

# Rule-based budgeting and the financial stability – the European solution

Árpád Kovács

## Abstract

From the perspective of his twelve years of service at the Fiscal Council of Hungary (Fiscal Council, FC, Council), the author reviews the so-called rule-based budgeting practices that have been in use in some sixty countries around the world for decades, and their role in creating and maintaining financial stability. The article refers to the possibilities of contribution of institutions overseeing the enforcement of fiscal rules while strengthening resilience to economic crises. It presents the links between EU and Hungarian legislation, and the main ideas that emerged in the preparation of the professional-political decisions for the further development of the system in order to better enforce fiscal responsibility. It proves that the framework and the body that enforces it have become a useful and indispensable part of the fiscal policy and, as its annual implementation, of the Hungarian budgetary practice.

**KEYWORDS:** fiscal policy, crisis management, debt management, fiscal stability

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## Introduction, substance of the rules-based budget

The truth of the slogan<sup>1</sup> of the Parliamentary Budget Officials (PBOs) and Independent Fiscal Institutions (IFIs) in OECD countries can hardly be disputed: “*Better budget, better life!*”. It expresses the fact that the *functioning of these organisations* is linked to the quality and availability of services financed by the treasury (“*better life*”) and to the basis of this, to *financial stability* (“*better budget*”).

Sustainable socio-economic functioning requires that the budget (public finances) remain close to balance over time and that the level of public redistribution is maintained at a level necessary to achieve these objectives. (KOVÁCS [2019]) We can

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1 10<sup>th</sup> OECD Network of Parliamentary Budget Officials and Independent Fiscal Institutions (PBO-s and IFI-s) Seoul, 3-4 July 2018

add: a constant combat is needed against the prevalence of complacency in “better” times. This has not been the case worldwide in recent decades. It is not only the emerging but a whole range of developed countries that experienced overspending and consequent increases in public debt. (BOD [2013]),(GYÖRFFY [2009]),(MURAKÖZY [2010]) This is why keeping and preserving the balance became a strategic issue around the world, constantly demanding new solutions, rules and institutions.

The so-called *rule-based budgeting* frameworks fit into this set of fiscal policy objectives. (KUTASI [2012]) Their application spread first in South America’s states hammered by economic crises, and then, from the 1980s, throughout the world, including Europe. Today, all EU Member States, including Hungary, apply this institutionalised set of rules with some differences, but along well-defined principles, because the so-called “rules-based fiscal policy” means more than just following the rules for preparing and implementing the budget. It creates a *framework for the enforcement of fiscal responsibility* through the rules of budgetary policy and procedural transparency, and the institutional mechanisms of financial management that guarantee compliance. (KUTASI [2012]) These rules and mechanisms make up the system used in practice, according to the specificities of each country. (ÓDOR [2014])

## The principles of rules-based budgeting as a therapy

In order to describe the *Hungarian* practice of rule-based budgeting (let us call it the “Hungarian solution”) we need to briefly discuss the global career of this *regulatory and institutional system*, which was intended to be seen as a “*fiscal silver bullet*”, ensuring fiscal balance in the first two decades of the 2000s, and the newer choices of its development.

In spite of factors related to the differences in national public finances, traditions and discipline of governance, which limit the efficiency of the system, the initial experience of the introduction showed that its consistent operation could influence the trend of fiscal overspending, unsustainable budgets and increasing public debt. (OBLATH-SZAPÁRY [2006]) According to György Kopits, rule-based budgeting and the financing based on it implies a better alignment of tasks and resources and clearly reduces its cyclicity. (KOPITS [2013])

The lessons of the economically-rooted crises of the first decade of the 2000s complemented this “classical function” with the introduction of rules for fiscal balance, which can be a tool for crisis management. (REINHART-ROGOFF [2010], (KOVÁCS [2013]). With its help, stresses in fiscal balance can be reduced. To this end, policy-makers included the budget’s expenditure-revenue ratios and acceptable levels of indebtedness in laws and even constitutional provisions in the form of numerical rules, planned according to a set procedure and controlled institutionally. (KOPITS [2013])

In practice, the introduction of the framework meant that

- fiscal policy rules (e.g. expenditure ceilings to keep the budget in balance, public debt ratios in terms of social performance) were introduced,

- fiscal procedural rules (e.g. medium-term budgeting, compulsory compensation of expenditure) were set forth,
- transparency standards (e.g. accrual based accounting system, technical rules) were enforced,
- institutional guarantees, both fiscal and administrative, were put in place to ensure transparency and compliance with the rules, and macro- and microeconomic “surveillance”.<sup>2</sup>

However, there are important differences in the speed and depth of the deterioration of national economic and financial conditions in each country, and the extent to which the circumstances that emerged became an incentive for immediate action or rather a constraint. Besides the traditions of the financial system in place, the differences in governmental concepts and the administrative system’s capacity for modernisation and absorption, and not least the international professional-political mainstream patterns (in our case, the impact of EU requirements) this also influenced the content of the regulatory framework, the pace of its introduction and the conditions of its operation, as well as the powers of the institution enforcing it, and the institution’s integration into public authority.

## Outline of solutions in European practice

### Some thoughts on the emergence of the regulatory framework and the characteristics of the European solution

The practice of rules-based budgeting, which originated in the recurring bankruptcy stricken states of South America, is now used in nearly 60 countries around the world with varying degrees of consistency and with a “supervisory” body operating outside the government with varying powers and mandates, and background institutional arrangements. The application of the financial stability framework is a characteristic of the functioning of the EU countries and, from 2015, of the EU Commission<sup>3</sup>.

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2 At first, mostly rules were introduced, but problems with their enforcement increasingly focused attention on the importance of Independent Fiscal Institutions to enforce them. (Jankovics [2021])

3 In October 2015, the European Commission established the European Fiscal Board, an Independent Fiscal Institution of the European Union, as an advisory and consultative body, whose activities, mandates and investigations are limited to the euro area. According to the decision, this new body operates independently of, but in cooperation with, the national and European institutions. The members of the body were appointed by the EU Commission in October 2016, after the first year, and it became operational afterwards. Its opinions increasingly cover the financial affairs of non-euro zone countries.

**Table 1: The duties and powers of the Independent Fiscal Institutions responsible for ensuring compliance with the rules-based budget in some EU Member States before the 2008 financial crisis**

	Country	DK	BE	LV	SW	BG	EE	PL	UK
	Date of introduction of the fiscal rule	1962	1989	1990	1997-98, 2007	1998	1998	1998	1998
A financial (political, administrative) rule defined at the national level, in laws and high-level legislation	Deficit limit					X			
	Structural surplus or deficit		X		X				
	Spending limit		X		X				
	Current balance								X
	General equilibrium	X	X	X			X	X	
	Efficacy studies								
	Medium-term planning	X							X
	Debt limit							X	X
	Stabilization fund					X	X		
Authority, administrative classification	State budget	X	X	X	X	X	X		X
	National (central, federal)		X						
	Subnational governments		X						
The basis of creation	Constitution								
	Law	X	X	X	X				
	International convention								
	Policy guide, agreement				X	X	X		X
Public law classification	Independent or parliamentary body	X	X	X	X	X	X		X
	Part of the executive branch								
Utilization of the IFI's recommendations, the sanction it can apply	Veto power								
	Loss of reputation	X	X	X	X	X	X		X
	Legal								

In the table, the abbreviation of each country name is in accordance with the international symbols.

