MNB Public Finance Workshop

TEMPORARY MEASURES AND OFF-BUDGET ACTIVITIES

edited by Gábor P. Kiss

MAGYAR NEMZETI BANK

Gábor P. Kiss (ed.)

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Introduction
Ferenc Karvalits and Gábor P. Kiss

As a result of the international tendency of a medium-term orientation for monetary policy, fiscal analysis and forecast have become more widespread in central banking. Central banks step up their efforts to evaluate and monitor fiscal policy; however, the analysis of public finances remains an extremely complex task. The economic assessment of statistical deficit figures is made very difficult by the practice of fiscal gimmicks and natural reasons such as cyclical developments. Cooperation within the European System of Central Banks provides good examples for methodological innovations. Workshops are regularly organised by members of the ESCB; in some cases the proceedings are also made available. Other results of this cooperation are published in the working paper series of the European Central Bank.

A working paper on cyclical adjustment was published in 2001, in which ESCB members developed the first practical solution for the composition problem neglected by the standard aggregated methods. Later, these disaggregated and aggregated approaches were integrated by the Magyar Nemzeti Bank. And, as a final achievement, a joint study of the OECD and MNB was prepared. In a more recent ECB working paper, prepared by several members of the ESCB, a disaggregated framework for fiscal analysis was introduced which incorporated the disaggregated approach of cyclical adjustment and the exclusion of identified temporary measures.

Participating in the cooperation, the MNB had decided to organise a workshop on fiscal gimmicks such as off-budget activities and temporary measures.[1] The issue of off-budget operations is usually ignored within the EU – the first mention of loss-making public companies was made in the Commission's latest country report on Portugal. The concept of temporary measures was introduced by the new Stability and Growth Pact. However, their identification may prove very difficult in practice, since there is no common methodology. In fact, capital injections are often claimed to be related to temporary measures, without recognising the underlying causes, namely, the off-budget operations hidden in the corporate sector.

This volume consists of seven papers and three discussions. The contributions cover a wide spectrum of topics, ranging from country experience to methodological issues. Country experiences from France, Germany, Hungary, Italy, Portugal and Spain underline the relevance of both temporary and off-budget operations in the EU, and some of the papers presented attempt to offer an explanation for their existence. Methodological aspects of their identification are discussed in the contributions by Langenus, Manesiotis, Mihajlek, Momigliano and Rizza, and P. Kiss.

Growing uncertainty about the government's true fiscal position seems to be a common problem. As an introduction, Mihajlek's paper reviews how central banks in emerging market countries address two problems of fiscal transparency that have recently gained importance from a central bank perspective: hiding liabilities (off-budget operations) and hiding assets by special fiscal funds. Fiscal gimmicks are of concern both to central banks that set monetary policy on their own, taking fiscal policy as given, and to those that have adopted an institutional framework for coordinating monetary and fiscal policies.

National accounts in the EU, as Manesiotis argues, have been polluted ever since the fiscal balance from this statistical concept became a binding legal obligation. Some of the papers indicated that off-budget operations are a relevant issue not only for Hungary (Corbacho), but also for Spain (Argimon and Marti) and even for Germany (Dr. Hamker). These papers suggest that the magnitude of such operations is different across countries and may also have different time patterns (Dr. Hamker). Temporary measures are identified as another type of fiscal gimmicks. They have made a sizeable impact in France (Paul and Schalck), Italy (Momigliano and Rizza), Portugal (Cunha) and, to a lesser extent, in Germany (Dr. Hamker).

Fiscal gimmicks have different explanations at state, regional and local government levels. For local and regional governments, the sub-national fiscal rules can provide incentives for gimmickry. It is a potential problem in federal states such as Germany or Spain. On the one hand, Dr. Hamker indicates specific measures which were aimed at avoiding breaches of constitutional borrowing limits in Germany. On the other hand, Argimon and Marti illustrate the low enforcement capacity of the rule that mandated a balanced budget or a surplus at the sub national level in

[1] This wokshop was held in Budapest on 22 June 2007.

Spain; two-thirds of the regions ran a deficit in the first year of implementation.

For the central government, according to Momigliano and Rizza, the rationale for circumventing EU fiscal rules could be the motivation of "buying time" when the economic cycle takes an adverse turn. Ex post information, however, reveals that this strategy was wrong in Italy; the use of temporary operations made it possible to postpone permanent measures. It was also the case in other countries, for example, in Portugal (Cunha). In his discussion, Langenus makes an important distinction between self-reversing and purely temporary measures, indicating that only the latter allows governments to buy time, while measures with self-reversing effects can be considered as "stealing time".

There are instances when the motivation of "buying time" is accompanied by the need to privatise companies with special employer schemes. In fact, short and long-term fiscal impacts can be very different in the case of upfront payments in compensation for the transfer to the government of pension liabilities. The paper by Paul and Schalck discusses the effect of such operations in France. During the privatisation of certain public companies, their special employer pension schemes were taken over by the government. Stress tests show that the risks of fiscal losses are limited, especially with the prospect of an increase in the contribution period that will apply to all pension schemes. The paper by Dr. Hamker also presents the fiscal effects of similar transfers of pension liabilities in Germany.

Since the situation of public finances can be examined from many different perspectives, there is no indicator which could answer every question, and therefore, alternative indicators can be desirable. Most of the papers are concerned with the structural deficit, that is, which excludes temporary fiscal impacts. Few papers deal with the fiscal impulse indicator, a measure which helps to assess the impact of a change in fiscal policy on the economy. In fact, fiscal gimmicks can be investigated from two different angles: one can assess either the fiscal or economic impact. As most of the papers address the first aspect, off-budget activities are regarded as a source of medium-term fiscal risks. Short-term economic impacts are rarely considered, although the consequences of off-budget operations must be taken into account in measuring the distribution of wealth and income within the economy. Private-public partnership projects exert the same effects as traditional public fixed investment: they boost domestic demand and cause a deterioration in external equilibrium (P. Kiss).

An alternative solution would be to analyse a broader definition of the government in order to gain further insight into public sector activity (Argimon and Marti). As already mentioned, capital injections (debt assumptions) can often be regarded as a sign of hidden off-budget operations. Such operations are not immediately compensated by the government, and therefore, they can be thought of as special self-reversing measures (Langenus). In fact, in the analysis of structural developments by the Banca d'Italia, the fiscal impact of debt cancellation was spread over the years 2003-2006, matching the observed surge in off-budget investment by the State Railways (Momigliano and Rizza). The MNB employs a similar method, known as augmentation (P. Kiss). The IMF classification of public companies by examining a broad range of aspects such as managerial independence and financial conditions provides an important alternative tool (Corbacho).

Analysing cash-basis deficits is another alternative for the standard accrual-basis indicators. It can be observed that certain EU countries improve the deficit through inconsistent recording in the accrual and cash-basis methods of accounting. In his discussion, Manesiotis highlights several advantages of analysing cash data and makes suggestions for other indicators which can also sound an alarm. Mihajlek also notes that central bankers in emerging countries rely extensively on cash data which are available almost in real time. P. Kiss poses a different question: whether the cash or accrual basis is justified in terms of the economic effect?

Opening the workshop, the chairman of the first session, Ferenc Karvalits premised that there was no simple statistical solution for gimmickry. Although statistics were corrected a couple of years after certain measures had been taken, any evaluation of fiscal policy requires that corrections be made in time, that is, in advance. Country experiences presented in the workshop show that expert judgement can help to solve this problem. Transparency remains a key issue here. According to the best practices suggested by the IMF, the budget documents should include an analysis of quasi-fiscal operations. Closing the workshop the chairman of the second session, Daniele Franco (Banca d'Italia), stressed the importance of the time dimension in fiscal policy. He noted that the papers presented at the Workshop show that policy-makers sometimes take measures that improve the budgetary outlook in the short-term without improving the long-term fiscal position or even at the cost of worsening it. Some presentations had included the expressions "buying time" and "stealing time". He concluded that the variety of new "fiscal animals" invented by creative policy-makers requires a continuous monitoring and a pragmatic approach by fiscal experts and statisticians.

Section 1

Dubravko Mihaljek:[1] Fiscal transparency from central banks' perspective: off-budget activities and government asset funds

This paper reviews how central banks in emerging market countries assess fiscal positions, and discusses two aspects of fiscal transparency that have recently gained importance from central banks' perspective: off-budget activities and special fiscal funds. By increasing uncertainty about the true fiscal position of the government, these activities are of concern both to central banks that set monetary policy on their own, taking fiscal policy as given, and to those that have adopted an institutional framework for coordinating monetary and fiscal policies.

JEL classification: H19, H50, H69, H81, H82.
Keywords: fiscal transparency, public sector accounts, off-budget activities, sovereign wealth funds, emerging market economies.

1. INTRODUCTION

This paper discusses two aspects of fiscal transparency that have recently gained importance from the perspective of central banks in emerging market economies: off-budget activities and special fiscal funds. The former could be referred to as "hidden liabilities"; the latter as "hidden assets" of governments. Because of widespread financing difficulties in the 1980s and the 1990s, trying to make fiscal liabilities less transparent was common not just in the emerging market economies, but also in the advanced industrial countries. In the 2000s, the turnaround in macroeconomic, external and fiscal positions of emerging market countries, and the abundant liquidity in global capital markets (at least through mid-2007), softened government financing constraints and led the authorities in many countries to start "hiding" fiscal surpluses in special vehicles such as sovereign wealth funds. This paper does not analyse the broader economic forces that underlie these developments. It focuses instead on the simple workings of some of the more common off-budget activities and special fiscal funds.

Section 2 reviews different ways of assessing fiscal positions by central banks in emerging market economies, with a focus on off-budget activities. This section is largely based on responses of central banks from emerging market economies to a BIS questionnaire (see Mihaljek and Tissot, 2003). Section 3 discusses the purposes and design of government asset funds, and outlines some issues they raise for transparency of central bank and fiscal operations.

2. HOW CENTRAL BANKS IN EMERGING MARKETS ASSESS FISCAL POSITIONS

Following the public finance literature, central banks in emerging economies rely on a range of budget balances in their analyses of the fiscal position of the government and the public sector.[2] The choice depends on the aspects of fiscal policy that are of greatest interest to central banks. The most common measure of the fiscal position remains the balance of the *cash-based central government budget*. This is the simplest measure of the fiscal balance and the one linked most clearly to monetary financing of the budget deficit (see IMF, 1986 and 2001). Moreover, information on central budget positions is usually available on a monthly basis with relatively short delays. Policymakers in central banks therefore rely extensively on updates concerning the central government budget, making various adjustments to arrive at the measures of fiscal position which are relevant for monetary policy. Another rationale for this measure is that the central government typically dominates local governments in terms of both size and involvement in financial markets.

In countries with a federal structure of government or large sub-national governments, it is necessary to look beyond the

[1] The views expressed are those of the author and do not necessarily represent those of the BIS. Helpful insights and encouragement provided by Gabor P. Kiss are gratefully acknowledged.

[2] The discussion in this section refers to 23 emerging market economies from Asia (China, Hong Kong SAR (hereafter, Hong Kong), India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand); Latin America (Argentina, Brazil, Chile, Colombia, Mexico and Peru); central and eastern Europe (the Czech Republic, Hungary, Poland, Russia and Turkey); and the Middle East and Africa (Israel, Saudi Arabia and South Africa).

central government to the fiscal positions of state and local governments. National fiscal authorities have often been forced to cover the losses and obligations of sub-national governments, in particular in Latin America. The coverage of the *general government* in fiscal accounts has improved in recent years, but data on the activities of local governments are usually only available with long delays. In central European countries, for instance, final outturns of local government budgets are sometimes known only nine months after the end of the fiscal year.

There are often considerable difficulties with consolidation of state and local government data, which may result in double counting. This creates significant uncertainty for monetary policy. A related issue is that, despite availability of fiscal accounts on a general government basis and significant improvements in fiscal transparency, the budgetary process and political attention in most emerging economies remain focused on central government budgets. This is a major concern for central banks in larger countries, where central government frequently accounts for less than two thirds of general government spending. On the other hand, to the extent that local governments are subject to tight borrowing limits, their activities need not affect monetary policy or GDP growth in a significant way.

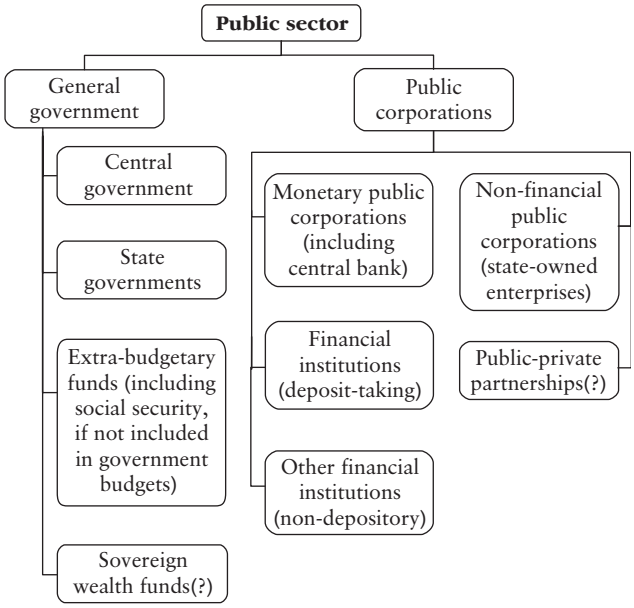
Off-budget activities

Central banks in emerging economies are increasingly using more comprehensive *public sector accounts* in their analyses (Figure 1). Heightened attention to such indicators has resulted not only from greater availability of fiscal data, but also from the realisation that general government fiscal accounts often exclude extensive quasi-fiscal activities and contingent liabilities of government and public sector institutions (see the Appendix for a taxonomy of fiscal risks).

It should also be noted that covering the activities of public corporations in public sector accounts is not always straightforward. Many public corporations are run like private companies and their shares are publicly traded (e.g. national petroleum companies). Most countries consider only investments of such firms as government capital spending.

The last few years have witnessed the emergence of two new forms of quasi-fiscal activities that have yet to be treated as part of public sector accounts: public-private partnerships and sovereign wealth funds. Arguments for including public-private partnerships in public sector accounts are considered by P. Kiss (2007) in an accompanying paper in this volume. Arguments for including sovereign wealth funds in fiscal

Figure 1



accounts have yet to be elaborated. Nonetheless, as the discussion in Section 3 indicates, there is little doubt that their activities can have major implications for both fiscal and monetary policies.

The scope of fiscal activities that remain outside government budgets is of considerable importance for central banks because it is difficult to conduct short run monetary policy without knowing the fiscal position. However, data on such activities are generally not provided to central banks on a regular basis. As a result, for many central banks the margin of uncertainty about the government's fiscal position often amounts to several percent of GDP. The following examples illustrate that any analysis of a country's fiscal position is far from complete if it overlooks the obligations the government has taken on outside its budgetary system.

- Measured fiscal balances in many Latin American countries during the first half of the 1990s looked better than they really were because they included privatisation receipts "above the line" but did not show liabilities such as pension arrears that were later partly recognised.

- In the Czech Republic, Mexico and Russia sizeable short-term public sector obligations were hidden in the balance sheets of weak financial institutions under government control.

- The crises in Asia (1997-98), Russia (1998) and Turkey (2001) have shown that when the stability of a country's financial system is at risk, markets usually expect the

government to provide financial support that far exceeds its legal obligation.

- Many emerging economies rely on guarantees, extra-budgetary funds and state development banks as a non transparent substitute for budgetary subsidies and for bypassing budgetary ceilings on government consumption and investment expenditure. One example is Mexico's public works programme Pidiregas (Projects with a deferred impact on public expenditure recording), worth an estimated 4% of GDP. It is financed with funds raised internationally under the guarantee of the federal government. Spending under this programme is not registered "above the line" until the project is finished and received by the public sector.

- China is another striking example of the importance of the broader public sector for the assessment of the fiscal position. The official data show that China's state budget deficit has hovered at relatively low levels (2-3% of GDP) over the last 20 years, even though fiscal activity extends well beyond the official state budget. Following the formal separation of state-owned enterprise finances from the budget, the government has used the banking system extensively to support state-owned enterprises, and a significant share of these loans has become non performing. The loan losses of the state-owned banks, although not legally a liability of the government, would have to be covered by additional state resources in the future if deposit liabilities are to be honoured. If the government's quasi-fiscal liabilities from the banking system were included, the broader fiscal deficit would be significantly larger (estimated at about 5-6% of GDP by the IMF), as would be the level of government debt.[3]

Table 1 indicates to what extent some of these non traditional budgetary items are being accounted for in the fiscal accounts. Off budget expenditure by various government-supported entities remains largely unaccounted for. Hungary, India, Indonesia, Israel, Mexico, Peru, the Philippines, Poland, Russia and Thailand estimate, but do not include, such expenditure in public sector accounts. Similarly, contingent liabilities are estimated, but not included, in public sector accounts in Brazil, Chile, Colombia, India, Israel, Mexico, Peru, the Philippines, Poland and South Africa.

Table 1 does not reveal considerable variation regarding the types of off budget expenditure and contingent liabilities that are being accounted for. Most countries identify ex post at least some of what had previously been contingent liabilities in their fiscal accounts; examples would be costs associated with banking failures or the need to clean up liabilities of entities being privatised. But ex ante coverage rarely extends to implicit direct liabilities such as future healthcare, pension and social security obligations of the government. With the exception of New Zealand, most industrial countries do not account for such items either.

The last part of Table 1 shows how countries account for proceeds from privatisation, an asset item that has been quite important for the assessment of fiscal positions over the past two decades. Many Asian countries still include proceeds of government asset sales in budget revenue, i.e. "above the line" rather than as a financing item. Most emerging economies, however, distinguish government asset sales as a special item in the budget, or account for it as a financing item (i.e. "below the line"). One should also note that creative accounting of the privatisation proceeds can survive even in an advanced government accounting framework such as ESA, when coverage of the government sector is insufficient.[4] For instance, proceeds from the privatisation of a profitable, cargo branch of the Hungarian railway company (which was separated into passenger and cargo branches) are reportedly being used to subsidise the loss-making, non-privatised company (former passenger branch). In principle, this transaction should be rerouted, by recording privatisation proceeds below-the-line, and the capital transfer above-the-line.

[3] Recognising the stock of non recoverable bank loans, estimated at between 50-75% of GDP at end 2000 (of which an amount equivalent to 15½% of GDP has been transferred to asset management companies), would raise public debt to 75-100% of GDP as of end 2000; see IMF (2002).

[4] I am indebted to Gábor P. Kiss for this insight.

Table 1

Accounting for special fiscal items

Off budget expenditure	
Estimated but not included in the accounts	Hungary, India, Indonesia, Israel, Mexico, Peru,[1] Philippines, Poland, Russia, Thailand
Not quantified	Chile, Czech Republic
Contingent liabilities	
Shown as financing or a balance sheet item	Indonesia, Russia
Estimated but not included in the accounts	Brazil,[2] Chile, Colombia, India, Israel, Mexico, Peru, Philippines, Poland, South Africa[3]
Not quantified	Argentina, Czech Republic, Hungary, Thailand
Government asset sales	
Shown as budget revenue or in government income statement	Argentina, Chile,[4] China, Hong Kong, India,[5] Malaysia, Mexico, Thailand, Turkey
Special item in budget revenue or government income statement	Brazil, Chile, Hungary, Philippines, Singapore,[6] South Africa[7]
Shown as financing or item in government balance sheet	Argentina, Colombia, Czech Republic, Indonesia, Israel, Peru, Poland, Russia, South Africa,[8] Turkey

[1] Included in budgetary accounts. [2] Included in the debt calculation and projections. [3] Actual audited data. [4] Only capital gains. [5] Proceeds from disinvestments in public sector undertakings. [6] Included under capital receipts in the budget. [7] Disposal of assets (ordinary). [8] Disposal of assets (privatisation).

Source: Central bank responses to the BIS questionnaire.

An issue of particular concern for central banks in highly indebted economies is how to disclose the information on contingent liabilities to the markets. There is a feeling among many central bankers that disclosure standards for emerging economies have become more stringent than for advanced market economies in recent years. Most central banks agree that appropriate accounting of contingent liabilities (such as local government borrowing, extra-budgetary funds and losses of state-owned enterprises and banks) is necessary in order to provide the right incentives to policymakers and borrowers. However, disclosure of previously unrecorded liabilities may be misinterpreted (Why is the government revealing the "skeletons in the closet" now? Is there more to come?), and sometimes gives speculators an idea of vulnerable points to attack. It has been argued, for instance, that one could not rely on market analysts to interpret the information on quasi-fiscal activities correctly: even with the IMF's SDDS, there were misinterpretations of the data. Harmonisation of information was therefore not sufficient; one also needed to educate the markets.

Private financial market participants in particular view sudden jumps in the debt-to GDP ratio as a sign of debt sustainability problems. There is thus an incentive to reveal contingent liabilities slowly or not at all. One way to avoid such jumps in expenditure is to include items such as loan guarantees in the budget at the time they are approved rather than when they come due. On the other hand, central banks that have dealt extensively with different contingent liabilities feel that one should not wait for a crisis to recognise such liabilities – if markets have not paid attention to contingent liabilities before a crisis, they will certainly do so afterwards.

In summary, although central banks and fiscal authorities in emerging economies are for the most part aware of the need to look beyond the narrow central government budget, their assessments of the fiscal positions of the general government and the public sector are still far from comprehensive. An additional problem is that the budget-making process typically retains a one year focus in most countries – in particular, line ministries' concerns rarely extend beyond the current fiscal year. Multi-year fiscal frameworks have been developed mostly in the context of IMF supported programmes (Indonesia, Korea, Turkey) or EU accession (central Europe), or have been in place as part of narrower budgeting (Hong Kong, Singapore) or planning exercises (India), rather than as part of a comprehensive macroeconomic framework.

3. SPECIAL GOVERNMENT ASSET FUNDS

Over the past few years many emerging market countries have established special government asset funds that are gradually becoming major institutional investors in global capital markets. One group of countries that established such funds are resource-rich economies, which are currently benefiting from high prices for oil, metal and other commodities, but over longer periods face considerable volatility in revenues from exports of these resources. Another group of countries are emerging market economies

that have decided to accumulate substantial foreign exchange reserves following financial crises of the 1990s and are now apparently willing to take more risk in their reserve management policies. Estimates of the size of these funds vary widely, from around $0.9 trillion (Rozanov, 2005) to around $2.5 trillion (Morgan Stanley, 2007) in the mid-2000s.

Special government asset funds can be divided according to several criteria, including goals or motives for their establishment; sources of funding; and (current) uses of resources (Table 2). The demarcation lines within and between these categories are in practice often blurred. For instance, many oil funds were originally established with the goal of stabilising disturbances from volatile export revenue on the government budget, monetary policy and the economy. As part of this function, many funds included (or gradually developed) rules for transferring part of their assets to the budget, thus assuming a financing function in addition to the stabilisation function. At some point, fund assets had to be invested, so they inevitably assumed some wealth preservation functions as well. And with the sharp and, perhaps, permanent rise in oil and commodity prices in recent years, some stabilisation funds have evolved further to wealth accumulation and saving for future generations.

In terms of sources of funding, the clear-cut cases are rents and tax revenues from natural resources; sales of government-owned assets such as land or state-owned enterprises; and fiscal surpluses. Less clear-cut are the cases when part of foreign exchange reserves is carved out to form a sovereign wealth fund – much of foreign exchange reserves represents borrowed funds on account of sterilised intervention of foreign exchange inflows to the private sector – or when assets are transferred from other government-owned portfolios (e.g. the finance or economy ministries' equity shares in various companies).

Finally, different funds could be distinguished on the basis of current uses of their resources: stabilisation of government budget based on overall fiscal developments ("needs-based" stabilisation); rules-based financing of a certain proportion of government expenditure; and the prevailing use of fund resources, for instance, infrastructure development, financial market development (e.g. recapitalisation of financial institutions) or external debt repayment.

Stabilisation funds

Countries relying on exports of natural resources face macroeconomic stabilisation challenges on several fronts. First, revenue streams associated with such exports tend to be very large and very volatile.[5] Second, the use of foreign exchange inflows from natural resource exports can have major effects on macroeconomic stability and economic structure. In particular, the domestic use of the inflows generally leads to an appreciation of the real effective exchange rate and a loss of competitiveness in the non-resource based tradable sectors of the economy. Third, much of the revenue from natural resource exports accrues to the government; spending of this revenue is thus subject to political influence and potential waste.

These considerations provide a rationale for the establishment of stabilisation funds for non-renewable resources, which are essentially mechanisms designed to reduce the impact of volatile foreign exchange inflows on the economy (and/or of volatile revenue on the government

Table 2

Taxonomy of special government asset funds

Goals/motives for establishment	Source of funding	Uses of fund resources
Stabilisation of macroeconomic impact of natural resource revenue	Natural resource rents and taxes	Fiscal stabilisation (needs-based)
Saving/intergenerational transfers	Fiscal surplus	External debt repayment
Sovereign wealth management	Government asset sales (land, privatisation revenues)	Rules-based financing of government expenditure
Fiscal surplus	Transfer of other government-owned assets (company shares, foreign exchange reserves)	Infrastructure/financial market development Funding of future pension and health care liabilities
	Borrowed funds (sterilised intervention of foreign exchange inflows to the private sector)	Intergenerational transfers

[5] Oil exports accounted on average for 65% of total exports and 26% of GDP in OPEC member countries during 2001-04. Regarding volatility, the standard deviation of the ratio of oil exports to GDP was 3.2 percentage points, compared with total GDP volatilities in industrial countries of about 2 percentage points of GDP.

budget) by transferring this impact to the fund. The fund's objectives may also include supporting fiscal and monetary discipline and providing greater transparency in the foreign exchange market and the spending of government revenue. For instance, most stabilisation funds allow the inflows to pay off public sector external debt as this automatically redirects the inflows abroad and thus limits the impact on the local economy.

Many oil-exporting countries – including Algeria, Norway, Russia, Venezuela and several Central Asian and Persian Gulf countries – have established oil stabilisation funds. Many of these funds – eg the Russian Federation's Stabilisation Fund – are designed to accumulate resources when the oil price or revenue exceeds some threshold, and to pay out when the price or revenue falls below a second threshold. Chile's copper stabilisation fund, established in 1985, has rules of accumulation and withdrawal that are based on a reference copper price set annually by a panel of experts advising the government. The existence of such a fund helps the government resist expenditure pressures during upswings in copper prices, and reduces the need to borrow during the downswings.

Some funds additionally have operational rules designed so that they regularly finance a part of government expenditure. In Norway, for instance, the expected real return on the fund, assumed to be 4% of the fund's market value, can be transferred to the central government budget each year. By providing an explicit and transparent link between asset accumulation and the budget, such rules-based financing shields the budget from revenue uncertainty and volatility.

One should note that stabilisation funds do not deal with spending or deficits at the government level. If there is insufficient control of spending or deficits on the regular budget, the operation of the fund cannot ensure fiscal discipline. This provides a rationale for supplementing stabilisation funds with special fiscal rules. For instance, the government in Chile has to generate a 1% surplus on its structural fiscal balance each year, estimated by removing the effects of variations in copper prices and the economic cycle on revenues.

Savings funds

Revenue from non-renewable resources constitutes national wealth that can be approximated by the rent earned in their production, essentially the proceeds from projected future sales after deduction of relevant extraction costs (including profits accruing to the companies involved). Using the principle of intergenerational equity one can argue that this national wealth should be managed in a manner that will leave future generations at least as well off as the current one. The idea to create a store of wealth for future generations represents the savings motive for the establishment of special foreign asset funds.

The savings motive does not preclude spending part of the resource revenue. In many countries there is a clear need to build up or upgrade domestic infrastructure, clean-up the financial sector from old debts or strengthen its capital base after a crisis, and improve the quality of public services. The present generation could thus use up part of the natural resource wealth and leave future generations wealth in the form of physical infrastructure, a more stable financial system and improved public institutions. Such public expenditure could also crowd in private investment in the process. The decision about the form of asset accumulation – financial vs. real – would depend on the absorptive capacity of the economy. One danger is that investment spending might rise to an unsustainable level, or that too quick an increase might result in poor-quality projects. In addition, a perception that resources are readily available for domestic uses could create incentives for rent seeking and make the fund prone to abuse.

Savings funds have for instance been established in Norway, Alberta, Alaska and Kuwait. Norway's Petroleum Fund, established in 1990 (now called the Government Pension Fund – Global), collects all government's net income from oil and invests it in financial assets to be drawn upon in the future. The present generation benefits from interest income earned on fund's investments. The future generation benefits from a permanent stream of income on financial assets that have replaced oil in the ground.

Sovereign wealth funds

The main objective of some large government asset funds is neither stabilisation nor accumulation of new saving but rather the management of new assets. Funds with this main objective could be termed "sovereign wealth funds". Some of these sovereign wealth funds were carved out of existing official foreign exchange reserves. Others, such as Government of Singapore Investment Corporation, Abu Dhabi Investment Authority and Kuwait Investment Authority have operated for several decades as institutional investors managing the government's assets portfolios. One should note that the distinction between sovereign wealth funds and saving funds such as Norway's petroleum fund becomes less clear as the size of accumulated savings increases. After some threshold, it becomes intuitively clear that enough savings has been accumulated – in the case of Norway, almost 100% of GDP – and the main issue becomes how to manage the fund's assets prudently while realising a reasonable rate of return.

In addition to the rapid increase in their number, sovereign wealth funds have attracted attention because of the size of their assets – especially in emerging Asia and the Middle East – which is comparable with some of the largest public pension plans and central bank reserves in the world. For instance, the Abu Dhabi Investment Authority, founded in 1976, is responsible for investing all of the Abu Dhabi government's oil revenues and assets in international capital markets. Its size is estimated conservatively at $500 billion, and up to $875 billion according to some private sector estimates. A few decades ago the government of Singapore created two investment arms: Temasek holdings, which manages government shares in many of Singapore's largest companies; and the Government of Singapore Investment Corporation (GIC), which invests primarily the government's foreign reserves.

A recent example of a sovereign wealth fund is Korea Investment Corporation. It was launched in 2005 with a capital of 100 billion won funded by the foreign exchange stabilisation fund. It will initially manage $20 billion of Korea's foreign exchange reserves with the objectives of generating return on foreign currency assets and fostering the development of Korea's asset management business. A similar case is State Investment Corporation, established in September 2007, which will initially manage $200 billion out of $1.4 trillion in China's foreign exchange reserves. Russia's oil stabilisation fund will be split into a reserve fund and a fund for future generations starting in February 2008.

Sovereign wealth funds take different forms and pursue different objectives but share one common characteristic: their origin lies in the prior accumulation of very large foreign exchange or fiscal reserves. As central banks and governments have become more comfortable with the level of reserves, they started to transfer a part of reserves to non-traditional purposes such as government investment corporations (Korea, Malaysia) or restructuring of state-owned commercial banks (China). In addition to conceptual issues, this shift in perspective raises a number of questions about the institutional locus, investment guidelines and governance of foreign asset funds.

Governance, transparency and accountability

Best practices have already been developed for governance of commodity-based funds and they generally mirror best practices for fiscal transparency (IMF, 2005). They highlight government and civic representation, access to dedicated expertise, accountability and transparency. A typical model governance structure includes enabling legislation (which includes the basic tenets of the fund, but not specific eligible investment instruments, portfolio parameters or benchmarks); a board of trustees comprising representatives from the government and legislature, or independent experts answerable to the legislature; and an investment management agent. The board typically formulates investment policy (in particular the strategic asset allocation), while the actual asset management can be performed by either a specialised government agency or the central bank. Asset management could also be subcontracted to private investment managers, with their selection decided in a similar way as for other government procurements.

Best practices for non-commodity-based SWFs have yet to be developed. For existing funds, actual practices span the whole spectrum, from full public disclosure and independent oversight of the rules and operations (as in Norway), to the exercise of more or less full discretion on the part of the authorities controlling the fund. In some cases, the provision of information about SWF operations is not allowed under local legislation. Control and oversight of funds in these institutions is usually restricted to a handful of key government officials. Thus, no information is available about their internal checks and balances, investment strategy or commercial goals.

Central banks have frequently played a role in designing the institutional setup of SWFs; in particular, how far the fund should be integrated with central bank operations or rather operated as a stand-alone entity. Direct central bank involvement in the management of wealth funds has the advantage of maintaining centralised control of SWF assets in one place and avoiding the additional costs of setting up a new and untested management entity. This reflects the fact that many central banks already have systems and skills to manage equity and other higher-return investments. The integrated approach could also allow faster reaction to market developments.[6]

Most SWFs nonetheless exist as stand-alone institutions. One major advantage of such an approach is that it insulates core central bank responsibilities, such as maintaining monetary and financial stability, from potential conflicts of interest. Another advantage is that wealth management is a different discipline from liquidity management. Even if both can be separated at the operational level, under any form of integrated approach the reporting lines might feed into the same group of senior central bank managers and board

[6] For instance, when Hong Kong's currency and equity markets were simultaneously under speculative attack in August 1998, coordination of official actions in foreign exchange and stock markets was helped by the fact that all decisions were taken within the Hong Kong Monetary Authority.

members, who might not have the same optimal risk-return trade-off as the government had mandated. A related issue is that of reputational risk: any significant loss suffered by an SWF operated by the central bank might harm the bank's reputation.

A midway solution is to establish a separate unit within the central bank to manage the SWF. In the case of Norway, the owner of the fund is the finance ministry, while operational management of the fund is delegated to the Norwegian central bank, with a mandate stipulated in a regulation issued by the ministry. The central bank established the fund as an independent wing, along the lines of an investment bank. Most fund managers come from outside the central bank and have experience in investment banking. Different reporting channels and different pay scales are used for fund managers and central bank officials. Responsibility for investment decisions always rests with a single fund manager. The central bank reports on fund operations to the finance ministry each quarter.

The benefits and costs of different governance arrangements are difficult to evaluate without considering the broader socio-political framework in countries where the funds are established. If the overall budget system is poor it is doubtful that a better subsystem can be created to deal with resource revenue and foreign assets. In a number of cases (e.g. Nigeria, Venezuela), oversight of natural resource funds has not always been adequate and assets of the funds were misallocated in the past (see Davis et al, 2003; Fasano, 2000; Mihaljek, 2005). Conversely, sovereign funds that have generated visible benefits for the population at large can be found both in economies that practice very transparent governance arrangements (e.g. Norway, Alaska, Alberta) and those that do not consider such arrangements necessary (e.g. Southeast Asian and Persian Gulf countries).

