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Hungary: Report on the Observance of Standards and Codes—Fiscal Transparency Module—Update

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REPORT ON THE OBSERVANCE OF STANDARDS AND CODES
HUNGARY—FISCAL TRANSPARENCY MODULE: AN UPDATE
APRIL 2004

The Report on the Observance of Standards and Codes (ROSC) in Hungary was issued in April 2001, and was subsequently updated in May 2002 and April 2003.[1] *The original report concluded that Hungary met many of the requirements of the Code of Good Practices on Fiscal Transparency, while identifying a number of areas where transparency could still be improved. Important progress has been achieved since then on several fronts to bring fiscal transparency in Hungary closer to international best practices. Hungary is joining the European Union (EU) on May 1, 2004 and many of the changes have been prompted by harmonization of Hungary's fiscal practices and norms with those of the EU. This note reports on developments since the 2003 update. For a full description of institutions and practices, and IMF staff recommendations, this note should be read in conjunction with the original report and its two updates.*

A. Clarity of Roles and Responsibilities

The original ROSC suggested a broadening of the fiscal coverage by including in the definition of general government the operations of a few key public institutions and companies, as well as the activities of a large number of nonprofit institutions that perform government functions. It also recommended the elimination of the remaining quasi-fiscal activities (QFAs) of public enterprises. It further suggested that the use of privatization receipts be made subject to ex ante parliamentary approval.

- Consistent with the ROSC recommendations, the Ministry of Finance (MoF) in cooperation with the Prime Minister's Office conducted a survey of all non-profit institutions that essentially perform government functions and in which the government and central budgetary units exercise ownership rights. The survey identified 175 foundations and "public benefit" companies, with a total initial capital of about Ft 70 billion. Based on this survey, all those non-profit institutions and public benefit companies that rely mainly on budget support for financing (with the threshold of support still to be determined) will be absorbed by the central budget. Work is in progress in this area. Otherwise, there has been no further broadening of the fiscal coverage of general government since last year.

- From 2004, and in the context of the 2004 budget law, the use of privatization receipts has been limited to financing infrastructure development projects included in the central budget and approved by Parliament. In 2003, their use was restricted to

[1] The original report *Hungary—Report on the Observance of Standards and Codes—Fiscal Transparency Module* and its 2002 and 2003 updates are available on the IMF internet web site at: www.imf.org./external/np/rosc/rosc.asp.

pre-financing EU-related infrastructure and human resource development projects, and prior to 2003 they were used entirely to retire public debt.

- Some QFAs were eliminated in 2003 when the central government purchased three key subsidiaries of the Hungarian Development Bank (MFB).[2] Also, a major source of QFAs arising from government regulatory operations was removed when electricity and natural gas prices were raised to cost recovery levels and implicit subsidies were eliminated in 2004.

B. Public Availability of Information

The periodicity and timeliness of fiscal statistics in Hungary meet or exceed the requirements of the IMF's Special Data Dissemination Standards.[3]

- In January 2004, the IMF Statistics Department (STA), in cooperation with the Hungarian authorities, conducted an in-depth assessment of the quality of government finance statistics.[4] STA reported significant improvements, particularly with regard to the coverage of general government, data consolidation, and reconciliation of deficit and financing—some of the data quality issues identified in the original ROSC.

- A 2003 amendment of the Public Finance Law required the government to publish, beginning with the final accounts of 2002, detailed explanation of the differences between the accounts based on the national definition and those reported to Eurostat on the basis of the European System of Accounts 1995 (ESA 95).[5]

- The MoF began compiling quarterly data for the "legal government" sector on an ESA 95 basis, currently for internal use and for reporting to Eurostat. The policy for

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[2] See the April 2003 update.

[3] MoF publications are available on its web site at: www.pm.gov.hu/enghome. See also *Hungary—Report on the Observance of Standards and Codes—Data Module* issued in 2001 and its three subsequent annual updates, all posted on the IMF web site (footnote 1).

[4] The STA report is also available on the IMF web site.

[5] In terms of coverage, the State Privatization Company (APV Rt), which since 2003 has been consolidated with general government on ESA 95 basis, is still not included in the official definition. Other important state enterprises which are still outside the ESA 95 framework include: the National Road Construction Company, the State Debt Management Company, and the State Treasury Management Company. There are also differences due to accrual (ESA 95) versus cash accounting (national definition) and a small difference arises from different treatment of a particular debt assumption in 2002.

publishing these data will be established soon in consultation with Eurostat, the Hungarian Central Statistical Office and the Magyar Nemzeti Bank (the central bank). The MoF also intends to begin consolidating the general government accounts quarterly on the basis of the IMF's *Government Finance Statistics Manual 2001*, which is compatible with ESA 95.

- As part of the "Glass Pockets" program (see below), a government decree has identified a comprehensive list of documents related to central government finances and central and local government budgetary institutions that should be made publicly available.

- Since 2002, government units (including local governments) are obliged to report their financial assets and liabilities on a "fair value" basis, and on the basis of market value when available. Their annual balance sheets and quarterly financial reports include the opening and closing stocks of their financial assets and liabilities on this basis.