\* Even then, the public classification was already much more diverse in each country (classifying to belong to national bank, supreme audit/supervisory institution, etc.)

Source: György Kopits/DG-ECFIN (2012b) /FC Websites/FC Secretariat/Editing.

**Table 2: The duties and powers of the Independent Fiscal Institutions responsible for ensuring compliance with the rules-based budget in the EU Member States nowadays**

	Country	SE	FR	DE	IE	PT	FI	DK	BE	AT	NL	IT	LU	ES	GR	BG	EE	PL	LV	HU	HR	RO	SK	SL	MT	CY	CZ	LT		
	Date of introduction of the fiscal rule	1997-98, 2007																												
A financial (political, administrative) rule defined at the national level, in laws and high-level legislation	Deficit limit			X	X	X				X							X			X										
	Stabilization fund															X	X	X												
	Structural surplus	X																												
	Primary expenditure limit	X	X						X				X																	
	Aggregated spending limit			X								X				X														
	Current balance																													
	General equilibrium		X	X	X	X	X	X	X	X	X	X	X	X	X	X		X	X	X	X	X	X	X	X	X	X	X	X	X
	Efficacy studies											X																		
	Medium-term planning		X				X	X		X	X					X					X		X		X					
	Debt limit						X			X	X		X	X				X		X	X	X	X	X		X	X	X	X	X
Sustainability									X	X	X												X				X			
Authority, administrative classification	State budget	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X		X	X	X	X	X	X	X	X	X	X	X	
	National (central, federal)	X	X	X		X				X		X	X							X										
	Subnational governments			X	X			X	X	X			X																	
The basis of creation	Constitution		X	X			X				X								X	X			X	X				X		
	Law	X	X		X	X	X	X	X	X	X			X	X	X	X			X		X	X	X		X	X	X		
	International convention																													
*Public law classification	Policy guide, agreement			X		X	X	X				X									X									
	Independent or parliamentary body	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X		X	X	X	X	X	X	X	X	X	X		
Utilization of the IFI's recommendations, the sanction it can apply	Part of the executive branch																													
	Veto power																			X										
	Loss of reputation	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X		X	X	X	X	X	X	X	X	X	X	X	
	Legal		X	X	X	X	X	X							X	X		X	X			X	X	X			X			

In the table, the abbreviation of each country name is in accordance with the international symbols.

\* The public law classification is much more diverse in the individual countries (classifying to belong to national bank, supreme audit/supervisory institution /Court of Auditors/, etc.).

\*\* Five countries (Austria, Italy, the Netherlands, Luxembourg and Belgium) have two institutions, such as the Fiskalrat (Fiscal Council) operating on the basis of the technical background of the Austrian Central Bank and the Budgetdienst (Parliamentary Budget Office) on the basis of the parliament.

\*\*\* As the idea of establishing an independent fiscal institution is also raised from time to time at these meetings, representatives of the Polish financial government are invited to OECD and ECFIN meetings.

Source: György Kopits/DG-ECFIN (2012b) /FC Websites/FC Secretariat/Editing.

Based on their common characteristics, the standardisation of their operating standards and their institutional cooperation efforts, the solutions operating in the European Union form a distinct and dominant group. Around half of the nearly sixty such fiscal policy, procedural and institutional solutions in the world, offering clustering opportunities, are to be found in EU countries.<sup>4</sup> This is why we can speak of a “European” solution, which may not be a “silver bullet” for keeping finances in balance, but which *is useful* in national budgetary practices, *and which is increasingly acting as a tool for the unifying intentions of the EU’s financial governance*, to which we can consider the Hungarian practice to belong.<sup>5</sup>

As can be seen from Tables 1 and 2, the elements of the EU framework are applied with technically different financial management solutions, but with common aspirations in terms of their basic principles.

The framework rules are usually introduced by a simple law or by a law adopted by a qualified majority in parliament, or by constitutional law in exceptional cases, or sometimes a political guideline (agreement) provides the basis for operation. Some European countries introduced the framework rules well *before the 2008 crisis*, and set up Independent Fiscal Institutions (IFIs) with fiscal responsibility.

The European Community’s Maastricht criteria, introduced in 1993, and the 1998 Growth Pact are themselves a specific financial framework. The Community’s and later the EU’s balance criteria in the fiscal rules include macro-balance indicators, such as debt and deficit limits as a share of GDP (60% and 3% respectively), and require a 5% annual reduction in debt above 60% of GDP since 2012 and an improvement in the so-called primary balance<sup>6</sup> as a procedural design rule. Consequently, among the Independent Fiscal Institutions, including the Fiscal Council of Hungary, issues of internal budgetary redistribution according to the government’s priorities (the allocation policy) have so far only been raised if and when financial stability and the threat to the balance of the national economy, such as excessive spending on public investment, have been perceived. While most fiscal institutions in the European Union also produce multiannual perspectives on the sustainability of socio-economic development, no coherent and complex fiscal framework has emerged so far that goes beyond the interests of fiscal sustainability.

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4 As we will see, with the inclusion of more and more countries, there is also a constant change in the number of “independent” fiscal institutions that the OECD identifies in a national government organisation, whether these are 1, 2 or more institutions. The latter is the case in the UK, where most recently, at the OECD meeting of 14-15 March 2023, the Scottish, Welsh and English institutions were represented on an equal and non-subnational basis.

5 In previous articles, the author identified several opportunities for the use of rules-based fiscal policy to promote rebalancing and financial stability. (Kovács [2013], [2014], [2016]) The experience of the European economic crisis caused by the pandemic and the war (i.e. not rooted in economics) shaded the perception of the impact of the application of the regulatory framework.

6 General government balance excluding interest expenditure.

The independent fiscal institutions have different possibilities and different degrees of public authority to enforce their views. The range of institutions operating in the EU is also wide. The most common are requests to comply with general balance requirements (without sanctions). At the same time, there are more specific legal consequences for budget planning, such as a ceiling on expenditure, deficit and debt, and a call for medium-term planning. This includes commenting on government reports on compliance with the balance rules, producing economic forecasts (“outlooks”) with a personal perspective, or “supervising” compliance with the EU’s balance or deficit reduction rules. A public statement on these, a government acceptance facilitated by political and professional public pressure, is in itself hardly a sanction but rather a guideline, which could open the way to the initiation of the corrections in the table, according to the relevant EU surveillance rules<sup>7</sup>. Sanctions that fiscal institutions can impose thus usually include the opinion of the institution itself on the government’s finances, which we included in our tables as “reputational damage” following international practice. Increasingly, the Councils’ mandates include the possibility to call for compliance with various balance and procedural rules, forecasts, technical projections.<sup>8</sup> An exceptional, very strong public law entitlement is the possibility to give approval to the budget in Parliament (the possibility of a “veto”). This is in practice only in Hungary since the reformation of the Fiscal Council – as in the words of György Kopits since the start of the “FC 2.0” operation –<sup>9</sup> has only been in place since 2011.