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APPENDIX

Table 3

The fiscal risk matrix

Liabilities	**Direct (obligation in any event)**	**Contingent (obligation if a particular event occurs)**
Explicit Government liability as recognised by a law or contract	• Foreign and domestic sovereign borrowing (loans contracted and securities issued by central government) • Budgetary expenditures • Budgetary expenditures legally binding in the long term (civil servants' salaries and pensions)	• State guarantees for non sovereign borrowing and obligations issued to sub-national governments and public and private sector entities (development banks) • Umbrella state guarantees for various types of loans (mortgage loans, student loans, agriculture loans, small business loans) • Trade and exchange rate guarantees on private investments • State guarantees on private investments • State insurance schemes (deposit insurance, income from private pension funds, crop insurance, flood insurance, war risk insurance)
Implicit A moral obligation of government that reflects public and interest-group pressures	• Future public pensions (as opposed to government civil service pensions), if not required by law • Social security schemes, if not required by law • Future health care financing, if not required by law • Future recurrent costs of public investments	• Defaults of sub-national government or public or private entities on non guaranteed debt and other obligations • Cleanup of liabilities of entities being privatised • Banking failure (support beyond state insurance) • Failure of a non guaranteed pension fund, employment fund, or social security fund (protection of small investors) • Default of central bank on its obligations (foreign exchange contracts, currency defence, balance of payments stability) • Bailouts following a reversal in private capital flows • Environmental recovery, disaster relief, military financing

Source: Polackova (1999).

Gábor P. Kiss:[1] One-off and off-budget items: An alternative approach

Fiscal analysis requires a set of indicators. For calculating the structural deficit, it is examined whether measures have permanent or temporary budgetary impacts, if any (creative accounting). For measuring fiscal impulse, it is examined when a given measure has a 'true' economic impact, if ever (creative accounting). For example, capital transfers to cover the losses of quasi-fiscal activities do not spread to the actual ('true') period of time by accrual recording. It is important to remove such illusory items from statistical expenditures and revenues, but in order to account for the 'true' effect, expenditures must be augmented, e.g. by quasi-fiscal losses and PPP investment. This type of analytical indicator has been employed by the central bank of Hungary for a decade. According to our experience, this 'true' measure is consistent in a macroeconomic sense and methodologically more robust than the statistical deficit, which often requires a subsequent upward revision. This kind of analytical methodology allows flexibility supported by expert judgement, and at the same time it requires transparency of methods and data.

JEL classification: E62, H19, H69.
Keywords: creative accounting, quasi-fiscal activities, private-public-partnership.

1. INTRODUCTION

'No simple and single indicator can answer many complex questions…' (O. Blanchard)

Central banks in different countries assess fiscal positions in several ways (Mihajlek, 2007). There are also new proposals for improving the way in which central banks can analyze the risk-adjusted balance sheets of the key sectors, including the government (Gray et al., 2007). In this paper, I present the analytical background of the fiscal indicator which has been employed by the central bank of Hungary for the last decade.

Since the situation of public finances can be examined from many aspects, there is no indicator which can answer every question. Depending on the aim of the analysis, different corrections are required (Blanchard, 1990; Chalk 2002; P. Kiss 2002; P. Kiss and Vadas, 2006).

One of the questions revolves around how large a part of the deficit can be considered permanent and structural. Thus, all *temporary* fiscal items are to be eliminated from the deficit – not only exogenous factors (economic cycle, effect of price and yield fluctuations), but one-off measures as well.

It can be examined what part of the change in the fiscal position is attributable to discretionary measures, which may be either permanent or one-off. In this case, however, the definition of the measure causes difficulties (for example, in the case of expenditures how to determine a 'no-policy-change' scenario serving as a basis for comparison).

One may also ask what magnitude of demand impulse a change in fiscal position represents. In this case, it is justified to ignore those fiscal items which *do not have a significant economic effect,* for example creative accounting operations and, under certain conditions, the inflation compensation included in interest.

The fiscal impulse and its impact on the economy differ. The fiscal impulse indicates first-round impacts, while the different spending and revenue components affect demand and supply in different ways. Fiscal impact depends on public spending multipliers; the sensitivity of investment to changes in the user cost of capital; taxes and transfers weighted by the propensity to consume, and, finally, whether fiscal measures were or were not anticipated.

Addressing these various questions requires different corrections of statistical revenues and expenditures. On the one hand, for example, in the case of cyclical adjustment, different elasticities are required (P. Kiss and Vadas, 2006), while on the other, differences are also justified when defining one-off measures. When the fiscal impulse is calculated, within the sphere of one-off measures a

[1] The views expressed here are those of the author and do not necessarily reflect the official view of the central bank of Hungary.

distinction must be made between those with and those without an impact.

First, I provide an overview of why corrections are needed for analytical purposes. Then, the concept of true deficit is introduced and the conceptual framework is determined. Subsequently, the types of corrections are reviewed and illustrated by simple numerical examples. Finally, I draw some conclusions.

2. MOTIVATION

'European governments are hiring private sector banks to help them disguise the scale of budget deficits…' (J. Almunia)

Underlying the problems of statistical recording there are 'natural' reasons, such as nominal interest expenditure is higher due to inflation, while the compensation of the inflationary loss could be treated as amortisation, in other words it is a financing rather than a deficit-increasing item.

However, most problems of recording are attributable to a behaviour of fiscal policy which aims at reducing transparency and masking the deficit (Alesina and Perotti, 1996; Dafflon and Rossi, 1999). The repeated subsequent upward revision of the actual deficit figures may indicate that the increasingly precisely defined statistical rules cannot succeed without a deeper economic analysis of the operations. Creative accounting plays an important role in the business sector as well, a reaction to which in certain countries has been a tightening of the accounting regulations and of control, while in other countries the emphasis has been on the deeper analysis of content. As opposed to this, the rules and control of government statistics are less strict in certain cases, but in other cases rigid in the sense that there is less emphasis on examining the content of specific operations. All this allows fiscal gimmicks to gain ground. Creative accounting is also facilitated by the fact that in some countries the statistical definition of the deficit is still based on budgetary data, the content of which may, as a matter of course, differ due to the national accounting rules stipulated by budgetary laws. As the criteria laid down in the common statistical rules are very often less strict than business accounting, it may happen in practice that fixed assets created through a public-private-partnership-type (PPP) investment are not included in either the private or the government balance sheets. To quote Joaquín Almunia, ' … in many cases the financial engineering concerned public-private partnerships.'[2] The other problem is that the fixed rules do not allow a flexible correction of the effect of gimmickry in government statistics, as the prescribed corrections are also closer to the budgetary concept than to the economic approach, and the latter relies more on estimations. Consequently, the statistical recording of revenues and expenditures may differ from the economic effect. Therefore, in addition to the statistical deficit, several countries also regularly apply various analytical corrections, a practice which has also been followed by the MNB since 1997 (Mihajlek and Tissot, 2003; Girouard and Price, 2004).

3. THE 'TRUE' DEFICIT

'They are legal operations, but we cannot consider them to be deficit reducing.' (J. Almunia)

For an analytical correction of the statistical deficit it first has to be decided what the aim of calculating 'true' deficit is. If fiscal impulse is estimated, it must be decided whether a given measure has a significant economic effect. If the structural deficit is calculated, it must be examined whether a given measure affects the net worth of the government sector permanently.

Table 1

How to measeure the true deficit

(components in bold)

	With an economic effect			Without an economic effect
Fiscal impulse	**Permanent**	**One-off without self-reversing**	**One-off with self-reversing**	Creative accounting (self-reversing)
	There is an effect on net worth		No effect on net worth	
Structural deficit	**Permanent**	One-off without self-reversing	Creative accounting (self-reversing)	

[2] Financial Times: EU states accused of 'hiding' deficits, 5 October, 2005.

Table 2

Statistical and true deficit

True deficit / Statistical	With an economic effect	Without an economic effect
Budget	One-off measures; with or without self-reversing effects	Creative accounting; upfront savings and delayed costs (financing QFAs)
Off-budget	Creative accounting; Quasi-fiscal activities (QFAs) + PPP projects	Market components of public credit and guarantee programmes

According to OECD definitions (Koen and van den Noord, 2005), creative accounting operations affect the fiscal balance or public debt but not, or to a far lesser extent, government net worth, since they have self-reversing effects. In contrast, one-off measures affect general government net lending or borrowing in a given year or for a few years, but not permanently. They have no self-reversing effects.

In the following part of the paper, we use the narrow definition of creative accounting; these are operations which are likely to prove economically insignificant. For example, the US Congressional Budget Office (CBO) routinely publishes an adjusted budget measure, the standardized-budget surplus or deficit, which excludes the effects of such operations. Some self-reversing measures can have insignificant effects on net worth, and prove to be efficient economically at the same time. For example, timing shifts in household transfers can be effective in the case of liquidity constraints. These self-reversing measures can be classified as one-off instead of creative accounting.

The statistical deficit is basically distorted by two kinds of operations. On the one hand, items with insignificant economic effect appear in the budget, while on the other, items which have significant economic effect are excluded (off-budget).

Off-budget activities include quasi-fiscal activities and public investment outsourced into private-public partnership projects.

PPPs may be justified on efficiency grounds, but from the perspective adopted by the OECD their main feature is that they initially reduce the general government deficit and debt for a given level of investment in publicly-used infrastructure (Koen and van den Noord). With this, the profile of the deficit can be altered by switching from traditional government investment to PPP, which holds true even for infrastructure which can profitably be operated by collecting a user fee.

Quasi-fiscal activities are defined by the IMF as: 'Activities (under the direction of government) of central banks, public institutions, and non-financial public enterprises that are fiscal in character – that is, in principle, they can be duplicated by specific fiscal measures, such as taxes, subsidies or other direct expenditures, even though precise quantification can in some cases be very difficult. Examples include subsidized bank credit and non-commercial services provided by an enterprise' (p. 76 in the manual on Fiscal Transparency, IMF).

The statistical deficit includes one-off measures which reduce the deficit and deficit increasing items which are related to the self-reversing effects of creative accounting, for example instalments of PPPs or financing QFAs by capital transfers to public enterprises. Temporary shifts in the timing of taxes or spending can distort not only the cash recording, but also the time adjusted cash recording. In other cases, cash transactions can have an immediate economic effect, while imputed accrual transactions have no impact.

4. CORRECTIONS BETWEEN THE STATISTICAL DEFICIT AND THE 'TRUE' DEFICIT

'Adjustment in these countries was at least partly an illusion.' (W. Easterly)

There are two ways to estimate the 'true' deficit – directly, through statistical deficit correction (Dafflon and Rossi, 1999; Koen and van den Noord, 2005), and according to the balance sheet approach, considering changes in net financial assets or debt (Easterly, 1999; Kharas and Mishra, 2003; Milesi-Ferretti and Moriyama, 2004; Buti et al., 2006). The latter, aggregated solution is easier to follow in practice, although it is incomplete and does not show the revenue and expenditure structure of the analytical corrections, which is necessary for estimating the fiscal impact.[3] The former, disaggregated solution, in turn, requires detailed estimations. The estimated range of one-off measures has been prepared

[3] As it evades both deficit and debt, PPP is not shown in the value of the stock-flow-adjustment (SFA) either, which reflects the difference between the two categories. Therefore, the SFA usable for the balance sheet side estimation of creative accounting does not show this item.

Table 3

Sale of future income, budget effect of upfront recording of concession fees

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
One-off revenue	10									
Lost revenue	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1

Table 4

The budget effect of real estate sales and lease-back

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Sale of real assets	10									
Fee payment (instalment)	1	1	1	1	1	1	1	1	1	1

for some years in only a number of EU countries (Koen and van den Noord, 2005; Public Finances in EMU, 2004; Kremer et al., 2006). Estimations typically have focused on the revenue side, and therefore, this issue is examined first. Following this, the question of timing of expenditures and tax refunds is reviewed. PPP investment and quasi-fiscal activities are dealt with later and finally their delayed appearance in the statistical deficit is also addressed.

One-off revenues which improve statistical deficit

Various OECD studies (Girouard and Price, 2004; Koen and van den Noord, 2005) have dealt with revenues which improve the deficit only temporarily, and later result in revenue losses or additional expenditure. These types of revenues may include mobile phone concession income, extraordinary payments by state-owned companies, sales of tangible assets and lump-sum revenues which involve long-time disbursement (e.g. taking over the liabilities of a corporate pension fund from a state-owned company, securitisation).

For the sake of simplicity, we assumed that the upfront operation is equal to the outspread effect, but this is not necessarily true in the case of compensations for the transfers to the government of pension liabilities from companies (L. Paul and C. Schalck, 2007). If these two amounts are identical, then nothing else happens, but the pattern of deficit changes (see the three examples below). A transaction of this nature can typically be considered as a financing operation, and thus, presumably, its economic effect is not significant. Therefore, when calculating the 'true' deficit, it is justified to correct the statistical deficit with it. Accordingly, in its own methodology the MNB has spread the lump-sum revenue of telecommunications concessions over the contract period.

Similarly, one can spread the lump-sum revenue from real assets over a lease-back period.

One-off revenue from transferring the liabilities of corporate pension funds to the government should be also removed. According to our assumptions it would be consistent with a correction with the related pension payments as well.

The effect of timing of individual items

The previous examples show that the statistical time of recording should be corrected by reclassifying capital revenue as a flow of current items. However, problems with the statistical time of recording are more general. In practice, by timing individual expenditure and revenue items, the government can reschedule the deficit between years without an economic effect. In order to eliminate this, the analytical

Table 5

Budget effect of taking over expenditure liability (e.g. corporate pension fund)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
One-off revenue	10									
Expenditure liability	1	1	1	1	1	1	1	1	1	1

Table 6

Time of recording and the economic effect

	Cash basis	Accrual basis
Fiscal impulse	First-round effect	Not applicable
Fiscal impact	Participants with liquidity constraint, OR unexpected measure	Not applicable
	Not applicable	Participants without liquidity constraint, AND expected measure

methodology applied by the CBO corrects the deficit with such measures. It can also be observed that certain EU countries improve the deficit through inconsistent recording of the accrual- and cash-basis approach (Buti et al., 2006).

There are various possibilities to record transactions. Recording on a cash basis is the simplest and fastest, and it is consistent with changes in debt. Recording on an accrual basis is much more complicated. But the question is: which approach is justified in terms of economic effect?

Recording on a cash basis can be considered an approximation of the first-round effect. This estimation of the fiscal 'shock' overestimates the actual impact, as in certain cases at the moment of payment it has no effect or a much less significant effect than the much smoother recording on an accrual basis. However, recording on an accrual basis underestimates the impact, since it smoothes the shock even when it is not justified, for example in the case of households with liquidity constraint *or* when faced with a surprise situation. Accrual recording is justified only where the revenue and expenditure of the current period do not determine the behaviour of the private sector (Levin, 1993) *and* there are no unexpected measures.

A solution in between the two types of recording is needed. In practice, statistical recording also follows a mixed solution, taking as a basis the cash-basis approach or its mechanical adjustment by some months *(time adjusted cash)*. As a consequence of that, it has remained as vulnerable as cash accounts, moreover, these distortions are less easy to identify by monitoring data from the Treasury. Another problem is that it is not a simple statistical issue to decide when recording on a cash basis or on an accrual basis is justified – that depends on when a liquidity constraint or a surprise can be assumed.

With regard to estimating the fiscal impact, it is necessary to take into account the heterogeneity of the population (Hayashi,1987; Mankiw, 2001; Matsen et al., 2005). In small, open economies the result of involving heterogeneous income groups in the models is that a fiscal shock changes relative prices as well, and even a temporary shock can have a permanent effect on the real exchange rate and the real economy.

While the fiscal impulse which measures the first-round shock could be based on the changes in expenditures and revenues on a cash basis (Philip and Janssen, 2002), the CBO's practice shows that it is worthwhile to perform certain analytical corrections, which are necessary for the assessment of the fiscal impact, immediately at this first level. The MNB has also opted for this approach, correcting the revenue on a cash basis with the effect of the timing of the VAT refund. From the aspect of temporarily bringing the refund forward or postponing it, it is not the effect on the budget balance which matters, but whether this affects the recipient's behaviour, or it can merely be considered as extending or receiving a short-term loan. A delay of some days or weeks apparently has not affected companies' investment decisions, although this is not necessarily true in the event of a several-month delay. In Hungary, this meant distortions in the cash deficit at the end of the year, when this was the only official indicator. By introducing the concept of the accrual deficit the simple time adjusted cash recording was applied. Since this method adjusts cash-basis figures by one or two months, the ESA deficit could also be manipulated by the scheduling of refunds.

Table 7

With unchanged underlying developments (e.g. investment activity) the timing of submitting the invoice and of payment changes

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Decelerating of expenditure	-1		-1		-1		-1		-1	
Accelerating of expenditure		1		1		1		1		1

Table 8

Postponing the fixed settlement day of tax refund, regular subsidy and operational cost by some days (from the end of the year to the beginning of next year)

Change	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Postponement of spending	-1									

Two numerical examples are presented below for the case when settlement on a cash basis (and sometimes on an accrual basis) does not have an economic effect, as it only involves general government borrowing. The first table provides an example for discretionary (ad-hoc) changes in the date of payments. These measures have self-reversing effects, but cannot be corrected by time adjusted cash recording.

The next table gives an example for a one-off improvement, which has no self-reversing effect due to a permanent legislative change in the settlement day of payments. It can be corrected by time adjusted cash recording only if time adjustment is extended e.g. by one month.

Outsourcing public investment into the PPP form

Certain countries use PPPs for circumventing fiscal rules (as well as the deficit and debt at the same time), results in temporary saving (Milesi-Ferretti, 2003; Milesi-Ferretti and Moriyama, 2004; Koen and van den Noord, 2005). The perverse incentives which arise from using long-term contracts in a short-term budgetary framework should be controlled (Monteiro, 2007). The problem related to PPP was already recognised in the United States earlier, thus the CBO follows stricter principles in accordance with business accounting when classifying PPP-type projects outside or within general government. One of the underlying reasons is that if business accounting does not allow certain fixed assets to be accounted for at the private partner, then they must be included in general government. In order to decide on the classification, the final risk is also examined – whether these fixed assets are general purpose assets or they are for the specific purpose of general government, and if they have a private market, i.e. whether they can easily be sold if necessary. According to the World Bank (Irwin, 2003), it is worth moving from the direction of binary classification, i.e. completely private or completely general government classification, towards a continuous classification. Under this approach, both partners may share economic ownership of the asset, recognizing all relevant rights and obligations as assets and liabilities to the extent of those rights and obligations.

When assessing the fiscal impulse or impact, what the MNB examines is whether the government demand results in the creation of new fixed assets. PPP projects exert the same effects as traditional public fixed investment does: they boost domestic demand and deteriorate external equilibrium, irrespective of the extent of risk transfer. However, if the structural deficit was examined, it is the existence of a private market of the given fixed assets based on which it could be decided whether the given PPP is private investment or it can still be classified as general government investment (P. Kiss, 2007).

Quasi-fiscal activities, which circumvent statistics, and appear only subsequently

ESA statistics classify a part of state-owned companies under the government sector and another part under the corporate sector. However, this binary classification is not strict. The

Table 9

Comparison between traditional and PPP investments, if there is no user fee income

Difference	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Investment cost	-10									
Fee payment (instalment)	1	1	1	1	1	1	1	1	1	1

Table 10

Comparison between traditional and PPP investments, if there is user fee income

Difference	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Investment cost	-10									
User fee income	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1

loss-making railways, for example, typically remain in the corporate sector. All in all, the general aspect underlying the various criteria of statistical classification into the government sector is whether the given organisation's activities are market-based or non-market-based, as in the background of sectors created in a statistical sense there is an assumption in terms of economics that the economic behaviour of these units is similar. The behaviour of the market sector is determined by the maximizing net worth, i.e. profitability considerations, while the behaviour of the public sector is determined by the objective of maximizing social welfare. Overall, this is what allows us to distinguish between market production, on the one hand, and non-market production as well as redistribution of income and wealth, on the other.

According to the IMF: 'Two separate motivations have been given for separating enterprises into the groups identified as public and private, even though enterprises could very well be categorized as public for one purpose and private for another. One motivation, based on the behaviour of enterprises, is for predicting an economy's reaction to policy changes and external shocks. The second reason, based on the consequences of enterprise operations, is for measuring the distribution of wealth and income within the economy.' (Stella, P. 1993). Quasi-fiscal operations relating to bank assistance should be included in the augmented balance… Bank assistance operations that have substantially divergent cash and economic impacts should, in principle, be recorded in the fiscal balance when the policy affects the economy (Daniel J. and M. Saal: "Macroeconomic Impact and Policy Response", in: *Systemic Bank Restructuring and Macroeconomic Policy,* IMF, 1997).

In 2001, the IMF extended its definition of quasi-fiscal activities to the central bank and non-financial public corporations, and proposed strict criteria for the classification of state-owned companies in 2004: 'This paper proposes nine criteria, falling into four broad categories: managerial independence, relations with government, financial conditions, and governance structure… Requiring that all the criteria be met would minimize the risk of errors in excluding enterprises from coverage, but would probably be too restrictive. It is therefore proposed that all four criteria related to managerial independence and relations with government, plus at least one of the criteria related to each of the financial conditions and governance structure, would have to be met for an enterprise to be considered commercially run.' (Public Investment and Fiscal Policy, IMF, 2004).

Examining the government sector was not considered sufficient in the United Kingdom either. Hence, in 1998 this was complemented by all public corporations, and the indicator of the net borrowing of the public sector was defined. The figures for net borrowing cover the entire public sector, whereas the Maastricht deficit criterion relates only to general government and excludes net borrowing by public corporations.

The analytical correction of quasi-fiscal activities can be performed by reclassifying either companies or their financing transactions. For example, the MNB augments the deficit with the loss-making companies, including the loss-making railways and the capital's public transport, by reclassifying the various forms of financing under government expenditures. This means that financing, credit and guarantees provided by the privatisation organisation and the state-owned development bank are reclassified as imputed current subsidy, removing subsequent capital transfers in a consistent way. It can be seen as a kind of "spreading" technique mentioned by S. Momigliano (S. Momigliano, 2007).

Hidden subsidy in the form of financing is, of course, a wider category; it covers the losses of not only public corporations. While statistical recording does not take into account in the deficit anything from lending by the government as subsidy, the IMF and the CBO divided these items into market (loan) and non-market (grant) components by determining the hidden subsidy included in the loans. 'Because official credit programs offer more lenient terms to borrowers than are available in the market, or in many cases than those at which the government itself borrows, they contain a pure loan component, reflecting the government's role as a financial intermediary, and a pure grant component, reflecting the government's role as a distributional agent (Wattleworth, M. A. 1993). The CBO extended its assessment method to the provision of loan guarantees as well: in the United States, federal offices have been required by law to prepare annual estimations regarding the grants included in the loans and guarantees provided by them. When estimating the fiscal impulse, the method of the researchers of the Treasury of New Zealand sets out from the cash-flow data, but they are corrected by the provision of advances, loans and guarantees (Philip and Janssen, 2002).

The above numerical examples also demonstrate that the financing of quasi-fiscal activities mostly appears as expenditure (debt assumption, PPP instalments) and to a smaller extent as lost revenue (lower user fee, dividend). If the deficit is augmented by the PPP investment, the losses of individual companies and their hidden subsidies, in order to avoid double recording, analytical correction with the expenditure appearing later and with the lost revenue is required as well.

Table 11

Quasi-fiscal activity (under-financed public services, provision of preferential loans and guarantees) with subsequent settlement of debt

Change	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Saving the grant	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1
Capital transfer					5					5

Table 12

Below-the-line financing of quasi-fiscal activity (e.g. from privatisation)

Change	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Saving the grant	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1
Lost income from dividend					-0.5	-0.5	-0.5	-0.5	-0.5	-1
Below-the-line financing					*5*					*5*

From this aspect, the analytical correction performed by the MNB so far has remained one-sided in the case of those so-called extraordinary items which typically appeared in the mid-1990s and were mainly related to the subsequent settlement of corporate losses during economic transition (see P. Kiss and Szapáry, 2000). These items have not been taken into account in the augmented deficit, neither at the date of settling the debt nor spread over time. In order to make the true deficit of the early 1990s determinable, these extraordinary debt assumptions should also be attributed to those years when the losses were actually produced. A relevant estimation was prepared earlier (P. Kiss, 2002).

5. CONCLUSION

'Central banks should increase their effort to monitor fiscal policy and to publicly stress the importance of sound fiscal policies' (K. Bernoth and G. B. Wolff)

This paper stressed that the determination of fiscal indicators depends on the aim of the analysis. In the case of structural deficit, for example, it is examined whether a given measure has a permanent impact on the net worth of the government sector or no impact at all (creative accounting), or a temporary effect (one-off measure). As the statistical deficit does not meet the various objectives of examination for natural reasons (e.g. cycle, effect of inflation) and due to creative accounting, it is necessary to create alternative, analytical indicators. This paper has proposed analytical corrections for the assessment of the 'true' fiscal impulse.

In terms of the fiscal impulse, what has to be decided is whether the given measure has an actual economic impact and if so, when. The expenditure can be recorded if and at the date when it is a revenue from the aspect of the *recipient's behaviour*. Similarly, a revenue can be accounted for when it is an expenditure from the aspect of the *taxpayer's behaviour*.

A consequence of examining the 'true' effect is that the recording on an accrual basis cannot be accepted automatically. First, discretionary changes in timing of individual items may distort accrual-basis figures. Second, in certain cases, recording on a cash basis represents a better approximation of the economic impact. Third, recording on an accrual basis does not spread the lump-sum concession payments or delayed capital transfers, which cover the losses of quasi-fiscal activities, to the actual ('true') period of time.

Another consequence of analysing the 'true' effect is that it is not sufficient to remove certain items from statistical expenditures and revenues, it is also necessary to augment them. The subsequent appearance of extraordinary capital transfers also indicates that the government sector's statistical recording does not include all fiscal activities. On the one hand, in order to account for the 'true' effect, expenditures must be augmented by the quasi-fiscal losses. On the other hand, public investment expenditure must be augmented by PPP investment, irrespective of the 'fine tuning' of the risk distribution between the public and private partners, as the short-term demand effect of the traditional and PPP-type public investment is identical.

Finally I summarize our experience regarding this type of analytical indicator. This 'true' measure is consistent in a macroeconomic sense and methodologically more robust than the statistical deficit, which often requires a subsequent upward revision. This kind of analytical methodology allows flexibility supported by expert judgement, and at the same time it requires transparency of methods and data.

Collecting information regarding off-budget items is not a simple task, thus our experts are encouraged to make their own judgements. As a result, the fiscal analysis and forecasts of the central bank are credible and often quoted as a benchmark.

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Ana Corbacho:[1] Hungary: Fiscal risks from public transport enterprises

Public enterprises may play an important role in government finances and pose substantial fiscal risks. However, these risks are not always adequately reflected in the fiscal accounts. This hampers the transparent assessment of the fiscal stance, provides incentives to move fiscal activities off budget, and increases risks that unrecorded liabilities materialize unexpectedly. The IMF's Fiscal Affairs Department proposed a framework to the coverage of public enterprises in fiscal indicators and targets based on the fiscal risks posed by public enterprises' operations. This paper applies this approach to the Hungarian State Railways and the Budapest Transport Company and draws some lessons for enhancing the transparency, quality and predictability of fiscal policy in Hungary.

JEL Classification: H32, H11.
Keywords: fiscal risk; public enterprises; quasi-fiscal activities; fiscal transparency.

1. INTRODUCTION

Public enterprises (PEs) may pose significant fiscal risks on account of their quasi-fiscal activities (QFAs) and contingent liabilities. QFAs can lead to financial difficulties, unless they are adequately and transparently compensated by government budget transfers.[2] Contingent liabilities can arise, for example, when there is political interference or mismanagement leading to excessive borrowing and poor profitability. These liabilities can be explicit, as in the case of guarantees, or implicit, if there is an expectation or precedent that PEs in financial distress will be eventually bailed out by the government.

Good practices in fiscal transparency call for the reporting on all activities of a fiscal nature and their associated risks. When PEs undertake QFAs, these operations are not captured in the conventional measures of the government fiscal balance, distorting the nature and extent of fiscal activities. This can lead to poor fiscal policy design and also creates incentives to move fiscal activities to PEs to make the reported government fiscal balances appear better than they actually are. At a minimum, therefore, the operations of PEs should be systematically monitored and transparently reported to the public. This requires adequate frequency and comprehensiveness to allow an assessment of fiscal risks.[3]

In 2005, the IMF's Fiscal Affairs Department proposed a framework to assess fiscal risks from PEs and define the appropriate coverage of fiscal indicators. Quantifying QFAs and contingent liabilities can be methodologically challenging. Thus, identifying in first instance those enterprises that pose the most significant risks becomes important. The Fiscal Affairs Department (FAD) proposed an approach to the treatment of PEs in fiscal indicators and targets, focusing on the fiscal risks posed by the operations of PEs.[4] The ultimate goal of this work is to assist authorities and Fund staff in defining the appropriate coverage of indicators and targets for the analysis of fiscal policy. Appropriate coverage is essential to allow an adequate, transparent assessment of the fiscal stance, mitigate incentives to move fiscal activities off budget, and reduce risks that unrecorded liabilities materialize unexpectedly.

This paper assesses fiscal risks posed by two key public transport enterprises in Hungary: the Hungarian State Railways (MAV) and the Budapest Transport Company

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[2] QFAs may be conducted by financial institutions (e.g., subsidized lending; credit ceilings; exchange rate guarantees), or by non-financial public enterprises (e.g., charging less than commercial prices; provision of social services; pricing for budget revenue purposes; paying above commercial prices to suppliers).

[3] For instance, the IMF Manual on Fiscal Transparency recommends that budget documents include statements on QFAs and fiscal risks, and that the consolidated position of the government and non-governmental public sector agencies that undertake significant QFAs be reported. Similarly, *the 2001 Government Finance Statistics Manual (GFSM 2001)* recommends the compilation of accrual-based statistics on the operations of PEs and the non-financial public sector.

[4] In 2004, FAD conducted several pilot studies to identify "commercially oriented" PEs, which could be considered candidates for exclusion from fiscal targets and indicators. Very few PEs were found to be commercially oriented. More importantly, the pilot studies also suggested various changes in the approach to the fiscal coverage of PEs. See IMF (2005) for further details.

(BKV). As noted by the IMF Report on Observance of Standards and Codes, Fiscal Transparency Module (fiscal ROSC), these PEs undertake QFAs on behalf of the government. However, annual transfers from the budget have been ad hoc and insufficient to cover recurring operating losses. As a consequence, MAV and BKV have resorted to borrowing, typically with government guarantees, which has resulted in an accumulation of contingent liabilities for the government. Since PEs are not covered by fiscal indicators and targets which apply to the general government, there are incentives to under-finance QFAs and report a lower headline fiscal balance until the PEs run into financial distress and have to be bailed out. In the past, these bailouts have been treated as "one-off" operations, hampering fiscal transparency and contributing to overshooting of fiscal targets. Against this background, this paper applies FAD's framework to assess the fiscal risks posed by MAV and BKV and draws some lessons for enhancing the transparency, quality and predictability of fiscal policy in Hungary.

The paper is organized as follows: Section 2 provides a brief overview of public sector enterprises in Hungary. Section 3 applies FAD's approach to assess the fiscal risks from MAV and BKV. The final section offers some concluding remarks.

2. OVERVIEW OF THE PUBLIC ENTERPRISE SECTOR IN HUNGARY

Key assets remain under government ownership and operation. Over 85 percent of the economy is in private hands.[5] According to the Privatization Act (Act XXXIX of 1995), assets may remain in long-term state ownership if they belong to a national public utility provider or are considered to be of strategic importance for the national economy or defence. Capital intensive (MAV, BKV, electricity production) and labour intensive (Post) enterprises remain as state property. The Privatization Act also established the Hungarian Privatization and State Holding Company (ÁPV Rt.) to oversee the privatization program.[6]

There is no centralized oversight and management of PEs. The organization of ownership rights follows a decentralized model.[7] This is regulated by the Privatization Act, which assigns rights and oversight responsibilities between ÁPV Rt. and line ministries.[8] PEs under the supervision of ÁPV Rt. aim to maintain an arms-length relationship with the government.[9] Dividends and transfers between these PEs and the budget are set in business plans. Arrangements regulating transfers between PEs under line ministries and the budget are not transparent. Dividend and transfer policies have been ad hoc, and QFAs have not been fully compensated by the government. QFAs are particularly significant in the cases of MAV and BKV, but are also present in the water, post, electricity, and gas sectors.[10]

Consolidated information on the PE sector is not available. The Hungarian budget covers the state budget sector, including central budget institutions, the health and pension funds, and other funds (e.g., Labour Market Fund; Cultural Fund). For the purpose of reporting on ESA-95 basis, and setting targets for the Convergence Programme, the state budget sector is consolidated with local government operations and certain central government units outside of the state budget sector.[11] The government does not report on the consolidated position of the PE sector, either in budget documents or within-year reports. Budget documents also lack information on QFAs. And the discussion on fiscal risks is limited to loan guarantees of the central government. To assess the fiscal impulse, the central bank of Hungary compiles an augmented measure of the fiscal deficit (the "augmented SNA deficit") which consolidates the general government sector with key QFAs, including those from public transport enterprises.

The operations of MAV and BKV are monitored closely by the government, but within-year data are not reported to the public. The Ministry of Economy and Transport (MET) exercises full ownership rights over MAV, while the Municipality of Budapest (MB) is the sole shareholder of BKV. Recognizing that these enterprises are in a difficult financial situation, their operations are monitored closely by

[5] See Báger and Kovács (2004) for a survey of privatization in Hungary.

[6] The government recently submitted to Parliament a new Act on State Asset Management, which will set up a state asset management company. This company will assume the responsibilities currently assigned to the ÁPV Rt., the Treasury Property Directorate, and the National Land Fund.

[7] See OECD (2005a) and OECD (2005b) for a survey on ownership function models for PEs.

