The role of the Hungarian State Audit Office in enhancing the transparency of the state budgeting process

Lack of transparency in the budgeting process

Over the past decade, Hungary pursued a markedly pro-cyclical fiscal policy: a prolonged expansionary stance, followed by a sharp adjustment. The deterioration in public finances was reflected in a significant buildup in public indebtedness. This situation reached its worse point in 2006. In that year the fiscal balance of the general government reached 9.2% of gross domestic product (GDP) on an ESA95 accounting basis due to pre-electoral fiscal profligacy, thus urgent mitigation was unavoidable. As a result of the budgetary austerity program, in 2007 the public finance deficit has dropped to 5 percent of the GDP, it nevertheless remains the highest among OECD member countries. At the same time, Hungary had a higher public sector debt (about 65% of GDP) than any other catch-up country in the region.

In May 2006 the Secretariat of the OECD carried out a budget review of Hungary (Kraan, D-J at al. (2006)). On the basis of the review the main weaknesses of the Hungarian budgetary framework could have been summarised as follows:

- The framework focused too narrowly on the actual (non-cyclically adjusted) deficit of the forthcoming year budget. Commitment to medium-term fiscal goals was not strong, even though the government regularly updated its four-year period Convergence Programme as part of its commitments to the European Union;
- Parliament had very limited possibilities to carry out extensive examinations of the draft budget proposals presented by government. The absence of sensitivity analyses of fiscal outcomes to domestic and international developments made the appraisal of the budget more difficult;
- The annual budget was prepared using over-optimistic assumptions, which contributed to undermining the credibility of announced targets. In general there were quite substantial forecasting errors in Hungary in the reviewed period. These occurred mostly at the revenue side of the budget and were a major cause of deficit overshooting.
- The absence of clear rules of budgetary discipline.

These features made the Hungarian budget formulation process particularly vulnerable to overspending and revenue shortfalls. Therefore OECD emphasized the need to improve transparency concerning assumptions and methodologies and to introduce fiscal rules.

The role of the Hungarian State Audit Office in the budget formulation process

The legally mandated task of the State Audit Office of Hungary (hereinafter: SAO) is to form an opinion on the well-foundedness of the state budget proposal, and on the realisability of the revenue appropriations. In the past two decades or so the SAO has performed this annual activity on the basis of experience obtained during the audits conducted at organisations in charge of planning the budget appropriations. The audits first of all strive to determine whether the methods and procedures applied in planning, as well as the system of state tasks and the modifications thereof as proposed by the regulators lay proper foundations for the budget bill. The SAO has fulfilled this duty since 1989 but was not able to halt the indebtedness process of the Hungarian state. The SAO in its opinion brought to the surface the risks of a higher annual budget deficit in several years but these warnings did not have any real consequences.

The budget review carried out by the OECD in 2006 dealt with the role of the SAO in the budget formulation process also. The document gave the following appraisal: “The SAO publishes its own analysis of the macroeconomic assumptions and forecasts, and criticises concrete estimates of expenditure if they are not deemed realistic. The SAO does not, however, calculate alternative macroeconomic forecasts. There is a continual debate between the SAO and the Ministry of Finance concerning these issues in the time leading up to the presentation of the budget to the Parliament.” It is obvious from this statement also that SAO used to have an important role in the budgeting process, but SAO’ legal mandate was not powerful enough to prevent the Parliament to adopt a macro-economically poor-founded budget.

SAO expressed repeatedly the need for not only tightening the independent control of fiscal policy, but also the importance of widening its institutional portfolio. The mandate of the SAO regarding control of the budgeting process made basically only one-time monitoring possible. SAO made thorough analyses of the budget bills every year. The several hundred pages assessment of the supreme auditors was bought to the Parliament, which was expected to use these comments in shaping the final version of the Budget Bill before it faces the final vote. Usually the Parliament made use for some of the suggestions, but another process could be seen also. The government often did not include in the bill and thus basically hide from the auditors certain critical elements of the budget using amendments formally submitted by individual MPs independently from the Ministry of Finance. SAO did not have the right to perform any check of amendments proposed to the budget by MPs.

While the standards of carrying out the function of auditing government finances were set and also kept high by the SAO, there was a major institutional lack of independent control of fiscal policy. The portfolio of tasks to be performed by the SAO included the preparation of an in-depth report on the Budget Bill. However, this analysis focused on issues of consistency, conformity with the law and the feasibility of policy objectives. As a matter of fact, this approach took the policy and the forecasting background of the Budget Bill more or less as given, while a string of critical points of the budgeting process may lie in the realm of macroeconomic background work as well.