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7 Monitoring is carried out by the European Commission and the Council with the aim of ensuring budgetary discipline in the Member States. The rationale for the monitoring system system is that the fiscal policy of one Member State may have negative effects on other Member States. Article 121 of the Treaty on the Functioning of the EU 2012 (TFEU) deals with the coordination of economic policies, Article 126 with the avoidance of excessive government deficits and Article 136 with provisions for countries using the euro. The Treaty and the annexed 12 Protocols on the so-called Excessive Deficit Procedure (EDP) provide the basic legal framework for economic governance, which is accompanied by further regulations and a directive detailing the requirements. The Stability and Growth Pact (SGP) was established under Regulations (EC) No 1466/97 and 1467/97, strengthening economic policy coordination and corrective mechanisms in the event of excessive deficits. Amendments to these two regulations (1175/2011/EU and 1177/2011/EU) and four other regulations make up the so-called “six-pack” adopted in 2011, which establishes the Macroeconomic Imbalance Procedure (MIP) and its preventive and corrective rules, while a further directive sets out rules for Member States’ national budgetary frameworks.

8 Similar to the EU practice at the time, such possibilities of consideration, covering essentially the entire budget but without any substantive sanctions, were included for the FC in Act LXXV of 2008 on Cost-efficient State Management and Fiscal Responsibility. See also Section 7.

9 Source: Fifth Annual Conference, European Fiscal Board Brussels, May 11, 2023, György Kopits’ presentation – the name is a continuation of the distinction between the short-period operation he managed and the current one, which is already longer than a decade, which is also reflected in his publications and presentations.

The public law classification of organisations monitoring compliance with the rules is generally characterised by organisational separation from government. The exception is Poland, where some elements of the framework were in place before the 2007-2008 crisis, but no independent body to monitor compliance was set up. Although the need to do so has been discussed time and time again, there has been no change since then, due to a lack of political and professional agreement.<sup>10</sup>

Table 2 shows that, as a result of the progress of integration, not to mention the successful crisis management of countries with rule-based fiscal practices, as two examples, all 13 countries *that joined the EU after 2004* have a rule-based fiscal mechanism in place and, as we have seen, with the exception of Poland, an institutional guarantee for respecting it, operating independently from the executive power. Five countries started this system before the 2008 crisis, while seven countries, including ours, introduced it between 2009 and 2014<sup>11</sup>. The multilateral monitoring system of Member States' budgetary policies put in place by the Stability and Growth Pact (SGP), as well as the Commission's comments and proposals on the introduction of rules-based budgeting and the system in place, have played a role in this.<sup>12</sup>

In European practice, the institutions that monitor compliance with the rules (*the Fiscal Councils*)<sup>13</sup> are independent not only from governments, with constitutional safeguards, but also from the *internal* budget support/preparatory (budget offices) and sometimes macroeconomic planning (planning offices) bodies of parliaments (Congress, National Assembly), which are called by the umbrella-term Parliamentary Budget Offices (PBOs).

In international practice, there are many examples of the body obtaining the analysis on which its decisions are based from the business community or from other independent institutions (the Court of Auditors, the national bank, the statistical office, the parliament) which sometimes determines the “deployment” of the institution. Of the EU countries, France, Finland, Lithuania, Latvia and Italy chose the

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10 See, for example, the Warsaw conference on 16 September 2022 with the participation of the author or the Council Recommendation on the 2022 National Reform Programme of Poland, in which it gives its opinion on Poland's Convergence Programme 2022. Recommendations – Point 1 <https://data.consilium.europa.eu/doc/document/ST-9421-2022-INIT/hu/pdf>

11 In Hungary, the 2008 law on frugal state management and fiscal responsibility introduced the rule-based budget. The law was adopted by the Parliament in November 2008 and entered into force in January 2009. Thus, the intention of the Hungarian regulation was born regardless of the crisis that broke out in September 2008.

12 Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances: Its Article 6 states that “The Commission should have a stronger role in the enhanced surveillance procedure as regards assessments that are specific to each Member State, monitoring, on-site missions, recommendations and warnings.”

13 There are 35 Independent Fiscal Institutions in the EU today, including the EU Fiscal Board, as there are several countries with two such institutions, and three other countries with an additional economic research and fiscal planning organisation classified into the same group.

way under the auspices of the Court of Auditors, while Bulgaria, Slovakia and Austria chose it with the national bank background. In the latter, however, it should also be noted that there is also an institution with parliamentary powers to watch over the budget, moreover, in our Austrian neighbour, as well as in the Netherlands and Belgium, there is also an organisation classified as an “independent” institution, which can be considered an economic researcher or “planning office”.

The differences in the integration into the state organisation and in the role are accompanied by strong differences in the personal and material conditions. The supporting background varies between secretariats employing a few people, operating with controlling role, organising, summarising background research in private research institutions and/or in the analytical organisations of the state, national banks, state audit offices, and support apparatus with own analytical capacity. However, the decisions of the boards of the Independent Fiscal Institutions, which consist of between 3 and 16 people, are always based on a substantial analytical base. Based on the author’s orientation, a review of websites, research materials and contract documents, this foundational background based mostly on external resources means integrating the work of a total of 50-100 highly qualified experts working in non-governmental positions. In some cases, as in the case of the Slovak, French, Austrian or even the Hungarian Fiscal Council, the analytical apparatus of the central bank and the Court of Auditors also plays a dominant role.