[8] ÁPV Rt. exercises ownership rights over several important public enterprises, including the long-distance bus company VOLANBUSZ and certain power enterprises. The Ministry of Economy and Transport exercises ownership rights over MAV, the National Road Construction Company, and the State Motorway Company, among others. The Municipality of Budapest is the sole shareholder of BKV. See Appendix 1 for a full list of enterprises under long-term state property as dictated by the Privatization Act.

[9] As part of its asset management duties, ÁPV Rt. defines and approves the enterprises' strategies and business plans, continuously tracks enterprises' financial management and liquidity, has enterprises' annual reports compiled, and decides on dividend payments.

[10] See fiscal ROSC for further details.

[11] These include, for example, ÁPV Rt, the National Road Construction Company, and the State Motorway Company. The budget documents include an appendix that explains the relationship between fiscal targets of the state budget sector and general government consistent with ESA 95.

the government. MAV reports to the MET on a monthly basis; and the amounts of capital injections and state guarantees are coordinated and approved by the MET and the Ministry of Finance. BKV also reports to the MB on a monthly basis. Its borrowing plans are approved by the MB, and by the state as well in the case of state-guaranteed loans. These within-year reports are not publicly available, although audited annual reports are.

3. ASSESSMENT OF FISCAL RISKS

This section reviews fiscal risks posed by MAV and BKV. Given precedents of financial difficulties and contingent liabilities, this section assesses the fiscal risks from MAV and BKV in light of the criteria proposed by FAD. These criteria relate to: (i) managerial independence; (ii) relations with the government; (iii) financial conditions; (iv) governance structure; and (v) other risk factors (Box 1).

Box 1: Criteria for Assessing Fiscal Risks of Public Enterprises

I. Managerial independence

Pricing policy: whether prices are in line with international benchmarks for traded goods and services; cover costs (for non-traded goods); and in regulated sectors, whether the tariff-setting regime is compatible with the long-term sustainability of the PE.

Employment policy: whether this is independent of civil service laws, and the government intervenes in wage setting and hiring.

II. Relations with the government

Subsidies and transfers: whether the government provides direct or indirect subsidies and/or explicit or implicit loan guarantees, which go beyond those given to private enterprises; and whether the PE make any special transfers to the government.

Quasi-fiscal activities: whether PEs perform uncompensated functions or absorb costs which are not directly related to their business objective and/or substitute for government spending.

Regulatory and tax regime: whether PEs are subject to the same regulations and taxes as private firms.

III. Financial conditions and sustainability

Market access: whether PEs can borrow without a government loan guarantee.

Less-than-full leveraging: whether PEs' liability-to-asset ratio is comparable to industry averages.

Profitability: whether PEs perform compared to relevant industry.

Record of past investments: whether past investments had an appropriate average rate of return.

IV. Governance structure

Periodic outside audits: whether these are carried out by a reputable private accounting firm applying international standards and are published.

Publication of comprehensive annual reports: whether annual reports are published, and what type of information they include.

Shareholders' rights: whether minority shareholders' rights are protected.

V. Other risk factors

Vulnerability: whether PEs have sizeable contingent liabilities relative to their operating balance.

Importance: whether PEs are large in some significant dimension (for example, debt service, employment, customer base).

Assessment of fiscal risks posed by MAV

1. MAV does not comply with several of the FAD criteria on fiscal risks. As described in detail below, MAV does not meet many of the criteria in the areas of managerial independence, relations with the government, financial conditions, and other risk factors (Table 1). Regarding governance, MAV complies with the criteria on external audits, but reporting could be improved.

Criterion 1: Managerial independence-pricing and employment policies

MAV does not enjoy managerial independence in employment and pricing policies. Employment and wage policies are determined in annual business plans, which have to be approved by the MET in compliance with the Labour Code. Passenger tariffs are set by the government, and these are not fully-aligned with cost-recovery levels. Prices for freight facilities have been set more freely since 1994 and better reflect market conditions. As noted by KPMG (2006), MAV has operated at a loss mainly due to services being priced at below operating costs and pricing policies being outside the control of the enterprise.

Criterion 2: Relations with the government-transfers, subsidies, and QFAs

MAV undertakes significant QFAs on behalf of the government, but these are not fully compensated by the

Table 1

Quasi-fiscal activity (under-financed public services, provision of preferential loans and guarantees) with subsequent settlement of debt

Public Enterprise	Managerial Independence						Government Relations		
	Pricing Policy		Employment Policy			Only Commercial Objectives	No Loan Guarantees	Quasifiscal Activities?	Standard Tax and Regulatory Rules
	Prices Reflect Costs	Subsidies	Civil Servants	Market Wages	Over-staffing				
Hungarian State Railways	No	Yes	No	Determined by the enterprise and trade unions	Yes; but decreasing	No	Loan guarantees exist	Yes; services provided at below commercial prices and for social purposes	Yes except for tax (rebate, and exemption on local business tax)

Public Enterprise	Financial Conditions			Governance Structure				Other Factors		
		Creditworthiness							Size	
	Profitability[1]	Debt Level[2]	Debt Cost[3]	Stock Listed	Outside Audits	Annual Reports	Minority Rights Protected	Contingent liabilities	Number of Employees	Annual Sales
Hungarian State Railways	Negative	100.8% (2006)	6.0%	Not listed	Yes	Yes	100% state owned	Hedging, guarantees	46,814 (2004)	131,119 million forint (2006)

Sources: Hungarian authorities; and IMF staff estimates.

[1] *The enterprise has had negative profitability over the last years. In 2006, MAV's net worth has also been negative, requiring capitalization.*

[2] *Debt level is defined as the ratio of total liabilities to total assets in most recent year in percent.*

[3] *Debt cost is defined as the ratio of accrued 4-year financial costs to average total debt, including short and long-term debt, in percent.*

budget. Subsidies or free tickets are provided for several groups, including students, children, senior citizens, families, civil servants, pensioners, and others. About 25 percent of passengers do not pay for transport services. The government makes annual transfers to MAV under two concepts: consumer price supplements and public service obligations. These transfers have been insufficient to cover the cost of QFAs. The share of passenger operating costs covered by budget transfers has fallen since 2003, from 57 percent to about 47 percent in 2005 (Table 2). MAV also receives budget support for investment and other goals (Table 3).

Table 2

Hungarian state railways: Passenger operations, 2000–2005

(In billions of forint; unless otherwise indicated)

	2000	2001	2002	2003	2004	2005
Revenues from passenger transport	101.9	114.4	122.0	122.5	121.8	116.1
Budget transfers	63.0	69.5	76.5	80.0	80.1	74.6
Consumer price supplement	16.9	19.3	20.7	22.2	23.6	24.2
Public service obligation	46.1	50.2	55.8	57.8	56.5	50.4
Inflow to cashier from paid fares	38.9	44.9	45.5	42.5	41.7	41.5
Costs from passenger transport	119.9	137.8	151.1	141.1	156.5	159.8
Share of costs covered by:						
Budget transfers (in percent)	52.5	50.4	50.6	56.7	51.2	46.7
Inflow to cashier (in percent)	32.4	32.6	30.1	30.1	26.6	26.0

Sources: KPMG (2006); and IMF staff estimates.

Table 3

Budget support to Hungarian State Railways, 2000-2006

(In billions of forint; unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006[1]
Public service obligation transfer	46.0	50.2	55.8	57.8	56.5	50.4	74.4
Consumer price transfer	17.0	19.3	20.7	22.2	23.6	24.2	24.3
Investment subsidy	26.0	21.6	27.5	17.2	12.6	18.4	36.5
Fuel tax rebate	6.9	6.7	6.5	6.5	6.1	5.7	5.7
Severance compensation	0.0	0.0	0.0	0.0	1.0	2.8	0.8
Budapest Transport Company Alliance Compensation	0.0	0.0	0.0	0.0	0.0	0.2	1.0
Other subsidies	0.2	0.0	0.0	0.0	0.0	0.0	0.5
Debt takeover	35.7	0.0	121.1	0.0	0.0	0.0	0.0
State guarantees	28.7	38.4	24.3	38.7	59.0	131.3	55.0
Total	160.7	136.2	255.9	142.4	158.8	233.1	198.3
In percent of GDP	1.2	0.9	1.5	0.8	0.8	1.0	0.8

Sources: Hungarian authorities; and IMF staff estimates.

[1] *2006 data excludes freight operations.*

Table 4

Hungarian State Railways: Summary of financial indicators, 2000–2006

	2000	2001	2002	2003	2004	2005	2006[1]
				(In percent)			
Liabilities/Assets	25.5	73.7	73.7	76.2	82.9	91.4	100.8
Liquidity[2]	59.5	57.3	34.2	44.2	42.7	37.2	45.7
				(In percent of GDP)			
Net operational losses							
Before government transfers	-0.6	-0.6	-0.4	-0.6	-0.6	-0.7	-0.8
After government transfers	-0.2	-0.2	0.1	-0.2	-0.2	-0.4	-0.4
Investment	0.5	0.3	0.4	0.4	0.3	0.3	0.3
Liabilities	1.2	3.3	3.0	3.0	3.1	3.3	3.6
Short-term	0.7	0.7	1.0	0.9	0.8	1.0	0.8
Long-term	0.5	2.5	2.0	2.1	2.3	2.3	2.8
of which: guaranteed	0.2	0.3	0.1	0.2	0.3	0.6	0.2
Debt takeover	0.3	...	0.7	...	...	...	...
Share capital increase	...	...	...	...	...	...	0.1

Sources: Hungarian authorities; and IMF staff estimates.

[1] *2006 data excludes freight operations.*

[2] *Current assets divided by current liabilities.*

The tax treatment of MAV is broadly in line with that of private enterprises. Since MAV does not use public roads, it receives a rebate from the government on paid excise taxes on fuel. The same treatment applies to water and air transportation enterprises. As MAV has been running losses, it has not paid dividends or corporate income taxes to the central government. MAV has also not paid the local business tax collected by municipalities.[12] However, loss-making private enterprises, which do not provide public services, do not receive the latter favourable treatment.

[12] Act C of 1990 on Local Taxes exempts public service enterprises from the local business tax when these enterprises do not incur corporate tax liabilities.

[13] See Appendix 2 for full details on the income statement and balance sheet of MAV.

Criterion 3: Financial conditions and sustainability

MAV is in poor financial health. The liability-to-asset ratio has increased from 25 percent in 2000 to over 100 percent in 2006 (Table 4). The company's equity and reserve position has declined significantly over the past 5 years, reaching below capital adequacy levels in 2004 (KPMG, 2005). Liquidity indicators also show marked deterioration. Net operational losses before government transfers were close to 1 percent of GDP in 2006. Investment levels have been compressed to under 0.5 percent of GDP in recent years.[13]

The government provides loan guarantees to MAV and has taken over MAV's liabilities in several occasions in the past. The state took over MAV's liabilities in 2000 and 2002. Despite these bailouts, liabilities have remained on the rise, reaching over 100 percent of assets in 2006. The cost of debt has been around 6 percent. This is close to government costs, arguably reflecting the state's backing of MAV's liabilities. State guarantees have averaged 0.3 percent of GDP in the past 6 years.

The recent separation of freight and passenger branches has increased transparency. A new and legally-independent firm for freight transport was established in January 2006. As noted earlier, prices for freight transport have been better aligned with market conditions, and freight operations are expected to post profits following the split in operations from passenger transport. This separation will increase transparency and will make it easier to define public transport services that are to be compensated by the state. However, unless passenger fares or budget transfers are increased, losses from passenger operations will continue and will cease to be cross-subsidized from freight operations. Following the separation of freight and passenger operations, MAV will also undergo a rationalization program (e.g. closure of underutilized branch lines).[14]

Criterion 4: Governance structure: External audits and shareholders' rights

MAV's accounts are audited externally on the basis of International Accounting Standards, and these reports are available to the public. Currently, the auditor is KPMG Hungária Kft. (KPMG Hungária Limited Liability Co). Annual reports are not posted on-line and there is no within-year reporting on MAV's financial position. MAV is not listed on the stock exchange and has no minority shareholders.

Criterion 5: Other risk factors

MAV dominates railway transport in Hungary. MAV faces little competition in passenger rail transport, serving over 150 million passengers a year. Gyor-Sopron-Ebenfurt Co., a joint Hungarian-Austrian enterprises, also offers rail transport services, but on much smaller scale. Five small private railway enterprises offer freight services. In terms of employment, the number of employees has declined in recent years, but with a staff of around 45,000, MAV continues to be a large employer in need of further restructuring.

Assessment of fiscal risks posed by BKV

BKV also fails to meet many of the FAD criteria on fiscal risks, including in the areas of managerial independence, relations with the government, financial conditions, and other risk factors (Table 5). External audits are performed and publicly available, and BKV's annual reports are also posted on-line.

Criterion 1: Managerial independence-pricing and employment policies

BKV does not enjoy managerial independence in pricing and employment policies. Prices are set administratively by the MB and fall short of cost-recovery levels. Given the current tariff structure, operating revenues before government transfers cover less than 50 percent of operating expenditures.[15] Employment and wage policies are set out in annual business plans, which have to be approved by the Budapest Municipal Owners' and Municipal Operations' Committees and comply with the Labour Code.

Criterion 2: Relations with the Government-Transfers, Subsidies, and QFAs

Budget transfers are not sufficient to make up for the cost of QFAs. Student, pensioners, and other groups receive discounted or free tickets. BKV receives subsidies to compensate for these QFAs under two concepts: price subsidies (linked to consumers) and normative subsides (linked to public service obligations). Both the central government budget and the MB provide financial assistance to the company (Table 6). Budget transfers are determined annually and cover about 40 percent of operating costs. In 2004, BKV and the MB signed an 8-year public service contract the defines quality standards, volume of services, compensation schemes, etc.

[13] See Appendix 2 for full details on the income statement and balance sheet of MAV.

[14] The OECD (2007) notes that the returns on this programme for 2007 and 2008 are uncertain, and that even with EU funds financing, the level of government support for this project is estimated to be large.

[15] Tariffs would need to increase by 134% to fully finance operations without any budgetary compensation.

Table 5

Budapest Transport Company: Summary of compliance with criteria on fiscal risks

Public Enterprise	Managerial Independence						Government Relations		
	Pricing Policy		Employment Policy			Only Commercial Objectives	No Loan Guarantees	Quasifiscal Activities?	Standard Tax and Regulatory Rules
	Prices Reflect Costs	Subsidies	Civil Servants	Market Wages	Over-staffing				
Budapest Transport Company	No	Yes	No	Yes	Yes	No	Loan guarantees exist	Yes; services provided at below commercial prices and for social purposes	Yes (except for on local business tax)

Public Enterprise	Financial Conditions			Governance Structure				Other Factors		
		Creditworthiness							Size	
	Profitability[1]	Debt Level[2]	Debt Cost[3]	Stock Listed	Outside Audits	Annual Reports	Minority Rights Protected	Contingent liabilities	Number of Employees	Annual Sales
Budapest Transport Company	-12% (2006)	28.4% (2006)	6.2%	Not listed	Yes	Yes	100% state owned	Legal cases related to damage claims	12,745 (2004)	63,322 million forint (2006)

Sources: Hungarian authorities; and IMF staff estimates.

[1] *Profitability is defined as the ratio of net profits to net worth in most recent years in percent.*

[2] *Debt level is defined as the ratio of total liabilities to total assets in most recent year in percent.*

[3] *Debt cost is defined as the ratio of accrued 4-year financial costs to average total debt, including short and long-term debt, in percent.*

Table 6

Budget Support to Budapest Transport Company, 2000–2006

	2000	2001	2002	2003	2004	2005	2006[1]
Public service obligation transfer	14.2	14.2	16.2	3.0	8.9	11.9	32.1
Central budget	0.0	0.0	0.0	0.0	5.9	11.9	32.1
Municipal budget	14.2	14.2	16.2	3.0	3.0	0.0	0.0
Consumer price transfer	14.5	15.8	16.8	18.8	18.7	19.0	17.9
Debt takeover	0.0	0.0	37.4	0.0	0.0	0.0	0.0
Share capital increase	0.0	0.0	0.0	5.0	3.0	11.9	10.6
State guarantees	0.0	0.0	0.0	0.0	0.0	15.0	0.0
Total	28.7	30.0	70.4	26.8	30.6	57.8	60.6
In percent of GDP	0.2	0.2	0.4	0.1	0.1	0.3	0.3

Sources: Hungarian authorities; and IMF staff estimates.

BKV is broadly subject to the same tax regulations as private firms. However, as noted below, BKV's poor liquidity position prompted the enterprise to apply for deferred tax payments to the tax authority (APEH) in 2004.[16] As BKV has been running losses, it has not paid dividends or corporate income taxes. Similarly to MAV, BKV also does not pay local business tax.

Criterion 3: Financial conditions and sustainability

The government assumed BKV's liabilities in 2002 and provided loan guarantees in 2005. The central government provided special assistance to BKV in 2002, taking over debt obligations worth HUF 36 billion (about 0.2 percent of

[16] A similar situation arose in 2000.

GDP). About 60 percent of these liabilities corresponded to short-term credits. Reflecting poor liquidity and difficult access to market financing in 2004 (see below), state loan guarantees in the amount of HUF 15 billion were provided for the first time in 2005.

BKV's financial conditions are weak. Following the government's bail-out in 2002, the ratio of total liabilities to assets continued to increase from 8 percent to close to 30 percent in 2006. Liquidity indicators also worsened (Table 7), rendering the financial position critical in 2004, due in part to shortfalls in expected price subsidies. At that point, BKV was granted deferred payments of tax liabilities to APEH and was authorized to issue new debt. The issuance was undersubscribed as banks regarded BKV's creditworthiness as less favourable compared to previous years. Net operating losses before transfers were 0.3 percent of GDP in recent years. Weak financial conditions have constrained investment at 0.2 percent of GDP, and equity levels have been on the decline.

Criterion 4: Governance structure: External audits and shareholders' rights

BKV's accounts are audited externally on the basis of International Accounting Standards, and annual reports are published on-line. Currently, the auditor is Deloitte & Touche, and audited reports are publicly available. BKV also publishes annual reports on its website, with useful and clearly presented financial information. As in the case of MAV, there is no public within-year reporting. BKV is not listed in the stock exchange, has no minority shareholders, and is not rated by any credit rating agency.

Criterion 5: Other risk factors

BKV is the largest local public transport enterprise in Hungary. BKV provides transport services to 1.4 billion passengers a year and does not face meaningful competition. It employs close to 13,000 people and its orders are significant in the local input markets.

4. CONCLUDING REMARKS

MAV and BKV pose important fiscal risks. Both enterprises fail to meet key FAD criteria. In particular, financial arrangements with the budget are not transparent and QFAs are not fully compensated by the government. The enterprises' financial conditions have been weak, and despite bailouts in recent years, liabilities have continued to rise. Some part of these liabilities are backed by government guarantees and, in the absence of improvement in financial conditions, could impact the government accounts in the near future. Externally audited reports are publicly available, but the assessment and disclosure of fiscal risks from PEs in budget documents is lacking. This hampers fiscal transparency and increases uncertainty regarding the true extent of fiscal activities.

Table 7

Hungarian State Railways: Summary of financial indicators, 2000–2006

	2000	2001	2002	2003	2004	2005	2006[1]
				(In percent)			
Liabilities/Assets	14.8	14.7	8.1	12.7	24.3	29.0	28.4
Liquidity[1]	60.9	51.1	103.2	42.3	28.4	36.2	16.7
				(In percent of GDP)			
Net operational losses							
Before government transfers	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
After government transfers	-0.1	0.0	0.1	-0.1	-0.1	-0.1	0.0
Investment	0.1	0.2	0.2	0.1	0.1	0.2	0.3
Liabilities	0.2	0.2	0.1	0.2	0.3	0.4	0.4
Short-term	0.1	0.1	0.1	0.1	0.1	0.1	0.2
Long-term	0.1	0.1	0.0	0.1	0.2	0.2	0.2
Debt takeover	...	...	0.2	...	...	...	...

Sources: Hungarian authorities; and IMF staff estimates.

[1] *Current assets divided by current liabilities.*

While these PEs pose risks to the government budget, government policies also entail risks for these PEs. Pricing policies are set by the government and tariffs have lagged behind cost-recovery levels. The enterprises' dependence on budget transfers poses risks to their operations. Incentives to under-finance QFAs and bail out the enterprises every few years will remain, until transparent financial arrangements between the budget and these enterprises are set out, and consistent pricing policies are determined.

The government is taking steps to improve transparency and governance. Over the past few years, the government has been discussing a public service contract with MAV. In the 2006-10 Convergence Programme, the government reaffirmed its commitment to increase the transparency of financial arrangements. The goal is to clearly define the principles governing operating subsidies in public service contracts. Under these contracts, subsidies would reflect the entire cost of efficient delivery of the service that the government requires the enterprise to undertake. Timely and proper completion of these contracts is essential to provide stability and transparency to funding arrangements. The government also increased budget support to MAV in 2007 and provided a capital injection.

The assessment in this paper suggests that additional efforts could enhance the quality, transparency and predictability of fiscal policy in Hungary. Although the general government balance on an ESA 95 basis is the key fiscal policy indicator and target, the extent of QFAs in these public transport enterprises, the history of bail-outs, and incentives to under finance QFAs, support the view that the existing coverage does not reflect the true extent of fiscal activities.[17] Best practices in fiscal transparency suggest that the government should include an analysis of these PE operations in budget documents, present a statement on QFAs, and report on the consolidated position of these PEs with the general government on a frequent basis. The budget should also provide a medium-term perspective of financial support to these PEs. Consideration could also be given to applying the criteria on fiscal risks to other sectors to identify other loss-making or vulnerable enterprises which may need closer monitoring.

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[17] As recommended in the fiscal ROSC, a first priority should be to align the coverage of the budget with the ESA 95 definition of government. This requires extending the coverage of the state budget to certain central government units that are currently excluded (e.g. the National Road Construction Company, the ÁPV Rt., the State Motorway Company, the State Debt Management Company, the State Treasury Company, public media enterprises, and certain non-profit institutions and enterprises).

APPENDIX I

Table 8

Business associations operating with company shares in long-term state ownership, percentage of state ownership, and agencies exercising the state's membership (shareholder's) rights according to the Privatization Act

Name of company	Minimum long-term state holding
Body exercising owner's rights: Állami Privatizációs és Vagyonkezelő Rt.	
Nemzeti Tankönyvkiadó Rt.	25% + 1 vote
MOL Magyar Olaj- és Gázipari Rt.	1 preference share with prior voting rights
Tokaj Kereskedőház Rt.	99%
Magyar Villamosművek Rt.	99%
Budapest Airport Rt.	25% + 1 vote
CD Hungary Ingatlanforgalmazó és Szolgáltató Rt.	1 preference share with prior voting rights
Balatonfelvidéki Erdő és Fafeldolgozó Rt.	100%
Délalföldi Erdészeti Rt.	100%
Észak-Magyarországi Erdőgazdasági Rt.	100%
Gemenci Erdő- és Vadgazdaság Rt.	100%
"Gyulaj" Erdészeti és Vadászati Rt.	100%
Ipoly Erdő Rt.	100%
Kisalföldi Erdőgazdaság Rt.	100%
Kiskunsági Erdészeti és Faipari Rt.	100%
Mátra-Nyugatbükki Erdő és Fafeldolgozó Rt.	100%
Mecseki Erdészeti Rt.	100%
Nagykunsági Erdészeti és Faipari Rt.	100%
Nyírségi Erdészeti Rt.	100%
Pilisi Parkerdőgazdaság Rt.	100%
Somogyi Erdészeti és Faipari Rt.	100%
Szombathelyi Erdészeti Rt.	100%
Tanulmányi Erdőgazdaság Rt.	100%
VADEX Mezőföldi Erdő- és Vadgazdálkodási Rt.	100%
Vértesi Erdészeti és Faipari Rt.	100%
Zalai Erdészeti és Faipari Rt.	100%
TISZAVÍZ Kft.	100%
Hungaropharma Rt.	1 preference share with prior voting rights
PICK Szeged Rt.	1 preference share with prior voting rights
Zsolnay Porcelángyár Rt.	1 preference share with prior voting rights
HERZ Szalámigyár Rt.	1 preference share with prior voting rights
KAGE Rt.	1 preference share with prior voting rights
Herendi Porcelánmanufaktúra Rt.	25% + 1 vote
Szerencsejáték Rt.	100%
Eximbank Rt.	25% + 1 vote
Name of company	Minimum long-term state holding
MEHIB Rt.	25% + 1 vote
Országos Takarékpénztár és Kereskedelmi Bank Rt.	1 preference share with prior voting rights
Magyar Posta Rt.	100%
Hitelgarancia Rt.	50% + 1 vote

Table 8

Business associations operating with company shares in long-term state ownership, percentage of state ownership, and agencies exercising the state's membership (shareholder's) rights according to the Privatization Act (cont'd)

Name of company	Minimum long-term state holding
Minister exercising owner's rights: Minister of Economic Affairs and Transportation	
Magyar Államvasutak Rt.	100%
MAVIR Magyar Villamosenergia-ipari Rendszerirányító Rt.	1 preference share with prior voting rights
Állami Autópálya Kezelő Rt.	100%
Győr-Sopron-Ebenfurti Vasút Rt.	50% + 1 vote
Közlekedéstudományi Intézet Rt. (KTI Rt.)	50% + 1 vote
Villamosenergia-ipari Kutató Intézet Rt.	50% + 1 vote
ExVÁ Robbanásbiztos Villamos Berendezéseket Vizsgáló Kht.	100%
Magyar Fejlesztési Bank Rt.	100%
Kisvállalkozás-fejlesztő Pénzügyi Rt.	50%+1 vote
Északdunántúli Gázszolgáltató Rt.	1 preference share with prior voting rights
Középdunántúli Gázszolgáltató Rt.	1 preference share with prior voting rights
Délalföldi Gázszolgáltató Rt.	1 preference share with prior voting rights
Tiszántúli Gázszolgáltató Rt.	1 preference share with prior voting rights
Déldunántúli Gázszolgáltató Rt.	1 preference share with prior voting rights
Paksi Atomerőmű Rt.	1 preference share with prior voting rights
Dunamenti Erőmu Rt.	1 preference share with prior voting rights
Vértesi Erőmű Rt.	1 preference share with prior voting rights
Bakonyi Erőmű Rt.	1 preference share with prior voting rights
PANNONPOWER Energiatermelő, Kereskedelmi és Szolgáltató Rt.	1 preference share with prior voting rights
Mátrai Erőmű Rt.	1 preference share with prior voting rights
Tiszai Erőmű Rt.	1 preference share with prior voting rights
Budapesti Erőmű Rt.	1 preference share with prior voting rights
Északdunántúli Áramszolgáltató Rt.	1 preference share with prior voting rights
Dunántúli Áramszolgáltató Rt.	1 preference share with prior voting rights
Délmagyarországi Áramszolgáltató Rt.	1 preference share with prior voting rights
Tiszántúli Áramszolgáltató Rt.	1 preference share with prior voting rights
Északmagyarországi Áramszolgáltató Rt.	1 preference share with prior voting rights
Budapesti Elektromos Művek Rt.	1 preference share with prior voting rights
Országos Villamostávvezeték Rt.	1 preference share with prior voting rights
Magyar Befektetési és Kereskedelemfejlesztési Kht.	50%+1 vote
Minister exercising owner's rights: Minister of Agriculture and Regional Development	
Állattenyésztési Teljesítményvizsgáló Kft.	75%
Érdi Gyümölcs- és Dísznövénytermesztési Kutató-Fejleszto Kht.	100%
Ceglédi Gyümölcstermesztési Kutató-Fejlesztő Kht.	100%
Fertodi Gyümölcstermesztési Kutató-Fejlesztő Kht.	100%
Újfehértói Gyümölcstermesztési Kutató-Fejlesztő Kht.	100%
Konzervipari Kutató és Fejlesztő és Minoségvizsgáló Kft.	100%
Magyar Tejgazdasági Kísérleti Intézet Kft.	100%

Table 8

Business associations operating with company shares in long-term state ownership, percentage of state ownership, and agencies exercising the state's membership (shareholder's) rights according to the Privatization Act (cont'd)

Name of company	Minimum long-term state holding
Országos Húsipari Kutatóintézet Kft.	100%
Zöldségtermesztési Kutató Intézet Rt.	100%
Agroster Besugárzó Rt.	25% + 1 vote
Concordia Közraktár Rt.	100%
ATEV Fehérjefeldolgozó Rt.	25% + 1 vote
Geodéziai és Térképészeti Rt.	25% + 1 vote
Országos Mesterséges Termékenyítő Rt.	25% + 1 vote
Minister exercising owner's rights: Minister of Environmental Protection and Water Management	
Hortobágyi Génmegőrző Kht.	100%
Hortobágyi Halgazdasági Rt.	100%
Dunamenti Regionális Vízmű Rt.	50% + 1 vote
Dunántúli Regionális Vízmű Rt.	50% + 1 vote
Észak-dunántúli Regionális Vízmű Rt.	50% + 1 vote
Észak-magyarországi Regionális Vízmű Rt.	50% + 1 vote
Tiszamenti Regionális Vízmű Rt.	50% + 1 vote
Vízgazdálkodási Tudományos Kutató Kht. (VITUKI)	50% + 1 vote
Body exercising owner's right: National Foundation for Employment	
Agora Ipari Kft.	100%
Erfo Ipari Kft.	100%
Fővárosi Kézműipari Rt.	100%
Főkefe Ipari Kft.	100%
Savaria Nett-Pack Kft.	100%
Szegedi Fonalfeldolgozó Rt.	100%
Minister exercising owner's rights: Minister of Health	
Gyógynövénykutató Intézet Rt.	25% + 1 vote
Minister exercising owner's rights: Minister of Cultural Heritage	
Nemzeti Színház Rt.	100%
Minister exercising owner's rights: Minister of Defense	
HM ARCOM Kommunikációtechnikai Rt.	50% + 1 vote
HM ARZENÁL Elektromechanikai Rt.	50% + 1 vote
HM CURRUS Gödöllői Harcjárműtechnika Rt.	50% + 1 vote
HM Elektronikai Igazgatóság Rt.	100%
HM Budapesti Erdőgazdasági Rt.	100%
HM Kaszói Erdőgazdasági Rt.	100%
HM VERGA Veszprémi Erdőgazdasági Rt.	100%
Dunai Repülőgépgyár Rt.	1 preference share with prior voting rights
Minister exercising owner's rights: Minister directing the Prime Minister's Office	
Regionális Fejlesztési Holding Rt.	100%
Magyar Hivatalos Közlönykiadó Kft.	100%
KOPINT DATORG Szervezési és Adatfeldolgozási Rt.	50% + 1 vote

Table 8

Business associations operating with company shares in long-term state ownership, percentage of state ownership, and agencies exercising the state's membership (shareholder's) rights according to the Privatization Act (cont'd)

Name of company	Minimum long-term state holding
Minister exercising owner's rights: Minister of Finance	
Államadósság Kezelő Központ Rt.	100%
Minister exercising owner's rights: Minister of Justice	
Országos Fordító és Fordításhitelesítő Iroda Rt.	50% + 1 vote
Minister exercising owner's rights: Minister of Information Technology and Communications	
Magyar Távközlési Rt.	1 preference share with prior voting rights
Minister exercising owner's rights: Minister of Regional Development and Land Use Planning	
VÁTI Magyar Regionális Fejlesztési és Urbanisztikai Közhasznú Társaság	100%
Építésügyi Minőségellenőrző Innovációs Kht.	50% + 1 vote
Body exercising owner's rights: National Bureau for Sports	
Sportlétesítmények Vállalat Rt.	75%

APPENDIX 2

Table 9

Hungarian State Railways: Income statement and balance sheet, 2000–2006

(In millions of forints)

	2000	2001	2002	2003	2004	2005	2006[1]
Income statement							
Sales at purchasers prices	142,717	148,118	150,097	161,752	174,770	183,222	162,520
of which consumer price transfer	16,989	19,302	20,705	22,161	23,597	24,226	24,306
- Indirect taxes on sales	9,832	10,795	9,605	11,824	21,534	23,249	31,321
= Revenues from sales	132,885	137,323	140,492	149,928	153,236	159,973	131,199
- Total employee compensation	89,658	98,611	108,396	117,102	130,426	130,976	124,616
of which social security contributions	24,428	25,909	27,177	28,480	30,939	30,638	28,840
- Purchases of goods & services	38,442	41,095	42,590	42,921	42,261	43,366	48,029
- Services provided by outsiders	50,016	54,683	56,017	56,327	58,157	69,447	56,290
- Depreciation & amortization	17,346	20,377	29,311	31,292	33,313	34,927	34,405
- Misc. fees/taxes	25,377	19,242	17,197	39,531	23,188	30,305	66,873
- Interest payments	5,724	15,167	6,656	5,903	11,061	13,090	21,015
+ Interest earned	5,086	3,840	5,055	3,302	7,177	2,883	6,934
+ Foreign grants	0	0	0	0	0	0	0
+ Transfers from government (public service obligation)	46,048	50,208	55,845	57,815	56,534	50,384	74,407
+ Other income	20,476	28,813	71,888	48,978	32,006	28,228	54,846
= Profit before tax	-22,068	-28,991	13,113	-33,053	-49,453	-80,643	-83,842
- Corporate income tax	143	191	29	13	8	0	0
- Dividends paid	0	0	0	0	0	0	0
To government	0	0	0	0	0	0	0
To others	0	0	0	0	0	0	0
= Retained earnings for the period	-22,211	-29,182	13,084	-33,066	-49,461	-80,643	-83,842
New investment	62,192	51,898	66,560	74,706	57,859	57,802	68,933
Balance sheet							
Current assets	59,201	62,109	59,463	73,929	68,150	81,812	87,168
+ Long-term investments	15,365	16,100	18,788	18,237	16,344	14,497	40,025
+ Fixed & other assets at cost	692,305	738,738	802,388	872,891	925,639	976,414	997,215
- Accumulated depreciation & amort.	125,868	143,717	183,710	214,580	244,249	275,868	273,498
= Total assets	641,003	673,230	696,929	750,477	765,884	796,855	850,910
+ Current liabilities	99,445	108,358	173,838	167,347	159,527	219,817	190,653
+ Long term liabilities	64,246	388,119	339,566	404,629	475,314	508,831	667,381
+ Equity and reserves	477,312	176,753	183,525	178,501	131,043	68,207	-7,124
= Total liabilities & equity	641,003	673,230	696,929	750,477	765,884	796,855	850,910
Financing							
Net external	48,875	63,153	7,417	35,213	37,880	54,250	78,873
New loan obligations	...	...	49,289	66,976	62,490	55,035	162,996
Repayment of old loans	...	...	13,061	7,898	7,388	7,115	32,780

Source: Hungarian authorities based on data provided by Hungarian State Railways.