Extension of the scope of the opinion of the SAO in order to enhance transparency

The deficit overshooting in 2006 cried for quick improvements of the budgeting process. Expert formulated specific proposals for the introduction of fiscal rules, but the politicians could not agree on them. In this situation SAO tried to expand the scope of its opinion to the macro economical risks as well. In line with this aim SAO’s opinion on the 2008 budget was supplemented with a new element: the Research Institute of the SAO (hereinafter RI) prepared an evaluating study on the macroeconomic foundations of the 2008 budget bill. The macro-study provided a summary review and evaluation of the economic growth and budgetary processes, presented the risks inherent in the system of conditions of the budget bill. By using novel analysis methods and approaches RI attempted to establish a methodological framework that can be used in the activity of any independent institution assisting the budgeting process. The methodology applied is presented in Bager G. – Pulay Gy. (2008a).Until that time risk analysis in the preparation of budget related decisions had been almost unknown in Hungary. The system of macroeconomic conditions that lay the foundations for the budget were stipulated in one version only instead of several versions, without indicating the risks of possible non-occurrence, and the expected impact thereof on budgetary revenues and expenditures.

Budgetary risk analysis has another value that shows beyond the concrete results of the individual analyses, and fosters the development of democracy and the modernisation of public finance regulations. The reason behind this is that budgetary risk analysis performed by an organisation that is independent from the Government (and is supervised by the Parliament) may significantly increase the decision-making power of the Parliament in relation to the budget. In budgetary issues the Parliament could so far rely only on the budget bill developed by the Government, the background materials of the budget bill, as well as the traditional opinion of the SAO. The budgetary risk analysis submitted to the Parliament provides a new tool for the parliamentary deputies to make a so called "informed decision" in budgetary matters, i.e. to face the risks of their decisions in advance. During reception of the study by the Parliament, as well as during its professional debate the RI found that the studies filled a void. Both the legislators and the broader profession were open for similar analyses. The first feedbacks justified that all factions of the Parliament require that their work be supported by this new tool. Therefore RI prepared a macro study on the macro-economical risks of the state budget for the year 2009 as well.

The introduction of a rule-based fiscal policy framework

Besides the effort of the SAO preparations for setting up a body of fiscal policy control independent from the government and not part of, but able to closely co-operate with the SAO were significantly accelerated in Parliament after the negative fiscal record of 2006. These things were not decided by October 2008 when events took a very much unexpected turn. The sudden drying up of channels of credit from abroad became manifest in the inability of the Hungarian government to sell government bonds in the auctions of October 2008.

The Hungarian economy was, in an international comparison, extremely hard hit by the crisis of 2008-2009. This occurred mainly owing to lax fiscal policies and the subsequent accumulation of foreign debt from 2002 on (the gross foreign debt/GDP ratio rose from 61% in 2001 to temporarily above 80% in the fall of 2008). However, this process with nearly dramatic consequences took place also a result of incomplete mechanisms of control of fiscal policy.

As Hungary experienced considerable pressures from the global financial crisis, the work for introducing a rules-based fiscal policy framework, including the establishment of a Fiscal Council (FC) was accelerated. The principal goals of the FC consisted of promoting fiscal transparency and restoring public debt sustainability. In November 2008 Parliament adopted the fiscal responsibility Act. The Act "on the economical government management and fiscal responsibility" set forth new fiscal policy rules for the central subsystem of the government, established the FC and introduced certain safeguards. The aim of the Act was to restore fiscal sustainability. Towards this goal two policy rules have been set: the debt rule and the expenditure rule. In addition the government is required to enforce a number of procedural rules, including the "pay-go" rule. The debt rule limited the stock of central government liabilities in real terms. According to the expenditure rule, government would set a growth target of consolidated primary expenditures two years prior to the budget year. Under the "pay-go" rule, all legislative proposals involving an increase in primary expenditures or revenue reduction must be offset with a commensurate expenditure cut or revenue increase, spelled out in the same proposal.

The FC was comprised of three independent experts supported by a technical staff. Like most other similar institutions, the FC was empowered with dissuasive rather than coercive means. In its first year of operation, the FC issued an assessment of the Government's macro-fiscal projections, against a current-legislation baseline. Also, it evaluated the conformity of the 2010 budget bill and of proposed amendments with the fiscal rules: the real debt rule, the expenditure rule, and the pay-go rule. In addition, it assessed the consistency of the budget bill with the transparency standards mandated by law.