### Cooperation, standardisation efforts

Organizational functioning according to these general principles created opportunities for cooperation between national institutions.<sup>14</sup> This allows the competent bodies of the EU Commission to be well informed about the functioning of national institutions, in addition to learning about best practices and each other’s functioning, and to establish rankings.<sup>15</sup>

While there has not yet been a declared intention to introduce a mandatory universal model for all EU countries in terms of operational features, such minimum requirements have already been set for euro area countries.<sup>16</sup> For the core institu-

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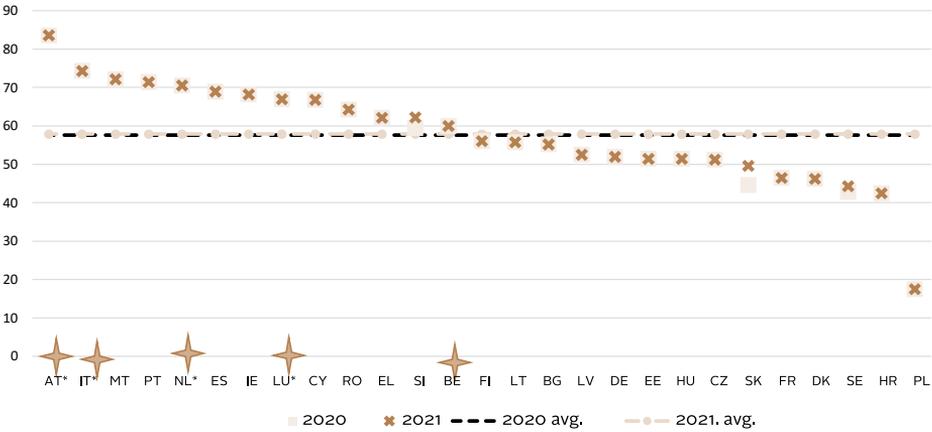
14 The IFIs Cooperation Forum, which operates under the auspices of ECFIN, provides an organised framework for this.

15 The EU’s economic governance, i.e. the coordination of national economic policies, is a complex system, and only the most important ones are mentioned here in the context of this article. Surveillance is carried out by the European Commission and the Council of the European Union with the aim of ensuring budgetary discipline in the Member States. The rationale behind the surveillance system is that the fiscal policy of one Member State may have negative effects on other Member States.

16 Without compliance with these, the introduction of the euro cannot be activated in countries that have not yet adopted it. The Fiscal Compact, in force since 2013, contains binding rules for signatory countries, a key element of which is the so-called structural balance rule, which is free from cyclical effects and must be monitored by an independent institution.

tional functions of the FCs, such as monitoring compliance with fiscal rules, macro-economic and budgetary forecasting, policy cost accounting, sustainability impact assessment, and promoting fiscal transparency and normative recommendations on fiscal policy in a coherent way, the EU Commission established a so-called *SIFI Index* in 2014.<sup>17</sup> (See Figure 3)

**Figure 3: Competence index of budgetary institutions by country (C-SIFI), 2022**



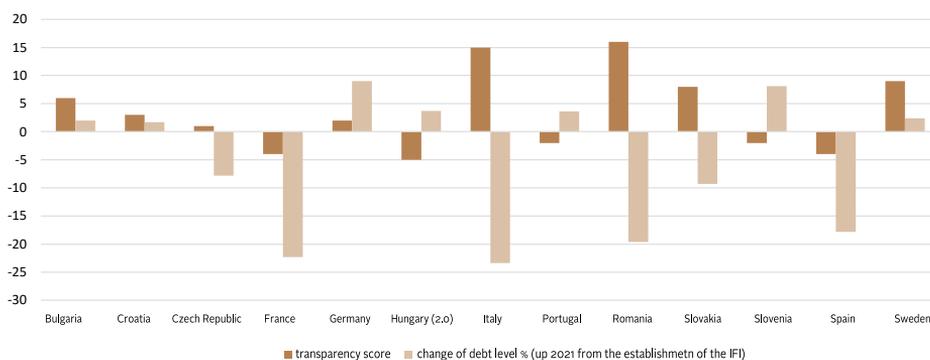
The asterisk indicates that there is more than one institution in the Member State, and regardless of which institution is dealing with the task, it is considered as completed for that country.

Source: European Commission Fiscal Governance database, December 2022

<sup>17</sup> The Scope Index of Fiscal Institutions (SIFI), calculated on the basis of a collection of data based on voluntary declarations, is published annually by the Commission, based on a typology representing the six separate functions listed. The country SIFI index (C-SIFI) builds on the institutional level SIFI index and illustrates the responsibilities undertaken by the IFI(s) in the Member States. The reason for its creation was that the “core institutions” of countries with more than one IFI in the database (i.e. AT, BE, LU, NL, SI) may be disadvantaged due to the index focusing on the institutional level; the aggregate index at the country level gives a more accurate picture. The country aggregation method used for Member States with two IFIs is the summation of all IFI mandates in the institution-level SIFI index. For tasks where both IFIs are active in the country, the higher score of the two institutions was taken into account.

The annual survey includes the so-called *Transparency Index* of the budgeting process and its documents,<sup>18</sup> and its changes.

**Figure 4: Improvement in transparency index and change in public debt levels\* for each country between the establishment of the Independent Fiscal Institution and 2021**



Source: Fifth Annual Conference, European Fiscal Board Brussels, May 11, 2023, presentation by György Kopits

\*The figure shows the increase in the debt level, i.e. the deterioration of the indicator, with a negative value.

Assessments based essentially on so-called soft parameters are common in the surveys. An example of this is the subjective opinion survey on which Figure 4 is based. It gathered information on the operational transparency of other actors in the fiscal mechanism, linked the time series to the establishment of the fiscal council of the country concerned, the IFI, and rated “progress” on this basis. We can add that the ratings thus produced are close to the general conclusion on the order established

<sup>18</sup> Article 121 of the Treaty on the Functioning of the European Union (TFEU), signed in 2007, amended in 2011 and in force from 2012, deals with the coordination of economic policies, Article 126 with the avoidance of excessive government deficits and Article 136 with provisions for countries using the euro. The Treaty and the annexed 12 Protocols on the so-called Excessive Deficit Procedure (EDP) provide the basic legal framework for economic governance, which is accompanied by further regulations and a directive detailing the requirements. The Stability and Growth Pact (SGP) was established under Regulations (EC) No 1466/97 and 1467/97, strengthening economic policy coordination and corrective mechanisms in the event of excessive deficits. Amendments to these two regulations (1175/2011/EU and 1177/2011/EU) and four other regulations make up the so-called “six-pack” adopted in 2011, which establishes the Macroeconomic Imbalance Procedure (MIP) and its preventive and corrective rules, while a further directive sets out rules for Member States’ national budgetary frameworks.

by experts, which is hardly acceptable as objective (according to the vocabulary of László Jankovics: “anecdotal”).<sup>19</sup> (Jankovics [2021])

It is of particular interest that the highly debatable measures of transparency reported in the assessment of the evolution of transparency correlate only very weakly with the evolution of the level of public debt in a given country. (Corr.2019: -0.53, Corr.2021: -0.33)<sup>20</sup> Several EU countries with “progress” and operating institutions with favourable ratings are still burdened with record levels of public debt.