[1] *2006 data excludes freight operations.*

Table 10

Budapest Transport Company: Income statement and balance sheet, 2000–2006

(In millions of forints)

	2000	2001	2002	2003	2004	2005	2006[1]
Income statement							
Sales at purchases prices							
Fare revenue at purchases prices	28,342	30,527	31,389	35,214	40,933	44,729	50,371
Social reimbursement for concessionary fares (consumer price transfer)	16,281	17,672	18,814	21,094	21,490	21,902	21,283
Revenue of other activities	2,693	13,417	2,873	4,201	2,547	5,413	2,667
- Indirect taxes on sales	5,073	7,781	5,852	6,785	8,554	9,610	10,999
= Revenues from sales	42,243	53,835	47,224	53,724	56,416	62,434	63,322
- Total employee compensation	29,238	30,790	33,643	36,774	42,035	46,158	51,202
of which social security contributions	8,007	8,081	8,472	9,099	10,261	11,243	12,225
- Purchases of goods and services	23,360	27,754	31,467	35,289	37,470	38,497	40,265
- Services provided by outsiders	531	818	1,419	1,469	1,491	1,894	2,243
- Depreciation and Amortization	10,825	11,192	10,930	11,363	11,594	12,275	13,296
- Misc fees/taxes	40	19	18	15	38	39	29
-Interest payment	1,848	1,918	2,034	700	3,862	4,064	5,054
foreign	428	401	395	71	0	0	0
domestic	1,420	1,517	1,639	629	3,862	4,064	5,054
+ Interest earned	24	137	51	105	5	5	57
+ Foreign grants	0	0	0	0	0	0	0
+Transfers from governments (public service obligation)	14,200	14,692	47,006	5,011	11,508	13,552	39,451
of which subsidies from the Municipality of Budapest	13,905	13,905	16,202	3,000	3,000	0	0
+ Other income	5,080	1,200	2,190	1,508	2,723	7,309	3,949
Other expenditure	4,360	6,959	2,855	2,472	3,801	5,682	9,410
Activated own performance	1,796	2,472	2,451	2,705	3,231	2,843	3,024
=Profit before tax	-6,859	-7,114	16,556	-25,029	-26,408	-22,466	-11,696
-Corporate income tax	0	0	0	0	0	0	
-Dividends paid	0	0	0	0	0	0	
To government	0	0	0	0	0	0	
To others	0	0	0	0	0	0	
= Retained earnings for the period	-6,859	-7,114	16,556	-25,029	-26,408	-22,466	-11,696
New investments	14,880	26,667	26,347	21,082	21,688	39,140	74,148
Balance Sheet							
+ Current assets	6,980	6,402	19,009	7,408	7,843	10,673	8,025
+ Long term Investments	2,731	2,480	2,319	1,633	1,699	1,153	1,160
+ Fixed and other assets at cost	225,970	244,822	268,299	298,766	320,179	365,003	439,814
- Accumulated depreciation and amortization	46,027	53,059	62,848	73,262	83,709	94,578	105,421
Accrued and deferred assets	84	68	295	294	98	118	111
= Total assets	189,738	200,713	227,074	234,839	246,110	282,369	343,689
+ Current liabilities	11,460	12,520	18,420	17,493	27,664	29,523	47,921
+ Long term liabilities	16,549	16,947	0	12,262	32,256	52,305	49,787
+Equity and reserves	146,930	140,213	156,351	136,589	112,865	102,598	101,568
Accrued and deferred liabilities	14,799	31,033	52,303	68,495	73,325	97,943	144,413
=Total Liabilities and Equity	189,738	200,713	227,074	234,839	246,110	282,369	343,689
Financing							
Net external	28,009	29,467	18,420	29,755	59,920	81,828	97,783
New loan obligations	4,202	4,568	25,804	16,542	27,672	22,784	9,932
Repayment of old loans	570	2,965	4,953	6,529	30	3,876	3,770

Source: Hungarian authorities.

Isabel Argimón–Francisco Martí: Available data on-budget and off-budget activities of Spanish central, state and local governments[1]

In this paper we present an analysis of the informative content of available public sector data for Central, State (Regional) and Local Governments in Spain. We first review the framework that defines budgetary arrangements in place in Spain, with a special emphasis on the decentralization process. We then present official budgetary projections for the balance of the different levels of Government and compare them with both outturn and national accounts data. We assess the magnitude of the differences between budgetary and national accounts balance data and between the latter and a balance obtained with currently available data on a broad definition of public sector activity. We attempt to establish some regularities in the relations among the different accounting variables.

JEL classification: H62, H68,H72.
Keywords: Budget forecasts and monitoring; State and Local deficits; Off-budget activities.

1. INTRODUCTION

The forecast and monitoring of fiscal policy and fiscal accounts requires that data be released in a timely pattern. The quality and amount of data referring to public sector activity available in Spain depends on the level of Government in question. While the amount of information from the Central level of government[2] is rather large and is provided with regularity and short lags, information for the rest of the General Government is rather poor, as is provided with rather long lags. In particular, data for State (Regional)[3] and for Local Governments is rather scarce. Such scarcity is relevant when we take into account that, in 2006, State Governments expenditure in Spain accounted for 14.6% of GDP, while Local Governments accounted for 6.2%. The increasing importance of lower levels of Government in the determination of General Government expenditure has not been accompanied by an equivalent increase in the amount of information being published in relation to these decentralised institutions. In particular, national accounts data for State and Local Governments is released with a long delay and with very little disaggregation. Hence, its usefulness for forecasting purposes is rather limited. Information related to budgetary data is more easily available, at least for the Central and Regional Governments and with shorter delays than national accounts data. Therefore, in spite of the fact that such data cannot be directly integrated in the macroeconomic scenario, as the latter are necessarily in national account terms, it is worth considering its use for monitoring and forecasting.[4] The comparison between initial and final budgetary outcomes and final national accounts data could provide an indicator of the usefulness of cash data to recast the initial forecasts and monitor government's performance.

On the other hand, some information that cannot be considered as referring to General Government under the national accounting framework seem to be relevant for fiscal policy analysis. In particular, such data correspond to activities by public firms, and other public entities or are associated to financing activities. Such data could provide additional insight into the activity of the public sector, and thus, in a broader assessment of the incidence of the public sector, they should be taken into account.[5] However, the lack of data on Public Private Partnership (PPP) activities in Spain limits the scope of this approach.[6]

[1] Paper prepared for the Public Finance Workshop on "Temporary Measures and Off budget Activities", held in Budapest, 22 June 2007. The authors are grateful for the comments received from the attendants to the workshop and from L. Gordo and P. Hernández de Cos.

[2] In fact, in all this paper, the term Central Government refers to central budgetary and non budgetary sections (Ministries, and the bodies and services reporting to them) and Public Corporations classified as General Government.

[3] In this paper, State (Regional) Governments include governing bodies of Regional (Autonomous) Governments (CCAA), their Administrative Agencies and similar, Universities and Public Corporations classified as General Government, and Social Security units managed by the Regional Governments.

[4] See J. Pérez (2005), for a model that integrates different public sector indicators to project fiscal outcomes.

[5] We would like to include information on public firms that carry out quasi-fiscal activities, public-private partnerships, contingent liabilities plus government asset funds. See the discussions carried out in the Fiscal Affairs Department of the International Monetary Fund on which activities to include to assess global fiscal risk.

[6] See L. Torres and V. Pina (2002), for an analysis of PPP initiatives in Local Governments.

This article presents the information currently available for the Spanish Central, State (Regional) and Local Government and tries to assess its relevance for forecasting, monitoring or structural analysis. In particular, by comparing the different trends in public finances provided by different accounting frameworks, it tries to assess their usefulness for short-term analysis, both in terms of forecasting and monitoring or for a more structural analysis. The article is structured as follows. In Section 2 we review the framework that defines budgetary arrangements in place in Spain. In the next two Sections we compare initial budgetary data, which is rather easy to obtain early in the fiscal year, with actual outturn and with national accounts data which is used to integrate government's activity with the rest of the economy. Section 5 moves away from national accounts, and assesses the inclusion in the analysis of information contained in public debt data, and other available data referring to public sector activity that is either carried out by institutions that are currently classified outside the Government sector in national accounts terms or that correspond to financial activity. Conclusions are drawn from the comparison between trends and levels in national accounts balances for the different levels of Government and the trends and levels resulting from such a broader approach.

2. INSTITUTIONAL FRAMEWORK FOR CENTRAL, REGIONAL AND LOCAL GOVERNMENT BUDGETS

The Central, Regional and Local Governments in Spain organize themselves in a general administration, which is composed of different administrative units, and an institutional administration that is composed of different autonomous organisms (administrative, financial, commercial…) and public entities and enterprises to provide some services. Both General administration and institutional administration are different from municipality to municipality and region to region in relation to the number of institutions, their denomination and functions. However, there are some common factors among all levels of government, such as the fact that budgets need parliamentary (or the municipal representatives') endorsement to be implemented and if they have not been approved by January 1st, they are automatically extended. Moreover, all levels of Government produce annual budgets that match natural years.

The Law that established the Autonomous financing system (Ley Orgánica 8/1980, of 22nd September) requires Regional Governments to produce budget laws that share homogeneous criteria in order for them to be able to be consolidated with the budget of the Central Government. The homogeneity is reflected in the fact that each regional and local budget and the Central budget share the same classification for revenue and expenditure chapters both for non financial and financial items. However, the institutional coverage does not need to be the same.[7]

The case of Regional Governments

The size of Regional Governments has been growing for many years. The recovery of democracy triggered a process of decentralization that, although it has already reached a rather mature stage, is still evolving and has not settled down. While the Constitution clearly specifies expenditure responsibilities across the different levels of government it only sets general principles as far as the financing system is concerned. Such asymmetric treatment has led to a periodic reconsideration of financing arrangements, starting in 1986 for Regional Governments, after an initial transitory period. Since that date, a series of agreements lasting five years each has defined a process, which has implied an increasing transfer to regions of responsibilities on the expenditure side, which has been ill matched with an equivalent transfer of resources or the capacity of raising them. In particular, the transfer of taxing capacity is still rather limited.

The process has not been homogeneous, neither through time nor among Regional Governments. In terms of powers assumed there have been major distinctions between those regions that had education and health responsibilities and those that had neither or only one of them. The last agreement, reached in 2002, when all regions assumed health care responsibilities, aimed at being the definitive one as, since then, all regions, with the exception of the Basque Country and Navarre, have the same expenditure responsibilities under a common financing system.

In terms of financing arrangements, the largest differences lays on the distinction between "ordinary regime" regions, with limited fiscal autonomy and "specific status" regions (the Basque Country and Navarre), with larger financial autonomy. Because of historical developments, the Basque Country and Navarre enjoy considerable freedom in establishing and administering personal and corporate income taxes. For these regions, most expenditure responsibilities have been devolved with the only notable exception of pensions, which are still administered by the central social security system. Both regions contribute to the central government with a fixed share of GDP to cover the expenditures that remain in the hands of the central government, including defence and nationwide infrastructure.

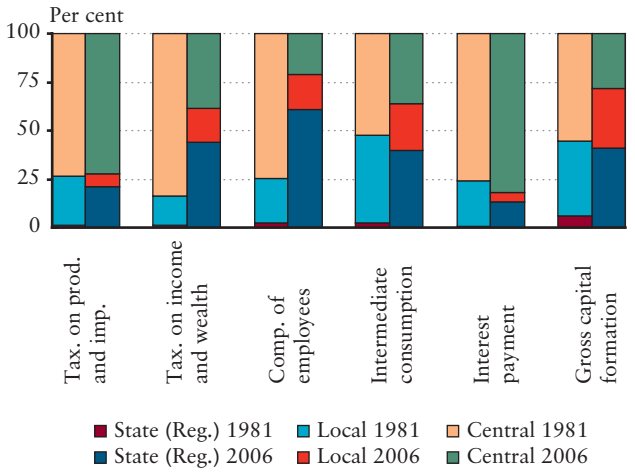
[7] This affects mainly health expenditure and its budgetary treatment.

The decentralization process has progressed in the direction of enhancing fiscal co-responsibility, although there is still considerable room for larger changes in this area. In particular, under the 2002 agreement, the one that prevails now, the sources of financing for the "ordinary regime" regions include shared taxes,[8] transferred taxes for which Regional Governments cannot change neither the tax rates nor the rules, but receive,[9] own taxes[10] and transfers from the Central government.[11]

The level of decentralization is rather large as shown in Figure 1, which presents the proportions of certain categories of revenue and expenditure in national accounts terms in the hands of State and Local Governments over the sum of these same expenditures and revenue channelled through State, Local and Central Governments. In all the categories analysed there has been an increase in the weight of State Governments. In particular, the increase has resulted in more than 40% of the sum being in the hands of State Government in the case of indirect taxation, and investment, while both components of consumption in the hands of State Governments account for more than 60% of the overall expenditure. The minor weight played by interest payments results from the fact that no transfer of debt in the hands of Central Government was made to State Governments when decentralization took place.

Figure 1

Devolution structure: 1981–2006[1]



Source: Ministry of Economy and Finance and Bank of Spain.

[1] Structure of 1981 based on ESA79. Structure of 2006 based on ESA2000.

Therefore, while in the 1980s the limited amount of information in relation to State Government budgetary data was not so relevant for the analysis of General Government developments, the decentralization process has implied that data for State and local Governments is growing more and more crucial for the analysis of fiscal policy in Spain

In 2002, the Budgetary Stability Laws (BSL, Leyes de Estabilidad Presupuestaria) were passed, establishing a rule that mandated a balanced budget or a surplus at the sub national level on a yearly basis. While in aggregate terms, the State Government sub sector managed to comply with the rule in 2003 (the first year of implementation), 11 out of the 17 regions ran a deficit that year, reflecting the low enforcement capacity of the Law. A reformed Law was passed in 2006, which aims at increasing ownership and observance by the regions, as well as providing explicit room for counter-cyclical action. It also requests the Central Government to run a balanced budget or a surplus, without allowing its consolidation with the Social Security Funds. It is still too early to assess its effectiveness.

The case of Local Governments

The Local Government Finance Act (Ley Reguladora de las Haciendas Locales (1988)) established the main elements which define the current local financing system for municipalities and other local organisms. Not only did it imply the end of the existing dependence based model, it also brought new resources into the system.[12] It introduced revenue autonomy for local governments as it allowed them to establish the rates of local taxes (with a lower and upper cap), which, moreover, were simplified and reduced in number. It also established a formula based transfer system that has been revised every five years. Moreover, the Act allowed Local governments to issue debt, within certain limits.

[8] In particular, 100 percent of the tax on retail sales of hydrocarbon fuels, 100 percent of special taxes on particular cars and 33 percent of personal income tax revenues. Moreover, Regional Governments are given the discretion of increasing by up to 20 percent the marginal personal income tax rate and may introduce new deductions.

[9] In particular, 35 percent of VAT revenues, 40 percent of some excises, 100 percent of taxes on electricity and vehicle registration and other minor indirect taxes.

[10] Regional Governments have exclusive power to tax gifts, wealth, legal documents, and gambling. Starting in 2002, the Regional Governments have freedom to set the rates and the exceptions for these taxes.

[11] The major part of central government transfers to the Regional Governments is channelled through the "Sufficiency Fund", which is intended to cover the gap between the mandatory expenditures and revenues accruing to the Regional Governments. The initial amount of the sufficiency fund was calculated as the difference between the estimated cost of the Regional Governments mandates and revenues calculated in the year 1999. Every year this amount is increased at the same rate as the central government's tax revenues. In addition to the "Sufficiency Fund", some Regional Governments also receive resources from other funds, including the Interregional Compensation Fund (Fondo de Compensación Interterritorial), which is the main instrument for regional development and is coordinated with regional transfers from the European Community.

[12] For a more detailed analysis, see Pedraja, F. Salinas J. and Suarez-Pandiello (2006)...

In 2002, the Law was reformed and the amended act is what is nowadays applicable. Currently, Spanish local authorities levy five taxes: property tax, business tax, vehicle tax, tax on buildings and tax on land value increase in urban areas. The first three taxes are compulsory in the sense that they have to be collected by all local councils. The remaining two are optional and municipalities may also collect fees and user charges.

The other main source of financing for local governments, representing around a fourth of total non financial local revenue, is transfers from other levels of Government, in particular the Central Government. The largest transfer from the central government to municipalities is the municipalities' sharing in central taxes (Participación Municipal en los Ingresos del Estado (PMIE)). It is a non conditional current transfer, whose total amount is revised every five years, and whose distribution is determined in relation to some specific criteria such as population, educational units, revenue raising capacity or tax effort.

3. BUDGETARY DATA: INITIAL PROJECTIONS AND OUTCOMES

Central Government

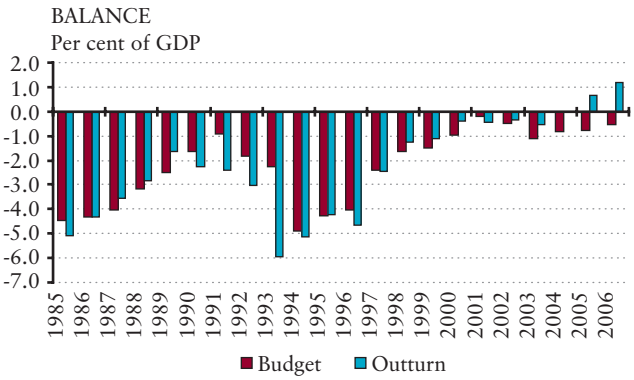
The information released for the Central Government budget and budgetary outturn does not suffer from large delays. In fact, the information referring to the closing of the previous fiscal year is available with a two month lag. Moreover, during the fiscal year, a large amount of budgetary data is released with a very short time lag, thus providing the opportunity for monitoring expenditure and revenue at the central level during the fiscal year.

As can be seen in Figure 2, the Central Government has been budgeting deficits in each and every year from 1985 to 2006, with a peak in 1994. The deficit trend was declining up to 1991, with an increasing trend since up to 1994, when a downward trend started again up to 2001. As for the outturn, the State shows a surplus in two out of six years of the current decade, with no other surplus being reached in the period under analysis. The peak deficit was attained in 1993 and the largest surplus in 2006.

The closing balance for the Central Government was much poorer than initially budgeted in most of the fiscal years in the decade of the 1990s, in 1985 and 2001. For the rest of the years, the outturn was better than initially budgeted. In fact, it may seem that there is a trend towards larger positive differences between outturn and initial budget since 2002, with the largest difference being the one observed in 2005.[13]

Figure 2

Central gov. initial budget and budget turn



SOURCE: Ministry of Economy and Finance and Bank of Spain.

Regional Governments

The Ministry of Finance and in particular the Dirección General de Coordinación Financiera con las CCAA, gathers all the data referring to the annual budgets approved by each State Government and releases consolidated data for their General Administration and its different organisms, after its transformation. Moreover, it provides the consolidated budget for the aggregate State Government sector. The most recent data refers only to budgetary chapters (available with a three month lag, approximately), while a larger disaggregation of the data is published much later (one and a half years, approximately) so that a functional expenditure budget is also provided. Currently, the latest available information on consolidated regional budgets refers to 2007 and the detailed one to 2006.

As far as data on outturn are concerned, the Ministry of Finance publishes a first estimate, which is disaggregated by budgetary chapters with over a 18 month delay, so that currently the latest information available corresponds to 2005.[14] Even later, the Ministry releases more detailed information for regional finances, including a functional approach. The latest detailed information covers up to 2003.

Information referring to both initial budgets and outturns for State Governments is presented in Figure 3 for the period 1985 2006 (with the 2006 outturn being an estimate). As can

[13] The BSL in place since 2002 sets a ceiling on central government spending. It also sets a contingency fund to deal with unforeseen circumstances, and forces the dedication of any social security surplus to the pension reserve fund.

[14] To build the figures, we have projected the outturn for 2006, taking into account the data contained in the EDP Notification.

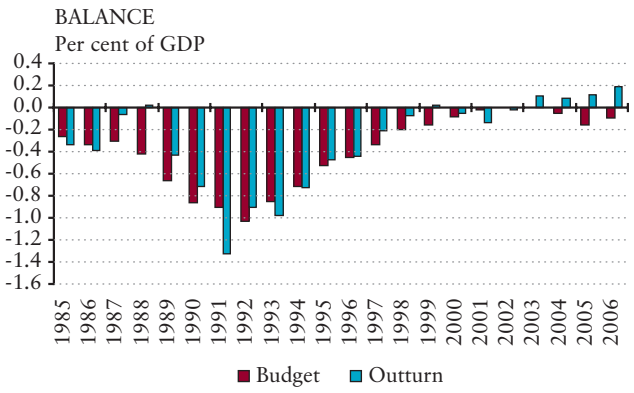
be seen, State Governments have always projected a budgetary deficit, the only exception being 2003. The budgeted deficit over GDP increased up to 1992 and then declined until 2003, when, after the projected surplus, a new upward trend started.

On the other hand, the budgetary outturn recorded a surplus in six years (1988, 1999, 2003 2006). It also followed a similar pattern to the one shown for the projections: an increasing deficit up to 1991 and a declining trend since, but not as systematic.

We observe that, in general, the closing balance attained was much better than the initial balance projection. Only in very few years, the balance was much worse than initially envisaged (1991, 1993 and 2001), while in very few others the negative difference (outturn budget) was rather small. The largest positive differences seem to show up at the end of the 1980s and 1990s, periods in which real GDP growth was relatively high. We must remember that the devolution process justifies some of the differences that we observe between projections and outcomes as the budgets were being designed before the transfer of responsibilities and thus of the associated expenditure and revenue had taken place during the fiscal year.[15]

Figure 3

State (regional) gov. initial budget and budget outturn



SOURCE: Ministry of Economy and Finance ("D.G. de Coordinación Financiera con las CCAA") and Bank of Spain.

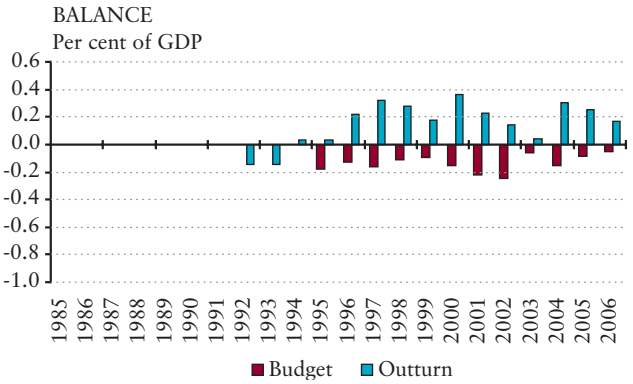
Local Governments

The Ministry of Finance and in particular the Dirección General de Coordinación Financiera con las EELL, gathers all the data referring to the annual budgets approved by large municipalities and publishes with a delay of two years a summary of the initial budgets and the outcomes.

As can be seen in Figure 4, showing data on budgets and outturn from 1992 to 2006, at the aggregate level, Local Governments have always projected a deficit, which declined up to 2000 and then rose until 2002. Except for the first two years, the outcome has always recorded a surplus.

Figure 4

Local gov. initial budget and budget outturn



SOURCE: Institute for Fiscal Studies, Ministry of Economy and Finance ("D.G. de Coordinación Financiera con las EELL") and Bank of Spain.

4. NATIONAL ACCOUNTS DATA

Information in national accounts terms for the whole General Government is available with high frequency and very short delays. The updated Stability Programme, the Excessive Deficit Protocol (EDP) Notifications, and the economic objectives which the Government needs to announce in the first term of the previous year for which the projections are defined, are all set in national accounts terms, so that this accounting framework is central for monitoring purposes.

Detailed national accounts data for each State Government are not available until two and a half years after the end of the fiscal period, so that a comparison among the different State governments can only be done with a significant delay. Only the aggregate State and Local Governments balances, but not their composition, are known at an earlier date, with a three-month lag (at the time of EDP notification by the end of March).

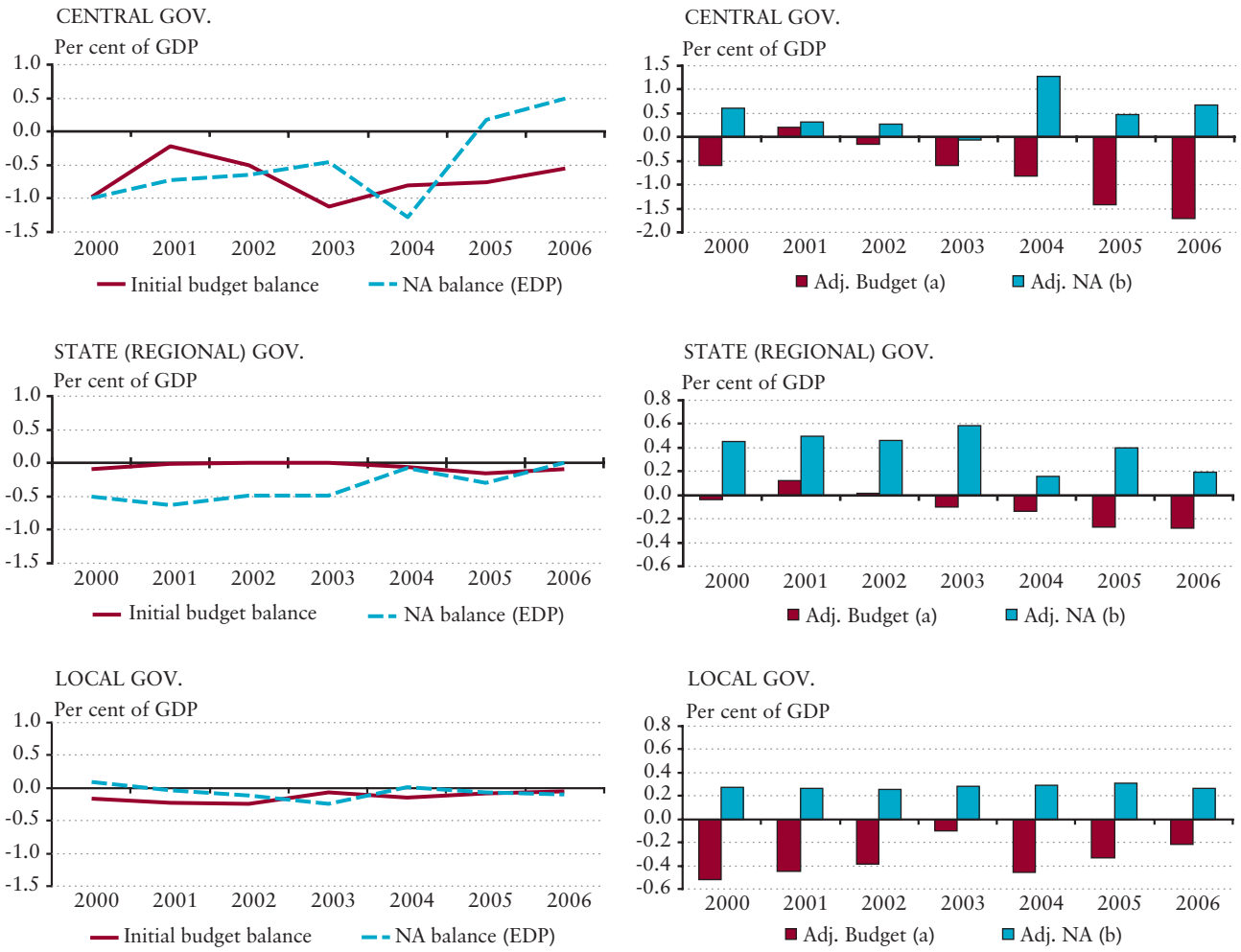
As for the Central Government, data in national accounts terms are available soon after the end of the fiscal year. In fact, during the year, monthly data on the balance are made available in both cash and national accounts terms, with more detailed information for the former.

During the 2000 2006 period, the Central Government recorded an improvement in its fiscal balance in national

[15] See Argimón, I. and Martí, F. (2006) for a more disaggregated analysis.

Figure 5

From initial budget balance to national accounts (EDP)



SOURCES: Ministry of Economy and Finance ("Estadísticas territoriales"), Institute for Fiscal Studies and Bank of Spain.

(a) Initial budget balance minus Budget outturn.

(b) Budget outturn minus NA balance.

accounts terms, expressed as a ratio over GDP (Figure 5). The exception to this trend took place in 2004, when exceptional circumstances, related mainly to the reorganization of the railways infrastructure system, resulted in temporary expenditures. In particular, they took the form of capital transfers, corresponding to the debt assumption from RENFE, the national railway company (0.7% of GDP) and the public television broadcaster RTVE (0.1% of GDP). In 2005, a surplus was attained and in 2006 this was even improved upon.

As for State Governments, the balance in national accounts terms has been slightly improving, except in 2004, but showing negative values except for 2006 when a balanced budget was recorded.

A rather different pattern from State Governments emerges for the national accounts balance data of Local Governments, as they record a tiny deficit over GDP or even a small surplus in 2000 and 2004. Since 2004 a worsening can be observed.

In the lower part of Figure 5 for each level of government, we include a comparison between the initial and final outcomes in budgetary terms and between the actual budgetary outcome and the national accounts data. A green positive value indicates that the actual deficit (surplus) in budgetary terms was higher (lower) than initially budgeted and the value measures the difference in GDP terms. A red positive value indicates that the deficit (surplus) in national accounts terms was larger (smaller) than actual budgetary deficit (surplus).

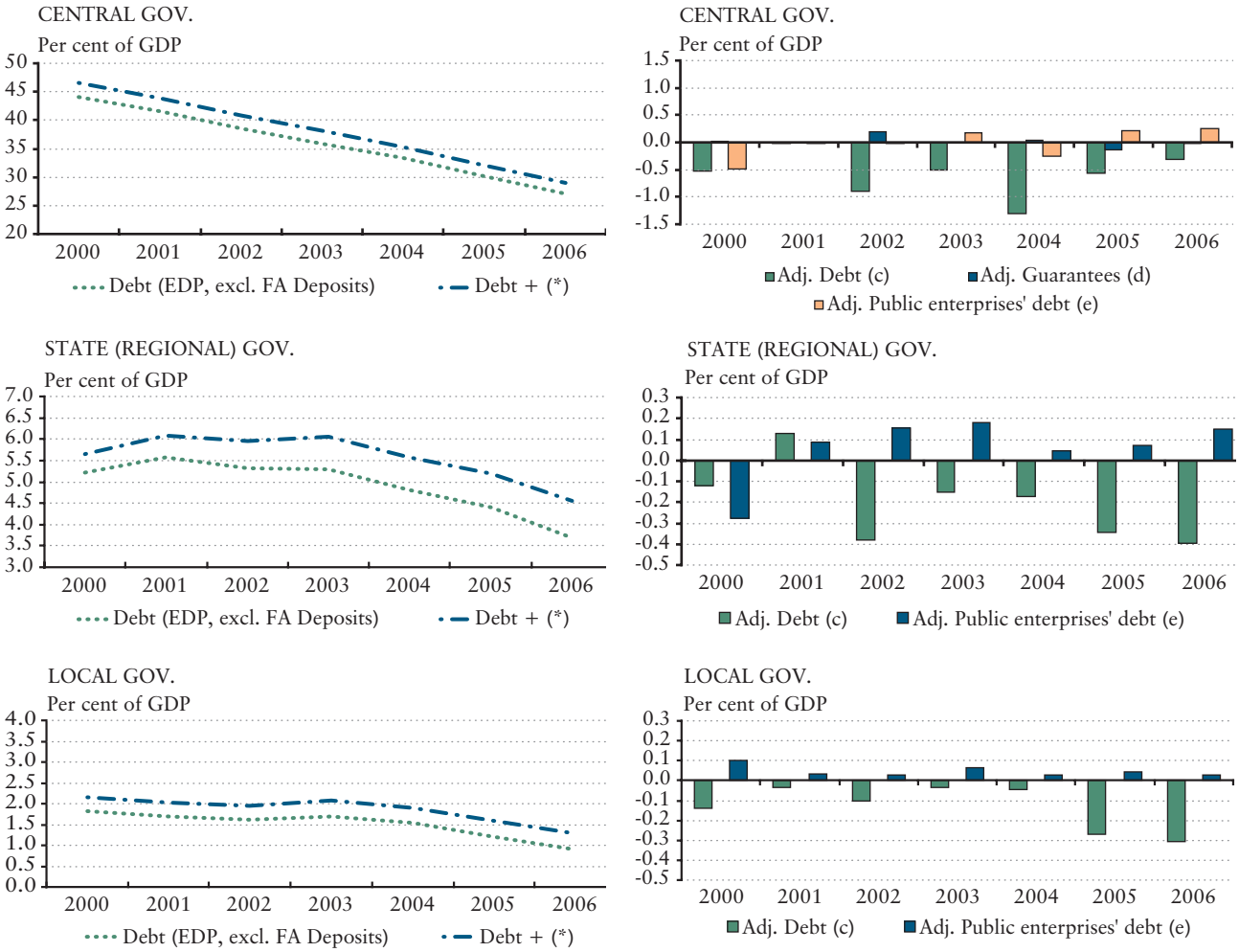
The comparison between the budgetary outturn and the national accounts data shows that the outcome is always worse in national accounts terms than in budgetary terms, for the three levels of Government, with the exception of 2003 for the Central Government. The major items that usually explain the adjustment between the two accounting methodologies are capital injections into public enterprises and cancellation of taxes. In some years, the advances to State Governments can also play an important role in the adjustment corresponding to the Central Government. In particular, while in the case of Local Governments and State (Regional) Governments the adjustment was always below 0.4% and 0.6% of GDP, respectively, in the case of the Central Government it reached over 1% in 2004 due to the already mentioned RENFE effect. For the rest of the years in the Central Government the adjustment was below 0.5 pp. of GDP.