In August 2009 the FC drew up an analysis about the macroeconomic outlooks and the budgetary risks. The analysis covers the years 2008-2012. FC developed a good analytical capacity but did not have enough power to compel the compliance with the fiscal rules.

The establishment of the FC did not influence directly the mandate of the SAO, which means that since 2009 two opinions were prepared on the well-foundedness of the state budget, one by the FC and one by the SAO. The division of labour between the FC and the SAO was arranged with the introduction of a very precise definition and description of the tasks and functions of the new body of fiscal control. Let's see two examples! FC was obliged to make independent short- and medium-term macroeconomic projections and forecasts. Therefore RI stopped to elaborate macro-study on the macro-economical risks of the budget, and the opinion of the SAO dealt with the macroeconomic environment of the budget with a limited extent only. FC was also expected to analyse all major amendments proposed to the budget both by the government side and the opposition. This was not a task of the SAO whose assessment of the Budget Bill is presented to Parliament before any amendment becomes known.

In December 2010 the Act on the economical government management and fiscal responsibility has been amended in several places which resulted in the reorganization of the FC. Within the meaning of the amendments, the members of the FC are the respective Presidents of Hungarian National Bank and the SAO as well as one person appointed by the President of the Republic. The mandate of the pervious members has been cancelled. The organisation that assisted the FC's work, the Secretariat of the FC, was also terminated. The FC can rely on the available work organisation of the Presidents of Hungarian National Bank and the SAO in fulfilling of its tasks.

According to the new rules, the sole task of the FC is to formulate an opinion regarding the respective draft annual budget. The draft budget is to be sent to the FC prior to being submitted to Parliament, and the FC will, if the draft budget has fundamental deficiencies, also be granted the right to formulate a second opinion. In such a case the Government is obliged to once again debate the draft budget and can only submit it to Parliament if the new opinion has been received or the deadline for providing such has been passed.

Fiscal transparency and accountability supported by the new constitution of Hungary

The FC is going to become a constitutional institution since the new constitution (Fundamental Law) of Hungary contains the basic rules of the composition and the tasks of the FC. The Fundamental Law has a separate chapter on public finances in order to enhance fiscal stability and transparency. For example the law says the following: "All bills on the State Budget and its implementation shall contain all state expenditures and revenues in the same structure, in a transparent manner and in reasonable detail." Even more important is the fiscal rule incorporated into the Fundamental Law. According to article 36 of the Fundamental Law "parliament may not adopt a State Budget Act which allows state debt to exceed half of the GDP. As long as state debt exceeds half of the GDP, Parliament may only adopt a State Budget Act which contains state debt reduction in proportion to the GDP." The deviation from the before mentioned provisions - regulated in Article 36(6) - shall only be possible during a special legal order, to the extent required for mitigating the consequences of the causes, and if there is a significant and enduring national economic recession, to the extent required for redressing the balance of the national economy.

The FC is the institutional guarantee of the compliance with these provisions. The Fundamental Law underlines that the adoption of the State Budget Act shall be subject to the prior consent of the FC in order to meet the requirements mentioned above.

Severe rules should be applied to the implementation of the budget as well. According to article 37 of the Fundamental Law "the Government shall be obliged to implement the State Budget in a lawful, practical and transparent manner, with efficient management of public funds. During the implementation of the State Budget, no debt or financial obligation may be assumed which allows state debt to exceed half of the GDP, with the exceptions defined by Article 36(6). During the implementation of the State Budget, as long as state debt exceeds half of the GDP, no debt or financial obligation may be assumed which allows the share of state debt related to the GDP to exceed its level in the previous year, with the exceptions defined by Article 36(6)." The monitoring of the implementation is the constitutional task of SAO, since the Fundamental Law fixes, that SAO **"**shall be the financial and economic audit agency of Parliament. Acting within its statutory competence, the SAO shall audit the implementation of the State Budget, the management of public finances, the utilisation of funds from public finances and the management of national assets. SAO shall examine the criteria of lawfulness, practicality and efficiency."

As a consequence of the new regulation the RI prepares a study on the macroeconomic risks related to the Budget Bill. SAO set up a monitoring system by which information gained during the audit of the implementation of the budget of the previous years could be used for the assessment of budget proposals of the next year. The relevance of this should not be underestimated hence many mistakes of the budget formulation were routed in the false figures of the basis years. It means that the new regulation opens a good possibility for the SAO for channeling its audit experience and analytical capacity into the formulation of the opinion of the FC in order to enhance the transparency and the accountability of the state budgeting process.

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