The relevant rows of Tables 1 and 2 and Figures 3 and 4 (and their uncertain ratings) suggest that the effectiveness of the monitoring fiscal institutions depends only partly on the nature and content of the analyses they carry out or even on the quality and transparency of their professional recommendations. At least as important are their place in public law, in the organisation of the State, the rules of guarantee which help to take account of their findings and, not least, their socio-political acceptance. All this shows that the guarantee and regulatory solutions to control the deficit and prevent overspending can only be interpreted in conjunction with the state organisation structure and financial management traditions of the country concerned, and there are limits to standardisation. In guarding the financial stability of a country, or even of the European Union, it remains crucial that independent fiscal institutions are seen as partners by governments and oppositions, with the admission that in budgetary disputes, independent guardians of stability cannot act as arbiters or interfering partners on one side or the other. (KOVÁCS [2016])

## Developing a rule-based fiscal system in the EU

Already at the beginning of the booming decade of the European economy in 2010, there was a need to increase the flexibility of the European financial framework and to ease the persistent tensions in risk reduction and sharing. (M.LARCH, M.BUSSE, M.GABRIELJELCIC, L.JANKOVICS, J.MALZUBRIS [2022]) In the meantime, it also became clear that, while maintaining the stability of financial operations, in terms of the balance of public finances considerable factors affecting the financing of environmental and social sustainability strengthened, which go beyond the issue of ensuring direct financial stability.

The pandemic period, starting in spring 2020, can also be seen as a phase boundary for the functioning of financial frameworks. In order to avoid the paralysing effects of the COVID epidemic on society and the economy, and to ensure a successful relaunch, the Council, on a proposal from the European Commission, suspended the application of the balance rules in 2020, which had been directional guidance,

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19 Examples are the OECD's independence index or the signal enhancement capacity index established under the auspices of the IMF.

20 Calculated by the Secretariat for the Fiscal Council of Hungary.

an “anchor” until then.<sup>21</sup> (EC [2020]) However, IFIs continued to operate. The impact of forced spending deteriorating balances in order to be able to bear the financial burden of the COVID pandemic was examined. They took advantage of the options available due to their advisory role.

And the burden of the (over)spending caused by the pandemic re-launched the thinking on the improvement of the regulatory framework applicable after the crisis. (M. LARCH, M. BUSSE, M. GABRIELJELCIC, L. JANKOVICS, J. MALZUBRIS [2022]) Building on the lessons learned from the application of the EU rules<sup>22</sup> introduced a decade ago and on the several ECOFIN<sup>23</sup> and EFC<sup>24</sup> discussions with Member States, the Commission invited in October 2021, within the scope of the re-opened debate on the review of the EU economic governance framework, EU institutions, national and international organisations, governments and EU citizens to express their views on how to make the European financial system more resilient to the expected challenges, which are no longer only economic ones.

As regards development paths, the exchange of views highlighted the need for reforms to provide both flexibility and rigour to follow expected deficit and debt paths and to respect the rules, while at the same time allowing for the consideration of complex (financial, environmental and social) components of sustainability. The EU Commission and other authoritative experts also considered it essential to introduce uniform, so-called minimum capability standards at EU level<sup>25</sup> in case IFIs are given additional powers in the framework of system development. (FROMAGE [2017]), (DARVAS [2019]), (JANKOVICS [2021])

The European Fiscal Board also expressed its views in the ECOFIN fora, which are reflected in the EU Commission’s proposals for the development of the regulato-

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21 On 20 March 2020, the European Commission took the initiative to address the European Council on the application of the general sunset clause. “The general exemption clause was introduced in 2011 through the “six-pack” of amendments to the SGP, following the lessons learned from the economic and financial crisis. Above all, this experience highlighted the need for specific provisions in EU fiscal rules to allow all Member States to deviate from standard requirements in a coordinated and orderly way in situations of general crisis caused by a severe economic downturn in the euro area or the EU as a whole. The clause provided for in Article 5(1), Article 6(3), Article 9(1) and Article 10(3) of Regulation (EC) No 1466/97 and in Article 3(5) and Article 5(2) of Regulation (EC) No 1467/97 shall facilitate the coordination of budgetary policies in times of severe economic downturn.” <https://eur-lex.europa.eu/legal-ontent/HU/TXT/HTML/?uri=CELEX:52020DC0123&from=EN>

22 See footnote 12

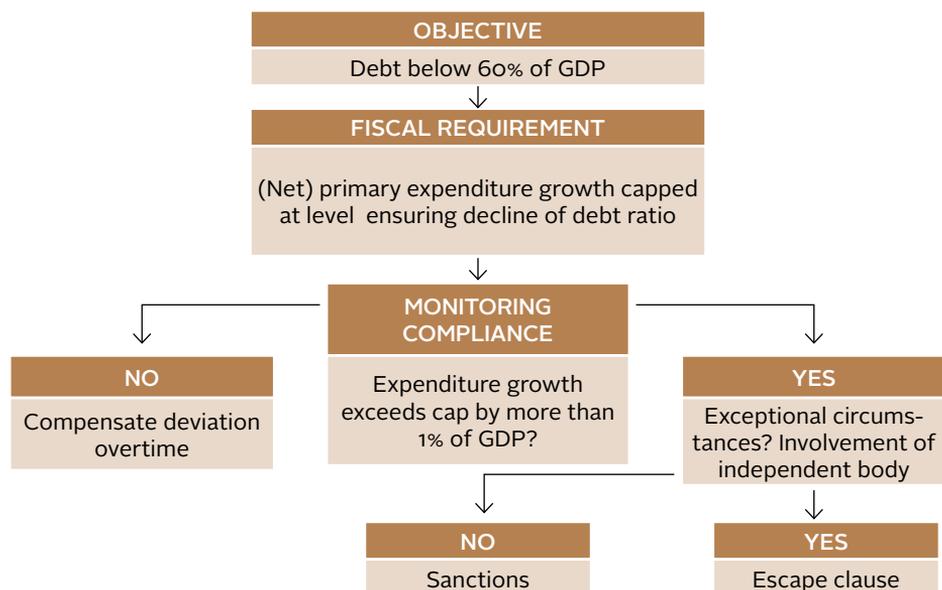
23 The EU Commission’s Directorate-General for Economic and Financial Affairs is responsible for the EU’s policies for economic growth, development, higher employment and sound public finances.

24 European Economic and Financial Committee

25 For example, they are required to produce macroeconomic and budgetary forecasts that are considered “official”.

ry framework published in spring 2023.<sup>26</sup> The Board’s recommendation is summarised in Figure 5.

**Figure 5: European Fiscal Board’s proposal for a new budgetary framework**



Source: Tygessen, 2021

The central idea behind the Commission’s consultation paper is that increasing the Member States’ responsibility is the most effective way to ensure compliance. Accordingly, while the so-called reference adjustment path, which the Commission considers appropriate, is proposed, Member States can formulate their own medium-term fiscal-structural plans, a sustainable fiscal path. Annual budgets are then drawn up according to these plans, ensuring that public debt is kept at a level appropriate to each Member State’s capacity to cope. The time horizon for reaching a given declining debt level is flexible, however, the Commission shall approve it if it is supported by appropriate reforms and investments in the Member State concerned to reach the reference level.

Another important element is to simplify both the quantity and complexity of the current large number of indicators, which are difficult to track.<sup>27</sup> However, risk-based monitoring and control would be prioritised.