5. BEYOND NATIONAL ACCOUNTS

Up to here, we have been analysing information that is contained within the limits established by the national accounts framework. It is, however, worth analysing the public sector activity beyond the limits set by such an approach, not only because some of these activities may imply contingent public liabilities that in the future will show up in those accounts, but also because public intervention adopts different approaches, which can be channelled through means and institutions not well aligned with the national accounts framework. Moreover, institutions evolve over time so that it could be the case that there is a change in the statistical classification of units from the government to the non government sector, and the other way round. The reclassification of such units would imply that the liabilities they were holding would be transferred inside or outside the

Figure 6

From initial budget balance to national accounts (EDP)



SOURCES: Ministry of Economy and Finance ("Estadísticas territoriales"), Institute for Fiscal Studies and Bank of Spain.

(*) Debt (EDP, excl. FA Deposits) plus Guarantees plus Public enterprises´debt. (c) NA balance plus change in Debt (EDP, excl. FA Deposits). (d) Change in Guaratees. (e) Change in Public enterprises´debt.

government following the change (as in the RENFE) case. Public enterprises tend to be one of the units more often affected by such reclassification, as the conditions of their previous classification within the private sector (unit mainly financed by the market) are not fulfilled anymore.[16] But public firms are not the only source of discrepancies.

Deficit debt adjustments

When the government budget records a deficit in the non financial accounts, the equivalent amount should be found in its financial accounts where its increase of liabilities should exceed the increase in financial assets to finance this deficit. In case of a surplus, the accumulation of financial assets should exceed its transactions in liabilities at the same value as the surplus.[17] The deficit debt adjustment records the variation in debt that is not accounted for by the deficit and surplus and may thus reflect part of the activity carried out by public sector which is not reflected in the data recorded in national accounts terms. In fact, its analysis may reveal inconsistencies between the financial and non financial data which could be used to assess weaknesses in the fiscal data.

Moreover, the Financial Assets (FA) Deposits that are included in the definition of EDP debt can hardly be regarded as corresponding to any activity carried out by the public sector, as these assets can be more associated with cash management needs. Therefore, we propose to exclude them from debt data (see upper part of Figure 6, continuous line) and analyse the dynamics of the remaining deficit-debt adjustment ratio. A positive (negative) value of the adjustment implies that the increase (decline) in debt that we have observed is larger (smaller) than the deficit (surplus) that has been recorded in national accounts terms.

Contrary to what we might expect, we observe mostly negative values for the adjustment in all levels of Government data (lower part of Figure 6). The main difference between the different levels of Government lays on the size of the adjustment. In the case of the Central Government it can reach just over 1 pp of GDP (in 2003 in negative terms) while in the case of State Governments its highest value is below 0.4 pp of GDP (in 2002) and in the case of Local Governments it is just above 0.4% of GDP in 2006. However, given that the debt ratios for State and Local Governments are much smaller than the corresponding ratio for the Central Government, the deficit debt adjustment has a marginally larger impact on regional and local accounts. In particular, while the deficit debt adjustment for the Central Government accounts only for less than 3% of the debt ratio, it reaches over 10% in the case of State and Local Governments.

Other data

An assessment of the fiscal activity carried out by a broader definition of the public sector unit could also include the debt held by all public firms, which are currently classified in the private corporate sector. This does not prejudge that these enterprises are going to be reclassified within the General government sector. In fact, such reclassifications are rather rare. However, the analysis of such units may provide some further insight into public sector activity, as national accounts are nothing else but a very useful accounting convention.

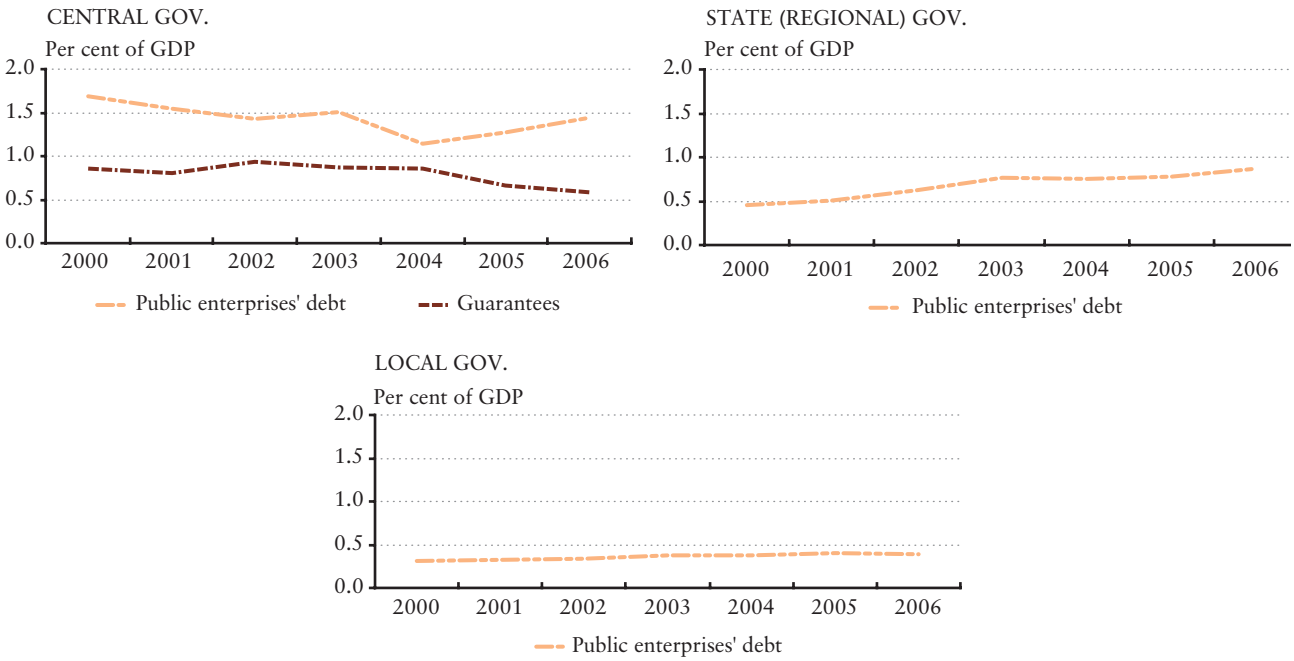
In any case, the weight of public enterprises debt over GDP is below 2% for the Central Government, below 1% for Regional Governments and below 0.5% for Local Governments (Figure 7). It seems that the State Government public enterprises debt ratio shows an increasing trend and the Local one a constant trend that are partially in contrast with a declining debt ratio for Central Government enterprises up to 2004, when we observe an increase in the latter. The relevance of public enterprise debt is large for State Governments as this debt reaches above 13% of the sum of both EDP and public enterprises debt. In the case of the Central Government, such debt accounts for less than 5% of the total amount of debt.

[16] It could be argued that the reliance on public firms or the use of PPP for the provision of goods and services aims at hiding public expenditure from published accounts. However, it could also be argued that different functional forms or property arrangements can deliver different outcomes, so that the real aim is to enhance efficiency in the provision of goods and services.

[17] To sum up, one can say that the deficit debt adjustments (DDA) are the variation in debt that is not accounted for by the deficit/surplus. Therefore, they include elements such as (1) the statistical discrepancy between financial and non-financial accounts, (2) the net acquisition of financial assets minus the net incurrence of liabilities that are not EDP instruments, (3) the market to face value adjustment, (4) the foreign exchange holding gains and losses and (5) other changes in volume of the debt.

Figure 7

Other liabilities



SOURCES: Ministry of Economy and Finance ("Estadísticas territoriales"), Institute for Fiscal Studies and Bank of Spain.

In Figure 6 (lower part), we include for each one of the three different levels of government the change in the total amount of debt over GDP held by public enterprises as an additional but independent element for consideration. In the case of the Central Government, the changes in the ratio of public enterprises debt go in both directions so that there are increases and decreases in outstanding debt by public enterprises. That is no so in the case of State and Local Governments, where we observe a positive contribution to debt by public firms, except in 2000 for State Governments.

Another element that can be analysed is the provision of public guarantees to private firms, which the different levels of government can offer. These can be regarded as contingent liabilities, as they may need to be made use of in the future.[18]

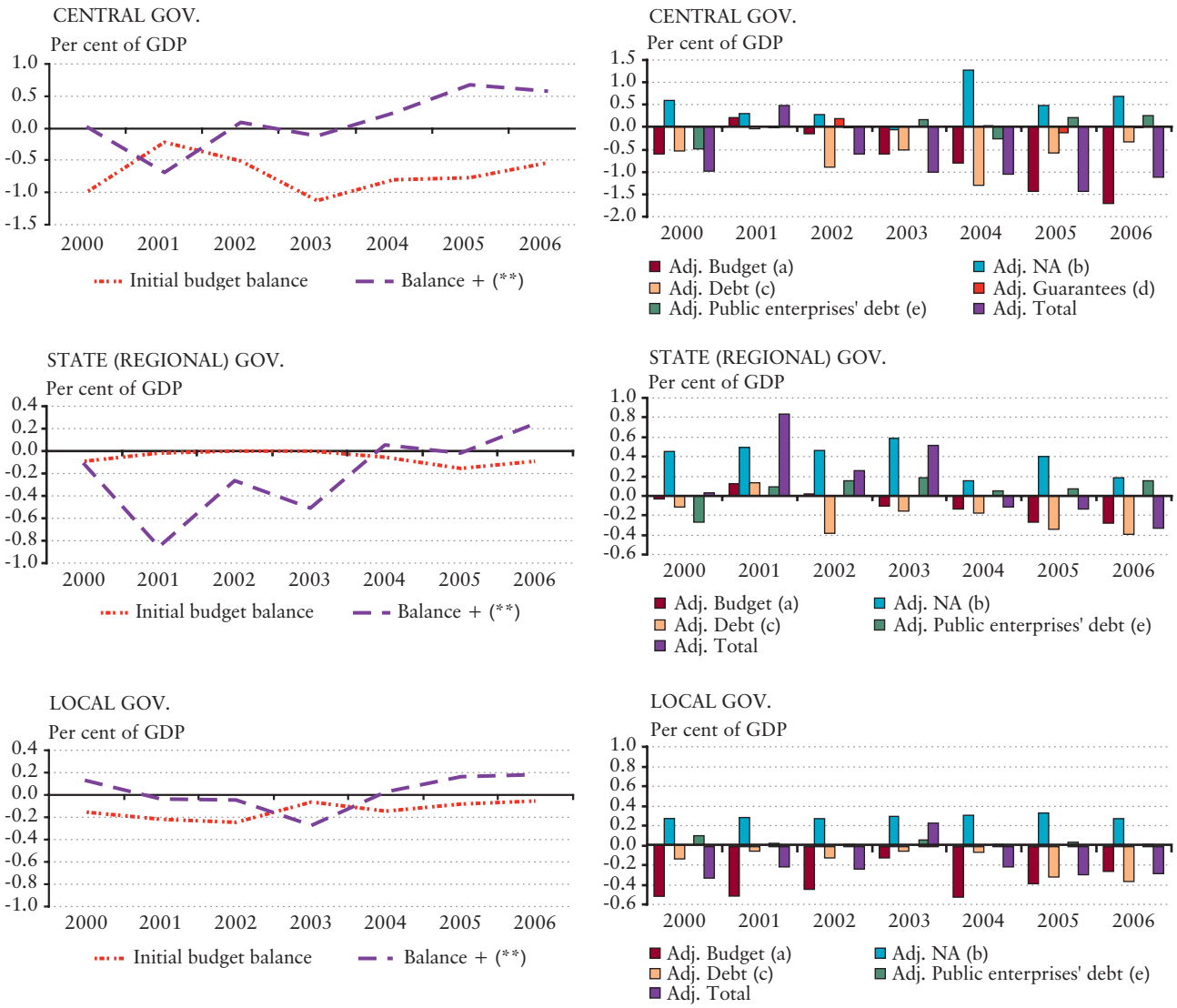
As the only available data refers to the Central Government, Figure 6 only includes the changes in the amount of these guarantees for this level of government: a positive value implies that the volume is growing in GDP terms. As the figure shows, the changes are rather small and have both signs. The volume of such guarantees is reflected in Figure 7, where it can be seen that they are on a declining trend.

The dotted line in Figure 6 reflects the sum of the newly defined debt ratio plus public enterprise debt plus guarantees that the government has provided to private firms at full value (the latter only for the Central Government). As we can see, the difference between the two series is not large, especially for the Central Government, especially if we take into account the total weight of the debt.

[18] In fact, in the case of Spain, such resource was required in relation to an Argentinean guarantee in 2004.

Figure 8

From initial budget balance to change in debt



SOURCES: Ministry of Economy and Finance ("Estadísticas territoriales"), Institute for Fiscal Studies and Bank of Spain.
(**) Initial budget balance plus adjustmens (a+b+c+d+e). (a) Initial budget balance minus Budget outturn. (b) Budget outturn minus NA balance. (c) NA balance plus change in Debt (EDP, excl. FA Deposits). (d) Change in Guaratees. (e) Change in Public enterprises' debt.

6. CONCLUSION

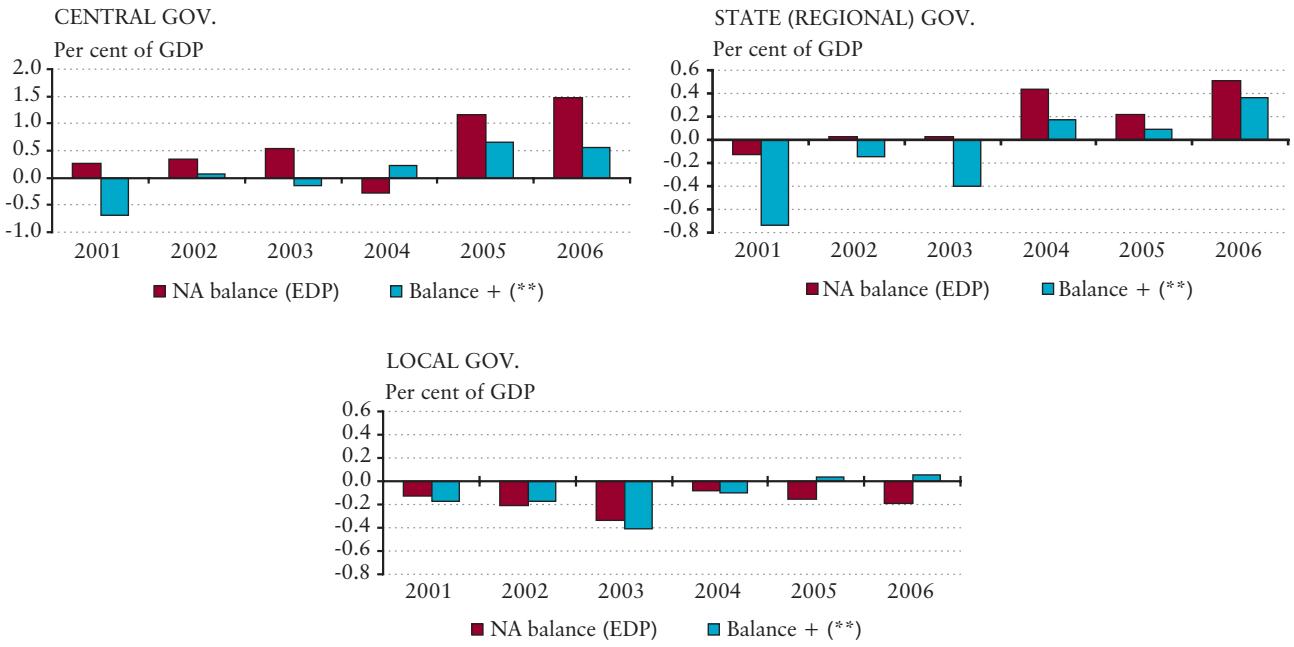
From all the information gathered and presented so far a new measure for the budgetary balance could be built and compared with the initial budgetary projections. This is done by adding to the initial budget, the final outturn, the national accounts adjustment, the deficit debt adjustment defined on debt net of FA deposits, the changes in public enterprise debt and the changes in public guarantees (only in the case of the Central Government).[19]

The new budgetary balance thus built for a very broadly defined public sector tends to record a surplus in the case of the Central Government that may be said to show an increasing trend (Figure 8). State (Regional) Governments show a completely different pattern, so that the budget for the broad public sector is in deficit during most of the years, but also on an improving trend, so that it also shows a surplus in 2004 and 2006. The balance for Local Governments show a declining trend up to 2003, when it starts improving again. In fact, a surplus is observed in 2000 and from 2004 to 2006.

[19] In other words, we add to national accounts data the deficit-debt adjustment, the changes in public enterprise debt and the changes in public guarantees.

Figure 9

Other liabilities



SOURCES: Ministry of Economy and Finance ("Estadísticas territoriales"), Institute for Fiscal Studies and Bank of Spain.
(**) Initial budget balance plus adjustmens (a+b+c+d+e, see Figure 8).

On the other hand, the new budget figure obtained is over the initial budget projection in the cases of the Central and Local Government and below such projection in the case of State (Regional) Governments. That is, the budgetary projection released by Local and Central Governments shows a deficit that when the public sector at large is taken into account does not materialise, so that the final balance records a surplus or at least a lower deficit. The contrary occurs with aggregate State (Regional) Government accounts, so that the projected deficit in budgetary terms is surpassed by the deficit computed with a broad definition of the public sector.

The role played in the difference between initial budgetary projections and the budget thus obtained by each of the components we have analysed is reflected in the lower part of Figure 8, where the total and an additive decomposition is shown. As can be seen, in the cases of the Central and Local Governments the main source of the difference is the discrepancy between the initial budget and the final outcome in cash terms (green bar). The deficit debt adjustment (blue bar) has also played an important role in some years, reinforcing the difference. In the case of State (Regional) Governments, the adjustment between cash outturn and national accounts data (red bar) drives most of the difference, being usually reinforced by the change in public enterprise debt ratio.

We could then conclude that a broader approach to public sector data than the one provided by the national accounts data shows that in the case of Spain, the different levels of government seem to respond to different patterns of budgeting.

The Central Government seems to overestimate the deficit, in the sense that when we consider a broad public sector which includes public enterprises and even public guarantees, the computed deficit turns out to be much lower than initially budgeted, or even a surplus is reached. In the case of the Central Government, the main factor which explains this difference can be found in actual revenue being larger than initially expected or expenditure turning out to be much lower (mainly interest payments) than initially programmed. A similar pattern seems to reflect Local Government budgeting. State (Regional) Governments seem to show a completely different pattern, so that the final computed deficit which a broadly defined public sector would attain is larger than the one initially budgeted. The main factor explaining such difference is the necessary adjustment between budget outturn and national accounts data. Capital injections into public enterprises and increases in the debt of these firms are at the root of the discrepancy. State (Regional) Governments are responsible for the management of large expenditure items related to public

services that are relevant for potential growth, such as education and health. In fact, they account for 90% of the expenditure that the General Government devotes to such matters. Therefore, the need to increase efficiency in the provision of such services is in their hands and need to be reflected in their accounts.

In cumulative terms, initial budgets have projected an improvement in the Central Government finances of 0.4 pp of GDP between 2000 and 2006, which has amounted to 1.6 pp in national accounts terms (Figure 9). With the broad definition of public sector, the improvement is only 0.6 pp of GDP. A similar pattern emerges from State (Regional) Government accounts: in national accounts an improvement amounting to 0.5 pp of GDP was recorded, while the broad definition shows a 0.3 pp improvement. In the case of Local Governments, national accounts record a worsening of 0.3 pp while the broad definition records an improvement of less than 0.1 pp. Therefore, a broad definition of public sector seems to record a smaller improvement in budgetary accounts both for Central and State (Regional) Governments than when national accounts figures are taken into account, while the opposite happens with Local accounts.

The new framework set by the Budgetary Stability Laws asks for regions to attain a budget balance or a surplus in national accounts terms, thus involving these decentralized units with the compromise set by the Stability and Growth Pact. Budgetary data could be used as a proxy to carry out the analysis of regional fiscal policy, both ex ante and ex post and thus, of assessing the feasibility of the targets set, before and during the year when they are operative. In any case, a broader definition of the public sector could help understand part of the activity which is carried out by public units and which the current accounting framework does not cover. However, it would be better to improve the availability of timely information on the activities carried out by decentralised units. The lack of timely and comprehensive information makes it difficult to ensure fiscal discipline at lower levels of government, where we observe that the budget tends to underestimate the activity carried out by a broad definition of public sector with a negative impact on the accounts.

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General comments by Basil Manessiotis[1]

Ever since the fiscal balance was transformed from a statistical concept into a binding legal obligation, countries (especially in the EU) have devised an astonishing number of fiscal gimmicks, usually referred to as "creative accounting," to circumvent fiscal rules.

The four papers discussed below propose several ways of approaching this problem. Although they are quite diverse in nature and motivation (ranging from a lack of fiscal data on regional governments in Spain, to the fiscal risks arising from transport enterprises in Hungary), they seem to imply a couple of very interesting common conclusions, which I think should be pointed out.

The first generalization is that the broader the (statistical) coverage of the government sector, the less room there is for fiscal gimmicks. Put differently, the narrower the coverage of the government sector (in statistics, fiscal targets and indicators), the greater the opportunities for creative accounting. Thus, for an appropriate assessment of fiscal positions (especially in the short term) and the containment of creative accounting, a broader possible definition of the government sector should be used, including for example public enterprises (PEs), private-public partnerships (PPPs), "sovereign wealth funds" and even state controlled financial institutions. Although one may question whether or not some of these entities should be included, it is certain that coverage should be broader than what is currently used by ESA 95.

Second,[2] a single fiscal indicator, or even a couple of indictors, is not sufficient for monitoring and assessing short-term fiscal positions. On the one hand, no single fiscal indicator can accurately and thoroughly describe the (complex) fiscal position. On the other hand, different analytical questions (i.e. estimating the structural balance, or the fiscal impulse) require different indicators. Thus, besides the general government balance (measured on an "accruals" or "national accounts" basis) currently in use in the EU, a combination of several other indicators could be used, such as the cash-deficit of the general government (compiled by the central bank), government sector net-worth, outstanding government guaranties, etc.

Hence, a broader definition of the government sector and the use of a larger number of appropriately chosen fiscal indicators is warranted, in order to limit as much as possible the opportunities for creative accounting and fiscal gimmicks. Moreover, it may be added that the evolution of the debt-to-GDP ratio should receive far greater attention than is currently the case.

1. "ONE-OFF" AND "OFF-BUDGET" ITEMS: AN ALTERNATIVE APPROACH (BY GABOR P. KISS).

The paper by Gabor P.Kiss poses a very interesting question: *"Given the extensive use of fiscal gimmicks by most countries in order to circumvent fiscal criteria, what should be done so that fiscal indicators are still meaningful and useful?"*. The answer, as the paper argues, is that the budget balance should be corrected for the various tricks and the *"true deficit"* be obtained (besides the usual cyclical adjustment).

It is recognized, however, that no single fiscal indicator can accurately and thoroughly describe the fiscal position. Moreover, it is also stated in the paper that different analytical questions (i.e. estimating the structural balance, fiscal impulse etc.) might require a different type of "correction" and even different indicators.

The paper then presents several types of "one-off" and "off-budget" items which should be taken into account in correcting the deficit. Such cases include "one-off revenue" (or "capital revenue"); timing of recording (or implementing) individual revenue and expenditure items; private-public partnerships (PPPs); quasi-fiscal activities, etc. Finally, appropriate methods of "correction" or adjustment are presented so that the "correct" or "true deficit" is obtained.

The paper accurately reflects the questions raised the last fifteen years or so in the EU regarding the monitoring and assessment of fiscal performance in the member states, and I agree with much of it. So, I will focus my comments on some points that I felt the paper could have developed further.

Regarding the proposed "correction" of the budget balance, it requires that in several instances "first round" and "second round" economic effects are traced and estimated. As is well known, second round effects are very difficult to capture. This is even more so if the analysis is carried out by an

[1] Bank of Greece

[2] Only three of the four papers suggest the use of several indicators. On the contrary, one paper suggests correcting the general government deficit (on a national accounts basis) to obtain the "true deficit".

international agency (i.e. OECD, EU, etc.) and a large number of countries is involved. Thus, from an operational point of view, the proper "correction" may not be feasible.

Moreover, the paper does not pay attention to an important alternative to the "true deficit". Namely, instead of using one fiscal indicator (even the "corrected" or the "true one"), why not use a *set of fiscal indicators* to assess the short-term fiscal developments in a country?[3] Such a set of indicators, in addition to the budget balance[4], could include:

- the *cash deficit* or borrowing requirement of the general government (GGBR) or, even better, the borrowing requirement of the public sector as a whole (the well-known PSBR),
- an index of government's *net worth,*
- outstanding *central government guaranties* to sub-sectors of general government (and perhaps public corporations),
- *suppliers' credit* to general government sub-sectors (i.e. social security, public hospitals, public universities, local authorities, etc.),
- a thorough analysis of the deficit-debt adjustment.

Although some of these indicators do not fit directly into the conceptual framework of ESA 95, they do provide valuable additional information and insight about fiscal developments, and need to be taken into account. Moreover, the use of such a set of indicators would have probably prevented most of the creative accounting schemes used during the last fifteen years or so in the EU context.

The *cash deficit,* for example, has numerous advantages:[5]

- it is compiled by the ("independent") central bank (and not by the Ministry of Finance) and is highly reliable and usually not subject to revisions,[6]
- it is more suitable for monetary analysis,
- it is immediately available, with higher frequency (i.e. monthly) and without any time lag,[7]
- there is a very high correlation between the cash deficit and changes in gross consolidated debt.

Thus, an improvement in the budget balance (on a national accounts basis) which is not reflected in the respective cash deficit should sound an alarm.

Second, monitoring government's *net worth* could have prevented many fiscal gimmicks. Creative accounting has been defined[8] as "the unorthodox statistical treatment of operations involving the general government, which affect the fiscal balance (or debt) *but not government net worth* (because they have self-reversing effects)". Thus, the use of government's net worth as an index of fiscal performance, would have prevented a large number of operations[9] which improve the (current) fiscal balance, but create future obligations. The combined use of both the fiscal balance and the net worth indices would have revealed the lack of any improvement in government accounts.

Third, monitoring the evolution of the *state's guaranties and suppliers' credit* to sub-sectors of general government also helps in assessing the overall fiscal developments. Credit of any form can be used to temporarily conceal deficits and debt, as relevant (public) obligations are hidden in the banking system.

Finally, one can hardly exaggerate the importance of monitoring the evolution of the debt-to-GDP ratio in assessing the fiscal position in a country. Virtually all shorts of fiscal gimmicks will eventually be reflected as higher debt. The recording, however, in most cases will take place with a considerable time lag (even four or five years). Thus, the debt-to-GDP ratio is the best single index of fiscal developments in the medium and longer-term. In the short term the evolution of deficit-debt adjustment should be carefully monitored and thoroughly analysed. If the deficit-debt adjustment exceeds, let us say, 0.5 per cent of GDP, then an alarm should sound.

It should be emphasized that all indices should be simultaneously monitored and, if possible, reconciliation between them should be carried out regularly. Reconciliation between the cash and the national accounts deficit in particular is extremely useful and revealing.

[3] If the use of one indicator is unavoidable, then the evolution of the debt-to-GDP ratio is the *best single* index in the medium and longer term. If the debt-to-GDP ratio is high and not falling, then there are problems, no matter what all other indicators say.

[4] On a national accounts basis (ESA 95 or EDP definition).

[5] Provided that the central bank is the exclusive banker of the state.

[6] In the case of Greece, for example, despite the extensive revisions of the deficit figures (on a national accounts basis), the cash deficit was never revised. Moreover, the revised ESA 95 deficit was eventually very close to the unrevised cash deficit.

[7] Under current arrangements in the EU, the accounts of the State operate on a "real time" basis.

[8] Vincent Koen and P. Van den Noord, F*iscal Gimmickry in Europe: One-off Measures and Creative Accounting,* OECD, working paper No 417, Feb. 2005, p.7.

[9] Several of which have been approved by Eurostat.

In addition to what has been mentioned so far, the paper also fails to recognize the importance of *transparency* and consistency in containing creative accounting. Consistent accounting rules and practices, and transparent and timely compilation and publication of fiscal accounts are fundamental prerequisites for any type of indicator, and limit the opportunities for creative accounting.

2. FISCAL TRANSPARENCY FROM CENTRAL BANKS' PERSPECTIVE: OFF-BUDGET ACTIVITIES AND GOVERNMENT ASSET FUNDS (BY DUBRAVKO MIHALJEK)

This paper provides an interesting report on how central banks in emerging market economies assess (short-term) fiscal positions.[10] The focus is on two particular aspects of fiscal transparency which have recently gained importance in these countries: "off-budget activities" and "special fiscal funds". The former refers to "hidden liabilities" and the latter to "hidden assets".

According to the paper, the most common measure of fiscal position remains the central government budget balance, measured on a cash basis. However, central banks are increasingly using more comprehensive public sector accounts. As the author states, "… any analysis of a country's fiscal position is far from complete if it overlooks the obligations the government has taken on outside its budgetary system".

In this respect, the concept of the "public sector" proposed by the paper (and used by several countries) is extremely broad, as in addition to general government and public corporations, it includes state-controlled financial institutions,[11] private-public partnerships[12] (PPPs), and "sovereign wealth funds."[13]

It is true that the narrower the sub-set of the public sector we monitor (i.e. central instead of general government, or general government instead of public sector) the greater the opportunities for creative accounting and vice versa. Thus, I fully agree with using a comprehensive definition of the public sector. However, the definition used here is, in my opinion, too broad, especially regarding state-controlled financial institutions and "sovereign wealth funds".

Concerning state-controlled financial institutions, only specific operations should be monitored; i.e. those considered as quasi-fiscal activities. In general, the criteria of the IMF could be used to decide which corporations should be classified in the government sector and which in the corporate sector.

In the EU context there is no relevant experience with "sovereign wealth funds". However, the general principle (in ESA 95) that stocks should be used to counterbalance (or "add" to) stocks (i.e. a reserve could be used to retire debt, but not to boost current revenue), and flows to "offset" or "add" to flows (i.e. only annual interest income or "capital gains" from a "wealth fund" should be included in current revenue), is a very useful starting point regarding the statistical treatment of such funds. Also, the monitoring of the government's "net wealth" would be very revealing, regarding the appropriate treatment of those funds. At the same time, more careful analysis regarding the fiscal and macroeconomic implications, as well as the statistical treatment of such funds is warranted.

3. HUNGARY: FISCAL RISKS FROM PUBLIC TRANSPORT ENTERPRISES (BY ANA CORBAHO).

This very interesting paper, using the IMF methodology, examines and assesses fiscal risks to the state budget in Hungary stemming from the two main transport companies in this country. At the same time, the paper (implicitly) raises a more general and very important issue, namely the proper treatment of public enterprises (PEs) in assessing fiscal developments in a country. Or, in other words, what is the appropriate (statistical) coverage of the government sector in order to "… allow an adequate and transparent assessment of the fiscal stance, mitigate incentives to move fiscal activities off budget, and reduce risks that unrecorded liabilities materialize unexpectedly".

The answer is that PEs (even those which are partly privatized and quoted 0n stock exchanges) should be regularly monitored and their results be incorporated and consolidated with the fiscal accounts of the general government. Fiscal targets and fiscal indicators should also include and reflect the results of all PEs which are not "commercially oriented".[14]

[10] The paper refers to 23 emerging market economies from Asia, Latin America, Eastern Europe, the Middle East and Africa.

[11] These are state-owned or state-controlled financial institutions (accepting or non accepting deposits).

[12] Regardless of the way the three risks are divided between the private investor and the public agency.

[13] The "sovereign wealth funds" are special government asset funds which are gradually becoming major institutional investors in global capital markets. Such funds are usually established either by resource-rich economies or by countries which have accumulated large foreign exchange reserves. In Europe, only Norway and Russia have such funds. In the EU context such funds do not really exist.

[14] In several pilot studies conducted by the IMF's Fiscal Affairs Division in 2004, *very few PEs were found to be commercially oriented.* Thus, the accounts of most PEs should be included in fiscal indicators.

We fully agree with the analysis and the conclusions of this paper. Students of public finances are well aware that the ties between the general government and PEs are in most cases much stronger than usually acknowledged, and run beyond the well known cases of "capital injections", the payment of (regular) dividends and the subsidies to finance QFA. PEs in the EU contest have been used as a "source of financing"[15] and as a "hideout" of liabilities of the general government. In other words, general government can "borrow" through PEs without this liability being recorded in public debt (as defined in ESA 95). Moreover, subsidies to PEs required to finance QFA can be postponed and PEs be instructed to use bank credit[16] (usually covered by a state guarantee), or suppliers' credit. So, for a number of years these obligations will not appear in the fiscal accounts (neither as a deficit, nor as debt).

One simple way out is that suppliers' credit[17] and the outstanding balance of all state guaranteed debt (especially to PEs) is added to the gross consolidated debt of the general government. Eurostat has proposed to include at least part of the outstanding balance of state's guarantees to the gross consolidated general government debt, on the basis of certain criteria.

4. AVAILABLE DATA ON BUDGET AND OFF-BUDGET ACTIVITIES OF SPANISH STATE AND REGIONAL GOVERNMENTS (BY ISABEL ARGIMON AND FRANCISCO MARTI).

I found the paper by I. Argimon and F. Marti very informative regarding data availability in Spain. Strictly speaking, however, this is not a paper about "one-off measures" and "creative accounting".

The paper states that substantial administrative decentralization has taken place in Spain the last twenty years or so, which has increased the importance of Regional Governments (RGs) in fiscal developments.[18] However, despite the increasing importance of the RGs, relevant fiscal data (on a national accounts basis) for each RG are scarce and are available with a 2 ½-year time lag. The problem seems to be of an administrative nature.

An important question is whether the administrative decentralization has been accompanied by d*ecentralization of the budgetary process,* which is usually associated with a *deficit bias.* The paper states that the RGs have more authority over spending than over taxing. Moreover, despite overruns in expenditure, budgetary outcomes in most RGs are improving (especially the last few years) mainly due to buoyant revenues.

Finally, the paper asks whether initial budgetary projections (not stated on a national account basis) may be used as a "good predictor" of the final outcome, which is expressed in ESA 95 terms. It is very interesting to note that according to the paper difficulties are overcome by the use of the broader concept of the public sector (instead of the "general government") and of additional fiscal indicators, similar to those suggested in the comments to the paper *"One-off" and "off-budget" items: An alternative approach, discussed above.*

[15] A PE, for example, borrows in the international capital markets and three days later gives the same amount as a dividend to the central government (thus increasing revenue and reducing the deficit). Second example. A state-controlled financial institution obtains several hundred million euros, by securitization operations on its housing loans, and then the same amount is transferred to the government budget as "ordinary" and "extra-ordinary" dividends.

