direct impact on the rule's operation. It could be worthwhile to "hold a mirror" to fiscal policy and examine the medium and long-term implications of keeping the fiscal policy unchanged in its current form.[24] One of the dimensions of the analysis is the estimation of the economic cycle, a cornerstone of medium-term forecasting. The other dimension is generational accounting, a cornerstone of long-term projections. The effect of structural measures may also be displayed, in which the distinction of long-term benefits and temporary costs is essential (see expenditure rule). Analytical activity may be positive (determining the fiscal impact of specific measures) or normative, formulating an evaluation (also taking into account social and welfare impacts), and may provide a basis for future decisions (such as the desired level of government activity). Such analyses may obviously be carried out by other independent institutions.

As the above shows, the range of possible functions varies widely, from analyses bearing no legal consequence to the right of veto. These functions call for different modes of operation from the various fiscal councils. The requirement for transparency increases in line with the severity of the legal consequences. While activation of the escape clause calls for the publication of the details of the applied methodology (applying, for instance, to cyclical adjustment), the results obtained and the record of the decision made, the right of veto also requires the statutory definition of forecasting rules.[25]

In summary, it can therefore be stated that it is the task of the fiscal council to increase transparency. This is the cornerstone of any fiscal framework. In order to gain broad support for the rules, public opinion must be formed in a way so as to also consider the restriction of high deficit or expenditures a necessity in addition to the limitation of public debt. Generally speaking, there is no one-size-fits-all solution for an optimal fiscal council. Its operation may provide support for the smooth operation of the other elements of the framework. The right of veto may be a fundamental element, similarly to the right of activating the escape clause. In order to carry out its functions adequately, the higher the level of competency held by the fiscal council, the higher the level of transparency called for. Its operations may also complement the rules in areas where they can be seen as overly simplified. From this perspective, fiscal analyses play an all-important role.

[24] According to the EU's package of economic governance legislative proposals, each member state should define the term of unchanged fiscal policy and make the assumptions, methodology and specific parameters public.

[25] Only sufficiently detailed measures that have been approved in legislation can be taken into account.

CONCLUSIONS

The economies of Visegrád countries (Czech Republic, Hungary, Poland and Slovakia) are characterised by several common features. Their differences mainly reside in the achievement of debt trajectories, if we compare debt-to-GDP ratio adjusted by the relative development (Chart 1). This relative development is measured in comparison to the EU average expressed in GDP calculated at purchasing power parity. This measure also diverges substantially among the four countries (Chart 2). The "stop-go" cycles in fiscal policy are apparent in the trends of both indicators, but given the small open nature of the Visegrád country economies, the increasing effect on public debt is more dominant. The regulation of fiscal policy is necessary for economic convergence, to restrict both the level of deficit and its fluctuations. Some Visegrád countries already have such rules in place, while those that do not are planning their introduction. The EU's recent package of economic governance legislative proposals lends relevance to the review of the various potential elements of the fiscal frameworks. The details of each national framework should be custom-tailored to the features of the country; nevertheless, all of the pillars analysed above may be necessary, although with varying importance.

The first pillar is the debt rule, which may serve as a long-term constraint on fiscal policy. The inclusion of this rule in the constitution lends it particular importance. The rule can only be truly efficient if its definition is close to the debt category determined by fiscal policy, and thus includes public companies and public private partnership liabilities. Effective operation is also contingent upon the escape clause to suspend the rule, in the event of exogenous factors increasing the level of debt, under well-specified conditions. In practice, however, the impact of fiscal loosening and exogenous factors is difficult to distinguish, and thus either a fiscal council should be granted the right to decide on the escape clause or protective bands allowing sufficient leeway surrounding the debt limit should be defined.

The second pillar is the balance target, where the medium term also becomes important in addition to individual years. Similarly to the debt limit, the target can only be truly efficient if its definition covers all items determined by fiscal policy, and thus includes investments by public companies and public private partnerships. As the effect of exogenous factors is difficult to filter out, provisions should be allocated to unforeseeable surprises or an escape clause should be incorporated for extreme cases. The balance target focused on the current year should also be assessed over a medium and long-term time horizon. The fiscal council's analyses presenting the effect of the economic cycle on tax revenues or the sustainability of expenditures may be a useful analytical tool.

The third pillar is the expenditure rule, reflecting the responsibility of the fiscal policy, which may be an instrument of meeting the balance target consistent with medium-term frameworks. At the same time, revenue plans should remain reliable, in which an independent forecasting body could also play a role. The effectiveness of the expenditure rule assumes that, similarly to the previous pillars, every expenditure-like item stemming from a government decision, such as quasi-fiscal spending, tax expenditure, guaranties, is included within the rule's scope. The adequate distribution of central and local government tasks and resources is also important for efficiency, as the absence of such distribution could lead to an excessive burden being put on the local government sector within an adjustment programme.

The fourth and final pillar is the fiscal council, which provides support for the entire fiscal framework. This may represent competences such as the right of veto or the activation of an escape clause. The higher the level of competency held by the fiscal council, the higher the level of transparency required. Supporting activity also means performing analyses. Compliance with the previous three pillars does not mean that their sustainability is supported by structural measures. The analysis of the fiscal council may highlight the absence of such measures. If, however, structural measures have been implemented, the analyses of the fiscal council may resolve the contradiction between long-term benefits and temporary costs, which it may take into account when defining the growth rate for expenditures.

There are two main conclusions to be drawn. Firstly, the effectiveness of a rule increases in line with its coverage of the scope of fiscal policy. In this sense, the exception does not prove the rule. Secondly, filtering out the effect of exogenous factors is also important to ensure that rules only restrict fiscal policy. This is important to avoid the rule requiring the offsetting of revenues lost due to an economic slowdown with procyclical measures. In this sense, the exception proves the rule. The difficulty resides in the fact that the effects of exogenous factors and fiscal policy are difficult to distinguish. Resolving this methodologically difficult distinction may be one of the tasks of the fiscal council.

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