<sup>26</sup> <https://www.consilium.europa.eu/hu/policies/economic-governance-framework/reform/>

<sup>27</sup> For example, the rule that debt-to-GDP ratios should be reduced by 1/20th of the surplus between the actual debt ratio and 60% of GDP averaged over three years would be removed, as would the structural balance requirements.

The EDP (Excessive Deficit Procedure) procedure of the adjustment arm of the Stability and Growth Pact would remain at the 3% deficit target, but the EDP (Excessive Debt Procedure) procedure linked to the level of public debt would be given greater weight, helping Member States to reach on the commonly agreed fiscal path. It would also add new, more effective instruments to the sanctions toolbox and maintain conditionality linked to macroeconomic performance.

This gives new tasks and intervention possibilities to the Independent Fiscal Institutions, which are given a substantially greater role in the Commission's proposal, which is still under discussion at the time of closing this article. Safeguards would be built in to guarantee their independence, and they would be given additional powers to carry out their new tasks and to ensure that their proposals are taken into account.

The improved system would also strengthen the financial control of Member States by the EU Commission.<sup>28</sup> At the same time, the IFIs would be responsible for preparing/approving budgetary forecasts and assessing debt sustainability.

It is an important and forward-looking idea that Independent Fiscal Institutions should help the medium term orientation of national budgeting and taking into account ecological considerations.

It should be noted here, however, that the practical implementation of this supervision also implies interference in the sovereign distribution policy considerations of governments. Distribution policies, however, depend on the political objectives of governments, and its assessment has so far been far beyond the scope of duties of independent fiscal institutions/councils. On the other hand, it requires a significant increase in analytical capacity, attention-sharing and a very complex consideration, not only in terms of finance and balances. Before it is introduced, this task should be considered not only from a legal and methodological point of view, but also from the consideration of the principles of ease of application and targeting.

The legal basis for introducing new EU-level rules is Article 121(6) TFEU. This legislation and its annexes must be adopted by the European Council, acting by qualified majority, together with the European Parliament, under the cooperation procedure. The European Central Bank must also be consulted on the proposal. Thus, although the proposal contains a number of forward-looking ideas, there is still a long process of consultation and decision-making before it is implemented.

## Rules-based budgeting in our country

In terms of Hungarian budgetary practice it is still fundamental today that the 1989 constitutional amendment, the Association Agreement signed with the European Community in 1994, and finally the 2004 accession already included among our objectives and instruments requirements that express our connection to the socio-economic and political community of European countries, and this was confirmed by our Fundamental Law adopted in 2011.

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28 See footnote 19

Accession entailed harmonisation obligations and the adoption of common European integration values and standards, *including the already numerous cited fiscal balance requirements*. After the socio-economic shock and consolidation that accompanied the regime change, Hungary, for external and internal reasons, was confronted in the mid-2000s with increasingly unmanageable budgetary overspending and consequently deepening debt problems that led to the country's financial instability. The problems of fiscal sustainability led in 2006 to the realisation that the "fiscal alcoholism" of governance<sup>29</sup> needed to be changed to ensure the longer-term sustainability of the public finance system [Báger (2006)],[ÁSZ (2007)].

By the end of 2008 in Hungary, in the shadow of the looming state bankruptcy and the pressure of borrowing from the IMF-EU, *the law on Cost-efficient State Management and Fiscal Responsibility* was passed,<sup>30</sup> which was also called the "ceiling law" due to its concept and intervention mechanism/spending limits.<sup>31</sup> In essence, it limits the amount of the following year's budget expenditure. In addition, rules were laid down on the balance of the budget allowed to be planned, as well as on the level of public debt allowed to be projected. The three-member Fiscal Council, which has been in operation since 2009, was composed of experts nominated by the heads of the SAO and the MNB and elected by Parliament, in addition to a renowned expert representing the Head of State. The office organisation supporting their work was a large apparatus carrying out macroeconomic analyses. The "ceiling law", whose findings were followed by awareness-raising initiatives, was in force until the end of 2011.

Hungary's *Fundamental Law*, adopted on 18 April 2011, has a separate chapter on public finances.<sup>32</sup> This opened a new chapter in the regulation of the rules-based budgetary system, which is also commensurate with its weight and importance. The Fundamental Law, when the *public debt rule* was created with it, also set the amount

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29 We borrow György Kopits' apt phrase here to describe the solutions for managing (over) spending public finances with ill-considered austerity measures which exceed economic capacities. (Kopits [2013])

30 Act LXXV of 2008 on Cost-efficient State Management and Fiscal Responsibility

31 The professional initiative, linked to the Magyar Nemzeti Bank and the SAO, focused on the most important cause of fiscal tensions, namely overspending and its prevention, and considered the adaptation of the elements of rule-based budgeting applied in international practice to be useful in solving domestic problems. Another initiative was a proposal from the Ministry of Finance, which would have created the Budget Office of the Parliament. After the proposal of the Ministry of Finance was taken off the agenda, the idea of introducing a framework to reduce propensity to generating deficit and prevent overspending became the exclusive one. In 2007 and 2008, there was a lively professional debate, shifting towards concrete solutions, on the main elements of the regulatory framework and, in particular, on the place of the Independent Fiscal Institution in the organisation of the state, which would play a controlling role.

32 It stipulated the budgetary powers of Parliament, and states that public funds must be managed in a transparent and auditable manner, in accordance with the requirements of legality, expediency and efficiency, and limits indebtedness not only in terms of public finances as a whole, but also for local governments in particular.

of public debt allowed to be planned each year.<sup>33</sup> The Fundamental Law set forth as a condition for constitutional operation the Fiscal Council, which is responsible for ensuring compliance with the rules of fiscal stability<sup>34</sup>, and whose tasks were set out in the Stability Law adopted in December 2011. (KOVÁCS [2016]). FC2.0 not only *gives its opinion on the soundness of the central budget*, but also *gives consent (or does not give consent) in advance to the adoption of the central budget law* in order to ensure compliance with the so-called public debt rule. With the latter task and power, the Council was given a public role in connection with the adoption of the budget law, *including the responsibilities that go with it*.<sup>35</sup>

The professional work carried out since 2012 is included in the annual reports of the Council, so only a few facts are summarised in Figure 6. This shows that the number of meetings of the Council was determined by the number of times it had to give its opinion on the annual budgets and their amendments that changed the expenditure and revenue figures, or the balance of the budget, to give consent on the final vote on them, to assess the biannual developments in public finance, and the annual reports on the work of the Council. It can be seen that the restoration of economic stability and the consequent evolution of budgetary positions essentially doubled or tripled the number of Council meetings and with them the number of decisions needed in 2012–2013, and there has been a similar increase from 2021 onwards in a period of fighting a different type of crisis. If the relevant figures in Figure 6 and the trend lines for Hungarian GDP and public debt to GDP in Figures 7 and 8 are assessed together, it becomes clear that the activity of the Fiscal Council in support of corrective mechanisms is associated with periods of crisis and financing stress, not least the period of strong growth and declining fiscal stress in the period 2014–2020.