[16] Preferably from state-controlled financial institutions.

[17] Suppliers' credit should definitely be included because it is not even a "contingent liability". It is a straight forward liability.

[18] As a percentage of GDP, spending by RGs almost tripled between 1984 (5.1% of GDP) and 2006 (14.5% of GDP).

Section 2

Sandro Momigliano–Pietro Rizza:[1] Temporary measures in Italy: buying or losing time?

In this paper we examine the effects of temporary measures on the Italian budget in the period 1997-2006 and assess their appropriateness. We also analyse the role of extraordinary operations which reduced the level of public debt in the same time frame while leaving the net worth of the public sector broadly unchanged. Our analysis suggests that temporary measures and extraordinary operations were used mainly to comply formally with EU fiscal rules without incurring the economic and political costs of more structural adjustment. Policy-makers bought time in a worsening cyclical context, expecting the recovery to be imminent. Ex post information reveals that the timing of this strategy was wrong. In a broader temporal perspective, the use of extraordinary operations has made it possible to postpone more permanent actions which would have improved the sustainability of Italian public finances. It is difficult not to conclude that precious time has been lost designing an equitable distribution across generations of the expected costs of the upcoming demographic transition.

JEL classification: H62, H20, H50, E69.
Keywords: temporary measures, economic cycle, budgetary policies.

1. INTRODUCTION

Temporary measures are not new in Italy (Sartor, 1998; Locarno and Staderini, 2007) but they have constantly played a crucial role in the design of Italian fiscal policy only since the Maastricht Treaty in 1992. The Treaty (Art. 104c) requires member states to avoid deficits in excess of 3 per cent of GDP, making this one of the convergence criteria for the adoption of the euro. It does not prevent member states using temporary measures to comply with the threshold.

Without temporary measures it is unlikely that the Italian fiscal consolidation of the 1990s would have achieved its main objective, i.e. Italy's participation in EMU from the beginning: in 1997 the deficit would probably have been over the threshold of 3 per cent of GDP[2] and it is very unlikely, had that been the case, that the list of EMU participants drawn up in the spring of 1998 would have included Italy. As we will show in this study, there has been no waning of the role of temporary measures since.

Of course, other EU countries that have had difficulty keeping the deficit below 3 per cent of GDP have also commonly resorted to temporary measures (Koen and van den Noord, 2005). Since their systematic use may contrast with the objective of achieving a sound fiscal position, the reform of the Stability and Growth Pact (SGP) in 2005 excluded the effects of temporary measures when determining the budget balance relevant for the multilateral surveillance procedure. Before the reform, the relevant balance excluded only the effects of the cycle.

In this paper we examine the effects on the budget balance of the temporary measures introduced by the Italian government in the period 1997-2006. We also assess whether it was appropriate to resort to them, as they were often aimed at formally respecting the EU fiscal rules while postponing the necessary structural adjustment. The starting year of our analysis reflects the availability of data.[3] Each temporary measure has had its specific motivations, independent from its immediate impact on the balance. An evaluation of these aspects is beyond the scope of this study.

After 1997, the Government planned to progressively replace temporary measures with more structural measures. This was also consistent with Italy's commitment, alongside the other European partners in the SPG, to reach a budgetary position in balance or in surplus in the medium term. This was true

[1] Bank of Italy, Structural Economic Analysis Department, Public Finance Division. The views expressed in this paper are those of the authors and do not necessarily reflect those of the Bank of Italy. We wish to thank Daniele Franco and Stefania Zotteri for very helpful comments, and Renzo Pin for technical support. The opinions expressed do not necessarily reflect those of Bank of Italy.

[2] The decision to speed up the consolidation process and target a deficit lower than 3 per cent of GDP in 1997 was taken relatively late, in the autumn of 1996. Given the short time available and the large gap that had to be closed (in 1996 the deficit was still 7.0 per cent of GDP), it would have been extremely difficult for the Italian Government to reduce the deficit below 3 per cent of GDP with structural measures alone.

[3] Since 1997 the Bank of Italy has systematically provided information, in its official publications, on temporary measures affecting the budget balance. To extend the analysis of temporary measures backwards, capital taxes can be used as a proxy for a major component of temporary measures, which includes tax amnesties and extraordinary levies. Their average ratio to GDP is 0.2, 0.4 and 0.3 respectively in the 1980s, 1990s and in the years 2000-06.

until 2000.[4] After that year, substantial use was again made of temporary measures.

In the theoretical literature and in policy practice different reasons have been given to justify the use of temporary measures.[5] At macro level, they may allow fiscal rules to be complied with in years of political or economic emergency.[6] In periods of economic downturn, their non-permanent nature may sometimes help fiscal authorities avoid hampering a cyclical recovery.[7] At micro level, they can be used to attain specific goals, such as inducing taxpayers to declare hidden assets (Das-Gupta and Mookherjee, 1996 and 1998), correcting distortions caused by tax rules, or temporarily patching up a defective regulation.[8] With particular regard to tax amnesties, other arguments have been offered in the literature, including self-selection (Franzoni 1994; Cassone and Marchese 1995), insurance effects (Andreoni 1991, Franzoni 1994 and 1996), and economizing on prosecution costs (Chu, 1990, Kaplow and Shavell 1994).

In spite of these potential benefits, temporary measures are a source of major concerns. First, their use reduces government accountability as they can contribute to window-dressing and reduce budget transparency. Second, in a situation of fiscal imbalance, temporary interventions might delay the necessary structural adjustment, which may prove to be very costly. Moreover, at micro level, the use of temporary measures can itself introduce new distortions in the economy and have perverse effects on taxpayers' expectations; a typical example of this is given by tax amnesties, which might encourage greater tax evasion in the future, as some studies of the Italian experience have also shown (Marchese, 1997; Fiorentini and Marchese, 1997).[9]

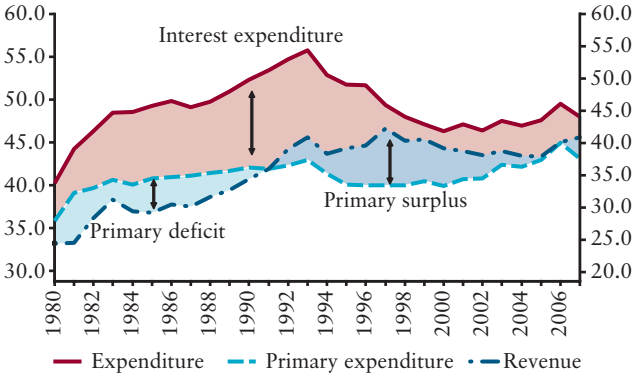
Identifying temporary measures and assessing their effects is not always straightforward. In the paper we use the criteria adopted by the Bank of Italy and compare them with the guidelines for identifying these measures recently provided by the European Commission.

We also analyse the role of extraordinary operations that have reduced the level of public debt while leaving the net worth of the public sector broadly unchanged. As in the case of temporary measures, it appears that these operations have been at least partly motivated by the wish to comply with the Maastricht Treaty rules[10] without incurring the political or economic costs of more structural adjustment.

The Italian government's use of temporary measures and extraordinary operation needs to be assessed in relation to the overall development of Italy's public finances. In the years 1998-2006 these deteriorated rapidly and uninterruptedly. The primary balance, at 6.6 per cent of GDP in 1997, shrank to virtually nil in 2006 (Figure 1). The extent of this deterioration was not immediately clear in the public debate. In the early years, the worsening of the primary balance was offset by the reduction in interest payments. Moreover, initial estimates of the yearly balance (made public by the National Institute of Statistics in the spring of the following year) were systematically more favourable than later assessments. Only in 2005 did the European Council identify the presence of an

Figure 1

General government expenditure, revenues and budget balance



Source: National Institute of Statistics (Istat). Data for 2007 are government forecasts from the DPEF update for the years 2008-2011, presented in September 2007.

[4] In this paper we report the budget balance in 2000 net of UMTS receipts, as this aggregate was the focus of the policy debate. In particular, the European Council referred to it in its Opinions concerning the developments in public finances in member states. The European Commission also reported the deficits net of UMTS receipts in its official publications (see e.g. European Commission, 2001, page 11). Accordingly, UMTS receipts are not included in the temporary measures.

[5] A review of the literature and a summary of the main results can be found in the section "Tax policy and administration" of the World Bank website.

[6] This role for temporary measures is a consequence of the fact that fiscal rules need to be relatively simple. For a discussion see Kopitz and Symansky (1998).

[7] Temporary measures do not necessarily have less impact on the cycle than structural ones, especially if the latter have a positive impact on expectations or, for example, enhance the system of incentives to work.

[8] A typical example of this might be a real-estate tax amnesty in the case of residential areas that are not recognized as such because of bureaucratic delays. However, real-estate tax amnesties risk encouraging economic agents to build without a licence in protected areas in the belief that they can take advantage of the next general amnesty.

[9] A number of studies of the impact of one-shot and intermittent amnesties exist, including Alm and Beck (1991, 1993), Cassone and Marchese (1995), Crane and Nourzad (1992), Das-Gupta and Mookherjee (1998), Dubin, Graetz and Wilde (1992), Graetz and Wilde (1993), Mikesell (1986), Stella (1989) and Uchitelle (1989). There appears to be no rigorous empirical work, as yet, evaluating permanent tax amnesties. Broadly, these studies find that the impact of one-shot amnesties, when pre-, during and post-amnesty effects have been considered, is highly context-dependent. However, all empirical studies that examine intermittent amnesties found that they had negative revenue effects.

[10] The Treaty requires that the debt ratio be *"sufficiently diminishing and approaching the reference value [60 per cent of GDP] at a satisfactory pace"*.

excessive deficit and ask the Italian government to redress the situation by 2007 at the latest.

In terms of the structural primary balance, i.e. the primary balance net of the effects of the economic cycle and temporary measures, there is a rapid worsening in the first six years of the period considered (more than 6 percentage points of GDP) and a sizeable improvement (almost 2 percentage points) in the following three years (see Marino et al., 2007; Kremer et. al., 2006).

2. DEFINITION AND IDENTIFICATION

Temporary measures and the budget balance

Since 1997 the chapter "The Public Finances" in the Bank of Italy's Annual Report has included information on temporary measures affecting the budget balance. The criteria followed to identify these measures have evolved slightly over time, due also to the appearance of new types of operations.

In this Section we provide an updated description of these criteria, and brief discussion of them.[11] They are generally in line with the recommendations of the European Commission for identifying temporary measures in the context of multilateral budgetary surveillance (European Commission, 2006).[12] A measure is considered temporary if its impact on the budget balance is deployed for no longer than three years or if it shows a high degree of uncertainty.[13] Deficit-increasing temporary measures are usually not taken into account. This caution reflects the fact that the aim of the analysis is to define a *prudential* structural balance to highlight potential risks for the public finances.[14]

Whether to account for deficit-increasing temporary measures and how to do it often require some arbitrary judgments. An important example is the Italian government's decision in 2006 to cancel the State Railways' debt towards the State for the creation of the high-speed rail infrastructure. According to ESA95, the entire amount written off (0.9 per cent of GDP) was treated as a capital transfer and attributed to 2006 (the year of the cancellation), although it helped to finance investment for some years.

The European Commission considered this operation a temporary measure (European Commission, 2007). This solution has the drawback of excluding from the structural balance a component of public expenditure only because it would be unreasonable to attribute it fully to 2006. Note that the high-speed rail programme is still in progress and will require additional resources to be transferred to the State Railways in the future.

In our analysis of structural developments, the impact of the debt cancellation on the budget has been spread over the years 2003-06, approximately matching the observed surge in investment in high-speed infrastructure carried out by the State Railways (an entity outside the general government). In other terms, in each year of the period 2003-05 the structural balance has been worsened by an amount equal to a quarter of the debt cancelled in 2006, as if the State had transferred resources to the State Railways for that amount. Correspondingly, in 2006 only three quarters of the cancelled debt are considered to be the effect of a temporary measure.

To identify temporary measures it is necessary to define an objective benchmark for the path of the fiscal variable in a no-policy-change context. This is fairly straightforward for revenue items, but it is often difficult for expenditure. Temporary measures are therefore most often identified on the revenue side.[15] The same asymmetric treatment is followed by the Commission and in the literature (see e.g. Koen and van den Noord, 2005).

The effects on the budget balance of events outside the control of the government are usually not counted as temporary measures. In this respect, the indicative list of temporary measures proposed by the European Commission (2006) allows only four categories of events to be taken into account: rulings of the European Court of Justice, decisions of the European Commission, emergency costs associated with major natural catastrophes, and the same with military actions. In the period covered in this study, we include in our definition of temporary measures only the exceptionally large impact on the balance of the European Court of Justice's ruling of September 2006 regarding VAT. In particular, we regard as temporary, and thus exclude from the structural balance for 2006, the entire estimate of the refunds due to

[11] A brief description can also be found in Banca d'Italia (2006).

[12] A tentative list of categories of operations that could be considered one-off or temporary measures had already been included in European Commission (2004).

[13] If a measure is extended repeatedly, it is considered "temporary" until the extension becomes a routine. At that point, the effects of that measure are attributed to non-temporary measures starting back from the year of its first introduction.

[14] In Europe, the exclusion of deficit-increasing temporary measures is justified by the fact that a government may be tempted to present a deficit-increasing permanent measure as temporary in order to improve its structural balance.

[15] Some exceptions are allowed and included in this study. In particular, we include the change in the timing of pension payments and the lengthening of severance payment lags for public employees. Temporary measures also include sales of real estate when their amount is exceptionally large. Sales of real estate are included in the budget among public investments with a negative sign.

Table 1

Estimates of temporary measures and extraordinary operations on the public debt

(as a percentage of GDP)

Year	Temporary measures		Extraordinary operations on public debt[1]
	Bank of Italy	European Commission[2]	
1997	1.4	-	0.9
1998	1.1	-	1.5
1999	0.1	-	1.4
2000	0.2[3]	-	2.2
2001	0.9	-	0.4
2002	1.7	-	2.9
2003	2.2	1.7	2.1
2004	1.9	1.3	0.7
2005	0.9	0.5	0.6
2006	-0.2[4] / -1.3	1.2	-0.4
Average	1.0 (d)	1.2	1.2

[1] Sales of financial and real assets, variations in the deposits held by the Bank of Italy and operations of debt restructuring. Figures in this column have been marginally revised in March 2008 (modifying the version of December 2007) to correct for a computational mistake. [2] Calculated as difference between the structural and the cyclically adjusted budget balance published in the 2007 Spring Forecasts. [3] Excluding sales of UMTS licences. [4] Excluding the effect of the ECJ ruling on VAT (-1.1 per cent).

taxpayers for unduly paid taxes (1.1 per cent of GDP) for the period from 2003 to September 2006, which will be paid starting in 2008. It was decided to include refunds for 2006 among temporary measures because the ruling, de facto, has no effect in the following years, as the Italian government, while incorporating it into national legislation, also modified fiscal regulations to compensate for the revenue shortfall from 2007.[16] While it is necessary to exclude from the structural balance the effects of this exceptional factor,[17] the latter was not a voluntary action on the part of government and is not included in the analysis of Section 3.

The temporary measures included in our analysis are listed in the Appendix. Table 1 contains our estimates of the total effects of temporary measures on the budget balance. Even if the European Commission guidelines are similar to ours, the estimates tend to be slightly different.

Extraordinary operations and public debt

In recent years the Banca d'Italia's official publications of have provided information on extraordinary operations affecting the public debt when their impact has been particularly large. The analyses have usually focused on sales of real and financial assets and on debt restructuring, as these operations leave the net worth of the public sector broadly unchanged but have a temporary impact on the level of the debt (Table 1). In this respect they can be considered a type of "window-dressing".

3. BUYING TIME AT THE RIGHT TIME?

Temporary measures were used extensively in 1997 (1.4 per cent of GDP) owing to the large adjustment required to join the EMU at a time of still negative cyclical conditions. A sizeable reduction in interest payments was expected in the following years, which should have made up for the phasing out of the temporary measures. However, the use of temporary measures diminished only until 2000, and became once more substantial afterwards.[18] In the whole period 1997-2006, the average impact on the net borrowing amounted to about one percentage point of GDP per year, with a peak value of 2.2 per cent in 2003.[19]

[16] The European Commission, instead, included among the temporary measures only the estimate of refunds of the undue amounts for the years 2003-2005 (0.75 per cent of GDP; European Commission, 2007). The estimate of the refunds for the unduly paid taxes in the first three quarters of 2006 (0.35 per cent of GDP) was not included in the effects of temporary measures and was therefore left in the structural budget.

[17] Currently available data suggest that refunds were considerably overestimated and it is very likely that the amount included in the 2006 deficit will be substantially reduced as soon the relevant information is complete.

[18] As mentioned earlier, UMTS receipts are not included in temporary measures but are directly excluded from the nominal balance (see footnote 3).

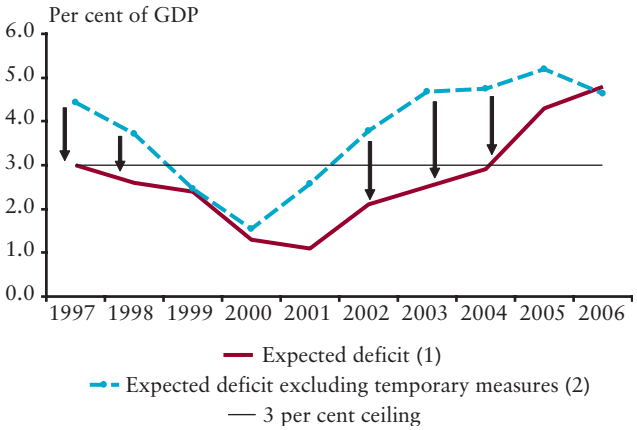
[19] The effects of the ruling of the European Court of Justice are not included in this calculation (see Section 2).

To understand the role of temporary measures in the period under scrutiny, in Figure 2 we plot the government forecast of net borrowing for the year t published in September of the same year[20] and the same estimate, net of the effects of temporary measures.[21] In a similar exercise for some EU countries, Koen and Van der Noord (2004) used the first notification in year t+1 as the real-time proxy of the deficit for year *t*.[22]

In five years out of nine the effect of temporary measures is necessary, according to the government forecasts, to bring the deficit below the 3 per cent ceiling. Moreover, in 1999 and in 2001 they may have been used to achieve this goal, given the uncertainty of fiscal forecasts. It is also worth noting that, when the expected deficit is well above the ceiling, as in 2005 and 2006, temporary measures decline.[23]

Figure 2

"Real time" expected net borrowing and temporary measures



(1) The source for the expected deficit is the Planning and Forecasting Report for various years.

(2) Temporary measures in 2001 include securitizations amounting to 0.56 per cent of GDP, which have been excluded from net borrowing in 2002 following a Eurostat decision.

Overall, these findings suggest that temporary measures have been used mainly to buy time, allowing the fiscal authorities to postpone introducing more structural measures while still complying with the fiscal rules. This, in turn, raises the question why the authorities chose to buy time. At least part of the explanation has to do with the notion, mentioned earlier, that for a given budgetary impact temporary measures have less impact on economic activity than permanent actions. Indeed, policy-makers often justified the use of temporary measures to comply with fiscal rules as a means of minimizing the negative impact in a macroeconomic context perceived to be adverse.[24]

Government statements aside, there is some evidence of temporary measures being used to avoid hampering the desired cyclical recovery.[25] Real-time estimates of the output gap indicate that the cyclical position was perceived as negative in every year of the period 1997-2006 (Figure 3). Moreover, there is a negative, although quantitatively small, correlation between the change in the size of temporary measures and the real-time estimates of the output gap, which suggests a weakly counter-cyclical use of such actions.[26]

It is probably more interesting to check whether, according to current information, the timing of this "buying-time" strategy – i.e. waiting for better economic conditions – has been broadly correct (Figure 3). Clearly, the answer to this question is "no". Temporary measures peaked in 2003, when GDP was still close to potential, and declined afterwards, when the cyclical low was reached. The correlation between the change in the impact on the budget of temporary

[20] We use real-time government estimates for net borrowing instead of the currently available estimates because the two sets of data differ considerably in some years and because the focus here is the analysis of government intentions rather than outcomes. The time of year selected (September) was based on the fact that many temporary measures were not included in the initial budgetary plans but decided in the course of the year, reflecting new information on budgetary developments.

[21] As government forecasts do not specify the expected impact of temporary measures we use our current estimates, adjusting for specific cases. For example, the figure for 2001 includes the receipts from two securitizations which were only excluded from net borrowing in 2002, following a decision by Eurostat.

[22] Koen and Van der Noord (2004) run a logit regression to show that when deficit rules tend to become more binding, recourse to gimmicks is more likely. Similar results are found in Le Borgne (2006).

[23] This evidence confirms the intuition underlying recent models of window-dressing behaviour by policy-makers facing fiscal rules (Buti et. al., 2006; Balassone et. al, 2007). In these models, part of the cost of window-dressing comes from the risk of being caught, which increases with the size of the fiscal gimmickery.

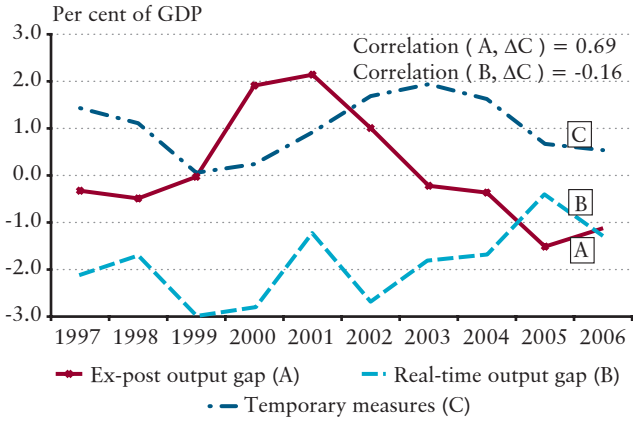
[24] The official documents of the government clearly indicate the perception of an adverse macroeconomic context in the years 2001-05 and the willingness not to hamper the cyclical recovery through permanent actions. See, for example, Relazione Previsionale e Programmatica (Economic and Financial Planning Document) for the years 2004-07 (introduction and pages 62-64). The smaller impact of temporary measures on economic activity compared with permanent actions was not only due to the transitory nature of the former but also to the fact that many involved the voluntary participation of private agents (as in the case of amnesties or sales of assets).

[25] For example, in the Stability Programme submitted at the end of 2002 the government estimated the negative output gap for the same year and for 2003 at around 2 percentage points of GDP; the years 2002-03 were indicated to be the peak of the economic downturn and the negative cyclical component of the deficit was estimated at around 1 per cent of GDP in both years. Also, for the years 2004-06 the economy was expected "to grow faster than its potential, at around 3 per cent a year, so as to close the output gap accumulated in 2001 and 2002".

[26] Real-time estimates of the output gap for each year are taken from the OECD Economic Outlook of the previous year, as in Forni and Momigliano (2004). Similar results can be obtained using other sources.

Figure 3

Temporary measures and output gap



Sources: for ex post output gap, European Commission (2007, AMECO); for real-time outpug gap, Forni and Momigliano (2004).

measures and the ex-post estimates of the output gap[27] is fairly large and positive indicating that, ex-post, their use by the fiscal authorities has been pro-cyclical.[28]

The wrong timing of the "buying-time" strategy may be largely attributed to the unexpected persistence of the downturn that began in 2001. Policy-makers, as well as virtually all forecasters (including international institutions), expected the economy to rapidly return to a favourable growth path, whereas the low rate of increase in GDP lasted for five years.

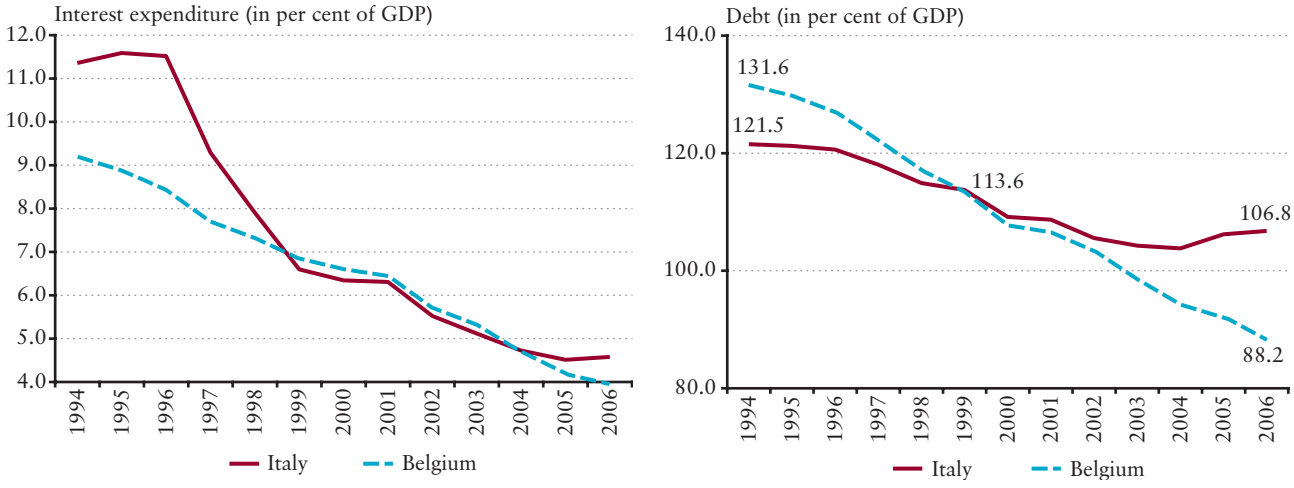
4. PRECIOUS TIME LOST?

In the period 1997-2006 public debt declined from 118.1 to 106.8 per cent of GDP. This outturn is very different from the objectives set in the government plans for the period. In particular, in the various stability programmes submitted between 1998 and 2003 the debt-to-GDP ratio was targeted to fall by more than 3 percentage points per year on average. Had this happened, the debt would already have fallen below the level of GDP in 2003.

The goal of rapidly reducing the debt was, and still is, highly justified by the expected demographic development in the next decades, which will entail a substantial increase in expenditure on pensions, health and long-term care.[29] There is a large consensus that the appropriate strategy to cope with these tendencies includes, along with structural reforms, a sizeable reduction of the debt, leading to lower interest payments.[30]

Figure 4

General government debt and interest expenditure: Italy versus Belgium



[27] Ex-post estimates of the output gap are those of the European Commission (AMECO Database, November 2007).

[28] If we include in our estimates of temporary measures the effects of the securitizations carried out in 2001 (see footnote 20), the positive correlation with the ex-post output gap becomes stronger (0.78), while the correlation with real-time data almost disappears (-0.07).

[29] According to the latest official forecasts by the State Accounting Office, the impact of demographic changes on the primary balance can be estimated at between 3 and 4 per cent of GDP by 2030 (Ragioneria Generale dello Stato, 2007). These projections do not take into account the risks associated with other factors, such as the rising cost of medical treatment, which has significantly increased health spending in recent decades throughout the industrial world, and the changes in family structure and in female employment, which could prompt greater demand for long-term care.

[30] At least since the late 80s, Italian policy-makers have been aware of the need to reduce public debt, as the following citation shows, *"We achieved the mission […] to free the Italian economy from inflation. We have now another [mission][…]; it requires the same energy, braveness[…]it is the mission to free this economy from the public debt"*, speech of the Treasury Minister G. Amato, July 15 1988, cited in Amato (1990), page 48.

In the end, the small decrease in the debt ratio suggests that time has been lost in preparing for the effects of population ageing and, in particular, in designing an equitable distribution of their expected costs across the generations.[31]

This conclusion is somehow reinforced by looking at the recent experience of another high-debt country, Belgium, which faces similar demographic challenges. Throughout the 1990s, the ratio of general government debt to GDP was higher in Belgium than in Italy until 1999, when the two values almost coincided. Both countries had substantially reduced their debt in the previous years as a result of consolidation in order to join the EMU. However, between 1999 and 2006 Belgium continued to reduce its debt rapidly, with the debt ratio falling by around 25 percentage points. Approximately the same result could have been achieved in Italy if the targeted annual reduction had been implemented; by contrast, the actual decline amounted to only 7 points (Figure 4).[32]

The different pace of debt reduction in Italy and Belgium affected the rate of increase in their interest expenditure. In 1999, interest payment in Belgium was higher than in Italy as a ratio of GDP (6.8 against 6.6). Thanks to the large debt reduction, interest expenditure in Belgium declined to 4.0 per cent of GDP in 2006, compared with 4.6 per cent in Italy. Considering the average cost of Italy's debt in 2006 (4.5 per cent), if the debt ratio had been reduced by the same amount as in Belgium, approximately 0.8 per cent of GDP in interest expenditure would have been saved in 2006 compared with the actual outturn.

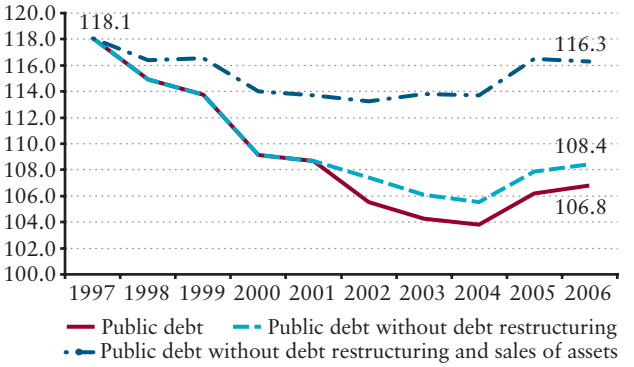
The assessment of the progress made towards sustainable public finances in Italy between 1997 and 2006 worsens if we consider the effects of some extraordinary operations concerning debt restructuring and the sale of assets. These operations have reduced the stock of public debt, leaving the net worth of the public sector largely unchanged. In other terms, they have lowered the debt at the cost of raising future flows of payments or reducing future flows of revenue.

Over the period 1998-2006, these operations determined an average impact of approximately 1 percentage point of GDP per year. Excluding the effects of such operations, the debt to GDP ratio in 2006 would have reached approximately 116 per cent, a reduction of only 2 percentage points with respect to the almost 11 points of the actual figure (Figure 5; see footnote 1 in Table 1). If the government had replaced the extraordinary operations undertaken in 1998-2002 by permanent measures, in 2003 it would have achieved its goal of bringing the debt level below GDP.

These highly simplified exercises suggest that the use of extraordinary operations may have allowed the Italian government, in the face of European pressures to reduce the debt ratio, to formally satisfy the latter while postponing any lasting adjustment.

Figure 5

The evolution of public debt without extraordinary operations*



** See footnote 1 in Table 1.*

5. CONCLUSIONS

This paper examines the effects on the Italian budget balance of temporary measures taken in the period 1997-2006, as well as the effects on the debt of a few extraordinary operations that left the net worth of the public sector broadly unchanged. After outlining the criteria followed to identify these actions, we assess the appropriateness of their use to achieve budgetary targets.

Our analysis suggests that temporary measures played a major role in reducing the deficit in most years during the period considered and helped in formally complying with EMU fiscal rules. In 1997 the use of temporary measures was essential in order to meet the convergence deficit criterion set in the Maastricht Treaty for the adoption of the Euro. Recourse to temporary measures decreased until 2000, becoming substantial again afterwards and peaking in 2003.

Policy-makers bought time at the beginning of the downturn, assuming it to be relatively short. Based on ex-post information, the timing of this strategy does not seem to have

[31] The potential generational imbalance is assessed in Cardarelli and Sartor (1999). The following citation shows the awareness of this problem among policy-makers: "The reduction of the debt needs to be the first investment of the State in favour of the young people and of the future generations". Letter of transmission of the Relazione Previsionale e programmatica for the years 2008-11 to the Parliament by Prime Minister R. Prodi and Treasury Minister T. Padoa-Schioppa, page V.

[32] The determinants of the different dynamics of the debt ratio in the two countries are examined in Artoni and Ceriani (2007).

been appropriate. Focusing on the last years, temporary measures increased sizeably in 2001 and 2002, when cyclical conditions were worsening but were still above potential, and declined in 2004 and 2005, when conditions deteriorated further (the negative peak of the cycle was reached in 2005). This pro-cyclicality can be attributed to the unexpected persistence of the downturn that started in 2001; Italian policy-makers, as well as virtually all forecasters, expected a rapid recovery, whereas the low growth lasted for five years.

Our analysis also suggests that the use of extraordinary operations and temporary measures has been short-sighted. There is a broad consensus that the appropriate strategy to cope with the upcoming demographic pressures requires a structural increase in the primary surplus and a drastic decline in the debt-to-GDP ratio. By contrast, extraordinary operations have allowed more permanent actions to be delayed while formally complying with the European fiscal rules.