C. Open Budget Preparation, Execution and Reporting

The budget process in Hungary is open and increasingly in conformity with EU procedures and norms. Budget preparation and execution has been strengthened over the years, and further progress was made last year. Specifically:

- Amendments to the Public Procurement Act have fully harmonized procurement procedures in Hungary with those of the EU, including the abolition of national preference. A proposed amendment intends to move the coverage of general government for procurement purposes to the broader ESA 95 definition.

- Line ministries will have to formulate, by end-September 2004, indicators of performance, that could be monitored, for budgetary institutions and all other institutions that essentially perform public functions and fall within the ministries' jurisdictions. As an important first step toward "value-for-money" budgeting, these indicators will be used in budget preparation and for ex-post control.

- Hungary's 2003 Pre-Accession Economic Program (PEP) submitted to the European Commission improved its analysis of medium-term fiscal risks and provided an estimate of the structural fiscal deficit.

But, there have also been reversals, notably:

- ➢ The government did not proceed as planned in developing a rolling three-year fiscal program with ceilings on overall expenditure and sub-ceilings on the main expenditure components. Currently, medium term objectives, published in connection with the 2004 budget, include non-binding deficit targets for 2005–06. (The 2004 deficit target was subsequently revised upward).

- A 2002 amendment to the organic budget law—which permits additional spending without supplementary budget appropriations and parliamentary approval, provided that the deficit does not exceed the budgeted amount by more than 5 percent of total expenditure—allowed additional expenditure and a higher deficit in 2004.

D. Independent Assurances of Integrity

The original ROSC concluded that internal and external audit controls are open and effective and that the State Audit Office (SAO) is an independent professional agency. Important progress has been made since the last update to strengthen audit and financial control procedures related to the use of public funds and property.

- Most importantly, in mid-2003, the government launched its "Glass Pockets" program to enhance transparency.[6] As a part of this program:

    - The SAO is empowered to scrutinize and audit not only the operations of budgetary institutions, but also of private companies involved in public procurement and all contracts involving public money and property.

    - Managers and members of the supervisory boards of state-owned enterprises with a share capital in excess of Ft 200 million are required to declare their assets.

    - Information related to the budgets of central and local governments, to public property, and to EU-related expenditures are no longer subject to protection of trade secrets.

    - All contracts in excess of Ft 5 million related to the spending of public funds and management of public property should be made public.

- A new government decree strengthened the internal audit of public budgetary organizations (PBOs) by establishing procedures for their financial, system-based as well as performance audits in line with internationally-accepted standards set by the Institute of Internal Auditors.[7] Internal auditors are provided functional and organizational independence and have to meet higher standards of qualification.

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[6] Formally, Act XXIV of 2003 related to spending of public funds, and transparency, management and control of public property, which became effective on June 9, 2003. This involved amendments to 19 existing codes and acts, including the Civil Code, the Act on State Audit Office, the Act on Public Finance, and the Act on the Protection of Personal Data and on the Openness of Official Documents.

[7] Government decree 193/2003 on internal audits of PBOs entered into force in November 2003, replacing the previous procedures set in a 1999 decree.

Audit summaries will be provided to the MoF annually. On the basis of these reports, the Minister of Finance—who will be solely responsible for the coordination and harmonization of the Hungarian internal audit system—will have to present a comprehensive report to the government on the quality of financial management and internal controls in the government sector.

- New regulations require the PBOs to develop and put in place a system of financial management and control, establish an audit trail, and undertake regular risk assessment of their own activities.[8] Proper documentation has to be maintained for control and audit purposes on all financial decisions in budgetary planning, commitments, contracts, disbursements and recoveries due to irregularities.

E. IMF Staff Commentary

Hungary made further progress last year in bringing fiscal transparency closer to international best practices, with some of these changes prompted by the EU accession. The progress in enhancing transparency and accountability in the management and use of public funds and property is particularly noteworthy. As a part of the "Glass Pockets" program, more information on the use of public funds is now being made available, the scope of ex-post supervision by the SAO has been expanded, and the internal audit procedure of PBOs has been significantly strengthened. Moreover, important first steps were taken toward performance-budgeting, the public procurement policy has been tightened to comply with EU norms, and the activities of many non-profit institutions and public benefit companies are being brought into the budget fold. There have also been improvements in data consolidation, reconciliation, and reporting.

Last year, the authorities were considering a three-year rolling budgetary framework with expenditure ceilings. Introducing such a framework would strengthen budget planning, execution, and management. With a view to further strengthening fiscal institutions, the practice of allowing additional budgetary spending without supplementary appropriations and parliamentary approval should be discontinued.

Some of the QFAs of the MFB have been eliminated. However, MFB lending to small and medium-size enterprises and to new family doctors is still of a quasi-fiscal nature and should be discontinued. Also, no progress has been made in quantifying and reporting tax expenditures, and a number of data quality issues still remains.

[8] These regulations are included in a new chapter on financial management and control of PBOs following amendments to the government decree 217/1998 on the operation of public finances.