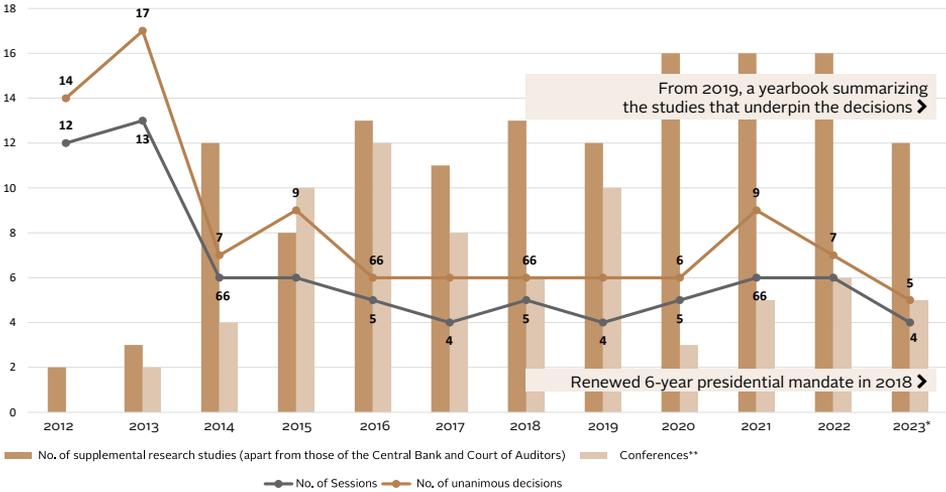
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33 This means that Parliament cannot pass a central budget law that would result in the public debt exceeding half of GDP. As long as public debt exceeds this level, Parliament can only pass a central budget law that includes a reduction in the ratio of public debt to GDP, except in years when the economy shrinks due to a crisis, pandemic, natural disaster, for instance.

34 Act CXCIV of 2007 on the Economic Stability of Hungary

35 If the FC expresses disagreement with the draft budget when forming its opinion, it must be discussed again by the Government and liaised with the Council. More “tough” is the Council’s power of prior consent on the compliance of the draft budget bill with the public debt rule: if the FC, exercising its “veto right” mentioned above, refuses to give its prior consent, the final vote must be postponed and this procedure must be continued until the Council gives its consent. The “veto” has been used twice so far with different solutions, in 2012 and 2015. On the first occasion, the Council did not give its assent to an item in the budget amendment proposal, and on the second occasion, the Council found that the macroeconomic path of the government’s draft was not sound enough so they anticipated the refusal of giving assent to the budget for the final vote. In both cases, the Government withdrew its proposal, or amended it in the direction of feasibility. <https://www.parlament.hu/web/koltsegvetesi-tanacs>

**Figure 6: The work of the Fiscal Council in terms of figures\***



- 2012: "Veto" used 1 time when amending the annual budget preparation of a new macroeconomic forecast in connection with the 2013 budget, with the preliminary prospect of a "veto"
- 2013: Proposal to revise the debt rule. Signaling that frequent amendments to the law reduce predictability, even if they are justified in some cases
- 2014: New debt rule
- 2015: "spring budget", the amendment of the national debt rule
- 2016: "spring budget"
- 2020: from 2017 "spring budget" amendment of the national debt rule. Online contact during the pandemic period, resumption of personal contact from 2021

\* The number of meetings held up to the date of closing this article, which could be 1 to 3 more by the end of the year depending on the budget process for 2023

Source: Parliamentary website of the FC

The remit of the Fiscal Council was amended three times, in 2015, 2017 and 2021. Two amendments were made to make the so-called debt formula applicable.<sup>36</sup> In line with EU requirements, the FC's remit was extended to include monitoring compliance with them.

The unprecedented strong public mandate among Independent Fiscal Institutions requires a decisive participation in the preparation of annual budgets and a

<sup>36</sup> According to the first amendment in 2015, if both the projected inflation and the real GDP growth rate exceed 3%, the growth rate of the amount of government debt relative to the previous year must be set so that it does not exceed half the difference between the projected inflation and the real GDP growth rate for the fiscal year. If among the projected inflation and real GDP growth rates at least one does not exceed 3%, the year-on-year decline in the public debt ratio must be at least 0.1 percentage point. Another change, another simplification took place in 2021: only the 0.1 percentage point reduction in the public debt ratio remained a requirement <https://www.parlament.hu/web/koltsegvetesi-tanacs>

correspondingly oriented, focused, expert background work, research and analytical base. Short-, medium- and longer-term outlooks, sustainability studies and analyses related to the biannual monitoring of the implementation of the current budget law complement the analytical work of the SAO and the MNB, providing the technical and scientific background that assists the Council in its multifaceted analysis of budgetary processes. The full transparency and credibility of its work is ensured by the fact that these documents, on which its decisions are based, are made known to the professional-political scene and the interested public at large.<sup>37</sup>

It is obvious that the Hungarian regulatory system and the institutional practice of supervision, the work and mission of the FC, must also adapt to the ongoing modernisation efforts. There is a strong desire to ensure that the Hungarian regulatory framework, and *the operation of the institution watching over the compliance*, comply with the European Union's financial set of standards provided for in *public, normative regulations*, with the rules on financial stability and sustainability, and align with the changes thereof. In addition to the annual horizon decisions, which are burdened with the responsibility of annual public mandates, one of the priority areas could be the preparation of outlooks with broader horizons, which are increasingly important for sustainability, as an alternative forecast to the Council's board opinion.<sup>38</sup> It is in line with this intention that in 2023 the Council no longer wishes to rely on studies of this focus prepared for it, but also prepares its own triennial macroeconomic outlook within its own competence. The latter became timely in the fall of 2023 because the solution adopted by the European Central Bank, which is being prepared as of this paper's writing, assigns a decisive role to the Fiscal Council in the regulation of the Hungarian National Bank's loss compensation from budgetary resources. The task of making proposals concerning the scale and schedule – similar to the consent of the final budget vote – further strengthens the public law role of the Fiscal Council.<sup>39</sup>

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37 In keeping with this ambition, the Council not only makes available on its website the full content of its academic studies prepared for them, and presents them at a conference organised jointly with the Hungarian Economic Association, which has been streamed most recently, online and accessible from anywhere in the world, but for the third year it has also published them in a bilingual, English-Hungarian volume of studies, edited (in the form of a yearbook, so to say), like economic history documents of an era. <https://www.parlament.hu/web/koltsegvetesi-tanacs>

38 The call for the Council to prepare triennial outlooks was a recurrent demand in EU Commission evaluations over the past decade. Partly as a consequence of this benchmarking gap, the Hungarian FC has so far been rated slightly below average in the evaluations, despite the strong public mandate. See Figure 3 and [https://economy-finance.ec.europa.eu/system/files/2023-02/dp181\\_en.pdf](https://economy-finance.ec.europa.eu/system/files/2023-02/dp181_en.pdf)

39 See Mihály Varga's letter to the President of the ECB and the Bank's response on September 4, 2023, described in detail in the press.