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APPENDIX

Table 2

Effects of the main temporary measures*

(as a percentage of GDP)

1997	Surcharge on personal income tax	0.24
1997	Tax and social security amnesty	0.04
1997	Shortening of payment lags for oil, methane and electricity taxes	0.15
1997	Lengthening of severance payment lags for public employees	0.15
1997	Advances on indirect tax revenue collection	0.14
1997	Bringing forward of taxation on severance payments	0.32
1997	Taxes paid by the Bank of Italy on extraordinary operations and by UIC on capital gain on the sale of its gold reserves	0.31
1997	Others	0.08
	Total	**1.43**
1998	Increase in the withholding tax for self-employed	0.09
1998	Taxes and social security amnesty and withholding tax on the re-evaluation of corporate fixed assets	0.09
1998	Bringing forward of taxation on severance payments	0.21
1998	Change in the timing of pension payments[1]	0.31
1998	Swaps and forward rate agreement operations 0.28	
1998	Partial reimbursement fund of the surcharge on personal income tax	-0.07
1998	Advances on indirect tax revenue collection	0.21
	Total	**1.11**
1999	Withholding tax on capital gains from transfers of enterprises	0.09
1999	Swaps and forward rate agreement operations	0.04
1999	Partial reimbursement fund of the surcharge on personal income tax	-0.09
1999	Tax amnesty	0.01
	Total	**0.06**
2000	Securitization and sales of public real estate assets	0.09
2000	Withholding tax on capital gains from transfers of enterprises	0.12
2000	Tax amnesty	0.01
2000	Swaps and forward rate agreement operations	0.03
	Total	**0.24**
2001	Securitization and sales of public real estate assets	0.16
2001	Withholding tax on capital gains from transfers of enterprises	0.33
2001	Withholding tax on the revaluation of corporate fixed assets	0.40
2001	Tax amnesty	0.01
2001	Swaps and forward rate agreement operations	0.02
	Total	**0.92**
2002	Securitization and sales of public real estate assets	0.85
2002	Withholding tax on capital gains from transfers of enterprises	0.19
2002	Withholding tax on the revaluation of corporate fixed assets	0.16
2002	Withholding tax on the revaluation of corporation equities and land properties held by individuals	0.10
2002	Scheme for the repatriation and regularization of assets held abroad	0.11
2002	Tax amnesty	0.06
2002	Increase in the payment on advance due by tax collectors	0.12
2002	Repayment by banks of reliefs obtained under Law 461 of 23 December 1998	-0.05
2002	Swaps and forward rate agreement operations	0.15
	Total	**1.69**
2003	Securitization and sales of public real estate assets	0.21
2003	Withholding tax on capital gains from transfers of enterprises	0.18
2003	Withholding tax on the revaluation of corporate fixed assets	0.14
2003	Withholding tax on the revaluation of corporation equities and land properties held by individuals	0.05
2003	Scheme for the repatriation and regularization of assets held abroad	0.05
2003	Increase in the payment on advance due by tax collectors	0.01
2003	Repayment by banks of reliefs obtained under Law 461 of 23 December 1998	-0.02
2003	Swaps and forward rate agreement operations	0.05
2003	Tax amnesty	1.27
2003	Cancellation of the State's claims on TAV spa	0.24
	Total	**2.18**

Table 2

Effects of the main temporary measures* (cont'd)

(as a percentage of GDP)

2004	Securitization and sales of public real estate assets	0.32
2004	Withholding tax on capital gains from transfers of enterprises	0.22
2004	Withholding tax on the revaluation of corporate fixed assets	0.28
2004	Withholding tax on the revaluation of corporation equities and land properties held by individuals	0.08
2004	Swaps and forward rate agreement operations	0.09
2004	Tax amnesty and regularization of building offences	0.55
2004	Cancellation of the State's claims on TAV spa	0.23
2004	Tax advances on insurance company	0.05
2004	Others	0.04
	Total	**1.86**
2005	Securitization and sales of public real estate assets	0.22
2005	Withholding tax on the revaluation of corporate fixed assets	0.08
2005	Withholding tax on the revaluation of corporation equities and land properties held by individuals	0.05
2005	Swaps and forward rate agreement operations	0.17
2005	Regularization of building offences	0.09
2005	Cancellation of the State's claims on TAV spa	0.23
2005	Sectoral studies	0.07
2005	Tax advances on insurance company	-0.05
2005	Others	0.04
	Total	**0.90**
2006	VAT reimboursement consequent to ECJ sentence (September 2006)	-1.08
2006	Cancellation of the State's claims on TAV spa	-0.65
2006	Securitization of agricoltural credits	-0.05
2006	Securitization and sales of public real estate assets	0.09
2006	Withholding tax on the revaluation of corporate fixed assets	0.29
2006	Withholding tax on the revaluation of corporate equities and land properties held by individuals	0.08
2006	Withholding tax on the revaluation of building sites owned by corporations not yet built	0.02
2006	Swaps and forward rate agreement operations	0.04
2006	Regularization of building offences	0.01
	Total	**-1.25**

** A positive sign is assigned to deficit-reducing measures.*

[1] Net effect of a lower pension expenditure and a lower revenue from withholding taxes on pension income.

Laurent Paul–Christophe Schalck:[1] Transfers to the government of public corporation pension liabilities: The French case study

Lump sum payments in compensation for the transfer to the Government of pension liabilities are one of the main categories of one-off budgetary measures that have developed in Europe over the recent years. These operations have been the most frequent in France, because of the various special employer schemes existing in the public sector. As pension systems and accounting standards are being reformed and former public companies are being privatized, adjustments seemed necessary. The paper studies the treatment of such measures in national accounts and reviews the different transactions implemented in France since 1997 and the various impacts on public finances. It assesses the risk of budgetary losses for the French government due to unexpected developments in the different parameters used for the calculation of the lump sums. Stress tests show that these risks are very limited, especially with the perspective of an increase in the contribution period that will apply to all pension schemes. Moreover, these operations were a prerequisite for a reform of the French public sector, enabling the deregulation of markets and increasing potential output in the medium term.

JEL classification: H60, M48
Keywords: pension liabilities, lump sum payment, fiscal sustainability, France.

1. INTRODUCTION

European countries' recourse to one-off measures has grown substantially in recent years (Besnard and Paul, 2004; Koen and von den Noord, 2005). One main category is lump sum payments received by the general government in compensation for the transfer of pension liabilities from a public company. Such transactions have been implemented in many countries (Belgium, Portugal, Austria, Greece, see Appendix A). But extensive recourse to lump sums was most prominent in France, due to the existence of a large public sector with many companies having developed special pension schemes for their employees. At the end of the 1990s, the French government started to reform these special schemes with different objectives in mind: adapting to IAS standards which require companies to make provisions for their pension liabilities, preparing for privatization in the context of the liberalization of European markets and securing the financial viability of these special schemes through an alignment or an integration with the pension schemes for civil servants and employees of the private sector.

The reform of special schemes generally took the form of a transfer of their pension liabilities by the public company to the State or Social security. The transaction brought revenue windfalls to public finances through the lump-sum paid in exchange to public administrations. The transfer of pension liabilities generates future expenditure in compensation for the income flow immediately recorded; therefore, the long-term net result for the general government sector may turn out to be nil. But even if the transaction is financially balanced on an intertemporal basis, it gives room for the government to improve transitorily its fiscal balance at crucial periods. It is not fortuitous that the two main transactions (France Telecom in 1997 and Electricité de France (EDF) and Gaz de France (GDF) in 2005) took place during years when the public deficit was in danger of exceeding the 3% of GDP reference value. In 1997, this helped France to qualify for EMU entry and, in 2005, it was crucial for putting an end to the excessive deficit in accordance with the recommendation made by the European Council. This is the reason why the European Commission considers these transactions as one-off measures in the sense that they have a temporary influence on the fiscal position and they are non-recurrent (EC, 2006a).

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The transfer of public corporation pension liabilities refers to a controversial treatment of transactions involving changes in the fiscal balance and possibly in government net worth. However, the lack of reliable statistical data concerning implicit liabilities of public government makes it difficult to assess the impact of this kind of transfer on the long-term sustainability of public finances. The paper studies French transactions in order to highlight related risks to public finances.

The paper is organized as follows: Section 2 presents the treatment in national accounts; Section 3 briefly reviews the main characteristics of the different transactions implemented in France; Section 4 describes the various impacts on public finances both immediate and in the long term; Section 5 assesses the financial risks associated with these operations using stress tests on the case of the EDF-GDF; and the final section presents the conclusions.

2. WHICH TREATMENT IN NATIONAL ACCOUNTS

The ESA 95 methodology[2] for lump sum payments to the government in the context of the transfer of pension liabilities gave rise to extensive debates within the Committee on Monetary, Financial and Balance of Payment Statistics (CMFB), which advises the European commission and its statistical body, Eurostat, on statistical issues. A first discussion took place in 1997 with the France Telecom transaction. As a result, the classification of the lump sum as a transfer of cash was validated by Eurostat, but no official decision was related. The issue resurfaced in 2003 with the Belgacom transaction. After difficult debates, Eurostat confirmed the methodology set up in 1997 and released two official decisions (120/2003 of 21 October 2003 and 26/2004 of 25 February 2004) clarifying the treatment in national accounts.

Corporations may set up specific pension schemes for their own staff which they manage directly. Different categories can exist and differently affect the intergenerational sharing of risks:

- A defined benefit or defined-contribution funded scheme: the employer builds up a segregated reserve for the purpose of paying pensions to its employees. This scheme allows for an optimal sharing of market and inflation risk between generations.
- An unfunded scheme: employers only make the commitment to ensure the payment of a defined level of pension benefits. This scheme aims at systematic redistribution between generations in accordance with the relative social preference weight.

When pension liabilities are transferred to the government, the company must pay a "lump sum", which is assumed to cover the future burden of pensions. This amount should represent either the present value of the promised pension benefits for a defined-benefit unfunded or funded scheme or the market value of the corresponding assets invested on markets for a defined-contribution funded scheme. When the pension scheme was originally funded, the result of the transaction is a transformation into an unfunded scheme. This methodology applies whether the company is publicly or privately owned.

Whatever the category of the scheme, the classification in national accounts is the same. The transfer of cash is classified as capital transfer (codified D99 in ESA 95) and the implicit liabilities taken over by government are not recorded. The reason why only one leg of the transaction is recorded (the transfer of cash and not the transfer of liability) is first that ESA 95 does not record contingent assets or liabilities regardless of what sector is involved. It also stems from the fact that, on an economic basis, the real net worth of both agents has not changed because the immediate improvement in the government balance is deemed to be offset in the future by an increase in pension expenditure. Conversely, the decrease in assets held by the corporation is compensated by the decrease in its liabilities vis-à-vis future retired employees. Therefore, the transfer of pension liabilities is assumed to be broadly neutral over time. Moreover, the capital transfer is recorded at the time pension obligations are effectively transferred. When Eurostat examined the EDF-GDF operation of 2005, it confirmed this treatment although a large part of the lump sum was paid after the transfer.

The only case where a possibility of reclassification exists today is when the amount of the lump sum is obviously overvalued compared to the pension liabilities transferred i.e. the amount in excess should be recorded as a financial transaction. The Belgian statistical authorities proceeded this way with the lump sum paid by the SNCB in 2005. The decisions at the CMFB, in 1997 and 2003 as well, were adopted by a small majority and the current methodology

[2] ESA 95 is the European System of National and Regional Accounts since 1995. It achieved the harmonization of methodology, the precision and accuracy of the concepts, definitions, classifications and accounting rules which have to be applied in order to arrive at a consistent, reliable and comparable quantitative description of the economies of the Member States.

continues to be strongly criticized. Many statisticians, including those at Eurostat and the ECB, consider that on a pure accrual basis the lump sum should not affect the net borrowing / net lending of the government. Balancing the transaction should imply to record pension liabilities for unfunded employer schemes,[3] a solution adopted in some Anglo-Saxon countries such as Australia and Canada. But this would have important consequences for many European governments with unfunded schemes for their civil servants[4] and it seems unlikely that the issue will be raised in the near future.

3. TRANSACTIONS IMPLEMENTED IN FRANCE DURING THE RECENT PERIOD

The French pension system is a typical Bismarckian one with pay as you go schemes for the two first pillars.[5] It is also very fragmented. In the private sector (around 70% of pension expenditure), employees are covered by a two-tier scheme. By contrast, civil servants and employees of public companies have their own single tier scheme. In 1993 and 2003, there were major reforms of pension systems that concerned the private sector and civil servant regimes, but not the special regimes still in force in the public sector companies. Instead of implementing a global reform which would face strong resistance from the trade unions,[6] the government preferred to treat the issue of special schemes on a "case-by-case" basis with a general objective to bring them closer to – or even merging them with – the two common regimes. In that context, over the last ten years, five major transactions involving a transfer of pension liabilities to the government were implemented (France telecom 1997; EDF-GDF 2005; RATP and La Poste 2006; SNCF 2007). Basically we can split them into two categories.

Integration in the civil servant scheme

France Telecom and La Poste (the French postal company) did not originally have any special pension regime schemes, but were employing civil servants affiliated to the State civil servant pension scheme. Indeed, before shifting to a corporation status, these two entities were considered as public administrations exclusively employing civil servants benefiting from the same pension entitlements as in the other administrations. Therefore, they had to bear the same financial obligations as the State for their employees: they were supposed to guarantee on a yearly basis the equilibrium between the pensions paid and the contributions received from their staff. Thus, because of the numerous advantages granted by the civil servant pension scheme compared to the general regime, the effective level of their employer contributions was much higher than for a private company, which was penalizing for competing in newly liberalized telecom and postal markets. Furthermore, the move to IAS standards and the perspective of privatization would have compelled France Telecom and La Poste to make provisions in their balance sheet for all the pension liabilities accumulated by their employees.

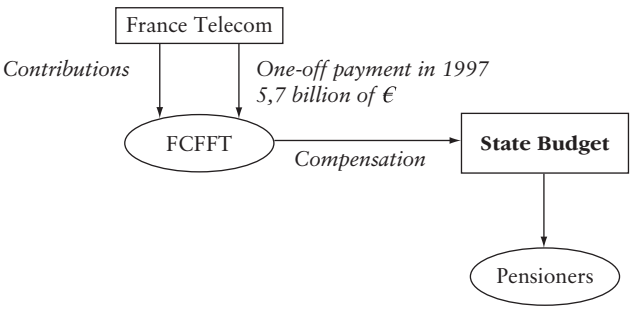
Regarding France Telecom, the total amount of these liabilities was estimated at 24 billion € at the end of 1996, concerning both civil servants still working in the company (150,000) and pensioners (70,000). In order to avoid a financial strain that would have damaged the solvency of the company, the Government accepted to take over all these pension rights. In return, France Telecom paid a lump sum of 5.7 billion € (0.5% of GDP in 1997) to a public body specially created for this purpose and classified in the General government sector: the "Fonds de compensation des retraites des fonctionnaires de France Telecom" (FCFFT). Every year the FCFFT refunds the State Budget for the burdens stemming from France Telecom former civil servant pensions, using the following resources (see Fig. 1.):

- for pension rights accumulated up to 31 December 1996, the lump-sum-payment plus interests earned on it;
- for pension rights accumulated as from 1 January 1997, standard contributions paid by France Telecom and the civil servants still working in the company.

The FCFFT will be liquidated as soon as all the pension rights transferred have expired (since 1997 the company no longer

Figure 1

France Telecom transaction



[3] An alternative proposal (Lequiller, 2004) is to record all pension liabilities of both funded and unfunded schemes in a satellite account below the line of net lending / borrowing. If the current treatment would not change, it would improve the information and make international comparisons easier.

[4] According to the State balance sheet for 2006, total pension liabilities of civil servants have been estimated at 941 billion €, i.e. 53% of annual GDP in France.

[5] The third pillar is not much developed in France which can be explained by the generosity of compulsory schemes.

[6] An attempt to reform all special schemes in 1995 collapsed because of severe strikes on the railways.

recruits civil servants). Besides, France Telecom is now liable for the same level of employer contributions for its staff as other companies.

A similar transaction took place in 2006 with La Poste which still employs 200,000 civil servants, but is now facing the same evolution as France Telecom in 1997. But an important difference with France Telecom is the obvious insufficiency of the lump sum paid by the postal company (2 billion €) compared to the amount of pension liabilities transferred (70 billion € at the end of 2006). This low amount is explained by the weak financial position of the company. Thus, the balance of the transaction is guaranteed by 1) additional contributions by the postal company which will be paid until 2010, the scheduled year of the complete liberalization of the postal services; and 2) the annual contribution by the State Budget the amount of which should progressively increase, from 0.5 billion € in 2006 to 2 billion € in 2020.

Preservation of a special scheme included in the public administration sector

Originally, there was a special pension scheme directly managed by the company for its employees. Related pension liabilities are transferred to the Social security but through the creation of an ad-hoc entity which guarantees the preservation of the financial advantages of the special pension scheme compared to the normal regime.

The main example is EDF-GDF. Since 1945, the two public companies had developed a joint pension regime covering all their employees with very attractive conditions. The financial burden of the regime became unsustainable when the electricity and gas markets started being liberalized and also because of the very unfavourable evolution of the demographic ratio (there were 143,000 contributors against 149,000 pensioners in 2004). Since they had given an irrevocable guarantee for the payment of pensions to their employees, the two companies were forced to increase continuously their contributions in order to safeguard the financial soundness of the special regime.

Pursuant to the law of 9 August 2004, EDF and GDF were transformed into private companies with the perspective of a rapid opening of their capital. In the meantime, from 1 January 2005 it transferred the special retirement regime to a new entity recorded as a social security administration within the General Government. This new entity will benefit from the following resources:

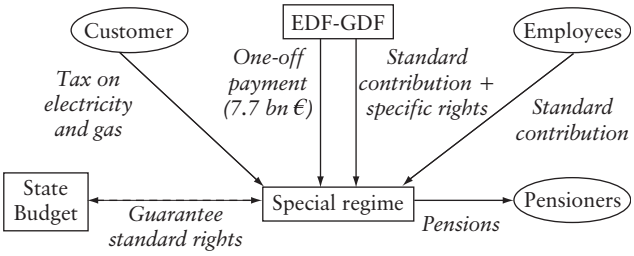
- to finance the pension rights accumulated up to 31 December 2004 the amount of which was estimated at 90 billion €: 1) Half of the burden will be borne by a lump sum of 7.7 billion € paid by EDF and GDF, of which 40% will be paid immediately and the remainder by annual payments up to 2020; 2) The rest will be financed by a tax on the transport and distribution of electricity and gas introduced on 1 January 2005 and paid by all consumers located in France;

- to finance the pension rights accumulated from 1 January 2005: standard contributions paid by EDF and GDF and their employees.

Unlike France Telecom, EDF and GDF are not entirely released from the burden of a special pension scheme. Indeed, the transfer of pension liabilities only concerns the "standard" pension rights defined as those which are allocated to the General social security regime (see Fig. 2.), and the two companies will continue to bear the burden of the additional advantages granted to their employees. The reason why a complete transfer has not been achieved is the huge cost, which would have compelled EDF and GDF to pay a much higher lump sum. Furthermore, all employees recruited after 1 January 2005 will continue to be affiliated to the special regime, which means it has no life limit. Therefore, the two companies are encouraged to restrain their recruitment in order to avoid an unsustainable accumulation of new liabilities to provision in their balance sheets.

Figure 2

EDF-GDF transaction



A similar scheme was applied to the Parisian Public Transportation Company (RATP). Due to its poor financial situation, RATP was unable to support by itself the full cost of the reform of its pension regime. Consequently, the government chose to assist the company in the transfer of pension liabilities to the Social security. Thus, the operation was neutral for the general government balance, the lump sum paid to the social security administrations being offset by a subsidy from the State budget. However there was an impact on the long-term sustainability of public liabilities with the increase of implicit liabilities (20 billion € of pension rights were transferred).

Finally, the French railway company (SNCF) reformed its special pension scheme since it had to transition to IAS accounting before the end of 2007. The French railways are heavily subsidized by the State budget (6 billion € paid in 2006 including 2.5 billion € allocated to the special pension regime). The total pension liabilities were worth 97 billion € at the end of 2006, which would have implied a very large lump sum estimated at 23 billion € by the Parliament (Carrez, 2005). But neither the company nor the State Budget was financially able to pay such an amount. Therefore, the government decided a simple transfer of the special pension scheme to the public administration sector. No lump sum has been paid and SNCF together with the State Budget continue to bear the burden of the regime. Moreover, implicit pension liabilities borne by general government increased by 97 billion €.

4. BUDGETARY IMPACTS RELATED TO THE TRANSFER OF PENSION LIABILITIES

A transfer of pension liabilities enters in the category of one-off budgetary measures producing reverse effects in the long term. It means one must consider not only the immediate flows impacting the government net lending/borrowing, but also the future flows which can only be estimated. In addition, one also has to take into account the "side effects" related to these operations which can generate other impacts on public finances.

Immediate impacts

Three kinds of impacts can be identified (see Table 1):

- The most apparent is the lump sum which directly improves the government's net lending/borrowing. When a part of the payment is made after the transfer (e.g. EDF-GDF), it creates a discrepancy between the actual deficit and the cash deficit which is reflected by the increase in deficit-debt adjustment (DDA). In such a case, DDA can be a useful indicator for assessing the effective impact of one-off measures (Balassone et al., 2007).

- A parallel increase in the public revenue and public expenditure to GDP ratio is also recorded with a transfer of the special pension scheme to the government sector. As public entities replace the public company for the payment of pensions and the collection of contributions, the tax burden can be increased significantly: around 0.1% of GDP each for the EDF-GDF, France Telecom and La Poste transactions. Overall, transfers of pension liabilities implemented since 1997 have supposedly increased the French tax burden by 0.3% of GDP.[7]

- Other flows indirectly linked to the transaction: this can include a change in State budget contributions and/or a change in employer contributions (e.g. La Poste), in order to balance the total value of liabilities which are transferred.

Long-term flows

The counterpart of the lump sum received is future expenditure generated by the transfer of pension liabilities. As this expenditure is spread over a long period as long as contributors turn into pensioners, they must be measured for their actuarial value. A simple way to assess the burden should be to consider the value of implicit liabilities transferred and to compare it to the total amount of implicit liabilities borne by General Government. However, official information is very fragmented. According to the Carrez report (2005), the pension liabilities borne by EDF-GDF, RATP, La Poste and SNCF amounted to 280 billion €, not

Table 1

Transfers to the French government

Company	Year of the transfer	Liabilities (€ Bn)	Capital transfer	
			€ Bn	% of GDP
France Telecom	1997	24	5.7	0.5
EDF-GDF	2005	90	8.5	0.5
RATP	2006	20	-	-
La Poste	2006	70	2.0	0.1
SNCF	2007	97	-	-

Note: Not all of transfers gave rise to a lump sum because some public companies were financially unable to pay.

Source: French Ministry of Economy and Finance.

[7] The SNCF operation should produce a similar effect in 2007.

including the 24 billion € in France telecom liabilities transferred in 1997. This would represent less than 10% of the total amount of pension liabilities of all compulsory schemes existing in France, which were estimated by the OECD at 3,300 billion € in 2002, i.e. 216% of GDP.

A complementary approach is to look at the flows of additional public expenditure currently recorded for the transactions conducted in the past years. In respect of France Telecom, the annual compensation paid by the FCFFT to the State Budget for pension rights accumulated prior to 1997 should reach 330 million € in 2005. Moreover, additional expenditure borne by the Social security in compensation for the EDF-GDF lump sum amounted to 321 million € in 2005. Thus, the increasing impact on the General government deficit (less than 0.05% of GDP) has been marginal so far.

However, the effects of immediate and long-term flows are not equivalent for public finances. The impact of the lump sum is certain whereas the impact of future expenditure is difficult to assess, as it is not recorded by the fiscal indicators usually monitored within the framework of multilateral surveillance.

5. HOW TO ASSESS THE FINANCIAL RISK OF SUCH TRANSACTIONS?

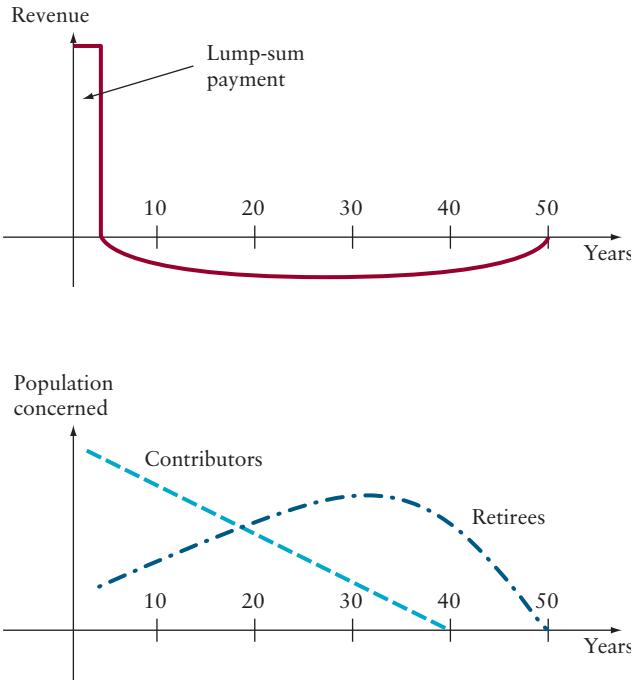
If some transactions are clearly unfavourable to public finances, because of the absence of a lump sum (SNCF, RATP) or an under-valuation of it (La Poste), the two main ones (France Telecom and EDF-GDF) are presumed to be financially neutral.

In order to check whether the supposed amount paid by the company in the form of the lump sum is sufficient to cover the pension liabilities transferred, it is necessary to look at the expenditure flows projected in the future. Their evolution over time will depend on the demographic pattern of the population concerned, defined at the moment the transaction is concluded, and which comprises both contributors and pensioners. Expenditure will increase as long as contributors turn into pensioners, the peak being reached when the flow of new retirees become lower than the death flow. Then, a regular decrease will be recorded until the natural extinction of the whole population (see Figure 3).

Only when the population concerned will be totally extinguished, which means in more than 50 years, will it be possible to know exactly the balance between the one-off payment and the discounted value of pension liabilities. For the time being, one can only assess the accuracy of the different parameters taken into account for the calculation:

Figure 3

Dynamic of transfers



- Demographic parameters set the average duration of pension payments with unchanged regulation. An unexpected lengthening of the average lifespan of the population concerned would entail an additional burden for the General Government.

- Financial parameters aim at taking into account the expected revaluation of pensions during the projection period. In the EDF-GDF transaction, it has been estimated at 2% per annum on the basis of an average inflation of 2%. Moreover, a discount rate of 2.5% per year has been applied for the 60% which will be gradually paid until 2020.

- Legal parameters: the amount of the one-off payment is based on the regulation in force at the time of the pension rights transfer. For all future developments, the rule is the following: this is the entity at the origin of the regulatory measure that will have to support its financial costs. Thus, if the State enforces for all pension systems a lengthening of the contribution time necessary to obtain a full pension, such a measure will reduce the value of implicit liabilities but there will be no reimbursement to the company for the difference. Conversely, if the company decides to grant additional benefits to its former employees, it will have to pay for them.

Available information suggests that the lump sums paid by France Telecom and EDF-GDF were fairly calculated, taking

into account the current conditions at the time when the transactions were concluded. The risks borne by the government lie in unexpected developments in the different parameters which would imply higher expenditure flows than projected: for example, an inflation surge that would imply revaluating individual pensions more than initially projected. Indeed, the financial terms used for the calculation of the lump sum are irrevocable and the government has no legal possibility to claim additional compensation if the balance of the operation proves unfavourable.

In order to asses these risks, we use numerical simulations on the EDF-GDF case taking into account the methodology implemented for the calculation of the lump sum as described by Glenat and Tourne (2006).[8] The amount of the lump sum results from equivalence between the pensions/contributions ratios of the general scheme and the special scheme in such a way that it will cover the entire additional burden borne by the general scheme due to the transfer of liabilities. Thus, one must compare the projected financial situation of the host regime with and without the transfer on the whole period where additional costs would be transferred. This benchmark scenario is built on the basis available information: age pyramids of contributors and retirees are derived from the EDF Annual Report 2005; the average lifespan in 2005 for different ages (at birth, at 20 and at 60) is issued by the French Statistical Office (INSEE); the statutory retirement age is assumed to be 60 years; and wages and pensions are assumed to follow the inflation rate (2%). Then, this scenario is compared to three alternate scenarios in which a parameter is modified, and a fourth scenario in which the three main parameters are modified.

- Scenario 1: the demographic parameter is changed. We follow the European Commission assumption that life expectancy at birth gradually increases by around 1.5 year by 2050 (EC, 2006b).

- Scenario 2: the financial parameter is modified. We assume a permanent price shock which increases the inflation rate to 3% over the whole period instead of 2%.

- Scenario 3: the legal parameter is changed. The statutory retirement age is gradually postponed from 60 years today to 65 years. We assume a transition period of 5 years as from today: the statutory retirement is postponed every year by one year.

- Scenario 4: the demographic, financial and legal parameters are modified as in scenarios 1, 2 and 3.

Results are synthesized in Table 2. They show the impacts on the volume of implicit liabilities and on the lump sum necessary to ensure financial neutrality of the transfer of pension rights. Results show that the impact of each scenario is heterogeneous. An inflationary shock and a higher life expectancy increase implicit liabilities and lump sum payment, but the potential losses for the government are small (respectively 2% and 6%). Conversely, an increase in the contribution time produces a strong reduction in the fiscal burden. Such a reform is very likely in the coming years as the government intends to postpone the normal statutory retirement age up to 65 years in all pension regimes through an increase of the contribution time needed for obtaining a full pension. This issue confirms conclusions of Werding (2006). He showed that the series of reforms on the German statutory pension scheme, in particular on the legal framework, have substantially reduced implicit liabilities. The fourth scenario shows that, even if the inflationary shock and higher lifespan increase pension liabilities, a postponement of the statutory retirement age for obtaining full pension allows a significant reduction of risk for public finances.

6. CONCLUSIONS

Transfers of pension liabilities from public corporations affect public finances in an asymmetric way, as there is a mismatch between the immediate receipt represented by the lump sum and future expenses which are not recorded. There is a large degree of uncertainty concerning the financial balance of the operation on an intertemporal basis. This is due to the multiplicity of parameters to be taken into account and also to the relative lack of transparency surrounding

Table 2

Transfers to the French government

	Benchmark	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Implicit liabilities	44.68	47.31	45.54	36.44	39.70
Lump sum payment	7.70	8.01	7.85	6.21	6.63
Δ Lump sum payment		+0.31	+0.15	-1.49	-1.07

Source: estimates by the authors.

[8] The methodology is detailed in Appendix B.

these transactions. However, if in theory the impact of such transactions could imply significant financial risks, in practice they seem rather limited due to the fact that the government can always modify the legal framework to prevent an unsustainable evolution of the burden of pensions.

In addition, it must be kept in mind that such operations can be part of a strategy of structural reforms. Indeed, to release France Telecom and EDF-GDF from the burden of their pension liabilities was an obligatory prerequisite for the opening-up of capital of these public companies and the deregulation of telecom and electricity and gas domestic markets. Regarding France Telecom, the State has succeeded in selling 70% of the capital of the company since 1997, raising close to 17 billion € in proceeds. Regarding GDF, the opening up of capital occurred in July 2005: 20% was sold for a net proceed of 2.5 billion €.[8] As these proceeds have been mainly allocated to the reduction of public debt and to the recapitalization of other public companies, they thus reduced current budgetary constraints. Such examples suggest that government must consider the following trade-off for public finances: in order to carry out the opening-up of capital successfully, public companies should present a sound financial position whereas a lump sum payment could be detrimental to the financial value of the company.

In conclusion, this kind of one-off budgetary measure undoubtedly contributed to a better functioning of the economy and this must be taken into account when assessing the pros and cons of such transactions.

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[8] EDF was also partly privatized in 2005, but through an increase of its capital which means no receipt was collected by the government.

APPENDIX A: LUMP SUM PAYMENTS IN EUROPE

Table A1

Lump sum payments in compensation for a transfer of pension liabilities in the EU countries

Year	Country	Public company	Lump sum (% of GDP)
1994	Sweden	Telecom postal companies	0.2
1995	Denmark	Danish Telekom	0.1
1997	France	France Telecom	0.5
	Austria	Postparkasse	0.1
	Portugal	Banco Ultramarino	0.3
2003	Portugal	Postal Services	0.9
	Belgium	Belgacom	1.9
2005	France	EDF-GDF	0.5
2006	France	La Poste	0.1
	Greece	Public corporations	0.5

Source: Koen and Van den Noord (2005).

APPENDIX B: METHODOLOGY OF THE LUMP SUM PAYMENT CALCULATION

The General scheme pension (P) is calculated from the average annual wage (AAW) and contribution time in the special scheme (d) and in the general scheme (D). The pension is written as follows:

$$P = 0.5 * AAW * (d / D)$$

The lump sum should neutralize the effect of the hosting by the General scheme. It is the actual value of necessary compensations to maintain the burden ratio constant. The burden ratio is equal to the pension/contribution ratio for a given scheme. Estimating the lump sum payment implies the calculation of a reference coefficient (RC) which corresponds to the discrepancy between the burden ratio in the general scheme and the one in the special scheme:

$$RC = \left(\frac{\sum_t GSP(t)}{\sum_t GSC(t)} \right) \Bigg/ \left(\frac{\sum_t SSP(t)}{\sum_t SSC(t)} \right)$$

where GSP and GSC are respectively pensions and contributions in the general scheme, SSP and SSC are respectively pensions and contributions in the special scheme.

This reference coefficient allows estimating a reference pension (RP). It corresponds to the maximum pension which is paid without damaging the general scheme. It is calculated by multiplying pension of the special scheme by the reference coefficient:

$$RP = RC * SSP(t)$$

With a discount rate (i) the lump sum payment is as follows:

$$lump \quad sum = \frac{\sum_t \left(SSP(t) - RP(t) \right)}{(1+i)^t}$$

Dr. Jürgen Hamker: Temporary measures and off-budget activities – developments in Germany[1]

Over the first years of this century, Germany's public finances developed very unfavourably. Significant pressures to reduce the overall budget deficit emerged. However, not least given the budgetary autonomy of the individual federal states and their influence on federal legislation, for several years central government failed to bring the German deficit ratio back below the Maastricht threshold by means of consolidation measures. Recourse to temporary measures remained limited, while Eurostat was reluc-tant to accept deficit-decreasing entries in the national accounts. With regard to national fiscal rules, asset sales and securitisations were used to avoid too obvious conflicts. Following the significant decrease in budget deficits experienced since the end of 2005, current European and national fiscal rules are now respected without circumventions. However, a planned tightening of national borrowing limits as well as the European aim to have a structurally balanced budgetary position might lead to a search for new sidestepping measures. Public-private partnerships – despite possible cost advantages – seem to be a part of such efforts. At the local government level, outsourcing seems to distort budgetary data, but the net effect on deficits should be negligible.

JEL-codes: H62, H72, H74
Keywords: borrowing limits, deficit, public private partnerships, temporary measures.

1. INTRODUCTION

The German constitution stresses the importance of legislation below central government level. A substantial proportion of federal laws – especially those affecting revenues from joint central (Bund) and state (Länder) government taxes – requires the approval of the second legislative chamber, the Bundesrat, where state governments are represented. In addition, budgetary autonomy is also assigned to the individual federal states. They are also responsible for their borrowing rules and for the finances of the local governments (Gemeinden) within their jurisdiction. As a large number of tasks must be fulfilled by state governments and local authorities, the sum of their budgets clearly exceeds central government expenditure. With regard to capital formation, local authorities contribute about 60% to general government expenditure, while the remainder is accounted for in almost equal parts by state and central government. However, since the late 1960s, regular borrowing limits as laid down in the federal and state constitutions refer to the sum of investment expenditure in budgetary terms. Therefore, not only capital formation but also acquisitions of financial assets and investment grants to other parts of general government or enterprises may be used to justify borrowing. Asset sales and depreciation allowances are not taken into account. Consequently, deficit financing is not restricted to the net increase in government assets but may also be chosen for replacements and subsidies for the private sector. At the local government level, however, stricter rules apply. In most federal states, long-term borrowing may only be used by local authorities to finance investment expenditure if the respective municipality can prove its ability to bear additional debt burdens. As regular redemptions have to be financed from current revenue, such borrowing is restricted in principle to net investments.

In general, borrowing limits in Germany do not seem to be very demanding for central and state government budgets. While the largest parts of the deficits throughout the last decades were incurred at the central level, state governments also significantly contrib-uted to the Maastricht deficit. The maximum level reached almost 1 ½% of GDP in 2003. On the other hand, local governments recorded limited borrowing requirements of less than ½% of GDP.

2. CONTINUED BREACHES OF THE MAASTRICHT DEFICIT LIMIT AND TEMPORARY MEASURES

Between 2002 and 2004, Germany had exceeded the 3% deficit limit set by the Maastricht treaty three times in a row – thus not following the initial Ecofin-Council instruction to

[1] The views expressed are those of the author. They do not necessarily reflect those of the Bundesbank.

eliminate the excessive deficit in 2004 at the latest. Despite being the main contributor to the high deficit level, the central government faced severe problems in bringing the German figures in line with European rules. On the expenditure side, the most important items, accounting for 2/3 of total central government expenditure, are grants for the statutory old-age pension scheme, interest payments, costs arising from long-term unemployment and defence. Treaties and constitutional commitments leave only moderate room for expenditure cuts in these areas. With regard to staff levels, the budgets contained reductions of about 1 ½% per year. However, given the relatively low share of compensation of employees in the federal budget (7%), the effects remained limited. Planned revenue-increasing measures affecting joint taxes, which yield about three quarters of German tax receipts, were not given the necessary approval by the Bundesrat, which was dominated by governments led by the big opposition party in the Bundestag (the Christian Democrats). Reaching agreements with the second chamber often involved additional burdens being placed on the central government budget. For example, in order to gain approval for the labour market reform in 2005, the central government had to promise to safeguard relief of € 2.5 bn per year for local authorities, which was ultimately taken from the federal budget. Such approval was not needed in order to raise consumption taxes as revenues accrue only to the central government budget. Following several increases made between 1999 and 2003 in order to finance additional grants for the statutory old-age pension scheme, growth in revenues from mineral oil taxes had come to a halt. Tobacco taxes had already been raised in order to finance measures for combatting international terrorism. Further increases from 2004 onwards were expected to generate about 0.2% of GDP for grants for the statutory health insurance scheme aimed at lowering contribution rates in order to promote employment. However, almost no additional revenues were observed, thus putting additional strains on central government deficit figures. Consequently, there seemed to be only limited scope for budgetary improvements by means of consolidation measures taken by central government.

Budgetary problems in 2005 – which by the end of 2004 was believed to be the decisive year for bringing the deficit in line with European rules – were augmented by the last step of the significant income tax rate reductions between 2001 and 2005. These were approved during the last boom period, when higher GDP trend growth was expected that would have enabled German general government to compensate for the tax cuts. However, several years of near-stagnation had followed and tax revenues had developed even worse than what might have been deducted from the macroeconomic figures and legislative changes.

Following the official tax estimate in November 2004, a further drop in revenue expectations had to be compensated for in order to reach a deficit ratio of slightly less than 3%. Opportunities for sizeable consolidation measures were limited as tax revenues were impaired by the last step of rate cuts as well as by expected ongoing decoupling from the development of the macroeconomic tax bases; therefore, temporary measures similar to those used in other European countries seemed to offer an escape. Between 1997 and 2004, some central governments had taken over old-age pension obligations from enterprises in exchange for substantial one-off payments. As national accounts on the basis of ESA 1995 do not record unfunded pension obligations which are to be paid by general government, such payments were treated as unrequited transfers with a positive effect on the Maastricht deficit. In Germany, the successor companies of the Bundespost had to bear pension obligations for their civil servants. In the nineties, Deutsche Telekom, Deutsche Post and Deutsche Postbank were obliged to pay old-age pension contributions of 33% of the wage sum of the civil servants still employed. Annual amounts of just over € 1 ½ bn were just sufficient to finance a quarter of total pension payments for retired civil servants. Since 1999, about € 5 bn (¼% of GDP) had to be added from the central government budget every year in order to avoid deficits and an accumulation of debt within this pension scheme. Copying similar cases in Europe would have required the successor companies to be released from their pension obligations. The net present value of the comparable contribution duties amounted to ¾% of GDP. This would have generated sufficient revenue for central government to avoid another breach of the Maastricht deficit ceiling in 2005. However, the companies did not want to incur this amount of additional debt. Another approach therefore had to be found. Finally, an agreement was reached to securitise the contribution claims. In 2005 and 2006, two transactions took place, yielding € 15 ½ bn for the pension scheme. Consequently, the central government did not have to make any payments in those two years and only minor funding was planned for 2007. If the pension scheme had been booked outside the government sector, this would have reduced the Maastricht deficit. As the securitisation was a sale of future revenue, the ESA 1995 accounting rules made it necessary to treat it as borrowing of the respective sector. However, Eurostat resisted to classify the pension scheme as part of the enterprise sector given the very strong influence exerted by central government on the pension scheme. In the end, it was reclassified within the government sector. Hence, no deficit-reducing effect was recorded and the excessive deficit could not be eliminated. After the reform of the Stability and Growth Pact in 2005, however, no further steps were taken within the excessive deficit procedure and no fine had to be paid. Instead, as

GDP growth had been weak for several years, the German central government was granted another two years to bring the deficit ratio back below the 3% limit.

At the state government level, some temporary measures had repercussions on the Maastricht deficit. However, these transactions were mainly aimed at avoiding breaches of constitutional borrowing limits. These limits, which are based on investment expenditure, are not corrected for sales of assets. Hence, such transactions were chosen as an easy way of alleviating short-term budgetary pressures. State governments, in most cases, do not possess large enterprises that could be privatised as easily as Deutsche Post and Deutsche Telekom. Instead, subcentral governments have many administrative tasks and consequently need numerous buildings. Given the substantial increases in real asset prices in the United States and most European countries government buildings could be sold at reasonable prices and were rented back. In particular, the state governments of Hamburg and Hesse used this opportunity in 2005 (and to a lesser extent in 2006) to sell government buildings for almost € 2 bn. These transactions were classified as sales of non-financial assets and hence reduced the German Maastricht deficit ratio by slightly below 0.1 percentage point. Other state governments took similar measures, but they had reorganised the ownership structure of the buildings in order to enhance the efficiency of their asset management. After the outsourcing of the assets into public corporations, only financial transactions with no direct effect on the Maastricht deficit were recorded. However, this was not considered to be important as the money received prevented the constitutional borrowing limits of the respective states from being exceeded.

Other temporary measures taken by state governments referred to interest claims. Owing to loans mainly granted to home construction companies and Landesbanken, state governments regularly receive interest payments. In order to alleviate budgetary pressures, sales of interest claims were discussed in several states. The biggest transaction occurred in Baden-Württemberg, reaching almost € ¾ bn over two years (slightly less than 0.02% of GDP in each year). However, the budget flagged these revenues as privatisation proceeds without any direct effect on the Maastricht deficit. In other states, smaller transactions may have been treated differently, but the overall effect on the general government deficit ratio should have remained small.

3. BUDGETARY RELIEF DUE TO POLITICAL CHANGES AND MACROECONOMIC DEVELOPMENT

Besides the changes to the European Stability and Growth Pact in 2005, which reduced the time pressure for bringing the deficit ratio in line with the Maastricht limit, a political change occurred. The coalition between the Social Democrats and the Green Party had lost a series of elections in the German states and opposition parties were close to a 2/3 majority in the Bundesrat that would have enabled them to block federal legislation almost completely. The central government wanted to hold early elections in order to receive a renewed mandate from the voters. However, neither the government nor the conservative-liberal opposition parties gained a majority. In the end, the two major parties – the Christian Democrats and the Social Democrats – formed a coalition. This government has a very large majority in the Bundestag as well as in the Bundesrat. As most state governments were facing severe budgetary problems in 2005 – only two of the sixteen states did not require asset sales or misuse of federal infrastructure development grants for Eastern Germany in order to avoid breaching the constitutional borrowing limits – even unpopular tax hikes found support in the Bundesrat given the lack of a major opposition party.

Notwithstanding this, no additional consolidation measures were implemented for 2006 as a whole, while expenditure growth remained subdued. However, strong GDP growth and – to an even greater extent – an unexpected additional increase in revenues from profit-related taxes helped to eliminate the excessive deficit in that year already. Budgetary problems, especially at the central government level, could not be completely solved by that. The budget had envisaged a borrowing requirement of € 38 bn, which exceeded the investment-expenditure-related constitutional limit by € 15 bn. The deficit outcome of € 28 bn was much more favourable, but still clearly above the regular limit in the German constitution. The fundamental position – calculated by just excluding budgetary relief from asset sales or securitisations – was actually far worse as such transactions amounted to about € 15 bn in 2006. Thus, despite the significant improvement in the general government Maastricht deficit figures, a fundamental gap of about € 20 bn with regard to the constitutional borrowing limit had to be closed. For that reason, the 2007 tax hikes announced after the 2005 general election could not be revoked despite the significant improvement of the overall budgetary situation.

As a consequence of these consolidation measures and the aforementioned additional positive developments, most states and the central government have been able to keep their deficits in line with the current constitutional borrowing limits in 2007. It is possible that nine out of sixteen states might even have at least a balanced budget in 2007, while the central government in particular is still facing a borrowing requirement of slightly above € 20 bn excluding one-off

revenues from asset sales and securitisations. However, its latest medium-term financial plan foresees a balanced budget in 2011.[2] This was considered as being in line with the European agreement concerning objectives for 2010 as other government sectors were expected to have sufficient surpluses by then. In order to prevent a return to high deficits and increasing debt ratios a change of the constitutional borrowing rules is planned. This is expected to be part of the second stage of the reform of the German federal system to be agreed upon by the major parties and state governments before the next general election, which is scheduled for 2009. With regard to transparency and simplicity, following the rules laid down in the European Stability and Growth Pact seems to be a promising approach also for constitutional borrowing limits.[3]

4. PPPS AS A SIGNIFICANT LOOPHOLE UNDER BALANCED BUDGET RULES

As investment expenditures are expected to generate utility in the future, present taxpayers may want to pass on at least part of the financing burdens. The current budgetary borrowing restrictions do not set any limits on this. However, if in future structural net borrowing is no longer allowed, other ways to shift burdens may be sought. Public private partnerships (PPPs) might be a particularly attractive option. Private companies commit themselves to build, operate and maintain public infrastructure for several years or even decades. According to a Eurostat decision clarifying ESA 1995 accounting rules for PPPs, the respective capital formation expenditures do not have a direct impact on the Maastricht deficit if the private partner takes over at least the financial risks involved in construction and the availability of the respective asset or demand fluctuations.[4] The government partner does not have to pay bills according to the progress of construction works. Instead, regular service fees are charged over a long-term period. Besides interest on invested capital also redemption payments may be included in the fees if the government finally becomes the owner of the assets. Such treaties come very close to credit contracts. Hence, from the perspective of budgetary accounts, PPPs could be used to circumvent balanced budget rules. Under such circumstances, efforts to promote the use of PPP models in Germany have to be observed carefully. Reported cost savings of up to 20% of total costs incurred over the lifecycle of a project might be another good reason for using such models. However, in practice it will be difficult to judge whether the circumvention of budgetary rules might also be important.

While central government accounts for only a minor part of government capital formation, it has major responsibilities in the field of long-distance road construction. At present, two different types of treaties for cooperation with private partners are available. The first ("A-model") consists of treaties assigning investment expenditure needed for the six-lane development of existing motorway sections to a private partner who will subsequently receive federal truck tolls collected for the respective sections. In spring 2007, the first respective construction works were started.[5] Treaties for four additional motorway extensions are expected to be signed soon or have already been agreed upon. Total respective capital formation expenditure is estimated to reach € 1.2 bn overall (0.05% of current GDP).[6] The other way of integrating private partners was already created in the nineties, but its use is still limited. Specific road construction projects like bridges, tunnels and new motorway sections on mountain slopes may be financed using fees collected outside the federal truck toll system ("F-model"). The lack of profitability of the first projects – the two streets can be circumvented by using somewhat longer toll-free roads – seem to impair the prospects of this model. The Fehmarnbelt bridge project would have been an opportunity to revitalise this model, but the responsibility for the main capital formation expenditure of about € 4 bn was taken over by the Danish government.

5. OFF-BUDGET ACTIVITIES BY LOCAL AUTHORITIES

As mentioned above, borrowing limits for local governments are much stricter. Those municipalities still using cash accounting are in principle only allowed to take up a regular loan if their current revenues exceed total current expenditures plus redemption payments due.[7] After the changeover to business accounting, which in early-acting states has to be finished by 2009, the sum of yields has to be at least equal to the total costs including depreciation allowances – a requirement which may be even stricter.[8] In most states, local government borrowing envisaged in the budget has to be approved by a supervisory institution. For larger municipalities, this task is designated to state

[2] Only three state governments are expected to need more time to balance their budgets.
[3] See for example Deutsche Bundesbank (2007b), p. 47 ff.
[4] See Eurostat (2004).
[5] See Federal Ministry of Transport, Building and Urban Affairs (2007b).
[6] See Federal Ministry of Transport, Building and Urban Affairs (2007a), p. 14.
[7] See Deutsche Bundesbank (2000), p. 45.
[8] See Deutsche Bundesbank (2007a), p. 42 f.

government, which ultimately might have to assume responsibility. However, owing to revenue shortfalls and significant social expenditure increases, many municipalities were not able to balance their budgets as prescribed and financed even current expenditure via short-term cash advances which were not to be included in the budgets.[9] In 2007, cash advances have reached a level of almost € 30 bn (just over 25% of local governments' debt stock).

Problems with keeping borrowing in line with the budgetary rules and the large responsibility in the field of government capital formation expenditure made PPP projects especially attractive for local governments. However, PPPs might be judged as contracts that are similar to borrowing. In that case, approval of supervisory institutions will also be needed. Hence, an extension of leeway for local politicians cannot be directly derived from such agreements. Nevertheless, as part of the government system and thus dependent on electoral support, supervisory institutions in practice have only limited possibility to forbid projects deemed politically important. Urgently needed school building maintenance works, for example, seem to be hard to stop by claiming budgetary problems. By limiting current budgetary pressures, PPPs might be more easily approved than investment projects which would have to be financed immediately from the budget. Given the current borrowing limits for central and state governments, which are based on investment expenditure, PPP projects were mainly a feature for local governments over the past few years. According to a survey, they were in charge of 38 out of all 46 PPP projects (excluding road construction) agreed upon between 2003 and 2005. The total multi-year capital formation expenditure involved was still limited and amounted to just € 1.4 bn (0.06% of overall annual GDP). Compared with the total ESA 1995 government investment of € 31 bn in 2005, the share seems to have still remained below 2%, while figures for the UK, which is considered to be the PPP-benchmark in Germany, reached almost 15%. Although 120 planned additional projects were estimated as including multi-year capital formation expenditure of about € 6 bn,[10] the difference in shares between the UK and Germany will still remain significant.

The limited use of PPPs in Germany is not only to be explained by the budgetary rules. In addition, some legal disadvantages with respect to taxes must also be taken into account. Until the PPP acceleration law came into force in 2005, local taxes on immovable property were charged for each project, while governments were granted exemptions. Similarly to taxes on immovable property, real property transfer tax is still levied unless PPPs are used for government activities and the government partner regains ownership later. Furthermore, services offered by PPP companies are subject to turnover tax, raising prices substantially. Finally, investment grants often play an important role, especially for local government projects. While financing investment expenditure directly from the budget does not pose any problems in that context, PPPs may be judged differently – particularly if the private partner is the legal owner of the respective assets. Altogether, an extended use of PPPs in Germany still seems to depend partly on changes in the legal conditions.

But even if conditions for PPPs were to improve further and the number of such projects were to increase significantly, public finance analysis need not face major problems. When calculating the deficit figures for the Maastricht notification, the national statistical authority takes a prudential approach, classifying assets according to counterpart information from construction enterprises. Consequently, PPPs are expected to be labelled as government investment expenditure with a direct effect on the deficit.[11] Given the common structure of limited transfer of risks and ownership to private partners, this seems adequate.

However, until now PPPs have seemed to be only a minor off-budget item compared with the outsourcing of public entities that has taken place since the 1990s.[12] One important reason for this type of restructuring of local government activities were the restrictions resulting from special rules for public employees and their compensation, government accounting and procurement. In order to gain more flexibility, entities were separated from the administration. Enterprises with limited autonomy and/or public enterprises with legal independence were founded and no longer included in the local government budgets as those institutions have a separate accounting system. Only payments between the administration and the enterprises have to be recorded within the framework of government budgetary statistics. With regard to the national accounts, the enterprises tend to be considered as institutional units outside the government sector. Besides having their own accounting systems, they generally cover most of their costs using fees collected from users and are also deemed to have sufficient autonomy

[9] Notwithstanding, this type of borrowing is included in ex-post budgetary as well as national accounts deficit figures. The stock of cash advances is also included in the Maastricht debt.

[10] For the data see Federal Ministry of Transport, Building and Urban Affairs (2007a), p. 12.

[11] See Eurostat (2007).

[12] For an estimate of the effects since 2000 see Deutsche Bundesbank (2007a), p. 33 ff. A more detailed analysis of the effects of outsourcing on budgetary data can be found in Deutsche Bundesbank (2000), p. 50-53.

concerning their main activities. While, in particular, budget figures for the compensation of employees and capital formation expenditures are lower than without outsourcing, this should on balance be practically offset by lower fee revenues and increased other operating expenditure. The net effect on the deficit should thus – if at all – be relatively small. As public utilities are also expected to cover their depreciation allowances, outsourcing of such enterprises might sometimes even lead to slightly higher deficits. However, disaggregated analyses of local government budget developments and comparisons between different municipalities are significantly impeded. Nevertheless, as most local governments will switch over to business accounting within a few years, they will have to integrate outsourced amenities into their accounting system again and such distortions may disappear.

6. CONCLUSIONS

Temporary measures played an important role in Germany in the first years of this century. However, most of them were intended to keep net borrowing within the constitutional limits and had no effect on the Maastricht deficit. Following the significant reduction of budget deficits since the end of 2005, achieving balanced budgets as prescribed by the European Stability and Growth Pact gained importance. Under such circumstances, budgetary leeway can be extended by using PPPs instead of government capital formation expenditure. Therefore, in order to avoid simple circumventions of borrowing limits, it could become necessary to establish a safeguard. This could be achieved by restricting the use of PPPs to cases in which significant cost advantages can be expected while also fixing a maximum level for capital formation expenditure involved in such contracts. The extension of off-budget activities through the outsourcing of public services observed over the past few years, mainly at the local and to some extent also at state government level, seems to have had only limited repercussions on the deficit figures. Structural breaks in specific revenue and expenditure categories caused by outsourcing may be corrected after a changeover to business accounting which is expected, at least for local governments, within the next years.

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Comments by Jorge Cunha: Temporary measures in Portugal

Temporary measures affecting the general government balance and/or debt have been implemented in a number of EU Member States in the past few years. The measures with an impact on the balance can be defined as policy decisions that change the level of general government revenue and/or expenditure during a very limited period of time (one-off measures), or simply modify the time profile of general government revenue and/or expenditure in the medium to long term (self-reversing measures). Portugal made very significant recourse to temporary measures from 2002 to 2004. Their direct impact on the fiscal balance reached 1.4, 2.5 and 2.3 per cent of GDP in 2002, 2003 and 2004, respectively, ensuring at that time a deficit below the reference value of 3 per cent of GDP every year. Table 1 shows the transactions that contributed to these figures and their impact on the different revenue and expenditure items, expressed as a percentage of GDP.

The 'extraordinary settlement of tax arrears' at the end of 2002 was a tax amnesty, involving the collection of taxes and social contributions in debt, without the obligation to pay interest and fines. Its impact on the 2002 deficit amounted to € 1,168.8 million (0.91 per cent of GDP). The 'sale of tax arrears' in December 2003 consisted in the selling of credits resulting from outstanding taxes and social contributions, by the amount of € 1,760 million (1.35 per cent of GDP), which

Table 1

Impact of temporary measures

(as a percentage of GDP)

	2002			2003					2004		
	'Direct' effects			'Direct' effects			'Reserving' effects		'Direct' effects	'Reserving' effects	
	Extraordinary settlement of debt arrears	Sale of the fixed telecommunications network	Sale of the rights of reintroducing tolls in a motorway	Extraordinary settlement of debt arrears (January 3)	Transfer of pension funds to general government	Sale of tax arrears	Net charges with transfers of pension funds to general government	Collection of tax arrears sold to *'Sagres'*	Transfer of pension funds to general government	Net charges with transfers of pension funds to general government	Collection of tax arrears sold to *'Sagres'*
Total revenue	**0.91**			**0.15**	**1.00**	**1.35**	**0.03**	**-0.08**	**2.26**	**0.05**	**-0.34**
Current revenue	0.91			0.15		1.35	0.03	-0.08		0.05	-0.34
Taxes on income and wealth	0.49			0.05		0.44		-0.04			-0.13
Taxes on production and imports	0.31			0.07		0.67		-0.04			-0.16
Social contributions	0.11			0.04		0.24	0.03	0.00		0.03	-0.05
Other revenue										0.02	
Capital revenue					1.00				2.26		
Total expenditure		**-0.28**	**-0.22**				**0.11**			**0.12**	
Current expenditure							0.11			0.12	
Pensions							0.11			0.12	
Capital expenditure		-0.28	-0.22								
Net acquisition of non-financial non-produced assets		-0.28	-0.22								
Overall balance	**0.91**	**0.28**	**0.22**	**0.15**	**1.00**	**1.35**	**-0.07**	**-0.08**	**2.26**	**-0.07**	**-0.34**
Total 'direct' effects	**1.42**			**2.49**					**2.26**		
Total 'direct' effects+ 'reversing' effects	**1.42**			**2.34**					**1.85**		

Source: 2004 Banco de Portugal Annual Report.

was recorded as revenue from the different taxes and social contributions, *pro rata* to their weight in the nominal value of the credit portfolio sold. In turn, as from 2003 for a period of a few years, part of taxes and social contributions collected by the tax administration are not being recorded as general government revenue, widening the deficit of this institutional sector. The 'transfers of assets from State-owned corporations to general government' were the counterpart to the future payment of pensions to their employees or former employees by the civil servants pension system (Caixa Geral de Aposentaçoões). The main transactions involved the Post Office (€ 1,300 million) in 2003 and, in 2004, Caixa Geral de Depósitos (€ 2,504.4 million), Navegação Aérea de Portugal (€ 235.7 million), Ana-Aeroportos de Portugal (€ 173.6 million) and Imprensa Nacional-Casa da Moeda (€ 137.8 million). These transfers have led to the build-up of special reserves which, together with income generated by their investment and in some cases the payment of contributions, will support future pension payments. These ones are reversing effects that will have a small impact on the deficit lasting for decades.

In Portugal, the rationale for the sizeable use of temporary measures was based on the need to keep the deficit equal to or below 3 per cent of GDP in the framework of the initial version of the Stability and Growth Pact. In a context of subdued growth, they were intended to avoid large tax increases, creating room for the implementation of permanent measures on the expenditure side. Indeed, in most cases the effects of these measures only gradually gain momentum, and require several years to produce a significant impact. The main problem with the use of temporary measures, as the Portuguese experience clearly shows, is that they may postpone the implementation of key structural measures necessary for a sustained reduction in fiscal imbalances. The consolidation strategy set forth in 2002 failed basically because the crucial reforms of public administration and the private sector social security system, which would have been instrumental in curbing the growth of current primary expenditure, were not even launched. In fact, in spite of the 2002 fiscal package, which included significant increases in indirect taxation, the cyclically adjusted balance net of temporary measures almost stabilized between 2002 and 2004. A further argument against recourse to temporary measures is that, as they rely in most cases on shortcomings of National Accounts, they hinder its use as an instrument for fiscal monitoring. Self reversing measures may even have a negative impact on future fiscal balances. Overall, certainly they do not contribute to fiscal sustainability.

Two main conclusions can be drawn from the sizeable use of temporary measures in Portugal over the period from 2002 to 2004. Firstly, the original Stability and Growth Pact created strong incentives for the use of temporary measures in countries prone to fiscal profligacy. Secondly, temporary measures are harmful for fiscal consolidation as they can delay the implementation of structural policies through some short-term window dressing.

General comments by Geert Langenus[1]

The presentations made in this session have provided a very interesting overview of the use of temporary measures in a number of euro-area countries. They show that, in order to obtain a complete and unbiased view of the budgetary situation, it is crucially important to clearly identify the full impact of temporary measures and off-budget activities. Against this background, I would like to focus my contribution on the definition of temporary measures: which temporary measures should we explicitly consider in fiscal analyses and assessments?

While everybody would undoubtedly agree on the general definition used by the presenters, i.e. that temporary measures are those that affect budget balances in only a limited number of consecutive years, there are a few 'open issues' that may complicate the harmonised interpretation of this general principle across countries.

The first issue is whether one should distinguish 'pure' temporary measures from self-reversing measures. The 'pure' temporary measures have a favourable impact, if they are of the deficit-reducing type, on budget balances in one or more years. Hence, they reduce public debt permanently and (slightly) improve fiscal sustainability. I guess this is typically what was referred to in Sandro Momigliano's presentation as 'buying time'. Self-reversing measures, on the other hand, only shift revenue and expenditure flows in time and have, in principle, no impact on sustainability as any budgetary gain in year t will be paid for later. If taking 'pure' temporary measures allows governments to buy time, self-reversing measures would amount to stealing time in my view. While both types should be included in the list of temporary measures used for the correction of headline budget balances, it seems obvious that the analysis and assessment of fiscal policy should clearly distinguish between the two. An identical impact of temporary measures in a certain year in two countries would warrant a different assessment if the first country only resorted to 'pure' temporary measures, while the second country only took self-reversing measures.

The second open issue in the definition of temporary measures is: What is the ceiling for 'a limited number of years'? In this respect, there is a broad agreement that 'temporary' can mean more than one year, but common wisdom seems to be to limit the scope to the normal horizon for medium-term projections, which would be some 2 to 3 years. This implies that, if the impact of a measure is spread over a longer period, it would not be considered as 'temporary'. However, it may be useful to distinguish a number of different cases.

The first case pertains to a situation where the budgetary impact of one specific measure is spread over a number of years. An example could be the introduction or increase of tax withholding, if taxes are typically settled and paid with a lag of more than one year. Depending on the exact length of the lag, this would temporarily increase revenue in one or more years: if taxes were only settled and collected, say, after three years, government revenue in the years t, t+1 and t+2 would be temporarily higher.

The second case is an alternative concerning a self-reversing measure. Assume, for instance, that the compensating part of a self-reversing measure is spread over a number of years. A typical example, at least before the June 2007 Eurostat decision that alters the statistical treatment of these operations and considers them as purely financial operations, is the securitisation and sale of tax arrears, such as those that were recently carried out in a number of EU Member States. Such an operation typically exchanges revenue flows in the following years for additional revenue in the current year. The impact is spread over all future years in which arrears are collected.

The third case, finally, pertains to a situation in which a one-off measure is repeated for a number of years. Consider, for instance, a tax that only exists for a couple of years.

While some guidance with respect to the maximum number of years that can still be considered as 'temporary' is definitely necessary, a 'blind' application of a specified ceiling, irrespective of the type of operation, may not be warranted. In this connection, a strict limit on the number of years for operations of the third type seems acceptable: e.g. if a tax is set to exist for two years, one may consider it as temporary while levying a tax for, say, 7 years would not be considered as temporary. At any rate, even if the measure only exists for two years, credible ex ante information about its unwinding would seem required to include it in the temporary measures. However, one may argue in favour of greater flexibility for measures of the first and second type. In those cases, it would seem natural to consider the full impact of a specific measure, even if it stretches over more than two to three years. Only registering the part of the

[1] The views expressed here are those of the author and not necessarily those of the National Bank of Belgium.

impact of such a measure that falls in a given time length of two to three years or not including it at all in the temporary measures as it stretches over too many years would seem counter-intuitive. I would personally only make an exception for self-reversing measures where the compensating part is spread over a very long period, such as the case studied by Schalck and Paul, where a capital transfer received in year t is offset by higher (pension) expenditure for many decades. In that case, it may only seem feasible to merely consider the capital transfer – and not the higher expenditure later – as a temporary measure.

The third issue of relevance for the definition of temporary measures is the possible distinction between deficit-reducing and deficit-increasing measures. There seems to be a certain reluctance to explicitly consider the latter when giving an overview of temporary measures. To my understanding, this is rooted in a political economy argument: explicitly acknowledging deficit-increasing temporary measures may open the door for governments attempting to pass off permanent deficit-increasing measures or events as temporary with a view to complying more easily with EU budgetary rules governing structural budget balances. However, to what extent should this weigh against the need to analyse structural fiscal developments, which is obviously hampered by not taking into account deficit-increasing temporary measures? In addition, do the possible political economy implications not depend on who is talking and in which context? Presumably, the possible adverse incentive effects would be much stronger if the ECOFIN Council publicly declares that, for the implementation of the EU fiscal rules, it will consider any deficit-increasing temporary measure proposed by the Member States, than if independent fiscal analysts make an objective assessment of both deficit-reducing and deficit-increasing temporary measures. In this latter connection, one can only observe that the European Commission seems to take an 'agnostic' approach, but at least explicitly considers some deficit-increasing temporary measures in a number of Member States.[2] If the European Commission is not afraid of the possible adverse incentive effects of explicitly recognising deficit-increasing temporary measures in its fiscal assessments, then why would institutions that are less directly involved in the implementation and monitoring of EU fiscal rules be?

In my view, the complete exclusion of deficit-increasing measures from the fiscal analyses and assessments seems inappropriate. This is especially the case for self-reversing measures such as the aforementioned securitisations of tax arrears or shifts in the funding of public corporations such as the bringing forward of a substantial part of the funding for the Belgian railway company from 2004 to 2003, thereby artificially increasing government expenditure in 2003 and reducing it to the same extent in 2004. An exclusion of deficit-increasing temporary measures from the definition would imply that the spike in 2003 expenditure is part of the 'structural' balance. Also, in the case of very important one-off expenditure increases such as the impact of a court ruling and a sizeable debt cancellation in Italy in 2006, it would seem appropriate not to include these in 'structural' budget balances. Finally, shouldn't the treatment of temporary measures at any rate not be symmetric: why would a temporary tax hike be treated differently than a temporary tax reduction?

A fourth issue is whether temporary measures should be identified on both the revenue and the expenditure side of the government budget. In this connection, one is typically somewhat reluctant to also look at the expenditure side, due to the fact that it may be difficult to define an appropriate benchmark for government expenditure: what is the normal 'level' of e.g. intermediate consumption, investment expenditure, transfers to households, etc. and what constitutes a temporary deviation from this normal level? However, there are a few commonly accepted exceptions such as the sale of real estate, shifts in the timing of expenditure or repayments of taxes following court decisions.

The use of the 'benchmark' argument is not always crystal-clear. Take the case of real estate sales: most governments sell some real estate every year. However, only certain real estate sales, that typically involve more important amounts than usual and are specifically undertaken with a view to improving the budget in a one-off manner, tend to be considered as 'temporary measures'. It is not always clear which benchmark is used to distinguish the 'exceptional' from the 'normal' sales. In addition, the use of the benchmark argument may be a bit selective. In many countries there is a clear electoral cycle in government investment which is typically not corrected for in standard fiscal assessments excluding temporary measures. However, in such a case one could argue that a specific trend increase in government investment would constitute a benchmark and deviations from that trend can be considered as temporary measures.

A fifth issue pertains to the distinction between temporary measures and temporary effects. A temporary measure pertains to an intentional intervention by the government, while a temporary effect is typically beyond the government's

[2] European Commission, 'Public Finances in EMU – 2007', European Economy, No. 3, 2007.

control. It should be stressed that the distinction is not always so straightforward. In the case of a natural disaster – which is obviously outside the government's control – the government may feel compelled to increase expenditure for emergency aid and compensation payments. Should all disaster-related expenditure be considered as a temporary effect or only the emergency aid and not the compensation payments which would be called 'measures'? And does the distinction between measures and effects matter for fiscal analysis? If the objective is to provide an overview of fiscal gimmickry, then it seems obvious to only include actual measures in the analysis. However, if one aims to analyse structural fiscal balances, then why would temporary measures and effects be treated differently?

A final issue pertains to the question about a possible quantitative threshold for considering temporary measures or effects. Usually a temporary measure is only explicitly considered if it is relatively large, e.g. at least 0.1% of GDP. This threshold may simply be related to a problem of data availability: information about minor temporary measures may be lacking or incomplete. For the same reason, temporary measures are typically only identified for the federal government although in certain federal countries, regional governments may also take (relatively important) temporary measures. However, if the information is available, there seems to be no reason to treat a real estate sale of 0.1%. of GDP any differently than two separate sales that each yield 0.05% of GDP. In that respect, blind application of a certain threshold may have undesirable political incentive effects, as in that case there would be a risk that a temporary measure would be split up in smaller operations that would then pass 'under the radar' of fiscal assessments.

All in all, it seems clear that the current ad-hoc approach used by different institutions (the EC but also the ESCB and individual central banks) for the identification of temporary measures is not always based upon strong theoretical foundations. In addition, any 'rigid' definition of temporary measures is bound to be controversial. Hence, a flexible approach may be more appropriate. Such an approach, which would rely heavily upon expert judgment, may be more specifically geared towards deriving structural budget indicators, start off from a commonly-agreed 'catalogue' of possible temporary measures, be based upon a consistent application of principles across countries and over time irrespective of the sign and size of the measure and explicitly identify self-reversing measures.

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