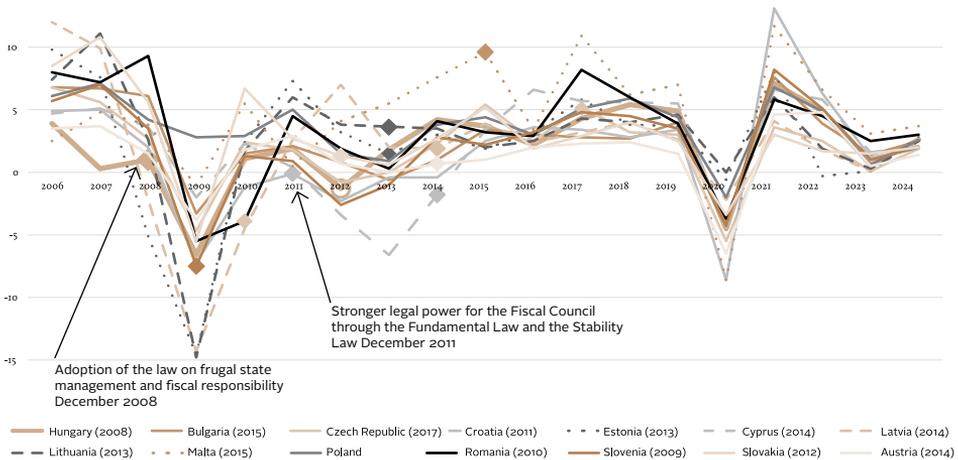
## Summary thoughts on how the rule-based fiscal system works

As we have seen in Figure 4, the correlation between the professional performance of the independent institutions that oversee the financial system and the indebtedness of a country, which is a key determinant of financial stability, is more than uncertain, especially when the difficulties are not due to economic mistakes but to an epidemic and war aggression.

It is obvious that the work of Independent Fiscal Institutions is utilised more with the strength of “authority”, “credibility”, especially when their activities are focused on advisory, risk signalling, thematic research and analysis works, and their experience is accompanied with modest public mandates. This is because rules and institutional framework can operate with and against a number of decisive globalisation and internal conditions, social and political circumstances, which offer different opportunities from country to country. And in this context, the professional development (with an orientation complying with the requirements of the EU) of the institution watching over the compliance with the framework rules is only one factor.

If we try to relate the results of the surveys in Figures 3 and 4 to the change in economic growth in Figure 7 and the change in public debt in Figure 8, we *cannot show a direct, exact correlation* between the application of a rules-based fiscal framework and the financial stability of EU nations. Moreover, if we look at the indices of competence and transparency of the Independent Fiscal Institutions in Figures 3 and 4 and the indebtedness and growth indices in Figures 4, 7 and 8, we become even more uncertain. We can only draw a few conclusions.

**Figure 7: GDP growth in the EU-13 and Austria** (the markings show the formation of the given country's Fiscal Council)

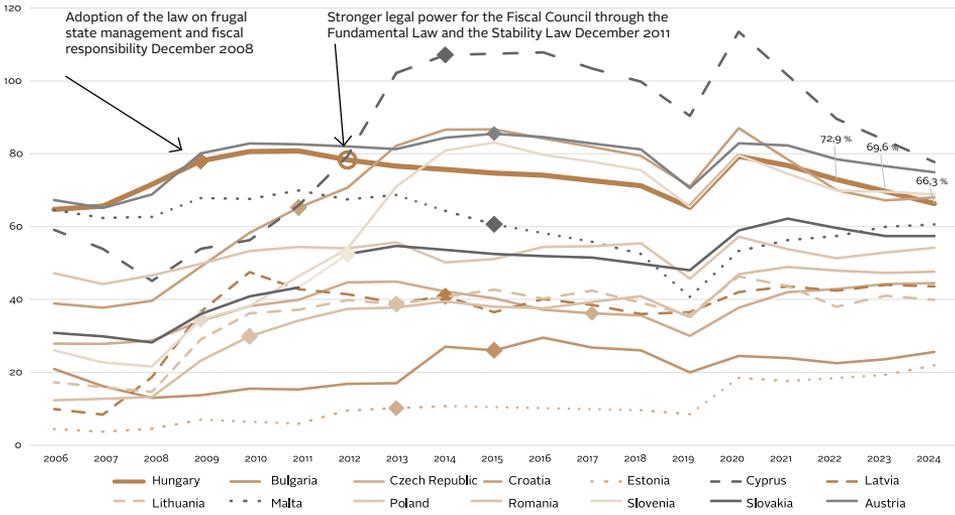


◆ and the ○ markings indicate the date of the establishment/amendment of the scope and responsibilities of the given country's Fiscal Council

Source: Eurostat, FC Secretariat editing, European Commission forecast, 2023 forecast, 2024 budget law macro trajectory

Figure 8, which indicates the evolution of public debt of countries accessed after 2004 and Austria, shows that after the global financial and economic crisis of 2008-2010, public debt as a share of GDP in the countries concerned declined in down-trend towards or below the Maastricht 60% criterion until 2019, and government spending moved less significantly in line with GDP.

**Figure 8: Public debt-to-GDP ratio and year of establishment of the Independent Fiscal Institution in the group of countries that joined the EU in the 2004 and afterwards, and in Austria (taking into account any institution functioning as a council)**



Source: Eurostat, FC Secretariat editing, European Commission forecast from 2022 (Spring 2022),

\* Hungarian data for 2022, 2023 projected and 2024 forecast

◆ and the ○ markings indicate the date of the establishment/amendment of the scope and responsibilities of the given country's Fiscal Council

In the decade of the 2000s preceding the pandemic, the countries of the European Union were characterised by prosperity and financial stability. It is also a fact that after the pandemic crisis, which was not due to economic reasons, there was a rapid return to a declining debt trajectory, which unfortunately was gradually reversed by the economic consequences of the war period. However, for regulatory, governance, political stability, or even force majeure reasons, the application of the framework proved to be of varying effectiveness in EU countries and did not bring about a decisive breakthrough in terms of the propensity to run deficits and reducing the pro-cyclicality of government spending. (FROMAGE [2017]), (JANKOVICS [2021]) One reason for this, according to professional opinion leaders calling for a higher level of standardisation, is that these

institutions operate in an excessively<sup>40</sup> diverse manner. As the planned changes now under preparation show, the *Commission and the experts working around it see the effectiveness of the framework and its national supervising institutions as being improved if the system is structured around a single set of principles and is more effective as a support mechanism for achieving the objectives of the Union's single financial governance.* ■

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